POLICY Brief[1]

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Agricultural Finance and Insurance in Ethiopia: Challenges and Policy Options

Hailu Elias[2] Mohammed Beshir[3] and Abule Mehare[4]

Executive Summary

This policy brief provides evidence-based policy options to fill the gaps in the provision of financial services such as credit, saving and insurance, and shade light on major agricultural risks and coping mechanisms used by smallholder farmers in Ethiopia. Saving of households in the country has been growing by about 12% during the study period, which was nearly half of the growth in nominal saving. Moreover, saving in kind was growing faster than saving in cash, which reflects the response of households to the growing inflation rate in the country over the years. Regarding the demand for financial services, the result revealed that there is ample and rising demand for credit by rural households but its supply from formal financial institutions is limited partly due to the growing interest of households for in-kind than in-cash saving and use of informal channels to send and receive remittances. The study result indicates that household income and knowledge of and access to financial services have significant and positive effect on households' propensity to save and access to credit.

The study result indicated that farming activity is practiced under several agricultural risks and shocks; where adverse market shocks, livestock disease and drought, being the major challenges. In response to these and other risks and shocks, rural households mainly resort to traditional risk coping methods such as selling of productive assets and reduction of consumption which either directly or indirectly risks future production and consumption. Modern index-based crop and livestock insurance have limited coverage (4.3% and 0.3% respectively) in spite of higher demand for index-based crop and livestock insurance. The result also revealed that household income, knowledge of insurance services, trust on formal financial institutions, membership in local institutions and time preference to have significant and positive effect on households' demand for crop and livestock insurance services.

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[2] PhD, Asst. Professor of Economics, Department of Economics, Addis Ababa University, hailu.elias@aau.edu.et.

[3] PhD Candidate, Department of Economics, Addis Ababa University, mohabeshir@gmail.com.

[4] PhD, Senior Researcher, Ethiopian Economics Association, abule.mehare@gmail.com.

Vision

The EEA is envisioned to become a premier economics association in Africa by 2030.

Mission

The mission of EEA is to provide a platform for networking, access to information and learning; to contribute to a better understanding of the global, national and local economic issues; to inform and influence economic policymaking and investment decision; to offer training and foster the advancement of the discipline of economics.

Values

Professionalism, integrity, independence, quality, efficiency, inclusiveness, teamwork, accountability and transparency.

1. Introduction

In the last two decades, there have been several initiatives to improve the provision of agricultural finance for smallholder farmers and there is a good progress in reaching out the rural poor through a variety of financial services. However, the supply of finance to smallholders still has gaps in quantity and quality of the services. To this end, dependable evidence on the extent and magnitude of these services is paramount to design appropriate policy interventions.

2. Rationale for Action/the Problem

It is unquestionable that, a sound financial sector with an adequate supply of services to the agricultural sector is essential for sustaining the sectoral economic growth and reducing poverty and food insecurity in Ethiopia. More specifically, *credit facilities* in rural areas play a positive role in technology adoption among rural households (Abate et al., 2016; Njagi et al., 2017; Bedru et al., 2020), startup of new businesses (Bedru et al., 2020) and in turn promote diversification that generates employment, improvements in income and food security status of households. Furthermore, in light of widespread climate and related risks in the context of rain-fed agriculture in Ethiopia, agriculture insurance helps to spread risks of agricultural players efficiently (Bridle et al, 2020) and overcomes limitations inherent to traditional risk management and coping methods. The various demand and supply side factors of the financial services of credit, saving and insurance to farm and pastoral households have been investigated in an isolated manner without focusing on agro-ecologies and livelihoods. Since all these gaps require closer examination, the study was instigated to gauge the demand for and the supply of financial services available in terms of credit, saving and insurance across agro-ecologies and livelihoods.

3. Main Findings

3.1. Demand and Supply of Credit in Ethiopia

Agricultural credit outstanding by Micro Finance Institutions (MFIs) in 2018/19 was ETB 27.28B which is more than two folds from the amount before five years (i.e., ETB 10.65B in 2014/15). Outstanding agricultural credit was 57.9% of the total credit outstanding in 2014/15 and slightly diminished over five years to reach 49.8% in 2018/19. In the past decade, the supply of agricultural credit by commercial banks nearly doubled. More specifically, in 2010/11, agricultural credit outstanding was ETB 10.58 billion and this has grown on average by 10% to reach ETB 21.09 Billion in 2019/20. However, in relative terms, the share of agricultural loan was 13.61% in 2010/11, which shrunk to 2% in 2019/20.

