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Interest Rates, Exchange Rates, Inflation, and Banking Stock Index Dynamics in Indonesia: Evidence from an Autoregressive Time-Series Model

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ABSTRACT

This study examines the effects of interest rates, exchange rates, and inflation on Indonesia's banking stock index using monthly time-series data from January 2020 to December 2024. The analysis employs a multiple regression model augmented with an AR (1) term to address autocorrelation and capture dynamic persistence in stock index movements. The empirical results show that interest rates exert a positive and statistically significant effect on the banking stock index, suggesting that higher policy rates may improve investor expectations of banking profitability through wider net interest margins. In contrast, exchange rates and inflation do not have statistically significant effects during the observation period, indicating that the Indonesian banking sector is relatively resilient to short-run fluctuations in external prices and domestic inflation. The AR (1) coefficient is positive and significant, confirming that the current banking stock index is partly explained by its own past value and revealing a momentum pattern in banking stock movements. These findings imply that banking stock performance in Indonesia is shaped not only by macroeconomic fundamentals, but also by time-dependent market dynamics. This study contributes to the literature by showing the sector-specific transmission of monetary variables to banking stocks and by demonstrating the usefulness of an autoregressive specification for improving model reliability and interpretation in emerging capital market studies.

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1. INTRODUCTION

The capital market plays a pivotal role in mobilizing savings and channeling funds into productive sectors, while stock indices function as key indicators of market expectations and sectoral performance. Within this framework, the banking stock index deserves particular attention because the banking industry occupies a central position in financial intermediation and is highly sensitive to monetary and macroeconomic developments. As a result, fluctuations in banking stock prices are not only relevant for investors, but also informative for understanding how macroeconomic signals are transmitted into financial markets.

Recent literature confirms that the relationship between macroeconomic variables and bank-related stock performance remains an important but unresolved issue. Joseph et al. (2024) show that interest rates, exchange rates, inflation, and other macroeconomic indicators are among the most frequently examined determinants of bank stock returns, yet the reported effects remain far from uniform across countries, sectors, and estimation methods. Joseph et al. (2025) find that macroeconomic factors significantly affect bank stock returns in India, while Çiçek and Yıldırım (2024) show that banking-sector returns in Türkiye are sensitive to interest-rate and exchange-rate risks, although the magnitude and transmission differ across ownership structures. These studies indicate that macro-financial linkages are real, but highly context-dependent.

The empirical evidence is also mixed when the focus shifts from broad market indices to sectoral or bank-related equities. Chiang and Chen (2023) report that inflation risk has a negative relationship with stock returns in both aggregate and sectoral markets, indicating that inflation-related uncertainty can weaken equity performance. Humpe et al. (2025) show that the macroeconomic determinants of stock markets differ systematically across economic structures, reinforcing the argument that stock-price responses are context-dependent and may vary substantially between developed and emerging markets. At the same time, studies centered on banks often do not produce identical conclusions regarding the direction or significance of interest-rate and exchange-rate effects, implying that banking stocks may react differently from the broader market and from one national setting to another.

A related stream of literature emphasizes that stock-market responses to monetary variables are dynamic and heterogeneous. Rosa (2025) shows that both conventional and unconventional monetary-policy surprises have statistically significant effects on stock prices, but that the magnitude of the reaction differs across market segments. Arin et al. (2025) similarly find that stock-price responses to monetary-policy shocks vary systematically across firms, implying that aggregate conclusions may conceal important heterogeneity. Schrank (2024) further demonstrates that the influence of monetary policy on financial markets becomes stronger during crisis periods, while Juhro et al. (2021) show that in ASEAN-5 countries, including Indonesia, monetary-policy variables and stock prices can exhibit interdependence. In the Indonesian setting, Suriani et al. (2024) also document that macroeconomic fluctuations affect sectoral stock-market movements differently before and during the COVID-19 period. Taken together, these findings indicate that the effect of macroeconomic variables on stock prices is not only sector-specific but also time-dependent.

