



OPEN ACCESS

Volume: 4

Issue: 1

Month: January

Year: 2025

ISSN: 2583-7117

Published: 25.01.2025

Citation:

Chandrakant Jalhare "The Role of Microfinance in Economic Development: A Critical Review of Impact and Effectiveness" International Journal of Innovations In Science Engineering And Management, vol. 4, no. 1, 2025, pp. 130–135.

DOI:

10.69968/ijisem.2025v4i1130-135



This work is licensed under a Creative Commons Attribution-Share Alike 4.0 International License

The Role of Microfinance in Economic Development: A Critical Review of Impact and Effectiveness

Chandrakant Jalhare¹

¹Assistant Professor, Economics, Govt. Naveen College, Vatgan

Abstract

Microfinance refers to providing financial services, including loans, savings, and insurance, to individuals or small businesses with low or moderate incomes. It is an effective tool for empowering small business owners in developing countries to overcome poverty. This review paper explores the sources of microfinance, with a focus on India, where microfinance institutions (MFIs) play a key role in supporting Micro, Small, and Medium Enterprises (MSMEs). The paper examines the significant impact of microfinance on economic development, poverty reduction, and business growth. Through this analysis, the paper highlights the importance of microfinance in fostering inclusive economic growth.

Keywords; Microfinance, MSME, Impact of Microfinance, Microfinance Institutions, Financial roles

INTRODUCTION

Microfinance is the practice of offering financial services (loans, savings, and insurance) to individuals on a small scale, such as enterprises with low or moderate earnings, although more detailed descriptions may be found here and here. One of the most well-known ways to assist small company owners in developing nations in escaping poverty is via microloans. Banking the unbankables, also known as microfinance or microcredit, makes credit, savings, and other crucial financial services accessible to millions of individuals who are too impoverished for traditional banks to serve because they lack enough collateral. Generally speaking, banks are for those who have money, not those who don't. Microcredit is a kind of financial service innovation that falls under the umbrella of microfinance. Other services that fall under this category include microinsurance, money transfer vehicles, and microsavings. One invention for poor nations is microcredit. Microcredit serves impoverished individuals without jobs, business owners, or farmers who are not bankable. (Adnan & Kumar, 2021)

Sources of Microfinance

There are many types of microfinance providers, which may be generally categorised as follows:

- **Formal Microfinance Institutions:** Formal microfinance institutions include telecom companies, commercial banks, rural/microfinance/village banks, and cooperatives that lend money to people in lower income brackets.
- **Semi-Formal Microfinance Institutions:** Non-governmental organisations that provide microloans are known as semi-formal microfinance institutions.
- **Informal Microfinance Sources** – Shopkeepers and moneylenders who often make daily loans at outrageous interest rates

Micro – Finance in India

Early in the 1980s, the financial institutions, rules, and practices in place were not appropriate for the needs of the underprivileged. Poor individuals often turn to the unorganised sector for borrowing. To protect the impoverished from moneylenders, NABARD suggested implementing alternative policies, protocols, and processes. Microfinance was therefore launched in the banking industry. (Alhassan et al., 2021)

The delivery of a wide variety of financial services, including deposits, loans, payment services, money transfers, and insurance, to low-income and impoverished people and their microbusinesses is known as microfinance. Financial services (savings, insurance, funds, credit, etc.) offered to low-income and impoverished customers in order to help them increase their income and, therefore, improve their standard of life is known as microfinance.

In a developing nation such as India, microfinance is considered an instrument for socio-economic improvement. It is anticipated to have a major impact on development and

the reduction of poverty. Mohammed Yunus won the Nobel Prize for establishing Grameen Bank in Bangladesh and putting the microfinance idea into practice. Microfinance and microcredit are not the same. While microfinance encompasses a variety of services such loans, savings, insurance, transfer services, microcredit loans, etc., microcredit is a small sum of money that is provided as a loan by a bank or any other legally recognised organisation.

