

CHAPTER I

INTRODUCTION

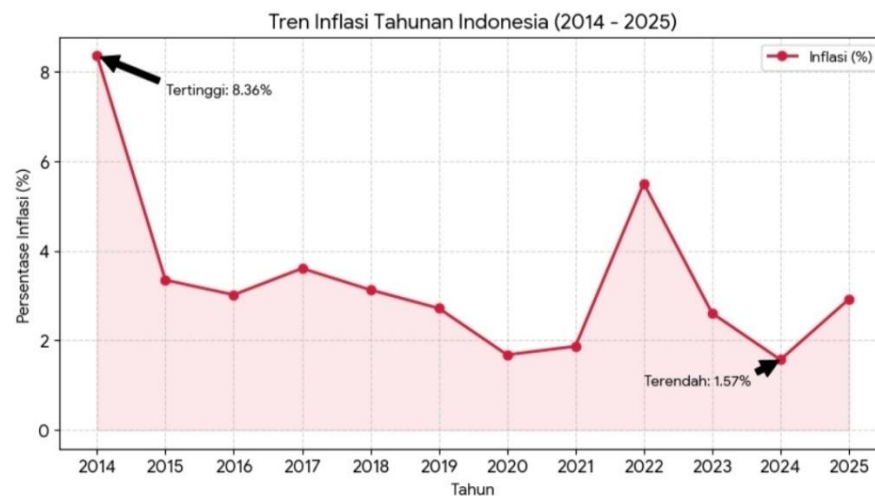
1.1 Background

Price stability is the cornerstone of Indonesia's economic management. Inflation, as an indicator of changes in the prices of goods and services, generally reflects the balance between supply and demand in the economy, while also serving as a barometer of the effectiveness of monetary policy implemented by Bank Indonesia. Between 2014 and 2025, Indonesia's inflation rate followed a dramatic trajectory: starting from a peak of 8.36 percent in 2014, it fell consistently to reach a record low of 1.57 percent in 2024 a figure never before recorded since Indonesia began measuring inflation in 1958 before rising again to 2.92 percent by the end of 2025. This twelve-year journey is more than just a series of statistical figures. Behind it lie shifts in monetary policy regimes, a succession of external shocks, and the structural transformation of Indonesia's economy all of which have made this period the richest and most complex policy laboratory in the history of modern Indonesian economics.

The starting point of this research period, namely the year 2014, was marked by extraordinarily high inflationary pressures. An inflation rate of 8.36 percent in that year was primarily triggered by the government's decision to significantly raise the prices of subsidized Fuel Oil (BBM), a fiscal policy that had direct ripple effects

against transportation costs, distribution, and consumer goods prices throughout the supply chain. The increase in domestic energy prices interacted with global oil prices, which remained around 99 USD per barrel in the same year, creating a double pressure on the production cost side (cost-push) that pushed inflation to its highest level in a decade. This condition forced Bank Indonesia to maintain the BI Rate at 7.50 percent throughout 2014-2015 as the last bastion of controlling inflation expectations.

Figure 1.1 Indonesia's Inflation from 2014-2025



Source: BPS, Data Processed by Researcher 2026

The period from 2015 to 2019 marked a phase of consolidation where inflation was successfully reduced gradually toward Bank Indonesia's target range of 2.5 percent plus or minus 1 percent. This success did not happen by chance. Bank Indonesia consistently lowered the BI Rate from 7.50 percent in 2015 to 5.00 percent in 2019, a cumulative decrease of 250 basis points, in line with the easing of inflationary pressures and the beginning of public confidence in the inflation targeting framework implemented by the monetary authority. On the other hand,

the plummeting world oil prices from 99 USD per barrel in 2014 to only 43.7 USD per barrel in 2016 also provided breathing room for domestic inflation thru lower energy and distribution costs. During this period, the money supply (M2) grew moderately in the range of 6-10 percent per year, reflecting a cautious monetary policy in maintaining the balance between liquidity and price stability.

