BI INSTITUTE

CENTRAL BANK POLICY MIX

Dr. Solikin M. Juhro
Executive Director,
Head of Bank Indonesia Institute
Bank Indonesia

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KEY MESSAGES

Post-GFC Economic Challenges

Lessons Learned from the GFC

From Standard ITF to Flexible & Inregrated ITF: Road to CB Policy Mix

- Monetary & Macroprudential Policy Integration
- Capital Flow Management

Challenges Ahead:

- Maintaining Growth under **'The New Normal'**
- Managing Digital Economy Uprising

Central Bank Policy Mix

("Integrated Policy Framework")

Closing

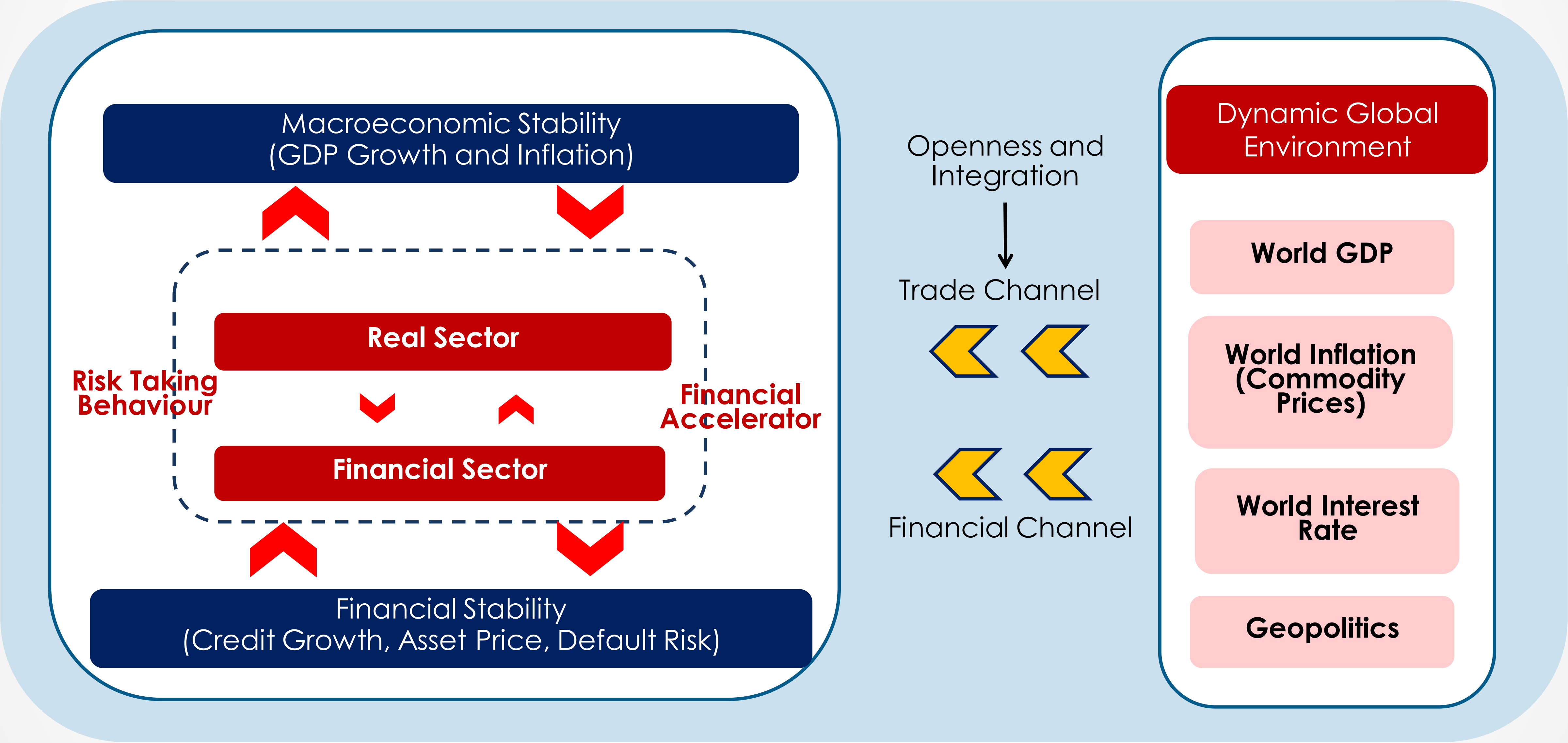
Flashback: Inflation Targeting Framework (ITF)

UU No.23 Tahun 1999 menjadi dasar bagi Bank Indonesia untuk menerapkan kerangka kerja Inflation Targeting sbg kerangka kerja kebijakan moneter di Indonesia (secara formal pada 1 Juli 2005) ....

No	Kriteria	Bernanke et al. (1999)	Svensson (2000)	King (2004)
1.	**Kestabilan harga** sebagai tujuan utama kebijakan moneter	Ya	Ya	Ya
2.	**Pengumuman target** inflasi	Ya	Ya	Ya
3.	Target inflasi **jangka menengah**	Tidak jelas	Ya	Ya
4.	**Komunikasi intensif** dengan publik	Ya	Ya	Ya
5.	Penggunaan **kaidah kebijakan** (*rule*) moneter secara spesifik	Tidak jelas	Penargetan prakiraan inflasi	Penargetan inflasi + respon thd sisi penawaran
6.	**Publikasi** prakiraan inflasi dan output	Tidak perlu	Ya	Tidak jelas
7.	**Target** ditetapkan oleh pemerintah (*goal dependence*)	Ya	Tidak perlu	Tidak perlu
8.	**Penggunaan instrument** secara independent (*instrument independence*)	Ya	Ya, tetapi tidak disebutkan secara tegas	Ya

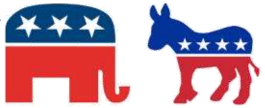
Post-GFC Challenges:

Managing Monetary & Financial Stability in a Dynamic Global Environment



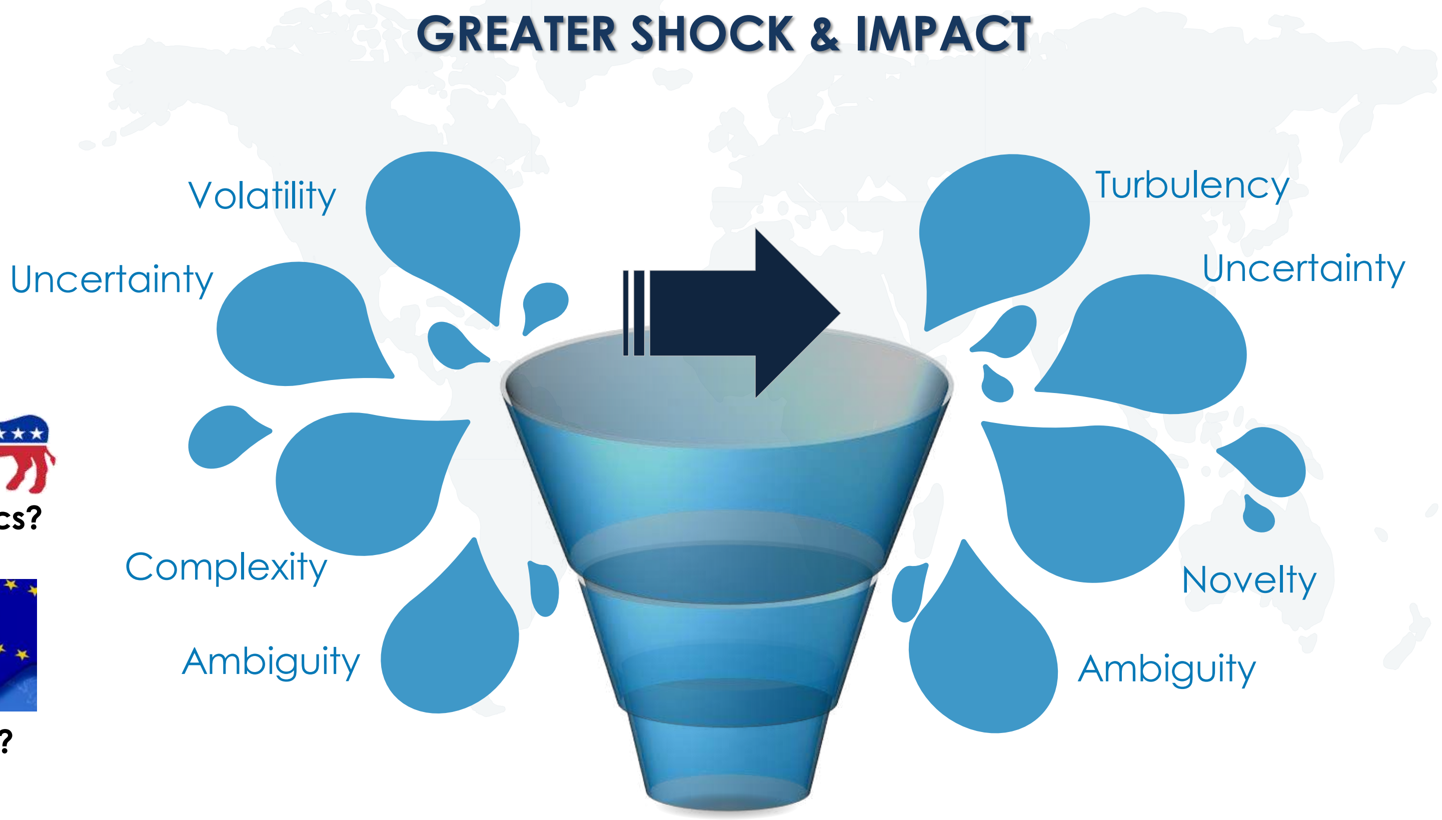
Post-GFC Challenges:
From VUCA to TUNA


Monetary Policy Normalization


Trumponomics?


Oil Price Volatility


EU Post Brexit?




Capital Outflow from EM Globally


Trade War


Turkey Geopolitics

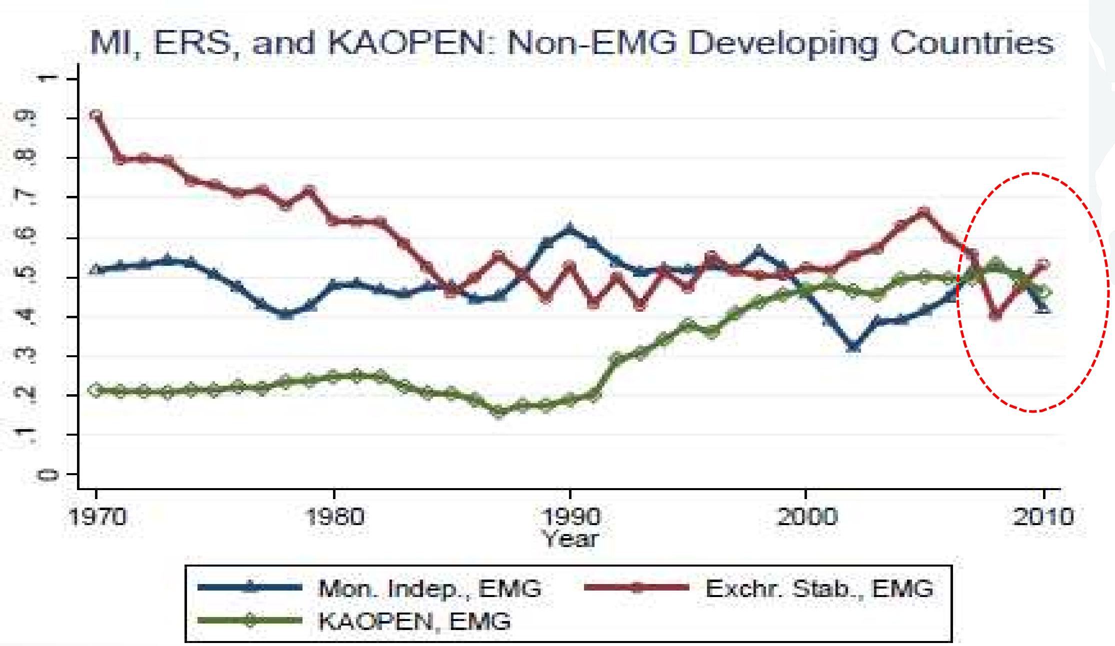

US-North Korea Relation

(Im)Possible Trinity Solution

Policy Trilemma....
"overtime, the three goals cannot be attained simultaneously" (Mundel, 1968). "only two out of three" conditions above can be applied together"

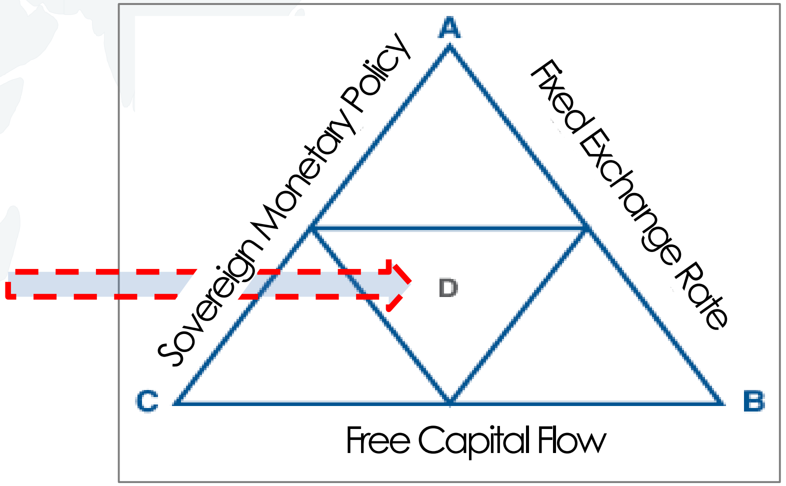
"The impossible trinity was managed by preferring middle solutions of open but managed capital account and flexible exchange rate but with management of volatility. Rather than relying on a single instrument, many instruments have been used in coordination." (Mohan and Kapur, 2009).

