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THE IMPACT OF DIVISIA MONEY ON MONETARY MODEL OF EXCHANGE RATE IN INDONESIA

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ABSTRACT. Stability of the exchange rate is critical for policy formulation in Indonesia and thus, has boosted the study of exchange rate behaviour. In this study, the monetary model of exchange rate has been utilised to determine the exchange rate for Indonesia. The model was improved by means of including the Divisia monetary aggregate as the money measure instead of conventional money supply. The ARDL approach, which was valid in spite of the variables' stationary properties, was used for the estimation. The findings indicated that monetary fundamentals are significant in explaining the exchange rate movements in Indonesia when Divisia money was incorporated into the monetary model of the exchange rate. As a result, monetary fundamentals can serve as the determinants of exchange rate in addition to non-monetary fundamentals in the case of Indonesia. High magnitude of the money supply differential and the real income differential coefficients also implied that monetary targeting can serve as a useful instrument for monetary policy in addition to inflation targeting. The research is based on the data ranging from 1984Q1 to 2017Q1.

JEL Classification: E41, E52, C22.

Keywords: a monetary model of exchange rate, Divisia monetary aggregates, bounds testing, Indonesia.

Introduction

Exchange rate has become one of the critical transmission channels for external factors on monetary policy in emerging market economies as a result of financial integration (Filardo *et al*., 2011). Due to the dynamic context of both increased inflation and currency appreciation, the challenge for emerging market economies in formulating their monetary policies is to compromise between price stability and exchange rate stability. There has been an acceleration of the influence of external shocks and thus maintaining the stability of nominal exchange rates becomes vital for emerging market economies. In the short run, inflation can be affected by exchange rate movements and at the same time floating exchange rates serve as the shock absorber attaining macroeconomic stability. In the long run, exchange rate can affect external competitiveness. Fluctuations in exchange rates have the tendency to reduce revenues while at the same time increase the cost of exports and imports (Miciuła, 2014). Generally, exchange rates alter inflation, exports, imports as well as economic activity and thus remain to be an exceptionally critical macroeconomic variables in emerging and