

Effect of Monetary Policy on Economic Development

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ABSTRAK: Judul riset ini adalah “Dampak Kebijakan Moneter terhadap Pertumbuhan Ekonomi di Indonesia.” Tujuannya ialah untuk membahas bagaimana inflasi, investasi, dan jumlah uang beredar memengaruhi perkembangan ekonomi di Indonesia. Penelitian ini memanfaatkan metode kualitatif untuk menjelaskan masalah dan fokus penelitiannya. Informasi yang dipakai mencakup informasi tentang inflasi, investasi, jumlah uang beredar, serta perkembangan ekonomi di Indonesia. Metode analisis yang diterapkan adalah studi kepustakaan, di mana data dikumpulkan melalui tinjauan literatur di perpustakaan, buku, bahan tertulis, dan sumber relevan. Hasil penelitian menunjukkan bahwa inflasi di Indonesia bersifat fluktuatif dan tidak selalu sejalan dengan perkembangan ekonomi. Dalam rangka meningkatkan stabilitas ekonomi, Indonesia harus terus menjaga kebijakan moneter yang tepat dan stabil, serta kebijakan fiskal yang bijaksana. Hal ini penting untuk menghadapi tantangan ekonomi yang kompleks, seperti volatilitas harga komoditas global, fluktuasi arus modal, dan faktor-faktor lain yang memengaruhi stabilitas ekonomi. Dengan kebijakan yang berkelanjutan dan terencana dengan baik, Indonesia dapat memperkuat sektor ekonomi, mengendalikan inflasi, dan menjaga stabilitas nilai tukar. Dengan demikian, ekonomi Indonesia dapat terus berkembang secara berkelanjutan.

Kata kunci: Kebijakan Money, Perkembangan, Ekonomi.

ABSTRACT: The title of this research is “The Impact of Monetary Policy on Economic Growth in Indonesia.” The aim is to discuss how inflation, investment and money supply affect economic development in Indonesia. This research utilizes qualitative methods to explain the problem and focus of the research. The information used includes information on inflation, investment, money supply, and economic development in Indonesia. The method of analysis applied is a literature study, where data is collected through literature reviews in libraries, books, written materials, and relevant sources. The results show that inflation in Indonesia is volatile and not always in line with economic development. In order to improve economic stability, Indonesia must continue to maintain appropriate and stable monetary policy, as well as prudent fiscal policy. This is important to face complex economic challenges, such as global commodity price volatility, fluctuations in capital flows, and other factors that affect economic stability. With sustainable and well-planned policies, Indonesia can strengthen economic sectors, control inflation, and maintain exchange rate stability. Thus, the Indonesian economy can continue to grow sustainably.

Keywords: Monetary policy, development, economy

1. INTRODUCTION

One of the factors supporting the progress of a country is its economic development. A country can be recognized as developed if its economy is stable, and conversely, if its economy is slumping, the country is not yet able to be said to be a developed country. In order to promote economic development, economic activity in the country must surge

in the following year (Mankiw, 2003:16). In order to boost economic development, it is important to continue to encourage development in potential economic sectors, such as production, tourism, and technology. In addition, the implementation of policies that support investment, innovation, and infrastructure development can also play a major role in creating a favorable environment for continued economic development. In this way, the country can achieve significant economic progress and provide wider benefits to its population. To secure economic development to keep pace, money supply must expand at a more consistent rate, not regulated or replaced by monetary authorities (Sean, 2019). Economic development is defined as an increase in Gross Domestic Product (GDP) or Gross National Product (GNP) to estimate whether the development exceeds or even lacks the level of population development, and whether it will cause changes in the structure of the economy (Asnawi, 2018). In the current globalization period, the economic situation of a country is interrelated, so the policies taken by state officials, both fiscal and monetary, are influenced by external factors (Ministry of Finance of the Republic of Indonesia, 2018). Salim (2018) describes that monetary aspects have a crucial role in a country's economy, and economic development cannot be predicted without considering monetary aspects.

