Research Article

# How Does the Impact of Political and Economic Risks Affect Foreign Investment in ASEAN-7

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**Abstract.**
Unstable economic and political conditions can increase uncertainty and potential foreign investment losses. According to Marsh (2019), ASEAN-7 countries (Indonesia, Myanmar, Vietnam, Thailand, Malaysia, Philippines, and Cambodia) have high and medium economic and political risks in ASEAN. An in-depth analysis of foreign investment that is assumed to be correlated with economic and political risk is required. The research methodology used is the Panel Corrected Standard Error (PCSE) as the analysis technique. The results show that economic risk with trade openness indicator positively and significantly affects foreign direct investment. This means that when ASEAN-7 countries have the ability to increase their international trade activities, the flow of FDI will increase. Political risk with political stability indicator has a positive and significant effect on Foreign Direct Investment. This means that good political stability conditions in ASEAN-7 will increase FDI flows to ASEAN-7 countries. The corruption perception index negatively and significantly affects the foreign direct investment. This means that the more corrupt the countries in ASEAN-7, the higher the FDI flow to ASEAN-7 countries.

**Keywords:** economic risk, political risk, foreign direct investment, panel corrected standard error (PCSE), ASEAN-7

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## 1. Introduction

After the 1990s, based on the 2017 report by the Organisation for Economic Cooperation and Development (OECD), FDI has received significant attention due to its potential and benefits for both the home country and the host country. There are several reasons why FDI is important and can provide benefits, including: Filling Domestic Capital Shortages; Promoting Technology Transfer; Knowledge Transfer; and Creating Employment Opportunities: FDI can create job opportunities, which ultimately contribute to economic growth and national development in the host country (1). These points highlight the multifaceted benefits of FDI in supporting economic development and human resource improvement in host countries.

In developing countries, the issue that always takes priority is the limited domestic investment capital resources. Most developing countries face a capital shortage, particularly in ASEAN developing countries (2). In the last two decades, ASEAN has attracted global attention through its dynamic and stable growth. However, this stable economic growth is not supported by high FDI inflows into developing countries. Another research demonstrate that the high demand for FDI in ASEAN countries is due to the low domestic savings rates penelitian (3).

