Evaluation of Interest Rate Policies in Creating Financial Stability and Price Stability in Indonesia

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Abstract

This study aims to evaluate the interest rate policy (rediscount policy) by Bank Indonesia to create financial stability and price stability in Indonesia. This research used data on the SBI interest rate, exchange rate of rupiah to US dollar, inflation rate, and money supply in Indonesia from January 2014 to December 2021. The econometric model to test the research hypothesis is the structural equation model - partial least square. The results showed that the interest rate instrument to create financial stability in Indonesia was appropriate because the interest rate had a negative impact on the exchange rate. It means that if desired exchange rate will decrease (the rupiah appreciated) it can be done by increasing the interest rate. However, the policy of raising the interest rate can cause the inflation rate to rise. Because the interest rate has a positive effect on the inflation rate. The money supply can mediate the effect of the interest rate on the inflation rate in Indonesia.

Keywords: inflation, exchange rate, interest rate, money supply

Introduction

The main objective of economic development is to improve people's welfare. The level of community welfare can be seen from the extent to which the community's ability to live. The higher the community's ability to meet their needs, the higher the level of social welfare.

The inflation rate is one of the macroeconomic problems that need attention to maintain people's purchasing power. The inflation rate reflects developments in the prices of goods and services that are widely consumed by the public. The high inflation rate reflects an increase in the prices of goods and services that are widely consumed by the public. The high rate of inflation causes people's purchasing power to decrease and results in a decrease in people's welfare (Subagyo, 2018).

The main task of Bank Indonesia as the central bank in Indonesia is to maintain financial stability and price stability in Indonesia. The price stability indicator uses the inflation rate, while the financial stability indicator uses the rupiah exchange rate against foreign currencies. To create price stabilization and financial stabilization, Bank Indonesia has several monetary policy instruments, one of which is the interest rate.

The inflation rate reflects the movement of the prices of goods and services that are mostly consumed by the public. A high inflation rate means that the prices of goods and services that are widely consumed by the public have increased. The increase in prices causes

people who have a fixed income to experience a decrease in purchasing power. This of course has an impact on reducing the ability of the community to meet their daily needs. In other words, a high inflation rate can reduce the level of social welfare. Therefore, the inflation rate needs to be controlled at a level that does not reduce people's purchasing power so that it does not have a negative impact on efforts to improve people's welfare.

The stability of foreign exchange rates is needed in the Indonesian economy so that the development process, especially economic development to achieve a higher level of social welfare can be achieved. The Indonesian economy exports to obtain foreign currency which will later be used to finance Indonesia's obligations to other countries, such as importing and repaying debts. Indonesia also imports goods and services, because the Indonesian economy still relies on imported goods and services for public consumption and to support domestic production activities. Instability in foreign exchange rates can disrupt Indonesia's export and import activities which in turn can hamper the process of economic development in Indonesia to improve people's welfare. As an effort to manage foreign exchange rates, Bank Indonesia has implemented a free foreign exchange regime. That is, exchange rate fluctuations are determined by the foreign exchange market. Thus, the foreign exchange rate in Indonesia is largely determined by domestic factors and foreign factors which are very difficult for Bank Indonesia to fully control.

The stability of foreign exchange rates and the inflation rate is the responsibility of Bank Indonesia. To create stability in foreign exchange rates and the inflation rate, Bank Indonesia has several monetary policy instruments. The monetary policy chosen by Bank Indonesia so far has often used the interest rate instrument. This interest rate policy often creates a dilemma for Bank Indonesia to create an ideal foreign exchange rate and inflation rate for the Indonesian economy. High-interest rates encourage foreign capital to enter Indonesia and can prevent capital go out of Indonesia so that foreign exchange rates can be kept at a low level. However, on the other hand, high-interest rates can increase production costs and ultimately high inflation rates. Thus this interest rate policy often creates a trade-off between foreign exchange rates and the inflation rate at the desired level.

