CHAPTER I
INTRODUCTION

1.1 Background

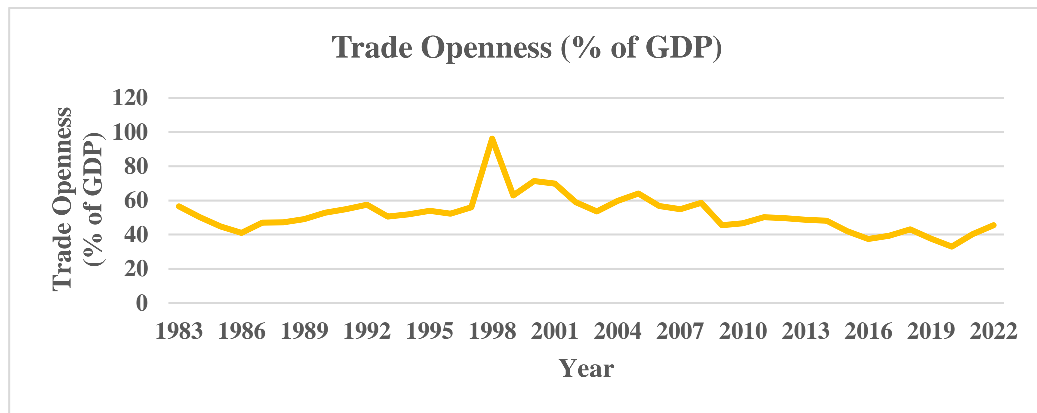
In recent decades, there have been major developments and changes in the global economy. This is driven by shifts in geopolitical conditions and economic progress as the basis for increasing globalization. According to the WTO (in Kilic, 2015), globalization is the integration of capital, labour markets, and investment or their integration with world markets. This makes national economies closer and more interconnected so that conditions towards a single economy are increasingly accepted (Dornbusch *et al*., 2018).

Increased globalization is caused by reduced transportation costs, increased information flows and technological advances or by economic and policy changes focused on reducing protectionism, regulating migration, and liberalizing foreign investment. (Gurgul and Lach, 2014). Therefore, globalization has an important role especially for developing countries.

In this case, globalization can create new opportunities in accessing developed country markets, promising technology transfer, and increasing living standards and productivity (Hamdi, 2013). According to Husain (in Kilic, 2015), globalization affects a country's economic growth through different channels such as trade, financial flows, labour flows and technical changes. As a result of these channels, globalization is not only about the interconnectedness between countries, but also expands access to previously limited resources.

According to Karras (2003), increasing openness to international trade is one of the clear aspects of globalization and is one of the defining characteristics of globalization. According to Raghutla (2019), neoclassical economists emphasize that trade is a major factor in economic growth due to the strong and significant relationship between trade and economic growth. Due to the significance of this, countries have begun to focus on increasing output to meet the demand for goods and services and increase productivity

Figure 1. 1 Trade Openness (% of GDP) of Indonesia 1983-2022



Source: World bank (2024)

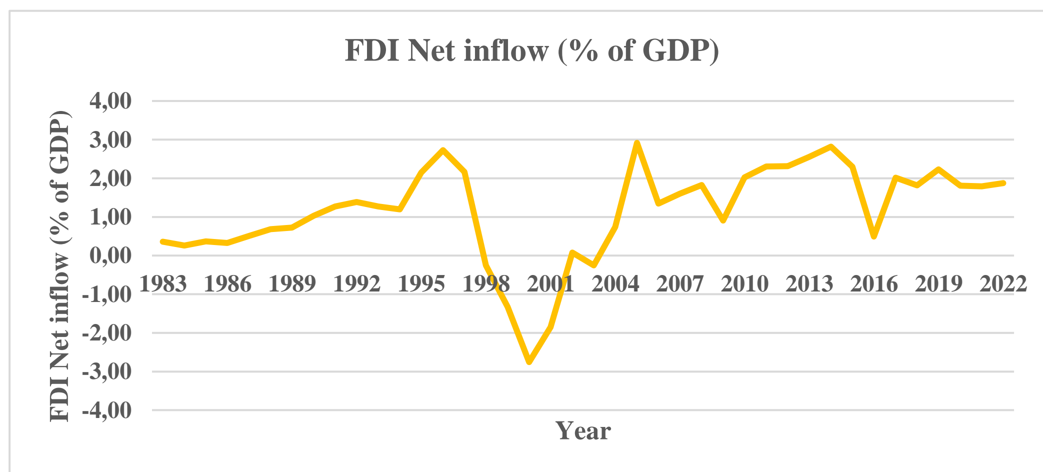
In recent decades, Indonesia's trade openness has been volatile, especially increasing sharply due to the Asian financial crisis to 96.19% in 1998, Due to the slow adjustment of prices and export volumes to high exchange rate depreciation. In addition, the contraction of domestic demand encourages exporters to lower prices to increase export demand (Rosner in Athukorala, 2006). After the crisis, trade openness declined gradually and stabilized at 40-50% of GDP in the 2000s to 2010s.

