



RESEARCH ARTICLE

Interest Rate Policy on Financial System Stability

Nalendra Rehan Ardiansyah

Law Study Program, Faculty of Law, Dr. Soetomo University Surabaya

nalendrarehan24@gmail.com

ARTICLE INFO	ABSTRACT
Received: August 1 2026 Accepted: August 12, 2026	Abstract: Interest rate policy is a primary instrument of monetary policy, playing a strategic role in maintaining economic and financial system stability. Changes in interest rates affect not only inflation and economic activity but also the behavior of financial institutions, liquidity conditions, credit disbursement, banking asset quality, and financial market stability. This article aims to analyze the impact of interest rate policy on financial system stability and to identify the challenges monetary authorities face in balancing price stability, economic growth, and financial sector resilience. The study employs a normative-juridical method, utilizing both statutory and conceptual approaches. It analyzes the interrelationship between interest rate policy, monetary policy transmission mechanisms, and systemic risk within the financial sector. The findings indicate a significant relationship between interest rate policy and financial system stability. While interest rate hikes can strengthen price stability and anchor inflation expectations, they simultaneously risk increasing financing costs, dampening credit demand, raising the risk of non-performing loans, and intensifying liquidity pressures in the financial sector. Conversely, lowering interest rates can stimulate credit expansion and economic activity; however, excessive rate cuts may heighten the risk of asset bubbles and debt accumulation. Therefore, the effectiveness of interest rate policy requires coordination between monetary policy and macroprudential policy to foster sustainable financial system stability.
Keywords: Interest Rate Policy; Financial Stability; Monetary Policy; Banking; Macroprudential. *Corresponding Author: nalendrarehan24@gmail.com	

INTRODUCTION

Financial system stability is a fundamental element in supporting the sustainability of the national economy. The financial system serves a strategic function as an intermediation

mechanism, connecting parties with surplus funds to those requiring financing. A stable financial system enables the effective conduct of fund mobilization, credit disbursement, investment, payment transactions, and other economic activities. Disruptions to financial system stability can have far-reaching consequences, as problems in the financial sector can be transmitted to the real sector through reduced lending, liquidity disruptions, weakened investment, declining consumption, and diminished public confidence. Thus, financial system stability relates not only to the health of individual financial institutions but also to the system's overall capacity to withstand shocks and continue performing its intermediation function sustainably.

Monetary policy plays a crucial role in fostering stable economic and financial system conditions. Interest rates are a primary instrument used by central banks to influence monetary conditions. Changes in interest rates can affect the behavior of households, businesses, banks, investors, and financial market participants. Interest rate hikes are generally aimed at curbing inflationary pressures and maintaining currency stability, whereas rate cuts can be used to stimulate economic activity by boosting consumption and investment. These mechanisms demonstrate that interest rate policy has broad economic implications, as monetary policy transmission occurs through various channels—including credit, interest rates, exchange rates, asset prices, and public expectations.

The constitutional basis for managing the national economy is found in Article 33 of the 1945 Constitution of the Republic of Indonesia. This provision frames the national economy as a collective endeavor based on the principle of kinship, aimed at achieving public prosperity. Financial sector stability is a vital component of this effort, as a healthy financial system is essential to ensure the availability of financing for economic activities. The management of monetary policy cannot be separated from the state's mandate to create an economy capable of delivering sustainable benefits to the public. A more specific legal basis for monetary policy is found in Law Number 23 of 1999 concerning Bank Indonesia, as amended several times—most recently by Law Number 4 of 2023 concerning the Development and Strengthening of the Financial Sector. Article 7 of the Bank Indonesia Law affirms that the objective of Bank Indonesia is to achieve stability in the value of the Rupiah, maintain payment system stability, and contribute to maintaining financial system stability to support sustainable economic growth. Stability in the value of the Rupiah encompasses both the stability of prices for goods and services and the stability of the Rupiah exchange rate. This formulation demonstrates the interconnection between monetary policy, payment system stability, financial system stability, and economic growth. Bank Indonesia is mandated not only to maintain price stability but also to contribute to maintaining financial system stability.

