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THE IMPACT OF MICROFINANCE INSTITUTIONS ON ECONOMIC GROWTH: A LITERATURE STUDY IN INDONESIA

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ABSTRACT

Objective: This study aims to analyze the impact of Microfinance Institutions (MFI) on economic growth and financial inclusion in Indonesia. It explores how LKM supports Micro, Small, and Medium Enterprises (MSMEs) and low-income communities by providing accessible financing and financial literacy programs.

Research Design & Methods: This study uses a qualitative method with a literature approach, which synthesizes existing studies on the role of MFIs in economic development. Relevant literature from peer-reviewed journals, government reports, and institutional studies are analyzed to identify key trends, challenges, and policy recommendations.

Findings: The findings indicate that MFIs contribute significantly to MSME growth, job creation, and overall economic expansion by facilitating access to affordable credit and business support services. MFIs play a critical role in enhancing financial inclusion, especially in rural areas where formal banking services are limited. However, challenges such as limited capital, credit risk, and the evolving regulatory framework remain constraints to the sustainability of MFIs.

Implications & Recommendations: To maximize the positive impact of MFIs, stronger collaboration between government, financial institutions, and business stakeholders is needed. A clear regulatory framework, increased accessibility of funding, and sustained financial literacy programs can enhance the effectiveness and long-term sustainability of MFIs.

Contribution & Value Added: This study provides a comprehensive synthesis of the role of MFIs in the Indonesian economic landscape, highlighting both opportunities and challenges. By offering insights into best practices and policy recommendations, this study contributes to the ongoing discourse on financial inclusion and MSME development.

Keywords: Microfinance Institutions, MSME Financing, Economic Growth.

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INTRODUCTION

Economic growth is a complex phenomenon, influenced by various social, economic and institutional aspects. Social aspects, such as the level of education and the quality of the workforce, play an important role in improving the productivity and competitiveness of a country (Angelika et al., 2022). From an economic perspective, investments from both the private and foreign sectors contribute to increasing production capacity and expanding industries, although the effects may vary depending on the sector receiving the investment (Asrinda & Setiawati, 2022). In addition, institutional factors, including political stability, regulatory quality, and government policy effectiveness, are also key components in creating an economic environment that supports long-term growth (Santika & Qibthiyyah, 2020).

Being a developing country with a large population and an economic growth rate of around 5.2% per year, Indonesia faces challenges in maximizing its demographic potential (David & Ardiansyah, 2017), including in equalizing access to capital for small business actors who often have difficulty obtaining loans from conventional banks. Microfinance Institutions or commonly abbreviated as MFIs are present as a solution in providing easier access to financing for Micro, Small and Medium Enterprises (MSMEs) (Kusjuniati, 2020). With the availability of more flexible and affordable sources of funding, MSMEs can increase production capacity, expand market reach, and develop business innovations. This increase in productivity directly contributes to national economic growth, considering that MSMEs are one of the main pillars in sustaining Gross Domestic Product (GDP) and creating jobs. Through sustainable financial support, MFIs help strengthen the competitiveness of MSMEs, promote economic stability, and encourage business sector growth in various regions.

The sub-optimal regulations and policies that still lack overall support are the main challenges in the development of Microfinance Institutions (MFIs), especially for sharia-based MFIs. One of the main obstacles is the imperfection in the implementation of policies that should ensure compliance with Islamic financial principles. This lack of regulatory clarity may hinder the operations of Islamic MFIs in providing services that comply with Islamic economic principles, such as the prohibition of usury and the implementation of a fair profit-sharing system (Sugeng et al., 2024). In addition, the low financial literacy of the community is also a factor hindering the effectiveness of the MFI program. Many small business owners still face difficulties in managing loan funds wisely and optimizing capital for sustainable business development. Lack of understanding on financial management, good financial record keeping, and business development strategies has caused many MSMEs to be unable to utilize financing facilities to the fullest. As a result, some of them experience difficulties in repaying loans, which in turn can increase the risk of bad debts for the MFI itself (Alam et al., 2023). Therefore, more comprehensive efforts are needed to improve financial education as well as regulatory improvements that are more supportive of sustainable MFI growth.

