

THE Blue Book

The Annual Ethiopian Microeconomic Handbook

How firms are coping with change and uncertainty



2015 E.C. (2022/23 G.C.)

FIRST  CONSULT

The Blue Book
Annual Report 2015 E.C. (2022/23)

***How the Ethiopian economy is coping with change and
uncertainty: The Microeconomy***

April 2024

Preface

The Blue Book is an annual economic publication by First Consult that intends to aggregate and connect the dots between various reports and studies while contextualizing them with insights and perspectives from ground-level economic agents. First Consult aims to serve as an aggregator of topical knowledge generated during the year, be it academic, statistical, media-driven or based on project-level data.

Various economic analyses and media reports regularly cover developments in the Ethiopian economy, both at a macro and micro level. However, forming a coherent picture and translating developments into their causes and effects is not a straightforward exercise. In a rapidly changing and complex economy such as Ethiopia's, it is not always clear how the developments are perceived by and impact on economic agents (businesses and consumers) on the ground. Nor is it clear how they will react and adapt.

This year's title "How the Ethiopian economy is coping with changes and uncertainty: The micro economy" covers the year 2015 in the Ethiopian calendar (2022-2023 Gregorian calendar). The Book aims to contribute to the existing discourse by linking the impact of macroeconomic trends and shocks on businesses and consumers. As such, this year's edition surveyed 312 micro and small businesses in Addis Ababa, Adama, Hawassa and Dire Dawa on production, sales, employment, inflation, forex, and access to finance among other things. It also incorporates consumer survey and key informant interview of different stakeholders.

First Consult is a leading economic development consulting organization with nearly two decades of experience in Ethiopia. It combines insights and experiences from analysis and research (proprietary and third party) together with a rich set of data and findings collected in the process of implementing multi-year development projects across the country in sectors ranging from enterprise development, agriculture, investment & export promotion, financial sector development, workforce development and job creation. It works with development partners, government, businesses, and individuals and has physical presence in 17 cities and towns across Ethiopia. This puts First Consult in a unique position to connect the dots by triangulating evidence from macroeconomic analyses & developments as well as their implications at firm and individual level.

This publication was made possible through support from our partnership with the Mastercard Foundation, researchers, and an external review committee.

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Acronyms

BoP	Balance of Payments
CBs	Commercial Banks
CBE	Commercial Bank of Ethiopia
CGFC	Capital Goods Finance Companies
CSA	Central Statistics Agency
DFS	Digital Finance System
EFY	Ethiopian Fiscal Year
EIA	Environmental Impact Assessment
ETB	Ethiopian Birr
FDI	Foreign Direct Investment
FMCG	Fast-Moving Consumer Goods
GDP	Gross Domestic product
GTP	Growth and Transformation Plan
HGER	HomeGrown Economic Reform
IDP	Internally Displaced people
IFC	Interest-Free Banking
KILM	Key Indicators of the Labor Market
LAMC	Liability Asset Management Corporation
LC	Letter of Credit
MFI	Micro Finance Institution
MoLS	Ministry of Labor and Skills
MSME	Micro, Small, and Medium Enterprise
NBE	National Bank of Ethiopia
ODA	Official Development Assistance
PPP	Public Private Partnership
SDG	Sustainable Development Goal
SME	Small and Medium Enterprise
SOE	State-Owned Enterprise
USD	United States Dollar

Executive summary

A. Macroeconomic Trends – “*Various changes but stable*”

The Ethiopian economy experienced numerous shocks and reforms during the 2015¹ Ethiopian Fiscal Year (EFY). Ethiopia started the year facing multiple threats partially attributable to the spillover effects of the COVID-19 pandemic and the 2-year conflict in the north that ended a year ago. These challenges included a severe forex shortage, a liquidity crunch in the banking system as well as a high debt burden, and a decline in both investment & Official Development Assistance (ODA). Auspiciously, the aftershocks of COVID-19 have started to fade, and businesses have demonstrated a stronger-than-expected resilience. Further, the Pretoria Peace Agreement has created a positive outlook for relations with the international community, and programs to rehabilitate conflict-affected areas are in the works although the much-anticipated financial assistance is yet to come.

The new HomeGrown Economic Reform (HGER) seeks to address the important concerns of small firms even though the reform itself has faced significant internal and external challenges. Some of these reforms included addressing foreign exchange imbalances, strengthening the monetary policy framework and financial regulations, strengthening public financial institutions, addressing vulnerabilities at public banks, enhancing financial sector development, and developing capital markets. The implementation of HGER 1.0 has helped the Ethiopian economy maintain growth in a time of unprecedented global economic downturn in the face of multiple compounded shocks. On the other hand, inflation reached 40% during 2014. Furthermore, the parallel market premium reached 33%, from 27% in 2013.² In response, the government has introduced HGER 2, which aims to recalibrate and build upon the reforms implemented during HGER 1.0.

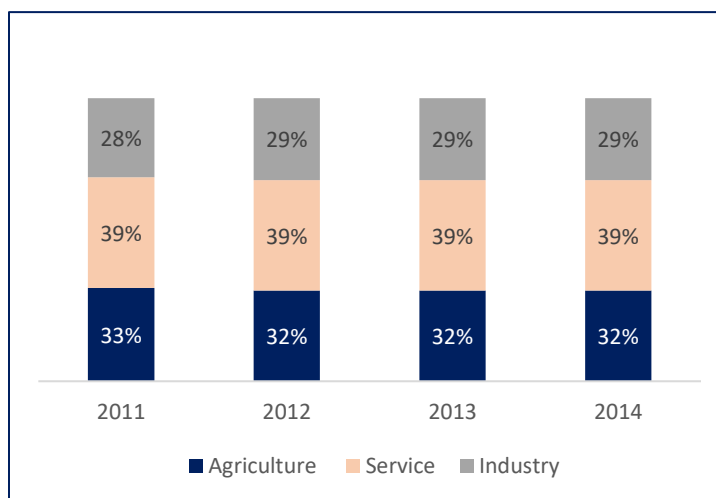
In general, multiple political, social, and economic changes and reforms have altered the country’s macroeconomic landscape. Such changes and reforms have impacted the private sector generally and small firms particularly.

¹ All years are indicated in the Ethiopian Calendar

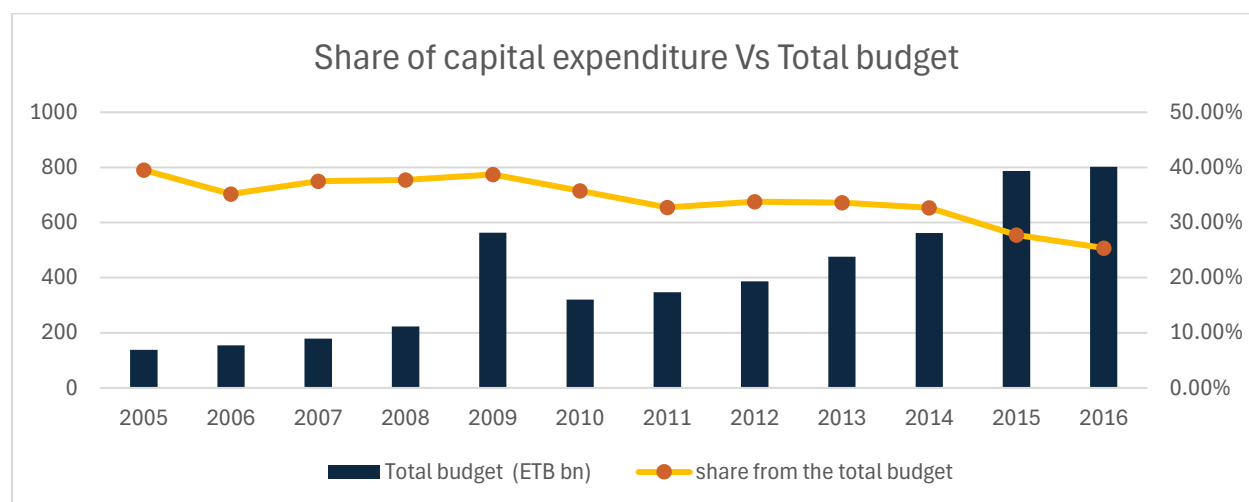
² Ministry of Planning and Development (2022). *HomeGrown Economic Reform 2.0*.



Real GDP has shown resilience, but a structural transition remains to be attained. The real GDP growth rate for 2014 was 6.4%, marking a slight increase from the rates of 6.3% and 6.1% recorded in the previous two years, 2013 and 2012, respectively. The service sector continued to be the largest contributor to the GDP, accounting for 39% of total GDP in the fiscal year 2014, which is a mere increase of 0.4% from the previous year. Agriculture follows the service sector, contributing 32% to the GDP. The industrial sector accounted for 29% of the total GDP, which is a slight decrease from the previous year. In terms of the industrial sector, the manufacturing and construction subsectors contributed 23% and 72% respectively. Specifically, investments in the construction of roads, railways, dams, and residential houses contributed to the growth of the construction subsector. However, this is expected to decline in the coming years as the share of capital expenditure to the total budget has reduced over the past three years and is at an all-time low (25%) in 2016. The Sub-Saharan Africa (SSA) average in terms of agriculture's contribution to the GDP is 25%, which is less than Ethiopia's average. However, SSA's industry contribution to GDP is similar to that of Ethiopia's, standing at 28%.



The government has taken various measures to tackle the expanding fiscal deficit including reducing government spending (in recent years) and increasing tax revenues – which affected businesses and consumers. Some of the measures taken by the government in this regard include reducing government spending, increasing tax revenues, and diversifying financing sources. Removing the fuel subsidy was one of the major shifts the government took in this regard, and this has resulted in a 167% increase in the price of a liter of gasoline over the past two years. Although the measure was taken to ease the deficit, the rise in fuel prices ended up contributing to an increase in the inflation rate, as fuel is an essential component of the entire cost structure of goods and services in Ethiopia. Higher transportation costs due to increased fuel prices have increased business production and distribution costs. To cover these additional expenses, prices for goods and services are often raised, increasing the economy's overall price level.



Government budget allocation focuses on maintaining existing programs and services rather than investing in new capital projects.

The total approved national budget for fiscal year 2016 is 801.65 billion Birr, which shows a 1.9% increase compared to the budget of 786.61 billion Birrs in 2015.³ 46% of the overall budget is allocated for recurrent expenses and only 25% for capital expenses. The overall budget arrangement indicates the shift in the government's priority towards allocating more resources to maintaining existing programs and services rather than investing in new capital projects. This is not a new phenomenon, but rather a continued approach to managing financial stress by the government. As capital

List of publications covered in the Blue Book

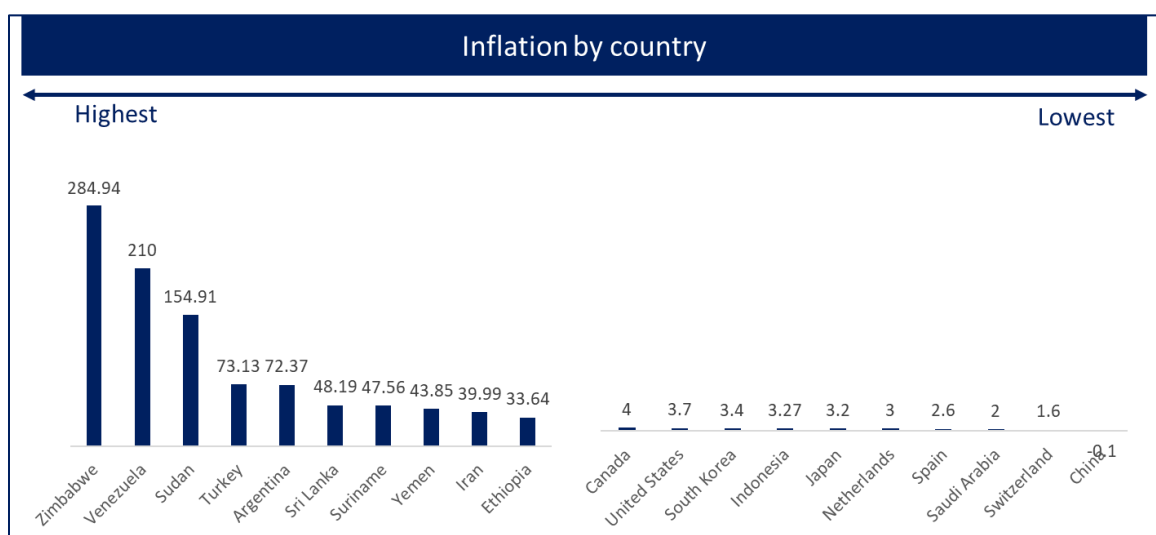
- Ten-Year Development Plan (2021-30)
- HomeGrown Economic Reform 2.0
- Key Indicators of the Labor Market (2022) by MoLS
- Cepheus, Macro-Economic Handbook of Ethiopia 2023
- Cepheus, Ethiopian 2023 Budget
- National Bank Annual Report 2021/22
- UNICEF Ethiopia, Highlights of the 2021/22 Federal Government Budget Proclamation, 2022/23
- IMF Annual Report 2023
- Ministry of Finance Budget Summary
- Ethiopia's Financial Inclusion Journey 2022

³ Ministry of Finance, Ethiopia (2023). *A Citizens' Guide to the Federal Budget of 2023/24*. Addis Ababa, Ethiopia

expenditure is known to promote growth, this reduction in the budget share allocated to capital expenditure could hurt the economy.

The increasing inflationary pressure continued to affect investment, employment creation, as well as the operations of small businesses. The inflation and consumer price index kept increasing with an annual inflation rate of 33.9% in 2015.⁴ Major factors pushing the inflation rate include the spillover effects of the COVID-19 pandemic, unrest in some parts of the country, the Russia-Ukraine war, a mismatch in aggregate supply and demand, global inflation, increased money supply and government spending.

As of June 2023, Ethiopia is the 10th country in the world with the highest inflation rate (33.6). The first one is Zimbabwe (285) followed by Venezuela (210). Of countries with the lowest inflation rates, China has the lowest (-0.1) and is in deflation, followed by Switzerland (1.6) and Saudi Arabia (2).

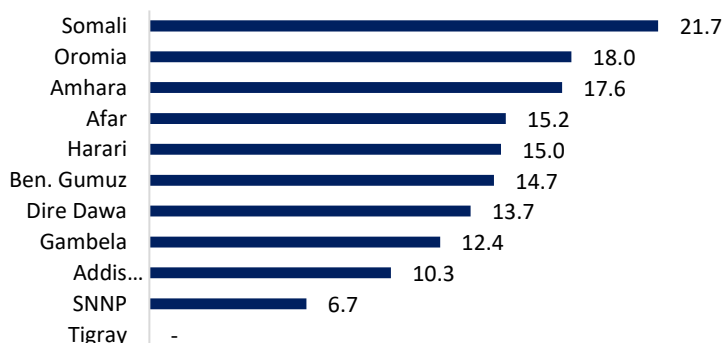


Source: <https://www.geeksforgeeks.org/inflation-rate-by-country/>

Although the government took several initiatives to maintain price stability, inflation has remained above the single-digit target over the past four years. The government undertook initiatives such as tightening broad money growth and putting a cap on outstanding credit growth. The annual average headline inflation rose to 33.8% in 2014 compared with 20.2% in 2013. The increasing inflation rate is explained by

the 17.1% increase in food & non-alcoholic beverages inflation and the 8.7% rise in non-food inflation. Out of all the food and non-food items, the most important variables that have affected the general

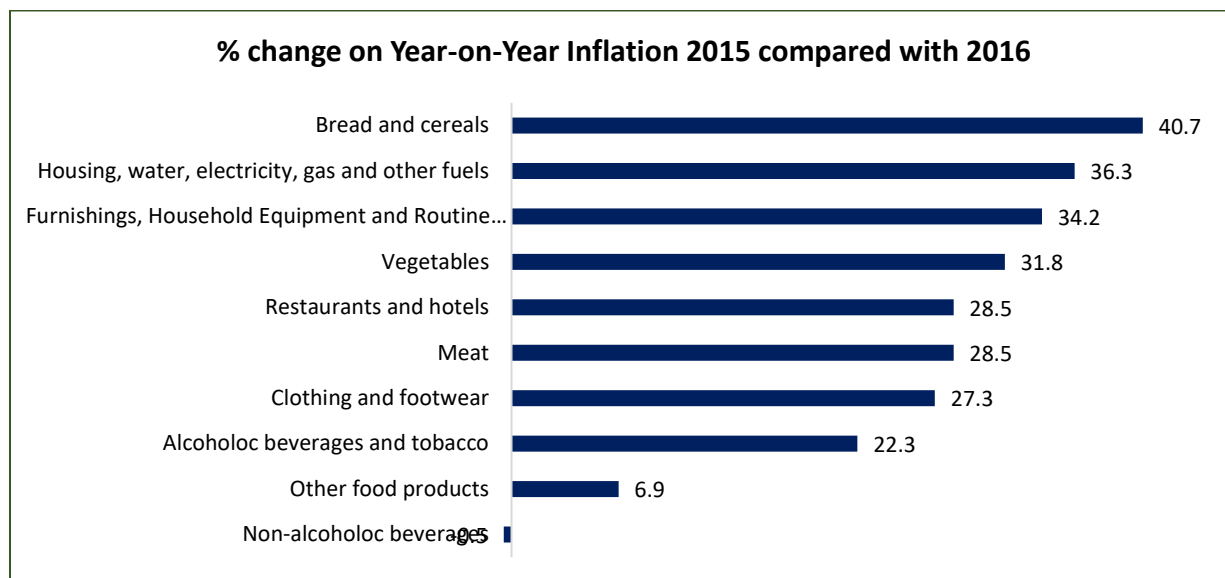
Change in inflation by region (2014-2013)



⁴ Ministry of Finance, Ethiopia (2023). *A Citizens' Guide to the Federal Budget of 2023/24*. Addis Ababa, Ethiopia

inflation rate are oils and fats, non-alcoholic beverages, meat, bread and cereals, milk, cheese, and eggs, housing, recreation, and education.

Comparing the inflation rate between regions, the highest change in inflation (from 2013 to 2014) was recorded in the Somali region (21.7) followed by the Oromia (18) and Amhara (17.6) regions. Compared with the regions, Addis Ababa has one of the lowest increases in inflation rate (10.3). In all regions, food price inflation contributed greatly to the general inflation rate.



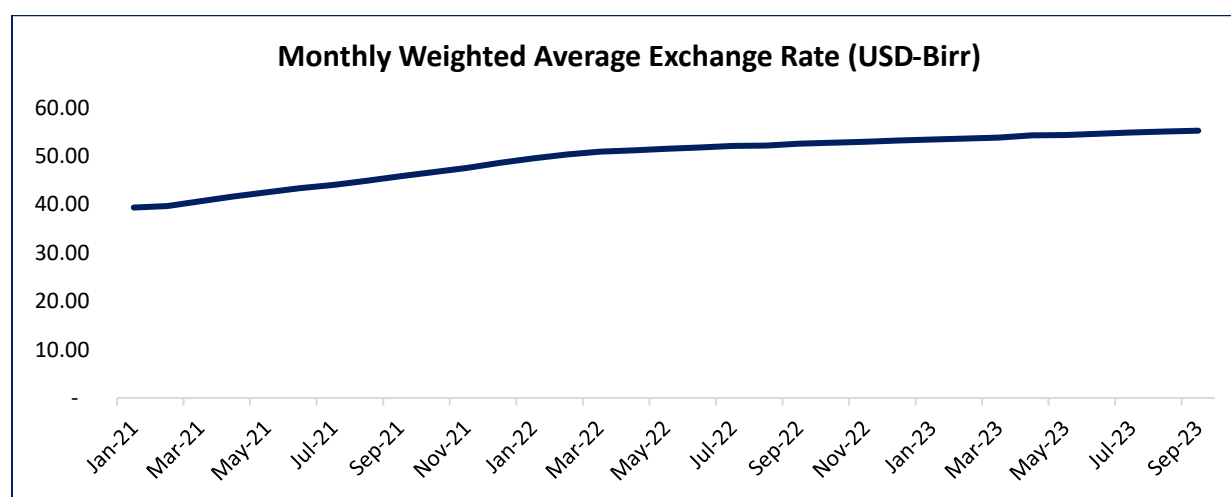
Source: *Own computation based on CSA data*

As can be seen from the above figure, bread and cereals are the basket of goods with the highest % change on year-on-year inflation, followed by housing, water, electricity, gas, and other fuels (36.3), and housing equipment (34.2). Vegetables, restaurants and hotels, and meat are also items with a significant change in price from the previous year.

High inflation is impacting investment due to high investment costs. In the fiscal year 2014, new investment spending accounted for only 25% of GDP, down from 28% the year before. In addition, public investment has decreased more than private investment. State enterprise investment has also decreased because of restrictions on their ability to borrow (especially in the form of non-concessional debt) as a result of intentional policies to limit overall debt accumulation. In the long run, this will further hinder employment creation and effect poverty alleviation. As indicated in the HGER, macro-financial and structural reforms taken since 2012 have had limited success in reducing the rate of inflation. Along with the reasons already mentioned that explain the increase in the inflation rate, the chronic foreign currency shortage has also contributed to the rise in inflation – this is mostly relevant for imported items (both food and non-food inflation).

	Data in billion Birrs				Share of investment in GDP			
	2011	2012	2013	2014	2011	2012	2013	2014
Total Investment	949	1032	1217	1560	35%	31%	28%	25%
Public investment	288	319	351	251	11%	10%	8%	4%
Federal government	175	204	235	129	7%	6%	5%	2%
State Enterprise	113	115	116	122	4%	3%	3%	2%
Private investment	661	713	865	1309	25%	21%	20%	21%
Foreign private investment	85	76	156	162	3%	2%	4%	3%
Domestic private investment	576	637	710	1148	21%	19%	16%	19%

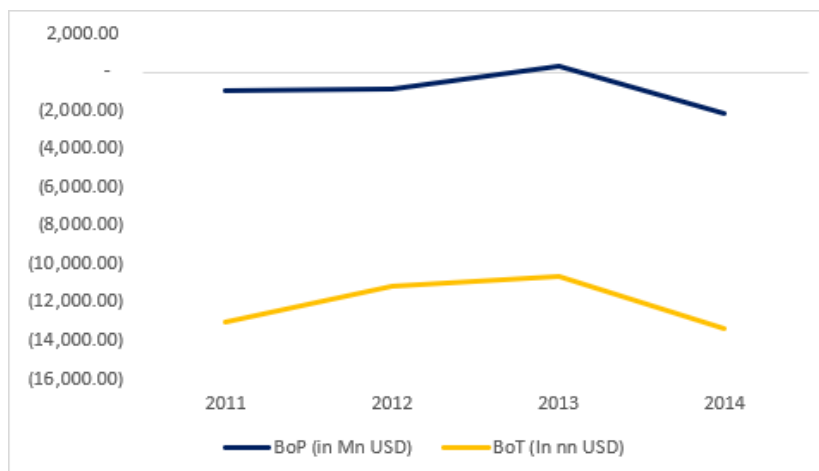
The forex shortage has reached a chronic level. At the beginning of 2014, the foreign currency reserves of the country stood at USD 3.2 billion covering only 2 months of import bills. Importers sometimes wait up to two years to get forex which pushes them to find alternative means of acquiring foreign currency. Recent news items are reporting that a number of cement factories and soft drink companies are reducing or fully stopping production because they are not able to import the necessary raw materials. Ethiopia has continued to maintain a managed float exchange rate regime to ensure external competitiveness. As such, the Birr was allowed to depreciate by 36.5 % in nominal terms against the US Dollar during 2014 while the real effective exchange rate depreciated by 24.5%. Global developments, coupled with domestic upheavals, have contributed to the current precarious forex situation. The shortage was worsened especially after the spike in the price of major import commodities such as fuel, fertilizer, wheat, and metal in the global market. Furthermore, a domino effect of the Ukraine war has also contributed to the shortage. In addition to the strict foreign currency management, the Ministry of Finance ordered the NBE to stop approving letters of credit (LC) for 38 selected import items which are labeled “luxury” products which seems a last resort action to address the forex shortage.



Source: Own computation with NBE data

As per the above chart, the forex rate (calculated in terms of the weighted monthly average exchange rate between the USD and the ETB) has been increasing for the past two and a half years. However, in the past year (2015), the change in the monthly weighted average exchange rate has decreased significantly relative to the previous year (2014). The average increment went from 3% in 2014 to 1% in 2015.

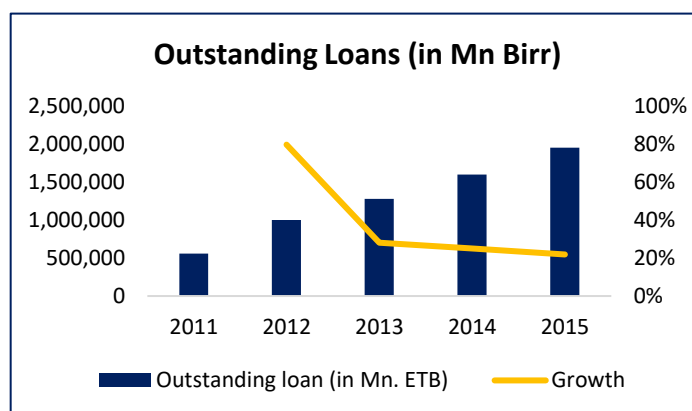
Declining investments and stagnant exports have impacted GDP through a widening negative trade balance and a BoP deficit. Ethiopia's balance of payments was underperforming with a deficit of USD 2.14 billion in 2014 compared to a surplus of USD 298.7 million in 2013, according to the NBE annual report. The current account deficit is mainly due to a large merchandise trade deficit which



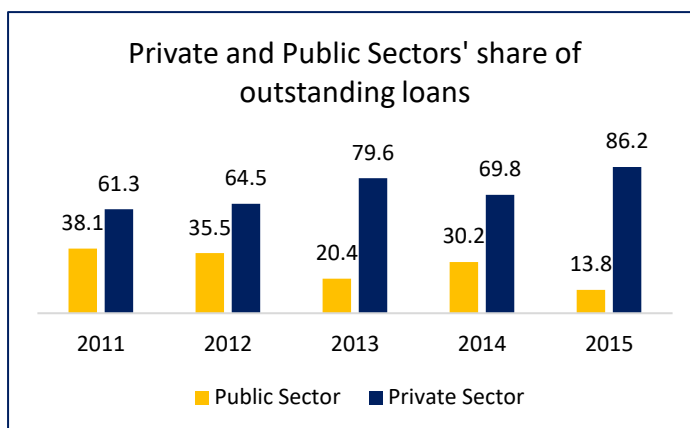
has widened from 10 billion in 2013 to 14 billion in 2014. Four items i.e coffee, gold, flower, and chat account for 70% of the export value during 2014. Consumer goods accounted for 42.1% of the total import bill while capital goods accounted for 16.8% (22% decline from previous year).

The Balance of Payments (BoP) deficit may suggest that the country is struggling to attract foreign investment or/and in securing external financing. This limitation could hinder the country's ability to finance important investments such as infrastructure development and technological advancements. Additionally, this situation may make it difficult for the country to meet its external debt obligations. A negative BoP can also put pressure on the exchange rate and cause the domestic currency to depreciate against other currencies. This depreciation can have a further impact on imports and exports, particularly for countries with a limited production capacity, which could further worsen the trade imbalance.

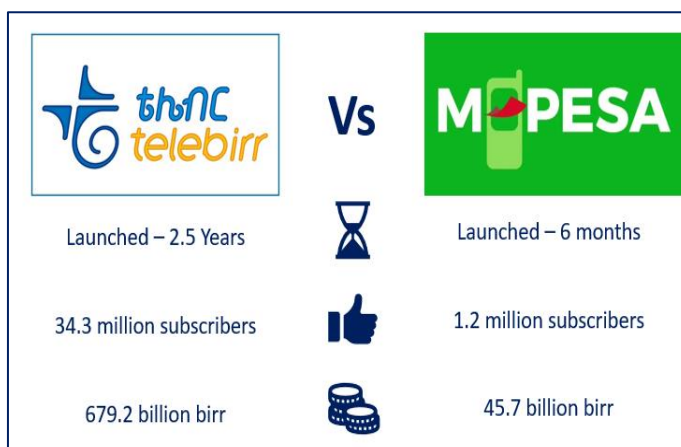
Total outstanding loans are increasing at a decreasing rate. Outstanding loans have been increasing for the past five years. However, the growth rate of outstanding loans has been decreasing for the past four years from 80% in 2012 to 22% in 2015. With the new directive from the National Bank of Ethiopia, the growth rate will only reach a maximum of 14% in 2016. This is expected to further restrict available finance that is already in shortage.



The share of private sector lending is increasing but it's concentrated. 86% of the new loans in 2015 were provided by the private sector – which is a 23% increase from the previous year. This is in line with the HGER plan to increase private sector engagement in the economy, which was also reflected in the Ten-Year Development Plan. However, it can also be explained by the government's establishment of the Liability Asset Management Corporation (LAMC). According to the Ministry of Finance⁵, State Owned Enterprises (SOEs) held 780 billion ETB (\$19.5 billion) in debt. 20 to 100 percent of this debt is transferred to LAMC to address the debt distress of the SOEs. The transfer of this debt from the CBE to the LAMC has resulted in a change in the private sector's dominant share of outstanding loans.



There are new players in the financial sector in 2015. Telebirr was introduced about two years ago and has already reached a 34.3 million subscriber base with a total transaction value of 679.2 billion (this is a 22.6-fold increase on the 30.3 billion Birrs value of just a year ago). In August 2023, a new foreign mobile money operator, Safaricom's M-PESA mobile financial service, went live. M-PESA has been able to reach 1.2 million subscribers and make 45.7 billion Birrs worth of transactions within six months of its launch.

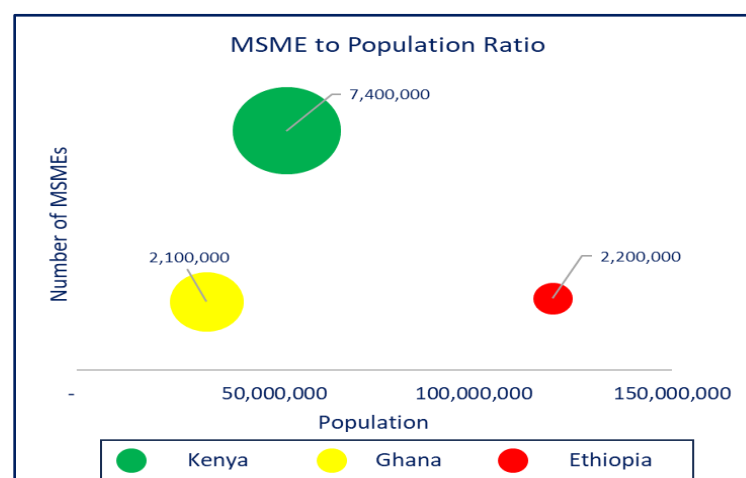
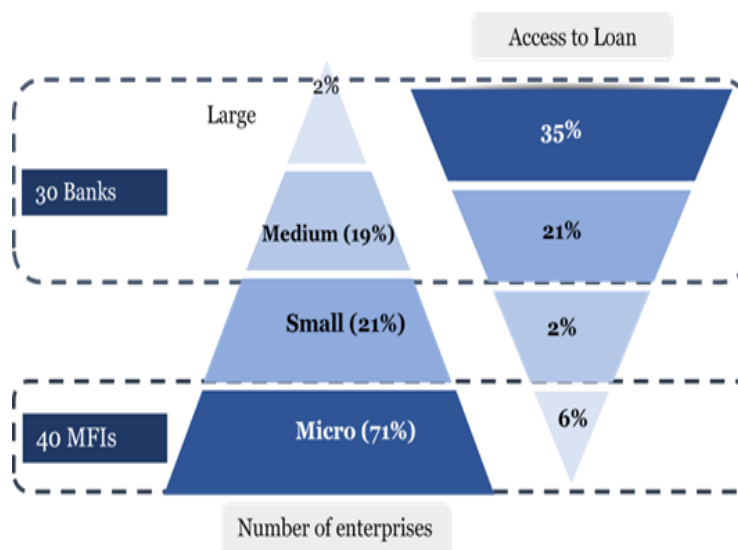
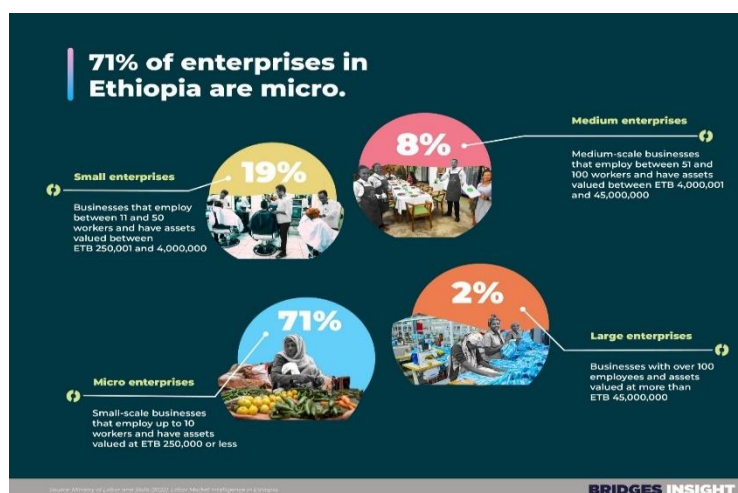


⁵ <https://www.mofed.gov.et/blog/overview-liability-asset-management-corporation-lamc/>

B. Experience of Small Firms – “Coping with the continuously changing trends”/Challenges and performance

Despite difficulties, MSMEs continue to be the backbone of job creation in Ethiopia. Youth unemployment is one of the most pressing challenges the country faces these days. With two million youth set to enter the workforce each year, Ethiopia now faces the risks and opportunities of integrating a rising number of youths into the labor market. The increasing rural-to-urban migration, returnee inflow from the Middle East, and internally displaced persons (IDPs) put a further burden on job creation and the capacity to sustain livelihoods. Despite the different initiatives of the government and development partners, youth unemployment continues to hurt the economic performance and social stability of the country.

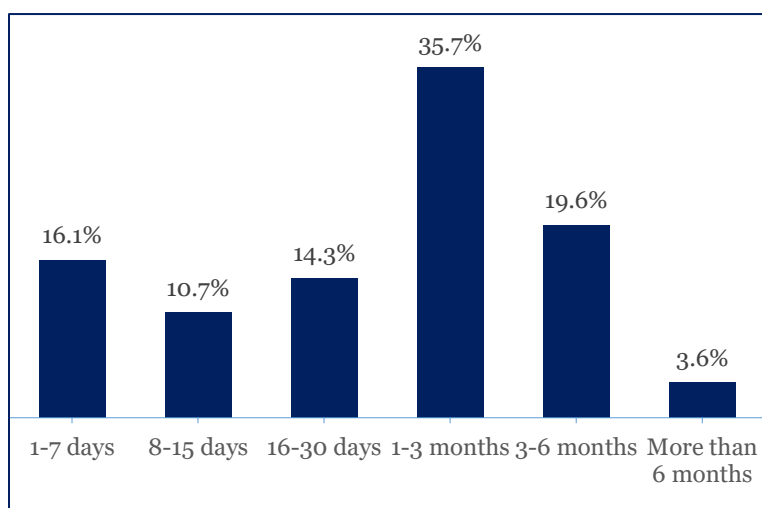
By creating self-employment opportunities for their creators and wage employment for hired workers, MSMEs are expected to absorb most of the labor force as, in emerging markets, MSMEs create 7 out of 10 jobs. Self-employment alone accounts for 53% of the total employment in Ethiopia. According to the Key Labor Market Indicators of July 2022 from the MoLS, there are 2.2 million MSMEs in Ethiopia. Of these, 71% are micro-enterprises, 19% are small, and 7% are medium. This skewness towards microenterprises shows that most enterprises do not graduate to the next stage. Comparing the number of MSMEs with peer countries, Ghana has an almost equal number of MSMEs (2.1



million)⁶, but there is a huge difference with Kenya which has 7.4 million MSMEs⁷. Compared with their population, Kenya has the lowest population to MSME ratio (7 people per MSME), followed by Ghana (16 people per MSME), and Ethiopia (55 people per MSME). A lack of working premises, low access to finance, and poor market linkage are the three most critical constraints hindering the formation and growth of enterprises in Ethiopia. According to the latest World Bank Ease of Doing Business report, Ethiopia is ranked 168th out of 190 countries in the world in starting a business. **Even though micro and small businesses make up the majority of MSMEs (71% and 21%, respectively), their access to loans is far more limited than medium and large-sized businesses.** Only 6% micro and 2% of small businesses have accessed finance. On the other hand, 35% of large enterprises have accessed finance due to the low risk and the considerable collateral that they can offer. This highlights the need for more accessible financing options for micro and small businesses. A demand-side diagnostic study of finance for MSMEs conducted by the BRIDGES Program indicated that there is a \$6.1 billion gap between demand and supply of finance for MSMEs.

First Consult surveyed 312 micro and small firms in the manufacturing and service sector in Addis Ababa, Adama, Hawassa, and Dire Dawa.

One-third of the firms that had finance needs were successful in getting credit from banks or MFIs with an average wait of 66 days. Slightly more than a third of the firms (36%) experienced a waiting period of one to three months, and a further 20% waited three to six months to hear back about their applications. These prolonged timeframes could be detrimental in a challenging economic context, in which timely access to credit could be essential for the survival and growth of firms. Firms



predominantly relied on real estate as collateral and a whopping 93% of firms that succeeded in securing loans from banks or MFIs used this form of security. Conversely, lack of collateral was one of the biggest hurdles for those firms that were not able to access credit. This could potentially point towards a systemic inclination or a regulatory framework that heavily favors real estate as a secure and preferred form of collateral. Despite the NBE's directive to provide loans using movable collateral, vehicles and equipment/machinery were significantly less utilized, with both being used by only 15% of the firms.

