Impact of financial liberalization on microfinance development in NTB Province

Pengaruh liberalisasi finansial terhadap perkembangan lembaga pembiayaan mikro di Propinsi NTB

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Abstrak

Paper ini berupaya untuk menilai dampak dari liberalisasi (sektor) keuangan pada pembangunan pembiayaan mikro di Indonesia dengan mengambil provinsi NTB sebagai daerah studi kasus. Liberalisasi (sektor) keuangan merujuk pada penghilangan pembatasan tingkat bunga dan kemudahan pembukaan bank. Pembangunan pembiayaan mikro merujuk pada akses and keberlanjutan lembaga keuangan mikro yang diukur dengan empat indikator, yaitu: jumlah lembaga pembiayaan mikro, ukuran relatip assetnya, besaran kredit program dan penampilan masing-masing jenis lembaga pembiayaan mikro itu sendiri. Penilaian dampak tersebut menggunakan data dari statistik lembaga keuangan (Bank Indonesia dan Dinas Koperasi) dan beberapa studi kasus terpilih. Ditemukan bahwa liberaralisasi telah mendorong beroperasinya lembaga-lembaga pembiayaan mikro baru dan menghasilkan dampak positip pada akses jasa pembiayaan mikro, tercermin jumlah lembaga pembiayaan mikro dan sebaran geografisnya yang meningkat tajam. Namun, keberlanjutan lembaga pembiayaan mikro tersebut dalam ancaman yang berat akibat persaingan tak sehat, skala operasi terbatas, ketergantungan pada pembiayaan pemerintah, pengawasan yang lemah, regulasi yang tidak pasti, dan managemen buruk.

Kata kunci: Pembiyaan mikro, Kebijakan pembiyaan mikro, Liberalisasi, Akses jasa pembiayaan mikro

Abstract

This paper attempts to assess impacts of financial liberalization on microfinance development in Indonesia, taking Nusa Tenggara Barat (NTB) Province as a case study. Financial liberalization refers to free interest rate control and easy bank entry. Microfinance development is measured in terms of access to microfinance services and sustainability of microfinance institutions as reflected by four indicators: number of microfinance institutions, *their relative size, their service performance, and the direct credit scale. The assessment uses data from official financial statistics and selected case studies. It was found that liberalization have both stimulated the establishment of new microfinance institutions and brought positive impacts on access to microfinance services. Improved access to microfinance services, as reflected by substantial increase in number and geographical distribution of the microfinance institutions, has also been found following the liberalization. However, contrast results were found with respect to the sustainability of the microfinance institutions, characterized with unfair competition, limited operational scale, dependency on government finance, weak supervision, ambiguous regulation, and bad management.*

Key words: Microfinance, Microfinance Policy, Liberalization, Access to microfinance Services

Introduction

Microfinance development has been an essential element of development policies in Indonesia for several reasons, including: promoting the economy of the indigenous people, the poor, the farmers, and the micro and small enterprises.

Microfinance development in Indonesia has been initiated during the last half century of the colonial era (1900-1945) when village financial institutions were introduced (Suharto 1988; Steinwand 2001). Some of these early microfinance institution remain in operation in several villages in Java island today, known as *Badan Kredit Desa* (BKD). Attempts for further development of the sector continue during the independent era.

This paper is particularly concerns with the development of the microfinance sector in Indonesia in the last fifteen years during which the financial sector is liberalized. These changes in policy environment may influence the extent of direct credit[1], and the development (number, type and performance) of microfinance institutions (MFI). These in turn may affect access to microfinance services and sustainability of the microfinance institutions. What are the impacts of these policy changes on microfinance development in Indonesia--based on data from *Nusa Tenggara Barat* (NTB) province—is the main question this paper attempts to answer.

To that objectives, the discussion in this paper is organized into four sections. Section two reviews relevant financial liberalization policies, after introducing the paper in section one. Section three discussed the development of the microfinance sector after liberalization. Section four

[1] Direct Credit refers to credits whose allocation and price (interest rate) is directed by government to target groups.

discusses the performance of major microfinance institutions in NTB province. Lastly, section five concludes the paper.

The Financial Liberalization Policies

Financial liberalization is a process to give a greater role of market forces in determining the price and allocation of financial assets, such as credits. Financial liberalization in Indonesia was initiated in 1983 with the introduction of a policy reform package, known as PAKJUN 1983.[2] The financial liberalization policies with relevant implications to microfinance development in Indonesia can be grouped into two, namely: policies that promote establishment of microfinance institutions (MFI), and policies that reduce government role in the market.

The major policies that promote establishment of microfinance institutions in Indonesia since 1983 include PAKTO 1988, Banking Law No.7/1992, and Regulation No. 9/1995. Relevant elements of these policies are summarized in Box 1.

