CHAPTER I

INTRODUCTION

1.1 Background

Economic growth is the key indicator of economic progress. In this point of view, countries around the world would try the best to achieve higher economic growth in order to provide higher standard of living for their people. According to Case & Fair (2006) economic growth generally defined as an increase in real GDP. In short, deficiency and availability of goods and services within a country will reflect the level of economic growth.

Generally there are two kinds of economy regime hold by countries around the world, which is open economy and closed economy. A country with open economy is doing international transaction with foreign country by exporting and importing goods and services. Meanwhile, a country with closed economy is not knowing about international trade, so they can not exchange their goods and services to foreign country.

Tsegaye (2014) says international trade plays an important role in improving the economic growth or it becomes the engine to stimulate the economic growth. To this point of view, trade can have positive and significant relationship with the economic growth. Matondang, et al (1997) agrees that country with open economy can add the savings through export and import in order to rise the economic growth.

Trade openness also can make domestic product easier to be promoted through the international market (Nurrahma, 2013). When goods and services are going bigger through this market, firms can be more competitive and innovative in create the products. The wider access of exporting goods and services on international market can increase the economic scale of firms which gives greater output for the country and end up by rising in economic growth.

According to the expenditure approach, consumption, investment, government spending, and trade (export and import) are the indicators in measuring the output (GDP) in a country with open economy. It means when trade increase, GDP also increase. The same meaning for the rest three indicators, when consumption, investment, and government spending is rising, so does economic growth rising. Meanwhile, a country with closed economy only have three indicators in measuring GDP which is consumption, domestic investment, and government expenditure.

Indonesia is considered as small open economy. In 1970s was the time when Indonesia became more open to international trade (Nurrahma 2013). The more open Indonesia towards international trade is generally because of several policies that were taken by governments. Then, in 1980s it was considered as the new transformation time of Indonesia's international trade policy.

The study about trade openness, capital formation, and foreign direct investment on economic growth conducted by Adhikary in 2011 shows a strong positive relationship in Bangladesh. Tsegaye (2014) also find positive effect of trade to robust Korea's economic growth. A research done by Matadeen, et al (2011) shows that trade openness indicates important engine of economic growth in Mauritius. The same finding also delivered by Olufemi (2004) mentioned that economic growth and trade openness are co-integrated in Nigerian economy. The policy implication of a study by Soi, at al. (2013) claims that trade openness being the robust determinants of economic growth and it expected that government of Kenya should provide more emphasis on trade openness to increase its exports as well as rates of GDP growth.

Conversely, the study conducted by Alege and Ogundipe in 2013 where the contribution of FDI appears negatively affect in the dynamism of GDP of ECOWA. This implies that foreign direct investment failed to contribute meaningfully to ECOWAS economies. The other opposite results also found by Yaqub, Adam, and Jiimoh (2013) observed that FDI and trade openness are not strong and statistically important determinants of real GDP performance in Nigeria. It shows that FDI has very little effect on real GDP. The implication of this is that the policy linkage between GDP and FDI are weak and unpredictable. The insignificant impact of FDI on Nigeria's economic growth could be due to the fact that FDI inflow is mostly in extractive industry which is subject to vegaries of international economy. Yaqub, Adam, and Ayodele (2013) suggest that Nigeria needs to improve the infrastructural facilities and put proper policy to check massive capital flight through profit repatriation from Nigeria.

The theories and research findings above inspire the writer to analyze the same topic research by focusing on the nexus between trade openness, capital formation, and foreign direct investment on Indonesian economic growth entitled : **" The Linkage Between Trade Openness, Capital Formation, and Foreign Direct Investment on Indonesian Economic Growth Using Vector Error Correction Model".**

1.2 Research Problem

1.2.1 What is the relationship between trade openness and Indonesian economic growth?

1.2.2 What is the relationship between capital formation and Indonesian economic growth?

1.2.3 What is the relationship between foreign direct investment and Indonesian economic growth?

1.3 Research Objective

1.3.1 To analyze the relationship between trade openness and Indonesian economic growth.

1.3.2 To analyze the relationship between capital formation and Indonesian economic growth.

1.3.3 To analyze the relationship between capital formation and Indonesian economic growth.

1.4 Research Advantages

1.4.1 This research is expected to give input and additional information for the government to improve and create a proper policy to increase the Indonesia’s economic growth.

1.4.2 This research is expected to be source of information and give additional knowledge for Andalas University’s students about trade openness and economic growth, and also expected to give an input for those who are interested to do the same research.

1.5 Limitation of Study

For framework in this study will be restricted into the main problem in order to get a proper result. This study focuses only about the linkage between trade openness, capital formation, and foreign direct investment on Indonesian economic growth. Data employed is secondary data obtained from Bank Indonesia and Federal Reserve Economic Data (FRED. The data are real gross domestic product (GDP), trade openness (TO), capital formation (CF), and foreign direct investment (FDI) which are delivered from 1993Q1 to 2014Q4.

1.6 Research Hypothesis

Based on the research problem, theoretical framework, and some previous research, the hypothesis of this research is trade openness, capital formation, and foreign direct investment are expected to have positive and significant relationship on GDP which can stimulate Indonesian economic growth.

1.7 Writing Systematic

This research consists of six chapters from introduction to the conclusion and recommendation. The list of writing systematic are organized as follows:

Chapter I Introduction

This chapter provides the background of research, research problem, research objective, research advantage, research limitation, and hypothesis of the research.

Chapter II Theoretical Framework and Literature Review

This chapter contains definition and theory of operational variables, and also provides some previous research that relevant with this study.

Chapter III Research Methodology

This chapter explains the operational data, research methodology, and model specification that is used in this study

Chapter IV General Overview

This chapter describes the development of Indonesian economic growth, Indonesian trade openness, capital formation and FDI from 1993 to 2014.

Chapter V Research Finding

This chapter explains the research output from all the methodology steps. The data is tested starting from unit root test (stationary test), and then lag optimal test, VAR stability test, co-integration test, granger causality test, VECM stability test, classical assumption test, IRF, and variance decomposition.

Chapter VI Conclusion and Recommendation

This is the last chapter of the research contains of conclusion and recommendation that is obtained from the discussion on the previous chapters.