CHAPTER II

MONETARY POLICY IN INDONESIA

2.1 Introduction

In the last two decades the Indonesia economy has undergone tremendous structural changes. With structural adjustment implemented across the full range of economic sectors and a far-reaching deregulation in the financial sector, monetary management has become a much more challenging task, given that the interdependencies among different monetary targets have become more volatile than the past. The ongoing trend towards globalization and the accompanying integration of world financial markets. Dramatic advances in information and communications technology have driven the process of financial transnationalization to unprecedented heights, as well as stimulating product innovation and encouraging widespread securitization. The result of this is vastly higher volume and greater rapidly in cross-border capital mobility, a development that has markedly complicated the tasks of managing domestic monetary aggregates.

The Indonesia government has implemented a gradual reform agenda in monetary and banking. In the first stage, by mid-1983 interest rates control and credit ceilings were removed. The monetary policy was shifted from direct control to indirect control through reserve money management. In the second stage, started at the end of 1988, barriers to entry and expansion of banking activities were eased. Alternative

sources of finance, in particular the stock markets, were revitalized. Reserve requirement was dramatically lowered. These changes have had a profound effect on the Indonesia financial system.

The ultimate objectives of the Indonesian monetary policy include economic growth, price stability, balance of payments, employment, etc. The emphasis of a particular objective varies from time to time depending upon the economic conditions, but for the last two decades (1980s to 1990s) the main concern seemed to be economic growth and price stability (in broad terms).

As in the case with most of developing countries, Indonesia's main economic concern is development. It is therefore clear that the sustainable economic growth is a major objective. Monetary is directed toward supporting the growth objective of the development program. Therefore, in its contribution to support development objectives, monetary policy in Indonesia is directed to ensuring that the growth of liquidity corresponds to the projected growth rate, equitable income distribution, and a tolerable level of inflation rate taking into account stability of the balance of payments.

Monetary policy is formulated and implemented by Bank Indonesia under the direction and coordination of the Monetary Council. Members of the Council include the Minister of Finance, the Governor of Bank Indonesia, and the Minister of Trade. The formal task of the Council is to manage and coordinate the implementation of the monetary policy established by the government. Bank Indonesia is responsible for the

implementation of monetary policy. In order to maintain the stability of the rupiah and to promote equitable development, Bank Indonesia is empowered under the Central Bank Act of 1968 to control the money supply and to regulate domestic credit and interest rates, as well as the allocation of credit to the various sector of the economy.

This chapter focuses on monetary policy in Indonesia. This chapter consists of two sections. In the first section a brief overview about implications and instruments of monetary policy in pre-reform period and post reform period are given. In the second section, a brief overview about framework of monetary policy in Indonesia prior to the crisis, as well as during the crisis will be given.

2.2 Implication and Instrument of Monetary Policy in Indonesia

2.2.1 Pre-Reform Period (Pre-1983)

From the mid-1970s until 1983, pre-reform period, the authorities directly controlled both quantity and price of money. The money supply and allocation of credits were proximate targets. From the mid-1970s until 1983, the major instruments of monetary policy were credit ceilings for individual banks as primary defense against excessive domestic money growth, interest rate controls for state banks, and rediscount credits to priority sectors.[6] The pre-financial reform of 1 June 1983 system of monetary control proved effective in limiting the expansion of bank credit. The growth in

PERPUSTAKAAN UNIVERSITI MALAYA

[6] Rediscount credits to priority sector is called liquidity credits. Banks were induced to promoted loans to selected priority sectors at below-market interest rate set by Bank Indonesia.

A511375265

liquidity credits, which successfully induced the development priority sectors including agriculture and small enterprises, was offset by the build-up of government deposits at Central Bank.

Despite its success in channeling funds derived mostly from oil revenues to selected borrowers and government programs, the use of credit ceiling as a major monetary instrument before 1 June 1983, accompanied by interest rate control on state banks and the extension of liquidity credit produced some undesirable side effect. The extension of central bank liquidity credits creates reserve money, which has a potential inflationary impact. In general the banking system suffer from considerable excess liquidity due to the augmented net foreign assets prompted by the two oil booms[7], and by uncontrolled liquidity credits to many high-priority sectors. The dominant state banks remained plagued by inefficiency and were unable to accumulate deposits from the private sector because of the controlled interest rate.[8] The excess of funds being created in the banking system had an adverse effect on the country's balance of payments position.

