Monetary Policy in Post Crisis Indonesia: Some Empirical Evidence

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Abstract

In the aftermath of the Asian crisis, determining the appropriate monetary policy has become more complex for small open economy such as Indonesia. The challenge for policymakers is to establish a new framework for monetary policy after the collapse of managed floating regimes in 1997. As the central banking law was enacted in 1999, the inflation targeting framework aimed primarily at promoting price stability is proposed to put in place as a new framework for monetary policy.

These recent developments clearly increase the need to investigate the monetary process in post crisis Indonesia. This paper examines both long run and short run relationships as suggested by monetary theory. In long run analysis, we employ the approach of cointegrating VAR. We identified two cointegrating vectors: a traditional money demand function and a Fisher effect relationship. In the long run, real money demand as measured by M1 is a function of real output and the opportunity cost of holding money. The existence of Fisher Inflation Parity allows us to estimate the long run real rate of return.

For short run analysis, we estimate monetary policy reaction function. To estimate the model, we employ the Generalized Method of Moment (GMM) approach. As Indonesia is a small open economy, the role of exchange rates could not be neglected. Thus, we need to investigate how central bank response to exchange rates. Here, we expand the basic model and investigate the role of exchange rate in the monetary policy reaction function.

The empirical results show that the central bank has put more weight on inflation as compared to output in its preference. This quantitative evidence clearly lend support to the view that central bank's main task is to achieve price stability. For post crisis period, it is also found that the response of interest rate to the expected inflation was more than one, ensuring the macroeconomic system to stabilize, as the central bank did not let the expected inflation to increase. The effectiveness of this policy can obviously be seen during the crisis, when monetary authority did increase the interest rate, as shown by much higher coefficient of the interest rate to the expected inflation, in order to contain the increase of expected inflation.

The empirical evidence lends quantitative support to implement inflation targeting as new framework for monetary policy in Indonesia. By inflation targeting, the central bank indirectly reduces the long run real interest rate, thus lowering the long run inflation rate. The monetary authority needs to use expected inflation as the target of monetary policy and to response sufficiently to the expected inflation.

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