Indonesia

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Summary

Specialist microfinance institutions (MFIs) of the kind common elsewhere in Asia have played a relatively minor role in Indonesia. However, the formal financial sector has extended sustainable financial services deep into the countryside. This is the result of financial sector reform and the operations of an effective state rural banking network (the BRI unit system) and a range of other small financial institutions.

In the past, Bank Indonesia has undertaken a range of activities — both "developmental" and "promotional" — to support broader financial system development, and these have also had implications for microfinance. However, the new central banking law abolishes the role of the central bank as an agent for development. Despite this, Bank Indonesia should continue to play a promotional role, by means including pilot projects, research, data collection, and policy dialogue and formulation. And while there is no case for a separate legislative framework for nonbank MFIs, the central bank should clarify the scope for such institutions to mobilize members' savings.

Indonesia

Currency Equivalent

Currency Unit – Rupiah (Rp)
US$1 = Rp7,500[1] (at mid-1999)

Abbreviations

BI	Bank Indonesia
BKD	Badan Kredit Desa (village credit institution/s)
BKK	Badan Kredit Kecamatan (district credit institution/s)
BPD	Bank Pembangunan Daerah (provincial development bank/s)
BPR	Bank Perkreditan Rakyat (people's credit bank/s)
BRI	Bank Rakyat Indonesia
CAMEL	capital, asset quality, management, earnings, liquidity (set of criteria used for rating banks)
CGAP	Consultative Group to Assist the Poorest
GBPKMI	Gerakan Bersama Pengembangan Keuangan Mikro Indonesia (United Movement for the Development of Indonesian Microfinance)
GDP	gross domestic product
GNP	gross national product
GTZ	German government technical assistance agency
IBRA	Indonesian Bank Restructuring Agency
IDT	Impres Desa Tertinggal (Presidential Instruction Relating to Backward Villages)
KLBIs	Bank Indonesia liquidity credits
KUD	Koperasi Unit Desa (village cooperative unit/s)
LDKP	Lembaga Dana Kredit Pedesaan (rural credit fund institution/s)
LPD	Lembaga Perkreditan Desa (village credit institution/s)
MFI	microfinance institution
NBFI	nonbank financial institution
NGO	nongovernment organization
P4K	Income Generating Project for Marginal Farmers and Landless
PERBARINDO	Association of Indonesian Rural Banks
PHBK	Project Linking Banks with Self-help Groups
PT	Perusahaan Terbatas (limited company)
SME	small and medium enterprise
UNDP	United Nations Development Programme
UNSFIR	United Nations Support Facility for Indonesian Recovery
USAID	United States Agency for International Development

Note

In this report, "$" refers to US dollars.

1 The rate of Rp7,500 is used for many currency conversions in this paper, and where other rates are used this is evident from the text. In a situation of extreme exchange rate instability such as in Indonesia since mid-1997, it is often misleading to convert to other currencies when discussing changes in rupiah values.

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1 Introduction and Background

1.1 Key Economic and Demographic Data

Incomes grew rapidly for three decades before the crisis. Absolute poverty fell dramatically, but many people remained vulnerable

For the purposes of this study, the most useful indicators of income per head, economic growth, and poverty levels for Indonesia (World Bank 1999, UNDP 1999) are those for 1997, immediately before the East Asian economic crisis. These can be taken to represent the levels of economic and social development which Indonesia had achieved during more than 30 years of the New Order government of Suharto (1966–1998). In 1997 Indonesia had some 200 million people with an overall population density of 109 persons per square kilometer. Gross national product (GNP) per capita was $1,110, placing Indonesia in 135th position out of 209. On a purchasing power parity basis, GNP per capita was calculated at $3,390, 125th among 209 countries. The rate of growth of GNP over the period 1965 to 1997 averaged a very creditable 7 percent. Per capita GNP grew by 4.8 percent per annum (World Bank 1999). Whereas some 60 percent of Indonesians were living in poverty in 1970, by 1996 this number had declined to below 12 percent, with the absolute numbers of the poor estimated at 22.6 million. On the face of it this was a remarkable achievement (McGuire et al. 1998).

However, as the economic crisis from 1997 was to show, many people were living just above the official poverty line and were extremely vulnerable to economic shocks. In 1997 UNDP's (United Nations Development Programme) Human Development Index for Indonesia was calculated at 0.681, putting it into the category of "medium human development" (UNDP 1999). Indonesia stood 105th among 174 countries, a position somewhat lower than its gross domestic product (GDP) per capita would have suggested. On UNDP's Human Poverty Index, Indonesia's ranking was 46th among 92 countries. The Gini index[2] of income distribution was measured at 36.5 in 1996, with the lowest decile receiving 3.6 percent of income, and the highest decile enjoying 30.3 percent (World Bank 1999).

Structural change before the crisis saw the service and industrial sectors expand; effective demand for microfinance services increased correspondingly

Such high rates of economic growth over a period of three decades resulted in substantial structural change. In relative terms, the labor force engaged in agriculture fell between 1980 and the period 1990–1997, from 59 percent to 39 percent (for males) and from 46 percent to 40 percent (for females). The proportions engaged in industry increased from 12 percent to 20 percent (males) and 12 percent to 15 percent (females). Corresponding increases occurred in the service sector: from 29 percent to 37 percent (males) and 32 percent to 39 percent (females). The increase in service sector employment reflected dynamic growth in a rapidly expanding and modernizing economy, but some service sector growth was due to the self-employment of low income people obliged to fend for themselves in the informal economy. Reflecting declining labor absorptive capacity in agriculture, due to increasing absolute population and improved agricultural productivity as well as the inability of industry to absorb all the surplus labor generated, the service sector acted as a "residual" for surplus labor. This was a situation in which the effective demand for small- and microcredit expanded rapidly.

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2 The Gini index appears in the literature, for example, World Bank (1999) and UNDP (1999), with a value between 0 and 100. This indicator is essentially the same as the Gini coefficient, with a value between 0 and 1.

No country was more severely affected by the financial crisis

No country was more severely affected by the financial crisis which commenced in mid-1997 than Indonesia. In the twelve months ending 31 March 1999, real GDP fell by 14.2 percent. In the subsequent twelve months to 31 March 2000, production recovered somewhat, although the growth was only an estimated 1.8 percent. Inflation, as measured by the Consumer Price Index, was 64.7 percent in 1998/99 and an estimated 8.5 percent in 1999/00 (Government of Indonesia and Bank Indonesia 2000). Following a decision in August 1997 to allow the Indonesian currency to float, the exchange rate depreciated drastically, triggered by capital flight. From an end-1996 level of Rp2,383 to the US dollar, the rate worsened to Rp4,650 at end-1997. In January 1998 the rate was 10,375 and by mid-year it had bottomed at around 15,000. Despite continuing volatility, the rate improved to end the year at 8,025. Some improvement and less volatility was seen in 1999, and by the end of that year the rate had firmed to Rp7,100. The pattern of interest rates over this period reflected the volatility of the rupiah; at the low point in mid-1998 the annual interest rate on the SBI (a 30-day central bank monetary instrument) stood at 71 percent, although by late 1999 it had returned to around 12 percent, with corresponding decreases in the general level of interest rates.

Deep weaknesses in the banking system were revealed; insolvency was rife and unemployment and poverty levels increased

Substantial private offshore debt held by banks and corporations proved increasingly difficult to service as the exchange rate plummeted and economic activity declined. A government guarantee of commercial bank deposits, supported by the massive provision of central bank liquidity, served to sustain the rate of capital flight during 1998 (a subject discussed in Section 3). The crisis revealed the extent of politically connected lending by the commercial banks, and especially by the state banks, and the inability of the majority of corporate sector borrowers to service loans under the conditions prevailing. From late 1997 it was becoming obvious that insolvency was rife in the banking system. In November 1997 the Government began to withdraw the licenses of insolvent private banks and decided to merge four state-owned banks into a single entity. In 1998 the Government established IBRA (the Indonesian Bank Restructuring Agency) for the purpose of managing the restructuring process and handling assets acquired in the course of this process. IBRA became responsible for merging the state banks and for taking over failing private banks for liquidation or restructuring.

The impact of the crisis on levels of poverty was severe. According to official Indonesian calculations, the proportion of population in poverty increased from 11.3 percent in 1996 to 16.7 percent in 1998, while the absolute numbers increased by some 12 million to 34.2 million people (Booth 1999, Table 6). There was evidence that lower income people were forced to trim expenditures on education and health; the numbers of primary school graduates enrolling in high school were substantially

Impact of the Financial Crisis on Indonesian Households

Official surveys over a 12-month period from late 1997 found that:

- average expenditures for all households had declined by close to one quarter
- average expenditures for households in urban areas had declined by more than a third
- regions most integrated into the international economy suffered worst, particularly the island of Java
- lower income households appeared to be maintaining expenditure better than middle and upper income households
- there was evidence of poor households selling assets to survive and patronizing the state-run pawnshops.

Source: World Bank 1999

affected at the opening of the new school year in 1998. Similarly, a pronounced drop occurred in progression rates from junior to senior high schools in both 1998 and 1999 (Booth 1999). Suharto stepped down from the presidency in May 1998 and was succeeded by his Vice President, B. J. Habibie. Following parliamentary elections in October 1999, B. J. Habibie was replaced by President Abdurrahman Wahid.

1.2 Financial sector

In terms of the relationship between microfinance and the formal financial sector, Indonesia is a special case. By comparison with other countries where microfinance is well established, the role of regulated financial institutions has been of great importance. Certain established banking institutions have been successful in extending sustainable financial services deep into the countryside and to some, at least, of the poor. There is also a wide range of small regulated financial institutions providing financial services to rural populations, including many of the poor, which have few parallels in other Asian countries.[3] The large institutions, and many of the small ones, are not microfinance institutions (MFIs) in themselves, but they have succeeded in incorporating elements of microfinance into the range of their activities (McGuire et al. 1998).

In microfinance, Indonesia is a special case — regulated financial institutions are the market leaders

The legislation governing the banking system in Indonesia (the Banking Act, 1992 and amending legislation of 1998) provides for two kinds of banks. These are the commercial banks (*bank umum*) and BPR (Bank Perkreditan Rakyat, literally, people's credit banks). Commercial banks have access to the payments system and provide general banking services. They may also provide foreign exchange services. The rural banks (as BPR are popularly known) are generally very much smaller, locally based, and privately owned institutions that do not offer check or foreign exchange facilities, nor do they have access to the payments system.

In mid-1997 there were 237 commercial banks in Indonesia. These *bank umum* comprised state banks, commercial banks owned by provincial governments (or BPD), private commercial banks, and joint venture/foreign-owned banks (Table 1). In mid-1999, after the onset of the East Asian financial crisis, this number of banks had shrunk to 179. Four of the state banks had been amalgamated, reducing the number of institutions in this class to four. The number of private national commercial banks had fallen drastically, with most of the casualties passing under the control of IBRA while others were incorporated into new joint venture banks.

