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THE DILEMMA OF INTEREST RATE REDUCTION BY BANK INDONESIA: A LITERATURE REVIEW ON THE IMPACT ON ECONOMIC GROWTH AND RUPIAH EXCHANGE RATE STABILITY

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Abstract

This study aims to examine the dilemma of lowering interest rates by Bank Indonesia (BI) through a literature review of its impact on economic growth and rupiah exchange rate stability. The reduction in the BI benchmark interest rate is one of the main instruments of monetary policy that is expected to encourage consumption, investment, and lending, thereby accelerating national economic growth. However, this policy also brings risks to rupiah exchange rate stability, especially due to potential capital outflows and weakening the attractiveness of rupiah-denominated assets in the eyes of foreign investors. This study uses a qualitative method with a literature review approach, analysing findings from various scientific journals, Bank Indonesia reports, and related economic publications. The results show that interest rate cuts are effective in promoting economic growth, but have the potential to increase exchange rate volatility if not balanced with adequate intervention and external risk management. Therefore, Bank Indonesia is faced with a trade-off between stimulating economic growth and protecting external macroeconomic stability, which requires prudent, measured, and coordinated policies with fiscal and macroprudential policies.

Keywords: Interest rate, Bank Indonesia, economic growth, rupiah exchange rate, monetary policy, capital outflow, macroeconomic stability.

Introduction

Bank Indonesia (BI) as the central bank has the primary mandate to achieve and maintain rupiah stability, as stipulated in Law No. 3 Year 2004 article 7 on Bank Indonesia. In carrying out this mandate, BI uses policy interest rates-currently known as the BI Rate or BI 7-Day Reverse Repo Rate-as the main instrument to influence national economic and financial activity. The setting of this benchmark interest rate is one of the important mechanisms in the transmission of monetary policy with the ultimate goal of controlling inflation and sustainable economic growth (Yagci ., 2023)

The BI benchmark interest rate is a benchmark for financial institutions throughout Indonesia in determining the amount of interest rates on deposits and loans to customers. When BI lowers the benchmark interest rate, it is expected that banks will also adjust lending and deposit rates, although this transmission process does not happen instantly and often takes several months (Cochrane & Taylor, 2020) . A cut in the benchmark interest rate is usually done in response to economic conditions that require stimulus, such as a slowdown in household consumption or the need to boost investment.

In recent years, BI has lowered its benchmark interest rate several times, including in 2025 when the BI Rate was lowered to 5.50%. This policy was taken by considering low and stable inflation forecasts, as well as the rupiah exchange rate which is still within its fundamental range (Wahid & Chaidir, 2025) . The reduction in interest rates is expected to be a stimulus for the national economy, especially in facing the challenges of slowing global and domestic economic growth.

The lowering of the benchmark interest rate by BI is also part of an expansionary monetary policy that aims to boost economic growth through increased consumption and investment. By lowering borrowing costs, companies and households are expected to be more encouraged to take out credit, thereby increasing economic activity. However, the effectiveness of this policy largely depends on the response of banks and market sentiment (Pakasi et al., 2023) .

However, lower interest rates also pose a dilemma for BI. On the one hand, this policy could boost economic growth through increased demand for credit and investment. On the other hand, there is a risk to the stability of the rupiah exchange rate, especially if lower interest rates lead to capital outflows as interest rate differentials with other countries become less attractive to foreign investors. Pressure on the rupiah exchange rate can increase the risk of depreciation and impact macroeconomic stability (Putri et al., 2024) .

The policy of lowering interest rates is also faced with transmission challenges that do not always run smoothly. A decrease in the benchmark interest rate is not necessarily followed by a proportional and rapid decrease in bank lending rates. There is a time lag in the transmission of monetary policy, where lending rate adjustments usually take 6-12 months after the benchmark rate change is made (Baglioni, 2024) . This is influenced by various factors, including the cost of funds structure, profit margins, and operational efficiency of banks (Rajan, 2024) .

