Comment on: "Monetary policy approaches and implementation in Asia: the Philippines and Indonesia" by Roberto S Mariano and Delano P Villanueva

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I am grateful to have the paper by Roberto S Mariano and Delano Villanueva reviewing the monetary policy approaches and implementation in the Philippines and Indonesia. It shares enlightened feedback and challenges that could encourage the refinement of our inflation targeting practice. My comment will be solely on the case of Indonesia.

Why targeting base money was abandoned

First of all I would like to briefly revisit the rationale behind Bank Indonesia's decision to abandon base money targeting and move to inflation targeting using the interest rate, instead of base money, as a policy response variable. This is related to the authors' hypothesis of base money as the more appropriate monetary policy instrument for Indonesia. There are four reasons underlying the decision. First, the relationship between base money and inflation and economic growth becoming increasingly unstable and even experiencing a reverse causality due to unstable money demand as well as uncertainty of money multiplier and money velocity behaviours. Second, the signalling of monetary policy to the market and public has been hindered not only because of the difficulty in understanding base money for the public in general, but also due to perceptions of dual nominal anchor, ie the base money target and inflation target. Third, the monetary policy response tends to be backward-looking and more difficult to implement, considering a time lag between instrument and inflation target. Fourth, base money is more difficult to control due to the dominant role and unpredictable behaviour of currency demand in Indonesia. Base money comprises 61% currency, 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 such weaknesses of base money, the use of the growth of the variable as a policy instrument on the left-hand side of the policy rule is likely to increase interest rate volatility. It can be excessively high in the case of monetary contraction and too low during an expansionary period. In the case of monetary contraction, the policy rate might need to be significantly increased in order to sufficiently absorb excess liquidity in the banking system. This could have a consequent adverse effect on banking and the real economy, through the interest rate and bank balance sheet channel of monetary transmission. Furthermore, higher interest rate volatility will imply an excessively high or low real interest rate. The latter can heighten the risk of currency substitution thus eventually increasing inflationary pressures. Moreover, the volatility of the interest rate differential could also increase. A very low interest rate differential would discourage short-term capital inflows and exert pressure on the exchange rate and thus inflation.

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Inflation targeting with interest rate policy response

On the other hand, the role of the interest rate post-crisis 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 does. Under the new framework, starting from July 2005 the interest rate called BI Rate is used as the monetary policy response and operational target. BI Rate is a policy interest rate with tenor of one month, which is periodically announced by Bank Indonesia for a certain period and designed to signalling its monetary policy response to the market and the public. BI Rate is currently the desired one-month rate of the Bank Indonesia Certificate (SBI), which is the current main instrument of liquidity adjustment in open market operations. The implementation of BI Rate through the open market operations for SBI relies on a number of reasons. First, one-month SBI has long been used as a benchmark by banks and market players in Indonesia for their activities. Second, the use of one-month SBI as operational target will reinforce the signalling of the monetary police response. Third, with significant improvements in the banking and financial sector, the important role of SBI in transmitting monetary policy to the financial sector and the economy has been evidenced. In the future, BI Rate will most likely be directed towards the desired rate of the overnight interbank money market.

The decision-making process within Bank Indonesia is continuously being strengthened, consistent with a forward-looking strategy for setting the current monetary policy response directed towards achieving the inflation target. For that purpose, an overall assessment of macroeconomic conditions, inflation forecast and monetary policy response is conducted in every quarterly monetary policy meeting of the board. An inflation forecast with contemporaneous output gap policy rule in a small macroeconomic model is employed in the preparation of policy recommendations to the board meeting. The macroeconomic forecast scenario and simulations using a medium-scale macroeconometric model are also taken into account, as well as leading indicators and other information variables and surveys.

