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Microfinance Industry in Indonesia : Challenge and Oppourtunity on Asean Economic Community

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Abstract: ***The emerging of MSMEs in Indonesia is deliberated significantly among the Asean Economic Community. In accordance with the objective of AEC, the purpose of this paper is to examine the influence of the microfinance industry on the development of MSMEs, as one item in the AEC Agreement. The literature review reveal that on the microfinance industry has a significant influence on the development of MSMEs, on the other hand both of AEC and the policy of Indonesia Goverment argued as the factor affecting the growth of the microfinance industry as a strategic industry in the development of MSMEs.***

Keywords: Microfinance Industry, Govermant Policy, MSMEs Development, AEC (Asean Economic Community).

1. Introduction

This paper aims to analyze the challenges and opportunities of the microfinance industry in facing the MEA. The focus of the analysis is on the microfinance industry as a strategic industry towards the development of MSMEs in Indonesia related to the integration market in ASEAN countries. ASEAN Economic Community, being an external factor in the microfinance industry in Indonesia and Government policy on the microfinance industry in developing MSMEs are internal factors in the proposed analytical framework. As it is known that one of the third main pillars in the MEA objectives is ASEAN as an area with equitable economic development with elements of small and medium enterprise development.

Small and medium enterprises have an important role in contributing to the absorption of labor and in the role of economic structure in Indonesia. A key factor in the development of MSMEs in Indonesia is the availability of capital services through affordable and widely accessible financial services, thereby the microfinance and banking industries generally have an important role in supporting the readiness of MSMEs in achieving MEA goals and Indonesia's readiness to address the integration market through ASEAN Economic Community (AEC).

2. ASEAN Economic Community (AEC)

Having first declared its support for the establishment of the ASEAN Economic Community (AEC) in 2007, Indonesia now faces the significant hurdle of realising the extensive regional integration that it mandates before 1st January 2016. In progressing beyond requirements for the elimination of tariffs detailed in the ASEAN Free Trade Area (AFTA), the AEC aims to establish a single market and production base among ASEAN member states by necessitating the free flow of goods, services, investment, capital and skilled labour.

ASEAN Economic Community is an integrated economic region in Southeast Asia. This term is known as the ASEAN Economic Community (MEA), the formation of the MEA marks Indonesia and nine other ASEAN members into a very tight competition in the economic field. Basically, the MEA is a very important place for the progress of ASEAN countries in realizing prosperity, so that its existence must be responded positively, and it is expected that countries in Southeast Asia can compete and can put ASEAN into the biggest market in the world.

The establishment of this single market encourages ASEAN countries to achieve stability and strong economic progress in the face of global competition. Although the existence of the MEA is still a matter of pros and cons, the debate tends to question the readiness of member countries in facing the new economic climate in Southeast Asia. The main purpose of MEA is to eliminate significantly the obstacles of economic activity across the region, and be implemented through four main pillars:

- ASEAN as a single market and an international production base with free flow elements of goods, services, investment, educated labor and a more free flow of capital.
- ASEAN as a region with high economic competitiveness (competitive economic region), with elements of competition rules, consumer protection, intellectual property rights, infrastructure development, taxation, and e-commerce;
- ASEAN as an area with equitable economic development with elements of small and medium enterprise development, and ASEAN integration initiatives for CMLV countries (Cambodia, Myanmar, Laos, and Vietnam); and
- ASEAN as a region fully integrated with the global economy with an element of a coherent approach to economic relations outside the region, and increasing participation in global production networks.

Challenges in the Field of Goods and Services Trade

Free trade flows, both goods and services, will raise competition risk. That is, in addition to being an exporting country, Indonesia is also the target of exporters from other countries. This has resulted in the emergence of a large variety of outsourced products to Indonesia, if the products coming from abroad have better quality, local industry will be threatened. The major effect is the existence of trade balance deficit.

