# Analysis of Foreign Direct Investment in ASEAN-9 Countries:

# The Role of Economic Integration

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Introduction: The existence of economic globalization, which involves trade and investment liberalization, allows for a more accessible flow of goods, services, and capital. The flow of Foreign Direct Investment to developing countries can help reduce the high inequality rate given the transfer of knowledge and technology, thus accelerating economic growth. Economic integration is a process in which a group of countries seek to increase their prosperity through competitiveness and the welfare of the country itself. This study aims to determine how economic integration affects Foreign Direct Investment in 9 ASEAN member countries. The data is secondary from the World Bank and The Fund for Peace. Data analysis in this study uses panel data including Brunei Darussalam, Cambodia, Indonesia, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam as cross-section data, and the time series used is 2009-2022. The model used is the SUR (Seemingly Unrelated Regression) panel model. The results of this study found that trade openness and population have a positive effect on FDI. Meanwhile, market size, infrastructure, political fragility, and control of corruption negatively influence FDI..

**Keywords:** Keywords: economic integration; trade openness; population; market size; infrastructure; political fragility; control of corruption; FDI.

## 1. INTRODUCTION

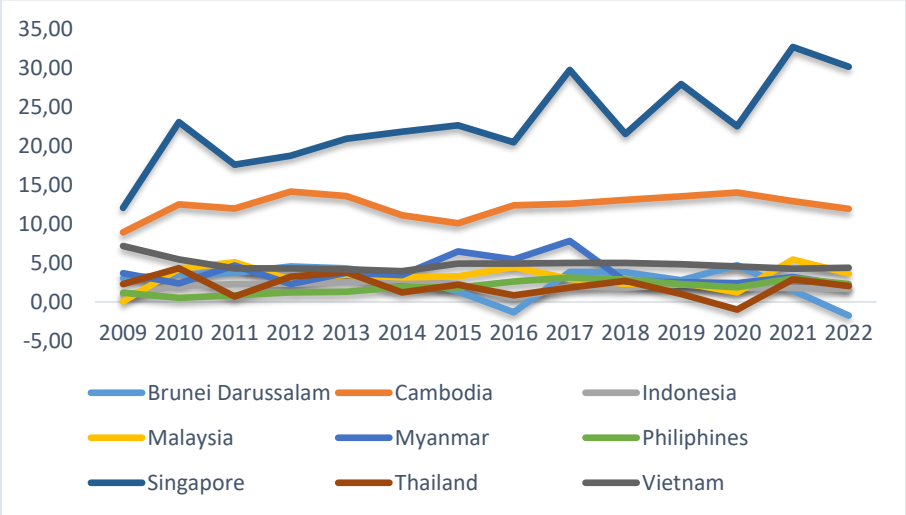
ASEAN economic development has been the focus of attention in recent decades. The existence of economic globalisation today creates conditions of interconnectedness in building a process of cooperation for economic activity. The impact of globalisation that can be felt is openness in various fields, including in the business sector known as the free market era or trade liberalisation. The rapid development of technology and patterns of economic activity has made people in the world come into contact with each other, need, and determine the fate of one another, but compete with each other (Ngadino, 2014). The presence of globalisation is also the cause of economic inequality between developed and developing countries, and has the potential to create unfair competition, resulting in social effects such as unemployment and poverty. Instability in the European Union (EU) region gives its own worry for every country in the world, including the Southeastern Countries which are members of Association of South-East Asian Nations (ASEAN) especially in relation to the existence of banking and financial relationship between two regions (Wardhono et al., 2014).

Investment has played a crucial role in shaping supply and production networks in Southeast Asia. When investors invest, there will be jobs that can be absorbed so that it can increase people's income (Mahrus Lutfi Adi Kurniawan, 2014). Foreign direct investment (FDI) is the driving force behind a country's economic growth, especially for developing countries. This is because the majority of developing countries still rely heavily on foreign financing for their economic development. Most countries choose foreign investment inflows as attractive capital flows due to its stable nature, low volatility, and long-term commitment in the host country as well as its significant impact on economic growth through technology transfer effects. However, the interest or desire for investment among foreign investors is heavily influenced by the internal conditions of a country to be entered, such as the country's economic and political stability. In addition, each country has different investment regulations and policies. These differences can make it difficult for foreign companies that want to operate in several investment destination countries because they have to deal with diverse regulations and requirements (Case, K. E., & Ray, 2007).

