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Interest Rate, Net Income, and Share Price: The Mediating Role of Profitability in Indonesia's Industrial Sector

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Abstract. This study examines how interest rates influence share prices in Indonesia's industrial sector by explicitly modeling net income as a mediating variable. While conventional valuation theory assumes a direct impact of interest rates on stock prices, empirical evidence in emerging markets remains inconclusive. Addressing this gap, the study adopts a parsimonious, earnings-cantered framework to clarify the financial transmission mechanism from monetary policy to equity valuation. Using a quantitative explanatory design, the study analyses longitudinal data from industrial companies listed on the Indonesia Stock Exchange over the periods 2012–2019 and 2023–2024, excluding the COVID-19 years to avoid structural distortions. The hypotheses are tested using Structural Equation Modelling with Partial Least Squares (SEM-PLS). The results show that interest rates have a significant negative effect on net income, but no direct effect on share prices. In contrast, net income has a strong and positive effect on share prices and significantly mediates the relationship between interest rates and share prices. From a policy perspective, the study highlights that stable stock prices may mask underlying profitability pressures, underscoring the importance of incorporating firm-level financial indicators into monetary policy assessment and investment decision-making.

1 Introduction

Interest rates represent one of the most influential macroeconomic instruments shaping corporate financial performance and capital market dynamics. As a central tool of monetary policy, interest rates determine the cost of capital, influence firms' financing structures, and affect investment decisions across sectors. Changes in interest rates may alter corporate borrowing costs, modify risk perceptions, and influence investor portfolio allocation. Consequently, fluctuations in interest rates are often expected to influence stock market valuation through both financial and behavioural channels (Ahmed & Mazlan, 2021; Baoquan et al., 2023).

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From the perspective of financial economics, the relationship between interest rates and stock prices has long been discussed within asset valuation theory (Basmar et al., 2019; Jahidah et al., 2024). Higher interest rates increase the discount rate applied to future cash flows, thereby reducing the present value of expected corporate earnings and potentially lowering stock prices. At the same time, rising interest rates may encourage investors to shift their portfolios toward fixed-income securities, which offer relatively stable returns compared with equities. These mechanisms suggest a theoretically negative relationship between interest rates and stock market performance.

However, empirical evidence regarding this relationship remains inconclusive, particularly in emerging markets. Several studies have found that interest rate increases significantly depress stock prices by raising capital costs and reducing expected corporate profitability (Goh et al., 2022; Halim et al., 2022). Other studies, however, report weak or insignificant relationships between interest rates and equity valuation. These inconsistencies suggest that the transmission mechanism linking monetary policy to stock prices may be more complex than a simple direct effect.

One explanation for these mixed findings is that macroeconomic variables may influence stock prices indirectly through firm-level financial performance. Among various indicators of financial performance, net income plays a particularly important role. Net income reflects the cumulative outcome of corporate operations, financing costs, and revenue generation, making it one of the most comprehensive measures of a firm's financial health. Investors frequently interpret earnings performance as a reliable signal of corporate value, growth potential, and future dividend capacity (Choiriyah et al., 2021; Tonkikh et al., 2022).

In this context, interest rate changes may first influence corporate profitability before ultimately affecting stock prices. Higher interest rates increase borrowing costs and interest expenses, which may reduce firms' net income (Suriani et al., 2022). Lower profitability can then lead investors to revise their valuation expectations, eventually influencing share prices. This sequential mechanism implies that net income may serve as an important transmission channel linking monetary policy signals to equity market outcomes.

Indonesia provides a particularly relevant context for examining this mechanism. As one of the largest emerging economies in Southeast Asia, Indonesia has experienced dynamic monetary policy adjustments over the past decade in response to inflation pressures, global capital flows, and macroeconomic stability considerations. Despite these adjustments, movements in policy interest rates have not always been followed by proportional changes in stock prices. This phenomenon suggests that the relationship between monetary policy and equity markets may operate through intermediary corporate financial indicators rather than through direct market responses.

