Financial Development and Financial Stability: Indonesia Experience

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3 Summary of Lead Speaker's Presentations

- Both speakers present important topic and interesting analysis about financial development, economic growth and stability.
- Conclusions:
  - Development of financial sector is important to facilitate economic growth.
  - The current global financial system has flaws and vulnerable to financial crises.
  - Islamic finance is conceptually convincing, but of its practice is still in infancy as was compared to the conventional finance.
- Recommendations:
  - Adoption of financial inclusion to alleviate poverty and enhance financial stability.
  - Development of Islamic finance based on shari'a principles.
  - Concerted policy actions by stakeholders at domestic and regional levels to improve economic condition of the OIC.

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4 Financial Crises: Four Failures

The financial crises reflected four failures …

1. Failure to remember History - we have a history of increasing volatility and financial crises.
2. Failure to see Macro-Systemic Issues - unsustainability of global Imbalance, low interest rates, implications of asset bubbles and excess.
3. Failure to understand systemic implications of micro-behaviour - embedded leverage in financial engineering, bad incentive schemes.
4. Failure of Economic Thought - specialization of academic disciplines and fragmentation of bureaucracies had huge blindspots that ignored the really important political economy issues of our times: social inequities, political capture by vested interests, global warming and complex factors that affect financial stability.

(Andrew Sheng, 2010)

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Evolution of Financial System
Indonesia (1966-2000)

1966-72 financial formation

-Balanced budget
-Foreign aid for development
-Open door policy for foreign investment
-Removal of FX control

-Bank:160 com + rural banks
-Loans: BI 30%, SOB 60%, private 10%.
-Savings: Govt scheme

1973-82 policy based finance

-Financial repression
-BI and SOB dominance in financing
-Tight monetary policy, to curb inflation from high oil price
-High reserve ratio
-High deposit rate; subsidized (capped) lending rate
-Development of capital market

1983-90 financial reform

-Deregulation policy, move to market based fin system
-Abolishment int rate ceiling (June 1983)
-Fin liberalization (Oct 1989), easy entry
-Increased number of bank (66 in 88 to 91 in 1989) and branches;

-Increased deposits and loans (Loan to GDP ratio: 19% in 1983 to 45 in 1990)

1991-97 financial expansion

-Tight monetary policy (1991)
-Prudential regulation (Feb 1991), capital, asset quality, LLL, management.
-Increased bank capital (Rp10 to 50bn)
-Loan to SME 20% of total loans

-Increased no of com bank (109 in '90 to 166 in '94) and branches;
-Deregulation of foreign invst (1994), 100% equity participation.
-Increased capital inflows and foreign exchange loans.
- Increased NPLs (10.6% in 1996)

1998- 2000 financial restructuring

-Asian financial crises of 1997/98
- Closure of 16 small banks without safety nets created systemic banking crisis.
-Sharp depreciation of IDR driven by political turbulence of 1988 and self fulfilling prophecy.
-Liquidity crisis, interbank rate 300%
-Sharp increased of NPLs driven by currency depr. and mismatch

-BI Liquidity Support, IDR164.5 tn to distressed banks
-Financial review to map banks based on their solvency
-Corporate restructuring by INDRA
-Closures of failed (ineligible) banks
-Bank restructuring and recapitalization of eligible banks by IBRA

Source: Batunanggar (1996,2002,2008), Hamada (2003)

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Macroprudential Policy

- Macroprudential policy is the use of prudential tools with the explicit objective of promoting the stability of the financial system as a whole, not necessarily of the individual institutions within it. (BIS)
- Focuses on the financial system as a whole, as opposed to individual institutions. It treats aggregate risk as dependent on the behaviour of financial institutions; actions that may be individually rational can result in undesirable aggregate outcomes.
- Macroprudential regulation is concerned with two dimensions of aggregate risk in the financial system: a time dimension and a cross-sectional dimension.
  - The time dimension concerns how aggregate risk evolves over the course of the macroeconomic cycle. Policy problem : how to address the procyclicality of the financial system.
  - The cross-sectional dimension concerns how aggregate risk is distributed across the financial system at a point in time, where the structure of the financial system influences how it responds to, and possibly amplifies, shocks. Policy problem: how to address common exposures across financial institutions or from network interlinkages.

