Analysis Of The Monetary Transmission Mechanism

The monetary transmission mechanism is the process in which the economy is directly affected by various monetary policy decisions being made by the central bank particularly in changing price levels. With that being said, the central bank needs to have a proper understanding of the monetary policies for it to be able to design and implement its monetary policy more efficiently that's why policymakers must have an accurate assessment of the timing and effects of their policies on the economy. To make this assessment, they need to understand the process through which monetary policy impacts real economic activity and inflation. Monetary policy has an impactful influence in the aggregate demand of an economy despite its effects on price level and the economy not easily translated from multiple diverse channels. In addition, an added feature of the transmission of monetary policy would be the enhancing of the various channels such as trade, investment, and financial transactions to be more adaptable to the current demands of the economy. Over the last few decades, we take into consideration how it is currently being done in Indonesia wherein there are numerous modifications being made in specific sectors in the economy. Such modifications have large effects on how money is being managed and on the transmission mechanism of monetary policy. It has likewise been proven most evident during the Asian Financial Crisis (1997/1998) and the Global Financial Crisis (2008/2009). It is to no surprise that there was an obvious change in the ways they managed the monetary policy in Indonesia as a result from the consequences brought by the 1997-2000 crises which brought about the legislation of Act No. 23/1999 along with its adjustment – Act No. 3/2004. This act allows for the Indonesian Bank to focus on a sole purpose of achieving and maintaining the stability of the rupiah even if this means that they would have to formulate and implement monetary policies. In order for Bank Indonesia to ensure that the objective is met, they agreed upon an inflation targeting framework or ITF last 2005 in the month of July. The Global Financial Crisis' monetary policy impact also provided a valuable lesson for central banks that without preserving financial stability, even with price stability and maintaining low inflation as a primary goal would still be insufficient to achieve macroeconomic stability. As mentioned above, it is really essential for the ability of the officials to allow for modifiable policy combinations.

Monetary Policy Objectives

It was in the year 2017 that Bank Indonesia upheld a monetary policy that would be dependable and had a sole purpose on ensuring stability in the macroeconomic condition. This purpose led to Bank Indonesia granting efforts into maintaining inflation rate within a limited scale and safeguarding the account deficit level. Since Bank Indonesia also commenced an exchange rate policy to guarantee the country's desire macroeconomic stability, such policy dealt with preserving exchange rate stability but not clashing or interfering with the market. Due to the effectiveness of the monetary policy transmission being of utmost importance, Bank Indonesia went the extra mile and took further actions such as enhancing monetary operations in addition to developing the financial market. The development of the financial market was noted as the financial market deepening policy which mostly focused on the three pillars of development: (i) sources of economic financing and mitigation of risks; (ii) market infrastructure; and (iii) policy coordination, regulatory harmonization, and education. The development of this section has been followed by improving the various channels, enlarging the market base and strengthening the reliability of market performers.

Monetary Policy Implementation

As stated before, throughout 2017, it has been the aim of Bank Indonesia to maintain inflation rate within their goal range and stabilize account deficit at a safe level. It is important to note that all the way through 2017 they were able to preserve the inflation rate to keep it within their objective range and even ended the year at 3.61% -being the third year in a row for Indonesia to succeed in keeping their inflation rate within range. Fortunately for Indonesia, they were smart enough to adjust their expectations for inflation for the next one or two years ahead in accordance with their aspired limit. Furthermore, Indonesia's current account deficit in 2017 was also sustained at a safe level of 1.7% of GDP dropping from 1.8% of GDP in 2016. During 2017's first half, the B17DRR policy rate of 4.75% was retained by Bank Indonesia bearing in mind the expected increase in inflation rate for 2017's first half. As for the second half, it was decided by Bank Indonesia to have a decline of 25 basis points in the policy rate for August and September of 2017, causing the B17DR rate level to now become 4.25%. All of these decisions were so clearly thought off while keeping in mind the decreased expectations in inflation and maintaining the current account deficit at the safe level.

Effects of the Monetary Transmission Policy

In 2017, Indonesia's monetary policy was generally conveyed properly, not being able to endure inadequately strong transmission to the credit channel. With regard to the interest rate channel of the monetary policy transmission, it showed downward movement in interest rates proportionate with the regression in the policy rate. It was also through the asset price channel that the transmission monetary policy worked with by being able to show the improving operations of the bonds market in the government and the Indonesian Stock Exchange Composite Index (IDX Composite) and even in the non-bank sector of financing. Although there was an incessant decrease in interest rates of loans, the credit channel had a more restricted expansion of 8.2% in 2017. This is considered as an insufficient rate for credit expansion therefore it prompts for changes to be made.

Transmission through the Interest Rate Channel

In the year 2017, the power of the monetary policy transmission through the interest rate

Channel displays a stable increase. The progress of overnight interbank rate then became more aligned with the policy rate over time. This stable development in the policy rate transmission to the overnight interbank rate was backed by both the strengthening of the monetary operations strategy and the reformulation of the monetary policy operation framework in 2016. If we carefully analyze the given data, we can note that there is a decrease of 200 basis points at the start of 2016 caused by the overnight interbank rate which then declined to 192 basis points therefore leaving it currently standing at 3.9% by December of 2017. The daily average amongst the overnight interbank rate was and the policy rate ranged from 43 basis points afterwards the introduction of the B17DRR.

