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Empirical analysis of the impact of monetary policy through interest rates on economic growth in Indonesia

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ABSTRACT

This study investigates how inflation and monetary policy, as reflected in the policy interest rate (BI Rate), affect Indonesia's economic growth, as indicated by the GDP. Multiple linear regression analysis was employed to discover connections between independent and dependent variables in an economic setting. The analysis's findings indicate that neither the BI Rate nor inflation significantly affects GDP growth. Although not sufficiently strong to be regarded as statistically significant, the positive coefficients derived from both variables show a propensity for increases in inflation and policy interest rates to enhance economic growth. The significance of the interaction between the two variables in monetary policy is confirmed by simultaneous analysis, which reveals that both inflation and the BI Rate significantly contribute to GDP variance when examined together. These results suggest that monetary policy must work in tandem with fiscal policy and the real sector, as well as be adaptively managed to respond to changes in the global economy to effectively stimulate economic growth in Indonesia. This study is anticipated to significantly aid policymakers in developing more potent plans to accomplish sustainable growth and national economic stability.

Keywords: Monetary policy; policy interest rate (BI Rate); inflation; economic growth; Gross Domestic Product (GDP).

1. INTRODUCTION

The past ten years have seen an increase in uncertainty in the global economy. Variations in primary commodities, energy costs, and geopolitical unrest have significantly strained global economic stability. US monetary policy, especially shifts in the Federal Reserve's benchmark interest rate, is one of the main contributing factors (Georgiadis, 2016). Capital flight from developing nations, such as Indonesia, is frequently triggered by interest rate increases in industrialized nations. This circumstance affects exchange rates, price stability, and export competitiveness (Davis & Zlate, 2023). The importance of domestic policy measures in preserving the resilience of the national economy has increased. Compared to developed nations, developing nations are more susceptible to external shocks. The domestic financial industry may experience exchange rate volatility and uncertainty due to fluctuating international capital flows (Caporale et al., 2017). Additionally, emerging nations' economies are vulnerable to drops in world prices due to their reliance on commodity exports. It is possible that this pressure may worsen inflation and slow economic growth. Monetary policy becomes the primary tool available to stabilize the economy in this scenario (Roch, 2019). Central banks use the setting of policy interest rates as a tool and a signal to manage macro stability (Hubert & Labondance, 2021). As a result, developing nations' ability to withstand international unrest depends heavily on how well their monetary policies work.

Monetary policy is critical to ensuring macroeconomic stability, notably by managing inflation and economic development. The financial and real sectors' actions are influenced by the tools that central banks employ, particularly policy interest rates (Jarociński & Karadi, 2020). Central banks may manage the community's liquidity, credit flows, and inflation expectations by controlling interest rates. Consequently, this influences national output, investment, and consumption (Ippolito et al., 2018). The major responsibility of Bank Indonesia is to preserve the rupiah's stability, which encompasses both price and financial system stability. Bank Indonesia employs a range of policy tools as the monetary authority to adapt to shifting domestic and international circumstances (Anwar et al., 2023). To achieve the best possible policy synergy, this has to be closely coordinated with the government's budgetary strategy (Bianchi & Melosi, 2019). As a result, Bank Indonesia is essential to preserving the viability of the country's economic growth (Purnamasari et al., 2022).

The primary reference interest rate since 2016 has been the BI 7-Day Reverse Repo Rate, which is thought to be more efficient at sending policy signals (Handayani & Kacaribu, 2021). Exchange rates, inflation expectations, and bank lending are some of the ways that monetary policy is transmitted. Raising policy interest rates makes borrowing more expensive, which lowers credit demand and slows economic growth. On the other hand, decreasing interest rates promotes the development and expansion of credit (Altavilla et al., 2020). Additionally, this process influences the currency rate, which in turn influences export competitiveness and import costs (Bräuning & Ivashina, 2020). The efficacy of monetary policy has faced additional difficulties as a result of the COVID-19 epidemic. Despite a decline in economic growth in 2020, Indonesia's economy started to rebound in 2021 thanks to stimulus measures and domestic spending (Anas et al., 2022). Strong domestic demand and the stability of the banking system also contribute to Indonesia's economic resilience (Indrawati et al., 2024). For monetary policy research focused on long-term stability, Indonesia's economic development pattern thus offers a crucial picture. In response, Bank Indonesia tightened policy interest rates since 2022 to manage inflation and exchange rates after relaxing during the epidemic (Sugandi, 2022).