This study aims to evaluate the effectiveness of the monetary policy that has been carried out by Bank Indonesia so far in creating financial stability (foreign exchange rates) and price stability (inflation rate) through interest rate instruments. The results of this research are expected to obtain empirical evidence of the impact of the interest rate policy implemented by Bank Indonesia on foreign exchange rates and the inflation rate. This research also looks for empirical evidence about the direct and indirect impact of interest rates on the inflation rate. Theoretically, the interest rate has an impact on the rate of inflation through the amount of money circulating in society.

Literature Review and Hypotheses

The foreign exchange rate is the comparison between the domestic value of currency a country and the value of currency another country. The inflation rate is a quantity that describes the price of goods and services consumed by the public. The inflation rate is generally determined based on the percentage change in the consumer price index. The money supply consists of currency and demand deposits. Currency consists of banknotes and coins circulated by a country's central bank. Meanwhile, demand deposits are current accounts issued by commercial banks (Subagyo, 2018). The interest rate is the amount that the lender charges the borrower and is a percentage of the principal or amount lent. The interest rate is also the value that a bank or other financial institution earns from a savings account or certificate of deposit.

This study aims to analyze the impact of interest rates on foreign exchange rates and inflation rates. There are three main theories that underlie the relationship between interest

rates, inflation rates, and foreign exchange rates, namely the purchasing power parity theory, the international Fisher effect theory, and the interest rate parity theory (Madura, 2020). The theory of purchasing power parity states that the value of a country's currency that has a higher inflation rate has an impact on depreciation. The depreciation of the currency is equal to the difference between the inflation of the two countries. The international Fisher effect theory states that under equilibrium conditions the future spot rate of a foreign currency differs from the current spot rate by an amount equal to the difference in nominal interest rates between domestic and foreign. Fisher's hypothesis explains that there is a positive relationship between the interest rate and the inflation rate. The theory of interest rate parity states that there is a relationship between exchange rates and differences in interest rates between one country and another. Investors in the foreign exchange market try to gain from changes in exchange rates by taking into account the movement of interest rates on currency deposits from one country to another. The three theories show the relationship between interest rates, inflation rates, and foreign exchange rates.

Many previous studies have been conducted to prove the effect of interest rates on foreign exchange rates and inflation rates. However, the resulting conclusions are still many that are inconsistent. Puspitaningrum et al. (2014) conducted research on the Indonesian economy using data from 2003-2012, Idris (2021) used data for 2007-2017, Yudha & Hadi (2009) used monthly data for 2002-2006 and concluded that interest rates have a negative effect on foreign exchange rates in Indonesia. However, the results of Kirana's research (Kirana, 2017) used data from 2009-2015, Istiqamah & Septiana (2018) used data from 2013-2015, Wijaya et al. (2019) used data from 1st semester 1997 - 2nd semester 2018, and Setyastiti (2015) used data from August 1997-May 2012 to conclude that interest rates have a positive effect on foreign exchange rates in Indonesia.

Murtadho's research (Murtadho, 2016) on the economies of Indonesia, China, and Australia using data for 2012-2015 found empirical evidence that interest rates have a positive effect on exchange rates in the Indonesian economy. However, interest rates have a negative effect on exchange rates in the economies of China and Australia. The results of research by Kardoyo & Kuncoro (2002) using data from February 1983 to March 2000 concluded that an increase in interest rates in Indonesia could reduce the rupiah exchange rate against American transactions. That is, an increase in domestic interest rates causes the rupiah to appreciate.

Research Amhimmid et al. (2021) on the Indonesian and Libyan economies using data for 2005-2019 and Ningsih & Kristiyanti (2018) using monthly data from 2014-2016 to conclude that interest rates have no effect on inflation in Indonesia. The results of Hadi's research (Hadi, 2005) on the Indonesian economy using data from 1992-2003 show that interest rates have no effect on foreign exchange rates in Indonesia. Meanwhile, the results of research by Saraç & Karagöz (2016) on the Turkish economy using data from February 2002-August 2015 concluded that interest rates have a negative effect on exchange rates.

