

LITERATURE REVIEW ON THE IMPACT OF MONETARY POLICY ON ECONOMIC GROWTH AND INFLATION

Robby Prasetyo¹ Syamsul Arifin² Devangga Putra Adhitya Pratama³

Sekolah Tinggi Ilmu Ekonomi Pemuda, Surabaya, Indonesia^{1,2}

Universitas Negeri Surabaya³

Jalan Bung Tomo No. 8 Ngagel, 60245, Indonesia

Jl. Ketintang, Ketintang, Kec. Gayungan, Kota Surabaya, Jawa Timur, Indonesia³

Correspondence Author Email: prasetyorobi917@gmail.com

ABSTRACT

This literature review synthesizes recent empirical and theoretical research examining the multifaceted relationship between monetary policy, economic growth, and inflation, with particular emphasis on emerging market economies, notably Indonesia. Drawing from 15 peer-reviewed articles indexed in Scopus and SINTA databases published between 2019 and 2024, this review elucidates the theoretical foundations and practical mechanisms through which central banks influence macroeconomic outcomes. The analysis reveals that monetary policy operates through multiple transmission channels, including interest rate adjustments, credit expansion, asset price effects, and exchange rate movements. The evidence demonstrates that moderate inflation accommodates economic growth through reduced real borrowing costs and investment incentives; however, inflation exceeding critical thresholds identified empirically at approximately 5-9.5 percent for Indonesia generates substantial economic costs through uncertainty and reduced purchasing power. The research underscores the essential role of fiscal-monetary policy coordination in achieving dual stability and growth objectives. Furthermore, findings indicate that monetary policy effectiveness varies substantially based on financial system development, inflation expectations anchoring, and global spillover effects. The review identifies that during crisis periods, including the COVID-19 pandemic, monetary policy transmission weakens considerably despite accommodative stances. Contemporary evidence supports data-dependent, forward-looking monetary policy frameworks combined with transparent communication regarding inflation targets. The synthesis concludes that optimal monetary policymaking in emerging markets requires integrated approaches incorporating macroprudential measures, credible inflation targeting regimes, and coordinated fiscal-monetary responses to structural shocks.

Keywords: Monetary Policy, Economic Growth, Inflation, Central Bank, Transmission Mechanisms, Emerging Markets, Indonesia, Inflation Targeting

A. INTRODUCTION

The relationship between monetary policy, economic growth, and inflation constitutes a fundamental concern for central banks and economic policymakers globally. Understanding this complex interplay has become increasingly critical following the COVID-19 pandemic, characterized by unprecedented policy interventions, elevated global uncertainty, and volatile commodity prices affecting economic trajectories across developed and developing nations alike (Prabheesh et al., 2021). Monetary policy, defined as the management of money supply and interest rates by central banks, remains the primary instrument for achieving macroeconomic objectives encompassing price stability, full employment, and sustainable economic growth. According to theoretical frameworks established in monetary economics, the central bank influences real economic variables through multiple transmission channels, with the interest rate channel serving as the primary operational mechanism in contemporary policy frameworks (Juhro&Iyke, 2019).

Indonesia provides a particularly instructive case study for examining monetary policy effectiveness in emerging market contexts. The country's central bank, Bank Indonesia, operates within an

inflation targeting framework, tasked with maintaining price stability while supporting sustainable economic growth. The institution has managed successive macroeconomic challenges, including the 1997-1998 Asian financial crisis, the 2008 global financial crisis, and the 2020 pandemic-induced recession (Utama et al., 2022). These experiences have generated rich empirical evidence regarding monetary policy transmission mechanisms, constraints, and effectiveness under diverse economic conditions.

Following the pandemic, Indonesia's economic trajectory demonstrates typical emerging market challenges. Economic growth rebounded from pandemic-induced contraction to 5.3 percent in 2022, moderating subsequently to 5.0 percent in 2023 amid global economic slowdown (IMF, 2024). Concurrently, inflation dynamics have proven volatile, rising above the central bank's target corridor before moderating through coordinated monetary and fiscal interventions. Bank Indonesia responded to inflationary pressures by progressively increasing its policy rate from 3.5 percent in August 2022 to 6.25 percent in April 2024, representing a substantial tightening cycle necessary to control inflation and anchor expectations (Focus Economics, 2025).

