

# Macro and Institutional Variables with Foreign Direct Investment in Emerging and Developing Countries in Asia

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# Macro and Institutional Variables with Foreign Direct Investment in Emerging and Developing Countries in Asia

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Foreign Direct Investment (FDI) inflows are the largest form of investment and one of the least volatile of all external financial flows. Therefore, FDI is believed to help drive sustainable investment growth in a country. The purpose of this study is to examine and analyse the factors that influence FDI Inflows in emerging and developing countries in Asia for the year 2002-2017. This study uses the Generalised Method of Moments (GMM), the results of the study indicate that GDP growth, inflation, exchange rates, money supply, interest rates, government effectiveness, and political stability have a significant relationship with FDI inflows.

**Key words:** *Foreign direct investment, emerging and developing Asia, macro variable, institutional quality.*

## Introduction

Research on investment has been developing in recent years (Lubis, Silangit, Ismail, & Muda, 2019; Mohammadi, Kardan, & Salehi, 2018; Nuradi, Badaruddin, Rujiman, and Lufti, 2017; Fitrianti, Ismail, Maski & Pratomo, 2018; 2015). Developing countries need investment to sustain economic growth, while funds from domestic sources are considered insufficient to meet investment needs (Adiyudawansyah and Santoso, 2012). Lack of capital, low levels of savings and investment, and technological underdevelopment encourage developing countries to improve the standard of living for their people, therefore an alternative to increase domestic savings is through investment and foreign capital imports, one of which is through foreign direct investment (Anwar, Kuswantoro, and Dewi, 2016).



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Foreign Direct Investment (FDI) is an international capital flow where companies from one country establish or expand their companies in other countries (Krugman and Obstfeld, 2011). FDI flow as a form of capital flow that is long term is the largest form of investment and one of the least volatile of all external financial flows, especially to developing countries (UNCTAD, 2017).

FDI will also bring technology from the country of origin to the recipient country, among others in the form of economic growth, capital infusion and new technology, and an increase in employment (Appleyard and Field, 2014). Especially for developing countries, this type of investment is needed to sustain sustainable economic growth (Adiyudawansyah and Santoso, 2012). Direct investment such as FDI is also preferred over portfolio investment, which tends to be short-term and less stable (Ruth and Syofyan, 2014). According to the 2016 UNCTAD global investment trend monitor report, global FDI has increased by 36% in 2015 (Kayalvizhi and Thenmozhi, 2017).

For the first time in history, developing countries received more than half the flow of global FDI (Todaro, 2015). Developing Asia continues to be the second largest recipient of FDI in the world, with China, Hong Kong, Singapore and India being the countries with the highest FDI recipients in the world. The outlook for FDI is quite positive in most regions, especially in developing Asian countries, where improved prospects in large countries are likely to increase investor confidence (UNCTAD, 2017).

FDI or foreign direct investment is one of the important characteristics of an increasingly globalised economic system and is widely understood as something big for economic development (Buchanan, Le, and Rishi, 2012). FDI now plays an important role in the business internationalisation process. Very large changes have occurred both in terms of size, scope, and method of FDI in the last decade. These changes occur due to technological developments, easing restrictions on foreign investment, and deregulation and privatisation in various industries.

Previous studies on what factors influence FDI inflows into a country have been widely studied in various journals, but in constructing a model there are differences in variables among authors, the scope of research also varies with time vulnerable and different countries (Ilmi, 2017; Meidayati, 2017; Kholis, Fatma, Maksum & Bukit, 2016; Rakhman, 2016). However, there has not been much research on the relationship of institutional factors, such as the effectiveness of the government and the political stability of a country with FDI inflows, where there are 22 emerging and developing Asian countries that were examined and used the year 2002-2017.



The objective to be achieved in this study is to examine and analyse the relationship of GDP growth, inflation, exchange rates, money supply, and interest rates significantly related to FDI inflows in emerging and developing countries in Asia. Furthermore, it is also to analyse the relationship between government effectiveness and political stability with FDI inflows in emerging Asia emerging countries and developing countries in 2002-2017.

