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1. Thomas Timberg
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STRATEGY OF FINANCING SMALL AND MEDIUM ENTERPRISES IN A NEW ECONOMIC ENVIRONMENT[1]

by Thomas Timberg, Ph.D.[2]

I. INTRODUCTION

A. Economic Background

The prospect for Indonesia in general and Small and Medium Enterprises (SMEs) in particular is beginning to improve. The economy has begun to recover and a strong positive rate of growth can be predicted (3-4%), bank credit has begun to rise, and other signs of a new beginning are on the horizon.[3] The economic crisis affecting Indonesia since mid-1997 has gradually subsided. Key indicators show that the economy has bottomed out and recovery begun. The economic recovery continues as reflected by surging export, investment, consumption and production activities, lower inflation, and a stronger rupiah. The economic contraction of 1998 has successfully been stopped, and there has been economic expansion since the second quarter of 1999. Meanwhile, interest rates were broadly stable and progress was recorded in banking sector.

Besides increased exports, investment activity contributed significantly to GDP growth. Vehicles and retail sales increased, while the occupancy rate of commercial property improved. Results from business and consumer confidence surveys also pointed to a more buoyant economy.

From the demand side, the upturn of economic activity was particularly supported by the increase in consumption. During the second quarter of 2000, public consumption grew by 2,5% compared to the same period in the previous year. The consumption increase is expected to be continue in following months, even though with a slower pace.

A number of banking indicators showed some notable progresses compared to the preceding months. Developments in fund mobilization, credit provision,

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[1] Presented at conference on "The Indonesian Economic Recovery in Changing Environment", held by the Faculty of Economics – University of Indonesia on her fiftieth anniversary. Jakarta, 4-5 October 2000

[2] Small Scale Credit Adviser for Bank Indonesia, Partnership for Economic Growth (PEG). I gratefully acknowledge the many inputs and insights for this paper provided by Mr. Abdul Azis and Mrs. Yunita R. Sari of Biro Kredit, Bank Indonesia. PEG is a USAID-funded Project. The views expressed in this report are those of the author and not necessarily those of USAID, the U.S. Government or the Government of Indonesia.

[3] Report for The Second Quarter 2000, Bank Indonesia

capital, and interest income pointed in promising directions. Meanwhile, both the bank recapitalization program and credit restructuring program continued to move forward.

B. New Cabinet and Bank Indonesia

While the economy recovers, a new cabinet has attacked economic problems with new vigor, and with a specific focus on assisting SMEs as a vehicle for overall economic growth. Bank Indonesia is, of course, in close cooperation with Government in assisting SME as in other respects.

Its cooperation involves a broad spectrum of matters. Bank Indonesia needs to insure that the banking system provides SMEs adequate financial services and that a stable currency and growing economy provide them a fostering environment.

C. SME Finance and the Conference Theme

As noted in the background paper for this Conference -- "the most important task for Indonesia, is to sustain the remarkable record of the past quarter century." It will be explained in what follows that we need to build on the considerable achievements of the financial system in serving SMEs, while learning from past mistakes and making appropriate corrections. This will have to be done in a context of much greater transparency, decentralization and democratization than was previously the case.

As noted in that same background paper the greatest short term priority is bank and corporate restructuring. While SMEs are neither the major problem nor the major focus of this restructuring they do play some role and at the same time we need to see that the restructuring serves their needs as much as prudently possible. There is some danger that in the process changes will be made that will incidentally impair SME service, without contributing to the desired goal of restructuring. In addition, the general problems of limited budget and debt carrying capacity on the part of the government, means that we need to develop market oriented assistance strategies for SMEs that keep these problems in mind. In general, financial services for SMEs will have to be funded on a financially sustainable, unsubsidized basis.

In the medium term, strategies for serving SMEs are a critical element in developing markets and market institutions. SMEs have represented a significant portion of bank and other financial portfolios for some time, and we hope they will represent an increasing portion in the future. The future architecture of our financial system must both be sustainable and prudent, and provide the needed financial services to support SME and thus overall economic growth.

II. SMEs DEVELOPMENT IN INDONESIA'S ECONOMY -- RECOVERY PROGRESS: THE IMPORTANCE AND BENEFITS OF SME

SMEs in Indonesia have historically played a significant role in the Indonesian economy. First, this is because of their high proportion in Indonesia economic activity in terms of the number of enterprises and employees as well as in output. Indonesia's almost 40 million SMEs account for over 98% of her enterprises and over 60% of her GNP.[4] Though the proportion of GNP they represent has undoubtedly declined over the last decades, it has risen slightly since the monetary crisis, which has affected SMEs less than it has large scale enterprise. Their role in manufacturing is relatively small – a little under 10% of value added and SMEs might be expected to decline relatively and change form over the course of future economic development.[5] Their role in agriculture, trade, and services is considerable. Roughly half of SMEs are in agriculture.

