

The Effect of Inflation and Interest Rates on Economic Growth in Indonesia

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ABSTRACT

This study aims to analyze the effect of inflation and interest rates on economic growth in Indonesia in the 2016-2021 period. The analysis method uses multiple linear regression analysis with the Eviews program. The results showed that the inflation variable did not significantly impact economic growth, while the interest rate variable significantly affected economic growth. This means that inflation cannot be a reference factor in economic growth because it is not substantial to economic growth in 2016-2021 of 1.51%, which is smaller than the t-table. On the contrary, the ttable on interest rates had a significant effect of 4.7% on the economic growth in the year in Indonesia. The inflation rate and interest rate as free variables, while economic growth as variables is bound. The type of data used is secondary data with a quantitative approach. Sample determination based on data for 2016-2021 uses a saturated sampling method obtained through Bank Indonesia and the Central Statistics Agency (BPS) websites.

INTRODUCTION

Economic expansion has become a focal point in global financial discussions. Nations' progress can be evaluated through various metrics, with economic growth being a crucial indicator. To achieve rapid economic advancement, countries primarily rely on economic development strategies. Economic growth quantifies the increase in a population's economic output and income generation within a specific timeframe. This growth often results in enhanced productivity, leading to increased output and, consequently, higher incomes for citizens. Essentially, economic growth represents the broadening of a country's economic activities, resulting in greater production of goods and services and an overall increase in national wealth over time. The effectiveness of a country's development efforts is frequently gauged by its rate of economic growth.

The advancement of all countries hinges significantly on economic development, as it plays a vital role in enhancing quality of life, tackling associated challenges, and diminishing poverty levels. This process of growth is fundamental in shaping the overall well-being and prosperity of nations. (Atigala et al., 2022).

The relationship between inflation and economic growth is a subject of debate in economic theory. Several major schools of thought, including the Tobin Effect, Neo-Keynesian Theory, Keynesian Theory, Neo-Classical Theory, and Endogenous Growth Theory, propose that inflation plays a crucial role in stimulating economic growth. This viewpoint has led to significant controversy surrounding the inflation-growth connection, with disagreements arising in both theoretical discussions and empirical studies. The complexity of this relationship continues to be a topic of interest and contention among economists. (Bhunia, 2016).

Economic challenges, particularly high inflation rates and slow economic growth, are common issues faced by developing countries. Despite long-term efforts to implement monetary policies aimed at curbing inflation, these measures have not yielded the expected results, according to (Tanner, 2021). Inflation serves as a crucial economic indicator, and the goal is always to maintain its growth rate at a low and stable level. This approach is essential to prevent macroeconomic imbalances that could lead to economic instability. The significance of inflation extends beyond economic metrics, as it directly impacts people's quality of life by influencing their purchasing power (Cupak & Siranova, 2023).

As inflation rates climb, consumers may experience a decline in their purchasing power. Conversely, when inflation levels decrease, there's potential for an increase in the public's ability to purchase goods and services. This inverse relationship between inflation and purchasing power highlights the significant impact that price changes can have on consumers' economic well-being.

LITERATURE REVIEW

Inflation serves as a crucial macroeconomic indicator with far-reaching effects across various economic sectors. It's important to note that not all inflation is detrimental to the economy. In fact, moderate inflation, typically below 10 percent, can act as a catalyst for economic growth. This mild inflationary environment can stimulate entrepreneurs, encouraging them to boost their production levels.

Achieving and maintaining a low and stable inflation rate requires collaborative efforts between the government, the private sector, and Bank Indonesia. While moderate inflation can be beneficial, high inflation rates warrant careful attention due to their potential to destabilize the economy or hinder economic growth. The management of inflation thus plays a pivotal role in fostering a healthy economic climate, balancing between providing sufficient stimulus for growth and avoiding the pitfalls of excessive price increases.

Macroeconomic stability is often gauged through price stability, and persistent high inflation rates are generally viewed as unfavorable indicators. When inflation levels fluctuate significantly, it creates challenges for businesses, individuals, and government entities alike. These substantial price variations can have a detrimental effect on the economy's capacity for sustained growth over an extended period. The unpredictability and volatility associated with high inflation can undermine economic planning and investment decisions, potentially limiting the overall long-term economic potential of a nation. (Anagaw, 2023).

An important financial indicator, inflation can positively and negatively impact the economy. If a country's economy experiences sluggishness, then Bank Indonesia can conduct an expansionary monetary policy by lowering interest rates.

