CHAPTER I
INTRODUCTION

A. Background

The definition of Money means of payment for an item or service made between the two parties concerned and has an agreement with each other in a transaction. In the current situation, the role of money is very important because the function of money itself is as a tool. The impact of these activities is that the function of money is needed and sought after by the community to fulfill their daily needs, both of primary, secondary and tertiary needs. Without realizing it to support the needs of human life, by transactions, activities arise which are called economic activities. All community activities dominated by the economy will certainly have an impact on the economy of a country. It can be concluded that money will move the economic sector found in a country.

The role of money between one country and another cannot be the same because of differences in lifestyle and the need to transact. In more developed countries, generally there is a large amount of money demand compared to countries that have economic quality under developed countries. The thing that triggered this phenomenon was because in most developed and developing countries more transactions were made compared to countries that were not yet developed. That way, there is a greater demand for money compared to countries whose economies are not yet developed. The function of money, according to Oliver (2000) is; (1) Medium of exchange, (2) Standard of value, (3) Different payment, and (4) Store of wealth.

The phenomenon arises because there is an economic movement carried out by transaction, there is a demand for money in the community. Demand for Money occurs because there is a need that must be fulfilled by the community and the form of the government's responsibility to fulfill the people's demand, namely through a policy from Bank Indonesia to always know the demand for money that continues to move through several economic variables such as the level of price increases in addition Bank Indonesia also needs to control the amount of circulating money in the community so as not to have an impact on other economic sectors such as inflation, exchange rates and interest rates. According to Arief Widodo (2015) Demand for money has a very important role for the authority of monetary policy in determining appropriate policies to maintain economic stability. Analysis of money demand is a large-scale analysis of the economy needed to support a policy taken by the government in the monetary sector. The government, in this case, is that Bank Indonesia can take a monetary policy aimed at achieving monetary stability (Prawoto 2010).

Indonesia is one of the countries with the largest amount of *Money Supply* in the region of the Group of Twenty (G20). There are factors that influence the money supply in the community. Inflation, GDP, Exchange Rate, Interest Rate and economic growth are variables that have the opportunity to influence the demand for money in society. So, to prevent an increase in the number in the money supply will have a very significant impact on other economic variables and trigger an excessive demand for money Bank Indonesia needs to make appropriate policies to prevent this from happening. With supervision and accuracy in taking policies that will be implemented for the people of Indonesia not only apart from the threat of instability in the Indonesian economy, but it actually increases the quality of the economic sector itself.

Table 1.1
Amount of M0 on G20 Country (Last Update Sept-18)

Country	Amount of M0
South Korea	KRW 99,333,700 (Billion)
United States	USD 3,584502 (Billion)
Mexico	MXN 1,520,063 (Billion)
Argerntina	ARS 1,208,276 (Billion)
Switzerland	CHF 554,256 (Billion)
Saudi Arabia	SAR 317,007 (Billion)
Brazil	BRL 227,677 (Billion)
South Africa	ZAR 249,862 (Billion)
Indonesia	IDR 583,200 (Billion)

Source : Trade Economics Data

Table 1.2
Amount of M1 on G20 Country (Last Update Sept-18)

Country	Amount of M1
Australia	AUD 355.11 (Trillion)
China	CNY 17,887 (Trillion)
Germany	EUR (2,119 (Trillion)
India	INR 31,578 (Trillion)
Russia	RUB 20,596 (Trillion)
Mexico	MXN 8,493,670 (Billion)
South Africa	ZAR 2,834,146 (Billion)
Brazil	BRL 2,741,884 (Billion)
South Korea	KRW 2,640,903 (Billion)
United Kingdom	GBP 2,371,545 (Billion)
United States	USD 3,702 (Trillion)
Indonesia	IDR 138,215 (Trillion)

Source : Trade Economics Data

Table 1.3
Amount of M2 on G20 Countries (Last Update Sept-18)

Country	Amount of M2
China	CNY 178,870 (Trillion)
India	INR 32,980 (Trillion)
Japan	JPY 1,006, 108(Trillion)
Russia	RUB 443,691 (Trillion)
South Korea	KRW 2,640, 903(Trillion)
United Kingdom	GBP 237,154 (Billion)
United States	USD 14,217 (Trillion)
Indonesia	IDR 5, 528, 976 (Trillion)

