CHAPTER I

INTRODUCTION

1.1. Background of Study

Money demand examines what motivates people to hold money balances. Assuming from the estimations of money demand equations, the monetary authority can adopt which monetary policies are better to implement under the present economic situations. A balanced demand function for money has long been considered as a requirement for the use of monetary aggregates in the establishment of policy (Goldfeld and Sichel, 1990). The effectiveness and success of a monetary programme crucially depend on a stable money demand function. The stable money demand function ensures that it would have predictable impacts on other economic variables such as inflation, interest rates, national income, exchange rate and private investments (Halicioglu and Ugur, 2005).

Targeting a monetary aggregate is a beneficial tool for managing inflation only if there is a predictable correspondence between movements in money and fluctuations in income, the opportunity cost of holding money, prices or whatever economic variables the central bank seek to affect. The economists have identified three major motives for holding money:

a. To settle transactions, since money is the medium of exchange.
b. As a precautionary store of liquidity, in the event of unexpected need.

c. To subtract the riskiness of a portfolio of assets by including some money in the portfolio, since the value of money is very stable compared to stocks, bonds, or real estate.

The money demand has been an integral part of economics from the origin of the subject. However, very little attention was paid to it before the 1920s. This apparent lack of attention appears to have specifically changed since the Great Depression of the early 1930s and the publication by John Maynard Keynes, in 1936, of The General Theory. These events have attracted special attention in monetary theory and consequently, equally special attention has been focused on money demand. The importance of money demand to the economy makes the theory continued to controversy and develop from time to time. The debate over the theory of demand for money cannot be separated from the debate between the two poles, namely Classic and Keynes. Keynes stated that there is a difference in the theory of money demand classical tradition, the diversity lies in the emphasis by Keynes on the other functions of money as a store of wealth (store of value) and not just as a means of transaction. In the theory of Keynes divided money demand based on three motives :

a. transaction motive
b. precaution motive and
c. speculation motive which affected by interest rates.

Money demand for transactions and precautions are depending on the income level where an increasing income affect the money demand and the rising in interest rates may lower the money demand. If the economy of a country is a human body, then the heart will be the central bank that works to pump blood to give life to the whole body, the central bank pumps money into the economy to make it stay healthy and grow. Sometimes economies need less money and sometimes they need more.

For any central bank, issue of the money demand function is one of the most important guiding policy issues that help decide whether to use the monetary targeting strategy or inflation targeting strategy in the monetary policy in bringing the desired changes in the economy. Stable money demand function enables the central bank accurately to predict money demand and hence control the money supply (using monetary policy instruments) in order to reach the primary goal of monetary policy and price stability. In general terms, the success of the monetary targeting regime hinges on two basic assumptions :

a. The relationship between the goal variable and the monetary targets must be strong enough; (i.e., money velocity is predictable).
b. Monetary aggregates must be under the control of the central bank; (i.e., the money multiplier is predictable) (Batini *et al* 2005).

Whereas, Anderson (1985), identified three sources of the instability of the demand for money:

a. Changes in the velocity of circulation in response to fluctuations in interest rates.
b. The demand for money function itself may shift. For instance, financial innovations and deregulation of interest rates may shift the demand for money at the prevailing levels of nominal interest rates.

c. Over shorter periods the money stocks actually held may not correspond to the desired money balances. If the speed of adjustment is low, then the mismatch between the desired and the actual money balances will induce large and unexpected changes in the velocity of circulation, leading to an unstable demand for money function.

The quantity of money circulating in the economy affects both micro and macroeconomic trends. At the micro level, a large inventory of easy money means a lot of personal expenses. Individuals also have an easier time getting loans such as personal loans, car loans, or home mortgages. At the macroeconomic level, money circulating in an economy affects the gross domestic product, overall growth, interest rates, and unemployment rates. central banks tend to manage the quantity of money in circulation to attain economic objectives and affect the monetary policy. Moreover, the development of money demand shows considerable improvement since the deregulation and it increased rapidly with a growth rate of narrow money (M1) by an average of 16.62%, broad money (M2) amounted to 15.64% and quasi money by 15.48%. In 2007, the greatest growth of narrow money (M1) and broad money (M2) amounted to 18.89% and 29.69%, respectively.

