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Original Research Paper

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USE OF MICROFINANCE IN ECONOMY DEVELOPMENT

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ABSTRACT RBI (2011)[1] defines Micro-finance as an economic development tool whose objective is to assist the poor to work their way out of poverty. It covers a range of services which include, in addition to the provision of credit, many other services such as savings, insurance, money transfers, counseling, etc. In addition to providing various financial products and services, micro-finance institutions also take up social intermediation and provide business development and social services. Hence, micro- finance serves dual objectives of poverty alleviation and women empowerment which are stated as Millennium Development Goals by the UN. It has been reinforced by the World Bank (1995, 2000/2001)2 that there is substantial evidence that organizing women around thrift and credit services is one of the most effective methods, not only for alleviating poverty but also for empowering women.

KEYWORDS : Microfinance, economy development, sustainable

INTRODUCTION

Introduction and motivation Around 1.4 billion people globally live on less than one dollar per day facing poverty, social, financial exclusion while recent food crisis has thrown millions into extreme poverty (World Bank 2009a, 2009b). As history of development economics revealed not all of the poverty eradication programs have been efficient in reaching the poorest of the poor. Microfinance has emerged as a promising tool to address this problem, as it requires less investment yet still serves a large portion of the poor that traditional banking finds unprofitable. In a broad definition microfinance is a non-standard provision of a large variety of financial services such as collateral free loans, saving deposits, insurance, remittances, leasing and money transfers to low-income households that are used to support their family business or productive activities (Armenda riz de Aghion & Morduch, 2005). The microfinance services are delivered by specialized microfinance institutions (MFIs) that can be both bank and non-bank type. Historical evolution of MFIs has been different from cooperatives, self-help and informal credit groups such as ROSCAs1 . NGOs appeared as new players in the late 1970s which laid further foundation for specialized microfinance institutions (Vanroose, 2007). The industry is rapidly increasing and around 133 million clients are served by 3300 MFIs worldwide that grew by 26% during 2005- 2007 worldwide (MIX, 2009). The success of microfinance is characterized by high (almost 95%) repayment rates and commitment, low probability of default and most important - social impact. Poor people running a tiny business from microfinance loans also improve their knowledge and skills, health, housing and have alternative employment opportunities. Also, by having access to microfinance, women s participation in society has rapidly increased which is especially important for the least developed countries where family and child-rearing responsibilities inherently fall to women. Since its first establishment in 1970 by Dr. Muhammad Yunus in Bangladesh the microfinance movement spread around the world, attracting the attention of a large community by its successful lending practices, poverty alleviation impact and women empowerment. As a global recognition the United Nations proclaimed 2005 as the Year of Microcredit, Dr. Yunus was awarded the Nobel Peace Prize in 2006 and Presidential Medal of Freedom in August 2009 by US President Barack Obama. The importance and value of microfinance has been reinforced amidst the global financial crisis of late 2008 as trust and reliability in formal banking sector has been seriously shattered. Few anecdotic surveys claim that microfinance has deep shock-resistant roots. As such during the currency crises in East Asia and the banking crises in Latin America in the 1990s the institutions serving low-income households generally performed better financially than commercial banks (Walter & Krauss 2006; Galema et al 2008; Visconti, 2008). However by current economic recession microfinance has been more integrated with domestic and international financial markets, and as a result today s financial crisis is more likely to infect microfinance institutions (Littlefield & Kneiding, 2009). It is expected that many MFIs may suffer and fail, but the important message is that the sector has built sound foundations and shock-resilience. Growing popularity and importance of microfinance has lured academic research. There is a wide range of literature on microfinance, its diverse services, socio-economic impact and overall promised success to combat poverty by reaching low-income households. However, adequate empirical test of theory and impact evaluation remains a challenging task because of the limited good quality, comparable data and the difficulty to design an appropriate methodology. Self-selection of borrowers, non-random placement of MFIs, difficulty to identify treatment and control groups, endogeneity and other measurement issues create inconsistency in results and misleading conclusions about the ultimate benefit of microfinance programs. As a result the evidence is mixed, biased or limited to anecdotal surveys and subject to various critiques (Karnani 2007; Dichter & Harper 2007; Morduch 2001). Most of the empirical microfinance research has been concentrated around the optimal design of the microfinance products, its impact on various development indicators, effect of moral hazard and adverse selection, i.e. overall micro level. In contrast the role of microfinance on meso and macro level, particularly the channel through which the sector contributes to the financial intermediation and growth is relatively underdeveloped. In addition to data constraints the problem of endogeneity and reverse causality between the key variables plague existing research on microfinance and growth nexus. Not controlling of these econometric problems can seriously hider the results and doubt the robustness of implications. Addressing these issues given paper thus contributes to the microfinance literature by laying the foundation of the channels through which microfinance affects the financial sector development-economic growth and the ways of controlling endogeneity. The aim is to test whether microfinance actually matters by identifying the direction of causality between microfinance, financial sector development and economic growth. Recent trends of commercialization of MFI funds and proposals for a hybrid1 structure by combining profit and social objectives imply that microfinance has the potential to become an alternative inflow to the capital markets. Microfinance is considered as a unique and nonstandard way to mobilize the enormous savings of millions of the poor that traditional banking does not serve. Therefore microfinance is perceived to deepen access to finance at the household level and hence contribute to financial development. In this regard it is important to investigate the impact of microfinance on commercial banking and financial sector development together, a question not addressed explicitly before. Of particular interest is to determine not only the direction of causality, but more importantly, the transmission channel which can be tested employing a Vector Autoregressive (VAR) model adapted for panel data and estimated by Arellano-Bond (1991) methodology. The paper is organized further as follows: section 2 summaries and reviews both theoretical and empirical literature on research agenda and microfinance transmission channels. Section 3 presents Arellano-Bond (1991) methodology and other panel data causality tests. Section 4 overviews the panel data from the Microfinance Information eXchange (MIX). Section 5 discusses the implications and the way how to interpret the results. The last section concludes.

CONCLUSION

Increasing growth of microfinance in recent decades in developing countries signals that alternative means of financing could play a significant role by filling the gap of immature formal intermediation. Theory and anecdotic country level studies suggest that microfinance could have significant effect on banking sector and growth and vice versa; while financial sector development and microfinance relationship is build on improved access to finance. In an attempt of addressing the lack of research on microfinance and growth interaction, this paper first, identifies transmission channels and second, defines appropriate empirical methodology to test the direction of causality, which to date remains ambiguous. Acknowledging reverse causality between the system variables vector autoregressive (VAR) model adapted for panel data is an appropriate model to use. The model choice is also justified by the limitations of the microfinance data obtained from MIX as on average 7-8 years data is available for majority of the countries leading to the unbalanced panel problems that Arellano-Bond (1991) technique cope with. As a result of estimation procedures we expect to obtain a robust answer whether microfinance matters, particularly for developing countries where formal financial intermediation is immature leaving significant space for alternative means such as microfinance

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