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# The Role of Savings in Local Financial Markets:

# The Indonesian Experience

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# The Role of Savings in Local Financial Markets: The Indonesian Experience

by

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# SECTION ONE

# SAVINGS AT THE LOCAL LEVEL: MYTH AND REALITY

Throughout the world and across many cultures and income groups, people save for varied purposes including emergencies; investment; finance of consumption in the case of irregular income streams; social obligations; long-term goals such as the education of children or pilgrimages; and for health emergencies, disability, and retirement.

Extensive household savings have been reported from developing countries for at least three decades. A 1962 United Nations study showed that household savings made up one-half to two-thirds of total savings in seven Asian countries.[1] During the 1970s and 1980s substantial household savings were reported from rural areas of developing countries. Rural savings of various kinds (in rotating savings and credit associations, in savings and loan associations, in nonfinancial forms, and the like) were widely documented from many areas of Asia, Africa, and Latin America.[2]

Clear, convincing, and increasing evidence collected since the 1960s attests that households save, and they will save in financial form if appropriate institutions and instruments are available. In their extensive writings on rural financial markets, Adams, Bouman, Vogel, Von Pischke, and others have suggested that appropriate savings instruments providing positive real rates of return to the household can induce households to put more of their savings into financial form; this, in turn, "may increase the average rate of return realized by the household on its savings portfolio and induce the household to divert more of its income to S (savings-investment activities)."[3]

Households are not the only savers at the local level. Although rarely considered in the literature or recognized by policy makers, local enterprises, groups, organizations, and institutions also save. Such savings are potentially available to financial institutions offering security, convenience, liquidity, and returns.

Although it has been argued for decades that financial markets influence both the forms in which savings are held and the amount of potential consumption diverted to savings, this view has so far had relatively little influence on policy decisions affecting the development of local financial institutions.[4] Neither the reality of extensive liquidity among households in many rural and urban areas of developing countries, nor the importance of savings mobilization for local financial markets and enterprise

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[1] United Nations (1962); see Adams (1978) for discussion.

[2] For discussion of rural savings in developing countries see, among others, Kelley and Williamson (1968); Adams (1973, 1978, 1984, 1988); Howse (1983, first published 1974); Bouman (1977, 1979, 1984, 1989); Mauri (1977); Von Pischke (1978, 1983b, 1991); Lee, Kim, and Adams (1977); Savings and Development (1977 - present); Von Pischke, Adams, and Donald, eds. (1983); Bourne and Graham (1980); Miracle, Miracle, and Cohen (1980); Sideri (1984); Adams, Graham and Von Pischke, eds. (1984); Vogel (1984); Agabin (1985); Adams and Vogel (1986); Germidis, Kessler and Meghir (1991).

[3] Adams (1978), p. 550.

[4] Ibid., p. 548.

development has yet been sufficiently understood.[5] One consequence is that few financial institutions provide appropriate deposit instruments in rural areas of developing countries, and few policy makers or donor agencies have made savings mobilization at the local level a high priority for economic development.

## THE MYTHS

Two widespread myths prevail about household savings in developing countries, particularly in rural areas. The first is that of pervasive "rural undersavings"; the second is the assumption that demand for financial savings instruments is low in most rural areas of developing countries. Such misguided assumptions are often extended to middle and lower-income urban households as well.

Reflecting a commonly held view, the authors of a recent paper on the theory of rural credit markets comment:

> To achieve viability, a financial institution must be adept and successful in savings mobilization to ensure a steady source of funds. This is not an easy task. The propensity to save in rural areas tends to be quite low with some significant exceptions like China, Taiwan or Korea.[6]

Savings have been rightly called "the forgotten half of rural finance."[7] It has been widely assumed that low institutional deposits in rural areas demonstrate that rural households cannot save because they are too poor, or will not save because they prefer to use their incomes for consumption, or choose to save in other forms. Because there is no significant demand for financial savings instruments, the argument goes, why develop financial institutions with savings programs? As a result, savings mobilization and the creation of sustainable financial institutions have not been given priority by either the governments of most developing countries or most donor agencies.

The view that there is little demand for rural savings has, in fact, become a self-fulfilling prophecy. Financial institutions in rural areas of developing countries, with a few significant exceptions, have been generally unsuccessful in mobilizing savings.

> Commercial banks and state-funded institutions have not mobilized much rural savings. The estimate of the percentage of loanable funds from rural sources has ranged from 5 percent to 40 percent, with the median much closer to the former than the latter figure.[8]

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[5] For discussion of the problem of neglect of savings in local financial markets, see, among others, Adams (1978); Adams and Graham (1981); Vogel (1984 b); Adams and Vogel (1986); Von Pischke (1991).

[6] Braverman and Guasch (forthcoming), p. 19. The author is indebted to the World Bank for permission to quote from the draft manuscript in which this paper, and others to which reference is made here, appears (Hoff, Braverman, and Stiglitz, eds., forthcoming).

[7] Vogel (1984); see also Adams and Vogel (1986).

[8] Braverman and Guasch (1986), p. 1256.

## LOW DEPOSITS IN LOCAL FINANCIAL INSTITUTIONS: THE REASONS

Often the reasons for low institutional deposits are neither undersavings nor lack of demand for financial savings instruments. Although mobilization of deposits and development of rural financial institutions are interdependent, and savings are crucial for households and enterprises in developing countries, most projects for local finance are still concerned only with credit, usually subsidized credit. The low interest rates that characterize subsidized credit programs discourage savings mobilization. Organizations dispensing subsidized credit are normally forbidden to mobilize savings or do not collect voluntary savings because financial regulations make deposit mobilization unprofitable.

The problem can be summarized briefly. Subsidized lending programs provide a limited volume of cheap loans. Because these loans are scarce and desirable, the loans tend to be allocated predominantly to local elites who have the influence to obtain them, bypassing those who need smaller loans (which can usually be obtained commercially only from informal lenders at far higher interest rates). In addition, there is substantial evidence from developing countries that subsidized rural credit programs result in high arrears[9]; generate losses both for the financial institutions administering the programs and for the government and donor agencies; and depress institutional savings and, thereby, the development of profitable, viable rural financial institutions.[10]

Credit subsidies, however, are often viewed as a mechanism for obtaining support for the government in rural areas; the subsidies, which come to be expected by local elites, tend, therefore, to be difficult to discontinue once begun.[11] The result is that the programs persist on a large scale and tend to prevent the growth of viable rural financial institutions, which can be made sustainable only by raising deposits.

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[9] The 1984 World Bank Agricultural Sector Policy Paper reported that the average arrears rate for 38 small farm credit institutions in Asia, Africa, and Latin America was 39.4 percent. For discussion of high default rates in subsidized rural credit programs, see USAID (1973); Donald (1976); Vogel (1979); Bangladesh Bank (1979); Adams and Graham (1981); Eaton and Gersovitz (1981); Von Pischke, Adams, and Donald, eds., op. cit.; Adams, Graham, and Von Pischke, eds., op. cit.; Shaefer-Kehnert and Von Pischke (1984); Adams and Vogel, op. cit.; (1986); Mosley and Dahal (1987); Adams (1988); Hossain (1988); Braverman and Guasch (1986, 1989, forthcoming 1992); Von Pischke (1991); Floro and Yatopoulos (1991). See Vogel (1981) and Siamwalla et al. (forthcoming) for discussion of the implications of low delinquency rates in Costa Rica and Thailand respectively. In the former case the result was severe credit rationing; in the latter loans are largely restricted in practice to supply of working capital to farmers with above-average incomes.

[10] For discussion of the problems of subsidized rural credit programs, see, among others, Penny (1983, first published 1968); Adams (1971); USAID (1973); Donald (1976); Gonzalez-Vega (1976); Lipton (1976); Von Pischke, Adams, and Donald, eds. (1983); Adams, Graham, and Von Pischke, eds. (1984); Meyer (1985); Von Pischke (1991).

[11] See Blair (1984).

## EFFECTS ON MICROENTERPRISES

The dearth of institutional deposit facilities at the local level has an adverse effect on savers in general, and on small-scale entrepreneurs, in particular. There are two main reasons.

First, self-finance of investment is especially important for micro- and small-scale enterprises. However, options for nonformal financial savings at the local level tend to offer either security or returns, but normally not both. Thus, opportunities for financial savings outside the formal sector are typically of two kinds: low risk with no, or very low, returns (rotating credit and savings associations, or ROSCAs; various types of savings clubs; and deposits made to employers, commodity wholesalers, and others for safekeeping) or risky but with a possibility of positive real returns (some small-scale finance companies and investment groups). Both types often place restrictions on liquidity, a crucial requirement for microenterprise finance. Deposit instruments for voluntary savings in formal institutions are often the only mechanisms that can provide the saver with a combination of convenience, security, liquidity, and returns. However, these are rarely available at the local level.

