

# CHAPTER I

## INTRODUCTION

### 1.1 Background

The South East Asian countries has established the *Association of South East Asia Nation* (ASEAN) as a regional organization with the aim to increasing regional economic growth. ASEAN was founded in Bangkok Declaration on August 8th, 1967 by five countries i.e. Indonesia, Malaysia, Thailand, Singapore, and Philipine which called as ASEAN-5. ASEAN are become more solid with the establishment of 9th ASEAN summit in Bali on 2003 with the final achievement to declare Bali Concoct II to attain full integration of ASEAN countries on 2020 in the ASEAN community forum. The ASEAN community has three main pillars i.e. politic and security cooperation, economic cooperation, and socio-cultural cooperation. Through economic cooperation the ASEAN economic convergence are expected in the form of ASEAN Economic Community (AEC) indicated by the movement of current goods, services, capital and invesment are flowing freely without any restriction. (Pratiwi, 2015)

ASEAN-5 countries principally linked through markets, international trade, financial flows, direct investment and other forms of economic and social exchange. An important indicator for a country's economic performance is the exchange rate and trade balance stability. Exchange rate as one of the entrances to the economic turmoil that came from outside of the country, while trade balance as the fundamental factors indicating that a country has a strong economic

foundation. According to Mundell-Fleming model rules that for small open economy, if there is incurring exchange rate fluctuations, for instance an exchange rate tends to appreciate, theoretically such condition would hurt export and conversely endorse import. This standard textbook theory and its prescriptions assume that markets are perfect and prices are given by world markets. In macroeconomic view points we can say that export would be more interesting for economic because it will encourage the trading within the country and increasing the value of export based trading. In shortly, the Mundell-Fleming theory taking the assumption that when the exchange rate get fluctuated in such case appreciating, it will decrease the value of export in the country because it will increase the price of goods and services within the country. Conversely, when the nominal exchange rate depreciating it will increasing the value of export, and import value will decrease. (Kusuma, 2010)

As a small open economy, ASEAN-5 economy are fully depended on trade in developing their country. Trade balance stability which came from exports and imports are vulnerable to the economic shocks came from inside and outside of the country. Such an exogenous economic turmoil are easily inhibit the economy development. One of the doorway for exogenous factor is from exchange rate. Therefore, the ASEAN-5 need to oversee their exchange rate fluctuations. Small open economy condition also require the countries under flexible exchange rate regime to applied an interdependent policy. Difference in interest rate level, in such case higher than the neighboring countries would rising up the capital inflows which later will increasing the foreign money, this

condition would drive up the demand for domestic money which later increasing the domestic currency. In order to maintain the currency stable, macroeconomic stability and fundamental factors becomes the focal point and become a very important component for ASEAN-5, especially in the face of global challenges and international competition. Moreover, if there is any exogenous factors that could harm the economy through exchange rate fluctuations. Fundamental economic condition as the indicator that the country can withstand the external economic turmoil has to be in a good performance. However, the characteristic of ASEAN-5 countries has differ one another. Thus, the way they response to the external economic turmoil are different. Table 1.1 shows the ASEAN-5 economic indicators for 2005 and 2014.

**Table 1.1**  
**ASEAN-5 Indicators for 2005 and 2014**

Country	GDP growth (%)		Private consumption (%)		Public consumption (%)		Gross domestic investment (%)		Inflation rate (%)	
	2005	2014	2005	2014	2005	2014	2005	2014	2005	2014
Singapore	7.49	2.92	3.41	2.49	5.03	0.05	-0.53	-2.35	0.47	1.02
Malaysia	5.33	5.99	9.11	6.96	6.5	4.4	5.84	2.64	3.03	3.14
Thailand	4.19	0.87	7.99	1.65	14.28	-2.61	12.78	-11.4	4.54	1.9
Indonesia	5.69	5.02	3.95	5.14	6.64	1.98	41.23	4.39	10.46	6.39
Philippines	4.78	6.13	4.42	5.42	2.06	1.74	2.96	5.41	6.6	4.17

*Source: Asean Development Bank*

In general, ASEAN-5 countries having the economic turmoil in a period of 2005 until 2014. It can be seen from GDP growth, most of all ASEAN-5 decrease except Philippine.

In 2009, the Global Financial Crisis (GFC) reduced demand for exports of Southeast Asian countries, where exports is a major growth driver. Recession in developed countries led to contraction in output of Asian countries through export shortfalls. Expansionary and accommodative monetary policy in response to recession in developed areas, through low interest rates and liquidity injection caused massive capital inflows to Southeast Asia. Consequently, Southeast Asian currencies appreciate substantially and exacerbated export downturn (Bhanupong, 2012).

