
Foreign Direct Investment, Financial Development, and Economic Growth in ASEAN Countries

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Abstract

Foreign direct investment can be a solution to overcome domestic capital limitations. The spillover effect from FDI does not necessarily exist but needs to be created. Advanced domestic financial development will encourage the positive influence of FDI on economic growth. This research analyzes the relationship between foreign direct investment, financial development, and economic growth in ASEAN countries from 1999 to 2019. Additionally, it also aims to analyze the effect of inflation, exchange rates, and human capital on economic growth. The research method uses panel data analysis using Fixed Effect Model (FEM). The research results show that foreign direct investment, exchange rates, and human capital have a positive and significant effect on economic growth. Inflation has a negative and significant effect on economic growth. Financial development strengthens the effect of foreign direct investment on economic growth. Thus, domestic financial development needs to be improved in order to maximize greater benefits from the presence of FDI.

Keywords: foreign direct investment, financial development, economic growth, panel data analysis

1. Introduction

Economic growth is one of the benchmarks for determining the success of economic development in a country. According to Todaro & Smith (2006), increasing economic growth can have an effect on increasing national income to overcome the problems of unemployment, poverty and inequality in income distribution through the process of trickledown effect. Capital flows are needed to carry out economic policies to encourage economic development. Sources of financing do not only come from domestic capital flows, but also come from foreign capital to meet financing shortfalls to encourage economic development in a country.

Foreign capital flows in the form of foreign direct investment (FDI) can be one solution to overcome domestic capital limitations. FDI is considered an important part of economic growth and the process of financial globalization because FDI is not only the main source of additional foreign capital, but also transfers technology and knowledge, creates jobs, increases productivity, and increases competition and access to foreign markets (Crespo & Fontoura, 2007; Chung, 2009; Uttama & Péridy, 2010; Alfaro, 2017). Based on research studies on foreign direct investment, several empirical studies provide mixed results regarding the role of FDI in contributing to economic growth. Ogbuagu et al. (2021) in ECOWAS countries, Liang et al. (2021) in developing countries, Hamoudi & Aimer (2017) in Libya, Trinh et al. (2015) in Vietnam, Sghaier & Abida (2013) in North Africa, and Koojaroenprasit (2012) in South Korea which stated that FDI will increase the economic growth of the host country. Neoclassical and endogenous growth models explain the relationship between FDI and economic growth, as stated by Lin & Saggi (2007) that FDI can increase the size and efficiency of investment which leads to short-term, medium-term and long-term investment towards increasing economic growth.

However, Musonera (2005) stated that the spillover effects produced by FDI do not necessarily exist but need to be created. Hermes & Lensink (2003), Alfaro et al. (2004), Alfaro et al. (2010), and Azman-Saini et al. (2010) stated that the positive impact of FDI growth on economic growth depends on the financial development conditions in the host country. This is because well-functioning financial markets can reduce the inherent risks of investments made by domestic companies seeking to imitate new technology, so that this can increase the capacity to absorb FDI inflows in a country. Thus, this implies that well-functioning financial markets are one of the important prerequisites for FDI to have a positive effect on economic growth.

As conducted by several previous studies, it shows that the positive growth effects of FDI depend on the policies and environment of the host country, including the conditions of financial sector development. Research related to this has been carried out by Alfaro et al. (2004) who stated that domestic financial development is an important prerequisite for FDI to have a positive influence on economic growth. Riache et al. (2021) in Algeria, Osei & Kim (2020) in middle and high income countries, Sghaier (2018) in North Africa, Alzaidy et al. (2017) in Malaysia, Bahri et al. (2017) in developing countries, Jahfer & Inoue (2014) in Sri Lanka, Choong (2012) in Malaysia, Adeniyi et al. (2012) in small open developing economies, Shahbaz et al. (2011) di Portugal, Hermes & Lensink (2003) in LDCs (Less Developed Countries) who have almost the same opinion that there is a link between domestic financial development and the positive effect of FDI on economic growth, where countries with more advanced financial development conditions will benefit from more FDI. Thus, the main pillar in the success of FDI depends on the creation of conditions conducive to economic growth.

