Governance Aspect of Foreign-Exchange Policy in Indonesia

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Abstract

While most recent central bank's foreign-exchange interventions have been directed at mitigating speculative currency pressures and reducing risks to price instability, as well as curbing volatility in capital flows, the good governance implementation plays significant role in making the foreign-exchange operations done in efficient and effective way. For Bank Indonesia, the implementation of foreign exchange policy strategy followed governance principle is essential and geared toward price and financial system stability. In practice, the objective is reached through foreign-exchange intervention policy combined with other monetary and macroprudential policy called policy mix.

1 Introduction

As a consequency of adopting floating foreign-exchange regime, a country would face rapid cross border capital flows. The excessive flows of foreign currencies put pressure on domestic exchange rate tend to be volatile and move to undesired direction (misaligned exchange rate movements). This conition is not good for the economy as it will disrupt international trade and capital flow performances, threaten price stability, as well as reduce business confidence. Thus, exchange-rate should be directed to its fundamental value in order to boost sustainable domestic economic growth. In many countries foreign-exchange interventions has been played more in order to mitigate those issues. The implementation of such policy have been followed by the concern on how this policy is implemented in a govern way to achieve its goal more effectively and efficiently (Figure 1). Furthermore, most of financial crisis around the world are erupted not only ignited by speculation motive but also lack of prudential and governance principle implementation. Without governance implementation, the objectives of corporates would face potential failure. On the other hand, governance principles implementation would help their objectives efficiently and effectively in a sustained basis.

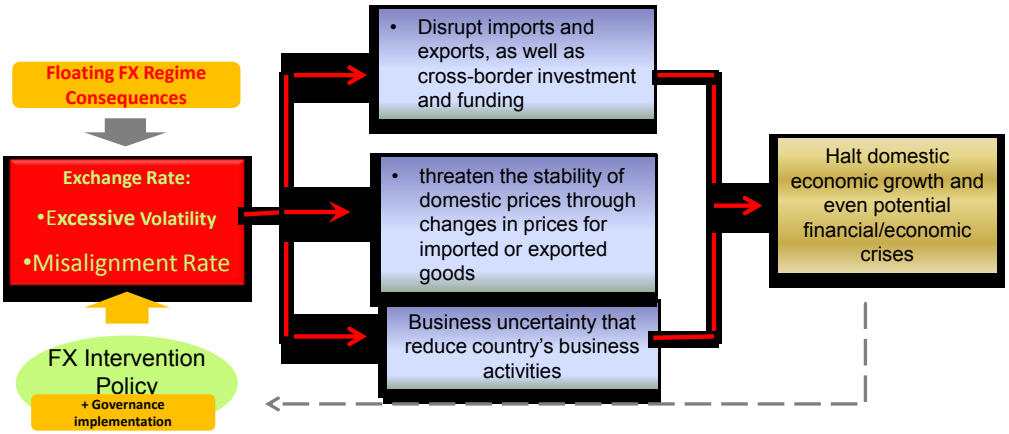

Figure 1. *The Impact of volatility and misalignment FX* ***Source****: BIS (2013) modified*

In good governance principle, all activities within organizations are needed to conduct in good manner and follow the commiteed regulations. Besides, it should be monitored continuously by the governing members of an organization in order to ensure it works based on the regulation that has been made. Generally, corporate governance is defined as a framework of rules and practices by which member of director ensures the implementation of accountability, fairness, and transparency in a company's relationship with its all stakeholders. In central banks, governance principles are implemented in every aspect of their activities included in the process of monetary policy formulations, decision makings, and operations to avoid price or financial instability in the future.

With regard to exchange rate policy governance, there are several argues concerning the role of foreign-exchange intervention by the central bank. One argue assumes in a unfavorable economic condition, a central bank has to let the exchange rate to fluctuate in order to adjust unbalanced economy and inflation back to its equilibrium or target level. However, this is not always done moreover in developing countries where their exchange rates fluctuate more volatile or overshoot. In the emerging economies, the exchange rates tend to be more sensitive to exchange rate changes both directly 'because of pass-through effects on domestic inflation', and indirectly 'because the exchange rate appears as an objective functions of monetary policy in the respective countries (Domac and Mendoza, 2002). This excessive exchange-rate volatility would not adjust current unbalanced economy to its equilibrium automatically. Therefore, this unfavorable condition pushes many central

banks in emerging countries mostly often implement foreign-exchange interventions in order to contain the negative impact of pass-through effects on domestic inflation and minimize exchange-rate volatility even though the economy is still unbalanced.

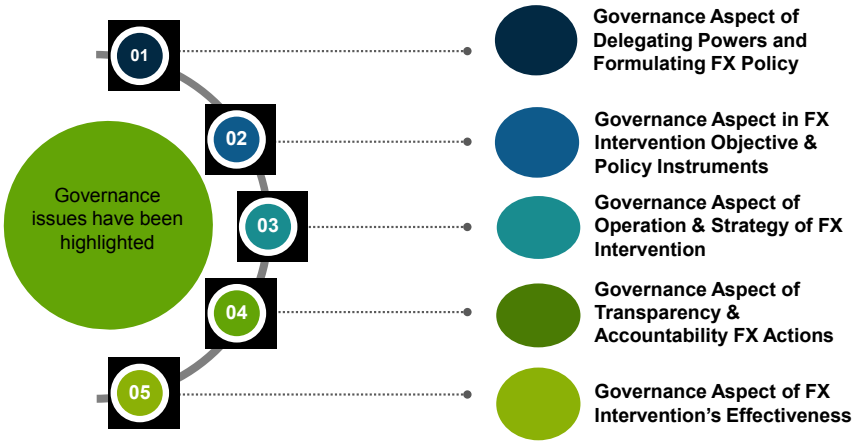

Figure 2. *The Element of Governance in FX Intervention* ***Source****: BIS (2013) modified*