Source : Trade Economics Data

Analysis of Money Demand is inseparable from the use of dynamic models. The dynamic function will affect the price level to the speed of the money supply. This phenomenon of the speed of money circulating automatically has an impact on price fluctuations. With these phenomena raises the statement that the demand for money plays an important role in monetary policy. In the theory, analysis the demand for money is generally associated with the discussion of the concept of the buffer stock approach. According to Insukindro (1998) The concept of buffer stock comes from the idea that the community is willing to hold money intent to absorb the day-to-day variations that are not anticipated or expected between public revenues and expenditures. (Melbourne, 1988: 1). The next theory that links between demand theory and buffer stock comes from Laidler 1997: 1215-1216 suggesting that the purpose of economic motives for holding money is as a form of transaction, just in case speculation can be predicted through the existence of buffer stock approaches. Insukindro (1998) said that the concept introduced by Laidler was the concept of buffer stock regarding the demand for money equal to the concept of inventory.

This theory of money demand has been debated from time to time. Frequent debates occur, but the issue is very crucial because the differences in theory, used by researchers will have an impact on the different forms of the functions or models of money demand that make economic policies and mechanisms differ. As is the case the theories made by two different camps are Classical Theory and Keynes Theory.

In classical theory, it is assumed that there is no influence of money demand on the real sector, interest rates, employment opportunities, and national income. According to classics, the thing that greatly affects money is the price of goods, better known as the quantity theory of money triggered by Irving Fisher. The result that will arise from the demand for money is only because of an increase in the price of goods, while the amount of output does not change.

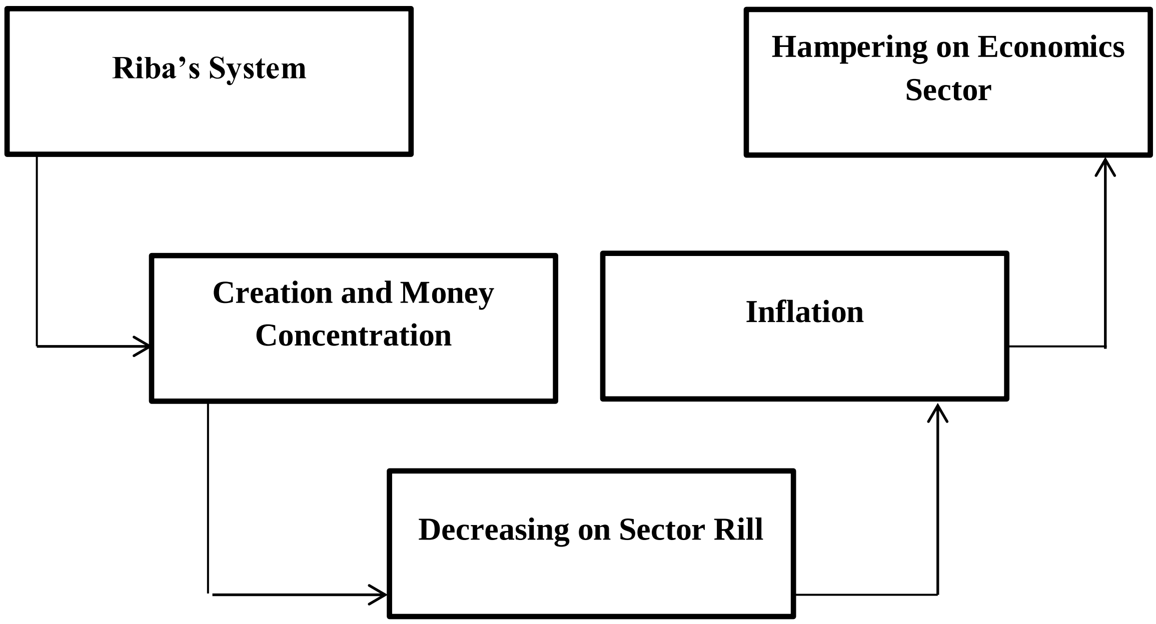
Whereas in Keynes Theory says that the reason people hold money is to be on guard, transact, and speculative where the reason for speculative people is influenced by interest rates, the reason people guard and transact is influenced by income. Keynesians also assume that with interest rates, there will be a monetary phenomenon. According to the Keynesian economy, it must adjust what happens with the interest rates set by the monetary system rather than the other way around. Then the conclusions that can be drawn from Keynesian theory are Income and Interest Rate will affect the demand for money, if income increases, the amount of money demanded will increase, whereas when there is an increase in interest rates, the amount of money demand will decrease in society.