Microfinance programs have grown rapidly in developing countries as a key tool in poverty reduction. By providing financial access to groups previously unreached by conventional banking institutions, these programs enable the poor to establish small businesses, increase income, and create economic stability. Microfinance also plays a role in improving the financial literacy of micro-entrepreneurs, enabling them to manage their businesses more effectively and sustainably (Amin et al., 2021). MFIs play a significant role in financial inclusion and poverty alleviation (Li et al., 2023). The need to understand the relationship between financial inclusion and economic growth has become an important concern in national development, especially in formulating income distribution and poverty reduction policies (Erlando et al., 2020). MFIs are considered an effective tool for development and poverty alleviation (Ahmed, 2009).

LITERATURE REVIEW

Microfinance Institutions

Microfinance Institutions (MFIs) are institutions that provide financial services, such as loans, savings, insurance, and fund transfers, to individuals and small businesses that do not have access to conventional banking (Adnan & Kumar, 2021). The main objective of MFIs is to provide financial services to the underprivileged and those marginalized from the formal financial system, with a focus on poverty alleviation and increasing financial inclusion (Annim, 2012; Mikail et al., 2024). According to Sonam et al., (2024), microfinance refers to small-scale financial institutions that play an important role in financial inclusion by providing financial services to the poor, with the aim of reducing economic and social disparities and supporting small business development. According to Law No. 1 of 2013 on Microfinance Institutions (MFIs), a Microfinance Institution is defined as a financial institution specifically established to provide financial services in the form of loans or financing for micro and small businesses, as well as providing deposit management services, but not included in the banking system.

In carrying out its operations, Microfinance Institutions (MFIs) have several business activities that aim to increase financial inclusion for small communities, especially in rural areas. In accordance with Law No. 1 of 2013 on Microfinance Institutions, the main activities of MFIs include providing loans or financing to micro and small businesses, managing public savings in the form of savings or time deposits, and providing financial consulting services to increase the capacity of micro businesses. MFIs are not allowed to collect funds in the form of current accounts or conduct other banking activities, so their operations focus more on financing that is easily accessible to people with limited access to conventional banks. MFIs may engage in fee-based activities as long as they do not violate any applicable laws or regulations.

MFIs have unique characteristics by pursuing dual goals, namely achieving social goals by reaching the poor and ensuring financial sustainability in order to continue operating independently (Quayes, 2012; Widiarto & Emrouznejad, 2015). MFIs realize their social objectives by providing financial services to groups marginalized from formal banking, such as women, rural communities, and micro-entrepreneurs (Ghising & Modi, 2024). Women, especially in rural areas, often have limited access to conventional financial services, and MFIs play an important role in empowering them through the provision of microcredit and financial inclusion programs (Kauser & Zubairi, 2022). In addition, MFIs also target rural communities through programs such as Self-Help Groups (SHGs), which have proven to be effective in promoting entrepreneurship and reducing poverty (Chattopadhyay & Roy, 2024).

Microfinance Institutions (MFIs) have an important role in improving access to finance, especially for small and medium enterprises in rural areas. A study by Budiman et al., (2020) shows that MFIs have healthy financial performance, with significant growth in assets, loans, savings, and deposits. The government is expected to continue providing capital support so that MFIs can develop better. Suryani et al., (2020) revealed that the sustainability of MFIs depends on the intensity of the relationship between the institution and its customers. The stronger the relationship, the higher the probability of customers obtaining access to credit, which in turn can increase the productivity of small businesses. A study conducted by Baskara and Suarjaya (2022) in Bali found that the social and financial efficiency of village-based MFIs can significantly boost local economic growth, with a community-based management system that is more adaptive to the needs of local communities.

