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Analysis of Monetary Policy Transmission Mechanism for Financing Line in Monetary System in Indonesia

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Abstract: The main problem that needs to be addressed in depth with regard to monetary policy is whether its process has a positive relationship to the economy. This study is intended to investigate monetary policy transmission mechanism for financing line in a dual monetary system in Indonesia. The results of the Granger Causality test revealed that the relationship pattern within variables in the monetary policy transmission mechanism for financing line cannot be clearly identified. In addition, the Impulse response function test proved that the Consumer Price Index (CPI) responds to other shocks. As a whole, CPI responds positively to the shock of Bank Indonesia Sharia Certificate, Islamic interbank money market, and financing. On the contrary, Consumer price index responds negatively to the shock of Third Party Funds and Bank Indonesia sharia deposit facility. Meanwhile, the Variance Decomposition test proved that Islamic Banking Financing contributes to the final goal of the policy. Yet, its contribution is relatively small, which is 0.04%.

Keywords: Analysis of Monetary Policy; Funding Pathways; Dual Monetary Systems Transmission Mechanisms

INTRODUCTION

Preserving the stability of rupiah is one of the goals of Bank Indonesia (BI) as the executor of monetary policies in Indonesia. The stability of rupiah refers to the stability of goods and services values as replicated in inflation rates. To preserve the stability of rupiah, Bank Indonesia has conducted various efforts since 2005 in which one of the efforts done is the implementation of a monetary policy framework called Inflation Targeting Framework. As reflected in its term, the monetary policy framework implemented by BI focuses on inflation as its main target. This framework adheres to the Free Floating system meaning that the monetary policy stance is changed by evaluating whether the inflation rate in the future is still in accordance with the predicted inflation rate.

The stability of rupiah exchange rate is crucial to achieve price stability. The monetary regulation is inseparable from the framework of macroeconomic monetary policy since the error of its system will give an impact on economy losses (Blanchard, Dell'ariccia and Maur, 2010). Therefore, financial intermediaries are declared as machines for financial cycle (Adrian and Shin, 2010) since it is at the heart of risk taking from this mechanism. The significance of financial friction in this transmission mechanism and financial stability is recognized by the global financial crisis views (Rey, 2016).

Strict monetary policy leads to a potential for low inflation and output due to high capital. Hence, monetary policy may give an impact on output growth but inflation may also occur (Blanchard, Cerutti and Summers, 2015). Through the aforementioned framework, Bank Indonesia has explicitly announced the target of inflation to the public. In this case, monetary policy has also been established to achieve the target set by the government. A graph of the inflation development from 2011 to 2017 can be seen in Figure 1.

When inflation is high, Bank Indonesia will strengthen the policy to reduce inflation so that it can immediately return to the established target. The mechanism of monetary policy transmission applied by Bank Indonesia can influence various economic and financial activities. In this sense, the monetary policy transmission in Indonesia can be overcome based on two concepts, namely conventional and sharia

(Sukmana and Wicaksana, 2019). The issuance of Law No. 23 of 1999 concerning Bank Indonesia gives new responsibility to Bank Indonesia, namely conventional and sharia monetary policy. The dual banking system began to be implemented in Indonesia in 1998 with regard to the issuance of Law No.10 of 1998 which defines dual banking system as the implementation of two banking systems, namely conventional or commercial banks operating with a system of interest and Islamic bank systems which provide services through Islamic window mechanisms by firstly establishing a Sharia Business Unit (UUS) (Kristianti, 2016).

