

THE EFFECT OF MONETARY POLICY ON MICRO, SMALL AND MEDIUM ECONOMIC GROWTH

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Abstract

The effect of monetary policy on the economic growth of Micro, Small and Medium Enterprises (MSMEs) can be defined as the impact that policies implemented by the central bank, particularly those relating to interest rates and money supply, have on the operating conditions and growth capabilities of MSMEs. Monetary policy plays a role in determining borrowing costs and inflation rates, which directly affect the capacity of MSMEs to access funds, make investments, and manage their business costs and product selling prices. The study conducted in this research uses the literature research method. The results show that the provision of low interest rates and controlled inflation create favourable conditions that facilitate MSMEs to expand their businesses and make investments. Price stability resulting from sound monetary policy maintains or increases consumer purchasing power, benefiting the sales and service sectors of MSMEs. However, variable currency exchange rates and limited access to credit sources pose challenges that limit the full impact of monetary policy on MSMEs, especially in the case of unexpected policy changes that could destabilise MSME operations.

Keywords: Monetary Policy, Economic Growth, Micro, Small and Medium Enterprises.

Introduction

Economic growth is one of the important indicators in measuring the progress of a country. In a modern economy, Micro, Small and Medium Enterprises (MSMEs) are the backbone of the economy due to their significant role in job creation, income distribution, and contribution to Gross Domestic Product (GDP) (Ahmad et al., 2021). MSMEs are also known to have strong resilience to various economic uncertainties and are often a catalyst in post-crisis economic recovery.

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Micro, Small, and Medium Enterprises (MSMEs) have long been recognised as important pillars in the economies of various countries, including Indonesia. The presence of MSMEs not only enlivens the market with various products and services, but also contributes significantly to Gross Domestic Product (GDP) and employment (Alam et al., 2021). The economic structure dominated by MSMEs shows that this sector has a vital role in driving the national economy. Furthermore, MSMEs are the foundation of economic resilience by providing extensive employment opportunities that contribute to poverty reduction and income equality in society (Ali et al., 2021).

MSMEs also act as agents of change in local and global economic dynamics. With rapid adaptation to market trends and consumer needs, MSMEs are able to introduce relentless innovation and creativity. In the current era of globalisation and digitalisation, many MSMEs are able to leverage technology to expand their market reach, even reaching the export market (Amberg et al., 2022). The strong presence of MSMEs also supports the resilience of the country's economy from various global economic shocks, demonstrating the importance of this sector in an inclusive and sustainable economic development strategy. Therefore, the development and empowerment of MSMEs is a priority agenda in government policies to promote comprehensive economic growth (Andersen et al., 2023).

On the other hand, monetary policy is a tool used by central banks to control the money supply that aims to achieve macroeconomic targets such as low inflation, price stability, and sustainable economic growth. This policy is carried out through instruments such as interest rate adjustments, open market operations, and exchange rate controls (Asriyan et al., 2021).

Often, monetary policy has a significant impact on the macro- and microeconomic operating environment that affects MSMEs. For example, changes in interest rates can affect the cost of capital and the availability of credit for MSMEs, which in turn, can determine their capacity to expand and survive market competition (Atil et al., 2020).

However, the relationship between monetary policy and MSME economic growth is not fully understood. Some studies suggest a positive relationship, while others suggest that monetary policy has a limited or even negative impact on MSMEs especially in terms of available bank credit. This could be due to various other factors beyond monetary policy itself, such as the unique characteristics of MSMEs, local market structure, fiscal policy, and global economic conditions (Auclert et al., 2020).

An in-depth understanding of the effect of monetary policy on the economic growth of MSMEs is important to determine strategic measures for policymakers. This can help them design more effective strategies to facilitate MSME growth while ensuring macroeconomic stability (Baqae et al., 2024).

Given the important role of MSMEs in the national economy and the complexity of monetary policy influences, there is an urgent need to delve deeper into how existing

policies to date affect MSMEs. This triggers research questions on the extent to which monetary policy affects MSMEs and how this relationship can be optimised to support the sector's vital growth. Therefore, this research is necessary to not only fill the gap in academia, but also provide practical insights that can be used to create an economic environment that supports the development of MSMEs.

Research Method

The study conducted in this research uses the literature research method. The literature research method is a systematic approach in research that relies on a collection of written sources or library materials to collect data, identify, and analyse information related to the topic or research problem. The aim is to gain an in-depth understanding of the topic under study, by reviewing various sources such as books, journal articles, theses, and other relevant documents. This process allows researchers to evaluate previous works, identify gaps in the literature, and set the context for their own research (Afiyanti, 2014); (Ainiyah, 2021).

