

## Fiscal and Monetary Policy Mix in the Indonesian Economy: A Theoretical Review

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### ABSTRACT

Economic development aims to achieve sustainable growth accompanied by price stability, employment opportunities, and equitable income distribution. However, economies, including Indonesia's, remain vulnerable to economic fluctuations that may lead to unemployment, inflation, low economic growth, and balance of payments disequilibrium. Fiscal and monetary policies are widely used to manage aggregate demand and maintain macroeconomic stability. Fiscal policy influences government expenditure and taxation, while monetary policy regulates money supply and interest rates. Within the IS-LM framework, fiscal policy shifts the IS curve, whereas monetary policy shifts the LM curve. The combination of expansionary fiscal policy and contractionary monetary policy may increase national income and interest rates, particularly under a fixed exchange rate regime. Furthermore, socio-political and security stability are important in supporting investment and economic certainty

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## **INTRODUCTION**

Throughout the history of global economies, economic stabilization has become a fundamental issue in promoting societal welfare (Filimonova et al., 2020). Economic stabilization has long been a subject of debate among economists across many countries. These debates also concern the necessity of fiscal and monetary policies as instruments for stabilizing economic activities. An economy can never be entirely separated from fluctuations or economic instability, including the Indonesian economy (Sanjaya et al., 2020). Persistent economic instability may generate various macroeconomic problems, such as unemployment, inflation, low economic growth, and balance of payments disequilibrium (Traore & Sene, 2020).

The primary objective of development, particularly in the economic sector, is to achieve sustainable economic growth. Such growth should be accompanied by price stability, broad employment opportunities, and equitable income distribution. Economic growth reflects the expansion of economic activities that increase the production of goods and services within an economy, thereby improving societal welfare (He & Krishnamurthy, 2019). This improvement is driven by the continuous expansion and enhancement of production factors, including technological advancement and capital accumulation. In this context, foreign investment plays a significant role in increasing capital formation through the provision of additional productive assets (Sanjaya et al., 2020). An increase in capital goods contributes to higher production capacity, enabling a country to expand its exports to international markets and ultimately increase its Gross Domestic Product (GDP).

Indonesia's economy has demonstrated relatively favorable growth in recent years, as reflected in changes in real Gross Domestic Product (GDP), unemployment rates, and labor force participation. In 2023, Indonesia's real GDP reached IDR 12,301.5 trillion, with an unemployment rate of 5.45%. One year later, in 2024, real GDP increased to IDR 12,920.3 trillion, while the unemployment rate declined to 4.91%. Furthermore, Indonesia's macroeconomic conditions in 2025 indicated an unemployment rate of 4.74%, equivalent to approximately 7.35 million people, economic growth of 5.11%, an inflation rate of 2.92%, and an exchange rate of IDR 16,475 per US dollar (Badan Pusat Statistik, 2026).

Addressing these economic dynamics requires appropriate and well-directed economic policy measures, particularly through a policy mix approach involving the coordination of monetary and fiscal policies. In addition, other complementary policy instruments, such as trade policies and socio-political and security policies, are also essential in supporting macroeconomic stability. Although fiscal and monetary policies cannot entirely resolve all macroeconomic problems, both policies remain crucial instruments for maintaining economic stabilization and may be effectively integrated with other economic policies (Nepram et al., 2021).

Despite the important role of the fiscal and monetary policy mix in determining macroeconomic equilibrium, its implementation faces several major challenges. First, fiscal and monetary authorities often pursue different

institutional objectives and policy priorities regarding public welfare. Second, these authorities may hold different perspectives on how fiscal and monetary policies affect the economy. For instance, expansionary fiscal policies, such as tax reductions, may stimulate economic growth by encouraging investment. However, central banks, as monetary authorities, may perceive tax reductions as a potential source of fiscal deficits that could undermine investor confidence and increase macroeconomic vulnerability. Third, fiscal and monetary authorities frequently employ different forecasting methods and theoretical frameworks in formulating policy decisions (Juhro et al., 2022). Therefore, examining the implementation of fiscal and monetary policies in Indonesia is essential to better understand their role in supporting economic performance and macroeconomic stability. The ultimate objective of the policy mix is to stabilize the Indonesian economy by achieving four key macroeconomic targets, namely high economic growth, low inflation, reduced unemployment, and balance of payments stability.

