# The Role Of Monetary Policy In Indonesia's Economic Development

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## Abstract

As a reflection of monetary policy, this study examines how Indonesia's money supply, savings, and credit at banks affect economic growth in Indonesia. With a study period of 2000 to 2021, this investigation makes use of secondary data from Bank Indonesia. Using an error correction model analysis, this study examines economic growth, money supply, total bank credit ratio, and total domestic savings. We found that monetary policy in Indonesia related to the money supply, total savings, and total credit is reflected in changes in the money supply, total savings, and total credit. Monetary policy which has a direct impact on the banking sector has a significant impact on economic growth. Appropriate monetary policy can encourage economic growth and improve people's welfare. However, inaccurate monetary policy endangers the country's economy.

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## Background

Monetary policy is one type of economic policy that influences various macroeconomic variables such as inflation, especially national. Through the economic developments witnessed in the history of economic thought on the critical side, he provides many points of view on monetary policy and the phenomenon of inflation, by analyzing the latter two and interpreting them from several aspects, attempt to discover a reasonable explanation that aids in combating the inflationary phenomena through monetary policy. The setting of a market economy employs independent monetary policy (Widarni, Drean, & Bawono, 2022).

Monetary policy is a system for economic stability and supports the macroeconomy in achieving a level of balance on the monetary side of the country so as to assist in achieving the desired economic development. Monetary policy is considered one of the areas of economic policy that influences economic activity because of its role in the monetary aspect of the country (Hidayanti & Prabowo, 2021).

Monetary policy is defined as an optimal strategy or guideline for action taken by the monetary authority to participate effectively in directing economic units towards achieving balanced growth by increasing national product to the extent that it guarantees access for countries to relatively stable prices, goods, services, interest rates, and exchange of national currencies (Bernanke, 2020).

Monetary policy is also defined as a set of rules, methods, procedures, and actions taken by monetary authorities to influence or control the money supply in line with economic activities to achieve certain economic goals, during a certain period of time (Chugunov, Pasichnyi, Koroviy, Kaneva, & Nikitishin, 2021). Monetary policy is a policy that has a relationship between money and the banking system, and which influences the money supply to control people's purchasing power (Sasongko & Huruta, 2018). Additionally, the methods used by the government or monetary authority to control the money supply and interest rates in order to achieve or maintain

full employment while preventing inflation (Abuselidze, 2019). Monetary policy is a practical path carried out by monetary authorities with the aim of influencing the monetary side of the country, to assist economic policy in ensuring and achieving economic growth (Dell'Ariccia, Rabanal, & Sandri, 2018).
A comprehensive economic system for the economy as a whole by controlling the quantity of money supplied and thereby achieving a balanced monetary level for the country (Lei, Xu, & Jin, 2022). In the 19th century, inflation and other monetary problems became important factors that led to the emergence of the study of monetary policy issues, and in the twentieth century, the study of monetary policy became an integral part of the economic policy of countries (Bordo & Levy, 2021).
The rediscount policy is one of the oldest tools used by central banks to control credit, as the Bank of England first used this tool in 1839, followed by the Bank of France in 1857, then the US Federal Reserve FED in 1913. Algeria in 1972. Although there may be some differences in the list of securities that the central bank accepts in the rediscount process (Lessambo, 2020).
Because of the close relationship between the discount rate and market interest rates, which is a positive relationship whereby an increase in the discount rate leads to an increase in market interest rates and vice versa, the effect of the discount rate can be seen (Landier & Thesmar, 2020). The focus is on influencing the credit market because it gives the central bank the ability to influence Commercial banks will reduce the discount rate if the monetary authorities want to extend loans or credit extended by commercial banks to their clients, but if the monetary authorities want to limit the volume of credit, they are forced to increase the discount rate. Therefore, this tool affects the lending capacity of banks, either by increasing or decreasing (Khalaf, 2018). If the central bank wants to reduce the money supply as a result of the latter reaching undesirable levels due to excessive lending expansion, the central bank will follow a deflationary monetary policy aimed at reducing the money supply, and the central bank will try to implement it. this policy by increasing the discount rate and thereby increasing the cost of borrowing and the liquidity provided by commercial banks, which encourages them to reduce their borrowing from the central bank and thereby reduce the credit or loans made (Kuttner, 2018).
An increase in the discount rate by the central bank will be adjusted concomitantly with an increase in the current bank discount rate (Walter & Wansleben, 2020). An increase in the cost of loans extended to their customers by commercial banks leads to a decrease in the demand for credit, since the expected return on investment of borrowed funds will be lower than before, and therefore this procedure will end the expansion in the provision of credit, which will reduce monetary expenditures and limit inflation pressure level (Abusharbeh, 2022). But if the monetary authorities see that there is a shortage of cash in circulation, the central bank will follow an expansionary monetary policy, because it will lower the discount rate, which will encourage commercial banks to go to the central bank for more money. Financial reserves will be converted into legal money, and thus their monetary reserves and their ability to create credit will increase (Nabi, Ullah, Shaeba, & Alamin, 2022).
Open market operations mean central bank intervention in the stock market, as a seller or buyer of financial and commercial securities, in general, and government securities, in particular, with the aim of influencing the volume of credit and the total supply of money according to prevailing economic conditions (Mosser, 2020). Central Bank activities in this area can extend to dealing with all types of commercial and financial securities, gold and foreign currency, on the basis of maintaining stocks and bonds in its financial portfolio (Mancini-Griffoli et al., 2018). And when

