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THE EFFECT OF MONETARY POLICY ON ECONOMIC STABILITY IN INDONESIA: A LITERATURE REVIEW

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Abstract

Monetary policy plays a vital role in ensuring the stability of the economic system in Indonesia, where Bank Indonesia as the monetary authority has the main responsibility in setting interest rates and controlling the amount of money in circulation. The determination of interest rates by Bank Indonesia has a direct impact on consumption and investment activities. A decrease in interest rates generally encourages an increase in consumption and investment, which in turn can boost economic growth. However, interest rates that are too low over a long period of time may increase the risk of excessive inflation and financial system instability, as they may encourage excessive risk-taking by financial institutions and economic actors. Conversely, an overly tight monetary policy, with high interest rates, can hamper economic growth and increase unemployment, as high borrowing costs reduce consumption and investment spending. Firms may experience difficulties in financing operations and expansion, while consumers will be more cautious in their spending and investment. Therefore, it is important for Bank Indonesia to implement a balanced and flexible monetary policy, which is responsive to current economic conditions and various economic indicators. This balance in monetary policy is needed to ensure price stability, sustainable economic growth, and public welfare. Effective regulation and strict enforcement of supervision are also key in avoiding the negative impact of monetary policy that is either too loose or too tight. In conclusion, appropriate

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and measured monetary policy is an important instrument to achieve sustainable and inclusive stability of the Indonesian economic system.
Keywords: Monetary Policy, Economic Stability, Indonesia: Literature Review

Introduction

Monetary policy is one of the important instruments in maintaining the stability of a nation's economic system. Bank Indonesia as a monetary institution in the country has a very vital role in controlling money circulation and interest rates to achieve price balance (inflation), economic growth, and Rupiah exchange rate balance. (Hodson, 2020). By regulating interest rates, central banks such as Bank Indonesia are able to influence the cost of borrowing and saving, which in turn encourages economic growth or prevents excess inflation. This policy helps create a stable economic environment, which is crucial for people's investment and consumption decisions. (Satragno, 2022).

Monetary policy also plays a role in keeping currency exchange rates in balance, which affects international trade. A stable exchange rate makes trade between countries more predictable, supporting exports and imports more effectively. As such, monetary policy not only works as a tool to maintain domestic stability, but also to strengthen trade and financial ties with other countries, ultimately improving overall economic livelihoods. (Akram & Li, 2020). Therefore, in recent decades, monetary policy has taken center stage in an effort to deal with various economic challenges, both domestic and global in nature.

During the Asian economic crisis of 1997-1998, for example, Indonesia experienced tremendous economic turmoil. The Rupiah exchange rate depreciated drastically, inflation soared, and many business sectors collapsed. In this situation, Bank Indonesia had to conduct various monetary interventions to stabilize the economy. Monetary tools such as tightening interest rate policy and controlling money supply became the main weapons in the effort to save the economy. (Simakov & Fedorenko, 2020).

However, monetary policy is not always successful in overcoming economic problems, especially if it is not balanced with effective fiscal policy and conducive global economic conditions. In the early 2000s until now, Indonesia was not spared from a number of economic challenges such as global commodity price fluctuations, the 2008 global financial crisis, and various other economic uncertainties. All of which affect the monetary policy responses that Bank Indonesia must take. (Weiping, 2023).

The low interest rate policy implemented by Bank Indonesia in recent years aims to support economic growth through increased investment and consumption. However, it is also faced with the risk of rising inflation and Rupiah exchange rate instability. In entering the digital age and economic globalization, monetary policy must also be prepared to face new challenges such as the growth of the digital economy, fintech, and the volatility of fast-changing global markets. (Waheed & Rashid, 2021).

One example of monetary policy that has received widespread attention is the setting of the benchmark interest rate (BI Rate). Changes in the benchmark interest rate can affect various aspects of the economy such as investment, consumption, and capital flows. In the literature analysis, the short-term and long-term effects of interest rate changes have been the subject of extensive discussion. Many studies have attempted to measure how effective changes in the BI Rate are in influencing broader economic variables (Burdekin & Nguyen, 2023)..

