Budi Mulya: The need to strengthen Indonesian financial market

Keynote speech by Mr Budi Mulya, Deputy Governor of Bank Indonesia, at Japan International Cooperation Agency's (JICA) seminar on "The Challenge in Developing Indonesia's Financial Market", Jakarta, 11 December 2009.

*   *   *

Distinguished speakers, ladies and gentlemen,

It is such a great pleasure to join in today's seminar, which will address Indonesia's financial market and its further development. This particular topic, I believe, become more relevant and crucial for Indonesian economy. In the last couple of decades, we all have been witnessing on the role of the financial market in many economies. Yet, within the last two years, we also have observed on how financial market malfunction has severely impacted the real economy, a very hard lesson to learn. Many aspects of this phenomenon have been written and discussed, both from policy makers' perspective as well as analysts'. All of these analyses are intended to search for the most possible cause of the crisis, in order to prevent a repeating occurrence in the future.

On that respect, I would like to highlight one important aspect from the most recent global financial turmoil, as background of my speech today and as one alternative reference of the approach in discussing the future development of Indonesia's financial market, that most fit with Indonesian economic characteristic.

In general, if we look back to the mid 2007, it can be reasonably seen that the crisis emerged in the debt market, particularly with regard to its derivative product, which reached its peak in September 2008 when Lehman Brothers collapsed. The financial market transaction and instrument development moved too far, beyond the need to serve the economic financing in a healthy way. The value of financial market instruments have been much higher, compared to their fundamentals value and their inherent risk. This is also closely related to the fact that the financial institution involved has also not been supported by adequate resource buffer to absorb potential capital loss. They tended to operate with very high leverage, depending their funding from money market, as well as debt market. On this regard, the liquidity of those markets is a crucial key, since in high leverage circumstance, counterparty risk could easily jump. As a consequence, when there is a serious disruption in money market, as we observed during financial crisis, funding becomes more difficult for those institutions. They had to undertake force sale of their assets, experienced big losses, and some of them even collapsed or had to be bailed-out by the government.

Some argued that those behaviors were closely related, or as consequences of the low interest rate policy, particularly in early 2000s, as well as the relatively loose financial institution regulation and supervision by authorities in major countries. Now, we are also again witnessing low interest rate environment in major countries, as one of the main parts of the crisis policy respond. However, there is now an increasing discussion on how to enhance the effectiveness of the financial regulation and supervision, to prevent, that what happened in the past will not be repeated. In addition, there is also an increasing attention, put in the risk taking behaviors of financial market players, such as we find in the Leaders' Statement of the G20 Summit in Pittsburgh last September. This risk taking behavior is believed, affecting monetary policy transmission through their significant distortion in financial stability. Hence, in turn it reduces the effectiveness of monetary policy. This issue, known as risk taking channel, is also relevant to today's discussion, but I will not discuss further this aspect in my speech this morning.

With the above background, I would like to emphasize my speech on the liquidity aspect of the banking and money market, as well as in the financial market. This liquidity aspect, along with the availability of related “infrastructure” is a crucial foundation, to ensure the soundness of financial institutions and to develop healthy financial market.

The Indonesian banking, money market and financial market

In contrast to those observed in major financial market, the Indonesian financial market can be considered as still in an early stage of its development, despite significant progresses achieved in the last couple of years. Also, from the type of transaction and instrument variety, as well as from their funding type of financial institution, the Indonesian financial market could be viewed as too traditional or too conventional. Yet, these facts became such a “blessing in disguise” and help sheltered the domestic financial market and the economy from the adverse impact of the recent global crisis.

Before I elaborate on the aspects that need to be improved in our domestic financial market, I would like to briefly discuss the characteristics of the Indonesian banking, money market and financial market as a background.

Banking

The Indonesia’s banking industry is actually operating in a new stage in post 1997/98 crisis and 1999 banks recapitalization era, as compared to the previous period. There are two factors that characterized the current Indonesian banking sector in general.

First, they are operating in structural excess liquidity in the inter-bank money market. In this regard, I refer the term liquidity as central bank’s reserve money. This is also reflected in the volume of Bank Indonesia’s open market operation – banks’ liquidity that Bank Indonesia absorb, as part of Bank Indonesia’s monetary policy implementation to maintain short-term money market (overnight PUAB) stable around BI Rate. This is cash alike in banks’ assets. This is actually a rather common phenomenon in countries that experienced financial crisis and had to bail-out the financial industry. For example, in the US, the central bank balance sheet has ballooned from around USD 800 billion before crises into around USD 2.2 trillion recently. This data also reflected in the US commercial banks or other financial institutions’ placement – usually in overnight basis as excess reserve and now remunerated at 25 bps – in the Federal Reserve. Thus, in essence similar to bank placement in Bank Indonesia’s OMO instrument (SBIs. FASBI, FTK).

The situation I just described was needed to facilitate the domestic banking sector consolidation process in the post 1997/98 crisis. However, if this continue to exist too long, will lead to a mislead incentives. It will not encourage banks to have a more efficient asset and liabilities management. Also, banks will tend to be less aware to liquidity risk, as there will be a perception that there will always be a huge supply of liquidity in inter-bank money market. This can be seen during the peak of global financial turmoil at the end quarter of last year, where our domestic money market also experienced a significant “perception” of tightening liquidity, despite that there was a large number of liquidity stock in the money market. There was more than Rp. 150 trillion of banks’ cash, placed into Bank Indonesia’s OMO instruments. Yet, the inter-bank money market indicators showed that the flow of liquidity in inter-bank money market has squeezed. The volume of inter-bank money market has declined from its normal level of around Rp. 10 trillion to below Rp. 5 trillion. The interest rate spread has also widened significantly. The JIBOR 1 month spread over BI Rate jumped from its normal level of around 50 bps to around 220 bps. Further, there was also indication of unhealthy competition among banks, to maintain third party’s fund by offering higher deposit rate.