Economic Growth

Economic growth is defined as an increase in the capacity of a country or region's economy, which reflects the production and increase of goods and services within a certain period. Economic growth is a key indicator in assessing a country's progress, which is generally measured through an increase in Gross Domestic Product or GDP per capita (Burgess et al., 2021; Elistia & Syahzuni, 2018). GDP per capita is used to describe the level of people's economic welfare by dividing a country's total economic output by its population (Agrawal, 2024).

Economic growth is closely related to factors such as human development, natural resource utilization, energy consumption, and environmental impacts (Adejumo, 2020; Elistia & Syahzuni, 2018; Shabbir et al., 2020). For example, Elistia and Syahzuni (2018) revealed that economic growth contributes to the improvement of human development, while on the other hand, high levels of human development also open up more opportunities for economic growth. The relationship between economic growth and human development is reciprocal, where economic growth contributes to improving people's quality of life, while better human development can accelerate economic growth. Studies show that the human development index (HDI) has a significant influence on regional economic growth, especially through investments in education and health (Anwar, 2017).

Many researchers have diverse views on economic growth. Some criticize the concept of sustainable economic growth, especially in relation to environmental sustainability (D′ Amato et al., 2019). However, other studies focus on strategies to realize sustainable economic growth through the use of renewable energy and transformation towards a green economy (Chou et al., 2023). Economic growth is influenced by various interrelated factors, such as exports (Begum & Shamsuddin, 1998), investment (Begum & Shamsuddin, 1998), energy consumption (Salim et al., 2014), and transportation sector development (Liu & Feng, 2020). In recent studies, economic growth is also associated with factors such as foreign investment, net exports, and labor, where net exports are shown to have a significant influence on a country's economic growth (Asrinda & Setiawati, 2022).

Further research shows that in the modern context, economic growth is also strongly influenced by factors such as technology, government policies, institutional quality, as well as social factors such as economic inclusion and equality (Storonyanska & Benovska, 2020). In addition, alternative approaches such as "green growth" and "post-growth" theories are gaining ground, emphasizing that economic growth should not only focus on increasing GDP but also on sustainability and social welfare (Yurevich, 2022). Therefore, the concept of economic growth theory continues to evolve along with global dynamics, including challenges such as climate change, digitalization, and economic inequality.

Research by Sembiring (2023) highlights the close relationship between economic growth and poverty reduction, noting that economic growth must be inclusive so that the benefits can be felt by all levels of society. Equitable economic growth will improve human resource competencies, expand employment opportunities, and increase access to better social services (Dalimunthe et al., 2022). Economic growth is a macroeconomic variable that has a theoretical basis that explains the factors that influence growth and the relationship between these factors. In general, theories of economic growth can be classified into several main approaches, such as classical theory that focuses on capital and labor accumulation, neoclassical theory that emphasizes market efficiency and productivity, and endogenous growth theory that sees the role of innovation and investment in human capital as the main drivers of growth (Buyanova & Averina, 2024).

METHODS

This research implemented a qualitative method with a literature approach, in which data was obtained and analyzed from various written sources, such as books, scientific journals, documents, and previous research reports. This approach aims to understand a phenomenon in depth through analyzing concepts that have been developed by experts. In qualitative research, the literature approach plays an important role in building a strong theoretical foundation and identifying patterns or trends relevant to the research topic (Fadli, 2021). In addition, this method allows researchers to synthesize information from various sources to build a deeper and more comprehensive understanding. Literature research not only focuses on descriptive analysis, but also applies an inductive approach in interpreting data, so that the results of the research become more contextual and relevant to the problems studied. By using qualitative, desk-based methods, this research can identify the main factors that influence the success of microfinance institutions in promoting economic growth and reducing financial inequality in communities, especially rural communities.

RESULT

Microfinance institutions (MFIs) have been playing a significant role in promoting financial inclusion globally, especially for underprivileged groups and small businesses. Recent studies highlight the growing potential of MFIs as instruments that provide social impact as well as investment opportunities, and offer diversification benefits for investors globally (Lee et al., 2024). Research also highlights the crucial role of MFIs in supporting entrepreneurship development, especially for women and marginalized groups, by providing access to financial services that cannot be reached through conventional banking (Coronel-Pangol et al., 2023).

