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RESOURCES MANAGEMENT INTERNATIONAL, INC.

INDONESIA:

FINANCIAL SERVICES FOR THE RURAL POOR

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I

INTRODUCTION

1.01 This report is the result of a visit to Indonesia by Dr. Claudio Gonzalez-Vega, hired by Resources Management International (RMI) as a consultant for the Mission in Jakarta of the United States Agency for International Development (US-AID), and by Dr. Robert E. Firestine, of the Office of Rural Development of US-AID in Washington. The two stayed in Indonesia between January 14 and February 10, 1982, and spent most of their time visiting rural financial institutions in East, West, and Central Java, in Aceh, and in West Sumatra, in addition to a few visits to banks and government agencies in Jakarta. Their work was made possible by the continuous and intelligent guidance of Dr. Richard H. Patten, a consultant for the Provincial Development Program of the Government of Indonesia, and by Dr. Widoyo Widodo, of the Ministry of Home Affairs (Departement Dalam Negeri). The four continuously discussed the concepts and ideas included in this report, to the extent that it has become impossible to attribute them to any one in particular. The final responsibility for writting the report remained with Dr. Gonzalez-Vega. The consultants are very grateful for the help and encouragement received from Mr.Douglas Tinsler, of the Rural Development Office at the US-AID Mission in Jakarta, from Dr. Colin McAndrews and Dr. James Kern, of Resources Management International, as well as from many other Indonesian officials and foreign consultants.

1.02 The main purpose of the report is to describe the activities of several types of semi-formal indigenous financial institutions found operating in the rural areas of Indonesia, some of which have been supported by the Provincial Development Program, and which the consultants believe contain the ingredients for successfully reaching the rural poor with a wide scope of financial intermediation services. The report attempts to compare the operations of some of these financial intermediary types, in order to identify the reasons for their successes or failures and, to the extent possible, to isolate success elements that could be incorporated in models for equivalent institutions elsewhere. The consultants found, however, that most of the strengths of these institutions come from their spontaneous, semi-formal operations, the absence of externally-impossed constraints, and their adaptation to their particular local environments. Rather than transplanting specific institutional types elsewhere, therefore, their success may

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be replicated by understanding the basic elements that provide them with financial viability and effectiveness in reaching the rural poor.

1.03 This was the first visit to Indonesia by the consultants, who did not have any previous knowledge about the Indonesian economy and financial system, and who did not speak the languages of the country. Inevitably, the conclusions and recommendations presented in this report are very partial and preliminary. Some of the main limitations of the report include the following:

a. The consultants were looking at a particular segment of the Indonesian financial markets almost in a vacuum. A more complete evaluation of these institutions would require the placement of the consultants' observations within the framework provided by the overall flow of funds in the economy, the aggregate and sectorial financial policies and regulations, and the evolution of the real side of the economy. Although some effort was made to provide such a framework, the consultants dis not have the opportunity to examine the overall financial system in sufficient detail. The perspective adopted looked at financial systems from the bottom up; that is, the

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consultants focused their efforts on a study of the provision of financial services at the village (desa) level, and examined the pyramid of financial institutions, regulations, and linkages above them only as a result of the direct observation of the impact of such super-structure of the village-level financial activities.

b. The sources of most of the information gathered were direct observations of isolated examples (individual branches, specific borrowers, particular communities). Most of it was collected through interviews of borrowers and lenders in the field. The sample was too small and the selection undoubtedly biased. The consultants observed specific cases because they had been identified as particularly successful or particularly acute failures.

This report is not, therefore, a comprehensive analysis of rural financial markets in Indonesia. It is a partial exploration of the main features of some institutional types found in this country. Actually, there is such a wide variety and complexity of indigenous financial arrangements, with so many regional variegations, that not even a complete typology of these intermediaries was possible. Because the consultants' observations were too few and varied, their generalizations are very tentative. They were checked, however, against the knowledge and experience of other consultants who have worked in Indonesia for many years, in order to eliminate the most obvious mistakes.

Moreover, the consultants did not find any on-going research on rural credit or financial intermediation either at Bank Indonesia, Bank Rakyat Indonesia or other governmental institutions, as well as at the universities. Nevertheless, the consultants had the opportunity to share their experiences in the field with a study mission of the World Bank, headed by Dr. Sarath Rajapatirana, which has been undertaking a similar exploration of rural financial markets in Indonesia. When secondary sources were employed by the consultants regarding aggregate data, policies and regulations, as well as the features of the macroeconomic framework of the country, the accuracy of the information was not checked, so that some errors may be reproduced in this report. Hopefully, the mistakes so introduced in the analysis are not sufficiently important to invalidate the conclusions of the report.

Given the limitations of the study, this report does not contain recommendations on overall financial policies, although some concern about these policies is implicit in the discussion. Eventually, the final success or failure of the institutions studied here will depend on the extent to which these regulations and policies help or limit their evolution. There is much need, therefore, to evaluate the aggregate policies affecting the financial system in Indonesia.

Rather, the report investigates a few types of institutions which look promising as mechanisms for reaching the rural poor with financial intermediation services at the village (desa) level or sufficiently close to it. It examines their main characteristics in an effort to identify factors for failure or success, in the light of the consultants' experience in other countries and in the light of the recent theoretical work on rural financial markets.

1.04 Specifically, the objectives of the report are:

a. To identify formal, semi-formal, and informal sources of credit which could potentially develop into successful financial intermediaries;

b. to compare some of the most successful systems already in place and evaluate them as potential models for replication elsewhere;

c. to identify the reasons for the failure or success of specific institutional types and/or particular units of lending institutions;

d. to relate the comparative performance of institutions and/or units to their specific structural form, financial policies and strategies, management quality, and features of the environment; and

e. to examine the impact of aggregate national financial policies on the evolution of the village (desa) level intermediaries.

A first portion of the report presents some basic concepts on the role of financial intermediation in economic development. Further on, the report discusses some very preliminary perceptions about the main features of the global financial system in Indonesia. A second portion of the report examines in some detail the most important of the indigenous intermediaries found in the rural areas. The report finally contains some recommendations for the Indonesian Government and US-AID in Jakarta.

II

THE ROLE OF FINANCE IN THE RURAL DEVELOPMENT OF INDONESIA

2.01 The contribution of the set of semi-formal financial institutions found in the rural communities of Indonesia must be evaluated in the light of the importance of financial intermediation in the development process. The most recent literature on economic development has recognized that financial processes, markets, and institutions play a more important role than previously accepted.[1/] In general, it has become widely recognized that efficient financial intermediation accelerates growth, improves the allocation of recources and reduces the concentration of the distribution of income in the rural areas.

2.02 Consider any economic unit operating in a rural community: for example, a farmer. The determinants

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[1/] See Edward S. Shaw. Financial Deepening in Economic Development. New York: Oxford University Press. 1973. Ronald I. McKinnon. Money and Capital in Economic Development. Washington, D. C.: The Brookings Institution. 1973. Bela Balassa. Policy Reform in Developing Countries. New York: Pergamon Press. 1977. Warren L. Coats, Jr. and Deena R. Khatkhate. Money and Monetary Policy in Less Developed Countries. New York: Pergamon Press. 1980. Dale W. Adams, Gordon Donald and J.D. Von Pischke. Uses and Abuses of Rural Financial Markets. Johns Hopkins University Press. (Forthcoming).

of the income generated by the unit include both the unit's productive opportunity as well as its control over the resources necessary to take advantage of this opportunity. Any given productive opportunity reflects (the farmer's) particular circumstances with respect to knowledge and experience, entrepreneurial ability, family size and age structure, amount and quality of land available, etc. The producer's control over resources, in turn, reflects his endowment of owned resources, as well as his access to the resources of others, through credit. In the absence of a financial mechanism, each producer must self-finance his activities; that is, each producer can take advantage of his productive opportunity only to the extent allowed by his endowment of owned resources.

The rural areas of most low income countries, like in Indonesia, are characterized by much fragmentation: the isolation of economic units and the absence of efficient mechanisms to transfer resources among producers. To the extent that the financial system is not integrated, there is a poor correlation between the determinants of income levels. Producers with good productive opportunities may have no enough resources of their own or access to sufficient credit to take advantage of such opportunities, while other producers, with ample resources, may have no productive opportunities of their own, to invest their resources profitably and are forced to devote them to inferior uses.

In such a fragmented financial environment there is a great dispersion of marginal rates of return on assets: while some units earn very high rates of return, others earn low rates. This dispersion indicates that resources could be better allocated if they were transfered from uses with low to uses with high marginal rates of return. That is, efficient financial intermediation makes it possible to take advantage of profitable opportunities which would otherwise remain unexploited and to eliminate inferior uses of resources.

There is no reason to expect that those sectors or households (surplus units) were savings are generated are necessarily those (deficit units) with the highest growth potential and, therefore, with the best productive opportunities. The role of the financial system is to channel those savings to investments where they can be most profitably used. That is, financial intermediation makes this division of labor between savers and investors possible, resulting in a better allocation of resources. Moreover, to the extent to which efficient financial intermediation reduces the costs and risks associated with saving and increases the average rate of return on investment, it stimulates savings, increases the rate of capital accumulation and, therefore, the rate of growth of incomes. In addition, efficient financial intermediation may also improve the distribution of income. Income differences among producers are due to differences in productive opportunities and to differences in the control over the resources necessary to take advantage of them. To the extent to which access to credit makes this control possible, financial intermediation eliminates one of the two potencial sources of disparities in income streams.[1/] This impact is equivalent to that of agrarian reform. Agrarian reform provides access to land to those farmers with a productive opportunity but without the land necessary to exploit it. Financial intermediation provides access to credit and, therefore, to all resources, for those farmers with good productive opportunities but

[1/] Claudio Gonzalez-Vega, "Interest rate restrictions and income distribution". American Journal of Agricultural Economics. Vol. LIX, N° 5. December, 1977. pp. 973-976. Claudio Gonzalez-Vega. "Interest rate restrictions and the socially optimum allocation of credit." Savings and Development. Vol. IV, N° 1. January, 1980. pp. 5-28.

without enough savings of their own to fully take advantage of them. To the extent to which economic activity in the rural areas of Indonesia is carried out by disperse, diverse and heterogeneous producers, with a very small resource base, financial services are crucial for their development and, in many instances, for their survival.

2.03 It could be claimed that in a Schultzian equilibrium, the households in a traditional agricultural system would have accumulated, through time, the capital required to continuously repeat their routine economic activities and that in this environment the need for financial intermediation is not much.[1/] Low marginal returns to traditional investments, in turn, provide little incentive to savers and capital formation results only from the replacement of existing capital. This is certainly not the case of rural Indonesia. The rural economy in this country is in a clear disequilibrium, that has resulted from greater market integration brought about, in part, by the rapid development of infrastructure (e.g. roads, as in the INPRES

[1/] Theodore W. Schultz. Transforming Traditional Agriculture. New Haven: Yale University Press. 1964.

programs) and the modernization of the country. This disequilibrium also reflects the adoption of technological innovations (the green revolution, to the extent to which it has been successful), and the changes in planting, harvesting, and marketing arrangements that it has induced. Moreover, increased population pressure on the land has augmented the relative importance of off-farm economic activities for the household survival, and all of this has led to important changes in relative factor prices in the rural economy of Indonesia.[1/]

It is important to remember that, for example, Central Java is one of the most densely populated non-urban regions in the world, where most of the population eke out there livelihood at near subsistence levels. Approximately one half of the households in this area own less than 0.1 hectares or no land at all. The majority of the households, therefore, are dependent for their survival on employment opportunities not derived from their own land.[2/]

[1/] See, for example, William L. Collier and Soentoro. "Rural development and the decline of traditional village welfare institutions in Java". Western Economics Association. 1978 Meetings. Honolulu, June 1978. Roger Montgomery. "Migration, Employment and Unemployment in Java". Asian Survey, Vol. XV. N° 3. March, 1975. Gary E. Hansen. Agricultural and Rural Development in Indonesia. Boulder: Westview Press. 1981.

[2/] John W. Duewel. "Socio-economic analysis of the Provincial Area Development Program (Program Pembangunam Daerah-PPD) for Central Java". AID report. August, 1977.

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2.04 Given greater market integration, a higher degree of monetization of the rural economy, and development in general, many new non-agricultural opportunities have appeared in the rural economy and the scope of the off-farm sources of employment has increased significantly. Population growth and pressure on the land has meant that the households of the rural areas of Indonesia must spend much less time in agricultural activities and, in order to generate a cash flow adequate for their present needs, they must earn a significant portion of their incomes in the production of handicrafts, in petty trade, etc.

The new opportunities in the non-agricultural sector are very dynamic, requiring combinations of skills, experience and geographical position different from those implicit in the old traditional occupations. The rural households of Indonesia seem to have responded rapidly and efficiently to take advantage of these new opportunities. The insufficient availability of working capital, however, has significantly restricted the magnitude of many of these productive efforts and/or has subjected many of these households to marketing and other sharing arrangements (variations of the *ijon*), that reward with low returns their labor efforts.

Access to credit, on the other hand, allows these households to take advantage of these new opportunities. By allowing them to hold their produce until they can receive a better price; by allowing them to better choose their occupation and/or allocate their time; by allowing them to widen the range of their input suppliers or the range of the buyers of their output, credit frees these households from the traditional sharing arrangements. Many times the construction of a road allows a craftsman to take his produce to a more distant and larger town, where he can get a far better price for it. Transporting a week's output would allow him to pay for the carrying costs and obtain a handsome profit. Insufficient working capital, however, may force him to sell his output day by day, at a much lower price. The availability of working capital, therefore, could increase the profitability of his enterprise mary times, as well as the welfare of his family. Since the amounts involved are very small, however, traditional, formal financial institutions could not provide these credit services efficiently.

In these off-farm activities, therefore, a very small addition of working capital can make a tremendous difference with respect to the returns to the household's labor. Those households without access to the required capital, on the other hand, are condemned to low productivity, to a not full use of the time available to family members, and to a dependence on intermediaries. The capital accumulated by these households during the periods of Schultzian equilibrium is not sufficient to meet the present needs and does not allow the household to take advantage of the new opportunities. In summary, credit can play a significant role in improving the welfare of the Indonesian rural poor.

At the same time, in the new rural environment risks have increased. In many cases, the decline of some traditional village welfare institutions (e.g., the <u>bawon</u>) has forced households to increase their precautionary asset holdings. As technological innovations change the patterns of distribution and as modernization reduces the extent of social risk-sharing arrangements, households need higher reserves and greater cash balances, which compete with productive capital in the household portfolio of assets. These greater requirements increase the demand for credit, while access to a more integrated and efficient financial intermediation system facilitates the households' more difficult cash and reserve management.

2.05 Access to financial services improves the welfare of individual households. From a social point of view, moreover, a more efficient financial system is an important ingredient for rapid economic growth. Financial deepening matters. It can assist in the breakaway from plodding repetition of repressed economic performance to accelerated growth. If, on the other hand, the development of the financial system is repressed and distorted, it can intercept and destroy impulses to development.

The financial system improves the allocation of resources when it channels them from surplus to deficit units. Only in this way will the financial system rescue resources from their investment in inferior uses and divert them toward more socially productive uses. This transfer of resources is necessary to take advantage of new productive opportunities in a dynamic environment.

The financial needs of a household vary during its life cycle. The financial needs of different producers are greater or smaller at different moments in time. Through their existence, therefore, most economic units will be sometimes deficit units, sometimes surplus units. The financial needs of different households are not all of the same nature at all points in time. Deficit units require credit services; surplus units need savings services. An efficient financial system must provide both types of services, in order to promote a better allocation of resources from a social point of view.

The aggregate capital available to all rural entrepreneurs at any one point in time must be reshuffled among them somehow, so that those with the best opportunities are net recepients of funds, even though some of these recepients may be net suppliers of funds in later periods. Then small but highly productive individual investments in input packages, on-the-job labor training, equipment purchases, or inventory holding can all be encompassed by a single allocative mechanism.

To the extent to which the development of financial mechanisms integrates the markets for savings and investment, the scope for better allocation of resources increases. As local financial systems are linked to other financial systems, the scope for a more productive allocation is further increased. Higher rewards to savers become possible given greater opportunities for portfolio diversification. As the growth of financial institutions provides more producers with access to borrowing, it gives investors the incentive to save and to accumulate the equity that makes borrowing easier. Savers' planning horizons are shifted to the more distant future and improvement in income expectations reduces the relative attraction of consumption now. The ratios of savings to income increase. Local capital markets are integrated into regional markets and regional markets into a national market. New opportunities for pooling savings and specializing in investment are created and development is promoted.

2.06 Interest rates play a crucial role in this allocation process. As the relative price of the present in terms of the future, interest rates affect savings and investment decisions. If interest rates are restricted below equilibrium levels, the terms of trade between present goods and future goods are twisted. The fact of life is scarce capital; but low interest rates tell savers not to bother with saving, that the future is amply provided for, that now is the time to consume. The same low rates tell investors that savings are plentiful, and that high prices can be bid for investment goods to induce a transfer of resources away from the production of consumables. Unfortunately, there can be no investment without savings. The conflict between the decisions of savers to save little and of investors to invest much has to be resolved by rationing, by decisions on some basis other than the willingness of individuals to save and invest.[1/] When interest rates are deprived of their role as a price that allocates resource uses, capital remains scarce and resources are misallocated. Higher interest rates, on the other hand, would tell consumers that the future is expensive and that sacrifices in present consumption are well rewarded; and they would tell investors that capital goods are scarce and that they have to be economized.

Interest rates are also the prices relevant in financial markets. As such, they are a signal influencing the composition of the portfolios of assets held. Savings can be incorporated in gold, housing, inventories of goods, foreign and domestic financial assets. Wealth holders compare the returns, risk, and liquidity of alternative assets, and choose a portfolio. The interest rates paid on domestic financial assets (i.e., a bank deposit) determine the extent to which these assets are incorporated in wealth portfolios and, therefore, the proportion of domestic savings which are mobilized for investment by the domestic financial system.

[1/] Claudio Gonzalez-Vega. "Arguments for interest rate reform". J. D. Von Pischke, Dale W. Adams, and Gordon Donald, eds. Use and abuse of Rural Financial Markets in Low-Income Countries. The Johns Hopkins University Press. (Forthcoming).

By paying a rate of interest on financial assets that is significantly above the marginal efficiency of investment in inferior (traditional) uses, financial institutions can induce some households to disinvest from these inferior processes, to permit lending for investments in improved technology, increased scale or new opportunities in other enterprises. The resources thus liberated would, in turn, be channeled by the financial intermediary to other households that are willing to pay a sufficiently high interest rate because they can earn high marginal rates of return on their investments. Even though all households will continue to do some internal investing of their own resources, a higher proportion of savings will pass through the financial markets. The households with the most productive investment possibilities change from one point in time to the next and once a producer upgrades his activity, the repayment flow can then be used by another one to do the same, again at a sufficiently high rate of interest to lure funds away from lower-yield investments elsewhere.

2.07 Financial intermediation is expensive. Valuable human and material resources, which could be devoted to other activities, are employed in mobilizing resources and in granting and administering loans. The use of these resources in the financial sector is justified only when the returns are sufficiently high to compensate for the opportunity costs.

In every financial transaction there are costs both for the financial institution and for the client. There are costs for savers, when these deposit their funds with a financial intermediary, as well as for the institution that attracts the savings. With respect to credit transactions there are both lenders' costs and borrowers' costs. Usually, interest rates are only a small proportion of these transaction costs, particularly in the case of small deposits or loans.[1/] Different procedures, institutional structures, policies and regulations imply different levels of transaction costs and a different distribution of these costs between the parties in the transaction. Interest rate restrictions, in particular, tend to increase transaction costs and to shift much of the burden of these costs towards

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[1/] Dale W. Adams and Gerald I. Nehman. "Borrowing costs and the demand for rural credit". The Journal of Development Studies. Vol XV. N° 2. January, 1979. pp. 165-176.

savers and borrowers.[1] The evolution and integration of financial markets takes place through the introduction and diffusion of innovations that reduce these transaction costs.[2]

2.08 In many rural communities in Indonesia only informal sources of credit are available: moneylenders, intermediaries and participants in all kinds of sharing (ijon) arrangements. Compared to most institutional sources of credit, these informal sources usually imply much lower transaction costs, both for borrowers and lenders. Informal lenders provide timely credit, when it is needed. They do not make artificial distinctions according to the use of the funds. Rather, these lenders recognize that the production-investment-consumption-reserve and cash management requirements of the household are complementary and result from a simultaneous decision. Moneylenders recognize that money is fungible.

1/ Claudio Gonzalez-Vega. "On the iron law of interest rate restrictions: the rationing behavior of financial institutions matters". Dale W. Adams, Douglas Graham and J. D. Von Pischke, eds. Why Cheap Credit Misscarries in Rural Development. The Johns Hopkins University Press. (Forthcoming).

2/ V. V. Bhatt. "On Financial Innovations and Development". J. D. von Pischke, Dale W. Adams, and Gordon Donald, eds. Use and Abuse of rural financial markets in Low-income Countries. Cit.

More importantly, informal lenders provide a <u>permanent</u> source of credit. They assure the borrower of access to credit when needed and provide a high quality service. Many borrowers prefer to pay a higher interest rate in order to secure these services. Moneylenders, however, do not mobilize savings and do not generate sufficient economies of scale to further reduce transaction costs. The interest rates charged frequently include monopoly profits and may subject borrowers to potentially exploitative positions. From a social point of view, moneylenders do not integrate financial markets and do not increase the scope of savings-investment processes. Despite their comparative advantages in the rural areas, therefore, moneylenders cannot lead to financial deepening.

2.09 In summary, financial deepening, the growth of financial services at a pace faster than "real" economic activity, stimulates development. As a result of increased ratios of financial to real assets, savings flows increase and a higher proportion of these savings in channeled through the financial markets, improving resource allocation. At the same time, the importance of institutional intermediaries increases as compared to informal sources of credit and transaction costs are reduced. This reduction in transaction costs implies <u>both</u> higher real rates of return on financial deposits to savers as well as lower costs of credit for borrowers. These reductions in borrowing costs are the result of market integration and financial innovations. They cannot be achieved by decree. On the contrary, interest rate restrictions and other efforts to artificially reduce these costs have been counter-productive everywhere.

III

GENERAL CONSIDERATIONS ON THE INDONESIAN FINANCIAL SYSTEM

3.01 The financial system in Indonesia consists, at least, of the following institutions:[1/]

a. the Central Bank (Bank Indonesia);

b. 5 state commercial banks;

c. 79 private national commercial banks;

d. 10 foreign commercial banks and one joint venture bank;

e. 49 representative offices of overseas banks;

f. 26 regional development banks;

g. the state-owned development bank (Bank Pembangunan Indonesia: BAPINDO);

h. 3 development finance companies;

i. 9 investment finance companies;

j. the state savings bank;

k. 4 private savings banks;

l. 66 insurance companies;

m. 33 pension funds;

[1/] Numbers of financial institutions at the end of 1979.

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n. the credit insurance agency;

o. the capital market;

p. a multitude of other (secondary) financial institutions such as rural, market and village banks, savings and credit associations, etc.