Concerning foreign exchange intervention operation by most modern central banks, there are at least three governance issues have been highlighted as mentioned by Moser-Boehm, 2005. The first governance issue concerns the allocation of powers between central bank and the government in decision making of monetary policy and for exchange rate policy. This is the regulation of power and the mechanisms required among members within organizations which concern accountability. This issue concerns on which party within an organization, has the authority to make strategic decision on the foreign-exchange policy such as formulating the ultimate objectives decisions, and the role of central banks or the government in formulating strategic policy. The issue should clearly mention whether the power is delegated to the central banks or to the governments before decision is made and stated in the respected act or regulation. The second issue is about the standard operating procedure when implementing the decisions made, included the possibility of whether the decision is made solely by the central bank/monetary authority or should consult before with the governments. The last crucial issue with regard to the governance principles concern transparency and accountability. Even though, transparency and accountability should also be implemented by most institutions, central banks need modified rules with regard to transparency and accountability rule when implementing the governance aspect to ensure their effectiveness in achieving its policy objectives. It is because, most foreign-exchange interventions should be carried out in secret to have good result as desired (Figure 2).

According to the governance principle, Bank Indonesia has also the authority to conduct foreign currency intervention at both strategic policy and operational levels. Foreign-exchange intervention policies are mainly intended to support exchange-rate stability, at all times or curbing undesired short-term capital flows. The exchange rate policy such as foreign-exchange intervention is implemented which has function to smooth out the volatility of day-to-day exchange-rate movements. Consequently, Bank Indonesia should monitor exchange-rate development regularly and closely monitor foreign currency transaction activities, either indirectly via on-screen figures and broker's information (off-site supervision), or directly (on-site supervision). Beyond on that, BI exchange-rate policy supported by other monetary policies as designed to achieve BI's ultimate objective such as domestic inflation and financial stability in the medium to long run horizon.

Beyond on those issues, another important issue regarding to governance principles in foreign-exchange intervention is whether the objective to conduct such policy to meet a certain target of exchange-rate level or to lessen the exchange-rate fluctuations, or to meet both objectives. The other is whether the foreign-exchange policy is also a measure to accumulate foreign-exchange reserve to raise central bank's credibility. With regard to foreign reserve accumulation objective, BIS survey (2013), concludes that most central banks agree that reserve accumulation main objective is to protect the economy from adverse future shocks and to enhance central bank's credibility. The adequate level of official foreign reserves (OFRs) can increase considerably over time, particularly in boom periods. The accumulation of reserves is possible during periods of large inflows. Within this context, Bank Indonesia conducts foreign currency intervention at both policy and operational levels to reduce exchange rate volatility as well as managing rupiah domestic liquidity. Foreign currency intervention policies are mainly intended to support exchange-rate stability and drive it to support domestic inflation, at all times. Moreover, it is undertaken whenever moral suasion is not working in influencing foreign-exchange expectation and curbing excessive exchange rate movements.

2 Delegating and Formulating Foreign-Exchange Policy

As mentioned before, many central banks implement governance principles in order to achieve their own objective efficiently and effectively. In strategic part, it is crucial for a central bank to state explicitly who will set operational objectives of foreign exchange. Moser-Boehm (2005) suggests the central bank or the government may have this task to set exchange rate objectives. Once it is decided, it should be clearly defined in the central bank law. Indonesia and most modern central banks have legal aspect as an independent monetary institution apart from government. The law may also regulate the power distribution between the government and the central bank to decide those objectives which may include exchange rate regime. In many circumstances, central bank has autonomy to set goal or even operational aspect of foreign exchange. Meanwhile, in some countries, the government has also strategic power in giving mandate to achieve specific target in implementation regularly. In the case of Indonesia, the central bank objectives are ruled out by the central bank law where Bank Indonesia has task to maintain Rupiah stability. In implementation, the government set the objective more specific to be reached yearly.

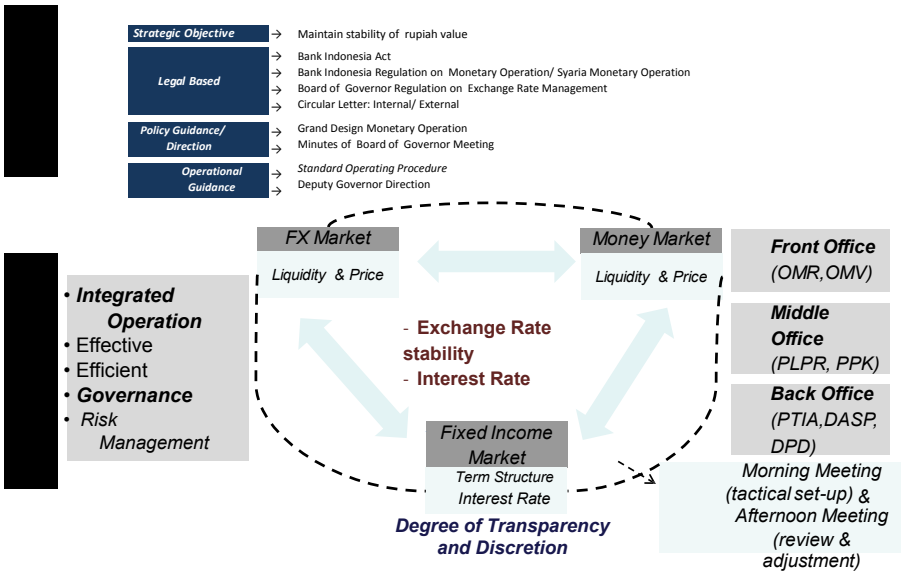

Figure 3. *The Governance in Delegating & Formulating FX Policy* ***Source****: BIS (2013) modified*