Foreign Direct Investment (FDI) continues to grow rapidly around the world. The scope of emerging markets continues to increase the attractiveness for foreign investors to absorb more capital flows especially FDI inflows. According to UNCTAD, global FDI experienced an average growth of 3.5% per year between 2009 and 2022 (UNCTAD, 2022). Developing countries became the motor of global FDI growth with an average of 5.1% in the same period where this record managed to exceed the percentage of global FDI growth. Meanwhile, developed countries experienced negative FDI growth with an average of -0.8% per year due to the European debt crisis and the relocation of multinational companies' activities.

**Figure 1. Value of Foreign Direct Investment**

**in 9 ASEAN Countries (% of GDP)**




Source: World Bank, 2023

Figure 1 shows the data of Foreign Direct Investment that occurred in the period 2009-2022. Overall, net FDI inflows to ASEAN countries grew at an average of 5.7% per year from 2009 to 2022 (UNCTAD, 2022). The highest growth occurred in 2010 (32.9% yoy) when countries started to recover from the 2008-2009 global financial crisis. Meanwhile, the lowest occurred in 2020 (-31.7% yoy) due to the COVID-19 pandemic. Vietnam experienced the most consistent FDI growth at an average of 17.9% per annum from 2009-2022, with the highest recorded in 2015 due to a wave of new investments. Meanwhile, Singapore as ASEAN's largest recipient of FDI only had an average growth of 0.3% per year as more and more foreign companies shifted to other ASEAN countries. Thailand and Malaysia experienced FDI growth that tended to stagnate and even contracted, at only 0.004% and -1.8% respectively. Their competitiveness is losing out to Indonesia and Vietnam in reforming regulations to attract foreign investors (JETRO, 2022). ASEAN has bright prospects to become a global production base. This is driven by ASEAN economic integration through the AEC (ASEAN Economic Community), a growing population, and the demographic bonus of a number of ASEAN countries (ADB, 2022).

## 2. LITERATURE REVIEW & HYPOTHESIS DEVELOPMENT

Dunning's electic theory is one of the theories of FDI (Foreign Direct Investment) that was first introduced by John Dunning in 1958 in his article entitled "American Investment in British Manufacturing Industry". This theory was then developed comprehensively by Dunning in 1979. Dunning's eclectic theory has three key elements:

a. Ownership Advantages (O). Refers to the competitive advantages of multinational firms that enable them to compete with local firms in the investment destination market. For example, technology, trademarks, management, etc.

b. Location Advantages (L). Refers to factors that make a location/destination country attractive for foreign direct investment. E.g. availability of natural resources, potential markets, infrastructure, etc.

c. Internalisation Advantages (I). Refers to the advantages of a firm integrating overseas operations into the corporate structure rather than licensing or outsourcing. E.g. control over supplies, technology, trademarks, etc.

According to research conducted by Hidayati et al. (2021)on the impact of economic integration on FDI in ASEAN, the existence of ASEAN economic integration does not directly increase the value of FDI. This is because before making an investment, foreign investors need to consider many aspects including the economic and political conditions in the destination country. The results show that population has a negative impact on FDI, while GDP and net exports have no effect on FDI in ASEAN member countries. The research related to the determinants of foreign direct investment in emerging market countries conducted by Yilmaz, R., & Löschnigg (2019) shows a positive and significant correlation between market size, growth potential, natural resources, real effective exchange rates, development progress, and FDI stocks on FDI inflows to developing countries. Furthermore, inflation has a significant negative effect in determining FDI inflows, while trade openness, infrastructure, government consumption, and urban population are not significant. The study findings suggest that market size is the main driver of FDI inflows into a country's economy.

Another study related to the determinants of foreign direct investment inflows in developing countries conducted by Kumari, R., & Sharma (2017) found that the results of FDI inflows are determined by market size, trade openness, and human resources. The three variables have a positive and significant relationship with FDI inflows. Meanwhile, based on research conducted by Ariyani & Firmansyah (2023) found that market size, control of corruption, and telecommunications infrastructure affect FDI positively and significantly. Another case with the level of education has a negative influence on FDI. Meanwhile, trade openness and interest rates have no significant effect on FDI.

