

THE EFFECT OF MEDIATION ON CAPITAL FLOWS AND INVESTMENTS ECONOMIC GROWTH IN INDONESIA

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ABSTRACT

This study aims to analyze more about the mediating effect of capital flows on interest rates, inflation rates, and the rupiah exchange rate on economic growth, both directly and indirectly through investment. This research uses time - series secondary data for the period 1992 - 2021. The analytical method used is the structural equations method. The results show that the mediating effect of capital inflows on interest rates has a negative effect on economic growth both directly and indirectly through investment. The mediating effect of capital inflows on inflation rate has a negative effect on economic growth both directly and indirectly through investment. The mediating effect of capital inflows on the exchange rate of the rupiah has a positive effect on economic growth both directly and indirectly through investment. The mediating effect of capital outflows on interest rates has a positive effect on economic growth both directly and indirectly through investment. The mediating effect of capital outflows on inflation rate has a positive effect on economic growth both directly and indirectly through investment. The mediating effect of capital outflows on the exchange rate of the rupiah has a negative effect on economic growth both directly and indirectly through investment.

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1. INTRODUCTION

Ordinary people think that developed countries have been free from all kinds of economic problems. However, the fact is that until now no country in the world has been free from these problems. One of the economic problems that are often found in various countries is economic growth that is not in line with expectations. Economic growth is an indicator used to measure the performance of an economy. A country's economy is said to experience growth when the production of goods and services has increased from the previous year.

In addition, economic growth shows the extent to which economic activity can generate additional income in a certain period. If a country's economic growth continues to show an increase, it indicates that the country's economy can develop well.

Indonesia as a developing country of course really needs a large capital to be able to increase economic growth. However, the availability of domestic capital is very limited. Therefore, there is a need for additional capital from abroad. One of them is in the form of capital flows. In general, capital flows are foreign capital moving in international capital traffic. Capital flows consist of capital inflows and capital outflows.

Based on published data, capital inflow in Indonesia from 2009 to 2021 has fluctuated and tends to increase. However, this increase still needs to be considered so that incoming capital does not cause economic instability. On the other hand, the development of capital outflows in Indonesia from 2009 to 2021 has increased. The increase that occurred was higher than the capital inflow.

Capital flows is expected to have a good impact on total investment in Indonesia. If the total investment is sufficient, of course it can be used to support increased economic growth. As we know that a very strong foundation for a country's economy comes from investment.

The development of investment in Indonesia from 2009 to 2021 is experiencing an increasing trend. This increase is inseparable from the support of foreign parties who invest in various domestic instruments. The increase in investment illustrates that there is an increase in the availability of capital that can be used to support increased economic growth. However, in fact the increase in investment was not in line with economic growth which experienced a decline in that period.

Increasing investment that is not in line with economic growth contradicts Harrod-Domar's theory of economic growth. The theory states that increased investment will increase the availability of domestic capital. The additional availability of capital can increase production capacity so that economic growth can increase (Vandenberg & Rosette, 2019).

There are various factors that can influence the movement of capital flows so as to increase investment and have an impact on economic growth. OK et al. (2020) divide these factors into pull factors and push factors. Pull factors include domestic interest rates, domestic economic growth, domestic inflation rates, domestic exchange rates, and other factors originating from within the country. Meanwhile, push factors include world interest rates, world economic growth, and other factors originating from abroad.

2. METHODS

Data Types and Sources

The type of data used in this research is time series data from 1992 to 2021. The data sources in this study come from Bank Indonesia, *National Single Window for Investment, Organization for Economic Co – Operation and Development* and the World Bank.