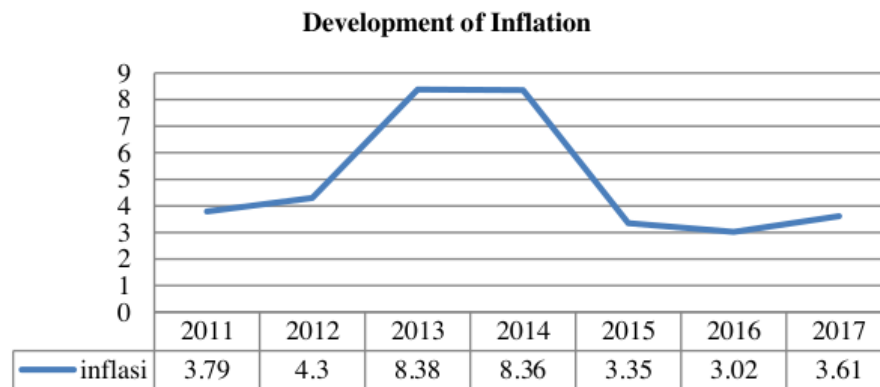


Figure 1: Development of inflation (Source: www.bps.co.id)

The mechanism applied by BI describes the effect of changes occurred in short-term interest rates policy on various variables, including reduction and idleness. The special lines of this transmission have an impact on interest rates, price exchange rates, equity and real estate prices, bank loans, and company balance sheets (Ireland, 2005). In contrast, sharia monetary system uses profit sharing, margins, and costs as a replacement to interest rate system since Islamic economists believe that interest rate system is usury. The advantage of loss sharing system (PLS) is a sense of justice since both capital owners and entrepreneurs can jointly work in carrying out their business. Thus, if the business loses, the loss will then be borne together. On the contrary, if the business generates profits, both parties will have their portion based on the ratio that has been agreed (Roe, 1991). Conventional banks will be more concerned to the issue of interest rates compared to Islamic Banks. It is because, as stated previously, Islamic banks do not apply interest rates in carrying out their business. Yet, conventional banks will be more stable due to high amount of capital they have (Naveed, 2015).

The main problem that needs to be addressed in depth with regard to monetary policy is whether its process has a positive relationship to the economy. The flow of monetary policy transmission mechanism through profit sharing financing is illustrated in one direction in which there is a relationship between variables so that the flow of monetary policy transmission is clear and unbroken indicating that monetary policy is going well. The Financing Response to the SBIS, FASBIS, DPK and CPI variables could be positive, negative or neutral indicating changes in inflation.

LITERATURE REVIEW

Understanding the mechanism of monetary policy transmission is significant in the context of inflation targeting so as to create more effective impact on its ultimate target. According to Pohan (2008) the efficacy of monetary policy will be contingent on transmission channel as a place determining the effect of a policy on real sector. Several previous studies related this transmission, including Alam (2014), described the relationship between bank risk and dual banking system. The Islamic bank system works well in a strict regulatory environment. Meanwhile, capital and liquidity requirements are less influential on Islamic banks than conventional banks (Alam, 2014). According to him, in dual banking systems, it was revealed that Islamic banks have a crucial role in transferring monetary policy in Malaysia since they have effectively transferred the effects of a policy to various economic activities (Sukmana and Kassim, 2010). On the other hand, Opolot and Nampewo (2014) analyzed the role of BLC (Bank Landing Channel) financial policy in Uganda. The study revealed that the tightening of the policy affects the supply of bank loan. Besides, the study also found the important role of BLC in influencing various monetary activities in Uganda.

Every change in monetary policy lead to a change in bank behavior. Strict monetary policy will make banks limit the loan supply and, consequently, will reduce investment level and decrease economic activity (Opolot and Nampewo, 2014). Conventional monetary transmission of SBMK and PUAB variables has a positive effect on CPI, while SBI and LOAN variables have a negative effect. Moreover, almost all sharia variables have a positive effect on CPI for sharia monetary transmission. Further, the results of Variance Decomposition showed that all conventional variables, except SBMK, lead to inflation in which LOAN gives the biggest contribution. On the contrary, almost all sharia variables have no role in triggering inflation (Pratama, 2014). Other research suggests that profit sharing financing (FLPS) responds to the shock of SBIS, FASBIS, DPK and CPI variables. In general, responses given by FLPS to movable variables are volatile

