THE INFLUENCE OF HOST COUNTRY POLITICAL RISK TOWARDS FOREIGN DIRECT INVESTMENT AND MACROECONOMICS AS CONTROL VARIABLE

(A study at Indonesia's Case Period of 2006-2015)

Natasya Halida Dwinitasari
Sri Sulasmiyati
Fakultas Ilmu Administrasi
Universitas Brawijaya
Malang
E-mail: halidanatasya20@gmail.com

ABSTRACT

House country political risk has a major effect on multinational company, and host-country government arranges the regulation of a country can cause either the company to gain or loss profit. Host country has the power to allowed business in accordance with its government policies and laws. Therefore, international business executives should be concerned about the host government's policies and their possible changes on the future. Foreign direct investment as a long-term investment may experience risk exposure in host country, either from economic and political condition in a country where they doing business. The research method that used is explanatory research with descriptive quantitative approach. There are two main locations for this research, which are the site of Bank Indonesia, www.bi.go.id for exchange rate, inflation and interest rate, World Bank site, data.worldbank.org for foreign direct investment inflows. The data used in this research is secondary with documentation collection techniques. Independent variables in this research are inflation (CPI), interest rate (BI Rate), exchange rate and political risk used dummy variable. Dependent variable for this research is foreign direct investment (FDI).

Keywords: Host Country, Political Risk, Inflation, BI rate, Exchange Rate, Foreign Direct Investment.

ABSTRAK

Resiko Politik Negara Tuan Rumah memiliki pengaruh yang besar terhadap perusahaan multinasional, regulasi yang diatur pemerintah Negara Tuan Rumah dapat meguntungkan dan merugikan perusahaan. Negara Tuan Rumah memiliki wewenang untuk mengijinkan bisnis sesuai dengan hukum dan kebijakan pemerintah. Oleh karena itu, pimpinan pebisnis internasional perlu memikirkan mengenai kebijakan pemerintah Negara Tuan Rumah dan kemungkinan adanya perubahan di masa mendatang. Penanaman modal asing langsung adalah investasi jangka panjang yang berisiko mengalami kerugian baik dari sisi ekonomi ataupun kondisi politik. Metode Penelitian yang digunakan adalah eksplanatori dengan pendekatan kuantitatif. Terdapat dua lokasi utama Penelitian yaitu, situs resmi Bank Indonesia, www.bi.go.id untuk data kurs, inflasi dan suku bunga, situs resmi World Bank, data.worldbank.org untuk data penanaman modal asing langsung. Variabel bebas yang digunakan adalah, inflasi (IHK), suku bunga (BI rate), kurs dan resiko politik Menggunakan dummy variable. Variable terikat dalam Penelitian ini adalah penanaman modal asing langsung (PMA).

Kata Kunci: Negara Tuan Rumah, Risiko Politik, Inflasi, *BI rate*, Kurs, Penanaman Modal Asing.

INTRODUCTION

Globalization not only affects technology, but also affects the global economy. The progressively widespread investment initiating from other countries or generally mentioned to as foreign investment, prove that globalization also affect the economy aspect. Before we talk more about foreign investment, we should first understand what an investment is. According to presidential regulation of the republic of Indonesia number 44 year 2016, investment means any form of activity to invest in the business either conducted by domestic investors or foreign investors within the territory of the republic of Indonesia. The explanation give us an insight that, foreign investment is an investment that conducted within the territory of a country by foreign investor.

There are various types of foreign investment; direct and indirect. Direct investment or more commonly known as foreign direct investment is having ownership or control of at least 10 percent or more of an enterprise in another country" (Cullen, 2010:118), whereas (Madura, 2008:370) explain that direct foreign investment, is an investment in real assets such as land, buildings, or even existing plants in foreign countries. Indirect investment "is an investment that does not involve obtaining a degree of control in a company" (Wild 2013:210) this type of investment also known as portfolio investment.

Foreign direct investment is important aspect in the economy, "it is supposed an engine of the growth for countries providing a package of financial capital, technology, managerial skills, jobs opportunities, information, good and services that can make an economy more competitive in the world market place. Especially for developing and transition countries that face liquidity constraints, this source of funding is considered as the best way to capture less volatile capital flows and attract MNEs that could boost their productivity"(Schneider, 2010:54).