Despite this growing body of work, three research gaps remain. First, much of the recent literature examines either aggregate stock indices, firm-level stock returns, or cross-country evidence, whereas relatively limited attention has been given to the banking stock index as a sector-level indicator in Indonesia. Second, previous studies still report inconsistent findings on whether interest rates, exchange rates, and inflation significantly influence stock performance, especially in emerging markets. Third, many studies rely on static regression, event-study, GARCH, or SVAR frameworks, while fewer studies investigate whether the Indonesian banking stock index exhibits dynamic persistence that should be modeled explicitly through an autoregressive specification. This matters because banking stock prices may respond not only to current macroeconomic conditions, but also to their own historical movements, reflecting momentum or gradual information adjustment.

Accordingly, this study examines the effects of interest rates, exchange rates, and inflation on Indonesia's banking stock index by employing a time-series model augmented with an autoregressive term. The study contributes to the literature in two ways. Substantively, it provides sector-specific evidence from an important emerging market where monetary conditions, exchange-rate stability, and inflation management remain central to financial-market performance. Methodologically, it incorporates an autoregressive structure to capture persistence in banking stock-index movements, thereby offering a more reliable representation of the dynamic behavior of sectoral stock prices. Based on this framework, the study aims to analyze whether exchange rates, interest rates, and inflation significantly affect the Indonesian banking stock index and whether past index values continue to influence current movements.

2. MATERIALS AND METHODS

2.1. Research Design

This study employs a quantitative explanatory design to examine the effects of selected macroeconomic variables on Indonesia's banking stock index. The explanatory approach is appropriate because the study seeks to estimate the direction and significance of the relationships between macroeconomic indicators and stock-index movements. Since the analysis is based on monthly observations arranged sequentially over time, the study adopts a time-series framework, which is suitable for identifying both contemporaneous relationships and dynamic persistence in financial variables (Shrestha & Bhatta, 2018; Wooldridge, 2025).

2.2. Data and Sources

This study uses secondary monthly data collected from official and publicly accessible sources for the period January 2020 to December 2024. The dependent variable is the Indonesian banking stock index, obtained from Indonesia Stock Exchange sectoral index data and related market-data publications (Indonesia Stock Exchange, 2025). The independent variables consist of the IDR/USD exchange rate, the policy interest rate, and inflation. The exchange-rate variable is represented by JISDOR, which is published by Bank Indonesia as a representative reference rate for USD/IDR spot transactions in the domestic interbank foreign exchange market (Bank Indonesia, 2025a). The interest-rate variable is represented by the Bank Indonesia policy rate; although the current official terminology is BI-Rate, Bank Indonesia explicitly states that it is the continuation of the BI 7-Day Reverse Repo Rate operational framework (Bank Indonesia, 2025b). Inflation is measured using the year-on-year consumer price index published by BPS-Statistics Indonesia (2025).

2.3. Variable Definition

The dependent variable in this study is the Banking Stock Index (BSI), which reflects the monthly performance of listed banking-sector shares in Indonesia and serves as a sectoral proxy for investor valuation in the banking industry (Indonesia Stock Exchange, 2025). The first independent variable is the exchange rate (EXC), measured by the monthly JISDOR value of IDR against USD (Bank Indonesia, 2025a). The second independent variable is the interest rate (RATE), represented by the Bank Indonesia policy rate or BI-Rate as the benchmark monetary-policy rate (Bank Indonesia, 2025b). The third independent variable is inflation

(INF), measured as monthly year-on-year inflation based on the CPI published by BPS-Statistics Indonesia (2025). In addition, the model includes a one-period lag of the dependent variable, denoted as BSI_{t-1}, to capture autoregressive persistence, which is common in time-series behavior where present values may depend partly on past realizations (Shrestha & Bhatta, 2018; Wooldridge, 2025).

