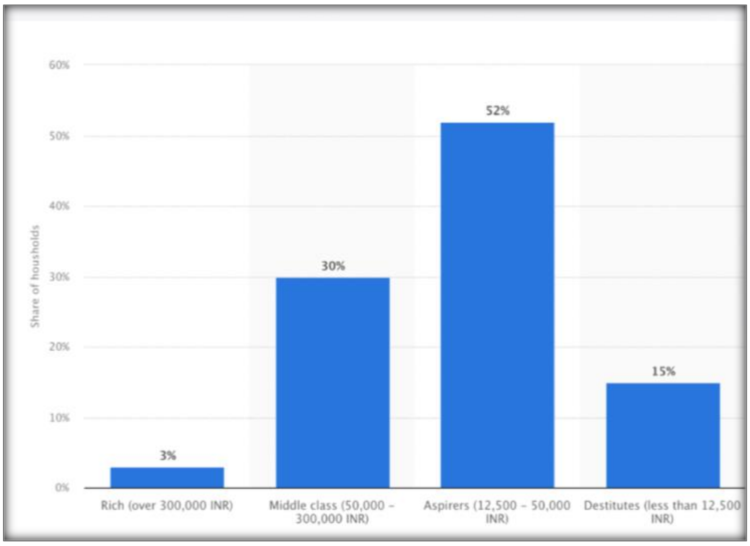
LENDING IN MICROFINANCE IN INDIA: RESEARCH PAPER BY YUVRAJ NAHAR

ABSTRACT:
In this paper, I have delved into the intricate world of microfinance, an essential tool that continues to prove indispensable in alleviating poverty and fostering entrepreneurial spirit in economically marginalized communities. I aim to examine its impacts and the complexities embedded within its implementation in India.
Microfinance, since its conception, has emerged as a significant financial instrument that enables the underserved and underprivileged to have access to credit, insurance, and other financial services.
My endeavour is to offer a holistic view of microfinance lending in India, providing an analysis of its strengths and benefits to the economy in the short and long run.

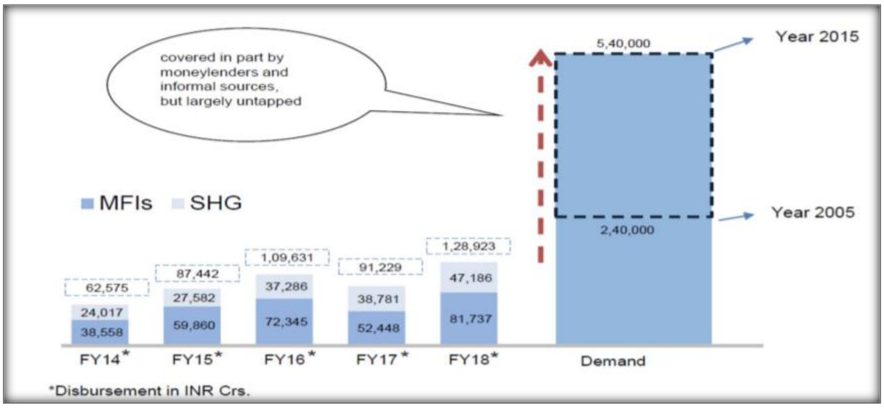
INTRODUCTION TO MICROFINANCE IN INDIA

Microfinance is the provision of financial services to households with modest incomes. In India, microfinancing is primarily comprised of financial institutions (banks and NBFCs) providing loans to households earning a maximum of 3 lakh rupees annually. Two loan models are utilised: Self Help Groups (SHGs) and Joint Liability Groups (JLGs). The latter is more prevalent (as there is a greater likelihood of loan repayment due to peer pressure), and will therefore be addressed. Essentially, Microfinance Institutions (MFIs) lend money (up to 2 lakh rupees) to low-income women who are part of the Joint Liability Group (each group containing between 4 and 10 members), primarily in rural and semi-urban areas of the country. The loans are unsecured, but an intriguing social security system comes into action. Under this system, if an individual does not repay a loan, the group is liable for its repayment. This technique exerts social pressure on the borrowers to make regular EMI payments.

