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THE IMPACT OF FORMAL CREDIT ACCESSIBILITY ON SME GROWTH AND SUSTAINABILITY IN LILONGWE OLD TOWN, MALAWI

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ABSTRACT :

Small and Medium Enterprises (SMEs) are widely recognized as engines of economic growth and employment. In Malawi, for example, SMEs contribute roughly 40–47% of national GDP and employ about 1.8 million people. This study examines how formal credit accessibility, defined as the ability to obtain loans from regulated institutions, affects SME growth (e.g. revenue and employment expansion) and sustainability (long-term viability encompassing economic, social, and environmental goals) in Lilongwe Old Town. Using a mixed-methods approach, we find that firms with better access to formal loans grow faster and survive longer. Specifically, formal credit access correlates strongly with revenue growth ($r = +0.58$) and survival ($r = +0.54$). Regression analysis confirms that credit accessibility is a highly significant predictor of growth (standardized $\beta = +0.45$, $p < .001$) and sustainability ($\beta = +0.41$, $p < .001$). However, these positive effects are substantially undermined by systemic barriers. The majority of SMEs report stringent collateral requirements (85.0%) and high interest rates (79.7%) as key obstacles. Lengthy, complex application processes (68.6%) and low financial literacy (63.3%) are also major impediments, and 41.5% of firms cite discriminatory practices against women or young entrepreneurs. These intertwined challenges rooted in information gaps, regulatory constraints, and macroeconomic instability create a cycle of financial exclusion that stifles SME innovation and resilience. To break this cycle, this study recommends coordinated policies such as credit guarantee schemes and movable collateral registries, reduced borrowing costs through macroeconomic stabilization, enhanced financial literacy and business development services, streamlined lending procedures and relationship-based lending by banks, and strict enforcement of inclusive lending practices. These measures aim to unlock the full growth potential of Malawi's vital SME sector.

Keywords: Small and Medium Enterprises (SMEs); Formal Credit Accessibility; SME Growth; Sustainability; Financial Inclusion; Collateral Requirements; High Interest Rates; Financial Literacy; Gender-Based Discrimination; Systemic Barriers; Malawi; Lilongwe Old Town.

INTRODUCTION

Small and Medium Enterprises (SMEs) are central to global and Malawian economies. They account for roughly 90–95% of all businesses worldwide and about 70% of employment (World Bank 2021; IFC 2022). In Malawi, for example, SMEs employ nearly 1.8 million people (about 38% of the workforce) and contribute between 40–47% of GDP. These enterprises drive innovation, competition, and income distribution, supporting Malawi's development goals (Malawi 2063 Vision) by diversifying production and empowering households. Lilongwe Old Town exemplifies this dynamic. The town's markets and informal firms form a microcosm of Malawi's SME sector. Despite their importance, most SMEs in Lilongwe operate at subsistence scale, constrained by limited capital and low formalization.

Access to finance is widely acknowledged as a critical enabler of SME expansion (Beck & Demirguc-Kunt 2006). Credit allows businesses to invest in inventory, equipment, and skills. However, in many developing countries including Malawi, access to affordable formal credit remains highly restricted. Globally, unmet SME financing needs exceed $5 trillion annually (IMF 2022). Sub-Saharan Africa alone faces an estimated $21 billion gap. In Malawi, studies show that formal financial inclusion is extremely low in a way that only about 17.7% of adults accessed any credit by 2019-20. Formal SME loans are scarce; for example, only 26.7% of Malawian firms had bank credit according to a World Bank survey. In practice, most Lilongwe entrepreneurs rely on personal savings, family loans, or informal ROSCAs rather than bank loans. This financing constraint limits SMEs' capacity to expand operations, adopt new technologies, and weather economic shocks.

