

EXCHANGE RATE RESPONSE TO INFLATION AND INTEREST RATES: SVAR APPROACH

Syakirah Ramadhani Putri Kurniawan^{1*}, Arsita Damayanti², Ibnu Ibrahim³, Putri
Nayla Pasha⁴, Fredericho Mego Sundoro⁵

¹²³⁴⁵Universitas Negeri Semarang

*Correspondence email: syakirahramadhani@students.unnes.ac.id

ABSTRACT

This study aims to analyze the response of the Indonesian rupiah exchange rate to inflation and interest rate shocks during the 2016–2025 period. The study uses monthly data obtained from Bank Indonesia (BI), Statistics Indonesia (BPS), and the Federal Reserve Economic Data (FRED). The analytical method employed is Structural Vector Autoregression (SVAR), complemented by Impulse Response Function (IRF) and Forecast Error Variance Decomposition (FEVD) analyses. The results indicate that inflation and interest rate shocks generate short-run responses in the rupiah exchange rate, although these effects gradually diminish over time. The FEVD results show that most of the variation in the exchange rate is explained by shocks to the exchange rate itself, while the contributions of inflation and interest rate shocks are relatively small. These findings suggest that the effects of inflation and interest rates on the exchange rate are limited in the short run, whereas exchange rate movements are largely driven by their own dynamics.

Keywords: exchange rate, inflation, interest rate, structural vector autoregression, Indonesia

1. INTRODUCTION

International trade refers to the export and import of goods or services conducted by various countries to meet domestic needs while expanding market reach. In the transaction process, the exchange rate plays a role in determining the value of one currency when measured against another currency. Therefore, exchange rate stability has become a crucial issue that directly affects a country's economy, particularly in developing countries such as Indonesia.

In an open economy, domestic inflation can be one of the factors that contribute to exchange rate depreciation. When domestic prices increase more rapidly than those in trading partner countries, investor confidence tends to decline, resulting in capital outflows that ultimately put pressure on the domestic currency. This condition is reflected in the movement

of the rupiah, which has continued to depreciate over recent years, from around IDR 13,300 per US dollar in early 2016 to IDR 16,768 per US dollar in April 2025. In addition to inflationary pressures, external factors such as the strengthening of the US dollar and increases in the Federal Reserve's interest rates have further exacerbated this condition, along with the instability of global financial markets in the aftermath of the COVID-19 pandemic.

Bank Indonesia (BI) responded to inflationary pressures and the depreciation of the rupiah exchange rate by gradually increasing its policy interest rate (BI Rate) starting in August 2022. This policy aimed to suppress aggregate demand, control inflation, and attract capital inflows in order to strengthen the rupiah. However, exchange rate appreciation did not always follow the implementation of this policy. The rupiah continued to experience pressure despite periods of monetary tightening, indicating that the relationship between interest rates and the exchange rate is not linear.

The complexity of the relationship among inflation, interest rates, and the exchange rate constitutes the core issue of this study. High inflation can reduce investor confidence, thereby contributing to exchange rate depreciation. Conversely, the depreciation of the rupiah can trigger inflation through increases in the prices of imported raw materials, given Indonesia's continued reliance on imports. On the other hand, the effectiveness of interest rate policy in stabilizing the exchange rate is also sensitive to changing external conditions.

This topic has been examined by several researchers using various approaches. Aji et al. (2021) investigated the relationship among inflation, interest rates, and exchange rates using the Vector Autoregression (VAR) approach. However, the study employed a relatively short sample period from 2013 to 2018, which may limit its ability to capture long-run dynamics. Moreover, as a reduced-form model, VAR cannot identify structural shocks or distinguish the underlying sources of fluctuations. Similarly, Alawiyah et al. (2019) examined the effects of policy interest rates, inflation, and money supply on exchange rates using the VAR approach. However, the use of a reduced-form VAR also limits the identification of structural shocks.

