

Effects on Microfinance of the 1997-1998 Asian Financial Crisis

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1 Introduction

Since mid 1997, a number of countries in East Asia have been hit by a severe economic and financial crisis. This has a number of potential implications for microfinance. Economic recession has led to fewer opportunities for employment in the formal sector of the economy, forcing more and more people into the informal sector. Combined with higher poverty, this has increased the number of potential microfinance borrowers. At the same time, the profitability of microenterprises has fallen, reflecting increased competition among microentrepreneurs and reduced demand for their output. Recession also means fewer resources for government program in general, including poverty alleviation programs. Moreover, the crisis largely reflected, and in turn has contributed to, weaknesses in financial institutions and systems. This too has direct and indirect implications for microfinance.

To obtain a better understanding of these and other issues, the Banking with the Poor (BWTP) Network instigated a survey of the impact of the crisis on microfinance in April 1998.¹ The survey covered the nine countries represented in the BWTP Network, namely the Southeast Asian countries of Indonesia, Malaysia, Philippines and Thailand, and the South Asian countries of Bangladesh, India, Nepal, Pakistan and Sri Lanka. Results from the survey were published as BWTP Newsletter No 11 (June 1998), and in the *MicroBanking Bulletin* (issue number 2, July 1998).

This article is based largely on the information derived from the survey. In addition, in July and August 1998 the authors conducted personal interviews with microfinance practitioners, commercial bankers, policy-makers, researchers and donor agencies in Bangladesh, Indonesia, Philippines and Thailand. These interviews followed up on issues raised in the survey, and provided information on developments since the survey was completed. As noted in the previous articles, the crisis is still unfolding, and many of the effects are yet to emerge. Nevertheless, the findings of the survey, and the more in-depth interviews conducted subsequently, provide an early indication of some of the effects of the crisis. We hope they will be useful to microfinance practitioners, policy-makers and other organisations involved in microfinance.

It is still too early to estimate the full effects of the current financial crisis in East Asia on microfinance. Nevertheless, this paper provides a number of tentative conclusions that may be of benefit to practitioners and policy-makers in the region. Not surprisingly, the crisis has had a much greater impact on microfinance in Indonesia than in any other country, although it has also impacted on MFIs in the Philippines, Malaysia and Thailand. There is increasing evidence that the crisis is having a greater effect on institutions serving small business clients than on specialist MFIs serving the poor. Another more tentative conclusion, is that microfinance appears to have suffered most where it is linked into the formal financial

¹The BWTP Network is a network of some 35 microfinance institutions, commercial banks and national policy institutions from nine countries in Asia, committed to linking microfinance with the formal financial system. The Foundation for Development Cooperation provides the secretariat for the network. The authors would like to thank the large number of institutions and individuals who responded to the survey and/or made themselves available for personal interviews. Particular thanks are due to Mr S M Al-Husainy (Bangladesh), Mr Bishnu Shrestha (Indonesia) and Mr Jose Medina (Philippines), who arranged the appointments for the country visits.

system. It is also apparent that there have been a number of policy reactions to the crisis which have had unintended adverse consequences for microfinance.

2 The crisis

From the mid 1980s and even earlier, a number of developing countries in East Asia experienced a period of rapid and sustained economic growth that became known in some quarters as the 'East Asian miracle'. However, the recent financial crisis has brought this to a halt, at least temporarily. Economic and financial conditions began to deteriorate in Thailand from mid 1996, reflecting a slowdown in export growth and over-borrowing by many business firms. By mid 1997 speculative capital outflows were threatening the convertibility of the Thai baht. It was floated in July 1997 and underwent a large depreciation. In the third quarter of 1997 financial instability spread rapidly throughout East Asia in what has become known as a 'contagion' effect. Stock market indexes fell, and most countries experienced large capital outflows. Currency pegs were placed under a great deal of pressure and were abandoned in a number of countries, giving rise to large depreciations.

Table 1: Key Economic Data for Selected Asian Countries

	Indonesia	Malaysia	Philippines	Thailand	India
Economic growth (1)					
1996 actual	8.0%	8.6%	5.7%	5.5%	7.5%
1997 estimate	4.6%	7.8%	5.2%	0.7%	4.9%
1998 forecast	-15.0%	-2.1%	2.5%	-8.0%	5.0%
1999 forecast	-0.6%	0.5%	4.0%	-1.0%	5.1%
Inflation (2)	29.7%	5.4%	8.1%	10.3%	8.4%
Interest rates (3)	70.0%	9.0%	13.75%	14.0%	na
Exchange rate (4)					
1996, average	2342.3	2.5	26.2	25.3	35.5
1998, latest	11,400.0	4.2225	43.173	41.703	42.585

(1) Growth in real GDP. Estimates and forecasts by Goldman Sachs (Asia).

(2) Consumer price index. Percentage change in latest three-monthly average on year earlier.

(3) Interbank 1 month interest rate, latest, annualised.

(4) Currency units per \$US, spot rate, latest.

Source: Far Eastern Economic Review, September 3, 1998.

The causes of the crisis are complex and differ between countries. However, common factors include overvalued exchange rates, structural weaknesses in the financial sector and excessive short-term borrowing, leading to asset price inflation, speculation and increases in non-performing loans. The crisis has led to a severe recession in a number of countries in East Asia, with forecast declines in some countries and much slower growth in others, sharp increases in unemployment, increased inflation and higher interest rates (see Table 1). Indonesia and Thailand have been especially badly affected, with GDP currently expected to plummet by 15 per cent and 8 per cent respectively in 1998. By contrast, the Philippines has weathered the initial shocks reasonably well, and the crisis appears to have had little impact in India and the other South Asian countries. The crisis is also having serious social and political impact, with increasing poverty levels and major political upheavals in Indonesia, Malaysia, South Korea and Thailand.

3 Indonesia

Prior to the financial crisis, certain formal financial institutions in Indonesia had been very successful in extending sustainable financial services deep into the countryside. Furthermore a range of very small financial institutions exists which effectively provide financial services to rural populations, including many of the poor. These are not microfinance institutions per se; rather they are financial institutions, both large and small, which have successfully incorporated elements of microfinance into their commercial activities.

The most notable of these institutions is Bank Rakyat Indonesia (BRI) which has succeeded through its *unit desa* system in providing financial services widely (and profitably) throughout rural Indonesia. BRI's operations are extensively documented. At the other end of the scale are the Indonesian rural banks (BPRs) which are regulated financial institutions set up with quite small minimum capital requirements. Rural banks in Indonesia could establish with a minimum capital requirement of only Rp50 million².

