Perry Warjiyo: US monetary policy normalization and EME policy mix – the Indonesian experience

Speech by Mr Perry Warjiyo, Deputy Governor of Bank Indonesia, at the NBER 25th Annual East Asian Seminar on Economics, Tokyo, 20–21 June 2014.

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I. Introduction

Indonesia is weathering relatively well this year the spillovers from the US monetary policy normalization process. In fact, over the past two months portfolio inflows are increasing, equity prices are rebounding, bond yield is decreasing, and exchange rate is appreciating (Graph 1-4). This is evidence that strengthening domestic macroeconomic fundamentals and financial system stability plays crucial role for minimizing the spillovers. The aggressive and bold measures of monetary and macroprudential policy mix since June 2013 have resulted in streams of positive news of benign inflation, faster than expected decline in current account deficit, and better than expected GDP growth to the markets.

This note draws Indonesian experience on the transmission mechanism and policy responses to global monetary factors, with a focus on the recent episode following the Fed announcement of planned tapering in May 2013. In particular, three main issues will be discussed. First, the setting of interest rate supported by exchange rate flexibility and capital flows management in responding to policy trilema arises from global monetary factors. Second, the efficacy of macroprudential measures in reinforcing lending channel of monetary transmission mechanism at the back of volatile capital flows and underdeveloped financial market. And third, the important of financial market deepening in smoothing out the transmission of global monetary factors to domestic monetary and financial system stability.

II. Making possible the policy trilemma

The UMP and its normalization process give rise to policy trilemma of the optimal setting on interest rate response, exchange rate flexibility, and some forms of capital flows management. Interest rate policy needs to be geared toward maintaining price stability, taking into account the impacts of global interest rate and some rooms of exchange rate flexibility as shock absorber. But market over-reaction and structural rigidities may cause unnecessary exchange rate overshooting and volatility that may hamper growth as well as overall monetary and financial system stability. Volatility in the capital flows is also complicating the optimal monetary policy response for achieving domestic economic objectives.

For Indonesian case, we cope with this policy trilemma through a monetary and macroprudential policy mix, consisting of interest rate response complemented by some exchange rate flexibility, capital flow management, and macroprudential measures. Clear communication, policy coordination with the government on inflation, fiscal and structural reforms, as well as central bank cooperation on strengthening regional financial arrangements also play crucial role. The interest rate policy, as in other inflation targeting countries, is the main instrument to anchor inflation expectation and forecast going forward to fall within the targeted range. Exchange rate policy is geared toward maintaining the stability along its fundamental path. Some forms of capital flows management are implemented to dampen its short-term excessive volatility. Macroprudential measures are targeted to manage procyclicality and excessive lending in some specific sectors. Overall, the policy mix is intended to reinforce the effectiveness of all monetary transmission channels (interest rate, exchange rate, money and lending, asset prices, as well as expectation channels) to better withstand the spillover impacts of global monetary factors.

Interest rate policy

Indonesia is among the first central bank that ahead of the curve raised its policy rate in the aftermath of Fed announcement on planned tapering in May 2013. We started to raise the BI policy rate by 25 bps in June 2013. We then aggressively raised the policy rate by 50 bps in July, another 50 bps in August, and 25 bps in September 2013. After pausing in October, we raised again the policy rate by 25 bps in November 2013. In total, the policy rate was increased by 175 bps to 7.50% within six months. We hold the policy rate since then and maintain our tight monetary policy stance.

The primary objective of this aggressive interest rate policy is to preemptively anchor inflation expectation that initially arose from food price shocks. Subsequently, the increase in policy rate is to contain the second round impact of fuel price hike that caused CPI inflation to reach its peak at 9.0% in July 2013. The large increase in policy rate is also to help in slowing down the domestic demand to dampen the current account deficit that rose to a peak of 4.4% of GDP in Q2-2013. The timing of the aggressive increases in policy rate is also important as they help in responding to the capital reversals and increasing interest rate and risks in the global financial market following the Fed announcement of planned tapering. We believe bold and aggressive response in interest rate is a key to send a strong and clear signal to the market in our monetary policy deliberation. Higher consideration is given to domestic factors, even though global monetary conditions and trends are always taken into account.

