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# **The Impact of Microfinance on Household Livelihoods: Evidence from Rural Eritrea**

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thirteen transition economies, Garalova and Gaffeo (2014:89), found that there exists a positive long-run relationship between financial deepening and real growth and the potential becomes full when the funds are allocated to the private sector.

Earlier studies for example by Robinson (1952) cited in Levine (1997:688) found that finance does not cause growth, but rather, it responds to demands from the real sector economic activities. More recent studies by Greenwood, Sanchez, and Wang (2013: 2010-2011) using cross-country data found that, financial intermediation contributes to economic growth via facilitating technological progress. Similar conclusion was also reached by (Goldsmith, 1969; McKinnon 1973; and Shaw 1973).

Patrick (1966:175-176) labeled the link between financial development and economic growth as the supply-leading and demand-following hypotheses. The supply-leading hypothesis proposes that the direction of causality goes from financial development to economic growth, whereas on the demand side, the creation of financial institutions is a dynamic response to the demand driven by investors and savers in the real sector of the economy. With further growth in the economic and financial sectors, the supply-leading characteristics of the financial sector diminish gradually and are eventually replaced by demand-following characteristics. When explaining the process of financial system development, Patrick says:

The evolutionary development of the financial system is a continuing consequence of the pervasive, sweeping process of economic development. The emerging financial system is shaped both by changes in objective opportunities i.e. the economic environment, the institutional framework and by changes in subjective responses--individual motivations, attitudes, tastes, preferences.

However, at initial stages of economic development, the supply-leading mechanism takes over demand-following as a means of triggering economic activities. This is a typically experience of developing countries, where the promotion of credit and other financial services is considered vital for fostering investment, whereas in a more developed economic environment, the financial sector mainly serves a complementary role for a more efficient performance of the real sector of the economy (Agbetsiafa, 2004:271). As far as studies on

the developing countries are concerned, Ang (2008:570) concluded that even though there is a positive impact of financial development on economic growth, structural and institutional differences among these countries may have differential impact on the relationship between finance and economic growth.

Berthemely and Varoudakis (1996) elaborate the linkage between finance and economic growth indicating that real sector growth fuels financial sector development which in turn the development of the financial sector through its mobilisation of savings and other specialised functions sustains capital accumulation and thus economic growth. This means that less developed financial institutions inhibit exchange and intermediation which then reduces the efficiency of investment. On the other hand, a matured economy with increasing growth rate could accommodate and support the growth and expansion of the financial sector. On the other hand, on the relationship between the size of the financial sector and productivity growth, Kharroubi and Cecchetti (2012) conclude that the size of the financial sector has an inverted U-shaped effect of productivity growth in that further enlargement of the financial sector beyond certain threshold reduces growth in the real sector.

Most economist agree that the vital role of the financial sector is that it enhances efficiency in the economy by reducing information, enforcement, and transaction costs and thus improving the productivity of investment. Financial institutions and markets offer a number of specialized functions to enhance efficiency in the conduct of economic activity. These specialized functions of the financial system include mobilising and pooling of savings, allocating capital, providing information, monitoring and exerting corporate governance as well as facilitating exchange, diversification and management of risks (King and Levine, 1993, Levine 1997, Levine, 2004, Stiglitz, 1998; Todaro and Smith, 2012).

The endogenous growth theory focuses on the importance of knowledge generation and innovation through research and development. In this regard, Thiel (2001) claims that the financial sector plays a supportive role by determining the cost of capital, and the incentive structures that affect innovative entrepreneurs.

The relationship between financial development and long-run growth was elaborated in the literature on endogenous growth (Laeven, Levine, and Michalopoulos, 2015). The endogenous growth theories postulate that long-run economic growth is determined by technological progress. Forces that govern the opportunities and incentives to create technological knowledge influence the rate of technological progress and thus the growth rate of total factor productivity (TFP) in an economy. Similarly Greenwood, Sanchez and Wang (2012) argue that a well-developed financial intermediation leads to higher TFP by allowing the allocation of funds to more efficient firms. While the neoclassical growth theorists assumed that technological progress is exogenously determined independent of internal economic forces, the endogenous growth theorists challenged this view by proposing channels on how internal economic forces affect the rate of technological progress. According to this theory, technological progress which determines long-run economic growth rates takes place in the form of innovations in new production methods, processes, and markets which in themselves are results of economic activities. These innovations are governed by policies and institutions that offer opportunities and incentives to create, disseminate and apply technical knowledge (Thiel, 2001).

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The financial sector is one of those institutions that promote innovations in an economy. King and Levin (1993) following the Schumpeterian endogenous growth model argued that there are entrepreneurs who strive to earn a monopoly profit by inventing new production methods and processes to produce new and better goods. Comin and Nanda (2014) find that greater financial deepening contributes to a faster invention and diffusion of technology particularly for capital-intensive technologies by enabling innovative ideas to be experimented and commercialised. The financing of research and development (R&D) is also another channel by which the financial sector contributes to economic growth. Brown, Fazzari and Petersen (2009) present empirical evidence on the role of finance in R&D which is a major force in innovation in most endogenous growth models (See also Hall and Lerner, 2009).

Financial institutions by making resources available allow entrepreneurs to initiate innovative activities which enhance productivity improvement and thus stimulate economic growth.

King and Levine (1993) and Galetovic (1996) for example argue that the extent of financial sector development determines the frequency with which society allocates funds to those aspiring entrepreneurs with the highest probability of success in innovation. Hsu, Tian, and Xu (2014), in their studies on developed and emerging countries identified that in countries with better developed equity markets, high-tech intensive countries that depend on external finance were found to exhibit higher innovation.

Levine, Michalopoulos, and Laeven (2011), claim that there is a positive correlation between financial innovation and technological change. This leads into the argument that in the absence of financial innovation, technological change will eventually stagnate and growth will not take place. Therefore, financial innovations such as improvements in screening methodology increase the probability of identifying successful technological entrepreneurs eligible for funding. According to Eschenbach (2004), financial systems by evaluating entrepreneurs, pooling resources, diversifying risks, and valuing expected profits affect innovative activities initiated by entrepreneurs. The cumulative outcome is that, financial intermediation by enhancing efficiency in investment and offsetting the diminishing returns to capital contributes to sustained growth in per capita GDP.

As we move down from the general functional relationship to the realities in less developed countries, DFID (2004) outlines the role of the financial sector in less developed countries in stimulating pro-poor growth. Firstly, as part of their conventional function, financial systems serve in the mobilisation of savings important for productive investment and facilitate inflows of capital and remittances from abroad. These resources are critical in developing countries to speed up investment in physical and human capital which are important determinants of increased productivity. Secondly, the financial sector can bring about productivity gains through reduction in transaction costs, facilitating technology transfer, and improved use of resources. Thirdly, financial sector development by extending loans to be invested in income-generating activities and various enterprises can facilitate employment generation and increased levels of income. Finally, an improved financial sector can reduce vulnerability and minimise risk by providing mechanisms to absorb shocks that could

otherwise have adverse effects on long-term income prospects. A number of studies such as (Chemli, 2014; Odhiambo, 2009; Perez-Moreno, 2011) confirms the above proposition.