As illustrated in the Figure 3, Bank Indonesia as the central bank of Indonesia is authorized to formulate and implement monetary policy to support achieving its ultimate objective i.e. price stability. The monetary policy which is designed to achieve price stability is divided in two main parts. The first one to achieve domestic liquidity in short term and price stability in the long-run is conducted through open monetary operation by setting appropriate policy interest rate. Meanwhile the second part to mitigate exchange rate volatility is conducted through exchange-rate intervention policy. To achieve its objective efficiently and effectively, Bank Indonesia set up foreign-exchange policy decision making process and dealing guidelines which are needed in policy implementation.

Thus, BI foreign-exchange intervention policy is divided in two parts i.e. strategic and operational level. The first part includes foreign-exchange intervention objective, legal based, policy guidance and direction, and operational guidance. Meanwhile, in the second part includes the method and strategy of foreign-exchange policy implementation depending on foreign-exchange market condition conducted by dedicated divisions (Front office, Middle office, and back-office/settlement divisions).

The legislation for the last decades has given many modern central banks greater operational independence in conducting monetary policy included foreign-exchange interventions even though in some cases the government has been involved moreover in setting specific objective target annually. According to BIS Survey (2005), exchange rate policy is a joint responsibility of the government and the RBI in India, BOK in Korea and Reserve Bank of New Zealand. Meanwhile, in the case of Mexico, the central bank has power to implement exchange rate policy itself as long as it is matched within guidelines set previously by the government and the central bank. On the other hand, in Malaysia, the regulation has given the government to set the objectives, after consulting the central bank. In the case of Indonesia, Bank Indonesia has full authority to conduct foreign currency intervention at both policy and operational levels. However, it should be harmonized with inflation stability policy in the strategic and operational level to avoid inefficiency.

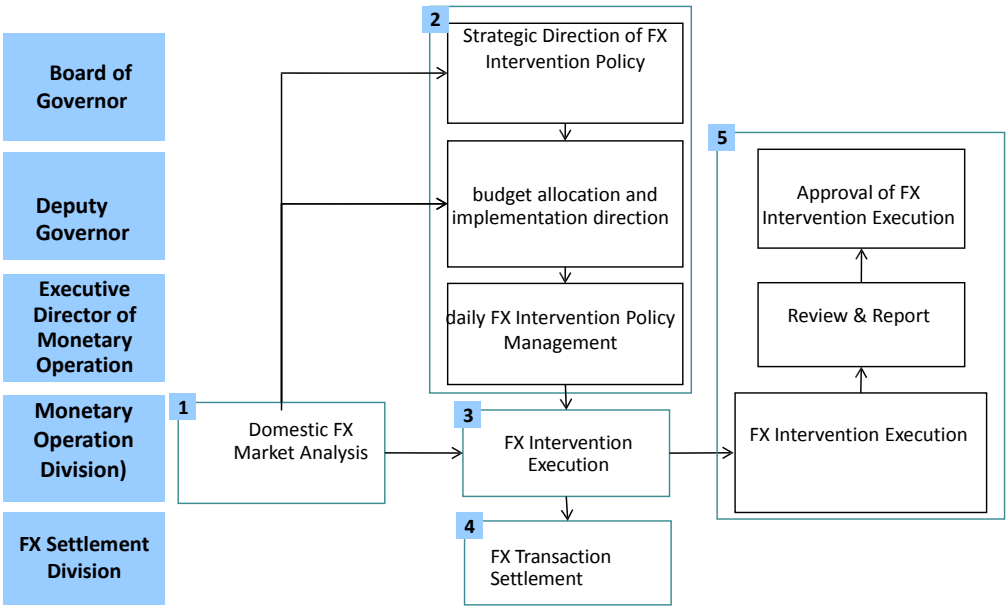

Figure 4. *The Steps of FX Policy and Execution* ***Source****: BIS (2013) modified*

Another governance issue is about the authority to make foreign exchange decision and to which department who will have the duty to execute the foreign exchange decision made by the authority. The decision may be set in the board of governor meeting or delegated to dealing room (monetary operation division) which also has a function as executing department, depending on various aspect to consider. In the case of Indonesia, BI has set up foreign-exchange policy decision making process guideline from formulating/directing policy until execution of the policy. The strategic plan of policy is made through board of governor meeting based on deep research regarding to exchange-rate development and its main determinants. The strategic decision is then implemented by the department/division in charge (Figure 4 and 5).