Although their outreach was comparatively small and many were said to have been operating under difficulties even before the crisis, the performance of good BPRs was still sufficiently encouraging to suggest the Indonesian rural bank as a model for the decentralised provision of sustainable financial services to local populations, including the poor, and to persuade Bank Indonesia to commence a research program dedicated to their support and development. The central bank has also made extensive use of rural banks for the conduct of various microfinance initiatives.

NGOs play a relatively minor role as the creators and operators of MFIs in Indonesia, although together with the BPRs they are involved in implementing a number of important directed credit schemes operated by agencies of Indonesian government, often with external assistance. Among such schemes with a specific microfinance focus are the P4K program of the Ministry of Agriculture, the PHBK program linking commercial banks and self-help groups of the poor and the Microcredit Program (the latter pair both operated by Bank Indonesia). In addition there have been a number of mass programs less focussed on sustainability, including the Prosperous Family and IDT programs.³

Impact of the crisis

Discussion of the impact of the East Asian financial crisis on microfinance in Indonesia must be prefaced by some remarks about the scale of the crisis as it has impacted on the Indonesian economy and financial system more generally. Nowhere in the region has the impact been so severe. As the World Bank noted recently, reviewing the recent events:

²All currency amounts are reported in Indonesian rupiah, in order to abstract from the large exchange rate depreciations experienced in Indonesia since late 1997.

³For a more comprehensive survey of microfinance in Indonesia see McGuire, Conroy and Thapa (1998).

Within the space of one year Indonesia has seen its currency fall in value by 80 percent, inflation soar to over 50 percent, the economy swing from rapid growth to even more rapid contraction, unemployment climb rapidly, and the stock exchange lose much of its value. Foreign creditors have withdrawn, investors have retreated. Capital and entrepreneurs have fled... Unfortunately, the crisis hit when Indonesia was experiencing its worst drought in fifty years, and the international oil price was registering a sharp decline. Social unrest has erupted and shaken to its very core the political stability of the nation. Years of development and poverty reduction are at risk.

The World Bank notes that the economy "...is expected to contract this year by 10-15 percent, inflation could exceed 80 percent, and the number of poor could well double". This gloomy forecast follows upon some three decades during which poverty had decreased markedly - from over 50 percent in 1970 to an estimated 10 percent in 1997, with concomitant improvements in other indicators of welfare.

Growing pauperisation reflects a collapse of domestic demand following upon the exchange rate depreciation, with a corresponding increase in the level of open unemployment. Possibly even more serious is the increase in levels of underemployment. Rural areas have been impacted both by a severe and prolonged drought and by consequences of urban recession: reduced inflow of urban remittances and return flow of displaced urban workers. These developments have serious implications for the capacity of the informal sector to provide opportunities for self-employment and the productive use of microfinance. However the situation is not uniformly bad; some rural areas with an export orientation, particularly tree crops, are benefiting from the devaluation.

The circumstances of the formal financial system are instructive in suggesting the pressures likely to be experienced by microfinance institutions under these extreme economic conditions. The World Bank describes the effects of the exchange rate "tsunami" on banks as follows:

First, their foreign exchange-denominated liabilities ballooned. Second, their assets crumbled as defaults climbed. Third, their deposit base shrivelled as panicked depositors withdrew their money... By January 1998, many private banks were technically insolvent.

Commencing in January 1998, Bank Indonesia (the central bank) took steps to shore up the banking system and to restore the confidence of depositors. A guarantee on bank deposits was declared, and Bank Indonesia began to pump substantial liquidity into the banking system. The guarantee was directed in particular to staunching the outflow of deposits from private Indonesian commercial banks (which, for example, had lost a good 12 percent of their deposits during November 1997 alone). Much of this money was being redeposited in the State banking system. However, neither the guarantee nor the liquidity support were extended to the Rural Banks (BPRs) which are important providers of microfinance in Indonesia. This appears anomalous, since the BPRs are named in the Banking Act, along with the commercial banks, as one of the two kinds of bank whose operation is permitted in Indonesia. As a result (apart from their not being troubled by foreign obligations) these small banks continued to be affected by loss of depositor confidence and other pressures which have mauled the banking system as a whole.

Outreach and loan portfolio

All respondents to our survey in March agreed that the number of people living in poverty has increased substantially, with reduced market opportunities and sharply increased prices, especially for basic foodstuffs. For instance Bina Swadaya, a leading MFI, commented that in three branches for which data were available, 16 per cent of clients had gone bankrupt. Follow up interviews in August, and the publication of official data such as those contained in the World Bank's annual country report on Indonesia (noted above) confirm these impressions. However data for rural banks cited below (Reille and Gallmann, 1998) suggest that the impact of the financial crisis may actually be less severe for the petty market traders and vendors who are important micro-borrowers, than for "small" business borrowers higher up the scale. At the same time, there is evidence of a reduction in the outreach of microfinance. This is confirmed by data available on the operations of the *Unit Desa* of BRI, the premier rural financial institution, and on those of the system of rural banks (BPRs).

Table 2: BRI Unit Desa

	June 1997	June 1998		Percentage change	
	(current prices)	(current prices)	(June 1997 prices)	(current prices)	(constant prices)
Loans outstanding (Rp billion)	4301.3	4594.4	2881.0	6.8%	-33.0%
Savings (Rp billion)	7741.2	13580.7	8516.0	75.4%	10.0%
Simpedes	4887.7	7201.1	4515.6	47.3%	-7.6%
Deposito	791.0	3615.0	2266.9	357.0%	186.6%
Other savings	2062.5	2764.6	1733.6	34.0%	-15.9%
Monthly repayment rate (%)	98.53%	98.40%			
Portfolio at risk (%)	4.41%	5.77%			

Source: BRI Unit Desa, Foundation for Development Cooperation estimates.

Loans outstanding under the BRI *unit desa Kupedes* scheme have increased slightly in current prices, from Rp4,301.3 billion in June 1997 to Rp4,594.4 billion in June 1998 (Table 2). However, this does not take account of the very high consumer price inflation over the period. In constant price terms, loans outstanding under *Kupedes* declined by a massive 33.0 per cent over the year to June 1998, suggesting that a greatly reduced level of economic activity is being financed by the *unit desa*. It may be questioned whether the consumer price index is an appropriate deflator for the rural economic activity financed by *Kupedes* (some 60 per cent of which is trade financing, involving many commodities relatively unaffected as yet by the currency devaluation). Nonetheless it is clear that the figures mask a real and substantial decline in underlying economic activity and in the real demand for credit. BRI stresses that the decline is a demand phenomenon; the window for *Kupedes* credit remains open, and has done throughout the crisis.