The emergence of MFIs in India has considerably contributed to the improvement of the country's financial inclusion, as women in rural areas now have adequate access to finance, leading to women's empowerment, among other advantages. Despite the slowdown caused by the COVID-19 pandemic, the industry is flourishing more than ever before. Favourable government policy (removal of the maximum limit on interest rates and increase of the maximum cap on incomes eligible for microfinancing) is among the primary cause of this boom. In addition, the large scale of the market encourages companies to enter the industry. In fact, nearly 97% of Indian households are eligible for microloans, resulting in a vast market opportunity (see Graph 1.1). Graph 1.2 also demonstrates that India's microfinance market is largely untapped, presenting a substantial opportunity for new entrants. Furthermore, firms have also seen higher profits as a result of lower credit costs due to higher collection efficiency, and strong provisioning covers (Jaipuria, 2023). The combination of these factors renders this opportunity lucrative for both businesses and investors.



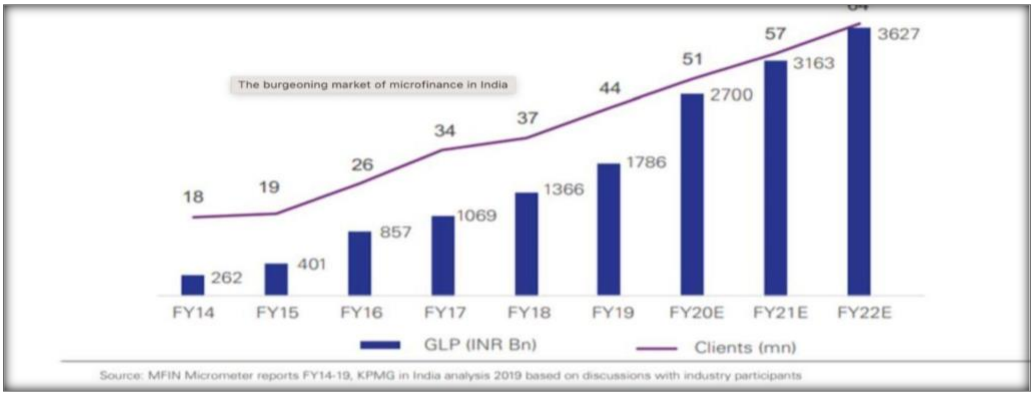
Graph 1.1
Share of Households by Gross annual income across India in the Financial year 2021
Source: Statista



Graph 1.2
Demand for Microcredit in India
Source: Bharat Finance 2019

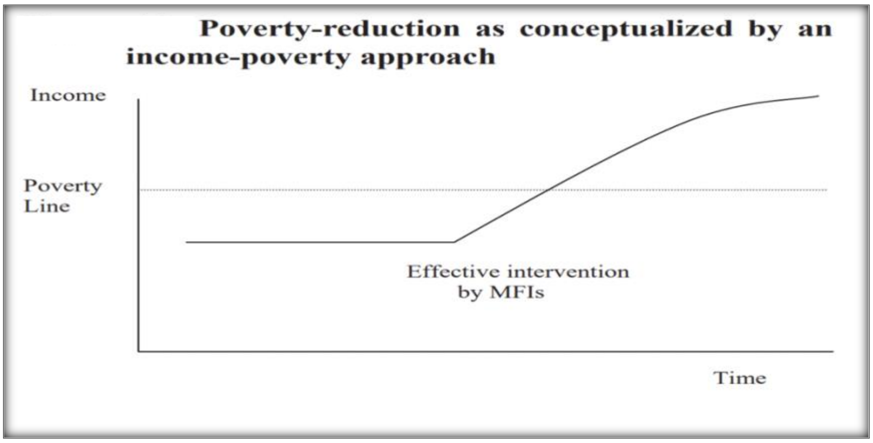
Microfinance serves an important role in reducing poverty and fostering economic growth in India:

Access to Capital and Financial Inclusion: Microfinance institutions (MFIs) offer small loans, savings accounts, and other financial services to low-income individuals and micro-entrepreneurs who lack access to conventional banking services. Access to capital increases considerably each year in India due to microfinance (as demonstrated by Graph 1.3), enabling beneficiaries to launch or expand small businesses and invest in income-generating activities. By providing financial resources, microfinance stimulates economic activity in rural areas and encourages entrepreneurial endeavours, resulting in local economic growth. According to Ranjula Bali Swain, the author of Microfinance: a Catalyst for Development at the Macroeconomic Level?, such financial inclusion is directly correlated with the growth of an economy.