2.4. Model Specification

To estimate the relationship between macroeconomic variables and the banking stock index, this study applies a multiple linear regression model augmented with an autoregressive term. The specification is formulated as follows:

$$BSI_t = \alpha + \beta_1 EXC_t + \beta_2 RATE_t + \beta_3 INF_t + \varphi BSI_{t-1} + \varepsilon_t$$

where BSI_t is the banking stock index in month t, EXC_t is the exchange rate, $RATE_t$ is the policy interest rate, INF_t is inflation, BSI_{t-1} is the one-period lag of the banking stock index, α is the intercept, β_1, β_2, and β_3 are slope coefficients, φ is the autoregressive coefficient, and ε_t is the error term. This specification is appropriate for monthly macro-financial data because time-series observations may contain serial dependence, and the autoregressive component helps capture persistence in the dependent variable (Shrestha & Bhatta, 2018; Wooldridge, 2025).

2.5. Stationarity Test

Prior to model estimation, the stationarity of each time-series variable was examined using the Phillips–Perron (PP) unit root test. This test was used to detect the presence of unit roots and to reduce the risk of spurious regression in the subsequent time-series estimation (Phillips & Perron, 1988). Variables that were found to be non-stationary at level were further tested in their first-differenced form until stationarity was achieved. The null hypothesis of the PP test states that the series contains a unit root, while stationarity is concluded when the null hypothesis can be rejected at the 5 percent significance level.

2.6. Estimation Procedure

The empirical analysis is conducted using EViews. The estimation begins with descriptive statistics, followed by Ordinary Least Squares regression to evaluate the direct effects of exchange rates, interest rates, and inflation on the banking stock index. Regression diagnostics are then used to assess the adequacy of the model, including normality, multicollinearity, heteroscedasticity, and autocorrelation checks. Because time-series regressions are vulnerable to serial-correlation problems, the model is re-estimated with an AR (1) term when autocorrelation is detected, so that coefficient estimates become more reliable and the model better reflects the dynamic structure of the data (Wooldridge, 2025; Shrestha & Bhatta, 2018). Hypothesis testing is conducted using the t-test for partial effects, the F-test for joint significance, and the coefficient of determination (R^2) to evaluate explanatory power.

2.7. Hypotheses

Based on the theoretical framework and prior empirical findings, the study tests the following hypotheses:

H1: Exchange rates significantly affect the banking stock index in Indonesia.

H2: Interest rates significantly affect the banking stock index in Indonesia.

H3: Inflation significantly affects the banking stock index in Indonesia.

3. RESULTS

3.1. Descriptive Statistics

Figure 1 presents the movement of Indonesia's banking stock index during the observation period from January 2020 to December 2024. Over this period, the banking stock index showed substantial variation, reflecting changing market expectations and sectoral performance. Table 1 reports the descriptive statistics of all variables used in the analysis. The average exchange rate was 15,002.3 IDR per USD, with values ranging from 13,662 to 16,421. The policy interest rate had a mean of 4.7375 percent, with a minimum of 3.5 percent and a maximum of 6.25 percent. Inflation averaged 2.7582 percent, fluctuating between 1.32 percent and 5.95 percent. Meanwhile, the banking stock index recorded a mean value of 2,346.833, with a minimum of 756 and a maximum of 4,314. The standard deviation of the banking stock index was 882.9644, indicating that the dependent variable exhibited considerable variation over time.

The descriptive statistics suggest that the banking stock index experienced a wider absolute dispersion than the macroeconomic variables, which is consistent with the nature of equity prices as highly responsive financial indicators. In contrast, inflation and the policy interest rate displayed more moderate fluctuations during the sample period. These preliminary statistics indicate that the dataset contains sufficient variation to support time-series estimation.