Table 3: Rural Banks (BPRs)

	Mar 1997	Mar 1998		Percentage change	
	(current prices)	(current prices)	(Mar 1997 prices)	(current prices)	(constant prices)
Loans outstanding (Rp billion)	2106.9	2090.4	1502.4	-0.8%	-28.7%
Savings (Rp billion)	1642.4	1587.4	1140.9	-3.3%	-30.5%
Savings accounts	580.5	621.1	446.4	7.0%	-23.1%
Time deposits	1061.9	966.3	694.5	-9.0%	-34.6%
Total assets (Rp billion)	2646.3	2745.1	1973.0	3.7%	-25.4%
Capital stock (Rp billion)	463.1	534.8	384.4	15.5%	-17.0%

Source: Bank Indonesia, Foundation for Development Cooperation estimates.

Data on rural banks from Bank Indonesia are available only up to March 1998 (Table 3). Loans by rural banks had fallen slightly in current prices, from Rp2,106.9 billion in March 1997 to Rp2,090.4 billion in March 1998. This represents a decline of 28.7 per cent after adjusting for inflation.

Government-initiated schemes with a specific microfinance focus include the Ministry of Agriculture's P4K program, and the PHBK (a program linking banks and NGOs) operated by Bank Indonesia and the German agency GTZ. The former is funded with assistance from IFAD and UNDP and makes extensive use of BRI's *Unit Desa* facility for disbursement, collection and supervision.

- Credit outstanding to the 'Small Farmer Groups' formed under the P4K fell by more than 10 per cent in nominal terms between April 1997 and April 1998, or considerably more if inflation is taken into account.
- Bank Indonesia's PHBK project, implemented with the technical assistance of GTZ and involving linkages between bank branches and self-help groups, grew rapidly in nominal terms in the two years to March 1998. However, allowing for inflation in the second year, the real volume of new lending declined by around 10 per cent, while the trend for the early months of the current fiscal year suggests the possibility that lending may fall in nominal as well as real terms in the near future. This project is also in transition, with the donor agency winding up its commitment (although Bank Indonesia has pledged to continue it).

Our survey in March indicated that specialist MFIs were also being more cautious in extending loans to new customers. This reduction in outreach, reflecting reduced availability of funds and a desire to maintain portfolio quality, was taking place at the same time as the number of poor people was growing rapidly. Our respondent noted that the changes meant that "...the poor will be left behind". In general, microfinance schemes in Indonesia have increased their average loan sizes to cope with the inflation, while making fewer actual loans.

Operations and sustainability

Most microfinance programs in Indonesia have experienced lower repayment rates, although the data for BRI are rather difficult to interpret. There has been some deterioration in repayment performance under the *Kupedes* scheme of BRI *unit desa*. Arrears as a proportion of loans outstanding had begun to increase even before the crisis, and have continued to

increase during it. This measure of portfolio at risk rose from 3.65 per cent in December 1996 to 4.41 per cent in June 1997, 4.73 per cent in December 1997, and 5.77 per cent in June 1998.

Portfolio quality may therefore be emerging as a matter of some concern, although Richard Patten (personal communication, September) discounts this. He explains the pre-crisis buildup in arrears as the result of a conscious policy of *unit desa* managers to reverse a tendency towards increased lending to salaried borrowers, which had developed for several years during the 1990s. He notes that the trend to increasing portfolio at risk (which continued with an increase to 5.94 per cent in July) was apparently arrested with a decline in arrears to 5.81 per cent in August.

Patten points to other measures as better reflecting BRI's repayment performance, especially the Twelve Month Loss Ratio (TMLR). This measure stood at 1.59 per cent for the 12 months to December 1996. It rose to 2.23 per cent as at December 1997, reflecting the onset of the crisis. However, the TMLR for the 12 months to August 1998 had declined to 2.16 per cent, despite the worsening crisis. Patten regards the fact that BRI unit managers have continued to collect better than 97 per cent of *Kupedes* loans as they fall due as the most significant indicator of the Bank's capacity to weather the storm.

Repayment problems have been much more pronounced in the case of the rural banks. Reille and Gallmann (1998) report that for rural banks as a whole, non-performing loans represented 24 per cent of loans outstanding as at June 1998. Over the year to June 1998, non-performing loans as a percentage of loans outstanding for the three rural banks that they considered in detail, increased from 9 to 12 per cent, from 15 to 32 per cent, and from 23 to 32 per cent respectively. For the second of these banks, the non-performing loan ratio stood at 50 per cent for small industry loans but only 12 per cent for market vendors and traders, suggesting that poorer clients tend to have maintained their repayments better than small business clients. The decline in repayment rates is consistent with evidence from our earlier survey, in which one rural bank reported that the proportion of outstanding loans more than 30 days in arrears increased from 14.6 per cent as at March 1997 to 18.9 per cent as at March 1998. It was also reported that many rural banks are now providing loans only to established customers with good records, and have tightened up on collateral requirements, in an effort to stem the decline in repayment rates.

While the increase in non-performing loans is a matter for concern, Reille and Gallmann comment that rural banks have not been affected as dramatically as commercial banks. They argue that this is because rural banks have no foreign exchange exposure and fewer related party transactions, and that their clients have been less affected by the crisis.

Nevertheless, it is clear that many rural banks are in serious trouble. Total assets of the rural banking system declined by 25.4 per cent over the year to March 1998 after adjusting for inflation (Table 3). Total capital stock declined by 17.0 per cent in real terms over the same period. Hence, in aggregate, the net profits of rural banks have been far too low to enable them to maintain the value of their capital after adjusting for inflation. This process of decapitalisation is illustrated by the case of four rural banks for which balance sheet data are available. Based on historical cost accounting, they earned a combined profit of Rp57.8 million over the six months to June 1998. However, they would have needed to earn profits of Rp310.2 million simply to maintain the real value of their capital stock. After adjusting for inflation, the return on equity for these four banks was negative 46.6 per cent for the six

month period. The three rural banks analysed by Reille and Gallmann also all earned negative returns on equity after adjusting for inflation.

Bina Swadaya reported that repayment rates had dropped sharply since the onset of the crisis. In seven of its branches for which data were available, between 20 and 70 per cent of borrowers were in arrears. It had been forced to extend loan repayment terms or reschedule loans, in agreement with borrowers.

Arrears under the P4K program also appear to have increased quite substantially, from 2.87 per cent of total credit disbursed as at April 1997 to 3.55 per cent as at April 1998. Arrears in relation to credit currently outstanding were 12.15 per cent and 21.09 per cent, respectively. It is fair to say that the financial crisis and resulting government budgetary difficulties coincided with the transition between two phases of this long-running project. This may have contributed to deteriorating repayment performance; it is well known that certainty of the future availability of credit is a powerful incentive to repayment, while doubt is corrosive.

