

Chapter 5

Monetary policy in emerging markets: The case of Indonesia

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This chapter discusses the Indonesian experience with inflation targeting (IT). The author emphasises rapid structural changes in post-crisis Indonesia as an important feature of the country's monetary regime. The need to deal with fiscal dominance and relatively shallow financial markets are additional important challenges for the monetary authorities, especially against a backdrop of exchange-rate volatility and sudden shifts in capital inflows. The author argues that, due to these characteristics of the Indonesian regime, policy co-ordination between the monetary authorities and the government at large needs to be enhanced. This co-ordination is particularly important to minimise the inflationary pressures associated with a large share of administered prices (which are set by the government) in the consumer price index and volatile food prices.

Introduction

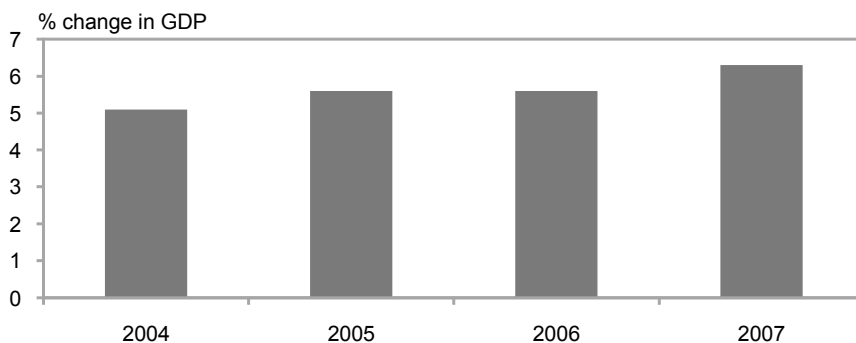
Conducting monetary policy in emerging markets is not only about setting a target for the exchange rate, inflation or another monetary aggregate and then deciding on the appropriate level of the interest rate as a policy response. As recent analysis and experience have shown, institutional factors both within and outside the central bank's control play an important role in the pursuit of monetary-policy objectives. It is evident, therefore, that in a large number of developing and transition economies, fiscal dominance and poor financial infrastructure severely constrain the scope for independent monetary policymaking. For most of these countries, monetary policy instrument independence would require comprehensive public-sector, banking and financial reforms. Even in developing countries with well-functioning financial markets, moderate-to-low inflation and no symptoms of fiscal dominance, the effectiveness of independent monetary policy depends on the exchange-rate regime and the extent of capital mobility (Masson *et al.*, 1998). Moreover, credibility, transparency and communication with the public about policy goals and operational strategies are also important elements of a successful policy strategy.

Recently, inflation targeting (IT) has become a popular monetary policy framework for the pursuit of price stability. IT is based on a clear commitment to a quantitative inflation target as the primary objective of monetary policy, supported by a high degree of transparency and accountability in policy formulation and implementation. Many central banks, including those in emerging-market economies, have explicitly adopted this policy framework. By explicitly setting a numerical target and placing emphasis on inflation forecasts, those central banks are able to justify their actions to the general public. The performance of inflation targeters has so far been impressive. The International Monetary Fund (IMF) has even recommended the adoption of IT and central bank independence to a number of countries in Asia following the financial crisis in late 1990s.

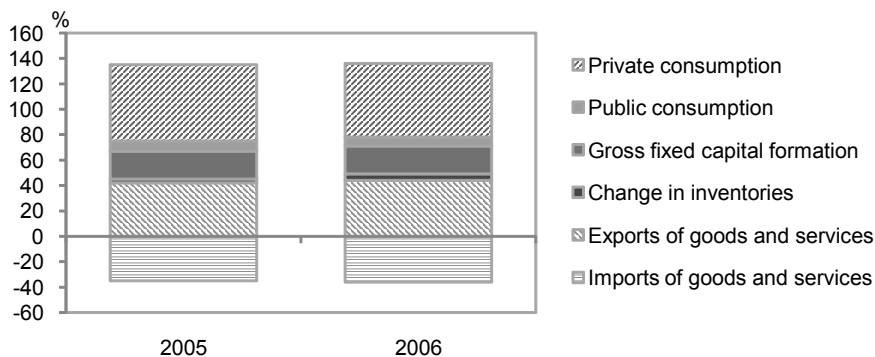
It is clear, however, that the adoption of IT is not a panacea. Post-crisis Indonesia is a good case study (Figure 5.1). While the adoption of this monetary policy framework provides a good tool for pursuing and maintaining macroeconomic stability, creating synergies among other macroeconomic and real-sector policies is also needed to bolster economic stability and to accelerate sustainable growth in countries that are confronted with various external shocks. Agreement among government, central bank and the legislature in determining policy options is crucial. It is also evident that a prompt, bold and consistent policy response must identify the major policy issues, if effective policy responses are expected.

