

CHAPTER I

INTRODUCTION

1.1 Background

Banking functions as an intermediary institution that distributes funds from those who have a surplus to those who need funds in the form of credit, so that it plays a role in maintaining smooth financing flows in the economy (. In this context, banking stability and health are very important to carry out the function of financial intermediation optimally. To maintain financial system stability and control inflation, Bank Indonesia (BI) has set a benchmark interest rate policy. Policy adjustments were made following global and domestic economic dynamics, including the impact of the COVID-19 pandemic and various inflationary pressures, as indicated by the BI rate which changed from 4.75% in 2016 to 6.00% in 2024. (Mamuaja et al., 2024)

Banks not only perform an intermediary role but are also responsible for creating liquidity and managing financial risk. According to Rose & Hudgins (2013) that banks face various kinds of risks. These include liquidity risk, market risk, operational risk, and most importantly credit risk, i.e. the possibility of debtors not fulfilling their promises. Credit risk that is directly reflected in the loan does not qualify for Non-Performing Loans (NPL). Credit risk is the main indicator for assessing the quality of a bank's assets.

One of the main indicators of the bank's asset quality and credit risk profile is Non-Performing Loans (NPL) loans. Non-Performing Loans (NPLs) show the ability of the debtor to meet principal and interest payments to the bank (. High NPL

ratios not only lower profitability through increased cost of servicing impairment losses, but if not managed properly, they can also disrupt the intermediation function and potentially threaten the stability of the financial system. Both regulators and bank management pay attention to NPL ratios that are close to or exceed the 5% limit set by Bank Indonesia for Indonesian banks. (Lestari, 2016)

Empirical facts show that credit risk is influenced by the multidimensional interaction between the internal conditions of the bank and the external macroeconomic conditions. According to data collected by the Financial Services Authority (OJK), the trend of fluctuations in commercial bank NPLs in Indonesia still requires special attention even though overall it is still below the safe limit of 5%. For example, in certain quarters from 2016 to 2024, there was an increase in pressure on credit quality, which coincided with periods of monetary policy tightening or inflationary turmoil. This trend shows that there is a strong relationship between Bank Indonesia's monetary policy and credit risk behavior in banks. (Sri Setiawati, 2020)

Conventional commercial banks dominate the Indonesian banking system and operate on conventional principles with interest rates as the main instrument in raising and disbursing funds. Due to these operational characteristics, the performance of conventional commercial banks is highly sensitive to changes in monetary policy and macroeconomic circumstances (Sukma & Octrina, n.d.). Increased credit risk is inseparable from macroeconomic dynamics. The debtor's ability to pay his or her obligations is significantly affected by changes in interest rates, inflation, and the money supply. Mishkin (2019) stated that economic conditions and the performance of the banking sector are largely influenced by

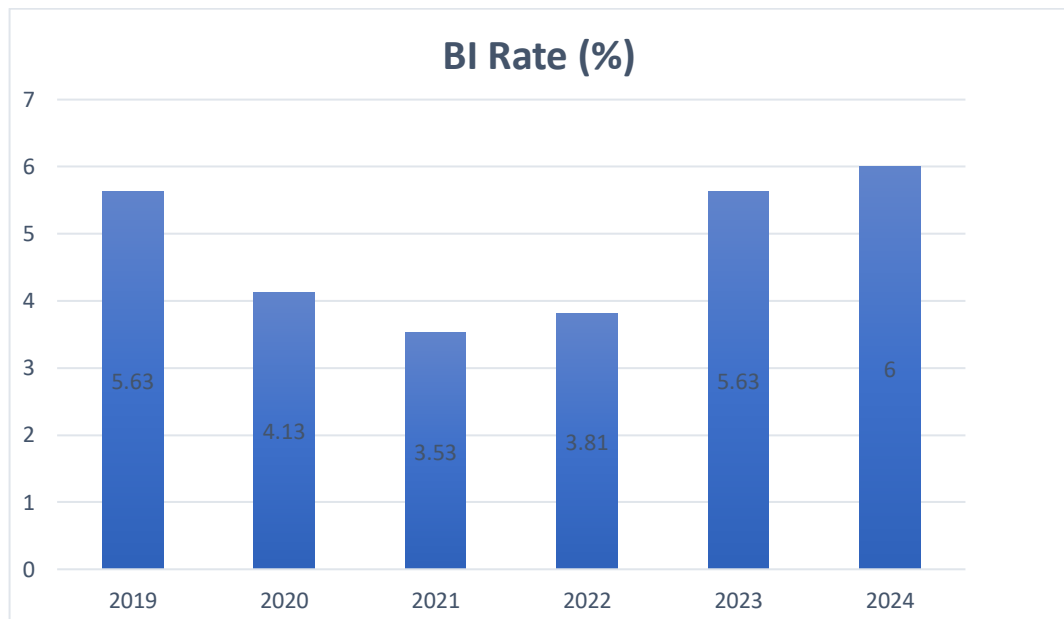
monetary policy through instruments such as the BI Rate, money supply control, and inflation management.(Dwinanda & Sulistyowati, 2021)(Kainde, 2021)

