

THE EFFECT OF BI INTEREST RATE AND INFLATION ON THE RETURN OF THE COMPOSITE STOCK PRICE INDEX (IHSG) AT THE INDONESIA STOCK EXCHANGE (IDX): A VECTOR ERROR CORRECTION MODEL (VECM) APPROACH

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Abstract

This study aims to analyze the influence of the BI Rate and inflation on the return of the Jakarta Composite Index (JCI) on the Indonesia Stock Exchange in the post-pandemic period and the monetary policy normalization period of 2017–2024. The analytical method used is the Vector Error Correction Model (VECM) equipped with Granger causality tests, Impulse Response Function (IRF), and Forecast Error Variance Decomposition (FEVD) using 96 monthly data observations processed with EViews 12. The results show that the BI Rate and inflation do not significantly affect the JCI return in either the short or long term, although the results of the Johansen cointegration test indicate a long-term equilibrium relationship between the variables. The results of the Granger causality test also do not find a direct causal relationship between the two macroeconomic variables and the JCI return. The IRF and FEVD analysis strengthen this finding, where the JCI return response to BI Rate and inflation shocks is relatively small, and the variation in the JCI return is largely explained by its own internal factors. This finding indicates that the movement of the JCI return during the research period was more influenced by the internal dynamics of the stock market than domestic macroeconomic factors in the form of the BI Rate and inflation.

Keywords: BI Rate; Forecast Error Variance Decomposition; Impulse Response Function; Inflation; IHSG Return.

INTRODUCTION

The capital market plays a strategic role in a country's economy, serving as a means of raising funds for companies and as an investment alternative for the public. Its existence can stimulate economic growth through increased investment, job creation, and optimized resource allocation. One of the main indicators of Indonesia's capital market performance is the Jakarta Composite Index (JCI), which reflects the price movements of all stocks on the Indonesia Stock Exchange. Changes in the JCI are often used as a barometer of financial market conditions and investor confidence in the national economy (Prasanti & al., 2023; Pratiwi, 2022).

In stock investment activities, investors not only pay attention to index movements, but also the level of returns obtained. The Jakarta Composite Index (JCI) represents the level of return on an investment over a specific period. A high rate of return indicates greater profit potential, while a low or negative return indicates declining investment performance. Therefore, understanding the factors that influence returns is crucial. The JCI is very important for investors in decision making.

The movement of JCI returns is influenced by various macroeconomic factors. During the COVID-19 pandemic in 2020, the Indonesian capital market experienced severe pressure, leading to a significant decline in returns. IHSG (Prawesti, 2022). Entering the recovery period, the market again faces challenges such as rising global inflation, geopolitical uncertainty, and changes in monetary policy of global central banks. (Jalil et al., 2024). This condition shows how sensitive stock returns are to domestic and global economic dynamics.

Two macroeconomic variables strongly suspected of influencing JCI returns are Bank Indonesia's interest rate and inflation. Interest rates are the primary monetary policy instrument for maintaining economic stability and controlling inflation. Rising interest rates tend to increase the cost of capital and reduce investment interest in the

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stock market, potentially lowering returns. (Mishkin, 2019) . Conversely, a decrease in interest rates can encourage investment activity. (Fitrahwaty et al., 2025) .

Inflation is also closely linked to the stock market. High inflation can increase production costs, reduce purchasing power, and reduce company profitability, ultimately affecting investor expectations and stock returns . Stable inflation, on the other hand, creates economic certainty that supports investment activity (Mankiw, 2021) .

Various previous studies have examined the relationship between macroeconomic variables and stock market performance. (Paryudi et al., 2021) found that data analysis showed that exchange rate fluctuations had a significant negative impact on the Composite Stock Price Index.

In addition, most studies only focus on short-term influences or use conventional regression methods so they are not yet able to describe the dynamic relationships between variables comprehensively.