Foreign direct investment as a type of international investment is common choice for the investor to expand their market. Based on figure 1.1 foreign direct investment inflows to Indonesia are considered high by 29 percent or $16 billion (UNCTAD: World Investment Report, 2016). This result shows that many investors are interested doing business in Indonesia. "As a developing country Indonesia need to boost its nation economic growth, the most effective and efficient way is to open room for foreign investment. Foreign direct investment is a long-term form of capital inflows and relatively invulnerable to economic shocks. It is expected to support sustainable investment growth in Indonesia" (Kurniati, et al 2007:13).

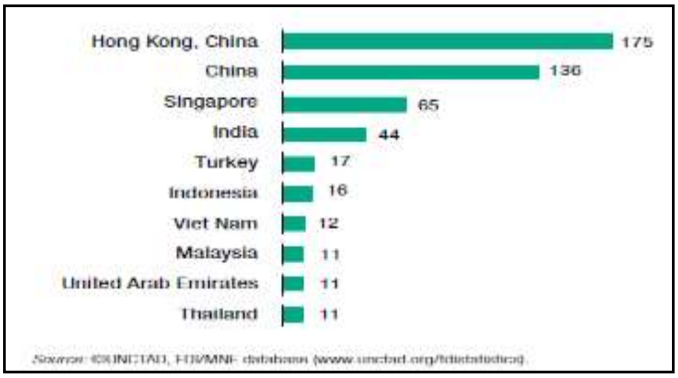

Figure 1: Foreign Direct Investment inflows, top 10 host economies, 2015 (billions of dollars)
Source: World Investment Report (2016:59)

Seeing foreign direct investment as a long-term investment, many aspect can affect it, especially host country's macroeconomic condition. Investor may monitor the potential host country through its macroeconomic indicators. Macroeconomic indicators that affected foreign direct investment are inflation, interest rate and exchange rate. These three macroeconomic indicators are usually the main criterion of investor and companies before conducting in international investment (Madura, 2009:450).

Inflation can be described as the rise in the general level of prices. When inflation occurs, each dollar of income will buy fewer goods and services than before. Inflation reduces the "purchasing power" of money (McConnell et al, 2009:529) therefore; inflation of a nation can affected the production cost of subsidiaries. On the other side interest rate is a financial cost that must be paid for borrowed funds (McConnell et al, 2009:299). The rate of an interest can determine the decision of investments. Interest rate is reflecting the monetary policy stance of a nation, which eventually can affect the funds of subsidiaries.

An exchange rate is the rate at which the currency of one nation can be exchange for the currency of another nation. Converting subsidiaries earnings from a weak host country currency into strong home currency reduces the amount of these earnings when stated in the home currency (Wild et al, 2013:238). Although macroeconomic has many indicators, researcher will focus on three indicators to be more specific and distinct.

The company's motive on doing business overseas is not only because they can expand their business, but also to take a chance to expand their market. A new market will provide the company an insight to evaluate their weakness and strength. Sometimes when doing business in their home country, a company is faced with a competitor that already takes over the market in a particular goods or services. In order to avoid rivalry, many companies decided to do international investment, by doing so the company will get fresh consumers and fresh market to begin with. The advantage in international investment is every now and then the host country may do not have the same quality of a product that these foreign companies do, this will gain the companies a big chance to expand their business.

Conducting business overseas has its challenges, one of these challenges is political risk; political risk has a major effect on multinational company. The regulation of a country is arranged by host-country government can cause either the company to gain or loss profit. "Politics is a universal activity which affects the business world in a variety of ways. Understanding political systems, institutions and processes provide a greater insight into business decisions and into the complexities of the business environment" (Worthington et al, 2006:68).

A multinational company that choose to invest overseas need to analyze every country risk where they doing business. According to Madura (2008:446), "country risk is the potentially adverse impact of a country's environment on a multinational company's cash flows. Country risk analysis can be used to monitor countries where the multinational company is currently doing business. If the country risk level of a particular country begins to increase, the multinational company may consider divesting its subsidiaries located there. Multinational company can also use country risk analysis as a screening device to avoid conducting business in countries with excessive risk."

Kurniati et al (2007) research findings shows a positive relationship exists between political stability in Indonesia and levels of incoming investment. The onset political stability of 1998 also marked a downturn in investment in Indonesia. However, as conditions in Indonesia improved, investment also gathered pace. Gani (2014:88) research findings also show that political stability in host country will be main consideration for investor, precisely for foreign investor. As stated before, foreign direct investment is a long-term investment that needed extensive period to gain profit; therefore long term political stability is main concern for any investor.