The bold response in interest rate has succeeded in containing the inflation pressures and helped in reducing current account deficit faster than initially forecasted. The CPI inflation returned to its normal path since September and downed to 8.3% in December 2013, much lower than our earlier forecast of 9.0%–9.8% (Graph 5). The inflation decelerated further to 7.3% in May 2014 and we believe it will down to 5.3% at the end of 2014, and thus falls within our targeted range of 4.5%±1% (Graph 6). Trade balance turns into surplus and current account deficit is falling much faster than expected from 4.4% of GDP in Q2-2013 to 1.9% of GDP in Q4-2013 and 2.0% of GDP in Q1-2014 (Graph 7–8). We are aiming to lower the current account deficit from 3.3% of GDP in 2013 to below 3% of GDP in 2014 and around 2% of GDP in 2015. We believe this level of current account deficit is more sustainable in the longer term for Indonesia. The good news is that these price and external stability can be achieved with better than expected economic growth. GDP growth recorded at 5.8% in 2013 and it is forecasted to moderate to 5.1%–5.5% in 2014 following the stabilization policies (Graph 9).

The interest rate transmission mechanism is working even though it is yet to complete. Following the 175 bps increase in policy rate, bank deposit rate rose by 240 bps as liquidity is tightened and competition among banks in raising funds is increasing (Graph 10). But interest rate on lending increased only by less than 50 bps due to a combination of factors, e.g. time lag in interest rate setting, excess liquidity and aggressive lending in some banks, and shallowness of domestic financial market. Aggregate liquidity and monetary aggregates have already declined substantially, e.g. M1 growth downed from around 22% in January 2013 to 9% in April 2014 (Graph 11), even though liquidity is not evenly distributed among banks. Bank lending growth declined more gradually from 23.5% to 19.0% during the same period even though it accounts for 16.1% if excludes exchange rate depreciation (Graph 12). Going forward, even though the policy rate is held constant, continuous monetary tightening will bring about further decline in lending growth to about 15–17% at end of 2014.

Exchange rate policy

Even though increases in policy rate have succeeded in anchoring inflation expectation and helped in slowing down the domestic demand, it could not left alone to play all the burdens of economic adjustments, including in further reducing current account deficit and mitigating the spillover effects from the UMP normalization process. It would need excessive increases in policy interest rate to do all the adjustments. Some room for exchange rate flexibility helps in

facilitating the reduction of current account deficit and the transmission of global monetary normalization.

For Indonesia, exchange rate policy is geared toward maintaining the stability of exchange rate movements that is consistent with its fundamental path. The path is calibrated through some methodology of determining the fundamental exchange rate and then inputted to be consistent with macroeconomic forecasting and simulation when determining the policy interest rate. Real Effective Exchange Rate (REER) is one approach to check the consistency of exchange rate movements to the fundamental (Graph 13). To achieve this objective, symmetric intervention in the foreign exchange market is conducted to smooth out the short-term volatility of day to day exchange rate movements in the market with the path that is consistent with the fundamental equilibrium exercises. The objective is not to achieve a certain level or range of exchange rates, but merely to avoid too excessive volatility that may give rise to panics and disruptions in the smooth functioning of foreign exchange market.

Introducing greater exchange rate flexibility is not always easy when facing shallow domestic foreign exchange market, however. This is what we are facing in Indonesia in the aftermath of Fed announcement on planned tapering last year. The markets were not ready to adjust to our new policy of greater exchange rate flexibility to facilitate the spillover impacts of Fed tapering and the adjustments on current account deficit, especially during the period of June to August 2013. There was large divergence of exchange rate determination among the banks that accompanied increasing volatility and depreciation of exchange rate movements during this period (Graph 14). Frequent and close communication with market participants is important to adjust their behavior to the new policy direction. The smooth functioning of domestic foreign exchange market has resumed since September 2013.