Repayment rates under the PHBK project also appear to have worsened under current economic circumstances; 12 month arrears increased from 6.0 and 6.2 per cent in March of 1996 and 1997 respectively, to 9.8 per cent at March 1998 (and 11.2 per cent by May). The cumulative repayment rate was 94.7 per cent at the end of May 1998, down from 97.1 and 96.3 per cent, respectively, in March of 1996 and 1997.

Many programs are also experiencing increased operational costs. MFIs associated with Catholic Relief Services (CRS) face a dilemma common to all: that operating costs are rising (an estimate of 25 per cent as at March this year, over the previous year) while interest income is shrinking. CRS partner institutions have slowed the disbursement of loans while permitting the rescheduling of overdue loans on a limited basis. 'The dilemma...is whether to focus on the sustainability of the partner - in which case interest rates should match or exceed the market rates and savings should be held as collateral - or on the welfare of the borrower, who is likely to be in a precarious economic situation' (Nestor 1998).

Interest rates

Operational and financing costs facing MFIs have increased significantly, and in many cases interest rates have been adjusted to reflect market conditions, which have seen commercial lending and deposit rates skyrocket. State bank 30 day deposit rates, which were around 15 percent in March 1997 before the crisis, topped 25 percent in March this year. Equivalent deposit rates for commercial banks were 17 and 28 per cent, respectively. Subsequently these rates have soared further, to around 57 or 58 per cent for both categories of banks. BRI's deposit rate is among the lowest on offer from the State banks, reflecting its credit rating, but was still above 50 per cent in August.

Earlier in 1998 the BRI *unit desa* increased interest rates payable on rural savings by between 4 and 5 percentage points per annum, and raised rates on loans above Rp3 million from 1.5 per cent flat to 2 per cent flat per month. Interest rates on loans up to Rp3 million remained at 1.5 per cent flat per month until 1 September 1998, at which time they were increased to 2.2 per cent flat. While this is still less than the units' deposit rate (for 30 days), it apparently provides an adequate margin over their average cost of funds.

Our March survey indicated that most rural banks had not increased their lending rates, which ranged for the most part between 2.0 per cent and 3.5 per cent flat per month. On the other hand, the one rural bank responding to the survey had increased interest rates on both deposits and loans by around 1 percentage point per month. Since that time increases appear to have become more widespread. The three rural banks analysed by Reille and Gallmann (1998) all increased their lending rates in March 1998, and rural banks lending in Bank Indonesia's PHBK scheme are said now to be charging 4 per cent per month to final users. Nevertheless, Reille and Gallmann argue that the rural banks were very late in increasing interest rates, and did not increase them by enough. They report that rural banks in Java are charging effective interest rates of around 45 to 55 per cent, lower than the 50 to 60 per cent being charged by commercial banks.

Our March survey also noted that the major NGO Bina Swadaya had found it necessary to increase lending rates by between 0.5 and 0.75 percentage points per month to cover increased operational costs and loan losses. Increases of such magnitude have now become fairly general where market conditions impact upon microfinance. The exceptions are in cases (such as the Bank Indonesia Microcredit Project, or the Agriculture Ministry's P4K project) where external funding sources have enabled the line to be held so far.

Availability of resources

The extent to which reduced outreach reflects reduced availability of resources varies considerably between institutions and programs. In the case of BRI *unit desa*, it is clear that the decline in lending does not reflect constraints on the capacity to lend. Deposits increased from Rp7,741.2 billion in June 1997 to Rp13,580.7 billion in June 1998, an increase of 10.0 per cent in constant price terms (Table 2). This quite clearly reflects the inflow of funds to the State banking institutions, described above. Much of this inflow appears to consist of the term deposits of middle class people. While savings in *Simpedes* accounts (held for the most part by poorer rural people) fell by 7.6 per cent in real terms over the period, term deposits (*Deposito*) increased dramatically by 186.6 per cent after inflation, albeit from a low base. Whereas in June 1997 loans outstanding were equivalent to 55.6 per cent of the value of savings, by June 1998 this figure had fallen to only 33.8 per cent.

This is a quite dramatic change in the structure of BRI's balance sheet, for which a change in the structure of deposit rates offered by the Bank provides some explanation. BRI moved with the market to treble its primary term deposit rate, from 19 to 57 per cent, during this period. However it held the *Simpedes* rates for savings deposits almost constant; the top *Simpedes* deposit rate rose only from 16 to 20 per cent. Under these circumstances a drop in *Simpedes* savings of only 7.6 per cent in real terms could be regarded as a measure of the strength of BRI as a repository for the savings of the poor under extremely difficult circumstances.

Unlike the situation for BRI's *unit desa*, deposits with BPRs declined substantially over the period (Table 3). Deposits stood at Rp1,587.4 billion in March 1998 compared with Rp1,642.4 billion a year earlier, a fall of 30.5 per cent in constant price terms. The fall was slightly larger for time deposits (34.6 per cent) than for savings accounts (23.1 per cent). These data support anecdotal evidence that some customers had been withdrawing their funds (especially their time deposits) from the rural banks and depositing them with BRI *unit desa*. Moreover (as noted above) despite the Government's decision to extend deposit guarantees to private national commercial banks in January of this year, the same consideration was not

granted to the BPRs. Reille and Gallmann (1998) comment that some owners of BPRs have responded to falling deposits by increasing paid-up capital and securing additional loans from non-bank sources.

It is also clear that there is considerable diversity between rural banks. For instance, of the three rural banks discussed by Reille and Gallmann, one experienced a 25 per cent increase in deposits (in nominal terms) over the year to June 1998, whereas another experienced a 28 per cent decline over the same period. They argue that BPRs with a strong community base and sound portfolios have withstood the crisis better than other BPRs.

The policy environment

Since the onset of the crisis the issue of strengthening and restructuring the financial system has preoccupied policymakers. Measures to strengthen the commercial banks included, as noted above, the injection of substantial amounts of liquidity and the guarantee on deposits. The Soeharto Government had announced a thorough review of central bank and banking laws, which is continuing under the Habibie administration. The Governor of the Central Bank was placed outside the Habibie cabinet as an indicator of a new degree of independence for the Bank.

One measure under consideration before Soeharto's downfall was to increase the minimum capital requirement for rural banks from Rp50 million to Rp500 million. A respondent to our survey in March noted that such a policy could force the closure or amalgamation of many rural banks serving the general public, including poor clients. Fortunately, however, this proposal seems no longer to be on the agenda.

