Indonesian Banking Review
Volume 3, Number 2, 2024

ZERA

Indonesia's Monetary Policy in Controlling Inflation and Maintaining Stability

I Made Bayu Dirgantara[1*]

[1] Universitas Diponegoro, Semarang, Indonesia

Abstract

Article history:
Received: July 18, 2024
Revised: August 12, 2024
Accepted: September 29, 2024
Published: December 30, 2024

Keywords:
Financial Stability,
Indonesia,
Inflation,
Interest Rate,
Monetary Policy,

Identifier:
Zera Open
Page: 160-177
https://zeraopen.com/journal/ibr

Monetary Policy is a central bank's primary instrument in maintaining currency stability, controlling Inflation, and creating conditions that support sustainable economic growth. In Indonesia, Bank Indonesia applies the Inflation Targeting Framework (ITF), which emphasizes price stability by utilizing the policy Interest Rate, open market operations, and Macroprudential instruments. Global developments, such as exchange rate volatility and changes in international Interest Rates, present significant challenges that influence the effectiveness of domestic policy implementation. This study employs a literature review method to analyze the role, dynamics, and adaptation of Indonesia's Monetary Policy in responding to external pressures and maintaining Financial Stability. The findings reveal that policy flexibility, central bank credibility, the integration of Sharia-based instruments, and the development of Central Bank Digital Currency (CBDC) are crucial elements in strengthening the monetary foundation. Therefore, Indonesia's Monetary Policy is not merely technical in nature but also strategic in addressing global challenges, while simultaneously supporting Financial Inclusion and long-term economic sustainability.

*Corresponding author:
(I Made Bayu Dirgantara)

1. Introduction

Monetary policy is one of the fundamental instruments that cannot be separated from a modern economy, as it serves as a central bank's primary tool for maintaining macroeconomic stability. In Indonesia, this role is held by Bank Indonesia, which has a constitutional mandate to ensure the stability of the rupiah's value. This stability includes two important aspects: the stability of prices for goods and services domestically, and the stability of the exchange rate against foreign currencies. Through controlling inflation, setting interest rates, and regulating the amount of money in circulation, monetary policy is expected to support sustainable economic growth. In addition, this policy also aims to strengthen the stability of the national financial system and increase market confidence in Indonesia's economic condition. The significance of monetary policy becomes even more apparent when the domestic economy faces external shocks from global volatility, such as movements in international commodity prices, changes in capital flows, and fluctuations in global interest rates, which often affect national economic stability (Hudaya & Firmansyah, 2023).

In its development, the function of monetary policy has undergone a broader meaning. The central bank is no longer solely focused on achieving price stability, but is also required to pay attention to the dimensions of financial system stability, mitigation of global risks, and efforts to encourage more inclusive economic growth. Monetary policy fundamentally acts as an anchor of confidence for economic actors, both domestic and international. This is realized through the Inflation Targeting Framework (ITF) that has been implemented since 2005. Through this framework, Bank Indonesia has the flexibility to set inflation targets with a relatively high degree of flexibility, while maintaining a balance between the need for price stability and the demands of sustainable economic growth (Ruslan et al., 2023).

However, the effectiveness of monetary policy in developing countries like Indonesia often faces quite complex challenges. Vulnerability to external shocks, such as exchange rate volatility, global energy price increases, and the heavy flow of foreign capital, can disrupt the achievement of inflation targets (Mirza et al., 2023). On the other hand, domestic structural factors also complicate the implementation of monetary policy. Some of these include the dominance of the informal sector which is difficult to monitor, industrial dependence on imported raw materials, and the limited policy instruments available. In this context, the institutional credibility of Bank Indonesia and the quality of public communication become crucial keys to strengthening market expectations, maintaining investor confidence, and securing long-term macroeconomic stability (Bernanke, 2020).