1. Data analysis

The data analysis method used for this research model is the structural equation model. This method is used to determine whether the mediation of capital inflow (Y1) and capital outflow (Y2) of interest rates (X1), inflation rates (X2), and the rupiah exchange rate (X3) has an effect on economic growth (Y4), either directly or indirectly. Indirectly through investment (Y3). The data analysis model is as follows:

$$\begin{aligned}
 Y1 &= f(x1, x2, x3) \dots\dots\dots(1) \\
 Y2 &= f(x1, x2, x3) \dots\dots\dots(2) \\
 Y3 &= f(Y1, Y2) \dots\dots\dots(3) \\
 Y4 &= f(Y1, Y2, Y3) \dots\dots\dots(4)
 \end{aligned}$$

The linear regression estimation equation is as follows:

$$\begin{aligned}
 \ln Y1 &= \alpha_0 + \alpha_1 x1 + \alpha_2 x2 + \alpha_3 \ln x3 + \mu_1 \dots\dots\dots(1.b) \\
 \ln Y2 &= \beta_0 + \beta_1 x1 + \beta_2 x2 + \beta_3 \ln x3 + \mu_2 \dots\dots\dots(2.b) \\
 \ln Y3 &= \delta_0 + \delta_1 \ln Y1 + \delta_2 \ln Y2 + \mu_3 \dots\dots\dots(3.b) \\
 Y4 &= \lambda_0 + \lambda_1 \ln Y1 + \lambda_2 \ln Y2 + \lambda_3 \ln Y3 + \mu_4 \dots\dots\dots(4.b)
 \end{aligned}$$

3. RELUST AND DISCUSSION

Based on Table 1, the direct effect of mediating capital inflow on interest rates on economic growth shows a negative and significant effect with a coefficient of 0.254. Meanwhile, the indirect effect of mediating capital inflow on interest rates on economic growth through investment shows a negative and significant effect with a coefficient value of 0.109. Meanwhile, the total influence of capital inflow mediation on interest rates directly or indirectly on economic growth shows a negative and significant effect with a coefficient value of 0.364.

Table 1. The Mediation Effect of Capital Inflow and Capital Outflow on Economic Growth through Investment

Variable Relations	Direct Influence	Indirect Influence	Total Impact
$x_1 \rightarrow Y_1 \rightarrow Y_4$	-0.254*		-0.364*
$x_1 \rightarrow Y_1 \rightarrow Y_3 \rightarrow Y_4$		-0.109*	
$x_2 \rightarrow Y_1 \rightarrow Y_4$	-0.423*		-0.605*
$x_2 \rightarrow Y_1 \rightarrow Y_3 \rightarrow Y_4$		-0.182*	
$x_3 \rightarrow Y_1 \rightarrow Y_4$	0.716*		1,025*
$x_3 \rightarrow Y_1 \rightarrow Y_3 \rightarrow Y_4$		0.308*	
$x_1 \rightarrow Y_2 \rightarrow Y_4$	0.309*		0.346*
$x_1 \rightarrow Y_2 \rightarrow Y_3 \rightarrow Y_4$		0.037*	
$x_2 \rightarrow Y_2 \rightarrow Y_4$	0.430*		0.481*
$x_2 \rightarrow Y_2 \rightarrow Y_3 \rightarrow Y_4$		0.050*	
$x_3 \rightarrow Y_2 \rightarrow Y_4$	-1,484*		-1,660*
$x_3 \rightarrow Y_2 \rightarrow Y_3 \rightarrow Y_4$		-0.176*	

Source: Results of AMOS Data Processing (2021)

The direct effect of capital inflow mediation on the inflation rate on economic growth shows a negative and significant effect with a coefficient value of 0.423. Meanwhile, the indirect effect of capital inflow mediation on the inflation rate on economic growth through investment shows a negative and significant effect with a coefficient value of 0.182. Meanwhile, the total influence of capital inflow mediation on the inflation rate directly or indirectly on economic growth shows a negative and significant effect with a coefficient value of 0.605.