Bank Indonesia's authority to implement monetary policy provides the legal basis for utilizing interest rate instruments to achieve these objectives. Monetary control is exercised through various instruments capable of influencing liquidity conditions and the cost of funds within the economy. The legal framework has been further strengthened by Law Number 4 of 2023 concerning the Development and Strengthening of the Financial Sector. This Law reforms the financial sector while reinforcing regulatory and supervisory coordination among Bank Indonesia, the Financial Services Authority (OJK), the Indonesia Deposit Insurance Corporation (LPS), and the Ministry of Finance to ensure financial system stability. This strengthening underscores that financial system stability is an institutional responsibility requiring inter-agency coordination, rather than the sole responsibility of a single authority.

This legal framework is directly relevant to interest rate policy. The policy interest rate serves as a primary signal for the direction of monetary policy, subsequently influencing money market conditions and the interest rates applied by financial institutions. Changes in the policy rate can affect banking funding costs and, ultimately, impact lending and deposit rates. Rising interest rates can increase financing costs for the public and the business sector; such conditions have the potential to dampen credit demand while increasing the repayment burden on borrowers. Conversely, lowering interest rates can incentivize increased credit demand and economic activity. However, rapid credit growth must be balanced with risk management to avoid creating vulnerabilities within the financial system.

These aspects demonstrate a two-way relationship between interest rate policy and financial system stability. While interest rate policy can be used to respond to economic pressures, such decisions also carry consequences for the health of the financial sector. A significant rise in interest rates, for instance, can increase the risk of non-performing loans as borrowers' capacity to meet repayment obligations becomes constrained. Higher funding costs can also place pressure on highly indebted companies. If widespread, these conditions can affect banking asset quality and heighten systemic risk. Lowering interest rates entails different risks, such as increased leverage, excessive credit expansion, and the potential for asset prices to diverge from economic fundamentals.

Regulatory developments at Bank Indonesia indicate that monetary policy is no longer treated in isolation from macroprudential policy. Bank Indonesia Regulation Number 4 of 2024 concerning the Bank Indonesia Policy Mix designates monetary policy, macroprudential policy, and payment system policy as Bank Indonesia's core policies. Monetary policy objectives include low and stable inflation, a stable exchange rate, and foreign exchange flows that support monetary, financial system, and macroeconomic stability. Macroprudential policy objectives encompass optimal credit or financing, financial system resilience, and inclusive and green finance. These regulations demonstrate that achieving financial system stability requires a complementary policy mix. Macroprudential policy plays a crucial role when interest rate policy yields divergent impacts on the financial and real sectors. Bank Indonesia Regulation Number 13 of 2024 concerning Macroprudential Policy affirms that such policy aims to help maintain financial system stability by fostering balanced, high-quality, and sustainable intermediation, while also mitigating and managing systemic risk. This framework demonstrates that financial system stability requires the control of risks emerging at the aggregate level. While interest rate policy influences credit supply and demand conditions, macroprudential policy can be employed to ensure that the evolution of intermediation does not lead to an accumulation of systemic risk.

The Indonesian banking context highlights the significance of this relationship. Banking is a key sector within the financial system, as the majority of financing needs for the public and the business sector are met through bank credit mechanisms. Changes in interest rates influence banks' decisions regarding credit disbursement, as well as the decisions of households and businesses regarding borrowing. Excessively high interest rates can impair borrowers' repayment capacity, whereas excessively low rates over the long term can encourage excessive borrowing and heighten the risk of unhealthy credit growth. Consequently, banking stability is heavily influenced by the authorities' ability to effectively manage the transmission of monetary policy.

Global factors also present challenges for domestic interest rate policy. Shifts in global interest rates can affect capital flows, exchange rates, financing costs, and the expectations of domestic market participants. Such external pressures complicate monetary policy decision-making, as authorities must weigh domestic conditions against international economic developments. Interest rate policies must uphold the credibility of monetary policy while simultaneously safeguarding financial system stability and supporting economic growth.

The core issue is not merely whether interest rates should be raised or lowered, but rather how policy is formulated to strike a balance among price stability, economic growth, and financial system stability. An overly expansionary policy can increase the risk of debt accumulation and asset price imbalances. Conversely, an overly restrictive policy can raise financing costs, dampen economic activity, and heighten the risk of non-performing loans. This dilemma underscores the need to analyze interest rate policy effectiveness from a broader perspective, taking into account the characteristics of the financial system, banking conditions, the behavior of economic agents, and global economic trends.

