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Factors Effecting The Elasticity of Micro Credit Demand In Southern Punjab, Pakistan

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Abstract: The purpose of this study is to explore the factors affecting the demand for microcredit among various borrowers, with a focus on identifying the barriers that influence microcredit utilization. This conceptual study employs a qualitative research technique, using data collected from previous research studies and companies' websites. The findings reveal that numerous factors influence the demand for microcredit, including interest rates, the relationship between lenders and borrowers, government policies, gender differences, prospective beneficiaries, borrowers' creditworthiness, transaction costs, limited access to credit, economic conditions, and the availability of information. These factors highlight the challenges that both borrowers and lenders face in the operation of microcredit systems. The study concludes that by understanding these factors, microfinance institutions can improve their credit distribution processes and better address the needs of their clients. Furthermore, this research fills theoretical gaps in the literature by identifying key elements that can aid in poverty reduction. Future studies should focus on these factors to enhance economic growth and alleviate poverty, particularly in southern Punjab, Pakistan.

Keywords: Government Policies, Gender Differences, Microfinance Institutions, Microcredit, Transaction Cost

1. Introduction

The role of microfinance institutions in poverty reduction and the well-being of poor people has garnered significant attention from policymakers in developing countries worldwide, including Malaysia (Al-Shami, Majid, Rashid & Hamid, 2013; Rashid & Ejaz, 2019). The fundamental premise is that by utilizing microfinance services, poor individuals can engage in various income-generating activities, thereby improving their well-being. This process reduces poverty levels and enhances the overall well-being of participants by boosting their economic activity (Hameed, Imran, Ślusarczyk & Haque, 2019; Hameed, Mohammad & Shahar, 2018; Ul-Hameed, Mohammad & Shahar, 2018; Ul Hameed, Nisar, Abbas, Waqas & Meo, 2019).

Microfinance institutions (MFIs) are organizations that provide a range of services to people who lack access to conventional banking systems (Beisland, D'Espallier & Mersland, 2019). These services encompass both financial and non-financial aspects. Financial services include credit, savings, and insurance, while non-financial services involve training to facilitate micro-enterprise and social capital development activities.

Microfinance institutions (MFIs) are composed of various organizations that play a pivotal role in poverty alleviation. Microfinance refers to the array of financial services provided to low-income individuals and disadvantaged households who are not served by traditional banking sectors (Fenton, Tallontire & Paavola, 2017). These institutions include microfinance banks and non-governmental organizations (NGOs).

This research offers a novel contribution by examining the multifaceted impact of microfinance institutions on poverty reduction and well-being, specifically within the Malaysian context. Unlike previous studies, this research provides a comprehensive analysis that integrates both financial and non-financial services offered by MFIs. Additionally, it explores the synergistic effects of these services on the economic activities and social capital development of poor communities. By focusing on the unique socio-economic dynamics of Malaysia, this study fills a gap in the literature and provides valuable insights for policymakers and practitioners aiming to enhance the effectiveness of microfinance programs in similar developing countries.

2. Literature Review

2.1. Microfinance Institutions

After introducing the Grameen bank model by Muhammad Yunus in 1974 in Bangladesh, microfinance emerged as a viable way to assist the needy and poor. In this program, small loans are given to needy individuals according to their demand or

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need. For lending loans, the borrowers are first arranged into groups, and each member of the group acts as a guarantor for the loan repayment of each other. Group liability and regular repayments help in lending the loan without the requirement of collateral (Chaudhuri, n.d.). According to Conroy (2002), microfinance encompasses a wide range of financial services, including payment services, credit, accepting deposits in accounts, lending loans, transferring money, and providing insurance to the poor.

According to Bastelaer (2000), microfinance institutions provide financial services on a small scale, primarily savings and credit facilities, to those with small businesses, who farm and fish, and who run micro-enterprises where goods are produced, repaired, sold, and recycled. This includes individuals who work for commissions and wages, earning income by renting and providing small pieces of land, tools, vehicles, and machinery, as well as those from urban and rural areas (Robinson, 2001).

2.2. Microcredit

Microcredit, also known as micro-lending, is defined as “a very small loan given to poor people to help them become self-employed.” It aims to improve the living standards of loan recipients by investing in income-generating activities (Fernando, 2006). Microcredit is emerging globally as a more demand-driven service, charging higher interest rates, emphasizing and mobilizing savings as a prerequisite for credit provision, and controlling costs (Otero and Rhyne, 1994; Morduch, 1999). Microcredit is particularly beneficial for individuals who want to start their own businesses and need help to escape poverty. These individuals often lack stable employment, collateral, and certifiable credit history, making them ineligible for formal credit (Nawai, 2010).

