CHAPTER I

INTRODUCTION

1.1. Background Research

Funding is one of the functions of a company that is important for the success of a company. Both large and small companies need funds to carry out their business activities. The funds needed can be obtained either through funding from within the company or financing from outside the company. External funding sources are obtained by companies by lending to other parties or selling their shares to the public (go public) in the capital market.

The capital market is one of the places that provide investment opportunities for individual and institutional investors. Therefore, the direction and magnitude of capital market movements is an interesting topic for academics and market practitioners to learn about. The Composite Stock Price Index has increased rapidly since the economic crisis that hit Indonesia in 1998. This is indicated by the development of CSPI values and transaction values. The CSPI value has increased to 400 percent from 2000 to 2008. The higher CSPI value is a form of investor confidence in the increasingly conducive condition of the Indonesian economy. But the global economic crisis starting in mid-2008 has pushed the CSPI value down by 50 percent in a relatively short period of time (one year). The crisis originating from the United States has brought down the economy in the Continent of Europe and Asia, especially developing countries.

Indonesia as a developing country has an influence from the global financial crisis. Various policies were taken by the government to reduce the adverse effects of the crisis, ranging from rising interest rates, rising fuel oil, and tightening foreign currency traffic.

Capital markets play an important role in the Indonesian economy, where the value of the Composite Stock Price Index can be a leading economic indicator for a country. The indexing movement was strongly influenced by investors' expectations of fundamental state and global conditions. The presence of new information will affect investors' expectations which will ultimately affect CSPI.

Broadly speaking, there are three main factors that influence the CSPI movement, namely: domestic factors, foreign factors, and capital flow factors to Indonesia. Domestic factors such as fundamental factors of a country such as inflation, national income, the money supply, interest rates, and the rupiah. These various fundamental factors are considered to be able to influence investor expectations which ultimately affect the index movement.

Foreign factors are one of the implications of the form of globalization and the increasingly integrated capital markets throughout the world. This condition allows the emergence of influences from the advanced exchanges against the developing stock exchange. The recent crisis that caused the fall of the United States stock exchange has dragged the exchanges in Asia in the 1997 crisis, including the Indonesian stock exchange.

The economic crisis that began with the monetary crisis influenced the local currency exchange rate with foreign currencies, especially in companies involved in international trade activities that are highly dependent on the use of foreign currencies, especially currencies that are classified as hard currency.

The existence of the association greatly affects the cash flow of the company, this was due to the exchange rate will significantly affect the cost of raw materials and Sales Company that can pose a huge risk. The risk arises because of the fluctuations in changes in exchange rates between local currency and foreign currency, which is called the exchange rate.

Inflation is a change in prices in aggregate. Development will run smoothly if inflation can be reduced as low as possible. The inflation calculation is carried out by the Central Statistics Agency. If the inflation rate rises further, the CSPI price level will decrease further. This is because, with the high rate of inflation, the company's profits will decrease. So that investors do not want to invest, this causes CSPI prices to decline.

Djayani Nurdin (1999) conducted research and the results of the study showed that inflation had a negative effect on stock prices.

Flannery and Proto Papadakis (2002) conducted a study of inflation and stock returns. The results of his research indicate that inflation has a negative relationship with the stock returns. The relatively similar results are also generated from the research of Wong bang po and Sharma (2002), where inflation has a negative influence on the rate of return on stock prices.

From 2002 to 2004 the rupiah exchange rate, interest rates and inflation experienced very significant fluctuations. The average value of the rupiah exchange rate against the dollar in that period fluctuated around Rp. 10,393 to Rp. 8,229 (www.bi.go.id).

The weakening of the Rupiah exchange rate against the Dollar has a negative impact on the capital market because investors prefer to invest in the money market. Studies of the relationship between exchange rates and stock market reactions have been carried out. Research related to the problem of exchange rates and stock returns has been done by several previous researchers. Chow, et al (1997) also found that the US dollar real exchange rate correlated significantly positively with stock returns and real exchange rates can explain the company's stock returns in the period March 1977 to December 1989. While Oghuzan Aydemir and Erdal Demirhan (2009) found that the negative effect of exchange rate on stock prices in Turkey.