Interest rates and inflation both significantly influence economic growth. According to by Mgbemena, Onyinye. O & Kalu (2016) identify interest rates as a crucial economic cost, asserting their fundamental impact on the economy, regardless of opportunity costs. As a key macroeconomic variable, interest rates directly affect economic expansion. interest rates as the cost associated with using currency for a specific period, or simply put, the price for utilizing loanable funds. Sanga et al. (2023) note that governments regulate and establish interest rates to maintain national economic health. These rates are particularly important as they shape investor expectations for investment returns. (Alam & Uddin, 2009). Interest rates are the price of the use of loanable funds. The research by Sanga et al., (2023) note that governments regulate and establish interest rates to maintain national economic health. These rates are particularly important as they shape investor expectations for investment returns.

The economy's real and monetary sectors are notably impacted by fluctuations in interest rates. Research indicates that in the long term, an extended money supply, along with interest rates and the natural logarithm of exchange rates, had a significant positive effect on GDP.

Interest rates thus play a multifaceted role in shaping economic outcomes, influencing everything from individual investment decisions to broader macroeconomic trends.

According to by Semuel, Hatane & Nurina (2015), A nation's Gross Domestic Product (GDP) growth is influenced by various macroeconomic factors. Since inflation and interest rates serve multiple functions within the economy, examining their relationship with economic growth carries significant theoretical and practical implications for monetary policy. According to by Taderera, et al, (2021). Economic growth necessitates the preservation of price stability as a crucial requirement. This is accomplished by monitoring inflation rates and utilizing monetary policy instruments, such as interest rates, to ensure they remain low and stable, according by Babalola et al., (2015), Although neither inflation nor interest rates directly drive economic growth, both can have a detrimental effect on it. The study recommended that policymakers aim to keep inflation low (in the single digits) and ensure stable interest rates.

As for other research by Tanner (2021) Ghana experiences a strong positive correlation between interest rates and inflation, which significantly affects its economic growth during this period. However, this correlation was more pronounced from 2006 to 2015 compared to the years 2016 to 2019. The study's empirical findings not only demonstrate the presence of the Fisher effect but also indicate that the nominal interest rate and expected inflation are in long-term equilibrium. However, in the short term, the Fisher effect is absent. As a result, the impacts of monetary policy are not perfect in either the short or long term. (Menshad, 2021).

The interest rate is a key macroeconomic factor that affects economic growth. It is generally considered the cost of funds, or the expense associated with using currency over a specific period. From the borrower's perspective, interest represents the price paid for borrowing money (the borrowing rate). Conversely, for the lender, the interest rate reflects the cost of providing credit (the lending rate). (Alam & Uddin, 2009).

Interest rates are key in determining economic growth (Sultana, 2018). Increased capital costs and decreased economic investment are two effects of higher interest rates that stifle economic growth. On the other hand, the increase in the saving rate is the one-way interest rate that helps the economy grow.

When interest rates are low on savings and high for investors' borrowing costs, they become the cost of capital. Interest rates are a return on investment; low rates are charged when lending, and investors are encouraged to save high (Mgbemena, Onyinye. O & Kalu, 2016). Interest rates play a critical role in the global economy's expansion and development by supporting the equitable distribution of resources (S. Inam & E. Etim, 2020). Many developing nations experienced slow economic growth and high inflation following the global financial crisis. Many researchers have attempted to quantify the connection between economic expansion and price increases due to the many questions this trend has raised (Taderera, Christie and Runganga & Simbarashe, and Mishi, 2021). Interest rate changes have always been one of the most crucial

macroeconomic policy variables because of their significant influence on economic agents' decision-making. This has drawn the attention of economic actors and participants (Karami, 2007).

Interest rates can impact foreign investors' perception of a country and their interest in investing money there in the context of the global economy. Because Indonesia's interest rates are higher than those in other Southeast Asian nations, foreign investors will be more interested in investing there to earn higher returns. Foreign investors are less likely to invest in Indonesia when interest rates are low. One of the domestic investors may transfer the funds overseas if interest rates are too low (Fitriani, 2019).

Interest rate influences on economic growth have a mixed effect and can be felt through various channels, but only concerning consumer spending and business investment choices (Drobyshevsky, 2017).

The relationship between inflation and economic growth is interrelated. If high inflation can cause economic growth to slow down, on the other hand relatively low and stable inflation can encourage economic growth. (Sitanggang et al., 2022).