More recently, steps have been taken to correct the anomaly which saw the commercial banks supported by the central bank while the rural banks were left to fend for themselves. In July the Bank announced that Working Capital Credits would be made available to BPRs satisfying certain 'health' standards, in order to permit the rural banks to expand the financing available for small enterprise and employment creation. The measure contains provisions which aim to reward good performance by BPRs, which can receive credits of Rp500 million up to three times under the scheme in the space of a year. In August, as a further measure to restore even-handedness to banking policy, in-principle approval was given for a deposit guarantee for BPRs. As of September, the operating procedures and regulations for these two measures had not yet been approved, and Bank Indonesia was awaiting a presidential decision.

The Working Capital Credits are to be made available at 15 per cent per annum, and may be on-lent at a maximum rate of 30 per cent, effective (or around 1.3 per cent per month). Given current market rates in the sector of anything from 2 to 4 per cent per month, this requirement has attracted criticism as likely to distort the local markets for credit in which the BPRs operate, thus compromising sustainability in the longer run. Similarly, the guarantee proposal has been criticised for various reasons: it is thought unlikely by some to attract back depositors and is said to represent a guarantee on savings to a class (the poor) which is actively dissaving at present.

Such criticisms probably miss the point of supporting the BPRs under present circumstances, where the issue is one of their short term survival rather than longer run sustainability. In the broader policy context of emergency subsidies to relieve societal distress it seems

unreasonable to quibble over these measures. What is particularly interesting, however is the fact that microfinance seems to play no role whatever in the World Bank's blueprint for immediate action in response to the present situation, *Indonesia in Crisis* (published July 1998).

Other issues arise in the case of government supported microfinance schemes such as the P4K, PHBK and Microfinance Project. All are experiencing difficulties under present circumstances, and, in the case of P4K and PHBK, their lending rates to final users are increasingly out of line with market rates. This is not likely to be the case with Bank Rakyat's Unit Desa operations, however, where the World Bank's injunction that Indonesia should insist on 'maintaining the integrity of the rural financial system and protecting it from accumulating ills in the rest of the financial system' seems likely to be observed.

One final, hopeful, note should be struck in this survey of the impact of the crisis on microfinance in Indonesia. It was notable that, under Soeharto's New Order regime, NGOs were kept under a tight rein, and played comparatively little role in microfinance, at least compared with countries such as India and the Philippines. However in the response to the crisis concerted by the new government with international agencies, NGOs have been given particular responsibilities in relation to creating and extending the 'social safety net' which is being put in place to minimise suffering. One NGO leader comments that practically every Ministry is now scouting for NGOs to assist in its responses to the crisis. Clearly this must be placing major strains on the capacity of the Indonesian NGO movement, but in the longer run it provides an opportunity for the release of considerable energies, and the microfinance movement could also benefit from the greater engagement of newly energised NGOs. The assistance of the international community will be needed to strengthen the capacities of Indonesian NGOs to support the expansion of microfinance once the immediate economic crisis is surmounted.

4 Malaysia

In Malaysia there is only a handful of institutions involved in microfinance. Of these by far the largest is Amanah Ikhtiar Malaysia (AIM), a Grameen replicator. AIM has been heavily subsidised by government and related agencies, reflecting the relative abundance of resources and relatively low incidence of poverty in Malaysia.⁴

AIM has continued to grow rapidly since the crisis, with the number of loans outstanding increasing from 31,853 in June 1997 to 38,251 in June 1998. The volume of loans outstanding increased even more rapidly, from RM44.4 million (\$10.5 million) to RM74.3 million (\$17.6 million) over the period.⁵ However, there has been a reduction in the number of new members since the onset of the crisis. In the June quarter 1998 there were 4,331 new members, nearly 20 per cent below the number of new members in the June quarter 1997. AIM reported that this primarily reflects operational factors, rather than reduced demand for the program. The number of loans disbursed in the June quarter 1998 (both to new and old members) was virtually unchanged from the June quarter 1997.

⁴The microfinance sector in Malaysia is described in McGuire, Conroy and Thapa (1998).

⁵In Malaysia, Philippines and Thailand, where exchange rates have much more stable than in Indonesia, local currency amounts are converted to US dollars using current exchange rates as per Table 1.

AIM commented that some borrowers have been experiencing difficulties in their businesses. At the same time, the program has become more important to many families. In some cases, the microenterprises operated by women borrowers have moved from being a secondary source of family income to the only source of income, as other family members in wage employment have lost their jobs. AIM has experienced an increase in defaults since the onset of the crisis with 197 loans in default as at June 1998, compared with 58 as at June 1997. Nevertheless, repayment rates are still very high, with the on-time repayment rate in June 1998 reported at 99.92 per cent. It was reported that there have been no significant changes in operating costs, and while AIM has recently introduced a number of changes including higher interest rates and higher loan sizes, these predated the economic crisis.

Even before the crisis the Government was committed to supporting AIM as an effective tool for poverty reduction. The crisis appears to have increased this commitment. In March 1998 the Government announced that it would allocate an additional RM100 million to AIM, reflecting the need to protect more vulnerable groups from the effects of the economic crisis. On the other hand, the crisis has made it more difficult for AIM to attract concessional funds from the commercial banks. Prior to the crisis, AIM was negotiating a bank loan of RM20 million at an interest rate of 1 per cent. However, the bank withdrew from these negotiations because of stricter lending policies adopted as a result of the crisis.

5 Philippines

The main institutions engaged in microfinance in the Philippines are some 300 NGOs operating as retail MFIs. Most of these are very small. A recent survey of 131 retail MFIs, including all the larger MFIs, found that these institutions had a total outreach of only 67,000 clients (Dingcong and Joyas 1998). Only 28 retail MFIs had more than 500 clients, and these accounted for almost 80 per cent of total outreach. In addition, the Philippines has a large number of small rural banks and slightly larger thrift banks operating at the local level, and these serve a broad cross-section of the community, including some poor clients. Three specialist MFIs are in fact registered as rural banks, including CARD Rural Bank, one of the largest MFIs in the country.

These specialist MFIs and small banks obtain their funds from a variety of sources. Most specialist MFIs receive funding from donor agencies or under government programs. Many small banks and a few specialist MFIs have obtained loans or lines of credit from commercial banks. The People's Credit and Finance Corporation (PCFC), an official second tier institution, provides loans to both specialist MFIs and rural banks. And another source of funds is member savings and, in the case of small banks, deposits from the public.⁶

Outreach and loan portfolio

Changes in the outreach of specialist MFIs since the onset of the crisis vary considerably from one institution to another. The loan portfolio of TSPI Development Corporation, a large specialist MFI, has shrunk from P110 million (\$2.55 million) in November 1997 to P95 million (\$2.20 million) in June 1998. However, this largely reflects factors other than the

⁶For more information about the outreach and performance of MFIs and small banks in the Philippines, see Dingcong and Joyas (1998), Llanto, Garcia and Callanta (1996), and McGuire, Conroy and Thapa (1998).

crisis. Moreover, the overall number of borrowers has not declined much because the reductions have been in the *Sakbayan* program which provides small loans to trishaw drivers, rather than the *Kabuhayan* program which provides micro loans to poor microentrepreneurs. In fact there has been increased demand for loans under the *Kabuhayan* program.