3.02 The monetary authorities are the Central Bank (Bank Indonesia) and the Treasury, to the extent that the latter exercises monetary functions, such as transactions with the IMF and other borrowings from abroad. The main functions of Bank Indonesia are "to regulate, safeguard, and maintain the stability of the value of the Rupiah, and to promote and facilitate production and development, as well as to increase employment opportunities, in order to improve the standard of living of the people."[1/] For these purposes, Bank Indonesia issues currency, controls the official foreign exchange reserves, and supervises and regulates all major financial institutions, except insurance companies. It implements the official monetary policy through the regulation of credit, and acts as the Government's fiscal agent.

Bank Indonesia extends two kinds of credits: liquidity credits, which are credits to the banks, and direct credits

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[1/] Bank Indonesia. Act.Nº 13/1968, concerning Central Banking. Article 7.

to specific sectors of the economy.[1] Most of the credits to banks represent the refinancing of these banks' loans to borrowers, while some have been extended to overcome liquidity problems under special circumstances. Direct credits are extended only to selected official entities and public enterprises, in order to finance the implementation of Government programs.[2]

By the end of the third quarter of 1981, Bank Indonesia claims on the Central Government (1,083 billions of Rupiahs) represented 10 percent of its assets, claims on official entities and public enterprises (2,378 billions of Rupiahs) represented 22 percent of its assets, and claims on the deposit money banks (2,403 billions of Rupiahs) represented 22 percent of its total assets. Foreign assets represented 41 percent of the total.

1/ Ibid. Article 32.

2/ Bank Indonesia. Statistik Ekonomi-Keuangan Indonesia. September, 1981.

Table 1. Bank Indonesia. Liquidity and direct credits outstanding, by economic sector. 1976-1981 (Billions of Rupiahs)

	1976	1977	1978	1979	1980	1981*
I. Liquidity credits to banks	640	682	846	1.129	1.722	2.314
Agriculture	372	322	414	419	418	569
Investment	122	183	173	277	419	646
Industry	90	123	169	278	449	543
Other	56	54	90	155	436	556
II. Direct credits	1.212	1.229	1.935	2.163	2.454	2.426
Mining (PERTAMINA)	1.020	1.042	1.679	1.875	1.849	1.696
Other	192	187	256	288	605	730
TOTAL	1.852	1.911	2.781	3.292	4.176	4.740

*As of September, 1981

Source: Bank Indonesia. Statistik Ekonomi-Keuangan Indonesia. September, 1981.

At the end of 1976, liquidity credits represented 34.6 percent of Bank Indonesia credits, but by the end of 1980, these credits represented 41.2 percent. Credits to PETRAMINA, for repayment of foreign borrowing, have represented the bulk of direct Bank Indonesia credits. Credits for agricultural purposes, however, represented 58.1 percent of liquidity credits in 1976, but their share had declined to 24.3 percent, by the end of 1980. As of September, 1981, liquidity credits for agricultural purposes represented only 24.6 percent of the total (See Table 1.).

3.03 Apart from Bank Indonesia, the five state commercial banks are the dominant financial institutions. These are relatively large nationwide banking operations, with head offices in Jakarta and branches at various levels outside Jakarta. These banks are:

a. Bank Rakyat Indonesia (BRI), which concentrates its operations on loans to agriculture, fisheries, cooperatives and other aspects of rural development. It has the most extensive system of branches and it is the only bank that reaches most of the provincial capitals (kabupaten). It also manages a system of Bank Unit Desa, which amount to "windows" for certain operations, not full branches, located below the kabupaten level, about the kecamatan level. (See section 4.02 for the organization of local government).

b. Bank Ekspor Impor Indonesia (BEII) specializes in granting loans for production, processing and marketing of export products.

c. Bank Negara Indonesia (BNI) specializes in industrial loans.

d. Bank Bumi Daya (BBD) concentrates its operations on state agriculture (sugar) and forestry.

e. Bank Dagang Negara (BDN) specializes in mining credit.

These banks, which control over three-quarters of the assets of all deposit money banks and grant above 80 percent of all bank loans outstanding, reflect the public credit policy by lending both working capital and investment funds to the priority sectors determined by the Government. Although they have been assigned one particular economic sector on which to specialize, in practice they have not adhered rigidly to this specialization.

The deposit and lending interest rates of the state commercial banks are set by Bank Indonesia, while their volume of lending is controlled through credit ceilings. State-owned enterprises must hold their deposits and savings accounts with the state banks. Bank Indonesia regulations have required these banks to provide loans to priority sectors at very low interest rates, while Bank Indonesia rediscounts various categories of loans in varying proportions and at varying discount rates. These banks have been the major participants in the special investment credit programs of Bank Indonesia.

Table 2. Bank credit outstanding, by groups of banks. 1976-1981. (Billions of Rupiahs)

	1976	1977	1978	1979	1980	1981*
TOTAL	3.566	3.937	5.394	6.268	7.880	9.550
Bank Indonesia (Direct credits)	1.212	1.229	1.935	2.163	2.454	2.426
State commercial banks	2.007	2.267	2.832	3.270	4.301	5.620
National private banks	159	205	299	406	566	769
Local development banks	38	52	66	87	145	219
Foreign banks	150	184	262	342	414	516

*As of September, 1981.

Source: Bank Indonesia. Statistik Ekonomi-Keuangan Indonesia. September, 1981.

3.04 The national private banks provide mainly short-term working capital credit and their principal customers are large Indonesian firms. The overall credit ceiling set every year by Bank Indonesia includes these private banks. They are free, however, to set their own deposit rates and their own lending rates, except when utilizing Bank Indonesia's rediscounting facilities. Very complex regulations govern the access to these rediscount facilities and stringent requirements must be met before a bank can get permission to open new branches. Since 1971, by Government policy, the opening of new private banks has been prohibited. Bank Indonesia has also strongly encouraged existing private banks to merge into larger units. Some of these banks are very active in the money market.

The Government has allowed foreign banks to have only one branch besides their respective head office and this branch must be located in Jakarta. These branches of foreign banks are restricted to lending only to enterprises based in the Jakarta area, unless they syndicate a loan with Indonesian-owned banks. No licenses have been granted for new foreign banks since 1969. Their main business is to provide working capital and other commercial banking services to foreign companies operating in Indonesia. They have to seek special permission, on a case-by-case basis, from Bank Indonesia, if they wish to make investment loans. They are free to set their won lending and deposit rates, but do not have access to Bank Indonesias's rediscounting facilities. Bank Indonesia also places ceilings n the growth of their net assets. In addition to these banks, representative offices of overseas banks arrange offshore loans, but cannot accept deposits or provide other commercial banking services.

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3.05 There is one regional development bank (Bank Pembangunan Daerah) in most of the provinces, with its shares owned exclusively by the provincial government. These banks usually perform kas daerah functions (fiscal agents) for the provincial governments, as well as for the kabupaten governments, when they have branches at this level. Although intended to act as development banks, in the past they have mainly concentrated on providing commercial banking services. Recently, a few have taken an active interest in developing their long-term lending capacities, both for medium -and small- scale industry. There are great differences in the financial and managerial strength of these banks, with the ones in Sumatera Barat and Jawa Tengah, visited by this team, usually considered among the strongest. The Bank Pembangunan Daerah Jawa Tengah has branches in over half of the kabupaten headquarter towns, while the one in Jawa Barat has branches in all kabupaten headquarters.

Bank Pembangunan Indonesia (BAPINDO) is the national state-owned development bank. While it accepts deposits and makes short-term loans, it is mainly engaged in granting medium- and long-term credit and in equity participations. Established in 1960, it was reorganized in 1970 with a view to making it the predominant source of medium- and long-term finance for industry.

3.06 Nonbank financial institutions include the Indonesian Development Finance Company, which is a joint venture between Bank Indonesia and the Netherlands Finance Company for Developing Countries; P.T. Private Development Finance Company of Indonesia, and P.T. Bahana, a state-owned venture capital company. They grant medium- and long-term credit and take equity participations. Investment companies, on the other hand, mainly deal in commercial paper and promissory notes and provide services of a merchant banking nature including underwriting, portfolio management and investment and financial consultancy.

3.07 There is a multitude of secondary banks, distributed throughout Indonesia. These include four private savings banks and one state-owned savings bank, 156 market banks (Bank pasar), 3.537 village banks of several kinds (Bank credit desa, etc.), 2.090 paddy banks (lumbung desa), and many other semi-formal indigenous financial institutions. Although their role at the national level is almost negligible, in terms of the resources mobilized, their impact on the specific communities in which they operate is very significant.

In the early 1970s, the government of Jawa Barat was

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putting in place a system of *kecamatan* level banks, supervised both by the provincial and *kabupaten* governments as well as the Bank Pembangunan Daerah. The Ministry of Finance stopped this setting up of banks, but it allowed the provincial governments to set up *badans* or *lembagas* (borrower associations) to disburse resources from the provincial government to the *desa* level people. The government of Jawa Barat set up *lembaga perkreditan* in the remaining *kecamatan* that did not have *kecamatan* banks. At the same time, the government of Jawa Tengah set up a *Badan Kredit Kecamatan* in each *kecamatan* throughout the province. These financial institutions constitute the main object of this paper. The team found that similar local banks and savings and loan associations have existed for decades in other parts of Indonesia (Sumatera Barat) or have been recently created. Many of these institutions represent important "innovations" as mechanisms to reach small poor rural households at low transaction costs. The cooperatives (*Koperasi Unit Desa*) have been organized at the *kecamatan* level to implement the *Kredit Candak Kulak* program, which provides small loans to petty traders who are members of the cooperative. It has been financed with grants of 500,000 Rupiahs per *Koperasi Unit Desa* (KUD) from the Central Government. Its administration is also partly subsidized by the Central Government. Those KUDs with a successful credit program have received a second injection of funds for another 500,000 Rupiahs. The team observed the operations of the KUD's in Madura.

Table 3. Indonesia: Number of recognized secondary banks and other non-bank financial institutions. Loans outstanding in million of Rupiahs (estimates). December, 1981

	Number of banks	Loans outstanding
I. Banks:	5.792	38.037
Badan Kredit Desa	3.295	7.796
Lumbung Desa	2.090	
Bank Pasar	164	30.241
Bank Karya Produksi Desa	217	
Bank Pegawai and others	26	
II. Non-bank:	1.033	3.166
Badan Kredit Kecamatan (Jawa Tengah)	486*	1.330*
Lembaga Perkreditan Kecamatan (Jawa Barat)	104**	1.270**
Lumbung Pitik Negari (Sumatera Barat)	472	566
III. Bank Rakyat Indonesia: Unit Desa	3.524	...

*As of December 1977.

**As of December, 1980

Source: Bank Indonesia. Unpublished records.

3.08 Both the five state commercial banks and the national private and foreign banks mobilize domestic resources under severe constraints. Bank Indonesia regulations determine the deposit rate that the state banks can pay and thus limit the ability of these banks to mobilize savings. Borrowings are also regulated by borrowing ceilings and by limits on swap facilities. Borrowing ceilings are set for each bank individually each year. These ceilings have tended to be liberal for state banks and foreign banks, while tight for national private banks. In this environment, access to Bank Indonesia's rediscount facilities becomes a very important source of funds.

Table 4. Deposit money banks. Liabilities at the end of the year. 1976-1981. (Billions of Rupiahs).

	1976	1977	1978	1979	1980	1981*
TOTAL	3.504	4.030	5.276	5.785	10.122	14.942
Deposits:	1.995	2.400	2.902	4.133	6.550	10.382
Demand deposits	703	959	1.193	1.737	2.795	3.501
Time and savings dep.	858	984	1.054	1.140	1.481	1.966
Foreign cy. deposits	167	140	263	670	1.174	1.044
Government deposits	94	171	218	373	735	821
Import deposits	83	146	174	213	365	281
Borrowings	1.200	1.209	1.859	2.154	2.769	3.521
Bank Indonesia	652	635	860	1.125	1.636	2.450
Foreign	270	275	444	430	388	415
Other	278	299	555	601	745	656
Capital:	309	421	515	502	803	1.039

* As of September, 1981.

Source: Computed from Bank Indonesia. Statistik Ekonomi-Keuangan Indonesia. September, 1981.

About one-fifth of all the resources of deposit money banks have been provided through Bank Indonesia's rediscount window. This proportion has been higher in the case of the state commercial banks. The deposit money banks, at the same time, have more than one-fifth of their assets (2,897 billions of Rupiahs, as of September, 1981, which represent 23.8 percent of their total assets) in the form of foreign assets. Many of these assets are apparently deposits held by these banks in Singapure and other overseas financial centers. Holdings of overseas assets suggest excess liquidity, combined with tight credit ceilings impossed by Bank Indonesia. Ironically, these banks have mobilized about one-fifth of their funds from the "lender of last resort", at heavily subsidized interest rates, while at the same time are holding over one-fifth of their assets in overseas deposit accounts, that pay higher interest rates and represent very low transaction costs.

That is, given the credit ceilings imposed on these banks they cannot expand their loan portfolios (although the state banks have been unable to meet their lending targets under the Bank Indonesia special credit programs). Instead, they hold other non-loan assets. At the same time, access to rediscount facilities at low interest rates makes this a cheaper source of funds than savings mobilization. That is, despite Bank Indonesia subsidization, funds mobilized from time and savings deposits are more expensive than rediscount funds. It is not surprising that these banks have made little attempt to mobilize more domestic resources in this form. While in 1976, time and saving deposits represented 24.5 percent of the resources mobilized by these banks, in 1981 they represented only 16.2 percent (See Table 4). Fungibility implies, therefore, that rediscount facilities merely facilitate overseas deposits by the deposit money banks, while at the same time discouraging domestic savings mobilization.

The National Development Savings Scheme (*Tabungan Pembangunan Nasional*: TABANAS) was introduced in 1971. Deposits earn an annual interest rate of 15 percent, if they are below 200.000 Rupiahs, and of 6 percent, above 200.000 Rupiahs. Previously, the deposit rates were 18 percent per annum up to 100.000 Rupiahs, and 12 per cent on the balance above 100,000. On account of these favorable rates paid, these savings deposits have grown more rapidly than time deposits. Their total number increased from 5,441 thousand, in 1976, to 9,356 thousand, by September, 1981. At the same time, the amount outstanding increased from

109.3 billions or Rupiahs, to 351.2 billions. The average deposit size increased from about 20,000 Rupiahs to about 38,000 Rupiahs.[1/]

Various factors favor the state commercial banks over other banks with respect to resource mobilization:

a. The state banks have a wide branch network. While the state banks had 687 branches (at the end of 1979), the private national banks had 274 and the foreign banks 20.

b. All deposits with the state banks are guarantee by the Govenrment.

c. Two-year time deposits receive an interest subsidy from Bank Indonesia of 4.5 percent, for deposits bearing 15 percent interest, and of 1.5 percent, for deposits bearing 12 percent interest.

d. Insurance companies are compelled by law to invest a certain proportion of their funds in state bank time deposits.

e. State bank deposits are exempt from taxes on interest.

f. All state-owned enterprises must invent in demand and time deposits with the state banks and are not

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[1/] Bank Indonesia. <u>Statistik Ekonomi-Keuangan Indonesia</u>. September, 1981.

allowed to make deposits in the other banks. This is a tremendous advantage because of the prominence of the public sector in Indonesia.

3.09 During the first decade of the New Order regime Indonesia experienced a remarkable success in formulating financial policies that promoted the development of the domestic financial sector as well as financial deepening. These policies brought the country out of a period of economic stagnation, financial repression and instability. The rate of inflation was reduced from 650 percent per year, in 1967, to 9 percent per year, in 1969. Full convertibility of the Rupiah in international transactions was achieved, and the ratio of money (broadly defined) to gross national product increased from 2.1 percent, in 1970, to 11.9 percent, in 1975. At the same time, the ratio of gross national savings to gross national product increased from 11.5 percent, to 18.2 percent.[1/]

[1/] This section, as well as others in this chapter, rely heavyly on the World Bank: Indonesia. Selected Issued of Industrial Development and Trade Strategy. Annex 4. Financial Policies for Industrial Development. 1981. The emphasis and additional observations are the responsibility of the authors of the present report.

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Stability and financial deepening were the result of greater control over the growth of the money supply, particularly through the avoidance of budget deficits, as well as of the return to a more market oriented economy, which relied less on the control of output prices and factor prices. It resulted also from restoring the attractiveness of holding domestic financial assets, through positive interest rates in real terms, and through the unification of the exchange rate. As indicated in Chapter II, alternative opportunities to earn high rates of interest on domestic financial assets move the spectrum of physical investments towards those yielding even higher returns, eliminating inferior uses of resources and improving the "quality" of investment.

With the increases in oil prices that took place after 1973 the stabilization problem re-emerged, since increasing foreign exchange assets and rapid credit expansion threatened domestic price stability. After 1974, monetary policies moved away from the allocation of credit through interest rates to a more administratively determined system which relies on credit ceilings. Sufficiently high lending and deposit rates prevailed as long as inflation was contained but became significantly negative in 1979. With the establishment of credit ceilings, the Government moved towards directing credit towards specific sectors, through a system of program and non-program credit. These guidelines, which were applied flexibly, lasted until 1978. Overall credit ceilings have remained.

These changes reflected a rekindling of the suspicion of market forces that characterized the pre-New Order period. It has been assumed, disregarding the previous success, that direct controls are more effective in curbing strong inflationary pressures. Moreover, these controls have been retained even when the rate of domestic inflation has been reduced, from 33 percent, in 1974, to 14 percen per year, in 1976, and to 8 percent, in 1978.

As a result of the shift away from the successful financial policies implemented earlier in the decade, by comparison with the experience of other countries in the region, Indonesia's financial development has lagged behind (as measured by the ratios of money, broadly defined, to gross national product). Also, compared to other countries at a similar stage of development, Indonesia appears to be under-banked (as measured by the number of bank branches in relation to population). The range of financial assets remains narrow and confined to the short end of the financial market. Real rates of return on domestic financial assets have declined and national financial savings performance, particularly in the case of the private sector, has been poor.[1/] The country, however, continues to have a free foreign exchange market and Indonesia's financial structure has been integrated with the international capital markets.

3.10 During the most recent years, the inflationary impact of the budget has not been fully neutralized, in spite of the commitment to an overall balanced budget. The reason is that the domestic expenditure budget is the critical factor in determining liquidity growth. Thus, although there has been fiscal restraint in the overall budget, this has not been sufficient to contain liquidity expansion. Credit ceilings have been used, therefore, as a second line of defense against inflation.

Fiscal and credit policy have favored the channelling of resources to public sector enterprises, which are larger, more protected, and more capital-intensive than those in the private sector. This has been the result, not only of the

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[1/] World Bank, cit. p. 11.

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rapid growth of the public sector budget, which constitutes the primary expansionary source, but also of the administration of the credit ceilings. For instance, while for the fiscal year 1978-79, the credit ceiling for the public sector was allowed to increase by 52.7 percent, the credit ceiling for the private sector increased by only 20.2 percent.

The aggretate ceiling for the expansion of all bank assets is established each year as part of an overall assessment of the economy (financial programming), which takes into account the demand for and supply of money, as well as factors such as the expected rate of inflation, the expected budget surplus, and the expected balance of payments surplus. Ceilings are set by Bank Indonesia for the fiscal year from April to March. The overall ceiling is first allocated to groups of banks (state, private, foreign, etc.). Then, each group ceiling is allocated to individual banks, according to their recent performance and growth records, as well as the activities that each bank intends to finance. The ceilings on credit expansion for the state commercial banks are further disaggregated on the basis of targets for lending under Bank indonesia's special credit programs. In turn, each state bank allocates these various ceilings among its branches.

In summary, credit ceilings have been used for three major purposes: to control overall credit expansion, to control the proportions of credit provided by various types of banks and reduce competition among them, and to control the flow of resources to the public and private sectors, as well as to various priority sectors.

3.11 The other main instrument to channel commercial bank credit to priority sectors has been the rediscount window at Bank Indonesia. Actually, rediscount facilities have been used as an instrument of selective credit control rather than a general policy instrument. The state commercial banks are viewed as <u>conduits</u> to provide credit to varios sectors at low interest rates.

In order to ensure adequate profits for the banks and to encourage the extension of credit to the preferred sectors Bank Indonesia rediscounts several categories of loans in varying proportions and at varying discount rates. Full access to rediscount facilities is allowed for the five state commercial banks, whose lending rates are fixed by Bank Indonesia. Access to rediscount facilities by national private banks is restricted and rediscount rates are higher for them. The private banks must onlend at the same rates as the state banks if they utilize the rediscount facilities at the same rates as those offered to the state banks. Foreign owned banks have no access to rediscount facilities.

Rediscount rates and proportions constitute a complex system. For all sectors of the economy, there are 19 categories of short-term credit, which imply seven different lending rates (ranging from 9 percent to 21 percent per annum), three discount rates (ranging from 3 to 6 percent per annum), and eight rediscount percentages (ranging from 25 to 100 percent). (See Table 5). The combination of all of these rates results in 10 different interest rates spreads for the banks. In addition, several special credit programs have their own lending rates and spreads, that further complicate the system.

Table 5. Rediscount, Lending and Deposit rates of Bank Indonesia and State Banks. (Percentages)

LOANS	BI's rediscount share	BI's rediscount rate	Lending rates
A. Short-term			
Group I			
1. Working capital for BUUD/KUD for procurement and distribution of rice and maize	100	3	9
Group II			
1. BIMAS/INMAS rice and secondary crops	100	3	12
2. BUUD/KUD/P.N. Garam for collection and distribution of salt and working capital for P.N. Garam	75	4	12
3. Working capital for flour mills	75	4	12
4. Export and exporting producers	75	4	12
5. Production, import and distribution of fertilizers	75	4	12
6. Import and distribution of nonfood items under foreign aid	75	4	12
7. Working capital for BUUD/KUD and cooperatives for collection and distribution of agricultural products, livestock and fish	75	4	12
8. Working capital for smallholder agriculture and cottage handicrafts	75	4	12
9. Working capital for livestock, poultry and fisheries	75	4	12

Cont'd ...

Table 5. Continued ...

	BI's rediscount share	BI's rediscount rate	Lending rates
Group III			
1. Working capital for rice mills/hullers, sugar, coconut oil, textiles, agricultural equipment, paper, cement, public transportation, printing and publishing and tourism	70	6	13.5
2. Working capital for other production	70	6	13.5
3. Import and distribution of controlled goods	70	6	13.5
4. Sugar stock financing	70	6	13.5
5. Domestic (inc. interinsular trade)	70	6	13.5
6. Working capital for contractors for DIP/INPRES projects financed out of regional governments' budgets and for low-cost housing	70	6	13.5
Group IV			
1. Working capital for contractors for projects other than those specified in III.6	60	6	15
Group V			
1. Import and distribution of imported goods not covered in II.5, II.6 and III.3	40	6	18
Group VI			
1. All other short-terms credits	25	6	21
B. Medium/Long-Term			
Fixed assets financing:			
Up to Rp 75 million	80	3	10.5
Rp 75 - 200 million	75	4	12

Cont'd ...