The difference from some economists related to the theory of money demand is supported by the assumptions of Baumol (1952) and Tobin (1956), then on further developing the demand for money for transaction purposes. They have provided the basis and theoretical reasons why the demand for money is not only influenced by income but also by interest rates. In this case it is considered that money demand can be considered as a form of inventory, because they argue that holding money with the purpose of transactions is related to opportunity costs because economic actors do not realize their wealth in the form of investments or bonds that provide income in the future.

From the theories that have been described, it is clear that the influence there is a variable interest rate on the demand for money, while in Indonesia, the Dual monetary system is Sharia and Conventional. In the banking system that is carried out using a conventional system, it is clear that the systems that contradict the Islamic system of Islam emerge. The most obvious difference is the application of interest rates, even though interest rates are the main instrument of monetary policy, which is very contradictory. With sharia law which is part of usury, because there is a unilateral agreement at the beginning before going. The prohibition on usury has been written very clearly in QS Al-Baqarah: 276-278. Then what is used by the sharia system is only based on Islamic recommendations by using a system called profit sharing from economic activities as an intermediary instrument.

With the implementation of the dual monetary system that exists in Indonesia simultaneously, it will have an impact on the performance of the real sector, as well as the monetary sector in the economy. Based on existing data that in recent years the development of international finance is growing rapidly, including Islamic financial institutions. The development of Islamic financial institutions is quite rapid, especially in Islamic Banking. Currently, more than 276 Islamic financial institutions in the world are spread in more than 70 countries, from London, New York and Zurich to the Middle East, Africa and Asia with a capitalization of more than US $ 13 billion. All of this includes banks, mutual funds, mortgages and Takaful (Islamic insurance). The amount of funds controlled by Muslims is more than US $ 13 trillion. At present there is an estimated US $ 1 trillion in Sharia funds in the market. The global Sharia capital market is growing at around 15% -20% per year, including deposits / investments in Islamic banks, estimated at more than US $ 560 billion (Joharris, 2007 Journal: Ascarya, Heni Hasanah, Noer Azam Achsani).

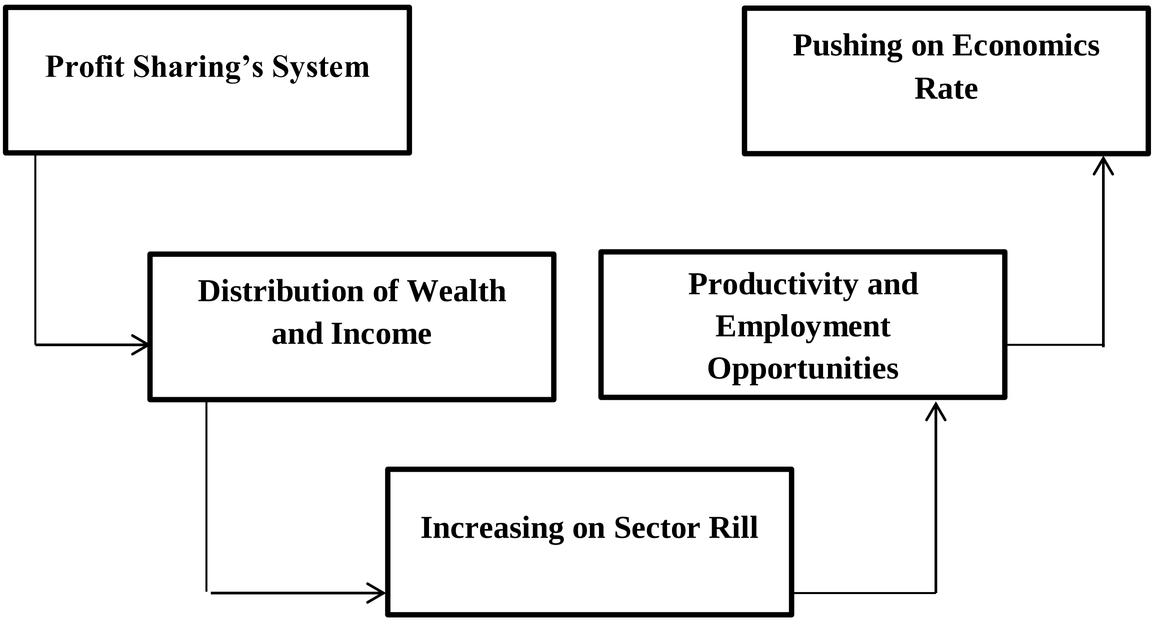
The crisis in Indonesia that occurred in 1997-1998 resulted in only Bank Muamalat who succeeded without assistance from the government because at that time Bank Muamalat was the only Islamic bank in Indonesia. So, since that phenomenon emerged various other sharia-based banks in Indonesia, which of course opened up alternatives other than interest. Although the development of sharia financial institutions is quite rapidly now in Indonesia, the development is only around (2%) compared to the rest of the world. The implementation of alternatives other than using interest rates is the goal of a Sharia Bank. In addition to interest-free Islamic banks also offer other products such as buying and selling systems and leases. This difference arises between Islamic banks and conventional banks. The concept of sharia itself is to avoid usury, therefore the Islamic financial system does not use fiat and fractional reserve system banking as practiced by conventional banks. The following is the difference between conventional systems and sharia systems and their implications for the economy.



