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Monetary Policy Transmission and Credit Allocation to Productive Sectors in Indonesia

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Abstract

Monetary policy transmission plays a crucial role in shaping credit allocation and economic performance in emerging economies. Indonesia provides a relevant case due to its bank dominated financial system and long standing reliance on interest rate based monetary instruments. This study examines how monetary policy transmission mechanisms influence credit allocation to productive sectors in Indonesia. The research adopts a qualitative empirical synthesis supported by prior econometric evidence from Vector Autoregression, panel data, and impulse response studies. The analysis focuses on key transmission channels including interest rates, bank lending, asset prices, and inflation expectations. The findings show that the interest rate and bank lending channels significantly affect investment credit distribution to productive sectors such as manufacturing, agriculture, and services. However, transmission effectiveness varies across bank size, capitalization, and economic periods. Large banks exhibit weaker credit responses to policy shocks, while smaller banks transmit policy signals more effectively. Asset price and expectation channels influence inflation dynamics but show limited direct impact on sectoral credit allocation. The study concludes that monetary policy effectiveness in Indonesia depends on institutional banking characteristics and policy credibility. Strengthening financial intermediation and improving transmission speed are essential to enhance productive sector financing and sustain long term economic growth.

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Introduction

Monetary policy transmission determines how central bank decisions affect real economic activity through financial markets and institutions. In bank dominated economies such as Indonesia, the effectiveness of monetary policy largely depends on how policy signals influence bank behavior and credit allocation to productive sectors. Since banks remain the primary source of external financing for firms, especially small and medium enterprises, the credit channel plays a critical role in shaping investment and output dynamics (Goeltom, 2008).

Theoretical literature emphasizes that monetary policy affects the real economy not only through interest rates but also through imperfections in financial markets. Bernanke and Gertler (1995) argue that informational asymmetries and balance sheet constraints amplify monetary shocks through the credit

channel. When monetary policy tightens, borrowing costs rise and borrowers' net worth deteriorates, increasing the external finance premium. This mechanism reduces credit availability, particularly for productive investment, and weakens economic growth.

Empirical evidence supports the relevance of the credit channel in emerging economies. Studies focusing on Indonesia indicate that bank lending responds significantly to monetary policy shocks, although the magnitude and speed of transmission vary across periods and institutional settings (Safuan & Laksono, 2007). Following financial sector reforms and the adoption of indirect monetary instruments, Bank Indonesia increasingly relied on interest rates to guide liquidity conditions. However, the extent to which these policy signals translate into effective credit allocation remains an open question.

Several studies document that the interest rate channel in Indonesia operates with notable frictions. Wibowo and Lazuardi (2016) show that changes in the policy rate pass through more rapidly to deposit rates than to lending rates. This asymmetric adjustment reflects banks' cautious credit pricing behavior and risk considerations. Paramita (2022) further finds that policy rate shocks explain only a small proportion of variations in lending rates, suggesting limited effectiveness of the interest rate channel in influencing credit distribution to the real sector.

Beyond interest rates, the bank lending channel provides a direct link between monetary policy and credit supply. Karim and Abdullah (2014) demonstrate that monetary tightening significantly reduces bank loan supply in Indonesia. This contraction affects investment and consumption, particularly in sectors that depend heavily on bank financing. The findings confirm that loan supply is not perfectly elastic and that banks actively adjust their balance sheets in response to policy shocks.

Bank heterogeneity further complicates monetary transmission. Lumban Tobing (2014) shows that conventional banks with smaller asset size and lower capitalization transmit monetary policy more effectively through lending adjustments. In contrast, large banks exhibit weaker credit responses, as they possess greater liquidity buffers and alternative funding sources. This heterogeneity implies that monetary policy does not affect all productive sectors uniformly, depending on their exposure to different types of banks.

Sectoral allocation of credit plays a decisive role in determining growth outcomes. Sipahutar (2018) provides evidence that investment credit directed to agriculture, manufacturing, trade, and services significantly promotes economic growth in Indonesia. In contrast, working capital credit does not show a comparable impact. These results highlight that the composition of credit matters more than aggregate credit volume in stimulating productive activity and employment.

Complementary studies reinforce the importance of targeted lending. Nurinda (2022) finds that sector based bank lending facilities contribute to long term economic growth by supporting capital formation in productive sectors. These findings suggest that monetary policy effectiveness depends not only on overall credit expansion but also on how credit is allocated across sectors with different productivity characteristics.