The roles and benefits of the financial sector in the developing countries have called for policy initiatives to strengthen the link and contribution of the financial sector to the real sector of the economy. McKinnon (1973) and Shaw (1973) in their seminal paper gave the theoretical foundations for the widespread adoption of financial sector liberalisation and reform measures in developing countries in the 1980s. They attributed financial repression in the form of interest rate ceiling, high reserve requirement, and other quantitative restrictions as the major causes for the low savings, credit rationing, low investment and thus poor growth rates. The solution for such restricted financial sector was to be found according McKinnon and Shaw on the policy of financial liberalisation. These policies can be summarized as ‘freeing’ financial markets from any intervention and letting the market determine the allocation of credit through the market mechanism. Interest rate deregulation, abolition of directed credit allocation, liberalizing entry into the banking sector, etc. constitutes instruments of liberalisation. According to the World Bank (1989), the liberalisation of the financial sector was part of the broader, sector-wide programmes of structural adjustment of the Bretton Woods institutions, which were intended to put developing countries onto a more stable and higher long-term growth path.

However, there is a general agreement that the results of the reform were disappointing, falling well short of expectations. Failure to recognise the underdeveloped and imperfect characteristics of financial markets in developing countries led policy makers and analysts to implement premature deregulation, with serious adverse consequences for the stability of the financial system as a whole (Brownbridge and Kirkpatrick 2000; Williamson and Mahar 1998:36-37). The immediate effects of the ensued financial problems was to slow economic growth and severely affect the most vulnerable section of the population with subsequent increase in levels of poverty in those countries hit by the crisis (World Bank, 2001). Odhiambo (2011) argues that studies on the effects of financial sector liberalisation on savings, financial deepening and economic growth are inconclusive. Moreover, understanding of government policies that preceded restricted financial policies was also



important to evaluate their implications. The adoption of various combinations of foreign fixed exchange rate regimes and external debts denominated in foreign currencies were actually the main reasons behind financial restriction in developing countries.

It was widely believed that improving access of the poor to financial services, including credit, savings and insurance against risk, could strengthen the productive assets of the poor and thereby enhance their productivity and potential for sustainable livelihoods (World Bank, 2001). Poverty can partly be associated with market failure and financial market imperfections particularly can limit access of the poor to formal finance because of the costs involved in extending small loans. Stiglitz (1998) indicates that the expansion of financial services to the poor can contribute directly to poverty reduction and livelihood improvement.

### **3.2.3 Financial market imperfections and microfinance**

Policy-makers and researchers have been exploring ways to improve the operations of financial markets in underdeveloped countries most often with unsatisfactory results. The main reason for such an outcome is attributed to the failure of financial markets. Various theoretical and empirical literatures attempt to clarify how and why financial markets fail particularly in rural areas of developing countries. According to Besley (1994:29), a market failure is observed when a market results in an inefficient allocation of credit. Kunieda and Shibata (2015) argue that lack of information about borrowers, and under developed enforcement rules and institutions result in credit market imperfection and low quality of financial markets.

According to Gine, Goldberg, and Yang (2012), under conditions of asymmetric information, lenders are unable to foresee the behaviour of borrowers and also limit borrowers' ability to fulfill their obligations. In the credit market, issues related to repayments affect the willingness of the lender to provide credit to a particular borrower where sufficient information about the borrower's willingness and ability to repay the loan is scarce. A borrower becomes unwilling to repay if he/she knows that the lender does not have sufficient

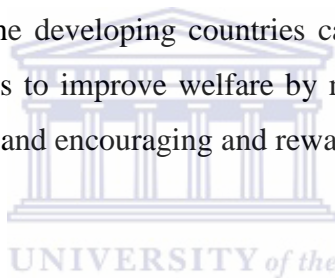
means to enforce repayment. Moreover, a borrower could be unable to repay if he/she becomes a victim of covariant or idiosyncratic shock such drought.

Therefore, information about borrowers' condition including their risk attitude, efforts, credit histories and characteristics is critical to the lender in the absence of which credit provision becomes quite difficult if not impossible. The unwillingness of formal financial institutions to operate in rural areas of developing countries or target the poor shows the high cost of doing business in these areas mainly due to informational problems and leads to inefficient allocation of credit (Rao, 2012; Todaro and Smith, 2012). Monitoring costs due to insufficient information negatively affects banks willingness to extend credit. The higher the monitoring costs the smaller would be the credit extended and thus small investment and low economic growth follows.

Besley (1994:31) indicates that the credit markets in rural areas of developing countries are characterised by collateral scarcity, underdeveloped complementary institutions such as absence of appropriate record of credit histories of borrowers, and absence of insurance arrangements that reduces uncertainty borrowers' income and assets which all contributes to enforcement problems during non-repayment or default by borrowers. For example, in rural areas poor borrowers are unable to provide assets that could be used as collateral (Hermes and Lensink, 2007). In many rural areas land is not eligible for collateral because of poorly developed property rights and absence of land codification and registration.

Imperfect information is the primary cause of market failure and results in adverse selection and moral hazard. Adverse selection arises when lenders have insufficient information about the characteristics of borrowers and is usually observed before the transaction takes place (Besley, 1994:35; Mishkin, 2004:174; Hyytinen and Vaananen, 2006). In the financial market, the interest rate represents an income to the lender and a cost to the borrower. According to Stiglitz and Weiss (1981:393), the interest rate serves as a screening device to distinguish between bad and good risk borrowers. The interest rate has also an incentive effect in influencing the behaviour of borrowers expressed in the form of moral hazard.

The adverse selection aspect of interest rate is the by-product of different borrowers having different probabilities of repayment to their loans. The probability of repayment affects banks expected return and thus banks would like to extend their loans to borrowers who are more likely to repay. The willingness of borrowers to pay different rates in turn shows their repayment probability and level of risk (Stiglitz and Weiss, 1981:393). According to authors, borrowers who would agree to pay higher interest rate are considered to be more risky and their probability of repaying the loan is perceived to be low which would possibly lower the bank's profits. On the other hand, borrowers who are least risky and are most likely to repay their loan would be discouraged most and be excluded from borrowing if high interest rate is charged. Therefore, banks who decide to charge higher interest rate to offset losses from defaults will finally end up selecting borrowers with adverse behaviour. Besley (1994:35-36) and Stiglitz and Weiss (1981:407-408), argue that in a market failure with adverse selection particularly in rural areas of the developing countries calls for government intervention to expand credit through subsidies to improve welfare by minimizing the negative externality imposed by bad risk borrowers and encouraging and rewarding the good borrowers to borrow at an acceptable rate.



