

# CHAPTER 1

## INTRODUCTION

### 1.1 Background

The interaction between monetary policies of major economies and emerging markets has been a cornerstone of global economic research. This is a negative-negative thing, the United States stands out because of its leading role in the global financial system. The Federal Reserve, including interest rate changes, program asset purchases, and liquidity injections, has a significant impact not only on the domestic economy but also across borders, affecting the economies of developing countries such as Indonesia (Moyo & Phiri, 2024). This feeling, called monitoring policy spillovers, has become an important focus for policymakers in emerging markets seeking to maintain economic stability amid external shocks.

Indonesia, which is now in Southeast Asia, will be able to connect with other countries that will be repeated. This may be different from other countries in the world, in Indonesia there is a dampening effect on the earth's surface because it is full of channels, if closed it will be modified and blown (Ahmed et al., 2021). The 2013 "Taper Tantrum", a reaction to the Federal Reserve's announcement of a reduction in its quantitative easing program, is very important. During this period, Indonesia experienced significant capital outflows, currency depreciation, and rising bond yields, highlighting its vulnerability to external monetary shocks (Fratzcher et al., 2016).

Important historical periods of U.S.-observed monetary policies like the quantitative easing (QE) policies set up according to the 2008 worldwide fiscal emergency have significantly prompted worldwide liquidity and resultant advancements in developing economies including Indonesia. These inflows often lead to higher asset prices and the appreciation of the currency; they provide an opportunity for economic growth but create challenges for policy (Tian & Wang, 2023). Conversely, during monetary tightening periods capital flows tend to flow back, exacerbating financial instability in the receiving economies (Antonakakis et al., 2019).

Indonesia's economy, which is reliant on commodity exports and strong domestic consumption, is especially susceptible to changes in global economic conditions. Typically of US interest hikes the depreciation of Rupiah play important role about exchange rate channel on global matter. Furthermore, as further demonstrated by Bank Indonesia's reaction—with measures taken in the form of recalibration in interest rate and foreign exchange interventions—this reflects on the need for pre-emptive nature in the course of monetary management in order to address forward-looking spillover (Dewi & Lukman, 2016).

Strengthening economic resilience in Indonesia also requires continuous monitoring of spillover effects, especially in the context of continuing global financial market uncertainty due to factors such as geopolitical tensions and post-pandemic recovery strategies. Understanding these spillover policies makes sense to understand the broader impact of these on Indonesia. It intends to provide useful insights that could help coordinate domestic and foreign monetary policies more effectively (Siyuan et al., 2021).

### **1.1.1. US Monetary Policies and Their Global Influence**

The U.S. monetary policy, which is conducted mostly by the Federal Reserve (the Fed), has been recognized for decades as a driving force of global financial relations. While important for the course of the U.S. economy, the Fed's decisions on interest rates, asset purchases, and liquidity management can have large spillover effects on economies around the world, particularly in the case of emerging markets. As the U.S. dollar accounts for more than 60% of all known central bank reserves (Fischer, 2023) and represents the world's dominant reserve currency, such policy decisions have global ramifications, impacting international capital flows, trade balances, and inflationary developments (Moyo & Phiri, 2024).

Driven by consumer spending, investment, government action, and international trade, the economy of the U.S. is one of the world's largest and most complex. Fundamentally, the Federal Reserve (the Fed) has been the great stabilizer of the economy through its monetary policy tool, which is most famously the federal funds rate (Fed rate). This rate drives the cost of borrowing throughout the financial system, impacting everything from mortgage rates to corporate loans

to investment choices. The Federal Reserve is now in the middle of a tightrope walk between economic growth and interest rates, between staving off a recession and keeping inflation in check. In boom times, the Fed will raise rates to avoid overheating and inflation. In contrast, in a recession or an economic slowdown, it slashes rates to induce borrowing and investment, boosting growth. These adjustments make the Fed rate inherently dynamic, as it adapts to changing economic conditions and policy objectives over time.

It has a lot of influence on volatility and the Fed rate, which are driven by many economic indicators and outside factors. One of the major forces behind these rate swings is inflation — when prices are climbing too rapidly, the Fed raises interest rates to crush excess demand and keep purchasing power stable. By contrast, during deflationary or recessionary periods, it lowers rates to encourage spending. Labor market dynamics also matter: Strong job growth and wages could lead the Fed to hike rates in order to stave off inflation; conversely, high unemployment could lead the central bank to cut rates to spur hiring and business activity. In fact, global economic developments may lead the Fed to raise the rates in response to external economic jolts such as financial turmoil, trade shocks or political unrest. Market expectations and investor sentiment also push volatility beyond the Fed's moves, with traders responding to the Fed's announcements or reports of inflation or employment — movements to which the Fed's actions can lead cause yields on bonds and prices of stocks to move sharply.