There are 16.3 million non-agricultural enterprises with less than 4 workers, 519,000 with 5-19, and only 65,000 enterprises with more than 20 employees. For statistical purposes, microenterprises are considered those with 4 or less employees, small enterprises are those with 5-19, and medium enterprises with 20-99.[6]

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[4] 1996 Economic Census, **Profile of Establishment with Legal Entity**, Jakarta, Badan Pusat Statistik, 2000, Table A and further.

[5] Donald R. Snodgrass and Tyler Biggs, **Industrialization and the Small Firm: Patterns and Policies**, International Center for Economic Growth and Harvard Institute for International Development, SF, CA: 1996.

[6] These are the definitions used by the Central Statistical Bureau, which are in accordance with international statistical usage. For other purposes SME are defined by the Small Business Law of 1995, which defines them as independent, nationally owned

Second, SMEs provide employment opportunities. The employees of SMEs in Indonesia account for as much as 99.44% of the total number of employees and SMEs are expected to continue to provide many new employment opportunities through the establishment of new businesses and the expansion of old ones. Most of the SMEs are tiny, typically employing only one family.

SMEs are also important players in the development of local economies and communities. This is due to their close link to the local economy. Many SMEs form themselves into clusters, such as the wood working industries of Jepara, where they give a dynamism to the entire local economy.

SMEs are also the creators of new markets and the introducers of innovation. SMEs are often directly exposed to ever-changing market conditions and tend to have a more flexible organization and quicker decision making processes than large enterprises, therefore they are quick to react to such change. They can often create new markets by responding to new market opportunities and by taking advantage of innovations.

A. Small and Medium versus Microenterprise

The credit to small and medium enterprises on the one hand, and micro borrowers on the other, flows in somewhat different forms, but more importantly has somewhat different goals. The smallest micro enterprises are often owned by poor households and the finance given them is intended to "empower" them socially as well as increase national income. The credit provided poor households is an integral part of the social safety net and antipoverty strategies. Some microenterprises are highly productive, but their social merit is an important motive for assisting them. Credit to small and medium enterprises is an integral part of industrial development policy and is judged primarily on the basis of the increase in national income it brings. These enterprises do have a social aspect, since they secure a broadening of economic participation, and provide the social basis for a small holders democracy. In Indonesia, most of the credit for both kinds of SMEs is

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businesses with a capital of less than 350 Million Rps excluding land and structures and a turnover of less than 1 Billion Rps. Bank Indonesia as noted latter adds to this some restrictions in terms of what is considered SME lending.

provided on a commercial basis. This has enabled the volume and efficiency of both kinds of credit, but especially those for microcredit to be among the highest in the world, and for Indonesian credit programs to achieve an international renown.

As I just indicated, the degree of subsidy in Indonesian commercial bank credit is low, but there are certainly proposals for larger and more subsidized efforts which would entail larger subsidies. This subsidy needs to be balanced by demonstrable social benefits. The present international consensus seems to be that very small credits (several hundred thousand Rps), need some subsidy to the organization that administers them – but that this subsidy can be quite limited and justified by attached social benefits, including the protection of beneficiaries from cyclical swings.[7] Whether this international consensus applies in Indonesia is certainly not clear. Most Indonesian SME bank credits, in any case, deal with amounts that are substantially larger than the small end programs referred to in the literature cited.

As will be seen later, we have concluded that subsidized credit schemes are not always effective. Many people think that they create moral hazard among small borrowers, and opportunities for outside rentseekers to pay rents to get access to the credit involved. They are unprofitable for banks, and dependent as they are on government budget money their amount is limited. As indicated by the heartening performance of KUPEDES, market based credit schemes are not only able to sustain access to banking services but also function as a catalyst in developing the self reliance and entrepreneurship of small-scale entrepreneurs. At the same, time Kupedes has been extremely profitable for Bank Rakyat Indonesia (BRI) and is not limited by budget funds. Roughly the same thing applies to the funds supplied through the Banks Perkreditan Rakyat (BPR).

B. Role of Bank Indonesia in SMEs Development

As a consequence of Act No. 23/1999 on Bank Indonesia dated 17 May 1999, the subsidized direct program credits managed by Bank Indonesia have been shifted to three state owned companies; BRI (state owned bank), PT. Permodalan Nasional

Madani PNM (state owned financial holding company) and PT. Bank Tabungan Negara (state owned Housing Bank). The Act prohibits Bank Indonesia to extend credit facilities including to the rural and agricultural sector. The amount of liquidity credit shifted from Bank Indonesia to these state owned companies was Rp 21.8 trillion. These state owned companies then have the duty to relend the liquidity credits until the credits are due of which will be repaid to Bank Indonesia. The future financing for these programs will have to be provided by the government out of its budget.

Bank Indonesia is still managing two-step loans and providing some related technical assistance, but in the long term these functions too should be transferred to other institutions. Bank Indonesia has commissioned a study of alternative institutions which might undertake this sort of technical assistance to financial institutions. The details of this technical assistance is given latter in this paper. The details on how future two step, i.e. foreign donor financed loans will be handled is being worked out by the Government. The issues are difficult because of the governmental guarantee that foreign lenders typically require.