## LITERATURE REVIEW

### *Fiscal Policy*

Fiscal policy is a macroeconomic policy instrument associated with the management of government revenues and expenditures in order to achieve economic stability, economic growth, equitable income distribution, and improved social welfare. From the perspective of modern macroeconomics, fiscal policy is utilized by governments to influence aggregate demand through adjustments in government expenditure and taxation (Mankiw, 2020). Fiscal policy therefore serves as one of the primary instruments for addressing economic instability, particularly during periods of economic slowdown, inflationary pressure, and rising unemployment.

Theoretically, the Keynesian approach positions fiscal policy as a strategic instrument for stimulating the economy through the enhancement of aggregate demand. During periods of economic recession, governments may implement expansionary fiscal policies by increasing public expenditure or reducing taxes in order to stimulate consumption and investment activities. Conversely, when the economy experiences high inflationary pressure, contractionary fiscal policies may be adopted through reductions in government spending and increases in taxation to suppress aggregate demand (Airaudo et al., 2022). Within the IS-LM framework, fiscal policy affects equilibrium in the goods and services market, which is reflected in shifts of the IS curve.

Fiscal policy is closely related to macroeconomic stability because government expenditure may generate a multiplier effect on national income. According to Papagni et al., (2021), increased public investment can stimulate economic growth through job creation, productivity enhancement, and the strengthening of economic infrastructure. In the context of developing countries such as Indonesia, government expenditure functions not only as an economic stabilization instrument but also as a mechanism for promoting equitable development and poverty reduction.

On the other hand, the effectiveness of fiscal policy is influenced by government fiscal capacity, public debt conditions, and coordination with

monetary policy. Elenev et al., (2021) argue that the relationship between fiscal and monetary policies has become increasingly important in maintaining financial system stability, particularly during periods of economic crisis and global uncertainty. Expansionary fiscal policy implemented without appropriate monetary policy support may generate inflationary pressure and crowding-out effects on private investment due to rising interest rates.

In the Indonesian context, fiscal policy is directed toward maintaining economic stability while simultaneously promoting inclusive economic growth. The Indonesian government utilizes the State Budget (*Anggaran Pendapatan dan Belanja Negara* or APBN) as the primary instrument for implementing allocation, distribution, and stabilization functions within the economy. Fiscal policy is also employed to maintain public purchasing power through subsidies, social assistance programs, and strategic national infrastructure development. According to Juhro et al., (2022), coordination between fiscal and monetary authorities in Indonesia has become increasingly important in responding to global economic dynamics, particularly in maintaining inflation stability, exchange rate stability, and sustainable economic growth.

Furthermore, the effectiveness of fiscal policy in developing countries is often influenced by domestic economic structures, the degree of economic openness, and the quality of government institutions. Khuong et al., (2021) state that institutional quality and effective governance significantly influence the successful implementation of fiscal policy in promoting economic growth. Therefore, fiscal policy should not merely be understood as a technical instrument for state budget management, but also as an integral component of a comprehensive national economic development strategy.

### ***Monetary Policy***

Monetary policy refers to the policy implemented by a central bank to control money supply, interest rates, and financial system stability in order to achieve macroeconomic objectives such as price stability, economic growth, and external balance. In the Indonesian context, monetary policy is administered by Bank Indonesia as the monetary authority mandated to maintain the stability of the rupiah through inflation control and financial system stability (Sanjaya et al., 2021).

