CHAPTER I
INTRODUCTION

A. Background

Developing countries generally have economic structures that tend to be vulnerable to shocks to the stability of economic activities. The economy is always the most important concern because if the economy is in an unstable condition, economic problems will arise such as low economic growth, high levels of unemployment, and high levels of inflation. Macroeconomic indicators play a very important role in stabilizing the economy. One macroeconomic indicator that can be used to see the stability of a country's economy is inflation because changes in this indicator will have a direct impact on the dynamics of economic growth.

Inflation is a monetary phenomenon in a country where the rise and fall of inflation tends to result in economic turmoil. Inflation is one of the important economic indicators, the rate of change is always kept low and stable so as not to cause macroeconomic disease which will later have an impact on instability in the economy. The phenomenon of inflation is a classic problem for the economy which still causes deep trauma. Basically, the inflation phenomenon in Indonesia is caused by various external and internal factors, both directly and indirectly. Low inflation can encourage countries to increase their output capacity, but on the other hand, high inflation also creates uncertainty in the economy. By maintaining inflation stability, economic actors will feel more comfortable in carrying out their economic activities, so that they can have a positive impact on the economy, which is reflected through increasing economic growth, expanding employment opportunities, and balancing the balance of payments according to (Pohan, 2008). In other words, achieving inflation stability is the first step to achieving national stability.

Djohanputro (2006), inflation is defined as a general trend of continuous price increases. Inflation can be calculated based on a group of goods and services consumed by the majority of society. Therefore, inflation is a problem of great concern in every country.

This term is never written explicitly in the Koran or Hadith. Inflation, which is a problem in modern society, arises for several reasons, including because of people's desire to consume excessively. From this perspective, long before the problem of inflation emerged, the arguments in the Al-Qur'an and Hadith provided guidance. To explain that humans really like material objects, is shown in Ali Imran's letter (14):

لِلنَّاسِ الشَّهَوٰتِ النِّسَآءِ الْبَنِيْنَ الْقَنَاطِيْرِ الْمُقَنْطَرَ ةِ الذَّهَبِ الْفِضَّةِ الْخَيْلِ الْمُسَوَّمَةِ الْاَنْعَامِ

الْحَرْثِ لِ كَ اعُ الْحَيٰوةِ الدُّنْيَا اللّٰهُ حُسْنُ الْمَاٰبِ

> Meaning to make beautiful in the eyes of humans the love of what they desire, namely women, children, wealth of various kinds, gold, silver, chosen horses, livestock, and fields (Ali-Imran:14)

This inflation phenomenon is a classic problem for the economy which is still causing deep trauma. According to its historical development, Indonesia's inflation fluctuations are quite varied from time to time and are persistent

(Pratiwi, 2013). The inflation phenomenon in Indonesia is caused by various external and internal factors, whether they have a direct influence or not.

According to Pratiwi (2013), low inflation can encourage the country to increase its output capacity, but on the other hand high inflation also creates uncertainty in the economy. For this reason, efforts are needed to maintain inflation at a low and stable level. By maintaining inflation stability, economic actors will feel more comfortable in carrying out their economic activities, so that they can have a positive impact on the economy which is reflected through increasing economic growth, expanding employment opportunities, and balancing the balance of payments (Pohan, 2008). In other words, achieving inflation stability is the first step to achieving national stability.

Low inflation also does not benefit the economy because it reflects low purchasing power and demand for goods and services which in turn slows down economic growth. This places the issue of inflation as a very important indicator in maintaining economic stability. Inflation has a big impact on the world economy and affects interest rates and the amount of money circulating in a country. A decrease in economic activity and an increase in unemployment will follow movements in nominal interest rates because high inflation will result in an increase in the amount of government foreign debt because it has increased the exchange rate and caused the domestic currency to depreciate more quickly than foreign currency.

Bank Indonesia's success in stabilizing the monetary system is not accompanied by a stable financial system, it does not have much significance in providing support for the long-term development of the economic system. Monetary and financial stability are like two inseparable things. Monetary policy has a significant influence on financial stability and vice versa. The financial system is a monetary policy system, so if instability arises in the financial system, monetary policy cannot be carried out normally. Likewise, if monetary instability occurs, it can fundamentally affect the stability of the financial system, this is due to the abnormality of the financial system.

This is the basis for why funding stability is BI's obligation and responsibility. Bank Indonesia's interest rate is a reference for various companies to carry out transactions and predict investment activities and company operations. For this reason, developments in Bank Indonesia's interest rate need to be monitored and analyzed to find out future predictions so that company planning can be more accurate and more convincing for investors. Monetary stability must of course be followed by maintaining that the inflation rate that occurs every year tends to always increase because the inflation that occurs will have an impact on the power of monetary values.