(Im)possible Trinity Evaluation in Emerging Markets



Source: Juhro,2014

Policy Trilemma



1 : 1 : 0 **"can reach only two of three"**

Vs.

2/3 : 2/3 : 2/3 **"possible to manage the three"**

Lessons Learned ….

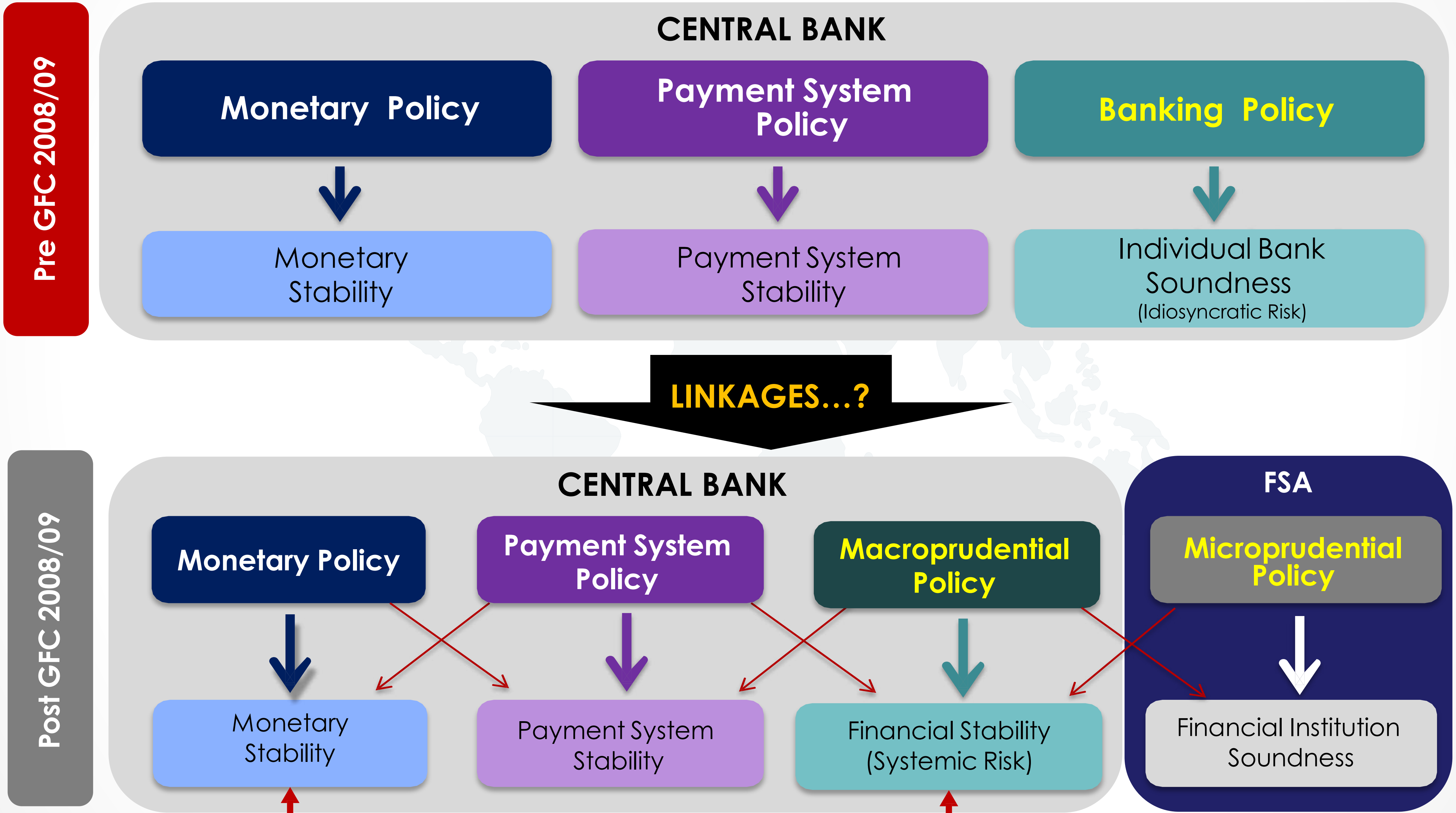
- ***"There is no macroeconomic stability without financial stability".*** Maintaining price stability, without maintaining financial system stability is not enough (insufficient) to achieve macroeconomic stability.
- **Capital flow dynamics lessen monetary policy effectiveness.**
- **Exchange rate dynamics are largely influenced by investor risk perception; need for managing the exchange rate in order to avoid excess volatility.**

➢ **The multiple challenges as a result of dynamic capital flows imply that monetary authorities should employ multiple instruments (a policy mix).**