The years 2020 and 2021 brought the biggest disruption the global economy has experienced in the last century: the COVID-19 pandemic. Indonesia's inflation rate fell to unprecedented levels, namely 1.68 percent in 2020 and 1.87 percent in 2021. However, these low figures conceal a dangerous paradox: inflation did not decrease because monetary policy was successful, but rather because domestic aggregate demand collapsed due to mobility restrictions, mass layoffs, and the collapse of consumer confidence. Bank Indonesia responded by aggressively lowering the BI Rate to a historic low of 3.50 percent in 2021, while implementing a quantitative easing policy that drove M2 growth to soar by 14.02 percent, the highest money supply growth rate during this research period. The combination of ultra-low interest rates and massive monetary expansion became the seeds for inflationary pressures that then exploded in 2022.

The year 2022 became the most dramatic turning point in this research period. Inflation surged to 5.51 percent, more than three times the previous year, in a shock that rattled all instruments of Indonesia's economic policy. Two external factors coincided: first, the post-pandemic global economic recovery that massively increased energy demand, causing world oil prices to surge from 41.8 USD per barrel in 2020 to 100.9 USD per barrel in 2022, a 141 percent increase in two years; second, Russia's invasion of Ukraine in February 2022, which fundamentally

disrupted global energy and food supply chains. This external shock interacts with domestic conditions where M2, which has increased rapidly since 2020, has created excess liquidity ready to suppress prices. Bank Indonesia was forced to make a drastic policy reversal by raising the BI Rate from 3.50 percent to 5.50 percent, a 200 basis point increase in one year, the most aggressive response in the last decade.

The period from 2023 to 2025 shows a normalization pattern that is proceeding faster than expected. Inflation fell back to 2.61 percent in 2023 and continued to decline to a record 1.57 percent in 2024, although it then rose again to 2.92 percent in 2025. The journey of inflation over these twelve years has formed a unique cycle pattern: the high-pressure phase (2014), the stabilization phase (2015-2019), the demand collapse phase (2020-2021), the external shock phase (2022), and the normalization phase (2023-2025). Each phase has its own characteristics in the response between policy interest rates, the money supply, and world oil prices to inflation, and the complexity of the inter-phase relationships is what makes a comprehensive study covering 2014-2025 essential to understand.

In this context, three variables are chosen as the main determinants of inflation to be analyzed in this study. First, the Bank Indonesia policy interest rate (BI Rate) which represents the monetary policy stance of the authority. Theoretically, thru the Fisher Effect, an increase in nominal interest rates responds to rising inflation expectations, so empirically, both move in the same direction in the short term before the demand cooling mechanism works in the medium term. During the study period, the BI Rate fluctuated between a low of 3.50 percent (2021) and a high of 7.50 percent (2014-2015), reflecting dramatic stance changes in response to volatile inflation cycles. Second, the money supply in the M2

definition, which includes currency, demand deposits, and quasi-money. Based on Irving Fisher's quantity theory of money ($MV=PT$), the expansion of M2 not matched by real output growth directly suppresses the price level. Indonesia's M2 grew from 4,173 trillion rupiah in 2014 to 10,133 trillion rupiah in 2025, a 143 percent increase over twelve years with a significantly varying rate each year. Third, world oil prices (Brent crude) which serve as the main proxy for external cost pressures on the Indonesian economy. As a country that still relies on oil imports to meet its energy needs, Indonesia is very vulnerable to global oil price volatility through the mechanism of cost-push inflation and spillover effects on the entire production and distribution cost chain.