Recent economic literature shows an increasingly close relationship between monetary policy and financial system stability. For example, the use of interest rates as a main instrument can sometimes cause side effects in the form of increased volatility in the banking and capital markets. Therefore, modern monetary policy must be complemented by macroprudential policies to minimize systemic risk and prevent potential financial crises. Bank Indonesia itself has undertaken a number of initiatives, including strengthening open market operation mechanisms, developing sharia-based financial instruments, and planning the issuance of a Central Bank

Digital Currency (CBDC), which is expected to increase financial inclusion and encourage the efficiency of the national payment system (Saraswati et al., 2020).

At the global level, the debate regarding the effectiveness of the inflation targeting framework continues to this day. A number of studies affirm that although the framework has been relatively successful in suppressing inflation to a low level, its implementation often ignores other important aspects, namely the sustainability of economic growth and resilience to external instability (Sethi & Acharya, 2020). This is highly relevant in the Indonesian context, where the balance between price stability and the sustainability of economic growth remains the main concern for policymakers. Therefore, this research is directed to analyze the dynamics of Indonesian monetary policy, focusing on its role in maintaining price stability, controlling inflation, and responding to various global challenges through a literature study approach.

2. Literature Review

2.1. Development of Indonesian Monetary Policy

Monetary policy in Indonesia over the last two decades has undergone a quite fundamental change, especially since Bank Indonesia officially implemented the Inflation Targeting Framework (ITF) in 2005. The implementation of this framework marked a shift in the orientation of monetary policy to be more targeted, placing the benchmark interest rate as the main instrument to achieve the set inflation target. The interest rate positioned as an expectation anchor, while various other instruments such as open market operations, minimum reserve requirements, and liquidity policies act as complementary supporting instruments. A number of studies, including one by Ruslan et al. (2023), show that changes in the benchmark interest rate have been proven to be able to influence inflation dynamics and contribute to national economic stability, although the impact is not always immediately apparent. The effects of interest rate policy often experience a delay due to existing structural barriers in the domestic economy, such as the dominance of the informal sector and the limitations of the financial market (Adely et al., 2021).

In its implementation, Indonesian monetary policy also faces quite complex external challenges. The volatility of the rupiah exchange rate and global interest rate fluctuations have been shown to put pressure on domestic inflation. A study conducted by Hudaya and Firmansyah (2023) confirms that global shocks have a real impact on domestic price stability, encouraging Bank Indonesia to respond with more adaptive and flexible policies to maintain the stability of the financial system. In addition, the study by Bernanke (2020) underlines the importance of the central bank's policy credibility as a factor that strengthens market confidence and guides the public's inflation expectations. Therefore, monetary policy today is no longer just seen as a technical instrument, but also as a strategic policy that emphasizes the importance of public communication, transparency, and accountability.

2.2. Monetary Policy and Financial Stability

Along with the increasing interconnectedness between monetary policy and financial system stability, the central bank's role faces much more complex challenges in maintaining macroeconomic balance. A study conducted by Saraswati et al. (2020) confirms that monetary policy in Indonesia not only has a direct influence on inflation movements but also has an impact on the performance of the banking sector and the dynamics of the capital market. This condition shows that monetary policy cannot stand alone, but needs to be combined closely with macroprudential policies so that systemic risks that have the potential to cause financial crises can be prevented earlier. Global economic literature also highlights the limitations of a rigidly implemented inflation targeting framework. According to an analysis by Sethi and Acharya (2020), even low inflation achievements do not automatically guarantee overall economic stability, especially if the financial sector is still vulnerable to external shocks and global volatility. The relevance of this finding is very clear for Indonesia, given that fluctuating foreign capital flows often trigger exchange rate volatility and add to domestic inflationary pressure.

As a form of response, Bank Indonesia strengthens its policy strategy through the implementation of a dual instrument. This step includes developing sharia-based financial instruments, accelerating monetary digitalization with the discourse of issuing a Central Bank Digital Currency (CBDC), and optimizing a more integrated mix of fiscal and monetary policies.Thus, the available literature shows that the effectiveness of Indonesian monetary policy is basically greatly influenced by the central bank's ability to adapt to global dynamics, maintain institutional credibility, and expand the scope of policy towards creating a more inclusive, resilient, and sustainable financial stability.