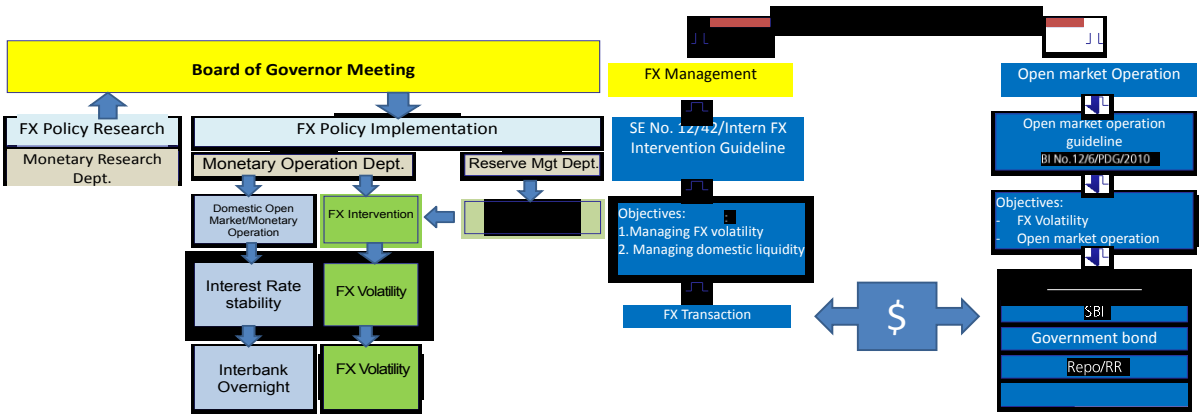

Figure 5. *The Monetary Policy Decision Making Process & Execution* ***Source****: BIS (2013) modified*

3 Foreign-exchange Intervention's Objectives and Policy Instruments

In the case of Indonesia, foreign exchange policy conducted by Bank Indonesia has two main objectives. Firstly, in the short horizon, this such a policy has task to maintain exchange-rate stability. Secondly, in the medium and longer term, the policy should drive the exchange-rate movements along its fundamental path which is consistent with the inflation and macroeconomic forecast over the policy horizon. In addition to that, BI has been implementing various monetary instruments so called monetary and macro-prudential policy mix which recently consists of the following several policy instruments such as BI Rate, capital flows management, macro prudential policy, and monetary policy communication (Figure 6). As Bank Indonesia has been implementing ITF, the short-term interest rate policy 'BI Rate' is the main instrument supported by other monetary policy instruments to achieve the inflation target. In this case, the BI rate is a policy rate which has function as a monetary signal made so as to ensure that the inflation forecast over the policy horizon without disturbing business activities. Other supported monetary policy such as window facility, it has objective to ensure the adequacy of banking liquidity daily.

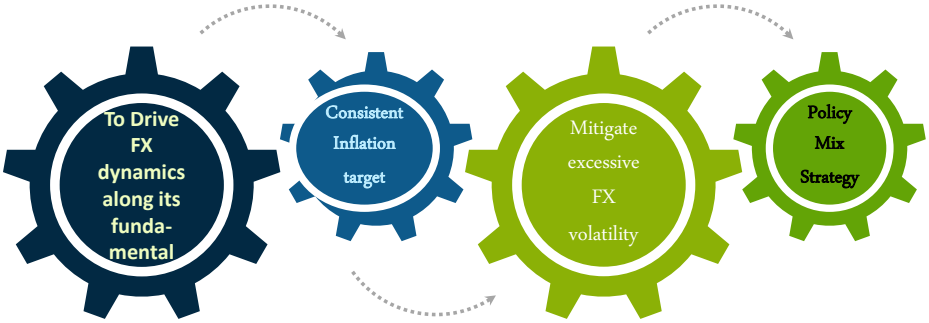

Figure 6. *The Governance Aspect in FX Intervention Objectives* ***Source****: BIS (2013) modified*

Meanwhile, to curb short-term undesired capital flows and mitigate the risks of capital reversal and financial system instability, BI has been conducting capital flow management. The implementation of this kind policy so far such as applying a longer maturity of SBI Certificate 'six-month holding period for BI's certificates', limiting on short-term bank off-shore borrowing, and foreign exchange reserve requirements is effective to curb short-term capital flows as the foreign portfolio in domestic securities (SBI central bank bill 'SBI' and government bill 'SUN') showing decreasing. With regard to maintain financial stability, another measure concerns to macro prudential policy which is designed to strengthen the resilience of the financial system, including its ability to withstand exchange rate risk, to mitigate the pro-cyclicality of the intermediation function, and to enhance the efficiency of the financial system. This policy applies mostly in banking sector for example by regulating loan-to-value ratio to contain excessive lending in the real estate and automotive sectors and pro-cyclical capital adequacy ratio. Besides, to support above policies, BI has also been implementing monetary policy communication especially to manage inflation expectations so that they are in line with the inflation and macroeconomic forecast.

4 Operation and Strategy of Foreign Exchange Intervention

With regard to foreign exchange policy implementation, most central banks included Bank Indonesia conduct foreign-exchange interventions in the spot market mostly and small portion in forward market as foreign-exchange market transactions was dominated by foreign exchange spot instrument. In term of currency, USD/IDR is still the most active traded currency, but the proportion of other currencies pair transaction such as EUR/IDR, JPY/IDR, and Asian Currencies tend to increase. To support foreign exchange liquidity, since mid-2012, BI has been offering foreign exchange term deposits (through weekly auctions) to those banks that are experiencing a temporary excess of foreign-exchange liquidity. In order to maintain domestic liquidity adequacy is consistent to support inflation target achievement, the implementation of foreign exchange intervention is supported with monetary operations for example interest rate corridor. This kind of monetary operation is called sterilized intervention which is designed to ensure that the objectives of maintaining price stability, exchange rate stability and financial system stability can be attained.