According to modern macroeconomic theory, monetary policy operates through the monetary transmission mechanism, which influences consumption, investment, exchange rates, and public expectations regarding future economic conditions. Within the IS-LM framework, monetary policy affects equilibrium in the money market, as reflected in shifts of the LM curve resulting from changes in money supply and interest rates (Mankiw, 2020). Expansionary monetary policy is implemented by increasing money supply and lowering interest rates in order to stimulate investment and consumption. Conversely, contractionary monetary policy is conducted through reducing money supply and increasing interest rates to control inflationary pressures.

In the context of the modern global economy, monetary policy plays a crucial role in maintaining financial system stability and mitigating the risk of economic crises. (Pratiwi et al., 2022) explain that financial sector stability has

become an integral component of monetary policy because disruptions within the financial system may weaken the transmission of monetary policy to the real sector. Consequently, central banks are not solely focused on inflation targeting, but also on maintaining the stability of financial institutions and financial markets.

The effectiveness of monetary policy is influenced by both domestic and global economic conditions, including economic openness, exchange rate regimes, and international capital flows. In an open economy, changes in domestic interest rates may significantly affect foreign capital inflows and exchange rate movements. (Hendrian, 2024) argues that monetary policy in Indonesia has a significant influence on macro-financial stability, particularly in responding to external shocks and global uncertainty in the post-pandemic era. Interest rate policy implemented by Bank Indonesia therefore serves as a primary instrument for maintaining inflation stability and exchange rate stability of the rupiah.

From the perspective of the Mundell–Fleming model, the effectiveness of monetary policy is highly dependent on the exchange rate regime adopted by a country. Under a flexible exchange rate system, monetary policy tends to be more effective in influencing output and exchange rates compared to fiscal policy. In contrast, under a fixed exchange rate regime, the effectiveness of monetary policy becomes more limited because the central bank must maintain exchange rate stability through foreign exchange market intervention (Juhro et al., 2022). Therefore, coordination between fiscal and monetary policies becomes essential in maintaining both internal and external economic equilibrium.

In Indonesia, monetary policy is directed not only toward maintaining price stability but also toward supporting economic growth and financial system stability. Contemporary monetary policy in Indonesia is implemented through an inflation targeting framework, with policy interest rates (BI-Rate or the BI 7-Day Reverse Repo Rate) serving as the primary instrument. In addition, Bank Indonesia applies various macroprudential instruments to preserve national financial system stability.

Coordination between monetary and fiscal policies has become increasingly important during periods of global economic uncertainty. Airaudo et al., (2022) explain that a well-coordinated fiscal and monetary policy mix is capable of generating more optimal economic stability compared to policies implemented independently. In the Indonesian context, synergy between the government and the central bank constitutes a critical factor in maintaining inflation stability, strengthening the rupiah exchange rate, increasing investment, and sustaining national economic growth momentum.

## **METHODOLOGY**

This study employs a literature review method. The literature review was conducted to establish a theoretical framework for the research by examining the depth and breadth of previous studies related to the topic under investigation (Cresswell et al., 2020). This approach also facilitates a comprehensive understanding of prior research findings in order to address the research problem systematically. Furthermore, this article examines the fiscal-monetary policy mix through a systematic, explicit, and replicable approach to identify, evaluate, and synthesize previous research findings and theoretical perspectives developed by scholars and practitioners. The literature review process is intended to provide a comprehensive theoretical explanation regarding the implementation of fiscal and monetary policy coordination within the context of the Indonesian economy.

## **RESEARCH RESULTS**

In economic theory, a policy mix refers to the simultaneous implementation of two or more policies within a particular economic condition (Elenev et al., 2021). Fiscal and monetary policies are generally regarded as instruments used to manage aggregate demand within the economy (Airaudo et al., 2022). In this study, fiscal policy refers specifically to pure fiscal policy, which influences government expenditure (G) and taxation (T), while monetary policy refers to policies affecting the money supply (MS). Within the IS-LM framework, fiscal policy shifts the IS curve, whereas expansionary monetary policy shifts the LM curve.