Capital flows management

Volatile capital flows, especially those of short-term and speculative natures, increase the risks of instability to both monetary and financial system stability. The carry trade flows often give rise to excessive volatility in the exchange rate movements beyond implied by fundamentals. Dual intervention is one of strategy to smooth out volatility. But in some cases, measures of capital flows management are needed.

For Indonesia, the policy on capital flows management is guided with three principles. First, the objective is to help mitigate the negative impacts of short-term volatility in capital flows to instability in exchange rate as well as overall monetary and financial system. Second, they are targeted to short-term and speculative capital flows since we welcome those flows that are medium-longer term that benefits the economy. And third, the measures are consistent with our broad principle of maintaining free foreign exchange system. They are temporary, i.e. the measures are strengthened when too much capital inflows and relaxed when too much capital outflows, and do not differentiated to both domestic and international investors.

Followings provide clear examples. During heavy capital inflows from the UMP easing, in 2010 we introduced six month holding period for transactions in the central bank bills and imposed a maximum of 30% capital to the short-term off-shore borrowings of the banks. But following the Fed announcement of planned tapering in 2013 we relaxed the holding period for central bank bills to one month and expanded a number of transactions that are excluded from the calculation on off-shore borrowing of the banks. We view that these measures help in dampening the short-term and volatile capital flows, and thus are consistent with the objective of managing financial stability.

III. Assessing the macroprudential measures

As underlined before, the interest rate transmission mechanism of monetary policy is not always smooth and fully effective in a country where financial market is not yet developed such as Indonesia. Other channels of monetary transmissions must be deployed, including

the lending channel. This is where macroprudential measures play key role, including in smoothing out the procyclicality nature of bank lending behavior. Thus, both the objectives of maintaining monetary and financial system stability are taken into account when we design macroprudential measures.

In Indonesia, the formulation of macroprudential measures is done as follows. We develop some methodologies to assess some sort of optimal lending growth of the banks, including what we call non-accelerating inflation lending growth model. We apply the model to aggregate lending growth as well as lending growth to each bank, certain types of lending (consumption, working capital, and investment) and per economic sectors. By comparing these optimal vs. actual lending growth, we have some idea where excessive lending occurs and thus some instruments of macroprudential measures are justified and can be applied.

This is the approach that we applied when introducing loan-to-value (LTV) ratio to lending to automotive and property sectors in 2012. We then strengthen the LTV ratio to lending to property sectors in 2013, especially to mortgages for the second, third, and so on purchases of certain types of housing and apartments. The measures are also complemented by supervisory actions to banks that we viewed exhibit excessive lending behavior. We note that the formulation and implementation of macroprudential measures require a much detail and complex analysis and calibration, as well as the need for clear communication to the banks and business community.

Our experience shows that the macroprudential measures and supervisory actions help in reinforcing the effectiveness of monetary transmission mechanism and supporting the financial system stability. Even though lending growths increased in the period prior the implementation of these measures, probably banks and their customers wanted to utilize the interim period, they declined substantially in relatively short-period in the subsequent episode. The growth of mortgage on housing for less than 21 M2, for instance, declined from more than 100% to the negative growth during the period of June to September 2012 (Graph 16). Likewise, the growth of mortgage on apartment less than 21 M2 dropped from more than 300% to less than 10% during the period of January to November 2013 (Graph 17). It should be noted that the automotive and property sectors contain substantially large import content, and thus managing lending growths to these two sectors help in reducing the current account deficit.

IV. Financial market deepening

The stage and depth of domestic financial market influence the transmission mechanism and policy response to global monetary factors, in both the UMP easing period as well as the normalization process. Preceding discussions clearly show the challenges that we face in Indonesia. Interest rate transmission is lagging in the absence of domestic money and fixed income markets that provide efficient mechanism interest rate and term-structure determination. The shallowness of domestic foreign exchange market often causes excessive volatility and overshooting of exchange rate movements in responding to global monetary and financial shocks.