The crisis caused drastic shrinkage in numbers of commercial banks and their branches

The commercial banking system in mid-1997 had around 7,300 branches. By the end of 1999 this network had diminished to some 5,800 branches, while the number of commercial banks in operation had declined further, from 237 to 173 (Bank Indonesia web site, <www.bi.go.id>). In mid-1999 there were 2,420 rural banks (BPR) in operation. In addition to the branch banking system and the offices of BPR, there were the field units (formerly called Unit Desa) of Bank Rakyat Indonesia (BRI), which numbered some 3,700 in mid-1999. This number had not been affected by the crisis.

Also included in the formal financial sector at mid-1999 were more than 5,300 Badan Kredit Desa (BKD, literally, village credit institutions). There is also a category of nonbank financial institutions (NBFIs), comprising some 2,300 rural credit fund institutions (Lembaga Dana Kredit Pedesaan or LDKP). These are regionally based MFIs, most of them associated with village governments. There are also some 630 state pawnshops, operated by the Government.

3 See Cole and Slade (1996) for a discussion of the development of the financial system prior to the East Asian financial crisis, also McGuire et al. (1998) for the development of microfinance in relation to the financial system. Bank Indonesia and GTZ (2000) describes the financial system as it relates to microfinance, post-crisis.

Table 1: Indonesian Commercial Banks: Impact of the Crisis

Date	State banks	Private Banks	Joint Venture and Foreign Banks	Provincial Government (BPD)	Total
6/97	7	160	43	27	237
6/99	4	91	57	27	179

Source: Pardede (1999).

Finally, in terms of formal financial institutions of relevance to microfinance, there are the cooperatives. Within the formal state cooperative movement (KUD, Koperasi Unit Desa or village cooperative units), there are some 5,300 cooperatives which operate savings and credit units as well as 1,160 other saving and credit cooperatives (Koperasi Simpan Pinjam). There is also an independent movement of credit unions, Badan Kordinasi Koperasi Kredit, or the Credit Cooperative Coordinating Board.

2 Development of Microfinance

NGOs have made relatively little contribution to microfinance in Indonesia

A discussion of microfinance in Indonesia must take account of two related phenomena: the limited role of nongovernment organizations (NGOs) and the importance of formal regulated financial institutions in microfinance (McGuire et al. 1998). These factors distinguish the situation in Indonesia from that elsewhere in Asia, or in other market economies more generally. NGOs have made the running in microfinance in notable cases such as Bangladesh and the Philippines; where the formal financial institutions have taken a lead in Asia, it has more commonly been as lending conduits for state-mandated "poverty alleviation" schemes, disbursing subsidized credit to limited effect. The Integrated Rural Development Programme of India is simply the best known of many such programs throughout the region. And while Indonesia has its own history of such lending, it also has more positive achievements in its financial sector development record.

The limited role accorded to NGOs in microfinance, and many other fields of social activity until recently, reflected the suspicion of the New Order government of Suharto (1966–1998) toward independent civil society organizations. The regime, and particularly its local-level functionaries, felt that NGOs could provide foci for localized political expression to challenge the elaborate and all-encompassing system of local administration, in which campaigns in sectors such as agriculture, health, family planning, and family welfare were conducted through the agency of mass organizations. While such organizations were community based, they did not have the character of civil society. In consequence, there was relatively little scope for private NGO initiatives to emerge, and such as did occur were generally linked to one or another government program.

One of the genuine successes of the New Order regime, on the other hand, was the establishment of a formal financial system, elements of which made savings and credit services accessible on a sustainable basis to a large proportion of the rural population. This is not to deny the poor performance of many banks, especially the state banks, and particularly the disastrous record of waste and corruption exposed by the financial crisis. But to understand the apparent contradiction it is necessary to acknowledge a degree of dualism in the pre-crisis financial sector. There was a gulf between those financial institutions serving the urban corporate sector and some

The "New Order" government of Suharto was successful in rural financial development

others with a substantially rural and small-to-micro base of clients. This dualism was nowhere more striking than within BRI itself, where a gulf existed between the profitable operations of its village-level units and its larger, especially corporate, operations.

The successful financial institutions with a rural and small/micro focus were the unit network of BRI, a number of small commercial banks with client bases reaching into the lower income groups and, to a lesser extent, BPR. In addition, the New Order tolerated and even nurtured the activities of several categories of small financial institutions with their origins in earlier times. These institutions are embedded in local communities. The existence of such relatively effective rural financial institutions with outreach to some, at least, of the poor was therefore another factor inhibiting the development of NGO initiatives in microfinance under the New Order government.

Box 1: Small Banks Proved More Robust in the Financial Crisis

Very small commercial banks are not only successful in microfinance, they also appear to have weathered the crisis comparatively well.

A rating list of commercial banks compiled from their published financial statements for 1998, and based on criteria of liquidity, return on assets and equity, quality of assets, efficiency, and capital adequacy showed only one bank in the top ten with assets greater than Rp1.0 trillion (say, $130 million, at an exchange rate of Rp7,700). Seven of the top ten had assets less than Rp0.5 trillion ($65 million) and four were BPD, regional development banks, one of which is found in every province (*Infobank* 1999, 22–27).

By contrast BRI, with assets of Rp34 trillion ($4.4 billion), occupied 150th place in a list of 168 banks, dragged down by the losses of its corporate lending division.

Some 13,700 "micro-banks" serve almost 30 million people

In summary, we can in broad terms accept the estimates of a Bank Indonesia (BI) publication, which describes the BRI units, the rural banks (BPR), and other small financial institutions (BKD and LDKP) as comprising some 13,700 "micro-banks." These serve a total of almost 30 million clients (Table 2). In addition, the pawnshop system serves more than 10 million clients, offering "ready cash against valuables at competitive rates of interest" (Bank Indonesia and GTZ 2000, 9). The cooperatives (KUD and the savings and credit cooperatives) are thought to serve some 6 million clients between them (Table 2). These elements of the formal financial system in Indonesia thus appear to serve a total of some 45 million people. Multiple account holding by individuals and households must mean that the actual numbers are less, though how much less is difficult to judge. Nonetheless, the degree of outreach in a nation of some 200 million people is clearly impressive. All of the institutions concerned are engaged, to varying degrees, in genuine microfinance, in the sense that they are able to serve some, at least, of the poor in a sustainable manner.

2.1 NGOs in microfinance

An estimate made soon before the financial crisis put the number of NGOs active in Indonesia at more than 5,000, of which relatively few were involved in microfinance and very few exclusively so (McGuire et al. 1998). Their activities in microfinance included participating as social and/or financial intermediaries in some official projects initiated with foreign assistance. These and other government initiatives are discussed in Section 2.7. NGOs were commonly involved in preparing self-help groups of the poor for linkage with formal financial institutions for savings and credit activities, with perhaps some "credit plus" activities. Financial intermediation including the disbursement and collection of loans was rather less common. Independent

Table 2: Outreach of Microfinancial Services in Indonesia (1999)

	No. of Units	No. of Account Holders/ Members/ Clients	Total Credit Outstanding (million Rp)	Average Loan (thousand Rp)	Total Deposits/ Savings (million Rp)	Average Deposits/ Savings (thousand Rp)
Banks/NBFIs						
BRI units	3,703	23,000,000	4,700,000	2,000	17,500,000	750
BPR	2,420	4,233,000	2,012,000	1,000	1,657,000	400
BKD	5,345	758,000	132,000	174	18,000	25
LDKP[a]	2,272	1,326,000	358,000	600	334,000	575
Pawnshops	633	10,000,000	793,000	80	—	—
Cooperatives						
KUD (Village Unit Coops)	5,335	3,050,000	356,000	115	46,000	15
Save/Cred Coops	1,160	3,050,000	553,000	820	169,000	55
NGOs						
NGOs[b]	400	200,000	—	—	—	—
Informal						
Self-help groups[b]	100,000	1,000,000	—	—	—	—
Arisan[b]	250,000	5,000,000	—	—	—	—
Total[c]		**51,617,000**				

— = data was not available or not calculated.
a Estimates for all LDKP are based on LPD and BKK data.
b Estimated.
c Double counting is likely: members of self-help groups may participate in an *arisan* and may also have a savings account at BRI units and a loan from a BPR.
Source: Adapted from Bank Indonesia and GTZ (2000), Table 2.

activities on more conventional MFI lines, such as a small number of Grameen replications, are still relatively rare. A more recent estimate (Table 2) puts the number of NGOs engaged in microfinance at around 400, and the number of their clients at perhaps 200,000.

While NGOs have been relatively insignificant in microfinance, some have acquired or established small regulated banks

One avenue for NGO initiative in microfinance, facilitated by the availability of the BPR institutional form since 1988 (see Section 2.3) and its modest capital requirements, has been for them to acquire or establish rural banks. Major NGOs such as Bina Swadaya and Yayasan Indonesia Sejahtera did so, with the former of these operating five such banks before the crisis, for a clientele which included both individuals and members of its self-help groups. PT Ukabima, a not-for-profit company affiliated with the international NGO, Catholic Relief Services, was building a small chain of affiliated BPRs. At least one NGO had taken this approach further, to the point of establishing a full commercial bank (Bank Purba Danarta) with initial capital of $5 million (McGuire et al. 1998).

In the face of the financial crisis and the major political changes it precipitated, the international community moved from 1998 to assist the new Habibie government to put a “social safety net” in place, to ameliorate the sufferings of the substantially increased numbers of the poor. The Government made commitments to the International Monetary Fund which involved “shielding the poor from the worst of the crisis” while moving to stabilize the economy. It recognized that NGOs have certain advantages when compared with normal bureaucratic agencies: greater flexibility in the face of emergency, and greater capacity to reach the poor under some circumstances. As a result, NGOs began to take on a new and higher status; they were to be given greater responsibility in the carriage of certain programs, as an "alternative solution to reaching out to the people" (see UNSFIR 1999, ch. 5). In fact, most of these social safety net programs involved simply the revival, enlargement, or adaptation of previous government programs, including some which had involved the use of subsidized credit for poverty alleviation (UNSFIR 1999). Such programs were not easily detached from the bureaucracy, and there was much criticism of the mistargeting and ineffectiveness of social safety net programs during 1998 and 1999.

NGOs came to prominence in social safety net programs after the crisis, and those active in microfinance have begun to organize

With the election of President Abdurrahman Wahid late in 1999, Indonesian NGOs believed the political environment had become favorable for more autonomous civil society initiatives in microfinance. Beginning in 1994, MFIs active in BI's pilot microfinance programs had attempted without success to form an umbrella body for coordination and information sharing (McGuire et al. 1998). However, in March 2000 President Abdurrahman presided over the inauguration of such a body, GBPKMI (United Movement for the Development of Indonesian Microfinance). Representatives from the NGO movement, government, the association of rural banks (PERBARINDO), research institutions, and self-help groups signed a declaration outlining the objectives of GBPKMI. A deputy governor of BI signed on behalf of the central bank.

Objectives stated in the declaration included increasing the quality and numbers of MFIs, encouraging financial interests to support the development of microfinance, and improving access of the poor to capital and micro-enterprise development services. Significantly, it stressed the value of a pluralistic approach to microfinance provision, avoiding any standardised (*seragam)* model (GBPKMI 2000). With the state minister for women's empowerment as its chair, the movement appears to have significant political support and the participation of the central bank is also important. However, there do not seem to have been any commercial bankers involved.

