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The demand for Indonesian narrow money: long-run equilibrium, error correction and forward-looking behaviour

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Abstract

Since the 1960s, the banking and financial sector has been at the forefront of the Indonesian development strategy. Thus in order to gain an understanding of the problems and opportunities facing Indonesia, it is essential to understand the workings of the monetary sector of the economy. The aim of this paper is to analyse the narrow component of money demand, using modern econometric techniques. But the major innovation of the paper (in the context of a developing country) is the use of an explicit forward-looking model. This approach, the consequence of financially sophisticated behaviour on the part of Indonesian agents, has significant policy implications. One of these is that announced changes in policy, if credible, will lead to a more rapid response from the private sector than if agents were purely backward looking. This may

make the operation of monetary (and other) policy more effective than would otherwise be the case.

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