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THE PRO-POOR POLICY OF MICROFINANCE IN INDONESIA

Agus Eko Nugroho
Economic Research Center,
Indonesian Institute of Sciences (P2E-LIPI)

This paper discusses and proposes the policy issues associated with the development of microfinance industry in Indonesia. Despite its capability of financing small-scale businesses, the development of the microfinance industry is far behind that of commercial banks. The policy focus on developing sound financial practices of microbanks has ignored the role of semi-formal and informal microfinance institutions (MFIs) in serving poor people. Compliance with the sound banking practices could inevitably drive microbanks away from serving the poor. Regarding the capability of informal and semi-formal MFIs of outreaching the poor, the challenges to microfinance policy in Indonesia is to develop inclusive financial systems through which the progress of microbanks goes in a parallel direction with the developments of semi-formal and informal MFIs, such as cooperatives and rotating saving and credit associations (ROSCAs).

Keywords: Indonesia; microfinance; poverty

Introduction

Over the years, poverty reduction has remained a top priority for the Indonesian economic development. In rural areas, it is conducted in two ways: (1) agricultural development and (2) poverty alleviation programs, such as nationwide family planning,[1] micro-credits for poor farmers *(Kredit Usaha Tani/KUT)*, presidential instruction for backward villages *(Inpres Desa Tertinggal/IDT)*, and most recently, *Kredit Usaha Rakyat/KUR*. Most poverty alleviation programs through microfinance have been undertaken through delivering subsidized credits to poor farmers, plus the development of revolving fund provisions for credit cooperatives and self-help groups of the poor. These programs are expected to increase the agricultural production and income of rural dwellers. However, it is unequivocal that such micro-credit programs can improve the agricultural production and income of rural poor families.

It is evident that the microfinance industry in Indonesia comprises a variety of institutions, including commercial banks, Bank Rakyat Indonesia Unit Desa (BRI-unit), Bank Perkreditan Rakyat/BPR (people's credit banks), Badan Kredit Kecamatan/BKK (sub-district credit institutions), Badan Kredit Desa/BKD (rural credit institutions), cooperatives, pawnshops, rotating saving and credit associations (ROSCAs), and moneylenders. Some research concludes that formal MFIs such as BRI-units, BPRs, and BKKs have successfully followed international best practices, leading to sound banking operations. The commercial-based practices of such MFIs result in reasonable profitability for micro-finance intermediaries serving low-income segments. However, the major concern is that focusing more on profitability may limit the outreach of MFIs to (very) poor people, particularly those who live in remote (rural) areas. A BRI survey in 2001 revealed that apart from the BRI-units' success, many poor villagers were persistently excluded from financial services. A lack of 'small-and-flexible' financial services at the rural level constrains the access of the poor to the MFIs (ADB 2003). As a result, they utilize various types of informal MFIs, such as moneylenders and ROSCAs. Being 'grass-root and self-help' institutions, informal MFIs have a long history in providing microfinance services to the poor in Indonesia. They are capable of giving 'flexible' services to the poor with high repayment rates.

Unfortunately, the microfinance authority of Indonesia lacks under-

[1] This program was set in the early 1970s, aiming at controlling the growth of population. It successfully reduced the population growth from 2.3 percent during 1980s to 1.7 percent in the 1990s. It also decreased the infant mortality rate from 90 to 49 per 1,000 live births. Life expectancy at birth was enhanced from 53 years in 1980 to 63 years for men and 67 for women in 1997 (World Bank 2001).

standing about the functioning of informal and semi-formal MFIs in serving poor people. The microfinance regime in Indonesia is substantially focused on strengthening commercial practices of microbanks (e.g., BPRs or people's credit banks). For instance, the central bank's policy on transforming the local-government credit banks (e.g., BKKs) into commercial microbanks (e.g., BPRs) indicates that the microfinance regime is more concerned over the institutional development of MFIs, rather than enhancing the capability of formal MFIs of serving poor clients. Being transformed into BPRs, they should comply with standard sound banking practices, including sufficient capital, standardized accounting reports, and many other regulations applied to commercial banks. Such rigid requirements potentially undermine the outreach capacity of many local-government credit banks to serve the rural poor (Martowijoyo 2007).

The objective of this paper is to examine the pro-poor policy of microfinance development in Indonesia. The reminder of this paper is structured as follows. The next section investigates the poverty incidence and the need for microfinance. Section 3 examines the institutional characteristics of the microfinance industry in Indonesia. Section 4 discusses the impact of microfinance policy bias toward the commercial practices of microbanks. The challenge of achieving the contradictory objectives of microfinance is discussed in section 5. Section 6 examines the internal and external factors of achieving microfinance objectives. Finally, section 7 presents the conclusion and policy implications of this paper.

Poverty Incidence and The Need for Microfinance

Prior to the financial crisis in 1997, Indonesia had made a substantial progress in reducing the number of poor people. Table 1 outlines the incidence of poverty in Indonesia from 1990 to 2006. In 1990, the proportion of poor people was estimated to be 15.1 percent of total population, compared to 40 percent in 1970 (BI and GTZ 2000). This incidence of poverty was then reduced to 11.3 percent in 1996. Following the crisis, the contraction in Indonesia's economy multiplied the incidence of poverty to 23.4 percent in 1999. In parallel to the economic recovery of Indonesia, the incidence of poverty gradually declined to 17.7 percent in 2006.

A more detailed look at Table 1 shows a greater proportion of poor people in rural areas compared to that in urban areas. In the period of 1990 to 1996, for instance, the urban poverty drastically decreased from 16.8 to 9.7 percent. The rural poverty incidence, however, modestly declined from 14.3 to 12.3 percent. In 2009, the number of poor people in the rural areas remained significantly greater than that in the urban areas. The incidence of rural poverty accounted for 20.6 percent of total poor people, compared to 11.9

percent in the urban area. This is consistent with a study by World Bank (2001) that the majority of poor people in Indonesia live in rural areas with main income from agricultural activities. According to the World Bank (2001), the incidence of rural poverty stems from a continuous decline in agricultural productivity, low wage of farm laborers, and unhealthy circumstances such as a lack of clean water and sanitation.