In addition, economic stability is also strongly influenced by the credibility of monetary institutions. The success of monetary policy is often closely related to public and market perceptions of Bank Indonesia's credibility. Uncertainty and lack of trust in the policies undertaken can cause turmoil in the domestic financial markets. (Othmani, 2023).

Thus, cooperation between monetary policy and fiscal policy is an important element in achieving macroeconomic stability. Fiscal policy, which includes budget management and government spending, provides balanced support to the monetary measures taken. Without effective cooperation, monetary policy may not be strong enough to achieve economic stability. (Cheng & Wu, 2024).

Furthermore, dynamics occur not only on the demand side but also on the supply side. For example, tightening monetary policy aimed at controlling inflation often results in a reduction in output and an increase in unemployment. Therefore, monetary policy needs to be designed carefully so as not to cause negative impacts that are greater than expected. (Satragno, 2022).

In the last decade, research in Indonesia has begun to highlight the impact of monetary policy on the banking and financial sector, particularly in the context of risk and liquidity management. Financial stability is a major concern, as the sector is highly vulnerable to changes in interest rates and other monetary policies. (Trehan, 2020); (Novoszáth, 2022).

Because of this, this research aims to examine in depth the various existing studies on the effect of monetary policy on economic stability in Indonesia. By understanding the impact of various policies that have been implemented, it is expected to provide better insight for policymakers in formulating strategic steps to maintain economic stability in the future.

Research Methods

The study conducted in this research uses the literature research method, which is an approach to research that involves collecting and analyzing written sources relevant to the topic being studied. The main purpose of this method is to understand and synthesize the findings of previous research, to identify knowledge gaps, and to build a theoretical basis for further research. (Firman, 2018); (Suyitno, 2021); (Jelahut, 2022).

Results and Discussion

Monetary Policy

Monetary policy is one of the main instruments owned by a country's central bank in managing the domestic economy. Various activities carried out by central banks such as Bank Indonesia such as setting benchmark interest rates, setting mandatory bank reserves, and conducting operations in the open market aim to achieve macroeconomic targets such as maintaining rupiah exchange rate stability, controlling inflation rates, encouraging economic growth, and creating jobs. (Booth & Booth, 2020).

One of the important objectives of monetary policy is to create long-term monetary and financial stability in the country. By controlling the money supply and influencing the price of money in the market, the central bank hopes to keep the rupiah exchange rate stable. This stability is expected to support sustainable economic growth because it can encourage increased levels of investment and public consumption. (Liu, 2023).

The benchmark interest rate set by the central bank is one of the main monetary policy tools at its disposal. When interest rates are raised, the cost of borrowing becomes higher, thus cutting the amount of money in circulation in society. (Faux, 2022). Similarly, when interest rates are lowered, the cost of borrowing becomes cheaper so as to encourage the smooth flow of money. In addition, the regulation of mandatory reserves that banks must keep at Bank Indonesia also affects bank liquidity. Open market operations conducted by BI to buy or sell government securities also have a major effect on the money supply. (Kawamoto et al., 2023)..

Overall, the various monetary policy instruments play an important role for the central bank in regulating the national economy. By controlling monetary factors such as interest rates and money supply, it is expected to achieve various long-term macroeconomic goals such as price stability and sustainable economic growth.

Economic Stability

Economic stability is a condition in which a country's economy experiences sustainable growth without significant fluctuations in inflation, unemployment, and output growth. Economic stability reflects a situation where prices are relatively stable, the unemployment rate is at a low and reasonable level, and economic growth is steady. (Frayyeh et al., 2022).. In a situation of economic stability, both businesses and consumers can plan their finances better, as the risk of economic uncertainty is low. This also forms a conducive environment for long-term investment and development, which in turn helps to create social and economic welfare (Ajello et al., 2022). (Ajello et al., 2022).