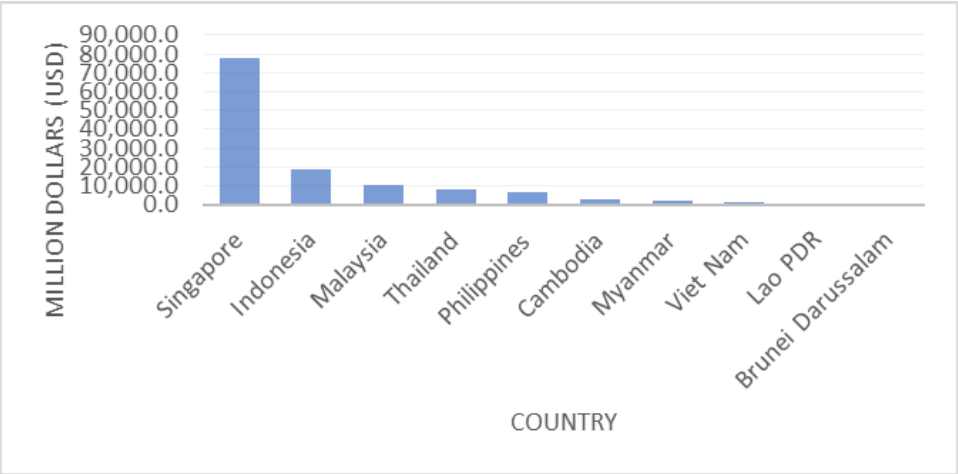


**Figure** 1: Average FDI in Each ASEAN Country from 2010-2022. Source: World Bank (Processed Data).

Figure 1 depicts the average FDI for each ASEAN countries from 2010 to 2022. Singapore continues to dominate FDI inflows to ASEAN countries, with the remaining nine countries receiving relatively tiny amounts of FDI in total. The state of FDI inflows to ASEAN shows an uneven trajectory between Singapore and the other ASEAN member countries. Singapore has always been the leading beneficiary of FDI in ASEAN, accounting for 56 percent of overall FDI entering the region. Meanwhile, developing ASEAN countries receive very little foreign direct investment (FDI).According to neoclassical theory, capital flows “downhill” from countries with abundant capital to countries with constrained capital. Countries with a capital constraint provide better returns on investment, causing foreign investors to shift their focus to these regions (4). This research focuses on the ASEAN-7 countries (Cambodia, Indonesia, Myanmar, Malaysia, the Philippines, Thailand, and Vietnam).

Internal factors influencing FDI inflows into a country especially in ASEAN-7 include two main aspects: economic risk and political risk, which encompass market size, economic growth, trade openness, inflation rates, interest rates, exchange rates, human resources, rule of law, democracy, political stability, and corruption (5). Meanwhile,

external factors influencing FDI inflows include: (a) The COVID-19 pandemic, which has affected FDI inflows by increasing protectionism and other concerns that erode investor confidence investor (6), and (b) The global economic recession that has caused investors to withdraw their capital (7). According to the International Country Risk Guide (ICRG) in 2018, economic risk can influence foreign investors' decisions to invest in a country. One indicator that affects FDI inflows is the interest rate. Investments are distributed among countries that offer good returns and security in the form of interest rates (8). The relationship between interest rates and investment, as described by Keynes, can be seen through the Marginal Efficiency of Capital (MEC). An increase in interest rates will hinder investment growth, while a decrease in interest rates will encourage investment (8). There is a positive relationship between the interest rate and FDI in India (9). Trade openness is another economic risk factor that influences FDI in the trade sector, as it can affect the investment climate and overall economic risk (10). An increase in trade openness will enhance short-term and long-term FDI inflows (11). The more open the host country is to enter and exit goods, services, and capital, the greater the incentives for foreign investors (12).The impact of inflation on FDI attractiveness is negative (13). Inflation is also a sign of instability and a lack of control over macroeconomic policies, which can have a negative impact on the attractiveness of foreign investment (14).

Political risk is the risk that occurs due to political disturbances in a country that can affect its economy (15). Political risk encompasses the likelihood of consequences due to weak institutional quality, high corruption, poor political stability, and lack of democratic (16). The higher the political risk, the greater the likelihood that investment in the host country will decline. Political risk can be considered a significant factor influencing FDI (17). Factors such as high levels of conflict, political terrorism, corruption, authoritarianism, and weak rule of law tend to increase risks and worsen political stability, thereby reducing investor interest (18). According to a 2019 report by Marsh, ASEAN is a region with varying levels of political risk from high to low. Research on political risk concerning FDI indicates that the consequences of corruption can lead to political risks that hinder foreign investment decision-making, as foreign investors may reject governments lacking transparency, nepotism, and abuse (19). Many foreign entrepreneurs view corruption as a "serious barrier to investment and trade. The increase in Foreign Direct Investment can be achieved by improving the corruption perception (20). The corruption perception index has a positive and significant effect on Foreign Direct Investment (21). In addition to corruption, civil liberties positively impact economic growth, and greater respect for political rights will enhance investment (22).

Increases or decreases in democracy within a country influence FDI in that country (23). Beside that, Political stability has a positive impact on business decisions because political freedom reflects a good image of the country and attracts increased foreign direct investment (24).

Research findings indicate that political stability has a positive impact and encourages the inflow of FDI both in the short term and long term (25). Other studies show that political stability has a positive and significant effect on FDI (20, 26). We can take Can be conclude political risk negatively impacts the inflow of FDI into the destination country (17, 27). Countries with high political risk can make investors no longer interested in investing in those countries. In this research, there is inconsistency in the empirical results conducted by previous studies and limitations in the methodology applied in previous research. Several previous studies have analyzed the impact of economic risk on FDI, and other earlier research has examined the influence of political risk on FDI. However, it is rare for past studies to combine both. The innovation in this research is the combination of economic risk and political risk, which are assumed to affect FDI. Based on the issues faced by ASEAN-7 mentioned above, this research aims to analyze and identify the impact of economic risk on foreign direct investment in ASEAN-7 using the Panel-Corrected Standard Errors (PCSE) method.