The incidence of rural poverty indicates that Indonesia's industrialization strategy results in urban bias development. This urban bias development stems from two factors. The first is the industrial concentration that has given a priority of infrastructure development to urban areas. For instance, according to Kirmanto (2005), approximately 31 percent of irrigation is in a state of dysfunctional condition. Only 6.4 percent of rural households have access to well-run water, compared to 32 percent of urban dwellers. Moreover, 68 percent of rural areas have no access to telecommunications. At the same time, the development of rural infrastructure has been overlooked due to the limited budget of the government. The ultimate impact is a stagnant agricultural production, which leads to low income of rural dwellers. The second factor is the industrialization with a low minimum-wage policy. To sustain this policy, the government sets low prices of agricultural commodities, particularly rice as the main nutrition of all Indonesians. Maintain-

Table 1. **Urban and Rural Poverty in Indonesia, 1990 - 2009**

	Urban Poverty		Rural Poverty		Total	
Year	**Number in Million**	**% of Poor People**	**Number in Million**	**% of Poor People**	**Number in Million**	**% of Poor People**
1990	9.4	16.8	17.8	14.3	27.2	15.1
1993	8.7	13.4	17.2	13.8	22.5	13.7
1996	7.2	9.7	15.3	12.3	15.3	11.3
1999	15.6	19.4	32.3	26.0	47.9	23.4
2002	13.3	14.5	25.1	21.1	38.4	18.2
2004	11.4	12.1	24.7	20.0	36.1	16.7
2006	14.3	13.3	21.9	24.7	39.0	17.7
2009	11.9	10.7	20. 6	17.4	32.5	14.1

Source: Central Bureau of Statistics/BPS (2009).

ing the low price of rice is ensured by the market-intervention policy through the involvement of a state-owned monopolist, namely *Badan Urusan Logistic (Bulog)*. To sustain rice production, the government provides subsidized credit schemes to farmers to purchase necessary inputs. However, such subsidy policies fail to increase rural income since setting low prices of agricultural commodities means that the government transfers the subsidy from farmers to urban laborers. As a result, industrialization in Indonesia contributes to the incidence of poverty in rural areas.

The question arises as to what extent the Indonesian government seeks to alleviate the rural poverty through microfinance. Prior to the 1990s, the government's poverty alleviation strategy with microfinance components was mainly undertaken through delivering subsidized credits to support agricultural productions, such as the *Bimas* program and *Kredit Usaha Tani/KUT* (a credit program for micro farmers). These subsidized credit schemes, however, failed in terms of high default rates. For instance, Robinson (2001) estimated that the default rate of the Bimas credit-subsidy program accounted for 54.5 percent, while the KUT default rate was approximately 18 percent annually. Two factors are responsible for such failures. Firstly, the policy of setting low prices of agricultural commodities, particularly rice, leads to low income of farmers. As a result, the lower income diminishes the repayment capability of farmers, leading to high default rates of subsidized credit schemes. Secondly, in a densely populated region such as Java, the growth of agricultural production to alleviate poverty is reaching its limit. This is the case as the industrial concentration in Java causes a significant decrease in the size of farmland. The agricultural census data of 2003 revealed that within the period of 2000-2002, the conversion of farmland into non-farm activities accounted for about 187,700ha annually (Sutomo 2004). This figure was far below the agricultural land conversion in the period of 1988-1993, which accounted for about 12,600ha annually (Nasution and Winoto 1999). Such a rapid deterioration of farmland then inhibits the subsidized credit programs from enhancing the agriculture production and the income of poor farmers.

The capabilities of MFIs of overcoming information and enforcement problems play a vital role in microfinance operations. The microfinance literature suggests that group lending (the Grameen Bank model) is one of the prominent solutions to such problems. According to Ghatak and Guinnane (1999), grouping a number of poor borrowers who know one another gives rise to social collaterals in the forms of moral sanction and peer pressure to delinquent borrowers. These collateral substitutes then enable MFIs to reduce information and enforcement problems. However, the application of group lending method is relatively new in Indonesia. The in-

come-generating project for poor families *(Usaha Peningkatan Pendapatan Keluarga Sejahtera (UPPKS)* has begun undertaking group lending since 1996. Hariyadi (2003) estimates that this lending method helps deliver small loans to 584,577 groups, encompassing 10.4 million poor members.

NGOs have also implemented group lending programs in Indonesia. The group lending programs of some NGOs gain a significant progress in terms of operational scale and loan mobilization. These group lending programs include *Yayasan Mitra Karya* established in 1993, *Yayasan Mitra Usaha (YMU)* in 1998, *Yayasan Dharma Bhakti Parasahabat (YDBP)* in 1999, and Ganesha Microfinance Foundation in 2003. For instance, the YMU has doubled the number of poor borrower groups served from 301 in 1998 to 653 in 2003, covering 3,440 members. Lending mobilization also significantly increased from Rp1.2 billion (US$130,434) in 1998 to Rp2.5 billion (US$222,934) in 2003. Similarly, the progress of group lending program by the YDBP could be recognized through a significant increase in lending mobilization and group membership. Since its establishment in 1999, the outstanding loans of the YDBP have improved from Rp3.9 billion (US$423,910) to Rp9.6 billion (US$1.0 million) in 2003. The active members of the groups also significantly increased from 2,250 in 1999 to 16,595 in 2003 (Haryadi 2003). The same is true for the replication of Grameen Bank model by the Ganesha NGO. The group lending program of the Ganesha could maintain the growth of loans at 50 percent annually. The number of poor borrowers involved in the group lending program by the Ganesha also significantly increased from 923 in 2003 to 16,056 in 2005 (Ganesha 2006).