The Indonesian government has provided solutions based on existing problems. As evidenced by the increase in the number of Microfinance Institutions (MFIs) registered with the Financial Services Authority (OJK) shows a consistent increase from year to year. In 2020, there were 227 MFIs supervised by OJK. This number increased to 238 MFIs in August 2022, with 81 of them operating as Sharia MFIs. By August 2024, the number of Sharia MFIs increased to 79 units with total assets reaching IDR 629.59 billion. This increase reflects the government's efforts to expand financial inclusion and strengthen the role of MFIs in the national economy. Microfinance Institutions (MFIs) are established with the main objective of supporting the growth and financial independence of small communities. Based on information from the official website of the Indonesian Ministry of Finance, here are some examples of MFIs operating in Indonesia.

Table 1. Type of MFIs in Indonesia

Type of MFIs	Function	Example
Koperasi Simpan Pinjam (KSP)	A cooperative-based financial institution that provides savings and loan services to its members. Providing loans at low interest rates, improving the welfare of members through savings and micro business financing.	KSP Sahabat Mitra Sejati, KSPPS BMT Berkah Sejahtera
Bank Perkreditan Rakyat (BPR)	A small-scale bank that serves the community, especially in rural areas, with credit and deposit services. By providing business capital to businesses and communities, and accepting deposits in the form of deposits or savings.	BPR Nusamba, BPR Lestari Bali
Badan Usaha Milik Desa (BUMDes)	A village-owned financial institution that aims to improve the village economy through productive businesses. By providing loans to villagers, managing productive businesses, and improving the welfare of the village community.	BUMDes Tirta Mandiri (Desa Ponggok), BUMDes Karya Mandiri
Program Kredit Usaha Rakyat	Credit schemes from the government provided through banks and financial institutions by providing access to capital at low interest rates for MSME players.	KUR BRI, KUR Bank Mandiri, KUR BNI
Bank Wakaf Mikro	A sharia-based financial institution established to assist the development of micro-enterprises, by providing collateral-free loans under a sharia scheme to the community around the pesantren.	BWM Pesantren An-Nawawi Tanara, BWM Pondok Pesantren Al-Ittifaq
Bank Kredit Desa (BKD)	A financial institution that caters to the capital and small-scale credit needs of rural communities, especially farmers and small traders.	BKD Jawa Tengah, BKD Jawa Timur

Through empowerment programs, MFIs in Indonesia strive to improve financial literacy, expand access to credit, and provide assistance to small businesses so that they can develop independently. The program not only aims to help people understand financial management better, but also to ensure that they have access to the capital needed to grow their businesses. In addition, the mentoring provided enables small business owners to acquire more effective managerial skills and business strategies, so that they can develop independently and contribute to local economic growth. With a more flexible and community-based financing model, MFIs can help improve financial inclusion and boost local economic growth.

There are some interesting findings on the relationship between MFIs and economic growth. Research results show a high level of relationship between financial inclusion, economic growth, poverty, and income distribution in Eastern Indonesia (Erlando et al., 2020). In addition, it is found that the success and performance of MFIs significantly affect economic development (Lopatta & Tchikov, 2016). This research is important to analyze the contribution of financial inclusion to economic growth, poverty alleviation, and income inequality in Indonesia. It can provide new insights on actions that can be taken to stimulate economic development and growth, as well as targeted development programs and socially responsible investments that can be implemented to strengthen growth and reduce poverty. Microfinance Institutions (MFIs) contribute directly to economic growth by increasing people's purchasing power through the financial services they provide. Through providing access to capital for small and medium enterprises, MFIs encourage increased productivity and income, which in turn strengthens the local economy. In addition, MFIs indirectly play a role in encouraging capital accumulation and expanding employment opportunities. As more businesses receive financial support, more jobs are created, which has a positive impact on the labor participation rate. This not only improves people's welfare, but also accelerates overall economic growth (Lopatta & Tchikov, 2016).

