Inflation Targeting in Indonesia: Trade-off and Strategy

Abstract
This paper examines the relevance and prospect of inflation targeting framework (ITF) in Indonesia, and such an exercise is facilitated by a dynamic stochastic general equilibrium (DSGE) with New-Keynesian features. There are four research questions to be addressed:
1) what are the social cost of ITF, 2) how should the cost be minimized, 3) what inflation should be targeted, and 4) can managed float regime increase the effectiveness of ITF. In this paper, we provide several interesting findings. The adoption of ITF in Indonesia can in fact reduce the volatility of inflation and thereby inflation becomes more manageable easing up the process of targeting itself. However, this can only be achieved by sacrificing output stability. Thus, there is a trade-off between price and output. In order to reduce the trade-off, the central bank should opt to a right strategy which can be chosen either discretionary, simple Taylor rule or commitment. Based on our simulation, policy under commitment is far more superior to other two strategies. Commitment yields the lowest trade-off and volatilities and therefore the social cost can be kept very low. Interestingly, the effectiveness of ITF is not improved by the choice of inflation types as well as exchange rate regime. The use of consumer price index (CPI) inflation as the target can only improve marginally the effectiveness compared to core inflation. There is no evidence that moderating the exchange rate stability can enhance the effectiveness.

Keywords: Inflation targeting framework, discretion, Taylor rules, commitment.
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