The results showed that there was a significant relationship between macro variables such as GDP growth, inflation, exchange rates, money supply, interest rates; as for institutional variables such as government effectiveness and political stability also have a significant relationship with FDI inflows in emerging and developing countries in Asia.

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Structure of this paper is as follows: Part 2 is literature review and hypotheses development; Part 3 is sample description and research variable; Part 4 is result and discussion; Part 5 is conclusions, limitations, and suggestions of this research.

### **Literature Review**

#### ***Gross Domestic Product (GDP) and Foreign Direct Investment (FDI)***

The role of GDP on investment is very important as the high national income will increase people's income which in turn will increase demand for goods and services. It will also have an impact on higher company profits which will then encourage more investment. In other words, if GDP increases then investment will also increase (Sukirno, 2006).

Research by Fedderke and Romm (2006) and 5 Mossa and Cardak (2006) found that a country's market size as measured by real GDP has a positive effect on FDI inflows. The greater the size of the host country market, in terms of the country's GDP, the higher the inflows of FDI (Uddin and Boateng, 2011). The greater the size of the market, the higher the prospects for the acquisition of FDI that are used to meet demand in the economy. An increase in the GDP growth rate characterises a dynamic economy that might be more attractive for investors to invest in.

**H<sub>1</sub>:** There is a relationship between Gross Domestic Product (GDP) and Foreign Direct Investment (FDI)

#### ***Inflation and Foreign Direct Investment (FDI)***

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Inflation rates reflect economic stability, the emergence of internal economic tensions and how the ability of governments and central banks to balance the national budget. High inflation will reduce the real value of income in local currency for companies that will invest capital (Buckley et al, 2010). On the other hand, low inflation indicates national economic



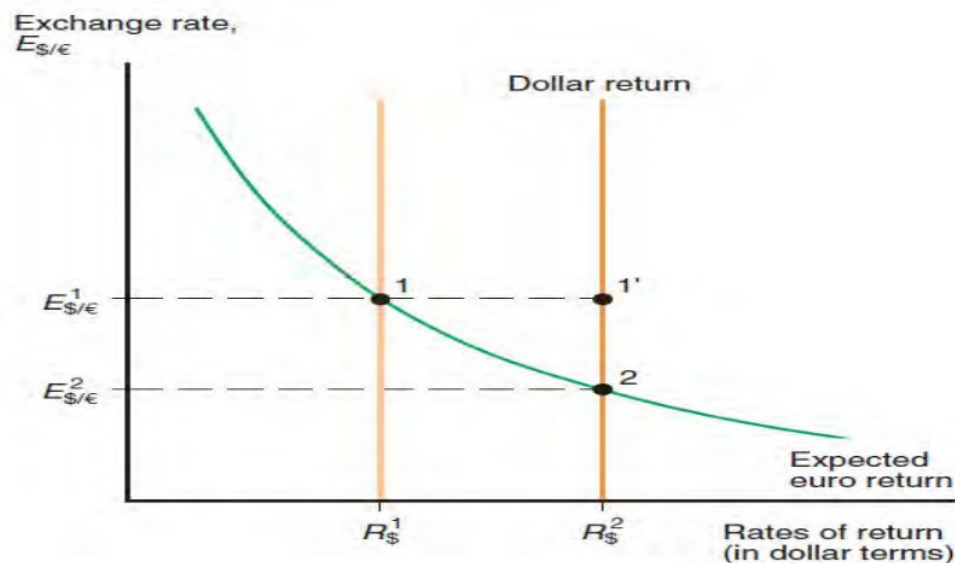
stability and encourages FDI to enter. Coskun (2001) examines FDI inflows into Turkey and finds that lower inflation rates tend to attract foreign investors and increase FDI inflows.