Moral hazard is observed after the transaction took place (Mishkin 2004:174). After the lending took place, there is no means to track whether the borrowers is using the loan in the stipulated project. This is also the outcome of information asymmetry that lenders are unable to discern borrowers' actions. The borrower after receiving the loan may engage in activities that are undesirable from the point of view of the lender and endangers the repayment of the loan. Therefore, According Mishkin "moral hazard lowers the probability that the loan will be repaid, lenders may decide that they would rather not make a loan". Like that of adverse selection, Stiglitz and Weiss argue that an increase in interest rate to offset moral hazard may increase the probability of borrowers selecting a project with high risk and engage in reckless behaviour that compromises repayment and profit of the lender and suggest credit rationing to include heterogeneous borrowers and government intervention to correct such externality and improve efficiency.

The arguments of imperfect information as a source of market failure seem to be more relevant for rural financial markets in developing countries. Besley (1994:40) argues that in rural areas information flows are concentrated over relatively close distances and within social groups. Individual characteristics tend to be easily identifiable making monitoring relatively easier and inexpensive. Such features make the availability of informal finance more prevalent in those areas. The fact that formal financial services are reluctant to operate at lower levels of income in rural areas means that the gap has to be filled with informal financial operators. The financial markets in developing countries are characterised by a dualistic financial structure of formal and informal financial institutions and markets (Chandavarkar, 1992:135). According to Ray (1998:538), the informal financial sector consists of money lenders, neighbors, relatives, friends, credit cooperatives, rotating savings and credit associations, landlords, millers, traders, and other agents who are using financial activities as a source of subsidiary income.

The informal money lenders have a comparative advantage in terms of access to information about the characteristics and activities of their clients as compared to formal financial institutions. According to Boucher and Guirkinger (2007), the informal lenders substitute the requirement for physical collateral with information-intensive screening and monitoring to extend loans to individuals excluded from the formal financial sector. Furthermore, informal money lenders accept collateral in different forms such as labour where formal financial institutions refused to do so. With regards to enforcing contracts, low social mobility of clients along with community networks most prevalent in rural areas can be used as a way of ensuring compliance with a loan contract. Social sanctions are also the main instruments to enforce loan contracts by spreading the credit worthiness of the client to the general public and other money lenders. In rural areas of the developing countries loan provision takes place along occupational lines such that landlords for example lend to tenants and farm workers, where the arrangement features a close relationship and the necessary monitoring mechanism to ensure enforcement for the lender (Ray, 1998:536-546).

Comparatively speaking, though informal money lenders have the advantage of micro level information about their clients, the amount of funds available is limited. Therefore, the

informal sector seems to be an imperfect substitute for formal financial lending. In such cases, microfinance either deliberately set up by the government or nongovernmental organisations is expected to fill the gap.

### **3.2.4 Microfinance as a solution to financial market failure**

Information asymmetry in the credit market is reflected when the lender does not have sufficient information about the credibility of potential borrowers. In effect, the lender is unable to accurately estimate the probability of success and potential payoffs of a borrower's project. The lack of information on the part of the lender ultimately leads to credit rationing. Microfinance institutions following the Grameen Bank model have been trying to solve the problem of information asymmetry confronting to formal financial institutions by adopting the concept of group lending (Armendariz and Morduch, 2005; Hermes and Lensink, 2007; Kumar, 2012).

Group lending has become more popular in many developing countries since the 1970s. It is by far one of the most innovative solutions to provide access to credit for the poor in the developing countries. It has been used as a mechanism by which the problems of adverse selection and moral hazards are mitigated by reducing the cost information imperfections (Armendariz and Morduch, 2005:86; Stiglitz, 1990:359). Group lending involves peer screening and monitoring in that trustworthy borrowers are allowed to join the programme and ensure the fact that clients will invest the funds properly. The approach effectively shifts the responsibility from the lender to the client to overcome information and transaction cost problems typically observed in credit markets, especially for poor households without sufficient collateral. It was found to improve repayments rates although at excessive pressure on group members (Gine and Karlan, 2014; Kumar, 2012; Hermes and Lensink, 2007).

According to Devereux and Fishe (1993), the number of organized groups in Ghana, Malawi, India, Mexico, Nepal, the Philippines and Zimbabwe grew dramatically following the introduction of group lending. For example in Ghana the number of groups grew dramatically from 23 in 1969 to over 5000 in 1980. A frequent argument for the use of group

loan is that it lowers transaction cost of the lender. However, Devereux and Fische (1993: 103), argue that the lower transaction cost must be weighed against the cost of organizing groups. They claimed that:

The long-term viability of a group and likelihood of repayment however will depend more on the economic relationship between members of the group than the transactions cost-saving between the groups and the bank. In the simplest of terms, the transaction cost explanation is the supply side argument for making group loans, while the economic interrelationships between group members provides the demand side explanation for group formation and stability, which may be affected by the terms of the loan contract.

Devereux and Fische (1993:105-110), found that success in group loan depends on five factors namely homogeneity among group members, social capital among group members, group size, joint liability and security fund. However, Chowdhury (2005: 429) argues that “social collateral” induced by group liability is not sufficient to ensure high repayment rates and therefore must be followed by sequential lending schemes where borrowers in a group do not access all the loans at once but sequentially.

Even though group liability lending has important merits, its shortcomings also call for attention. Some of its shortcomings as outlined by the World Bank (2008) includes the tension created among clients caused by group liability, the prevalence of “free riders”, cost implication for clients with good risks, and divergence in preferences which appears as group members mature and demand for more resources for investment. Group liability lending triggers tension among clients when members of the group become overwhelmed to the activities of others in the group. Excessive tension harms the existence of social capital which is an important safety net in developing countries and results in voluntary dropouts from the group. Gine and Karlan (2010) and Savita (2007) also contend that group lending imposes additional costs in the form of group formation, higher frequency on installments, the need for higher supervision and penalises good credit risk customers.

Moreover, Armendariz and Morduch (2005:110-111) argue that the scale of lending and the possibility of collusion can threaten the repayment rate among borrowers. Monitoring costs grow as the scale of lending grows. This means that as the amount of loans increase the financial implication of default also rises. Therefore, up to a certain amount, preference for group lending dominates individual lending but beyond that critical point, individual lending will be preferred by clients. Kodongo and Kendi (2013) in their studies in Kenya conclude that as far as the risk of default is concerned group lending programme is more effective in mitigating the risk of non-repayment than individual lending programme.

Empirical literature on the outcome of joint liability group lending show mixed results. Paxton, Graham, and Thraen (2000:648-649) use data of 140 groups from a group-based lending programme in Burkina Faso. They show that the homogeneity of the group in terms of their ethnicity, occupation, income, etc., reduces its repayment performance. Contrary to the findings by Devereux and Fische (1993) the more members are homogeneous the less will be the incentives to screen, monitor and enforce each other. Furthermore, they found that training of members and good leadership were found to positively influence loan repayment. Hermes, Lensink, and Mehrteab (2005:160) investigate the role of the group leader in reducing moral hazard behaviour, using data of 102 groups from two Eritrean group lending programmes. Their findings suggest that monitoring and social ties of the group leader with group members reduce moral hazard behaviour of members. Moreover, distance was found to be an important factor. The findings indicate that as the distance between the group leader and the other members' increases, the probability of occurrences to moral hazard also increases. The evidence shows that the role and efforts of the group leader is a determinant factor in improving repayment performance of the group.