Prior studies on Indonesia's monetary policy have tended to concentrate on inflation rather than the whole influence on economic growth. This method has produced a partial understanding since economic growth is a macroeconomic goal of comparable importance. Furthermore, some studies continue to only use data from particular time periods, which prevents them from reflecting long-term patterns. It is urgent to update Indonesia's empirical study of monetary policy in light of the global shifts that have occurred over the last five years. Compared to the preceding decade, new elements including the pandemic, supply chain interruptions, and global geopolitical unrest pose distinct problems (Indrawati & Satriawan, 2024). This has ramifications for modifications to the transmission pattern of monetary policy, which require careful consideration. Without updating the analysis, the resulting policies risk becoming

irrelevant to the present situation. Furthermore, studies that particularly assess the efficacy of monetary policy tools like the BI 7-Day Reverse Repo Rate are necessary for their development. This disparity necessitates a more thorough empirical investigation using current data to determine how well monetary policy supports long-term economic growth. It is anticipated that this study will advance monetary studies both theoretically and practically. Academically, this study adds empirical analysis of the transmission of monetary policy in emerging nations to the macroeconomic literature. Practically speaking, the findings of this study can help the government develop strategic policies and policymakers assess the efficacy of interest rate instruments.

2. LITERATURE REVIEW

2.1. Monetary Policy

The term "monetary policy" describes the steps the central bank takes to regulate interest rates and the money supply in order to achieve price stability, economic expansion, and financial system stability (Carl, 2021). The credibility and independence of the central bank will determine how well this policy works, which is crucial for preserving the equilibrium between total demand and supply (Mishkin, 2019). Price stability, sustained economic growth, and fostering an environment that is favorable to trade and investment are among its goals (Thammarak, 2016). Bank Indonesia in Indonesia prioritizes rupiah stability, highlighting the significance of monetary policy as a stabilizing tool and an engine of economic growth (Anwar et al., 2023). The efficacy of policies in underdeveloped nations is limited by issues like exchange rate volatility and reliance on commodities, whereas policies in rich nations concentrate more on containing inflation within a stable financial system (Tobal & Menna, 2020). While inadequate financial access frequently hinders policy transmission through interest rates in underdeveloped nations, it is more seamless in rich nations. To connect policy with economic activity, monetary policy tools are used, both directly (benchmark interest rates) and indirectly (open market operations) (Mishkin, 2019). Since 2016, Bank Indonesia's primary tool has been the BI 7-Day Reverse Repo Rate (Handayani & Kacaribu, 2021).

2.2. Interest rates

The interest rate that the central bank sets as a standard for the economy and communicates to the financial markets is known as the policy rate (Kallianiotis, 2024). Variations in this interest rate have an impact on investment, borrowing costs, and buying power (Ulrich, 2007). They are also thought to be useful in reducing inflation and stabilizing growth (Nakamura & Steinsson, 2018). As a benchmark for bank interest rates and a reflection of money market liquidity circumstances, Bank Indonesia has employed the BI 7-Day Reverse Repo Rate (BI7DRR) as its primary policy interest rate since 2016 (Handayani & Kacaribu, 2021). Interest rates are more effective than other devices, but their efficacy is contingent on market circumstances and faith in monetary authorities. Under the inflation targeting framework (ITF), interest rates are used by the central bank to reach an annual inflation goal (Rigdon & Hoyle, 1997). The relevance of interest rates in preserving price stability and promoting sustainable economic growth has been reinforced by Indonesia's adoption of the ITF since 2005 (Altavilla et al., 2020).

2.3. Economic Growth

Economic growth, as indicated by GDP, is the expansion of an economy's potential for output. A rise in GDP is a measure of a society's prosperity as it represents the production of goods and services generated (Caballero & Simsek, 2024). Capital, labor, technology, and government policy are some of the factors that affect growth; macroeconomic stability is also a significant factor (Carl, 2021). Adam Smith and others' classical growth theory placed a strong focus on the accumulation of labor and capital, but it did not adequately account for technology. According to contemporary ideas like the Solow model, long-term growth is mostly dependent on technical advancement (Chukwuemeka, 2024). Investment and capital accumulation are also impacted by public policy, especially monetary policy (Mankiw, 2021). Both demand (consumption, investment, and government expenditure) and supply (labor, capital, and technology)

variables affect economic growth. The sustainability of growth is also influenced by public policy, infrastructure, human resource quality, and macroeconomic stability (Davoodi, 2021).

