

CHAPTER I

INTRODUCTION

1.1 Research Background

The stock market has gained worldwide recognition as one of the main sources from which one can derive important information about the state and direction of an economy within a country. Stock market changes, such as the ones witnessed in the Jakarta Composite Index (IHSG), have always responded in an elastic manner to the changes in the global and local economic landscape, particularly in light of the interconnection between economies in the present era. Such dynamic responses result from the increased influence that capital flow and signals play across borders in today's economy. The stock market, in Indonesia, serves two major purposes that go beyond its basic function. This can also be considered a critical metric, which measures the perceptions of the investors regarding the durability, sustainability, and future course of the economic environment of the country. As the level of confidence in economic management, policymaking, or growth prospects increases, the performance of the stock markets tends to correspondingly rise via high levels of indexes. On the other hand, any doubt or exogenous events may adversely affect the level of confidence, thereby creating instability in the stock prices. Thus, fluctuations in the IHSG are not merely coincidental occurrences but have deep-rooted connections with the economic stories surrounding the nation and the world at large. However, when economic performance is favorable, stock markets tend to exhibit consistency in terms of an upwards trend, as a result of increased investor optimism regarding future gains. The upwards trend may be attributed to favorable macroeconomic trends and enhanced corporate performance, resulting in increased investor optimism. On the other hand, when economic performance is poor or there exists economic uncertainty, the Jakarta Composite Index (IHSG) is subjected to strong downward pressure. Poor economic performance leads to the change in investor attitudes towards risk, leading to the implementation of certain strategies in the investment process. In some cases, investors may move away from risky investments such as equities and venture into less-risky investments. It is worth noting that any

variations in the value of the IHSG are linked to economic uncertainties or instabilities. Therefore, the movement in stock market prices is strongly influenced by risk and returns.

In today's world, where global economies are becoming more interdependent due to globalization, various global uncertainties have the potential to impact the financial markets of developing economies quite rapidly. The main reason behind such a phenomenon is the fact that globalization has increased the flow of information and capital at unprecedented rates. As the levels of perceived risks in the global market increase, the tendency among foreign investors to change their portfolio allocations to relatively safe assets become more apparent; a process known as the "flight to quality." Such reallocation tends to bring significant capital flows out of emerging economies like Indonesia in order to avoid possible losses, thereby increasing the level of volatility as well as making the Jakarta Composite Index (IHSG) increasingly sensitive to external disturbances. Such externalities can be sourced from various events such as changes in the level of interest rates internationally, recessions in developed nations, and increased threats of war between countries, which can affect international financial stability.

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and JCI is vital to assess the sensitivity of the Indonesian stock market to external influences.

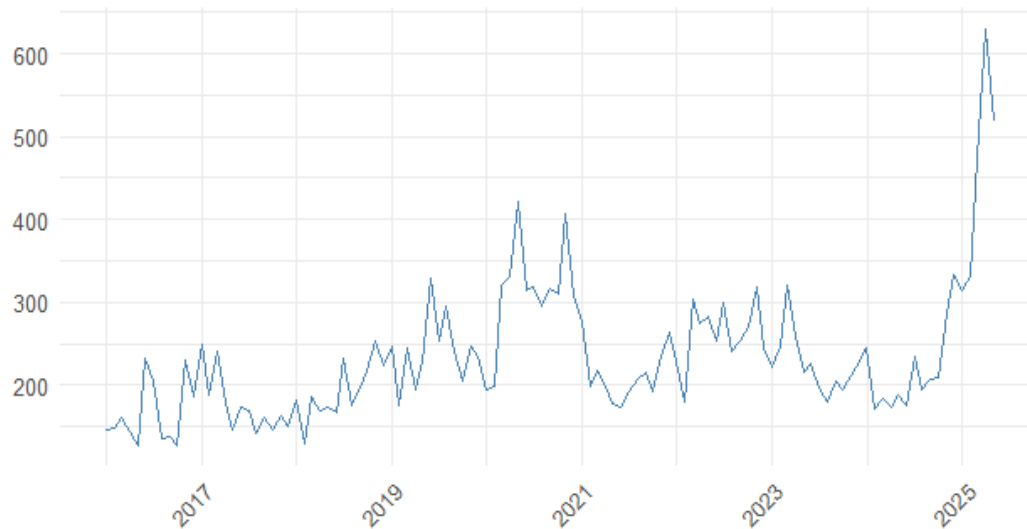


Figure 1.1 Global Economic Policy Uncertainty (2016 - 2025)

Source: Policy Uncertainty, 2025

Based on the information presented in Figure 1.1, the graph depicting the GEPU index reveals that global economic policy uncertainty experiences considerable fluctuations throughout the observation period. There are several sharp peaks in the index, which can be attributed to the high level of global risks. In particular, from 2018 to 2020, the index experienced a significant rise due to growing US-China trade disputes and uncertainties regarding the UK's exit from the EU. The trend persisted, and even a higher peak was reached during the coronavirus outbreak between 2020 and 2021. After stabilizing somewhat in 2022-2023, there is another dramatic rise in 2024-2025 when the index goes beyond 600. This represents the highest peak of the index since the start of the last decade.