Figure 5.1. Indonesia: Post-crisis performance, 2004-07

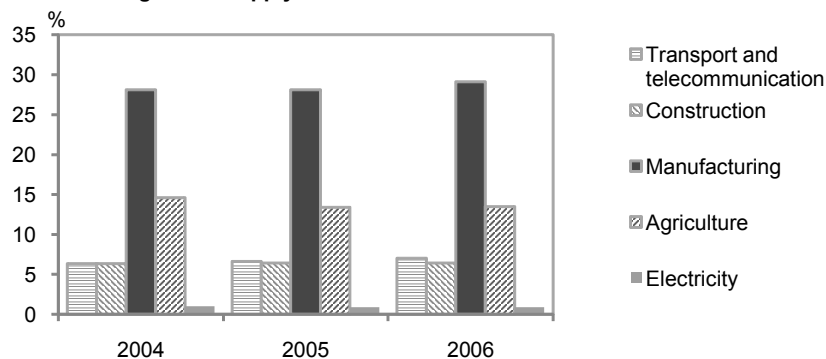
A. Sustainable economic growth



B. Sources of growth: Demand side



C. Sources of growth: Supply side



Source: Bank Indonesia.

This chapter examines the practice and promise of IT in Indonesia. It also considers the challenge of implementing such a framework in an economy that is small and open to capital movements. Of particular concern is the relationship between exchange-rate movements and the recent unpredictability of global capital flows. The chapter also places the monetary policy framework in the context of rapid structural changes in post-crisis Indonesia.

Indonesia's monetary policy framework: A brief history

Indonesia's experience during the recent crisis offers invaluable lessons on the role of the central bank in the economy and its institutional setting. It was this experience, together with recent global trends towards reforming the central bank's role to focus on stabilising prices, that prompted the approval by parliament of the new central bank law in 1999 (Law No. 23/1999). The law states that Bank Indonesia's (BI) objective is to achieve and maintain the stability of the rupiah. The new law provides an important basic framework for monetary policymaking. The central bank was granted full autonomy in setting the inflation target (goal independence) and to use monetary instruments in pursuit of this target (instrument independence). The law also gives BI, as an independent state institution, formal autonomy from government. Other parties are prohibited from being involved in any manner in the implementation of BI's tasks, and BI is obliged to refuse or to disregard any form of involvement by any parties.

According to the new law, BI has to set an inflation target every year. Although it is not explicitly stated in the law, the setting of an inflation target, together with supporting institutional arrangements, places BI's monetary policy regime within an IT framework. By definition, IT is a framework for the conduct of monetary policy characterised by the public announcement of official quantitative targets for the inflation rate over one or more time horizons (Bernanke *et al.*, 1999). With the mandate of the new law, BI started to announce its annual inflation targets at the beginning of 2000. A monthly board meeting has also been conducted to review and set the monetary policy stance and direction. The results of these meetings have been communicated widely to the public through various media, including press releases and conferences, seminars with academics and other stakeholders, as well as through the BI website. For accountability, quarterly reports are submitted to parliament, including assessments of monetary policy, and the state of the banking and payment systems, which are under BI's purview.

The target is set for CPI inflation. For 2000 and 2001, the targets excluded prices that are set by government and those affected by its incomes policies. For example, the targets were 3-5% for 2000 and 4-6% for 2001. In addition, BI

forecasted the impacts of administered prices and incomes policies on inflation, which for 2000 and 2001 were 2% and 2-2.5%, respectively. Therefore, adding these two components, the BI forecasts of total CPI inflation amounted to 5-7% and 6-8.5% for 2000 and 2001, respectively (Table 5.1). For 2002, in light of difficulties in its communication strategy with the public, the target was set for total CPI inflation at 9-10%, while the central bank used core inflation as a basis for formulating monetary policy. In addition to the annual target, starting in 2002 the central bank also announced its commitment to bring CPI inflation down to 6-7% within five years as a medium-term inflation objective.

Table 5.1. **Indonesia: Macroeconomic indicators, 2000-04**

	CPI target (%)	Economic growth assumption (%)	Base money growth target (%)	Rupiah exchange rate per USD (average)	Actual base money growth (%)	Actual CPI inflation (%)
2000	5.0-7.0	3.0-4.0	8.30	8.238	23.40	9.53
2001	6.0-8.5	5	11.0-12.0	10.255	18.30	12.53
3002	9.0-10.0	3.5-4.0	14.0-15.0	9.353	0.30	10.03
2003	8.0-10.0	3.5-4.0	13	8.593	10.30	5.06
2004	4.5-6.5	4.0-5.0	13.0-14.5	8.940	15.14	6.40

Source: Bank Indonesia.

It should be emphasised, however, that the policy framework adopted in the early 2000s was not formal, fully-fledged IT. Rather, it was simply a monetary policy framework with an explicit target for inflation. During the stabilisation period under the IMF-supported programme, BI adopted base money as the operational target, as well as an anchor to achieve the ultimate inflation target. Furthermore, at the same time BI also monitored various aggregates, as well as the interest rates.

Triggered by strong public sentiment with respect to the independence of the central bank, the law was amended at the beginning of 2004 (Law No. 3/2004). Accordingly, the central bank is no longer allowed to set the inflation target. The previous goal and instrument independence has therefore been reduced to only instrument independence. Although the government is now responsible for setting the inflation target, this development is not a setback. It can be argued on the basis of democratic accountability that the government is better equipped to represent the public (through the electoral process) than the central bank, so that the government has a clear mandate to set the target for the benefit of the people. In addition to this argument, goal dependence is relevant for the case of Indonesia, where the inflation outcomes

depend heavily on the supply side of the economy, which cannot be controlled only by monetary policy (see below). By setting the target, the government is expected to make its contribution through supply-side policies.

