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Did Monetary Policy Stabilize Inflation during the COVID-19 Pandemic? Evidence from Indonesia

Afaqa Hudaya✉, Zulfahmi, Etty Puji Lestari

Development Economic Study Program, Faculty of Economics and Business, Universitas Terbuka

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Abstract

This study examines the relationship between monetary policy and inflation in Indonesia during the COVID-19 period, from March 2020 to June 2023, over the short and long term. It focuses on how interest rates, money supply, and exchange rates influence inflation and identifies which factor is most effective. Using Indonesian monthly time-series data, the analysis employs econometric methods, including an error correction model, to assess stationarity, long-term relationships, and cointegration. The results show that the exchange rate is the most influential driver of inflation in both the short and long run, while interest rate policy is less effective, especially during crises. These findings challenge the conventional view that interest rate adjustments alone can stabilize inflation, emphasizing the critical role of exchange rate management. The study also finds that changes in the exchange rate begin to affect inflation within five periods, indicating a rapid short-term transmission. Overall, this research underscores the importance of coordinated monetary and exchange rate policies to maintain price stability and economic resilience in Indonesia, especially during crises.

Keywords: Inflation, Money Supply, Interest Rate, Exchange Rate, Error Correction Model

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✉ Correspondence Address :
Address: Gedung Fakultas III Universitas Terbuka, Jl. Cabe Raya, Pondok Cabe, Pamulang, Tangerang Selatan, 15418
E-mail : afaqa.hudaya@ecampus.ut.ac.id

INTRODUCTION

Indonesia confirmed its first COVID-19 case on March 2, 2020. Following this, the number of infections steadily increased, leading the government to implement major interventions in both public health and economic sectors. Like many other countries, Indonesia turned to monetary policy during the pandemic as a key strategy to stabilize the economy. Monetary policy is often favored for

controlling inflation because of its adaptability and efficiency. The central bank can respond swiftly to economic changes by adjusting monetary instruments.

Inflation generally arises when the money circulating in the economy exceeds the supply of goods and services. The central bank uses monetary policy to regulate the money supply by adjusting reserve requirements or carrying out open market operations, including the purchase or sale of government securities. These measures help regulate inflation by aligning the money supply with demand.

Interest rates are among the key instruments of monetary policy. In times of high inflation, the central bank may increase interest rates to curb borrowing and limit spending, as higher loan costs tend to discourage consumers and businesses.

This decline in consumption and investment helps ease inflationary pressures. Furthermore, a transparent and consistent approach to monetary policy helps shape public and business expectations. If people trust the central bank to maintain stable inflation, they are less likely to increase prices rapidly.

As illustrated in figure 1, Indonesia experienced low inflationary pressure, mainly due to subdued domestic demand during 2020–2021. Given the low inflation and restored external stability, Bank Indonesia decided to adopt an accommodative monetary policy stance.

This was implemented by cutting the Bank Indonesia 7-Day Reverse Repo Rate (BI7DRR) and increasing liquidity through reduced reserve requirements and monetary expansion. Inflation remained low throughout 2021, contributing positively to economic stability. The main factor behind this was the low core inflation rate of 1.56 percent year-on-year, which was slightly lower than the previous year. This reflected weak household consumption due to the COVID-19 pandemic, a stable exchange rate, anchored inflation expectations, and limited impact from global price increases (Bank Indonesia, 2022).

