CHAPTER 2
LITERATURE REVIEW

2.1 Introduction

This chapter will be more focused on the review of the existing literature that are related with the macroeconomic factors that can affects the FDI inflows. It will be comprises of the empirical studies and underpinning theory that are related with the current study. The empirical review consist of the review on macroeconomic factors that influencing FDI inflows. The underpinning theory focuses on theory that are related to factors that influenced FDI inflows. Lastly, the section will be concluded by developing suitable research framework for the study.

2.2 Empirical Review

2.2.1 Foreign Direct Investment

Foreign Direct Investment is a form of investment that have been conducted from the foreign country or can be said as an investment from one country to another country on the name of the capital owners (Jhingan, 2004, as cited in Rahajeng, 2014). Based on the explanation of (Jhingan, 2004, as cited in Rahajeng, 2014) it can be concluded that Foreign Direct Investment or FDI for short is an ownerhsip stake in a foreign company project made by an investor, company, or government from another country thus resulting FDI can help improving and maintain the sustainability of the economic growth of the host country. According to Krugman (1991, as cited in Rahajeng, 2014) Foreign Direct Investment (FDI) refers to international capital flows in which corporations from one country create or grow businesses in other countries. As a result, there is not only a shift of resources, but also the imposition of controls on enterprises overseas.

Todaro (2000, as cited in Rahajeng, 2014) argue that private direct foreign investment (FDI) is an investment fund that is directly used to carry out commercial activities or acquire equipment or production facilities such as purchasing land, opening factories, bringing in machines, purchasing raw materials, and so on. Foreign direct investment (FDI) can also be defined as the

reinvestment of capital of corporate income and the supply of short and long-term financial services between the parent firm and its subsidiaries or affiliates. FDI is typically associated with investment in productive assets, such as the purchase or construction of a factory, the purchase of land, equipment, or buildings, or the construction of new equipment or structures by foreign enterprises.

Foreign Direct Investment (FDI) is a frequently discussed topic in developing countries since FDI is a key accelerator for economic change and economic transition. Foreign direct investment stimulates economic growth through all channels. Foreign direct investment (FDI) makes a major contribution to human capital, such as managerial skills and research and development (R&D). Through the training courses they provide to their subsidiaries' local personnel, multinational companies (MNCs) can have a positive impact on human capital in host nations (Romer, 1986 ; Lucas, 1988 ; Mankiw et al., 1992, as cited in Prinivasan, Kalaivani and Ibrahim, 2011).

2.2.2 Gross Domestic Product

According to Mankiw (2005, as cited in Prinivasan, Kalaivani and Ibrahim, 2011) Gross Domestic Product (GDP) is a measure of the market value of final products and services produced in an economic cycle over a specific time period. GDP is widely regarded as the most accurate indicator of economic performance. GDP's objective is to summarize economic activity in monetary terms during a specific time period.

GDP measures the monetary value of final goods and services produced in a country in a given period of time, where it counts all output generated within the country's borders because it is composed of goods and services produced for sale in the market and also includes some non-market production such as defence or education services provided by the government. (Callen, 2019, as cited in Rahmawati, 2022).

2.2.3 Inflation Rate

Inflation is defined as an increase in prices that results in a loss of buying power over time. The average price increase of a basket of selected goods and services over time can show the rate at which buying power declines. The increase in pricing, which is frequently stated as a percentage, signifies that a unit of currency buys less than it did previously. Inflation is distinguished from deflation, which happens when prices fall but buying power rises (Fernando, 2020, as cited in Rahmawati, 2022). Inflation has a direct impact on profit and firm success in the real sector, as well as on people's purchasing power. Inflationary pressures can raise manufacturing costs, diminishing firm profits and eroding people's purchasing power as prices continue to climb. Inflation is one of the measure that might describe a country's economic stability.

2.2.4 External Debt

According to Todaro (2000, as cited in Prinivasan, Kalaivani and Ibrahim, 2011), External (foreign) debt refers to all government loans and aid in the form of money or goods that are primarily designed to move resources from rich countries to developing countries, with the ultimate goal of development and income distribution. Foreign finance sources (grants and loans) play an essential role in efforts to supplement a lack of local resources in order to accelerate the growth of foreign exchange and savings.

