BANK INDONESIA

Incorporating Macroprudential Instruments Into Monetary Policy: Indonesian Experience

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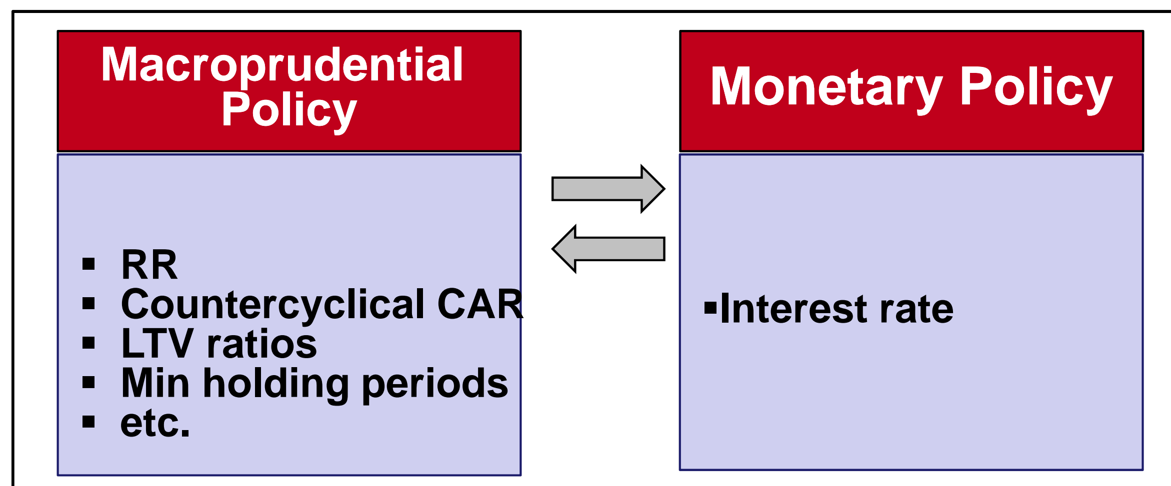
Outline

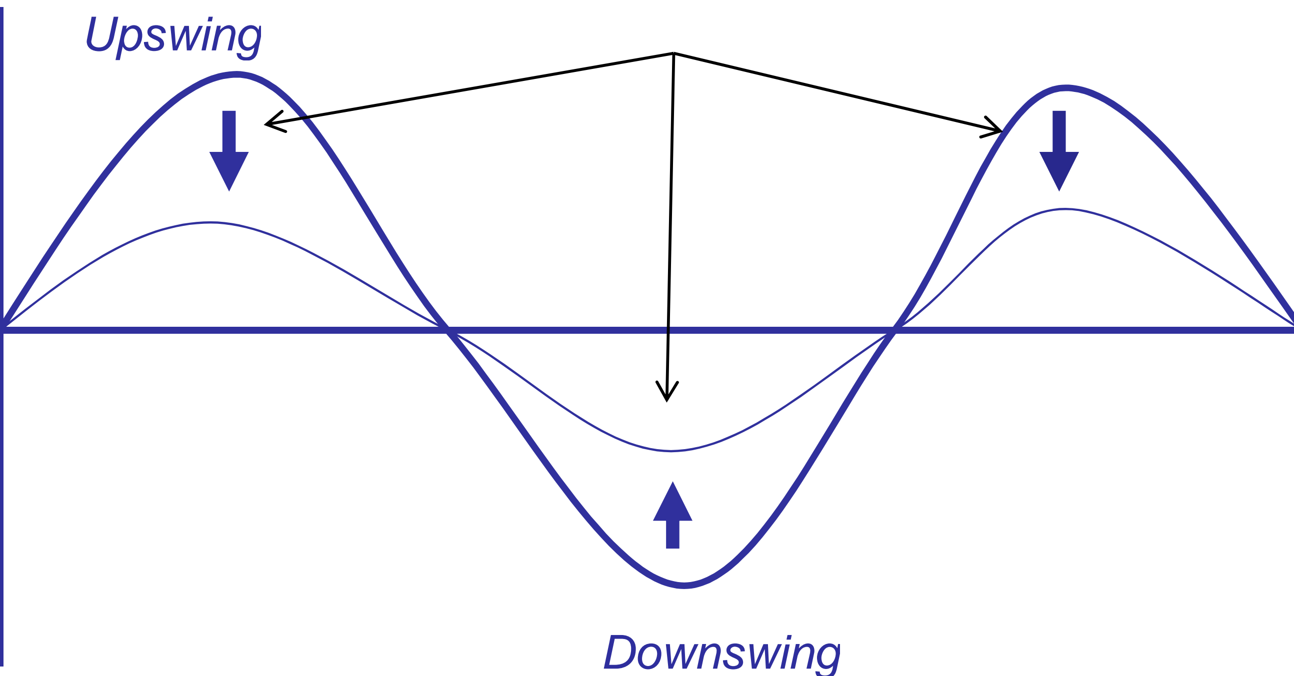
- Background
- Framework of Interaction between MP and MaP
- Recent Indonesian Experience
- Some Issues Going Forward
- Final Remarks

