

# Review on: The Impact of Microfinance on Poverty Reduction in Ethiopia

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## Abstract

Microfinance has proven to be an effective and powerful tool for poverty reduction. The objectives of this review were to identify factors that affect microfinance and the impact of microfinance on poverty reduction in Ethiopia, respectively. The result of some studies indicated that age, education, time laps between loan application, disbursement, loan size, loan diversion, and repayment period, number of dependents, high interest rate, wealth status, gender, repayment policy, training, and supervision were important variables which had affected microfinance either positive or negative. And also the effects of those variables were depends on the area of studies had taken. This implies the same variables sometimes have different effect at different area. Other objective of this review was the impact of microfinance on poverty reduction. Many researchers believed that the microfinance service is indeed having clear impact: improving the food security situation, the health status, educating the children, creating additional assets (improved housing). Finding of other studies concluded that lack financial sustainability the key element of poverty expansion. Despite the fact those results indicated that the impact of microfinance is inconclusive. Furthermore, the impact of microfinance on poverty reduction indicated that further verification study may be required before concluded.

**Keywords:** Microfinance, poverty reduction, poor households

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## 1. INTRODUCTION

Now day, poverty alleviation is a major issue all over the world. Poverty is one of the widespread hurdle in achieving higher escalation and attractive standard of living of the people in the majority of the low income countries (Taruna and Arpit, 2016). This means a condition in which a person of community is deprived of the basic essentials and necessities for a minimum standard of living (Aziza, 2013). About 1.5 billion people in developing countries are living not as much of US \$ 1.25 a day as per to World Bank report. Over the years, a huge amount of the countries have been running different policies and programs to eliminate poverty. Policy depend up on microfinance has the potential to become an important component of a successful and sustainable poverty alleviation program (Namrata, 2013).

The institution particularly encourage poor households and the result will show that how poverty reduced by encouraging and providing access to finance poor household (Bogale, 2016)

In developing countries, including Ethiopia, micro financing institutions (MFIs) emerged with unique opportunity to poor people who do not have access to commercial Banks (Gudata et al. 2016). Governments of developing countries are responsible for the socio-economic development of their countries (Ampratwum, 2014).

Microfinance involves the provision of micro-credit, savings, and other services to the poor that are excluded by the commercial banks for physical collateral and other reasons (Zerai and Rani, 2012).

The approximately 700 savings and credit cooperative organizations (SACCOs) in Ethiopia are urban, employee-based cooperatives (for example, Ethiopian Airlines). While some service cooperatives provide credit and savings, very few rural savings and credit cooperatives exist.

Since the last two decades different microfinance institutions are filling the gap of poverty in Ethiopia, according to Lafourcade et al. (2005) survey data, Ethiopian microfinance ranked largest MFI in Africa by number of borrowers, ACSI and DECSI microfinance institutions are the two largest MFIs (ACSI and DECSI) in Ethiopia and Africa, even though these institutions are only eight and seven years old respectively.

Different microfinance institution are working on poverty reduction and vulnerability of poor households by increasing agricultural productivity and income by providing credit to poor household in different regions of Ethiopia, most of them are effective in the strategy targeting of the poor (Bogale, 2016).

A key component of Ethiopia's development strategy is the establishment of sustainable microfinance institutions serving large numbers of poor people (Sida, 2003). Therefore, Microfinance, defined as efforts to improve poor people's access to loans and savings services – may be the fastest growing and most widely recognized anti-poverty tool (John, 2010).

### 1.2. Review Objectives

The review is focused on achievement of following two objectives. These are:

- ➔ To review the factors affecting microfinance in Ethiopia and
- ➔ To review the impact of microfinance on poverty reduction in Ethiopia

## 2. LITERATURE REVIEW

As the 2015 deadline for achieving the Millennium Development Goals is fast approaching, the incidence of poverty remains a critical issue in most African countries. Since the 1990s, Africa has experienced a slow rate of decline in poverty and is currently 41 per cent off the 2015 MDG target date.