Box 1. Relevant elements of policies promoting the establishment of microfinance institutions

Policy	Relevant Elements
PAKTO 1988	Introducing rural banks into the banking system Easy requirements for rural bank opening Allowing private ownership of rural financial institutions, the rural banks.
Banking Law No. 7/1992	Confirm elements of PAKTO 1988 (above) Opening the opportunity for establishing Islamic rural banks
Regulation No.9/1995	Opening opportunity for establishing rural cooperative financial institutions

Notes: Budastra (2003) and Steinwand (2001).

PAKTO and the 1992 banking law promoted the establishment of rural banks, known as *Bank Perkreditan Rakyat* (BPR), through easy requirement and private ownership permit. The minimum capital requirement for rural bank opening was Rp.50 million (about US$25.000 in 1988) for a rural bank. Tougher requirements were set in the more recent policies, the 1998 Banking Law and the Central Bank Regulation on the Architecture of Indonesian Banking System (2003). Similarly, the 1995 government regulation promoted

[2] The policy reform packages (which then synthesised in Banking Law No. 7, 1992) were commonly referred to by acronyms built from *Paket* (policy package) and the issue year, i.e., PAKJUN 1983 stands for policy package issued on June, 1983.

the establishment of rural cooperative financial institutions, known as *Koperasi Simpan Pinjam* (KSP). The new rural financial institutions--BPR and KSP—served the market along with *Bank Rakyat Indonesia* (BRI)-Unit which was dominated the market since 1970s.[3]

BPR, KSP and BRI-Unit are generally regarded as MFIs (Robinson 1992; Steinwand 2001; Budastra 2003) since they generally serve small financial services which are generally demanded by low-income population.

The major policies that reduce government control on interest rate and credit allocation include: PAKJUN 1983, PAKTO 1988, PAKJAN 1990, Policy Response to the 1997 crisis, and Central Bank Law No. 23/1999. Relevant elements of these policies are summarized in Box 2.

Box 2. Relevant elements of policies promoting the reduction of government role in interest rate and credit allocation

Policy	Relevant Elements
PAKJUN 1983	Rising interest rate ceilings Promoting domestic saving mobilization Reducing the extent of government financed direct credits
PAKTO 1988	Promoting market competition through establishment of MFIs
PAKJAN1990	Shifting financing responsibility of direct credits from government to banks under the small business credit scheme, *Kredit Usaha Kecil* (KUK).
1992 Banking Law	Liberalizing interest rate on savings and credits
1998 Policy Response to crisis	Introducing three schemes for financing microfinance institutions: *Kredit Pengusaha Kecil dan Mikro* (KPKM) , *Kredit Modal Kerja BPR (KMK-BPR)* , and *Kredit Modal Kerja Usaha Kecil and Menengah (KMK-UKM)*
1999 Central Bank Law	Promoting greater role of market forces in the market—through Independency of central bank from direct credit responsibilities

Source: Budastra (2003) and Steinwand (2001).

[3] The ancestor of BRI-Unit was established during the 1970s nationwide as a part of the national green revolution program, or BIMAS program.

These policies (Box 2) promote a greater role of market in determining price and allocation of financial assets (services) through application of market interest rate, elimination of private ownership ban for rural financial institutions, and a smaller role of government in the market (direct credit).

Impacts of the Liberalization on the Extent of the Microfinance System

This section examines the extent to which the microfinance system has been developed after liberalization. The examination primarily relays on three indicators, namely: changes in number of the MFIs, their relative size, and the scale of direct credit.

Changes in number of microfinance institution

As noted above, the liberalization and decentralization policies had motivated the establishment of the tree types of new MFIs, namely: BPR, KSP, and LKMD. Thus, along with BRI-Unit, there are four types of MFIs in operation in the market The current structure of the microfinance system in NTB province is given in Figure 1.

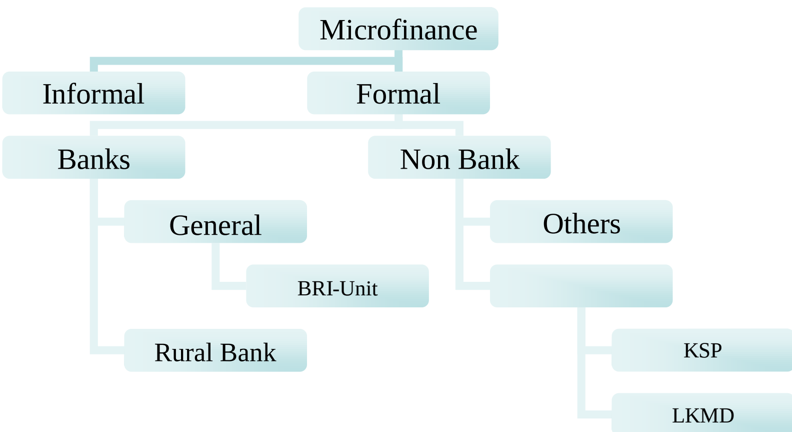

Figure1. The Structure of the microfinance system in NTB

The number of MFIs in the province increased substantially during 1988-2000 (Bank Indonesia Mataram & Department of Cooperative Mataram). BRI Units increased from 35 in 1988 to 48 in 1998. The number of BPR increased vastly up to 76 by 1998 (from just one in 1983), before the authority put tougher requirements for rural bank openings in 1998. The old BPR became a general bank in 1991. The number of KSP increased from 20 in 1996 to 142 in 2000.

