The Impact of Mandatory Use Of Rupiah Currency to Indonesia Trade Value Competitiveness and Economic Growth

Author: Tumpak Silalahi
DOI: 10.32734/lwsa.v1i2.205
Electronic ISSN: 2654-7066
Print ISSN: 2654-7058

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The Impact of Mandatory Use Of Rupiah Currency to Indonesia Trade Value Competitiveness and Economic Growth

Dr. Tumpak Silalahi

Abstract

Volatility of Rupiah’s exchange rate to Foreign Currency in 2015 was indicated by Rupiah’s depreciation. The purpose of this paper is to see how the implementation of mandatory use of Rupiah in Indonesia affects factors that cause its depreciation. In this paper, descriptive analysis and econometric analysis will be used to demonstrate and explain the impact of some variables to the amount of money circulated in the market. Bank Indonesia’s Regulation Number: 17/3/PBI/2015 was issued on March 31, 2015 and Circular Letter Number: 17/11/DKSP was issued on June 1, 2015 that it require mandatory on the use of Rupiah in Indonesia territory. The policy consists of economic, nationalism, and law perspectives. However, this paper focus only on the economic side with the main objective to see how it contributes to Rupiah’s stability. By analysing quantitatively and qualitively data by using statistic procedure and simulation, this paper able to show the effect of policy measure on the financial condition as an aggregate figure during the period of research time.

Keywords: Mandatory Use of Rupiah; Payment System, Money in Circulation; Economic Transaction; Foreign Currency Transactions. JEL code: E51, E52, E58

1. Introduction

In 2015, Bank Indonesia (BI) with some related government institutions created a policy that requires all transactions made in Indonesia to use Rupiah. This includes Bank Indonesia’s regulation No. 17/3/PBI/2015 on March 31, 2015 and Letter No. 17/11/DKSP on June 1, 2015. These two correlate with Bill No. 7 in 2011 about currency. Transactions included in these laws are transactions that are used for payment, any obligations that have to be done using money, and/or any financial transaction, either cash or non-cash.

According to Bill No. 6 in 2009, BI as the holder of monetary and payment system otiority in Indonesia has the right to rule the use of Rupiah in every transaction in Indonesia. BI’s objective is to ensure Rupiah’s stability as Indonesia’s currency. The stability is measured in two components, which are Rupiah’s stability towards goods and services and Rupiah’s stability towards other currencies. The first component can be seen from inflation while the second component is seen from Rupiah’s exachange rate.

Regulations that mandate the use of Rupiah in Indonesia will ensure Rupiah’s competitiveness, purchasing power, and exchange rate. This regulation was based on trends of increasing number of the use of foreign currencies in Indonesia as shown in Figure 1.
According to Bank Indonesia’s data, 94.6% of foreign currency transactions are in USD. It creates a high demand for USD that causes an imbalance of supply and demand of USD and Rupiah. As a result, Rupiah’s exchange rate receives high pressure as illustrated in Figure 2.

It makes Indonesia’s economy vulnerable to economic wave. The net demand of USD for domestic transactions inputs pressure to the depreciation of Rupiah’s exchange rate. It can intrude Rupiah’s stability and bring complexity to monetary and exchange rate policy. Bank Indonesia realizes the importance of using Rupiah for domestic transaction in Indonesia as the foundation of a strong national economy. In the long run, it can prevent dollarization, so it can support a healthier economy.

Also, Bank Indonesia considers Rupiah’s position that has not been recognized as a payment system worldwide. Because of that, there are some exceptions to the laws that will ensure that it does not limit economic activities that can bring negative effects to Indonesia’s economy. These exceptions are:
• Transaction in accordance with the nation’s income and spending budget that includes Indonesia’s debt payments (debt expense and its interest), foreign goods and capital purchase, and income from government’s bonds
• Receiving from or giving grants to offshore sources
• International trade transactions, which is export and/or import goods to or from foreign countries, and trade services done by cross border supply and/or consumption abroad
• Foreign currency savings in a bank that has foreign activities. Transactions that can be done are withdrawal and/or deposit in foreign currency
• International transaction if the sender or the receiver lives in foreign countries

The law to use Rupiah was implemented in March 2015 for cash transactions and in June 2015 for non-cash transactions. As the regulator, it is important for Bank Indonesia to know the effectiveness of this law. Some agreement and disagreement was shown from different parties. Even though some private and public institutions support this regulation, data and analytic support is critical in determining its effectiveness. Therefore, this paper will answer the question of what is the effect of mandatory use of Rupiah in Indonesia to the amount of Rupiah circulated in the market. The amount of money circulated is one of the indicators of Rupiah’s stability. By measuring this, we can see whether the regulation has a positive or a negative impact.

