Journal of
Economics and Political Economy
www.kspjournals.org
Volume 7 September 2020 Issue 3

The potential of Islamic financial institutions in promoting small and medium enterprises (SMEs) in Ethiopia

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Abstract. It is universally proclaimed that SMEs are engines of growth and development in various countries in the world. Nonetheless, access to finance remained an acute obstacle. This paper aims to assess the potential of Islamic financial institutions in promoting SMEs to get access to alternative financial services in Ethiopia. Similar to other developing countries, SMEs in Ethiopia have lack of access to finance and alternative financial services. Hence, the experience of other countries show that Islamic financial institutions have been providing alternative services based on risk sharing, asset-based and ethical principles in order to achieve financial inclusion and wide-ranging growth. In order to encourage SMEs to get access to alternative source of finance, regulatory and legal frameworks, proper financial infrastructure, market and industry issues, awareness creation, and producing trained workforce should get proper attention.
Keywords. SMEs, Islamic financial institutions, Access to finance, Ethiopia.
JEL. G21, G51, D25.

1. Introduction

Small and medium enterprises (SMEs) are universally considered as locomotives of regional and global economic growth, creating employment opportunities for both trained and untrained workforces in various sectors of the economy, reducing poverty and enhancing the living standards of people in both developing and developed nations. In line with The World Bank (2019), approximately 90% of businesses and above 50% of employment opportunities globally are created by SMEs along with 40% of the gross domestic product (GDP) of emerging nations without counting the informal ones. Even in emerging economies, 70% of most formal jobs are engendered by SMEs. Therefore, the World Bank estimate shows that the contribution of SMEs throughout the world is

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uppermost primacy since around 600 million more jobs will be required in order to engage the rising worldwide labor force.

The most critical challenges faced by SMEs in both developing and emerging countries are: domestic policy and regulatory environment, managerial and human resource (Xiangfeng, 2007; Farsi & Toghraee, 2014), lack of finance, low level of research and development expenditures, inadequate use of information technology (Xiangfeng, 2008; Farsi & Toghraee, 2014; Yoshino & Taghizadeh, 2016; Wang, 2016; Buraiki & Khan, 2018), lack of an efficient and effective financial management system (Karadag, 2015), lack of professionalization of SMEs' founders and managers to be competent enough in the market and deficient management system or approach (Montaño *et. al,* 2011; Okręglickaa *et. al.,* 2015).

Consequently, access to finance is a fundamental restraint to SME progress, it is the second most mentioned impediment encountered by SMEs to grow their businesses in emerging markets and developing countries and they are unlikely to acquire bank loans than big companies instead they depend on financial sources from family and friends to establish and subsequently keep up their businesses (World Bank, 2018).

Concerning the challenge of finance for SMEs, the estimation of The International Finance Corporation (IFC) illustrates that 65 million firms, or 40% of formal SMEs in developing countries, have an unsatisfied financing need of about $5.2 trillion every year, which is corresponding to 1.4 times the current level of the universal SME lending. For small businesses with or without foregoing access to financing in the form of availability of loans and other financing and payment mechanisms will remove their main impediment and lead to growth. In addition, easy access to finance the needs of SMEs facilitates to enlarge their working capital and fixed assets, which sequentially initiates better production boost, better employment, and possibly expanded productivity (IFC, 2018).

Islamic finance, a thriving field in the course of the last four decades, can be an alternative source of funding for SMEs in developing and emerging countries throughout the world. Refraining from riba (interest) and other prohibited actions and sectors, Islamic financial products have been provided for users through profit and loss sharing, cost plus markup sales, leasing, fee based services etc. for micro, small, medium and big firms. Explicitly, SMEs, which have scarcity of funds and excluded due to religious reasons, can benefit from Islamic financial products from both banks and microfinance institutions. Hence, the main objective of this study is to probe the potential of Islamic financial products towards bolstering SMEs in Ethiopia.

The study used descriptive method of research. It illustrates the possible alternative methods of financing SMEs in Ethiopia. The fact that Islamic finance is a comprehensive concept, this study will focus on the role of Islamic financial institutions and the benefit of Islamic financial products to enhance the development of SMEs. This will be explained how financial inclusion, risk sharing and financial stability are achieved through the provision of several profit and non-profit based products. Both empirical and theoretical studies were used to demonstrate the application of Islamic financial products in different countries. Furthermore, the reports of international financial and developmental organizations were included in the study.