3. METHOD

This study uses a quantitative approach with the aim of empirically testing the effect of monetary policy on economic growth in Indonesia. A quantitative approach was chosen because it provides an objective and measurable picture through the use of numerical data sourced from official publications by relevant institutions. Quantitative research is founded on positivistic concepts that emphasize causal relationships between variables using statistically tested data (Mahardini et al., 2024). This research therefore compares economic growth, as measured by real Gross Domestic Product (GDP), with monetary policy factors, including interest rates, inflation, exchange rates, and investment. To assess the association between variables over a certain time period, econometric approaches were used in the analysis. The requirement to provide results that may serve as a foundation for economic policymaking also had a role in the choice of this methodology. It is anticipated that this study will use this paradigm to theoretically and practically advance our understanding of how monetary policy affects the dynamics of the Indonesian economy. This research focuses on the Indonesian economy, as reflected by macroeconomic variables such as monetary policy and economic growth. The study focuses on aggregate data that represents national socioeconomic dynamics rather than on specific people or community groupings. Policy interest rates, inflation rates, and domestic product growth are among the variables that are utilized as topics. Secondary data from a variety of official sources, including the Ministry of Finance, Bank Indonesia (BI), and the Central Statistics Agency (BPS), was used in this study.

3.1. Data Analysis

Variables used are below.

Dependent Variable (Y) : Gross Domestic Product (GDP)
Independent Variable (X1) : Inflation
Independent Variable (X2) : Policy Interest Rate (BI Rate)

The regression model used to analyse the effect of inflation and the BI Rate on GDP can be expressed in the following multiple linear regression equation:

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + e$$

4. RESULT AND DISCUSSION

4.1. Result

4.1.1. Gross Domestic Product (GDP)

The GDP variable has a minimum value of -5.320, a maximum value of 7.080, and an average (mean) of 4.659, according to descriptive analysis. A period of severe economic contraction, caused by the effects of a crisis or national economic disruption, is indicated by the negative number at the very least. The highest score of 7.080, on the other hand, denotes a period of robust economic prosperity. The economy is generally on a stable and favorable trajectory, as seen by the average growth of 4.659. Economic changes between quarters or periods are reflected in the large range of numbers between the minimum and maximum. As a result, the GDP variable generally exhibits a variety of growth dynamics while staying within a range that is comparatively sound for the country's economy.

4.1.2. Inflation

The inflation variable has an average of 3.957, a minimum of 0.5667, and a maximum of 8.600. This average figure shows that inflation is still within the monetary authorities' target range and is typically in the mild level. While the greatest value of 8.600 denotes a period of relatively significant price spikes, perhaps brought on by rises in the cost of food and energy or a declining exchange rate, the smallest value,

which is near zero, shows a period of very low price pressure, even approaching deflation. The significant degree of inflation volatility over the observation period is reflected in the large range between the minimum and greatest readings. As a result, although the inflation variable in this data exhibits a fluctuating pattern, it stays within a range that monetary policy can regulate.

4.1.3. Statistical Analysis

4.1.3.1. Partial Test (t-test)

A partial test is conducted to determine the effect of each independent variable (inflation and BI rate) on the dependent variable (GDP) separately.

Hypothesis for Inflation

H_0: Inflation does not have a significant effect on GDP

H_1: Inflation has a significant effect on GDP

Based on the output, the t-value = 1.359 with a p-value = 0.180. Since the p-value > 0.05, H_0 is accepted. This means that, statistically, inflation does not have a significant effect on GDP growth at a significance level of 5%. Although the inflation coefficient is positive (0.264), indicating that an increase in inflation tends to be followed by an increase in GDP, the effect is not statistically significant. This can be interpreted to mean that inflation fluctuations during the observation period were not large enough to significantly drive or suppress economic growth.

Hypothesis for BI Rate

H_0: BI Rate has no significant effect on GDP

H_1: BI Rate has a significant effect on GDP

From the regression results, a t-value of 1.196 with a p-value of 0.237 was obtained. Since the p-value is greater than 0.05, H_0 is also accepted. This means that the BI Rate does not have a significant effect on GDP in part. The positive coefficient of 0.3505 indicates that an increase in the BI Rate is followed by an increase in GDP, but empirically this relationship is not statistically significant. This could be due to the existence of a time lag in the transmission of monetary policy to the real sector, or because the GDP variable is more influenced by other factors outside of the policy interest rate.

4.1.3.2. Simultaneous Test (F Test)

The simultaneous test is used to test whether all independent variables (inflation and BI rate) together have a significant effect on GDP.