In its role as banking regulator, Bank Indonesia is preparing a policy to encourage banks to lend to small scale enterprises and micro-enterprises. This policy will help banks to diversify their portfolio and deliver credit based on market orientation and interest rates. It will also devote itself to developing and providing an enabling regulatory environment for rural banking and the Islamic banking system. Moreover, Bank Indonesia will encourage the setting up of a specialized bank for Agricultural financing and improvement in the performance of credit guarantee institutions.

The technical assistance activities of Bank Indonesia presently include Proyek Kredit Mikro (PKM) jointly financed with the Asian Development Bank through which micro borrowers access money primarily through groups from BPR, Proyek Hubungan Bank dan Kelompok Swadaya Masyarakat (PHBK) through which self help groups and NGOs are linked to banks, Sistem Informasi Agroindustri Berbasis Ekspor

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[7] Jonathan Morduch, "The Microfinance Promise," **Journal of Economic Literature** XXXVII, 4, December 1999, pp. 1569-1614; Hasan Zaman, "Assessing the Impact on Poverty and Vulnerability in Bangladesh," World Bank Policy Research Working Paper 2145, World Bank, Washington, DC: July 1999.

(SIABE) dan Sistem Informasi Baseline Economic Survey (SIB) which serve as resources for those borrowing and lending especially for agroindustry, the dissemination of a series of sector specific lending models to help banks lend to small industry, and a number of other initiatives.

III. HOW SMEs ARE SERVED TODAY

For many years the Government and Bank Indonesia supported SMEs lending through directed lines of credit. Since the PAKTO (Paket Oktober) reforms of 1988, it has moved to a more market based approach. In particular in PAKJAN (Paket Januari) reforms of 1990 it established a quota for SMEs lending by commercial banks. Originally, lending was required to be 20 % of all lending, but this was changed to levels of 22-25% of all lending. Those banks which exceed the limit received incentive payments, while those who fell short had to pay a penalty, which funded those incentives. Since 1998, the penalties have been suspended. Commitments were made to the Asian Development Bank and the IMF to phase out the quotas and provide a replacement for them. The precise new regulations are still being prepared but they will probably entail requiring each commercial bank in its annual projected business strategy. The actual levels would be published either by the banks or Bank Indonesia. Banks would be interested in showing that they were serving the public interest by lending to SMEs and some other positive incentives might be offered.

Considerable increases in SMEs lending were achieved in increasing commercial bank SMEs lending until the monetary crisis. During the crisis new direct credit programs were instituted largely funded with liquidity funds of Bank Indonesia. These have now been transferred to various state enterprises as noted elsewhere.

A. SMEs Lending Through Commercial Banks

Small and Medium as distinguished from microenterprises are in need of commercial bank credit, but most are probably underserved. Of the 240,000 enterprises with legal status, most of them of small or medium size, only 47,000 reported that they were experiencing difficulties with capital, of which 22,000 sought solutions through a bank loan, according to the BPS.[8] One Akatiga study reported that of a sample of such enterprises only 32% had a bank loan.[9] Of course, Bank Indonesia data shows that 7.5 million small scale borrowing accounts exist, but most of these are microenterprises.

For the banking system, SMEs lending is presently defined by Bank Indonesia as lending conforming with a set of conditions. These include all loans of under Rp 25 million, no matter the purpose – and therefore a considerable amount of consumer lending. They include housing lending up to 70 million. Also business loans of up to Rp 350 million if made to a business which qualifies as a small business under the Small Business Law. The figures also contain lending to cooperatives and rural banks, and lending for shophouses.

The do include a considerable portion of lending using government funded program loans, but do not include lending by institutions like BPR, village finance institutions, and cooperatives out of their own funds. A revision of the Small Business Law of 1995 is under serious consideration by the government, at the same time that Bank Indonesia is considering revising the standard for being counted as SMEs lending, partially in response to the significant inflation in Indonesia over the last few years.

Attached : Table IA SMEs Lending by Types of Bank

Overall SMEs lending declined from Rp 68 trillion in 1997, to Rp 46 trillion in 1998, and Rp 37 trillion in December 1999. It had recovered to Rp 40 trillion by July 2000, and the rise seems to be sustained. However, the disaggregated position is more complex. Lending by State Banks has declined relatively little from Rp 33 to 27 to 25 trillion -- and appears to be rising again. The decline is hardly dramatic, but State Banks which accounted for 48% of SMEs Lending in December 1997 rose to 60% by December 1998 and have remained at roughly that level. They accounted

[8] 1996 Economic Census, **Profile of Establishment with Legal Entity**, Jakarta, Badan Pusat Statistik, 2000, Table 16-20.

[9] Tim Usaha Kecil, Studi Monitoring Dampak Krisis Terhadap Usaha Kecil, Bandung: Akatiga, 1999.

for 63% of SMEs lending in July 2000. Roughly half of that lending is accounted for by BRI.[10]

Domestic Private Banks declined from accounting for 43% of SMEs lending in December 1997 to 32% in December 1998 and 21% in December 1999 and they still accounted for 21% in July 2000. Some small part of this decline is accounted for by the closure of a number of private banks, and some to the transfer of SMEs NPL to IBRA.