There are several stages that can be carried out in the literature study method, starting from searching for relevant keywords in catalogues, indexes, and search engines, collecting data from trusted sources, to analysing and synthesising the information found to develop the theoretical framework of the research. Utilising a variety of existing sources, this method also helps in building arguments or hypotheses for research (Alaslan, 2022); (Arikunto, 2000).

Results and Discussion

Micro and Small and Medium Economic Theory

Micro, Small, and Medium Enterprises (MSMEs) refer to a category of businesses that have a relatively small scale of operations and working capital compared to large enterprises. This classification is generally based on several criteria such as total assets, turnover, or number of employees, which may vary depending on the policies or regulations in each country (Boeing et al., 2022). In Indonesia, for example, a business is classified as an MSME based on certain criteria set by the government, such as having a maximum number of employees of up to 300 people or having a maximum annual turnover of up to IDR 50 billion, depending on its category as a micro, small, or medium enterprise. MSMEs encompass a wide range of businesses, from trading, services, handicrafts, agriculture, to small industries operating in various economic sectors (Bräuning & Ivashina, 2020).

Characteristics of MSMEs include high flexibility and adaptability to market changes, as well as proximity to local communities. MSMEs are often praised for their ability to create products or services that are innovative and customised to local market needs, giving them a certain competitive advantage. In addition, the relatively simple ownership and management structure of MSMEs, often with family or individual owners

directly involved in day-to-day operations, allows for quick and personalised decision-making (Buera et al., 2023). This also contributes to creating a business climate that is more flexible and responsive to opportunities and challenges. Nonetheless, MSMEs often face larger-scale challenges, such as limited access to capital, technology and markets, which limit their growth potential and scalability in the long term (Canavire-Bacarreza et al., 2020).

Micro, Small, and Medium Enterprises (MSMEs) play a crucial role in the economy, especially as drivers of economic growth, job creators, and as reducers of economic inequality. MSMEs contribute significantly to Gross Domestic Product (GDP) and are a major source of employment, helping to reduce unemployment. Through their high adaptability and innovation, MSMEs also promote healthy economic competition, stimulate the development of new products and services, and enhance economic diversification (Candraningrat et al., 2021). Furthermore, their role in supporting the local economy, by channeling money into the community and supporting local infrastructure development, not only improves the general welfare of the community but also plays an important role in reducing economic inequality between regions. Thus, empowering MSMEs has become one of the key strategies in national and global economic development agendas, given their huge potential in realising inclusive and sustainable economic development (Chenet et al., 2021).

Monetary Policy

Monetary policy is an action taken by a country's central bank or monetary authority to control the amount of money circulating in the economy with the aim of achieving macroeconomic targets, such as stable inflation, low unemployment, and sustainable economic growth. Monetary policy is conducted through instruments such as policy rates, open market operations, the ratio of minimum required reserves, and the quantity of money in circulation (Cao et al., 2021). Through interest rate setting, the central bank can influence the inflation rate and make investment decisions more attractive or not. Meanwhile, with open market operations, they sell or buy government securities to absorb liquidity or inject it into the banking system (Chaudhary et al., 2020).

The main objective of monetary policy is to create a stable economic environment conducive to economic growth. By keeping inflation at a manageable and stable level, monetary policy helps ensure that the value of the currency remains strong, which in turn will maintain investor and consumer confidence and boost economic activity (Chenet et al., 2021). Supporting employment is another objective, where by managing interest rates and liquidity, monetary policy seeks to optimise a country's unemployment rate. Indirectly, economic stability achieved through monetary policy can help reduce income disparities and improve people's overall standard of living, making it an important tool in achieving long-term economic prosperity (Chenet et al., 2021).

Interest rates are one of the most important monetary policy tools. The central bank sets a benchmark interest rate that will affect all interest rates in the economy, including lending, mortgage, and savings rates. Lower interest rates can encourage lending and investment as the cost of borrowing funds is cheaper, potentially increasing consumer spending and investment from firms. On the other hand, higher interest rates can cool economic activity by increasing borrowing costs, which is usually done to control rising inflation or "overheat" the economy (Chu et al., 2020).

Open market operations are the buying and selling of government securities by central banks in the open market to regulate the level of liquidity circulating in the banking system. When central banks buy securities, they inject funds into the market which increases money supply and lowers interest rates, which promotes economic growth (Cloyne et al., 2020). Conversely, selling securities reduces liquidity in the system, tends to increase interest rates, and restrains economic growth. Open market operations are a very effective means used by central banks to help achieve their inflation and economic growth targets (Correa et al., 2022).