The research result of Susmiati & Senimantara (2021) shows that the money supply has a negative effect on inflation in Indonesia. Research conducted by Langi et al. (2014) using data from 2005:3 to 2013:3 concluded that interest rates have a positive effect on the inflation rate in Indonesia. The money supply has no effect on the rate of inflation in Indonesia. The results of Larasati and Amri's research (Larasati & Amri, 2017) using data from January 2006 to December 2016 concluded that in terms of interest rate has a positive effect on the inflation rate in Indonesia. Aprileven (2015) used data from 2006-2012 to conclude that interest rates have a positive effect on the inflation rate in Indonesia. Martanto et al. (2021) using data for 1998-2020 using the error correction model approach, concludes that interest rates have a positive effect on the inflation rate in Indonesia.

The impact of interest rates on foreign exchange rates and inflation rates is still an interesting topic for debate because there are theoretical explanations and findings from

inconsistent research results. Research on the impact of interest rates on exchange rates and inflation in Indonesia and other countries also yields different conclusions. Therefore research on the impact of interest rates on foreign exchange rates and inflation rates is still being carried out in various countries.

Interest rates and exchange rates are crucial elements in the transmission mechanism of monetary and fiscal policies in economic activity (Hakkio, 1986). An increase in interest rates on the one hand can strengthen the value of the domestic currency in the monetary sector, but on the other hand, it can reduce investment and production costs in the real sector. A decrease in investment in the real sector can hamper economic growth, while an increase in production costs will increase the prices of goods and services.

The rupiah exchange rate against the US dollar shows a comparison between the rupiah value and the US dollar value. The exchange rate is stated at a certain amount of rupiah for one US dollar. The higher the exchange rate, the lower the value of the rupiah against the US dollar. An increase in the US dollar exchange rate indicates that the rupiah has depreciated and vice versa, a decrease in the US dollar exchange rate indicates that the rupiah has appreciated. An increase in interest rates in Indonesia can encourage the flow of foreign capital into Indonesia so that Indonesia's foreign exchange reserves increase. This increase in foreign exchange reserves shows that the supply of dollars in the country has increased and the price of the US dollar has fallen. In other words, the rupiah has been appreciated. Based on this description, this research formulates the first hypothesis as follows:

H1: The interest rate has a negative effect on exchange rates in Indonesia

In the real sector, the interest rate is the cost of borrowing money. Companies that use loans in carrying out their production activities experience an increase in production costs when there is an increase in interest rates. This increase in production costs can encourage companies to adjust the selling price of their production to maintain the expected profit level. Based on this description, this research formulates the second hypothesis as follows:

H2: The interest rate has a positive effect on the inflation rate.

The interest rate is one of Bank Indonesia's policy instruments in the monetary sector to control the inflation rate. Bank Indonesia uses the interest rate instrument to influence the money supply in society. The increase in interest rates is expected to reduce the amount of money circulating in the community so that the inflation rate decreases. Preferably, when interest rates fall, the amount of money circulating in society increases and the rate of inflation increases. The impact of the interest rate on the rate of inflation differs between the real sector and the monetary sector. An increase in interest rates has an impact on rising prices (inflation rate) in the real sector. However, in the monetary sector, price increases can reduce the amount of money circulating in society and the inflation rate is low. This study wants to find empirical evidence of the effect of direct interest rates (in the real sector) and indirect effects (in the monetary sector) through the money supply on the inflation rate in Indonesia. Based on this description, this research formulates the third hypothesis as follows:

H3: The money supply in society mediates the effect of interest rates on the rate of inflation in Indonesia.

Bank Indonesia uses interest rate instruments (rediscount policy) to create financial stability (exchange rate) and price stability (inflation) in Indonesia. The interest rate policy by Bank Indonesia is expected to have an impact on foreign exchange rates and the rate of inflation in Indonesia. Interest rates have an impact on the rate of inflation through changes in the money supply.

