

**THE IMPACT OF CREDIT ON MICRO- ENTERPRISE
GROWTH IN DEVELOPING COUNTRIES: A CASE
STUDY OF KENYA 1994 - 2004**

BY: OMWOYO F. JOHN

**This Dissertation is Submitted in Partial Fulfilment for the
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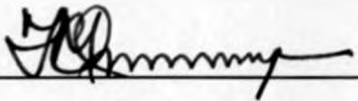


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OCTOBER 2006

DECLARATION

This dissertation is my original work and has not been presented for the award of a degree in any other University.

Signature:  _____

Date: 13/10/2006

Omwoyo F. John

This dissertation has been submitted for examination with my approval as a University Supervisor.

Signature:  _____

Date: 13/11/2006

Njoroge Lucas

DEDICATION

To my late parents Benjamin Omwoyo and Esther Nyakerario for their untiring concern for my progress, my wife Tabitha, and children Bina, Bosibori, Brian and Derrick.

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ABSTRACT

The micro-finance sector has been considered to be of extreme importance for developing countries such as Kenya given its potential on poverty alleviation, employment creation and promoting socio-economic transformation. The core focus of this study was to investigate the impact of credit on micro enterprise growth in developing countries with reference to Kenya for the period 1994-2004.

The study sought to examine the impact of credit accessibility on MSE growth in Kenya, investigate the mechanisms the Kenya government has put in place to improve credit accessibility by MSEs and outline policy options that can enhance credit accessibility by MSEs in Kenya.

The study found out that limited credit access by MSEs has been a major constraint in their development in Kenya. The mainstream financial institutions advance credit against property, debentures on stock, and moveable assets as security which majority of MSEs lack. As a result only 6% of MSEs were able to successfully access and use credit. Indeed more than a third of MSEs close down due to inadequate working capital. This implies the potential role of MSEs in poverty reduction and socio-economic transformation is unlikely to be achieved.

The MSEs that access credits successfully survive longer and are able to expand. The stringent collateral requirements need to be reviewed. Access to bank credit in Kenya is largely confined to medium and large scale enterprises

with secure land titles or property. This has forced MSEs to seek credit from informal sources such as friends and relatives whose terms are flexible. In fact from the study the most important source for starting and additional capital is own/family funds. Equally governmental efforts on addressing credit access have not been successful.

The study recommends that in order to facilitate MSEs access to credit; establishment of micro finance banks that cater exclusively for MSEs is necessary, nurturing cooperation between mainstream commercial banks with micro finance institutions, strengthening existing credit institutions such as KIE, and establishment of MSE forum and enactment of MSE – specific laws.

CHAPTER ONE

1.1 Introduction

The International lending agencies such as the World Bank, United States Agency for International Development (USAID), Germany Technical Cooperation (GTZ), Care International, Plan International, European Investment Bank (EIB), Department for International Development (DFID) and other lending institutions, have had credit programmes that lend to micro enterprises in Developing countries. Most of the funding from international institutions has been channelled either through governments of these Developing countries, private agencies or Non –Governmental Organizations. Developing countries have also been able to initiate micro credit programmes either through informal savings and credit associations or cooperative savings and credit societies.

The micro enterprise sector in Kenya (also known as informal sector) first gained recognition in 1972 when the International Labour Organization (ILO) studied the contribution of the informal sector to the economy. The study highlighted the importance of the sector towards the creation of employment and poverty alleviation. A comparison of the trend in employment in the informal and formal sectors, indicated that the formal sector had the potential to employ a large number of people as compared to those employed by the formal sector. Following the International Labour Organization's Report of 1972 a number of studies have been carried out identifying the role of micro enterprises as being important to the economy of the country.

The micro enterprise sector in Kenya plays an important role in the provision of employment and income to a large section of the population. The sector has also led to increased production of affordable goods and services in Kenya.

The government of Kenya has recognized this sector through its National Development Plans and other official publications. The Sessional Paper No 1 of 1986, the sixth National Development Plan 1989 – 1993, Sessional Paper no. 2 of 1992 and the National Development Plan 1997 – 2001 are some of the publications highlighting the importance of the micro enterprise sector.

The micro enterprise sector is now considered to have a capacity to generate employment and provide the foundation for the country's industrialization. This sector will help in the achievement of development objectives such as alleviating poverty, promoting employment, facilitating transition to the market economy and promoting national and regional social – economic development.

However, a number of studies have identified various constraints that hinder the growth of micro enterprise sector. The constraints include, lack of credit or capital, infrastructure, such as transport, premises and markets.

There is also the problem of harassment from local authorities and stringent government laws and regulations such as taxation and lack of incentives for micro enterprises. Lack of access to credit has been identified as a major constraint hindering growth of micro enterprises. Lack of financial services and access to mainstream lending through commercial banks have been identified as a major constraint. Although these lending programmes exist in Developing

countries there is no significant growth or development of micro enterprises. The reasons advanced for the slow growth is limited access to credit. This will be the focus of this study.

Organization of the Paper

This study is organized into five chapter chapters. Chapter one entails statement of the problem, objectives and justification of the study, theoretical and empirical literature review, hypotheses and methodology. Chapter two looks into the micro enterprise sector in Kenya for the period under study (1994-2004). Chapter three covers the sources of financing of MSEs in Kenya. Chapter four evaluates the research findings and the way forward while chapter five entails summary, conclusion and recommendations of the study.

1.2 Definition of Concepts

Micro-Enterprises - in this study Micro enterprises refers to those enterprises in the informal sector popularly known as Jua Kali which employ up to 50 employees and have limited degree of legal formality which distinguishes them from formal sector of the economy¹.

Growth of micro enterprises - refers to positive change in the incomes and or consumption, employment and profitability of micro enterprises².

Jua Kali – Strictly speaking refers to the full range of enterprises employing between 1-49 workers in all sectors.

¹ A. Mullei and C. Bokea (eds) **Micro and Small Enterprises in Kenya**. (Nairobi: International Centre for Economic Growth, 1999).

² Ibid.

1.3 Problem Statement

A variety of credit programmes have been in operation in the country since independence to assist Micro and Small Enterprises (MSEs). These were either government initiated programmes for example Industrial and Commercial Development Corporation (ICDC), Kenya Industrial Estates (KIE) or Non-Governmental Organization (NGO) initiated programmes like K-REP. Though evidence points out that credit has been increasing steadily than expected, the (MSE) Sector has not been able to benefit from this increase. Indeed credit accessibility has been on the decline. The various studies done on MSE have covered different aspects of financing in the MSE Sector. Some have pointed out the importance of credit accessibility to MSE growth; others have identified the impediments to MSEs accessing credit.

This study examines the impact of credit accessibility on MSE growth; identifies impediments to credit access by MSEs, and most important outlines strategies and policies to improve MSEs credit accessibility. In a nutshell it will endeavour to synthesize the main aspects of credit accessibility and MSEs growth.

Shortage of credit has arguably been identified as a major constraint that faces micro enterprises in Developing countries. Micro enterprises have had little or no access to credit, a factor which has stifled growth of micro enterprises. A number of studies have concluded that performance of micro enterprises is expected to grow once the problem of access to micro credit is solved. Lending to Micro Enterprise Sector by mainstream banking sector is however limited for a number of reasons which include past lending experience with small and micro enterprises which generated a notion of high risk and cost of lending to the

sector. This left the micro enterprise sector to be served by non-banking financial institutions and other non-governmental institutions or agencies.

It has been observed that provision of credit would accelerate the growth of micro enterprises. This is because credit enables micro enterprises to acquire better tools and equipment/markets.

A number of micro finance institutions have been established to provide credit to micro enterprises. Such institutions include non-governmental organizations, community based organizations, rural savings and credit societies and other agencies. Some studies have concluded that access to credit improves profitability and quality of goods and services besides enhancing incomes and employment.

The mainstream financial institutions advance credit against property, debentures on stock and moveable assets as security. They sign detailed loan contracts with clients and follow complex administrative procedures for loan approval. Accessing bank credit is formal and lengthy. Potential clients with no real assets are locked out, small loans are discouraged because they do not cover the administrative cost.

These factors in addition to incomplete information about operations of MSE seriously limit their access to credit.

1.4.1 Theoretical Literature Review

There has been change in our understanding of development since the 1970s. Neoclassical economics saw the enterprise as a fixed production unit which could produce a certain output if it received sufficient inputs, and which operated at competitive, homogeneous and anonymous market, where the strategies of enterprises could be reduced to decisions about the price and quantity of goods to be bought, produced and sold. Petty commodity and dependency theory also saw enterprises as fixed entities, but they saw them as operating in monopolistic markets dominated and controlled by a few large enterprises. In view of these theories, the assumptions have been relaxed.

In the Scandinavian Network Theories, the neoclassical assumption of homogenous and anonymous markets saw the small enterprise as operating in specialised product markets, organizing and developing within specific often personal networks, where economic and social relations are highly independent and where the development of market networks, innovation process and the competitiveness of the enterprises depend in social relation as much as economic ones.

The theory of flexible specialisation³, focuses on market specialisation, technological and labour market differentiation among enterprises operating in a network of therapy of independent enterprises operating in an unstable and risky environment.

¹ M. Piore and C. Sabel, **The Second Industrial Divide: Possibilities for Prosperity**, (New York: Basic Books, 1984).

These theories have in common a focus not only on the material flows going in and out of the enterprise, but also on the dynamic, technological and organizational changes in the enterprise which are related to these flows. They equally consist not only of economic networks of large and small enterprises, but also the wider social and institutional relations.

Flexible specialization theory calls into attention several factors which are critical for the understanding of the dynamic of petty production, especially the fact that enterprise cooperation in clusters may lead to vertical disintegration and collection efficiency.

It also stresses that deliberate joint action involving the various actors at that stage can bring micro enterprises up to a higher level of development.

Stiglitz and Weiss⁴ contend interest rates charged by credit institutions have a dual role of sorting potential borrowers and affecting the actions of borrowers. Interest rates affect the nature of transaction and do not necessarily clear the market because of imperfect information in credit markets.

In an attempt to identify borrowers with high probability of repayment banks tend to use the interest rate that an individual is willing to pay as a screening device. However, the higher the interest rate the higher the risk of default. To mitigate against default the bank formulates the terms of the loan contract to induce borrowers to take actions in the interest of the bank and to attract low risk borrowers. This results in an equilibrium rate of interests at which the demand for

⁴ J. Stiglitz and A. Weiss. "Credit Rationing in Markets with Imperfect Information" in *American Economic Review* vol.71 No. 3 1981 pp 393-410.

credit exceeds the supply. The amount to be borrowed and collateral required will affect the behaviour of borrowers as well as the return to banks.

Besley⁵ argues there is need to intervene in rural credit markets in the face of market failure. Given that markets are characterized by imperfect information, and high costs of enforcement intervention is necessary. These problems lead to credit rationing in credit markets, adverse selection and moral hazard. Lenders fix interest rates at a lower level and important factor that explains the existence of credit rationing in rural credit markets. Moral hazard occurs because projects have identical mean returns but different degrees of risk and lenders are unable to discern the borrowers actions.

Bell⁶ concurs that limited information or imperfect contract enforcement leads to possible loan default and eventually problems of credit rationing.

1.4.2 Empirical Literature Review

Morris and Sommerset⁷ in their study of entrepreneurship and development in Kenya identified inability of African businessmen to access financing as a major constraint in their growth. Whereas the government could aid in financing micro enterprises it was narrowly circumscribed because when it took a strong initiative it overwhelmed the entrepreneurial drive of small business. They contended that the government could improve access to capital for MSE where social barriers inhibited economic relationships.

⁵ T. Besley "How do Market Failures Justify Information in Rural Credit Markets?". **The World Bank Research Observer** Vol. 9 No.1 1994 pp.27-47.

⁶ C. Bell. "Interactions Between Institutional and Informal Credit in Rural India." **World Bank Economic Review** Vol. 4 No.3 pp. 297-327.

