CHAPTER I

INTRODUCTION

1.1 Background

Development is a process towards continuous change striving to improve the welfare of the community. One indicator of the successful implementation of development that can be used as a measure of economic growth at the macro level is reflected in the changes in Gross Domestic Product (GDP) in the region. A higher the economic growth of a region indicates a better economic activity as obtained from the GDP growth rate at constant prices (Todaro and Smith, 2008).

Mohamed (2014) defined economic growth as a sustained expansion of potential output as measured by the increase in real Gross Domestic Product over certain period of time. Economic growth can be defined as a process which causes an increase in real income per capita of a population in a country in the long run accompanied by system improvements in institutional (Nwanne, 2014).

In order to boost economic growth, a country could do many ways such as gain investment from local or foreign investor, foreign aid, gain debt from internal or external, and so on. One of way is investment, investment is a conscious act of an individual or any entity that involves deployment of money (cash) in securities or assets issued by any financial institution with a view to obtain the target returns over a specified period of time (Nwanne, 2014)

In 1999, FDI accounted for more than half of all private capital flows to developing countries (World Bank, 2011). The main argument in favor of FDI is the belief that FDI has several positive effects which include productivity gains, technology transfers, the introduction of new processes, managerial skills, and know-how in the domestic market, employee training, international production networks, and access to markets (Caves, 1996).

For developing countries, FDI is also viewed as an attractive alternative to long-term bank loans as a form of capital inflow. According to PwC's Annual Indonesian Infrastructure Report (2015), investment contributed 1.66% to Indonesia's GDP growth (of the 4.79%) in 2015. Total foreign direct investment (FDI) in Indonesia rose to US$ 29.27 billion in 2015, up 2.6% from US$ 28.52 billion in 2014, with mining and transport being key destinations for investors. FDI in key infrastructure-related sectors in particular increased 9.6% in US dollar terms. However, domestic direct investment in infrastructure related sectors declined 4% in 2015 in Rupiah terms, perhaps since domestic investors tended to 'wait and see' whether to participate in infrastructure projects. The contribution of investment to GDP growth continued to increase in the first and second quarter of 2016, to 1.77% and 1.82% in IDR terms respectively.

In other hand, another government's strategy in order to gain the capital is take a debt. Debt is the aggregate of all claims against the government held by the private sector of the economy or by foreigners, whether interest bearing or not less, any claim held by the government against private sectors and foreigners (Oyejide, Soyede and Kayode, as cited in Nwannebuike et al, 2016). Debt could be from within a nation's boarder (Internal) or from outside (External). External debt may be defined as debt owed to non-residents repayable in terms of foreign currency, food or service.

External debt may be used to stimulate the economy but whenever a nation accumulates substantial debt, a reasonable proportion of public expenditure and foreign exchange earnings will be absorbed by debt servicing and repayment with heavy opportunity costs (Albert, Brain and Palitha, 2005). Excessive external debt constitutes obstacle to sustainable economic growth and poverty reduction (Maghyere and Hashemite, 2003; Sanusi, 2003 and Berensmann, 2004).

Those who argue that external debt has positive effect on the economy do that from the stand point that external debt will increase capital inflow and when used for productive ventures, accelerates the pace of economic growth. The capital inflow may be associated with managerial know-how, technology, technical expertise as well as access to foreign market. The above is in agreement with the views of the Keynesian Theory of capital accumulation as a catalyst for economic growth. However, external debt may have negative impact on investment through debt overhang and credit-rationing problem (Eduardo, 1989).

In the first part of 1990s, Indonesia was beginning to accumulate a high level of external debt as the corporate sector borrowed heavily in the international market induced by the relatively low interest rate and government policy of gradual depreciation of the exchange rate. Although the country was able to grow at 7 percent in the middle of 1990s, it was not clear whether the borrowed foreign funds had contributed to the growth, as stated by an official from the Indonesian Central bank which is the huge growing number of external debt used however has not always significantly contributed to the growth expected (Azam et al, 2011).