Based on the background of the problems that have been described and the various differences in the results of the determinant variables in previous studies, the authors consider that further studies should be carried out related to the driving factors of foreign direct investment in ASEAN countries by referring to several theories of foreign direct investment that have developed and in the range before and after economic integration. The determinant variables chosen to be investigated in this study include trade openness, population, market size, infrastructure, political fragility, and control of corruption. The research contribution to the literature is to explore the determinant variables of foreign direct investment based on panel data in ASEAN countries. In addition, the author hopes that the research will be used as a

reference for policy makers, especially in efforts to face global competition and increase investment to increase state revenues so that public welfare can be achieved.

## 3. RESEARCH METHODOLOGY

This study examines the effect of trade openness, population, market size, infrastructure, political fragility, and control of corruption on Foreign Direct Investment (FDI) in 9 ASEAN countries. The use of data relies on secondary data collection. Data is obtained through several research sources such as the World Bank, and The Fund for Peace. In detail, the use of variables in this study is described as follows:

Table 1. Variable Definition

| Proxy Variables | Description | Symbol | Source |
|---|---|---|---|
| Foreign Direct Investment (% of GDP) | Net FDI inflows to 9 ASEAN Countries (*net inflows).* | *FDI* | World Bank |
| Trade Openness (% of GDP) | The ratio of the value of exports plus the value of imports per GDP (% of GDP) which is an indicator of the openness of a country's economy to other countries. | *TO* | World Bank |
| Population (Soul) | Population growth of the 9 ASEAN member states. | *LnPOP* | World Bank |
| Market Size (US$) | A measure that reflects the amount of market demand for a good or service in a particular geographic area. Usually measured in terms of real GDP. | *LnMS* | World Bank |
| Infrastructure (in units per 100 people) | The number of active mobile phone subscribers recorded and expressed in units per 100 inhabitants in a region/country. | *LnINFR* | World Bank |
| Political Fragility (Scor) | A country's level of political risk or fragility that describes the ability of a country's government to ensure a favourable investment environment. | *LnPOL* | The Fund for Peace |
| Control of Corruption (Scor) | Corruption control measured on a nominal scale of -2.5 to 2.5. | *LnCOC* | World Bank |

The data analysis was carried out using the panel data regression method which is a combination of cross section and time series for the level of ASEAN countries (A'yun & Khasanah, 2022). According to Gujarati (2004), the use of panel data has a number of advantages, including being able to project individual heterogeneity explicitly, minimising bias that may occur due to individual aggregation because it has more data units, having the ability to detect and measure influences that cannot be observed or ignored by pure cross-section data or pure time series, and presenting data that is more informative, varied, reduces multicollinearity problems, and increases the degree of freedom.

The modelling used is Seemingly Unrelated Regression (SUR). Arnold Zellner (1962) introduced the SUR method. Zellner stated that SUR is a multiple regression model and is part of multiple linear regression. SUR model consists of a number of equations with variables that are not bidirectional, however, each equation has a correlation between the errors of the equations, better known as correlation of wealth. This estimation is used to overcome the autocorrelation and heteroscedasticity problems that occur. SUR models are categorised as multiple systems of equations that are unrelated, which means that each variable (dependent and independent) is in a single system. In short, most regression systems of linear equations can be solved using a single set of equations. The different regression equations can be unified to obtain efficient parameters with SUR. The formulation for multivariate regression equations is expressed:

$$FDI_{it} = \beta_0 + \beta_1 TO_{it} + \beta_2 LnPOP_{it} + \beta_3 LnMS_{it} + \beta_4 LnINFR_{it} + \beta_5 LnPOL_{it} + \beta_6 LnCOC_{it} + e_{it}$$

where FDI is Foreign Direct Investment (in per cent), β_0 is a constant β_1,…, β_6 are regression coefficients; TO is trade openness (per cent); LnPOP is the logarithm of population; LnMS is the logarithm of marketsize; LnINFR is the logarithm of telecommunications infrastructure; LnPOL is the logarithm of political fragility; and LnCOC is defined as the logarithm of control of corruption. The i is for cross-section; t is for time series; and eit is the error term. If the above modelling is written in matrix notation, the following equation is obtained:

$$\boldsymbol{Y_j} = \boldsymbol{X_j \beta_j} + \boldsymbol{\mu_j}$$

where

$$\begin{bmatrix} y_1 \\ y_2 \\ \vdots \\ y_m \end{bmatrix} = \begin{bmatrix} x_1 & 0 & \cdots & 0 \\ 0 & x_2 & \cdots & 0 \\ \vdots & \vdots & \ddots & \vdots \\ 0 & 0 & \cdots & x_m \end{bmatrix} \begin{bmatrix} \beta_0 \\ \beta_1 \\ \vdots \\ \beta_m \end{bmatrix} + \begin{bmatrix} \mu_1 \\ \mu_2 \\ \vdots \\ \mu_m \end{bmatrix}$$

where $Y_j$ is a column vector of dependent variables of order $n \times 1$, $\beta_j$is a vector of SUR model parameters of size $Ki \times 1$, $\mu_j$ is a column vector of errors in order $n \times 1$ normally distributed multivariate, and $X_j$ symbolises the diagonal of the matrix $n \times K_i$, $K_i$ as a symbol of vector dimensions.

## 4. RESULT AND DISCUSSION

Economic co-operation between countries such as free trade agreements or the use of a common regional currency has created a broader market. Standardisation of economic rules of the game and regulatory certainty among regional trading bloc member countries result in a

more conducive and efficient business climate. These conditions encourage foreign investors' interest in FDI (UNCTAD, 2018).

**Table 2. Panel Data Results with CEM, FEM, REM, and SUR Models**

| Variable | Model | | | |
|---|---|---|---|---|
| | CEM | FEM | REM | SUR |
| TO | 0,02 | -0,04 | 0,002 | 0,02 |
| | (2,41)** | (-2,56)** | (2,23) | (2,28)** |
| LnPOP | 3,33 | -12,48 | -0,24 | 3,33 |
| | (6,15)*** | (-1,69)* | (-0,25) | (6,61)*** |
| LnMS | -5,57 | 3,17 | -0,53 | -5,57 |
| | (-9,44)*** | (2,43)** | (-0,52) | (-10,10)*** |
| LnINFR | -0,91 | 0,18 | -0,44 | -0,91 |
| | (-2,11)** | (0,42) | (-1,08) | (-2,60)*** |
| LnPOL | -26,17 | -8,56 | -14,42 | -26,17 |
| | (-8,07)*** | (-1,93)* | (-4,09)*** | (-7,63)*** |
| LnCOC | -12,29 | -1,48 | -6,35 | -12,29 |
| | (-3,70)*** | (-0,47) | (-2,16)** | (-3,66)*** |
| C | 181,39 | 175,43 | 74,75 | 181,39 |
| | (8,86)*** | (1,44) | (2,78)*** | (8,77)*** |
| $R^2$ | 0,8225 | 0,1136 | 0,6001 | 0,8225 |
| F-stat | 91,92*** | 3,83*** | 33,90*** | 649,55*** |
| Obs | 126 | 126 | 126 | 126 |

Table 2 shows that in four pooled data models including the Common Effect Model (CEM), Fixed Effect Model (FEM), Random Effect Model (REM), and Seemingly Unrelated Regression (SUR) that the best modeling is obtained using SUR. Regression analysis shows that the R-Squared value is 0.8225 or 82.25%. This value can be interpreted that the independent variable can describe the dependent in the model by 82.25%. While as much as 17.75% is explained by other variables outside the modeling. The F-statistic value is 649.55 and significant at the 1% level. This implies that simultaneously, the independent variables have a significant influence on FDI. Thus, the ASEAN economic integration region is a driving force in increasing Foreign Direct Investment. Economic growth continues to be pursued in order to create public welfare in integrated ASEAN countries. When economic

growth increases then FDI also increases. The existence of economic integration facilitates access for foreign investors to invest.