Second, there is large number of government bonds (SUN) in banks’ balance sheet, which mostly originated from banks’ recapitalization in 1999. Recently, banks hold around 50% of outstanding SUN of Rp. 570 trillion. This type of asset is risk free hence no bad debt provision is needed. It helps banks in maintaining a strong capital, but with result a lower yield compare to other earning assets. However, on the other side, this result in banks being more expose into market risk, as has been showed when the SUN prices (IDMA Index) dropped to their lowest level of 67.11 in 29 October 2008. Under excess liquidity condition, banks' attention on the liquidness of this type of assets is relatively low. In this regards, I refer liquidity as an easiness of SUN to be traded, or exchange into cash without significantly impact their price. Banks tend to practically borrow in unsecured money market, rather than undertake repo transaction to serve their short-term liquidity need. This could be seen, that despite Bank Indonesia has actually facilitated market participants to establish a standard repo agreement (MRA) since June 2005 as one infrastructure to increase the liquidity of SUN market, but in reality their respond is quite marginal.

Money market and financial market

The Indonesian money market is basically inter-bank money market, as it mostly involves only banking. So far, the transaction in the inter-bank money market is dominated by unsecured lending/borrowing (PUAB), and mostly in a very short term maturity. Around 60% of inter-bank transaction is overnight. There may be some short-term debt instrument in OTC (over the counter market), but I believe in a very small numbers and not actively traded amongst bank. There is also perhaps, an interest rate swap (IRS) or overnight index swap (OIS) in OTC market, as there is sometime a quotation in Bloomberg or Reuters. But, it seems not quite regular and the transaction is supposed to be in a very small number. Thus, in general, money market is not yet considered to better serve banks' portfolio management.

Meanwhile, in the foreign exchange market, the transaction is also still dominated by spot transaction. The daily volume of inter-bank spot transaction is about 1.5 – 2 billion US Dollar in the last two years. In addition, swap transaction is around 300 million US Dollar in 2009, a bit lower compare to around 500 million US Dollar last year.

Further, the financial market is dominated by government debt instrument. The development of Indonesian financial market actually took place from the post 1997/98 period. The SUN market begun in 2002 when banks were started to be allowed to gradually trade their recap bond holding. The development in government bond market then triggered the development of corporate bonds as government bond serve as a risk free benchmark in debt market. However, the transaction in SUN market is, so far, dominated by outright transaction. The repo market is not yet active, partly for the reasons as I have previously described, which lead to a perception of bank that undertake repo is in a desperate liquidity need situation, hence will be punished with higher interest rate.

The relatively less liquid domestic financial market can be seen from the SUN turnover. Recently, the daily outright trading volume of SUN is just around Rp 6.5 trillion and 300 transaction within the last two years. Thus, just around 1% of SUN outstanding. While the repo transaction is much lower, below Rp. 1 trillion daily, but not always occurring every day.

Why we need to further develop Indonesia's financial market?

From the above description, basically, I have just explained the main reasons, the need to further develop the Indonesian financial market. First, to increase the resiliency of domestic financial market, including the banking sector, from possible liquidity shock. Second, to increase the efficiency of financial portfolio management and to strengthen liquidity risk management, which in turn it will increase the effectiveness of monetary policy from Bank Indonesia's perspective. And third, given the increasingly importance of financial market in the economy, it is crucial to have a strong, efficient and healthy financial market to avoid any possible distortion, including from inefficient practice that will add more cost in economic financing. However, the development should be undertaken in gradual manner, and again, should always be linked closely with the need of the real economy.

I will now highlight some issues that I believe should be firstly considered as a starting point to develop our domestic financial market.

The development of repo market can be considered as a starting point to increase financial market liquidity. This will increase efficient banking liquidity and portfolio management, as well as government financing. In this regard, as financial transaction is mostly in essence a legal contract, thus having a commonly accepted standard repo agreement is a key. In this area, Bank Indonesia and the Government Debt Management Office, has again encouraged market participants to establish a standardized repo agreement that complies with international standard. In line with this, the progress of the commitment from major market players in debt market (HIMDASUN) signed in 20 August 2009 has to be monitored closely. On the other side, Bank Indonesia will also continue to promote the use of repo transaction by enhancing the strategy adopted in Bank Indonesia's liquidity management operation. In addition, the need to have a commonly accepted standardized transaction among market participants is also valid for transaction in foreign exchange market.

It is also important to encourage the establishment of broader self regulatory organization (SRO) in domestic financial market that covers all segments in the market, to provide convention for various market transactions, and to assist in monitoring OTC market, as well as a counterpart for the authorities and regulators.

However, it is important to note that coordination among authorities, and the continued dialog with market participants, is a key element in developing financial market that most fit with the need of the economy.

Ladies and Gentlemen,

I hope today's seminar produces fruitful discussion for all of us, as well as exchange perspectives from expertise speakers to enrich our understanding on developing the Indonesian financial market.

Thank you.