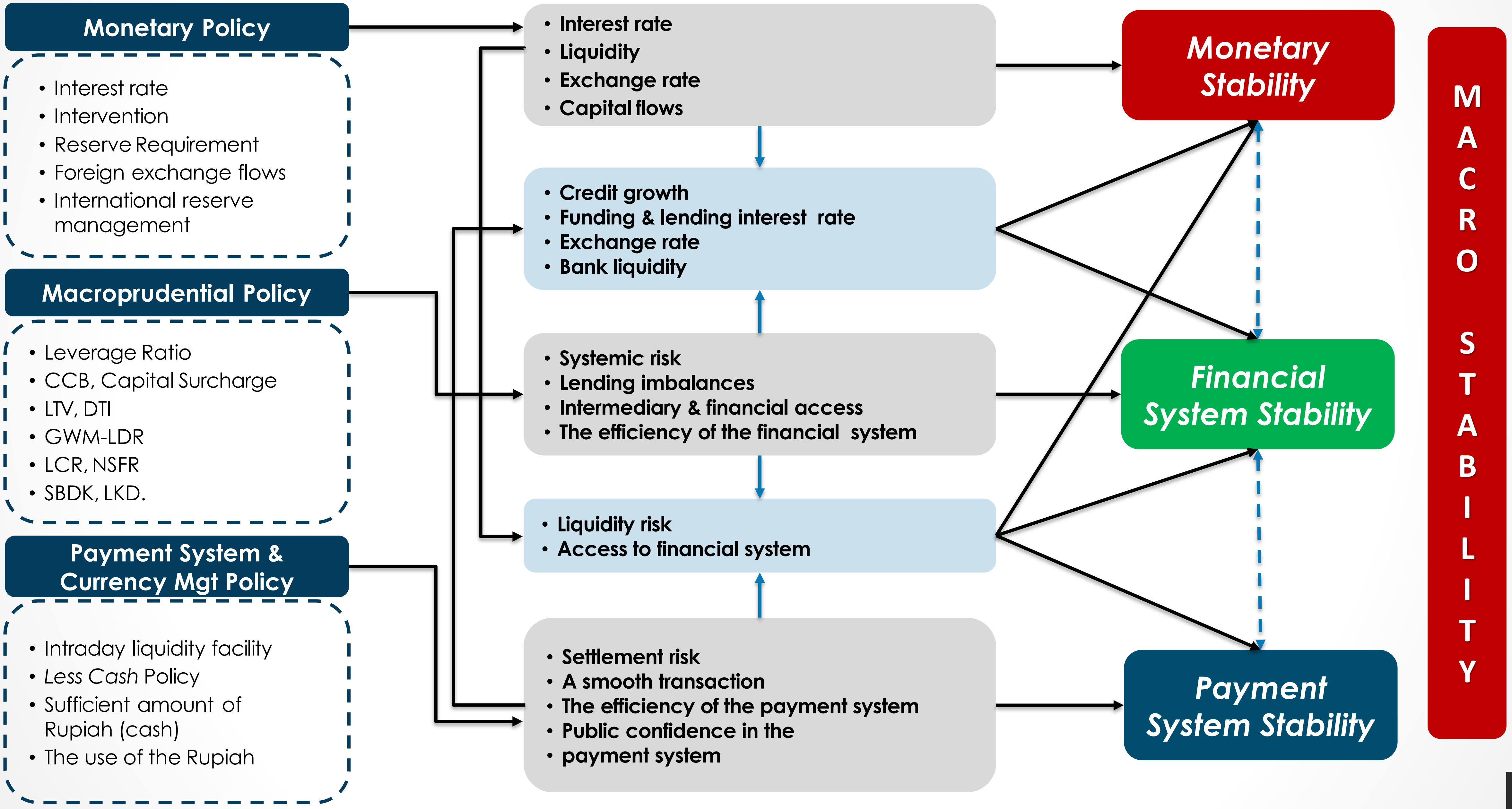
➢ **It requires integration of monetary and macroprudential policy, including capital flow management and exchange rate policy.**

➢ **Managing the 'Trilemma': Impossible Trinity vs Possible Trinity**

Post-GFC Central Bank Policy: Pivotal Linkages



Post-GFC Central Bank Policy: Pivotal Linkages



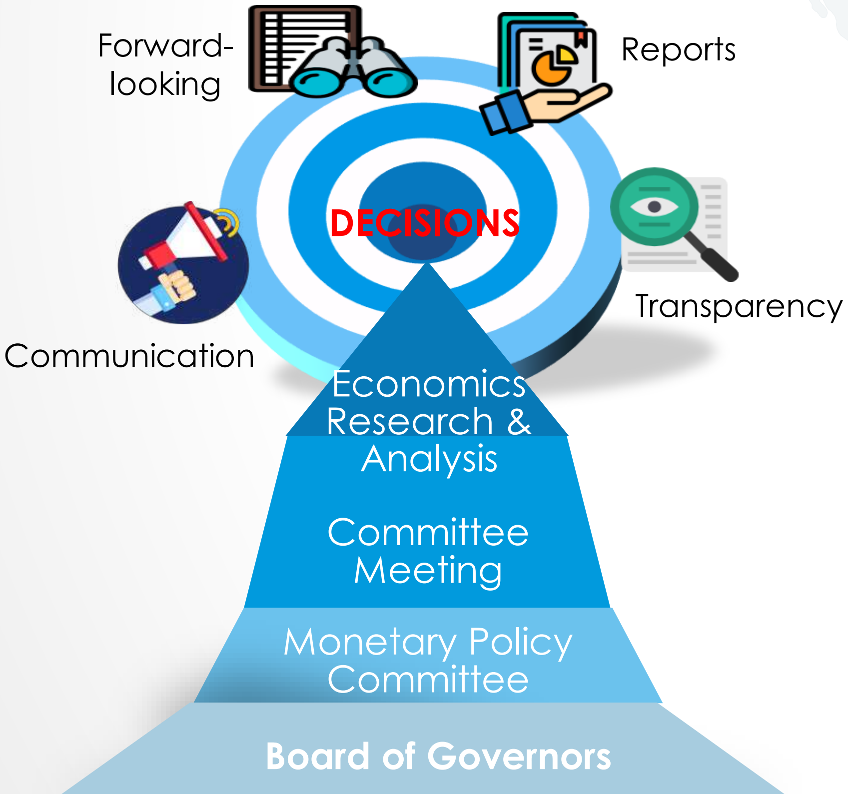
From ITF to Flexible ITF

Mishkin (2011): "none of the lessons from the financial crisis in any way undermines the nine basic principles of science of monetary policy".

Standard Inflation Targeting Framework (ITF) which solely rely on interest rate policy to achieve the inflation target is not always effective in EM countries.

Enhancement

Flexible ITF was built while remaining grounded in the important elements of the ITF that had been built.
(Juhro & Goeltom, 2012; Juhro, 2016)