Based on these problems and the results of previous research, the main aim of this research is to analyze the role of financial development in strengthening the influence of foreign direct investment and several other control variables on economic growth in ASEAN countries from 1999-2019.

2. Hypothesis and Research Framework

2.1 Foreign Direct Investment and Economic Growth

Foreign direct investment (FDI) is the process of economic actors, both individuals and companies from a country, having ownership of assets with the aim of carrying out production, distribution and other activities in the host country (Moosa, 2002; Krugman & Obstfeld, 2003). FDI can overcome the gap between the availability of savings, government revenues, foreign exchange reserves and managerial expertise in recipient countries to achieve development targets and economic growth. The greater the FDI inflow, the higher the level of economic growth. Srinivasan et al. (2011) and De Mello (1997) state that FDI can encourage economic growth through two channels. First, through capital spillovers where FDI provides access to the adoption of new technology in the production process. Second, FDI can stimulate knowledge transfer on workforce training and skills, management practices, and better organizational capabilities. Thus, FDI can increase productivity thereby encouraging economic growth.

H₁ : Foreign direct investment has a significant positive effect on economic growth

2.2 Inflation and Economic Growth

Inflation is a continuous increase in aggregate prices for commodities. Several theories have explained the relationship between inflation and economic growth. For example, Keynes's theory, which states that inflation can occur due to the behavior of people who want to live beyond the limits of their economic capabilities. In the long run, the relationship between inflation and economic growth is negative. High inflation causes the rate of economic growth to decrease. Endogenous growth theory states that economic growth depends on rate of return on capital, where inflation will reduce the amount of profits so that it can reduce capital accumulation which can reduce economic growth (Romer, 2006). An inflation rate of more than ten percent will hinder the economy because it causes the price of domestic goods to be relatively more expensive than the price of imported goods.

H₂ : Inflation has a significant negative effect on economic growth

2.3 Exchange Rate and Economic Growth

There are two approaches that discuss how exchange rate changes can affect economic growth, namely the traditional exchange rate approach and the structuralist approach (Koroma et al., 2023). The traditional approach states that there is a positive relationship between the exchange rate and economic growth. Depreciation of the domestic currency will cause the price of domestic goods abroad to become cheaper, thereby increasing demand for goods and encouraging exports (Salvatore, 2004). In contrast, the structuralist approach states that there is an inverse relationship between exchange rates and economic growth. Depreciation of the domestic currency can cause a decrease in output due to an increase in the price of imported goods which can have a negative effect on the economy. Depreciation will increase import costs and domestic production costs through imports of production inputs (Acar, 2000).

H₃: Exchange rate has a significant positive effect on economic growth

2.4 Human Capital and Economic Growth

Endogenous growth states that human capital can influence economic growth. This theory discusses the differences that occur in real income levels between countries. In the long term, economic growth throughout the world will only be achieved if there is endogenous technological progress and human resource development. Countries with a fast rate of technological progress tend to have a higher rate of economic growth compared to countries with a slower rate of technological progress (Suhendra, 2020). Romer (2006) also put forward the theory of endogenous growth of human capital, namely that output is produced based on three inputs, namely capital, labor and technology. Simeonova-Ganeva (2010) stated that increasing human capital is one of the production factors that plays a role in increasing economic growth, because it is directly related to the production function. Human resources are directly related to the level of technological progress which will ultimately affect economic growth.

H₄: Human capital has a significant positive effect on economic growth

2.5 Foreign Direct Investment, Financial Development and Economic Growth

The financial sector's role is to collect funds from third parties and distribute them to the community. If the intermediation function carried out by the financial sector runs well, it will have a positive impact on the economy. Sghaier (2018) states that there are several reasons why financial development has become one of the main contributors to economic growth. First, a good financial system will provide opportunities for monitoring and allocating resources, low information asymmetry, and economic growth (Shen & Lee, 2006). Second, the financial system plays a role in influencing the amount of credit disbursement which ultimately affects economic growth. Third, the development of the domestic financial system plays a role in determining how much foreign companies can be given loans to expand their innovative activities in the host country. This will increase technological spillovers on domestic companies.