Building upon the limitations of previous studies, this research is designed to address this gap. The use of the Structural Vector Autoregression (SVAR) method enables a more structural and detailed identification of the exchange rate response to inflation and interest rate shocks. Studies that combine these three variables using the SVAR approach over the 2016–2025 period also remain relatively limited. The selected period encompasses several important economic events, including the normalization of global monetary policy, the COVID-19 pandemic, and the subsequent recovery period, all of which have influenced the movements of inflation, interest rates, and the exchange rate in Indonesia.

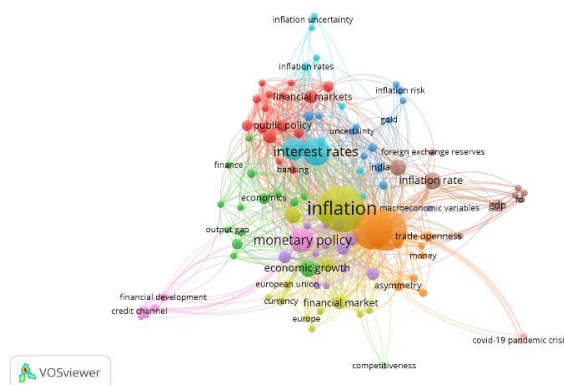
To strengthen the mapping of previous studies, bibliometric analysis was conducted using RStudio and VOSviewer software. The aim was to examine the development of research related to inflation, interest rates, and exchange rates through the relationships among keywords extracted from various scientific publications.

Figure 1. Biblioshiny Output Processed Using RStudio



Based on the bibliometric analysis results, a total of 117 documents originating from 88 different publications were identified, with an annual growth rate of 4.75%. These studies involved 274 authors, with an average of 2.41 authors per document, and an international collaboration rate of 19.66%, indicating that issues related to macroeconomic stability and exchange rate movements continue to attract the attention of the global scientific community. The average number of citations per document, amounting to 4.846, further confirms that this topic remains relevant and continues to develop within the macroeconomic literature.

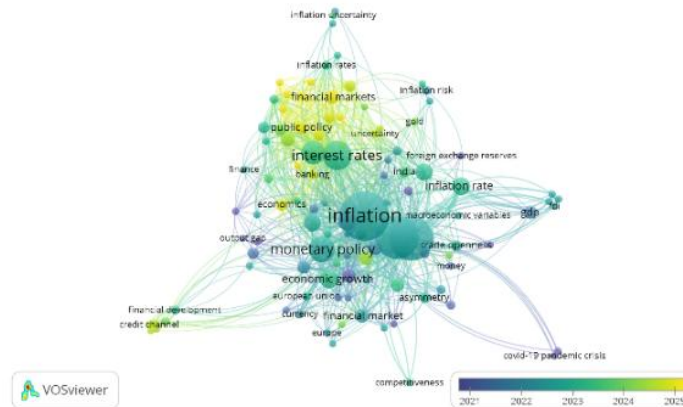
Figure 2. Network Visualization Generated Using VOSviewer



The network visualization presented in Figure 2 shows that the most dominant theme is inflation, which has strong linkages with exchange rates, monetary policy, money markets, and trade openness. Furthermore, the relationships among variables also indicate that exchange rate stability is closely associated with financial market conditions and trade openness. Nevertheless, the visualization also illustrates that studies examining the response of exchange

rates to inflation shocks and interest rate shocks using a structural approach remain relatively limited.

Figure 3. Overlay Visualization Generated Using VOSviewer



The Overlay Visualization presented in Figure 3 shows that recent research developments have been concentrated on issues related to interest rates, public policy, financial markets, and monetary transmission mechanisms. This is indicated by the dominance of lighter colors associated with the keywords interest rates and credit channels during the 2024–2025 period, suggesting a shift in research focus toward effective monetary policy amid global economic uncertainty.

Given the research developments discussed above, studies examining the relationship among inflation, interest rates, and exchange rates remain relevant and present research gaps that need to be addressed. Therefore, the research questions of this study are: (1) how does the rupiah exchange rate respond to inflation shocks in Indonesia, and (2) how does the rupiah exchange rate respond to interest rate shocks during the 2016–2025 period? The findings of this study are expected to provide a deeper understanding of Indonesia's macroeconomic dynamics, particularly during the periods before and after the COVID-19 pandemic, and to serve as a reference for future research.