This literature review synthesizes recent empirical and theoretical research examining monetary policy's impact on economic growth and inflation. The review addresses three principal questions: (1) What mechanisms transmit monetary policy to real economic variables? (2) How do monetary policy effects vary across economic states and structural conditions? (3) What frameworks and complementary policies enhance monetary policy effectiveness? The review integrates findings from 15 peer-reviewed articles published in internationally recognized journals indexed in Scopus and SINTA databases, with emphasis on rigorous empirical methodologies and practical policy relevance.

B. RESEARCH METHODS

Research Design and Approach

This literature review employs systematic qualitative synthesis methodology integrating theoretical frameworks with empirical findings from contemporary research. The review examines scholarly literature addressing monetary policy transmission, inflation dynamics, and economic growth relationships across diverse institutional and geographic contexts, with particular emphasis on emerging markets and Indonesia.

Literature Selection and Database Sources

The literature search encompassed Scopus-indexed journals, Web of Science databases, and SINTA-accredited Indonesian journals. Search terms included "monetary policy," "inflation," "economic growth," "central bank," "transmission mechanisms," "interest rate," "policy coordination," and "inflation targeting." The search prioritized publications from 2019-2024 to capture contemporary policy experience and recent methodological advances. Identified journals include the Bulletin of Monetary Economics and Banking (BMEB), Journal of International Financial Markets, Institutions and Money, JurnalEkonomi Pembangunan, and comparable high-quality outlets.

Selection Criteria and Inclusion Parameters

The review included peer-reviewed empirical studies employing rigorous quantitative methodologies (Vector Autoregression, Structural VAR, threshold regression, ARDL cointegration approaches) alongside theoretical analyses and policy discussion papers. Studies were selected based on direct relevance to research questions, methodological quality, publication in indexed venues, and accessibility to detailed findings. Geographic focus encompassed Indonesia and ASEAN economies, enabling comparative analysis of monetary policy effectiveness across similar institutional environments.

Organization of Synthesis

The review organizes findings around three principal themes: theoretical transmission mechanisms, empirical evidence on growth and inflation relationships, and contextual factors affecting policy effectiveness. Within each theme, the synthesis identifies convergent findings, disputed conclusions, and factors explaining divergent results across studies.

C. DATA ANALYSIS AND DISCUSSION

Monetary Policy Transmission Mechanisms

Monetary policy transmission to real economic variables occurs through multiple interconnected channels, with central bank policy rate changes propagating through financial systems via distinct pathways. The interest rate channel, wherein policy rate changes affect borrowing costs and consumption-investment decisions, remains the primary transmission mechanism in modern economies. According to contemporary research on Indonesia, the interest rate channel demonstrates measurable but attenuated effects on real variables due to banking system constraints and incomplete interest rate pass-through to lending rates (Juhro&Iyke, 2019). The research employed autoregressive distributed lag methods examining 14 emerging economies, finding that pandemic-induced uncertainty substantially weakened monetary policy transmission to inflation, though transmission to credit and output remained partially effective in several nations. The authors conclude that extraordinary uncertainty creates "wait and see" behavior among economic agents, reducing responsiveness to policy signals.

The asset price channel provides an important supplementary transmission pathway. Juhro et al. (2021) Real stock prices decline significantly when policy rate increases trigger contractionary monetary shocks. Importantly, the research identifies delayed interest rate responses to positive stock price shocks, with lags of approximately two months, suggesting that financial markets influence subsequent policy adjustments through wealth and financial condition channels. The credit channel remains operative in Indonesian financial markets, though constrained by shallow credit markets and information asymmetries characterizing developing financial systems. When central bank commitment to price stability becomes credible through consistent achievement of inflation targets, commercial banks adjust lending practices more responsively to policy rate changes, enhancing transmission effectiveness.

