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The Effect of Financial Development on Foreign Direct Investment in ASEAN+4

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ABSTRACT

Foreign direct investment (FDI) is an important input to the achievement of a country's goals such as economic growth and poverty. The study looks at the impact of financial development (FD) on foreign direct investment (FDI) in nine ASEAN member states along with China, India, Japan, and South Korea in 2018-2022. The estimate method used is the GMM method (generalized method of moment). The study found that financial development positively and significantly influenced the flow of foreign direct investment. Trade openness, human development, and price levels were also found to influence FDI while economic growth was found to have no significant impact. The findings in this study imply that a good financial system is essential to attract even higher FDI. To attract more FDI, ASEAN+4 countries should strengthen financial systems, enhance trade openness, and invest in human development. Maintaining price stability and fostering regional collaboration will create a sustainable investment environment.

Keywords: Foreign Direct Investment, Financial Development, GMM, Human Development

JEL Classification: E31, F21, F36, G00, O16

INTRODUCTION

Economic growth is the objective of any country worldwide, which requires a consistent amount of savings and investment to sustain it. However, most developing countries struggle to break free from the cycle of low development. Developing countries require external sources such as foreign direct investment (FDI) to achieve rapid and stable economic growth and poverty reduction (Agbloyor et al., 2013; Emako et al., 2022). Foreign Direct Investment (FDI) plays a crucial role in transforming the international economic system to become more efficient and open (Humta & Şahin, 2024). Several studies have found that foreign direct investment has a significant impact on economic growth (Agbloyor et al., 2013; Emako et al., 2022). The increased foreign direct investment (FDI) in the manufacturing sector contributes to positive economic growth for developing countries (Che Arshad & Irijanto, 2023; Djulius et al., 2022; Emako et al., 2022; Rostiana et al., 2022; Setiawan et al., 2021). FDI alone does not have a direct impact on production growth, but economic freedom is considered an important driver for long-term growth, where countries with high economic freedom will benefit from foreign direct investment (Azman-Saini et al., 2010a).

Foreign direct investment (FDI) is often considered to be more stable than other types of capital flows, such as loan flows and portfolio investments. This is supported by the fact that foreign investors prioritize the political stability and transparency of the country they invest in, as uncertainty only increases the risks associated with their investments (Ameer & Xu, 2017). Furthermore, Foreign Direct Investment (FDI) has a positive impact on the achievement of Sustainable Development Goals (SDGs) through several channels, including job creation, technology transfer, and infrastructure development (Eriandani et al., 2020). Evidence from India's economy indicates that higher investor confidence in the domestic market acts as an incentive to attract more FDI inflows, as foreign investors seek stable and transparent policies to protect their investments. Subsequent research on Pakistan has found that FDI has a positive association with factors such as population growth, exchange rate, economic growth, and inflation, indicating the importance of a stable economic and political environment in attracting FDI (Iqbal et al., 2013; Jan et al., 2021).

International investment in SDGs sectors in developing countries is expected to increase in 2022, particularly in infrastructure, energy, water and sanitation, health, and education. However, the increase in investment after the adoption of SDGs in 2015 has been rather slow and there has been a sharp decline, especially during the Covid-19 epidemic. Subsequently, developing countries are experiencing an escalating annual investment deficit as they strive to achieve the Sustainable Development Goals (SDGs). The World Investment Report indicates that worldwide FDI declined by around 12 percent in 2022, primarily in the renewable energy sector. Foreign Direct Investment (FDI) decreased by around 37 percent in advanced economies, while in the Asian region, FDI remained stable. However, developing countries had a 4 percent increase in FDI. The data also indicates that despite growth, the disparity in investment between developed and developing countries is widening. Although there is a widening

disparity in SDG investment across developing countries, there is a positive trend in sustainable investment in the global capital market. Sustainable financial markets will see a 10% increase by 2022 (UNCTAD, 2023).

Financial markets have a crucial role in influencing the flow of Foreign Direct Investment (FDI) in a country. The development of the financial market includes the enhancement of information regarding investment opportunities, monitoring ongoing investments, and the implementation of government cooperation, trade, diversification, and risk management, as well as the mobilization and accumulation of savings and the exchange of goods and services (Agbloyor et al., 2013; Azis et al., 2022; Safitri et al., 2023). On the other hand, financial development is also one of the factors contributing to economic growth worldwide. The impact of FDI on output is strengthened through financial development. Financial development strengthens a country's economic growth and enhances its financial stability due to a deep and liquid financial system with diverse instruments that help bolster the country's resilience against economic shocks (Sahay et al., 2015).