---

[7] Since 1970s there have been two oil booms: the first in 1973, and second in 1979. First and second oil booms brought a great influx in money.
[8] Many of the state banks were dependent on captive markets, notably the state-owned enterprises.

2.2.2 Post-Reform Period (1983-now)

The decline in the oil revenues in the late 1982 called for a necessary reform. The plunge in oil prices led to a shortfall in government revenues and balance of payments deficits. This, in turn, constrained the interest spreads of Indonesian banks and forced the government to promulgate monetary and financial reforms in June 1983. These reforms were aimed at dismantling the old system of monetary control, replacing it with a more indirect approach based on reserve management through open markets operations.

The indirect monetary control method is implemented to affect deposit money banks' reserve positions by using instruments that rely on the open market operations, the discount windows and the reserve requirements. Among these operations, open market operations are the most actively used to achieve the desired growth in reserve money. Open market operation in Indonesia is implemented by affecting deposit money banks' reserve positions through buying or selling Bank Indonesia short-term securities (SBI's) and SBPUs. In 1984, Sertificat Bank Indonesia (SBI) was introduced, followed by the issuance of promissory notes, known as Surat Berharga Pasar Uang (SPBU), in early 1985. The SBI is a debt certificate that may be used by the central banks to reclaim its share of net foreign assets and to create government debt instruments, to secure greater control over reserves.

Table 2.1
Chronology of Monetary and Financial Policy Adjustment, 1983-1995

1. Financial reform initiated on June 1, 1983 involving removal of credit and rate ceilings for state bank's operations, a reduction in the scope of credit programs and introducing of new market-oriented instruments of monetary control.

2. New deregulation measures introduced in December 1987, October and December 1988, March 1989, February 1991 and May 1993 aimed at enhancing financial sector prudential standars and efficiency, and developing the capital market by, among others, removing barriers to entry

3. Improved monetary management to control inflation and to curb exchange rate speculation.

4. Removal of central bank's direct credits (liquidity credits) and major reduction of economic sectors covered by subsidized priority credits in January 1990 to curb inflationary pressures and credit fundability.

5. New regulations introduced on March 14, 1991, which are aimed at strengthening the capital base of banks and tightening supervision over financial institution. The new measures require the banking system to meet the BI guidelines on capital adequacy ratio 8% of the bank assets by December 1993.

6. Relaxation of prudential standards introduced in May 29, 1993 and the deadline to meet the CAR of 8% was extended to December 1994.