Examining the impact of interest rate policy on financial system stability is crucial for analyzing the interplay between Bank Indonesia's mandate to conduct monetary policy and the imperative of maintaining financial system resilience. Evolving legal frameworks indicate that financial system stability has become part of Bank Indonesia's policy mandate, reinforced by the P2SK Law and a mix of monetary and macroprudential policies. Analyzing interest rate

policy is essential to understanding how this instrument affects the banking sector, financial markets, and the economy as a whole. Such an approach fosters the understanding that an effective interest rate policy is not merely one that controls inflation, but one that maintains a balance among monetary stability, financial system resilience, and sustainable economic growth.

Literature Review

1. Interest Rate Policy

Interest rate policy is a component of monetary policy employed by the central bank to influence monetary conditions and economic activity. Interest rates serve as an instrument affecting the cost of funds within the financial system and act as a signal regarding the direction of monetary policy. Changes in the policy interest rate are transmitted through the banking sector in the form of adjustments to deposit rates, lending rates, financing demand, and investment decisions.

From a legal perspective interest rate policy falls within the scope of Bank Indonesia's authority to implement monetary policy. Law Number 23 of 1999 concerning Bank Indonesia as most recently amended by Law Number 4 of 2023—mandates Bank Indonesia to achieve stability in the value of the Rupiah, maintain payment system stability, and help safeguard financial system stability to support sustainable economic growth. Interest rate policy is one of the instruments used to fulfill this mandate.

Interest rate policies can be distinguished based on their policy stance. An expansionary interest rate policy involves lowering interest rates to stimulate economic activity and financing. A contractionary interest rate policy involves raising interest rates to curb inflationary pressures and maintain monetary stability. Any policy change has consequences for the banking sector; therefore, implementation requires consideration of economic conditions and financial system risks.

2. Financial System Stability

Financial system stability refers to a condition in which the financial system is capable of effectively performing intermediation, payment system, and risk management functions, even when facing economic pressures. This stability encompasses the resilience of financial institutions, the smooth functioning of financial markets, liquidity adequacy, and the system's capacity to absorb shocks.

Indonesia's legal framework positions financial system stability as a crucial element of financial sector policy. Law Number 4 of 2023 concerning the Development and Strengthening of the Financial Sector reinforces the financial sector's institutional framework by strengthening coordination among Bank Indonesia, the Financial Services Authority (OJK), the Indonesia Deposit Insurance Corporation (LPS), and the government. These arrangements demonstrate that financial system stability requires policy coordination among institutions.

Financial system stability is closely linked to banking stability. The banking sector is a key component of the financial system, as it performs the function of mobilizing public funds and channeling them as credit. Disruptions to the soundness of the banking sector can impact public confidence, liquidity, credit disbursement, and economic activity. Banking stability serves as a crucial indicator for assessing the resilience of the financial system.

3. Banking Policy and Prudential Principles

Banking policy comprises a set of regulations governing banking operations to ensure that the intermediation function operates in a sound and sustainable manner. Aspects addressed by banking policy include fund mobilization, credit disbursement, liquidity management, capitalization, risk management, governance, and consumer protection.

Law Number 7 of 1992 concerning Banking, as amended by Law Number 10 of 1998, establishes the legal framework for banking operations. Article 2 of the Banking Law stipulates that Indonesian banks must conduct their business based on the principles of economic democracy while adhering to prudential principles. These principles require banks to conduct business

activities by taking into account risks and their own capacity to maintain operational soundness.

Article 29 paragraph (2) of the Banking Law mandates that banks maintain a sound financial condition in accordance with regulations regarding capital adequacy, asset quality, management quality, liquidity, profitability, solvency, and other aspects related to banking operations. These provisions are directly linked to interest rate policy, as changes in interest rates can affect credit quality, liquidity, borrower capacity, and the soundness of the bank. Prudential principles serve as a vital instrument for managing risks arising from interest rate fluctuations. Banks must consider a borrower's capacity to meet payment obligations and account for potential changes in economic conditions. High credit growth cannot be the sole measure of the success of banking policy. Credit quality and a bank's ability to manage risk are integral parts of financial system stability.

4. Macroprudential Policy

Macroprudential policy is aimed at maintaining financial system stability by controlling systemic risks. It differs in nature from monetary policy because its focus extends beyond price stability to include the resilience of the financial system and balanced intermediation.