2. LITERATURE REVIEW

Previous Studies

Many previous studies have examined the relationship among inflation, interest rates, and exchange rates using various approaches. The following is a summary of previous studies along with a comparison between those studies and the present study.

Researcher(s), Year	Method	Variables	Research Findings	Limitations	Relevance to the Present Study
Aji et al. (2021)	VAR.	Inflation, interest rates,	The Granger causality results show that inflation affects interest rates, while	The study employed a relatively short sample	This study extends the analysis by using a longer observation period (2016–2025)

		and exchange rates	exchange rates affect inflation. However, no causal relationship was found between interest rates and exchange rates. The IRF results indicate that the responses of interest rates and inflation to shocks were generally volatile, while the FEVD results show that each variable was primarily explained by its own shocks.	period (January 2013–December 2018). The authors also recommended extending the research period to capture possible long-run relationships.	and applying the Structural Vector Autoregression (SVAR) approach to identify structural shocks and analyze the dynamic responses of exchange rates to inflation and interest rate shocks more comprehensively.
Alawiyah, Haryadi & Amzar (2019)	VAR	Policy Interest Rate, Inflation, Money Supply, Exchange Rate	Policy interest rates and money supply positively affect the exchange rate, while inflation has a negative effect on the exchange rate.	The study employed the reduced-form VAR approach, which cannot identify structural shocks.	This study extends the previous research by employing the SVAR approach to identify structural shocks and analyze the dynamic responses of exchange rates to inflation and interest rate shocks.
Ibrahim & Kornitasari, (2023)	Error Correction Model (ECM)	Inflation, interest rates, and exchange rates	Inflation had a negative and significant effect on the exchange rate in the long run, while interest rates were not significant.	The observation period was limited to 2016–2020 and did not cover the post-pandemic period. In addition, The Error Correction Model (ECM) is not specifically designed to analyze the dynamic responses of variables to shocks over time.	This study reinforces the focus on inflation, extends the observation period to 2025, and employs the SVAR approach.

Previous studies have explained the relationship among inflation, interest rates, and exchange rates from various methodological perspectives. However, differences in research findings and limitations in terms of variables and observation periods still exist. Therefore, this

study employs the SVAR method over the 2016–2025 period to examine the response of the Indonesian rupiah exchange rate to inflation and interest rate shocks in Indonesia.

Relationship Between Inflation and Exchange Rates

Inflation is a condition characterized by a sustained increase in the general price level of goods and services within an economy. Changes in the prices of particular groups of goods merely reflect relative price movements and therefore cannot be used to measure the overall inflation rate (Greenwood & Hanke, 2021). In Indonesia, inflation is measured using the Consumer Price Index (CPI), which is compiled by Statistics Indonesia (BPS) based on changes in the prices of a basket of representative goods and services.

Inflation can arise from various factors. One of its causes is excess demand (demand-pull inflation), which drives prices upward, as well as increases in production costs (cost-push inflation), which also lead to higher prices of goods and services (Okon et al., 2023).

In addition to affecting domestic prices, inflation may also influence exchange rate movements, particularly in an open economy. One of the theories that explains this relationship is Purchasing Power Parity (PPP), introduced by Gustaf Cassel. This theory states that differences in inflation rates across countries will affect exchange rate movements, causing purchasing power among countries to tend toward equilibrium (Oktafiani, 2023).

The PPP concept is based on the law of one price, which states that identical goods should have relatively equal prices when valued in the same currency. If price differences occur across countries, market mechanisms will encourage adjustments through changes in prices and exchange rates until equilibrium is restored.