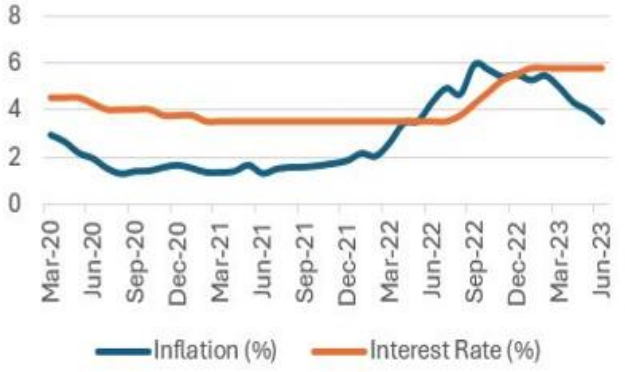

Figure 1. Interest Rate and Inflation Trends in Indonesia Throughout the COVID-19 Pandemic
Source: Bank Indonesia, 2025

To counter the economic slowdown caused by the pandemic, Bank Indonesia, like many other central banks, boosted liquidity using various stimulus tools. An increase in the money supply can potentially lead to inflation as it fuels demand for goods and services, pushing prices upward (Ebrahimy et al., 2020).

Fiscal stimulus and loose monetary policy contributed to a rise in third-party funds, driving money supply growth. In June 2020, both M1 (narrow money) and M2 (broad money) recorded an annual increase of 8.21 percent. By December 2020, M1 growth reached 18.54 percent, while M2 increased by 12.44 percent.

This growth was supported by expanded government financial operations and Bank Indonesia's purchase of Government Securities (SBN). The overall growth in M2 was also influenced by the rise in M1 and quasi-money components (Bank Indonesia, 2021).

Interest rate cuts were intended to stimulate economic activity by lowering borrowing costs, thereby encouraging consumer spending and investment. However, despite this monetary easing, inflation remained restrained because aggregate demand stayed weak amid social restrictions and lingering uncertainty (Eggertson & Kohn, 2023).

Following five consecutive rate cuts since 2020, Bank Indonesia reduced the BI7DRR again in February 2021 to 3.50 percent. The rate was maintained for the rest of the year, reflecting efforts to balance inflation control, exchange rate stability, and economic recovery support (Bank Indonesia, 2022).

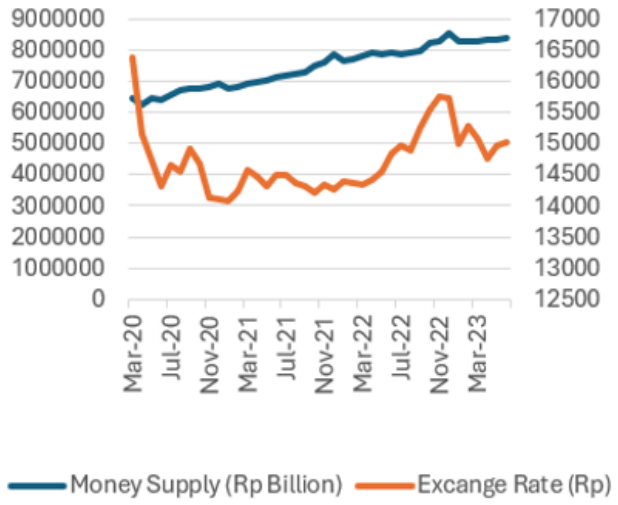

Figure 2. Money Supply (Axis on the Left) and Exchange Rate (Axis on the Right) in Indonesia During COVID-19
Source: Bank Indonesia, 2025

The depreciation of the IDR can raise the cost of imported goods, which is typically passed on to consumers through higher prices, this phenomenon is referred to as imported inflation (Eggertson & Kohn, 2023). Based on figure 2, IDR remained relatively stable in the first half of 2021, with an exchange rate ranging from IDR 14,300 to IDR 14,400. This stability was supported by Bank Indonesia's active stabilization measures and steady inflows of foreign capital into the domestic financial markets during the COVID-19 pandemic.

Indonesia's internal conditions were also stable, indicated by a low inflation rate of 1.33 percent year-on-year in June 2021. To help manage inflation—particularly that stemming from imports, Bank Indonesia took steps to stabilize the exchange rate and counter external pressures such as the strengthening USD and global financial uncertainty.

These measures involved interventions in the foreign exchange market via spot transactions, Domestic Non-Deliverable Forward (DNDF) contracts, and the trading of Government Securities on the secondary market (Bank Indonesia, 2023).

