CHAPTER I

INTRODUCTION

A. Background

Financial market is a term of any marketplaces where trading of securities including equities, bonds, currencies, derivative securities occurs. For investor and also firms who engaged in international activity will transfer money back and forth regularly, they need a transaction exchange between their home currencies to other currencies. Value in converse the currencies is defined as exchange rate. Exchange rate could also be defined as “the foreign currency price of a unit of the domestic currency” (Salvatore, 1993:387). It is also defined as the value of one country currency against another country currency (O'Sullivan & Sheffrin 2003).

The investor and also firms who need to exchange their currency with other currencies could do the activity in foreign exchange market. Foreign exchange rate market is global decentralized market for the trading of currencies against one other currency and it is the largest financial market in the world in terms of both geographical dispersion and daily turnover, which is in excess of $5 trillion (Bank for International Settlements, 2013). More than trillion dollars of currency is traded each day in the foreign exchange market, primarily through a network of the largest international banks.

The importance of exchange rate can be seen in its activity and also daily turnover of exchange rate itself. Exchange rate is also one of macroeconomic indicators that sensitive on external turmoil condition. “Among the instruments that are crucial in economic management and stability of basic prices is the exchange rate "(Were, Geda, Karingi & Ndung'u, 2001). In this case, exchange rate reflects the economic power as a result of economic global condition. The more stable exchange rate value, the more it shows that fundamental strength of countrie's economic.

According to Chou (2000) defines that the movement of exchange rate in the market (up and down) shows the degree of volatility occurred in the currency of the country against another country. The movement of exchange rate is depends on purchasing power of exchange rate under the influences of demand and supply of market. The supply and demand is affected by several factors. The factors affecting exchange rate and its volatility are divided into two groups that are economic and non-economic factors.

Based on Twarowska and Kąkol (2014), economic factor consist of rate of economic growth, inflation rate, interest rate in the country and abroad, and etc. Non-economic factors consist of political risk (e.g. risk of armed conflict), natural disasters, policy approaches and psychological factors. In this research is focusing on variable of political risk and its relation with the exchange rate movement. The political risk is an important factor, especially in emergent economies and in the developing ones. Howell and Chaddick (1994) define the political risk as being "the possibility of the political decisions and political events from a country, including the social ones, to affect the business environment, so that the investors recall the investments or the profit leeway reduces".

During the last decades, a range of studies has emphasized the way in which the economic and political news and event that tend to be a political risk affecting the currency market. There are many studies that examine the way in which the elective systems, the elections, the political alliance and the political incertitude affect both the evolution and the volatility of capital market and of exchange rate market. The political events influence the assets price in different ways. In some cases, these significantly influence the financial markets, and on the other hand, the markets sometimes react calmly to political changes.

Several previous researches did a research in exchange rate volatility caused by political news and also events. According to Schwidht (2014) a coup or riot would give depreciate effect on Bolivar currencies because the event is resulting on political instability would create a climate of fear that would push domestic investors to unload Bolívares and hold onto Dollars which are more secure, and would lessen foreign demand for the Bolívar. Another studies about the effect of political event on exchange rate are did by Kuncoro and Inayah (2003) who researched about impact of Gus Dur Statement on Rupiah currency against US Dollar period January 1, 1999 to April 30, 2002. Researcher found that Gus Dur Statement make Rupiah currency experiences depreciation.

In this research, British Exit event was used as variable that affect exchange rate. British Exit event is recent event that happened as a result of United Kingdom society who wants to exit from European Union. This event not only shocked at the level of Europe, but also the worldwide. On 23th June 2016 British was exit from European Union (EU).

The European Union is an economic and political partnership involving 28 countries. It began after world war and has since grown to become a “single market”, allowing goods and peoples are moving around and it has its own parliament and currency used in 19 countries. British decided to exit following the referendum vote to leave European Union (EU) with more than 30 million people voted in the referendum a turnout of 71.8 percent and the result is to leave won by 52 percent to 48 percent.