Business actors, especially producers must be able to create products that have the best standards, so that local products still have quality. In this sector trade in goods and services, which has a great opportunity is the perpetrators of MSMEs. Nevertheless, there are still some weaknesses faced by SMEs, namely: First, the cost of domestic production is very expensive so as not to be able to create production efficiency. Second, the lack of knowledge of small and medium entrepreneurs (SMEs) in producing goods or services quality, and the three aspects of capital.

These three things are very related and need to be immediately solved by both the Government and the business actors themselves. Therefore, since the introduction of the MEA in early January 2016, the government has worked hard through the Center for Research and Standardization of Industries (Baristand) under the coordination of the Ministry of Industry (Kemenperin) to socialize and improve the quality of MSMEs human resources in Indonesia.

3. Indonesian Economy

The Indonesian economy will continue to grow in 2017 and 2018, buoyed by increased private investment and exports, as well as higher public infrastructure spending. Indonesia's gross domestic product growth will reach 5.1% this year and 5.3% in 2018. In 2016, the Indonesian economy grew 5.0% (ADB, 2017). Government infrastructure spending continues to support economic activity, and private consumption and private investment show signs of strengthening the economy. The current account deficit is projected to be stable.

The government has released a series of packages of economic policy reforms over the last year to improve the business environment, streamline investment and liberalize inward investments. There should be scope for some rate cuts in the medium term, as inflation is projected to remain intact. However, the balance sheet deteriorated due to slower growth and lower commodity prices. Public spending is tied to avoid violating the legal deficit limit of 3% of GDP. (ADB, 2017).

Government priorities in increasing infrastructure spending and social services, especially health and education, will increase growth and make it more inclusive. However, the proximity of the deficit with the legal ceiling has led to cuts in planned expenditures. Policies are needed to address the narrow tax base, the low number of taxpayers and weak compliance (World Bank, 2017).

The analysis of ADB and the World Bank is justified by Finance Minister Sri Mulyani (2017) stating that, in 2016 we expect to have bottom, so that in 2017 start positive. The indicator was visible from all the engine economy started to run normally. External factors are no longer a factor in Indonesia's economic weakness, further Sri Mulyani said that, with per capita income of nearly US $ 4,000 and population close to 250 million people, Indonesia's economy is currently entering middle income country, the government will use all instruments to overcome stagnation , So that Indonesia can become a country with the fifth major economy in 2045 and the MSME sector can be an asset of the nation and not a liability.

The optimism of the government and national economic conditions as described above, and adequate support from the government in the policy of empowerment of MSMEs, becomes an important capital in the readiness to face the ongoing ASEAN economic integration.

4. Microfinance and SMEs (Small & Medium Entreprises)

Microfinance is a phenomenon over the last twenty-five years that needs little introduction.Most MFIs deal in sub-prime markets, which offer services to poor and needy people. Theglobal crisis in 2008, driven by the collapse of major banks in the USA and Europe (NorthernRock), shows “the perception that microfinance operation are somehow riskier than theoperation of the more established middle class banking sector has clearly been proved wrong”(Hulme & Arun, 2009 : 15). Microfinance is a popular financial instrument particularly indeveloping countries whose governments cannot provide some of their citizens with sufficientwelfare. In other words, voluntary sectors and microfinance may be viewed as the failures ofgovernment rural credit schemes to reach small farmers (Hulme & Mosley, 1996), a failure ofthe formal banking sectors to fulfill low-income household needs, a government strategy to cutwelfare spending and diminishing the role of the state in economic development, basichealthcare, education and welfare (Fernando, 2006). The failure of government to providesubsidised agricultural credit for developing the poor in the past due to higher transaction cost,interest rate restrictions, corrupt practices and high default rates have stimulated the growth ofinformal financial markets (Arun, 2009).

