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EDITORIAL

Inflation Targeting and Central Bank Policy

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This issue of the *Bulletin of Monetary Economics and Banking* contains seven papers. The first four papers are on the special issue of inflation targeting and central bank policy. These four papers mark 20 years of Bank Indonesia's existence as a modern central bank with a mandate to safeguard currency stability in Indonesia. These four papers offer different insights on the theme of central bank policy in achieving monetary, payment system, and financial system stability. The remaining three papers offer insights from central banks/banking systems of other markets.

The first paper by Paresh Narayan analyses consumer price index (CPI) dynamics. The author proposes the hypothesis that amongst many cities there will be some cities that will drive most of the country's CPI while other cities will play a trivial role. Using data for 82 Indonesian cities grouped into provinces, and applying a price discovery model, he shows that there are indeed a small number of cities in each province that are responsible for influencing the bulk of the aggregate (national) CPI. The message of this paper from a policy perspective is that when the goal is to rein in price stability, the monetary authority can choose to target cities that are price movers (or what he refers to as leader cities). This model can be applied to other countries to identify leader cities.

The second paper by Solikin Juhro and Bernard Iyke examines the effectives of large-scale inflation forecasting models for Indonesia. The authors undertake both in-sample and out-of-sample tests and utilize posterior inclusion probabilities to determine predictors that successfully predict inflation. Amongst a large number of predictors, the paper concludes that key predictors of inflation are the first lag of inflation, industrial production, import and export prices, global food prices, the global prices of agricultural raw materials, the money supply, the IDR-US exchange rate, consumption expenditures, and the unemployment rate. This model can be employed to test the effectiveness of forecasting models in other emerging markets.

The third paper is about Indonesia's economic growth. Seema Narayan examines the role of financial technology (FinTech). Using an endogenous growth framework fitted to time-series data she shows that FinTech positively influences Indonesia's economic growth. This is an important finding because FinTech development in Indonesia is still at a nascent stage and it is predicted to grow.

As the role of FinTech matures, from a growth point of view, this augurs well for Indonesia's growth prospects. The paper though is preliminary in the manner in which FinTech is measured conditional obviously on availability of data. Future studies will be able to build on this finding. Since FinTech is a relatively new phenomena, the FinTech-economic growth nexus can be tested for other economies to build consensus on the effectiveness of FinTech as an ingredient of economic growth.

The fourth paper is a survey paper. Rakesh Padhan and K.P. Prabheesh review the literature on the effectiveness of early warning models (EWMs). The main part of the review story is that the authors suggest a new agenda for constructing EWMs to enhance their effectiveness in predicting financial crises. Their motivation has roots in the failure of EWMs to predict the 2007/2008 global financial crisis. They suggest capturing the dynamics of the financial crisis and including interconnectedness/contagion variables as determinants of the financial crisis. This survey paper will constitute an effective reference for future research on EWMs and any refinements and/or extensions to those models.

The next three papers deal with central banking policy from the experience of other markets. The fifth paper by Kesavarajah Mayandy, for instance, examines monetary policy rules and macroeconomic stability in Sri Lanka. Their econometric analysis concludes that the Central Bank of Sri Lanka follows the Taylor rule to set interest rates. An important finding is that the Central Bank of Sri Lanka responds to nominal exchange rate depreciation by tightening its monetary policy.

The sixth paper by Mehmet Ezer on the UK develops the Divisia index and shows that the UK monetary policy does not follow a Taylor rule. The author argues in favour of an interest rate-money rule as a preferred formulation for the conduct of UK monetary policy.

The final paper by Mansor Ibrahim is on the financial intermediation costs in a dual banking system. This is an important contribution to central banking policy because the emergence of a dual banking system characterizes several emerging markets, including Indonesia and Malaysia. This paper shows, using Malaysian data, that Islamic banks enjoy higher margins compared to conventional banks. Entry of Islamic banks reduces bank margins. This not only has implications for the stability of the banking system but also for the FinTech industry as a competitor to banks.

Six messages emerge from this special issue. First, understanding inflation dynamics is important in targeting price stability in Indonesia. Second, multiple macroeconomic and financial variables can predict Indonesia's inflation. Third, there is a role for FinTech in Indonesia's economic growth. Fourth, the conduct of monetary policy is different in an emerging market setting (such as Indonesia and Sri Lanka) compared to a developed country (such as the UK). Fifth, bank margins are important for banking sector policies and a dual banking system has implications for margins. Sixth, the EWMs are not cast in stone; there remains more work to be done to make them better. It is these six messages that make this BMEB issue special, as they have the potential to inspire additional research. This is the hope of this special issue.