“Firstly, they say that there is no money left. Secondly, even after following the proper procedures, they reveal that there is no money this year and claim not to offer loans.”

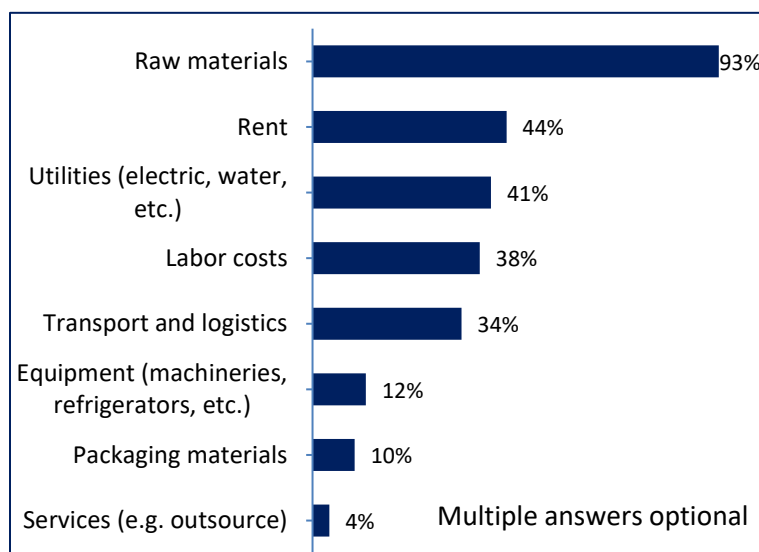
Manufacturing firm – Concrete Block producer

⁶ Ghana SME Sector Report 2023, by the Strategy and Research Department of the GCB Bank

⁷ UNDP MSEA MSME Recovery and Resilience Report (2021)

Raw materials are the factor of production most affected by inflation.

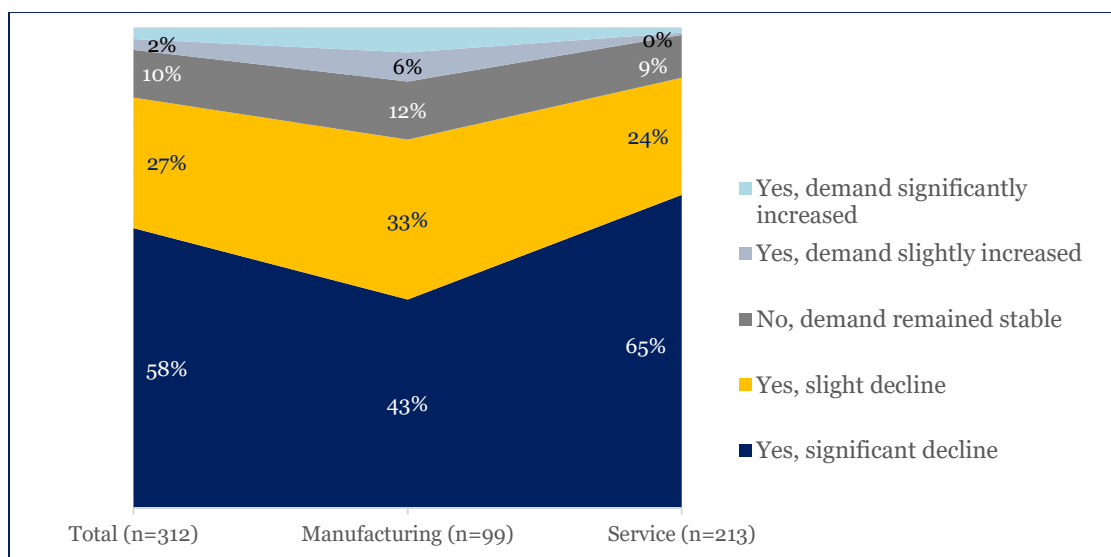
When it comes to the costs of production, the rise in prices was most severe in raw materials (mentioned by 93% of firms), followed by rent (44%), utilities (40%), and finally labor costs (38%). Other input categories, such as transport and logistics, equipment, packaging materials, and outsourced services, also saw varying degrees of price hikes. While raw materials are often considered to be more important for the manufacturing sector, rent fees are considered more important in the service sector. This shows us that the rise in costs in production is highly correlated to the changes in the price of raw materials, rent, and utilities, among others.



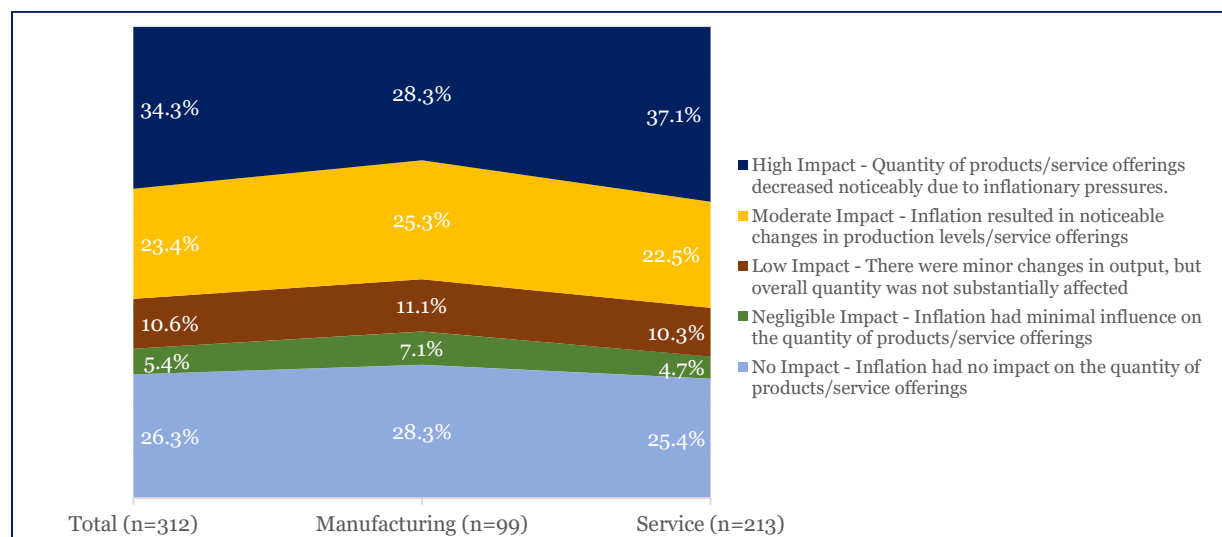
“Our biggest challenge is the availability of raw materials. The process of importing raw materials has become much slower than in the past, and it is taking more days than necessary. This has forced us into idleness.”

Manufacturing firm – Garment

Firms adjusted their pricing strategies in response to the higher costs of production, and it has resulted in reduced demand. This was more pronounced in the service sector than in manufacturing. The majority of companies (59.6%) increased their prices to cover costs and maintain their profit margin. As a result, 86% of the firms have experienced a moderate to significant decline in demand. There is a more pronounced decline in demand in the service sector when compared to manufacturing, which might imply a potentially higher sensitivity to price changes among service consumers or a more elastic demand. This could be due to the manufacturing sector producing necessary goods while the service sector offers more discretionary purchases.

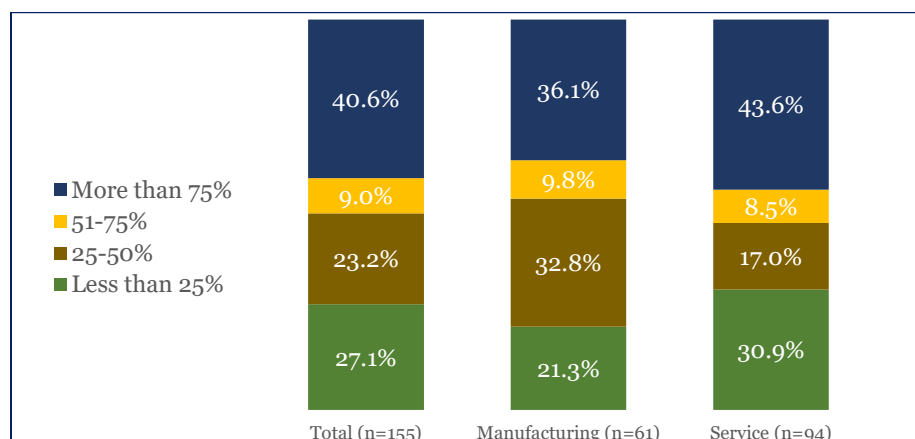


The reduced demand along with the high cost of production has resulted in a reduced quantity of products but the quality of production remains intact. 58% of the firms indicated that inflation has a moderate to high influence on their production level. This is more pronounced in the service sector (62%) as compared to manufacturing (53%). On the contrary, the repercussion of inflation on the quality of production was limited. The divergence in the influence of inflation on quality and quantity suggests varied adaptive and mitigative strategies adopted by firms. The high percentage of firms that maintained product/service quality despite high inflation points towards a possible prioritization of quality retention to sustain customer satisfaction and loyalty. On the contrary, the quantity of products/services provided appears to have been more susceptible to inflationary pressures, which might be attributed to the difficulty of maintaining output levels amidst rising costs without compromising quality.



62% of manufacturing firms use imported inputs as compared to 45% for firms in the service sector. Overall, 50% of firms reported using imported inputs. However, the manufacturing sector exhibited a greater dependency on imported inputs, with 62% of firms confirming usage. This contrasts with the service sector, where only 45% of firms reported using imported inputs. **Furthermore, 40% of firms rely on imported input for more than 75% of their total inputs.** This heavy dependence on imported inputs is

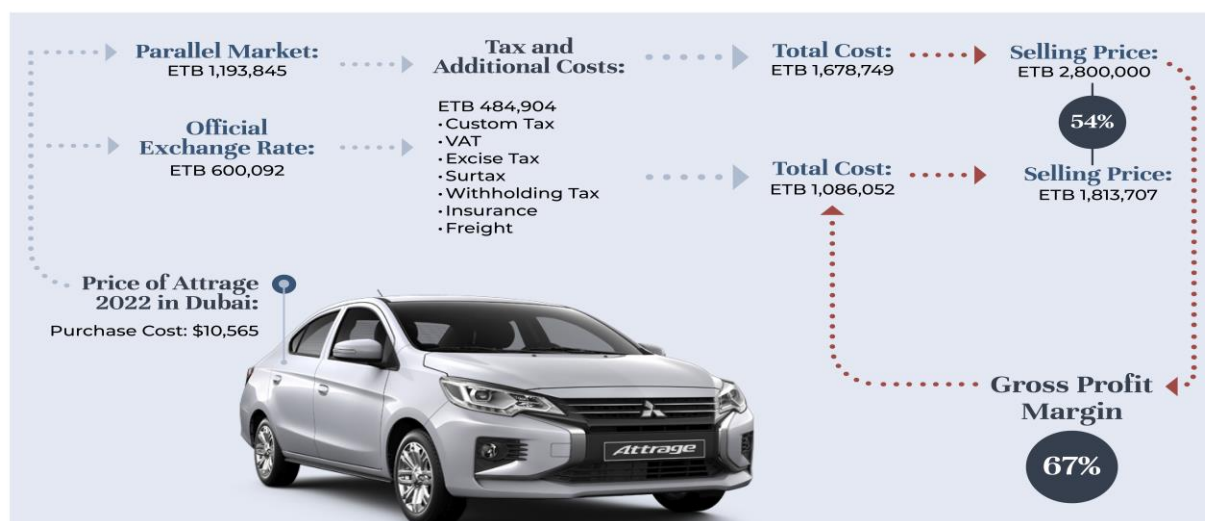
problematic as small firms do not have control over international prices and forex availability. What is more, small firms are not direct importers themselves which means they have to rely on the goodwill of wholesalers and retailers.



The shortage of forex supply has resulted in limited availability of imported inputs and at least a 100% price increase to account for the parallel market exchange rate. According to key informant interviews, there is almost no access to forex through the official channel (requests via letter of credit). Hence, importers are accessing hard currency through negotiations with exporters or parallel market rates. Firms operating in the importing sub-sector indicated that exporters who earn hard currency are the main influencers on the price of imported commodities. According to importers, there is adequate hard currency in the parallel market, but the price is very high and will influence the final imported product. The parallel market rate is currently almost double the official exchange rate and therefore anything imported will automatically have a 100% markup without accounting for the profit margin.

Case study: Gross profit margin of Mitsubishi Attrage 2022

The domestic price of cars could have been 54% cheaper had car dealers acquired 100% of the forex they needed through official channels instead of on the parallel market.



Small firms were affected by the forex shortage indirectly. A considerable portion of firms experienced multiple operational impacts due to the unavailability or rarity of main imported inputs, including increased input prices (60%), an inability to meet customer orders/demand (56%), and reduced output or under-utilization of production capacity (54%). Although expected to get better, the availability of inputs in 2015 was worse than in the previous year. This also adds to the inflationary pressure on the cost of production and the corresponding price of the final goods or services.

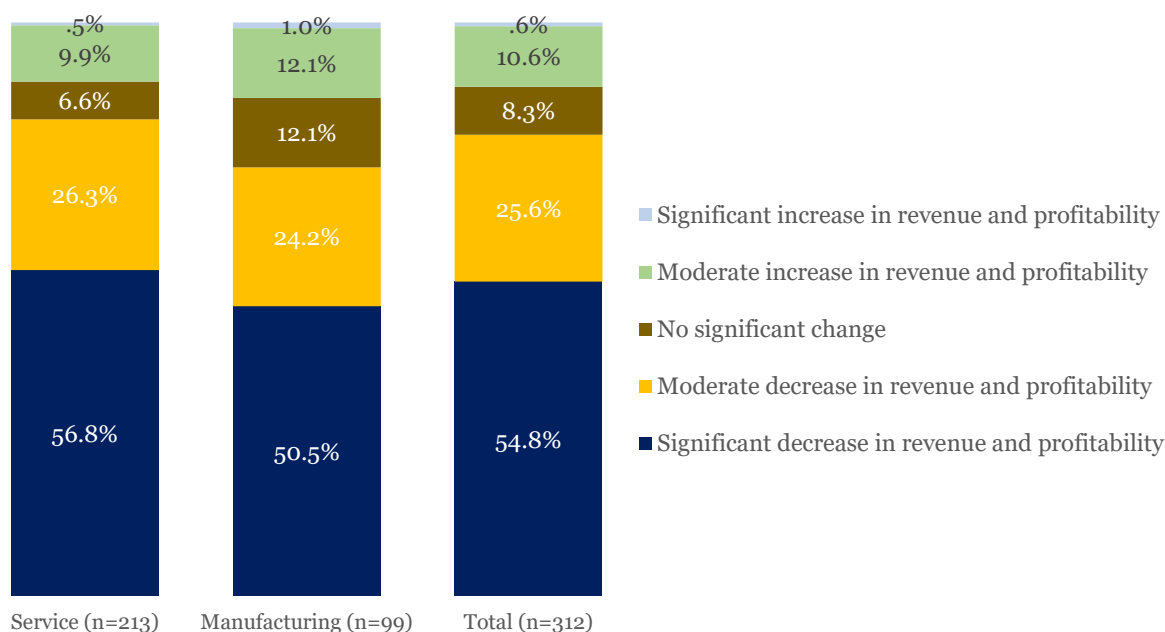
“The issue is that access to foreign currencies is very limited currently. The question then becomes: what are the means of accessing such foreign currencies? Can you go to the banks and formally obtain it at any time? No, you can't.”

Key informant – Professional Association

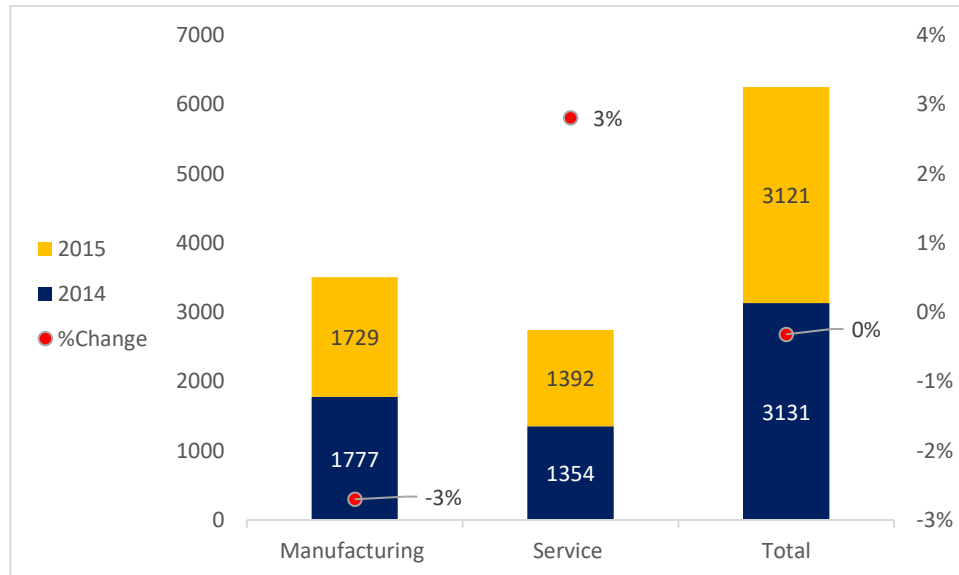
“The lack of raw materials in the market is also a challenge. Only a few people might have the required raw materials, making it easy for them to set the prices. We have no other options.”

Manufacturing firm – Metalwork

Firms’ revenue has dwindled despite transferring price rises to consumers to account for the rise in the costs of production because consumer demand has declined. These rapid price increases shrank profit margins, as firms could not proportionately increase selling prices without losing market share. Consequently, firms absorbed the rise in input prices through lower profits to remain competitive. Most firms (54.8%) encountered a notable decline in both revenue and profitability in 2015 as compared to 2014. Within the manufacturing sector, the result was slightly less severe but still large, with 50.5% of firms experiencing a marked decrease in their financial performance. In contrast, the service sector faced a more severe blow, as evidenced by 56.8% of firms reporting a significant dip in their financial performance.



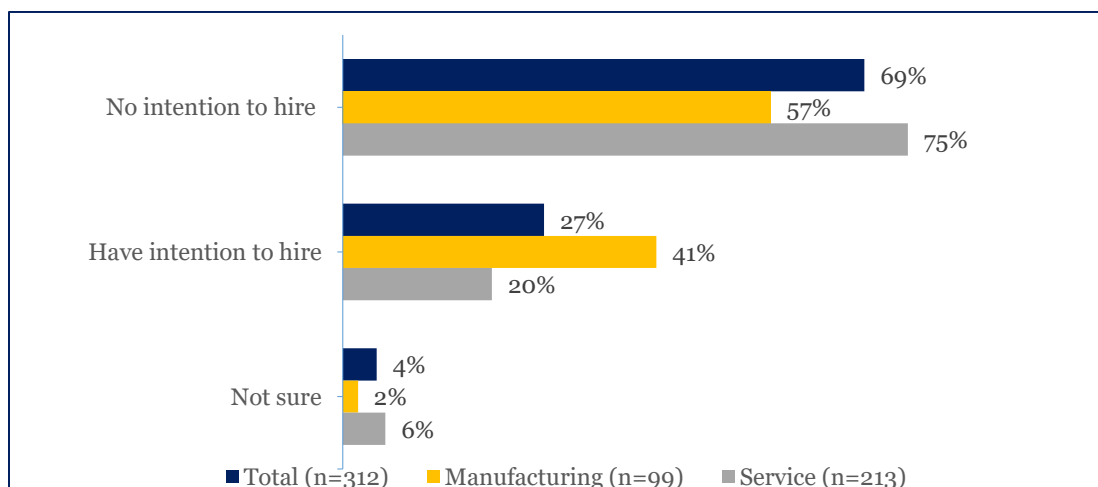
The dwindling revenue has also hit employment which showed a marginal decrease in 2015 as compared to 2014. The total number of employees decreased by 0.32% as compared to the previous year, reflecting resilience amidst economic woes. Manufacturing firms saw their workforce shrink by 2.7% while, in contrast, service firms showcased workforce growth, expanding by 2.8%.



"Sales are declining; we are laying off our own staff. We only need workers when there's work available; otherwise, we don't."

Manufacturing firm

More than two-thirds (70%) of firms have no intention of hiring additional personnel in 2016. This suggests a cautious or constrained approach to operational expansion. 20% of firms are planning to hire a maximum of an additional 5 employees while the other 10% are planning to hire less than 5. The intention to hire fewer new employees is an indication of firms' reluctance to increase operations. This might indicate one of two things or both. The first one is the overall macroeconomic effect on employment created by MSMEs, and the second one is the intention of firms that might affect overall employment in the coming year.

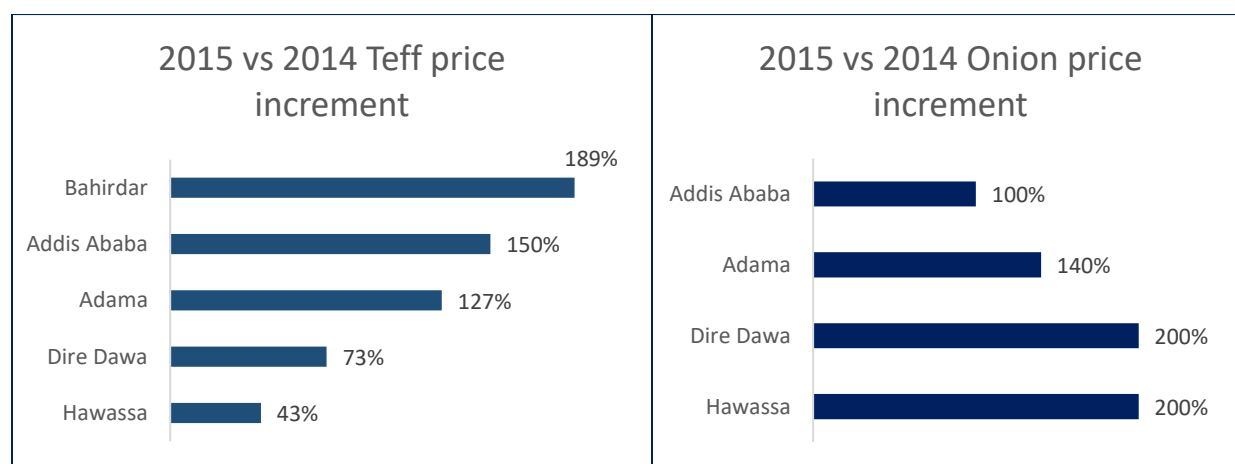


“We had plans to acquire additional space, expand our workspace, and hire more employees, but things don't always go as planned. Given the challenging current conditions, which you might be aware of, our progress has been hindered.”

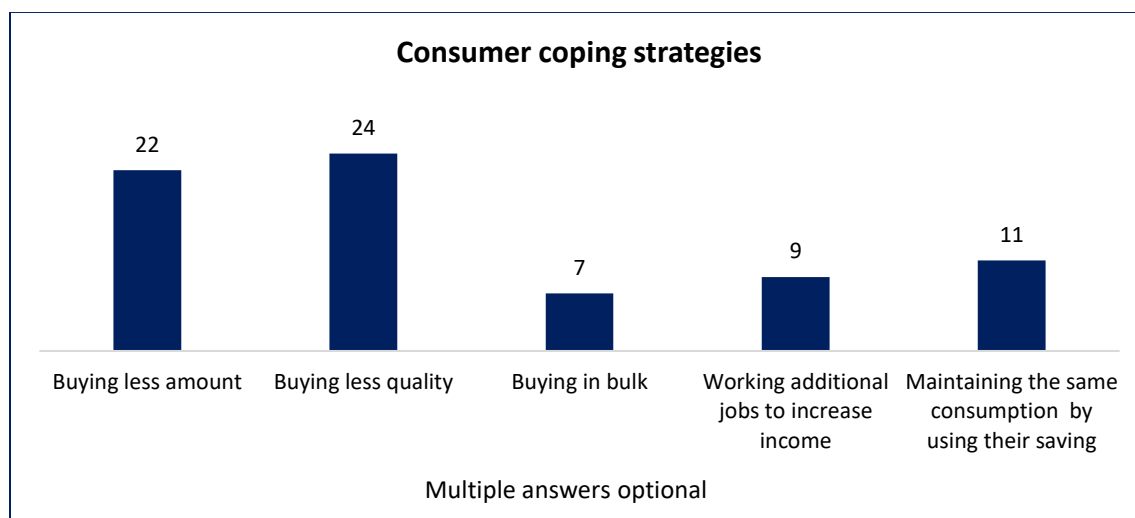
Manufacturing firm – Woodwork

Half of the firms instituted cost of living adjustments to support their employees. Firms have indicated that inflation is not only affecting their business performance but also their employees’ well-being. Nearly half of firms implemented cost of living measures (although the extent of these actions is not indicated) to employees’ salaries. While the others applied different bonuses and performance incentives. Some firms did not revise any of their salary or benefit packages to account for the rise in the price of goods and services.

Consumers have indicated the increase in their income is not proportional to inflation rates. Consumers point out that food items are heavily impacted by inflation, with significant rises in two of the most common Ethiopian staples, teff and onion. Teff prices have increased by 43% in Hawassa and by up to 189% in Bahir Dar when compared to the previous year. Similarly, onions have increased by 100% in Addis Ababa and by up to 200% in Dire Dawa. While most consumers stress that their increased pay packages are not in line with the inflation rate.



This less-than-proportional increase in consumers’ income is resulting in buying both a lesser quality and a smaller quantity of goods. Consumers have indicated they are using different coping strategies to account for the inflationary pressure of food items. While the majority have indicated they are buying lower quality goods, others indicated that they buy less quantity and purchase in bulk to save money. The remaining respondents indicated that they are either dipping into their savings or working additional jobs to maintain the same level of consumption. It has also been found that the decline in economic activity and the decrease in consumer spending are among the biggest obstacles currently faced by firms.



“If you increase prices, customers leave, period. They seek cheaper products, even if cheaper products have inferior quality.”

Manufacturing firm – Garments

Newlyweds struggling to cope with inflation: Case study.

Wondossen (30) and his wife Melat (28) are a married couple with a one-year-old boy, Yitbarek. Wondossen is a driver for a company and Melat is a public servant. They have a combined net income of ETB 14,000 per month (ETB 12,380 during the previous year). They have rented out a single bedroom around Alem Bank for 7,000 (this is a 40% increase from the previous year), which is 50% of their disposable income. Melat takes three transports in the morning to get to her workplace which costs her ETB 800 per month (a 45% increase over the previous year). Even though there is a transport service for civil servants to and from their office, she is not able to take advantage of this in the morning because she has to nurse her baby. The couple have mentioned that groceries take a chunk of their disposable income which is ETB 6,000 on average (a 33% increase compared to the previous year). Common staples such as teff, onions and tomatoes make up most of the grocery items. Melat purchases edible oil, sugar, and flour directly from her work organization as a benefit package. The couple have added up their monthly expense and it comes to ETB 17,200 which is ETB 3,200 more than their disposable income. For the time being family members are covering the difference considering that they are newlyweds, but they don't expect this to continue and if their disposable income does not increase, they expect to reduce their consumption to their basic

As indicated above, firms use price transfer related to the cost of doing business whether it's from domestic or import/forex-related inflation. Consumers are also showing pushback by spending less. The question remains, how long will this sustain?

C. Firms outlook: “Gloomy or hopeful?”

The predominant challenge firms grappled with was accessing inputs. Raw material shortages and soaring prices hit manufacturing firms hard, particularly those in the garment, textile, bakery, and metalwork industries, grinding production to a halt. Service firms also experienced critical inventory shortages. These firms attributed the difficulty in accessing inputs to a confluence of factors: a foreign currency shortage that curtailed imports, a soaring inflation rate, and the unreliability of local suppliers. Lacking essential inputs, firms failed to fulfill customer orders, resulting in revenue loss, and proving to be a great hindrance to their performance.

“The biggest challenge for us is the ever-increasing price of raw ingredients. Prices are rising daily, and attempting to convince our customers of these continual increases is very difficult.”

Manufacturing firm – Bakery

Another significant hurdle was limited access to the working capital and credit needed to sustain operations, procure inputs, and cover expenses such as rent and salaries. While some firms managed to secure bank loans or private financing, most of them aspired to obtain more credit than they could secure. These loans often came with strict restrictions on both the loan amounts and repayment terms. Additionally, the combination of high-interest rates and stringent collateral requirements rendered bank and MFI financing unattainable. Consequently, firms operating on tight budgets struggled to stock materials, meet customer orders, and cover essential costs.

“We are depleting our capital and lack a source from which to obtain loans.”

Manufacturing firm – Woodwork

“If we receive the credit that we asked for, we will do a better job. However, the conditions are not convenient. One cannot even fulfill all the requirements due to the many procedures. Even upon completing all the procedures, one cannot obtain it immediately. These are impediments.”

Manufacturing firm – Garment

The ongoing political instability and conflict in different parts of the country harmed the performance and viability of many firms by constraining mobility, depressing demand, stoking uncertainty, and disrupting supply chains. In this regard, a very common consequence, described by many firms, was restricted mobility and transportation stemming from conflict and instability. With growing security concerns in different regions, several firms highlighted that customers in rural areas were either unable or unwilling to travel to make purchases. A few firms cited supply chain problems caused by political conflict. These supply disruptions then cascaded into production delays and revenue losses for the affected firms.

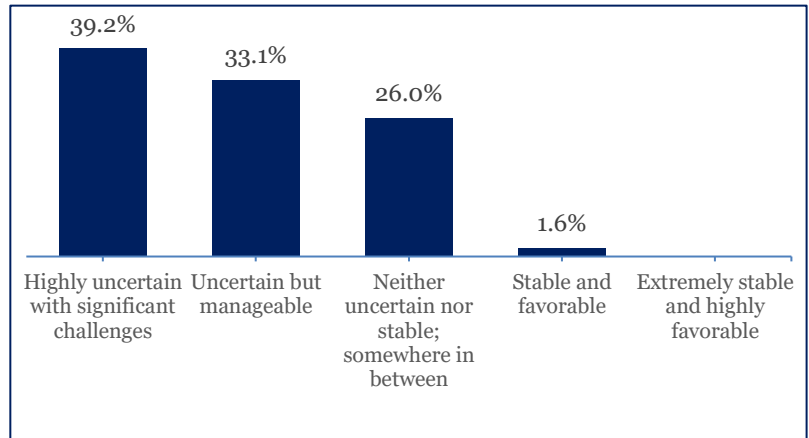
“The unrest in the country causes roadblocks, so the materials cannot reach their destination on time.”

Manufacturing firm – Concrete block producer

“We send our products out to the rural areas, but if there is no peace, it will stop.”

Manufacturing firm – Concrete Block producer

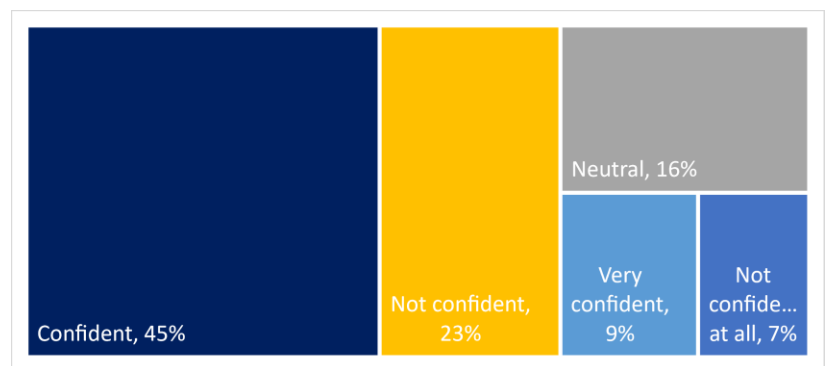
Firms maintain a cautious sense of optimism about the future in the face of numerous threats. Most firms expressed a cautious sense of optimism about the future. 39% of the respondents indicated the future is highly uncertain with significant problems to manage. Around 60% of respondents believe that even with these difficulties it will be manageable, and a few businesses believe conditions are stable and favorable.



“I am confident that improved circumstances await, even though present challenges stand in the way. Things won't remain this way. Tomorrow is a new day, and I believe better times are ahead.”

Manufacturing firm – Woodwork

Firms demonstrated a diverse range of confidence in sustaining and growing operations amid economic woes. While 54% of firms were confident, 30% expressed their lack of confidence. The remaining 16.1% were undecided about prospects. With no significant difference between the manufacturing and service sectors.



“If the conflicts arising here and there are not resolved soon, they will cause significant harm in the future.”

Key informant – Professional Association

D. Bringing it all together

The Ethiopian economy is undergoing a period of significant change, marked by both positive trends and challenging circumstances. One key trend is the shift in the composition of GDP, in which the industry and service sectors are growing, while the share of agriculture is declining. This diversification holds promise for future economic growth, but there are also new threats.

The country is currently grappling with a variety of macroeconomic imbalances, including high inflation, restricted access to foreign exchange, and a liquidity crunch within the banking system. These conditions have created a complex and difficult environment for small firms across various sectors. One of the most significant problems for small firms is soaring inflation, which has led to escalating input costs for raw materials, rent, utilities, and labor. This has put immense pressure on their profitability and forced them to pass on some of these increased costs to customers, ultimately depressing demand, and lowering sales. Another major hurdle is the foreign currency shortage, which is making it difficult for small firms to access the necessary supplies for their operations. This is particularly problematic for firms that are heavily reliant on imported inputs, as they are forced to pay significantly higher prices due to limited supply. Small firms are also struggling to access formal financing due to insufficient collateral, stringent eligibility criteria, and liquidity constraints within banks and microfinance institutions (MFIs). This lack of access to capital is further compounded by the NBE's measures to limit bank credit expansion, which aims to control inflation but inadvertently restricts access to funding for already struggling businesses.

In the face of these uncertainties, small firms have adopted various strategies to survive and navigate the volatile economic landscape. These include improving operational efficiency, sourcing alternative suppliers, diversifying their product and service offerings, and passing on increased input costs to customers. However, not all these strategies have been successful, and many firms have resorted to informal financing sources, primarily using personal savings, which is not a sustainable solution in the long term.

The overall outlook for small firms in 2016 is cautiously optimistic, but their future success will depend heavily on improvements in the broader economic and political environment. Adaptive strategies and financial flexibility will be crucial for these firms to navigate the complications of input shortages, inflationary pressures, restricted access to credit, and political instability. Addressing these unknowns requires a multi-pronged approach. The first step is to continuously monitor progress, particularly in addressing the structural hurdles that hinder small firms' growth. This will allow for the implementation of concrete actions to tackle these issues and ensure their effectiveness.

It is critical to implement strategies that offset the negative consequences of inflation control efforts and improve the availability of funds to small firms. This includes expanding access to microloans with relaxed collateral requirements and flexible repayment options tailored to their specific needs. The government could also introduce guarantee schemes to reduce risks for financial institutions and encourage them to lend to these businesses. In addition, commercial banks that are directly or indirectly (wholesale lending to MFIs) reaching small firms could be exempted from NBE's 14% credit cap. Furthermore, different initiatives such as digital lending, lease financing and introduction of capital market could be fast paced and substantial scaled.

Additionally, initiatives that encourage local production of essential inputs can help ease the burden of rising import prices. This could be achieved through tax breaks, subsidies, and infrastructure development projects that support local businesses in this sector. The Ministry of Industry has introduced an “Ethiopia Tamirt” initiative to substitute imports. Such kinds of initiatives should be well-resourced and scaled to reduce dependence on imported inputs.

Small firms can also benefit from forming cooperatives, which can help them negotiate better prices and secure bulk discounts for essential supplies. This collaborative approach can play a significant role in reducing costs and enhancing their competitiveness.

The government has a crucial role to play in fostering these outcomes. It can create a more supportive environment for small firms by implementing the proposed policy recommendations and playing a more active role in supporting their development. This includes prioritizing government procurement from small firms, particularly those owned by women and youth, to stimulate demand and nurture economic growth.

By addressing the difficulties faced by small firms and actively supporting their growth, the Ethiopian government can ensure their long-term sustainability and contribution to economic development. This will require collaboration between the government, financial institutions, and the private sector to create a supportive ecosystem for these vital businesses.

1. Setting the Scene

1.1 The Ethiopian macroeconomy and business landscape

Businesses can be greatly affected by macroeconomic changes, which can have huge repercussions on their viability. Higher macroeconomic uncertainty usually affects businesses' ability to make pricing, employment, and investment decisions, and these effects are economically significant. During periods of high economic growth, businesses typically experience an increased demand for goods and services, leading to higher sales and potential expansion opportunities. Conversely, during economic downturns or recessions, businesses may face reduced consumer spending, lower sales, and the need to cut costs or downsize. These constraints can include limited access to finance, high-interest rates, and difficult collateral requirements.

Macroeconomic changes are often accompanied by changes in government policies. Government decisions regarding taxation, regulations, trade policies, and fiscal stimulus packages can directly affect businesses. For example, tax cuts can increase disposable income and stimulate consumer spending, while stricter regulations can increase compliance costs and restrict business operations. Macroeconomic changes can influence consumer confidence, which in turn affects consumer spending patterns. During periods of economic stability and growth, consumers tend to have higher confidence levels and may be more willing to make major purchases or invest in discretionary goods and services. In contrast, during economic uncertainty or downturns, consumer confidence can decline, leading to reduced spending and a more cautious approach by businesses. For example, changes in interest rates set by central banks can influence borrowing costs for businesses and households. However, in low-income developing countries such as Ethiopia, access to finance is often more of a constraint than the cost of borrowing. This is because many businesses and households do not have access to formal financial services, such as loans from banks⁸.

Limited access to finance may hamper the ability of businesses to invest in research and development activities, innovation, and technology adoption. It may also hinder businesses' ability to expand their workforce and create new job opportunities. Additionally, businesses without access to formal finance may be more vulnerable to economic shocks and crises and this may have a greater effect on marginalized groups, including women entrepreneurs and those living in rural areas.

