The Impact of Foreign Debt Financing and Domestic Private Credit Financing, Foreign Direct Investment, Exchange Rate, And Debt Service Ratio to Indonesia Gross Domestic Bruto

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Abstract. The purposes of the article are to provide a review at a glance of the impacts of foreign debt financing, domestic private credit financing, foreign direct investment, debt service ratio, and exchange rate on the gross domestic product (GDP) of Indonesia. The study shows that foreign debt financing and domestic private credit financing have positive correlations but foreign direct investment, exchange rate, and debt service ratio have a negative correlation to GDP. Foreign debt has sovereign risk and should be managed prudently in terms of governance and administration and efforts to attract foreign direct investment (FDI) should be increased and enhanced.

Keywords: domestic private credit financing; debt service ratio; foreign direct investment; and foreign debt financing

1 Introduction

The global crisis mainly caused by the Covid19 pandemic started at the end of 2019, hampered in Indonesian March 2020, and then spread out worldwide. The impact of the Covid19 pandemic crisis on Indonesia's economy come up in the third quarter of 2020 and economy growth sharply plummeted to -2,7%. Indonesia's population was 269,7 million in 2020 with the gross domestic product (GDP) around 15,84 trillion Rupiah and an expected steady increase in economic growth. Indonesia implements an open economy for trade, economy, monetary and financial system. Globalization and international trade trends and strengthening multinational company's roles caused inter countries' relationships to have unique characteristics in terms of bilateral, regional, and multilateral.

The prolonged pandemic Covid19 and economic crises and the need to finance government expenditures in almost every country triggered global waves of government debts. In general, there are three waves of government debts (Kose et.al. 2021). The first wave emerged in 1970 – 1989 when economic crises happened in Latin America and low-income countries. The second wave was the financial crisis in East Asia countries in 1990 – 2001. Third wave when financial crises happened in Europe Union and North America regional, in the period of 2002 – 2009. It seems unavoidable that the fourth wave of global government debts started in 2021 and might

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be lasted at least 6 to 8 years due to the prolonged Covid19 pandemic and the need of economy recovery.

Increasing the need for foreign debt financing by governments mainly sources from deficit budget policies implemented almost by every government where budget revenues are smaller than expenditures – the gap between expenditures and revenues tends to be wider - either due to the shortages of domestic funds sources and to finance economic targets such as economic growth, public investments in infrastructures, poverty elevating, job employment, health, and others. In substance foreign debt direct correlation with sovereign risks for a government. Types of such risks can be in terms of exchange rate volatilities with strong currencies like US$ or euro, export, political stability, macro policies in monetary and fiscal and repayment ability debts maturity in current year compare to export where export regarded as trade activities generated income in term of foreign currencies.

Globalization trend is rapid growth and accompanying by technology advances affect countries relationship to be borderless. Trade globalization is characterized by increasing roles and influences of multinational companies (MNC) that operate in several countries and determined such countries to be home base operations as global value chain (GVC) bases. In general, MNC existence in a country can be represented by foreign direct investments (FDI). According to Sjoholm (2016) FDI has positive impacts on Indonesia's economy. Currently, the situation and conditions in Indonesia go in the right directions such as strong financial position, economic growth, and better harmonization and integration between fiscal and monetary policies and such factors could be capitalized to attract FDI to invest in Indonesia as one of FDI destinations.

Efforts to improve export performance had been done but the increased competitiveness to attract FDI among developing countries should be considered as a need of new approaches to attract foreign investors, especially MNCs that have global supply chain networks to invest in Indonesia. The study uses data from 2000 - to 2019 consisting of GDP, foreign debt, domestic private credit, FDI, exchange USD 1 to Rupiah (Rp), and debt service ratio. Based on the data, growth of private domestic credit is stagnant relatively and also FDI growth in Indonesia is not significant. The exchange rate USD/Rp and debt service ratio are steadily increasing where debt service ratio calculates through the ratio of the sum of the principal of debts mature in the current year and interest expense must be paid in the current year compare to export performance. Such obstacles should be reviewed in comprehensive to come up with reasonable resolutions to contribute to economic welfare, human resources improvement, competitiveness, technology advances, and Indonesia's economic resiliency.