Table 1.1 below showed, as per April 2015 Indonesia's political risk index is high, compared to Malaysia, Thailand and Philippines (www.prsgroup.com). Table ranked from low to high risk within East Asia or Pacific. The higher the index number it's more likely safe for investors to conducting a business.

Indonesia as a "host country have the power to allowed business in accordance with its government policies and laws. Therefore, international business executives should be concerned about the host government's policies and their possible changes on the future" (Kotabe et al, 2010:142).

Table 1: Political Risk Index April

Year	**Apr 15**	**14**	**13**	**12**	**11**
East Asia/Pacific Avg	**79**	**79**	**79**	**78**	**76**
Singapore	92	92	92	89	89
Japan	85	86	86	84	82
South Korea	82	82	80	78	73
Malaysia	78	78	80	80	79
Thailand	76	76	76	76	72
Papua New Guinea	72	72	72	71	71
Indonesia	69	71	72	73	72

Source: www.prsgroup.com, 2015

The political risk indicators for this research according to Madura (2008:447) are actions of host government which is policies that will affect the company's cash flow and macro assessment in financial factors. Financial factors for this research consist of inflation, interest rate and exchange rate, while the technique to assess political risk is quantitative analysis with regression analysis.

LITERATURE REVIEW

Foreign direct investment

There are two main types of foreign direct investment: horizontal and vertical. A firm that engages in horizontal foreign direct investment invests in facilities abroad that are at the same stage of the value chain, for example Mittal Steel builds steel plants in different countries. A firm that engages in vertical foreign direct investment invests in facilities abroad that are in different stages of the value chain, for example, British Petroleum invests in crude oil exploration and production in some countries, refining capacity in other countries, and retail service stations in yet others (Spulber, 2007:121).

Foreign direct investment is an act of purchasing physical assets or a significant amount of the ownership of a company in another country to gain a measure of management control (Wild et al 2013:210).

Foreign Direct Investment is often associated with mergers and acquisitions. In fact, cross-border mergers and acquisitions are the main vehicle through which companies undertake foreign direct investment. Many cross-border mergers and acquisitions deals are driven by the desire of companies to get (1) a foothold in a new geographic market, (2) increase a firms global competitiveness, (3) fill gaps in companies product lines in a global industry, (4) reduce costs of research and developments, production, distribution and so forth (Wild et al, 2013:211).

Political Risk

Kotabe et al (2010) addressed "national politics affect business environment directly through changes in policies, regulations, and laws. The government in each country determines which industries will receive protection in the country and which will face open competition. The political stability and mood in a country affect the actions a government will take, actions that may have an important impact on the viability of doing business in the country".

All companies doing business domestically or internationally confront political risk. Political risk is the likelihood that a society will undergo political changes that negatively affect local business activity. Political risk abroad affects different types of companies in different ways. It can threaten the market of an importer, the production facilities of a manufacturer or the ability of a company to extract profits from a country in which they were earned. A solid grasp of local values, customs, and traditions can help reduce company's exposure to political risk (Wild et al, 2013:106).

Inflation

Inflation described as the rise in the general level of prices. When inflation occurs, each dollar of income will buy fewer goods and services than before. The inflation data using consumer price index, which is an index that measures the prices of a fixed market base of some 300 goods and services (McConnell, 2009:529)

Interest Rate

Interest rate is a financial cost that must be paid for borrowed funds. The rate of an interest can determine the decision of investments. There are two basic features of investment, expected returns and interest rate. In theory, the sum of the expected returns must exceed the interest rate, or at worse the expected returns is equal the interest rate, if the interest rate is exceed the expected returns then that investment should not be conducted (McConnell et al, 2009:299).

Interest rate are important variables for macroeconomics to understand because the link the economy of the present and the economy of the future through their effect on saving and investment. There is distinction between the nominal interest rate and real interest rate.

Exchange Rate

Movement in a currency's exchange rate affects the activities of both domestic and international companies. For example, "exchange rate influence demand for a company's products in the global marketplace. Exchange rate also affect the amount of profit a company earns from its subsidiaries, the earnings of international subsidiaries are typically integrated into the parent company's financial statements in the home currency. Translating subsidiaries earnings from a weak host country currency into strong home currency reduces the amount of these earnings when stated in the home currency" (Wild et al, 2013:284).

Just as the price in any market, international prices help coordinate the decisions of consumers and producers as they interact in world market. There are two most important international prices: the nominal and real exchange rate

Hypothesis

H_1 : Host country political risk partially affects FDI inflows.

H_2 : Inflation partially affects FDI inflows.

