Boediono: Living in a global economic crisis

Speech by Prof Dr Boediono, Governor of Bank Indonesia, at the Bankers' Dinner 2009, Jakarta, 30 January 2009.

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Ministers of Indonesia's United Cabinet,
Members of the People's Representative Council,
Prominent Bankers,
Ladies and Gentlemen,

Assalamu'alaikum wr.wb,
Good evening and may God bless us all,

Introduction

To open my speech here this evening, I would like to invite us all to jointly extend our prayers and gratitude to God Almighty for this fantastic opportunity to gather together in such salubrious settings at the Annual Bankers' Dinner 2009. To the banking community, this event represents a tradition as a moment of reflection and information exchange between us all.

I would quickly like to take this great opportunity, if not slightly belated, on behalf of all members of the Board of Governors of Bank Indonesia, to wish everyone a Happy New Year 2009. The upcoming year of 2009 will be beset with challenges, however, we continue to be blessed with strength and guidance from God Almighty in all our endeavors.

Distinguished guests, ladies and gentlemen,

It is already extremely clear that numerous challenges and tests of our proverbial character will bedevil 2009. We are currently riding upon the crest of a great wave that represents the deepest global economic crisis since the Great Depression befell the world in 1929. Dominating the thoughts of economic policymakers and players worldwide is how to weat her this "perfect" maelstrom successfully. We have all entered "survival mode".

To the majority of us here in Indonesia, the salvo that heralded the onset of a global economic crisis was heard during the first months of the second semester 2007. At which time it was disclosed that a number of banks and financial institutions in the U.S and U.K were suffering financial hardship. The reason was attributed to sub-standard quality mortgages, or subprime mortgages, that began to perform poorly.

In hindsight, the subprime mortgage debacle was merely the tip of the iceberg and was immediately followed by rapid escalation. The impact of the crisis spread like wildfire and deepened further. What began its life as a mortgage crisis quickly became a global credit crisis within a matter of months. The risk perceived by economic players increased almost exponentially. Credit flow for normal activities was severely disrupted as investors switched their savings to cash or gold instead of extending loans. Banks and financial institutions stretching across all corners of the globe faced their toughest time and some of them, including those with a global reach, filed for bankruptcy.

The governments of several countries were forced to provide bailout and rescue packages to inject liquidity into the economy in previously unheard of amounts. To this day banks and financial institutions remain in a state of financial distress and credit flows are far from normal. "*The financial sector is broken*", remarked Paul Volcker.

What has deeply concerned economic players worldwide, and is to be avoided almost at all costs, is the vicious downward spiral between the financial sector and real sector. In other words, the financial sector fails to function effectively, thus exacerbating the real sector, which subsequently undermines financial sector performance and so on, hence the downward spiral.

The governments and central banks of many countries have taken any measures necessary, including unconventional steps to save the situation. In order to stop the downward spiral that I mentioned, the monetary authorities, particularly of the major economies, poured in vast amounts of liquidity. In addition, almost all governments have rolled out fiscal stimulus packages.

To save their respective financial sectors, the governments of several countries have intervened, including through the implementation of blanket guarantee schemes for savings held at banks, insuring or taking over disputed assets, injecting capital into financial institutions and even buying out such institutions.

If I portray a gloomy picture of the global economy, I certainly do not wish for us to be pessimistic, particularly regarding our own domestic economy. Objectively speaking, the current situation, and indeed the outlook, of the global economy is dreary at best. It is important that we view our problems objectively and as such we can take appropriate actions to really deal concisely with the problems. Actually, I would like to encourage you all to be more positive. I believe that with mutual determination and measurable steps we can traverse this challenging path safely and soundly, and God Willing, we will emerge stronger on the other side.

At a global level, I foresee a bright spot. At the epicenter of this crisis, the United States, new hope is dawning in the form of a new government with their new economic team, who have pledged to take prompt and forceful actions in order to deal with the crisis. The willingness of major countries to coordinate their policies has also strengthened. I have also observed that some components of previously taken actions have demonstrated favorable results, despite remaining relatively minor as the scale of the crisis has mushroomed.

Meanwhile, amidst such inauspicious surroundings, Indonesia is certainly not in the worst position compared to other countries. In general, our macro posture, including economic growth, is not bad. Our banking industry also remains robust.

