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Missing Role of Central Bank on Monetary Transmission Mechanism – Evidence From Indonesia

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Abstract. This study provides evidence from Indonesia to understand whether Bank Indonesia (BI) could promote economic growth and reducing both unemployment and poverty. Based on model estimation and institutional relationship, there is trade–off between the role of BI in terms of exchange rate stability, price stability and inflation to bank view. It is necessary to add the role of BI on bank view through the authority that obligates banks mandatorily to implement monetary policy in the operational order as credit channel. The addition role of BI in bank view has implications for ability of BI in directing monetary policy comprehensively. With the addition of this role, banks become an integral part of BI in every monetary policies. In addition, the Indonesian government through the Ministry of State–Owned Entreprises has the authority to intervene state–owned banks that dominate banking market nation–wide to be more responsive to macroeconomic and monetary policies.

Keywords: banks view, credit depth, economic growth, monetary transmission

1. INTRODUCTION

Banks have a strategic role in Indonesian economic development. Banks are the driving force for accelerating economic growth together with government spending. The synergy between government spending on capital and the role of banks will result an equitable economic growth, include the distribution of development outcomes (Beck and Levine 2004; Levine 2003; Beck, Levine and Loayza 2000; Levine 1997; King and Levine 1993; Bencivenga and Smith 1991; Dornbusch and Reynoso 1989).

When there is only relying on government spending without supporting of banks, the government spending incurred will not be able to encourage economic growth and economic prosperity. The multiplier effect of government spending can be achieved through business development in government–financed economic sectors with banks support (Barro and Sala-i-Martin 2004; Blanchard and Perotti 2002; Beck, Levine and Loayza 2000; Benhabib and Spiegel 2000; Mankiw 1987). Banks enhanced economic activity through financing of corporates and individuals business that can support the development process so that they become interrelated and mutually supportive economic linkages (Shan, Morris and Sun 2001; Mankiw 1987).

The remainder of this paper is structured as follows. Section 2 discribes Bank Indonesia on monetary transmission mechanism; Section 3 is government on state–owned banks business planning; and conclusion is in Section 4.

2. BANK INDONESIA ON MONETARY TRANSMISSION MECHANISM

Without the role of banks in the development of real sectors of economy, the impact of fiscal expansion is not strong enough to improve the quality of economic growth, so that it is not also strong enough to improve social welfare, especially through reduction of unemployment and poverty. Therefore, the banking management policy needs to get the serious attention of the government, Bank Indonesia (BI), the Financial Services Authority (OJK) and Indonesia Deposit Insurance Corporation (LPS) so that the banking response becomes a whole unit to fiscal and monetary policies.

The strategic role of banking is in terms of synchronizing fiscal and monetary policies to business entities such as individual–scale businesses, Micro, Small and Medium Enterprises (MSMEs) and corporate scale businesses. With this role, bank is an institution that is expected to be able to distribute national income more evenly in line with the increase in labor demand which in turn encourages the improvement of social welfare. Through banks intermediation that is able to increase the real sectors escalation, employment is maximized then reducing unemployment and poverty. Synchronization of macroeconomic policies with banks intermediation will result a sustainability of qualified economic growth (Fase and Abma 2003; Levine, Loayza and Beck 2000; Beck, Levine and Loayza 2000). Banks credit are able to stimulate the creation of various derivative businesses from the main business funded by banks (Bernanke 1993). This derivative business is a multiplier of banks credit, which not only encourages business–scale expansion but also increasing employment and ultimately reducing unemployment and poverty.

As an intermediary institution, the role of banks in economic growth is very important. Indonesian development which is directed to achieve a better quality of life can be achieved through the role of banking, in addition to the main components of economic growth, such as consumption, investment, government spending and net exports (Todaro and Smith 2012; Mishkin and Eakins 2012; Romer 2006; Just, Hueth and Schmitz 2004). The role of banks as credit channel on transmission mechanism framework is able to increase the escalation of business in the real sectors in such a way as to increase labor demand, reduce unemployment and poverty. Through this main role, banks are the main actors for continuous economic development. Then, sustainable economic growth can be achieved by banks which are responsive to monetary and fiscal policy.