Figure 1.1 NPL Growth in Conventional Commercial Banks



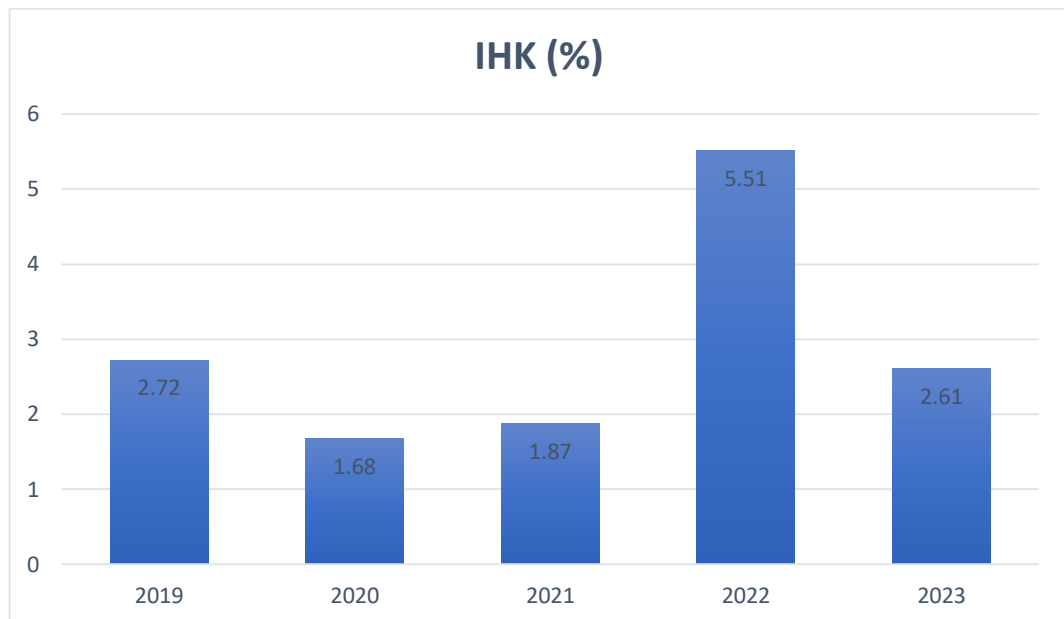
Source: OJK, 2025 (data processed)

Data from the chart shows a highly volatile trend in conventional commercial bank NPLs from 2020- 2024. The highest peak reached 3.16% in 2020, due to the impact of the COVID-19 pandemic affecting debtors' ability to pay. In the financial authorities' response to monetary stimulus and credit restructuring, NPLs fell to 3.04% in 2021. This trend continued in 2022 (2.44%) and 2023 (2.19%) as a result of economic recovery and monetary policy normalization. However, in 2024, NPLs rose again to 2.8%, indicating the potential for new pressures from tightening liquidity or slowing growth. This pattern confirms the vulnerability of NPLs to macroeconomic and monetary policy conditions, so the analysis of the impact of the BI Rate, inflation, and money supply is essential to understand the dynamics of conventional banking credit risk in Indonesia.

Figure 1.2 BI Rate Data 2019-2024

Source: Bank Indonesia, 2025 (data processed)

To maintain macro stability and control inflationary pressures, interest rates are used as monetary policy. If interest rates rise, borrowing costs will rise, increasing pressure on debtors and increasing credit risk. Hariyanti's study (2024) found that interest rates, also known as SBI or BI proxy rates, have a significant impact on increasing NPLs in commercial banks in Indonesia. Inflation is also an important determinant in credit quality. High inflation rates can reduce people's purchasing power, causing debtors to have difficulty repaying their loans. Research by Setiawati (2020) shows that inflation increases credit risk and has a major impact on banking stability.

