

Indonesia. A monetary swing that causes a longrun unstable impact in economic growth is unfavorable. To overcome this problem, Friedman (1968) suggests a steady rate of growth in a specified monetary total to avoid instability in the economy. A steady rate of monetary growth would constitute a major improvement if the monetary authority followed a self-denying ordinance of avoiding wide swing. From the experiences of the USA and other countries, periods of relative stability in the rate of monetary growth have also been periods of relative stability in economic activity.

2. The international interest rate has no explanatory power to nominal interest rate. It implies that economic agents in Indonesia are not responsive to the difference between foreign and domestic interest rate. The free capital movement, which has been introduced by the Indonesian government since 1991, seems has no significant impact to agents' behavior in interest rate model.

CONCLUSION

Since there is an endogeneity problem in the model, OLS estimator is not longer consistent. To obtain consistent estimate, instrument variable estimate is used. There are two instrument variable models are used. First model is exactly identified instrument variable model. The first lag of inflation is used as an instrument variable for expected inflation. Second model is over-identified instrument variable model, or often called as two stage least square (2SLS) estimator.

The test of over-identification for IV(2) shows that all moment condition are valid. Hence this estimate is more efficient than IV(1) because it contains more information. Furthermore, the "endogeneity test" shows that the

endogeneity problem does cause OLS estimator to be inconsistent.

Based on IV(2) model, Individual significant test for inflation shows that null hypothesis for $\lambda_1=1$ is rejected. Hence, there is no evidence for Fisher Hypothesis. Change in the expected inflation cause variation in the nominal interest rate more than unity.

There are two possible explanations about this finding. Firstly, this result may be partly because the change in the inflation generating processes that happened during the period of sample (Barsky, 1987). If this is the case, the unit root test might be necessary to check the stochastic data. Secondly, the inflation rate during the period of study might be not really on a steady state as it is assumed (Purwandaya and Suyanto, 2000). The period of crisis (July 1997 to June 1999) might be the reason of unsteady in the state of inflation.

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