⁷ P. Morris and A. Sommerset. **African Businessman: A study of entrepreneurship and Development in Kenya in Kenya** (Nairobi: E.A Publishing House. 1971) P. 204.

The reluctance of private finance to support MSE arose not only from lack of information but also from doubts about their competence. They argued that MSEs could not organize their labour, keep accounts or manage technical process hence money alone could not help them. Morris and Somerset tend to shift the blame to the MSEs for their inability to access credit while ignoring such vital factors as social structure which isolated them from mainstream financial network.

Oketch⁸ contends that lack of access to credit is not just a Kenyan phenomenon it is cited around the world as the biggest constraint to micro enterprises growth. Studies in the country indicate that lack of credit and finance, whether for working capital, fixed capital or other type is a major impediment to 32.7% of firms in MSE sector. The majority of MSEs rely exclusively on own savings and reinvested profits for their business finance.

Available evidence demonstrates that accessibility to credit determines the success of many MSEs. Most MSE surveys in Kenya indicate that enterprises that have had access to credit as well as other inputs have survived longer and additionally were able to expand more than those without access. The studies equally show a positive relationship between an enterprises access to credit and the level of net income in the enterprise.

The sessional paper No. 2 1992 identified a number of factors constraining access to credit by small-scale clients. These include lack of experience of

⁸ H. Oketch "Credit and Finance". A. Mullei & C. Bokea (eds) **Micro and Small Enterprises in Kenya**. (Nairobi International Centre for Economic Growth, 1999) pp.35-41.

borrowers with credit institutions, reluctance by formal institutions to lend to small enterprises and regulations that limit the funds available for lending to stringent collateral requirements, high interest rates and high administrative overheads have made credit access difficult.

Otero and Rhyne⁹ proposes that for micro enterprises to prosper they must have sufficient supply of working capital for the purchase of supplies and inventories. As they expand micro enterprises need to invest in assets such as tools, equipment or improved premises. The centrality of accessibility to capital cannot be down played as lack of it makes MSE miss opportunities for business growth.

They contend that main stream financial institutions cannot serve micro enterprises because banks must process loans at a cost that can be covered by interest charges, and they must have confidence in the borrowers interest and ability to repay¹⁰. The practices that most banks use to gain confidence in the quality of loans are expensive. These involve credit checks to gain information about the client's character, project appraisal to access the client's business prospects, and formal collateral. These cannot be used in micro enterprises lending because project appraisal is too expensive and most MSE do not keep records. They equally lack marketable collateral. These factors keep mainstream commercial banks out of MSE lending.

Given the importance of MSEs in income generation and employment creation governments in the developing countries can aid their access to capital by

⁹ M. Otero and Rhyne (Eds). **The New World of Micro Enterprises Finance: Building Health Financial Institutions for the poor** (London: Intermediate Technology Publication, 1994) p.1.

¹⁰ Ibid

making it easier for programmes offering specialized financial services to micro enterprises to become financially self sufficient. Giving support to the efforts of NGO based programmes to become specialized financial institutions, encouraging main stream financial institutions to develop specialized micro enterprises operations on their own, and supporting the efforts of NGO based programmes to gain access to commercial sources of funds. However these not withstanding the two contend with the fact that the above policies will only succeed depending on the general economic climate in which they take place¹¹. The developing countries cannot be treated uniformly for instance there are some experiencing rapid economic growth, those in stagnation while others have virtually collapsed e.g. Somalia.

National Micro and Small Enterprise Baseline survey 1999 points out access to credit as a key problem curtailing the growth of MSEs. While credit in the banking sector has been growing steadily in past very little of this credit has reached the MSE sectors¹². This has made a majority of Kenya's MSEs to operate without any form of credit. How to improve the accessibility of credit by MSE has remained a daunting task.

Reinforcing the centrality of credit accessibility to MSEs growth ending. Ondiege¹³ points out initial and working capital and credit accessibility as the most critical issues in the informal sector's and small enterprises growth and

¹¹ Ibid

¹² **National Micro and Small Enterprises Baseline Survey** 1999. (Conducted by CBS, ICEG and K-REP Ltd. 1999) Pp. 52-54

¹³ P.O. Ondiege "Capital and Performance of Small Enterprises in Kenya" in D. McCormick and P.O. Pederen (Eds) **Small Enterprises: Flexibility and Networking in an African context**. (Nairobi: Longhorn Kenya Ltd. 1996) Pp. 168 – 169.

development. Drawing from research done in Nairobi, Kisumu and Mombasa on small enterprises Ondiege concluded that inadequate working capital is the major constraint to expanding businesses and improving their productivity. In his view increasing capital availability through credit facilities to the sector will lead to increased employment, income and profit margin levels¹⁴. That credit improves the performance of MSEs, in terms of the changes in profits and quality of goods and services of MSEs as a result of being able to access better technology, working capital and raw materials with ease.

Kibas¹⁵ drawing from a study done about impact on credit on women - operated businesses in Uasin Gishu district drew attention to the necessity of drawing policies and other strategies to be developed and implemented so as to make credit available, accessible, and affordable. This requires a lot of effort by NGOs, the government and other private sector stakeholders involved in the MSEs sector. Kibas eloquently demonstrated the impact to credit on small enterprises and recommended the need to come up with strategies to improve accessibility but did not give these strategies. This will be one of the key objectives of this study that is outlining policies and strategies to improve credit accessibility by MSEs.

Furness¹⁶ underscoring the importance of credit access for small enterprises growth, contends that even in Western countries the establishment of credit

¹⁴ Ibid p. 171.

¹⁵ P. B. Kibas "Impact of Credit on Women-Operated Micro-Enterprises in Uasin Gishu District" in P. O. Alila and P. O. Pederson (Eds) **Negotiating Social Space: East African Micro-Enterprises**. (Trenton: Africa World Press Inc, 2001) P.220.

¹⁶ E.L. Furness **Money and Credit in Developing Africa** (Nairobi: Heinemann Educational Books Ltd. 1975) p.26.

institutions not only facilitated industrialization and capital accumulation but also gave a further boost to thrift and economic development.

The important role MSEs play in Kenya's economy cannot be down played. The MSEs contribute to poverty alleviation, employment efforts to obtain supplementary soft loans for on lending to public and private financial institutions that would then lend to the Small Scale Enterprises and Jua Kali sector.

The various studies have shown the vital issues regarding financing are: availability, credit accessibility, and efficient use to achieve business growth. Though these studies have pointed out credit accessibility to be important few have suggested on how to surmount this problem. This study will contribute by giving policy recommendations on how improve credit access by MSEs.

Ochieng¹⁷ carried out a study on the effects of financial capital (credit) in the growth of Nairobi's urban informal sector. The study observed that lack of access to credit was one of the major limitations of the informal sector and by extension, a major constraint to employment creation in the sector. The study investigated the impact of credit by looking at the volume of sales, investment levels in the informal business, changes in innovative capacity of the entrepreneurs and changes in employment.

It captured the relationship between credit and growth by looking at the size of the business before and after receiving of credit; the type of business the credit it is injected into, experience in business management and the nature of sales

¹⁷ O. N. Ochieng. **An Evaluative Study of the Effects of Financial Capital (Credit) on the Growth**. (Nairobi: Kenya Institute of Administration, 1987).

(volume) before and after the loan is injected. It found out that the injection of credit had a positive impact on the growth of the informal sector such that incomes increased with time, investment and cash flow increased¹⁸. There was also improvement in managerial skills.

The study was done in Nairobi and in the pre-liberalization period (before 1992). Being a city, Nairobi has a heterogeneous environment in terms of economic activities, is prone to artificial inflation and thus, data on economic activities (especially trade) may not reflect the true behaviour of economic agents. The study collected a sample of 30 firms which (as he admitted is a limitation) was too small for generalization purposes.

The study noted implementation of structural adjustment programs (SAPs) enabled people to engage in trade; and sub-division of agricultural land enhanced the growth of Micro Enterprises. Lack of institutional credit facilities, management skills, and competition from formal domestic and multinational companies also affected the performance of the enterprises.

The government, through several Sessional Papers¹⁹ (e.g. Sessional Papers No. 1 of 1986, No- 2 of 1992 and No. 2 of 1996) on Micro Enterprises outlined several measures aimed at boosting credit availability to Micro Enterprises. These include the promotion of credit and finance (fixed and working capital) and establishment of Non-Financial Promotional Programmes (NFPPs). The

¹⁸ Ibid

¹⁹ Republic of Kenya, **Sessional Paper No. 2 of 1992: Micro Enterprise Credit, Employment, Incomes and Output, National Development Plan 1997-2001, National Micro and Small Enterprise Survey Results 1999**, (Nairobi: Government Printer).

Sessional Paper No. 2 of 1992 proposed detailed promotional measures and programmes. These measures and programmes were in the form of structural adjustment policy of deregulation and liberalization. Investment incentives were also proposed so as to encourage entrepreneurs to start Small Scale Enterprises in the informal sector. These included: investment allowances for factories established outside Nairobi and Mombasa, exemption of import duties of machinery worth not more than Kshs. 20 million for small enterprises located in the rural areas and establishment of District Development Fund in 1987 to enhance the provision of an enabling infrastructure via establishment of rural trading and production centers in some towns. A Rural Enterprise Fund was established in 1987 to finance Jua Kali artisans and entrepreneurs through the Jua Kali fund in the Ministry of Technical Training and Appropriate Technology.

Dondo²⁰ noted that ministerial agencies providing credit/assistance programmes for the informal sector had been established for example, Kenya Industrial Estates (KIE), Kenya Institute of Business Training (KIBT), Small Enterprise Finance Company (SEFCO), the Industrial Commercial Development Company (ICDC), District Industrial Committees and Women Training Bureau. The government of Kenya in 1992 outlined several measures that were aimed at easing accessibility of credit by Small Scale Enterprises. An enabling environment for the operation of small-scale enterprises finance institutions was to be provided. Banks were allowed to charge competitive rates that would give them adequate margins meant to cover the relatively high costs of loans to Small Scale Enterprises. Intensifying government efforts to obtain supplementary soft

²⁰ A. C. Dondo. **Financial Services for the Jua Kali Sector in Kenya.** (Nairobi K-Rep Occasional Paper No.5, 1989).

loans for on lending to public and private financial institutions that would then lend to the Small Scale Enterprises and Jua Kali sector.

In addition, banks and Development Finance Institutions (DFIs) that provided services to their Small Scale Enterprises clients before credit extension were to be allowed to charge reasonable fees for such services for sustainability purposes; and establishment of a special training fund for Small Scale Enterprises and Jua Kali entrepreneurs.

The Central Bank of Kenya was required to establish a consultative forum that would enable banks to continuously review various policies and regulations that hinder the flow of credit to the Small Scale Enterprises sector. It was also to initiate studies concerning the comparative risks and costs associated with lending to Micro enterprises, so as to lay the groundwork for future policies in the banking sector.

Development Finance Institutions were allowed to mobilize and accept savings deposits as a source of funds for lending to Small Scale Enterprises; the government was to reduce its domestic borrowing so as to release/facilitate availability of more funds for lending to the Small Scale Enterprises sector. Modalities of establishment of an export credit guarantee insurance scheme, and the possibility of the establishment of a Small Scale Enterprises export credit scheme were to be explored. Regarding collateral for loans security, the CBK, in collaboration with commercial banks and financial institutions was to review the procedures and regulations of lending in order to make collateral requirements

flexible and responsive to the credit needs of the Small Scale Enterprises and Jua Kali sector.

The government of Kenya in 2001 proposed measures in support of Micro Enterprises as a poverty reduction strategy. In this regard, financial services and loans would be made more available and affordable. Through this a majority of Kenyan entrepreneurs would be able to invest for income generation and creation of a solid savings base for further investment.