Graph 1.3
Rise in capital access
Source: Mentioned in Graph

Microfinance focuses on individuals living in poverty, who frequently encounter greater obstacles to accessing financial services. By providing them with microloans and savings opportunities, microfinance enables these individuals to enhance their standard of living, generate income, and escape poverty. This creates a virtuous cycle in the economy, as the family can invest, for example, in their child's education in the future. Graph 1.4 demonstrates a probable relationship between income and poverty over time as a result of effective microfinance intervention.



Graph 1.4
Decreasing poverty due to a rise income over time
Source: Microfinance Theory and Practise Book (Author: H.M.W.A Herath)

Microfinance facilitates the development of microenterprises, which are frequently labour-intensive and contribute to job creation at the local level (Table 1.1 demonstrates that over 98 per cent of microfinance loans in India are used for labour-intensive activities that increase employment). As individuals gain access to financial services and invest in their businesses, they are able to increase employment opportunities and decrease unemployment rates in small communities and villages. Lower unemployment rates contribute to improving living standards because crime rates decline.

Purpose	% Mix
Livestock	48%
Grocery stores and other Retail outlets	11%
Tailoring, Cloth Weaving	8%
Agriculture	8%
Trading of Vegetable & fruits	7%
Vehicle Repairs	6%
Trading of Agri. commodities	3%
Garments & Footwear Retailing	3%
Masonry, painting, plumbing, electrician, carpenter and related	2%
Eateries	1%
Bangles shop	0.1%
Trading of utensils, plastic items	0.1%
Other Income Generating activities	2%

Table 1.1
Purpose of Microfinance Loans in India
Source: Fusion Microfinance RHP 2022 and Bharat financial 2019 Presentation are the cited sources.

Social and Gender Empowerment: Microfinance has been especially effective in empowering women, who frequently encounter greater obstacles to accessing financial services and are disproportionately affected by poverty. By providing women with financial resources, microfinance improves their economic status, increases their domestic decision-making power, and promotes gender equality. This also contributes to the eradication of the age-old system of discrimination against working women. Notably, 99% of MFI clients in India are women (Bhargava 2023).

THE IMPACT OF MICROFINANCE ON MACROECONOMIC GROWTH

Microfinance has numerous short run and long run effects on the macroeconomy, as providing loans for business purposes directly increases business output.

SHORT RUN

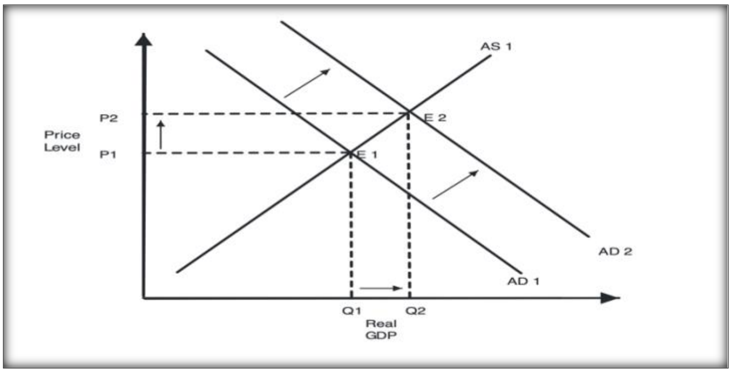
Due to the increased money supply for business use, microfinance lending causes an increase in aggregate demand (AD) in the economy in the short run. Increased access to capital encourages entrepreneurs to establish small businesses or invest in their enterprises, which are typically MSMEs (Micro, Small & Medium Enterprises). In turn, this enables entrepreneurs to generate a greater income, which increases their purchasing power. The increasing purchase power often translates to higher consumption, which is the cause for the increase in the aggregate demand (rightward shift of AD). Similarly, entrepreneurs sometimes invest in capital goods (such as sewing machines, computers, etc.). Since investment is a component of AD, the investment in capital also directly increases aggregate demand.