The remaining part of the paper has been arranged as follows: the first part deals with the literature review about SMEs in Ethiopia. The next parts discuss the overview of Islamic finance and its role for SMEs, Islamic finance products for SMEs, Islamic finance in Ethiopia and challenges of providing Islamic finance products for SMEs in Ethiopia respectively.

2. Literature review

Ethiopia has been experiencing a robust economic growth in the past decade. The government has envisaged a growth and development plan that can lift the country to lower level middle income country by 2025 (Weldesilassie *et. al.,* 2019). The economy is dominated by agriculture, where 80% of the population in one way or another way makes living out of it. However the contribution of the agriculture sector is second to the service sector with 36% contribution to GDP. The service sector has been expanding in the past years. Currently the sectors contribution to GDP amounts to a 47%. Though the industry sectors contribution expanded from 10% in 2009 to 16% in 2016, it is immature despite the country's ambition of industrialization (NBE, 2017). Small and Medium Enterprises (SMEs) played a vital role in the broad base advancement of the Ethiopian economy, Nevertheless the performance of the sector is poor compared to other sub-Saharan African countries like Kenya, Uganda and Tanzania (Gebeyehu, & Assefa, 2004).

According to world trade organization there is no globally accepted common definition for SME. Most countries define SME based on the number of employees hired. The majority of them define small enterprises as firms with 10 to 50 employees, while medium enterprises are those firms with employees between 50 and 250 (WTO, 2016). Nationally small firms are defined as enterprises with 5 up to 30 employees, while medium size firms are enterprises with more than 30 employees (Weldesilassie *et. al.,* 2019). In terms of capital employment level small scale firms falls between 3000 USD and 9000 USD, while medium scale industries fall between 9000-30000 USD. According to World Bank MSME Country Indicator Report (2019), there were 44,771 SMEs in Ethiopia by 2014. Given the higher emphasis given by the growth and development plan of Ethiopia, we can estimate that this number is far higher by now. However there is no explicit recent data regarding their number.

It is crystal clear that, in a developing country like Ethiopia, small and medium Enterprises (SMEs) are key drivers of economic development and employment. Since 2000 The Ethiopian Government adopted development plans in light of poverty reduction through employment generation. The second growth and development plan of Ethiopia (GTPII), a grand strategy that is designed with the aim of lifting the country to lower level middle income countries level by 2025 has given due emphasis to Micro Small and Medium Enterprises (MSMEs) as a main economic actors that can create myriads of employment opportunities, advance production volume and enhance innovation (Assefa, *et. al.,* 2014). Along with micro enterprises, SMEs comprise the largest share of total enterprises and employment in the non-agricultural sector (Weldesilassie *et. al.,* 2019). Quite apart from adding competitive strength to the economy by creating massive job opportunities, MSMEs add flexibility to the economy and industrial diversification (Sileshi, 2001). In addition, SMEs played undeniable role in transforming traditional industries into modern manufacturing (Stephen & Wasiu, 2013). Despite the myriads of articles that empirically describe the role of SMEs to the Ethiopian economy there is no systematic and organized data about the amount of employment created and the level of measureable economic contribution (Woldesilassie *et. al.,* 2019). The latest available data is for the year 2010 found in MSME CI data base. According to this data a total of 176,543 MSMEs created 666,192 Jobs until the year 2010 (MSME CI, 2019)

The role of SMEs is not confined to low level income countries like Ethiopia. Ayyagari *et. al.,* (2007) collected data of 76 developed and developing countries. The data indicates that on average MSMEs created 60% of manufacturing employment. According to ILO (2015) empirical evidences confirm the fact that SMEs are major job creation engines. A study conducted by Mead & Liedholm (1998) on five African countries (Botswana, Kenya, Malawi, Swaziland, and Zimbabwe) found that SMEs generate nearly twice more level of employment than registered, large-scale enterprises and the public sector. Emerging countries have also reaped the fruit of SMEs. In Malaysia SMEs have been bed rocks of the private sector playing a pivotal role in economic development (Abaduljabar *et. al.,* 2016). In India SMEs created 40% of the countries labor force second to only the agriculture sector, helping the country accelerate the process of inclusive economic growth (Sangvikar & Pawar, 2019).