2.2 Commercial Banks and Microfinance

Leaving aside BRI, a handful of small commercial banks operating at the local level have developed a small-to-micro level clientele, of which Bank Dagang Bali is possibly the best known example. There has otherwise been very limited autonomous involvement of commercial banks in microfinance in Indonesia. Official microfinance schemes implemented by BI (see Section 2.7) have involved a number of banks as channeling agencies, mostly state banks but including some smaller private banks as well. Rhetoric aside, programs of the latter years of the New Order government, such as the small-scale business credit (which required 20 percent of commercial bank lending to be directed to the "small" enterprise subsector), and the channeling of subsidized central bank "liquidity credits" to the agricultural cooperatives via commercial banks, involved little genuine microcredit and did not reach the poor to any significant extent. The experience of small commercial banks such as Bank Dagang Bali provides encouragement for those who think commercial banks can be profitably involved in microfinance (see Goodwin-Groen 1998) but their achievements remain relatively isolated.

At the other end of the scale, BRI is one of the largest banks in Indonesia, and one of the three state commercial banks (of seven) to survive the crisis without amalgamation. Its unit (formerly Unit Desa) system within the renamed Microbanking Strategic Business Unit has successfully encompassed elements of microfinance by even the strictest definition (McGuire et al. 1998). A publication by the Consultative Group to Assist the Poorest (CGAP) summarizes factors often cited to explain the good performance of the BRI units (CGAP 1997). Interest rate liberalization in 1983

> **Box 2: Bank Dagang Bali — A Small Bank Successful in Microfinance**
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> Bank Dagang Bali is a successful small bank with a strong microfinance focus. At end-1999, it had almost 400,000 savings accounts with a mean value of Rp1.43 million (say, $200 at the exchange rate of 7,100 on 31 December) and 9,600 loan accounts with a mean value of Rp24.1 million (say, $3,400) (Oka 2000).
>
> In an *Infobank* survey (1999) the bank was rated 69th among 168 banks, with an overall rating of "adequate" (*cukup bagus*). It scored well on liquidity, asset quality and capital adequacy, fairly poorly on profitability and efficiency. However, returns on both assets and equity were still positive, in a banking landscape of heavy and widespread losses.

A few small commercial banks have entered microfinance with profit

freed BRI to set lending and deposit rates at levels sufficient to cover costs and mobilize savings. A stable macroeconomic environment, political commitment to the sustainability of unit operations, substantial investment in professionalizing their human resources and, finally, "clear and transparent financial reporting and accountability" are among the most important of these factors.

The corporate turnaround of BRI's village-level operations, from being primarily a channeling mechanism for subsidized agricultural credit prior to 1983, with characteristically low repayment rates, to an efficient and profitable rural financial institution on the eve of the financial crisis in 1997, has been extensively documented.[4] However, its performance in the face of that crisis puts the seal on its reputation as the most effective and efficient rural financial institution in the developing world. BRI's micro-banking operations serving small clients through the unit network provided the lifeblood of liquidity for the bank as a whole throughout the crisis.[5] Microfinance borrowers from the BRI units (including microcredit clients from among the poor) continued to make over 97 percent of the installments that fell due in the period from mid-1997 to mid-1999. This performance was better than that for small loans through the BRI branch network, and much better than for its corporate sector lending (Patten 1999).

BRI is a major bank with a profitable "micro-banking" division

BRI as a whole experienced a substantial increase in nominal savings over the crisis period as a "flight to quality" occurred from banks perceived to be more risky. BRI units maintained their share in BRI's total deposits during this process, as the nominal volume of micro-savings also increased substantially. While BRI as a whole adjusted interest rates on its term deposits as market rates rose, it allowed the rates paid on the unit-administered Simpedes and other passbook savings products to lag substantially behind the market (Patten 1999). Holding down deposit rates lowered the units' average cost of funds and enabled them to maintain a positive interest rate spread throughout the period (when many banks were experiencing negative spreads). The BRI unit lending window remained open right through the crisis, while many commercial and rural banks suspended lending altogether.[6] Patten's analysis of this performance is instructive, pointing to a characteristic of microfinance borrowers which may help to explain their good repayment performance (Patten 1999, ii):

4 See Cole and Slade (1996), Patten and Rosengard (1991), and Boomgard and Angell (1994).

5 It is customary for the Microbanking Strategic Business Unit to supply liquidity to other divisions of the bank, at a transfer price above its own cost of funds.

6 This, as already noted, did not cause the units to lose savings. In fact, unit savings deposits, in nominal rupiah terms, rose from Rp7.09 billion at end-1996, to Rp8.84 billion at end-1997, to Rp16.15 billion at end-1998 and Rp17.06 billion at end-1999 (Zakaria 2000). So far as lending was concerned, Kupedes loans rose from Rp4.08 billion at end-1996 to Rp4.68 billion at end-1997, Rp4.70 billion at end-1998, and Rp5.96 billion at end 1999 (Zakaria 2000).

BRI's micro-banking division performed outstandingly during the crisis

Micro borrowers appear to value their access to credit and savings services very highly. They are reluctant to break their banking relationship with the BRI units even if they have to squeeze consumption to make their loan repayments on time. BRI has been careful to keep the micro credit window open so that those who pay on time are able to borrow again if their enterprise justifies it. BRI learned from an earlier experience when this window was partially closed for fear that savings were going to decline; the result was an increase in the number of borrowers who did not pay on time.

As mentioned, BRI is one of three state banks which the Government will allow to continue trading as a single entity in future. However, a letter of intent addressed to the International Monetary Fund in January 2000 (Government of Indonesia and Bank Indonesia 2000) indicated (para. 46) that BRI would divest its corporate loans except for "certain traditional customers," which would amount to no more than 20 per cent of total portfolio. It was to "refocus" on its "traditional activities of retail banking and microfinance"; these changes were to be effected during 2000.

Quite separately, BRI has considered establishing a "Microfinance Foundation" which could trial methods of outreach, including group approaches, found effective in international microfinance experience. This would enable BRI units to trial collateral-free lending based on group guarantees. Unit lending has always been, with some minor experimental exceptions, secured against collateral. Units have adopted a liberal approach, allowing, for example, household utensils to serve as collateral for very small loans. But, inevitably, the physical collateral requirement has filtered out the poorest borrowers. Such borrower groups might be permitted to access BRI funding at the internal transfer price for which the Microbanking Unit makes liquidity available to other divisions of the bank. Such an innovation would involve BRI in social intermediation activities not previously undertaken by units (R. Patten, personal communication).

2.3 BPR (Rural Banks) in Microfinance

Rural banks (BPR) were launched by financial deregulation

The term "BPR" (people's credit bank, but more commonly translated simply as rural bank) is used in the Banking Act and elsewhere to describe a range of small financial institutions. In this report the term will be used only for the institutions having that status under the Act and which are subject to the direct regulation and supervision of the central bank.[7] There were (as seen in Table 2) 2,420 of these small banks in mid-1999. Their present status is a product of a financial deregulation "package" in 1988. This recognized some existing small financial institutions as BPR, to be regulated and supervised by BI. Some other existing institutions (LDKP, see Table 2) were given the opportunity to upgrade themselves to that status. Finally, new institutions were allowed to seek licenses as BPR supervised by BI. These BPR had a minimum capital requirement of only Rp50 million (at that time around $28,000). For one reason or another, the great majority of LDKP have either chosen not to come under the BI supervisory umbrella, or have not satisfied the criteria. They continue to operate as before, and are discussed in the next section and elsewhere.

Under the Banking Act, BPR may only accept time and savings deposits; they may not issue checks or have access to the payments system. They may provide credit, and in doing so are subject to the same limits as other banks, including related party and large borrower limits. They may make and accept interbank deposits and

7 For a guide to the classification of those small financial institutions in Indonesia which are collectively called BPR, together with recent data, see Bank Indonesia and GTZ (2000, 14–15). See also Cole and Slade (1996, 128–30).

deal in short-dated BI securities. More than 80 percent of BPR are on Java or Bali, where only 60 percent of the population live. And despite the term "rural bank," most are in urban or peri-urban areas rather than rural areas (the largest single concentration in Jakarta), with relatively few in the impoverished provinces of Eastern Indonesia. Most are limited liability companies in private ownership, operated for profit. Some are in chains associated with commercial banks or with NGOs. Some are registered as cooperatives, others are organized on Islamic principles (BPR Syariah), while some are owned by local governments.

The typical BPR borrower is a petty trader with a short-term micro-loan

In mid-1999, according to BI, mean loan size was around Rp1 million ($135) and the mean savings deposit (that is, excluding time deposits) was Rp130,000 ($17.50). Loan-to-deposit ratios were typically around 80 percent, and the average BPR had assets of perhaps Rp1,500 million ($200,000), serving some 3,000 clients (Bank Indonesia and GTZ 2000). In total, BPR credit outstanding was around $250–$300 million in mid-1999 (at an exchange rate of Rp7,500), some 40 percent of the credit outstanding from BRI units, but dealing with lower level borrowers on average. Compared with the average BPR loan size of Rp1 million, the mean BRI unit loan size was Rp2.0 million. In May 1999, BPR accounted for 0.65 percent of credit outstanding in the banking system and their deposits were some 0.25 percent of all deposits. Their assets exceeded the total outstanding credit reported by the savings and loan cooperatives and cooperative savings units, though the cooperatives tended to make even smaller loans (Timberg 2000a, see also Table 2). According to Bank Indonesia and GTZ (2000, 16), "[t]ypical loans offered by a BPR are short-term microloans for petty traders ranging from Rp100,000 to Rp2 million, with 3–6 months maturities, daily instalments, flat rates of interest in the range 2–4 % per month."

Timberg commented that before the financial crisis there was "an emerging pattern" among these small banks of "a good number of large, generally profitable BPR with good management and loan recovery, and a number of generally smaller, marginal or dormant ones." He noted that BPR had withstood the crisis, in general, much better than the commercial banks, although the marginal institutions had been badly affected.[8] The reported level of nonperforming loans rose from 18.7 percent in December 1997 to 21 percent of portfolio in December 1998 (Timberg 2000a). These developments resulted in a strengthening of prudential supervision and some remedial intervention by BI during 1999, both of which are discussed later. In 1999, BI froze the operations of 72 BPR while the overall level of nonperforming loans rose to 37 percent.[9] However, BI reported that in general the urban BPRs were in worse shape. By contrast, "rural BPR operating in niche markets, especially those owned by the communities or with strong community links, have been doing rather well. Some of them have been able to increase their savings position, while maintaining their portfolio quality and increasing their margins" (Bank Indonesia and GTZ 2000, 17).

8 In 1998/99, BPR deposits declined from Rp1,600 trillion to Rp1,530 trillion ($213 million to $ 204 million) while credits declined from Rp2,290 trillion to Rp1,990 trillion ($305 million to $265 million) and reported profitability went from positive Rp30 billion to negative Rp42 billion (positive $4 million to negative $ 5.6 million) (Timberg 2000a, 6–7).

