CHAPTER II

LITERATURE REVIEW

2.1 Previous Research

In a research, theoretical foundation needed to support theory to be tested. One of the theories that will be used is a previous research done by another researcher. The previous research referenced in this research is research conducted by following researchers:

1. Aguiar, Conraria, Gilamhussen and Magalhaes (2012)

The previous research done by Aguiar, Conraria, Gilamhussen and Magalhaes analyze the relation between Foreign Direct Investment and Home Country Political Risk where previous research looks into factors that explain foreign direct investment in Brazil by country of origin. The samples used by previous research are 180 countries with and without foreign direct investment in Brazil. The dependent variables used are Foreign Direct Investment in Brazil by country of origin in US Dollars while the independent variable is euro money country risk index, Gross Domestic Product (GDP) and Direct Investment Abroad (DIA) as proxies for the size of the economic size of a country, and domestic wealth. Multiple regression and controls used in this research to isolate the effect of country political risk on outward foreign direct investment and show that countries with lower level of political risk undertake more foreign direct investment in Brazil.

This research finding, controlling for domestic output, market size, language, geographic distance, and bilateral trade, reveal that higher levels of home-country political risk are conducive to lower level of foreign direct investment in Brazil. This research also found that the main component of political risk that seems to be driving the negative relationship between risk and foreign direct investment into Brazil is related neither to regime type nor to political stability, but to the quality of policy formulation and implementation.

Similarities between previous research and this research are about purpose of the research. Both of researches are explain about foreign direct investment. Another similarity is the variable that used to measure country risk, that variable is the level of foreign direct investment.

The difference of previous research and current research are about the data that used for research. Previous research use 180 countries with and without foreign direct investment in Brazil while current research use the data of interest rate, exchange rate, inflation, and Foreign Direct Investment Level from the year 1998-2013 study period. The other difference between current research and previous research is that the previous research counts the number of country which invests in Brazil while current research counts total incoming foreign direct investment in Indonesia.

2. Haque (2008)

The purpose of this study was to identify the risk level of each of the developing countries. A total of 70 countries were used, 35 never defaulted and 35 that have defaulted on their international loan. With the independent variables are total external debts to export of goods and services, total external debt to gross national income, debt service ratio, interest payment to export goods and services, interest payment to gross national income, international reserves to total external debt, etc. Analyze technique used in this research is the discriminant analysis technique.

The result of this research is there is no real pattern of the level of risk based on the size of economy. For international lenders, country risk is crucial because the interest rate they charge on the international loans can be adjusted to risk.

Similarities between previous research and this research are the purpose of research is to identify the risk level of a country and both researchers use interest rates data as the main variables. The difference between previous research and this research lies in the samples studied. Previous researcher choose the sample consist of 70 countries, 35 countries have defaulted on their loans and 35 countries never defaulted on their international debt repayment, while the researcher are currently used the data of interest rate, exchange rate, inflation, and Foreign Direct Investment Level from the year 1998-2013 study period. The other difference is previous research use cross section while current researches use time series.

3. Sarwedi (2002)

This research analyzes relation between GDP, Growth and export with Foreign Direct Investment. Foreign Direct Investment becomes one from many financing source that important enough for development country. The samples used by previous research are Foreign Direct Investment data from 1978-2001. Previous research done by Sarwedi (2002) "*Investasi Asing Langsung di*

Indonesia dan Faktor yang Mempengaruhinya" use Gross Domestic Product (GDP), Growth, and export as the dependent variables, while the independent variable is Foreign Direct Investment. Regression analysis used in this research.

These researches explain that macroeconomic variables (GDP, Growth and Export) have positive relation with Foreign Direct Investment in Indonesia. This indicated that actually strengthening economics determinants supported by conducive policy will affect Foreign Direct Investment performance in Indonesia.

Similarities between previous research and this research are both of researchers explain about foreign direct investment and the subject of this research is Indonesia. The difference of previous research and this research are the data that used for research. Previous research used Foreign Direct Investment (FDI) data from 1978-2001, while current research use the Foreign Direct Investment (FDI) data from 1998-2013. The variable between previous research and this research was also different. Previous research use GDP, Growth and Export as variables. While this research used interest rate, exchange rates and inflation as variables.

4. Yati Kurniati, Andry Prasmuko, Yanfitri (2007)

Research titled "*Determinant FDI"* aims to analyze Foreign Direct Investment determinants in Indonesia. Sample used in the previous research are Foreign Direct Investment data from 1996-2005 in Indonesia. With the variables are Growth, Political Stability and Exchange Rates. Multiple regressions used in this study as the analysis tool.

The result of this research is there are positive and significant impacts from market potential, financial stability that can be seen from the stability of exchange rates to Foreign Direct Investment (FDI) in Indonesia.

