ARE FOREIGN DIRECT INVESTMENT IN INDONESIA INFLUENCED BY POLITICAL RISK? A PANEL REGRESSION APPROACH[1]

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Abstract

Foreign direct investment was needed to encourage a country's economic growth. Foreign direct investment did not only function as an engine of development, but also became a picture of economic openness. Theoretical developments showed that foreign direct investment was not only influenced by macroeconomic variables, but also institutional and political. By using six political risk indicators from the World Bank, this study aimed to look at the influence of political risk and macroeconomic variables on investment in Indonesia. The data used were secondary data from 2004 to 2017 and used the panel data regression model. Political risk indicator data showed that Indonesia's political indicators were getting better from year to year. While the panel data regression results showed that overall political risk did not have a significant effect, the effectiveness of bureaucracy had a significant influence on foreign direct investment in Indonesia.

Keywords: Foreign Direct Investment, Political Risk, Panel Regression, Indonesia

1. Introduction

Foreign Direct Investment (FDI) for developing countries is an economic activity that is very much needed to accelerate economic growth. Domestic investment is considered not enough to encourage economic growth. With the presence of FDI, a country can get the opportunity to accelerate development and will encourage economic growth by itself. Some previous studies show that FDI, which is a direct investment, is far more resistant to crises compared to portfolio investment. FDI plays an important role in the process of forming working capital for developing countries, especially through the exchange of technology and managerial knowledge. By bringing in capital, especially in the form of foreign currency, FDI helps generating more investment in the targeted country and improves its trade balance, that the growth cycle increases more.

The growth of direct investment in Indonesia from year to year shows a positive progress. The highest FDI occurred in 2017 with a growth of 24.9%. This increase in FDI was prompted by the acquisition and issuance of global bonds through overseas affiliated companies (Bank Indonesia, 2017). The increase in FDI mainly occurred in the non-oil and gas sector. In 2017 there were four domestic e-Commerce companies acquired by foreign investors from China, the United States and Singapore. On the different side, oil and gas investment were tend to be stagnant and decline due to the lack interest of foreign investors to invest in the oil and gas sector in Indonesia.

Through the following figure, the development of investment realization in the form of domestic investment and FDI in Indonesia can be seen. In terms of value, the realization of FDI is far greater than the realization of domestic investment. The highest realization of FDI occurred in the third and fourth quarter of 2017, which was 111.7 trillion rupiahs and 122.1 trillion rupiahs. Graph 1 also shows that from 2015 to the first quarter of 2018, Indonesia's FDI experienced a significant increase. In more detail, investment in new projects in Indonesia is more than the expansion of investment. In 2017, the proportion of investment increased by 18.7 percent in the form of investment expansion, while 81.3 percent was in the form of new investments.

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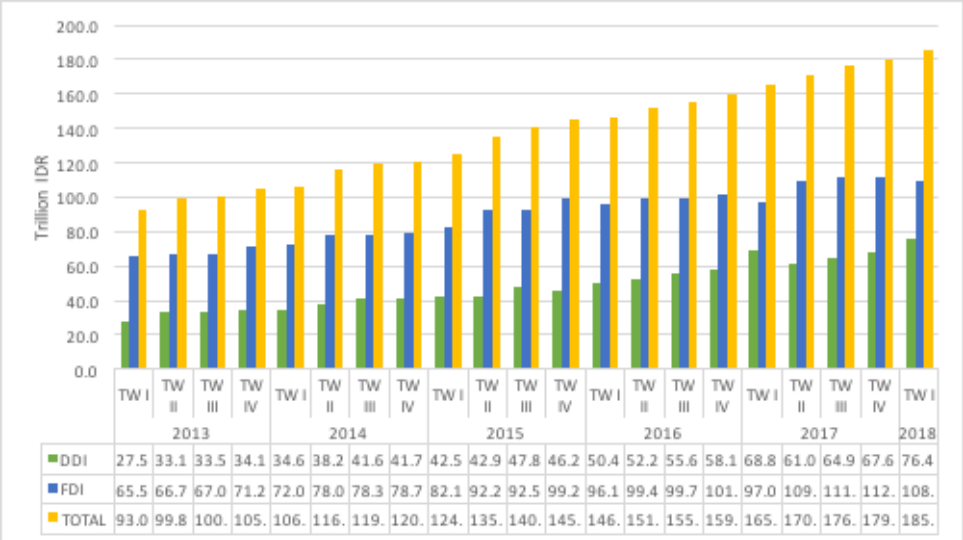
Figure 1. Development of Investment Realization 2013-March 2018