Development in the economic field requires the role of financial institutions, policies in banking are part of economic that aim to achieve the country's development goals. Therefore, the role of banking is very important. Banking institutions are one of the most strategic institutions for advancing the national economy, they are obliged to facilitate the flow of the economy and the monetary system. Basically, the Bank brings benefits because of the owners, users and managers of the capital meet. Thus, it encourages the progress of economy in a country.

In recent years, a commercial bank is the core of the financial system in each country. The basic business bank such as raising funds from excessive parties then channelling them back to the society within a certain period of time. The function of accumulating funds in the form of deposits greatly determines the growth of a bank because the volume of funds collected determine the volume that can be developed by the bank in the form of investment funds. The presence of banks in Indonesia has a very significant influence for the public, huge industry, medium or lower industries, these happen because it is needed to strengthen capital or saving money has become commonplace.

In additions, the presence of Sharia Banks is one solution to increase public confidence in banking activities, especially in Indonesia. The Islamic financial system growing rapidly, Joharris (2007) estimate more than 276 Islamic financial institutions are scattered in more than 70 countries, from London, New York and Zurich to the Middle East, Africa and Asia with a capitalization more than US$ 13 billion. These are including banks, mutual funds, mortgages and Takaful (Islamic insurance). The number of funds controlled by Muslims more than US$ 13 trillion. There were an estimated US$ 1 trillion Islamic funds in the market and global Islamic capital markets develop around 15% - 20% per year, it is included bank deposits or investments in Shariah approximately US$ 560 billion.

Islamic Bank in Indonesia became famous when it emerged during the crisis of 1997-1998, Bank Muamalat Indonesia is the only Islamic bank who could survive without government assistance. It is one of the banking products based on the Islamic economic system and currently being discussed in Indonesia. Since then, Islamic banking has begun to emerge as an alternative financial institution free of interest. Conceptually, the idea of Islamic financial system does not use interest rate, fiat money and fractional reserve banking system as it used by the conventional financial system because all of them are contained the elements of usury.

The implementation of a profit sharing system is the cornerstone in their operational, either in funding, deposit and financing. In the profit-sharing method, inflation typically favors employers and automatically increased the revenue of depositors. Extra money demand resulting in increased income entrepreneurs. In the practicing of profit sharing method, the profit will be accepted by the banks and depositors in accordance with nisbah. Therefore, Islamic banks more responsive to inflation and customers do not have to worry about the level of inflation and interest rates. Islamic banks function to invest public funds in accordance with Islamic role effectively, productively and for the benefit of Muslims. The main objective of the Islamic Bank is to unite Muslims, restore the strength, role and position of Islam on the earth can be achieved.

According to Antonio (2005), Islamic banking products can be divided into three parts: (1) fund collection products (Wadi'ah and Mudharabah), (2) distribution of funds (buying and selling, profit sharing and rent) and (3) products related to services (Wakalah, Kafalah, Hawalah, Rahn and qardh). Products for distributing funds offered by Islamic banks through buying and selling are ba'i murabahah, ba'i salam and ba'i al istisna, products offered through profit sharing, namely, mudharabah contract, Musyarakah contract and ijarah contract, while the products offered through rent are ijarah. Products issued by Islamic banks are based on operational functions, Islamic banks have four functions as follows:

a. as the recipient of the mandate to manage investment funds that have been entrusted by investment account holders.
b. as managing investment funds desired by the fund owner.
c. as a provider of payment services and others, as opposed to sharia principles.
d. as managing social functions.