Second, small entrepreneurs are typically bypassed by subsidized credit programs, and unsubsidized institutional credit is often unavailable to them. Therefore, one of the most important benefits of institutional savings for microenterprise finance is an indirect one. Creditworthy small and microenterprises can benefit from the expanded volume of institutional lending made possible by deposit mobilization (larger enterprises are more likely to have financing already, often through subsidized credit programs). Substantial growth in institutional deposits can both increase significantly the amount of credit available to smaller entrepreneurs and provide loans at much lower interest rates than are otherwise available to them on the informal commercial market. This is especially true in the case of the trade sector, which has been ignored by most rural credit programs.

## SHATTERING THE MYTHS

Indonesia's rural banking system recently shattered the myths concerning the difficulties widely believed to be inherent in mobilizing local savings in developing nations. Massive local savings mobilization has occurred in Indonesia since 1986. This became possible because, by the early 1980s, the country's economics ministers understood that the government's subsidized credit programs offered since the early 1970s were deficient in the various respects mentioned above, and the policy makers were prepared to try a new approach to rural financial intermediation.

Beginning in 1984, a program of general rural credit offered at commercial interest rates was introduced in combination with rural savings mobilization; both were later extended to urban areas. Because Indonesia's approach to rural financial intermediation has been so successful, reference will be made in this chapter to different aspects of this program. The reader is referred to Section Three for detailed discussion of the lending side of the Indonesian program.

Before 1984 Indonesia's approach to financial intermediation at the local level was similar to that found in many countries today. Institutional credit was subsidized, losses were high, and deposits were low. After more than a decade of offering savings accounts in the country's more than 3,600 village banks located nationwide at the subdistrict level, deposits in what is known as the "unit banking system" totaled only $17.6 million in 1983.

Administered by the Bank Rakyat Indonesia (BRI), a state-owned commercial bank, the primary purpose of the unit banking system was to channel government-subsidized credit to farmers, especially rice farmers, through BRI's unit banks; this was known as the BIMAS credit program. Because BRI was required to lend at 12 percent annual effective interest rate and to pay 15 percent annual interest on most deposits, there was no incentive within the bank to mobilize savings through the unit banking system. As one depositor complained to the author in 1983, "BRI gives beautiful calendars to its customers every year, but only to borrowers. As a saver, am I not also a customer?"

With the exception of a few high-level policy makers, however, the poor deposit record of the unit banking system was almost universally attributed to rural undersavings, and to assumptions about villagers' lack of trust in banks, lack of education, consequent aversion to the use of financial institutions, and "psychological inability" to make use of banks.[12] These assumptions persisted despite mounting evidence of extensive household savings. Since 1968, studies of household savings in Indonesia had found the marginal propensity to save to be between 10 and 20 percent.[13] Yet these results were typically either ignored or disbelieved.

In 1983, however, the Indonesian government began a series of major financial reforms. The first of these, issued in June 1983, permitted banks to set their own interest rates on most loans and deposits. As expected, this deregulation of interest rates had immediate and far-reaching effects on local finance throughout the country.

In 1984 Indonesia introduced a program of general rural credit offered at commercial interest rates (known as Kredit Umum Pedesaan or KUPEDES); this program was complemented in 1986 by a program of savings mobilization designed specifically to meet local demand. The spread between loan and deposit interest rates was set to enable institutional profitability, and both programs were offered nationwide through BRI's unit banking system. The system, which had previously generated considerable losses for both the government and the bank, became profitable in 1986; by 1991 it supplied over two-thirds of BRI's total profits.

The new savings program, still in place, offers a mix of deposit instruments and features a liquid instrument, previously unavailable at the local level. The result of the new program was that village bank deposits increased from $17.6 million at the time of the financial deregulation in June 1983 to $1.30 billion in December 1991.

This dramatic growth in the mobilization of local deposits resulted from a combination of factors: a spread that provided institutional incentives for savings mobilization and permitted the profitability of the system, extensive study of local demand for financial services and systematic identification of potential savers, the design of banking instruments and services to meet the demand, and effective leadership in both the BRI and the government.

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[12] Bank Indonesia Jakarta dengan Pusat Penelitian Pembangunan Pedesaan dan Kawasan Universitas Gadjah Mada (1987).

[13] See Kelley and Williamson (1968), p. 390; World Bank (1983). The World Bank's 1983 study of rural credit in Indonesia found rural savings propensity to be 20 percent.

Studies of local financial markets in widely differing regions of Indonesia during the 1980s offered massive evidence for two conclusions.[14] First, economic growth and monetization of the economy in rural areas had created a large and predominantly met demand for banking facilities. As an Indonesian villager commented, "I used to save in goats, but goats take a lot of work. Now the shepherds are all in school, and the parents have jobs. Now we have no time to save in goats. We prefer to save in the bank." Second, there is large demand at the local level for a liquid financial savings instrument. These findings were drawn from extensive discussions with household members, enterprise heads, and leaders of organizations concerning their actual forms of saving and their preferred savings alternatives. The discussion here primarily concerns rural Indonesia. However, fieldwork in the latter part of the decade indicated that the banking needs of middle- and lower-middle-income neighborhoods in urban areas are similar in many respects to those of villages. In 1989 BRI began to open unit banks in urban areas; these became profitable rapidly.

Before starting its new savings program, BRI conducted extensive research into existing forms of savings in rural areas, both formal and nonformal. Common forms of savings and savers' views about them are discussed in the section below. Although some of the specifics may be particular to Indonesia, the general principles illustrated by the findings of this research have widespread application for developing countries.

[14] The data reviewed here are drawn from unpublished reports by BRI, the Center for Policy and Implementation Studies in Jakarta, and the Harvard Institute for International Development during the period 1980-1990.

# SECTION TWO

# THE ROLE OF SAVINGS IN LOCAL FINANCIAL MARKETS

## NONFINANCIAL SAVINGS

### Cash

BRI found a widespread practice among households and enterprises: They kept more cash in the house than they considered desirable because they did not know what else to do with it. Although they said they did not want to keep large amounts of cash at home, they did not convert excess cash into institutional financial savings primarily because the deposit instrument offered at the local level limited the number of withdrawals. One reason for not wanting too much cash at home is security, which is considered a major problem. Equally important, however, is the view that if one has cash on hand, it is difficult to avoid lending to kinsmen and neighbors. Other reasons they gave for not wanting to keep excess cash in the house are that children may find it and that it provides temptation for spending. Husbands complained that their wives use extra cash to buy radios or television sets. Wives said that their husbands use the excess cash to buy motorcycles and take unnecessary trips to town.

However, holding some cash in the house is considered important primarily for use in emergencies. For traders, businessmen, and artisans, the opportunity to purchase supplies at low cost may come unexpectedly. Thus, a supplier who needs cash quickly may come at night prepared to sell quickly; the buyer with sufficient cash on hand benefits. Beyond these needs for ready cash, households and enterprises throughout the country said what they wanted was a savings account from which they could withdraw on demand in a conveniently located and secure bank. Because this was not available, they kept their cash at home.

### Grain

Attitudes toward saving in grain, particularly rice, were similar to those expressed about cash savings. Virtually everyone wants to have enough rice on hand to meet a reasonable level of unexpected need, but very few wish to store grain beyond that level. Unlike cash, excess grain is rarely stored (a result of the general availability of rice in the 1980s, combined with the problems of grain storage). In addition, there is a strong village ethic that if you have grain stored, you must give or lend it to kin and neighbors in the preharvest season. Except for some informal commercial lenders, villagers say they are generally relieved not to give loans. There are analogous reasons for wanting savings accounts. Villagers also tend to be relieved not to have to borrow from relatives and friends. Except in certain circumstances such as a young married couple's borrowing from parents, intravillage borrowing of this type tends to lower the borrower's status.

### Animals

In general, rural households prefer to have on hand some large animals: goats, sheep, and cows (and pigs in some non-Muslim areas). However, except for those who breed or trade animals professionally, households do not want to care for more than a few. They clearly perceive the opportunity cost.

Particularly in densely populated areas where grass is scarce and space limited, the care of such animals is considered onerous and time-consuming. While carrying grass that he had cut to feed his animals, one villager commented, "Taking care of goats is worse than being colonized by the Dutch!"