The financial landscape of ASEAN, China, Japan, and South Korea (ASEAN+3) has seen significant transformation in recent decades due to rapid globalization and digitalization (Asian Development Bank, 2021). In 2023, Foreign Direct Investment (FDI) to ASEAN had a modest growth also the Asia Pacific and India area emerged as the primary beneficiary of Foreign Direct Investment, capturing almost one-third of global investment flows (Arguero & Radulovich, 2024). While there is progress in regional financial integration, fragmentation in the capital markets and limited regional financial products hinder the efficient use of financial resources (Park, 2013). A study conducted in China and ASEAN countries revealed that financial integration fluctuates between moderate and high levels, with greater diversification benefits from cross-industry investments compared to cross-border investments (Nguyen & Elisabeta, 2016). India, along with other ASEAN countries, is projected to become one of the top five largest economies in the world. Due to the stable economic growth of most ASEAN countries, there is a constant demand for capital investment due to low gross domestic savings. Foreign direct investment plays a crucial role in the economic development and achievement of breakthrough growth in these countries (Dang & Nguyen, 2021). Both foreign direct investment and the financial development index play crucial roles in achieving economic growth. The inflow of FDI stimulates countries to enhance government policies and investor protection, ultimately leading to an increase in capital market growth. A well-developed capital market will enhance foreign investment. In essence, a strong financial sector may serve as a source of comparative advantage for a country and facilitate the country's ability to reap positive benefits from foreign direct investment (FDI), hence boosting economic performance (Irandoust, 2021).

Several studies have examined financial development, foreign direct investment, and economic growth. Most studies examine the impact of financial development on economic growth and the environment. Subsequently, other studies have examined

the causal relationship between financial growth and foreign direct investment. This study examines the impact of financial sector development on foreign direct investment. However, research examining the impact of financial development on foreign direct investment is still limited. Many studies have primarily focused on the causal relationship between FDI and FD, without considering the short-term and long-term effects of FD on FDI, particularly in ASEAN countries where most of their financial markets are still in the developmental stage. Unlike previous studies that were primarily focused on the private credit to GDP ratio as a proxy for financial development, this study takes a different approach. This study utilizes the comprehensive index constructed by the International Monetary Fund, which captures the multidimensional complexity of financial growth. This study examines the short-term and long-term effects of Financial Development on FDI in nine ASEAN countries, including India, China, South Korea, and Japan, from 2018 to 2022. This research has several contributions, including the use of the most comprehensive proxy for financial development, namely the index developed by the IMF, which encompasses the depth, access, and efficiency of financial markets. Secondly, this study use GMM to provide consistent estimates in the presence of endogenous FDI conditions.

METHOD

This study uses panel data, which combines cross-sectional and time series data. The data used includes 13 Asian countries, consisting of many ASEAN countries (Indonesia, Malaysia, the Philippines, Thailand, Vietnam, Cambodia, Laos, Myanmar, and Singapore), as well as China, India, South Korea, and Japan, from 2018 to 2022. The macroeconomic variables such as FDI inflow, GDP, and trade openness mostly originate from the World Development Indicator database of the World Bank, while financial development and CPI statistics are sourced from the IMF, and HDI is sourced from the United Nations Development Program. This study utilizes FDI inflows as a ratio of GDP as an independent variable. The Financial Development Index is utilized to assess the impact of financial development on Foreign Direct Investment (FDI). This index encompasses financial institutions and financial markets, each comprising depth, access, and efficiency. Economic growth, trade openness measured as the percentage of trade to GDP, and consumer price index are used as control variables. The relationship between variables and hypothesis design is as follows.

This study used the panel GMM (Generalized Methods of Moments) estimator developed by (Arellano & Bond, 1991). The model estimator is chosen to control for country-specific effects, which cannot be achieved using specific country dummies due to the dynamic regression equation structure. Estimators subsequently control for the bias of simultaneity caused by the possibility that some explanatory variables may be endogenous (Manik et al., 2023; Setiawan et al., 2021; Wooldridge, 2002). Several studies have found that FDI tends to be endogenous since increased output might attract more markets seeking FDI (Azman-Saini et al., 2010b). The estimated model of the relationship between FDI and Financial Development is as follows:

$$FDI = \beta_0 + \beta_1 FDI_{i,t-1} + \beta_2 FD_{i,t} + \beta_3 GDP_{i,t} + \beta_4 TRADEOPEN_{i,t} + \beta_5 HDI_{i,t} + \beta_6 CPI_{i,t} + \varepsilon_t \ldots\ldots\ldots (1)$$

FDI represents Foreign Direct Investment (percentage), FD stands for Financial Development Index (index score), GDP indicates Gross Domestic Product growth (percentage), TRADEOPEN represents trade openness (percentage), HDI describes Human Development Index (index score), and CPI represents the price level (index). In this context, i and t refer to the country and year, particularly (t=2018-2022). β0 is a constant, β1, βN are regression coefficients, and εt represents the error term.

