CHAPTER I

INTRODUCTION

In Chapter I, the discussion is mainly about the outline of primary and essential circumstances regarding the overall study of the topic. This part will describe why and how the context rises along with the explanation of relevant general knowledge, followed by the research questions that would be reviewed in the other part of the paper.

1.1 Background of Study

Dynamic global economic conditions have brought the level of uncertainty to an increasingly high level throughout the world since the global financial crisis (the great recession) in 2008. Uncertainty in economic policy is always associated with macroeconomic conditions that underlie the decline in investment, output, consumption, and employment. Rates in sectors that are sensitive to policies, such as the defense, health, finance, infrastructure, and construction sectors in response to financial friction (Baker, 2016; Jurado *et al*., 2015). In addition, according to Pastor and Veronesi (2013), policy uncertainty is also associated with fluctuations and volatility of price movements in the stock market which increase the perception of risk for capital market players.

Research on uncertainty has been carried out by many previous researchers, for example Liu and Zhu (2017), found that uncertainty conditions caused the saving rate to increase by 18% in China in 1989 and 1990 as an effect of political uncertainty, while Bloom (2009) showed Economic uncertainty attracts the attention of policy makers, especially causing companies to be cautious in responding to business conditions during periods of high uncertainty, which could lead to a recession. The negative effect of uncertainty that makes economic activity decline will have consequences for companies, investors, and also the country's economy (Duong *et al*., 2020). In addition, several other studies assessed that uncertainty also triggers movements in the business cycle, bank runs, and fluctuations in asset prices, which have the potential to cause large shocks in the short term which can then result in a long-term recession (Bloom *et al*., 2012; Fagjelbaum, *et al*., 2014; Bacchetta, *et al*., 2012).

Given the various risks in facing uncertainty, there is a probability of experiencing financial shortfalls and adaptation of corporate financing activities must be carried out due to changes in investor perceptions regarding uncertainty risk which then affects the cost of equity as part of the company's leverage, as well as increasing cash flow risk (Dai and Zhang, 2019). The company's financial decisions made in the midst of uncertainty, when associated with the company's target leverage, have a dependence on company characteristics such as cash holdings, total assets, and investment-to-capital ratios (Shuetrim, Lowe, and Morling, 1993). However, in the midst of uncertainty, it is difficult for companies to evaluate target leverage based on anticipated future profits, cash flows, and investments, thus hampering the reaction of company managers and the efficient allocation of the company's capital structure (Baum *et al*., 2006).

Generally, company characteristics consisting of company age, company size, asset structure, profitability, growth opportunities, anticipated dividends, risk, tax benefits, and managerial ownership (Abor, 2008) will be associated with short-term and long-term leverage for prove the theory of trade-offs, pecking orders, and market timing models in finding the most optimal capital structure (Fama and French, 2002; Frank and Goyal, 2009). In addition, the capital structure decisions taken also have differences, depending on the category of the company and the industry (Gombola, Liu, and Chou, 2019). In Indonesia, as a developing country and one of the emerging markets in Southeast Asia, it has unique company characteristics, which are on average low in long-term debt (Pontoh and Budiarso, 2018). The capital structure decided by the company as in the example above is crucial for increasing the value of the company, maximizing the utilization of available funds, reducing the cost of capital, solvency and liquidity position, as well as flexibility for adaptation in order to increase the probability of success of the company (Kim, 2019).

In previous studies, researchers failed to examine whether leverage only depends on firm characteristics and does not interfere with uncertainty. Several researchers after that (Julio and Yook, 2012; Cao *et al*., 2013), have found that there is a relationship between uncertainty and company characteristics independently, with a decline in corporate investment in years with high political uncertainty as an effect of the presidential election process in the

United States. This literature study is supported by other researchers, namely Gulen and Ion (2016) who use the policy uncertainty index to measure uncertainty, finding that doubling the index is associated with an 8.7% decrease in the company's investment ratio in the next quarter.

The interaction between macroeconomic dynamics and uncertainty, apart from those mentioned as examples, is generally also caused by changes in monetary policy, which then has an influence on the investment discount rate (Baum *et al*., 2009). As a result of changes in the discount rate, the effect of policy stimulus on rising real asset prices, tax reductions in interest payments (due to debt tax-shields), and general goods price inflation, provide incentives for high levels of leverage. Then, it makes the aggregate calculation of the real cost of debt and real cost of equity affect the company's decision to achieve equilibrium by adjusting the target leverage. The developed literature on uncertainty focused as a result of macroeconomic dynamics was documented by Lowe and Shuetrim (1992) over two decades in Australia.

Determining the target leverage in conditions full of uncertainty in economic policies that must be adjusted to the characteristics of the company invites the question of whether there is a causal relationship to the combined effect of the two in determining the company's capital structure. Since previous research has only focused on the relationship between uncertainty and firm characteristics independently of firms' capital structure decisions, it has attracted the interest of researchers to further explore the combined effect of uncertainty and firm characteristics on firms' capital structure decisions in Indonesia.

1.2 Statement of Problem

Based on the background that has been raised above, the formulation of the problem in this study is:

A. On average, does uncertainty have a negative impact on target leverage?

B. Does the marginal effect of uncertainty on target leverage (and actual leverage) vary across firms in Indonesia depending on firm characteristics at time t?

1.3 Research Objectives

Based on the existing problem formulation, the researchers conducted research with the aim of:

A. Knowing whether on average, uncertainty has a negative impact on target leverage.

B. Knowing whether the marginal effect of uncertainty on target leverage (and actual leverage) varies among Indonesian firms depending on the firm's characteristics at time t.

1.4 Benefits of The Study

The research conducted is expected to be useful for many parties, including:

A. For companies

This research is expected to be one of the considerations for companies, especially financial managers, to regulate the composition of the right capital structure, according to the characteristics of the company amidst the uncertainty of economic policy.

B. For academics

This research is expected to be a reference for the development of further research related to the combined effect of uncertainty and company characteristics on the capital structure of companies in Indonesia.

C. For researchers

This research is expected to be a reference for developing further research related to capital structure in relation to company characteristics and uncertainty.

1.5 Limitation of The Study

The limitation of research conducted by researchers in researching the combined effect of uncertainty and company characteristics in decisions on the capital structure of companies in Indonesia is the use of reports from Indonesian companies for 10 years from the period 2009 – 2019 in every sector except banking and using uncertainty measurements from the World Uncertainty Index (WUI).

1.6 Systematic Writing of The Study

The systematics of writing in this study consisted of:

Chapter I

This chapter will explain about the background of study, statement of problem, research objectives, benefits of the study, research limitations, and systematic writing of the topics chosen by the researcher.

Chapter II

This chapter will contain the theoretical basis and literature review relevant to the topic raised by the researcher as a rationale in research and developing hypotheses that will be verified in the research to be carried out.

Chapter III

This chapter will explain the methods and data used in the research, along with the empirical model and how to test the dependent and independent variables contained in the model. This chapter will explain the methods and data used in the research, along with the empirical model and how to test the dependent and independent variables contained in the model.

Chapter IV

This chapter will present the results of data processing that is processed using the methods that have been defined in the empirical model. These results will then be analyzed to answer the problem formulation and draw conclusions.

Chapter V

This chapter is the concluding part of the research and summarizes the conclusions of the results obtained from the research, the implications of the research results, along with useful suggestions for improving research by further researchers in the future.