H₅ : Financial development strengthens the effect of FDI on economic growth

3. Method

This research uses secondary data in the form of panel data, with time series data for 21 years from 1999-2019. The cross section data consists of ten countries in ASEAN, namely Indonesia, Malaysia, Philippines, Singapore, Thailand, Brunei Darussalam, Vietnam, Laos, Myanmar and Cambodia. Some of the data used is economic growth as the dependent variable which is measured by Gross Domestic Product. Meanwhile, the independent variables consist of foreign direct investment, inflation, exchange rate and human capital. Apart from that, to find out the role of financial development in strengthening the influence of FDI on economic growth, it will be represented through the interaction variable between FDI and financial development. The financial development variable is measured by the Financial Development Index. The data used was obtained from the World Bank and Penn Table. Summary of variables used in this study in Table 1.

Table 1. Variable and Measurement

No.	Variable	Notation	Measurement
1.	Economic growth	GDP	GDP per capita
2.	Foreign investment	direct FDI	Foreign Direct Investment, net inflows
3.	Inflation	INF	Inflation, consumer prices
4.	Exchange rate	EXR	Official exchange rate
5.	Human capital	HC	Human Capital Index
6.	Interaction of FDI with financial development	FDI*FD	Interaction of FDI with financial development

Thus, the panel data model specifications used in this research can be formulated as follows:

$$LGDP_{it} = \alpha_0 + \beta_1 LFDI_{it} + \beta_2 INF_{it} + \beta_3 LEXR_{it} + \beta_4 HC_{it} + \beta_5 FDI*FD_{it} + \varepsilon_{it}$$

where, GDP is gross domestic product, FDI is foreign direct investment, INF is inflation, EXR is exchange rate, HC is human capital, FDI*FD is the interaction variable between FDI and financial development, α is the intercept coefficient, β is the regression coefficient, and ε is error term. In panel data regression there are 3 estimation models, namely common effect model, fixed effect model, and random effect model. The best model estimation can be determined using the Chow test and Hausman test.

4. Results

Based on descriptive statistical analysis, there were 10 ASEAN countries samples for a period of 21 years from 1999 to 2019.

Table 2. Descriptive Analysis

Variable	Mean	Std. Dev.	Min	Max	Obs.
GDP	3.582550	0.598626	2.456363	4.787982	210
FDI	9.352632	0.823454	6.648487	11.02240	210
INF	5.449284	10.69106	-1.241718	125.2721	210
EXR	2.158500	1.606467	0.096760	4.362675	210
HC	2.368187	0.522692	1.499773	4.351568	210
FDI*FD	3.496739	2.278528	0.212508	8.108259	210

Source: Data processed, 2024

Descriptive analysis in Table 2 shows that GDP has an average value of 3.582550 with the lowest value of 2.456363 and the highest value of 4.787982. Foreign direct investment has the highest average value among other variables of 9.352632 with the lowest value of 6.648487 and the highest value of 11.02240. Inflation has an average value of 5.449284 with the lowest value of -1.241718 and the highest value of 125.2721. The exchange rate has an average of 2.158500 with the lowest value of 0.096760 and the highest value of 4.362675. Human capital has an average of 2.368187 with the lowest value of 1.499773 and the highest value of 4.351568. The

interaction of FDI with financial development has an average of 3.496739 with the lowest value of 0.212508 and the highest value of 8.108259.