It is evident from Figure 1.1 that the high degree of volatility indicates that there is an increased level of global risk. Therefore, it is necessary to explore the effects that shocks from global uncertainty may have on financial markets in emerging economies. In the case of Indonesia, the market is quite susceptible to fluctuations due to its sensitivity to sentiment and foreign investment. When global uncertainty increases, any change in investors' sentiments can rapidly affect the

local market. It is worth noting that current global uncertainty seems to be linked to changes in the international economy.

The global economy following the end of the Coronavirus pandemic can be described by an uneven recovery among different countries, along with sustained inflationary pressure, resulting in major central banks undertaking drastic hikes in interest rates. From 2022 onwards, the tightening strategy pursued by the US Federal Reserve saw the US interest rates rise to their highest levels in two decades. This trend has seen spillover effects in global financial markets, one of which is the substantial strengthening of the US dollar, exerting pressure on several developing countries' currencies. Such a situation has seen financial market volatility as capital tends to flow away from these emerging markets into the more stable United States market. The change in global monetary policy, therefore, is one of the reasons for the volatility of the GEPU index.

However, besides the monetary factors, the rising level of uncertainty on a global scale can also be traced back to the growing geopolitical tensions that have been witnessed recently. For instance, the continuous war between Russia and Ukraine has been causing constant unrest in the global energy and food markets. Furthermore, geopolitical tensions have also risen in the Middle East region in 2023-2024, which has sparked fears about any disruptions to the oil market in the region. Additionally, the Chinese economy has seen a slowdown in growth rates due to various problems in the real estate sector and poor manufacturing performance. These factors, combined with geopolitical risks and economic slowdown, have helped keep the GEPU index at higher levels and increased its volatility, as shown in Figure 1.1.

Oil prices globally have turned out to be one of the main sources of uncertainty for the entire global economy. Due to increasing geopolitical risks as well as policy measures taken by OPEC+ countries, the price of oil had been quite volatile in the 2022 to 2024 period. This poses serious economic concerns since higher oil prices lead to higher cost of production, lower purchasing power of consumers, and affect international capital flows. For Indonesia, as the country is dependent on oil imports, higher oil prices may cause difficulties for its trade deficit, fuelling inflation, and deterring investors from entering the stock market.

The role of monetary policy as carried out by Bank Indonesia is highly important for maintaining macroeconomic stability within the domestic setting. The BI Interest Rate serves as the main tool used for managing the levels of inflation and exchange rate stability. Since 2022, Bank Indonesia has undertaken several adjustments to its policy rate in response to external challenges, particularly those stemming from the Federal Reserve's tightening measures and heightened volatility in global financial markets. Such policy changes have a bearing on investor psychology, as well as on the flow of foreign investment into the country and, consequently, on the level of the Jakarta Composite Index (IHSG).

While many researchers have examined the dynamics of the Indonesian stock market, the majority of the available literature tends to focus on the effects of domestic macroeconomic variables with little attention paid to the effect of channels of global uncertainty. For instance, Putri & Widodo (2021) explore the influence of inflation, exchange rates, and interest rates on the returns of the IHSG, but no external shocks are accounted for in their study, resulting in the assertion that the stability of the domestic economy is the major determinant of stock market dynamics. Likewise, Nasution & Azizah (2022) analyze the transmission mechanism of domestic monetary policy, but no indicator of global uncertainty is included in their study model. This demonstrates a conceptual gap in the literature, especially considering the increasing global economic integration of the Indonesian economy through growing trade operations and capital mobility, as well as exposure to international commodity price fluctuations.

Additionally, studies with uncertainty variables usually make use of country-specific indexes instead of looking at the bigger picture. For example, Rahmawati et al. (2023) employ the Indonesian Economic Policy Uncertainty Index (IEPU) and prove its importance in influencing the volatility of the financial market. However, their study fails to consider international events such as monetary tightening around the world, international conflicts, or the mechanism through which policy uncertainty in one country influences another. Similarly, Sari and Hakim (2022) examine the impact of geopolitics and the price of crude oil but overlook the global economic policy uncertainty index in terms of a more holistic

systemic factor. The above-mentioned issues suggest that there is a lack of studies regarding the effect of the Global Economic Policy Uncertainty index on the Indonesian stock market's performance when taking into consideration macroeconomic variables and commodity price fluctuations.