While stimulus policies are essential for economic recovery during crises, monetary measures must be carefully managed to prevent inflation from rising sharply and harming the economy. This study aims to assess Indonesia's monetary policy response during the COVID-19 pandemic using an error correction model (ECM).

This study examines the impact of monetary instruments, specifically the exchange rate, interest rate, and money supply, on inflation in both the short and long run. The aim is to gain a deeper understanding of how monetary policy influences inflation dynamics in Indonesia and to identify the most effective tools, particularly during times of unusual economic challenges.

The impact of key macroeconomic instruments, particularly interest rates and money supply, on inflation in the post–COVID-

19 period can be examined using the Mark-0 agent-based model. Lower interest rates may stimulate consumer spending and business investment; however, they can also generate inflationary pressures if inflation expectations are not well anchored.

Similarly, liquidity injections through Helicopter Money can support economic recovery but tend to amplify inflation. The effectiveness of interest rate policy is closely linked to the central bank's ability to maintain public trust in its inflation targets. Although exchange rates are not explicitly modeled, indirect effects arise through fluctuations in global energy prices.

External shocks, such as the Russia–Ukraine conflict, triggered sharp increases in energy prices, leading to higher production costs that were subsequently passed on to consumers, mirroring the typical effects of currency depreciation. Overall, inflation is influenced not only by monetary variables but also by structural conditions and agents' responses to policy signals, particularly during periods of crisis (Knicker et al., 2025).

During the COVID-19 pandemic, many OECD countries adopted expansionary monetary policies, mainly by reducing interest rates to support economic activity. The evidence indicates that these lower rates promoted economic growth and increased inflation but were also associated with a rise in unemployment.

This suggests that while easier monetary conditions encouraged spending and investment, the labor market remained under pressure due to pandemic-related disruptions. Additionally, a stronger domestic currency (reflected by a higher exchange rate) tended to limit economic growth and inflation slightly, while contributing to higher unemployment, particularly in trade-sensitive industries.

One of the most significant influences during the pandemic was heightened economic uncertainty, which had a clearly negative effect on growth and positive effects on both inflation and joblessness.

These patterns highlight the limited and uneven impact of traditional monetary policy tools during crisis periods, reinforcing the need for more flexible and responsive policy strategies in the face of major global shocks (Rathnayaka et al., 2024).

Amid the COVID-19 pandemic, numerous central banks in major Asian economies implemented expansionary monetary policies—like reducing interest rates—to help mitigate the economic slowdown. These rate cuts were aimed at boosting consumption and investment, which, as explained by the Phillips Curve, tend to increase inflation through demand-side effects. The study notes that inflationary pressures were partly driven by these measures as governments sought to stimulate economic activity amid falling output.

At the same time, the depreciation of domestic currencies raised the cost of imports, further contributing to inflation. Central banks also expanded the money supply through instruments like reserve requirement reductions and bond purchases. While these efforts helped ease liquidity constraints, they also intensified inflation over the longer term.

Overall, the results indicate that, in contrast to the 2008–2009 global financial crisis where the priority was stimulating economic output, monetary policy during the pandemic shifted its focus more toward controlling inflationary pressures (Ma et al., 2022). The relationships between inflation and its key

determinants—interest rates, output gap, and the exchange rate—changed markedly during the COVID-19 pandemic. At the onset of the pandemic, Mexico's central bank significantly reduced interest rates to mitigate the economic downturn, before subsequently increasing them as inflationary pressures intensified.

Estimates based on a Taylor-rule framework indicate that the central bank's responsiveness to inflation weakened in the post-pandemic period. In contrast, the policy response to exchange rate fluctuations strengthened considerably, reflecting heightened concerns over exchange rate volatility, commonly referred to as an increased "fear of floating."