2.3. Purpose of Micro Financing and Credit

In developing countries, various NGOs and governments use microfinance as an instrument to reduce poverty (Llanto, 2003). The primary purpose of microcredit is to provide funds to very low-income individuals and the poor to use in various business activities and to improve their living standards. These loans are usually short-term, small, non-collateral-based, and often require weekly repayments. One obstacle that financial institutions face in continuing microcredit services is the problem of loan repayment. This issue arises because micro-credit lending institutions are often NGOs and non-governmental organizations, which are non-profit entities funded by donors and governments (Nawai, 2010).

The poor are often disqualified from borrowing and accessing credit facilities due to high transaction and monitoring costs. They have insufficient collateral, low literacy, and low income, and they usually engage in informal and micro-business activities, such as food sales and processing, small-scale agriculture, petty trading, crafts, and services. These activities contribute significantly to the gross domestic product and total employment in the country. In the third world, micro and small enterprises are considered major sources of income and employment (Mead & Liedholm, 1998). According to the World Bank, under three-quarters and one-third of all employment in underdeveloped countries are derived from the informal sector (Webster & Fidler, 1996).

2.4. Micro Financing Institutions

Over time, the number of banks and financial institutions entering the micro-financing market has increased (Delfiner & Perón, 2007). Various factors motivate banks to deal with microloans, related to both the internal organization of the bank and the market in which it operates. One main incentive is the high risk associated with high profit. With increasing competition, banks need to find niches and innovate beyond traditional operations. In countries with no prior experience in microfinance, an unattended market exists, which can become a source of positive returns and growth for banks (Delfiner & Perón, 2007).

The idea of microfinance institutions was suggested by Muhammad Yunus, aiming to eliminate poverty in Bangladesh. In 1983, he initiated the Grameen Bank, the first institution to use this concept and formally start micro-financing. Both Muhammad Yunus and the Grameen Bank were awarded the Nobel Prize for their efforts in promoting social and economic development through micro-financing.

Microfinance lending institutions are primarily NGOs and non-governmental entities that are not profit-oriented. Many NGOs believe that social procedures are the main cause of poverty among the poor, preventing them from accessing social resources like credit. Therefore, these NGOs provide short-term loans to poor individuals to invest in income-generating activities and small businesses. They act as financial intermediaries, similar to formal banks, but with a focus on poor clients, unlike formal banks which focus on wealthier clients (Nawai, 2010).

Several microfinance lending institutions also offer business support services, such as advice on sales, cash flow, accounting, pricing and costing, marketing, and taxation. They also help in developing business plans and provide support services after loan disbursement (The Regulation of Microcredit in Europe, 2007).

E. Institutions Providing Microfinance Services in Pakistan

- NRSP (National Rural Support Program) Microfinance Bank
- Kashf Foundation
- First Microfinance Bank

- Khushhali Bank
- Akhuwat Foundation

2.2. Factors Effecting on Demand of Microcredit

2.2.1. Interest Rate

The interest rate on microfinance credit should be calculated on the basis of these combinations of costs:

Credit price (interest rate) = Administration cost + cost of capital + cost of default (Johnson, 1997:51).

2.2.1.1. A. Expanding Access to Borrowers

A lender can expand access to cheap loans for borrowers by adjusting the price of the loan. Decreasing the interest rates may reduce the lender's profit but only by a small amount. They can use these cuts in interest rates to attract more customers. For example, poor people and females are generally more sensitive to price compared to others. Lowering the interest rate increases the demand for loans among these groups (Karlan & Zinman, 2008). When interest rates decrease, borrowing by poor females increases (Chaudhuri, n.d.). Banks recognize that raising interest rates for marginal groups can damage their reputation.

The primary purpose of microfinance institutions is to provide loans to low-income households and poor individuals based on reasonable financial services. The main source of income for microfinance institutions is the interest charged on loans, leading to comparatively high interest rates due to high operational costs. Four major factors influence the interest rate: the operating expenses of the microfinance institution, loan losses, funding costs, and the profit margin necessary for expanding the capital base and future growth (Fernando, 2006).

