CHAPTER 2
LITERATURE REVIEW

2.1 Introduction

According to economic theory, stock prices represent investors' expectations about future corporate profitability. Profits, in this sense, represent the whole amount of activity. Most investors invest in stocks with the aim of maximizing the return on their investment. Chapter 2 provides an analysis and review of previous literature. The theory is also applied in Chapter 2 to discover how the independent variable impacts the dependent variable. This chapter presents the suggested conceptual framework and hypotheses that were established for this research.

2.2 Empirical Review

Some of the main economic factors as an influence in investors' decisions to invest with the aim of getting high stock returns in the future. Inflation, interest rates, exchange rates, and money in circulation are examples of macroeconomic variables. Jefry and Abid (2020) studied the effect of inflation, interest rates, and exchange rates on stock prices of manufacturing companies in the basic and chemical industrial sectors on the Indonesia Stock Exchange (IDX) using yearly data from 2013 to 2017. The study found that (1) Inflation, interest rates, and exchange rates have a significant impact on securities. with basic industrial and chemical manufacturing companies on the Indonesian Stock Exchange (IDX); (2) Inflation has a significant effect on the shares of manufacturing companies in the basic and chemical industries listed on the Indonesian Stock Exchange (BEI); (3) There is no significant interest rate effect on shares of chemical and basic industrial companies listed on the Indonesian Stock Exchange (BEI); (4) The shares of chemical and basic industrial enterprises listed on the Indonesian Stock Exchange (IDX) have no major exchange rate impact.

Mochammad (2019) investigated The Influence of Exchange Rate, Interest Rate, and Inflation on the Stock Price of the LQ45 Index in

Indonesia using yearly data from 2013 to 2017. According to the study, the foreign exchange rate and interest rate have substantial explanatory power in influencing stock price. Inflation rates, on the other hand, have no major impact on stock prices. And other studies related to this research such as Jihadi et al. (2021), Chinedu (2018), Hasanudin (2018), Sugiharti & Emi (2019), Faizal (2022), Aminullah et al. (2019), Abu (2019), Suharyanto & Achmad (2021), Agustinus (2021), Theresia (2021), Risma (2022), Nugi (2020).

2.2.1 IDX30 Index

The IDX30 is an index that gauges the price performance of 30 equities with strong liquidity, significant market capitalization, and solid corporate fundamentals.

2.2.2 Stock Returns

In general, stock returns can be interpreted as the results obtained by investors from their investments and can be seen as an increase in value (gain) or even a decrease in value (loss), where these two concepts are based on the condition of the ups and downs of the value of the investments made by investors. As a result, investors should predict and monitor the potential realization of returns.

Aminullah et al. (2019) studied The Effect of Macro Economic Variables on Stock Return of Companies That Listed in Stock Exchange: Empirical Evidence from Indonesia. According to the study inflation has a significant positive affect on stock returns, interest rates have a significant positive affect on stock returns, money supply has a significant positive affect on stock returns, and the exchange has a significant negative effect on stock returns in manufacturing companies food & beverage listed on the Indonesia Stock Exchange for the 2016-2018 period.

2.2.3 Inflation

Inflation is the process of prices growing steadily over a lengthy period of time. Theoretically, there are two main causes of inflation. Inflation is driven by demand and costs. Demand inflation occurs because the demand for goods and services increases, while cost inflation occurs because the cost of producing goods and services increases. In addition, demand-pull and cost-push factors can eventually lead to inflation (Wollie, 2018). In other words, economic sector reform can be accomplished by controlling inflation. A policy based solely on economic growth is one that restricts the flow of wealth among the wealthy (Martinelli, 2019). Inflation is defined as a reduction in a currency's buying power, which has an impact on the performance of the Composite Stock Index. Inflation raises the price of commodities and diminishes people's buying power (Kewal, 2012).

Jefry & Abid (2020) studied The Effect of Inflation, Interest Rates and Exchange Rates on Stock Prices of Manufacturing Companies in Basic and Chemical Industrial Sectors on the Indonesia Stock Exchange (IDX). According to this study, inflation has a favourable and considerable impact on the Indonesia Stock Exchange (IDX) shares of manufacturing companies in the Basic Industry and Chemical Sector. Suharyanto & Achmad (2021) studied The Effect of Inflation, Interest Rate, and Exchange Rate on Stock Returns in Food & Beverages Companies. According to this study, inflation has a considerable negative impact on stock returns.

2.2.4 Interest Rates

The interest rate or BI rate, according to Bank Indonesia, is a guideline to govern interest rates, represents the position established by Bank Indonesia, and is generally available to the public. In Indonesia, inflation is the primary determinant of the BI rate's value. Inflation is caused by price variations caused by the quantity of money in circulation in a country, output, and public demand. When inflation increases, he increases his BI rate, and conversely, when inflation decreases, Bank Indonesia decreases his BI rate (Ardelia & Saparila, 2018).