Villagers say that although a number of goats could be turned into a cow which would require less care, cows are less liquid than goats. As one man put it, "When you have to pay the school fees, you cannot sell the cow's leg." Overall, the disadvantages of saving in animals (opportunity cost for household labor, liquidity problems, lack of space, and the risks of shareherding) are usually considered to outweigh the advantages (relatively high returns given normal propagation).

**Gold**

In the early 1980s many government bureaucrats and bankers believed that a savings account could not compete with gold as a form of savings in the rural areas; villagers, however, usually disagreed. They frequently said that although gold may be a good long-term investment, it is not suitable for the needs of most families, beyond the amount worn as jewelry. The most important perceived advantages of gold are its liquidity and its ability to serve as a hedge against currency devaluation and inflation. However, there are two primary disadvantages which, taken together, are widely thought to outweigh the benefits of saving in gold — except, perhaps, for long-term investors.

The first is that gold prices were generally stagnant during the 1980s, and villagers in all the regions visited reported that when they sell gold, they take a 5 to 12 percent loss on the buying price. They say that the gold merchants treat them as inferiors and assume (usually correctly) that the seller must dispose of his or her gold quickly because of an emergency.

The second is that saving in gold presents a serious security problem. It must be hidden both from outsiders who might steal it and from insiders who might appropriate it, claiming shared rights. As employment opportunities increase and school attendance rises, more rural houses are empty during parts of the day, intensifying the concern about saving in gold. "If we have gold in the house, we cannot sleep peacefully."

**Land**

Government and BRI officials also tended to assume in the early 1980s that rural households want to use their savings to invest in land, either through purchase or by renting land for cultivation. It is, of course, true that land control is a high priority for many Indonesian villagers. Normally, however, there are numerous factors that must be carefully evaluated before purchasing or renting land: the amount and type of land available, the water supply, the amount and cost of the financial capital required, the availability and costs of labor supply, management capacity, legal title (in the case of land purchase), and the opportunity cost to the household.

Under village conditions, there is usually more excess liquidity at a given time than there is opportunity to purchase suitable land. Thus, although villagers often want to purchase or rent land, they view these goals as complementary to the holding of financial savings. Families waiting for suitable land to become available for purchase and farmers who calculate the risks of renting land as too high for a particular season or stage of the household cycle can benefit from use of appropriate financial savings instruments. Older couples whose children are employed in nonfarm activities may decide to retire from land management and may also prefer liquid assets. In addition, the medium and long-term savings goals of some rural households are not focused on control of additional land, but are aimed instead at trade and business expansion, construction, higher education, and other endeavors.

Thus, rural households that can afford to do so usually keep on hand some grain and cash, a few animals, and some gold; they attempt to control land as appropriate for their resources and requirements. However, many villagers have excess liquidity (permanently, seasonally, or occasionally) beyond that which optimally can be kept in these forms. As one villager commented, "My investment opportunities are not the same throughout the year. I need a place to store money safely while I look for the right openings."

## FINANCIAL SAVINGS AT THE LOCAL LEVEL

Household, enterprise, and group savings in financial form may be held in ways that are informal, quasi-formal, or formal. Informal financial markets are ubiquitous. Though formally unregulated and unreported, these markets are nonetheless organized. They form part of the local political economy; financial channels and market shares of lenders are inextricably related to the local distribution of wealth and power, market linkages, political alliances, and information flows.

Informal markets are linked in a variety of ways with the formal financial sector and with quasi-formal bodies. The latter are unlicensed and generally unsupervised financial intermediaries that may, nevertheless, operate under particular laws and regulations (for example, some credit cooperatives and credit unions). However, the formal-informal distinction is not a dichotomy but a continuum. Thus, various kinds of financial intermediaries such as pawnshops, small-scale finance companies, cooperatives, and credit unions occupy positions on the formal-informal axis that vary according to country and sometimes vary even within countries.[15]

The extent and character of the interactions among formal, quasi-formal, and informal financial markets in rural areas can vary considerably depending on the degree of regulation in the formal sector; the extent of monetization in the rural areas, the confidence of the public in the government in general, and in the available financial institutions in particular; the ease of customer access to formal financial services; the activities of parallel and black markets; and on a variety of geographic, economic, cultural, and other factors.[16]

In Indonesia, as elsewhere, informal financial savings may be held in the ubiquitous ROSCAs or in nonrotating or Regular Savings and Credit Associations (RESCAs), or placed for safekeeping with local patrons.[17] Savings are also held in quasi-formal bodies such as some credit cooperatives, credit unions, and various forms of credit societies. These tend to accept fixed amounts of forced savings,

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[15] See Germidis, Kessler, and Meghir, op. cit.

[16] See Roemer and Jones (1991).

[17] See Bouman (1989).

usually as a condition of providing loans. Returns and risk vary. Such accounts tend to be nonliquid; typically the savings are not refundable until the loan is fully repaid.

Savings in formal financial institutions may be forced savings (which often accompany subsidized credit programs), or voluntary savings. As discussed above, appropriate instruments for mobilizing the latter are not widely available at the local level in many countries. However, the Indonesian experience demonstrates the potentially vital role that can be played by the effective institutional mobilization of voluntary savings. For savers, appropriately designed institutional deposit instruments usually provide the only opportunity to combine security, convenience, liquidity, and returns. For the financial institution, voluntary savings are the key to long-term viability.

## THE BENEFITS OF INSTITUTIONAL SAVINGS

Secure, conveniently located financial institutions that offer a choice of deposit instruments providing different ratios of liquidity and returns can simultaneously benefit households, groups, enterprises, the participating financial institutions, and the government. Well-designed and carefully implemented savings programs can contribute to local, regional, and national economic development and can help improve equity. The benefits from institutional savings at local levels may include those detailed below, all of which have been realized in the Indonesian case.

### Benefits to Households

**Liquidity (the key to mobilization of household savings).** Rapid access to at least some financial savings is considered essential by many households in monetized or partially monetized economies. Liquidity is crucial for mobilizing household savings. The demand for deposit instruments permitting an unlimited number of withdrawals is high because people save for emergencies and for investment opportunities that may arise at any time. Financial savings that are not deposited in institutions present either a security problem (if stored at home) or a liquidity problem (if held in savings societies). Thus, in areas characterized by economic growth and development and by a reasonable level of political stability, potential household demand for liquid deposit instruments in financial institutions may be high even if unrecognized by governments and banks.

**Returns on deposits.** Positive real returns on deposits are typically not available at low risk outside financial institutions. Where such institutions offer appropriate deposit instruments, the interest can be used by the household as an income flow or as savings. In addition to saving in liquid accounts, some households also demand fixed-deposit accounts that feature lower liquidity and higher returns. In Indonesia most households holding fixed-deposit accounts also hold liquid current accounts; however, the reverse does not hold. Fixed deposits, especially in conjunction with liquid accounts, are suitable in various ways for the types of savings mentioned below.

**Saving for consumption.** Households with uneven income streams (from agriculture, fishing, and enterprises with seasonal variations) can save for consumption during the periods in which income is low.

**Saving for investment.** Saving for development of household enterprises is discussed below. In addition to saving for such investment, however, households also save for other kinds of investment such as children's education, house construction and electrification, and the like.

**Saving for social and religious purposes and for consumer durables.** Social ceremonies (birth, puberty rites, weddings, and funerals) and religious donations or pilgrimages are some of the long-term goals for which people frequently save. Others are consumer durables; these vary from cooking pots to automobiles, depending on household income level.

**Saving for retirement, ill health, or disability.** Saving for old age or disability may take the form of building retirement savings or of saving to help establish junior members of the household who will then have the responsibility of caring for their elders, or both.

**Use of savings in lieu of credit; use of savings to build credit ratings; savings as collateral.** Households save in order to self-finance investments and to avoid paying what are often very high interest rates on the informal commercial credit market. Self-finance of investments is particularly important for middle and lower-income households that often do not have access to institutional credit.

The interest rates charged by informal commercial lenders, typically flat rates on the original balance, are widely reported to range from 2 percent to over 35 percent per month, with rates between 2 percent and 10 percent per month especially common.[18] In general, the poorer the borrower, the higher the interest rate, because lower-income borrowers normally have fewer credit options.

Many households hold savings accounts and loans simultaneously, especially if institutional loans are available to them. This strategy permits some stocks to be held for emergencies, while loans, used for working and investment capital and in some cases for consumption, are repaid from income flows. Institutional savers may also use their deposits to build credit ratings; in addition the deposits can be used as collateral for loans. These features are especially important for those who do not own land.

**Benefits to Enterprises**

Many of the benefits gained from institutional savings by households — security, returns, self-finance of investment — are also applicable to enterprises. Enterprises at all scales tend to have high demand for liquidity; many also have high demand for transfer facilities.

