CHAPTER I

INTRODUCTION

1.1. Background

Most of the developing countries in the world try to increase their economic growth over time. Economic growth is one of the success indicators of the country's development. According to Sadono (2006), economic growth is a process that causes the amount of the production of goods and services produced by a production unit to increase within one year. Economic growth is defined as a process, because of the linkages pattern and the reciprocal influence between factors in economic growth. A country's economic growth rate is indicated by the Gross Domestic Product (GDP) rate (Arsyad, 2010). If the GDP of the country is high, the level of economic growth is also high. High economic growth can overcome some macroeconomic problems such as poverty, unemployment, and inequality of income.

As a developing country that is carrying out economic development and having problems with economic, political, social and cultural conditions, Indonesia cannot be separated from external debt problems. In carrying out economic development, Indonesia has become one of the countries in the world, especially in Southeast Asia, which has a shortage of funds and other resources, both technology, labor, and raw materials. These are because of the low savings rate, low investment level, and low growth rate. On the other hand, low income received and high government expenditure is also one of the reasons why Indonesia has a shortage (deficit) of funds. These conditions resulted in Indonesia facing problems in the economy, which are managing the government budget deficit and financing for development. However, trade openness helps the government to overcome the financing problems, because there is financing from other countries to finance the budget deficit. Therefore, this matter makes Indonesia cannot be separated from external debt problems.

The Investment Coordinating Board (BKPM) noted the realization of investments, both from domestic investment (PMDN) and foreign capital investment (PMA) in 2017 reached IDR 692.8 trillion or exceeded the target of IDR 678.8 trillion. Although the investment has increased, the realization growth of investment growth in the past few years has been relatively stagnant (Investment Coordinating Board, 2018). This condition indicates that the government must try to find other financing sources for national development. One alternative step that can be taken by the government is borrowing from both inside and outside the country. Most of the funds that come from abroad are foreign aid and external debt.

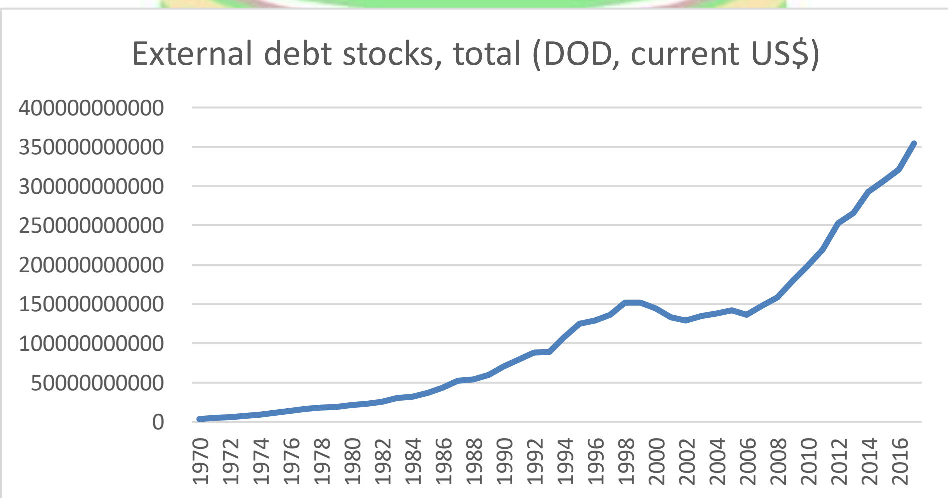
Foreign aid is usually in the form of military assistance, health assistance, or other assistance provided voluntarily by other countries. Meanwhile, external debt is usually in the form of money obtained from creditors abroad with loan interest. Therefore, this condition increases Indonesia's dependence on foreign capital to overtake the difference in investment savings, to achieve economic growth and to meet the needs of state funds.

Foreign aid and external debt have a positive and negative impact on economic growth as has been found in some empirical literature. According to Burnside, C., & Dollar, D. (2004), foreign aid has a positive impact on growth in developing countries with good fiscal, good finance, and good trade, but it has a negative effect in the presence of bad policies. This condition is supported by the finding of Jilenga, M. T., Xu, H., & Gondje-Dacka, I. M. (2016) proves that in the long run foreign capital will have a positive impact on economic growth. In contrast, the research conducted by Bräutigam, D. A., & Knack, S. (2004) stated that foreign aid has negative impact on economic growth. Meanwhile, Jensen, P. S., & Paldam, M. (2006) found that foreign aid has no impact on growth.