According to Dincer et al., (2022), they were said that policy makers explain the reasons behind policy decisions relatively rarely and there is no fixed structure for parliamentary hearings. Therefore, reforms implemented in 2009 significantly increased monetary policy transparency, with Dincer et al., (2022) transparency scores showing the largest increase in monetary policy transparency in Iceland since 2008 among developed countries. Likewise, Indonesia cannot avoid economic contraction, but compared to many other countries it is relatively not too deep. This growth achievement was also supported by an expansionary but still prudent fiscal policy. Widening deficits and increasing debt are inevitable consequences for almost all countries.

The majority of policymakers feel that inflation is caused by the money supply. As a result, many countries experienced hyperinflation. The focus of this research is to analyze the factors behind these recent developments. Is it just "luck" reflecting Lang et al., (2016) "vanishing inflation" phenomenon, or does it also reflect improved domestic monetary policy performance that manifests itself in a long-term downturn? long-term inflation expectations relative to the official inflation target? To answer this, a forward-looking open economy is needed.

Countries are trying to increase their country's economic growth rate by increasing output continuously through the availability of capital goods, technology and human resources. One of the references used to see/measure the stability of a country's economy is inflation. From an economic perspective, inflation is a monetary phenomenon in a country where the rise and fall of inflation tends to result in economic turmoil. Maintaining price stability continues to be the main goal of macroeconomic policy for most countries in the world. This is done to achieve sustainable economic growth. Among other things, emphasis is given to price stability in implementing monetary policy with the aim of promoting sustainable economic growth and strengthening the purchasing power of the currency (Umaru and Zubairu, 2012).

Inflation is seen as one of the most important factors influencing a country's economic growth. There are various views regarding the impact of inflation on economic growth, including in 1958, Philips stated that high inflation positively influences economic growth by reducing the unemployment rate. This opinion is also supported by structural and Keynesian perspective figures who believe that inflation is not dangerous for economic growth, while the monetarist view believes that inflation is dangerous for economic growth. This is supported by events in 1970 where countries with high inflation, especially Latin American countries, began to experience a decline in growth rates and thus led to the emergence of the view that inflation had a negative effect on economic growth, not a positive effect.

The crisis period provides an example where the monetary crisis that occurred in 1998 made the Indonesian economy unstable due to an increase in inflation. The increase in inflation had increased to reach 77.63% at that time. According to Atmadja (1999), inflation in Indonesia was triggered by an increase in the price of imported commodities (imported inflation) and swelling foreign debt as a result of the depreciation of the rupiah exchange rate against the US dollar and other foreign currencies. As a result, to control inflationary pressures, the rupiah exchange rate must first be stabilized against foreign currencies, especially the US dollar.

The way to follow up on high changes in inflation is to encourage the monetary authority to create a monetary policy framework or in other words an inflation targeting framework (ITF) with the aim of maintaining and achieving low and stable changes in inflation. According to Arimurti and Trisnanto (2011), The implementation of the Inflation Targeting Framework (ITF) in 2005 was a milestone in the changes to the monetary policy framework carried out after the economic crisis in Indonesia.

According to data World Health Organization (WHO) in 2020 has officially announced the extraordinary event of the coronavirus disease 2019 (COVID-19) as a global pandemic. Makes everyone flinch. Some may be unfamiliar with the term pandemic, but you can feel that something big is happening. The Covid-19 pandemic is indeed an extraordinary event, the virus has spread rapidly in at least 21 countries/territories. Total global infections have exceeded 81 million cases with 1.7 million deaths as of December 28 2020. The high speed of the spread of this outbreak has had an enormous negative impact on all countries, both in terms of health, social and welfare, and the economy.

According to data from 2020, before the pandemic occurred, various parties still saw that 2020 was a year of global economic recovery. The IMF even estimates that the world will grow 3.3%, higher than global economic growth in 2019 which reached 2.9%. Even though it is still very vulnerable to being influenced by various economic dynamics such as falling productivity, protectionism, and trade wars, no one expects an economic storm to come and occur due to health issues. Covid-19 has drastically changed the socio-economic face of the world and changed the direction of the global economy, which was initially optimistic about improving, towards a recession.

