

## The Effect of Economic Growth, Interest Rates, Remittances, and Green Investment on Foreign Direct Investment in Indonesia

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### Abstract

*This study aims to analyse the effect of economic growth, interest rates, remittances, and green investment on Foreign Direct Investment in Indonesia. This study uses time series data during the first quarter of 2013 to the fourth quarter of 2021 in Indonesia. The dependent variable used is Foreign Direct Investment and the independent variables include economic growth, interest rates, remittances, and green investment. The analytical tool used is multiple linear regression with the Error Correction Model (ECM) method. The results showed that economic growth in the short term and long term has a significant positive effect on foreign direct investment in Indonesia. Interest rates in the short term have a significant negative effect on foreign direct investment in Indonesia, while in the long term have no effect on foreign direct investment in Indonesia. Remittances in the short and long term have no effect on foreign direct investment in Indonesia. Green investment in the short term has no effect on foreign direct investment in Indonesia, while in the long term it has a significant negative effect on foreign direct investment in Indonesia.*

**Keywords** FDI, Economic Growth, Interest Rates, Remittances, Green Investment

### INTRODUCTION

Economic development is a multidimensional process that involves fundamental changes to social structures, people's behaviour, and national institutions, in addition to pursuing accelerated economic growth, addressing income inequality, and alleviating poverty (Todaro & Smith, 2011). In the process of economic development, investment plays a very important role. Indonesia as a developing country requires a large amount of funds to carry out the economic development process. With limited funds in a country, there are limited savings needed in investment activities in the next period. Thus, the role of foreign investment is needed to help accelerate the economic development of a country.

According to Salvatore (2014), foreign investment is divided into two, namely foreign portfolio investment and foreign direct investment. Foreign direct investment (FDI) is a form of foreign investment that is considered to have a more significant impact than foreign investment in the form of a portfolio (Sari & Baskara, 2018). This is because in foreign direct investment there is not only a transfer of capital but followed by the transfer of technology, while in foreign portfolio investment investors only want returns from passive investment without involving active management in a company.

According to Blanchard & Johnson (2014), investment is influenced by output and interest rates. Every country produces economic output which is assessed as national income or Gross Domestic Product (GDP). GDP is said to grow if the total demand for goods and services in an economy during a certain period increase compared to the previous period. The percentage of GDP growth per year is usually used by a country as an indicator of measuring economic growth. Economic growth is the development of economic activities



that occur in a country that causes an increase in the production of goods and services in a certain year (Aida et al., 2021).

According to the accelerator theory (Dunberg and Muchtar, 1986) in Nanga (2005), changes in aggregate output can affect investment. When economic growth increases, investment will increase and vice versa. This is because economic growth shows how much the population of a country is able to produce output and also shows the extent of market coverage in the country. In addition, an increase in economic growth shows an increase in people's income. When people's income increases, people's demand for goods and services is high so that the total demand for goods and services will increase (Sauqi et al., 2023). With a lot of demand for goods and services, companies will get more profits so that the urge to invest will be greater.

Another factor that affects investment is interest rates. According to Ekananda (2014), interest rates are one of the important factors in making a decision to invest or not invest in the future. Interest rates are a measure of the profit that can be obtained by the owner of capital and a measure of the cost of capital that must be incurred by the company for the use of funds from the owner of capital. Investments need to consider interest rates because when the rate of return is smaller than the interest rate, the investment does not provide a profit. Dewi & Cahyono (2016) in their research showed that Bank Indonesia interest rates have a significant negative effect on FDI in Indonesia.

FDI inflows are also influenced by the state of human capital in the destination country. Remittances play an important and indispensable role in improving human capital in remittance-receiving countries over time. According to Mishra et al. (2022) in their research in the country of Nepal, remittances increase spending on food and education. Thus, it can be said that an increase in remittances can increase aggregate demand for goods and services in the economy which in turn helps economic growth and can improve the quality of human capital in the remittance-receiving country. Better human capital can lead to higher labour productivity, which attracts foreign investors to countries where the labour force is more potential, educated, and healthy. Long (2017) in his research also proved that remittances have a positive influence on the net inflow of FDI to ASEAN.

Besides economic growth, interest rates, and remittances, green investment is also one of the factors that influence FDI inflows. Environmental and social issues such as environmental policies in a country are a consideration for investors who want to invest in that country. Green investment or sustainable investment is an investment that focuses on environmental, social, and governance (ESG) aspects, with the aim of maintaining the continuity of the economy and life on earth (KEHATI, 2020).