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**H<sub>2</sub>:** There is a relationship between Inflation and Foreign Direct Investment (FDI)

### *Exchange Rate and Foreign Direct Investment (FDI)*

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Tolentino (2010) mentions that there are two basic channels in which exchange rates affect FDI: the wealth effect channel and the relative production cost channel. The depreciation of the host country's currency induces a reduction in the cost of local production in terms of foreign currencies which then increases the profitability of export-oriented FDI. Higher returns naturally attract further FDI inflows. In terms of wealth effects, the relative wealth of foreign investors compared to domestic investors also increased after currency depreciation. For foreign investors, all production inputs, such as labour, land, machinery and assets, in the host country become cheaper after depreciation, thus encouraging them to obtain more domestic assets. Fluctuating exchange rates will worsen the economic condition of a country, so foreign investors are reluctant to invest. The relationship of the exchange rate to investment is illustrated by the curve in Figure 1 below:

**Figure 1.** Exchange Rate and Investment



Source: Krugman (2011)



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In short, several discoveries belonging to Caves (1989), Froot and Stein (1991) and also Healy and Palepu (1993), have found a positive correlation between dollar depreciation and an increase in FDI.

**H<sub>3</sub>:** There is a relationship between Exchange Rates and Foreign Direct Investment (FDI)

#### ***Money Supply and Foreign Direct Investment (FDI)***

An increase in the money supply also improves a country's national economic position, which in turn will attract further FDI inflows (Resende, 2008). The above is consistent with the opinion of Harford (2005) that the position of economic liquidity positively influences the aggregate level of FDI. From a theoretical point of view, increasing national liquidity must attract further FDI inflows, given that the cost of financing in the host country is then expected to be cheaper.

**H<sub>4</sub>:** There is a Relationship between the Amount of Money Supply and Foreign Direct Investment (FDI)

#### ***Interest Rate and Foreign Direct Investment (FDI)***

The government, in its efforts to increase capital accumulation in various development sectors, then enforces domestic interest rate policies. Low interest rates in developed countries have resulted in increased capital to developing countries lately, so it can be concluded that international and domestic interest rates have a relationship with FDI inflows into emerging and developing countries in Asia.

Billington (1999) shows that interest rates are a significant determinant of the choice of inward FDI in seven industrialised countries. Similar findings by Hong and Kim (2002), also report that low interest rates in European Union countries are one of the most influential factors for Korean multinational companies when deciding on a chosen location in the manufacturing sector in EU countries. On the other hand, Yang et al. (2000), and Jeon and Rhee (2008), suggest that higher interest rates in the host country make foreign investment more attractive because it leads to profitable investment. Therefore, based on the above discussion it can be concluded that FDI can be driven by both low and high interest rates.

**H<sub>5</sub>:** There is a Relationship between Interest Rate Relations and Foreign Direct Investment (FDI)



### ***Institutional Indicators and Foreign Direct Investment (FDI)***

Gani (2007) provides strong confirmation that governance indicators, such as the rule of law, corruption control, quality of regulation, government effectiveness, and political stability are positively correlated with FDI in developing countries in Asia and Latin America. Previous research also shows that Indonesia is a country with a large political influence especially in business (Harymawan, Lam, Nasih & Rumayya, 2019; Harymawan, Nasih, Madyan & Sucahyati, 2019; Harymawan & Nowland, 2016). Busse's study (2007) explains the relationship between political, institutional, and FDI inflows. The results in 83 countries showed that government stability, internal and external conflicts, corruption and ethnic tensions, law and order, democratic government accountability, and the quality of the bureaucracy were very significant determinants of foreign investment inflows.

3 **H<sub>6</sub>:** There is a relationship between Institutional Indicators and Foreign Direct Investment (FDI)

#### **Research Design**

##### ***Sample and Data Source***

The data sought is data to analyse the factors related to the magnitude of FDI inflows in 22 emerging and developing Asian countries, by comparing with previous research. Data sources were obtained from several international websites, including: World Investment Report by UNCTAD, World Bank's World Development Indicators, International Financial Statistics (IFS) by the IMF, The Worldwide Governance Indicators (WGI) by the World Bank, World Economic Outlook by the IMF.