The industrial sector offers a particularly suitable setting for exploring this relationship. Industrial firms are typically capital intensive and rely heavily on external financing to support investments in machinery, infrastructure, and production capacity. Because of this financial structure, changes in interest rates can significantly affect financing costs and corporate profitability. As a result, industrial firms may be especially sensitive to interest rate fluctuations, making them an appropriate empirical context for examining the transmission mechanism between monetary policy and equity valuation.

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Despite the theoretical importance of this mechanism, many previous studies continue to focus primarily on the direct relationship between interest rates and stock prices, often overlooking the mediating role of profitability. As a result, the literature provides limited insight into how macroeconomic policy signals are translated into market valuation through firm-level financial performance. Addressing this gap is essential for developing a more comprehensive understanding of the interaction between monetary policy, corporate performance, and capital market dynamics.

Therefore, this study aims to examine the relationship between interest rates, net income, and share prices in Indonesia's industrial sector, with particular emphasis on the mediating role of net income. By adopting a mediation-based analytical framework, this research seeks to clarify how interest rate changes influence corporate profitability and how these changes subsequently affect stock market valuation.

Using a quantitative explanatory approach and Structural Equation Modeling with Partial Least Squares (SEM-PLS), this study investigates whether interest rates affect share prices directly or indirectly through corporate profitability (Hair et al., 2019; Bougie & Sekaran, 2019). The findings are expected to contribute to the financial transmission literature by providing empirical evidence on the macro–micro linkage between monetary policy and equity market valuation in an emerging market context. Furthermore, the study offers practical insights for policymakers, corporate managers, and investors in understanding how monetary policy decisions may influence financial markets through corporate performance channels.

2 Theoretical Framework

2.1 Interest Rate and Net Income

Interest rates are a key instrument of monetary policy that influence corporate financial performance through the cost of capital. When interest rates increase, firms face higher borrowing costs and greater debt servicing expenses, which can reduce corporate profitability. This mechanism is particularly relevant for capital-intensive industries that rely heavily on external financing for investment and operational expansion.

Higher interest rates may also weaken economic activity by tightening credit conditions and reducing consumption and investment. These macroeconomic adjustments can indirectly reduce corporate revenues and compress profit margins. Consequently, changes in interest rates may significantly influence firms' net income through both financial cost pressures and broader economic conditions.

Previous empirical studies generally support this relationship, indicating that firms with higher leverage tend to experience declining profitability during periods of rising interest rates. Based on these theoretical considerations, the following hypothesis is proposed:
H1: Interest rates have a significant effect on net income.

2.2 Interest Rate and Share Price

Financial valuation theory suggests that interest rates may influence stock prices through discount rate adjustments and investor portfolio decisions. When interest rates rise, the discount rate applied to expected future cash flows increases, reducing the present value of those cash flows and potentially lowering share prices.

Higher interest rates may also encourage investors to shift their portfolios toward fixed-income securities that offer relatively stable returns. This portfolio substitution effect can reduce demand for equities and place downward pressure on stock prices.

However, empirical evidence on this relationship is often inconsistent, particularly in emerging markets. In some cases, investors respond more strongly to firm-level financial performance than to macroeconomic indicators. Nevertheless, the theoretical relationship remains relevant and leads to the following hypothesis:

H2: Interest rates have a significant effect on share prices.

2.3 Net Income and Share Price

Net income is widely regarded as one of the most important indicators of corporate financial performance and firm value. Earnings reflect a firm's operational efficiency, financial health, and ability to generate future cash flows. According to signaling theory, profitability conveys important information about a company's performance and growth prospects, which investors use to evaluate investment opportunities.

Companies that report higher net income are generally perceived as financially stronger and more capable of sustaining future performance. As a result, investors often respond positively to improvements in corporate earnings, leading to increased demand for the firm's shares and higher market valuation.

