

## **Comment on ‘Toward Improved Monetary Policy in Indonesia’**

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Under the current institutional arrangements that operate in many countries, central banks are very powerful and important institutions. The norm, especially in developed economies, is that central banks have full operational independence in setting monetary policy and a number of them (including the Federal Reserve Bank in the United States) also have some goal independence. The standard focus of central banks is, as it should be, on maintaining low and stable rates of inflation in the medium term. In developed economies, and in many developing economies, the short-term interest rate is the instrument for achieving the central bank’s goals.

Typically, this interest rate is controllable by actual and expected operations in the overnight interbank money market.

How does Indonesia fit into this generalisation? Under revisions to the Bank Indonesia (BI) law, it has instrument and some goal independence. The instrument is base money growth and its goal is stability of the rupiah (which is left to the central bank to define). How has it performed? Reading Ross McLeod’s paper, the answer is ‘not well’. McLeod shows that inflation in Indonesia surged in 1998 and post-crisis inflation performance has been relatively poor in comparison to the other crisis-affected economies in East Asia. His basic point is that Bank Indonesia could have done much better if its inflation goal had been clearly set and if it had kept proper control of base money. This can be re-expressed as advice about what to do in the future. Looking forward, he says that Bank Indonesia should be clear about its inflation target and should use base money growth to achieve it.

My comments focus on two issues: inflation as the objective of monetary policy and base money as the instrument to achieve that target.

It is not difficult to have strong sympathy with the view that an independent central bank has to be clear about what its goals are. Lack of clarity in the objectives of policy increases the risk of policy drift and mistakes. It is also hard to keep an independent central bank accountable for its policy if there is no clear benchmark, criterion, or set of criteria by which to judge the stance of policy. If the central bank does not know what it wants to achieve, how can it set policy and how can the public evaluate its actions? I agree with McLeod that the benchmark, ‘stability of the currency’, is too loose.

Setting policy with reference to some numerical inflation objective or target is a good idea. The term ‘inflation target’ is not as well understood in East

Asia as it could be. Because policymakers make forecasts of inflation, they sometimes say that they have an ‘inflation target’. As the forecasts change, they also change their target. But this is different from an inflation objective. When the objective of monetary policy is to keep inflation around a particular target rate, the central bank tightens monetary policy when the inflation forecast rises above the acceptable rate of inflation. McLeod wants BI to explicitly commit to an inflation objective or target (like 2 or 3 per cent).

There is substantial merit in the argument that BI should be more explicit about the inflation rate that it is aiming at. It is also timely for public debate about what the number should be. But here let me diverge in two ways from McLeod’s view about the way to interpret the inflation objective or target.

McLeod prefers headline inflation. He does not like the focus on underlying inflation since it too easily allows the central bank to ‘cop out’. There is room for nuance on this. Central banks (almost) universally focus on underlying inflation because they do not want to respond to short-term disturbances typically caused by relative price shifts. For example, consider seasonal patterns in fresh fruit and vegetable prices. Why should the central bank tighten policy when fruit and vegetable prices rise when they are out of season and then loosen policy when prices fall once fruit and vegetables are back in season? Responding to seasonal variations in these prices increases the variability in output and in the prices of other goods and services. It is much better to look through the ‘noise’ and focus on the underlying price movement.

McLeod also takes exception to the requirement that BI has to take macroeconomic conditions into account in setting monetary policy. So long as BI knows what inflation rate it wants to achieve in the medium term (and acts to achieve that objective), there should be no problem with this condition.

In standard stochastic monetary models with lagged adjustment, the monetary authority faces a choice between the variability of inflation and the variability of output growth in achieving a particular rate of inflation: the variability of output increases at an increasing rate as the variability of inflation around target is reduced. If the central bank wants to minimise variability in inflation around target as much as possible (that is, the short-term), then the output and employment cycle become more pronounced. This is why many economists recommend that inflation-targeting central banks have a medium-term focus. The reference to macroeconomic stability

in the BI law is an appropriate way to keep in policymakers' minds the unnecessary output costs that are associated with strict short-term inflation-targeting.