Monetary policy in Indonesia has a broad scope, as it is directed not only toward influencing aggregate demand but also toward affecting aggregate supply within the economy (Budiman et al., 2022). Accordingly, monetary policy is designed to support the achievement of macroeconomic objectives. As the monetary authority, Bank Indonesia is responsible not only for regulating the money supply in accordance with the real needs of the economy, but also for influencing the allocation of financial resources in ways that encourage production and investment activities, particularly in sectors characterized by strong multiplier effects, high labor absorption, and support for productive economic activities.

In the long term, monetary policy in Indonesia is aimed at achieving economic growth and equitable development, including income distribution. In the short term, monetary policy focuses on expanding employment opportunities, maintaining price stability, and achieving balance of payments equilibrium (Dan Doddy Zulverdi, 2012). Furthermore, monetary policy in Indonesia is also directed toward influencing aggregate expenditure and aggregate demand management within the economy. The national economic environment is closely associated with monetary equilibrium, where money demand equals money supply. The quantity of money in circulation, particularly substantial changes in money supply, significantly affects the equilibrium between monetary flows and the flow of goods and services within the economy (Sanjaya, 2019).

The implementation of monetary policy cannot be separated from other macroeconomic policies, including fiscal policy and real sector policies. This is because economic growth and price developments are determined by both demand-side and supply-side factors. In this context, monetary and fiscal policies primarily influence economic performance and price movements through the demand side, namely through the effects of money supply and interest rates in monetary policy, and government expenditure in fiscal policy. Meanwhile, supply-side influences on economic growth and price stability are largely determined by real sector policies related to industry, trade, investment, labor, and technology. Therefore, achieving optimal macroeconomic objectives generally requires a coordinated policy mix among various economic policy instruments (Juhro et al., 2022).

The concept of optimality in this context refers to the effective coordination among policies in order to avoid contradictory impacts on overall macroeconomic objectives. One of the most widely recognized examples is the coordination between monetary and fiscal policies. During prolonged economic recessions, appropriately coordinated expansionary fiscal and monetary policies may stimulate economic activity while generating only moderate inflationary effects. Conversely, when the economy experiences excessive growth accompanied by rising inflationary pressures, coordinated contractionary fiscal and monetary policies may help moderate the pace of economic expansion and maintain macroeconomic stability.

## DISCUSSION

Pancasila as the ideological foundation and the 1945 Constitution as the constitutional foundation serve as the guiding principles for Indonesia in achieving its national development goals, particularly the realization of a just and prosperous society. One of the essential prerequisites for achieving these objectives is the establishment of a stable national economy. Through the circular flow of economic activity, a simplified representation of the highly complex economic system can be understood by illustrating the fundamental elements and interrelationships among economic actors (Mankiw, 2020). Within economic life, there are three fundamental activities: production undertaken by producers, distribution conducted by both private and government distributors, and consumption carried out by consumers.

Economic growth is widely recognized as one of the key indicators for evaluating the success of national development (Traore & Sene, 2020). High economic growth constitutes a primary objective for developing countries as it accelerates the achievement of higher living standards and societal welfare. Furthermore, rapid economic growth enables developing countries to reduce development gaps relative to more advanced economies. Nevertheless, achieving sustained economic growth is not without challenges (Pfajfar & Žakelj, 2018). One of the principal obstacles faced by developing countries is the limited availability of financial resources required to support development programs and economic transformation.

Historically, development strategies in many developing countries were initially characterized by government policies involving restrictions and repression within the financial sector (Khuong et al., 2021). Such policies included government-imposed interest rate controls, selective credit allocation, high banking reserve requirements, and taxation on capital income. These measures often hindered rather than stimulated economic growth. Consequently, financial liberalization has become increasingly necessary in promoting economic growth and enhancing financial sector efficiency within developing economies (Li & Ye, 2021).

