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A CRITICAL REVIEW OF THE LINK BETWEEN SOCIAL CAPITAL AND MICROFINANCE IN INDONESIA

Agus Eko Nugroho

Indonesian Institute of Sciences / LIPI

(ae_nugroho@hotmail.com)

ABSTRACT

Literatur menyebutkan bahwa metode kredit mikro secara kelompok (group lending method) *dapat meghasilkan tingkat pengembalian yang tinggi karena berfungsinya modal social* (social capital), *seperti kekerabatan dan kerja-sama antar anggota kelompok, serta adanya sangsi kelompok* (peer sanctions). *Studi ini mengidentifikasi keterkaitan antara modal sosial dan keuangan mikro di Indonesia. Ada dua kesimpulan yang dapat diambil. Pertama, metode kredit secara kelompok di Indonesia masih jauh dari memuaskan karena kecilnya skala operasional. Disamping perkembangan kredit kelompok di Indonesia juga masih tergantung pada keberadaan subsidi dari pemerintah maupun lembaga donor lainnya. Kedua, kredit mikro yang mendasarkan pada modal sosial tidak harus menggunakan metode kredit kelompok. Kredit mikro yang diberikan secara individual, seperti BRI unit desa dan BKK, menunjukkan perkembangan yang baik karena mengaitkan kredit dengan modal-modal sosial di masyarakat. Dalam hal ini kredit mikro yang disalurkan dengan cara memperkuat rasa saling mempercayai* (mutual trust), *kekerabatan antara peminjam dan petugas bank, serta keterlibatan tokoh masyarakat dapat menghasilkan tingkat pengembalian yang baik. Hal ini dimungkinkan karena modal-modal sosial tersebut dapat memperkuat loyalitas, dan memberi insentif kepada peminjam untuk berlaku jujur, dan mengembalikan kredit yang telah diberikan.*

Keywords: *Indonesia, Microfinance, Social Capital.*

INTRODUCTION

Commercial banks distrust poor people for credit because they cannot enforce repayments without a presence of loan collateral. Informational problems arise as banks fail to distinguish ‘good’ among ‘bad’ borrowers, due to the poor lacking accounting report of their business. It has been recognized, however, that non-market institutions play the role in overcoming such informational and enforcement problems (Varian, 1990; Stiglitz, 1990; Hoff and Stiglitz, 1993; Besley *et al.*, 1993; Conning, 1999; Karlan, 2005). In group lending methods non-market institutions, such as interpersonal relations and cooperation among group members can become ‘social collaterals’, substituting the lack of poor people to physical collateral. This collateral substitute enhances the self-enforceable repayment of group members through the functioning of peer monitoring and sanctions. The success of group lending method, such as the Grameen Bank is said to be a prominent microfinance innovation, enhancing access of poor people to non-collateral loans. The worldwide replication of the Grameen Bank paves the way for microfinance movement to become a major instrument of development across countries. The United Nations regards the trend by declaring 2005 as the International Year of Microcredit through which an increase in the global access of microfinance can lead to the achievement of the Millennium Development Goals by 2015. Such promise was further increased when Dr. Muhamad Yunus, the founder of the Grameen Bank received the Nobel Peace prize in 2006 (Hermes and Lensink 2007).

However, lending to poor people on the basis of social collateral is not new in microfinance. Traditional moneylenders have long utilized social collateral through lending in parallel with building up close networks with poor clients. This individual lending has also been successfully adopted by microfinance institutions (MFIs), such as the BRI-units and BKKs in Indonesia. The successful performance of these MFIs is largely associated with the utilization of social networks of poor clients (Chavez and Gonzales-Vega, 1996; Robinson, 2002; Martowijoyo, 2007). Hence, the importance of non-market institutions provides the ground for an analysis of social capital in relation to microfinance performance. This paper aims to critically review the role of social capital in microfinance performance in Indonesia. It begins with exploring the definition of social capital in which the emphasis is given to the aspect of social networks and trust. It is then followed by reviewing social capital in different types of MFIs in Indonesia. The last section concludes this paper.

CONCEPTIONS OF SOCIAL CAPITAL: THE IMPORTANCE OF SOCIAL NETWORK AND TRUST

Long time ago the term social capital was introduced by Hanifan (1916), referring to tangible assets, such as goodwill, fellowship, sympathy, and social intercourse among individuals, underpinning sociality. However, social capital takes some times to become a popularized concept in social science debates. It begins with the work of Loury (1977), Bourdieu (1986), Coleman (1990) and Putnam (1993). In Loury (1977) social capital stems from social relationships among community members in fulfilling their individual interests. It is said that social relationship is not only the essential component of social structures but also a resource that facilitates individuals to achieve their best interest. According to Loury (1977), social capital is a set of resources emerged within family and community relations. It is important for the cognitive development of young person through the accumulation process of human capital. In a similar perspective, Bourdieu (1986: 248) refers to social capital as “the aggregate of actual and potential resources which are linked to the possession of durable networks of more or less institutionalized relationships of mutual acquaintances or recognition”. According to Coleman (1988, 1990), the value of social capital can be identified as the functioning of social relationship and networks in the achievement of group’s interest. Similarly, Putnam (1993: 67) terms social capital as “features of social organization such as networks, norms, and social trust that facilitate coordination and cooperation for mutual benefit”. The importance of interrelationship is emphasized further by O’Hara (2007) through defining social capital as a durable process of communication and interaction within the community that can establish and promote networks, trust, social obligation and practices.