According to information provided by Bank Indonesia and the Central Bureau of Statistics (BPS), soaring Bank Indonesia lending rates resulted in a slowdown in domestic economic development. For example, when Bank Indonesia increased its benchmark interest rate (Bank Indonesia rate) by more than 12%, economic development only expanded by 4.59% in the first period of 2006. Then two years later in 2008, when the BI rate skyrocketed to 9%, the Indonesian economy declined (expanded by approximately 4%) in the second period of 2009. In contrast, the following year, in 2017, the decline in the Bank Indonesia 7-Day Rate (BI7DR) to 4.5% allowed the economy to develop in a balanced manner at a 5 percent warning (Bank Indonesia, Central Bureau of Statistics, 2018). In this context, monetary policy, particularly in terms of lending rate setting from Bank Indonesia's perspective, plays a crucial role in regulating domestic economic growth. The lending rate set by Bank Indonesia has a significant impact on the level of investment as well as public consumption. When interest rates are raised, this tends to discourage investment and borrowing, which can slow down economic growth. Conversely, a decrease in interest rates can encourage investment and consumption activities, thereby boosting economic development.

However, the effect of borrowing rates on economic development is not always linear and can be influenced by other sectors, such as global market conditions, fiscal policy, and political conditions. In addition, the market response to borrowing rate policy may also vary depending on the level of confidence and expectations of market participants on the direction of the economy. Loan interest is part of the indicators that are always considered in the economy because it has a significant impact on people's lives and the overall health of the economy (Nofitasari, et al., 2019). Falling interest rates can have a positive impact on the efficiency of capital allocation and the level of investment, which in turn can lead to the optimal use of capital and secure materials. However, declining interest rates that last for a long period of time can create instability in the form of an unreasonable increase in the value of goods (Sari & Baskara, 2018). Money supply refers to the total funds circulating in a country's economy (Putri & Rosyetti, 2017).

A booming economy can cause incomes to rise, which in turn can lead to overspending and trigger inflation. High inflation rates can undermine Indonesia's economic performance (Sukirno, 2006:334). Sutawijaya (2012:86) says that soaring inflation can have a chilling effect on the economy, which can then destabilize social and political stability. The stability of a relatively stable exchange rate reflects the macroeconomic stability of a country. This exchange rate stability shows that the monetary and fiscal policies that have been practiced by the government can maintain

economic stability, including controlling inflation. Conversely, significant fluctuations in the exchange rate can be a warning sign of potential economic instability, which if not followed up carefully can alter the social and political stability of the country.

The exchange rate of a country's currency often reflects conditions in the economy as a whole, so a relatively level currency indicates the country's macroeconomic stability. Conversely, currency values that deviate with large fluctuations will reduce investor interest in investing in the country. Inflation is one of the macroeconomic variables that has a major influence on the economic development of the country. Controlled inflation has a good impact on economic development, while high inflation will have a less good and significant impact on economic development (Aydin, Esen, & Bayrak, 2016). Tambunan (2014) also stated that rising inflation will cause adverse effects on economic growth. One way to secure inflation resilience is through monetary policy. Monetary policy is decided and carried out by Bank Indonesia as the party responsible for monetary policy, aiming to achieve and secure the balance of the rupiah value by regulating the supply of dispersed money and loan interest rates. (Bank Indonesia Law Amendment, 2004). Effective implementation of monetary decisions requires the autonomy of the monetary bank in selecting suitable policy tools to achieve macroeconomic objectives. The success of monetary policy also depends on the central bank's ability to respond to changes in economic and financial conditions quickly and efficiently. In the current context of globalization, where economic and financial events in different countries can quickly drive the country's economic activities, the independence of the central bank in making monetary decisions becomes increasingly important. External factors such as movements in goods prices, shifts in global monetary rules, and foreign political uncertainty can also affect a country's monetary policy. Thus, central banks need to have the flexibility to adapt their policies according to global and domestic economic conditions to achieve and maintain currency stability and sustainable economic growth.

The implementation of monetary rules as well as the autonomy of monetary banks in determining appropriate policy instruments have a major impact on the effect of monetary policy on economic development and changes in overall economic activity (Alavinasab, 2016). In the current context of globalization, where financial events from different countries have a significant impact on a country's economy, external factors play an important role in the government's policy-making process, including fiscal and monetary policy. Cioran (2014) recognizes that if the financial business is an integral part of the economy, then the analysis of economic development is incomplete without considering monetary aspects. Therefore, in Indonesia, monetary policy is considered a tool to improve and maintain stable economic growth, given that Gross Domestic Product (GDP) is considered a key indicator of a country's progress. By using monetary policy, the government has control over money supply and interest rates, which have a direct impact on the level of investment, consumption, and overall economic growth. Effective implementation of monetary policy requires the autonomy of the monetary bank in choosing appropriate policy instruments to achieve macroeconomic objectives. The success of monetary policy is also greatly influenced by the central bank's ability to respond to changes in economic and financial conditions quickly and efficiently. In this era of globalization, where economic and financial events in other countries can quickly affect a country's economy, central bank independence in monetary decision-making is becoming increasingly important.