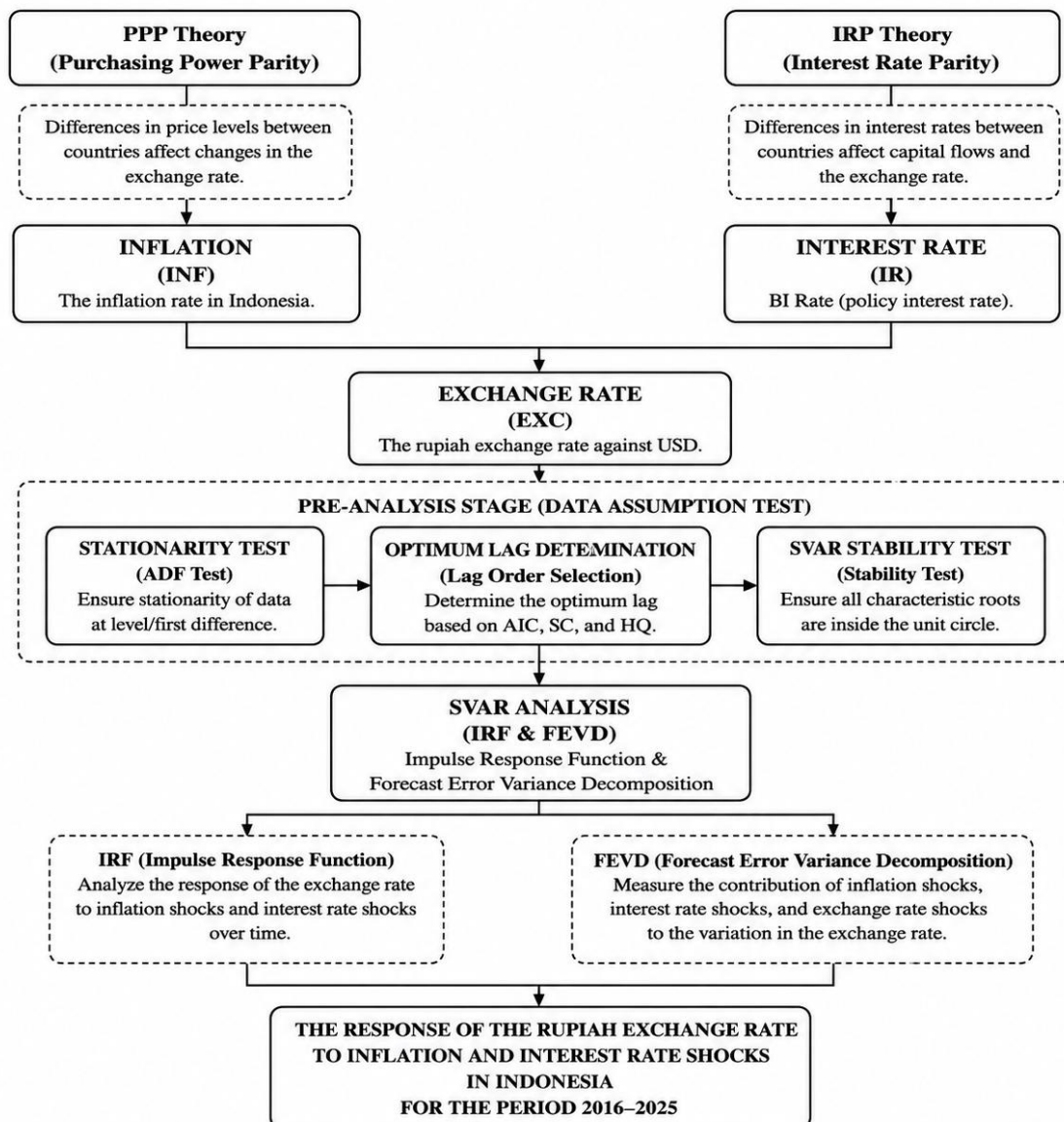
PPP is divided into two forms, absolute PPP and relative PPP. Absolute PPP explains that the general price levels of two countries will be equal after being converted using the prevailing exchange rate. Meanwhile, relative PPP emphasizes that changes in exchange rates over time are influenced by inflation differentials between countries (Monadjemi & Lodewijks, 2021). Therefore, a country with a higher inflation rate tends to experience currency depreciation compared to a country with a lower inflation rate.

Relationship Between Interest Rates and Exchange Rates

Interest rates represent the cost charged for the use of funds over a certain period and are generally expressed as a percentage. Changes in interest rates influence people's decisions regarding saving, consumption, and investment (Alafif, 2023). In Indonesia, interest rate policy is determined by Bank Indonesia through the BI Rates, which serves as the primary monetary policy instrument for maintaining inflation stability and macroeconomic conditions.