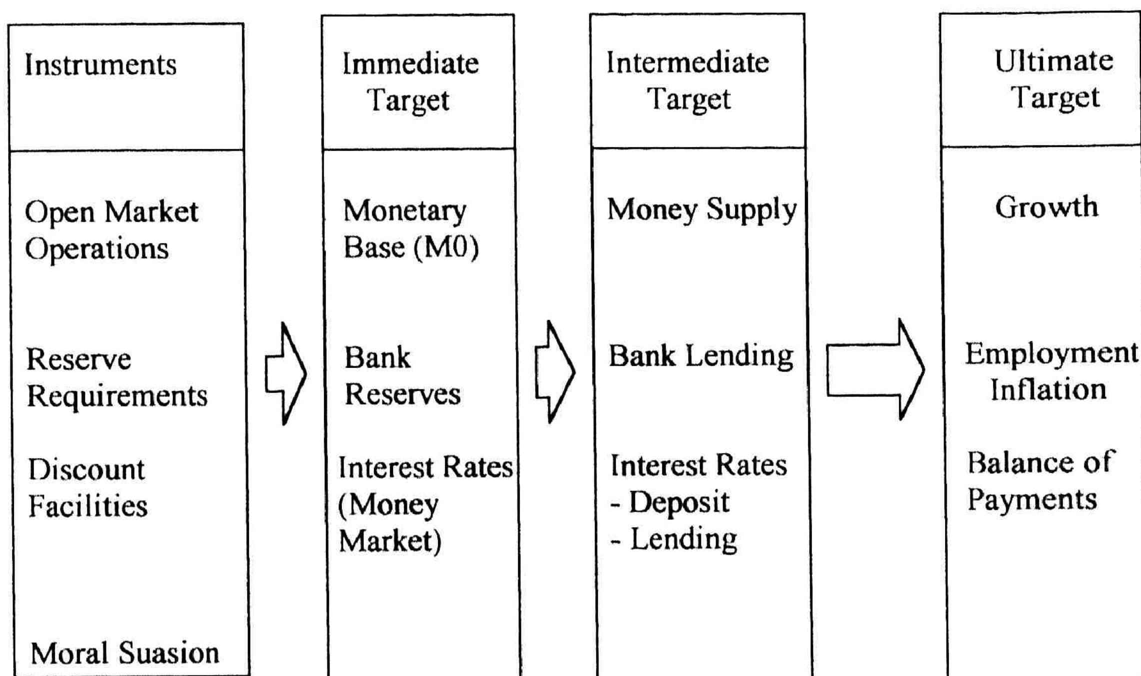
Source: Indonesia Assessment 1994

Bank Indonesia will sell SBIs to banks, and also to non-bank financial institutions (NBFIs), when they are needs to absorb reserves from the banking system. The system also allows banks to rediscount the SBIs and SPBUs directly with Bank Indonesia or indirectly through a non-bank financial institution acting as discount houses, when Bank Indonesia needs to provide reserves to the banking system. This accommodative process assists the banks to manage their excess reserves to an adequate level, which in turn affect the cost of capital and the level of interest rate. The change in banks' reveres will affect the amounts of funds extended for credits. For example, the purchase of SPBU by Bank Indonesia will increase banks excess reserves and hence, provides a base for credit expansion. Subsequently, through the multiplier process, this will expand money supply. The increasing excess reserves would lead to banks to lower their lending rates to encourage borrowing which in turn will affect interbank rates. On the other hand, the sales of SBIs by Bank Indonesia will help banks reduce their excess reserves. The maintenance of banks reserves to an adequate level would stabilize interbank rates, which in turn will affect the level of price, output, and employment.

The implementation on indirect monetary control in Indonesia using especially open market operation as an active monetary instrument had proven the ability of the monetary authority to control reserve money in accordance with the achievement of immediate targets (commercial banks' reserves), and in turn through the existing money multiplier, also intermediate targets (narrow money and broad money). In addition, the indirect monetary control also made possible for Bank Indonesia to target interest rate in

the short run which is an important factor in enhancing economic activities and reducing pressures on the balance of payments.

Table 2.2
Framework of Monetary Policy in Indonesia



2.3 Framework Monetary Policy

2.3.1 Framework Monetary Policy Prior to the Crisis

Prior to the crisis, Indonesia's monetary policy framework was mainly conducted using base money as the operational target. While the ultimate objective of monetary policy was formulated rather vaguely and multiple objectives in fact existed –

such as a low level of unemployment, high economic growth, sustainable balance of payments position, and a tolerable rate of inflation – the anchor of monetary policy during this period (prior to the crisis) was clearly the nominal exchange rate, which was managed heavily within a relatively narrow band that depreciated at a fairly steady rate. The band was gradually widened after 1992, to reach 12 per cent in May 1997 just one month before the currency crisis broke.[9]

Although the framework for monetary policy using base money as the policy target seemed to have been effective in the 80's and early 90's. There have been concerns that it is difficult for the policy makers to control base money growth[10] in Indonesia. There are at least three important reasons behind this problem.

First, money markets instruments, consisting of central bank bills (SBIs) and money market papers (SPBUs), were relatively thin and fragmented. Thus the reserve positions of the banks were not generally distributed evenly and they were prone to sudden shocks.