A Micro Finance Institutions' Bill was drafted by the Central Bank of Kenya in 2002 so as to regulate the organizations that support Micro enterprises. This was an attempt to promote effectiveness in provision of credit services to Micro Enterprises. However, the MFI Bill is yet to be concluded and passed by Parliament.

A survey by the government of Kenya showed that since independence, Kenya has recorded considerable growth of financial institutions, some of which have been designed specifically for lending to the informal sector. According to Oketch²¹, of the 17 categories of financial institutions which were operating in the finance sector, four were active in financing Micro and Small Enterprise activities. These include savings and credit co-operative associations (SACCOs), Non Governmental Organizations (NGOs), and informal associations like rotational savings and credit associations (ROSCAs). In 1995 10.4% of Micro Enterprises had access to Small Scale Enterprises credit. Of this 3.45% was from formal

²¹ H. O. Oketch et al **Micro-enterprise Credit, Employment, Incomes and Output: Some Evidence From Kenya.** (Nairobi: K-Rep, 1991).

sources as compared to 4% in 1993 and 5.9% in 1994. The amount of credit supplied to Micro Enterprises in 1995 was Kshs 847 million.

According to the government of Kenya survey in 1999²² there were about 150 organizations in Kenya that had credit programs for Micro Enterprises. 130 of which were NGOs. Sixty-nine percent of the Micro Enterprises' credit came from informal savings and credit association's especially rotational savings and credit associations (ROSCAs), friends, and relatives.

Dondo²³ found that numerous Micro enterprise credit organizations exist: private, public, national and international that pursue programs to assist Micro Enterprises in Kenya that aim at improving/increasing income and welfare levels, and generating employment through credit provision, training and technical assistance.

The study noted that 10% of Kenya's entrepreneurs surveyed did not know of the existence of Micro finance Institutions that were already in operation at that time. Then, there were 43 organizations (NGOs, Church based organizations, International agencies, private or public) that had SME programmes offering credit, training and technical assistance. The number of NGOs that were involved in provision of credit to Micro Enterprises increased from 46 in 1995 130 in 1999²⁴.

²² Republic of Kenya: **National Micro and Small Enterprise Survey Results**. (Nairobi: Government Printer, 1999).

²³ A.C. Dondo, **Sustainability of Micro-Enterprise Credit Schemes in Kenya's Informal Sector**. (Nairobi:K-Rep Occasional Paper, No. 22, 1993).

²⁴ Ibid

However some scholars tend to differ on the role of NGOs provision of credit to MSEs. Tomecko et al²⁵ blame the NGOs for still having a social orientation to small enterprise lending and for finding it difficult to harmonize a tough banking approach with their original goals of social welfare. The argument is that subsidised interest rate and soft repayment policy do no good but only weaken the position of the credit institution. Alternatively socially oriented NGOs are less convinced about the advantages of the trickle down approach.

The credit problem withstanding there has been a focus on MSE as a source of employment and growth by the government. Currently many developing countries have incorporated micro-enterprises into their development plans. After the impact of the world recession on developing economies, micro enterprises are no longer considered a last resort²⁶. It is widely acknowledged that micro scale economic activities are currently a major source of employment creation in most developing countries.

Kimuyu and Omiti²⁷ point out MSEs in Kenya are generally undercapitalised due to operational difficulties in accessing credit. Only a limited number of MSEs are able to successfully access credit. This has meant high mortality rate of MSEs due to inadequate working capital. Productivity is poor for MSEs that fail to access credit as they are unable to operate efficiently.

²⁵ Tomecko & A. Dondo, **Improving the Growth Potential of the Small Scale and Informal Sector.** (Nairobi: Overseas Development Agency, World Bank 1993).

²⁶ J. Billetoft **Between Industrialization and Income-Generation: The Dilemma of Support for Micro Enterprises; A Policy Study of Kenya and Bangladesh** (Copenhagen: Centre for Development Research, 1996) p.16.

²⁷ P. Kimuyu and J. Omiti. **Institutional Impediments to Access to Credit by Micro and Small Scale Enterprises in Kenya.** (Nairobi: Institute of Policy Analysis and Research, 2000).

The various studies have shown the vital issues regarding financing Viz: availability, credit accessibility, and efficient use to achieve business growth. Though these studies have pointed out credit accessibility to be important few have suggested on how to surmount this problem. This study will contribute by giving policy recommendations on how to improve credit access by MSEs.

1.5 Objectives of the Study

- i) To investigate the impact of credit access on MSE development in Kenya.
- ii) Investigate what mechanisms the Kenya government has put in place to improve credit accessibility in Kenya for MSEs.

1.6 Justification of the Study

Policy Justification

Micro enterprises play a major role in the creation of employment and enhancement of incomes and therefore help in the alleviation of poverty in developing countries.

In Kenya, it is now widely recognized that the promotion of micro enterprises sector is a viable and dynamic strategy for achieving national goals including employment creation, poverty alleviation and balanced development between sectors and sub-sectors of the economy. There is need to address the challenges hindering MSE growth such as limited access to credit. This study will contribute towards this goal by making policy prescriptions.

Academic Justification

The findings of this study will contribute to the available literature on (MSE) Micro and Small Enterprise sector in Kenya. The previous studies have not sufficiently addressed the centrality of credit/capital to MSE development in Kenya, though they have addressed various factors affecting MSE development. This study intends to cover the gap by focusing on the centrality of credit to MSE growth, and also outline policy recommendations.

1.7 Hypotheses

1. Limited access to credit is a hindrance to the development of micro enterprises in developing countries.
2. Credit has a direct relationship with the development of micro enterprises in developing countries.
3. Government mechanisms have not adequately addressed credit accessibility by MSEs in Kenya.

1.8 Methodology

The study draws from primary and secondary sources.

- i) **Primary data:** this was collected through interactive interviews with selected institutions that lend principally to the MSE sector such as K-Rep Bank, Kenya Industrial Estates (KIE) and MSE division Ministry of Planning and National Development. The study randomly picked on these three because they are representative of lending efforts to the MSE. KIE represents a governmental organization formed to lend to MSEs. K-REP represents a non-governmental organization (there are hundreds of NGOs lending to MSEs). The study picked on this being a relatively successful

and pioneer on MSE lending in Kenya. The Ministry of Planning and National Development MSE division represents the policy position of the government.

- ii) **Secondary data:** Secondary data was collected through library research from sources such as academic papers, scholarly journals, text books, newspapers, documents from the government of Kenya. Reports from Central Bank, other financial institutions, and the World Bank reports. The study utilized secondary data for conceptual and methodological reasons. For economic reasons the study drew from the National Micro and Small Enterprise Baseline Survey 1999).

1.9 Theoretical Framework

This study is informed by the conceptual framework of Stiglitz and Weiss. They argue banks use interest rates to sort out potential borrowers and determine the actions of borrowers. The interest rates are determined by imperfect information inherent in credit markets. To mark out borrowers with a high propensity of repayment banks use the interest rates an individual is willing to pay as a screening device.

Lack of information regarding the operations of MSEs and the perception to be risky makes their access to credit quite limited. Stiglitz and Weiss model largely addresses the issue of credit access and potential borrowers.

CHAPTER TWO: AN OVERVIEW OF MICRO AND SMALL ENTERPRISE IN KENYA

2.1 Introduction

In Kenya, like in many parts of Africa, a burgeoning informal sector has been the response to stagnating employment growth in the informal economy and the retrenching of parastatals and of private companies as they reduce costs in a liberalizing environment. In Kenya, these causal factors are combined with one of the fastest population growth rates in the world, requiring the economy to absorb annually about 500,000 new labour market entrants. Estimates indicate that Kenya's informal sector constitutes 98% of all businesses in the country, absorbs annually up to 50 per cent of new non-farm employment seekers, has an employment growth rate of 12-14 per cent, contributes 30 per cent of total employment and 3 per cent of GDP²⁸.

To its credit, Kenya, unlike most developing countries, has in official development policies recognized informal enterprises as more than a residual employer for the survival of poor households.

The government identified the small scale and Jua Kali enterprise sector for support to assist it to "graduate into the formal sector" and to become a major player in the creation of new jobs and economic growth. Access to technical and managerial training, work-sites, involvement of Jua Kali in technological

²⁸ Sessional Paper No. of 1992. **Small Enterprises and Jua Kali Development in Kenya** (Nairobi: Government Printer).

innovation, and creation of a positive, enabling environment were key elements in the Government's Jua Kali development strategy²⁹.

2.2 Historical Perspectives of Micro and Small Enterprise In Kenya

The informal sector in Kenya is dominated by Micro and Small Enterprises (MSEs) which first gained recognition after the International Labour Organization (ILO) employment mission of 1972, whose report highlighted the importance of the sector in terms of its contributions to economic development. The report gave recommendations to the government in relation to the promotion of the informal sector: increasing credit availability; establishing special institutions of education and training; reorganizing of the informal sector in order to enhance provision of inputs; technical aid and research so as to encourage production and rationalization of output³⁰.

The informal sector in Kenya has emerged as an important source of employment and income for a sizeable section of the population. It has also led to increased production of affordable goods and services in Kenya.

In the period 1993 – 1999, the number of MSEs increased from 910,000 to 1.3 million while the sector's employment increased from 1.3 million to 2.4 million people for the same period³¹. The sector has recorded different growth rates in different periods. In the period 1989 – 2001, it was projected that the employment growth rate would be 20 per cent. However, in the period 1994 – 1995, the sector

²⁹ Thyra A. Riley and William F. Steel – **Voucher Program for Training and Business Development Services Kenya Micro and Small Enterprises Training Technology Project**, 2000 Pp 1 – 2.

³⁰ Government of Kenya: **Strategy for Small Enterprises Development in Kenya: Toward the year 2000**. (Nairobi: Government Printer, 1989).

³¹ Republic of Kenya. **National Micro and Small Enterprises Survey Results**. (Nairobi: Government Printer, 1999).

realized a 10 per cent growth in employment. Employment growth rate in 1999 was 11.5 per cent whereas in 2000 the sector accounted for 70.4 per cent of total employment in the country³².

Lack of financial services and access to commercial lending for micro and small businesses and small-scale farmers has been identified as a major constraint. It is argued that the performance of the MSEs is expected to improve with better access to credit.

A number of institutions including governmental agencies, non-governmental organizations (NGOs) and Community and Church-based Organizations (CBOs) have emerged to provide support services to MSEs in form of credit or loans, management assistance, research and information dissemination.

Micro and Small Enterprise (MSEs) cut across all sectors of the country's economy and provide one of the most prolific sources of employment, not the breeding ground for medium and large industries, which are critical for industrialization.

Today, these are found in every corner of Kenya and they have great potential for creating a variety of jobs, while generating widespread economic benefits.

³² Republic of Kenya. **Poverty Reduction Paper 2001-2004**. (Nairobi: Government Printer, 2001).

2.3 Challenges to Development of MSEs Sector in Kenya

The MSE sector in Kenya plays an important role in the socio-economic development of the country. Its significance can be seen in terms of contribution towards economic growth, employment creation, poverty reduction and development of an industrial base³³.

However, despite the critical role played by the sector, it is faced with many challenges and constraints that include; limited access to financial services and markets, unfavourable policy environment and inhibitive legal and regulatory framework, inadequate access to skills and technology, inadequate business know-how and linkages with large enterprises.

i) Limited Access to Financial Services

Lack of access to credit is a major constraint inhibiting the growth of the MSE sector. The issues and problems limiting MSE acquisition of financial services can be grouped into two broad categories: Lack of tangible security coupled with an inappropriate legal and regulatory framework that does not recognize innovative strategies for lending to MSEs, and the limited access to formal finance due to poor and insufficient capacity to deliver financial services to MSEs³⁴.

Further, there is no structured institutional mechanism in the formal financial sector through which Micro-Finance Institutions (MFIs) can lend to the MSEs. This increases the cost of credit to both the entrepreneur and financial institutions as they are tailored to offer credit services to formally registered businesses,

³³ Republic of Kenya. **National Baseline Survey 1999**. (Nairobi: Government Printer, 1999). p.1.