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Table 5. Continued

	BI's rediscount share	BI's rediscount rate	Lending rates
Rp 200 - 500 million	70	4	13.5
Above Rp 500 million	65	4	13.5
Working capital financing:			
Up to Rp 300 million	70	4-6	12-18[a/]
Above Rp 300 million	65	4-6	12-18[a/]
C. Loans to Small Enterprises			
Fixed asset financing (KIK)	80	3	10.5
Permanent working capital financing (KMKP)	75	4	12
D. Foreign Aid Project Financing			
Foreign currency requirements	100	4-6	12-15[b/]
Domestic currency requirements	90-100	4-6	12-15[b/]

	Deposit rate	Interest rate subsidy on deposits
DEPOSITS		
Time deposits		
24 months for the first Rp 2.5 million	15	4.5
On balance exceeding Rp 2.5 million	12	1.5
12 months	9	
6 months	6	
		Determined by bank
Demand deposits		
Up to Rp 1 million to banks		3.0 - 9.0
More than Rp 1 million to Rp 50 million		3.0
On balance exceeding Rp 50 million		6.0

Cont'd ...

Table 5. Continued

	Determined by bank
Call Money	9.0 - 15.5
Tabanas (National Development Savings Scheme)	
For the first Rp 200,000 deposited	15
On balance exceeding Rp 200.000	6
Certificate of Deposit	
1 month	3.0 - 14.75
3 months	4.0 - 15.25
6 months	6.0 - 15.25
9 months	7.0
12 months	8.0 - 14.75

a/ Depending on the economic sector concerned.

b/ 12% up to Rp 100 million; 15% above Rp 100 million.

Source: Bank Indonesia.

3.12 The entire structure of interest rates has been influenced by the rediscount facilities offered to the state commercial banks. Moreover, because of the dominance of these banks in the financial system, they tend to act as price leaders within the oligopolistic bank scructure. Since the combination of rediscount rates and proportions to be rediscounted, as well as the lending rates, lead to differential costs of funds and profits to the banks, depending on the purpose of the loans, these mechanisms heavily influence at least the "explicit" availability of bank credit for different sectors of the economy. Further, Bank Indonesia's special credit schemes, described in the next chapter, have additional implications for the allocation of financial resources among sectors of economic activity.

In summary, the main instruments of credit policy have been credit ceilings and rediscount facilities. While ceilings have been administered with some degree of flexibility, nevertheless, they have been biased towards increased allocation of financial resources to public enterprises, at the expense of providing credit to the private sector. This private sector has been proned to be "squeezed out", particularly when inflationary pressures have been strong, when the availability of resources in real terms has decline, and when interest rates have become negative in real terms. Therefore, credit availability for smaller and more labor-intensive enterprises has been more erratic, while the brunt of the control -or lack of control- of liquidity has fallen on the private sector.

To the extent to which the structure of interest rates is dominated by the lending rates fixed for the state commercial banks, when these rates become very low or even negative in real terms, credit ceilings are the device used to ration excess demands for bank credit. Public enterprises have benefited from the lion's share of the resources allocated through this rationing process. Credit to the private sector has become, as a result, merely a residual. Such administratively determined rationing of the supply of loanable funds always leads to extreme rigidity, inhibits innovations both in the financial and the productive sectors, and favors lending to borrowers and for activities with low transaction costs and minimum risks. Eventually, this rationing process also contributes to more concentrated distributions of wealth.[1/]

[1/] Claudio Gonzalez-Vega. "Redistribution in reverse: cheap credit cannot redistribute income in favor of the small farmer". Dale W. Adams, Douglas Graham and J. D. Von Pischke, eds. Why Creap Credit Miscarries in Rural Development. The Johns Hopkins University Press. (Forthcoming).

3.13 The most salient characteristic of general financial policy in Indonesia has been the Government's attitude towards the financial system. The financial system has been perceived as just another <u>fiscal</u> mechanism, not as a <u>financial</u> instrument. This perspective, which implies a significant departure from the interest on financial deepening which characterized the early years of the New Order regime, explains must of the main characteristics of the present financial structure in Indonesia.

During recent years Indonesia has experienced relatively high rates of growth of output, in real terms. National purchasing power has been continually increasing through the improvement in the country's international terms of trade, that has resulted from the sustained rise in oil prices, leading to increasing balance or payments surpluses. The 1980 boom in the Indonesian economy, propelled by massive, largely oil-financed, public expenditure programs and supported by a record rice harvest, was continued into 1981.[1/] The country has not faced foreign exchange restrictions, while it has managed to mobilize substantial public external borrowing.

Higher oil prices have clearly improved the prospects for rapid growth in Indonesia. Growth, however, will be constrained more by the absorptive capacity of the economy,

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[1/] D.T. Healey. "Survey of recent developments". <u>Bulletin of Indonesian Economic Studies</u>. Vol. XVII. N° 1. March, 1981. H. W. Arndt. "Survey of recent developments". <u>Bulletin of Indonesian Economic Studies</u>. Vol. XVII. N° 3. November, 1981.

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as well as by the productivity of the domestic investment undertaken, than by the availability of foreign exchange. This is particularly true in the case of the public sector. Oil revenues have significantly increased total Government revenues. During 1979-80, oil revenues increased by 84 percent and their share increased to represent 64 percent of total Government revenues. These sharp increases in Government revenues have accentuated the impact of manpower and real resources contraints as well as the limitations imposed by the public sector administrative capacity. That is, in its efforts to carry out a larger development program, the most serious constraint that the Government has had to face has been the pervasive shortage of skilled manpower.

The acute shortage of human capital is universally recognized as the single most important constraint to the effective utilization of the large and sudden increase in foreign exchange revenues.[1/] The magnitude of this manpower problem is illustrated by the fact that in 1976, only 0.7 percent of the Indonesian labor force had received higher education, and only 9.3 percent had received secondary education. Successful implementation of an expanded public

[1/] The World Bank. Indonesia. Development Prospects and Policy Options. April, 1981.

expenditure program will also be determined, in part, by the effectiveness of procedures and other aspects of the administrative framework. Improvements in these areas have been relatively slow, despide important efforts, when compared to the expanding availability of resources. It is clear that a simplification of many regulatory schemes could improve the efficiency of resource allocation. This is particularly true with recpect to the financial system.

The main objectives of fiscal policy have been the promotion of growth, equity, and stability. For the first purpose, the authorities have striven to implement a sizable development budget. In order to promote equity, the budget has been used to dispense the benefits of rising oil revenues to the poorer sections of the population, through subsides. The manpower and administrative constraints described above have restrained the implementation of these programs. The attempt to share the oil profits with all, including the poor, has also affected the government's perception about the role of the financial sector. Given the feeling of abundance of (fiscal) resources, while faced with a limited absorptive capacity in terms of real resources, credit has been perceived as just another mechanism to push the oil profits down the social structure.

In summary, institutional and manpower constraints have limited the scope and effectiveness of most sharing mechanisms. Health, education, and extension programs, rapidly expanded, have not been able to absorb all of the augmented oil revenues. Subsidies have been increasingly used as a mechanism for further disbursing these resources. Notable cases have been the subsidies on the domestic consumption of petroleum products, the food subsidies, which are meant to cover the deficit of BULOG's operations, mainly arising from rice imports, and the subsidies on imports of fertilizers. The credit system has become just another mechanism to disburse the subsidies made possible by exceptional oil revenues.

There are some dark clouds on the horizon, however. The most immediate seems to be a sharp fall in the world market prices of most of Indonesia's non-oil exports, Even more important in the medium and longer run is the likelyhood of an early re-emergence of the serious resource constraint on the country's economic growth from which the oil price increases freed her for a decade. It seems that the volume of crude oil available for export may soon begin to decline, since increases in production cc not match the rapid growth in domestic consumption. The World Bank believes that this secular decline in the volume of oil available for export is probably inevitable. Improvement in the efficiency of financial intermediation and domestic financial deepening, in general, will not only be a key element for the allocation of investment funds in the short run, but will be particularly crucial in the medium term, when the country will have to rely relatively more on the mobilization of domestic savings. The present fiscal perspective on the role of the financial system is not conducive to such an improvement.

3.14. Credit has been given a fiscal treatment in Indonesia.

This means that the financial system has not been seen as a mechanism to integrate capital markets and to mobilize resources from surplus to deficit units in the economy but, rather, that it has been seeen as a tool to transfer Government revenues, via subsidized credit, to specific sectors of economic activity. Within this process, although the poor have received some resources, their share has been minimal.

Dapice describes the Indonesian financial system in the following terms: "the banking system is dominated by a few state-owned banks with major problems. Several of the banks have difficulty functioning as lending institutions. Bad loans are a recurring problem, and solvency is not assured even with very high margins between borrowing and lending rates.

Reports of illegal payments to bank officers are common, and traders are reported to pay over 1C percent per month for "informal" credit ... Further, virtually all banks have problems as development institutions. Their ability to loan intelligently to small farmers, traders, or manufacturers is limited; their capacity to assist this class of borrowers in improving operations is even more deficient. Too much pressure on the banking bureaucracy to move funds earmarked for small businesses results in bad loans; too little pressure, and the rate of disbursements slows drastically."[1/] Most of the deficiencies listed by Dapice reflect, in some sense, the consequences of this fiscal attitude towards the financial system.

The most important consequences of this fiscal approach have been:

a. There has been little or no interest in an active promotion of domestic savings. Savings mobilization has not only been more costly than rediscounting and other borrowed funds for the banks; also additional resources cannot be used by them in lending and other asset expansion, given

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[1/] David O. Dapice. "An overview of the Indonesian economy". Gustav F. Papanek, ed. The Indonesian Economy. Praeger, 1981.

the credit ceilings imposed. Further, more reliance has been placed on compulsory rather than voluntary savings, for which few or no incentives are offered.

b. The price mechanism (interest rates) is not used to allocate loanable funds. Rather, there is a "project" approach to credit allocation. Credit programs are created very much in the nature of budgetary allocations. That is, given the annual amount of revenues to be disbursed, these are administratively allocated to priority sectors according to a credit budget.

c. The annual allocations of resources for specific purposes have deprived the credit programs of any sense of "permanency". These credit programs have been, therefore, perceived by the borrowers as just "budgetary" allocations that will last as long as the fiscal sources are replenished. Because borrowers perceive that they will not last long, they are tempted to borrow now as much as possible and not to repay. As default becomes high, other borrowers behave in a similar ashion, originating a demostration or "ripple" effect. Thus, theirs becomes a self-fulfilling prophecy about the programs lack of permanency.

d. The budgetary treatment of financial processes leads to a proliferation of specific credit programs.

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That is, there is a tendency to create a program for every purpose that someone with influence considers important. Project multiplicity significantly increases transaction costs. For example, the branch of Bank Rakyat Indonesia in Surabaya has to manage 126 separate credit programs, each one with its own weekly, monthly, quarterly required reports to the main office; with its own procedures and criteria for borrower selection; with its own terms and interest rates.

e. The programming of credit allocations is undertaken in Jakarta by a centralized bureaucracy that cannot take into consideration the specific needs and requirements of particular borrowers throughout the country. Rather, it tends to replicate historical patterns, with changes resulting from *a priori* prejudice, rather than from experience. There is a generalized tendency to believe that this bureaucracy knows what the "proper use" of the loans must be, and that it is in a better position than the borrowers to judge what the most profitable uses of the resources are. Actually, much energy is spent in trying to guarantee such "proper use" of the funds. There is no recognition of fungibility [1/] and of the borrower's better judgement about his own circumstances.

[1/] J. D. Von Pischke and Dale W. Adams. "Fungibility and the design and evaluation of agricultural credit projects". *American Journal of Agricultural Economics*. Vol. LXII. N° 4. November, 1980.

f. One of the consequences of this administrative allocation of loanable funds has been that rigid technological packages are forced upon the borrowers, at the same time that the terms and conditions of the loans are not adjusted to the needs and cash flow requirements of very heterogeneous producers throughout the country. There is very little room for innovation in the system. This narrow project design explains, in part, the excessive preoccupation of loan officers with the "proper use" of the funds. Also, frequently resources not spent within one project remain undisbursed and can be used for another project only at the added transaction costs involved in a budgetary reallocation.

g. There has been little concern with collection and repayment. Since the name of the game is to disburse the budgetary allocations, collection is not a continuous and systematic effort. Collection has actually been a sporadic and spasmodic activity, that receives attention cyclically, as default becomes too high. But, if funds are "abundant" and "cheap", why collect?

h. The subsidy makes access to credit particularly attractive, while excess demands make administrative allocations vulnerable to social and political pressures and provide ample room for corruption. The Indonesian authorities, however, have no knowledge at all about the income distribution implications of these credit programs. Most likely these programs have been very regressive as redistribute mechanisms. Despite the good intentions, therefore, to push the oil revenues down to the poor, the institutional credit system has reached only an insignificant minority among the poor who, by and large, have remained dependent on the local semi-formal and informal sources of credit. When only a limited proportion of the rural population has access to the special institutional programs, the wellbeing of the few beneficiaries is improved, given the subsidy implicit in the underpriced loans, but the negative consequences on financial development of this approach further limit the possibility to reach wider populations with financial services. To reach a significant proportion of the rural poor with this fiscal approach would require massive transfers of resources (e.g. ten times larger than the present transfers), which are not feasible. Therefore, there is a need for promoting savings mobilization in the rural areas and to expand the actual lending capacity of the local intermediaries. Financial deepening in this sense, however, has been constrained by the fiscal approach of the national credit programs.

i. The participating banks look at the special credit programs as activities that they must carry out given their social responsibility; they do not look at them in business terms. That is, they do not have an entrepreneurial attitude towards these special programs, but rather a political attitude. The banks, too, realize that these programs constitute mere transfers of resources rather than a credit program. As a result, banks have little interest in borrower selection, which is left to the Government's technical agencies (dinas dinas) in many instances, and very little interest in collection, which is an extremely expensive activity. Some of the bankers suggested that they look at these projects, therefore, as an "inevitable evil" or as a social cost that they have to incur, given political realities.

j. Finally, the fiscal attitude implies that competition is avoided at all levels in the financial system.

3.15 The limitation of competition constitutes another one of the main characteristics of Indonesia's institutional credit markets. Many tools are used, at all levels, to supress competition. The specialization of the state commercial banks by sector of economic activity is one mechanism to avoid competition among them. Another one is the setting of ceilings on bank asset growth.

No new foreign banks have been allowed in Indonesia since

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1969. The existing foreign banks, moreover, are not allowed to lend outside Jakarta. These foreign banks are not allowed to open branches. No more licenses for national private banks have been granted since 1971 and these banks have been encouraged to merge into a smaller number of institutions. A very complicated system of requirements mitigates against the national private banks being allowed to open more branches. It is also very difficult for private banks to get foreign exchange licenses. The access of national private banks to rediscount funds is extremely limited, while foreign banks have no access to rediscount funds. The national private and foreign banks have not been allowed to lend investment funds, with a few exceptions, to economically disadvantaged groups. The deposits of foreign and national private banks are neither insured nor subsidized. Interest rate control has been another tool to supress competition. The state commercial banks have to lend at rates fixed by Bank Indonesia and cannot adjust their lending rates according to the creditworthiness of the client. Competition among borrowers through price, therefore, has not been the criterium for the allocation of scarce loanable funds. Deposit rates have not been used as an instrument to compete for voluntary savings from the public. Specific restrictions have further limited the extent of domestic resource mobilization by the secondary banks. Most of these institutions have been prohibited to mobilize time deposits.

Competition is also restricted by setting size limits on the loans granted under various credit schemes. This division of labor by size of loan compartmentalizes bank clients and avoids competition for the funds. The general rule is that borrowers are allowed to deal with only one bank: that is, banks will not usually lend to another bank's borrowers. Unsatisfied borrowers are forced, however, to resort to informal sources of credit to complement the loan sizes received from the institutional programs.

3.16 Indonesia's very paternalistic environment is not conducive to the development of an efficient credit system. Both the poor and the not so poor have learnt to look at the credit programs as <u>conduits for public transfers</u> of resources to selected beneficiaries. They have learnt how to adjust their individual circumstances to the disbursement criteria, in order to benefit from the implicit gifts. They have not learnt to evaluate their own productive opportunities and to contrast them to the true costs of the resources acquired through credit. They have not learnt that loans must be invested profitably, because they must be repaid. As a result, resources have been misallocated and innovation has been stunted.

If the authorities treat the financial system as if it were simply a tube through which subsidized loans flowed, investors and producers do not receive adequate signals about the true scarcity of resources. Institutional performance is also poor, because the incentives are not adequate. There is a general tendency to avoid incentives and to rely on regulation. Regulation, however, ignores the strength of fungibility, and breeds conservatism and corruption. The absence of competition further leads to rigidity and inefficiency.

Financial deepening will require strong incentives for domestic savings mobilization as well as the discipline of the market for their allocation. Rather than looking at the financial system in fiscal terms, the authorities must look at it as a market in which savers and investors find profitable opportunities to postpone consumption and to undertake socially productive investment projects. Only at the desa level is there sufficient competition now to enssure that the resources mobilized are being used for their best alternative employment. Financial intermediaries at this level do not perceive their role, however, as conduits for Government subsidies, but they have adopted an entrepreneurial attitude towards credit. They are particularly concerned about their own financial viability and choose their customers and price their funds accordingly. Their success in

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reaching the rural poor with financial services will be discussed in the following chapter.

The fiscal strategy has been a "soft" option for the Government. It is easier to disburse subsidies than to improve the country's absorptive capacity. There is no need to generate projects and to innovate: disbursement is the name of the game. Most of the time, however, the intended target groups, as elsewhere, have not been reached.[1/]

[1/] Edward J. Kane. "Good intentions and unintended evil". Journal of Money, Credit and Banking. Vol IX. N° 1. February, 1977.

IV

FINANCIAL SERVICES FOR THE RURAL POOR

4.01 Financial services are provided at the local level by a large variety of formal, semi-formal, and informal financial intermediaries. Their modes of operation, institutional structure, financial viability and quality of management, as well as other relevant features vary tremendously from province to province and from region to region. This chapter describes the institutional forms found by the team in the areas visited: Aceh, Sumatera Barat, Jawa Timur, and Jawa Tengah. Nationwide formal programs that attempt to reach the rural poor are also described and compared with the indigenous mechanisms.

The advantages and disadvantages of the various institutional forms are contrasted, in order to identify elements for success. No specific institutional model is found to be superior. Rather, a collection of policies and patterns of behavior shared, in part, by many institutional forms, appear to determine success or failure. Among these, interest rate policies, cost management and attitudes with respect to collection appear to be crucial. Many different institutional forms are compatible with the behavior required, while the institutional structure is important from the point of view of local traditions and experiences. That is, while the successful institutions owe their success to policies, attitudes and management, institutional forms must be appropriate for the socio-cultural environment in which they have to operate.

4.02 Several of the credit schemes described in this chapter have been supported by the Provincial Area Development Program (PDP). In order to examine the role played by this Program, as well as in order to understand the scope of local financial institutions, it becomes necessary to describe the structure of local organization.

The organization of local government in rural Indonesia is essentially divided into four levels:

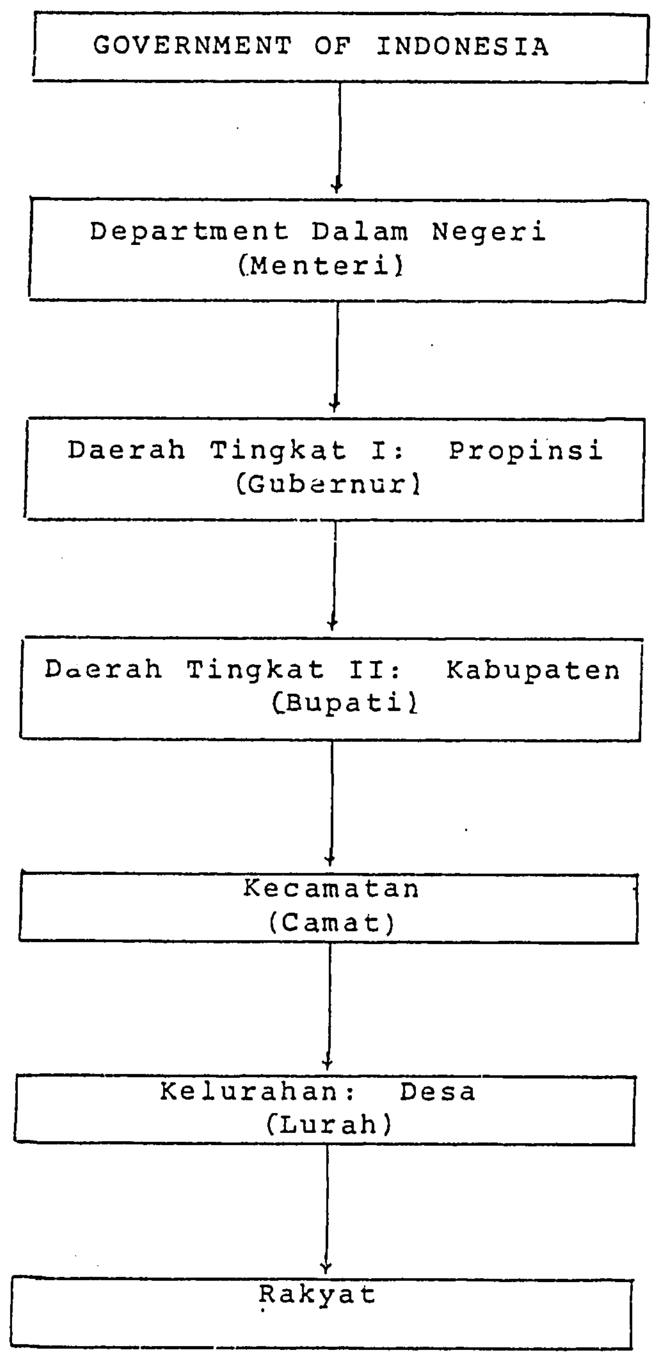
a. Daerah Tingkat I or Propinsi: the province, headed by a gubernur.

b. Daerah Tingkat II or kabupaten: the district, headed by a bupati. In the urban areas the kabupaten is replaced by a kotamadya, or incorporated municipality, headed by a walikota.

c. Kecamatan: the sub-district, headed by a camat.

d. Kelurahan or Desa: the village, headed by a lurah. (See Chart 1).

Chart 1. The organization of local government in Indonesia.



4.03 Most local government administration and operations are controlled by the <u>Departement Dalam Negeri</u>, the Ministry of Home Affairs. The provincial <u>gubernur</u> serves two functions: he represents the Central Government in the region and, accordingly, falls within the hierarchy of the Department Dalam Negeri; at the same time, he heads the first level "autonomous" region <u>(Daerah Tingkat I)</u> and, therefore, he is responsible to the region's elected Assembly.

This duality of functions is also shared by the <u>bupati</u>, since the <u>kabupaten</u> represents the second level "autonomous" region (<u>Daerah Tingkat II</u>). The <u>bupati</u> is both a representative of the <u>gubernur</u> (and of the Central Government's <u>Departement Dalam Negeri</u>), as well as being the chief executive of the <u>kabupaten</u>, responsible to the <u>kabupaten's</u> elected Assembly.

The <u>kabupaten</u>, therefore, is the lowest level at which the people's elected representatives meet a civil servant, who is, as a consequence, forced to concentrate his efforts in improving the welfare of his own region. Although the <u>camat</u>, which functions as the <u>bupati's</u> representative, has no "autonomous" functions, he is also key for rural development, since he is the lowest level at which there is a trained civil servant. The <u>lurah</u> is both a Central Government representative and a village chief. He possesses a fair amount of authority.

4.04 There are 27 provinces and about 290 kabupaten in Indonesia. The province is the prime source of sub-national policy. The gubernur is assisted by staff within the Provincial Secretariat, the Provincial Inspectorate, and the Badan Perencanaan Pembangunan Daerah (BAPPEDA), the Regional Development Planning Board.