9 By comparison, at the height of the crisis the nonperforming loans of the commercial banking sector were calculated at some 60 percent (Bank Indonesia and GTZ 2000). Data for the BPR sector in mid-1999, based on CAMEL ratings, show 42.5 percent of BPR as "sound," with 14.7 percent "fairly sound," 14.7 percent "less sound," and 28.1 percent "unsound" (Bank Indonesia and GTZ 2000). More recent efforts to clean up the sector and to reduce the number of institutions are described in Section 5.

The "small financial institutions" are a diverse group of locally based institutions with a genuine micro-finance client base

2.4 Small Financial Institutions

These are NBFIs, consisting of BKD (village credit institutions) and LDKP (rural credit fund institutions (see Table 2).[10] The former date back to the late nineteenth century and were formed under Dutch rule on Java and Madura islands as pioneer microcredit institutions. "LDKP" is a generic title for a variety of small savings and credit institutions which exist in many provinces with regional variations. There were some 5,300 BKD in mid-1999. They are credit-only institutions serving three quarters of a million people, with loans outstanding of Rp132 trillion ($17.6 million) at an average loan size of Rp174,000 ($23). This suggests genuine microcredit. BKD and other locally based small financial institutions of the NBFI type were never subject to BI interest rate restrictions. This enabled them to set interest rates at sustainable levels well before the financial sector reforms of the 1980s.

LDKP mostly came into existence during the period from around 1970 (when recovery from the economic chaos of the Sukarno years commenced) to 1988, when the financial reform package, mentioned previously, lifted the ban on establishment of new banks. Nearly 2,300 LDKP were operating in mid-1999 (Table 2) with 1.3 million clients. Two particular provincial models of LDKP, found respectively in Central Java and Bali, are of particular interest. The BKK of Central Java (Badan Kredit Kecamatan, or district credit institution) served 440,000 clients with loans totaling Rp96 trillion ($12.8 million) at an average of Rp325,000 ($44). Total savings held by BKK were Rp66 trillion ($8.8 million) at an average of Rp150,000 ($20).

Box 3: Grassroots Banking in Indonesia — The BKK

BKK Operations

- There are now 788 BKK units in Central Java operating an estimated 4000 village posts
- A typical BKK office consists of 5–10 staff, equipped with motorcycles, in a small office building with simple furniture.
- A unit runs 5–7 village posts, which open on certain days of the week or sometimes only once a month, according to the installment periods of loans made at that post. Village post accounts are consolidated at the BKK.

Lending Procedures

- Loans are unsecured and character based, relying on references from local officials rather than based on feasibility studies.
- Initial loans are small and gradually increased, based on repayment performance. This mechanism functions as the primary repayment incentive.
- Loans are paid in equal installments, carrying maturities from 22 days to 12 months, according to six different repayment plans with monthly effective interest rates ranging from 2.2 to 10.8 percent.
- Savings are mandatory for every loan and are treated as cash collateral, becoming accessible only after full loan repayment.

Source: Bank Indonesia and GTZ (2000), 20, 21

The small financial institutions have developed and refined best practice microfinance procedures

BKK were set up by the provincial administration of Central Java and their success during the 1970s attracted replication in a number of other provinces, including Bali, where local communities set up LPD (Lembaga Perkreditan Desa, or village credit institutions). LPD differ from the provincial government controlled institutions in Central Java in being owned by local community organisations, and the glue of customary obligations and relationships is a significant factor in holding these small

10 This section is based very largely on Bank Indonesia and GTZ (2000) a publication of the Bank Indonesia and GTZ project, to be discussed later. The writer is indebted to Mr. Dominique Gallman of GTZ for generously making this material available.

financial institutions together. In mid-1999, 910 LPD served some 545,000 clients (of a total population of 2.8 million on Bali). Some five of every six households are reached by LPD, a degree of outreach which Bank Indonesia and GTZ think may be unrivaled anywhere.

LPD on Bali are "highly profitable," and their operations suggest the value of community involvement and social cohesion for MFIs

In mid-1999, LPD had loans outstanding of Rp170 trillion ($22.7 million), at an average of Rp860,000 ($115) per loan. Savings totaled Rp182 trillion ($24.3 million) with the average balance at Rp1 million ($135). While the degree of social cohesion in local communities in Bali is probably exceptional, there may still be a lesson here concerning the value of community involvement. Twenty-four LDP operate with assets above Rp1 billion ($130,000), which is larger than the average BPR. LDP are "highly profitable," earning 10 percent per annum on assets and 60 percent on equity. Earnings are gained almost exclusively from lending, with loanable funds derived from savings and deposits. BPD of Bali operates as banker to the LPD system. Under a government decree of 1992, LPD ought to have become licensed as BPR under BI supervision by October 1997, but none has applied to do so. Since they now mobilize more savings than BPR on Bali, this poses a regulatory problem, discussed later.

Among NBFIs listed in Table 2, there are also the state-operated pawnshops, said by Bank Indonesia and GTZ to serve as many as 10 million people. In fact, that was the figure for 1998, at the height of the crisis. In 1996 and 1997, the numbers had been around 5 million, while in the latter year some 23 million items were pawned (Bank Indonesia 1998). Cole and Slade (1996) describe them as offering important financial services to the poor who hold savings in the form of valuables and other moveable possessions, by enabling them to obtain cash for limited periods at rates of interest close to those charged by BRI units for Kupedes loans. This observation was certainly corroborated by the events of 1998. Cole and Slade quote McLeod (1984, 95) as saying that "the pawn redemption rate may be as high as 99 percent, and unredeemed pawns are auctioned without delay. In this respect, at least the pawnshop ... service is more effective in providing the poor with access to institutional credit than some of the programmes administered by State banks." Data for 1998 (Bank Indonesia 1999) indicating that only 0.7 percent of pledged goods were auctioned that year suggest that operations still conform to McLeod's description. While McLeod's positive evaluation predates the success of the BRI units, it still serves to describe the current value of pawnshops in the particular circumstances of many poor people.

The state pawnshops provide a valuable service for the poor

2.5 Cooperatives

From Table 2 we see that the KUD units which operate financial services cooperatives serve some 3 million people, while the Koperasi Simpan Pinjam (savings and credit cooperatives) serve a similar number. Of the KUD, Bank Indonesia and GTZ (2000, 9) say that:

> [they] have so far played a minor role as financial intermediaries due to repressive regulation and excessive government interference under the New Order regime of former President Suharto. However, the more than 5,335 government-sponsored KUDS are established throughout the country and would in fact possess a tremendous microfinance potential if properly stimulated and regulated.[11]

11 On the status of KUD in the late years of the New Order government, see McGuire et al. (1998, 147–48). Under the Habibie government (1998–1999) KUD were given much responsibility for the disbursement of emergency credits during the financial crisis, a process which, as noted in Section 2.7, attracted criticism due to mistargeting and leakage. While there has been some speculation about the future of cooperatives it would be difficult to write these institutions off, given the importance of the cooperative principle in the Indonesian national ideology of Pancasila, as enunciated by presidents Sukarno (1949–1966) and Suharto (1966–1998). Much depends on the balance of forces within future governments.

Independent savings and credit cooperatives may flourish in the new political climate. This is an opportunity for microfinance

In fact, according to data compiled by Timberg (2000a, Table 1B), the two groups of cooperatives already mentioned held levels of passbook savings broadly comparable with those of BPR in 1998 and 1999, and from 55 to 70 percent of the value of performing loans made by BPR. Timberg comments that cooperative loan sizes are generally even smaller than those of either the BRI units or BPR, but the judgment that their role in microfinance is still a minor one seems appropriate. In the more liberal environment of the Abdurrahman Wahid government, independent cooperatives are now free to obtain licenses and to set up networks even at the national level. This may offer opportunities for the emergence of new, poverty-focused, cooperative initiatives. Bank Indonesia and GTZ (2000) refer to the activities of a number of such new institutions, including some for women. The major NGO, Bina Swadaya, has taken advantage of the new situation to set up a financial services cooperative, Koperasi BMM.

2.6 Informal Finance

There is a well-established tradition of informal rotating savings and credit associations in Indonesia, known as *arisan*. In Table 2, Bank Indonesia and GTZ (2000) estimate there may be a quarter of a million such *arisan* in operation at any time, involving some 5 million members. This suggests there is an indigenous framework in which group-based microfinance methods might flourish. Groups have been trialed in a series of government-sponsored projects with international support (including the P4K and PHBK projects and the Microcredit Project discussed in the next section). Groups have also been used in several mass campaigns conducted by other government agencies. These latter activities are also discussed in the next section. Perhaps 100,000 self-help groups exist, with a million members (Table 2), though no data are available concerning the funds in circulation through these groups. Microfinance services are also provided, as in many countries of the region, by commercial moneylenders, family networks, and shopkeepers and traders. Again, no basis exists for an estimate of the value of financial services provided in these ways.

2.7 Government Microfinance Programs

The Government, acting through the central bank and a number of line departments, has actively supported microfinance programs.[12] These became more important over time as the overall incidence of poverty fell and the need for a more targeted approach was felt. To some extent this reflected a realization by the New Order government that, despite the successes of BRI units and the small financial institutions in extending sustainable financial services to lower strata of the population, there remained a core group of the very poor untouched by this progress. BI, supported by the German government technical assistance agency, GTZ, took the first initiative in this field with the PHBK Project (Project Linking Banks with Self-help Groups) from 1989. In this, BI relied on the services of "self-help promoting institutions" which included NGOs, to nurture the linkages between self-help groups of the poor and banks. During the 1990s, PHBK made progressively greater use of the BPR system to link directly with self-help groups in their local areas. GTZ technical support for the project phased out in 1999, but it continued with some further assistance from BI.

Rotating savings and credit associations are a well-established tradition in Indonesia

Other government microfinance programs that have employed the mechanism of self-help groups include the Proyek Kredit Mikro (Microcredit Project) operated by

12 This section draws substantially upon McGuire et al. (1998, 152–60). We do not deal in detail in this present study with programs fuelled by BI "liquidity credits" and mediated through the KUD system, which despite the rhetoric have had little to do with microfinance. Nor do we deal with the KUK (small-scale credit program).

Some official microfinance programs have used self-help groups and attempted to achieve sustainability

BI with support from the Asian Development Bank since 1995 and the P4K Project (Income Generating Project for Marginal Farmers and Landless) initiated by the Department of Agriculture with assistance from UNDP. The latter project is now in its third five-year phase with support from the Asian Development Bank and the International Fund for Agricultural Development.

Under the Microcredit Project, BI disburses funds to BPD (the provincial government commercial banks) and BPR. The latter onlend directly to microentrepreneurs, while BPD lend to small financial institutions of the type discussed in Section 2.4. P4K makes use of BRI rural branches for disbursement and supervision, while repayments by individuals are made to the BRI units. In the PHBK and Microcredit projects, the final on-lending rate to individual borrowers is set at a sustainable level. Rural banks and other small financial institutions involved in PHBK and the Microcredit Project onlend at their normal levels, from 2 to 4 percent per month depending on the circumstances of each loan. In the P4K Project, lending rates are lower and there may still be a small implicit subsidy for participating groups. BRI branches lend to groups at 12 percent flat per annum (22.15 percent effective annual),[13] with the self-help group determining the rate at which individual members borrow.