Bekele & Worku (2008) conducted a survey on 500 randomly selected MSMEs and followed their progress for six years with the aim of identifying long term viability and survival. Their finding portrayed that, despite the sectors huge impact with regards to job creation and alleviation of poverty among women, the strategic support provided to the sector is inadequate. Ageba & Amha (2006) studied a randomly selected 1000 SMEs with the aim of assessing the availability of finance to SMEs. Their finding indicates the lack of adequate support from government and the infertility of the macro-economic environment for SMEs to flourish. Though Ethiopia's industrial development strategy crafted in 2003 envisages promoting SMEs development (Rahel, & Issac, 2010), the overall macro-economic policy of the country does not take the basic needs of the SME sector into account. As a result the SMEs are underperforming in terms of Job creation and capital mobilization (Bekele, & Worku, 2008). Kibret *et. al.,*

(2015) also argued that policy and institutional challenges are impediment for the development of the sector.

As the 2020 doing business report of World Bank revealed Ethiopia ranked 149 in ease of doing from 190 economies. The report uses 11 indicators which are assumed to be critical for a better business environment. The overall doing business score of the country is below the region average. This fact has a tremendous impact on the progress and development of SMEs in Ethiopia. Quite apart from the challenge related with the lack of adequate working premises, SMEs in Ethiopia mainly face lack of access to credit, inadequate market links, shortage of power supplies, weak employee development programs and lack of business support services (Ageba & Amaha, 2006; Weldeslassie *et. al.,* 2019; Bekele & Worku, 2010; Getahun, 2016; Abdulmelike *et. al.,* 2018; Gebreeyesus *et. al.,* 2018).

According to World Bank ease of doing 2019 report, Ethiopia ranked 175 out of 190 countries falling under the category of the worst countries to get credit. The credit access score of Ethiopia is 15, which way below the sub Saharan average score that stands at 45. It is crystal clear that the SMEs who suffer most from the adversity of access to credit. Moreover most SMEs lack the necessary collateral to secure a loan hence the viable source of loan is family and other informal source of credit, in addition to microfinance. Nevertheless, the cost of borrowing from microfinance is expensive, which is an additional impediment for SMEs (Abdulmelike *et. al.,* 2018; Weldeslassie *et. al.,* 2019).

In addition to policy, institutional and working environment challenges, religious views of managers/owners of SMEs also adversely affect their willingness involve in mainstream financial services. Some studies show that religious motives causes manufacturing SMEs in Addis Ababa (Eriksson, 2015), 519 business enterprises in selected large towns (Nega & Hussein, 2016), micro and small enterprises in West Oromia Region (Lakew & Birbirsa, 2018) and 204 SMEs in Addis Ababa (Ayalneh, 2018) to distance themselves from interest-based loan offered by conventional financial institutions.

3. Islamic finance and its significance for SMEs

The Islamic finance industry has been growing rapidlyand its popularity increasing during the last two decades. Its role on financial inclusion, saving mobilization, investment, infrastructural development, poverty alleviation is crucial in different countries. According to the Islamic Finance Development Report, more than 61 countries reported the existence and services of different Islamic financial institutions and the total asset values of the Islamic finance industry was also reached to US$ 2.52 trillion in 2018 (IFR, 2019). The Islamic finance industry has different sectors that works based on same principles. Among the different sectors inthe industry, the Islamic banking segment is the largest sector that holds $1.76 trillionor 70% of the industry's total assets. The Islamic capital market (Sukuk) is the second largest segment contributing to 19% or $460 billion of the Industry's assets.

Since their first establishment in the mid-1970, the Islamic banking sector is showing enormous growth despite the various internal and external challenges. With such tremendously tough operational environment, Islamic banks are concentrating on strengthening themselves through gathering adequate financial resources to accomplish their banking requirements alongside with providing Shari'ah compliant products to achieve sustainable growth and focus on undervalued sectors for anticipated future (Hakeem, 2019). One of the areas which need consideration is SMEs sector.

The presence of Islamic financial institutions in a country's financial system is expected to contribute in the real sector including financing SMEs. The investing and financing activities of Islamic financial institutions are working based on universal values. The underpinning principles of their activities are encouraging ethics, participation, risk sharing, equity, and property rights which all are universal values (Elasrag, 2016). Based on these values, Islamic financial institutions use various Shariah-compliant instruments to finance activities of SMEs and other projects. However, the main emphasis of Islamic finance ison partnership-style financing and risk-sharing methods which improve access to finance at a fair and reasonable cost for micro, small and medium businesses. Access to SMEs and micro enterprises, consequently, could help to provide alternative agricultural financing which contributes to improve food security.