Based on information from 146 groups in Madagascar on the role of social ties, Zeller (1998) find that, groups with stronger ties show higher repayment rates. This finding disproves the possibility of collusion among socially tied group members postulated by Armendariz and Morduch (2005). Moreover, Zeller concluded that it is not the level of physical and human assets of the group members but the degree of variance of risky assets among members that contributes to a better loan repayment.



### **3.2.5 Dynamic incentives: The repay-to-borrow principle**

When group lending is followed with other incentives, it motivates borrowers to repay their loan. Such arrangements are called dynamic incentives. It involves rejecting applications to access future loans for those who did not comply as well as progressively increasing the amount of future loans for those who repay their loans regularly and on time. Dynamic incentives in the form of allowing future loans for borrowers who repaid their previous loans successfully and cut-off future loans otherwise, secures high repayment rates by overcoming information problems and improving efficiency (Bruno and Khachatryan, 2011; Kumar, 2012).

As Armendariz and Morduch (2005:123) and Morduch (1999:1582-1583) state, the justification is that microcredit programmes especially in villages start by lending just small amounts and thereby renewing clients application for another cycle of loan upon satisfactory repayment. This mechanism is effective for forward-looking borrowers whose need for further credit is binding and thus access to future loans is very important. The approach increases the cost of non-repayment and deters borrowers from defaulting strategically. As Armendariz and Morduch put it, “even without recourse to peer monitoring, collateral, or social sanctions, micro-lenders can give incentives to borrowers by threatening to exclude those defaulting from future access to loans”. This shows that for patient borrower long-term gains from accessing future loan outweighs the short-term gain from default (Shapiro, 2015). Moreover progressive lending allows the lender to test the seriousness of the borrower, develop relationships through time and detect potential defaulters before the loan amount is scaled up (Ghosh and Ray 1997, cited in Morduch 1999:1583).

Installment payment on the part of borrowers is also another dynamic incentive to increase the rate of repayment. Most microfinance institutions insist that repayment of loans shall start soon after the initial disbursement and motivate their clients repay in small installments instead of requiring them to repay the full amount at the end of the term. The rationale of this mechanism is that regular repayment schedules alerts loan officers and group members to make note of the emerging problems of non-repayment and take appropriate measures to



address them. It also ensures repayment discipline among borrowers, screens out potential defaulters as early as possible (Armendariz and Morduch, 2005:129-131 and Morduch 1999: 1784-1585; Kumar, 2012). However, they further state that, though frequent repayments keep the likelihood of default low, since borrowers are required to start repayments before investment returns are due, it increases the transaction costs to borrowers thereby reducing the intended benefits to the client. This is because borrowers are necessarily required to look for additional source of income on which to draw to settle their debts.

### **3.2.6 Multidimensional pathways of microfinance impacts**

The impact of microfinance at household level depends on the household's demand for financial services which is a function of household's initial resource endowment in terms of its physical, human, financial, and natural capital and other factors including the structure of markets affecting input and output prices, interest rates, socio-economic factors affecting income earning opportunities, government policies and institution as well as other related transaction costs. Thus, while access to financial services is basically determined by the microfinance institutions themselves, the choice to make use of the services available is left to the household (Zeller, Ahmed, Babu, Broca, Diagne, and Sharma, 1996)

The evaluation of microfinance impacts assumes that a borrower participates in income earning activities (such as agriculture, trade, microenterprises) for which their output growth is limited either by lack of capital or by the high marginal cost of credit. The provision of micro-financial resource is thus expected to relieve the capital constraint and permit the borrowers to increase output, profits, diversify livelihoods and hence their own welfare (Asiama, 2007; Boiwa and Bwisa 2014; Eshetu, 2014). Wanambisi and Bwisa (2013), state that microfinance contributes to the growth of private sector by supplying the financial needs of small and microenterprises. In a situation where internal financing is not sufficient, microfinance institutions by providing credit opportunities enable entrepreneurs to start and expand their enterprises. As Barnes (1996) argues that with improved access to financial services, households can effectively ensure the stability of income and consumption patterns as well as strengthen their resilience in times of shocks. When financial institutions provide

households with adequate financial resources at the right time and with appropriate terms and conditions, they can provide households with opportunities to diversify their economic activities.

There are a number of pathways by which participation in microfinance services could affect household livelihood activities by way of increasing their income sources, reducing their vulnerability and risk, strengthening their asset base and diversifying their livelihood strategies.

### **3.2.6.1 Risk-coping and livelihood diversification**

Risk is inherent in human life. Sebstad and Cohen (2000) define risk or shock as the chance of loss or a loss itself. Risk is defined as a “probability or threat of damage, injury, liability, loss, or any other negative occurrence that is caused by external or internal vulnerabilities, and that may be avoided through pre-emptive action” (Business Dictionary, 2015). Risk has a variety of forms and sources. It may be caused by variables related to seasonality, or fluctuations in weather, inflation, negative events such as sickness or death of a family member, loss of employment, natural disaster, war, etc. Risk can also be associated with life cycle events such as the cost of marriage, education, etc. The ability of the household to deal with different shocks and economic stress depends on the resource endowment (Sebstad and Cohen, 2000).

Households particularly in rural areas attempt to reduce their exposure to risks and shocks by combining different strategies and diversification of economic activities. Barrett, Reardon, and Webb (2001) observe multiple motives prompt households and individuals to diversify assets, incomes, and activities. These motives are triggered by ‘push’ and ‘pull’ factors. The push factors show the response of households to risks due to a decrease in factor returns. The objective of diversification driven by push factors is mainly to stabilise income and consumption flows. The pull factors are carried out to make advantage of strategic complementarities between activities, such as crop-livestock integration, specialization according to comparative advantage based on skills, endowments and technologies the

objective of which is to create opportunities for income diversification in production and expenditure-linkage activities.

Barrett, Reardon and Webb (2001) further state that in the absence of a well-developed asset markets (labour, financial, land) whereby households can exchange their assets and make use of opportunities to achieve the optimal mix of income sources, diversification becomes the natural response. In a study conducted in Zambia, Kalinda (2014) finds that households exercise crop diversification and substitution, livelihood diversification, selling of livestock as a means of reducing and mitigating shocks.

The demand for micro-financial resources in rural areas can be seen in the context of an attempt to reduce their exposure to risk, improve their flexibility and mobility as well as diversify their livelihood activities (Eshetu, 2014). As the extent and degree of shocks and economic downturns differ, their consequences in terms of loss are also different. According to Sebstad and Cohen (2000), households respond to the consequences of loss differently. Some of them may be forced to draw down their resource base and aggravate their long-term vulnerability. Example includes sell of an asset that comprises the household's capability to generate future income. On the other hand, for the better off households who command more options, the response could be through reducing consumption, mobilising labour, searching for new source of income, using up previous savings, etc. These strategies do not potentially diminish the long-term security of the household.