By contrast with these three government programs, there has been the parallel development of mass credit schemes, in which sustainability has not been an objective, and which tended to undercut the sustainable programs already described. These mass schemes reflected political concern with the problem of the hardcore poor (McGuire et al. 1998). The first was the Inpres Desa Tertinggal (IDT) which commenced in 1993; a second campaign, the Prosperous Family Program, was introduced as an emergency measure in 1996. IDT was an inter-departmental program coordinated by BAPPENAS (the national development planning board). Targeting “backward” villages, especially those on the “Outer Islands” other than Java, Bali, and Sumatra, the IDT program was particularly concerned to redress regional income equalities. Among a package of infrastructure, training, and other initiatives, the program made capital grants to each backward village to fund income-generating activities of the poor, organized in groups. Loans were made at the highly subsidized rate of 6 percent flat per annum to final borrowers. By 1997 some 120,000 groups and 3.3 million persons had received loans.

In 1996 as an emergency response to political concerns about income inequality, President Suharto launched the Prosperous Family Program[14] using the National Family Planning Coordinating Board (BKKBN) as the implementing agency. Some 9.8 million Indonesian families received highly subsidized funding under this program in just 12 months. These programs were financed by a levy of 2 percent on the incomes of corporations and high income individuals, channeled through one of the Suharto family foundations. The Prosperous Family Program was essentially a populist response to resentment of the perceived wealth of certain groups within Indonesian society. While the IDT program received no further direct funding after 1997, the Prosperous Family Program was still growing when the financial crisis commenced. It became one of the social safety net programs designed to ameliorate the impact of the crisis on the poor (see Section 2). Cumulative disbursements by the various microcredit programs implemented by BKKBN rose from Rp317 billion in December 1997 to Rp768 billion in December 1998 and Rp900 billion in March 1999. This last figure is equivalent to approximately $120 million at an exchange rate of Rp7,500 (Timberg 2000a).

Mass government credit programs have been less concerned with sustainability

13 Over the crisis period from mid-1997 this rate would have been below the BRI internal transfer price for liquidity from the unit division to other divisions of the bank.

14 This scheme had a number of activities, including the Takesra (Prosperous Family Savings Scheme) and the Kukesra (Prosperous Family Credit Scheme).

Politically inspired credit programs have threatened to reverse the trend toward sustainability

The Prosperous Family and IDT programs reversed the movement towards sustainability in rural financial services for the poor in Indonesia. This regressive tendency was reinforced by a massive expansion of other forms of subsidized credit after the onset of the crisis, financed by central bank "liquidity credits." These included credit for farmers, credit for members of primary cooperatives, and credit to rural cooperative units. BI liquidity credits were also channeled to commercial banks, to enable them to be onlent to particular targeted groups of borrowers at below-market interest rates. The 1998/99 central government budget allocated Rp1.8 trillion ($240 million at an exchange rate of Rp7,500) to 17 separate credit programs in order to subsidize their lending rates (*Bisnis Indonesia* 1999). The Habibie government budget for credit subsidies of all kinds (including agricultural and housing credits) totaled Rp9.0 trillion ($1.2 billion) for 1999/00 (*Bisnis Indonesia* 1999). However, even this was not the height of BI's liquidity credits during the crisis. This subject is discussed at greater length in the next section.

While this expansion of subsidized lending was perhaps understandable in the face of widespread suffering, it distorted rural credit markets for programs aiming at sustainability. Also, as previously mentioned, the implementation of these and other social safety net programs has been much criticized. The president of a leading Indonesian NGO said that:

> [The social safety net] was widely criticised by NGOs. In short, critics indicate that the project has wrong target, having no vision of people empowerment, [that it] neglected the existing self-help groups, promot[ed] quasi-participation, contain[ed] political interest and [was] uncoordinated (Ismawan 2000, 9).

3 Role of the Central Bank

3.1 BI under the New Order and Habibie governments, from 1966

In the early years of the New Order government, BI had a strong developmental mandate

The late years of the Sukarno government, to 1965, were a period of inflation and economic stagnation.[15] Much economic exchange was either demonetized or conducted in foreign currency. In this period the role of the central bank was primarily to act as a "payment agency" for the Government, while presiding over what was effectively a monobank system, with all state banks amalgamated and the private banks essentially inactive. A new central bank law of 1968 was designed "to provide some autonomy for BI, to give it the major responsibility for supervision of the banks ... and to set an appropriate legal structure for banks" (Cole and Slade 1996, 37). Under this legislation, BI was given the objective of improving the standard of living of the people by:

(i) regulating, safeguarding, and maintaining the stability of the value of the rupiah; and

(ii) promoting stability of production and development, as well as expanding employment opportunities.

This appeared to imply a strong "developmental" mandate, as well as a concern for price and exchange rate stability. These tasks were to be conducted in line with

15 This account of the evolving role of BI between 1966 and 1999 draws heavily upon Cole and Slade (1996).

government policies, and ultimately in conformance with presidential directions, suggesting severe limits to the independence of the central bank.

Financial liberalization commenced in the 1980s

During the 1970s, BI maintained a financial sector regime in which central bank refinancing of priority sector lending, the control of bank deposit and lending rates, and restrictions on entry to the banking industry were pervasive and financially repressive influences. However, in 1983 interest rate restrictions were removed, freeing the private banks to compete with the then dominant state banks and triggering an expansion in the private share of total bank assets which continued until the crisis of 1997. Another longer term consequence of these reforms was the turnaround of BRI's rural operations. The introduction of the BRI rural savings and credit products, Simpedes and Kupedes, changed the bank radically, as already described. A financial deregulation "package" introduced in 1988 reduced barriers to the entry of new private banks, facilitated the expansion of existing branch networks, and reduced the reserve requirements imposed on banks. It also liberalized entry to the small financial institutions sector, permitting new, privately owned BPR to be licensed with very low minimum capital requirements (see Section 2.3). This stimulated rapid growth in numbers of these rural banks. Commencing 1990, the Government committed to rolling back the KLBIs (BI liquidity credits) which refinanced much priority economic activity and were associated with resource misallocation and corruption. This effort met with limited success, at best (McLeod 1999a).

BI achieved a degree of independence, but the crisis of 1997–1998 showed the limits of this

Cole and Slade (1996, 40) suggest that over time BI achieved a fair degree of independence for the day-to-day management of monetary policy and other central banking functions. But it was beholden to a broader coalition of policymakers for major macroeconomic policy and for decisions on new credit programs, major credit allocations, or banking regulation. This coalition "endeavored to protect BI and the financial system from the worst ravages of powerful special interests," although it was "unable to prevent all such intrusions." Cole and Slade believe a more independent BI would not have been so successful. Further, Cole and Slade (1998) regard BI as having essentially financed the run on the rupiah in the second half of 1997 and early 1998, by propping up overexposed commercial banks with massive liquidity credits. Coupled with a government guarantee of all bank deposits in early 1998, this funded capital flight and left a large number of banks deeply in debt to BI, ultimately requiring their transfer to the control of IBRA. In the meantime, the governor and a number of directors had been dismissed by President Suharto, presumably for impeding these processes.

Central bank legislation in 1999 asserted BI's independence and revised its mandate

A new central banking law was enacted in 1999 by the Habibie government (Law No. 3 of 1999 on Bank Indonesia) at the urging of the International Monetary Fund. Designed to secure greater independence for BI, the Act protects members of BI's board of governors from dismissal. The Act also reduces BI's mandate to the single objective of maintaining the stability of the rupiah, both internally and externally. The central bank may not lend to the Government, nor may it buy government bonds except in the secondary market. Its capacity to act as lender of last resort to commercial banks, so abused at the height of the crisis, is circumscribed. BI's function as the prudential supervisor of banks is to be transferred, by the end of 2002, to a new institution to be created for the purpose. However, it is to retain the role of bank regulator and will remain responsible for the overall soundness of the banking and payments systems. Finally, BI's previous role as an "agent of development," responsible for channeling credit to priority sectors and groups, was abolished. These credit functions were to be transferred to other entities, and the costs of any credit subsidies were to be approved as part of the government budgetary process, rather than being funded by BI.

4 Central Bank Support for Microfinance Initiatives

4.1 Perceptions of the Central Bank about Microfinance

With regard to the views of BI on microfinance, McGuire et al. (1998) concluded that the central bank in the late Suharto period did not have policies on microfinance as such. Instead, it saw its core functions as set out in the 1968 legislation: monetary management, the payments system, and bank supervision. Support for MFIs by the central bank, discussed in sections 4.2 and 4.3, was concerned with aspects of financial sector development (as also mandated by the 1968 legislation), not specifically with poverty alleviation. A former governor, when invited (in effect) to make a statement of the central bank's support for microfinance at the BankPoor '96 conference in Kuala Lumpur, treated the issue with caution, while acknowledging that BI's policies concerned with "financial aspects of poverty alleviation" did have relevance to "national efforts to alleviate policy." He made it clear, however, that poverty alleviation itself was a national government function, which BI could only address "within the scope of its role as a central bank" (Djiwandono 1996).

Poverty alleviation is a government function, which BI addresses only within the scope of its role as a central bank

The above is probably still a valid statement of BI's position, the more so since the legislation of 1999 has focused the central bank primarily on monetary stability and distributed its credit functions to other agencies. On the other hand, financial sector development is still an appropriate concern of BI, in terms of its concern for monetary stability, and especially since it retains regulatory responsibilities for financial institutions, including those which provide microfinance services.

4.2 Developmental Activities for Microfinance

A major activity of BI under the successive governments since 1966 has been the refinancing of a wide variety of credit schemes for small-scale economic activities, some of which were at least nominally concerned with the economic activities of the poor.[16] BI liquidity credits (KLBIs) were made available for members of KUD (village cooperative units) and for support of the units themselves. Special credits were available for the purchase of crops from KUD members and to finance necessary agricultural inputs; other credits supported the small business enterprises of members. The credit of most general application was the farmers' activities credit. Sometimes described as microcredit, these lending arrangements benefited landowners and the cooperative movement itself; they did not benefit the poor to any significant extent. The same judgment may be made for the great bulk of KLBI refinancing via the cooperative units, which were noted for the extent of their misappropriation and misuse.

BI's numerous credit commitments, which had little to do with micro-finance, have now been surrendered to other agencies

Other KLBI credits were available for a range of small- and medium enterprise (SME) activities, channeled via commercial banks and BPR. Again, these had little of the character of microcredit, and their benefits did not usually reach far down to the lowest strata. Under the central bank legislation of 1999, BI was required to surrender these refinancing functions to a new entity, PT Madani. As a second tier institution created specifically for the purpose, PT Madani was to take over BI's SME loan portfolio and some of the agricultural loans to cooperatives, with BRI responsible for the balance.

16 BI has reviewed its involvement in such schemes since the early 1970s (Bank Indonesia 1997).

Developmental and Promotional Activities of Central Banks

Developmental activities include:

- participating in the capital and management of development institutions
- mandating priority sector lending
- administering differential interest rates, and preferential rediscount rates and credit facilities.

