ABSTRACT

Central banks that are not independent wtih discretionary monetary policy tend to be controlled by the government and has less authority in order to achieve its main goal so that the policies formulated by the central bank are less precise. As a result, inflation is even higher than it should be (biased inflation) which leads to price instability. Price instability might cause uncertain value of money, which in turn might lead to instability in the economy. Inflation bias can be prevented through an independent and conservative central bank. Underneath the Law No. 23/1999, Bank of Indonesia has officially become an independent institution with a single objective: to maintain price stability.

The purpose of this study was to analyze Bank of Indonesia's independence in affecting inflation through its policy instruments by which is represented by following variables: BI independence index, inflation expectations, BI rate, and money supply to inflation rate. Error Correction Model (ECM) are employed using time series data during the period of 1999Q2-2015Q4 in Indonesia.

The result showed that inflation expectation positively affects the inflation rate significantly both in long term and short term. Money supply (M2) insignificantly affects the inflation rate both in long term and short term; BI rate positively and significantly affects the inflation rate both in long term and in the short term. Central Bank Independence index (CBI) negatively and significantly affects the inflation rate both in long term and short term.

Keywords: Price Stability, Inflation Expectation, Money Supply, BI rate, Central Bank Independence Index, Inflation Bias, Error Correction Model (ECM)