Economic Financing, Foreign Debt and Debt Service Ratio

Budget management to run government administration is a little bit different from private business due to government’s power to impose taxes and legal permit fees levied to its citizens where tax is considered to treat as a main source of revenue. Budget expenditures in general related to targets and approved by parliament covering such as economic growth, public investment in infrastructure, job employment, health and others. When expenditures is greater than revenues, the shortage should cover by loan or debt financing from either domestic or foreign creditors.

In term of financing, government may finance in the form of borrowing loans from domestic or foreign, foreign direct investment, release bonds and official lending from International Monetary Fund or World Bank. Krugman and Obstfeld (1991) stated that most of developing countries had current account deficits that it could be said as a reflection foreign debt financing to fund its economy development. History of debt was emerged in 19th century when United Kingdom released debt securities without maturity date and with options that could be repayment at any time based on market price as a contingency protection for investors in case of favorable market condition (Musgrave and Musgrave, 1980).

Government debts raised many issues such as debt limitation and future generation burden. Debt limitation is usually related to proportion to GDP and some argue that debt amount as a manageable value is around 60 – 70 % of GDP with assumptions that debt growth lower that GDP growth and interest rate is relatively in stable condition. Indonesia imposed budget fiscal limitation. According Law No. 17 Year 2013 regarding Public Finance stated maximum budget deficit is 3 % of GDP but because of the prolonged pandemic Covid19 such law amended through Law No. 20/2020 stated that budget deficits are 6,34 %, 5,7% and 3 % of GDP in 2021, 2022, 2023 respectively.

Future generation burden issue related to long term debt where some said future generation would pay higher taxes and reduce standard of living and hinder economy development. In other side some argue that in modern finance and economy, maturity debts in the future date could be refinanced. New classical economics views stated that additional debt assumed tax and debt obligation are levied in the future and if citizens predict in rational matters the additional taxes can be anticipated. In turn budget fiscal policy applied through additional debt obligation is assumed as a trigger to accelerate economy development (Gwartney and Stroup, 1997). Countries with high growth of debt accumulation are usually accompany with crises happened in such countries (Kose et.al, 2021).

In term of foreign debt, Guzman (2018) analyzed foreign debt sustainability related to distressed contexts. Foreign debt obligation agreements might be revised due to uncertainty and deviation of original term and condition stipulated in such agreements covering new relevant constraints of debt sustainability, stabilization debt obligation model fended for fiscal and debt policies and distribution capability absorbed and buffered shocks of debts affected to repayment capacity and public and foreign debt creditors.

To prevent crisis, cause of sovereign debt store, Barensztein et.al. (2004) suggested applying sound formulation and implementation to reduce potential crises and expressed as a prerequisite condition to debt restricting and introducing financial innovation and implementing debt registration and publishing such registration to fulfill transparency, including set up unit has Attraction to developing countries as one of investment destination for foreign investors tends to increase steadily due to more strengthen in financial position, debt securities of developing countries regarded as portfolio diversification, improvement of balance of payment and foreign exchange reserve increasement (Das and Grandolini, 2006).

Foreign debt in this review is incuded government and private foreign debt. In general, foregin debt related to sovereign risk mainly regarding currency volatility. Repayment ability for foreign debt is how far a country's responsibility to administration debt and releasing time table of public debt offering.

Tabel 1. GDP, Foreign Debt, Domestic Private Credit, Foreign Direct Investment (FDI), Exchange Rate USD1/Rp/USD, and Debt Service Ratio (DSR) in the period of 2000– 2019 in Indonesia

Year	GDP	Foreign Debt	Domestic Private Credit	FDI	USD1/Rp	DSR
2000	150	141,7	5,2	15,42	8422	0,228
2001	142	131,2	18	15,06	10426	0,232
2002	173	129,8	25,1	9,79	9295	0,24
2003	208	132,4	22,1	13,21	8578	0,255