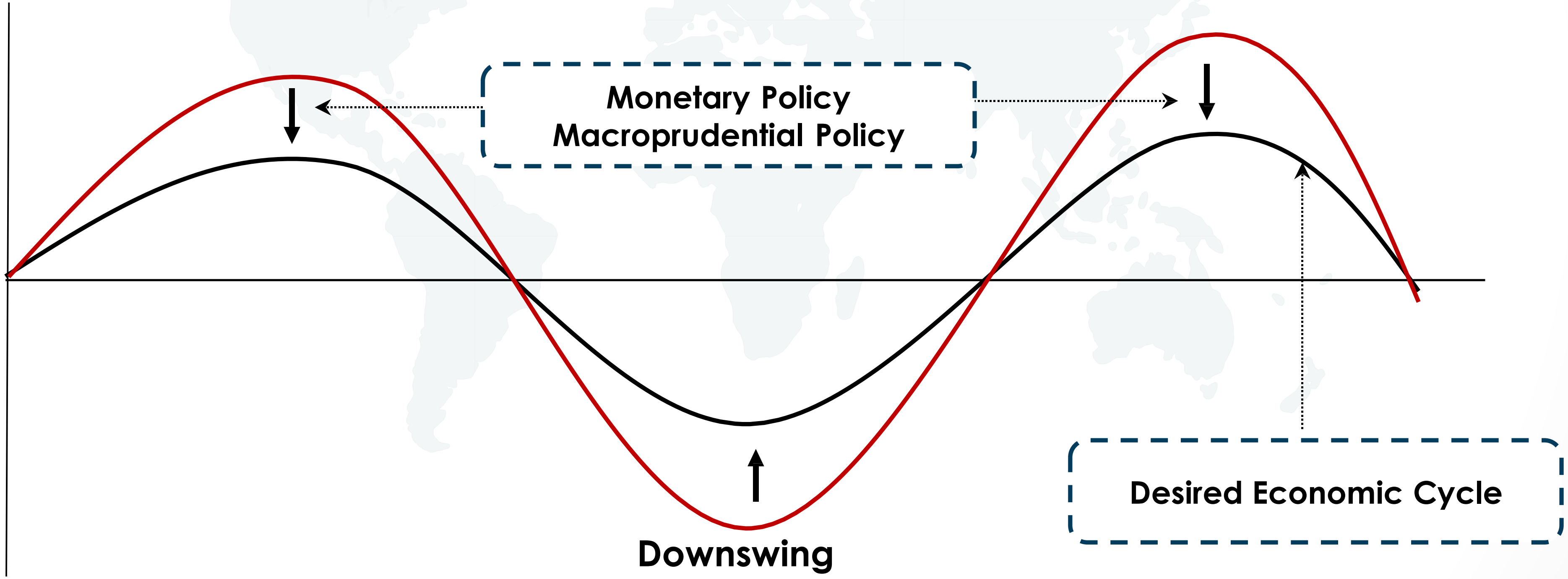


Key Elements of Flexible ITF

- **Inflation remains the main target of monetary policy.**
- Monetary policy and macroprudential policies integration
- Strengthening exchange rate policies & capital flows
- Strengthening policy coordination between CB & Government
- Strengthening policy communication as part of policy instruments.

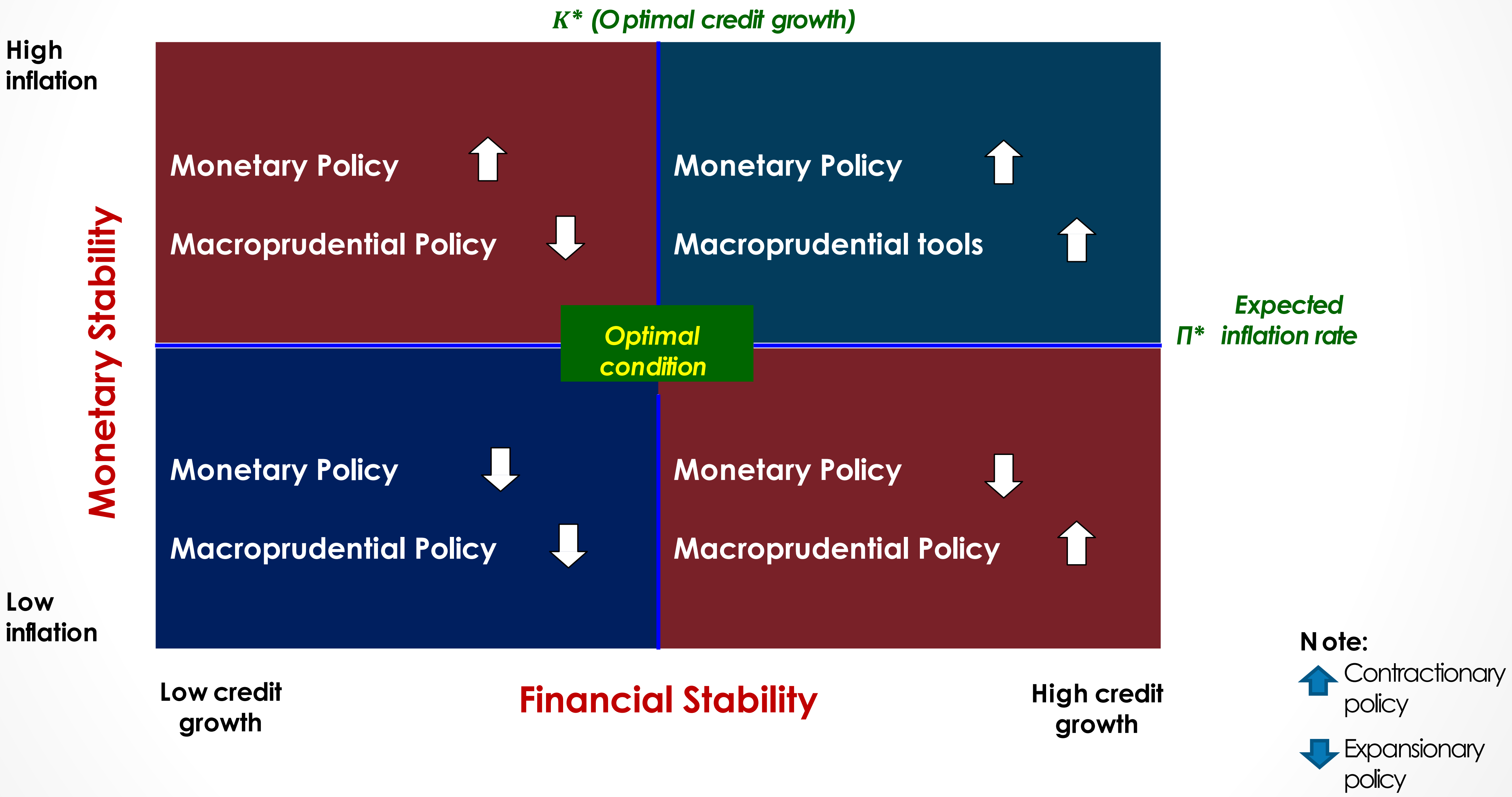
Monetary & Macroprudential Policy Integration

“Macroprudential policy seeks to develop, oversee and deliver appropriate policy responses to the financial system as a whole. It aims to enhance the resilience of the financial system and dampen systemic risks that spread through the financial system”. (The G-30).



Monetary and macroprudential policies are countercyclical measures to reduce magnitude of the business and financial cycles and they are reinforcing each other.

