ABSTRACT

Stability of price condition affected the decision of consumption, investment, and production, and even so the economic growth. The appropriation of economic decision making, either in national or regional level, needs a very complete understanding of all the influencial factors and characteristics of inflation. This research analyses the affecting factors of inflation, both in demand side (money supply, output gap, and interest rate) and supply side (exchange rate and price expectation). And then, the projection model of Central Java inflation is analysed by using Vector Autoregressive (VAR) model.

Money supply and real interest rate of loan, significantly influenced the inflation in a short term. These monetary instruments are more effective in affecting inflation rate through aggregate demand side. Otherwise, the output gap that develop in a cyclical pattern, does not significantly affected the inflation. The exchange rate of Rp/USD influenced the inflation through the price of raw material of production imported, and then influenced the quantity of production and producer's price decision. The price expectation either does not significantly affect the inflation. In this case, price expectation is an adaptive expectation that based on the historical inflation rate rather than economic conditions.

Based on forecast error variance decompostion method, the shock contribution of exchange rate and money supply have more influence the inflation rather than other variables used in this research.

Keywords: inflation, agregat demand, agregat supply, Vector Autoregressive (VAR), projection model