The Islamic methods of financing are based on five key guidelines and principles: Prohibition of interest (*riba*), Prohibition of *Gharar* (excessive uncertainty and speculation), Prohibition of investments in prohibited products and activities (products that harm the society), profit and risk sharing, and Asset-backing principles. All Islamic finance products and schemes are based on these core Shari'ah principles and frameworks.

Risk Sharing Principle: Islamic finance is obviously aligned with risk-sharing financing. One of the unique features of Islamic financial institutions such as banks is their risk sharing. Risk-sharing is one of the fundamental principles that distinguish Islamic finance from its conventional counterpart. Islamic finance has different moods of finance and the underlying principle of all financing arrangements is that the party who contributes financial capital and the entrepreneur who runs the business share the risks of the business in exchange for explicitly stated earnings (Iqbal & Mirakhor, 2013). In Islamic finance, it not moral and acceptable to acquire return by merely providing finance without bearing the risk of what is being funded.

Islamic finance can be a better alternative source of financing for SMEs using risk-sharing principles. In IMF staff discussion note, Kammer *et. al.*, (2015) maintained that Islamic finance has the potential for added contributions as it is essentially less predisposed to crisis because its risk-sharing characteristics lessen leverage and strengthen enhanced risk management on the part of both financial institutions and their customers. The conventional debt-based financing hinders SMEs from fairer access due to the perceived high risk of the SMEs (Lajis, 2018). On the other hand, the risk-sharing nature of Islamic banks and the strong relationship of loan to collateral makes it a perfect choice for SMEs and funding newly established businesses both ultimately enhances overall growth in the economy (Elasrag, 2016). It also promotes risk management via distributing the risks in the economy.

Asset-Based Financing: Financial dealings, in order to be acceptable from *Shari'ah* point of view and legitimate enough to claim profit, should be accompanied by tangible real assets. Financiers cannot produce money out of nothing without the involvement of real assets. Therefore, the returns of the one who provides finance are associated with the selling or leasing of an asset to the client thereby accepts the risk of ownership of the asset in question. This method promotes development in the form of enhancing asset-based investment and the partaking in risk-based capital (Ayub, 2007). In addition to the economic motive, Islamic financial institutions underline the social well-being of the people and firms. It is possible to serve SMEs by providing finance and minimize the credit gap through asset-based financial products (Hassan, 2015). Financing SMEs using asset-based products will help these enterprises to create jobs, alleviate poverty and contribute for the growth of their respective nation.

These two fundamental principles of Islamic finance namely risk-sharing and asset-based financing methods have the potential to enhance financial stability for the reason that the risk-sharing nature of finance shrinks leverage which might lead to bankruptcy or the inevitability of cash losses. Furthermore, the asset-based characteristics of financing SMEs achieve the intended purpose of business development and circumvent any financial speculation as it is entirely collateralized.

There is evidence that an increased share of lending to SMEs has given rise to financial stability, essentially by plummeting non-performing loans and the likelihood of default by financial institutions (Morgan & Pontines, 2014). They recommend that there ought to be policy actions to boost financial inclusion targeting SMEs since it lends a hand to augment financial stability. Implementing Islamic financial products for SMEs which are in need of fund not only embrace these businesses in the economy but also contribute to the betterment of the financial stability.

4. Islamic financing schemes/products for SMEs and country experiences

Under the framework of the core Shariah principles, Islamic financial institutions, mainly banks, in various countries have developed variety of alternative financing products and schemes to support micro, small, and medium enterprises. These financing can be categorized into five and three of them are trade-based financing, equity-based financing, and lease-based financing. The core financing products used in many countries to finance

SMEs are *Murabaha*, *Musharakah* (Joint venture), *Mudarabah* (Partnership), and *Ijarah*. *Musharakah* and *Mudarabah* are partnership contracts between two parties based on the profit-loss-sharing principle.

