

# **CHAPTER I**

## **INTRODUCTION**

### **1.1 Background**

Inflation is one of macroeconomic indicators become an important issue among economists. Inflation is the tendency increase in average price in general (Parkin, 1993). Meanwhile in other side, inflation is a condition which excess demand for goods and services generally (Lerner in Gunawan, 1995). According to (Mankiw, 2000), inflation is rise in all prices. So, a policy related to inflation is a policy relating to price stabilization.

Inflation phenomenon in Indonesia actually is not the short phenomenon, that is only happens incidentally (Adwin in Adya Fadhila Annisa, 2011). In fact, the same general problem also happens in other developing countries. The inflation problem in Indonesia is kinds of long-term inflation that caused by structural of economic obstacles that still occur in Indonesia. The economic and stability were influenced by many factors; some of the factors which influence development of economics are the level of inflation rate (Friedman in Adya Fadhila Annisa, 2011).

Inflation is an indicator of economic stability which becomes focus and attention in macroeconomics policy so that is growth rate is always afforded to be low and stable (Bank of Indonesia, 2003). For that, Bank of Indonesia has authority to maintain the stability of inflation in order to create expected economic growth, employment expansion, and the availability of good or services to fulfill the people needed.

In 1990s, At Soeharto's government pressures the inflation rate but could not reach below 10% per years because Bank of Indonesia has fold missions as agent of development, in which giving credit as unlimited. As a result, inflation rate going to monetary crisis in Indonesia and Asia in 1997. The inflation rate rise again about 11.10% and then jumped become 77.63% in 1998 which at that time value of Rupiah depreciated from Rp 2.909/ USD in 1997 to Rp 10.014/ USD in 1998. Inflation rate is high because pressure of prices from supply side as a caused by depreciation of Rupiah sharply in this year. At Habibie's government took the tight monetary policy, as a result created lowest level of inflation about 2.01% in 1999. (Statistics of Monetary Indonesia, 1990 – 1999)

In 2000 – 2006 inflation still occurs in Indonesia. Especially in 2005 the inflation rate about 17.11%, this is the highest inflation after a monetary crisis in 1997/ 1998. This condition caused by adjustment of fuel price that becomes main factor of inflation causes. Inflation rate in Indonesia is higher rather than neighbor's country likes Malaysia and Thailand about 2%, meanwhile Singapore less than 1%. (Statistics of Monetary Indonesia, 2000 – 2006)

In 2007, Inflation rate in Indonesia relatively stable due to price of goods and services price are relative stable. During 2008 economy crisis has occurred, inflation rate increase sharply becomes two digits about 11.36%. Price of goods and services was increased; the Rupiah exchange rate also depreciated become 10.950 Rupiah. All of foreign investors out from this country because invest in domestic country is risky. In 2010, the level of inflation seems to improve about 6.96%. If the real sector is not supported in Indonesia, then effort on monetary

sector of the macroeconomic stabilization becomes useless in the long-term period. (Statistics of Monetary Indonesia, 2007-2010)

Some factors were causes unstable inflation rate in Indonesia are fluctuations of fuel prices, growth of money supply, and growth of gross domestic product. The world oil price has directly correlation with domestic fuel prices. In other words, fluctuates of world oil prices directly impact to all sectors in many countries in the world, especially in importer countries likes United States, Thailand, Malaysia, Indonesia, and some countries in Europe.

Fluctuations of world oil prices are concern to countries in the world (both of exporter and importer countries) because of important role of oil as a fuel that drives the economy. World oil price directly impact on the price of domestic oil price especially for fuel. Fuel is vital input in industries production, beside that fuel is important in sustainable development economy and social.

As explained before, fuel has important role in economy. If the fuel prices increases, so it will impact on the Indonesian economy directly. For example in 2005 level of inflation in Indonesia reached 17.11% it was caused by adjustment of fuel prices. All commodity prices, production costs, and others are increases. The impact of fuel prices on developing countries is significant. Most of oil importer countries from Asian raises several issues which include inflation, so economic growth and income is threatened and balance of payment also deficit.