Empirical studies consistently demonstrate a positive relationship between profitability and stock prices. Therefore, the following hypothesis is proposed:

H3: Net income has a significant effect on share prices.

2.4 Research Model and Hypotheses

Based on the theoretical discussion above, this study proposes a conceptual model linking macroeconomic policy variables and firm-level financial performance to stock market valuation. Interest rates are expected to influence corporate profitability, which subsequently affects share prices. In addition, the model examines the possibility of a direct relationship between interest rates and share prices.

In this framework, interest rates represent the macroeconomic policy variable, net income functions as the mediating variable reflecting corporate financial performance, and share price represents the market valuation determined by investors.

Accordingly, the study formulates the following hypotheses:

H1: Interest rates have a significant effect on net income.
H2: Interest rates have a significant effect on share prices.
H3: Net income has a significant effect on share prices.
H4: Net income mediates the relationship between interest rates and share prices.

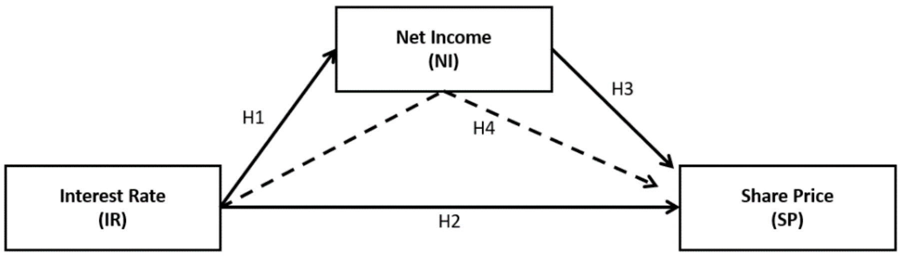

Fig. 1. Research Model (Author, 2026)

3 Results And Discussion

3.1 Results Overview

This section presents and interprets the empirical findings concerning the relationship between interest rates, net income, and share prices in Indonesia's industrial sector. The analysis focuses exclusively on four hypotheses: H1 (interest rate → net income), H2 (interest rate → share price), H3 (net income → share price), and H4 (the mediating role of net income). By adopting a parsimonious mediation framework, the study aims to clarify how monetary policy signals are transmitted into capital market outcomes through firm-level profitability rather than through direct market repricing.

Overall, the results reveal a coherent and theoretically meaningful pattern. Interest rates exert a significant negative effect on net income, confirming the sensitivity of industrial firms' profitability to borrowing costs. However, interest rates do not have a statistically significant direct effect on share prices. In contrast, net income has a strong and positive effect on share prices, underscoring profitability as the primary valuation anchor for investors. Crucially, mediation analysis demonstrates that net income significantly mediates the relationship between interest rates and share prices, indicating that the capital market responds to interest rate changes indirectly—through their impact on earnings—rather than directly to the policy signal itself.

Table 1. Summary of Hypothesis Testing Results (Author, 2026)

Hyp.	Relationship	Original sample (O)	Sample mean (M)	Standard deviation (STDEV)	T statistics (|O/STDEV|)	P-values	Decision
H1	IR -> NI	-0.171	-0.174	0.025	6.749	0.000	Supported
H2	IR -> SP	0.008	0.007	0.027	0.313	0.755	Not Supported
H3	NI -> SP	0.612	0.606	0.154	6.591	0.000	Supported

Hyp.	Relationship	Original sample (O)	Sample mean (M)	Standard deviation (STDEV)	T statistics (|O/STDEV|)	P-values	Decision
H4	IR -> NI -> SP	-0.105	-0.106	0.036	4.823	0.000	Supported

Table 1 presents the summary of hypothesis testing results obtained from the SEM-PLS analysis, including path coefficients, t-statistics, p-values, and decision outcomes for both direct and indirect relationships. Overall, the results indicate a consistent and theoretically meaningful pattern, supporting the proposed mediation-based research model.

