CHAPTER I

INTRODUCTION

A. Background

In the Act of the Republic of Indonesia No.23/1999 about Bank Indonesia, it is said that in order to maintain continuity of the implementation of national development and to make a Indonesian people live properly prosperously based on Pancasila and the Constitution of 1945, the implementation of economic development is directed towards the realization of the national economy in favor of the people's economy, equity, self-contained, reliable, fair, and competitive in the international economy. Thus, in order to create prosperous society, economic growth must be improved to have a better direction.

Economic growth is one indicator that is very important in the analysis of economic development that occurs in a country. Economic growth shows the extent to which economic activity will generate additional income to the communities in a given period. It is because economic activity is basically a process to produce output, measured with the GDP indicator.

as a developing country, Indonesia tries to build the nation without expecting help from other countries. However it is difficult to survive in the middle of the swift currents of globalization that continue to grow rapidly.

collaborating with other countries in the implementation of national development, especially the joint national economy.

Indonesia actually never had a promising economy in the early 1980s to middle 1990s. Based on data from BPS, Indonesia's economic growth since 1986 until 1989 continued to increase, i.e. 5.9% respectively in 1986, then 6.9% in 1988 and to 7.5% in 1989. Yet from 1990 to six years later the economic growth rates fluctuated. However, at a certain point, the Indonesian economy finally collapses under the brunt of the economic crisis globally around the world. It is characterized by high rates of inflation, the value of the rupiah which continued to weaken, the high rate of unemployment, and coupled with the increasingly growing number of Indonesian foreign debt due to weaker exchange rate.

Since the crisis hit in the middle of 1997 it has become a big shock for the growth of the national economy. The monetary crisis affected the rate of economic growth in 1998 which experienced a minus of 13.1% and the increase of foreign debt from 269 trillion rupiah in 1997 to 573 trillion rupiah. Further indirect impacts of this crisis also hit the banking world one year later, when total bank credit in the form of consumption and capital declined from Rp. 487 trillion in 1998 to Rp. 225 trillion.

Table 1.1
Economic Growth, Foreign debt, Banking Credit and Inflation in Indonesia 1995-2002

No.	Year	Economic Growth	Foreign debt (Rp, Trillion)	Banking Credit (Rp, Trillion)	Inflation
1	1995	8,24	148660.59	242423	9,4
2	1996	7,77	140660.59	306125	7,9
3	1997	4,59	269049.00	476841	6,2
4	1998	-13,24	573538.73	487426	58,0
5	1999	0,79	573140.40	225133	20,7
6	2000	4,86	782462.66	269000	3,8
7	2001	3,83	742320.80	307594	11,5
8	2002	4,25	700967.52	367410	6,8

Source: BPS and BI (data processing)

Indonesia's economic growth in 1999 starts growing positively despite only at the rate of 0.79% after a huge decline in 1998. Early signs of economic recovery has begun It seems, that monetary stability was under control, which was reflected in a low inflation rate and a stronger exchange rate, and political and social circumstances that have been more favorable.

A level of economic growth is determined, among others by the power of investment sector, foreign aid sector, and labor productivity. Economic growth requires an increase in investment funds that in turn require funding from both domestic and abroad. From these two sources of financing, domestic sources should be the principal source of financing, especially should base their investment financing from domestic sources (Syaharani, 2011).

Because of the limited domestic resources owned while fund requirement for economic development is very large, and to overcome the lack of funds needed in the process of national development since *Pelita I* recent years, revenue funding is made from abroad, both in the form of foreign debt and foreign direct investment (FDI) (Kamaluddin, 2007).

The role of foreign aid and foreign capital to the progress, growth and economic development of developing countries has long been a heated debate among groups of the world economy. A group of economists in the 1950s and 1960s argued and believed that foreign aid has a positive impact on the economic development of a country without causing disruption in the aftermath of the debtor countries (Kamaluddin, 2007).

Indonesia proposed foreign debt due to two factors, namely because of the state of Indonesia, which is still a lack of funds and due to the effect of global economic conditions. However, this issue is a serious problem in Indonesia. Because of the problems that arise later due to foreign debt, among others, is the burden of the payment due to the large amount of debt, which is direction of future policies that unknown (Kusumaningtuti in Widowati, 2010).

For developing countries such as Indonesia, the rapid flow of capital is a good opportunity to obtain economic development financing. However, if the funds are give through debt, then gradually foreign debts seem to be a boomerang for Indonesia because it leaves a lot of issues, especially foreign debts that have high interest rates. For a government, foreign debt payment is the largest consumption in the state budget in the last decade. While our country still has to pay for a wide range of other economic sectors that are also important and urgent (Anwar, 2011).

As an alternative to foreign debt, to get the funds from abroad can be done through Foreign Direct Investment (FDI). As well as with foreign debt, Foreign Direct Investment (FDI) is one of the sources of financing for development and national economic growth. FDI is directed to replace the role of foreign debt to finance the growth and development of the national economy. The role of foreign capital becomes even more crucial given the fact that the amount of Indonesia's foreign debt has increased significantly.

Foreign Direct Investment (FDI) destination country is believed to be beneficial, especially in terms of development and economic growth. Much

Thailand, China, and many other countries shows that the presence of FDI gave a lot of positive things to the economy of the host country. In the case of Indonesia, the most obvious evidence is the past under the new order. Indonesian economy may not be able to rise again from the destruction created by the Old Order and could experience an average economic growth of 7% per year during the period of the 1980s when no FDI. Of course many other factors that also serve as a source of growth drivers such as aid or foreign debt and the seriousness of the New Order government to build a national economy when it is reflected by the presence of *Repelita* and political and social stability. Literature theory also gives a strong argument that there is a positive correlation between FDI and economic growth in the recipient country (Tambunan, 2007).