The focal point for kabupaten operations, on the other hand, is the office of the bupati, supported by a secretariat and by a large number of its own administrative, financial, and technical offices. The government at the kecamatan level, of which there are some 3.550 in Indonesia, often includes just the camat, the deputy, a clerk and perhaps one other official.

The Departement Dalam Negeri, which deals with regional development through the provincial goverments (Pembangunan Daerah), has been the "decentralizing" force in the Government of Indonesia. Its role differs from the Central Government's efforts at the village level (Pembangunan Desa), a "centralizing" program with the Central Government's own people in the field. All kinds of technical agencias (Dinas dinas), emanating from Jakarta, have field offices in all provinces and generally in all kabupaten. At the kecamatan level there is a more limited range of technical agents.

The dinas dinas are involved in agriculture, livestock, irrigation, health and family planning, community education, cooperatives, religion, land use, information, and community development. Most of the dinas dinas have responsibility to implement "national" projects and activities and look towards their Jakarta-based ministries for guidance and financing. Some, however, are charged with executing local level functions and consequently receive financing and direction from the local governments. The gubernur, bupati, and camat are charged with the responsibility of coordinating the activities of both the "autonomous" regional offices and the Central Government ministry representatives. These relationships are complex and there are a variety of regional patterns.

In summary, at the local level there are:

a. Activities carried out by the local representatives of Central Government technical ministries and financed from the Central Government budget (e.g., national road improvement, large scale irrigation and flood control systems, etc.).

b. Projects which are completely planned locally, financed and implemented with local resources.

c. Programs which are planned and executed by local governments, but which are financed through grants and subsidies from the Central Government.

4.05 The most substantial source of local revenues is the land tax (IPEDA), utilized at the kecamatan level for development activities, except for a percentage forwarded to the provincial leve. In addition, REPELITA II (The Second Five-Year Development Plan, 1974-1979) established a number of revenue-sharing programs for local development, financed by the Central Government. These grants, known as "Inpres" (Instruksi Presiden), provide funds:

a. for the provincial government's development budget, eigher earmarked for such things as roads, bridges, irrigation and water works, or to be spent at the discretion of the provincial government (Provincial Inpres Program);

b. for the improvement of the local economic infrastructure (a rural works program known as Kabupaten Inpres Program);

c. in order to encourage local participation in small-scale development activities (Desa Inpres Program).

In addition, there are a number of specialized Inpres programs: for primary schools, health, market construction, reforestation, etc. These national grants constitute the largest source of funds for local development and have grown substantially in recent years, as a visible sign of a conscious national shift towards local development. As a result, provinces and lower levels, particularly kabupaten, are called upon to bear an increasing responsibility for local development.

4.06 There are some problems with decentralization, however.

Insufficient quantities of skilled and capable manpower are more acute at lower levels of government. Substantial increases in local government development budgets have not always been met with fully capable organizations, clear lines of authority, or well established procedures. There has been an inevitable resistance by "centralizing" national technical ministries to increased local government authority. The Provincial Area Development Program (PDP) was created as a means for enhancing local government institutional capabilities to carry out rural development activities effectively, in order to reach the majority of the rural poor.

In particular, the PDP Program was expected to "assist and improve integrated area/rural development planning and staff management capability of provincial planning boards (BAPPEDA), kabupaten, and other agencies operating in the provinces."[1/] This program, carried out in selected kabupaten in a few provinces, has been viewed as experimental, as an introspective and evolutionary approach to improved local government capability for planning, project identification, implementation, management

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[1/] U.S. AID. Project Paper. Indonesia. Provincial Area Development I. September, 1977.

b. To improve the capabilities of key central agencies to support local government rural development activities which impact on the income of the rural poor.

c. To increase the incomes of the rural poor within the project area. The assumption is that precise, universal formulae for raising incomes of the rural poor in Indonesia do not exist. The purpose of the PDP is to work with various local governments, under an umbrella of national attention and concern, to search for some of these. Clearly, it is a learning process.

PDP was started in 1977 in two provinces (Jawa Tengah and Aceh). Funding was authorized in 1979 for an additional six provinces. AID has plans for further expanding the program. It is not the purpose of this paper to evaluate the PDP program, a task that has been undertaken elsewhere.[1/] Credit programs, however, have been among the components of PDP in all provinces and in some cases (e.g., in Jawa Tengah and in Aceh), credit has represented a substantial portion of the funding. The PDP credit programs have experienced varying degrees of failure and

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[1/] Jerome French et al. Evaluation of the Provincial Area Development Program. Draft Report. U. S. AID. September, 1981.

success, providing interesting contrasts, which are a reflection of the contrasting performance of financial intermediaries also found outside the PDP program. The elements of failure or success in the PDP credit programs include the same behavioral and policy features (interest rates, costs, collection) which determine the performance of all types of financial institutions. The PDP credit programs will be discussed in detail below.

Table 6. Bank credit outstanding, by economic sector. 1976-1981. (Billions of Rupiahs).

	1976	1977	1978	1979	1980	1981*
Total	3.566	3.937	5.394	6.268	7.880	9.550
Agriculture	266	270	345	438	526	734
Mining	1.036	1.062	1.699	1.893	1.866	1.726
Manufacturing	990	1.156	1.624	1.933	2.563	3.173
Trade	858	911	1.114	1.338	1.977	2.724
Services	260	319	389	422	482	619
Other	156	219	223	244	466	574

* As of September, 1981.

Source: Bank Indonesia. Statistik Ekonomi-Keuangan Indonesia. September, 1981

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4.07 The Indonesian institutional financial system has served the agricultural sector poorly. While during the second half of the 1970s the agricultural sector contributed about 30 percent of Gross Domestic Product, it received only between 6 and 8 percent of the total portfolio of bank credit outstanding. (See Table 6). In addition to mining (PERTAMINA), manufacturing industry has received the lion's share of the banks' loan portfolio. That is, while this sector contributed only about 9 percent of Gross Domestic Product, it has received between 30 and 36 percent of the loan portfolio.

The preferential treatment received by manufacturing industry, as compared to agriculture, is reflected also in the proportion of Bank Indonesia credits granted in connection with bank lending to these sectors. (See Table 1). While the share of agriculture in these credits has been decreasing steadily, the share of manufacturing industry has been increasing rapidly. As a consequence of this differential treatment, while the ratio of credit outstanding to value added by sector has been about 5 percent, in the case of agriculture, it has been about 50 percent in the case of manufacturing industry.[1/]

[1/] Sarath Rajapatirana et al. Background paper on rural credit in Indonesia. Unpublished.

These data do not reflect, however, the availability of credit in the rural areas since, as has been indicated, non-agricultural occupations constitute a very important proportion of economic activity in rural Indonesia. Some institutional non-agricultural credit programs, therefore, also reach the rural poor. Nevertheless, these figures suggest that the degree of formal financial deepening in rural Indonesia is low and that only a very small proportion of the rural producers in this country have had access to institutional credit.

4.08 Among the deposit money banks, Bank Rakyat Indonesia (BRI) and Bank Bumi Daya concentrate on the rural areas. BRI, however, is the only major supplier of institutional credit in these areas, since Bank Bumi Daya concentrates on estate agriculture and on forestry. Also, BRI has the most extensive system of branches among all the banks. It possesses 15 regional offices (Kantor Daerah), 294 local branches (Kantor Cabang), 37 Kantor Kas and 15 Kas Mobil units, and 3.524 operating Unit Desa (out of 3.610 authorized units). In total, BRI operates 3.979 banking offices.

There are three basic types of credit programs handled by the deposit money banks and, in particular, by BRI:

a. Government programs, financed from the Central Government's budget. These programs receive budget allocations each year and the banks act mostly as a conduit for the funds. That is, in these programs the banks follow instructions from the technical agencies (dinas dinas) on how the funds have to be channelled, while the Government bears all or most of the risk. The most conspicuous examples of this type of program are the BIMAS (bimbingan massal) program and the Mini Credit program.

b. Special Bank Indonesia programs, based on access to rediscounting or liquidity credits. In the Kredit Investasi Kecil (KIK) and Kredit Modal Kerja Permanen (KMKP) programs, for example, Bank Indonesia provides liquidity credits up to a certain percentage of the loans made within the rules laid down for the program. Generally, these liquidity credits can be pyramided into total lending four to five times the original amount of resources supplied by the lending bank.

c. Loans from the bank's own resources. The banks have various credit programs for lending to specific sectors or for specific activities outside the previously described programs. The term Kredit Umum is sometimes used to describe these other general credit programs. Provided the bank maintains the quality of the loans, liquidity credits from Bank Indonesia are also available with respect to these non-program loans.

In addition to the above, BRI also manages several special credit programs established with the support of bilateral aid agencies and international lending institutions.

4.09 Most of BRI's funds come from deposits from the public and state enterprises and from Bank Indonesia credits. At the end of 1980, deposits mobilized represented 65.8 percent of total resources, while Bank Indonesia credits represented 29.0 percent of the total. (See Table 7). While savings deposits constitute the largest number of accounts (3.696.200, which account for 96.6 percent of the total), their volume amounts to only 9.0 percent of the deposits mobilized. A significant portion of demand and of time deposits comes from the public sector or from insurance companies required by law to do so. Borrowings from international lending institutions have contributed only 2.4 percent of the total resources available.

At the end of 1980 total loans outstanding in BRI's portfolio amounted to 986.3 millions of Rupiahs, while the number of accounts was 6.415,715.[1/] This number does not

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1/According to the household survey data (SUSENAS) from May, 1978, there were 23.3 million rural households in Indonesia.

Table 7. Bank Rakyat Indonesia. Sources of funds. December, 1980. (Billions of Rupiahs)

	Amounts	Percentage Structure
Deposits:	855.8	65.8
Demand deposits	717.5	53.3
Savings deposits	79.6	5.9
Time deposits	88.7	6.6
Funds from Government budget	37.6	2.8
Bank Indonesia credits	391.2	29.0
Borrowings from international agencies	32.6	2.4
Total	1.347.2	100.0

Source: Bank Rakyat Indonesia. Agricultural loans in Indonesia. 1981

represent the number of borrowers reached, however, since multiple loans are a regular practice. Most of the loans (5.953.000) were (Government) program loans. (See Table 8).

Program credit is directed towards cooperatives, agricultural activities and fisheries. It is financed totally or partly by the Central Government, Bank Indonesia or an international agency. Non-program credit is directed towards other sectors of the economy and is financed entirely with BRI funds. Non-program credit represented 29.4 percent of the amounts outstanding.

Table 8. Bank Rakyat Indonesia. Loans outstanding. December, 1980. (Amounts in billions of Rupiahs and numbers in thousands)

		Amounts	%	Number	%
I.	Mass program credit	349.0	35.4	5.253	82.0
	Rice BIMAS/INMAS loans	133.0	13.5	4.912	76.7
	KIK/KMMP Mass/Special	74.9	7.6	320	5.0
	Fertilizer/Food procurement	105.4	10.7	3	0.1
	Project aid	35.7	3.6	18	0.2
II.	Individual program credit	346.6	35.2	700	11.0
	Mini/Midi loans	35.1	3.6	560	8.8
	KIK/KMKP general	260.1	26.4	132	2.1
	Investment credit	51.4	5.2	8	0.1
III.	Non-program credit	290.7	29.4	463	7.0
	TOTAL	986.3	100.0	6.416	100.0

Source: Bank Rakyat Indonesia. Agricultural loans in Indonesia. 1981.

Mass program credit is directed towards small household-firms in great numbers, when these borrowers can be treated as homogeneous units. Specific fixed technological packages are used to disburse the funds. The largest proportion of the number of loans (82.0 percent) were granted in this form, but they represented only 35.4 of the amounts disbursed by BRI in 1980. Non-mass or individual credit, on the other hand, is undertaken by BRI without participation of other Government agencies, in order to finance non-homogeneous small businesses, while the amount of the loan is tailored to the specific needs of each borrower.

As a consequence of all these variations in credit programs, according to source or end use of the funds, there are at present 262 different types of credit granted by BRI! All of these types of credit differ in terms of their relative profitability for BRI, the risks associated with them, as well as the simplicity or lack of simplicity of the procedures to be applied. In all cases they represent different ways to distribute transactions costs between the borrowers and the bank and reflect different rationing criteria.

4.10 In 1963 the Bogor Institute of Agriculture conducted successful field experiments in the intensification of rice cultivation is Jawa Barat, which led to the formulation of BIMAS, a comprehensive program to increase yields and incomes of small rice producers.[1/] The program was launched

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[1/] For a detailed history of BIMAS see "The BIMAS Program in Indonesia. Selected Papers". Small Farmer Credit in East Asia. AID Spring Review of Small Farmer Credit. Vol. XI.. 1973.

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in 1965. Credits and inputs totalling 7.8 billion Rupiahs were supplied between 1965 and 1969, to groups of farmers through cooperatives or through the _lurah_ (village chief). Only about half of these loans were recovered.

The BIMAS _Gotong Royong_ (self-help) program, started in 1969, supplied a fixed package of credit and inputs, through the _lurah_, to all farmers in a particular area, irrespective of whether they wanted it or could use it efficiently. This program survived only two years. No records were kept at the village level and recovery was again extremely low.

INMAS was also started in 1969, in order to provide technical assistance and subsidized inputs, but not credit. The rationale was that the credit requirements under BIMAS would diminish as farmers generated their own savings from their increased incomes. Since 1977, however, INMAS has included loans for incremental fertilizer purchases, using the same procedures and on the same terms as BIMAS.

In 1970 BIMAS and INMAS assumed their present form. At the lowest level, the BIMAS organization is a village unit: it can be a village unit cooperative (_Koperasi Unit Desa_: KUD) or a village unit operations body (BUUD). These, in turn, are organized into regional village leagues (WILUD).

Village units represent agro-economic units in areas consisting of one or more villages with a wet rice field acreage between 600 and 1,000 hectares, in Java, and of about 2,000 hectares outside Java.

There are two types of BIMAS program: BIMAS paddy (rice) and second crop BIMAS (corn, cassava, mungbean, peanut, soybean, sorghum and sweet potatoes). Beneficiaries are individual farmers, who carry BIMAS indentification books. Credit processing is usually done at the BRI Unit Desa, by using a relatively simple one page from. Elegible borrowers are landowners and tenant farmers who can get a recommendation from the <u>lurah</u>. Collateral involves land or livestock.

For the implementation of the BIMAS programs, Bank Indonesia provides credit to <u>Bank Rakyat Indonesia</u> for as much as 100 percent of the amount of credit extended by the latter to the farmers. The discount rate charged by Bank Indonesia is three percent per annum, while the interest rate that BRI can charge the farmers is 12 percent. No commission fees are charged. The term of the loans is seven months from disbursement or one month after harvest time. The loans can be repaid either in cash or from proceeds realized by the sale of crops to cooperatives. No penalty is levied for overdue loans, but once two seasons' loans are

Table 9. Bank Rakyat Indonesia. BIMAS paddy - Credit disbursement and repayment performance, as of October, 1981.

Season	Area (mln ha)	N° of recipients (mln)	Loans disbursed (Rp bln)	Credit outstanding (Rp bln)	Default rate (%)	Average area per loan (ha)
1970-71	1.0	1.3	8.5	0.3	3.5	0.76
1971	0.3	0.4	2.5	0.1	5.7	0.83
1971-72	0.9	1.2	7.3	0.2	3.0	0.75
1972	0.3	0.4	2.6	0.2	6.2	0.86
1972-73	1.4	1.7	12.8	0.7	5.2	0.80
1973	0.5	0.5	4.9	0.3	6.7	0.89
1973-74	2.1	2.6	31.6	2.7	8.5	0.83
1974	0.8	1.0	12.5	1.4	10.8	0.82
1974-75	2.2	2.6	40.6	3.7	9.1	0.83
1975	0.9	1.0	17.3	2.6	15.0	0.87
1975-76	2.2	2.5	55.1	7.5	14.0	0.87
1976	0.9	0.9	22.4	5.0	22.2	0.94
1976-77	1.8	2.1	48.9	10.7	22.0	0.86
1977	0.7	0.6	17.5	6.9	39.5	1.06
1977-78	1.6	1.8	44.6	12.7	30.1	0.87
1978	0.6	0.6	17.7	6.3	35.6	1.00
1978-79	1.3	1.5	42.2	13.9	33.0	0.90
1979	0.4	0.4	13.0	4.1	32.0	1.06
1979-80	1.1	1.2	36.3	11.9	33.0	0.94
1980	0.4	0.4	14.2	5.3	37.0	0.98
1980-81	1.0	1.1	35.9	21.3	60.0	0.92
1981	0.6	0.6	19.2	17.0	n.a.	0.93

Source: Bank Rakyat Indonesia.

Table 10. Bank Rakyat Indonesia. BIMAS secondary crops. Credit disbursement and repayment performance, as of October, 1981

Season	Area ('000 ha)	N° of reci-pients ('000)	Loans dis-bursed (Rp bln)	Credit out-standing (Rp bln)	Default rate (%)	Average area per loan (ha)
1972-73	6.3	6.4	0.05	0.006	11.0	0.98
1973	12.9	19.4	0.1	0.006	5.8	0.66
1973-74	103.9	124.4	1.2	0.009	7.4	0.81
1974	155.4	191.6	2.2	0.23	19.6	0.81
1974-75	167.6	168.9	3.2	0.8	26.1	0.99
1975	220.4	254.4	4.7	1.1	22.5	0.87
1975-76	181.4	188.0	4.4	1.2	25.0	0.96
1976	168.6	175.5	4.5	1.6	26.0	0.96
1976-77	169.0	173.2	4.4	1.3	36.1	0.98
1977	105.3	91.7	3.3	1.2	38.1	1.15
1977-78	131.6	144.0	3.6	1.4	33.0	0.91
1978	94.6	90.6	3.2	1.4	43.0	1.05
1978-79	103.1	103.5	3.2	0.8	42.1	1.00
1979	57.8	52.6	2.0	1.5	42.5	1.10
1979-80	105.8	107.1	3.2	1.5	47.0	0.99
1980	60.0	48.0	2.4	3.2	65.0	1.25
1980-81	109.3	98.4	3.8	2.5	82.2	1.11
1981	59.4	49.1	2.6	n.a.	n.a.	1.21

Source: Bank Rakyat Indonesia

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overdue the farmer ceases to be elegible for BIMAS credit. If due to weather conditions or pests the crops are substantially damaged (between 85 and 100 percent), the farmers are not required to repay and the obligation is assumed by the Government. The risks from delinquent payments are assumed by the Government (50 percent), Bank Indonesia (25 percent), and Bank Rakyat Indonesia (25 percent). Moratorium on arrears is frequently decreed.

At the end of 1980 BIMAS loans outstanding amounted to 133 billion Rupiahs. The annual flow of paddy loans has been declining, from 55.1 billion, in 1975-76, to 35.9 billion, in 1980-81. In real terms the reduction has been even more pronounced. The number of recepients every year has also declined, from 2.6 million, in 1974-75, to 1.1 million, in 1980-81. (See Table 9). The average BIMAS loan of 30,000 Rupiahs (about US$ 50) has gone to farmers holding more than half a hectare, thereby excluding the vast majority of farmers. Moreover, the average landholding size of BIMAS borrowers has been gradually increasing.

Several circumstances may explain the decline in participation in the BIMAS program. It has been suggested that participation in BIMAS was primarily motivated by the desire to obtain the physical inputs (fertilizer and seeds),

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rather than by the credit component. Thus, while BIMAS credit has declined, input use and rice production have increased. Whereas in the past BIMAS fertilizer was much cheaper, it is now more expensive than the fertilizer available from private kiosks. Farmers, therefore, have avoided what continues to be a costly procedure to obtain a BIMAS package, as well as the lack of flexibility inherent in the BIMAS input package, which seems to be not very popular with the farmers in its entirety.[1/]

A very important element in the decline in BIMAS participation has been the increasing ineligibility of farmers who have defaulted on previous loans. Actually, delinquency has been increasing during the most recent years. The most significant explanation of this increased default has been the readiness of the Government to reschedule repayments or write off debts. Moratory measures of several types have been announced almost every year since 1970. Recently the Government announced that BRI should not recover loans outstanding from the 1970 through 1975 planting seasons. Moreover, defaulting farmers have been allowed to apply for new loans. This attitude has succeeded in conveying the impression to

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[1/] Sarath Rajapatirana et al. Indonesia Rural Credit Study Mission. Unpublished.

borrowers that sooner or later unpaid loans will be pardoned. This has had a negative demostration effect on other borrowers who were previously willing to repay, but that now feel that they must get their share of the transfer implicit in defaulted loans.

4.11 In 1969 Bank Indonesia established the Kredit Investasi Biasa (KIB) program, to be operated by all the commercial and development banks, in order to provide investment credit of up to 10 years maturity (15 years in the case of BAPINDO), at interest rates which vary between 10.5 percent and 13.5 percent per annum, according to loan size. Bank Indonesia rediscounts these loans at four percent per annum, in proportions varying from 65 to 80 percent. Originally, the KIB program was intended to cover the needs of small-scale enterprises as well as medium- and large-scale enterprises. However, the state commercial banks were reluctant to accept the greater risks and higher administrative costs associated with lending to small-scale enterprises. Moreover, these enterprises were often unable to meet the standard collateral requirements and could not supply all the operational and financial data required by the banks. Neither did they offer the banks much prospect of additional income from ancilliary banking services. So, in December of 1973, two new programs of financial assistance specifically designed for small-scale enterprises, were established: the *Kredit Investasi Kecil* (KIK), for the financing of fixed investment, and the *Kredit Modal Kerja Permanen* (KMKP), for permanent working capital.

The main objective of these programs has been to provide long-term financing to indigenous small-scale enterprises, with limited means, which engage in relatively labor-intensive activities. For these purposes, fairly lenient qualifying conditions are prescribed. All productive activities in industry, agriculture, trade, and services have been declared elegible. No *minimum* equity contribution is required from the borrowers; such a contribution is set on an individual basis, according to the borrower's capacity.

Later on, given the success of the KIK and KMKP programs, the mass KIK/KMKP for the rural sector was launched. This has led to two types of arrangements: general (*umum*) lending, under which all loans are made on an individual case-by-case basis, and mass (*massal*) or special (*khusus*) lending, for which separate credit programs are developed by type of activity or subsector, before credits are made available on either an individual or group basis. Under the massal approach, the establishment of specific lending programs is the result of collaborative efforts between the handling banks and the *dinas dinas*.

Since these programs have been directed towards small-scale enterprises, a maximum size of loan has been set at 10 million Rupiahs (equivalent to US$ 16,000). For repeat loans the ceiling on loan size may be increased to 20 million Rupiahs, provided debt service of the previous loan was satisfactory. KIK loans currently carry an interest rate of 10.5 percent per annum, while KMKP loans carry an interest rate of 12 percent per annum. Maximum maturity is 10 years, including up to four years of grace, in the case of KIK loans, while maximum maturity is three years in the case of the KMKP loans. KMKP loans are granted on an overdraft basis, i. e., as standby credit lines. (See table 11).[1/]

Bank Indonesia rediscounts 80 percent of all KIK loans, at three percent per annum, as well as 75 percent of all KMKP loans, at four percent per annum. In order to guarantee the repayment of these loans to the banks, the Government established PT. ASKRINDO (The Indonesia Credit Guarantee Corporation). ASKRINDO provides insurance against 75 percent of the loan amount approved, for a one-time premium of three percent of the loan size. One half of the premium is paid by the handling bank; the other half by Bank Indonesia.