A similarity between previous research and this research lies in the variables. Both of researchers use Exchange rates as independent variable and Foreign Direct Investment as the dependent variable.

The difference between previous research and this research lies in the sample. Previous research use Foreign Direct Investment (FDI) from the year 1996-2005, while the researcher uses Foreign Direct Investment (FDI) data from the year 1998-2013.

5. **Ruiz and Pozo (2008)**

Ruiz and Pozo (2008) analyze the impact of exchange rate levels and exchange rate uncertainty on US foreign direct investment into Latin America. The samples used in Ruiz and Pozo research are seven Latin American Countries – Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela – for the 1994-2005 periods. By using exchange rate and exchange rate uncertainty, this research also use GDP growth and inflation as the variables. The impact of exchange rates and exchange rate uncertainty on FDI is estimated using a fixed effects model.

The results of previous study find 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. A similarity between previous research and this research lies in the variables both researchers use exchange rates as the main variable. While the difference between previous research and this research lies in the sample and the analysis technique. Previous research use seven Latin American Countries – Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela – for the 1994-2005 periods, while the researcher uses Foreign Direct Investment (FDI) data from the year 1998-2013 and regression data time series while previous study use panel data analysis.

2.2 Theoretical Basis

1.2.1 Foreign Direct Investment

MNCs commonly capitalize on foreign business opportunities by engaging in foreign direct investment (FDI), which is investment, in real assets (such as land, buildings, or even existing plant) in foreign countries (Madura and Fox, 2007:463). MNCs engage in joint ventures with foreign firms, acquire foreign firms and from new foreign subsidiaries. Any of these types of FDI can generate high returns when managed properly.

MNCs commonly consider foreign direct investment because it can improve their profitability and enhance shareholder wealth. In most cases, MNCs engage in FDI because they are interested in boosting revenues, reducing cost, or both. The following are typical motives of MNCs that are attempting to boost revenues according to Madura and Fox (2007:464-465):

a. Attract new sources of demand

b. Enter profitable markets

c. Exploit monopolistic advantages

d. React to trade restriction

e. Diversify internationally

f. Fully benefit from economic of scale

g. Use foreign factors of production

h. Use foreign materials

2.2.2 Multinational Corporation

The commonly stated goal of a firm is to maximize its value and thereby maximize shareholders wealth (Madura and Fox, 2007:464). Developing business at an international level is an important means of enhancing value for many firms. Many barriers to entry into foreign markets have been reduced or removed recently, thereby encouraging firms to pursue international business.

Many firms have evolved into multinational corporations (MNC), which are defined as firms that engage in some form of international business (producing and selling goods or services in more than one country) (Madura and Fox, 2007:2). It ordinarily consists of a parent company located in the home country and at least five or six foreign subsidiaries. Firms may merely attempt to export products to a particular country or import supplies from a foreign manufactures.

An understanding of an international financial management is crucial not only for the Multinational Corporation (MNC) but also for small and medium sized enterprises. International financial management is important even to companies that have no international business because these companies must recognize how their foreign competitors will be affected by movement in exchange rates volatility, interest rates and inflation. Such economic characteristic can affect Multinational Corporation (MNC) cost of production and pricing policies.

2.2.3 Country Risk Theory

Multinational Corporation (MNC) conducts country risk analysis when assessing whether to continue conducting business in a particular country (Madura: 2003). The analysis can also be used when determining whether to implement new projects in foreign countries. Based on Shapiro (2009:317) country risk is the assessment of the potential risk and reward associated with making investment and doing business in a country. Country risk analysis is not restricted to predicting major crises such as a terrorist attack, the imposition of trade restrictions on import, etc. by necessity; it must also study the political factors that give rise to particular economic policies. This is the subject matter of Political Risk the interaction of politics and economics. Country risk can be divided into several risks such as Political Risk, Financial Risk and Socio-Cultural Risk (Hamdy Hadi, 2012:284).

Multinational Corporation (MNC) must asses' country risk not only in countries where it currently does business but also in those where it expects to export or to establish subsidiaries. Although expropriation is the most obvious and extreme form of political risk, there are other significant political risks. Although the consequences are adverse, changes in political environment can provide opportunities as well. As one might expect, many country characteristics related to the political environment can influence Multinational Corporation (MNC). In some cases of expropriation, some compensation is awarded. In other cases, the assets are confiscated and no compensation is provided (Madura and Fox, 2007:549). Based on Madura and Fox (2007:550) and Hamdy Hady (2012:284-285). The following are some of the more common forms of country political risk:

a. Attitude of consumers in the host country
b. Actions of host government
c. Blockage of fund transfer currency inconvertibility
d. War and regulatory restrictions
e. Corruption
f. Bureaucracy
g. Government system
h. Political system
i. Law

Socio-Cultural Risk consists of:

a. Social group (ethnic, religion, language and social class)
b. Attitude of the population (against time, work, success and change)
c. Illiteracy rate
d. Political awareness of the population
e. Social unrest

In general, political factors and financial factor, more dominant and take effect to firms operational. But in certain thing, socio-cultural can be more dominant for example in the case of religion or race.