Partially, trade openness has a positive and significant effect on the inflow of FDI in ASEAN. This is characterized by a coefficient of 0.02 and a calculated t stat of 2.28 > t table 1.97 at a significance level of 5%. That is, if trade openness increases by 1%, Foreign Direct Investment also increases by 0.02%. This is consistent with the findings of Kumari, R., & Sharma (2017) and (Barorah et al., 2019). In the current era of globalization, trade openness in every country in the world is expanding, both trade openness itself and financial openness (Barorah et al., 2019). However, economic openness can strengthen and weaken depending on how a country responds to it. The more open a country's economy is, the more it can increase the profitability and expansion opportunities of multinational companies' investments into the country's market. Historical data shows that ASEAN countries with high trade openness such as Singapore, Malaysia, and Vietnam tend to be the main destinations for ASEAN FDI in the last ten years (ASEAN Secretariat, 2022). Meanwhile, countries with low trade openness, such as Brunei Darussalam, are considered less conducive to FDI. Trade openness is considered a key determinant of FDI as it implies the level of economic integration of the host country with the world economy. High trade openness means that trade barriers for goods and services from the host country have been gradually reduced/eliminated. This creates the potential for foreign investors to exploit the comparative advantage of the host country in order to re-export to the home country and the rest of the world (vertical FDI) (Hoang & Bui, 2015). However, trade openness is not always beneficial because it can make domestic industries less competitive than quality foreign products, which can create imbalances between countries. When the economy becomes more open, the output depends not only on individual decisions but also on other factors that can not be controlled by the agents (Subanti et al., 2019).

The relationship between population and FDI is positive and significant. The coefficient is 3.33 and t stat is 6.61 > t table 2.61 at 1% significance level. That is, when the population increases by 1 person, it will increase FDI by 3.33%. This finding is consistent with Hidayati et al. (2021) and Yohanna & Handoyo (2018). The higher population creates a high consumption of a country so that economic activity also increases. Thus, a country with a large population has the potential to attract foreign investors because it shows a wide domestic market for their products and services. The Asian Development Bank study noted that Indonesia and the Philippines as high-demand markets remain an attraction for foreign investment to the region despite the pandemic. Meanwhile, in the Article IV Consultation report by the IMF in 2022, it was mentioned that the relatively small size of Brunei's population and economy posed a challenge for the country to attract overseas foreign investment. Population growth will have a positive effect if the population in an area is productive, so they can meet the mandatory levies set or pay user fees (Ramadhona et al., 2022).

Market size is one of the important factors determining the inflow of FDI into a country. The large ASEAN market requires efficient resource utilization and exploitation of economies of

scale. The vast market size in ASEAN provides more opportunities to increase product sales as well as profits of foreign firms thus attracting more FDI inflows to ASEAN. The existence of economic integration indicated by reduced tariffs between members will cause the market to become larger, thus increasing trade. The size of the market reduces costs so that economies of scale can be adjusted for larger producers (Yuniarti, 2007). However, the results obtained from testing using the SUR regression method found that market size has a negative effect on FDI. The coefficient obtained is -5.57 and has t stat -10.1 < t table -2.61 at 1% significance level. This means that if market size increases by US$1 million, FDI decreases by US$10.1 million. This contradicts the hypothesis and a number of previous studies which found that the relationship between market size and FDI is positive. The large market size of ASEAN countries may potentially reduce incentives for foreign investors to transfer technology, product and business process innovations. This large and stable market condition tends to make multinational companies stagnate and less motivated to improve long-term competitiveness through innovation and optimal efficiency. In addition, the negative effect of market size on FDI can occur due to the strong domestic market dominance of conglomerates or national companies. Therefore, foreign investors are less interested in entering the market through FDI.

In relation to infrastructure, a large market size is not necessarily followed by adequate infrastructure and industrial conditions, making it potentially inefficient for multinational companies. Infrastructure has a significant negative impact on FDI inflows to ASEAN. From the test conducted, it is known that the coefficient value is -0.91 and t stat -2.60 at 1% significance level, which means that every increase of 1 unit of infrastructure (per 100 people) will reduce 0.91 million US$ of FDI. Dunning's eclectic theory states that one of the aspects of concern in terms of location advantage is infrastructure. This is considered important because infrastructure facilitates product distribution. The infrastructure in question can be in the form of various facilities such as communication services, road networks, energy sources, and various other infrastructure facilities that encourage the ease of product distribution. Poor infrastructure can be a barrier to foreign direct investment. The World Bank and IMF in their annual reports often highlight strong infrastructure as a key factor that can increase a country's FDI and economic growth. Meanwhile, countries with poor infrastructure are considered less attractive to global investors as they can increase the operational costs of foreign companies looking to invest.