Microfinance refers to an array of financial services, including loans, savings and insurance, available to poor entrepreneurs and small business owners who have no collateral and wouldn't otherwise qualify for a standard bank loan (Churchill & Frankiewicz (2006). However, a large number of the population of the globe has a problem to access of finance. This is because formal commercial banks take into consideration the poor people as un-bankable as a result of their information irregularities or asymmetries and lack of collateral (Hailay, 2013).

Microfinance, which is the provision of a variety of financial services to poor, low-income people and micro and small enterprises that lack access to banking and related services, is proving vital to empowering communities (Munira, 2012). Therefore, Microfinance directly affects the livelihood of poor people and their wellbeing by providing them financial help in form of small loan (Namrata, 2013). Having access to financial services helps people improve their lives and work their way out of poverty. Indeed, growth of the microfinance industry was central to the social progress achieved in South Asia in the past four decades, even though the microfinance industry in India and Bangladesh is facing challenges. The African microfinance sector can benefit from the best practices and lessons of South Asian experience (United Nations, 2013).

Micro finance service intervention in Ethiopia have also be considered as one of the policy instrument of the government and non-government organizations (NGOs) to enable rural and urban poor increase output and productivity, induce technology adoption, improve input and productivity, induce technology adoption, improve input supply, increase income, reduce poverty and attain food security.

The sustainability of micro finance institutions that reach a large number of rural and urban poor who are not served by the conventional financial institutions, such as the commercial banks, has been a prime component of the new development strategy of Ethiopia. MFIs must struggle to have good financial and operational performance so that they can play a major role in the poverty reduction (Wolday, 2008).

In Ethiopia, MFIs are to be established in the form of share companies defined under article 304 of the Commercial Code of Ethiopia (CCE). The Code defines a share company as “a company whose capital is fixed in advance and divided into share and whose liabilities are met only by the assets of the company.” The NBE registers and licenses MFIs upon the latter fulfilling the requirements set by the MFI Proclamation and directives. A share company may not be established by fewer than five shareholders (Art. 307 of CC). An initial capital of ETB 200,000 is required to form an MFI. Like in the other financial services sub-sectors, capital/shares of MFIs must be fully owned by Ethiopian nationals and/or organization wholly owned by Ethiopian nationals and registered under the laws of and having their head office in Ethiopia (Art. 2(3) Proclamation No. 626/2009), Foreigners must not own an MFI, fully or partially (Andinet Asmelash, 2013).

### 2.1. Overview of Microfinance in Ethiopia

Ethiopia is one of the second largest populations in Africa with the population of 100 million next to Nigeria, it has a huge virgin resources that was not yet exploited but the population are suffering with hunger and lack of opportunities, and poverty became critical issues in most developing countries, due to this, NGO's and other international organizations provide funds a huge finance as a solution for poverty reduction strategy.

As above mentioned, Poverty is a condition in which a person of a community is deprived of the basic essentials and necessities for a minimum standard of living.

Poverty reduction has been a major concern for successive governments in Ethiopia over the years because it is believed to be the universally accepted way of achieving economic growth in the country. The intended purpose is to raise the living standards of the people and improve upon their quality of life.

Microfinance programs globally considered as one of the most significant tool to fight against poverty (Namrata, 2013). The Ethiopia government has been implementing polices to expand financial access to the poor including promoting microfinance credit access to the poor.

Microfinance programmers are increasingly publicized as one of the most successful tools for development with the ability to positively affect its participant's economic and social status (Hailay, 2013). And these were temporary solution in some regional; some nongovernmental organizations (NGOs) shifted their fund more on microfinance organizations, for instant USAID and SIDA supports targeting microfinance institution for poverty reduction in Ethiopia.

According to Bogale 2016 suggested that Ethiopia has recognized and licensed thirty one microfinance institution as poverty reduction strategy, and among these Amhara Credit & Savings Institution S.C, Dedebit Credit & Savings Institution S.C and Oromia Credit & Savings Institution S.C have become the dominant institutions in

service delivery and different poverty reduction strategy, accordingly all financial institutions in Ethiopia contributes financial services to poor and fight against poverty giving more emphasize on women living under poverty line.