Recent years, the Indonesian economy tends to stable, despite conditions of Indonesian economy still influenced by weakness of global and regional economy. In 2013, the economic growth predicts reaches 5.8%, this predicted is

stable but Indonesian also anticipates about risk that can be appearing suddenly to macroeconomic indicators.

Fluctuations in fuel prices become threaten to Indonesian economy. From macroeconomic views, inflation become higher so create higher unemployment, exchange rate of Indonesia in term of Dollars is depreciated reaches Rp. 11,000/USD, real sector become threatened and gross domestic product (GDP) will decline.

Money supply also an indicator that causes inflation occurs. Role of money in economic growth has been main issues of economic. Increase in money it means demand for money increase. Automatically, the more money circulating in the community causes the value of money become lower, so Rupiah exchange rate will be depreciate in term of Dollar. A trend of money supply (M2) from year to year is fluctuated both of increase and decrease. Increase and decrease in money supply caused by authority that taken by monetary authorities in term of economic stabilization that considered not conducive.

Gross domestic product (GDP) is one of indicators that measure economic of Indonesia. Gross domestic product cannot reflect the wealth of nation, but GDP can be one of indicators that measure Indonesian economic progress.

According to World Bank Statistic report in 1980 and 1990 is period in which increased economic growth in developing countries included Indonesia that reaches more than 8% per years. During period of 1995-1996 which in that period is never forgotten because economic growth of Asian countries higher than United

States and European that recorded 8.22% in 1995 and 7.82% in 1996. This situation will be caused by increase of consumption and investment boom in 1995.

Otherwise, mid-1997 Indonesia faces an economic crisis. This crisis has brought bad effect to economic growth. This is proved by decline sharply about 4.7% in 1997 become -13.12% in 1998. Declines of GDP growth in this years caused by decline of consumption and investment activities in domestic. Investment activity decrease caused by demand for consumption is decreased.

Decline in investment activity worse off to economic activity like business, banking system, and lack of confidence of foreign investors. In 2000s economic growth in Indonesia tends to stable and unstable, like happens in 2005 and 2008 which the economic crisis has occurred. In 2010, economic performances began to improve economic growth in Indonesia. This condition reflects on GDP growth improves about 5.75%. In the middle of economic performance improvement, Indonesian economic still faces problem such as capital inflow, inflation rate, banking sector, and sector real problem.

Based on some of the explanation above, the authors are interested in studying and analyzing the impact of fluctuations in Fuel Prices, Money Supply (M2), and Gross Domestic Product on inflation rate for developing countries, especially Indonesia, which is why the author gave a report entitled:

**“THE IMPACT OF FUEL PRICES, MONEY SUPPLY (M2), AND GROSS DOMESTIC PRODUCT ON INFLATION: THE CASE OF INDONESIA”**

## **1.2. Problem Identification**

Main factors that causes inflation rate in Indonesia are fluctuation of fuel prices, growth of money supply (M2) and growth of gross domestic product. As we know, Indonesia is one of developing countries that economy condition tends to go up and down which is also called fluctuation that caused by domestic and global effect. If developed countries face crises, so these crises will be impact to developing countries directly. For example crises that happen in United States on 2008, this crises directly impact on Asian countries included Indonesia.

As we can see, the Indonesian economy threatened the cause of high inflation, value of Rupiah in term of Dollar is depreciated, and growth of money supply is increase. As we know, inflation is all prices of goods or services increase generally. Inflation creates many problems such as lower purchasing power, high cost of production, higher unemployment rate.