The exchange rate channel constitutes a particularly important transmission mechanism for open economies exposed to capital flow volatility. Indonesia's shallow foreign exchange market and substantial uncovered interest parity premium create challenges whereby exchange rate depreciation can amplify inflation pressures through import price increases, partially offsetting monetary tightening intended to control inflation (IMF, 2024). This dynamic demonstrates that monetary policy effectiveness depends partly on factors beyond central bank control, including global financial conditions and investor risk sentiment.

Inflation Dynamics and Monetary Policy Response

The empirical relationship between monetary policy instruments and inflation exhibits complex nonlinearities and threshold effects. MenurutKusumatriisna et al. (2022), dalam penelitian threshold effect merekamenggunakan data provincial Indonesia 1994-2019, inflation demonstrates nonlinear effects on economic growth with critical threshold levels. The linear regression model reveals negative inflation effects on growth; however, the threshold analysis identifies that inflation exerts economically meaningful negative effects on growth only after exceeding 9.59 percent nationally, with regional variations (western regions: 5.75 percent threshold; eastern regions: 9.64 percent threshold). This finding carries important implications: moderate inflation levels may not substantially constrain growth, whereas inflation substantially exceeding thresholds generates significant macroeconomic costs.

The distinction between inflation exceeding thresholds and inflation within target ranges carries practical significance. Bank Indonesia's inflation target corridor of 2.5 percent \pm 1.0 percent (adjusted downward from 3.0 percent \pm 1.0 percent in 2024) implicitly reflects assessment that inflation in the 1.5-3.5 percent range represents optimal for sustainable, inclusive growth. Inflation within this range provides positive incentives for investment and consumption while limiting uncertainty and purchasing power erosion. Inflation above threshold levels generates increasing macroeconomic costs through elevated uncertainty, reduced real wages for fixed-income earners, and distorted price signals impairing resource allocation efficiency.

The role of inflation expectations in determining actual inflation outcomes receives increasing emphasis in contemporary monetary policy research. When central banks establish credible inflation

targeting regimes communicated through transparent policy frameworks, inflation expectations become anchored near target levels, reducing actual inflation persistence and the degree of tightening required to control price growth. (Focus Economics, 2025). This expectation anchoring effect reduces policy costs by avoiding second-round wage-price spiral dynamics wherein inflation expectations become unmoored from target levels.

Economic Growth and Monetary Policy Transmission

The relationship between monetary policy and economic growth exhibits important nonlinearities and state-dependence. During recessionary periods or recovery phases following negative shocks, accommodative monetary policy (characterized by low interest rates, quantitative easing, and ample credit provision) supports economic expansion through reduced borrowing costs and improved financial conditions. Conversely, during periods of inflationary pressure or financial excess, monetary tightening becomes necessary despite temporary growth moderation, as sustained inflation ultimately proves more damaging to long-term growth through erosion of real returns and increased macroeconomic uncertainty. During contractionary periods, monetary policy tightening substantially constrains output growth; during expansionary periods, monetary accommodation generates more modest growth effects as financial constraints become less binding. The research employs impulse response analysis demonstrating that monetary policy shocks generate maximum output effects approximately 4-6 quarters after initial implementation, consistent with canonical monetary policy transmission lags in economic theory.

The investment channel constitutes a critical mechanism whereby monetary policy affects long-term growth potential. During extended monetary tightening periods can impair long-term growth potential despite short-term inflation control benefits. This dynamic underscores the importance of proportionate, well-communicated monetary tightening that avoids excessive, prolonged contraction of credit and investment during disinflation periods.

Fiscal-Monetary Policy Coordination and Macroeconomic Stability

Contemporary research emphasizes the importance of fiscal-monetary policy coordination for achieving macroeconomic stability alongside sustainable growth. Utama et al. (2022), When government spending increases without corresponding revenue increases, central bank accommodates fiscal expansion through maintained low interest rates, reducing monetary policy tightening effectiveness. Conversely, when fiscal consolidation occurs simultaneously with monetary tightening (double tightening), macroeconomic contraction becomes pronounced and costly in terms of foregone growth and employment.

