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Thesis

LONG RUN MONEY NEUTRALITY: THE CASE OF INDONESIA

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Long-run Money Neutrality: the Case of Indonesia
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ABSTRACT

This research study about Long-Run Neutrality of Money in the case of Indonesia. This thesis analyzes the long-run neutrality of money in Indonesia using vector auto-regression (VAR), in range 1990Q1-2009Q4. Variables used are Consumer Price Index (CPI) as inflation, M2 as money supply, and Gross Domestic Product constant as output. The evidence suggests that M2 is not neutral with respect to real GDP because there is close relationship between them in long run. It means that, money neutrality is rejected in Indonesia. Because of that, any changes in money supply will make fluctuation to output.

Keywords: long-run money neutrality, vector auto-regression, reject

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CHAPTER I

INTRODUCTION

1.1 Background

Indonesia has a market-based economy in which the government plays a significant role. Slightest fluctuation would directly affect the market directly related to the condition of society. This situation occurred several times in Indonesia, one of the largest fluctuations that ever happened was a crisis that occurred in 1998. Rupiah currency volatility after the crisis started happening since January 2004. As at 1998, originated from the depreciation of the baht which was then attacked the Indonesian economy Indonesian economy resulting in collapse.

Due to crisis, in the monetary sector, the high liquidity assistance provided forced central banks to banks has increased money supply is large enough to enlarge the previous inflationary pressures have increased sharply due to the sharp depreciation of the rupiah. This indicates the effect is more internal than external influences determine. In other words, the condition of Indonesia was making a weaker rupiah. In addition, the performance of a slow economy also led to open unemployment, which in 2005 reached 10.84 percent (11.6 million), far higher than pre-crisis level in 1997 amounted 4.7 percent. In other words, economic growth is currently not sufficient to accommodate the growing labor force 1.8 million people per year. Difficult to reduce unemployment or to create new jobs, a reflection of the slow motion expansion rate of the real sector that is able to absorb a growing labor force every year. In the real sector, production and investment activities having contractions while the unemployment rate increased rapidly. In addition, many entrepreneurs out of business because the heavily indebted banks, so many workers or factory workers who had been laid off or discharged by the company. This has become one of the triggers the explosion of unemployment, ie, to higher unemployment in a relatively short time. Unemployment explosion occurred in 1998, raise about 1.4 million new unemployment. These developments clearly illustrate that the crisis has happened lead to a very broad negative impact to the joints national economy.

In the fiscal sector, especially government expenditure on subsidies for fuel oil and foreign debt payments, so that the financial deficit is quite large.

Throughout the history of the Indonesian economy had fluctuated and unstable condition and caused economic instability. Economic instability can lead to shocks to the macro-sectors of real economy, as happened in recent years. Macroeconomic stability will make it possible to grow the economy. To reach out that instability, it already conducted several steps to cure crisis, such happen in 1998. The steps were taken to focus on monetary and financial deregulation. It is often questioned arise in mind, why the policy is the deregulated often on the monetary sector first than real sector itself while the impact hit the real.

Money supply arrangement is very important because through money supply target variables can be achieved or failed altogether. Keynes Group believes that money plays an important role in the economy, while the c[illegible] to the contrary, money has no role at all in the long run, they said money is a factor of the causes of rising prices. Different views between these two groups need to know the empirically described by exactly how the function of money toward this

CHAPTER VI

CONCLUSION AND RECOMMENDATION

6.1 Conclusion

Based on research results and discussion described in the previous chapter concludes as follows:

1. Testing money neutrality in Indonesia from 1990Q1-2009Q4 by using vector auto regressive (VAR) with variables CPI, M2, and GDP constant as base year = 2000.
2. Money is the most influential variable for money itself and for GDP. GDP and M2 influenced to appearance M2, and vice versa. All variables significant influence GDP. Inflation of CPI is influenced most by GDP than M2.
3. Test composed result that money of M2 persuades output of GDP in and also inflation of CPI in long run. Test results show that there is cointegration between money and output. Even, money and output have simultaenous effect and very close relationship.
4. For money and inflation in long run there is also relationship during time observation but not strong as money and output.
5. Empirical results show that long-run deviations from money neutrality in Indonesia does not exist.

6.2 Recommendation

1. There is close relationship between money and output, they have simultaneously relationship. Control of output directly can affect money,

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