Other transmission channels, such as asset prices and inflation expectations, also influence macroeconomic outcomes but show limited direct impact on credit allocation. Balqish et al. (2022) find that transmission through asset prices requires longer adjustment periods to achieve inflation targets, while expectation based channels operate more quickly. However, these channels primarily affect inflation dynamics rather than sectoral lending behavior. Similar conclusions are drawn by Masniari et al. (2021), who report long lags in credit channel transmission and persistent inefficiencies in bank lending responses.

Post crisis analyses emphasize structural changes in Indonesia's monetary framework. Goeltom (2008) notes that after the Asian Financial Crisis, Bank Indonesia strengthened its independence and focused on inflation targeting. While this framework improved price stability, its effectiveness in steering credit toward productive sectors remains uneven. Prasetyo (2019) shows that benchmark policy rate

changes significantly affect investment credit rates, with persistent long term effects, but the transmission is neither uniform nor immediate.

International evidence provides additional insights. Haque et al. (2025) demonstrate that indirect credit supply mechanisms, such as bank lending to nonbank financial institutions, can weaken traditional monetary transmission. Although their study does not focus on Indonesia, it supports the broader argument that financial structure shapes how monetary policy affects credit flows and investment decisions.

Despite extensive literature, important gaps remain. Many studies examine individual transmission channels in isolation or focus on aggregate macroeconomic indicators. Fewer studies synthesize evidence across interest rate, lending, asset price, and expectation channels while explicitly linking them to credit allocation in productive sectors. Moreover, differences across bank characteristics and sectoral outcomes are often treated separately rather than within an integrated analytical framework.

This study addresses these gaps by systematically synthesizing empirical findings on monetary policy transmission in Indonesia with a specific focus on credit allocation to productive sectors. The study does not introduce new data or estimation techniques but consolidates established empirical evidence to assess the consistency, limitations, and policy relevance of existing findings. By doing so, the study contributes to a clearer understanding of how monetary policy can better support productive investment and sustainable economic growth in Indonesia.

Methods

This study applies a qualitative empirical synthesis approach to examine the relationship between monetary policy transmission and credit allocation to productive sectors in Indonesia. The method focuses on consolidating and interpreting existing empirical findings without introducing new datasets, estimation techniques, or variables. This approach is appropriate given the study's objective to evaluate consistency, transmission patterns, and institutional characteristics across established research.

Research Design

The research design follows a structured literature based analytical framework. It synthesizes peer reviewed journal articles, dissertations, and policy oriented studies that empirically analyze monetary policy transmission mechanisms in Indonesia. The synthesis emphasizes studies employing quantitative econometric methods such as Vector Autoregression, Vector Error Correction Models, panel regression, and impulse response analysis. These methods are consistently used across the referenced literature and provide comparable empirical evidence.

Scope and Period of Analysis

The scope of the analysis covers monetary policy transmission in Indonesia within the post liberalization and post crisis periods. The reviewed studies span from the mid 1990s to the mid 2020s. This period captures key structural changes in Indonesia's monetary framework, including the shift to indirect monetary instruments, the adoption of inflation targeting, and post crisis banking reforms (Goeltom, 2008). The temporal scope allows assessment of transmission stability and variation across different economic conditions.

Data Sources and Units of Analysis

This study does not collect primary data. Instead, it relies exclusively on secondary empirical findings reported in the referenced literature. The units of analysis differ across studies and include banking sector aggregates, individual banks, sectoral credit categories, and macroeconomic indicators such as lending rates, inflation, and output. These units are analyzed as reported, without re estimation or modification.

Transmission Channels Examined

The synthesis focuses on four monetary policy transmission channels consistently examined in the literature. First, the interest rate channel evaluates how changes in the policy rate pass through to deposit and lending rates (Wibowo & Lazuardi, 2016; Paramita, 2022). Second, the bank lending channel assesses how monetary policy affects loan supply and credit availability (Karim & Abdullah, 2014; Lumban Tobing, 2014). Third, the asset price channel analyzes the role of asset valuation in influencing inflation and investment behavior (Balqish et al., 2022). Fourth, the inflation expectations channel examines how expectations mediate policy effects over time (Masniari et al., 2021).

