The Importance of Microfinance Institutions in the Development of Developing Countries

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Abstract
This study intends to provide light on the favourable benefits of microfinance on a variety of social and economic outcomes, such as poverty reduction, job creation, economic independence for women, and long-term societal advancement. By enhancing the availability of financial and non-financial services to MSEs, we can increase their impact on the national economy. Microcredit programmes administered by non-governmental organisations (NGOs) have effectively reduced poverty in developing nations by providing loans with low-interest rates and minimal requirements for collateral. This study’s methodology is based on a discussion and a review of prior research. However, the study’s primary finding demonstrates that microfinance is critically essential. However, it confronts other obstacles that could restrict its contribution to long-term growth and monetary inclusion.

Keywords: Microfinance, Sustainable Development, Third World Countries, Poverty Reduction, Financial Inclusion, Women Empowerment, Entrepreneurship

Introduction
More than half a century has passed since Third-World growth began, coinciding with a period of primary economic aid from the North to Third-World economies. Despite this aid, poverty in the Third World endures. Numerous fundamental causes have contributed to this circumstance. Still, the conventional development paradigm, which encourages the distribution of foreign aid and loans through state and non-governmental organisations, is predominantly criticised in the contemporary literature. As a result, old development theories have been questioned, and new ones suggested. Two of these concepts that have spawned a global movement are microcredit and microfinance. Over 7,000 microlenders currently service approximately twenty-five million microentrepreneurs across the globe. Most of them are disadvantaged rural women (Pearl and Phillips, 2001). Microcredit and microfinance remain relatively controversial concepts despite their widespread popularity. Their contributions and impacts on poverty in the Third World have been called into doubt.
Prior to around three decades ago, microfinance as a concept exploded in order to provide previously excluded financial services. In Bangladesh, the microfinance programme was established in 1976 with the promise of giving loans to the needy without collateral, reducing poverty, and releasing the inventiveness and initiative of the impoverished. In third-world countries, microfinance has also been viewed as a crucial tool for eradicating poverty and promoting development. Due to the uneven land distribution in these nations, most of the rural population lacks adequate productive resources. It has been asserted that microcredit is a remedy for the majority of problems caused by the state’s efforts to alleviate poverty through the use of credit. Initially, local non-governmental groups directed the microfinance sector (NGOs). In recent years, however, numerous countries have frequently sponsored this business in conjunction with foreign governments, international NGOs, and philanthropists. In some less developed countries, microcredit administered by non-governmental organisations (NGOs) has shown to be an effective and financially sustainable strategy for alleviating rural poverty by providing loans and empowering rural women.

The Objective of the Study

This study’s major aim is to investigate the role of microfinance institutions in the growth and sustainability of third-world nations, as well as their involvement in reducing poverty in these nations.

The Problem of the Study

Financial deprivation and the difficulties in gaining access to financial services were among the primary impediments to the development and sustainability of third-world nations. They contribute to the increase in poverty rates, among other factors. Because of this, microfinance institutions were created, and their primary purpose was to provide loans to the poorest individuals. This study will examine the function of microfinance institutions in third-world nations’ sustainable development and poverty alleviation.

Literature Review

Since the early 1980s, microfinance has offered financial access to individuals and small and medium-sized enterprises (SMEs) who were unable to participate in the regular banking system. The industry strives to serve the poorest people through micro-lending, micro-assurance, micro-savings, and money transfers (van Rooyen et al., 2012), (Ledgerwood, J., 1999), while solidifying itself as a long-term, economically viable financial institution. According to the literature, the financial structure, the significant roles of foreign donors (Garca-Pérez et al., 2018), the heterogeneity with respect to size, location, and legal status (Ledgerwood, J,1999), and the specific risk control mechanisms of the MFIs are some of the most distinguishing features of microfinance institutions (Morduch, 1999).

(Dylick and Hockerts, 2002) Sustainable development is a holistic concept that encompasses social and economic achievement without violating planetary boundaries (Steffen et al., 2015). The current socio-economic development is thus linked to future generations’ commitment to welfare. From a holistic viewpoint, the balance between the elements of finance, social, environment, and governance is seen as sustainability (García-Pérez et al., 2018), (Gladwin et al., 1995), (Starik & Kanashiro, 2013), which underlines the short- and long-term relevance of the interrelation and balance between the four dimensions (Lozano & Huisingh, 2011).