Table 1. Operational Variable

Variable	Definition
Foreign Direct Investment	The value of cross-border transactions related to direct investment during a specified period, typically a quarter or a year, is recorded by Foreign Direct Investment (FDI) flows. Equity transactions, intercompany debt transactions, and the reinvestment of earnings comprise financial flows (OECD, 2024).
Financial Development	Captures the advancement of financial institutions and markets regarding their depth (size and liquidity), access (the capacity of individuals and enterprises to utilize financial services), and efficiency (the capability of institutions to deliver financial services at minimal cost while ensuring sustainable revenues, alongside the activity level of capital markets)(IMF, 2024).
Gross Domestic Product	The aggregate of the gross value added by all resident producers in an economy, plus any product taxes and minus any subsidies that are not included in the value of the products (World Bank, 2024).
Trade Openness	The total of exports and imports of goods and services expressed as a percentage of gross domestic product (World Bank, 2024).
Human Development Index	The indicator that summarizes average performance in essential aspects of human development: longevity, education, and quality of living (UNDP, 2024).
Consumer Price Index	The index that quantifies the expense of a collection of products and services for the typical consumer. The Consumer Price Index (CPI) is derived by surveys assessing the prices of a representative assortment of goods and services, often serving as an indicator of inflation (World Bank, 2024).

RESULT

The modelling of foreign direct investment (FDI) involves the use of several variables that are believed to influence FDI. This is done using a dynamic panel model and the System Generalized Method of Moments (Sys-GMM) or the Arellano-Bover/Blundell-Bond Estimator. The results of the first dynamic panel data model using Sys-GMM estimation in the two-step estimator may be explained in Table 2.

Table 2. Foreign Direct Investment Modelling (FDI) using System Generalized Method of Moments (Sys-GMM)

Independent Variable	Coefficient	Std. error	P-value
L1. FDI	-.2384965	.0387676	0.000
FD	.0575732	.0248008	0.020
GDP	.0165765	.04241	0.696
TRADEOPEN	.0532985	.0148555	0.000
HDI	.458578	.1754948	0.009
CPI	-.0417371	.0118002	0.000
_cons	-31.50802	14.70923	0.032

Source: Data Processed by Researchers, 2024

Next, the Sargan test, also known as the Sargan-Hansen test or the overidentifying restrictions test, is conducted to examine the validity of the instruments used in the model. The determination of instrument validity ensures that the instrument is not correlated with errors in the model. The Sargan test results are shown in Table 3, where the p-value is 0.6703. This number is more than the significance level of 0.05, thus, we may conclude that we failed to reject the null hypothesis (H_0) and state that the instrument used is valid.

Table 3. Sargan Test

Sargan's test statistic value	p-*value*
5.793934	0.6703

Source: Data Processed by Researchers, 2024

Next, the Arellano-Bond test is conducted to identify the presence of serial autocorrelation in the residuals. The AR(1) test examines if there is first-order serial autocorrelation in the residuals. In dynamic panel data, first-order autocorrelation is often found, although it does not affect the validity of the instruments if detected. The AR(2) test examines if there is second-order serial autocorrelation in the residuals. If no autocorrelation is found, the instrument used is considered genuine. The results of the Arellano-Bond test on Table 3 indicate that the AR(1) value of 0.1293 is not statistically significant. For an AR(2) value of 0.1293, the p-value is greater than the significance level of 0.05, indicating insufficient evidence to claim the presence of serial autocorrelation. Therefore, the instrument is considered valid.

Table 4. Arellano-Bond Test

Arellano-Bond Test	z	p-*value*
AR (1)	-1.5168	0.1293
AR (2)	-1.1912	0.1293

Source: Data Processed by Researchers, 2024

The significance of parameters is determined to ascertain if all independent variables are significant about the dependent variable and the fit of the model. This is done using the Wald test. The results of the Wald test are presented in Table 4. The results from Table 4 indicate that the Wald test statistic is 2143.00 with a p-value of 0.0000.

At a significance level of 5 percent, we can conclude that the null hypothesis (H0) is rejected, meaning that there is at least one coefficient that has a significant impact on the dynamic panel data regression model for FDI. Therefore, the model is deemed suitable.