Indonesia can be considered lucky as its banks' and financial institutions' exposure to subprime mortgages is minimal. However, we are certainly not immune to the impacts of the crisis. As global credit crunch reached its pinnacle following the bankruptcy of Lehman Brothers, which dealt a psychological blow to the domestic market, in November 2008 the Government took over Bank Century in order to maintain national banking stability. Moreover, Indonesian banks are not immune from the problem of derivative products, and the scale being relatively smaller compared to several other developing countries, and significantly less than in developed countries.

Meanwhile, some have expressed that our delay in integrating our financial sector with the global financial network is really a blessing in disguise, as it has saved us from more serious crisis fallout. I tend to agree with this view. In my opinion, it serves as a lesson for us not to be over enthusiastic to advance or be considered advanced before we truly understand the inherent risks and before we are ready with the required tools to manage such risks. Later I will return to this subject on the lessons learned from the ongoing crisis.

A current issue we face today is the waning access of corporations and banks to sources of foreign financing. The exodus of funds from developing countries, including Indonesia, has been stemmed. Furthermore, the signs of capital inflows to Indonesia are yet to materialize, except on a small scale. The return to a normal flow of funds has not yet transpired but, as I have mentioned, there is reason to be optimistic.

We have all witnessed how developed countries have gone all out when taking measures to normalize the supply and flow of credit to their own countries in order to stem the tide of deteriorating economic activities. Once credit flows in such countries have returned to normal, fund flows to developing countries will gradually return to normal too. Indonesia must position itself among other developing countries so that we can be among the first to benefit from the global financial awakening. In my view, the key lies in positioning Indonesia to be considered as a safe and convenient place to conduct business and investment. We have to assure investors that our macro economy is properly managed and sustainable, and that our financial sector, particularly the banking sector, is robust. This is our joint responsibility.

Another issue of concern is the domestic interbank money market that has not operated normally in terms of daily transaction volume, in particular from the aspect of access by medium and small banks to this fund source. For your information, this issue regarding the interbank money market has been experienced by numerous countries and each country has responded differently. In general, the response is one or a combination of three steps: guarantee provision by the government; an insurance program with government support; and an expansion of the liquidity facility provided by the central bank to banks. Hitherto, Indonesia has relied primarily on the third option, namely by expanding the liquidity facility to banks.

Over the past several months, Bank Indonesia has taken several steps towards this common end. It is important to admit that these steps have not resolved all of the outstanding problems, particularly in terms of access by medium and small banks that do not have adequate secondary reserves. Expansion of the central bank's facility, such as through the short-term funding facility (FPJP), is not a perfect substitute for an optimal interbank market. Bank Indonesia expects national banks to jointly take initiatives and play a more active role in jumpstarting the domestic interbank market. We at Bank Indonesia always welcome further discussion with banks on this issue.

Meanwhile, during the past two quarters, as has been evident in all countries, Indonesia is no exception; the global financial turmoil has crushed economic activities in general. This is a dangerous stage that requires forceful and effective steps to bring it to an end. Countries' experiences have shown that a structural financial crisis such as is occurring now will have lasting impacts on the real sector. Sluggish economic growth will continue for several periods despite liquidity returning to normal. Consequently, I would like to reiterate the importance of strategies with clear targets. I will mention three targets that we must strive towards together: (a) to pass safely through this period of global credit crunch; (b) to ensure that national economic activity does not deteriorate in the short term; and (c) to promote conducive conditions so that the subsequent domestic economy is on a track to sustainable economic growth.

Fiscal stimuli are a key step in preventing the further deterioration of economic activities in the short term. Furthermore, the expeditious implementation of the 2009 National Budget is required and it also has to succeed. However, as Ben Bernanke often reminds us; to emancipate ourselves from the shackles of this crisis, fiscal stimuli have to be introduced concomitantly with financial sector strengthening. Fiscal stimuli are basically a way to prime the pumps. They will not catalyze sustainable economic growth if not buttressed by a reawakening of private and business sector activities. Furthermore, the private sector will only be roused if supported by a fully functioning financial sector.