However, Parhusip and Seibel (2000) argue that the replications of the Grameen Bank model in Indonesia remain far from satisfaction. 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 an operationally profitable microbank. According to Robinson (2001), 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 microfinance businesses to the Indonesian context. For instance, the rigid target for serving the poor disadvantages the Grameen Bank replications because the failures of poor members to repay will substantially deteriorate their financial bases. Secondly, the reliance on subsidies plus the rigid target of poor clients lower saving mobilization of the Grameen Bank replications in Indonesia (Robinson 2001). The logic is that the reliance on subsidies tends to result in operational inefficiency and unwillingness of the Grameen Bank replications to mobilize savings (Murdoch 2006, Armendaris de Aghion and Murdoch 2005). A focus on poor borrowers con-

strains saving mobilizations of the Grameen Bank replications due to the subsistence income of the poor.

The Indonesian government has long utilized cooperatives to help alleviate poverty. However, their aim has never been to build sound business practices of cooperatives. Instead, they are employed to channel subsidized credit schemes to the poor. As a result, the widespread failures of subsidized credits adversely cause cooperatives to suffer from a lack of trust, thereby failing to mobilize voluntary savings of their members. Moreover, a large number of cooperatives often experience operational defaults due to mismanagement and corruption. As a consequence, many cooperatives, especially government-sponsored cooperatives (e.g., KUDs), remain highly dependent upon subsidies from the government (Charitonenko and Afwan 2003). Nevertheless, the recent developments of credit cooperatives *(Koperasi Simpan-Pinjam/KSP and Unit Usaha Simpan Pinjam Koperasi/ USP)* and Islamic cooperatives *(Baitul Mal wat Tanwil/BMT)* restore new expectations that cooperatives have the potential to be prominent MFIs. For instance, data published by the Ministry of Cooperatives and Small and Medium Enterprises indicate an increase in the number of KSPs and USPs from 37,220 in 2000 to 38,000 in 2005.

Some microbanks such as BRI-units, BKKs and BPRs have also successfully utilized lending methods on the basis of social capital. Robinson (2001) and Chavez and Gonzales-Vega (1996) recognize that the lending progress of these MFIs has been associated with frequent face-to-face contacts between their lending staff and clients. It is undertaken through the pro-active screening processes in which the lending staff of these MFIs frequently visits the workplaces and homes of borrowers. As such, the lending staff can recognize the pre-existing networks of borrowers. Information on the creditworthiness of borrowers can also be gathered from their neighbors, relatives, and community leaders. The lending staff is encouraged to treat clients with friendly and respectful manners so as to develop close relationships with, trustworthiness, and loyalty of borrowers. Building a close relationship is also perceived as important, providing incentives for borrowers to prudently manage their loans. Moreover, lending contracts are also linked to community leaders in the form of loan co-signers or witnesses. The aim is to generate moral pressure and sanction to borrowers to repay their loans. According to Robinson (2001) and Mosley (2001), the utilization of social capital is found to lead to high repayment rates of BRI-units and BKKs, contributing to their financial progress.

The discussion above has shown that poverty remains a major problem in Indonesia. The subsidized credit programs of the government fail to alleviate poverty due to the problem of high default rate. The subsidized credit of the Bimas program, for instance,

could not sustain its operational services to poor farmers owing to the high rate of loan defaults. As previously emphasized, such a high default rate is closely associated with the low level of farmers' income. When income is low, the ability of farmers to sustain the repayments of subsidized credit schemes is also low, leading to high default rates. In the case of Java, the low farmers' income is particularly related to the small size of farmland, the traditional methods of farming, and the rapid development of industrial sector causing a significant decrease in the size of farmland (Nugroho 2009).

The utilization of cooperatives as a channeling agent of subsidized credits has yet to produce better outcomes of the country's microfinance programs. Instead, many government-sponsored cooperatives (e.g., KUDs) fail to become self-financing MFIs as they remain dependent on subsidies. The replications of the Grameen Bank model in Indonesia are also far from being sustainable due to failures to mobilize savings. However, other MFIs such as moneylenders, credit cooperatives, and microbanks (e.g., BRI-unit and BPRs) can sustain business operations without subsidy. Utilizing lending methods on the basis of profitability, these MFIs can sustain self-financing capacity to serve their poor clients. The importance of operational profitability underpins the commercial approach to developing the microfinance industry in Indonesia. The successful performance of BRI-unit system provides empirical evidence to support the implementation of commercial approach to microfinance operations.

Microfinance Policy Bias toward Commercial Practices of Microbanks

There are two opposing approaches concerning the suitable way to serve poor people and MSEs. The first is *the commercialization approach* through which MFIs should achieve profitability to sustain their financial operations. The central focus of this approach is on attaining healthy MFIs in the sense of having profitable operations. The logic is that failure to gain sufficient profits will deteriorate capital base, leading to the bankruptcies of MFIs. The future of the microfinance industry, then, comprises few large-scale formal MFIs with profit-driven operations (Charitonenko et al. 2004, Christen 2001). According to this approach, the most favorable model of microfinance development in Indonesia is to follow the success of the BRI-unit system (Robinson 2001). The operational success of the BRI-unit can be achieved by implementing an operational focus while serving small-scale clients. In contrast, the second approach is *the welfarist* in which the focus of microfinance explicitly aims at reducing poverty. Hence, the targeted clients of MFIs are the (very) poor people, and the microfinance services are delivered to help them get out of poverty. According to this approach, the successful indicator of MFIs is to

follow the Grameen Bank model in Bangladesh and the village bank model of the Foundation for International Community Assistance (FINCA) (Woller et al. 1999). In the Grameen Bank and FINCA models, operational profitability is not the main concern of microfinance services. Instead, the major objective of such models is to provide the poor with an access to microfinance.