Severe environmental pollution has become an increasing global problem in recent years. With increasing environmental pollution, environmental awareness has become stronger around the world so that environmental regulations for pollution and greenhouse gas emissions in many countries have become stricter. According to Grossman & Krueger (1995) in Chen et al. (2022) mentioned in the Pollution Haven Hypothesis (PHH) changes in environmental regulations can lead to the transfer of pollution-intensive industries from countries with stricter environmental regulations to looser environmental regulations. As a

result, multinational corporations prefer to invest in places with looser environmental regulations than in places with stricter environmental regulations. According to Walter & Ugelow (1979); Cole & Elliott (2005) in Chen et al. (2022) state that differences in environmental regulations are an important factor in determining domestic and foreign investment. This is because to maintain competitiveness multinational companies have an incentive to avoid high environmental regulatory standards by investing in countries with low levels of environmental regulations, thus shifting their corporate investment from domestic to foreign.

With this background, the researcher aims to analyse the effect of economic growth, interest rates, remittances, and green investment on foreign direct investment in Indonesia.

## METHOD

This research is quantitative descriptive research. The dependent variable in this study is Foreign Direct Investment (FDI), while the independent variables consist of economic growth, interest rates, remittances, and green investment. The scope of this research is the country of Indonesia during the first quarter of 2013 to the fourth quarter of 2021. The data used in this study is time series data which is quarterly data with the type of data sourced from BI and the World Bank. The analysis method in this study is to use the Error Correction Model (ECM) data analysis method. In determining the linear regression model using the Error Correction Model (ECM) approach, several steps or conditions must be met first, such as stationary test, cointegration test and also ECM test.

The cointegration equation in this study is as follows:

$$\text{LogFDI}_t = \beta_0 + \beta_1 PE_t + \beta_2 IR_t + \beta_3 \text{LogRM}_t + \beta_4 GI_t + \varepsilon_t$$

The model of the Error Correction Model (ECM) test in this study is as follows:

$$d(\text{LogFDI}_t) = \beta_0 + \beta_1 d(PE_t) + \beta_2 d(IR_t) + \beta_3 d(\text{LogRM}_t) + \beta_4 d(GI_t) + \beta_5 ECT(-1) + \varepsilon_t$$

Description:

d(LogFDI)	= Foreign Direct Investment
d(PE)	= Economic Growth
d(IR)	= Interest Rate Description:
d(LogRM)	= Remittances
d(GI)	= Green Investment
t	= Time
$\beta_0$	= Constant
$\beta_1, 2, 3, 4$	= Regression coefficient
ECT(-1)	= Error Correction Term
$\varepsilon$	= Residual (error term)



## RESULTS AND DISCUSSION

The stationarity test is used to determine which order the data is stationary. The stationary test in this study uses the unit root test with the Augmented Dickey-Fuller (ADF) method at the same degree, namely at the level, first difference, or second difference so as to obtain stationary data by comparing the absolute value of the ADF statistic with the MacKinnon critical value at the  $\alpha = 1\%$ ,  $5\%$ , and  $10\%$  levels. If the absolute value of the ADF statistic  $<$  MacKinnon's critical value then  $H_0$  is accepted, meaning the data is not stationary. Conversely, if the absolute value of the ADF statistic  $>$  MacKinnon's critical value then  $H_0$  is rejected, meaning the data is stationary.

**Table 1. Stationary Test Results with ADF test method at Level**

Variable	ADF t-statistic value	Mackinnon critical value			Prob.	Description
		1%	5%	10%		
LogFDI	-4.7239	-3.6329	-2.9484	-2.6128	0.0001	Stationary
PE	-9.4179	-3.6394	-2.9511	-2.6143	0.0000	Stationary
IR	-0.3500	-3.6329	-2.9484	-2.6128	0.9069	Non Stationary
LogRM	-2.2144	-3.6394	-2.9511	-2.6143	0.2051	Non Stationary
GI	-3.3493	-3.6463	-2.9540	-2.6158	0.0205	Stationary

Based on Table 1. above, it can be seen that the results show that the data used in this study are not integrated at the level level, and it is necessary to test stationarity again for all variables in this study at the first difference level.