Depreciation of the peso, driven by capital outflows, contributed to rising inflation through higher import prices. In response, monetary policy became more proactive in addressing exchange rate movements to anchor inflation expectations. Counterfactual simulations suggest that, in the absence of this adjustment, inflation and exchange rate volatility would have been substantially higher.

Overall, the increased sensitivity to exchange rate movements appears to represent a short-term policy response aimed at preserving the credibility of the inflation-targeting regime amid heightened global uncertainty (López-Mares et al., 2025).

An analysis covering the period from 1995Q1 to 2022Q4 indicates that exchange rate fluctuations exert a significant and positive effect on inflation in Turkey, Brazil, Russia, and India, confirming the presence of exchange rate pass-through in these economies. Currency depreciation increases import costs, which subsequently contributes to higher domestic prices. In contrast, no statistically significant relationship between exchange rate movements and inflation is observed in China, likely reflecting the country's tightly managed exchange rate regime and strong trade controls.

The effects of interest rates on inflation vary across countries. In Turkey and Russia, higher interest rates are associated with lower inflation, suggesting an effective monetary transmission mechanism operating through demand compression. Conversely, a positive relationship between interest rates and inflation is observed in China, consistent with the cost channel, whereby higher borrowing costs raise production prices.

For Brazil and India, the impact of interest rates on inflation is weak or statistically insignificant. Overall, these results highlight that the effectiveness of interest rate policy in controlling inflation is highly dependent on national economic structures and the role of financing costs in the production process (Akbaş et al., 2024).

Despite the extensive use of expansionary monetary policy during the COVID-19 pandemic, inflation dynamics in Indonesia exhibited atypical patterns, with subdued price pressures persisting alongside aggressive interest rate cuts and rapid monetary expansion.

This raises a critical question regarding the effectiveness of conventional monetary policy instruments—particularly interest rates—in stabilizing inflation during periods of severe economic disruption. Moreover, the relative roles of money supply growth and exchange rate movements in driving inflation during the pandemic remain empirically contested, necessitating a more rigorous examination using Indonesia's recent experience.

This study aims to analyze the impact of monetary policy instruments—namely interest

rates, money supply, and exchange rates—on inflation in Indonesia during the COVID-19 period, both in the short run and the long run. Specifically, the research seeks to (1) identify the existence of a long-term equilibrium relationship between inflation and key monetary variables, (2) assess the short-term adjustment dynamics of inflation in response to monetary shocks, and (3) determine which monetary policy instrument is most effective in influencing inflation during times of crisis.

The findings of this study are expected to contribute to the empirical literature on monetary policy effectiveness under crisis conditions, particularly in emerging economies. From a policy perspective, the results provide valuable insights for Bank Indonesia and fiscal authorities in designing more effective and coordinated monetary and exchange rate policies to maintain price stability during economic shocks.

Academically, this research enriches the discussion on monetary transmission mechanisms by highlighting the limitations of interest rate policy and the critical role of exchange rate management during periods of heightened uncertainty.

RESEARCH METHODS

This study utilizes secondary data obtained through internet sources and literature reviews, focusing on time series data during Indonesia's COVID-19 period. The variables used—namely money supply, interest rate, exchange rate, and inflation—were sourced from Bank Indonesia and are presented in monthly intervals covering the period from March 2020 to June 2023.

The money supply is measured using broad money (M2), expressed in billions of IDR. Interest rate data is represented by the BI Rate, recorded in percentage units. Meanwhile, exchange rate data reflects the transaction rates from Bank Indonesia, based on the daily closing middle rate of the IDR against the USD. The mathematical model used in the study is formulated in the following equation:

$$INF = f(MS, IR, ER)$$

This study employs the Error Correction Model (ECM) as its method of data analysis. ECM is used to adjust regression models involving individually non-stationary variables, helping them return to a long-term equilibrium. A key requirement for using ECM is the existence of a cointegration relationship, which indicates a stable long-run connection among non-stationary variables (Ajija et al., 2011).