With the amendment to the BI Law in early 2004 and following BI's recommendation, the government set annual and medium-term targets for CPI inflation at 6% ($\pm 1\%$) in 2005, 5.5% ($\pm 1\%$) in 2006 and 5% ($\pm 1\%$) in 2007. These targets were set in the context of gradual disinflation with the objective of achieving 3% over the long term, an inflation rate that is consistent with those prevailing in other emerging-market economies. A severe oil-price shock in 2005 forced the government to cut back the existing oil subsidy, which resulted in the doubling of domestic oil prices during the year. Attainment of the inflation target was therefore unrealistic in the sense that monetary policy would need to be too tight to bring inflation back to its targeted level. The government then revised the targets to 8 and 6% for 2006 and 2007, respectively, and set it at 5% for 2008.

The amendment of the BI Law did not cover the operational framework for monetary policymaking. Over time, however, BI noticed a number of problems in the use of base money as its operational target. These included difficulties in achieving the targets and the poor signals these targets conveyed to the market about the direction of monetary policy, which could endanger attainment of the ultimate policy objective of price stability. As a result, BI adopted a fully-fledged IT framework in July 2005.

The implementation of fully-fledged IT

Adoption of formal IT in July 2005 was based on the argument that the financial environment was appropriate and that the framework for so-called "inflation targeting light" was facing a considerable credibility problem. The new framework included four new major elements; namely, *i*) the use of an interest rate, the BI Rate, as the policy reference rate, *ii*) the implementation of anticipative (forward-looking) monetary policymaking, *iii*) the development of an enhanced, transparent communication strategy, and *iv*) improved policy co-ordination with government. These elements were aimed at achieving price stability in support of sustainable growth and strengthening social welfare.

IT places inflation as the overriding policy objective and nominal anchor for the conduct of monetary policy. In this regard, BI is to apply a forward-looking strategy by directing its current monetary policy towards

achieving the medium-term inflation target. Within this new policy framework, the interest rate is used as the signal of BI's stance on monetary policy and the target for monetary operations, instead of base money. There are four reasons underlying the change in the policy framework. *First*, the relationship between base money and inflation or economic growth is becoming increasingly unstable, and even subject to reverse causality due to instability in the demand for money, as well as uncertainty on the magnitude of the money multiplier and velocity parameters. *Second*, the signalling of monetary policy to the public has been hindered not only because of the public's difficulty to understand the concept of base money in general, but also due to perceptions that BI uses two nominal anchors (*i.e.* base money and inflation). *Third*, the monetary policy response tends to be backward-looking and more difficult to implement, considering a time lag between changes in the instrument and inflation. Finally, the operational target for base money is more difficult to achieve due to the dominant role and unpredictable behaviour of money demand in Indonesia. Base money comprises 61% of money supply, of which 85% is held by the public, while the excess reserve that is controllable using the monetary instrument is only 8% of base money.

Taking into account these shortcomings, the use of base money as a policy instrument would most likely increase interest-rate volatility. It can be excessively high in the event of a monetary contraction and too low during an expansion. In the case of a contraction, the policy rate might need to be increased significantly in order to absorb excess liquidity in the banking system. This could have an adverse effect on the banking system and the real economy through the interest rate and bank balance-sheet channels of monetary transmission. Furthermore, increased interest-rate volatility would imply an excessively high or low real interest rate. The latter may exacerbate the risk of currency substitution, therefore eventually increasing inflationary pressures. The volatility of the interest-rate differential with respect to global rates could also increase. A very low interest-rate differential would discourage short-term capital inflows and exert pressure on the exchange rate and thus on inflation. On the other hand, the role of the interest rate in post-crisis Indonesia is empirically more important than that of base money growth in influencing the exchange rate and inflation. It also provides a clearer signal of the monetary policy stance than base money growth.

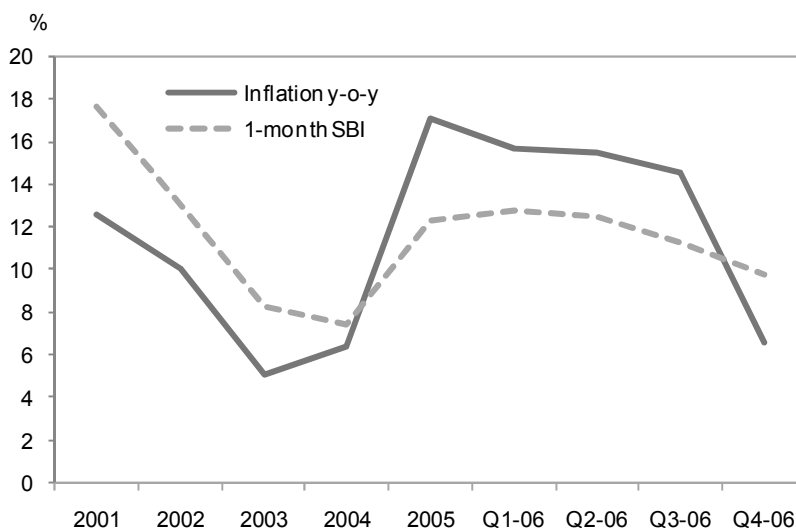
Within the new framework, which was adopted in July 2005, the BI Rate is used as the monetary policy instrument and operational target. The BI Rate is a policy interest rate with tenor of one month, which is periodically announced by the central bank for a certain period and designed to signal its monetary policy moves to the public and market participants. The BI Rate is the rate of return on