**Table 2. Stationary Test Results with ADF test method at First Difference**

Variable	ADF t-statistic value	Mackinnon critical value			Prob.	Description
		1%	5%	10%		
LogFDI	-6.7145	-3.6537	-2.9571	-2.6174	0.0000	Stationary
PE	-4.5906	-3.6891	-2.9718	-2.6251	0.0011	Stationary
IR	-4.0731	-3.6394	-2.9511	-2.6143	0.0033	Stationary
LogRM	-4.3144	-3.6394	-2.9511	-2.6143	0.0017	Stationary
GI	-6.4833	-3.6463	-2.9540	-2.6158	0.0000	Stationary

Based on Table 2. above, it can be seen that the results show that the data used in this study are integrated at the first difference level, which means that the stationary test requirements on all variables have been met at the first difference level and the estimation of long-term short-term relationships can continue using the cointegration test and the Error Correction Model (ECM).

### Cointegration Test Results

The cointegration test is conducted to determine whether the data is cointegrated or not and indicates that the data has a long-term relationship using the Engle-Granger (EG) method. The cointegration test with the Engle-Granger (EG) method is carried out by

regressing the variables to be tested with OLS and then taking the residual value. This residual value must be stationary at the level to be said to have cointegration.

**Table 3. Cointegration Test Results**

Variable	Coefficient	Std. Error	t-statistic	Prob.	R <sup>2</sup>
C	6.625770	3.032390	2.184999	0.0366	0.374372
PE	0.057801	0.018531	3.119187	0.0039	
IR	-0.003583	0.033939	-0.105571	0.9166	
LogRM	0.369169	0.373783	0.987655	0.3310	
GI	-0.069827	0.032809	-2.128272	0.0072	

The results of the cointegration test equation are as follows:

$$\text{LogFDI} = 6.625 + 0.0578\text{PE}_t - 0.0035\text{IR}_t + 0.3691\text{LogRM}_t - 0.0992\text{GI}_t$$

**Table 4. Residual Cointegration Test Results**

Variable	ADF t-statistic value	Critical Value			Prob.	Conclusion
		1%	5%	10%		
ECT(-1)	-5.6912	-3.6329	-2.9484	-2.6128	0.0000	Cointegrated

Based on the cointegration test results in Table 4, shows that there is a long-term relationship between the Foreign Direct Investment (LogFDI) variable and the variables that influence it, namely economic growth (PE), interest rates (IR), remittances (LogRM), and green investment (GI).

### Error Correction Model (ECM) Regression Results

The ECM model analysis is used to overcome the influence of independent variables on the dependent variable in the short term. The ECM approach is able to correct spurious regression results by explaining short-term and long-term parameters. The ECM test in this study uses the Engle-Granger model. A good ECM model is significant at a probability value smaller than the 90 per cent, 95 per cent, and 99 per cent confidence levels. The results of the Engle-Granger method ECM regression estimation in this study are as follows:

**Table 5. Error Correction Model (ECM) Test Results**

Variable	Coefficient	Std. Error	t-statistic	Prob.
C	0.016806	0.045169	0.372063	0.7126
ΔPE	0.047989	0.012647	3.794635	0.0007
ΔIR	-0.212613	0.099549	-2.135774	0.0413
ΔLogRM	0.463738	0.841510	0.551079	0.5858
ΔGI	-0.115137	0.101469	-1.134704	0.2658
ECT(-1)	-0.954213	0.170569	-5.594277	0.0000
<b>R-Squared</b>	0.675273		<b>Prob. F-Statistic</b>	0.000002





Based on the ECM short-term estimation results in Table 5. above shows that the ECT coefficient has a statistically negative and significant effect at the 99 per cent confidence level or ( $\alpha = 1\%$ ). The ECT value has a coefficient of -0.954213 or 95.42 per cent, meaning that the difference between the actual value of foreign direct investment and its equilibrium value of -0.954213 will be adjusted within one quarter.

With an R-Squared ( $R^2$ ) value of 0.675273, it shows that all independent variables contained in the model can affect foreign direct investment by 67.52 per cent, while the remaining 3.48 per cent is influenced by other factors outside the model. The economic growth variable (PE) has a significant positive effect on the foreign direct investment variable (LogFDI) and the interest rate variable (IR) has a significant negative effect on the foreign direct investment variable (LogFDI) with a probability value of PE of 0.0007 and IR of 0.0413 smaller than 0.05 or ( $\alpha = 5\%$ ).