	TW I	TW II	TW III	TW IV	TW I	TW II	TW III	TW IV	TW I	TW II	TW III	TW IV	TW I	TW II	TW III	TW IV	TW I	TW II	TW III	TW IV	TW I
	2013				2014				2015				2016				2017				2018
DDI	27.5	33.1	33.5	34.1	34.6	38.2	41.6	41.7	42.5	42.9	47.8	46.2	50.4	52.2	55.6	58.1	68.8	61.0	64.9	67.6	76.4
FDI	65.5	66.7	67.0	71.2	72.0	78.0	78.3	78.7	82.1	92.2	92.5	99.2	96.1	99.4	99.7	101.	97.0	109.	111.	112.	108.
TOTAL	93.0	99.8	100.	105.	106.	116.	119.	120.	124.	135.	140.	145.	146.	151.	155.	159.	165.	170.	176.	179.	185.

Source: Indonesia Investment Coordinating Board

Based on historical data, there are 10 countries which have the biggest investments in Indonesia. The value reached US$ 13.33 billion or 86% of the total investment of US$ 15.55 billion. It is equivalent to IDR 206.9 trillion. The FDI to Indonesia in throughout the first half of 2018 has grown into 5.8% compared to the first half of 2017. The total investment in Indonesia in the first six months of 2017 reached IDR 678.8 trillion or about 49.6% of the target. The China, Hong Kong, Japan, South Korea and Singapore are the 5 countries that have the most investment in Indonesia during the past five years. In Indonesia, Singapore still became the biggest investor for Indonesia until the beginning of semester 1 in 2017. Based on the data of Indonesia Investment Coordinating Board, it is noted that FDI from Singapore in semester 1 2017 reached US$ 3.66 billion or IDR 48.69 trillion. This number is equivalent with 24% of the total FDI in Indonesia and it became the biggest one compared to other countries. Japan was on the second place with the investment value of US$ 2.85 billion. China was on the third place with US$ 1.95 billion. Almost all countries have a pattern that is not so stable in their investment. The investment patterns of China, South Korea and Hong Kong are relatively stable, but are still lower compared to Japan and Singapore.

The increase in FDI in Indonesia is related to the increasing ease of doing business in Indonesia. Based on the World Bank's report on ease of business (EODN, 2018), business ease in Indonesia has increased by 19 ranks to rank 72. The Indonesian government targets that by 2020, Indonesia will be ranked 40th in ease of business.

One of important variables in maintaining stability of economic condition and increasing the rank of doing business is the Central Bank policy interest rates. Central Bank policy interest rates plays an important role, because these interest rates will be derived to deposit rates, savings rates and loan interest rates. During the third quarter of 2017, Bank Indonesia reduced interest rates from 4.75% in July to 4.50% in August 2017, and then fell again in September 2017 to 4.25%. This reduction in policy rates was carried out to encourage credit growth, and because of relatively low and well-controlled inflation. On the other hand, almost all Central Banks in various groups of countries seemed not to change interest rate policies during the third quarter of 2017. The Fed still maintains the interest rate at 1-1.25%. The inflation rate that has not met the 2% target is a measure of holding the Fed's interest rate. The Central Bank of China was also seen maintaining interest rates of 4.35%.

In addition to macroeconomic variables that affect investment, the development of FDI theory moves rapidly. In recent times, institutional problems and also the condition of democracy have become one of the highlights in determining the flow of FDI into a country. Several previous studies have analyzed the relationship between fundamental democratic rights and FDI. Using different econometric techniques and periods, Harms and Ursprung (2002)) found that multinational companies are more interested in democratic countries. They found that democratic rights, especially leading to better protection of property rights, would increase foreign investment. On the other hand, there are also findings that increasing democracy can reduce FDI.

