CHAPTER I

INTRODUCTION

1.1 Background

Money is an object that essentially serves as medium of exchange, store of value, unit of account, standard for deferred payment. Bank Indonesia as the central bank of Indonesia that trying to implement the function of monetary authorities whose job was to issued and circulated the money. If we remember again a flashback during Eid yesterday most of us must realize is receiving new money still seamlessly with its distinctive odor.

Ordinary people generally (perhaps some of us) are familiar with the new currency trend but did not realize what was actually happening. Throughout the month of fasting until the feast of the government, through Bank Indonesia, increase the amount of money circulating in the community. This is caused by the high demand for cash and the high level of consumption throughout the day even when Ramadhan.

The all of money circulating in the community is called money supply. Money Supply is the amount of money circulating in the economy and available for trading. Based on Keynes's theory of money supply (Karpetis, 2006) stated that increase in the money supply has a positive effect on output and economic growth. Due to the increasing the money supply is expected that the consumption rate will be increased so as to encourage increased economic growth. If there is excess supply of money, Bank Indonesia will take the policy lowering interest rates. These conditions may encourage investors to invest in Indonesia which in turn creates an increase in output and boost economic growth. The money supply also has a close relationship with interest rates in a country.

According to Apir Justine (2015) about the quantity theory of money by Irving Fisher, he said that when the money supply increase, the price of goods and services will also increase. So that, increased circulation of money in the community is one of the causes of inflation and this is driving the rising prices of goods and services in a country. If a country is in a state of inflation, the government should reduce the level of money supply.

Money supply is a very sensitive variable, the size of which determines the pace of any economic activities. Apart from being a powerful instrument of monetary policy, its expansion or contraction dictates the growth in investment and output of any economy. It is therefore the usual slogan of the Monetarist school of thought that money matters. They argued that changes in the amount of money in the circulation are the sources of other economic changes. In other words, the changes in the size of money supply have a number of implications on the macroeconomics variables especially inflation.

The growth of Money Supply in Indonesia is always increasing every year from the Central Bank's Data. In 1995 money supply of Indonesia is 8.35%. When the monetary crisis happen in 1998, money supply change but not too large, that is 8.76%. After the crisis, money supply in Indonesia is increasing every year or tend to increasing untill the money supply in 2016 is 9.70%. The average growth of Money Supply in Indonesia from 1995 to 2016 is 0.72%.

UNIVERSITAS ANDALAS
UNTUK KEDJAJAAN BANGSA

According to Kaplan and Gungor (2017), assume that money supply is endogenous, Central Bank is not the sole authority in the identification of neither money supply nor interest rate. According to Fiedman, while the amount of money is under the control of money authorities, interest rate may differ with the development of monetary transactions irrespective of the demands of authorities (Mankiw, 2008). An interest rate is very well stated as the rate of increase over time of a bank deposit.

An Interest, which is charged or paid for the use of money, is often expressed as an annual percentage of the principal. It is calculated by dividing the amount of interest by the amount of principal. Interest rates often change as a result of the inflation and Government policies. The real interest rate shows the nominal interest rate and inflation. There is a very close relationship between interest rates and the inflation level. Any change in interest rates will likely have an impact on consumption and, therefore, will create a shift in inflation levels. On the other hand, any increase in price levels will oblige central banks to adjust interest rates. This phenomenon forms the basic equation of regulation for central banks.

Interest Rate in Indonesia also quitely fluctuate every year, from 1995 to 2016. In 1995, the Interest Rate in Indonesia is 13.99% then in the next year its keep increasing untill the peak in 1998 become 38.44%. In 2008, when crisis happen, Interest rate didn’t change significally but stay same. Then Interest Rate in Indonesia decrease significantly from 7.5% in 2015 become 4.75% in 2016. The average from Interest Rate in Indonesia from 1996 to 2015 is 1.67%.

The control of inflation has been a major macroeconomic policy goal in most countries of the world. In the period of inflation not all prices and wages rise proportionately and this affects income distribution negatively. For instance, retirees in many countries have payments that do not keep up with the price level and this makes them to suffer economically. Also, when some prices are fixed by law/regulation, they lag behind other prices resulting in changes in relative prices and price distortions.

The trend of inflation in Indonesia is fluctuate every year, in 1995 inflation of Indonesia about 9.4%, but in 1998 inflation Indonesia increase significantly become 58.4% which is in the previous year 1997 inflation rate is just 6.2%. This is happen because at the time there is economic crisis, the price of goods and services are increase. In the next year, government with central bank are able in recovery the economic, even not clear yet. So, inflation in 1999 decrease become 20.5%. Inflation rate move up and down in the next year, until 2016 inflation in Indonesia is 3.02%, this the lowest rate of inflation but it's already predict by the government.