Based on the regulatory aspects of BI, OJK, LPS and Commercial Banks, the institutional role according to legislation explicitly indicates that development supported by sustainable economic growth is the main function of BI, OJK, LPS and Commercial Banks (Table 1). The similarity and harmony of institutional role are the important factors that support the economy in such a way that banks can carry out their role as growth accelerator factor through banks credit.

In addition to institutional alignment based on the law, as a financial provider directly to business entities in the real sectors, banks not only carry out regulations that apply to the banking system themselves, but have institutional linkages with other authorities. BI as the monetary authority, OJK as the financial supervision authority –both banks and nonbanks– and LPS as the guarantor authority for banks funds and banks rescue, affect the banking business respectively. These three authorities controlled banks institutionally with the aim that the role of banks in development goes well. The strength of institutional linkages between BI, OJK and LPS to Commercial Banks showed the degree of authority based on institutional regulations.

Tabel 1 The institutional role between BI, OJK, LPS and Commercial Banks in economic development through sustainable economic growth based on the law

INSTITUTIONS	ROLE ON DEVELOPMENT AND ECONOMIC GROWTH
BI	To achieve a stable value of the rupiah to support sustainable economic development and improve social welfare, BI implements a monetary policy in a sustainable, consistent, transparent manner and must consider the general policy of the government in the economic field. The monetary policy adopted by BI in a sustainable, consistent and transparent manner can be used as a clear reference for the business community and the wider community. In addition, the policy taken by BI has considered its impact on the national economy as a whole, including the country's financial sector and developments in the real sectors
OJK	The overall financial services activities in the financial services sector are organized regularly, fairly, transparently and accountably, and are able to realize a sustainable and stable financial system, and are able to protect the interests of the community so as to improve national competitiveness
LPS	The continuity of a bank's business in a healthy manner can guarantee the safety of its customers' deposits and increase the role of banks as providers of development funds and banking services
COMMERCIAL BANKS	Banking business is intended to support the implementation of national development in order to improve equity, economic growth and national stability towards improving social welfare

Furthermore, banks will be able to encourage economic growth if and only if banks are in a good performance as indicated by the level of health indicator. Macro–prudential aspects that are represented by

high financial stability will ensure a conducive economic situation, and this stability can only be achieved through banking in a healthy category.

Sipahutar, Oktaviani, Siregar and Juanda (2017); Sipahutar (2016); Sipahutar, Oktaviani, Siregar and Juanda (2016) explained that banks credit is a vital element to increase the real sectors, promote economic growth, and reducing unemployment and poverty (Table 2,3,4). Banks credit has 6.5% variance on economic growth. Therefore, the role of banks must be encouraged in order to create a better and sustainable Indonesian economic development through two options, (1) add the role of BI in Indonesian banks institutions in the framework of the monetary transmission mechanism, and (2) increasing the role of the Ministry State–Owned Enterprises in the state–owened banks business plan.

Table 2 Vector Auto Regression (VAR) model estimation between credit depth (*CRE*) and economic growth (*NGR*)

Vector Auto Regression Estimates
Sample (adjusted): 1993 2014
Included observations: 22 after adjustments
Standard errors in ( ) & t-statistics in [ ]

	ΔNGR	ΔCRE
$\Delta NGR_{(-1)}$	-0.757464	-0.447334
	(0.17568)	(0.09480)
	[-4.31164]	[-4.71875]
$\Delta CRE_{(-1)}$	0.682732	0.578140
	(0.29946)	(0.16160)
	[2.27985]	[3.57770]
C	0.291456	-0.190715
	(1.98207)	(1.06956)
	[0.14705]	[-0.17831]

Source: Sipahutar, Oktaviani, Siregar, Juanda (2016)

Table 3 Error Correction Mechanism (ECM) model estimation between credit depth (*NGR*) and unemployment rate (*NUNE*)

Dependent Variable : $\Delta NUNE$
Method: Least Squares ; Sample (adjusted): 1993 2014

Variable	Coefficient	Std. Error	t-Statistic	Prob.
$\Delta CRE_{(-1)}$	-0.013925	0.032061	-0.434320	0.6689
$ET_{(-1)}$	-0.521164	0.154809	-3.366506	0.0032
C	0.161647	0.226416	0.713936	0.4839