Research Method

This study uses secondary data obtained from the portals of Bank Indonesia and the Indonesian Central Bureau of Statistics (Badan Pusat Statistik Indonesia). The data used in this study is monthly data from January 2014 to December 2021 which includes interest rates on Bank Indonesia Certificates (SBI), the rupiah exchange rate against the US dollar as measured by the arithmetic average exchange rate in one month, the inflation rate as measured by the percentage change Indonesia's Consumer Price Index, and the Money Supply, which consists of currency plus demand deposits (M1). The use of research data began in early 2014 to reduce exchange rate fluctuations due to external impacts, namely the tapering off policy carried out by the US Central Bank (FED) in 2013.

The purpose of this research is to evaluate monetary policy in Indonesia to create financial stability and price stability in Indonesia through the determination of interest rates. This monetary policy is suitable for creating financial stability and price stability when setting interest rates has an impact on foreign exchange rates and the inflation rate in Indonesia. The interest rate policy implemented by Bank Indonesia aims to influence the amount of money circulating in the community. The increase in interest rates is expected to reduce the amount of money circulating in society and the rate of inflation can be suppressed. Thus the impact of the interest rate on the rate of inflation occurs through changes in the amount of money circulating in society.

The variables in the research model consist of one independent variable, namely the interest rate, two dependent variables, namely the foreign exchange rate and inflation rate, and one mediating variable, namely the money supply in Indonesia. Using more than one dependent variable and mediating variable in this study, researchers use a structural model in explaining the relationship between the variables observed in this study. The structural model used is the partial least square model obtained with the SmartPLS program 3.0.

Results and Discussion

Research Results

This study uses four macroeconomic variables, namely interest rates, the rupiah exchange rate against the US dollar, the inflation rate, and the money supply in Indonesia in the period January 2014 to December 2021. The purpose of this study is to obtain empirical evidence of the relationship between the effect of interest rates on the rupiah exchange rate on the US dollar and the inflation rate. The money supply is thought to mediate the effect of interest rates on the inflation rate. Table 1 follows a description of interest rates, inflation rates, the rupiah exchange rate against the US dollar, and the money supply in the community during the study period.

Table 1. Description of Interest, Inflation, Exchange Rates,
and Money Supply January 2014-December 2021

	Min	Max	Mean	Std. Dev.	Coef. Var.
Interest (%)	3.50	7.75	5.5157	1.4576	26.43%
Inflation (%)	1.32	8.36	3.7455	1.8477	49.33%
Ex. Rate Rp/USD	11,404.00	16,367.00	13,679.39	910.18	6.56%
Money Supply (Billion Rp)	834,532.41	2,282,157.25	1,352,402.48	337,625.19	24.96%

The average SBI interest rate in the period from January 2014 to December 2021 is 5.5368 percent with the lowest interest rate of 3.5 percent occurring in February 2021 to December 2021 and the highest of 7.75 percent occurring in early 2014 to early 2016. The average inflation rate during the study period was 3.7653 percent per month, where the lowest

inflation rate was 1.32 percent in August 2020 and the highest inflation rate was 8.36 percent in December 2014.

The average rupiah exchange rate against the US dollar during the period from January 2014 to December 2021 was IDR 13,672.57 for each US dollar. The lowest exchange rate was IDR 11,404 per US dollar in March 2014 and the highest was IDR 16,367 for every US dollar in March 2020. The average money supply (M1) during the study period was IDR 1,352,402.48 billion with the lowest money supply of IDR 834,532.41 billion occurring in February 2014 and the highest occurring in December 2021, namely IDR 2,282,157.25 billion.

The coefficient of variation describes the fluctuation in the value of the research variable. The coefficient of variation during the study period for interest rates was 26.43 percent, the inflation rate was 49.33 percent, the rupiah exchange rate against the US dollar was 5.56 percent, and the money supply in society was 24.96 percent. Based on the value of this correlation coefficient, it can be seen that the inflation rate experienced the highest fluctuation, which was 49.33 percent during the period from January 2014 to December 2021. Meanwhile, the rupiah exchange rate against the US dollar had the lowest fluctuation, namely 6.56 percent.