The vulnerability of informal small businesses to economic shocks is a concern that has been highlighted by various studies. These businesses often face significant difficulties due to their limited access to social protection, low wages, income insecurity, lack of formal finance, and a workforce with limited skillsets.

In 2014, the Ministry of Labor and Skills (MoLS) conducted a Key Indicators of the Labor Market (KILM) study, which revealed that approximately 21% of the total labor force in urban areas, amounting to 1,306,553 individuals, was engaged in the informal sector. This statistic shows that a sizable portion of the workforce operates in an environment characterized by economic vulnerabilities.

Moderate inflation helps prevent deflation and encourages individuals and businesses to invest, thereby promoting economic growth. However, high inflation can have adverse consequences by diminishing

⁸ <https://www.sciencedirect.com/science/article/pii/S1879933717300106>

consumer purchasing power and generating uncertainty, leading to reduced consumer spending and potentially affecting businesses negatively. Fluctuations in exchange rates can also impact businesses engaged in international trade. Overvalued exchange rates can make exports more expensive and reduce competitiveness in foreign markets while making imports relatively cheaper. On the other hand, a competitive exchange rate can boost export competitiveness but increase the cost of imported inputs. Businesses that rely heavily on imports or exports need to monitor exchange rate fluctuations and manage potential risks accordingly.

It is important to note that the effect of macroeconomic changes can vary across industries and individual businesses. Factors such as the nature of the business, its size, market segment, and geographic location can all influence how macroeconomic changes affect a specific business.

Macroeconomic stability has a general influence on private businesses, with Micro Small, and Medium Enterprises (MSMEs) being particularly susceptible. The ability of MSMEs to perform well in overseas markets and their ability to import technology or critical inputs are affected by macroeconomic stability and the availability and cost of foreign exchange, both of which are the domain of a state's macroeconomic policy.

In the context of Ethiopia, MSMEs can be affected by different macroeconomic policies and changes that have been implemented. These policies and strategies may affect the MSMEs in diverse ways; The National Bank of Ethiopia (NBE) is currently implementing a contractionary monetary policy to control inflation, which might lead to higher interest rates and reduced access to credit for MSMEs. This can hamper their ability to invest, expand operations, and meet working capital needs.

Fiscal policies such as high tax rates and excessive regulations may burden MSMEs, particularly those operating in the formal sector. Complex tax compliance procedures and high compliance costs can discourage informal MSMEs from entering the formal economy, leading to limited access to government support programs and financial services.

Trade policies, such as tariffs, quotas, and trade agreements, might also impact MSMEs by affecting the cost of imported inputs, market access, and competition. Protectionist measures may shield domestic industries but can limit opportunities for MSMEs to access international markets and benefit from global supply chains. Conversely, trade liberalization can expose MSMEs to increased competition, requiring them to enhance competitiveness and productivity.

Regulations related to business registration and licensing as well as standards related to labor, health, safety, and the environment are additional factors that determine MSMEs' productivity. Complex and burdensome regulatory processes can discourage entrepreneurship, hinder business growth, and increase compliance costs for MSMEs. Simplifying regulations, streamlining administrative procedures, and improving access to information can facilitate MSME development.

Macroeconomic policies that promote financial sector growth can positively influence the growth of MSMEs by encouraging microfinance institutions and enhancing access to credit. Additionally, government initiatives to support MSMEs through targeted loan schemes, credit guarantee programs, and capacity-building initiatives can foster a conducive environment for their development.

Adequate infrastructure, including transportation networks, power supply, and digital connectivity, is crucial for MSMEs' competitiveness and growth. Macroeconomic policies that prioritize infrastructure development can improve access to markets, reduce transportation costs, and enhance productivity for MSMEs⁹.

In general, multiple political, social, and economic changes and reforms have altered the country's macroeconomic landscape. This is partially attributable to the spillover effects of the COVID-19 pandemic and other shocks, such as the conflict in northern Ethiopia. Ethiopia started the 2015 fiscal year facing multiple hurdles, namely: (Youth) unemployment, a foreign currency shortage, a liquidity crunch in the banking system as well as a decline in investment and Official Development Assistance (ODA). However, there appears to be hope for a recovery because the aftershocks of COVID-19 have started to fade, and businesses have demonstrated strong resilience. Furthermore, the Pretoria Peace Agreement is creating a positive outlook for relations with the international community, and different development programs to rehabilitate conflict-affected areas. The country is also taking various economic measures including introducing new reforms and strategies to ease the above-mentioned macro issues.



Figure 1: Major reforms and events in 2015.

⁹ The role of micro, small and medium enterprises (MSMEs) in the sustainable development of sub-Saharan Africa and its challenges: a systematic review of evidence from Ethiopia | Journal of Innovation and Entrepreneurship | Full Text (springeropen.com)

1.2 The path towards transformation via HGER

During the first and second Growth and Transformation Plans (GTP I and II), Ethiopia's economic model relied heavily on public investment and had relatively less engagement from the private sector. This approach could potentially threaten the long-term sustainability of economic growth and stability, especially in the face of economic or political shocks, and could result in macroeconomic vulnerabilities and imbalances. To address this issue, the Ethiopian government has taken steps towards establishing a self-sustaining economy that ensures macroeconomic stability, rebalances the involvement of the public and private sectors in the economy, and unlocks untapped growth opportunities.

The macro-financial changes that were put into place in the HomeGrown Economic Reform (HGER) were extensive and addressed assorted concerns. These reforms included addressing foreign exchange imbalances, strengthening the monetary policy framework and financial regulations, strengthening public financial institutions, addressing vulnerabilities in public banks, enhancing financial sector development, and developing capital markets¹⁰. They also included strengthening public sector finances and state-owned enterprise (SOE) reforms. The implementation of HGER has helped to set policy and institutional structures, improve macroeconomic management, and exploit new potentials across sectors and markets including in manufacturing, the digital economy, the financial sectors, and exports, among others. However, the aftermath of shocks such as the COVID-19 pandemic, the domestic conflict, and the Russia-Ukraine war have reversed and hampered key reforms and key macroeconomic indicators, including inflation, debt risks, unemployment, and foreign currency shortages have remained critical during the HGER implementation period.

The HGER faced several internal and external obstacles in addressing macroeconomic imbalances. In response, the government has introduced HGER 2, which aims to recalibrate and build upon the reforms implemented during HGER 1.0. The new reform includes deepening and scaling up reform measures in light of changing global and domestic contexts and mobilizing citizens, partners, and investors through policies and market frameworks that support economic growth, recovery, and transformation.

1.3 GDP has shown resilience but structural transition unattained.

The Ethiopian economy demonstrated remarkable resilience in recent years regardless of multiple internal and external shocks. The real Gross Domestic Product (GDP) growth rate for the year 2014 was 6.4%, marking a slight increase from the rates of 6.3% and 6.1% recorded in the previous two years, 2013 and 2012, respectively. However, the growth rate of 6.4% was significantly lower than the 9% recorded in 2011. It also fell short by 3.8 percentage points compared to the target set in the Ten-Year Development Plan.

In 2015, the industry sector accounted for 28.9% of the total GDP, which is a slight decrease from the previous year's figure of 29.3%. However, the sector saw a modest rise over the years, with its share increasing from 28.1% in 2011 to 28.9% in 2014. It experienced a growth rate of 4.9% in 2014, which is 2.4 percentage points lower than the growth rate recorded in the previous fiscal year. The increase is mainly attributed to the growth of the manufacturing and construction subsectors, which contributed

¹⁰ Home Grown Economic Reforms (HGER) 1.0 and 2.0

23.4% and 72.2%, respectively, to the industrial output. Investments in the construction of roads, railways, dams, and residential houses contributed to the growth of the construction subsector.

In 2015, the agriculture sector contributed 32.4% to total GDP, which is slightly lower than the 32.5% recorded in 2013. Over the past few years, the contribution of the agricultural sector to the GDP has been declining, from 33.3% in 2011 to 32.4% in 2014. In 2014, the sector witnessed a growth rate of 6.1%, which is the highest in the last four years. The increase was due to a 6.9% rise in crop production, and a 4.6% and 4.3% expansion in animal farming and hunting and forestry, respectively. According to the NBE report¹¹, crop production remains the largest component of agricultural output, accounting for 65.6%, followed by animal farming and hunting at 25.6%, and forestry at 8.5%.

The service sector continued to be the largest contributor to the GDP, accounting for 40% of the total GDP in the fiscal year 2014, which is an increase of 0.4% from the previous year. The sector grew by 7.6% in 2014, which is 1.3 percentage points higher than the previous fiscal year. The growth was mainly due to the expansion of services in transport and communications, real estate, renting and business activities, hotels and restaurants, wholesale and retail trade, public administration, and defense, contributing to 40% of the service sector output.

The contribution of various sectors to the GDP is important to understand the structure of an economy. From 2011 to 2014, there were notable changes in the sector-wise contribution to the GDP. While the industry sector saw a slight increase in its share, the agriculture sector witnessed a decline, and the service sector's share remained relatively stable. This indicates a gradual shift in the structure of the economy.

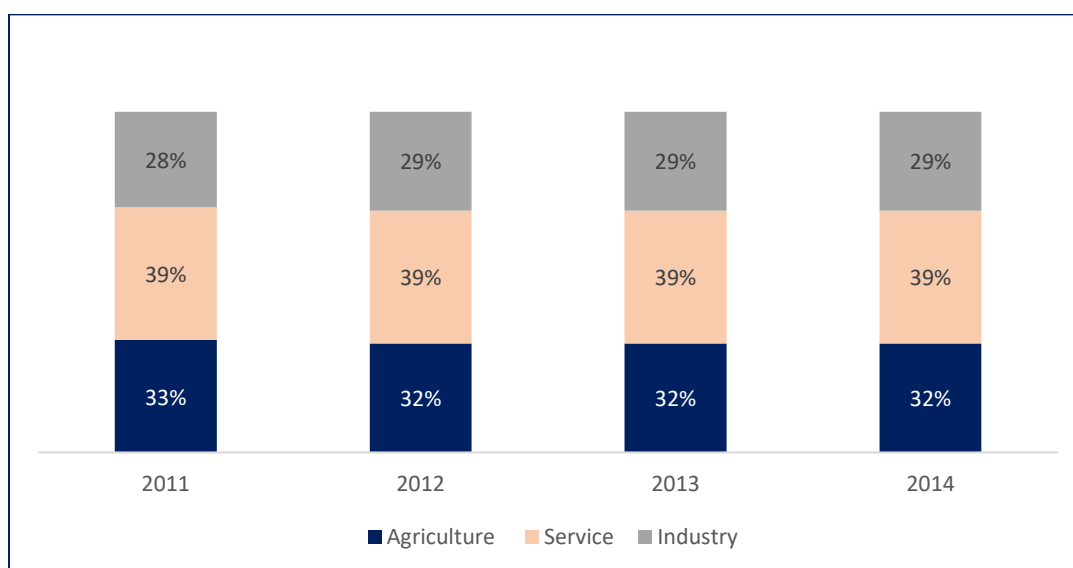


Figure 2: Sectoral contribution to the GDP.

The Sub-Saharan Africa (SSA) average in terms of agriculture's contribution to the GDP is 25%, which is less than Ethiopia's average. However, SSA's industry contribution to the GDP is almost similar to that of Ethiopia standing at 28%.

¹¹ NBE 2014 Annual Report

1.4 Shift in budget allocation and reduction in government spending

The total approved national budget for the fiscal year 2016 is 801.65 billion Birrs, which shows a 1.9% increase compared to the budget of 786.61 billion Birrs in 2015. According to the budget breakdown, about 46.2% (ETB 370.13 billion) of the total budget is allocated for recurring expenses, 25.4% (ETB 203.4 billion) for capital expenses, 26.7 % (ETB 214.07 billion) for regional governments, and 1.7 percent (ETB 14 billion) is dedicated to supporting projects aimed at achieving the Sustainable Development Goals (SDGs)¹². This represents a shift towards allocating more resources to maintaining existing programs and services rather than investing in new capital projects. A similar trend has been observed in recent years, with the share allocated to recurrent expenditure increasing from 47 % in 2014 to 61 % in 2015, while the share of capital expenditure declined from 53% in 2014 to 39% in 2015¹³. The financial stress experienced by the government has led the Ministry of Finance to announce for two consecutive years that no major capital projects will be initiated, and the government will make no new hires. As capital expenditure is known to promote growth, the reduction in the budget allocated to capital expenditure could hurt the economy.

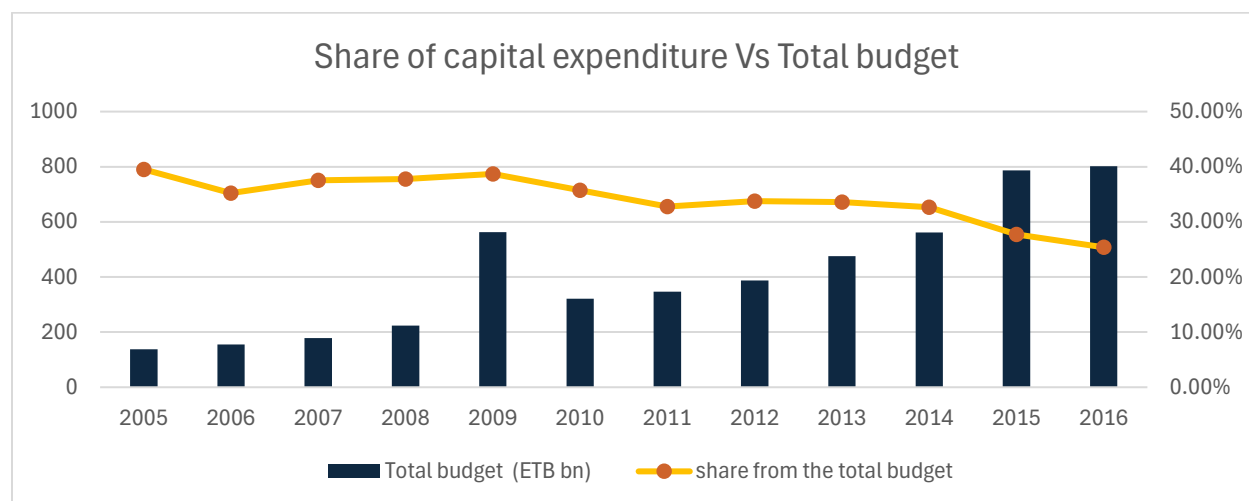


Figure 3: Share of Capital Expenditure from total budget.

The significant rise in the recurrent budget can be attributed to the increased allocation for debt servicing and the growth in recurrent spending on national defense. In 2015, public debt servicing and spending on national defense accounted for about 37 % of the federal budget. The high cost of the conflict in the northern part of the country led to a considerable budget shift towards peace and security. According to the Minister of Finance, Ahmed Shide, the cost of the conflict could be as high as 28 billion USD¹⁴. The budget allocated for debt servicing increased from ETB 25.2 billion in 2011 to ETB 159.19 billion in 2016. The total current expenditure in 2016 is 47% of the total budget.

¹² Ethiopian federal government budget for 2016 fiscal year, Draft Laws, House of Peoples Representatives

¹³ UNICEF Ethiopia 2022/23, Highlights of federal budget proclamation 2022-23, (unicef.org)

¹⁴ <https://www.africa.com/ethiopias-post-conflict-reconstruction-after-a-two-year-civil-war-will-cost-about-20-billion/>

Recurring expenses account for 40% of the 2016 budget. The budget required for debt financing has been on the rise in recent years due to increased borrowing to fill the widening fiscal deficit. Increasing debt service may have certain advantages, such as raising credit scores, getting access to more funds, or financing development initiatives. But it can also have negative effects, such as reducing the fiscal space, increasing the debt burden, or creating debt distress.

To tackle the expanding fiscal deficit, the government has implemented various measures, such as reducing government spending, increasing tax revenues, and diversifying financing sources. One of the measures taken to reduce government spending was removing the fuel subsidy in 2014, except for a selected group of transporters. This resulted in a 167% increase in the price of a liter of gasoline over two years¹⁵. According to the government's report, this decision saved ETB 4 billion in monthly recurrent expenditures. It was anticipated that this would lower the deficit and inflation rates. However, the rise in fuel prices also contributed to an increase in the inflation rate, as fuel is an essential component of the entire cost structure of goods and services in Ethiopia. Higher transportation costs due to increased fuel prices have increased business production and distribution costs. To cover these additional expenses, prices for goods and services are often raised, increasing the economy's overall price level.

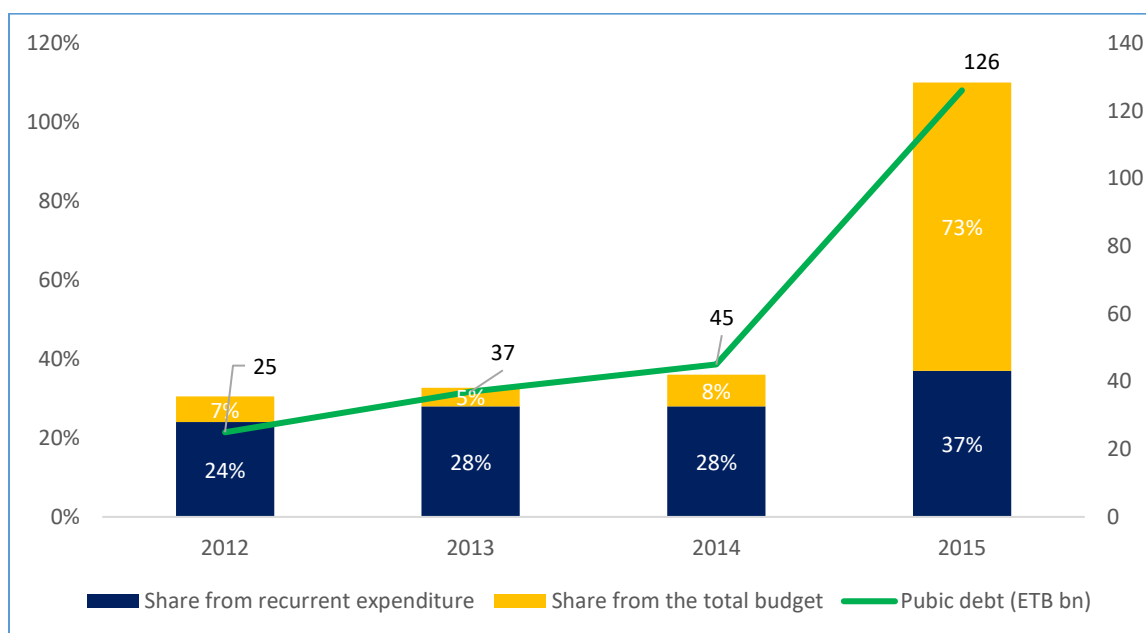


Figure 4: Public debt from total budget and recurrent expenditure.

1.5 Inflation continued to affect investment, employment, and business.

The inflation and consumer price index has continued to increase with an annual inflation rate of 33.9% in 2015. This rising number is costing society by reducing the purchasing power of buyers: simply put, Ethiopian consumers can buy less with the same amount of money when compared to the base year. The major reasons for the higher inflationary pressure in Ethiopia during 2015 are the aftershocks of the COVID-19 pandemic, continued unrest in some parts of the country, the Russia-Ukraine war, a mismatch

¹⁵ July fuel price, motri.gov.et

in aggregate supply and demand, high commodity prices in the global market as well as loose monetary and fiscal policies, such as increased money supply and high government spending¹⁶. The high inflation rate is also a consequence of the imbalanced correlation between economic growth and the money supply. In the year 2014, the broad money experienced a notable increase of 25.6% compared to the previous year, indicating a significant influx of new money into the economy without corresponding production¹⁷.

*Broad Money: It represents the total money supply in an economy. It includes not only physical currency (coins and banknotes) in circulation, but also various types of deposits held by the public, such as demand deposits, savings deposits, time deposits, and other liquid assets.

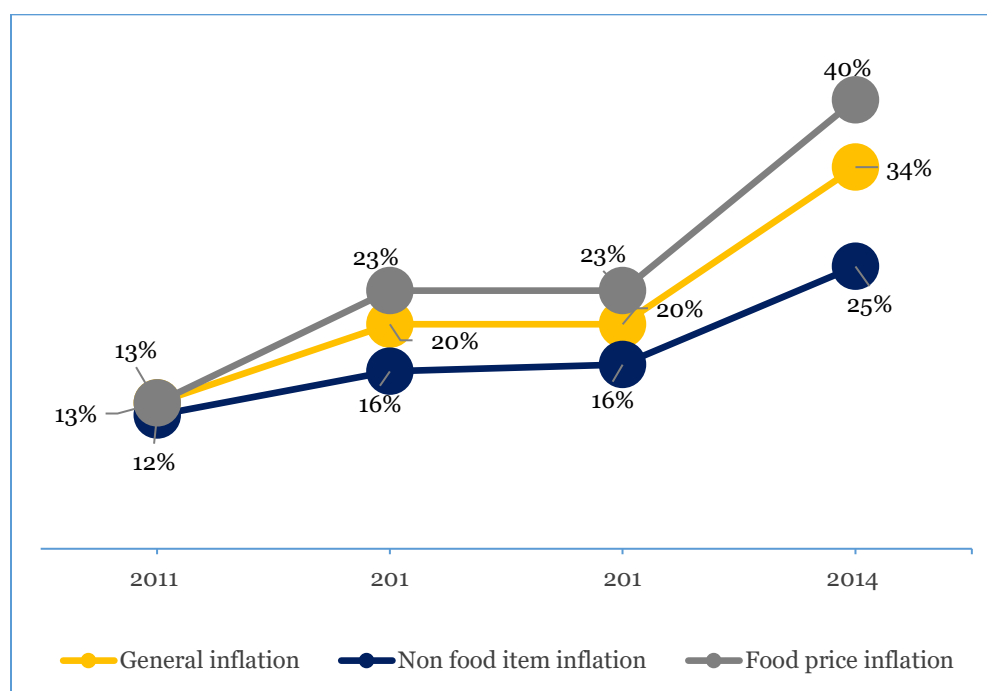
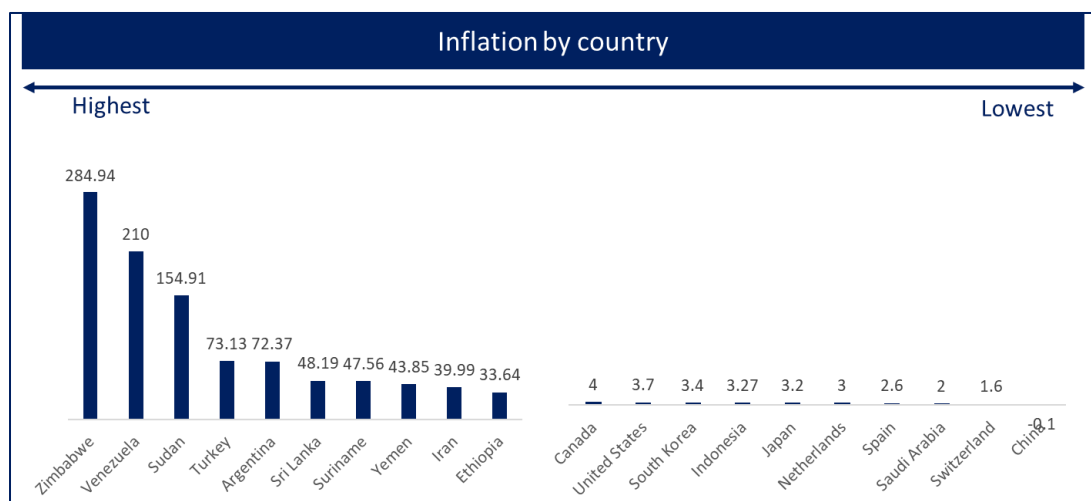


Figure 5: Trend of inflation from 2011 to 2014.

As of June 2023, Ethiopia is the 10th country in the world with the highest inflation rate (33.6). The first one is Zimbabwe (285) followed by Venezuela (210). Of countries with the lowest inflation rates, China has the lowest (-0.1) and is in deflation, followed by Switzerland (1.6) and Saudi Arabia (2).

¹⁶ The Federal Democratic Republic of Ethiopia and the IMF

¹⁷ IMF-FDRE selected issues (August 2013), The Federal Democratic Republic of Ethiopia: Selected Issues - Staff Report; IMF Country Report 13/309; August 29, 2013



Source: <https://www.geeksforgeeks.org/inflation-rate-by-country/>

Figure 6: Inflation rate by country (highest and lowest)

Although the government took several initiatives to maintain price stability, inflation has remained off the single-digit target in the past four years. The government undertook initiatives such as tightening broad money growth and putting a cap on outstanding credit growth. The annual average headline inflation rose to 33.8% in 2014 compared with 20.2% in 2013. The increasing inflation rate is explained by the 17.1% increase in food & non-alcoholic beverages inflation and the 8.7% rise in non-food inflation. Out of all the food and non-food items, the most important variables that have affected the general inflation rate are oils and fats, non-alcoholic beverages, meat, bread and cereals, milk, cheese, and egg, housing, recreation, and education.

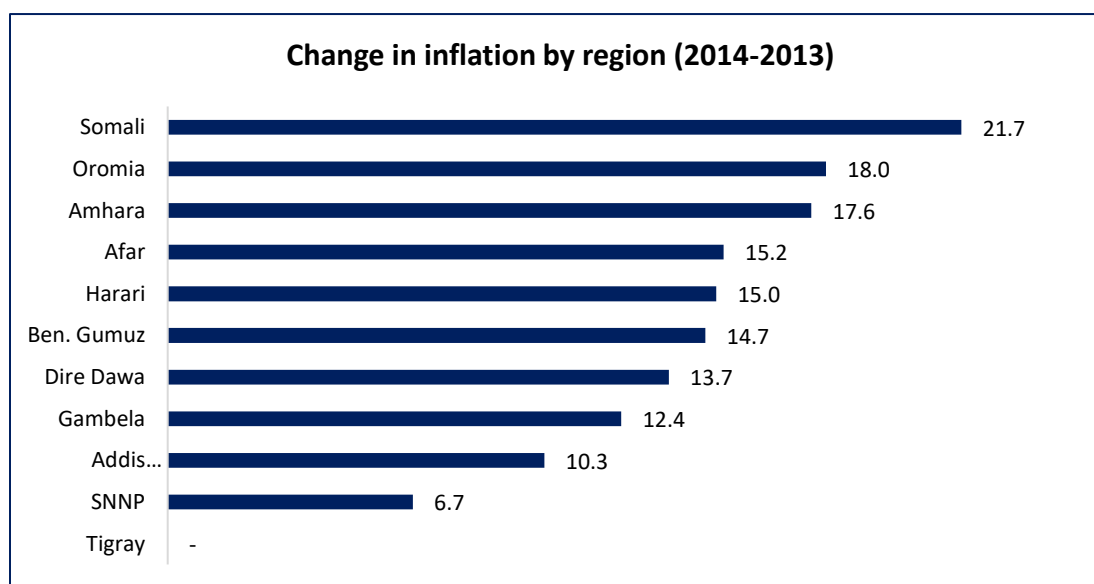


Figure 7: Change in inflation by region (2014-2013)

Comparing the inflation rate between regions, the highest change in inflation (from 2013 to 2014) was recorded in the Somali region (21.7) followed by Oromia (18) and Amhara (17.6) regions. Compared with regions, Addis Ababa has one of the lowest increases in inflation rate (10.3). In all regions, food price inflation contributed highly to the general inflation rate.

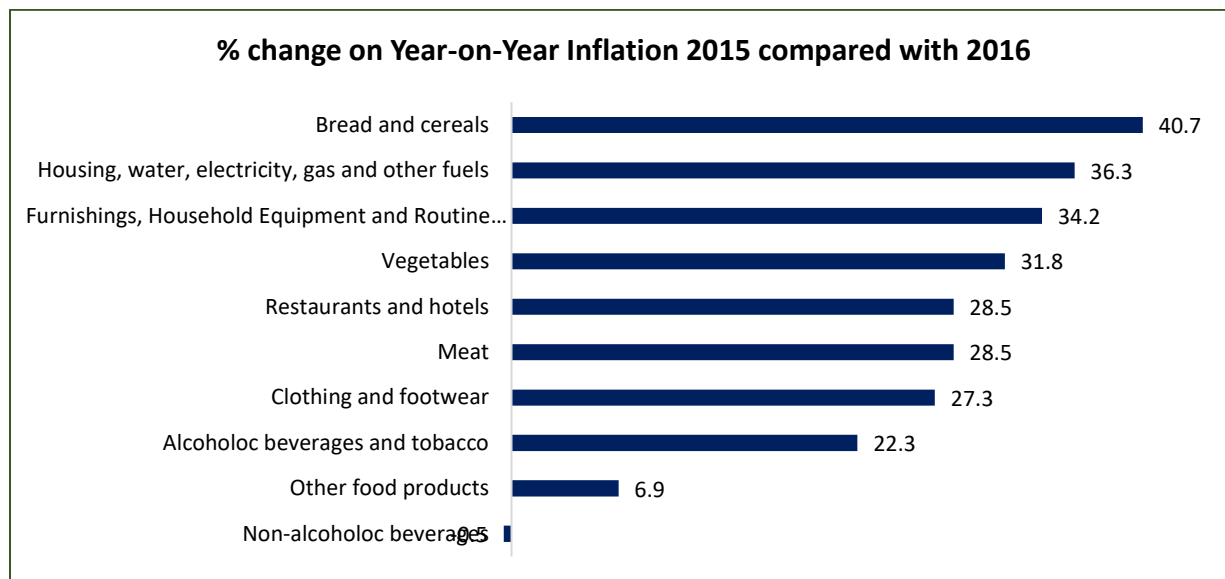


Figure 8: Percentage change in year-on-year inflation rate 2015 vs 2016.

As can be seen from the above figure, bread and cereals are the basket of goods with the highest % change in year-on-year inflation, followed by housing, water, electricity, gas, and other fuels (36.3), and housing equipment (34.2). Vegetables, restaurants and hotels, and meat also underwent significant increases in price compared to the previous year

1.6 Investment to GDP ratio is going down.

High inflation hurts private finance mobilization and discourages investment in the country. In the fiscal year 2014, new investment spending accounted for only 25% of GDP, down from 28% the year before. In addition, public investment has decreased more than private investment. State enterprise investment has also decreased because of restrictions on their ability to borrow (especially in the form of non-concessional debt) because of policies that limit overall debt accumulation. In the long run, this will exacerbate the burden on employment creation and poverty alleviation. As indicated in the HGER, macro-financial and structural reforms taken since 2012 have had limited success in reducing the rate of inflation. Along with the reasons mentioned above that explain the increase in the inflation rate, the chronic foreign currency shortage also contributes to the rise in inflation – mostly with imported items (both food and non-food inflation).

Private domestic and international investment either slightly decreased or mostly remained steady (relative to the GDP). If they are not reversed, declining investment rates will eventually result in declining growth rates. A decline in investment rates towards the mid-20s or below (in percent of GDP) would imply long-term growth remaining at rates of just 5–6% assuming similar capital formation-to-output ratios from recent trends that Ethiopia experienced in the five years leading up to 2019 at record growth rates of 8%–10%.

Table 1: Trends in investment from 2011 to 2014

	Data in billion Birrs				Share of investment in GDP			
	2011	2012	2013	2014	2011	2012	2013	2014
Total Investment	948.9	1032	1216.6	1560.3	35.30%	30.60%	28%	25.30%
public investment	288	319	351	251	10.70%	9.50%	8.10%	4.10%
Federal government	174.9	204.2	235.4	129.4	6.50%	6.10%	5.40%	2.10%
State Enterprise	113	114.8	115.9	121.6	4.20%	3.40%	2.70%	2%
Private investment	660.9	713	865.3	1309.3	24.60%	21.10%	19.90%	21.30%
Foreign private investment	84.6	76.4	155.7	161.7	3.10%	2.30%	3.60%	2.60%
Domestic private investment	576.3	636.6	709.6	1147.6	21.40%	18.90%	16.30%	18.60%

In 2014, the Ethiopian Investment Agency (EIA) and Regional Investment Offices licensed a total of 112 projects which commenced operations with a total capital of Birr 2.2 billion. The number of projects and investment capital declined by 85.7% and 93.6%, respectively, compared to 785 projects with a total capital of ETB 34 billion in the preceding year. All the investments in 2014 were private, of which 67 projects (59.8%) were domestic with a capital of ETB 862 million. From the 2013 projects, 752 (95%) were domestically owned, with a budget of ETB 31 billion. The government's initiative for public-private partnerships (PPP) and privatization advocacy has contributed to the dominance of private investment¹⁸.

The government's privatization policy encouraged the private sector to engage in investment. Additionally, the government's reform and economic diversification strategies support the private sector investment schemes. Ethiopia's fiscal travails have been particularly severe over the last two years as a series of shocks (COVID, conflict, and drought) called for exceptional spending measures while also slowing revenue growth. This has greatly diminished public investment spending.

1.7 Chronic forex shortage

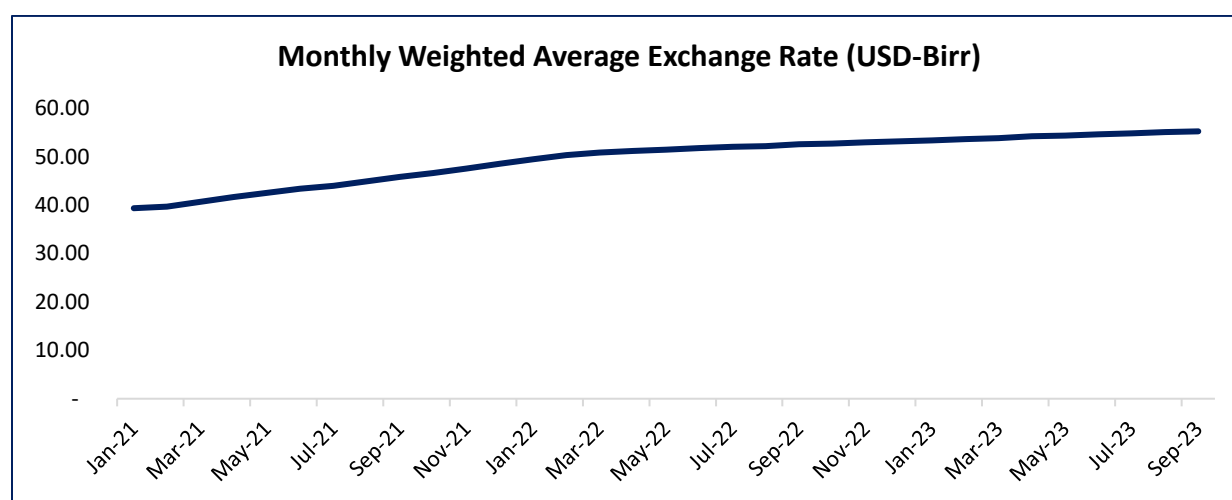
With its heavy reliance on the import of goods and services, Ethiopia finds itself in a precarious foreign currency reserve situation. At the beginning of 2014, the foreign currency reserves of the country stood at USD 3.2 billion, covering only 2 months of import bills and importers have attested waiting up to two years to get forex which is forcing them to find alternative means of acquiring foreign currency. There is recent news that cement factories and soft drink companies have reduced or stopped production because they are not able to import the necessary raw materials. Ethiopia has continued to maintain a managed float exchange rate regime to ensure external competitiveness and as such, the Birr was allowed to depreciate by 24.5% in nominal terms against the US Dollar during 2014, while the real effective exchange rate depreciated by 36.5%.

The two-year-long conflict in the country and global price increases, combined with stagnating exports and poor FDI performance have all contributed to the depletion of the country's foreign currency

¹⁸ National Bank Annual Report 2014

reserve¹⁹. Additionally, COVID-19, which has reduced tourism, remittances, and FDI has also impacted the foreign currency reserve negatively²⁰. This was followed by pressure from the international community and delays in development assistance which further exacerbated the forex shortage. The problem was compounded by increases in the price of major import commodities such as fuel, fertilizer, wheat, and metal in the global market. Furthermore, the domino effect of the Ukraine war also contributed to the shortage.

There has been a lot of discussion around the foreign currency problem, with some experts suggesting that floating the currency could be a solution. However, there is no clear decision on whether to float or manage the currency, and both options come with their own set of pros and cons. On the one hand, floating the currency could lead to higher levels of inflation, while managing the currency may result in inefficiencies in how foreign currency is distributed among users.



Source: Own computation based on NBE data

Figure 9: Monthly weighted average exchange rate (USD-ETB)

As per the above chart, the forex rate (calculated in terms of the weighted monthly average exchange rate between USD and ETB) has been increasing for the past two and a half years. However, in the past year (2015), the change in the monthly weighted average exchange rate has decreased significantly relative to the previous year (2014). While there was an average 3% increase in 2014, this has now decreased significantly to an average percentage change of less than 1%.

During the acute foreign currency shortage, in addition to the strict foreign currency management, the Ministry of Finance ordered the NBE to stop approving letters of credit (LC) for 38 selected import items that were labeled as "luxury" products. As a result, commercial banks ceased allocating foreign currency for the importation of these 38 items for an indefinite period. The directive was expected to improve domestic production and import substitution and the government of Ethiopia was expecting to save close to USD 100 million per year from the measure²¹. However, this move may have consequences for other

¹⁹ NBE 2014 Annual Report

²⁰ UNICEF Ethiopia, 2020-2021 National Budget Brief

²¹ Balancing competing priorities in the era of Covid-19-Ethiopia, Budget Brief 2013

sectors of the economy by eroding the trust of international investors. When the import ban was applied, the price of the imported commodities escalated either by artificial price incrementation or supply and demand mismatches. Since the import ban made it hard to acquire Dollars, importers were discouraged from importing commodities and this could decrease the availability of imported goods in the domestic market. This can result in shortages and limited consumer choices, particularly for goods that are heavily reliant on imports. The import ban could also significantly affect businesses that rely on imported inputs or raw materials. Industries that heavily depend on imports may experience disruptions in their supply chains, leading to reduced production, job losses, and potential business closures.