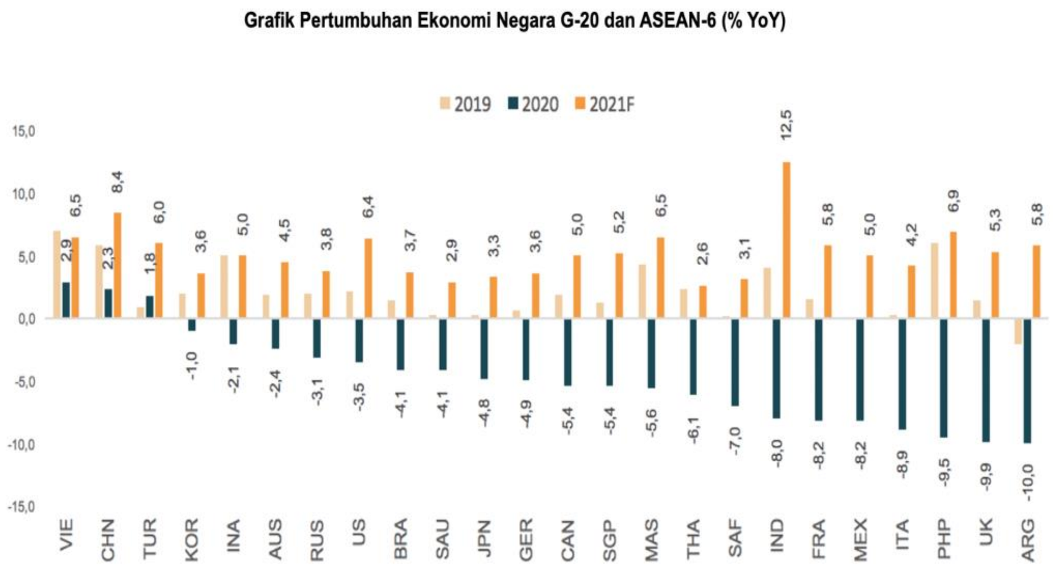
Transmission is very fast and causes casualties, as well as mitigation efforts unprecedented creating major changes in interactions at the individual level up to the institutional/country level. Massive restrictions on movement and interaction have consequences for the economy. Unavoidable policies such as lockdowns, *physical distancing*, *travel bans/restrictions*, and others have resulted in a significant decline in economic activity, which of course has huge implications.

The global economic situation is also increasingly challenging because the slowdown in production activities has resulted in millions of people being laid off from work. The United States, the largest economy in the world, saw more than 30 million new unemployment claims occur in just the first six weeks of implementation of social *distancing*, and exceeded 72 million in the 10 months of the pandemic. New unemployment claims were recorded to have exceeded 6 million people in one week. This figure is also a record high, even when compared to the Great Depression period which saw a total of 8.7 million unemployment claims. Most of the new unemployment that emerged in the United States (US) came from sectors that were badly affected by Covid-19, such as the entertainment, accommodation, transportation, trade, and manufacturing industries. Similar trends also occur in various other countries.

The threat of a health and economic crisis also caused major turmoil in financial markets at the start of the pandemic. Volatility in global financial markets began to increase at the start of the spread of Covid-19, triggered by concerns about the economic impact of China, which is the main supporter of global growth. Volatility intensified as Covid-19 escalated in many countries. *CBOE Volatility Index*(VIX), as an indicator that reflects investor anxiety, touched an all-time high in mid-March 2020, when the spread of COVID-19 was escalating in Europe and the United States. Investor panic triggered this capital *flight* and shifted demand on safe assets like gold, US Treasury *bonds*, and the American Dollar (US). Developing countries are again the ones most cornered in a situation like this. The IMF estimates capital outflows from the country's financial markets emerging *markets reached* US$100 billion in a relatively short time, or the equivalent of 0.4% of its Gross Domestic Product or GDP, much faster and deeper and exceeding other periods of stress such as the GFC and Taper Tantrum.

Relaxation often occurs with social restrictions in various countries, economic activity is gradually recovering but it is still very high risk because the pandemic is far from over. Various global economic indicators show that in general, the world has left behind its worst performance that occurred in March-April 2020. Manufacturing activity has even returned to expansion since July 2020, especially supported by the gradual normalization of production activities and increased output. Commodity prices, such as crude oil, palm oil, coal, and metals are also on an upward trend, indicating improving demand in various countries. These various recoveries in economic activity have also raised positive sentiment in global financial markets.

The economy in various countries is starting to reach a turning point towards recovery in the third quarter of 2020. The recovery that has occurred has still not reached normal levels before the pandemic. The rapid development of vaccines increases optimism, but the ongoing escalation of the pandemic and the risks ahead still limit the level of recovery on the household consumption side, *business confidence*, employment, to international trade.