From the perspective of business players, the reduction in the benchmark interest rate was generally welcomed positively as it could lower financing costs and increase people's purchasing power. The Chairman of the Indonesian Employers Association, for example, sees this policy as a stimulus that can maintain domestic market stability and support business expansion, especially amid the challenges of weakening purchasing power and slowing consumption. However, businesses also realise that the real impact of lower interest rates takes time to be felt in the real sector (Wicaksono, 2023) . In addition, the rate cut is expected to strengthen household liquidity and encourage consumption credit growth. However, the effectiveness of this policy depends on how far banks are able to reduce interest rates on consumption loans and increase lending to the productive sector. If the policy transmission does not run optimally, the goal of encouraging consumption and investment growth may not be achieved optimally (Aguirre et al., 2023) .

Amid efforts to boost economic growth, BI must also remain vigilant against external risks that could affect the stability of the rupiah exchange rate. Global uncertainty, changes in monetary policy in developed countries, and the potential widening of the current account deficit are challenges that must be anticipated with careful and measured policies. BI seeks to keep rupiah depreciation under control so that local assets remain attractive to foreign investors and market confidence is maintained (Turyandi et al., 2025) .

The rate cut policy should also be combined with macroprudential policies and payment system strengthening to ensure optimal support for economic growth. BI has optimised accommodative macroprudential policies and strengthened payment system infrastructure, particularly to support the trade sector and MSMEs. These measures are expected to accelerate monetary policy transmission and increase the effectiveness of economic stimulus (Pontines & Siregar, 2017) .

Despite the benefits of lower interest rates, BI is still faced with a dilemma between promoting economic growth and maintaining rupiah exchange rate stability. This trade-off requires BI to always conduct a careful assessment of domestic and global macroeconomic conditions, and consider various risks that may arise from changes in interest rate policy (IMF, 2022) .

Based on this background, this study will examine in depth the interest rate cut dilemma by Bank Indonesia, with a focus on its impact on economic growth and rupiah exchange rate stability. This literature review is expected to provide a more comprehensive understanding of the effectiveness and challenges of interest rate policy in Indonesia, as well as provide input for the formulation of future monetary policy.

Research Methods

The research method used in this study is a qualitative method with a literature review approach, where the data analysed comes from secondary sources such as scientific journals, Bank Indonesia reports, government publications, and relevant economic articles. Data were collected through literature searches that discuss the impact of interest rate cuts on economic growth and rupiah exchange rate stability, then analysed descriptively and comparatively to identify patterns, findings, and policy dilemmas faced by Bank Indonesia in this context (Eliyah & Aslan, 2025) ; (Ferrari, 2020) .

Results and Discussion

Impact of Interest Rate Reduction on Economic Growth

The reduction of the benchmark interest rate by Bank Indonesia (BI) is one of the main instruments in monetary policy aimed at encouraging national economic growth. This policy is taken with the hope of increasing consumption, investment, and lending, so that economic activity moves more dynamically (Warjiyo ., 2023)

In theory, a decline in interest rates will lower borrowing costs for businesses and households. This encourages people to borrow more actively, both for consumption and investment. In the Keynesian framework, lower interest rates increase aggregate demand through two main channels: consumption and investment. The direct impact of lower interest rates is increased lending by banks (Suratman, 2025) . With lower interest costs, people and businesses are more encouraged to apply for credit, whether for working capital, investment, or consumption. Data shows that the growth of working capital, investment, and consumption loans increased significantly after the interest rate cut policy was enacted (Bordo et al., 2024) .