This study examines the impact of interest rate policy on efforts to create price stability through controlling price inflation and financial stability through controlling the rupiah exchange rate against the US dollar. Figure 1 below presents the path coefficients of the structural model which describes the direct and indirect impact levels of interest rates on inflation and the impact of interest rates on foreign exchange rates in Indonesia using data from January 2014 to December 2021. In the structural model, the interest rate is the exogenous variable, the inflation rate and the exchange rate are the endogenous variables (response variables), and the money supply is the mediating variable that mediates the impact of interest rates on the rate of inflation.
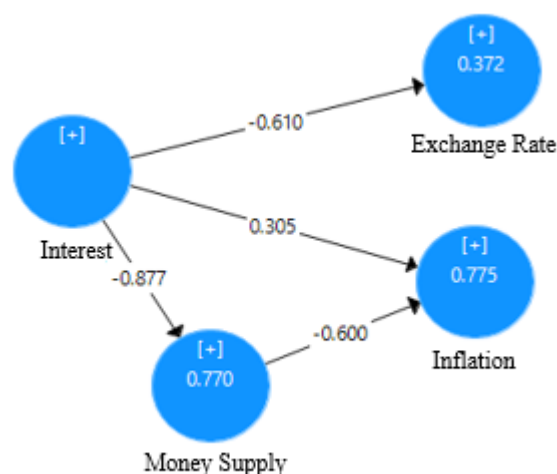

Figure 1. Structural Model Path Coefficient

The magnitude of the path coefficient from the interest rate (Interest) to the inflation rate (Inflation) is 0.305 indicating that every 1 percent increase in the interest rate has a direct impact on an increase in the inflation rate of 0.305 percent. The path coefficient for the interest rate to the exchange rate is -0.610 indicating that every 1 percent increase in the interest rate results in a decrease in the exchange rate by 0.610 percent (the value of the rupiah appreciates by 0.61 percent). The path coefficient for the interest rate to the money supply is -0.877, meaning that for every 1 percent increase in the interest rate, the money supply in society decreases by 0.877 percent. The path coefficient of the money supply is -0.600 indicating that

every 1 percent increase in the money supply has an impact on reducing the inflation rate by 0.600 percent.

Table 2 below presents statistical values for evaluating the structural model generated from research data, consisting of R Square, f Square, Standardized Root Mean Square Residual (SRMR), and Q2. This statistical value is used to determine the feasibility of the structural model to estimate the value of endogenous variables (Algifari & Rahardja, 2020).

Table 2. Statistical Value of Structural Model Evaluation

Statistics Value	Interest → Money Supply → Inflation	Interest → Ex. Rate
R Square	0.775	0.372
R Square Adjusted	0.771	0.365
f Square	0.096	0.592
SRMR	0.099	
Q2	0.768	0.368

The R Square value of the impact of the interest rate on the inflation rate is 0.775 indicating the ability of the interest rate to explain inflation is included in the high category, while the R Square value of the impact of the interest rate on the exchange rate is 0.372 indicating that the interest rate can explain the exchange rate is classified as moderate. The Standardized Root Mean Square Residual (SRMR) value of the structural model of 0.099 is less than 0.1 indicating that the structural model obtained is feasible for testing the impact of interest rates on the inflation rate and foreign exchange rates. The Stone-Geisser's Q2 value of 0.768 and 0.368 is greater than 0 indicating the structural model has good predictive ability. The results of the evaluation of the structural model indicate that the model is feasible to test the research hypothesis.

Table 3 contains the statistical values used to test the research hypothesis. In this study, three hypotheses were formulated. The first hypothesis states that interest rates have a negative impact on foreign exchange rates in Indonesia. The second hypothesis states that the interest rate has a positive effect on the inflation rate. The third hypothesis states that the money supply in society mediates the effect of interest rates on the inflation rate.