Beyond those economic fundamentals, the Fed's own decision-making process creates additional rate whipsawing. The Fed rate-setting body, known as the FOMC, takes a wide array of data into account in making decisions on policy, which occasionally leads to unexpected rate adjustments. Forward guidance — statements by Fed officials about what actions they plan to take — and it too helps guide behaviour, as investors respond in advance to expected rate movements. Likewise, political pressures and fiscal policy which would necessitate government stimulus packages or high levels of national debt could prompt the Fed to adopt a more aggressive rate policy. In worst-case scenarios like the 2008 Global Financial Crisis or the COVID-19 pandemic, the Fed is left with little choice but to

take emergency action, slashing rates to the vicinity of zero or deploying quantitative easing (buying bonds) to restore order to markets. This dynamic interactions among economic, financial, and policy factors guarantee that the Fed rate is one of the most watched and volatile financial benchmarks in the world economy (Ahmed et al., 2021).

The United States, being a key player in the world economy, has a strong impact on its financial situation through its monetary decisions, which are globally determining for financial markets and economic stability. As the nation's central bank, the Federal Reserve employs several policy tools in order to achieve its dual mandate of maximum employment and price stability. These include interest rate adjustments, open market operations (buying or selling government securities), and cash injections into the financial market via quantitative easing (QE) programs.

Historically, expansionary monetary policies in the U.S., including those employed in the 2008-2009 global financial crisis (GFC), consisted of large-scale asset purchase programs, popularly designed as quantitative easing (QE). These non-standard monetary policies (UMP) aim at domestic economy stabilization by increasing liquidity in the financial system. But their effects were felt beyond the United States borders, and were pushing and driving more inflows of capital into emerging markets. As money flowed to these trust-of-benefit-ers, this capital was often associated with currency appreciation as well as asset price inflation in these economies, creating both opportunities and challenges for the policymakers.

One important example of the outside influence of U.S. monetary policy is the 2013 Taper Tantrum. That's a nod to the economic upheaval that erupted when the Fed signalled that it would start winding down its quantitative easing (QE) program, which it had unleashed to revitalize the economy following the global financial crash in 2008. Even the announcement of tapering plan shocked global markets in unprecedented way and developing economies more. These areas experienced capital outflows, currency depreciation, rising bond yields, and excess market volatility (Fratzscher et al., 2016).

Southeast Asia proved no less immune, as shown by the Taper Tantrum of 2013, which revealed deep vulnerabilities in economies tightly integrated into

global financial markets. The nations suffering most were those with fiscal and current account deficits, and those reliant on foreign capital. Indonesia was even struck by a massive devaluation and skyrocketing yields on the bond market with dire consequences for its economy. Likewise, India also witnessed substantial capital outflows and steep currency depreciation during the pandemic, prompting a swift policy response involving the adoption of tighter monetary positions and foreign exchange interventions in an attempt to reinstate stability (Ahmed et al., 2021).

The Taper Tantrum era tells the darker story of the global monetary spider web, and the difficulty of emerging markets to maintain their monetary sovereignty in the face of external economic damage. It underlined the need for exploring the spillover effects of U.S. monetary policies into other economies and the channels through which these spillover effects take place (Antonakakis et al., 2019). Studying these dynamics over turbulent times such as the Taper Tantrum, this research aims to maximize the significance of the findings on the Southeast Asian Central Banks towards supporting the future monetary policy directions.

US monetary policies can affect domestic and foreign financial markets in many ways. One such mechanism: the Federal Reserve's changes to interest rates, which usually strengthen the U.S. dollar. A stronger dollar can weigh on other currencies as well, affecting exchange rates and making borrowing more expensive globally. Such fluctuations can have large implications for countries with high bilateral trade exposure to the U.S., affecting the trade capacity and overall economic growth (Siyuan et al., 2021).

U.S. monetary policy decisions are also key drivers of global capital flows. When investors seek higher returns through quantitative easing, there are significant capital inflows for emerging markets. Yet, as the Federal Reserve transitions to tighten its monetary stance, these flows can easily reverse and thus threaten economic stability in recipient economies that are reliant on foreign funds (Tian & Wang, 2023).