The direct effect of capital inflow mediation on the rupiah exchange rate on economic growth shows a positive and significant influence with a coefficient value of 0.716. Meanwhile, the indirect effect of capital inflow mediation on the rupiah exchange rate on economic growth through investment shows a positive and significant effect with a coefficient value of 0.308. Meanwhile, the total effect of capital inflow mediation on the rupiah exchange rate directly or indirectly on economic growth shows a positive and significant influence with a coefficient value of 1,025.

The direct effect of mediating capital outflows on interest rates on economic growth shows a positive and significant influence with a coefficient of 0.309. The direct effect of mediating capital outflows on interest rates on economic growth shows a positive and significant influence with a coefficient of 0.309. Meanwhile, the indirect effect of mediating capital outflows on interest rates on economic growth through investment shows a positive and significant effect with a coefficient value of 0.037. Meanwhile, the total influence of capital outflow mediation on interest rates on economic growth shows a positive and significant influence with a coefficient value of 0.346.

The direct effect of capital outflow mediation on the inflation rate on economic growth shows a positive and significant influence with a coefficient value of 0.430. Meanwhile, the indirect effect of capital outflow mediation on the inflation rate on economic growth through investment shows a positive and significant influence with a coefficient value of 0.050. Meanwhile, the total influence of capital outflow mediation on the inflation rate on economic growth shows a positive and significant influence with a coefficient value of 0.481.

The direct effect of mediating capital outflows on the rupiah exchange rate on economic growth shows a negative and significant effect with a coefficient value of 1,484. Meanwhile, the indirect effect of mediating capital outflows on the rupiah exchange rate on economic growth through investment shows a negative and significant effect with a coefficient value of 0.176. Meanwhile, the total effect of capital outflow mediation on the rupiah exchange rate on economic growth shows a negative and significant effect with a coefficient value of 1,660.

Discussion

The Mediation Effect of Capital Inflow on Interest Rates on Economic Growth through Investment

The research findings show that the mediation of capital inflow over the interest rate directly has a negative effect on economic growth. It can be said that if the mediation of capital inflow over interest rates increases, then economic growth decreases. Rising interest rates cause capital inflow to decrease. This differs from the Mundell-Fleming theory that increased interest rates can increase capital inflow because capital owners are interested in the increased returns offered. Capital inflow that occurs in Indonesia is not only aimed at pursuing high returns, but also aims for consumption, investment, assistance, and so on. An increase in the interest rate can cause an increase in the cost of domestic capital. If the cost of capital increases, this can lead to an increase in the price of domestic goods. This can reduce the consumption of capital owners on domestic goods. Then an increase in interest rates will also weaken the value of the company thereby reducing the attractiveness of capital owners to instruments in the domestic capital market. In addition, an increase in the domestic interest rate which has not exceeded the world interest rate cannot increase domestic capital inflow. This is because the returns offered domestically are not attractive enough for capital owners so that capital inflow decreases. Then the decline in capital inflow led to a reduction in domestic sources of funds that could be used to facilitate the development of technology transfer and industrial innovation, which resulted in a decline in economic growth. This can reduce the consumption of capital owners on domestic goods. Then an increase in interest rates will also weaken the value of the company thereby reducing the attractiveness of capital owners to instruments in the domestic capital market. In addition, an increase in the domestic interest rate which has not exceeded the world interest rate cannot increase domestic capital inflow. This is because the returns offered domestically are not attractive enough for capital owners so that capital inflow decreases. Then the decline in capital inflow led to a reduction in domestic sources of funds that could be used to facilitate the development of technology transfer and industrial innovation, which resulted in a decline in economic growth. This can reduce the consumption of capital owners on domestic goods. Then an increase in interest rates will also