The promotional role is activity that generates externalities and reduces transaction and information costs within the financial system.
This can include:

- support for pilot projects using innovative approaches to provision of financial services
- conduct of research
- collection and publication of data
- advocacy, leadership, and training.

Source: Chandavarkar (1996)

In terms of genuine "developmental" support for microfinance by BI, there were a small number of examples. One instance was the refinancing of lending under the PHBK project of bank/self-help group linkages, from its commencement in 1989. Participating banks benefited from liquidity credits until 1992, when this support was phased out as part of a more general process of reducing reliance on KLBI. Again, BI's collaboration with the Asian Development Bank for the Microcredit Project has required BI counterpart financing, and this might be regarded as a developmental expenditure, albeit very small in relation to other BI outlays. However, the greatest contribution of the central bank to such projects is "promotional" rather than developmental, in terms of leadership for innovation in microfinance.

There are few instances of BI "developmental" support for microfinance

Another example of direct developmental support was the extension to BPR of the deposit guarantee, originally extended to commercial banks by BI in January 1998, after some delay. A related instance in 1999, also triggered by the financial crisis, was the offer of funding for recapitalization to those BPR satisfying certain criteria of financial soundness. This assistance was analogous to the recapitalization of commercial banks, which had commenced earlier. However, these measures were due more to the desire to preserve financial infrastructure in the face of the crisis than to pursue a consciously developmental strategy in support of the microfinance sector.

Similarly, BI used BPR and other small financial institutions to channel emergency liquidity credits as part of broader social safety net responses to the crisis in 1998–1999. While this helped to sustain these small financial institutions during a difficult period, there is some ambiguity in this situation. The central bank, which is also the ultimate regulatory body, should be seen to uphold principles of sustainability for these institutions, rather than to compromise them through involvement in unsustainable and ill-targeted lending.

Finally, there is the proposal that BI and PERBARINDO (the Association of Indonesian Rural Banks) should set up a jointly owned private company during 2000 (Bank Indonesia and GTZ 2000) to provide a deposit guarantee service for BPR. This is discussed later in the broader context of deposit protection for the banking sector as a whole. For BI to take equity in such an entity and to participate in its management would be a clear example of a developmental measure.

BI has best promoted sustainable microfinance through its contributions to macroeconomic stability and financial liberalization, prior to 1997

4.3 Promotional Activities for Microfinance

The most significant factor promoting microfinance for which BI can claim credit (albeit credit shared with the broad coalition of policymakers already described) is the macroeconomic policy environment established under the New Order government of Suharto. Sustained economic growth and relatively low inflation in Indonesia over the period from the early 1970s to the mid-1990s (with GNP per capita growing at an annual 6 percent over the period 1985–1995) together with financial sector liberalization created both the demand- and supply-side conditions for microfinance to flourish. Economic growth and substantial reduction in the incidence of absolute poverty stimulated informal sector productive activity, and with it the effective demand for financial services. Financial sector liberalization, with freeing of interest rates and opportunities for formal financial institutions to expand, increased the supply of financial services. The character of particular financial institutions (the BRI units, the small financial institutions, and others) was in turn influenced by liberal financial sector policies, ensuring that services were extended to many of the poor.

The reference to a coalition of policymakers is appropriate in considering the role of BI as a promoter of MFIs. Until amendments to the banking legislation in 1998, control of the banking system had involved the Department of Finance as well as BI, with the former responsible for bank licensing, among other things. Much of the foreign technical assistance which influenced broader financial sector policy was delivered via the Department of Finance. An influential United States Agency for International Development (USAID) technical assistance project in the 1980s, concerned with the small financial institutions (LDKP, BKD, BKK, and LPD, among others), was actually located in the Department of Home Affairs and worked through the provincial development banks, for which that department had responsibility. BI's own history of its support for small credit (Bank Indonesia 1997) makes quite fleeting reference to microcredit, beginning only with its bank/self-help group linkage project (PHBK) in 1989.

The central bank's leadership role in the PHBK and microcredit projects was "promotional"

From BI's account of PHBK it appears that this project was seen as a new approach, stimulated by the failure of the many schemes financed by liquidity credits to reach the poor. This and the central bank's Proyek Kredit Mikro (Microcredit Project), which commenced in 1995, were clear examples of promotional activity by BI designed to create sustainable financial services for the very poor. The central bank's recent participation in the formation of GBPKMI (United Movement for the Development of Indonesian Microfinance), discussed earlier, also indicates a more proactive stance. BI appears willing to lend its prestige to this attempt to build an institutional platform for initiatives in microfinance, in a more NGO-friendly environment. In fact as early as 1994 BI had associated itself with unsuccessful attempts to create an umbrella group for MFIs.

BI's "hands-off" approach to the operations of the small, locally based financial institutions (called, generically, BPR) during the 1970s allowed them to flourish without interest rate restrictions. This was certainly favorable to their development as sustainable institutions. But whether this reflected an enlightened attitude, or the pressing nature of BI's other concerns at the time (or indeed the resistance of other agencies with an interest in the matter) is difficult to judge. BI's support for the licensing of new BPR as regulated banks with low capital requirements, a result of the financial reforms of 1988, was certainly a positive approach. Its current partnership with GTZ, concerned with technical assistance for BPR and other small financial institutions,[17] is also a potentially fruitful measure. BI has supported efforts

17 Project Pro-Fi, a joint enterprise of Bank Indonesia and GTZ, commenced in 1999 in succession to the PHBK Project. Pro-Fi is concerned with capacity building and the regulatory and supervisory environment for BPR and other small financial institutions.

to strengthen the umbrella body for BPR, PERBARINDO, and has provided some loan funds for capacity building of BPR staff, as well as conducting a feasibility study of a deposit guarantee scheme for the rural banks and actively preparing for its introduction.

A generally supportive policy environment has been more influential than any specific promotional activity

The extent of microfinance provision in Indonesia by formal, regulated financial institutions is very impressive. However, it appears that the overall supportive policy environment, rather than any purposive campaign of microfinance promotion by the central bank, provides an explanation for the progress which has occurred. This is not to say that promotional effort is not needed in future to fill the many remaining gaps in microfinance provision in Indonesia. Further strengthening of BPR and small financial institutions, and support for community-based cooperative and NGO initiatives which have flourished elsewhere, could form part of a promotional agenda for BI.

A strategy for SME development has been suggested by Timberg (2000b). This could serve as a model for a parallel effort for microfinance development. Timberg suggests that:

> Bank Indonesia needs to orient itself for its role under its new Act as the policy maker for small scale lending and lending to small scale business … it needs to pursue a research agenda, or see that it is pursued elsewhere, that monitors the access and use of formal sector finance by SME as well as the health, interaction and efficiency of the various financial institutions which serve it.

BI has established a bureau for credit, which may lead to more active promotion of microfinance

Timberg's emphasis here is on SMEs and small-scale lending, rather than microfinance, in BI's policy and research brief. However, the approach would lend itself equally well to microfinance. Perhaps BI management has something of this in mind, for despite the surrender of its credit functions the central bank is to maintain a "bureau for credit." This will, among other things, "formulate policy on technical support to banking related credit extension to the small scale and micro business" (Bank Indonesia 2000). This suggests that BI will become more active, in a promotional sense, for both SME and microfinance in future.

5 Regulation and Supervision of Banks

BI will lose its prudential supervision role for the banking system in 2002 while retaining responsibility for regulation

The new central bank legislation of 1999 confirms BI's role as regulator of the banking system, while amendments to the Banking Act in 1998 removed practically all finance department control from the sector (McLeod 1999a). However, the new Bank Indonesia Act follows precedent in some other countries (including the United Kingdom and Australia) by calling for the prudential supervision of banks to be transferred from the central bank to a new institution, which transfer is to be effected by the end of 2002.[18] Resistance is to be expected from within BI, but the legislated transfer of credit functions has already taken place, despite similar misgivings. Likewise, a new and independent bank superintendency is likely to take charge in due course.

5.1 Regulation and Supervision in Relation to Microfinance

Table 2 cites the estimate of a BI publication that Indonesia has some 13,700 "micro-banks" (BRI units, BPR, BKD, and LDKP) serving 30 million account holders. From

18 A former president of the German Bundesbank had advised that both regulatory and supervisory functions be divested by BI, but resistance from within the central bank resulted in at least the regulatory function being retained.

New Legislative Provisions for the Central Bank

The central bank Act of 1999:

- confirms Bank Indonesia's role as regulator of the banking system
- assigns prudential supervision of banks to a new entity by end-2002
- assigns prudential supervision of small financial institutions (which BI has largely delegated to other institutions) also to the new entity, though it is not clear how the new entity will approach this additional responsibility.

the same source (Bank Indonesia and GTZ 2000) comes the categorization of the regulatory framework for these micro-banks as "multi-agency and tiered." Apart from regulating the commercial banks, BI is also, in principle, responsible for regulating all of these micro-banking institutions, under the banking legislation of 1992. In practice, however, it has farmed out much of the responsibility to other agencies, depending on the size and kinds of deposit taking practiced by each micro-bank. In Indonesia, as Bank Indonesia and GTZ (2000) point out, there is no special law on microfinance; rather the banking legislation applies in principle to all the varieties of micro-bank which come under the tiered regulatory system. Similarly, the arrangements for their supervision are described as "hybrid," in the sense that BI directly supervises only a minority of the micro-banks, while delegating supervisory responsibility for the rest.

Of the micro-banks listed in Table 2, BI directly regulates and supervises only BPR, while BRI is responsible for the BRI units and BKD. BRI's supervision of BKD is conducted on a fee-for-service basis, paid for by the central bank. LDKP are supervised by provincial governments (which were responsible for setting them up in the first place) and specifically by BPD in each province. In this section we will deal with BI's regulation and supervision of commercial banks (*bank umum*) and BPR, insofar as it is relevant to microfinance, while the other micro-banks are dealt with in Section 6.

5.2 Minimum Capital Requirements

Low minimum capital requirements for BPR proved favorable to microfinancing

On the eve of the financial crisis in mid-1997 the minimum capital requirement for a commercial bank was Rp50 billion (then $21.4 million) and for a BPR Rp50 million (then $21,000). Prudential requirements were broadly the same for both kinds of banks: an 8 percent capital adequacy norm on Basle guidelines applied, and bank rating was done for both using CAMEL and other criteria (although for BPR the process was less demanding). BI was said to be increasingly emphasizing "self-regulatory banking principles." Reporting requirements for BPR were also less onerous than for commercial banks. However, they were subject to restrictions on branching and location, as well as on their activities. As previously mentioned, they could not issue checks and had no access to the payments system. Neither kind of bank was subject to any interest rate restrictions, nor did the Banking Act require any collateral for loans. Both of these circumstances were favorable for microfinancing. However, the required loan loss provisioning for non-collateralised loans was more onerous. Reserve requirements of a prudential nature were not onerous, but in any case applied only to commercial banks. Particular qualifications were required for directors of banks, which were somewhat less demanding in the case of BPR (McGuire et al. 1998).