Small nonagricultural enterprises are typically bypassed by subsidized rural credit programs, and nonsubsidized institutional credit is often unavailable at the local level. Household savings are typically the main source of small and microenterprise finance, but in many cases small entrepreneurs must also borrow on the informal credit market at rates which, in Indonesia, range from 3 to more than 20 times nonsubsidized bank rates.

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[18] Interest rates in this range have been widely reported for rural areas of developing countries. See, for example, Reserve Bank of India (1954); Nisbet (1967); Ladman (1971); Bottomley (1975); Mundle (1976); Tun Wai (1977, 1980); Kamble (1979); Marla (1981); Adams and Graham (1981); Singh (1983, first published 1968); Wilmington (1983, first published 1955); Roth (1983); Chandavarkar (1987); Hossain (1988); Robinson (1988); Bouman (1989); Varian (1989); Von Pischke (1991); Germidis, Kessler, and Meghir, op. cit.; Chen (1991); Floro and Yatopoulos (1991); Aleem (forthcoming 1992); Braverman and Guasch (forthcoming 1992); and Siamwalla (forthcoming 1992). For a classic study see Darling (1978), first published in 1925. Interest rates lower than this range are also reported, and the rates in some areas have decreased over time; see, for example, Tun Wai (1977, 1980); Chandavarkar (1987); Fernando (1988); Bouman (1989); Von Pischke (1991). See Robinson (1992) for analysis of the reasons for the high rates prevalent in informal commercial credit markets.

Therefore, micro- and small-scale enterprises can benefit from institutional savings programs directly through encouraging self-finance of investment, and indirectly through the expanded volume of institutional lending available to small entrepreneurs at much lower rates than are otherwise available to them on the informal commercial market.

As financial institutions become sustainable through local savings mobilization, institutional financing for micro- and small-scale enterprises becomes feasible on a large scale. This has been demonstrated in Indonesia. Loans to such enterprises were not widely available from financial institutions before the advent of BRI's program of general rural credit at commercial interest rates, made viable by the accompanying rural savings program. Since 1984, however, many micro- and small-scale enterprises have been financed by KUPEDES loans, including those in trade, agriculture, livestock, poultry, dairying, food processing, services, and manufacturing of products such as textiles, garments, leather goods, crafts, furniture, jewelry, herbal medicines, and processed foods.

All KUPEDES borrowers are provided with unit bank savings accounts for voluntary deposits; unlike many banks, BRI does not require forced savings. Many KUPEDES borrowers are also savers, using loans and savings for working or investment capital and holding savings for emergencies and for use during periods in which business is slack.

Thus small entrepreneurs at the local level benefit from institutional savings, both directly by the encouragement given to self-finance and indirectly through access to lower-interest credit than is otherwise available to most micro- and small-scale enterprises.

**Benefits to Local Groups, Organizations, and Institutions**

Deposit instruments that permit savings to be held in the name of organizations and institutions provide significant benefits to the depositors. In Indonesia, the provision that savings accounts may be held in the name of a group, organization, or institution opened a large new market for rural deposits derived from village treasuries, government offices, schools, religious institutions, development programs disbursing funds for rural projects, and from a plethora of local organizations including employees', women's, youth, and sports associations; informal savings and loan associations; and voluntary agencies. The members of such groups generally prefer this arrangement to the customary one under which joint savings are held by the group leader or treasurer.

Although not yet common in other countries, in Indonesia group savings accounts have been reported to improve the financial security of the group, to decrease opportunities for corruption, and to improve the accountability and financial management of group funds.[19] Institutional saving also provides groups with the opportunity to earn returns on their deposits. A liquid instrument allays concerns that the group may not have access to its funds when needed, whereas fixed-deposit instruments meet demand from groups saving for building construction, religious festivals, sports trips, and other projects.

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[19] See Robinson (1992). The day that the instrument permitting accounts to be held in the name of organizations was first introduced to a particular area of Indonesia, the author observed a street fight between members of the local horse-cart drivers association and the treasurer of that organization. The members wanted the group funds deposited in the bank in the name of the association; the treasurer objected. When the members threatened to elect a new treasurer, the funds were deposited in the bank.

**Benefits to Financial Institutions**

Deposits mobilized in conjunction with commercial credit programs enable sustainable financial institutions. As of December 31, 1991, BRI's KUPEDES program had 1.8 million loans outstanding that were fully financed by unit bank deposits from 8.6 million savings accounts. In 1983 none of BRI's more than 3,600 unit banks was profitable; by 1991 nearly all, other than the recently opened units, were earning profits. KUPEDES supplies an increasing amount of the large demand for local credit at commercial interest rates. With deposit mobilization more than covering outstanding KUPEDES loans, the prognosis seems excellent for the long-term viability of the unit banking system.

Comparison of BRI's unit banking system with the Grameen Bank of Bangladesh is instructive in this regard. There are many differences between the two banks in aims, priorities, and target population. Nevertheless, there are certain ways in which they can be compared. The two banks charge nearly identical annual effective rates to borrowers (33 percent), both have very high repayment rates, both are socially profitable and help to finance rural development and to improve equity.[20] However, BRI's unit banking system is also economically profitable, whereas Grameen is not. As of June 1991, 42 percent of Grameen funds were from subsidized foreign donor and bank loans. In contrast, BRI's KUPEDES loans are fully funded by unit bank deposits, no subsidies are needed, and the unit banking system contributed over two-thirds of BRI's 1991 profits. The volume of KUPEDES lending is more than 10 times that of Grameen's. Grameen is constrained by its subsidies; BRI can expand to meet local demand for credit because of its deposits.

**Benefits to the Economy, Development, and Equity**

Local savings mobilization benefits the economy directly by increasing the resources available for productive investment. If coupled with a program of credit offered at commercial interest rates, the deposits can also benefit development through substantially increasing the volume of credit available to middle- and lower-income households and to small and microenterprises, thus helping to generate employment and to improve equity. Effective savings mobilization is crucial for local development because it encourages self-finance of investments, it meets the large demand for credit at commercial interest rates that typically range from 5 percent to 50 percent of the rates charged by informal commercial lenders, and it enables the growth of sustainable financial institutions.

The Indonesian experience has demonstrated the benefits of savings to the economy and to local development. In addition to its aims of transforming the unit banks into a profitable system and supplying the growing rural demand for financial services, a third BRI goal was to increase the availability of loans to villagers who had not previously received institutional credit, especially those with lower incomes. Considerable progress has been made in realizing this aim. Most KUPEDES borrowers had never before received an institutional loan or held a savings account. Because all KUPEDES borrowers have deposit accounts (and many use them), the number of savers has grown rapidly at the same time.

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[20] BRI's annual effective interest rate for prompt payers is 33.2 percent. As of 1988, Grameen's annual effective rate to the borrower was 33.3 percent; this consisted of 16 percent interest on the loan and the remainder in forced savings (Hossain, 1988, p. 46). Grameen subsequently raised the interest on its general loans to 20 percent but decreased forced savings to maintain the same annual effective rate to the borrower.

Section Three provides a broader look at the lessons from the Indonesian experience for the development of local financial markets in general and the role played by savings mobilization in particular.

In Indonesia the primary problem in mobilizing deposits from households, enterprises, and organizations at the local level was on the supply side. There were two main obstacles: the prevalence of subsidized rural credit programs, which provided a negative incentive for institutions to mobilize deposits, and the resultant lack of convenient, secure financial institutions that offer savings instruments appropriate for local demand. Without such institutions and deposit instruments, local savings are unlikely to be deposited in banks or other institutions, beyond the forced savings typically required for lending programs.

In the early 1980s BRI staff asked villagers why they did not make use of TABANAS (the national savings program administered by Bank Indonesia, the Central Bank); TABANAS had been available through BRI's unit banks since the mid-1970s. The replies were nearly unanimous. People from one end of the country to the other responded that TABANAS permitted withdrawals only twice a month, and that the restriction on withdrawals was unacceptable to them.

Accordingly, Indonesia's new savings program was designed to incorporate four main principles: (1) liquidity is the key to local savings mobilization; (2) convenience and security are crucial; (3) a mix of instruments is needed to meet varied local demand; and (4) a set of deposit instruments offering different proportions of liquidity and returns can simultaneously meet demand and, in combination with the KUPEDES program of general rural credit, permit institutional profitability. BRI's unit bank savings program, which mobilized deposits from both stocks and flows at the local level, has shown that an institution can profitably offer a set of deposit instruments for voluntary savings that provides the saver with convenience, security, liquidity, and returns.

