Towards Improved Monetary Policy in Indonesia: Response to De Brouwer

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Abstract: This paper presents a number of responses to Gordon de Brouwer's criticisms of my paper on monetary policy in Indonesia. Among other things, it argues that de Brouwer has failed to disentangle the impact of two exogenous disturbances on prices—and relative prices—during the crisis and post-crisis period. These disturbances were *capital flight*, which resulted in real depreciation of the rupiah, and *rapid growth of base money*, which resulted in inflation. Thus all prices rose, but tradables prices rose more than those of non-tradables. The paper also shows that the kind of monetary policy that de Brouwer criticises, which I describe here as active monetary policy, or fine-tuning, is quite different from the one I proposed in my paper—namely passive monetary policy, the settings of which are changed infrequently, if at all. Other misstatements of my arguments and views are also discussed.

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My paper on monetary policy in Indonesia (McLeod 2003) had two main aims: first, to explain Indonesia's outlier performance in relation to inflation and depreciation during the Asian crisis; and second, to suggest a more appropriate approach to monetary policy for the future. In his Comment on this paper (de Brouwer 2003), Gordon de Brouwer asserts that Indonesia's burst of inflation and depreciation during the crisis was not caused by the rapid growth of base money, as I argued, but that the inflation was caused by the depreciation (in turn, the result of political factors that led to capital flight). He then goes on to criticise my preferred policy approach.

On the cause of the 1998 inflation episode

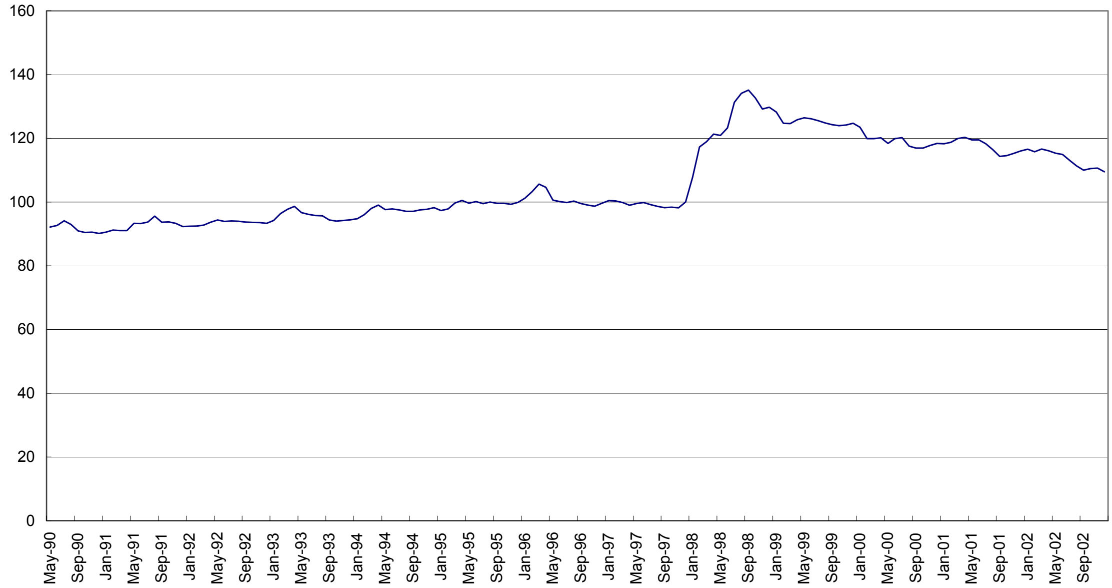
De Brouwer accuses me of confusing correlation with causation, arguing that '[t]he collapse of the rupiah created the inflation, not the injection … of funds [by Bank Indonesia, in its attempt to stave off collapse of the banking sector]' (p. 327). This view is widely held in Indonesia, and it has been used by the central bank to explain the inflation in 1998 and subsequently, and thus to absolve itself of responsibility. He goes on to argue that '[i]f base money creation were really the driver of inflation, there should have been no difference between traded and non-traded goods inflation' (p. 327). With a floating exchange rate, and other things equal, that is correct, but that is not the whole story.