1. Social Network

The definitions of social capital cited above highlight the importance of social networks and trust in generating social capital of the community. According to Burt (2005), the social structure of the community is made up from interlinks between clusters consisting of dense connections and communication among individuals. In each cluster connections among individuals are often characterized by clear and frequent information flows. This is the case as the cluster is formed by connected individuals who have similarities, such as personal interest, hobbies, religion, ethnicity, profession, income, location (e.g., neighborhood) and many others. For instance, people who attend the same church, mosque or get involved in the same project are very likely to have face-to-face contacts and casual conversations that could expand into close relationships. Networks that emerge within a cluster is known as *closed networks (network closures),* referring to a set of entire links among individuals within a social unit/group (Burt, 1992, 2005). Such a network allows connected individuals to receive support and information among themselves, and become an enforceable tool of strengthening group cooperation (Coleman 1990). However, the network closure is often characterized by redundant informational flows, providing little benefits to the connected individuals within the closure (Burt, 2005). This is the case because individual relationships within a network closure are often characterized by overlapping information flows across its members. Hence, gathering information within a such closure will be costly in the sense of gaining redundant information.

According to Burt (1992, 2005) however, there are often a gap between clusters creating 'empty space' or 'holes' in the social structure. The presence of holes does not mean that information flows between clusters is absent within the social structure. Instead, information flows is bridged by variable networks connecting one cluster to another. This is known as *networks with structural holes*. The potential benefit of networks with structural holes is that overlapping information is minimized because various individuals within different clusters enrich information flows. Consequently, individuals who take up the role of connecting two or more different network closures will gain benefits in terms of access to diverse information (Quibria, 2003). Burt (2005) refers to this role as informational brokerages, facilitating the early access to current information, and being able to control information distributions. Such an informational brokerage is an entrepreneur who invests resources, time, efforts and sociability to develop personal networks across different clusters, in order to gain economic benefits from information flows (Burt, 2005).

Similar to the network with structural holes hypothesis, some studies have divided networks in terms of strong and weak ties (e.g., Granavotter, 1973; Henning and Lieberg, 1996; and Wahba and Zenou, 2005). Henning and Lieberg (1996), for instance, refer to networks with strong ties as when they are characterized by frequent and regular contacts between actors, such as relationships between family members and close friends and neighbors. This type of networks shares similar characteristics with the network closure that is when most individuals' contacts are overlapping with one another. Networks with strong ties are highly noticeable in family relationships. Parents mostly know with whom their children have frequent contacts, and similarly, their children very likely know close friends of their parents. In contrast, networks with weak ties refer to relationships between individuals who are less likely to be personally and socially involved with one another, such as networks of acquaintances, conversational contacts and contacts for practical help (Henning and Lieberg, 1996). According to Granovetter (1973), networks with weak ties occur when there is a lack of overlap in personal networks between connected individuals. For instance, a network between two individuals A and B having weak ties is when A's contacts with others do not appears in B' networks. Networks with strong and weak ties are both important for building a healthy social life and have different consequences to the community (Wahba and Zenou, 2005). In the dense area, such as big cities, individual's relationships are often characterized by random and infrequent contacts or weak ties. In big cities however, individual relationships lead to wider networks because they are less personal and infrequent. People in big cities also have wider networks, due to their capability of accessing to modern communication devices, such as the internet and telephone. On the other hand, rural dwellers tend to have networks with strong ties because they often have persistent and frequent face-to-face contacts with one another. The lack of access to modern communication devices also constrains rural dwellers to build wider networks.

From an economic perspective, social networks provide economic benefits to individuals through reducing transaction costs. The logic is that strong social networks can facilitate information gathering about the reliability of agents, building up mutual trust and confidence. Strong networks can stem from repeated transactions (interactions), generating incentives for agents to behave honestly. This is the case as they consider the norms of reciprocity and loyalty underlying such transactions to build reputation and credibility. Long time ago Polanyi (1944) identified the importance of social norms in the economic life of individuals through the term to be known as *embedded economy*. As Polanyi (1944; 1975: 46) states, "[individual] does not act so as to safeguard his [self] interest in the possession of material goods; he acts so as to safeguard his social standing, his social claims, his social assets". In the traditional community, the individual motive in material ownerships is not always dominant. Whereas, sustaining social cohesion and harmony is more important because disregarding this can lead to social exclusion and humiliation. Social obligation is considered because it is reciprocal, and often serves economic ends. Polanyi puts forward the notion that the sustenance of production and exchange relies on the implementation of reciprocal norms in the society.

2. Trust

The second element of social capital is trust. Trust has long been an interesting subject for various disciplines because it is the moral foundation that makes social life possible. People are willing to take a risk of being a passenger in an aeroplane because the air-traffic system is deemed to be trustworthy and safe. However, the perception on trust remains debatable among scholars. The advocate of the individualistic approach argues that trusting others makes sense only if it is based upon available information, expectations and predictions. In this approach, then, trusting strangers is impossible. The economic conceptions on trust usually belong to this genre. In contrast, the moralistic approach believes that trusting strangers is likely if it is based on the moralistic values of the community. In the community, people are required to share common values, such as egalitarianism, honesty, and acceptance with others, including strangers. Consequently, if people take these values into account in their social life, trusting strangers is not too risky. Even if they do not have enough information about the trustworthiness of others, they need to have positive views of strangers (Uslaner 2002). From a different perspective, Weber and Charter (2003) refer to trust being the product of social interactions. Trust as a social phenomenon "emerges from and maintains itself within the context of social interaction of everyday people" (p.1). Trusting others is "the belief that others will take one' perspectives into account when making a decision and will not act in ways to violate the moral standard of the relationship" (p.3). This conception of trust is often regarded as a societal-based approach on trust.