However, Indonesia is an exception. Although institutional savings, and consequently the development of sustainable financial institutions, are depressed by the ubiquitous subsidized credit programs of developing countries, both the myth of rural undersavings and the presence of subsidized credit programs persist. As Sideri put it in 1984: "The special role of savings mobilization for the development process and its actual realization is barely treated in most of the relevant development literature."[21]

Indonesia's success in local savings mobilization in the second half of the 1980s can be summarized succinctly: The spread was set to provide incentives for savings mobilization, and the bank staff went into the villages regularly to study local financial markets. Other countries may wish to study the Indonesian experience.

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[21] Sideri (1984), p. 207.

# SECTION THREE

# A CASE STUDY IN SUCCESS: FINANCIAL INTERMEDIATION AT THE LOCAL LEVEL IN INDONESIA

## CREATION OF THE UNDERLYING CONDITIONS FOR A SUCCESSFUL RURAL BANKING SYSTEM

Had the BRI attempted to develop its rural banking system in the mid-1960s instead of the mid-1980s, it would undoubtedly have failed. With more than 600 percent inflation in 1966 and sharply decreasing real per capita income, falling production and investment, and a massive budget deficit, a successful rural banking initiative would have been impossible.

However, beginning in 1967 under the New Order government, stabilization and rehabilitation policies were given the highest priority.[22] The following two decades were a period of sustained emphasis on economic development, accompanied by political stability. A considerable share of the wealth gained from the oil booms of the 1970s was invested in the development of the country's rural areas, creating rural demand for banking services. Investments laid the foundations for the achievements of the 1980s, including the attainment of rice self-sufficiency, employment creation, real per capita income growth, and substantial rural development. During the 1980s major financial deregulations and tax, trade, and investment reforms strengthened the economy while permitting the development of a profitable nationwide rural banking system.

BRI's unit banks, established nationwide in the early 1970s to dispense agricultural credit, familiarized many rural people with banking activities. Government deregulations in the 1980s permitted the introduction of banking instruments that could meet local demand and permit bank profitability. Control of inflation and political stability contributed to the growing trust of the people in government banks. These were the conditions under which BRI's experiment in nationwide rural banking was undertaken.

## THE BRI UNIT BANKING SYSTEM: OVERVIEW

Each of Indonesia's five state-owned commercial banks has traditionally held specialized responsibilities; BRI's special assignment is the provision of banking services to the rural areas, with particular emphasis on agricultural credit. In accordance with this mandate, BRI developed a rural banking

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[22] General Suharto, who took de facto control of the country in March 1966, became Acting President in 1967 and President in 1968. He has been elected President for five consecutive five-year terms.

network in the early 1970s.[23] Known as the BRI unit banking system,[24] it was begun in Yogyakarta in 1969 as part of a pilot project for the national rice intensification program (BIMAS).[25]

Until the end of 1983, the unit banking system functioned primarily as a channeling agent for subsidized rural lending programs, especially the BIMAS credit program. As has occurred worldwide in subsidized rural credit programs, arrears were generally high, and both the bank and the government faced continuing losses. The loans, offered at low interest rates, were scarce and desirable and, therefore, were often allocated to rural elites with local influence. Credit options for other villagers usually consisted of doing without or borrowing at much higher interest rates on the informal commercial credit market. Savings accounts were offered in the unit banks beginning in 1976; however, the annual interest rates set by the government at 12 percent for loans and 15 percent for most deposits provided a disincentive for the bank to mobilize savings. By 1983 deposits in more than 3,600 unit banks nationwide totaled only Rp 16 billion ($17.6 million).[26] In 1983 BRI's unit banking system sustained a loss of 25 billion rupiah (Rp) ($27.5 million).

[23] For the development of BRI's unit banking system, see Suharto (1985, 1988); Robinson and Snodgrass (1987); Patten and Snodgrass (1987); Robinson and Sumarto (1988); International Labor Organization (1989); Sugianto (1989, 1990a, 1990b); Robinson (1989, 1991, 1992); Bank Rakyat Indonesia (1990); Boomgard and Angell (1990); Afwan (1991); Holt (1991); Liong (1991); Moermanto (1991); Patten and Rosengard (1991); Snodgrass and Patten (1991); Sartono (1991); Schmit (1991).

[24] The term unit bank has a special meaning in Indonesia. BRI's sub-district-level banks were originally called village units (unit *desa*); when urban units (unit *kota*) were added in the late 1980s, the term unit bank came to be used for all BRI's local banks, both rural and urban. Known as the unit banking system, it operates at the subdistrict (*kecamatan*) level, serving the villages of each sub-district and selected urban neighborhoods; the unit banks are under the supervision of the BRI branch, regional, and head offices.

[25] Improved National BIMAS (an acronym for Bimbingan Massal, or Mass Guidance) was begun during the 1970-1971 wet season.

[26] As of June 1983, the time of the major financial deregulation that marks the beginning of the change in the unit banking system.

# Table 1

# THE BRI UNIT BANKING SYSTEM

## 1984 - 1991

### Unit Bank Savings
(in billion rupiah)

| Year | TABANAS | SIMPEDES | SIMASKOT | Giro | Deposito | Other | Total Savings | Total No. of Accounts |
|---|---|---|---|---|---|---|---|---|
| 1984 | 39.10 | 0.31 | N.A. | 2.01 | 0.77 | N.A. | 42.19 | N.A. |
| 1985 | 63.60 | 5.13 | N.A. | 13.83 | 2.15 | 0.15 | 84.87 | N.A. |
| 1986 | 78.16 | 82.60 | N.A. | 10.93 | 3.92 | 0.20 | 175.80 | N.A. |
| 1987 | 79.55 | 182.64 | N.A. | 12.46 | 12.71 | 0.18 | 287.53 | N.A. |
| 1988 | 89.52 | 341.95 | N.A. | 16.64 | 44.45 | 0.39 | 492.95 | 4,183,983 |
| 1989 | 113.58 | 699.77 | 0.86 | 26.27 | 117.33 | 1.33 | 959.12 | 6,261,988 |
| 1990 | 153.53 | 999.75 | 147.63 | 40.23 | 322.99 | 30.71 | 1694.83 | 7,262,509 |
| 1991 | 217.61 | 1334.13 | 283.89 | 54.75 | 566.21 | 83.87 | 2540.45 | 8,587,872 |

Source: Bank Rakyat Indonesia, July, 1992

### KUPEDES Credit
(in billion rupiah)

| Credit Outstanding | Long-Term Loss Ratio** | No. of Loans Outstanding |
|---|---|---|
| 111.1 | 0.98% | 640,746 |
| 229.0 | 1.66% | 1,034,532 |
| 334.3 | 2.23% | 1,231,723 |
| 429.6 | 2.56% | 1,314,780 |
| 542.3 | 3.23% | 1,386,035 |
| 846.5 | 2.92% | 1,643,980 |
| 1381.8 | 2.62% | 1,893,138 |
| 1455.7 | 3.29% | 1,837,549 |

Source: Bank Rakyat Indonesia, July, 1992

### Number of BRI Unit Banks

| Total Unit Banks | Share of Profitable Unit Banks to Total Unit Banks |
|---|---|
| 3626 | 9.27% |
| 2450 | 48.65% |
| 2273 | 72.46% |
| 2341 | 80.61% |
| 2585 | 80.85% |
| 2844 | 79.22% |
| 3040 | 89.31% |
| 3210 | 83.99% |

Source: Bank Rakyat Indonesia, July, 1992

### Rupiah Exchange Rate per Us $ (annual averages)

| Year | Rupiah Exchange Rate per US $ (annual averages): |
|---|---|
| 1984 | 1025.9 |
| 1985 | 1110.6 |
| 1986 | 1282.6 |
| 1987 | 1643.9 |
| 1988 | 1685.7 |
| 1989 | 1770.1 |
| 1990 | 1905.0 |
| 1991 | 1950.6 |

Source: International Monetary Fund and Bank Indonesia

## NOTES

- The totals are for the end of each year; discrepancies are due to rounding.

** Long-Term Loss Ratio = [Cumulative arrears + Payments due] x 100

*** Portfolio status = [Cumulative arrears + Current outstanding] x 100

Between December 31, 1983, and December 31, 1991, however, BRI's unit banking system extended Rp 7.0 trillion in 10.1 million loans in its KUPEDES program of general rural credit. As of December 31, 1991, KUPEDES loans outstanding were $746 million, with a long-term loss ratio of only 3.29 percent[27]; unit bank deposits totaled $1.3 billion on the same date (Table 1).[28] The annual KUPEDES effective interest rate is 33 percent for prompt payers (late payers are penalized). KUPEDES began in 1984; BRI's unit banking system broke even by early 1986 and by 1991 contributed over two-thirds of BRI's total profits.