The financial crisis that attacked the world economy, including Indonesia in 1998 and 2005, brought new awareness of the importance of FDI compared to portfolio investment. Countries that have a larger portfolio investment than FDI will experience a more severe impact. In fact, FDI is not only influenced by macroeconomic variables, but also political and institutional variables. Based on this background, this study aims to analyze the

determinants of FDI inflows to Indonesia both from the macroeconomic side as well as from the institutional political aspects. The importance of this study is a two-dimensional approach, namely a macroeconomic approach and a political risk approach as a determinant of investment in Indonesia.

2. Literature Review

The main theoretical studies of the determinants of FDI stated that foreign direct investment was motivated mainly by the possibility of high profitability in growing markets, along with the possibility of financing these investments at relatively low rates of interest in the host country. Other determinants were the necessity to overcome trade barriers and to secure sources of raw materials. Other empirical studies that attempted to estimate the importance of the different determinants of FDI concentrated more on attraction factors, i.e., locational factors.

Some of the previous studies related to macroeconomic concepts were Akinkugbe (2003), Benacek et. al (2000) and Lim (2004). Akinkugbe (2003) showed that high per capita income, orientation to international trade, high levels of infrastructure development, and high returns on investment are significant factors for FDI. Benacek et al (2000) also found that the main motive of investors is market search. The number of people and national income was the best indicator of the market. This finding was corrected by Lim (2004) who argued that market size, infrastructure quality, economic stability and free trade zones were important for FDI. Other factors that influenced investment decisions were fiscal incentives, business climate or investment, labor costs and trade openness (Lim, 2004).

The relatively new theory of FDI used market and institutional variables as factors that influence investment decisions. Market-oriented factors confirmed the theory of basic investment such as gross domestic product, inflation, interest rates, exchange rates, trade openness, labor costs, and resources and so on. Institutional oriented factors used institutional, social and political indicators to determine investment behavior. Bevan et al (2001) said that institutions were very important for market economy operations and facilitate business operations.

Bevan et al. (2001) found that institutional indicators positively influenced FDI such as private sector development, banking sector reform, and legal development. Efficient legal infrastructure reduced institutional uncertainty for foreign investors, facilitated the establishment and enforcement of contracts. Research conducted by Alfaro et.al (2008) showed that political risk reduction would increase investment. Kurul and Yalta (2017) also found that some institutional factors have an important impact than others in attracting FDI. Kurul and Yalta (2017) considered that various dimensions of institutions like political regime, security of property rights, enforcement of law and order affected FDI flows. This happens because foreign investors were sensitive to political risks. The main reason was that foreign investors were sensitive to political risks, fearing direct takeovers, such as nationalization of foreign investment projects. There was also the possibility of other indirect effects of increased political risk.

The findings were supported by Coeurdacier, Santis and Aviat (2009) who stated that the impact of political turmoil on formal law such as investor protection became a significant variable in foreign investment. Dumludag et al (2007), Busse and Hefeker (2007), Chen and Funke (2008) and Carril-Caccia, Milgram-Baleix, and Paniagua (2019) also found that an unstable political environment could be a significant investment barrier. Unstable political environment such as government stability, internal and external conflicts, law and order, security of ownership rights, prudence standards, corruption, ethnic tension and the quality of bureaucracy reflected political risks. Another study conducted by Trevino and Mixon (2004) in Latin America found that political risk is a significant indicator of direct investment. Likewise, Hefeker (2007) saw that government stability, internal and external conflicts, ethnic tensions, corruption, law, democratic accountability and the quality of bureaucracy determined foreign investment. On the other side, Asiedu (2013) found that FDI risk variable does not a significant effect on FDI flows. Similar with Asiedu, Okada (2013) showed that political risk and institution have indirect effect on FDI flows. Shah (2017) used the data in five developing economies from South Asia – found that the changes in institutional variables did not make a significant positive impact on FDI. But when he used disaggregated factors, the significance effect on FDI inflows increased.

