TEST OF FISHER EFFECT IN A CASE OF INDONESIA: FURTHER EVIDENCE

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ABSTRACT


Keywords: Fischer Effect, Inflation, Nominal Interest Rate

Neo-classic economists believe that inflation could be lowered to some extent by reducing the growth of the money supply. The same suggestion was also given by Ahmed and Kapur (1990), economists from the World Bank, for Indonesian economy in their study about Indonesia's monetary policy. They argued that to some degree monetary variable has a positive effect on domestic inflation in Indonesia. The Indonesia's monetary authority, that had a target of single digit inflation, imposed a tight monetary policy to control inflation in July 1990. This policy was in purpose to reduce high inflation that could lead to overheating of the economy. In 1997, a tight monetary policy was also used by the monetary authority to diminish the effect of economic crisis on inflation.

From 1988 to 1990, the money supply (M2) grew on the average 2.8 percent monthly. It decreased sharply to only on the average 0.26 percent per month from 1991 to 1997. There was even a contraction of money supply in November 1997 and January, June, July, and September 1998. It increased again on the average 1.2 percent per month from 2000 to the first half 2002. On the other hand, the inflation rate grew quite rapidly following the banking reform introduced in October 1988. In 1991 and 1992, the inflation rate was 9.5 and 5 percent respectively. It began to increase in two digits in 1997 and reached a peak to 59.5 percent in 1998 because of the economic crisis. The inflation rate decreased to 2.14 and 8.9 percent in 1999 and 2000.

According to Leeatham et al. (1991) a monetary policy to reduce inflation would cause a high interest rate. A high interest rate in turn might produce an economic recession. Based on a Mundell-Fleming model (Mundell, 1963 and Flemming, 1962) and an economy with an open capital account policy, a tight monetary policy would depress the domestic economy and hence would cause increasing of interest rate and appreciation of exchange rate. Since Indonesia had applied a tight monetary policy, this problem could

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