Given the importance of SMEs and the acute financing gap, this research addresses a pressing policy question: How does formal credit access influence SME growth and sustainability in Lilongwe Old Town, and what barriers block its benefits? Previous literature has linked credit to firm performance (positive correlation with investment and longevity), but also notes that high borrowing costs and rigid lending practices can negate those benefits. The research focuses specifically on Lilongwe Old Town to provide localized evidence. The study's objectives are to (a) assess the level of formal credit accessibility for these SMEs, (b) measure the impact of credit access on their growth and long-term viability, and (c) identify the main barriers preventing access. Using a mixed quantitative-qualitative methodology (surveys of 207 SMEs and in-depth interviews), this research offers evidence-based recommendations for policymakers, financial institutions, and SME owners.

LITERATURE REVIEW

Extensive research confirms that **financing constraints** are among the most significant obstacles to SME growth. Globally, studies find that firms with better access to credit invest more, grow faster, and survive longer. Beck and Demirguc-Kunt (2006) show strong positive links between external financing and revenue growth/firm survival. However, the terms of credit are crucial. High interest rates and short repayment periods can erode benefits. A World Bank/IFC report notes that nearly half of SMEs in emerging economies cite financing as a major constraint (EIB 2011; World Bank 2022).

Sub-Saharan Africa (SSA) faces particularly acute SME financing gaps. Banks in SSA often hold ample liquidity but are reluctant to lend to small firms due to perceived risk and information asymmetry. Microfinance has expanded but typically serves very small-scale loans, leaving many SMEs undercapitalized. Innovations like mobile money and credit guarantee schemes show promise (GSMA 2023; AfDB 2020), but uptake is limited. Contextual factors (infrastructure, regulation, macro stability) also critically shape outcomes.

Malawian evidence echoes these trends. Surveys report that only 17.7% of adults accessed any formal credit by 2020, and most SMEs depend heavily on informal sources. Studies in Lilongwe and beyond consistently identify *stringent collateral*, *high interest rates*, *low financial literacy*, and *complex procedures* as top barriers. Gender disparities are also noted in such a way that female entrepreneurs in Malawi and elsewhere face additional challenges in obtaining loans (Gondwe 2016; Berhanu & Gebremedhin 2011). In short, the literature establishes that while formal credit can power SME expansion, African SMEs are typically excluded from banks unless they can meet demanding terms.

The study draws on several theoretical frameworks. **Information Asymmetry Theory** (financial intermediation) explains how banks require strict collateral and charges due to opaque borrower profiles. SMEs often lack audited records, exacerbating lenders' risk aversion. **Resource-Based View (RBV)** suggests that SME-internal capabilities (e.g. financial literacy) determine how well firms leverage obtained finance. Our findings indeed show that better-educated entrepreneurs use credit more effectively. The **Sustainable Livelihoods Framework (SLF)** conceptualizes formal credit as a livelihood asset: access can enhance economic and social sustainability, but only if accompanied by supportive structures. **Institutional theory** highlights how regulatory and policy environments (e.g. collateral laws, banking regulations) shape access. Together, these lenses help interpret our findings: supply-side constraints (high rates, lack of guarantees) and demand-side factors (literacy, organization) jointly determine outcomes.

MAIN CONTENT / DISCUSSION

Key concepts. *Formal credit* in this context refers to loans and financing obtained from regulated financial institutions (commercial banks, microfinance institutions, etc.). Importantly, true accessibility implies not just *having* credit products available, but obtaining them on reasonable terms (without prohibitive interest or collateral). In contrast, *SME growth* is understood broadly with traditional indicators which increases in turnover, profit, and employment, but also qualitative improvements like organizational resilience and adoption of new technologies. *Sustainability* denotes long-term viability of the enterprise thus ensuring it can meet present needs without undermining future prospects. In practice, this means pursuing a "triple bottom line" of sustained profitability along with positive social and (where relevant) environmental impact. Our analysis uses revenue growth and years of survival as quantifiable proxies for these outcomes.