The relationship between interest rates and exchange rates can be explained through the Interest Rate Parity (IRP) theory. Differences in interest rates across countries may influence investment in foreign financial assets. These changes affect the demand and supply of currencies, which in turn contribute to exchange rate movements (Adhawiyah et al., 2018).

Conceptual Framework



3. METHODS

A quantitative approach is a research method based on numerical data that are analyzed using statistical techniques to examine the relationships among variables in a study (Aida et al., 2025). This study employs a quantitative approach using the Structural Vector Autoregressive (SVAR) method to analyze the response of the exchange rate to inflation and interest rate shocks in Indonesia.

The data used in this study are time-series data, which are arranged according to a specific chronological order to identify patterns and characteristics of variables over time. The data consist of monthly secondary data covering the period 2016–2025 and were obtained from Bank Indonesia (BI), the Federal Reserve Economic Data (FRED), and Statistics Indonesia (BPS).

The variables analyzed include interest rates, inflation, and the Indonesian rupiah exchange rate against the United States dollar. The interest rate variable is represented by the BI Rate, which serves as Bank Indonesia's monetary policy instrument. The research sample consists of monthly observations during the study period and was selected based on data availability and suitability for the research objectives. Data were collected using the documentation method through downloading data from the official publications and databases of the respective institutions. The operational definitions of the variables used in this study are presented as follows:

Table 1. Operational Definition of Variables

Variable	Symbol	Indicator	Unit	Source
Inflation	INF	Inflation Rate	Percent (%)	BI
Interest Rate	IR	BI Rate	Percent (%)	BPS
Exchange Rate	EXC	Rupiah Exchange Rate against USD	Rupiah	FRED

Structural Vector Autoregression (SVAR) is an extension of the reduced-form Vector Autoregression (VAR) model that employs identification restrictions to recover structural shocks (Braun & Brüggemann, 2020). This model enables researchers to observe the response of a variable to specific economic shocks using the Impulse Response Function (IRF). In addition, SVAR can capture the dynamic relationships among variables within an economic system, thereby providing an overview of the impact of shocks in one variable on other variables over a certain period (Meneses Crispín et al., 2023). Therefore, this study employs the SVAR approach to analyze the response of the exchange rate to inflation and interest rate shocks in Indonesia.

Data analysis was conducted using STATA software to process time-series data and estimate the SVAR model. The analysis began with a stationarity test to determine whether the data exhibited a stable pattern over time. This test was performed prior to model specification because the results of the stationarity test affect the appropriateness of the analytical model used in time-series research (Bawdekar & Prusty, 2022). The stationarity test was conducted using the Augmented Dickey–Fuller (ADF) test to identify whether the data contained a unit root. After the data were confirmed to be stationary, the optimal lag length was determined, followed by a VAR stability test to ensure that the model was stable and suitable for further analysis. Subsequently, the SVAR model was estimated, and Impulse Response Function (IRF) analysis was performed to examine the response of the exchange rate to inflation and interest rate shocks over subsequent periods. The SVAR model employed in this study can be expressed as:

$$\begin{bmatrix} 1 & 0 & 0 \\ b_{21} & 1 & 0 \\ b_{31} & b_{32} & 1 \end{bmatrix} \begin{bmatrix} INF_t \\ IR_t \\ EXC_t \end{bmatrix} = A_1 \begin{bmatrix} INF_{t-1} \\ IR_{t-1} \\ EXC_{t-1} \end{bmatrix} + A_2 \begin{bmatrix} INF_{t-2} \\ IR_{t-2} \\ EXC_{t-2} \end{bmatrix} + \dots + A_p \begin{bmatrix} INF_{t-p} \\ IR_{t-p} \\ EXC_{t-p} \end{bmatrix} + \varepsilon_t$$

Where:

INF_t	: Inflation rate in period t
IR_t	: Bank Indonesia policy interest rate (BI Rate) in period t
EXC_t	: Rupiah exchange rate against the U.S. dollar in period t
$A_1 \dots A_p$	: Coefficient matrices of lagged variables
b_{ij}	: Structural parameters
p	: Optimal lag length
ε_t	: Error term
t	: Observation period

The identification of the SVAR model in this study employs short-run restrictions based on the monetary policy mechanism of Bank Indonesia. Inflation is placed as the most exogenous variable because it reflects price conditions that constitute the primary target of monetary policy. When inflation increases, Bank Indonesia may respond by adjusting the policy interest rate to maintain price stability.