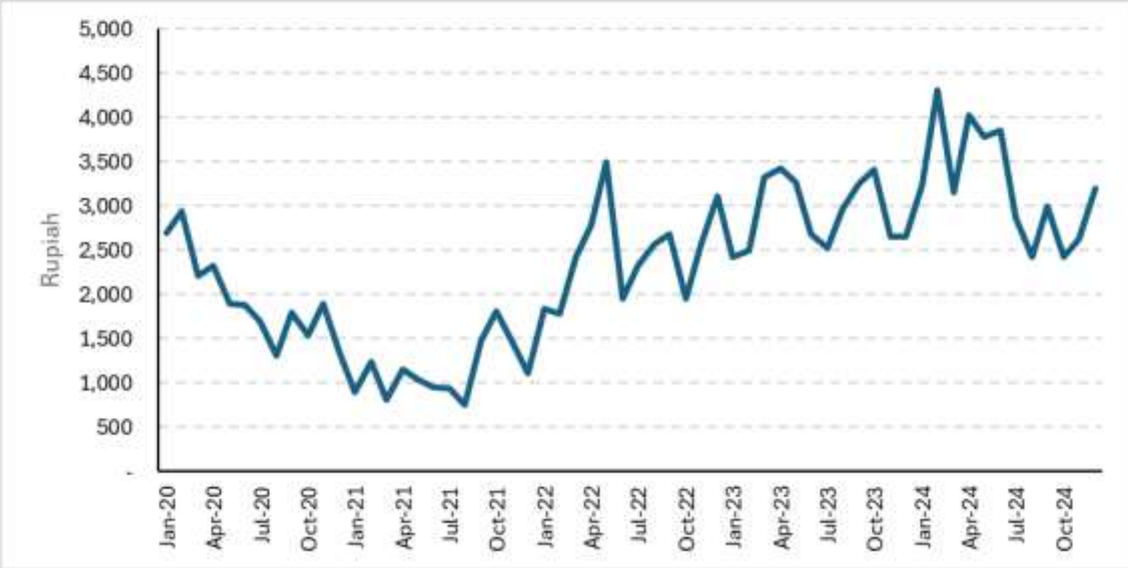

Figure 1. Banking Stock Index, January 2020–December 2024
Source: Indonesia Stock Exchange (processed, 2025)

Table 1. Descriptive Statistics of Research Variables

Numerical Statistic	EXC	RATE	INF	BSI
Mean	15002.3	4.7375	2.758167	2346.833
Maximum	16,421	6.25	5.95	4,314
Minimum	13,662	3.5	1.32	756
Std. Dev.	695.9284	1.103178	1.330747	882.9644

Source: Processed data (2025)

3.1. Stationarity Test Results

Table 2 reports the results of the Phillips–Perron (PP) unit root test. The exchange rate (EXC) is stationary at level, whereas the banking stock index (BSI), interest rate (RATE), and inflation (INF) are non-stationary at level but become stationary after first differencing. Accordingly, EXC is integrated of order zero, or I(0), while BSI, RATE, and INF are integrated of order one, or I(1). These results indicate that all variables are integrated at a maximum order of one and that no variable is classified as I(2), thereby supporting the feasibility of the subsequent dynamic time-series estimation.

Table 2. Phillips–Perron (PP) Unit Root Test Results

Variable	PP Statistic (Level)	p-value	PP Statistic (1st Diff.)	p-value	Order of Integration	Decision
BSI	-2.4719	0.1225	-11.1312	0.0000	I(1)	Non-stationary at level, stationary at first difference
EXC	-2.9289	0.0421	-10.6356	0.0000	I(0)	Stationary at level
RATE	-0.7834	0.8240	-3.7003	0.0041	I(1)	Non-stationary at level, stationary at first difference
INF	-1.5611	0.5031	-7.2508	0.0000	I(1)	Non-stationary at level, stationary at first difference

Note: The null hypothesis of the Phillips–Perron (PP) test is that the series contains a unit root (non-stationary). A variable is considered stationary when the p-value is less than 0.05.
Source: Processed data (2025)

3.3. Model Diagnostics and Specification Adjustment

The initial estimation was conducted using the Ordinary Least Squares approach. However, the diagnostic results revealed an autocorrelation problem, as indicated by a Durbin–Watson statistic of 0.824, which is substantially below the benchmark value of 2.0. This result suggests that the residuals of the initial model were serially correlated, implying that the pure OLS specification was not adequate for the time-series structure of the data. Accordingly, the model was re-specified by incorporating an autoregressive term of order one, AR (1), to account for persistence in the dependent variable and improve estimation reliability.