Tabel 3. Chow Test and Hausman Test

Test	Summary Test	Prob.	Decision
Chow Test	Prob. <i>Cross-section</i> <i>Chi-square</i>	0.0000	<i>Fixed effect model</i>
Hausman Test	Prob. <i>Cross-section</i> <i>random</i>	0.0001	<i>Fixed effect model</i>

Source: Data processed, 2024

Based on the model selection test in Table 3, the Chow test shows that the probability value of Cross-section Chi-square is 0.0000 or smaller than 0.05, so the estimation using the fixed effect model is chosen rather than the common effect model. Meanwhile, based on the Hausman test, it can be seen that the probability value of Cross-section random is 0.0001 or less than 0.05. Therefore, the best model to be used in this research is Fixed Effect Model (FEM).

Table 4. Estimation Results *Fixed Effect Model* (FEM)

Dependent Variable : GDP

Variable	Model Fixed Effect
C	1.721375*** (0.089932)
FDI	0.118151*** (0.012206)
INF	-0.001345*** (0.000445)
EXR	0.104601*** (0.012516)
HC	0.173025*** (0.023355)
FDI*FD	0.036590*** (0.012516)
R-squared	0.990351

Notes: Standard error in parentheses. Significance levels at which the null hypothesis is rejected: ***p<0.01, **p<0.05, *p<0.1

Source: Data processed, 2024

The results of testing with the fixed effect model (FEM) show that foreign direct investment, exchange rates, and human capital have a positive and significant effect on economic growth. Apart from that, the test results show that inflation has a negative and significant effect on economic growth. The research results also found that financial development strengthens the influence of foreign direct investment on economic growth. Based on the R-square value, it can

be interpreted that 99.03% of the economic growth variable can be explained by the variables foreign direct investment, inflation, exchange rates, human capital, and the interaction between FDI and financial development. The remaining 0.97% is explained by other variables outside the model.

Table 5. Robustness Test

Dependent Variable : GDP

Variabel	Model 1	Model 2
C	1.561030*** (0.080039)	1.683139*** (0.082680)
FDI	0.127632*** (0.009865)	0.108650*** (0.009951)
INF	-0.001830** (0.0007666)	-0.001346*** (0.000418)
EXR	0.109396*** (0.019671)	0.122742*** (0.020450)
HC	0.253693*** (0.019847)	0.208519*** (0.019816)
FDI*FD		0.037702*** (0.007149)
R-squared	0.989717	0.990635

Notes: Standard error in parentheses. Significance levels at which the null hypothesis is rejected: ***p<0.01, **p<0.05, *p<0.1

Source: Data processed, 2024

The robustness test in Table 5 shows that the estimation results were carried out by eliminating several independent variables, namely by using 4 independent variables in the first model and 5 independent variables in the second model. This test was carried out to see how the independent variable influences the dependent variable if the number of independent variables is reduced. Thus, based on the results of the robustness test, it shows that in general the coefficient values in all the models used do not differ significantly from the results of the fixed effect model estimates. The range of values of the coefficient, foreign direct investment, inflation, exchange rate, human capital, and the interaction between FDI and financial development as a whole do not have much difference. Overall, the first and second models have a significant influence on economic growth. The large value of the coefficient of determination for each model shows that the R-squared value is not much different, but the R-squared value in the second model has a higher value.

Table 6. Summary of Hypothesis test

Hypothesis	Description	Result
H ₁	Foreign direct investment has a significant positive effect on economic growth	Accepted
H ₂	Inflation has a significant negative effect on economic growth	Accepted
H ₃	The exchange rate has a significant positive effect on economic growth	Accepted
H ₄	Human capital has a significant positive effect on economic growth	Accepted
H ₅	Financial development strengthens the effect of FDI on economic growth	Accepted

5. Discussion

5.1 Foreign Direct Investment and Economic Growth

The research results show that foreign direct investment (FDI) has a positive and significant effect on economic growth. FDI can improve the host country's economy through capital accumulation, transfer of new technology, transfer of knowledge and skills. The endogenous growth model states that economic growth is driven by two main factors, namely the supply of human resources and technological change. Mahembe & Odhiambo (2014) explain that FDI is a potential source of economic growth because (i) FDI can produce technological impacts; (ii) assisting in the formation of human resources; (iii) help host countries to integrate into global economic trade; and (iv) help create a more competitive business environment and increase business development. The results of this study are supported by research conducted by Ogbuagu et al. (2021), Liang et al. (2021), Anetor (2020), Hamoudi & Aimer (2017), Bahri et al. (2017), Trinh et al. (2015), Sghaier & Abida (2013), and Koojaroenprasit (2012) which states that FDI has a positive and significant effect on economic growth.