Microfinance is a financial product which provides financial services such as credit, saving and basic insurance to micro entrepreneurs. It is called “micro” because the poor as micro entrepreneurs can only afford to save, borrow, or buy insurance in small amounts that covers the outstanding balance on a loan owed to the microfinance institution. Microcredit or microfinance is expected to provide the capital for the informal business sector. The most famous MFI in the world is the Grameen Bank in Bangladesh. It is phenomenal because “its movement has blossomed and captured the public imagination, drawn billions of dollars in financing, reached millions of customers, and garnered a Nobel Peace Prize” (David Roodman & Morduch, June 2009). Hernandi de Soto in his book titled The Mystery of Capital (2001) bottom-lines the significance of informal business sector in a developing country’s economy.

In many developing countries, microfinance plays a vital role in providing the poor (i.e., small farmers, fishermen, and micro-entrepreneurs) with access to credit and helping them improve their lives by encouraging entrepreneurial activity (Arch, 2005; Bhatt & Tang, 2011; Khandker, 1996; Llanto, 2004). It has also proven to be “a potent tool for poverty reduction by helping the poor increase their income, smooth consumption, build assets, and reduce their vulnerabilities in times of contingencies and economic shocks" (Micu, 2010, p.4).

As an industry, microfinance has grown tremendously over the past decades, with players offering financial services to those who were "previously marginalised" (Arch, 2005, p.227). According to Micu (2010, p.4), "it now reaches more than 100 million poor people all over the world through a combined portfolio of US$15 billion." Moreover, programs such as ACCION's BancoSol in Bolivia, Bank Rakyat Indonesia's Unit Desa program in Indonesia, and the Grameen Bank in Bangladesh are often cited as evidence that "it is possible for microfinance institutions to make small loans to large numbers of poor people in a sustainable manner" (Bhatt & Tang, 2011, p.319).In line with the above opinions, it is clear that microfinance (micro credit) has an effect on the performance of SMEs (Rosman Mahmood M. MohdRosli, 2013). Thus, the greater the support of microfinance industry, the better the development of SMEs.

5. Microfinance Industry in Indonesia

The microfinance industry in Indonesia is exceptionally old. It is made of a largevariety of institutions, programs, services, clients, target groups, and is also subject to various legal, regulatory, and supervisory frameworks (Holloh, 2001). The country's microfinance industry is also one of the most commercialised in the world in terms of its provision of sustainable microfinance with wide scale and sustainable outreach (Charitonenko and Afwan, 2003).

Indonesia has come to be considered by many, including World Bank sources, a model country: both with regard to its success in poverty reduction in recent decades and with regard to the vigor and diversity of its microfinance sector as it evolved over the past one hundred years. Since 1983 it has also provided an outstanding example of the direct impact of financial and economic liberalization policies on microfinance and poverty alleviation, proving beyond doubt that policies work. Decision-makers in countries that are just about to embark on such a course may greatly benefit from a thorough exposure to some of the experiences in Indonesia (Hans Dieter Seibel & Uben Parhusip, 1997).

The extent of poverty has been drastically reduced in Indonesia since 1970: from 60 % in 1970 to 14 % in 1993. Three major factors have been cited: explicit government policies, sustained economic growth and, since 1983, financial and economic deregulation. Annual rates of poverty reduction have been substantially higher after the deregulation of 1983 than before. Microfinance has played a role in that process. In 2013, the number of SMEs in Indonesia reached 57.9 million, and able to absorb the workforce of 104 million people of Indonesia (Kemenkop, 2013).

Indonesia more than 97% of micro and small businesses enterprises, the question of how to encourage growth and job creation are vital reduces the vulnerability to poverty of micro business owners where capital limitations limit their ability to grow. Very few Small businesses get credit from formal sources. Extending credit for this is a challenging task. Small businesses borrow for a relatively small amount, this makes them unable to get a commercial loan. Instead, most small business-borrowers in Indonesia get credit from various microfinance institutions (MFI).

In 2013, the Government issued UU No. 1 on Microfinance Institutions aimed at enhancing microfinance markets, financial access to micro-entrepreneurs, and financial inclusion, followed by OJK (Financial Services Authority) launching OJK Proxy to encourage financial inclusion in the year 2016. Indonesia is known as a pioneer country in doing microfinance revolution as written by microfinance expert Dr. Marguerite S. Robinson (2001), she said that BRI is the pioneer of the new paradigm shift in microfinance revolution. In addition, also a microfinance expert from Germany, Dr. Dirk Stenwand (2004), states that Indonesia is the largest microfinance laboratory in the world.