U.S. monetary policy also has a major effect on global commodity prices. Interest rates can have an immediate impact on the demand for major commodities,

including oil, which is mostly traded in U.S. dollars. This has serious consequences for commodity-exporting economies because price volatility can affect their trade balances, fiscal revenues, and general economic stability (Siyuan et al., 2021).

### **1.1.2. The Economic Dynamics of Indonesia**

For the last few decades Indonesia, as the largest economy in Southeast Asia, has experienced dramatic transformation from being an economy highly dependent on agriculture to a more economic diversified and dynamic powerhouse. Agriculture, manufacturing, services and a fast-growing digital economy are now key sectors. This transformation has been driven by Indonesia's growing integration into the global value chains, positioning the country as a key player in the region's economic development. Therefore, these progressions emphasize on impact of domestic policy transformation and the country's cross-reactivity to the changing world economy (Moyo & Phiri, 2024).

Agriculture is the most important sector in the economy of Indonesia, contributing the most to GDP through a 20th century agrarian economy. However, the world had witnessed great emphasis on tech and industrial growth, but in the meantime, the nation had slowly shifted its focus to dependence on manufacturing, and the service sectors. Agriculture remains key, but its share of GDP has fallen as the manufacturing and services sectors expanded. The industrial sector, which encompasses textiles, automotive manufacturing and electronics, has flourished, bolstered particularly by foreign investments and increasing domestic demand.

The services sector in Indonesia, encompassing finance, tourism, and retail, has grown rapidly over the years and contributes significantly to the country's growth. Among these, the digital economy is one of the most active areas. E-commerce, and other forms of digital services, have boomed on the back of a nascent middle class and more general access to the internet. Based on the Google—Temasek—Bain & Company report (2020), Indonesia's digital economy could reach \$124 billion in 2025 (Siyuan et al., 2021).

A further factor in Indonesia's economic resilience is its size: the large domestic market. With a population of over 270 million people, Indonesia taps into

strong internal demand, providing a stabilizing force for the economy. Consumer spending makes up more than 55% of GDP, making it the most important driver of growth (Abdullah et al., 2022). This large consumer base creates a buffer effect for Indonesia in times of external shock, such as global recession or slowdown in international trade.

Indonesia's growing middle class has fuelled a boom in domestic consumption. Meanwhile, with incomes growing, demand for consumer goods and housing, as well as services in general, has soared, spurring the expansion of essential sectors like retail, real estate and banking. This momentum will be leveraged by focusing on infrastructure investments at scale, which is necessary for better connectivity between urban centres and rural areas to facilitate balanced economic development across regions.

But Indonesia is affected by global financing conditions, too, and its commodity-reaching export dependence makes it sensitive to the churn in global markets. Relatedly, being one of the top palm oil, coal and natural gas exporting countries in the world, its economic output is sensitive to variations in global commodity prices (Moyo & Phiri, 2024). Historically, periods of falling prices have been associated with lower export earnings, lower fiscal revenues and slower overall economic growth.

Besides commodity earnings volatility, Indonesia is susceptible to changes in global financial conditions. Global interest rate trends, most importantly those emerging from the United States, strongly affect capital flows into and out of the country. For example, when the U.S. Federal Reserve raises interest rates, Indonesia and other emerging markets usually face capital outflows that can depress the currency and send the country into a financial crisis. These outflows also increase borrowing costs for Indonesian companies and the government, further slowing economic growth (Siyuan et al., 2021).

In Indonesia, monetary policy is conducted by Bank Indonesia (BI), the country's central bank, which has a crucial role in achieving macroeconomic stability. BI carries out monetary policy through key aspects like inflation targeting, interest rate decisions, and currency stabilization. Inflation Targeting Frame as the

aim that Bank Indonesia's core missions is to explain the policy of inflation targeting as a frame of macroeconomics from the focus of economic fundamentals leading to sustainable economic growth.