The ECM approach involves several stages: testing for stationarity through a stochastic process, determining the degree of integration, and estimating both short-run and long-run models.

The Augmented Dickey-Fuller (ADF) test is used to assess the stationarity of the data, whether at its level form or after differencing. Stationary data is defined as having limited variance over time and a tendency to move toward a consistent average. If the ADF test statistic is greater than the Elliott-Rothenberg-Stock critical value, the data is considered stationary, meaning it does not contain a unit root.

If the test statistic falls below the critical value, the data is considered non-stationary and needs to be differenced—usually at the first order (I(1))—by subtracting each value from its preceding value.

If one variable is found to be stationary at the first difference, all variables in the model

must also be transformed to the same level (Ajija et al., 2011). The cointegration relationship among the variables is assessed using the Engle-Granger two-step method. The first step involves estimating the long-term equation, which is formulated as follows:

$$LINF_t = \phi_0 + \phi_1 LMS_t + \phi_2 LIR_t + \phi_3 LER_t + u_t$$

After estimating the long-run equation, the residuals from the Ordinary Least Squares (OLS) regression are derived using the following expression:

$$\hat{u}_t = LINF_t - \widehat{\phi_0} - \widehat{\phi_1} LMS_t - \widehat{\phi_2} LIR_t - \widehat{\phi_3} LER_t$$

One method to test for cointegration is by performing a unit root test on the residuals. This entails regressing the first-differenced residuals on their lagged values and examining the statistical significance of the estimated coefficients (Ghozali & Ratmono, 2017).

The results from the ECM estimation help explain the adjustment process between short-term dynamics and the long-run relationship. The model also captures the short-term responsiveness (elasticity) of the independent variables (Ajija et al., 2011). The ECM used in this research is structured as follows:

$$\Delta LINF_t = \phi_0 + \phi_1 \Delta LMS_t + \phi_2 \Delta LIR_t + \phi_3 \Delta LER_t + \phi_4 u_{t-1} + \varepsilon_t$$

This equation is estimated using OLS. Since it contains both level and differenced variables, standard statistical tests such as t-tests and error diagnostics are valid. For the ECM to function properly, the adjustment coefficient ϕ_4 should be negative, indicating that any short-term imbalance will be corrected toward the long-run equilibrium.

RESULTS AND DISCUSSION

Prior to model estimation, the stationarity properties of all variables were examined using the Augmented Dickey–Fuller (ADF) test. Table 1 reports the ADF results at the level form, showing that inflation (LINF), money supply (LMS), interest rate (LIR), and exchange rate (LER) are non-stationary at the 5 percent significance level. This indicates the presence of stochastic trends, a common feature of nominal macroeconomic variables, and is consistent with standard macroeconomic theory and empirical evidence (Nelson & Plosser, 2002).

Table 1. Results of Stationary Stochastic Process Estimation: The Level Form

Variables	t-Statistic ADF Test	Critical Value (5% level)
LINF	-1.4933	-3.1900
LMS	-3.1131	-3.1900
LIR	-1.7165	-3.1900
LER	-2.3655	-3.1900

Source: Data processed, 2025

Following this result, stationarity was tested at the first-difference level. As presented in Table 2, none of the variables achieve stationarity at I(1). This outcome departs from much of the inflation literature, where first differencing typically removes unit roots. The persistence observed here may reflect structural characteristics of the Indonesian economy, including prolonged monetary accommodation, exchange rate rigidity, and delayed policy transmission.

To determine the integration order conclusively, the ADF test was extended to the second-difference level. The results in Table 3 indicate that all variables become stationary at I(2). This suggests that shocks to inflation,

money supply, interest rates, and exchange rates are highly persistent and dissipate only gradually.

Table 2. Estimation Results of the Stationary Process at the First-Difference Level

Variables	t-Statistic ADF Test	Critical Value (5% level)
LINF	-2.7828	-3.1900
LMS	-3.0339	-3.1900
LIR	-3.0233	-3.1900
LER	-2.5533	-3.1900

Source: Data processed, 2025

Given the identified integration properties, the long-run relationship between inflation and its key determinants was estimated. Table 4 presents the long-run coefficient estimates, with inflation (LINF) specified as the dependent variable.

