CHAPTER I

INTRODUCTION

1.1. Background

Indonesia as one of the country in the world that has became a concern of world international trade. Indonesia has the strategic location that makes Indonesia become the centre of many nations to do the trade. The international trade has been given the good impact for Indonesia welfare it could be seen from the Indonesia economic growth. Economic growth is one of the important instruments to measure the welfare of the countries. The country will be claimed as the developing countries if their economic growth is stable or increase every year. Every country is trying hard to promote their economic growth and stabilize the welfare of the people. Many aspects included to measuring economic growth and many factors that could promote the economic growth such as globalization and international trade.

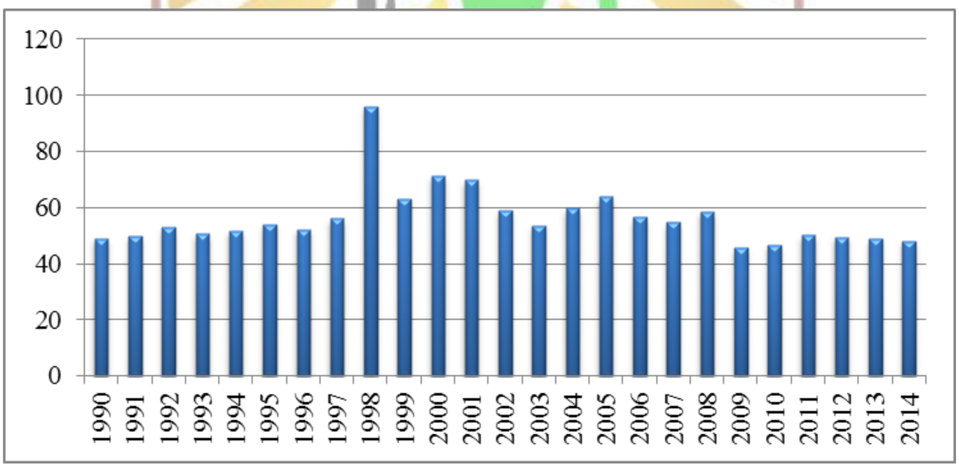
Nowadays, globalization becomes a great phenomenon, with the globalization, many countries can be connected each other. Globalization is the revolution of many scopes especially in term of industrial revolution. Industrial revolution will give a big contribution to the trade activity because industrial product is one of the product that has more comparative advantages rather than the other products. This condition also could promote the economic growth because globalization offered many advantages for the countries. International trade is one of the ‘things’ that offered by globalization (Salvatore, 2013).

Before join the international trade, every country has to open their economy in order to achieve the globalization. The globalization will connect each of the country by some sectors but if the country wants to connected their economy with the other country, they have to open their economy first. After open the economy the country is able to join the international trade.

Indonesia has been open their economy since a long time ago. Even it is still a small open economy, Indonesia has been join the international trade. Many countries have been done the trade transaction with Indonesia. Since Indonesia join the international trade, the percentage of trade in Indonesia increase every year and it could be seen from graph 1.1.

Graph 1.1

Trade in Indonesia 1990 – 2014 (% of GDP)



Source: World Bank

The graph shows the development of the trade every year. In 1998, the trade of Indonesia takes the higher point. At that time Indonesia face the great monetary crisis but the trade balance got the surplus that’s why trade in Indonesia is higher in 1998. The surplus trade balance is exist because of the lacking of import and foreign investment at that time then it makes a big range between the value of import and export and the surplus trade balance is existed (Merdeka, 2013). After 1998, the development of the trade in Indonesia is going fluctuated. In 2009 the trade is decrease significantly, but slowly increase in the next year and it is going to be stable until 2014.

International trade is became a famous topic for the economists, it has been discussed since long time ago. The international trade or could be defined as export and import activity to across the country, will help the country accelerated the economic growth.

One of the theories that say about the international trade is The Mercantilism. This theory says that a country should export more and reduce more import. This theory exists because when a country focuses more export they get many gains from trade and it could increase their welfare. From that theory, we can see that the export activity could improve the value of GDP which is one of the indicators for measuring the economic growth (Salvatore, 2013).

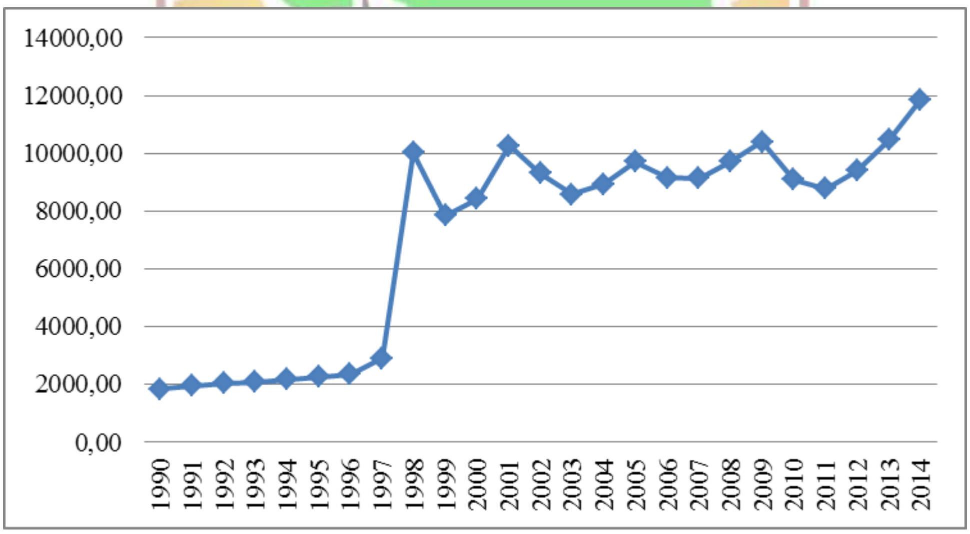
In some case, the import could promote the economic growth better than export because a country will get some commodities from abroad if they cannot fulfill the demand of the country. Import will reduce the income of the country because the country usually import in a big amount of commodity but if the imported goods could increase the productivity of the country, import will help the country to promote the economic growth. Indonesia is one of the countries that has some problems caused by the lacking of the commodity, it makes