Murabaha: Murabaha is a kind of trade-based financing. This kind of financing is a comprehensive and long-established not only in the Islamic banking industry but also it is prominent in microfinance sectors throughout the world because of its straightforwardness as compared to other forms of financing. *Murabaha* is a form of financing based on buying and selling mechanisms adding markups on the cost of the product which enables the buyer to pay the price on an installment basis (Khan, 2008). Under this mode of finance, both the financier and client should agree in advance on the cost and mark-up rate from financing. The *Murabaha* is the most overriding form of financing offered by Islamic financial institutions. Hassan (2015) criticized *Murabaha* as a genuine mode of Islamic financing tool to SMEs as it resembles the conventional lending system and it is inadequate to enhance financial inclusion in the right way. However, Shaban & Fry (2016) contend that *Murabaha* is more appropriate and rather alluring to SMEs as it solves the issue of collateral, managerial experience, and information asymmetry as compared to conventional financing mechanisms.

Musharakah and Mudarabah: A unique feature of Islamic banks is its profit and loss sharing (PLS) scheme which are usually conducted through the principle of Mudarabah (profit-sharing) and Musharakah (joint-venture). *Musharakah* is a partnership form of financing whereby both the capital provider and the micro-entrepreneur contribute some amount of money to a business venture agreeing to share the profit as per a predetermined ratio whereas the loss will be shared according to the capital each party allocated. On the other hand, in a *Mudarabah* one party (the principal or *Rabb al-mal*) contributes money and the other party (the entrepreneur or *Mudarib*) brings his managerial skill, business expertise, time to do the business. These two kinds of equity-based financing modes are deemed suitable for SMEs as they enable Islamic banks to advance loan on a longer-term basis to projects with greater risk-return profiles (IFC, 2017). In practice, however, in contemporary socio-cultural and business surrounding the financier is expected to put complete trust and depend on the reliability, capability and exceptional management of the entrepreneur or SMEs and this often doesn't happen (Kettle, 2011). The other challenge is the unavailability of adequate legal ground to settle the issue in most countries (Habib, 2018). Though there are challenges when they are applied for SMEs, they can be used by taking the necessary procedures to reduce the risk to the extent that the fund provider doesn't lose his capital.

*Ijara***:** The Ijarah mode of financing resembles the conventional leasing but has some differences in application. In *ijara* contract, the owner of an asset or property allows the other party for the usufruct of the asset against prearranged rental payments until the end of the contract period (Hanif, 2014). There are some evidences which corroborate the use of *ijara* for

SMEs. Dalimunthe *et. al.*, (2019) studies the performance of SMEs in Indonesia comparing *murabaha*, *musharaka* and convertible *ijara* contracts. The result based on simulation of nine sectors shows that convertible ijara has outpaced *murabaha* but not *Musharakah* whereas as in the long-term basis the convertible *ijara* contract outshined both *murabaha* and *musharaka* for nearly all sectors. In the same way, Muneer *et. al.*, (2017) investigated the impact of Islamic financial products on the performance of SMEs in Pakistan and found that most of the SMEs used *ijara* as a preferred form of financing to acquire fixed assets which ultimately were able to decrease their operational and carriage costs.

The above Islamic finance instruments and other financing schemes are used effectively to finance SMEs in various Muslim countries including Bangladesh, Pakistan, and Indonesia.

In Bangladesh, SMEs account for 30% of GDP, 40% of employment, 80% of industrial jobs and 25% of the total labor force. In the country, interest free banks play significant roles in supporting SMEs. Islamic financial institutions value the roles of SMEs and Microfinance that can play in building the nation. For example, the country's biggest IFB, *Islami Bank Bangladesh Limited* (IBBL), holds the highest position in financing SMEs among banks and financial institutions in the country. The bank adopted a comprehensive SME Investment Policy and its SMEs exposure was reached 27% of the total national SME financing in 2016. The Bank's main modes of investment to finance SMEs are Capital Investment (Hire Purchase *Shirkatul Melk, Musharakah* and *Mudarabah*), working Capital for all concerns (*Murabaha, Bai Muajal*, etc.), and Specific Modes of investment for the Schemes and other items as per existing norms. The bank's special schemes of financing SMEs involve Women Entrepreneurs' Investment Scheme, Micro Industries Investment Scheme, Small Business Investment Scheme, Transport Investment Scheme, and Micro Entrepreneurs Investment Scheme. IBBL's investment to finance SMEs contributes over 40% in the total investment of the bank (IBBL, 2016).

