

Keynote Speech

Towards a More Contributing Financial Sector in Asia

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Vice Commissioner Masamichi Kono, Excellencies, Distinguished Colleagues,

Good Afternoon.

I am pleased to have this opportunity to talk to you in the *International Conference on Financial Regulation and Growth in Asia*, hosted by FSA of Japan. This conference is very timely. Market has been calmed down in the last couple of weeks and yet the great crises still lingers. Tranquil market gives us a moment to discuss things in a more ease mood which quite often inspires brilliant ideas. Those ideas, I strongly hope, will be beneficial in streamlining the reforms undertaken. This is also a perfect timing to push global financial reform, since the best time to make a reform is in the crises time.

Before I start, let me express my gratitude to the FSA of Japan and FSB-RCGA for inviting me to this important event and Vice Commissioner Kono for insightful remarks, and also to the organizers who have contributed to the excellent organization of this Conference.

My speech will be in two folds. First, I will touch the element of communication in maintaining financial system stability. Then I will proceed with the proposed arrangement in increasing financial sector contribution to economic growth.

Ladies and Gentlemen,

Just days before the month of May came to its end, the news of possible tapering by the Fed broke out. Suddenly, through the magic of global economy interconnectedness, the decision made in the USA hit financial market all over the world. In the first instance, equity indices dropped, bond's yield rose, and exchange rate depreciated. Emerging market suffered the most. There was a huge wave of net outflows from non-resident investor in the domestic financial market. The shaky global economic recovery was in jeopardy.

It is true that some countries hold fundamental problems. But those are arguably the main determinant for severe correction in each respective jurisdiction. Indonesia, for example, despite its current account deficit, is actually in decent state. We are still recording high economic growth, among the highest in the region. Core inflation stabilizes. Debt profiles are also in much better condition, compare to what we had prior to 97/98 crises, as 82% in the form of long-term debt and mostly hedge. However, Indonesia is one of the worst hit countries. Thus, there must be some other factors that create this commotion.

First, most of domestic investors in emerging market are prone to nervousness in facing of capital outflows. Herding behavior is common practice. Taking the case of Indonesia, the negative sentiment can easily be multiplied due to traumatic experience 15 years ago. Whenever Rupiah depreciates crossing psychological barrier, people tends to react irrationally. Why do this happen? I might argue that economic fundamental is an abstract form in the eye of people. To them, it is easier to understand the value of Rupiah against dollar than to understand the concept of sustainable growth. To common people, the potential overheating of 8% economic growth is always better than sustainable 5,5% growth. Then, it is our task to send the message of sound economic fundamental in a more simple way.

Second, while countercyclical is the important features of macroprudential policy, there is a tendency that its implementation is biased toward the bad times. It is easier to launch a stimulus packages to fight recession than to hold up credit to curb the expansion.

We seem to forget the fact that the ongoing recovery is attributable to series of stimulus packages given by authorities, most notably from developed countries. Huge flows of fund came to emerging markets that offered higher return. Financial indicators were all in the green zone. But, these policies must be reverse at certain point in time. We should have been prepared when the time comes.

Unfortunately, there are too many pressures to constraint expansion even if we want to do so. If you ask 10 economists from securities houses about the probability to countercyclical the expansion, all of them will go against you. They might ask you back why regulator should intervene the market. There is a market mechanism that will do the job.

There are some factors that make regulators halfheartedly try to stop the party. Political pressures among other things. Regulators themselves quite often use the expansion as

their milestone. There even an award for the best bourse of the year, no matter the source of growth comes from strong fundamental factors or just a bubble.

Ladies and Gentlemen,

While financial system stability has been around for many years, not before the current crises so much attention has been given to its importance. Macroprudential becomes a new mantra. Lots of central banks or financial regulators now have financial stability in their mandate as complement to their traditional task of maintaining inflation.