If market-oriented or macroeconomic variables were easily measured, institutional variables did not. Institutional variables required qualitative measurements. The Political Risk Services Group (PRS) provided the International Country Risk Guide (ICRG), namely (i) Political risk index of voice and accountability (PRSVA), (ii) Political risk index of political stability and absence of violations (PRSVP), (iii) Political risk index of government effectiveness (PRGE), (iv) Political risk index of regulatory quality (PRSRQ), (v) Political risk index of rule of law (PRSRL), (vi) Political risk index of control of corruption (PRSCC).

3. Methodology

This study used secondary data obtained from the Central Bureau of Statistics, Ministry of Finance, Investment Board, UNTAC Bank Indonesia, and PRS from the World Bank Group

(https://info.worldbank.org/governance/wgi/pdf/prs.xlsx). The period of data taken for this study is 2004-2017. Data analysis used panel data regression equation (between Indonesia and the top ranking of FDI realization, namely China, Japan, Hong Kong, South Korea, Japan and Singapore) for the years 2004-2017. The Investment Equation was developed from the model used by Chantasasawat, et al (2004), Gast (2005), Dumbludag (2007), Busse and Hefeker (2007), and Chen and Funke (2008).

$$FDI_{ijt} = f(GDP_{jt} / GDP_{it}, OPENNESS_{ijt}, ER, R_{jt}/R_{it}, Riskpol_{it}) \quad \ldots.1)$$

$$fdi_{ijt} = \alpha_0 + \alpha_1 (gdd_{jt} - gdp_{it}) + \alpha_2 OPENESS_{ijt} + \alpha_3 ER + \alpha_4 (R_{jt} - R_{it}) + \alpha_5 Riskpol_{it} + \varepsilon_t \quad \ldots 2)$$

Where

- FDI_{ijt} is FDI to Indonesia (i) from 5 countries (j) in year (t)
- GDP_{jt} is GDP Nominal of 5 countries (j) in year (t);
- GDP_{it} *is* GDP Nominal of Indonesia (i) in year (t);
- $OPENNESS_{ijt}$ = level of trade openness.
- ER is Indonesia's exchange rate compared to partner (another country)
- R_{jt} *is* the interest rate of 5 countries (j) in year (t);
- R_{it} *is* Indonesia's interest rate (i) in year (t);
- ε is disturbing factor.
- Σ*Riskpol* = Composite political risk factors derived from PRS

4. Description of FDI in Indonesia and influencing variables

Foreign investment was influenced by gross domestic product of country partners. Theoretically, if a country had high Gross Domestic Product, it would expand its investment to other countries. Viewed through economic growth from 2004 to 2017, it was seen that China was a country with the highest average economic growth, which is 15.09%. Indonesia also had a high average economic growth which is 10.34%. Whereas Hong Kong, Japan, South Korea, and Singapore, in the period 2004-2017 had growth rates of 5.6%, 1%, 5.92% and 8.53% respectively. In 2010 and 2011, almost all countries experienced high economic growth.

Figure 2. Relationship between FDI and GDP (Million USD)

Source: International Financial Statistics, IMF, data processed

Based on the data, we should see the relationship between Gross Domestic Product and Foreign Investment in Indonesia. It is clearly seen that trend of foreign investment is in line with trend of gross domestic product. The

higher the gross domestic product, the higher the foreign investment. The graph showed that Japan described clearly about this theory. When Japan's Gross Domestic Product increased, its foreign investment is also increased. On the contrary, if Japan's Gross Domestic Product decreased, its foreign investment also decreased. High economic growth has pushed the growth of Chinese FDI to Indonesia also experienced a high increase. This phenomenon still needed to be proven in a regression model to find out whether the GDP of each country had a significant influence on FDI entering Indonesia.

The next variable that is interesting to be observed was the openness index. The Openness Index of a country the total number of export and import divided by Gross Domestic Product. If the Openness Index was high, the influence of international trade on domestic activities was also higher. It showed that the country's economy was stronger. The correlation of the Openness Index and FDI was when a country was more open to trade flow of other countries, it would be the next destination of foreign investment since it was more interesting than other countries that are closed. The openness of a country showed that domestic economy was not only dominated by domestic products but also foreign products.