## 2. Methods

The problem to be addressed in this research is whether economic risk and political risk affect FDI. The subjects of this research are the ASEAN-7 countries. (Kamboja, Indonesia, Myanmar, Malaysia, Filipina, Thailand, dan Vietnam). The research period was taken from 2010-2022, considering relevant factors and ensuring that the period allows researchers to effectively understand the phenomenon being studied. The data used in this research are secondary data in the form of panel data using the Panel-Corrected Standard Errors estimation (PCSE) method.

### 2.1. Research Methodology

The research methodology used is to implement the *Panel-Corrected Standard Errors* (PCSE) model with the type of panel data. The PCSE model is used to test and answer the formulation of the problem in this study, namely whether economic risk and political risk affect *Foreign Direct Investment* in 7 ASEAN countries.

TABLE 1: Operational variable.

| VARIABLE | INDICATOR | SYMBOL | UNIT | SOURCE |
|---|---|---|---|---|
| **Foreign Direct Investment** | % GDP | FDI | Percent | World Bank |
| **Interest** | Real interest rates | IR | Percent | World Bank |
| **Trade Opennes** | $TO = \frac{X+M}{GDP} \times 100$ | TO | Percent | Our World in Data |
| **Inflation** | IHK = (Pn/Po) x 100 | INF | Percent | World Bank |
| **Political Stability** | Estimation (-2.5 to 2.5) | SP | Index | World Bank |
| **Corruption Perception Index** | Corruption perception index scale 0 to 100 | GPA | Index | Tranparancy International |
| **Democracy** | Democracy index, range 0 to 10 (most democratic) | THE | Index | Our World in Data |

## 2.2. Panel Corrected Standard Error (PCSE)

Panel Corrected Standard Error (PCSE) is used to address issues of heteroskedasticity, autocorrelation, and cross-sectional dependence in panel data regression analysis. This method works well on panel data with a small T-to-N ratio (28). PCSE corrects for heteroskedasticity and serial correlation. When the panel exhibits heteroskedasticity and serial correlation, Ordinary Least Squares estimation is inefficient and its standard errors are inaccurate. An accurate estimation of the variability of Ordinary Least Squares estimation can only be achieved if its standard errors are corrected. The PCSE method is also more efficient compared to the LSDV (Least Squares Dummy Variable) method in addressing issues of heteroskedasticity and correlation between units/individuals.

The model in this study refers to the research model conducted by Adeleye et al published in 2023, namely:

$$FDI_{it} = \alpha + \beta_1 IR_{it} + \beta_2 TO_{it} + \beta_3 INF_{it} + \beta_4 SP_{it} + \beta_5 IPK_{it} + \beta_6 DEM_{it} + \epsilon_{it} \ldots\ldots (1)$$

Where:

$\alpha$ = Constanta

FDI = Foreign Direct Investment

TO = Trade openness

IR = Interest rate

INF = Inflation

SP = Political stability

CPI = Corruption Perception Index

DEM = Democracy

$\epsilon$ = Error Term

I = ASEAN-7 countries

t = Year 2010-2022

# 3. Result and Discussions

## 3.1. Multicollinearity Test

Table 2 below is the value of the correlation coefficient between each of the independent variables displayed in the form of a correlation matrix.