Amendments to the banking legislation in late 1998 effected a number of changes, many of them impelled by the crisis. These remove most impediments to the privatization of the state banks, which is a potentially significant change, given their central role in government lending programs. A BI decree (No. 31/147/KEP/DIR of November 1998) effected what McLeod (1999a, 150) called "a dramatic erosion of previous standards" by lowering the required capital adequacy ratio to 4 percent.[19] This occurred in a situation where most commercial banks had negative capital, and where the bulk of the cost of recapitalizing the selected banks falls on the Government, through bond-raisings.[20] The amendments also provide for the creation of a deposit insurance institution for the commercial banking system (a provision which would also enable the proposed BI/PERBARINDO deposit guarantee company for BPR to be established). The deposit insurance institution would replace the Government guarantee on all deposits in Indonesian commercial banks, which was announced in January 1998 and subsequently applied also to deposits in BPR (Bank Indonesia and GTZ 2000). Depositors in 72 "unsound" BPR which were liquidated in 1999 will be paid out under this guarantee.

The new banking Act of 1998 will lead to deposit guarantee mechanisms for both commercial banks and BPR

New regulations for BPR issued by BI in May 1999 increased the minimum capital requirements for new BPR, to Rp2 billion ($270,000) for BPR in the greater Jakarta metropolis, to Rp1 billion ($135,000) in provincial capitals, and to Rp0.5 billion ($67,500) elsewhere. While these amounts are still comparatively small, the minimum requirement may prove rather high for some poorer parts of the country where comparatively few BPR exist at present and where more are needed (as in the eastern provinces). All existing BPR were required to appoint two managers, for purposes of internal control. The formal qualifications required of managers were also raised, and it appears BI is attempting to force the restructure or liquidation of many BPR, to leave a smaller number of larger banks in the industry. These requirements may be difficult to meet in areas of the country where levels of human resource development are lower. The Bank Indonesia and GTZ ProFi technical assistance project, mentioned earlier, is designed to bring all BPR to a sound condition by the time BI hands over regulatory responsibility to a new institution at the end of 2002 (Bank Indonesia and GTZ 2000).

New, higher minimum capital requirements for BPR will make it difficult to establish them in poor parts of Indonesia

5.3 Rating Rural Banks

While BI has simplified the CAMEL rating tool to meet the requirements of BPR, this instrument is criticized for not adequately reflecting the status of BPR loan portfolios. Bank Indonesia and GTZ are considering the introduction of a form of risk rating as an alternative tool for supervision, as well as cashflow-based liquidity management in place of current liquidity requirements. This latter innovation would seek to avoid liquidity risks imposed by the term structure of the typical BPR's deposit base. As already discussed, these two initiatives are related to the introduction of a deposit protection company (Bank Indonesia and GTZ 2000), and are designed to provide the company with tools for analyzing the BPRs with which it deals. Related analytical work, funded by USAID, is being conducted by Catholic Relief Services, previously mentioned as being associated with a chain of BPR.

"Risk rating" is under consideration as a tool for supervision of the BPR system. Fewer than 60 percent of rural banks were classified "sound" at end-1999

Present CAMEL ratings are assigned to BPR on the basis of off-site supervision, with analysis of monthly reports in the provincial offices of BI. While once-yearly inspection visits are considered appropriate, in practice these visits are less frequent

19 In fact to 2.75 percent, if the decision to permit loan loss provisions to be included in the capital base is taken into account (McLeod 1999a).

20 The cost to the Government is enormous. As at end-1999, the State had issued bonds with a face value of Rp500 trillion ($67 billion), with a further Rp140 trillion scheduled by mid-2000. These were for capitalization of Bank Mandiri, which incorporates four former state banks, for recapitalization of private banks and those taken over by the Government, and to compensate BI for liquidity credits issued during the crisis (Government of Indonesia and Bank Indonesia 2000).

due to staff shortages in the provincial offices. Aggregated data for the system as a whole are collected at the BI head office in Jakarta, where BPR licensing decisions are made. A BI publication (Bank Indonesia and GTZ 2000, 19) attributes the current state of the BPR system, where some 43 percent of institutions are classed as either "less sound" or "unsound," as due to a combination of rapid growth and "shortcomings" in supervision. It concludes that "[a]n effective and efficient supervision is a must … for the functioning of a future deposit protection scheme that shall be based on self-financing rather than on government bailouts."

5.4 BRI units

With regard to the regulation and supervision of the BRI units, these are a division of BRI, which as a commercial bank is itself supervised by BI. The units, while independent of the BRI branches in an accounting sense, are supervised by unit managers, who are located within branches and responsible to the branch manager. Unit managers visit each unit weekly. Together with regular reporting required of units (from the daily trial balance, to the weekly liquidity report to monthly, quarterly, and semi-annual financial reports), these frequent on-site supervisory visits assure a high standard of documentation and adherence to BRI's performance standards. The norms set by BRI for unit loan classification and reserves are, in fact, stricter than those required of BPR by BI (Bank Indonesia and GTZ 2000).

6 Regulation and Supervision of Nonbank MFIs

In this section we deal with the rest of the small financial institutions, or "micro-banks," and with other formal and semi-formal institutions such as pawnshops, cooperatives, and NGOs (see Table 2). Some of these institutions are within the ambit of BI, while others are not.

6.1 Micro-banks (BKD and LDKP) and Other Institutions

Overall responsibility for supervision of the small financial institutions will pass to a new entity, along with banking supervision

BKD and LDKP, as micro-banks, are subject to the Banking Act. They are also among the "small financial institutions" whose improvement is the objective of the ProFi project of technical assistance currently conducted by Bank Indonesia and GTZ. However, as previously mentioned, their supervision is conducted by agencies other than BI. BKD, which are typically very small and number more than 5,000, were granted legal status by colonial legislation in 1929 although they date from the late nineteenth century. BKD are supposed not to mobilize savings, and are closely identified with their local communities (where, in fact, some of them do provide savings services). While in-principle responsibility for their supervision resides with BI, they are actually supervised by BRI, just as they were by BRI's predecessor bank in colonial times. BRI is paid by BI for this service. Whether the new entity to be set up to assume supervisory responsibility for the banking system from the end of 2002 will give adequate priority to such supervision, or continue to pay BRI to perform it, is unknown.

LDKP (including the two most important models of this class of small financial institution discussed earlier) are closely associated with their respective provincial governments. BI leaves issues of supervision to them and to BPD (provincial development banks) in each case. BPD also deliver technical guidance to them, although the quality of this assistance and supervision is said to vary greatly from province to province, just as the quality of the respective provincial banks varies. Some, as previously mentioned, were among the best performing commercial banks in Indonesia in the face of the crisis; a number of others have had to be recapitalized by the Government. It is difficult to imagine the new supervisory entity having an interest in supervising LDKP. In terms of regulation, BI will continue to have ultimate responsibility for both BKD and LDKP.

The future role and status of the official cooperative movement is a political issue beyond the purview of the central bank

Indonesia's only legal pawnshops are a monopoly enterprise operated by a state-owned company. The company issues bonds and notes to raise working capital, which are normally redeemed within the year. In 1998 it also resorted to borrowing from government as well as taking BI liquidity credits to meet the greatly increased demand for loans from the public. It raised Rp350 billion ($47 million) from all external sources. Turnover was Rp3.1 trillion ($410 million) for some 10 million customers. The company is profitable, with net earnings of Rp307 billion ($41 million) in 1998 (Bank Indonesia 1999). The pawnshop system is regulated and supervised by the Department of Finance and there seems to be no strong argument for changing this.

Cooperatives are regulated by the Department of Cooperatives and, reflecting the central role given to cooperatives in the ideology of independent Indonesia, the Cooperative Law (No. 12 of 1967) was one of the first pieces of legislation of the New Order government. The financial chaos of the late Sukarno years had virtually wiped out all cooperatives and Suharto wanted all new and revived cooperatives under government control. Independent initiatives were discouraged, despite which some nongovernment cooperatives developed, including Badan Kordinasi Koperasi Kredit (the Credit Cooperative Coordinating Board), which is associated with the World Council of Credit Unions. A new cooperative law in 1992 attempted to entrench the official cooperatives in certain areas of the economy. It also provided for official cooperatives to conduct "credit union" activities, which were to be the subject of special central government regulations. These were to be outside the control or supervision of either BI or the Department of Finance (although cooperatives had been entitled to collect the deposits of members, even prior to this new Act). As mentioned already, the atmosphere for independent cooperative ventures became freer under the government of Abdurrahman Wahid from 1999, and the future role and status of the official cooperatives and their financial activities is unclear. The central bank is unlikely to play any role in the resolution of this highly political issue.

6.2 Nongovernment Organizations

The inability of NGOs to mobilize any category of savings legally is an unnecessary constraint

The circumstances which led to NGOs playing a subdued role under the New Order government were described in Section 2. Procedures for establishing and registering an NGO are described in McGuire et al. (1998) and these are relatively simple and straightforward. It is advisable if not compulsory to register an NGO with the Department of Home Affairs, but in any case the formal regulatory requirements are not onerous. Supervision was minimal under previous governments unless an NGO attracted political attention. NGOs conducting microfinance require no permission to extend credit, and there are no reporting requirements or supervisory arrangements for such activities. However, they are forbidden to mobilize the savings of members unless these are deposited directly in a regulated financial institution. Some savings mobilisation appears to have been tolerated as long as the amount was small; and some larger NGOs have set up their own BPR to overcome the problem. However, for NGOs unable to take this path, the inability to mobilize even compulsory savings in conjunction with lending is a constraint on their activities, which the central bank would be in a position to loosen.

7 Conclusions and Recommendations

7.1 Conclusions

The good performance of smaller financial institutions, and some banks, distinguishes Indonesian microfinance

In terms of microfinance, Indonesia is a special case, where the formal financial sector has extended sustainable financial services deep into the countryside and to some, at least, of the very poor. A wide range of small regulated financial institutions, for which there are few parallels elsewhere, provide financial services to rural populations. However, the commercial banking system (with the exception of a limited number of small banks which have demonstrated the possibilities) has had little genuine involvement with microfinance.

By comparison with other countries where microfinance has developed, nongovernment organizations (NGOs) have played a relatively minor role as microfinance institutions (MFIs). On the other hand, the government of President Abdurrahman Wahid appears to have a more positive attitude to NGO initiatives, and some NGOs are moving to take advantage of emerging opportunities in the sector. A recent initiative to establish a national umbrella body for the support of microfinance development has received high-level political support and the active involvement of Bank Indonesia (BI).

BRI's performance during the crisis confirmed the reputation of its village units

Among commercial banks, Bank Rakyat Indonesia (BRI) is distinguished by the outreach and sustainability of its village units, which provide a national system of small finance and microfinance services. The excellent performance of the BRI unit system in the face of the Indonesian financial crisis, during which the units maintained their profitability and essentially carried the other, loss-making, divisions of the bank, has confirmed BRI's status. The regulated BPR, which comprise the second category of bank in Indonesia, have also in general weathered the financial crisis better than the commercial banking system. This also appears to be true of other small financial institutions which are subject to the Banking Act and hence subject in principle to BI regulation (including village credit institutions, BKD, and rural credit fund institutions, LDKP, in Central Java and Bali, respectively).