3. Methods

This study uses a library research method, which focuses on the collection, analysis, and synthesis of scientific literature related to monetary policy in Indonesia. This method was chosen because the issue of monetary policy is closely related to macroeconomic theory, central bank practices, and global dynamics that can only be understood comprehensively through an extensive literature review. The data collection process is carried out by searching international journals, proceedings, official reports from Bank Indonesia, and other recent scientific publications to be in line with developments. Some of the main sources come from reputable journals that discuss monetary policy, financial stability, and the application of the Inflation Targeting Framework (ITF) in Indonesia. These articles are analyzed to identify key themes, such as the effectiveness of interest rates in controlling inflation, the relationship between monetary policy and financial system stability, and policy adaptation to external challenges.

The analytical approach used is descriptive-analytical, which involves presenting existing facts and research findings, then linking them to the conceptual framework of monetary policy. The literature found is compared and synthesized to form a comprehensive understanding of the dynamics of Indonesian monetary policy. For example, the study by Hudaya and Firmansyah (2023) which emphasizes the influence of global shocks on domestic inflation is linked to the study by Ruslan et al. (2023) which highlights the credibility of monetary policy post-pandemic. This synthesis allows researchers to see the continuity and differences in academic views regarding the effectiveness of monetary policy in Indonesia.

In addition, the library research method also provides room for normative analysis regarding the strategic role of the central bank. By reviewing global literature, such as the study by Sethi and Acharya (2020) on the limitations of the inflation targeting framework, researchers can draw lessons that are relevant to the Indonesian context. This approach not only emphasizes the technical aspects of monetary policy but also the strategic and institutional implications in maintaining economic stability. Thus, the library research method used in this study does not only aim to describe Indonesian monetary policy but also to analyze its effectiveness in facing domestic and global challenges. This approach produces a comprehensive picture of how monetary policy develops, adapts, and contributes to price stability and sustainable economic growth.

4. Results

The results of this literature review research indicate that Indonesian monetary policy has a very central role in maintaining national economic stability. This role is mainly realized through efforts to control inflation, maintain the stability of the exchange rate, and support sustainable economic growth. Based on the literature analyzed, it can be concluded that the monetary policy framework implemented by Bank Indonesia, especially since the adoption of the Inflation Targeting Framework (ITF) in 2005, has had a significant positive impact on macroeconomic stability. This policy framework emphasizes the importance of using the benchmark interest rate as a main instrument to guide the inflation expectations of the public and market players. However, the effectiveness of this policy is not always absolute, because it is influenced by external factors in the form of global dynamics and domestic factors that are structural in nature, such as instrument limitations and real sector conditions.

A study conducted by Hudaya and Firmansyah (2023) confirms that global shocks, such as the international financial crisis and changes in the benchmark interest rate in the United States, have a significant impact on the rate of inflation in Indonesia. This impact occurs because of the increasingly close link between the domestic financial market and the global financial system, so that any changes at the international level have the potential to cause rapid transmission into the country. The adjustment of domestic interest rates carried out by Bank Indonesia is indeed able to withstand inflationary shocks, but the results are often only short-term due to strong external pressure. This condition shows that monetary policy cannot stand alone but must be integrated with other policies, especially fiscal policy concerning state expenditure and revenue management, and macroprudential policy that functions to maintain the stability of the entire financial system. This finding is in line with the view of Bernanke (2020) who emphasize that the credibility of monetary policy is a crucial factor in guiding public expectations. The credibility of the central bank ultimately becomes the key that determines policy effectiveness, because the public's inflation expectations are greatly influenced by the level of confidence in Bank Indonesia's commitment to maintaining price stability.