the Bank Indonesia Certificate (SBI), which is the main instrument for liquidity management in open-market operations. The operational framework for achieving the desired level of the BI Rate includes weekly open-market operations (OMO). To enhance the effectiveness of liquidity management, daily Fine-Tuning Operations (FTO) are carried out using the one-month SBI and government bonds as instruments.

The setting of the BI Rate through open-market operations is due to a number of reasons. *First*, the one-month SBI has long been used as a benchmark security by banks and market participants. *Second*, the use of the one-month SBI as an operational target reinforces the signalling of monetary policy responses. *Third*, with a significant strengthening of the banking and financial sectors, the role of SBI in transmitting monetary policy moves to the financial sector and the economy has been strengthened. However, the use of the one-month SBI rate as the policy interest rate is a temporary measure. BI is now in the process of replacing this rate by the overnight interbank money market rate as its policy instrument.

Monetary policy is conducted through gradual changes in the BI Rate, so that monetary policy signals remain clear to the public. The incremental change of the BI rate is 25 basis points (Figure 5.2). The policy rate is set at monthly board meetings. Decisions are based on analyses, forecasts and policy recommendations discussed at the meetings. A wide range of data, such as model-based projections, leading indicators, surveys, anecdotal information, expert opinions, risk assessment and uncertainties, as well as empirical research, are used in the meetings. Short-term assessments of monetary conditions are carried out at weekly board meetings. Other strategic monetary measures, such as changes in reserve requirements, regulations on foreign-exchange transactions, and changes to the monetary operational framework, are taken in special weekly board meeting.

Figure 5.2. Indonesia: Inflation and interest rates, 2001-06

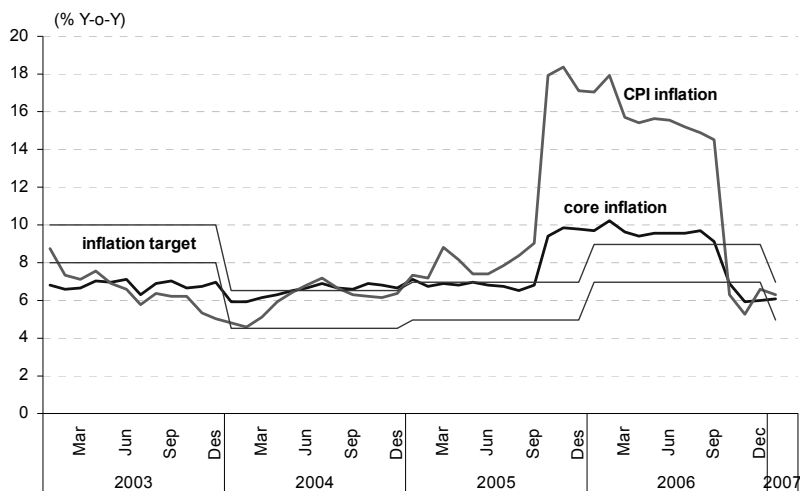


Source: Bank Indonesia.

Monetary policy is communicated periodically through media instruments, such as press and investor conferences, websites and the publication of the Monetary Policy Report (MPR). The objective is to create and form public expectations about economic and inflation forecasts. As for accountability, BI is required to submit annual and quarterly reports on policy implementation to parliament and the executive branch of government. These reports are discussed in parliament as part of the annual evaluation of BI's performance, as well as that of its board. Should parliament require further explanations concerning BI's operations, including an assessment of its performance, the central bank is required to comply.

If the inflation target is missed (Figure 5.3), the government and BI are required to explain openly to parliament and the public the reasons for deviating from the targets no later than February of the following year. These requirements can be interpreted as stemming from the fact that the achievement of inflation targets is the joint responsibility of BI and the government, since the characteristics of inflation are not related to monetary factors alone, but are also affected by government policy in administered and food price development.

Figure 5.3. Indonesia: Inflation: Outturns and targets, 2003-07



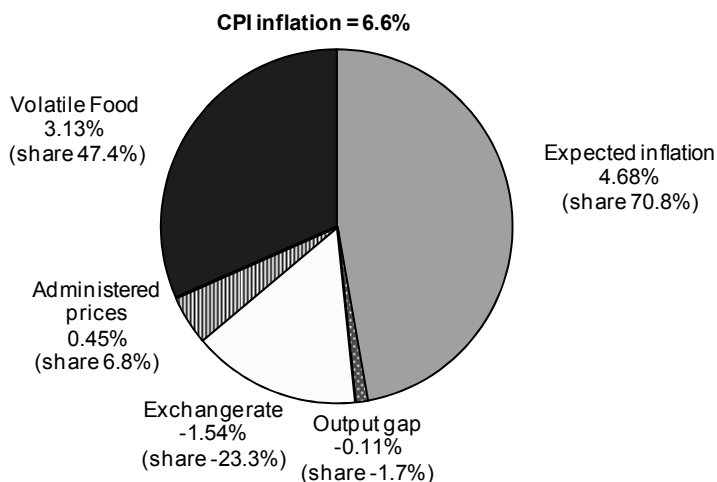
Source: Bank Indonesia.