an unwanted state of economic downturn occurs, the central bank intervenes as a purchaser of securities, leading to an increase in the volume of cash balances with commercial banks and subsequently their ability to extend credit, leading to a recovery in economic activity countries and vice versa occurs when the central bank aims to follow a contractionary monetary policy, or when it is necessary to reduce credit (Macalós, 2020).
Under conditions of inflation, the Central Bank provides credit according to priority sectors which are not causes of inflation (Wansleben, 2018). Meanwhile, when inflation spreads sharply, the state formulates a mandatory loan framing policy, then the central bank determines the maximum volume of loans provided by banks, or determines the loan growth rate, and usually the loan framing policy is accompanied by a stabilization program for the monetary mass, such as reducing public spending (Coombs & Thiemann, 2022). Encouraging savings , issued bonds, and took all necessary means to reduce excess monetary mass (Nersisyan & Wray, 2021).
Changes in the money supply, savings, and credit at banks are all impacted by monetary policy (Ufoeze, Odimgbe, Ezeabalisi, & Alajekwu, 2018). As a reflection of monetary policy, this study examines how Indonesia's money supply, savings, and credit at banks affect economic growth in Indonesia.

## Research Method

With a study period of 2000 to 2021, this investigation makes use of secondary data from Bank Indonesia. This study uses Error Correction Model (ECM) analysis with the following econometric equations to look at economic growth, money supply, ratio of total bank credit, and ratio of total domestic savings.

$$EG_t = \beta_0 + \beta_1 Ms2_t + \beta_2 Rt_t + \beta_3 Dv_t + e_t$$

Economic growth is denoted by EG, while the money supply is denoted by Ms, total bank credit is denoted by Rt, and domestic savings are denoted by Dv. β is coefficient, is error term, and t is time period.

## Results and Discussion

Results of the ECM estimation are shown for both the short term and the long term. The short-term estimation findings demonstrate the link between short-term influence, which is shown in table 1. And the findings of the long-term estimation demonstrate the link between long-term influence, which is shown in table 2.

**Table 1.** Short-term ECM Results

| | **Coeff.** | **t-stat.** | **Prob.** |
|---|---|---|---|
| **Ms** | -0.071249 | -0.726114 | 0.0000 |
| **Rt** | 0.082113 | 0.211532 | 0.0000 |
| **Dv** | 0.072317 | 0.628154 | 0.0000 |

The money supply significantly inversely economic growth in the short run. The ratio of total domestic savings to total bank credit has a positive favourably benefic influence. This indicates that the increase in the money supply must be controlled so as not to depress economic growth.

**Table 2.** Long-term ECM Results

| | Coeff. | t-stat. | Prob. |
|---|---|---|---|
| **Ms** | 0.021152 | 0.132743 | 0.0000 |
| **Rt** | -0.01121 | 0.546251 | 0.0000 |
| **Dv** | 0.021161 | 0.823112 | 0.0000 |

In the long run, the money supply has significantly impacted favourably. However, the ratio of total bank credit has significantly impacted and inversely even though domestic savings significantly impacted favourably on economic growth in Indonesia.

## Conclusions

Monetary policy in Indonesia related to the money supply, total savings, and total credit is reflected in changes in the money supply, total savings, and total credit. Monetary policy which has a direct impact on the banking sector has a significant impact on economic growth. Appropriate monetary policy can encourage economic growth and improve people's welfare. However, inaccurate monetary policy endangers the country's economy.

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