[1/] Bank Indonesia. Ketentuan-Ketentuan Pokok. August, 1981.

Table 11. Current Terms of KIK/KMKP Lending.

	KIK	KMKP
Direct Loans		
For Borrower		
Maximum loan amount	Rp 10 million	Rp 10 million
Maximum amount including supplementary loan	Rp 15 million	Rp 15 million
Interest rate	10.5% p.a.	12.0% p.a.
Maximum duration	10 years	3 years
Maximum grace period	4 years	a/
Collateral requirements	Assets financed by loan, and if required, additional collateral up to 50% of loan amount	
Borrower's financial contribution	--- none b/	---
For Handling Bank		
Rediscount rate	3% p.a.	4% p.a.
Rediscount share	80%	75%
Credit insurance fee (frontend charge)		
Up to 5-year duration	3% c/	3% c/
Over 5-year duration	5%	...
Risk exposure	25%	25%
Co-Financing Arrangements		
Co-Financing Share		
Bank Pembangunan Daerah	10%	10%
BAPINDO	10%	15%
Bank Indonesia	80%	75%
Interest Income Share		
Bank Pembangunan Daerah	50%	33-1/3%
BAPINDO	27%	33-1/3%
Bank Indonesia	23%	33-1/3%
Risk Exposure		
Bank Pembangunan Daerah	10% x 30% = 3% of the loan amount	
BAPINDO	90% x 30% =27% of the loan amount	

a/ Loan is normally extended as an overdraft facility.

b/ Supplementary KIK credit above Rp 10 million requires 10% self-financing.

c/ To be absorbed by Bank Indonesia and Handling banks in equal shares

Source: Bank Indonesia

Under the KIK program, between 1974 and 1980, agriculture received 45.8 percent of the number of loans approved and 31.7 percent of the amounts disbursed, while manufacturing industry received 9.5 percent of the number of loans and 10.9 percent of the amounts granted. The rest has been supplied to trade, services, and transportation activities. During the same seven year period, under the KMKP program agriculture has represented 84.4 percent of the number of loans and 40.0 percent of the amounts disbursed, while manufacturing industry benefited from 3.0 percent of the number of loans and 10.6 percent of the amounts granted.

As of September, 1981, loans outstanding in the KIK program portfolio amounted to 322 billion Rupiahs, for a total number of 153,014 loans. As of the same date, loans outstanding in the KMKP program portfolio amounted to 958 billion Rupiahs, for a total number of 1.186.224 loans. (See Table 12).

The previous data reflect a very rapid growth of lending under these programs during the two most recent years. As a result, the proportion of KIK/KMKP lending with respect to total lending has increased from 2 percent, to its present level of 12 percent. This surge began in mid-1979, when a strong push was provided by the Central Government and Bank Indonesia.

Table 12. Number of loans and amounts outstanding under the KIK and KMKP programs. 1976-1981. (Billions of Rupiahs).

	1976	1977	1978	1979	1980	1981*
KIK:						
Number	27.827	39.737	54.970	72.097	114.504	153.014
amounts	36	50	65	99	210	322
KMKP						
Number	166.149	322.391	420.495	544.003	889.761	1.186.224
amounts	41	62	84	154	321	543

Source: Bank Indonesia. Statistik Ekonomi-Keuangan Indonesia. September, 1981

In addition, procedures were changed, in order to improve the efficiency of lending, credit limits were raised, maturity periods extended, and KMKP renewals were not made conditional upon loan repayment. Most importantly, KIK/KMKP lending has not been constrained by the aggregate credit ceilings imposed by Bank Indonesia; rather, Bank Indonesia has set targets which have been interpreted as floors by the handling banks.[1/]

[1/] Sarath Rajapatirana et al. Op. cit.

4.12 Besides the KIK and KMKP lending programs, Bank Indonesia's special programs include the rural <u>MINI</u> credit, established in 1974, and the <u>MIDI</u> credit, introduced in July, 1980. Loans are granted both for investment purposes and for working capital. The funds borrowed are used by farmers for the purchase of equipment and of livestock; by traders for the purchase of transportation equipment; by fishermen, for the purchase of production and processing equipment; and by home industries for production equipment and inventory carrying. These loans are handled by BRI's Unit Desa, whose operating costs are subsidized by the Central Government.

Eligible applicants need the recommendation from the <u>lurah</u>. Loan size goes from 10,000 to 200,000 Rupiahs, in the case of mini loans, and from 200,000 to 500,000 Rupiahs, in the case of midi loans. The term of the loans is one year for working capital and three years for investment credit. Acceptable collateral includes both land and livestock. The interest rates charged are 12 percent per annum for working capital loans, 12 percent per annum for investment loans under the mini program, and 10.5 percent per annum for investment loans under the midi program. No commission fees are allowed.

Mini/midi loans represented, at the end of 1980, 8.8 percent of the number of loans granted by BRI, but absorbed only 3.6 percent of its outstanding portfolio. Most of the funds have been used for working capital loans, which may suggest the nature of the credit needs of the rural poor. The repayment performance is considered good, but no data are available.

BRI also grants mass loans for commodities other than rice and secondary crops (palowija). Among these programs are intensification efforts in sugar cane, pepper, clove, and coffee plantations. There is also the cattle fattening program and the poultry intensification program. Mass investment credit also includes the cattle breeding intensification program and the dairy cattle intensification program. For these programs farmers are organized in groups, in order to increase the effectiveness of technical assistance. Loans for working capital have terms of three years and loans for investment have terms of five years. Interest rates are 12 percent per annum on working capital loans and 10.5 percent per annum on investment loans. There are also credit programs for replanting, rehabilitation, and expansion of estate crops, as well as agribusiness and agribased industry loans.

4.13 Among the credit programs financed from the Central Government budget is the Kredit Candak Kulak (KCK). Within this program, funds are channelled directly as budgetary transfers from the Department of Cooperatives to the Koperasi Unid Desa (KUD), via Bank Rakyat Indonesia, which merely acts as a conduit, but plays no administrative or supervisory role.

This program was initiated in 1976 in order to serve very small borrowers, such as food retailers and small craftsmen. Loan size varies between a minimum of 3,000 Rupiahs and a maximum of 15,000 Rupiahs per borrower. Elegible borrowers are recommended by the lurah or kepala desa (village chief). No collateral is required. Interest rates are one percent per month, but an additional four percent per month is collected as forced savings.[1] Maximum loan terms are three months, while repayments could be made as often as daily, but more usually are made weekly. These repayment schedules reflect the nature of the off-farm activities financed and allow a very high turnover rate.

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[1] Bank Indonesia. Ketentuan-ketentuan Pokok, August, 1981.

Delinquency rates for the Kredit Kandak Kulak in Madura appeared to be in the range of 17 to 35 percent towards the end of 1980.[1] The current policy in the KCK program with respect to delinquency has the following elements:

a. Borrowers with unpaid loans are not allowed to borrow again until the loan is repaid.

b. Forced savings cannot be withdrawn until the loan is repaid.

c. The lurah and the camat are informed about the delinquency problem and requested to help in its solution.

d. KCK officials contact individual borrowers with bad debt, when possible.

e. The lurah screens loans applications before they are released, in order to provide character references.

Despite these *ex post*, mostly punitive measures, default is still high. Any program of this type must plan to obtain sufficient revenues to be able to cover a significant percentage of default losses.

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[1] James Kern. "Measuring and controlling lending cost in Indonesia cooperative credit program: an analysis of loan delinquencies and the utility of groups for lessening delinquencies". Resources Management International. 1981.

4.14 In Madura (Jawa Timur), the team observed the Kredit Usaha Rakyat Kecil (KURK) program, which has been supported by the Provincial Area Development Program (PDP). The funds come from the Central Government through the PDP budget. These funds are transferred to the provincial government (with BRI acting as cashier) and administered by the BAPPEDA. The BAPPEDA, in turn, issues the money to the village cooperatives (KUD), usually through the Regional Development Bank (Bank Pembangunan Daerah). Where the Bank Pembangunan Daerah does not possess branches, as in Madura, BRI acts as the conduit. In those provinces in which there is no PDP program, the KURK program gets its funding from the provincial government's budget. In addition, the Koperasi Unit Desa may soon get funds for this program from the Pusat Koperasi Unit Desa (PUSKUD), the regional central office for cooperatives. The Kantor Wilajah Koperasi, the Central Government's office on cooperatives at the provincial level, supervises both the Kredit Candak Kulak and the KURK programs.

Interest rates charged on KURK loans in Madura are 1.6 percent per month, plus 1.6 percent per month additional as forced savings, in the case of 24-week loans, and 4 percent per month additional as forced savings, in the case of 12-week loans. These rates may not be sufficient to cover the risks and costs involved in this type of credit, as will be indicated, despite the fact that the expenses of the KUD are partly subsidized from the Central Government. Loans are granted for 12-week and 24-week terms. The first type are usually granted to traders, who have a fast turnover. Installments are paid every week or every other week. The existence of waiting lists in Madura suggests that there is an excess demand for this type of credit. Cooperative officials claimed that loans are granted on a first come, first served basis, but it was clear that other rationing mechanisms were in effect. Actually, some officers indicated that the size of loans is reduced when there is much demand, in order to reach as many people as possible (rationing by size of loan). Also, it was indicated to us that borrowers with a good repayment record get priority treatment in the distribution of new loans.

Borrowers have to be recommended by the lurah. It is expected that, if the village chief signs, he will later help in the collection of the loan. Very few recommendations from the lurah (about two percent) have been rejected by the KUD, which suggests that the lurah is usually selective. When the same borrower has paid in time his first two loans, his application does not go to the lurah any more. The whole procedure, between the application and the loan authorization, takes from two to three days. The potential borrower is then told when the funds (usually from repayments) will become available. This may take at most two weeks.

4.15 Although the Kredit Candak Kulak program reaches the rural poor to a larger extent than the regular institutional credit programs, it is still administered at the kecamatan level and far from the desa where the poor reside. Also, it serves only traders. The PDP has set up the Kredit Usaha Rakyat Kecil Program, in an effort to get closer to the borrowers and to reduce their transaction costs. That is, within the KURK program, the loan officials are supposed to visit the desa in search for the borrowers.

The KURK program has been, therefore, an effort to link the cooperatives with the Government's organization at the desa level. In fact, the Government's representatives, the lurah and the camat, exert a strong influence, particularly since the lurah's recommendation is essential to become elegible for the loans. Some cooperative leaders believe that borrower groups should be organized, in an effort, not only to reduce transaction costs and risks of default, but also to free the KUD from the Government's patronage. They

Table 13. Kredit Usaha Rakyat Kecil (KURK) program in Madura. First 14 months of operations, up to November, 1981

Number of desa reached		82
Resources received from the PDP program		46 million Rupiahs
Amount loaned (cumulative):		
12-week loans:	number	6,385
	amount ('000 Rupiahs)	81,385
	average size of loan (Rupiahs)	12,746
24-week loans:	number	6,369
	amount ('000 Rupiahs)	129.995
	average size of loan (Rupiahs)	20,411
Total :	number	12,754
	amount ('000 Rupiahs)	211,380
	average size of loan (Rupiahs)	16,574
Outstanding balances ('000 Rupiahs)		
12-week loans		17.803
24-week loans		45.082
Total		62,886
Outstanding savings ('000 Rupiahs)		13,570
Earned income ('000 Rupiahs)		10,877
Loans overdue before the final payment due:		
number		1,475
amount ('000 Rupiahs)		6.155
deliquency rate		2,9 percent
Loans overdue after final payment due:		
number		1,132
amount ('000 Rupiahs)		9,251
delinquency rate		4.4 percent
Total delinquency rate		7.3 percent

Source: BAPPEDA Tingkat I Jawa Timur. Unpublished records.

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believe that a "private" cooperative movement has more possibilities for success. Group organization, in any case, seems to have been tried successfully in Malang.

The KURK program received 46 million Rupiahs of seed capital from the PDP program. In a 14-month period it had managed to lend a cummulative amount of 211 million Rupiahs. In addition to the PDP program, several KUD have been receiving funds from other sources. Some have borrowed from BRI, at a rate of interest of one per cent per month, while others have borrowed from Bank Pembangunan Daerah Jawa Timur, at a rate of interest of 0.75 percent per month. Also, several KUD expect to receive funds from the federation of cooperatives (PUSKUD). During the 14-month period examined, the KURK program had granted in Madura 12,754 loans, of an average size of 16,574 Rupiahs. Although about one-half of the loans were 12-week loans and the other half 24-week loans, the latter represented 61.5 percent of the total amounts loaned. There is, in general, a revealed preference, both on the part of the borrowers and of the lenders, for the 24-week loans, since these loans imply lower transaction costs for both. For these reason, as of November, 1981, the 24-week loans represented 71.7 percent of the KURK total outstanding portfolio. This share has been increasing rapidly.

A significant number of loans have become overdue, some before the final payment has become due, some after the final payment has become due. The amounts involved, however, are relatively small and the total amounts overdue represent only 7.3 percent of the outstanding portfolio. This is relatively low for this type of program. There is some dispersion, however, from KUD to KUD, with the delinquency rates ranging between 0.6 percent and 30 percent. For 16 out of 23 kecamatan the delinquency rate was below 10 percent of the outstanding portfolio. In general, it appeared that a number of KUD were progressing well, while other KUD were clearly faultering.

In summary, it seems that in the KURK program some success has been achieved in reaching the borrowers at the desa level. This is important to the extent that it reduces the significant transaction costs that the small borrowers have to face. The main mechanism for this reduction has been to transfer transportation costs from the borrower to the KUD.

4.16 Both the Kredit Candak Kulak and the Kredit Usaha Rakyat Kecil programs in Jawa Timur charge their lending rates on the total amount of the original loan and not on the outstanding balance, as is usually the case in other programs. This means that, while the stated rate of interest is one percent per month in the KCK program, the rate effectively charged is 1.96 percent per month. Similarly, while the stated interest rate charged in the KURK program is 1.6 percent per month, the effective lending rate is 3.27 percent per month. The effective lending rates are even higher in the Badan Kredit Kecamatan program in Jawa Tengah, to be described below, where some quoted rates are 3.33 percent per month, but the effective rates are 6.53 percent per month.[1/]

These lending rates are, obviously, fairly high. However, they are much lower than the rates charged on loans from the informal lenders or the rates implicit in sharing (*ijon*) arrangements. Most importantly, many borrowers have shown a preference to use these sources over other formal sources, which suggests that when non-borrowing transation costs are added to the interest payments, these sources of credit are still competitive.

[1/] James Kern. "Cutting costs to the borrower in Indonesian rural credit programs". Resources Management International. Jakarta, October, 1980.

Inflation reduces the level of the lending rates charged, when measured in real terms, but it also imposses an additional cost on the borrower when the credit program, as in these cases, has a forced savings component. No interest is paid on the forced savings associated with the KCK and KURK programs.

Most of the KCK loans have been granted to small traders who engage in the business of buying and selling food items (eggs, vegetables, chickens, etc.), household supplies (mats, baskets, pots, etc.), and farm supplies (simple tools). The average size of the loans is extremely small (about US$ 6 to US$ 40), with the most frequent loan size been approximately 10,000 Rupiahs (US$ 16). These class of loans imply very high transaction costs both for the borrower and for the lender.

Dr. James Kern has described the transaction costs implied by KCK loans. These costs include transportation costs for the borrower. Since KCK operations are usually conducted on the same day as the market day, the borrower comes to the <u>kecamatan</u> in order to conduct various types of business, and does not feel the effect of these transportation costs as much as if he had to go to the <u>kecamatan</u> only in connection with his credit operations. Kern allocated 20 percent of the transportation costs to the credit operation. Transportation costs varied between 100 and 400 Rupiahs per trip. Over the 12-week period of the loan, transportation costs represented between 1,200 and 4,800 Rupiahs. Kern selected 2,400 Rupiahs as the most frequent value, of which 20 percent (480 Rupiahs) represented the portion to be attributed to the loan. This represents an implicit rate of 0.6 to 3.2 percent per month, depending on loan size. With the most frequent size of loan being 10,000 Rupiahs, this represents 1.6 percent per month of transportation costs for the borrower, in addition to the lending rate paid.

Another component of borrower non-interest costs are the opportunity costs of the time spent in transacting the loan. The time at the KCK office varies from one-and-a-half to two hours per visit, although it is possible that some of this time is spent in socializing. The time spent in travelling is between one and two-and-a-half hours, each way. Kern considers one hour transacting business plus three hours of travel. Since only 20 percent of the travel costs are attributed to the loan, the total opportunity costs equal 21.6 hours in a 12-week period. This is equivalent to three seven-hour days. If the typical daily earning is 400 Rupiahs, the opportunity costs would be 1,200 Rupiahs, which would represent between 1.6 and 8.0 percent of the principal, depending on loan size. With the most frequent size being 10,000 Rupiahs, these opportunity costs represent four percent per month of additional borrower costs. If only these two non-interest costs are added, it appears that the typical KCK borrower is incurring in 5.6 percent per month of transaction costs, in addition to the interest rates paid.[1/]

Kern's interviews, as well as our own observations, indicate that borrowers are very much aware of these transaction costs and compare them amont sources of credit, in order to select the cheapest.[2/] Interest rates charged become, in this context, only a minor component of loan costs. Also, borrowers have frequently requested to be allowed to pay at least on a monthly basis, to help reduce these transaction costs. Borrowers also show a strong preference for having loan transactions take place closer

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[1/] James Kern. Op. cit.

[2/] For instance, a money lender charging 10 percent per month at the desa level and implying almost no transaction costs would be a cheaper source of credit than the KCK program for a borrower of less than 5,000 Rupiahs, which cost, according to Kern, 13.24 percent per month.

to their residence. It is this factor, the distance from the bank office to the borrower's residence, which implies one of the most important comparative disadvantages of the institutional sources of credit that, like the BRI; do not get close enough to the desa level.

4.17 This type of operations also imply very high transaction costs for the lender. Interest revenues constitute the most important, if not the only, source of funds to cover these transaction costs. Therefore, while interest rates are relatively unimportant from the point of view of the borrowers, given the relative magnitude of non-interest costs, the level of the lending rates is a crucial determinant of the lender's financial viability. It appears that the lending rates charged have not been sufficient to cover the administration costs and the risks associated with the KURK program.

The interest collected is called "administration charge" (beaya pengelolaan), which seems to be a good approach to overcome religious or cultural prejudice against interest charges. During the 14-month period of operation the system has collected 10,876,985 Rupiahs of interest payments. This represents a monthly income from interest of just above

10,000 Rupiahs per desa. This is about one third of the interest that the PDP consultants consider adequate to run a KUD. A model unit desa spends about 35,000 Rupiahs per month.

Furthermore, some simulations indicated that, if the funding level of the KUD is increased from the present 500,000 Rupiahs, to 1,000,000 Rupiahs, monthly interest income would probably increase to somewhere between 16,000 and 25,000 Rupiahs, while administration costs would increase to about 44,000 Rupiahs; and that, if the funding level is increased to 1,500,000 Rupiahs, interest income generated would be somewhere between 25,000 and 37,500 Rupiahs, while expenses would increase to 52,500 Rupiahs. That is, the system cannot generate sufficient economies of scale at the level of operation of the individual units which is appropriate at the desa level. Therefore, just increasing the volume of operations will not be sufficient to guarantee the financial viability of the program. For this, interest charges will have to be increased. The PDP consultants have estimated that, with a funding level of 1,000,000 Rupiahs, an interest rate of 3.3 percent per month will be just sufficient to cover administration costs. With a funding level of 1,500,000 Rupiahs, the required interest rate would be 2.5 percent per month.

One possible way to increase the interest rates charged would be to change the composition of the total charge: the bunga (interest) and the simpanan (forced savings) charges, without altering the total charge. For example, while in the KURK program the amount collected is divided 25 percent as interest and 75 percent as forced savings, in the Badan Kredit Kecamatan program in Jawa Tengah, which has the same total charge, the division is 50 percent for interest and 50 percent for forced savings. Since the interest payments do not cover the costs of administration and the bad debt in the KURK program, the forced savings are not returned to the borrowers and, therefore, cannot be considered really as "savings". Until January, 1982, the KURK borrowers had been allowed to withdraw only 50 percent of their forced savings once, at the time of a big religious holliday, when people incur in exceptional expenditures. This policy of forced retention of savings is not a good practice and certainly is not the way to promote the desirable voluntary savings habit.

There are, of course, severe difficulties in estimating the rate of interest that must be charged. While a reasonably accurate estimate of the administrative costs can now be made on the basis of the 14-month experience, the wide variation of the badt debt rates among the KURK units makes it almost impossible to predict reliably what the total lending rate should be. If the charge is set before the bad debt has been experienced, the lending rate would have to be very high. This would punish those KUD which have established a good repayment record. It has been suggested that, instead, the unit that makes a profit by holding down bad debt, by circulating working capital efficiently, and by avoiding wasteful administrative expenditures, should be able to distribute "savings" to its members. Those units in which bad debt is high, working capital is left idle, or administrative expenses are allowed to rise unnecessarily, on the other hand, will have no profits and no savings to distribute to its members.

This is a good suggestion, to the extent that social pressure will help to hold down loan default, without increasing supervisory expenses. On the other hand, combining interest and forced savings into a single fee, and calling "savings" the residual, after administration costs, bad debt, and inflation have been covered, again is not a good way to promote voluntary savings mobilization. There is a need, therefore, not only to increase interest charges, but alto to reduce lending costs. There seems to be some room for it. Moreover, it is likely that these costs may be reduced, as the "learning" period for the system is completed.

4.18 The PDP consultants have developed a very useful and interesting system for ranking the KURK units, according to their performance. The ranking is the result of a composite index which includes the following elements: bad debt, both for those cases in which the final installment has already become due and when it has not; the extent of savings retention in the unit; the cumulative loan activity and the current loan activity. From 1 to 5 points are assigned for each one of five categories, so that the maximum number of points possible is 25. (See Table 14).

According to the number of points scored, the units are classified into 5 different classes. By definition, all KURK units begin their operations with a class three (or neutral) ranking. Therefore, the important question is which direction they move from this class three. As of September, 1981, 13 percent of the Madura units were in the best class (class one) and another 16 percent were in class two. Class three included 40 percent of the KURK units, while 16 percent were included in each one of the classes four and five. From the previous observation, 9 units had moved upward, while 3 had moved down. The PDP consultants expected that, if those trends continued, 20 percent of the KURK desa units would be bankrupt within six months. One would expect such a high mortality rate when dealing with a cooperative credit program in a relatively poor area like Madura.

Table 14. Ranking System for the Kredit Usaha Rakyat Kecil. Madura.

1. BAD DEBT I: $$\frac{\text{Tunggakan Merah + Tunggakan Hitam}}{\text{Jumlah Pinjaman}}$$

(Measure of total unvailable money)

0 - 1,99 percent = 5 points
2 - 3,99 percent = 4 points
4 - 5,99 percent = 3 points
6 - 7,99 percent = 2 points
> 7,99 percent = 1 point

2. BAD DEBT II: $$\frac{\text{Tunggakan Merah}}{\text{Jumlah Pinjaman}}$$

(Measure of "Stuck" money)

0 - 1,99 percent = 5 points
2 - 3,99 percent = 4 points
4 - 5,99 percent = 3 points
6 - 7,99 percent = 2 points
> 7,99 percent = 1 point

3. SAVINGS RETENTION: $$\frac{\text{Sisa Simpanan}}{\text{Jumlah Simpanan}}$$

.75 - 100 percent = 5 points
.50 - .74 percent = 4 points
.25 - .49 percent = 3 points
.10 - .24 percent = 2 points
> .10 percent = 1 point

Cont'd ...