After the autoregressive term was added, the model quality improved markedly. The final AR (1) specification produced a Durbin–Watson statistic of 2.0010, indicating that the autocorrelation problem had been effectively addressed. The residual diagnostics also showed that the model satisfied the classical assumptions reported in the study: the residuals were normally distributed, no serious multicollinearity was detected, and the Breusch–Pagan test did not indicate heteroscedasticity. These results support the adequacy of the final model for inference.

3.4. Regression Results

Table 3 presents the estimation results of the autoregressive model. Overall, the model is statistically significant, as indicated by an F-statistic of 35.7435 with a probability value of 0.0000. This means that the explanatory variables, taken together, significantly explain variations in the banking stock index. The coefficient of determination (R^2) is 0.7258, indicating that approximately 72.58 percent of the variation in the banking stock index can be explained by the exchange rate, interest rate, inflation, and the lagged dependent variable included in the model.

With respect to the individual coefficients, the exchange rate variable has a coefficient of 0.0887 with a probability value of 0.6309. This result indicates that the exchange rate does not have a statistically significant effect on the banking stock index during the study period. Thus, the first hypothesis is not supported.

The interest rate variable has a positive coefficient of 509.0599 with a probability value of 0.0004. This shows that the policy interest rate has a positive and statistically significant effect on the banking stock index at the 5 percent level. Therefore, the second hypothesis is supported. Among the contemporaneous macroeconomic variables included in the model, the interest rate is the only variable that remains significant in the final specification.

The inflation variable has a coefficient of 156.2234, with a probability value of 0.0661. Although the coefficient is positive, the result is not statistically significant at the conventional 5 percent level. Therefore, the third hypothesis is not supported.

Table 2. Estimation Results of the AR (1) Model

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-1833.8630	2390.0440	-0.7673	0.4462
EXC	0.0887	0.1836	0.4832	0.6309
RATE	509.0599	134.4084	3.7874	0.0004
INF	156.2234	83.2739	1.8760	0.0661
AR(1)	0.4339	0.1302	3.3324	0.0016
R-Squared	0.7258			
F-Statistic	35.7435			
Prob (F-Statistic)	0.0000			
Durbin-Watson stat	2.0010			

Source: Processed data (2025)

A notable result of the final model is the autoregressive term, AR (1), which has a positive coefficient of 0.4339 and a probability value of 0.0016. This finding indicates that the current value of the banking stock index is significantly influenced by its value in the previous period. The significance of the lagged term confirms the presence of dynamic persistence in the banking stock index and supports the use of an autoregressive specification in the estimation model.

3.5. Summary of Empirical Findings

In summary, the empirical results show three main findings. First, the autoregressive specification performs better than the initial OLS model because it resolves the autocorrelation problem and produces a more statistically adequate model. Second, interest rates have a positive and significant effect on the banking stock index. Third, exchange rates and inflation do not show statistically significant effects in the final model, whereas the lagged banking stock index remains significant, indicating persistence in sectoral stock-index movements over time.

4. DISCUSSION

The empirical results indicate that interest rates are the only contemporaneous macroeconomic variable that significantly affect Indonesia's banking stock index in the final AR (1) specification, while exchange rates and inflation do not show statistically significant effects at the conventional 5 percent level. In addition, the significant positive autoregressive coefficient indicates that the banking stock index exhibits persistence over time, meaning that current movements are partly influenced by past values. Taken together, these findings suggest that Indonesia's banking stock index is shaped by a combination of monetary policy sensitivity and dynamic market adjustment rather than by an equally strong response to all macroeconomic indicators.

