CHAPTER I

INTRODUCTION

1.1 Background

Economic activity around the world supports by many kinds of industries operated by company that can be divided into two groups, the first one is Domestic Corporation (DC) and the second one is Multinational Corporation (MNC). Many firms have evolved into Multinational Corporations, which are defined as firms that engage in some form of international business (Madura and Fox, 2007:2). These kinds of companies have offices, plants, or subsidiaries in many countries. Multinational Corporation (MNC) usually has a head office. Multinational Corporation (MNC) coordinates a global management. Multinational Corporation (MNC) is a development of international activity which is trading with exporting goods.

Look at Indonesia economic activity which begin to enter into free market, it is very important for Multinational Corporation (MNC) to know about country risk where Multinational Corporation (MNC) will put or open their branch into that country so Multinational Corporation (MNC) can analyze whether by opening a branch in this country seen from country risk factors can give a profit for a company or give a disadvantage for Multinational Corporation (MNC). *Country risk* in international business is a risk that might be happen in the form of extraordinary events which occurs mainly in host country or home country or third country or a political situation and international finance, so it can disturb firms operational (Hamdy Hady, 2012:283). In other words, Country Risk potentially adverse impact of a country's environment on Multinational Corporation (MNC's) cash flows. Country Risk consists of Political Risk and Financial Risk.

Multinational Corporation (MNC) must assess country risk not only in countries where it currently done business but also in those where it expects to export or to establish subsidiaries. Several risk characteristic of a country may significantly affect performance, and the Multinational Corporation (MNC) should be concerned about the likely degree of impact for each many countries characteristic related to political environment that can influence Multinational Corporation (MNC). An extreme form of political risk is the possibility that the host country will take over subsidiary. In other cases, the assets are confiscated and no compensation is provided (Madura and Fox, 2007:549). Expropriation can take place peacefully or by force. Some of common forms of political risk are the attitude of the consumers in host country, actions of host government, blockage of fund transfer, etc.

One of the aspects of country risk is Financial Risk. One of the most obvious financial factors is the current and potential state of the country's economy. Multinational Corporation (MNC) that exports to a country or develops a subsidiary in a country is highly concerned about that country's demand for its products. This demand is, of course, strongly influenced by the country economy.

Because of a country's economic growth depends on several financial factors, Multinational Corporation (MNC) must consider all of these factors. According to Hamdy Hady (2012:284), the most important factors are *interest rates, exchange rates volatility,* and *inflation*.

Interest rates can affect Multinational Corporation (MNC) financing cost. Higher interest rates tend to slow the growth of an economy and reduce demand for the Multinational Corporation (MNC's) products. Lower interest rates often stimulate the economy and increase demand for the Multinational Corporation (MNC's) products.

Exchange rates volatility can influence the demand for the country's exports, which in turn affects the country's production and income level. A strong currency may reduce demand for the country's exports, increase the volume of products imported by the country, and therefore reduce the country's production and national income. A very weak currency can cause speculative outflows and reduce the amount of funds available to finance growth by businesses.

Inflation can affect consumer's purchasing power and therefore their demand for Multinational Corporation (MNC's) goods. It also indirectly affects a country's financial condition by influencing the country's interest rates and currency value. A high level of inflation may also lead to a decline in economic growth.

Financial Risk can affect Foreign Direct Investment (FDI) through those three factors. If one factor increases or decreases, it will give an effect to other factors.

If a country financial risk not in a stable condition, Multinational Corporation (MNC) must think twice if they want to invest in that country. Because if Multinational Corporation (MNC) decides to invest in that country, can inflict a financial loss for Multinational Corporation (MNC). With high inflation, of course the operation cost will be higher because of the rising cost of raw materials. If a country's interest rates increased, the financing cost would increase because Multinational Corporation (MNC) interest costs increased.

There are many researches examine the influence of country financial risk toward multinational corporation (MNC) foreign direct investment (FDI). Research conducted by Aguiar, Conraria, Gilamhussen and Magalhaes (2012) prove that the higher a country's level of risk is significantly associated with the lower level of Multinational Corporation (MNC) Foreign Direct Investment (FDI). Research was also conducted by Haque (2008) over 70 countries. This research reveals that there is a negative relationship between high interest rate with a low level of Multinational Corporation (MNC) Foreign Direct Investment (FDI). The other research conducted by Ruiz and Pozo (2008) also reveals that discrete variations in the real exchange rate do not impact FDI. A more or less depreciated real exchange rate does not seem to encourage or discourage FDI.

Based on some previous research, researcher is interested in doing another research related with country risk that is about **"The Influence of Country Financial Risk toward Foreign Direct Investment Of Multinational Corporation in Indonesia"**

1.2 Research Problem

Based on the background, research problem of this study is:

Do exchange rate volatility, interest rate, and inflation partially effect MNC foreign direct investment in Indonesia?

1.3 Research Objective

The purpose of this study is:

To examine the influence of country financial risk toward foreign direct investment of Multinational Corporation in Indonesia partially.

1.4 Research Benefit

1. Multinational Corporations

   Provide information about level of Country Financial Risk in Indonesia.

2. Academics

   This research is expected to be a tool for other researcher to conduct more research in University or College.

3. Indonesia

   Expand and adding knowledge about the importance of Country Financial Risk for Multinational Corporation before MNC make a decision whether MNC want to invest in a country and as a reference for Indonesia who wants to conduct more research with the same topic.

1.5 Systematic of Thesis Writing

Thesis was prepared with the systematic of writing that consists of three chapters with the following details:

CHAPTER I : INTRODUCTION

This chapter describes about background issues that underlying this research, formulation of research problem, and systematic of proposal writing.

CHAPTER II : LITERATURE REVIEW

Literature review chapter describes about previous research, basis theory, framework, and hypothesis of this research.

CHAPTER III : RESEARCH METHOD

Chapter describes in detail the research methods of study design, study limitations, identification of variable, operational definitions, and measurement variables, population, sample, and sampling techniques, data and data collection methods and data analysis technique.

CHAPTER IV : DESCRIPTION OF RESEARCH SUBJECT AND DATA ANALYSIS

This chapter describe in detail about description of research subject, sample, data analysis, and discussion about research result by previous study result.

CHAPTER V: CONCLUSION

This chapter describe about research conclusion based on WarpPls analysis.