The proponent of individualistic approach on trust believes that one trusts other people only because she/he has enough information about their reputation. Thus, interactions over time between two people are required to develop reputation as a basis of trust. This approach has three implications. Firstly, mutual trust between individuals will be limited only to subjects they know well. If one knows that she has a credible reputation for painting a house, for instance, she will only trust the person to paint her house, not in other areas of social life. The grammatical plausibility of trust is never X trust or X trusts Y for all reasons, rather X trust Y (based on information available) to do Z (Uslaner, 2002). Secondly, trust based on information and expectation implies that trusting others is a prediction that they will behave in a way that is expected. Considering experience, one trusts others because they have treated her/him fairly. Conversely, one has the lack of trust because she/he has experience of becoming the victim of crimes, discriminations, or violence. However, this type of trust is not a prediction on the negative view of the world, rather it is the way to minimize uncertainty involved in dealing with other people (Uslaner, 2002). The reason is because trusting others involves risks of being disappointed in the case of betrayal (Luhmann, 1979). According to Gambetta (1988), thus, trusting others is a risky investment involving calculations through the assessment of information about others' reputation and the availability of sanctions towards any distrustfulness.

The concept of trusts is often excluded in economic analyses, particularly the orthodox economics, due to the assumption of purely competitive market. In this market, trust is negligible as any economic transaction is characterized by anonymous agents who know one another perfectly. Under this perfect information assumption, there is no reason for any economic agent to behave distrustfully. Market will punish dishonest agents through alienating them from market transactions. As Williamson (1993) argues, economics implicitly incorporates the notion of trust, and therefore, "trust adds nothing to the analysis of commercial or more broadly economic problems" (p.469). Trust is a "moral sentiment" and is not relevant to economic transactions because agents disregard the moral quality of other agents. Instead, they will consider institutional structures of information-gathering and formal legal system that enforce the fulfillment of market agreements. However, the recent economic approach proposes that information flows in the markets are often distributed unequally across economic agents (e.g., Stiglitz and Weis, 1981), and hence trust plays a vital role in shaping economic transactions. Arai (2007) argues that trust can enhance production (organization) efficiency through reducing transaction costs due to strong cooperation among agents. In credit markets, the central issue of credit contracts is a matter of trust between lender and borrower (Edgcomb and Barton, 1998; Guinnane, 2005). Lenders will trust borrowers for credits, if they can gather information about their creditworthiness and being able to impose sanctions to loan defaulters. Here, collateral can provide information about the repayment capacity of borrower. It can enforce sanctions, as lenders will seize collaterals of the default loans (Guinnane, 2005). This conception of trust in credit relies on individualistic approaches, emphasizing the failure of banks to serve poor people due to the absence of collateral. However, informal lending such as among relatives, friends and neighbours, ROSCAs and moneylenders is undertaken without physical collateral. Instead, they consider *social collateral*, such as mutual trust, friendship and the norms of reciprocity to enforce loan repayments.

If we only accept the individualistic-based trust, there is no possibility of one trusting strangers; if individual A does not know much about individual B, there is no basis for A to trust B. However, in practice, allowing people to be members of a particular social club is evident that trusting others is not solely based on information and expectation. Many social clubs do not rely their membership provision on extensive contract and regulation, rather than shared moral values of the community, such as honesty, cooperation, egalitarianism and tolerance (Fukuyama, 1995). At individual levels, Uslaner (2002) points out that trusting strangers is possible for two reasons. Firstly, the optimistic worldview is the fundamental element of one trusting strangers. If someone has optimistic views on her/his future and is capable of controlling her/his own life, trusting strangers is not too risky. Optimists believe that dealing with strangers will hardly change their future. Indeed, it may lead them to learn something new and provide good opportunities to have wider networks, enriching the quality of their life. Such optimistic views can stem from various factors, ranging from personal achievements (e.g., educations, life-satisfaction in marriage, family, occupation, health, income and others) to the satisfaction in social interactions (e.g., friendship, neighborhood, co-worker associations, and social clubs). People with life-satisfaction, good personal and social interactions are very likely to have positive views of the world. In contrast, pessimists will look at strangers as competitor and potential enemy who may control over their life. Therefore in contrast to optimists, pessimists will believe that trusting strangers is too risky. Secondly, moral community provides a foundation of moralistic action-values of trust to exist. Fukuyama (1995: 26) states that "trust arises within a community of regular, honest, and cooperative behavior, based on commonly shared norms". In this sense, the community insists on individual members to share fundamental moral values in dealing with others. For instance, the moral community of egalitarianism requires individual to treat others equally because everyone including strangers is entitled to the same respect. Hence, when community members have a good sense of moral community, they will see strangers as their fellow community members. In sum, the behavior of trusts may not require specific agreement and information, and predictions of others' behavior. Rather, it is based on moralistic-action values of trust, such that they believe that others will treat them as they did and will not try to take advantage of being trusted. In such the case, moralistic and social trust is the key element of sociality, facilitating personal interactions to happen (Uslaner, 2002).

In this paper trust refers to as a social behavior that goes beyond individualistic motives. Bebbington and Gomez (2006) define trust in a Mexican term as *confianza*, referring not only to the notion of trust but also kindness, generosity, and personal interest in one another (p.116). Trust is also better seen as the product of sociality where individual involved, contribute and gaining benefits from a 'culture' of trusting. Then, the social system of the community affects mutual trust among individuals through two following mechanisms. Firstly, face-to-face contacts among members within and across community organizations can build up mutual trust through the imposition to accept and implement the norms of reciprocity, cooperation and friendships. Hence, a society characterized by the abundance of community associations will likely create high levels of trust (Putnam, 1993). Secondly however, community organizations as the only medium of generating social trust is too narrow for understanding the complexity of interpersonal relationships among individuals. Indeed, the behavior of trust emerges as a result of individuals' participations in various networks of everyday life. It includes participations in the relationship among family members, friends, neighbors, and formal and informal organizations, such as sport clubs, religious, ethnic and co-worker, business associations. Hence, social trust comes from generalized norms of morality (e.g., reciprocity, loyalty, honesty, generosity and friendship) embedded in socioeconomic networks of the community. From economic point of views, such networks can build social trust which is critical for any economic transaction under unequal distribution of information across agents. It can reduce risks resulting from uncertainty due to any opportunistic behavior of others (e.g., moral hazard problems). Social trust arising from the norms of reciprocity, loyalty, and friendship can be an effective enforcement mechanism, discouraging economic agents from behaving dishonesty.