The banking sector is one of the sectors that benefits the most from this policy. The decline in interest rates encouraged banks to be more expansive in lending, especially to the real sector and MSMEs. This has an impact on increasing economic activity in productive sectors, such as property, construction, and consumer goods (Juhro & Azwar, 2021) . For the household sector, the decline in the BI rate had an impact on the decline in interest rates for consumer loans, such as home ownership loans (KPR) and multipurpose loans. Demand for mortgages increased significantly, followed by an easing of household credit standards, especially in terms of collateral and interest rates. This has the potential to boost the purchasing power of the upper middle class through increased credit-based consumption (Gagnon & Hinterschweiger . , 2024)

The MSME sector has also had a positive impact. The decline in interest rates has made bank loans cheaper, making it easier for MSMEs to obtain loans for business capital. In addition, the increasing purchasing power of the community has also boosted demand for MSME products and services, resulting in the rapid growth of this sector.

Declining interest rates also provide more attractive investment opportunities in the stock and bond markets. Yields from fixed-income instruments such as deposits and bonds tend to decline, so investors turn to the stock market which offers greater profit potential. This has resulted in increased stock prices and activity on the stock exchange. However, the effectiveness of interest rate cuts in promoting economic growth is not instantaneous (Wicaksono & Siregar, 2023) . There is a time lag in monetary policy transmission, where lending rate adjustments usually take 3-6 months, even up to 1.5 years for the full impact on the economy. Factors such as bank liquidity conditions, market sentiment, and external stability affect the speed of this policy transmission. In addition, lower interest rates also have the potential to increase inflation if not matched with price and supply controls. Increased consumption and investment can boost aggregate demand, which in turn has the potential to suppress the prices of goods and services in the market (Hakim & Aji, 2025) .

In terms of economic growth, the reduction in BI's benchmark interest rate is one of the preventive efforts to maintain growth momentum, especially amid slowing household consumption and external pressures. BI revised the projection of Indonesia's economic growth in 2025 to 4.6-5.4 per cent, lower than the initial projection, but still shows optimism for economic recovery. The policy of lowering interest rates must also be accompanied by coordination of fiscal and macroprudential policies. The effectiveness of monetary policy is highly dependent on synergies with government policies, such as fiscal stimulus, structural reforms, and strengthening the national financial system (Rahayu, 2023) .

While lower interest rates provide many benefits, there are also challenges that must be faced. One of them is the risk of capital outflows as interest rate differentials with other countries become less attractive to foreign investors. This could put pressure on the rupiah exchange rate and external stability. In addition, lower interest rates do not necessarily address structural problems in the economy, such as a decline in middle-class purchasing power, stagnation of real income, and a slowdown in labour-intensive industries (Ekaputri & Yefriza, 2023) . Therefore, monetary policy needs to be supported by structural reforms and well-targeted fiscal policy.

Overall, interest rate cuts by Bank Indonesia have been proven to boost economic growth through increased consumption, investment, and lending. However, its effectiveness is highly dependent on banking responses, liquidity conditions, market sentiment, as well as coordination with fiscal and macroprudential policies. Thus, this policy must be implemented carefully and measuredly in order to provide optimal benefits to the national economy.

Impact of Interest Rate Cut on Rupiah Exchange Rate Stability

The reduction of the benchmark interest rate by Bank Indonesia (BI) is a monetary policy that not only impacts economic growth, but also has significant implications for the stability of the rupiah exchange rate. Exchange rate stability is one of the key indicators of macroeconomic health, as sharp fluctuations can trigger uncertainty in the financial sector and international trade (Aji, 2023) .

In theory, a decline in domestic interest rates tends to cause a depreciation or weakening of the rupiah exchange rate. This happens because the interest rate differential between Indonesia and other countries, especially the United States, becomes smaller so that rupiah-denominated assets become less attractive to foreign investors. As a result, the potential for capital outflows increases and depresses the rupiah exchange rate (Rivani, 2025) .

In practice, a decrease in the BI rate is often followed by an increase in rupiah exchange rate volatility. This volatility is triggered by market reactions to expectations of declining yields, as well as global uncertainty that can accelerate capital outflows from domestic financial markets (Honohan, 2020) .