The regression results of the Engle-Granger error correction model approach in the table above can be rewritten in the following equation:

$$\Delta \text{LogFDI} = 0.0168 + 0.0479\Delta \text{PE}_t - 0.2126\Delta \text{IR}_t + 0.4637\Delta \text{LogRM}_t - 0.1151\Delta \text{GI}_t - 0.9542\text{ECT}(-1)$$

### Classical Assumption Test Results

#### Normality Test Results

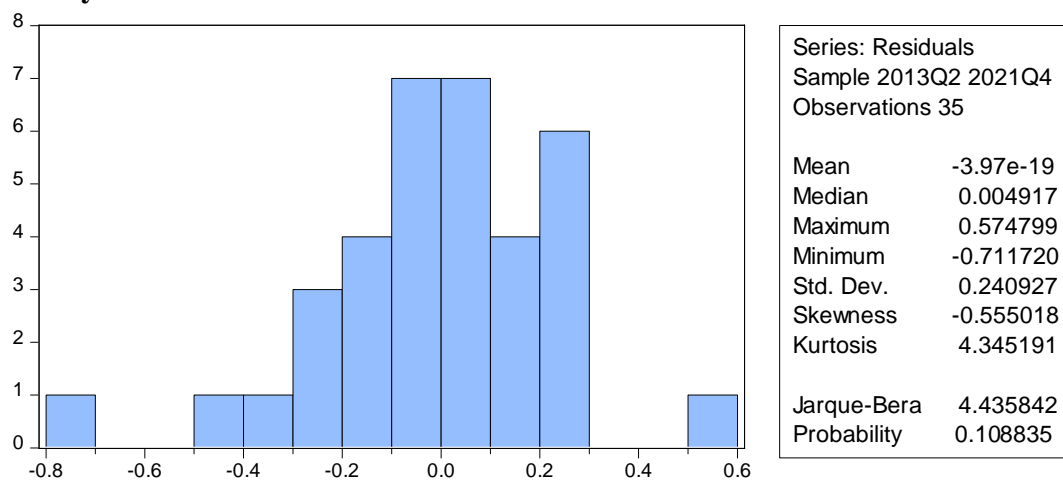


Figure 1. Normality Test Results

Based on the results of the normality test in Figure 1 above, it is known that the Jarque-Bera P value is 0.108835 which is greater than 0.05 ( $\alpha = 5\%$ ). Thus, it can be concluded that in this research model the data is normally distributed.

#### Multicollinearity Detection Results

Table 6. Multicollinearity Detection Results VIF Method

Variable	Coefficient Variance	Uncentered VIF	Centered VIF
C	0.002040	1.049272	NA
$\Delta \text{PE}$	0.000160	1.085699	1.085678
$\Delta \text{IR}$	0.009910	1.101243	1.080181

$\Delta\text{LogRM}$	0.708140	1.151038	1.136362
$\Delta\text{GI}$	0.010296	1.034705	1.025491
$\text{ECT}(-1)$	0.029094	1.017934	1.017899

The results of multicollinearity detection show that all independent variables, namely economic growth (PE), interest rates (IR), remittances (LogRM), and green investment (GI) have a VIF value of less than 10 or in accordance with the multicollinearity detection criteria using the  $\text{VIF} < 5$  method so that it is declared low multicollinearity or data in the study there is no multicollinearity problem.

### Heteroscedasticity Test Results

**Table 7. Heteroscedasticity Test Results**

Prob. Chi-Squared	Obs*R-Squared	Chi-Square Tabel	Results	Conclusion
0.5049	4.316128	9.487729	$H_0$ accepted	Homoscedasticity

The heteroscedasticity test results show that the Obs\*R-Squared value  $<$  Chi-Square table ( $4.316128 < 9.487729$ ), then  $H_0$  is accepted, which means that in this research model there is no heteroscedasticity problem in the ECM model, or the model is homoscedasticity. In addition, the probability of 0.5049 is greater than  $\alpha = 0.05$  ( $p > \alpha$ ) which also indicates that  $H_0$  is accepted.

### Autocorrelation Test Results

**Table 8. Autocorrelation Test Results**

Prob. Chi-Squared	Obs*R-Squared	Chi-Square Tabel	Results	Conclusion
0.4294	1.690938	9.487729	$H_0$ accepted	No Autocorrelation

The autocorrelation test results show that the Obs\*R-Squared value  $<$  Chi-Square table ( $1.690938 < 9.487729$ ), then  $H_0$  is accepted, which means that in this research model there is no autocorrelation problem in the ECM model. In addition, the probability is 0.4294 which is greater than  $\alpha = 0.05$  ( $p > \alpha$ ) which also indicates that  $H_0$  is accepted.

