Chapter 2

Literature Review

2.1 Theoretical Background

2.1.1 International Trade Theory

International Trade Theories analyzes and provides explanations of the form, origin, and distribution of benefits of International Trade. As for some theories of International Trade according to experts:

2.1.1.1 Theory of Mercantilism

Mercantilism theory is a theory that believes that the prosperity of a country is only determined by the amount of capital or assets stored in the country and the amount of international trade carried out by the country. Mercantilism also includes national economic policies aimed at accumulating foreign exchange reserves through a positive trade balance, especially in manufactured goods. The term was first introduced by Victor de Riqueti and Marquis de Mirabeau in 1763 and popularized by Adam Smith in 1776. (Ananda, n.d.) A nation may grow its riches and influence by exporting more commodities than it imported, according to mercantilists. This was referred to as a positive trade balance. A positive trade balance, according to mercantilists, would result in an influx of gold and silver, which would raise a nation's riches and power.

The following were some of the strategies that mercantilists favored in order to attain a favorable trade balance:

a. Promotion of exports: Mercantilists held that a nation should increase its exports to other nations while reducing its purchases from other nations.
b. Tariffs and other trade restrictions were supported by mercantilists as a way to control imports and shield native businesses from foreign competition.
c. Colonialism and imperialism: Mercantilists held the view that colonies might serve as a market for exports and a supply of inexpensive raw materials, therefore boosting a nation's power and riches

d. Government regulation of business and trade: Mercantilists held that government regulation of business and trade was necessary to guarantee that exports outweighed imports and to foster the expansion of home industries.

However, foreign direct investment (FDI) can be viewed as a tool for businesses to grow internationally and enhance exports. Businesses may create a presence abroad and start exporting their products and services to the local market by making investments there. By creating items locally, FDI can also assist to lessen dependency on imports.

However, some elements of the mercantilism hypothesis could be in opposition to the advantages of FDI. For instance, the mercantilism doctrine places emphasis on the need to build up gold and silver reserves, which may result in measures intended to stop the movement of money out of the nation. This could deter international investors from making FDI in that nation.

Overall, FDI may be viewed as a means for businesses to grow internationally and enhance their exports, even if there may be some conflicts between mercantilism ideology and the advantages of FDI. Businesses may create a presence abroad and start exporting their products and services to the local market by making investments there. Additionally, by producing items locally, FDI can aid in reducing the dependency on imports, which is consistent with the goals of the mercantilism thesis. It is crucial to remember that some facets of the mercantilism thesis can deter foreign investors from doing FDI nations.

FDI may be a successful strategy for businesses to grow internationally and boost exports, even if the mercantilism doctrine emphasises the value of encouraging exports and restricting imports. By creating items locally, FDI can also assist to lessen dependency on imports. However, while choosing to make FDI investments in various nations, foreign investors must consider the policies of the host nation, particularly those that may be at odds with the goals of the mercantilism thesis.

2.1.1.2 Theory of Absolute Advantage

The theory of Absolute Advantage is the second theory that is the basis of international trade where with a country doing international trade, the country can meet needs and

get benefits. This theory was proposed by Adam Smith in 1766 through a work entitled An Inquiry into the Nature and Causes on the Wealth of Nations. Smith revealed that the prosperity of the country cannot be determined by the number of metals but must look at the amount of national income in the form of Gross Domestic Product and the contribution of foreign trade. If a country is more efficient in producing one commodity than another, but less efficient in another, then both countries can benefit through socialization in the commodity production process that has an absolute advantage (Andrew, n.d.) This theory has important consequences for foreign direct investment (FDI), since businesses can decide to invest in nations with unquestionable advantages in a certain industry or area, such natural resources or trained labor. Companies can acquire high-quality resources or cheaper prices by investing in a nation with distinct advantages, which can assist to boost their profitability. For instance, a business that produces electronic goods could opt to make an investment in a foreign nation with a thriving semiconductor sector. By doing this, the business may be able to get premium components for less money, so boosting its profitability.

The possibility for knowledge and skill transfer across nations is another advantage of FDI connected to the principle of absolute advantage. When a business invests abroad, it brings its expertise, know-how, and technology with it, which may boost production and efficiency. By making an investment in a nation with underdeveloped industries, a corporation can, for instance, introduce innovative manufacturing technologies to boost local employee productivity. This knowledge and skill transfer can contribute to the development of a new ecosystem of enterprises and skilled people in the host nation, which can increase the advantages of FDI.