Background

- A post-crisis consensus on interdependence between monetary and financial stability in analysis and policy formulation.
- Financial sectors are inherently procyclical and hence coordination between monetary policy and macroprudential policy is necessary to maintain financial and macroeconomic stability.
- Recent capital inflows to Indonesia have led to complexity in monetary management (trilemma). Policy mix integrating monetary and macroprudential policies is necessary to address multiple challenges.
- Hence, Bank Indonesia recently develops a new monetary framework by incorporating macroprudential into monetary policy.

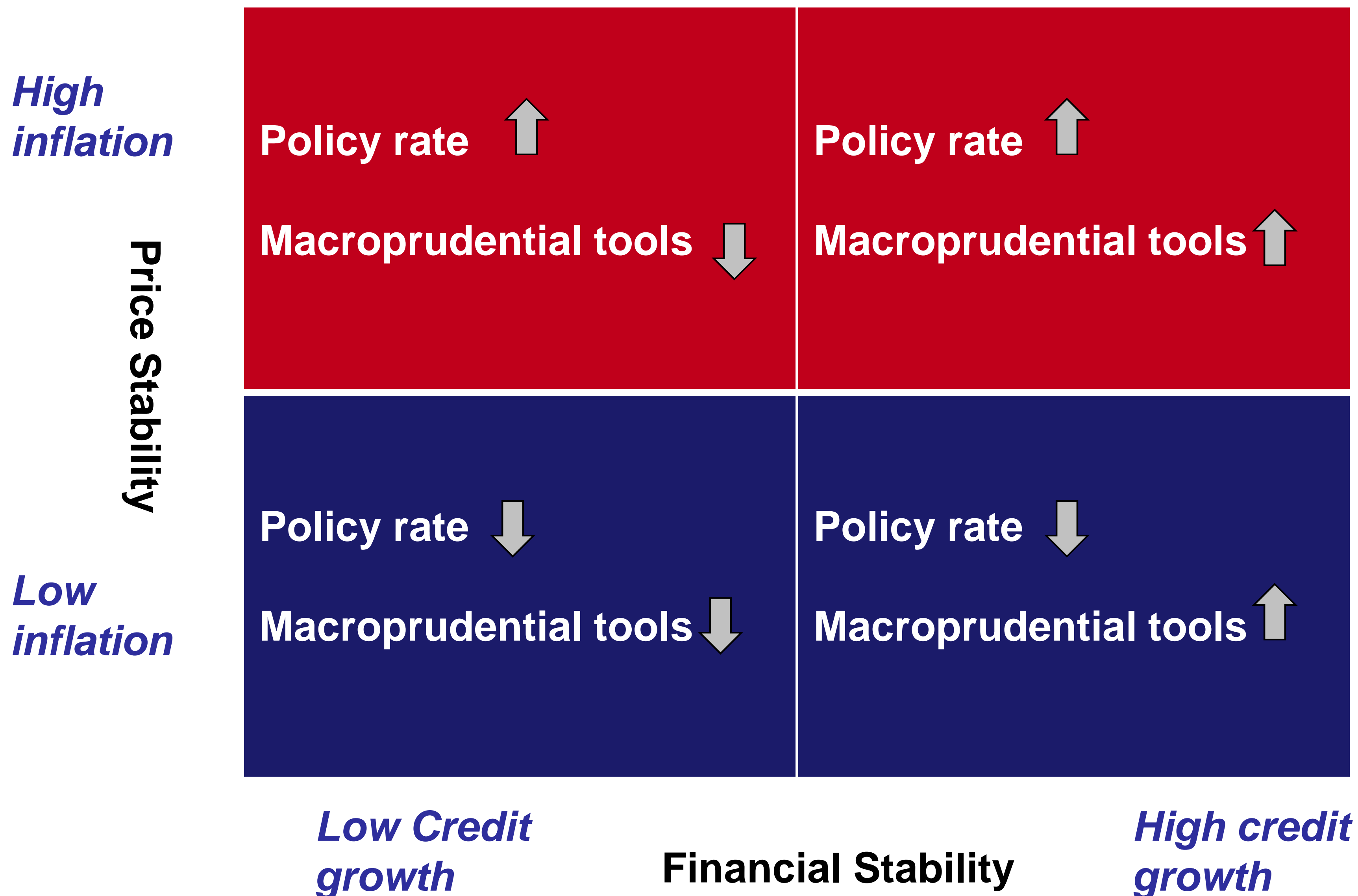
Framework of MP and MaP Integration





- *Procyclical movement of business and financial cycles*
- *Monetary and macroprudential policies are countercyclical measures to reduce magnitude of the business and financial cycles.*
- *They are reinforcing each other*