Furthermore, the review results show that Indonesian monetary policy is no longer only oriented towards achieving price stability but has also started to pay attention to the dimension of financial system stability. Research proves that changes in policy interest rates can have a direct impact on banking conditions, especially with regard to liquidity, asset quality, and potential credit risk. Therefore, Bank Indonesia strengthens coordination with macroprudential policies through measures such as regulating the loan to funding ratio, managing foreign exchange reserves, and setting provisions regarding banking liquidity. These efforts are intended to reduce the potential for systemic risk that could threaten overall financial stability (Handayani et al., 2021). Thus, monetary policy has developed into a multidimensional instrument that not only functions to regulate the amount of money in circulation but also acts as one of the main pillars in supporting the stability of the national financial system.

The results of the analysis also found that the volatility of the rupiah exchange rate is one of the main challenges in the implementation of monetary policy in Indonesia (Kuncoro, 2020). Exchange rate fluctuations are often triggered by the movement of foreign capital that enters and exits the domestic financial market quickly, especially when there are changes in global sentiment. In certain conditions, rupiah depreciation can increase the price of imported goods, which in turn adds to domestic inflationary pressure. To face this challenge, Bank Indonesia not only relies on interest rate policy but also intervenes in the foreign exchange market with the aim of maintaining the stability of the rupiah. A study conducted by Sethi and Acharya (2020) warns that even if inflation is successfully controlled, exchange rate instability and financial market volatility can still be a serious threat to the national economy. This is increasingly relevant in the era of globalization, when the integration of international financial markets is getting closer and foreign capital flows are very sensitive to changes in global monetary policy.

In line with that, the analyzed literature also shows that the Covid-19 pandemic provided valuable lessons about the importance of flexibility in monetary policy. During the crisis, Bank Indonesia took quick steps by significantly lowering the benchmark interest rate and expanding liquidity policies to support national economic recovery. In addition, monetary policy was also supported by a relaxation of macroprudential policies to maintain banking stability and ensure the smooth flow of financial intermediation. The study by Ruslan et al. (2023) confirms that the credibility of monetary policy was maintained even when facing heavy pressure, because Bank Indonesia was able to balance three main goals at once, namely maintaining price stability, supporting economic growth, and ensuring the stability of the financial sector. These steps show that flexibility and adaptability are key to maintaining the effectiveness of monetary policy, especially in the face of high global uncertainty. Bank Indonesia holds a strategic role in guiding, maintaining, and stabilizing the interconnected global economic system (Andersson et al., 2021). This strategic role includes various dimensions that are not only limited to domestic policy but also have broad implications for the international economic order. One of the main roles is as a determinant of monetary policy which aims to control inflation, maintain exchange rate stability, and support sustainable economic growth (Younsi & Nafla, 2019).

Another prominent aspect of the research results is the important role of public communication in increasing the effectiveness of monetary policy. The transparency, consistency, and openness of Bank Indonesia's communication have been proven to be very influential in guiding the public's inflation expectations and strengthening policy credibility. By conveying policy directions clearly, systematically, and easily understood by the public, the central bank can minimize uncertainty in the market while increasing the level of confidence of economic actors. The study by Bernanke (2020) emphasizes that good public communication is not just a supporting tool but is a strategic factor that determines the success of monetary policy, especially when the central bank is faced with a dilemma between lowering inflation and encouraging economic growth.

In addition to the technical dimension, the research results also highlight the importance of monetary policy innovation in Indonesia. One of the breakthroughs being developed by Bank Indonesia is the Central Bank Digital Currency (CBDC). This initiative aims to increase the efficiency of the payment system, expand financial inclusion, and strengthen monetary sovereignty. The development of CBDC is in line with a global trend, where many central banks around the world are starting to test digital currencies in response to developments in financial technology and the increasing use of digital assets. For Indonesia, the presence of CBDC is not only expected to increase transaction efficiency and expand access to financial services but also to be an instrument to reduce the risks of using uncontrolled digital assets that have the potential to disrupt monetary stability.

