



## **Abstract**

A prolonging current account deficit has been a threat to Indonesia for years. One of Bank Indonesia's attempts to overcome the deficit is through a contractionary monetary policy. In this case, the trade balance deficit plays a significant role in the current account deficit in Indonesia. Therefore, this study investigates the impact of a contractionary monetary shock towards the performance of the trade balance. Utilizing the Structural Vector Error Correction Model (SVECM) that comprises transitory and permanent restrictions, it discovered that the impact of the contractionary monetary policy shock towards the performance of the trade balance is negative due to the assumption of an appreciation on the nominal exchange rate in the short run. In addition, this occurrence is due to the dominance of "the expenditure switching effect". However, in the long run, the quantity of exports and imports would adjust to the lowering price level that causes domestic goods to be more affordable which leads to the rise of trade balance. Other evidence affirms that the contractionary monetary policy results in a price puzzle and liquidity puzzle.

Keywords: trade balance, current account, contractionary monetary shock, income absorption effect, expenditure switching effect, Indonesia, Structural Vector Error Correction Model