Extent of credit access. In Lilongwe Old Town, the study finds that formal credit is **rarely obtained** by micro and small firms. The overall loan approval rate in our survey was only ~32.8%, meaning about two-thirds of applications were rejected. Entrepreneurs report a low perceived ease of access (mean ~2.1 on a 1–5 scale). Many SMEs are unbanked or informal, often operating with no formal credit history. In settings like the Lizulu market, shopkeepers rely on savings groups, family funds, or microloans, reflecting a context where less than 11% of MSMEs ever took a bank loan. In short, while formal finance "exists" nominally, **effective access is severely limited** by both supply-side policies and demand-side capacities.

Statistical analysis of impact. We examine how variation in credit access correlates with SME outcomes. Using Pearson correlations, we find strong, statistically significant relationships: firms with more formal credit experience higher revenue growth ($r = +0.58$, $p < 0.01$) and longer survival ($r = +0.54$, $p < 0.01$). Conversely, higher perceived borrowing costs (interest rates) correlate negatively with credit uptake ($r = -0.46$) and with both growth ($r = -0.38$) and survival ($r = -0.40$). Financial literacy shows a moderate positive correlation with both credit access ($r = +0.39$) and growth ($r = +0.31$), suggesting more knowledgeable entrepreneurs leverage loans more effectively.

Multiple regression confirms these findings while controlling for other factors. For **SME growth**, formal credit accessibility is a strong positive predictor: standardized $\beta \approx +0.45$ ($p < 0.001$). This means that improvements in credit access translate into significantly higher revenue growth. Interest rates have the opposite effect ($\beta \approx -0.33$, $p < 0.001$), meaning that high rates severely dampen expansion. A similar pattern holds for **sustainability** (years of operation): credit access ($\beta \approx +0.41$, $p < 0.001$) boosts longevity, while interest burden ($\beta \approx -0.36$, $p < 0.001$) shortens it. Notably, financial literacy enters both models positively ($\beta \approx +0.17$–0.20, $p < 0.05$), reinforcing its dual role in enabling borrowing and firm performance. Overall, credit access explains roughly 44–48% of the variance in outcomes (R^2 ~0.44–0.48), indicating a substantial impact.

Local context and cases. Qualitative interviews illuminate these quantitative patterns. Small traders routinely describe banks as "not designed for us" due to heavy documentation demands and collateral rules. For example, one retail owner recounted applying three times, only to face requests for land title deeds or multipage business plans beyond his capacity. Female entrepreneurs mentioned that application processes are time-consuming (over 10-page forms and repeated branch visits) and disheartening. Many indicated that even when banks offer loans, the terms (interest + collateral) make repayment infeasible, often trapping them in debt. These narratives underscore that **accessibility is about more than existence** of credit: transaction costs and lender attitudes also matter. In this urban Malawian setting, the formal credit market largely excludes the poorest and smallest firms. Without bank funds, SMEs in Old Town invest minimally – rarely in machinery, training, or expansion – and tend to remain in survivalist modes.

