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Full Length Paper

The Role of Microfinance in Economic Development

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Abstract

The economic role that micro finance specifically in developing nations has been discussed thoroughly in this paper. Apart from touching on how microfinance institutions operate and render financial services to the low income individuals and small enterprises, the discourse emphasizes the significance of micro finance in enhancing women empowerment, poverty eradication, and stimulating economic growth. In light of both success stories but also critiques, the discussion seeks to highlight the impacts of microfinance in various sectors but also the many challenges that arise from the initiatives such as over indebtedness and sustainability. The results suggest that there are many issues and risks that have implications for financial inclusion which can best be addressed by the use of detailed approaches. The discourse makes its contribution to the broader discussion regarding the role of microfinance in achieving sustainable economic development through the analysis of successful and unsuccessful practices.

Keywords: Role, Microfinance, Economic Development

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1.0 INTRODUCTION

1.1 Understanding Microfinance and Its Framework

Understanding Microfinance and Its Framework Microfinance is described as a combination of financial services for the low-income earners and small businesses without access to conventional banking services. The core aim is to ensure that those people are included financially by enabling them to get loans, save, insure and receive other financial services (Ledgerwood et al, 2017). This chapter reviews the microfinace ecosystem, its history, how it works, and the various models that exist across the world..

1.2 Historical Context of Microfinance

There doesn't seem to be a clear definition of microfinance however, it is evident that it stems from the indigenous mode of informal lending that was common in many societies. Nevertheless, it became a global buzzword towards the end of the twentieth century following the efforts of Muhammad Yunus and Grameen Bank of Bangladesh. The model of Yunus showed that small loans were effective when granted to low income, especially women, population to proper them (Yunus, 2018). The microfinance movement has today become a measurable social movement by the vast number of institution formed to service the un-reached clients.

1.3 Working Principles of Microfinance

Community based microfinance models are commonly used by microfinance institutions with the main aim of increasing repayment and decreasing default risk through group lending. Social accountability is established when small groups of borrowers are formed to take interpersonal responsibility for each other's loans (Lafourcade et al., 2018). Also, this method combined with small loan sizes facilitate trust and mitigate risks of lending to those with no formal credit history.

In addition, micro finance institutions are not just in the business of providing credit but also provide aid alongside credit like financial literacy training which enables their customers to be more informed (Battaglia & Piva, 2019). When education and support services are included with microfinance, the results show that the wellbeing of the beneficiaries improves significantly (Duvendack et al., 2019).

1.4 Different Models of Microfinance

Microfinance is several service models aimed at serving the different needs of its clientele. The dominant one is microcredit which concentrates on providing small amounts of loans to entrepreneurs. But apart from the above there are savings led microfinance in which encouraging the clients to save is the primary goal (Morduch, 2017). Moreover, social microfinance involves social aspects and emphasizes sociocultural purposes including increased access to health care and education (Hassan et. al, 2019).

Every model has its own pros and cons. For example, microcredit has expanded the business operations, but it is critiqued for contributing to over-indebtedness of a certain category of borrowers who may be unable to balance their credit burden (Roodman, 2018). Furthermore, although the savings led models encourage people to be financially responsible, they may not adequately fulfill immediate emergency capital requirements efficiently in comparison to microcredit.

1.5 Regulatory Framework

For microfinance to be successful, an adequate regulatory environment is important. These frameworks can differ greatly in their scope and importantly affect the growth and sustainability of MFIs over time (Zeller et al., 2017). There has to be balance in the regulation that is implemented: on one side it has to facilitate financial inclusion, on another, it has to protect the borrowers and ensure good conditions for the MFIs. Regulatory measures may include enabling access to subscribers' databases for good risk management (Armendariz & Szrek, 2017).

Microfinance can, therefore, be regarded as an important instrument of economic empowerment of the excluded through increasing their access to financial services. An overview of its conceptual framework represents the changing faces of microfinance and identifies a number of different models and modalities of its operations while bringing in a number of regulatory issues necessary for proper implementation. Subsequent chapters look more in depth at the evidence of microfinance's impact on poverty alleviation, women's empowerment, and aggregate economic development.

2.0: Microfinance and Poverty Alleviation

Microfinance has indeed become an important poverty reduction tool in many parts of the world where people lack adequate access to different financial services. The chapter describes how microfinance helps in alleviating poverty, outlines some supporting empirical evidences, and reviews some criticisms in practice.

2.1 Mechanisms of Poverty Alleviation through Microfinance

Microfinance is most effective in poverty reduction through ensuring access to financial services to poor people and small enterprises so they can use such funds for profit-generating activities. Through microloans, MFIs enable clients to take out or expand small enterprises, potentially translating into higher income and better living standards (Banerjee et al., 2015). Such higher levels of income can result from improved consumption, better nutrition, improved health, improved education and better investments in children's education, which in turn can lead to a wider poverty alleviation cycle (Morduch, 2018).