As a consequence of a shift to the right in the aggregate demand curve, the output of the economy increases further, and employment in the economy rises to support the rising output. Individuals in the economy, particularly in rural areas, can enjoy enhanced living standards and quality of life in the short run due to microfinance (as more goods and services become available).

The Reserve Bank of India (RBI) has further facilitated and improved the microfinance lending process by allowing families with an annual income of 3 lakh rupees to also apply for microfinance loans. In addition, they have increased the loan ticket size (to a maximum of 2 lakh rupees per year). Overall, this has resulted in a greater increase in the money supply than before, as it encourages more companies to lend and enables borrowers to borrow more.

As is associated with an increase in the short-run output of the economy, price levels rise; however, they tend to be concentrated in rural areas and are frequently controlled in the long run.

Graph 2.1 shows the increase in AD, and hence output and price level.



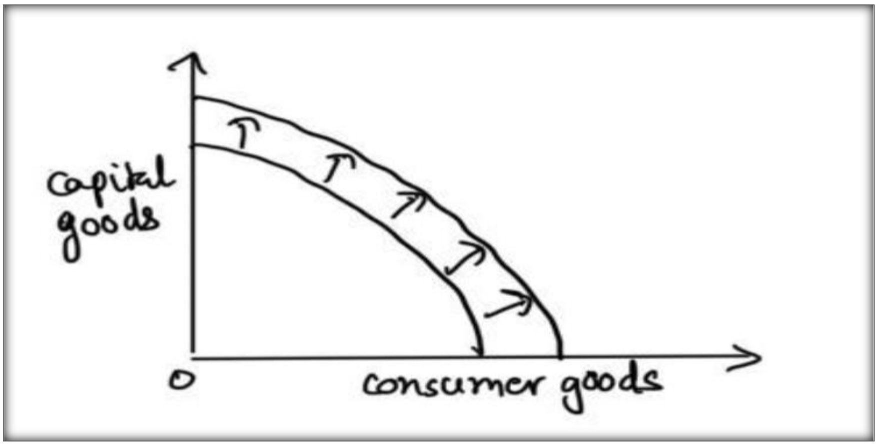
Graph 2.1
AD/AS in the Short Run - Indicates the Rightward Movement of AD

LONG RUN

Additionally, the output of the economy increases in the long run too. However, there are two reasons for the increase in output.

First, microfinance lending increases the number of entrepreneurs in the long run, thereby expanding the economy's resource base. Moreover, investment in capital products leads to an increase in the economy's capital stock and also the resource base. Increase in the resource base results in a rise in the economy's productive capacity, as it is now able to produce more goods and services than before. As indicated by a Production Possibility Curve (PPC), the production boundary shifts outward.

The rightward movement of the PPC is depicted in Graph 2.2 below.



Graph 2.2
PPC – Rightward Shift of the PPC

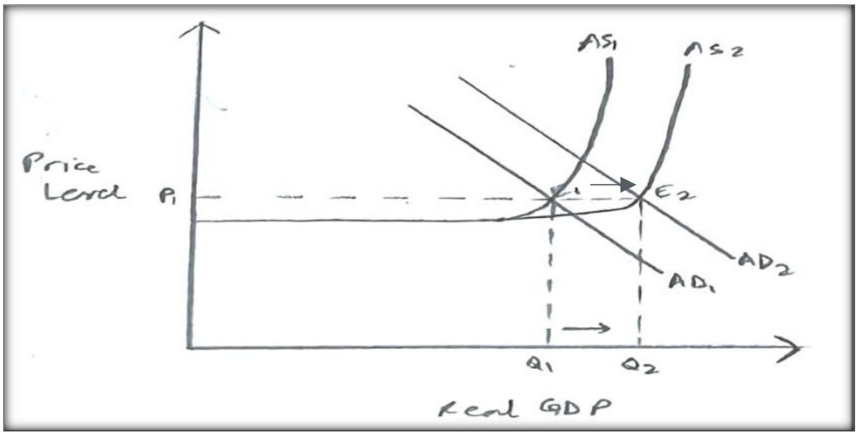
Both, the increase in the quantity of capital goods and the number of entrepreneurs result in an increase in the Aggregate Supply (AS) as the cost of production decreases due to the greater availability of resources. This indicates a movement to the right of the AS.