### Partial Test Results (t-Statistic Test)

The t-statistic test is used to test each independent variable partially. The criteria for partial testing or the t test are if the t-statistic is greater than the t-table then  $H_0$  is rejected and  $H_a$  is accepted. This means that statistically the independent variable has a significant effect on the dependent variable, and vice versa. The partial test results for each variable on the independent variable are as follows:



**Table 9. Short-term t-test results**

Variable	t-statistic	t-table	Prob.	Conclusion
ΔPE	3.794635	1.69552	0.0007	Significant
ΔIR	-2.135774	1.69552	0.0413	Significant
ΔLogRM	0.551079	1.69552	0.5858	Not Significant
ΔGI	-1.134704	1.69552	0.2658	Not Significant

**Table 10. Long-term t-test results**

Variable	t-statistic	t-table	Prob.	Conclusion
PE	3.119187	1.69552	0.0039	Significant
IR	-0.105571	1.69552	0.9166	Not Significant
LogRM	0.987655	1.69552	0.3310	Not Significant
GI	-2.879398	1.69552	0.0072	Significant

Based on the results of the t-statistic test, the economic growth variable has a significant positive effect and the interest rate variable has a significant negative effect on Foreign Direct Investment (FDI) in Indonesia in the short term. In the long term, the economic growth variable has a significant positive effect and the green investment variable has a significant negative effect on Foreign Direct Investment (FDI) in Indonesia.

#### Simultaneous Test Results (F-Statistic Test)

The F-Statistic test is used to see the relationship or influence of the independent variables in this research model together or simultaneously on the dependent variable. The F test criteria are if the F-statistic is greater than the F-table then  $H_0$  is rejected and  $H_a$  is accepted. This means that the independent variables jointly affect the dependent variable, and vice versa. The results of the F-statistic test are as follows:

**Table 11. F-Statistic test results in the short term**

Df (k-1 ; n-k)	$\alpha$	F-statistic	F-table	Prob.	Conclusion
4 ; 31	5%	12.06114	2.68	0.000002	Significant

**Table 12. F-Statistic test results in the long run**

Df (k-1 ; n-k)	$\alpha$	F-statistic	F-table	Prob.	Conclusion
4 ; 31	5%	4.637557	2.68	0.004738	Significant

Based on the results of the F-statistics test, it shows that in the short and long term the independent variables jointly affect the dependent variable. In other words, the variables of economic growth, interest rates, remittances, and green investment in the short and long term jointly affect Foreign Direct Investment (FDI) in Indonesia.



### **The Effect of Economic Growth on Foreign Direct Investment (FDI)**

Based on the estimation results, economic growth variables in the short term and long term have a significant positive effect on Foreign Direct Investment (FDI) in Indonesia. The results of this study are in line with research conducted by Njenga et al. (2023), which states that economic growth has a positive and significant effect on Foreign Direct Investment (FDI) in Kenya. Then research conducted by Astuty (2018), which states that economic growth has a significant positive effect in the short and long term on Foreign Direct Investment (FDI) in Indonesia.

The results of this study are also in line with the view of accelerator theory, which states that changes in aggregate output can affect investment. Where the change in aggregate output is economic growth. So that when economic growth increases, then net investment will be positive and vice versa, if economic growth increases by a larger amount, then net investment will increase by an even larger amount. Thus, economic growth has a positive relationship with Foreign Direct Investment (FDI), where when economic growth increases, Foreign Direct Investment (FDI) will increase and vice versa when economic growth decreases, Foreign Direct Investment (FDI) will decrease.

### **The Effect of Interest Rates on Foreign Direct Investment (FDI)**

Based on the estimation results, the interest rate variable in the short term has a significant negative effect on Foreign Direct Investment (FDI) in Indonesia and in the long term the interest rate variable has an insignificant negative effect on Foreign Direct Investment (FDI) in Indonesia. The results of this study are in line with research conducted by Astuty (2018), stating that the real interest rate in the short term has a significant negative effect on Foreign Direct Investment (FDI) in Indonesia. Then research conducted by Emmanuel et al. (2018), states that interest rates in the short term have a significant negative effect on Foreign Direct Investment (FDI) in Nigeria, while in the long term interest rates have an insignificant negative effect on Foreign Direct Investment (FDI) in Nigeria.