The mechanism of monetary policy transmission will function by applying various instruments. As an executor of monetary policy, BI has a goal to preserve the stability of rupiah. To achieve this goal, BI implements a monetary policy framework called Inflation Targeting Framework. As reflected in its term, the monetary policy framework implemented by BI focuses on inflation as its main target. This framework adheres to the Free Floating system (Aliyu and Englama, 2009). In his study, Hamzah (2009) states that realizing the effectiveness of money supply to the development of real sector and stabilizing market changes can be done in two ways, namely the issuance of sharia monetary instruments, such as SBSN (State Shariah Securities) and ORI (Indonesian Retail Bonds), with sharia-based and conventional banks that can play a role through reducing the use of derivative instruments (Hamzah, 2009). The results of other studies revealed that there is a significant effect between SBI and SBIS on the stability of the total monetary amount (Azizi, 2018). Various stakeholders have agreed that monetary policy has an impact on real sector (Alam and Waheed, 2006). However, it still needs to be studied, not only for the development of monetary economic theory but also to provide input for monetary authorities in formulating monetary policy.

METHODOLOGY

Data Analysis

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This study utilized time series data, namely data obtained from Indonesian Economic and Financial Statistics-Bank Indonesia (SEKI-BI). Here, data from January 2011 to December 2017 were used.

The analytical model used were Granger causality model and Vector Error Correction Model (VECM). The Granger causality model was used to find out the bound between variables, while VECM was used to estimate the effectiveness reflected in the results of Impulse Response and Variance Decomposition. The VAR/VECM equation used in this study were:

rSBIS_t = f(rSBIS_{t-p}, rFASBIS_{t-p}, rPUAS_{t-p}, DPK_{t-p}, FPL_{t-p}, CPI_{t-p})
rFASBIS_t = f(rSBIS_{t-p}, rFASBIS_{t-p}, rPUAS_{t-p}, DPK_{t-p}, FPL_{t-p}, CPI_{t-p})
rPUAS_t = f(rSBIS_{t-p}, rFASBIS_{t-p}, rPUAS_{t-p}, DPK_{t-p}, FPL_{t-p}, CPI_{t-p})
FPL_t = f(rSBIS_{t-p}, rFASBIS_{t-p}, rPUAS_{t-p}, DPK_{t-p}, FPL_{t-p}, CPI_{t-p})
CPI_t = f(rSBIS_{t-p}, rFASBIS_{t-p}, rPUAS_{t-p}, DPK_{t-p}, FPL_{t-p}, CPI_{t-p})

Where,

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- SBIS = Bank Indonesia Sharia Certificate
- FASBIS = Bank Indonesia Sharia Deposit Facility
- PUAS = Sharia Interbank Money Market
- FPLS = Sharia Institution Financing Facility
- CPI = Consume Price Index
- DPK = third-party funds
- r = rate
- t = time
- p = period
- t-p = rate-period

Stationarity Test

The term stationary is labeled to a data from random process fulfilling three criteria, namely if the average and its variants are constant throughout the time and the covariance of the data only depends on lag within two time periods. Basically, there are several stationarity test methods. Yet, the methods used in this study were the root tests unit of Phillips-Perron (PP) and Dickey-Fuller (ADF).

Determination of Optimal Lags

Economic policies, such as monetary and fiscal policies, will not directly give an impact on economic activity because it requires time. A new economic policy may require some time to work, such as 6 months to 12 months. When we analyze slowness models, the crucial question arising is how to set the lag length.

Cointegration Test

The cointegration test conducted by Johanssen aims to determine the existence of cointegration viewed from the comparison between trace statistic and critical value. If the value of trace statistic is higher, it can be concluded that the variables are cointegrated.

Empirical Model of VAR²⁶ VECM

After knowing that there is cointegration, the error correction method is done. If there is a different integration degree between variables, the test is carried out simultaneously (jointly) between the long-term and the inaccuracy correction equation. VECM is the estimated form of VAR because³¹ of the existence of data form that is not stationary but is cointegrated. VECM is often referred to as VAR design for non-stationary series that has a cointegration relationship.