##### ***Variable Definition and Data Measurement***

6 The dependent variable in this study is FDI inflows. FDI inflows are the value of direct investments made by non-resident investors in the reporting economy. FDI flow is measured in USD and is part of GDP. The FDI inflows used in this study are annual FDI inflows data sourced from the World Investment Report (UNCTAD) and the unit used is million USD.

The independent variables in this study are Gross Domestic Product Growth, Inflation, Exchange rates, Money Supply, Interest Rates, and State Governance Indicators. GDP is the amount of value added by all residents in an economy plus any product taxes and subtracted by all subsidies that are not included in the value of the product. Inflation as measured by the consumer price index reflects the percentage of annual changes in costs to the average consumer in obtaining goods and services that can be fixed or changed at specified intervals, such as annual. The exchange rate is the price of one unit of a country's currency in terms of another country's currency, which is determined in the foreign exchange market or the market



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that trades various currencies and is reported daily to the IMF by the issuing central bank. The unit used is the annual percentage of the domestic currency per USD. Broad money (M2) is the most inclusive method for calculating a country's money supply. Broad money itself is the amount of currency outside the bank; current accounts other than the central government; time, savings and foreign currency deposits from the resident sectors apart from the central government; bank and traveller checks; and other securities such as certificates of deposit and securities. In this study, the broad money unit is the annual percentage of GDP of each country. Interest rates are divided into two – the nominal interest rate and the real interest rate. The data used in this study is the real interest rate data which is the interest rate adjusted for inflation measured by GDP deflator (usually expressed as a percentage).

The Worldwide Governance Indicators (WGI) are part of a research project to develop governance indicators across countries. WGI consists of six indicators combining a broad dimension in governance covering more than 200 countries since 1996, namely voice and accountability, political stability and the absence of violence / terrorism, government effectiveness, regulatory quality, rule of law, and corruption control. Six aggregate indicators are reported in two ways: (1) In standard normal units, ranging from -2.5 to 2.5, and; (2) In terms of percentile ranks from 0 to 100, with higher values corresponding to better results. The combined measure of governance is produced by the Unobserved Components Model (UCM). In this study, the method used was index (1), and the data obtained were sourced from Worldwide Governance Indicators by the World Bank.

### ***Research Method***

The analysis technique used in this research is quantitative analysis and descriptive analysis. Descriptive analysis is used to form a picture systematically by trying to find the facts using the correct interpretation, where the results of this analysis are a generalisation of patterns with typical cases from certain individuals or groups. The form of this descriptive analysis is to provide an overview of economic growth using dynamic panels. Data processing in this study uses Microsoft Office Excel 2010 and STATA 13 software. In processing data, to overcome the problem of endogeneity, this study uses a panel methodology using Generalised Method of Moment (GMM) to obtain estimates of a consistent relationship between FDI inflation and macroeconomic factors and institutional quality factors.