Microfinance development in Indonesia is more likely to follow the commercialization approach rather than the welfarist approach. The development of local-credit institutions, such as BKKs in Central Java, LDKPs in East Java, LDPs in Bali, is intended to serve the poor. These MFIs can fully adopt the microbank regulations as they have a social mission of serving the poor. However, the recent microbank policy of the central bank requires the BKKs, LDKPs, and LDPs across the country to transform their businesses into the microbank system (BPRs). This transformation mainly purports to strengthen the sound financial practices of microbanks, including CAMEL (Capital adequacy, Asset quality, Management, Earnings, and Liquidity) (Martowijoyo, 2007). However, the adherence to CAMEL, the greater minimum capital, and the loan-loss provision have shifted the market segment of microbanks toward higher income groups. In surveys on BPRs and BKKs in Surakarta and its surrounding areas, Nugroho (2009) finds that the new microbank policy reduces the ability to expand to new borrowers since the microbank staff spends more time and efforts to prepare weekly and monthly reports to the financial authority (Nugroho 2009). More importantly, Martowijoyo (2007) shows that the new CAMEL ratings of microbanks have excluded criteria for measuring the outreach to serve poor people, such as the number of village posts, new borrowers served, and loan disbursements. Considering the high costs of managing small loans, many microbanks become reluctant to serve poor people. The recent progression of credit cooperatives and BMTs across rural and semi-urban areas of Indonesia is probably a result of a decline in the supply of microbank loans to poor people and micro-scale enterprises.

However, there are also microfinance programs that seek to follow the welfarist approach, including the microcredit programs of the government and the local NGOs that gain financial supports from international donors and the government to alleviate poverty through microfinance. The major government-credit programs include the introduction of Rural Income Generation Project *(Proyek Peningkatan Pendapatan Petani dan Nelayan Kecil)* and National Family Planning Coordination Board, which are set up to promote the national family welfare income generation *(Usaha Peningkatan Pendapatan Keluarga Sejahtera (UPPKS)*. In 2002, the government allocated around US$155.5 million to finance these projects (Charitonenko and Afwan 2003). Since the late 1990s, some NGOs have also

actively replicated the Grameen Bank model in Indonesia, among others are *Yayasan Mitra Karya* established in 1993, *Yayasan Mitra Usaha (YMU)* in 1998, *Yayasan Dharma Bhakti Parasahabat (YDBP)* in 1999, and Ganesha Foundation in 2003.

However, many believe that the government-credit programs of Indonesia are very likely to experience the same failures of the programs in the 1970s (e.g., Bimas program). There is evidence that cheap loans discourage repayments as the targeted recipients often consider such loans to be *grants* (Adams and Vogel 1986). Many credit programs are faced with misplaced targeting because of a lack of knowledge of microfinance and poverty issues. Poor people are often excluded from microcredit programs because they are deemed not having creditworthiness (Datta 2004). Charitonenko and Afwan (2003) warn that the government credit-subsidy programs undermine the microfinance development in Indonesia through crowding-out effects of cheap credits. According to Todd (1999), such cheap credits diminish the credit discipline of MFIs delivering non-subsidized credits, thereby rendering their expansion to new clients quite difficult.

Institutional Characteristics of the Microfinance Industry

The heterogeneous characteristics of clients and institutions matter in microfinance in relation to informational and enforcement problems of lending to the poor. There is evidence that the poor have a diverse capacity to get an access to financial services due to differences in income, assets, skills, education levels, and the like. Heterogeneous clients penetrate informational problems as appraising the creditworthiness of the poor is difficult due to geographical remoteness, mini-scale businesses, and inappropriate accounting reports (Zeller 2003). Lending to the poor generates enforcement problems since lenders cannot enforce repayments due to a lack of collateral (Hoff et al. 1993). Because of their specific operational characteristics, MFIs do not have an equal capacity to overcome such problems. Microbanks are less flexible in serving the poor compared to informal and semi-formal MFIs such as moneylenders and cooperatives. Being a formal entity, microbanks should conform to the rules set by shareholders and regulators (Meyer and Nagarajan 1999). Having formal banking procedures, microbanks also tend to be socially far from the networks of the poor. In contrast, moneylenders and cooperatives are operationally close to the social networks of the poor. Being a grassroots institution, these MFIs can link financial services with the social networks of the poor. As such, they can gather information on the creditworthiness of poor borrowers, and more capable of exploiting social sanctions to enforce repayments. In this regard, informal and semi-formal MFIs are said to have a greater competitive advantage in lending to poor people

than do formal MFIs (Zeller 2003, Meyer and Nagarajan 1999, Hoff and Stiglitz 1993).

It is evident that the Indonesian microfinance industry encompasses a variety of formal, semi-formal, and informal MFIs. However, the dynamic competition among MFIs does not result in a single equilibrium of market interest rate. Instead, various MFIs coexist with different interest charges on financial services, leading to market segmentation in microfinance. In many cases, interest charged by moneylenders is higher than that by cooperatives, while it can be twice that by microbanks. Such interest rate disparity occurs for two reasons. Firstly, microbanks set low interest rates because they seek to avoid adverse selection problems in microfinance markets (Hoff and Stiglitz, 1993, 1997). The rationale is that at a higher rate of loan interest, only "risky" borrowers have incentives to borrow whereas creditworthy borrowers are crowded out from the markets. Setting a low rate of loan interest is the way microbanks attempt to screen 'good' among 'bad' borrowers. However, when interest rates are set well below the market equilibrium, the supply-demand gap can lead to the presence of credit rationing. As a result, poor people are often excluded from the access to microbank loans as they are seen as risky borrowers due to a lack of collateral. The excess demand in the markets, then, paves the way for informal MFIs such as moneylenders and ROSCAs to provide small-scale loans to the poor. However, they tend to charge high loan interest rates to poor borrowers due to high operational costs of managing small loans. Among others, these costs include transportation expenditures to maintain close relationships with poor clients such as frequent visits to the homes and workplaces of the poor. Although the loan interest charged by informal MFIs is high, it does not result in the borrowing constraint of the poor. Unlike microbanks, lending provisions of informal and semi-formal MFIs such as moneylenders and cooperatives are delivered to the poor on the basis of social collaterals rather than physical collaterals.