In addition to the foreign currency reserve situation, Ethiopia's balance of payments was underperforming with a deficit of USD 2.14 billion in 2014 compared to a surplus of USD 298.7 million in 2013, according to the NBE annual report²². This was attributed to factors such as the conflict in the country, a widening current account deficit, and declining net inflows of aid, grants, loans, and other types of financial assistance. The current account deficit is mainly due to a large merchandise trade deficit. Moreover, the COVID-19 pandemic, high inflation, and foreign exchange shortage worsened the negative current account.²³

1.8 Widening negative trade balance and BoP deficit.

The balance of payments and GDP are interconnected economic indicators that reflect the overall health and performance of an economy. The balance of payments is a systematic record of all international economic transactions, visible and invisible, of a country during a given fiscal year. The balance of payments is closely related to exchange rates. Changes in exchange rates can influence the competitiveness of a country's exports and imports, which, in turn, affects the trade balance and overall GDP. For countries with surplus production, a depreciation in the currency can make exports more competitive and imports relatively more expensive, potentially improving the trade balance and boosting GDP. Conversely, an appreciation in the currency can have the opposite effect. It is doubtful that the government's devaluation of the Birr will lead to an increase in exports. This is because such a measure can only be effective if there is a surplus of production on the supply side compared to the demand in both the domestic and international markets²⁴.

It is important to note that the effect of the balance of payments on GDP is not always straightforward and can be influenced by various factors such as domestic economic policies, global economic conditions, and the specific structural characteristics of an economy. Additionally, GDP itself can also influence the balance of payments, as changes in domestic output and income levels can impact imports and exports. According to the NBE, the Birr has depreciated by 19% in the fiscal year 2014²⁵. The devaluation will stress importers by increasing the cost of imports, which will raise the price of goods and services domestically. For a country such as Ethiopia which is heavily dependent on imports and has a weak import substitution

²² NBE 2013 Annual Report

²³ Ethiopia Current Account Balance | Moody's Analytics (economy.com)

²⁴ <https://nbebank.com/wp-content/uploads/pdf/directives/bankingbusiness/Cash-Withdrawal-Limit.pdf>

²⁵ The effects of currency devaluation on Ethiopia's major export commodities: The case of coffee and khat: Evidence from the vector error correction model and the Johansen co-integration test-March 2023

capacity, it can only result in higher inflation. The large jump in key global commodity prices including edible oils, fertilizers, fuel, and freight rates has significantly contributed to the foreign currency shortage.

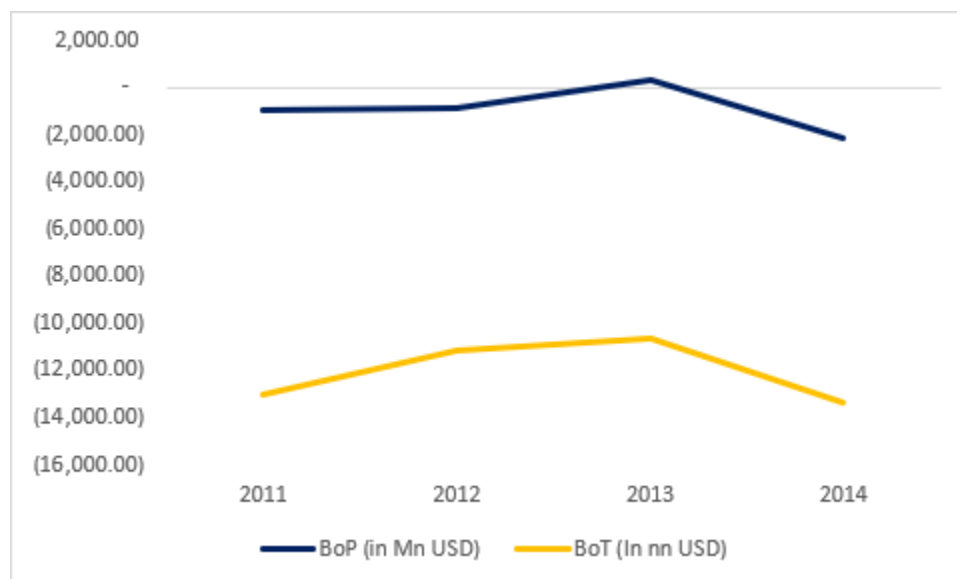


Figure 10: Trends of external trade performance.

Declining investment and stagnant exports have affected the GDP through a widening negative trade balance and BoP deficit. Ethiopia's balance of payment was underperforming with a deficit of USD 2.14 billion in 2014 compared to a surplus of USD 298.7 million in 2013, according to the NBE annual report. The current account deficit is mainly due to a large merchandise trade deficit which has widened from 10 billion in 2013 to 14 billion in 2014. Four items i.e coffee, gold, flower, and chat account for 70% of the export value during 2014. Consumer goods accounted for 42.1% of the total import bill while capital goods accounted for 16.8% (22% decline from previous year).

The Balance of Payment (BoP) deficit may suggest that the country is facing challenges in attracting foreign investment or securing external financing. This limitation can hinder the country's ability to finance important investments such as infrastructure development and technological advancements. Additionally, this situation may make it difficult for the country to meet its external debt obligations. A negative BoP can also put pressure on the exchange rate and cause the domestic currency to depreciate against other currencies. This depreciation can have an impact on imports and exports, particularly for countries with limited production capacity, which could further worsen the trade imbalance.

1.9 Increased finance going to private sector but still more demanded.

The Ethiopian financial sector mainly consists of commercial banks (CBs), microfinance institutions (MFIs), development banks, and insurance companies. Capital goods financing companies (CGFCs) and payment system issuers have also started playing an important role in providing finance. At the end of June 2014, the number of banks reached 30, insurance companies 18, and MFIs 43. CBs disbursed ETB 427.9 billion in new loans during the 2014 fiscal year (43% attributable to state-owned banks). Commercial banks'

outstanding loans reached ETB 1.6 trillion (94% of the total outstanding loan)²⁶. The demand for finance and its supply in Ethiopia is unmatched. The Ethiopian economy has faced both internal and external political and economic shocks, which are causing a periodic deterioration in the liquidity situation.

Total outstanding loans are rising at a decreasing rate. Outstanding loans have been increasing for the past five years. However, the growth rate of outstanding loans has been diminishing for the past four years from 80% in 2012 to 22% in 2015. With the new directive from the National Bank of Ethiopia, the growth rate will only reach a maximum of 14% in 2016. This is expected to further restrict available finance that is already in shortage.

The share of private sector lending is increasing but is concentrated. 86% of the new loans in 2015 were provided by the private sector – which is a 23% increase from the share of the previous year. This is in line with the HGER plan to increase private sector engagement in the economy, which was also reflected in the Ten-Year Development Plan. However, it can also be explained by the government's establishment of the Liability Asset Management Corporation (LAMC). According to the Ministry of Finance²⁷, State Owned Enterprises (SOEs) hold 780 billion ETB (\$19.5 billion) in debt. 20 to 100 % of this debt has been transferred to the LAMC to address the debt distress of the SOEs. The transfer of this debt from the CBE to the LAMC has resulted in a change in the private sector's dominant share of outstanding loans.

Beyond the shortage of loanable funds, the distribution of outstanding loans is also concentrated around commercial bank clients i.e., 94% of the total outstanding loans go to 6% of the total number of borrowers²⁸. According to the World Bank Ease of Doing Business Report, 2020, Ethiopia is ranked 168th out of 190 countries in ease of getting credit. The 20% mandatory treasury bill proclamation by the government further exacerbates the credit crunch of financial institutions to MSMEs. Moreover, the recent liquidity crunch reduced the lending capacity and profitability of commercial banks, high-interest

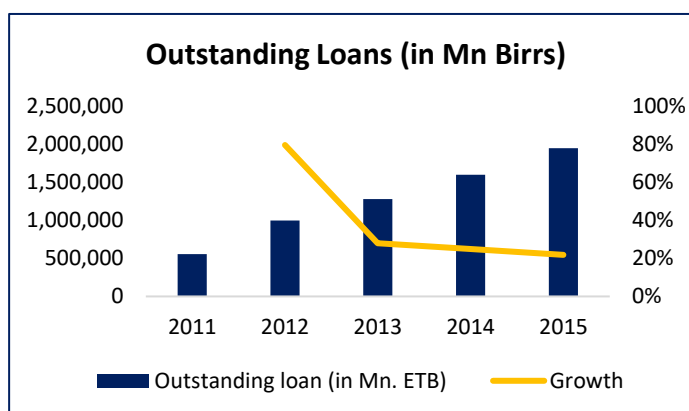


Figure 11: Outstanding Loans (in Mn Birrs) (2011 to 2015)

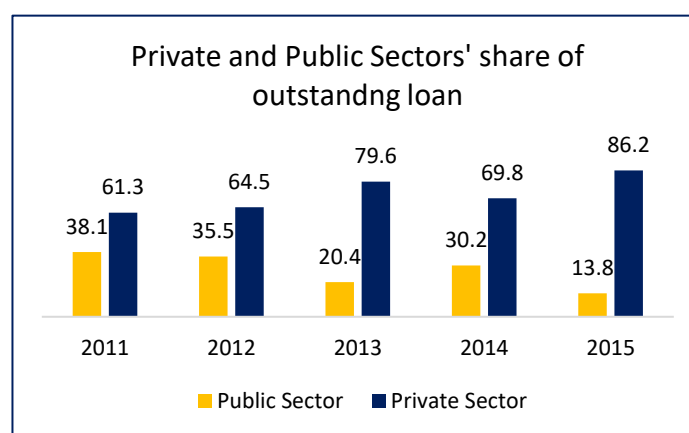


Figure 12: Share of Private and Public Sectors' Outstanding Loan

²⁶ National Bank of Ethiopia, 2021/2022 Annual Report

²⁷ <https://www.mofed.gov.et/blog/overview-liability-asset-management-corporation-lamc/>

²⁸ A Demand-Side Diagnostic Study of MSMEs conducted by the BRIDGES program

rates, and borrowing costs for borrowers, and delayed or suspended payments to suppliers and contractors, which discouraged investors and investment, especially in the private sector²⁹.

There are new players in the financial sector in 2015. Telebirr was introduced about two years ago and has already reached a 34.3 million subscriber base with a total transaction value of 679.2 billion (this is a 22.6-fold increase on the 30.3 billion Birrs value of just a year ago). In August 2023, a new foreign mobile money operator, Safaricom's M-PESA mobile financial service, went live. M-PESA has been able to reach 1.2 million subscribers and make 45.7 billion Birrs worth of transactions within six months of its launch.

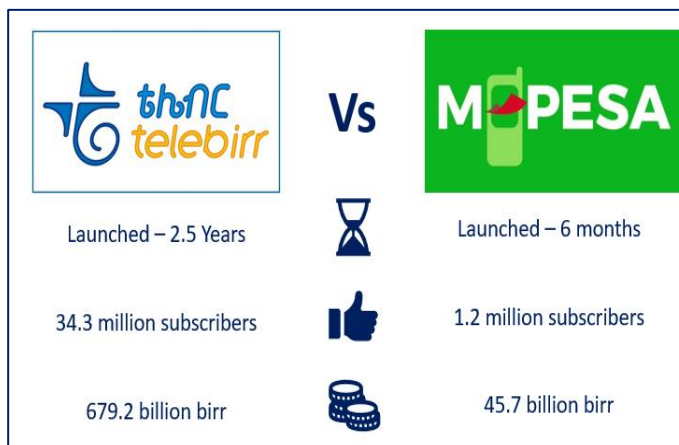


Figure 13: Current Status of New Mobile Money Providers

There are new players in the financial sector in 2015. The introduction of a foreign mobile money (M-Pesa) operator also took place. Tele birr was introduced about two years ago has reached 34.3 million subscriber bases with a total transaction value of 679.2 billion birr that was boosted 22.6 folds in contrast to 30.3 billion birr, a year ago. In August 2023, Safaricom's M-PESA mobile financial service went live. Within six months since launch, M-PESA was able to reach 1.2 million subscribers making 45.7-billion-birr worth of transactions.

1.10 The new monetary proclamation

A combined impact of supply-side factors, cost-push factors, and expansionary fiscal/monetary policies contributed to the recent surge in Ethiopia's inflation rate³⁰. Currently, in addition to the different reforms and regulations, the government is following a contractionary monetary policy aimed mainly at controlling high-rate inflation.

The Ethiopian year-on-year inflation rate reached 29.3% in 2015. The NBE intends to decrease the inflation rate to below 20% by the middle of this year. To achieve this goal, the NBE has passed different measures, which all contribute to the end goal of a sustainable and stable macroeconomy.

An assessment done by the NBE identified a combination of factors driving inflation. Conflicts in various parts of the country and disruptions in production and distribution of goods and services have all contributed to high inflation. Moreover, international prices for imported fuel and fertilizer have also seen sharp increases. This has led to higher costs for businesses and consumers. Finally, elevated demand as a result of expansionary monetary and fiscal policies has also contributed to inflation by increasing the supply of money in the economy.

²⁹ <https://kflip.info/2023/04/11/ethiopias-banking-sector-grapples-with-historic-liquidity-crisis/>

³⁰ NBE's Monetary Policy Statement, 11 August 2023 - <https://nbebank.com/wp-content/uploads/pdf/news/Press-Release-on-Aug-11-2023en.pdf>

As a result, the NBE decided to take measures aimed at reducing inflation. These are the core decisions:

- The NBE will work towards reducing inflation below 20% by June 2024 and to below 10% by June 2025.
- For this fiscal year 2016, credit growth is to be limited to 14% and all commercial banks will be instructed to limit the growth of their loan books to be consistent with the aggregate credit ceiling.
- The NBE limits advance loans for the government to just one-third of the prior year's level. Also, loans are provided when sufficient treasury bills and bonds cannot be raised in the market.
- The interest rate for emergency lending facilities, which banks utilize when they face liquidity problems, will be increased from 16% to 18%.
- The exchange surrender requirement is also reduced to 50% and the remainder, 10%, and 40% go to the bank and individual accounts, respectively.

The new 14% credit has a positive effect on contracting the vast money supply and stabilizing economic growth. However, it needs to be carefully implemented because it may limit the lending capacity of commercial banks. Reducing credit availability can have negative consequences on the economy, particularly on MSMEs.

- **Reduced lending capacity:** When credit availability is low, banks may have limited funds to lend to businesses and individuals. This can hinder investment, potentially slowing down economic growth. Decreasing credit availability in the bank can make it difficult for businesses to obtain the necessary funds for expansion or operational needs. This can constrain their ability to invest in new projects, purchase equipment, or hire additional employees. It may also impede entrepreneurship and innovation.
- **Impact on small and medium enterprises:** Small and medium-sized enterprises (SMEs) often rely heavily on banks and MFIs financing. Limited credit availability disproportionately affects these businesses, as they may have fewer alternative funding sources compared to larger corporations. This can hinder their ability to expand, create jobs, and contribute to economic development.
- **Increased reliance on informal financing:** In the absence of formal bank credit, individuals and businesses may turn to informal lending sources, such as money lenders or loan sharks, which often charge exorbitant interest rates. This can lead to a cycle of debt and financial vulnerability for borrowers.
- **Slow economic activity:** Decreasing the availability of credit will make it difficult for businesses to access credit, and their growth prospects could be curtailed. This can lead to reduced production, lower employment levels, and decreased consumer spending. As a result, overall economic activity may slow down, potentially leading to a decline in GDP growth.

The reform has the potential to reduce the money supply and lower inflationary pressure in the economy. Increasing the interest rate for emergency lending facilities to commercial banks will make it more expensive for the banks to borrow from the NBE when they face liquidity problems. This will encourage banks to manage their liquidity more prudently and efficiently and avoid excessive lending or risky investments³¹.

³¹ Press release by MoF (monetary policy statement, August 2023)

Banks will also have to diversify their sources of funding and offer more attractive products and services to their customers, creating more competition and innovation among the banks³². Ultimately, this could reduce the money supply and reduce inflationary pressure in the economy, as the banks will pass on the higher cost of borrowing to their customers through higher lending rates³³.

Previously, exporters had to surrender a significant portion of their foreign exchange earnings to the NBE (70%) and their bank (10%), leaving them with only 20% to retain. This has hurt the private sector, particularly the manufacturing industry, as it reduced their competitiveness.

The new reform will allow exporters to retain 40% of their foreign exchange earnings. This will reduce the incentive for importers to turn to the parallel market to acquire foreign exchange, which drives up the prices of imported goods. Additionally, since export-import businesses will have more foreign exchange than before, they will be able to import a wider range of products at a lower transaction cost, which will reduce the market prices of imported goods.

1.11 Ethiopia's financial inclusion journey

Progress in account ownership in Ethiopia has been largely driven by a slow but steady increase in financial institution account ownership³⁴. Despite the growing access to a financial account, the percentage of adults in Ethiopia with an account (46% in 2014), is still lower than the average percentage in Sub-Saharan Africa (55%). The major reason for the higher access to finance rate for most Sub-Saharan countries was the adoption of mobile money. The digital financial service provision in Ethiopia is growing following the issuance of the first mobile money service license to a foreign investor, Safaricom M-Pesa Mobile Financial Service, alongside Ethio telecom's Telebirr mobile money service. Continued progress in access to digital finance will depend on affordable, accessible, and safe Digital Financial Services (DFS) and mobile devices, as well as inclusive and secure verifiable identification systems.

Even though financial accounts and institutions are booming, there is still a significant gender gap in financial inclusion. The major factors contributing to the gap are affordability, accessibility, and lack of documentation. Insufficient funds and distance from service points are also major barriers to financial inclusion. Surprisingly, notwithstanding the expansion of financial institutions, cash is still preferred as a form of payment in Ethiopia. Even though people's saving sources are diversified with family and friends, savings clubs, and financial institutions, total saving rates have declined since 2010. Informal borrowing from friends and family in Ethiopia is still predominant, while there has been a decline in borrowing from financial institutions and saving clubs over the years.

Access to and usage of financial products and services is fundamental to advancing financial inclusion, yet these alone are not enough to improve financial health. Ethiopians face difficulties coming up with emergency funds and resort to family and friends or the sale of assets as a last resort. To improve digital financial health and services that will enhance the well-being of society, it is crucial to enhance financial

³² <https://www.ceicdata.com/en/ethiopia/interest-rates/et-lending-interest-rate>

³³ <https://www.zawya.com/en/economy/africa/ethiopia-hikes-emergency-loan-rate-targets-below-20-inflation-by-mid-2024-wbwiowtx>

³⁴ Assessing progress and priorities: Ethiopia's financial inclusion journey 2011-2022

literacy and digital skills, ensure reliable, accessible, and safe infrastructure, and evaluate the effects of financial policies and regulations.

2. Experience of Small Firms³⁵

2.1 MSMEs are the backbone of job creation in Ethiopia.

According to the Job Creation Commission 2020 Plan of Action, youth unemployment is one of the most pressing challenges the country faces these days. With two million youth set to enter the workforce each year, Ethiopia now faces the risks and opportunities of integrating a rising number of youths into the labor market. The increasing rural-to-urban migration, returnee inflow from the Middle East, and internally displaced persons (IDPs) put a further burden on the need to create jobs and sustain their livelihood. Despite the different initiatives set up by the government and development partners, youth unemployment continues to have adverse effects on the economic performance and social stability of the country.³⁶

Related to the job creation agenda, MSMEs have been deemed to be the backbone of the Ethiopian economy. By creating self-employment opportunities for their members and wage employment for additional workers hired, they are expected to absorb most of the labor force. In emerging markets, SMEs create 7 out of 10 jobs³⁷. Self-employment accounts for 53% of the total employment in Ethiopia. According to the Key Labor Market Indicators of 2014 from the MoLS, there are 2.2 million MSMEs in Ethiopia. Of these, 71% are micro-enterprises, 19% small, and 7% medium. The skewness towards microenterprises shows that most enterprises do not graduate to the next stage. Lack of working premises, access to finance, and market linkage are the three most critical constraints hindering the formation and growth of enterprises in Ethiopia. According to the latest World Bank Ease of Doing Business report³⁸, Ethiopia is ranked 168th out of 190 countries in the world in starting a business.

According to the World Bank, MSMEs account for many businesses worldwide and are important contributors to job creation and global economic development. They represent about 90% of businesses and more than 50% of employment worldwide. Formal MSMEs contribute up to 40% of GDP in emerging economies. These numbers are significantly higher when informal enterprises are included. The World Bank estimates 600 million jobs will be needed by 2023 to absorb the growing global workforce, which makes MSME development a high priority for many governments around the world. The International Finance Corporation (IFC) estimates that 65 million firms, or 40% of formal MSMEs in developing countries

³⁵ This section discusses the findings from a quantitative survey (First Consult undertook a survey of 312 micro and small firms in manufacturing and service sector in Addis Ababa, Adama, Hawassa and Dire Dawa) and in-depth interviews involving micro and small firms. It also includes insights from key informants. Among others, it explores the impact of inflation, of the limited foreign currency availability, and financing accessibility on the operation of firms, along with the strategies they are employing to manage and endure these challenges. It also offers an insight into firms' prospective economic expectations. All results and analyses presented pertain to the fiscal year 2015 unless indicated otherwise.

³⁶ Assessing progress and priorities: Ethiopia's Financial inclusion journey 2011-2022

³⁷ National Employment Policy and Strategy of Ethiopia, November 2009

³⁸ <https://www.un.org/en/observances/micro-small-medium-businesses-day>

have an unmet financing need of \$5.2 trillion every year, which is equivalent to 1.4 times the current level of global MSME lending³⁹.

Despite the difficulties, MSMEs continue to be the backbone of job creation in Ethiopia. Youth unemployment is one of the most pressing challenges the country faces these days. With two million youth set to enter the workforce each year, Ethiopia now faces the risks and opportunities of integrating a rising number of youths into the labor market. The increasing rural-to-urban migration, returnee inflow from the Middle East, and internally displaced persons (IDPs) put a further burden on the need to create jobs and sustain their livelihood. Despite the different initiatives set up by the government and development partners, youth unemployment continues to have adverse effects on the economic performance and social stability of the country.

By creating self-employment opportunities for their members and wage employment for additional workers hired, MSMEs are expected to absorb most of the labor force. In emerging markets, MSMEs create 7 out of 10 jobs. Self-employment accounts for 53% of the total employment in Ethiopia. According to the Key Labor Market Indicators of July 2022 from the MoLS, there are 2.2 million MSMEs in Ethiopia. Of these, 71% are micro-enterprises, 19% small, and 7% medium. The skewness towards microenterprises shows that most enterprises do not graduate to the next stage. Comparing the number of MSMEs with peer countries, Ghana has an almost equal number of MSMEs (2.1 million)⁴⁰, but there is a huge difference with Kenya that have 7.4 million MSMEs⁴¹. Compared

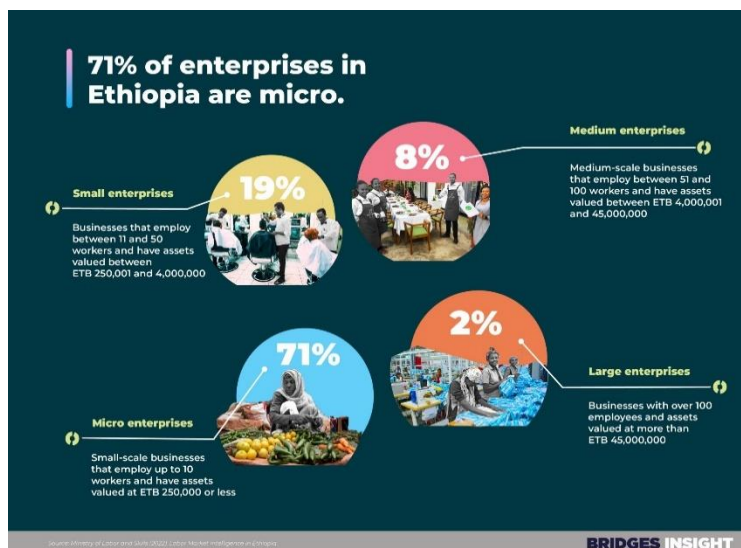


Figure 14: Size of Enterprises in Ethiopia

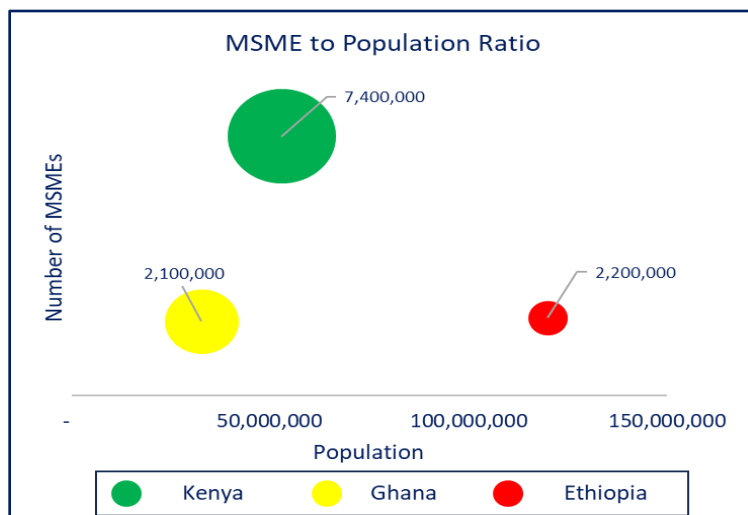


Figure 15: MSME to Population Ratio in Ethiopia and Peer Countries

³⁹ Financing gap for micro, small and medium enterprises (MSMEs) in Ethiopia (A demand-side diagnostic study)

⁴⁰ Ghana SME Sector Report 2023, by Strategy and Research Department of the GCB Bank

⁴¹ UNDP MSEA MSME Recovery and Resilience Report (2021)

with their population, Kenya has the lowest population to MSME ratio (7 people per MSME), followed by Ghana (16 people per MSME), and Ethiopia (55 people per MSME).

Even though micro and small businesses make up the majority of MSMEs (71% and 21%, respectively), their access to loans is far more limited than medium and large-sized businesses. Only 6% micro and 2% of small businesses have accessed finance. On the other hand, 35% of large enterprises have accessed finance due to the low risk and the considerable collateral that they can offer. This highlights the need for more accessible financing options for micro and small businesses.

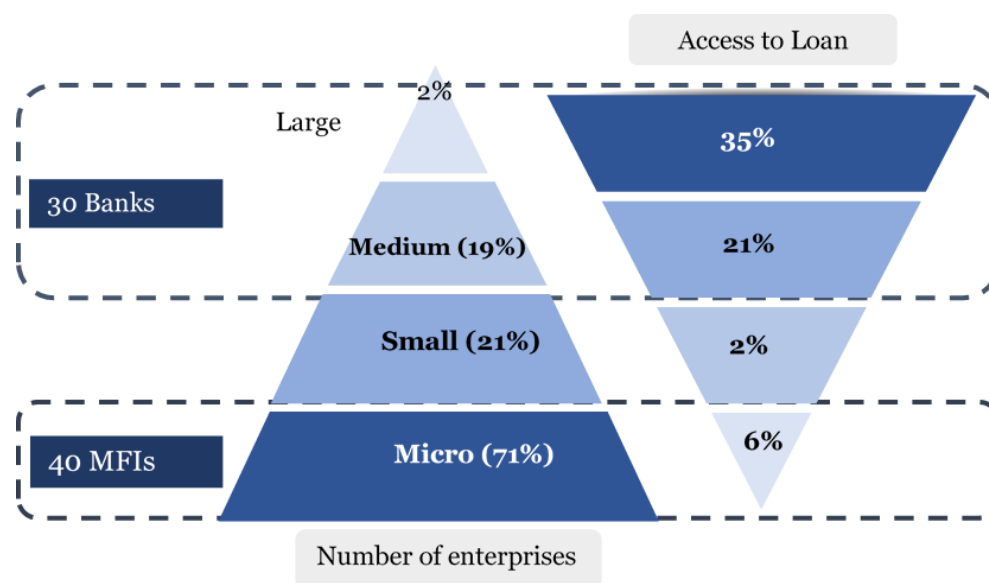


Figure 16: MSME financing in Ethiopia.

2.2 Access to finance

Personal and family savings are the dominant initial and subsequent finance sources for firms; external financing via banks and MFIs remains minimal; banks and MFIs heavily favor real estate as collateral over other forms of security; the preference for real estate, coupled with perceived high-interest rates and a bleak economic outlook, deters firms from seeking loans; firms are generally dissatisfied with the available financing options.

2.2.1 Sources of financing during the establishment

The financial sources leveraged by firms during their establishment phase, across the manufacturing and service sectors, reveal insights into the landscape of entrepreneurial finance. A sizeable majority of firms, constituting approximately 68% in both sectors, primarily utilized the personal savings of founders as their initial source of financing. Funding from family or relatives emerged as the second most prevalent source for 15.8% of firms. External financing through bank and MFI loans played a minimal role, especially within the service sector.

	Total (n=310)	Manufacturing (n=99)	Service (n=211)
Personal savings of founder(s)	68.10%	67.70%	68.20%
Family/relatives	15.80%	15.20%	16.10%
Bank loan	6.50%	7.10%	6.20%
MFI loan	5.50%	8.10%	4.30%
Equb	1.30%	0.00%	1.90%
Moneylenders	0.60%	0.00%	0.90%
Friends	0.60%	0.00%	0.90%

Figure 17: Sources of finance at the time of establishment.

The heavy reliance on personal and familial financing sources may suggest potential barriers to accessing formal external sources, possibly resulting in financial difficulties for firms during their early startup phases.

*Equb refers to a traditional rotating savings and credit association that is commonly practiced in Ethiopia. It is a form of informal financial system where a group of individuals pool their savings together and take turns receiving a lump sum of money from the collective fund. Each member contributes a fixed amount of money on a regular basis, and during each cycle, one member is chosen to receive the entire pooled amount. The rotation continues until each member has received their share. Equb is often used as a means of saving money, accessing capital for various purposes, and fostering a sense of community and cooperation among participants.

2.2.2 Financing needs and access to bank/MFI loans.

The survey explored the financing needs of firms in 2015. Overall, 59.5% of all firms sought additional financing. Manufacturing firms had a marginally greater demand for extra financing in contrast to their service counterparts. While 64.3% of manufacturing firms pursued additional financing, this was true for 57.3% of service firms.

Diverse drivers propelled firms' demand for additional financing across both sectors. The need for working capital emerged as a predominant factor, especially within the manufacturing sector, where 48.4% of firms identified it as a crucial factor behind their financing needs compared to 38.0% in the service sector.

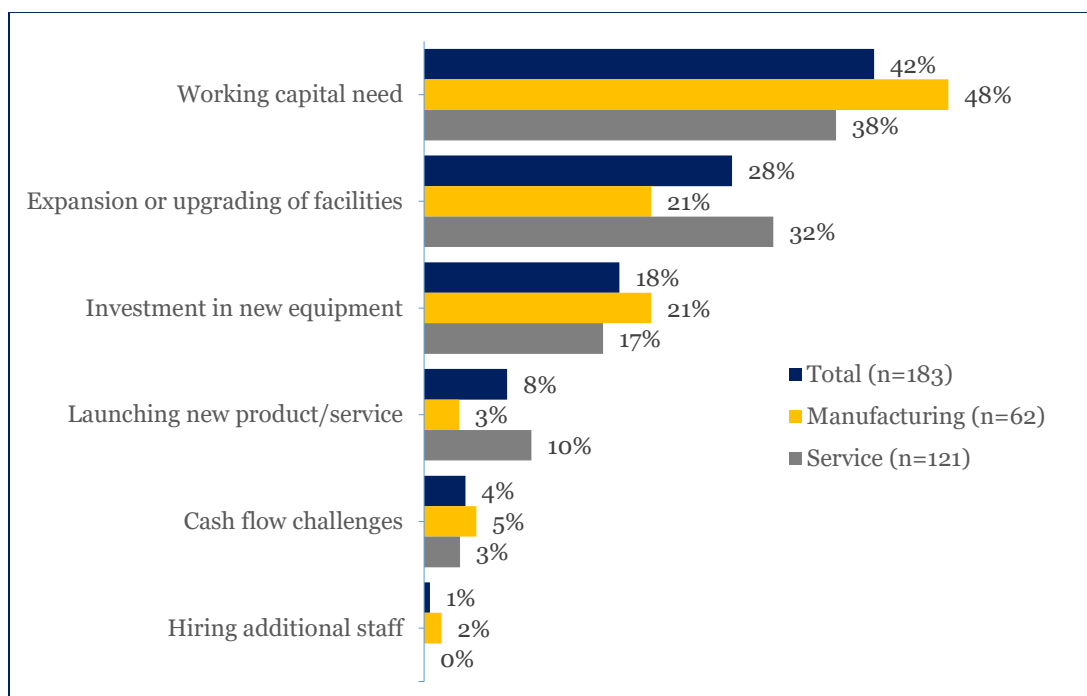


Figure 18: Main drivers for additional financing.

The need to expand, which entails opening new branches, and the upgrade of facilities was another pivotal factor driving the financing needs of firms, particularly within the service sector, where 32.2% identified it as a primary reason for seeking additional finance, as opposed to 21% of manufacturing firms. On the other hand, manufacturing and service firms exhibited a similar inclination towards the expansion of facilities and investment in new equipment, each accounting for 21%.

An exploration into how firms addressed their financing needs revealed that only 51.4% sought external financing from banks or MFIs. Interestingly, a pronounced difference was observed between manufacturing and service firms in their inclination to finance their needs through loan applications. In the manufacturing sector, a substantial 59.0% of firms submitted loan applications to banks or MFIs, whereas the majority of service firms, 56.7%, refrained from doing so.

Nearly a third of the firms (31.8%) that submitted their applications secured loans from Banks or MFIs. While 34.1% of firms encountered rejections, another 34.1% were waiting for a decision. Across manufacturing and service sectors, a balanced landscape of loan application outcomes was observed.

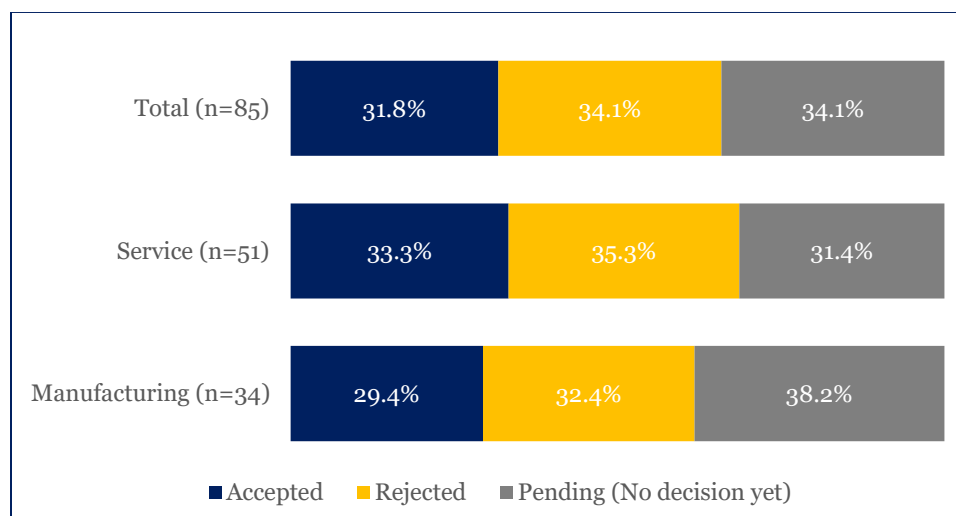


Figure 19: Outcome of firms' loan applications.

Insufficient collateral was the primary reason for the rejection of loan applications, accounting for the majority of all rejections (58.6%), with a slightly higher prevalence in the service sector (61.1%) compared to manufacturing (54.5%). Some key informants concurred that the collateral requirement disproportionately impacted small firms with limited assets. This could indicate a tangible gap in the financial market, wherein traditional lending practices may inadvertently marginalize smaller firms that lack the requisite collateral. Failure to meet the eligibility criteria of banks and MFIs was also a significant obstacle, accounting for 20.7% of loan rejections. The liquidity constraint in banks and MFIs, which led to another 20.7% of rejections, further complicated small firms' access to financing. Even when firms met all requirements and provided adequate collateral, it did not always guarantee loan approval.

"We recently applied for a credit service, but our application was put on hold due to a shortage of funds in the bank. Although it wasn't declined outright, we were asked to wait because of a monetary shortfall. Currently, there is a shortage of money in the banks, making it more difficult to obtain a loan than it used to be."

Service firm – Food.

"Firstly, they state that there is no money left. Secondly, even after we follow the proper procedures, they inform us that there is no money available this year and claim not to be offering loans."

Manufacturing firm – Concrete block producer

Some industry experts described the liquidity constraint as a systemic problem, tied to the political and economic context, rather than merely a short-term issue. Moreover, the severity of the constraint varied significantly across financial institutions, impacting some banks severely while others experienced less pressure. With tight liquidity, banks and MFIs often tend to avail available funds to long-standing clients and deny loans to micro and small firms that they deem riskier.

To complicate the situation, the NBE took measures to limit the amount of capital being lent by commercial banks in a bid to bring down inflation. The new rule, which came into force in 2016, restricts banks' yearly credit expansion to 14%. This limit will likely have a trickle-down effect on MFIs, as they

partially rely on bank loans for funding. Given these circumstances, this restriction might perpetuate and exacerbate the struggles of firms to access external finance from banks and MFIs.