In conducting foreign-exchange intervention policy, a central bank will choose between open or closed method as its strategy (Figure 7). This strategy would be selected depending on the interconnectedness of financial markets between domestically and cross-border issue. In fact, most central banks conduct foreign-exchange policy in a closed method as it may improve its effectiveness. This closed method of course may be contradictive with one of governance principle (transparency issue). Others prefer open method whenever conducting foreign-exchange intervention policy to give signal to foreign-exchange players that the central banks is concerned to maintain exchange-rate stability. With regard to exchange-rate policy, as outlined from BI foreign-exchange dealing guideline, Bank Indonesia has two methods of conducting foreign-exchange intervention. First, the foreign-exchange intervention altered directly with the market without using an intermediary, called open method. The second type of intervention is using intermediaries (an agent bank/financial institutions), which is called the closed method. In the case of Indonesia, BI conducts foreign-exchange interventions through agent banks to trade foreign currency (mostly US dollars) depending on excess liquidity conditions in the market. The objective is to smooth out the volatility of exchange rate movements along the chosen fundamental path. According to Dealing Room Guideline, Bank Indonesia chooses between the open and closed method, considering some aspects such as market psychology, kinds of market sentiments, exchange-rate forecast calculated from technical analysis, liquidity condition of domestic foreign exchange market, and Foreign-exchange reserve adequacy.

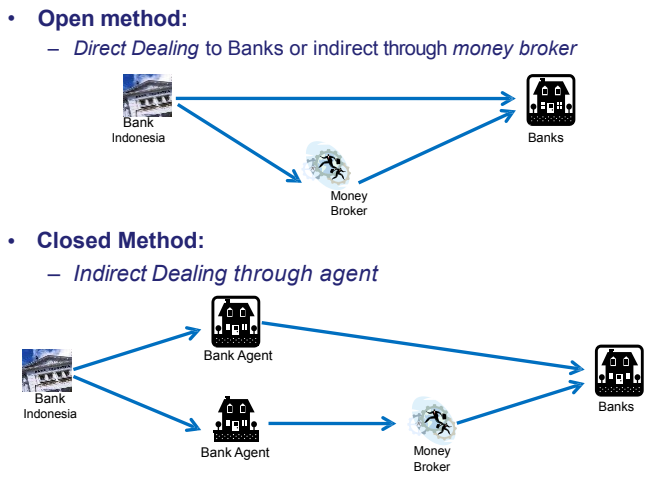

Figure 7. *The Methods of Conducting FX Intervention* ***Source****: BIS (2013) modified*

Supply and demand conditions in the foreign currency market are always taken into account when Bank Indonesia plans to enter foreign-exchange market or setting new policy directions caused by external shocks. Several factors such as global/regional/domestic financial market conditions/perception, potential mover (fundamental or speculative based foreign-exchange transactions), domestic market liquidity conditions and transaction turnovers are taken into account whenever foreign currency interventions are undertaken through appropriate FX management and implementation, as stated in internal Bank Indonesia guidelines and regulations. As illustrated in Figure 8, a comprehensive market coordination analysis is formulated to decide how (with respect to monitoring, moral suasion, intervention, match maker), when (with regard to timing of intervention execution), and whom (with regard to what institution the intervention is implemented trough) regarding to FX intervention implementation.

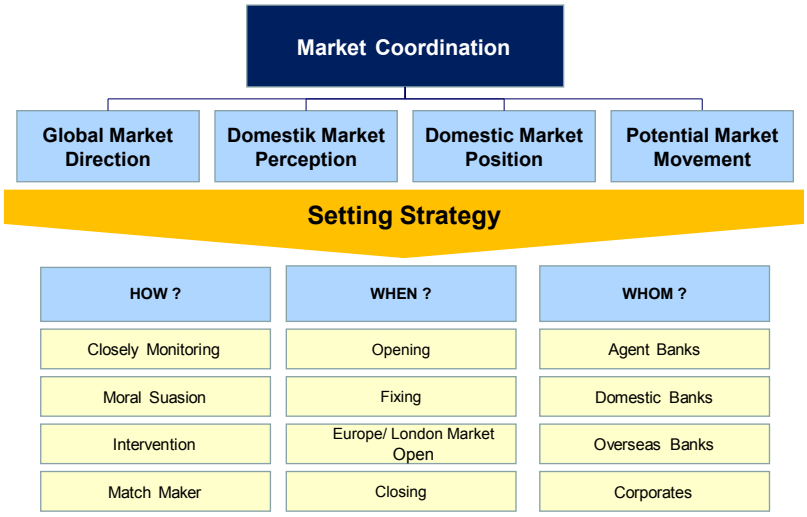

Figure 8. *The Market Coordination & Implementation FX Intervention's Strategy* ***Source****: BIS (2013) modified*