The second aspect of McLeod's article that is worth discussing is the monetary dimension to inflation. As he says in his article, McLeod is a monetarist. He draws on Milton Friedman's insight that inflation is always and everywhere a monetary phenomenon. That is right. But it is right because it is a tautology. If prices are expressed in monetary terms (which is what currencies are expressed in), then money prices must be monetary phenomena. This does not mean that money growth is the originating mechanism of inflation in all instances. The assessment that inflation is always and everywhere only due to money growth confuses an identity ( $PY \equiv MV$ ) with behavioural relations in a complex economy.

McLeod disparages what is widely regarded as the conventional view that interest rates are the key transmission mechanism in an economy where the central bank does not monetise the fiscal deficit or create direct credits in the banking system. The reader is referred to Romer (2000) and Walsh (2003: chapters 10 and 11) for authoritative theoretical and empirical analysis of this view of the transmission mechanism.

What really matters in the case of Indonesia is whether base money is the real story behind the inflation process. Here, it is worth making just two observations on the evidence presented in the article.

First, it is not enough to say that inflation is caused by base money growth just because growth of base money leads inflation (McLeod's Figure 3) and interest rates do not (McLeod's Figure 5). McLeod's argument confuses correlation with causation. For example, an alternative view of Indonesia's inflation shock in 1998 is that it was driven by the collapse of the rupiah, exacerbated by deep political crises and capital flight. The growth of base money reflects the injection of funds into the banking system to stave off complete collapse, even if this itself, as McLeod rightly points out, provided some fuel to the capital flight. The collapse of the rupiah created the inflation, not the injection itself of funds into the banking system.

With reference to his Figure 5, McLeod argues that since the rise in inflation preceded the rise in interest rates, interest rates cannot be used to explain inflation. This is misleading. It ignores the role of shocks in the dynamic path of an economy and the multiple sources of shocks to inflation, including – in addition to central bank financing of fiscal deficits and central bank direct credits – the exchange rate, labour market conditions,

competition in the economy and foreign shocks. It is an extreme Monetarist view to argue that all movements in inflation are due to monetary shocks (as opposed to arguing that the remedy for inflation shocks is control of money). Interest rates rose *after* the inflation shock as a policy response to reduce inflation. If interest rates are the policy tool to respond to inflation shocks, they cannot rise before the shock occurs (when the shock is unanticipated).

The second observation on the empirical importance of base money in Indonesia's case focuses on what happened to traded and non-traded goods inflation during the 1998 episode. If base money creation were really the driver of inflation, there should have been no difference between traded and non-traded goods inflation. If the exchange rate was the key driver of inflation, then traded goods prices should have increased more than non-traded goods prices and should have increased before non-traded goods prices did (since the rise in non-traded goods prices would have captured second-round price effects of the exchange rate fall on the non-traded part of the economy).

Figure 1 plots monthly annual traded and non-traded goods price inflation in Indonesia from 1991 to 2003. It shows that traded goods prices rose substantially more than non-traded goods prices in 1998 and that traded goods prices rose before non-traded goods prices rose. This would suggest that the depreciation of the rupiah, rather than the rise in base money itself, was the cause of Indonesia's inflation surge in the crisis year of 1998. (And in this context it is worth noting that traded goods include commodities like rice which are subject to price controls; the non-traded goods component has relatively few commodities with controlled prices.) As an empirical proposition, McLeod's view that all inflation is monetary does not look right.

What remains important in McLeod's paper is the broader spirit of the message it contains. Bank Indonesia needs to be clear about what it is doing. We can argue about the merits of base money targeting or using interest rates as the operation tool for monetary policy, and the value of inflation targeting and other policy objectives. But the key thing is for the central bank to have a clear and workable framework. It is also the case that Indonesia's inflationary performance in the post-crisis period does not seem to be as good as it could have been, at least in comparison to some of its peers. In this context, there is always a place to encourage our central banks to do better.

**Figure 1: Traded and Non-Traded Inflation in Indonesia**