### **3.2.6.2 Income generation and consumption-smoothing**

The conventional belief is that loans can provide additional financial resources used to enhance household's initial endowments so as to generate more income. Credit allocation to a particular use is determined by the level of opportunity costs involved in consumption, production, and investment activities. Improved access to credit reduces the cost of productivity-enhancing technologies in the farm and non-farm production activities. For example, access to credit can allow farmers to increase the use of productivity-enhancing methods such as improved seeds and fertilizer and produce more crops per unit of land and labour (Feder, Just, and Zilberman, 1985 cited in Sharma and Zeller, 2000). Similarly Khan

(2014), in his study in Pakistan finds that microfinance has positive impact on household income and consumption levels.

The prime objective of the poor is to avoid the reduction of food and non-food consumption as well as income flows below a minimum threshold. According to Morduch (1995), the priority of any household is to make sure that income flows are uninterrupted. This can be achieved by applying conservative production methods and diversifying economic activities. Households with steady flow of income stream that satisfies its demand for cash flows choose less negative coping mechanism for the purpose of smoothing consumption. Steady flow of income presupposes diversifying sources of income to protect the poor against shocks and adverse economic events.

The neoclassical economic theory assumes that the financial sector permits an intertemporal resource transfer in which individual agents would be able to forgo present consumption so that capital accumulation will be possible through investment and enables resource allocation overtime. The Keynesian economic theory also focuses on the macroeconomic role of finance and postulates that the financial sector allows the financing of long-term and productive investment projects (Winkler, 1998). At the household level, Mago (2014) argues that improved access to financial services relaxes shortage of capital thereby improving productivity and thus household income with a positive multiplier effect on consumption, investment and asset accumulation and thus contributes to economic development. This is the conventional argument for the provision of resources by micro-finance institutions. Investment and asset accumulation can effectively reduce the variability of consumption and income over time. However, in a poorly functioning credit market, where credit constraint is binding, poor households are unable to shield their consumption in the face of income shortfalls. In a study in Peru, Jacoby (1994) cited in Zeller (1999) found that during adverse income shocks, household without access to credit were forced their children from school so as to help them participate in income generating activities which amounts to substituting present consumption over future consumption.

Within the context of consumption and income, access to microfinance can have a positive effect on food consumption and thus contributing to household food security. Zeller (1995) observes that households respond to food shortages by selling assets, calling in gifts from friends and relatives, and searching for ways to obtain credit from formal and informal sources. With access to credit therefore, households will have the opportunity to stabilise consumption, protect against forced selling of assets, and strengthen their potential for long-term risk management.

As far as the food security of the poor is concerned, according to Heidhues and Schrieder (1995), the absence of rural financial services has two main consequences. Firstly, lack of access to financial resources to bridge temporary, often seasonal short-term food shortages, can cause loss of human productive capacity because of malnourishment and undernourishment. Lower productive capacity which could be translated into loss of future incomes can lead into chronic food insecurity with serious long-run effects. Secondly, lower income and lack of access to financial resources can undermine the ability of rural households to invest in agriculture which may further jeopardise long-term food security. Access to affordable and appropriate rural financial market services can, therefore, improve food security through consumption and production effects of micro-financial resources. The work of Islam, Maitra, Pakrashi, and Smyth (2015) concludes that microcredit programme participants were found to have improved calorie, reduced incidence of food poverty, and lower incidence of stunting among children under the age of five supporting the contribution of microcredit to food security.

### **3.2.6.3 Financial intermediation and saving mobilisation**

Historically by the standard of formal financial institutions, the rural poor either cannot save or save very small amount, therefore cannot respond to the incentives or opportunities offered by financial institutions. This led to the conclusion that collecting savings in small accounts would be unprofitable given their huge transaction costs. As a result the microcredit institutions were exclusively focusing on the provision of credit. Vogel (1984) describes the neglect of the saving component as ‘the forgotten half’ of the financial intermediation.

The long standing point of view has come to an end with the transformation of microcredit to microfinance to incorporate not only credit but also saving and insurance services. The transformation proved the fact that low-income households can positively respond to a wider availability of financial services. The argument is based on ample empirical evidence that shows that there exists high demand for financial savings, and that saving is more crucial for microfinance clients than credit (Robinson, 2001). Studies on the Financial Diaries of the poor in India, Bangladesh, and South Africa, MicroSave studies in eastern and western Africa, as well research by the International Food Policy Research Institute, have documented that the poor does indeed save (African Union, 2009). For example, the findings by Masumbuko, Kerongo, and Wafula, (2014) reveal that microfinance enhances financial intermediation in the form of improved resource allocation, reduced transaction cost, and improved saving culture.

According Zeller and Sharma (2000), savings by households represent the largest component of domestic savings particularly in low-income countries. The evidence suggests that savings by the poor involves both monetary and non-monetary forms including in the form of human capital. The nature to which saving is kept is determined by the availability of appropriate institutional saving facilities. At the household level, the lack of appropriate institutional saving facilities forces the household to depend upon in-kind forms of saving which include jewelry, livestock, and other durable assets. A more pronounced form of monetary saving in rural areas is the Rotating and Credit Associations (ROSCAs). Although ROSCAs services are restricted in terms of liquidity, rate of return and convenience, they represent an informal saving alternative to the poor.

Why do the poor save? Poor households save for many reasons. Zeller and Sharma (2000) argue that saving facilitates the accumulation of capital over time which boosts income and consumption in the future. The need for saving can be attributed to two main motives. The first motive is the need for accumulation or to take advantage of investment opportunities, and the second one relates to precautionary saving that helps cope with emergencies (Ledgerwood, 2013). In this motive households save to meet unforeseen or unexpected

contingencies. Its objective is to maintain a minimum level of consumption for the future. Adverse income shortfalls and unexpected increase in expenditure due to factors such as inflation, events that require lump-sum expenditure such as wedding are typical examples of the need for precautionary saving. Saving facilities also help household keep their lump sum resources in a secure place (CGAP, 2005).

The inter-temporal model which depends on life-cycle income hypothesis indicates that individuals borrow when very young, save when they are in middle age, and dissave when they get older. The model predicts that consumption is likely to be relatively stable over the life cycle and does not depend on cyclical fluctuations of current income (Ando and Modigliani, 1963). Saving models that depend on life-cycle hypotheses are dictated by long-term accumulation. However, households can also save to finance short-term investments and to smooth consumption fluctuations. This type of saving model is based on permanent-income hypothesis developed by Milton Friedman in the 1950s (Friedman, 1957). Therefore, in times of economic slowdown households will either withdraw past savings or borrow in order to maintain relatively stable consumption levels over time. Similarly in times of economic upswings, they tend to save the extra income above a certain threshold.