DISCUSSION

Microfinance Institutions (MFIs) play a significant role in supporting the growth and resilience of Micro, Small, and Medium Enterprises (MSMEs) by providing easier and more affordable access to finance (Gora et al., 2024). One of the main challenges that MSMEs often face is limited working capital, which can hamper their business operations and expansion (Gupta & Kumar Singh, 2023). With financing support from MFIs, MSMEs can be more flexible in developing their business, increasing productivity, and facing various economic challenges. This role becomes even more crucial in crisis situations, such as during the COVID-19 pandemic, when many MSMEs are under significant financial pressure. Access to flexible sources of funding allows them to survive and adapt to changing market conditions, thus helping to maintain broader economic stability (Chozarira et al., 2023).

Microfinance Institutions (MFIs) act as a platform that connects lower-middle-income communities with access to funding, financial management services, and consulting facilities for businesses. The existence of MFIs is also very important in expanding financial inclusion in rural areas and areas underserved by conventional banking, thus improving the overall economic welfare of the community (Firdaus et al., 2020). In addition, business advisory and mentoring programs provided by MFIs contribute to improving business efficiency and promoting small business sustainability, which in turn has a positive impact on economic growth (Goel, 2024).

The development of the financial sector, which is reflected in the increase of domestic credit, has a positive impact on Indonesia's economic growth in the long run (Elfaki et al., 2021). This finding confirms that easy access to credit, which is one of the main functions of Microfinance Institutions (MFIs), plays an important role in driving economic activity. By providing financing for small and medium enterprises, MFIs can help increase productivity and encourage investment in various sectors. The study also indicates that financial sector development can stimulate national economic growth, which further emphasizes the great potential of MFIs in supporting inclusive economic development. By strengthening the role of MFIs in providing wider and more flexible access to capital, economic stability can be better maintained, while at the same time encouraging equitable distribution of community welfare, especially in areas that still experience limited access to conventional banking services.

To maximize the positive impact of Microfinance Institutions (MFIs) on economic growth, synergy between the government, financial institutions, and businesses is needed to create more inclusive policies that support the sustainability of MFIs. The government has a role in creating conducive regulations and providing incentives for MFIs to reach more micro and small businesses (Kurnianty & Sitorus, 2023). In addition, support from the banking and fintech sectors can help expand access to finance through digitization of financial services, so that micro businesses can more easily obtain financing that suits their needs (Rohmayanti et al., 2023). On the other hand, businesses must also improve their managerial capacity and financial literacy in order to optimally utilize the facilities provided by MFIs. With a strong collaboration between the government, financial institutions, and businesses, the sustainability and effectiveness of MFIs in driving economic growth can continue to be improved, while accelerating equitable distribution of economic welfare in Indonesia.

CONCLUSION

Microfinance Institutions (MFIs) have an important role to play in driving economic growth and increasing financial inclusion in Indonesia. By providing access to finance for MSMEs and low-income communities, MFIs help overcome financial barriers that often become obstacles in business development. Various forms of MFIs, such as Koperasi Simpan Pinjam (KSP), Bank Perkreditan Rakyat (BPR), dan Badan Usaha Milik Desa (BUMDes), and many other types of MFIs scattered in various regions. Not only offer low-interest loans but also provide mentoring and training to clients. Through various empowerment programs, MFIs contribute to increased productivity, job creation, and improved community welfare, especially in areas that are hard to reach by conventional banking services. However, despite the positive impact of MFIs, their sustainability still faces various challenges, such as limited capital, bad credit risk, and evolving regulations. To ensure the effectiveness and sustainability of MFIs, synergy between the government, financial institutions, and businesses is needed to create more inclusive policies that support the development of this sector. Support in the form of clear regulations, wider access to capital, and sustainable training programs will strengthen the role of MFIs in supporting economic growth, reducing financial inequality, and improving overall community welfare.

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