Bank Indonesia Regulation Number 13 of 2024 concerning Macroprudential Policy stipulates that such policy is directed at maintaining financial system stability by fostering balanced, high-quality, and sustainable intermediation, as well as mitigating and managing systemic risks. This regulation demonstrates that macroprudential policy serves as a crucial instrument for balancing credit growth with financial sector resilience.

Macroprudential instruments can be utilized to strengthen the transmission of monetary policy. Instruments such as the Countercyclical Capital Buffer, Loan-to-Value (LTV)/Financing-to-Value (FTV) ratios, the Macroprudential Intermediation Ratio, and Macroprudential Liquidity Incentive policies can influence banking intermediation behavior. The use of these instruments enables authorities to respond to systemic risks in a more targeted manner, without relying solely on interest rate adjustments.

5. The Relationship Between Interest Rate Policy and Financial System Stability

The relationship between interest rate policy and financial system stability can be observed through the monetary policy transmission mechanism within the banking sector. Changes in the policy interest rate affect the cost of funds, lending rates, demand for financing, credit quality, and liquidity, as well as the economic decisions of households and businesses. An increase in interest rates can strengthen price and exchange rate stability but raises financing costs. Borrowers with high debt levels may face increased repayment burdens. The risk of non-performing loans can rise if borrowers' repayment capacity declines; such conditions can impact asset quality and the health of the banking sector.

Conversely, a reduction in interest rates can stimulate the economy by boosting the demand for credit and investment. However, unchecked credit expansion can lead to increased leverage and systemic risk. Prudential principles and macroprudential policies are essential to ensure that intermediation growth remains at a healthy level.

Bank Indonesia Regulation Number 4 of 2024 concerning the Bank Indonesia Policy Mix demonstrates the integration of monetary policy and macroprudential policy. Monetary policy is directed toward maintaining the stability of the Rupiah's value, while macroprudential policy aims to safeguard financial system resilience and foster balanced intermediation. This integration establishes the conceptual basis that interest rate policy must be implemented in conjunction with banking and macroprudential policy instruments. This conceptual framework serves as the foundation for analyzing interest rate policy from the perspective of banking law. Policy effectiveness is determined not only by changes in interest rates but also by the capacity of legal and institutional systems to manage the policy's impact on the banking sector. Prudential principles, bank soundness, risk management, consumer protection, and systemic risk control are key elements that must be addressed to ensure financial system stability.

RESEARCH METHODOLOGY

This research uses a normative juridical method with a statutory approach and a conceptual approach. The statutory regulations approach is used to analyze the legal provisions governing Bank Indonesia's authority in determining monetary policy, interest rates and financial system stability. A conceptual approach is used to examine the concepts of interest rate policy, financial system stability, monetary policy transmission, and macroprudential policy. The legal materials used include primary legal materials in the form of statutory regulations, secondary legal materials in the form of books, scientific journals and research results, as well as relevant tertiary legal materials. The analysis was carried out descriptively-analytically to obtain systematic conclusions.

RESULTS AND DISCUSSION

1. Interest Rate Policy Regulation within the Framework of Banking Law and Financial System Stability

Interest rate policy is a monetary policy instrument that directly influences banking activities. The setting of interest rates by Bank Indonesia relates not only to inflation control but also to liquidity, credit disbursement, the mobilization of public funds, borrowers' ability to meet their obligations, and the resilience of banking institutions. From a banking law perspective, this policy operates within a framework of authority that must be exercised in accordance with statutory regulations and principles of accountable governance.

The legal basis for monetary policy is found in Law Number 23 of 1999 concerning Bank Indonesia, as amended several times—most recently by Law Number 4 of 2023 concerning the Development and Strengthening of the Financial Sector. Article 7 of the Bank Indonesia Law mandates that Bank Indonesia achieve stability in the value of the Rupiah, maintain payment system stability, and help safeguard financial system stability to support sustainable economic growth. This formulation demonstrates the direct link between monetary policy and financial system stability. As a monetary policy instrument, interest rates must be managed so that achieving Rupiah value stability does not disrupt the resilience of the financial system.