After the crisis, Indonesian external debt to GDP ratio was fluctuating 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 debtis 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 analysis of tends to increase, from a small amount in 1970s to well over US$200000 in 2011, although temporarily declining in the beginning of 2000s (Bank Indonesia, 2013).

In other hand, the role of domestic investment, foreign direct investment, and external debt on the growth of economy in country is different. When an investment come to a nation means the capital come from inside the country. The increase in private investment signals high return on investment in the domestic economy whereas public investment shows the improvement in infrastructure and thereby reduction in cost of doing business (Ullah, 2014). In the end, the domestic investment will give beneficial in term o return of investment back to the host country.

Then, FDI also play a crucial role for the economic growth in acountry. Once FDI come to a country, it will affect many sector, such as transfer of knowledge, capital, and technology, create the employment opportunities, improve the current account of the host country's balance of payment, and supporting export growth of the countries (Kastrati, 2013). Eventhough, the return of invesment on this investment also give the beneficial to the home country or investor country.

Another source of fund, is external debt. External debt is found to be a driver of economic growth if properly managed but its servicing rather than repayment is an inhibiting factor to economic growth (Ijirshar, 2016). If the external debt is used for productive sector/project, it will lead the positive growth of economy growth.

Based on above explanation, the author tries to analyze about domestic investment, foreign direct investment and external debt condition in Indonesia and the correlation on economic growth by lifting the title **"The Impact of Domestic Investment, Foreign Direct Investment, and External Debt on Economic Growth in Indonesia"**

1.2 Problems

Based on the description that has been described in the background, then it can be argued the main problems of research are :

a. What is the impact of domestic investment to economic growth in Indonesia in the period 1981 – 2015 in short run and long run?

b. What is the impact of foreign direct investment on economic growth in Indonesia in the period 1981 – 2015 in short run and long run?

c. What is the impact of external debt on economic growth in Indonesia in the period 1981 – 2015 in short run and long run?

1.3 Research Objectives

The objectives to be accomplished in this research are :

1. To determine how much influence the domestic investment on the economic growth in Indonesia in the period 1981 – 2015 in short run and long run.
2. To determine how much influence foreign direct investment on the economic growth in Indonesia in the period 1981 - 2015 in short run and long run.
3. To find out how much influence external debt on the economic growth in Indonesia in the period 1981 - 2015 in short run and long run.

1.4 Research Advantages

This research is expected to provide advice and information as follows :

a. As the analysis about the impact of domestic investment, foreign direct investment, and external debt on economic growth in Indonesia in the period 1981– 2015.

b. As a reference for the Government and the parties concerned, this research is expected to provide an overview and knowledge about the impact of domestic investment, foreign direct investment, and external debt on economic growth in Indonesia, and then it can be served as a point of comparison to determine the further direction policy.

c. As a source of studies, information, and additional reference materials for students in Department of Economics, Faculty of Economics, Andalas University, especially for students who want to do further research.

1.5 Limitation of Study

For more orderly study, the framework used in this study will be limited, among others :

a. This study focuses only about the impact of domestic investment, foreign direct investment, and external debt on economic growth in Indonesia in the period 1981 - 2015

b. The data used in secondary data obtained from the World Development Indicator provided by World Bank.

1.6 Systematic Writing

The result of this study are arranged in such a way that can be understood easily. Writing this thesis is divided into six chapters with each chapter details the following :

Chapter I contains description of the background of the domestic investment, foreign direct investment, and external debt on economic growth in Indonesia. This chapter also describes about problems, research objectives, research advantages, limitation of study, and systematic writing.

Chapter II will provide the theory and the relationship between domestic investment, foreign direct investment, and external debt on economic growth in Indonesia. To support the literature review some explanation from empirical studies in the past, as proven.

Chapter III is about study method of problem, containing research data such as research variables, data characteristics that accompanied by clarification about data collecting procedure, and also technique data analysis. Then, chapter IV explains about the outlook and recent development of variables in Indonesia related to research data from 1981 until 2015.

Chapter V explains about the output of the research and the analysis from the processed of data. Last, chapter VI, in this chapter consist of conclusion of the analysis, suggestion, and implication arising from the conclusion of the problem.