Many studies have been carried out in microfinance following the principles of FESG, with literature predominantly analyzing financial and social matters (García-Pérez et al., 2017). Recent research focuses on environmental issues and governance, as well as their connections to the other two components of sustainability. It includes, for example, the study of the social and ecological links between microfinance, Gender equity, and the environment (Archer & Jones-Christensen, 2011) and the analysis of regulatory changes needed to implement successful SD microfinance (Ramaswamy & Krishnamoorthy, 2015) (Chakrabarty & Erin Bass, 2015) as part of its commitment to its financial product structures, and governance- and financial performance(Mersland & Øystein Strøm, 2009) (Hartarska, 2005). However, few scholars had analyzed sustainability and
holistic perspective to this economic system and its institutions (Hassan et al., 2011), (García-Pérez et al., 2018).

In addition, the results of MFI efficiency studies on the effects of microfinance on poverty, financial inclusion, household development, and gender equality are inconsistent. (van Rooyen et al., 2012), (Khandker, 2005). Moreover, inequalities occur when the effects per region are studied. Micro-financing, meantime, seems to be very helpful in areas like South Asia and EAP, whereas in other places like Africa, the problem appears to be exacerbated (Copestake et al., 2002), (Ben, 1996).

Given the numerous influencing elements, it is difficult to provide an explanation for these variances. A number of issues such as market and infrastructural restrictions (Shaw, 2004), (Parajuli, 2017), cyclical income (Kar, 2017), health service variation (Geissler & Leatherman, 2015), power interactions (Siwale, 2015), (D’Espallier et al., 2013) or particular institutional requirements models (Gutiérrez-Nieto et al., 2009), (Mahmud & Tulla, 2015) are identified by the local environment. Several research in microfinance has explored the Hofstede Theory of Cultural Dimensions (1980) directly or indirectly. The impact of transnational values on the conduct of society is defined in this theoretical framework.

For Hofstede (Khandker, 2005), culture is a group program that shapes thought processes and distinguishes groups of individuals. Individuals are subject to a strong social impact, allowing for the comparison of large groups. Individualism against collectivism, masculinity versus femininity, ambiguity avoidance, power distance, and long-term versus short-term orientation are the cultural components that describe and compare national culture. The authors then approach microfinance academic literature based on the Hofstede model, which connects to the principles of FESG.

**Methodology of the Study**

Since the study depended on secondary data, the review approach was used to acquire second-hand data. The studies on microfinance, sustainability, and socioeconomic development were reviewed, and microfinance, business, and socioeconomic development-related conclusions were formed. This study assessed the influence of microfinance on the sustainable development of third-world countries. The consequences of microfinance on socioeconomic development will then be explored.

**Poverty in Third World Countries**

Currently, more than a tenth of the world’s population lives in abject poverty, while billions enjoy comfortable lifestyles. Instead of a lack of global resources, political and economic inequality is the root cause of poverty. However, the poorest individuals are most susceptible to environmental degradation, climate change, and resource competition. The poorest feel the effects of an unsustainable economy first and hardest. The term Third World Countries is used to designate developing and underdeveloped nations. Low economic development, agriculture, illness, high birth and infant mortality rates, overpopulation, inadequate infrastructure, unstable governments, poor health care, environmental difficulties, ignorant populations, starvation, and death are characteristics of third-world nations. These are the first things that spring to mind while thinking about third-world nations. Africa, Latin America, and Asia constitute the majority of third-world countries. Populations in the third world are often destitute with high birth rates. In addition, the exclusion of third-world countries from financial institutions is one of their most significant challenges. This is because the citizens of these nations lack access to the financial system to utilise the financial services offered by these organisations. Due to a lack of capital, the citizens in third-world countries may be unable to create their own businesses, which may result in a rise in unemployment. Consequently, this will result in a rise in the number of poor people.

**Vicious Poverty Round**

Around ninety per cent of persons in developing nations do not have access to financial institutions for loans or savings. That contributes to the “Vicious Poverty Round” (refer to Fig. 1). If countries with less development have limited investment capacity, productivity declines, revenues fall, domestic savings remain low, and all productivity gains are thwarted.
In addition to limiting entrepreneurs’ ability to engage in new business ventures, lack of access to capital impedes economic development. Frequently, neither the causes nor the effects of entrepreneurial activity are financially or environmentally sustainable. Microfinance empowers the impoverished and is a vital tool in economic development. Nonetheless, the roles of microfinance, entrepreneurship, and sustainability in decreasing poverty in LDCs across the world are inescapably circumscribed by a number of restrictions and hurdles.