Table 3. Estimation Results of the Stationary Process at the Second-Difference Level

Variables	t-Statistic ADF Test	Critical Value (5% level)
LINF	-7.8399	-3.1900
LMS	-3.3196	-3.1900
LIR	-6.8339	-3.1900
LER	-8.4788	-3.1900

Source: Data processed, 2025

The results indicate that money supply (LMS) and exchange rate (LER) have positive and statistically significant effects on inflation at the 1 percent level, while the interest rate (LIR) is statistically insignificant. The positive elasticity of inflation with respect to money supply supports the monetarist proposition that sustained liquidity expansion ultimately translates into higher price levels (Friedman, 1968). In the Indonesian context, this finding suggests that excess liquidity—particularly during periods of economic stimulus—tends to generate inflationary pressures rather than real output expansion.

Table 4. Long-Run Model Estimation Results: LINF as the Dependent Variable

Variables	Coefficient	t-Statistic	Prob.
LMS	3.3278	7.0308	0.0000*
LIR	0.2729	0.9287	0.3592
LER	7.0260	4.5688	0.0001*
C	-119.5309	-7.4265	0.0000

Notes: *) Statistically significant at the 1% level; **) Statistically significant at the 5% level; ***) Statistically significant at the 10% level.
Source: Data processed, 2025

The exchange rate coefficient is both positive and economically large, indicating a strong exchange rate pass-through to domestic inflation. This result aligns with empirical evidence from developing and import-dependent economies, where currency depreciation rapidly increases domestic prices through higher import costs for consumption goods, energy, and intermediate inputs (Taylor, 2000). The magnitude of the coefficient reflects Indonesia's structural reliance on imported inputs and limited short-term substitution capacity.

In contrast, the insignificance of the interest rate variable suggests a weak interest-rate transmission mechanism. This may be attributed to shallow financial markets, low interest sensitivity of investment, or the prevalence of non-bank financing channels. Policy rates often play a limited role in inflation control in emerging economies (Mishra &

Montiel, 2013). Table 4 provides the long-run model estimation results using the following equation:

$$\mathrm{LINF_t} = -119.5309 + 3.3278\mathrm{LMS_t} + 0.2729\mathrm{LIR_t} + 7.0260\mathrm{LER_t} + \mathrm{u_t}$$

To assess whether a stable long-run equilibrium relationship exists among the variables, a cointegration test based on the residuals was conducted. The results are reported in Table 5.

Table 5. Estimation Result of Cointegration Test

Variables	Prob.
RESID_LINF(-1)	0.0076

Source: Data processed, 2025

The probability value of the lagged residual term is 0.0076, which is significant at the 1 percent level, indicating that the residuals are stationary. This finding confirms the existence of a long-run equilibrium relationship among inflation, money supply, interest rates, and exchange rates. Economically, it implies that although these variables may diverge in the short run, they tend to move together over time due to underlying macroeconomic linkages. Based on this result, the ECM is formulated as follows:

$$\Delta\mathrm{LINF_t} = 0.0150 - 1.3149\Delta\mathrm{LMS_t} + 0.6379\Delta\mathrm{LIR_t} + 1.9541\Delta\mathrm{LER_t} - 0.1886\mathrm{u_{t-1}} + \varepsilon_t$$

Given the presence of cointegration, an Error Correction Model (ECM) was estimated to capture short-run dynamics and the speed of adjustment toward long-run equilibrium. The ECM estimation results are presented in Table 6. The error correction term (RESID_LINF(-1)) is negative and statistically significant at the 5 percent level, confirming the validity of the ECM specification. The error correction term coefficient implies that 18.86 percent of the deviation from the long-run inflation equilibrium is adjusted within five periods.