While high interest rates support industry growth and provide millions of low-income households and poor individuals with credit access, some needy people cannot afford microcredit loans due to high costs. Microcredit is not accessible to the poorest people and is not widely utilized for financing agricultural activities. Only those who can generate a sufficiently high surplus can afford such high-interest microcredit (Fernando, 2006).

Karlan and Zinman (2008) argue against the assumption of 'price inelastic demand,' which suggests that borrowers are indifferent to interest rates, allowing lenders to charge bearable interest rates without affecting demand. Their research shows that lower rates increase borrowing among females, while higher rates reduce loan repayment.

2.2.1.2. Limited Access to Credit Services

Various factors contribute to limited access to credit services, such as poor infrastructure, small land holdings, and the nature of land tenure systems. According to Von Pischke and Adams (1980), lack of access to credit in areas with poor rural households negatively impacts agricultural and non-agricultural output, input creation, and family well-being (Diagne & Zeller, 2001). Poor farmers' inability to obtain formal credit support hinders their ability to increase output and improve living conditions. Rural poor often lack knowledge about where to obtain credit for their activities. Additionally, they have less access to banks, which are typically located in urban areas.

2.2.1.3. Transaction Cost

Transaction cost is a significant barrier to obtaining loans. The growth of microfinance institutions aims to address this issue. Once social capital is integrated, it should facilitate poor individuals' access to credit and reduce costs. Transaction costs should decrease, and well-being should improve by increasing information flows (Bastelaer, 2000). Providing sustainable microcredit to the poor and low-income groups is crucial for achieving the Millennium development goal of reducing poverty. Several factors have been recognized by authors as input factors determining rural households' demand for credit and various credit sources.

2.2.1.4. Economic Condition

Microcredit provides opportunities for poor people to invest capital in profit-generating activities. It promotes self-employment in rural areas and helps improve economic conditions with the aid of microcredit (Taj, Akmal, Shah, Ahmad, & Saddozai, 2008). Farmers' literacy levels, land under cultivation, and total income and revenue positively affect microcredit demand (Bakhshoodeh & Karami, 2008). Support services such as market information enhance the productivity of microcredit loans. Economic factors include inflation, market conditions, demand and supply factors, business environment, and consumer behavior, all of which create challenges in obtaining loans.

Microfinance, as a market-driven initiative, emerged practically after Yunus introduced the Grameen Bank Model (GBM). This program provides minimal amounts to poor people based on their needs. Loan recipients were organized into groups, with group members acting as guarantors for each other's loans. Group responsibility for loan repayment eliminates the need for securities and addresses incomplete information related to such lending. Anggraeni (2009) found that group and individual characteristics influence participation in lending programs. Group similarity, common profession, and income levels contribute to group success. Individual economic conditions, such as government employment, higher education, and fixed income, affect participation likelihood. Factors like health, temporary usage requirements (e.g., weddings), and debt/income ratio significantly impact the likelihood of credit control.

Anggraeni (2009) used a large rural household survey to analyze demand-side factors affecting the outreach of Grameen-style lending. Cheng found that household incomes, female borrowers' education levels, and access to other formal lending sources influence program outreach. Off-farm investment opportunities determine demand for such loans. Results indicate that these programs do not automatically target the poorest people but rather those better off among rural populations. Cheng further observed that credit demand is negatively correlated with poor households' wage income, who lack off-farm investment opportunities. This review paper highlights microfinance's impact on poverty reduction, aligning with six of the seven-millennium goals (Anggraeni, 2009).

Fernando (2006) reported that Grameen bank members' incomes were approximately 43% higher than the target group in organized villages and about 28% higher than non-participating target groups in project villages. Bakhshoodeh & Karami (2008) documented that the Grameen bank not only reduced poverty and increased participant benefits but also enhanced households' capacity to sustain gains over time. Bastelaer (2000) noted higher per capita income rates among microcredit program borrowers compared to non-borrowers. Diagne & Zeller (2001) asserted that men and women participating in BRAC-sponsored activities had higher incomes, assets, and employment rates compared to non-participants.

Demand-side factors are primarily linked to income, education, health, profession, and assets, while supply-side factors are associated with credit costs, proximity to banks, crop output (reducing repayment uncertainty), future credit share (policy-driven), and weather characteristics. A larger population base also helps reduce credit distribution costs. NGOs play a vital role in connecting potential borrowers to lenders, forming demand for credit services and assessing borrowers' creditworthiness to lower borrowing costs.

