

The Role of Exchange Rates and Interest Rates in the Growth of Micro, Small, and Medium Enterprises (MSMEs) in West Java

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ABSTRACT

This study investigates how exchange rate and interest rate movements affect MSME growth in West Java amid frequent rupiah volatility and monetary shifts. The objective is to identify transmission channels influencing costs, credit access, and demand, and to inform policy measures that bolster resilience. Using qualitative methods, semi-structured interviews were conducted with the Head of the Inflation Control Subdivision and three provincial economic staff, supported by document analysis. Thematic analysis reveals that rupiah depreciation raises input costs for import-reliant firms and complicates investment decisions, while exporters gain uneven benefits; higher interest rates constrain affordable credit, disproportionately affecting micro and small enterprises. Respondents recommend coordinated macroeconomic management, expanded subsidized microcredit, local supply-chain development, and capacity building. Further quantitative research is advised to measure effect magnitudes and policy effectiveness.

INTRODUCTION

The role of exchange rates and benchmark interest rates in shaping the growth prospects of micro, small, and medium enterprises (MSMEs) is multifaceted and deeply consequential. Fluctuations in the nominal exchange rate influence input costs, export competitiveness, and price stability – factors that collectively determine MSME profitability, investment capacity, and market orientation. Empirical evidence from recent studies indicates that depreciation of a domestic currency can have ambiguous effects: on one hand, a weaker currency may enhance the competitiveness of export-oriented MSMEs by making their goods cheaper abroad; on the other hand, it raises the cost of imported raw materials, intermediate goods, and capital equipment, eroding margins for firms reliant on imported inputs.

For many Indonesian MSMEs, which often operate with thin margins and limited hedging capacity, exchange rate volatility translates directly into operational uncertainty. Research by Pardasia (2024) highlights that exchange rate movements are significantly affected by macro variables such as interest rates and trade flows, and that exchange rate dynamics feed back into broader economic indicators; similarly, Devi and Artini (2019) argue that rupiah depreciation signals macroeconomic weakness and can depress investor confidence, potentially tightening local financing conditions and reducing equity valuations – outcomes that constrain MSME access to capital and slow expansion plans.

Benchmark interest rates – the policy rate set by a central bank – serve as the primary conduit for monetary policy transmission and are central to the cost of finance for MSMEs. Higher policy rates generally translate into more expensive borrowing, dampening entrepreneurial activity, delaying capital expenditures, and raising the threshold for profitable new ventures. Sartika (2019) finds that interest rates, along with exchange rates and GDP, exert a positive influence on firm value in certain manufacturing sub-sectors, indicating that the relationship between rates and firm performance can be sector-dependent and mediated by expectations about growth and inflation.

Conversely, Umam and Isabela (2018) present evidence that interest rates can drive inflationary pressures, which then interact with exchange rate developments to produce complex effects on real incomes and demand conditions for MSME products. When higher interest rates are intended to restrain inflation, the short-run cost of credit may rise even as inflationary expectations moderate; this trade-off can be particularly harmful for MSMEs that lack long-term financing and rely heavily on short-term bank credit or supplier financing.

Inflation itself – closely intertwined with both exchange rates and interest rates – affects MSME operations through input price instability and purchasing power shifts. Several studies emphasize the inflationary implications of currency movements: Ningsih and Kristiyanti (2019) report that exchange rates have a positive and significant partial effect on inflation, underscoring the pass-through from currency depreciation to domestic prices. For MSMEs, unexpected inflation increases transaction costs, complicates financial planning, and discourages long-

term investments. Yanti and Soebagyo (2022) frame inflation as a persistent rise in prices that can be a consequence of prolonged economic shocks; in such environments, MSMEs often face compressed demand, reduced saving rates among households, and a higher risk of business failure. Consequently, macroeconomic stability – anchored by prudent exchange rate management and appropriately calibrated policy rates – becomes a prerequisite for sustained MSME growth.

Beyond direct price and cost channels, exchange rates and interest rates influence MSMEs through financial market sentiment and the availability of formal financial services. As Devi and Artini (2019) note, currency depreciation can erode investor confidence and lead to equity market declines, increasing the reliance of MSMEs on bank loans and informal credit sources. Windusancono (2021) points out that globalization and intensified import-export competition elevate the need for MSMEs to innovate in marketing and sales channels, including digital platforms, to remain competitive. However, such strategic shifts often require upfront investment in technology, training, and supply-chain adjustments – investments that are sensitive to borrowing costs and currency risk. In environments where policy rates are high and the currency is volatile, MSMEs face higher costs for working capital and capital goods, while at the same time confronting uncertainties in revenue when operating in export markets or competing with imported goods.