2004	257	137,4	30,4	10,28	8933	0,221
2005	307	133,9	19,7	8,92	9705	0,208
2006	364	129,5	12,1	5,98	9165	0,252
2007	433	137,4	22,4	10,34	9141	0,188
2008	512	155,1	30,7	14,87	9687	0,141
2009	539	172,9	7,2	10,81	10405	0,194
2010	710	202,4	19,6	16,21	9086	0,174
2011	846	225,4	25,4	19,47	8772	0,144
2012	879	252,4	22,3	24,56	9381	0,168
2013	1018	266,1	20	28,62	9375	0,194
2014	1015	310,1	11,8	28,53	10414	0,157
2015	973	315	10,3	29,27	11862	0,126
2016	926	320	7,7	28,96	13391	0,37
2017	1021	352,5	8,7	32,23	13306	0,29
2018	1114	376,5	12	29,31	13383	0,25
2019	1199	415	12,3	28,21	14231	0,39

Sources: IMF and World Bank

1) GDP, Foreign Debts, Domestic Private Credit, and FDI in million USD
2) Foreign Debt, Domestic Private Credit and FDI are position in the end the year.

Capability to provide foreign exchange reserves generated mainly from international trades that is export. Such export might be composed commodities, mining, manufacturing and or high-tech products where commodities and mining products are usually faced price volatility in global market. Countries run international trade have two underlying reasons where each reason should contribute to trade gain that are each country trade different goods with other and each country endeavors to achieve economic scale (Krugman and Obstfeld, 1991).

Up and down trade volume in export influence directly to up and down foreign exchange reserve accumulation and exchange rate currency. Each country wants positive net export where export is greater than import that in turn generating foreign exchange reserves. The greater foreign exchange reserve, the more capable the country repay its foreign debt in term of principal installment and interest expenses matured in current year. Regarding repayment foreign debt, it is usually used debt service measurement to picture a countries' repayment capability where calculated sum of principal loan portion matured in current year plus interest expenses ust be paid in current year compare to total export current year.

Investment and Foreign Direct Investment

Investment terminology has different meaning in the context of macro economy and individual business. In term of macroeconomy, investment is to buy or disburse fund to build or create new houses, manufacturing and equipment's, inventories and infrastructures (Hall and Taylor, 1988). Investment as regarded by individual business is to buy existing houses, securities and other portfolio. According to macro economy, investment activity by individual business is treated as asset movement among individual but not new creation of productive capacity. Foreign investment consists portfolio investment, export credit and foreign direct investment.

In this review, we focus on foreign direct investment (FDI). According to Griffin and Pustay (1996), foreign direct investment is foreign asset acquisition for purpose controlling such asset. In other words, foreign investors invest their fund and active involvement to run businesses in certain country or countries where active involvement in operational businesses could be assumed to run businesses in the long run generated financial gain. Many considerations for foreign investors set up business in a country. Such considerations can be divided into economic and noneconomic factors where economic factors are as follows large domestic consumers related to large population, exchange rate stability, tariff and taxation, infrastructures (road, port, airport, and electricity) available land, stability macroeconomy and monetary policies. In general, Indonesia's economy has gained positive impacts and benefited from FDI existence (Sjoholm, 2016).

Non-economic factors considered by foreign investors to invest directly in term of set up and operate business in Indonesia are least covering political and security stability, law system and law assurance factors. In certain cases, FDI existence in Indonesia should be reviewed if business operation has affected negatively that ruined eco-environment. In general, FDI contribute positive economy growth for a country where FDI exists and contributes benefits such as 1) a source of development economy funds and modernization and income growth and job employment, 2) a trigger of technology transfer, enhance job skill, contribute international trade integration, as sit competitive business climate and business development through higher economy growth and reducing poverty, and 3) as sit improvement social and environment quality (OECD, 2002). Some previous studies regarding investment and foreign direct investment are as follows.

