CHAPTER I

INTRODUCTION

1.1 Background

Developing countries face so many problems because of mismanagement, lack or late progress of technology, scarcity in capital, low savings, low investment, and the result for all of this is sluggish economic growth, low in levels of income per capita, and standards of living also low (Azam, Emirullah, Prabhakar, & Khan, 2013) . So, it is difficult for a developing country to support itself with only domestic financial resources because these resources are limited. External (foreign) debt and foreign direct investment (FDI) are required by developing nations to compete globally (Azeez, Oladapo, & Aluko, 2015). According to Siddique (2015) external debt is an important source of finance for achieving national objectives, supporting development and other needs of a country. Usually external debt is incurred by a country which suffers from lack of domestic savings and foreign exchange. However, if the external debt is not used for creating income and productive activities, the ability of a debtor nation to repay the debt is absolutely reduced.

Since the Old Order (Orde lama) Indonesia has used foreign borrowing to finance development. In the mid 1960s foreign borrowing of indonesia reached USD 2,015 million while export earning was only USD 679 million, but need to service its debt. The country became deeply indebted by 1966, and the Government ran a large budget deficit by printing money. The consequence is annual inflation increased dramatically from about 51 percent in 1961 to 635 percent in 1966. In 1969/1970 fiscal year, nearly 80 percent of development budget was financed through foreign aid (Hill in Cholifihani, 2008).

Economic condition improved during the oil boom years in 1970s and 1980s. The government gained revenue from oil earnings. However, stock of foreign borrowing in these periods jumped to more than USD 4 billion by the end of the 1970s and increased by almost five times to USD 20.9 billion in 1980. Declining oil prices in the first half of 1980s resulted in the rapid accumulation of debt. In 1980, percentage of total external debt on GDP is 26.8 percent and increase at 53.6 percent in 1986 (Cholifihani, 2008).

In the late 1980s and mid 1990s, during Indonesia's economic boom, foreign debt incurred by state – owned and private enterprises also increased. The investment climate was conducive to borrowing, and supported by political stability. The economy grew at an average of 7 – 8 percent annually, attracting foreign investors. However, higher domestic interest rates forced local investors to look for other alternative resources from abroad. Therefore, private debt increased significantly at this period. The debt service ratio in the 1980s, especially in 1988 and 1989 still rose to an average 39.9 percent but then declined as rapid export growth take hold (Hill in Cholifihani, 2008). According to Azam et al (2013) it was not clear about external debt had contributed to 7 percent of growth in the middle 1990s.

When the Asian financial crisis surfaced in mid 1997, external debt increased significantly from more than USD 136 billion in 1997 to more than USD 151 billion in 1998 mainly due to a lot depreciation of Rupiah

(Cholifihani, 2008). Azam et al (2013), said indonesian currency (Rupiah) lost 84 percent of its value, the unemployment rate went up tenfold whereby 15 percent of males working in 1997 had lost their jobs by the middle of 1998, and Debt Service Ratio (DSR) rose from 45 percent in 1996 to 58 percent in 1998 while Debt to GDP ratio jumped from 49 percent to 146 percent during the same period

In terms of repayment of debt, after paying more than USD 21.5 billion in 1996, from 1997 to 2002, the external debt service burden decreased modestly. From 1970 to 1996 GDP increased significantly and then dropped dramatically in 1999 due to the massive impact of the Asian crisis. The ratio external debt over GDP during Asian crises 1998 and 1999 achieved the highest level on average more than 130 percent per GDP. However, debt service ratio during 2000 to 2003 increased slightly from 24.6 percent to 28 percent. Share of private debt to total external debt after year 2000 declined slightly. Total external debt outstanding declines from 137 billion USD in 2004 to 125.3 billion USD in 2006 (Cholifihani, 2008).

After the crisis, Indonesian external debt to GDP ratio was fluctuating albeit on a decreasing trend, going down to 35.9 percent in 2006 from 46.9 percent in 2005. However, in 2012 it increased to 28.2 percent from 26.4 percent in 2011. During 1970-2012, at average Indonesia's external debt is estimated at US$ 86258.82 million per year. The Bank Indonesia reported that total external debt in Indonesia increased to US$ 251199.94 million in 2012 from US$ 225374.53 million in 2011. The trend of Indonesia's external debt tends to increase, from a small amount in 1970s to well over US$200000 in

2011, although temporarily declining in the beginning of 2000s (Azam, Emirullah, Prabhakar, & Khan, 2013).

Because of the relationship between external debt and economic growth in Indonesia is not clear. So in this study the author will investigate the relationship between external debt and economic growth in Indonesia. Then, author conduct the research entitled ***"External Debt and Economic Growth in Indonesia 1996 – 2015"***.

1.2 Research Problems

Many developing countries using external debt to promote economic growth and develop their nation. The reason behind this is they have lack of capital or in another word they have budget deficit. So it hard to promote economic growth and develop their nation with that limited fund, especially in early stage of development.

So many expert said if external debt use effectively and efficiently in productive sector it will promote economic growth and develop the nation. But in some evidence showed external debt has negative impact to economic growth. One of the reason behind this is debt service, debt need to be services.

Based on the above conditions, the problems will be review in this study is how the relationship between economic growth, external debt, investment, inflation, and corruption.

1.3 Research Objectives

Objectives for this study to know what will be happens, then the basic purpose of this study is:

1. To analyze external debt and its impact on economic growth in Indonesia.
2. To analyze inflation and its impact on economic growth in Indonesia.
3. To analyze corruption and its impact on economic growth in Indonesia.

1.4 Hypothesis

Hypothesis is the temporary answer for the question of this study. So, based on the study, the hypotheses are:

1. It is assumed that external debt has negative impact to economic growth in Indonesia.
2. It is assumed that total investment has positive impact to economic growth in Indonesia.
3. It is assumed that inflation has negative impact to economic growth in Indonesia.
4. It is assumed that labor participation rate has positive impact to economic growth in Indonesia.
5. It is assumed that corruption perception index has negative impact to economic growth in Indonesia.

1.5 Limitation of Study

The limitations of the study are the characteristics of methodology. The purpose is to make sure the discussion is not out of the topic discussed, in order to obtain the solution of the problem solving in this study, the authors limit the scope of discussion, focuses on External Debt and Economic Growth in Indonesia. Some discussion of the limitations such as:

1. The research conducted in the Indonesia.
2. Real GDP Growth Rate in Indonesia
3. External Debt in Indonesia.
4. Inflation in Indonesia
5. Corruption Perception Index in Indonesia
6. Discussion period is 20 years (1996 – 2015).

1.6 Systematic of Writing

In writing this research, it is grouped into six chapters, which are details as the following:

Chapter I : *Introduction*

In this chapter consist of six part, that are background, research problem, research objectives, hypothesis, limitation of study and systematic of writing.

Chapter II : *Literature Review*

The literature review chapter consist of two part, first is theoretical framework and the second is previous studies.

Chapter III: *Research Methodology*

This chapter is describe type and the sources of data. Definition of each variable, model of analysis, OLS (Ordinary Least Square), statistical hypothesis test, and classical assumption test.

Chapter IV*: Overview Research Variables*

This chapter give general overview of Indonesian economy starting from real GDP growth, external debt, total investment, inflation, labor participation rate and corruption perception index.

Chapter V : *Empirical Result and Analysis*

This chapter outlining the results and the analysis from the processed of data.

Chapter V1: *Conclusions and Recommendations*

This is a closing chapter describes the conclusions of the study and the recomendation that arise from the conclusion.