Summary Remarks at Bank Indonesia

by

John B. Taylor[1]

The representatives at this conference from inflation targeting central banks—including Brazil, Canada, Chile, Czech Republic, New Zealand, Korea, Thailand, and the United Kingdom—have provided us with a useful overview of how inflation targeting works in practice. These experiences will be very important as other countries, including Indonesia, consider inflation targeting. We have also had some contrasting perspectives from Malaysia and Singapore where the focus has been more on the exchange rate.

I want to discuss three issues in this summary. The first is a semantic issue, relating to the alternative to inflation targeting; I think that this issue has at times confused the policy debate about whether inflation targeting is a good idea or not. The second issue is about the importance of a political commitment to inflation targeting. And the third is about the role of the exchange rate.

What is the Alternative to Inflation Targeting?

In several of the discussions at the conference about whether inflation targeting should be adopted in Indonesia, it has been implicitly assumed that the alternative to inflation targeting is money or monetary base targeting. At the opening session, Deputy Governor Nasution remarked that velocity has been

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fluctuating, and that is a reason to consider inflation targeting. Similarly, the papers by Mr. Alamsjah and Mr. Sitorus, indicated that questions about the stability of money multiplier or about velocity are reasons for considering inflation targeting. And in his comments this morning, Joshua Felman argued that Indonesia should use monetary base targeting, rather than inflation targeting.

In my view it is mistake to think of inflation targeting and money base targeting as mutually exclusive alternatives. The alternative to inflation targeting, as indicated by the different perspectives we heard from Malaysia and Singapore, is exchange rate targeting, such as fixed exchange rate, a currency board, or crawling peg. Inflation targeting is an alternative to exchange rate targeting, because it focuses on the domestic price level; domestic price stability is focus of policy. And with inflation targeting comes a flexible exchange rate. Once a country or a central bank decides to target the inflation rate it then has to decide what instrument to use to achieve that goal: the monetary base and the interest rate are two possible instruments. The important point here is that *it is possible for an inflation targeting central bank to use the monetary base as the instrument to achieve that target*. The correct question is: ”Should we use the interest rate or monetary base?” not “Should we use inflation targeting or the monetary base?”

Which instrument would be better to use if Indonesia decides to proceed with inflation targeting? First note the similarities between the two instruments. A policy that keeps the money base or some other money aggregate growing at a constant rate has implications for the short-term interest rate. For example, a depreciation of the exchange rate, in the case of money base targeting, is going to cause the inflation rate to rise and the demand for goods and services in the economy to increase. Both would increase the demand for money and thus put upward pressure on the interest rate. Similarly, if a central bank was using the interest rate as an instrument (and acted according to a typical policy rule) it would raise the interest rate if inflation rose or if aggregate demand increased. So it seems to me, that the two are similar in this respect.

The reason why many countries have moved away from a money base target to an interest rate target is due to an important difference between the two instruments, namely that an interest rate policy works better in the face of the high volatility of velocity we have seen in recent years. But a monetary target can be used to achieve an inflation goal in some circumstances. For example, in the United States, price stability was achieved in early 1980s by focusing on the money aggregates. Gradually over time, the Federal Reserve has moved to focus more on the interest rate.

I think there are some good reasons to use a money base instrument in Indonesia if inflation targeting is adopted. As I look back at the last few years, it seems to me that there has been a quite significant correlation between money growth and inflation. As indicated by Deputy Governor Nasution in his opening remarks, the inflation rate took off as money growth accelerated right before, and then during, the crisis. If you look at those statistics, you see a typical boom bust cycle; you worry that money growth was not been given enough consideration.

Another problem is that the short term interest rate can be misleading in time of crisis, and particularly in times of deflation or hyper inflation. That is why I have recommended a stronger emphasize on money aggregates in Japan in recent years. And I think in case of crisis, you have to watch the money aggregates.

But a focus on the interest rate has its advantages too. One problem with the focus on the money base compared to the interest rate is transparency. In the early 1980s, I was at an after-conference cocktail party in which James Tobin asked Paul Volcker the Chairman of the Fed, “Why don’t you cut the interest rate?”. Chairman Volcker replied that he controlled the money supply, not the interest rate, which of course was a way of deflecting criticism about the very high interest. That may have been a good political reason, but it might have suggested a lack of transparency about the real actions being taken. And of course even today when Indonesia is money base targeting, a lot of attention is paid to the interest rate decision.

So, in any case, to the question that was originally put by Anwar Nasution in the opening remarks “should we wait or should we go with the inflation targeting?” my answer is “go with the inflation targeting approach and the commitment to the flexible exchange rate, but not to abandon the use of money as part of the process”. It would very much depend on how useful the two instruments are. I don’t see any inconsistency between using the money base and targeting the inflation rate.

I have two other minor suggestions that are related to this answer. First, I very much enjoyed reading the two papers prepared by Bank Indonesia this morning. One of those papers had a money demand equation in it and I strongly recommend keeping that equation in your model. As more central banks have focused on interest rate as an instrument, including the Fed, they have focused less on the money aggregate in their models. Nevertheless, I would keep the money demand equation in there, even your focus turns out to be on the interest rate. That will give you an estimate of what the interest rate decisions do to money growth.

Second, Article 10 of the Bank Indonesia Act calls for setting a money growth target consistent with the inflation target. I don't see any reason not to do that right now. Of course if there’s a significant deviation from money growth target, it should be explained.

Commitment

What would be the importance of a commitment to inflation targeting from those outside Bank Indonesia if inflation targeting were adopted? Just by way of comparison, the United States doesn’t have a numerical inflation target. Legislation that would call for inflation targeting has been proposed many times in the U.S. Congress, but it has never gone anywhere. So inflation targeting is not much an issue for the Fed because the Congress is not committed to the concept.

In contrast, the Bank Indonesia Act gives both instrument and goal independence to Bank Indonesia. So it has a responsibility for choosing some numbers or goals. It is important to communicate the reason why a particular goal has been chosen and what happens if it is not achieved. As Mr. Boediono said, it is very important to develop the concept of independence by communicating, by taking position on certain issues. Every debated issue is very important to the future. And it is important to communicate the reason why having price stability is very important for the economy, strong growth and financial stability depend on price stability.

One thing a visitor to Indonesia quickly appreciates is how big it is, and how different the regions are. Some regions are booming and others are slumping, which is inevitable in any large economy. That is a reason for communicating even more about monetary policy. The upcoming decentralization of fiscal authority to the regions will be helpful. If fiscal policy can be used in certain regions, then monetary policy can focus on the whole country. This decentralization should improve the trade off between output stability and inflation stability.

The Exchange Rate

The exchange rate is clearly a very important variable in Indonesia. Even if inflation targeting is adopted I think it's inevitable that the interest rate is going to be adjusted in response to exchange rate developments, even if the interest rate doesn't make a big impact in the short run.

Inflation targeting, of course, requires some reaction to exchange rate developments because the latter may affect the domestic inflation through a pass-through or indirect demand effect. The open question for monetary research is whether there should be larger reaction in Indonesia than in other countries that have adopted inflation targeting. Perhaps, the experience of Brazil will be useful because of its similar size and openness. In any case, greater transparency about such a policy towards the exchange rate would make it work better.