Limitation of interest-rate responses and co-ordination with government

Indonesia's high, volatile inflation could call for a very high interest-rate response to bring inflation down through the aggregate demand channel of monetary transmission. Such high, volatile inflation might be caused by several factors: *i*) a dominance of adaptive inflation expectations, as indicated from surveys and internal research, *ii*) an ongoing transition process towards the government's target of elimination of price subsidies, and *iii*) price-setting mechanisms characterised by downward price rigidities and upward price flexibility in response to cost hikes. In addition, inflation volatility also reflects some supply-side shocks associated with both production and distribution.

Because of these characteristics of Indonesia's inflationary process, the interest rate alone cannot be effective in bringing inflation to its desired level. The conduct of monetary policy therefore calls for enhanced policy co-ordination with government. Co-ordination is important especially in minimising inflationary pressures arising from administered prices and volatile food items (Figure 5.4). These two factors can easily affect other determinants of inflation, namely expected inflation. Due to a long history of high and volatile inflation, the latter factor plays the most important role in the inflationary process. Consequently, using monetary policy to combat high and stubborn core inflation becomes particularly challenging.

Figure 5.4. Indonesia: Decomposition of inflation, 2006



Source: Bank Indonesia.

For that reason, BI and the government set up an Inflation Control Taskforce, whose members are from various line ministries. The primary objectives of this Taskforce include to propose the inflation target to be set, to evaluate the sources of inflationary pressure and their impact on the achievement of the inflation target, to recommend policy options for achieving the inflation target, and to disseminate information on the inflation target and the policy efforts to achieve it, so that market expectations can be anchored around the inflation target.

The Inflation Management Team (IMT) was established in 2004 to develop a comprehensive and integrated policy roadmap to tackle inflation. This roadmap was set after the Team identified the sources of inflationary pressure and recognised that only a concerted policy effort would be effective in controlling inflation. The roadmap contains detailed policies recommendations for the short and medium-to-long terms. It consists of policy outlines that have already been, or are planned to be, put in place to achieve the inflation target. Furthermore, the roadmap can be used as a monitoring and policy evaluation instrument; more generally, it is essential for creating sound policy synergies to achieve the targets set by the National Medium-Term Development Plan. The policy options contemplated in the roadmap focus on fostering supply and improving distribution in response to inflationary pressures induced by volatile

commodity (food) prices. One such measure is to monitor and safeguard the distribution of strategic commodities, such as rice. Also, the recommendations emphasise restraint in terms of both first- and second-round effects of raising administered prices. Moreover, the roadmap is being used to influence the process of expectations formation, so as to move away from adaptive (as is currently the case) towards forward-looking inflation expectations.

The implementation of the roadmap calls for policy co-ordination between the government and the central bank. This is necessary to gradually limit inflationary pressures without triggering excessive adverse shocks to economic growth and unemployment. The policy package includes monetary policies to administer aggregate demand and stabilise the exchange rate; fiscal policies to foster economic capacity building, to ease demand by maintaining fiscal sustainability, and to co-ordinate policies concerning administered prices; and some sectoral policies to improve production primarily through enhanced productivity, building production capacity, fostering an expansion of supply and ensuring the continued distribution of goods and services.

Conducting monetary policy with an open capital account

It is widely accepted that a substantial degree of integration into the global financial system has benefited economies in many ways. Nonetheless, it has also complicated the task of policymakers in pursuing and maintaining macroeconomic stability. In theory, the policy implication of this reality is complicated by the need to deal with capital flow reversals, while maintaining monetary independence and balancing pressures on the exchange rate – the so-called “impossible trinity”. The challenge for IT seems to be greater in small open economies, such as Indonesia, which are vulnerable to external shocks, most likely transmitted through exchange-rate fluctuations. Policy options to deal with these challenges are limited. It is very unfortunate that the early stage of IT has coincided with mounting uncertainties about global capital flows.

It is obvious that the growing global imbalances add a new dimension to the already complicated issue of managing capital flows. Although some policy measures have been introduced, the risks of a disorderly adjustment are still clouding the global financial outlook. A disruptive adjustment could have substantial detrimental effects on the global economy and financial system, especially for emerging-market economies. With slow progress in resolving global imbalances, uncertainties are likely to remain a challenge for market participants and policymakers, as well as for the conduct of monetary policy.

The recent surge in private inflows has been reflected primarily in portfolio investments, whereas FDI has been relatively more stable. Managing these

short-term capital inflows poses a particular challenge for the monetary authority, since this type of investment is susceptible to swings in international sentiment, changes in interest-rate differentials and expectations about currency movements. Even if there is no substantial development in an economy, swings in capital flows can take place if risk appetite changes. All countries in the region aimed at reducing their external vulnerabilities and protecting themselves from sudden reversal of capital flows. The preferred first line of defence has been a large accumulation of foreign-exchange reserves.