This study differs from previous studies in that it utilizes the post-pandemic period and the normalization period of Bank Indonesia's monetary policy from 2017 to 2024, using the Vector Error Correction Model (VECM), Impulse Response Function (IRF), and Forecast Error Variance Decomposition (FEVD) approaches to identify the short-term and long-term relationships, as well as the dynamic response of JCI returns to changes in interest rates and inflation. Therefore, this study is expected to provide more comprehensive empirical evidence regarding the influence of macroeconomic factors on JCI returns in Indonesia.

This research is crucial to provide a more comprehensive picture of the transmission of monetary policy to the performance of the Indonesian capital market. The results are expected to inform investors, Bank Indonesia, and capital market authorities when formulating policies that support financial stability.

Based on the description above, the objective of this study is to analyze the effect of BI interest rates and inflation on the return of the Composite Stock Price Index (IHSG) on the Indonesia Stock Exchange using the Vector Error Correction Model (VECM) approach.

LITERATURE REVIEW

Composite Stock Price Index (IHSG)

The Jakarta Composite Index (JCI) is an index that reflects the movement of all stocks listed on the Indonesia Stock Exchange. The JCI is used as a primary indicator to measure the performance of the Indonesian stock market. Changes in the JCI's value reflect changes in the average price of traded shares, and therefore, it is often used as a benchmark by investors in evaluating market conditions (Nabiilah, 2024) . An increase in the JCI indicates growing investor optimism regarding the economic outlook, while a decrease indicates weakening investor confidence. (Hafifa et al., 2025) The JCI's movement is influenced by various macroeconomic factors, political conditions, global financial stability, and the performance of listed companies. In this study, the JCI is used in the form of returns so that it can describe changes in investment profits over time.

IHSG Return Theory

The Jakarta Composite Index (JCI) return is the profit level or percentage change in the value of the Jakarta Composite Index (JCI) on the Indonesia Stock Exchange (IDX) over a specific period (SILALAH & SIHOMBING, 2021) . This index measures the average performance of all stocks listed on the exchange.

Mathematically, the IHSG return can be calculated using the following equation.

$$R_m = \frac{IHSG_t - IHSG_{t-1}}{IHSG_{t-1}}$$

with:

R_m = Market Return (Market Return)

$IHSG_t$ = IHSG value in the current period

$IHSG_{t-1}$ = IHSG value in the previous period

BI Interest Rate (BI Rate/BI 7-Day Reverse Repo Rate)

Interest rates are the primary monetary policy instrument used by Bank Indonesia to maintain price stability and control inflation. Since 2016, Bank Indonesia has used the BI 7-Day Reverse Repo Rate as the national benchmark interest rate. According to (Mishkin, 2019) , rising interest rates will increase the cost of capital, thereby reducing investment in risky assets, including stocks. Conversely, lowering interest rates will increase investment activity because borrowing costs become cheaper.

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Inflation

Inflation is a general and persistent increase in the prices of goods and services over a period of time. According to Mankiw (2021), inflation reflects a decline in people's purchasing power due to increases in aggregate prices. High inflation can increase a company's production costs, leading to lower profits. Declining profits will impact investor expectations regarding the company's prospects and lead to lower stock prices.

Vector Autoregression (VAR)

The Vector Autoregression (VAR) model is a multivariate econometric model introduced by Sims (1980). The VAR model is used to analyze dynamic relationships between economic variables without having to determine which variables are exogenous or endogenous.

The general equation of VAR of order p is

$$Y_t = A_1 Y_{t-1} + A_2 Y_{t-2} + \dots + A_p Y_{t-p} + \varepsilon_t$$

The VAR model is widely used in macroeconomic analysis because it is able to describe the reciprocal relationship between variables.

Vector Error Correction Model (VECM)

If the variables in a VAR model are non-stationary but have a cointegration relationship, then the model used is the Vector Error Correction Model (VECM). According to (Enders, 2015), the VECM is able to explain short-term relationships as well as adjustment mechanisms towards long-term equilibrium.