As we try to set rules and regulation to keep financial stability in place, the loss of market confidence easily deteriorates stability. I do not mean to undermine the hard work done by international standard setting bodies. It is necessary, but not sufficient. We need to control the perception of market players as they are the real participant in the daily economic transactions.

Containing the disruption of market confidence is not an easy job when market jitter. Prompt policies response, certainly, should be the first step taken. But we should ask question why investor easily gets nervous? When the fundamental is strong, why people act irrationally? I suspect, there is no anchor that can be used or understood by the people to check whether economic development is on the right path.

In the '90s we saw the emergence of inflation targeting framework. Under this framework, public communication is predominant features. Openly stated inflation target, pre-scheduled policy meeting, and clear and easy to interpret policy signal set every party in a concord move. When the correlation between monetary base and the inflation was diluted, central bankers found a way to restore its prominent role of maintaining price stability.

However, unlike inflation, it is hard to set an anchor for financial system stability. We may create financial stability index and publish it periodically. Yet, people cannot feel it or understand it. The FSI does mean anything to the people. Financial stability is more for our internal usage. Instead, I think we should use indirect strategy of communication. Rather than trying to convince people that financial condition is in a good shape, I think it is influential to announce simple and clear long term target that deals directly with people. It can be GDP/capita or certain rate of unemployment, but it should be real indicator. We should also set intermediate targets along the way that confirms the path towards

ultimate goal. If everything is intact, undoubtedly leads to the construction of confidence. This communication strategy should be done continuously and repeatedly. At the same time, regulators and authorities should focus on their job to preserving stability through their regulation and/or interventions whenever needed.

Ladies and Gentlemen,

Now I move to my second concern. We all know that financial stability is prerequisite in supporting sustainable growth. A greater responsibility is to function properly, which providing source of finance to the real sector.

With its increasing role in global economy, Asian countries should keep the high-sustainable growth. How can Asian countries cope with that?

The answer is to build a sound growth platform, which is by strengthening the production sector in the same wave length as the development of service/financial sector. Since the collapse of Lehman brothers 5 years ago, we witness the high-yielding financial sector grew more rapidly than the production sector did, thanks to loose monetary policy from advance economies. It creates vulnerability. We observe dichotomy between financial sector and real sector. Low interest rate and easing monetary policy does not transform to better economic growth. While financial indicators showed tremendous development, real growth remains subdued.

The problem in most emerging market is the dominant role of banking sector in financing economic activity. By its nature, banking sector is heavily regulated industry. While it is good to protect the money deposits in the bank, it sometimes hinders access to credit, especially to small businesses. Meanwhile, the capacity of non-bank financial institution to fill the credit void is limited. RCGA survey shows that NBFIs comprising only one third of the total financial system of RCGA members.

This is the time when we should emphasize more on inclusive growth. As in Indonesia, liquidity is never the problem. The access is! For developing and emerging economies this is quite pivotal. That is why now we have blue-print of Inclusive Growth under the command from the office of the Vice President. It is a national priority in Indonesia.

We also need to strengthen the capacity of NBFIs. The practice of shadow banking might become an alternative solution. Nevertheless, it has to come hand in hand with more stringent prudential regulations to prevent risk emanating from its operation.

RCGA has pointed out that leverage and maturity mismatch are the key potential risk. I believe this risk can be mitigated, for example by providing credit guarantee scheme or opening up the possibility of taking portion in a huge liquidity in debt market.

Lastly, we should not left the financial education program behind. To know does not necessarily mean to understand. Financial inclusivism should be supported by higher financial literacy. The more investor and customer understand the risk they are facing upon taking financial decision, the less irregularity may occur.

I am glad to see Mr. Anoop Singh in this conference as an expert of this matter and eager to hear his sheer experience and insights, as well as others distinguish speakers. We should also come up with stronger commitment and deeper collaboration between regulators to tackle any issue that prevent us to reach prosperity in Asia and the world. That is why we gather here this beautiful afternoon.

Thank you.