Other determinant of Inflation in Indonesia is fuel prices which occurred in 2005 which creates high inflation rate. Price of goods or services is expensive; increased production costs so many industries reducing their production as a result certain industries reducing their labor thereby causes unemployment. Growth of Money Supply and Gross Domestic Product also impact on inflation rate in Indonesia. Number of printing money by Bank of Indonesia will pressure the price of goods and gross domestic product will be decrease then it creates inflation.

Based on the background problem above that problem is how much influence or impact of fuel prices, money supply growth, and gross domestic

product growth on inflation rate in Indonesia during period 1981 – 2010 in which fuel prices and two macroeconomic variables are dominant factors determinant of inflation in Indonesia. Thus, government should take the policy with the aim of creating a stable inflation.

### **1.3. Research Questions**

1. What is the impact of fuel prices on inflation in Indonesia?
2. What is the impact of money supply (M2) on inflation in Indonesia?
3. What is the impact of gross domestic product on inflation in Indonesia?

### **1.4. Research Objectives**

1. To analyze the impact of fuel prices on inflation in Indonesia.
2. To analyze the impact of money supply (M2) on inflation in Indonesia.
3. To analyze the impact of GDP on inflation in Indonesia.

### **1.5. Research Advantages**

This study is expected to be useful for writer and other interested parties.

As for the benefits of this research include:

1. As the partial fulfillment of Bachelor of Economics in Economic Faculty, Andalas University.
2. For the writer, improving my ability in writing report and doing research, especially in monetary sector.

3. For the reader is expected to add understanding regarding the economic analysis about the context of inflation and factors that can be impact the inflation such as fuel prices, money supply (M2), and Gross Domestic Product (GDP).
4. For the investor is expected to provide a new discourse in considering those aspects that need to be taken into account in investment that are not solely rely on monetary measures.
5. For researcher in the field of economics and finance is expected this study can be a reference for the next research.
6. For society will provide a proactive stimulus as a controller of economics and increase public awareness to reach stability of economic growth.
7. For government will be recommended to take better policy about inflation rate and other indicators, how to handle of fuel prices and money supply (M2), and how can reach a better economic growth.

### **1.6. Scope of Research**

Given the complexity of the problem or scope of discussion to simplify and make more focused writer hence the need for restriction, that are:

1. Analyses the determinants of inflation rate in Indonesia started from 1981 until 2010.
2. Inflation seen at average growth in Consumer Price Index (CPI).

3. Meanwhile variables that influence or effect inflation rate in this research are fuel prices, money supply, and gross domestic product.
4. Fuel prices seen at average prices of non-subsidized fuel; money supply seen at broad money (M2) where M2 are narrow money (M1) plus quasi money (time deposit + savings), and gross domestic product seen at constant prices.

### **1.7. Writing Systematic**

Systematic writing of this study is divided into six chapters. As for each chapter are briefly described as follows:

#### **Chapter I: Introduction**

This chapter contains description of the background of the inflation rate. Theoretically inflation rate influenced by macroeconomic variables such as money supply, gross domestic product and so on. This chapter also describes about problem identification, research questions, research objectives, the research advantage, the scope of research, and writing systematic.

#### **Chapter II: Theoretical Framework and Literature Review**

This chapter will provide the inflation theory and the relationship between inflation and economic variables such as fuel prices, money supply (M2), and gross domestic product. To support the literature review some explanation from empirical studies in the past, as proven.

### **Chapter III: Research Methodology**

This chapter elaborates about study method of problem, containing research data such as research variables, data characteristics, population that accompanied by clarification about data collecting procedure, and also technique data analysis.

### **Chapter IV: Overview of Indonesian Macroeconomics Performances**

This chapter describes the overview of research object, such as overview about trend of inflation, fuel prices, money supply (M2), and GDP in Indonesia.

### **Chapter V: Empirical Results and Analysis**

This chapter discusses more about the study description contains a description of the research object, data analysis, interpretation and discussion of the result obtained from the study.

### **Chapter VI: Conclusions and Recommendations**

This chapter consists of conclusion of the study and implication on the future research.