Source: Sipahutar, Oktaviani, Siregar, Juanda (2016)

Table 4 Error Correction Mechanism (ECM) model estimation between credit depth (*CRE*) and poverty rate (*NPOV*)

Dependent Variable : $\Delta NPOV$
Method: Least Squares ; Sample (adjusted): 1993 2014
Included observations: 22 after adjustments

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-0.165976	0.458237	-0.362205	0.7212
ΔCRE	-0.139009	0.077476	-1.794232	0.0887

$ET_{(-1)}$	0.560690	0.207714	2.699339	0.0142

Source: Sipahutar, Oktaviani, Siregar, Juanda (2016)

In accordance to the banking priorities in its operation, there is a trade–off between the role of the monetary policy by BI and its role as a monetary authority in terms of exchange rate stability, price stability and inflation. In a situation where BI conducts monetary expansion –money supply expansion by reducing the BI 7 day Reverse Repo Rate (an interest rate base for interbank money market)– this policy is not simultaneously serves as a reference by banks to reduce deposit and credit interest rates to increase credit demand. The increase in credit demand designed by BI through monetary expansion is not meaningful when banks do not respond simultaneously to their role as a credit channel.

However, if banks prioritize banking health as a priority, there will be a trade–off between the meaningfulness of the policy and its implementation. A nonmandatory of institutional relations has triggered a time–lag between policies that make the meaningfulness of implementation will not be optimal. This situation occurred because banks that absorb funds with a higher interest rates will not necessarily be able to reduce their credit interest rates because they will directly reduce profitability as indicated by the NIM and ROA indicators.

The objective of BI is to achieve the stability of rupiah through sustainability monetary policy. This objective cannot be separated from the role of banks as a transmission channel. Only if the role of BI is directly related to the banking system, the transmission mechanism is ensured to be running well, in such a way that the stability of the rupiah to support sustainable economic development and improve social welfare can be achieved. The monetary policy taken by BI must be used as an exact reference for business operation, taking into account the impact on the national economy driven by banks in the operational order (Sipahutar 2016).

Sipahutar, Oktaviani, Siregar and Juanda (2017); Sipahutar (2016) explained that there is a BI 7 day Reverse Repo Rate effect on the credit depth, credit depth on economic growth, credit by usage and economic sectors to economic growth, and the effect of credit depth on reducing unemployment and poverty. The implication of that model is that policy set up by BI will be meaningful when BI has a strong linkage to banks institutionally.

However, because banking performance indicators are part of the supervisory system which is the authority of the OJK, meaning that, (i) effect of BI 7 day Reverse Repo Rate on credit depth, (ii) effect of credit depth on economic growth, and (iii) effect of credit by usage and by economic sector on economic growth, (iv) the effect of credit depth on reducing unemployment and poverty, cannot be fully implemented by BI. Therefore, the aim of BI to achieve sustainable economic development and improve social welfare is unreliabe. BI has no authority over banks which is its transmission channel of monetary policy due to the absence of mandatory regulations on implementation of monetary policy in the operational order of banks (Sipahutar, Oktaviani, Siregar and Juanda 2017; Sipahutar 2016; Sipahutar, Oktaviani, Siregar and Juanda 2016).

The trade–off between the role of the monetary authority held by BI for exchange rate stability, price stability and inflation to *bank view* is a factor inhibiting the effectiveness of any monetary policy. This situation can be minimized by increasing the role of BI to *bank view* so that banks do not become worse–off even though the role of BI becomes better–off. This Pareto efficient will have an impact on the sustainability of economic growth supported by healthy banking (Just, Hueth and Schmitz 2004). BI will have better capabilities if BI has authority on banking mandatorily to simultaneously implement monetary policy in the operational order as a credit channel.

The addition role of BI in the *bank view* has implications for ability of BI to implement monetary policy directly in the operational level. Credit depth by usage (investment, working capital and consumption) and by economic sectors (agricultural, mining, industrial, trade and services) will be in accordance to the monetary policy stance in order to achieve qualified economic growth (Sipahutar 2018). Furthermore, the additional role given to BI will directly impact the stronger banking sector in the Indonesian economy.