Significance of expansion and financial development. Any nation is concerned approximately expansion file for financial development and supportability. Since, in the event that the expansion rate surpasses the drive reaction, it causes diminishing GDP development. (Van Dinh, 2020).

Economic growth measures a nation's capacity to produce more goods and services. Measuring economic growth continuously is important because it reveals whether the economy can survive with society's growing demand in various aspects (Nalaka, 2020). Economic growth is a sign of successful development. Long-term economic growth is the process of raising output per person. As a result, economic growth results in greater welfare (Sukirno, 2013).

Bank Indonesia (BI) has made room for an accommodative monetary policy to reduce inflation and stimulate domestic economic growth. Because of this, the Central bank will be able to reduce key interest rates shortly. The central bank's lowering of interest rates encourages investment, which spurs economic expansion. A nation's top priority should be economic growth. The government will create policies to promote economic development and social well-being. Strategies for boosting the economy through entrepreneurship, exports, employment, investment, and infrastructure (Fitriani, 2019).

According to Ajide and Lawanson, economic growth in neoclassical theory is caused by an increase in the number of productive resources measured by GDP and the effectiveness with which they are distributed and used. Each country's monetary policy aims to maintain stable prices for its goods and services to encourage sustainable development and GDP (Anochiwa L.I; Maduka, 2010).

To a large extent, economic growth is affected by the interplay between inflation, interest rates, and inflation rates. Inflation and GDP have a positive relationship, which implies that higher inflation causes higher growth rates and vice versa (Canakci, 2021). According to by Okeke, C. Charles; Awogbemi, (2016) interest rates play a crucial role in the efficient allocation of resources to

promote economic growth and development and in a demand management strategy to achieve internal and external balance, with a particular emphasis on mobilizing deposits and generating credit to support economic development.

According by Khumalo et al., (2017) the theory that links inflation and interest rates, inflation is a state of the economy in which the general level of prices paid by consumers for goods and services rises over time. The overall economy becomes unstable as a result of this. Both the demand and supply sides of the economy play a role in creating inflation, with the former contributing to cost-push inflation and the latter to demand-pull inflation. However, some strategies can be used to control an economy's inflation rate, including monetary and fiscal policies. These policies use various tools or techniques, such as introducing interest rates to limit aggregate demand for money when interest rates are high and vice versa.

The empirical data suggests no short-term relationship between economic growth and interest rates in the Gambia. However, real interest rates, exchange rates, and GDP are all interconnected in the long run. The Ministry of Finance and Economy has issued a report based on these findings, recommending that The Gambia exercise caution when managing its budget and avoid unnecessary expenditures that could lead to a deficit. Since rising interest rates are detrimental to economic growth, these budget deficits are a major cause of those rates (Matarr & Momodou, 2021). While the data show a weak correlation between unemployment and expansion, it also reveals strong dynamic long-term relationships between interest rates, inflation rates, and economic expansion. Interest rates, unemployment rates, inflation rates, and economic growth are all interconnected, as shown by the Granger causality test. When making choices that support economic stability and growth, policymakers should be aware of these interrelationships (Panigrahi et al., 2020).

Economic growth is one of the annual goals that every country should strive to reach. The economic growth in a country will be one of the benchmarks of success. This is also one of the focuses of the Indonesian state.

Economic growth is a long-term problem that must be done by every country where it is expected to have very rapid economic growth. Every country has the same goal: how to accelerate its economic growth. Economic growth is the long-term process of increasing per capita output continuously. Economic growth is the cause of the healthy economic absence of a Megara, and economic growth becomes an absolute requirement to advance and prosper the nation. Increases in per capita output are a long-term, ongoing process of economic growth. A growing economy is good for a country's economy. A nation must have economic growth in order to be prosperous.

The relationship between interest rates, unemployment, inflation rates, and economic growth is suggested by Granger's test of causality. It is important for policy makers to consider these connections when making decisions in order to support economic growth and stability. (Panigrahi et al., 2020)

The empirical evidence suggests a long-term causal relationship between economic growth and inflation and a one-way causal relationship between

interest rates and economic growth. The results of these studies give the Indian government and policymakers some direction on how low inflation and the best interest rates will affect economic growth in India's current economy. The impact on economic growth was discussed in the paper; the Reserve Bank of India did not alter interest rates while keeping inflation under control. This study addresses the issue of how interest rates and inflation affect economic growth (Bhunia, 2016).