weaken the value of the company thereby reducing the attractiveness of capital owners to instruments in the domestic capital market. In addition, an increase in the domestic interest rate which has not exceeded the world interest rate cannot increase domestic capital inflow. This is because the returns offered domestically are not attractive enough for capital owners so that capital inflow decreases. Then the decline in capital inflow led to a reduction in domestic sources of funds that could be used to facilitate the development of technology transfer and industrial innovation, which resulted in a decline in economic growth. Then an increase in interest rates will also weaken the value of the company thereby reducing the attractiveness of capital owners to instruments in the domestic capital market. In addition, an increase in the domestic interest rate which has not exceeded the world interest rate cannot increase domestic capital inflow. This is because the returns offered domestically are not attractive enough for capital owners so that capital inflow decreases. Then the decline in capital inflow led to a reduction in domestic sources of funds that could be used to facilitate the development of technology transfer and industrial innovation, which resulted in a decline in economic growth. Then an increase in interest rates will also weaken the value of the company thereby reducing the attractiveness of capital owners to instruments in the domestic capital market. In addition, an increase in the domestic interest rate which has not exceeded the world interest rate cannot increase domestic capital inflow. This is because the returns offered domestically are not attractive enough for capital owners so that capital inflow decreases. Then the decline in capital inflow led to a reduction in domestic sources of funds that could be used to facilitate the development of technology transfer and industrial innovation, which resulted in a decline in economic growth. an increase in the domestic interest rate that has not yet exceeded the world interest rate cannot increase domestic capital inflow. This is because the returns offered domestically are not attractive enough for capital owners so that capital inflow decreases. Then the decline in capital inflow led to a reduction in domestic sources of funds that could be used to facilitate the development of technology transfer and industrial innovation, which resulted in a decline in economic growth. an increase in the domestic interest rate that has not yet exceeded the world interest rate cannot increase domestic capital inflow. This is because the returns offered domestically are not attractive enough for capital owners so that capital inflow decreases. Then the decline in capital inflow led to a reduction in domestic sources of funds that could be used to facilitate the development of technology transfer and industrial innovation, which resulted in a decline in economic growth.

Indirectly, the mediation of capital inflow over interest rates has a negative and significant effect on economic growth through investment. It can be said that the increase in capital inflow mediation on the interest rate causes a decrease in economic growth through investment. Increased capital inflow due to lower interest rates can support the availability of domestic funding sources. Furthermore, the capital can be used to stimulate increased investment. Increased investment can play a role in developing and improving the economy and the quality of a country's human resources in order to increase economic growth.

The results of this study are in line with research conducted by Suhendra & Anwar (2014), Nguyen & Trinh (2018), and David (2021). Declining interest rates can increase capital inflow which leads to increased investment. Investment can act as an engine of growth that leads to increased economic growth.

The Mediation Effect of Capital Inflow on the Inflation Rate on Economic Growth through Investment

The research findings show that the mediation of capital inflow over the inflation rate directly has a negative effect on economic growth. It can be said that if the mediation of capital inflow over the inflation rate increases, then economic growth decreases. The rising inflation rate illustrates an increase in the prices of goods and services in general. Furthermore, an increase in price causes public demand to decrease and has an impact on decreasing company performance. This can cause domestic economic activity to become unattractive to capital owners resulting in a decrease in capital inflow. Furthermore, the decline in capital inflow will reduce domestic capital capacity which can be used to increase production. Then, the decline in production will lead to a decrease in economic growth.

Indirectly, the mediation of capital inflow over the inflation rate has a negative and significant effect on economic growth through investment. It can be said that the increase in capital inflow mediation of the inflation rate causes a decrease in economic growth through investment. Increased capital inflow due to a decrease in the inflation rate can be useful to support the availability of sources of funds so as to increase investment. Investment can increase economic growth. Through investment there can be increased productivity, employment, and wage levels.

The results of this study are in line with research conducted by Nasir & Nawaz (2010), Barros (2013), and Pratiwi et al. (2015). Declining inflation rates will increase capital inflow leading to increased investment. Increased investment can increase production thereby encouraging increased economic growth.