Figure 1.3 Indonesia's CPI yoy inflation data 2019–2023

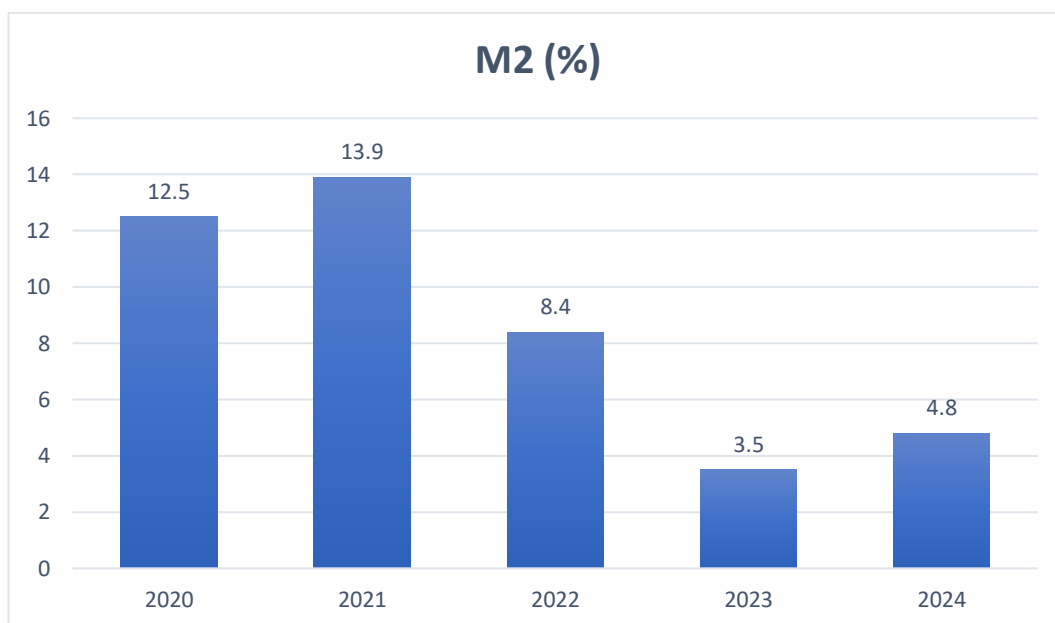
Source: BPS, 2025 (data processed)

Indonesia's inflation rate fluctuated from 2019-2023, according to Consumer Price Index (CPI) data. Due to the decline in economic activity during the COVID-19 pandemic, inflation dropped dramatically to 1.68% in 2020. With the economic recovery, inflation began to increase moderately in 2021 by 1.87%. In 2022, inflation soared to 5.51% due to global price pressures, supply chain disruptions, and home energy price adjustments. In addition, in 2023, inflation is back under control at the level of 2.61%, indicating that price stabilization and monetary tightening policies are successful.

In this study, the Consumer Price Index (CPI) is used to measure inflation because the CPI is an official indicator that describes changes in the prices of goods and services consumed by the general public. In relation to NPLs in conventional banking, CPI-based inflation is considered the most relevant to show the real economic pressures faced by the household and business sectors. This is due to the

fact that CPI-based inflation has a direct correlation with people's purchasing power and the debtor's cost of living, so it can affect credit repayment ability and default risk level. The condition of economic liquidity, which is reflected in the money supply, also affects the stability of the banking sector. Changes in the money supply can affect credit disbursement, the debtor's ability to pay, as well as the level of credit risk reflected in NPLs.(Hardiyanti & Aziz, 2021)

Figure 1.4 Indonesia's M2 yoy growth (2020-2024)



Source: Bank Indonesia, 2025 (data processed)

The money supply (M2) is also an important instrument in monetary policy. As a result of the post-pandemic fiscal stimulus, which increased market liquidity and encouraged credit expansion, a significant increase in M2 reached 12.5% in 2020. However, if credit controls are ineffective, these conditions can also increase inflation risks and degrade the quality of banking assets. With an increase in the amount of money that is out of control, inflationary pressures can increase, reduce

people's purchasing power, and increase the risk of credit default, especially in conventional banking that dominates the national credit market. (Khan et al., 2020)(Syed & Aidyngul, 2022)

Research conducted by Hariyanti (2024) found that interest rates, inflation, loan to deposit ratio (LDR), and NPL values in previous periods significantly affect current NPLs. However, because the study is only in 2023, it does not cover the post-pandemic period that is important for understanding the dynamics of recent credit risk. (Hardiyanti & Aziz, 2021)

More specifically, Sukma and Octrina (2024) investigated the influence of NPLs on credit disbursement at state-owned banks during 2016–2023, with control variables such as GDP, BI Rate, and inflation. They found that NPLs have a negative influence on credit disbursement. However, the focus of this study is to understand the determinants of NPL from the BI Rate, money supply, and inflation, not the impact of NPLs on credit.