Secondly, market segmentation in microfinance is associated with diverse capabilities of MFIs of coping with informational and enforcement problems in lending to poor people (Nugroho, 2009). Microfinance markets are segmented as formal MFIs, such as microbanks, prefer to penetrate non-poor clients, thereby neglecting the poor clients. On the other hand, the financial services of informal and semi-formal MFIs (e.g., credit cooperatives and moneylenders) have a focus on serving the poor. They cannot serve the non-poor clients due to limited funds and operational scales.

Theoretically, market segmentation in microfinance is related to the presence of informational problems since poor people have various motives in harnessing financial services. These motives include financing production, household expenditures, child

education, medication, social and religious ceremonies, wedding, and funeral. Such heterogeneous motives then lead to high risks of lending to the poor people as microbanks often fail to control the usage of loans. Similar to money, the use of loans is *fungible* or *interchangeable* (Adam and Vogel 1986). Having an inseparable economic activity, poor borrowers can utilize loans for production and/or consumption purposes. Because of such fungibility, lending to the poor creates high transaction costs of screening and monitoring the usage of loans. Such costs can be significantly high when lending involves a large number of small clients in dispersed locations. As a result, microbanks prefer to serve the segmented market of non-poor people as they are perceived as more bankable in the sense of having sufficient collaterals and being more capable of providing appropriate accounting reports than the poor. On the other hand, cooperatives and moneylenders can reduce the transaction costs of serving poor clients through informal lending practices. These informal MFIs can thus build close relationships with clients so as to gather information on the creditworthiness of poor borrowers and minimize the risk of loan default. Poor borrowers are also encouraged to repay for they consider the norms of friendship such as trust, honesty, and reciprocity.

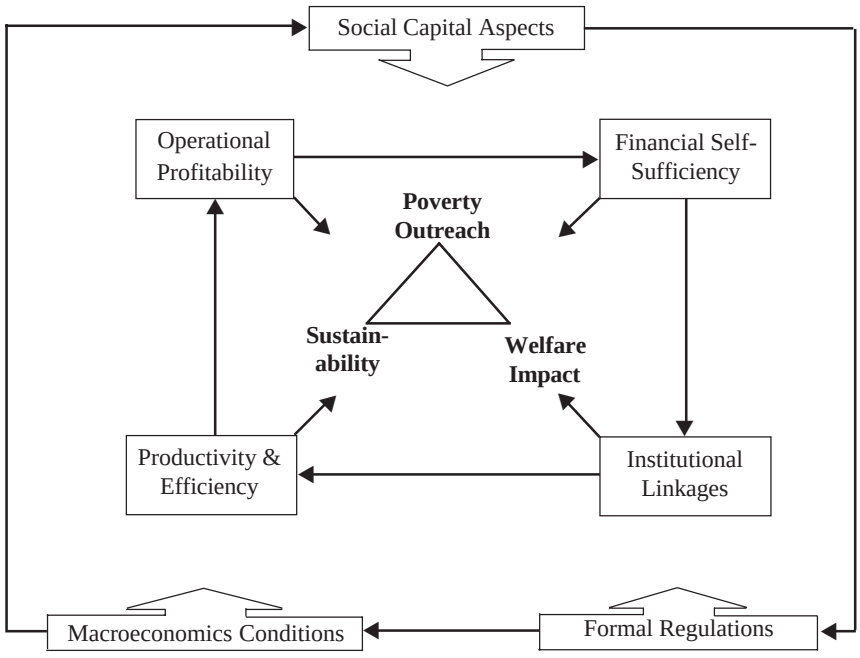
Trade-offs and Synergies among Microfinance Objectives

To be capable of reducing poverty, MFIs should accomplish the triangular objectives of maintaining: (1) operational sustainability, (2) outreach, and (3) the welfare impacts of microfinance on poor people (Zeller and Meyer 2002). The sustainability objective means that microfinance practices should result in sufficient profits so as to cover operational costs of serving poor clients. Apart from maintaining profitability, MFIs should deepen their financial services to a number of poor people, and this is basically the outreach objective of microfinance. Subsequently, the ultimate objective of microfinance is the extent to which an access to microfinance services can improve the welfare of the poor. Figure 1 describes internal and external factors affecting the achievements of microfinance objectives. The three hexagon shapes in the figure indicate the interrelated objectives of microfinance operations. It is worth noting, however, that there are potential synergies and contradictions among the three objectives of microfinance. A trade-off exists, for instance, between the sustainability and the outreach objectives of microbank operations, as focusing on profitability discourages microbanks

to provide small-scale loans to poor clients. The reason is that operational costs of managing small loans to a large number of poor borrowers are significantly higher than serving one large loan to non-poor clients. However, there are potential synergies between operational profitability and outreach of microbanks to provide saving services to poor people. Here, operational profitability is vital because none will put faith should MFIs be seen as unprofitable (Zeller and Johanssen 2006). There is mounting evidence that business and financial performances of BRI-units lead to the successful mobilization of rural savings, which in turn leads to a greater lending capacity.

Moreover, a potential synergy also arises between the achievement of sustainability and the welfare impacts of microfinance on poor clients. For instance, attempts to achieve profitability encourage microbanks to improve the quality of financial products. As a result, microbanks can anticipate poor clients demanding more sophisticated financial services. Having an access to more advanced financial services can lead the poor to expand production and income. There is much empirical evidence showing that an access to loans from microbanks facilitates poor people to improve child education and basic nutrition, and be more capable of financing production and smoothing consumption in re-

Figure 1. **Determinant Factors of Achieving the Objective of Microfinance Operations**



sponse to unpredictable shocks such as harvest failures, sicknesses, and deaths (e.g., Khandker 2003, Meyer and Nagarajan 1999, Hulme and Mosley 1996).