The implementation of the fiscal-monetary policy mix in this study is assumed to occur within the framework of an open economy using the Mundell-Fleming model. In the era of globalization, international economic interaction has become an essential aspect of economic development in increasingly open economies. Greater interdependence among countries contributes to higher levels of economic openness, as reflected in expanding international trade transactions and cross-border capital flows. Countries that are unable to satisfy domestic demand for certain goods and services through domestic production may import such products from abroad. Conversely, countries may export domestically produced goods and services to international markets. Similarly, international capital flows have expanded significantly as a consequence of economic openness and financial globalization. Investment financing is no longer limited to domestic banking credit or domestic capital markets, but may also originate from foreign direct investment, external borrowing, and foreign portfolio investment (Papagni et al., 2021).

Economic openness has important implications for the formulation and implementation of macroeconomic policies, including fiscal and monetary policies. As international trade and financial transactions increase, the volume of foreign capital inflows and outflows also expands. One of the major benefits of international trade is the ability to absorb larger volumes of domestic output through international markets rather than relying solely on domestic demand, which may be constrained by limited purchasing power (Zhu et al., 2022). Export activities therefore play a significant role in promoting economic growth in developing countries (Ali et al., 2021). Increased exports may also contribute to an expansion of the money supply because export activities generate foreign exchange earnings. From the perspective of households and firms, export activities increase income and purchasing power, thereby affecting the circulation of money within the economy (Sanjaya et al., 2020).

The importance of exports in driving economic growth intensifies competition among countries in international markets (Chrid et al., 2021). One of the principal advantages of international trade is that it enables countries to specialize in the production of goods and services more efficiently, both in terms of resource utilization and production methods. Moreover, international trade generates several economic benefits, including increased national income, higher foreign exchange earnings, capital transfers, and broader employment opportunities (Jones & Kierzkowski, 2018). Consequently, export expansion

contributes to an increase in domestic money circulation because export revenues tend to raise income levels within society (Sanjaya et al., 2020).

Foreign capital flows subsequently influence money supply, interest rates, and exchange rates within the economy, which ultimately affect economic growth and inflation dynamics (Budiman et al., 2022). The magnitude and transmission mechanism of these effects are highly dependent on the exchange rate regime and foreign exchange system adopted by the country concerned (Ngiik et al., 2021). Development itself is a multidimensional process involving changes in social structures, societal attitudes, and national institutions (Rahman et al., 2020). In addition, development encompasses economic growth, reductions in income inequality, and poverty alleviation. To achieve these development objectives, national development strategies should focus on three major dimensions: increasing the availability and distribution of basic necessities, improving societal welfare, and enhancing public access to both economic and social opportunities (Ginevicius et al., 2020).

Indonesia's Open Unemployment Rate (OUR) has shown a declining trend in the post-pandemic period, decreasing from its peak of approximately 7.07% in 2020 to around 4.74%-4.85% by the end of 2025. Although the number of unemployed individuals declined to approximately 7.46 million people in August 2025, challenges remain within the formal employment sector, particularly among youth aged 15-24 years, which continues to record the highest unemployment rate. Conditions in Indonesia also indicate that informal workers still account for more than 57% of the labor force, while the formal sector continues to recover from the pressures of layoffs. Youth unemployment, especially within the 15-24 age group, remained the highest throughout the 2020-2025 period. The major factors contributing to layoffs in 2025 included pressures within the manufacturing industry, declining export demand, and efficiency measures in the digital sector.

Indonesia's inflation rate in 2020 was recorded at 1.68%, reflecting weak domestic demand during the COVID-19 pandemic. In 2021, inflation slightly increased to 1.87%, remaining relatively low and under control alongside gradual economic recovery, although still below the government's target range. In 2022, inflation rose significantly to 5.51%, primarily due to adjustments in subsidized fuel prices in September 2022 and rising global food prices. Inflation subsequently declined to 2.61% in 2023 and further decreased to 1.57% in 2024. However, in 2025, inflation increased again to 2.92%, marking the highest inflation level since the end of the pandemic, driven mainly by rising prices in food, beverages, tobacco products, and volatile food commodities.