The accumulation of international reserves can be argued to exacerbate global imbalances. But, for a small open economy in Asia, the fear of sudden capital reversals is not irrational. The Asian financial crises provided an important lesson on how sharp reversals in capital flows may take place at an unimaginable speed. These abrupt reversals put exchange rates under pressure, which may result in financial crises, as evidenced by the experience of Indonesia. This fear is rooted not only in the past experience of the Asian crisis, but also in our recent experience. To illustrate, prior to October 2005, when the authorities took some clear and strong policy measures, the fiscal and monetary authorities were perceived as unable to deal with the problem of a mounting fiscal deficit and rising inflation expectations. Capital fled the country and the rupiah depreciated sharply. Only after a bold policy action to significantly reduce the oil subsidy and tighten monetary policy did market sentiment recover.

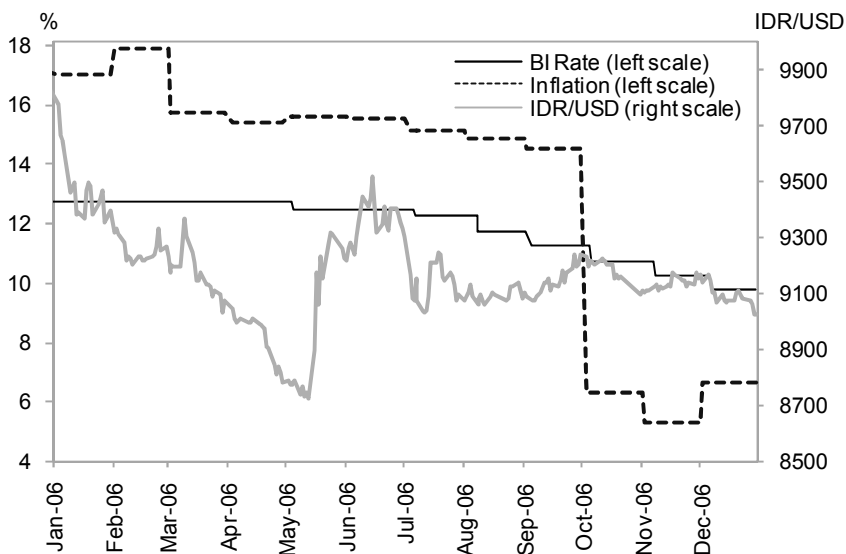
Against a background of ample global liquidity and search for yield, capital inflows have surged since late 2005, clearly indicating a regain of market confidence. Additional policy measures were taken in the first quarter of 2006 to ensure economic stability, especially a fall in inflationary expectations. As confidence was restored, which was reflected in further capital inflows, a strengthening rupiah and falling inflation expectations, BI started to ease monetary policy cautiously in May by lowering its policy rate by 25 basis points, accompanied by some measures to stabilise the exchange rate. The outlook was positive; in particular, the exchange rate reached a two-year high of 8 735 rupiah per US dollar on May 12, making the rupiah the world's best performing currency at the time. Indonesia, however, did not escape the emerging-market sell-off of mid-May and early-June, which was associated with an increase in global financial market volatility owing to a reassessment by fund managers of their risk appetite. After sizeable portfolio inflows and a substantial increase in international reserves, financial-market developments in May and June demonstrated just how easily these flows can be reversed. In Indonesia's shallow market, even relatively modest shifts in capital flows can generate large swings in asset price.

Looking at more fundamental indicators, BI was of the view that global, rather than Indonesia-specific factors, were at play. However, to err on the side of caution, BI reacted by not reducing the policy rate in its June board meeting (a decrease had been widely expected before the turmoil started) and intervening in a very limited scale in the foreign-exchange market to smooth intra-day volatility in the exchange rate. All in all, a more sensitive global financial market is a key challenge facing monetary authorities when setting monetary policy. Swing in capital flows are a major concern. The fear of a disorderly adjustment of global imbalances is obviously a major contributor. Global excess liquidity adds to the financial risk, and swings in oil prices put extra pressure on the stability of capital flows.

As for policy implications, the conventional wisdom is of course to have strong macro-economic fundamentals, a flexible exchange rate and a robust financial system with good supervision. But these are not easy achievements for small emerging-market economies, such as Indonesia. Emerging markets have to remain open so as to allow them to reap the benefits of private capital inflows and international trade. One possibility would be to impose well designed controls to limit destabilising short-term inflows without discouraging long-term flows. But such controls have proved difficult to design and implement in practice. BI would therefore prefer to exercise prudence in maintaining macroeconomic stability. Still in this context, the resilience of our domestic economy should be strengthened and financial markets deepened to fend off excessive speculations arising from disruptive capital flows. To this end, specific and temporary measures designed to maintain exchange-rate stability and to limit speculation are justified so as to allow countries to pursue macroeconomic stability. But, this does not mean that the Indonesian authorities would abandon their commitment to open, market-based policies. On the contrary, stable and non-disruptive capital only flows to countries or regions with a track record of stability.