There are also potential trade-offs and synergies among the triangular objectives of semi-formal and informal MFIs. Unlike microbanks, the profitability objective of cooperatives and moneylenders can be achieved in parallel with fulfilling the outreach objective of serving poor clients. This is the case since attempts to maintain profitable operations do not cause these MFIs to increase the size of loans to poor people. Semi-formal and informal MFIs can provide small loans to the poor with profitable operations through exploiting social capitals of the poor. They can minimize the risk of such small-scale loans through informal lending approaches and linking the loans to the social networks of the poor. However, a trade-off exists between the outreach objective and the welfare impacts of informal loans on poor clients. In a survey on microfinance clients in Boyolali, Nugroho (2009) finds a positive correlation between borrowing from moneylenders and the probability of having household financial difficulties. This means that poor people borrowing from moneylenders have a greater probability of having financial problems since loans from moneylenders are often utilized to finance household consumption rather than production. Consequently, loans for consumptive purposes have few income-generating effects, and hence fail to reduce the probability of facing financial difficulties, implying that the capability of moneylenders of serving the outreach objective through providing small-scale loans cannot improve the welfare of poor people as such loans are used to finance consumption instead of supporting production. In addition, a contradiction also occurs between the profitability objective and the welfare impacts of informal finance on the poor. Moneylenders for instance, seek to maintain profitable operations by setting high loan interests to poor borrowers. Combined with frequent loan installments (e.g., daily and weekly), high loan interests of moneylenders put downward pressure on the low income of the poor. Profitable operations of moneylenders thus potentially have a low impact on the welfare of poor people.

Internal and External Factors in Achieving Microfinance Objectives

Recalling Figure 1, the achievements of microfinance objectives are affected by internal and external factors. The figure constitutes the internal factors, including productivity and efficiency, profitability, financial self-sufficiency, and operational linkages among MFIs. The figure also encompasses the external factors, consisting of social capital aspects, macroeconomic conditions, and formal regulations. These factors are interrelated in affecting the microfinance objectives. Regarding the internal factors, there is

evidence that profitability is the result of an increase in the labor productivity and efficiency of microfinance operations. The BRI-unit system, for instance, is the leading MFI in rural areas of Indonesia that has successfully maintained profitable operations through an increase in productivity and organizational efficiency. A small number of staff in each unit (e.g., five staff members and one chief officer) can generate remunerations that support the labor productivity of the BRI-units. Around 6 to 10 percent of annual profits of the BRI-unit are distributed to all employees as bonus incentives. Financial rewards and certificates of appreciation are also given to all staff of the BRI-units that achieve sound business practices. Such financial bonuses and awards provide strong incentives for the BRI-unit staff to increase labor productivity (Robinson 2001). However, the successful performance of the BRI-units is the result of long-term efforts and experiences in dealing with small-scale clients. The BRI-units took more than 25 years to become one of the most profitable MFIs in the world (Robinson, 2001).

The immediate effect of operational profitability is a greater capacity of MFIs to achieve financial self-sufficiency. The achievement of financial self-sufficiency depends on two-related factors: (1) profitability and (2) saving mobilization capacity of MFIs (see, Zeller and Johannsen 2006, Charitonenko and Afwan 2003, Charitonenko et al. 2004, Christen 2001). The profitability focus of microbanks can lead to a greater capability of mobilizing saving from the public. The profitable operations give rise to saving mobilization capacity because this is the basis for small-scale depositors to save their money with microbanks. It is evident that the key issue of micro-financial businesses is the matter of trust in the credibility of financial institutions. Depositors put faith in MFIs that hold huge cash because they recognize that such MFIs are operationally profitable. There is thus no doubt that the saving mobilization capacity of MFIs hinges on their capabilities of maintaining profitable operations. A greater saving mobilization capacity, then, facilitates MFIs to finance their operations, which are deemed vital for achieving the outreach objective and the welfare impacts of microfinance services on poor clients.

However, the outreach objective and the welfare impacts of micro-finance cannot be attained without operational linkages among formal, semi-formal, and informal MFIs. Such operational linkages are important to avoid trade-offs among the triangular objectives of microfinance operations. As previously stated, focusing on profitability can reduce the ability of microbanks to provide loans to poor clients. In contrast, semi-formal and informal MFIs such as cooperatives, ROSCAs, and moneylenders can attain profitable operations in parallel with deepening their outreach of serving the poor. In this regard, the achievements of the sustainability and out-

reach objectives of microbanks can be synergized by developing operational linkages with cooperatives, moneylenders, and other informal MFIs, such as ROSCAs. These MFIs can play a role as channeling agents of microbank loans to poor clients. Over time, the operational linkages facilitate microbanks to maintain the expansion of serving non-poor clients without reducing their outreach capability of serving the poor. This can be accomplished in two ways. Firstly, the linkage of banks may reduce the operational costs of managing small-scale loans to poor clients through decentralizing loan monitoring and collection to cooperatives, ROSCAs, and moneylenders. Secondly, in the long run, the linkage of banks can gain market expansion through a greater demand of the poor for financial services of microbanks. This will materialize as small loans provided by informal and semi-formal MFIs can increase the production and the income of the poor, leading to the demand for more sophisticated financial products of microbanks. Subsequently, this indicates that a potential synergy between the sustainability objective and the welfare impacts of microfinance can be attained when there are operational linkages among the MFIs. In the microfinance survey in Boyolali, Nugroho (2009) finds that the lending of the BRI-units through self-help groups of poor people, such as ROSCAs, results in high repayment rates. This is consistent with the results of Parhusip and Seibel (2000) that having operational linkages with cooperatives enhances the lending mobilizations of microbanks to poor people with high loan repayment rates.

