BANK INDONESIA

Monetary Policy in Emerging Markets: Indonesia's Case

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Outline:

- A Brief History of Indonesia's Monetary Policy Framework
- The Implementation of Formal Inflation Targeting Framework
- Limitation of Interest Rate Response and the Need for Coordination with the Government
- Doing Monetary Policy in an Open Capital Account
- Some Lessons to be Learned
- Where to go?

A Brief History of Indonesia's Monetary Policy Framework

Central Bank Act in 1999:

- Focus on maintaining Rupiah stability
- Goal and instrument independent
- Institutionally independent

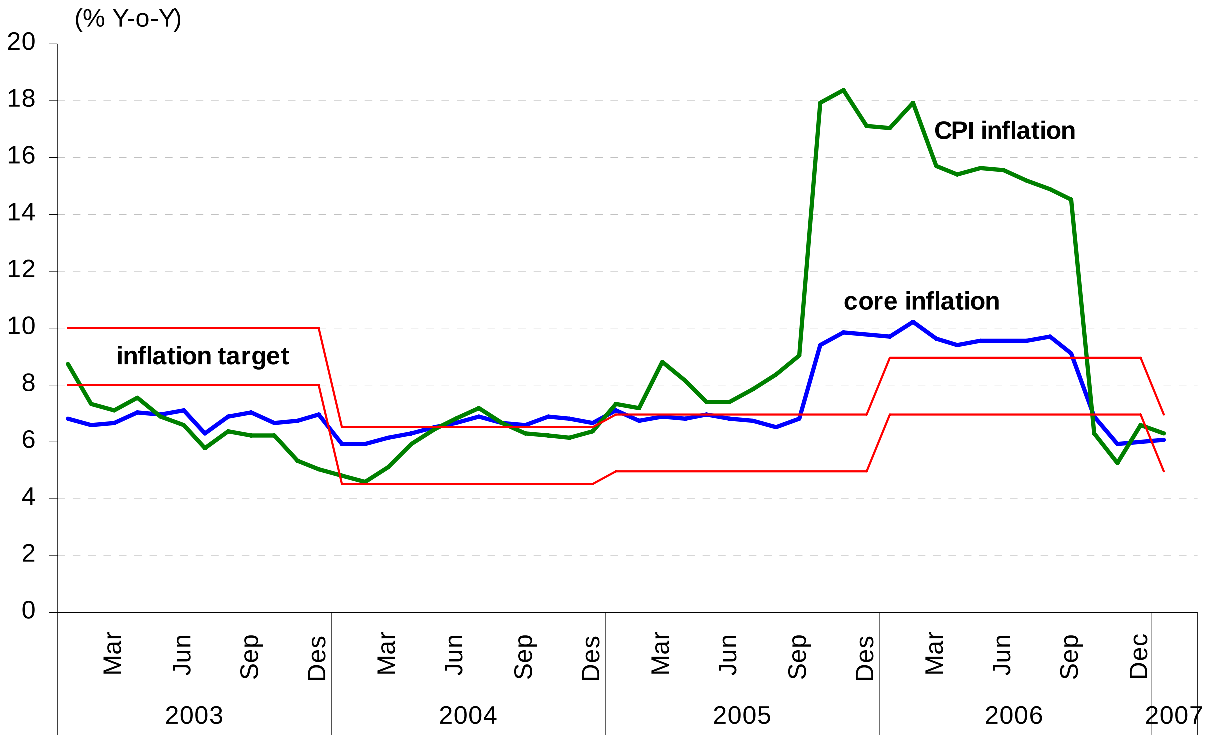
- Start announcing inflation target in 2000
- Base Money Target under IMF program
- Inflation fell down, but hardly achieve target

Year	CPI Target	Economic growth assumption	Base money growth target	Actual base money growth	Actual CPI inflation
2000	5-7%	3-4%	8.3%	23.4%	9.53%
2001	6-8.5%	5.0%	11-12%	18.3%	12.53%
2002	9-10%	3.5-4.0%	14-15%	9.3%	10.03%
2003	8-10%	3.5-4.0%	13%	14.25%	5.06%

A Brief History of Indonesia's Monetary Policy Framework

Central Bank Act amended in 2004:

