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THE LINKAGE ANALYSIS OF INTEREST-FREE AND INTEREST-BEARING MONETARY AGGREGATES TO BUSINESS CYCLE AND INFLATION IN INDONESIA

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Abstract

The Money supply, which consists of M1 (interest-free monetary aggregates) and QM (interest-bearing monetary aggregates), is a monetary policy instrument often used by Central Bank of Indonesia to achieve the final target of output and price. The purpose of this study is to identify which component is the more effective to be a monetary policy instrument. We apply Vector Autoregressive (VAR) combined with Vector Error Correction Model (VECM) to analyze the responses of Indonesia's quarterly real GDP and price to the shock of M1 and QM. The result indicates that the shock of QM is relatively more able to explain the variance of real GDP and price compared to the shock of M1. This means, in the long-run QM is more related to real GDP and price, so QM is more effective to be a monetary instrument to overcome the business cycle and inflation in Indonesia.

Keywords: Interest-Free Monetary Aggregates, Interest-Bearing Monetary Aggregates, Business Cycle, Inflation.