From the perspective of informal and semi-formal MFIs, the major benefit of having operational linkages is that they could obtain financial supports and business trainings, such as basic accounting skills, from their fellow microbanks. Such linkages help informal MFIs improve productivity and operational efficiency. However, it is worth noting that the development of operational linkages among MFIs hinges on their business performance. Microbanks are possibly unwilling to establish operational linkages with semi-formal and informal MFIs that are seen to have unprofitable operations. Only microbanks that are operationally profitable and financially sufficient will be capable of developing operational linkages with other MFIs. This indicates that sound business practices are a prerequisite for the achievement of market-driven linkages among formal, semi-formal, and informal MFIs.

Furthermore, in Figure 1, social capitals of poor clients can be recognized as internal and external factors that contribute to the achievements of microfinance objectives. Being an internal factor, social capital affects business operations of MFIs in serving poor people. Lending provisions of cooperatives, ROSCAs, and moneylenders are delivered to poor people on the basis of trust, friendship, and reciprocity. These MFIs can provide non-

collateral loans to poor borrowers because they can link loans with the social networks of the poor. Face-to-face interactions and close friendships with poor clients facilitate these MFIs to recognize the creditworthiness of the poor, thus minimizing the rate of loan default. Having close friendships with lenders, the poor borrowers are encouraged to repay their loans since loan defaults can lead to them facing social punishments (e.g., bad reputation and social exclusion) as the disappointed lenders will inform the public.

Moreover, social capital can be seen as an external factor in the sense that it arises in the context of community relationship. Here, social capital is similar to an institutional environment that affects decisions to lend and borrow from others. For instance, a lending provision on the basis of moral community, such as lending among relatives, neighbors, and friends, is the way poor people cope with the lack of access to bank loans. It can provide an access to financing as loans are delivered without physical collateral, and the loans often carry no (very low) interest rate. Social capital in the form of kinship relationships may also enhance the access of poor people to formal financing in two ways. First, maintaining kinship and friendship networks can lead to a greater access to microbank loans. For instance, maintaining relationships with relatives and community leaders will enhance the access of the poor to microbank loans through their roles as loan co-signers and witnesses. Second, relatives, friends, and community leaders could provide information on the borrowing procedures of microbanks. In the survey on microfinance clients in Boyolali district, Nugroho (2009) provides evidence that a large proportion of poor people obtain microbank loans through information provided by their relatives, friends, and community leaders. Hence, it can be said that the utilization of social and family networks can help the poor reduce informational constraints in accessing formal financing.

Moreover, the external factors affecting the microfinance objectives are macroeconomic conditions and formal regulations of MFIs. Several studies have found that the unstable macroeconomic circumstances, such as banking (financial) crisis, have severe impacts on the microfinance industry. A collapse of MFIs resulting from financial crisis can create losses of valuable savings of poor people, and potentially reduce the welfare of the poor. More importantly, the collapses of MFIs may also lead to the loss of relationship-specific social capital established between MFIs and poor clients (Moll 2005). Social capitals in the forms of mutual trust and social networks between MFIs and poor clients cannot be replaced in the short-to-medium run. Instead, building up confidence of the poor clients with MFIs requires long-term efforts. It is also evident that financial crisis can hinder the development of MFIs as the government often prefers to restructure large banks rather than MFIs. In the

Indonesian financial crisis of 1997/98, for instance, the government's priority was to rescue large banks while a large number of insolvent MFIs were less visible, and thereby neglected. The government is seemingly unwilling to give financial supports to the insolvent MFIs as they prefer to work with "modern" institutions, such as BRI-units (Martowijoyo 2007). Hence, the achievements of microfinance objectives in Indonesia are highly affected by the macroeconomic stability.

The second external factor is associated with the formal regulations of MFIs. Microfinance regulations in Indonesia are complex in the sense that various formal institutions are involved in the microfinance supervision and regulation. The Ministry of Cooperatives and Small and Medium Enterprises, for instance, is responsible for supervising and promoting credit cooperatives. The supervisory role on microbanks is undertaken by the central bank, Bank Indonesia. BRI-units supervise the rural credit institutions (BKDs) on behalf of the central bank whereas the provincial development bank (BPD) picks up the role of supervising the local-government credit banks, such as BKKs in Central Java province. Following the financial crisis of 1997/98, there has been a substantial change in microbank regulations in Indonesia. Microbank regulations were renewed in 2000 so as to enhance the capital structure of the microbank industry. Sound banking practices of microbanks have been advanced through the implementation of new CAMEL requirements (Capital adequacy, Assets quality, Management, Earnings, and Liquidity). The new CAMEL policy can strengthen sound financial practices of microbanks, but potentially decrease their outreach capacity of serving poor people.

Compliance with the new CAMEL rating requirements has resulted in microbanks, particularly BKKs, suffering from a decline in the number of poor clients. They shift segmented markets from poor people to non-poor people to maintain profitability, thereby conforming to the new CAMEL requirements. A number of village posts and small-scale clients are no longer considered in the new CAMEL rating criteria. As a result, they are discouraged from serving poor people. The new microbank policy also leads to the termination of a long-term linkage between provincial development banks (e.g., BPDs) and local government-owned credit institutions (such as BKKs). The BPD of the Central Java province is no longer permitted to supervise the BKKs as they have been transformed into microbanks. The business operations of BKKs are presently subject to the central bank regulations and supervision. Moreover, the BKKs also cannot legally place their liquidity surpluses in the BPDs because such a placement is subject to legal lending limits for the third party. Consequently, the BPDs have withdrawn their share contributions in the BKKs, thus reducing the relationship between BPDs and BKKs

(Martowijoyo 2007). Therefore, the BKKs will be no longer likely to gain financial supports and trainings from the BPDs.