However, the private MFIs tended to cluster around the city district. In 1998, for instance, more than 50 % of the private BPR and KSP were in the vicinity of the city district of Mataram (the capital of NTB province). The geographical distribution of the financial institutions in the province should be associated with the general condition of the regions (often described as the market environments), such as population, economy, and infrastructure, (Asian Development Bank, 2000; Chaves & Gonzalez-Vega, 1996; Hoff *et al.,* 1993). Would the increase in types and number of MFIs increase the extent of the microfinance services provided by the microfinance system is a question to be answered in Section four.

Changes in the relative size of microfinance system

The relative size of the microfinance at regional level can be reflected by the volume of microfinance institutions' assets relative to Regional Gross Domestic Product (RGDP). However, an exclusive analysis of the changes in the relative size of the microfinance system is not possible because the available financial statistics do not record data for BRI-Units and KSP. Thus, the relative importance of all bank and rural banks are calculated (see Table 1).

Table 1. Relative importance of the microfinance system in NTB Province, 1988-1998

Year	All Bank (%RGDP)	BPR (%RGDP)
1988	20.30	1.19
1989	32.16	1.91
1990	30.22	2.40
1991	21.09	0.21
1992	19.98	0.29
1993	19.53	0.34
1994	21.22	0.44
1995	22.93	0.42
1996	27.34	0.42
1997	30.26	0.56
1998	57.05	1.23

Source: Calculated from Data by Bank Indonesia Mataram

Table 1 shows that the total assets of all banks in the province increased dramatically during the first two years following the bank entry liberalization (PAKTO), but then continued to decline to the lowest points until the government released the tight money measures in 1993 (PAKMEI). Thus, the dramatic increase in number of banks resulting from the financial liberalization policies had initially resulted in a rapid increase in the relative size of the bank assets. But the rapid increase in bank assets brought a monetary disease, the high inflation rate, which led the monetary authority to apply tight money measures during 1990–1993. The volumes of the rural banks' assets also followed the same trend, increased during the first few years (1988-1990) but declined sharply in 1991 following the conversion of the old rural bank into a general bank. Hence, the liberalization redistributed bank assets to larger number of smaller new banks, rather than increasing the relative size of the banks.

Changes in the scale of direct credits

The liberalization is supposed to reduce the scale of direct credit but the outcomes turned out be the contrary (Table 2). The volumes of direct credits financed by government and donor agencies (including KUT, KKPA & PKM) continued to increase from IR 2.3 billion in 1992 to IR 12.7 billion in 1997, before diving to IR 4 million in 1998 as the government budget shrank during the 1997 crisis time. Similarly, the volume of direct credit financed by banks (KUK) tended to increase in most of the years during 1992-1998.

Table 2. Volumes of major direct credits in NTB Province, 1992–1998

Year	Direct Credit Financed by Government and/or International Agencies —KUT, KKPA & PKM		Direct Credit Financed by Banks – KUK	
	IR million	% Bank credit	IR million	% Bank credit
1992	2287	0.81	140633	49.75
1993	2672	0.83	233019	72.28
1994	2706	0.66	336108	82.09
1995	5125	1.00	409886	79.66
1996	9452	1.41	501299	74.73
1997	12666	2.03	493746	79.31
1998	4059	2.62	113101	72.97

Source: Calculated from data by Bank Indonesia (unpublished Statistics)
Notes: KUT = kredit usahatani (credit for farming activities); KKPA = kredit koperasi primer untuk anggota (credit for members of cooperatives); KUK =kredit usaha kecil (credit for small entrepreneurs).

Considering that large parts of the direct credits were likely allocated to the rural sector of the economy, the rural microfinance market and the performance of the MFIs would be repressed. This and the declining trend of the MFIs' relative size (above) might suggest that the liberalization might not bring a significant improvement in access to microfinance services and sustainability of microfinance services (and institutions) although the numbers of MFIs substantially increased.