SMEs lending by Provincial Development Banks did decline but has recovered to higher absolute levels than previously, and now accounts for 15% of all SMEs lending, versus 7% as of December 1997. SMEs Lending by Foreign and Joint Banks has collapsed.

Attached : Table IB Overall Credit by Group of Banks

For comparison, overall lending by state banks rose from Rp 153 trillion in December 1997, to Rp 221 trillion in December 1998, and fell to Rp 112 trillion in December 1999. This reflected the transfer of loans to IBRA. That is, overall lending was roughly halved from 1998, while SME lending was sustained. As a percentage of all credit from State Banks SMEs lending increased from 12% in December 1998, to 23% in December 1999, and 25% in July 2000. In the case of BRI, SMEs lending represents more than half of all its outstanding credit, but the proportion was obviously high for other State Banks as well. Though the percentage of SMEs lending by small private "Class A" banks is often high, their total SMEs lending is much lower than the state banks.

Private Bank percentages rose from 8% to 14% between December 1998 and 1999 and was 12% as of July 2000, but the decline in overall credit was much steeper than with the State Banks. Provincial Development Bank SMEs lending rose from 52% of all credit in December 1997, 60% in 1998, to 64% of what is a rising overall level in December 1999. Overall lending by Foreign and Joint Banks has also more or less recovered -- but SMEs lending has collapsed. The figures cited here are

[10] Mr. Sarwono Sudarto, Speech at Seminar on Usaha Kecil/Menengah sebagai penggerak roda perekonomian, Malang, September 7, 2000.

for percentages of bank credit, which are different from that of total earning assets on which the official SMEs lending requirements are calculated.

Attached : Table IC Types of SME Lending

The internal composition of SMEs credit changed as well. In December 1997 65% was ever investment capital and working capital and 35% was consumption credit. By July 2000, only 54% was such SMEs lending for investment and working capital and 13% was for consumption. Housing and Consumption lending rose in percentage terms. Credit to cooperatives acatually rose dramatically in absolute terms. Obviously Bukopin does considerable cooperative lending, reflected in the recent SME's lending figures released by IBRA. Another large, and overlapping proportion of SME Lending is accounted for by direct credit programs, Rp. 10 trillion according to a recent Japanese study. On the other hand, foreign and joint bank which now (May 2000) account for 25% of all bank lending, do little SME's lending.

B. Microenterprise Lending Through Alternative Financial Institutions

The vast majority of Indonesia's 40 million microenterprises get little institutional credit. In Indonesia, of those without legal status (the overwhelming majority of microenterprises) only 60,000 had a bank loan, 113,000 a loan from cooperatives, and 62,000 loan from Non-bank Financial Institutions.[11] The data about credit from financial institutions shows a higher level – both BRI Unit Desa and BPR have roughly 2.5 million borrowers – though some of these are certainly consumers they would seem to indicate a larger number of business borrowers than the census figures. Almost 10 million borrowers are reported to have received funds through Takesra/Kukesra, though it is not clear that these would have been reported in the Census data.[12] In addition, large numbers of SMEs lending have reportedly been made through various sorts of Lembaga Keuangan Masyarakat.

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[11] 1996 Economic Census, **Profile of Establishment Without Legal Entity**, Jakarta: Central Statistical Bureau, 1998, Tables 20 and 21.

[12] Bank Indonesia, "Pengaturan Kelembagaan Lembaga Keuangan Mikro (LKM) di Masa Datang", Lokakarya Lembaga Keuangan Mikro, Bogor, July, 2000.

Banking services for small-scale entrepreneurs involve not only the provision of credit facilities but also providing savings and remittance facilities. Microentrepreneurs can gain self reliance through accumulating their own equity. In fact, the burden of several recent studies in other countries has been that microenterprises need first and foremost a safe place to deposit their funds.[13] Nonetheless, some microenterprises can make profitable use of credit, either to deal with seasonal fluctuations or expand and modernize their operations, and this is reflected in the rapid absorption of increased microloans as they are made available in the Indonesian market.

Commercial banks have some difficulty in serving microenterprises using their normal approaches, but Indonesia has been among the leaders in developing specialized institutions to serve them to complement the informal market. The secret has been simple and well adapted credit approval and supervision procedures, often coordinated with appropriate technical assistance and a careful attention to the sociocultural aspects of the communities concerned. Often the assistance of NGOs and other informal and self help groups has been taken to use community ties as a form of social collateral for lending. A recent estimate is that more than 9 million Indonesians have access to microcredit from formal sector financial institutions. There are about 7 million microborrowers in Bangladesh with 12 million poor households.[14] An Indonesian national credit survey is under consideration which would give some more comprehensive data on these questions for Indonesia.