1. Microfinance Institutions in India

Nearly all of India's modern banks, international corporations, and non-governmental organisations provide microfinance. In India, several modern banks use microfinance techniques as a component of their corporate social responsibility. In India, public limited corporations even provide microfinance. Microfinance for public limited companies is solely a commercial endeavour. It is a known fact that MFIs have more opportunities to market their microfinance initiatives in developing countries like as India. (Revankar, 2023)

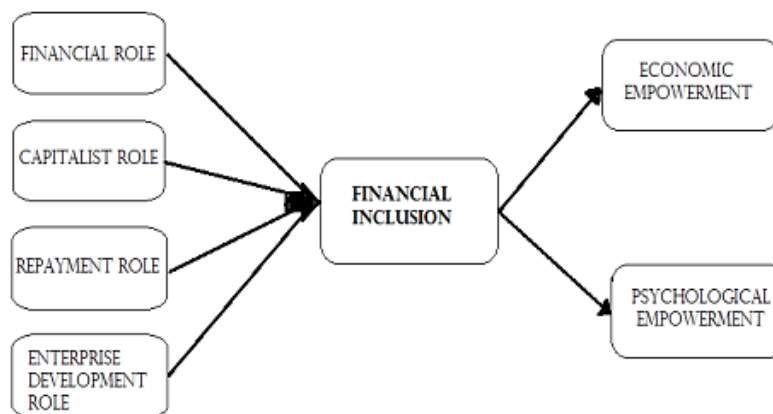


Figure 1 Financial Inclusion (Revankar, 2023)

Financial Role: To help potential micro entrepreneurs launch a firm, microfinance institutions provide funding and training. This assistance for aspiring microbusiness owners is mostly for the pro-poor. Making it possible for the impoverished to launch their own businesses can help them generate more income and lower their poverty levels. Current microbusiness owners may also get services from microfinance organisations.

Role of Repayment: According to An Exploratory Study of Microfinance Practices, 90% of borrowers paid back the loans they obtained from MFIs as doing so was a

requirement for being eligible for further loans. In some cases, the refund was made beforehand. It is enough for monitoring the goals of small business owners and for quality control.

Capitalist Role: Micro Insurance has given small company owners legitimate and affordable projects at the appropriate points in their ventures. Users of microcredit have also developed a tiny saving habit, which has enabled them to access funds continuously. Up until they start doing business with microfinance institutions (MFIs), small business owners' biggest financial obstacle is a lack of

operating cash. The entrepreneurs' access to microcredit significantly increases their capacity to buy raw materials.

Enterprise Development Role: Employees in an organisation might get training and development from microfinance banks. They may add value to their initiatives and goods with the aid of microfinance. The growth of the business via microfinance organisations ensures that the activity that generates revenue is covered by risk. It helps the entrepreneurs feel more competent in their pursuits and provides them a sense of increased confidence.

Financial Inclusion: This refers to ensuring that everyone has fair, transparent, and equal access to financial services and financing at a reasonable cost.

Economic Empowerment: The term "economic empowerment" describes the persistent, coordinated efforts of the community and policymakers to raise the quality of life and economic well-being in a particular region. It is the procedure that gives recipients more actual control over financial choices that affect their lives and social priorities.

Psychological Empowerment: The most enhanced components of psychological empowerment are self-assurance, knowledge of children's education, and health awareness. Focussing on children's education has been made easier with the aid of microfinance. Additionally, microfinance has a significant role in gaining information about public and personal cleanliness as well as health.

Roles of Microfinance in Micro, Small and Medium Enterprises (MSMEs)

Potential microbusiness owners and existing microbusiness owners are the two categories of microentrepreneurs that microfinance institutions assist. Potential microbusiness owners refer to the establishment of such business, while current microbusiness owners refer to its growth. (Revankar, 2023)

There are three kinds of sources for microfinance. formal organisations like cooperatives and banks in rural areas, semi-formal organisations like NGOs, and unofficial sources like merchants and moneylenders. Financial and non-financial services are the two categories of services offered by microfinance. Microcredit, money transfers, microinsurance, and savings are examples of financial services. Training, counselling, education, health, and other services are examples of non-financial services. The goal of microfinance and micro entrepreneurship is the same: to reduce poverty and provide job opportunities for the

underprivileged. Among the things that microfinance does are:

1. Small loans for working capital
2. Collateral securities such as group guarantees or compulsory savings
3. Access to repeat and larger loans based on repayment performance
4. Stream line loan disbursements and monitoring
5. Secure savings

