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The Stock Market as a Central Hub of Macroeconomic Dynamics: Multivariate VAR Evidence on the Relationship between the Current Account and Indonesia's Composite Stock Index (1990–2024)

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Abstract: This study examines how the stock market transmits global financial shocks to Indonesia's current account. Using a multivariate VAR model with quarterly data (1990–2024), the analysis includes domestic variables current account, inflation, and interest rates—alongside global indicators (DJIA and WTI). Empirical results show that the lagged Indonesia Composite Stock Price Index (IHSG) is statistically significant in the current account equation. Granger causality tests indicate unidirectional causality from IHSG to the current account without reverse feedback. Impulse response analysis reveals immediate but transitory adjustments following stock market shocks. Forecast Error Variance Decomposition results indicate that IHSG explains approximately 5.4% of the medium-term forecast error variance of the current account, exceeding the contribution of other domestic macroeconomic variables. These findings provide quantitative evidence that IHSG operates as a central transmission channel within Indonesia's macro-financial system.

Keywords: Current Account, IHSG, Vector Autoregression, Open Economy

INTRODUCTION

Indonesia is an increasingly integrated open economy. Global economic fluctuations are rapidly transmitted to domestic macroeconomic performance through multiple channels, particularly international trade and cross-border capital flows. Portfolio investment flows—especially in government bonds and equities—play a dominant role in shaping financial market dynamics in emerging economies such as Indonesia. Shifts in global investor sentiment often trigger large-scale capital reallocation between developed and emerging markets, amplifying volatility in domestic financial markets and external sector balances.

In this context, the stock market serves not only as a barometer of economic expectations but also as a critical transmission mechanism through which global shocks affect domestic economic activity. Within the asset price channel framework, movements in stock prices influence consumption and investment decisions through wealth effects, which subsequently affect external transactions such as imports and exports. Rising stock prices tend to stimulate

domestic demand and imports, potentially widening current account deficits, whereas declining equity prices may suppress consumption and investment, reducing import demand.

The relationship between stock markets and macroeconomic variables has been widely examined in the literature. Several studies document bidirectional linkages between equity markets and current account dynamics (Yan et al., 2016; Jung & Kim, 2018). Other research emphasizes the role of capital flows and asset price movements in shaping external balance adjustments (Fratzscher, 2009; Kim & Yang, 2011). More recent studies highlight how global financial cycles transmit into emerging markets through asset price channels and portfolio reallocations (Bekaert et al., 2024).

The current account, as a core component of the balance of payments, reflects a country's net transactions in goods, services, and primary income with the rest of the world. Persistent imbalances in the current account often signal underlying structural vulnerabilities and may heighten exposure to external shocks. In emerging markets, these vulnerabilities are further amplified by the dominance of foreign investors in domestic capital markets. In Indonesia, foreign ownership in the stock market has historically remained substantial, making equity prices particularly sensitive to global financial conditions. Episodes of global uncertainty or domestic political instability often prompt rapid capital outflows, leading to sharp stock market corrections and adverse effects on the current account position.

Empirical evidence increasingly suggests that stock markets do not merely respond passively to macroeconomic fundamentals but actively shape external balances through capital flow dynamics, exchange rate movements, and investor expectations. Global financial indicators, such as major international stock indices and commodity prices, play a significant role in influencing both domestic stock markets and external sector performance. This highlights the need for an analytical framework that integrates domestic and global variables in a unified system.

Despite the growing body of literature on the relationship between stock markets and macroeconomic variables, most existing studies analyze the interaction between the current account and stock markets using partial or bivariate approaches. Such frameworks often fail to capture the complex feedback mechanisms and indirect transmission channels operating within an open-economy macroeconomic system. Moreover, the role of the stock market as a central node that connects domestic macroeconomic conditions with global financial dynamics remains underexplored, particularly in the context of emerging economies.

This study addresses these gaps by positioning Indonesia's Composite Stock Price Index (IHSG) as a central hub within a multivariate macroeconomic system. By employing a Vector Autoregression (VAR) framework with quarterly data from 1990 to 2024, the analysis simultaneously incorporates domestic macroeconomic variables—current account balance, inflation, exchange rate, and interest rates—alongside key global indicators, namely the Dow Jones Industrial Average (DJIA) and West Texas Intermediate (WTI) crude oil prices. This approach allows for a comprehensive assessment of dynamic interactions, causal relationships, and shock transmission mechanisms.