A poor person can earn enough money to escape poverty over time.

**Concept of Microfinance and Mechanism of Operation**

Microfinance is a financial institution that offers financial services to low-income individuals and small businesses who do not have access to standard bank services and related services. Microfinance contains microcredits and microsavings. In addition to other benefits, microinsurance and payment mechanisms are provided. (Carmella 2018) (Kagan, Julia 2018). Microfinance services are designed to reach and assist excluded clients, who are typically the poorest, most socially or geographically isolated members of society. (Colorado, 2018) (Robert et al., 2004).

Initially, the concept of microfinance was limited, giving few loans to underprivileged entrepreneurs and small businesses who lacked access to credit. The two primary methods employed to deliver financial services to these customers were: Relationship Banking for individual corporations and small businesses, and group-based arrangements in which numerous contractors apply for loans and other services as a group. Microfinance has become the leading movement whose goal is “a world where everyone has access to a wide range of affordable, high-quality financial products and services, including credit, savings and insurance, payment, and money transfers, both for poor and socially marginalised individuals and families.” (Robert et al., 2004).

Microfinance advocates often say that these accesses will assist the poor in escaping poverty, including those participating in the Microcredit Summit. Many believe that microfinance promotes economic development, job creation, and growth by aiding small and microbusinesses. In contrast, it enables the poor to better manage their resources and take advantage of economic possibilities while mitigating risk. Critics often allude to a specific microcredit sickness that may result in debt. Due to the diverse conditions under which microfinance operates and the vast array of microfinance services, it is neither possible nor prudent to obtain a comprehensive understanding of microfinance’s effects. Numerous studies have attempted to analyse its effects. (Wigenberg et al., 2010).
Role of Microfinance Institutions in Poverty Reduction and Sustainability Development

Programs designed to alleviate poverty provide supplies, resources, information, and project services to unemployed or underemployed individuals. Due to the credit risks and relatively high cost of small loans, the traditional banking sector is typically unable to embrace a microcredit system. The debtors are not guaranteed to repay, and the necessary funds are frequently denied due to the substantial risk of default. When they visit underground sources, they often have a high level of interest. This quick remedy does not address the fundamental structural issue, which is the lack of adequate financial channels.

Several international agencies and nations have attempted to alleviate poverty with limited success. Due to the improper distribution of resources, only a minuscule fraction of the budgeted funds reaches the poor. This is one of the leading causes of poverty. In contrast, the microfinance programme founded by Dr. Yunus for Grameen Bank is a huge success among all the failures. The basic purpose of microfinance programmes is to provide modest loans in non-traditional economic sectors to make up for the deficiencies of conventional financial institutions. The programme features adaptable reimbursement procedures and reasonable interest rates. As numerous accomplishments, particularly among women in rural and remote areas, have demonstrated, there is a limited amount of money.

Two conditions must be met by a successful poverty alleviation program: effective distribution of resources and self-sufficiency. Experience has shown that preferential loans sponsored are not a response. When the funds are restricted, the available money flows predominantly to companies with relatively strong bank contacts, while micro-sized enterprises and the needy are left unfunded. Therefore, poverty is not mitigated. Even if some funds reach alarming high-interest rates and poor savings practices, the recovery rate is modest. This strengthens the choice to limit loans to those in need. The usual low level of efficiencies in government-owned banks, frequently too passive or lacking managerial skills has made the system less efficient. The preferential loan schemes have been gradually eroded.

The collaborating organizations have created a particular method to restrict every microloan amount to ensure that the monies reach the hands of the impoverished. To resolve this problem, compulsory deposits, group loans, or the use of machinery to provide that financial institutions can cut transaction costs. Together with a flexible payment scheme, the implementation of such measures resulted in a low default rate.

At the community level, microcredit institutions work admirably. Loan officers must have a good working relationship with borrowers and comprehend both the anticipated use of the money and the borrowers’ sources of income. A group attitude must be created for “collateral” to take the form of social responsibility. This emphasis on the group increases the repayment guarantee and the program’s long-term viability. Operators of the program can help build the community by engaging in village organizations, establishing a basic accounting system, and forming a collaborative decision-making mechanism. Some loan-granting institutions also offer technical training and educational aid, which helps borrowers improve their ability to repay their loans. Paying attention to borrowers’ long-term aspirations, reverting the lending mechanism to a fundamental market function, and guaranteeing efficient institutional management and operation all contribute to microcredit program success.