Similarly, Islamic finance, especially Islamic banks, plays a vital role in financing SMEs in Pakistan as well. Although the SMEs sector in Pakistan comprise over 30% of the country's GDP, a study made in 2017 indicated that only 11% of the small and medium enterprises are well-served in terms of access for finance. The remaining 22% claimed to be underserved and 67% remains unserved. It means that at least 89% of SMEs are either deprived or totally neglected by the banking sector of the country (Raza, *et. al.,* 2017; Dar, *et. al.,* 2017). The study indicated that religion is one of the major factors thatprevent the SMEs entrepreneurs from using the conventional sources of financing. Majority of the SMEs avoid interest based conventional financing opportunities due to spiritual beliefs. The central bank of Pakistan has put its effort to develop an Islamic banking product line, particularly for the SMEs sector. This creates a positive attitude in the sector and pushes the demand for Islamic banking from the SMEs to increase (KPMG, 2017).

Small and Medium Enterprises (SMEs) greatly require the role of Islamic Financial Institutions (LKS) in a Muslim majority country like Indonesia. In Indonesia, SMEs are a major source of employment. Indonesia Ministry of Cooperatives and SMEs acknowledged that SMEs have been representing approximately 58% of national GDP as well as contributing a significant 97.16% to job creation (Yunita & Hendranastiti, 2018). Islamic financial institutions and *Baitul Mal WaTamwil (BMT)* significant roles in financing SMEs (Jamaluddin & Abdullah, 2019). There are more than 8 banks and other non-banking financial institutions giving Shariah compliant services in the country. The role of these financial institutions in financing SMEs is vital. More than 70% of the Islamic banks financing is given in Micro, Small, and Medium financing forms. Since the SMEs sector is still untapped by conventional banks, the Islamic financial institutions can use the sector to avoid severe competition from conventional banks and financial institutions.

5. Islamic finance in Ethiopia: An overview

The establishment of interest-free banking (IFB) has been the demand of the Ethiopian Muslims for a long time. This demand has been reflected to the concerned government bodies (including the regulatory body, National Bank of Ethiopia (NBE)) in different occasions both individually and collectively. After a recurring request, NBE issued the Banking Business Proclamation of 2008, authorizing IFB to operate in the financial industry (Ahmed, 2019). All of a sudden, the IFB proclamation was amended by IFB directive SBB/2011 which outlaws full-fledge IFB rather allows "*a conventional bank exclusively offering interest-free banking services*". When this directive was issued, there is no logical explanation as to why the proclamation amended and barZamZam Bank, which was on the verge of getting banking license and commence operation, to be the forerunner to be full-fledged bank in the country.

Following the IFB directive which allows conventional banks to provide the service through windows enticed most. The privately owned, Oromia International Bank became the pioneer to take advantage of this opportunity and launched the service in 2013 followed by the giant state owned Commercial Bank of Ethiopia(CBE) and United Bank (Aman, 2019). Currently, apart from offering interest-free window services by more than 10 conventional banks, some banks are vigorously engaging on opening up interest-free braches both in the capital Addis Ababa and some regional cities.

Subsequent to the political reform in the ruling party, the NBE shows commitment to reinstate the establishment of full-fledged IFB. Right now, some have completed selling shares and speed up commencing the banking service while others are struggling to do so. It seems obvious that a handful of full-fledged banks will join the banking sector soon.

The annual reports of the banks which have interest-free window services are offering current and saving account products like *wadiah* and *qardhasan* and *mudaraba* investment products. From the financing side, *murabaha*, *salam*, *isitsna* and *ijara* are the most commonly used products. Despite the fact that there is limited evidence and specific information as to how these Islamic banking products are being utilized to fill financing gap for SMEs, other country experiences with comparable economic and social status show that there is a room for SMEs to get access to finance.

Like the interest-free banking services, the provision of interest free microfinance services is a recent phenomenon. Until now, the services are being offered by conventional microfinance institutions which are jointly owned by regional governments and individual shareholders. Somali microfinance institution (SMFI), a pioneer in providing interest-free microfinance services in the country, delivers Shari'ah compliant loans and savings for users in eastern part of Ethiopia (The Guardian, 2015; Aljazeera, 2019). As it is common in many countries, the dominant financing tool provided by SMFI is *murabaha*. In addition to SMFI, Rays microfinance institution is the other giving murabaha, ijara and salam products since its inception in 2014.