In an environment of heightened uncertainty about global capital flows, exchange-rate movements during the post-crisis period have been more sensitive to risk premia (Figure 5.5). This explains why the exchange rate is not included explicitly in our policy reaction function. Instead, the central bank reacts to the effects of exchange-rate movements on the output gap and forecasts of core inflation gap forecasts. Increasing the interest rate may have the positive effect of avoiding a depreciation through the exchange-rate pass-through of the aggregate demand channel. However, given the low responsiveness of the exchange rate to interest rate changes, the resulting interest rate hike may even be more harmful to economic growth through the other aggregate demand channels of monetary transmission.

Figure 5.5. Indonesia: Trends in inflation, exchange rate and interest rate, 2006



Source: Bank Indonesia.

Lessons to be learned and policy implications

In addition to the deviation between inflation forecasts and the target, the rapid adjustment of the Indonesian economy should be taken into consideration in formulating monetary policy. At the same time, the dynamism of the global economy could rapidly affect the domestic economy; hence, immediate and consistent policy responses are required. Several examples in recent years showed how fluctuations in financial markets can take place if policies lack credibility. Financial markets are now more sensitive and its “punishment” of bad policies seems more severe than in the past.

In an uncertain environment, it is not easy to design good policy responses to deal with external shocks. Policymakers have to react to these shocks, as well as taking account of domestic concerns about poverty and unemployment, which have often constrained choices over optimal policies. Furthermore, the ability of the Indonesian economy to effectively absorb external shocks is still constrained by somewhat shallow domestic financial markets.

Policy reactions should be swift to mitigate any overreaction by market players. For instance, the sudden capital flow reversals by foreign investors and their effect on domestic players, which substantially weakened the rupiah in

mid-2005, as mentioned above, could have been muted, if clearer policy signals could have been given and if the market had captured those signals. Internally, BI had aimed at a pre-emptive monetary policy response, but the markets had a different view on its timing and magnitude. Therefore, we take the view that any policy has to be communicated more intensively to stakeholders both in financial markets and in the real economy.

The recent shocks in global oil prices and weaker demand are not new to Indonesia. Nonetheless, their impact on the exchange rate, inflation and the current-account balance has been different than in the past. Agents' expectations have played an important role in the effectiveness of policy, as partially reflected in a general anticipation of a prolonged policy decision-making process (inside-lag). Changes in agents' behaviour in response to policies have been most visible through risk perception in the foreign-exchange market. From a monetary policy perspective, anchoring expectations seems to have become easier after implementation of the new monetary framework using the interest rate as BI's operational instrument. This instrument is much easier to understand, and policy responses are swifter in comparison with the previous monetary regime based on base-money targeting.

In terms of monetary policy design and implementation, improvements are to be made in BI's research strategies to achieve price stability, to develop models for economic and inflation projections, and to monitor various economic and financial indicators. Bolstering monetary operations will be achieved through improvements in liquidity projections, development of money and foreign-exchange markets, monetary instruments and strengthened monetary policy signals. The dilemma of Indonesia's monetary policy response associated with high inflation and ongoing recovery under restricted sources of growth enhances the importance of policy credibility. Boosting monetary policy discipline, transparency and communication is expected to help to reduce inflation persistence and the cost of disinflation. Efforts to strengthen the credibility of monetary policy, including through the use of the BI Rate and enhanced policy communication, are expected to contribute to a better role for BI in striking a balance between disinflation and economic recovery, as it will improve the effectiveness of monetary transmission.

Macroeconomic policies would also be more effective if supported by sufficient institutional capacity outside the central bank. At the central government level, recent experience indicates that administrative constraints on the fiscal front have resulted in sluggish government spending due to delays in investment plans and a newly adjusted budget format. Therefore, enhancing the spending capacity of both the central and local governments should become a priority. Moreover, a slow implementation of structural reform has slowed the

accumulation of capital, as reflected in supply-side rigidities. This explains Indonesia's steep Phillips curve, which makes the design of monetary policy more difficult, as supply does not respond to stimuli provided by monetary policy. In addition, microeconomic risk and structural distortions in the economy, which underscore supply-side rigidity, have caused the economy to be more vulnerable to external shocks and inflationary pressures. In accordance with the mandate given by law, BI can only contribute to the economy through its efforts to maintain macroeconomic and financial stability. Still, the achievement of such a mandate will largely depend on co-ordination with other authorities, co-operation with various parties, and the help and support of various stakeholders.

Maintaining prudent fiscal and monetary policies should also be accompanied by financial market reform. The market is currently too thin and fragile to withstand global financial uncertainty. The most notable weakness in Indonesia's microeconomic fundamentals is the vulnerability of the financial sector and the banking industry, in particular. The recent experience taught us the importance of diversifying the sources of capital and financing. One important measure to achieve this objective has been the efforts to develop a domestic bond market to foster financial diversification and stability by mobilising domestic savings to provide new financing sources for investment. In Indonesia, as much as in most of East Asia, the banking sector has been and continuous to be a major source of domestic financing. Capital markets are at an embryonic phase of development. The financial sector is now in better shape, but much still needs to be done. The effort to build a sound and stable financial system is now of strategic importance and will remain a key part of building an efficient market economy. In this respect, strong financial infrastructure supported by sufficient regulation and supervision is the principal requirement for integrating the domestic market into the global financial system.