The linkage of the openness index with FDI was that when a country was more open to the flow of trade in other countries, the country would become a more attractive FDI destination compared to a closed country. In the period of 2004-2011, the highest index of openness was between Indonesia and Japan. Indonesia-Japan openness index 1.786. If the value of the openness index was carried out in absolute terms, the next high openness index was between Indonesia and Singapore (0.654) and Indonesia and China (0.603).

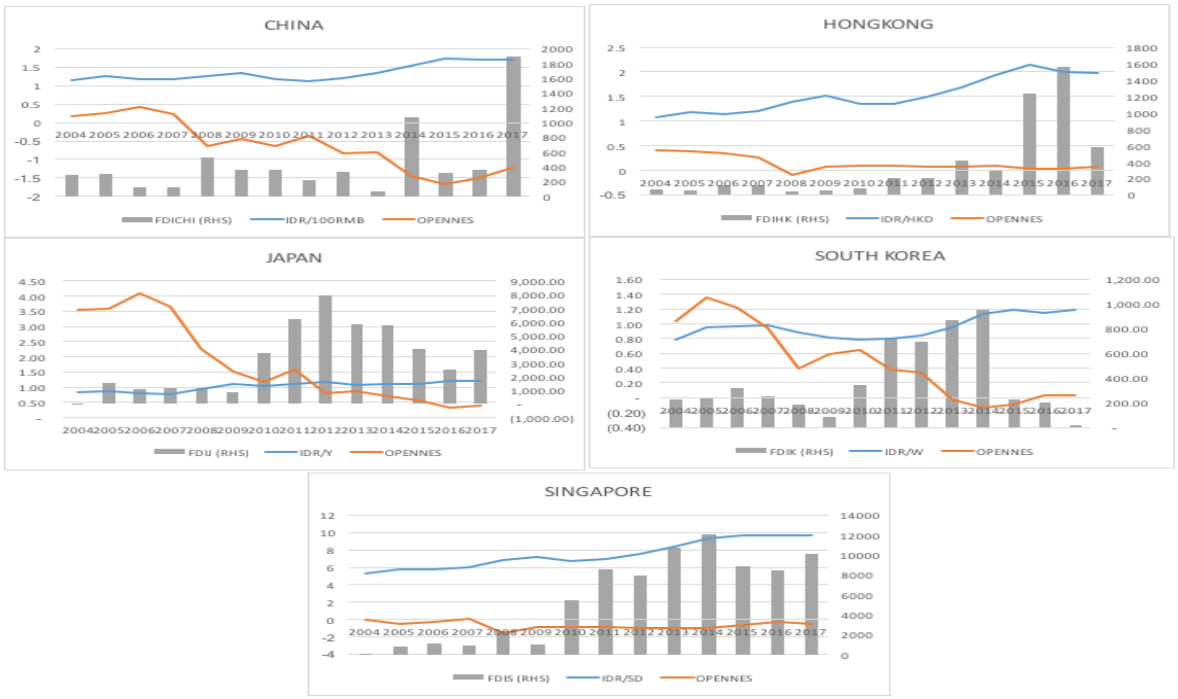
Table 1. Indonesia's Level of Openness to Main Partner Countries
2004-2017

Year	China	Hong Kong	Japan	South Korea	Singapore
2004	0.180	0.401	3.537	1.034	-0.029
2005	0.264	0.386	3.584	1.356	-0.526
2006	0.430	0.342	4.090	1.215	-0.279
2007	0.238	0.265	3.639	0.933	0.141
2008	-0.647	-0.100	2.260	0.392	-1.599
2009	-0.433	0.072	1.509	0.588	-0.914
2010	-0.627	0.085	1.168	0.645	-0.863
2011	-0.366	0.084	1.599	0.380	-0.842
2012	-0.842	0.077	0.803	0.336	-0.975
2013	-0.794	0.066	0.855	-0.019	-0.975
2014	-1.461	0.104	0.691	-0.138	-0.941
2015	-1.668	0.028	0.552	-0.090	-0.624
2016	-1.503	0.040	0.334	0.036	-0.288
2017	-1.218	0.074	0.388	0.033	-0.448

Source: International Financial Statistics, IMF, data processed

The exchange rate, theoretically, also influenced foreign investment. The exchange rate could be functioned as a stimulation of investment entry to the destined countries. It is because currency strengthening of destined countries improved the investment results of investors and vice versa (Benassy-Quere, et al, 2001). The following graph showed the relationship between economic FDI, openness and exchange rates. Based on the data it appeared that IDR tended to depreciate from year to year. The biggest average depreciation was against the Hong Kong Dollar, which was 5.12%. Whereas against the Singapore dollar, IDR depreciated around 4.92%. From the graph, depreciation was correlated with FDI.