The potential demand for credit by smallholders is estimated to be about ETB 122 billion for the year 2021/22. Even though rural households have financial deficit, they show low appetite to apply for credit from formal financial institutions. According to the respondents, the reasons for not applying for credit include: fear of indebtedness (51%), high-interest rate (38%), high transaction cost (30.5%), fear of risk of default and its consequences (29.8%), lack of collateral (27.46), pre-conception that there is less likelihood to get credit (26.5%), no information about sources of credit (17.9%) and already being indebted (17.2%). Farm households tend to prefer informal sources of credit over formal ones due to ease of access, flexibility in the payback arrangement, and little or no collateral requirement.

The econometrics analysis shows that household income, prior knowledge, and proximity to formal financial institutions to have positive effect on the demand for credit. Membership to various local institutions, living in the desert and woina-dega agro-ecologies reduces the demand for credit compared to those households living in the dega areas.

The findings are also supported by key informants where on the supply side, lack of all-weather roads and lack of internet services in rural areas hinder MFIs and banks to expand their outreach. On the demand side, limited financial knowledge about the services and products of formal financial institutions (FFIs), high cost to reach the nearest FFIs, poor trust on the services and working procedures of FFIs, and availability of local and informal financial service providers such as Iqqubs, money-lenders, 'Tsewa-mahbers. found to have negative effect on the demand for the services from formal financial institutions.

3.2. Savings Dynamics

MFIs' saving has grown on average by 32.5% per annum for a decade (2010-2019). More importantly, the share of voluntary saving has continuously increased to reach 84.7% in 2019 of the total saving from 68% in 2010. However, growth in saving per borrower was below the growth of loan per borrower which challenged the MFIs' capacity to meet the farm households' demand for credit. Data at household level show that majority of the households (72.6%) save their resources either in kind or in cash. For those who save, the average value of in-kind saving amounted to ETB 11,728 while the cash saving was almost half of that amount (ETB 5,512). Moreover, we found that saving in kind was growing faster than saving in cash, reflecting households' response to the country's growing inflation rate over the recent years.

As far as the institutions for saving concerned, 22.6% were using only formal financial institutions, 27.8%, were using informal institutions and the remaining were using both formal and informal financial institutions. Among those respondents who used to save in informal institutions, 65% and 33.1% of them replied that proximity and ease of access respectively are the main drivers to save in informal institutions. Safety (78%), ease of access (13.9%) and motive to get other services such as loan (4.3%) are the other factors behind visiting FFIs for deposits.

The results also indicate that cash saving by rural households is positively correlated with household income, participation in off-farm activities, and trust on formal financial institutions. In addition, household income, knowledge about financial services, land holding and livestock size have a positive and statistically significant effect on in-kind savings whereas participation in off-farm activities, trust on formal financial institutions, and living in the desert area have a negative significant effect.

3.3 Shocks and Coping Mechanisms

The major risk factors for rural smallholders are adverse market prices (50%), livestock diseases (39%), drought (27.5%), illness of a household member (27%), crop diseases (25.5%) and death of livestock (25%). The major coping mechanisms for these shocks are reduction of consumption and selling productive assets including livestock and dis-saving and borrowing from relatives and friends. The distribution of shocks across agro-ecologies shows that it is very low in the dega and very high in the desert agro-ecology and roughly equally distributed across Woina-dega and Kolla agro-ecologies.

There is a limited knowledge about Index Based Insurance (IBI) as only 15.2% and 5% of respondents heard about index-based crop & livestock insurances, respectively. Moreover, the coverage was limited as low as 4.3% of the households purchased crop IBI at least once in the last 5 years from an insurance company. The average annual premium payment was 213 ETB per policy. None of the respondents have purchased livestock IBI so far in the study area. However, if available, 21.5% and 15.56% of respondents have shown demand for index-based crop and livestock insurances respectively.

