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Effectiveness and commitment to inflation targeting policy: Evidence from Indonesia and Thailand☆

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ABSTRACT

The chief objective of our paper is to highlight basic features of the Information Technology (IT) policies adopted by Indonesia and Thailand, and to evaluate the commitment of the monetary authorities and the overall performances of the IT regime. The results demonstrate that the IT regime in these two economies has had some success, but not during the immediate aftermath of the Lehman Brothers' collapse in the last quarter of 2008. Furthermore, the implementation IT policy in these economies has largely been "flexible" during the stable period, seeking the balance between narrowing the output gap, managing exchange rate volatility, and anchoring inflationary pressure. However during the turbulent period, there had been a heightened focus on anchoring inflationary expectations.

1. Introduction

Managing price stability, especially for emerging economies with prohibitive vulnerability to sudden shifts in global investor sentiment, is imperative. The efforts to achieve this policy objective have been made more complex with unstable commodity prices and the global financial meltdown, triggered initially by sub-prime mortgage defaults in the United States. A number of policy initiatives have been carried out. To rein in the unwanted consequences of volatile capital inflows on the local currencies in particular, and on the domestic economies in general, most of the major Asian economies were often forced to resort to heavy sterilization (Table 1). However, facing the mounting cost and declining effectiveness of sterilization measures, a number of these countries have gradually introduced more flexible regimes of exchange rate and carried out the necessary adjustments in their monetary, fiscal, investment and trade policies. For some emerging markets, the adoption of a more flexible exchange rate policy signified initial steps toward the full adoption of inflation targeting (IT) as the anchor of their monetary policies in particular and their macroeconomic policies in general.

Two of the most severely affected economies by the 1997 East Asian crisis, namely Indonesia and Thailand, have officially adopted IT regimes. Although the process and the timing for the IT regime implementation varied between the two

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Table 1
Sterilization coefficients[a,b].

	2000–2007	2000–2002	2003–2004	2005–2007
India	−0.79*	−0.72*	−1.00*	−0.72*
Indonesia	−0.82*	−0.85*	−0.79*	−0.77*
Korea	−1.00*	−0.93*	−1.02*	−1.06*
Philippines	−0.85*	−0.72*	−0.92*	−1.15*
Thailand	−0.87	−0.91*	−0.69	−0.90*

Source: Asia Pacific Regional Economic Outlook, IMF, October 2007.
[a] The sterilization coefficient is the coefficient from a regression on the contribution of net domestic assets to reserve money growth on the contribution of net foreign assets to reserve money growth. Net domestic assets in the regression are defined as reserve money minus net foreign assets.
[b] An asterisk denotes that the null hypothesis of full sterilization (a coefficient equal to or smaller than −1) cannot be rejected at the 95% confidence level.

countries, the need to abandon the unsustainable rigid exchange rate policy, strengthen the operation of exchange rate policy, and improve effectiveness of monetary policy were among the common and principal motivations behind the adoption of the IT policy by these two major Southeast Asian countries.

There are two primary objectives of our paper. The first one is to highlight the basic features of the IT policies adopted in Indonesia and Thailand, and to evaluate their overall performances, especially during the recent turbulent years. We will first review a number of performance indicators such as price stability, growth rates and output volatility. Subsequently, our study will examine pass-through effects in both tradable and non-tradable prices, and effectiveness of the nominal exchange rate as a shock absorber.

The second objective is to examine the commitment of the monetary authorities of these two major Southeast Asian countries to implement the IT framework credibly. While this pertinent concern has been frequently debated in past studies, it has not been fully examined. The IT policy is credibly enforced if the monetary authority is committed to rein in inflationary expectations as a primary or one of the key objectives of its monetary policy reaction function during *both* stable and volatile economic environments (Bernanke & Mishkin, 2007; Schmidt-Hebbel & Tapia, 2002). Prior to 2007, a sustained mild global inflation environment induced price stability in general and reduced potential trade-off and cost of having low inflation in the local economy. However, uncertainties about global economic conditions have heightened significantly, particularly since early 2007, posing challenges to policy efforts to manage price stability. Hence, it is pertinent to evaluate the commitment of these two countries to their implementation of the IT policy, and more importantly, to draw lessons on the effectiveness of the policy during the turbulent period of the past few years.

Recent studies have been conducted on the above list of issues. Yet, most of these early works focused their analyses mainly on the implementation of IT policy in the industrialized economies, and only a few have attempted to examine the implementation of the IT regime in these two economies.[1] Our study hopes to fill in the gap in the literature and ultimately aims to draw further policy lessons for the other emerging markets around the globe.

This paper proceeds as follows. The next section briefly discusses policy backgrounds and basic economic performance indicators under the IT regime. Section three lays out the pass-through equation and the monetary policy rule framework to be tested in our study. The empirical section introduces the data sets and presents the findings of the autoregressive distributed lag (ARDL) for the pass-through effects. We employ the Markov-switching approach to examine the monetary reaction functions of the central banks. The test results allow us to compare and contrast the objectives of the monetary authorities of these two countries during the pre- and post-IT periods, and thus scrutinize their commitments to implement the IT policy. The last section concludes the paper.

2. Brief policy backgrounds and primary performance indicators

2.1. Policy backgrounds

2.1.1. Indonesia

Bank Indonesia (BI), the monetary authority of Indonesia, officially launched its IT policy as its new monetary policy framework in July 2005. Under the IT framework, the inflation target represents the overriding monetary objective set by the Indonesian government in coordination with BI. The authorities have initially allowed the headline inflation to fluctuate between the range of $9 \pm 1\%$ in 2003, before gradually revising the headline inflation target downward to $5 \pm 1\%$ for 2008 (Table 2).

Several reasons have been well documented as factors behind the move away from the past base money targeting framework to the current IT framework. To start, the effectiveness of the base money targeting policy of BI has significantly declined since the mid-1990s, especially during the period of the post-1997 East Asian financial crisis. Boediono (1998) underlined two reasons behind this. The first has to do with the open market instrument. The markets for the central bank

[1] Charoenseang and Manakit (2007) and Kubo (2008) have examined the monetary policy transmission in Thailand during the IT period. Alamsyah, Joseph, Agung, and Zulverdy (2001) discuss issues facing Indonesia during preparation stages of the inflation targeting policy.