Previous research on the determinants of inflation in Indonesia has been conducted extensively, but it faces three fundamental limitations that create scientific gaps that need to be filled. First, the temporal limitation: most studies use data that ends before 2022, thus failing to capture the most extreme phenomenon in the last decade, namely the inflation spike in 2022 due to the post-pandemic energy shock and the Russia-Ukraine war, as well as the sharp and rapid reversal of monetary policy in response. Second, the methodological limitation: studies using annual data tend to be overlooked even though they are more relevant for analyzing the effects of medium-long term structural policies, where the BI Rate decision is evaluated in annual cycles and its impact on inflation expectations operates within the same horizon. Annual data allows for the identification of clean policy effects without the noise of monthly seasonal fluctuations that can distort estimates. Third, contextual limitations: there is almost no research that explicitly integrates the analysis of the pandemic period (2020-2021) and the post-pandemic period (2022-

2025) as a single interconnected cycle, even tho both are manifestations of a continuous series of events that cannot be understood separately.

Based on the dramatic inflation phenomenon during 2014-2025, as well as the limitations of previous research that have not comprehensively analyzed the interaction between policy interest rates, money supply, and world oil prices in a full cycle encompassing various policy regimes and external shocks, this study aims to fill that gap. By using monthly data from the period 2014-2025, which includes 144 observations, a deliberate methodological choice to capture the effects of medium to long-term structural policies, this research aims to provide a more comprehensive understanding of the mechanisms of inflation determination in Indonesia, while also serving as empirical input for Bank Indonesia in refining its monetary policy strategy amid the increasing global uncertainty.

1.2 Problem Formulation

Based on the background that has been previously presented, the following are the research questions in this study:

1. Does the Bank Indonesia policy interest rate have a significant effect on inflation in Indonesia both in the short term and the long term?
2. Does the money supply (M2) have a significant impact on inflation in Indonesia both in the short term and the long term?
3. Does the world oil price have a significant impact on inflation in Indonesia both in the short term and the long term?

1.3 Research Objectives

Based on the background and problem formulation presented in the previous section, this research aims to:

1. Analyze the impact of Bank Indonesia's policy interest rate on inflation in Indonesia in both the short and long term.
2. Analyze the impact of the money supply (M2) on inflation in Indonesia in both the short and long term.
3. Analyze the impact of world oil prices on inflation in Indonesia in both the short and long term..

1.4 Research Scope

This study limits the analysis to the influence of three independent variables on Indonesia's inflation, measured thru the annual change in the Consumer Price Index (CPI). The use of monthly data in this study is a deliberate methodological choice and not a technical limitation. The BI Rate policy is set and evaluated within the framework of an annual cycle thru quarterly Board of Governors meetings, while Bank Indonesia's inflation target is set and assessed on a monthly basis. Therefore, monthly data is more appropriate for identifying the effects of medium-term structural policies free from seasonal noise, in line with the actual policy horizon used by Bank Indonesia in decision-making. The research period spans from January 2014 to December 2025, covering twelve years strategically chosen to represent a full cycle of Indonesia's monetary policy, including phases of high inflation pressure (2014), stabilization (2015-2019), the COVID-19 pandemic shock (2020-2021), post-pandemic energy shock (2022), and policy normalization (2023-2025). The analysis was conducted at the national level using aggregate data

sourced from the Central Statistics Agency (BPS), Bank Indonesia, and reliable international sources for Brent crude oil price data.

1.5 Research Benefits

This research provides three main contributions. Theoretically, this research enriches the Indonesian monetary economics literature by presenting empirical evidence on the relationship between domestic monetary policy instruments, global external factors, and inflation over a period that encompasses various policy regimes and shocks, something that has not been comprehensively addressed by previous studies. Methodologically, this research demonstrates that the analysis of monthly data within the appropriate policy horizon can yield relevant findings that can be directly interpreted by policymakers, particularly in understanding the medium-term structural effects of changes in the BI Rate and M2 on inflation. Practically, the results of this research provide input for Bank Indonesia in calibrating monetary policy, especially in situations where external pressures such as oil price volatility interact with domestic liquidity conditions, as well as for investors and business actors in anticipating inflation dynamics based on the movements of key macroeconomic variables analyzed in this study.