The results show that interest rate has a significant negative effect on net income (H1), as indicated by a path coefficient of −0.171 and a t-statistic of 6.749 ($p < 0.001$). This finding confirms that increases in interest rates significantly reduce corporate profitability, reflecting higher financing costs and constrained operational flexibility in capital-intensive industrial firms.

In contrast, the direct effect of interest rate on share price (H2) is not statistically significant, with a very small path coefficient (0.008) and a t-statistic of 0.313 ($p = 0.755$). This result suggests that changes in interest rates do not immediately translate into stock price movements, indicating that investors do not directly reprice equities based solely on monetary policy signals.

Furthermore, net income exhibits a strong and positive effect on share price (H3), with a path coefficient of 0.612 and a t-statistic of 6.591 ($p < 0.001$). This finding underscores net income as the dominant valuation driver, confirming that investors respond more strongly to firm-level profitability than to macroeconomic indicators in isolation.

Most importantly, the indirect effect test demonstrates that net income significantly mediates the relationship between interest rate and share price (H4). The indirect path coefficient (−0.105) is statistically significant ($t = 4.823$, $p < 0.001$), providing robust evidence that the impact of interest rates on share prices operates through corporate profitability rather than through a direct pricing channel. Taken together, the results reported in Table 2 provide empirical support for the study’s central argument: interest rates influence share prices indirectly via net income, reinforcing the role of profitability as the key transmission mechanism linking monetary policy to equity valuation in Indonesia’s industrial sector.

3.2 Interest Rate and Net Income (H1)

The results show that interest rates negatively and significantly affect net income, supporting Hypothesis 1. Higher interest rates increase firms’ financing costs and debt servicing obligations, which reduce corporate profitability. This effect is particularly evident in capital-intensive industrial firms that rely on external financing for investment and operational expansion. Rising interest expenses compress profit margins, while tighter monetary conditions may also reduce economic activity and demand. These combined effects weaken corporate earnings.

This finding is consistent with previous studies showing that interest rate increases often reduce financial performance, especially in firms with higher leverage (Jahidah et al., 2024). It also highlights the importance of managing financing structures and interest rate risk in order to maintain profitability during periods of monetary tightening.

3.3 Interest Rate and Share Price (H2)

Contrary to traditional valuation theory, the results indicate that interest rates do not have a statistically significant direct effect on share prices, leading to the rejection of Hypothesis 2. Although higher interest rates theoretically reduce stock valuation through higher discount rates, the empirical results suggest that investors do not immediately adjust stock prices based on interest rate changes.

One explanation is that interest rate movements are often anticipated and already incorporated into market expectations. Investors may also perceive such changes as temporary or manageable, particularly when firms demonstrate stable financial performance. Additionally, industrial firms often operate with long-term contracts and diversified revenue structures that buffer short-term macroeconomic fluctuations. As a result, investors may rely more on firm-level financial indicators than on macroeconomic policy signals when evaluating stock prices.

3.4 Net Income and Share Price (H3)

The analysis shows that net income has a strong and statistically significant positive effect on share prices, supporting Hypothesis 3. This result confirms the central role of profitability in determining firm valuation (Choiriyah et al., 2021; Tonkikh et al., 2022). Net income represents a comprehensive indicator of corporate performance, reflecting operational efficiency, financial stability, and growth potential. Investors interpret higher earnings as a signal of stronger future cash flows and dividend capacity.

Consistent with prior research, this finding indicates that investors in the Indonesian industrial sector respond more strongly to firm-level financial performance than to macroeconomic variables. Consequently, profitability serves as a primary determinant of stock market valuation.

3.5 The Mediating Role of Net Income (H4)

The most important finding concerns the mediating role of net income in the relationship between interest rates and share prices. The results show that net income significantly mediates this relationship. Although interest rates do not directly affect share prices, they influence corporate profitability, which subsequently affects stock valuation. This mediation effect clarifies that investors respond mainly to the financial consequences of interest rate changes rather than to the policy signal itself (Rocha et al., 2018). This finding strengthens the financial transmission mechanism perspective, which suggests that macroeconomic variables influence asset prices through firm-level financial performance.