Table 6. Estimation Results of the ECM with ΔLINF as the Dependent Variable

Variables	Coeffi-cient	t-Statistic	Prob.
D(LMS)	-1.3149	-1.0079	0.3206
D(LIR)	0.6379	1.2535	0.2186
D(LER)	1.9541	1.8585	0.0718***
RESID_ LINF(-1)	-0.1886	-2.0971	0.0435**
C	0.0150	0.6789	0.5018

Notes: *) Statistically significant at the 1% level; **) Statistically significant at the 5% level; ***) Statistically significant at the 10% level.
Source: Data processed, 2025

In the short run, changes in the exchange rate (ΔLER) have a positive and statistically significant effect on inflation at the 10 percent level, reinforcing the evidence of strong exchange rate pass-through. This suggests that inflation in Indonesia is particularly sensitive to short-term exchange rate volatility, a characteristic commonly observed in economies with a high import content in consumption.

Conversely, short-run changes in money supply and interest rates are statistically insignificant, indicating that their inflationary effects materialize primarily in the long run. This finding implies that effective inflation stabilization requires sustained and consistent policy interventions rather than short-term monetary adjustments.

From a policy perspective, the findings emphasize the central role of money supply

control and exchange rate stability in managing inflation in Indonesia. Given the strong long-run inflationary impact of monetary expansion and exchange rate depreciation, policymakers should prioritize prudent liquidity management and strengthen coordination between monetary and exchange rate policies, particularly in an import-dependent economy.

During periods of economic shocks, such as the COVID-19 pandemic, exchange rate stabilization is crucial to mitigating imported inflation, while fiscal stimulus measures should be carefully calibrated to avoid excessive inflationary pressures.

For future research, further studies could incorporate structural breaks to explicitly capture crisis episodes, examine nonlinear exchange rate pass-through effects, and explore alternative monetary transmission channels, including credit and expectation-based mechanisms. These extensions would deepen understanding of inflation dynamics in Indonesia and support the development of more resilient and effective macroeconomic policy frameworks.

CONCLUSION

This research confirms that monetary policy—particularly through the money supply and exchange rate—significantly influences long-term inflation in Indonesia. The findings reveal that both variables have a statistically significant and positive effect on inflation at the 1 percent level.

Specifically, a 1 percent rise in the money supply leads to a 3.3278 percent increase in inflation, while a 1 percent rise in the exchange rate (reflecting currency depreciation) results in a 7.0260 percent inflation increase, assuming other factors remain unchanged. The stationarity of the residuals supports the existence of cointegration, justifying the application of the ECM. In the short term, fluctuations in the exchange rate also have a notable impact on inflation, with a 1 percent increase causing a 1.9541 percent rise, significant at the 10 percent level. The model further suggests that 18.86 percent of any de deviation from the long-run inflation equilibrium is corrected within approximately five periods.

These findings highlight the importance of exchange rate management as a tool for inflation control. During the COVID-19 pandemic, rising import costs—especially for essential goods like medical supplies—contributed to inflationary pressure. The depreciation of the IDR during this time had a measurable impact, as shown by the long-run effect of the exchange rate on inflation.

Additionally, an expanding money supply contributed to inflation expectations and actual inflation in the long term. The Indonesian government used fiscal measures, such as social assistance programs and healthcare infrastructure investments, to stimulate demand. The widespread adoption of digital transactions, notably via QRIS, also contributed to the growth in money circulation. Empirically, each 1 percent increase in money supply correlated with a 3.3278 percent increase in long-term inflation.

Conversely, interest rate policy was less effective during the pandemic due to weakened demand. In times of crisis, people tend to hoard cash, limiting the transmission of interest rate adjustments to spending and investment. Furthermore, banks remained cautious in lending, resulting in subdued credit growth. These conditions underscored the critical role of both fiscal and monetary authorities in

maintaining demand and ensuring stable economic growth through inflation control.

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