³⁴ Ibid

which meet criteria such as proper maintenance of books of accounts and a verifiable asset base. Most MSEs cannot, however, meet these criteria. In addition, availability of collateral is limited by the difficulty of obtaining legal title to land. Even where collateral exists, commercial banks are not confident that the legal system will allow them to realize it in cases of default.

Formal financial institutions perceive MSEs as high risk and commercially unviable. As a result, only a few MSEs access credit from formal financial institutions in the country. The problem is greater in the rural areas where bank branches are few and far apart. Limited competition between the banks accentuates the problem.

The present legal and policy framework for financial services is less supportive of smaller than larger borrowers and needs to be addressed. The Banking Act prohibits MFIs from mobilizing savings and taking deposits for re-investment.

As a result the MFIs face problems in building sustainable funding base for MSEs. For instance the Post Office Act prohibits the Post Bank from lending and the Co-operatives Act does not provide for effective supervision of the savings and credit Co-operative Societies (SACCOs).

Despite the increasing number of MFIs, their outreach has remained severely constrained, especially in the rural areas, because of their limited resource base and lack of institutional capacity to provide a wide range of financial services. At present, MFI outreach is basically through group lending schemes, which have limited absorptive capacity for financial resources. Commercial Banks however,

have a strong resource base and wider outreach but lack the expertise and "best practice" for MFI lending to the MSE sector. Policies and strategies designed to boost credit and finance to the MSE sector have been formulated in the absence of reliable information on reliable methodologies, data on magnitude of the MSE sector, characteristics of MSE operators, and factors influencing the growth and dynamics of the sector. The situation translates into high credit transaction costs, for collecting and verifying available information, mainly on the creditworthiness of MSE borrowers.

ii) Unfavourable Policy Environment

The major shortcomings in the MSE sector development have been inappropriate policy design, weak implementation framework and failure to institute and effectively monitor policy implementation. In the past, the policy formulation and design has not been consultative and has mainly been driven by government, as a result of which the policies failed to address the specific needs of the target groups; and lacked ownership by the entrepreneurs³⁵.

Over the period, there has been no provision for an institutional mechanism to promote consultation mechanism and co-ordination of stakeholders. The previous policy documents failed to address the critical area of delegation of responsibility and follow-up on the actual implementation. In some instances, lack of clarity of roles has sent conflicting signals to MSEs. At the operational level, poor coordination has led to duplication of efforts and sub-optimal utilization of scarce resources.

³⁵ Ibid.

In sessional paper No.2 of 1992, the Government acknowledged the potential of the MSE sector in employment creation and poverty reduction, however institutional framework for effective co-ordination of the various MSE policies and programmes were not put in place. Specifically, there was no institutional mechanism within government for identifying and resolving policy conflicts and for overseeing implementation of policies and programmes. Neither was there a mechanism for coordinating all the stakeholders and facilitating their participation in policy development and implementation.

Because of incoherent Monitoring and Evaluation mechanism, it has not been possible to follow the progress on policy implementation to identify gaps, take corrective measures, develop feedback mechanism and assess the impact.

iii) Legal and Regulatory Environment

An enabling legal regulatory environment is imperative for the MSE sector to play an effective role as an engine for economic growth, poverty eradication and employment creation. Despite significant achievements in reforming the legal and regulatory framework a number of existing laws and regulations still remain cumbersome, out of step with current realities and hostile to the growth of MSE sector. Specifically, the by-laws applied by many local authorities are not standardized and appear, in most cases, punitive instead of facilitative. At the same time, the role of Provincial Administration in the enforcement of regulations, and in jurisdiction over land and utilities tends to overlap and conflict with those of local authorities³⁶.

³⁶ Ibid.

Finally the bureaucratic and lengthy process of transacting business with Government Agencies adversely impacts the operations of the MSEs by diverting the scarce resources from production to sheer housekeeping

The decentralization of registration of Business Names in Nairobi poses problems for MSEs located outside the capital city. The requirement for details of business physical and postal address also poses a major problem to business operators who may not have permanent physical locations. All these translate into high implicit costs forcing many entrepreneurs to stay informal. The Single Business Permit (SBP) system, launched in 1999, is not yet fully operational and the few charged are considered by many MSEs to be prohibitive³⁷.

Dispute resolution is another area of problem for small business people. They find the judicial system complex, expensive, time consuming and sometimes unfair. While an alternative sub-contracting arrangements and contract-enforcement framework is currently lacking.

iv) Limited Access to Markets

Access for markets and marketing information is a severe constraint to MSE development in Kenya. Overall, aggregate demand is low, markets are saturated due to dumping and overproduction, and in many cases markets do not function well due to lack of information and high transaction costs. Competition in some products is unfair, with imported goods finding their way into the local market without payment of statutory duties. Many MSEs are also ill-prepared to compete in liberalized markets. Very few are capable of venturing into export markets and

³⁷ W. Karingithi "The Legal and Regulatory Framework in A. Mullei & C. Bokea. **Micro & Small Enterprises in Kenya**. (Nairobi: ICEG, 1999). p. 20.

even fewer are able to tap the new market frontiers through electronic commerce. Thus, most MSEs are confined to very narrow local markets where intense competition drives prices down, resulting in very low profit margins. In many cases, the market mechanisms that can deal with these problems are either missing or weak. Also, a small capital base and limited technological sophistication confine MSEs to products and services which cannot compete effectively in a globalized and competitive market environment due to quality limitations³⁸.

While the Government has made efforts to liberalize financial and product markets over the past decade significant barriers to-entry into certain markets still exist. There are also high unit transaction costs for small volume producers due to their underlying low economies of scale. Specifically, public sector purchasing practices, where pre-qualifications standards demand assurance of large supplies and proof of adequate financial resources to produce them, have for the most part excluded MSEs from the large public sector market.

Many MSEs still do not access to the flow of information on MSE markets, making it difficult for them to know where and how to access existing and relevant market information, as a result of which the majority rely on informal feedback from customers. Competitiveness of the MSEs remains weak due to poor product quality, packaging, advertising and distribution.

v) Inadequate Access to Skills and Technology

Kenya's MSEs are characterized by restricted levels of technology, inappropriate technology and inadequate institutional capacity to support adaptation and absorption of modern technological skills. In addition, they also suffer lack of

³⁸ Ibid.

information on existing technologies and their potential environment that hampers co-ordination and transfer of appropriate technology. Consequently, the sector continues to experience low productivity, poor quality and limited range of products, resulting in low competitiveness of the MSE products.

Because of lack of capacity to identify, seek and use appropriate technology MSEs are constrained. The sector also lacks access to limited technical services available, as well as outputs and innovations arising from research activities.

Low levels of education and technical training of the majority of MSE operators, and inadequate financial capacity to acquire available technology and infrastructure, typify the MSE sector. Most of the operators in the MSE sector are primary learners, only a few of whom have ever had technical training.

The institutions expected to provide technical services to MSEs are weak and lack specialized capacity to meet the needs of the sector. Where such capacity is available, there exist poor links between MSEs and the institutions of technology training.

vi) Limited Linkages with Large Enterprises

Linkages between MSEs and large enterprises in Kenya are either weak or non-existent. This leads to inadequate technological transfer and development, poor information flow, weak sub-contracting arrangements and inadequate marketing opportunities to promote expansion and especially vertical growth of MSEs. This state of affairs is a hindrance to the goal of developing and mainstreaming MSE sector into the national economic framework.

2.4 Conclusion

In comparison with most developing countries access to credit is relatively smooth for micro enterprise in Kenya. However, this doesn't mean it is enough to satisfy the extensive need. The Kenyan government has been operating a couple of loan schemes aimed at small enterprises.

Kenya in Eastern and Central Africa has a relatively sophisticated banking sector though banks have been reluctant to lend to micro and small enterprises out of their 'own' means. Several of the major banks are involved in donor guaranteed or subsidized credit programmes for small enterprises. Most of these are earmarked for specific target groups for example women entrepreneurs, rural enterprises, typically the borrower is responsible for providing the securities while the rest is covered by the guarantee scheme³⁹. These efforts notwithstanding it is only a small number of entrepreneurs who have benefited from donor-guaranteed bank schemes.

A number of Development Finance Institutions are extensively involved in extending credit to small scale enterprises. The leading are KIE, Small Enterprise Finance Company (SEFCO), together they account for 70% of all institutional lending to MSEs⁴⁰.

There has been an increasing number of donor funded NGOs involved in credit schemes for people engaged in micro activities. Petty traders, women groups

³⁹ J. Billetoft. **Between Industrialization and Income-Generation: The Dilemma of Support for Micro Enterprises**. A Policy Study of Kenya and Bangladesh. (Copenhagen: Centre for Development Research, 1996).

⁴⁰ Ibid.

and self employed artisans are the typical clients of NGOs. The majority of these schemes are based on the Grameen Bank Model i.e. loans based on loan guarantee, savings mobilization, eligibility for a larger loan, punctual repayment, relatively small loans and short repayment time, and attempts to use commercial interest rates. However, the NGOs have been criticized for their subsidized credit because it makes it difficult for the credit institution to become self-reliant. The most pressing institutional issue today is the sustainability of the credit schemes.

The Kenyan government extended loans to small scale businesses through two major programmes. The Joint Loan Board Scheme (JLBS) and its Rural Enterprise Fund. JBLs which started in 1955 evolved from the credit arrangements which were administered by the colonial government and the African District Council. JBLs provided loans to progressive Africans who wanted to establish business in areas of the country that were not involved in conflict in the 1950s. At independence the JBLs was an important vehicle for Africanization of trade in the small towns and enabled Africans take over from Asians who were pushed out of rural trading centres. However, JBLs performed poorly in terms of loan repayments, technical assistance and the number of people catered for⁴¹. JLBS provided loans to all types of MSEs in all districts, unfortunately all the districts are in substantial arrears and the funds have dried up in many districts. The Rural Enterprise Fund focuses on micro firms and women groups.

The rediscovery of the importance of the MSE sector was influenced by the failure of centrally planned socialist economies. It was also enhanced by the

⁴¹ A. Fowler and K. Kinyanjui. *Indigenizing Foreign Seed on African Soil: the Story of K-Rep*. Nairobi: K-Rep 2004). p.28.

achievement of impressive prosperity by certain East Asian and Western countries as a result of mobilizing the creative energies of entrepreneurs and by reaping the benefits of relatively unrestrained competition.

The small and medium size enterprise sector has assumed a position of almost universal orthodoxy. In all successful economies of the world they feature as a dominant force. The impressive economic performance of certain South East Asian such as Taiwan, Korea and Western countries draw the attention of policy makers on the prominent role played by MSEs.

Drawing on the experience of these countries and seeing what tremendous influence MSEs have on economic growth and development African countries also resorted to it as the engine for economic growth and development. The MSEs are the most effective job creators because they are generally more labour intensive than larger enterprises and generate more direct and indirect jobs per unit of capital invested. They aid the promotion of free enterprise and self-sufficiency by creating and spreading wealth to the grass roots level and as a result enhance economic and political stability.

Evidence from East Asian countries that the MSE sector can loom large and important in an economy and that when it does so both the economic growth and development and the income distribution performances are great.

CHAPTER THREE: SOURCES OF FINANCING MICRO ENTERPRISES IN KENYA (1994-2004)

3.1 Introduction

The overall economic and political environment of a country affects how micro finance is provided. Government economic and social policies as well as the development level of the financial sector influence the micro finance institutions provision of financial services to the MSEs⁴². In Kenya there are many institutions assisting MSEs, this assistance comes in various packages. These include; credit, technical support, extension services, training, shelter provision and marketing.

The demand for credit currently exceeds supply. The commercial banks have concentrated on larger well developed firms while NGOs cater for the very small groups or individuals neglecting the middle group who have the potential to grow⁴³. Formal credit is obtained against assets used to collateralize loans and more important against projected future cash flows. A majority of MSEs lack marketable collateral/assets⁴⁴.