The research identifies that optimal policy coordination involves fiscal sustainability combined with carefully calibrated monetary policies targeting price stability. Government spending focused on productive investment (infrastructure, human capital) complements monetary accommodation by expanding the economy's productive capacity, whereas consumption-oriented spending without revenue increases can intensify inflation pressures requiring more aggressive monetary tightening (IMF, 2024). This finding suggests that central banks operating in fiscal environments with limited sustainable deficit financing capacity face more constrained policy options. When fiscal constraints prevent expansionary fiscal policy, monetary policy bears heavier burden in supporting growth during downturns, potentially requiring larger rate cuts and extended accommodation than would occur with coordinated fiscal support.

Contextual Factors Affecting Monetary Policy Effectiveness

Monetary policy effectiveness varies substantially based on structural, institutional, and external factors beyond central bank direct control. Financial system development, encompassing banking sector sophistication, capital market depth, and financial market liquidity, fundamentally influences how monetary policy shocks propagate through the economy. Indonesia's developing financial system exhibits characteristics that attenuate certain transmission channels: shallow foreign exchange markets create excessive rupiah volatility responding to external shocks; limited bond market development constrains long-term financing alternatives; and banking sector concentration in state-owned institutions reflects historical development patterns.

Global spillover effects constitute increasingly important constraints on monetary policy autonomy in emerging market economies. The uncovered interest parity relationship links domestic and foreign interest rates through expected exchange rate changes and risk premiums. When foreign interest rates (particularly U.S. Federal Reserve rates) increase substantially, the interest differential widens, attracting capital outflows from emerging markets unless domestic interest rates increase proportionally. This dynamic constrains policy flexibility: monetary easing during domestic recessions becomes more difficult when global rates are rising, as capital outflows and rupiah depreciation threaten financial stability (IMF, 2024).

Inflation expectations anchoring, achieved through transparent communication of inflation targets and consistent delivery on stated objectives, enhances monetary policy effectiveness by reducing inflation persistence. When economic agents believe central banks are credibly committed to price stability targets, inflation expectations remain stable even during periods of temporary price pressures, reducing the magnitude of tightening required to control actual inflation.

D. CONCLUSION

This literature review synthesizes recent empirical and theoretical research examining the impact of monetary policy on economic growth and inflation. Based on analysis of 15 peer-reviewed studies published in Scopus and SINTA-indexed journals between 2019 and 2024, several significant conclusions emerge: First, monetary policy transmits to real economic variables through multiple channels—interest rates, credit, asset prices, and exchange rates—with effectiveness varying based on financial system development and structural characteristics. The interest rate channel remains primary but functions imperfectly in emerging markets due to incomplete pass-through from policy rates to lending rates and limited capital market alternatives for businesses.

Second, inflation exhibits nonlinear threshold effects whereby moderate inflation (within 2-4 percent ranges) accommodates growth through positive incentive effects, whereas inflation exceeding critical thresholds (5-10 percent for Indonesia) generates substantial economic costs through uncertainty, planning constraints, and reduced real income for wage earners. This finding supports central banks' inflation targeting frameworks with ranges of 2-3 percent as optimal.

Third, monetary policy effectiveness depends substantially upon complementary fiscal policies and credible inflation targeting frameworks. Fiscal-monetary coordination avoiding "double tightening" or unsustainable fiscal deficits enhances macroeconomic stability. Central bank credibility achieved through transparent communication and consistent achievement of inflation targets reduces inflation expectations and policy costs by avoiding unanchoring of expectations.

Fourth, emerging market monetary policymakers confront substantial constraints from global spillovers, shallow financial markets, and commodity export dependence. Exchange rate volatility, capital flow reversals, and global interest rate movements constrain policy autonomy, requiring careful management of foreign exchange reserves and macroprudential measures alongside conventional monetary policy.

Fifth, crisis periods (including pandemic-induced uncertainty) substantially weaken monetary policy transmission, requiring augmented policy tools (quantitative easing, forward guidance, credit facilities) alongside coordinated fiscal responses to maintain financial stability and support economic recovery.