From the institutional side, six major types of institutions serve microborrowers in Indonesia. These borrowers borrow for many purposes of which microenterprise is only one – and it is often difficult to determine the use to which they put their funds. Each of the types of institution serves a somewhat different clientele, in terms of size and type of loans. The quality of data reported varies as well as do the spreads and administrative costs concerned. And finally the legal status of the different types of institution differs. However, all these types of institutions face the challenge of expanding on a sustainable basis without posing

[13] Stuart Rutherford, **The Poor and Their Money: An Essay About Financial Services for Poor People**, forthcoming Oxford University Press, 2000.

[14] These data come from a communication to the Development Finance Listserve by Mr. Nimal Fernando of the Asian Development Bank, August 31, 2000.

undue prudential risks to their clients. So far there is little indication that any have saturated the market they serve, even while charging rates which largely cover their costs:

Attached : Table II Institution Types and Volume of Activity

The BRI Unit Desa are only one part of BRI but generate much of its profits and lendable funds. There are 3701 Unit Desa throughout the country, with roughly Rp 6 trillion in loans to roughly 2.5 million borrowers in December 1999, and Rp 17 trillion of savings. A number of other commercial banks have smaller microcredit operations. The Swamitra program of Bank Bukopin now has Rp 88 Million in credit and 45,000 customers (June 2000). The smaller Bank Dagang Bali and Bank Purba Danartha concentrate their efforts on microenterprises.[15]

The BPR are a miscellaneous collection of smaller, second tier banks, many of them owned by local governments but others owned by private investors and NGOs. They are reported to be 7772 of them as of December 1999, though only 2427 are so called "new" BPR, directly supervised by Bank Indonesia.[16] In addition, there are several thousand smaller village financial institutions which it was intended to include in the BPR category, but have remained separate. Both commercial banks and BPR are currently supervised by Bank Indonesia, and covered by a government deposit guarantee.

The 38,000 savings and loans to cooperatives (and cooperative units) are supervised by the State Ministry of Cooperatives and Small Scale Enterprise.

Syariah institutions are a new and rapidly expanding category of institutions serving all levels of SMEs borrowers. They range from Bank Muamalat and the new syariah branches of the major commercial banks, to syariah BPR, to syariah Baitul Mal Wa Tamwil (BMT) cooperatives. They have engaged the enthusiastic participation of large parts of the public, and need to have developed for them an appropriate human resource base and regulatory framework. By Second Quarter of

[15] Letter from Ir. Karl Palallo, Assistant Vice President, Bank Bukopin, 8/7/2000.
Infobank, May 2000, as of December 1999, Bank Dagang Bali had 230 Billion Rps. and Purba Danartha 8 Billion Rps. probably less than half of each as microcredit.

2000, there are 2 syariah commercial banks with 20 branches, 7 syariah branch office of conventional banks and 79 BPR syariah.

The smallest borrowers are served by NGOs, especially government sponsored ones (GONGOs as they are called) who are generally connected with specific ministries, but by independent NGOs as well The total volume of their lending is unclear except that thousands of organizations and trillions of rupiah are involved. The government supported programs have channeled a fair amount of money through the years though there is some doubt about how much has been repaid and thus about the sustainability of the different credit programs and their impact. Independent non-government sponsored NGO credit programs have traditionally been less significant in Indonesia than in other countries, both because the government did not encourage them and because of the active Self Help programs connected with the banks, which as in India, diverted the credit interests of many NGOs. But independent NGO credit programs are increasing in volume, both because of the availability of foreign funds and the examples of such models as Grameen Bank. Little is reported in general form about these NGO activities, so it is difficult to assess them at present.

C. CREDIT ALONE IS NOT ENOUGH -- *Technical Assistance from Government/International Institutions*

In developing small-scale businesses, capital inadequacy and lack of collateral are just few of the constraints faced by small-scale enterprises. There are other constraints that stem from the inadequacy of entrepreneurship, production, managerial and marketing capabilities. These inadequacies increase a bank's financing risk. To reduce the risk, it is necessary that financial assistance be provided simultaneously with other forms of assistance to enhance production, marketing and managerial capabilities. We have observed that financial assistance is easier to promote once the enterprise can obtain such assistance.

However, such technical assistance is not really connected with banking. It is, thus, imperative that the assistance be performed by other appropriate agencies,

[16] This is a total figure from the Bank Indonesia annual report, the bulk of these are small Badan Kredit Desa in Java and Madura supervised by BRI, only 2427 are so-called new BPR, directly supervised at present by Bank Indonesia.

government or NGO. Cooperatives can be useful entities for providing technical assistance and credit extension services to small-scale enterprises, particularly micro enterprises. Cooperatives can also sometimes actually serve as credit intemediaries or assist banks in linking themselves to small enterprises. Cooperatives and other NGOs are often valuable parts in lending programs targeted at micro enterprises, where problem of high credit risk and transaction costs is the most acute. Bank Indonesia has considerable experience with this sort of linkage in its PKM and PHBK projects referred to elsewhere.

A large amount of technical assistance is provided both by various government ministries, NGOs, educational institutions and private consultants to SMEs -- among the more active programs are those run by the State Ministry of Cooperatives and Small Enterprise and the Ministry of Industry and Trade -- but other networks are run by KADIN, and a program of subsidized assistance from consultants is funded by the SWISSCONTACT international NGO. Almost all of these programs assist SMEs in financial management and in approaching commercial banks for credit, and a number of them have associated credit programs.