Moreover, microfinance promotes savings behavior among low-income households. There are a great many MFIs who push clients towards savings by giving them low opening balance account, so as to build financial resilience to economic shocks (Rutherford, 2017). Savings have the ability to be used as a life cushion in emergency situations, so families can avoid borrowing money with sky-high interest rates (Schreiner, 2017). This financial stability is crucial for long-term poverty alleviation.

2.3 Empirical Evidence Supporting Microfinance Impact

Several authors set out to determine the impact of microfinance in fighting poverty. Banerjee et al. (2015) conducted a groundbreaking trial where they randomized subjects and found that with access to microcredit, households could significantly increase investments in their businesses and consumption levels. The research further pointed out that in general, these microloans had a positive impact on the income of the respondents, although the extent of the impact varied based on their wealth and business skills before getting the loans.

Also, Karlan and Zinman (2017) observed that microfinance is beneficial to income but also that the magnitude of that benefit can be small. Moreover, the authors attach great importance to complementary services such as financial literacy and business incubation in fully realizing the poverty reduction potential of microfinance.

Again, the role and effect of microfinance on subsections of the population, in particular women, have become highly debated.. A number of evidences points out that women with access to microfinance are more likely to focus on health and education of the family and, as a result, having a positive impact on the latter's future (Pitt et al., 2018). It is clear from research that loans directed at women lead to improved repayment rates and improved community development results, such that female borrowers are central contributors to poverty reduction schemes (Kabeer, 2019).

2.4 Critiques of Microfinance

Though there is ample evidence that supports the fact that microfinance plays the role of reducing poverty, it is still criticized by many. Critics claim that while microfinance may enable poor people to survive on the money that they have for a brief period of time, it does not affect the root cause of their poverty in the long run (Bateman, 2019). The pressure of needing to repay the loan and pay back large sums of money due to loans with interest can cause borrowers to spiral deeper into debt, especially if they do not have sufficient income which covers the repayments and the loans (Duvendack et al., 2018). Even though having access to microcredit might alleviate some poverty, it is feared that having access to credit might lead the already poor deeper into an abyss by causing them to incur debts many times over.

Microfinance, on its part, has come under criticism and scrutiny from some of the researchers regarding its humanitarian applicability and its overall efficacy as a poverty reduction technique. It has been argued by them that microfinance alone would not lead to significant political or socio-economic transformations, citing the minor impacts on poverty levels, economic expansion and other such metrics (Hulme & Mosley, 2017). It is recommended by the critics that microfinance should not be treated on its own but as part of a strategy which has other facets, such as investing in infrastructure locally, skills development, and establishing social safety nets too for durability of poverty alleviation initiatives.

Considered crucial to help women in developing countries out of poverty, microlending enables low-income individuals to save and generate income by providing them with financial services which in turn, helps them to gain self-empowerment economically. Even if there is sufficient evidence to support its usefulness, one must always keep in mind the criticisms and constraints that come with the model. In order for the poverty alleviation strategy to be effective, however, microfinance must be accompanied by sufficient support services and institutional changes.

3.0: WOMEN'S EMPOWERMENT THROUGH MICROFINANCE

Micro lending is powerful enough to be a key driver of a woman’s self-empowerment economically especially in the developing countries’ context (Hart, 1997). It is clear that women’s economic achieved standing and their position in a the social discourse is improved when they have been given the access to financial resources and services (Banerjee et al., 2015). This chapter researches the relation that exists between microlending and women economic empowerment with a specific emphasis on women empowerment when leveraging financial services.

At the household level, studies have shown that when women have access to microcredit there is higher economic activity, household income and women’s decision making (Hashemi et al., 1996). Informal micro lending has proven to be an effective method for women's financial empowerment, particularly in developing countries, as it allows women to access services that generally are out of their reach or are not available to them (Kabeer, 1999). It has also been observed that women entrepreneurs have been able to grow their businesses and positively impact their communities through the aid of financial institutions that provide informal micro loans.

Women in these communities traditionally are kept at the periphery of decision making and have limited control over finances which is why informal loans help when women are financially empowered, leading to gender equality in the economy (Chen, 2001). These women have reported being relieved from overbearing dependence on male family members, ultimately increasing their family role and overall market stability (Katz, 2011).

In Pakistan, for instance, the role of microfinance in improving women's economic standing by giving them easy access to finance has been noted with microlending institutions enabling building of assets and businesses through desegregation, where women are banked more broadly (Armendariz & Morduch, 2005). This is echoed by findings in Bangladesh, where formal support to women operated businesses has resulted in better health and increased earnings due to reduced overall work (Rahman, 2006).