Among other members of the Alliance of Philippine Partners in Enterprise Development (APPEND), a network of MFIs, growth has slowed but in no case has outreach actually declined. For instance, in the case of Alalay sa Kaunlaran sa Gitnang Luzon (ASKI), the number of borrowers increased from 4,072 in June 1997 to 4,649 in June 1998, but this was well below projections. The loan portfolio increased only marginally from P19.9 million (\$461,000) to P20.1 million (\$466,000), representing a slight decline after adjusting for inflation. The fact that the number of borrowers has increased while loan portfolio remained broadly unchanged suggests that as with TSPI, lending to small business borrowers has been affected more than lending to poor borrowers.

Both TSPI and ASKI reported that demand for loans among the poor has increased since the crisis. However, lack of resources has prevented them from fully meeting this increase in demand. By contrast, CARD has enjoyed very strong growth despite the crisis. The number of borrowers increased from 7,833 in June 1997 to 15,138 in June 1998, while loans outstanding increased even more rapidly from P23.6 million (\$547,000) to P66.0 million (\$1.53 million). This very rapid growth may be because CARD lends only to poor borrowers, and/or because as a rural bank it has greater access to savings to fund its loan portfolio.

Aggregate data on the net loan portfolio of small banks are available from the central bank. The net loan portfolio of thrift banks has fallen from a peak of P144.8 billion (\$3.35 billion) in September 1997 to P130.4 billion (\$3.02 billion) in June 1998 (the net loan portfolio of commercial banks increased by 5 per cent over the same period). Data for rural banks are available only up to December 1997, but their net loan portfolio continued to increase up to that stage to be 22.3 per cent higher than a year earlier.

PCFC is a second tier institution which lends to retail MFIs, including specialist MFIs and rural banks. Its loan portfolio has continued to grow during the crisis, suggesting there is still a strong demand for loanable funds from retail MFIs. Nevertheless, three or four retail MFIs from the island of Mindanao that have been approved lines of credit have not drawn down these lines because of concerns about the crisis.

Operations and sustainability

For the leading MFIs, the crisis does not seem to have had a major effect on repayment performance, especially in their poverty-focused programs. In the case of TSPI, the past due rate (outstanding balance on loans past due as a percentage of loans outstanding) has increased from 2 per cent as at June 1997 to 4 per cent as at June 1998. It was reported that the crisis has contributed both directly, by reducing borrower incomes, and indirectly, with some borrowers using the crisis as an excuse for avoiding repayment. However, the deterioration in repayment performance has been among small business borrowers, rather than poor borrowers. The past due rate under the *Kabuhayan* program actually declined significantly from 5 per cent to 1 per cent.

CARD reported that it has maintained an excellent repayment performance throughout the crisis, with portfolio at risk less than 0.1 per cent in June 1998. Monthly repayment rates fluctuated between 99.6 per cent and 100 per cent over 1997-98. ASKI reported an increase in its repayment rate since the crisis, because resource constraints have made it more selective in its lending operations.

On the other hand, data from the central bank indicate that in the case of thrift banks, non-performing loans increased from 7.9 per cent of net loan portfolio in June 1997 to 17.4 per cent in June 1998 (in the case of commercial banks, the ratio increased from 3.4 per cent to 9.2 per cent over the same period). For rural banks, non-performing loans represented 15.7 per cent of the net loan portfolio in December 1997, only slightly higher than before the crisis, but these data do not take account of the most recent developments.

PCFC data also suggest that some MFIs have experienced problems. PCFC reported that the past due rate on its loans to retail MFIs has increased from 0.8 per cent in March 1998 to 3.0 per cent in June 1998. Six retail MFIs now have amounts past due, with most of the amount past due attributable to rural banks rather than NGOs. Repayment rates from final borrowers to retail MFIs in the PCFC program have also fallen in a number of cases, although they are still generally high. PCFC felt that these developments reflect the effect of natural disasters more than the financial crisis.

In general, it appears that poor borrowers have maintained very good repayment records, whereas the repayment performance of small business borrowers has slipped. It was suggested that this may be because the poor need continued access to credit and will go to great lengths to make their repayments even in times of crisis. An alternative explanation is that the crisis has caused consumers to shop around for the cheapest products and services, increasing the demand for products and services offered by poor microentrepreneurs. It is also possible that specialist MFIs serving the poor are closer to their clients than rural banks and other institutions serving small business borrowers, and that this enables them to maintain their repayment rates better.

Some MFIs have increased interest rates on loans since the crisis, because of the increased cost of funds. Whereas TSPI used to have a stepped interest rate structure, it has increased some interest rates to standardise them at 3 per cent per month. On the other hand, CARD and ASKI have not found it necessary to increase their interest rates.

The crisis has also had some other adverse effects on the operations of some MFIs. For instance:

- Some APPEND members were adversely affected by the depreciation of the peso because they had loans from private foundations abroad denominated in US dollars. However, the foundations concerned have been happy to restructure these loans.
- Some institutions reported that the crisis is affecting staff morale, in that staff salaries have not kept pace with inflation.
- There has also been an increase in the crime rate in some areas since the onset of the crisis. For instance, TSPI reported that for the first time ever a branch was burgled recently.

Availability of resources

The crisis has reduced the resources available for microfinance in a number of ways. First, commercial banks have reduced loans and lines of credit to specialist MFIs. APPEND commented that individual loan officers at the commercial banks have acknowledged that MFIs are very good clients, but have stated that they are obliged to follow board decisions to reduce such lending. Lending to MFIs is perceived by the commercial banks as being risky, even if in reality it is not. Interest rates have also increased, making commercial bank loans less viable for MFIs. Borrowing rates for MFIs peaked early in 1998 at around 27 per cent, but by July 1998 had fallen to around 22 per cent. Still, MFIs feel that bank loans are not attractive at current interest rates. Before the crisis five APPEND members had lines of credit from seven commercial banks, but only two have maintained their lines, reflecting both reduced willingness of banks to lend and higher interest rates.