The impact of trade openness in Indonesia shows mixed results. For example, a study by Susanti and Sholeh (2020) found that only import value contributed to growth, due to consumer preferences for more expensive imports. Meanwhile, Elfaki *et al*. (2021) found a negative impact of trade openness on growth. This is due to the dominance of low value-added export commodities and dependence on high-value manufactured import. (Tijaja and Faisal in Elfaki *et al*., 2021)

Besides trade, financial flows are important for economic development. According to the World Bank (2024), financial flows include foreign direct investment, external debt, and foreign aid. Financial flows help developing countries that have limited domestic funds for sustainable development (Zardoub and Sboui, 2021). Brookings (2014) explains the importance of financial flows to finance public spending and socio-economic investments. However, Eichengreen *et al*. (2021) state that the effects of financial flows vary depending on the type of flow, policies, and economic conditions of each country.

Foreign direct investment (FDI) plays an important role in increasing economic growth. In some cases, countries often offer tax incentives and subsidies to attract foreign capital, which shows that FDI can drive economic growth (Sultanuzzaman *et al*., 2018). In developing countries, FDI has a major impact due to the lack of domestic savings for development investment (Agusty and Damayanti, 2015). Brookings (2014) states that FDI is the main source of external funding for developing countries, so the right policies are needed to get maximum benefits.

Figure 1. 2 FDI Net Inflows (% of GDP) of Indonesia 1983-2022



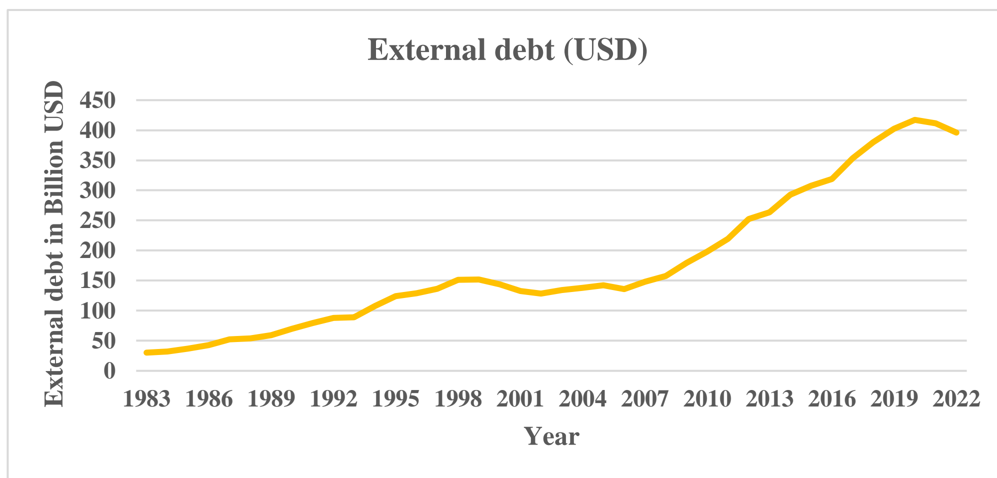
Source: World bank (2024)

According to Figure 1.2, in the last few decades, FDI contribution to Indonesia has experienced very significant volatility. In 1983, FDI inflow was 0.36% and increased steadily to 2.72% of GDP in 1996. However, the 1997 Asian financial crisis reduced FDI to -2.76%, FDI began to recover in 2005 to 2.92%. Furthermore, the COVID-19 pandemic that occurred in 2020 could provide obstacles to FDI expansion in Indonesia (Syarifuddin and Setiawan, 2022). FDI remained stable and recovered slowly in 2022 as the economy recovered post-covid.

According to Hanim's research, FDI has a significant positive impact on Indonesia's economic growth by reducing income disparities among regions (Hanim, 2021). On the other hand, Meivitawanli (2021) stated that FDI can slow down economic growth. This occurs due to a decrease in the value of country investment due to tight competition between foreign and domestic investment which results in a decrease in the value of domestic investment.

Besides FDI, financial flow in the form of debt can be used as capital for development and economic growth. Efficient debt management can support infrastructure development, increase economic growth, and cover deficits. According to Agyapong and Bedjabeng (2020), external debt can boost the economy by encouraging financial development. However, if the debt management is ineffective and the quality of a country's institutions is low, it would have a negative impact on external debt (Mumba and Li, 2020).

