CHAPTER I

INTRODUCTION

1.1 Background

Stock indices are powerful tools for monitoring economies since they indicate how a nation's capital market fares. Indonesia's flagship index revealing how all the stocks being traded on Indonesia Stock Exchange (IDX) perform is its composite stock price index, IHSG. The IHSG shows how the national economy is doing and how it is changing, and it also helps investors decide where to put their money. The Islamic financial market grew at the same time as the introduction of the Indonesia Sharia Stock Index (ISSI), which includes all stocks on the Financial Services Authority's (OJK) Sharia Securities List (DES). ISSI is a broad measure of how well Indonesia's sharia capital market is doing. From ISSI, a more selective sub-index was created, namely the Jakarta Islamic Index (JII), including the 30 largest and most liquid of the sharia stocks. These stocks not only meet Islamic principles but also pass strict selection based on market capitalization and daily trading volume.

Sharia-compliant stocks are investment instruments that adhere to Islamic principles. Unlike conventional stocks, sharia stocks have specific characteristics governed by fatwas issued by the National Sharia Council (DSN-MUI) and the regulations from the Financial Services Authority (OJK) (Khoirin Andi, 2023). In the context of the capital market, sharia stocks represent ownership in a company, with the requirement that the company must not engage in activities prohibited under Islamic law, such as interest (riba), gambling, or excessive speculation (Fauziah & Andri Ibrahim, 2022). All processes related to issuance and trading of sharia stocks must comply with Islamic principles and regulatory guidelines issued by relevant authorities.

For something to be categorized as a sharia-compliant stock, issuers must fulfil both quantitative and qualitative benchmarks. Qualitatively, the firm should not engage in any business activities that are commonly considered subversive to Islamic tenets, including interest-based financing, gambling, and manufacture or distribution of alcohol and other non-halal activities (Fauziah & Andri Ibrahim, 2022) as well as exhibit responsible management of their investments or assets through shielding against risky/insecure instruments, and exhibit transparency and active investing. The business must also quantitatively meet the financial ratio standards, such as maintaining debt below the prescribed amount by the fatwas of DSN-MUI (Fauziah & Andri Ibrahim, 2022). Additionally, the business must demonstrate strong revenue growth and provide investors with competitive returns. Following DSN-MUI's fatwas, which provide the legal basis for guaranteeing the halal status and moral integrity of all stock transactions, is necessary in order to list as a sharia-compliant stock on the IDX (Khoirin Andi, 2023). Thus, in addition to being halal investment vehicles, sharia-compliant stocks also exhibit moral rectitude and support equitable and sustainable economic growth that is consistent with Islamic principles.

The correlation between sharia and typical stock indices in recent years shows they often move together, but they possess different performance characteristics. Up to the end of 2024, Jakarta Composite Index (IHSG) was at 7,036.57 with a 5% market capitalization increase. Indonesia Sharia Stock Index (ISSI), on the other hand, was at 213.86, having registered a 0.57% increase, translating to a near-10% sharia market capitalization increase (OJK, 2024). Such figures suggest that the sharia stock market has been relatively stable, including during the COVID-19 pandemic period. The

Financial Services Authority (OJK) also recorded a significant rise in the number of sharia investors and increased trading volume in the sharia capital market between 2020 and 2022. One of the main indices that reflects the sharia stock performance is the Jakarta Islamic Index (JII). JII only includes 30 carefully chosen sharia-compliant equities that satisfy strict requirements in terms of Islamic principles, basic performance, and market liquidity, in contrast to the more encompassing ISSI. People think that JII is a better way to tell how investors feel about changes in the macroeconomic landscape because of these traits.