The implementation of foreign currency intervention policy also considers timing, in order to avoid predictability and magnitude by the foreign-exchange players. The exchange-rate intervention in the domestic foreign exchange market is structured so as to provide a resistance level for the currency, with the objective of reducing the probability of exchange rate movements beyond that level. In addition, the foreign exchange intervention in the foreign exchange market by the central bank is conducted by entailing selling and buying of domestic currency, which directly affects the central bank's liabilities. Such policies are financed by official foreign reserves (OFRs), which are assets on the central bank's balance sheet. In this case, the central banks has also task to manage their portfolios of Official Foreign Reserves (OFRs) as their exchange rate management. As defined by IMF, central bank's official foreign exchange reserves (OFR) are official public sector assets reflecting the capacity to intervene in support of the national or union currency which are controlled by the monetary authorities to support and maintain confidence in conducting monetary and exchange rate policies. OFRs is designed to absorb external shocks during period of crisis. Moreover OFRs can improve central bank's

credibility to stake holders to meet its external obligations, government foreign obligations and for some extend to guard debt obligations as well as maintain a reserve for national disaster or emergencies.

5 Transparency and Accountability of Foreign-Exchange Intervention Policy

Another interesting issue of governance implementation on exchange-rate policy concerns transparency and accountability. Transparency and accountability are other important aspects as part of governance principles. Most government institutions and private corporations, implement this aspect rigorously, as it will impact indirectly to its performance. According to this, to ensure the desired result upon exchange-rate expectation of foreign-exchange market participants, foreign-exchange policy implementation should be based on transparent mechanism and should be applied sparingly (Domac and Mendoza, 2002). However, this is not the case for central banks when conducting foreign-exchange interventions. The hypothesis predicts that central bank may influence exchange rate movements, under certain circumstances, secretly use volatility-changing strategies to manage exchange-rate levels. This is strongly supported by the fact that central banks frequently intervenes covertly in the foreign-exchange market.

As explained previously, it may be commonly accepted recently that a good central bank is a transparent central bank. However, it is different when discussing foreign-exchange intervention by the central banks. Transparency may halt the effectiveness of foreign-exchange intervention. In fact, foreign exchange interventions by most central banks are conducted secretly instead of transparency that in general this is well accepted in markets and compliant with central bank laws as well as with codes of common practice. This is because transparency about operations in the foreign exchange market may reduce their effectiveness in achieving their objectives. Moreover, the exchange-rate interventions are applied to mitigate the misaligned exchange-rate movements or when exchange-rate movements are inconsistent with the goals of monetary policy. Hence, the effectiveness of foreign-exchange interventions would be reached as they are implemented secretly as supported by Volcker (1995). He argues the further the actual exchange rate has departed from the fundamental equilibrium, the more damage the misalignment will do, the more confident the central banks can be that they will be acting as profitable stabilizing speculators, and the greater likelihood of success of any foreign-exchange intervention on the part of central banks. Several studies by Dominguez and Frankel (1993), Neely (2000), Sarno and Taylor (2001), argue that central banks conduct secret interventions to maximize the impact on the exchange rate. While Archer (2005) concludes the transparent intervention is preferable because it increases the power of the signaling and coordination channels. According to this aspect of governance, Bank Indonesia's foreign exchange interventions are done secrecy mostly. BI has not been announcing foreign currency intervention to the public, reserving to itself information regarding volume, strategy, and timing.

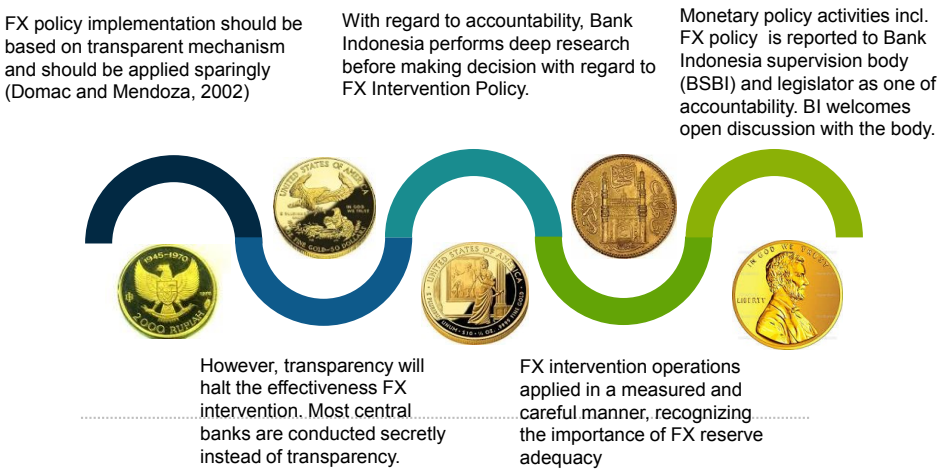

Figure 9. *The Governance of Transperancy & Accountability in FX Intervention* ***Source****: BIS (2013) modified*

With regard to governance aspect of accountability, it is hard to be implemented as foreign exchange intervention for a central bank than one for the conduct of monetary policy as interventions are actions to mitigate exchange-rate volatility or misalignment within short or longer horizon. Moreover, exchange-rate adjustment is probably only effective in short-run not in the medium or longer run. Beyond on that, Bank Indonesia always perform deep research before making decision with regard to exchange rate policy. Many factors including global/regional/domestic financial markets are playing significant role in determining or formulating foreign-exchange policy in term of foreign-exchange market management or policy direction from the board of governor. As a consequence, foreign-exchange intervention operations by BI are applied in a measured and careful manner, recognizing the importance of foreign exchange reserve adequacy. Furthermore,

BI always makes a regular report of its monetary policy activities included foreign-exchange policy implementation to Bank Indonesia supervision body (BSBI) as one of accountability implementation. BI also welcomes open discussion with the body to explain it more comprehensively. Regularly, a legislator will review a central bank's performance reported in the banks' annual reports (Figure 9).