## **2.2. The Factors That Affect Microfinance in Ethiopia**

According to Alemayehu and Lemma (2014) assessed different factors which affect the performance of microfinance institutions. The identified factors related to clients includes: problems related to the repayment, diversion of loan into non income generating activities, business condition of the borrowers and so on. On the other hand, institutional factors such as shortage of human resource, lack of cost effective technologies, shortage of loan capital and some others are identified. Political factors which are related to MFIs performance are also recognized in their study.

Based on the analysis, (Tadele et al. 2016) are identified factors that affect microfinance includes: Age, Education level, Wealth status, Residence, Gender. Based on the analysis and the finding of the study, the researchers suggested some recommendations to improve more age people and well business experience people can able to repay their loan amount` timely to micro finance institution.

According to Aziza Geleta (2013) conducted her study on “The Role of Microfinance in Poverty Reduction”. The identified factors related to clients includes: income, living condition, asset accumulation, saving, decision making power, self-esteem, self-confidence, business management skills along with the strength and weakness of the institution among others. The finding indicates that SFPI (Specialized Financial Promotion Institute) scheme has made positive contribution to the clients in relation to observed variables. Nevertheless significantly higher number of the clients complained about the institutions high interest rate, too small loan size, repayment policy, problematic group dynamics. Therefore, as a pointer to future endeavors, the current services of SFPI need to amend the loan size and reduce the interest rate in order to resolve the issues at hand and to fit the financial problem of the poor in the sector.

Gudata et al. (2016) did their paper on Determinants of Loan Repayment Performance: The case of Sidama Micro Financing Institution, Sidama Zone, SNNPR, and Ethiopia. Result of the econometric model indicated that age, education, time laps between loan application and disbursement, loan size, loan diversion, repayment period, number of dependents, training, and supervision were important variables which had significantly determined loan repayment rate. Therefore, the overall finding of the study underlined the high importance of institutional support in the areas of training and continuous follow-up borrowers, especially for youngsters and low educated and or illiterate borrowers.

## **2.3. Impact of microfinance on poverty reduction in world**

Tulchin (2006) observed that the microfinance is a valuable tool for the alleviation of poverty around the globe. In order to microfinance to realize its full potential, it must be sustainable and capable of expansion beyond the limitations imposed by a reliance on development assistance. Bhuiyan et al. (2012) interlinked microfinance and sustainable livelihoods and also described about conceptual linkages of microcredit towards a sustainable livelihood framework. Kauffman and Riggins (2012) concluded that Information and Communication technology (ICT) is an important driver in the maturing microfinance industry and for balancing the dual goals of microfinance that are outreach and sustainability. Salim (2013) interlinked the outreach and sustainability of microfinance sited by (Fidelis, 2013).

Gilbert et al. (2015) carried out their study on “Microfinance and Poverty Reduction in Ghana”. The study found a positive relationship between microfinance and the benchmark variables (individual income, household growth, and access to education, housing and participation in social and religious activities).

Appah et al. 2012 conducted their study on “An Analysis of Microfinance and Poverty Reduction in Bayelsa State of Nigeria”. Their result shows that the microfinance alone cannot reduce poverty in any society where basic infrastructures like good roads, steady power supply, good transportation system etc., are nearly not available for the women to benefits from the introduction of microfinance in Nigeria.

Okonkwo et al. (2015) did their paper on “Poverty in Nigeria and Effects of Microfinance on Poverty Alleviation among Rural Farming Households”. There is no state or region in Nigeria that is not afflicted by this disease called poverty. Financial services for poor have proven to be a powerful instrument for reducing poverty, enable them to build assets, increase earnings and reduce their vulnerability to economic stress. Microfinance is a credit methodology, which employs effective collateral substitute for short term and working capital loans to micro-entrepreneurs.

Alessandro et al. 2015 carried out her study on “The Impacts of Microcredit: Evidence from Ethiopia”. Their result shows that the lack of significant changes in socioeconomic outcomes was not a mere result of low demand for the loans. Income-generating self-employment activities, their find that increased access to loans was not associated with more nonfarm business creation, while we find some evidence of impacts on the scale of farm activities, although the estimates are imprecise. The intent-to-treat for total revenues from self-employment

activities is very large.