In addition, there is an increase in long run Aggregate Demand as a result of the higher money supply (more money circulating in the economy as individuals earn more income). Moreover, if industries become self-sufficient and produce better quality and affordable products as a result of microfinance, this may also result in an increase in exports from the country. This results in a rise in the economy's net exports and a further increase in AD.

This is demonstrated once more by the movement of the AD curve to the right.

Hence, both output and employment increase in the long run. But, in the long run, the effect on the price level, if any, is not as significant. This is predominantly due to the fact that the rise in AD is offset by the rise in AS. Consequently, the economy can enjoy more goods and services at a similar price level as before, which contributes to the enhancement of living conditions in the economy.

Graph 2.3 demonstrates that a greater output results from a greater AD and AS.

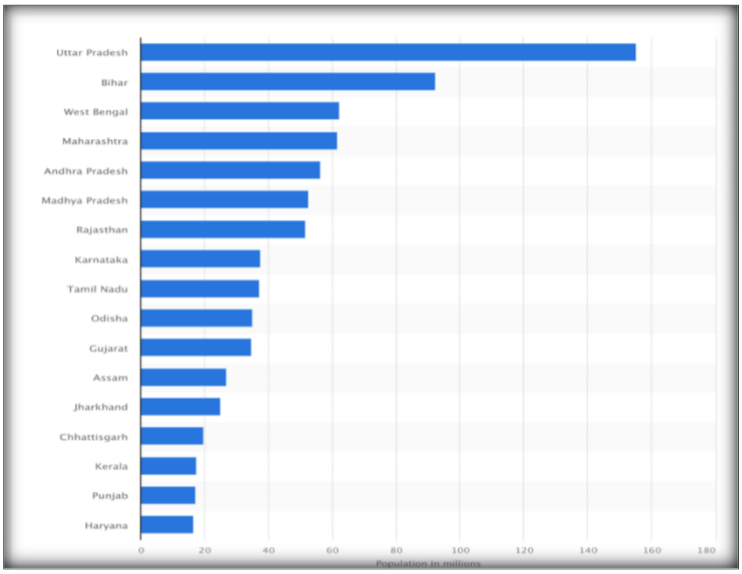


Graph 2.3
AD/AS in the Long Run – Indicates Rightward Movement of AD and AS

Overall, it can be assessed that microfinance is a sector that will play a significant role in India's pursuit of a $5 trillion economy.

ECONOMIC CAUSES OF INITIATING MICROFINANCE

The primary reason for initiating microfinance in India is that it bridges the funding gap between individuals with high and low incomes. Even though traditional banking systems are crucial in urban areas, rural areas with a significant population of low-income individuals rely heavily on microfinance (Graph 2.4 depicts the population of rural regions in 17 Indian states as of 2011).



Graph 2.4
States in India with greatest number of people Residing in rural areas (2011)
Source: Statista

The principal justifications are as follows:

Lack of Collateral: In rural areas, residents frequently lack the collateral necessary to secure a loan. This discourages the bank from lending to the individual because there is no assurance that the loan and interest will be repaid, and hence, this motivates low-income groups to obtain loans from MFIs.

Small Loan Amounts: Typically, MFIs provide loans that are significantly smaller in size compared to commercial institutions. Commercial banks grant much larger loans (as it is more economically viable), which enable them to generate greater returns. In contrast, MFIs offer smaller loans that can be repaid by individuals with modest incomes.