## MOBILIZING LOCAL SAVINGS

BRI's new savings program was designed to meet local demand for savings instruments offering different mixes of liquidity and returns. The program, designed after extensive fieldwork throughout the country, was based on studies of local financial markets and on the views of the participants in these markets. The methodology, in itself, was a major innovation, and one which paid off.

Four savings instruments, with different ratios of liquidity and returns, were made available at the unit banks during 1986 as part of BRI's new rural savings program. SIMPEDES, a deposit instrument that permits an unlimited number of withdrawals, was introduced as the flagship of BRI's new rural savings program, which was extended in 1989 to urban areas as well. TABANAS, the national savings program offered in the unit banks since 1976, was continued; Deposito Berjangka, a fixed-deposit instrument previously available from BRI only through its branches, was now offered at the unit banks as well. The fourth instrument, Giro, a type of current account used primarily by institutions with special requirements, was also made available at the unit banks.

Unlike the KUPEDES program of general rural credit, the savings program was developed gradually. In the case of KUPEDES, the imminent termination of the BIMAS credit program, combined with the fixed costs of maintaining more than 3,600 unprofitable unit banks, forced an all-or-nothing

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[27] BRI uses two measures of long-term arrears:

$$\textit{Portfolio status} = \left[\frac{\textit{cumulative arrears}}{\textit{current outstanding}}\right] \times 100$$

$$\textit{Long-term loss ratio} = \left[\frac{\textit{cumulative arrears}}{\textit{payments due}}\right] \times 100$$

Because portfolio status measures cumulative arrears as a percentage of current outstanding (which includes loans not yet due), long-term loss ratio is considered the more accurate measure of the program's loan recovery. The KUPEDES long-term loss ratio was 3.28 percent, and its portfolio status was 8.55 percent as of December 31, 1991.

[28] December 31, 1991, figures for the unit banking system are used where available. Where these are not available, earlier figures are used. In comparing 1990 and 1991 figures, it should be noted that the slow growth in KUPEDES lending during 1991 was caused primarily by credit restrictions in BRI resulting from the government's "tight money policy" in 1991 (imposed in order to control inflation, which had risen from below 6 percent in 1989 to 9.5 percent in both 1990 and 1991).

decision in mid-1983: The rice banks would either be closed or, beginning in 1984, transformed into real banks, starting with a commercial lending program. Regarding rural savings mobilization, however, there was both less urgency and less information about demand. Fieldwork throughout the country beginning in 1982 had shown that there was extensive rural demand for financial savings in general, and in particular for liquid savings accounts in which financial stocks (usually kept in the house) and savings from income flows could be safely deposited. In addition, many villagers wanted to convert some nonfinancial savings into institutional deposits if these could be held in liquid form.

The magnitude of the demand, however, was unknown in 1984. BRI decided, therefore, to proceed through a series of pilot projects under which different deposit instruments could be tested and local demand studied. Accordingly, SIMPEDES was introduced in a pilot project in Sukabumi District (West Java) in November 1984; the instrument was extended to 12 other district-level pilot projects in 1985 and became available nationwide during mid-1986.

The most important characteristic of SIMPEDES is its liquidity and the fact that it pays generally positive real returns except on very small accounts. There was enormous, but previously unrecognized, demand for a liquid deposit instrument. However, TABANAS, the only savings instrument previously available at the local level, permitted only two withdrawals per month. In further contrast to TABANAS, SIMPEDES allows deposits to be made in the name of organizations and institutions.

Other features of SIMPEDES are that interest is compounded and posted monthly, and that lotteries for SIMPEDES savers are held locally. The number of SIMPEDES lottery coupons a depositor holds is determined by the amount of the minimum monthly balance in his account. Lottery prizes (ranging from cars to clocks) are awarded in district-level ceremonies; the opportunity is used to invite local dignitaries and to provide, in a festive setting, information about BRI and its services. In contrast, TABANAS (administered by Bank Indonesia), posts uncompounded interest annually and holds national lotteries.

The first pilot project in Sukabumi quickly showed evidence of massive demand for the liquid SIMPEDES instrument, which was offered there at a 12 percent annual interest rate on the minimum monthly balance (a lower rate than the 15 percent annual interest rate then paid on TABANAS deposits of Rp 1 million or below). At the end of October 1984, after nearly a decade of collecting savings in its unit banks, there was a total of Rp 173 million ($169,000) in BRI TABANAS deposits in the unit banks located in Sukabumi District. The pilot project on savings mobilization began on November 1, 1984, in the unit banks throughout the district. By the end of December, two months later, Sukabumi's unit bank deposits totaled Rp 471 million ($459,000), an increase of 172 percent in two months.[29] SIMPEDES accounted for 65 percent of the total. By December 31, 1990, deposits in BRI unit banks in Sukabumi District totaled Rp 8.5 billion ($4.5 million), of which SIMPEDES accounted for 91 percent.

Although it rapidly became apparent that the Sukabumi pilot project would be successful in mobilizing funds, it also became clear that SIMPEDES as implemented in the pilot project was a labor-intensive and expensive way to raise funds (for a variety of reasons, including recording of numerous

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[29] This rapid increase was caused, in part, by the fact that the timing of the pilot project coincided with the government's annual disbursement of village grants for development (Rp 1 million per village in 1984), under the national village grant program (INPRES Desa). In 1984 in Sukabumi District these funds were, for the first time, deposited in village bank accounts in BRI's unit banks. However, even if the INPRES Desa deposits in village accounts are excluded, Sukabumi's unit bank savings rose dramatically in two months: from Rp 173 million to Rp 301 million, an increase of 74 percent.

transactions, monthly posting of interest, activities related to the SIMPEDES lottery, and promotional efforts). As more SIMPEDES accounts were added daily, it seemed that additional staff would have to be employed, raising costs, or the workload would cut into KUPEDES lending, lowering income. Either way, the profitability of the Sukabumi unit banks would be negatively affected. It was decided, therefore, that the SIMPEDES instrument must be revised before it could be expanded to other areas; otherwise its success in mobilizing deposits might drive the unit banking system into bankruptcy!

In mid-1985, therefore, a second-stage pilot project was begun in the unit banks of 12 BRI branches on Java; a modified, lower-cost SIMPEDES instrument was introduced in those districts. Changes included offering a split interest rate determined by the level of minimum monthly balance, holding lotteries semiannually instead of quarterly, and improving efficiency in administration. During 1985 the modified SIMPEDES instrument was adjusted further and adapted in various ways to rural conditions. The cost of money for the modified instrument was reduced to approximately the same level as the costs for TABANAS and Deposito Berjangka, the other savings instruments then offered in the unit banks (2 to 3 percent above the 15 percent cost of loanable funds from Bank Indonesia in 1985).[30] In April 1986, BRI began expanding the modified SIMPEDES instrument to other areas; by September of the same year it was available through the unit banking system nationwide.

Annual SIMPEDES interest rates in 1986, based on the minimum monthly balance, were split: No interest was paid on accounts of Rp 25,000 or less; 9 percent on those between Rp 25,001 and Rp 200,000; and 12 percent on accounts above Rp 200,000. Over time, the rates for the larger accounts rose; in 1990 14.4 percent per year was paid on accounts with minimum monthly balances from Rp 200,001 to Rp 750,000, and 15 percent was paid on accounts over Rp 750,000. In 1989 an urban version of SIMPEDES (SIMASKOT) was introduced in the new unit banks opened in cities.

SIMPEDES was introduced as part of a set of four savings instruments designed to supply different types of demand. The SIMPEDES instrument was aimed at households, firms, and organizations that demand liquidity in combination with positive real returns. SIMPEDES is especially attractive to traders because of its liquidity. BRI found that it also has a comparative advantage over other banks in obtaining accounts from large urban-based corporations that conduct substantial business in rural areas. For example, some of the large companies engaged in national distribution of soft drinks, cigarettes, cosmetics, and processed foods demand SIMPEDES accounts into which their local distributors can make deposits and from which funds can be transferred to urban banks. Similarly, urban-based companies purchasing raw materials or goods wholly or partially produced in rural areas found SIMPEDES accounts useful for making payments to their suppliers.