The Effect of Capital Inflow Mediation on the Rupiah Exchange Rate on Economic Growth through Investment

The research findings show that directly mediating capital inflow over the rupiah exchange rate has a positive and significant effect on economic growth. It can be said that the increasing mediation of capital inflow over the rupiah exchange rate has led to increased economic growth. An increase in the rupiah exchange rate, in this case depreciating, can cause export products to become more competitive. This is because domestic products become cheaper for foreign parties. Furthermore, there is an increase in export volume which can increase the company's income and have an impact on the greater yields that can be offered to capital owners. This can be a pull factor to increase capital inflow. Furthermore,

Indirectly, the mediation of capital inflow over the rupiah exchange rate has a positive and significant influence on economic growth through investment. It can be said that the increase in capital inflow mediation on the rupiah exchange rate has led to an increase in economic growth through investment. An increase in the rupiah exchange rate (depreciation) can increase capital inflow due to increased domestic export performance thereby increasing yields. Furthermore, increased capital inflow can contribute to the realization of foreign investment. Increased investment can provide many benefits, such as additional capital, skills and technology that can increase economic growth.

The results of this study are in line with research from Lee et al. (2010), Omarkhanlen (2011) and Zakari (2017). An increase in the rupiah exchange rate (depreciation) causes exports of domestic goods to become cheaper for foreigners. Then the company's income increased due to increased demand for exports. Increasing company performance can increase the attractiveness of capital owners so that capital inflow increases. Furthermore, increased capital inflow can stimulate increased investment leading to increased economic growth.

The Effect of Capital Outflow Mediation on Interest Rates on Economic Growth through Investment

The research findings show that directly mediating capital outflows over interest rates has a positive and significant effect on economic growth. It can be said that the increased mediation of capital outflows on interest rates has led to increased economic growth. Declining interest rates illustrate that there is a decrease in the return that will be obtained by the owner of capital. This causes domestic economic activity to become unattractive to investors. Furthermore, capital owners will look for opportunities in other countries that are able to provide higher returns resulting in an increase in capital outflow. Increased capital outflows can hamper economic activity which leads to a decline in economic growth.

Indirectly, the mediation of capital outflows on interest rates has a negative and significant impact on economic growth through investment. It can be said that the mediated increase in capital outflow on interest rates causes a decrease in economic growth through investment. An increase in the domestic interest rate which causes the domestic interest rate to be higher than the world interest rate can reduce capital outflow. Then the reduction in capital outflow can maintain the availability of domestic capital that can be used for financing in order to increase investment. Through investment, companies can improve their business equipment, increase their workforce, and expand their business. Furthermore, companies can grow well so that they are able to provide greater taxes to the government.

The results of this study are in line with research from Ajayi (2012), Umore (2013), and Forson et al. (2017). If the Central Bank increases interest rates causing domestic interest rates to be higher than world interest rates, it can reduce the risk of capital outflows. Capital owners will always look for opportunities that can provide more attractive returns. Reducing capital outflows can support increased investment. Increased investment can increase the ability to produce goods and services needed in the economy thereby increasing economic growth.

The Effect of Capital Outflow Mediation on the Inflation Rate on Economic Growth through Investment

The research findings show that directly mediating capital outflow over the inflation rate has a positive and significant effect on economic growth. It can be said that the increase in capital outflow mediation on the inflation rate causes economic growth to increase. Inflation that occurred during the research year tends to be under control and not yet dangerous for investors. The increase in the inflation

rate illustrates an increase in people's purchasing power. The occurrence of inflation can be exploited by companies by increasing market prices so that profits can increase. Increasing company profits can affect the returns that capital owners get. This can maintain the attractiveness of capital owners to domestic economic conditions so that the risk of capital outflows can decrease. Then the availability of domestic capital is maintained so that it can be used to encourage production leading to increased economic growth.

Indirectly, the mediation of capital outflows over the inflation rate has a positive and significant impact on economic growth through investment. It can be said that the increase in capital outflow mediation on the inflation rate causes an increase in economic growth through investment. For companies, an increase in the inflation rate can be an opportunity to earn higher income than production costs. High income can have an impact on increasing the returns that are obtained by capital owners who invest in the company. Furthermore, the attractiveness of capital owners will be maintained thereby reducing the chances of capital outflows. The reduced capital outflow can support the formation of domestic capital which is used to finance investment so that investment increases.