In terms of the rupiah exchange rate against the United States dollar (USD), the rupiah experienced a gradual depreciation trend from 2020 to 2025. Beginning at approximately IDR 14,000 per USD during the pandemic period in 2020, the rupiah gradually weakened and surpassed the IDR 16,000 per USD level during 2024-2025, largely driven by global economic uncertainty and United States interest rate policies. During the 2020-2021 COVID-19 pandemic period, the rupiah experienced substantial volatility. It sharply depreciated above IDR 16,000 per USD in early 2020 before recovering and stabilizing within the range

of IDR 14,000–15,000 per USD. Between 2022 and 2023, the depreciation trend continued, primarily due to aggressive interest rate hikes by the United States Federal Reserve, causing the rupiah to fluctuate within the range of IDR 15,000–15,800 per USD. During 2024–2025, the rupiah faced significant pressure and exceeded the IDR 16,000 per USD threshold. By the end of 2025, reports indicated that the exchange rate had reached approximately IDR 16,700–16,800 per USD (Badan Pusat Statistik, 2026).

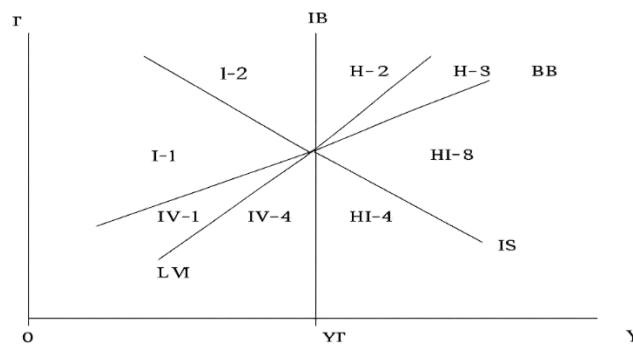


Figure 1. IS-LM in Internal and External Equilibrium

Considering these economic conditions, the appropriate policy response involves implementing a policy mix consisting of expansionary fiscal policy and contractionary monetary policy. Contractionary monetary policy, through the reduction of money supply, is intended to increase domestic interest rates from  $r_0$  to  $r_1$ . To offset the negative effects of higher interest rates on national income, expansionary fiscal policy is required in order to maintain income stability while simultaneously achieving balance of payments equilibrium and full employment conditions. Such a policy combination may help reduce unemployment while maintaining tighter monetary conditions under higher interest rate levels. Under these equilibrium conditions, both internal and external balance can be achieved. This policy mix framework is analyzed under a fixed exchange rate regime. A clearer illustration of this mechanism is presented in Figure 2 below.

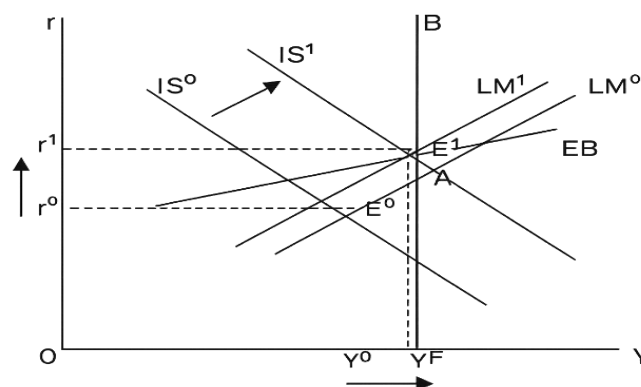


Figure 2. IS-LM in Internal and External Equilibrium

Figure 2 illustrates that the initial equilibrium of the economy is located at point  $E_0$ , with national income at  $Y_0$  and the interest rate at  $r_0$ . The government implements fiscal policy under a fixed exchange rate regime through an increase in government expenditure ( $G$ ) or a reduction in taxes ( $T$ ). As a result, the IS curve shifts from  $IS_0$  to  $IS_1$ , creating a new equilibrium at point  $A$ . The resulting balance of payments (BOP) deficit reduces the money supply and increases the interest rate to  $r_1$ , thereby shifting the LM curve from  $LM_0$  to  $LM_1$ . Consequently, a new equilibrium is achieved at point  $E_1$ , reflecting an increase in national income. This condition indicates that the simultaneous implementation of expansionary fiscal policy and contractionary monetary policy leads to higher national income and higher interest rates.