Interest rates are placed after inflation because changes in interest rates serve as one of the instruments used by Bank Indonesia to control inflation. Exchange rates are subsequently placed as the final variable because their movements may be influenced by changes in both inflation and interest rates within the same period. For example, an increase in interest rates may affect capital flows and demand for the rupiah, thereby influencing the exchange rate.

Based on these considerations, the SVAR identification structure is arranged in the order of inflation, interest rates, and exchange rates. This structure is used to represent the short-run relationships among the variables in accordance with the monetary policy transmission mechanism in Indonesia.

4. RESULTS AND DISCUSSION

Data Stationarity Test

The unit root test is the initial stage that must be conducted in time series data analysis because VAR and SVAR models require stationary data to ensure that the relationships among variables are not spurious (spurious regression). The test was conducted using the Augmented Dickey Fuller (ADF) method, which is capable of accommodating autocorrelation in time series data (Bawdekar & Prusty, 2022).

Table 2. Summary of Unit Root Test Results

Variable	ADF Statistic Level	Prob.	ADF Statistic (First Difference)	Prob.	Decision
INF	-1,976	0,2971	-9,768	0,0000	I(1)
IR	-2,261	0,1848	-6,856	0,0000	I(1)
lnEXC	-0,882	0,7938	-8,982	0,0000	I(1)

The summary of the unit root test results shows that the three variables examined were not stationary at the level because the probability values of each variable were greater than 0.05, namely 0.2971 for inflation, 0.1848 for interest rates, and 0.7938 for the exchange rate. As a result, the null hypothesis indicating the presence of a unit root could not be rejected. To address this issue, a first difference test was conducted, and the results showed that all variables became stationary at the first difference level (I(1)), as indicated by probability values lower than 0.05. Therefore, the inflation, interest rate, and exchange rate variables satisfied the stationarity requirement at the first difference level and could be used in VAR and SVAR estimation.

Optimal Lag Selection

The number of lags used in the model must be determined beforehand because it affects the estimation results. Too few lags may cause important information in the data to be inadequately captured, whereas too many lags may reduce the efficiency of the model. Therefore, lag selection was performed by comparing several criteria, namely the Likelihood Ratio (LR), Final Prediction Error (FPE), Akaike Information Criterion (AIC), and Hannan Quinn Information Criterion (HQIC). The test results are presented in Table 3.

Table 3. Optimal Lag Selection Results

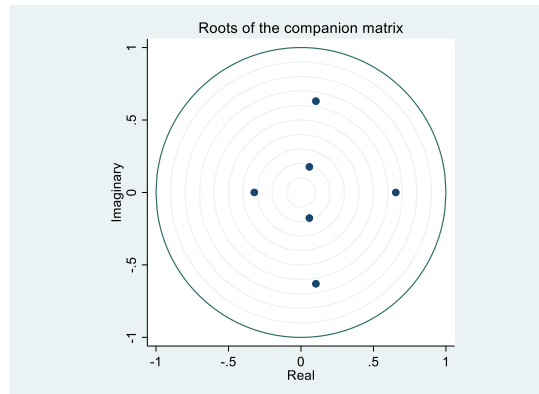
Lag	LR	FPE	AIC	HQIC
0	-	1.8e-06	-4.7217	-4.6926
1	37.913	1.5e-06	-4.8949	-4.7786
2	31.259*	1.3e-06*	-5.0102*	-4.8067*
3	16.575	1.4e-06	-4.9978	-4.7071
4	7.7135	1.5e-06	-4.9083	-4.5305

Table 3 indicates that lag 2 is the optimal lag, as denoted by the asterisk (*) across all selection criteria. Therefore, lag 2 was selected for the VAR and SVAR estimations.

