

CHAPTER I

INTRODUCTION

1.1. Research Background

It is true that the main objective of every nation is to find a good way to obtain and maintain the long-term development of the national economy to reach welfare life (Claudius, 2017). According to (Mankiw, 2008, pp. 491-509) the level of welfare usually measured by the gross domestic product GDP because it measures two things at once, it measures the total income of everyone in the economy and the total expenditure of on the economy's output of goods and services. GDP used as an indicator for economic health, as long as the GDP keeps rising it means that the economy has good condition and there is development in the economy.

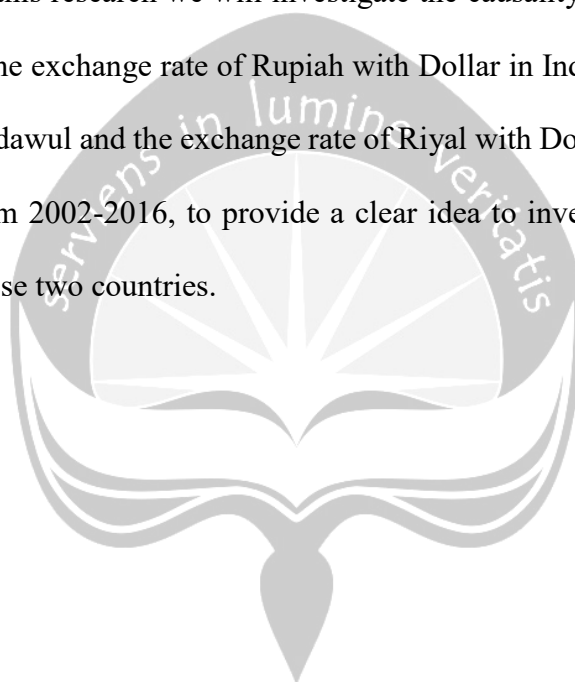
Form the GDP equation we can know which variable enhance the economy, which it contains consumption, investment. government purchases, and net exports. Financial markets help to efficiently direct the flow of savings and investment in the economy in ways that facilitate the accumulation of capital and the production of goods and services. The combination of well-developed financial markets and institutions, as well as a diverse array of financial products and instruments, suits the needs of borrowers and lenders and therefore the overall economy. according to (Liaw, 2004, p. 255) stock markets are an essential part of economic development because it provides a place where corporations become able to raise long-term capital to finance a multitude of projects. (Noman, 2012) points out that

the fluctuations of stock prices indices depend on many reasons such as the performance of enterprise, dividends and share prices in other countries, GDP, exchange rates, interest rates, current account, money supply, employment, information, etc. may have an impact on daily stock prices. Over the past few years, the development of technology and globalization have played a significant role in the integration of stock markets around the world, this integration results on the stock prices fluctuation to be more volatile (Ansari, 2009). Since the early 1970s, because of the adoption of floating and the integration of markets has raised the exchange rate to be one of the main determinants of the price of stock markets fluctuations. the exchange rate is representing the (forex) foreign exchange, based on (Liaw, 2004) foreign exchange market is vital to international trade and to the integration of the global capital markets.

After we saw the connection between the two markets and how they are probably important to the economic development, that's why we will focus to study the direct relation between them, this is not the first and it will not be the last research tries to find out the causal relation between the stock and forex markets because the relation between those markets has been in position of interest since the early 1990s where many studies conducted many types of research to investigate the relationship between stock prices and foreign exchange markets, It is important to understand the relationship between exchange rates and stock prices from the perspective of policy makers and the investment community in such changeable global environment especially after the adoption of the flexible exchange rate (Kutty, 2010). where, the dynamics increased between the two

markets, the investment opportunities as well as the threat increase also, and that's required serious study to investigate whether there is a relationship between the stock market and forex exist or not in specific country or in such a given period of time, the result of the investigation will give the advantage to make a wise investment decision in aim to avoid the possible risk produced form the fluctuation that exists in those two markets.