SOCIAL CAPITAL AND ECONOMIC PERFORMANCE

Social trust and networks are the key ingredients of social life. People are willing to have close contacts and build up friendships because they believe that others will behave in a way of being expected. At the same time, mutual trust among them is strengthened when such relationships have been sustained. Hence, it is rational to define social capital as the interconnected linkage between social trust and networks, facilitating individuals to achieve their socioeconomic goals (e.g., economic performance). However, the extent that social trust and networks lead to the formation of social capital, and then contribute to socioeconomic activities is influenced by social infrastructures, such as norms, values, religions, beliefs, and the like. In contrast to Putnam (1993), norms and beliefs are not seen as the key component of social capital, rather they play a facilitating role of social trust and networks in constructing social capital. I have two reasons for this. Firstly, norms are a “moral judgment” to consider whether the behaviour of individual is being socially acceptable or unacceptable (Lyon, 2000), and they can take a various form, such as the norms of friendship, loyalty, reciprocity, egalitarianism and many others. Consequently, it will lead to a serious difficulty in selecting what norms should be included in constructing social capital. Secondly, norms share a similar role with religions and beliefs, facilitating individuals (groups) to build and sustain social interactions (networks) and trust. Therefore, norms are better seen to be the component of social infrastructures, facilitating the ups and downs of trust and networks within the community. For instance, when the norms of acceptance, friendship, loyalty and egalitarianism are strong in the community, they can help people to develop mutual trust, communication, networks and sociality. Similarly, religious practices can strengthen mutual trust and networks across different religions by nurturing their religious members with tolerance. Conversely, when religions fail to enhance tolerance, the religious majority suppresses the minority, preventing them from having equal opportunities and power in the community.

The question to rise is the extent that social capital affects economic performance. Figure 1 presents the circular linkage between social capital, social infrastructures and economic performance. Social capital contributes to economic performance through their capability to sustain cooperation, and reduce transaction costs involved in production and exchange. At the same time, the resulting production and exchange can lead to the social capital accumulation, when they are characterized by equal distributions of power and income among community members. According to Rothstein and Uslaner (2005), the community with more equal distributions of income and power tends to have strong social trust. Then, agents are willing to engage in collective actions (cooperation) due to the following reasons (Dasgupta, 2002). Firstly at individual levels, economic agents are willing to sustain long-term cooperation because they care about one another. If each agent is well informed that they care each other, they will trust one another to carry out their obligation. When each agent behaves honorably toward his/her obligation, monitoring costs are lowered due to the absence of moral hazard problem. Secondly, at community levels, agents will sustain their obligation because violating agreement of collective actions can lead to social exclusions. In the society the disposition to be trustworthy at personal and communal levels exists at various degrees. Having feelings of shame, incredible, and socially excluded in the case of violating collective agreement will encourage agents to honor their obligations.

Thirdly, long-term interactions and cooperation can generate self-enforcing mechanism to sustain business agreement. As agent can observe one another's action, outside party is less needed to enforce the agreement. In microfinance, rotating saving and credit association (ROSCA) is an example that long-term interactions can become self-enforcing mechanism for the members to sustain the ROSCA agreement. The members of ROSCA are unlikely to violate the agreement because they are afraid of being socially excluded within the group/community. Fourthly, reliable enforcement agencies can provide incentives for agents to sustain economic agreements. This agency may not necessarily be formal institutions but also informal ones. In the rural community, religious and ethnic leaders for instance, can be effective enforcement authorities for sustaining any economic agreement. However, to be an effective enforcement agency, the important factor is if agents recognize reputation and credibility of such authorities (Dasgupta, 2002).

In the informational asymmetric world, social trust and networks contribute to economic performance through reducing transaction costs of any economic contract. When networks are strong, information about credibility and reputation of agents will be easily observed, strengthening mutual trust among agents. It does so, for instance, through pooling information (e.g., gossips) about agents' reputation and credibility. In the microfinance literature this is known as peer monitoring. Coupled with strong group sanctions toward potential free-rider behaviors, peer monitoring can inhibit agents from behaving opportunistically. Varian (1990) and Stiglitz (1990) reveal that group lending with joint-liability principles can generate incentives of group members to monitor one another. This is the case as the loan default of one member declines the others' access to future loans. Hence, peer monitoring and sanctions do help lenders to overcome informational and enforcement problems in lending to poor people. In a similar context, other scholars emphasize the importance of social cohesion that can facilitate monitoring processes within a group lending (Hermes *et al*., 2004; Wydick, 1999; Besley and Coate, 1995). When the group lending is characterized by strong social cohesion among members, peer monitoring and sanctions will increase loan repayments. For instance, a study on group lending in Eritrea reveals that peer monitoring and social ties reduce the incidence of moral hazard problems in group lending methods (Hermes *et al*., 2004).