Figure 1. 3 External debt (USD) of Indonesia 1983-2022



Source: World bank (2024)

Indonesia's external debt has increased rapidly in recent years to cover the funding gap for development and other needs. Figure 1.3 shows the spike in debt from 1983 to 2022, especially during the New Order era and peaking during the 1998 Asian financial crisis. In 1990, debt reached USD 69.849 billion or equivalent to 69.2% of GNI and increased to USD 151.467 billion during the 1998 crisis. By the end of 2022, debt reached USD 396.234 billion.

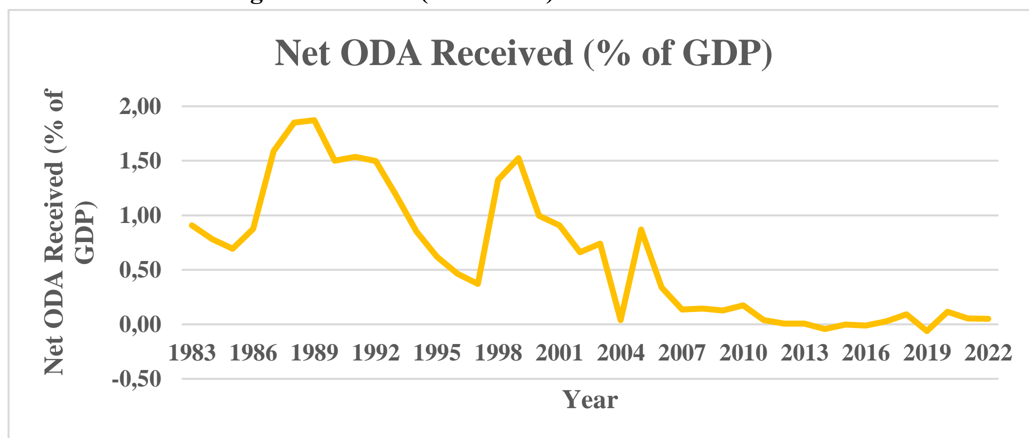
This increase in debt highlights the importance of understanding the asymmetric relationship between debt and economic growth. When managed effectively, debt can serve as a catalyst for development, but excessive debt can have negative impacts, as expressed by the Debt Overhang Theory. This theory states that high debt levels can discourage investment and reduce economic growth, as future debt repayment obligations create uncertainty and pressure on public finances.

Several studies have produced mixed results regarding the impact of external debt in Indonesia. Research conducted by (Özyilmaz, 2022) found that foreign debt has a negative impact on economic growth in E7 countries, a term for countries with large market sizes and significant economic growth. This is due to excessive debt burdens that can reduce the government's capacity to invest in productive projects, in line with the debt overhang theory. Meanwhile, research by (Suidarma and Yasa, 2021) found that in the long term, foreign debt contributes to economic growth in Indonesia. This is because good debt management can contribute to sustainable economic growth.

In addition to external debt, official development assistance (ODA) can be a source of development funding in the form of assistance. According to Niyonkuru (2016), ODA provides assistance for state development. This assistance includes service assistance, production sector assistance, economic infrastructure, and social infrastructure. In this case, social infrastructure includes education and sanitation. It aims to improve human development and ultimately contribute to long-run economic growth (Addison and Trap in Yiew and Lau, 2018).

Indonesia is a recipient country of ODA, with Japan as the largest contributor since the 1970s (Anabraja, 2012). Other countries such as France, Australia, and the US as well as various institutions such as the Asia Development Bank, the World Bank, and the UN also contribute. ODA channelled to Indonesia can be a solution to close the savings and investment gap. However, Sugema and Chowdhury (2005) stated that dependence on aid can weaken the government's fiscal performance.

Figure 1. 4 ODA (% of GDP) in Indonesia 1983-2022



Source: World bank (2024)

In recent years, ODA in Indonesia has experienced a significant decline. Figure 1.4 is ODA receipts to GDP in Indonesia from 1983 to 2022. During the Asian financial crisis, ODA increased and peaked in 1999 at 1.65% of GDP, this was due to the increase in ODA supply to stabilize the economy and the depreciation of the rupiah during the crisis. In the following year, ODA has declined until now, indicating an increase in Indonesia's economic independence and the beginning of the strengthening of the rupiah after the Asian financial crisis.

Several studies have examined the impact of ODA and economic growth with mixed results. For example, research by Dunusinghe (2020) found a positive impact of ODA on the development of social and economic infrastructure. However, Zardoub and Sboui (2023) found that financial flows such as ODA have mixed effects on the economic growth in developing countries, mainly because they are often not used properly.