In light of this discussion, it can be seen that the inclusion of the Global Economic Policy Uncertainty (GEPU) index in the current study can be considered highly appropriate due to its comprehensive coverage of different types of uncertainty, such as fiscal policy talks, monetary policy disagreements, geopolitical tension, and regulation uncertainty in different countries. Baker et al. (2016) contend that the GEPU index reflects the sentiment of the global economy, which could affect investor psychology, causing them to shift funds, postpone their investments, and become more risk-averse, especially in emerging markets. Considering Indonesia's high level of exposure to foreign portfolio investment and its strong dependence on the economy based on commodities, it can be said that any shock in terms of global uncertainty can create a significant effect on the Jakarta Composite Index (IHSG). This view is also backed by evidence from similar studies in other emerging markets. According to Zhang & Hamori (2023), the role played by the GEPU index in creating volatility in the stock markets of the ASEAN region is significant, whereas the results provided by Khan et al. (2024) suggest that any shock created by the GEPU index tends to reduce stock market returns in emerging Asian markets.

Methodologically, existing studies on Indonesia have mostly made use of econometric models that adopt a static perspective, such as OLS, GARCH, and ARDL models. Although they are useful in some cases, these models are limited when it comes to examining dynamic relationships and feedback effects between the variables under consideration. Take, for example, Wulandari (2020), who uses the GARCH model to investigate stock market uncertainty in Indonesia; however, the study does not address any causation or shock transmission problems in the system. The current research, on the other hand, makes use of VAR and VECM approaches in order to address the mentioned limitations. The use of VAR and VECM models allows each variable, such as GEPU, oil price, BI Interest Rate, and

IHSG, to be affected by its previous values as well as those of other variables in the system. This research will also be enhanced by the application of Johansen cointegration, impulse response functions, and forecast error variance decomposition.

The incorporation of measures of global uncertainty, the behavior of commodity prices, and domestic monetary policy measures, together with the system-based time series approach, gives this study an enhanced ability to look at the impact of external shocks on the stock market in Indonesia in a more comprehensive manner. Through the use of this framework, more can be learned about the interplay between the two, as compared to what can be achieved using a more conventional method. Therefore, the study contributes significantly to filling a major void in the extant literature.

1.2 Problem Formulation

From the background discussion presented above, the following research questions may be formulated:

1. How does the Global Economic Policy Uncertainty (GEPU) affect the performance of the Indonesian stock market especially from the perspective of Jakarta Composite Index (IHSG)?
2. What is the extent of global uncertainty that leads to changes in the stock return of Indonesia in the short and long-run periods?
3. How do domestic macroeconomic variables including BI rate and oil price affect the stock market of Indonesia in interaction with GEPU?

1.3 Research Objectives

The main objective of this research is as follows:

1. To determine the impact of Global Economic Policy Uncertainty (GEPU) on stock market returns in Indonesia with the focus on IHSG index.

2. To examine the relationship between Global Economic Policy Uncertainty (GEPU) and stock market volatility in Indonesia using the VAR/VECM model.
3. To examine the linkage between global uncertainty and domestic macroeconomic variables such as BI rate and crude oil prices.

1.4 Research Benefits

1. Academic Benefits

In terms of academic contributions, this research study is considered a meaningful contribution to the empirical literature dealing with uncertainty within financial markets. First, it provides practical evidence about the potential influence of policy uncertainty within a global setting on the stock performance of an emerging economy such as Indonesia. Second, through choosing Indonesia as the subject of this research, one is able to enrich the discussion in the field, which tends to revolve around matured economies. Third, the adoption of the VAR/VECM methodology in the current study helps to add new depth into the research area through uncovering various dynamics as well as interactions of studied variables.

2. Practical Benefits

The results obtained from the present research can be of great help to practitioners who are involved in the trading activity and work as portfolio managers or financial analysts. Specifically, through understanding the connection between global economic policy uncertainty and the index performance of the Indonesian market, market players are expected to obtain more knowledge in order to act wisely in periods when the level of uncertainty is rather high in the global environment. Hence, investors are likely to benefit from this information in relation to asset allocation, risk management, and portfolio diversification.

3. Policy Benefits

Speaking about the policy contributions, it should be noted that the current research offers important insights for financial policymakers, especially Bank Indonesia, as far as it highlights several mechanisms according to which external

shocks caused by global uncertainty tend to be transmitted to the local financial system. On the basis of the findings, policymakers may develop new effective monetary and macroprudential measures aimed at preventing the adverse effects caused by global uncertainty in the market environment.