Monetary & Macroprudential Policy Integration



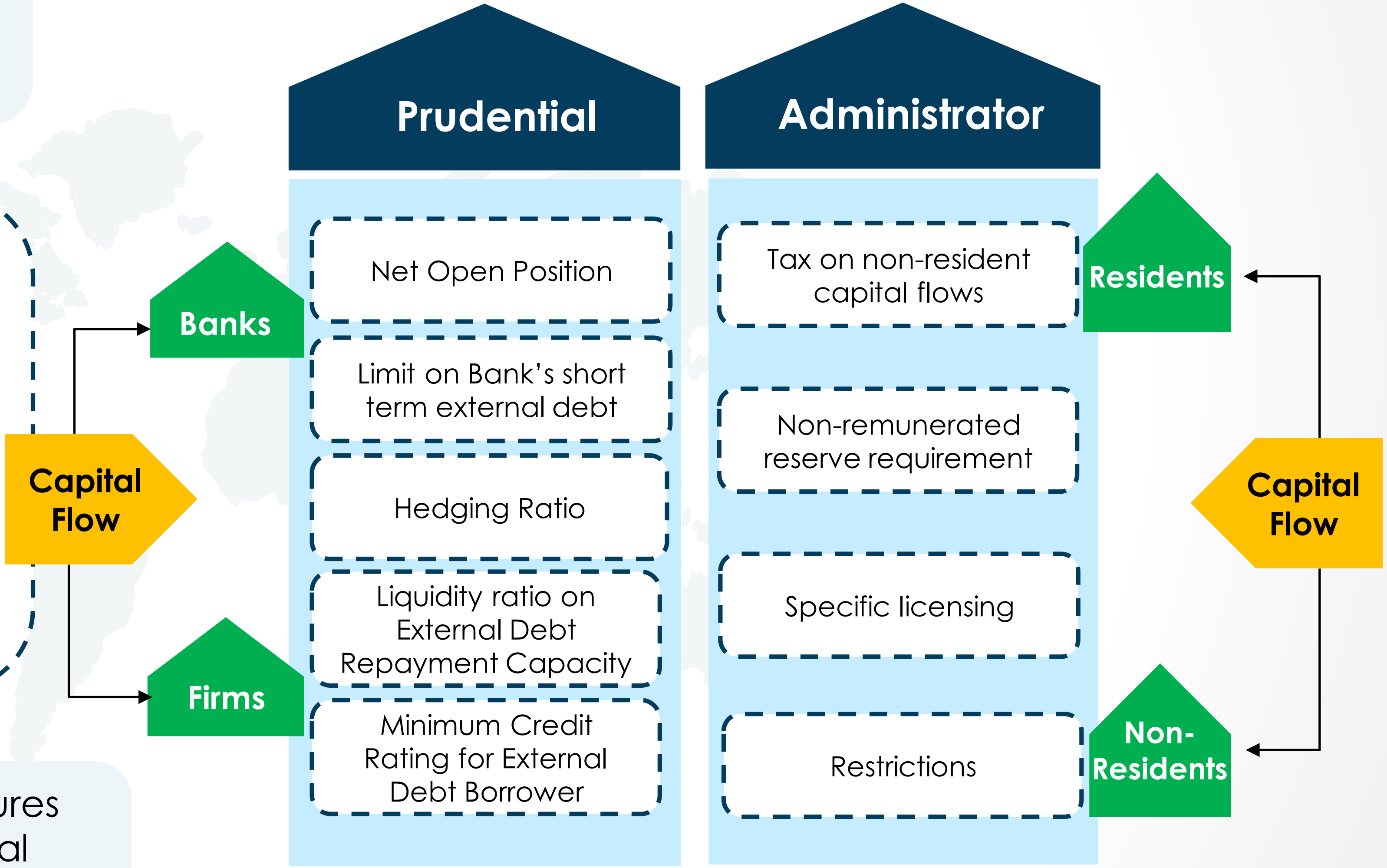
Capital Flow Management (CFM)

The IMF's "institutional view" (2012): CFMs refer to measures that are designed to limit capital flows, and encompass both measures that discriminate on the basis of residency and those that do not.

Goals of Capital Flow Management

- Support exchange rate stability, and prevent the risks of balance of payments crises and sudden-stop capital reversal.
- Mitigate pro-cyclical and systemic risks from external debt accumulation and the volatility of foreign capital flows.

CFM's Instruments: Prudential & Administrative



Macroprudential measures refer to measures that are designed to limit systemic financial risks, including risks associated with capital flows.

Integrated Policy Responses to Capital Flows (Indonesia's experience)

Monetary Policy Measures

- Sterilized FX market intervention
- Dual intervention (FX and bonds intervention simultanously)
- Interest rate
- FX Reserve acummulation

Capital Flows Management

Minimum Holding periods for short term bills (CB bills)

- Increase duration during inflows
- Reduce duration during outflows

Macroprudential Measures

- Increase RR Rp. and FX and Secondary RR
- Limiting Short Terms Borrowings Exposure of Banks (eg 30% capital)
- Risk Management of Corporate FX borrowings (hedging requirement, FX liquidity req, credit rating)
- LDR-linked reserve requirement
- Loan To Value Ratio for Housing Loans and Down Payment Rule for Automotive Loans

Structural Policy

- Financial market deepening (FX market, bonds market and money market)
- Export proceed regulation

Bank Indonesia's Trilemma Management

Policy instrument mix is an important strategy to optimally manage monetary policy trilemma

Monetary and Macro-prudential Policy (instrument) mix

Maintaining monetary policy autonomy to achieve price stability and financial stability

- Interest rate to address inflation expectation
- Macro-prudential measures to manage liquidity and financial stability

Exchange Rate Management

Stabilizing exchange rate movement in line with its fundamental

- Foreign exchange intervention to smooth out ER volatility
- Manage foreign exchange reserve adequacy: acummulate FX reserves during inflows and use the reserve during outflows (self insurance)

Capital Flow Management

Managing capital flow to support macroeconomic stability

- Macroprudential to manage capital flow, especially short term and prevent external sector risks (i.e. sudden stop capital reversal) .
- Promote financial deepening (FX market, bonds market, money market)
- Support foreign exchange reserves management as a form of self-insurance.

Source: Juhro & Goeltom, 2012; Juhro, 2015

CB Policy Framework under Flexible ITF

Policy Instrument

Monetary Instruments
- Policy Rate
- Forex Intervention
- Liquidity Management

Macroprudential Instruments
Regulation on:
- Liquidity
- Credit
- Capital

Macroprudential Surveillance

Operational Targets / Transmission Channels

- Interest Rate
- Exchange Rate
- Credits/liquidity
- Expectation

Risk potential/perception:
- Liquidity risks
- Credit risks
- Market risks

Solvency

Intermediate Targets

Policy Trilemma:
- Monetary Autonomy
- Exchange rate stability in line with fundamental
- Managed capital flows

- Financial Resilience
- Balanced intermediation
- Financial Inclusion

Overriding Objective

Monetary Stability (Price Stability)