Table 3. Statistical Value of the Effect of Interest on Inflation and Exchange Rate

Variable	Path Coefficient	t Statistics	Prob.	Results (α= 5%)
Interest → Inflation	0.305	3.360	0.001	significant
Interest → Exchange Rate	-0.610	10.460	0.000	significant
Interest → Money Supply → Inflation	0.527	6.726	0.000	significant

The magnitude of the path coefficient of the influence of the interest rate on the exchange rate is negative, which is -0.610 with a statistical t value of 10.460 and a probability value of 0.000. With α = 0.05 and a probability value of 0.000, the first hypothesis which states that interest rates have a negative effect on foreign exchange rates is proven. The path coefficient value of the influence of the interest rate on the inflation rate is positive, which is equal to 0.305 with a statistical t value of 3.360 and a probability value of 0.001. The results of this study can prove the second hypothesis which states that the interest rate has a positive effect on the inflation rate because the probability value of 0.001 is smaller than α = 0.05. The magnitude of the path coefficient of the indirect effect of the interest rate on the rate of inflation through the amount of money circulating in society is positive at 0.527 with a statistical t-value of 6.726 and a probability value of 0.000. The probability value of 0.000 is less than 0.05 indicating the third hypothesis which states that the money supply mediates the effect of interest rates on the inflation rate is also accepted.

Discussion

The results of the evaluation of the structural model based on the R Square value, SRMR value, and Q2 value show that the structural model obtained is classified as feasible to use for testing this research hypothesis. The first hypothesis of this study states that interest rates have a negative effect on exchange rates in Indonesia. If the interest rate in Indonesia rises, it can have an impact on a decrease in the exchange rate (the rupiah appreciates). Conversely, if interest rates in Indonesia fall, it will have an impact on increasing foreign exchange rates (the rupiah depreciates). The path coefficient value of the influence of the interest rate on the exchange rate is negative with a probability value of 0.000 which is less than 0.05 ($p = 0.000 < \alpha = 0.05$) indicating that the interest rate has a negative effect on the exchange rate. This means that if there is an increase in the interest rate, it will have an impact on the decline in the rupiah exchange rate against the US dollar. It means that the value of the rupiah has been appreciated. Conversely, if there is a decrease in interest rates in Indonesia, it can have an impact on the exchange rate rising (the value of the rupiah depreciates). The results of this study indicate that the theory of interest rate parity applies in Indonesia. If there is an increase in the interest rate in Indonesia, it will cause foreign models to flow into Indonesia and can increase Indonesia's foreign exchange reserves. The increase in foreign exchange reserves increases the supply of foreign currency in the country so the price of foreign currency decreases. The value of the rupiah against foreign currencies rise (the rupiah appreciated).

The results of this study also support some of the results of previous studies which concluded that interest rates have a negative effect on foreign exchange rates. Research conducted by Puspitaningrum et al. (2014) on the Indonesian economy using data from 2003-2012, Idris (2021) used data for 2007-2017, and Yudha & Hadi (2009) used monthly data from 2002-2006 to conclude that interest rates have a negative effect on foreign exchange rates in Indonesia.

The path coefficient for the impact of the interest rate on the inflation rate is positive at 0.305 with a probability of 0.001 ($p = 0.001 < \alpha = 0.05$) indicating that the interest rate has a positive impact on the inflation rate in Indonesia. This means that if there is an increase in the interest rate in Indonesia, it will increase the inflation rate. Changes in interest rates can have an impact on the rate of inflation through the real sector and the monetary sector. The impact of changes in interest rates on the inflation rate in the real sector is that if there is an increase in the interest rate, the business sector will increase the prices of goods/services produced as an adjustment measure for the increase in production costs as a result of the increase in the interest rate. The impact of changes in interest rates on the inflation rate in the real sector if there is an increase in interest rates can increase the inflation rate. In other words, the interest rate has a positive impact on the inflation rate. The results of this study are in line with the results of research conducted by Langi et al. (2014), Aprileven (2015), Larasati & Amri (2017), and Martanto et al. (2021) concluded that interest rates have a positive effect on the inflation rate in Indonesia.

