CHAPTER I

INTRODUCTION

1.1. Background

Inflation is overall increase in price (Mankiw, 2010). It means a rising trend in the general price level of a country. Inflation is sustained increase in the price level at least consecutive three years (Gillis et al, 1996). Most of the countries in the world trying to stabilize this inflation by giving some policy. Such as reducing money supply by increasing interest rate. The impact of inflation is most of consumer will be loss purchasing power and it will be reduce the economic growth. If inflation in a country higher it will be reduce the welfare because everyone can't by something because the price high.

The highest inflation in Indonesia occurred in 1998 with 11.10% on February and jumped to 77.68% on August. This highest inflation based on pressure of prices from supply side because of depreciation of Rupiah sharply in this year. Then lower became to 2.01% in Habibie era. Inflation rate in Indonesia is the highest one in south east Asia because Malaysia, Thailand still get 2% and the lowest is Singapore with 1%. This Inflation come back highest in 2008 11.06%, because of the economics crises in the world. Then, stable in 2012 after that increasing in 2013-2014 around 8% (bps.go.id).

Economic Growth in a country reflect of the wealth of nation of a country. Economic Growth is one of indicators to know the rapid of economy on Indonesia it tend to low or high. The government of Indonesia want to tend their economic growth around 6%. Most of the countries in the world want to increase their economic growth because they want to increase their wealth of nation.

Afaf A.J (2007) on his research he get the result that there exists a statistically significant long-run negative relationship between inflation and economic growth. Every increase of economic growth will decrease the inflation. This increase because of increase in output, so it will be better to make the economic growth always increase.

Foreign Direct Investment (FDI) is a policy from the government to increase economic growth of a country. Most of country try to invite more investor to invest their money on that country and also for Indonesia did it. The aim for this policy is to increase output in Indonesia because increasing in capital. The highest FDI happen in 2002 is Rp 3146 billion and 2014 is Rp 7593 billion.

Interest rate is a tool of government to control the money supply in Indonesia. And it is also a tool to control the inflation in Indonesia. This policy come from Bank of Indonesia with announce of BI rate. BI rate in Indonesia around 6-8%, it is still highest than other country. Most of developed country keep their interest in 1% or under 1%. The problem is because Indonesia still has high inflation so the Central Bank keep maintain interest around 6-8%. The highest inflation in Indonesia happen in 2002 around 12-16% and in 2006 around 10-12%. But in 2014, BI rate slowing down become 7%. Interest rate will also increase the money supply on hand if interest rate low. Most people increase their loan after interest low and it will give impact on inflation. Mostly, interest using by government to control inflation by reducing money supply on hand.

Based on some explanation above, the authors are interested in studying and analyzing Inflation, Economic Growth, Foreign Direct Investment and Interest rate especially for Indonesia. Which is why the author gave a report entitled:

“Short and Long term effect of Economic Growth, Foreign Direct Investment and Interest rate on Indonesia”

1.2 Research Problem

According to the data from Central Bureau of StatisticsIndonesia, the inflation of Indonesia unstable year per year or month. This factor can be influence by many factors of macroeconomics variable that determine the cause of inflation in Indonesia. Inflation on a country should to keep stable because it would be make unstable on economics.

Especially for foreign direct investment and economic growth those macroeconomic variable always related on Inflation. It's mean that two variable closely related with capital and output. If foreign direct investment and economic growth increase it will be increase capital and also output. It’s mean that those variables increase the welfare of country because more output will produce.

For interest rate, if the interest increase it will be decrease the amount of money on hand from individual. Then, most of the individuals want to saving their money and decreasing their consumption and the effect of inflation will slow down. But if interest decrease, the effect is the money on hand increase because they increase their money by loan to banking and it will give negative effect because it will increase inflation.

1.3 Reserch Questions

1. What is the effect economic growth on Inflation in short term and long term to Indonesia?
2. What is the effect foreign direct investment on inflation in short term and long term to Indonesia?
3. What is the effect interest rate on inflation in short term and long term to Indonesia?

1.4 Research Objective

Based on the research problem, the author want to analyze the cause of inflation in Indonesia, such as :

1. To analyze the effect economic growth on Inflation to Indonesia during period 2000-2014.
2. To analyze the effect foreign direct investment on inflation to Indonesia during period 2000-2014.
3. To analyze the effect interest rate on inflation to Indonesia during period 2000-2014

1.5 Research Advantages

This study hopefully expected to be useful for writer and the others interest parties. And the benefits of this research include:

1. The results of this study are expected to contribute ideas or additional study materials, especially for the students of Department of Economics.
2. As input for academics and researchers who are interested to discuss the effect of economic growth, FDI and interest rate on inflation in Indonesia.

3. To see the result of effect of long-term and the short-term from that variables.

4. In addition, complementary and as the result of a comparison of the existing research on the topic.

1.6 Writing Systematic

Systematic writing of this study is divided into six chapters. As for each chapter are briefly described as follows:

Chapter I: Introduction

This chapter contains description of the background of the foreign direct investment in Indonesia. Theoretically and study case inflation influenced by macroeconomic variables such as economic growth, foreign direct investment (FDI) and interest rate. This chapter also describes about problem identification, research questions, research objectives, the research advantage, and writing systematic.

Chapter II: Theoretical Framework and Literature Review

This chapter will provide the Inflation theory and the relationship between inflation and economic variables such as economic growth, foreign direct investment (FDI) and interest rate. To support the literature review some explanation from empirical studies in the past, as proven.

Chapter III: Research Methodology

This chapter elaborates about study method of problem, containing research data such as research variables, data characteristics, population that accompanied by clarification about data collecting procedure, and also technique data analysis.

Chapter IV: General Overview

This chapter describes the overview of research object, such as overview about trend of inflation, economic growth, foreign direct investment (FDI) and interest rate.

Chapter V: Empirical Results and Analysis

This chapter discusses more about the study description contains a description of the research object, data analysis, interpretation and discussion of the result obtained from the study.

Chapter VI: Conclusions and Recommendations

This chapter consists of conclusion of the study and implication on the future research.