Burhanuddin Abdullah: Monetary and exchange rate policy in a global financial integration – Indonesian experience

Paper by Mr Burhanuddin Abdullah, Governor of Bank Indonesia, presented at the South East Asia – Latin America and Caribbean Countries (SEACEN-LAC) Governors Seminar, Kuala Lumpur, 15 September 2006.

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Introduction

First of all, let me thank BNM for hosting the first SEACEN-LAC Governors Seminar with an excellent arrangement. I am both delighted and honored to be here before Fellow Governors from two regions of separate hemisphere, to discuss important issues of common interest. Indeed, the theme of this seminar "Monetary and Exchange Rate Policy and International Financial System" is timely and very relevant for Asian and Latin American economies. We are all aware that over the past two decades, these two regions have undergone daunting challenges in managing monetary and exchange rate, in particular dealing with major external shocks. In spite of our improved resilience in addressing such kind of shocks, thanks to major reforms we have conducted in the aftermath of the late 1990s crises, the downside risks in the global economy could not be dismissed.

In fact, under the globalized and integrated financial market, central bankers all over the world, most notably the emerging markets have been confronted with unprecedented potential challenges arising from surges in short term capital flows. Currently, the low interest rates in the international market and concerns over the sustainability of the US twin deficits have been driving factors in pushing capital to flow to emerging markets. At the same time, the high yields on domestic currency-denominated instruments in emerging markets have been the pull factor. As we are all aware, there are distinct characteristics of capital flows during the pre- and post-crisis periods. Before the crisis, capital inflows were mainly associated with efforts by domestic market actors to avail foreign sources of finance through international bank loans and issuance of various global financial instruments. However, since 2003, foreign capital flows have mainly been driven by the flush global liquidity in search of optimum rates of return. The differences between these types of capital inevitably entail different consequences for emerging markets, and as a corollary in monetary and exchange rate policy, which I will briefly elaborate further.

Policy on open capital account

Dating back to 1970, Indonesia began to seek liberalizing its capital account. Initially, the liberalization started with the removal of compulsory surrender of export proceeds. By 1982, all types of capital controls were dismantled leaving the capital account virtually open. Until the Asian crisis hit in 1997, the existing restriction on capital inflows were only applied to foreign borrowings by banks and companies with government-linked projects and net open foreign exchange position (NOP) on banks as a prudential regulation.

Prior to the crisis, this system had contributed to sustained high economic growth, thereby promoting our long term development program. Foreign capital inflows had also fostered the deepening of domestic financial sector by expanding market liquidity. However, the benefits of capital inflows, in particular in the early 1990s, were undermined by financial market imperfection stemming from lax regulation and supervision and moral hazard due to implicit guarantees. These problems were reflected in the inefficient allocation of capital, unhedged foreign liabilities, and inflated asset prices. As market confidence in the prospect of the economy of the emerging market in Asia faltered, reversal of capital outflows could not be arrested, thereby leading to capital account crisis.

With the hindsight of the Asian crisis, the Central Bank has sought to strengthen the monitoring on the capital movement and minimize speculative transactions. To this end, in 2001 Bank Indonesia issued a regulation on the non-internationalization of the rupiah. Subsequently, when a wave of capital reversal and speculation against the rupiah triggered by rising world oil prices heightened in 2005, we issued a series of micro policies addressing the imbalances in the demand and supply in the forex market. Furthermore, prudential regulation in the banking sector was also strengthened through a tighter ruling on the NOP and particular transactions in forex trading.

Indonesian floating exchange rate regime

Needless to say to Fellow Governors that the choice of an exchange rate system depends to a great extent on the condition of a country at a given time. In the current context of Indonesia, under a free capital mobility and limited amount of international reserves, we believe that our floating exchange rate system adopted on August 14, 1997 is an optimal choice. The system, we believe, provides a built-in discipline in a market whereby all other infrastructures are not sufficiently strong. This float will in part create a break on imprudent overseas borrowing, because in doing so market participants will have to factor in the cost of possible movements of rupiah.

We are fully aware that in the case of domestic financial markets with imperfections, such as the thin forex market and limited availability of hedging instruments, a floating rate system often leads to high volatility with adverse consequences on stability. Therefore, while in practice we adopt a floating rate system, we are of the view that smoothing of exchange rate movements is necessary. In fact, our measures to reduce volatility are not unique. As posited by Calvo and Reinhart, almost all countries adopting *de jure* free floating rate system do not rule out interventions to curb volatility in their exchange rates. Such interventions are conducted both through direct intervention on the forex market and through the use of interest rates.