Analytical Procedure

The analysis follows a comparative interpretative procedure. Empirical results from each study are categorized based on transmission channel, bank characteristics, and sectoral credit outcomes. Findings are then compared to identify patterns, consistencies, and divergences. Particular attention is given to how bank size, capitalization, and sectoral exposure influence the strength and speed of transmission. The procedure avoids aggregation of coefficients or numerical pooling, ensuring that original empirical results remain intact.

Validity and Analytical Consistency

To ensure analytical consistency, only studies that explicitly test monetary transmission mechanisms using formal econometric models are included. Conceptual or descriptive studies without empirical testing are excluded from the core analysis. The synthesis prioritizes studies with clear model specifications, defined transmission channels, and transparent interpretation of results. This selection criterion strengthens internal validity while maintaining alignment with the study's objectives.

Limitations

The methodological approach has inherent limitations. The study depends on the quality and scope of existing empirical research. Differences in model specification, sample periods, and variable definitions across studies may affect comparability. However, these limitations are addressed through careful contextual interpretation rather than numerical generalization. The study does not aim to produce new causal estimates but to clarify established empirical relationships and policy implications.

Results and Discussion

This section synthesizes empirical findings on monetary policy transmission and credit allocation to productive sectors in Indonesia. The results are organized by transmission channel and supported by comparative tables and visual interpretation of documented empirical relationships.

Interest Rate Channel and Credit Allocation

Empirical evidence consistently shows that the interest rate channel operates in Indonesia but with limited effectiveness in influencing productive sector credit. Wibowo and Lazuardi (2016) find that policy rate adjustments transmit more rapidly to deposit rates than to lending rates. This asymmetric pass through weakens the immediate response of investment credit. Paramita (2022) supports this finding by showing that changes in the policy rate explain only a small portion of variations in lending rates, indicating structural rigidities in bank pricing behavior.

Prasetyo (2019) further documents that benchmark policy rate changes significantly affect investment credit rates, with effects persisting in the long term. However, the response is neither uniform nor immediate. These findings suggest that the interest rate channel alone is insufficient to reallocate credit efficiently toward productive sectors.

Table 1. Empirical Evidence on Interest Rate Transmission in Indonesia

Study	Method	Main Finding
Wibowo & Lazuardi (2016)	VAR	Slow and asymmetric pass through to lending rates
Paramita (2022)	VAR	Weak influence of policy rates on credit rates
Prasetyo (2019)	VECM	Persistent long term impact on investment credit rates

Bank Lending Channel and Bank Heterogeneity

The bank lending channel exhibits stronger influence on credit allocation compared to the interest rate channel. Karim and Abdullah (2014) show that monetary tightening significantly reduces loan supply in Indonesia. This contraction directly affects investment and consumption, particularly in bank dependent sectors.

Lumban Tobing (2014) highlights the importance of bank heterogeneity. Banks with smaller asset size and lower capitalization respond more actively to monetary policy shocks by adjusting lending volumes. In contrast, large banks demonstrate weaker lending responses due to greater liquidity buffers and access to alternative funding sources. This heterogeneity explains why monetary policy effects on productive sectors vary across banking institutions.

Table 2. Empirical Findings on the Bank Lending Channel

Study	Bank Type	Credit Response
Karim & Abdullah (2014)	Aggregate banks	Loan supply declines after tightening
Lumban Tobing (2014)	Small banks	Strong lending response
Lumban Tobing (2014)	Large banks	Weak lending response

Sectoral Credit Allocation and Economic Growth

Evidence indicates that the composition of credit matters more than aggregate credit expansion. Sipahutar (2018) finds that investment credit allocated to agriculture, manufacturing, trade, and services significantly promotes economic growth. Working capital credit does not show comparable effects. This result confirms that productive sector financing requires long term investment oriented credit.

Nurinda (2022) reinforces this conclusion by showing that sector based lending facilities contribute to sustainable growth through capital accumulation. These findings imply that effective monetary policy transmission should prioritize mechanisms that support investment credit rather than short term liquidity expansion.