In the case of the banking system, the crisis seems to have encouraged a modest 'flight to quality', with depositors moving their savings from thrift banks to commercial banks. Between June 1997 and June 1998 total deposits of the thrift banks declined by 9.3 per cent, with declines recorded in each of the four quarters. Clearly, this has constrained the ability of the thrift banks to maintain their lending operations. By contrast, deposits with commercial banks increased by 22.8 per cent. But it is not clear if the shift from small to large banks has also affected rural banks. While rural bank deposits fell by 0.5 per cent in the September quarter 1997, they rebounded strongly to increase by 4.7 per cent in the December quarter, and were 21.1 per cent above the level recorded a year earlier. More recent data are not yet available.

The crisis has also reduced the flow of resources from commercial banks to smaller banks. One commercial bank reported that it has cut lines of credit to a number of thrift banks, and put others under very close monitoring. These smaller banks use the commercial bank as a clearing house, and some have not made good their cheques. Before the crisis, the bank had been aggressively trying to expand this business, but it has taken a policy decision not to pursue such lines actively for the time being.

The policy environment

The central bank is currently increasing the minimum capital requirements for establishing banks by between 54 and 100 per cent, depending on the type of bank. The increases are being phased in between December 1997 and December 2000. After December 2000:

- The minimum capital requirement for thrift banks will be P400 million (\$9.27 million) - previously P200 million (\$4.63 million) - where the head office is in Metro Manila, and P64 million (\$1.48 million) - previously P40 million (\$927,000) - where the head office is outside Metro Manila.
- The minimum capital requirement for rural banks will vary from P3.2 million (\$74,000) to P32 million (\$741,000) - previously P2 million (\$46,000) to P20 million (\$463,000) - depending on location.

These increases are part of a plan to strengthen the banking system. While they are not directly related to the current financial crisis, the crisis has revealed weaknesses among some thrift and rural banks (as well as among some commercial banks). By July 1998, five thrift banks and eight rural banks had been closed, and around twenty had availed of the emergency

loan facilities of the central bank. Nevertheless, it can be argued that these failures were due not to inadequate capital, but to bad management. There does not appear to be any correlation between the size of the bank and financial performance.

The required capital increases make it harder to establish small banks, and for MFIs to establish regulated banks. It has been reported that the increases are one factor that led TSPI to reverse its previous decision to establish a thrift bank in Metro Manila (it is understood that the direct effect of the crisis was also a factor). The increases in minimum capital requirements are considerably in excess of expected inflation over the period.

Moreover, the central bank has recently been taking a stricter stance on loan collateral. Banks which exceed the prudential limit on unsecured loans, currently 30 per cent of the loan portfolio, are directed to reduce their exposure to the said limit. This is a new policy, and no sanctions have been imposed. Nevertheless, such an approach is clearly inappropriate for banks engaging in microfinance, and could severely disadvantage the specialist MFIs that have established rural banks (including CARD) if it were applied to them. This is clearly a matter for concern.

6 Thailand

While no official data are yet available, it is clear that the crisis has led to increased poverty in Thailand. Between February 1997 and February 1998 total employment fell by 800,000 and the unemployment rate rose to 4 per cent. This has forced many unemployed urban workers to return to the rural areas. The crisis has reduced the scope for non-agricultural activities in the rural areas, which before the crisis contributed more than 60 per cent of rural income. While this has mainly affected the better off farm households, it has also had a major impact on landless workers. On the other hand, the depreciation of the baht has boosted prices for agricultural products, mitigating the effects of the crisis for farm households, which make up the vast majority of the rural population. As a result the Bank for Agriculture and Agricultural Cooperatives (BAAC), which lends to around 85 per cent of farm households (but few households that can properly be described as poor) has been largely unaffected by the crisis.

Microfinance in Thailand is dominated by small community organisations funded under government programs, with NGOs having a much more limited role than in many other countries.⁷ One government program is that operated by the Urban Community Development Office (UCDO). The UCDO program does not appear to have grown much during the crisis. The number of community organisations with loans increased from 165 in June 1997 to 204 in June 1998, but total outstanding credit under the program increased by only 4.9 per cent from B473 million (\$11.34 million) to B496 million (\$11.89 million). This represents a small decline after adjusting for inflation. Total savings of the organisations themselves increased broadly in line with inflation by 11.2 per cent over the period.

At the same time, however, repayment performance deteriorated. The loan non-recovery rate on loans from UCDO to community organisations increased from 0.8 per cent in June 1997 to 3.0 per cent in June 1998, with the number of organisations with credit problems increasing from 24 to 56. The loan non-recovery rate on loans from community organisations to their

⁷See McGuire, Conroy and Thapa (1998) for more information about microfinance in Thailand.

members increased from 6.0 per cent to 6.8 per cent over the period. UCDO has not changed any of its guidelines for providing loans to community organisations, and interest rates have remained the same. However, it is applying its guidelines more carefully given the deterioration in repayment performance.

The Government Savings Bank credit program for rural development continued to expand, with total outstanding credit increasing by 18.2 per cent from B378 million (\$9.06 million) in June 1997 to B447 million (\$10.72 million) in June 1998. Non-performing loans from the Bank to individual savings and credit groups were estimated at only 0.7 per cent of loans outstanding at 30 June 1998. However, it should be noted that loans are only classified as non-performing after two instalments are missed, and instalments are usually six monthly. Hence it is likely that the full impact of the crisis is not yet reflected in the data. Moreover, only the amount of the instalments missed is included in the calculation, not the balance outstanding. This measure therefore significantly understates portfolio at risk.

7 South Asia

Respondents from the five countries in South Asia included in the survey reported that the financial crisis in East Asia has not yet had any significant effects on microfinance. No program reported any changes in the demand for microfinance or in program membership as a result of the crisis. Similarly, there have not been any systematic changes in repayment performance, program operations or sustainability, or the availability of resources.

Some of the South Asian countries have been experiencing financial and economic difficulties unrelated to the financial crisis in East Asia. Most notably, Bangladesh has been experiencing extremely severe floods since mid 1998, reported to be the longest and worst ever. Over two thirds of the country is under water, and a large number of farmers will not receive income from the present production season. Numerous poor people have lost their assets, and opportunities for income generating opportunities are greatly diminished. The floods are expected to result in serious economic loss and poverty. While it is too early to tell what effect the floods will have on microfinance a number of institutions, such as the South Asian Network of Microfinance Initiatives (SANMFI), have begun to focus seriously on these issues.

Nepal has been experiencing slower economic growth since before the crisis, largely reflecting the over-valued Nepalese rupee. Some microfinance programs have also been disrupted by Maoist insurgents. India and Pakistan experienced slight slowdowns in economic growth in 1997, but at this stage these are expected to be temporary. In Sri Lanka the economy seems to have remained robust.