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In conclusion, the notion of absolute advantage is a basic idea in economics that has a big impact on foreign direct investment. Companies can get access to high-quality inputs, cheaper prices, and knowledge and experience transfer by making investments in a nation with unquestionable advantages. These advantages might assist businesses in achieving their long-term objectives and expanding globally. Therefore, while choosing where to place their FDI investments, foreign investors should take the principle of absolute advantage into account.

2.1.1.3 Theory of Comparative Advantage

This theory is a refinement theory of the theory of absolute advantage initiated by David Ricardo which was raised by Adam Smith. Although a country is efficient in producing both commodities, profitable trade can still be done. A less efficient country will specialize in the production and export of commodities that have smaller absolute losses. This is the so-called country that has a Comparative Advantage. This theory is based on labor value which states that the value or price of a product is determined by the amount of time or labor hours required to produce that commodity. It is said that a country will benefit from international trade if it specializes in products that are produced more efficiently. (Pratama, 2022). David Ricardo argues that comparative differences determine the trade relation. This theory tells us why a country joins International Trade regardless of whether workers in other countries produce commodities more efficiently at an absolute advantage than workers in other countries. David also believes that technology has a very important role in the pattern of International Trade because technological differences in each country are also the largest source of product movement. According to the principle of comparative advantage, international investors should think about making investments in nations that have a comparative advantage in a certain area or industry. Foreign investors may be able to acquire high-quality inputs or reduce prices as a result, aiding in the growth of company profitability. Additionally, FDI can aid in the transfer of information and skills between nations, which can help to boost production and efficiency.

2.1.2 Foreign Direct Investment Theory

The theory of foreign direct investment was first developed by Hymer (1965) by developing the modern theory of monopolistic advantage which shows that foreign direct

investment is more prevalent in oligopolistic industries than in industries operating in near perfect competition. Hymer suggests that the essence of direct investment is maximum profit, which can lead to actions to control resources, reduce the degree of competition between foreign investors to operational cooperation between them (Agung Nusantara, 2014) Then, Buckley-Casson (1976) expanded on Hymer's ideas by assuming that foreign investment decision-making was based on: (1) companies need to maximize profits when market conditions are imperfect; (2) when market conditions are imperfect, there is an opportunity for the development of an international market to lessen the impact of market imperfections; along with (3) this international market internalization effort results in to the creation of multinational companies (MNCs). Hymer also argue that multinational firm exist due to market imperfection which are structural in nature and caused a divergence from perfect competition in the market of final product. Buckley & Casson also added that internalization of economic activities happened because firm can overcome market imperfection (tariff and non-tariff barriers). Firms will feel the internalization when there is an imperfection in the external market or when the cost of production through.

The approach "The OLI Framework" proposed by John Dunning (1977, 1981, 1988) explains the factors that influence foreign investment through electrical design theory. In this theoretical draft, a set consisting of three requirements is set if a company is to enter foreign investment. The three requirements, namely:

a. Ownership Advantage is when competing with enterprises from other nations in supplying certain markets, especially international markets, a company must have specialized advantages, particularly net ownership advantages. In this particular case, ownership-related factors include technological advances, leadership abilities, promotional activities, differentiation of products, trademarks, scale economies, and high expenditures on capital for factories with minimally effective sizes.

b. Internalization of Advantage is when The corporation could gain more from using standard ownership than from granting licenses to foreign owners.

c. Locational Advantage, which can be used by businesses with overseas or host country locations. Natural resources, for instance, or labor that is both affordable and reliable.

The OLI Framework proposed by Dunning above has several weaknesses, among others, it cannot further explain the existence of foreign companies (MNCs), especially regarding developments in FDI. Therefore, it compares the data with existing theories.

2.1.3 Foreign Direct Investment and Trade as Substitute

The general explanation of Foreign Direct Investment as substitute is when a multinational company decides to invest directly in a host country rather than exporting goods to a host country. This will increase FDI and lower exports. According to Mundell, capital movements are affected by trade barriers. Import tariffs reduce exports and affect the FDI rate. Brainard attributes this to a proximity-concentration trade-off approach. FDI becomes an alternative when the fixed costs of setting up a new branch are lower than the cost of trade. High transportation costs and trade barriers will also make companies choose FDI. According to Markusen, FDI is an alternative option to trade when transportation costs and rates are rising even though the FPY proportion becomes greater than the trade. Instead of exporting, the company chose to build production facilities in the host country with the aim of providing local market needs directly and also to avoid transportation costs and other costs such as tariffs.