12 Granger Causality

This test is used to evaluate the predicting ability of a time series variable in the previous period against other time series variables in the present. In other words, this test aims to see the influence of a past variable on a variable in the present. This result of this test can show whether there is a one-way or two-ways relationship between variables.

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Variance Decomposition

Variance Decomposition is a tool in VAR model separating variations from variables estimated to be shock components or innovation variables with assumption that the variables do not correlate with each other. In this case, the Variance Decomposition can give a clear description about the shock effect proportion of a variable on other variables in the current and future periods.

Impulse Response Function (IRF)

This test describes one variable's rate against another variable on a period of time. Thus, the shock effect duration of one variable on another can be seen. IRF can measure the relative strength of various shocks and trace the pattern and direction of shaking transmission.

RESULTS AND DISCUSSION

Stationary Test

Table 1 shows that none of variables is stationary because³⁶ the probability value of PP is more than 0.05. Thus, the authors carried out the test at the first difference level. The result of the stationary test at the first difference level revealed that all stationary variables are in each critical value of MacKinnon and the probability value of PP is less than 0.05.

Table 1: Results of variable stationary

Variable	Level		1st Difference	
	t-statistics	Prob-ADF	t-statistics	Prob-ADF
CPI	-2.336969	0.4100	-9.524509	0.0000
SBIS	-1.820531	0.6871	-6.889745	0.0000
FASBIS	-1.500742	0.8227	-5.982304	0.0000
PUAS	-3.906699	0.0160	-14.51266	0.0000
DPK	-1.756466	0.7180	-14.20213	0.0000
FINANCING	-1.987214	0.6005	-9.025615	0.0000

Lag Length Criteria Test

Table 2 shows the result of the lag length criteria test. From its result, it can be concluded that it will use lag 1 judging from the smallest and starred SIC (Schwarz Information Criteria) values. Thus, this length will be used for further tests, such as VAR stability, cointegration, etc.

Table 2: Results of root lag length criteria

Schwarz Information Criteria (SIC)		
0	1	2
5.685322	-17.57617*	-16.42880

VAR Stability Test

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Table 3 shows the results of the VAR stability test. It can be said to be stable if the modulus value is less than 1. Thus, from the table, it is clear that the modulus value is less than 1 meaning that the model is stable. Thus, the results of IRF and FEVD tests are valid.

Table 3: Results of root VAR stability test

Modulus Value	Description
0.982399	Stable
0.921557	Stable
0.921557	Stable
0.897293	Stable
0.549898	Stable

Cointegration Test

The res465 of cointegration test showed that a cointegration relationship exists indicating a long-term balance relationship between the variables. This is because the probability value $\alpha = 0.05$ or 5%. Thus, the next phase can be for the long-term test by using VECM. Results of cointegration test can be seen in Table 4.

Table 4: Results of cointegration test

Hypothesis	Trace Statistics	5% critical value	Prob.	Conclusion
None	142.2005	95.75366	0.0000	There is cointegration
At most 1	86.73598	69.81889	0.0013	There is cointegration
At most 2	49.15514	47.85613	0.0375	There is cointegration

VECM Estimation

From the results of VECM Estimation test, it can be stated that the variables of Islamic monetary instruments (SBIS) can affect the inflation rate in a long-term. From the result of VECM estimation in Table 5, it is known that sharia monetary instruments (SBIS) have a negative effect of -0.19 percent. It means that the decrease in SBIS level will cause a decrease in the inflation rate of 0.19 percent.