Figure 3 demonstrates that the initial equilibrium of the economy is also located at point  $E_0$ , with national income at  $Y_0$  and the interest rate at  $r_0$ . The government implements fiscal policy under a flexible exchange rate regime through an increase in government expenditure ( $G$ ) or a reduction in taxes ( $T$ ). Consequently, the IS curve shifts from  $IS_0$  to  $IS_1$ , resulting in a new equilibrium at point  $A$ . Under this condition, the domestic currency depreciates, causing export prices to become relatively cheaper and import prices relatively more expensive. As a result, exports increase while imports decline, leading the balance of payments curve to shift from  $BOP_0$  to  $BOP_1$ . Simultaneously, the IS curve shifts further from  $IS_1$  to  $IS_2$ .

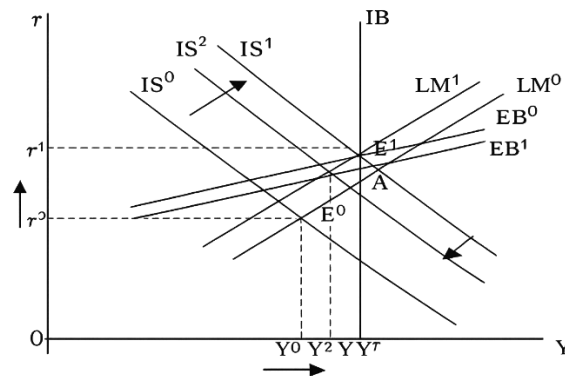


Figure 3. Fiscal and Monetary Policies under a Fixed Exchange Rate Regime

Therefore, the simultaneous implementation of expansionary fiscal policy and contractionary monetary policy may lead to an increase in both national income and interest rates. However, this policy mix tends to be more effective under a fixed exchange rate regime. In practice, the Indonesian government has previously implemented monetary tightening policies through Bank Indonesia by restricting money supply, while expansionary fiscal measures through increased government expenditure or tax reductions have not been fully implemented. If the government were to adopt policies involving higher taxes and increases in subsidized fuel prices, such measures could potentially prolong economic instability by triggering inflationary pressures and even increasing unemployment levels.

Socio-political instability also contributes significantly to economic instability (Hale, 2023). This condition is reflected in the incomplete enforcement of legal supremacy and persistent security concerns, which reduce investor confidence in investing in Indonesia. Such conditions may also hinder the realization of foreign assistance and international investment commitments. Therefore, socio-political and security factors should be considered essential components in supporting economic recovery alongside fiscal and monetary policies. This consideration became particularly important in 2024, when Indonesia entered a major democratic election period, during which political and security stability required serious attention and effective management from the government and other relevant stakeholders.

## **CONCLUSION AND RECOMMENDATIONS**

Expansionary fiscal policy combined with contractionary monetary policy tends to be more effective under Indonesia's current economic conditions, as such a policy mix may facilitate the achievement of four major macroeconomic objectives: high economic growth through increased national income, low inflation or reduced inflationary pressure, lower unemployment levels, and improved balance of payments conditions. Ultimately, the achievement of these objectives is expected to enhance public welfare. In addition, socio-political and security policies should complement fiscal and monetary policies in order to provide greater legal certainty and a conducive business environment for investors seeking to invest in Indonesia. Such policy support is essential for accelerating national economic recovery.

## **FUTURE RESEARCH**

Future studies should place greater emphasis on analyzing the effectiveness of fiscal and monetary policy coordination in maintaining economic stability. Further research may also examine how coordination between the government and the central bank influences macroeconomic indicators such as inflation, economic growth, unemployment, and exchange rate stability. These analyses may incorporate macroeconomic variables including government expenditure, taxation, interest rates, money supply, and Gross Domestic Product (GDP).

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