Todaro assumes that developing countries in general face constraints in the form of limited domestic savings that are far from sufficient to carry out existing investments, as well as a scarcity of foreign exchange that prevents the import of capital goods and the development of important intermediary goods. Simple meaning of Foreign debt is money borrowed by a government, corporation, or private household from the government or private lenders of another country. Foreign debt also includes liabilities to international institutions like the World Bank, Asian Development Bank (ADB), and International Monetary Fund (IMF). Total foreign debt might include both short-term and long-term liabilities (Kenton, 2020, as Cited in Rahmawati, 2022).

2.2.5 Interest Rate

According to Kasmir (2002, as cited in Prinivasan, Kalaivani and Ibrahim, 2011), interest rate are payments made by banks to consumers who buy or sell using conventional principles. Customers can earn two types of interest: deposit interest and interest loan interest. Deposit interest is paid as an incentive to save money in a bank, whereas loan interest is given to the borrower or the price to be paid by the borrower's client. Because the two types of interest are mutually exclusive, if the interest on deposits is high, the interest on loans will automatically rise, and vice versa.

The interest rate is the amount charged by a lender to a borrower and is expressed as a percentage of the principal amount lent. The annual percentage rate (APR) is the term used to describe the interest rate on a loan. An interest rate can also be used to the amount earned from a savings account or certificate of deposit (CD) at a bank or credit union. The income generated on these deposit accounts is referred to as the annual percentage yield (APY) (Banton, 2021, as cited in Rahmawati, 2022).

2.3 Underpinning Theories

Underpinning theory for this study will be differ into two categories which divided into the investment related theory that are related to the study and foreign direct investment related theory that are also related to the study.

2.3.1 Keynes Theory

According to Keynes' theory, the interest rate, cost of use, and profit size are all factors to consider when making investments. The predicted level of profit is referred to as "Marginal Efficiency of Capital" (MEC). The profit rate projected net rate of return on extra capital expenditures is denoted by MEC. Investors are hesitant to invest when MEC exceeds the interest rate. Because when interest rates are high, investors will prefer to put their money in the money market rather than participate in risky investments. However, Keynes claimed that interest rates are not the sole factor influencing investment; there are other factors, such as the economic condition, that influence investment. (Amin, 2003, as cited in Rahajeng, 2014).

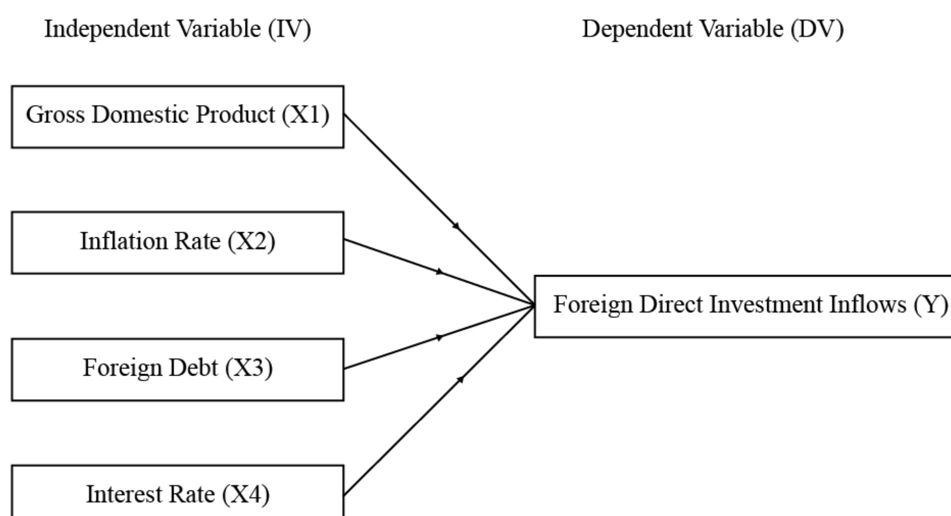
2.3.2 Stephen Hymer's Theory

The theory of foreign direct investment was first developed by Hymer (1965, as cited in Prinivasan, Kalaivani and Ibrahim, 2011) by proposing the contemporary monopolistic advantage argument, which demonstrates that investment Foreign direct investment is more common in oligopolistic businesses than in near-perfect competition industries. Hymer argues that the essence of direct investment is maximum profit, which can lead to actions of resource mastery, decreasing the degree of competition amongst foreign investors to operational collaboration between them (Nusantara, 2014, as cited in Rahmawati, 2022).