Table 5. Wald Test

Wald Test	2143.00
P-value	0.0000

Source: Data Processed by Researchers, 2024

Next, a z test is performed to see the significance of each variable. Based on the estimates of the test-F, the P-value of 0.00 is obtained, where <alpha 0.05 is the result of H_0 rejection. The results of the z test to see the significance of each variable show that the FDI, financial development (FD), economic openness (TRADEOPEN), human development index (HDI) and consumer price index (CPI) have p-values <0.05 so that we reject the null hypothesis, which means financial development variable (FD), open economy (Tradeopen), index of human development (HDi) and index of consumer prices (CIP) have a significant impact on foreign direct investment (FDI), while economic growth (GDP) is found to have no significant impact over foreign direct investments because it has a p-valuation greater than alpha 0.05. After testing the dynamic panel data regression model using the Sys-GMM method, then the model estimate obtained as follows:

$$FDI = -31{,}50802 - 0{,}2384965FDI_{i,t-1} + 0{,}0575732FD_{i,t} + 0{,}0165765GDP_{i,t} + 0{,}0532985TRADEOPEN_{i,t} + 0{,}458578HDI_{i,t} + -0{,}0417371CPI_{i,t} \quad (2)$$

Once the final model generated by Sys-GMM has been determined, the dynamic panel data regression model may also identify the short-term and long-term impact. Table 5 illustrates the results of short-term and long-term effects. The Table 5 indicates that the coefficient of financial development (FD) has a positive value. The coefficient value of 0.0575732 in the FD indicates the short-term impact of FD on FDI. This means that when there is a 1 unit increase in FD index, FDI can increase by 0.0575732 percent in the short term, *ceteris paribus.* Meanwhile, a coefficient value of 0.0248008 may be interpreted as when there is a 1 unit increase in FD, it can increase FDI in the long term by 0.0248008, *ceteris paribus.*

The trade openness (TRADEOPEN) has short-term and long-term coefficients of 0.0532985 and 0.0148555, respectively. This implies that a 1 percent increase in TRADEOPEN will result in a short-term increase of 0.0532985 percent in FDI and a long-term increase of 0.0148555 percent, *ceteris paribus*. The Human Development Index (HDI) variable has a coefficient of 0.458578 in the short term, which means that a 1 unit increase in HDI will result in a 0.458578 percent increase in FDI in the short term, *ceteris paribus*. In the long run, a coefficient value of 0.1754948 for HDI means that when HDI increases by 1 index unit, FDI will increase by 0.1754948 percent, *ceteris paribus*. The Consumer Price Index (CPI) has a coefficient value of -0.0417371 in the

short term, indicating that a 1 unit increase in CPI will decrease FDI inflow by 0.0417371 percent, *ceteris paribus.* However, in the long run, a 1 unit increase in CPI will result in a 0.0118002 percent increase in FDI, *ceteris paribus.*

Table 6. Short-term and Long-term impact

Independent Variable	Short-term impact	Long-term impact
FD	0.0248008	0.0464864
	(0.020)	(0.027)
GDP	0.04241	0.0133843
	(0.696)	(0.699)
TRADEOPEN	0.0148555	0.0430349
	(0.000)	(0.000)
HDI	0.1754948	0.3702699
	(0.009)	(0.009)
CPI	0.0118002	-0.0336998
	(0.000)	(0.001)

Source: Data Processed by Researchers, 2024

DISCUSSION

This study examines the relationship between foreign direct investment and the financial development index. This study used foreign direct investment as the dependent variable and financial development index as the independent variable, along with four control variables. The findings of this study indicate a positive correlation between the financial development index, trade openness, and the human development index in the short term. The positive and significant impact of financial development, as indicated by the conducted research (Humta & Şahin, 2024; Islam et al., 2021). This indicates that foreign investors are more confident in investing in countries where businesses may be easily accessed with various financing options outside the investor's personal resources (Islam et al., 2021). Advanced financial markets tend to be more transparent and operate under a robust regulatory framework, reducing uncertainty and risk for foreign investors (Hermes & Lensink, 2013). A well-developed financial system, characterized by factors such as access to various financing options, transparency, efficient capital allocation, and strong regulations, is a significant driver of FDI. This can mitigate risks, enhance investor confidence, and ultimately contribute to sustainable economic growth (Aibai et al., 2019; Desbordes & Wei, 2017).