The main reasons for not buying IBI was that they do not need it (33%), or they do not know the institutions selling the insurance (28%), or do not have the money to pay for it (18%), or do not know the benefits of this insurance (10%).

The regression result shows that household income, trust on formal financial institutions, size of land holding, membership to local institutions and time preference to have a positive effect on the probability of revealing demand for IB crop insurance. On the other hand, demand for crop insurance is negatively correlated with age of the head, number of livestock and being risk averse.

Household income and trust on FFIs correlate with livestock insurance in a similar fashion as they are correlated with crop insurance. A striking difference in IBLI is the correlation between number of livestock and demand for Index-based crop insurance (IBCI) and Index-based livestock insurance (IBLI). Consistent with prior expectations, the number of livestock positively and significantly correlates with demand for IBLI whereas it has no significant effect on the demand for IBCI. In addition to the above variables, Prior knowledge of insurance products increases the demand for IBLI.

From the key informants interview, it was also noted that the dissemination of modern insurance services is further hampered by absence of clear and full-fledged agricultural insurance policy and regulatory framework to guide and control the efforts the existing few insurance companies. Lack of complementary apparatuses (rainfall gauges, satellite information) in rural Ethiopia are also found to be some of the limiting factors to persuade and increase uptake of IBI since farmers lose trust on distantly located rainfall gauges. Moreover, absence of market intermediary to sell insurance products, high costs of insurance relative to rural households' income and limited knowledge about IBI are also critical impediments.

4. Policy Recommendations

- To overcome farm households' financial deficit, extensive work is needed to create a conducive credit market environment for the rural poor. To this end, reducing borrowing interest rate, alternative collateral (land, livestock, etc.), and access to financial institution by increasing number of branches can be proposed as possible interventions.
- Following the huge awareness campaign undertaken by formal financial institutions like banks, MFIs and SACCOs to increase their outreach, the financial literacy rate in Ethiopia is on the rise. However, Ethiopia is still one of the lowest performers in global adult financial literacy rate with only 34% and this implies the need for more effort to increase the knowledge about financial services as it has been found to be one of the key determinants for demand for credit.
- To narrow down the shift of households from cash to in-kind savings, an extra effort to control the current inflation is crucial. To this end, increasing productivity, interest rate adjustment and efficient market monitoring can be listed as possible entry points.
- Given the high poverty level in rural areas, designing innovative insurance products and government intervention to provide subsidized insurance products (premium subsidies) for poor farmers is decisive to encourage rural use insurance products. To this end, building local technical skill/knowledge in the area of crop and livestock insurance products is required to design a customized policy.
- Agricultural insurance involves severe losses and reinsurers are unwilling to provide cover for direct insurers. This needs appropriate intervention by relevant stakeholders to make the sector more attractive for re-insurers. For instance, investment on digital technology is crucial to reach out pastoral and agro-pastoral areas to increase the pool, linking credit with saving and insurance can serve as an enabler or loan portfolio protection mechanism for those who apply for credit since it enables them to be creditworthy and at the same time the financer uses it to protect the loan. It can also help to promote small holder farmers practicing both crop production and livestock rearing on sedentary basis in agro-pastoral and highland livelihood systems.
- The government's commitment to creating fertile grounds for insurance companies to expand crop and livestock insurance products is crucial. So far, there is no clear and full-fledged agricultural insurance policy and regulatory framework to guide and control the efforts of handful of insurance companies which strive to introduce and improve uptake of agricultural insurance products as potential feasible option to overcome agricultural shocks. This calls for appropriate action to be taken by the government.

Further Readings

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Further inquiries and information:

Email: info@eea-et.org

Website: http://www.eea-et.org

https://facebook.com/EEAEthio

https://twitter.com/EthioEconAssoc

https://www.youtube.Ethiopian Economics Association

Ethiopian Economics Association
Yeka Sub-city, Woreda 11
CMC area adjacent to St. Michael Church
Tel: +251-11 - 645 32 00/645 30 76/645 30 41
Fax +251 - 11 - 645 30 20
P.O.Box 34282, Addis Ababa, Ethiopia

Conflict of Interest

There is no conflict of interest among researchers.