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Financial Stability Framework: Objectives and tools

Objective and tools	Prudential policy	Monetary policy	Fiscal policy
Current	**Limit distress of individual banks (microprudential)** Quality/quantity of capital Leverage ratio Liquidity standards Counterparty credit risk Limits to bank activities (eg prop trading) Strengthened risk management	**Maintain price stability** Policy rate Standard repos Collateral policies Interest on reserves Policy corridors	**Manage aggregate demand** Taxes Automatic stabilisers Countercyclical (discretionary) approach
Macro-prudential	**Limit system-wide distress (macroprudential)** Countercyclical capital charge Forward-looking provisioning Systemic capital charge Leverage ratio LTV caps Robust infrastructure	**Lean against booms** Increase policy rate Raise reserve requirements Mop up liquidity (central bank bills, exceptional repos) **Provide support on downside** Decrease policy rate Lower reserve requirements Inject liquidity Quantitative and credit easing Emergency liquidity assistance **Exit strategies** **FX reserve buffers**	**Build fiscal buffers in good times** Reduce debt levels Introduce taxes/levies on financial sector **Provide financial sector support in times of stress** Capital injections Deposit and debt guarantees Bank rescue packages Discretionary stimulus

Hannoun, Hervé (2010)

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Strengthening Financial System Stability Indonesia (1999 – present)

1999-2003
Microprudential policy

-IMF assisted programs

-Banking restructuring and recapitalization

-New central bank Act (1999)

-Enhancing banking regulation and supervision

-Adoption of bank risk management and corp. governance (2003)

-Adoption of risk-based supervision (2003).

2003-2007
Macroprudential Policy

-Development of Financial Safety Nets

-Establishment financial system stability function and unit in BI (2003)

-Amendment of BI Act incl on ELA (2004) following issuance of regulation on ELA (BI and MoF)

-Establishment of Indonesian Deposit Insurance Corporation (2004)

-Establishment of Financial Stability Forum: BI, MoF,IDIC (2005)

-Indonesian Banking Architecture (2004) to strengthen banking system performance and resilience

-Implementation of Basel II: start preparation in 2005

-Enhance adherence of banking regulation and supervision to int'l standards

2008-present
Global financial reform

-Policy package to address the impact of global crisis incl. large capital inflows.

-Financial Stability Assessment program (2009-10)

-Enhancement of bank risk management and risk-based supervision (2011) to become more forward looking.

-Global financial reform initiatives (remuneration, liquidity stndrd and capital buffers (Basel III), fin. inclusion

-Development of Crisis Management Framework and Protocols

-Establishment of Financial Services Authority (OJK); impact on BI's functions

-Preparing Amendment of BI Act incl. BI powers on macroprudential policy

-Prepare for regional econ integration.

Source: Batunanggar (2002,2008)