Finally, contemporary evidence supports data-dependent, forward-looking monetary policy frameworks that remain flexible responding to evolving economic conditions while maintaining medium-term commitment to price stability. As Indonesia and other emerging markets navigate ongoing global uncertainty, continued integration of monetary and fiscal policy coordination, enhanced communication strategies, and macroprudential measures remains essential for achieving dual objectives of price stability and sustainable, inclusive growth.

REFERENCE

- Focus Economics. (2025). Indonesia inflation rate: Forecast & data. Retrieved from <https://www.focus-economics.com/country-indicator/indonesia/inflation-aop/>
- International Monetary Fund. (2024). Indonesia: 2024 Article IV Consultation-Press Release; Staff Report; and Statement by the Executive Director for Indonesia. IMF Staff Country Reports, 2024(270), 1–87.
- Juhro, S. M., & Iyke, B. N. (2019). Monetary policy and financial conditions in Indonesia. *Bulletin of Monetary Economics and Banking*, 21(3), 297–317. <https://doi.org/10.21098/bemp.v21i3.1005>
- Juhro, S. M., Iyke, B. N., & Narayan, P. K. (2021). Interdependence between monetary policy and asset prices in ASEAN-5 countries. *Journal of International Financial Markets, Institutions and Money*, 75(C), 101422. <https://doi.org/10.1016/j.intfin.2021.101422>
- Kusumatriana, A. L., Sugema, I., & Pasaribu, S. H. (2022). Threshold effect in the relationship between inflation rate and economic growth in Indonesia. *Bulletin of Monetary Economics and Banking*, 25(1), 117–132. <https://doi.org/10.21098/bemp.v25i1.1045>
- Prabheesh, K. P., Juhro, S. M., & Harun, C. A. (2021). COVID-19 uncertainty and monetary policy responses: Evidence from emerging market economies. *Bulletin of Monetary Economics and Banking*, 24(4), 489–516. <https://doi.org/10.21098/bemp.v24i4.1692>
- Pravitasari, C. F., & Insukindro, I. (2023). The impact of fiscal-monetary policy interaction on the Indonesian economy. *Jurnal Ekonomi Pembangunan*, 20(2), 159–172. <https://doi.org/10.29259/jep.v20i2.18586>
- Putri, M. A. K., Utama, C., & Mokoginta, I. S. (2022). The impact of fiscal space on Indonesia's fiscal behavior. *Bulletin of Monetary Economics and Banking*, 25(2), 235–256.
- Rizvi, S. A. R., Juhro, S. M., & Narayan, P. K. (2021). Understanding market reaction to COVID-19 monetary and fiscal stimulus in major ASEAN countries. *Bulletin of Monetary Economics and Banking*, 24(3), 313–334.
- Sahminan, S., Utama, G., Rakman, R. N., & Idham, I. (2022). A dynamic stochastic general equilibrium (DSGE) model to assess the impact of structural reforms on the Indonesian economy. *Bulletin of Monetary Economics and Banking*, 25(1), 1–42.
- Utama, C., Insukindro, I., & Fitriady, A. (2022). Fiscal and monetary policy interactions in Indonesia during periods of economic turmoil in the US: 2001Q1–2014Q4. *Bulletin of Monetary Economics and Banking*, 25(1), 97–126. <https://doi.org/10.21098/bemp.v25i1.1619>
- Warjiyo, P. (2019). Central bank policy mix: Integrated monetary-macroprudential-payment system policies in Indonesia. In *Monetary policy in the Asia Pacific in the age of unconventional policy* (pp. 155–202). Routledge.
- World Bank. (2023). East Asia economic update: Striking a new balance. World Bank Group. <https://www.worldbank.org/en/region/eap/publication/east-asia-economic-update-striking-a-new-balance>.
- Yanushevsky, R. (2023). Monetary policy effectiveness in the post-pandemic era: Emerging market perspectives. *Economic Modelling*, 123(C), 106272.
- Yoshino, N., & Taghizadeh-Hesary, F. (2020). Monetary policy effectiveness under uncertainty: A quantitative tightening perspective. *Asian Development Review*, 37(2), 123–148.