The results of this study are in line with research from Samson & Edema (2012), Henry (2013), and Afrizal (2020). The increase in the inflation rate illustrates an increase in the price of goods and services, thereby increasing demand. This can encourage companies to expand production so that profits can increase and have an impact on increasing yields offered to capital owners. This can reduce the occurrence of capital outflows. Foreign-owned capital that remains in the country can stimulate foreign investment so that total investment increases and can contribute to increasing economic growth.

The Effect of Capital Outflow Mediation on the Rupiah Exchange Rate on Economic Growth through Investment

The research findings show that directly mediating capital outflows on the rupiah exchange rate has a negative and significant effect on economic growth. It can be said that the increase in capital outflow mediation on the rupiah exchange rate has caused economic growth to decline. Exchange rate fluctuations that often occur can affect the company's performance in achieving profits. The rupiah exchange rate increased, which in this case experienced a weakening (depreciation) causing the cost of importing raw materials for production to increase. Increased costs will reduce the company's profits and the returns obtained by the owners of capital. This can reduce the attractiveness of capital owners to maintain their capital in domestic companies resulting in an increase in capital outflow. Furthermore, an increase in capital outflow will reduce the availability of domestic capital. Reduced capital can hamper the production process so that economic growth declines.

Indirectly, the mediation of capital outflows on the rupiah exchange rate has a negative and significant impact on economic growth through investment. It can be said that the increase in capital outflow mediation on the rupiah exchange rate has led to an increase in economic growth through investment. An increasing or weakening rupiah exchange rate (depreciation) can encourage an increase in capital outflow due to the declining performance of domestic companies. An increase in capital outflow will result in reduced investment in the capital market so that total investment decreases. Decreasing investment can reduce domestic financing sources so that the production process can be hampered. Furthermore, reduced output leads to reduced economic growth.

The results of this study are in line with research from Wujung and Mbella (2016), Alobari et al. (2016), and Otieno et al. (2022). The decline in the rupiah exchange rate against the dollar (appreciation) led to a decrease in the price of raw materials originating from abroad. Furthermore, domestic companies can increase production to obtain greater profits. This can be an attraction for capital owners to maintain their capital in the country so that capital outflows decrease. Reducing capital outflows can maintain the availability of domestic capital to increase investment so as to create increased economic growth.

4. CONCLUSION

Capital inflows has a negative mediating effect on the interest rate on economic growth directly or indirectly through investment. It can be said that the increasing mediation of capital inflow over interest rates causes economic growth to decline directly or indirectly through investment and vice versa. Capital inflows has a negative mediating effect on the inflation rate on economic growth directly or indirectly through investment. It can be said that the increase in capital inflow mediation over the inflation rate causes economic growth to decline directly or indirectly through investment and vice versa. Capital inflows has a positive mediating effect on the rupiah exchange rate on economic growth directly or indirectly through investment. It can be said that the increase in capital inflow mediation on the rupiah exchange rate has caused economic growth to increase directly or indirectly through investment and vice versa.

Capital outflow has a positive mediating effect on interest rates on economic growth directly or indirectly through investment. It can be said that the increasing mediation of capital outflows on the rupiah exchange rate causes economic growth to increase directly or indirectly through investment and vice versa. Capital outflow has a positive mediating effect on the inflation rate on economic growth directly or indirectly through investment. It can be said that the increased mediation of capital outflow over the inflation rate causes economic growth to increase directly or indirectly through investment and vice versa. Capital outflow has a negative mediating effect on the rupiah exchange rate on economic growth directly or indirectly through investment. It can be said that the increasing mediation of capital outflows on the rupiah exchange rate causes economic growth to decline directly or indirectly through investment and vice versa.

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