As I noted at the beginning of my paper, there had been 'a significant increase in the perceived risk … of holding assets in Indonesia'. This could be expected to result in 'a reduction of capital inflow... [and] a real depreciation of the rupiah' (p. 303). In the period under consideration, prices were therefore being affected by both the expansionary monetary policy of the central bank *and* the loss of investor confidence. Base money growth caused both traded and non-traded goods prices to rise, but the need for a real exchange rate depreciation to restore equilibrium meant that traded goods prices rose more (figure 1).[1] The observed difference in the rates of inflation

[1] The real exchange rate is the ratio of prices of traded and non-traded goods.

for traded and non-traded goods noted in de Brouwer's Comment is therefore precisely in line with the entire thrust of my paper. It is de Brouwer's analysis that is shown by these data to be deficient because, although depreciation of the currency can be used as a proximate explanation for the increase in traded goods prices, it does not directly affect those of non-traded goods. De Brouwer provides no explanation for the surge in non-traded goods inflation to around 50% p.a. at this time.[2]

Figure 1 Real Exchange Rate
(Dec 1997 = 100)



Note: The real exchange rate shown here is the ratio of prices of traded and non-traded goods and services in the CPI.

Source: Bank Indonesia

My paper deals explicitly with this crucial issue in the section 'Headline and Core Inflation', but de Brouwer chooses to ignore my argument. If the nominal exchange rate depreciates as a result of a negative shock to the capital account, traded goods prices rise. On the innocuous assumption that the demand for money is positively related to prices, the demand for money rises as a result. If the stock of base money is held constant, the resulting excess demand for money must result in other prices—

[2] Ultimately (by September 1998) the market would be satisfied with a real depreciation of about 36% (falling to lower levels as the political situation stabilised; see figure 1). This is vastly less than the peak nominal depreciation of about 500%; roughly speaking, the difference reflects the inflationary impact of monetary policy.

i.e. those of non-traded goods—falling, in order for equilibrium to be re-established. If non-traded goods prices are observed instead to increase dramatically, the obvious explanation is that the money supply has also increased dramatically. This is exactly what we observed in Indonesia in 1998.

It is instructive to recall the stereotypical Latin American balance of payments crises of the past, which began with a large budget deficit funded by the central bank—that is, by the creation of base money. With the passage of time, money growth led to inflation and, under a fixed exchange rate, to a loss of competitiveness. The current account went into deficit and international reserves fell. As this became common knowledge, capital flight caused remaining reserves to disappear, thus forcing a devaluation of the exchange rate to a level at which domestic goods and services were once again competitive in the world market. In short, rapid base money growth (the cause of which is largely irrelevant) resulted in inflation and depreciation. The only reason why the exchange rate adjusted in a single step rather than continuously was the fact that central bank intervention was able to postpone the adjustment temporarily. This story is so well known that it is surprising that de Brouwer is so reluctant to concede that it still holds when the exchange rate is floating, as in Indonesia since August 1997.

On Friedman and inflation

In relation to Friedman's dictum that 'inflation is always and everywhere a monetary phenomenon', de Brouwer suggests that this is correct only because it is a tautology—since prices are expressed in money terms. This line of reasoning seems both vacuous and beside the point. We are concerned with inflation rather than prices, and inflation is *not* expressed in monetary terms. More important, Friedman's statement is an empirical finding rather than a tautology. The proper interpretation of it is that there has never been, in any country, a significant inflationary episode in which money has not increased rapidly; nor has there ever been, in any country, a significant episode of rapid money growth that has not been accompanied by inflation. The implicit argument in my paper is that the experience of the four crisis countries (Indonesia, Korea, Malaysia and Thailand) is entirely consistent with Friedman's finding.