Economic stability is pervasive;

First, Inflation is an indicator that measures the general rate of increase in the prices of goods and services in the economy over time. A moderate level of inflation is considered normal in a healthy economy, but inflation that is too high or too low can cause various economic problems. (Serletis & Xu, 2020).. High inflation reduces consumers' purchasing power as prices of goods and services increase faster than incomes. Conversely, too low inflation or deflation can signal weak demand, which also has a negative impact on the economy. The Consumer Price Index (CPI) and Producer Price Index (PPI) are the two main tools used to measure the inflation rate (Lee & Park, 2022). (Lee & Park, 2022).

Second, economic growth is an indicator that shows the increase in the production capacity of an economy over time. It is usually measured by changes in Gross Domestic Product (GDP), which includes the total value of goods and services produced within a country over a given period. Positive economic growth reflects an increase in economic output and widening employment opportunities, which in turn can improve living standards. Steady and sustainable growth is a key objective of economic policy, as it enables countries to improve the overall welfare of society. (Gupta, 2024).

Fifth, the unemployment rate is an important indicator to gauge the condition of the labor market and the economy in general. The number of people without jobs who are actively looking for work can indicate how easy or difficult it is for job seekers to find work. If the unemployment rate is low, it is usually a sign that the economy is in good shape with many job opportunities available. (Markakis, 2020). Conversely, a high unemployment rate tends to indicate structural problems in the job market such as a mismatch between the skills of job seekers and the needs of industry. The unemployment rate also fluctuates in line with the business cycle, increasing during recessions and decreasing when economic growth improves (Boucekkine et al., 2020). (Boucekkine et al., 2021)..

Sixth, financial system stability is essential to maintain public confidence in financial institutions such as banks and capital markets. This stability is reflected in the ability of all components of the financial system such as banks, money markets, and supporting infrastructure to function properly without significant disruption. This includes the ability to manage various risks such as credit, liquidity, and market. With financial system stability, investment and economic growth can be maintained. Central banks and financial services authorities monitor various indicators such as bank leverage, liquidity ratios, and market volatility to ensure the long-term stability of the financial system is maintained. (Dritsaki & Dritsaki, 2022).

Economic stability is one of the important factors for the growth and development of a country. The continuity of economic activity can be maintained if the unemployment rate can be kept at a low level and economic fluctuations can be prevented. Targeted monetary policy is able to withstand economic turmoil, for example through open market operations or interest rate adjustments to deal with recession or overheating. (Schneider, 2021). In addition, the coordination of monetary policy with fiscal policy and financial regulation can strengthen financial system stability, which in turn will support overall economic stability. For example, during the financial crisis, expansionary monetary policy was able to provide the liquidity needed to maintain the stability of the financial mechanism and support economic recovery. (Tuori, 2020).

The Effect of Monetary Policy on Economic Stability

Monetary policy plays a vital role in maintaining economic stability by regulating inflation and maintaining the unemployment rate. Central banks such as Bank Indonesia may implement tight monetary policy by increasing interest rates to lower high inflationary pressures. (Cavallari, 2020). Higher interest rates tend to reduce the money supply, making loans more expensive for consumers and businesses, thus reducing demand for goods and services. As a result, inflationary pressures fade and prices stabilize. On the other hand, when inflation is low and the economy is slowing down, central banks may lower interest rates to encourage investment and consumption, boosting total demand and promoting economic growth. (Cairó & Sim, 2023).

Apart from controlling inflation, monetary policy also affects the unemployment rate and economic output. In times of recession or economic slowdown, loose monetary policy can play an important role to stimulate economic activity. Lower interest rates encourage businesses to invest and expand, which in turn creates new jobs and reduces the unemployment rate. (English, 2022). The availability of cheaper credit also increases the purchasing power of consumers, motivating them to consume more goods and services, thereby increasing income and industrial production. In this way, monetary policy helps to maintain economic stability by ensuring sustainable and stable growth rates (Gomes & Sarkisyan, 2023).

However, monetary policy is not always risk-free and limited. Setting interest rates too low in the long run may trigger economic imbalances, such as asset bubbles or excessive increases in household debt. In addition, an overly lenient monetary policy could potentially pose a risk of high inflation in the future (Purificato & Sapienza, 2022). Therefore, central banks need to adopt a balanced approach, consider various economic indicators, and maintain transparency and good communication with the public and stakeholders. Thus, monetary policy can make a sustainable contribution to economic stability without posing excessive long-term risks.