Source: IMF and Ministry of Finance

Graph 1.1
Economic Growth of G-20 and ASEAN -6 Countries

Economic recovery continued in the final quarter of 2020, although in several countries it was hampered by the tightening of restrictions due to the new wave. For the whole of 2020, data shows a deep economic growth contraction experienced by many countries from both developed and developing countries. Some countries even experienced contractions of more than 8%, such as Mexico, France, Italy, the Philippines and the UK. China and Vietnam are countries that are still able to grow positively. Meanwhile, Indonesia's economic contraction of -2.1% is considered moderate in both the G-20 and ASEAN-6 groups. Indonesia's achievements cannot be separated from its role in *countercyclical* fiscal policy including the National Economic Recovery program.

Indonesia also cannot avoid economic contraction, but compared to many other countries it is relatively not too deep. This growth achievement was also supported by an expansionary but still prudent fiscal policy. Widening deficits and increasing debt are inevitable consequences for almost all countries. The Covid-19 pandemic, which has had an extraordinary impact, must be responded to with extraordinary policies that require state financial funding at a time when other economic wheels are paralyzed. Many countries even had to push the fiscal deficit up double *digits* and some have had to increase their debt to over 20 *percentage points*. The temporary realization of Indonesia's APBN deficit in 2020 itself is at 6.1% of GDP, or quite moderate between the widening deficits of the G-20 and ASEAN-6 groups. The prudent attitude that Indonesia continues to maintain is also reflected in the level of debt and additional public debt in Indonesia which remains the lowest, even amid policy constraints *countercyclical.*

Financial conditions include an energy crisis and a food crisis leading to fears of a recession. Stagflation is a condition where economic growth tends to stagnate or even fall, accompanied by high inflation. Covid-19 has drastically changed the world's socio-economic status and changed the direction of the global economy, which was initially optimistic about improving, towards a recession. Massive restrictions on movement and interaction have consequences for the economy. Policies that cannot be avoided such as lockdown, *physical distancing*, *restriction*, and others resulted in a significant decline in economic activity, which of course had huge implications for the world economy. A country's economic activities can never be separated from money payment activities. Money payment traffic means the amount of money in circulation. Changes in the money supply will affect economic activities in various sectors. An excessive increase in the money supply can push prices up (high inflation) beyond the expected level, which in the long term can disrupt economic growth.

On the other hand, if the increase in the money supply is very low, an economic downturn will occur. If this continues, the prosperity of society as a whole will in turn decline. Thus, management of the money supply must always be carried out carefully by considering the impacts that will occur (Manuela et al., 2014).

The principle of the monetary policy framework is the framework for adopting a more credible policy framework, which refers to the use of interest rates as operational targets and anticipatory policies. It is hoped that the ITF can change backward-looking expectations, which are the source of still high inflation, into forward-looking expectations. In this way, it is hoped that the ITF can encourage a reduction in the persistence of inflation.

Source: Bank Indonesia (processed)

Figure 1.2

Development of Inflation Rates in Indonesia for the Period 2001-2023 (%YoY)

Based on Figure 1.2, it can be seen that the development of inflation during the period 2001 to 2023 experienced various fluctuations. The highest inflation occurred in the 2005 period at 17.11%, then moved down in the 2006 period at 6.6%. After that, it rose again in 2008, namely 11.06%, because at that time there was a global crisis that hit the world, which hurt the economy in Indonesia. The development of inflation each year has the lowest value and was obtained in the 2009 period, namely 2.78%, but then experienced an increase in the 2010 period, namely 6.69%, and then decreased in the 2011 period by 3.79% until then experienced an increase in the 2013 period of 8.38%, which causes the percentage Economic growth becomes insignificant and then has an impact on increasing poverty rates in Indonesia.

One of the factors that influence changes in inflation in Indonesia is the Indonesian bank reference interest rate or in other words the BI Rate which is a signal for banks to determine interest rates for savings, deposits, and credit. According to Yodiatmaja et al., (2012), changes in the BI Rate will affect several macroeconomic variables which will then be transmitted to inflation.

Changes in the form of increasing the BI Rate level aim to reduce the rate of economic activity which can trigger inflation. When the BI Rate level rises, credit and deposit interest rates will also increase. When deposit interest rates rise, people tend to keep their money in banks and the amount of money in circulation decreases. In terms of credit interest rates, an increase in interest rates will stimulate business actors to reduce their investments because capital costs are getting higher.