Bank BRI as a bank with core business in UMKM sector, especially micro segment is not only committed to being a business actor only, but Bank BRI actively build microfinance related discipline. Bank BRI has owned BRI International Institute for Microfinance & Financial Inclusion (BRIIM) which has been visited by 7,000 top level management from 50 countries around the world. This fact illustrates that the microfinance industry in Indonesia is worthy of study, and based on the theory of microfinance evolution put forward by Marguerite S. Robinson in 2001, where the new paradigm in microfinance is a microfinance service from subsidies to the sustainability of financial services, and the microfinance sector in Indonesia has fulfilled that paradigm.

The Government of Indonesia has long recognized the important role of microfinance on national economy, especially on poverty alleviation efforts. The main development was the formulation of the National Strategy for Microfinance in 1995, during which the Government launched its microfinance year in Indonesia. The Government of Indonesia lists the following principles as the foundation of national microfinance policy: (a) a policy environment that facilitates better private sector participation in microfinance, (b) Market-oriented financial and credit policies, (c) non participation Government agencies in the implementation of credit / guarantee program, and (d) greater role of the private sector / MFI in the provision of financial services. These principles serve as guidelines for subsequent policies and regulations designed to help microfinance industry actors achieve their twin goals to achieve financial outreach and sustainability.

Indonesia's microfinance sector performed healthily throughout 2015 with almost all financial institutions recording significant credit growth. The volume of microcredit disbursed by the country's largest state-owned bank, Bank Mandiri, for example, rose to 42.48 trillion IDR as of the end of December 2015, up 22.9% over December 2014.

The Financial Services Authority (OJK) also noted that Indonesian banks in general have complied with the OJK rules that mandate them to allocate 10% of their loan portfolio to small and medium enterprises (SMEs) in 2016 which will be increased to 20% in 2018. The Indonesian government's support for SMEs continues to improve too as evidenced by an increase in the allocation of the People's Business Credit (KUR) or small business loans from 30 trillion IDR in 2015 to 120 trillion IDR in 2016. In addition, OJK's decision to allow multifinance companies to disburse KUR will enhance the people's access to small business loans. Such a strategy is in line with President Joko Widodo's efforts to bolster the SME segment through simplifying processes in relation to starting a company and obtaining licenses (OJK, 2017).

The year 2015 was an exciting period for the Indonesian microfinance industry. Almost all banks, both state-owned and private, posted a significant growth in microcredit disbursement. According to Bank Indonesia (BI), SME loans grew 10.1% in 2015 to 739.8 trillion IDR as of December 2015 compared to 671.7 trillion IDR as of December 2014. On a monthly basis, SME loans recorded an increase of about 1% per month.

The SME loans consisted of 164.9 trillion IDR for micro enterprises, 215.9 trillion IDR for small enterprises and 359.0 trillion IDR for medium enterprises. About 537.2 trillion IDR of the loans are for working capital and 202.6 trillion IDR are for investment.Indonesia's largest state-owned bank, Bank Mandiri, for example, managed to disburse microcredit to the value of 42.4 trillion IDR in 2015, up 22.9% year on year from December 2014. This equates to 56% of the bank's total SME lending which reached 75.78 trillion IDR and 1,112,385 borrowers.

Bank Rakyat Indonesia (BRI), which focuses on microcredit and allocates 35% of its total credit portfolio to the SME sector, also enjoyed a similar growth in 2015 of 17% over the previous year. The bank managed to post high profits thanks to its huge volumes of microcredit that offers net interest margin (NIM) of at least 8%.According to data from the Indonesian central bank, the growth of microcredit continued into the first quarter of 2016. As of February 2016, SME loans accounted for 18% or equivalent to 728.97 trillion IDR of a total credit portfolio of 3,998.09 trillion IDR. State-owned banks remained the dominant force in SME financing by disbursing 82.61 trillion IDR in total. This is followed by the regional development banks (BPD) with total microcredit loans equating to 48 trillion IDR, private banks with 282.41 trillion IDR, and foreign banks as well as others accounting for 15.93 trillion IDR.