Traditional government interventions to assist MSEs have attempted to compensate for lack of low-cost financial and non-financial services for MSEs by providing them free or at subsidized interest rates, MSEs business centres

⁴² J. Ledgerwood. *Microfinance Handbook: An Institutional and Financial Perspective*. (World Bank: Washington D. C., 1999). p. 11.

⁴³ J. N. Onkunya. *Modes of Intervention to Assist Small Scale Enterprises in Kenya*. (Nairobi, 1990).

⁴⁴ Banks take mortgages on real property, debentures on stock and moveable assets, and personal guarantees. Banks deal in cheques and bills, they sign detailed loan contracts with their customers, and follow complex administrative procedures for loan approval. Access to bank credit is typically formal and lengthy. Potential borrowers who do not possess real assets are seriously disadvantaged. Banks also discourage small loans because they cannot cover the administrative cost.

funded by the public sector and by Ministry of Industry, and government sponsored export promotion agencies were thought to be necessary to bring needed services within the reach of MSEs⁴⁵.

However, the problem with traditional approaches to MSEs is that these programmes are limited by the availability of public funds. They tend to reach a limited MSEs and many not be sustainable in the long term⁴⁶. Indeed subsidized credit undermines the efficient allocation of financial resources and may discourage the development of non credit financial instruments.

The MSEs are vital in the early stages of economic development given their ability to create employment and wealth. The National Baseline Survey of 1999 revealed the existence of 1.3m MSEs employing as many as 2.4m Kenyans⁴⁷.

In Kenya the MSEs remain under-capitalized implying difficulties in accessing credit. The Baseline Survey showed that only 6% of MSE successfully applied for and used credit⁴⁸. Enterprises that have limited access to credit tend to be less productive and cannot always move to points of best practice. The net effect is that since the MSE sector does not have adequate access to credit its potential role in reducing poverty and in Kenya's socio-economic transformation is unlikely to be achieved.

⁴⁵ K. Hall berg "Bringing MSEs into Global Markets" in G.S. Fields et al (eds). **Pathways Out of Poverty: Private Firms and Economic Mobility in Developing Countries**. (London; Kluwer Academic Publishers 2003) p. 234.

⁴⁶ Ibid

⁴⁷ P. Kimuyu and J. Omiti. **Institutional Impediments to Access to Credit by Micro and Small Scale Enterprises in Kenya**. (Nairobi: Institute of Policy Analysis and Research, 2000) p.3.

⁴⁸ Ibid

The consumption of credit tends to be inversely related not only to interest rates but also to collateral requirements. The MSEs tend to have a poor collateral base and therefore get excluded from the credit market. When entrepreneurs can successfully seek out credit from formal sources they may not be inclined to borrow because of limited ability to comprehend debt management and costs of borrowing, fear related to hidden costs, previous bad experiences with financial services, presence of savings and credit associations. The mere presence of financial services does not therefore guarantee the demand for and use of credit.

This chapter looks at the Kenyan financial market, and how it has provided credit to the MSEs for the period under study.

3.2 The Kenyan Financial Market

The formal segment of Kenya's financial sector is dominated by a few large commercial banks with roots in the colonial period. These commercial banks were geared toward meeting the financial needs of external trade and large scale commerce. There is no evidence of these banks lending to the MSE sector⁴⁹.

It was probably due to this fact that the government of Kenya backed initiatives such as Small Enterprise Finance Company, Kenya Industrial Estates among others to fill the financing gap for the MSEs. These government supported schemes and development finance initiatives under performed and may have distorted the evolution of financial markets in the country.

⁴⁹ Ibid

In the 1980s Savings and Credit Cooperatives (SACCOs) and Non-Bank Finance Institutions (NBFIs) rose exponentially to fill the gap created by commercial banks but they were only useful for salaried employees whom lending and borrowing entitlements were easy. The financing gap in the MSE sector attracted the attention of non governmental organizations. These included the Kenya Rural Enterprise Programme (K-REP), the Kenya Women Finance Trust (KWFT), FAULU Kenya and PRIDE Africa⁵⁰. All these schemes have attracted the support from the donor community.

There are also a wide range of informal institutions that extend financial services to different segments of the business community. The most common are Rotating Saving and Credit Associations (ROSCAs) which act as conduits for converting small regular savings into lumpsum especially among women. These associations are anchored on trust and close familiarity that is in turn based on social institutions such as kinship.

Entrepreneurs do rely on friends, relatives, customers and suppliers of materials and provisions as sources of working capital. These divergent credit sources are important components of credit markets in Kenya⁵¹.

3.2.1 The Move toward a Liberalized Credit Market

During the last half of the 1980s the government's policy was to get markets to determine interest rates. The gap between interest rates applied by commercial banks and non-bank financial institutions narrowed but the gap between

⁵⁰ P. Kimuyu. *The African Factor in Enterprise Structure and Performance in Kenya*. (Nairobi:IPAR. 1999).

⁵¹ Ibid.

minimum deposit rates and maximum lending rates widened⁵². The interest rates were fully liberalized in 1991, however, this did not increase MSEs access to credit because in addition to broader market imperfections, withholding taxes increased administrative costs of small accounts.

These reforms notwithstanding there was no improvement discernible in the efficiency of the financial sector as evidenced by a widening of the interest rate spread. However, of significance was the excessive borrowing by the government of Kenya from the domestic market, mopping out existing financial resources from the market and in the process crowding out the productive sectors. Given the limited credit flow to the MSE sector, excessive domestic borrowing by the government further reduced financial resources that were trickling down to the sector⁵³.

During the 1990s lax licensing of financial institutions, poor enforcement of prudential regulations, and bad debts made the banking industry unstable. Although liberalization saw entry barriers reduced and opening of new opportunities for extending financial services to the business community the financial status of many local banks remained weak.

In an effort to address this problem the Central Bank has pushed banks to close loss making branches and improve loan recovery. The CBK allowed banks to set minimum balances, limiting the access of small clients to banking services and reducing the potential for mobilizing savings. Issues such as depositor protection have led to conservative liquidity and cash ratios and increased the reserve

⁵² S. Johnson. "The Local Level Financial Market a Kenya Case Study" unpublished PhD Research Proposal. Department of Economics and International Relations. University of Bath, United Kingdom.

⁵³ P. Kimunya and J. Omiti OP CIT p.10.

requirements. All these measures have increased the cost of funds and further distancing the MSEs from the banking sector⁵⁴.

The 1990s period experienced a phenomenal rise in interest rates, this had adverse implications for the MSE sector. First business opportunities and existing enterprises were ruined. While the banks kept piling up debts based on loans which had accumulated arrears due to the high interest rates, the businesses could not continue⁵⁵ as sources of credit had dried up. Not even Development Finance Institutions such as the Industrial Development Bank, Agricultural Finance Corporation could avail credit at affordable interest rates.

It is the position of this study that if DFIs can extend credit at affordable terms mainstream commercial banks will be compelled to sell cheaper commodities in the money market to compete with DFIs. However the running down of DFIs has led to the dominance of the commercial banks since farmers and entrepreneurs have nowhere to turn for cheaper credit.

3.3 Credit Access and MSEs in Kenya

The Kenyan banking sector is dominated by a few large firms which focus mainly on short-term lending. The short term nature of their lending operations and their focus on a small corporate clientele has meant limited reach to small savers and borrowers. A number of financial institutions provide credit however commercial banks rarely lend to small and micro-enterprises since they insist on collateral which MSEs lack.

⁵⁴ Ibid.

⁵⁵ Anyang' Nyong'o "High Interest Rates: What Must Be Done" in Sunday Nation 22 October, 2000. p.17.

Only a limited number of MSEs are able to provide marketable collateral and guarantee requirements of commercial banks implying those MSEs lacking such requirements cannot access credit from banks. The NGOs that have attempted to provide finance to MSEs have had limited success because of their inexperience in financial intermediation and limited financial resources. Rotating savings and credit associations have provided a source of credit for those locked out from mainstream financial institutions. ROSCAs dot both the rural and urban areas in Kenya. ROSCAs mobilize savings from their members but these alone are not enough to meet the credit needs of the members⁵⁶.

In developing countries the credit market is characterized by imperfections such as thin bond and equity markets, information asymmetries and weaknesses in enforcement of formal credit contracts⁵⁷. From the foregoing analysis in this study it is evident that MSEs access to credit in Kenya is limited. The Baseline Survey revealed that only a small proportion of MSEs tend to borrow.

The following table will illustrate.

Table 1: Factors for Business Closure

Factors leading to closure	Response %
Shortage of working capital	36.2
Personal reasons	20.0
Too few customers	14.3
Opened another business	13.3

⁵⁶ R. Atieno. "Formal and Informal Institutions Lending Policies and Access to Credit by Small-scale Enterprises in Kenya: An Empirical Assessment". Nairobi: African Economic Research Consortium (AERC) Paper No.III, November 2001) Pp.15-16.

⁵⁷ D. Mookherjee. **Contractual Constraints on Firm Performance in Developing Countries**. IED Discussion Paper Series No.98. Boston University, 1999.

Other reasons	9.5
Too many competitors	6.7
Relevant sample size (n)	105

Source: Computed from the 1999 Baseline Survey

The above table indicates that of the businesses that closed down more than one third did so for lack of working capital. This indeed is the most critical factor for business closure.

A study by Moyi⁵⁸ demonstrated that among MSEs involved in manufacturing, credit related information needs are second only to market information needs. Equally the Baseline Survey shows that lack of credit is the second severest problem faced by MSEs, the most important being lack of markets and competition. These points out that credit is a real constraint on MSEs growth.

An evaluation of sources of seed/initial capital indicate the extent to which MSEs access to credit is constrained as the following table illustrates.

Table 2: Sources of Seed and Additional Capital

Sources	Relative Contribution of Source %	
	Seed Capital	Additional Capital
Own/Family funds	88.6	80.4
Loan from family/friends	7.0	6.2
Commercial banks	0.7	1.8
Formal and informal cooperatives	1.2	1.3

⁵⁸ E. Moyi "Networks, Information – Search and Competitive Pressure: Evidence from Kenya's Small-Scale Manufacturing Industry". A Paper presented at the Workshop on Information for the Development of Micro and Small Enterprises. Panafric Hotel, Nairobi, April 3.

Non bank finance institutions	0.7	1.1
Rotating saving and credit schemes	0.7	1.1
Others (NGOs, Government Programmes, trade credit, money lenders)	1.1	8.1
Relevant sample size(n)	1795	450

Source: Computed from the 1999 Baseline Survey

Table 2 indicates that for the MSE sector the most important source for both seed and additional capital are own/family funds. Due to the fact that MSEs are characterized by low incomes and savings rate the MSEs usually fall on these sources for lack of alternatives. If the alternative sources of credit exist, they are either costly or outreach for the majority of MSEs⁵⁹.

A majority of MSEs perceive credit as essential for business growth but few access it. This credit problem is acute among the small registered enterprises and those that are rural based. The latter are remote from credit sources and tend to be shunned by MFIs because of high costs since the potential clients are spread over a large geographical area.

Enterprises that need credit may not borrow if their perceptions on the costs of applying for a loan outweigh the expected receipts, or lacks enough cash to meet the application costs. This is in addition to a poor collateral position. Most MSEs perceive borrowing as necessary for business and the impact of borrowing on business performance as positive. However, only a small percentage of MSEs

⁵⁹ P. Kimuyu & J. Omiti Op Cit.

do apply for loans. The rural based enterprises borrow even less than urban enterprises.

Informality represents low productivity poor access to infrastructure services and poor property rights over business premises, making credit markets out of reach for most such enterprises.

The commercial banks tend to supply more credit than any amounts supplied by other sources. Those enterprises that are unable to access credit from commercial banks are therefore unlikely to borrow significant amounts. Supply side restrictions exist. Most credit providers are urban based so that lower levels of credit used by rural enterprises is evidence of a credit supply constraint.