Microfinance programmes have been implemented globally to reduce poverty by assisting the poor in accumulating their savings and investing them in job-creating businesses. The questions of who is considered poor, how poverty is measured, and its definition are all strongly discussed. It is argued whether poverty is largely about material wants or a much broader range of needs that contribute to well-being in the poverty debate. According to (Sida, 2005), the reasons of poverty are many and complicated. Not only are the poor deprived of primary resources, but they also lack access to information essential to their lives and livelihoods, such as information about market prices for the goods they produce, health information, about the structure and services of public institutions, and information about their legal rights. They lack access to and comprehension of income-generating options, among other factors.
Most of the poor in emerging countries, particularly women, lack access to life-sustaining financial services. The poor have restricted access to official financial services, leaving them with inferior informal options. Therefore, microfinance is viewed as a critical tool for breaking the vicious cycle of poverty, which is characterised by low income, low savings, and low investment. According to (Hulme et al., 1996), the majority of institutions view low-income households as “too poor to save.” Capital is only one of the balance components required for a successful company to generate greater profits, savings, and investments. To alleviate poverty, entrepreneurial skills and effective markets are needed. According to (Ismawan, 2000), the fundamental objective of microfinance is to aid the most vulnerable members of civil society who are impoverished in this circumstance. Rural microentrepreneurs might need access to transportation, communications, electricity, water, storage facilities, and a legal framework for contract enforcement and dispute settlement.

Microfinance Institutions in Enhancement Women Empowerment

Microfinance has a substantial influence on the economic and social circumstances of women in general. Although the benefits are not immediately apparent, they become increasingly evident as time passes. It successfully provides work to women who previously had no way of supporting themselves. However, access will not result in empowerment; the loan must be used positively to produce actual empowerment. It must be decided whether the loan is used and managed by the woman or by a male family member in the fullest sense. Microfinance gives them economic power, laying the groundwork for social empowerment. Microfinance encourages women to gain entrepreneurial skills and operate their own microbusineses, according to the study. Microfinance enhances the self-esteem and social capital of women. Microfinance also facilitates the personal growth of women. They typically have better self-esteem and confidence. They become more aware and obtain more knowledge. Women can also use microfinance to save for emergencies and the future. Women generally spend a considerable percentage of their loan money on their children’s education. If borrowers can improve their quality of life through the revenue created by a microfinance loan, microfinance can help eradicate poverty. When women use loans to invest in their enterprises, they achieve economic autonomy and self-sufficiency. In addition, they contribute to the family’s costs, which may at times make it difficult to repay the debt. The loan must be utilised in a manner that turns it into a source of income rather than a burden. According to our research, the impact of microfinance on women’s empowerment is a lengthy process that requires time to enhance quality of life. To guarantee that a loan is used efficiently, it is advised that it be granted only after a comprehensive analysis of how the money will be invested and create revenue. Microfinance will progressively improve the standard of living for women, their families, and their children.

Microfinance Institutions and Entrepreneurship

Microfinance institutions are precise instruments for the growth of entrepreneurship due to the diversity of services they provide and their involvement in economic development. The significance of microfinance in entrepreneurial activity is often seen as an essential driver of economic growth. By combining existing resources with fresh concepts, entrepreneurs increase value by selling new products, creating new employment, and starting new enterprises. According to the Global Entrepreneurship Monitor (GEM), countries with higher entrepreneurial activity have more robust economic growth. Entrepreneurs connect new ideas to economic prosperity.

Conclusion

The economic benefits of sustainable microfinance institutions in underdeveloped countries are evident, as are the potential repercussions on development. In terms of development and social effect, the microfinance business enhances the quality of life for microentrepreneurs in the world’s less developed nations. They may now ensure the enterprise’s cash flow by stabilising the cash flow of their economic activity. This helps individuals to better control their spending, resulting in savings and a higher housing, nutrition, health, and education standard for their family and dependents. Finally, having
access to banks and improved security develops a sense of enterprise, which increases self-esteem and reputation. The initial small loan, usually less than $100, can gradually reintegrate these businesses into formal economic networks and foster structural and long-term growth in local communities. Furthermore, forecasts show that just 5% of microcredit demand is now being met, so the microfinance industry is expected to overgrow in the coming years. Despite the challenges ahead, this blossoming enterprise and the process of sustainable microentrepreneurship combine to provide a feasible relief solution to the 21st-century poverty crisis and a path to a sustainable future.

References


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