CHAPTER I

INTRODUCTION

1.1 Background

For the last two decades, s growing numbers of countries have introduced what's known as "inflation targeting." The hallmarks of this approach are an explicit commitment by the central bank to keep an inflation index close to a periodically-adjusted target, and the use of an inflation forecast as the intermediate target for policy. IT regimes stress a high degree of transparency, supported by regular public statements that interpret inflation outcomes and explain monetary policy actions in terms of the inflation objective.

Inflation targeting (IT) is generally defined as a monetary policy framework where in the central bank would adjust the policy interest rate to keep the conditional inflation forecast close to the inflation target, and to achieve price stability and low inflation as the primary objectives of monetary policy. The initial phase, It was adopted mainly in developed countries. Due to successful experience especially in terms of price stabilization, the introduction of IT has spread not only to other developed countries but also emerging and developing countries.

The predecessor of inflation targeting was monetary targeting (where central banks target money supply growth), but it encountered several difficulties in the 1980s, so a discussion about its successor began. Gradually, inflation targeting had been considered the most suitable approach. The first country which, in March 1990, adopted inflation targeting was New Zealand. Later on, this framework was also chosen by major developed countries. It was broadly supported by academia, among others also by current Fed chairman Ben Bernanke and one of the most prominent scholars in the field of monetary policy Frederic Mishkin. The policy framework proved to be very successful and became the main monetary policy strategy in the previous two decades.

Inflation targeting is becoming a standard operating procedure for central banks around the world. By mid-2008, most central banks in the OECD countries and growing number of developing economies had adopted inflation targeting. There is no international coordination to promote this monetary regime change, and the countries do not join an internationally recognized monetary system nor follow common “rules of the game “. Adopter of inflation targeting do so primarily because of the framework’s perceived success in delivering low and stable inflation.

Despite its popularity, there is substantial controversy and mixed empirical evidence in the evaluation of the inflation-targeting framework. There are two main empirical approaches. The first approach focuses on the macro-economic outcomes of countries following inflation-targeting regime as and the second approach is the influences of real exchange rate to IT regime. Although few argue that inflation targeting has harmful effects, there remains a vigorous academic and policy debate over whether the adoption of this monetary regime in advanced industrial countries has contributed to substantial declines in average inflation, lower inflation volatility, and general macro-economic stability compared to those countries not following inflation-targeting rules.

The second empirical approach evaluating inflation-targeting (IT) policies focuses on central bank behavior under inflation targeting and how they operate in an IT environment. Even this strand of the literature there mixed evidence over whether formal adoption of an inflation-targeting regime substantively changes the behavior of central banks, and in particular their responses to inflation and output. Earlier empirical literature tended to explore IT largely in industrial countries, while there is limited evidence of IT less developed countries partly because of the lack of data as well as the credibility problem of central banks.

This thesis investigates the empirics of inflation targeting in three ASEAN economies within the context of the second strand of the literature-central bank operating behavior. We focus in particular on ASEAN central banks responses to inflation, output, and real exchange rate. This study aim is to distinguish between episodes when central banks are committed to an explicit inflation-targeting monetary regime and those periods of time when they are not (including central banks that have never followed inflation targeting).

This study focus on two factors critical to the conduct and control of monetary policy in ASEAN-wide swings in the real exchange rate. We demonstrate, in the context of a simple illustrative model, that these distinguishing characteristics are in principle important designing the form of the monetary policy rule. For experiencing large real exchange rate shocks that can affect potential output a modified version of inflation targeting dominates a pure inflation targeting strategy.

The empirical work is based on time series data so as distinguish between group characteristics, respectively, of the inflation-targeting central banks

ASEAN and further between commodity exporting inflation targeters from other IT regime countries. We characterize inflation-targeting strategies in the context of a modified Taylor Rule operating procedure (as well as inflation-targeting industrial countries). Moreover, our focus is on real of the real exchange rate in the policy rule and how this is affected by the countries exposure to inflation and other macroeconomics variable.

Some factors motivate this empirical research. Firstly, the great bulk of the research in this area is concerned with the inflation targeting in advanced industrial countries and relatively less research address the particular features of inflation targeting in ASEAN. There are many reason that emerging markets may differ from industrial countries in the approach to inflation targeting. These reasons include different institutional arrangements, especially those relating to the credibility and political independence of the central bank, different inflation and macro-economic histories, different exposures to the terms-of-trade shocks, and different levels of financial development. Secondly, this study emphasis is on introducing real exchange rate fluctuations into the inflation-targeting framework. Real exchange rates are likely to play an important role in the formulation of optimal monetary policy in ASEAN. The last factor, we follow a time series methodological approach in examining these issues.

The results indicate that publically announced adoption of inflation targeting strategies by central banks in ASEAN, often with much fanfare, is a substantive deviation from past monetary policy. As our theoretical model predicts, however, inflation targeting ASEAN are not following "pure" inflation targeting strategies. Rather, we find that external variables play a very important role in the policy rule inflation-targeting central banks in ASEAN systematically respond to the real exchange rate. In line with this recent trend, this study focuses on the last decade of experience in IT for selected ASEAN, such as Indonesia, Philippines and Thailand. According the explanation before the entitled for this study is "**Inflation targeting and Real Exchange Rates in ASEAN-3 (Indonesia, Philippines and Thailand)".**

1.2 Research Problem

After some who need formulation on the problem in this paper are:

1. Is real exchange rates importance for Inflation Targeting regimes?
2. How the role of the real exchange rate in the policy rules and how this affected by the countries (ASEAN-3) as well as inflation targeting industrial countries?
3. Whether emerging markets are following "pure" Inflation Targeting rules, or are also attempting to stabilize real exchange rate?

This paper investigates the empirics of inflation targeting in ASEAN-3 economies within the context of the second strand of the literature central bank operating behavior. Focus in particular on emerging markets central bank' responses to inflation, output, and real exchange rate using Taylor rule models.

1.3 Objective and Benefits Research

The purpose of this study to see the empirics of inflation targeting in ASEAN-3 economies within the context of the second strand literature central bank operating behavior. This research focus on some indicators:

1. We focus in particular on emerging market central bank's responses to inflation, output, and real exchange rates.
2. This study also concerned with the inflation targeting in advanced industrial countries and relatively less research address the particular features of inflation targeting in ASEAN-3.
3. This research we also introducing real exchange rate fluctuations into the inflation-targeting framework.

This research is useful to see the nature of inflation targeting in ASEAN-3 and transition economies. And from this research we can also find that inflation targeting in ASEAN-3 are following mixed-IT strategy whereby central bans respond to both inflation and real exchange rates in setting policy interest rates.

1.4 Hypothesis

Hypothesis is the temporary answer for the question of this study that needs more collected data. So, based on the study, the hypotheses are: the emerging market countries is not pure following the inflation targeting policy, because both inflation and real exchange rate are the important determinants of policy interest rates and the other hypothesis is the inflation targeting may be superior to fixing exchange rates as nominal anchor.

1.5 Systematic Writing

Writing sequence is divided into several chapters. Chapter I contain the introduction, which consists of the background of the title selection, formulation of the problem, research objectives, hypothesis, research benefits, as well as systematic discussion. Chapter II contains the theoretical framework related to their topic and present the previous research will be a review of literature in this study. Chapter III discusses the research methodology. Chapter IV provides an overview of the variables used in this study. In chapter V, Analysis it provides the empirical and analysis result. In chapter VI, Conclusion and Recommendation will be explained specifically.