Along with political factors, financial factors should be considered when assessing country risk. In this research, researcher use Financial Risk as variables to assess Multinational Corporation (MNC) Foreign Direct Investment (FDI).

1.2.4 Country Financial Risk

One of the most obvious financial factors is the current and potential state of the country's economic. 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's economy.

A country's economic growth is dependent on several financial factors (Madura and Fox, 2007:557)

a. Interest Rates. 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.

b. Exchange Rates volatility. Exchange rates volatility can influence the demand for the country's exports, which in turn affects the country's production and income level. The more volatility a country currency indicates that the current economic condition of that country is vulnerable. It 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.

c. Inflation. 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.

2.2.5 Inflation

Inflation is an increase in the average level of prices of goods and services (Schiller, 2006:133) or the annual percentage rate of change in the price level (Madura and Fox, 2007:495). In this case, for make a calculation to measure inflation, we first determine the average prices of all output and then the average price level then look for the changes in that average. A rise in the average price level is referred to as inflation (Schiller, 2006:133).

The average price level may fall as well as rise. Like a deflation that can be define as a decline in average prices or a situation which the prices of most goods and services are falling over time so that inflation is negative (Schiller, 2006:133). It occurs when price decreases on some goods and services outweigh price increases on all another.

There are three types of inflation: moderate inflation, galloping inflation, and hyperinflation (Suparmoko, 2000:299-300). Moderate inflation characterized by prices rise sharply. If the price relatively stable, people believe to money because the value of money will be same next month or next year. These things of course give a positive sign for Multinational Corporation (MNC) because there is a potential that a big inflation will not happen because it could bring Multinational Corporation (MNC) to a loss. Galloping inflation is two digit or three digit inflation like twenty, a hundred or two hundred percent per year. If galloping inflation happen, then come a serious economic interference such as the loss of money value will be drop very fast. As the consequences, people only hold a minimum amount of money. Of course it will be disadvantages for Multinational Corporation (MNC) if still want to invest in this kind of country. So Multinational Corporation (MNC) must delete this kind of country from investment destination list. The last one is hyperinflation. This kind of inflation is the most dangerous than the other two kinds of inflations.

2.2.6 Interest Rates

Interest rates are the prices paid for borrowing money or the rate at which interest is paid by for the borrower for the use of money that they borrow from a lender (Samuelson and Nordhaus, 2012:190). A small company borrows capital from a bank to but new assets for their business, and in return the lender receives interest at a predetermined interest rate for deferring the use of funds and instead lending it to the borrower. Interest rates are normally expressed as a percentage of principal of a period one year.

Based on Samuelson and Nordhaus (2012:194), Interest rate can be divided into two kinds of interest rates. The first one is nominal interest rates that can be defined as interest in the value of money. In finance and economics, for interest rates as stated without adjustment for the full effect of compounding referred to as nominal annual rate. Otherwise, the real interest rate is the nominal rate of interest minus inflation.

Business people carefully monitoring interest rates levels because interest rates determine the amount of money must be paid to a bank if borrowing money. Interest rates fluctuation in the market can affect Multinational Corporation (MNC) interest costs because interest on loans requested by the bank based on interest rates determined by Central Bank.

Interest rate affect financing costs, some project regarded feasible in low interest rates period may not feasible in high interest rate period. Project maybe cannot restore it financing costs. As the consequences, firms tend to decrease the expansion level if the interest rates in high period.

Interest rates also affect Multinational Corporation (MNC) income and interest costs. If interest costs increased, financing costs also increased. So Multinational Corporation (MNC) demand will be decreased because if interest costs and financing costs increased, Multinational Corporation (MNC) operational costs will be increased as the effect from the payment of higher interest costs. It means that the price of Multinational Corporation (MNC) goods and services become higher so consumers will reduce their purchases.

2.2.7 Exchange Rates Volatility

An exchange rates measures the value of one currency in units of other currency (Madura and Fox, 2007:123) or in the other word, exchange rates is the rate at which two currencies can be traded for each other (Frank and Bernanke: 2007:865).