However, FDI as a substitution also has an effect in the form of an import substitution policy where the state will try to replace imported goods that are the same or similar to local products produced by local companies. Companies that carry out export activities in high-cost countries are forced to build production facilities and replace their export activities.

FDI is mostly market-seeking, and the market is readily available, this reduces or minimizes risk when building production facilities. According to Dunning, if a multinational company targets all advantages (ownership, location, internalization) then it is very likely that the company will choose FDI over export activities.

2.1.4 Foreign Direct Investment and Trade as Complements

Foreign Direct Investment and Trade have complementary relationships where the intermediate goods that are produced in one country are shipped to their affiliates in other country for further processing.

Foreign Direct Investment and export must go hand in hand in the same direction. So, if FDI goes up, then it is expected that exports will also increase. This is what is meant by FDI and trade as complementary aspects to each other. The complementary between FDI

and trade is due to the increasing fragmentation of production, combined with distribution networks found in various countries or continents.

According to Kiyoshi Kojima, FDI and trade are complementary if FDI generates or expands export opportunities. Added by Terutomo Ozawa, FDI occurs in a sector where the home country is lacking, so this expands export opportunities. Meanwhile, according to Robert and Merle, FDI and trade are complementary if when one of the production products produced by foreign subsidiaries increases the demand for the entire product line. Li Gang-Liu and Edward argue that FDI generates new markets in host countries, FDI also gives rise to marketing and distribution capabilities that may result in the export of goods and services to foreign markets which would not be possible without FDI.

FDI and trade as complementary can also be connected with the vertical theory of FDI where vertical FDI aims to achieve economies of scale where production sites are based on cost minimization. Vertical FDI is carried out by the company by moving production stages such as assembling that requires intensive labor to countries that have cheaper labor.

2.1.5 Positive Impacts from Foreign Direct Investment to International Trade

However, there are some studies from past researchers who argue that FDI has positive impacts on International Trade. Tintin argues that FDI spurs economic growth and development in developing, developing, and very slowly developing countries. The analysis also explains how FDI has a greater impact on developing countries compared to those that have developed or whose development is very slow. He stands with a pro-opinion against FDI policies and also improvement in quality of institution because they are interconnected with growth and development. A similar suggestion was also presented by the African Development Bank (2015) in the case of North Africa. Where this research also suggests the same thing to reduce inequality, investment should be made in labor-intensive and prefer weak sectors such as agriculture, fisheries, etc.

Research conducted by Borenstein (1996) also proves that FDI has a positive side. FDI is an important source of technology exchange and contributes more comparatively to economic growth than domestic investment. He also argues that higher FDI productivity depends on the threshold stock of human capital in a country. Not only that, Boreinsten revealed that FDI contributes to economic growth when host countries have substantial absorptive capacity to efficiently absorb (Boreinsten, 1996) foreign modern technology.

Domestic enterprises have greater knowledge of and access to domestic markets, according to Graham and Krugman (1991), and if a foreign firm wishes to enter the market, it must make up for the advantages enjoyed by local firms. A foreign company that chooses to invest in another nation is most likely to benefit from reduced costs and greater productivity than its domestic rivals. It is possible that the better efficiency of FDI in the case of developing nations in particular would emerge from a mix of more contemporary managerial skills and technology; FDI may be the primary conduit via which sophisticated technology is transmitted to developing countries.

2.2 Indonesian Economy

2.2.1 Indonesian Economy Over Time

Although it had experienced an extreme decline due to the Covid-19 pandemic which caused economic growth of minus to -2.1% in 2020, the Indonesian economy again experienced an increase of up to 5% and as published by the Coordinating Ministry for the Indonesian Economy, this increase was the highest since 2014. On the demand side, most expenditure components in the fourth quarter of 2022 grew strongly. Supported by windfall of leading commodities, exports were able to grow double digits to reach 14.93% (yoy). Meanwhile, imports grew 6.25% (yoy), driven by an increase in imports of capital goods and raw materials. Furthermore, consumption growth rate as the main contributor to GDP was recorded at 4.48% (yoy) in line with PMTB growth of 3.33% (yoy) and LNPRT consumption of 5.70% (yoy). Nevertheless, Government Consumption still contracted by -4.77% (yoy). From the supply side, all business sectors experienced positive growth in the fourth quarter of 2022. The Transportation and Warehousing sector became the sector with the highest growth of 16.99% (yoy) followed by the Accommodation and Food and Drink Sector which grew by 13.81% (yoy) driven by increased public mobility and increased tourist arrivals both foreign and domestic tourists. The Manufacturing Industry sector as the largest contributor to GDP also recorded positive growth of 5.64% (yoy). (Pertumbuhan Ekonomi Tahun 2022 Capai 5,31%, Tertinggi Sejak 2014, 2023).