The amount households actually save and consume depends on their time preference and the level of interest rate which measures the opportunity cost of consumption. In an intertemporal setting, if households' time preference is greater than the market interest rate, they become impatient to save and thus consumption today becomes higher than consumption in the future. However, as put by Ledgerwood (2013), poor people put priority on convenience, access, security and proximity over interest rate earnings.

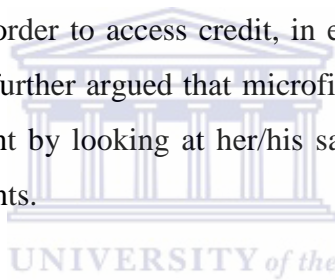
#### **3.2.6.3.1 Forms and determinants of saving in rural areas**

In the previous section, we have seen that poor household in rural areas save for a variety of reasons. Some of them save to smooth income and consumption flows. Robinson (2001) argues that farmers save to dampen seasonal fluctuations in output, entrepreneurs save for the purpose of business expansion. Mas (2009) argues, when comparing saving and credit,



households prefer to save than to borrow, because savings are relatively cheaper and are fully under the control of the household.

For many microfinance institutions involuntary or forced savings constitute a precondition to access credit. Savers are required to prove themselves that they are financially disciplined with convincing saving records to qualify for loan. There are many instances where microcredit programmes have used involuntary savings as part of their innovative approach by way of withholding part of the loan allocated to the client. The benefit of forced saving is that it serves as a collateral substitute in that small and regular payments will gradually contribute to higher repayment performance. Its disadvantage is that it restricts the opportunities to withdraw and utilise at any time at the client's discretion (Armendariz and Morduch, 2005; Bruno, and Khachatryan, 2011). Therefore, when households put aside certain amount of the loan in order to access credit, in effect it means that part of the loan becomes unproductive. It has further argued that microfinance institutions may evaluate the financial discipline of the client by looking at her/his saving records and serves them as a criterion for selection their clients.



According to Adams (1978), in spite of some limited success, forced savings programmes appear to be severely restricted in their ability to mobilise large amounts of rural financial resources. In part this is due to the fact that most farmers view forced saving programmes negatively. Farmers see forced deposits as additional costs for securing loans or other services provided by microfinance institutions. This is due to the negative or very low rates of return which savers realise on their deposits.

Voluntary saving on the other hand represents integral components of financial intermediation. Economic theory tells us that disposable income is either consumed or saved. The availability of saving instruments enables clients to convert non-interest bearing cash to interest-earning savings. As Barnes (1996) indicates, access to voluntary saving instruments ensures safety, increases the absolute amount saved, and allow households to undertake large sum of expenditures that otherwise could not be possible. Therefore, the provision of financial services on a sustainable basis could be an important strategy for poor people to



convert small amounts of savings into large lump sums to protect themselves against shocks as well as take advantage of investment and business opportunities.

According to (Fiebig, Hannig, and Wisniwski, 1999; Robinson, 2001; Armendáriz and Morduch, 2005, Ledgerwood, 2013), savers choose to hold a range of assets that presents various forms of savings: real assets in different forms, cash or deposits in formal, semi-formal and informal institutional arrangements. The composition and type of portfolio in which savers wish to store their excess liquidity depend among others on transaction costs, ease of liquidity, rate of return, divisibility of savings, safety, confidence of savers, financial reciprocity, etc.

Johnson and Rogaly (1997) assert that deposits at financial institutions have substantial benefits over in-kind saving or keeping cash at home. The choice of savers for deposit accounts reflects their preferences for security, accessibility, liquidity, divisibility, and rate of return. Available empirical evidences show that depositors react positively to an increase in the rate of return by comparing both expected interest income and transaction costs (Robinson, 2001). However, there is the case that the poor can save even if the rate of return is low indicating their emphasis on other factors such as safety and accessibility and particularly proximity (Ledgerwood, 2013). Furthermore, deposits give savers more control over their resources as they know when and how they can withdraw their deposits and predict what interest income they can expect in advance.

In-kind saving such as grain or livestock on the other hand can easily deteriorate and lose value over time. When it comes to divisibility, in-kind savings are often not divisible, i.e., cannot be liquidated in appropriate units to fit smaller liquidity demands. Cash is the most liquid and convenient of all assets. In a monetised economy, it is perceived to be important to keep some cash in the house for the purpose of emergencies and make use of unexpected business and investment opportunities. However, savings in the form cash at home are also liable to the risks of theft, fire, flood, lose its value during inflation, and liable to unintended expenditure.

As far as the gender dimension of saving is concerned, Fiebig, *et al.*(1999) reported that “research on women in finance demonstrates that saving facilities and instruments are probably the most important financial services that can be offered to women On the one hand, experience indicates that female clients of financial institutions show more thriftiness and are often more disciplined than men are in making regular savings”.

#### **3.2.6.4 Enterprise promotion and employment creation**

Microenterprises play an important role as a source of income and employment. In most developing countries, micro and small enterprises employ large proportion of the workforce. Microenterprises have been gaining importance as an engine of growth and poverty alleviation tool in the developing countries (Liedholm and Mead, 1998; De Mel, Meckenzie, and Woodruff, 2008).

The contribution of microenterprises to household income may vary from rural to urban contexts. In a rural context, microenterprises typically supplement seasonal agricultural income, link the agricultural household to the local market, and provide employment opportunities for those not directly involved in agricultural activities. As a source of employment, the microenterprise sector is more reliable than farming in some ways due to its ease of entry and low start-up capital requirements. In urban areas, by contrast, microenterprises may play a more critical role in household economic security due to limited employment options in the formal sector of the economy (Sebstad, Neill, Barnes, and Chen, 1995).

The extent to which microenterprises contribute to increasing income and employment and thus to economic growth depends on the general performance of the economy and the extent to which microenterprises are linked to the formal sectors of the economy. There are ‘demand pull’ and ‘supply push’ arguments to the contribution of microenterprises to the overall economic activity. With regard to ‘demand pull’ scenarios, some papers argue that microenterprises and the informal sector in general can have the potential to increasingly evolve and penetrate to wider markets. This increases the overall level of economic activity,

and can lead to more efficient allocation of resources, and to increased income and welfare for the owners of microenterprises. In this case, microenterprises are considered as part of a dynamic economic growth process (Liedholm and Mead, 1998:66-68). A section of the literature also claims that, microenterprises and the informal sector are merely the result of poor economic performance. Although they may generate economic benefits in the short-run, the basic reason for their existence is due to excess supply of labour, and serves as a survival strategy for poor people. In this "supply push" scenario, microenterprises are a source of income and employment for surplus labour, but are not linked to dynamic growth sectors of the economy (Sebstad, *et al.*, 1995).