Few of these programs provide technical assistance to lending institutions. At earlier periods, some programs were funded by USAID and others working with village financial institutions, but almost all such assistance is now handled through Bank Indonesia and will be treated in the next section. A program of assistance to commercial banks on small scale lending has been proposed with World Bank funding. GTZ and the Asian Development Bank has sponsored some microfinance focussed assistance. As noted elsewhere, Bank Indonesia has been providing technical assistance in connection with its credit lines, and continue to do so even after their transfer to other organizations, at least for the short term.

IV. FACTORS GOVERNING COMMERCIAL BANK SMEs LENDING

In connection with its review of SMEs lending requirements Bank Indonesia recently completed a study of commercial bank lending practices and attitudes. The review surveyed a sample of commercial banks stratified by percentage of lending to SMEs, including 6 government banks, 10 provincial development banks, 22 domestically owned foreign exchange banks, 24 domestically owned non-foreign exchange banks, and 2 foreign/joint banks. The small representation of these latter reflects the almost entire cessation of SMEs lending by these banks since the end of Bank Indonesia sanctions. In addition to these 60 bank head offices, 30 branches were also surveyed.

Of the Head Offices, 82% supported the previous system of lending quotas. However, they felt Bank Indonesia should consider the capacity of each bank in setting quotas. Most of the banks also wanted the limits on size of SMEs lending raised. Nonetheless, most of the banks said they would have lent considerable sums to SMEs regardless of these quotas, because such lending was profitable (96.6% said it was profitable.) The reasons for profitability included the low level of Non Performing Loan as compared to other credit. As of June 2000, SMEs lending reported a level of 11.5% Non Performing Loan as contrasted to 31,1% for all bank credit.

Overall funds for bank lending are still quite limited because much of bank funds are in the form of recapitalization bonds with limited tradability. IBRA has now permitted its banks to lend to SMEs similar authorizations have been extended to government banks and quite dramatic increases of lending have been reported in the newspapers – mostly for SMEs purposes.[17] Nonetheless, the general atmosphere is still such that branch and regional managers who typically have the sanctioning authority for SMEs lending (and in fact for retail lending in general) have reported in some regions that they rarely reach the budgeted limits for such sanctioning.

The survey respondents cited a number of other factors which inhibited and promoted SMEs lending.

Attached : Table III -- Factors Which Promote and Inhibit SME LENDING

What these different factors meant to the various respondents is generally clear. The network of branches, delegation of authority to lower levels within the bank, and the availability of specially trained cadres would be expected to contribute

[17] See Note 12.

to SMEs lending. It is notable that the very number of SMEs and their market potential is seen as a strong promoting factor. The implication is that bankable demand for SMEs Lending is strong. The interbank linkages which are desired may exist on one of three levels as follows -- between commercial banks in sharing credit information, between different commercial banks in sharing funds, and between commercial banks and BPR.

The patterns of response is quite similar between head offices and branches, with generally lower levels of response by the branches. It is notable that branches rate Bank Indonesia policy higher than head offices and are less optimistic about the market potential for SMEs. Not surprisingly, branches also see the limited branch networks and limitations of lending authority as more important than do head offices. Given the small size of the branch sample, its results are only indicative, however.

Of note among inhibiting factors is the requirement for a Business License and Tax Registration Number (NPWP) which is triggered by a Bank Indonesia regulation requiring such a license for lending of over 25 million. Also noted is the problem of suitable collateral, which some banks say has been exacerbated since the due diligence audits which forced them to restrict the collaterals they would take. Both of these areas are obviously possible ones for regulatory reform. The collateral problem might be addressed by the new loan guarantee programs which are now under consideration and which will be covered latter in this paper.

V. INSTITUTIONAL DEVELOPMENT INITIATIVES

Several important initiatives are now underway to increase finance of SMEs.

Because of the weaknesses of the commercial banks and their limited branch network and outwork, especially after the Monetary Crisis, it is essential to develop the institutional network on which they can relay to lend to SME. This includes letting the commercial banks draw on state enterprises, BPR, Non Bank Financial Institutions, Village Financial Institutions, NGOs, and Cooperatives to extend their networks. It includes providing the commercial banks and other financial institutions technical assistance and training, and a conducive regulatory environment. It may soon include assistance from specialized banks and revived guarantee organizations.

A. Bank Networking

The directed program credit lines formerly handled by Bank Indonesia have been transferred to various state enterprises as noted above (BRI, PNM, and BTN) and they are all expanding their lending activities.

More importantly, the commercial banks on-lend funds to BPR, and these funds almost all count as SMEs lending. Bank Muamalat, for example, lends more than Rp 30 million to Banks Syariah, Bank Niaga has a little under Rp 200 million with BPRs, etc. This interlending had been expanding rapidly before the monetary crisis, to some extent driven by SMEs lending requirements but has not been expanding recently. Nonetheless older lending relationships are being sustained. There is already under advanced consideration a funding institution which would facilitate lending to BPR not only by commercial banks and finance companies, but also by other BPR.