Framework of MP and MaP Integration

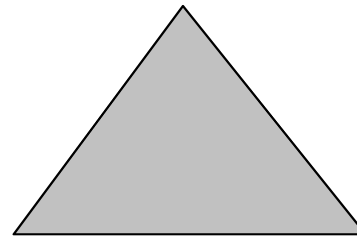


The Recent Indonesian Experience

- **The recent policy challenges to respond large and volatile capital flows is a clear example of the need for integrating macroprudential instrument into monetary policy, for 2 reasons:**
  1. **Capital flow volatilities pose challenges to monetary stability as well as financial stability:**
     - exchange rate volatilities,
     - excess liquidity,
     - inflationary pressures,
     - Risks of asset price bubbles,
     - Risks of capital reversal – interruptions in FX liquidity
  2. **Capital flows are procyclical in nature; inflows during good times (creating bubble and appreciation pressures) and outflows during bad times (bubble burst and depreciation pressures) - (Kaminsky, Reinhart, and Veigh, 2004).**

Trilemma

Free Capital Movement



Exchange Rate

Monetary Policy Independence

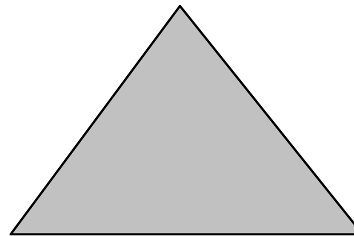
Managing Trilemma: Integrating MP and MaP

Capital flows

- Regime: Free cap account

- *Macroprudential tools:*

➢ Minimum holding periods
➢ Limit on banks' offshore borrowings



Exchange Rate

- Exchange rate flexibility
- Macroprudential tools:

➢ Accummulate reserves during good times (inflows), and used it during bad times (outflows) – through FX intervention

Monetary-Macroprudential Policy Mix

- Interest rate instruments

- Macroprudential tools:

➢ Reserve requirement (RR)
➢ LDR-linked RR
➢ Loan To Value (LTV) Ratio

Macroprudential Measures

- Lessons from recent experience suggest that the implementation of macroprudential policies to be guided by the following principles:
    1. **Macroprudential is complement, but not substitute to the monetary policies.**
    2. **Macroprudential measures should have clear target** (eg. to limit the short-term capital inflows; limit credit to property sector).
    3. **Macroprudential should be effectively implemented.** Prefer macroprudential measures that can be effectively monitored and supervised.
    4. **Communication on macroprudential should be clear.** The need to have a continuous communication, often in advance, to the market and public on the principles, objectives and modalities of the measures.

Timeline : Post-Crisis Macroprudential Policy

Mar 2010
Introduced SBI Lengthening Maturity Profile (implemented in a number of phases from Mar to Dec 2011)

Jul 2010
Introduced One Month Holding Period for SBI
Introduced Rupiah Term Deposits

Nov 2010
Increased Primary Rupiah Reserve Requirement from 5% to 8%

Jan 2011
Normalized the Policy to Limit Bank's Short Term External Borrowing (effective no later than the end of Jan 2011 with a 3-mo transition period)

Mar 2011
Increased Foreign Currency Reserve Requirement from 1% to 5%
Introduced LDR based Reserve Requirement

May 2011
Introduced Six Month Holding Period for SBI

Jun 2011
Increased Foreign Currency Reserve Requirement from 5% to 8%

March 2012
Introducing LTV property and automobile sectors

Post Global Crisis Macroprudential Policies

The Measures	Objectives
• **Minimum Holding Period** on BI bills, 1 month holding period (June 2010) and 6 month holding (May 2011)	• To "put sand in the wheels" on short-term and speculative capital inflows, and mitigate risks of sudden reversals.
• **Shifting BI bills to Term Deposit** since June 2010	• To lock up domestic liquidity to longer term, and limits the supply BI bills in the market.
Reinstate **limits on short-term offshore borrowing** of the banks • Maximum of 30% of capital • Effective end January 2011	• To limit the short-term and volatile capital inflows. • To limit FX exposure of the banking system stemming from capital inflows.
Increase **FX reserve requirements** of the banks from 1% of FX deposits to: • 5% effective March 2011 • 8% effective June 2011	• To strengthen FX liquidity management, thereby the resilience, of the banking system in facing increasing FX exposure stemming from capital inflows • Helps absorb domestic liquidity.