Table 5: Results of VECM estimation

(Long-term)	
Cointegration Equation (cq):	CointEq1
LOG_CPI(-1)	1.00000
SBIS(-1)	-0.193190
	[-4.36026]
FASBIS(-1)	0.500948
	[6.97171]
PUAS(-1)	-0.147681
	[-4.90941]
LOG_DPK(-1)	2.659558
	[-1.97262]
LOG_FINANCING(- 1)	-1.557861
	[3.25429]
C	-8.380088
(Short-term)	
CointEq1	-0.012858
	[-0.90795]
D(LOG_CPI(-1))	[0.21643]
	0.026134

Granger Causality

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The result of granger causality can be seen in Table 6. The results indicate a long-term balance relationship exists in variables. This is because the probability value (α) is lower than 0.05%.

Table 6: Result of Granger causality

Null hypothesis	Observation	F-Statistics	Prob.
BIS does not Granger Cause LOG_CPI	83	8.48406	0.0046
ASBIS does not Granger Cause LOG_CPI	83	7.24683	0.0086
OG_CPI does not Granger Cause FASBIS	83	5.09780	0.0267
UAS does not Granger Cause LOG_CPI	83	3.84862	0.0533
BIS does not Granger Cause PUAS	83	9.24469	0.0032
BIS does not Granger Cause Log_Financing	83	6.13856	0.0153
ASBIS does not Granger Cause PUAS	83	35.2396	7.E-08
ASBIS does not Granger Cause OG_Financing	83	12.9531	0.0006
UAS does not Granger Cause LOG_DPK	83	12.0595	0.0008
UAS does not Granger Cause Log_Financing	83	13.7944	0.0004
og_Financing does not Granger Cause LOG_DPK	83	4.91095	0.0295

Impulse Response Function

The result of the test indicates that SBIS and PUAS variables shock are responded positively by CPI level. Meanwhile, FASBIS and DPK variables shock are responded negatively by the CPI level. Thus, in general, CPI response towards these variables fluctuates from the 1st period to 14th period and starts to stay constant in the 15th period.

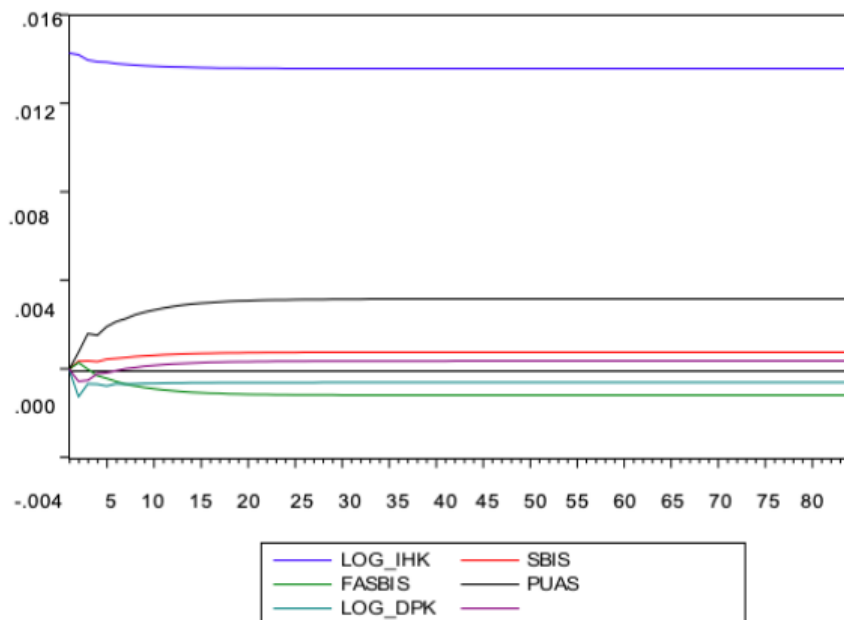


Figure 2: Impulse response function

Variance Decomposition

The amount of contribution given by SBIS, FASBIS, PUAS, DPK, and Financing variables towards CPI can be seen in Table 7. In the 1st period, the CPI level contributes to its variable. Then, in the 5th period, the biggest contribution is given by PUAS and followed by SBIS, DPK and FASBIS. In the 30th period, the most contributing variable is PUAS with 3.88% and the smallest contribution is the amount of Islamic bank financing with 0.04%.