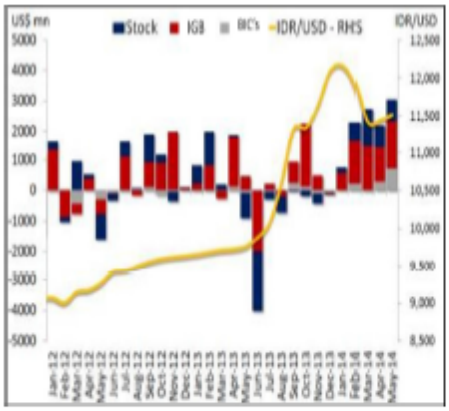
This is the rationale for our focus and priority on financial market deepening, as an integral part of our policy responses to the normalization process of the UMP in the advanced countries. In addition to strengthening the economic fundamentals, sound macroeconomic and financial system stability, the best defense for withstanding the spillover effects of such global monetary and financial factors is to make our financial market more conducive and resilience to swings in the international investor preferences.

We embark on a series of policy initiatives to deepen our financial market, especially domestic money and foreign exchange markets. In the foreign exchange market, we succeeded in establishing the Jakarta Interbank Spot Dollar Rate (JISDOR), reflecting the actual transacted exchange rates, as a reliable reference for the market. Recently, the Association Banks of Singapore (ABS) recommends their members to use JISDOR as

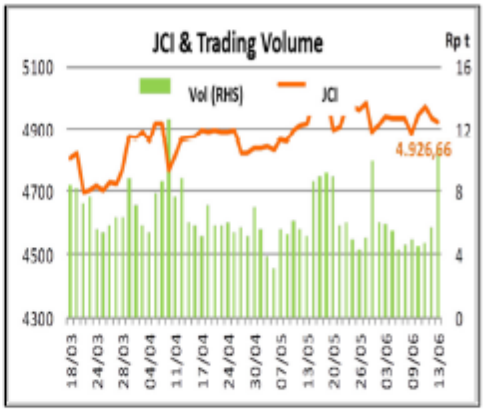
reference rate in fixing their NDF transactions. We also introduce FX swap transactions with the banks both bilaterally and weekly auctions. Further relaxation on regulations regarding underlying transactions for forward and swap as hedging instruments has been issued, and we are now campaigning to the banks and corporates to use more hedging instruments in managing their increasing exchange rate risks.

We also make significant progress in deepening domestic money market, especially those of collateralized transactions. We use more reverse repo with government bonds in our monetary operations. We have succeeded in developing interbank repo using government bonds as underlying transactions. Within less than three months, the size of transactions increases substantially from almost nonexistence to equivalent of USD3 billion. The number of banks participate in this interbank repo enlarges from only 8 to 65 banks, and more will follow. We believe this progress of financial deepening play important role in supporting our policy mix of monetary and macroprudential measures in responding to the spillover effects from the normalization process of the Fed monetary policy.