The impact of microfinance

Despite the simplicity of microfinance theory, when applied in reality, concepts can produce unexpected outcomes.(Ibrahim, 2013)

The following are some ways that microfinance supports the country's social and economic growth:

1. Financial Stability

Microfinance plays a significant role in local economies by giving low-income and impoverished families the tools they need to achieve financial stability. The ability to earn enough money to cover essentials like food, housing, and basic medical expenses is made possible by small microloans. Reducing the number of persons on public assistance programs may help these families achieve long-term financial stability, which is good for the local and national economies.(Palanisamy & Parthasarathy, 2020)

2. Job Creation

The number of employment created by a firm that starts and runs thanks to a microloan is not as high as that of larger multinational businesses. Loans to residents of some of the world's poorest regions are the primary focus of many microfinance lenders. Because there aren't many employment in these local areas, the jobs that these tiny enterprises generate are important. It is more probable that residents of these tiny towns will spend their money locally when they are making more money. This promotes economic development in the area.

3. Global Poverty

Giving low-income and impoverished households the chance to achieve long-term financial stability via these modest loans, according to proponents of microfinance, helps halt the cycle of poverty in the present generation and

contributes to the effort to eradicate global poverty for future generations. The world's gross domestic product will rise and the income gap between the richest and poorest individuals will start to close as more of these communities expand and local economies start to thrive.

4. High Interest Rates – Problem In Microfinance

The reliability of the explanations offered for the variations in interest rates between commercial banks and microfinance organisations is under doubt. Microfinance organisations often point to the high transaction costs associated with handling many minor transactions as well as the high transportation expenses associated with serving customers who are dispersed across wide geographic regions. Additionally, profit-oriented microfinance institutions are subject to a tiny premium, which is a topic of discussion in and of itself.

5. Reducing Interest Rates In Microfinance – Lower Cost Of Funds

In the microfinance world, high interest rates have created a stir. While the media criticises the statistics, microfinance institutions defend them. A recent development in the Indian microfinance problem caused everyone to question if these explanations were sound: the country's five biggest microfinance firms all cut their interest rates to 24% at the same time, drawing strong condemnation from the media and government.

LITERATURE REVIEW

(Barguelli & Bettayeb, 2020) Microfinance has been expanding quickly since its inception in the 1970s with the goal of assisting individuals in escaping poverty and fostering economic development. In the midst of the global financial crisis, when traditional banking is losing credibility, its function and significance have increased. Despite microfinance's widespread acceptance and popularity, there is conflicting data about its overall advantages and little research on how it affects financial intermediation as well as economic expansion. This study initially finds and examines potential microfinance transmission routes before determining the best approach for a reliable empirical test. By adapting the Arellano-Bond (1991) approach for panel data, the Granger-Causality type test may solve the endogeneity problem and disclose the direction of causality. The estimation's primary goal is to determine if microfinance is important for the growth of the financial sector and the economy.

(Bali & Campus, 2024) In order to provide a thorough understanding of the impact of microfinance on many aspects of financial growth, this research delves into the complex relationship between microfinance and economic development. In the fight against poverty, microfinance has shown to be a valuable tool, and its role in fostering financial development has generated a lot of attention. The assessment takes into account the challenges and barriers that microfinance projects encounter and suggests anticipated avenues for further research and strategy recommendations. It looks at problems related to sustainability, excessive debt, and the need for client protection and competent lending. When analysing and discussing the present research on the relationship between microfinance and economic growth, the historical context is taken into consideration. In order to provide a deeper understanding of how microfinance interventions might affect economic growth and poverty alleviation, this research aims to explore and analyse the relationship between microfinance and economic development.

(Revankar, 2023) With several initiatives by the Indian government, microfinance revolution in India shows that it is playing a crucial part in the goal of eradicating poverty. Nowadays, microfinance plays a more strategic role than it did in the past. By focussing on microbusinesses and implementing individual loans to the underprivileged, it encourages financial inclusion. It extends beyond the industrious poor to include entrepreneurs who are focused on innovation. Microfinance is a significant source of financing for entrepreneurs, one of the factors of production. Small business owners have plenty of land and labour, but they constantly struggle with money when they want to benefit from economic activity by using production variables. Since microfinance is so practical for young entrepreneurs, small-scale enterprise is now entirely reliant on it.

