CHAPTER 1

INTRODUCTION

1.1 Background

The exchange rate is define a the price of foreign currency in domestic currency, so that an increase in te exchange rate means higher price of foreign exchange is causing domestic currency is relatively cheap or occur depreciation, otherwise if there is a decrease the number of unit of domestic currency needed to buy one unit foreign exchange, there is a relative increase in the value of domestic currency appreciation or occur (Mishkin,2006). The exchange rate is very important, if a country must conduct economic transactions with other countries. This is because the process is in use two different currencies. For example, Indonesia and the United States, the United States should buy rupiah to buy goods or conduct economic activities in Indonesia, and vice versa. Indonesia must buy dollars to buy goods or conduct economic activities in the United States. In simple terms the exchange rate can be interpreted as the price of a domestic currency against the currency of another country.

In economics, the exchange rate of a country's currency can be divided into two, namely the real exchange rate and nominal exchange rate (Mankiw, 2006). The nominal exchange rate is the value that is used when exchanging the currency of a country with the currency of another country. Thus, the rupiah of exchange rate is the value of a rupiah currency that is exchanged into other countries' currencies. For example, the rupiah exchange rate against the US dollar, the rupiah exchange rate against the yen and others. While the real exchange rate states the rate at which someone can trade goods or services from a country with goods or services from other countries.

The real effective exchange rate is a measure of the international competitiveness of an economy and an overvalued real exchange rate increases the price of domestic goods abroad, leading to lower demand for exports. Moreover, misalignment of the real exchange rate leads to price distortions and hence resource misallocation (between the tradable and non-tradable goods sectors). While misalignment of the real exchange rate can be an undervaluation or overvaluation, overvaluation has been the common case in developing countries. An overvalued real exchange rate reduces profit in the tradable goods sector, thereby reducing investment in this sector. This has negative implications on export and hence the trade balance.

The exchange rate becomes important because the exchange rate can be used as an instrument to measure the economic condition of a country. A country that has a stable currency value indicates that the country has stable economic conditions (Salvatore, 1997). Extremely high exchange rate fluctuations will disrupt economic activity from both the real sector and the monetary sector. So good exchange rate management is required in order for the movement of the exchange rate to be stable so that fluctuations can be predicted and the economy can continue to run well.

In order to maintain exchange rate stability, it is necessary to first identify the factors that influence the movement. Many studies have been conducted to develop exchange rate models that can explain the factors that influence it, and measure the significance and magnitude of the influence of each of these factors.

Indonesian economy in early 1983 experienced a fluctuating movement, due to declining world oil prices. In those days, the economy was faced with declining economic growth and a balance of payments deficit. Thus, the exchange rate of the rupiah is over-valued and reduces the competitiveness of Indonesian exports abroad. To improve the competitiveness of exports, the exchange rate policy undertaken is to devalue the rupiah exchange rate by 38.1% (Simorangkir, 2004). The deregulation of the monetary, financial and banking sectors of 1988 has succeeded in increasing the flow of foreign capital into Indonesia. the capital flows are not limited to long-term capital flows, but also short-term capital flows. Short-term capital returns can be harmful to the national economy if the government does not have sufficient foreign exchange reserves to keep the floating exchange rate system under control. To avoid the negative impact of short-term capital flows, since 1992 adjustment of exchange rate policy by widening the band of intervention. The widening is also intended to encourage the development of foreign currency and reduce the dependence of foreign exchange demand on Indonesian banks

The bad experience that hit in middle 1997, Indonesia is experiencing an Asian financial crisis, where the rupiah exchange rate weakens, so it moves above ten thousand rupiah per dollar. This is due to the falling value of the Thai currency which impacts the stock market and currency of Southeast Asian countries. Its influence in Indonesia begins with the fall of assets worth the rupiah (Prasetiantono, 2013). This condition is getting more difficult when capital inflow had changed become capital outflow, which could be harmful to exchange rate of rupiah or national economy. Depreciation sharply of exchange rate has resulted in a rise price of import goods and occurrences of inflation up to 77.6 %. The depreciation of the rupiah also gives impact to many industries in the country to face difficulties, especially the industries whose raw materials depend on imports. All these factors accumulated have resulted in economic activity being a deep contraction up to -13.1% in 1998.

Capital inflows tend to increase foreign exchange reserves, thus improving the performance of the balance of payments. Increase in foreign exchange reserves causes the exchange rate of currency tends to appreciation. Conversely, the deficit in capital transactions indicates the occurrence of net capital outflows. If this happens, the flow of foreign exchange reserves abroad increases which further worse the balance of payments and is followed by the depreciation of the exchange rate of the country's currency (Efraim Sadka, Assaf, & Razin. 2003)..

The growth of stable currency values indicates that the country has a stable economic conditions, in 2013 Indonesia's economy suffered due to the weakening of the rupiah exchange rate. The weakening of the exchange rate caused the economy to be hit by the economic crisis. The Indonesian economy is likely to be unstable, requiring the government and the monetary authorities to adopt the right policy, so that if the stability of the domestic currency can be achieved, the national income will also increase. According to Mundell Fleming in Mankiw (2007), fiscal policy through government expenditure instruments has a dampat on exchange rate movements. Fiscal expansion will increase aggregate demand, aggregate demand increases will drive domestic prices so demand for money increases causing exchange rate appreciation. Chinn (1999), examined the relationship between fiscal policy, especially government spending and real exchange rates, found a correlation between increased government consumption expenditure and long-term exchange rate appreciation. Chowdhury (1999), the real exchange rate reacts to a series of real and nominal disturbances, including international terms of trade shocks, government expenditure patterns, trade restrictions, net capital inflow, foreign aid and technological progress.