- **Government set the inflation target**
- **Instrument independent**



Inflation (CPI) target:

Announced in 2004:

2005	6% ±1%
2006	5.5% ±1%
2007	5% ±1%

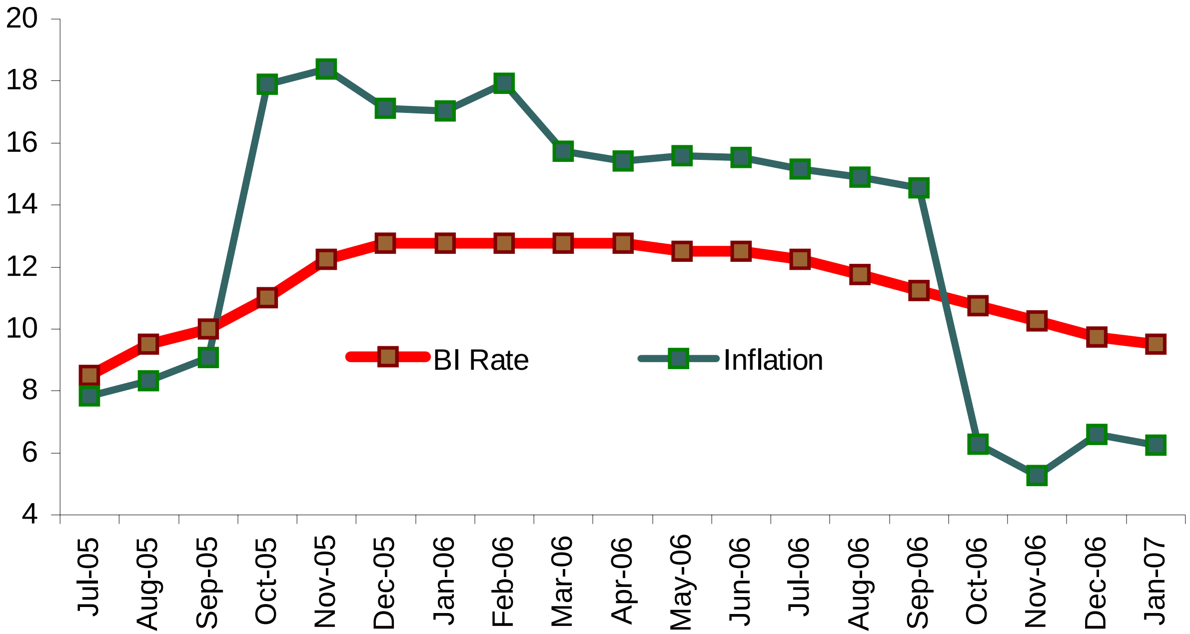
Revised in 2005 (due to oil shock):

2006	8% ±1%
2007	6% ±1%
2008	5% ±1%

The Implementation of Formal Inflation Targeting Framework

Announced in July 2005:

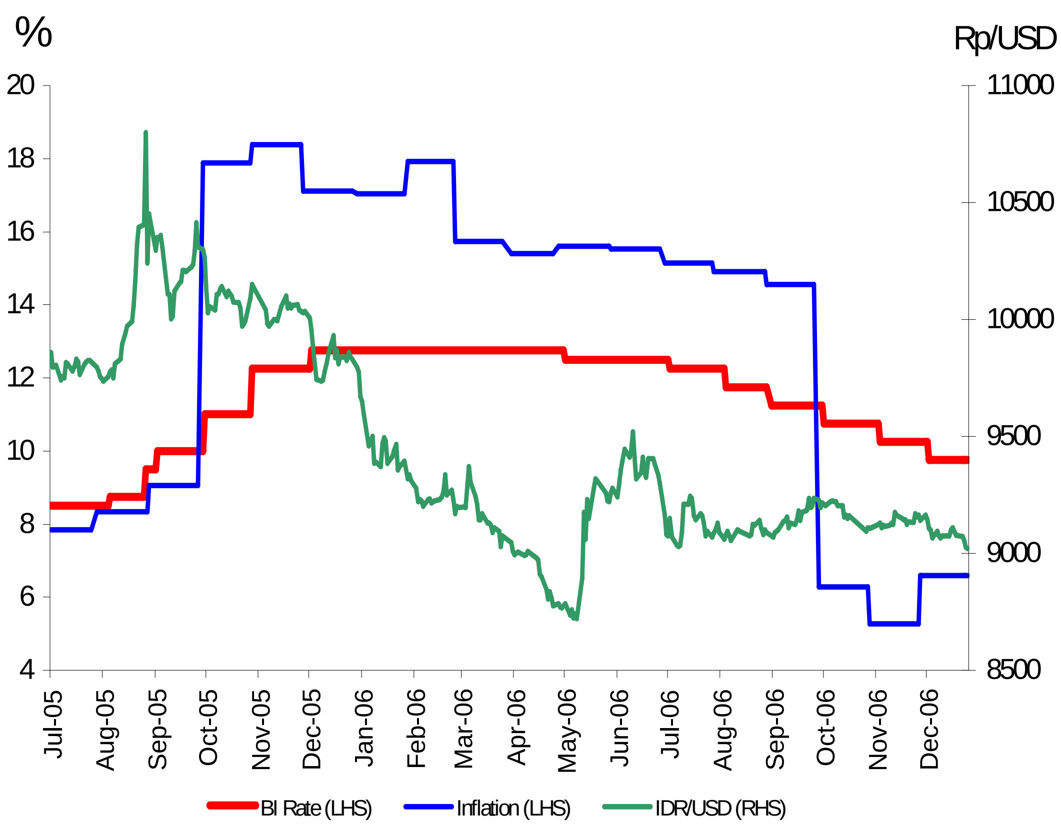
- The use of interest rate, called BI Rate, as the policy reference rate
- Forward looking monetary policy decision-making
- Enhancing transparent communication strategy
- Improving policy coordination with the Government.

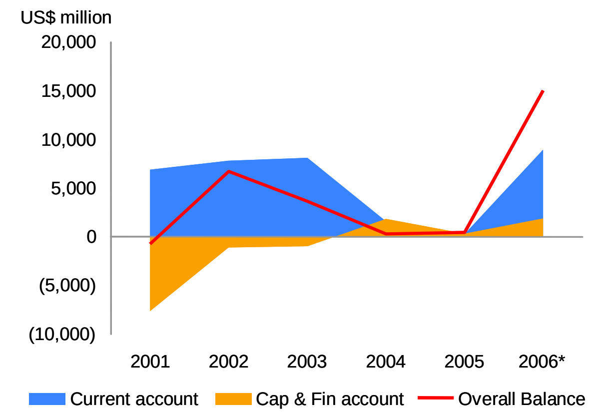


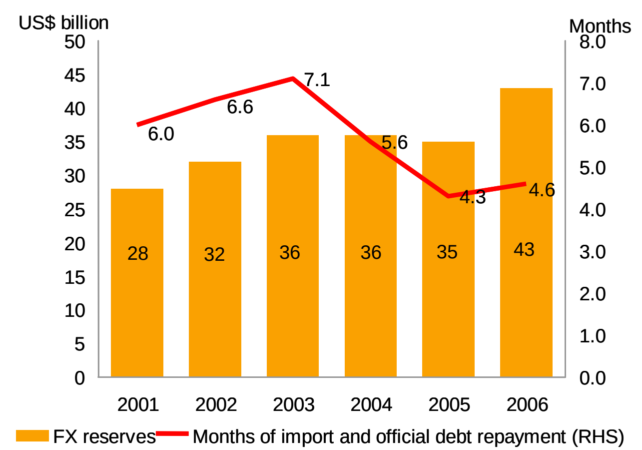
Interest rate can quickly response to any pressure of inflation and easier to be understood (thus influence expectation)

Doing Monetary Policy in an Open Capital Account

A complicated policy implication of a small-open economy is the need to deal with the capital flows uncertainty while maintaining the monetary independence and balancing the pressure on exchange rate.