Minimum reserve requirements are provisions set by the central bank regarding the minimum amount of funds that must be held by commercial banks in the form of cash or account balances at the central bank (Dell'Anna, 2021). By increasing the required reserve ratio, the central bank can reduce the amount of money that commercial banks can lend, leading to a decrease in the total money supply and potentially controlling inflation. In contrast, by lowering the required reserve ratio, the central bank allows commercial banks to lend more money, which can stimulate the expansion of economic activity (Disemadi & Shaleh, 2020).

Besides these main instruments, other monetary policy tools include discount facilities and unconventional market operations such as quantitative easing (QE). Discount facilities are lending facilities where commercial banks can borrow emergency funds directly from the central bank at a set interest rate, which is usually higher than the market rate (Durante et al., 2022). While QE is the purchase of long-term assets by the central bank to increase the money supply in an effort to lower long-term interest rates, increase bank lending, and encourage investment and consumption. Quantitative easing is often used in situations where interest rates are so low that conventional monetary policy is no longer effective (Endris & Kassegn, 2022).

The monetary policy transmission mechanism is the process through which monetary policy affects the economy and the inflation rate. In general, this mechanism starts from a change in monetary policy by the central bank, such as a change in the policy rate, which then affects interest rates in the money market, inflation expectations, currency exchange rates, and liquidity conditions in the banking system. These changes then affect the economic behaviour of market participants, such as consumers and businesses, which is manifested in decisions to spend, save, invest, and set prices (Erlando et al., 2020). Finally, through various channels such as interest rate

effects, exchange rate effects, equity effects, and wealth balance effects, monetary policy affects total demand, production, employment levels, and price dynamics, thereby achieving set policy objectives such as inflation targets or sustainable economic growth. The transmission mechanism is crucial in helping policymakers to predict the impact of their policy changes on the overall economy (Esubalew & Raghurama, 2020).

Monetary Policy and Economic Growth of MSMEs

Monetary policy has a significant influence on economic growth, especially on Micro, Small, and Medium Enterprises (MSMEs). MSMEs, which are the backbone of the economy in many countries, including Indonesia, are highly sensitive to changes in monetary policy, especially changes in interest rates (Etim & Daramola, 2020). Lower interest rates can lower borrowing costs for MSMEs, making access to capital more affordable and enabling operational expansion or investment in productive assets (Eton et al., 2021). Thus, a relaxed monetary policy or lower interest rates can boost MSME growth by increasing investment and consumption.

On the other hand, a tight monetary policy, characterised by an increase in interest rates, can make access to funding for MSMEs more difficult. Loans become more expensive, which can choke off business expansion and even affect the viability of MSMEs operating on thin profit margins. Reduced access to credit not only hampers growth but can also increase the risk of business failure in the MSME sector (Fachrurazi et al., 2022). Therefore, it is important for central banks to consider the impact of monetary policy on the MSME sector when formulating and implementing such policies.

In addition, monetary policy can also affect the liquidity available for lending by the banking sector to MSMEs. For example, open market operations by the central bank, through the purchase or sale of securities, can adjust the money supply in the banking system (Franco et al., 2021). When liquidity increases due to the central bank's action of buying securities, commercial banks have more funds to lend, including to MSMEs. This can not only lower interest rates but also incentivise banks to expand credit to MSMEs by boosting overall economic growth. Thus, prudent and targeted implementation of monetary policy can be an important tool in supporting the growth of MSMEs and the economy at large (Gherghina et al., 2020).

Factors Affecting Economic Growth of MSMEs

The economic growth of MSMEs is influenced by various factors, both from within the businesses themselves and from the external environment in which they operate. The first internal factor is the innovation capacity and adaptability of MSMEs to change. Small and medium enterprises that are able to innovate, both in their products and marketing methods, tend to survive and thrive in a competitive market. Adaptation to the latest technology, such as the use of e-commerce and social media

for marketing, is key for MSMEs to increase their market reach and strengthen competitiveness (Gormsen & Koijen, 2020).

Furthermore, access to funding sources is also crucial to the economic growth of MSMEs. MSMEs often face difficulties in accessing financing from traditional financial institutions due to limited collateral and untested financial track records. Access to broader financing, through microcredit schemes or support from government and non-bank institutions, can improve MSMEs' capabilities in business expansion, innovation, and production capacity building (Gruin & Knaack, 2020).

