

Chapter 8

MSMEs and Access to Financing in a Developing Economy: The Indonesian Experience

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ABSTRACT

Historically, micro, small, and medium enterprises (MSMEs) have played an important role in economic development in Indonesia. MSMEs are very numerous, amounting to, on average, almost 99% of total enterprises and also more than 90% of total employment across sectors in the country. Although the lack of finance is not the only problem facing many MSMEs, this chapter discusses the Indonesian experience with MSME financing with the focus on a government-initiated credit guarantee scheme, namely KUR (people business credit), aiming to give the enterprises more access to finance and the development of microfinance institutions. It also provides a brief description of MSMEs' development, their main constraints, and their main finance sources. The chapter shows that, in spite of government efforts, the majority of MSMEs, especially micro and small enterprises (MSEs), still depend on informal sources for their capital.

INTRODUCTION

Historically, micro, small, and medium enterprises (MSMEs) have played an important role in Indonesia's economic development. MSMEs are very numerous, amounting to, on average, almost 99% of total enterprises across sectors in the country. They have always been the main drivers of domestic economic activities, contributing to more than 50% to the country's gross domestic product (GDP). The enterprises have also been the primary source of employment creation, which means that they have made a significant contribution to government efforts in the region to reduce unemployment, especially among youths, relatively low-educated workers, and women.

Within developing economies, Indonesia is more advanced in MSME policies, especially with respect to MSME financing and microfinance institutions. Indonesia began supporting MSMEs with government-

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initiated subsidized credit in 1971, and since then, various types of subsidized credit schemes for MSMEs have been initiated and implemented. In 2007, the government launched for the first time a guarantee credit scheme, known as Kredit Usaha Rakyat, or KUR, particularly for micro and small enterprises (MSEs), as they have limited access to commercial banks for financing their activities because they have no valuable assets as collaterals (so they are considered as nonbankable by commercial banks).

This chapter discusses MSME financing in Indonesia with the focus on the country's experience in the implementation of the KUR.

LITERATURE SURVEY

Financial Constraints of MSMEs

For many developing countries, micro, small and medium enterprises (MSMEs) are the backbone of their economy. These enterprises have always been the main players in their domestic economic activities, as, on average, they made up more than 90.0 per cent of all enterprises, generated more than 50 per cent of total employment, and contributed more than 50 per cent of their gross domestic products (GDP). However, despite their recognized importance and so many government programs have been initiated and implemented to support them, MSMEs suffer from many constraints, hampering them to growth in size and to become viable/efficient larger enterprises. The constraints include their lack of capital; even this appears to be the most serious constraint faced by majority of MSMEs, particularly MIEs during the start up, in these countries. It is obvious that their capital shortages are linked to, among others, their lack of access to financing, particularly borrowing money from banks (e.g. Teo and Cheong, 1994; Hasan, *et al.*, 2011; Shahin, 2012; Gichuki, *et al.*, 2014; Tambunan, 2015). In Indonesia, for instance, although the government has initiated many regulations to give more access to bank credit for MSMEs, only a small fraction of total MSMEs in the country ever borrowed money from banks and other non-banks formal financial institutions (Tambunan, 2015).

In the literature, it is often said that the problem is in fact from both sides, i.e. MSMEs themselves and banks. From the MSMEs-side, the lack of registered valuable assets (e.g. land with license) to be used as collateral, the lack of proven track records, the lack of proper business plans and the need to show good sales turnover, the lack of information about financial possibilities from formal sources (e.g. banks), and the high interest rates charged by the financial institutions. Also, many often, their businesses are not promising; at least from the banks' perspective. From the banks-side, even if they are interested in providing loans to MSMEs, they find it difficult to significantly expand their lending while meeting lending criteria. Also many banks have perception of MSMEs as a high-risk sector and the high transaction costs for loan processing and appraisal (i.e. relatively small loan amounts that are below banks' normal lending threshold), and conversely, low returns. The perceived high risk is a more serious issue for MIEs that require small loans, and for first-generation entrepreneurs with little or without credit history, few or no reliable records, and lack of or inadequate collateral (e.g. Teo and Cheong, 1994; Robert, 1996; World Bank, 2008; Samujh, *et al.*, 2012; ADB, 2014a,b; OECD, 2000, 2014, 2015; Yoshino, *et al.*, 2015). The lack of capital faced by MSMEs is generally considered as a sign of financial market failure in financing MSMEs, i.e. unbalanced between high demand for financing by the enterprises and short supply of financing by banks and other formal financial institutions. Therefore, facing this unfavorable condition for MSME, credit guarantee scheme (CGS) is seen by many governments as an important

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