The distortions introduced by the mainstream banks in ability to reach small firms and start ups are only partly compensated by non-bank forms of credit. These include; trade credit, loans from friends and relatives, and to a smaller extent, loans from savings associations. Non-bank credit, however suffers from the same limitations as the contract enforcement mechanisms on which it rests most strongly i.e. trust and reputation. In the absence of global reputation mechanisms, access to non bank credit remains confined to the narrow circle of friends and business relations.

Indeed as a result the borrowers share the good and bad fortune of their circle of friends and relations. If they are doing well then credit is forthcoming, if they are not credit is restricted. Because the size of the pool from which any individual borrower can draw is limited, an efficient allocation of resources cannot be

achieved. Therefore non-bank credit alone is unable to entirely correct distortions in access to credit.

3.4 Conclusion

Limited access to credit by MSEs is one of the biggest impediments to their growth around the world. The Kenya government has made efforts in the past to enable MSEs access credit from the banking industry, however it is evident that these efforts have not succeeded given the small percentage of MSEs that successfully get credit.

There seems to be a positive relationship between MSEs access to credit and business longevity. The MSEs that have successfully sought credit survive longer and are able to expand than those that do not. An enterprise's access to credit influences the level of net income in the enterprise.

The prevailing policy environment has not enabled the MSEs access credit. For example excessive government borrowing from local financial institutions tended to lock out the MSEs as it offers high rates of return. The liquidity requirements by Central Bank limit the credit expansion to effectively cover the MSE sector. There has been reluctance by formal financial institutions to lend to MSEs and other regulations like stringent collateral requirements have limited the funds available for loaning.

Financial institutions around the world rely heavily on mortgages as their primary form of loan security. For it to work effectively, however, many prerequisites must be satisfied; land surveying, land titling, registration of land transactions and

mortgages, etc. These prerequisites are extremely costly. Many sub Saharan African countries have found it beyond their means to provide them beyond the confines of major cities.

The MFIs largely NGOs have tried to fill this financing lacuna left by formal financial institutions but their reach is limited. In the process some NGO financial institutions have tried transforming into regulated financial intermediaries in order to access deposits from the public and capital markets. For example K-REP Bank Ltd the first one to do so in Kenya finds itself operating in a difficult environment as the regulations do not recognize the unique elements of microfinance lending.

The existing banking regulations are designed for a loan portfolio with borrowers whose features differ from those of the typical institutions specialized in the provision of micro-finance. For instance a micro finance portfolio consists of thousands of small, unsecured short term loans which make the methodology of assessment of individual borrowers impossible to implement. While the normal bank regulatory and supervisory practices focus on risks associated with traditional finance⁶⁰.

To facilitate credit access by MSEs from the mainstream banking impediments such as stringent collateral requirements, the Central Bank in conjunction with commercial banks need to review the existing regulations. To make the requirements flexible to meet credit needs of MSEs.

⁶⁰ H. Oketch "Credit and Finance" in A. Mullei & C. Bokea (eds) **Micro and Small Enterprises in Kenya**. (Nairobi: International Centre for Economic Growth, 1999).

The liberalization of the financial sector has not increased MSEs access to credit because bank credit has non-price barriers imposed on access to credit. In fact studies on financial liberalization in Africa show little short-term impact of financial deepening, liabilities structures, product innovation or outreach of formal banking systems despite some strengthening of portfolios, competition and supervision⁶¹.

The majority of institutional credit provided to MSEs in Kenya comes from the NGOs rather than banks. The lack of interest of mainstream banking in smaller clients can be explained by their collateral based methodologies, perceptions of high risks, costs of small transactions and strong competing⁶² incentives for lending to the public sector. Though the Kenyan banking sector is relatively competitive the banks have not aggressively sought the MSEs as clients.

The success of MSE targeted banks like Equity Bank and K-REP which started as societies and micro finance respectively and later transformed into banks provoked mainstream banks to respond and introduce products aimed at the MSE sector. However, experts opine that mainstream banks need to develop new techniques of appraising credit for MSEs for it to be long lasting⁶³. This is one issue the proposed micro finance bill seeks to address⁶⁴.

There is ample evidence to show that access to credit is a critical factor enabling investment in raw materials and production equipment. Experience from Brazil

⁶¹ W. F. Steel and E. Aryeetey. "Informal Financial Markets Under Liberalization in Four African Countries" in *World Development* Vol. 25 No.5 May 1997. p. 817.

⁶² H. Oketch. "Credit and Finance" Op Cit p.45.

⁶³ "MSE: Cornerstone or Stepping Stone" in *The Financial Post*. July 3-9 2006 (Nairobi) p.2.

⁶⁴ The Micro finance Bill seeks to allow micro finance institutions to take member deposits after meeting several conditions to be laid by the Central Bank of Kenya among other provisions. Most MSEs will most likely save with MFIs. Once commercial banks experience the erosion of depositors, they will probably adapt to this by offering cheaper credit and business advice, the hallmark of MFIs.

and Mexico for instance shows that joint marketing initiatives allow small producers to penetrate markets otherwise beyond their reach. In Kenya MSEs growth has been facilitated at three ways; training, the provision of credit, and physical infrastructure.

All literature that focuses on the provision of credit uniformly concludes that lack of access to investment and working capital is the most severe impediment encountered by MSEs. However, there is less agreement on how to surmount the problem. But there is the view that loan schemes that show the best long-term results are those that minimize the element of subsidy, and take a non-bureaucratic approach to the evaluation and distribution of loans. The provision of credit is best carried out by autonomous institutions which are less vulnerable to political interference.

The Economic Recovery and Poverty Reduction Strategy see MSEs as an integral part of the economy. The MSE investments are beginning to be understood by policy makers and private sector. There is need to understand the potential of the MSE sector, its unique attributes that partly limit its access to credit in order to benefit from the financial sector.

CHAPTER FOUR: CRITICAL ANALYSIS OF THE RESEARCH FINDINGS FROM THE STUDY AND THE WAY FORWARD

The overall objective of this study was to investigate how the MSEs access credit in Kenya, the impediments to credit and how this impacts on MSEs growth. Limited access to credit has been identified as a major impediment that faces MSEs in Kenya yet this sector is of significant importance to the overall functioning of the economy.

The economic, financial and legal developments in any country often shape the way micro finance institutions emerge, are managed, governed and regulated. In this study it emerged that it is necessary for the micro finance institutions that the government and Central Bank of Kenya articulates policies that facilitate their growth and maturity. Enactment of legal instruments and establishment of administrative mechanisms and institutions to facilitate regulation, supervision and growth of the micro finance industry thereby enhancing their reach to the MSE sector.

Although MSE credit schemes exist in Kenya they are evidently biased against the rural areas. This is a trend of micro finance institutions all over Africa. The MFIs are concentrated in urban areas where returns on investments are high. The funding agencies also play a big role in the evolving MFIs. Donor policies, fads and financial resources have profoundly influenced the environment in which the MFIs have emerged and thrived in Kenya⁶⁵.

⁶⁵ A. Fowler & K. Kinyanjui. *Indigenising Foreign Seed on African Soil: The Story of K-REP*. (Nairobi: K-REP 2004) p209.

Prior the 1990s period the existing credit institutions and systems were limited in terms of clients served, sectors covered, efficiency and sustainability. The government was the key actor in provision of credit, but this credit was highly subsidized, and thereby obfuscating other potential players.

This chapter brings out the evidence for the three study hypotheses and a possible way forward that can enhance credit accessibility by MSEs.

4.1 Limited Access to Credit has hindered the development of Micro Enterprises in Kenya

Evaluating the various forms of credit available for MSEs in Kenya it is fairly evident that their access to credit is limited.

i) Bank Credit

In Kenya bank credit is tied on real property, debentures on stock and moveable assets. This demand for collateral is a major weakness for the MSEs as they lack it. Banks sign detailed loan contracts with potential borrowers and rely on complex administrative procedures for credit approval. As a result access to credit is formal and lengthy. The majority of MSEs is locked out because they do not possess real assets; borrow small loans which do not cover administrative cost. This heavy reliance of legal enforcement of contracts seriously disadvantages the MSEs access to credit in Kenya.

ii) Informal Credit

This has made MSEs to turn to informal sources of credit largely among friends. This system operates like a mutual insurance system than like a credit market.

Credit is disbursed to cater for liquidity constraints and other exigencies. While enforcement is largely informal and based on repeated interaction between friends and reputation within the business community. Defaulting means one forfeits the insurance that friends provide.

Access to informal credit is usually fast and the friendship that serves as a major enforcement mechanism has to be built up over time. An enterprise's ability to withstand shocks and prosper is a function of the entrepreneur's network of friends and relatives. If they are numerous and wealthy the insurance they provide enables the enterprise to take risk and prosper.

The repayment of informal loans is usually flexible. Repayment can be stretched over many months, debts waived, this is because lenders are well informed about the borrower's business that they are flexible. This is borne out the relationship that ties them with the borrower. Maximum flexibility and insurance are achieved when information flows most freely.

iii) Trade Credit

The enforcement mechanisms that support trade credit contracts combine elements of the other two forms of credit. Repeated interaction is the most basic enforcement mechanism. As a customer repeatedly buys from a single supplier, the supplier learns about the volume and regularity of the customers business. This trust is built over time and it is grounded on an understanding of the customers' preferences, technology, outside opportunities, and honesty. In Kenya various groups of Kenyan-Asians and other ethnic groups have been successful in setting up such networks. Enterprises that are part of a network are

more likely to get trade credit from the start. They get trade credit from more suppliers at better terms, enabling them to expand their business much faster than enterprises outside any network. Because they get more credit and this credit is flexible, enterprises in community networks survive exogenous shocks more easily and do not have to reduce the size of their business in order to survive.

Enterprises that are not well connected are less able to absorb shocks. Although trade credit does rely on legal enforcement of contracts through courts and arbitrators is rarely used. Trade credit is a major source of flexibility for those enterprises that have access to it.

However these forms of credit alone have not been sufficient to meet the demands of the MSE sector. That is why the government has had to play a role in facilitating credit access to MSEs aided by the NGOs.

4.2 Governmental Efforts on Addressing Credit Access by MSEs have not been Successful

The Kenya government has initiated several credit programmes to support the development of local entrepreneurs. These included the Joint Loans Board, the Industrial and Commerce Development Corporation (ICDC) and Development Finance Company of Kenya (DFCK) among others.

In 1967 ICDC established a subsidiary KIE to cater for the small scale entrepreneurs. KIE's strategy was to develop small scale enterprises by providing industrial sheds, credit, extension services and training. It equally

undertook feasibility studies, procured equipment, and designed production lines for its clients. When the Rural Industrial Development Programme (RIDP) was started in 1975, KIE was mandated to run it⁶⁶.

The DFCK started in 1978 the Small Scale Industries Programme to enable it to reach out to small and medium entrepreneurs. This programme later transformed into Small Enterprises Finance Company (SEFCO) Limited which became a subsidiary of DFCK. The main focus for SEFCO was to promote indigenous African entrepreneurs through financial and technical assistance for expansion and modernization or rehabilitation of existing enterprises. The initial credit programmes that SEFCO operated required clients to have securities for the loans and to fund part of the project costs⁶⁷.

The first main shortcoming of these programmes was the methodology utilized in the provision of credit. The programmes provided a number of services to the entrepreneur which did not distinguish welfare from strict business activities. Secondly, collateral was considered as an essential element in securing loan repayment hence other mechanisms for ensuring high rates of repayment of loans tended to be ignored. For example by the end of 1980, KIE had disbursed 288 loans half of which were in default⁶⁸.

Since these schemes were politically inclined, the clients used political pressure to defeat measures intended to ensure timely and full repayment of loans. Most of the programme particularly ICDC and DFCK were concentrated around Nairobi

⁶⁶ Ibid p.29.

⁶⁷ Ibid.