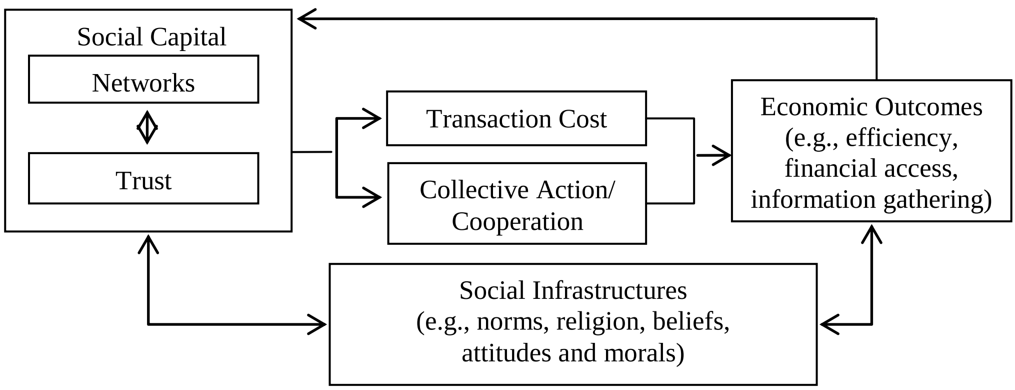

Figure 1. The Circular Linkage between Social Capital and Economic Performance

THE ROLE OF SOCIAL CAPITAL IN MICROFINANCE PERFORMANCE

1 Group Lending Method

Over the last two decades, extensive researches have examined the extent that social capital affects the performance of group lending, such as the Grameen Bank model. The ‘blueprint’ for the functioning of social capital in group lending stems from informal finance such as ROSCAs and moneylenders. These MFIs can minimize loan defaults by linking loans with social networks of poor borrowers (Stiglitz, 1993; Hoff and Stiglitz, 1997; Zeller, 1998). Being a ‘grassroot’ institution, ROSCAs and moneylenders utilize personal approaches to serve the poor. As a result, they can develop mutual trust and close friendships with their clients, minimizing the risk of lending to poor people (Bebbington and Gomez, 2006).

Economics approaches on which group lending leads to high loan repayments can be accommodated into two categories. The first emphasizes that social interactions can improve loan repayments through self-selected mechanism in forming the group. Here, information flows embedded in the dense interaction among poor borrowers help recognize the creditworthiness of one another. Hence, they will select themselves, into a homogeneous group of low risk borrowers (Gathak, 1995). This self-selection process of membership decentralizes screening efforts within the group, minimizing information problems in lending to the poor. This is the case as self-screening efforts within a group can be more effective than that of being made directly by lenders. The second approach emphasizes the functioning of peer pressure and sanctions in group lending methods (Armendariz de Aghion, 1999; Wydick, 1999, 2001). Peer pressure and sanctions can be generated through implementing joint-liability principles in group lending. Because lending to individual members is jointly guaranteed by all members within the group, they have incentives to strengthen moral pressure and sanctions against imprudent use of loans. Besley and Coate (1995) argue that the joint-liability principle will be disadvantage without a presence of strong social sanctions. Karlan (2005) in a study of group lending in Peru reveals that the close social connection among group members facilitates the functioning of peer enforcement mechanism with the joint-liability principle.

The application of lending to a group of poor people is not new in Indonesia. For instance, the introduction of *Proyek Peningkatan Pendapatan Petani dan Nelayan Kecil* (Rural Income Generation Project) since 1979 has been designed through providing small loans to a group of poor farmers. In 2002, the Ministry of Agriculture has allocated Rp 19,855 million or equivalent to US$ 2.2 million to run the project. Similarly, in 1996 the National Family Planning Coordination Board set up the national project of family welfare income generation *(Usaha Peningkatan Pendapatan Keluaraga Sejahtera (UPPKS)*. This project has spent Rp 1.79 trillion (US$ 195.5 million) through delivering small loans to about 584,577 groups, consisting of 10.4 million poor households (Hariyadi, 2003). However, there is no rigorous documentation whether the utilization of lending to a group of poor borrowers positively affects the outcome of the project. Martowijoyo (2007) warns that such micro-credit projects are very likely to face the same default rate as of the Bimas program in the 1980s. This can be the case for two reasons. Firstly, it is worth noting that the government credit programs have not utilized group lending with joint-liability principle. Lending to a group of poor people in many microcredit programs does not aim to exploit social networks of the groups, rather it is to accelerate loan disbursement to the targeted recipients. As a result, while the massive expansion of microcredits can be achieved, their repayment rates are very low.

Secondly, there are mounting evidences that cheap loans discourage poor people to repay, as they often regard such loans as a grant (Adams and Vogel, 1986). Coupled with the absence of joint-liability principle, such misperception can generate *anti-social capital* in the sense that loan recipients are collectively unwilling to repay their loans. A survey on microcredit programs for poor farmers in the East and West Java provinces by Ernany et al. (2002) reveal that many farmers are voluntary default not because of having repayment difficulties. Instead, they are afraid of being socially excluded because repaying the loans will lead them to be regarded as a disloyal member of the group. The result of such moral hazard problems is that the massive default of such loans is evident. Thirdly, the involvement of local NGOs as channeling agents does not lead to better outcomes of many microcredit programs. Instead, many commentators state that allowing incompetent NGOs as another loan channel lead microfinance programs to repeat the same sad stories, but with NGOs as the new defaulters (Martowijo, 2007: 8). Having a lack of knowledge on microfinance and poverty issues also lead to the misplaced targeting of such credit programs. In addition, Charitonenko and Afwan (2003) point out that the recent government microcredit projects undermine, rather than support microfinance development in Indonesia.