Hypothesis

H_0: Inflation and BI Rate simultaneously have no significant effect on GDP

H_1: Inflation and BI Rate simultaneously have a significant effect on GDP

Based on the output, the F-count value = 4.835 with a p-value = 0.01163. Because $p < 0.05$, H_0 is rejected. This means that simultaneously, the variables of inflation and BI Rate have a significant effect on GDP. Although individually insignificant, together they explain the variation in GDP in a meaningful way. This indicates the existence of interrelated macroeconomic relationships, where monetary policy (through interest rates) and price pressures (inflation) together affect economic growth.

4.1.3.3. Coefficient of Determination (R^2 and Adjusted R^2)

The R^2 value of 0.1495 indicates that 14.95% of GDP variation can be explained by the variables of Inflation and BI Rate, while the remaining 85.05% is explained by other factors not included in the model. The Adjusted R^2 value of 0.1186 confirms that the model still has limited predictive power, but is relevant enough to describe the tendency of macro variables to influence economic growth. The following is an academic discussion of the research results based on your regression analysis output. Each point is explained systematically with 3–5 paragraphs of academic narrative based on empirical facts from the regression and reinforced with theoretical reasoning and macroeconomic context.

Based on the results of the statistical analysis that has been carried out. The following is the resulting equation:

$$Y=1.64 + 0.26X1 + 0.35X2$$

4.2. Discussion

4.2.1. The Effect of BI Rate on GDP

The results of the analysis show that the BI Rate variable has no statistically significant effect on GDP. Empirically, these findings indicate that changes in the policy interest rate set by Bank Indonesia do not necessarily affect economic growth in the short term. In other words, monetary policy through interest rate instruments has not shown a direct effect on the increase or decrease in GDP during the observation period. Theoretically, the relationship between interest rates and economic growth is explained through the monetary policy transmission mechanism. An increase in interest rates is usually expected to curb inflation and reduce aggregate demand, while a decrease in interest rates can stimulate investment and consumption, which in turn increases GDP. The study's findings, however, indicate that this process is not operating very well. The time lag in monetary policy transmission to the real sector, wherein interest rate changes take some time to affect people's finance, investment, and consumption decisions, is one potential explanation for this. Additionally, the efficiency of monetary policy transmission may be weakened by Indonesia's economic structure, which is still reliant on sectors based on natural resources and unorganized activity. Policy interest rates might not have a direct impact on lending rates or investment in the productive sector in this situation. These empirical findings are thus in line with the literature, which claims that underdeveloped financial market arrangements frequently impede the effectiveness of monetary policy in developing nations. However, the positive correlation between the BI Rate and GDP suggests that interest rate hikes may occasionally be a policy reaction to improving economic circumstances. To put it another way, monetary authorities typically boost interest rates in response to economic growth in order to preserve price stability and avoid an overheated economy. To put it another way, this positive connection is a policy response to macroeconomic dynamics rather than direct cause. All things considered, these findings suggest that for interest rate policy to have the greatest possible influence on economic growth, it must be combined with fiscal policy and the real sector. Changes in the BI Rate by themselves are insufficient to either accelerate or slow GDP growth in the absence of fiscal stimulus and structural policy support.

4.2.2. The Effect of Inflation on GDP

The findings of the regression indicate that, in part, the inflation variable has no discernible impact on GDP. This demonstrates empirically that changes in inflation over the study period have not significantly affected economic expansion. Although the effect is not big enough to be deemed statistically significant, the coefficient's positive direction suggests a propensity that modest increases in inflation can nevertheless coexist with economic growth. According to macroeconomic theory, there is frequently a non-linear relationship between inflation and economic growth. A rise in aggregate demand, which is what really propels economic activity, can be reflected in inflation at low to moderate rates. However, the impact turns negative if inflation rises above a particular level since it lowers purchasing power and breeds economic instability. According to the study's findings, which indicate a positive but negligible association, Indonesia's inflation rate remained within a safe range over the observation period, meaning that price pressures did not impede GDP development. Furthermore, efficient monetary policy tools for preserving price stability may also be the cause of the negligible correlation between GDP and inflation. In order to limit its impact on economic growth, Bank Indonesia has managed to keep inflation within the target range through interest rate control and liquidity tools. Therefore, even while inflation fluctuates occasionally, its effect on GDP is typically minimal due to the successful maintenance of macroeconomic stability. From a structural standpoint, these findings also show that non-monetary factors including government expenditure, real sector investment, and commodity exports are more important drivers of Indonesia's economic growth. The link between inflation and economic growth is negligible because these factors can

offset the effects of inflation. Therefore, modest inflation might be a sign of increased domestic economic activity rather than a threat to growth. Overall, the study's findings lend credence to the idea that while price stability is a necessary precondition for long-term, steady economic growth, controlled inflation need not be the primary engine of expansion. For economic growth to be inclusive and sustainable, monetary policy must continue to be centered on striking a balance between price stability and increasing real sector productivity. The academic discussion's conclusion, which summarizes how the BI Rate and inflation affect GDP, is provided below. It is written in a scientific narrative form and may be directly incorporated into your research report's results and discussion chapter.