### **Result and Discussion**

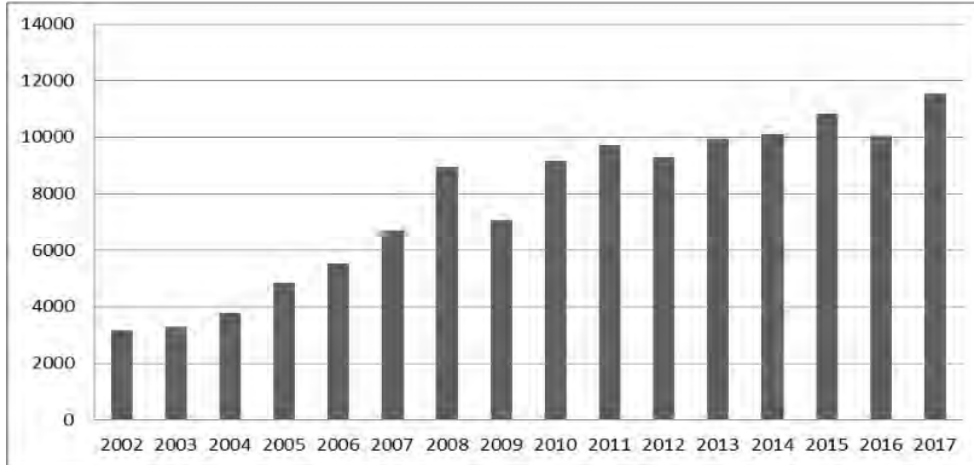
#### ***Descriptive Statistics***

FDI inflows in emerging and developing Asian countries generally increased from 2002 to 2008 which reached \$ 8.6 trillion (Figure 2).





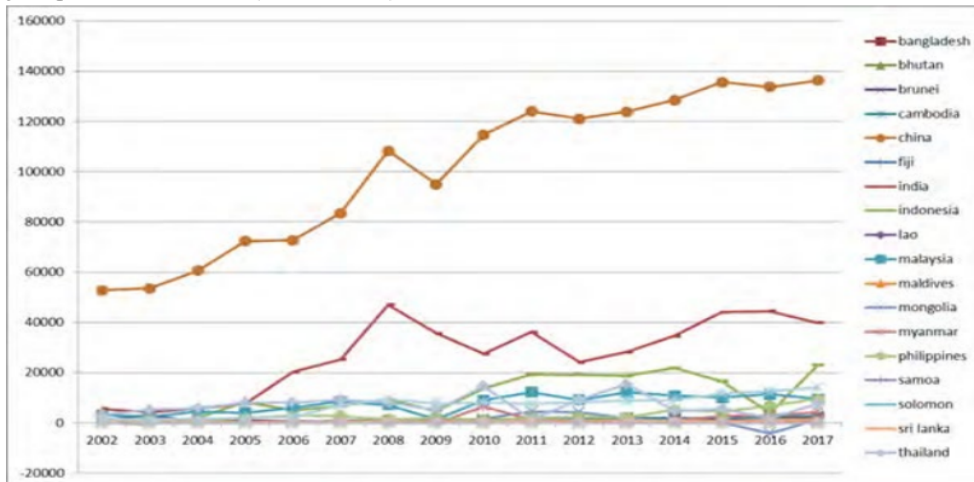
**Figure 2.** Average Flow of Foreign Direct Investment (FDI) in 22 Emerging and Developing Countries Asia period year 2002-2017 (million US\$)



Sources: UNCTAD 2017

FDI inflows in each of Asia's emerging and developing countries show different trends, this is shown in Figure 3.

**Figure 3.** Trend of FDI Inflows in Each Emerging and Developing Countries Asia for the year period 2002-2017 (million US\$)



Sources: UNCTAD 2017



Table 1 is a descriptive statistical data from the data of variables used in the period 2002 to 2017. FDI inflows have an average of 6.176101 with a standard deviation of 2.776053 and a minimum value of -0.8915981 and a maximum value of 11.82276.

**Table 1:** Descriptive Statistics

Variables	Number of observations	Mean	Std. Dev	Min	Max
FDI inflows	343	6,176101	2,776053	-0,8915981	11,82276
GDP	352	5,635408	6,04505	-26,04971	64,06996
Inflation	351	5,407894	5,853557	-18,10863	57,07
Exchange Rates	352	3,954225	3,044336	0	10,01793
Money Supply	352	3,968936	0,6624744	1,323988	5,33974
Interest Rate	352	5,408798	7,878099	-18,73	78,77869
Gov Effectiveness	352	-0,2519971	0,6380712	-2,270754	1,267115
Political Stability	352	-0,1024015	0,878636	-2,094643	1,387627

**The Relationship between GDP Growth and FDI Inflows**

The estimation results in Table 2 show that GDP growth has a positive and significant relationship to FDI inflows. The results of this study are in line with findings made by Fedderke and Romm (2006) and Moosa and Cardak (2006) in their study explaining an increase in FDI inflows that is directly proportional to GDP growth in Africa and in 138 countries.