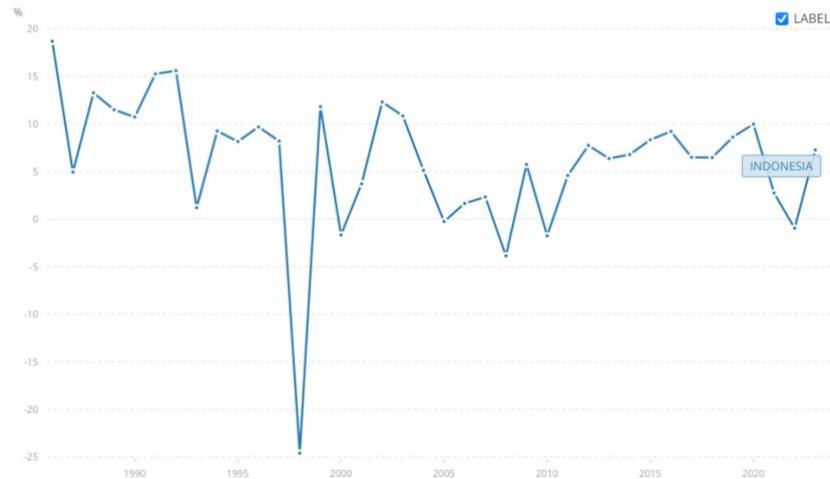
Over the years, BI has consistently fine-tuned its different monetary policy frameworks in response to domestic and external economic dynamics. The early years of BI were at a time of a much less flexible exchange rate regime. Yet Indonesia's economy is increasingly intertwined with that of the world, and the country's central bank sought a more flexible exchange rate system. This transformation has provided more leeway to respond to external shocks such as commodity price volatility and shifts in global capital flows. The holistic approach enabled Indonesia to withstand the increased uncertainties of the global economy during periods of turbulence (Tian & Wang, 2023).

The economic challenges Indonesia faces in recent years put the monetary policy framework to the test. For instance, the quantitative easing (QE) program of the U.S. Federal Reserve following the 2008-2009 global financial crisis prompted a tidal wave of capital inflows into emerging markets including Indonesia. While such inflows initially provided liquidity and fuelled growth, they also introduced new risk — bubbles and inflation. In these conditions, BI has kept the economy stable by using monetary policy through hikes in interest rates and monetary conditions tightening.

The other challenge came in 2013 with the “taper tantrum” when the U.S. Federal Reserve announced potential steps to extend the practice of its quantitative easing (QE) plan. Such signal caused a massive capital flight from emerging markets such as Indonesia, leading to a quick depreciation of rupiah. In response, Bank Indonesia hiked interest rates and intervened in the foreign exchange market to support the currency. This episode further demonstrated Indonesia's vulnerability to exogenous monetary shocks and underscored the role of BI in stabilizing the macroeconomic environment (Siyuan et al., 2021).

Inflation targeting framework is one of the main monetary policy instruments of Bank Indonesia. BI within this framework aim inflation at a 2.5% to 4.5% range year on year. In order to reach this target, the central bank established

BI 7-Day Reverse Repo Rate and utilizes various monetary instruments to regulate liquidity in the economy. The target is intended to help anchor inflation expectations, a crucial factor for economic stability and a pillar of confidence in the monetary policy framework.



Source: Data processed, 2025

Figure 1.1 Indonesia's Real Interest Rates 1986 - 2023

Figure 1 displays Indonesia's real interest rate over the last several decades, indicating high levels of volatility consisting of sharp increases and sharp decreases. The most drastic times in which the country faced turmoil was during the Asian Financial Crisis (1997-1998), where Indonesia encountered an economic crisis resulting in adverse effects in the nation. The graph reflects this instability in the form of a tributary steeply waterskiing down, as real interest rates reach unprecedented lows, a result of the country's struggle with runaway inflation, capital flight, and high dependence on foreign capital. This was a period of intense economic stress and turmoil.

The figure illustrates Indonesia's continued battle towards economic stability after the crisis, although real interest rates remained highly volatile leading into the 2000s. This tug-of-war likely is driven by Indonesia's reliance on commodity exports and its sensitivity to external economic conditions that affect inflation and exchange rate policies. The occasional surges in interest rates, at times over 20%, suggest times when Bank Indonesia undertook aggressive

measures to contain inflation or boost foreign investment. These sharp movements also underscore the continued economic challenges Indonesia faced even after the crisis as the country tried to navigate its way to greater stability.