2. Literature Review

2.1. Money Function

Money in general is something that can be accepted generally as a payment system in a region or as a debt payment or to buy goods and services. In other words, money is a tool that is used in trading goods and services (Kasmir, 2011). On the other hand, currency determines the unit of money that is generally acceptable to be used as a payment system for goods and services and debt (Mishkin, 2008). Money plays an important role in a country’s economy. It is the payment system and the measurement for price. It replaces old payment systems that are more complex, inefficient, and cannot be applied to modern economy since it requires another party who has the same desire and results in confusion in determining the value. Money’s efficiency will encourage trade and better distribution of human capital which results in higher productivity.

In Indonesia, money was printed by the government (Djiwandono et al., 2006). However, after Bill No. 13 in 1968 Article 26 Chapter 1, the government’s right to print money was lifted. Then, BI (as the central bank) got oktroil rights to be the only institution who has the right to print money.

There are two functions of money:

• Primary function
  Money is used as medium of exchange, unit of account, and store of value. As a unit of account, money shows the value of goods and services, wealth, and debts. It is also used to quote price of goods and services. As a store of value, it enables people to save their money and use it for later purchase.

• Secondary function
  a. For payment
  b. Quoting price of goods and services
  c. Debt payments
  d. Wealth: Savings in checking or savings account have high liquidity, which is beneficial in urgent situation
  e. Transferrable wealth. It can be transferred from one party to another or from one bank to another
  f. Economy activities. A stabil value of a currency or money will encourage people to invest, which is good for the economy
In Indonesia, money is classified into two categories, which are money printed by central bank and money printed by banks. The differences between these two are explained in Table 1.

Table 1. Types and Characteristics of Money.

| Description     | Money printed by central banks          | Money printed by banks                     |
|-----------------|----------------------------------------|--------------------------------------------|
| Usage           | Can be used by everyone                 | Can be used by certain individuals         |
| Nominal         | Printed and limited                     | According to the holder’s need and unlimited |
| Guarantee       | Guaranteed by the government            | Guaranteed by banks who sell it and by the government in a limited period |
| Example         | Paper money and coins                   | Checks and deposits                        |

2.2. Demand and Supply of Money

Keynes (1936) differentiates motifs of demand of money into three:

- Demand for transactions
  Keynes argue that the demand for transactions depends on income. If income is high, transactions will be high too. People will higher income will have more transactions/consumption

- Demand for savings
  It is used for unexpected expense, such as illness. It also depends on income. If income is high, demand for savings will be high too.

- Demand for investments
  It depends on interest rate. If interest rate is high, people will be more reluctant to invest because the opportunity cost of withdrawing money is high, and there is an assumption that interest rate will go back to its normal level, and vice versa. Other factors that should be taken into consideration are time value of money and opportunity cost of having cash.

Factors that affected supply of money: interest rate, income, population, geographical condition, economic structure, human capital, globalisation, inflation, wealth, exchange rate, and credit facility provided by financial services.

2.3. Money in Circulation

Legal tender is the most important element in money in circulation in each country, especially in developing countries. In Indonesia, narrow money (M1) consists of money printed by central bank and banks. Broad money (M2) consists of M1, quasi money, and marketable securities besides stocks. Calculation of money in circulation can be done with two methods, which are accounting and behavior methods. Bank Indonesia uses accounting method with formula stated below.

\[
M1 = NFA + DC - TD - COI \\
\text{or} \\
M1 = NFA + NDA1 \\
M2 = NFA + DC - COI = M1 + TD \\
\text{or} \\
M2 = NFA + NDA2
\]

- \( M1 \) = Narrow money
- \( M2 \) = Broad money
- \( NFA \) = net foreign assets from banking systems
- \( DC \) = domestic credit from banking systems
- \( TD \) = Timed Deposits in banks (deposit berjangka)
COI = capital and other liabilities (net)
NDA1= net domestic assets from banking systems
NDA2= net domestic assets from banking systems before calculating TD

3. Research Methodology

3.1. Methods Used

Analysis in this paper is descriptive to illustrate the facts and characteristics of the implication of BI’s regulation to some variables systemically and accurately. By analysing quantitatively and qualitatively using statistic procedure and simulation, we will be able to see the effect of a regulation to the financial condition in a period of time.

3.2. Data Collection and Data Analysis Technique

Data collected are qualitative and quantitative secondary data received from BI’s published data and Indonesia’s Statistic Institution Center. Then, we will use descriptive analysis by creating systematic, factual, and accurate illustration about facts, characteristics, relationship and correlation between the regulation to require the use of rupiah to the changes of the use of foreign currency in Indonesia.