6 Foreign Exchange Intervention Effectiveness

Obviously, it is hard to conclude that central bank's foreign exchange per se, is able to stabilize exchange rate due to several other monetary policy instruments are applied at the same time. However, central banks can measure the applied policy effectiveness by how far the policy's objectives reflected by economic indicators development are achieved. In the case of Indonesia, applied foreign-exchange intervention policy by BI, can stabilize rupiah volatility reflected by lower exchange-rate volatility comparing to its condition before foreign-exchange intervention done. A research by Bank of Thailand (2005) suggests that the Bank of Thailand (BOT) manages the exchange rate by intervening in the foreign exchange market regularly in order to prevent excessive Thai Baht volatility, while fundamental trends are accommodated. Specifically, BOT focuses on containing excessive and persistent exchange rate volatility and intervenes when exchange-rate movements appear to be inconsistent with fundamental changes. Meanwhile, short-term exchange-rate volatility is not a major concern for BOT unless the volatility persists and becomes a threat to stability.

However, there are some circumstances that foreign-exchange intervention is not gain good results. Therefore, to assess the effectiveness of foreign exchange intervention, one should examine a number of aspects that are in line with the central bank's overall objective of maintaining price stability as well as monetary and financial system stability. There should be clear enough whether the objective of the exchange rate policy is – merely smoothing volatility, or also managing the path of exchange rate movement. There should also considered the condition of the depth and behavior of the microstructure of the foreign exchange market, e.g. the number of players, volume of transactions, availability and variety of financial instruments, liquidity conditions and distribution across players, counter-party risks, and the infrastructure needed for efficient market functioning. Another interesting issue concerns the predictability of exchange-rate movements. A study by LeBaron in US (1999) reveals that the absent of exchange-rate interventions by the Fedres, make exchange-rate predictability is reduced as the market players still wait Fedres presents as done before. Conversely, a study by Uribe and Toro (2005) reveal that exchange-rate call volatility options implemented by the central bank in Colombia, have contributed to curb acute exchange-rate deviations, thus helping to reduce market uncertainty. Similar study by Domac and Mendoza (2002) in Mexico and Turkey find that both the amount and frequency of FX interventions have decreased the exchange-rate volatility in both countries.

Another important aspect regarding to the effectiveness of foreign exchange intervention is central banks credibility reflected by the adequacy of international reserves relative to the depth of the markets and the country's external vulnerability. A study by Disyatat and Galati (2005) reveal that in fact Asian Central Banks have accumulated large foreign reserves as a consequence of their foreign-exchange buying intervention policy and incomplete sterilization. They also suggest that several factors such as exchange-rate regime pursued, history of policy actions, the depth and sophistication of the foreign-exchange market, and regulatory controls on foreign-exchange transactions, have significant influence to support foreign-exchange intervention. Commonly, the more reserves, the more confidence the central bank does its monetary policy, and the more effective foreign-exchange intervention would be. Bank Indonesia's findings firm the views that Rupiah exchange rate movement is not always reflecting the economic fundamentals. Thus, foreign-exchange intervention is conducted in order to be consistent with the overall objective of achieving price stability and supporting financial system stability. Thus, as stated above, the objective of foreign exchange intervention is to stabilize the exchange rate along its fundamental path and to ensure a path that is consistent with achieving the inflation target and supporting financial stability.

In shorter horizon, the effectiveness of intervention in influencing foreign-exchange market expectations is more difficult to assess, since the exchange rate is more sensitive to speculative foreign-exchange attacks driven by global shocks pronounced by financial or political news and market responses on them. The global shocks may overshoot exchange rate from its fundamental value within a short horizon. Exchange rate overshooting in the short horizon may also occur ignited by a number of factors, e.g. volatile capital flows, irrational behavior of market players, and the microstructure conditions of the market, as well as influence from offshore markets. In this case, the effectiveness of intervention will also depend on the central bank's ability to influence foreign-exchange participant's expectations to central bank's desired. As explained by Bank Indonesia, the microstructure of the domestic foreign exchange market also influences the effectiveness of intervention in the case of Indonesia. Under these conditions, USD/IDR movements are prone to changes in perceptions and market conditions, both domestically and offshore. Therefore, it is important for central bank to identify the foreign exchange market player whether fundamentalists or chartists. The thinness of the market makes the banks heavily dependent on the central bank to absorb any excess supply in the market (during current account surplus

and/or large capital inflow periods) and to supply any excess demand in the market during current account deficit or capital outflow periods.