4. CUMULATIVE LOAN ACTIVITY: $\dfrac{\text{Jumalah Pinjamam (Kumulative)}}{\text{Sisa Pinjaman + Sisa Kas}}$

3,5	=	5 points
3,0 - 3,5	=	4 points
2,5 - 2,99	=	3 points
2,0 - 2,49	=	2 points
< 2,0	=	1 point

5. CURRENT LOAN ACTIVITY: $\dfrac{\text{(Pinjaman Bln. ini + Angsuran Bln. ini)}}{\text{Sisa Pinjaman + Sisa Kas}}$: 2

,30	=	5 points
,25 - ,299	=	4 points
,20 - ,249	=	3 points
,15 - ,199	=	2 points
<, 15	=	1 point

Note: Adding Angsuran and dividing by 2 is in order to "smooth-out bumps" when there is very little loan activity.

RANKING SCALE

(Sum points of all 5 categories)

Class 1	= 25, 24, 23	Total points
Class 2	= 22, 21, 20, 19, 18	Total points
Class 3	= 17, 16, 15, 14, 13	Total points
Class 4	= 12, 11, 10	Total points
Class 5	= < 10	Total points

Source: Sr. James Kern. Personal communication.

4.19 The team also observed the Badan Kredit Desa (BKD) in kabupaten Sidoarjo, Jawa Timur. These are local banks established under the Dutch regime in 1927. Successful in their earlier days, because they operate at the village level, they had stagnated afterwards. In 1972 all the active BKD were licensed by the Ministry of Finance and a few more have been added in more recent years. There is now a pusn to reactivate the rest. There are 1,554 active and 467 non-active desa banks in all of Jawa Timur. In kabupaten Sidoarjo the team found 94 active and 158 non-active BKD.

These local banks are not allowed by Bank Indonesia to have branches, while their operations are restricted to lending. They are not allowed to offer other financial services. Also, the term of their time and savings deposits is restricted to a maximum of three months. Bank Indonesia is now considering the possibility of regulating the deposit rates that they pay and the lending rates that they charge. This would be most unfortunate. They are supervised by Bank Rakyat Indonesia, which also is allowed to lend to them, acting as a "lender of last resort". Much of their legal framework remains from the 1927 Dutch regulations, which in some cases limits unnecessarily the scope of their operations.

The BKD system in Jawa Timur has over 4,800 million Rupiahs in outstanding loans. The BKD in Sidoarjo had 175.3 million Rupiahs of outstanding loans, at the end of December, 1981. (See Table 15). Most of the Sidoarjo portfolio consisted of 12-week loans (73.8 percent), with some 20-week loans (23.1 percent) and a few seasonal agricultural loans, usually for six months (3.1 percent).

Loans had been granted to 10,875 borrowers, with an average size of 15,172 Rupiahs. These loans represented an increase of 33.3 percent over the amounts granted the previous year. Limits on loan size are established by BRI. Previously to December, 1981, these limits were 30,000 Rupiahs in the case of 12-week loans, and 40,000 Rupiahs in the case of 20-weeks loans and of seasonal loans. These limits were increased in December, 1981, to 75,000 Rupiahs, for the 12-week loans, which constitute the bulk of the portfolio, and to 100,000 Rupiahs for the other two classes of loans. Over 60 percent of loan sizes have been between 25,000 and 30,000 Rupiahs. At the same time, the limit on the amount that any individual BKD can borrow from BRI was increased from 500,000 Rupiahs to 1,000,000 Rupiahs.

Prior to December, 1981, BRI charged one-and-three quarters percent per month of interest on BKD borrowings,

Table 15. Badan Kredit Desa in kabupaten Sidoarjo, Jawa Timur.

		December 1980	December 1981
Assets and liabilities		216,019,879	277,166,243
Deposit with BRI		67,901,569	81,741,547
Loan portfolio		131,483,415	175,274,445
Capital		141,458,242	180,217,108
Forced savings		29,781,854	42,730,652
Loans from BRI		5,919,723	5,721,801
Profits		38,860,059	48,496,683
Income and expenses:			
Interest income		6,382,730	7,960,597
Expenses		5,729,463	5,125,024
Annual profits		653,267	2,835,573
Loans:			
12-weeks	(amount)		129,338,850
	(number)		8,525
20-weeks	(amount		40,428,845
	(number)		1,803
Seasonal	(amount		5,506,750
	(number)		547
Average size			15,172
Delinquency:	Total	(2.3 percent)	4,026,805
	Before last payment due	(0.2 percent)	387,400
	After last payment due	(2.1 percent)	4,026,805
Total BKD			252
Active BKD			94
Average portfolio			1,864,622

Source: Bank Rakyat Indonesia. Kantor Cabang Sidoarjo. Unpublished records.

but this rate was reduced to one-and-one quarter percent per month. The Badan Kredit Desa, in turn, charges three percent per month to its borrowers, except for the seasonal loans, that earn two percent per month. At the same time, 10 percent of the principal is added as forced savings, in the 12-week loans. The seasonal loans have no forced savings component. These interest rates have allowed to BKD to remain financially viable and to accumulate profits that permit increased lending. (See Table 15).

Bad debt represents only 2.3 percent of the outstanding portfolio. This is an extremely low level of delinquency for this type of institution. It results from the operation of the bank at the desa level, as part of the village structure of government. The bank is administered by the lurah and by a konisi with other desa members, usually two more (pamumdesa). The committee (komisi) members earn a commission fee of 2.5 percent on the principal, only when the loan is repaid. Formally, the komisi has the responsibility to collect and must cover the bad debt from their own funds. This happens frequently, but it is not always honored. In any case, when a loan is not repaid, "before the evening, the komisi arrives at the house of the borrower, and the loans is repaid in a few hours".[1] When the komisi find that the failure to

[1] Interviews at desa Siring and desa Candi, Jawa Timur. January, 1982.

repay is justified, they advance the money to the bank and expect eventual repayment from the borrower. The *komisi* contacts the borrowers, who reside in the same *desa*, every time an installment is missed. Frequently the borrower promisses to pay a double installment the next time. Moreover, since there is an excess demand for this credit, good repayment records are an important ingredient in the rationing process that takes place. That is, since this credit is much valued by the rural poor, and since the *komisi* is very selective in granting the loans, borrowers attempt to keep good records with the *Badan Kredit Desa*. Usually the same loan is renewed immediately to the same borrower, just after maturity. Many borrowers pay the last two installments at once, in order to get their new loan immediately.

As indicated, the *Badan Kredit Desa* system is supervised by the *Bank Rakyat Indonesia*. That is, BRI has been entrusted with supervising its competitor! This is not a healthy relationship. The BKD system has a tremendous potential, given the availability of rural savings which can be financialized. However, the BRI supervision, rather than promoting the system, has limited it in several ways. Most conspicuous is the regulation that the BKD must hold their savings and other non-utilized funds with the BRI. As a consequence, the BKD system has deposited 1,500 million Rupiahs with the BRI, while at the same time they have only borrowed 162 million Rupiahs from BRI. That is, the BKD has become a mechanism to channel resources from the rural poor to BRI and its much more priviledged _kredit umum_ clients. In the case of _kabupaten_ Sidoarjo, the deposits with BRI amounted to 81.7 million Rupiahs, while loans from BRI amounted to 5.7 million Rupiahs. That is, the amounts deposited with BRI represented almost 30 percent of their assets, which constitutes an exceedingly high level of idle resources. This situation was explained by indicating that the BKD must hold their forced savings idle, in order to disburse them when required, usually at the time of the religious holliday Hari Raya. However, the BKD are not rewarding savers for their effort, while the BKD are earning half as much as BRI is charging them for the loans. This situation, therefore, indicates a lack of interest on the BRI part in promoting the turnover of these funds at the BKD themselves, and a preference on the BRI part to capture these cheap and easy resources from their competitors.

Table 16. Lumbung Pitih Nagari system. Sumatera Barat. ('000 Rupiahs). 1979-1980

	1979	1980
Number of LPN	392	472
Loans from the provincial government	191,000	236,000
Repayments to the provincial government	47,557	56,895
Loans outstanding	371,859	566,036
Profits and reserves	106,955	155,009

Source: Bank Pembangunan Daerah. Sumatera Barat. Annual Report. 1980.

4.20 In Sumatera Barat (East Sumatra) the team observed the Lumbung Pitih Nagari (village money associations) and the Lumbung Padi Sibayau-bayau (village rice associations). Local organization in Sumatera Barat differs somewhat from that described in section 4.02, following the muslim ADAT (common law). Traditional culture is very strong in this area. The nagari, the level at which the Lumbung Pitih Nagari (LPN) operate, is below the kecamatan level and above the desa level. The jorong, of which there are 3,518 in Sumatera Barat, is a level somewhat below the desa, but was equated to the desa level by the provincial government, in an effort to benefit from the INPRES DESA program more fully.

The _Lumbung Pitih Nagari_ were very successful in Sumatera Barat before World War II, but after the war were not running well. Between 1934 and 1973 they were government owned and entrusted with promoting development at the local level. In the early 1970s, the provincial government requested the _Akademi Pemerintahan Dalam Negeri_ (a Government training academy), to survey their operations. The result was the establishment of 10 successful pilot projects. The provincial government decided, on the basis of this successful experience, to build them up and revived about 40 per year, to reach 561 by the end of 1981. They have been set up, not as government institutions, but as village institutions, that belong to the village people. In this sense, they are like borrowers' associations. Each one has received 500,000 Rupiahs from the provincial government, to be repaid eventually (the provincial government expects to get this back in two-to-four years). No interest is charged on these loans. The LPN have rapidly accumulated their own profits and reserves, increasing their lending capacity. (See Table 16). In January, 1978, Bank Pembangunan Daerah Sumatera Barat was appointed by the provincial _gubernur_ as supervisor and technical inspector of the LPN.

Loans are used both for agricultural purposes and in

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small trade, food processing and retailing, and handicraft enterprises. The LPN charges borrowers 10 percent interest for a six-month (24-week) period (equivalent to 1.66 percent per month), as well as another 10 percent per semester, as forced savings. Loans are repaid in 12 installments, every other week. The first two installments are allocated to interest and forced savings. No collateral is required. Rather, the nagara chief signs that this particular borrower is reliable. The average size of loan varies between 10,000 and 50,000 Rupiahs, although some 200,000 Rupiah loans were observed.

It was indicated to us that most LPN have an almost perfect repayment record. This was explained in terms of the strength of the local culture. The LPN are seen as the result of the traditional egalitarian culture of Sumatera Barat. During a visit to the LPN in nagara Kapau, it was indicated that the borrower's whole family is responsible for the loan. The signature of both husband and wife is required, as well that of as the clan's chief. Loans are granted by a komisi of four, which possesses enough inside information about the villagers to make good selection decisions. It was also indicated that the BIMAS program had experienced a poor repayment record in the area, which was attributed mostly to bad management. When pressure to repay the BIMAS loans had been exerted, exporadically, the LPN had granted loans for this purpose.

The team visited the LPN in Bayur, the first one to be revived, in 1973. It is an outstanding operation. The number of members had increased from 175, in 1973, to 582 in 1981. Loans outstanding increased from 3,130 thousand Rupiahs, in 1973, to 28,008 thousand, in 1980, and then declined to 25,527 thousand, in 1981. Interest earnings had increased, in the same period, from 449 thousand to 2,476 thousand Rupiahs. About 74 loans were overdue, for less than 10 days. Savings outstanding had increased from 289 thousand to 2,211 thousand. Net accumulated profits amounted to 12,009 thousand Rupiahs.[1/]

The most important question for the future of the Lumbug Pith Nagari is the nature of their relationship with Bank Pembangunan Daerah Sumatera Barat. So far, the LPN have operated as autonomous, independent units, designing their own procedures and lending according to their own criteria. They have been culturally adapted to the communities where they operate and have managed to

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[1/] Akademi Pemerintahan Dalam Negeri. Bahan Ekspose. Lumbung Pitih Nagari. January, 1982.

keep administration costs to a minimum. They have usually operated from the _lurah_'s office and have mobilized local resources for the _komisi_ and staff. The relationship with the Bank Pembangunan Daerah presents two types of danger: a) the uniformization of procedures and regulations may increase unnecessarily transaction costs; and b) the capitalization program from BPD may induce them to invest their funds in building, capital-intensive equipment, etc. The provincial government has requested the Central Government a 3,000 million Rupiahs loan, at no interest, in order to proceed to the further capitalization of the LPN. It is planned to invest approximately four million Rupiahs in each one, depending on their volume of operations. The availability of too much "outside" cheap money, however, may reduce their efforts in mobilizing local savings, and may lead to the temptation of reducing interest rates below the levels necessary for long-term financial viability. The nature of this relationship, therefore, must be examined carefully, and the promotion of the LPN designed in such a way that they do not lose their present comparative advantages.

4.21 The existing credit programs of the Central Government and of Bank Indonesia do not touch the financial needs of the smallest village economic activities, either for working capital or for equipment. Some autonomous credit programs sponsored by provincial governments and some semi-formal indigenous financial institutions have been more successful in reaching the rural poor. Amongh these, one of the most outstanding systems is the *Badan Kredit Kecamatan* (BKK), developed in Jawa Tengah. This credit program resulted from the preoccupation of the provincial *gubernur* to find mechanisms to raise the incomes and standard of living of the rural poor, increase the availability of skills and of working capital at the *desa* level, and eliminate the *ijon*, *rentenier*, and other informal credit and/or sharing arrangements. A committee set up by the *gubernur* in 1969, to deal with the problems of credit availability at the *desa* level, suggested the BKK as the operational unit for such an effort. A *gubernur*'s decree in 1972 finally organ zed the system.

One *Badan Kredit Kecamatan* was eventually established in almost every *kecamatan* in Jawa Tengah, since the creation of the system. At present there are 486 BKK in 492 *kecamatan*. The *camat* was made chairman of the Badan for his *kecamatan*. Two to three young people who were not able to continue their schooling were hired as loan officers and cashiers (petugas). At that time one of the objectives was that the BKK would provide employment for school "dropouts". This reliance on a not highly qualified staff was partly responsible for the development of a system of loan application and borrower selection which did not require extensive investigation of each applicant. Rather, it was decided to rely on the lurah's recommendation. In this way, by implication, the lurah has to accept a responsibility to assist the BKK staff (petugas) in collecting from those who fail to pay in time. The result has been a financial mechanism at the desa level which directly reaches its clientele, in easy, simply and inexpensive terms.

Each Badan Kredit Kecamatan was granted a loan for one million Rupiahs from the provincial budget, to be repaid during three years, with the first amortization of principal due at the end of the first year. An interest rate of one percent per month was charged on this loan. The camat received and signed for this loan. By 1975, all of the kecamatan had obtained their initial capital injection and their BKK had started to grow. The stringent terms on which this initial capital was made available necessitated setting terms of loans by the BKK which would allow the recovery of this capital, payment of the staff, and the accumulation of sufficient working capital to continue operations after the initial loan was repaid.[1/] The Bank Pembangunan Daerah Jawa Tengah was given the responsibility for collecting the repayments from the BKK and was allocated the one percent per month from the loans to cover for the expenses incurred. As the loans were repaid, the funds were returned to the provincial government for their allocation to other provincial development projects. Since the unpaid balance declined with each repayment, the one-percent-interest income for Bank Pembangunan Daerah has been a declining amount, which has become less and less sufficient to cover the expenses related with the supervisory role that the BPD had been assigned. These institutional arrangements had been under revision during 1981. These revisions imply a greatly intensified role in monitoring and supervision for the BPD.

A minimun on loan size was set at 1,000 Rupiahs and a maximum at 100,000 Rupiahs. The first time that a loan is requested the borrower pays the provisi, currently one percent of the principal, to become a member (anggota) of the BKK.

[1/] This section relies heavily on several papers written by Richard H. Patten, in his capacity of consultant to the PDP program. The proffesional efforts and imagination of Dr. Patten have been an important ingredient in the recent success of this system.

Later loans do not require this payment. A standard set of six different loan terms and of interest rates for each set, so that each installment on the loan would be of the same amount, was devised. These repayment systems are:

a. Daily repayment (harian): Under this system, the borrower pays five percent of the amount borrowed each day, during 22 days. The Badan Kredit Kecamatan earns, therefore, 10 percent on the principal of the loan over a 22-day period. (This implies an effective rate of over 25 percent per month, since it is charged on the original amount and not on the unpaid balance).[1/] The 10 percent is divided between 3.5 percent as interest (bunga) and 6.5 percent as forced savings (tabungan).

b. Repayment on market days (pasaran): Under this system the borrower pays 12 installments, one every five days. Over a period of 60 days, therefore, the borrower pays 20 percent on the principal of the loan to the BKK. (This implies an effective rate of over 18 percent per month). The 20 percent is divided between 8 percent as interest and 12 percent as forced savings.

[1/] The effective interest rate per period of the loan is computed as: $r = \frac{2it}{t+1}$, where "r" is the effective and "i" is the quoted rate and "t" is the number of installments. James Kern. Op. cit

c. Weekly repayment (minggon): The borrower has to repay 10 percent of the amount borrowed each week, during 12 weeks. He ends up paying 20 percent on the principal over the 12 week period. (This is equivalent to over 12 percent per month of effective interest). Of the 20 percent charged, 10 percent represents interest and 10 percent represents forced savings.

d. Monthly repayment (bulanan): The borrower pays 40 percent of the loan monthly, during three months. He pays 20 percent on the principal during that period, 10 percent as interest and 10 percent as forced savings. (This is equivalent to an effective rate of 10 percent per month).

e. Lapanan: Under this system the borrower pays 28 percent of the loan five times, one installment every seven days. The BKK earns 40 percent (20 percent interest and 20 percent forced savings) over a 175-day period.

f. Seasonal loans (musiman): After a six month period the borrower makes a single payment for 122 percent of the amount borrowed. Of the 22 percent earned by the BKK over this period, 12 percent corresponds to interest and 10 percent corresponds to forced savings. The effective interest rate earned, of 3.66 percent per month, is completely out of line with the other interest rates, but the BKK felt constrained by the interest rates which have been charged on the BIMAS loans.

Most of the loans granted have been under the weekly (minggon) system. In the kecamatan Karangtengah, visited by the team, for example, 81.2 percent of the loans were weekly loans, 7.4 percent were monthly loans, and only a handfull of seasonal loans had been granted.

4.22 After the system was established, to grant credit for small trading, handicrafts, food preparation and retailing, as well as agriculture, and for many other general purposes in the rural areas (the BKK umum program), on the basis of the original one million Rupiahs of capital contributed by the provincial government, it was decided that the BKK should aldo serve as the cashier for all other programs sponsored by the technical agencies (dinas dinas) of the provincial government. This originated the BKK khusus program.

The BKK khusus credit programs have been mainly experimental programs, many of which have since been taken up by the Central Government. For example, the palowijo (secondary) crop credit program was initiated by the BKK khusus before the Departement Pertanian (Ministry of Agriculture) initiated the BIMAS palowijo. It was stopped as a provincial

Table 17. Badan Kredit Kecamatan in Jawa Tengah. Loans from the provincial government for the kredit umum and kredit khusus programs. 1970-1979. (Millions of Rupiahs).

	Number of BKK	Initial loan	Amount repaid	Outstanding balance
BKK umum	486	517.0	305.9	211.1
PDP (BKK umum)	39	67.5	(not due)	67.5
BKK khusus	215	244.7	83.7	161.1
Total	486	829.2	389.5	439.7

Source: Richard H. Patten. Memo. May 9, 1980.

program when the Central Government's program was started. The same is true of the fresh-water fishing programs, Sapi kereman and Sapi potong, which received 55.7 percent of the kredit khusus funds.

Some of the khusus programs, however, did not cake adequate account of the risks involved, while some set the interest rates to be charged too low to cover the risks and administrative cost involved (frequently set at one percent per month). In these cases, the BKK have attempted to absorb the funds and are trying to use them for the BKK umum program. In other cases, when the khusus program has been successful, on terms comparable to the BKK umum, the BKK has continued to make loans for the same purposes.

By 1977, when the PDP designers looked at the BKK, a valuable learning period had been completed. Some of the BKK had done very well financially, while others had gone bankrupt. Several lessons were drawn from the experience of this initial period:

a. Those BKK which concentrated on low interest, high risk agricultural loans (because of lack of new, more profitable technology), had ended up bankrupt or with very little loanable funds to operate at the minimum size necessary for success.

b. Wherever the camat had understood that his job was to get the money out as quickly as possibl , large sums of money had been lost. BIMAS type of target setting on loan disbursement had been a mistake.

c. Where there had been corruption, involving the camat or the lurah, the BKK had gone bankrupt, as there was no audit system to catch this until it was too late.

d. The procedures which worked best had relied on spreading the available funds among a large number of borrowers and had started each borrower with a very small loan, but had increased loan size progressively, on the basis of the borrower's repayment record.

e. There was plenty of evidence of a significant unsatisfied demand for small working capital loans for off-farm activities which provide a cash flow from which the loan can be regularly serviced.

f. Wherever a very active BKK had accumulated more than enough working capital to serve the _desa_ around the _kecamatan_ headquarters, and had moved loan operations, on a weekly basis, to outlying _desa_, it had found that the collection of previous loans to borrowers is those _desa_ improved immediately. Also, many potential borrowers were found who had not previously applied for loans because of the transaction costs involved in applying for loans and paying installments at the _kecamatan_ headquarters. Since motorcycles were necessary to get the BKK staff to these outlying _desa_, Bank Pembangunan Daerah Jawa Tengah developed a system of loans to the BKK for the motorcycle, if their montly income was sufficient to cover the repayment.

g. Most of the borrowers were aware that the forced savings were simply an extra cost of borrowing. Even so, most of them found the borrowing costs from the BKK to be lower than from other sources available to them. Most of the borrowers, therefore, did not consider taking their money out of the BKK savings, as long as they were allowed to continue borrowing. Of course, for many of the BKK, if all of the borrowers asked for their savings at the same time, the loan operation would have to be close down. For this reason, it has been frequent that the camat (or the petugas) demand the borrower an explanation about the intended use of the savings, in order to allow their withdrawal.

The PDP designers evaluated this experience and recognized its tremendous potential and decided to build up the financial viability of the Badan Kredit Kecamatan. The main feature for success in the system had been to set interest rates high enough to cover administration costs and default losses, making the institution viable without further subsidy, once the need for concentrating on small, fast turnover, loans rather than on BIMAS type agricultural loans had been understood. Contrary to what frequently happens when an outside donor institution "adopts" one of these programs, the PDP designers recognized the importance of this feature and did not force the BKK to lower interest rates. Also, it was recognized that another element for success were the comparatively low transaction costs, both for borrowers and lenders, that had resulted from simple loan procedures, which could be operated on a routine basis and did not require the management of a highly skilled staff.