The research model used in this paper is based on money quantity theory with regression described below.

\[
UB_t = \alpha_0 + \beta_1 DV_t + \beta_2 DKPR + \beta_3 GV_t + \beta_3 TV_t + \beta_4 CPI_t + \beta_4 GDP_t + \varepsilon_{it}
\]

Using VAR, we will generate results showing how each variable responds to shocks caused by this regulation. The model is shown below.

\[
\begin{align*}
\text{Variable} & & \text{Constant} & & \text{Parameter} & & \text{LagError} \\
M_t & & \alpha_{10} & & \alpha_{11} \alpha_{12} \alpha_{13} \alpha_{14} & & M_{t-1} & & \varepsilon_{1t} \\
GDP_t & & \alpha_{20} & & \alpha_{21} \alpha_{22} \alpha_{23} \alpha_{24} & & GDP_{t-1} & & \varepsilon_{2t} \\
DKPR_t & & \alpha_{30} & & \alpha_{31} \alpha_{32} \alpha_{33} \alpha_{34} & & DKPR_{t-1} & & \varepsilon_{3t} \\
GV_t & & \alpha_{40} & & \alpha_{41} \alpha_{42} \alpha_{43} \alpha_{44} & & GV_{t-1} & & \varepsilon_{4t}
\end{align*}
\]

There are two approaches to see how this regulation affects the stability of rupiah using variables above. First, we should see the changes of the amount of foreign currency circulated and/or used in transaction in Indonesia. This can be seen from non-bank transaction in foreign currency, non-cash payment using foreign currency, demand deposit and savings in foreign currency. Second, we should look into the changes of the amount of rupiah used in Indonesia. This can be retrieved from the amount of checking and savings in rupiah.
4. Results

4.1. Non-Bank Transaction in Foreign Currency in Domestic Banks

One of the ways in determining the effectiveness of BI’s regulation is to see if there is any decrease in the usage of foreign currency in Indonesia. In September 2015, there is a decrease of foreign currency usage in terms of value compared to the monthly average from January – August 2015 from USD 5.19 million to USD 3.37 million. The frequency of transaction in foreign currency in September 2015 also decreased from 36,333 transactions on average in September 2014 – August 2015 to 18,000. It shows that the implementation of mandatory use of Rupiah decrease the use of USD in transaction between Indonesians.

![Graph showing decrease in non-bank transactions in foreign currency in domestic banks](image-url)

Figure 3. Non-Bank Transactions in Foreign Currency in Domestic Banks in January 2014 - September 2015.

*) Temporary Number  
**) Very Temporary Number Services Financial Capital

Source: DSta and DPKL of Bank Indonesia

If we look into payments from Nostro to Nostro and Nostro to OCA since the implementation of BI regulation for non-cash transaction in June 2015 to three months after the implementation, we can see from graph below that non-cash transactions in foreign currency decrease by 38%.

![Graph showing decrease in non-bank transactions in foreign currency in domestic banks](image-url)

Figure 4. Payments from Nostro to Nostro and Nostro to OCA.
4.2. Money in Circulation

Below is a graph showing the amount of money in circulation for both M1 and M2 bi-monthly in January 2014 – September 2015.

[Graph showing Money in Circulation]

Figure. 5. Money in Circulation in January 2014 - September 2015.

Source: Bank Indonesia

There is an increase in the amount of money in circulation in 2015 compared to 2014. We can see that the increasing trend had been happening before the regulation was implemented. Therefore, there are other factors that affect the amount of money in circulation, which are CPI and GDP. Detailed information about CPI and GDP can be found below.

| Variable     | First Quarter 2015 | Second Quarter 2015 | Third Quarter 2015 |
|--------------|--------------------|---------------------|--------------------|
| CPI          | 118.48             | 120.14              | 121.67             |
| GDP (in trillion Rupiah) | 2,157.8 | 2,239.3 | 2,982.6 |

A more detailed analysis about each variable will be explained below.

4.3. Currency outside bank, demand deposit in rupiah and foreign currency, savings in rupiah and foreign currency, and GDP

Using quarterly data from January 2013 – September 2015, we can see that savings in Rupiah (it includes savings account and deposits) increase from fourth quarter in 2013 to fourth quarter in 2014 and experience a higher increase since the second quarter of 2015 (after the implementation of the regulation). Similar trend has been happening to currency outside bank since second quarter of 2015.
Figure 6. GDP, Currency Outside Bank, Demand Deposit in Rupiah, Savings in Foreign Currency, Demand Deposit in Foreign Currency in January 2013 – September 2015 (in Million Rupiah)

GDP and Savings in Rupiah uses right-hand side axis

Source: www.bi.go.id

A more detailed data about GDP, currency outside bank, demand deposit in Rupiah and foreign currency, savings in Rupiah and foreign currency can be seen below.