The contribution of this study is threefold. First, it offers a long-run multivariate analysis that captures both domestic and global determinants of Indonesia's current account dynamics. Second, it explicitly conceptualizes the stock market as a central transmission hub linking global financial conditions to external sector performance. Third, it provides policy-relevant insights into Indonesia's vulnerability as a small open economy, highlighting the importance of coordinated macroeconomic and financial market policies in mitigating external shocks.

Unlike prior studies that examine macro-financial linkages in partial settings, this study offers an integrated multivariate framework that positions the stock market as a structural transmission hub within Indonesia's open-economy system.

METHOD

Model Specification

This study employs a quantitative time-series approach using a **Vector Autoregression (VAR)** framework to examine the dynamic interactions among macroeconomic variables and the stock market in Indonesia. The VAR model is particularly suitable for this analysis as it treats all variables as endogenous and allows for feedback effects, thereby capturing both simultaneous and dynamic relationships within an open-economy macroeconomic system.
The baseline VAR model can be expressed as:

$$\mathbf{Z}_t = \mathbf{A}_1\mathbf{Z}_{t-1} + \mathbf{A}_2\mathbf{Z}_{t-2} + \cdots + \mathbf{A}_p\mathbf{Z}_{t-p} + \mathbf{B}\mathbf{X}_t + \boldsymbol{\varepsilon}_t$$

where Z_t is a vector of endogenous variables consisting of current account growth (CR), IHSG growth, inflation growth (INF), and interest rate growth (TDRATE); X_t represents exogenous global variables (DJIA and WTI); A_i and B are coefficient matrices; and ε_t denotes a vector of white-noise error terms.
The treatment of DJIA and WTI as exogenous variables is justified under the small open economy framework, where Indonesia does not exert systematic influence on global stock indices or oil prices.

The endogenous variables include the **current account balance (CR)**, **Indonesia Composite Stock Price Index (IHSG)**, **inflation rate (INF)**, and **interest rate (TDRATE)**. To capture global financial and commodity market influences, the **Dow Jones Industrial Average (DJIA)** and **West Texas Intermediate (WTI) crude oil prices** are incorporated as exogenous variables.

Stationarity and Lag Length Selection

Prior to estimating the VAR model, unit root tests are conducted to examine the stationarity properties of all variables. Stationarity is essential to avoid spurious regression results and to ensure valid statistical inference. The results indicate that all variables are transformed into quarterly growth rates to ensure stationarity, allowing the VAR model to be estimated without further differencing.

The optimal lag length is determined using standard information criteria, including the Akaike Information Criterion (AIC) and the Schwarz Information Criterion (SIC). The selected lag structure ensures model stability while preserving sufficient degrees of freedom for estimation.
Residual diagnostic tests indicate no serial correlation and no heteroskedasticity, confirming model adequacy.

Granger Causality Test

To identify the direction of causality among variables, this study applies the **Granger causality test** within the VAR framework. Granger causality does not imply true causation in a philosophical sense; rather, it assesses whether past values of one variable contain statistically significant information that helps predict another variable.

The Granger causality analysis focuses on the relationships between the current account and key domestic and global variables, particularly IHSG, DJIA, and WTI. This test provides insights into whether the stock market and global factors act as leading indicators for external sector dynamics, or whether feedback effects from the current account to financial markets are present.

Impulse Response Function

To further examine the dynamic effects of shocks, **Impulse Response Functions (IRFs)** are generated from the estimated VAR model. IRFs trace the response of the current account and stock market to one-standard-deviation shocks in domestic and global variables over time.

This analysis enables an assessment of the magnitude, direction, and persistence of shocks, as well as the speed at which the system converges back to equilibrium.

Conceptual Framework

The conceptual framework positions global variables (DJIA and WTI) as external shocks influencing domestic financial variables (IHSG), which subsequently transmit into macroeconomic outcomes including the current account.