TABLE 2: Correlation Matrix.

| | FDI | AND | TO | INF | SP | IPK | THE |
|---|---|---|---|---|---|---|---|
| FDI | 1.0000 | | | | | | |
| IR | -0.2669 | 1.0000 | | | | | |
| TO | 0.3519 | -0.4832 | 1.0000 | | | | |
| INF | 0.0146 | 0.0053 | -0.2350 | 1.0000 | | | |
| SP | 0.4265 | -0.3893 | 0.6203 | -0.2015 | 1.0000 | | |
| IPK | -0.5089 | -0.1527 | 0.3241 | -0.3396 | 0.2716 | 1.0000 | |
| DEM | -0.3761 | -0.1754 | -0.1140 | -0.3825 | 0.0461 | 0.6147 | 1.0000 |

Source: Output Stata 17, processed.

From the correlation matrix table, it can be seen that there is no intercorrelation coefficient that has a value of 0.8 or more. The relationship between independent variables that is quite close only occurs between the political stability variable and trade openness with a correlation coefficient of 0.6203, and between the democracy variable and the corruption perception index with a correlation coefficient of 0.6147. Meanwhile, the value of the correlation coefficient between other variables was low, which was 0.4. By looking at these intercorrelation values, it can be concluded that there is no multicollinearity problem in the model.

## 3.2. Cross-sectional Dependency Test

According to the aforementioned results, H0 is rejected since the interest rate, inflation, and corruption perception index variables have CD test p-values less than $\alpha$= 0.05. This suggests that in terms of interest rate, inflation, and corruption perception index variables, the ASEAN-7 countries have similar developments. The factors that fail to

TABLE 3: Cross-sectional Dependency Test.

| Variable | CD-test | p-value |
|---|---|---|
| FDI | -1.077 | 0.281 |
| IR | 5.196 | 0.000* |
| TO | 0.278 | 0.781 |
| INF | 5.589 | 0.000* |
| SP | 0.384 | 0.701 |
| IPK | 6.09 | 0.000* |
| DEM | -0.116 | 0.907 |

*** p<0.01, ** p<0.05, * p<0.1
Source: Output Stata 17, processed.

reject H0 in the CD test have a p-value > $\alpha$= 0.05 for FDI, trade openness, political stability, and democracy. The lack of reliance on the variables trade openness, political stability, democracy, and foreign direct investment suggests that the ASEAN-7 nations respond to these factors separately.

## 3.3. Unit Root Test

TABLE 4: Results of IPS Unit Root Test.

| Variable | p-Value of IPS at Level | Information | p-Value of IPS 1st Difference | Information |
|---|---|---|---|---|
| FDI | 0.0009*** | Stasioner | 0.0000*** | Stasioner |
| IR | 0.0000*** | Stasioner | 0.0000*** | Stasioner |
| TO | 0.5508 | Not stationary | 0.0462** | Stasioner |
| INF | 0.0393** | Stasioner | 0.0000*** | Stasioner |
| SP | 0.2903 | Stasioner | 0.0000*** | Stasioner |
| IPK | 0.2808 | Not stationary | 0.0000*** | Stasioner |
| DEM | 0.9062 | Stasioner | 0.0009*** | Stasioner |

*** p<0.01, ** p<0.05, * p<0.1
Source: Output Stata 17, processed

Table 4 shows the results of the unit root test with IPS. At the level of the variables Trade Openness, Political Stability, Corruption Perception Index, and Democracy, they are non-stationary, so they need to be tested at the first difference level. At the first difference level, the IPS p-value < $\alpha$= 0.05, thus all variables are stationary.

## 3.4. Cointegration Test

Table 5: Westerlund Cointegration Test Results.

| Cointegration Test | Statistic | p-value | Hypothesis |
|---|---|---|---|
| Variance Ratio | 1.9356 | 0.0265** | H0 rejected |

*** p<0.01, ** p<0.05, * p<0.1
Source: Output Stata 17, processed.

Based on the test results as shown in table 5, it indicates that H0 is rejected because the Westerlund p-value is 0.0265 < $\alpha$= 0.05. Thus, it can be concluded that there is a long-term relationship between the variables in the model.