The cause of dampening economic activity and ultimately reducing inflationary pressures. One of the ways used by the government to increase the relatively high rate of economic growth from year to year is through the increasingly rapid development of the financial sector today. However, current monetary developments have caused the relationship between the money supply and economic growth and the rate of inflation to tend to be less stable. As a result, the monetary crisis hit developing countries and devastated their economic structures. In fact, for Indonesia, this has continued with the economic and political crisis which has caused significant damage to the foundations of the national economy (And and Padula, 2003).

An economy driven by an increasing money supply can lead to increases in the prices of goods which tend to cause inflation. On the other hand, development requires a large expenditure of funds and it cannot be denied that the increasing development activities characterized by growth in state expenditure will give rise to inflationary pressures (Wahjuanto, 2003).

Exchange rate instability will affect capital flows or investment and international trade. Indonesia as a country that imports a lot of industrial raw materials is experiencing the impact and instability of this exchange rate, which can be seen from the increase in production costs, which has caused the prices of Indonesian goods to increase.

The weakening value of the rupiah caused the Indonesian economy to decline and be hit by an economic crisis as well as confidence in the domestic currency (Sitorus, 2018). The impact of the low economy causing drastic spikes in the exchange rate will make it difficult for producers to obtain raw materials, capital goods, and capital goods that have a high import content, which will then have an impact on increasing costs for importing goods for the production process. so that it will affect the domestic price level which is a reflection of the inflation rate.

The level of uncertainty due to this crisis is very high, one of which can be seen from the differences (deviations) between growth projections made by various parties and their realization, especially at the beginning of the pandemic. Projections for economic growth also change quite frequently and tend to continue to be revised downwards. As a result, it will show that it is difficult to estimate and predict because this crisis is very different from its source, namely from the health aspect: it has a very broad impact on various social and economic aspects, policies are dynamic and must continue to move to respond to situations that can change quickly.

The impact of the declining economy has resulted in increasingly heavy burdens on people's lives, especially those in the lower economic strata. If you look at the serious influence of the surge in inflation rates in Indonesia (the result of imported inflation which was triggered by the depreciation of the rupiah exchange rate against foreign currencies) on the national economy,

How does the government deal with the flow of high inflation in its country by implementing monetary policy? why are money supply expansion and inflation related to each other? Whether inflation results from a stagnant money supply is a statement.

Maintaining price stability continues to be the main goal of macroeconomic policy for most countries in the world. This is done to achieve sustainable economic growth. Among other things, emphasis is given to price stability in implementing monetary policy to promote sustainable economic growth and strengthen the purchasing power of the currency (Umaru and Zubairu, 2012).

Based on this controversy, The target of this research is to analyze a country's monetary policy in facing inflationary growth and compare the inflation rate to the growth of the money supply influences other factors that influence a country's economic growth. Inflation is also a problem that every economy always faces, and inflation is also the main agenda of politics and policy makers for the government (Mishkin, 2008).

B. Research Questions

Based on the description above, the main problems in this research are:

1. How do variables contribute to the formation of inflation from an Islamic monetary perspective in Indonesia in the 2016-2022 period?
2. What is the contribution of variables to the formation of inflation from a conventional monetary perspective in Indonesia in the 2016-2022 period?

C. Research Objectives

Based on this problem, the objectives of this research are:

1. To analyze the contribution of variables to the formation of inflation from an Islamic monetary perspective in Indonesia in the 2016-2022 period
2. To analyze the contribution of variables to the formation of inflation from a conventional monetary perspective in Indonesia in the 2016-2022 period**.**

D. Benefits of Research

D.1. Theoretical Benefits

It is hoped that this research can provide valid information in understanding and contributing ideas in deepening insight and theory regarding the theory of the determinants of inflation in the dual monetary system in Indonesia.

D.2. Practical benefits

This study is expected to be beneficial for:

a) The author hoped that this research can be a useful tool in implementing the knowledge that the author has.

b) The researcher continued, that it is hoped that this research can contribute to the development of theory regarding the determinants of inflation in the dual monetary system in Indonesia.

Other researchers interested in this research topic are expected to use this research as a source of inspiration or as a guide:

1. This research provides academics with the opportunity to practice academic learning so they can broaden their expertise in the field of development economics, especially with a focus on Islamic economics.

2. This research can be used by others as a resource for additional investigation and can be incorporated into the literature to advance understanding.

3. Universities can use research results to expand their library collections.
4. This study can be useful for organizations or bodies that oversee financial institutions, especially those tasked with monitoring the Islamic economic system.