The effect of monetary policy on inflation

Monetary policy plays a vital role in regulating the inflation rate through a number of instruments such as interest rates, open market operations, and mandatory bank reserves. When inflation soars and becomes a threat to the economy, central interbank institutions often implement tight monetary policy by increasing interest rates. This increase in interest rates makes funding costs more expensive, thereby reducing spending and investment (Hirose et al., 2020). (Hirose et al., 2020). The volume of money in the economy decreases, which in turn helps to dampen demand pressures and stabilize the prices of goods and services. (Iddrisu & Alagidede, 2022).

Conversely, in conditions where inflation is too low or there is a risk of deflation, the interbank central bank may implement expansionary monetary policy to raise inflation to the desired level. (Dierks, 2023). Lowering interest rates is one of the most common ways used to encourage more borrowing and spending. When interest rates are low, the cost of borrowing funds becomes cheaper for both consumers and firms. This increase in credit and consumption boosts aggregate demand in the economy, which then pushes the prices of goods and services up to a more stable and healthy level. (Khattab, 2024).

However, the effect of monetary policy on inflation is not always immediate and may involve a significant time lag. Changes in interest rates, for example, take time to impact investment and consumption decisions in the economy. (Danylyshyn & Bohdan, 2022).. In addition, monetary policy should be synergized with dynamic global and domestic economic conditions to avoid undesirable side effects, such as asset price imbalances or currency exchange rate fluctuations. Hence, central interbank institutions need to take a prudent and data-driven approach to ensure monetary policy achieves its objective of controlling inflation without compromising overall economic stability. (Hossain, 2023).

The effect of monetary policy on economic growth

Monetary policy plays an important role in promoting economic growth by regulating the volume of money supply and borrowing costs. One of the main tools used by central banks is interest rates. By lowering interest rates, central banks can spur increased investment and consumption, as borrowing costs will become cheaper for both companies and individuals. (Sumithra, 2020). Increased investment in the economy can expand production capacity and create new jobs, while increased consumption can increase demand for goods and services which in turn will drive economic growth. (Talahite, 2021).

However, too lenient monetary policy also comes with risks. For example, if interest rates remain low for a long time, this could lead to excessive inflation and create asset price bubbles, such as in the stock or property markets. This could potentially destabilize the economy if asset prices suddenly fall. (Hasui, 2020). Therefore, central banks should consider the balance between promoting economic growth and maintaining price stability. The central bank also needs to conduct continuous monitoring of economic indicators and adjust monetary policy accordingly. (Omodero & Okafor, 2020)..

On the other hand, tight monetary policy can slow down economic growth. When central banks raise interest rates to control inflation, borrowing costs will become more expensive. This can reduce investment and consumption, and slow down economic growth. In addition, tight monetary policy can also reduce liquidity in the economy, which can slow down business activity and increase unemployment. (Morales & Reding, 2021). Therefore, it is important for central banks to implement monetary policy in a prudent and measured manner, in order to promote sustainable economic growth without causing instability.

The effect of monetary policy on unemployment

Monetary policy has a significant impact on the unemployment rate in an economic system. When monetary regulators lower lending rates, the cost of borrowing money for firms and individuals becomes more affordable. This encourages firms to increase investment in various projects, expand production capacity, and hire more workers. (Das & Song, 2023). Conversely, public consumption also increases as credit becomes more affordable, increasing demand for goods and services. This increase in investment and consumption can immediately reduce the short-term unemployment rate, as more labor is needed to meet the increased demand (Chojnowski, 2022). (Chojnowski, 2022).

On the other hand, tight monetary policy may lead to an increase in unemployment. When money supervisory agencies raise interest rates to control inflation, the cost of borrowing money for companies and individuals becomes more expensive. As a result, firms may postpone or cancel investment plans that require funding, which may slow down business expansion and reduce job creation. (Laeven et al., 2022). In addition, rising interest rates may also reduce consumer purchasing power as the cost of credit rises, which may lower demand for goods and services. This decrease in demand may eventually force companies to reduce production and even lay off some of their workforce, resulting in an increase in the unemployment rate (Satragno, 2022). (Satragno, 2022).