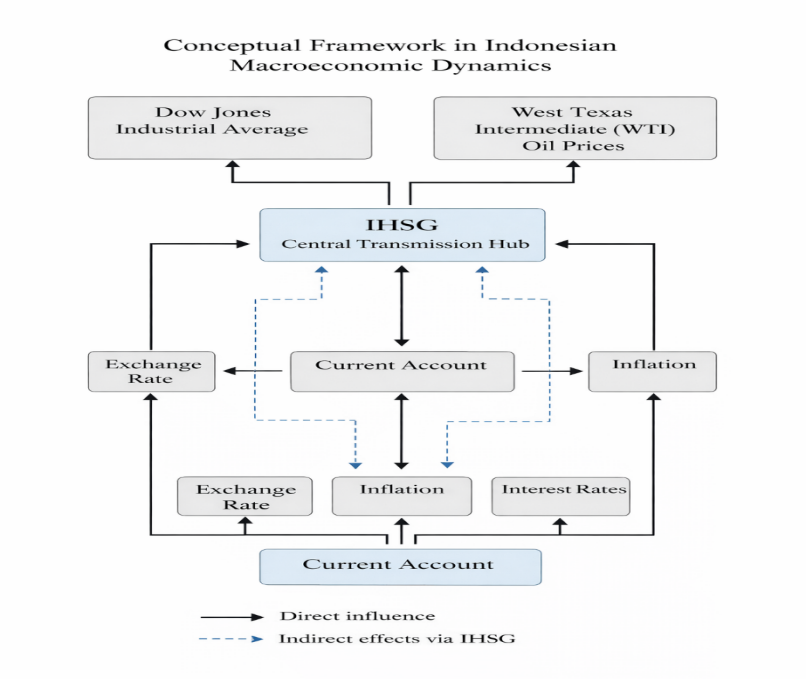

Figure 1 : Research Framework

Data and Variables

This study utilizes quarterly data covering the period from 1990Q1 to 2024Q1, allowing for a comprehensive analysis of long-term macro-financial dynamics in Indonesia. All data are obtained from reliable secondary sources, including Bank Indonesia, Statistics Indonesia (BPS), the World Bank, and Bloomberg Terminal.

Table 1. Definition of Variables and Data Sources

Variable	Description	Source	Frequency	Unit
CR	Current Account Balance	Bank Indonesia	Quarterly	Ratio
IHSG	Indonesia Composite Stock Price Index	Bloomberg	Quarterly	Index
INF	Inflation Rate	Bank Indonesia	Quarterly	Percent
TDRATE	Treasury/Policy Interest Rate	Bank Indonesia	Quarterly	Percent
DJIA	Dow Jones Industrial Average	Bloomberg	Quarterly	Index
WTI	Crude Oil Price (WTI)	Bloomberg	Quarterly	USD/barrel

RESULTS AND DISCUSSION

Empirical VAR Estimation Results

The Vector Autoregression (VAR) model was estimated using one optimal lag selected based on the Akaike Information Criterion (AIC) and Schwarz Criterion (SC). The stability test confirms that all characteristic roots lie within the unit circle, indicating that the system satisfies the stability condition and that the estimated dynamics are economically meaningful.

The estimated VAR coefficients reveal a structured macro-financial interaction pattern, particularly in the current account (CR) equation.

The lagged value of IHSG exhibits a positive and statistically significant coefficient in the CA equation (t = 2.28), indicating that improvements in domestic stock market performance tend to be followed by improvements in the current account balance. This suggests that equity markets affect the external sector through capital flows, exchange rates, and confidence effects. The finding supports the asset price transmission channel, where financial market conditions affect real economic outcomes.

In contrast, the lagged CR term is not statistically significant, implying limited persistence in current account dynamics within the VAR framework. This suggests that Indonesia's external balance adjusts relatively quickly to shocks rather than exhibiting prolonged inertia.

The DJIA coefficient in the CR equation is positive, though not statistically significant at conventional levels. Nonetheless, its role becomes more evident in the causality and impulse response analyses, indicating that global financial conditions affect Indonesia primarily through dynamic channels rather than direct static effects.

The WTI coefficient is positive, reflecting that increases in oil prices may temporarily improve the current account, potentially through export price effects. However, the magnitude of this effect remains limited, consistent with Indonesia's dual role as both commodity exporter and energy importer.

Dynamics of the Stock Market (IHSG)

The IHSG equation provides further insight into the stock market's central role.

First, IHSG(-1) is positive and statistically significant, indicating strong persistence in stock market movements. This autoregressive behavior reflects the tendency of financial markets to incorporate information gradually over time.

Second, DJIA(-1) exerts a positive and significant influence on IHSG, confirming strong financial integration between Indonesia and global markets. This result aligns with international spillover literature and supports the hypothesis that Indonesia's equity market is highly sensitive to global investor sentiment.