Only small amounts are loaned to new BKK members, whose reputation in the desa is good, at least with the lurah. If they pay back, they are granted larger loans. Meanwhile, interest rates are high enough to cover the losses from those who do not repay. Over the years, the system leads to the accumulation of known reliable borrowers as a higher percentage of the total number of borrowers, and the percentage losses suffered decline. Therefore, since the BKK were dealing with the poorest group which could benefit from credit and the system was viable, the PDP decided to channel credit through the BKK. Concerned with institution building, the PDP consultants have dealth with several problems. In the first place, the original stringent terms on the provincial government loans to the BKK meant that loanable funds were continually being taken out of the BKK units. Those BKK which had hit on the most profitable loan strategy from the beginning were able to pay back their loans and continued to build up their equity. These BKK have managed to increase their loan volume faster than the rate of inflation and have continued supplying additional borrowers through time.

Another group of BKK with sufficient capital have managed to maintain a staff and to balance the repayment of the original provincial government loan against their increase in equity, thus keeping loan volume about even with inflation. These BKK are merely loaning progressively larger amounts to their established clients. There is a third group of BKK, however, which would have had to close down if they had been forced to return savings to the members or repay the original loan. By postponing both and by cutting down the number of staff to the bare minimum, these BKK have kept going. They would eventually have to give up, without an injection of additional loanable funds. There is still a fourth group of BKK that have been closed down as bankrupt. Since there was no provision for new capital after the initial loan from the provincial government, it was impossible to start them up again, although past experience, in some cases, might have been sufficient to cause the unit to use the new capital successfully.

In this situation, the first requirement was simply to provide additional loanable funds, in order to take advantage of this successful experience and consolidate financially stable units. The PDP, therefore, made available 132 million Rupiahs from the 1978-79 PDP budget, and 65 million Rupiahs from the 1979-80 PDP budget, as a revolving fund to be placed with the Bank Pembangunan Daerah Jawa Tengah, to be loaned to BKK in the five kabupaten were the PDP program was operating. As of January, 1982, the BKK system had received 216 million Rupiahs from the PDP program.

Table 18. Badan Kredit Kecamatan. Balance sheet. September, 1981 (Millions of Rupiahs)

Assets:	
Cash	85.8
Loan portfolio	3,024.7
Savings deposits with BPD	44.3
Buildings and equipment	143.9
Other	18.2
TOTAL	3,316.9
Liabilities:	
Provincial government and BPD	520.8
Kas desa	19.5
Dinas funds	23.9
Member savings	631.1
Accumulated equity	1,625.6
Net profits as of September, 1981	496.0

Source: Bank Pembangunan Daerah Jawa Tengah. Unpublished records.

Once funds were available, it was possible to work on improving other aspects of the BKK system, and to set conditions for the release of the funds to individual BKK. All current staff in the 65 BKK within the five PDP *Kabupaten* were trained for two weeks in the provincial training institute near Semarang. This training was followed up in the field by visits from the PDP staff.

4.23 As of September, 1981, funds from the provincial government and from Bank Pembangunan Daerah Jawa Tengah represented 17 percent of the resources mobilized by the BKK system. About 19 percent, on the other hand, came from borrower (anggota) savings. The rest constituted accumulated profits and equity. (See Table 18). Over 91 percent of the BKK assets were held in the form of loans: contrary to what was observed in the case of the Badan Kredit Desa in Jawa Timur and in the case of similar institutions elsewhere, the BKK did not have idle resources. This full utilization of loanable funds explains, to a large extent, the success of the system in reducing lending costs. The BKK, therefore, have managed to accumulate about two-thirds of their annual revenues as net profits. (See Table 19).

BKK loans outstanding increased from 213.4 million Rupiahs, at the end of 1972, to 2,507.7 million Rupiahs, at the end of 1980, and to 3,071.8 as of September, 1981. This implies an average annual rate of growth of 36.1 percent, between 1972 and 1980. From December, 1975, to December, 1981, a period with an average annual rate of inflation of 16.8 percent, loans outstanding increased at an annual average rate of 18.0 percent and the amount of new loans granted each year increased at an average rate of 17.0 percent per annum.

Table 19. Badan Kredit Kecamatan. Statement of income and expenses. From January 1st. to September 30, 1981. (Million of Rupiahs)

Income:	
Interest:	692.4
from weekly loans	327.6
from monthly loans	341.9
from seasonal loans	22.8
Propisi (member fees)	29.5
Other	24.2
TOTAL	746.0
Expenses:	
Interest	18.1
Wages	113.3
Overhead costs	33.2
Operational costs	26.6
Other	58.7
TOTAL	250.0
Net Profits:	496.0

Source: Bank Pembangunan Daerah Jawa Tengah. Unpublished records.

Since total loaned funds stayed about even with the inflation rate, the number of borrowers dropped somewhat between 1975 and 1980. That is, the total number of new loans granted during the year augmented from 119,870, at the end of 1972, to 377,059, at the end of 1974, but then steadily declined, to 212,391, at the end of 1980. At the same time, the total number of loans outstanding declined, from 296,613, at the end of 1978, to 256,502, as of September, 1981 This reduction in the number of borrowers may be explained, not only by the impact of inflation on the portfolio and the need to maintain size of loans for preferred borrowers constant in <u>real</u> terms, but also by the elimination of less creditworthy borrowers as the BKK accumulated experience about their repayment records

Between 1972 and 1980, borrowed capital increased from 152.3 million, to 550.3 million Rupiahs. Between 1975 and 1980, however, the annual average rate of growth of borrowed capital was only 0.5 percent and, without the PDP contributions, it would have been negative, since as the original provincial government loans were being repaid, this item declined.

Savings increased very rapidly in the earlier years, but between 1975 and 1980 their average rate of growth, of 14.7 percent per annum, did not keep up with the inflation rate. This slower growth of "forced" savings suggests the need to face voluntary savings mobilization as a more responsive way to tap local resources. Equity (defined as loans outstanding minus overdue payments, borrowed capital

Table 20. Badan Kredit Kecamatan. 1972-1981 (Amounts in millions of Rupiahs).

Year	N°of BKK	Loans out-standing	Overdue payments	Borrowed capital	Savings	Equity	New loans during year	New loans cumu-lative
1972	200	213.4	31.5	152.3	38.4	(- 8.7)	442.6	442.6
1973	350	498.3	89.8	306.0	110.7	(- 8.2)	1.178.5	1.621.1
1974	432	857.9	181.3	446.1	220.1	10.5	2.032.5	3.653.6
1975	465	1.096.3	245.3	463.6	285.4	101.9	2.479.7	6.132.3
1976	486	1.305.8	326.5	462.2	338.4	178.7	2.632.0	8.765.3
1977	486	1.420.1	361.6	422.0	356.3	280.2	2.726.1	11.491.4
1978	486	1.581.2	475.0	394.3	385.5	426.4	2.994.3	14.385.7
1979	485	1.886.2	454.9	397.6	435.7	598.8	3.597.1	18.082.8
1980	485	2.507.7	561.0	500.3	565.9	880.5	5.436.8	23.519.6
1981	485	3.071.8	633.7	547.6	647.6	1.242.9	n.a.	n.a

Source: Bank Pembangunan Daerah Jawa Tengah. Unpublished records.
Richard H. Patten, personal communication.

and savings) has increased tremendously, at an average annual rate of 53.9 percent between 1975 and 1980. (See Table 20).

The average size of loan increased, between 1975 and 1980, at an average annual rate of 27.5 percent, which was sufficiently above the inflation rate to make increments in the size of loans in real terms possible. The average size of savings, on the other hand, increased at the average annual rate of 18.1 percent. (See table 21).

The general picture is that of an institution which has been successful financially, but has been undercapitalized, to the extent that its growth has just been able to keep up with inflation. The BKK, therefore, have settled down to turning over their loanable funds, mainly through loans to the established borrowers, increasing the size of their loans slightly faster than the inflation rate. At the same time, however, there is ample evidence of an excess demand for this type of credit. Savings mobilization and additional capitalization, therefore, could further increase the successful operation of the system.

The repayment record of the BKK deserves a special consideration. Table 20 indicates that the ratio of overdue payments (tunggakan merah) to the outstanding portfolio increased, from 14.8 percent, in 1972, to 18.0 percent, in

Table 21. Badan Kredit Kecamatan. Number and average size loans, savings, and payments overdue. 1972-1980

	N° of loans during year	Average size of loan	Cumulative N° of loans	N° of savers at end of year	Average size of savings	Cumulative N° loans w/overdue repayments	N° Overdue as % of Cumul. N°. of loans	Average amount overdue
1972	119.870	3.692	119.870	73.456	523	19.210	16 %	1.638
1973	277.860	4.241	397.730	160.011	692	45.810	12 %	1.960
1974	377.059	5.390	774.789	240.248	916	78.957	10 %	2.296
1975	360.352	6.881	1.135.151	260.456	1.096	98.203	9 %	2.498
1976	304.909	8.632	1.440.040	262.558	1.289	117.434	8 %	2.780
1977	232.044	11.748	1.672.094	244.469	1.457	117.574	7 %	3.075
1978	212.988	14.059	1.885.082	232.164	1.660	103.503	5 %	3.623
1979	213.746	16.829	2.098.828	234.263	1.860	114.016	5 %	3.982
1980	212.391	23.222	2.311.219	224.625	2.520	117.490	5 %	3.982

Source: Richard H. Patten. Personal communication.

1973, ant to 25.5 percent, in 1976, to then slowly decline, to 20.6 percent in 1981. This ratio, however, does not accurately reflect the repayment record of the BKK, given the very short term of the loans granted, which make possible a fast turnover of the loanable funds. A better measure of delinquency, therefore, can be obtained by relating the total volume of loans granted (cumulative) to the total amount defaulted (cumulative). This ratio declined, from 7.0 percent, in 1972, to 2.4 percent, in 1980. That is, of the total volume of credit granted by the BKK system, of 23,519.6 million Rupiahs, during the 1972-1980 period, only 561.0 million had not been repaid. This means that the total default accumulated since the beginning of the BKK system represents only 2.4 percent of the accumulated lending of the system. This is an extremely low default rate. Moreover, not all of the <u>tunggakan merah</u> is necessarily lost. The PDP consultants believe that about 40 to 50 percent may still be collectible, given a determined drive on the part of the <u>camat</u>. Furthermore, the above data include both the BKK <u>umum</u> program, as well as the BKK <u>khusus</u> program, under which various <u>dinas dinas</u> funds are turned over the BKK to act as cashier. In general, bad debt in the BKK <u>khusus</u> program has been much higher than in the BKK <u>umum</u> program.

Of course, not all of the individual BKK are in the same financial position. They range from the very successful, which have as much as 50 million Rupiahs in circulation in the kecamatan, to those which are essentially bankrupt and are closed down for correction of administrative or other problems and the injection of new loanable funds before they can be reopened for credit operations.

4.24 The PDP program made available additional loan capital in five kabupaten (Demak, Jepara, Kudus, Pati, and Rembang), for upgrading and extending the operations of 65 BKK in the area. Between December, 1978, and September, 1981, the total number of borrowers with loans from the 65 BKK in these five PDP kabupaten actually increased from 52,907 to 64,803. This represents an average of 997 borrowers per BKK, as compared to 795 for the remaining 421 BKK in Jawa Tengah. Average size of loans had increased from 4,778 Rupiahs, in 1978, to 12,295 Rupiahs, in 1981. Total outstanding loans increased, in the same period, from 252.8 million Rupiahs, to 796.7 million Rupiahs, augmenting their share in the total BKK system from 16 to 26 percent. Overdue loans, in turn, increased from 79.7 million Rupiahs, to 139.9 million Rupiahs. That is, the ratio of overdue loans to outstanding loans declined from 31.5 percent of the outstanding portfolio, to 17.6 percent, while at the same time, the delinquency rate for the total BKK system declined only from 23.7 to 20.6 percent. Member savings increased from 52.7 million to 161.3 million Rupiahs. (See Table 22).

Table 22. Badan Kredit Kecamatan. 65 BKK included in the PDP program. (Million Rupiahs). 1978-1981

	1978	1979	1980	1981*
Outstanding portfolio	252.8	320.2	588.5	796.7
Overdue	79.7	86.2	118.8	139.9
Number of loans	52,907	53,058	58,940	64,803
Average size of loan	3.778	6.034	9.984	12.295
Savings	52.7	63.9	121.4	161.3
Profits	27.5	39.1	111.0	79.8*
Equity	109.0	134.0	173.1	284.2

*As of September, 1981

Source: Bank Pembangunan Daerah Jawa Tengah. Unpublished records.

Table 23. Badan Kredit Kecamatan. Loans, savings, and overdue repayments. Comparison of number and average size. 1979-1981

Time Period	N° of loans during period	Average size of loans	N° of savers end of period	Average size of savings	Cumulative N° loans w/overdue Repayments	Average amount overdue
All Central Java - 486 BKK Units						
Jan thru Aug 1979	152,114	Rp 15,959	243,050	Rp 1,771	114.907	Rp 3,801
Jan thru Aug 1981	173,308	Rp 26,315	232,792	Rp 2,684	116,106	Rp 5,449
Change:						
Absolute	+21,194	+ 10,356	-10,258	+ 913	+ 1,199	+ 1,648
Percent	+14 %	+ 65 %	- 4%	+ 52 %	+ 1 %	+ 43 %
PDP Kabupaten - 65 BKK Units						
Jan thru Aug 1979	30.736	Rp 13,117	46,473	Rp 1,279	26,280	Rp 3,159
Jan thru Aug 1981	70,803	Rp 20,531	57,783	Rp 2,561	26,143	Rp 5,211
Change:						
Absolute	+40,067	+ 7,414	+11,310	+ 1,282	- 137	+ 2,052
Percent	+ 130%	+ 56 %	+ 24 %	+ 100 %	- 0.5 %	+ 65 %
Central Java Outside PDP Area - 421 BKK Units						
Jan thru Aug 1979	121,378	Rp 16,679	196,577	Rp 1,887	88,627	Rp 3,992
Jan thru Aug 1981	102,505	Rp 30,310	175,009	Rp 2,725	89,963	Rp 5,518
Change:						
Absolute	-18,873	+ 13,631	-21,568	+ 838	+ 1,336	+ 1,526
Percent	- 15%	+ 81 %	- 11 %	+ 44 %	+ 2 %	+ 38 %

Continued ...

Continued ...

Change from Aug. 31, 1979 to Aug. 31, 1981

	PDP area-65 BKK units		Outside PDP area 421 BKK units	
	Rp	%	Rp	%
Loans Outstanding	+471,429,602	+ 168%	+702,372,972	+ 46%
Payments Overdue	+ 53,221,972	+ 64%	+142,644,590	+ 40%
Current Assets	+418,207,630	+ 21%	+559,728,382	+ 48%
Borrowed Capital	+152,777,691	+ 198%	- 12,125,307	+ 4%
Members' Savings	+ 88,531,182	+ 149%	+105,902,103	+ 28%
"Equity" or Undivided Profits	+176,898,757	+ 291%	+465,951,587	+ 94 %

Source: Richard H. Patten. Personal communication.

Recent growth of the 65 BKK in the PDP program has been contrasted with the growth of the whole system in Table 23. Between August, 1979, and August, 1981, while loans outstanding in the PDP units increased by 168 percent, they increased by only 46 percent in the remaining BKK. Current assets increased, at the same time, by 212 percent in the PDP units, but by only 48 percent in the other BKK. Member savings increased by 149 percent in the PDP units, by 28 percent in the rest. Equity or undivided profits, in turn, increased by 291 percent in the PDP units, by 94 percent in the remaining BKK. The BKK included in the PDP program were no better (actually, they were possibly worse), than the other BKK, prior to the upgrading support. This is a clear evidence of how a well-guided effort can push a potentially successful system in the right direction, as long as it is ready to recognize the crucial elements for financial viability.

Before the PDP program was launched, a team from the provincial and from the Central Government, as well as from BPD, developed and tested a survey form to be utilized in gathering information in order to evaluate each BKK, before funds coult be released. In the basis of this survey, a system of classification, similar to the one now also used by the KURK in Jawa Timur, was developed, since it was clear that not all BKK could be loaned the same amount of money at the same speed. On the basis of this survey, all BKK were classified into five classes (there were originally no class I units), and a loan ceiling was set for each BKK on the basis of their ability to use funds effectively.

The classification system was based on six different factors. Half the total weight (50 percent) in the final classification was given to equity accumulated by each BKK since it started to operate. Since all BKK had started with

Table 24. Badan Kredit Kecamatan. Classification criteria.

N°	Criterium	Weights	I	II	III	IV	V
1	Accummulated equity (Undivided profit) ('000 Rupiahs)	50 %	>10.000	5000-9999	1000-4999	0-999	< 0
2.	Ratio desa: post	10 %	2	2-3	3-4	4-8	> 8
3.	Number of borrowers ('000)	10 %	20	15-19	10-14	5-9	0-4
4	Quality of portfolio(%)	10 %	> 90	89-80	79-70	60-50	< 50
5	Savings ('000 Rp)	10 %	>2.000	1000-1999	500-999	200-499	0-199
6	Monthly lending ('000 Rupiahs)	10 %	> 5.000	2000-4999	1000-1999	100-999	< 99
7	Points		1 - 1.5	1.6-2.5	2.6-3.5	3.6-4.5	> 4.5
8	Limit on PDP loan ('000 Rupiahs)		5.000	4.000	3.000	2.000	1.000

Source: Bank Pembangunan Daerah Jawa Tengah. Unpublished records.

an initial one million Rupiahs loan from the provincial government, the equity accumulated served as a convenient basis of comparison of the performance of individual BKK for the entire period. BKK with negative equity were placed in class V and were not allowed to borrow until the problems were corrected. Other classification factors were the number of desa per post, the number of borrowers, accumulated savings, monthly turnover rates, and the quality of the portfolio. Each one of these factors had a weight of ten percent.(See Table 24).

The original survey classified 11 percent of the 65 BKK in class II, while 40 percent were included in class V. By May, 1980, already two BKK had reached class I. At this time, 20 percent were in class II or above, but the 40 percent still in class V were not surveyed. By December, 1980, however, 6 BKK were already in class I, and those in class II and above represented 26 percent of the total, while the proportion of BKK in class V had declined to 18 percent. The same criteria were applied to all BKK in Jawa Tengah in April, 1981. About three percent (15 BKK) were included in class I. Those in class II and above represented about 14 percent, while those in class V represented 42 percent. By August, 1981, the proportion in class V had declined to

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about 38 percent. Much upgrading is still required, but there is much potential for additional success. (See Table 25).

Table 25. Badan Kredit Kecamatan. Classification results. 1979-1981

	PDP area (65 BKK)			Jawa Tengah (486 BKK)	
Class	Sept. 1979	May 1980	Dec. 1980	April 1981	Aug. 1981
I	0	2	6	15	18
II	7	11	11	58	49
III	15	21	28	106	113
IV	17	5	8	105	122
V	26	26	12	202	184

Source: Bank Pembangunan Daerah Jawa Tengah. Unpublished results. Richar H. Patten.

The original class V BKK in the five PDP kabupaten were not allowed to borrow until a more detailed study indicated exactly what problems had caused each one to fail. Only after the initial problem had been corrected was the BKK allowed to receive credit, in tranches of 200,000 Rupiahs each. This did not happen until April, 1980. By December, 1980, 20 of the original 26 BKK in class V had corrected their problems and begun to borrow.

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4.25 A very important question, in terms of the future of the BKK system, is the treatment of savings. Up to now, all savings are forced savings which are paid with the loan installments. Where the BKK is short of loanable funds, the camat and the staff tend to make it difficult for the saver to withdraw his savings. Also, the interest rate paid, where it is paid at all, is 1/2 percent per month, not enough to keep up with the inflation rate. Forced savings, therefore, are just another cost of borrowing. (Compensating balances are required by financial institutions that cannot increase interest rates).

This policy of forced savings is supposed to "educate" people on the value of saving, that is, it would eventually induce people to voluntarily save. It seems that present financial policies are not conducive to this result. In the first place, there is no institution which reaches the desa level in Indonesia and which can accept savings except from the people who borrow. However, financial deepening is as important for savers with surplus funds that cannot be invested profitably, as it is for investors without sufficient resources to take advantage of their opportunities. While attempting to reach the rural poor with credit programs, the Indonesian authorities have ignored the savings mobilization side of financial intermediation. In part this is due to the belief that there are no savings in the rural areas. On the basis of the household survey data (SUSENAS) of May, 1978, however, it has been found that high average propensities to save can be measured in the rural areas at the peak of the agricultural season. This average propensity to save was around 25 percent for all households and around 30 percent for rural households.[1/] Savings propensities, therefore, are high. It was also found that savings in the rural areas tend to be concentrated among the top quartile of the income distribution. At the same time, the data on financialized savings indicates that most of the annual increases in the asset portfolio of households are not beint channelled through financial intermediaries. Therefore, it seems that a substantial potential exists for mobilizing domestic savings through financial institutions in rural Indonesia.

The lack of concern about savings mobilization was also justified by indicating that, until the management abilities of the rural semi-formal financial institutions were improved, these were not in a position to handle both savings and

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[1/] Sarath Rajapatirana et al. Op. cit.

credit operations.1/ It seems that the Badan Kredit
Kecamatan, for example, should have by now reached anough
maturity to be able to mobilize savings successfully and at
low administrative costs. In general, there is a tendency
to argue that there is no need to mobilize savings, b aus
these do not exist in the rural areas. But, why not try
Possibly, one would discover that once the impediments to
savings mobilization are removed, voluntary savings will
flow into these institutions. Sufficiently attractive
inducements will have to be offered, however. As long
the deposit rates earned on these savings are lower th
annual rate of inflation, there will be little hope i
respect. That is, there must be institutions in the
areas, convenient to the producers, which can recei
savings whenever these producers have a cash surplu
institutions must pay deposit rates on these savin
are high enough to protect them from the eroding
inflation. In real terms, deposit rates must be
positive. Finally, it must be clear that the sa
belong to the saver and not to the institution.

1/ Interview with Masdoeki. BAPPEDA Jawa
January, 1982.

the saver must be able to withdraw his savings when he needs them, unless he has acquired a time deposit.

It seems that the Badan Kredit Kacamatan is the kind of institution which could successfully promote voluntary savings in the rural areas, because it conducts business close enough to the desa level, and because it charges lending rates that make it possible to afford deposit rates which protect savings from inflation. Additional incentives would be to link loan size to the amount of voluntary savings and to grant savers the opportunity to get a share in the BKK profits. Forced savings could be converted into voluntary savings, if a sufficiently high interest rate is paid, retrospectively, when the savings are kept, let's say, for another an additional period of equal length. The PDP consultants are well aware of the importance of savings mobilization for the growth of these institutions and have made important suggestions in this connection.

Among the suggestions from the PDP consultants are:

a. That the BKK pay two percent per month interest on savings remaining in the BKK at least three months. This will be sufficient to protect the savings from inflation, assuming that Bank Indonesia can hold down inflation as in the recent past.

b. The BKK will return the savings immediately when requested by the member, provided he is not overdue with the loan.

c. Any person who is a member (<u>anggota</u>) of a BKK may place his savings with the BKK, whether or not he is borrowing from the BKK at the time. To become an <u>anggota</u>, any person must present a certificate from the <u>lurah</u> stating that he is a member in good standing of the <u>desa</u>, and must pay the <u>provisi</u> (entrance fee).