This study found that GDP did not have a significant impact on FDI. This is inconsistent with the findings of the research done by (Alshamsi et al., 2015; Anwar et al., 2023; Grace, 2019) which found that GDP has a significant positive impact on FDI. Several factors might be the cause of this. First, at a certain level of GDP, an increase in GDP does not proportionally attract more FDI, especially if other factors such as inadequate infrastructure and low-quality workforce act as impediments. When it comes to investment objectives, if FDI is influenced by resource-seeking or efficiency-seeking goals rather than market-seeking goals, the GDP indicator may be less relevant.

Companies may also choose countries with specific advantages in their value chain, regardless of the total GDP of such countries. The openness of trade is found to have a positive and significant impact. This is consistent with the research done by (Agbloyor et al., 2013). Trade openness makes foreign direct investment (FDI) more attractive since it allows foreign businesses to access a larger market. This is especially true for FDI with an export focus, when foreign businesses invest in one country to produce goods that can be exported (Hailu, 2010). The open trade agreements usually result in lower tariffs and trade barriers, which lower production costs for foreign companies operating in developing nations (Wahyuningsih, 2021). The Human Development Index (HDI) has been found to have a positive and significant impact on Foreign Direct Investment (FDI), indicating that HDI serves as a potential attraction for FDI. A higher HDI indicates the presence of a healthier and more skilled work environment, which will attract companies seeking high-quality labor (Sharma & Gani, 2004). A more effective system of governance, less corruption, and a strong legal system, which are all part of the HDI, can mitigate risks for investors (Reiter & Steensma, 2010). A high HDI might indicate a growing consumer market with more purchasing power.

The Consumer Price Index (CPI) has a positive and significant impact on Foreign Direct Investment (FDI) in the short term, meaning that when the price level increases, it will boost FDI inflow. However, in the long term, the impact of CPI has a negative coefficient, indicating that an increase in the price level will reduce FDI inflow. This is due to the complex and not always direct relationship between prices and FDI. The positive relationship may be observed by its impact on specific sectors. In certain sectors, such as natural resources, they may be less responsive to price fluctuations. If there is a sustained high worldwide demand for certain specific commodities, foreign direct investment (FDI) will likely continue, even with higher prices (Borensztein et al., 1998). Similarly, the benefits of depreciation result in a higher price level, causing the currency of the investor's destination country to depreciate. This leads to cheaper export goods, ultimately attracting market-seeking foreign direct investment. The positive impact of CPI may also be seen as a government's success in maintaining price stability (Khawar, 2005). Other policies that may be implemented, such as tax incentives, infrastructure development, and stabilization, will attract FDI at a moderate inflation rate. The negative impact of price levels can be shown through inflation costs and investments. High inflation can elevate production costs, labour expenses, and raw material prices, so rendering countries with high inflation less appealing to investors seeking profit. (Suraksha, 2023). The high inflation also leads to depreciation, which may make exports cheaper but also makes imported goods, especially those needed for production, more expensive, which hinders the inflow of foreign direct investment (FDI). The volatility and high inflation rates make it difficult for investors to predict costs and returns, leading them to choose economies that are more stable and predictable in the long term. In the long run, there is a positive relationship between financial development, trade openness, human development index, and consumer price index and foreign direct investment. In recent years, several studies have demonstrated the impact of financial development on foreign direct investment, and

vice versa, through a causal relationship with diverse outcomes. This research demonstrates a positive correlation between financial development and foreign direct investment in both the short and long term.

CONCLUSION

This study examines the relationship between financial development and foreign direct investment in thirteen Asian countries, including several ASEAN countries (Indonesia, Malaysia, the Philippines, Thailand, Vietnam, Cambodia, Laos, Myanmar, and Singapore), as well as China, India, South Korea, and Japan, from 2018 to 2022 using the GMM method. This study also utilizes data on economic growth, trade openness, human development index, and price level. The estimation results indicate that in the long run, financial development, trade openness, human development index, and consumer price index have a positive and significant impact on foreign direct investment. However, economic growth is shown to have no significant impact on FDI. The economic, social, and political policies must be aligned with the strategic plan of the target country to maximize the impact of financial development, open trade, and human development in a more significant and efficient manner. The ASEAN+4 member countries must prioritize monetary policies, particularly inflation control, as short-term inflation has been found to harm foreign direct investment. The government and policymakers must prioritize policies to enhance the banking and financial sector. The limitations of this study are its exclusive focus on foreign direct investment as opposed to other forms of investment, and its reliance solely on the overall value of incoming foreign direct investment without considering specific sectors. Researchers suggest that for future research, it would be beneficial to include control variables that might influence foreign direct investment and conduct a more comprehensive analysis by comparing a specific group of countries with other countries worldwide.

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