BRI was also a major contributor to the microcredit growth. In the first quarter of 2016, the bank's microcredit grew 22.2% from 91.8 trillion IDR in 2015 to 111.2 trillion IDR and contributed 31% of its total loans of 361.2 trillion IDR. Other banks, including private banks, are also aiming to increase their microcredit portfolio in 2016. Bank Tabungan Pensiunan Nasional (BTPN), for example, has set a target to increase its SME loans by 50% in 2016. In 2015, the bank disbursed microcredit and SME loans amounting to 8.73 trillion IDR and 6.86 trillion IDR, respectively.

A similar strategy was undertaken by Bank Negara Indonesia (BNI). In 2015, the state-owned bank disbursed a significant amount of loans to the SME sector with a total value of 42.2 trillion IDR. These loans were either disbursed directly to the SMEs or through cooperation with other financial institutions. The bank's linkage programme in 2015 has successfully disbursed loans of 3.2 trillion IDR whereby rural banks (BPR) accounted for the major share of 50%.The OJK recorded that banks in general have complied with its rules that mandate them to allocate 10% of their loan portfolio to small and medium enterprises in 2016 which will be increased to 20% in 2018.

Small business loans in Indonesia have bright prospects due to the sheer size of the SME market. According to data from the Ministry of Cooperatives and Small and Medium Enterprises, the number of SMEs in the country reached 55.2 million consisting of 54,559,969 microenterprises, 602,195 small enterprises and 44,280 medium enterprises. In Indonesia, SMEs account for 99.99% of the total number of existing businesses and absorb 97.24% of the labour force as well as contributing 57.48% of the country's GDP.

Shariah-based microfinance

Although the Islamic finance industry recorded growth of 6.1% in 2015, it still lags behind its conventional counterparts. Its contribution to microcredit growth is even smaller because the share of SME financing among Islamic financial institutions is only between 5-10% despite its natural inclination towards this type of cooperative style lending. The majority or 90% of Islamic microfinancing has been channeled to motor vehicle loans as opposed to the SME segment. To spur the growth of SME lending among Islamic banks, the OJK has offered incentives to relax the core capital requirements for Islamic banking if their SME financing accounts for 20% of the total loans. However, a constraint to shariah compliant microfinance growth is the relatively high level of non-performed financing (NPF) among Islamic banks which reached 4.73% whereby the SME sector accounted for 43%. This has made Islamic financial institutions more cautious in providing financing to small businesses that are considered to be at higher risk.

Indonesia's largest Islamic bank, Bank Syariah Mandiri (BSM), for example, disbursed loans of 70.37 trillion IDR in 2015, an increase of 5.1% from 66.94 trillion IDR in 2014. Its microfinancing, however, only accounts for 3.5 trillion IDR or only 5% of its total loan portfolio.

KUR: New growth driver

KUR Disbursement in 2015 (in trillion IDR)

Banks	Micro KUR	Retail KUR	KUR for Migrant Workers	Total
BRI	13.4	2.79	0.595	16.2
Bank Mandiri	0.675	2.8	0.638	3.5
BNI	0.015	3.02	1.5	3.04
Bank Sinarmas	-	-	0.01	0.01
Total				22.75

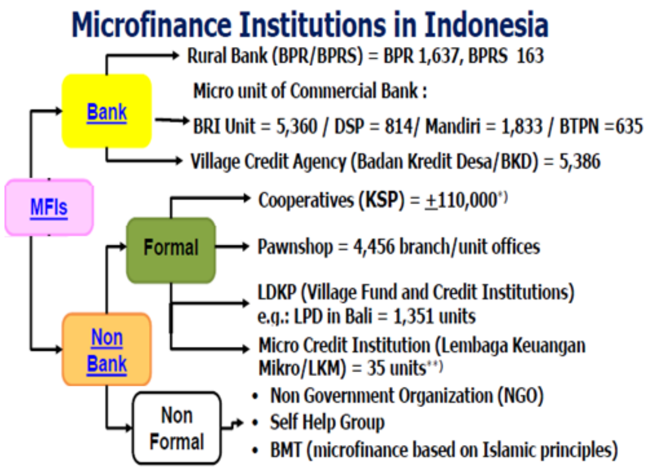
Source : OJK, 2015.