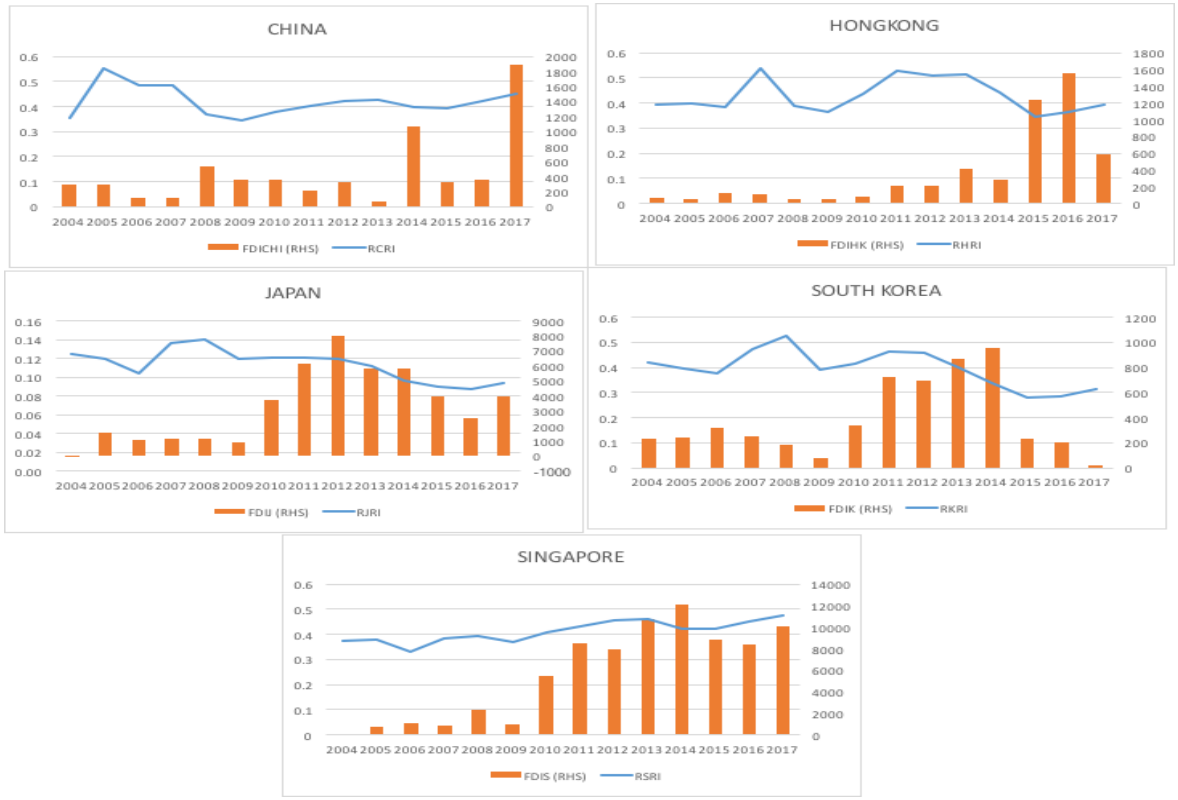
Figure 3. Relationship between FDI, Exchange Rate and Openness Index 2004-2017



Source: International Financial Statistics, IMF, data processed

The interest rate was a cost that needs to be paid by capital borrowers because of the loaning or the use of some fund to capital lenders. There was a negative relationship between interest rate and investment rate. If the interest rate was high, the total of investment was low. On the contrary, if the interest rate was low, the total of investment was high. When compared with other countries, Indonesia's loan interest rates were relatively higher compared to interest rates in other countries. On average from 2004 to 2017, Indonesia's interest rates were 13.10%. China, Hong Kong, South Korean and Singapore tribes were almost the same, which is at 5%. The lowest average interest rate was Japan's loan interest rate of 1.49%. Of the five countries, in the last 5 years it has been seen that interest rates show more and more declining.