In identifying the determinants of outreach, loans disbursed result from both demand and supply-side factors. Both supply factors as bank optimization and demand for loans as borrower decisions are considered.

2.2.1.5. Gender Differences

The demand for loans is higher in districts where female literacy is high and there is a greater agricultural labor force. Male loan recipients typically use the loans to expand their existing businesses, such as poultry farms and retail shops, while females often take loans to start new businesses. However, income increases more significantly when expanding existing businesses compared to starting new ones. Generally, access to microcredit provides opportunities for poor people, especially landless households and women, to invest in income-generating activities. It also creates self-employment opportunities, improving the economic condition of the country (Taj, Akmal, Shah, Ahmad, & Saddozai, 2008).

Microcredit is one of the most effective techniques for reducing poverty among poor people, helping them become self-employed, especially women, as many are not allowed to seek wage employment due to social customs (Fernando, 2006). One significant social barrier to developing equitable enterprises and the economy is gender discrimination. Creating gender equality is essential for involving women in economic activities. Barriers to women's access to formal credit include cultural and social factors, as well as procedural, economic, attitudinal, and geographical barriers.

Microcredit is provided to community organization members, particularly women, through easy and convenient procedures, especially for those who previously had no access to formal credit institutions. However, the credit amounts are often small, and beneficiaries suggest increasing them. Men typically take loans to expand existing businesses, whereas women take loans to start new businesses. Returns are higher when expanding businesses, likely due to differences in experience between men and women. Overall, access to microcredit has increased among landless households and women (Taj, Akmal, Shah, Ahmad, & Saddozai, 2008).

2.2.1.6. Creditworthiness

To determine whether a borrower can repay a loan, lenders should consider the borrower's economic prospects and credit history (Chakravarty & Shahriar, 2010). Factors such as farmers' literacy levels, land under cultivation, total income, and revenue positively affect microcredit demand (Bakhshoodeh & Karami, 2008). Borrowers with collateral can easily obtain loans, reducing the lending institutions' risk of fund loss. Important characteristics include character, education, collateral, and creditworthiness (Fred, 2009). Clients facing issues such as irregular income, illiteracy, and poor credit history encounter difficulties in borrowing loans and often need support to start new businesses.

In addition to borrower characteristics, lenders should consider the borrower's ability and capacity to repay, collateral requirements, and market conditions when providing loans (Shariff & Nawai, 2010). Three main elements affecting individual lending include nonconventional collateral demands, new screening procedures with dynamic incentives, and traditional elements for mitigating default threats, ensuring a 100% interest rate (Chakravarty & Shahriar, 2010). Saleh & Ndubisi (2006) identify four factors characterizing loan repayment problems: 1) lender-related causes, 2) extraneous causes, 3) business operation-related causes, and 4) borrower-related causes.

2.2.1.7. Informal Relationships

An informal and close relationship between microfinance institutions and borrowers helps detect issues such as non-repayment early. Cooperation and coordination between different agencies provide necessary support for

borrowers' business success (Roslan Abdul Hakim et al., 2007). The interaction between lenders and borrowers is defined as the relationship, which helps identify lending problems and improve loan efficiency (Chakravarty & Shahriar, 2010).

A strong borrower-bank relationship significantly impacts the probability of applying for and being approved for microcredit. Potential borrowers with long-term membership in microfinance institutions, previous loan records, and non-mandatory savings accounts are more likely to apply for and receive group-based loans. However, borrowers associated with multiple lenders have a higher likelihood of demanding loans but a reduced probability of loan approval (Chakravarty & Shahriar, 2010).

2.2.1.8. Government Policies

Barriers to developing micro-enterprises include a lack of specific legal and administrative procedures, limited access to micro-credit institutions, lack of skill development opportunities, and imperfect market information (Census of Establishment and Enterprise 2005). Small-medium enterprises face challenges such as limited human capital skills, low technological penetration and capability, few skill development opportunities, minimal research and development, high international competition, a focus on domestic markets, difficulties accessing loans from financial institutions, and high bureaucracy levels in government agencies (Saleh & Ndubisi, 2006).