Sugiharti (2021) studied An Analysis The Effect of Inflation, Interest and Exchange Rate on Stock Return in Indonesia Manufacturing Exchange Companies. The interest rate has a strong beneficial impact on stock returns in industrial businesses listed on the Indonesian stock exchange. Jihadi et al. (2021) studied The Effect of Exchange Rates Towards Stock Return Mediated with Inflation Rates and Interest Rates. According to the study, Interest rates have a substantial and negative impact on stock returns.

2.2.5 Exchange Rates

An exchange rate is the price of a foreign currency in relation to the price of the home currency. The currency rate utilized is the Rupiah's median rate versus the US dollar. When the dollar is weak against the rupiah and the dollar is expected to strengthen again in the future, and when other investment options are viewed as less promising, investors tend to invest their funds in the dollar. Otherwise, a depreciation of the local currency versus the foreign currency would promote exports since items sold at home would be less expensive than those sold abroad. This will improve the competitiveness of the country's export products in the international market. An increase in exports impacts the country's foreign currency reserves in the form of foreign exchange, resulting in an increase in money in circulation and economic development. A falling exchange rate, on the other hand, promotes money in circulation and economic development.

Chinedu (2018) studied The Effect of Inflation, Exchange Rate, Labor, And Money Supply on The Manufacturing Industry Sector in Indonesia 2011 – 2020. According to the study, the exchange rate variable has a positive and significant influence on Indonesia's manufacturing industry. The value of the rupiah, which continues to devalue in the period 2011-2020, might boost the expansion of the manufacturing sector since depreciation increases demand for local products exports, which increases output created by the manufacturing industry. Faizal (2022) studied Macroeconomic factors, firm characteristics and financial performance manufacturing firms in Nigeria. According to the study, the exchange rates have no discernible impact.

2.2.6 Money in Circulation

Money in circulation is positively correlated with economic growth in Indonesia Government measures to restrict the circulation of money and economic growth have a long and consistent link. When more community money circulates, so does economic growth (Kistianingsih, 2019). This is consistent with the Keynesian assumption that money in circulation has a positive effect on output and growth. When the public has a lot of money in circulation, the central bank lowers interest rates. This situation increases production, which encourages investment and causes economic growth. Faizal (2022) studied The Effect of Inflation, Exchange Rate, Labor, And Money Supply on The Manufacturing Industry Sector in Indonesia 2011 – 2020. According to the study, the money supply variable has a positive and considerable impact on Indonesia's manufacturing industry.

2.3 Theory of The Study

2.3.1 Signal Theory

The existence of information asymmetry between Company and external party management explains why corporations provide financial statement information, according to signal theory. Company management has more information and is more knowledgeable about the company's future prospects. Financial reports, corporate policy information, and other information voluntarily performed by the firm manager are examples of information. Signal theory describes how corporations should display signals to financial statement recipients. This signal takes the form of information regarding what management has done to meet the owner's wishes. The signal might be in the form of advertising or other material indicating that the firm is superior than others (Maity and Hartono, 2012).

Investor reaction to positive and negative signals has a significant impact on market conditions; they will react in a variety of ways, such as seizing sold shares or taking actions in the form of not reacting, such as "wait and see" the developments that exist before taking action. And to realize that the wait-and-see option is not inherently good or bad, but rather an investor's reaction to avoid incurring further risk as a result of market conditions that have not been lucrative or on their side. So that the signals about that information are very important for investors to know when to buy and sell shares, so that these investors get the expected stock returns and can also avoid unwanted risks.

2.3.2 Agency Theory

According to Jensen and Meckling (1976), agency theory depicts shareholders as principals and managers as agents. Management is the party authorized by the shareholders to act in their best interests. As a result, management has the authority to make choices in the best interests of shareholders. As a result, it is the obligation of management to justify all of its efforts to shareholders. Because the contract under the principal-agent relationship is the analytical unit of agency theory.

When management does not control the majority of the firm, agency issues arise between shareholders (company owners) and potential managers. Shareholders undoubtedly want managers to operate with the goal of maximizing shareholder prosperity, ensuring that shareholders receive the desired rate of return on shares. Managers may behave not to maximize shareholder prosperity, but rather to maximize their own.

2.4 Conceptual Framework

Based on our review of available previous literature and theory, we have discovered a number of factors that can affect stock returns. However, to determine the impact on stock returns, we selected four of the many variables as the most important independent variables in our study: inflation, interest rates, exchange rates, and the money in circulation The conceptual framework developed to test the link between independent and dependent variables is shown in the figure below.