One of the main risks of lower interest rates is capital outflows, where foreign investors withdraw their funds from Indonesia's bond and stock markets in search of higher yields in other countries. This phenomenon can weaken the rupiah exchange rate significantly, especially if it occurs simultaneously with external pressures such as Fed rate hikes or global geopolitical tensions (Warjiyo ., 2023)

Bank Indonesia responded to this risk by intervening in the foreign exchange market, either through spot transactions, Domestic Non-Deliverable Forward (DNDF), or the purchase of Government Securities (SBN) in the secondary market. This intervention aims to maintain liquidity and stabilise the rupiah exchange rate amid increasing external pressures. In addition to direct intervention, BI also strengthened its monetary operation strategy to keep interest rate instruments attractive to foreign investors. This is done by adjusting interest rates on monetary instruments and strengthening policy communication to maintain market confidence in Indonesia's macroeconomic stability (Wullweber ., 2024)

However, the effectiveness of BI intervention in maintaining exchange rate stability is highly dependent on the resilience of national foreign exchange reserves. If the pressure on the rupiah lasts for a long time and foreign exchange reserves are depleted, the room for BI to intervene will be increasingly limited, so the risk of rupiah depreciation increases.

A decline in interest rates can also trigger an increase in demand for foreign exchange, both for import needs and foreign debt repayments. If the demand for foreign exchange increases while the supply is limited, the pressure on the rupiah exchange rate will be greater. The impact of lower interest rates on the rupiah exchange rate is also influenced by external conditions, such as the direction of the Fed's monetary policy and global economic developments. If the Fed also lowers interest rates, the pressure on the rupiah can be reduced because the yield difference remains competitive, and there is even the potential for capital inflow to Indonesia (Cahyadi, 2024) .

In some cases, a reduction in the BI rate is actually followed by a strengthening of the rupiah exchange rate, especially if done in a measured manner and supported by strong economic fundamentals, such as low inflation and adequate foreign exchange reserves. This shows that exchange rate stability is not only determined by the level of interest rates, but also by market perceptions of Indonesia's macroeconomic risks (Yagci, 2023) . However, if interest rate cuts are conducted aggressively without considering external conditions and economic fundamentals, the risk of rupiah depreciation and exchange rate volatility will increase. Therefore, BI tends to be cautious and gradual in reducing interest rates, while still prioritising exchange rate stability as the main mandate of the central bank (Cochrane & Taylor, 2020) .

In addition to the risk of depreciation, lower interest rates may also increase the volatility of the rupiah exchange rate. This volatility can have a negative impact on the business world, especially sectors that depend on imports of raw materials or have debt in foreign currency. Exchange rate uncertainty can increase production costs and corporate financial risks. To minimise the negative impact of interest rate cuts on exchange rate stability, BI combines interest rate policy with macroprudential policy and payment system strengthening. These measures aim to maintain investor confidence, strengthen market liquidity, and ensure the stability of the national financial system (Wahid & Chaidir ., 2025)

Overall, interest rate cuts by Bank Indonesia have a complex impact on rupiah exchange rate stability. This policy may boost economic growth, but it risks putting pressure on the exchange rate if not balanced with appropriate intervention and good external risk management. Therefore, BI must always conduct a careful assessment and be responsive to global and domestic dynamics in every interest rate decision.

Dilemmas and Trade-offs of Bank Indonesia's Interest Rate Cut Policy

The lowering of the benchmark interest rate by Bank Indonesia (BI) is always faced with a complex policy dilemma. On the one hand, this policy is expected to boost economic growth through increased consumption, investment, and lending. However, on the other hand, there are risks to the stability of the rupiah exchange rate and potential capital outflows that could weaken the national economy (Pakasi et al., 2023).

The central bank must balance two main objectives: maintaining macroeconomic stability, particularly the exchange rate and inflation, and promoting economic growth. Declining interest rates may lower borrowing costs and boost economic activity, but also potentially reduce the attractiveness of rupiah-denominated assets in the eyes of foreign investors, thereby increasing the risk of rupiah depreciation (Putri et al., 2024) .