3.6 Integrated Interpretation and Theoretical Implications

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Overall, the findings indicate that interest rates influence stock market valuation indirectly through corporate profitability. Net income functions as the key bridge linking monetary policy to investor valuation decisions. This result challenges simplified models that assume a direct relationship between macroeconomic variables and stock prices. Instead, the findings suggest that earnings realization plays a crucial mediating role between policy signals and market responses. The study therefore contributes to the macro–micro linkage literature by demonstrating that monetary policy affects capital markets through firm-level financial performance.

3.7 Policy and Practical Implications

The findings provide important implications for policymakers, corporate managers, and investors. For monetary authorities, stock market stability should not be interpreted as evidence that interest rate changes have no economic impact, as corporate profitability may still be affected. For corporate managers, maintaining profitability during periods of rising interest rates is essential. Strategies such as improving operational efficiency, optimizing capital structures, and managing financing costs can help mitigate the effects of monetary tightening. For investors, the results emphasize the importance of focusing on corporate earnings rather than reacting directly to macroeconomic policy signals. Evaluating firm profitability provides a more reliable basis for investment decisions.

3.8 Comparative Perspective with Previous Studies

Compared with previous research, this study contributes by integrating the relationships between interest rates, corporate profitability, and stock prices within a mediation framework. While many studies examine these variables separately, fewer studies explicitly analyze the indirect transmission mechanism linking monetary policy to stock valuation. By focusing on Indonesia's industrial sector and excluding crisis years, this research provides clearer evidence of the normal financial transmission mechanism. The findings therefore offer a useful reference for future studies examining the interaction between macroeconomic policy and capital markets in emerging economies.

4 Conclusion

This study provides clear evidence that the influence of interest rates on share prices in Indonesia's industrial sector operates indirectly through corporate profitability, rather than through immediate market repricing. The findings demonstrate that interest rates exert a significant negative effect on net income, reflecting higher financing costs and reduced operational flexibility for capital-intensive firms. However, interest rates do not directly affect share prices. In contrast, net income emerges as a strong and positive determinant of share prices, confirming profitability as the primary valuation anchor for investors.

The most critical contribution of this research lies in confirming the mediating role of net income in the interest rate–share price relationship. This mediation effect clarifies why monetary policy changes may weaken corporate financial performance without triggering immediate reactions in equity markets. Share prices respond not to interest rate movements per se, but to the earnings consequences that follow. This insight refines the understanding of financial transmission mechanisms in emerging markets and helps reconcile inconsistent findings in previous studies that focused solely on direct effects.

From a policy perspective, the results suggest that monetary authorities should not rely exclusively on stock market movements to assess the impact of interest rate decisions. Stable or muted equity market responses may mask underlying pressures on corporate profitability that could materialize into broader economic risks over time. Accordingly, policymakers are encouraged to complement market-based indicators with firm-level financial metrics—particularly profitability trends—when evaluating the real-sector consequences of monetary tightening.

For corporate managers, the findings underscore the strategic importance of profitability resilience. Since investors ultimately price earnings rather than policy signals, firms should prioritize interest rate risk management, optimize capital structures, and strengthen operational efficiency to stabilize net income during periods of monetary tightening. Such strategies are likely to preserve investor confidence and mitigate valuation volatility.

For investors, this study reinforces the value of earnings-centered analysis. Interest rate changes should be interpreted as contextual signals whose relevance depends on their impact on corporate profitability. Focusing on net income dynamics allows investors to make more informed, fundamentals-driven decisions and avoid overreacting to macroeconomic noise.

Despite its contributions, this study is limited by its sectoral focus and exclusion of additional macro-financial variables. Future research may extend the analysis across sectors, incorporate alternative profitability measures, and explore dynamic or cross-country models to further enrich understanding of monetary transmission and equity valuation in emerging economies.

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