As such, measures to repair and reinforce our financial sector must be taken along with the introduction of fiscal stimuli. In our great nation, banks remain a reliable source of financing for the business sector, and thus, tidying up and strengthening our banking sector must remain a priority for continuous implementation. Within its authority but constrained by capacity limits, Bank Indonesia will take any and all measures required to attain this target. For a developing country such as Indonesia, I would like to add one more ingredient to Bernanke's recipe; that is we also have to perform structural reforms to remove the obstacles to business activity.

Lessons learned

Distinguished guests,

Experience is the best teacher in life. The ongoing global crisis provides valuable lessons for our future endeavors. Allow me to highlight a few.

A simple lesson learned from this crisis is the importance of going back to basics. Let us view the reason. The current crisis can be seen as a consequence of financial sector development that is detached from its roots, which is real economic activity. Expansive development of the financial sector in many countries for over a decade has stemmed from financial product innovation as well as the great strides made in financial institutions. Such innovative growth has been made possible by the revolution in information technology and global financial liberalization.

The financial sector in many countries has attracted many people, including the best and the brightest, as it is often a fast track to wealth and riches. Those who are skillful, innovative and dare to take risk can receive a befitting reward. Financial products that have become more varied, more sophisticated and more complex have a fatal side effect, namely that the inherent risks are more difficult to assess. Financial instruments are becoming separated from underlying transactions that should form their base and have developed into bubbles. Due to their internal dynamics, the bubbles are swelling and many have finally burst, which precipitated this crisis. In short, the ongoing crisis is basically a consequence of failed risk management, both at the micro and macro levels.

Back to basics applies to all financial institutions, particularly banks. The main role of banks is to facilitate and finance activities associated with the supply of goods and services to the people; more specifically “real” activities. Banks perform their function through financial intermediation; that is to collect funds from their owners and distribute it to borrowers. However, banks can act as more than just intermediaries. Banks can create additional liquidity through demand deposits. Such bank activities inherently contain risks, either to the bank itself, to savers, to the banking system or to the economy. These risks have to be properly mitigated by the banks, which is their primary responsibility and requires the full attention from bank management, above and beyond a full-time job.

Banks play a role in financing activities with clear underlying transactions, which have to be based on clear risk assessment. Dabbling with speculative instruments is not the domain of bankers. Banks should avoid activities that contain bubbles. If such activities cannot be avoided, effective risk management must be applied. Bank Indonesia, as a regulator, has an interest in encouraging banks to apply prudential principles. In the future, we will strengthen the protocols required to accomplish this objective.

The current crisis has also provided concrete proof that the concept of universal banking is not a crisis-durable model. We should reconsider this concept thoroughly and with caution. Policies taken to further develop the industry towards more advanced concepts must be followed by various strengthening measures and the preparation of resolute risk management. Meanwhile, we can conclude that the narrow-bank concept is more befitting the banking domain and has been proven to endure during a crisis. The selection of a bank business model determines the resilience of the banking sector. During the current crisis and the catastrophic crisis of 11 (eleven) years ago, we can clearly observe that banking sector resilience is the main line of national defense against financial turbulence.

Allow me briefly to draw one more important lesson from the ongoing crisis. The lesson is that the basic principles of conventional macro management have been proven to be relevant in conditioning an economy against turbulence. Countries that observe and protect their basic indicators, such as the national budget deficit, current account deficit, ratio of debt to repayment capacity, foreign reserves, inflation rate, liquidity growth and exchange rate under a framework of sustainable economic growth, in general, are in a better position to confront a crisis. Conventional wisdom prevails even (or especially) during a storm.

With reference to macro equilibrium management, I believe that this crisis has brought a more structural lesson. Using experience gleaned from the current crisis, we need to consider some more basic questions; questions that will help guide us when positioning Indonesia during this era of globalization. For instance, what is the best equilibrium for our economy: between the domestic market and export market, between the financial sector and real sector, between the outward orientation and inward orientation of our financial sector, particularly our banks, between relying on domestic financing or foreign financing. Such questions require a fair, thorough and in-depth thought process. It is imperative to answer these questions if we want to develop a more resilient national economy to future turbulence.

