Microfinance, Financial Development and Poverty Outreach:
The Case of Sri Lanka

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Background

Economists, more often, find that there is a positive correlation between financial sector development and economic growth (Levine 1997, Masoud & Hardaker 2012, Greenwood, Sanchez & Wang 2012). Further, some empirical investigations have shown that financial sector development can contribute to poverty reduction (Jalilian & Kirkpatrick 2005). Economic theory also suggests that financial development can contribute to economic growth, and growth in turn can contribute to poverty alleviation and accordingly, Barr (2005) argues that microfinance, a form of financial development could play an important role in poverty reduction. There has been a debate however, whether the role of Microfinance Institutions (MFIs) in tackling poverty should be based on *financial systems approach* that focusses on financial and institutional success, rather than *poverty lending approach* (Robinson 2001). The contribution from MFIs to financial sector development resulting from the evolving of a wide array of institutions, instruments and markets has not been widely discussed, despite the increasing capacity of MFIs in mobilizing and allocating resources. In this background, our study, deviating from focus of several other studies on microfinance and poverty link relating to Sri Lanka (Charitonenko & De Silva 2002, Shaw 2004) attempts to investigate Sri Lanka's case with regard to relationship of microfinance, financial development and poverty.

Research Problem

According to Barr (2005, p. 281), financially self-sustainable microfinance programs are able to contribute directly to poverty alleviation and enhance market deepening while microfinance in general could facilitate financial markets in developing countries to mature, leading to poverty reduction. In this context, the poverty outreach can be identified as a function of financial performance and other institutional related factors such as experience, loan delivery method, asset size of an MFI. Accordingly, in this paper we attempt to address two areas of the research gap, i.e., a) whether operations of MFIs in Sri Lanka, that directly link to financial development could contribute to achieve poverty outreach effectively and b) whether self-sufficient MFIs of Sri Lanka can make direct impact on poverty outreach.

Objectives of the Research

The objectives of the research are to examine in Sri Lankan context

a). the relationship between assets/loans of MFIs with the depth of poverty outreach

b). whether self-sufficient MFIs can contribute directly to depth of poverty outreach than the MFIs which are not self-sufficient

Research Methodology

A panel dataset was compiled from a sample of 50 MFIs in Sri Lanka, which had 922 branch outlets by end of 2012 including the head office. Accordingly, outreach data and financial data were compiled for each MFI, ranging from a minimum of 2 years and maximum of 6 years within the period of 2007 – 2012. The sample of 50 MFIs represents 85% of client outreach, 54% of lending portfolio and 39% of deposit portfolio of the MFIs operating in the country. A fixed effects (FE) panel data model is used for the study. It is assumed that the dependent variable changes only in response to variables that vary over time and therefore, through the FE model unobserved heterogeneity disappears by treating it as a constant term. Thus, with the adoption of the FE model, the effect of time-invariant characteristics from the predictor variables can be removed so that it is possible to assess the predictors' net effect.

Key Findings

The growth of assets/loans of financial sector institutions (in relation to GDP or other macro-level variable selected) has been used as an indicator of financial development in many research studies (King & Levine 1993a, Ang & McKibbin 2007, Mersland & Strøm 2010). Hence, finding the relationship between increase of assets/loans of MFIs and poverty outreach would resolve the question whether functions of MFIs which directly link to financial development could reach the poor effectively. Results of the Regressions show that if the size of the assets of an MFI increases, then the depth of poverty outreach (measured in terms of average loan balance per borrower or average loan balance per borrower plus the percentage of female borrowers) also increases. The regression results also confirm that increase of gross loan balance positively contributes to the poverty outreach reflecting the fact that MFIs have the ability to grant more smaller loans when increasing their loan portfolio.

Another important finding is that financially self-sufficient MFIs can make direct impact in achieving poverty outreach than the MFIs which are not financially self-sufficient. For example, according to regression results, self-sufficient MFIs are estimated to have a 6.7% smaller average loan balance per borrower at the 1% level of significance, than the MFIs which are not self-sufficient. These results further convince that, adoption of *financial systems approach* is important for MFIs to tackle poverty effectively.

Conclusions

It is concluded that increase of assets/loans of MFIs which directly link to financial development could contribute to achieve poverty outreach in Sri Lanka effectively. Further, it can be observed that achieving financial self-sufficiency by MFIs, which is inherently related to *financial systems approach* is crucial for reaching the poor in the country effectively.

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