Figure 4. Relationship between FDI and Loan Interest Rates 2004-2017



Source: International Financial Statistics, IMF, data processed

One of the non-economic aspects used in this study is Political Risk. Political risk had an influence on investment decisions to a country. The lower the political risk of a country, the country would become increasingly attractive to foreign investors. This was because investment must depend on the security of a country. The political risk indicators issued by the World Bank in the form of Political risk index has indicators (i) Political risk index of voice and accountability (PRSVA) which contains the indicator of military in politics and democratic accountability, (ii) Political risk index of political stability and absence of violations (PRSVP) which contains the indicator of government stability, internal conflict, external conflict and ethnic tensions, (iii) Political risk index of government effectiveness (PRGE) which contains the indicator of quality of bureaucracy, (iv) Political risk index of regulatory quality (PRSRQ) which contains indicator of investment profile, (v) Political risk index of rule of law (PRSRL) which contains indicator of law and order, and (vi) Political risk index of control of corruption (PRSCC) which contains indicator of corruption condition. Overall, the political risk rating can be divided into several categories (www.prsgroup.com):

1. 0.0% - 49.9% indicates a very high risk
2. 50.0% - 59.9% indicate high risk
3. 60.0% - 69.9% indicates moderate risk
4. 70.0% - 79.9% indicate low risk
5. > 80.0% indicates a very low risk

Table 2 showed the conditions of Indonesia's political risk. From all indicators, from year to year, it could be seen that Indonesia's political risks are getting smaller. This showed that Indonesia's political conditions were getting better, even though the Indonesian index still showed relatively high-risk conditions because there was only one risk indicator that had a low index. In 2017, very high risks were found in law enforcement indicators. An index that showed high risk is found in PRSVA, PRGE and PRSCC. This showed that the effectiveness of government was not optimal, the level of corruption is still high, and the accountability of democracy was still relatively low. Whereas internal and external conflicts and pressures between ethnic groups contained moderate risks. While investment profile indicators were stated as low risk, this showed that Indonesia was a relatively attractive investment destination.

Table 2. Indonesian Political Risk Index 2004-2017

Year	PRSVA	PRSVP	PRSGE	PRSRQ	PRSRL	PRSCC
2004	0.63	0.61	0.50	0.50	0.50	0.17
2005	0.63	0.61	0.50	0.73	0.50	0.17
2006	0.63	0.63	0.50	0.73	0.50	0.42
2007	0.63	0.63	0.50	0.73	0.50	0.58
2008	0.63	0.62	0.50	0.73	0.50	0.67
2009	0.63	0.64	0.50	0.73	0.50	0.50
2010	0.63	0.62	0.50	0.64	0.50	0.50
2011	0.63	0.61	0.50	0.64	0.50	0.50
2012	0.63	0.55	0.50	0.55	0.50	0.50
2013	0.63	0.57	0.50	0.68	0.50	0.50
2014	0.54	0.59	0.50	0.68	0.50	0.50
2015	0.54	0.56	0.50	0.50	0.42	0.50
2016	0.54	0.62	0.50	0.73	0.42	0.50
2017	0.54	0.62	0.50	0.73	0.42	0.50

Source: World Bank

5. Regression Analysis and Discussion

Based on the econometric completeness check, the models used in this study are two, namely the common model and fixed effect model. The model also be divided into two models, namely (i) models with political risk separated from one another and (ii) models that use the composite index of political risk. In the second model, there were 6 types of political risk, namely (i) political risk index of voice and accountability (ii) political risk index of political stability and absence of violations, (iii) political risk index of government effectiveness, (iv) political risk index of regulatory quality, (v) political risk index of rule of law, and (vi) political risk index of control of corruption.

Another variable used in regression is the ratio of partner country GDP to Indonesian GDP (in the form of logs), the level of openness of a country's trade (openness) seen from the ratio of trade to GDP, Indonesia's exchange

rate to partner countries (in the form of logs), rate ratio partner country interest with Indonesian interest rates (in log form).