Third, inflation and interest rates negatively affect IHSG, suggesting that macroeconomic tightening dampens stock market performance. This finding is consistent with standard monetary transmission theory, where higher interest rates reduce equity valuations through discount rate effects.

Collectively, these results confirm that IHSG is not an isolated financial variable but a key node within a broader macroeconomic network

Table 2 presents the estimated VAR coefficients for all endogenous variables.

Table 2. Empirical VAR Estimation Results

Variable	CR Equation	IHSG Equation	TDRATE Equation
CR(-1)	-0.076	-0.009	0.0026
DJIA(-1)	2.997	0.256**	-0.135
INF(-1)	2.721	-0.547*	0.414
IHSG(-1)	2.895**	0.250**	-0.256***
TDRATE(-1)	1.350	-0.034	0.473***
WTI(-1)	0.933	-0.155	0.145**

Notes:

*, **, *** indicate significance at 10%, 5%, and 1% levels.

The estimated CR equation reveals several important results:

1. The coefficient of **IHSG(-1)** is positive and statistically significant (t = 2.28), indicating that improvements in stock market performance contribute positively to the current account in the subsequent period.
2. The coefficient of **DJIA(-1)** is positive but not statistically significant at conventional levels.
3. The coefficient of **WTI(-1)** is positive, suggesting that increases in oil prices may temporarily improve the current account, although the effect is limited.
4. The lagged CA term is not statistically significant, suggesting limited persistence in the current account dynamics.

These results confirm that financial market variables—particularly IHSG—play a meaningful role in shaping Indonesia's external balance.

Granger Causality Analysis

The Granger causality test results reveal a structured and asymmetric pattern of dynamic interactions among macroeconomic variables, confirming the dominant role of global and domestic financial factors in shaping Indonesia's external balance.

The findings indicate that the Dow Jones Industrial Average (DJIA), Indonesia Composite Stock Price Index (IHSG), and West Texas Intermediate (WTI) oil prices Granger-cause the current account balance, while no reverse causality is detected. This result suggests that Indonesia's current account is primarily responsive to external and financial market developments, rather than acting as a driving force influencing global or domestic asset prices.

The absence of feedback from the current account to DJIA and WTI reinforces Indonesia's position as a small open economy, where global financial and commodity market conditions are largely exogenous. In contrast, the strong causal influence of IHSG on the current account highlights the pivotal role of the domestic stock market as an internal transmission channel linking global shocks to external sector performance.

Interestingly, the causality structure also shows that IHSG Granger-causes the domestic interest rate (TDRATE) and WTI, indicating that stock market dynamics contain forward-looking information relevant for both monetary conditions and commodity-related expectations. This supports the notion that equity markets aggregate information on future economic prospects more rapidly than traditional macroeconomic indicators.

Overall, the Granger causality results provide empirical evidence that the stock market occupies a central position within Indonesia's macroeconomic system, influencing not only the current account but also other key policy-relevant variables.

Impulse Response Analysis

Impulse Response Function (IRF) analysis is employed to examine the dynamic effects of shocks originating from domestic and global financial variables on Indonesia's current account. This approach allows for an assessment of the direction, magnitude, and persistence of shocks, as well as the speed at which the system converges back to its long-run equilibrium. Overall, the results indicate that shocks to both domestic and global variables generate temporary responses that gradually dissipate over time, suggesting a stable macroeconomic system despite exposure to external disturbances.

Response of the Current Account (CA) to Composite Stock Price Index (IHSG)

Figure 2 illustrates the response of Indonesia's current account to a one-standard-deviation shock in the Composite Stock Price Index (IHSG). The current account exhibits an immediate positive response in the first quarter, indicating that improvements in domestic stock market performance are associated with short-run enhancements in external sector conditions. The response remains fluctuating over subsequent quarters before gradually converging toward equilibrium. This pattern suggests that stock market-driven shocks affect the current account

only temporarily and do not generate persistent structural changes. The convergence behavior reflects the presence of adjustment mechanisms within the macroeconomic system and supports the interpretation of the stock market as a key transmission channel linking financial market developments to external sector performance

Response to Cholesky One S.D. (d.f. adjusted) Innovations ± 2 S.E.