The job creation potential of microenterprises has been a subject of debate. Some evidences show that microenterprises have the potential to generate employment through the relatively easy entry to start and expand business. Others argue that their employment creation is negligible because of high contraction and closure. Liedholm and Mead (1998:62) in their survey find that microenterprises provide employment to 17-27 percent of the population of working age. The findings suggest that most activities are categorised as very small consisting of self-employed. The major contribution of these enterprises to employment is mostly in the form self-employment. Working proprietors represent more than half of the work force created by micro and small enterprises. Unpaid family labour also constitute substantial amount to microenterprise activities. From this survey it is evident that the use of family labour is a typical characteristic of most microenterprises in the developing countries.

Daniels (1999:55) in his study on five Sub-Saharan African countries estimated that while the micro and small enterprises sector offers employment on average to 22 percent of the work force, the formal sector provides employment to only 15 percent of the adult working age. In a study conducted in Kenya in 1994, Daniels (1999:59-60) found that micro and small enterprises significantly contribute to job creation and national income in Kenya. It contributes employment to more than one-third of all working age and accounts to 13 percent of GDP of the country. He further added that even though their individual contribution may be small, their overall contributions to the national economy cannot be ignored. The study

also reported that for some households' micro and small enterprises represent the sole source of income.

It has been well documented that access to financial resources is an integral component of economic development. Financial institutions offer the opportunity of accessing capital to small firms that have the potential to grow. However, in the developing countries, lack of access to credit is claimed to be the major constraint deterring the growth of small businesses and talented entrepreneurs. According to Somolekae (1996) and Fox (2012) microenterprise owners report that their topmost constraint on the start-up and expansion stage is the difficulty in obtaining credit services. Lack of collateral is the primary reason for not borrowing from banks. In his survey in Nigeria Owualah (1990:423), found that 61 percent consider lack of collateral security to be responsible for their inability to secure bank credit. According to Kuzilwa (2005:134) only less than 5 percent of households in the urban and rural areas in Tanzania had access to credit from formal sources; less than 2 percent of low-income entrepreneurs have access to financial services.

Although credit is a critical financial resource for the growth of microenterprises, the claim that it is the single problem faced by micro entrepreneurs and thus access to credit will help poor people to successful enterprises is over-estimated. Kuzilwa (2005:134) observes that it is not only finance but also the overall dynamics in the entrepreneurial processes and available economic opportunities determines their success. He further argues that “finance along with other institutional factors enhances the ability of the entrepreneurs to take advantage of these opportunities, thereby leading to entrepreneurial success. Lack of it could lead to business failure”.

### **3.2.7 Microfinance and livelihood development**

The provision of financial resources is not an end in itself. It is a means to achieve a specific objective such as livelihood development. Microfinance enables households to mobilise and harness their resources and optimally exploit the opportunities available to them. Private and local resources are the foundation for household and community development. It is believed

that resources at the disposal of households are the basis for their livelihood development. Microfinance brings a positive change in household livelihoods through its production and consumption effects as well as its social effects in empowering women and promoting the culture of entrepreneurship (FAO, 2000; Ziaul, 2014).

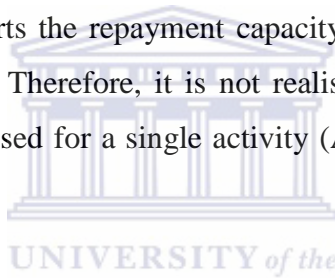
Access to small financial resources encourages the expansion of existing or setting up new non-farm microenterprises by mobilising and putting up together the resources owned by the household. Microfinance also improves agricultural productivity by adopting productivity enhancing methods and inputs thus increasing yields per hectare. Therefore, financial resources used for investment purposes increase production and income for the household and positively contributing to the local economy. According to FAO (2000), an increase in income in turn, will have a multiplied effect on the quantity, composition, and timing of consumption, saving, and asset holding. The acquisition of new assets and improvement and consolidation of the existing ones along with increased income ensures consumption stability, food security and strengthens economic security. Through its effect on household livelihood and local economic development, microfinance can also have positive repercussion effects on natural resources. By relaxing the dependence and pressure of the rural poor on natural resources and promoting diversification of alternative economic activities, microfinance can have beneficial impacts on environmental sustainability.

The linkages between microfinance and household resources on the one hand and their production and consumption activities on the other hand are best explained using the Household Economic Portfolio Model (HEPM) and Sustainable Livelihood Approach (SLA). The HEPM explains the interaction among resources, economic activities and the circular between them. The ability of the household to pursue different livelihood strategies is dependent on their resources endowments (Scoones, 1998). Economic activities include consumption, production and investment activities with returns in the form of satisfaction, income and asset accumulation respectively.

Microcredit is one component of the microfinance services. According to Dunn (1996), loans from microfinance institutions provide an additional financial resource in the current period

to be allocated to any or all of the household's activities. The proportion of household loan that is actually allocated to various activities depends on several factors, including available economic opportunities, economic and social constraints, joint and individual preferences, as well as intra-household decision making dynamics (AIMS, 2001).

The main advantage of the HEPM in assessing the impact of microfinance is that it incorporates the issue of fungibility of microcredit in the sense that credit may be used for a variety of purposes within the household activities. If the loan is used for production or investment activities, it may increase the size of the resource flow back into the household. This increased resource flow can both augment the resource base available to support activities in future periods and enhance the household's repayment capacity. If the loan were allocated to consumption activities, it would divert resources off the production and investment activities and thwarts the repayment capacity of the household as resources are leaked from the circular flow. Therefore, it is not realistic to implicitly assume that loans taken by a household will be used for a single activity (Al-Mamun, Adaikalam, Mazumder, and Wahab, 2011).



The livelihood approach stresses the significance of assets or capitals and their contribution of household livelihood outcomes. DFID (1999) distinguishes five capitals or assets: physical, human, financial, natural and social owned and used in a variety of combinations to achieve livelihood outcomes. Household assets represent the stock of resources on which they can depend to generate income, meet their basic needs, manage risk, and cope with stresses and shocks. A larger stock of assets generally means a greater livelihood opportunities and greater livelihood and economic security.

The term livelihood is often used interchangeably with strengthening economic empowerment and refers generally to economic production, employment, and household income. A more holistic understanding of livelihood, however, incorporates a broader context of economic development, reduced vulnerability, and environmental sustainability. It could be for this reason that the livelihood approach is also called the Sustainable Livelihood Approach. A hallmark of the livelihood approach is its emphasis on the capabilities and

assets of the rural poor, based on the recognition that they hold wealth in at least some household assets.

The value added by a sustainable livelihoods approach to microfinance is its focus on households' capabilities, assets and vulnerability, and how rural micro financing can play a part in enhancing people's livelihood strategies and outcomes. It offers the opportunity to examine the role that targeted microfinance services can play in raising rural households' resource endowments and capitals in a sustainable and meaningful way.