The third factor is macroeconomic conditions. Inflation, currency exchange rates, and interest rates, for example, directly affect consumer purchasing power and production costs. A stable macroeconomic environment provides certainty for MSMEs in planning and expanding their businesses. In addition, government policies, which include regulations, tax policies, and infrastructure support, also greatly influence the operating environment of MSMEs. Policies that support entrepreneurship, provide fiscal incentives for MSMEs, and ease business licensing can help the sector grow (Herliansyah et al., 2020).

On the other hand, other external factors such as global market dynamics also play a role in determining opportunities and challenges for MSMEs. In the era of economic globalisation, MSMEs with unique and quality products have the potential to export and expand their market to the international level (Hernández et al., 2020). However, this also means they must be prepared to face tougher competition and be able to meet global quality standards. Supporting MSMEs' capacity to compete in the global market is therefore crucial, including through training, product certification, and international trade promotion. All of these factors are interrelated and influential in carving out the direction of MSME economic growth (Hernita et al., 2021).

Relationship between Monetary Policy and Economic Growth of MSMEs

Monetary policy has a significant influence on the economic growth of MSMEs. Basically, monetary policy managed by the central bank in the form of setting interest rates and money supply aims to control inflation and maintain price stability, which directly or indirectly affects the operations and success of MSMEs (Hertati et al., 2020). Low interest rates, for example, tend to make borrowing costs cheaper, thus providing opportunities for MSMEs to access capital under better conditions, whether for expansion, investment in new tools or technology, or their day-to-day operations (Hohberger et al., 2020).

In addition, monetary policies that lead to low inflation favour consumer purchasing power. In a state of controlled inflation, the value of money tends to stabilise so that consumers have higher confidence to make expenditures and investments. This benefits MSMEs, especially those in the retail and service sectors, as

they can maintain or even increase their sales volume. When consumers tend to spend more, it will indirectly boost the sales growth of MSMEs (Holm et al., 2021).

Monetary policy can also affect currency exchange rates, which has a direct impact on MSMEs involved in international trade. If monetary policy strengthens the domestic currency, it may increase the cost of importing raw materials used by MSMEs for production (R. Huang et al., 2021). Conversely, if the currency weakens, MSMEs' export products become more competitive in the global market as prices become relatively cheaper. Therefore, monetary policy strategies should be implemented with careful consideration to find the right balance to help MSMEs optimise profits from both local and international markets (H. Huang et al., 2022).

However, monetary policy also has limitations in its effect on MSMEs. For example, while low interest rates can help reduce borrowing costs, MSMEs often still face challenges in gaining access to credit due to creditworthiness issues or insufficient collateral. On the other hand, monetary policies that focus too much on controlling inflation by drastically raising interest rates may discourage MSMEs from taking loans for business development (Hunjra et al., 2022). Therefore, effective monetary policy formulation should be accompanied by fiscal and regulatory policies that support MSMEs to optimise the benefits of a stable economic environment.

In conclusion, monetary policy plays an important role in influencing the economic growth of MSMEs. Low interest rates and controlled inflation tend to create a conducive environment for MSMEs to access cheaper capital, which supports expansion and investment. Controlled inflation also increases consumer purchasing power, which has a positive impact on MSME revenues. Currency exchange rates regulated through such policies have an effect on the international trade competitiveness of MSMEs. However, monetary policy is not the only determining factor and has its limitations, so collaboration with fiscal policy and easy access to other financial resources is needed to increase the contribution of MSMEs to the overall economy.

Conclusion

In summarising the research findings, it was found that monetary policy has a significant impact on the growth and sustainability of MSMEs. The findings emphasise that low interest rates and controlled inflation contribute positively to MSMEs' ability to access capital under more favourable conditions. This allows MSMEs to expand, invest in new technologies, and improve their daily operations, which in turn can boost their economic growth. In addition, monetary policies that facilitate price stability support consumer purchasing power, which directly impacts MSME sales and profits.

Furthermore, the research findings also reveal that currency exchange rates influenced by monetary policy play an important role for MSMEs that depend on imports and exports. The power of regulated currencies to affect MSME

competitiveness in the global marketplace reveals the complexity of the relationship between monetary policy and MSME success in international trade. In a global context, MSMEs that can manage exchange rate risk more effectively tend to be more successful in conducting cross-border business operations.

However, the findings also highlight the limitations of monetary policy in supporting MSMEs, particularly with regard to credit access and the consequences of tight inflation control policies. While low interest rates theoretically support credit accessibility, in practice, MSMEs often still experience difficulties in accessing loans due to various constraints. This calls for the need for monetary policy to collaborate with fiscal strategies and regulatory adjustments, in order to create a more inclusive and supportive economic environment for the sustainable growth of MSMEs.

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