Because SIMPEDES is labor-intensive, very small accounts are discouraged (through a policy of no interest on accounts of Rp 25,000 or below). TABANAS provides a higher interest rate and pays interest on all accounts regardless of size; however, the number of withdrawals continued to be limited to two per month. Annual TABANAS interest rates in 1986, calculated on the minimum monthly balance, were 15 percent for accounts of Rp 1 million or less and 12 percent for accounts of more than that amount. By 1990, BRI's annual TABANAS interest rate had risen to 17 percent for all accounts, and withdrawal provisions had been liberalized. TABANAS is aimed at depositors who want middle levels of liquidity and returns. School children and other holders of small accounts are encouraged to save in TABANAS.

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[30] "Cost of money" is used by BRI to refer to all costs of an instrument, including interest, lottery prizes, promotion, and overhead. The term "cost of loanable funds" (COLF) is used for costs excluding overhead.

Deposito Berjangka, a fixed-deposit instrument, provides the highest interest rates and the lowest liquidity of the instruments offered at the unit banks. In 1986, Deposito Berjangka began to be offered in the unit banks for 1-, 3-, 6-, 12-, or 24-month periods; the 1986 annual interest rates for these time deposits ranged from 13 to 16 percent. By 1990 the range of interest rates had reached 18 to 21 percent. Many Deposito Berjangka account holders also hold SIMPEDES accounts. Deposito Berjangka is used by wealthier villagers and by firms that want to realize higher returns and that can afford to save in nonliquid instruments, and by those saving for particular future goals (such as building construction, land purchase, education, retirement, and pilgrimage).

The savings instruments offered in the unit banks since 1976 have provided positive real interest rates, with two exceptions: small SIMPEDES accounts and Giro, a low-interest demand deposit account designed primarily for specialized institutional purposes.[31] During 1990 and 1991, however, the interest received by SIMPEDES depositors with accounts from Rp 25,001 to Rp 200,000 was approximately equal to the inflation rate. Smaller SIMPEDES account holders who wanted higher returns could switch to TABANAS, but few did because of the high priority given to liquidity. All TABANAS and Deposito Berjangka accounts, and all SIMPEDES accounts with minimum monthly balances over Rp 200,000, provide positive real returns, even after the tax on the interest owed by the account holder. Interest is taxed by the government at 15 percent per year, with the exception that TABANAS accounts of Rp 1 million or less are exempt from tax. Deposits in all instruments are guaranteed by BRI.

As of December 31, 1991, SIMPEDES, with Rp 1.3 trillion, and its urban counterpart SIMASKOT, with Rp 284 billion, together accounted for Rp 1.6 trillion ($ 830 million) or 63.7 percent of total unit bank deposits (Rp 2.54 trillion, or $1.30 billion). Deposito Berjangka, with Rp 566 billion ($290 million) accounts for 22.3 percent, and TABANAS with Rp 218 billion ($112 million) accounts for 8.6 percent. The remaining 5.4 percent is in Giro and other instruments.

With 8.6 million savings accounts as of December 31, 1991, BRI's unit banking system, operating in local areas throughout the country, serves 20 percent of Indonesia's households. SIMPEDES and its urban version, SIMASKOT, along with TABANAS are the instruments designed particularly to appeal to households, to micro- and small-scale enterprises, and to smaller account holders in general. As of the same date, these instruments accounted for 97.1 percent of total unit bank accounts and 72.3 percent of the amount of unit bank deposits. Among these instruments, the average deposit as of December 31, 1991, was $113. It is clear, therefore, that households and household-financed enterprises are increasingly benefiting from BRI's unit bank savings program. They also benefit indirectly from the expanded volume of institutional credit made available by the savings program for finance of local enterprises.

BRI's accomplishments were made possible by 10 specific changes carried out within the bank. These included (1) a major reorganization of BRI management at all levels from the head office to the unit banks; (2) the high priority accorded by the head office to the management of the unit banking system; (3) extensive reorganization and training of staff throughout the country; (4) establishment of a system of promotion that incorporates the unit bank staff into the wider BRI personnel system, and a start in developing promotion criteria that reflect the new expectations for performance; (5) a fundamental revision of bookkeeping, audit, and supervision systems that permitted the establishment of the unit banks as independent financial units (in contrast to their earlier status as branch windows), making accountability possible and also making feasible the sustained anticorruption drive that was implemented in the unit

[31] Annual interest rates were raised again in 1991: SIMPEDES rates reached 19 percent for accounts over Rp 2 million; TABANAS rates rose to 22 percent for accounts over Rp 10,000; and Deposito Berjangka rates ranged from 24 to 26 percent. Inflation was 9.5 percent in 1991.

banking system; (6) the opening of new unit banks and the relocation of others to areas with high demand; (7) attention to learning about rural financial markets and emphasis on using this information to avoid potential problems associated with moral hazard and adverse selection; (8) crucial improvements in communication and computerization facilities; (9) a complete overhaul of BRI's public relations; and (10) the implementation of an effective unit bank staff incentive system that rewards good performance.

Of course, the system has remaining problems and difficulties (and some new ones): some "old culture" managers still remain; unit bank staff recruitment procedures are still inadequate; the new criteria for staff promotion are not fully developed or systematically implemented; and continued improvement is needed in diverse areas such as supervision, communications, transfer of funds, relations between the branches and the unit banks, and data collection and analysis. What is different about the new culture, however, is that these difficulties are recognized by BRI's management, and their improvement accorded priority.

The Indonesian experience shows that there can be extensive rural demand for general rural credit at commercial interest rates and that a large volume of credit can be financed through local savings. Low institutional deposits may be due not to lack of savings potential but to lack of appropriate institutions and instruments. BRI undertook its major initiative in rural savings mobilization despite considerable expert advice to the contrary. As unit bank deposits increased by 73 times from 1983 to 1991, an old proverb came to be quoted in BRI: "The person who says it cannot be done should not interrupt the person doing it."

## SECTION FOUR

## POLICY ISSUES: LESSONS FROM THE INDONESIAN EXPERIENCE

The Indonesian experience provides a number of lessons. On the lending side, KUPEDES is attractive because the rates are far lower than those available from informal commercial lenders, usually the only competition, and people repay primarily because, under these circumstances, they want to reborrow. On the savings side, the experience shows that households, groups, and enterprises are often relieved to save in financial institutions for several reasons. These include security, which is related not only to possible theft but also to the multiple claims on ready cash that exist in local settings; positive real returns; and financial savings as an appropriate way to hold funds from uneven income streams and to save money needed at particular times for specific purposes. The Indonesian experience also provides overwhelming evidence that deposits can be mobilized locally in ways that are profitable for the institution and beneficial for the savers, that sustainable rural financial institutions can be created and maintained, and that successful development of rural financial intermediation is possible on a large scale.

To what extent are Indonesia's achievements adaptable to rural financial markets in other parts of the developing world? It appears that some of the lessons are general and might be adapted to the conditions of other countries. These lessons include the following:

**Good macroeconomic management and rural development are requirements for the sustainable development of a successful rural banking system operating on a large scale.** In Indonesia, rural banking followed the government's investment of oil wealth in rural development. A growing economy resulted in households and enterprises with potential financial savings that could be mobilized by a trusted, convenient institution with appropriate deposit instruments. With an appropriate spread between lending and deposit interest rates, BRI's unit banking system has become profitable and sustainable. The particular Indonesian pattern is not, of course, a necessary component of a successful rural banking system. Nevertheless, for an effective large-scale rural banking system, there must be rural development, inflation must be controlled, deposits must be mobilized, and financial institutions must be permitted to set interest rates that will enable institutional profitability. In some circumstances, local financial institutions may function well in the absence of some of these criteria, but all are crucial for sustainable large-scale systems of rural banking.

**A reasonable level of political stability is required so that people have trust in the broad continuity of institutions and policies.** Although households and enterprises will take loans from institutions they may not trust, they will voluntarily deposit their savings only when they have trust in the institution (public or private) and in the broader political and economic system. Viable financial institutions serving the local level depend on savings mobilization, the success of which depends heavily on trust. Thus, reasonable macro-level stability is required for voluntary savings mobilization which, in turn, is required for profitable rural banking.

**"Rural undersavings" is a myth; savings mobilization is both achievable and essential for sustainable rural financial intermediation.** Despite more than two decades of evidence and much thoughtful literature to the contrary, savings mobilization is still the forgotten half of rural finance. Overlooking savings mobilization is one of the primary causes of often-repeated, but seriously mistaken, policy decisions concerning the development of rural financial markets. Thus, it is still widely assumed that the poor savings record of many rural financial institutions in monetized or partially monetized economies demonstrates that the tendency to save in rural areas is low and that savers prefer to save in other forms. What the record usually demonstrates, however, is the lack of appropriate institutions and instruments. This mistaken assumption, in turn, leads to severe underemphasis of the importance of building rural financial institutions. Rural financial institutions, of course, can be viable only if they mobilize deposits, a task usually assumed to be too difficult.