H_3 : Interest rate partially affects FDI inflows.

H_4 : Exchange rate partially affects FDI inflo

H_5 : Host country political risk and Macroeconomics variables simultaneously affect FDI inflows.

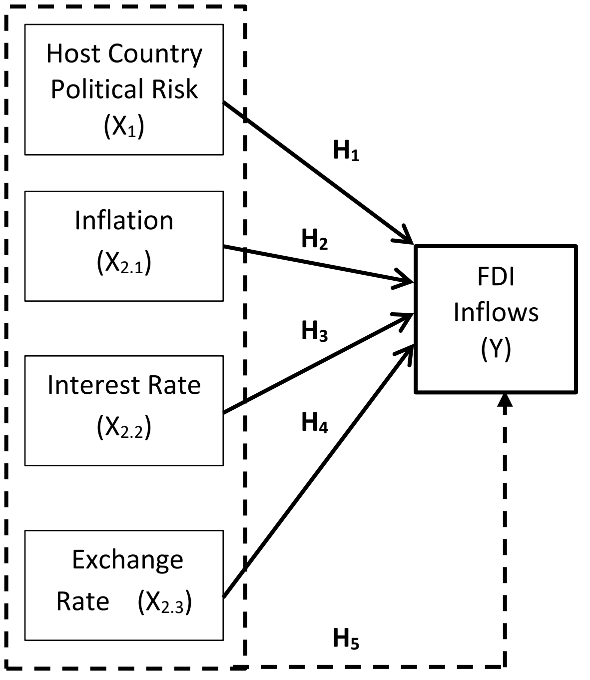

Figure 2: Multiple Linear Hypothesis model

RESEARCH METHOD

The research method that used was explanatory research with descriptive quantitative approach. There are two main locations for this research, which are the site of Bank Indonesia, (www.bi.go.id) for exchange rate, inflation and interest rate, World Bank site, (data.worldbank.org) for foreign direct investment inflows. The population used in this undergraduate research are all the time series data that are calculated from first quarter year 2006 until the fourth quarter of year 2015. Each quarterly data covered three months, so the population is 40 (4 quarters x 10 years).

RESEARCH RESULTS AND DISCUSSION

Table 2: Simple Linear Regression

Coefficients[a]

Model		Unstandardized Coefficients B	Std. Error	Standardized Coefficients Beta
1	(Constant)	-.007	.025	
	plt	.018	.026	.114

a. Dependent Variable: fdi

Table 3: Multiple Linear Regression

Coefficients[a]

Model		Unstandardized Coefficients B	Std. Error	Standardized Coefficients Beta
1	(Constant)	-.001	.007	
	dplt	-.037	.017	-.339
	dinf	.000	.003	-.008
	dexc	-1.469E-5	.000	-.189
	dint	.031	.018	.306

a. Dependent Variable: dfdi

Table 4: t Test for Simple Linear Regression

Model	t	Sig.
1 (constant)	-.304	.763
Pol	.697	.490

Table 5: t Test for Multiple Linear Regression

Model	t	sig
1 (Constant)	.501	.620
Plt	.198	.844
Inf	.842	.406
Int	.775	.444
Exc	-2.817	.008

Table 6: F Test Result

ANOVA[a]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.614	4	.153	14.500	.000[b]
	Residual	.370	35	.011		
	Total	.984	39			

a. Dependent Variable: FDI

b. Predictors: (Constant), POLITICAL, EXCHANGE, INTEREST, INFLATION

Table 7 Determination Coefficient for Simple Linear

Model Summary[b]

Model	R	R Square	Adjusted R Square
1	.249[a]	.062	.038

a. Predictors: (Constant), POLITICAL

b. Dependent Variable: FDI

Table 8 Determination coefficient (R^2)

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.790[a]	.624	.581	.1028561095

The Partial effect of Host Country Political Risk Towards Foreign Direct Investment

From simple linear regression test result, the partial effect of host country political risk towards foreign direct investment is 0,114. The significant value is greater than α = 0,050, this mean that host country political risk does not have partial effect towards foreign direct investment. The result is similar with Schneider (2010:59) as the result from political risk is also does not have significant effect as expected.

As the coefficient value from host country political risk towards foreign direct investment is 0,114. The positive relation means that if host country political risks increase one unit the foreign direct investment will increase 0,114 units. This condition applies with the assumption that the other independent variable is constant.