In addition, previous studies, such as Setiawati (2020) and Agustina & Daryono (2022) have confirmed the impact of BI Rate and inflation on different economic outcomes and banking stability. However, in the empirical model of determining NPLs, the variable money supply (money supply) as a direct instrument of expansionary or contractive monetary policy is rarely included. In fact, liquidity expansion through increased money supply can encourage more aggressive credit disbursement, which has the potential to lower the quality of underwriting, while contraction can suppress existing debtors' ability to pay. A study conducted by Kainde & Karnoto (2021) looked at how the availability of

funds impacts the return on bank shares, but did not look at credit risk (NPL) outcomes. Therefore, to explain NPLs, an analysis model that combines BI rates, money supply, and inflation is helpful.(Silitonga & Manda, 2022)

In addition to the gap from previous research, there is also a period gap. Many previous studies only looked at data from 2020 or 2021, so the study did not look at changes in Bank Indonesia's monetary policy, global interest rate hikes, and international inflationary pressures after the pandemic. The study covering 2016–2024 will provide a more complete picture, including the period after economic recovery. In the period 2016 to 2024, Indonesia has undergone several significant changes. These include a decline in the 2016–2019 BI Rate, a surge in liquidity needs during the 2020 pandemic, an increase in the supply of funds, a massive credit restructuring program, and a drastic increase in interest rates in 2022–2023 to contain inflation. All of these conditions are very important in terms of their influence on the credit risk of conventional commercial banks.

Monetary policy and macroeconomic factors influence the dynamics of conventional commercial bank NPLs. The cost of funds and the interest rate of bank loans are influenced by the interest rate, which is the policy interest rate of Bank Indonesia. This has a direct impact on the debtor's ability to meet their payment obligations. In addition, inflation affects people's purchasing power and business performance, while the money supply, or money supply, indicates the level of liquidity in the economy, which also determines the ability of banks to provide credit. Credit risk and NPL ratios in conventional commercial banks can be affected if there are changes in these three factors.(Syed & Aidyngul, 2022)(Warjiyo, n.d.)

Based on this description, research on how the BI Rate, inflation, and money supply have an impact on the NPL of conventional commercial banks in Indonesia needs to be conducted. Monthly data from 2016–2024 were used in this study to describe more deeply how macroeconomic variables and credit risk interact with each other. It is hoped that the results of the study will provide empirical evidence on the variables that affect NPLs and become a consideration for regulators and banking industry players in maintaining the stability and resilience of the national financial system.

1.2 Problem Formulation

Based on the background that has been described, the formulation of the problem in this study is as follows

1. What is the effect of the BI Rate on Credit Risk (NPL) in conventional commercial banks in Indonesia
2. What is the effect of inflation on NPLs in conventional commercial banks in Indonesia
3. What is the effect of money supply on NPLs in conventional commercial banks in Indonesia

1.3 Research Objectives

Based on the formulation of the above problem, the research objectives to be achieved are:

1. To analyze the influence of BI Rate on Credit Risk (NPL) in conventional commercial banks in Indonesia.

2. To analyze the effect of money *supply* on *Credit Risk* (NPL) in conventional commercial banks in Indonesia.
3. To analyze the effect of inflation on Credit Risk (NPL) in conventional commercial banks in Indonesia.

1.4 Scope

This study only focuses on conventional commercial banks and uses *the Non-Performing Loans* (NPL) ratio as a dependent variable. The independent variables studied are interest rates, inflation and money supply, which are measured as a whole at the national macro level. Therefore, this study does not discuss differences between regions or between manuscript segments. The time interval from 2016-2024 is set to observe changes in monetary policy since before the pandemic, during the COVID-19 pandemic, and after the pandemic. The secondary data used comes from official publications such as Bank Indonesia, BPS, and OJK. It was analyzed quantitatively using econometric techniques to evaluate the influence of the BI Rate, money supply, and inflation on conventional commercial bank NPLs partially and simultaneously.

1.5 Research Benefits

1. Theoretical Benefits
 - a. As a development of science, especially in the study of monetary and banking economics, by providing the latest empirical evidence on the influence of BI Rate, Money Supply, and inflation on credit risk (NPL) in conventional commercial banks.
 - b. Adding research references related to macroeconomic factors that affect the quality of banking assets, as well as filling research gaps that have not

discussed the relationship between these three variables simultaneously in conventional commercial banks in Indonesia.

2. Practical Benefits

- a. For Bank Indonesia and OJK, the results of the research can be an input in formulating interest rate policies, liquidity management, and credit risk supervision in conventional commercial banks.
- b. For conventional commercial bank management: research results can be used to improve risk management strategies, credit planning, and credit portfolio management to be more adaptive to changes in interest rates, inflation, and money supply.