De Brouwer apparently sees no merit in these observations: nowhere in his Comment is there any recognition that the rapid monetary expansion in 1998 contributed to the surge in inflation. His scepticism in relation to my arguments would carry more weight if accompanied by data that refuted the hypothesis—

examples of countries where base money increases of the order of 100% in six months were not accompanied by a burst of inflation such as Indonesia experienced in 1998, or examples of countries where prices increased by 80% in ten months while the supply of base money was held roughly constant. The reason for the absence of such data from his Comment is presumably that they do not exist.

On monetary policy approaches

Besides disagreeing with my diagnosis of Indonesia's inflation problems, de Brouwer also disagrees with my recommendation for the future conduct of monetary policy. Unfortunately, however, he has misunderstood what that recommendation is. My specific suggestion was that if, for example, the aim is to keep inflation at around 2.5% p.a., then 'base money … should be made to grow at 6% p.a.' (p. 318).

By contrast, de Brouwer asserts that

> [w]hen 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 (p. 326).

The implication is that this is my preferred approach, yet nobody who read my paper carefully could be under any illusion that this is the case. I said nothing whatsoever about inflation forecasts (except in discussing Bank Indonesia's approach), and I explicitly *argued against* fine-tuning (that is, altering monetary policy settings frequently in response to observed or predicted changes in economic conditions):

> ... it is a waste of time trying to fine-tune inflation ... it makes much better sense to keep the settings of monetary policy fairly constant so as to achieve a steady, low rate of inflation over periods of several months, *without being too greatly concerned by possible short run fluctuations* (emphasis added) (p. 318).

This seems fairly unambiguous.

The kind of monetary policy I advocate can be described as passive rather than active. In this approach, the job of policy makers is to estimate the rate of growth of base money that is consistent in the medium- to long-run with the target rate of inflation, and then to ensure that this rate of growth is maintained, only changing it infrequently (not more than every couple of years), and by a small amount, if it should become clear that actual inflation is consistently above or below the target. The issue of inflation forecasting does not arise, since the underlying principle is that in the medium- and long-run, inflation is not caused by outside factors but is determined by the policies of the central bank itself.

On headline and core inflation

Despite de Brouwer's suggestion, nowhere in my paper do I put what he refers to as the 'extreme monetarist view... that all movements in inflation are due to monetary shocks' (p. 327). On the contrary, I explicitly acknowledge that 'the ratio [of base money to nominal GDP]... is quite variable in the short run' (p. 319), which is equivalent to saying that prices move independently of base money within this time frame. This is the reason why I advocate maintaining a slow and steady rate of base money growth rather than an active monetary policy.

Thus de Brouwer's criticism of my preference for targeting headline inflation rather than underlying or core inflation, based on the example of seasonal fluctuations in the prices of fruit and vegetables, is misplaced, since we are, in fact, in full agreement on this point (although for rather different reasons).

More important, however, he totally ignores my arguments in favour of targeting headline, rather than core, inflation. For example, I pointed out that when the government changes administered prices, it obviously intends for them to change relative to other prices—and thus to remove what may be unplanned and unwarranted subsidies (as when it tries to raise electricity prices to levels that would allow the state electricity company to function without budgetary support). But Bank Indonesia's policy of targeting core inflation, and excluding administered prices when calculating it, has implications that run counter to this aim. Assuming core inflation is on target to begin with, then if administered prices rise (all other things equal), the demand for money rises, and this tends to reduce core inflation below the target level. Under its current approach, Bank Indonesia (BI) would respond to this by increasing the money supply, thus ensuring that the government's attempt to alter relative prices resulted in inflation (an increase in the level of average prices). The government would be blamed for causing inflation, whereas it should have been lauded for trying to remove a distortionary subsidy. The change in relative prices would not have been inflationary in the absence of the central bank's action.