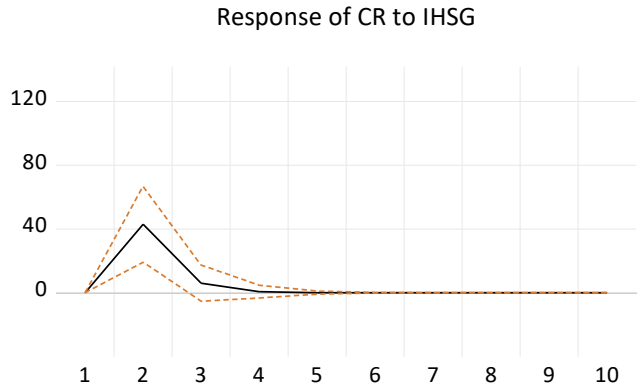

Figure 2. Impulse Response of Current Account (CR) to IHSG Shock
Source: Author's estimation

Response of the Current Account (CR) to Dow Jones Industrial Average (DJIA)

Figure 3 Presents the impulse response of the current account to a one-standard-deviation shock in the Dow Jones Industrial Average (DJIA). The results show a positive response in the initial period, reflecting the influence of improved global financial conditions and increased investor risk appetite on Indonesia's external balance. However, the effect diminishes over time and gradually converges back to equilibrium, indicating that global financial shocks exert only transitory effects on the current account. This finding reinforces Indonesia's characterization as a small open economy, in which external sector dynamics are highly sensitive to global financial conditions but do not lead to long-lasting deviations from equilibrium.

Response to Cholesky One S.D. (d.f. adjusted) Innovations ± 2 S.E.

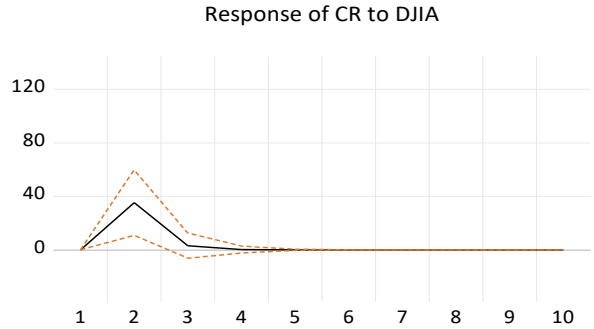

Figure 3. Impulse Response of Current Account (CR) to DJIA Shock
Source: Author's estimation

Response of the Current Account to WTI Oil Price Shock

A similar transitory response is observed following **WTI oil price shocks**. Increases in oil prices initially improve the current account, potentially reflecting higher export revenues from energy-related commodities. However, as Indonesia remains a net energy importer, the positive impact diminishes over time, and the current account returns to its long-run equilibrium. This finding highlights Indonesia's continued vulnerability to commodity price volatility.

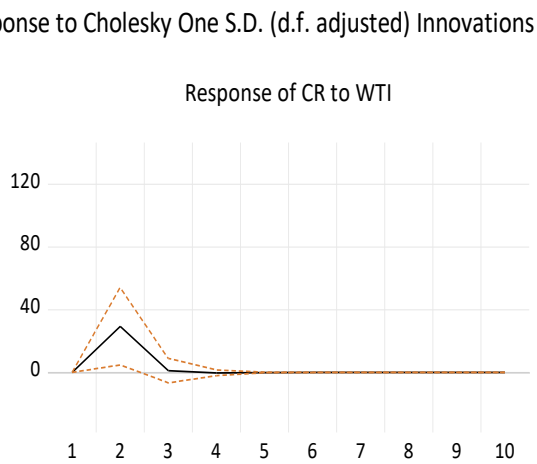

Figure 4. Impulse Response of Current Account (CR) to WTI Oil Price Shock

Shocks to the domestic stock market (IHSG) generate a notable response in the current account, with positive effects in the short run that gradually dissipate. This result confirms that stock market performance plays a critical role in shaping external balances through channels such as capital inflows, exchange rate movements, and import demand. The temporary nature of the response indicates that financial market-driven improvements in the current account are not structurally persistent unless supported by real-sector adjustments.

The impulse response of IHSG to current account shocks also reveals a short-lived positive response, followed by convergence toward equilibrium. This suggests that improvements in external balances may temporarily boost investor confidence, but stock market dynamics remain primarily driven by broader financial and macroeconomic conditions.

Across all impulse response functions, shocks are characterized by temporary but convergent dynamics, indicating a stable macroeconomic system in which disturbances do not generate explosive behavior. This stability reflects the effectiveness of macroeconomic management in absorbing shocks, while simultaneously underscoring the economy's exposure to recurrent external disturbances.