Table 7: Variance decomposition

Period	S.E.	CPI	SBIS	FASBIS	PUAS	DPK	Financing
1	0.0143	100.00	0.0000	0.000000	0.00	0.000000	0.000000
5	0.0317	98.595	0.0673	0.034261	0.95	0.291311	0.066032
10	0.0447	97.426	0.1251	0.158547	2.01	0.249945	0.036131
15	0.0546	96.522	0.1731	0.274267	2.77	0.228865	0.035362
20	0.0631	95.894	0.2070	0.358735	3.28	0.215990	0.040418
25	0.0703	95.460	0.2306	0.418370	3.64	0.207538	0.045502
30	0.0772	95.151	0.2475	0.461137	3.89	0.201666	0.049607

DISCUSSION

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Inter Variable Relationship Pattern in the Mechanism of Monetary Policy Transmission

The result of Causality test through VECM method revealed that there is a direct relationship between FASBIS level and CPI level. This result refers to the monetary

policy theory in which the issuance of FASBIS as an operational target influences the intermediate and the ultimate goal of inflation. Other study suggests that the small market share of financing and credit is influenced by external factors, namely monetary instruments (Kashyap, Stein and Wilcox, 1992).

In general, this mechanism describes the way in which monetary policy is established by the central bank influences various activities in economy and finance in order to achieve its objectives. Miller and VanHoose (2004) stated that the efficacy of monetary policy as well as the constancy of financial system can be monitored based on important parameters, including the elasticity of demand and supply of financial assets and real assets, namely deposit and credit interest rates which are largely influenced by the structure of financial market and alternative availability of other financing sources (Miller and VanHoose, 2004). The monetary policy transmission mechanism with sharia principles which aim to achieve the final target of output and inflation is done through the implementation of sharia monetary operations with Open Market Operations (OPT) system applying SBIS and FASBIS instruments. This aims to influence the rate of return on PUAS which ultimately affects Islamic banking financing. This increase in financing is assumed to affect real sector in order to achieve monetary policy targets (Wahyudi and Sani 2014). The results showed that SBIS only affects PUAS, while FASBIS and CPI influence each other as the results of granger causality test showed a two-way relationship. Meanwhile, PUAS has an effect on SBIS, FASBIS, CPI and Financing. From the overall results, the flow of monetary policy transmission has not been clearly identified. This result is in accordance with Ascarya (2012) stating that the flow of sharia monetary policy transmission has not been clearly identified. In the same vein, Magdalena and Pratomo (2014) in their study proved that there is no sharia variable influencing inflation.

The rate of CPI response to shock, SBIS, FASBIS, PUAS, TPF, and financing in the monetary policy transmission mechanism

IRF can provide an overview of the response of a variable in the future against the shock of other variables. Hence, the duration of a variable shock against other variables, until there is no more effect or returns to the balance point, can identified. Here, IRF analysis indicates the reaction of variable shock to all variables over a period of time. The following figure shows the result of IRF test:

The new CPI variable began to respond to changes or shock occurring in TPF in the first period. The CPI responds negatively to the shock occurring in the DPK variable up to the eleventh period and is relatively constant or permanent in the next period. Then, the new CPI variable began to respond to changes or shock occurring in PUAS in the first period. Moreover, the CPI responds positively to the shock occurring in the PUAS variable up to the twenty-fourth period and is relatively constant or permanent in the next period. Then, the new CPI variable began to respond to changes or shocks occurring in Financing in the first period. The CPI responds negatively to the shocks occurring in the financing variable up to the fifth period and responds positively to the shock occurring in the Financing variable until the twelfth period. The CPI variable responds positively to the shock occurring in the financing variable until the twelfth period and is relatively constant or permanent in the next period. The CPI variable responds positively to the shock occurring in

the SBIS variable up to the tenth period and is relatively constant or permanent in the next period. The CPI variable responds positively to the shock occurring in the PUAS variable up to the twenty-fourth period and is relatively constant or permanent in the next period. This result is consistent with Ascarya (2012) who states the turmoil in SBIS, PUAS, and Islamic banking financing give permanent impact on inflation.