Table 3. Resume Econometric Model

Variables	Common model 1		Common model 2		Fixed Effect model	
	Coefficient	t-Statistic	Coefficient	t-Statistic	Coefficient	t-Statistic
LN GDP	-0.20325	-1.489163	-0.244516	-1.74634	-1.127481	-2.160069
OPENNESS	-0.211355	-0.88137	-0.524391**	-2.599171	-0.175363	-0.815522
LN EXCHANGE RATE	0.182837**	2.126927	0.13255	1.532191	3.260609*	4.286599
LN INTEREST RATE	-1.833044	-4.021051	-2.222008	-5.259344	1.888864	2.200404
POLITICAL RISK INDEX			3.3313	0.644861	-0.777084	-0.20892
PRSVA	-6.703092	-0.837248				
PRSVP	-21.55591*	-2.406253				
PRSGE	29.63232*	2.816844				
PRSRQ	3.79513	1.361072				
PRSRL	4.847753	0.577344				
PRSCC	1.650421	1.196054				
FIXED EFFECTS (CROSS)						
CHINA					-3.19864	
HONGKONG					-7.60516	
JAPAN					9.76835	
SOUTH KOREA					11.22172	
SINGAPORE					-10.18627	
R-SQUARED	0.428127		0.341224		0.715697	
ADJUSTED R-SQUARED	0.342346		0.289758		0.673051	
DURBIN-WATSON STAT	0.585474		0.574701			

Source: Data processed

Remarks: ** significant at $\alpha = 5\%$, * significant at $\alpha = 1\%$

The regression results using the common model showed that there were two variables that had a significant influence on FDI in Indonesia, namely the exchange rate and political risk index for government effectiveness. The exchange rate variable showed a significant positive effect on FDI. If there was a depreciation of 1%, the FDI would increase by 0.18%. This showed that FDI entering Indonesia was still an investment that seek the difference in exchange rate differences and considered that cheap Indonesian currencies would benefit them. This condition on the one hand was not favorable for Indonesia, because the exchange rate depreciation did not always have a positive impact on the economy even though it would encourage the entry of investment into Indonesia.

Based on the political index, it could be seen that the more effective the government will be to encourage FDI to enter Indonesia. If the government effectiveness index rose by 1%, investment entering Indonesia would increase by 29.63%. The effectiveness of the bureaucracy contributed greatly to the significance of this variable. Changes in the bureaucratic system and the spirit of clean bureaucracy in Indonesia in recent years contributed to foreign trust in investing in Indonesia.

Another interesting thing that could be discussed was the interest rate. In general, interest rates in Indonesia were relatively higher than the 5 investment partner countries. In theory, if external interest rates rose while fixed interest rates remained, or fixed interest rates remained but domestic interest rates fell, investment in Indonesia should increase. But the results obtained were the opposite, if the interest rate ratio rose, the investment would decrease. This means that the decline in domestic interest rates had not been able to encourage the increase in investment entering Indonesia.

In the second model regression was done with the composite index of the political risk index. When all political risks were combined, it turns out that the political risk index did not have a significant effect on foreign investment entering Indonesia. This finding was actually in line with the first model. In the first significant model only bureaucratic effectiveness. This gave a signal that the political risk index was not a key and main variable for investors to invest in Indonesia.

Because each country had different characteristics, the fixed effect model was used to see the heterogeneity of each country. The results obtained were almost the same as the common model. The variable that gave a significant impact was the exchange rate variable, while other variables including political risk did not have a significant impact. This showed that politics had not become a variable that was considered strongly by trading partner countries, while a strong economic variable was the exchange rate variable.

6. Conclusion

Foreign direct investment had an important place in the development of the countries. When the investors decided to make an investment, they took various factors into consideration. One of them was the political risk. Political risk factors were difficult to quantify, so we used six indicators from PRC as a proxy. The study result showed in Indonesian case only government effectiveness index that affect the FDI in Indonesia. The effectiveness of the bureaucracy contributed greatly to the significance of this variable. Changes in the bureaucratic system and the spirit of clean bureaucracy in Indonesia in recent years contributed to foreign trust in investing in Indonesia.

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