Prospects and challenges in 2009

Distinguished guests,

Allow me to further explain the horizon we face in 2009. One issue that can be considered undeniable is that all countries around the world face an economic downturn. Indonesia is no exception. For us, the effects of the crisis began to be felt during the last quarter of 2008. The economic slowdown will be more obvious in 2009, particularly during the first semester. Estimations we ran at end of 2008 projected that our domestic economy in 2009 will grow in the range of 4%-5%. Certainly not too bad when compared with the projections of many other countries. However, observing the current global trend, the downside risk will increase.

In line with efforts to protect economic growth, the key here is how to maximize domestic market potential to bolster domestic economic activities. The foremost element of this policy is to expedite the implementation of a fiscal incentive package and the 2009 national budget. Well-controlled inflation as well as government, political party and public expenditure for the upcoming General Election, will also help underpin public purchasing power. In addition, certain policies that must be intensified include measures to improve the business climate and reduced domestic business costs. The implementation of such policy should not require any additional funding, however, more focused and determined actions to detangle the knots are necessary. We hope that during this year of the general election, such policies can be continued and even intensified.

Meanwhile, along with tumbling commodity and fuel prices as well as solid rice production, the interest rate in 2009 is expected to decline, in the range of 5.0-7.0%. If current developments persist, however, the lower limit of this range is expected.

Questions often arise on the prospect of our Balance of Payments this upcoming year. Based on detailed calculations performed at the end of last year, we estimate that the Current Account will run a deficit of around 0.11% of GDP in 2009. Global fund flows are estimated to return to normal in 2009. However, there is one particular note for Indonesia. If the experience of the 2004 General Election reoccurs this year, namely a safe General Election that results in the formation of credible cabinet, then during the fourth quarter there will be relatively large inflows of funds. The majority of such funds belong to our nation's citizens, temporarily placed abroad while awaiting confirmation of the domestic political situation. Based on our calculations, foreign reserves by the end of 2009 are estimated at USD51 billion; adequate to finance 4.7 months of imports and government foreign debt repayments.

In the banking sector, stress tests indicate that the resilience of our domestic banking industry is sufficient. In 2009, the capital adequacy ratio (CAR) is estimated to decrease slightly from 16% in 2008 to 14%. From regulatory capital point of view, this ratio is still well above its minimum limit. However, from the economic capital view, this development should be anticipated in a timely fashion. A declining capital adequacy ratio indicates the reduced ability of banks to absorb various risks and expand credit. Therefore, I would like to see efforts to reinforce bank capital remain as our primary focus in the future. Bank Indonesia will continue to closely monitor the development of capital at each bank. We are all aware that without safe and adequate capital, the bank intermediary function will not run optimally, and industry resilience to inauspicious conditions, such as now for example, will be undermined.

Based on current capital strength and contradictory to credit growth in developed countries such as in the European Union and United States, where a downturn was experienced in 2008 and perhaps negative growth will prevail in 2009, credit growth in Indonesia in 2009 is estimated to remain in the range of 18%-20%. Yet the downside risks are relatively large. Meanwhile, slow economic growth will precipitate a rise in NPL to around 5% in 2009, which is still considered within safe boundaries.

It is important to be aware that liquidity in our banking system is currently adequate. This is evidenced by large placements in Bank Indonesia Certificates by Indonesian residents; now totaling Rp200 trillion, and undisbursed loans of Rp253 trillion (November 2008). This large liquidity pool indicates that our economy is not suffering from a liquidity shortfall. Our challenge is how to utilize this liquidity to finance economic development and business sector activities.

Direction of monetary and banking policy in 2009

Distinguished guests,

Under the all-encompassing blanket of the current global crisis, we are fully aware of the importance of monetary policy that supports the real sector. However, policy must be consistently implemented in the context of sustainable economic growth, supported by economic stability in the mid-long term. Monetary policy must strike a balance amongst stimulating the real sector, maintaining price stability, maintaining financial market harmony and ensuring financial system integrity. Monetary and liquidity loosening will be complemented with thorough surveillance and assessment by Bank Indonesia on indicators associated with these targets.

Distinguished guests,

We are aware that the various obstacles emanating from the global financial crisis in 2009 require concrete steps by the relevant authorities to maintain the performance of business players in productive sectors.