The general equation of VECM is

$$\Delta Y_t = \Pi Y_{t-1} + \sum_{i=1}^{p-1} \Gamma_i \Delta Y_{t-i} + \varepsilon_t$$

Where

ΔY_t = Vector of changes in variables in period t (i.e. $Y_t - Y_{t-1}$)

Π = Long-run cointegration matrix. $\Pi = \alpha \beta'$

α = Speed of adjustment matrix (speed of adjustment towards long-term equilibrium)

β' = Cointegration matrix (long-term cointegration vector) which produces the relationship $\beta' Y_{t-1} = 0$.

$\beta' Y_{t-1}$ = Also known as Error Correction Term (ECT).

Γ_i = Short-term dynamic parameter coefficient matrix.

ε_t = Error terms (residuals) that are not correlated with each other.

Impulse Response Function (IRF)

The Impulse Response Function (IRF) is used to determine how a variable responds to shocks to other variables over the next several periods. According to Enders (2015), the IRF can indicate the direction, magnitude, and duration of a shock's effect on an endogenous variable.

In this study, IRF is used to see how the JCI return responds to shocks to BI interest rates and inflation.

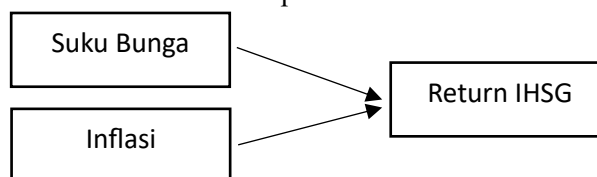
Forecast Error Variance Decomposition (FEVD)

Forecast Error Variance Decomposition (FEVD) is used to measure the contribution of each variable in explaining the variation in prediction error of an endogenous variable.

Through FEVD, it can be seen whether changes in the IHSG return are explained more by itself or by shocks originating from the BI interest rate or inflation.

Conceptual Framework

Table 1. Conceptual Framework



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Hypothesis

H1: The BI interest rate level has an effect on the IHSG return on the Indonesia Stock Exchange.

H2: Inflation has an effect on the return of the JCI on the Indonesia Stock Exchange.

METHOD

This study uses a quantitative approach with an explanatory research approach, which aims to analyze the causal relationship between independent and dependent variables through hypothesis testing based on empirical data. This quantitative approach was chosen because this study uses numerical data in the form of time series data analyzed using econometric methods. The analytical method used is the Vector Error Correction Model (VECM). The VECM model was chosen because it is able to explain the short-term and long-term relationships between cointegrating variables. Furthermore, this study also uses Impulse Response Function (IRF) analysis. And Forecast Error Variance Decomposition (FEVD) to determine the response and contribution of each variable to changes in the Composite Stock Price Index (IHSG) return.

Data Types and Sources

This study used secondary data in the form of monthly data from January 2017 to December 2024, resulting in 96 observations. The data used include:

1. <https://www.idx.co.id>
2. <https://www.bi.go.id>
3. <https://www.bps.go.id>

JCI data was obtained from the Indonesia Stock Exchange (IDX), while BI 7 - Day Reverse Repo Rate data was obtained from Bank Indonesia. Inflation data was obtained from the Central Statistics Agency (BPS). All data was collected through documentation techniques from the official publications of each agency.

Variable Operational Definition

This study uses one dependent variable and two independent variables as follows.

Table 2. Operational Definition of Variables

Variables	Symbol	Measurement
IHSG Return	RETURN	IHSG monthly log return
BI 7-Day Reverse Repo Rate	BI_RATE	Percentage of Bank Indonesia's benchmark interest rate (%)
Inflation	INF	Monthly inflation rate (%)

Data Analysis Techniques

Data analysis was carried out using EViews 12 software through several stages such as Stationarity Test, Determination of Optimum Lag, VAR Stability Test, Johansen Cointegration Test, Granger Causality Test, Vector Error Correction Model (VECM) Estimation, Impulse Response Function (IRF), Forecast Error Variance Decomposition (FEVD).

RESULTS AND DISCUSSION

Table 3. ADF Test Results

Variables	Unit Root	Probability	information
BI Interest Rate	Level	0.6233	Non-Stationary
	1st Diff	0.0000	stationary
Inflation	Level	0.0693	Non-Stationary
	1st Diff	0.0113	Stationary
Return	Level	0.0000	Stationary
	1st Diff	0.0000	Stationary

Source: Eviews data processing results, 2026.