The existence of Islamic Banking is expected to be a solution to the failure of the interest-based banking system. Even though inflation continues to occur, the presence of Sharia Banks is still evident from the growth of third party funds (DPK) collected by Islamic Banks. Based on the research, the Islamic banking system is more resistant to crisis compared to conventional banks. These indicated by several indications; (1) Growth in deposits, assets, labor costs and output (financing and operating income) on average, both before and after the global crisis, tends to increase; (2) The efficiency of Islamic banking before and after the global crisis, generally included in the efficient condition; (3) There is no significant difference in efficiency performance Islamic banking before and after the global crisis; (4) The profit sharing system, profit orientation and long term profits and partnership relations between banks and customers are one of the factors supporting the resilience of Islamic banking facing the economic crisis.

Even though Islamic bank third-party funds (DPK) experienced growth every year. Yet Ismal (2011), explained that the motives of customers to invest their capital through Islamic banks are based on several motives; (1) religious motives, (2) motives for maximum profitability, and (3) motives to obtain banking transaction facilities. When a Sharia Bank customer only aims to get high profits and conventional bank interest is more promising, then the customer will switch from a Sharia Bank to a conventional bank. Third party funds are funds collected by banks originating from society, either individuals or business entities. Third party funds (DPK) have a greater proportion than other funding sources, therefore Islamic banks are always trying to increase third party funds (DPK). The increasing shows positive growth from year to year, Components of third-party funds (DPK) are three types, namely; savings and time deposits that apply the principles of mudharabah and demand deposits that apply the wadi'ah principle.

Associated with the economic stability of a country closely related to the performance of financial institutions. Economic stability is a benchmark for the sustainable development of the economy. However, the problem of economic stability is also a classic problem, especially for developing countries, in every developed country facing problems of stability and economic growth. The research on money demand which is based on the Islamic economic system is still rare in Indonesia. Thus, it’s expected the presence of this research will provide enrichment to academic literature and other researches related to money demand based on the Islamic economic system. In addition, this study will contribute an additional form of third-party funds and equivalent rate variable that has not been widely used. This research will use variables money demand (M2), industrial production index (IPI), inflation, interest rate, exchange rate, third party funds (DPK) and equivalent rate. As for the research will use secondary data in the form of time series from 2009 to 2018 as well as the method of error correction model (ECM).

1.2. Problem's formulation

Based on the background of study described earlier, this research focuses on the problem as follows:

a. How are the effect of third party fund, equivalent rate (profit sharing), inflation, industrial production index (IPI), interest rate, exchange rate on money demand (M2) in Indonesia?

1.3. Objective of the research

Based on the formulation of the problem that has been described above, the purpose of this research as follows:

a. To determine the effect of exchange rate, third party fund (DPK), equivalent rate, inflation, industrial production index (IPI) and interest rate on money demand in Indonesia.

1.4. The benefit of research

This research is expected to provide benefits to multiple stakeholders such as researchers, academia and government in supporting the economic system in Indonesia. The benefits of this research are:

a. For researchers: It is expected to be able to increase knowledge and analysis of researchers in understanding the problem of today's economy, and can provide a through understanding of the existing monetary system in Indonesia.

b. For academics: It is expected to be a reference for academics in order to conduct the next research, especially with regard to the effect of money demand in Indonesia. And to improve knowledge and enrich their knowledge.

c. To the Government: As input or suggestion for the government, as an alternative to the economic system to be better and they can maintained the stability of the economy.

1.5. Organization of the research

The organization of the study contains five main parts: Chapter I discuss Introduction: in this chapter, explained the background of the decision of research topics, the determination of title of the study, objective of the study in the research, the purpose of the research, as well as organization discussion on research purpose. Followed by Chapter II discussed the Basis Theory and Literature: this chapter will explained the theory, literature review, and previous research journals related to the topic and supported in this study. Moreover, Chapter III discussed on Research Methods: described the research methods of which consists of the selection and sample population, resources and techniques of data collection, operational definitions of study variables, hypothesis testing, as well as methods and data analysis used in the study. The last two chapter which are chapter IV will discussing about the Result and Analysis, it describes the data used in the study, the results of the data analysis, interpretation of research results, as well as a discussion of the results of these studies. Chapter V is the conclusion which it will present the conclusions of research that takes the results of the analysis that has been done before, limitations in the study, suggestions for further researches and also the implementation of the research that has been done.