Source : Sakti (2007)

Figure 1.1

Impact of Riba's Transaction to the Economy Sector



Source : Sakti (2007)
Figure 1.2
Impact of Profit Sharing’s Transaction to the Economy Sector

In the above concept, it can be seen clearly that in an economy that uses a conventional system, usury fiat money system, fractional reserve system in banking, and legal speculation causes the creation of currency and demand and triggers the withdrawal of money in the monetary sector to gain profits without the risk. The result is that the money or invested that should be channeled into the real sector for productive purposes will mostly fall to the monetary sector, which will hamper growth and also reduce the real sector. Money created without being followed by adding value will result in inflation which will end with the economic situation which is increasingly slowing down.

The opposite situation with the implication of the profit sharing system is with zakat and the sharing of results also the prohibition of speculation in the

Islamic economy, will encourage an investment climate that is channeled smoothly to add the rail sector with fully very productive goals. This will guarantee the distribution of wealth and income to increase the real sector, which will increase productivity and work and business opportunities which will lead to a prosperous society.

Although the sharia system can have a far better effect on the economy, the fact remains that Conventional Banks still dominate in Indonesia, but Sharia Banks have succeeded in gaining customer confidence in receiving yields from deposits and wadiah using a profit sharing system or more familiar with profit-loss sharing. . But still there are still limitations that are owned by Islamic banks compared to conventional banks. Analysts of economists argue that the development of the economic system adhering to sharia principles shows that by implementing a profit sharing system it is far better than the interest system. Other differences that are also evident from the conventional Islamic banks and banks that are clearly visible in terms of performance according to the 2012 Siraj and Pilai research. Islamic banks have more equity that can be financed compared to conventional ones. Therefore, Islamic banks have a higher level of income and operating profit than Conventional Banks. Therefore the risk of a defense against the crisis of a Sharia Bank will be far better than that of a Conventional Bank. To strengthen these assumptions, it is necessary to have concrete and empirical evidence that by not implementing the interest system, the economy will be much better, and very positive for the real sector growth.

Looking at the background above, the researcher was interested in conducting a study of "Analysis of Money Demand in the Double Monetary System in Indonesia". in this study the Demand for Money (Conventional) is reviewed from the amount of M1 (currency + deman deposit) and M2 (M1 + saving + time deposit) in the form of secondary data by means of data selection based on Inflation, Exchange Rate and Interest Rate compared to Demand for Money (Shari'ah) in terms of the amount of M1 (currency + deman deposit of wadi'ah deposits) and M2 (M1 + saving + deposit mudharabah) in the form of secondary data by means of data selection based on Inflation, Exchange Rate, and Return Syari'ah period January 2013 until February 2018, using the regression vector Vector Autoregression (VAR) and Vector Error Correction Model (VECM).

1.1 Problem Formulation

Based on the background, the formulation of the problem in this study is as follows:

1. How do the Inflation, Exchange Rate, and Interest Rate affect the amount of Money Demand (using Conventional's component) in Indonesia?
2. How do the Inflation, Exchange Rate, and Return Shariah affect the amount of Money Demand (using Syariah's component) in Indonesia?

B. Research Objectives

The research objectives are as follows:

1. Analyze the influence of Inflation, Exchange Rate, and Interest Rate on Money Demand (using Conventional’s component) in Indonesia.
2. Analyze the influence of Inflation, Exchange Rate, and Return Shariah on Money Demand (using Syariah’s component) in Indonesia.

C. Benefits of Research

1. As a matter of consideration for the government, especially the monetary authorities in making policies concerning the issue of stability in the demand for money.
2. As a consideration for the community in investing in Indonesian financial institutions both conventional and sharia.
3. Add empirical studies regarding the analysis of money demand.
4. As input for further similar research.
5. Provide an understanding of the dual monetary system in Indonesia.