A closing remark: 2007 and beyond

2007 is the tenth anniversary of the multi-dimensional crisis that devastated all aspects of our nation's life. Ten years is a long period for a nation to recover. Macroeconomic conditions are now expected to remain stable and will become the primary foundation to achieve higher growth, provided that microeconomic risk and distortions in the real sector can be minimised, and the investment climate improves significantly.

Economic growth is projected to reach 6% in 2007 (within a range of 5.7-6.3%), which exceeds growth in 2005 and 2006. With respect to the projections, we have to reiterate that distortions and the unfavourable investment climate are the primary constraints that could retard a balanced

economic recovery in 2007. From our perspective, these constraints could affect the array of measures taken by BI to achieve and preserve macroeconomic stability. The economy would become more vulnerable and less able to mitigate the range of domestic and external shocks. Our monetary policy stance would tend to be particularly cautious, especially in the presence of shocks that may exacerbate risks to price stability.

Bearing in mind the limitations of what a central bank can do, BI sees the benefits of the following policy strategy. From the standpoint of monetary policy, the implementation of IT has been a strategic step that must be taken by BI to maintain market confidence on macroeconomic and overall financial stability. A number of issues related to capital flows, exchange rates and the interest rate within a liberal capital-account regime and a floating exchange-rate environment should be placed in the context of global economic adjustments and the kind of macro-monetary policy responses that would be appropriate to deal with them. In this context, policies that provide incentives for long-term capital flows should be given priority over policies that “punish” short-term capital flows. In addition, to support financial market development and to improve monetary policy effectiveness, BI also sees the need to improve the operational structure of monetary policy in particular and to expand and deepen the domestic financial sector in general.

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List of acronyms

ADF	Augmented Dickey-Fuller Test
AR	Autoregressive Model
BCB	Central Bank of Brazil (<i>Banco Central do Brasil</i>)
BER	Bureau for Economic Research
BI	Bank Indonesia
BIS	Bank for International Settlements
BRSA	Banking Regulatory and Supervisory Agency
CBC	Central Bank of Chile
CBT	Central Bank of Turkey
CDT	Colombian Interest Rate (<i>Certificado de Depósito a Término</i>)
CETES	Mexican Interest Rate (<i>Certificados de la Tesorería de la Federación</i>)
CMN	Brazilian National Monetary Council (<i>Conselho Monetário Nacional</i>)
CNB	Czech National Bank
COPOM	Brazilian Monetary Policy Committee (<i>Comitê de Política Monetária</i>)
CPI	Consumer Price Index
CPIX	Consumer Price Index (excluding mortgage interest costs)
DSGE	Dynamic Stochastic General Equilibrium
EMBI	Emerging Market Bond Index
FAVAR	Factor-Augmented Vector Autoregressive Model
FDI	Foreign Direct Investment
FIML	Full Information Maximum Likelihood
FPAS	Forecasting and Policy Analysis System
FTO	Fine-Tuning Operations
GDP	Gross Domestic Product
GNP	Gross National Product
IGP-DI	Brazilian General Price Index (<i>Índice Geral de Preços - Disponibilidade Interna</i>)

IMACEC	Chilean Monthly Economic Activity Index (<i>Indicador Mensual de Actividad Económica</i>)
IMF	International Monetary Fund
IMT	Inflation Management Team
INPC	Mexican Consumer Price Index (<i>Índice Nacional de Precios al Consumidor</i>)
IPC	Chilean and Colombian Consumer Price Indices (<i>Índice de Precios al Consumidor</i>)
IPCA	Brazilian Consumer Price Index (<i>Índice Nacional de Preços ao Consumidor</i>)
IRF	Impulse Response Functions
IT	Inflation Targeting
M-GARCH	Multivariate Generalised Autoregressive Conditional Heteroskedasticity Model
MPC	Monetary Policy Committee
MPR	Monetary Policy Report
OMO	Open-Market Operations
PP	Phillips-Perron Test
QPM	Quarterly Projection Model
SADC	Southern African Development Community
SARB	South African Reserve Bank
SBI	Bank Indonesia Certificates (<i>Sertifikat Bank Indonesia</i>)
SDIF	Savings Deposit Insurance Fund
SEE	Survey of Economic Expectations
SELIC	Brazilian Policy Interest Rate
SIC	Schwarz Information Criterion
TJLP	Brazilian Long-Term Interest Rate (<i>Taxa de Juros de Longo Prazo</i>)
TPM	Chilean Policy Interest Rate (<i>Tasa de Política Monetaria</i>)
TR	Brazilian Reference Interest Rate (<i>Taxa Referencial de Juros</i>)
UF	Chilean <i>Unidad de Fomento</i>
VAR	Vector Autoregressive Model
VMA	Vector Moving Average

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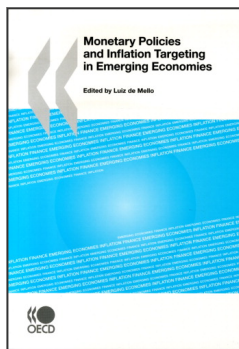
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