Then Hymer's theory was developed by Buckley-Casso (1976, as cited in Rahajeng, 2014) who assumed whereas foreign investment decision-making is based on, first the company must maximize profits during imperfect market conditions. Second during imperfect market conditions, there is an opportunity to create an internal market to reduce the impact of market imperfections. Lastly the third is the efforts to internalize international markets result in the creation of multinational corporations (MNCs).

2.4 Research Framework

Based on the literature review above, the study will propose a conceptual framework that will be illustrated on the figure 2.1



Source: Data Processed, 2023

Figure 2.1 Conceptual Framework

2.5 Research Hypotheses Development

The goal of this study is to uncover the macroeconomic factors that may or can influence the Foreign Direct Investment (FDI) inflows of recognized ASEAN States member. This resulting on the construction of the hypotheses were it will be using the conceptual framework outlined in the previous section. This study uses one dependent variable and four independent variables.

Based on the research framework, the hypothesis in this study is the allegedly macroeconomic factor variables that may affect the FDI inflows of recognized ASEAN States member in 2010-2021. The following are hypotheses developed based on research findings or gaps that occurred in previous studies.

2.5.1 Gross Domestic Product and FDI Inflows

When there is an increase in demand means an increase in economic growth so that it will stimulate investors to invest (Dumairy, 1996, as cited in Rahajeng, 2014). According to Sukirno (2003, as cited in Rahajeng, 2014) A high level of national income will increase people's income and will further increase the demand for goods and services. Profit the company will grow taller and will encourage more investment (Adhitiya, 2007, as cited in Rahajeng, 2014). The GDP does have a strong bond with the investment and also applies the same with the FDI. Furthermore, the link between FDI and domestic investment is complex. It is believed that with the correct government measures, total productivity will rise, resulting in more stable macroeconomic conditions. Economic growth can be highlighted in the context of the economic cycle and long-term sustainable growth of the country in question. Long-term growth is represented in GDP levels, therefore high GDP levels promote greater inflows of foreign investment (Solnik and McLeavey, 2009, as cited in Prinivasan, Kalaivani and Ibrahim, 2011). This indicates that GDP have a significant impact towards FDI.

H_1: *Gross Domestic Product influences FDI inflows of ASEAN States.*

2.5.2 Inflation Rate and FDI Inflows

A high inflation rate suggests internal economic instability; it signifies that the government is unable to balance the economy and that the central bank has

failed to implement appropriate monetary policy. Companies experience price and input price unpredictability as a result of the high inflation rate. Thus under such conditions, multinational corporations will avoid or restrict investment in nations with high inflation rates. (Dhakal et al., 2007, as cited in Rahajeng, 2014).

H_2: *Inflation rate influences FDI inflows of ASEAN States.*

2.5.3 External Debt and FDI Inflows

Agung (2014, as cited in Rahajeng, 2014), finds that debt has a negative role towards FDI inflows in developing countries. Agung (2014, as cited in Rahajeng, 2014), indicated that the existence of debt will raise government risk. The more the debt value, the greater the risks that a country's government faces.

H_3: *External debt influences FDI inflows of ASEAN States*.

2.5.4 Interest Rate and FDI Inflows

According to classical theory, investment is a function of interest rates. If the interest rate rises, so will the desire to invest. This is because if an entrepreneur increases his investment, it is assumed that the investment will still be more than the cost of capital in the form of interest rate paid. if a result, if interest rates fall, investors will be pushed to make investments due to lower consumption and costs. (Sukirno, 2003, as cited in Rahajeng, 2014). If an entrepreneur increases his investment, it is assumed that the investment will still be more than the cost of capital in the form of interest rate paid. if a result, if interest rates fall, investors will be pushed to make investments due to lower consumption and costs. (Sukirno, 2003, as cited in Rahajeng, 2014).

H4: *Interest rate influences FDI inflows of ASEAN States*.

2.6 Chapter Summary

In brief this chapter revolving on every macroeconomic factor that influencing FDI inflows, theories that related to the investment, also the gap that resulted from the previous study. This chapter also presenting the research framework for the study and the development of the hypothesis.