Based on data and literature that has been discussed above about the impact of various financial and trade flows, researchers are eager to know the impact of financial flows and trade on economic growth in Indonesia. In addition, this research will look at the impact of these aspects on economic growth in the long-run and short-run based on data in 1983-2022. This is deemed necessary because the dynamics and conditions of each variable and economic conditions in Indonesia can change over time. There is a suggestion for further research by Epor et al. (2024). Epor et al. said that besides FDI, trade, and external debt, there are other dimensions of international financial flows that can explain a country's economic growth so these other dimensions must be studied further. Furthermore, this research will also explore the asymmetric relationship between external debt and economic growth. Understanding this aspect is crucial, as the asymmetric effects may reveal whether the impact of debt on growth differs depending on its levels or management quality. By analyzing these nuances, the study aims to provide a more comprehensive picture of how external debt interacts with Indonesia's economic conditions over time. With the existence of a gap in terms of the variables used, research methods and different years and data, researchers want to know more about the conditions, relationships, and impacts given by the variables included in international financial inflows and trade on Indonesia's economic growth which

began in the rapid development of globalization in the 1980s until now with the title ***" THE IMPACT OF FINANCIAL FLOWS AND TRADE ON INDONESIA'S ECONOMIC GROWTH: AN ASYMMETRIC APPROACH TO EXTERNAL DEBT***

1.2 Problem Formulation

The economic growth of a country is influenced by many factors, including trade and financial flows. International financial flows such as FDI, external debt, ODA, and trade openness play an important role in supporting economic development, especially in developing countries such as Indonesia. A deep understanding of this is needed to formulate effective policies.

Since 1983 to 2022, the Indonesian economy has undergone significant changes including capital flows, foreign aid, and trade. However, there are different results regarding the relationships between international financial flows, trade, and economic growth, which have become a subject of debate among researchers. Therefore, the problems that will be answered in this study are as follows:

a. How is the relationship between international financial flows (FDI, external debt, and ODA), trade, and economic growth in Indonesia between 1983 until 2022?
b. How is the asymmetric relationship between external debt and economic growth in Indonesia between 1983 until 2022?

1.3 Research Purpose

Based on the problem that have been formulated, the researcher determines the objectives of the research as follows:

a. To analyse the relationship between international financial flows (FDI, external debt, and ODA), trade, and economic growth in Indonesia between 1983 until 2022.
b. To analyse the asymmetric relationship between external debt and economic growth in Indonesia between 1983 until 2022.

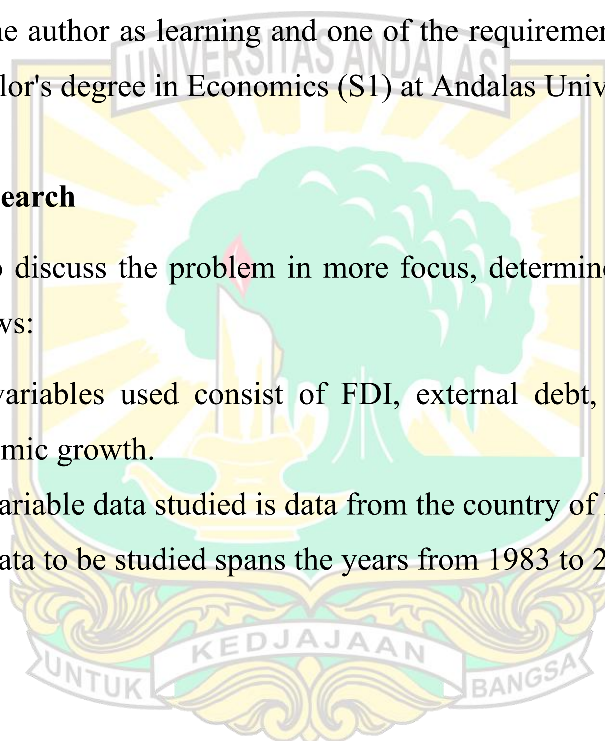
1.4 Research Advantages

The benefits of research are as follows:

a. For the government, this research is expected to be able to provide information regarding the conditions of Indonesia's economic growth in 1983-2022 and what factors can increase economic growth.

b. For academics, it is hoped that the findings of this research will serve as references for further research.

c. For the author as learning and one of the requirements for obtaining a bachelor's degree in Economics (S1) at Andalas University



1.5 Scope of Research

To be able to discuss the problem in more focus, determine the scope of the research as follows:

a. The variables used consist of FDI, external debt, ODA, trade, and economic growth.

b. The variable data studied is data from the country of Indonesia.

c. The data to be studied spans the years from 1983 to 2022