## 3.5. Panel Corrected Standar Error (PCSE)

Table 6: PCSE Estimation Results.

| Variable | *Coefficient* | with | Prob>\|z\| |
|---|---|---|---|
| Cons | 12.86631 | 7.17 | 0.000*** |
| IR | -.0346645 | -0.51 | 0.609 |
| TO | .029839 | 3.84 | 0.000*** |
| INF | -.0642747 | -0.75 | 0.451 |
| SP | 2.440149 | 4.83 | 0.000*** |
| IPK | -.3432581 | -9.10 | 0.000*** |
| DEM | .2903938 | 1.35 | 0.178 |
| R-squared | 0.6846 | | |
| Prob > chi2 | 0.0000*** | | |

*** p<0.01, ** p<0.05, * p<0.1
Source: Output Stata 17, processed.

The interest rate variable has a z-statistic probability value of 0.609, which is greater than $\alpha$ = 0.05 (do not reject H0). The calculation results show that the calculated z-value for interest rates is -0.51 < z-table = -1.65, thus it can be concluded that we do not reject H0, indicating that interest rates do not affect foreign direct investment in ASEAN-7. The trade openness variable has a z-statistic probability value of 0.000, which is less than $\alpha$ = 0.05, leading to the conclusion that H0 is rejected. The calculation results show that the calculated z-value for trade openness is 3.84 > z-table = 1.65, so it can be concluded that we reject H0, indicating that trade openness significantly affects foreign direct investment in ASEAN-7. The inflation variable has a z-statistic probability value of

0.451, which is greater than $\alpha$ = 0.05 (do not reject H0). The calculation results show that the calculated z-value for inflation is -0.75 < z-table = -1.65, thus it can be concluded that we do not reject H0, indicating that inflation does not affect foreign direct investment in ASEAN-7. The political stability variable has a z-statistic probability value of 0.000, which is less than $\alpha$ = 0.05 (reject H0). The calculation results show that the calculated z-value for political stability is 4.83 > z-table = 1.65, so it can be concluded that we reject H0, indicating that political stability significantly affects foreign direct investment in ASEAN-7. The corruption perception index variable has a z-statistic probability value of 0.000, which is less than $\alpha$ = 0.05 (reject H0). The calculation results show that the calculated z-value for the corruption perception index is -9.10 > z-table = -1.65, thus it can be concluded that we reject H0, indicating that the corruption perception index significantly affects foreign direct investment in ASEAN-7. The democracy variable has a z-statistic probability value of 0.178, which is greater than $\alpha$ = 0.05 (do not reject H0). The calculation results show that the calculated z-value for democracy is 1.35 < z-table = 1.65, so it can be concluded that we do not reject H0, indicating that democracy does not affect foreign direct investment in ASEAN-7. Based on Table 6, the results of the PCSE model equation are as follows:

$$FDI_{it} = 12.86631 - 0.0346645IR_{it} + 0.029839TO_{it} - 0.0642747INF_{it} + 2.440149SP_{it} - 0.3432581IPK_{it} + 0.2903938DEM_{it} + \epsilon_{it} \quad (2)$$

## 3.6. The Influence of Economic Risk on Foreign Direct Investment

The research findings indicate that economic risk, measured by interest rates, does not have a significant impact on foreign direct investment in ASEAN-7. This is because FDI has long-term goals, not short-term ones like speculation on interest rate changes. Interest rates do not significantly affect FDI because this study uses domestic interest rates, whose influence is not strong enough to affect overall FDI flows. Conversely, international interest rates are more dominant in influencing FDI (24, 29, 30). However, the results of this study align with Keynes's opinion that, in reality, investment is relatively unresponsive to changes in interest rates. Keynes placed greater emphasis on the importance of investment expectations influenced by factors such as political stability, production costs, a conducive business climate, etc.