FINDINGS / OBSERVATIONS

- **Formal credit strongly boosts SME performance.** Quantitative analysis shows a strong positive link between credit access and SME outcomes. Formal loan access correlates with revenue growth ($r = +0.58$) and with enterprise longevity ($r = +0.54$). In other words, firms that obtain loans grow faster and survive longer.
- **Financial literacy matters.** SME owners with higher financial knowledge are both more likely to get credit ($r = +0.39$) and to put it to productive use, yielding faster growth ($r = +0.31$). This suggests that internal capabilities – per the Resource-Based View – significantly influence how credit translates into firm success.
- **High borrowing costs deter growth.** The burden of high interest rates has large negative correlations with credit and performance (e.g. $r \approx -0.46$ with credit access). Regression results further show that each percentage point higher perceived interest significantly reduces growth ($\beta \approx -0.33$, $p<.001$) and shortens firm survival ($\beta \approx -0.36$, $p<.001$).
- **Statistical validation:** In regression models controlling for other factors, formal credit accessibility remains a **significant positive predictor** of both growth and sustainability. For instance, a one-standard-deviation increase in access yields ~0.45 SD increase in growth and ~0.41 SD increase in sustainability. Both models fit well (R^2 ≈0.48 and 0.44). These findings confirm that credit is a critical enabler, provided the cost of borrowing is manageable.
- **Severe barriers to access.** The survey identified the prevalence of key obstacles: *stringent collateral requirements* were reported by 85.0% of firms, often valued at 170–293% of the loan amount (per industry norms). *High interest rates* burden 79.7% of SMEs. *Lengthy, complex application processes* were cited by 68.6%, imposing significant transaction costs. Over 63% blamed *low financial literacy/poor record-keeping*. Finally, *gender and youth discrimination* were mentioned by 41.5% of respondents. These percentages match the qualitative picture of exclusion.
- **Discrimination against women/youth.** Female- and youth-led businesses reported rejection rates about 1.7 times higher than average. This systemic bias suggests that formal lending practices are not inclusive, further undermining inclusive growth in the sector.

CONCLUSION AND RECOMMENDATIONS

This study underscores that **formal credit access has immense potential** to drive SME growth and long-term viability in Malawi, but this potential is largely **unrealized under current conditions**. Our findings clearly show that when SMEs overcome barriers to obtain loans, they expand sales, invest in assets, and survive longer. However, entrenched obstacles – high collateral demands, unaffordable rates, poor borrower knowledge, and procedural hurdles – form a "self-reinforcing cycle of exclusion". In practice, this means the benefits of formal credit are currently confined to a small, better-connected subset of firms.

To break this cycle, **holistic, coordinated interventions** are needed. Key recommendations include:

- **Policymakers/Government:** Establish **credit guarantee schemes** to mitigate collateral shortfalls. Reform collateral laws (e.g. enable movable assets as security). Integrate financial literacy training into education and entrepreneurship programs. Use fiscal and monetary policy to stabilize inflation and interest rates, making loans cheaper. Support digital finance (e.g. mobile lending) through regulatory frameworks (sandboxes, incentives). Mandate transparency and inclusion: require banks to report lending by gender/age, and enforce anti-discrimination codes. Incentivize SME formalization (e.g. simplified registration, bundled services) to encourage growth and bankability.
- **Regulators/Reserve Bank:** Promote tiered regulations for SME loans (simpler rules for smaller loans) and enhance credit bureaus to include alternative data (mobile money, utilities). Monitor financial institutions for bias and encourage fintech innovations tailored to SMEs.
- **Financial Institutions (Banks/MFIs):** Shift toward **relationship-based lending**: create dedicated SME units with staff skilled in small business needs. Simplify application processes and use digital applications to cut transaction costs. Develop flexible loan products (graduated

sizes, grace periods) and adopt non-traditional credit assessments (cash-flow lending, group loans). Most importantly, train officers to recognize and support viable small enterprises rather than imposing one-size-fits-all criteria.

- **SME Owners/Associations:** Invest in **financial capability** – keep proper accounts, produce business plans, and understand loan terms. Explore gradual formalization to access benefits of the system (even while managing costs). Use group networks, cooperatives, and associations to pool resources and improve bargaining power. Build transparent bank relationships by sharing performance data and demonstrating growth potential.
- **Researchers:** Future studies should track SMEs longitudinally to observe long-term impacts of interventions, and explore innovative finance models (e.g. fintech lending, credit scoring) for this context. Detailed analysis of demographic subgroups (women, youth) and institutional reforms would also be valuable.

In summary, unlocking Malawi's SME potential requires integrated action: reforming collateral and lending policies, enhancing entrepreneur capacity, leveraging technology, and ensuring inclusive practices. Only by addressing both the **supply-side constraints** and the **demand-side gaps** can formal credit accessibility translate into broad-based SME growth and sustainability.

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