Since the 1990s non-governmental organizations (NGOs) have actively implemented group lending in Indonesia. Many of them fail, while others gain a significant progress in terms of high loan repayment and greater operational scale and clients. Among others are *Yayasan Mitra Karya* established in 1993, *Yayasan Mitra Usaha (YMU)* in 1998, *Yayasan Dharma Bhakti Parasahabat (YDBP)* in 1999, and the Ganesha Microfinance Foundation in 2003. In the four years of operation for instance, the YMU has doubled the groups of poor clients served from 301 to 653, covering 3,440 members. Lending mobilization also significantly increased from Rp 1.2 billion (US$ 130,434) in 1998 to Rp 2.5 billion (US$ 222,934). In 2006 the active clients of the YMU accounted for 1,747 poor clients with total outstanding loan of $44,475. The loan repayment rate is considerably high, accounting for 98 percent annually. Similarly, the progress of YDBP can be recognized through a significant increase in lending mobilization and group memberships. Since its establishment in 1999 the outstanding loan of YDBP improved from Rp 3.9 billion (US$423,910) to Rp 9.6 billion (US$1.0 million) in 2001. The active members of the group borrowers increased from 2,250 to 16,595. By 2003 the outstanding loans of the YDBP reached at about US$ 772,284 having nearly 100 percent rate of repayment. Recently, the YDBP has transformed into a microbank (BPR), which will allow it to mobilize deposits. The same is true for the replication of Grameen Bank model by the Ganesha NGO. The annual growth of loans of this Grameen Bank replication can be maintained at around 50 percent annually. The loan repayment rates accounted for 99 percent of outstanding loans in 2005. The active clients significantly increased from 923 in 2003 to 16,056 in 2005. It is expected that by 2010 the outreach of the Ganesha microfinance can serve 400,000 poor people.

Three factors are noticeable to lead to the successful performance of the group lending methods described above. The first is the proactive staff of NGOs to consistently encourage the members to attend regular meetings of the group. The benefit of regular meetings for lenders is that face-to-face contacts among group members can lead to effective monitoring in the usage of loan (Abbas, 2003). It also generates peer pressure in terms of gossip and moral sanctions to loan defaulters, providing incentives of repaying the loans. Being actively involved in group meetings, the lending staffs can immediately recognize which groups face repayment difficulties, and then provide solutions to minimize loan default. Moreover, regular meetings also help to maintain close relationships with borrowers. There is evident that lending on the basis of friendship can inhibit poor borrowers from behaving dishonestly, and repay the loans, as they consider reciprocity obligations of friendships. The second factor is associated with the heterogeneous occupations of members within a group. The diverse occupations of group members can insure against the risk of loan default. This is the case as loan default by one member will not reduce repayment capability of other members. In contrast, there is evident that a group of borrowers with a homogenous occupation, such as farmer is highly prone to covariate risks of harvest failure (Zeller *et al*., 1997). For instance, a presence of draught can lead to harvest failure, and hence reduce the repayment capability of all members of the group. Form a social capital perspective, the heterogeneous characteristics of groups facilitate members to develop friendships that can expand into business networks. For instance, farmers can undertake business cooperation with traders and food producers when they are in the same group of borrowers. As a result, strong business networks and cooperation can sustain production of group members, enhancing their repayment capacity.

The third factor is the requirement of group members to engage in compulsory savings. This is undertaken through which the NGOs provide initial loans to group members, and then group members are required to engage in compulsory savings every week. The accumulated saving has two roles. The first is that savings can improve lending capacity of NGOs and insure against loan defaults. The second is that compulsory savings can generate self-belonging of group members, providing incentives of repaying the loans. The utilization of mandatory savings can also produce peer pressure and sanctions, as the failure of one member to repay his/her loan can prevent other members from accessing to loans.

However, Parhusip and Seibel (2000) argue that the replication of the Grameen Bank model in Indonesia remain far from satisfactory in terms of financial insufficiency and incapability of serving a significant number of poor people. For instance, the degree of Mitra Karya's financial self-sufficiency is only 39 percent, and hence it should take a long way to grow into a formal microbank. Robinson (2002) criticizes that the replications of the Grameen Bank in Indonesia are unlikely to become sustainable MFIs for two reasons. Firstly, being a clone institution, many Grameen Bank replications have not adapted their products with the Indonesian context. For instance, the rigid target of poor clients disadvantages the Grameen Bank replications, as the failure of poor members to repay the loans will deteriorate their financial performance. This is in contrast to the lending method of BPRs, BKKs and BRI-units, in which a combination of poor and non-poor clients served allows cross-subsidizing services to the poor with services from the non-poor. Secondly, reliance on subsidy from donors, and the rigid target of poor clients lead to small deposit base of many Grameen Bank replications, constraining their lending capacity.

To have a balanced perspective however, the small-scale operation of many Grameen Bank replications is not surprising, as they are still in the early stage of operation. In the case of the Grameen Bank, it takes more than 25 years to have a massive coverage. The same is true for the BRI-unit system, as it requires a long-term process to become the world-most prominent MFI without subsidy. The question to rise is that should the Grameen Bank replication ovoid funding subsidy, and move to purely for-profit orientation? Subsidization of MFIs remains a debatable issue among microfinance scholars and practitioners. There is a tendency that profitability focus can lead MFIs away from their social mission of serving poor people (Mosley, 2001; Zeller and Johannsen, 2006). This is the case as profitability can cause MFIs to focus more on serving non-poor people, rather than poor clients. MFIs become reluctant to serve the poor because operational costs of managing small loans are considerably high, while their returns are often low and uncertain compared to large loans. In contrast, the advocate of microfinance commercialisation argues that reliance on subsidy can lead to operational inefficiency, and undermines saving mobilization of poor people (Christen, 2001; Drake and Rhyne, 2002; Charitonenko *et al.*, 2004; Charitonenko and Afwan, 2003). Regarding such a contradict view, it is worth nothing to consider the term *smart subsidy* introduced by Morduch (2006). The logic of smart subsidy is that subsidisation of MFIs is acceptable so long as it is well designed and accountable. Using smart subsidy, MFIs can maximise social benefits of serving poor people, while minimising distortion and misplaced targeting. The well-designed and transparent use of subsidy can attract other donors to provide funding support to the MFIs. Smart subsidy is not equal to cheap credits in which interest rates are set well below market rates. It should avoid cheap credit, and promote financial innovation to minimize risks of lending to poor people (Morduch, 2006).