However, According to Abeysinghe and Yeok, (1998) they argue that the higher the imported input content, the less would be the impact of exchange rate fluctuation on exports. Exchange rate appreciation considered would have nothing to do with export, whilst, currency depreciation would have some what raise the export. However, the export rising during the period of currency appreciation could be backed up from one of the following possibilities or combinations of them. First, the import content of exports could have been relatively large so that exports were little affected. Second, external demand of goods and services could have been rising as the countries could able to defferentiate the product. Third, the countries could be rising their productivity. Fourth, pricing-to-market policies could have countered the negative effects of currency appreciation.

Irاندoust and Ericsson (2004), also found some evident that trade balance imbalancement can predict the exchange rate fllctuation. evident to shed light on the policy implications of a long-term relationship between imports and exports.

The relationship can be discerned from its convergence or econometrically being called as its co-integration which later suggests co-existence of co-integrating vector between exports and imports are implied that a country is not in violation of her international budget constraints and any trade imbalances are only a short-run phenomena so that the equilibrium instituted in the long run are sustainable.

In brief, the correlation between exchange rate fluctuations and trade balances are seemingly correlated as the sustainability of trade is indicated by how strong its currency fluctuations precipitated and how far the existence of a productivity gap takes place. The productivity gap would drive up both exchange rate and interest rate abroad. Consequently, for developing countries the export would decrease, and investment as the effect of interest rate will go down as well. Conversely, the import and saving would increase as the influence of exchange rate and interest rate jointly. For additional, the high saving gap would affect to the shortfall of productivity domestically. For an export-oriented countries, the wide saving gap also would affect to the external sector disequilibrium. In short, the final effect of these movements is increasing the amount of debt. (Kusuma, 2010)

The Findings above encourage the author to take a research about the correlation between export and import which are important as the fundamental factors indicating that the country has a strong economic foundation and can withstands the external economic turmoil which came through exchange rate fluctuations. Under above pre-quisite, the author taking the research through this undergraduate thesis with the title **“Analysis of The Interraction of Exchange**

## **Rate Fluctuations Towards Exports and Imports Performance In ASEAN-5 Countries”.**

### **1.2 Limitations of Research**

Since the topic are quite general. The author want to restrict the research problem that might arised. The research are limited to several point of study,

1. Focus on the trade balance performance and exchange rate of ASEAN-5 namely; Singapore, Malaysia, Thailand, Indonesia, and Philippine.
2. The variables used are exports, imports, and nominal exchange rate.
3. The data used for the research are monthly data spaning from 2005:M1 until 2015:M12.

### **1.3 Research’s Problems**

Shortly, this research have some question remark in respect to search some empirical evidence of the topic, the impact of exchange rate fluctuation on the export and import performance in ASEAN-5 countries. The questions are;

1. Does the export and import in ASEAN-5 countries co-integrated?
2. Does the nominal exchange rate fluctuationss have a significant effect toward the export and import performance and vice versa in ASEAN-5?

#### **1.4 Purposes of Research**

As the research questions arised, the aims of this research want to make sure of two things;

1. To analyze the existence of co-integration relationship between exports and imports in ASEAN-5 countries.
2. To analyze if there is bidirectional relationship between exchange rate and trade balance performance.

#### **1.5 Research's Outline**

In order to deepy understanding this undergraduate thesis, the author made this reserach outline so the reader can fully understand this research. Research outline of this undergraduate thesis are devided into several chapters which represented each materials.

Chapter I, Introduction; this chapter describes the general information that the research background, problem formulation, purpose and benefits of the research, the scope of research, time and place of study, research methodology, and systematic research.

Chapter II, Theoretical Framework and Hypothesis; this chapter contains the theory that some excerpts taken from the book, in the form of understanding and definition. This chapter explains the theory that not explained in the background, and also including the basic concepts of the topics, and other definitions associated with the macroeconomics variables.

Chapter III, Research Methodology; This chapter contains the definition of variables that used in this research, data and the source, the methodology of co-integration test analysis and Vector Error Correction Model (VECM).

Chapter IV, Research Findings; this chapter describes the general overview of the research. Finding some empirical evidence from the analytical study. It also contains the result from the analysis of co-integration test and vector error correction model (VECM), the result table and diagram, the analysis of empirical result with the theoretical framework and previous study.

Chapter V, Conclusions; this chapter contains of conclusion from the research, suggestion for the policy maker in Indonesia and suggestion for the next research.