In the global economy, economic interaction with other country is one of importnt aspects of country’s economic development that has open economy. Greater the interconnection between countries, the more open the economy of the country concerned, as reflected in the increase of trade transactions and the flow of capital between countries. A country which can not fulfill requirement of certain goods and services of production in the country may import goods and services from othe countries. In other hand, a country may export the goods and services for country who need goods and services that . Openness economy of a country will have consequences on planning and implementation of macroeconomic policies, including policies monetary. That's because the greater the trade and financial transactions internationally conducted by a country, the greater the flow foreign capital entering and leaving the country concerned. Flow the foreign capitl will then affect the amount of money supply, interest rates, and exchange rates in the economy (Syarifuddin, 2015). According to Mankiw (2007), a country with an open economy is a country whose economy is integrated with a world that characterized by export and import activities of goods and services as well as engaging in activities in world capital markets. According to Nopirin (1999), economic openness through international trade can be seen from two components, namely export and import. Exports are goods and services sold to buyers outside the country, while imports are those purchased from foreigners.

Atif et al. (2012) analyzes the behavior of the Australian dollar exchange rate and the factors that influence it and distinguish between the factors economic and non-economic. The analysis used is a coherent analysis time with analytical methods of autoregressive (AR) and cointegration Engle-Granger. The variables used in the study, between others, interest rates, capital account, money supply, inflation index, export net, net foreign assets, share price index and dummy political stability. Results research shows that the components of trade in the economy and fundamental economic indicators, such as economic output relative and the level of domestic liquidity against a foreign country, has a significant role in the determination of exchange rates. However, contradictory with the existing literature, interest rate and inflation variables do not have a significant influence in the determination of exchange rates.

Oriavwote and Oyovwi (2012) who studied about "The Determinants of Real Exchange Rate in Nigeria" show the result from the error correction model shows that increase in trade openness, capital inflow, capital accumulation and appreciates the real effective exchange rate of Nigeria. This is a major contribution of the this paper because other studies including that by Mungule failed to realize the important influence of the price level on the real exchange rate. Also, an increase in the nominal effective exchange rate and output depreciate the real effective exchange rate.

Foreign aid, more commonly known as official development assistance (ODA) has given impact on real exchange rate. according to Chowdhury (1999), if major share of foreign aid is spent on nontradable, the price of tradable will be pushed down, relative to nontradables, which tends to appreciate Real Exchange Rate. Weisman in Arhenful (2013), impact of aid inflow to Papua New Guinea, he finds that aid inflow increased government spending, which in turn increased in prices of non tradable goods and services. Ouattara and Strobl (2004), apply the first difference-generalized methods of moments (GMM) estimator on a sample of 13 CFA countries and find that foreign aid inflows are associated with a depreciation of the real effective exchange rate

Therefore, based on these condition, the authors are interested to analyze this problem in a thesis with the title: "THE DETERMINANTS OF REAL EXCHANGE RATE (RER) IN INDONESIA".

1.2 Research problem

There are several main problems that we have found in this study those as follows:

1. What are the factors that affect the real exchange rate?
2. How do the short term and long term effect of variable economic that effect on Real Exchange Rate in Indonesia ?

1.3 The Main Objectives

The main objectives of this study are:

1. To analyze the impact of Net Capital Inflow, Government Expenditure, Trade Open and Foreign Aid to Real Exchange Rate in Indonesia during 1981 until 2013?

2. To describe the determined short term and long-term effect of Net Capital Inflow, Government Expenditure, Trade Open, Foreign Aid and changing of exchange rate system on Real Exchange Rate in Indonesia.

1.4 Research Advantages

This study result will over several advantages to several users:

1. As an additional materials and complementary to previously existing researches.
2. As a supplementary study materials and literature for students of the Faculty of Economics of Andalas University, especially for students of in Economics Department.
3. As references materials and information for further research, as well as to increase of knowledge for the writers.
4. As an input for the benefit of the government or related institutions

1.5 Research Hypothesis

Hypothesis is the temporary answer for the question of this study. So based on the study, the hypotheses are:

1. It assumed that capital inflow has positive impact on Real Exchange Rate in Indonesia
2. It assumes that government expenditure has negative impact on Real Exchange Rate in Indonesia
3. It assumed that trade open has positive impact on Real Exchange Rate in Indonesia

4. It assumed that foreign aid has positive impact on Real Exchange Rate in Indonesia.
5. It assumed that changing of exchange rate system positive impact on Real Exchange Rate in Indonesia

1.6 Systematic Writing

The results of this study are arranged in such a way that can be understood easily. Writing this thesis is divided into six chapters with each chapter details the following:

Chapter I **:** Introduction

This chapter contains the description of the background of the determinants Real Exchange Rate in Indonesia. This chapter also describes about problems, research objectives, research advantage, and systematic writing

Chapter II : Literature Review

Describe the theory of real exchange rate, theory Of Trade Open, Theory of Government Expenditure, Theory of Capital inflow and Theory of foreign aid. Provides the previous research with some review of past research that explains from empirical studies in the past as proven

Chapter III : Theoretical Framework & Methodelogy

This chapter tells about research methods, operational definition of the variables study, collection all data, source of data, method and data analysis method.

Chapter IV : General Overview

This chapter describes about the trend that happened in each variable include RER, TO, CI, GEX and AID

Chapter V : Research Finding

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

Chapter VI : Conclusion and Recommendation

This chapter consists of conclusion of analysis carried out, suggestion, and implication arising from the conclusion of problem