Financial System Stability

Communication

Policy Coordination

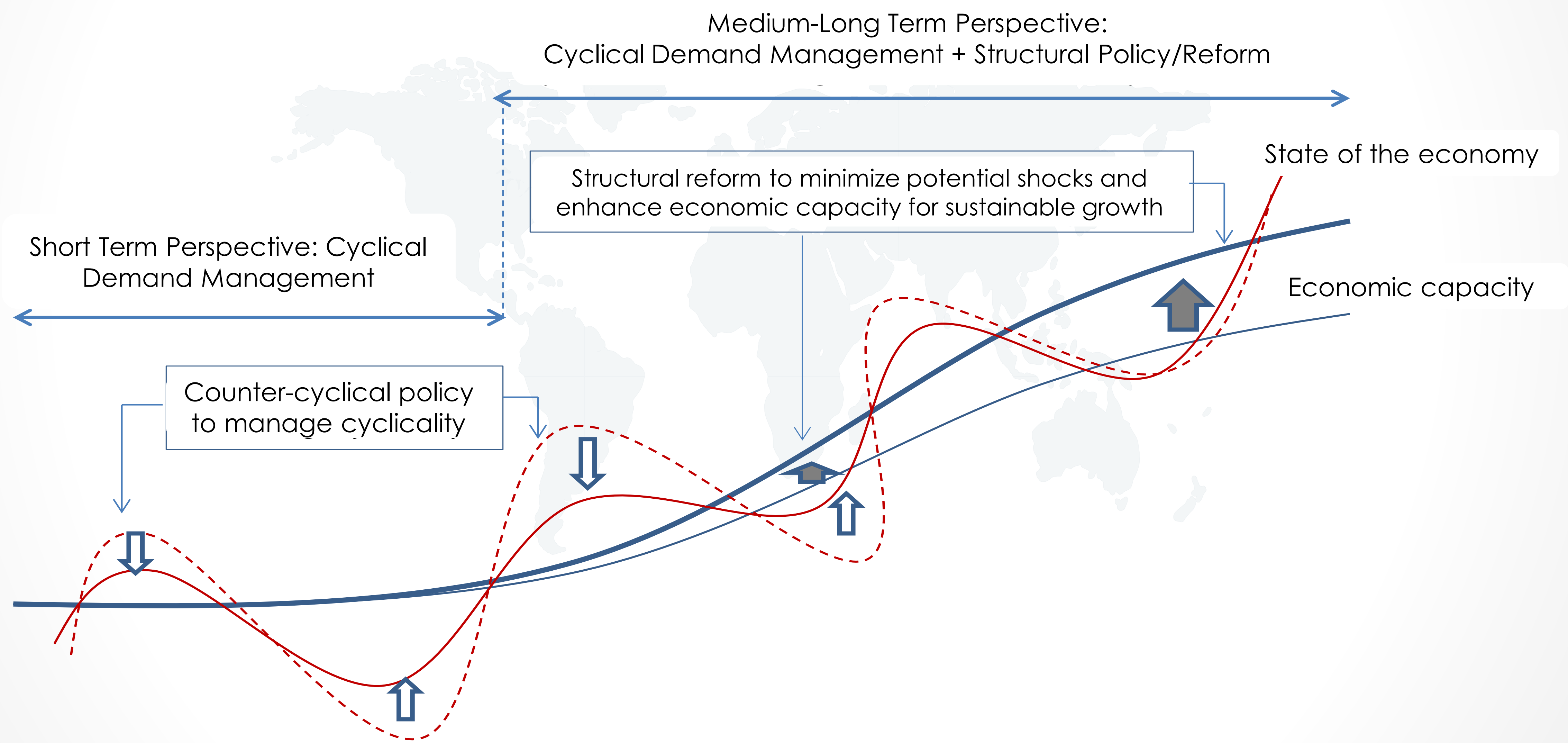
Source: Juhro & Goeltom, 2012

Flexible vs. Integrated ITF: Road to CB Policy Mix

<table>
<tr><th colspan="3">Flexible IT and IIT regimes</th><th>Table 7.1</th></tr>
<tr><th colspan="2"></th><th>Flexible IT</th><th>Integrated IT</th></tr>
<tr><td rowspan="4">Objectives: macroeconomic stability</td><td>Price Stability</td><td rowspan="2">Inflation target (point/centre of band) using Taylor rule for short-term interest rate</td><td rowspan="3">Inflation target (point/centre of band) using state-contingent, augmented Taylor rule for jointly calibrated short-term rate with financial/credit argument</td></tr>
<tr><td>Output Stability</td></tr>
<tr><td rowspan="2">Financial Stability</td><td>Microprudential</td></tr>
<tr><td>Floating exchange rate</td><td>Macroprudential instruments + floating exchange rate with FX interventions, not peg/fix, but smooth volatility and impact on balance sheets</td></tr>
<tr><td rowspan="4">Institutional arrangement</td><td>Price Stability</td><td>Monetary Policy Committee</td><td>Monetary Policy Committee</td></tr>
<tr><td>Financial Stability</td><td>Prudential Authority</td><td>Financial Stability Committee</td></tr>
<tr><td>Location</td><td>Two independent agencies</td><td>Mostly within same agency (central bank)</td></tr>
<tr><td>Operational modus</td><td>Separation</td><td>Coordination</td></tr>
<tr><td rowspan="4">Supportive policies</td><td>Financial debt sustainability</td><td>Fiscal rule on consolidated public sector deficit</td><td>Fiscal rule on consolidated public sector deficit + stabilization fund (commodity exporters) + prudential rules on private sector debt, especially FX-denominated</td></tr>
<tr><td rowspan="3">Capital flows</td><td rowspan="2">Open capital account floating exchange rate</td><td>Open capital account, floating exchange rate with: (upswing) ER appreciation, macroprudential instruments up to CFM; (downturn) ER depreciation, FX intervention for smoothing, not to set level</td></tr>
<tr><td>Spillovers and spillbacks of policies including macroprudential instruments call for some international coordination</td></tr>
<tr><td>Reserve accumulation and (IFIs) external credit lines</td><td>Reserve accumulation and (IFIs) external credit lines and bilateral/regional swap lines</td></tr>
</table>

Source: Agenor and Da Silva (2019)

Challenges Ahead:
Macroeconomic Stabilization under "The New Normal"



Source: Juhro,2015

Challenges Ahead: Digital Economy Uprising

- Efficiency vs stability
- Money vs technology
- Intermediation form
- Crossborder payments

Global Prospects

Global economic recovery
Increase in commodity prices

Domestic Prospects

Domestic economic recovery & structural reforms
Lower current account deficit

GLOBAL

Increasing Pressure on Global Inflation

US Policy:

- Fiscal Expansion & Tight Monetary
- Relaxing the Financial Regulations
- Protectionism

EU: Increase in Geopolitical Risk

- Populism

Challenges

DOMESTIC

Pressure on Currency from Global

Increasing Pressure on Inflation:

- Increase in administered prices & volatile foods prices

Optimizing monetary transmission:

- Slow decrease on lending rates
- Weak overall lending figures

Financial Stability:

- Banking & corps consolidation
- Credit risk: NPL

Central Bank Policy Mix

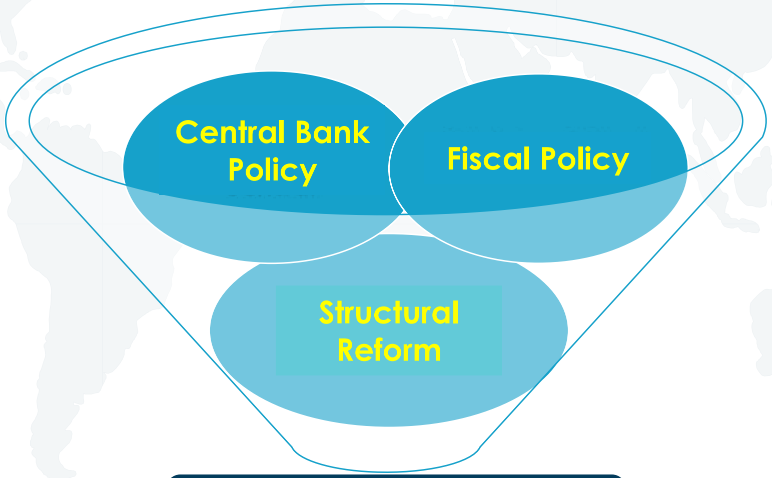
"Integrated Policy Framework"

Central Bank Policy Mix is directed at continuing to strengthen economic stability and maintain the momentum of economic growth

The central bank's POLICY COORDINATION with the Government's fiscal policy and structural reforms is SUFFICIENT to promote high and inclusive growth, while maintaining macroeconomic and financial system stability.

Central Bank Policy

- **Goal:** Maintaining price stability and supporting financial stability
- **Mix of instruments:** interest rates, exchange rates, capital flow management, and macroprudential policies



Fiscal Policy

- Maintaining macroeconomic stability through credible fiscal deficits and public debt.
- Tax policies and allocation of productive expenditures for high and inclusive growth stimulus.

Structural Reform

- Achieve high growth through the productivity of capital, labor, and technology improvements.
- Reforms in infrastructure, investment climate, trade and labor sectors.

Source: Warjiyo & Juhro, 2016

Economic Policy Coordination in Indonesia

Policy coordination between Bank Indonesia (BI), the Government and related authorities will continue to be promoted to maintain macroeconomic stability and encourage economic growth...

1 INFLATION CONTROL

National & Regional Inflation Control Team (TPI & TPID). Programs to cope with availability of supply, affordability of price, smooth distribution, eEffective coordination.

2 IMPROVEMENT OF ECONOMIC STRUCTURE

Quarterly Coordination Meeting between Central-Regional Governments and BI (Rakorpusda) focused on improving the current account deficit, investment financing, especially infrastructure, and the development of digital economy & finance.

3 FINANCIAL SYSTEM STABILITY

- **KSSK (FSS Committee).** Prevention and handling of financial crises.
- Harmonization of **BI-OJK (FSA)**'s macro-prudential-microprudential policies.
- **BI-LPS (Deposits Insurance Corp.)** Coordination.

4 FINANCIAL MARKET DEEPENING

The FK-PPK (Coordinating Forum for Financial Market Deepening) focused on innovating economic financing instruments through financial markets, infrastructure development and expanding the investor base, and harmonizing regulations

5 DIGITAL ECONOMY & FINANCE

- ✓ **Coordination between BI-OJK** on digital financial policies in the payment system with digital financial policies to encourage financial intermediation.
- ✓ Coordination across ministries and agencies to build a digital economic & financial ecosystem.
- ✓ Establishment of a **National Committee for the development of digital finance.**

Technical Aspect of Implementation

Several aspects that need to be considered to make instrument mix work optimally: (Juhro, 2014):

signals (source of risks) necessary to elicit a response

Origin, trigger, built-in period, impact, indicator (EW).

response characteristic

Macroprudential policy rule: cyclical & cross sectional risks. Mix policy rule?

timing of implementation & (pro)**cyclicality**

Different lag/frequency Timing to activate/end policy responses

effectiveness and **calibration** of policy measures

Developing theoretical framework. Policy modeling & simulation.

policy **communication**

Clear signals, facilitating public accountability, info sharing, “balancing act”.

Closing

- Against the backdrop of a dynamic global environment, **multitude of challenges** confronting the EMEs demand a policy mix response utilizing **multiple instruments**.

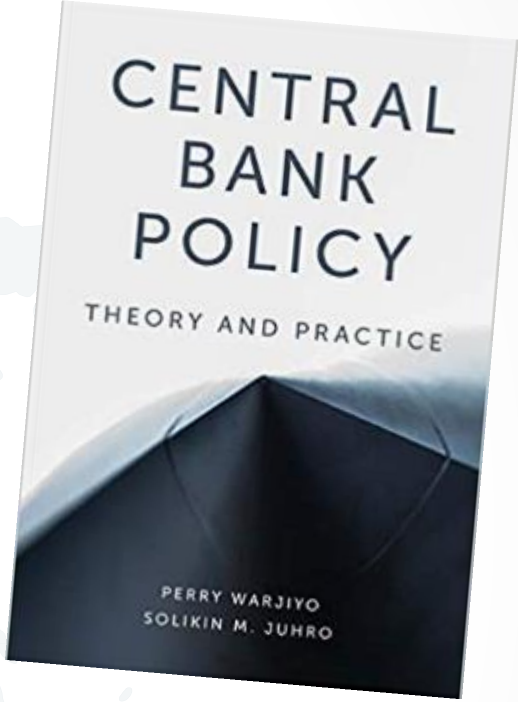
- In the initial period of post-GFC, monetary policy framework enhancement in Indonesia is, in general, characterised by the **'Flexible' ITF.** It continues to adhere to an inflation target as the overriding objective of monetary policy. The main characteristics of ITF remain; yet, ITF is implemented in a more feasible way.

- Further framework enhancement implies that **central bank policy mix** is ultimately part of an important strategy to optimally manage central bank **policy trilemma** in the current climate blighted by widespread uncertainty.

- Under central bank policy mix, strengthening **policy coordination between central bank and government** is SUFFICIENT, in maintaining the momentum of economic growth, while safeguarding monetary and financial system stability.


KEBIJAKAN
BANK SENTRAL
TEORI DAN PRAKTIK
4835.143
Dr. Perry Warjiyo
Dr. Solikin M. Juhro

THANK YOU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POLICY
THEORY AND PRACTICE
PERRY WARJIYO
SOLIKIN M. JUHRO