(Sangeetha, 2023) Examining how microfinance institutions (MFIs) support financial inclusion and stimulate economic growth is the goal of this research. In order to combat poverty and promote sustainable development, financial inclusion—which is defined as having access to and using financial services—has become essential. MFIs are essential to increasing financial access and strengthening marginalised groups because of their emphasis on helping low-income people and underserved populations. To determine the role of microfinance institutions in fostering financial inclusion & economic development, this study

used an exploratory research design. Journals and published publications are the source of secondary data.

(Adnan & Kumar, 2021) Microfinance plays an important part in empowering society and nation as a whole because it helps women become more respected, independent, and involved in their homes, workplaces, and other settings. This article has more detailed definitions of microfinance. As to the World Bank's definition, microfinance institutions provide small-scale financial services such as loans, savings accounts, and insurance to individuals and small enterprises, with a focus on serving those with low or moderate incomes.... One of the most popular methods for helping small company owners in developing nations push themselves out of poverty is to provide them low-interest loans with little monetary value. Small company owners are granted microloans, which are loans with a modest economic value. A variety of financing strategies enable microfinance institutions (MFIs) to provide small and medium-sized businesses (SMEs) loans and savings services.

(Thai-Ha, 2021) Despite having only been around since the 1970s, microfinance has garnered a lot of interest from academics, decision-makers, businesses, and financial institutions all over the globe. Microtrusts, microsavings, microbanks, money transfers, microremittances, microguarantees, and microinsurance are all part of microfinance. By offering essential financial services to the segment of the population that is typically underserved by traditional financial products and at risk of financial exclusion, technology for communication and information is category of financial services which is thought to have the potential to reduce global poverty.

(Zeb et al., 2021) The emphasis of microfinance is on small-scale economic growth. Microfinance is used to lower the economic system's poverty rate. The purpose of this research is to look at the growth, outreach, and difficulties that microfinance institutions—both microfinance banks and microfinance institutions—face. Data is gathered via focus groups, interviews, and MFBs and MFIs operating in Muzaffarabad. The conclusions are predicated on loans, the headcount ratio, offers, offer's worth, and the potential for microfinance in Muzaffarabad to develop. Additionally, during analysis, the difficulties in reaching a wider audience with microfinance were brought to light, and MFBs and MFIs were given advice on how to improve their outreach. The industry's dependence on traditional financing sources is the cause of its financial instability.

(Alhassan et al., 2021) In India, microfinance institutions, or MFIs, are crucial to development. For individuals and microbusinesses without easy access to banking and associated services, microfinance is a vital source of financial services. Financial services are provided to these individuals where Relationship-Based Banking for Small Businesses, Individual Entrepreneurs, and Group-Based Models In general, a large number of proponents of MFI think that this kind of access will enable the impoverished to escape poverty. Others see it as a means for the impoverished to better manage their money and seize business possibilities while minimising dangers. From microcredit to microfinance and now "financial inclusion," the terminologies have changed throughout time. The role of microfinance in India and its models are the subject of this research.

(Barguelli & Bettayeb, 2020) The purpose of this essay is to examine how microfinance affects economic growth. We made use of data from the Microfinance Information Exchange (MIX Market), which was gathered from "Enda Tamweel" microfinance institutions between 1995 and 2017. According to the VAR calculation, microfinance significantly and negatively affects both the GINI index and the ratio of poverty to per capita. Granger's causation test demonstrates that microfinance's social performance makes it a more effective contributor to economic growth. Conversely, financial performance prioritises initiatives that support the microfinance institution's long-term growth.

(Palanisamy & Parthasarathy, 2020) Although you can read more detailed descriptions here and here, microfinance is the provision of financial services (loans, savings, insurance) to individuals and enterprises operating on a small scale, such as those with low or moderate incomes. One of the most well-known ways to assist small company owners in developing nations in escaping poverty is via microloans. Microentrepreneurs employ the loans and savings services offered by Microfinance Institutions (MFIs) via a range of lending strategies. According to the hypothesis, the impoverished can plan and enhance their livelihoods via empowerment, healthcare, and education if they have access to these services, which will make their financial life more safe, stable, and predictable. Self-empowerment may also be achieved via microfinance. The high cost of capital, which comes from a variety of sources, including commercial banks that lend to microfinance institutions at market rates, is one of the factors contributing to interest rates in microfinance.

