ABSTRACT

This study analyzes the effect of exchange rate changes on the effectiveness of the Inflation Targeting Framework (ITF) in Indonesia through the asset channel of the monetary policy transmission mechanism. Using quarterly data for the period 2010Q1–2025Q4 obtained from Bank Indonesia, the International Monetary Fund, and Statistics Indonesia, this study estimates three structural equation blocks using the Ordinary Least Squares (OLS) method: (1) the effect of real exchange rate changes on the real interest rate differential, (2) the effect of the real interest rate differential on the financial market and output gap, and (3) the effect of the output gap on the inflation gap. The three blocks are subsequently consolidated to capture the cumulative effect of exchange rate transmission on the inflation gap. The estimation results indicate that the direction of exchange rate transmission to ITF effectiveness is generally consistent with theory, although the strength of the effect is partial. In the initial stage, an anomaly is observed in which exchange rate depreciation increases the domestic real interest rate, which is inconsistent with the concept of Uncovered Interest Parity (UIP). This finding may be attributed to the foreign interest rate being treated as given. The subsequent transmission through the asset channel is theoretically consistent, as the effect of the real interest rate on financial asset flows is statistically significant; however, the effect of financial asset flows on the output gap is not statistically significant. In the final stage, the inflation gap is influenced more strongly by inflation expectations, as reflected in the lagged inflation gap, and by the real interest rate than by aggregate demand pressures represented by the output gap. These findings indicate that, although the exchange rate remains one of the factors affecting the achievement of the inflation target, its transmission through the asset channel remains limited and depends on strengthening financial market intermediation and the management of inflation expectations by Bank Indonesia.

Keywords: exchange rate, Inflation Targeting Framework, asset channel, interest rate, output gap, inflation gap, Bank Indonesia
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