Post Global Crisis Macroprudential Policies

The Measures	Objectives
• Lengthen (from weekly to monthly) auction and offer longer maturity (3, 6, 9 months) of BI bills since June 2010.	• To enhance the effectiveness of domestic liquidity management, including from capital inflows, by locking up to longer term and helsp develop domestic financial markets.
• Increase **Rupiah reserve requirement** from 5% to 8%, effective Nov 2010.	• To absorb domestic liquidity and enhance liquidity management of the banks, without exerting negative impact on lendings that are needed to stimulate growth.
• Loan to value (LTV) ratio for property sector (max 70%) • Down-payment (DP) for automobile (min 30%), for productive vehicle (min 20%), and for motor-cycle (min 25%)	• To control accelerating growth of credit to consumer sectors (especially property and automobile sectors)

Some Challenges Ahead

- **Framework of integration** between monetary and macroprudential policies should be developed to guide policy formulation.
- Require **a better understanding of transmission** of macroprudential policies.
- **Analytical tools** should also be developed; eg. Macroeconimic model with financial sector and macroprudential rule
- On **institutional front**, a new FSA Act clearly separate microprudential authority (FSA) dan macroprudential authority (BI).
  - Clear mandate, Instruments/tools, Coordination, Accountability mechanism

Final Remarks

- Monetary policy and macroprudential policy are **reinforcing each other.**
- Monetary policy could assist in actively leaning against financial cycles. At the same time, macroprudential policies could support the monetary policy in achieving price stability.
- Macroprudential policy should be used to support, but **not to substitute**, monetary policy.
- On institutional front, more **precise mandate for central bank in setting macroprudential policy** – should be established.
- **Policy coordination and communication** are crucial.

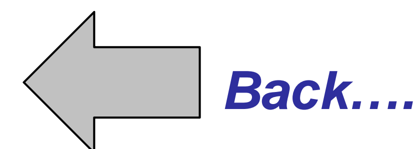
Business cycles and financial cycles in Indonesia

%y-o-y (left axis): 8, 7, 6, 5, 4, 3, 2, 1

%y-o-y (right axis): 30, 25, 20, 15, 10, 5, 0, -5, -10, -15

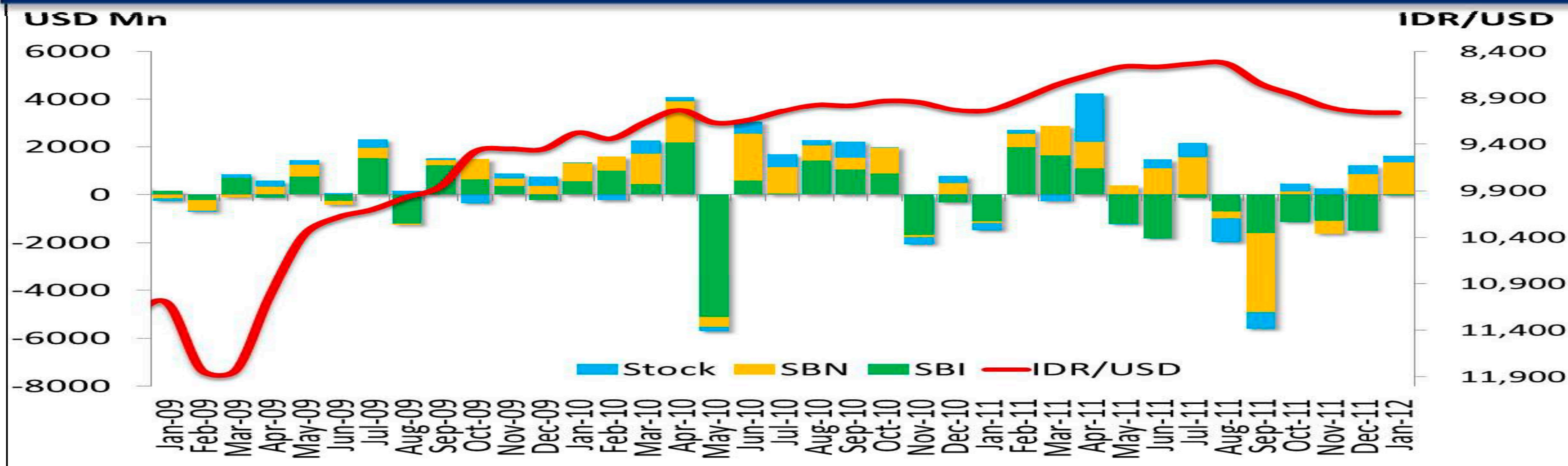
Q1-2001, Q1-2002, Q1-2003, Q1-2004, Q1-2005, Q1-2006, Q1-2007, Q1-2008, Q1-2009, Q1-2010, Q1-2011

PDB — Kredit Riil (Skala Kanan)



Capital Flows and Exchange Rate Volatility

Portfolio Flows and Exchange rate



Portfolio Flows: Gov bonds and CB Bills (SBI)