The dilemma sharpens when external pressures increase, such as Fed rate hikes or global geopolitical turmoil. If BI cuts interest rates too aggressively, the yield differential with other countries narrows, so foreign investors tend to withdraw their funds from the domestic financial market (Baglioni, 2024) . This can weaken the rupiah exchange rate and increase volatility in the financial market. Conversely, if BI holds or even raises interest rates to maintain rupiah stability, domestic borrowing costs will increase. This could hold back economic growth, reduce consumption and investment, and slow down real sector recovery, especially amid global and domestic economic pressures (Rajan, 2024) .

This policy trade-off is also evident from its impact on the banking sector and the business world. Lower interest rates cut the cost of funds and encourage lending, but the transmission to the real sector is not always quick. Banks need time to adjust lending rates, while businesses wait for macro stability before expanding. In addition, lower interest rates may increase the risk of inflation if not matched by price and supply controls. Increased consumption and investment have the potential to boost aggregate demand, which in turn can suppress the prices of goods and services in the market (Wicaksono & Siregar, 2023) .

Another dilemma arises from the fiscal and macroprudential side. The effectiveness of monetary policy depends heavily on synergies with government policies, such as fiscal stimulus, structural reforms, and strengthening the national financial system. Without good coordination, interest rate cuts could fail to achieve their optimal goals (Wicaksono ., 2023)

Bank Indonesia must also consider the resilience of national foreign exchange reserves. If the pressure on the rupiah lasts for a long time and foreign exchange reserves are depleted, the room for BI to intervene will be increasingly limited, so the risk of rupiah depreciation increases.

The policy dilemma becomes more complex when considering the long-term impact. Prolonged low interest rates may encourage excessive risk-taking behaviour in the financial sector, increase the potential for asset bubbles, and reduce the incentive to save. Moreover, lower interest rates do not necessarily address structural problems in the economy, such as declining purchasing power of the middle class, real income stagnation, and slowdown in labour-intensive industries. Therefore, monetary policy needs to be supported by structural reforms and well-targeted fiscal policy (Turyandi et al., 2025) .

In practice, BI often opts for a gradual and cautious approach in lowering interest rates. The decision is taken by considering inflation forecasts, exchange rate stability, and external dynamics. Transparent policy communication is also key to maintain market confidence and minimise volatility (Aguirre et al., 2023) .

Overall, the dilemmas and trade-offs of Bank Indonesia's rate cut policy demand careful assessment and responsiveness to global and domestic dynamics. BI must be able to balance the need to promote economic growth and maintain external macroeconomic stability, so that the policies taken actually provide optimal benefits to the national economy.

Conclusion

Interest rate cuts by Bank Indonesia have proven to be an important instrument in driving national economic growth. This policy lowers borrowing costs, increases credit demand, and encourages consumption and investment in both the household and business sectors. However, its effectiveness is not instantaneous as transmission to the real sector takes time and is heavily influenced by banking responses, market sentiment, and liquidity conditions. In addition, interest rate cuts must also be balanced with macroprudential and fiscal policies for optimal benefits to the economy.

On the other hand, lower interest rates bring risks to the stability of the rupiah exchange rate. A narrowing yield gap with other countries may trigger capital outflows, depress the exchange rate, and increase volatility in financial markets. Bank Indonesia must intervene and strengthen its stabilisation strategy to maintain investor confidence and prevent excessive rupiah depreciation. Exchange rate stability is crucial, especially amidst global uncertainty and mounting external pressures.

The main dilemma faced by Bank Indonesia is balancing the need to promote economic growth and maintain macroeconomic stability, particularly the rupiah exchange rate. The policy of lowering interest rates must be taken carefully, gradually, and accompanied by an in-depth assessment of domestic and global dynamics. Thus, Bank Indonesia can achieve an optimal balance between growth stimulus and external stability protection, so that monetary policy really provides sustainable benefits to the national economy.

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