The impact of changes in interest rates on the rate of inflation in the monetary sector is that if there is an increase in interest rates it can have an impact on reducing the amount of money circulating in the community. This decrease in the money supply can reduce the rate of inflation. The mechanism that occurs in the monetary sector is that if the interest rate rises it can have an impact on reducing the amount of money circulating in the community and the inflation rate decreases. So, in the monetary sector, the interest rate has a negative impact on the inflation rate.

The results show that the path coefficient of the impact of interest rates on the money supply is negative, indicating that an increase in interest rates can reduce the money supply in society. However, the path coefficient for the impact of the money supply in society is negative, which means that a decrease in the money supply in society has an impact on increasing the

inflation rate. The path coefficient of the impact of the interest rate on the inflation rate through the money supply is positive with a probability value of 0.000 which is less than 0.05 (p = 0.000 < α = 0.05) indicating that the money supply in society mediates the impact of the interest rate on the inflation rate in Indonesia. The results of this study contradict the theory which states that a decrease in the money supply in society has an impact on reducing the rate of inflation. The anomalous phenomenon in the Indonesian economy has caused Bank Indonesia's policies to create financial stability and price stability to become a trade-off. Bank Indonesia's monetary policy to raise interest rates can have the effect of increasing the value of the rupiah, but on the other hand, it can increase the rate of inflation.

Conclusion

This research gives three important conclusions that can be used to evaluate the monetary policy implemented by Bank Indonesia in carrying out its main task, namely creating financial stability and price stability. First, interest rates have a negative impact on exchange rates. The results of this study strengthen Bank Indonesia's reasons for choosing a rediscount policy in managing foreign exchange rates in Indonesia. On the other hand, if it is desired that the exchange rate increase (the value of the rupiah depreciates) this can be done by reducing the SBI interest rate.

Second, the interest rate has a positive effect on the inflation rate. That is, an increase in interest rates can increase the rate of inflation. An increase in the interest rate means that the cost of borrowing money increases and this will be responded to by the business sector by increasing the prices of goods and services. The results of this study provide a signal to Bank Indonesia to choose an interest rate instrument to create financial stability and price stability. When Bank Indonesia wanted to increase the value of the rupiah against foreign currencies using the interest rate increase instrument, on the one hand, the value of the rupiah increased, but on the other hand, the inflation rate increased. This shows that there is a trade-off between the increase in the value of the rupiah and the decline in the rate of inflation in Indonesia.

Third, the interest rate has a negative impact on the money supply in society. Meanwhile, the amount of money circulating in society has a negative impact on the rate of inflation. Theoretically, the money supply has a positive impact on the inflation rate. In the monetary sector, the central bank can carry out interest rate policies to achieve the desired inflation rate. When it is desired that the inflation rate decrease, the central bank can raise interest rates so that the money supply in the community decreases and the inflation rate decreases. However, this study obtained a different conclusion from the theory. A decrease in the money supply can cause the inflation rate to increase. The results of this study indicate that the mechanism for the impact of interest rates on the inflation rate in Indonesia occurs in the real sector, where an increase in interest rates causes production costs to increase and pushes the prices of goods and services (inflation rate) to increase.

Suggestions to Bank Indonesia when adopting an interest rate policy to maintain financial stability and price stability need to pay attention to the impact on foreign exchange rates and the inflation rate. This research concludes that there is a trade-off between the exchange rate and the inflation rate in the Indonesian economy. The interest rate policy cannot simultaneously obtain the desired exchange rate and inflation rate, namely, the value of the rupiah against foreign currencies rises and the inflation rate is low. When Bank Indonesia raises interest rates so that the rupiah appreciates, at the same time there can be an increase in the prices of goods and services (inflation rate increases).

There are some suggestions for future research. The next research should use data on the amount of money in a broad sense (M2) for the variable amount of money circulating in society. The econometric model used in subsequent research is suggested to use the time series model

to produce an efficient estimation model to test the research hypothesis. Time series econometric models can analyze the relationship between interest rates, exchange rates, inflation rates, and the amount of money in circulation, both in the short term and in the long term.

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