Bank Indonesia's authority to implement monetary policy provides the basis for using interest rates as a policy signal. Changes in the policy interest rate affect money market conditions and can subsequently be transmitted to banking deposit and lending rates. Such changes carry legal and economic consequences for the relationship between banks and their customers. Lending interest rates are a crucial component of credit agreements; therefore, their application must comply with banking regulations and adhere to principles of prudence, transparency, and customer protection.

Law Number 7 of 1992 concerning Banking, as amended by Law Number 10 of 1998, establishes the primary legal basis for the conduct of banking activities. Article 2 of the Banking Law stipulates that Indonesian banking in carrying out its business is based on economic democracy by using the principle of prudence. This principle is an important basis for linking interest rate policy with banking stability. Banks are not only required to improve their intermediation function, but are also required to take into account the risks arising from providing credit.

Article 29 paragraph (2) of the Banking Law stipulates that banks must maintain a sound financial condition in accordance with regulations regarding capital adequacy, asset quality, management quality, liquidity, profitability, solvency, and other aspects related to banking operations. These provisions are relevant to interest rate policy because changes in interest rates can affect a bank's asset quality and liquidity. Rising interest rates can increase the credit repayment burden for borrowers. A risk of rising non-performing loans may emerge if a borrower's capacity to pay does not keep pace with the increase in financing costs. Such conditions can ultimately impact the bank's financial health.

The prudential principle serves as a legal instrument that constrains banking practices to prevent the pursuit of credit growth at the expense of all other considerations. Banks are required to assess a borrower's repayment capacity, business prospects, collateral quality, and financing risks. While an expansive interest rate policy may boost credit demand, credit growth must remain within the limits of sound risk management. Conversely, a restrictive interest rate policy must not disrupt a bank's ability to perform its intermediation function in a balanced manner.

This legal framework is reinforced by Law Number 4 of 2023 concerning the Development and Strengthening of the Financial Sector (UU P2SK). The UU P2SK strengthens coordination and regulation within the financial sector to create a stable, efficient, and sustainable financial system. Strengthening this institutional framework is crucial because financial system stability depends not only on Bank Indonesia's monetary policy but also on the supervision of the financial services sector, consumer protection, deposit insurance, and fiscal policy.

Bank Indonesia Regulation Number 4 of 2024 concerning the Bank Indonesia Policy Mix provides more operational guidelines regarding the interplay between monetary policy and macroprudential policy. The Bank Indonesia policy mix encompasses monetary policy, macroprudential policy, and payment system policy. Monetary policy is directed toward achieving the stability of the Rupiah's value, whereas macroprudential policy aims to help maintain financial system stability through balanced, high-quality, and sustainable intermediation. The framework demonstrates that interest rate setting cannot be separated from banking policy. Interest rates serve as a monetary instrument, whereas macroprudential policy functions to control systemic risks arising from the behavior of the financial sector. A combination of these two policies is necessary to ensure that interest rate changes are transmitted effectively without imposing excessive pressure on the banking sector.

2. The Impact of Interest Rate Policy on Banking Intermediation and Financial System Stability

Changes in interest rates are closely linked to the banking sector's intermediation function. Banks mobilize public funds through deposit products and channel them back into the economy in the form of loans. Changes in the policy interest rate can affect the cost of funds borne by banks and determine the interest rates charged to borrowers. This dynamic positions the banking sector as a primary channel for the transmission of monetary policy.

Interest rate hikes can raise borrowing costs and dampen the demand for financing. Borrowers with floating-rate loans may face increased repayment obligations. The risk of default rises if the increased cost of credit is not matched by an improvement in the borrower's economic capacity. A rise in non-performing loans can degrade bank asset quality and, under certain conditions, impact a bank's overall financial health.

Conversely, a decline in interest rates has different consequences. Lower financing costs can boost credit demand and stimulate economic activity. However, rapid credit growth poses risks if not underpinned by robust credit analysis and adequate risk management. The potential for asset price bubbles and increased leverage also warrants attention during periods of loose liquidity. Bank Indonesia Regulation No. 13 of 2024 concerning Macroprudential Policy stipulates that such policies aim to safeguard financial system stability by fostering balanced, high-quality, and sustainable intermediation, while simultaneously mitigating and managing systemic risk. These provisions demonstrate that banking policy is not solely focused on increasing credit volume but also on ensuring the quality and sustainability of intermediation.