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Based on the results of the Augmented Dickey-Fuller (ADF) test, the BI Rate and inflation are not stationary at the level (probability 0.6233 and 0.0693) but become stationary after the first difference (0.0000 and 0.0113), while the JCI return has been stationary at the level (0.0000). These results indicate that the data has a mixed integration order of I(0) and I(1), which still allows the use of the Vector Error Correction Model (VECM) as long as there is a cointegration relationship between the variables.

This finding is in line with research (Paryudi et al., 2021) which found that the interest rate and inflation variables in Indonesia became stationary after the first difference analysis, making them suitable for analysis using the VECM approach .

Table 4. Determination of Optimum Lag

LAG	AIC
0	-7.020498
1	-13.14822
2	-13.21214*
3	-13.14307
4	-13.18673
5	-13.03622
6	-12.92554
7	-12.87577
8	-12.86766

Source: Eviews data processing results, 2026

Based on the Akaike Information Criterion (AIC), the optimum lag was obtained at the 2nd lag with an AIC value of -13.21214, indicating that the relationship between variables is best explained using information from the previous two periods. According to (Lütkepohl, 2005) , the selection of the optimum lag aims to obtain a model that is able to capture the dynamics of the relationship between variables optimally without overfitting or underfitting, while avoiding the loss of important information due to lags that are too short.

Table 5. Var Stability Test

Root	Modulus
0.968997 - 0.082374i	0.972492
0.968997 + 0.082374i	0.972492
0.354829 - 0.059286i	0.359748
0.354829 + 0.059286i	0.359748
-0.031260 - 0.181975i	0.184641
-0.031260 + 0.181975i	0.184641

Source: Eviews data processing results, 2026

The test results show that all characteristic root modulus values are below one with a maximum value of 0.972492, so that the VAR model meets the stability requirements and all further analyses can be carried out.

According to (Enders, 2015) , the stability of this model is the main requirement before conducting Impulse Response Function (IRF) and Forecast Error Variance Decomposition (FEVD) analysis, because shocks to the system are guaranteed to subside gradually without causing divergence.

Table 6. Cointegration Test
Panel A: Trace Test

Hypothesized		Trace	0.05
No. of CE(s)	Eigenvalue	Statistics	Critical Value
None *	0.351521	53.71861	29.79707
At most 1	0.103754	13.87100	15.49471
At most 2	0.040393	3.793315	3.841466

Source: Eviews data processing results, 2026

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Panel B: Maximum Eigenvalue Test

Hypothesized No. of CE(s)	Eigenvalue	Max Eigen Statistic	0.05 Critical Value
None *	0.351521	39.84760	21.13162
At most 1	0.103754	10.07769	14.26460
At most 2	0.040393	3.793315	3.841466

Source: Eviews data processing results, 2026

The results of the Johansen test show a Trace Statistic value of 53.71861 and a Maximum Eigenvalue of 39.84760, both exceeding their respective critical values (29.79707 and 21.13162), so there is a cointegration relationship between the BI Rate, inflation, and IHSG returns, which means the three variables have a long-term equilibrium relationship even though they fluctuate in the short term. According to (Engle, 1982), the existence of this cointegration relationship indicates a tendency for variables to move together in the long term so that the use of VECM is appropriate, in line with (Paryudi et al., 2021) who also found a long-term relationship between inflation, interest rates, and exchange rates on the JCI.

Table 7. Granger Causality Test

Null Hypothesis	F-Statistic	Prob.
BI_7 DAY RR does not cause Return	0.38358	0.6826
Return does not cause BI_7 DAY_RR	0.88362	0.4169
Inflation does not cause Return	0.68229	0.5081
Returns do not cause inflation	0.50868	0.6030
Inflation does not cause BI_7 DAY_RR	2.64104	0.0769
BI_7 DAY_RR does not cause inflation	4.00597	0.0216

Source: Eviews data processing results, 2026

The test results show that neither the BI Rate nor inflation have a causal relationship with the JCI return, as all probability values are greater than 0.05. Conversely, there is a one-way causal relationship from the BI Rate to inflation with a probability of 0.0216, indicating that changes in Bank Indonesia's interest rate policy affect inflation before they affect the JCI return. In theory, the monetary policy transmission mechanism begins through changes in interest rates which then influence inflation before impacting overall economic activity (Mishkin, 2019).