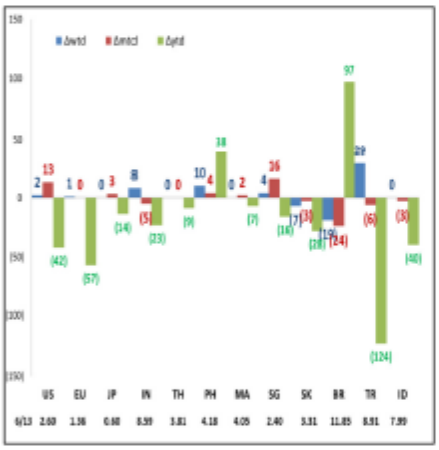
Graph 1. Portfolio Inflows and IDR/USD



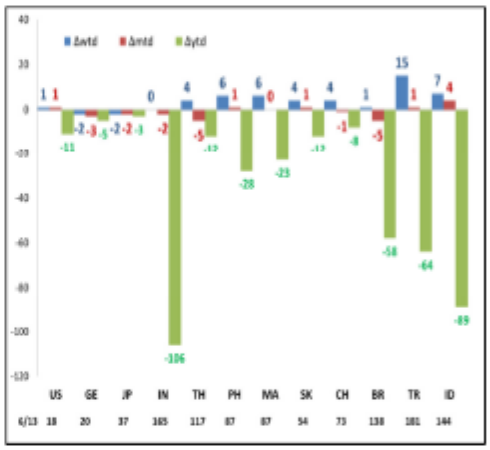
Graph 2. JCI Stock Prices and Volume



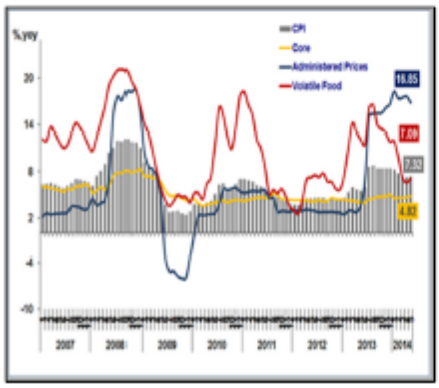
Graph 3. Bond Yield: Indonesia vs Others



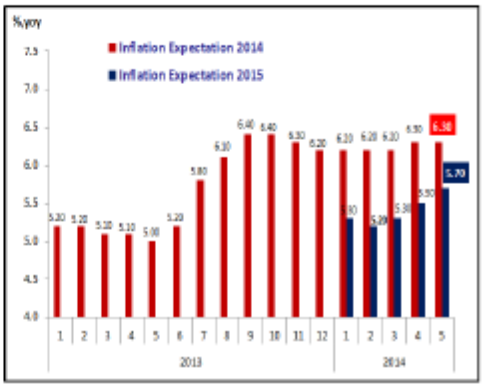
Graph 4. CDS Spread: Indonesia vs Others



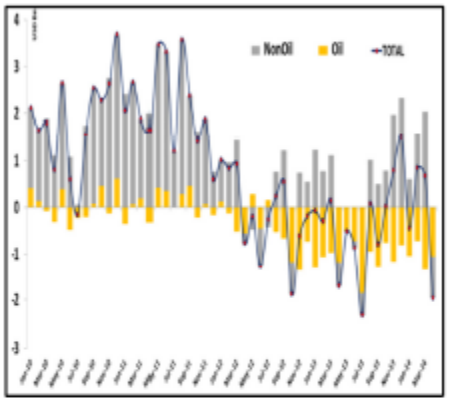
Graph 5. CPI Inflation: Core, Foods, Energy



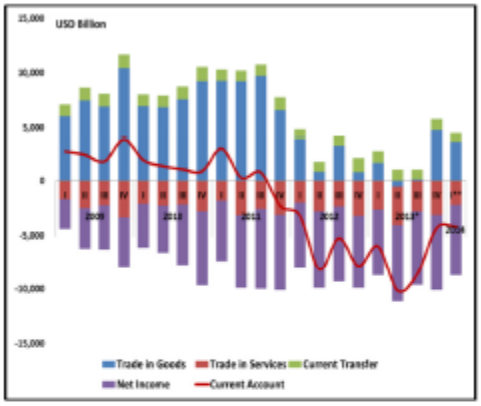
Graph 6. CPI Inflation: Consensus Forecast