The development of the average rupiah exchange rate against the dollar is indirectly related to the inflation rate, and the interest rate issued by Bank Indonesia. The average interest rate of Bank Indonesia issued by Bank Indonesia ranges from 7.32% to 17.22% and the inflation rate ranges from 4.60% to 14.42% in the period January 2002 to 2004 However, in 2006 the interest rate of Bank Indonesia experienced a sharp decline of around 9%. The impact of various things resulted in investment activities and businesses and industries in Indonesia in general experiencing losses.

Investors can use the interest rate as a benchmark for comparison if they want to invest. Generally, the interest rate has a negative relationship with the stock exchange. This is due to the increase in interest rates resulting in the owners of capital preferring to save their money in the bank rather than choosing to invest in the stock market, thus causing stock prices to decline.

Ana Octavia (2007) also argues that there is a positive influence between interest rates on stock prices.

Mukherjee and Naka (1995) examine the influence of interest rates on stock prices in Japan and the results of interest rates negatively affect stock prices.

In an economic situation in a crisis, systematic risk is greater than the economic situation in good condition. So that the total risk contained in investment in shares during a crisis will be greater than the total risk during the economy in a good condition. Because of the increased risk, the stock price will tend to fall. A sharp decline in stock prices as a whole will result in changes in the stock price index on the stock exchange.

Various information entered in the capital market and events that are not related to the capital market can affect volatility or fluctuation in stock prices. CSPI movement is influenced by various factors both internal and external. The influence of world events that occur in the movement of foreign stock indices is the dominant external factor. While internal factors are more influenced by domestic events that occur. Many factors influence the fluctuations in the movement of the Composite Stock Price Index (CSPI).

In determining investment choices, empirical macroeconomic factors have been shown to have an influence on the development of investment in several countries. Tandelilin (2001), mentions that one of the macroeconomic factors that influence investment in a country is the interest rate. When the economy is good, interest rates are low, whereas when the economy is bad, interest rates are high. Changes in interest rates can affect the variability of return on investment. Stock return is reflected in the stock price. Changes in interest rates will affect stock prices negatively, ceteris paribus (Nasseh and Strauss, 2000).

The focus of this study is the effect of inflation, exchange rates, and interest rates on Bank Indonesia on the Composite Stock Price Index in Indonesia. Taking these three factors are not caused by these three factors which are suspected of having an influence on changes in stock prices in Indonesia, but rather on the suspicion that these three factors have a very dominant influence on changes in stock prices.

From these reasons the author is interested in conducting research about **"The Effect of Inflation, Exchange Rate, and Interest Rate on Indonesia Composite Index 2013-2018".**

1.2. Problem Formulation

Based on the background of the problem described earlier, the formulation of the problem that arises is as follows:

1. What is the effect of inflation on changes in the Composite Stock Price Index (CSPI)?
2. What is the influence of the exchange rate on changes in the Composite Stock Price Index (CSPI)?
3. What is the influence of Bank Indonesia interest rates on changes in the Composite Stock Price Index (CSPI)?

1.3. Research Objectives

From the formulation of the problems mentioned above, the purposes of the research to be performed are:

1. To find out whether inflation significantly affect the CSPI.
2. To find out whether the exchange rate has a significant effect on CSPI.
3. To find out whether the interest rates of Bank Indonesia significantly influence CSPI.

1.4. Benefits of Research

- For researcher

  To gain valuable experience in writing scientific work, and deepen knowledge, especially in the field of capital markets.

- For Academics:

  The results of this study can be used as a reference source for further research.

- For investors

  Investors and prospective investors obtain correct information about the influence and relationship of inflation, exchange rates, and interest rates on Bank Indonesia because information is a fundamental need for investors in decision making on the capital market as a result of the existence of economic mechanisms and market expectations. Investors can use this additional information in conducting activities on the Indonesia Stock Exchange.