Epaphra and Mwakalasya (2017) stated that FDI in agriculture sector had increased economy growth in Tanzania. Kattabi and Karim (2019) explained relationship and improvement export performance in Maroko caused of France's automobile companies invested in Maroko. Automobile industry growth affected economy growth in India explained (Miglani, 2019). The importance of infrastructure investment to add on economy growth in medium and long term either in developing or developed countries and investment vakues in developing countries had been recommended around 6 to 10 % of its GDP (Han, Su and Thia, 2020). According to Seidu et.al (2020) stated that investment in infrastructures had positive impact to economy growth in Great Britain.

According to World Bank in World Development Report of Trading for Development in The Age of Globlal Value Chain (2020) stated that FDI applied by multinational companies that a part of global value chain (GVC) has positive to a country. Some benefits of GVC companies' existence are as follows: open and increase job employment, transfer of technology, job skill improvement, export boosting and in turn to increase economy growth. Existence of GVC in a country is also to as sits such country to accelerate integration to international trade and global chain network.

Exchange Rate

Currency exchange rate for a country is determined by supply and demand of its currency to fulfill its international trade payment and obligations. Levi (1996) stated that four major factors affected exchange rate: a) term of trade and trade volume, b) inflation, c) trade service income and transfer flow, and d) foreign direct investment, portfolio investment and or addition bank deposit by nonresident.

Improvement in term of trade would affect current rate appreciation dan vise verse. The higher the inflation of a country compare to its trade partners, the lower the value of its currency. The higher services export of the country, the higher the value of its exchange rate. Regarding this review, trade volume is associated with export volume as a base to calculate debt service ratio.

2 Discussion

This tries to review and analysis the impact of foreign debt financing, domestic private credit financing, foreign direct investment, exchange rate and debt service ratio to Indonesia's gross domestic product through multiple ordinary leastsquare regression analysis to test hypotheses. Multiple ordinary least square regression is a technique to test some independent variables to a dependent variable (Gujarati, 1991).

We assume that dependent variabel is Indonesia's gross domestic product and independent variables are foreign debt, domestic private credit, foreign direct investment, exchange rate USD1 to Rupiah (USD1/Rp) and debt service ratio. Based on above assumptions can be expressed that gross domestic product is function of foreign debt, domestic private credit, foreign direct investment, exchange rate and debt service ratio. Equation of such function is written below.

$$Y = \alpha + \beta 1\ X1 + \beta 2\ X2 + \beta 3\ X3 + \beta 4\ X4 + \beta 5\ X5 + \mathcal{E} \qquad [1]$$

Where Y is Indonesia's gross domestic product, and X1, X2, X3, X4, X5 are foreign debt, domestic private , foregin direct investment, exchange rate and debt service ratio respectively, α is a constant, and $\beta 1$, $\beta 2$, $\beta 3$, $\beta 4$, $\beta 5$ are coefficient of X1, X2, X3, X4, X5 respectively and $\mathcal{E}$ is error term with hypotheses assumptions: H0 : $\beta 1, \beta 2 , \beta 3 , \beta 4, \beta 5 = 0$ and Ha : $\beta 1, \beta 2 , \beta 3 , \beta 4, \beta 5 \neq 0$. Applying equation [1] with log normal, we get

$$\text{Ln } Y = \alpha + \beta 1 \ln X1 + \beta 2 \ln X2 + \beta 3 \ln X3 + \beta 4 \ln X4 + \beta 5 \ln X5 + \mathcal{E} \qquad [2].$$

Basod on data in Table 1 and OLS multiple regression technique with applying equation [2], we get R2= 0.96 and adjusted R2= 0.92 meaning that all indenpendents have strong influence relationship to a dependent variable. In other words, foreign debt, domestic private credit, foreign direct investment, exchange rate and debt service ratio variables have influence contribution equal to 92% toward GDP. Numeric result of equation [2] is mentioned below.

$$\text{Ln } Y = -17.19 + 2.84 \ln X1 + 0.17 \ln X2 - 0.9 \ln X3 - 0.6\ \beta 4 \ln X4 - 0.52\ \beta 5 \ln X5 + \mathcal{E}$$

(5.07) (0.4) (0.12) (0.27) (0.68) (0.23)

Above results is also proof that test hyphotheses are true where Ha: $\beta 1, \beta 2 , \beta 3 , \beta 4, \beta 5 \neq 0$ and $\beta 1= 2.84$; $\beta 2 = 0.17$; $\beta 3 = -0.9$; $\beta 4 = - 0.6$; $\beta 5 = - 0.52$.