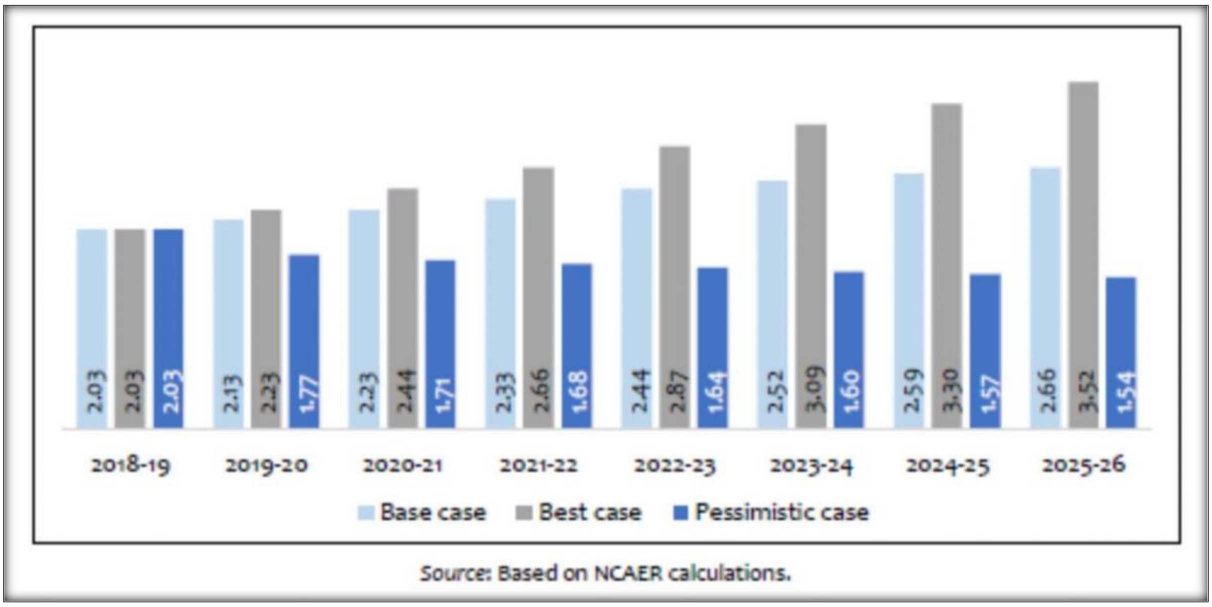
Locational Restrictions: MFIs establish branches in rural areas, such as villages, near to their customers. Frequently, MFIs directly visit the homes of locals to provide financial services. However, banks tend to concentrate their activities in urban financial hubs in order to attract wealthier clients and maximise profits. MFIs are an obvious option for low-income individuals due to their proximity to low-income groups and their service facilities.

High Transaction Costs: In order to serve residents of rural areas, MFIs incur a variety of administrative expenses, such as transportation costs and costs associated with routinely evaluating creditworthiness. Traditional banks located in city centres (rather than on the ground-level) are unable to effectively serve low-income groups due to the substantially higher costs involved.

Because the majority of Indians are low-income individuals, traditional banks have opened separate subsidiaries that operate as MFIs or have partnered with existing MFIs in order to access a broader market (which includes low-income individuals).

CONCLUSION

Microfinance can have several positive impacts on an economy. It promotes financial inclusion, boosts entrepreneurship, facilitates income generation, alleviates poverty, empowers women, and stimulates local economic development. By addressing the financial needs of low-income individuals and micro-entrepreneurs, microfinance plays a crucial role in creating an inclusive and sustainable economy. It also enables lower-income groups, who are denied access to traditional finance, to improve their living standards and earning potential. Consequently, this ensures that economic growth and development occurs throughout the economy - leading to a more equitable distribution of income. The contribution of microfinance in the near future is also likely to be very impactful on the GDP of India. For instance, graph 3.1 depicts increasing contribution of the microfinance sector to the overall Gross Value Added (GVA) from 2018-2026 (in the base and best case). In conclusion, this shows the pivotal role microfinance will play in the economic growth of India, and this emphasises the importance of this subject and its nature to be carried forward in a sustainable manner.



Graph 3.1
Contribution of the Microfinance Sector as a whole to the Overall GVA under Alternative scenarios
Source: Mentioned in Graph

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