

Indonesia's Monetary Policy Dilemma-Constraints of Inflation Targeting

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Abstract

This research was motivated by current constraints on macroeconomic policy-making in Indonesia. On the fiscal side, the government is burdened with debt and the pressure to maintain social expenditure. On the monetary side, there is a preoccupation with a lower inflation rate which conflicts with the need to maintain liquidity in a repressed economy. By examining the inflation-growth relationship, this study examines whether there is any room for inflating the economy. This would ease the pressure on government debt repayment while maintaining social expenditure, and the fragile economic recovery would not be stalled by prematurely tightening monetary policy. The study finds a two-way relationship between inflation and growth; but there is some evidence of long-run neutrality of money. This implies that inflation is unlikely to affect economic growth adversely in the long-run. Based on a simple model that explicitly takes into account inflation-growth trade off, it is found that there is room for a higher inflation rate than what is currently targeted. Thus, this study favours a more expansionary macroeconomic policy mix.

Keywords: Inflation, Economic Growth, Monetary Policy.