Inflation is reasonably predictable to the extent that the predetermined assumptions of exogenous variables, especially oil and fuel price changes, are quite accurate. This has been justified through ex post analysis of the inflation forecast produced by the small macroeconometric model. In this regard, a better quality of inflation forecast targeting in Indonesia needs further enhanced fiscal-monetary coordination so that major discretionary changes in fiscal policy are informed to Bank Indonesia well in advance, which would provide enough time for Bank Indonesia to factor them into its macroeconomic assessments and monetary policy response. For example, the percentage increase in the fuel price is better informed to Bank Indonesia beforehand, which allows the monetary authority to assess more appropriately its impact on the inflation forecast, interest rate and economic growth.

Limitation of interest rate response

Another essential issue discussed in the paper I would like to comment on is difficulties associated with the interest rate as an instrument. The paper points out the issues of indirect fiscal dominance and exchange rate dominance that could constrain the flexibility of the interest rate policy response. I would like to elaborate on this.

High and volatile inflation

High and volatile inflation could imply a very high interest rate response to bring inflation down through the aggregate demand channel of monetary transmission. Such a behaviour of inflation might be caused by several factors. First, the dominance of adaptive behaviour of inflation expectation formation, as indicated from surveys and estimated econometrically.

Second, an ongoing transition process towards the target of a zero subsidised and flexible fuel price system that is anchored to oil price movements. Third, price setting behaviours characterising downward price rigidity and upward price flexibility on cost increases.

Ongoing recovery under restricted sources of growth

The inflexibility of an interest rate hike policy is related to the need to support economic recovery under the condition of limited sources of economic growth. The first aspect is related to the ongoing recovery of the banking system's intermediary function. The flexibility of the interest rate hike is therefore bounded by the consequential risk of worsening banking soundness, ie increasing non-performing loans, and decreasing the risk-weighted capital adequacy ratio.

Slow acceleration of economic growth could also be associated with the empirical estimate of contractionary exchange rate depreciation that could be explained through the imported input effect, investment demand effect and balance sheet effect. Increasing the interest rate may have the positive effect of avoiding decelerating growth through the indirect exchange rate pass-through of 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. Besides, exchange rate movements during the post-crisis period have been more sensitive to the risk premium. This explains why the exchange rate is not included explicitly in the policy reaction function. Instead, the exchange rate movement is responded to implicitly via the output gap and core inflation gap forecast.

Another important source of inadequate growth is the limited fiscal stimulus due to the large oil subsidy and government debt. Oil subsidy reduction has slowed down economic growth and has the potential to further hamper growth as the process is not finished yet. The consideration for the fuel price increase is not only fiscal deficit reduction. Other factors include achieving an international economic price, reducing the international price differential and domestic industrial-transportation price differential to avoid smuggling, encouraging more economical consumption of non-renewable energy, switching to a more appropriate form of subsidy, and imposing an oil tax. The contractionary effect of the administered price policy could limit the room for increasing the interest rate.

I also agree with the author that the fiscal condition with large stocks of government domestic debt could lead to indirect fiscal dominance that might hamper monetary policy conduct in raising the interest rate. However, the strengthened fiscal-monetary coordination, notably in determining the inflation target and formulating macroeconomic assumptions for the government budget, does not sacrifice the instrument independence. Moreover, recent events showed that Bank Indonesia independently raised BI Rate promptly in its effort to curb rising inflation expectations following the government's much larger than expected increase of the transportation fuel price. The policy then continues as realised inflation is actually much higher than the previous estimate, leading to a higher updated inflation forecast. The monetary policy response has then led to a higher SBI rate than that used as an assumption for the government budget.

In contrast, the lower bound of interest rate rises is restricted by the minimum real interest rate and interest rate differential that are sufficient to prevent exchange rate depreciation. Therefore, exchange rate depreciation resulting from an inadequate interest rate increase could not only accelerate inflation but also worsen the fiscal condition due to the large stocks of government foreign debt.

Bank Indonesia has been trying to use an ex ante real interest rate based on its headline inflation forecast as in line with a forward-looking policy framework. However, most goods market players are still likely to take the ex post real interest rate into account for their business decisions, as their inflation expectation formation is still dominated by adaptive

behaviour. On the other hand, Bank Indonesia's inflation target has been seen as too optimistic, while the uncertainty of the inflation forecast has increased mostly due to the uncertainty in the future course of administered price adjustment.