According by Davcev et al., (2018), we can infer from the correlation matrix that Bulgaria's GDP is only weakly negatively correlated with interest rates and inflation. In line with the underlying monetary policy, there is a strong positive correlation between the country's interest rates and inflation rate. Inflation and interest rates in Romania have a negative relationship with GDP, even though they are much higher than in Bulgaria. Additionally, there is a strong positive correlation between interest rates and inflation, suggesting that monetary policy keeps a close eye on the rate at which prices in the country are rising or falling.

Inflation and interest rates have been linked to economic growth in various ways, according to competing for economic theories. In light of the preceding, this research looks into the connection between inflation and interest rates and economic growth in India (Bhunia, 2016). Inflation, interest rates, and economic growth are all intertwined in the long run, but the relationship between unemployment and growth is weak (Panigrahi et al., 2020). Interest rates, unemployment rates, inflation rates, and economic growth are all interconnected, as shown by the Granger causality test. Policymakers should keep these connections in mind as they make decisions that encourage economic growth and stability.

According by Drobyshevsky (2017), higher nominal and real interest rates may not hinder growth, according to the analysis of relatively tight monetary policy at the global level, given lower inflation expectations, the economy's appeal to foreign investors, the effects of technology transfer, and domestic savings accumulation. Although the central bank has moderately tightened monetary policy, the effectiveness of the channels mentioned above in Russia can be used as a prerequisite for accelerating economic growth in the medium term. The risk premium declines as the economy stabilize, and the inflation rate moves closer to the target rate.

Suggested that the government, policymakers, and budgetary educate centre on overseeing swelling by the judicious usage of monetary and money related arrangements and keeping up a control of intrigued rates, the amplified cash supply, and genuine trade rates moreover swelling focusing on ought to be underlined by moving forward the central bank's communication, straightforwardness, and responsibility to dodge swelling instability and invigorate financial development (Sanga et al., 2023).

METHODOLOGY

The Research object with data and numbers, and analysed using The Eviews program and multiple linear regression analysis are used in the analytical process. Secondary data with a quantitative approach make up the type of data used. Sample determination based on data for 2016-2021 uses a saturated sampling method obtained through Bank Indonesia and the Central Statistics Agency (BPS) websites.

RESULTS AND DISCUSSION

1. Model Estimation Results

Table 1. Regression Model Research Table

Independent Variables	Type
	PE
C	-2.318.739
INFLATION	1.455.212
INTEREST	1.175.574
R-squared	0.276453
Adjusted R-squared	0.255480
F-statistic	1.318.175
Prob(F-statistic)	0.000014
Durbin - Watson stat	0.197688

Source: Processed data Eviews 9

Description: Significant Rate *=10% **=5% ***=1%

To see how interest rate inflation affected Economic growth in Indonesia from 2016-2021, we ran some tests using the fixed effect method, and the results are displayed in the table above. Seeing how much the influence of inflation and interest rates in Indonesia has a major effect on economic growth in Indonesia in 2016-2021 with unstable economic growth conditions due to the covid virus outbreak that has hit the whole world, including Indonesia, by seeing that economic growth has grown unfavourably in the last two years.

2. Quantitative Testing Analysis

Research analysis by determining the best method for estimating regression models using three methods: fixed effect, common effect, and random effect. Conducting a chow test aims to compare the common effect model with the best-fixed effect.

Table 2. Chow Test Results

Variable	PE	
	Statistic	Prob
Cross-section F	13.18175	0.0622

Source: Processed data Eviews 9

The variable of interest is the "Cross-section F" statistic, which has a value of 13.18175 and a corresponding probability (Prob) value of 0.0622.

The key points to interpret this Chow test result are the null hypothesis for the Chow test is that the regression coefficients are the same across the two groups or time periods. The F-statistic of 13.18175 is the calculated test statistic value. The probability (Prob) value of 0.0622 is the p-value associated with the F-statistic. Since the p-value (0.0622) is greater than the typical significance level of 0.05 (5%), we fail to reject the null hypothesis. This means that the Chow test results indicate that the regression coefficients (the effect of inflation and interest rates) are not statistically different across the two groups or time periods being examined in this study on the relationship between inflation, interest rates, and economic growth in Indonesia.