Policy implications for fostering MSME growth therefore revolve around promoting macro stability, enhancing access to affordable and appropriately designed financial products, and supporting risk-mitigation mechanisms. Practical measures include the development of hedging instruments or pooled procurement arrangements to reduce input cost exposure; targeted credit facilities with concessional pricing for MSME digitalization and export readiness; and monetary policy communication that reduces uncertainty about future interest rate and exchange rate paths.

Evidence from the literature suggests that while monetary tightening may be necessary to control inflation, care must be taken to shield credit-constrained MSMEs from abrupt cost shocks. Likewise, exchange rate policies that prioritize gradual adjustments and market predictability can help MSMEs plan investment and pricing strategies more effectively. In sum, the interplay between exchange rates and benchmark interest rates critically shapes the operating environment for MSMEs; stable, predictable macroeconomic conditions combined with tailored financial and institutional support are essential to translate favorable currency and rate dynamics into inclusive MSME-led growth.

METHODOLOGY

This study employs a qualitative approach to explore and interpret the phenomena under investigation in depth, prioritizing participants' perspectives and contextual understanding. Data collection will be conducted using two complementary methods: semi-structured interviews and document analysis. Semi-structured interviews will be carried out with purposively selected participants who possess relevant experience or knowledge; an interview guide with open-ended questions will ensure consistency while allowing flexibility for emergent themes. I conducted interviews with four respondents: The Head of the Inflation Control Subdivision and three economic staff from the West Java provincial government.

They explained that exchange rate fluctuations affect raw material costs for MSMEs, especially those relying on imported inputs, while interest rate changes influence access to affordable credit and investment decisions. The Head emphasized coordinated policy tools – price monitoring, targeted subsidies, and microcredit programs – to stabilize small business operations. Staff highlighted training, digitalization support, and strengthened local supply chains to mitigate external shocks. All agreed that balanced macroeconomic policies and close government–MSME engagement are crucial for sustaining MSME growth in West Java. Document analysis will involve systematic review of relevant texts, reports, meeting minutes, policy documents, and archival records to triangulate findings and contextualize interview data. Data collection will follow ethical procedures, including informed consent, confidentiality, and secure data storage.

Data processing begins immediately after each interview and document retrieval. Audio-recorded interviews will be transcribed verbatim, and all materials will be organized using a qualitative data management tool or secure file system. Initial data cleaning includes verifying transcriptions against recordings, anonymizing identifiers, and formatting documents for analysis. The researcher will create a data inventory and memos to capture early impressions and reflexive notes.

Data analysis follows an iterative thematic analysis procedure. First, open coding will identify meaningful units and assign provisional codes. Codes will be grouped into categories through constant comparison, and axial coding will explore relationships among categories. Themes will be refined through successive rounds of coding, memoing, and peer debriefing to enhance credibility. Triangulation between interview insights and documentary evidence will be used to corroborate interpretations and identify convergences or discrepancies.

Results will be presented as richly described themes supported by direct quotations and documentary excerpts, highlighting patterns, variations, and illustrative cases. Finally, conclusions will synthesize key findings, relate them to the research questions and theoretical framework, discuss implications, acknowledge limitations, and propose recommendations for practice and future research.

RESEARCH RESULT AND DISCUSSION

The findings from interviews and documentary analysis indicate that exchange rates and interest rates play interconnected roles in shaping the growth prospects of MSMEs in West Java. Respondents – comprising the Head of the Inflation Control Subdivision and three provincial economic staff – consistently noted that depreciation of the rupiah raises input costs for firms that rely on imported raw materials and intermediate goods, squeezing margins and forcing small producers to either raise prices or absorb losses. The Head observed that volatile exchange rates create planning difficulties for MSMEs, reducing their willingness to invest in capital improvements or expand production. One economic staff member added that when firms face higher import costs, they often cut back on inventory and delay purchases of new equipment, slowing productivity gains across the sector. Another staff respondent highlighted that exporters among MSMEs can benefit from weaker rupiah, but argued that such gains are uneven and often offset by imported input costs for value-chain segments that depend on foreign components.