Monetary policy framework in a floating exchange rate regime

A logical consequence of a flexible exchange rate system is that the exchange rate can no longer serve as a monetary policy anchor. During our stabilization period under the IMF program, Bank Indonesia adopted base money as an anchor. Over the long run, however, we noticed a number of shortcomings in the use of base money as the operating target, such as the difficulties in achieving its target and the poor signal it transmits to the market. Such a poor signal of monetary policy direction and targets obviously fails to meet the need to maintain market expectations on the future exchange rate movement. In view of those factors, Bank Indonesia adopted a fully-fledged inflation targeting framework in July 2005.

The framework at least consists of three primary characteristics. First, monetary policy is directed towards achievement an inflation target explicitly announced to the public for a specified time horizon. In this regard, under the new Central Bank Law the inflation target is set by the Government. Second, monetary policy must be implemented on a forward-looking basis, responding to future developments in inflation. On the operational level, Bank Indonesia uses the BI Rate as policy rate to respond to the future trend in inflation. In formulating monetary policy, the Taylor-type rule is used as a benchmark. Thus in essence, interest rates used as monetary policy instruments are adjusted in such manner so as to respond to deviations in the inflation gap and output gap.

Obviously, rules like these are not to be applied mechanically. A balance between rule and discretion, or constrained discretion, as I see it, is especially necessary when monetary policy must be pursued within an increasingly globalized and complex financial environment. We must always be alert of market developments, whether the money market or markets for goods, and a number of other signals and indicators reflecting domestic and global economic developments. We should also keep in mind that while inflation is the sole objective of a central bank, the public also pursues its own objectives, such as job creation and improvement of incomes. For this reason, the inflation targeting framework retains the fundamental monetary policy paradigm of striking the optimum balance between inflation and output.

Apparently, when a central bank faces a dilemma of choosing between inflation and growth, inflation remains the priority. An example of this can be seen in the problems we faced last year, when world oil prices almost doubled. This disturbing trend became highly problematic for monetary policy because not only did it boost inflationary pressure, but also inhibit economic growth. Many suggested that the central bank did not need to respond to this temporary surge in inflation. However, our view at the time was that despite the temporary nature of the disturbance, the inflationary impact emanating from the higher oil prices through increased price for other goods and services, such as transport and wages, would drive up core inflation. In this situation, the tight policy was necessary to prevent sustained escalation in public inflation expectations.

The third characteristic of the ITF is that monetary policy is implemented on a transparent basis with measured accountability. In my view, with elements like these, inflation targeting is more than a mere framework for monetary policy. Inflation targeting promotes the good governance of a central bank. By announcing the inflation target to the public, the central bank commits itself to its achievement.

Uncertainty over future inflation will ease because public inflation expectations have a point of reference, and thus economic costs arising from uncertainty will also be reduced. Communication to the public on the future monetary policy direction is also vital so that the public can anticipate the central bank monetary policy and to avoid 'surprises' that could trigger volatility in the money market.

To strengthen policy effectiveness in this present age of disclosure, the central bank must also carry out a process of educating the public on what the monetary policy objectives are, the strategy for achieving these objectives, and what lies behind the decisions taken. One example involves the communication of the monetary policy response to soaring oil prices and risks from global imbalances at a time of weak conditions in the real sector and high unemployment. Communications between the central bank and market players are also necessary, especially when financial markets are experiencing turbulence. In financial markets fraught with asymmetric information, the wealth of information held by the central bank is frequently of great benefit in mitigating this issue and thus preventing panic and herding by investors. In this regard, the credibility of the central bank is crucial.

Concluding remarks

Under the environment of financial integration, the task of a central bank in maintaining both monetary and financial system stability has become more challenging. To navigate under this changing environment, in my view a central bank should have at least three critical tools at its discretion. First is the flexible exchange rate system, which provides for autonomy of monetary policy. Second is a monetary policy framework which is consistent, credible, and transparent so as to provide a monetary policy anchor within the flexible exchange rate system. Third is a strong banking system capable of absorbing the various risks created by financial globalization.

The mounting risks and uncertainties emerging within the financial globalization process also underscore the importance of the central bank role in guiding public expectations. Within this context, the credibility of the central bank is crucial. To this end, transparency, accountability, and effective communication must be integral to the entire monetary management process. In short, communication may serve as an additional "instrument" that a central bank should use at its disposal to complement other monetary instruments for monetary policy to operate effectively.

Thank you.