Second, in certain periods, base money is endogenous with respect to the output. For example, during periods of 'upswing' in the economy, the growth of base money is largely caused by aggregate demand as reflected by the growth in foreign borrowings and the liquidation of SBI. Although this did not necessarily mean that the growth of base money cannot be completely controlled by the central bank, this is a

[9] See Joseph Charles and Gunawan Anton (2000)

difficult job which sometimes needs an extremely high interest rates in order to slow the growth of aggregate demand. The difficulty of controlling the target using market instruments led, in some cases, to the use of non-market instruments such as reserve requirements, moral suasion and bank regulations.

Third, the relationship between nominal income and money became increasingly unstable. Global financial innovations and deregulation were the major factor behind this. Consequently, monetary policy using quantity targets become less effective. Faced with this challenge, Bank Indonesia initially followed a pragmatic or eclectic approach. Without abandoning the quantity approach, more attention was given to interest rates. Moreover, the intervention band under the managed exchange rate regime was widened several times to allow some flexibility and to ease the burden on monetary policy. However, this pragmatic approach was viewed as a transitional phase while the monetary authority shifted its policy from quantity targeting to price (interest rate) targeting.

2.3.2 The Framework in the Aftermath of the Crisis

The financial crisis during late 1997 and 1998 had a destabilizing impact on the Indonesian economy. Pressures on the exchange rate and on foreign currency reserves early in the crisis forced the monetary authority to abandon defense of the "crawling

---

[10] Budiono (1998)

band" exchange rate regime and to allow the rupiah to float in August 1997. Soon after floating the currency, the government adopted an extremely tight monetary policy by raising interest rates sharply, and also suspended several monetary instruments that had an expansionary impact, such as auction of SBPUs, discount facilities, and the purchase of SBIs.

The high interest rates and the enormous depreciation of the rupiah severely affected the banking and real sectors. Given the fragility of the banking and corporate sectors, the high interest rate and the depreciation worsened the banks' asset quality and contributed to widespread corporate failures. To prevent banks run and a collapse of the entire banking system, Bank Indonesia was obliged, as the lender of last resort, to provide large-scale liquidity support to troubled banks, causing a temporary loss of monetary control in late 1997 and early 1998. As the results, broad money (M2) and base money (M0) both grew by around 30 per cent from December 1997 to March 1998. As people's confidence in the rupiah eroded, a cycle of weakening currency, increase prices, and expanding money supply threatened to break out into hyperinflation.

The stability of prices and exchange rate is a prerequisite for the economic recovery. Low inflation rate helps stabilize exchange rate and therefore accelerates balance sheet adjustments in the banking and business sectors. The speed in restoring monetary stability determines the reduction of interest rate, which is prerequisite for the

economic growth. Monetary policy in crisis period was primarily focused on the efforts to restore exchange rate and price stability.

The efforts to stabilize price and exchange rate included setting sharper quantitative targets, enhancing the effectiveness of open market operations, reigning in the expansion of liquidity support of Bank Indonesia, and restoring access to external financing. In addition, the government also sought to stabilize prices through raising the supply and improving the distribution of basic necessities.

In pursuit of monetary policy objectives, Bank Indonesia, with support from the IMF, set quantitative targets for base money and its components, namely net foreign assets (NFA) and net domestic assets (NDA). To achieve the quantitative target, open market operation as an essential instrument of monetary policy has been improved. Due to a number of constraints in the money market instruments such as the thin market for SBIs, open market operations were not able to fully absorb all of the excess of liquidity in the economy. On July 29, 1998, Bank Indonesia changed the auction system of SBIs whereby emphasis was shifted from interest rate targets to quantitative targets. Furthermore, participation in the SBIs auctions was broadened from primary dealers to include bankers, money brokers, capital market brokers and the general public. These changes were intended to allow greater competition among auction participants, hence the SBI rate was expected to better reflect the interaction between demand and supply.

To sum up, targeting of the monetary base after the crisis was adopted by Bank Indonesia as a temporary framework mainly aimed to absorb the monetary expansion originating from liquidity support to the banking system, rather than being based on more fundamental considerations such as a stable relationship between inflation and base money (Iljas, 1999).