VAR Model Stability Test

After determining the optimal lag, the next step is to test the stability of the VAR model. The stability test is necessary to ensure that the estimated model does not produce responses that deviate from equilibrium, thereby allowing the results of the SVAR, IRF, and FEVD analyses to be interpreted validly.

Figure 4. Position of the Characteristic Roots of the VAR Model



The figure shows that all characteristic roots are located within the unit circle, with none lying outside or exactly on the boundary of the circle. Therefore, the model satisfies the stability condition and does not generate responses that deviate from equilibrium in the long run.

SVAR Estimation

The model has satisfied the stationarity requirement, uses the optimal lag length, and is stable. On this basis, the analysis can proceed to the Structural Vector Autoregression (SVAR) estimation stage to identify the structural relationships among the variables under study.

Table 4. SVAR Estimation Results

Parameter	Coefficient	P-value
A21	-0,0531	0,209
A31	-0,0069	0,088
A32	-0,0056	0,526
b11	0,3654	0,000
b22	0,1670	0,000
b33	0,0160	0,000

The results indicate that parameters A21, A31, and A32 have probability values greater than 0.05, indicating that the contemporaneous structural relationships represented by these

parameters are not statistically significant. Therefore, the estimated contemporaneous effects among the variables are not statistically significant.

In contrast, parameters b_{11} , b_{22} , and b_{33} are statistically significant at the 1% significance level. These findings indicate that each variable is influenced by structural shocks originating within the model.

Impulse Response Function (IRF) Analysis

After the SVAR model was estimated, IRF analysis was conducted to examine how the exchange rate responds to shocks occurring in the variables included in the model. Through this analysis, the pattern of exchange rate movements from one period to another following inflation shocks, interest rate shocks, and shocks to the exchange rate itself can be identified.

Figure 5. Exchange Rate Response to Inflation Shocks

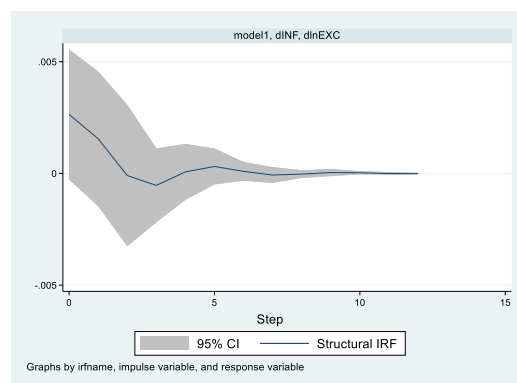


Figure 5 shows that when an inflation shock occurs in the initial period, the exchange rate responds positively and then gradually moves in a negative direction, approaching zero over time. These results indicate that the effect of inflation shocks on the exchange rate is only temporary.

Figure 6. Exchange Rate Response to Interest Rate Shocks

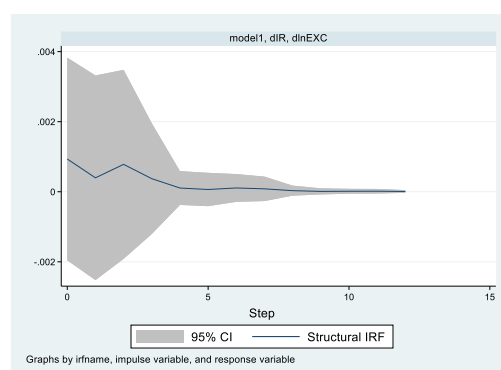


Figure 6 illustrates that the exchange rate initially exhibits a positive response following an interest rate shock. However, the response gradually declines and approaches the equilibrium level in subsequent periods. These results indicate that interest rate shocks tend to affect the exchange rate only in the short run.