Forecast Error Variance Decomposition (FEVD)

To quantitatively assess transmission strength, FEVD was conducted

Table 3. Forecast Error Variance Decomposition (FEVD) of Current Account Growth (CR) (%)

Horizon	CR	DJIA	IHK	IHSG	TDRATE	WTI
1Q	100.000	0.000	0.000	0.000	0.000	0.000
4Q	86.805	6.426	0.282	**5.422**	0.099	0.966
8Q	86.788	6.427	0.289	**5.426**	0.102	0.968
12Q	86.788	6.427	0.289	**5.426**	0.102	0.968

Source: Author's estimation

Beyond its own innovations, IHSG explains approximately 5.4% of the medium-term forecast error variance of CR, exceeding the contribution of other domestic macroeconomic variables. This provides explicit empirical support for the stock market's role as a key domestic transmission channel.

Discussion: IHSG as a Central Hub in the Macroeconomic System

The empirical findings from Granger causality, impulse response analysis, and FEVD consistently indicate that IHSG operates as a central transmission channel within Indonesia's

macro-financial system. This role is supported not only by statistical significance but also by transmission hierarchy: IHSG exhibits unidirectional causality toward the current account and contributes a larger share of forecast error variance than other domestic macroeconomic variables.

The centrality of IHSG can be explained through several mechanisms. First, stock market movements reflect portfolio capital flows that influence exchange rate dynamics and financial account adjustments, thereby affecting the current account. Second, equity prices aggregate investor expectations and transmit global financial sentiment into domestic macroeconomic adjustments. Third, interactions among asset prices, exchange rates, and trade flows amplify short-run external balance responses.

The relatively rapid dissipation of impulse responses suggests the presence of stabilization mechanisms, including exchange rate flexibility and macroeconomic policy adjustments. While global variables such as DJIA and WTI remain important, IHSG demonstrates stronger domestic transmission capacity compared to inflation and interest rates. This indicates a structural shift in which financial markets increasingly mediate real-sector outcomes in emerging economies.

These findings extend prior macro-financial linkage studies by explicitly identifying transmission hierarchy rather than merely documenting correlations. The stock market emerges not simply as a reactive variable, but as an active node within Indonesia's macroeconomic adjustment process.

CONCLUSION

Conclusion

This study investigates macro-financial transmission in Indonesia using a multivariate VAR model with quarterly growth data. The findings consistently show that the Indonesian stock market (IHSG) functions as a key domestic transmission channel linking global financial shocks to current account dynamics. Evidence from Granger causality, impulse response analysis, and FEVD indicates that stock market shocks exert meaningful short- to medium-term influence on the external balance, exceeding the predictive role of several traditional macroeconomic variables.

These results suggest that macroeconomic stability in small open economies is increasingly mediated through financial market channels. Therefore, macroeconomic surveillance frameworks should incorporate stock market indicators alongside conventional variables such as inflation and policy interest rates to better anticipate external balance pressures.

This study has several methodological limitations. The VAR framework assumes linear dynamics and does not capture nonlinear or regime-switching behavior. Moreover, the use of growth specifications ensures stationarity but focuses on short-run dynamics rather than long-run equilibrium relationships. Future research may employ structural VAR, nonlinear models, or network-based approaches to further examine evolving transmission mechanisms.

Policy Implications

The empirical findings of this study carry several important policy implications for macroeconomic management in Indonesia and other emerging economies.

First, policymakers should incorporate stock market indicators into macroeconomic surveillance and early warning systems. Given the central role of the stock market in transmitting both domestic and global shocks to the current account, monitoring equity market dynamics can provide timely signals of emerging external sector pressures.

Second, macroeconomic policy coordination is essential in an increasingly financially integrated environment. Monetary, fiscal, and external sector policies should be designed in a complementary manner to mitigate the impact of global financial volatility. In particular, policy

responses to stock market fluctuations should consider their potential spillover effects on the current account and exchange rate dynamics.

Third, strengthening economic resilience to external shocks remains a priority. The transitory nature of impulse responses suggests that while shocks dissipate over time, repeated exposure to global financial and commodity market volatility may still pose risks. Structural policies aimed at diversifying the export base, reducing dependence on commodity cycles, and deepening domestic financial markets can enhance long-term stability.

Finally, for investors and market participants, the findings highlight the importance of considering macro-financial linkages in investment and risk management strategies. Understanding the interconnectedness between stock markets, global financial conditions, and external balances can improve portfolio diversification and decision-making in emerging markets.

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