On multiple objectives for monetary policy

De Brouwer also takes issue with my suggestion that BI should focus exclusively on inflation, without taking other macroeconomic conditions into account. The basis for his concern is that 'the variability of output rises at an increasing rate as the variability of inflation around the target is reduced' (p. 326). The related reference to 'the unnecessary output costs that are associated with strict short-term inflation targeting' (p. 326) seems to imply—again, wrongly—that this is what I am advocating. On the contrary: I am in fact one of the 'many economists [who] recommend that inflation-targeting central banks have a medium-term focus', to whom he refers (p. 326). The first point to note, therefore, is that this is not a criticism of my preferred passive control approach, since this explicitly does *not* call for tightening of monetary conditions whenever inflation deviates from the target. The second is that de Brouwer's concern here is a result from 'standard stochastic monetary models' (p. 326), whereas what matters is how things work in the real world. In this regard, I made the point in my paper that the relationship between monetary policy and the level of output in Indonesia is quite unclear, given our present state of knowledge, and seems at best very weak. If the central bank has virtually no idea about the impact on output of any change in monetary policy settings, then there is no point in including forecasts of output growth in determining those settings. De Brouwer ignores this argument, and fails to present any evidence to the contrary.

On interest rates and base money

According to de Brouwer, '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' (p. 327). This comes as some surprise to me: I made no reference to this view, let alone disparaging it; the term 'transmission mechanism' does not appear in my paper. This additional misstatement of my views helps draw attention to a source of confusion in de Brouwer's Comment, however. This arises from his tendency to treat changes in interest rates and base money as unrelated. In fact, of course, they are opposite sides of the same coin.

If BI wants to tighten monetary conditions, for example, it must reduce the stock of base money. In normal circumstances it does so by issuing SBIs (central bank certificates) through an auction process. To achieve the desired result, it can either set the interest rate (price) at which these certificates are offered, or the quantity that it offers. The choice between these alternatives depends on whether it is targeting the interest rate or the stock of base money but, having determined one, the market response then determines the other. In the simple case when the only concern is the inflation rate, the choice will depend, in turn, on the central bank's degree of confidence in its understanding of the relationship between interest rates and inflation on the one hand, and between base money and inflation on the other.

The experience of the crisis suggests strongly that we have very little understanding of the relationship between interest rates and inflation. The authorities had no idea as to what interest rate was appropriate during the early months of the crisis, as is indicated by the extraordinary gyrations of both controlled and market rates during this period. By contrast, my paper was at pains to argue that the medium- and long-term relationships between base money and the price level are reasonably clear, so that keeping the growth of base money slow and steady (as the other crisis countries did) would have helped to minimise the disruption resulting from the sudden flight of capital.[3]

On alternative policy approaches

Although de Brouwer makes it clear that he is opposed to my policy prescription, he offers little by way of a concrete alternative; presumably he supports the kind of approach set out in Alamsjah *et al.* (2001), which relies on the ability of the central bank accurately to forecast inflation and output growth. In the circumstances of an incipient balance of payments crisis such as Indonesia experienced in the second half of 1997 this becomes virtually impossible, so we can confidently predict that it will fail the next time Indonesia faces a significant macroeconomic shock. De Brouwer has no advice to offer in this respect. While conceding that 'Indonesia's inflationary performance in the post-crisis period does not seem to be as good as it could have been' (p. 328)—a considerable understatement, given the acceleration of Indonesia's inflation rate to peak at 15% p.a. in 2002 while the other crisis countries held theirs to levels below 5%—he offers no explanation of his own as to the nature of the policy deficiency.

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[3] De Brouwer does not comment on the fact that my policy recommendation has also been a feature of virtually all of the various letters of intent to the IMF. Unfortunately, the central bank's commitments in this regard were largely ignored in practice during the crisis.

Perhaps, as an ex central banker himself, he is reluctant to offer even constructive criticism of Indonesia's central bank, ending his Comment with the bland suggestion that 'there is always a place to encourage our central banks to do better' (p. 328). This, I think, is unhelpful. Surely, in fairly straightforward cases such as these, the economics profession should be able to offer concrete analyses of what has been going wrong, and concrete suggestions as to how policy performance can be improved.

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