While all respondents stated that the crisis had not yet had any direct effect on microfinance, a number pointed to potential dangers that could give rise to increased poverty over the medium term:

- The large currency depreciations in East Asia are reducing the competitiveness of manufacturing operations in South Asia, such as clothing production in Bangladesh and Nepal. This may further increase the number of people in self-employment in the informal sector.

- Higher unemployment in East Asia is resulting in the repatriation of guest workers, such as workers from Bangladesh previously employed in Malaysia, giving rise to a reduction in foreign remittances and excess labour supply.
- Some commentators also suggested that the crisis was giving rise to a more cautious attitude on the part of bankers and regulators in South Asia. This may further reduce the willingness of banks to establish linkages with MFIs, and of regulators to permit the establishment of small regulated banks.⁸

8 Concluding comments

It is still too early to estimate the full effects of the current financial crisis in East Asia on microfinance. The crisis itself is still unfolding. GDP is expected to contract sharply in a number of countries in 1998, with further falls expected in 1999. It is also likely that the crisis will affect microfinance institutions and programs with a lag. For instance, reduced opportunities for income generating activities may take several months to manifest themselves in lower repayment performance and/or changed demand for loans. And lags in the collection and publication of data mean that many of the data in this paper relate to events that occurred several months ago. Hence it will be some time, possibly years, before a complete analysis of the effects of the crisis on microfinance will be possible. Nevertheless, this paper provides a number of tentative conclusions that may be of benefit to practitioners and policy-makers in the region.

One important conclusion is that the countries in Asia with the greatest concentrations of poverty have so far been little affected by the crisis. While the nine countries included in the study had an estimated 495 million people living in absolute poverty in 1995⁹, some 440 million of these were in South Asia, which has been relatively untouched by the crisis. The five countries most affected by the crisis are Korea, a high income country, and Malaysia, Thailand, Philippines and Indonesia, all middle income countries. Of these, the only two with large numbers of people in absolute poverty are Indonesia (an estimated 22 million people in 1995) and the Philippines (25 million people in 1995). Indonesia is the country that has been most devastated by the crisis, while the Philippines has been the least affected of the five.¹⁰

Not surprisingly, the crisis has had a much greater impact on microfinance in Indonesia than in any other country. The value of loans outstanding by BRI unit desa and the rural banks have fallen by between one quarter and one half in constant price terms since the onset of the crisis. These institutions are supporting a much reduced level of activity among small entrepreneurs, at the same time as living standards are falling significantly. Moreover, at least in aggregate, the rural banks are running down the real value of their capital stock at an alarming rate. There are also signs of growing fragility in Government schemes such as P4K and PHBK, which call for renewed commitment of resources to assist them to survive the

⁸McGuire, Conroy and Thapa (1998) found that none of the countries in South Asia encourage the establishment of small banks, which are much more likely to engage in microfinance than larger banks.

⁹See McGuire, Conroy and Thapa (1998).

¹⁰While the countries in South Asia have been little affected by the crisis, since mid 1998 Bangladesh has been devastated by floods that are possibly the worst it has experienced.

crisis. By comparison, the crisis has had a more moderate effect in other countries. While it has impacted on MFIs in the Philippines, Malaysia and Thailand, in most cases it has served to reduce the rate of growth in their outreach, rather than reduce outreach in absolute terms.

There is also increasing evidence that the crisis is having a greater effect on institutions serving small business clients than on specialist MFIs serving the poor. In the Philippines this seems to be a robust conclusion. Evidence from a number of quarters suggests that programs focusing solely on the poor appear to have withstood the crisis better so far, in terms of client numbers and repayment rates, than programs not specifically targeted to the poor. This seems to be the case even where such programs are run by the same institution, such as TSPI. In Malaysia, too, AIM has maintained high repayment rates among poor borrowers while other institutions catering to higher income borrowers have reportedly experienced increased arrears.

Another more tentative conclusion, is that microfinance appears to have suffered most where it is linked into the formal financial system. This is not surprising as the crisis has been first and foremost a financial one. As noted above the rural banks in Indonesia, which are a major supplier of micro financial services, are facing a very difficult situation. In the Philippines, it appears that thrift banks and possibly rural banks have suffered more than specialist MFIs, with reduced deposits forcing the thrift banks to reduce their loan portfolios. And MFIs in the Philippines and Malaysia have found it very difficult to maintain linkages with commercial banks, because of increased interest rates and more cautious lending policies. On the other hand, MFIs which rely on government and donor agencies rather than the formal financial system for resources appear to have fared better.

This does not imply that microfinance should not become more integrated into the formal financial system. Such linkages are critical if microfinance is to reach large numbers of poor people on a sustainable basis. Nevertheless, they may make the microfinance sector more prone to cyclical fluctuations. The findings also suggest that much greater attitudinal change is necessary within the formal financial system about the scope for commercial engagement with microfinance. It is instructive that in the Philippines, individual loan officers at the commercial banks have acknowledged that MFIs are very good clients, but have been obliged to follow bank policy to reduce lending that is perceived as 'risky'. There is a need to further educate senior bank management about the scope for profitable linkages with MFIs, and the need to avoid blanket lending policies which inadvertently work against such linkages.

It is also apparent that there have been a number of policy reactions to the crisis which have had unintended adverse consequences for microfinance:

- In Indonesia, the Government guaranteed the deposits of commercial banks in January 1998, but did not extend this guarantee to rural banks. This has encouraged depositors to move their savings from rural to commercial banks and threatened the viability of many rural banks, which are much more likely than commercial banks to provide micro financial services to poor clients. Encouragingly, the Government has announced that working capital credits will be made available to the rural banks, and it is understood that it has also decided to guarantee their deposits.
- In the Philippines the Government has announced a timetable for increasing the minimum capital requirements for rural banks and thrift banks. These increases have already been a factor in discouraging one prominent MFI from establishing a thrift bank. In Indonesia also, the Government considered increasing the minimum capital

requirement for rural banks, but it is understood that the Government has decided not to proceed with this course of action.

- In the Philippines the central bank has been taking a stricter stance on loan collateral, directing banks to limit unsecured loans to 30 per cent of their loan portfolio. This policy would severely disadvantage the specialist MFIs licensed as rural banks if applied to them.

Hence in responding to the financial crisis, policy makers have taken a number of steps that are counter-productive to the establishment of a strong and sustainable microfinance sector. It is important that policy makers pay greater attention to the implications for microfinance when developing policies for financial sector reform and poverty alleviation.¹¹

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¹¹We would be very grateful if interested parties could send suggestions, comments and data to the Foundation for Development Cooperation, PO Box 10445 Adelaide Street, Brisbane QLD 4000, Australia. Tel: (61 7) 3236 4633, Fax: (61 7) 3236 4696, Email: fdc@ozemail.com.au

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