Besides CBDC, the results of the literature study also confirm the importance of integrating sharia instruments in Indonesian monetary policy. Given the great potential of the sharia financial market in Indonesia, Bank Indonesia seeks to expand its monetary policy base through the development of sharia-based instruments. This is not only relevant for supporting monetary stability but is also important in encouraging more inclusive, just, and suitable economic growth for the majority Muslim population of Indonesia. In this way, monetary policy in Indonesia not only emphasizes technical effectiveness but also promotes the spirit of social inclusivity and sustainable economic development.

The results of this study show that Indonesian monetary policy has developed into an increasingly complex policy with the demand to maintain a balance between three main goals, namely price stability, financial system stability, and sustainable economic growth. Policy effectiveness is highly dependent on the central bank's credibility, flexibility, and ability to respond to continuously changing global dynamics. Amid challenges in the form of external volatility, Indonesian monetary policy has shown adaptability through strengthening coordination with fiscal and macroprudential policies, increasing the transparency of public communication, and developing innovative policy instruments such as CBDC and sharia instruments. With these strategic steps, Indonesian monetary policy can continue to contribute significantly to macroeconomic stability, while supporting more inclusive, resilient, and sustainable economic growth.

5. Discussion

The research results show that Indonesian monetary policy has undergone an evolution from a traditional focus on controlling inflation to a broader role in maintaining financial system stability and supporting sustainable economic growth.

This discussion highlights three main aspects, namely the effectiveness of monetary policy in the domestic context, external challenges that influence policy implementation, and the strategic innovations carried out by Bank Indonesia in strengthening the monetary foundation.

First, the effectiveness of domestic monetary policy is greatly influenced by the central bank's credibility in maintaining price stability and guiding inflation expectations. The study by Bernanke (2020) confirms that public confidence in the central bank's commitment is an absolute prerequisite for monetary policy to be effective. This credibility is strengthened through the Inflation Targeting Framework (ITF) which allows Bank Indonesia to control inflation more measurably by making the benchmark interest rate an anchor for expectations. However, the effectiveness of the ITF is not always maximal given the structure of the Indonesian economy which still faces fundamental constraints, such as high dependence on imported raw materials and the dominance of the informal sector which limits the transmission of monetary policy.

Second, external challenges are a determining factor that often tests the capacity of Indonesian monetary policy. The volatility of the rupiah exchange rate triggered by the movement of foreign capital, global energy price fluctuations, and changes in monetary policy in developed countries, especially the United States, can trigger inflationary pressure and financial market instability. Hudaya and Firmansyah (2023) highlight how external shocks directly impact domestic inflation, while Bank Indonesia must balance its policy response between price stability and maintaining economic growth. This policy dilemma is even more complex when global interest rates increase, because an overly aggressive domestic interest rate hike can depress investment and consumption, while a too slow increase risks worsening the rupiah's depreciation. Third, monetary policy innovation is an important aspect in facing global and domestic dynamics (Walter & Wansleben, 2020). The development of the Central Bank Digital Currency (CBDC) shows that Bank Indonesia is not only reacting to short-term challenges but also anticipating long-term structural changes in the financial system. The CBDC is expected to increase transaction efficiency, expand financial inclusion, and strengthen monetary sovereignty amid developments in financial technology.

In addition, the integration of sharia-based monetary instruments reflects Bank Indonesia's commitment to creating an inclusive policy that is in line with the characteristics of the domestic market. The discussion also confirms that monetary policy cannot be seen as a completely technical instrument. Its impact on price levels, employment opportunities, and economic growth makes monetary policy a strategic instrument that requires cross-sectoral coordination. This is in line with the findings of Saraswati et al. (2020) who emphasize the close relationship between monetary policy and financial system stability. Therefore, policy coordination between monetary, fiscal, and macroprudential is a prerequisite for policy effectiveness in Indonesia.

By considering the research findings, it can be concluded that Indonesian monetary policy has succeeded in maintaining stability in the face of various shocks, but still faces challenges in balancing price stability and economic growth. Future success will be highly determined by policy consistency, strengthening public communication, and strategic innovations such as monetary digitalization and the integration of sharia instruments. With these strategic steps, Bank Indonesia can strengthen its role as a monetary authority that not only maintains short-term stability but also supports long-term economic growth that is inclusive and sustainable.