Moreover, the Indonesian government has also developed a project that links microbanks with groups of small scale business in 1988, namely *Proyek Pengembangan Hubungan Bank dengan Kelompok Swadaya Masyarakat (PHBK)*. The idea of the project is drawn from the concept of social intermediation introduced by Bennett (1996). Social intermediation is a process in which financial services are made in conjunction with building up both human resources and social capital of poor people. The ultimate aim is to enhance the self-reliance of the poor, and preparing them to engage in formal financial intermediations. According to Bennett (1996), social intermediation has two important elements. *Firstly,* building up social capital through creating and strengthening local institutions will improve the capacity of poor people to manage and control risks associated with financial intermediations. As has been previously reviewed, the utilization of social capital through grouping poor clients can facilitate intensive interactions among members, perceived important for knowledge accumulation, and generating mutual trust. Social interactions facilitate poor people with various backgrounds to learn one another, propelling networks and cooperation. They can generate mutual trust perceived vital for the decision-making process within the group. *Secondly*, microfinance services should involve the need of the poor to economic-related support services, such as managerial and production techniques. The aim is to enhance the capacity of the poor to engage in various income-generating activities. Financial trainings such as basic accounting technique are also needed to strengthen the capacity building of poor borrowers to deal with financial business (Edgcomb and Barton, 1998). In this regard, social intermediation of microfinance requires the involvement of external parties, such as NGOs and government agencies. NGOs are seen as favorable institutions to improve skills and organizational capacity, and organize the poor into a solidarity group of borrowers. However, the role of NGOs should be gradually reduced as the linkage between the poor clients and formal banks has been sustainable (Bennett *et al*., 1996; Johnson and Rogaly, 1997).

Bina Swadaya is probably the most prominent NGO that has successfully linked groups of poor clients with microbanks under the PHBK project. Since its establishment in 1988, the PHBK project indicates a significant progress in terms of lending mobilization, microbank participation and a number of group borrowers involved. In the period of 1998 to 2001, microbanks (BPRs) participants increased from 703 to 931, while the number of NGOs slightly improved from 206 to 257. Lending mobilization through the PHBK program significantly increased from

Rp140.39 billion (US$ 12.26 million) in 1998 to Rp 330.56 billion (US$ 35.93 million) in 2001, serving to 34,227 groups of poor clients. However, the sustainability of the PHBK program is uncertain as such a progress remains largely dependent on funding subsidy from the government. There was also a downward trend in the number of active microbank participants. For instance, in the period of 1998 to 2001 the percentage of microbank (BPRs) that actively participated in the PHBK program considerably declined from 86.7 percent to 44.1 percent of total participants. Similarly, the percentage of active NGOs significantly declined from 70 percent to 33 percent. From my survey in Surakarta, Boyolali and Sukoharjo districts, it is found that unsound performance of NGO participants has led BPRs to reevaluate their participation in the program. While some BPRs seek to decline their participation, many others BPRs prefer to directly form and serve the groups of poor clients, rather than channeling loans through NGOs.

According to Robinson (2002), the more players in financial intermediaries, the greater is operational costs of serving poor clients. She calculates that the annual cost of the PHBK program accounts for approximately 95 percent of total annual loans. In this regard, Bank Shinta Daya for instance, decides to directly form and serve the groups of poor clients without involvement of local NGOs. Parhusip and Seibel (2000) reveal that this microbank has been capable of reaching 310 groups with 7,750 poor members. The implementation of group lending method also contributes to financial performance of Bank Shinta Daya. This gives more evidences that the functioning of social capital in group lending method plays the role in microfinance performance in Indonesia.

2 Individual Lending Method

While group lending method is a recent microfinance movement, some prominent MFIs in Indonesia have successfully utilized individual lending methods. The classic example is the progress of BRI-units, BKKs in the Central Java province and LDKPs in the East Java province. From the perspective of social capital, the successful performance of these MFIs is largely associated with the frequent face-to-face interaction between lending officers and clients (Robinson, 2002; Chavez and Gonzales-Vega, 1996). It begins with pro-active screening process through delivering bank staffs to visit work place and home of potential borrowers. In such method, the bank staff will recognize social capital of clients in terms of social networks. Then, information about creditworthiness of borrowers is gathered from the pre-existing social networks, such as neighbors, relatives and community leaders. The involvement of community leaders as loan cosigner or witness aims to provide moral pressure for the borrowers to repay their loans. Moreover, treating the borrowers with friendly, helpful and respectful manners help to develop, and sustain close relationship, trustfulness and loyalty of clients. Such close relationships can also provide incentives for the borrowers to prudently manage their loans (Robinson, 2002; Mosley, 2001).