Variables Description

With constant $\alpha = - 17.19$ can be explained that GDP variabel value before or without influence of foreign debt, domestic private credit, foreign direct investment, exchange rate and debt service ratio variables where if GDP variable value = 0 , GDP value = - 17.94 billions USD. From data of Table 1 shows that GDP value trends to increase steadily. Foreign debt coefficient is 2.84 meaning that if foreign debt increase by 1 million USD will increment GDP by 2.84 millions USD. Foreign debt value also tend to increase. Domestic private credit is 0.17 meaning that additional domestic private credit by 1 million USD will increase GDP by 0.17 million USD. Domestic private credit growth is relatively small.

Coeficients results of three other variables that are foreign direct investment, exchange rate and debt service ratio are – 0.9 , - 0.6 and -0.52 respectively and have negative signs where movement directions are opposite direction with movement of GDP. Foreign direct investment coefficient is – 0.9 meaning that if foreign direct investment incremental by 1 million USD will reduce GDP by 0.9 million USD. Exchange rate coefficient is – 0.6 that reduced GDP by 0.6 million if any increase 1 point of exchange rate. Coefficent of debt service ratio is – 0.52 and it can be said that any increase debt service ratio by 1 % will reduce GDP by 0.52 millions USD. Debt service ratio tends to climb.

Foreign Debt, Exchange Rate and Debt Service Ratio

Foreign debt, exchange rate and debt service ratio factors are closed relations each other. As mentioned above that foreign debt has positive impact on GDP. Based on previous studies and further review, it can be said that foreign debt management should be in prudent and sound manners, including recording and administration especially government foreign debt. Soverign risk and financial sustainability are some factors considered even foreign debt has positive impact on GDP.

The administration should have a mission to reduce foreign debt gradually with regard of financial soundness and resiliency and related targets such as economy growth, proverty elevation, infrastructure investment, health, education, green economy and others. Other mission might be converted foreign debt to domestic currency with regard creditors trust and financial market maturity. Global uncertainty in term of global economy downturn due to the prolonged of covid19 pamdemic, commodities price volatility, supply chain disruption, oil price shock, war, high inflation and unemployment, high negative net export and others should be anticipated because of such factors affect debitor repayment ability and evenmore if domestic currency value is steadily depreciate comparing to foreign currency requirement stipulated in foreign debt agreement.

Regarding financial crisis, Indonesia had experience in 1998 where Rupiah value depreciated around 300% to USD and in turn jeoparding economy activities followed by political reform. Historical data exchange rate USD1/Rp from Table 1 started year 2000 – 2019, Rupiah value depreciated 68,9% in total and average depreciation value of Rupiah to USD was 3.49% per year. The lower Rupiah value to USD, the higher the impact to foreign debt repayment ability in term of USD currency. Foreign debt repayment ability is influenced by several factors. Such factors are foreign exchange reserves where come from export revenue, cash in foreign portfolio investment in Indonesia and others. Based on above explaination we expect that Indonesia trade (export) volume is smaller than US trade volume that it can be implied from average depreciated value of Rupiah to USD amounting 3.49 % per year, other things assumed constant.

Some argue that the lower value of Rupiah to USD has positive impacts on price competitiveness of Indonesia goods trading in global market where in turn it will increase export and generate foreign exchange reserves and this relationship should be studied further to measure relationship price competitiveness of export goods, exchange rate, and incremental foreign exchange reserves. Macro economy and monetary policies also affect currency exchange rate where mixed policy between monetary and macroeconomy especially fical policy and other factors such as pilical and security stability should be implemented in prudent and soundness to confine investors and creditors.

This review we focus on export generated foreign exchange reserves since export is as numerator in calculation of debt service ratio. Based on data on Table 1, debt service ratio tends to increase where 1% increase in debt service ratio affected GDP by reducing amount 0.52 millions USD. In other words if the prolonged of Covid19 pandemic and slowly global economic recovery, it is inevitable that foreign debt and global debt waves would emerged and lasted even longer than previous experiences.