External influences on Bank Indonesia's monetary policy, especially the U.S. Federal Reserve, often render monetary policy ineffective. The Fed, therefore, is an important global actor: Its decisions around interest rates or quantitative easing (QE) programs directly influence capital flows globally and contribute to the determination of exchange rate levels and price inflation. As a result, Indonesia's monetary policy is often modified to follow the world's financial situation. When the Fed hikes interest rates, for example, investors flock to higher yielding American assets and emerging markets such as Indonesia feel the sting of capital flight. This may lead BI to increase domestic interest rates in order to stabilize the rupiah and minimise capital outflows, despite domestic inflation being within the target (Tran & Pham, 2020).

Indonesia's economy is also extremely sensitive to broader financial trends globally since it relies heavily on exports of commodities like palm oil, coal and natural gas. These commodities are most vulnerable to price fluctuation in trading international market, thereby giving a bad impact toward trade balance of Indonesia in an overall way. Moreover, changes in global demand and supply, such as changes in Indonesia's main trading partners: China, the United States, and the European Union are fundamental to make up Indonesia's export revenue and its future economic direction.

The global shift toward greener energy and sustainability poses both challenges and opportunities for Indonesia's commodity-dependent economy. As one of the world's largest coal exporters, Indonesia is vulnerable to revenue drops as global demand for fossil fuels wanes. Because of sustainable palm oil needs, Indonesia could potentially take a lead in the green commodity market by implementing sustainable practices and reinforcing its position within the global supply chain.

Indonesia's deepening integration with global financial markets has also made its economy more vulnerable to swings in investor sentiment and capital

flows. Emerging markets tend to retreat in the face of high global risk aversion — typically spurred by geopolitical showdowns or financial contagion. This makes the currency depreciate and causes capital flight in Indonesia, which can put pressure on its financial stability. Bank Indonesia should take immediate action in such cases, through monetary policy measures such as raising interest rates or intervention in the currency market to mitigate the economic pain and restore confidence.

Indonesia has shown amazing resilience as it has weathered the storms of global finances despite being very vulnerable. That resilience is supported by a major domestic marketplace powered by a populace of over 270 million. As Moyo & Phiri (2024) observes, Domestic Consumption forms a very large share of the country GDP and has always been a reliable pointer of GDP — even when global economic activity is in full swing. This solid domestic demand acts as a buffer against the full impact of external shocks, from global recessions to disruptions in trade. Indonesia has also shown strong progress on financial and regulatory reforms. These reforms have enhanced the country's resilience to various economic shocks. New financial infrastructure will be complemented with sensible regulation provides greater resilience of Indonesia against volatility of global finance and strengthens the synergy for its sustainable economic development.

### **1.1.3. The Importance of Understanding Monetary Spillovers Between Major Economies and the Indonesian Economy**

The monetary policies implemented by key economies in the world such as the United States, European Union, China, and Japan play a crucial role in determining global financial conditions, significantly influencing the economies throughout the world. Such policies — particularly interest rate, inflation control, and currency valuation — create what are called monetary spillovers. In emerging markets such as Indonesia, these spillover effects significantly impact financial stability, economic growth, and macroeconomic conditions as a whole (Moyo & Phiri, 2024). As Indonesia became more integrated into the global economy,

understanding and anticipating these external dynamics has become a crucial part of its economic strategy.

In the global economy of today, no country functions on an island, and the actions of dominant economic actors inevitably have effects in other markets. For Indonesia, with its open financial system and increasing dependence on foreign direct investment and capital inflow, those spillovers pose both opportunities and challenges. Positive spillovers can spur investment and growth, on the one hand. By contrast, negative spillovers, for example, a sudden reversal of capital flows or an abrupt devaluation of a currency, can contribute to financial instability. As Indonesia's economic growth is significantly derived from sectors such as manufacturing, commodities and services, which are driven by external trade and investment, spillovers from global financial conditions could have an immediate and large impact on the economy's soundness.

Capital flow is one of the major channels through which global monetary spillovers affect Indonesia. Shifts in monetary policy in major economies (most notably interest rates) often lead global investors to rebalance their portfolios. For example, when an expansionary monetary policy is adopted by the US (e.g. the QE program after the 2008 financial crisis), investors often seek a better return in emerging markets and pour capital into Indonesia and other countries (Tran & Pham, 2020). These injections can raise asset prices, promote growth, and strengthen the currency for a time. But even those have only been temporary, as monetary tightening from the Federal Reserve or other central banks could quickly reverse the trend and trigger sudden capital outflows. This change brings depreciation of the local currency, global inflationary pressures and increasing risks of financial instability.