So, one of the strategies used to increase and secure the stability of economic development in Indonesia is through monetary policy. This is because GDP is seen as the main indicator of economic growth which is a measure of a country's progress. Thus, the purpose of this study is to investigate how monetary policy affects economic development in Indonesia by considering inflation and exchange rate variables.

2. METHOD

2.1 Type of Research

This research uses a qualitative approach to explain the problem and research objectives. The qualitative method is a procedural step in social research that aims to obtain descriptive data in the form of words and images. This approach is in line with the view expressed by Lexy J. Moleong that the data collected in qualitative research is descriptive and not in the form of numbers. The qualitative approach does not depend on statistical analysis, but rather focuses on qualitative evidence. This approach also relies on direct experience experienced by respondents, which is then associated with relevant theories.

2.2 Data Source

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2.3 Data Collection method

Information in this study was generated from two sources, namely primary data and secondary data. According to Sugiyono, information collection can be done through two sources, namely primary information sources and secondary information sources. Primary sources of information are sources of information that provide data directly to researchers, while secondary sources of information are sources of information that do not provide data directly to researchers. Primary data is obtained directly from the original source, for example through interviews, direct observation, or questionnaires distributed to respondents. Meanwhile, secondary data is data that has been collected by other parties previously and can be in the form of statistical data, reports, articles, or other publications. The use of these two types of data allows researchers to obtain comprehensive and in-depth information on the research topic being studied.

2.4 Data Analysis Technique

Analysis in qualitative research involves describing the phenomena that occur and interpreting their meaning. Data analysis was carried out using descriptive methods to describe the facts and relationships between the events being investigated systematically, factually, and accurately after the information was collected.

3. RESULT AND DISCUSSION

3.1 Effect of Monetary Policy on Economic Development

Money neutrality over long periods is an accepted theory in economics. The concept explains that although monetary policy may affect short-time economic development by spurring or dampening demand, it has a positive impact on long-time real variables, such as employment, economic growth, and others. This is due to the fact that the long-time

equilibrium level of these variables is determined by factors such as supply, use of adequate technology, demographics, and economic preferences. Every economy has a small level of production that can be achieved with full utilization of all available factors of production, known as potential output. The top economic development that is minimally inflationary is called the potential growth rate (Kaponya, 2012). In this context, structural and fundamental factors which include supply, available technology, demographics, and economic preferences, play a larger role in determining the direction and rate of economic growth over a longer period of time. For example, increases in production and productivity in the long run are driven more by technological developments, investments in education and infrastructure, and structural changes in the economy, rather than by monetary policy alone.

Economic growth can be explained as an increase in the total value of goods and services produced by a particular country in a given year. Decreases in the value of currency are not counted in the measurement of economic development. The Gross Domestic Product used in this analysis is the constant Gross Domestic Product, which does not take inflation into account (Boediono, 1999) explains that economic growth is an increase in the country's national income in the following year, which is often seen from changes in the value of GDP from year to year. In economics, GDP is explained as the total value of goods and services produced in an economic area within a specified period of time, such as several years. The Gross Domestic Product formula is the total market value of all final goods and services produced by a country in one year, which is equal to total consumption, investment, and government spending, plus exports minus imports (Hamed & Ume, 2011). During the period 1986-2019, Indonesia's GDP has continuously experienced positive growth, except in 1998 when it experienced negative growth due to the Indonesian financial crisis. However, a short time later, Indonesia's GDP recovered and experienced a significant increase. The consistently positive economic growth of Indonesia's GDP during the 1986-2019 period shows the strength of the country's economy. Despite experiencing a decline in 1998 due to the financial crisis that hit Indonesia, Indonesia's GDP managed to recover and even experienced significant growth in the following period. This shows that despite facing serious economic challenges, Indonesia was able to bounce back and recover quickly. This success also reflects the resilience of the Indonesian economy in the face of global economic turmoil and its ability to undertake the necessary reforms to resolve its economic problems.