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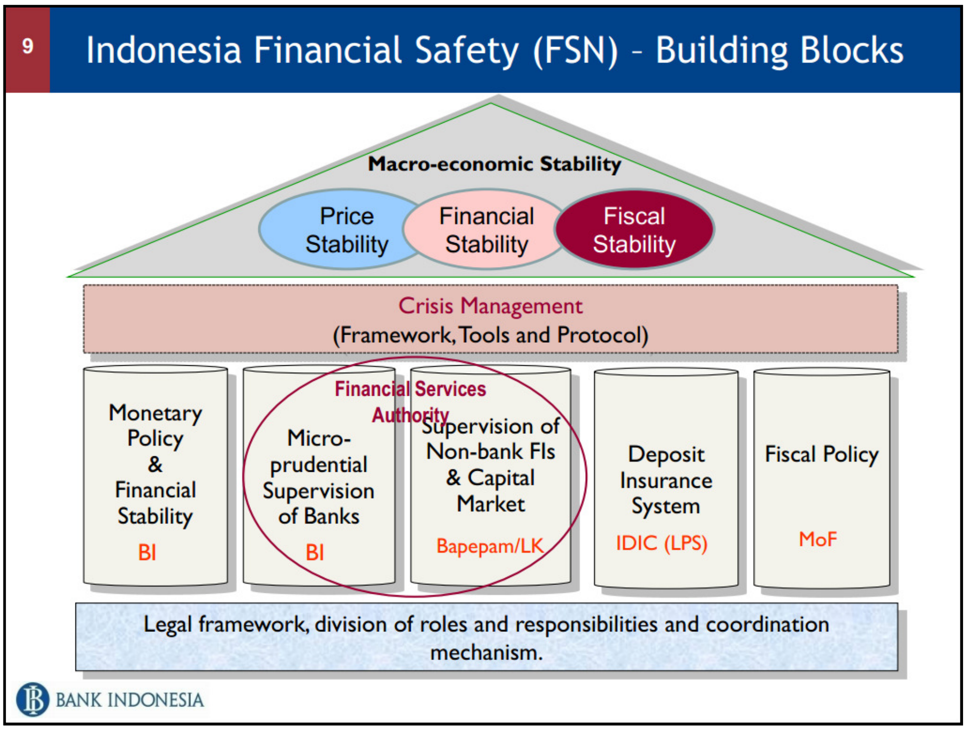
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Indonesia Financial Safety (FSN) – Building Blocks
Macro-economic Stability
Price Stability
Financial Stability
Fiscal Stability
Crisis Management
(Framework, Tools and Protocol)
Monetary Policy & Financial Stability
BI
Financial Services Authority
Micro-prudential Supervision of Banks
BI
Supervision of Non-bank FIs & Capital Market
Bapepam/LK
Deposit Insurance System
IDIC (LPS)
Fiscal Policy
MoF
Legal framework, division of roles and responsibilities and coordination mechanism.
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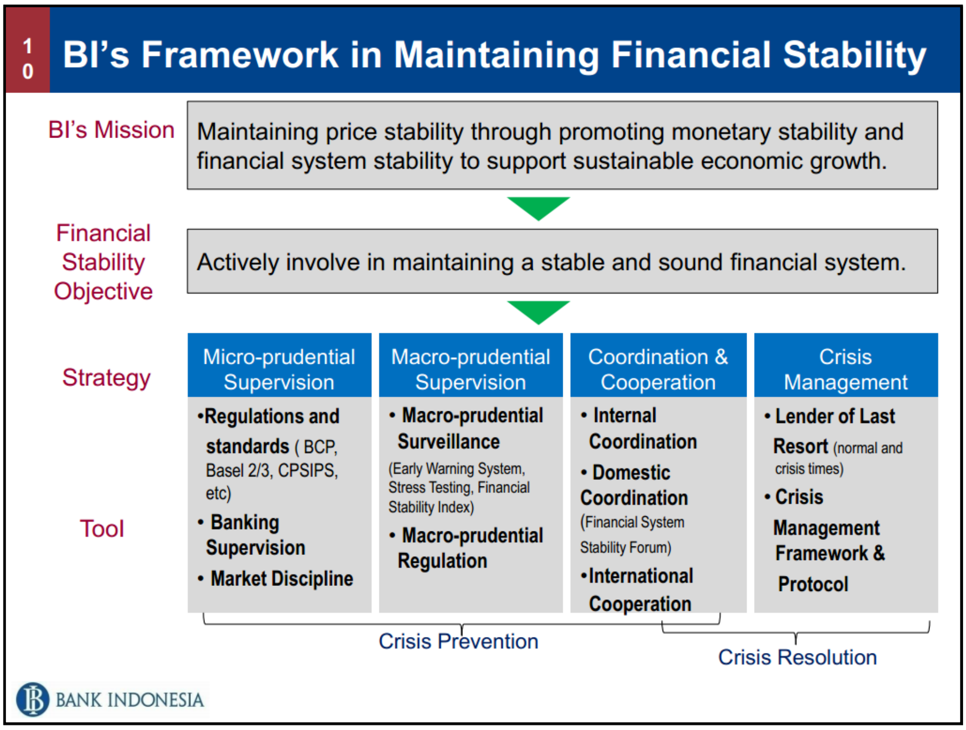
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BI's Framework in Maintaining Financial Stability
BI's Mission
Maintaining price stability through promoting monetary stability and financial system stability to support sustainable economic growth.
Financial Stability Objective
Actively involve in maintaining a stable and sound financial system.
Strategy
Tool
Micro-prudential Supervision
•Regulations and standards (BCP, Basel 2/3, CPSIPS, etc)
• Banking Supervision
• Market Discipline
Macro-prudential Supervision
• Macro-prudential Surveillance
(Early Warning System, Stress Testing, Financial Stability Index)
• Macro-prudential Regulation
Coordination & Cooperation
• Internal Coordination
• Domestic Coordination
(Financial System Stability Forum)
•International Cooperation
Crisis Management
• Lender of Last Resort (normal and crisis times)
• Crisis Management Framework & Protocol
Crisis Prevention
Crisis Resolution
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Concluding Remarks

- Islamic economics should be developed based two core values which is honesty and sadaqah (sharing) without difference. Honesty will create openness and avoid suspicious which in turn generate trust from society to the system. Sadaqah is the ultimate goals of any forms of economic transactions, which maintain balance in economic system that we develop; since economy in Islam is a harmony of all society which is based on a dynamic and balanced system.
- A challenge to develop a comprehensive model of Islamic development which integrate related dimensions (economics and finance, social, political and spiritual aspects).
- Urgent needs for a cross country and cross sector dialogue to discuss fundamental issues facing by Islamic community and to formulate policy actions with "open mind, open heart and open will".

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Thank You

Terima Kasih

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