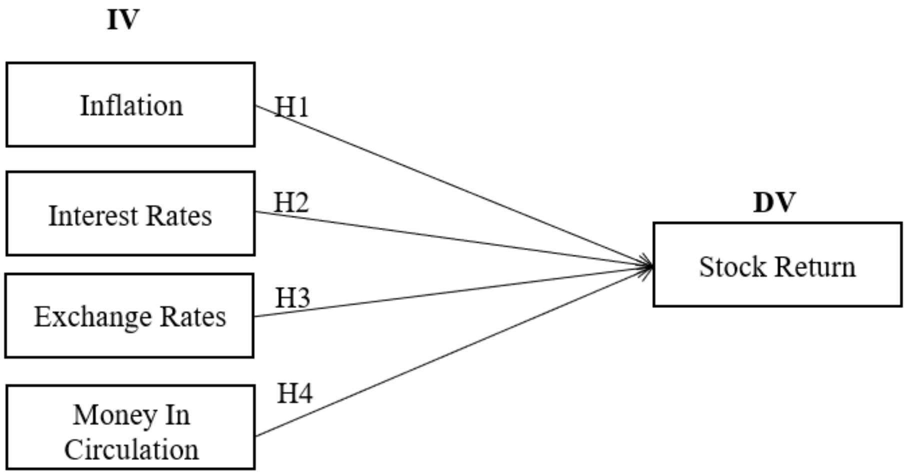

Figure 2.1 Conceptual Framework of The Effect of Inflation, Interest Rates, Exchange Rates, and Money in Circulation on Stock Returns in Companies Listed in Indonesia Stock Exchange

2.5 Research Hypotheses

The purpose of this study is to determine the factors influencing the stock returns of Indonesian index 30 firms. For this purpose, hypotheses were developed based on the conceptual framework identified in the previous section.

2.5.1 Inflation and Stock Return

Rising inflation can push production costs above the commodity prices set by the company. Investors find investing in the capital markets less attractive and more risky, which can lead to lower company profitability and bad news for the company. A drop in investor interest in investments can cause business stock prices and stock indexes to fall. On the other hand, when inflation is low, commodity prices are low and selling prices are fixed, so any reduction in production costs will increase profitability. The development of a firm's profitability is equated with an increase in its stock price, since many investors invest in the company in the belief that it will lead to an increase in the stock index. The development of research hypotheses in this setting can be expressed as follows.

H_1: There is a significant effect between the inflation and stock returns

2.5.2 Interest Rate and Stock Return

High interest rates generally mean that inflation in this country is also very high. High inflation diminishes the value of money held by consumers while also lowering national consumption of commodities created by corporations. Because it reduces corporate income, it reduces the rate of return on investment. In exchange, the company's stock price changes (Suci, 2012). The development of research hypotheses in this setting can be expressed as follows.

H_2: There is a significant effect between the interest rate and stock returns

2.5.3 Exchange Rate and Stock Return

Exchange rate is one of the factors that affects how stock indices behave in capital markets, according to (Siti & Rizki, 2015). A falling currency rate has various effects on importers and exporters. The weakening of their own currencies would result in greater expenses for businesses employing imported raw materials than before. Less profits will be earned and investors will receive fewer dividends if the cost growth exceeds the present net worth, which will be reflected in a decrease in the stock price.

If the amount of exports grows, a depreciation of the currency will almost likely benefit exporters with foreign receivables. Increased exports will almost probably boost the company's profitability and dividends paid to shareholders. High dividend yields will entice investors to invest, driving up stock prices and boosting stock indexes. When the rupiah exchange rate rises or falls, the opposite situation happens, according to (Siti & Rizki, 2015). The following is the evolution of the research hypothesis based on the previous explanation.

H_3: There is a significant effect between the exchange rate and stock returns

2.5.4 Money in Circulation and Stock Return

The macroeconomic element of money in circulation influences the national economy because money in circulation surpassing a country's economic demand affects the stock market performance of enterprises. Because Indonesia has a good balance between the money in circulation and the commodities available. It leads to product shortages and the uncertainty affects the company's growth in the stock market. Trading decisions are usually short-term, as long-term sales contracts tend to hurt finished product sellers and raw material suppliers, thereby impacting prices on the Indonesian stock market.

H_4: There is a significant effect between money in circulation and stock returns

2.6 Summary

This chapter mainly contains a summary of the literature review. Overall, Chapter 2 offered a review of the literature on this and earlier research. By referring to the critical literature review to get the theory relevant to this investigation, we may identify the link between the independent and dependent variables in the study, as well as the definitions we can know about each variable.