Monetary policy is the action taken by an authorized financial institution, usually the monetary bank, to control the supply of dispersed money and loans, which in turn drives the economic activity of the population. Its main objective is to create economic stability, which can be calculated from the level of career opportunities, value stability, and balance of the foreign transaction balance. If economic stability is compromised, monetary policy is used to correct the broken situation, known as stabilizing measures. Monetary policy is a component of macroeconomic policy that also involves various other policies in driving economic activity. Apart from monetary policy, the government also implements fiscal policy, international trade policy, and policies related to licensing and regulation. In addition, the government also carries out specific policies related to investment, capital markets, and the real sector (Ismail, 2006: 234).

According to a study conducted by Jul Fahmi Salim in 2017, it was found that the currency exchange rate has a positive and significant impact on economic growth in Indonesia. This means that when the currency exchange rate increases, economic growth also tends to increase significantly. On the other hand, the inflation rate has a negative and significant effect on economic development, meaning that the higher the

inflation rate, economic growth will tend to decrease significantly. Simultaneous testing results show that together, currency exchange rates and inflation rates have a significant impact on economic development in Indonesia. In the context of economics, the currency exchange rate is the relative price of a currency against another currency. The inflation rate, on the other hand, measures the rate of increase in the prices of goods and services over a period of time. Both of these factors have an important influence on a country's economic growth. When the exchange rate strengthens, exports become more expensive for trading partners, but imports become cheaper. Conversely, if the exchange rate weakens, exports become cheaper and imports more expensive. This impact can affect a country's trade balance, which in turn can affect economic growth.

3.2 Inflation growth in Indonesia

The results show that the inflation rate in Indonesia has varied over the past few years. In 2009, inflation was 2.78 percent, increasing to 2.90 percent in 2010. In 2011, inflation rose to 3.79 percent, then continued to increase to 4.30 percent in 2012, and reached its peak in 2013 with 8.38 percent. In 2014, inflation was still high at 8.36 percent, but decreased the following year to 0.2 percent. In 2015, inflation continued to decline to 3.35 percent, then fell again in 2016 to 3.02 percent. However, in 2017 inflation rose again to 3.61 percent. In 2018, inflation decreased to 3.13 percent, but in 2019 inflation increased again. Research also shows that inflation is influenced by the level of economic growth. If economic growth increases, inflation also tends to increase, and vice versa. This happens because when economic growth is high but not accompanied by an adequate increase in productivity, the demand for goods and services will exceed the existing supply, which then triggers inflation. Keynesian theory explains that an increase in expenditure-side GDP will increase people's effective demand, which, if it exceeds the amount of goods and services produced, will cause inflation. Mishkin (2009) also states that a drop in unemployment below the natural rate will increase wages, which will then push up prices. In addition, the results also show that monetary policy implemented by the central bank can affect the inflation rate. When the central bank raises interest rates to control inflation, it can reduce consumer spending and investment, which in turn can suppress the inflation rate. However, monetary policy must also be balanced so as not to hamper economic growth. Therefore, the central bank needs to conduct careful and precise analysis in determining monetary policy in order to secure value stability as well as parallel economic development.

In previous studies, monetary policy through the exchange rate was less fixed to economic developments. This is the cause of the high degree of openness of the Indonesian economy, making it fragile to circumstances, especially exchange rate activities. Pressure on the value of the rupiah is also triggered by investors' fear of rising interest rates.

In this study, Bilateral Exchange Rate calculation is used, where the price of one unit of money value of a country is said to be equivalent by the value of money from various countries. Warjiyo, as cited by Solikin and Suseno (2002) in Laeli Dwiwardani (2019), categorizes instruments in monetary policy as follows:

1. Some of the instruments in monetary policy are direct and indirect. Direct instruments such as interest rate controls can directly affect the operational target, while indirect instruments such as monetary controls through movements in the central bank's balance sheet.
2. Monetary policy orientation can be financial market (market-based and non-market-based). Open markets, for example, do not burden banks with taxes, policy direction is straightforward, and discretion lies with the central bank or financial markets.