Although both are sharia-compliant stock indexes in Indonesia, the Indonesia Sharia Stock Index (ISSI) and the Jakarta Islamic Index (JII) differ significantly in terms of coverage, number of stocks, selection criteria, and market focus. The ISSI covers all sharia-compliant stocks listed on the Indonesia Stock Exchange (IDX) and registered in the Sharia Securities List (DES) issued by the Financial Services Authority (OJK). Therefore, the ISSI broadly reflects the overall performance of the Indonesian sharia capital market. In contrast, the JII is a sub-index of the ISSI, comprising only 30 sharia-compliant stocks with the highest market capitalization and liquidity. Stocks for inclusion in the JII are chosen according to average market value as well as having had the highest average value of transaction over a given time period. Hence, the JII reflects the most liquid and active sharia-compliant stocks, which make it more concentrated and reflective of Indonesia's largest sharia-compliant stock market changes. Due to these differentiations, the ISSI serves as a comprehensive index, which includes all Islamic stocks, whereas the JII serves as a selective index, which suits investment performance appraisal as well as empirical studies of Indonesian Islamic capital market better. For this reason, this paper utilizes the JII, as it best reflects the basic performance of actively traded Islamic stocks and exerts significant influence on Indonesian Islamic capital market as a whole.

The rate of exchange (IDR/USD), inflation, export and import transactions are key macroeconomic variables that indicate a national economy's performance, which strongly correlates with monetary conditions, price levels, as well as a nation's competitiveness as compared to others. Such factors possess a high capability of impacting Jakarta Islamic Index's (JII) behaviour in the market. The rate of exchange (IDR/USD), inflation, as well as export as well as import activities function as crucial macroeconomic variables that reflect national economic performance, largely correlated with external sector strength as well as international competitiveness (Irfan et al., 2021). Export performance refers to the extent to which a local industry may access or create a presence in global markets, while importing refers to the level of a local industry's reliance upon foreign raw inputs or finished products. A rise in exportations will often result in a boost to foreign exchange reserves and positively influence investor sentiment, yet high levels of importing may increase exposure to exchange rate fluctuations. Therefore, fluctuations in both exportation and importing levels may affect Jakarta Islamic Index (JII) performance, more so for players who participate in raw exportation importation.

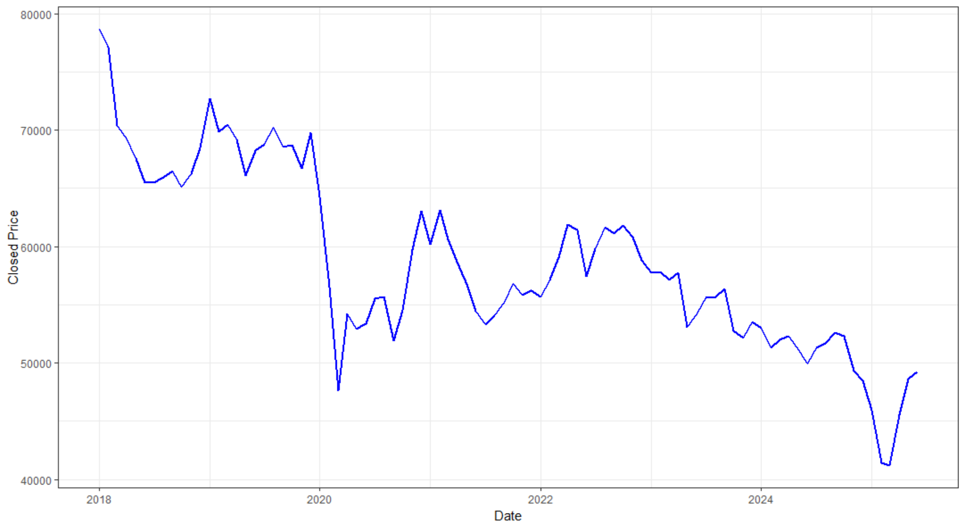

Figure 1.1 The latest price of the Jakarta Islamic Index

Source: Investing.com (2025)

Figure 1.1 illustrates factors affecting closing price for Jakarta Islamic Index (JII) from 2017 to 2025. Notice that the graph shows a constant decline trend with a sharp decline at the beginning of 2020, which reflects COVID-19 pandemic impacts. In spite of a temporary recovery during 2021, the index has remained volatile with a general weakening pattern during 2025. This indicates that the JII responds most strongly to changes in macroeconomic conditions, which stresses that understanding the relationship between such factors and performance of JII remains imperative.