⁶⁸ P. Fleuret & G. Ned. **The Kenya Social and Institutional Profile**. Nairobi: USAID/Kenya. p.116.

and member indicating a clear bias towards major urban centres, medium and large scale enterprises, and the privileged few. The bias toward major urban centres is a trend that is evident up to date.

These programmes did not sufficiently reach small-scale enterprises in the informal sector. Indeed the Report of the Presidential Committee On Unemployment (1982/83) recognized these shortcomings of government policies observing that "the informal sector did not enjoy the privileges and facilities that are easily available in the formal sectors such as access to credit, legal protection, modern technology, and basic infrastructural facilities"⁶⁹. The report concluded the MSEs activities in the informal sector were often ignored and discouraged, this challenge was later taken up by NGOs.

The initiatives were not effective in generating the much needed employment opportunities, and most fundamental increase incomes. The loans provided were viewed in many occasions as grants and the beneficiaries were reluctant to pay. These institutions became heavily indebted to the government and in the long run were unsustainable. They were a drain on the country's treasury and did not reach where they were needed most⁷⁰.

4.3 To ensure development of Micro-Enterprises in Kenya it is necessary to facilitate their access to credit

The oil shocks, declining commodity prices, and the increasing external indebtedness curtailed the capacity of the government to deal with internal

⁶⁹ Republic of Kenya. **Report of the Presidential Committee on Unemployment 1982/1983**. (Nairobi: Government Printer, 1983).

⁷⁰ P. Fleuret & G. Ned op cit p.117.

challenges of unemployment and institutional weaknesses. Foreign assistance increasingly becomes important in initiating and supporting new projects that complimented government efforts.

Towards the end of the 1970s some donors started to explore modalities for channeling funds for the development of small and medium enterprises. Among the donors who diversified their funding to meet the needs of MSE entrepreneurs were German Technical Cooperation (GTZ), Swedish International Development Agency (SIDA), Canadian International Development Agency (CIDA). UN agencies, ILO, UNDP, and UNIDO were engaged in efforts to uplift micro-enterprises in the informal sector⁷¹.

The most notable initiative was the Rural Private Enterprise funded by the USAID and implemented by the Kenya Commercial Bank, the Standard Chartered Bank and Barclays Bank of Kenya. USAID availed 24M dollars for Small Scale Enterprises development in rural areas. Other donor agencies which provided funds through local banks included Women World Banking (WWB), International Finance Corporation (IFC), the Organization of Petroleum Exporting Countries (OPEC)⁷².

However, these efforts through the banks have been limited in their scope and entirely dependent on availability of donor assistance. The major local banks have not been interested in the businesses in the informal sector because of perceived high risks and expenses involved in management of small and medium

⁷¹ United Nations, **Informal Sector Development in Africa**. New York: 1996. R. Gichira "Institutions Assisting Small Scale Enterprises in Kenya". Government of Kenya/ILO/UNDP Centre Project, 1998. p.6.

⁷² Aleke-Dondo "Survey and Analysis of Credit Programmes in Kenya" 1991. p.53.

loans. Their insistence on security for loans has made it unfeasible for them to provide credit to the MSE sector.

The efforts by the donors to orient the commercial banks to the MSE sector entrepreneurs, notwithstanding, the banks have never created their own programmes to address the financial needs of the sector. Instead they have continued to attract savings from rural small holders which they lend to urban developers and corporations. The only major bank to have recently shown interest in the MSE sector is the Co-operative Bank of Kenya (and now the new Equity Bank which also actively lends to the sector). In fact USAID and Department for International Development (DFID) have each contributed Kshs60 million to support the bank in institution building, technical assistance and advice and exposure to micro-finance practices⁷³.

The growth oriented NGOs represent a new generation of Development Finance Institutions in Kenya. They are more efficient than traditional DFIs, have a better understanding of the entrepreneurs situation and are less vulnerable to political interference. However the most critical problem faced by the growth oriented NGOs is their modest loan portfolios implying that most of them are still operating at the fringes of sustainability. The fundamental question is; do they have the potential to become sustainable?

The experience of Asia and Latin America demonstrates that in becoming large NGOs have the same tendencies to develop bureaucratic traits and political vulnerability as any other institution. For example the Grameen Bank and BRAC

⁷³ The Cooperative Bank Digest. Vol. 1 May, 1999.

(Bangladesh Rural Advancement Commission) in Bangladesh continue to depend on injections of external financial support, not only for their research and monitoring but also for their core activity which is lending⁷⁴.

Lack of starting and working capital is the most important factor for business closure for more than a third of MSEs. The majority of MSE entrepreneurs consider credit on business growth as positive, however, a small proportion of them successfully borrow. Although differences do exist, for instance urban enterprises enjoy high success rates than rural ones. Also informal enterprises are more successful than formal ones. Enterprises seeking credit from cooperatives are more successful than those applying elsewhere for example non-bank finance institutions while entrepreneurs who belong to support groups enjoy a substantially higher success rate.

Rural Kenya is less attractive to credit suppliers because these areas are more affected by deteriorating infrastructure. Rural MSEs are less concentrated and therefore expensive to serve. Due to lower rural incomes rural based enterprises witness lower volumes of business and lower demand for credit. The demand side of the rural credit market is therefore relatively small and less attractive to credit providers. Credit availability in rural Kenya can be increased by improving rural infrastructure to open up rural commerce and increase the profitability of rural-based MSEs. An increase in the number of rural enterprises would act as a pull for general business services including financial services⁷⁵.

⁷⁴ J. Billetoft. **Between Industrialization and Income-Generation: The Dilemma of Support for Micro-Enterprises.** A Policy Study of Kenya and Bangladesh (Copenhagen: Centre for Development Research, 1996), p.107.

⁷⁵ P. Kimuyu & J. Omiti. **Institutional Impediments to Micro and Small Scale Enterprises Access to Credit in Kenya.** (Nairobi: IPAR, 2000).

Informality inhibits access to credit in that even though the MSE sector has inadequate access to credit, the informal segment has even less access than the rest of the sector due to uncertain legal status, higher mortality rates, and less visibility. Informality and its credit related complications can be addressed by developing mechanisms for mainstreaming informal enterprises such as reducing registration costs and delays whose avoidance encourages non-registration of businesses⁷⁶. This in turn would increase access to credit.

4.4 The Way Forward

This study suggests the way forward. These options are informed by experiences from other developing countries such as Bangladesh, Malaysia, India, Indonesia, etc that have had relative success in addressing credit needs of their MSEs.

International experience indicates that any comprehensive MSE developments strategy should contain definite objectives. Understanding what a good policy may comprise remains incomplete. Mobilizing financial resources by way of appropriate financial assistance programmes is essential for MSE wealth creation and growth.

i) Establishment of Micro-Finance Banks

Given the number of micro finance institutions in Kenya, it is not possible to regulate all of them⁷⁷. Some MFIs would like to move into the formal sector so that they can take deposits from the public for growth. Deposits are important to

⁷⁶ Ibid.

⁷⁷ The Ministry of Finance has gazetted the Micro Finance Bill that is currently being debated by players in the sector. The MFI Bill seeks to set up a regulatory framework for MFIs, for instance it sets a capital base of Kshs60M for urban based MFIs and Kshs20M for rural MFIs. The Bill borrows from the Banking Act Cap 488 regarding conditions on licensing, prohibited business, reserves, accounts and audit, information on reporting requirements, inspection and control of institutions.

MFIs because deposit mobilization leads to scope economies, given that saving is a natural step in becoming credit worthy and the combination of deposits and lending enhances loan recovery.

However, under the current banking regulations they cannot because they do not meet cash and liquidity requirements or capital base. It is therefore prudent to explore an option that would set up a regulatory system for MFIs. This is one of the objectives of the yet to be enacted micro finance bill by the Ministry of Finance, i.e. providing a framework to regulate MFIs instead of lumping them together with established mainstream commercial banks. Amendments to the Banking Act that may facilitate the formation of second-tier bank institutions with less stringent conditions than those of commercial banks are necessary.

The amendments could allow MFIs to operate under realistic prudential guidelines to guard against abuse but at the same time allow them to retain sufficient flexibility to encourage further innovations in informal credit mechanisms.

Such second-tier institutions have assisted in providing micro-credit facility successfully in Ethiopia, Bolivia, Indonesia and Bangladesh⁷⁸. Such institutions have the ability to handle small transactions cheaply and additional costs of screening credit worthy borrowers unlike commercial banks. The East Asia tigers like Thailand and Malaysia have full fledged banks catering for MSEs only.

⁷⁸ Kenya Institute of Public Policy Analysis and Research. **Legal and Other Constraints on Access to Financial Services in Kenya.** (Nairobi: Kippra, 2001). p.30.

For example Bangladesh is well recognized as one of the few countries in the world where micro finance is extensively developed covering 70% of the poor households. There are over 600 micro finance institutions in Bangladesh providing services to over 15.4 million clients⁷⁹.

Indonesia has a long successful history of micro finance⁸⁰. The activities of MFIs and associations have been recognized as having played critical role in bringing down the rate of Indonesia poverty from 60% in mid 1970 to 14% in 1993⁸¹.

For instance the intended plan to transform Post Bank into a MFI will add value to the MSEs. Post Bank has the advantage of having many outlets including some in small shopping centres throughout the country. These outlets receive savings in areas out of reach of commercial banks. The banks minimum balance requirements are relatively small when compared with those of mainstream commercial banks. It is possible for MSEs to use Post Bank to accumulate internal resources for growth and expansion of business.

However Post Bank does not offer credit facilities nor does it have links with other credit offering institutions. Hence holding an account in Post Bank does not promote the eventual build up of reputation and credit worthiness both of which are critical in increasing access to credit.

⁷⁹ S. Charitonenko & S.M. Rahman. **Commercialization of Finance: Bangladesh.** (Manila: Asian Development Bank, 2002).

⁸⁰ The country is home to a large number of highly diverse MFIs and programmes ranging from Bank Rakyat Indonesia (BRI), Unit Desa Network, to the very small user – owned financial associations. BRI was one of the largest Banks in Indonesia with 12 billion dollars in assets. The government of Indonesia played a critical role between 1983-1986 in the transformation of BRI into a sustainable MFI. The role of the state in the transformation of BRI into a sustainable financial institution with a country wide network effectively serving the MSEs and rural poor is one of the remarkable achievements of micro finance in any developing country.

⁸¹ Siebel Hans Dieter & Parhusip Urben. **“Microfinance in Indonesia: An Assessment of Micro Finance. Institutions Banking with Poor”** Rural Finance Programme. Ohio: Ohio State University, 1998.

It is important to make regulation more flexible by allowing use of collateral substitute for security loans to MSEs. Reduce entry and exit barriers in the financial sector to make the sector contestable and therefore more customer-friendly.

ii) Nurturing cooperation between mainstream commercial banks with micro finance institutions

Discontinuities exist in the flow of resources from the MSEs to the main stream commercial banks. The MSEs savings and retained earnings are limited coupled with collateral and minimum balance requirements by commercial banks which hamper interaction between the latter and MSEs. Neither have the efforts to link the two through micro finance institutions and other potential intermediaries succeeded because of the negative regulatory environment.

It is necessary to explore methods of linking up mainstream commercial banks and other less formal financial institutions serving the MSEs sector to create indirect links between MSEs and commercial banks. This kind of working relationship is advantageous. First, the MFIs and financial NGOs tend to have a close knowledge of their borrowers and the nature extent of their business assets.

However, the lenders in the formal sector such as mainstream commercial banks and non-bank financial institutions cannot generate this kind of knowledge about micro enterprises and still generate a profit on small loans lent at relatively high interest rates.

The MFIs acting as intermediaries will assume the responsibility of screening borrowers across the market and overtime. With the MFIs as financial intermediaries getting involved in loan enforcement activities like collateral, appraisal and credit ceilings ,that increase the likelihood of loan repayment and reduce the scope of opportunistic default. In all these undertakings MFIs as financial intermediaries take advantage of gains from specialization in the form of learning by doing and returns to scale to information capital.