Direct instruments in monetary policy may include the setting of benchmark interest rates or minimum bank reserves, which directly affect liquidity and banking activity. On the other hand, indirect instruments, such as foreign exchange market interventions by the central bank, tend to have a more indirect impact and may be difficult to predict. A market-based orientation of monetary policy may provide greater flexibility in responding to changes in market and economic conditions. Whereas non-market based monetary policy may be more tied to more complex political and regulatory considerations.

This shows the complexity of the relationship between the economy and inflation in Indonesia, which does not always follow the same pattern. A market-based monetary policy orientation may provide greater flexibility in responding to changing market and economic conditions, while a non-market-based monetary policy may be more tied to more complex political and regulatory considerations. To manage inflation effectively, the central bank needs to consider various factors that affect the economy in a holistic and sustainable manner. The impact of the economy on inflation in Indonesia is not always consistent. While economic growth increases, it is not always followed by an increase in inflation. Conversely, a decline in economic growth does not always mean that inflation will fall. In fact, in some cases, a decline in economic growth can cause inflation to rise. One example is when there is a rise in oil prices in many countries, which can lead to a general rise in the value of goods and services. This can reduce the production of goods and services in the country due to higher production costs, creating scarcity of goods and services, which in turn increases inflation.

According to Mankiw (2007), fluctuations in the economy can affect Aggregate Demand and Aggregate Supply in the near or long term. These fluctuations cause a decrease or increase in Aggregate Demand as well as a decrease or increase in Aggregate Supply. A decrease in Aggregate Supply in the short term can lead to imbalances in the economy. An example is the rise in world oil prices, which is the main cause of production. This rise can lower the overall Aggregate Supply, which in turn can result in a fall in national output and a rise in value. On the other hand, an increase in Aggregate Demand over a short period of time can lead to an increase in output. This is because in a short period of time, values tend to be rigid and the economy has not yet reached a state of full resource utilization, so an increase in Aggregate Demand does not cause inflation. This research is in line with Yudisthira's research (2013) explaining that inflation does not have a steady influence on (GDP), but it leads to a better direction.

Economic fluctuations can change Aggregate Demand and Supply, in the short term or in the long term. For example, a rise in oil prices can lower Aggregate Supply and result in a decline in national output and a rise in prices. On the other hand, a rise in Aggregate Demand can increase output as values tend to be rigid in the near term.

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3.4 Money supply growth in Indonesia

The money supply has a steady and adverse effect on the development of the current economy. This shows that monetary policy, i.e. the inflation rate, has an influence on the money supply in the previous year. When the previous year's money supply starts to rise, inflation tends to decrease due to the fall in domestic demand the following year, and vice versa. This surge in domestic demand leads to an increase in economic output, which in turn increases the money supply in the following period. However, if the previous money supply falls, inflation tends to fall due to reduced domestic demand and output. This is consistent with the theory that high output at a given interest rate will increase the money supply. An increase in money supply will cause inflation, and conversely, a decrease in money supply will reduce inflation. The link between money supply in the previous quarter and the inflation rate suggests a delay in monetary policy.

A dispersed money supply can affect inflation by several mechanisms. First, the money supply will increase drastically from the growth of the real economy, this can cause inflation due to too much money chasing too few goods, which means the demand for goods and services exceeds the supply. Secondly, a large money supply can increase the consumption rate of the population as people have more money to spend. This can encourage producers to raise prices as demand increases, which in turn can lead to inflation.

However, it is important to note that the relationship between money supply and inflation is not always linear. Other factors such as fiscal policy, commodity prices, and global market conditions can also affect the inflation rate. In addition, there are also internal factors such as the level of domestic production, population utilization rate, and investment rate that play a major role in determining the inflation rate.

4. CONCLUSION

The Indonesian economy during this period experienced fluctuations that were influenced by various external and internal factors. Economic growth, inflation, and balance of payments conditions reflect the complexity and dynamics of the Indonesian economy. Appropriate and stable monetary policy and prudent fiscal policy are key in dealing with the economic challenges faced by Indonesia, such as volatility in global commodity prices, fluctuations in capital flows, and other factors that can affect economic stability. The importance of sustainable and well-planned policies in strengthening the

economic sector, controlling inflation, and maintaining exchange rate stability in order for the Indonesian economy to continue to develop sustainably.

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