For the semi-formal MFIs, the cooperative regulation of 1999 abolishes the monopoly of state-sponsored cooperatives (KUDs) as the only cooperative in the sub-district level. This policy paves the way for an increase in the number of microcredit cooperatives, including Islamic-based cooperatives (BMTs). The number of credit cooperatives *(Koperasi Simpan Pinjam/KSP)* significantly increased from 1.0 million in 2000 to 1.6 million in 2006, while BMTs increased from 2,914 to 3,038 (Ministry of Cooperatives and SMEs 2006). However, since 2004, the status of the Ministry of Cooperatives has been reduced to a "state ministry", meaning that it no longer has provincial and district-level offices, which results in a lower capability of supervising cooperatives. Overall, it can be concluded that the changes in formal regulations potentially have both positive and negative effects on the achievements of microfinance objectives.

Conclusion and Policy Implications

The commercialization approach claims that there is no contradiction between profitability and the outreach capacity of MFIs to serve the poor. Instead, profitability is the milestone of microfinance operations, which provides sustainable financial serves to the poor. This view arises as the proponents of commercialization propose the business-like approaches to understanding the business operations of MFIs. Hence, MFIs are recognized as similar to other "modern" financial institutions, and their business operations are narrowly assessed according to the prudent standards of banking practices. This paper does not support this view with respect to the diverse operational characteristics of MFIs in Indonesia. MFIs are not an automatic panacea to poverty outreach as they have different capabilities of serving poor people. Indeed, in this paper, we propose that a trade-off exists between the profitability and the outreach objectives of microbanks to serve poor people. Unlike microbanks, however, cooperatives, ROSCAs, and moneylenders can maintain profitable operations without reducing their capabilities of serving poor people. These MFIs can serve the poor with profitable operations as they can link loans to the social networks of the poor people. However, the financial businesses of these MFIs are largely constrained by limited resources, low skills, small-scale operations, and locality. As such, they mostly fail to anticipate the poor demanding sophisticated financial services. A single commercial-based approach is thus inappropriate to understanding the complexity of the microfinance industry in Indonesia. Instead, microfinance policies and practices require a holistic approach

that links diverse operational characteristics of MFIs to the socioeconomic nature of poor clients.

This paper offers the following policy implications from the perspectives of microfinance practitioners, policymakers, and scholars. Firstly, it is evident that Indonesia has successfully promoted its microfinance industry through the commercialization approach to microbank operations. The widely-cited example is the development of the BRI-units and the BPR systems. However, the notion that the commercial practices of microbanks lead to a greater capability of serving poor people should be challenged. It is found that the majority of the BRI-unit clients are middle-class farmers, traders, and government officials. The average size of the BRI-unit loans is too large to be accessible by poor people demanding small-scale loans. In this regard, this paper proposes that a favorable microfinance policy for Indonesia promote the development of microbanks in parallel with semi-formal and informal MFIs, such as cooperatives, rural banks, self-help groups, and moneylenders. As such, the microfinance authority should facilitate operational linkages among the MFIs through the following policies. *First,* the microbank authority can provide tax incentives to microbanks that have successfully linked their business operations to cooperatives, rural banks, microfinance NGOs, and self-help groups of poor people. Second, the authority should design the CAMEL rating criteria of microbanks that include the number of cooperatives, NGOs, and self-help groups being served. This will encourage microbanks to develop operational linkages with semi-formal and informal MFIs. Third, the operational linkages with informal and semi-formal MFIs can be encouraged by promoting the corporate social responsibility of microbanks to provide financial business trainings to cooperatives, self-help groups (ROSCAs), rural banks (e.g., BKDs), and small-enterprise associations (farmer and petty trader associations). The aim is to enhance the capacity building of poor people and micro-enterprises in dealing with financial businesses.

Secondly, microbank policy intervention should not only focus on the financial aspect but also on the outreach capability of serving poor clients. Despite the achievement of profitability, microbanks should accomplish the social mission of serving poor people. Hence, the microbank authority should create regulations that strengthen prudent microbank operations in parallel with enhancing the outreach capacity of serving poor people. Such regulations, among others, include the microbank rating criteria that value the number of poor clients being served, small-scale savings and loans, and village posts. Considering the high costs of managing small loans and village posts, the government could provide financial subsidies in the form of soft loans or tax relief to support the operations of village posts. Furthermore, the deposit

guarantee policy for microbanks since 1998 should be sustained in order to protect poor savers against capital losses due to the bankruptcies of microbanks.

Thirdly, it is vital for microfinance practitioners, such as cooperative leaders, microfinance NGOs, and microbank officers to continuously create financial innovations of serving poor clients. However, such innovations do not necessarily mean the creation of new financial products or methods. Instead, they can be developed through the adaptation of existing business practices of informal MFIs, such as moneylenders and ROSCAs. These informal MFIs have successfully coped with the high risk of lending to the poor people through informal approaches. There is evidence that informal lending approaches enable informal MFIs to exploit the social networks of poor clients, leading to the high repayment rate of loans. In this regard, microfinance practitioners need to consider informal approaches rather than formal borrowing procedures in dealing with poor clients. This can be undertaken through frequent visits of lending officers to the homes and workplaces of the poor clients. The benefit of having close friendships with clients is the ability to generate reciprocal obligations of the poor borrowers to repay their loans. Lending innovation can also be developed through delivering loans to self-help groups of poor people, such as ROSCAs, religious associations, and many other community associations. As has been widely known, lending to groups of poor people enables MFIs to exploit the roles of social cohesion and peer pressure in minimizing the rate of loan defaults.

Fourthly, government microcredit programs should be linked to the existing networks of rural community, including religious organizations, self-help groups, and micro-enterprise associations. In such community organizations, face-to-face interactions and community leaders can help strengthen the accountability of microcredit programs so as to avoid corrupt practices. Furthermore, community leaders, local academics, and NGOs can be assigned to provide financial and business trainings and organize group meetings and discussions, while microbanks play a role in channeling microcredit programs to group members. In the long run, the performance of such microcredit programs can underpin the functioning of social intermediations of microfinance to poor people. Social intermediation of microfinance means that the financial services of MFIs are delivered in parallel with strengthening production, human resources, and social capitals (e.g., wider networks) of poor clients, and that they are prepared to deal with more advanced banking practices.

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