Nonetheless, we need to be aware of the challenges and constraints within which women can benefit from microfinance. From a social perspective, women’s financial participation and opportunities may be limited as a result of gender biases (Katz, 2011). Inadequate attention is being paid to issues of gender equity and social justice most likely as a direct outcome of microfinance’s somewhat myopic focus on income achievement (Mayoux, 1999).

The literature reviewed, does corroborate microfinance as on optimum way for integrating women into the formal-financial system by ameliorating their economic status and enhancing their self-sufficiency. Still though it has been increasingly recognized over the past decades that more women's economic and sociopolitical progress is still needed, much research is still required to find out and contextualize the appropriate mechanisms for overcoming the intricacy microfinance entails within the context of women empowerment and the other wide range of treatment that these women are subjected to in the economic scenario. Tangible outcomes such as poverty reduction, better health, better education and women's greater agency and involvement in various decision making are all possible through microfinance especially in developing countries where women have no economic power.

4.0: GROWTH AND CRITICISM OF MICROFINANCE INITIATIVES

4.1 The Economic Impact of Microfinance

Research indicates that microfinance could be very useful in fostering growth and helping eradicate poverty (Khandker, 2003; Pitt & Khandker, 1998). Pitt & Khandker (1998) observe that it is during the poor consumers' first exposure to micro credit that it is most likely to create a greater impact, especially in rural set ups where access to other means of service is not fully developed. In a similar fashion, Khandker (2003) shows that there were great changes in income increase and decrease in poverty after programs of microcredit in Bangladesh.

Nevertheless, some other studies have voiced caution with respect to the viability of micro finance initiatives. A report by Armendariz & Morduch (2010) notes that high interest and fees on micro loans result in over borrowing and resultant lack of credit worthiness among micro finance clients. Moreover, in India, Banerjee et.al (2015) have found micro finance based models to have increased debt levels especially for low-income households which is not desirable.

4.2 Constructive Critiques and Hurdles of Microfinance

There are some scholars who criticize microfinance and state that it can exacerbate the inequality already present in society and also induce in debt burden in poor people primarily residing in third world countries (Bateman & Chang, 2012). For instance, in Bateman & Chang (2012) argue that microfinance programs lease lan or offer credit on a high interest rate and restrict low income people to be in a debt cycle.81 They further argue that the encouragement of entrepreneurship or self-employment creates an illusion about the economic potential available and if such opportunities do not exist it creates a negative feedback loop, instability and debt.

On the other hand, Morduch (1999) counters this by arguing that microfinance can be helpful in empowering people economically, albeit it must be used along with other social supports. Morduch (1999) cites a good example of this kind of microfinance which helps small scale farmers by enrolling them into initiatives focused towards increasing their productivity and poverty levels.

There is a general consensus that microfinance can help in improving the gross economic growth while also acting as a poverty alleviation tool, however, there is a lot of debate on the effectiveness of microfinance and its accessibility globally, considering the numerous socio-economic issues such as indebtedness or inequality that surround the industry. This chapter gives a broader understanding of microfinance through a few case studies and some critiques and how mi can be made better for society as a whole.

5.0 SUMMARY AND CONCLUSION

5.1 Summary

The critique on microfinance practices as a tool of economic growth has been persistent, however the concepts of the practice are outlined in prior chapters. The chapters detail the need for microfinance in eradicating poverty by granting access to the financial resources required to build businesses. The role of microfinance in relieving poverty is noticed in nurturing entrepreneurial initiatives through access to microloans and microfinance services.

The chapter goes into considerable detail about the empowerment of women through access to these services, and then goes on to highlight some of the structural modifications that AmeriCase has made with its focus on providing microfinance to economically active low-income women. These services have allowed women to take charge of their finances and even start their own businesses. Nonetheless, the text goes on to describe some of the structural changes that AmeriCase has implemented in its approach to offering microfinance to low-income women. The design and alteration of enabling structures together with barriers to access is one of them.

5.2 Conclusion

To sum up, microfinancing has opportunities and challenges in the context of economic development. Even though the concept has been proved to be an important instrument for poverty alleviation and empowering economies, its risks and criticisms necessitate a more careful examination of microfinance practices. Thus, in order for microfinance to prevent unwanted effects, stakeholders should ensure the effective use of the ideology by emphasizing transparency, responsible lending and appropriate framing of integrating support systems to the problem of poverty in a wider perspective. For instance, tackling the problem of social justice and stand both microfinance and Sg against gender discrimination. Evaluation of microfinance initiatives will assist the development processes and their complementary components for social equity and economic growth. The multidimensional debates on microfinance should bear more solutions through creativity and building capacity so that the vulnerable target population can prosper in a more egalitarian economy.

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