Generally, the readings on waiting times for responses to loan applications were not favorable. Firms encountered long delays in receiving feedback on their loan applications, with an average turnaround of 66 days. Slightly more than a third of firms (35.7%) experienced a waiting period of one to three months, while a further 19.6% waited three to six months to hear back about their applications. These prolonged timeframes could be detrimental in a challenging economic context, where timely access to credit can be pivotal for the survival and growth of firms. Only a few firms witnessed rapid processing times. Specifically, 16.1% of firms received a response within a relatively short duration of one to seven days, while a mere 10.7% were informed within eight to fifteen days.

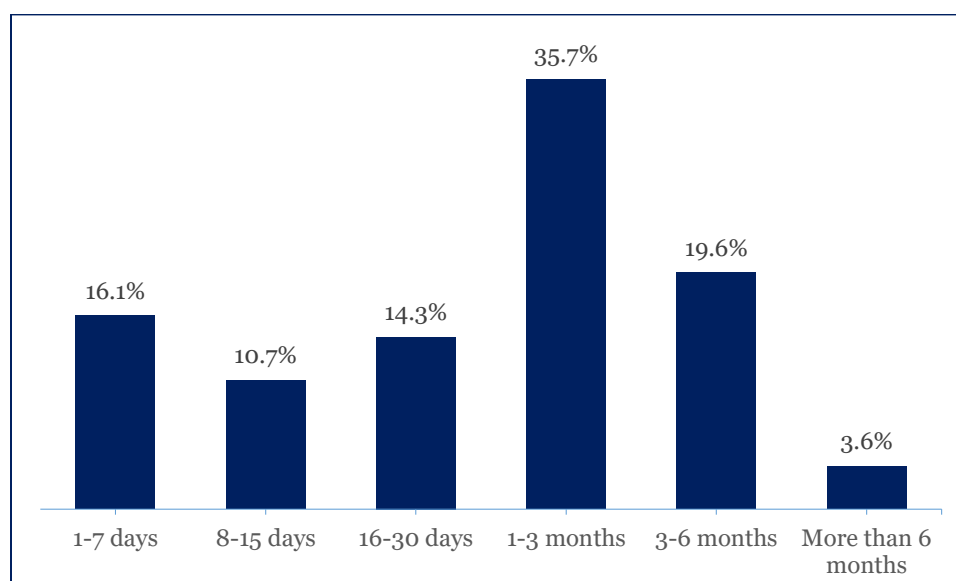


Figure 20: Turnaround time on loan applications.

Predominantly, firms had to present real estate properties as collateral. A high number of 92.6% of firms succeeded in securing loans from banks or MFIs using this form of security. This could potentially point towards a systemic inclination or a regulatory framework that heavily favors real estate as a secure and preferred form of collateral. Vehicles and equipment/machinery were significantly less utilized as collateral, with both being used by only 14.8% of the firms.

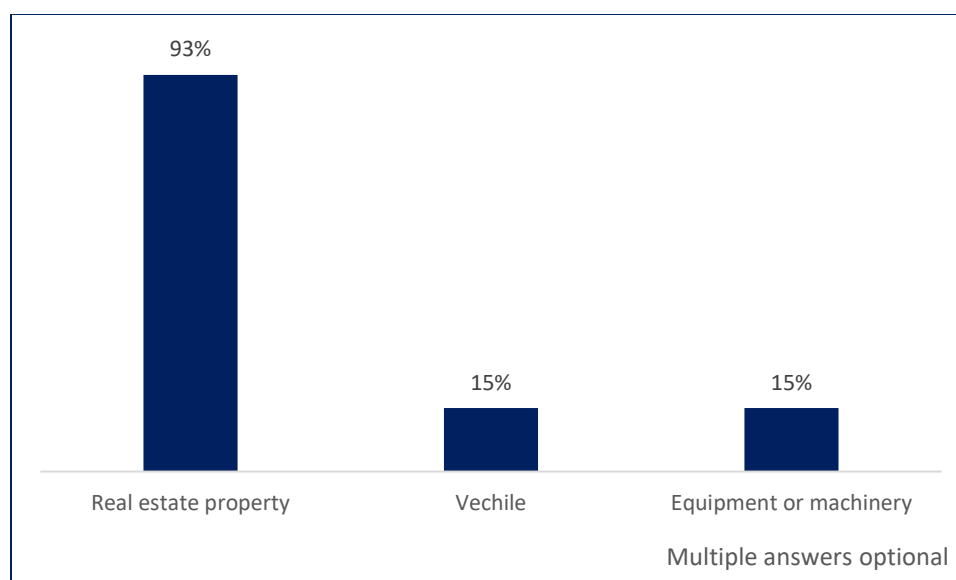


Figure 21: Collateral requirements.

Multiple factors influenced the decisions of firms that refrained from seeking financial assistance from banks or MFIs. Predominantly, the difficulty in meeting collateral requirements emerged as an obstacle, deterring many firms in both the manufacturing and service sectors from pursuing bank or MFI loans. Specifically, 31.2% of firms identified this as a reason. It was particularly pronounced in the service sector, at 33.8%, compared to the manufacturing sector, at 24%.

	Total (n=93)	Manufacturing (n=25)	Service (n=68)
Difficulty in meeting collateral requirements	31.20%	24.00%	33.80%
High-interest rates and related fees	19.40%	12.00%	22.10%
Bleak future economic outlook	17.20%	24.00%	14.70%
Concerns about repayment capabilities	16.10%	16.00%	16.20%
Preference for alternative financing sources	14.00%	12.00%	14.70%
Unfavorable repayment period	10.80%	12.00%	10.30%
Perceived credit unworthiness	7.50%	12.00%	5.90%
Lack of awareness about available loan options	6.50%	8.00%	5.90%
Already have bank or MFI loan obligations	6.50%	8.00%	5.90%
Previous negative experiences with banks/MFIs	3.20%	8.00%	1.50%
Urgency of financing needs	1.10%	4.00%	0.00%

**** Multiple answers optional

Figure 22: Factors influencing firms' decision not to seek bank or MFI loans.

Concerns related to high-interest rates and associated fees, as well as fears about future economic stability, have surfaced as deterrents amid inflation and foreign currency shortages. While service firms exhibited a pronounced sensitivity to interest rates (22.1%), manufacturing firms demonstrated a heightened apprehension toward future economic outlooks (24.0%). These insights suggest that external macroeconomic variables critically shape firm behavior and attitudes toward financing. Furthermore, the

perceptible anxiety regarding repayment capabilities, shared almost equally among firms in both sectors, hints at an underlying financial vulnerability permeating these firms. In a rare occurrence, a firm chose not to pursue bank or MFI loans due to religious reservations about interest-based lending.

“We started with our own finances and have not taken loans from any institution so far because there are no programs that align with Sharia law. We were able to sustain the business by borrowing from family and individuals, and by taking and extending credit just like any other merchant. We have neither obtained nor sought [bank or MFI loans] so far, as Sharia does not permit it. While interest-free services are emerging, we have not yet explored these options.”

Manufacturing firm – Woodwork

A significant portion of firms that refrained from seeking financial assistance from banks or MFIs (28.7%) did not address their apparent financial needs at all, with 18.2% in the manufacturing sector and a notably higher 30.9% in the service sector. The remaining firms reported a predominant reliance on internal and informal financing mechanisms, especially personal savings and assistance from family and friends. Specifically, 52.3% of firms leveraged personal savings, while a slightly lower percentage, 47.7%, of firms sought financial assistance from family and friends.

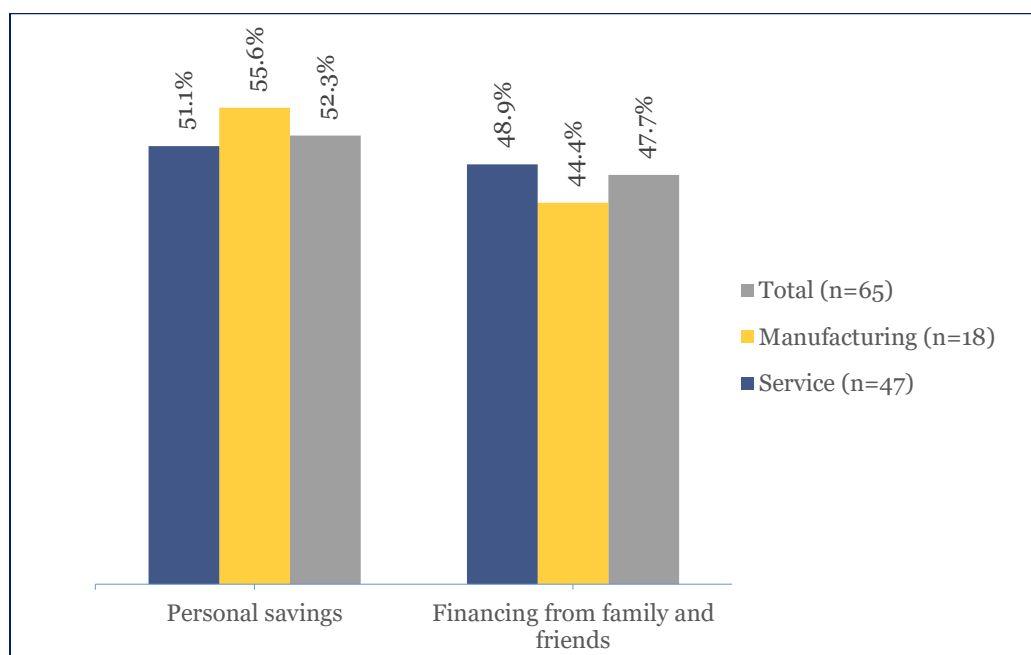


Figure 23: Financing sources for firms that did not seek bank or MFI loan.

2.2.3 Suppliers' credit

Firms predominantly relied on non-credit purchases, with 58% of all firms not engaging in credit purchases. Specifically, 53.5% of manufacturing firms and 60.1% of service firms did not participate in credit purchases. Suppliers, deterred by the economic conditions and risks, were reluctant to offer credit, making it difficult even for long-standing customers to make credit purchases. Inflation strained business relationships, eroding the trust that underpinned informal credit arrangements. Moreover, delayed payments due to cash flow problems, stemming from the challenging economic environment, further

damaged relationships with suppliers. Consequently, suppliers increasingly preferred upfront cash payments, even from established buyers. This shift forced firms to pay upfront for inputs, creating cash flow bottlenecks and intensifying the need for working capital financing.

“Who would sell to you on credit? No one offers credit when you can't even buy an item outright. Back then, due to our rapport and the bulk work we had, suppliers were more cooperative and understanding. They used to extend credit to us.”

Manufacturing firm – Woodwork

Only 6.4% of firms made more than 75% of their purchases on credit, with a negligible difference between the manufacturing and service sectors.

“We make only small purchases on credit. For example, we buy eggs on credit, but we don't have access to credit for high-cost purchases.”

Service firm – Food.

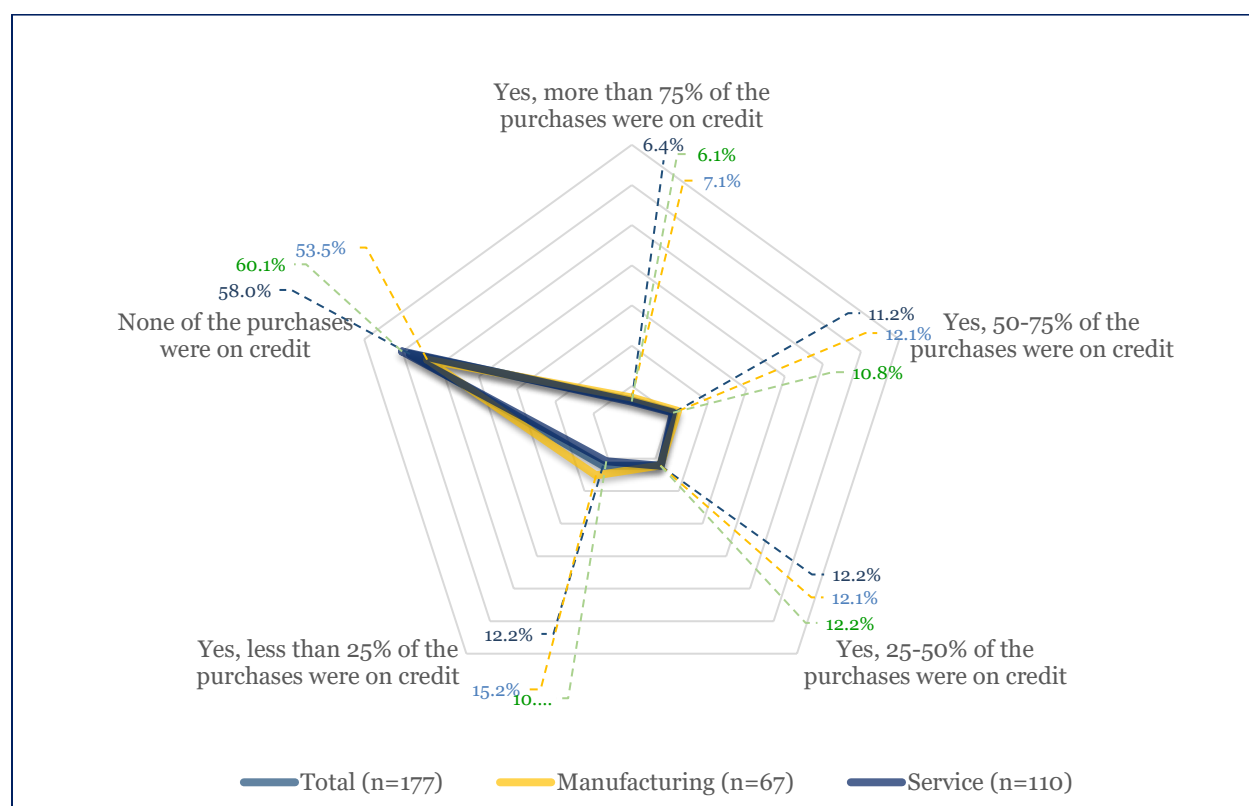


Figure 24: Prevalence of suppliers' credit.

An examination of the average value of credit purchases acquired by firms revealed interesting results. Overall, there was a distinct polarization in the average credit value that firms acquired, with a high proportion obtaining either high (more than Birr 200,000) or low (less than Birr 25,000) suppliers' credit.

A deeper investigation illustrated the differences between the manufacturing and service sectors. Firms in the manufacturing sector appeared to have better access to higher-value credit purchases, with 33.3% of firms accessing credits exceeding Birr 200,000. This might indicate a robust engagement in high-stakes financial activities. Conversely, service firms demonstrated a different pattern, with more pronounced

access to lower-value credits. Slightly more than a third of firms (34.5%) accessed credits below Birr 25,000, while 25.0% accessed credits within the Birr 25,001 to 50,000 range, suggesting smaller-scale transactions. This divergence between manufacturing and service firms could be rooted in the inherent differences in the nature of transactions and capital requirements.

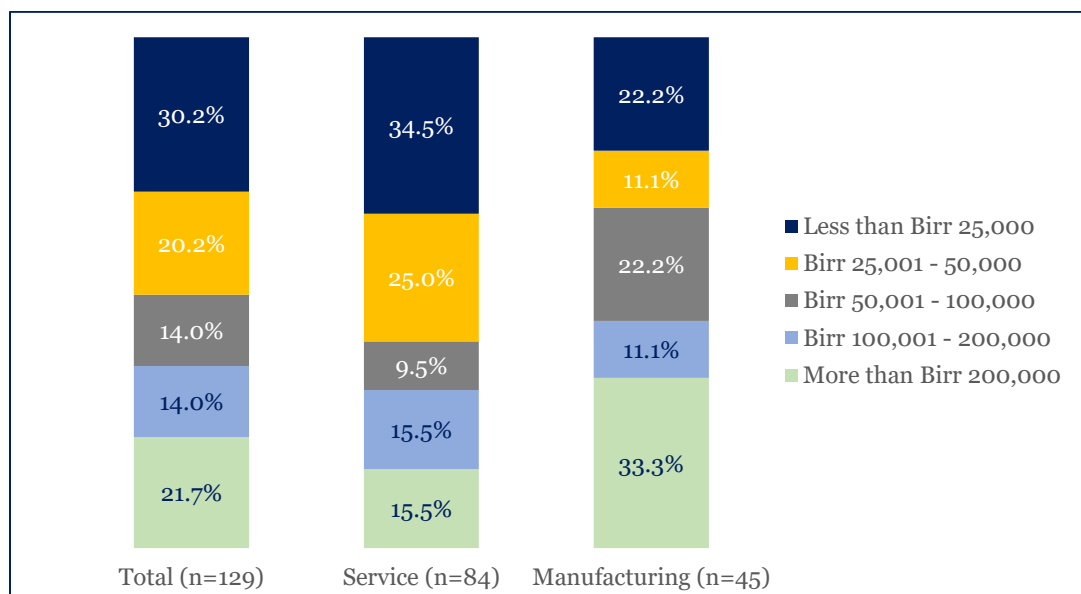


Figure 25: Average value of credit purchases.

A sizable number of firms in both the manufacturing and service sectors had access to extended credit durations, especially those surpassing 30 days. This trend was evident in 37.8% of manufacturing firms and 36.5% of those in the service sector.

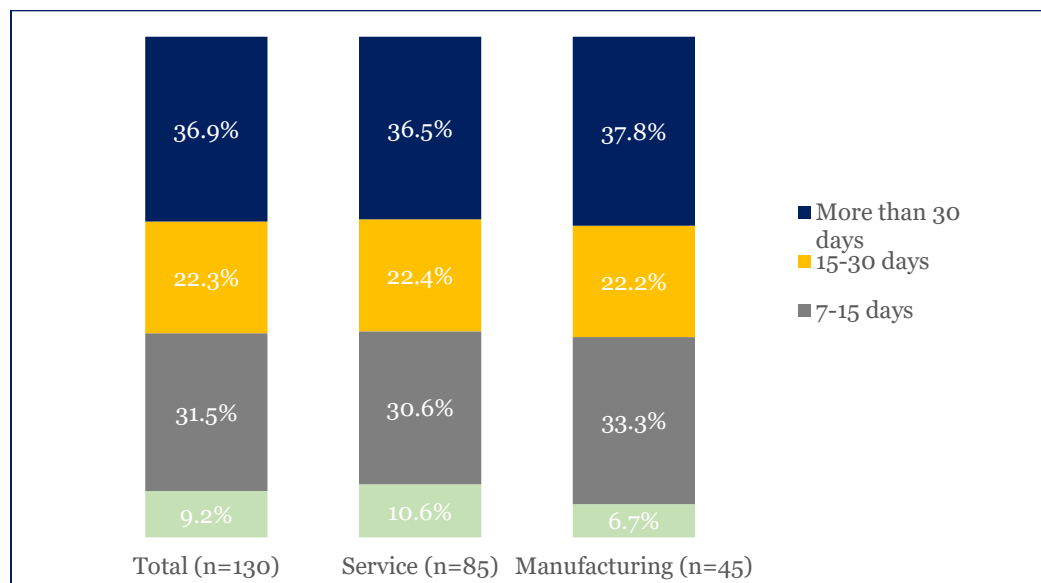


Figure 26: Average length of suppliers' credit.

Compared to 2014, firms across both the manufacturing and service sectors predominantly witnessed a reduction in access to suppliers' credit in 2015. Notably, 57.8% of manufacturing firms and 60.7% of service firms experienced a decline in credit access, ranging from moderate to significant. Less than a quarter of firms in each sector saw an increase in access to suppliers' credit.

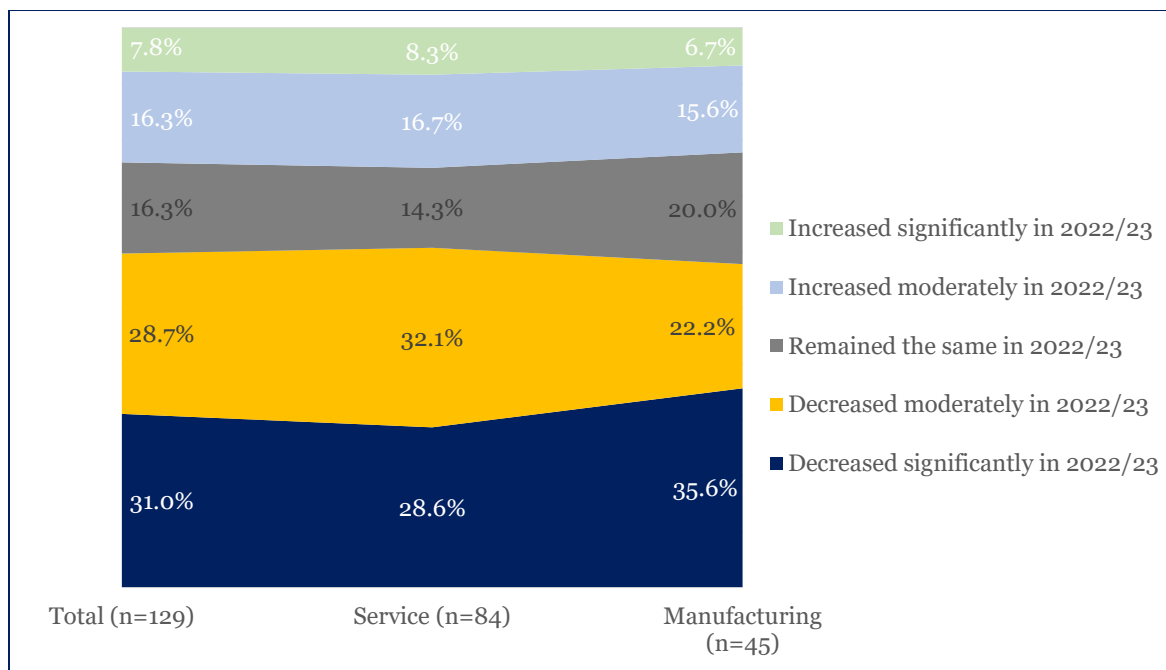


Figure 27: Access to suppliers' credit in 2015 vs. 2014.

2.2.4 Overall perception of financing options available

Cumulatively, 61.6% of respondents expressed moderate to strong dissatisfaction with the financing options available to their firms. Only under a quarter of respondents were satisfied with their financing options. Furthermore, this sentiment was slightly more pronounced within the manufacturing sector, hinting at sector-specific needs that might not be adequately met by the prevailing financial system. The difficulty and rejection firms face when seeking finance from banks and MFIs have proven discouraging. These negative experiences have diminished their propensity to apply for credit from the formal financial sector. This signals a profound concern regarding accessibility, adequacy, and perhaps the terms of available financing options.

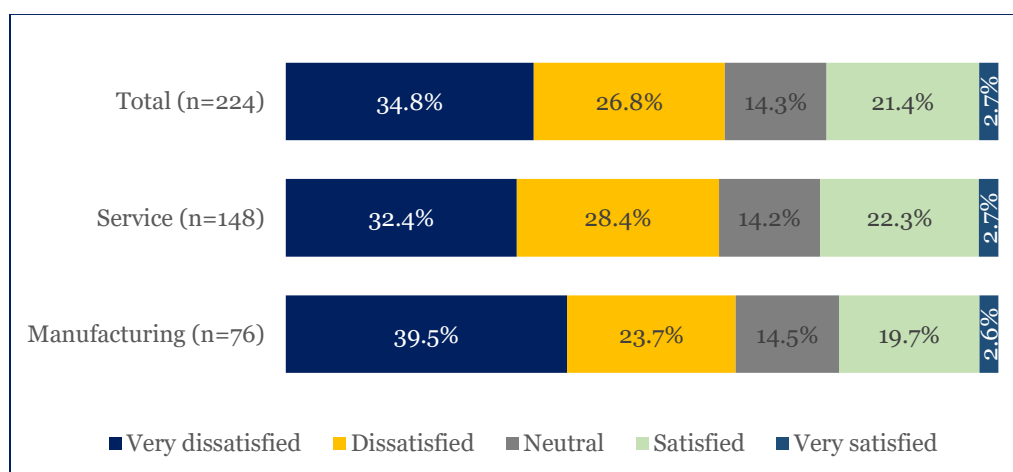


Figure 28: Satisfaction with financing options available.

2.3 Impact of inflation

Most firms perceive inflation as having a moderate to a major negative impact on their operations; the rise in the cost of raw materials, rent, utilities, and labor are significant concerns; raw material and rental costs are identified as crucial inputs; a majority of firms have increased prices to cover rising costs, while others periodically adjust pricing; demand has declined significantly due to inflation for most firms; inflation's influence on product/service quality is minimal for most firms, but it affected quantity for many; firms are coping by passing costs to customers or improving efficiency; employee well-being is affected, with firms taking measures such as salary increments and bonuses; firms are moderately confident about enduring inflation, but a significant number express concern.

2.3.1 Impact on the cost of inputs

The survey assessed the repercussions of inflation on input costs. Nearly 93% of firms reported a rise in the cost of raw materials, with this increase being more prevalent in the manufacturing sector. About 44% of firms experienced higher rental expenses, a trend more pronounced among service sector firms, while 40.7% acknowledged soaring utility costs, a concern evenly distributed across both sectors. Slightly over a third of firms (38.1%) cited an increase in labor costs, which was notably higher in the manufacturing sector. Other input categories, such as transport and logistics, equipment, packaging materials, and outsourced services, also saw varying degrees of price hikes.

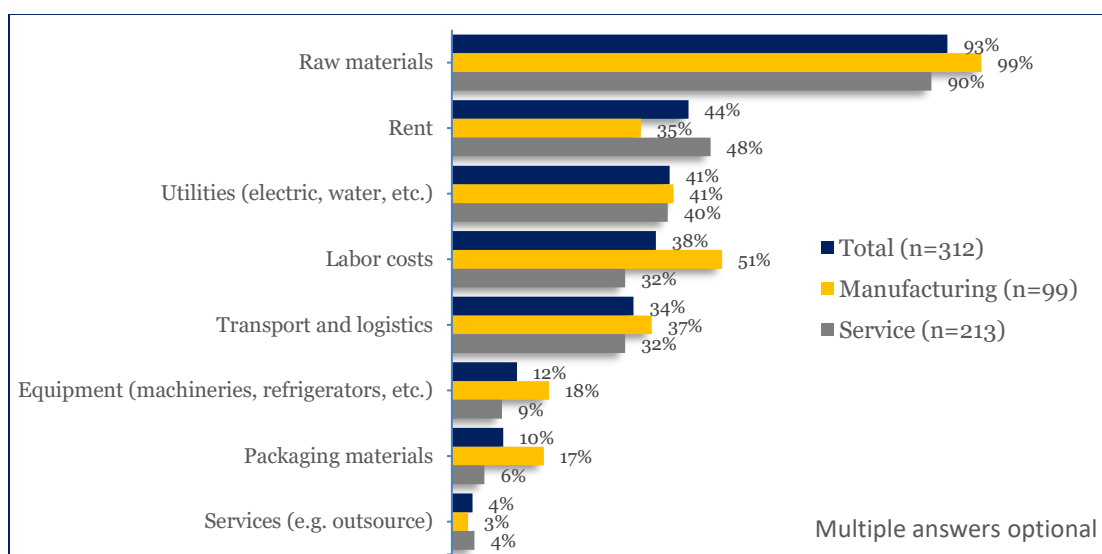


Figure 29: Input categories witnessing increases in costs due to inflation.

“Our biggest challenge is the availability of raw materials. The process of importing raw materials has become much slower than in the past, and it is taking more days than necessary. This has forced us into idleness.”

Manufacturing firm – Garment

2.3.2 Pricing adjustments

Firms adjusted their pricing strategies in response to inflation and higher input costs. The majority (59.6%) increased their prices proportionally to cover costs, a more prevalent strategy in the manufacturing sector (62.6%) than in the service sector (58.2%). This group has reduced their profit margin despite increasing price proportionality to cover costs. Just under a third of firms (30.8%) raised prices above costs to preserve profit margins, a tactic more notable in the manufacturing sector.

	Total (n=312)	Manufacturing (n=99)	Service (n=213)
Increased prices proportionally to cover costs	59.6%	62.6%	58.2%
Increased prices above costs to maintain profit margins	30.8%	35.4%	28.6%
Absorbed some cost increase, but increased prices moderately	25.0%	26.3%	24.4%
Maintained prices despite cost increase	2.9%	1.0%	3.8%

*** Multiple answers optional

Figure 30: Price adjustments in response to inflation and rising input costs.

2.3.3 Impact on consumer demand

Many firms (85.5%) experienced a moderate to significant decline in demand in 2015 due to inflation. The decline was more prevalent in the service sector (89.7%) compared to the manufacturing sector (76.7%). Nearly 10% of firms witnessed stable demand despite price fluctuations.

The evident decline in market demand for a majority of firms, especially in the service sector, underscores the vulnerability of small firms in a challenging economy characterized by inflation and price fluctuations.

The more pronounced decline in demand in the service sector compared to manufacturing might imply a potentially higher sensitivity to price changes among service consumers or a more elastic demand. On the other hand, the manufacturing sector, even if also facing difficulties, has shown more resilience or potential to find opportunities amid the economic difficulties.

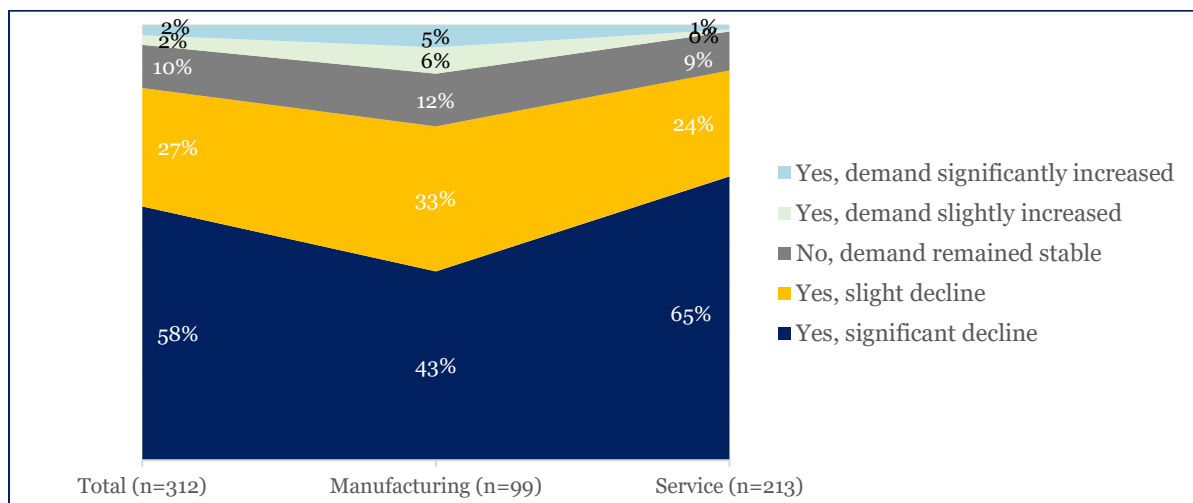


Figure 31: Market demand changes due to price fluctuations/inflation.

The survey explored how the customer base of firms responded to price increments. As shown in Figure 32, a predominant 68.1% of firms indicated that customers, while complaining, continued to purchase after prices were adjusted. This trend was slightly more prevalent in the manufacturing sector, with 71.4% of firms reporting such responses, compared to 66.5% in the service sector. A smaller yet notable 16.9% of firms experienced significant pushback from customers, with the service sector experiencing slightly more resistance (18.2%) than the manufacturing sector (14.3%). Only 15.0% of firms stated that their customers accepted the price increases without resistance, showing a similar level of acceptance across the manufacturing (14.7%) and service (15.3%) sectors.

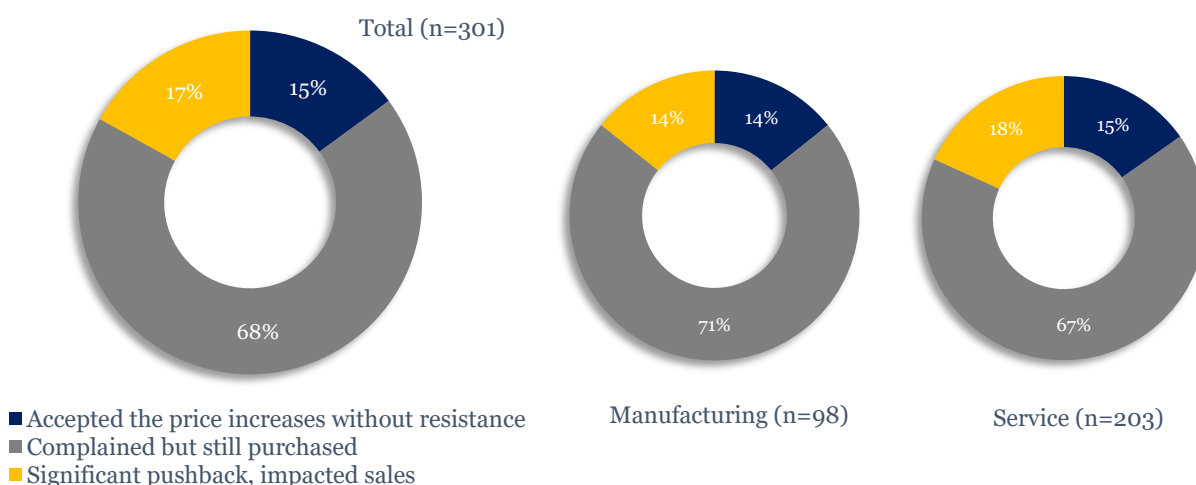


Figure 32: Customer response to price adjustments.

2.3.4 Impacts on quality and quantity of production/service

The impact of inflation on the quality and quantity of products/services was assessed. Inflation had no repercussion on product/service quality for the overwhelming majority (70.1%) of firms, with a similar trend in both manufacturing (68.4%) and service (70.9%) sectors. However, 4.5% of firms did experience a strong hit to their product/service quality.

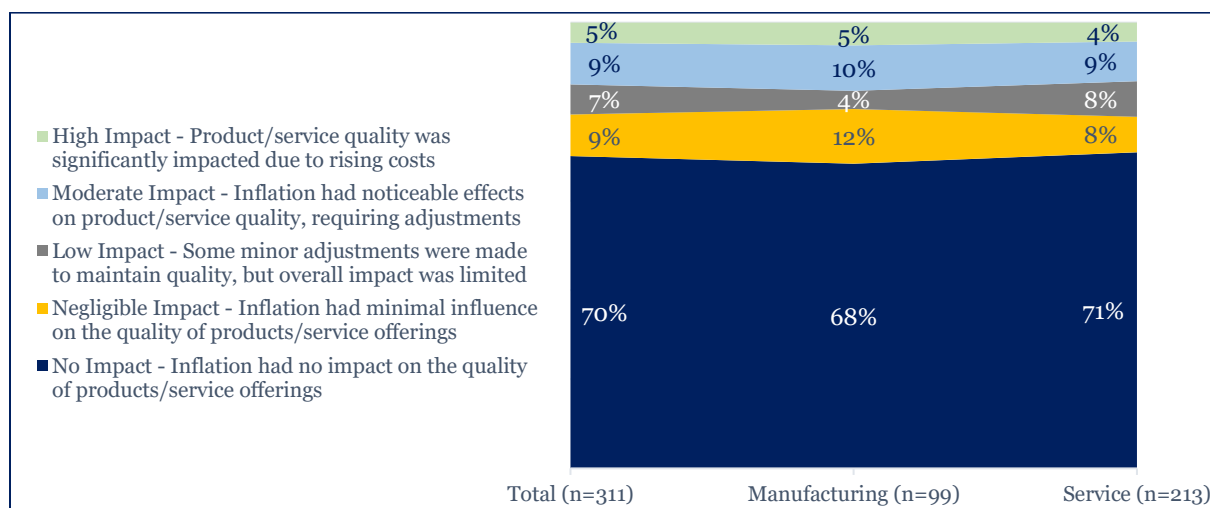


Figure 33: Impact of inflation on the quality of products/services.

In contrast, inflation had a “moderate to high” impact on the quantity of products/services for most firms (57.7%). Just over a third of firms (34.3%) witnessed strong adverse effects, which were more acute in the service sector, affecting 37.1% of firms, as opposed to 28.3% in the manufacturing sector. Only less than a third of firms (31.7%) reported inflation as having “negligible to no impact” on the quantity of products/services produced.

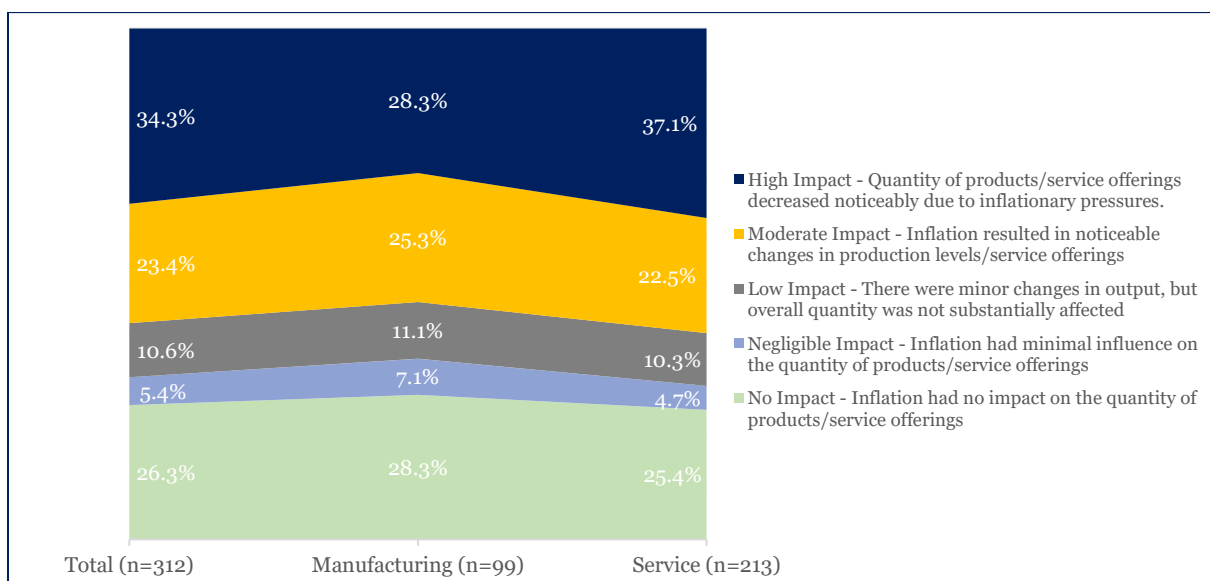


Figure 34: Impact of inflation on quantity of products/service offerings.