However, monetary policy cannot perfectly control the unemployment rate as there are other influential factors, such as fiscal policy, global conditions, and technological changes. For example, even if the central bank lowers lending rates to encourage investment and consumption, if the global economy is in recession, the impact may not be as effective as expected. (Benchimol & Bounader, 2023). In addition, rapid technological change can also lead to structural unemployment if the workforce cannot quickly adapt to the necessary skills. Therefore, monetary policy must be integrated with other supportive policies in order to effectively reduce unemployment (Christiano & Fitzgerald, 2023). (Christiano & Fitzgerald, 2020).

The effect of monetary policy on financial stability

Monetary policy plays an important role in sustaining financial system stability by controlling interest rates and regulating the availability of funds flow in the economy. Bank supervisory agencies, through monetary policy, are able to lower interest rates to promote economic growth and raise them to control inflation. (Katsu, 2020). By regulating interest rates, bank supervisors influence consumption and investment behavior, which in turn affect capital flows and liquidity in financial markets. Financial stability is maintained when both investors and consumers are confident that interest rates remain within a predictable range and inflation is contained. This helps prevent market turmoil that may arise from economic uncertainty. (Chen & Phelan, 2023).

However, monetary policy that is too loose over a long period of time can jeopardize financial stability. For example, prolonged low interest rates may encourage excessive risk-taking behavior among investors and financial institutions. (Elster, 2020). They may engage in high-risk speculative investments, such as subprime lending or over-leveraging, because of higher returns. When the asset bubbles formed by these behaviors burst, it could trigger a financial crisis that adversely affects the stability of the overall economy. Loose monetary policy can also encourage asset inflation, where property or stock prices rise too quickly, creating the risk of bubbles that could damage the financial system when they pop. (oorkolil, 2024).

On the other hand, monetary policy that is too tight can also disrupt financial stability. Drastically raising interest rates to control inflation can slow economic growth and increase borrowing costs for consumers and companies. This has the potential to increase bankruptcies and bad debts, which can undermine the soundness of banking institutions and reduce liquidity in the financial market. (Ginn & Pourroy, 2022). This decrease in liquidity could trigger a crisis of confidence among market participants, exacerbating the financial turmoil. Therefore, bank supervisory institutions need to be careful in determining monetary policy in order to support economic growth while maintaining financial stability (Markakis, 2020). (Markakis, 2020).

Conclusion

The influence of monetary policy on economic stability in Indonesia is significant and requires a careful and balanced approach. Bank Indonesia, as the monetary authority, has an important role in stabilizing the economy through setting interest rates and regulating the money supply. Interest rate decisions made by Bank Indonesia have a direct impact on consumption, investment and overall economic activity. When interest rates are lowered, consumption and investment levels generally swell, which in turn boosts economic growth. Conversely, when interest rates are raised, the threat of inflation is averted, thus maintaining price stability and people's purchasing power.

However, too loose monetary policy in Indonesia can carry its own risks, especially in the context of an overheated economy or excessive inflation. For example, a long period of low interest rates may encourage excessive risk-taking by financial institutions and investors, such as increasing credit without strict controls. This allows for bubbles in the property sector or stock market that, if burst, can cause serious economic instability. Therefore, strict supervision and effective enforcement of regulations are necessary to ensure financial sector stability and prevent the negative impact of loose monetary policy.

On the other hand, overly tight monetary policy can also hamper Indonesia's economic growth. A drastic rise in interest rates can make borrowing expensive, reduce consumption and investment spending, and depress economic growth. Companies may face difficulties in financing operations and expansion, while consumers may refrain from spending and investing. This could slow down the pace of economic growth and increase the unemployment rate. Therefore, Bank Indonesia should adopt a balanced monetary policy that is responsive to current economic conditions, taking into account various economic indicators and their impact on financial stability and people's welfare.

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