In this research we will investigate the causality between the stock market IDX and the exchange rate of Rupiah with Dollar in Indonesia, and between stock market Tadawul and the exchange rate of Riyal with Dollar in Saudi Arabia for the period from 2002-2016, to provide a clear idea to investors and policymakers as well in those two countries.



1.2. Problem formulation

This research study aims to investigate the existence of a causal relationship between stock markets and exchange markets. In case if there is a relation between stock market and forex market, what is the direction of that relationship in Indonesia and Saudi Arabia. Therefore, the question that needs to be answered in this research is:

Is there a causal relationship between the stock market index and the forex exchange market of Indonesia, and Saudi Arabia from 2002 until 2016?

1.3. Scope of the study

This research study focuses on analyzing the relationship between the stock market index and the exchange rate of foreign exchange (FOREX). In order to limit the area of study, the following points are the boundaries of the study area:

- a) There are two countries: this study will analyze only Indonesia and Saudi Arabia. The selection of the countries is based on the fact that those two countries are varying to each other on the basic pillars of the economy. I choose the stock market in Saudi Arabia because it considered as emerging market compares to the Indonesian stock market; therefore, we would learn from them and they are a good model for this study to make a comparison.
- b) We will use in this paper the index of Saudi's stock market (Tadawul), and the Indonesian stock exchange which is known as JKSE.

- c) the research calculates data during the period from 2002 until 2016 on a daily basis.
- d) The base currency used for comparison is US Dollar in which the exchange rate for Indonesia will be IDR /USD, and SAR/ USD for Saudi Arabia.
- e) The study will be about Detect the relationship between the variables and then compare the results between the two countries

1.4. Motivation of the Research

As we have already discussed in the background secession and we will discuss deeply in the next chapter about the importance of the stock and Forex markets and how they play a major role in supporting the economy in any country, that role varies from one country to another based on different factors. there are a lot of studies has been done to investigate the relation between the stock market and forex market in many countries, but it was rare to find a study has been done in an Arabic country or Indonesia on the same topic. actually, I choose Saudi Arabia as an example for an emerging stock market instead of my country (Yemen). that's because Yemen still has no stock market yet. All of us know how the stock market and forex market enhance the economy, in case if there is any evidence of an interaction between those two markets for sure that will have an impact on the economy. this could be considered as an evidence for the policymakers about the usefulness of establishing a stock market in the country which still has no stock market yet. the result that I will get form doing

this research keeps me motivated in hope to see stock market operating in my country.

1.5. Objective of The Study

This research study is purposed to examine the interaction “the causality” between the stock market index and foreign exchange rate by doing a comparison among Saudi Arabia and Indonesia.

1.6. Contribution of the Study

This study will contribute to the enrichment of scientific content for articles on emerging capital markets. This study will benefit three types of readers:

1. **Students:** who are studying about financial management, it will give them about a vision to widen their knowledge about the how two of the most important markets interact with each other, and about the nature of this relation especially in Saudi Arabia and Indonesia.
2. **Investors:** it will give an opportunity to the investors to take more rational decisions before investing in the stock markets especially in Arabic countries where stock markets there still emerging and the risk is high.
3. **Policymakers:** many studies were done and proved the impact of capital market and the forex market on the economy but the question is If a country's equity market is expected to outperform that of other countries, should we expect its currency to appreciate or depreciate? That answer that will be carried in this research will have an importance for policymakers.

1.7. Outline of the Study

Chapter 1: Introduction

This chapter deals with the details of the study by providing background about the topic, the problem statement, the problem formulation, the scope of the study, the objectives of the study, the research motivation, and the contributions of the study.

Chapter 2: Theoretical Review

In the second chapter will review the literature review of concepts and keywords related to research and what the analysis will focus on. This second chapter also reviews the results of the preview research.

Chapter 3: Research Methodology

This chapter focuses on the sources of data and how to obtain it for the research, methodology type, sampling determination. Research data. And method of analysis

Chapter 4: Research finding and analysis

The fourth chapter represents the process of data collection, examination of the data collected, analysis and discussion of the outcome.

Chapter 5: Conclusion

In the fifth chapter, we will include the result that has been found in chapter four to analyze it, including the limitation of the research, and suggestions for readers.