Our recent experience following the sharp inflation shocks due to high percentage increases in fuel price adds difficulty to the use of an ex ante real interest rate. Even though next year's inflation forecast is for a decline, inflation expectations among the public might be greater than Bank Indonesia's inflation forecast. As a consequence, Bank Indonesia might do better to temporarily shorten the lead time horizon considered in calculating the ex ante real interest rate. The measure could reduce the risk of currency switching that can lead to rising inflation. Nevertheless, this temporary action is a part of learning process that, we believe, will move towards best practices as Bank Indonesia's policy credibility improves.

Notwithstanding its limitations, a monetary policy response using interest policy enables Bank Indonesia to manage interest rate volatility by giving appropriate weight to interest rate smoothing and the forward-looking aspect of the policy reaction function. This feature strengthens the argument for abandoning base money as a choice of policy response variable.

Fiscal and financial sector reform and prerequisites of full-fledged inflation targeting

I am not in full agreement with the conclusion that the financial sector and fiscal reform should serve as prerequisites for full-fledged inflation targeting in Indonesia. Banking and financial sector reform could be beneficial in reducing cost of disinflation. However, its positive impact on the persistence of inflation will be dependent on the relative responsiveness of consumption and investment to an interest rate increase.

Fiscal reform is most likely to increase the persistence of inflation through the continuing process of oil subsidy reduction and imposition of an oil tax. The realised effects of the recent drastic subsidy policy are already being faced by the public in terms of increasing social welfare loss, as reflected by soaring inflation and slowing consumption growth. If the subsidy policy is then followed by imposing a substantial increase in the tax rate, coverage and ratio, it could weaken private consumption further. However, its negative impact on the cost of disinflation might be reduced if the government can achieve the appropriate level of infrastructure spending. The extension of such spending benefiting from tax reform could also reduce inflationary pressure in the medium term as it could increase economic capacity.

Fiscal and financial sector reform are clearly important, but the policy measures might not lessen inflation pressure and disinflation cost as well. It is the implementation of fiscal and financial sector reform with costless disinflation that does have prerequisites. First is an increasing growth of investment through government and domestic private investment, and foreign direct and portfolio investment. Second is the improvement of monetary policy credibility, which is the at the core of full-fledged inflation targeting.

Issues and challenges in strengthening credibility and communication strategy

The dilemma of Indonesia's monetary policy response associated with high inflation and ongoing recovery under restricted sources of growth leads to the increasing importance of policy credibility improvement. Increasing monetary policy discipline, transparency and communication is expected to help lessen inflation persistence and the cost of disinflation. Efforts to strengthen the credibility of monetary policy, eg through the use of BI Rate and

enhancing policy communication, are expected to contribute to a better role of Bank Indonesia in striking the balance between disinflation and economic recovery, as it will improve the effectiveness of monetary transmission.

Regarding the issue of exchange rate dominance and communication, I agree that exchange rate movements could be regarded as a key indicator of central bank performance. However, there has also been an increasing perception among both public and government that inflation management is the central bank's core competence and responsibility. We have been trying to educate the public that we treat inflation as the overriding objective while remaining concerned to reduce the volatility of the exchange rate as one inflation determinant.

More important is the way Bank Indonesia communicates to the public regarding the sources of inflationary pressure and exchange rate movement. With the experience from the last currency depreciation and fluctuation, Bank Indonesia has communicated to its stakeholder in a clearer way about the fundamental factors behind exchange rate depreciation that are beyond monetary policy control, ie the non-oil and gas trade deficit, oil trade deficit, lack of portfolio and direct investment capital inflow, oil price shocks, strengthening of the US dollar against regional currencies, and heightening public concern over fiscal sustainability. Moreover, the public is likely to have recognised that the fuel price shock can be a significant source of increasing inflation expectations. Monetary policy response to the recent inflation shocks and Bank Indonesia's communication to the public, as well as its coordination with the government, could also increase public understanding of the importance of controlling inflation as the central bank's overriding objective.

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