Table 8. Vector Error Correction Model (VECM) Estimation

Variables	Coefficient	Long-term	
		Std.Error	T-Statistic
RETURN(-1)	1,000,000		
BI_7 DAY_RR(-1)	40.33776	(38.4117)	[1.05014]
INFLATION DATA (-1)	44.99812	(34,8116)	[1.29262]
CONSTANT	-3.634183		

Source: Eviews data processing results, 2026

The estimation results show that the BI Rate has a t-statistic value of 1.05014, while inflation is 1.29262. Both values are still below the critical value of 1.96, so they have no statistically significant effect on the long-term return of the JCI. These results indicate that during the 2017–2024 period, changes in interest rates and inflation have not been able to explain permanent changes in IHSG returns.

This condition can occur because the movement of the JCI is not only influenced by domestic factors, but also by global conditions such as world central bank interest rate policies, foreign capital flows, international commodity prices, and investor sentiment. These results differ from those of (Paryudi et al., 2021), who found a significant influence of macroeconomic variables on the JCI. This difference is likely due to the different research periods, particularly since this study covered both the COVID-19 pandemic and the post-pandemic monetary policy normalization period.

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Variables	Short-term		
	Coefficient	Std.Error	t-Statistic
ECT (CointEq1)	-1.138384	0.17189	-6.62281
D(Return(-1))	0.240961	0.14332	1.68134
D(Return(-2))	0.240436	0.10785	2.22938
D(BI Rate(-1))	-73.58312	265.58100	-0.27707
D(BI Rate(-2))	374.08540	266.00400	1.40632
D(Inflation(-1))	81.96140	118.69600	0.69051
D(Inflation(-2))	-5.182156	118.30000	-0.04381
Constant	-0.024109	0.38280	-0.06298

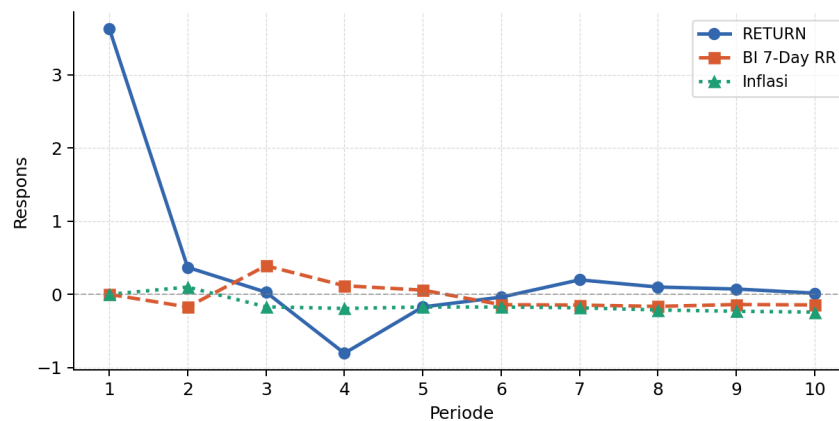
Source: EViews data processing results, 2026

The Error Correction Term (ECT) coefficient of -1.138384 with a t-statistic value of -6.62281 indicates that the adjustment mechanism towards long-term equilibrium is significant.

A negative value for ECT indicates that if a deviation from long-term equilibrium occurs, the system will automatically correct the situation in the next period. A large coefficient indicates that the adjustment process is relatively rapid, allowing the imbalance to quickly return to equilibrium.