4.2.3. The Relationship Between Inflation and BI Rate on GDP

Concurrently, the F test results demonstrate that the combined impact of the BI Rate and inflation variables on GDP is significant. This result demonstrates that while each variable is not significant on its own, taken as a whole, they both significantly contribute to variations in economic growth. This demonstrates that monetary policy and price stability in the national macroeconomic system interact to drive GDP growth patterns rather than being only influenced by one economic component. Therefore, monetary policy and inflation control should be viewed as complementing tools for preserving economic equilibrium rather than as distinct concepts. The study's findings highlight how crucial it is for monetary authorities and the real sector to coordinate their policies. Through the mechanics of credit costs and public inflation expectations, the BI Rate, the primary tool of monetary policy, helps to manage inflation. In the meantime, inflation is a crucial measure of purchasing power and price stability, which ultimately influences investment, consumption, and economic output. Price stability can promote economic growth while avoiding undue inflationary pressures if both are coordinated. On the other hand, the impact of stimulus on growth may be restricted if inflation and interest rate policy diverge. The Indonesian economy is also in a phase where inflationary pressure and monetary policy are still operating in an expansionary corridor, as evidenced by empirical findings showing positive coefficient values for both variables. This means that a moderate increase in inflation does not necessarily impede economic growth, but rather may indicate increased aggregate demand. Similarly, Bank Indonesia's efforts to balance monetary stability and economic growth are reflected in moderate policy interest rates, which is consistent with the moderated

4.2.4. Phillips Curve theory, which holds that there is a positive trade-off between output and inflation at low to moderate inflation.

Overall, the study's findings support the idea that price stability and monetary policy effectiveness are balanced, and that Indonesia's economic growth is the result of a balance between the two. From the standpoint of public policy, these results show that monetary policy in Indonesia has been relatively successful in maintaining macroeconomic stability, despite having a weak impact on GDP. This suggests that a synergy between monetary, fiscal, and real sector policies is still required to make the boost to economic growth more effective. Fiscal policy intervention in the form of increased productive spending and infrastructure investment can strengthen the transmission of monetary policy, allowing the two to increase national output in a sustainable way. In an open economy like Indonesia's, economic growth is dependent not only on demand but also on the consistency and legitimacy of monetary policy in controlling the expectations of economic players. This is confirmed by the simultaneous association between GDP and the BI Rate and inflation. In order to achieve equitable and sustainable economic growth, inflation stability and adaptive interest rate policy are crucial pillars

5. CONCLUSION

The analysis's findings suggest that the variables of inflation and the BI Rate have a complicated relationship with GDP. Changes in policy interest rates and inflation have not had a large direct impact on national output, as evidenced by the fact that none of these variables significantly affects economic growth. This demonstrates that major economic shifts are still not entirely driven by the short-term monetary policy transmission mechanism. Nevertheless, it has been demonstrated that both factors

significantly affect GDP when examined together. Both help to explain the dynamics of economic growth, even though they are not powerful enough on their own. The interaction of monetary policy and price stability demonstrates how these two elements complement one another and have a substantial macroeconomic impact on GDP performance. The study's conceptual findings support the idea that the Indonesian economy is presently experiencing a period of balance between responsive monetary policy and price stability. While a moderate interest rate policy reflects Bank Indonesia's efforts to achieve a balance between economic expansion and inflation control, a moderate increase in inflation does not impede economic growth. Therefore, economic stability and sustainable growth can be facilitated by an adaptable policy strategy.

Ethical Approval

Not Applicable

Informed Consent Statement

Not Applicable

Authors' Contributions

MQH responsible for conceptualization, developing the main research ideas and framework. He also designed the methodology and drafted the initial version of the article. AR focused on validation, ensuring the accuracy of the data used, and conducting in-depth statistical analyses. He provided feedback and revisions to improve the quality of the manuscript. IA assists in final revision of articles, translation, ensuring clarity and coherence before submission.

Disclosure Statement

The Authors declare that they have no conflict of interest

Data Availability Statement

The data presented in this study are available upon request from the corresponding author for privacy.

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