The manufacturing sector in Indonesia's economy contributes the most to the country's foreign commerce. In recent years, Indonesia's manufacturing industry has expanded quickly because to the government's emphasis on industrialization and export-oriented

policies. Around 80% of the nation's non-oil and gas exports are accounted for by this sector, which makes a considerable contribution to the country's international trade activities. The manufacturing industry in Indonesia is diverse, with many subsectors including food and drink, textiles and apparel, automotive, electronics, and chemicals. The largest sub-sector is the food and beverage industry, followed by textiles and apparel. The strategic position, plenty of natural resources, and sizable domestic market of the nation make it a desirable place for international investment. The low labour costs and welcoming investment environment of Indonesia have attracted a number of global corporations to set up manufacturing facilities there.

The government has also put in place a number of initiatives, including tax breaks, infrastructural improvements, and investment facilitation, to assist the expansion of the manufacturing industry. The sector's competitiveness will be boosted by these initiatives, which also seek to enhance foreign investment.

2.2.2 Analysis of Indonesia's inward FDI

Foreign direct investment (FDI) to Indonesia was recorded at USD 20.1 million in 2021. Based on data from the ASEAN Secretariat, the amount of FDI to Indonesia increased 8.06% from the previous year which was valued at US $ 18.6 million. FDI to Indonesia in 2021 was the second largest in Southeast Asia. Its position is only below Singapore with FDI of US $ 99.1 million. (Sadya, 2022). An astonishing amount of foreign direct investment (FDI) has been attracted to Indonesia in recent years, which has resulted in sustained economic development. The foreign direct investment (FDI) in Indonesia grew by 4.4% in the first quarter of 2021 compared to the same period in the previous year, according to the Indonesia Investment Coordinating Board. This increase in FDI is evidence of Indonesia's welcoming business environment and expanding consumer market, which make it a desirable location for international investors.

Indonesia's strategic position is one of the main factors making it such a desirable place for international investment. Due to its strategic location at the intersection of many important shipping routes, Indonesia serves as an excellent base for companies looking to enter South-east Asia's expanding markets. Large-scale investment opportunities exist in industries including mining, agriculture, and forestry because to the nation's abundant natural resources, particularly its rich mineral reserves and fertile terrain.

In addition to its geographic location and wealth of resources, Indonesia has made tremendous progress in strengthening its infrastructure, educational system, and business climate, further increasing its appeal as a location for FDI. The government has been making significant investments in infrastructure, with an emphasis on enhancing digital connections, enhancing electricity and water supply, and enhancing transportation networks. These changes have not only made it simpler for companies to operate in Indonesia, but they have also contributed to the country's economic expansion.

The primary industries that drew FDI in the first quarter of 2021 were transportation, warehousing, and telecommunications. During this time, businesses from Singapore, Japan, and China were the largest providers of FDI in Indonesia, investing in a variety of sectors. Along with these nations, Indonesia's government has been aggressively trying to entice investment from other nations, providing incentives including tax reductions, reduced rules, and simpler procedures to international companies Indonesia provides enormous prospects for development and expansion, thus international investors thinking about FDI should give the country deeper consideration. Foreign businesses who invest in Indonesia can benefit from cheaper labor costs, access to a sizable and expanding consumer market, and Indonesia's abundant natural resources. Indonesia is well-positioned to continue luring international investors in the years to come thanks to continued efforts to strengthen its infrastructure and business climate and a government dedicated to encouraging investment.

The prospects for international investors investing in FDI in Indonesia are favorable due to Indonesia's favorable investment climate, geographic advantages, and continuing improvements to infrastructure and the business climate. Numerous opportunities exist for development and expansion, and the government's dedication to encouraging foreign investment ought to inspire confidence in those who want to do so. Foreign investors can better understand the local market and use the advantages of FDI to achieve their long-term business goals by collaborating with local businesses to build a significant presence in the foreign nation.