The consequences of British Exit occurs in many areas like Economic and also political and social. The Economic consequences for United Kingdom happened in several areas like Trade, United Kingdom GDP growth, Inflation, and also Exchange Rate. This event is mentioned as a risk for economic activity especially for firm and investor who engaged the international business activity. The impact of this event is not just felt by European continent, but also the other country because United Kingdom has multilateral relationship with other country both in economic and also politic. One of risks that faced by United Kingdom is weakening of Pondsterling (GBP) against some other currencies.

Figure 1 below showing the depreciation of GBP. In figure 1 show the weakness in Poundsterling. This weakness could be attributed to British Exit fears. The cost of three-month currency options spiked three months before referendum, on March 23 and remains high. It indicates that investors expect further depreciation. The volatility of exchange rate also reported in *Euro Exchange Rate News*:

> “British Exit has already made a clear impact upon PoundSterling, with the GBP/EUR exchange rate falling -6% in the first eight weeks of 2016,

while GBP/USD has dropped -4.5% over the same period. There is still a long way to fall, according to Bank of America Merrill Lynch (BaML), which believes Pound Sterling is still overvalued by around 3%. 'Our valuation suggests that Sterling is overvalued and, in an extreme scenario where capital inflows temporarily slow in the run-up to the referendum, it could face large declines."

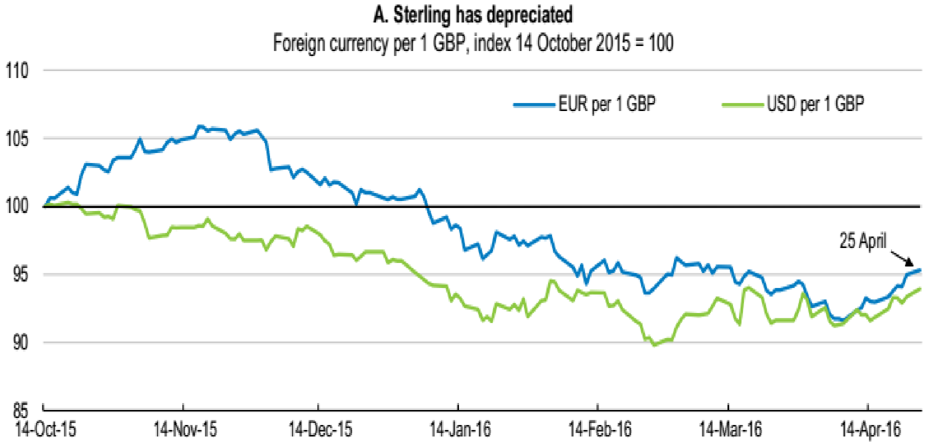

Figure 1 Uncertainty about Brexit has led to capital outflows and weaker Exchange Rate
Source: DataStream by OECD, April 2016

The impact of British Exit is not only in exchange rate area but also in many areas in United Kingdom. The Centre for Economic Performance at the London School of Economics estimates that the United Kingdom leaving the European Union and joining the European Free Trade Association will reduce British GDP by at least 2.2% in its optimistic scenario, and between 6.3% and 9.5% in its pessimistic one (Paper of The London School of Economics and Political Science, London: 2015).

Some of impacts made global market is releasing Poundsterling (GBP) and move their funds to currencies that they thought is safe than Poundsterling (GBP) like US Dollar, Yen and gold. This is because the uncertainty condition facing by United Kingdom. This is also occurs in Indonesia market although the effect is not felt directly. In closing at Friday (24/6), composite stock price index (CSPI) fell down in 39,74 point or 0.82 percent to 4.834,57.

The value of exchange rate is also fall. Based on middle rate of Bank Indonesia, close price of rupiah depreciate against US Dollar to 13.296 and one day before in 13.265 per Dollar. However several analysts said that the British Exit was not significant factor affected on economic condition of Indonesia. Governor of Bank Indonesia, Agus Maragainstojo said that it was normal for the exchange rate volatility happened and it was temporary.