The thought that supports that foreign capital has a positive effect on domestic savings and financing imports got a lot of challenges from the camp followers of dependency theory (dependencia). They concluded that only a small proportion of foreign capital has a positive effect on domestic savings and economic growth. The main hypothesis is the dependency theory of FDI and foreign debt in the short-term that increase economic growth; more countries depend on FDI and foreign debt, so the difference in earnings [illegible] it is not achieved (Anwar, 2011).

Foreign direct investment (FDI) is an alternative to meet the development needs of capital. In Indonesia, FDI regulated in the Act of Foreign Investment (UUPMA) which is a legal base of FDI to come to Indonesia. The Indonesian government attempted to encourage the business climate so as to attract the interest of private sector enterprises, especially for foreigners, so the Act No. 1/1967 on Foreign Direct Investment (FDI) was issued. The Act was refined in 1970 to be Act No. 11/1970.

In addition to investment, labor is a factor that affects the output of a region. A large labor force will be formed from a large population. However, population growth could cause significant negative effects on economic growth. According to Todaro (2000) rapid population growth gave rise to the problem of underdevelopment and make the prospect of the development becomes increasingly distant. Further, it is said that the population problem arises not because of the large number of family members, but because they are concentrated in the urban areas as a result of the rapid rate of migration from rural to urban. However, quite a number of people with high levels of education and have the skills to be able to encourage economic growth. As the total population of productive age is big it will be able to increase the amount of available work force and will eventually to increase the production output in a region (Rustiono, 2008).

Today the condition of Indonesian labor has always been central of attention in economic development. Previously Indonesia has experienced a period of rapid population growth, but the redundant characteristic colors the economic life in Indonesia. The implementation of equity-oriented to the development is also done with the direction to improve and increase the income of low-income communities. Because in the development the population also serves as the workforce development issues that will arise in employment. Hence the ever growing population in the presence of continued economic development needs more investment.

In addition, the problem of capital and labor, the banking sector as intermediary institutions that facilitate the distribution of funds from the excess (surplus) to that lack of funds (deficit) also takes an important position in the economic development, which is reflected through credit. Banking credit has an important role in financing the national economy and is a driving force of economic growth. Availability of credit allows households to make better consumption and enables the company to make an investment that cannot be done with their own funds. In addition to the problems of moral hazard and adverse selection that are common, banks play an important role in allocating capital and monitoring to ensure that public funds are channeled to activities that provide optimal benefits. Regardless the recent rise in the role that include banks and financial institutions, bank credit is still dominating the total credit of the private sector with an average of 85% (Diah, Arimurti and Kurniati, 2012).

Banking has a function to stimulate economic growth and expand employment opportunities through the provision of a number of funds and business development. Especially for businesses, a fund provided by banks is in the form of credit. Total demand for loans in a bank is affected by various factors, both in terms of the debtor and the creditor (bank) itself. Credit demand from the debtor (business) is influenced by the presence of an effort to increase business activity, either in the form of investment or working capital. In terms of banking, credit demand is influenced by factors such as interest rate loan, line of credit, SBI, government policies and services to the customers of the bank itself. In the end, if the bank that issues the funds through various financing can be put to better use then it will trigger good climate in economic and business climate and will trigger economic growth in general.

Looking at the description of issues described above of course back in the end it boils down to one purpose of Indonesia's economic growth, which indicates the extent to which economic activity will generate additional income of the people in a given period. It is because economic activity is

Therefore, the researcher is trying to discuss the extent of the influence of foreign debt, investment, bank credit and labor to economic growth in Indonesia, in a thesis with the title: ***"Factors Influencing Economic growth in Indonesia An Approach to Error Correction Model (ECM)"***

B. Research Questions

Based on the background, the researcher needs to formulate the problem as the ultimate goals of this research which includes:

1. How does the influence of Foreign Direct Investment (FDI) to the Indonesian economic growth in the short term and long term?
2. How does the influence of foreign debt of the Indonesian economic growth in the short term and long term?
3. How does the influence of bank credit to the Indonesian economic growth in the short term and long term?
4. How does the influence of labor force on Indonesian economic growth in the short term and long term?

C. **Research Objectives**

In harmony with the formulation of the problem that has been mentioned, this study aims:

1. To determine the effect of Foreign Direct Investment (FDI) to the Indonesian economic growth in the short term and long term

2. To determine the effect of foreign debt to the Indonesian economic growth in the short term and long term.
3. To determine the effect of bank credit to the Indonesian economic growth in the short term and long term.
4. To determine the effect of the labor force on Indonesian economic growth in the short term and long term.

D. Research Benefits

The benefits expected from this study are:

1. For researchers, this research can become a vehicle of knowledge and experience in understanding one of the economic concepts that has been studied and compared with the real applications in the field. In addition it is a requirement to obtain a degree of Stratum 1 (S1).
2. For academicans, this research can be a source of reading material and references for the reader and gives information about Indonesia's economic growth and cause factors. Furthermore, it can be used as a comparison for further research in conducting research with similar titles.
3. For related institutions, this research can be information and expected as a material consideration in determining the policies associated with Indonesia's economic growth.
4. For the general public, this study can be a source of knowledge about the state of Indonesia's economic growth.

E. Problem Limitation

Given the vastness of the discussion about economic growth and the limited ability of the author, this study is limited only about Indonesia's economic growth and the variables studied including Foreign Direct Investment (FDI), foreign debt, bank credit and the labor force. The data used are annual time series data from 1985 to 2013.