The divergence in the consequences of inflation on quality and quantity suggests varied adaptive and mitigative strategies adopted by firms. The high percentage of firms that maintained product/service quality undeterred by inflation points towards a possible prioritization of quality retention to sustain customer satisfaction and loyalty. The fact that manufacturing and service sectors exhibited similar patterns indicates the emphasis on maintaining quality amidst inflationary pressures.

On the contrary, the quantity of products/services provided appears to have been more susceptible to inflationary pressures, especially in the service sector, which might be attributed to the challenges in maintaining output levels amidst rising costs without compromising quality.

2.3.5 Strategies to cope with inflationary pressures.

To cope with the strains of inflation, firms implemented various strategies, revealing insightful patterns across the manufacturing and service sectors. A majority (57.1%) opted to pass on the cost increase to customers without affecting sales, a tactic more prevalent in the service sector (59.2%) than in the manufacturing sector (52.5%). Additionally, 35.9% of firms improved operational efficiency to reduce expenses, with a slightly higher adoption in the manufacturing sector (39.4%) than in the service sector (34.3%). Sourcing alternative suppliers with lower costs was a strategy utilized by 33.0% of firms, notably more in the manufacturing sector (40.4%) than in services (29.6%). Diversification of product/service offerings was adopted by 18.3% of firms, with minimal sectoral variation, while implementing cost-cutting measures was chosen by 17.9% of firms, more pronounced in manufacturing (26.3%) compared to services (14.1%).

	Total (n=312)	Manufacturing (n=99)	Service (n=213)
Passed on the cost increase to customers without changes to product/service	57.1%	52.5%	59.2%
Improved operational efficiency to reduce expenses	35.9%	39.4%	34.3%
Sourced alternative suppliers with lower costs	33.0%	40.4%	29.6%
Diversified product/service offerings	18.3%	20.2%	17.4%
Implemented cost-cutting measures (e.g., reducing staff, downsizing)	17.9%	26.3%	14.1%
Introduced new, higher-priced product/service options	4.8%	7.1%	3.8%

*** Multiple answers optional

Figure 35: Strategies to navigate and thrive amidst inflation-driven challenges.

2.3.7 Overall perception of the impact of inflation

A significant majority of firms (89.4%) perceived that inflation had a moderate to major negative impact on their operations, with 59.6% indicating a major negative impact and 29.8% citing a moderately negative impact. When dissected sector-wise, manufacturing firms appeared slightly more adversely affected by inflation (61.6%) than their service counterparts (58.7%).

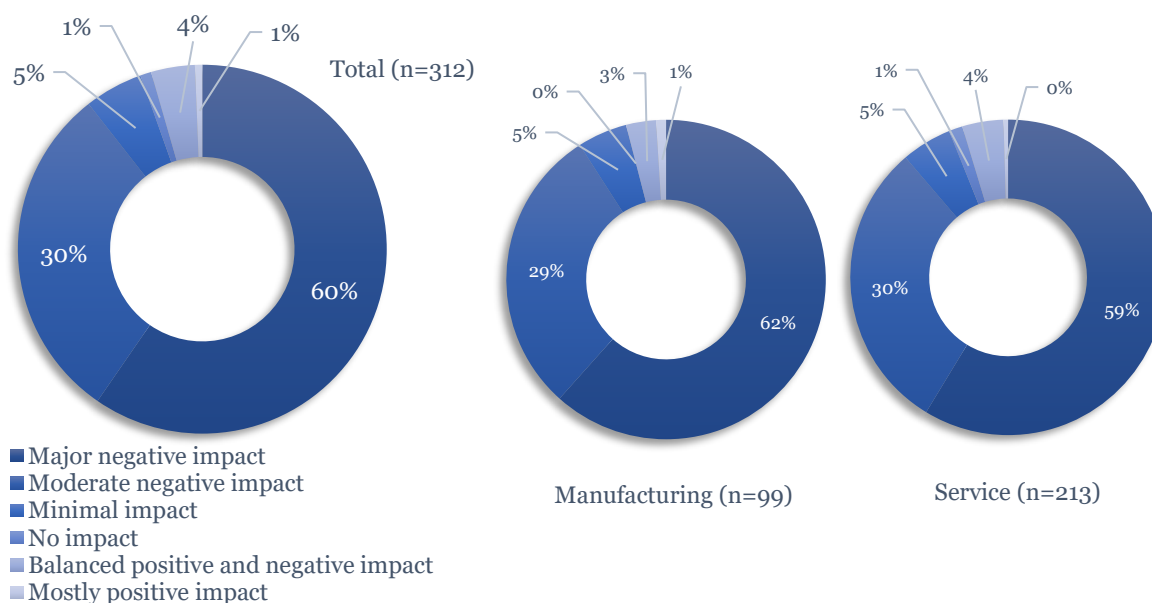


Figure 36: Overall perception of the impact of inflation.

Exploring the discussions with firms about inflation, it also became apparent that a predominant theme is the rapidly escalating costs of key inputs affecting many firms. Raw materials, equipment, wages, and rent were becoming significantly more expensive, making it increasingly difficult to preserve profit margins and manage expenses. Some firms reported input costs doubling or even tripling within a short time. This forced firms to repeatedly revise selling prices upward, which hurt customer retention and sales volumes.

Even though firms took measures to adjust prices, they were unable to raise selling prices in line with soaring input costs because they did not want to risk losing customers or market share to competitors, which squeezed profit margins over time. Instead, some firms resorted to sacrificing quality or variety to contain costs, while others reduced production volumes because they could not compete on price with firms that had greater financial capacity.

“We cannot raise prices at the same rate, because if you do you will only lose customers. You would lose the market competition to competitors with better prices.”

Manufacturing firm – Woodwork

“Higher costs of inputs, transportation, and rent have forced small firms to increase their prices, which in turn reduces consumer demand and profitability.”

Key informant – Professional Association

2.3.8 Business confidence in dealing with inflation.

There was a mixed bag of confidence levels among firms. Interestingly, 45.1% of firms expressed moderate to strong confidence in their ability to endure the consequences of inflation and prosper in the future. Viewed through a sectoral lens, manufacturing firms demonstrated a slightly stronger confidence level compared to service firms. However, a notable percentage of firms exhibited worry, with 25.5% stating they were “not confident” and 10.3% indicating they were “not confident at all”.

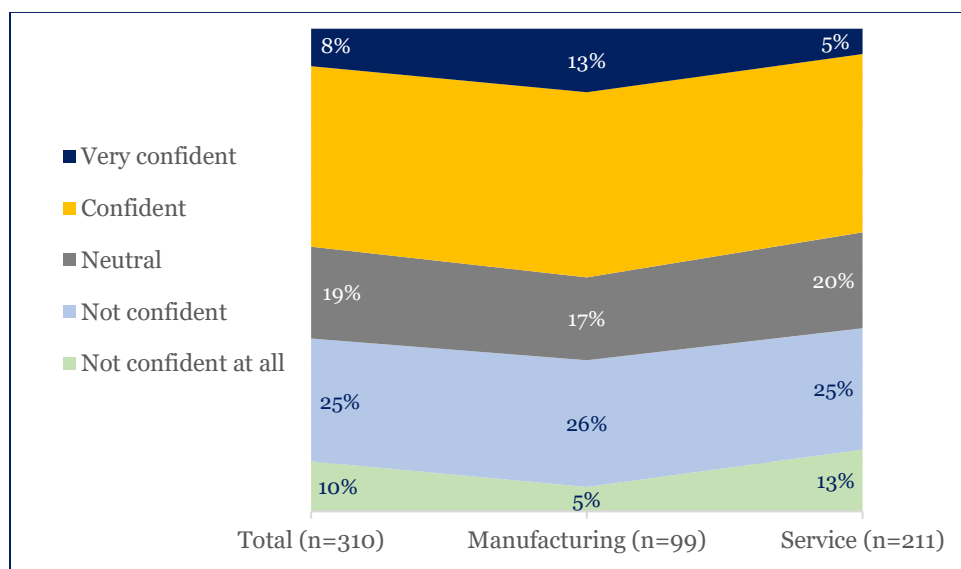


Figure 37: Firms' resilience to inflation and confidence about the future.

2.4 Impact of the foreign currency situation

Half of the firms depend on imported inputs; wholesalers and retailers are major suppliers of these inputs; many firms find their main imported inputs scarce or unavailable locally, often due to forex shortages or government import policies; this unavailability leads to operational consequences such as increased input prices, inability to meet demand, and reduced output; the availability and cost of imported inputs worsened significantly, impinging on demand and production costs; firms responded by passing price increases to customers, cutting costs, and seeking local alternatives.

2.4.1 Reliance on imported inputs⁴²

Overall, 50% of firms reported using imported inputs. However, the manufacturing sector exhibited a greater dependency on imported inputs, with 61.6% of firms confirming usage. This contrasts with the service sector, where only 44.6% of firms reported using imported inputs.

⁴² Imported operational inputs or resources in the context of this report are items obtained from foreign countries to facilitate daily operations. These encompass materials such as raw components, parts, or supplies required for crafting products or delivering services.

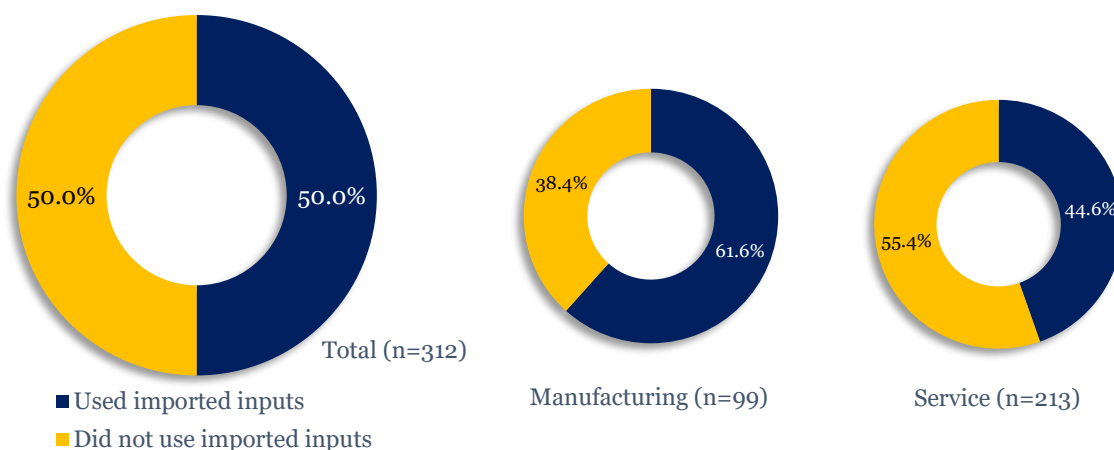


Figure 38: Use of imported inputs for daily operations.

Across all firms, 40.6% relied on imported inputs for over three-quarters of their total input value. Conversely, for 27.1% of firms, imported inputs constituted less than 26% of their total input value.

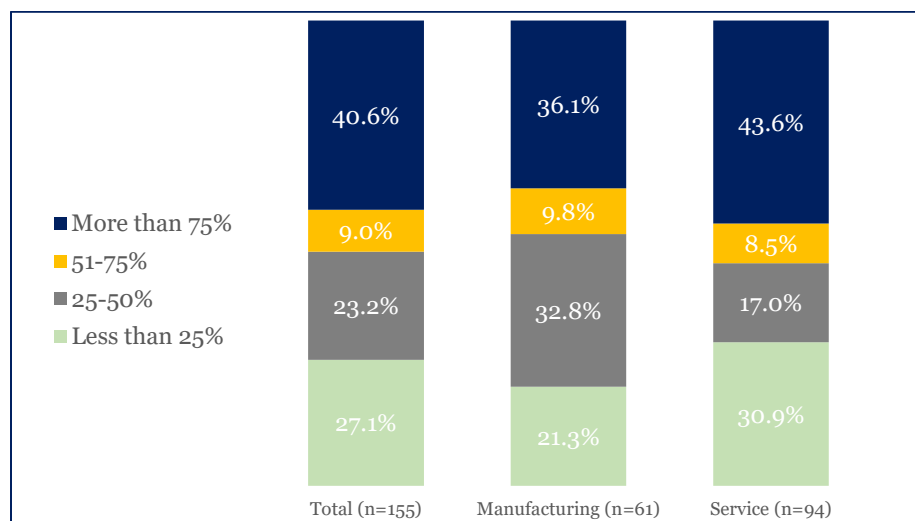


Figure 39: Share (in value) of imported inputs in total inputs utilized in 2015.

2.4.2 Availability and supply challenges for key imported inputs

Firms relied on diverse channels for their imported inputs. Wholesalers directly supplied 62.2% of firms, while retailers furnished 35.3%. Direct importing was the least utilized, with only 7.1% of firms employing it. This option was more prevalent in the manufacturing sector (13.1%) compared to the service sector (3.2%). This implies that these micro and small firms encounter constrictions in directly accessing global supply chains, leading to a dependency on wholesalers and retailers. This situation likely results in higher costs and logistical hurdles, impinging on their operational flexibility, cost-effectiveness, competitiveness, and ultimately their profit margins.

The manufacturing sector demonstrated a more diverse sourcing strategy, with comparable percentages across purchasing from retailers (37.7%) and directly from importers (24.6%). Conversely, the service

sector exhibited a pronounced inclination towards wholesalers (71.6%), indicating a potential preference for or dependency on intermediary sourcing entities.

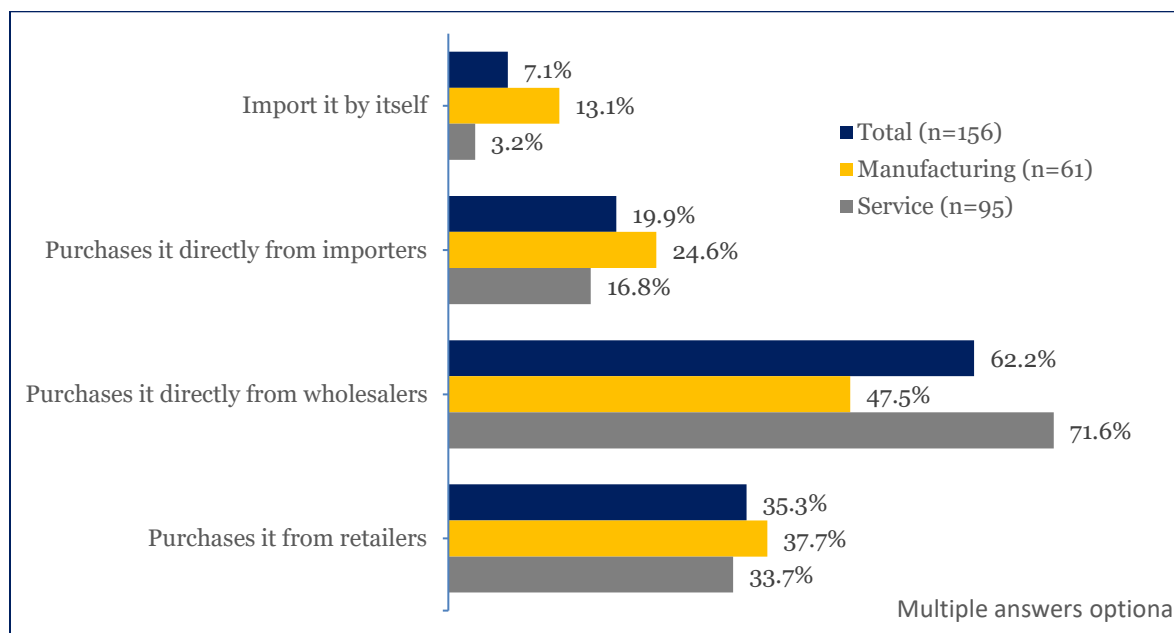


Figure 40: Supply sources for main imported inputs.

For 52.6% of firms, their main imported input was either rarely available or completely unavailable in the local market. This was particularly pronounced in the manufacturing sector (59.0%) in contrast to the service sector (48.4%).

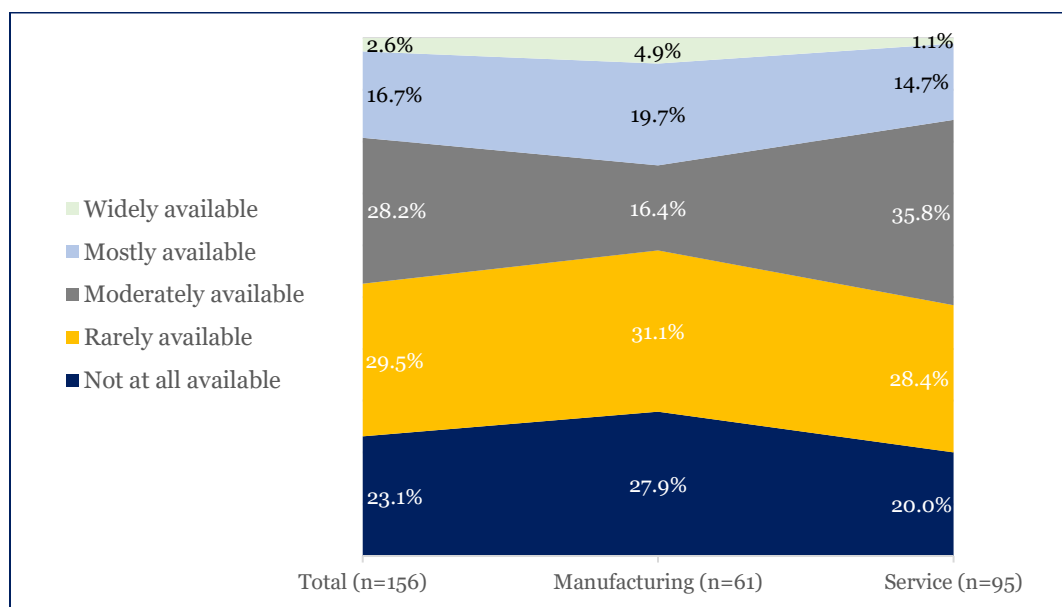


Figure 41: Availability of main imported input in the local market.

The majority of firms (61.0%) attributed the unavailability or rarity of their main imported input in the local market to a shortage of foreign currency. This was particularly emphasized in the manufacturing sector (72.2%) as opposed to the service sector (52.2%). Furthermore, 29.3% of firms attributed the scarcity to the government's prioritization of essential imports, while 18.3% pointed to limited access to credit/finance to import inputs. Delays in foreign currency allocation or approval processes were also cited by 14.6% of firms.

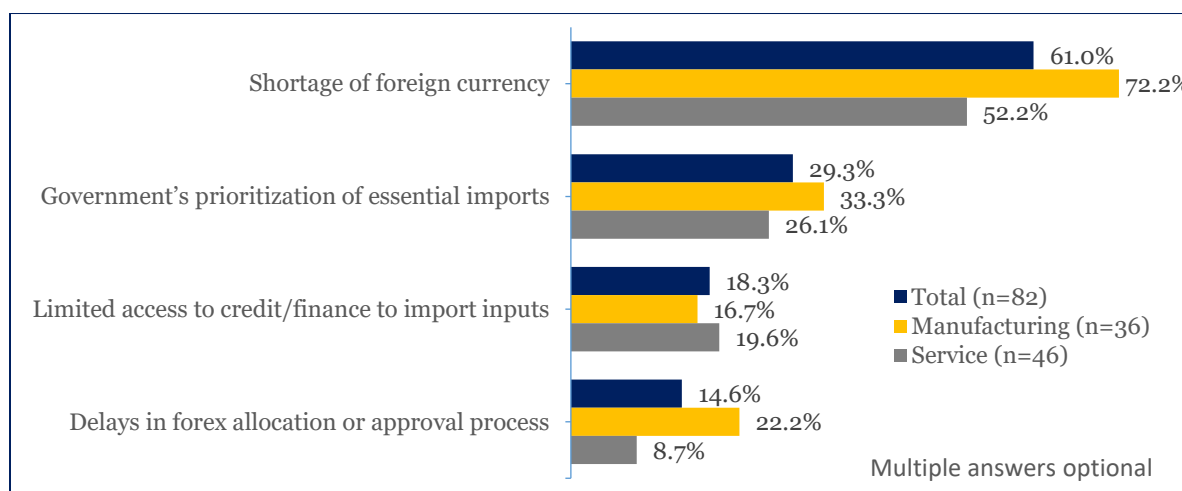


Figure 42: Factors contributing to rare availability of main imported input.

2.4.3 Impact of foreign currency unavailability on operations and performance

A high number of firms experienced multiple operational impacts due to the unavailability or rare availability of main imported inputs, including increased input prices (59.8%), an inability to meet customer orders/demand (56.1%), and reduced output or under-utilization of production capacity (53.7%). Manufacturing firms particularly faced a stark impact on their output and production capacity (69.4%) and market competitiveness (44.4%). Conversely, service firms highlighted a notable impact on financial performance and profitability (32.6%).

	Total (n=82)	Manufacturing (n=36)	Service (n=46)
Increased input price	59.8%	61.1%	58.7%
Inability to meet customers' orders/demand	56.1%	55.6%	56.5%
Reduced output/under-utilization of production capacity	53.7%	69.4%	41.3%
Loss of market competitiveness	32.9%	44.4%	23.9%
Poor financial performance and profitability	28.0%	22.2%	32.6%
Scale back labor force/lay-offs	6.1%	8.3%	4.3%
Loss of quality in product/service	6.1%	5.6%	6.5%
Did not impact the firm as it was replaced with local input	4.9%	8.3%	2.2%
Reduction in supplier credit	3.7%	2.8%	4.3%

*** Multiple answers optional

Figure 43: Impact of scarcity in main imported input on firms' operations.

2.4.4 Magnitude of cost increases for imported inputs.

A large majority of firms (86.6%) reported that the availability of the main imported input worsened in 2015 compared to 2014. This was particularly pronounced in the manufacturing sector, with 69.4% indicating the worsening situation.

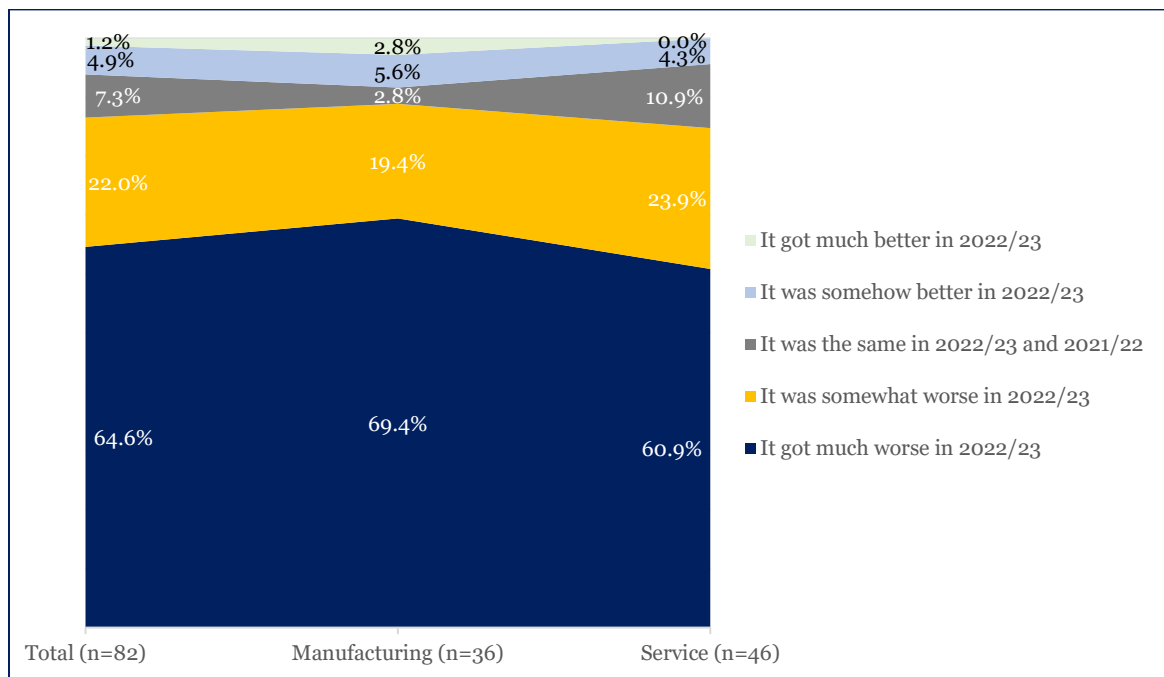


Figure 44: Availability of main imported input in 2015 vs. 2014.

Firms experienced a large rise in the cost of their main imported input. Nearly 92% witnessed an increase of 26% or more, while 63.6% reported a surge of 51% or more. Particularly noteworthy is that 23.7% of firms encountered a cost increase of more than 100%. In the manufacturing sector, this was more pronounced, with 27.9% reporting a cost escalation exceeding 100%, in contrast to 21.1% within the service sector.

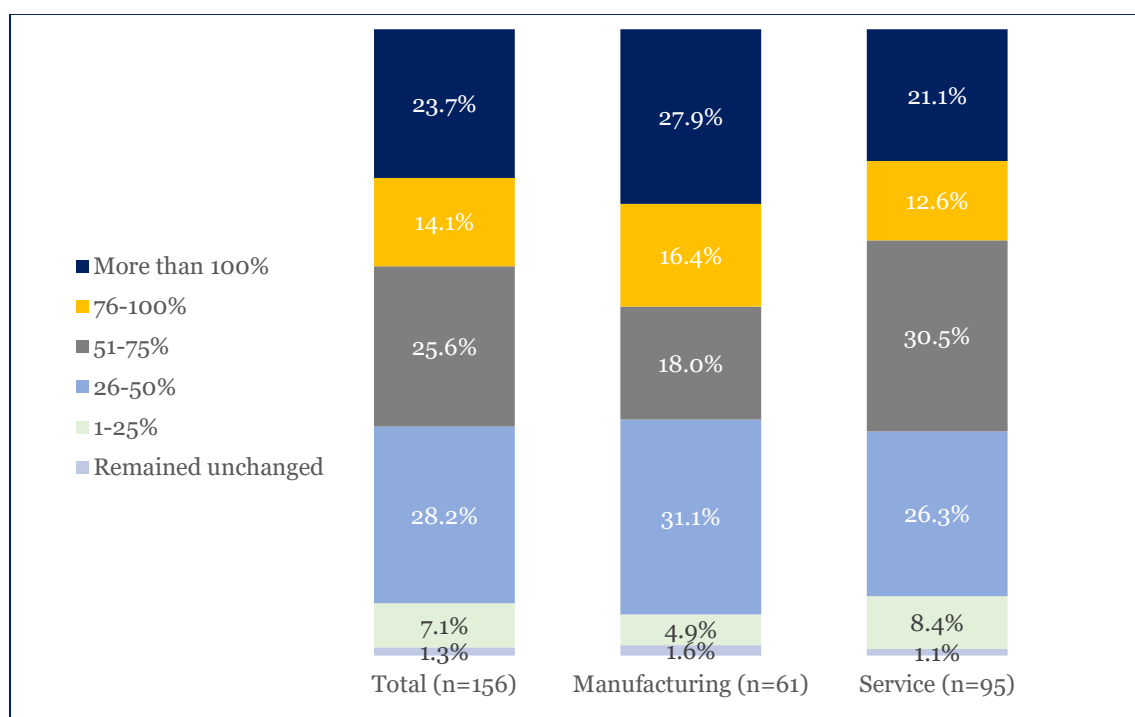


Figure 45: Price increase of main imported input – 2015 vs. 2014.

2.4.5 Coping strategies adopted by firms.

A notable 64.1% of firms adopted a strategy of passing on the price increase to customers, indicating a widespread reliance on adjusting pricing strategies to navigate through the input cost pressures. Firms also engaged in various other coping strategies, such as implementing cost-cutting measures (34.0%), seeking alternative local inputs (26.3%), and scaling back production to conserve resources (14.1%). Noteworthy are the variances between manufacturing and service sectors in approaches like seeking financing (18.0% vs. 7.4%) and scaling back the labor force (13.1% vs. 5.3%).

	Total (n=156)	Manufacturing (n=61)	Service (n=95)
Passed on the price increase to customers	64.1%	63.9%	64.2%
Implemented cost-cutting measures in other areas	34.0%	37.7%	31.6%
Sought alternative local input	26.3%	23.0%	28.4%
Scaled back production to conserve resources	14.1%	16.4%	12.6%
Sought financing/credit to manage cash flow challenges	11.5%	18.0%	7.4%
Scaled back labor force/lay-offs	8.3%	13.1%	5.3%

*** Multiple answers optional

Figure 46: Coping strategies to mitigate price hikes in main imported inputs.

Following the series of survey results above, insights gained from the discussions with firms also uncovered that several manufacturing firms relied on imported inputs such as machinery, spare parts, or raw materials. The share of imported inputs ranged from 40 to 100% for firms producing metalwork, woodwork, textiles, and garments. Some service firms that import food ingredients reported that 70% of

their total inventory consisted of imported goods. This significant reliance on imports left these firms exposed to the risks associated with fluctuations in foreign exchange rates and scarcities.

According to firms, shortages of foreign currency complicated the process of importing inputs. With a shortage of foreign currency, the costs of imported inputs have risen exponentially, often doubling, or tripling within a short period. Some vital inputs were not available at all due to foreign currency shortages, forcing some firms to halt production.

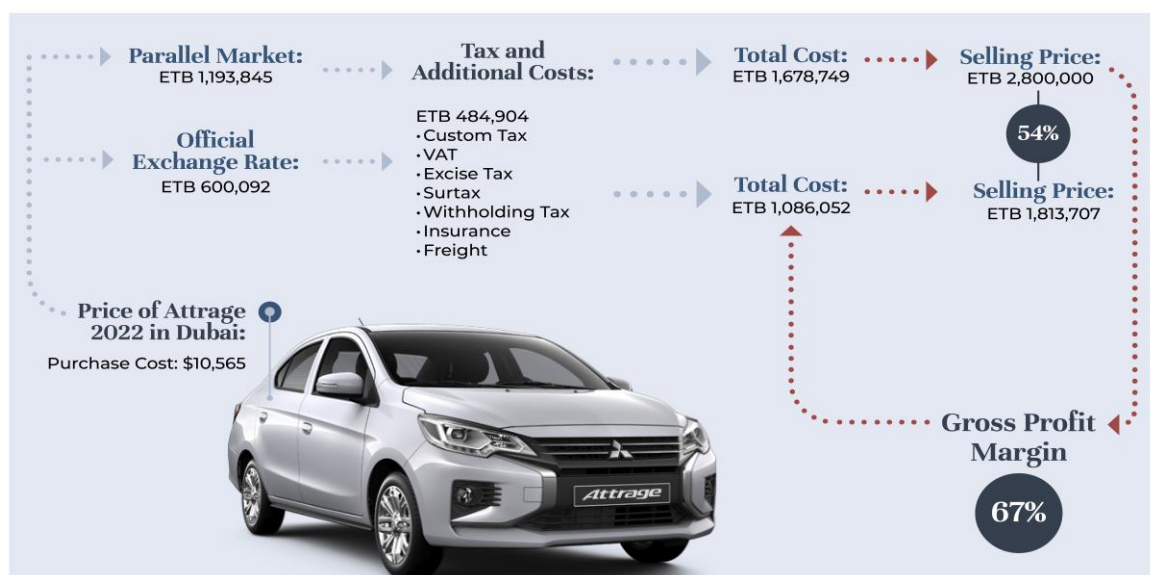
“The lack of raw materials in the market is also a challenge. Only a few people might have the required raw materials, making it easy for them to set the prices. We have no other options.”

Manufacturing firm – Metalwork

The rapid price surges in imported inputs shrank profit margins, as firms could not proportionately increase selling prices without losing market share. Consequently, firms absorbed the rise in input prices through lower profits to remain competitive.

Case study: Gross profit margin of Mitsubishi Attrage 2022

Domestic price of cars could have been 54% cheaper, had car dealers acquired 100% of the forex needed through official channels instead of parallel market.



Industry experts (key informants) shared the concerns of firms related to the shortage of foreign currency as well as devaluation. According to some experts, the shortage of foreign currency disproportionately affected small firms compared to medium and large firms. In addition to the shortage of foreign currency, the weak bargaining power of small firms severely limited their access to forex. Moreover, when firms obtained foreign currency through the official channels, the amounts allocated were usually insufficient, forcing them to resort to the parallel market, where rates are typically higher. The constant devaluation of the Birr further exacerbated the situation. All these factors combined to inflate production costs and impair the operations and competitiveness of firms.

"The issue is that access to foreign currencies is very limited at this time. The question then becomes: what are the means of accessing such foreign currencies? Can you go to the banks and formally obtain it at any time? No, you can't."

Key informant – Professional Association

"Even when obtained through official channels, [forex] allocations are often insufficient, forcing firms to rely on the black market. This situation affects their competitiveness against firms that secure forex through other means."

Key informant – Financial Institution

"Constant devaluation is creating a situation where imported goods, raw materials, and machinery are becoming increasingly costly over time. This problem is hitting all sectors."

Key informant – Business Association

2.5 Economic situation and firm performance

Firms are generally uncertain about the economic situation; financial performance is mixed, with many rating it as poor; there is a notable decline in revenue and profitability; major challenges include decreased sales, rising production costs, and reduced consumer spending, with increased production costs being most dominant; common strategies include price increments and cost-cutting; firms show varied confidence in sustaining and growing amid challenges; a portion of firms plan to expand or invest, primarily motivated by offering new products and aiming for profitability.

2.5.1 Perceptions of the economic climate

The survey explored firms' perceptions of the current economic situation. Generally, firms were uncertain about the economic situation. Slightly more than a third of firms (39.2%) thought that the economy was highly uncertain with significant challenges, while 33.1% believed that the situation was uncertain but manageable. Only 1.6% of firms thought that the economy was stable and favorable. About 26.0% of firms took a neutral stance, categorizing the economic situation as neither uncertain nor stable.

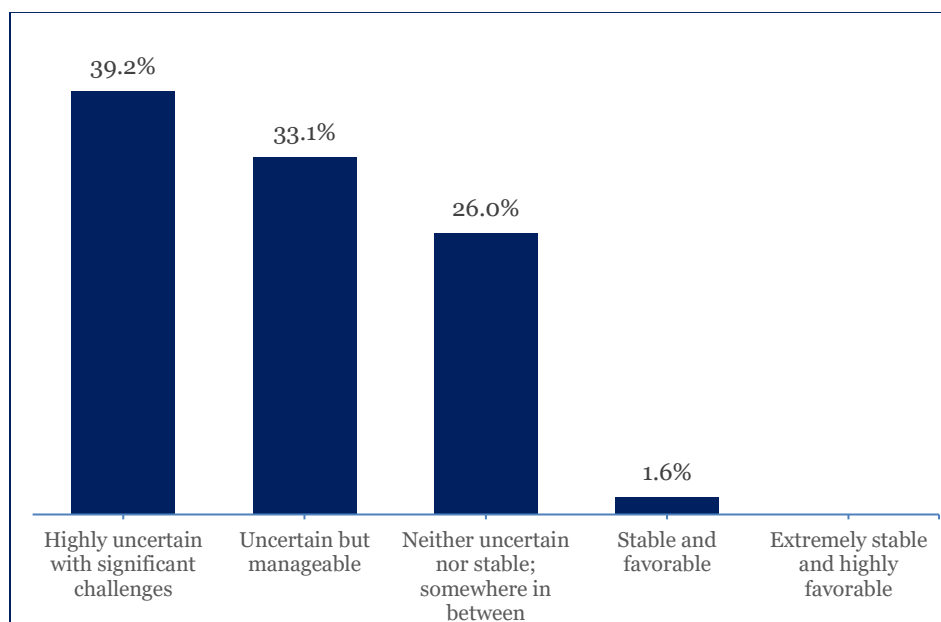


Figure 47: Perception of the economic situation in Ethiopia.

Following the survey result above, insights gained from the discussions with firms also revealed that the majority of firms described the economic environment as extremely challenging, with little positive outlook. They reported facing a multitude of hardships that hampered their performance and operations. They ran into many difficulties, such as a shortage of inputs, inflation, a foreign exchange crunch, and depressed consumer demand.

"In 2015, every aspect was difficult — from purchases and customer interactions to managing rent; the year provided no break."

Manufacturing firm – Woodwork

Many firms highlighted soaring prices for raw materials, imported inputs, and rent, to which they adapted by frequently adjusting product prices, often every month. However, with inflation eroding consumer purchasing power and consumers prioritizing essentials, the situation complicated their planning. Many firms reported a recession in their sub-sectors and an erosion of customer bases. Demand for perceived non-necessities, such as construction materials, furniture, and restaurant services, softened. In turn, weakened consumption rippled across supply chains.

"The price list on the menu changes at least monthly. The price customers paid this month for the service they received will change the next month."

Service firm – Food.

Limited access to foreign currency severely hit firms that relied on imported inputs. An inability to adequately stock equipment and other raw materials, due to foreign exchange scarcity, led to operational struggles, forcing some firms to even cut staff and functions.

"We didn't have any work in 2015. We used to import raw materials from abroad. There weren't any Dollars available. So, it has been a year since we last imported raw materials from abroad."

Manufacturing firm – Woodwork

Overall, most firms viewed the economic climate as extremely challenging, particularly for new entrants.

“It is not a favorable period to enter the business world. When I say to you that it is not a favorable period to get involved in business, I mean that we would have faced bankruptcy and exited the market if we had opened recently. We would not have survived if we had started this company recently.”