In recent years Indonesia's external debt has increased rapidly. Indonesia made the debt as a cover for the lack of funds and pillars in national development. When Indonesia lacks capital from the tax, oil and gas and non-oil and gas sectors, foreign capital remains a major component of income in the state budget. External debt consists of government external debt, central and private banks. The chart below is a graph of the increase in Indonesia's foreign debt from 1971 to 2017.

Figure 1.1

Development of Indonesia's external debt stocks in 1971-2017



Source: World Development Indicator (2018)

Figure 1.1 shows the development of Indonesia's external debt stock in 1971-2016. Based on the figure, Indonesia's external debt continued to increase during the Soeharto era and reached its peak during the financial crisis of 1998. In 1990, Indonesia's external debt reached 69.849 billion USD or 69.2% of GNP. Meanwhile, Indonesia's largest external debt occurred in 1998, reached 151.467 billion US dollars or the ratio of the percentage of external debt to GNP reached 168.17%. External debt continues to increase until 2017 and became the largest after the financial crisis in the amount of 354 352 billion USD.

The increase in Indonesia's external debt over the past few years has triggered public anxiety. From 2006 to 2012, the position of Indonesia's external debt increased by USD 119.7 billion (90.3%). However, in the same period the increase in external debt was followed by an increase in GDP is relatively larger, around USD 520.9 billion (Bank of Indonesia). Does this show that is its external debt has contributed significantly to development in Indonesia?

External debt is an important financial source for Indonesia which is used to increase domestic funding sources and support the development and other needs of a country (Bonokeling, 2016). Indonesia is one of the favorite countries for creditors to channel their funds, because there are political interests that influence the direction of the monetary and fiscal policy of Indonesia. Some countries have been active in terms of providing assistance in the form of loans to Indonesia, both in Asia, Europe, United States, and several other international financial institutions. Table 1.1 below shows the sources of external debt from several countries or lending institutions for Indonesia.

Table 1.1

The biggest list of countries/creditors (external debt providers) for Indonesia

Countries	Total Debt (Billion USD)	Total Debt (Trillion Rp)
Japan	13.4	199,57
Prancis	2.5	37,000
Germany	2.2	32,560
China	1.44	21,312
South Korea	1.41	20,868
USA	1.36	20,128
World Bank	16.8	249,67
Asian Development Bank	8.8	130,28

Source: Bank Indonesia (BI) External Debt Statistics 2018

From the table above, the countries that provided the most loans for Indonesia were Japan, France, Germany, China, South Korea, and the USA. From the table, Japan has provided a loan of 199.57 trillion rupiahs and the most dominant country in providing loans to Indonesia. Then, France was second in providing loans to Indonesia amounting to 37,000 trillion rupiahs. Meanwhile, the financial institutions that provide the most loans to Indonesia are the World Bank and the Asian Development Bank. The World Bank is the financial institution that provides the most loans of 249.67 trillion rupiahs. Then, the second is the Asian Development Bank that provides loans to Indonesia amount of 130.28 trillion rupiahs.

In addition to external debt, foreign aid in Indonesia for many years also attracted a lot of attention. Foreign aid is believed to play an important role in the economic transformation in Indonesia since the early 1970s. From 1967 to 1991, most of the assistance was coordinated through the Inter-Governmental Group in

Indonesia (IGGI) which was established and led by the Dutch. In the early 1970s, IGGI collectively allocated more than $ 600 million per year to Indonesia.

Indonesia is one country that has always been a place for donors to provide funds. Some countries play an active role in providing assistance in the form of loans to Indonesia, such as Japan, Australia, the United States, the World Bank, etc. Japan and the Asian Development Bank are the main donors to the country of Indonesia. The following table 1.2 is a list of foreign aid in Indonesia, both multilateral and bilateral.