The positive and significant effect of interest rates is an important finding because, in standard equity valuation theory, higher interest rates are often expected to reduce stock prices through a higher discount rate. However, for banking-sector stocks, the direction of the effect can differ from the broader market because banks may benefit from improved interest margins when policy rates rise. Segev et al. (2024) show a positive relationship between interest rates and banks' net interest margins, particularly when the initial interest-rate environment is low. This interpretation helps explain why, in the Indonesian banking sector, rising policy rates may be viewed by investors not only as a tightening signal, but also as a potential source of stronger banking profitability. In that sense, the present finding is economically plausible and sector-specific rather than anomalous.

This result is broadly consistent with recent literature showing that banking-sector equity performance is often more sensitive to interest-rate developments than to other macroeconomic variables. Joseph et al. (2024) conclude that interest rates are among the most frequently examined and most influential macroeconomic determinants of bank stock returns, although the sign and strength of the relationship vary across settings. Similarly, Çiçek and Yıldırım (2024) find that, in Türkiye, interest-rate policy became the main variable affecting banking-sector stock returns, while the historical relationship between exchange rates and banking stocks weakened over time. Therefore, the present study reinforces the view that interest rates deserve primary attention when explaining banking stock movements, especially in financial systems where bank intermediation remains dominant.

At the same time, the positive sign found in this study differs from a number of studies on broader stock-market indices, where higher interest rates are often associated with weaker stock performance. Purnamasari et al. (2025) report a negative and significant effect of interest rates on the Jakarta Composite Index, while Sia et al. (2025) show that the effect of interest rates on Indonesian stock prices is asymmetric and depends on model specification and adjustment dynamics. This difference is substantively meaningful. It implies that sectoral banking stocks should not be interpreted in the same way as the aggregate market. The banking sector may respond differently because interest-rate increases affect bank revenues, margins, and balance-sheet expectations more directly than they affect non-financial firms.

The exchange-rate variable is positive but statistically insignificant in the final model. This suggests that rupiah fluctuations against the US dollar did not exert an independent and robust short-run influence on the Indonesian banking stock index during the observation period. One possible explanation is that the listed banking sector may have been relatively protected from direct exchange-rate exposure during the sample period, especially when compared with export-oriented or import-intensive sectors. This result supports the argument that exchange-rate transmission to stock prices is sector-dependent. Suriani et al. (2024), for example, show that the linkage between exchange-rate movements and Indonesian sectoral stock markets varies across sectors and across pre- and during-pandemic periods. The finding is also not inconsistent with Purnamasari et al. (2025), who report that the exchange rate has a positive but insignificant effect on the broader Indonesian stock index in one linear time-series setting.

However, the present exchange-rate result differs from studies that find stronger exchange-rate sensitivity in banking stocks outside Indonesia. Çiçek and Yıldırım (2024) document that exchange-rate movements remain relevant for Turkish bank returns, although their role changes depending on ownership structure and market conditions. This contrast strengthens the sector-and-country specificity argument that underlies the research gap of this article. In other words, the effect of exchange rates on banking stocks cannot be generalized uniformly across markets, and Indonesia's banking stock index appears less directly exposed to short-run exchange-rate shocks than banking equities in some other emerging economies.

Inflation also does not reach statistical significance at the 5 percent level, although its coefficient is positive and marginal. This result indicates that, during the study period, inflation did not independently drive banking stock index movements once interest rates and lagged index values were taken into account. One interpretation is that the effect of inflation may already be partially embedded in monetary-policy adjustments, thereby making its separate impact less visible in the final specification. Another possibility is that moderate inflation may not necessarily be interpreted negatively by investors when the banking sector is still able to preserve margins and maintain intermediation performance. This outcome is compatible with the broader literature showing that inflation effects on stock prices are often unstable, non-linear, or conditional on model choice. Joseph et al. (2024) highlight that inflation is frequently studied but does not generate uniformly signed results across bank-stock research. Likewise, Sia et al. (2025) find that inflation and interest-rate effects on Indonesian stock prices are asymmetric, implying that linear models may not always detect a simple one-direction effect.

