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Bank portfolio model and monetary policy in Indonesia☆,☆☆

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Abstract

This paper analyzes the banks' behavior in selecting their portfolio composition and their impact on the effectiveness of monetary policy transmission process in Indonesia. We employ an analytical model of the banking portfolio behavior based on microeconomic theory to understand how banks' portfolio behavior in maximizing their profit links to the efficacy of monetary policy. This study finds that micro banking factors affects the effectiveness of monetary policy. This study also finds structural changes in banks and borrowers have altered the effectiveness of monetary policy to encourage the economic growth and hindered the process of economic recovery. As perception on risk has large impact in supporting the effectiveness of the monetary policy, effort to reduce risk through the formation as credit bureau, credit guarantee scheme, and rating agencies is critical as it will improve transparency and availability of debtor information. The need for better coordination and harmonization between macro and micro policies would be beneficial.

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1. Background

Efficient resource mobilization and financial intermediation are critical to support real sector development and boost economic growth. Banks are one of financial intermediaries that play a

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key role in financing economic development and more superior compare to other financial institution as banks can solve with asymmetric information and high cost operation in financial intermediary activities (Stiglitz & Greenwald, 2003). The economic literature has identified two channels through which banks exert their influence on the process of economic growth. First channel considers effect of finance to growth through capital accumulation (Hicks, 1969), where banking institutions by reducing transaction costs and by diversifying risks, enable the mobilization of savings to finance the investments necessary to stimulate and sustain economic development. Second channel, emphasizes the allocation of loans, where development is driven by innovations and the role of banks is to identify the most innovative entrepreneurs and by providing them with the purchasing power necessary to divert the means of production, contribute to economic growth.

The important role of banks in emerging countries such as Indonesia is even true since the development of non-bank financial institutions has been impeded by inadequate institutional infrastructures and weak investor basis. Therefore, the rise and fall of banks in Indonesia would have strong correlation with the economic development in Indonesia. Instead of the economic development, bank behavior in selecting its portfolio composition with special attention to banks' credit also plays an important role in explaining the monetary policy transmission, particularly in the aftermath of crisis (Agung et al., 2001). The slow growth and the lack of bank loans identified as one of the important factors causing the process of Indonesia's economic recovery to proceed slower compared to other Asian countries affected by the crisis like South Korea and Thailand. The awareness of the importance of banks' credit in the monetary policy transmission process is driven among others by concerns over the impact of financial sector weaknesses, bank failures, non-performing loans (NPLs), and credit rationing on the effectiveness of the transmission process (see e.g., Bernanke & Blinder, 1988; Brunner & Meltzer, 1988). Recent stream of monetary policy paradigm has also acknowledged the importance of supply and demand of credits.

This paper tries analyzes the banks' behavior in selecting their portfolio composition particularly as an intermediary agent and their impact on the effectiveness of monetary policy transmission process in Indonesia. We begin with a historical overview of the development of banking sector and monetary policy in Indonesia. We then proceed with a brief explanation of the model being used in analyzing the banks' behavior and their impact on the monetary policy. Based on this framework, we conduct an empirical simulation that will compare banks' behavior and their impact on the effectiveness of monetary policy before and during the post-crisis period. Finally, we conclude how changes in banks portfolio behavior could alter the efficacy of monetary policy and come to the need for some policy recommendations.

2. Banking sector and monetary policy development in Indonesia

2.1. Pre-crisis period: 1966s–mid 1997

The early stage of banking development in Indonesia was started in 1967 characterized by the elucidation of Banking Act Number 14 and the establishment the state-owned banks and private national banks. The Banking Act of 1967 was designed to establish a banking system with the main task to mobilize funds and to extend loans to stimulate economic growth under the guidance of the central bank. However, the use of bank services at that time was fairly low reflecting the characteristics of typical emerging economy. Banking activities were highly concentrated in the state-owned banks with about 70% of market share. State-owned banks acted almost as a sole