Figure 7. Exchange Rate Response to Exchange Rate Shocks

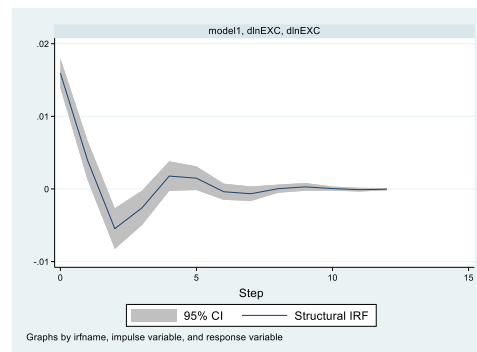
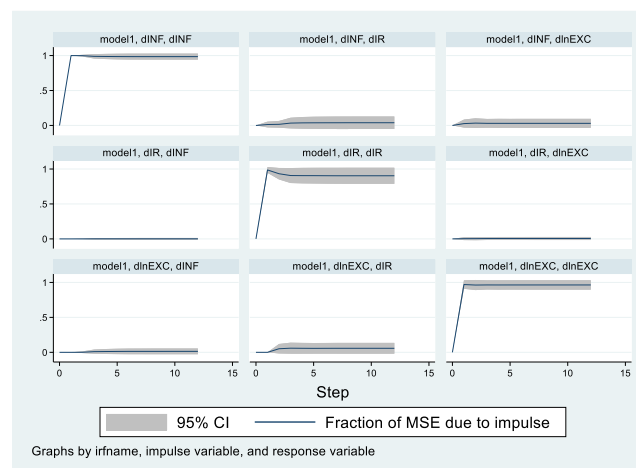


Figure 7 shows that the exchange rate experiences a sharp decline in the initial period before gradually returning toward equilibrium. Furthermore, the exchange rate appears to respond more strongly to shocks originating from the exchange rate itself than to inflation shocks or interest rate shocks.

Forecast Error Variance Decomposition (FEVD)

Forecast Error Variance Decomposition (FEVD) is used to determine the extent to which each shock contributes to explaining exchange rate fluctuations during the observation period. While the IRF illustrates the direction of a variable's response to a particular shock, FEVD indicates the magnitude of each shock's contribution to the changes observed in the exchange rate.

Figure 8. FEVD Result



Based on the FEVD results, exchange rate fluctuations during the observation period are largely explained by shocks originating from the exchange rate itself. On the other hand, the contributions of inflation and interest rates in explaining exchange rate movements are relatively smaller, although both variables continue to play a role in several periods following the occurrence of shocks.

The dominant role of exchange rate shocks suggests that exchange rate movements are primarily driven by the dynamics of the exchange rate itself. Under a freely floating exchange

rate system, rupiah movements are influenced by various conditions in the financial and foreign exchange markets. These results reinforce the IRF findings, which indicate that the effects of inflation and interest rates on the exchange rate are relatively limited in the short run. Therefore, efforts to stabilize the exchange rate through monetary policy instruments may require time before their effects become more pronounced. These findings are consistent with (Alawiyah et al., 2019), who reported that exchange rate fluctuations were primarily explained by exchange rate shocks, while policy interest rates and inflation made relatively smaller contributions to exchange rate fluctuations.

5. CONCLUSION AND LIMITATION

This study examined the response of the Indonesian rupiah exchange rate to inflation and interest rate shocks during the 2016–2025 period using the Structural Vector Autoregression (SVAR) approach. The findings indicate that both inflation and interest rate shocks generated immediate responses in the rupiah exchange rate. However, these effects gradually diminished over time, indicating that the impacts of inflation and interest rate shocks on the exchange rate were temporary. Furthermore, the Forecast Error Variance Decomposition (FEVD) results show that most of the variation in the exchange rate is explained by exchange rate shocks, whereas inflation and interest rate shocks account for relatively smaller proportions. These findings suggest that exchange rate fluctuations during the observation period were primarily explained by shocks originating from the exchange rate itself.

This study has several limitations. The SVAR model includes only inflation, interest rates, and the exchange rate. Other external factors, such as the U.S. Dollar Index, the Federal Reserve's policy interest rate, global commodity prices, and international capital flows, were not incorporated into the model. In addition, although the observation period covers the COVID-19 pandemic, this study does not explicitly account for possible structural changes through structural break tests or dummy variables. Future research is encouraged to incorporate additional external variables and consider structural changes associated with major economic events to provide a more comprehensive understanding of exchange rate dynamics in Indonesia.

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