As shown in Figure 3, GDP growth trends are in line with the trend of FDI inflows in Indonesia, between 2002 and 2017, with both variables in an upward trend. Indonesia has the largest increase in FDI inflows in developing countries as a whole, at \$23 billion. FDI inflows to Southeast Asia rose about 11 percent to \$134 billion, driven by increased investment in most ASEAN countries and a strong rebound in Indonesia (ASEAN Secretariat and UNCTAD, 2017).

**Table 2:** The Results of System GMM Estimator

Variables	Emerging and Developing Countries Asia	
	Coef.	P-value
L.Infdi	0.698	0.000*
GDP	0.033	0.000*
Inflation	0.027	0.000*
Exchange Rate	0.048	0.000*

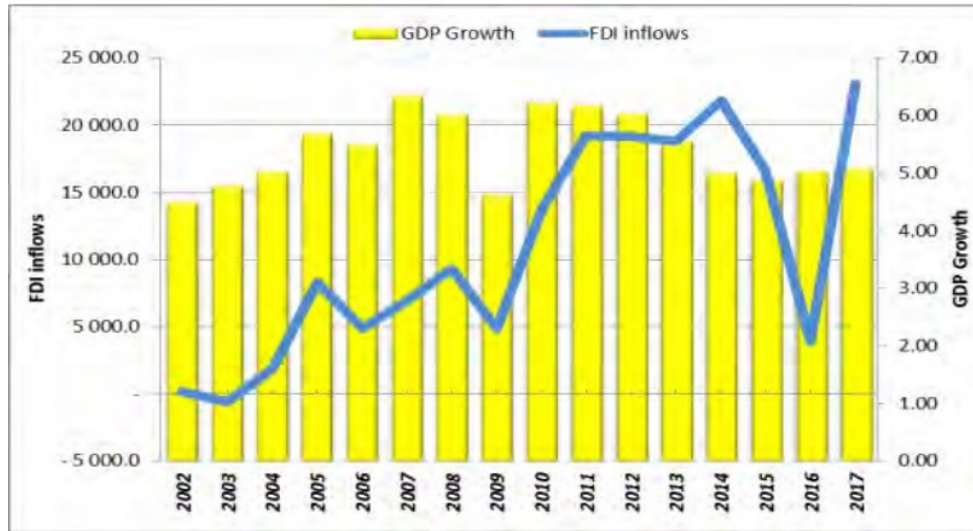


Money Supply	0.412	0.000*
Interest Rate	-0.014	0.000*
Gov Effectiveness	0.387	0.000*
Political Stability	-0.466	0.000*
Cons	-	-
AR (1)	0.156	
AR (2)	0.399	
Sargan Test	0.110	
Hansen Test	0.891	
Hansen Test (GMM)	0.407	
Hansen Test (Diff GMM)	0.988	
Hansen IV	0.589	
Hansen (Diff IV)	0.998	

Sources: Output Results from STATA 13, 2019

Notes: Regression estimation \* show significance level on 1%.

Figure 4. The Relationship between GDP growth and FDI in Indonesia



Sources: UNCTAD 2017 and World Bank

This research shows the results which state that increasing a country's GDP growth will increase the interest of foreign investors to invest their capital. This investment is expected to contribute to improving the welfare of the developing countries concerned, as well as increasing demand for higher export value added from developed countries (OECD Policy Brief, No. 6, 1998).