Service firm – Food.

2.5.2 Financial performance (self-assessment)

Understanding the financial performance of firms provides insights into the broader health of the economy. Accordingly, the financial performance of the firms was somewhat mixed. More than half of the firms rated their performance as either poor (35.8%) or very poor (16.1%), indicating manifold challenges in the economic environment. This could be reflective of broader economic factors influencing their operations adversely. Nevertheless, 30% of firms navigated the economic landscape successfully, with 27.4% rating their financial performance as good and 2.6% as excellent. Some firms (18.1%) deemed their performance satisfactory, suggesting they might be experiencing mixed fortunes, possibly due to varying degrees of resilience and adaptability.

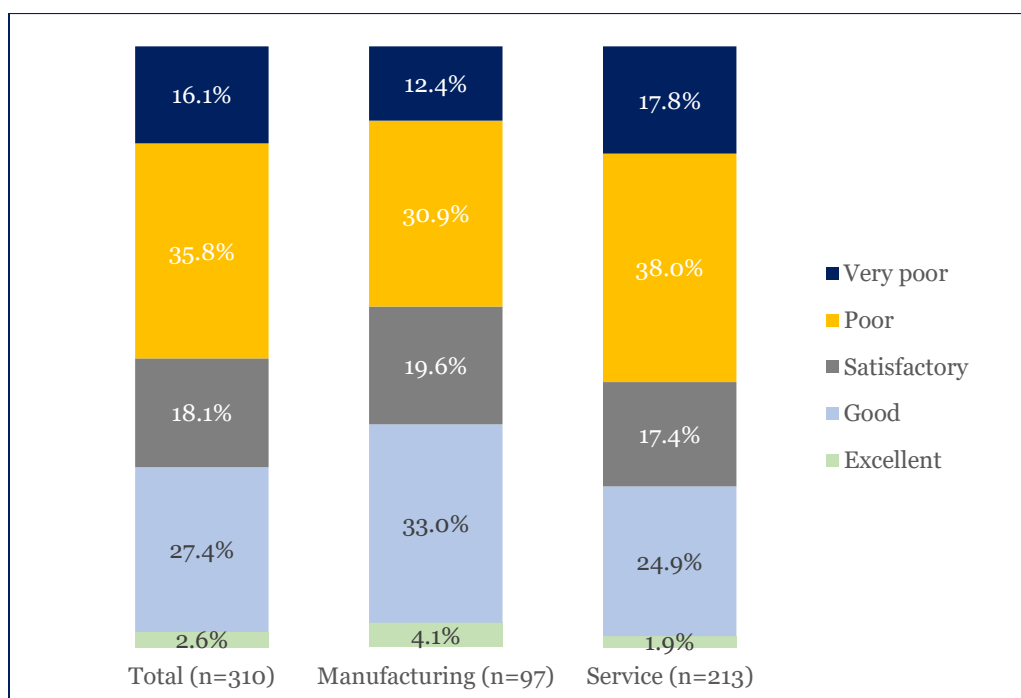


Figure 48: Self-assessed financial performance ratings of firms.

Breaking it down by sector, the manufacturing sector had a larger proportion of firms (37.1%) reporting good to excellent financial performances. Conversely, a greater proportion of service sector firms (55.8%) reported their financial performance as being poor or very poor, compared to the manufacturing sector. This suggests that the service sector might be facing more pronounced challenges than its manufacturing counterpart.

A comprehensive analysis was carried out to identify differences between firms with strong financial performance (good to excellent) and those with weaker financial outcomes (poor to very poor). Of the firms reporting “good to excellent” financial results, 38.7% were in manufacturing and 61.3% in services (n=93). This contrasts with those in the “poor to very poor” category, where 26.1% were in manufacturing and 73.9% in services (n=166). Regarding access to finance, 61.2% of firms with “good to excellent” performance reported satisfaction with their financing options (n=67), which sharply contrasts with only 27.6% satisfaction in the “poor to very poor” category (n=116). Confidence in maintaining and growing operations amid economic shifts was high among financially stronger firms, with 79.6% expressing such confidence (n=93), while only 37.3% of financially weaker firms felt similarly confident (n=161). Furthermore, 52.2% of the financially strong firms were actively planning to expand or invest, with only 23.9% having no such plans (n=92). In comparison, 23.8% of financially weaker firms had plans for expansion or investment, but a significant 55.0% had no intention to expand or invest (n=160).

2.5.3 Comparison of revenue and profitability between 2015 and 2014

This section presents the consequences of the economic situation on the revenue and profitability of firms in 2015 compared to 2014. The majority of firms (54.8%) encountered a notable decline in both revenue and profitability. Within the manufacturing sector, the impact was slightly less severe but still high, with 50.5% of firms experiencing a marked decrease in their financial performance. In contrast, the service sector faced a heavier blow, as evidenced by 56.8% of firms reporting a significant dip in their financial performance.

Furthermore, 25.6% of firms witnessed a moderate decline in their financial performance. Interestingly, 8.3% of firms maintained a steady financial performance, reporting no significant fluctuations. This trend was more pronounced in the manufacturing sector, where 12.1% of firms indicated no notable change, displaying a certain level of resilience. In comparison, only 6.6% of firms in the service sector reported a stable financial trajectory. On a positive note, 10.6% of firms observed a moderate increase in their revenue and profitability.

An extensive examination of financial performance across a range of sectors and subsectors reveals a general trend towards underachievement. This detailed result focuses on firms with a minimum sample size of five, ensuring a more representative analysis. Notably, service-based sectors such as ‘liquor stores’, “restaurants”, “household appliances/furniture”, and “hotels” predominantly exhibit poor financial results. In contrast, only a limited number of businesses in sectors like “motor vehicle spare parts”, “beverages”, “cafés”, and “stationery/books” show positive financial outcomes. Meanwhile, certain manufacturing subsectors, including “concrete block manufacturing”, “textile/garments”, and “woodwork”, display a more balanced mix of well-performing and underperforming firms, suggesting resilience in these areas. However, sectors such as “bakeries” have reported weak financial performance. These findings point to distinct dynamics within each sector, with some subsectors showing stability, while other subsectors face more significant economic headwinds.

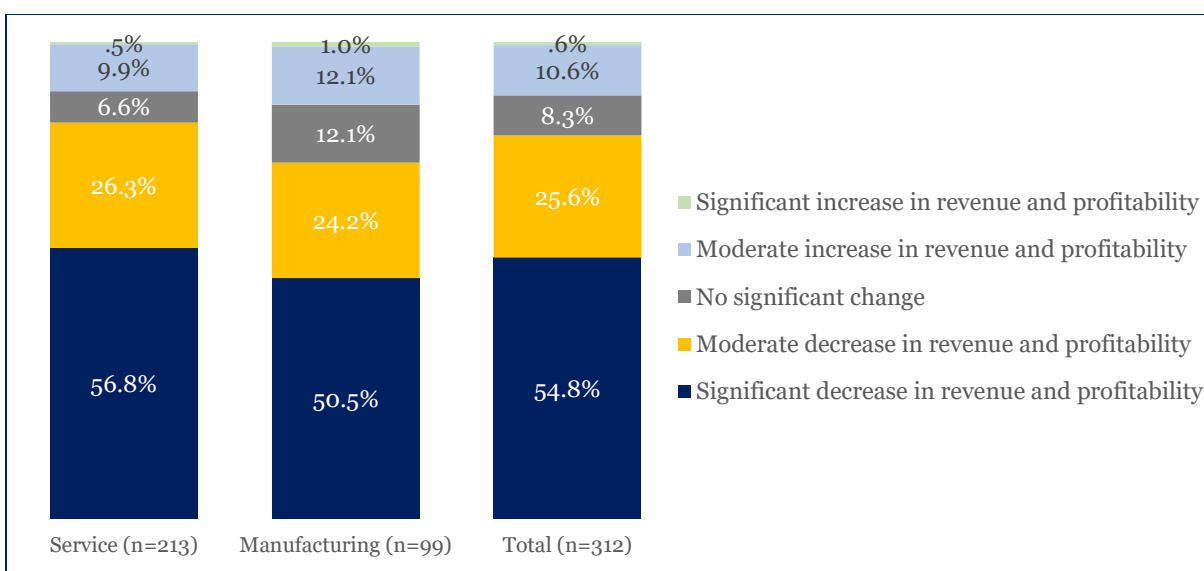


Figure 49: Comparison of revenue and profitability between 2015 and 2014.

2.5.4 Significant challenges faced.

In this section, a detailed analysis of the most significant hurdles firms encountered during the fiscal year 2015 is presented. The biggest challenges were a decline in sales or revenue (56.7%), increased production/input costs (54.5%), and decreased economic activity with reduced consumer spending (54.2%). Concerns about rising inflation rates (38.8%) and supply chain disruptions with shortages (33.3%) were also notable.

	Total (n=312)	Manufacturing (n=99)	Service (n=213)
Increased production/input costs	54.5%	59.6%	52.1%
Decreased economic activity & reduced consumer spending	54.2%	53.5%	54.5%
Rising inflation rates	38.8%	35.4%	40.4%
Supply chain disruptions and shortages	33.3%	44.4%	28.2%
Cash flow constraints	17.9%	23.2%	15.5%
Political instability	17.3%	15.2%	18.3%
Tax burden	14.4%	17.2%	13.1%
Increased competition	13.1%	11.1%	14.1%
Difficulties in accessing financing	10.6%	19.2%	6.6%
Currency fluctuations	8.3%	12.1%	6.6%
Labor shortages	6.1%	12.1%	3.3%
Regulatory changes or compliance Issues	5.4%	6.1%	5.2%
Trade restrictions or tariffs	5.4%	8.1%	4.2%

*** Multiple answers optional

Figure 50: Significant challenges faced by firms.

From a sector-specific perspective, the manufacturing sector was more adversely affected by increased production/input costs (59.6%) and supply chain disruptions and shortages (44.4%) compared to the service sector. In contrast, the service sector was disproportionately affected by a decline in sales or revenue (60.6%) and inflation (40.4%).

Following the survey result above and the insights gained from discussions with firms one can identify the top three challenges for business operations in 2015. The predominant difficulty firms grappled with was accessing inputs. Raw material shortages and soaring prices hit manufacturing firms hard, particularly those in the garment, textile, bakery, and metalwork industries, grinding production to a halt. Likewise, service firms experienced critical inventory shortages. These firms attributed the difficulty in accessing inputs to a confluence of factors: a foreign currency shortage that curtailed imports, soaring inflation, and the unreliability of local suppliers. Lacking essential inputs, firms failed to fulfill customer orders, resulting in revenue loss, and proving to be a great hindrance to their performance.

“The biggest challenge for us is the ever-increasing price of raw materials. Prices are rising daily, and attempting to convince our customers about these continual increases is a challenge.”

Manufacturing firm – Bakery

Another significant challenge involved limited access to the working capital and credit needed to sustain operations, procure inputs, and cover expenses such as rent and salaries. While some firms managed to secure bank loans or private financing, the majority of them aspired to obtain more credit than they could secure. These loans often came with strict restrictions on both the loan amounts and the repayment terms. Additionally, the combination of high-interest rates and stringent collateral requirements rendered bank and MFI financing unattainable. Consequently, firms operating on tight budgets struggled to stock materials, meet customer orders, and cover essential costs.

“We are depleting our capital and lack a source from which to obtain loans.”

Manufacturing firm – Woodwork

“If we receive the credit that we asked for, we will do a better job. However, the conditions are not convenient. One cannot even fulfill all the requirements due to the many procedures. Even upon completing all the procedures, one cannot obtain it immediately. These are hindrances.”

Manufacturing firm – Garment

Infrastructure gaps, such as insufficient workspaces and unreliable utilities, emerged as key impediments. Such physical limitations meant that firms operated at low efficiency and could not meet full demand.

“Electricity and water shortages are still occurring. Water is supplied to the site only once a week, so we purchase tens of thousands of liters from water trucks, costing at least five to six thousand Birrs per week. Additionally, frequent electricity outages mean that the cement batch mixer will face problems whenever they occur.”

Manufacturing firm – Concrete block producer

While issues with raw materials, financing, and infrastructure were widespread, firms also described context-specific challenges, particularly political instability. The ongoing unrest prevailing in different

parts of the country harmed the performance and viability of many firms by constraining mobility, depressing demand, stoking uncertainty, and disrupting supply chains. In this regard, a very common impediment, described by many firms, was restricted mobility and transportation challenges stemming from conflict and instability. With growing security concerns in different regions, several firms highlighted that customers in rural areas were either unable or unwilling to travel to make purchases. A few firms cited supply chain problems caused by political conflict. These supply disruptions then cascaded into production delays and revenue losses for the affected firms.

“The unrest in the country causes roadblocks, so the materials cannot reach their destination on time.”

Manufacturing firm – Concrete block producer

“We send our products out to the rural areas, but if there is no peace, it will stop.”

Manufacturing firm – Concrete block producer

Firms reported that they generally received insufficient support from both governmental and non-governmental organizations. Of the 18 firms interviewed, 14 did not receive any form of support or assistance. Only 4 firms received some limited training or other minor forms of support, though not on an adequate regular basis.

“Government authorities have proposed creating a market connection between buyers and businesses like ours. However, we haven’t seen any tangible progress yet.”

Manufacturing firm – Metalwork

“The support? Yes, it has been beneficial. They assist whenever they visit, even if it’s only for six months.”

Manufacturing firm – Metalwork

Discussions with industry experts echoed the critical challenges firms faced, specifically insufficient access to formal external financing, scarcity of inputs, soaring inflation, deficient working space and infrastructure, and conflict and insecurity. Additionally, they highlighted uncertainties and contradictions around regulations, as well as changes in taxation, as factors that further could complicate the situation.

“Rules and regulations fluctuate now and then. This affects them. There are tax issues and trade regulations.”

Key informant – Business Association

“There are contradictions in the rules and regulations, and executive institutions are uncoordinated. This creates difficulties in interpreting the law, posing significant challenges for enterprises.”

Key informant – Financial Institution

The key informants anticipate that the wall and roof tax, revised in 2015, will greatly affect firms in the future. They predict that building owners will pass the full cost of the tax onto tenants and lessees, thereby increasing production and operational costs for firms.

“The newly introduced wall and roof tax has caused a serious turmoil which in turn will have direct implications on the cost, profit, and income of micro and small enterprises.”

Key informant – Business Association

2.5.5 Adapting business strategies.

Firms adopted various strategies to navigate the stormy economic climate. The most common strategies were price increments and cost-cutting. Around half of firms (51.3%) adopted product/service price adjustments. Cost-cutting measures were also practiced by 45.8% of firms. Other less common strategies included exploring new markets (19.2%), supplier diversification (18.3%), and introducing new products/services (15.7%).

	Total (n=312)	Manufacturing (n=99)	Service (n=213)
Product/service price adjustments	51.3%	54.5%	49.8%
Cost-cutting measures	45.8%	48.5%	44.6%
Exploring new markets or customer segments	19.2%	27.3%	15.5%
Supplier diversification (sought alternative suppliers)	18.3%	23.2%	16.0%
Introduced new products/services	15.7%	18.2%	14.6%
Strengthened cash flow management	13.1%	20.2%	9.9%
Improved inventory management	8.3%	7.1%	8.9%
Negotiated better terms with existing suppliers	7.4%	12.1%	5.2%
Did nothing	6.7%	3.0%	8.5%
Enhanced marketing and promotional activities	5.4%	7.1%	4.7%

*** Multiple answers optional

Figure 51: Adaptations in business strategies and operations amid economic challenges.

The widespread practice of price increments and cost-cutting suggests that firms prioritized financial flexibility to maintain their market competitiveness. Financial flexibility, in this context, pertains to the strategic modifications made in firms' financial management to competently navigate through fluctuating economic circumstances which could include preservation of profit margins, safeguarding liquidity, maintaining financial health, and ensuring sustained operational functionality amidst financial challenges.

Once more, following the quantitative survey results above, the qualitative insights gained from the interviews with firms are presented as follows. In response to the demanding economic climate, firms demonstrated adaptability by employing various strategies, as detailed below.

Many firms adjusted prices or costs due to inflation and foreign currency shortages. To keep up with rising input costs, they increased sales prices. However, most firms recognized the drawbacks of excessive price adjustments, understanding that significant hikes could deter customers. The survey results show that while a significant majority (70.1%) of firms reported no impact on the quality of their products/services due to inflation, there were instances where firms resorted to using less expensive substitute inputs as imported materials became excessively costly. Additionally, some businesses downsized portions or made concessions in product quality to preserve their profit margins.

“If you increase prices, customers leave, period. They seek cheaper products, even if cheaper products have inferior quality.”

Manufacturing firm – Garment

“We tried to find items at lower prices. When costs increase, there's a tendency to buy lower-quality goods. Consequently, our firm has resorted to purchasing lower-quality items at reduced prices.”

Manufacturing firm – Building materials.

Some firms made changes to their operations and workforce to cut costs. These changes included layoffs, reduced hours and pay, replacing paid labor with family members, and owners putting in extra hours themselves. Others focused on the most profitable products, temporarily sidelining less profitable ones.

A few firms implemented operations to enhance efficiency, such as minimizing waste, reusing materials, and managing time effectively. Meanwhile, other firms improved their quality control processes to reduce product rejections. In each of these instances, the overarching goal was to extract maximum value from limited resources.

“We prioritize using purchased inputs effectively to prevent any waste. By avoiding wastage of raw materials and ensuring efficient utilization, we try to offset our losses.”

Manufacturing firm – Woodwork

While the majority of firms found growth unattainable, a selected few sought to boost sales through enhanced marketing efforts, diversified product designs, and the introduction of new delivery options. Firms also focus on cultivating a loyal customer base by providing exceptional customer service.

“Concerning the business strategies that we apply, as you can see in our menu, we offer not only full-size meals but also half-size meals by reducing the price. The reason why we have done this is that customers who cannot eat the full-size meal can eat the half-size meal at half the price within their means.”

Service firm – Food.

While firms demonstrated ingenuity in deploying coping strategies, the primary objective for most was survival rather than growth. Although their approaches effectively mitigated immediate challenges, they might have lacked the sustainability required for long-term solutions.

2.6. Job creation

Firms' workforce largely remains stable; the average workforce size stands at 10 employees, though with stark variations between service and manufacturing firms; gender distribution is marked by male dominance, particularly in the manufacturing sector; most firms have no intention of upsizing their workforce in 2016.

2.6.1 Employment landscape

In 2015, the surveyed firms employed a combined total of 3,121 individuals, representing a slight decrease of 0.32% compared to total employment in 2014. Such a marginal change in overall employment might signal the stability of the surveyed firms, even amidst challenging economic conditions.

Despite the overarching stability, closer examination revealed variations between manufacturing and service firms. Manufacturing firms witnessed their workforce shrink by 2.7%. In contrast, service firms showcased workforce growth, expanding by 2.8%.

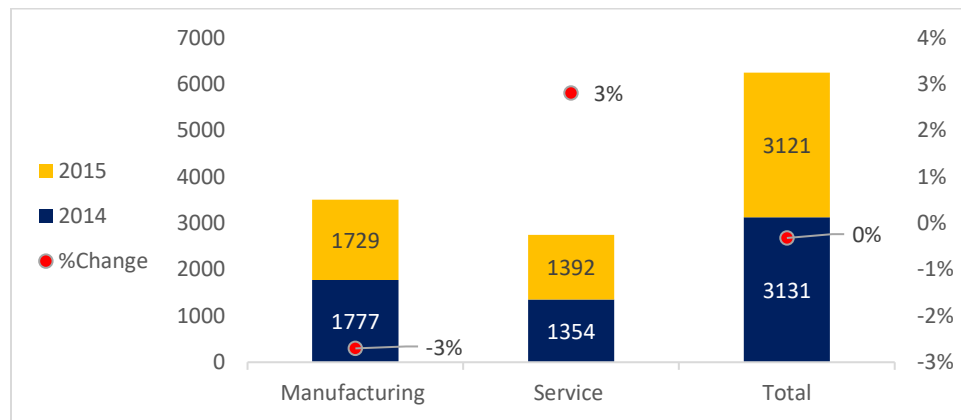


Figure 52: Employment in 2015 vs. 2014

Collectively, firms maintained an average workforce of 10 individuals. However, there were marked differences in the average workforce size between manufacturing and service firms. Manufacturing firms had a more sizable average workforce, with around 17 employees per firm, whereas service sector firms operated with a more streamlined staff, averaging 7 employees. The observed workforce discrepancy between the two sectors might be attributed to the intrinsic complexities and labor-intensive character of manufacturing processes. The manufacturing domain, characterized by its production lines, machinery operations, and intricate manual tasks, likely demands a larger workforce.

The gender distribution of the workforce in these sectors was also of particular interest. A gender imbalance leaning towards male employees was evident in both sectors. The disparity was particularly stark in manufacturing firms, where there were, on average, four more males than females. Service firms, while still favoring males, had a milder imbalance with an additional one male employee on average.

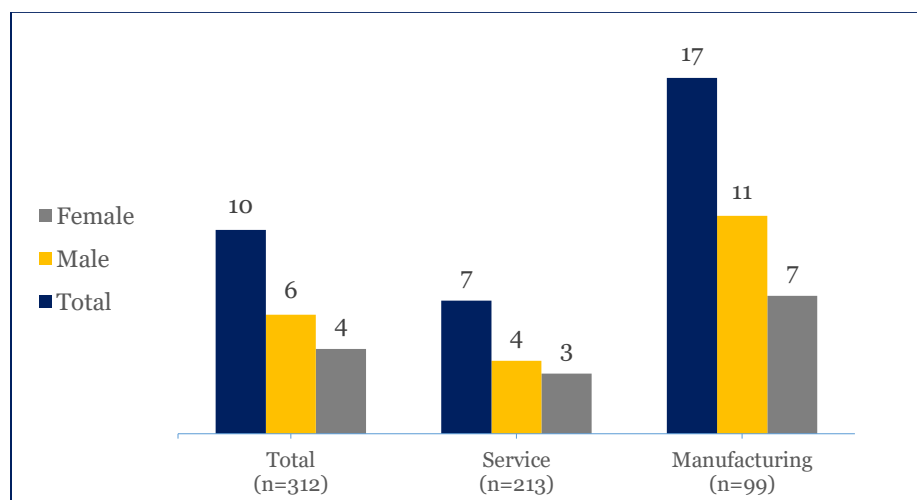


Figure 53: Average workforce size.

Most service sector firms (83.1%) employed 10 or fewer individuals. Moreover, 20% of these firms were one-man businesses. In contrast, the majority of manufacturing firms (60.6%) employed from 11 to 50 individuals. Figure 54 illustrates how firms in the manufacturing and service sectors differ in the number of people they employ.

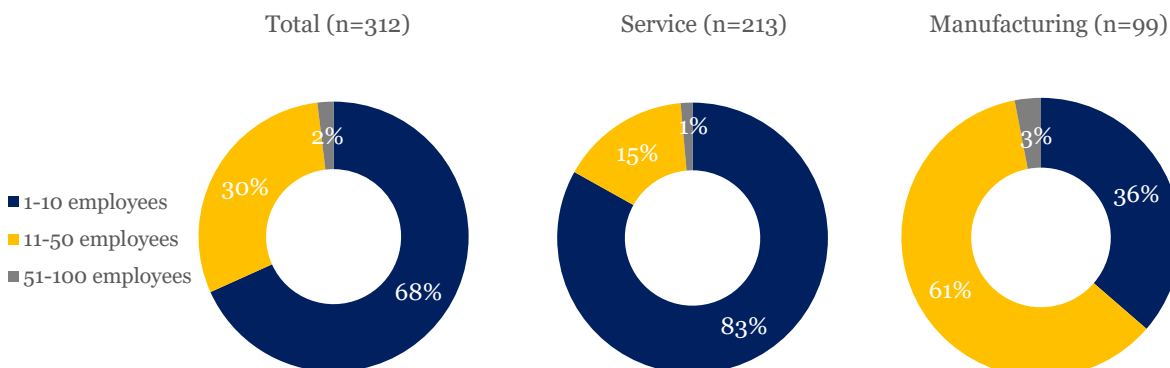


Figure 54: Workforce size by category.

The vast majority of firms relied on employees hired on a permanent, full-time basis. Specifically, 83.8% of employees in service firms and 76.1% of employees in manufacturing firms were permanent full-timers. Manufacturing firms demonstrated a greater tendency towards seasonal or temporary employees compared to service firms. The difference might be attributed to the nature of the manufacturing process, which may require a more flexible workforce to adeptly manage operational costs and production capacities.

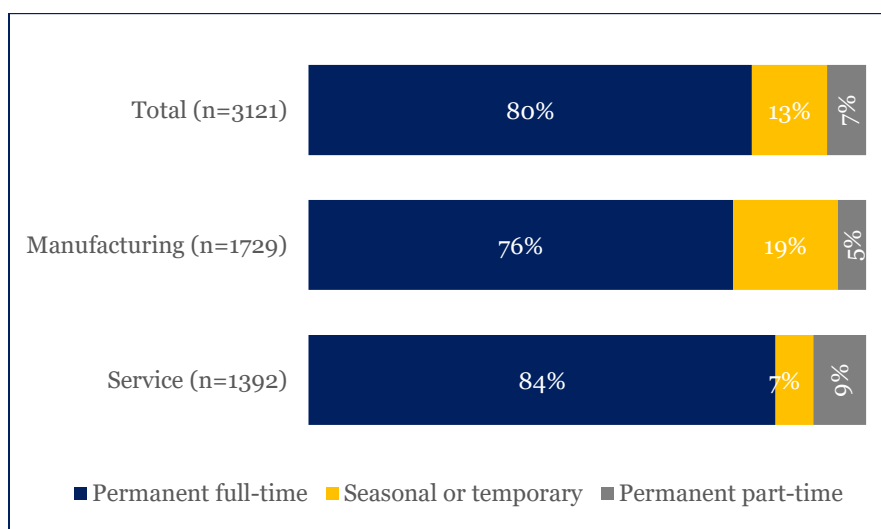


Figure 55: Employees by contract type.

2.6.2 Hiring intentions.

In 2015, the vast majority of firms (70.5%) had no plans to expand their workforce. Dissecting this trend by sector, a clear difference emerges. While just over half (50.5%) of manufacturing firms refrained from hiring, this figure was much higher in the service sector at 79.8%.

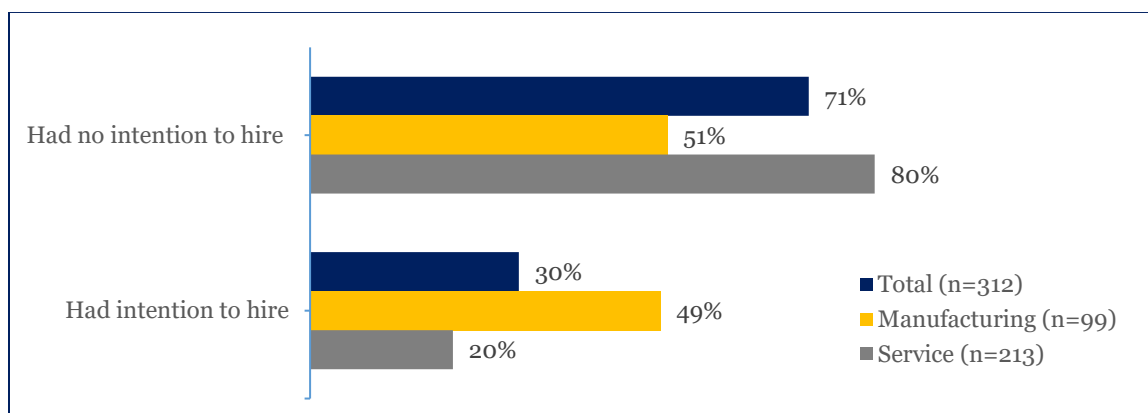


Figure 56: Firms' hiring intentions for 2015.

Among firms that had a hiring plan, not all were able to execute it fully. Primarily, inadequate workspace and cash flow constraints hampered these firms' hiring intentions. Inadequate workspace was a major concern, especially for manufacturing firms. Furthermore, external constraints such as foreign currency shortages, high inflation, depressed market conditions, and political instability made additional recruitment unjustifiable, dissuading initial intentions.

"We had plans to acquire additional space, expand our workspace, and hire more employees, but things don't always go as planned. Given the challenging current conditions, which you might be aware of, our progress has been hindered."

Manufacturing firm – Woodwork

"No, we did not have plans to hire more employees. The primary reason is the question of cash flow. This is due to the limited opportunities for importing goods. The availability of foreign currency has decreased, and overall, there are fewer opportunities for business expansion."

Manufacturing firm – Garment

"As per our plan, we could have hired additional employees. However, as mentioned earlier, the current circumstances prevent us from doing so. In summary, the key reasons we did not hire more staff were the rising inflation and instability in Ethiopia."

Service firm – Building materials.

Moving into 2016, the trend persists, with 68.9% of firms across both sectors showing no intention to hire, again pointing to a cautious or constrained strategy in operational expansion. The sectoral divide remains notable. A striking 74.6% of service sector firms plan no new hires, in stark contrast to the manufacturing sector, where 41.4% of firms are looking to bolster their workforce.

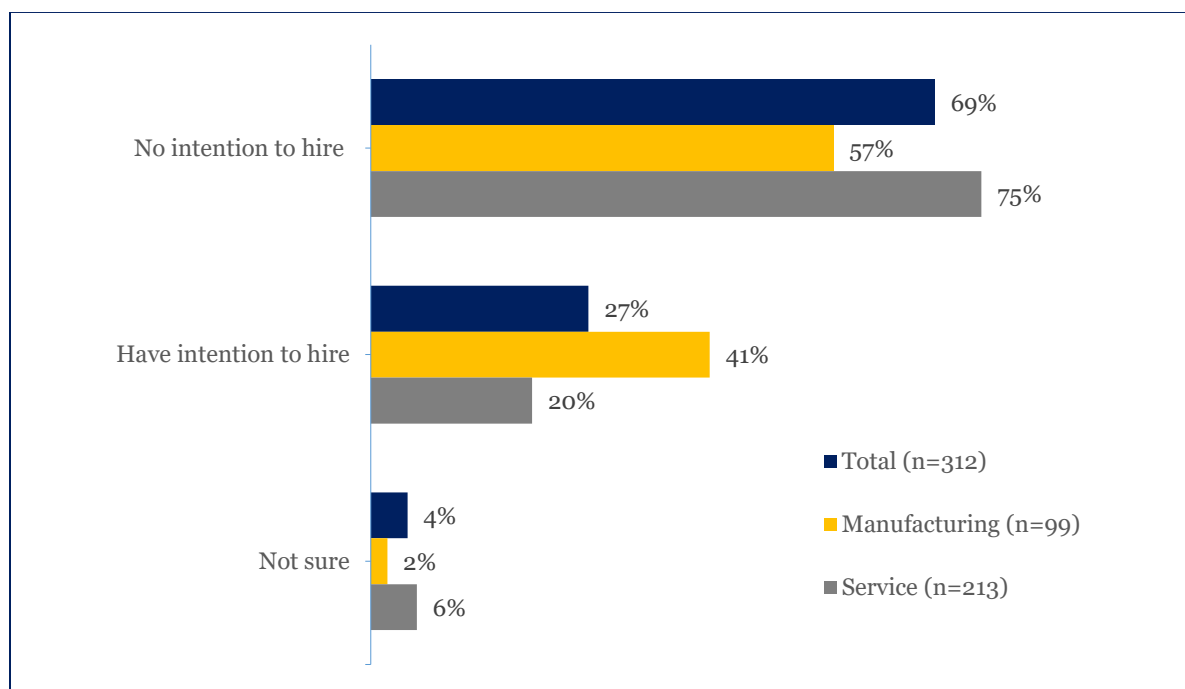


Figure 57: Firms' hiring intentions for 2016.

The majority of firms, 63.9%, plan to hire between one and five employees. Noteworthy is the sharp disparity between the manufacturing and service sectors in their intended hiring figures. Around 95% of service firms intend to hire within the 1 to 5-employee range, which stands in stark contrast to manufacturing firms that show a more evenly distributed intention to hire across different size categories. Figure 58 illustrates the hiring intentions of firms.

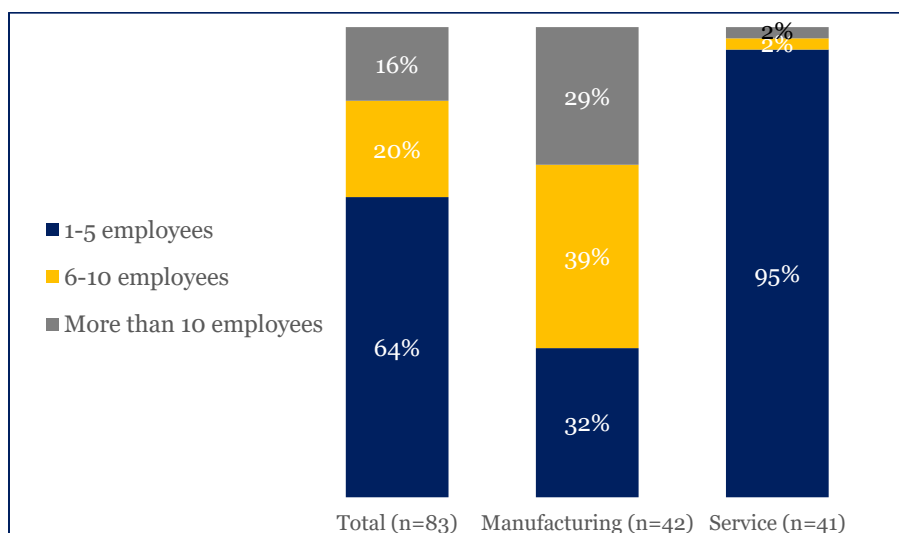


Figure 58: Number of employees firms intend to hire for 2016.

2.6.3 Firms' support of employees in response to inflation.

Firms reported varied effects of inflation on the well-being of their employees (this includes the owners of the firms). A substantial 70.8% of firms cited financial strain and reduced purchasing power among

employees, slightly more pronounced in the service sector (72.3%) than in manufacturing (67.7%). Moreover, 53.2% noted a higher cost of living and necessities, with minimal difference between the manufacturing (55.6%) and service (52.1%) sectors. Decreased job satisfaction was observed in 50.0% of firms, notably higher in the service sector (52.1%) than in manufacturing (45.5%). Additionally, 28.8% of firms reported job insecurity and stress among their employees. Interestingly, 7.7% of firms perceived no significant impact on employee well-being.

Total (n=312)	Manufacturing (n=99)	Service (n=213)	
70.8%	67.7%	72.3%	Financial strain and reduced purchasing power
50.0%	45.5%	52.1%	Decreased job satisfaction
28.8%	29.3%	28.6%	Job insecurity (uncertainty) and stress
7.7%	9.1%	7.0%	No significant impact on well-being
1.9%	4.0%	.9%	Disrupted work-life balance

*** Multiple answers optional

Figure 59: Impact of inflation on employees' well-being.

Firms adopted a variety of measures to support their employees. As depicted in Figure 60, nearly half of firms (47.6%) provided cost-of-living increases to employee salaries, while 42.4% implemented bonuses or incentives to offset the rising cost of living. 26.4% of firms took no specific measures in support of their employees, whereas 24.3% sought to maintain transparent communications with their employees (the practice of openly, honestly, and regularly sharing relevant firm information with employees). A sectoral breakdown reveals that manufacturing firms were more likely to provide cost-of-living adjustments (64.4%) and bonuses (51.1%) compared to service firms (39.9% and 38.4%, respectively). Conversely, a higher percentage of service firms (32.8%) took no specific supportive measures, compared to 12.2% in the manufacturing sector.

	Total (n=288)	Manufacturing (n=90)	Service (n=198)
Provided cost-of-living adjustments to employee salaries	47.6%	64.4%	39.9%
Bonuses or incentives to offset the rising cost of living	60.8%	62.8%	47.6%
No specific measures were taken	26.4%	12.2%	32.8%
Implemented flexible working arrangements	4.5%	11.1%	1.5%
Organized financial literacy workshops	.3%	1.1%	0.0%

*** Multiple answers optional

Figure 60: Measures to support employees in 2015.

2.6.4 Consumers' coping strategy to shocks

Consumers indicated that the increase in their income was not proportional to the rate of inflation. Food items that saw steep increases in price include the staples teff and onions. Teff has increased by 43% in Hawassa and by up to 189% in Bahir Dar as compared to the previous year. Similarly, onions have increased by 100% in Addis Ababa and up to 200% in Dire Dawa.