Political fragility can be categorized as political risk which is defined as the inability of the host country to ensure a good and stable investment environment. Political risk affects economic uncertainty, the security of invested capital, as well as the future economic prospects of the host country. Therefore, high-risk countries are generally considered unattractive for FDI. The coefficient obtained is -26.17 and has a t stat -7.63 < t table -2.61 at a significance level of 1%. This means that if political fragility increases by 1 score, FDI will decrease by 26.17 million US dollars. This research is in line with the findings of Dimitrova, A., & Triki (2018) which show the results that one of the Fragile States Index (FSI) indicators, namely political fragility, has a negative and significant effect on FDI flows. In addition, (Al-Khouri, 2015) and Goswami & Haider (2014) in their research concluded that political risk

significantly affects FDI. The annual ASEAN Investment Report 2020 states that political uncertainty due to upheaval and civil conflict such as that in Myanmar has significantly reduced FDI into the country. In addition, the risk of significant changes in investment regulations and policies due to the change of government also makes global investors reconsider investing long-term capital amid uncertain political situations. In that way, investors prefer to hold their investment in countries with high uncertainty because they have a high risk (Kurniawan & A'yun, 2022).

Corruption and slow bureaucratic systems are also often triggered by weak or failing political and governance systems in a country. This can certainly worsen the business and investment climate for foreign companies. Based on the SUR estimation results, the coefficient obtained is -12.29 and has a t stat -3.66 < t table -2.61 at a significance level of 1%. This means that if corruption increases by 1 score, FDI decreases by 12.29 million US$. This study is in line with the grabbing hand theory which reveals that corruption increases investment costs, reduces profits, so that investment inflows will fall. The research with the same estimation results was conducted by Saad Alshehry (2020) and Zander (2021). According to the ASEAN Policy Brief report (2021), corruption is a significant challenge in ASEAN economic integration because it reduces the competitiveness of this regional bloc in attracting multinational investment. Uncontrolled corruption can reduce the interest of global investors to invest in a country. In addition, high levels of corruption can lead to bureaucratic inefficiencies and create policy uncertainty in investment and business licensing and regulation.

### 5. CONCLUSION AND RECOMMENDATION

This study seeks to examine the main determinants of FDI inflows in 9 ASEAN countries using panel data for 2009-2022. The analysis shows that trade openness and population have a positive and significant impact on FDI. The higher the trade openness of a country, the lower the trade barrier in the country so that foreign investors are more free to distribute capital without worrying about existing trade restrictions. A country with a large population has the potential to attract foreign investors because it shows a wide domestic market for their products and services. Meanwhile, market size, infrastructure, political fragility, and corruption have a negative influence on FDI. The large market size of ASEAN countries may potentially reduce the incentive for foreign investors to transfer technology, product and business process innovation. Meanwhile, countries with poor infrastructure are considered less attractive to global investors because they can increase the operational costs of foreign companies that want to invest. Politically unstable or vulnerable countries will increase uncertainty in doing business, which can reduce the level of FDI entering a country. Then, the amount of uncontrolled corruption in a country can lead to bureaucratic inefficiency and reduce the attractiveness of foreign investors to invest. Lastly, although the estimation results simultaneously economic integration increases FDI, in fact the existence of ASEAN economic integration does not necessarily make FDI rise. However, the existence of an integrated economic region seeks to increase the global competitiveness of member countries and make it easier for countries to carry out foreign direct investment.

## IMPLICATION/LIMITATION AND SUGGESTIONS

The implications of these findings for policy makers, corporate leaders and investors. The government should create an investment-friendly environment by supporting the private sector to mobilize domestic resources for productive investment, bureaucratic conditions should be transparent on all macroeconomic issues, fight corruption in all sectors of the economy and should increase the confidence of the outside world to invest in the country, and encourage the improvement of the host country's GDP performance in order to increase investor confidence through increased domestic productivity. In addition, infrastructure development also needs to be continuously improved in order to increase company productivity and attract more investors. This study also found results that were not in line with the hypothesis and previous research, namely the market size and infrastructure variables which were found to have a negative effect on FDI inflows. Future research can look deeper into the effect of market size and infrastructure on FDI. In addition, future research is expected to look at the effect of determinants other than the variables used in this study on each country and determine which determinants play the most role in attracting FDI.

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