Inflation is also a macroeconomic influence that impacts capital market performance. If inflation is widespread, it gets more challenging for firms to control costs as prices as well as costs for products and operations might increase. This can adversely affect corporate profits and stock prices. This issue remains most relevant for shariah-compliant stock benchmarks, like the Jakarta Islamic Index (JII). The companies that constitute members of the JII are almost entirely members of the real sector, meaning that they are prone to price volatility in the market. Inflation that goes unchecked destroys predictability for profits while increasing uncertainty. Other studies, for instance, (Afrinal, 2024) indicate that surging inflation has a connection with business irregularities, thus putting sharia stock at risk. Price stability being an integral component in ensuring that sharia-related investments are upheld for the long term. The IDR/USD FX also receives critical attention with respect to the capital market, at least its impact on firms whose products are imported or owed debt in foreign currency. The situation is similar when the rupiah weakens against the dollar, making imports and repayments on debts more costly and squeezing companies' finances further leading to reduced profits. This in turn usually drives down the stock price. The problem is even more relevant to sharia compliant companies that are importing raw materials or operating globally. Fluctuations in the exchange rate have been found to have an impact on Islamic stock indices as well, according to (Dini, 2021) and (Irfan et al., 2021). The fixed exchange rate is seen as an important indicator to investors as it lowers uncertainty and mitigates portfolio risks. Also, a number of studies have shown the relationship between stock indices movements, even Islamic indices around the Jakarta Islamic Index (JII). This has a connection of macroeconomic variables such as inflation and exchange rate to the economy.

There are existing studies that consider Islamic stock indices no more than conventional indices, disregarding the possibility that macroeconomic variables may affect Islamic-based assets differently (Mulyadi et al., 2023). This shows that there is less research identifying the specific effects of macroeconomic variables on the Islamic Index like the Jakarta Islamic Index (JII) (Latifatunnisa & Sudarsono, 2024). To fill this void, the current study takes on the VAR and VECM methodologies. These models enable the study of both short-term processes and long-term associations, as well as causality testing between variables. This study uses long and extended time series data to try to give a better and deeper explanation on JII direction based on the movement of inflation, exchange rate, export, and import.

1.2 Problem Formulation

1. How are the short- and long-run relationships between exchange rate, exports, imports, inflation, and the Jakarta Islamic Index (JII) modelled within the VECM framework?
2. Is there a causal relationship between macroeconomic indicators (exchange rate, exports, imports, and inflation) and the Jakarta Islamic Index (JII)?

1.3 Research Objective

1. To analyse the short- and long-run dynamic relationships between exchange rate, exports, imports, inflation, and the Jakarta Islamic Index (JII) using the Vector Error Correction Model (VECM) approach.
2. To examine the existence of causal relationships between those macroeconomic indicators and the Jakarta Islamic Index (JII) within an endogenous system framework.

1.4 Research Benefit

1. Theoretical Benefits

   This research is expected to enrich the empirical literature in the field of Islamic economics and finance, particularly regarding the dynamic relationship between macroeconomic indicators and the Islamic stock index in Indonesia. The application of the Vector Error Correction Model (VECM) allows us to have an empirical contribution that serves to analyse relations between endogenous variables both in the long period as in the short period.

2. Practical Benefits

   The results of this study will constitute a rich asset for investors, Islamic investment managers, as well as policymakers, such that they will understand the effects of macroeconomic factors on the performance of the Islamic stock market. Such an understanding is crucial since it forms a groundwork for sound investment decisions, risk management, as well as drawing of more relevant economic and financial policies that are more aligned with Islamic market dynamics.