Interviewees linked interest rate movements to credit accessibility and cost. Higher policy and lending rates translate into more expensive borrowing for working capital and investment, limiting MSMEs' ability to scale or adopt productivity-enhancing technologies. The Head emphasized that commercial banks' risk perceptions of small firms amplify the pass-through of policy rate increases to actual lending rates for MSMEs. Staff respondents reported that even modest rate hikes disproportionately affect micro and small enterprises, which have limited collateral and short cash buffers, thereby reducing investment and hiring. Conversely, lower interest rates were described as creating an enabling environment for microcredit programs and formal lending, fostering entrepreneurship and expansion when complemented by targeted outreach and capacity building.

These qualitative observations align with and are illuminated by empirical findings in the literature. Several studies point to significant links between interest rates, exchange rates, and broader economic variables that influence firm behavior. Pardasia (2024) finds that, in the long run, interest rates and exports have a significant negative impact on the exchange rate, while imports and other variables have a significant positive effect; in the short run, only certain variables show positive effects, and inflation lacks a significant immediate impact on exchange rates. Such dynamics help explain respondents' accounts that export-oriented MSMEs may see mixed outcomes from currency moves depending on input structures and time horizons. Research by Devi and Artini (2019) suggests that rupiah depreciation signals economic weakness and can depress investor sentiment, which may indirectly affect MSMEs through reduced access to finance and lower market demand. Sartika (2019) observes that inflation negatively relates to firm value, while interest rates and exchange rates can have positive influences on firm value – an insight that echoes respondents' view that stable macroeconomic conditions and predictable rates support stronger enterprise valuations and investment.

Other studies corroborate the transmission channels described by interviewees. Umam and Isabela (2018) report that interest rates and the RP/USD exchange rate positively and significantly affect inflation in Indonesia, implying that monetary and external shocks can feed into domestic price pressures that constrain real incomes and demand for MSME goods. Ningsih and Kristiyanti (2019) find that exchange rate movements significantly influence inflation, advising cautious monetary policy regarding money supply, interest rates, and exchange rate management to avoid inflationary spillovers. Together, these findings suggest policy implications consistent with respondents' recommendations: coordinated macroeconomic management, targeted microcredit and subsidy programs, strengthened local supply chains, and capacity-building to reduce import dependence can mitigate adverse effects of currency and rate volatility on MSME growth. In sum, both interview evidence and prior studies indicate that stable exchange rates and prudent interest rate policies, combined with micro-level support measures, are critical to sustaining and enhancing MSME development in West Java (Pardasia, 2024; Devi & Artini, 2019; Sartika, 2019; Umam & Isabela, 2018; Ningsih & Kristiyanti, 2019).

CONCLUSIONS AND RECOMMENDATIONS

The study concludes that exchange rate volatility and interest rate movements significantly influence the growth prospects of MSMEs in West Java through cost, credit, and demand channels. Rupiah depreciation raises input and production costs for firms reliant on imported materials, undermining margins and investment incentives, while appreciation benefits exporters unevenly when import dependence exists. Higher interest rates constrain access to affordable credit, disproportionately affecting micro and small enterprises with limited collateral, thereby reducing expansion, innovation, and hiring. Interview evidence from provincial inflation-control and economic staff aligns with empirical literature showing transmission from exchange rates and interest rates to inflation and firm outcomes. Stable macroeconomic conditions, predictable policy signals, and supportive micro-level interventions therefore matter critically for MSME resilience and growth.

Recommendations strengthen coordinated monetary and exchange-rate monitoring with targeted fiscal and microfinance measures to shield vulnerable MSMEs from shocks; expand subsidized microcredit and risk-sharing schemes to lower borrowing costs for micro and small enterprises; promote local input substitution and supply-chain development to reduce import dependence; provide capacity building in financial management, digitalization, and export readiness to help firms capture benefits from favorable currency movements; improve information provision and price-monitoring to reduce uncertainty; and design conditional support that prioritizes productivity-enhancing investments. Further quantitative research is advised to measure effect magnitudes and evaluate policy interventions' effectiveness.

ADVANCED RESEARCH

A follow-up study should quantitatively assess the causal impact of exchange rate and interest rate volatility on MSME performance in West Java using firm-level panel data over multiple years. Employ difference-in-differences and instrumental variable techniques to isolate policy shocks, and compare sectors with varying import dependencies and export orientations. Incorporate microfinance receipt, digital adoption, and supply-chain integration as moderating variables. Collect survey data to measure investment, employment, and productivity changes, and combine with high-frequency macro indicators. The study will evaluate the effectiveness of targeted credit programs and local input-substitution policies to provide actionable policy recommendations.

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