### ***The Relationship between Inflation and FDI Inflows***

Inflation rates reflect economic stability, present the internal economic tensions, and the ability of governments and central banks to balance the national budget (Boateng et al., 2015). In other words, inflation can be used as an indicator of the economic and political conditions of the host country, but the difference between "high" inflation and "low" inflation does not differ (Singhania and Gupta, 2011). Inflation has a positive and significant impact on FDI inflows in research conducted by Coskun (2001), where he examines the validity of Turkey's foreign investment policies. The results show that companies investing in Turkey are highly motivated by the country's economic performance and growing market size. This was mainly due to the majority of foreign companies intending to produce for the local market. In addition, Coskun also explained that lower inflation rates tend to attract foreign investors and increase FDI inflows into Turkey.

There are other findings that are not in line with Coskun's findings. These other studies have found that the correlation between inflation and FDI is positive. Research conducted by Anitha (2012) revealed an unexpected positive relationship between FDI inflows and inflation in India in 2008 to 2012 that contradicted the expected negative relationship. In this study, the inflation coefficient is positive, which means an increase in inflation can increase FDI inflows. This can occur because of high domestic prices which result in an increase in production costs, which in turn also affects domestic and foreign demand for commodities. On the basis of these findings it can be said that foreign capital inflows depend on a number of factors besides the inflation rate.

### ***The Relationship between Exchange Rate Depreciation and FDI Inflows***

Tolentino's research (2010) examined the relationship between a number of macroeconomic factors for origin countries and FDI outflows outside China and India using several time series data from 1982 to 2006, and respectively from 1980 to 2006. The resulting currency depreciation for the host country induces a reduction in the cost of local production, in terms of foreign currencies, which will ultimately increase the profitability of export-oriented FDI. Higher returns naturally attract further inflows of FDI into the host country. Some discoveries belonging to Caves (1989) and Healy and Palepu (1993), agree that dollar depreciation is positively correlated with increased FDI inflows.

### ***The Relationship between Money Supply and FDI Inflows***

Money supply has a positive and significant impact on the variable FDI inflows in research conducted by Clarke and Ioannidis (1994) and Resende (2008) in the UK. In their opinion an increase in the money supply also improves the national economic position of a country,



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which will ultimately attract further FDI inflows. Likewise, the results of Harford's (2005) study explained that the position of economic liquidity positively affected the aggregate level of FDI. From a theoretical point of view, increasing national liquidity should attract further FDI inflows, given that the cost of financing in the host country is then expected to be cheaper (Boateng et al., 2015).

#### ***The Relationship between Interest Rates and FDI Inflows***

In accordance with the results of estimates that have been done previously, rising interest rates have a negative and significant relationship to FDI inflows. Billington (1999) demonstrates that interest rates are an important determinant in the choice of locations of FDI inflows to host countries in the seven industrialised countries he studies. Similar research was also reported by Hong and Kim (2002), where they explained that the low interest rates in European Union countries were one of the most influential factors for Korean multinational companies when deciding on their preferred location in the manufacturing sector in countries of the European Union.

However, other studies are not in line with the findings of Hong and Kim. Namely research by Yang et al. (2000) and Jeon and Rhee (2008) suggest that higher interest rates in the host country make foreign investment more attractive because it leads to profitable investment. Therefore, it can be concluded that FDI can be driven by low and high interest rates.

#### ***The Relationship between Institutional Indicators (Government Effectiveness and Political Stability) and FDI Inflows***

The results of estimates that have been done previously showed that the value of government effectiveness has a positive and significant relationship to FDI inflows. Research presented by Gani (2007) provides strong confirmation that government indicators, such as the rule of law, corruption control, quality of regulation, government effectiveness and political stability are positively correlated with FDI in developing countries in Asia and Latin America. In line with Gani's research, Buchanan et al. (2012) stated that the impact of institutional quality on the level and volatility of FDI in 164 countries has been shown to have a positive and significant effect on FDI.