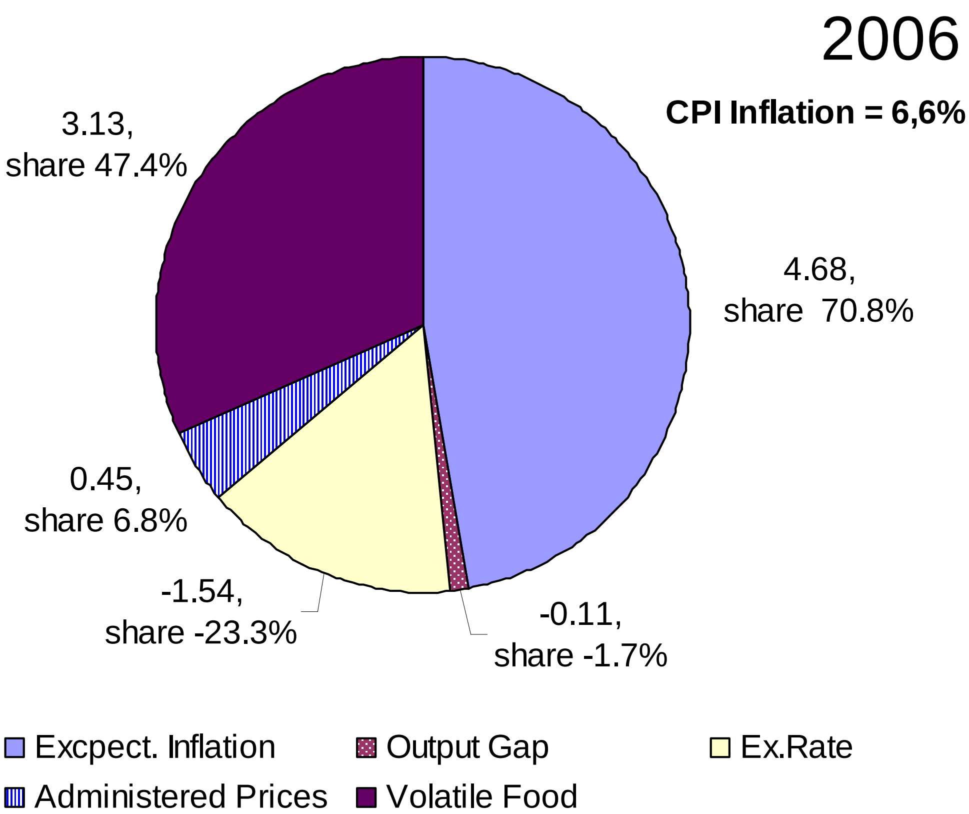






Limitation of Interest Rate Response…

Source of Inflation:



Volatile inflation associated with supply shock and administered prices.

With long history of relatively high inflation, it can easily be transmitted to people's expectation of inflation.

Interest rate alone can not be used to combat inflation.

Limitation of Interest Rate Response…

Interest rate alone can not be used to combat inflation.

A concerted effort, both in demand and supply side, is needed to combat Indonesia’s high and stubborn inflation.

Bank Indonesia and the Government established **The Inflation Management Team** in 2004.

The team introduced an integrated policy roadmap:

- monetary policies to administer aggregate demand and stabilize the exchange rate;
- fiscal policies to ease demand by maintaining fiscal sustainability and to coordinate direct policies concerning administered prices;
- sectoral policies to fostering supply (production) and ensuring the continual distribution of goods and services.

Some Lessons to be Learned

- ITF has served well in formulating consistent monetary policy and in anchoring public's inflation expectation.
- A rapid adjustment of Indonesian economy should take into serious consideration in formulating monetary policy. Here, the supply side policy to combat inflation is also needed.
- Market is now more sensitive and its "punishment" to any bad policy seems more severe than before. Fluctuations in capital flows could happen in a massive and instantaneous way if a policy seen to have a low level of credibility.

Credibility matters!

Increasing policy discipline, transparency and communication will lessen inflation persistence and the cost of disinflation, i.e. striking the balance between disinflation and economic recovery.

Where to go?

- Improving the implementation of ITF, within the wider structure of macroeconomic policy, is a strategic step that will continually be taken to maintain market confidence on macroeconomic stability and overall financial system stability.
- To support the financial market development and to improve monetary policy effectiveness, improving the operational structure of monetary policy and deepening the domestic financial sector is already in our agenda.
- A number of issues related to capital flows, exchange rates and the interest rate response will be placed within the current liberal capital account regime and a floating exchange rate system. In this context, policies that provide incentives for long-term capital flows should be prioritized over policies that “punish” short-term capital flows.