An important result of the neglect of savings is that the institutional loan funds available in rural areas generally cannot meet demand. In addition, villagers are deprived of the opportunity to save in a financial form with positive real rates of return (and of the opportunity to build up credit ratings through savings accounts). The lesson from Indonesia is crucial. As BRI discovered, the use of previous institutional savings performance as a predictor for future potential may be seriously misleading. The spread had provided a disincentive for savings mobilization, and TABANAS was insufficiently liquid for most village demand. BRI's impressive growth in unit bank deposits between 1983 and 1991 was accomplished in large part because the bank learned the importance of liquidity for voluntary savings mobilization; how to identify and contact potential sources of savings at the local level; how to design instruments to meet varied local demand from individuals, households, enterprises, organizations, and institutions; and the critical role of staff incentives for good performance.

**Analysis of rural markets, and the training of institutional staff in understanding the markets they finance, are essential for the design and implementation of successful financial instruments and services and for the development of sustainable financial institutions.** Successful rural banking is founded in analysis of rural markets and their linkages, in understanding rural behavior under changing social and economic conditions, and in knowledge of the financial requirements and aspirations of villagers who control different economic resources and whose households are at different stages in the developmental cycle of domestic groups. Studies of these types were carried out extensively in Indonesia, and the country now has a profitable nationwide banking system serving households, enterprises, and organizations.

As would be expected in financial institutions without large-scale subsidized local lending programs, BRI's unit banking system has many more savings accounts than loans; the ratio is nearly five to one. Under these circumstances, savers are not only a source of funds; they are also a source of information to the institution concerning local financial markets and the identification of low-risk borrowers.

**Effective leadership and management are essential for selection of the priorities required for the development of viable rural financial institutions, and for the successful implementation of appropriate services and instruments.** BRI's President Director from 1983-1992, its Director responsible for the unit banking system, and the other members of BRI's board of directors led the development of what they called BRI's new culture and Indonesia's new rural banking system. To accomplish a number of related goals, they emphasized extensive restructuring of BRI's management from the head office to the unit banks; development of a system of training, incentives, and promotions that reflects and incorporates the new expectations; development of the technical capability needed for the design and successful implementation of the new banking programs; and development of staff capability to analyze rural markets and their linkages. BRI's board was supported in its efforts by the Indonesian Ministry of Finance, the Coordinating Minister for the Economy, Finance, and Industry, and other policy makers at high levels in the government.

BRI planned its lending and savings programs together, along with the crucial changes in management, training, incentives, accounting, and supervision that would support the new unit banking system. Other priorities (relocation of unit banks, expansion to urban areas, computerization and communication improvement, expansion of financial services, and the like) were phased in more gradually. Some details — for example, staffing and recruitment procedures, relations between the branches and the unit banks, and facilities for transfer of funds — have only recently been accorded high priority. BRI kept its goals in focus and selected well among options.

**Lending and deposit instruments and the spread in their interest rates should be planned in conjunction with one another.** These instruments need not be implemented simultaneously (for example, an institution may need to build up trust through lending before mobilizing voluntary savings), but if one is planned without regard for the others, the system cannot be sustainable for the long term. Subsidized credit programs are a case in point.

Beginning with the 1983 financial deregulations, BRI's unit banking system was planned as a sustainable nationwide system of local financial intermediation. For reasons relating to BRI staff capacity, the new savings program was begun nearly two years after KUPEDES started. Yet credit, savings, and the spread in interest rates were planned together. At the time, some had suggested that KUPEDES could become self-sustaining even without substantial rural savings; that approach was rejected. There were four primary reasons.

The idea behind KUPEDES was to meet the country's demand for general rural credit at commercial interest rates. It was correctly anticipated that this undertaking would eventually require substantially more financing than had been required for all previous rural credit programs (for which the targets had been borrowers with particular kinds of productive enterprises).

The government, concerned in the early 1980s about the possibility of a decline in the real value of oil revenues, had begun to seek new sources of income growth, encourage private sector savings and investment, and implement major financial reforms. Under these conditions, it was decided that extensive long-term funding for a nationwide rural credit program could not be committed from Bank Indonesia, the Central Bank. Emphasis was placed instead on the encouragement of private sector savings and investment.

The risk was considered too high for long-term commitment of Central Bank funds. It was well known that many government rural credit programs in Indonesia and in developing countries throughout the world had a history of high arrears. No example could be found of a profitable nationwide rural credit program in a major developing country. Indonesia's economics ministers recognized the potential for a large-scale rural banking system and supported its introduction with government funding; they also recognized the importance of limiting government risk.

As part of a wider policy of encouraging private savings, the government wanted to arrange for the supply of what was accurately estimated as a large potential rural demand for savings in financial institutions. Government planners thought an approach that offered savings instruments appropriate for rural demand could provide villagers with positive real returns and at the same time build the long-term viability of the unit banking system. Both results would contribute to rural development, a primary aim.

For these reasons, extensive rural savings mobilization became a crucial component of the overall plan for the unit banks.

**In a country undergoing significant rural development, there is likely to be substantial demand for rural-urban financial intermediation. In addition, banking instruments and services that work in rural areas can be adapted for urban neighborhoods, and vice versa.** Given the recent large-scale rural-urban migrations and the widespread communication facilities that link urban and rural areas in Indonesia and in other developing countries, the economics of rural organization often cannot be considered apart from the wider context. Under these circumstances, there is considerable opportunity for the expansion of successful methods of rural financial intermediation into urban areas.

Critics have sometimes said that BRI's unit banking system draws funds from rural to urban areas, thus contributing to urban bias. In fact, the unit banks may help to counteract urban bias. In urban units, savings (35 percent of total unit bank deposits) are higher than KUPEDES loans outstanding (25 percent of total outstanding) as of December 31, 1990, whereas the reverse is true in rural units. Although most of the deposits are in rural areas, the trend is changing (the new savings program began nationwide in rural areas in 1986 and in urban areas in 1989). Also, the prevalence of remittances from urban workers to their rural families suggests that some rural savings originate from urban sources.

**It is not necessary to choose between the economic profitability of the financial institution and the social profitability to the country.** A recent review paper on rural credit markets poses the question: "Should viability be understood in terms of economic profitability of the institution, or should it be understood as social profitability to the country? . . . Given the decision to intervene . . . the salient criteria for viability should be social profitability to the country."[32]

The crucial point is that it may not be necessary to choose. Though, of course, circumstances vary in different countries and regions, the Indonesian case shows that there need not be a tradeoff between economic and social profitability. In Indonesian rural banking, the former is in fact necessary for the latter. The Indonesian government could not possibly make available the large volume of credit needed to meet demand for full development of its rural areas. However, the demand for credit for productive uses in rural areas can be met by profitable financial institutions, both government and private. These can, of course, be viable only if they mobilize deposits.

The sectoral lending programs of the 1970s could not meet most of Indonesia's rural demand for credit because the programs were subsidized and therefore rationed. In contrast, KUPEDES, supported by local savings, has driven the unit banking system to profitability and extended a much larger volume of credit to millions of borrowers throughout the country. It is, therefore, no longer necessary for many of Indonesia's local borrowers to pay the high interest rates of informal commercial lenders.

The unit banks have had a positive effect on both development and equity; this can be demonstrated in several ways. First, a large amount of funds has been provided for rural credit at substantially lower interest rates than had been previously available. Unlike subsidized credit programs in Indonesia and elsewhere, these loans are not rationed and, therefore, are not limited de facto to higher-income borrowers. Second, the savings instruments offered in the unit banks provide generally positive real returns to millions of customers. Third, both KUPEDES and SIMPEDES have been successful in reaching customers who had never before borrowed or saved in a bank. Finally, KUPEDES provides loans to a wide range of borrowers; 33 percent of the survey respondents reported monthly household incomes of $78 or less. There are still many potential customers who have not yet been reached by the unit banking system, but it is clear that the system plays an important role in rural development and assists in poverty alleviation. Officials at the highest levels in Indonesia have recognized that, in meeting the widespread demand for rural banking, BRI's unit banks help maintain social stability and promote economic development.

The Indonesian experience thus demonstrates that a spread between lending and savings interest rates can be set that permits bank profitability while offering loans at interest rates significantly below those of informal commercial lenders and providing savers with generally positive real rates of return on

[32] Braverman and Guasch (forthcoming).

their deposits. The fundamental lessons from Indonesia are that institutional viability, rural development, enterprise finance, and improvement in equity can be achieved simultaneously and that this can happen only if savings mobilization is transformed from the forgotten half to the sustaining half of rural finance.

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