UNIVERSITAS ANDALAS
UNTUK KEDJAJAAN BANGSA

While, the matters concerning fiscal policy is a policy in the field of Government Expenditure. The role of government in this case is very important to control the money supply and interest rate and its relation to the inflation rate, so expect the budget balance, expenditure and receipt are the same. Government Expenditure refers to money spent by the government of any nation in carrying out its constitutional responsibilities of providing social amenities for its citizenry and protecting its territorial integrity. Inflation on the other hand is a sustained rise in the general level of price in the economy while inflation rate is the rate at which the price level increases (Blanchard, 2006). Theoretically, government expenditure may have causal relationship with inflation rate, *ceteris paribus.* It is may be merely correlated with it sometimes.

The growth of the Government Expenditure in Indonesia is always increasing every year from percentage of GDP. Government Expenditure in indonesia in 1995 is 7.83% from the GDP, then in 1998 when the monetary crisis happen, government expenditure of Indonesia decrease become 5.69%. After the crisis, government expenditure in Indonesia is tend to increase untill 2016 is 9.79%, so the gowth of government expenditure in Indonesia since 1995 until 2016 is 1.34%.

According to Komolafe and Addison in Momodu and Ogbole Journal's (2015), Government expenditure (together with monetary and exchange rate policies) influences inflation (and other macroeconomic aggregates), and also opines that fiscal policies affect inflation and advocates for a reduction of overall expenditure in selected areas by consolidating overlapping expenditure programmes and by reprioritization of expenditure to improve budgetary transparency. He added that government should investigate the impact of its spending on the economy so as to guide it in its future spending.

According to the explanation before, it is interested in analyzing the impact of money supply, interest rate and government expenditure to inflation in Indonesia. Which is why the author gave a report entitled:

"***THE IMPACT OF MONEY SUPPLY, INTEREST RATE AND GOVERNMENT EXPENDITURE TO INFLATION IN INDONESIA***"

1.2 Research Problem

The government expenditure is relatively more effective compared with money supply and interest rate on economic activities. Government expenditure as a fiscal policy instrument is greater, more reliable (predictable) and faster than the use of money supply and interest rate as a monetary policy instrument in stabilizing the economy. Since both government expenditure, money supply and interest rate are policy instruments use to stabilize the economy, government should rely more on government expenditure than money supply and interest rate. So then, this study aims to answer the following question:

1. What is the development of money supply, interest rate and government expenditure to inflation in Indonesia during 1995 until 2016?
2. How does the relationship of money supply, interest rate and government expenditure toward Inflation in Indonesia?

1.3 Research Objective

Based on the formulation of the problem above, by using a reference point to solve the problem, researcher are trying to get briefly goals and to be achieved:

1. To analyze the development of money supply, interest rate and government expenditure toward inflation in Indonesia during 1995 until 2016.
2. To analyze the relationship of money supply, interest rate and government expenditure toward inflation in Indonesia.

UNIVERSITAS ANDALAS

1.4. Research Advantages

This study hopefully expected to be useful for the writer and the others interest parties. There are some advantages of this research:

1. To see the condition of money supply, interest rate and government expenditure in Indonesia whether it could give contribution to solve inflation in Indonesia.

2. The result as the references for another researcher to find important policy measured that can be adopted by concerned authorities to control money supply, interest rate and government expenditure towards inflation.

3. As a source of information, studies and additional reference materials for students of the Department of Economics Faculty of Economics, University of Andalas, especially for students who want to do further research.

1.5. Systematic Writing

This thesis is prepared using the following systematic:

CHAPTER I : INTRODUCTION

Contains background and formulation of the problem, the objectives to be achieved, the benefits of the research, and writing the systematic thesis is used.

CHAPTER II : THEORITICAL FRAMEWORK AND LITERATURE REVIEW

Contains theories include previous research, understanding about Money Supply, Interest Rate, Government Expenditure and the factor that influence the Inflation in reference supporting and related issues presented, review past research and the research hypothesis.

CHAPTER III : RESEARCH METHOD

This chapter consist of a frame of mind, several sub-chapters that include data and data sources, identification of variables, methods of data analysis and technique of data collection, and data analysis techniques used.

CHAPTER IV : OVERVIEW RESEARCH VARIABLES

This chapter describes about the trend that happened in each variable include money supply, interest rate, government expenditure and inflation.

CHAPTER V : EMPIRICAL RESULT AND ANALYSIS

This chapter consists of the outline result, discussion of description in object research, data analysis and description.

CHAPTER VI : CONCLUSION AND RECOMMENDATION

The last chapter is a cover consisting of conclusions and recommendations based on research and analysis of the results obtained from the data processing.

UNIVERSITAS ANDALAS
UNTUK KEDJAJAAN BANGSA