Granger causality which explained by Sipahutar, Oktaviani, Siregar and Juanda (2017); Sipahutar (2016); Sipahutar, Oktaviani, Siregar and Juanda (2016) that there is a significant linkages of credit depth on economic growth and the significant effects of economic growth on credit depth are the reason for the need of linkages between BI and Commercial Banks to implement monetary transmission mechanism. Through the enrichment role of BI in institutional relations to OJK, LPS and Commercial Banks is a new stimulus on Indonesian economic development.

Based on the reasons above, there are three roles that need to add to BI in order to institutionally implemented by banks in a mandatory manner, (1) setting the BI 7 day Reverse Repo Rate, (2) the composition of bank credit both by usage and economic sectors, and (3) bank soundness, especially in terms of liquidity, profitability, solvency, asset quality, minimum capital adequacy ratio, maximum lending limit, loan to deposit ratio, and bank reserves. Through additional mandatory regulations, the direction of BI on monetary policy can be directed without time–lag.

The meaningful of the mandatory policy of BI will increase the effectiveness of banks as a growth accelerator, as well as that credit depth will increase due to bi–direction causality between credit depth and economic growth. With the existence of linkages between BI and banks in terms of bank view, the role of BI as monetary authority does not become distorted but instead becomes a stimulus for the effectiveness of BI in the monetary transmission mechanism framework (Sipahutar, Oktaviani, Siregar and Juanda 2017; Sipahutar 2016; Sipahutar, Oktaviani, Siregar and Juanda 2016). Regulation as a binding rule especially in the framework of policy synchronization in the implementation order is fundamental to achieving sustainable economic growth (Levine 1999). Likewise, that the fiscal policy set by the government will experience acceleration by high responsiveness of banks.

3. GOVERNMENT ON STATE–OWNED BANKS BUSINESS PLANNING

There was a concentration of banking business dominated at 4 banks from 134 banks operating nation–wide –Bank Rakyat Indonesia (BRI), Bank Mandiri, Bank Central Asia (BCA) and Bank Negara Indonesia (BNI)– which controlled 42% of the credits portfolio and 48% of funds portfolios. If only using a portfolio of BRI, Bank Mandiri and BNI as state–owned banks where the government of the Republic of Indonesia is the dominant shareholder, the three state–owned banks controlled 34% of the credits portfolio and 36% of funds portfolios. The dominance of the three state–owned banks is a huge potential resource to make banks as the basis of Indonesia's economic growth which ultimately can reduce unemployment and poverty.

The Government of Indonesia as the dominant shareholder in the three state–owned banks has authority in directing of state–owned banks policy. Through its authority, the Government of Indonesia has mandatory on banks to, (i) respond directly to BI 7 day Reverse Repo Rate, (ii) determining credit composition in terms of both usage and economic sectors that are in line with the direction of national development policies, and (iii) determining credit allocation with special purposes to improve equity of development.

The reasons why need to intervene state–owned banks are, (i) the role of banks in the Indonesian economy which are explained based on model estimates (Sipahutar 2016; Sipahutar, Oktaviani, Siregar and Juanda 2016), (ii) the dominance of the state–owned banks in the Indonesian banking market so that they are expected to induce other banks to be in line with the business direction of the state–owned banks, (iii) the strength of the Indonesian government as the dominant shareholder in state–owned banks, (iv) maximizing the role of the state–owned banks to stimulate the potential resources for the prosperity, (v) although the functioning of the market mechanism will encourage competitive advantage, however, for the banking sector that has a broad strategic role in the Indonesian economy, government intervention is necessary, and (vi) experienced from other countries that tend not to fully liberalize banking sector.

4. CONCLUSION

Based on the estimation model and institutional relationship described above, there is a trade–off between the role of the monetary authority owned by BI and its role as a monetary policy in terms of exchange rate stability, price stability and inflation to *bank view*. It is necessary to increase the role of BI to *bank view* through the authority that obligates banks mandatorily to implement monetary policy in the

operational order as a credit channel. The addition role of BI to *bank view* has implications for ability of BI in directing monetary policy comprehensively. With this addition role, banking becomes an integral part of BI in every monetary policies. In addition, the Indonesian government through the Ministry of State–Owned Entreprises has the authority to intervene to state–owned banks that dominate banking market nation–wide to be more responsive to macroeconomic and monetary policies.

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