A prominent example of this dynamic happened during the "Taper Tantrum" of 2013. U.S. Federal Reserve indicated that it would start to cull its QE program from the markets and what followed was a fit of global market reaction. This made investors immediately pull their fund out of emerging markets, inclusive of Indonesia, and resulted in the depreciation of the Indonesian rupiah more than 20% against U.S. dollar between May and September 2013 (Siyuan et al, 2021).

The sudden capital flight also caused bonds yields to rise and created inflation pressures, forcing Bank Indonesia to respond with a series of interest rate increases to stabilize the rupiah, and tame inflation. This episode highlighted the difficulties that are facing developing economies as they grapple with changes in global money policy.

These events affirm the susceptibility of emerging markets — such as Indonesia — to the monetary policy decisions made in capital markets. Whenever global interest rates increase, especially in developed economies, capital flies off of riskier, emerging countries towards safer, more stable returns. This outflow can trigger a feedback loop: declining capital inflows trigger currency depreciation, which in turn intensifies inflationary pressures, undermines investor confidence, and destabilizes the economy.

Beyond capital flows, monetary spillovers also matter for Indonesia through trade channels. Indonesia is a major exporter of commodities like palm oil, coal, and natural gas, so the country is especially sensitive to global price changes, a lot of which are driven by those monetary policies of bigger economies (Moyo & Phiri, 2024). For example, when the U.S. or European central banks raise interest rates, their currencies tend to appreciate, making Indonesian exports costlier for foreigners. This combination can result in less demand for Indonesia's goods, slowing economic growth and decreasing foreign exchange earnings. Such dynamics highlight the complex relationship between monetary trends globally and Indonesia's economic performance.

This exposure to monetary spillovers (the cross-border effect of monetary policy), poses challenges to the economy, which Bank Indonesia plays a key role in managing. Inflation is just one of the central bank's mandates, as the primary objectives are monetary stability, including inflation control and rupiah stability. Bank Indonesia uses a number of tools including interest rate adjustments, foreign exchange interventions and macro-prudential policies, to achieve those goals." For example, the central bank may decide to increase interest rates in response to rising levels of capital inflows to avoid overheating in the economy and to help keep inflation expectations in check. By contrast, in episodes of capital outflows, Bank

Indonesia will intervene in the foreign exchange market to limit sharp depreciation of the rupiah in order to protect the stability of the financial system.

In addition, Bank Indonesia had implement common exchange rate regime in order to provide better absorb to the external shock. The central bank does not have an exchange rate target but keeps a close watch on the rupiah's movements and intervenes when needed to ease excessive volatility. This flexibility helps the economy better cope with external shocks and respond to challenges more smoothly, which avoids dramatic disruptions that can destabilize markets. In fact, it is one of the key challenges for the Bank of Indonesia to strike a balance between stabilizing the currency while also managing forex reserves, which could be quickly exhausted during prolonged capital outflow periods. In the context of this complex balancing act, the central authority's objective is to grapple with the global issue of monetary spillovers through the judicious calibration of trade-offs to anchor economic resilience.

In the past few years, Bank Indonesia has implemented a lot of macroprudential loose to strengthen the resilience of the financial system to shocks from the external side. These actions come through increased control on foreign currency exposure, establishing capital buffers for banks, and ban on certain speculative investments (Tian & Wang, 2023). Bank Indonesia has also taken a proactive stance in financial regulation to maintain and strengthen its resilience in light of international financial spillover while at the same time mitigating the domestic financial system risk of financial contagion.

At the same time, the Indonesian government has launched significant economic reforms that have reduced the country's vulnerability to external shocks. Sluggish growth In line with these goals, key initiatives in this area include the need to diversify the economy away from a heavy reliance on commodities to promote growth in value-added sectors like manufacturing and services. Moreover, to enhance connectivity and competitiveness, major infrastructure investments have been undertaken, and reforms to attract foreign direct investment and improve regulatory frameworks have resulted in a more predictable and stable business environment. These reforms are designed to create a more resilient economic base

that will reduce the country's reliance on volatile capital flows and commodity price changes while promoting longer-term growth prospects that are more sustainable.

However, those efforts can only reduce, not eliminate, the vulnerability of the economy as the country continues to depend on external financing to support mass-scale infrastructure projects and will run a current account deficit until at least the end of the first half of 2023. As the such, mitigating the risks of monetary spillovers remains a top priority of policymakers. This will provide protection against external challenges as Bank Indonesia, along with the Indonesian government, closely monitors financial developments globally and promptly helps address any economic vulnerability (Moyo & Phiri, 2024).