Over the years the government interferes in the development of (credit) cooperatives in Indonesia. However, the aim has not been to build cooperatives as sound microfinance institutions, instead of channeling subsidized credit programs to poor people. As a result, the widespread failure of subsidized credits adversely leads cooperatives to suffer a lack of trust, and fail to mobilize voluntary savings from the public. Despite, they often experience operational defaults due to mismanagement and corruptions. To sustain operation, a large number of cooperatives remain highly dependent upon external funds from the government (Charitonenko and Afwan, 2003). Nevertheless, the recent development of credit cooperatives and Islamic-based cooperatives *(Baitul Mal wat Tanwil/BMT)* restores a new expectation that cooperatives can progress toward prominent MFIs with a greater capability of serving poor people. For instance, the number of credit cooperative *(Koperasi Simpan Pinjam/KSP)* significantly increased from 1.097 in 2000 to 1,596 in 2004, while BMTs increased from 2,914 to 3,038 (Martowijoyo, 2007). However, many have accused the commercial practice of credit cooperatives being similar to moneylenders; they exploit the urgent need of poor people to loans through setting high rates of loan interest. The negative view on lending practice of cooperatives is not, however, based on convincing argument. High rates of loan interest are unlikely being the result of monopolistic power of credit cooperatives, as microcredit markets encompass numerous players that compete one another. Credit cooperatives set high interest rates because they should spend more resources to overcome information and enforcement problems in providing non-collateral loans to the poor. For instance, they should maintain frequent contacts, so as to closely monitor the repayment capability of their clients. In order to develop close friendships, cooperative staffs also often attend various social activities of the clients, such as wedding and religious ceremonies. This reflects that the utilization of social capital lead to greater costs of lending to poor people. However, the benefit of social capital is that it can strengthen the norms of reciprocity and loyalty, encouraging poor clients to repay the loans.

The linkage program between a commercial bank and cooperatives also indicate a significant progress in terms of lending mobilization to poor people. In 1997, Bank Bukopin developed a partnership with local cooperatives through an introduction of ‘Swamitra’. In many cases the Swamitra was developed from saving and credit units of multipurpose cooperatives (e.g., KUD) into independent credit cooperatives. In 2002 there were 230 units of Swamitra. By 2005 there have been 403 units of Swamitra across 20 provinces in Indonesia (ProFi, 2007).The bank provides additional funds, managerial training and equipments to SWAMITRAs, so as to increase their capacity of serving poor clients. For-profit oriented focus characterizes their financial operation. The office of Swamitra is administratively designed as of microbanks, aiming to attract small-scale depositors of rural and semi-urban areas. Similar to moneylenders, the Swamitra provide small loans with frequent installments to poor borrowers. In such a lending method the lending staffs of Swamitra have intensive face-to-face interactions with borrowers that can develop into personal relationships. The benefit of having close relationships is that the lending staffs can gather information about the creditworthiness of borrowers. Moreover, when the borrowers consider the moral value of friendships, they have greater incentives to repay their loans. As a result, the rate of loan defaults can be minimized, enhancing the lending capacity of Swamitra. In the period of 1999 to 2000, for instance, their lending mobilization considerably increased from Rp 98.9 billion (US$10.1 million) to Rp 152.8 billion (US$16.6 million) in 2000, while savings doubled from Rp 35.7 billion (US$3.9 million) to Rp 73.32 billion, equivalent to US$7.9 million (Glenardi, 2003).

The significant progress of credit cooperatives cited above indicates the gap between demand and supply of microcredit markets. The Central Bank policy to improve business performance of microbank (BPRs), such as adherence to CAMEL, greater minimum capital, loan-loss provision has shifted the market segment of microbanks toward higher income groups (Martowijoyo, 2007). In the survey of BPRs and BKKs in Surakarta and its surrounding areas, I found that the new microbank policy reduces the capability to expand new borrowers, as the microbank staffs spends more times and efforts to prepare weekly and monthly reports to the financial authority. More importantly, Mortowijoyo (2007) emphasizes that the new CAMEL rating of microbanks has excluded criteria for measuring the outreach to serve poor people, such as the number of village posts, new borrowers served and loan disbursements. Considering high costs of managing small loans, many microbanks become reluctant to serve poor people. As a result, a decline in the supply of microbank loans to poor people paves the way for the progression of credit cooperatives and BMTs across rural and semi-urban areas of Indonesia.

CONCLUSION AND FUTURE RESEARCH

In this paper I have scrutinized that social capital in the forms of social trust and networks play a important role in microfinance practices. In group lending methods, trust and dense networks of interaction among group members generate the functioning of peer pressure and sanctions to loan defaulters. Regarding the advantage of lending to a group of poor people, the government and local NGOs have replicated the Grameen Bank model across rural and urban areas of Indonesia. The existing progress of such replications, however, remains far from satisfactory in terms of small-scale operations. The sustainability of Grameen Bank replications is also uncertain, as their financial practices are still highly dependent on funding subsidy from donors. In contrast, individual lending methods of many microbanks, such as BKKs, BRI-units and BPRs are capable of achieving financial self-sufficiency with greater operational scale (Robinson, 2002; Chavez and Gonzales-Vega, 1996; Hadinoto, 2005). Individual lending methods in parallel with building up close relationships with poor clients enable these MFIs to minimize loan defaults. Similarly, the significant progress of many credit cooperatives emphasizes further that individual lending methods with friendships can lead to high rates of loan repayment.

Regarding the sustainable operation of traditional ROSCA, such as *Arisan* among poor people throughout Indonesia, the development of group lending methods is prospective. The sustainability of Arisan is due to the functioning of social capital, such as peer pressure and moral sanction, preventing Arisan members from behaving dishonestly. However, apart from the nationwide replication of group lending, the knowledge about the extent that social cohesion affects the performance of group lending methods remains limited in Indonesia. In this regard, future researches need to closely examine the following aspects. The first is the extent that social cohesion, the norms of solidarity and reciprocity, and the role of formal and informal leaders contribute to the performance of group lending. The second is the issue related to group formation. Here, the question to be raised is whether autonomous or self selection of group members lead to better lending performance, compared to the groups being formed by program officers (NGOs). This is vital to examine the extent that social capital generates peer selection, leading to effective monitoring and enforcement of loan repayments of group members. The third aspect is internal characteristics of group members, such as heterogeneous members in terms of age, gender, occupation, ethnicity, income affect lending outcomes of group lending. Last but not least, future researches should focus on the assessment of whether linkage programs between formal and informal MFIs can expand social and business networks of poor people, enhancing their production activitiy, reputation and credibility to access greater loans from commercial banks.

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