Macroprudential policies can serve as complementary tools when interest rate policies have varying impacts across economic sectors. Instruments such as the Countercyclical Capital Buffer (CCyB), Loan-to-Value/Financing-to-Value (LTV/FTV) ratios, Macroprudential Liquidity Incentive Policy (KLM), and the Macroprudential Intermediation Ratio (RIM) can be employed to steer banking intermediation behavior. Utilizing these instruments enables Bank Indonesia to strike a balance between the need to stimulate credit growth and the need to contain systemic risk.

The Macroprudential Liquidity Incentive Policy is particularly relevant to the interplay

between interest rates and the banking sector. This instrument incentivizes banks to increase credit disbursement or financing to specific sectors in alignment with Bank Indonesia's policy direction. Such mechanisms illustrate that monetary policy extends beyond mere adjustments to interest rate levels. Macroprudential instruments are employed to strengthen policy transmission and ensure that banking liquidity is channeled into productive economic activities.

Financial system stability also requires banks to adhere to prudential principles. Article 29, paragraph (2) of the Banking Law mandates that banks maintain a sound financial condition in accordance with regulations regarding capital adequacy, asset quality, management quality, liquidity, profitability, solvency, and other aspects related to banking operations. These provisions establish the legal basis that credit growth cannot be decoupled from the obligation to maintain banking soundness. Setting competitive interest rates cannot serve as a justification for disregarding a debtor's repayment capacity or credit risk.

From a banking law perspective, financial system stability emerges from the interplay between monetary policy, banking policy, and macroprudential policy. Bank Indonesia holds the authority to set monetary policy to maintain the stability of the Rupiah's value. Banks are required to conduct their business operations based on prudential principles. Macroprudential policy is utilized to manage systemic risk and maintain a balance in financial intermediation. The Financial Services Authority (OJK) performs regulatory and supervisory functions over the financial services sector in accordance with the framework of the P2SK Law.

From a legal perspective, the effectiveness of interest rate policy is not measured solely by its success in controlling inflation. Effectiveness is also gauged by the policy's ability to preserve banking soundness, maintain smooth intermediation, manage credit risk, and prevent the emergence of systemic risk. Harmonizing monetary policy with banking and macroprudential policies is essential to simultaneously achieve the goals of Rupiah value stability and financial system stability. Ultimately, Indonesia's banking legal framework positions prudential principles, risk management, capital adequacy, liquidity, and systemic risk control as critical elements in ensuring that interest rate policies benefit the economy without creating new vulnerabilities for the national financial system.

CONCLUSION AND RECOMMENDATIONS

The conclusion, interest rate policy serves as a crucial instrument for maintaining the stability of the Rupiah's value and the financial system. Changes in interest rates influence liquidity, the cost of credit, financing disbursement, asset quality, and banking soundness. Raising interest rates can curb inflation and exchange rate pressures but carries the potential to increase the risk of non-performing loans. Lowering interest rates can stimulate credit growth and economic activity but may heighten systemic risk if not accompanied by prudential principles. Financial system stability requires the integration of monetary, banking, and macroprudential policies. The Bank Indonesia Law, the Banking Law, the P2SK Law, and Bank Indonesia regulations provide the legal framework for implementing these policies. Prudential principles, risk management, banking soundness, and the control of systemic risk are vital elements in upholding the resilience of the financial sector. The effectiveness of interest rate policy is measured not only by inflation control but also by the ability to maintain banking soundness, ensure smooth financial intermediation, and sustain financial system stability. The recommendations should be based directly on the research findings and provide constructive suggestions for future research, professional practice, or policy development.

Recommendations, Bank Indonesia needs to set interest rates in a measured manner, taking into account inflation, the value of the Rupiah, credit growth, liquidity, and systemic risk. Monetary policy needs to be reinforced through macroprudential measures to maintain financial system stability. Banks must strengthen prudential principles, risk management, and interest rate transparency for customers. Effective credit and liquidity risk management is essential to safeguard banking health amidst interest rate fluctuations. Coordination among Bank Indonesia, the Financial Services Authority (OJK), the Indonesia Deposit Insurance

Corporation (LPS), and the government needs to be strengthened. Harmonizing monetary, banking, and macroprudential policies is necessary to create a financial system that is sound, stable, and capable of supporting sustainable economic growth.

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