Indonesia's microfinance sector got a boost in 2015 after the government allocated 30 trillion IDR for the People's Business Credit (KUR) and cut its interest rate from 22 to 12%. Until the end of the year, the total amount of small business loans disbursed reached 22.75 trillion IDR or 75.85% of the total target.There were three state-owned banks and a private bank involved in KUR disbursement in

2015. The three state banks are BRI, Bank Mandiri and BNI. Meanwhile, the private bank is Bank Sinarmas which disbursed loans for Indonesian migrant workers.In 2016, the Indonesian government increased the KUR disbursement target to 100 - 120 trillion IDR at an even lower interest rate of 9%. In addition, the government now allows multifinance companies and cooperatives to be involved in KUR disbursement. The OJK has set a low target of 1.2 trillion IDR for non-bank institutions during their first year of involvement. Some 70% of this year's KUR allocation have been awarded to three state-owned banks. BRI gets an allocation of 67.5 trillion IDR, Bank Mandiri of 13 trillion IDR, and BNI of 11.5 trillion IDR.

The remaining 11.24 trillion IDR will be disbursed by 16 financial institutions, including seven Regional Development Banks (BPD): West Kalimantan, East Nusa Tenggara, Yogyakarta, South Sulawesi, West Sulawesi, Central Java and North Sumatra. Two private banks, namely Maybank and Bank Sinarmas, who will disburse KUR for migrant workers.Currently, the Indonesian government is also considering providing KUR to SME venture capital firms so as to finance start-up companies. This was conveyed by the Minister of Communications and Informatics after President Joko Widodo asked the ministry to allocate state budget funds to finance start-up companies as part of his efforts to boost national competitiveness.

Microfinance Institution in Indonesia



Source: Indonesia Banking Statistik, December, 2015, Annual Report, processed.

6. Economic Policy Package to the Benefit of SMEs

On April 2016, the Indonesian government unveiled its 12th economic policy package aimed at improving the ease of doing business in the country. With specific focus on small and medium enterprises (SMEs). The new package will simplify the procedures associated with setting up a business and reduce the fees involved. President Widodo has set the specific aim of improving Indonesia's global standing in the Ease of Doing Business Index from its 2016 ranking of 109th worldwide (up from 120th in 2015). The aim of the latest package's extensive deregulation is to improve the business climate for local SMEs in Indonesia which will benefit international investors as well.

The World Bank Group (who compiles the Ease of Doing Business Index) identifies ten core indicators for measuring the ease of doing business including establishing a business entity, obtaining a construction permit, paying taxes, securing credit, enforcing legal contracts, getting electricity, trading across borders, resolving insolvency and protecting minority investors. For Indonesia, the time to complete all of these processes was 1,566 days and involved 94 procedures and nine permits. This will now be reduced to 132 days and 49 procedures as well as six permits under the new policy package.

For SMEs in particular, Law No. 40/2007 on Limited Liability Companies has been replaced by Government Regulation No. 7/2016 which retains the minimum authorised capital at 50 million IDR but leaves open the amount of basic capital to the discretion of the founders. The costs involved for company establishment have also been reduced to 2.7 million IDR from 6.8-7.8 million IDR previously, with the process condensed into seven procedures to be completed in ten days.