Finally, to induce the BKK to mobilize savings, loans from the PDP program above the ceilings set on the basis of the ranking already discussed, could be made available on the basis of the voluntary savings mobilization effort. These loans could also be used to bridge the gap in resources that could occur between the moment a BKK releases its forced savings and replaces them with voluntary savings.

V

CONCLUDING COMMENTS

5.01 The extreme market fragmentation found in rural Indonesia, as well as the isolation of economic actors, as a consequence of physical and cultural barriers to the mobility of goods and services and of factors of production, have precluded many producers, consumers, and local governments from responding quickly and appropriately to continuing economic change and from taking advantage of new investment, production and development opportunities. There is, therefore, a significant role for financial services in the rural economy, as a mechanism to further integrate markets, to mobilize savings, and to improve the "quality" of investment, by channelling existing savings towards more profitable activities. In addition, since during the past decade national oil revenues have made possible the accummulation of resources at a much faster pace than fiscal processes (infrastructure building, health and education provision, etc.) could be expanded in order to take advantage of these resources, there is much potential scope for the use of the financial system as a mechanism to allocate these exceptional revenues more efficiently.

One of the negative results of the limited absorptive capacity to deal with the increasing resources has been that the financial system has been perceived as a fiscal mechanism to disburse transfers and subsidies to special groups and priority sectors of the economy, rather than as a market integrating network developed to serve desirable and naturally evolving financial needs.

Among the unfortunate consequences of this fiscal approach has been the piecemeal creation of credit programs primarily intended to assist in the disbursement of these growing fiscal resources. As a result, this otherwise well-intentioned effort has defined the nation's financial sector into a fiscal rather than a financial device, seeking to direct resources into the economy in a much too specified manner which, among other things, ignores the prevalence of fungibility, even at low income levels. To function efficiently financial markets, instead, should be allowed to flexibly respond to the very diverse demands for financial services, which necessarily arise in such a dynamic economic environment, particularly given the heterogeneity of producers found in the rural areas.

As a consequence of this fiscal approach, not sufficient attention has been devoted to domestic savings mobilization through the financial system, as well as to the development of a more "complete" and integrated financial system. That is, the fiscal approach has severely limited the scope of financial intermediation and as a result Indonesia is lagging behind equivalent countries in terms of financial deepening.

Another consequence of this fiscal approach has been the absence of any real concern for repayment of loans among the state commercial banks and other public credit institutions, although such collection is essential in order to maintain the solvency of the system. Moreover, interest rates have been set, in the institutional financial sector, at relatively low levels. These rates have frequently not covered the costs of administration and the risks associated with the management of loan portfolios, particularly when access to these portfolios has been granted to more costly, small marginal clients.

The resulting lack of financial viability, of course, has required the constant infusion of resources through budgetary allocations from the Central Government as well as from the provincial governments that, in turn, are highly dependent on the oil revenues, which will not last for ever. Moreover, credit subsidies coupled with low deposit rates paid to savers, sometimes negative in real terms, imply that the Government has been channelling a significant portion of the inflation tax and of Bank Indonesia's seignorage towards the few priviledged borrowers with access to the under-priced loans. These borrowers constitute a very small fraction of all Indonesian producers. Moreover, despite the stated support of decentralization, these largely centrally-funded credit arrangements and transfers of subsidies actually serve to make local governments, local financial institutions, and local economic activity in general more, rather than less, dependent upon the center.

Despite the efforts to push the oil revenues down, in order to benefit with them Indonesians at all levels of wealth, there are very few of the centrally-funded credit programs that actually reach the *kecamatan* and *desa* level where the rural poor work and live. On the other hand, there are several semi-formal, indigenous, autonomous, locally-oriented financial institutions that are successfully reaching the poor and that have managed to become financially viable by themselves or with intelligent outside support. This paper has described some of the most conspicuous examples found in Jawa Tengah, Jawa Timur and Sumatera Barat. These institutions should be looked upon as providing the elements for successful models of lender behavior in the rural areas of Indonesia.

5.02 The credit mechanisms that reach close enough to the rural poor in the _kecamatan_ and the _desa_ levels of Indonesia may be classified into four types:

a. Credit projects attached to the extension work of technical agencies (_dinas dinas_) of the Central Government and of the provincial governments.

b. Bank Indonesia's special credit programs, usually associated with preferential rediscounting facilities.

c. Government-sponsored cooperatives and other groups of producers.

d. Local "savings and loan" associations or similar classes of semi-formal institutions.

The _dinas dinas_ projects are in the borderline between credit programs and something else, usually straight _welfare_ programs. The emphasis of these credit programs in on _end use_ of the funds. That is, the _dinas dinas_ identify a particular activity or technology which they want to promote and credit becomes a potential vehicle for such a promotion. The main purpose is not institution building in the financial sector but technological innovation. Fungibility is not usually recognized by the extension agents working for the *dinas dinas*, but the team was able to verify that it takes place frequently, at all levels.

In this type of credit program the initiative in project design, borrower selection, and loan size (usually according to a rigid technological package), comes from the *dinas dinas*, with little or no bank participation. Most of the loans are for groups, because this reduces the costs of extension and technical advice. Most of the time the loans are in kind (*natura*), not in cash, in a futile attempt to defy fungibility. Both disbursement of the loan as well as repayment are conducted in kind, ignoring all the advantages of money over barter. These procedures, obviously, lead to bureaucratic rigidities, additional complications, inefficiency, and injustice. In an attempt to cope with special needs and local circumstances, a multitude of systems of disbursement and of repayment have been designed, further increasing the operational costs of the programs.

The criteria used for the design and evaluation of these programs is not conducive to financial deepening. The emphasis is on technology, not on profitability. In many cases the *dinas dinas* did not even know what was the expected profitability of the projects financed. Successful performance was judged in terms of the numbers of beneficiaries reached or of the volume of the projects implemented. The most immediate criterium for success has usually been the rate at which the funds have been disbursed. When consideration of the impact of the loans has been made, usually this impact has been measured in terms of increases in physical output. In these programs there is no active role for the financial institution, no "learning" about financial processes. The participating bank is merely a _cashier_ with no direct responsibility for the outcomes. Banks, in turn, accept this role as a lesser evil which is impossed on them by the political system.

There is little or no bank participation in borrower selection. There is no bank participation in project evaluation. The borrowers selected by the _dinas dinas_ are almost never rejected by the participating bank (most frequently _Bank Rakyat Indonesia_). This is so because it would be too costly for the participating bank to revise the loan applications already accepted by the _dinas dinas_, because the information required is too difficult to get (that is, too expensive), and because it may be politically very difficult to oppose the _dinas dinas_. Moreover, at least in theory there is little acceptance of risk by the participating bank (usually none or at most 25 percent of the loan amount). In practice, however, there are many problems with the risk-sharing mechanisms among the Central Government, Bank Indonesia, and the banks. In many casis the participating bank has just no available mechanism to collect. The bank expects, therefore, that the Central Government will eventually accept all of the losses from these type of credit programs.

The financial institution, therefore, is also contaminated by the "welfare" orientation of these programs. As a consequence, there is no interest in collection. The name of the game is disbursement, not collection. The team even found some programs in which the repayment period was left undefined. At the pace at which repayments were coming forward, the expected term of the loans had become four to five times the term considered in the feasibility study. In other cases, to repay or not to repay was a voluntary decision left to the beneficiaries of the "loans". Still in many other cases the team found that the beneficiaries had not been told about repayment at all.

It is clear that these dinas dinas credit programs are the least promissiong of the systems observed by the team, as a means to promote financial development. Credit in kind, in particular, seems to be very inefficient. The borrowers dislike it, byt they still acept it, because in mani cases it is the only way to get additional capital. After all, it is not easy for the poor to reject gifts. They would much prefer, however, cash, which provides them with generalized purchasing power. To call them "credit" programs, when they are not, is a big mistake. It leads people to the belief that government credit programs do not require repayment. It destroys financial discipline.

In some cases, a link with credit may be necessary or actually effective in promoting technological change. This needed access to credit, however, can alternatively be provided by regular financial institutions that offer a wide scope of financial services. The dinas dinas are good to put the money out, but do not have incentives to get it back. As a result, they soon run out of funds, leaving a substantial unsatisfied "demand" behind. A regular financial system would introduce the discipline necessary to evaluate the actual profitability of the projects financed, while at the same time would mobilize the additional resources needed to keep the program going.

Moreover, the real resources of the dinas dinas, particularly trained manpower and administrative and managerial abilities, are very scarce. Their comparative advantage is in the transfer of technology. By diverting their resources towards the administration of credit programs, where they do not have such a comparative advantage, these resources are not being employed in their best alternative use. The efficiency of the whole system is reduced. On the other hand, if the technical tasks of the _dinas dinas_ were successful in their own field, this would automatically create the demands for the financial services required by technological innovation. A regular financial system is usually better equipped to deal with these than a Central Government Ministry.

In Jawa Tengah, Jawa Timur and Aceh, the PDP has allocated a substantial portion of its funds to credit programs. Several of these credit programs have been associated with the _dinas dinas_. This is particularly true in Aceh, where the PDP did not find a local financial institution equivalent to the _Badan Kredit Kecamatan_ of Jawa Tengah. As a result, the PDP credit program in Aceh is merely groping its way along. Moreover, it was not clear in these cases if the PDP was reaching the poor or the not-so-poor. The PDP evaluation team led by Jerome French found that there was a tendency to follow a "strategy of betting on the strong", and that many of the group leaders financed are relatively wealthier producers, who could probably afford the technological changes recommended without the subsidies implicit in the PDP program.

The problems have been particularly acute in Aceh because the groups, organized on the basis of blocks of land, had no prior corporate life of their own, and prove unwilling to discipline themselves adequately to pay interest and repay loans. Working in Aceh has also been particularly difficult because of a supposed traditional antipathy towards interest payments which has prevented the PDP designers to organize financially viable credit programs. The team found, however, that the interest rates implicit in the informal sharing (ijon) arrangements, which are too common, were extremely high. They simply did not call it "interest".

5.03 The special credit programs funded directly by Bank Indonesia, or by the Central Government via Bank Indonesia, include the Kredit Investasi Kecil (KIK) and Kredit Modal Kerja Permanen (KMKP) programs, as well as the BIMAS/INMAS, Midi and Mini credit programs. These programs attempt to reach the rural poor via the Unit Desa of Bank

Rakyat Indonesia which, despite their name, are located usually at the kecamatan level. All of these programs enjoy priviledged access to rediscounting funds and are not restricted by Bank Indonesia credit ceilings.

The main advantage of these programs has been their access to the large pool of bank resources in the official financial system. That is, they have had access to a "lender of last resort". Also, they have been under the supervision and have enjoyed the technical assistance of the Jakarta-based technocracy of the Central Government and of Bank Indonesia. In summary, they are integrated into a well-established institutional infrastructure.

The main disadvantages of these programs are related to the very high transaction costs, both for borrowers and for lenders, which they imply. These transactions costs are so high that many small rural borrowers prefer other sources, in spite of the very low interest rates charged in these programs. These high borrower costs effectively limit the access of the smallest and poorest producers in the rural areas to these credit programs. At the same time, because they are heavily subsidized, they become attractive for the not-so-small, not-so-poor potential borrowers, eager to capture the implicit fiscal transfers.

Contrary to the situation of the credit projects associated with the technical agencies (dinas dinas), which depend exclusively on Central Government or provincial government budget allocations, and are therefore less "permanent" and reliable (they are organized as annual projects), these special credit programs associated with Bank Indonesia have a more stable source of funds. Bank Indonesia has granted them a special status in the allocation of credit ceilings and targets. Also, the funds turn around a little more in these programs than in the dinas dinas programs, although high default rates reduce the turnover rate. In both cases there is, of course, strong government support.

These credit programs, therefore, are preferable to those exclusively associated with the dinas dinas. Some revision of financial policies, however, could greatly increase their effectiveness. Particularly important is a reconsideration of interest rates and of collection attitudes and procedures. Loan procedures should also be simplified and less emphasis should be placed on the "proper use" of the funds borrowed. A particularly major defect of these programs has been the absence of a voluntary savings mobilization effort at the local level.

5.04 The government-sponsored cooperative credit programs observed by the team included the Kredit Candak Kulak (KCK) and the Kredit Usaha Rakyat Kecil (KURK) programs. Resources in these cases come from the Central Government as budget allocations, as well as from the provincial governments and from the monopoly profits allocated to cooperative federations. These programs also attract strong government support. Transaction costs are lower than in the previous cases, at the retailing end. Collection records, however, are not always good. Although they have a strong potential to mobilize local voluntary savings, they have not done so. Rather, they have relied on a "forced" savings component of their credit operations, which is perceived by borrowers as just another cost of borrowing.

One of the most important aspects of these cooperative programs is that they are truly reaching producers at the desa level. The KURK, in particular, appears to be effectively reaching the rural poor. In this respect, therefore, these programs deserve special attention. In Jawa Timur, however, it has been suggested at the provincial government level that the koperasi unit desa should become the only financial institution at the desa level and that all credit programs be channelled through them. Competition, nevertheless, is an important ingredient for more efficient financial markets. It seems a mistake to try to promote just only one type of credit institution at the desa level and to eliminate all other institutional forms. This is particularly true in Jawa Timur, where another financial institution with great potential also operates at the desa level: the Badan Kredit Desa. The BKD, the KURK desa unit, and perhaps other credit institutions can coexist, even in the same desa and competition will induce a better service for the rural poor.

Permanency is a very important feature of a good financial system. The rural poor have no faith in institutions that are financially unstable. At present the KURK units are charging interest rates that do not cover their administration costs and losses due to default. They have to be heavily subsidized by the Government, in order to continue in operation. Rural households know that if the institution is not financially viable it will not be permanent. This is particularly dangerous in the case of cooperatives, because of a previous history of failures. When borrowers do not trust that the financial institution will be permanent they tend to default heavily. Theirs becomes a self-fulfilling prophecy. In Jawa Timur the team found, however, a promising trend towards increasing financial viability, through tentative plans to increase interest rates, as well as efforts to reduce transaction costs by increasing the amounts of loanable funds available to each Unit. Also, important innovations and improvements are being introduced through the influence of the PDP consultants.

Access rather than a low price of loans is valued by small borrowers. The KURK has introduced important innovations directed at reducing borrower non-interest costs, thereby increasing access. Interest rates are not as important as assuring that credit is readily available in sufficient amounts, with minimal procedural requirements, and with minimal waiting time. Also, the financial institution should be able to provide a variety of financial services for both borrowers and savers. The provision of savings services, however, has not been attempted.

Institutional form, in any case, is not the most important ingredient for success. Policies, attitudes, and management practices are. Some cooperatives may be good as intermediaries between regular financial institutions and the final borrowers. This is so because of the mechanisms to collect and to lower transaction costs which they can implement. Not all cooperatives are good. In particular, multipurpose cooperatives are not good lenders. Good cooperatives, however, could have access to the funds of other financial institutions at "wholesale" interest rates and make use of their comparative advantages in retailing. They would have to overcome, however, the spurious conflict that plagues many of them between a profit-oriented strategy and the "cooperative spirit". If they do not solve this conflict successfully, favoring financial viability, they will not survive.

When cooperatives are organized by the Central Government, top-to-bottom, such as in the case of the koperasi unit desa, without the existence of a previous local corporate form, they usually cannot become successful as financial intermediaries. One danger is that they be culturally rejected. Anti-cooperative feelings were very strong in several places visited by the team, particularly in Aceh and in Sumatera Barat. In summary, while cooperatives can play a role in rural financial markets, they will not be the cornerstone for financial deepening. If they are imposed by the Government and assigned a multiplicity of disparate functions, they will certainly suffer from huge default problems, and will certainly fail.

5.05 Finally, there are the local, indigenous institutions of the "savings and loan" type. Among these, the team observed the Badan Kredit Kecamatan in Jawa Tengah, the Lumbung Pitih Nagari in Sumatera Barat, and the Badan Kredit Desa in Jawa Timur. Their strength comes from having developed and grown without being constrained by formal banking regulations. Even when they have been created, revived, or upgraded by the local (provincial) governments, they have continued to simulate the features of the informal credit markets. They all resemble the traditional institutions and project a local-government, not a central-government image.

Since their access to outside, subsidized sources of funds has been limited, they have been forced, in order to ensure their own survival, to become financially viable. That is, they have shown that financial intermediaries can behave as viable lenders in rural Indonesia and still find a large demand for their services.

Financial viability is their strength. They have achieved it through appropriate interest rate policies, very low transaction costs, both for the borrowers and for the institution, and an excellent repayment record. At the same time, they have been culturally adapted and flexible enough to serve many of the credit needs of the rural population. They have represented a viable and less oppressive competition for the moneylender. Despite the high rates of interest that these institutions have to charge, their loans have been cheaper than those from more informal sources. At the same time, they have also offered a viable competition to the Unit Desa of Bank Rakyat Indonesia, because of their comparative advantages in reducing transaction costs. These advantages arise particularly from the possession of inside information about the creditworthiness of potential borrowers in the desa. Because of the absence of regulation and of controls, they have had the opportunity to experiment and to innovate. The result have been extremely effective and inexpensive procedures. They truly constitute the best institutional models of lenders for rural Indonesia.

5.06 The relative abundance of resources due to the exceptional oil revenues will not last long. At least, oil profits will not continue to grow at the same rate as in the immediate past. Price stability, on the other hand, will require greater domestic fiscal and monetary restraint. This restraint means that fiscal transfers will have to be reduced. If, on the other hand, inflationary pressures are allowed to mount, price increases will lead to an erosion of loan portfolios in real terms and the result will be the same: less real resources will be available through the financial system. Such a contraction of the institutional financial system is not unlikely. As credit becomes more scarce the special credit programs that reach closer to the rural poor will suffer the most. That is, most probably there will be a tendency for the crowding out of the most expensive and difficult, less "successful" programs. The funds allocated to these programs will just not keep up with inflation and, in real terms, will decline. The rural poor, therefore, will not be reached by the subsidized credit programs.

To avoid the financial repression that characterized the pre-New Order regime, Indonesia must mobilize domestic resources more actively. There is much scope in her rural areas for channelling savings through financial intermediaries. The institutions of the formal financial system, however, are not prepared to undertake this task efficiently and will not be able to do it given present financial policies. In this environment, however, the local institutions described in detail in the last portion of this report, are a very promising possibility to serve the rural poor with a wide scope of financial services. Nevertheless, their financial viability will have to be assured.

Most of these institutions have gotten the basics correct on how to reach the poorest groups that can benefit from credit. Their interest rates have been set high enough to cover administration costs and default losses. This makes the institution viable without the need for a subsidy. They have also developed simple lending procedures, which imply low lender and borrower costs. They have been prevented, however, from more actively mobilizing local savings and, in many cases, they are undercapitalized, both in terms of existing credit demand, and in terms of the minimum size necessary to further reduce transaction costs.

In the Badan Kredit Kecamatan, for example, the basic requirements for a viable system of credit which can reach the desa and provide for the working capital required by rural households for their off farm activities is already in place. The same is true of the Badan Kredit Desa in Jawa Timur and of the Lumbung Pith Nagari. In the first case, the PDP has already tested methods for carefully supplying the additional capital required, while monitoring and supervising the individual units. Both in Jawa Tengah and in Sumatera Barat, in addition, a role has been defined for the Bank Pembangunan Daeran. There is obviously much scope for expansion of the PDP program in Jawa Tengah. More importantly, there is much to be done in developong these institutions into more effective mobilizers of voluntary rural savings.

5.07 Financial deepening implies the integration of financial market into wider networks, which make possible the division of labor and specialization, not only between savers and investors, but also among financial intermediaries. The local financial institutions are now performing a successful job at the "local" level, but there has been little integration with the overall financial system. This has been, at the same time, an advantage and a disadvantage. It has been these institutions' most crucial advantage, to the extent that it has saved them from stifling regulation and formal constraints. It has worked for their advantage, because they have remained, and are looked at as, local institutions, culturally adapted. It has meant, also, that they are financially isolated, vulnerable to the random impacts of floods, pests, and other exogenous events which seriously endanger their financial viability. They have had no access to a "lender of last resort". They are still a fragmented financial system.

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Thus, the most important question with respect to rural financial development in Indonesia is the question of the link. How to link these very successful local financial intermediaries to the overall financial system, without at the same time lossing them for ever. The trade offs are huge. The potential benefits from the link arise from the possibility to increase their capital base, to generate economies of scale, and to reduce transaction costs. The link may also generate greater confidence in their status as "permanent" institutions, to the extent that institutional supervision may reduce fraud and corruption. The link may also provide training opportunities for their staff, thus increasing their efficiency (and possibly their costs). From the social point of view, the link would make possible the development of a wider, more integrated, financial network.

The risks and the dangers implicit in the link are also important. Access to subsidized funds from outside will kill these institutions' drive to mobilize local savings. Government loans can always substitute for local resources. Institutions rapidly become adict to these cheaper resources, at the same time that attract borrowers who do not necessarily have the most profitable investment options. When the time for phasing out the subsidy comes, these borrowers cannot pay "true" interest rates. No "learning" process takes place with respect to savings mobilization, either. Another important danger with the link would be the identification of the institution as a "government" project. This weakens repayment performance, as well as community participation in running the institution. The best examples observed by the team, however, were "borrower association" types of institutions. Costs were kept to a minimum and collection was severely pursued. When pay employees replace local patrons in credit committees, a lot of this discipline is lost. Another danger would be the imposition from outside of unnecessary formal requirements on loan procedures. This will only increase transaction costs, both for the institution and for the borrowers. The supervisory bodies may also attempt to guide the allocation of funds to alternative borrowers and activities, thus reducing the institution's flexibility to serve the actual needs of the rural poor. The comparative advantages of these institutions, however, are their local character and cultural adaptation, their flexible procedures, and their low costs. All of this may be lost with an inadequate link.

The most advanced of the local financial institutions found is the Badan Kredit Kecamatan in Jawa Tengah. This system has managed to mobilize significant resources and enjoys much political support. The Lumbung Pitih Negari in Sumatera Barat are close to this stage, but the PDP program has not been operating in this province. Because of their perceived success and of the attention that they are receiving now, the BKK will play an strategic role in making the desired financial development in the rural areas possible. There will be a tendency to copy their successful features elsewhere. Their failure, on the other hand, could instantly kill other efforts elsewhere. Given the close attention that the BKK are receiving and the reluctance of the Jakarta- based institutions to promote agencies which are one more step removed from their control, their future performance will be decisive in shapping attitudes towards this class of financial intermediaries. That is, they will have an important -negative or positive- demonstration effect. This suggests the desirability to concentrate AID resources in their development. Their use in more traditional credit programs (e.g., the KIK/KMKP) will be much less rewarding. AID resources should also be spent in strenghthening the second-floor institutions to which these local agencies will be linked, in particular, the Bank Pembangunan Daerah.

Obviously, given the implicit dangers of the link, it would be much better to relate these institutions to provincial-level rather than national-level institutions. The local institutions must remain independent, however. They must not become "quasi-branches" of their supporting institution.

The team was rewarded by the opportunity to observe this remarkable set of financial intermediaries. We believe that intelligent support, of the kind that in the past has respected their crucial features, is desirable. We would feel tremendous frustration, however, if as a consequence of the increased attention that these institutions are receiving, they become finally subjected to the suffocating regulations that characterize other sectors of the Indonesian economy and to constraining limits on their lending behavior which destroy their financial viability.