Formal financial institutions tend to be reluctant to extend financial resources to the poor and vulnerable rural household, primarily engaged in smallholder farming. Some of the reasons include, dispersed demand for financial sector, low economic activity, high information and transaction costs, weak institutional capacity, seasonality of agricultural activity, and lack of usable collateral. For these reasons, targeting them is usually considered too costly and carries high risks in the form of default and non-repayment. Nevertheless, history and experience proved that the rural poor households constitute a substantial part of microfinance institutions' potential client base in the developing countries (Besley, 1994; CGAP, 2003; Rabobank, 2005). Hence, adopting a sustainable livelihoods approach can contribute to the understanding of microfinance institutions on the specific needs and priorities of potential clients who are otherwise not considered bankable by main stream financial institutions. Such understanding is not only central to the analysis of impact but also crucial for microfinance institutions to develop appropriate microfinance products and lending strategies that respond to small farmers' real needs and capacities (Mago, 2014).

The causal relationship between microfinance and its benefits to the rural household could be explained by way of its effect on investment on household assets, consumption-smoothing, promotion of income generating activities in rural areas. As Gulli, (1998) outlines, microfinance provides additional purchasing power, permitting households and individuals to exceed the limitations of their current economic situations. For instance, access to financial resources provides a means to accelerate accumulation of assets. The accumulation of physical and human assets in turn augments households' capabilities to improve their living



standard by enhancing their long term productive potential. Access to financial resources enables poor people to manage their natural resources in a more sustainable and efficient manner. For instance, they can reduce working capital constraints if financing allows them to purchase inputs for their microenterprises which play an active role in the households' income earning capacity and contribute to the gradual development of a viable private sector that could play a leading role in the transformation of the economy. Furthermore, Mago (2014), argues that the availability of assets determine the livelihood strategies that people in rural areas need to adopt and the availability of financial intermediation in the form of microfinance supports the building up and accumulation of assets.

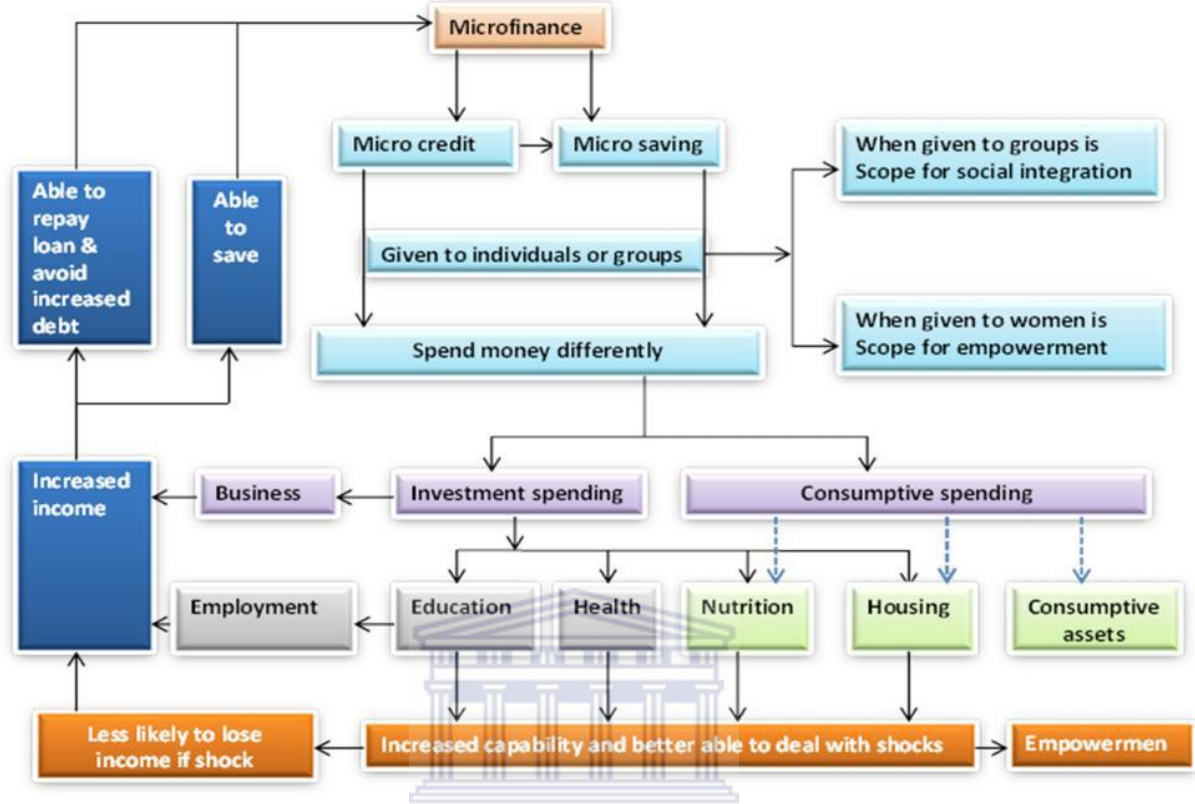
“Microfinance enables rural households to have control over their assets and environment. As a result they become capable of defending themselves against impoverishment as they engage in coping strategies for their livelihoods. Access to finance makes them to engage in risky but potentially profitable economic activities that are likely to make them wealthy. The poor are thereby empowered to pull themselves out of poverty and the vicious cycle of poverty transforms to a virtuous cycle of positive livelihoods outcomes” (Mago, 2014:558).

Accesses to financial resources also reduce households' vulnerability by providing means to cope with emergency needs during seasonal changes and market fluctuations. It also helps to prevent households from selling their productive assets in times of low cash flows thereby increasing the economic security of the household without compromising their asset base in the long-run. Furthermore, the household can improve its social capital through its participation in solidarity group loans, and establish mutual trust and reciprocity. In addition, household members may experience a rise in self-esteem, dignity and a sense of empowerment through opportunities provided by access to financial services. Therefore, the provision of micro financial resources can directly or indirectly contribute to strengthening of the livelihood assets and activities which constitute a center stage in the livelihood approach.

In conclusion Stewart, Rooyen, Majoro, and de Wet (2010) present the multidimensional channels of microfinance impact and their linkages in the following schematic model.



Figure 3.1: Microfinance impact pathways



Source: Adapted from Stewart, et al., (2010) *UNIVERSITY of the WESTERN CAPE*

As displayed in Figure 3.1, microfinance intervention both in the form of microcredit and microsavings can be given either to individuals or groups. Clients spend their financial resources differently signifying the fungibility of microcredit. When given to groups and women, it is expected to strengthen social cohesion and women empowerment respectively. Clients use their money either by investing in the future such as the acquisition of productive assets, business investment and investing in human capital formation in the form of educating their children. They may also spend it for consumption purposes that would enhance their scope for productivity and household durables that retain value. Consumptive spending can also include nutrition, housing, etc. These investments have significant impact on clients' capabilities, their scope to deal with shocks and their ability to earn income. The accumulation of productive and business assets, the improvement in human capital through training, education, and nutrition, the protection against risks and shocks as well as the creation of employment opportunities contribute to increased income which will ultimately





















































































































































































































































































































































































































