43rd SEACEN Governors' Conference and
27th Meeting of SEACEN Board of Governors

Opening Address by
The Coordinating Minister for Economic Affairs,
Dr. Boediono

Jakarta, March 21, 2008

Governor Burhanudin Abdullah,
Governors,
Distinguished Guests,
Ladies and Gentlemen

1. It is an honor for me on behalf of the Government of Indonesia to welcome you to Indonesia and to give the opening address of the 43rd SEACEN Governors' Conference. As I understand, the theme of the conference is, "Financial Deepening to Support Monetary Stability and Sustainable Economic Growth." That is quite a large topic, and there will be plenty of time during the presentations and roundtable discussions to delve more deeply into it, and to share our collective country experiences.

2. In the short time I have here, please allow me, by way of introduction, to touch on some of the key issues of the conference theme, and then to share with you some of the initiatives under way here in Indonesia. I would like to end by reflecting on the broader challenges facing the region, particularly as they relate to financial integration.

Financial Deepening and Growth

3. Let me begin by asking the questions: What do we mean by financial deepening and why do we care about it? In general, financial deepening means financial development, marked by an increased provision and wider choice of financial services. Economic literature going all the way back to Schumpeter nearly a century ago has emphasized important linkages between economic growth and poverty reduction on the one hand and financial deepening on the other. There are many channels at play, and the direction of causality is not always clear. But in essence, as this group well knows, an efficient and robust financial system can help both to raise savings and investment levels, reduce the cost of capital, increase the efficiency of investment, and diversify risk. These, in turn, enhance long term growth prospects. Access to financial services by the poor and development of micro finance institutions has also been shown to reduce poverty and promote growth.

4. There is ample empirical evidence to support the link between financial deepening and economic growth. In fact, recent studies show that the link may be strongest for developing countries.[1] Not surprisingly, empirical studies also find a strong relationship between financial development and poverty reduction.[2]

5. Policies to promote strong financial sectors include removal of impediments to market development; improvements in regulatory, supervisory, and legal frameworks; and sharing of credit information. Development of the nonbank financial sector is also a policy priority in many of our countries, including here

[1] See Apergis et al, "Financial Deepening and Economic Growth Linkages," Review of World Economics, 2007.

[2] See, "The Importance of Financial Sector Development for Growth and Poverty Reduction, DFID Working Paper, August 2004.

in Indonesia. It is a way of tapping and promoting longer term savings and financing, for development needs such as infrastructure. Strengthening of bond and capital markets is especially important in this regard.

Lessons from Recent Global Market Turmoil

6. But rapid financial deepening can also carry risks. As a reminder of this, we need look no further than the ongoing fallout of the subprime problem in the U.S. and spillovers to global financial markets. Yes, financial deepening is important for growth, but it must be carried out sequentially and with adequate safeguards and incentives. The importance of building strong regulatory and supervisory frameworks, better risk management systems, and transparency requirements in the introduction of new and complex market products are just some of the lessons.

Fortunately, for most of us here, our financial systems have relatively little, if any, direct exposure to problem structured products. In many cases, this itself reflects limited financial market deepening and relatively low levels of market sophistication—a blessing in disguise! We are therefore in a somewhat fortunate position of being able to learn the lessons from others who are now dealing with the fallout.

7. The subprime problem have also revealed that central banks and supervisors had incomplete knowledge of how complex and deep the markets for structured debt had become and the cascading of risks.

Indonesia's Financial Sector Reforms

8. Here in Indonesia, and elsewhere in Asia, we have learned lessons the hard way, built from the experience of our own banking crises of 1997-98. For Indonesia, that episode was one of the largest and most costly banking crises in modern history. Fortunately, our banking sector has come a long way since the crisis. It is now profitable, well capitalized, while non-performing loans in a stable range at below 5 percent. And while credit growth is now strong, the loan-to-deposit ratio remains relatively low, and some sectors of the economy still do not have sufficient access to credit. Indeed, Indonesia lags behind in traditional measures of financial deepening.

9. The key objectives of Indonesia's financial sector reform program are to continue strengthening the banking sector, diversify the financial sector to reduce vulnerability to shocks, strengthen institutional investors, establish a sound financial safety net. We also want to further strengthen financial sector regulation and supervision (including consolidated supervision), and improve access of the poor to the financial services. One of our key priorities is to accelerate the development of the domestic capital market, as banks still account for the vast majority of the financial system.

8. The key elements of our banking sector reforms are implementation of a "banking architecture" (API) initiated in 2004; adoption of Basle II which is to commence this year with full implementation by 2010; development of a financial safety net; further development of a credit bureau; and formulation of a broader Financial System Architecture.

9. As a coordinating mechanism for the financial safety net, we have recently established the Financial System Stability Forum representing the Ministry of Finance, Bank Indonesia, and the deposit insurance agency. And we are enhancing the quality of capital markets supervision.

Issues and Challenges for the Region

10. This brings me to my final point, on the challenges facing the region as a whole. As a group, we have recently embarked on initiatives to foster closer and deeper financial integration: essentially, financial deepening on a regional level. Among the rewards from integration are greater competition and efficiency, lower cost of capital, longer maturity of financing, greater diversification of risks, and greater liquidity. The process of financial integration can help us all to develop our domestic financial sectors, by making resource allocation more efficient and economy more resilient to shocks. At the same time, we should also recognize that there are risks of greater integration, including greater volatility of capital flows, and exposure to new risks, such as those I mentioned earlier relating to complex structured products.

11. As a group, we have launched several initiatives to deepen domestic markets and foster regional integration. Here I see five important elements in the process. The f*irst* is the need to strengthen capital markets—in particular reforms to strengthen issuers, broaden the investor base, and build market infrastructures. The impact of institutional investors in broadening and deepening capital markets could be enhanced by the appropriate tax treatment of long-term savings products, the transparency of such financial products, and ability of foreign institutions to enter domestic markets. Pension reforms are also a key measure. Mobilizing pension and other non-bank funds could be useful to generate longer term financing for infrastructure. Finally, strengthening corporate governance and improving transparency is essential for deep and liquid financial markets.

12. *The second* element is the imperative to develop market infrastructure, domestically and regionally. Many initiatives have already started in this regard,

although regional initiatives and linkages are only just beginning. The remaining agenda includes steps to enhance the depth and liquidity of capital markets, especially bond markets; establish links between national clearing and payments systems; and create regional credit rating agencies and benchmarks.

13. *Third* is the need to manage and minimize risks that come with financial integration. A strong framework for prudential regulation and supervision is necessary to ensure that risks arising from integration are being assessed and well managed. This involves a move towards risk-based supervision, and changes in prudential regulation and supervisory oversight to address cross-sectoral and cross-border activities.

14. And *fourth and fifth* are, respectively, the unfinished agenda of harmonizing differences in laws, regulations and tax treatments; and improving international and regional cooperation.

15. We have a large agenda ahead of us, and it is appropriate that this SEACEN Conference take up this topic. On that note, I wish you a successful conference.

Thank you.