Indonesia has to import many commodities from the other countries in a big amount and it reducing the saving of Indonesia.

International trade always has a relationship with the exchange rate because exchange rate is one of the important things in doing the trade especially in the international market. Exchange rate and international trade cannot be separated because of the price that able in the world market. World market or international market will use Dollar as the world price it makes every country have to exchange their currency that's why the value of exchange rate is important in the world market. The growth of the exchange rate will be explained in graph 1.2.

Graph 1.2

Exchange Rate of Indonesia 1990 – 2014



Sources: Federal Reserve Economic Data (FRED)

From graph above, in 1997 to 1998 there is a significant increasing of the value of Rupiah to US Dollar. This situation exists in the monetary crisis in 1998. At that time, the value of rupiah is depreciate, it makes Indonesia cannot import from the other country.

This problem is begin with the Asia Crisis in 1997 where Indonesia is one of the Asian country that get the dramatically impact from the crisis. This crisis makes Rupiah depreciated and it become worse because of the higher inflation in the next year (Wikipedia, 2016). From that condition, exchange rate has the important role in economic growth because when the value of the exchange rate uncontrollable, the economy become worse.

Rupiah takes time to be recovery and there are many rules that protect the stabilization of Rupiah. Based on the previous monetary crisis, the Central Bank of Indonesia always focus on stabilize the inflation and also the value of Rupiah in order to avoid the monetary crisis in the future. The relationship between the exchange rate and international trade to the economic growth in Indonesia could be positive and negative in some period, because of the condition and also the regulation at that time.

Given the economic growth is one of the fundamental variables of the economy, decision-making and the scale of international trade and exchange rate certainly become a consideration for policy makers. Not only considering the gains from trade that would be obtained through the international trade, exchange rate stability must also be considered in order to achieve the economic stabilization. This makes author interested in conducting research on "The Nexus of International Trade, Exchange Rate and Economic Growth in Indonesia: A Vector Error Correction Model (VECM) Approach".

1.2. Research Problem

Many developing countries focus on trade because the gains from trade will help to promote the economic growth of the country. The more a country exports, the more benefit gained by the state itself. And also the stable exchange rate would give a significant impact on international trade and economic growth. But in some cases imports will provide a positive impact on economic growth. Based on the above conditions, the problems will be review in this study is how the relationship between international trade, exchange rates and economic growth in the long run and short run?

1.3. Research Objectives

Every country has their own shape of economic and problems on their economy. Sometimes export did not give any impact on a country's economic growth. In several cases, import could promote the economic growth better than export and it happen in some countries. Not only trade, some aspects like currency and politics could increase the economic growth of a country especially exchange rate. Based on the problem that has been presented, this study is aimed to analyze the relationship between international trade and exchange rate to Indonesia economic growth in the long run and short run.

1.4. Research Hypothesis

This study is discusses about trade, exchange rate, economic growth and the nexus between them in Indonesia. The Mercantilism said that to promote economic growth the country have to export more and reduce import and maintain the positive trade balance (Salvatore, 2013). Some previous researches have the same opinion where export will increase the value of economic growth and import will reduce the value of economic growth.

When discussing international trade, the exchange rate is one part of it that cannot be separated. Exchange rate will affect the relative price of domestic and foreign good (Mishkin, 2004). Some of researches stated that exchange rate has a negative relationship with economic growth, when the value of the exchange rate increase, the value of economic growth will be decreased. From both of explanation, it can be hypothesized that international trade will increase the economic growth and exchange rate has a negative relationship economic growth.

1.5. Research Advantages

International trade, exchange rate and economic growth is the topic that is discussed in this research. This research is expected to provide important information about the effect of international trade and exchange rate on economic growth in Indonesia in the long term or short term.

The academics also can make this as proof of the existing theories regarding to international trade, exchange rate and economic growth, and this research also reinforce the theory based on the experience of Indonesia. This research can be used as a complement previous studies and also used as a reference for further research. This research can be taken into consideration for the decision makers in determining the trade rate and exchange rate in Indonesia.

1.6. Limitation of Study

The data used in this research is quarterly time series data during 1990-2014 and the population in this study is the whole world because this research can be applied in many countries, but in this research take Indonesia as the sample. The variables that will be to examine the nexus of international trade, exchange rate and economic growth are Gross Domestic Product (GDP), Export, Import and Exchange Rate.