Another important contribution of this study lies in the significance of the AR(1) term. The positive and significant lagged dependent variable indicates that banking stock-index movements are not determined solely by current macroeconomic conditions, but also by their own prior trajectory. This suggests a degree of persistence, momentum, or gradual information adjustment in the Indonesian banking stock index. Empirically, this is important because the original OLS model suffered from serial correlation, and the inclusion of AR(1) materially improved the model's adequacy, including the Durbin–Watson statistic. The significance of this term also supports the methodological argument advanced in this study: a static contemporaneous regression alone is insufficient to explain banking stock-index movements, because sectoral equity prices evolve dynamically over time.

From a broader theoretical perspective, the results support the view that stock-market responses to macroeconomic and monetary variables are heterogeneous across sectors and institutional settings. Rosa (2025) shows that monetary-policy surprises have economically significant effects on stock prices, while Arin et al. (2025) demonstrate that stock-price responses to monetary policy vary across firms and market characteristics. In the Indonesian context, this article extends that idea by showing that even within the stock market, the banking sector displays a distinct sensitivity pattern: interest rates matter, but exchange rates and inflation do not appear as strong standalone short-run drivers once persistence is accounted for. This is where the present study contributes to the literature. Rather than treating the Indonesian stock market as a homogeneous aggregate, it highlights the importance of sector-specific and dynamic modeling in understanding macro-financial transmission.

Overall, the discussion confirms the three research-gap arguments formulated in the introduction. First, the findings provide evidence specifically for the Indonesian banking stock index, not merely for the aggregate market. Second, they help explain why previous studies produced mixed results: the effect of macroeconomic variables depends on sectoral structure, country context, and estimation strategy. Third, the significance of the autoregressive component demonstrates that dynamic persistence is not a secondary technical issue, but a substantive feature of banking stock-index behavior. For that reason, the present study not only adds empirical evidence from an emerging market, but also shows that the relationship between macroeconomic variables and banking stocks should be interpreted through a dynamic sectoral lens rather than through a purely static market-wide framework.

5. CONCLUSION

This study concludes that, among the macroeconomic variables examined, only interest rates have a positive and statistically significant effect on Indonesia's banking stock index, while exchange rates and inflation do not show significant effects during the observation period. These findings indicate that the performance of banking stocks in Indonesia is more sensitive to monetary-policy signals, particularly policy-rate movements, than to short-run fluctuations in exchange rates and inflation. In addition, the significant AR (1) coefficient confirms that the banking stock index exhibits dynamic persistence, meaning that current index movements are partly influenced by their past values. This suggests that Indonesia's banking stock index is driven not only by contemporaneous macroeconomic fundamentals but also by historical market dynamics and investor behavior. Overall, the study contributes to the literature by showing that the transmission of macroeconomic variables to stock performance is sector-specific and that a dynamic autoregressive specification is more appropriate than a purely static regression model for explaining movements in the banking stock index.

Based on these findings, several recommendations can be proposed. For investors, interest-rate movements should be treated as a primary indicator in formulating investment strategies in banking stocks, while past index trends should also be considered when assessing short-term market direction. For regulators and capital-market authorities, the significance of the autoregressive component implies that market movements may also be influenced by trend-following behavior; therefore, improving market transparency, disclosure quality, and investor education remains essential to reduce excessive speculative behavior. For banking management, rising interest-rate periods may create opportunities to strengthen earnings performance, but such opportunities should be managed carefully in relation to asset quality, credit risk, and financial-system stability. For future research, the analysis can be extended by incorporating bank-specific variables such as non-performing loans, return on assets, return on equity, and capital adequacy, as well as external variables such as global oil prices, the Federal Funds Rate, or broader financial-market volatility. Future studies may also employ alternative dynamic approaches, such as VAR, VECM, ARDL, or GARCH, in order to obtain a more comprehensive understanding of the interaction between macroeconomic conditions and banking stock performance in Indonesia.

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