Government policies aiming to generate employment, provide skills and training, and support development become major tools for helping poor people benefit from microcredit (Delfiner & Perón, 2007). According to Helms and Reille (2004), governments should expand the financial sector's scope by promoting innovation, transparency, and competition through suitable regulatory and legal frameworks and consumer protection policies. They argue that competition is the most effective way to reduce interest rates and microcredit costs. Consequently, lowering interest rates increases loan borrowing among poor females (McLoughlin, 2013).

2.2. Prospective Beneficiaries

Loan demand is high in areas where female literacy is higher and there is more agricultural labor. The purpose of microloans is to finance activities that generate income, and microfinance includes a wide range of services for the poor, such as savings, microcredit, and insurance (Chakravarty & Shahriar, 2010). Male loan recipients mostly use the loans to expand their existing businesses, such as poultry farms and retail shops, whereas females often take loans to start new businesses. However, income increases more significantly when expanding existing businesses compared to starting new ones. Generally, access to microcredit provides opportunities for poor people, especially landless households and women, to invest in income-generating activities. It also creates self-employment opportunities, improving the country's economic condition (Taj, Akmal, Shah, Ahmad, & Saddozai, 2008).

Large and medium farmers mainly have access to rural credit for agriculture, whereas non-farmers and small farmers lack collateral and, due to their low economic condition, are un-bankable (Waheed, 2009). The consumption of credit for agricultural inputs is high in rural areas of Pakistan, often met by informal loan sources, helping households maintain better living conditions. Without credit, farmers would likely fall below the poverty line (Saleh & Ndubisi, 2006). Credit increases household income, providing more resources for investment in assets, savings, and expenditure. Studies show that microcredit positively influences borrowers' well-being, helping them cope with economic difficulties (Hoque, 2008).

2.3. Availability of Information

Lenders can offer more loans and favorable interest rates if they have comprehensive information about borrowers' repayment history, total current loans, and any previous bankruptcies. When microfinance institutions utilize soft information, they reduce the risk of lending loans. This, in turn, increases the firm's profitability and reduces the reliance of microfinance institutions on government and private sector subsidies. This soft relationship helps microfinance institutions achieve sustainability (Chakravarty & Shahriar, 2010).

Saleh & Ndubisi (2006) argue that the Grameen Bank builds close ties with borrowers during the loan application, approval, and utilization stages. This reduces information asymmetry by generating soft information on borrowers' creditworthiness. Borrower-bank relationships significantly impact the likelihood of applying for and being approved for microcredit. Potential borrowers with long-term membership in microfinance institutions, previous loan records, and non-mandatory savings accounts are more likely to apply for and receive group-based loans. However, borrowers associated with multiple lenders have a higher likelihood of demanding loans but a reduced probability of loan approval (Chakravarty & Shahriar, 2010).

3. Conclusion

The objective of this study was to explore the factors affecting the demand for microcredit. Using data from previous studies, it is concluded that numerous factors influence the demand for microcredit among various borrowers. These factors include interest rates, relationships between lenders and borrowers, government policies, gender differences, prospective beneficiaries, borrowers' creditworthiness, transaction costs, limited access to credit, economic conditions, and the availability of information. This study helps analyze the obstacles borrowers and lenders face in operating microcredit. Therefore, microfinance institutions can benefit from this study by considering these factors during credit distribution.

4. Recommendations for Further Study

Based on the study's findings, several recommendations are proposed for microfinance institutions in Pakistan. Firstly, the current loan amounts are too small to meet the requirements of farmers and other borrowers; hence, they should be increased. Additionally, the high interest rates are a significant deterrent, particularly for farmers, and should be reduced to encourage more people to take loans. The government should establish specialized microfinance institutions to lower operating costs and ensure the sustainability of these services. Moreover, expanding the branches of microfinance organizations would enhance the dissemination of information and make services more accessible to rural populations. Simplifying the loan borrowing procedure is essential, as the current lengthy processes discourage many potential borrowers. Addressing the factors that reduce microcredit demand, such as cultural, economic, and procedural barriers, would also mitigate their negative impacts. Regular meetings with loan recipients can help ensure that loans are used effectively for business purposes. Microfinance institutions should focus on extending their services to the poorer segments of the population, particularly women, to promote gender equality and economic empowerment. Lastly, this review paper can serve as a foundation for further research to evaluate the intensity and actual effects of these factors on microcredit demand in Pakistan, ultimately improving the services provided by MFIs for the benefit of poor women and broader gender equality.

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