To measure the influence between independent variable and dependent variable, researcher use determination coefficient. The result from determination coefficient is 0,062, the result mean that 6,2% of foreign direct investment variable is explained by host country political. Whereas the other 93,8% is explained by other reasons.

This result showed that, the impact of political risk depends on the strategic behavior of the multinational as a partner with host firms having strategic interactions with the host government (Schneider, 2010:3).

The Partial effect of Host Country Political Risk ,Inflation, Interest Rate and Exchange Rate Towards Foreign Direct Investment

Host Country Political Risk Influence Towards Foreign Direct Investment

In some country, political risk influences the inflows of foreign direct investment. Political risk is the likelihood that a society will undergo political changes that negatively affect local business activity. Political risk abroad affects different types of companies in different ways. Political risk, especially in host country will create a parameter to investor before conducting investment.

Host Country Political Risk variable has no significant partial influence towards foreign direct investment. This can be seen from significant value which is 0,844 that is greater than alpha α = 0,050 (0,844 > 0,050). It concludes that H_0 is accepted and H_a rejected means Host Country Political Risk does not have significant partial influence towards foreign direct investment. This result is similar with Schneider (2010:59) the result of political risk variable are a little disappointing in the sense that this variable is not significant and does not have the positive sign as we expected.

Coefficient value from host country political risk -0,339 means that, if host country political risk increase one unit, foreign direct investment will decrease 0,339 units, with assumption other independent variable is constant. The negative relation of host country political risk and foreign direct investment means that the increase in host country political risk will decrease foreign direct investment significantly.

To put into perspective, there are many factors that determine the foreign direct investment inflows to a country. According to the World Investment Report published by World Bank in 2006, the Indonesia's investment growth in recent years is explained by several factors, i.e. sharply improved economic growth, low interest rates and resurgent performance on the stock markets (Kurniati et al, 2007:15).

Inflation Influence Towards Foreign Direct Investment

Inflation presents the economic situation of a nation; through inflation, investor can measure and presume the successful rate of an investment. The fluctuation in inflation can indicate that a nation is going through unstable economic situation, doing investment in an unstable economic situation can be risky. Inflation can affect the flow of company fund, and company profit. According to Madura (2008:450) inflation can affect consumers' purchasing power and therefore their demand for MNC's goods. However, the research result is opposing the theory; the result is that inflation does not have significant affect towards foreign direct investment.

Based on t test the result of inflation influence towards foreign direct investment is 0,406 with α value is 0,050. Since the value of t Test of inflation is greater than 0,050 means, that inflation has no partial influence towards foreign direct investment. The result of the research is similar with the result of Schneider (2010:59) the variable "inflation" does not have the expected sign and are not significant. Coefficient value from inflation is -0,008 means that if inflation increases one unit, foreign direct investment will decrease 0,008 units, with the assumption that other independent variable is constant.The negative relation of inflation and foreign direct investment mean that the increase in inflation will decrease foreign direct investment significantly. This research finds that inflation during 2006 – 2015 in Indonesia has no significant influence partially. The same result from other research is from Schneider (2010), the result also showed that inflation variable does not have the expected sign and are not significant.

Most financial factors that affect a country's economic condition are difficult to forecast. The list of financial factors listed here represent just a subset of the financial factor considered when evaluating the financial strength of a country (Madura, 2008:451).

Interest Rate Influence Towards Foreign Direct Investment

Bank Indonesia rate is the policy rate reflecting the monetary policy stance adopted by Bank Indonesia and announced to the public. Interest rate is an indicator for investor before doing business in the country. A high interest rate will make the investor to think twice to invest; on the contrary, a low interest rate will likely attract more investment to the country. According to Madura (2009:450) Higher interest rates tend to slow the growth of an economy and reduce demand for the MNC's products. Lower interest rates often stimulate the economy and increase demand for the MNC's products. With the value of 0,444 which is greater than 0,050, interest rate has no significant partial influence.

Coefficient value from interest rate is 0,306 means that if interest rate increases one unit, foreign direct investment will increase 0,306 units, with the assumption that other independent variable is constant. The positive relation of interest rate and foreign direct investment mean that the increase in interest rate will increase foreign direct investment significantly.

Interest rate variable has no significant partial influence towards FDI. This can be seen from significant value which is 0,444 that is greater than alpha $\alpha = 0{,}050$ ($0{,}444 > 0{,}050$). It concludes that H_0 is accepted and H_a rejected means exchange rate does not have significant partial influence towards foreign direct investment. This result is supported by the research of Kurniati et al (2007:46) interest rate is not variable with significant influence on investment, the reason is because foreign direct investment is a long-term investment, an interest rate arising in the short term will not encourage investors to make any immediate increase or reduction in their investment.