(Kumar et al., 2018) Over the last several decades, research on the economies of emerging countries has become a vibrant discipline, and this trend is only expected to increase as the significance of economic growth gains speed. Consequently, it will be seen as more and more crucial to comprehend the economies of emerging countries. Microcredit is an excellent technique of giving financial assistance to those who lack the resources to get loans from conventional banks, which might contribute to economic development. However, it serves as a vehicle for taking advantage of poor by charging exorbitant interest rates and fees for a variety of additional services, which further impoverishes them.

(Ibrahim, 2013) This essay looks at how crucial microfinance banks are to a country's economic growth. It highlights that rural transformation and empowerment of rural residents are essential for any country to achieve sustained economic growth. Thus, this highlights the pressing necessity to realign microfinance institutions to best fulfil their contributions to our country's economic growth. Lastly, it highlights the roles played by Central Bank of Nigeria & Nigeria Deposit Insurance Corporation in accomplishing these goals and reiterates that microfinance banks need to be at the centre of Nigeria's development and poverty alleviation initiatives.

CONCLUSION

Microfinance is essential in the provision of financial services to marginalised individuals and small enterprises, particularly in developing countries. Microfinance institutions play a crucial role in assisting Micro, Small, and Medium-Sized Enterprises (MSMEs) in India, which promotes financial stability, job creation, and economic progress. High borrowing rates are still a problem, however. This review paper highlights the sources of microfinance, its impact on poverty reduction, and the role of MFIs in promoting financial inclusion, while also addressing issues like high interest rates and potential solutions to enhance microfinance effectiveness.

References

- Adnan, S. A., & Kumar, P. (2021). Role of Microfinance in Economic Development. *Adhyayan: A Journal of Management Sciences*, 11(02), 22–30. <https://doi.org/10.21567/adhyayan.v11i2.4>
- Alhassan, Y., Kuagbela, F., Nurokina, C. D., & Appiah, B. (2021). The Role of Microfinance in Africa. *International Conference on Science, Technology and Management*, May 2021, 54–81. <https://doi.org/10.4018/978-1-7998-7499-7.ch003>
- Bali, R., & Campus, P.-L. (2024). Understanding the Impact of Microfinance on Economic Development: A Historical Perspective. *OPJU University*, 3, 49–57.
- Barguelli, A., & Bettayeb, L. (2020). The Impact of Microfinance on Economic Development: The Case of Tunisia. *International Journal of Economics and Finance*, 12(4), 43. <https://doi.org/10.5539/ijef.v12n4p43>
- Ibrahim, U. (2013). The role of microfinance banks in the economic development of a nation 1. *Second North-East Economic Summit*, 1–15.
- Kumar, A., Seth, P., Sethi, H., & Venkateshwar, P. A. (2018). the Relationship Between Microfinance and Economic Development in Developing Nations. *IAEME Publication*, 9(4), 1–9.
- Palanisamy, K., & Parthasarathy, K. (2020). ROLE OF MICRO FINANCE IN ECONOMIC DEVELOPMENT - A THEROTICAL PERSPECTIVE. *South Asian Journal of Marketing & Management Research*, October 2015.
- Revankar, P. U. (2023). Role of Micro Finance in Empowerment of Small-Scale Enterprise. *International Conference*, 1–12.
- Sangeetha, M. . (2023). “A study on The Role of Microfinance Institutions in Promoting Financial Inclusion and Economic Development.” *2023 JETIR July 2023, Volume 10, Issue 7, 10(7)*, 163–180. www.jetir.org
- Thai-Ha, L. (2021). Microfinance and Social Development: A Selective Literature Review. *Asian Development Outlook 2021: Financing a Green and Inclusive Recovery*.
- Zeb, N., Jalal, R. N.-U.-D., Fayyaz, U.-E.-R., & Zaheer, M. A. (2021). Micro finance and economic development: The role of microfinance institutions outreach in Pakistan. *Journal of Asian Finance, Economics and Business*, 8(5), 117–126. <https://doi.org/10.13106/jafeb.2021.vol8.no5.0117>