Transmission through the Asset Price Channel

Contrary to the restriction in bank lending expansion, an incline in financial asset prices as well as in non-bank financing was initiated due to the monetary relaxation. The stock in IDX gradually and progressively increased because of the company's performance and a growth in initial public offerings. Considering the government's bond market performance is also displaying positive results, then it will inevitably reflect a decrease in yield which is why corporate bond issues were conquered by the progress in non-bank financing.

Transmission through the Bank Credit Channel

Transmission of monetary policy relaxation lasted through the bank credit channel, although on a comparatively restricted scale. The credited growth was logged at 8.2% which is a bit more than the 7.9% attained from 2016. As for supply, what caused the slow growth in credit for the year 2017 was the current strengthening of the banking system which would expectedly result in worsened credit risk. Thus, this led to constant high lending standards especially in the first half of 2017. Lastly, as for demand, since credit growth is subtle it results in a slow and steady economic recuperation.

Analysis of Monetary Transmission Policy

It is important to first set the foundation of the monetary transmission policy wherein its overriding aim is to preserve and uphold stability in the value of the rupiah which results from a low and steady inflation rate. In order for this to effectively take place, a policy rate known as BI 7DRR was implemented by Bank Indonesia therefore serving as the main tool for manipulating the economic activity in order to result in the desired inflation rate that is within a target range. Therefore, the adjustments made under BI 7DRR would be frequently known as the monetary policy transmission mechanism. Under such would display the actions done by Bank Indonesia such as making alterations using various monetary instruments to achieve the desired inflation rate. The monetary policy transmission mechanism is the collaboration of the central bank with the banking system and both the real and financial sector and therefore these changes that would come about in the BI 7DRR would in effect impact inflation due to the different channels like interest rate channel, credit channel, exchange rate channel, asset price channel and expectations channel.

Beginning with the interest rate channel, the changes in BI 7DRR under this channel would take effect in the levels of rates in bank deposits as well as lending. For example, say the economy is going down, Bank Indonesia may choose to implement an expansionary monetary policy that would decrease interest rates to encourage economic activity. This illustrates how a decrease in the BI 7DRR would eventually cause a decrease in credit interest rates and thus lead to stimulate both household and firm's demand for credit. If say we decrease lending rates in banks, this would lead to a decrease as well in the cost of capital for firms involved in investment. Overall, this explicitly demonstrates the enhancement and life in the resulted increase in economic activity.

An alteration in the BI 7DRR could also impact the exchange rate more commonly known as the exchange rate channel. For example, if BI 7DRR increases, this would result to an increase as well between interest rates of other countries and Indonesia. Therefore, an increase in the interest rate differential would reassure foreign investors and make them want to place their capital in some of Indonesia's financial instruments like certificates from Bank Indonesia or

SBIs because they know this will make them gain higher returns. It is known for a fact that an increase in capital inflows would eventually result to an increase in the value of the rupiah. Since rupiah would appreciate in value, exports would cost more and imports would cost less which would bring about an increase in imports and a decrease in exports. A decrease in net exports would cause a negative effect on the growth and activity of the economy.

Correspondingly, any given increase in the interest rates would proportionately lower prices for assets like stocks and bonds therefore decreasing both the individual and firm's wealth which would in turn decrease their economic activity because they would then be able to afford it less. Another effect of a change in interest rate would be the influence it has on the public's expectations of inflation. Since a decrease in interest rates result to an increase in economic activity, it would inspire workers to look forward to an increase of inflation rates in the future by negotiating for higher wage and in turn firms would hand these wages to individuals with an increase in prices.

Given the conditions that affect each specific channel, it would have a prescribed time lag which varies on the given channel. Since interest rates have quite fast effects on exchange rate, it is expected that the exchange rate would normally operate faster. If for example there would be a decrease in BI7DRR, the bank would typically respond fairly slows because it sees significant risk. Albeit these are all predictions, it is still not fully predictable and results could still vary. Therefore, to sum it all up, the current state of the banking system, financial and real sector each play a substantial part in the efficiency of the entire process of the monetary policy transmission.

Conclusion

Results from 2017 illustrate how well it turned out for the implementation of the monetary policy transmission albeit the insufficiency through the credit channel was quite disappointing. There was also a decline in interbank money market rates and bank interest rates due to the monetary policy relaxation (the lowering of the policy rate, the BI 7-Day (Reverse) Repo Rate (BI7DRR). Since there is a decrease in the policy rate therefore an increase in asset prices of stock and bond markets and an extension in non-bank financing would follow as mentioned earlier but it is important to remember that there would still be difficulties in monetary policy transmission that would surface from restricted bank credit expansion. In conclusion, the monetary policy transmission was able to successfully preserve macroeconomic stability in the year 2017 because it was able to succeed at its goal of keeping inflation within a target range and the current account deficit to be held at a safe level. Therefore, it can be concluded that that is a useful way to uphold the macroeconomic stability that was caused by the harmonization between the central and regional governments with Bank Indonesia.

Overall, it is significant to note that the development of the economy brought up by the monetary policy transmission is indeed very evident. These enhancements could definitely be due to the fact that such policy really ensures the progression as its sole purpose is headed towards advancement. Although there would be officials butting heads with certain areas to be agreed upon, in the end, having an aligned goal of maintaining inflation rate at a certain target range and keeping account deficit at a safe level would somehow result to cohesiveness in the end.