Graph 7. Trade Balances: Oil and Non-Oil



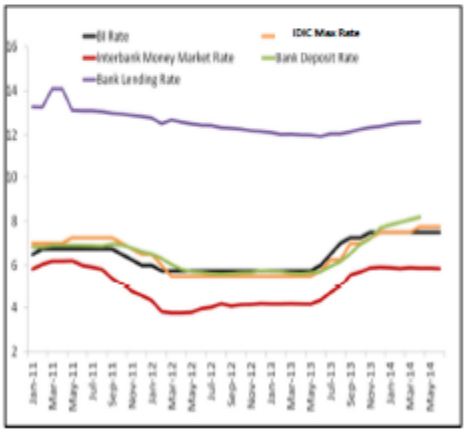
Graph 8. Current Account Deficit



Graph 9. GDP Growth By Expenditures

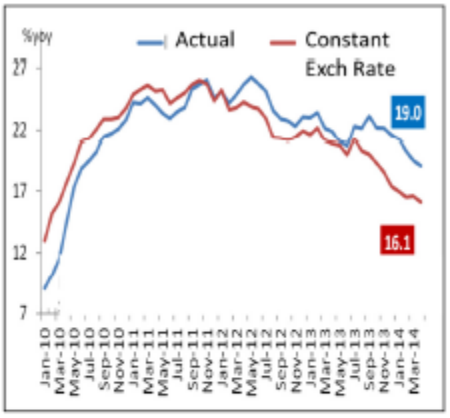
No	Components	2012				2013				2014			2015
		I	II	III	IV	I	II	III	IV	I		End of Year	End of Year
										Forecast	Actual		
A	**Domestic Demand^**	**6.40**	**7.38**	**5.94**	**4.90**	**4.99**	**4.69**	**5.50**	**5.13**	**5.59**	**5.33**	**5.36**	**5.46**
1	Consumption	5.09	5.64	4.50	3.91	4.77	4.78	5.89	5.44	5.89	5.41	5.49	5.45
	- Household C.	4.94	5.24	5.57	5.36	5.24	5.15	5.48	5.25	5.81	5.61	5.36	5.43
	- Government C.	6.52	8.66	-2.80	-3.31	0.44	2.17	8.91	6.45	6.70	3.58	6.40	5.63
2	Gross Fixed Cap Formation	9.86	11.96	9.68	7.49	5.54	4.47	4.54	4.37	4.84	5.13	5.04	5.47
	- GFCF Building	7.08	6.67	7.56	8.18	6.78	6.61	6.23	6.68	6.40	6.54	6.37	6.55
	- GFCF Nonbuilding	17.61	26.90	15.24	5.78	2.39	-0.64	0.40	-1.49	0.70	1.37	1.54	2.50
B	**Net Export**	**5.75**	**-27.32**	**-9.93**	**-22.03**	**16.44**	**26.61**	**5.79**	**46.34**	**12.19**	**-1.14**	**5.00**	**6.45**
3	Export	8.23	2.63	-2.56	0.48	3.58	4.82	5.25	7.40	6.76	-0.78	1.68	4.72
4	Import	8.95	11.33	-0.17	6.82	-0.03	0.69	5.09	-0.60	4.99	-0.66	0.72	4.19
	Gross Domestic Product	**6.33**	**6.34**	**6.21**	**6.18**	**6.03**	**5.76**	**5.63**	**5.72**	**5.77**	**5.21**	**5.32**	**5.61**

Graph 10. BI Rate vs Deposit and Lending Rates

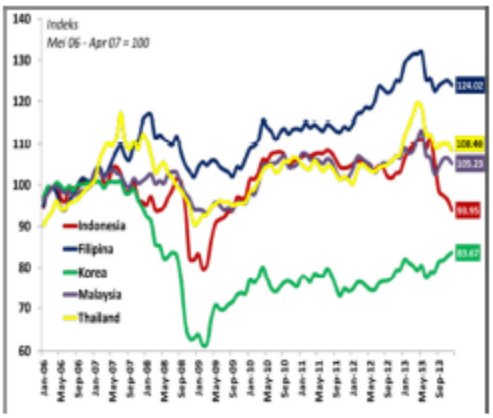


Graph 11. M1 and M2 Growth

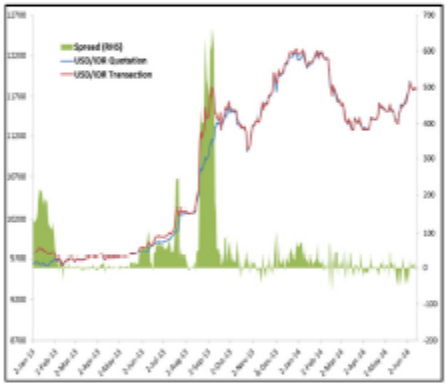
Graph 12. Lending Growth



Graph 13. Real Effective Exchange Rate (REER)



Graph 14. IDR/USD: Quotation vs Transaction



Graph 15. FX Reserves

Graph 16. LTV and Housing Mortgage

Graph 17. LTV and Apartment Mortgage