The increasing scale of credit program might reflect the government's standing on directed finance: that it is necessary to direct the allocation of credits to priority sectors for equity and developmental reasons, which the market forces regarded a failure to address. This government view on directed finance is obvious from the policies, reviewed above, where the government launched PAKJAN 1990 that directed the commercial banks to finance the priority sectors under the KUK program, just a few years after introducing the major liberalization policies (PAKJUN 1983 and PAKTO 1988).

After examining the performance of the microfinance system on the basis of secondary data, the discussion turns to the performance of the MFIs on the basis of primary data, in section below.

Performance of major mincrofinance institutions

This section discussed the performance of major MFIs in NTB province, with particular emphasis on MFIs whose establishment was regarded as a result of the financial liberalization and the decentralization. As noted above, the MFIs include BRI-Unit, BPR, KSP, and LKMD (BUMDES & KOPTAN). Their performances are given in Table 3.

Tabel 3. Average performances of major microfinance institutions in NTB Province

INDICATOR	BRI-Unit	BPR	KSP	KOPTAN	BUMDES
Savers	6567	3641	-	-	68
Borrowers	941	2138	Na	45	224
Saving Volume (IR 000)	5673	2005	-	-	61
Credit Volume (IR 000)	1522	913	176	69	149
Saver occupation (%)[1]	39	7	-		20.59
Borrower occupat (%)[1]	21	11		100	11
Village served	8-12	Many	Many	1	1
Op. Self sufficiency	Na	58.82	71.05	56.69	65.52

Source: Budastra (2003) and Budastra & Halil (2003)
Notes: 1 is Per cent of farmers

Table 3 shows that BRI-Unit, in many respects, performed better than either the MFIs established following the liberalization or the MFIs established following the decentralization. This superior performance of BRI-Unit is understandable as its has a larger asset, been in the market in a much longer time, and a wider variety of financial services. Looking from access of low-income population to financial services, the newer MFIs (BPR, KSP, and LKMD) should give a positive result because of reasons, as follows. The new MFIs could extend the outreach of financial services to low-income population in wider areas because they generally offer financial services in small sizes, conveniently serve the clients in their working or home places, and require relatively easy requirements. For instance, BPR had more borrowers although it had a much smaller credit volume than BRI-unit had (see Table 3). KOPTAN served a group of population who were generally ignored by the other MFIs. Because of the reasons and relatively low interest rate (subsidized), most clients of LKMD (about 90%) considered unnecessary to obtain financial services from other sources (Budastra and Halil, 2003).

However, some cautions need to take into accounts considering the sustainability of the MFIs, and hence their financial services. There are too many of them in the market, most of them are very small in assets, many operate within a restricted very small (one village), and many of them only serve a few clients (their members). To illustrate, consider a microfinance market of a sub-district, it consists of a BRI-Unit, a BPR (of provincial government), sometime a private BPR and a private KSP in the sub-district center. To this, one or more LKMD in each of the villages in the sub-districts are added. Such structure of microfinance market would certainly give tough environment for the MFIs, particularly the smaller ones, to sustain their services. Lastly, most of the LKMD were dependent on government or donor (subsidized) funds for financing their loanable funds.

Conclusions

With believe that market forces are better regulator of the market and the microfinance system would develop better accordingly, the government of Indonesia liberalized its microfinance system with a series of policy reforms since 1983. The policy reforms included policies that promoted establishment of new microfinance institutions and that reduced government control on interest rate and credit allocation.

The liberalization had successfully increased the number and types of microfinance institutions participating in the market. There were two new types of microfinance institutions were established, including rural banks, and rural cooperatives. By 1998 there were 76 BPR established and by 2000 there were 142 KSP established. The substantial increase in number of microfinance institutions, however, did not result in substantial increase in the relative size of the microfinance institutions' assets. The liberalization redistributed bank assets to larger number of smaller new banks, rather than increasing the relative size of the banks. Moreover, the microfinance institutions, particularly the private ones, tended to cluster around the provincial capital.

The liberalization also apparently failed to reduce the scale of credit program. The scale of the direct credit tended to increase rather than decline during 1988-1998. As consequence, the microfinance market continued being repressed by massive amounts of (subsidized) direct credits. The increasing trends in the scale of direct credit while the financial liberalization in progress might reflect the Government of Indonesia views that: direct credit as imperative for equity and developmental reasons.

The examination of the performance of individual microfinance institutions indicates that the liberalization had improved access of low income population to financial services as number of microfinance institutions increased. However, many of the microfinance institution might find it hard to sustain their operation in longer terms since there were too many, small in asset, and restricted service areas.

Financial liberalization is insufficient for developing the microfinance system: to widen service outreach and to sustain the services of microfinance institutions, and to deepen access of low-income population to financial services. A great improvement in the number of microfinance institutions does not necessarily imply a larger extension of the microfinance services (service outreach, access or efficiency). New financial institutions need time and hard work to gain trust and build their market bases.

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