The sums provided by commercial banks to Non-Bank Financial Institutions, such as leasing and factoring companies is quite large, in the tens of billions of Rupiah, and these do serve many SMEs, particularly in the small and medium category, and particularly in leasing motor vehicles. The Non- Bank Financial Sector is universally agreed to be a high priority one for serving SMEs, particularly those of somewhat larger size. The sector itself was severely effected by the Monetary Crisis, and its reorganization and recovery will help in meeting SMEs financial needs. At the same time SMEs also need insurance services, which also come from this sector.

All three of these avenues have potential for considerable development as the economy recovers and it is essential to take the regulatory and legal reform efforts that may be required for these expansions to occur.

B. Creation of Special Institution

As noted earlier, Bank Indonesia will support the Government in creating or fostering specialized lenders and guarantors for small scale industry and agriculture. In particular, it will try to provide an appropriate regulatory climate in which they can operate, and encourage commercial banks and BPR to work with them. The initiative is due to the current banking condition, of which most Indonesian banks face difficulties in accomplishing prudential banking regulation and capital adequacy. Therefore, it is imperative to have a special institution devoted to SMEs lending, which is exempted from such banking regulations.

This is in line to the study of the high level adviser and his team provided by the Japanese Ministry of International Trade and Industry at the request of the President. The team headed by Professor Shujiro Urata covered the entire SMEs policy area. Bank Indonesia exposure study to some Asian countries also tells the same story. In the countries with developing SMEs, they are mostly supported by bank or institution which specialized in lending to SMEs.

C. Credit Supplementation -- Credit Guarantees and Insurance

Indonesia has had considerable experience with credit guarantees and insurance through Perum PKK and PT ASKRINDO. A number of policy recommendations have been made or are under consideration in relation to these issues. Among them are the report of Prof. Urata as mentioned earlier. Chapter three of the report contains specific recommendations on financial matters. Included are the proposal for the promotion of a core credit guarantee either using a new or existing institutional form such as ASKRINDO. This institution would be funded and guaranteed by the Government of Indonesia out of its own funds. A similar institution was described at some length in a paper commissioned by Bank Indonesia from ECONIT, which would draw on market funds for its financing. These proposals are all under priority consideration by the government. The difficulty is connected with the exposure such a guarantee would entail for the budget, but the popularity of such guarantees may make the government willing to bear the risk.

In theory, guarantees should help meet the difficulties with collateral mentioned earlier, as well as enabling the leveraging of large amounts of money with the use of very limited funds. This leveraging is contingent on a high level of repayment of guaranteed debt -- something which has proved difficult to achieve in the past.

Related to government and government sponsored guarantees, are the pilot efforts sponsored by the State Ministry for Cooperatives and Small Enterprises under which local groups and governments use their bank deposits to leverage SMEs lending.

D. Training and Technical Assistance

As noted earlier Bank Indonesia, some donors like the World Bank, and independent training institutions are all engaged in providing training and technical assistance to commercial banks, BPR, and alternative financial institutions in providing specialized financial services to small and microenterprise. As demonstrated earlier this is rated by banks as an important element in promoting SMEs lending. Foreign donors are providing some level of such training and technical assistance. Bank Indonesia's own role in this respect will have to be curtailed or transferred over time -- but as the banking industry emerges from the Monetary Crisis it will be able to afford to pay for training in SMEs lending on its own.

E. Reform of Supervision and Regulation

Bank Indonesia is in the middle of a massive reform and upgrading of bank regulation and supervision, both for commercial banks and BPR. The actual supervision is to be transferred to a new independent agency by the end of 2001, but Bank Indonesia will retain general regulatory authority.

It is essential to see that the details of these regulations -- such as the treatment of collateral and guarantees, the requirements for licenses and accounts, the simplicity and speed of the procedures and approvals all be appropriate to SMEs lending, within the general constraints of prudent banking. Bank Indonesia will vigilantly strive to see that this is the case.

In addition, work is on going for reforming the regulatory scheme for yet smaller financial institutions (village financial institutions etc.) so that they can play a complementary role in extending financing into rural areas

VI. CONCLUSION

Building on Indonesia's considerable achievements in creating healthy and market based financial institutions serving micro and to a lesser extent small and medium enterprise borrowers, the prospect for SMEs lending in Indonesia is good. Already SMEs lending seems to be rising. Lending from BRI and the IBRA Banks have each increased by several Trillion Rps over the last six months.

The record proves that SMEs finance is a profitable area for banks, which should enable a larger and larger portion of deposits to be used to support SMEs development. Many banks assure us that their recovery strategy is concentrated on SMEs finance for this reason. Indonesia, whatever the future challenges it will face is considered a world leader in microfinance. Indonesia can build on these facts to develop SMEs finance further.

In the future, as banking regulator and as the guarantor of a stable currency, Bank Indonesia remain committed to promoting SMEs as a key economic sector and seeing that SME receive adequate financial services.