Enoch 2018 conducted their study on “impact of microfinance on poverty and household income in rural areas in Nigeria”. This study concludes on the position that, as expected, the method of repayment and income generated from business are two major factors militating against the effectiveness of microfinance in reducing poverty among virus micro economic agent in the society. Of more significance is the consumption pattern of individual which is also negatively reduction. This funding tends to follows standard economic propositions and lends credence to bane of microfinance institution in a developing economic.

#### **2.4. Impact of microfinance on poverty reduction in Ethiopia**

Many studies were conducted on the issue related to microfinance institutions performance, challenges their impact on the economic and social condition of the rural poor or poverty reduction. Gudata et al. 2016 conducted their study on Determinants of Loan Repayment Performance: The case of Sidama Micro Financing Institution, Sidama Zone, SNNPR, and Ethiopia. Result of the econometric model indicated that age, education, time laps between loan application and disbursement, loan size, loan diversion, repayment period, number of dependents, training, and supervision were important variables which had significantly determined loan repayment rate. Therefore, the overall finding of the study underlined the high importance of institutional support in the areas of training and continuous follow-up borrowers, especially for youngsters and low educated and or illiterate borrowers.

Ebisa et al. (2013) found that microfinance institutions are decisive way outs from the vicious circle of poverty particularly for the rural and urban poor, particularly in a country like Ethiopia where many people live barely below the absolute poverty line. The micro financing industry of Ethiopia is escalating in the face of the growing deep concerns for inflation and low interest rate in the microfinance industry affecting the financial health and viability of MFIs.

The study done by Birhanu (2018) on “Impact of Microfinance on Poverty Reduction in Ethiopia: Case of Omo Microfinance in Hosana Town”. The estimation ATT results from PSM output show that participation in OMFI had brought significant impact on household income, saving and aggregate expenditure, but insignificant impacts on asset accumulation value. Thereby, improving living standard of participant and as far as ATT result was the only effect of intervention, thus microfinance intervention reduce poverty at household level. It can be recommended that, importance of microfinance in poverty reduction is of immense benefit to the participant households in study areas.

D. Guruswamy (2012) carried out her study on” the role of microfinance institutions on poverty alleviation in Ethiopia”. In this study both secondary and primary data via self-administered questionnaires and interviews were used. Following the information collected from both MFI’s managers and their clients, it was revealed that MFI have changed the life of poor people in a positive way. Despite these achievements it was further observed that some conditions like high interest rates, loan application process and approval, collateral, service delivery and lack of close relationship between institution management and the borrowers have been limiting factors for poor people to access the MFI services.

Aziza (2013) carried out her study on the role of microfinance in poverty reduction: the case of specialized financial promotion institute (SFPI) using data obtained from a sample of 120 clients from four branches of Addis Ababa to discern its contribution towards poverty reduction. The finding indicates that SFPI scheme has made positive contribution to the clients in relation to observed variables. Nevertheless significantly higher number of the clients complained about the institutions high interest rate, too small loan size, repayment policy, problematic group dynamics.

Bamlaku (2006) conducted his study on “Micro financing and Poverty Reduction in Ethiopia”. This study was conducted with the objective of investigating the impact of Amhara Credit and Savings Institute (ACSI) in Ethiopia taking a sample of 500 households from five different zones in the Amhara Region. The study has found out that the poor have smoothed their income in the study area. However, there was fungibility in the sense that clients were using the loan for unintended purposes. It was also observed that clients lack technical skills to engage in more profitable business activities. This may indicate that financial services alone could not be sufficient enough to raise the living conditions of the poor.

### **3. CONCLUSION**

Over the years, a huge amount of the countries have been running different policies and programs to eliminate poverty. Policy depend up on microfinance has the potential to become an important component of a successful and sustainable poverty alleviation program. Despite the fact that results are inconclusive, a bulk of the literature indicates that there are situation where microfinance could help the poor in many respects such as serving as a buffer against shocks, as an instrument of consumption smoothing. It could also help households to increase their income and assets and help them increase consumption expenditure and develop savings habits. Finding of other studies considers financial sustainability the key element of poverty outreach expansion. Because of microfinance alone cannot reduce poverty in any society where basic infrastructures like good roads, steady power supply, good

transportation system the impact of microfinance on poverty reduction.

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