In the longer horizon, Indonesia's capacity to respond to the challenges posed by monetary spillovers will be contingent upon a number of factors, including the relevance of Bank Indonesia's framework policy, the continued evolution of economic reforms, and the global economic conditions more broadly. With major economies still grappling with the aftereffects of the COVID-19 pandemic, inflationary pressures, and geopolitical uncertainty, the risk of further monetary spillovers remains high. Indonesia's road to sustainable economic growth and stability goes through its ability to remain nimble and reactive to changing global financial environment while continuing its structural reforms towards creating a more resilient and diversified economy.

Being aware of how the monetary spillovers between major economies and Indonesia affect the country is imperative for preserving the robustness of the domestic economy. As Indonesia becomes more fully integrated into the global financial system, the speed of its economy will continue to be extremely sensitive to external money policies, above all those of the U.S. Federal Reserve and other major central banks. Understanding the insidiousness of these spillovers, and formulating the necessary policies to reduce their impact, would enable Indonesia to effectively capitalize on opportunities in the global economy, ahead of a sustainable future (Siyuan et al., 2021).

## 1.2 Research Problem

This study is intended to investigate the US monetary policy spillover to the Central bank of Indonesia, more specifically focused on how the policy of the US Federal Reserve is reflected on Indonesia monetary policy. THE central role of the U.S. dollar as the world's leading reserve currency, along with the global importance of the U.S. economy, means that the policy coming out of the Federal Reserve — be it from an increase of interest rates, extensions of quantitative easing, or other unorthodox monetary means — can lead similar economic adjustments in other parts of the economy, especially those countries with open and interconnected capital markets, including Indonesia.

Indonesia has a large economy, a complicated financial system and an extensive policy setting framework, yet remains vulnerable to U.S. monetary policy. Its vulnerability derives from its dependence on international trade, foreign investment and U.S.-denominated debt. We begin with the research problem, which stems from the notion that the Federal Reserve's policy-making process leads to capital inflows and outflows in emerging markets, which exert pressures on exchange rates, inflation rates, and domestic interest rates in Indonesia.

## 1.3 Research Question

Based on the background presented, the author draws the following research question:

1. How do US monetary policies spill over into Indonesian economies?
2. What are the transmission mechanisms for monetary policy spillovers between the US and Indonesia?

## 1.4 Research Objective

The points presented articulate the distinct and specific research objectives that serve as the focal points guiding the research:

1. To analyse how US monetary policy influences the monetary policies of Indonesian countries.

2. To explore the transmission mechanisms for monetary policy spillovers between the US and Indonesia.

### **1.5 Research Advantage**

The research advantage are as follows:

1. This study fills an important gap in the existing literature by investigating the time- and frequency- varying effects of U.S. monetary policy spillovers on Indonesian economy. Existing studies usually focus on static or time-specific analysis (e.g. calculating the average spillover over the full period) while this study provides a newer perspective of spillovers providing dynamic analyses and hence they provide a comprehensive understanding of how much spillovers vary over time and across different feature cycles. By modelling these changes, the research uncovers new understanding of how U.S. monetary policy impacts Indonesia's economy through a variety of channels.
2. These results have several implications to Indonesian central banks. Focusing on the relationship between U.S. monetary policy decisions and key sectors of the economy such as inflation, interest rates, and exchange rates, the research informs policymakers how to prepare for and calibrate their response to external shocks. Such deeper understanding can help formulate improved monetary policies, which may enable Indonesia to better avoid adverse effects of global economies and increase its economic resilience.
3. This study elaborates and emphasizes the very close link between U.S. and Indonesian economies, which would be valuable input for global monetary policy coordination. Through providing insights on the spillover effects of monetary policy, the findings can stimulate more coordinated responses of central banks, which can contribute to improved financial stability not just in Indonesia but also the world.
4. The use of a Vector Error Correction Model (VECM) model is a first for the study as a methodological step forward. However, this model allows not only estimating spillover intensity, but also its duration and frequency-specific effects, providing more nuanced and comprehensive insights than traditional approaches.

5. The characteristics of the spillovers uncovered in this study have wide-ranging implications for economic planners and investors. These results can enhance forecasting models and lead to more effective risk management and sound decision-making in financial markets by elucidating the immediate and lasting consequences of external monetary shocks.