Bank Indonesia will do this through creating incentives through publicity for commercial bank SMEs lending, promoting BPR, assisting in the development of other alternative financial institutions, and providing some level of technical assistance as appropriate.

But the increase in lending will primarily have to respond to commercial market forces. To facilitate the operation of these forces Bank Indonesia will cooperate with others to reform the regulatory requirements, simplify the procedures, provide Technical Assistance, and reduce the risk of such lending.

Success in SME development will be connected with coordination of all participants in promotion SME -- banks, the government, and the enterprises themselves.

Lending is not the only financial service SMEs require -- they need savings and remittance services to improve the efficiency with which they use their financial resources. But finance is only one element in successful SMEs growth. Regulatory reform, improved knowledge and support services and infrastructure will also have to be provided and coordinated with whatever improvement in financial services provision occurs. It is in this context, that the specific initiatives in the previous section fit.

Jakarta, 4 October 2000

TABLE IA. SME Lending by Type of Bank **A**

Source : Statistics of SMEs Lending – July 2000, Bank Indonesia

In Billions of Rps

	July 2000	April 2000	Dec 1999	May 1999	Dec 1998	Dec 1997
Total	40,533	39,032	37,239	38, 171	45,571	68, 723
State Banks	25,699	25,287	25,375	26,379	27,255	32,882
Private Banks	8693	8952	7709	8209	14,770	29,623
Prov. Dev Banks	6084	4832	4082	3407	3421	4580
Foreign And Joint Banks	57	61	73	132	125	1638

TABLE IB. Overall Credit by Group of Banks **B**

In Billions of Rps

Month	Dec 1997	Dec 1998	Dec 1999	April 2000	May 2000
Total	378,134	487,426	225,133	228,777	237,929
State Banks	153,266	220,747	112,288	102,308	102,745
Private Banks	168,723	193,361	56,012	63,293	66,769
Provincial Dev. Banks	7539	6570	6793	7632	8061
Foreign and Joint Banks	48,606	66,748	50,040	55,544	60,354

Source: Bank Indonesia Website, Statistik

TABLE IC. Types of SME Lending **C**

In Billions of Rps

Month	July 2000	April 2000	Dec 1999	May 1999	Dec 1998	Dec 1997
Total	40,533	39.032	7,239	38, 171	45,571	68, 723
Working Capital	16,148	16,547	15,758	15,902	17,557	34,098
Investment Capital	5667	5457	5389	5439	8326	11,188
Consumption	18,718	17,028	15,997	16,112	19,688	23,435

Source: Statistics of SMEs Lending – July 2000, Bank Indonesia

TABLE II. Institution Types and Volume of Activity D

Institution Type	Amount of Loans 1997/1998/ 1999 End of Year	Amount of Savings 1997/1998/ 1999 End of Year	Number of Borrowers 1999 End of Year	Number of Savers 1999 End of Year
BRI Unit Desa	4685/4697/5957 Million	-- /16146/17068 Million	2616/2457/2474 Thousand	
Other Commercial Bank Programs	Swamitra 88 Million ;Purba Danartha and Dagang Bali	NA	Swamitra 45000	
BPR	2238/1986/2367 Million	1601/1527/1897 Million	2855 Thousand	5255 Thousand
Savings and Loan Coops				

Institution Type	Average Loan Size	Average Deposit Size
BRI Unit Desa	1.8/1.9/2,4 Million	
BPR	829000 Rps	361000 Rps
Savings and Loan Coops		

Source : Bank Indonesia Website, Statistik

TABLE III. Factors Which Promote and Inhibit SME LENDING E

In Percentage

No.	Factor	Promoting Head Office	Promoting Branch	Inhibiting Head Office	Inhibiting Branch
I	**Internal**				
1	Formation of Special Unit For SME LENDING	46.6	37.9	25.9	22.4
2	Availability Of Trained Cadres for SME LENDING	56.9	36.2	29.3	32.8
3	Existing Procedures for SME LENDING	75.9	51.7	15.5	18.9
4	Extent of Branch Network	70.7	44.8	27.6	41.4
5	Extent of Delegation of Authority For SME LENDING	68.9	50.0	24.1	36.2
6	Facilities Available at Bank Branches	75.9	50.0	15.5	22.4

II	**External**				
1	Government Policy to Promote SME LENDING	89.6	87.9	3.45	5.20
2	Bank Indonesia SME LENDING Requirement	72.4	86.2	18.9	10.3
3	The Number Of UK	77.6	72.4	10.3	5.20
4	Market Potential Facing SME LENDING	58.6	50.0	22.4	31.0
5	SME Linkages with Big Business	60.3	50.0	17.2	17.2
6	Interbank Cooperation in SME LENDING	53.5	41.4	17.2	10.3
7	Requirement For Licenses For SME LENDING	6.90	10.3	82.8	77.6
8	Availability Of Collateral	10.3	15.5	82.8	65.5
9	Burden of Supervising SME LENDING Clients	46.6	37.9	44.8	31.0