Table 1.2

The biggest list of countries or creditors (donors) for Indonesia

Countries	Total Aid (USD)
Asian Development Bank	886,000,000
World Bank	706,000,000
Japan International Cooperation Agency	662,000,000
Australia Agency	521,000,000
Francis	192,000,000
USA Agency	180,000,000
United Nations	160,000,000

Source: Official Donor Data

Based on the table 1.2 above, the biggest foreign aid in Indonesia comes from the agencies of multilateral, are World Bank and Asian Development Bank. Meanwhile, foreign aid comes from bilateral agencies is Japan, the amount of 662,000,000 USD. Under these conditions, foreign aid might be suggested as the right choice to increase the savings-investment gap.

Foreign aid in Indonesia makes the government become lazy in fiscal terms because it tends to depend on aid (Sugema, I., & Chowdhury, A., 2005). Similar to the research from Friedman, M. (1995); Peter, B. (1972) and Easterly, W. (2003) that foreign assistance that is only wasted will cause the government bureaucracy to become large, perpetuate bad governance and enrich the elite in poor countries. Meanwhile, the research conducted by Rana, P. B., & Dowling Jr, J. M. (1988) cases in Asian countries shows that foreign aid only contributes to capital formation. This argument is supported by the findings of Moreira, S. B. (2005), that foreign aid has a positive impact on economic growth. In addition, research by Sachs J., et al (2004), Stiglitz, J. (2002); Wolfensohn, J. D., Stern, N., et al, (2002) and others argue that foreign assistance will reduce poverty and have a positive impact on growth in some countries and prevent worse performance, although assistance sometimes fails. This is because there are many weaknesses in aid, including a lot of assistance give to political allies rather than to support development.

Based on the data and the literature is still disagreeable about foreign aid and external debt, this is the motivation of this paper: we want to investigate the impact of foreign aid (Official Development Assistance) and external debt on the growth of Gross Domestic Product (GDP) in Indonesia. This analysis uses time series data for 47 years starting from 1970 until 2017. This study wants to find out how much foreign capital is able to provide benefits to Indonesia's economic growth. So based on the explanation above the writer is interesting in analyzing research with the title:

"The Impact of Foreign Aid and External Debt on Economic Growth in Indonesia (1970-2017)"

1.2. Research Problem

Based on available data, it shows that Indonesia's external debt and foreign aid had increased trend every year. Increasing in external debt and foreign aid is expected to have a significant positive impact on the Indonesian economic growth, because in the future there will be a debt burden that must be funded by the government.

Many experts stated that if foreign capital use efficiently and effectively in the productive sector, it will encourage economic growth. However, some studies found that there is negative relationship between external debt and economic growth. One of the reasons is the debt service, which the debt needs to be serviced. Based on this condition, the problems will review in this study is how the relationship between economic growth, foreign aid, and external debt.

1.3. Research Objective

According to the research problem, the objectives of the study are to know what will happen, so that the basic purposes of the study are analyzing the impact of foreign aid and external debt on economic growth.

1.4. Research Advantages

This study hopefully expected to be useful for the writer and the other interest parties. And the benefits of this research include:

1. Government

For the government, it will be recommended for the government to use and manage state finances, especially implementing foreign capital management and making decisions to add or not a new debt.

2. Readers

For readers, it is expected for the readers will be able to add insight and understanding about the current economic condition of Indonesia, especially the relationship between foreign debt and economic growth.

1.5. Systematic of writing

The writing system aims to provide a thorough explanation of this research. The following is the systematic of writing in this paper which consists of six chapters, as follows:

Chapter I: Introduction

Background, research problem, research objective, research advantages, and systematic of writing are the part of the chapter one.

Chapter II: Literature Review

This chapter contains theories that support the variables studied. This chapter is also supplemented by previous research related to the title of this research.

Chapter III: Theoritical Framework and Research Methodology

This chapter contains research data, data sources, research models and definitions of variables and methods of analysis of the data obtained.

Chapter IV: General Overview

This chapter describes the trend of all variables that include in the study. This chapter includes a graph, description, and data for variables.

Chapter V: Empirical Result and analysis

This chapter describes the empirical findings from the results of calculations and processing data with analysis. Then, discuss the results of several tests carried out in this study.

Chapter VI: Conclusion and Recommendations

The closing chapter is the final part of the research which contains conclusions and suggestions obtained from the discussion in the previous chapters.