There is some subjectivity in predicting these financial factors. Because of these various types of subjectivity, it is not surprising that risk assessors often arrive at different opinion after completing a macroassessment of country risk (Madura, 2008:452).

Exchange Rate Influence Towards Foreign Direct Investment

Movement in a currency's exchange rate affects the activities of both domestic and international companies. For example, "exchange rate influence demand for a company's products in the global marketplace. Exchange rate also affect the amount of profit a company earns from its subsidiaries, the earnings of international subsidiaries are typically integrated into the parent company's financial statements in the home currency. Just as the price in any market, international prices help coordinate the decisions of consumers and producers as they interact in world market.

Exchange variable has significant partial influence towards foreign direct investment. This can be seen from significant value which is 0,008 that is less than alpha $\alpha = 0{,}050$ ($0{,}008 < 0{,}050$). It concludes that H_0 is rejected and H_a is accepted means exchange rate does have significant partial influence towards foreign direct investment. This result is supported Madura theory that a very weak currency can cause speculative outflows and reduce the amount of funds available to finance growth by businesses. Gani (2014) research also shows that exchange rate can affect foreign direct investment inflows, when IDR is appreciate, investment flow is rising and many investors starting to invest when the economy condition is stable.

Coefficient value from exchange rate is -0,189 means that if exchange rate increases one unit, foreign direct investment will decrease 0,189 units, with the assumption that other independent variable is constant. The negative relation of exchange rate and foreign direct investment mean the increase in exchange rate will decrease foreign direct investment significantly.

The Simultaneous Effect of Host Country Political Risk, Inflation, Interest Rate, and Exchange Rate towards Foreign Direct Investment.

According F test result shows that the value of Sig is less than $\alpha = 0{,}050$ ($0{,}000^b < 0{,}0050$) which means there is significantly simultaneous influence, can be concluded that H_0 is rejected and H_a is accepted means there is significantly simultaneous influence between inflation, interest rate, exchange rate, and political risk towards foreign direct investment. The result of F test is similar to the research from Kurniati et al (2007) that macroeconomic and political risk serves as the determinants of foreign direct investment inflows into a country.

CONCLUSION & SUGGESTIONS

Conclusions

1. From Simple linear regression

   The result showed that the relation between host country political risk and foreign direct investment is positive, which mean the increase in host country political risk also increase the foreign direct investment. t Test result from simple linear showed there is no partial influence as the significant value is 0,490 which is greater than α = 0,050. Determinant coefficient from simple linear regression result is the 6,2% variation of foreign direct investment inflows is explained by host country political and the other 93,8% is explained by other reasons.

2. From Multiple Regression with Control Variable

   When combined, host country political risk and macroeconomic variables create diverse result. There is significant simultaneous influence between host country political risk and macroeconomics variable towards foreign direct investment. The relation is also changed from positive to negative. The negative relation means that if host country political risk increase one unit the foreign direct investment will decrease.

   In contrast, exchange rate has significantly partial influence towards foreign direct investment. Inflation, interest rate and host country political risk has no significantly partial influence towards foreign direct investment. The determinant coefficient results drastically change when used control variable, from 6,2% to 62,4%. The multiple linear regression showed that there is 62,4% variation of foreign direct investment explained by host country political risk, inflation, interest rate and exchange rate.

3. The similarity from simple and multiple linear regression is the host country political risk variable does not have partial influence towards foreign direct investment. On the other hand, when the macroeconomics is included as control variable the result is more affecting. There is significant partial effect from exchange rate also there is simultaneous influence between host country political risk towards foreign direct investment. As for the determinant coefficient, the result is greater into 62,4% when macroeconomics is included for control variable.

Suggestions

1. For investor that planning on doing investment in Indonesia makes sure to observe and analyze each fluctuating in inflation, interest rate, exchange rate and other macroeconomics indicator. The result for political risk may not affect the inflows of foreign direct investment significantly; nonetheless, political risk can be consideration indicator before organizing business in foreign country.
2. For a further research, the dummy variables may not represent the political risk as a whole. There are various method to assess political risk, may further research considering to use different assessment method for political risk. The control variable used for this thesis showed that there are more effects when the control variable included. Other method and variable in analyzing macroeconomics indicator and political risk can give different result; hence, this undergraduate thesis can be used as a reference for investor and other researcher.

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