The results of this study are also in line with the view of the Marginal Efficiency of Investment (MEI) theory proposed by Keynes, which states that a decrease in interest rates will trigger demand for more capital equipment, which in turn will result in increased equipment prices. An increase in the price of capital equipment will increase interest rates and will increase the value of investment costs of each investment project, so there is a negative relationship between investment and interest rates. Where when interest rates rise, Foreign Direct Investment (FDI) will decrease and vice versa when interest rates fall, Foreign Direct Investment (FDI) will increase.

### **The Effect of Remittances on Foreign Direct Investment (FDI)**

Based on the estimation results, the remittance variable in the short term and long term has a positive and insignificant effect on Foreign Direct Investment (FDI) in Indonesia. The results of this study are in line with research conducted by Basnet & Upadhyaya (2014), which states that remittances are not significant in explaining cross-country variations in



Foreign Direct Investment (FDI) inflows. However, the geographically separated estimation results provide different effects of remittances on Foreign Direct Investment (FDI), namely remittances have a significant positive effect on Foreign Direct Investment (FDI) in African countries, remittances have an insignificant positive effect on Foreign Direct Investment (FDI) in Latin American countries, and remittances have an insignificant negative effect on Foreign Direct Investment (FDI) in the Asia-Pacific region.

In the short term and long term, remittances have a positive and insignificant effect on Foreign Direct Investment (FDI) in Indonesia. This is because in the study period there was a global economic contraction caused by the Covid-19 pandemic, causing remittances to decline and their allocation was prioritised to meet household consumption. This is supported by research conducted by Noveria & Romdiati (2022), which states that the Covid-19 pandemic has caused a decrease in the standard of living of migrant workers' families, reduced savings and investment, and decreased spending on food, education, and health. Thus, the Covid-19 pandemic caused a global economic contraction that affected the decline in remittances and reduced the allocation of remittances for investment in education and human resource training.

### **The Effect of Green Investment on Foreign Direct Investment (FDI)**

Based on the estimation results, the green investment variable in the short term has an insignificant negative effect on Foreign Direct Investment (FDI) in Indonesia and in the long term green investment has a significant negative effect on Foreign Direct Investment (FDI) in Indonesia. The results of this study are in line with research conducted by Vechiu (2018), which states that domestic environmental regulations have a significant positive effect on the outflow of Foreign Direct Investment (FDI), and there is a significant positive effect of regulatory gaps such as companies fleeing from strict environmental regulations at home and being attracted to countries that have relatively weaker regulations. Thus, when the environmental regulations of the destination country are relatively weaker, the inflow of Foreign Direct Investment (FDI) in that country will increase.

However, green investment in a country should still be considered. Since green investment refers to the allocation of funds to projects that aim to improve environmental and social welfare, the existence of environmental regulations that support green investment can push the country into a sustainable economy and can help reduce negative environmental impacts such as air pollution, water pollution, and land degradation as well as reduce greenhouse gas emissions. Thus, it can be said that green investment and foreign direct investment are both needed in a country.

### **The Effect of Economic Growth, Interest Rates, Remittances, and Green Investment on Foreign Direct Investment (FDI)**

Based on the estimation results, in the short and long term economic growth variables, interest rates, remittances, and green investment together have a significant effect on Foreign Direct Investment (FDI) in Indonesia. The results of this study are in line with research conducted by Astuty (2018), which states that in the short term the variables of economic

growth, interest rates, rupiah exchange rates, labour productivity, and exports and Error Correction Term (ECT) together have a significant effect on foreign direct investment in Indonesia. Economic growth is an indicator of prosperity in a country. Strong economic growth in a country can attract both domestic and foreign investment. Strong economic growth can put pressure on interest rates. If the economy grows rapidly, the central bank needs to raise interest rates to prevent economic overheat and excessive inflation.

## CONCLUSION

Based on the results of research and discussion that has been done in this study, it can be concluded that the economic growth variable has a significant positive effect in the short term and long term. The interest rate variable has a significant negative effect in the short term, but in the long term the interest rate variable has an insignificant negative effect. The remittance variable has a positive and insignificant effect in the short and long term. The green investment variable has a negative and insignificant effect in the short term, but in the long term the green investment variable has a significant negative effect. And the variables of economic growth, interest rates, remittances, and green investment in the short and long term together have a significant effect on Foreign Direct Investment (FDI) in Indonesia.

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