

Welcoming Remarks by Hon. Burhanuddin Abdullah, at the SEACEN BOG Meeting, Jakarta, March 22, 2008 -.

Safely Riding the Wave of Financial Globalization

Hon. Coordinating Minister of Economic Affairs,

Fellow Governors, Distinguished Guests, Ladies and Gentlemen,

It is indeed a pleasure to welcome fellow Governors, distinguished speakers and other officials from the SEACEN countries to the 43rd SEACEN Governors' Conference and 27th Meeting of the SEACEN Board of Governors. I also wish to welcome all of you to Jakarta and Bank Indonesia. The fact that we have been convening for the 43rd time marks the importance and relevance of this forum among fellow central banks. It is truly encouraging to see fellow Governors to be here today to deliberate and exchange views regarding regional and global developments pertaining to the economy. By having a thorough understanding of our environment which is currently unfortunately not so benign, we will be better prepared to take preemptive measures so as to mitigate its adverse consequences.

Distinguished guests, ladies and gentlemen,

As we may observe, central bankers in the region today are confronted with potential risks posed by the recent surges of short term capital inflows. It is worth noting that the recent inflows differ markedly from those of the pre-crisis period. Before the crisis, capital inflows were mainly prompted by domestic market actors' efforts to avail foreign sources of finance through international bank loans and issuance of various global financial instruments, such as international bonds and commercial papers. In contrast, today's foreign capital inflows originate from the flush global liquidity by and large composed of sovereign wealth funds in search of optimum rates of return amidst the weakening global economic growth. In this case, I am inclined to agree to the characterization of the this difference as what Bill White of the BIS once mentioned that *the world is flush with liquidity but not enough capital*.

The differences between these types of capital flows inevitably entail consequences for the economies. First, the pre-crisis capital inflows, much of which flowed into the banking system, were utilized to facilitate real economic growth. By comparison, the more recent portfolio capital inflows have barely shown positive impact in the real economy, other than the strengthening of domestic currency and the

booming of capital market. Second, the recent capital inflows are susceptible to reversals in the event of adverse changes, both, in the international environment and the domestic economy—as we have witnessed in the past few months.

Distinguished guests, ladies and gentlemen,

We are now having a conference against the backdrop of heightening global uncertainties. Adding to the uncertainty is the recent financial market turbulence and the rising prices of energy and food which have put global economic expansion to a test. It is a wake up call, reminding us of the interdependence of financial markets world wide, the presence of asymmetric information among players, and the certainty of uncertainties. As many of us here represent economies which fall into the category of ‘less mature’ emerging market economies, such reminders call for increasing vigilance towards the sources of vulnerability in emerging markets. Roubini and Setser in 2004 have nicely summarized such sources, namely large economic imbalances, risky financing of budget and current account, doubts about credibility, fixed or semi-fixed exchange rates, inadequate banking regulations, political shocks, and external shocks.

The less mature emerging markets with large capital inflows and a shallow financial market are by no means spared from being vulnerable to those sources of shocks. In fact, instead of absorbing shocks, financial markets in those countries tend to amplify shocks. As a corollary, what are policy options available for us? Standard literature has suggested financial market deepening, which amounts to enhancing the promotion of more instruments, players and market liquidity in the financial market. In this standard mainstream view of financial market deepening, domestic financial market integration to the global financial market is seen as a welcomed consequence.

But a more integrated domestic financial market to the global market may also mean that shocks in other countries can be easily and quickly transmitted to the domestic financial market. Hence, our initial aim to insulate the economy by implementing measures to develop our financial market so as to make it an effective and efficient shock absorber may easily bring the unintended consequence of increasing volatility and vulnerability. In short, rather than creating a shock absorber from our financial system, we could in fact be creating a shock amplifier! Therefore, we must also take note that pro-cyclicality of financial markets can also add to the increasing risks of the financial market, and thus, reinforcing the roles of the said shock amplifier.

Distinguished guests, ladies and gentlemen,

What I just said brings into question the standard conviction that financial market deepening is a precondition for a more sustainable economic growth. I must therefore say that we have to add one more myth in our economic analysis tool box.

Adding such a myth does not necessarily suggest that financial market deepening imply no added value in our efforts to improving the economic welfare of the population in less mature emerging markets. It is only that our perspective in viewing the interconnection must change. I am proposing that the performance of the real sector should serve as the main indicator to gauge the success of efforts to promote financial market deepening. In this context a policy maker might want to proceed with new measures to develop financial market if and only if, such efforts have been empirically proven as effective measures to promote growth, create employment, and alleviate poverty in less mature emerging markets.

Hence, in accordance with the objective reality of rampant poverty incidence in the less mature emerging markets, one then could start to approach the notion of financial deepening from a thoroughly different angle, such as the extent of inclusiveness of the financial systems towards the disenfranchised.

Distinguished guests, ladies and gentlemen,

Very briefly we are discussing the complex issues relating to our main tasks as central bankers. Despite the complicated issues that we face nowadays, I believe we are fortunate that our discussions will be very much facilitated by the presence of distinguished speakers with in-depth knowledge in their respective areas for which I wish to express our appreciation. Our speakers include Mr. Takatoshi Kato, Deputy Managing Director of the IMF who is going to deliver his keynote address and Mr. Hervé Hannoun, Deputy General Manager of the BIS who will present his view on Financial Deepening without Financial Excesses. We are also honored to have Mr. Richard Murray and Mr. Perry Warjiyo both are Executive Directors of the IMF, who will, respectively, speak on the world economic outlook and the impact of IMF's initiative in refocusing and modernizing itself to the SEACEN region.

Finally, before I conclude my remarks, I wish to inform you that I will relinquish my post as the Governor of Bank Indonesia as my term will come to an end soon. I wish to tell you that it has been a lot of pleasure to work with you during my term in the office.

Therefore, on this occasion, I wish to express my gratitude for the amiable cooperation that we have fostered and the joy that we have shared before I bid you farewell. Although we will not meet again on the same occasion, I hope to come across with you on other occasions.

On that note, I am looking forward to the conclusions of this prestigious forum. Thank you and have a pleasant stay in Jakarta.

BANK INDONESIA

GOVERNOR

Burhanuddin Abdullah