New central bank legislation enacted in 1999 was designed to secure greater independence for BI. The central bank's mandate now focuses on the single objective of maintaining the stability of the rupiah. BI may not lend to the Government nor may it buy government bonds except in the secondary market. Its capacity to act as lender of last resort to the commercial banks has been greatly reduced. BI is to lose its function as prudential supervisor of banks by the end of 2002, while retaining the role of bank regulator. BI has ceased to exercise any refinancing functions in connection with government-mandated credit schemes.

Bank Indonesia has a new mandate

BI's major contribution to the development of sustainable microfinance has been its role as a contributor to the policy consensus which secured macroeconomic stability, healthy growth, and financial sector liberalization over most of the period between 1967 and 1997. BI did not, in general, have specific policies in support of microfinance. Nor are the changes in its role and functions, resulting from the 1999 legislation, conducive to its playing any further "developmental" role in support of microfinance.

On the other hand, in terms of promotional activity in support of microfinance, the central bank supported the bank/self-help group linkage program with German technical assistance (PHBK). It implemented the Microcredit Project with the Asian Development Bank and, more recently, has entered into a project with the German government technical assistance agency (GTZ) to improve the operations of BPR and other "small financial institutions." Its support to strengthen the umbrella body for BPR (Association of Indonesian Rural Banks or PERBARINDO) and for the new umbrella body for microfinance development (United Movement for the Development of Indonesian Microfinance or GBPKMI) are also positive promotional initiatives. BI intends to set up a deposit protection scheme for BPR.

BI's Bureau for Credit may become a vehicle for promoting microfinance

Overall, however, BI's promotional support of microfinance has been relatively limited in the past, and many gaps remain in microfinance provision in Indonesia. Further strengthening of BPR and the small financial institutions, and support for community-based, cooperative, and NGO initiatives, could form part of a promotional agenda for BI in future. The central bank has established a "Bureau For Credit," despite having lost its operational credit functions. BI sees this as having a policy formulation role, concerned with technical support for the provision of small- and microfinance through banking institutions. This suggests that BI will become more active in promoting microfinance in future.

Amendments to the banking legislation in 1998 were impelled by the financial crisis, with some implications for microfinance. There is provision for the creation of a deposit insurance institution for the commercial banks, which will also make possible the creation of a deposit protection scheme for BPR. Minimum capital requirements for BPR have been increased to levels which may make it difficult to establish new BPR in some of the poorest provinces in Indonesia. Other requirements placed on BPR may result in the liquidation, amalgamation, or takeover of many weaker institutions. BI wants to see the industry composed of a smaller number of BPR, larger in size and financially sound, before handing these over to the new supervisory body at the end of 2002. The joint BI/GTZ program for the small financial institutions supports this objective.

BPR are undergoing consolidation and capacity building while the small financial institutions are subject to uncertainty

Apart from the regulated BPR, the other small financial institutions (BKD and LDKP) are subject to the Banking Act but their supervision is conducted by agencies other than BI. BKD are supervised by BRI and the cost of this supervision is a charge against the central bank's budget. However, when BI transfers its responsibility for banking supervision to a new agency at the end of 2002, it is not clear whether that agency will have either the resources or the mandate to concern itself with BKD. The small institutions known collectively as LDKP are closely associated with their respective provincial governments. These institutions in Bali are relatively strong, but so long as they opt to remain outside the network of BPR regulated by the central bank, their situation is ambiguous. As in the case of BKD, the transfer of BI's supervisory responsibilities to a new agency may compound the uncertainties confronting this group of small financial institutions, a group which is important for microfinance.

Civil society initiatives in microfinance may now flower

The prospects for the independent flowering of civil society initiatives in microfinance have not been so good for many years. A continuing disability affecting NGOs engaging in microfinance is the prohibition of savings mobilisation among members of credit schemes. The inability to mobilize even compulsory savings legally, in conjunction with lending, is a constraint on the development of such activities.

7.2 Recommendations

(1) Under 1999 legislation, BI retains responsibility for broad issues of financial sector development. It should continue to play a promotional role in support of the development of a sustainable system of microfinance in Indonesia.

The new central bank Act mandates continued promotion of microfinance

Under the central banking legislation of 1999, BI remains responsible for the overall soundness of the banking and payments systems, and for the regulation of banks. Aside from its overall concern for the stability of the rupiah, it has a continuing obligation to consider broader issues of financial sector development, including the development of that part of the financial system catering for the needs of the poor. It should continue to play a promotional role for the development of a sustainable system of microfinance.

(2) The central bank should maintain its overview of the full range of financial institutions that provide microfinance services and that fall within the provisions of the 1998 Banking Act. When its supervisory functions are transferred in due course to the new entity created for that purpose, BI should ensure that this transfer is effected with due regard to the interests and needs of those institutions.

In terms of its continuing regulatory responsibilities, BI should maintain its overview of the whole "multi-tiered" set of arrangements for the regulation of those financial institutions which fall under the provisions of the 1998 Banking Act, and which are providing microfinance services. These include the BRI units, those BPR which it regulates directly, and the other "small financial institutions." Given that BI is to transfer the function of supervision to a new entity by the end of 2002, it will need to ensure that this transfer is done with due regard to the interests and needs of all those regulated financial institutions which provide microfinance services. It will be important to maintain their capacity to provide sustainable financial services to the poor (who form a minor but significant part of their clientele) and to enable them to improve their outreach and sustainability.

Is there a role for the new deposit guarantee institution as supervisor?

(3) Concerning the transfer of supervisory responsibility for BPR and other small financial institutions, it may be that the new institution to be created to provide deposit protection for the BPR system would be a more appropriate supervisor for them, should the new bank supervisory agency lack either the resources or the capacity to provide this service.

BI also needs to consider the implications of the creation of a deposit protection scheme for those BPR which it regulates, and for the small financial institutions which have the potential to upgrade to regulated BPR status. Such an institution has the capacity to fill the supervisory role for the institutions whose deposits it is guaranteeing, and has a considerable incentive to do this well, considering it may be bankrupted by their failure. This may be a relevant consideration in negotiating the transfer of supervisory responsibility to a new entity, if that entity lacks capacity for or interest in assuming the responsibility for BPR, and for any required oversight or supervision of potential (*calon*) BPR.

(4) BI should consider whether new regulations for BPR issued in May 1999 unnecessarily prevent the establishment of these small banks in poorer regions of Indonesia, and whether exemptions or other supportive measures could be put in place to encourage the establishment of BPR in such regions.

How to get rural banks established in poor regions is a significant issue

BI should consider whether new regulations for BPR, issued in May 1999, unnecessarily prevent the establishment of new BPR in poorer regions of the country. These include minimum capital requirements of Rp0.5 billion for BPR outside provincial capitals, and Rp1.0 billion in provincial capitals, together with other stipulations regarding qualifications and experience of managers. Such requirements may be particularly onerous at the *kecamatan* (district) level in Eastern Indonesia, where relatively few BPR have been established so far. BI should consider whether exemptions and other supportive arrangements could be put in place to encourage the establishment of sustainable BPR in regions which are currently under-served.

(5) While Indonesia does not need a formal regulatory framework for microfinance as such, BI should exercise regulatory discretion to prevent current regulations from impeding the development of microfinance outside the regulated banking institutions. An example is deposit mobilization by NGOs among members; BI should explicitly authorize this practice.

It is not proposed that Indonesia should have any formal structure of regulation for microfinance, other than the provisions of banking law which govern the operations of regulated financial institutions. There is no case under Indonesian circumstances, for example, for a formal microfinance law. However, there will be cases where the existing legal framework unnecessarily impedes the development of microfinance outside the regulated financial institutions. For example, BI should exercise its regulatory discretion to clarify the situation of MFIs operated by NGOs, so as to permit them to mobilize the savings of members in the context of lending. It should be prepared to consider making any reasonable modification in its regulations to permit the development of sustainable microfinance outside the regulated financial institutions.

Sort out the savings issue for NGOs

(6) BI should attempt as far as possible to quarantine financial institutions providing microfinance services on sustainable principles from participating in programs of subsidized credit, whatever agency is responsible for such schemes.

Given that BI itself is no longer to be involved in credit schemes, and that its concern should be with the integrity and sustainability of regulated financial institutions, it should attempt as far as possible in future to quarantine financial institutions providing microfinance on sustainable principles from programs of subsidized credit. This should apply whatever other agency is responsible for such schemes. BI's regulatory powers could be employed to encourage such quarantining, in order to avoid compromising the objectives of regulated financial institutions engaged in microfinance.

Avoid subsidy contagion

(7) The central bank's promotional activities should be directed at nurturing a pluralistic approach to provision of microfinance, including small regulated financial institutions and community-based, cooperative, and NGO initiatives.

In terms of a continuing promotional role (as recommended earlier), BI should develop an agenda which includes further strengthening of BPR and small financial institutions. It should also include support for community-based, cooperative, and NGO initiatives, which have flourished in other countries but which have been relatively stunted in Indonesia, for historical reasons. BI's objective should be to nurture a pluralistic approach to microfinance provision, the better to meet the diverse demand for financial services of the poor in a very diverse country.

Nurture a pluralistic approach

(8) BI should consider further opportunities for pilot projects trialing innovative approaches to microfinance service delivery, without taking them past the pilot phase.

BI has played an innovative promotional role through its implementation of pilot projects, including the PHBK Project (bank and self-help group linkages), the Microcredit Project, and the Pro-Fi Project supporting the development of the BPR system. At least one of these projects went well beyond pilot status to more general implementation. This would no longer be acceptable, given BI's new status and role. BI should consider opportunities for further pilot projects trialing innovative approaches to service delivery, without permitting such projects to go beyond the pilot phase. Once such initiatives have been proved, arrangements for their more general application should be made by the Government. Projects concerned with capacity building and the strengthening of existing institutions, such as the Pro-Fi exercise, also appear appropriate for the central bank to pursue in future.

There is still a hands-on role for BI

(9) BI's newly established Bureau for Credit can play an appropriate role in the promotion of microfinance by participation in pilot projects and through research, data collection, and policy formulation.

In this connection, the establishment by BI of a credit bureau is an appropriate measure, so long as its role is confined to "formulat[ing] policy on technical support to banking related credit extension to the small scale and micro business" (see Section 4.3). The formulation of policy should extend to participation in the conduct of restricted pilot and capacity-building projects, as well as to research and the collection and publication of data relating to microfinance activities of all kinds.

(10) BI should support activities for communication between stakeholders in microfinance, and lend its prestige to efforts at consultation and policy discussion involving the microfinance community.

BI support for the microfinance "movement" is an example of constructive leadership

In a situation where BI no longer has supervisory control of regulated financial institutions, and where space has to be created for a range of initiatives from the NGO and cooperative sectors in support of microfinance, BI can best play a leadership role through persuasion and consensus. Its support for GBPKMI (United Movement for the Development of Indonesian Microfinance) is an appropriate initiative in this respect. This "movement" could provide a vehicle for coordination and communication between stakeholders in microfinance, whether from the regulated financial sector or from other institutions. By lending its prestige to deliberations in such an arena, BI can assist in making this an effective means of consultation and policy making for microfinance.

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