Exchange rate movements affect Multinational Corporation (MNC's) values because exchange rates can affect the amount of cash inflows received from exporting or from a subsidiary, and the amount of cash outflows needed to pay for import. A decline in a currency's value is often referred to as depreciation (Madura and Fox, 2007:123). When Indonesia Rupiah depreciates against the US dollar, this means that the US dollar is strengthening relative to the rupiah. The increase in a currency value is often referred to as appreciation.

Exchange rates can affect a country export demand that will affect production and a country income level. A strong exchange rate can decrease a country export demand, increased a country product import and because of that it will decreased production and national income of that country. A weak exchange rate can cause speculative outflow and decrease funds available to fund business growth.

Based on Madura and Fox (2007:124), if Indonesia currency experience depreciation, then company in other countries can get Indonesia Rupiah with fewer dollars. So, Multinational Corporation (MNC) tends to invest in Indonesia. The changes in currency's value can have a major impact on cost and revenue.

The potential impact of exchange rates movements on Multinational Corporation (MNC's) costs and revenue is obvious.

In this study, researcher use exchange rate volatility to see the fluctuation of the exchange rate in Indonesia. Indonesia Central Bank defines that there have two kind of exchange rate stability. First is the exchange rate stability toward goods and services. Second is the stability against the currencies of other countries. Exchange rate stability very important to support sustainable economic development. The more stable the exchange rate of a country can foster public confidence and the business world in a variety of economic activities, both consumption and investment. The more fluctuate a country exchange rate will complicate a planning in business activities, both in production and investment activities as well as the pricing of goods and services produced.

2.2.8 The Effect of Financial Country Risk to Foreign Direct Investment

Inflation can affect Multinational Corporation (MNC) operational cost that create products because the increasing of raw materials. Higher inflation level will result in higher operational cost. At this time, inflation level in Indonesia is high. These tend to make Multinational Corporation (MNC) less interested to invest or to open a branch in this country. This is due because inflation can affect consumer purchasing power and also their demand to the Multinational Corporation (MNC's) products because inflation means the rise of many products and services prices. Inflation also has indirect impact to a country financial through its effect to interest rates and exchange rates. High inflation can lead to the decreasing of economic growth.

Higher interest rates tend to slow down the economy growth and decrease Multinational Corporation (MNC) product demand. Otherwise, lower interest rates can often stimulate economy and increase the demand of Multinational Corporation (MNC) products.

The more volatility an exchange rate tends to decrease multinational corporation (MNC) foreign direct investment (FDI). But, the more stable an exchange rate tend to increase multinational corporation (MNC) foreign direct investment (FDI) in Indonesia. It happen because the exchange rates volatility in Indonesia will complicate a planning in business activities, both in production and investment activities as well as the pricing of goods and serviced produced.

2.3 Research Framework

Based on research done by Aguiar, Aguiar, Conraria, Gilamhussen and Magalhaes (2012) there are a positive relation between high levels of risk in a country with low level of Foreign Direct Investment (FDI).

High inflation and interest rates tend to make Multinational Corporation (MNC) not invest in Indonesia. It happen because high inflation and interest rates will make Multinational Corporation (MNC) income decreased. The more volatility an exchange rates will also make Multinational Corporation (MNC) not invest in Indonesia.

From the above description, the author adopted the research framework that could be described as follows.

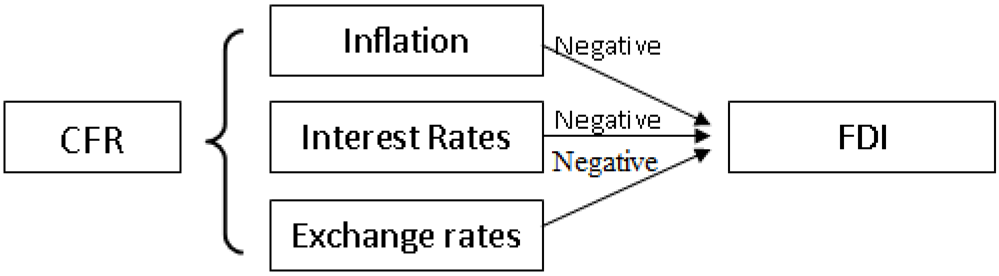

Figure 2.1.

RESERACH FRAMEWORK

2.4 Research Hypothesis

Hypothesis is the answer while the formulation of problem posed in this study. As the formulation, the problem presented and previous studies are used as reference. In this study the proposed hypothesis is as follows:

1 : Inflation has a partial negative and significant impact to Multinational Corporation (MNC) Foreign Direct Investment (FDI) in Indonesia.

2 : Interest Rate has a partial negative and significant impact to Multinational Corporation (MNC) Foreign Direct Investment (FDI) in Indonesia.

3 **:** Exchange Rate Volatility has a partial negative and significant impact to Multinational Corporation (MNC) Foreign Direct Investment (FDI) in Indonesia.