# THE EFFECT OF MONETARY POLICY ON MACROECONOMIC STABILITY AND STOCK MARKET: EVIDENCE FROM INDONESIA

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**Abstract**

*Monetary policy can have a significant effect on the movement in the stock market. This paper investigates the effect of monetary policy through monetary instruments on macroeconomic objectives and stock market utilizing Vector Error Correction Model (VECM) in order to examine the dynamic effect of Bank Indonesia Rate and Overnight Money Market Rate in achieving price stability, foreign exchange stability, economic growth, and capital market stability. This paper utilizes Impulse Responses and Variance Decomposition approach to examine the responses and the contribution of monetary policy instruments in affecting the macroeconomic objectives. The findings confirmed that Bank Indonesia Rate and Overnight Money Market Rate are statistically significant in affecting the inflation rate, foreign exchange rate, the output growth and the Jakarta Composite Index. Finally, there is a trade-off between inflation and economic growth.*

## INTRODUCTION

According to major fluctuations and high volatility in inflation rates, exchange rates, gross domestic products growth rates and the stock index movements during the empirical period of 1990 to 2009, Bank Indonesia implemented several monetary policies to reduce the high volatility. However, some policies were found to be insufficient to mitigate the negative shocks affective macroeconomic stability. Therefore, Bank Indonesia continued working on minimizing the negative impact of economic shocks that can influence the stock market's performance as well as the macroeconomic stability. The Indonesian Capital Market, Financial Institution Supervisory Agency, and the Indonesian Stock Exchange Board played an important role in limiting deeper financial market's decline, particularly on the Indonesia Composite Index. Since stock market has become one of the main elements in influencing macroeconomic stability, movements in the stock market can have a significant impact on the macroeconomy.[1] To some extent, some literature argued that changes in the macroeconomic variables can have a significant impact on the movements in the stock market.[2] With respect to these linkages, Bank Indonesia's role in maintaining macroeconomic and financial sector stability would be strongly influenced by the effectiveness of the monetary policy implementation or the effectiveness of monetary instruments. An important monetary policy instrument used by Bank Indonesia is the Bank Indonesia (BI) Rate. This is the main instrument of Bank Indonesia in controlling macroeconomic and financial performance. According to the operational mechanism, the instrument is known as the Interbank Overnight (O/N) Money Market Rate. In order to assess whether Bank Indonesia can influence inflation rates, exchange rates, economic growth and the stock market effectively, the relationship between these variables must be tested empirically. If the empirical test results identifies that the monetary policy instrument is significant in influencing the macroeconomic and financial stability, Bank Indonesia will be able to identify measures to reduce the volatility that encourages positive expectations of investors and businesses in Indonesia's economic and investment activity. With uncertainty and high volatility in macroeconomic indicators, these tend to increase the cost of all economic activities. Furthermore, it is important to conduct a study to test how effectively Bank Indonesia implements monetary policy through its instruments in achieving the ultimate goals namely price stability, exchange rate stability, economic growth, and sta-