ABSTRACT

This paper studies the impact of inflation rates and US Dollar exchange rates on Indonesian stock market return volatility in the period of 2002-2012. GARCH methodology, proposed by Bollerslev (1986) is used to estimate the daily volatility of the stock return. Daily data of stock market return, inflation rates and US Dollar exchange rates is used to estimate the daily volatility of the stock return. The data is assumed to be symmetrical to validate the use of GARCH model. This study intends to explain whether inflation rates and US Dollar exchange rates have impact on Indonesian stock market return volatility or not.

GARCH methodology is going to be used in this study. The regression equation in this research would be $\sigma_t^2 = \omega + \alpha\mu_{t-1}^2 + \beta_0\sigma_{t-1}^2 + \beta_1 inflation_{t-1} + \beta_2 exchange_{t-1}$ (Hull, 2007). Preliminary analysis and post diagnostic analysis are done in this research as well. The preliminary analyses are unit root test and white test. While the post diagnostic analyses would be normality test and ARCH-LM Test.

The result shows that both inflation rates and US Dollar exchange rates does not have a significant impact on the Indonesian stock market return volatility. Inflation rates contribute to a 0.03% change in daily stock market return volatility whereas a 1% appreciation of Rupiah contributes to a 0.0000001% change in daily stock market return volatility.

Keywords: Investment, Stock market return, US Dollar exchange rates, inflation rates, GARCH