Meanwhile, changes in the BI Rate and inflation in the short term have not shown a significant influence on the JCI return because the respective t-statistic values are still below the significance limit. These findings indicate that the short-term return of the JCI is more influenced by other factors such as investor sentiment, political conditions, foreign capital flows, and global information than by changes in domestic macroeconomic indicators.

4.7 Impulse Response Function (IRF)

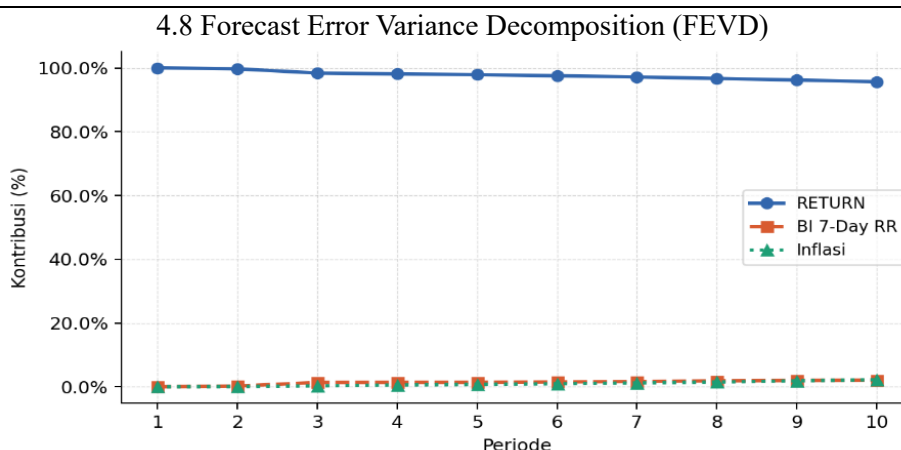


Source: EViews data processing results, 2026

The IRF results show that in the first period, the JCI return responded to its own shock by 3.6325. The response to the BI Rate shock was initially negative in the second period (-0.1737), then turned positive in the third period (0.3900), and then fluctuated around the negative value again until the tenth period (-0.1453). The response to the inflation shock moved negatively starting in the third period and deepened to -0.2434 in the tenth period. This indicates that in the medium to long term, inflation shocks exert more persistent negative pressure on JCI returns than BI Rate shocks.

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Source: EViews data processing results, 2026

The FEVD results show that the JCI return variation is dominated by itself throughout the 10 observation periods, namely 100% in the first period and still reaching 95.66% in the 10th period. The contribution of the BI Rate to the variation of the JCI return increased gradually from 0% in the first period to 2.10% in the 10th period. Similarly, the contribution of inflation increased from 0% to 2.24% in the 10th period. These findings confirm that the JCI return is explained more by its own internal factors than by domestic macroeconomic variables such as the BI Rate and inflation in the next 10-month horizon.

CONCLUSION

This study aims to analyze the effect of the BI 7-Day Reverse Repo Rate and inflation on the Jakarta Composite Index (JCI) return on the Indonesia Stock Exchange for the 2017–2024 period using the Vector Error Correction Model (VECM) approach. The results indicate that the BI Rate and inflation do not significantly influence the JCI return, either in the short or long term. However, the cointegration test results indicate a long-term equilibrium relationship between the variables, indicating that the three variables are related in the long term.

The Granger causality test results indicate no direct causal relationship between the BI Rate and inflation on JCI returns. The VECM estimation also indicates that JCI returns are more influenced by its own historical movements than by changes in the BI Rate and inflation. This finding is reinforced by the Impulse Response Function (IRF) results, which show that the JCI's return response to BI Rate and inflation shocks is relatively small, and the Forecast Error Variance Decomposition (FEVD) results indicate that most of the variation in JCI returns is explained by internal shocks to the JCI itself.

Overall, the JCI return movement during the study period was more influenced by internal stock market factors than domestic macroeconomic factors, represented by the BI Rate and inflation. This finding implies that investors need to consider market dynamics, investor sentiment, and historical stock price movement trends when making investment decisions. Future research is recommended to include other macroeconomic variables, such as exchange rates, money supply, or global market indices, to provide a more comprehensive understanding of the factors influencing JCI returns.

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