Economic minister said the same argument about the economic condition of Indonesia. Because of uncertainty condition, the investors tend to release their asset in Rupiah and move to more secure asset like Dollar or Yen and also gold. One of currencies which is most used and liquid is US Dollar where based on Liputan6.com (January 2016) it is reported that the sequence for most currencies used in international payment are US Dollar in the first rank and Euro in the second rank and the third is Poundsterling and fourth is Yen with 2,69 percent.

It is means that US Dollar is one of stable currencies and become one of most interested currencies that was used by investor. Although Rupiah is not liquid as US Dollar, but the effect of US Dollar appreciate against Poundsterling (GBP) give impact on Rupiah because the investor tend to choose US Dollar as safest asset besides gold and yen, moreover in unstable economic and political situation.

Within this research, the relationship between effects of political event variable against exchange rate volatility is measured. This research using two approaches that are autoregressive conditional heteroskedasticity (ARCH)/general autoregressive conditional heteroskedasticity (GARCH) models to explore the volatility effect of the British exit event and the event study methodology to study the level impact of British Exit. The observation period of this research is fifty days before and after British Exit which is 5 workdays start from April 14th until September 1th 2016. Based on background above, the title of this research is "**The Effect of Political Event on Exchange Rate Volatility (Study at Bloomberg January-December 2016)".**

B. Problem Formulation (s)

Based on the background above, problem formulations of this research are as follows:

1. Is there any difference on Poundsterling (GBP) against US Dollar exchange rate before and after British Exit?
2. Is there any difference on US Dollar against Rupiah exchange rate before and after British Exit?
3. Does British Exit affect the Poundsterling (GBP) against US Dollar exchange rate volatility?
4. Does British Exit affect the US Dollar against Rupiah exchange rate volatility?

C. Research Objective (s)

Based on problems formulation above, the objectives of this research are as follows:

1. To analyze the differences of Poundsterling (GBP) against US Dollar Exchange rate before and after British Exit
2. To analyze the differences of US Dollar against Rupiah Exchange rate before and after British Exit
3. To analyze the effect of British exit on Poundsterling (GBP) against US Dollar exchange rate volatility
4. To analyze the effect of British exit on US Dollar against Rupiah exchange rate volatility

D. Research Contribution (s)

This research gives the contributions both in theoretical and practical. These contributions are described as follows:

1. Theoretical Contribution

   The result of this research is expected to become a reference and also material contribution for the same field (especially for the research that conducts in Macro Economic field). This research also can be developed in the future related with an event that effect on exchange rate fluctuation.

2. Practical Contribution

   a. For Investor

      The result of this research is expected to give information for investor and it can be used as references in making decision relating maximize the return on foreign exchange investment especially when the political event happen.

b. For Government

The result of this research can be used as reference for government to make the policy in line with the trend happening in foreign exchange rate. Because the decision that turn into policy will influence the country and make foreign exchange market turmoil.

E. Systematic Discussion

Systematics discussion needed to expand the understanding about the content of this research, the composition as follows:

CHAPTER I INTRODUCTION

This chapter explains the background of study, problem formulation, research objectives, research contribution (research benefits) as well as a systematic discussion.

CHAPTER II LITERATURE REVIEW

This chapter consists of previous research and theoretical basis that support the research. The theory focuses on Macro Economic which is consist of exchange rate theory and factors that affecting exchange rate movement. Subsequently the theory will be formulated into concept and hypotheses.

CHAPTER III RESEARCH METHOD

This chapter explains about type of research, concept, definition of operational variable, measurement scale, research population and sample, date source and data collection methods, variable and variable measurement as well as data analysis method.

CHAPTER IV RESEARCH RESULT

This chapter consists of analysis and discussion of research analysis results by using the methodology that was described in chapter three. In this chapter the hypotheses will be proved.

CHAPTER V CONCLUSION

This chapter contains of conclusion based on research result and alternative improvements suggestions which are expected to be a benefit.