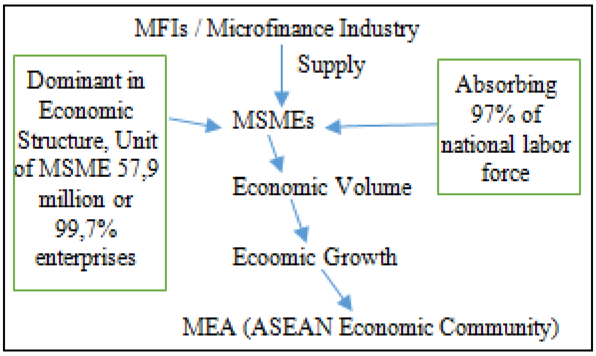
The latest package is part of President Widodo's nine-point development programme called 'Nawacita' aimed at promoting competitiveness and national self-reliance. However, this 12th economic policy package should also be seen as a direct reaction to the dampened business climate and perceived threat of the ASEAN Economic Community for Indonesia's SMEs which make up close to 60% of the country's GDP and absorb over 95% of the workforce (Ministry of Cooperatives and Small and Medium Enterprises).

For foreign investors, the sentiment of simplifying business procedures and streamlining bureaucratic procedures should be welcomed, even if many of the policies within the package are aimed squarely at domestic SMEs. A more transparent, efficient and vibrant business climate that encourages greater entrepreneurism should encourage investors in Indonesia and dispel concerns regarding the creeping complacency that appeared to take hold prior to the commodity down cycle beginning.

7. Analysis of the Effect of Microfinace Industry on Challenges and Opportunities of ASEAN Economic Community

The provision of microfinance services through MFIs in Indonesia is one of the largest in the world besides Bangladesh and India. The sustainability of industrial microfinance has a strategic role in the development of the MSMEs sector. Government policies and support will determine the role of the microfinance industry in Indonesia, as factually the number of MSMEs in Indonesia is huge.

On the other hand MSMEs in the Indonesian economy have a significant role. References that have been mentioned before, give an idea how the influence of microfinance industry to MSMEs, here is a figure of significance of microfinance industry to MSMEs.

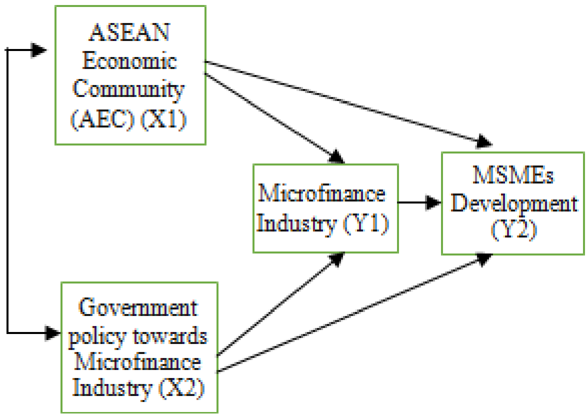


Figur 1: Significance of Microfinance Industry to Micro-Small & Medium Entreprises.

Flow model: The Role of Microfinance Industri on MSMEs in Indonesia , by own author 2017.

8. Propose Framework

In respect of the formulation of microfinance industry influence model on the development of SMEs in Indonesia to explain the readiness in entering the ASEAN Economic Community, the previous literature review is useful to complement this model.The model used to test the hypothesis and get the model fit and get the standard regression weight, the level of significance of output will be the basis for the hypothesis of conclusion. If the significance level is less than 0.05, there is a significant relationship and if it is higher than 0.05, there is no significant relationship.The existing literature on efforts to develop MSMEs through the microfinance industry can be derived from this approach: external factors (AEC), Internal Factors (Government Policy), Microfinance Industries as strategic development, and MSMEs. The elements of this approach are described as follows:



Propose Model : The Strategic Effect of Microfinance Industry on MSME development, author, 2017.

9. Conclusion

One of the main results of this study is expected to answer the main variables that can improve the development of SMEs in Indonesia. This finding is a consideration for the government in facing the AEC. This study will prove that the Microfinance Industry is an intervening strategy in developing MSMEs in Indonesia, given the large potential of MSMEs and the volume of MSMEs in the national economic structure.

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