Through MFIs mainstream commercial banks will overcome information and enforcement problems. The MFIs will raise the efficiency of loan transactions in the presence of barriers to credit and in so doing improve the level and efficiency of MSEs investments.

Cooperation between commercial banks and MFIs will create new institutional frameworks for assessing credit risks and obtaining security. For instance K-REP which has had considerable experience in dealing with MSEs can use its knowledge and capacity about MSEs to borrow from mainstream commercial banks such as Kenya Commercial Bank, Barclays, Standard Chartered using its own assets and performance to secure loans which it will in turn lend to individual MSEs.

However for this system to work, the intermediary MFIs must have an acceptable credit rating that commercial banks can recognize. They must have intimate knowledge of micro-enterprises; demonstrate trust, respect and confidence of the MSEs entrepreneurs.

This special credit schemes will mean improved credit accessibility for MSEs. through this MSE growth and expansion would be realized.

iii) Strengthening existing MSEs credit institutions such as KIE

Although highly desirable, it is not possible to eliminate all barriers to credit. Directed credit is necessary. However the problem is that any credit program directed or not is bound to run out of funds if sufficient care is not given to contract enforcement issues.

Many directed programmes turn out to operate as welfare transfers; when loans become due default rates rise, and funds are no longer replenished. As a result most directed credit programmes are short lived. They constitute an ineffective form of welfare transfer since they fail to reach the neediest.

Indeed existing credit institutions must rely on innovative contract enforcement mechanisms, whether group lending, credit guarantee schemes, hire purchase, computerization of credit histories and chattel mortgages. The approach adopted by KIE takes some of these innovations.

Many MSEs could grow more efficiently with better access to credit. A financial support system will work better when it has better designed rules to guide lending to MSEs and MSE – specific personal expertise where MFIs fit well. Few institutions in the developing world have performed impressively in this regard. Kenya can learn from the former Small Business Development Corporation (now known as Business Partners) in South Africa as an example of how financial

support, supply of venture capital and the development of MSE in a developing economy should be handled.

A supportive economic milieu, as well as appropriate government policies will play critical roles in MSEs success or failure. MSEs in African countries Kenya included are residual businesses with a lack of access to credit.

iv) Establishment of MSE forum and MSE – Specific Laws

It is imperative to devise a system/forum for information dissemination among NGOs that deal with MSEs, government departments and the private sector. Such a forum with relevant government agencies and NGOs will share progress on various activities in order to ensure complementarity's on ongoing activities in the MSE sector. Instead of working at cross-purposes. Organizations that champion MSEs interests such as K-REP, Kenya National Chamber of Commerce and Industry (KNCCI) among others will be useful. For example the proposed MFI Bill will be beneficial when the input is widespread which requires awareness at all levels.

Having a legislation that will address the MSEs in Kenya will be extremely important. For example a Micro and Small Enterprises Legislation will define what MSEs are thereby facilitating policy implementation. Currently the definition varies among government departments and private sector (especially among mainstream commercial banks).

MSE development requires solid support systems. For informal sector, effective policy at national level this hurdle needs to be overcome for example by providing more complete knowledge of policy makers and MSEs sector representatives.

Indeed in Japan such legislation exist known as "The Fundamental Law of Small-Medium Enterprises" which provides a policy framework within which MSEs are handled. Such legislation in Kenya will amount to positive intervention in favour of MSE growth and development.

5.1 Summary

This study set out to investigate the impact of credit access on MSE development in Kenya, the mechanisms the Kenyan government has put in place to improve credit accessibility by MSEs. This study demonstrated that despite the presence of a variety of credit programmes in Kenya either government initiated such as ICDC, KIE or non governmental – led like K-Rep, credit access by MSEs is minimal. Limited access to credit by MSEs in Kenya is a major constraint for their growth and development.

The MSE sector in Kenya is important for employment creation and poverty reduction. The Kenyan government has expressed confidence in the potential of micro enterprises in several policy documents. A National Baseline Survey 1999 of these enterprises revealed that there were 1.3M such enterprises employing 2.4 million Kenyans, equivalent to 15% of total employment and contributing 18% of the national gross domestic product⁸².

In Kenya, the MSEs sector is generally undercapitalized due to difficulties in accessing credit. Only 6% of MSEs were able to successfully apply and use credit. More than one third of micro enterprises close down due to inadequate working capital. This inadequate credit access implies the potential role of the micro-enterprises in poverty reduction and socio-economic transformation in the country will not be achieved. For instance the Baseline Survey indicated that

⁸² Central Bureau of Statistics, ICEG & K-REP National Micro and Small Enterprise Survey: Survey Results, Nairobi, 1999.

only 6% of MSEs successfully accessed credit⁸³, this is quite low given the potential of the sector.

The Kenyan financial sector is dominated by few commercial banks geared toward meeting the financial needs of large scale commerce. The efforts by the Kenyan government and NGOs to bridge the financial gap for the MSEs have registered minimal success. Not even with the liberalization of the financial sector in early 1990s helped the situation. This was compounded by excessive government borrowing from the domestic economy that seriously disadvantaged the private sector especially the MSEs.

The MSEs that successfully seek credit survive longer and are able to register growth. To facilitate access to credit by the MSEs in the mainstream commercial banks impediments such as stringent collateral requirement need to be reviewed. In Kenya bank credit is tied on real property and movable assets, the banks tend to limit themselves to overdrafts and medium term loans mostly used for the purchase of capital equipment. Both types of credit are secured with real property as a result access to bank credit is largely confined to medium and large scale enterprises with secure land titles or property.

This inability to reach MSEs with no or little collateralizable property is not peculiar to Kenya a similar situation obtains in East Asia. The MSEs have in turn sought credit from informal sources such as friends and relatives whose terms are flexible. The study indicated for a majority of MSEs the most important source for starting and additional capital is own/family funds. The MSEs fall for these

⁸³ See Chapter Three.

sources for lack of alternatives given their low incomes and savings rate. This demonstrated the inability of the established financial institutions to meet the credit demand for MSEs. The existing lending regulation locks out potential borrowers who need credit.

The limited access to credit account for more than a third of business closures. This indicates that credit plays a critical role in enterprise performance growth and development. MSE entrepreneurs turn to informal credit sources this requires time in developing long-term relationships and good reputation with suppliers. However a short life span of many MSEs reduces opportunities for building such relationships.

A huge body of literature exists on the provision of credit which almost uniformly concludes that lack of access to investment and working capital is the most severe impediment encountered by micro and small enterprises. However, there is less agreement on how the shortcoming is best resolved. This study suggests the following options to enhance credit access by MSEs in Kenya. Establishment of micro finance banks that caters exclusively for the MSE sector, nurturing cooperation between mainstream commercial banks with microfinance institutions, strengthening existing credit institutions such as KIE and establishment of MSE forum and enactment of MSE – Specific Laws.

5.2 Conclusion

The concept of micro finance is a relatively a new phenomenon but all over the world societies have had mechanisms for provision of credit for the ordinary people. The objective that has occupied the development of micro finance has been the search for appropriate practices for delivery of financial services to the MSEs efficiently, effectively and sustainably.

The challenge that faces Kenya (just like other African countries) is to create a process that would allow micro finance institutions to deal with issues of access, provision of information, collateral, repayment and cost. Throughout the 1990s most micro finance institutions have developed practices that aim at low delinquency, minimal operational costs, high repayment rates, and expanding outreach. The donors have supported and guided the growth of the microfinance sector in developing countries; they play a critical role in shaping the nature and orientation of the emerging institutions.

In the period prior mid 1990s government credit institutions and systems were limited in terms of clients served, sectors covered, efficiency and sustainability. The government was the key actor in provision of credit which was highly subsidized. These government-backed schemes and development finance efforts performed below par and may have distorted the evolution of financial markets in the country. These credit institutions lacked mechanisms of excluding risky borrowers for instance those enjoying political patronage. As a result many borrowers fail to repay and the credit institutions are left with a progressively drying pool of funds for lending.

The initiatives were not effective in generating employment opportunities and make a dent on poverty. The loans provided were viewed as grants as a result the institutions became heavily indebted to the government, and finally unsustainable. However loan schemes that show the best long term results are those that minimize the element of subsidy, take a non-bureaucratic approach to the evaluation and distribution of loans. The provision of credit is sustainably carried out by autonomous institutions less prone to political interference.

The collaboration between donors and major commercial banks in extending credit to the MSEs, but were limited and entirely dependent on availability of donor funds. The banks themselves were not interested in the informal sector because of high risks, lack of collateral and expenses involved in management of small and medium loans. The donors themselves were experimenting with a participatory bottom up approach to development.

In Kenya the challenge is how to overcome institutional limitations, inappropriate practices, credit bias to elite and embrace the opportunities of working with micro-entrepreneurs in the rural and urban areas.

5.3 Recommendations

The micro-enterprises have always played a crucial role in socio economic transformation of all countries for example the vaunted East Asian tigers. In Kenya too MSEs can play a critical role in poverty reduction and wealth creation, but the major constraint of credit in accessibility must be addressed.

MSEs play a central role in economic growth and poverty alleviation in developing countries and transition economies. MSEs suffer from market imperfections especially those caused by underdeveloped financial and legal systems severely limit their ability to grow and expand. Economies of scale and entry cost tend to favour large firms and large entrepreneurs that usually wield more political influence.

There is no universal approach that Kenya can take to facilitate credit access by MSEs. The unique political and economic environment prevailing in each country will determine the approach. The key objective for Kenya is to identify mechanisms that will cater for the financial needs of the MSE sector for it to grow and expand.

The international political economy is dynamic at independence for instance the state was a dominant player in the economy. This explains why the schemes such as ICDC, KIE that lent to the enterprises were exclusively government led initiated and owned. However, in the 1990s the state has been gradually taking the position of a regulator as a reflection of changes in the global economy.

That is why the study recommends a government initiated regulatory regime that will see micro finance institutions sprout, and cooperation of these MFIs with mainstream commercial banks. Enactment of MSE-specific laws that address the needs of MSEs. Government schemes already in operation such as KIE need not be closed but strengthened and probably open it up to private sector participation.

Hence any further research need to be done while paying attention to the above reality.

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The following questions were addressed to the following officials on a one-to-one interview at various dates. The study focused on these organizations (KIE, K-REP and Ministry of Planning and National Development – MSE division) because they are exclusively concerned with micro enterprise development. KIE (governmental organization) has been in operation for more than three decades and lends exclusively to the MSE sector. K-REP (Non governmental organization) has played a pioneering role in micro finance development in Kenya and lends largely to MSEs sector. The MSE division Ministry of Planning and National Development reflects the policy position of the government on MSEs development.

However, MSE enterprises range over one million and cut across sectors with different success rates in credit access. The study could not interview all these because of cost and logistical problems which are beyond the scope of this study. To cater for this, the study borrowed from National Micro and Small Enterprise Baseline Survey: Survey Results 1999 carried out by Central Bureau of Statistics, ICEG & K-REP.

1. D. K. Opiyo, General Manager, Kenya Industrial Estates (KIE) Nairobi, 4-09-2006.
2. Head of MSE Division, Ministry of Planning and National Development, Republic of Kenya, 5-09-2006.
3. K. Mutua Head of Research Division, Kenya Rural Enterprise Programme (K-REP), Nairobi. 11-09-2006.

Questions

1. How do you rate the MSEs access to credit in Kenya in general?
2. What are the major impediments to credit access by MSEs in Kenya?
3. How do you view credit access vis a vis growth and expansion of MSEs in Kenya?
4. What can Kenya learn (if any) from other developing countries that have been relatively successful in enhancing their MSEs and rural poor access to credit?
5. Taking the above into consideration what is the way forward for MSEs and credit access in Kenya given the centrality of MSEs in the economy?

Thank you.