The results of estimates show the value of political stability has a negative and significant relationship to FDI inflows. This means that if the value of a country's political stability increases, the more inflows of FDI will actually decrease. Busse's study (2007) explains the relationship between political, institutional, and FDI inflows. The results in 83 countries showed that government stability, internal and external conflicts, corruption and ethnic tensions, law and order, democratic government accountability, and the quality of the



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bureaucracy were very significant determinants of foreign investment inflows. In addition, Jensen (2007), using qualitative evidence from investors, insurance companies, and location consultants, explored the mechanism linking democratic regimes with lower levels of political risk. And found that democratic regimes reduce risks for multinational investors, in this case FDI.

However, there are other studies that are not in line with Busse and Jensen's findings. Other studies have found that the correlation between high political stability and FDI is negative. Research by Li and Resnick (2003), which examined 53 developing countries in the period 1982 to 1995, argues that improvements in democratic rights leads to increased protection of property rights, which in turn increases FDI. Apart from these indirect effects, democracy may have a negative influence on foreign investment. However, these results could be different if the number of countries and time periods of their research were expanded, because there has been a substantial increase in the flow of FDI especially to developing countries (and improvements in democracy) since the mid-1990s.

As in Indonesia, the growth in FDI inflows has been linked to a series of economic policy packages implemented by the government over the past few years. The government has introduced 14 stimulus packages, mainly focussing on deregulation, law enforcement and business certainty, cutting interest rate taxes for exporters, cutting energy tariffs for labour-intensive industries, and tax incentives for investment in special economic zones and reducing tax rates on property obtained by local real estate investment trust (Santander Trade Portal, 2019).

Based on data from the Investment Coordinating Board (BKPM), FDI inflows fell by 20.2% to USD \$5.9 billion in the third quarter of 2018, which was the third consecutive quarter of decline in FDI realisation. The Indonesian government is able to improve the overall market atmosphere in 2018 by consolidating political and economic stability and through structural reforms that can eliminate some investment risks. However, it turns out there are still some obstacles, such as rising credit costs, excessive and unpredictable regulations, poor quality infrastructure, the risk of terrorism, and high levels of corruption.

## Conclusion

Based on the background, the formulation of the problem, and the discussion, the conclusions obtained from this study are the variables of GDP growth, inflation, exchange rates, and the money supply which correlate positively significantly with FDI inflows. The interest rate variable is negatively and significantly related to FDI inflows in 22 emerging and developing countries in Asia during the period 2002-2017. In addition, state institutional indicators such as government effectiveness and political stability are also determinants of FDI inflows. But



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based on the estimation results, these two variables show different results. The government effectiveness variable is significantly positively related, while the political stability variable is significantly negatively related to FDI inflows in 22 emerging and developing countries in Asia during the period 2002-2017.

In this study, there are still many shortcomings and limitations of both the data, research objects, and analysis techniques that have been used. Coverage of the research area is only 22 out of 30 countries included in emerging and developing countries in Asia and the research year is only 15 years, from 2002 to 2017 due to limited data. This study also only uses GDP growth, inflation, exchange rate, money supply, and interest rate variables as macroeconomic variables. The indicators of state governance only use the variables of government effectiveness and political stability, where in fact in the global governance indicators (WGI), there are several other indicators that can be used, such as voice and accountability, quality of regulation, legal regulation, and corruption control.

The government, in its efforts to increase FDI inflows into a country is expected to create a conducive investment climate, simplify the bureaucratic chain, and provide legal certainty to attract more interest and maintain the confidence of foreign investors. The government must also pay more attention to the inflation rate, overcoming this needed control in fiscal and monetary policy. From the fiscal side, savings in state spending and providing incentives to producers to further increase production output can be done. As for the monetary side, the central bank needs to stabilise the domestic exchange rate against foreign currencies, especially the dollar by strengthening foreign exchange reserves, either by increasing exports or reducing imports. An indicator of government effectiveness is one of the qualifications indicators in measuring how policies and systems implemented function effectively and play an important role in investor decisions. Therefore, the government can improve public and civil services, the quality of policy formulas and their implementation, and the credibility of government components.

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