Table 2. GDP, Currency Outside Bank, Demand Deposit in Rupiah, Savings in Foreign Currency, Demand Deposit in Foreign Currency in January 2013 – September 2015 (in Million Rupiah).

| Period       | Constant GDP | Currency Outside Bank | Demand Deposit in Rupiah | Savings in Rupiah | Savings in Foreign Currency | Demand Deposit in Foreign Currency |
|--------------|--------------|-----------------------|--------------------------|-------------------|-----------------------------|-----------------------------------|
| 1st quarter 13 | 1,959,690    | 331,168.76            | 478,886.13               | 2,057,109.45      | 252,390.98                  | 190,841.39                        |
| 2nd quarter 13 | 2,036,920    | 347,146.05            | 511,352.94               | 2,067,209.57      | 270,591.40                  | 205,484.35                        |
| 3rd quarter 13 | 2,103,340    | 360,078.55            | 507,636.37               | 2,137,916.64      | 313,283.66                  | 240,771.78                        |
| 4th quarter 13 | 2,058,250    | 399,608.66            | 487,474.84               | 2,256,849.35      | 321,255.14                  | 242,416.04                        |
| 1st quarter 14 | 2,060,480    | 377,437.65            | 476,064.75               | 2,267,532.41      | 298,005.05                  | 219,638.62                        |
| 2nd quarter 14 | 2,139,300    | 381,637.54            | 564,080.28               | 2,352,854.50      | 323,109.84                  | 227,450.90                        |
| 3rd quarter 14 | 2,206,870    | 395,229.50            | 553,938.83               | 2,473,531.40      | 335,365.95                  | 235,944.54                        |
In the second and third quarter in 2015, there is an increase in the amount of currency outside bank in circulation, demand deposit in rupiah and foreign currency, and savings in rupiah. Savings in foreign currency experienced a decrease in second quarter in 2015 due to shock effect from the regulation that was implemented in March 2015. Indonesians converted their savings in foreign currency to Rupiah to be saved again or used for transaction. However, savings in foreign currency increased in the third quarter because Indonesians are more aware of the importance of Rupiah in doing transactions. As a result, foreign currency that they have are saved in savings accounts or deposits (there is a 5.9% increase from second to third quarter). Percentage of increase and decrease of each variable can be seen below.

Table 3. Increase/Decrease in Currency Outside Bank, Demand Deposit in Rupiah, Savings in Rupiah, Savings in Foreign Currency, Demand Deposit in Foreign Currency.

| Period   | Increase/Decrease |
|----------|-------------------|
|          | Currency Outside Bank | Demand Deposit in Rupiah | Savings in Rupiah | Savings in Foreign Currency | Demand Deposit in Foreign Currency |
| Q1 to Q2 | 7.25%              | 9.42%                   | 0.12%            | -1.05%                       | 12.05%                           |
| Q2 to Q3 | 4.67%              | 0.69%                   | 2.96%            | 6.88%                        | 5.95%                            |

4.4. Statistic Simulation

Data used in statistic simulation for this paper are:

- GDP based on price
- GDP based on constant price
- Consumer Price Index (CPI)
- Narrow money ($M1 = $currency outside bank + demand deposit in Rupiah$)
- Broad money ($M2 = M1 + Quasi Money($Deposits in Rupiah and foreign currency, Savings in Rupiah and foreign currency, and Demand Deposit in foreign currency) + marketable securities besides stock$)
- Dummy $Mandatory Use of Rupiah$, where period before its implementation is represented with “0” and “1” after the implementation

Simulation is done to know the correlation between the regulation and the changes of the use of foreign currency using indicators stated above. Data analysis is performed on EViews 7 by using Ordinary Least Square (OLS) method. The results are shown below:
Table 4. Explanatory Power “Effectiveness of Requiring the Use of Rupiah” Simulation.