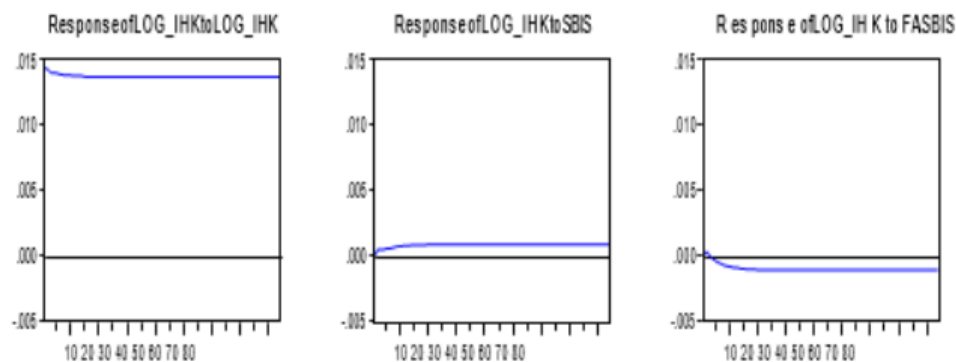


Figure 3: Impulse response function

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Contribution of Islamic banking system to the CPI in the mechanism of monetary policy transmission

The Variance Decomposition Test result proved that the initial period of movement of CPI level is influenced by the shock of CPI variable itself. The Financing variable shock contributes to the 30th period with percentage of 0.04%. This percentage is far compared to the credit contributions given by conventional banks. According to Magdalena and Prator (9), even though Islamic banking financing increases every year (47) but its capacity is still far compared to conventional banking. In the same vein, Sukmana and Kassim (2010) analyzes the monetary policy transmission mechanism through Islamic bank financing channels.

CONCLUDING COMMENTS

This research provides several findings: firstly, the Granger Causality test revealed that the relationship pattern within variables in the monetary policy transmission mechanism for financing line cannot be clearly identified. Secondly, the IRF results declare that the CPI responds positively to the shock of SBIS, PUAS and Financing variables. Then, the CPI responds negatively to the shock of DPK and FASBIS. Since the CPI responds negatively, the increase in DPK and FASBIS levels will reduce the CPI level. Thirdly, the Variance Decomposition test revealed that Islamic Banking Financing contributes to the final goal of the policy. Yet, the contribution is relatively small, which is 0.04%. Fourthly, there was inter variable relationship pattern in the flow of monetary policy transmission mechanism. Moreover, Granger Causality Test on variables intends to uncover short-term relationship direction within variables. In testing Granger Causality, the probability value which is less than 5% (0.5) proved a causality relationship between variables.

LIMITATION OF THE RESEARCH

This study analyzes the pattern of causality relationships between variables in the transmission mechanism of sharia monetary policy in the financing channel, using variables in the form of monetary control instruments in Sharia Monetary Operations (CSOs) imposed by Bank Indonesia on sharia banking in the form of returns on Bank Indonesia Sharia Securities (SBIS), The Sharia Bank Indonesia Deposit Facility (FASBIS) and the Sharia Interbank Money Market (PUAS). In addition to being a controlling variable, this study uses the variable Third Party Fund (DPK) as a source of banking funds in carrying out the intermediation function.

In addition to analyzing the relationship pattern (granger causality), this study analyzes the CPI response rate to shock with SBIS, FASBIS, PUAS, DPK, and Financing variables using the Impulse Response Function (IRF). This research also analyzes the contribution of financing in the monetary policy transmission mechanism with the Consumer Price Index (CPI) as an indicator of the real sector.

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