6. Conclusion

This study affirms that Indonesian monetary policy has a vital role in maintaining price stability, controlling inflation, and supporting sustainable economic growth amid increasingly complex global dynamics. By adopting the Inflation Targeting Framework (ITF), Bank Indonesia is able to make the benchmark interest rate the main instrument in guiding inflation expectations, while balancing macroeconomic stability. However, the effectiveness of monetary policy is not entirely free from external challenges, such as exchange rate volatility, foreign capital flows, and changes in global interest rates which often cause pressure on the domestic economy.

Besides the technical dimension, central bank credibility and the quality of public communication have been proven to be strategic factors in maintaining market confidence. Coordination with fiscal and macroprudential policies is also an important prerequisite for reducing systemic risk and strengthening financial stability. Policy innovations, including the development of a Central Bank Digital Currency (CBDC) and the integration of sharia-based instruments, show that Bank Indonesia is not only responsive to short-term challenges but also visionary in anticipating long-term structural changes. Thus, Indonesian monetary policy can no longer be seen merely as a technical instrument but as a national strategy to maintain economic stability while expanding financial inclusion. Consistency, flexibility, and innovation will be the main foundation for the effectiveness of Indonesian monetary policy in the future in facing global challenges and realizing inclusive and sustainable economic growth.

References

Adely, F. I. J., Mitra, A., Mohamed, M., & Shaham, A. (2021). Poor education, unemployment and the promise of skills: The hegemony of the "skills mismatch" discourse. *International Journal of Educational Development*, *82*, 102381.

Andersson, M., Axelsson, T., & Palacio, A. (2021). Resilience to economic shrinking in an emerging economy: the role of social capabilities in Indonesia, 1950–2015. *Journal of Institutional Economics*, *17*(3), 509-526.

Bernanke, B. S. (2020). The new tools of monetary policy. *American Economic Review*, *110*(4), 943-983.

Handayani, M., Farliani, T., Fandika, R., & Islami, I. (2021). Peran Bank Indonesia Dalam Menjaga Stabilitas Sistem Keuangan Di Tengah Pandemi Covid 19. *Jurnal Penelitian Ekonomi Akuntansi (JENSI)*, *5*(2), 171-182.

Hudaya, A., & Firmansyah, F. (2023). Financial stability in the Indonesian monetary policy analysis. *Cogent Economics & Finance*, *11*(1), 1-17.

Kuncoro, H. (2020). Interest rate policy and exchange rates volatility lessons from Indonesia. *Journal of Central Banking Theory and Practice*, *9*(2), 19-42.

Mirza, N., Naqvi, B., Rizvi, S. K. A., & Boubaker, S. (2023). Exchange rate pass-through and inflation targeting regime under energy price shocks. *Energy Economics*, *124*, 106761.

Ruslan, D., Tanjung, A. A., Lubis, I., Siregar, K. H., & Pratama, I. (2023). Monetary Policy in Indonesia: Dynamics of Inflation, Credibility Index and Output Stability Post Covid 19: New Keynesian Small Macroeconomics Approach. *Cuadernos de economía*, *46*(130), 21-30.

Saraswati, B. D., Maski, G., Kaluge, D., & Sakti, R. K. (2020). The effect of financial inclusion and financial technology on effectiveness of the Indonesian monetary policy. *Business: Theory and Practice*, *21*(1), 230-243.

Sethi, D., & Acharya, D. (2020). Monetary policy and financial stability: the role of inflation targeting. *Australian Economic Review*, *53*(1), 50-75.

Walter, T., & Wansleben, L. (2020). How central bankers learned to love financialization: The Fed, the Bank, and the enlisting of unfettered markets in the conduct of monetary policy. *Socio-Economic Review*, *18*(3), 625-653.

Younsi, M., & Nafla, A. (2019). Financial stability, monetary policy, and economic growth: Panel data evidence from developed and developing countries. *Journal of the Knowledge Economy*, *10*(1), 238-260.