| Fixed Variable→ | Money in Circulation | Money in Circulation | Money in Circulation | Checking in Rupiah |
|-----------------|----------------------|----------------------|----------------------|--------------------|
| Variable:       |                      |                      |                      |                    |
| Dummy           | 14144,87**           | 26976,98*            | 18408,97*            | 84407,12***        |
| Mandatory Use of Rupiah | 16958,83            | 15640,47             | 15644,78             | 18233,93           |
| Deposits in Foreign Currency | 0,327548*          | 0,618159**           |                      | 7,40E-07*          |
| Checking in Foreign Currency | 0,294293           | 0,246108             |                      | 5,45E-06           |
| CPI             | 50,29443*            | 134,2137*            | 618,1801*            | -433,7709*         |
| GDP Constant Price | 448,81***           | 456,9067***          | 414,5634***          |                    |
| Deposits in Rupiah | 97,50324           | 100,5287             | 96,80492             |                    |
| Savings in Rupiah | 0,102292*           | 0,063098             |                      |                    |
| Savings in Foreign Currency | 0,195775*           | 0,154605             |                    | -1,76E-05*         |
| Observation     | 33                   | 33                   | 33                   | 33                 |
| Number of N     | 33                   | 33                   | 33                   | 33                 |
| R Squared       | 92.01                | 91.17                | 92.19                | 72.15              |
| D-W Statistic   | 1,836365             | 1,724453             | 1,965334             | 1,913552           |

We can see that current account and deposits in foreign currency give a positive contribution to the amount of money circulated even though its contribution is not significant. On the other hand, GDP based on constant price gives a significant contribution to the amount of money circulated.

4.5. Autocorrelation Test

To ensure that estimation and data used before are free from Autocorrelation and any classic assumption problem, we have done Autocorrelation test. Method used is Durbin-Watson (D-W). It assumes first order autoregressive AR (1). Hypothesis for this test are:

- H0: ρ = 0 and H1: ρ > 0, it means if d < du, H0 is declined on level α, so statistically there is a significant positive autocorrelation
- H0: ρ = 0 and H1: ρ < 0, it means if (4 – d) < du, H0 is declined on level α, so statistically there is a significant negative autocorrelation
• H0: \( \rho = 0 \) and H1: \( \rho \neq 0 \), it means if \( d < du \) or \( (4 - d) < du \), H0 is declined on level \( 2 \alpha \), so statistically there is a significant positive and negative correlation

Table 5. Criteria Autocorrelation Test.

| Null Hypothesis | Estimation Result | Conclusion |
|-----------------|-------------------|------------|
| \( H_0 \)       | 0 < \( dw < dl \) | Declined   |
| \( H_0 \)       | \( dl \leq dw \leq du \) | No conclusion |
| \( H_1 \)       | \( 4 - dl < dw < 4 \) | Declined |
| \( H_1 \)       | \( 4 - du \leq dw \leq 4 - dl \) | No conclusion |
| No positive nor negative autocorrelation | \( du < dw < 4 - du \) | Accepted |

Source: Basic Econometrics, Damodar N. Gujarati (2003)

Results from running Eviews are shown on Table 7.

Table 6. Durbin-Watson Test for \( \alpha = 5\% \).

| Simulation | D-W Stat | Observation (n) | Independent Variable (k) | \( dl^* \) | \( u^* \) | dl | du |
|-----------|----------|-----------------|--------------------------|------------|----------|----|----|
| 1.883273  | 1.12698  | 81282           |                          | 87302      | 18718    |
| 1.724453  | 1.25756  | 65110           |                          | 74244      | 34890    |
| 1.965334  | 1.19272  | 72978           |                          | 80728      | 27022    |

Source: www.stanford.edu

Table 7. Conclusion from Durbin-Watson Autocorrelation Test.

From Table 6 and 7, we can see that D-W statistics on all three simulations is within area \( du < dw < 4 - du \), which means that there is no autocorrelation.

In addition, VAR test shows that impulse response from demand deposit in foreign currency to shocks of this regulation went through an increase from the first to third quarter since the policy implementation. However, moving forward, there is a new balance.
5. Conclusion and recommendation

5.1. Conclusion

Based on statistical simulation, we know that there is a positive contribution from requiring the use of Rupiah in Indonesia to Rupiah’s stability, which is illustrated from:

- A decrease in the use of foreign currency in domestic transactions between residents
- An increase in the amount of rupiah in circulation. Even though, this increase is also caused by increase in CPI and GDP
- An increase in kartal money, demand deposit in rupiah and foreign currency, and savings in rupiah.

It decreases volatility of Rupiah which results in positive contribution to Rupiah’s stability.

5.2. Recommendation

Further research has to be done to get a more in-depth analysis of the impact of mandatory use of Rupiah in Indonesia since data series used in this paper is limited, especially the period after the implementation (only 6 months). Using a wider range of data, for example one until two years after implementation will inform more significant data and information will be more beneficial, especially for testing second round effect financial instrument attached.

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