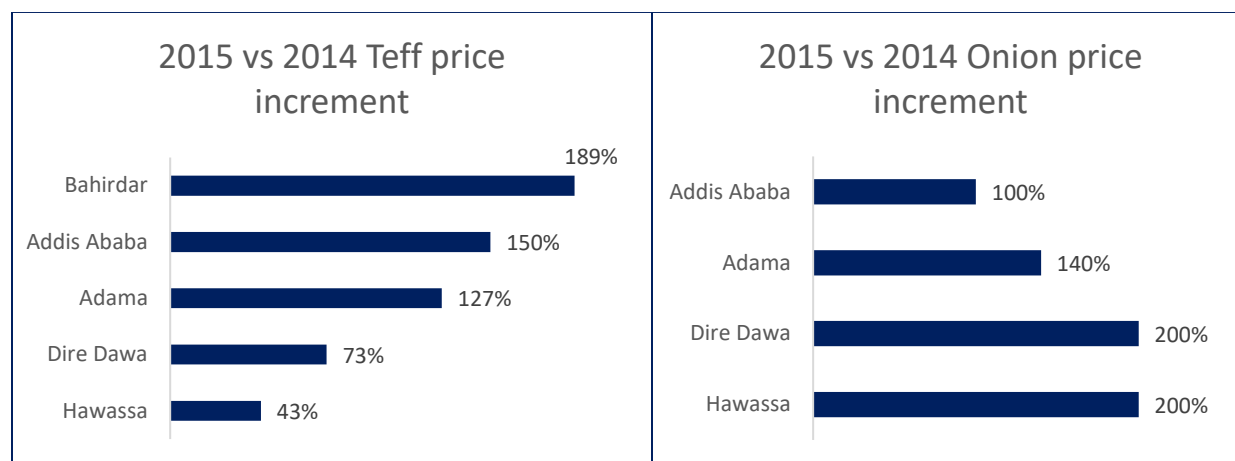


Figure 61: Comparison of the Price of Selected Commodities in Different Cities of Ethiopia

The less than commensurate increase in consumers' income is resulting in lower purchases, both in terms of the quality and the quantity of goods. Consumers are using different coping strategies to account for this inflationary pressure on essential food items. While the majority have indicated they are buying less quality, others indicated buying less quantity as well as shopping in bulk. The remaining respondents indicated that either they are diving into their savings or working additional jobs to maintain the same level of consumption. **Firms see any further decline in economic activity and reduction in consumer spending as one the biggest challenges they are facing.**

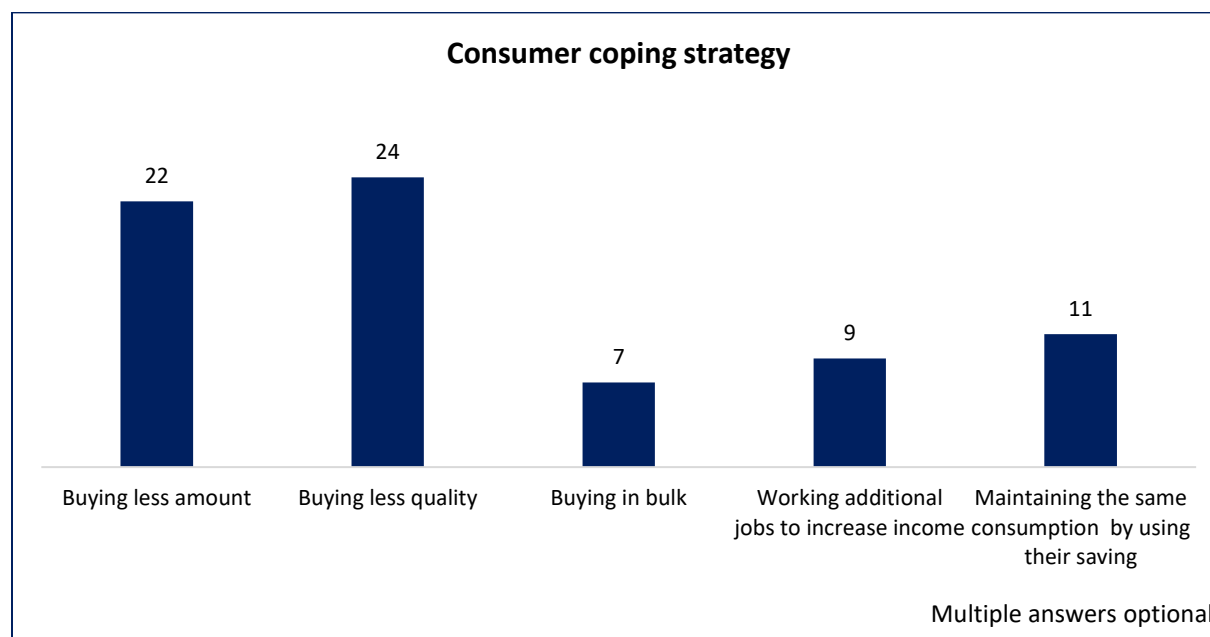


Figure 62: Coping Strategy of Consumers

"If you increase prices, customers leave, period. They seek cheaper products, even if cheaper products have inferior quality."

Manufacturing firm – Garment

As indicated above, firms use price transfer related to the cost of doing business whether it's from domestic or import/forex-related inflation. Consumers are also showing pushback by spending less. The question remains, what gives?

Newlyweds struggling to cope with inflation: Case study.

Wondossen (30) and his wife Melat (28) are married couple with a one-year-old boy, Yitbarek. Wondossen is a driver for a company and Melat is a public servant. They have a combined net income of ETB 14,000 per month (ETB 12,380 during the previous year). They have rented out a single bedroom around Alem Bank for 7,000(40% increase from previous year) which is 50% of their disposable income. Melat takes three transport in the morning to get to her workplace which costs her ETB 800 per month (45% increase from previous year). Even though there is service for civil servants to and from their office, she is no able to take advantage of this in the morning because she has to nurse her baby. The couple have mentioned that groceries take a chunk of their disposable income which is ETB 6,000 on average (33% increase from previous year). The usual suspects such as teff, onions and tomatoes make up most of the grocery items. Melat gets edible oil, sugar, and flour from her organization as benefit package. The couple have added up their monthly expense and it comes to ETB 17,200 which is ETB 3,200 more than their disposable income. For the time being family members are covering the difference considering they are newlyweds, but they don't expect this to continue and if their disposable income does not increase, they expect to reduce their consumption to their basic minimum needs.

2.7 Firms' outlook

2.7.1. Expected Challenges

The predominant challenge firms grappled with was accessing inputs. Raw material shortages and soaring prices hit manufacturing firms hard, particularly those in the garment, textile, bakery, and metalwork industries, grinding production to a halt. Likewise, service firms experienced critical inventory shortages. These firms attributed the difficulty in accessing inputs to a confluence of factors: a foreign currency shortage that curtailed imports, soaring inflation, and the unreliability of local suppliers. Lacking essential inputs, firms failed to fulfill customer orders, resulting in revenue loss and proving to be a great hindrance to their performance.

“The biggest challenge for us is the ever-increasing price of raw materials. Prices are rising daily, and attempting to convince our customers about these continual increases is a challenge.”

Manufacturing firm – Bakery

Another significant challenge involved limited access to working capital and credit needed to sustain operations, procure inputs, and cover expenses such as rent and salaries. While some firms managed to secure bank loans or private financing, most of them aspired to obtain more credit than they could secure. These loans often came with strict restrictions on both the loan amounts and repayment terms. Additionally, the combination of high-interest rates and stringent collateral requirements rendered bank and MFI financing unattainable. Consequently, firms operating on tight budgets struggled to stock materials, meet customer orders, and cover essential costs.

“We are depleting our capital and lack a source from which to obtain loans.”

Manufacturing firm – Woodwork

“If we receive the credit that we asked for, we will do a better job. However, the conditions are not convenient. One cannot even fulfill all the requirements due to the many procedures. Even upon completing all the procedures, one cannot obtain it immediately. These are hindrances.”

Manufacturing firm – Garment

The ongoing political instability and the conflicts in different parts of the country harmed the performance and viability of many firms by constraining mobility, depressing demand, stoking uncertainty, and disrupting supply chains. In this regard, a very common impediment, described by many firms, was restricted mobility and transportation challenges stemming from conflict and instability. With growing security concerns in different regions, several firms highlighted that customers in rural areas were either unable or unwilling to travel to make purchases. A few firms cited supply chain problems caused by political conflict. These supply disruptions then cascaded into production delays and revenue losses for the affected firms.

Firms maintain a cautious sense of optimism about the future in the face of numerous challenges. Most firms expressed a cautious sense of optimism about the future. 39% of the respondents indicated the future is highly uncertain with significant challenges to manage. Around 60% of respondents believe that despite these challenges it will be manageable, and a few businesses believe conditions are stable and favorable.

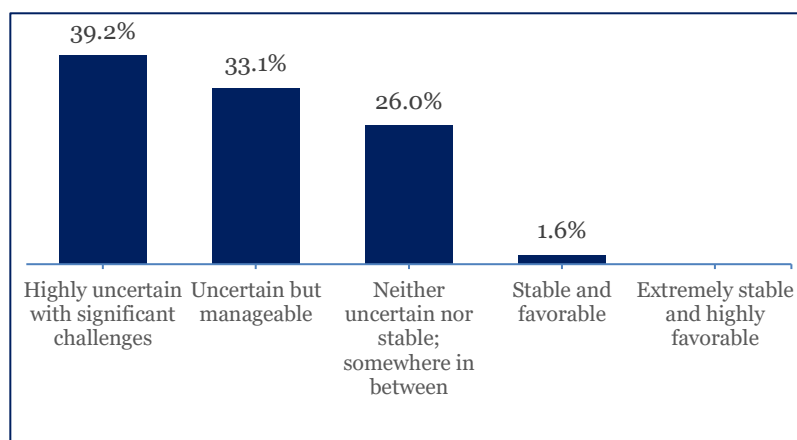


Figure 63: Firms' Outlook of the Future

"I am confident that improved circumstances await, even though present challenges stand in the way. Things won't remain this way. Tomorrow is a new day, and I believe better times are ahead."

Manufacturing firm – Woodwork

2.7.2. Confidence in sustaining and growing operations

Firms demonstrated a diverse range of confidence in sustaining and growing operations amid economic challenges. While 54% of firms were confident, 30% expressed their lack of confidence. The remaining 16.1% were undecided about prospects. With no significant difference between the manufacturing and service sectors.

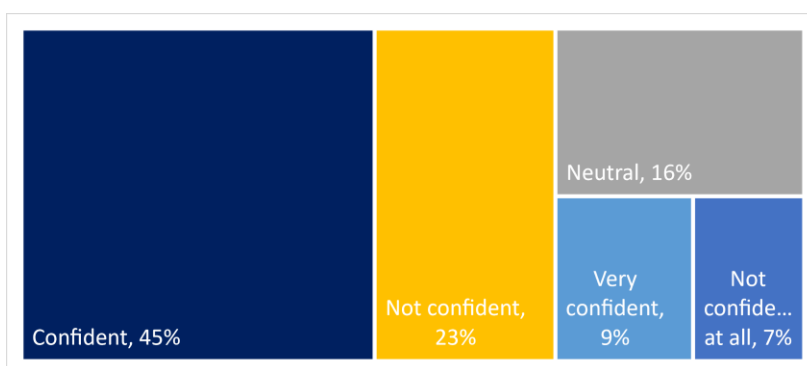


Figure 64: Confidence in sustaining and growing amid economic challenges.

"If the conflicts arising here and there are not resolved soon, they will cause significant harm in the future."

Key informant – Professional Association

2.7.2. Expansion plans and driving factors.

Many firms had expansion on their minds, but there was a divide. A total of 34% were planning to expand or invest, while another 23.3% were considering it but undecided. In contrast, 42.7% of firms were not planning expansion or investment shortly.

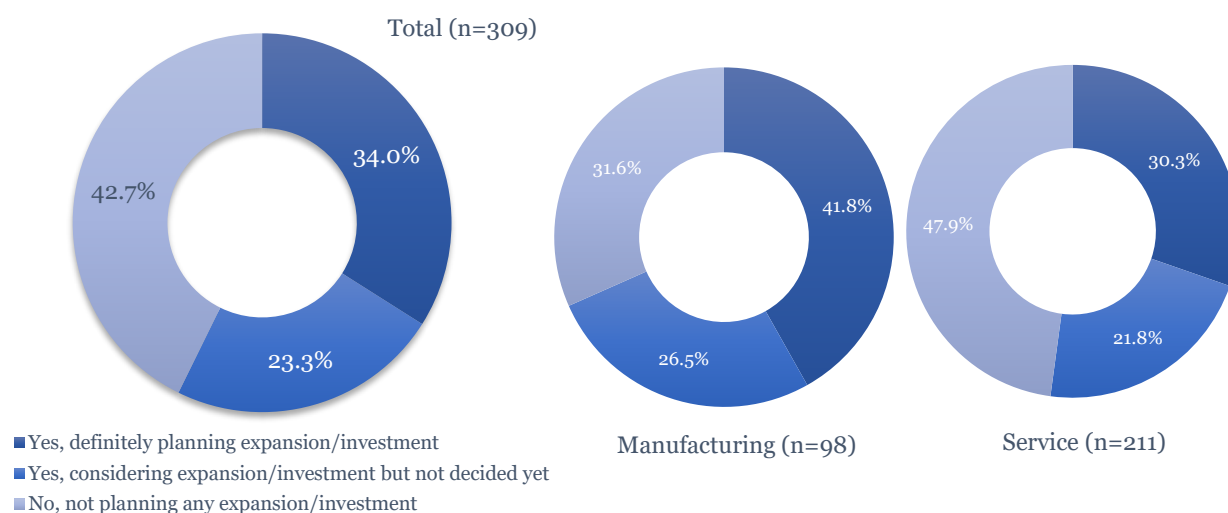


Figure 65: Expansion or investment plans in the near future.

The manufacturing sector seemed more optimistic about future growth prospects than the service sector, with 41.8% of manufacturing firms actively planning to expand, compared to 30.3% in the service sector. In-depth discussions with firms also disclosed that most firms expressed a cautious sense of optimism about the future. Despite current challenges, many hope that conditions will improve. However, the prevalent sentiment of optimism often hinged on changes in external factors, particularly the attainment of peace and stability in the country.

"I am optimistic. But looking back to the fiscal years of 2013 and 2014, we have come a long way."

Manufacturing firm – Metalwork

"I wouldn't claim the future looks promising. Currently, we don't see any bright spots. It all hinges on how circumstances evolve."

Service firm – Building materials.

Industry experts also expressed similar viewpoints, highlighting the importance of peace and political stability for the growth of micro and small firms. These conditions are seen as essential prerequisites for creating a conducive environment in which firms can thrive. Therefore, the prospects for these firms are closely tied to the restoration of peace and political stability in the country.

"The necessary and sufficient condition is maintaining peace and stability."

Key informant – Professional Association

While optimism prevailed overall, a few firms expressed outright pessimism about the future.

"My current experiences have damaged my morale. Overall, things aren't favorable. In the past, we persevered through many challenges, always hoping for a better tomorrow. Now, it feels hopeless. I believe only a small percentage of people would agree to venture into such a business in the future."

Service firm – Woodwork.

2.8 Firms' stories

To gain deeper insights into firms' perspectives, the following composite personas were created, based on the in-depth interviews conducted with key representatives of the firms, to reflect the core themes and viewpoints that emerged from the conversations while protecting their anonymity. The AI-generated images help visualize these archetypes in a realistic yet anonymous way. By humanizing the qualitative data through these fictional but representative narratives, the aim is to highlight the key motivations, struggles, and visions voiced by participants as they navigate a challenging and evolving economic landscape.

Alemu | The struggling optimist



"In spite of the setbacks, especially with getting enough raw materials and dealing with high costs, I'm keeping my hopes up. We've managed to keep going so far, and I believe that with some hard work and a bit of luck, we can expand our business and maybe even start exporting one day."

Alemu is a seasoned manager running a small garment factory. For years, Alemu has navigated raw material shortages and inflationary currents. He constantly adapts to fluctuating markets, overcoming customs hurdles to keep the business afloat. Alemu remains persistently optimistic about future growth, believing threats are also opportunities. His resilience reflects the sector - struggling but unwilling to give up. Alemu plans equipment upgrades and potential export markets. Rather than wait for conditions to improve, he persists through the storm.

Business environment: Alemu faces significant headwinds due to raw material shortages, customs issues, and inflation. However, he remains hopeful about the future.

Performance factors: Alemu struggles with increasing costs, political instability, and a lack of resources, including workspace and materials. In spite of these logjams, Alemu has managed to maintain steady operations and even see modest success.

Future outlook: Alemu is determined to overcome obstacles through innovation, persistence, and strategic planning. He plans to expand operations, improve production capabilities, and possibly explore new markets undeterred by current problems.

Haile | The cautious striver

"Last year was incredibly hard. With the costs of materials skyrocketing and the market being so unstable, it's getting harder to see a bright future. I'm seriously thinking about whether it's worth continuing or if I should just cut my losses and move on."

Haile's woodworking shop exemplifies the struggles of small firms in a volatile climate. Running the workshop for over ten years, he now faces soaring costs, falling demand, and unreliable supplies that have brought his operations to the brink. Haile laid off staff as his once-busy workshop downsized. Striving under adversity, his outlook remains darkened by dwindling resources even if he still hopes for a turnaround. Like many owners, he persists on a sliver of optimism while braced for hardship.



Business environment:

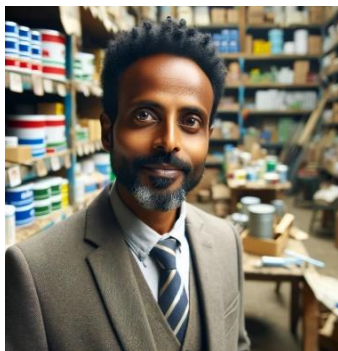
Increasingly stumped by the current economic climate, marked by high inflation, supply chain issues, and political instability. Haile feels that conditions have worsened significantly compared to previous years.

Performance factors:

Struggles with material shortages, high operational costs, and a lack of space. Political instability and market fluctuations have had a severe impact on business operations.

Future outlook: Pessimistic about the immediate future, with concerns about sustaining operations in the current environment. Haile is considering downsizing or liquidating assets due to the pressures of maintaining business viability.

Abebe | The resilient optimist



"Things are heavy right now, but we keep supplying building materials. We're ready for what's next. We change when we need to and keep our hopes up because we know our work is important for the future."

Abebe runs a building supplies business in the changing economic landscape. Despite the hardships of inflation and reduced purchasing power among the populace, his determination never falters. His shop, once active, now faces the reality of scarcity, both in customers and supplies. Yet, he stands firm in the belief that his services are vital for the nation's future.

Business environment:

Abebe feels the pinch of the economic downturn firsthand. His sales have dipped as the cost of living rises, but he adapts swiftly to the new normal, ever hopeful for an improvement.

Performance factors:

Abebe struggles with the daily grind of running a business amid soaring prices and material shortages. His managerial acumen is tested each day, yet he remains unwavering, dedicated to his company's survival and growth.

Future outlook:

His outlook is a blend of pragmatism and optimism. While cautious about the immediate future, he nurtures a vision of recovery and prosperity, driven by the continuing need for housing and construction.

Selam | The adaptive businesswoman

"Running a bakery these days feels like a daily battle, especially with the input shortages and having to close early for safety. But we're pushing through, focusing on keeping our doors open and serving our community as best as we can."

Selam is the dedicated owner of a bakery that has been a fixture in her community for over two decades. Faced with an environment where imported ingredients are scarce and growing security concerns affects daily operations, she has adapted her business strategy to focus on maintaining quality and her employees' welfare. Despite the restrictions, Selam's bakery remains a hub of activity, a testament to her resilience and commitment to her craft.

Business environment:

Encounters difficulties due to the lack of imported inputs and the inability to plan or maintain inventory, leading to a constant struggle to meet strong product demands.

Performance factors: The main obstacles are the scarcity of essential inputs like flour and maintaining high-quality standards under these constraints. Growing security concerns have also led to reduced operating hours for employee safety, adversely affecting profitability.



Future outlook: While hopeful of maintaining her business through a turbulent period, Selam is cautious about the possibility of significant expansion, focusing instead on adapting to current limitations and ensuring business continuity.

Tesfaye | The determined survivor

"We keep cooking and serving, no matter how hard it gets. We're not just filling plates today; we're keeping our place ready for better times that are sure to come. We keep smiling and waiting for the day when everyone can enjoy being here again."

Tesfaye has been running his bar and restaurant for decades. Lately, things have been hard. Prices keep going up, so he has to charge more for food and drinks. He doesn't want to lose his workers, so he keeps the place open, even if it's not making much money. He doesn't expect big changes soon but thinks that if he can keep his restaurant going, it might start to do a bit better. He's working hard and trying to stay positive, waiting for peace so his business can grow again.

Business environment:

Struggles with high inflation, unstable supply chains, and input shortages, leading to frequent price changes and reliance on loans to keep the business running.

Performance factors: Continues operations out of loyalty to employees, despite the financial strain and the temptation to close unprofitable branches. Tackles the hurdle of cash shortages, inflation, and fixed expenses while navigating the additional difficulties posed by political instability.



Future outlook:

Remains hopeful about the long-term prospects of the economy, betting on improvements in tourism and infrastructure to support business growth.

4. Conclusion and recommendations

The Ethiopian economy is undergoing a period of significant change, marked by both positive trends and strained circumstances. One key trend is the shift in the composition of GDP, where the industry and service sectors are growing, while the share of agriculture is declining. This diversification holds promise for future economic growth, but there are also new threats.

The country is currently grappling with various macroeconomic imbalances, including high inflation, restricted access to foreign exchange, and a liquidity crunch within the banking system. These conditions have created a complex and challenging environment for small firms across various sectors. One of the most significant hurdles facing small firms is soaring inflation, which has led to escalating input costs for raw materials, rent, utilities, and labor. This has put immense pressure on their profitability and forced them to pass on some of these increased costs to customers, ultimately reducing demand and reducing sales. Another major problem is the foreign currency shortage, which is making it difficult for small firms to access the necessary supplies for their operations. This is particularly problematic for firms that are heavily reliant on imported inputs, as they are forced to pay significantly higher prices due to limited supply. Small firms are also struggling to access formal financing due to insufficient collateral, stringent eligibility criteria, and liquidity constraints within banks and microfinance institutions (MFIs). This lack of access to capital is further compounded by the NBE's measures to limit bank credit expansion, which aims to control inflation but inadvertently restricts access to funding for already struggling businesses.

Despite these challenges, small firms have adopted various strategies to survive and navigate the volatile economic landscape. These include improving operational efficiency, sourcing alternative suppliers, diversifying their product and service offerings, and passing on increased input costs to customers. However, not all of these strategies have been successful, and many firms have resorted to informal financing sources, primarily using personal savings, which is not a sustainable solution in the long term.

The overall outlook for small firms in 2016 is cautiously optimistic, but their future success will depend heavily on improvements in the broader economic and political environment. Adaptive strategies and financial flexibility will be crucial for these firms to run the gauntlet of input shortages, inflationary pressures, restricted access to credit, and political instability. Addressing these challenges requires a multi-pronged approach. The first step is to continuously monitor progress, particularly in addressing the structural bottlenecks that impede small firms' growth. This will allow for the implementation of concrete actions to tackle these issues and ensure their effectiveness.

It is critical to implement strategies that offset the negative consequences of inflation control efforts and improve the availability of funds to small firms. This includes expanding access to microloans with relaxed collateral requirements and flexible repayment options tailored to their specific needs. The government could also introduce guarantee schemes to reduce risks for financial institutions and encourage them to lend to these businesses. In addition, commercial banks that are directly or indirectly (wholesale lending to MFIs) reaching small firms could be exempted from NBE's 14% credit cap. Furthermore, different initiatives such as digital lending, lease financing and introduction of capital market could be fast paced and substantial scaled.

Additionally, initiatives that encourage the local production of essential inputs can help ease the burden of rising import prices. This could be achieved through tax breaks, subsidies, and infrastructure development projects that support local businesses in this sector. The Ministry of Industry has introduced the “Ethiopia Tamirt” initiative to substitute imports. Such kinds of initiatives should be well-resourced and supported to reduce dependence on imported inputs.

Small firms could also benefit from forming cooperatives, which can help them negotiate better prices and secure bulk discounts for essential supplies. This collaborative approach can play a significant role in reducing costs and enhancing their competitiveness.

The government has a crucial role to play in realizing these outcomes. It can create a more supportive environment for small firms by implementing the proposed policy recommendations and playing a more active role in supporting their development. This includes prioritizing government procurement from small firms, particularly those owned by women and youth, to stimulate demand and foster economic growth.

By addressing the trials and tribulations faced by small firms and actively supporting their growth, the Ethiopian government can ensure their long-term sustainability as well as their contribution to economic development. This will require collaboration between the government, financial institutions, and the private sector to create a supportive ecosystem for these vital businesses.

Annexes

Annex 1. Background and Methodology

1.1 Background

First Consult is a prominent economic development consulting firm in Ethiopia. It focuses on helping dynamic and leading organizations reach their full potential, contributing to the development of Ethiopia and Africa as a whole. It specializes in workforce development, enterprise development, and access to finance. It provides effective and business-oriented solutions to its clients' development, business, strategy, human resources, finance, and investment needs.

1.2 Rationale

During the 2015 fiscal year, the Ethiopian economy faced a range of shocks and experienced various changes. These were due, in part, to the ongoing effects of the COVID-19 pandemic and conflicts from previous years. At the start of the year, the country grappled with issues such as a foreign currency shortage, liquidity constraints in the banking system, and declines in investment and Official Development Assistance (ODA).

Nonetheless, prospects for an economic rebound are emerging as the impact of COVID-19 begins to wane and businesses display notable resilience. Furthermore, the Pretoria peace accord has fostered improved ties with the international community, with active endeavors underway to rehabilitate areas marred by conflict. The consequences of these and other economic and non-economic developments on businesses and consumers is not always evident in Ethiopia's rapidly evolving and complex economy. It is equally uncertain how businesses and consumers will respond to and adapt to these changes.

In light of this, First Consult seeks to enrich the discourse by offering insights to various stakeholders who are striving to understand the interconnections among these developments and their effects on businesses. As part of this endeavor, it has conducted research to explore the performance of the Ethiopian economy—particularly that of small firms—during these uncertain and changing times. The research examined key macroeconomic indicators and synthesized perspectives from the government, the private sector, and academia, with a particular emphasis on small firms.

1.3 Objective of the research

The research embarked on a journey to unravel various facets of the Ethiopian economy and the implications of its performance on small firms, particularly through a series of pertinent questions. The first part of the research explored the state of the Ethiopian economy in the fiscal year 2015, examining a spectrum of macroeconomic indicators along with significant changes and developments.

The second part of the research assessed the repercussions felt by small firms due to these economic developments and changes, particularly during the specified fiscal year, with a focus on the impact of inflation, the foreign currency shortage, devaluation, and access to finance. The research probed into the risk management strategies employed by small firms to navigate these economic perils and uncertainties. Additionally, it explored the performance and adaptive strategies of small firms amidst periods of change

and fluctuation. Finally, it captured the perceptions and anticipations of small firms regarding the future, providing a holistic view of their current operations and forward-looking strategies amidst the evolving economic landscape.

1.4 Methodology

1.4.1 Desk review

A desk review was carried out to assess the macroeconomic environment and provide a broader picture of the state of the Ethiopian economy. The review sifted through a wide array of secondary data sources, including industry reports, economic forecasts, and government publications pertinent to the Ethiopian economic landscape. The intent was to create a comprehensive context that could be compared and contrasted with the findings of the primary research. The desk review delved into macroeconomic trends, policy shifts, and prior studies that revealed patterns and insights critical to understanding the current economic dynamics.

1.4.2 Survey and in-depth interviews of small firms

The primary research on small firms explored how they survived and thrived within the dynamic economic environment. This component of the research utilized a dual-faceted approach, incorporating both quantitative and qualitative methods to obtain a holistic view of firms and draw in-depth insights from key stakeholders and industry players.

Quantitative data was gathered from small firms actively engaged in the manufacturing and service sectors. The survey reached out to 312 firms distributed across Addis Ababa, Adama, Hawassa, and Dire Dawa, with approximately 60% of these firms located within Addis Ababa.

Table 2: Distribution of firms by sector and size

Sector	Firm size ⁴³		Total
	Micro ⁴⁴	Small ⁴⁵	
Manufacturing	39	60	99
Service	162	51	213
Total	201	111	312

The word cloud visualization below depicts the distribution of surveyed firms across manufacturing and service sub-sectors. The left cloud illustrates the distribution within manufacturing sub-sectors, while the right cloud displays it across service sub-sectors, based on sample frequencies. Notably within the manufacturing sector, sub-sectors such as woodwork, textiles/garments, bakery/injera production, and concrete block manufacturing, were prominent. In contrast, the service sector was characterized by a concentration of firms in fast-moving consumer goods (FMCG) shops, hotels, bars, and restaurants.

⁴³ Definition of Organization, Powers and Duties of the Ethiopian Enterprise Development Regulation No. 526 /2022

⁴⁴ Firms in this category had a maximum of 10 employees and their total assets were worth less than Birr 600,000.

⁴⁵ These were firms with 11 to 50 employees and total assets worth between Birr 600,000 and 10,000,000.

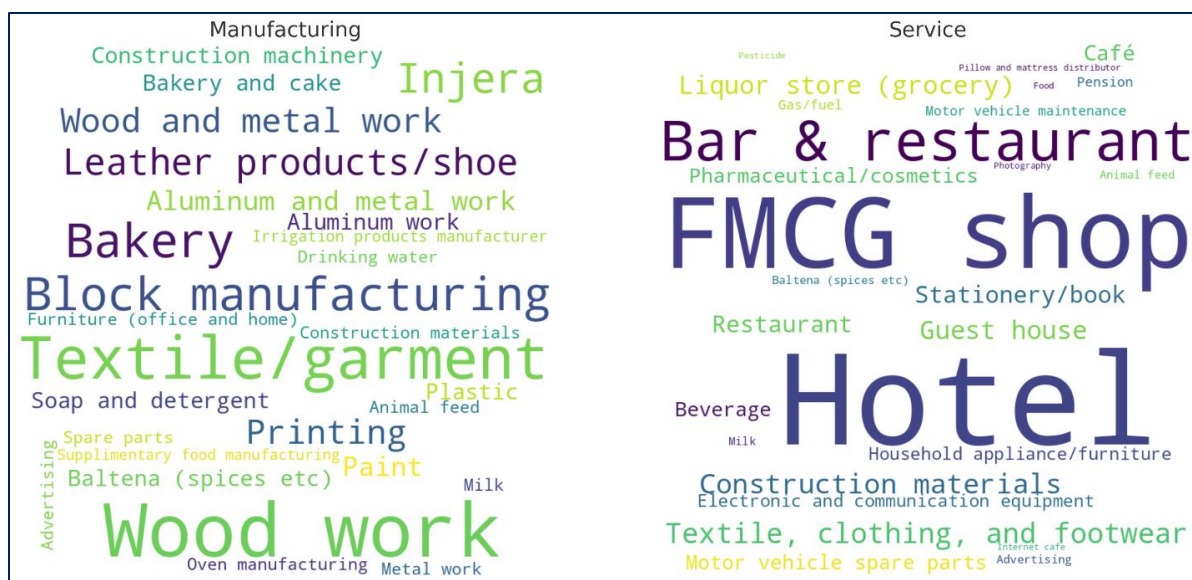


Figure 66: Sectorial and sub-sectorial composition of surveyed firms

Concerning qualitative data, narratives were captured from 18 selected firms in the same sectors, complemented by valuable perspectives from 8 key informants recognized for their thorough industry understanding and capacity to impart significant insights.

1.5 Scope and limitations

The results of the primary research pertain solely to the surveyed sample and are not meant for broad application across the wider small firm population. Omissions of key locations in the survey, forced by concerns over insecurity and instability, may have implications for the comprehensiveness and wider applicability of the findings. Limitations in sample representation and geographic distribution should be taken into account in the interpretation of the outcomes.

Annex 2. Survey Locations

Survey locations.

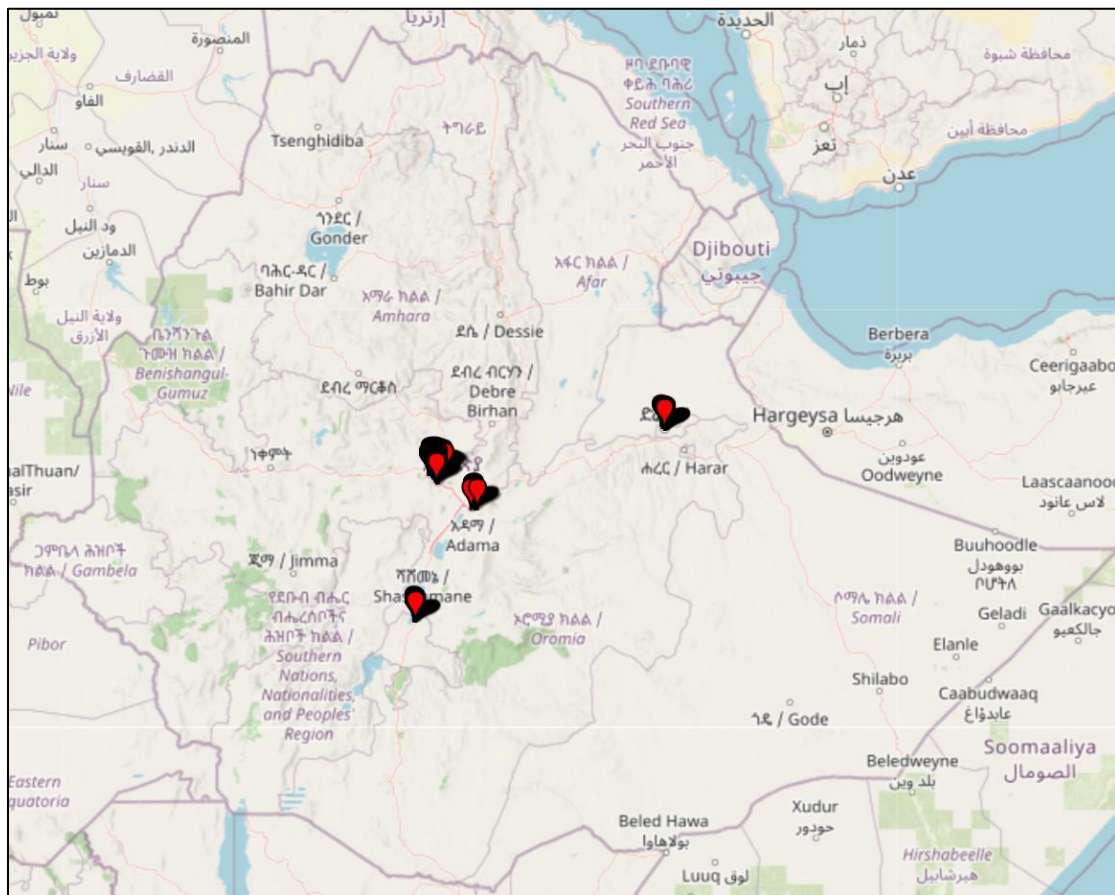


Figure 67: Survey locations.

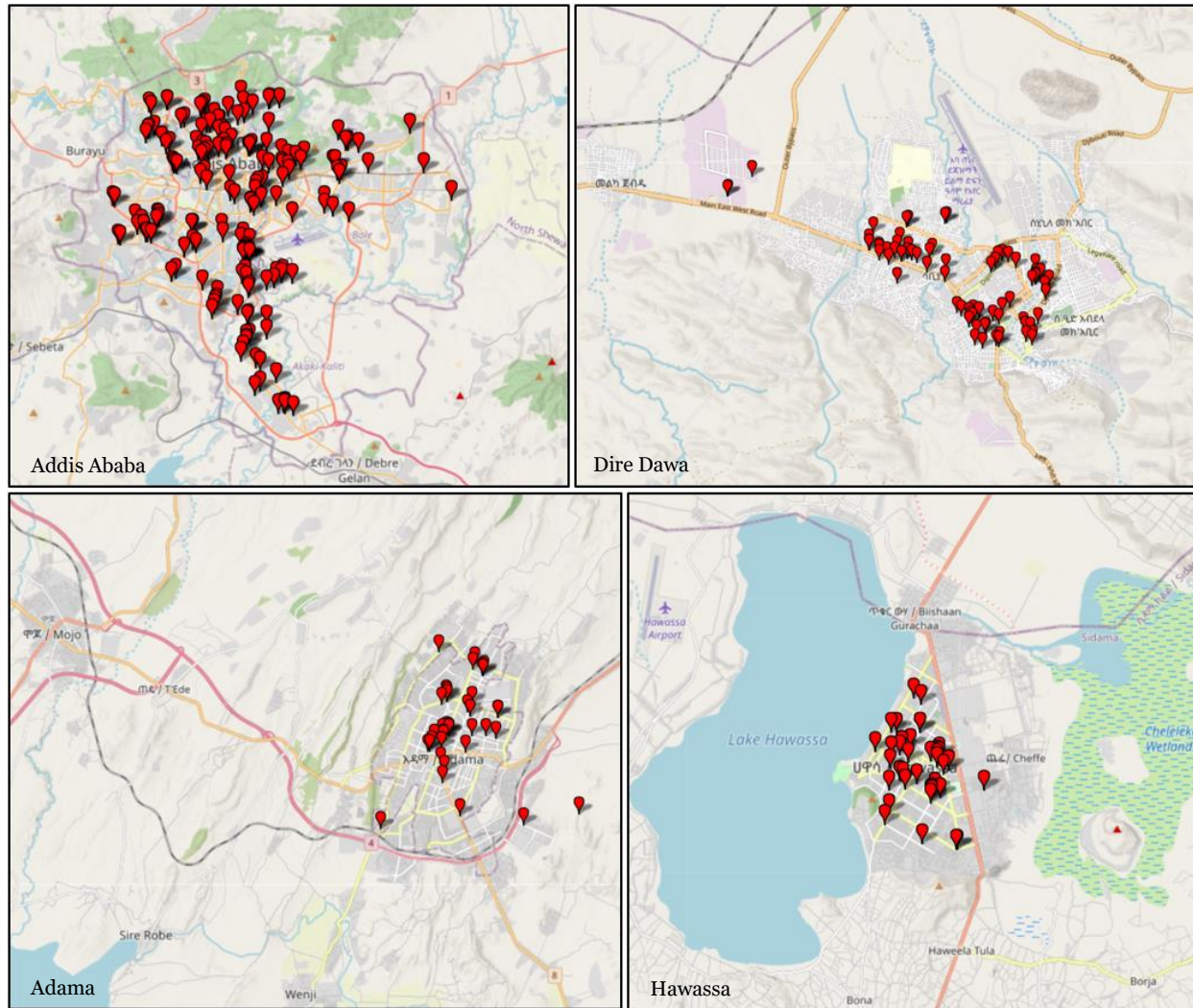


Figure 68: Detailed overview of survey locations.