3. Coefficient of Determination (R²)

Measuring how much a free variable rises or falls concerning constrained variable yields the R² coefficient of determination. The better the regression model, the higher the value of R² (close to 1), and the closer to zero the dependent variable cannot be explained by itself (Gujarati, 2009), where R-square (R²) is the adjusted R² value. According to the poor nutrition model's explanatory regression data, the free variable (1) Inflation (2) Interest Rate explains why inflation of 0.27 percent in Indonesia over five years cannot fully account for inflation's influence on economic growth.

Table 3. Regression Value R²

	PE
R-squared	0.276453
Adj. R-square	0.255480

Source: Processed data Eviews 9

The result of a value used to be able to see the impact of increasing and decreasing changes in free variables and variables bound to the inflation rate on economic growth in a country is the Coefficient of Determination (R²). The greater the value of R² (close to 1), the better the regression model is against the dependent variable, and the closer to zero the independent variable cannot explain from the dependent variable. Since inflation instability in several cities affects Indonesia's economic growth, the R² value for this variable is 0.27, which suggests that it may have a stronger impact on inflation and interest rates than on economic growth. This is based on the regression data analysis regarding the effect of interest rates and inflation on Indonesia's economic growth.

Such as the increased price of goods too often, the scarcity of manufactured goods and the scarcity of goods in the market can cause unfavourable improvements to economic growth in Indonesia in 2016 - 2021. Many factors caused this influence, one of which is the global economic

problem it happened from late 2019 to 2021, namely covid 19 cases in almost all countries where almost two years of Indonesia experienced covid cases, causing Indonesia's economic growth not to grow well.

The very high increase in the price of goods is due to many people not being able to produce in their business, and many farmers cannot produce their agricultural products in the fields and the garden; this is what makes the effect of inflation on economic growth not so optimal.

4. T-test (Partial Testing)

The T-test is used to determine the presence or absence of significant values between the influence of individual free variables and bound variables by holding other variables to be constant, which is carried out by comparing t-statistics with the t-table degree of freedom values of 72 and a confidence level (α) of 5 percent. The regression of table values at the economy's growth is known to be 3.12.

Table 4. T-Test Results (Economic Growth)

Variable	DF= n-k	A	t- table	t- statistic	conclusion
Inflation	70	5%	3.13	1.518762	insignificant
Interest	70	5%	3.13	4.709692	Significant

Source: Processed data Eviews 9

The results of the T-test explained that there was an insignificant influence on the inflation variable in the last five years of 1.518762 with a significant level of $\alpha = 5\%$ (t-table = 3.13) on economic growth in Indonesia. The inflation-free variable explains that the t-table is larger than the t-statistic and that inflation has no major effect in explaining the economic growth variable in Indonesia. On the contrary, interest rates can explain a significant influence in encouraging the economy in Indonesia.

CONCLUSIONS AND RECOMMENDATIONS

The study examines how inflation and interest rates will affect Indonesia's economic growth from 2016 to 2021. It is possible to conclude from the discussion above that there is a correlation between the effects of inflation and interest rates on Indonesia's economic growth between 2016 to 2021. This means that inflation cannot be a reference factor in economic growth because it is not significant to economic growth in 2016-2021 of 1.51%, which is smaller than the t-table. On the other hand, the interest rate table significantly impacts Indonesia's annual economic growth, which is 4.7%. Interest rates and inflation are regarded as free variables, whereas economic growth is regarded as a bound variable.

The Indonesian government needs to maintain interest rate stability, as the research shows that interest rates have a significant impact on economic growth. Careful monetary policy in managing interest rates can support sustainable economic growth. Although inflation did not show a significant

effect during this research period, the government still needs to monitor and control inflation levels. Stable and controlled inflation can create a conducive economic environment for investment and growth. The government needs to develop a comprehensive strategy to promote economic growth, not relying solely on monetary policy. This could include increasing infrastructure investment, human resource development, and economic diversification.

FURTHER STUDY

Extend the research period to obtain a more comprehensive long-term picture of the relationship between inflation, interest rates, and economic growth in Indonesia. Include other macroeconomic variables such as exchange rates, foreign direct investment, or exports-imports to gain a more holistic understanding of the factors affecting Indonesia's economic growth. Conduct comparative analysis with other ASEAN countries to understand how the influence of inflation and interest rates on economic growth differs in various regional contexts. Investigate the impact of specific monetary policies or major economic events (such as the global financial crisis or COVID-19 pandemic) on the relationship between these variables. Conduct sectoral analysis to understand how inflation and interest rates affect growth in various sectors of the Indonesian economy. Research the optimal threshold of inflation and interest rates that support economic growth in Indonesia.

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