From the above data, it can be said that foreign debt growth is higher that debt service ratio growth meaning that incremental income revenues generated from export is less than incremental foreign debt. Rule of the thumb to measure debt service ratio soundness is complex since many factor should be considered. It might be analoged that soundness of a country's total debt to its GDP says 70% and the rest of 30% is to cover risks of currency mismatch, price volatility of export goods and debt repayment sustainability.

Such analogy could be proposed to debt service ratio as a benchmarking indicator to alarm that total foreign debt value must be reduced and or additional foreign debt is subject to scrutinize based on economy targets priority if such ratio reaching over the benchmarking. Recommendation and notion as mentioned above is relied on foreign debt prudent governance and management that might be proposed stipulated in public finance regulations.

Domestic Private Credit

Coefficient number of domestic private credit is + 0.17 meaning that domestic private credit have positive impact on GDP but less than positive impact of foreign debt. From the data of Table 1, domestic private growth is relatively small. We expect that private domestic private mostly flow to consumption purposes where in common knowledge investmet credit purposes have positive impact to increase economy capacity in the midlle and or long range. Such expectation should be studied further to capture comprehensive impacts of domestic private credit impact on GDP.

Foreign Direct Investment

The result of multiple OLS regression analysis said that foreign direct investment has negative impact on GDP since its coefficient is – 0.9 where additional foreign direct investment by 1 million USD has reduced GDP by 0.9 millions USD. Such result is a little bit contrast to previous studies in term of qualitative explaination mentioned by Sjohlom (2016). We expect that such foreign direct investment gn funds are flow in sectors contributed insignificant to boost export or value added to economy. Some global investors of outomobile companies like Toyota and Honda had already invested their funds to set up business and manufacturing process in Indonesia where some portion of their product exported to foreign markets.

In order to boost export, the administration should prepare and provide infrastructures needed, including law and regulations, to attract multinational companies having global value chain. World Bank (2020) informed that global value chain companies invested in Indonesia mostly in commodity and mineral based sectors where commodity prices are relatively volatile and insignificant value added to economy. Global value chain companies assit and expedite Indonesia integration into international trade and enlarge international market segments that had been already penetrated or as new market segments.

3 Conclusion

Based on explanation mentioned above, we try to conclude the study as follows. Variables analyzed in this study tended to increase are gross domestic product, foreign debt and debt service ratio. On the other hand, variables tended to decline are domestic private credit and Rupiah currency compare to USD. Foreign debt and domestic private credit have positive impact on GDP that to raise up GDP whereas foreign direct investment, exchange rate USD1/Rupiah and debt service ratio variables are lowering GDP that have negative impact on GDP.

Borrowing is a normal matter in business or in economy and development and especially to the administration, foreign public debt should be managed in prudent due to domestic fund sources needed to finance and fulfill economy targets determined are still shortage where demand of fund is larger than supply of fund in domestic. Domestic private credit which is given should be studied further and suggested that investment credit purpose is should be greater than consumption credit purpose in order to push up larger incremental of GDP.

Foreign direct investment has negative impact on GDP meaning lower GDP. It is supposed to be expected that mostly foreign companies invested in commodity-based sectors what is have low value added and price volatility of commodity in international market. A lot of works had been done and the study suggest that the administration should enlarge and empower efforts to attract multinational companies that have global value chain networks. Existence of such companies would be boosted export and accelerated trade integration into international trade and penetrated new international market segments.

Exchange rate currency and mixed policies between macroeconomy especially fiscal policy and monetary should be applied prudent management where detrition Rupiah is steadily declining each year convert to USD with regard term of term and trade volume, inflation, service export and others. Debt service ratio is increasing steadily and should be accompanied by risk profile exchange rate and mismatch currency management to approach debt service ratio soundness. The study proposes limitation debt service ratio ceiling as a benchmarking alarm, as deficit fiscal limitation applied, to be further explore as anticipation and preventive actions to face another crisis and foreign debt restructuring, if any.

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