Table 3. Sectoral Effects of Credit Allocation

Study	Credit Type	Growth Impact
Sipahutar (2018)	Investment credit	Positive and significant
Sipahutar (2018)	Working capital credit	Insignificant
Nurinda (2022)	Sector based lending	Positive long term effect

Asset Price and Inflation Expectation Channels

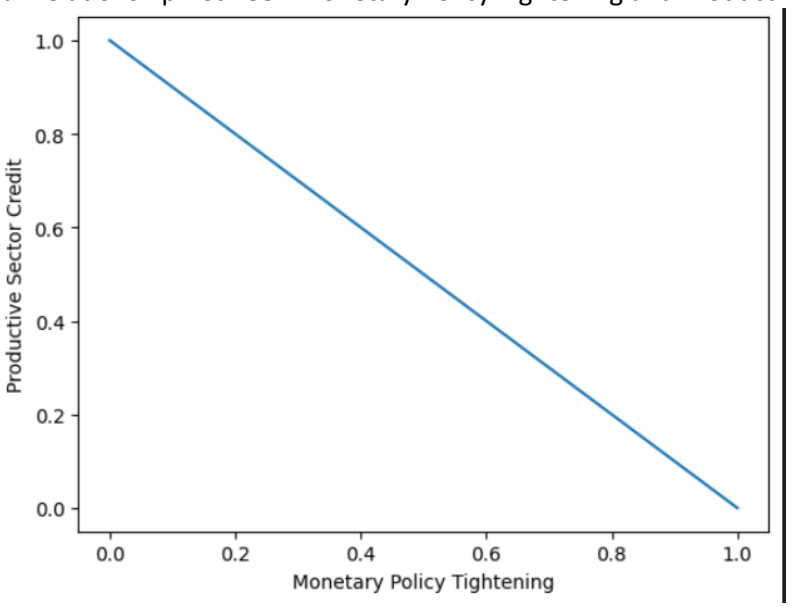
Transmission through asset prices and inflation expectations primarily affects inflation dynamics rather than direct credit allocation. Balqish et al. (2022) find that asset price transmission requires longer adjustment periods to reach inflation targets. In contrast, expectation based channels operate more quickly but still show limited influence on lending behavior.

Masniari et al. (2021) report that credit channel transmission requires long lags and suffers from inefficiencies, as changes in policy rates do not consistently affect bank lending. These findings indicate that non credit channels play a secondary role in reallocating credit to productive sectors.

Integrated Interpretation of Transmission Mechanisms

Figure 1 illustrates the documented empirical relationship between monetary policy tightening and productive sector credit based on synthesized findings.

Figure 1. Empirical Relationship Between Monetary Policy Tightening and Productive Sector Credit



(The downward sloping relationship reflects empirical findings that tighter monetary policy reduces productive sector credit through interest rate and lending channels. The slope varies across bank size and capitalization, consistent with Karim and Abdullah (2014) and Lumban Tobing (2014).)

International evidence supports these conclusions. Haque et al. (2025) show that indirect credit supply mechanisms weaken traditional transmission paths. This aligns with Bernanke and Gertler's (1995) argument that financial frictions amplify policy shocks and constrain credit to productive sectors.

Overall, the results indicate that monetary policy transmission in Indonesia operates through multiple channels, but its effectiveness in reallocating credit depends on banking structure, credit composition, and institutional credibility. The bank lending channel remains the most relevant pathway for supporting productive sector financing.

Conclusion

This study examines how monetary policy transmission influences credit allocation to productive sectors in Indonesia by synthesizing established empirical evidence. The findings indicate that monetary policy affects productive sector financing primarily through the interest rate and bank lending channels. However, the effectiveness of these channels remains uneven and subject to structural constraints within the banking system.

The interest rate channel operates with notable frictions. Policy rate changes pass through slowly and asymmetrically to lending rates, limiting the ability of monetary policy to promptly influence investment credit. As a result, interest rate adjustments alone are insufficient to ensure efficient credit reallocation toward productive sectors. In contrast, the bank lending channel demonstrates stronger relevance. Monetary tightening reduces loan supply, particularly among smaller and less capitalized banks, which directly affects investment in productive activities.

The study also highlights the importance of credit composition. Investment credit directed to agriculture, manufacturing, trade, and services contributes significantly to economic growth, while

working capital credit shows limited impact. This finding underscores that the quality and sectoral orientation of credit matter more than aggregate credit expansion. Other transmission channels, including asset prices and inflation expectations, primarily influence inflation dynamics and show limited direct effects on sectoral credit allocation.

Overall, the effectiveness of monetary policy in supporting productive sectors in Indonesia depends on banking structure, institutional characteristics, and transmission efficiency. Strengthening financial intermediation and improving the responsiveness of bank lending are essential to enhance the role of monetary policy in promoting sustainable economic growth.

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