To this end, policy should be directed to ensure that the bank intermediary function can be performed optimally. Meanwhile, we also expect that the extension of Rural Business Loans and MSME loans will experience relatively strong growth. Such credit is vital to rural people and those in remote areas in order to enable them not only to survive but also expand their businesses during difficult periods such as we expect in 2009.

Several policy measures have already been taken and will continue to be taken in the future to facilitate credit flow. This evening, I do not wish or have the time to convey in any detail the regulations that will be promulgated. I opine that during this difficult period filled with uncertainty, the policies of Bank Indonesia will continue unabated, following economic dynamics that require appropriate responses as well as anticipatory measures.

However, generally speaking, I would like to disclose that Bank Indonesia recently issued regulations aimed at providing freedom of action for banks to extend credit. The regulations cover several issues that constitute areas of concern for most of you present here this evening, such as: extending the transition period for Basel II implementation with reference to the capital cost of operational risk calculations; procedure simplification for opening a branch office, including sharia banks; adjustment of risk-weighted assets for Small Enterprise Loans with a guarantee scheme; adjustment of the credit assessment method for specified amounts; providing USD repurchase agreement (repo) facility between banks and Bank Indonesia; as well as reducing liabilities regarding the provisions for losses of nonearning asset (abandoned assets). In the very near future, in-depth regulatory steps to improve bank transparency, as well as strengthen the effectiveness of liquidity risk management and derivative products will complement these regulations farther. Under such a policy, all players in the banking industry, including shariah, is expected to have sufficient space to maintain its intermediary function, as well as continue the implementation of prudential principles and risk management as a priority.

Distinguished guests,

As I mentioned earlier, the cornerstone of our defense against a crisis is the banking sector. The economy is crisis resistant if its banking sector is crisis resistant. The banking sector I allude to is based on two pillars, namely good governance and good supervision.

Regarding good governance, I would like to stress one pivotal aspect. With the circumstances found pervading our financial and banking sectors lately, I am even more assured that human integrity and character, above all else, are determining factors. We can adopt a sophisticated risk management system and put in place a good supervision system, however, in the end the result is subject to the integrity and character of the administrators. No matter how good a system is it will not work if the administrators seek loopholes to abuse and exploit.

In the future, Bank Indonesia will strengthen its screening process based on the character and integrity of our bankers, and certainly, our supervisors. Bank Indonesia will also impose strict sanctions for those who abuse their authority. PSP and bank management must take full responsibility, bound by prevailing laws and regulations, for incidents that occur at their respective banks.

Improvements to bank resilience closely correspond to the quality of bank supervision. With this in mind, I am happy to report that Bank Indonesia is currently undertaking steps to augment bank supervision. The repositioning and revitalization of personnel is currently underway. Supervisory procedures and methods are constantly reviewed to focus on issues that determine the wellbeing of a bank.

In 2009, we plan to boost the effectiveness of bank supervision through two key measures. The first is to complete the risk-based supervision framework by improving the risk assessment process, oversight, auditing and system surveillance. Ameliorating the quality of risk management, particularly liquidity management and control over new products and bank activity, represents the mainstay of ongoing endeavors. This is considered sufficiently urgent to be handled during the current financial turmoil. Second is to improve the function and organization of supervision both at head office and all branch offices of Bank Indonesia.

We will continue to strengthen the correlation between findings and actions; between audit results and management steps. We will form a panel team to improve audit quality and managerial steps. This year, we will also increase our budget for training. These measures are expected to secure our pathway through this crisis period as well as also build more solid foundations for better bank supervision in the mid term.

Closing

Distinguished guests,

This brings me to the end of my speech here this evening. The ship that represents our national economy is currently navigating a tempestuous ocean. The ship itself is relatively robust, certainly stronger than the ship we sailed eleven years ago. However, the current weather front dwarfs that of eleven years ago. Notwithstanding, I am convinced we can weather the storm. The key is that the ship’s crew and passengers are unified and open to help one another based on trust. I am confident that this is our joint resolution, as the alternative is too expensive for our country, as transpired eleven years ago.

I sincerely wish you all a productive year ahead and once again, Happy New Year for 2009. Hopefully during this New Year, God Almighty will bless us and light our way towards a better and more prosperous future.

Thank you.

Wassalamu'alaikum wr. wb.