Harar and Dire Microfinance institutions are also offering Shari'ah complaint microfinance services in the adjacent region. The former started the services in interest free saving in 2014 and interest free financing in 2015 whereas the latter provides *murabaha* and *ijara* under its financing scheme and *wadia* and *mudaraba* as saving products since 2013 (Ali, 2019). One of the largest microfinance institutions, Oromia credit and savings institutions also offers *murahaba* finance, *wadiah* saving and *qard* current account services to micro-entrepreneurs. The financing product is delivered in three forms for individuals, small businesses and groups of one to five individuals.

6. Challenges for utilizing the full potential of Islamic finance for SMEs in Ethiopia

Notwithstanding the interest-free banking services persist in the banking sector for nearly seven years, a number of challenges have restrained its growth. Among other things lack of proper and accommodative legal and regulatory frameworks, shortage of trained human workforce both in administrative and Shari'ahadvisory levels, lack of awareness and erroneous understanding amongst Muslims and non-Muslims about Islamic banking and its functions, lack of infrastructure appropriate for Interest free banking operation are some of the impediments. The unavailability or inadequacy of this enabling environment severely affects the capability and potential of Islamic banks to perform their financial services in general and to SMEs in particular.

Like Islamic banking services, there are several problems in the Islamic microfinance services in the country. Some of the challenges include under developed Islamic microfinance industry, lack of understanding of the generic Shari'ah models by clients and policy makers, shortage of Islamic-finance providers including funders and donors, unavailability of clear and detailed legislation from the National Bank of Ethiopia, shortage of trained and knowledgeable workforce related to interest free microfinance services, immense and arduous administrative cost of the system and clients' nonconformity with some Sharia principles (Ali, 2019; The Ethiopian Herald, 2019). The fact that most SMEs aren't entitled to get access to finance from banks and a significant number of SMEs are operating in rural areas, interest-free microfinance institutions can play a pivotal role if the above stated barriers are taken into consideration.

All the way through this paper, access to finance has been mentioned as a major impediment for SMEs development. Islamic financial products can partly abate this barrier through innovative, comprehensive and social welfare based techniques to fuel entrepreneurial venture. Nevertheless, lack of fund is not the only nuts and bolts which happen to be a stumbling block against the success of SMEs. The fact that SMEs have small size, short experience, less skilled personnel, little access to technology and operate in an informal sector puts them in an underprivileged position. In addition to these shortcomings and external challenges which were pointed out before, there are other internal factors that need consideration. The most common internal barriers SMEs face are lack of managerial and entrepreneurial capabilities to manage businesses effectively, shortage of a proper business structure, limited information to locate and analyze markets, high labor and operating costs, inefficiencies of human resource management (Khattak *et. al.,* 2011; Kazimoto, 2014; Bouazza *et. al.,* 2015; Al-Maskari *et. al.,* 2019; Febriani *et. al.,* 2018).

7. Conclusion

The existence of SMEs is highly conspicuous in developing countries like Ethiopia as it covers the great segment of the economy. However, lack of access to finance, among other challenges, deter their progress to contribute in job creation, poverty alleviation and economic growth. Alongside the provision of funds in conventional manner, Islamic financial institutions can provide alternative financing schemes to realize financial inclusion, promote risk sharing in business dealings, and secure financial stability. These financial products can be offered by banks, microfinance institutions and other NBFIs. Though interest-free financing services have been provided both in windows and braches of conventional banks and microfinance institutions in Ethiopia, there is no evidence as to how they support the development of SMEs in the country.

The provision of Islamic financial services to SMEs is significantly affected by the regulatory, legal, administrative, human resource, infrastructural factors which are common for all irrespective of their size, sector, and location and so on. Therefore, government and other financial sector stakeholders should take part to ease these impediments to smooth the level playing field for SMEs to contribute in the productivity and economic growth both in urban and rural areas.

In order to improve the expansion and improvement of SMEs from access to finance perspective, there should be a special focus from regulatory and policy makers to consider and encourage alternative ways to supply funds. Besides, market and industry related issues such as the creditworthiness and guarantee and capacity building measures like providing trainings which can boost the skills of SMEs' owners/managers need proper attention.

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