Economic risk with the trade openness indicator was found to have a positive and significant impact on the inflow of FDI to ASEAN-7. This means that when ASEAN-7 countries have the ability to increase their international trade activities, the flow of

FDI will increase. This is in line with the hypothesis put forward that as international trade becomes more open, FDI will increase (31). The relationship between FDI and international trade is complementary, although both represent different types of transactions and play different economic roles. FDI can facilitate the transfer of intangible assets such as skills and technological knowledge that cannot be achieved through trade. (32). Trade openness indicates that trade barriers and financial traffic between countries are increasingly diminishing. The reduction of trade barriers will encourage foreign investors to invest their capital in the domestic country because the returns obtained are likely to be greater (9, 11). The inflation indicator does not affect FDI in ASEAN-7. This is because the inflation rate in ASEAN-7 is still relatively stable and falls into the mild category, with an average inflation rate during the research period (13 years) of 3.8 percent (below 10 percent). The results of this study are consistent with previous research that inflation does not significantly affect the entry of FDI (33, 10).

### 3.7. The Impact of Political Risk on Foreign Direct Investment

Not all political risk variables significantly affect FDI. The significant indicators are political stability and the corruption perception index. Meanwhile, democracy does not have a significant impact on FDI. Generally, investors will choose to invest in countries with low economic risk and minimal political risk. (21). Political stability has a positive and significant impact on FDI. When political conditions are stable, the risk to investments decreases because there are no significant threats to policies or laws that could harm their investments. (34). The ASEAN-7 countries should pay more attention to political stability in each country. Good political stability will encourage investors to invest in the ASEAN-7 countries. The results of this study are in line with previous research which argues that the level of political stability has a significant and positive impact on FDI, where political instability in a country will reduce foreign investors' interest in investing in that country (20, 25, 34).

The corruption perception index has a negative and significant impact on FDI in ASEAN-7. This means that the more corruption practices occur, the lower the realization of FDI in ASEAN-7. Sometimes corruption acts as a lubricant in accelerating economic expansion in ASEAN-7. The grease the wheel hypothesis (GWH) states that sometimes corruption can function as a lubricant for the economy. Corruption can act as "assistance" for foreign investors (35). This is because bribery can evade restrictions and regulations. Many FDI flows into more corrupt countries (usually occurring in developing countries)

(36). This is because the FDI destination countries are able to protect international investors from higher taxes and wages. (36). Political risk with democracy indicators was found to have no significant impact on FDI in ASEAN-7 (23, 37, 38). Democracy is not the main determinant of a country's economic performance (39). For low-income countries, law enforcement, political stability, and the absence of terrorism are more decisive in supporting economic performance than democracy and the quality of institutions. In developing countries, especially in the ASEAN-7 countries, it is considered that they can still drive their economic growth, even though they are not yet ready to fully implement democracy. Countries in the ASEAN region that are considered democratic include Indonesia, Malaysia, and the Philippines. Nevertheless, good democratic conditions do not guarantee that bureaucratic and other political risks will not deter investors from making FDI.

## 4. Conclusions

Some conclusions from this research are economic risk with the indicator of Trade openness has a positive and significant impact on Foreign Direct Investment. This means that when the ASEAN-7 countries have the ability to increase their international trade activities, the flow of FDI will increase. Meanwhile, the indicators of Interest rates and Inflation do not have a significant impact on Foreign Direct Investment. This indicates that the interest rate levels and inflation conditions in the ASEAN-7 are not obstacles for foreign investors to invest in the form of FDI in the ASEAN-7 countries.

Political risk with the indicator of Political Stability has a positive and significant impact on Foreign Direct Investment. This means that good political stability conditions in ASEAN-7 will increase the flow of FDI to ASEAN-7 countries. The Corruption Perception Index has a negative and significant impact on Foreign Direct Investment. This means that the more corrupt the countries in ASEAN-7, the higher the FDI inflow will be to ASEAN-7 countries. Meanwhile, the Democracy indicator does not have a significant impact on Foreign Direct Investment. This means that good democracy does not yet guarantee investors will invest their capital in ASEAN-7 countries. Suggestions for future researchers could include adding financial risk variables that may influence FDI. Future researchers could also incorporate relevant political risk indicators such as bureaucratic quality, rule of law, and government effectiveness to obtain more accurate results. In addition, it is hoped that future researchers can expand the research subjects and extend the observation period to provide more detailed and in-depth results.

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