5.2 Inflation and Economic Growth

The research results show that inflation has a negative and significant effect on economic growth. Inflation has a close relationship with economic growth, because the rate of inflation can influence the increase and decrease in the economy. The relationship between inflation and economic growth in the long term is negative, that is, a high level of inflation will cause a decrease in the level of economic growth. Endogenous growth theory also explains that economic growth is very dependent on profits from capital, so that inflation will reduce profits and ultimately have a negative impact on the economy. This research is in line with research conducted by Osei & Kim (2020), Sghaier (2018), Bahri et al. (2017), Sghaier & Abida (2013), and Shahbaz & Rahman (2012) which states that inflation has a negative and significant effect on economic growth.

5.3 Exchange Rate and Economic Growth

Based on the results of this research, it is known that the exchange rate has a positive and significant effect on economic growth. Shahbaz & Rahman (2012) found that a high level of

economic growth is supported by adequate export growth, so that it will strengthen the exchange rate due to an increase in the domestic currency. A strong exchange rate will encourage capital market liquidity, so that investment will increase and ultimately achieve the desired level of economic growth. The results of this research are in line with research conducted by Samuel & Nurina (2015) and Uddin et al. (2014) which states that the exchange rate has a positive and significant effect on economic growth.

5.4 Human Capital and Economic Growth

The research results show that human capital has a positive and significant effect on economic growth. Human capital will enable the economy to grow when human resources increase in various fields, such as science, education and management. This can lead to increased innovation, social welfare, equality, increased productivity which can contribute to economic growth. At the macro level, an educated workforce is an important factor in achieving greater aggregate productivity, innovation and long-term economic growth. In the endogenous growth model, it is stated that human resources will contribute to economic growth in the long term indirectly through innovation and technological diffusion. The results of this research are supported by research conducted by Osei & Kim (2020), Bahri et al. (2017) and Susilo & Wicesa (2021) which states that there is a positive and significant influence between human capital to economic growth.

5.5 Foreign Direct Investment, Financial Development and Economic Growth

The research results show that financial development strengthens the effect of foreign direct investment on economic growth. Alfaro et al. (2004) stated that the development of domestic financial markets is very important so that FDI has a positive impact on growth. Well-functioning financial markets can encourage more efficient distribution of foreign investment in productive sectors, thereby attracting investors who can encourage FDI inflows which will ultimately increase economic growth. The results of this research are supported by previous research conducted by Osei & Kim (2020), Sghaier (2018), Bahri et al. (2017), Alzaidy et al. (2017), Choong (2012), Azman-Saini et al. (2010) and Hermes & Lensink (2003) which states that the interaction between FDI and financial development has a positive and significant influence on economic growth.

6. Conclusion and Recommendation

The results of research using the fixed effect model (FEM) were obtained to determine the influence of financial development in moderating foreign direct investment on economic growth. The following are the conclusions from the research results from panel data processing in accordance with the framework of thought, namely:

Foreign direct investment (FDI) has a positive and significant effect on economic growth in ASEAN countries. Inflation has a negative and significant effect on economic growth in ASEAN countries. The exchange rate has a positive and significant effect on economic growth in ASEAN countries. Human capital has a positive and significant effect on economic growth in ASEAN countries. Financial development strengthens the effect of foreign direct investment (FDI) on economic growth in ASEAN countries.

The results of this research can be used by the government to pay more attention to factors that have a positive influence on economic growth. Creating a positive climate to encourage FDI inflows in host countries and creating better financial development conditions in order to encourage the positive impact of FDI on economic growth. Future researchers can develop research topics by adding other variables.

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