The exchange-rate is crucial factor in determining future economic growth especially for the open economies. Apart from being the price of money in terms of other currency, exchange-rate dynamics can affect domestic price stability as well as financial stability. In term of price stability, for example, a country that heavily depends on imports, would suffer significantly when price of the import products increase or its exchange rate depreciates. This phenomenon could lead to a significant increase in foreign-exchange demand as well as domestic goods price depending on is power of exchange-rate pass through to inflation. Meanwhile, regarding to financial system stability, in a country that has huge foreign debt, for example, excessive exchange-rate depreciation will increase foreign debt value in term of domestic currency rapidly. If the country cannot increase its foreign exchange sources accordingly, this will affect the country's ability to repay its foreign debt, which could lead to an episode of financial crises. As explained in the first part of this paper, the success of foreign exchange intervention in Indonesia will be judged on its contribution to achieving the inflation target and supporting financial system stability as they are explicitly stated as a mandatory in the central bank law. However, the effectiveness of foreign exchange intervention policy cannot be ruled out without other policies implementation such as macro prudential policy and fiscal policy. In the context of capital flows, the macro prudential policy by BI for managing capital flows apply to both residents and non-residents, has been working well supported by monitoring ad mitigating short-term and speculative capital flows (Figure 10).

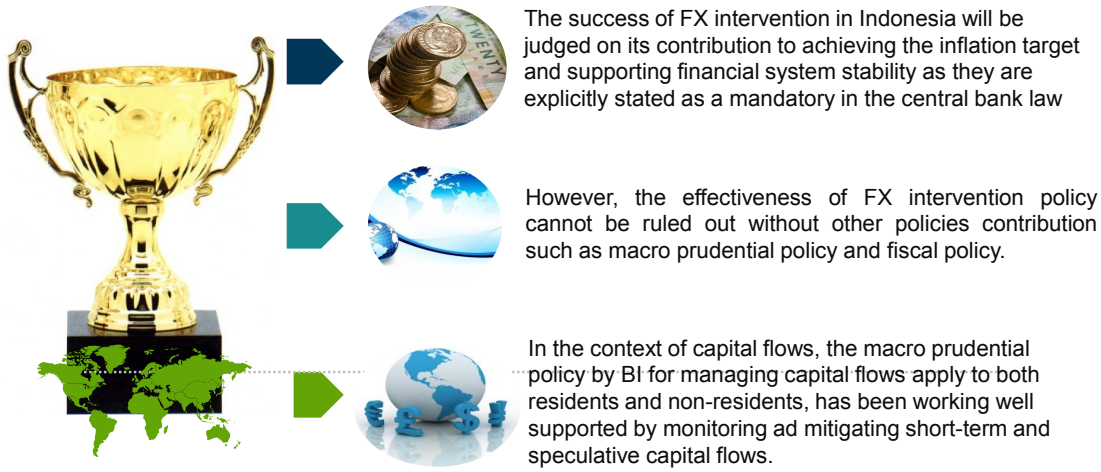

Figure 10. *The Governance in FX Intervention's Effectiveness* ***Source****: BIS (2013) modified*

With regard to ITF objective, exchange rate policy should be able to maintain domestic price stability stemming from external shocks such as foreign commodity prices an oil price (imported inflation). Summarized from BI economic reports, rupiah exchange appreciation in 2009, 2010, and 2011 (up to August) in the period of both the current account surplus and huge capital inflows during which help to reduce imported inflation during these periods of high commodity prices. The policy has been able to reduce the inflation pass-through effects of rupiah depreciation in the price decline of global commodity in 2012. Although recently, the rupiah experienced more than 10% depreciation in nominal terms, the inflaton is still below the target 4.5% in 2015 as demand is decreasing.

In the last several years of periods, BI efforts in supporting financial system stability, has been successfully managed through dual interventions of the central bank in both the foreign exchange and bond markets – called 'operation twist'. The operation twist has been able to ensure that domestic liquidity is sufficient and consistent with managing monetary and financial system stability (Warjiyo 2013). This can be illustrated for example when financial global crises happened in 2008 and recenlt , BI heavy foreign exchange intervention to defend the rupiah from the impacts of the global crisis caused a shortage of domestic liquidity and put pressures on conditions for banks, especially smaller banks. Thus BI encounter it by injecting domestic rupiah liquidty by several expansionary monetary policy including building governmet bond up from secondary market. The mentioned central bank purchases of government bonds in the secondary market not only have been able to stabilize government bond price and to stabilize the financial markets but also solving liquidity shortage.

7 Conclusion

Governance implementation is a must for the authority in achieving its objectives effectively and efficiently. In the context of foreign exchange intervention, the main objective of foreign exchange intervention is to

stabilize the exchange rate along its fundamental. Exchange-rate policy in Indonesia is also geared toward price and financial system stability. Bank Indonesia applies the policy with measured and careful manner according to governance principles. Tactically, this has been done through various strategies includes operation strategy and presenting new instruments applied side by side with conventional monetary policies. The most recent policies called 'operation twist' combining dual intervention (in the foreign exchange market in addition to the central bank's operations in the secondary government bond market) augmented with macro-prudential policy, have been admitted as new powerful instruments in achieving Bank Indonesia's objectives.

Bank Indonesia regards exchange rate policy as an integral part of an overall monetary and macro-prudential policy mix designed to achieve price stability while paying due attention to economic growth as well as monetary and financial system stability. For a small open economy like Indonesia, exchange rate movement does not always reflect fundamental value. Increasing exchange rate volatility often occurs as a result of volatile capital flows, irrational behavior of market players, the microstructure conditions of the market, and offshore market influence. In this case, relying solely on interest rate policy to achieve the inflation target and maintain stability is not always sufficient. Thus, the central bank's strategy is to include exchange rate policy in the monetary and macro-prudential policy mix. BI Foreign-exchange intervention policy combined with other monetary policies especially during unfavorable global economic condition, are effective to support USD/IDR exchange-rate stability as well as to maintain domestic financial stability.

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