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Does Corruption and Government Regulation Matter to Foreign Portfolio Investment: Evidence from Asian and the European Union Countries

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ABSTRACT

Economic integration in various countries impacts fluctuations in and out of capital and multiple economic cooperation between countries. The investment that is one form of implementation of economic integration positively influences a country's capital reserves. The study analyzed the influence of macroeconomic variables and proxied institutions with corruption variables and government regulations on foreign *portfolio investment* fluctuations in the twenty Asian and EU countries with the largest funds flows. The data used in this study is a data panel with a period from 2002-2019. The analysis method used in this study uses two methods at once, namely the *Generalized Method of Moment* (GMM) and *the Panel Vector Error Correction Model* (PVECM), to analyze the cost of the analysis results. The study found that macroeconomic instruments projected with *GDP* variables had a positive and significant influence on foreign portfolio investments, while exchange *rate* variables negatively affected foreign portfolio investments. Important findings in this study that corruption consistently negatively and significantly affects foreign *portfolio investments* are based on both GMM test results and PVECM tests in the long term. In contrast, the results of PVECM tests in the short term do not have any macroeconomic variables or institutions that significantly affect foreign portfolio *investment.* This means that investors' consideration in investing in Asian countries and Europe is based on a long-term perspective than on short-term economic dynamics. In addition, regulatory variables have a positive and significant effect on foreign investment *portfolios* in twenty Asian countries and the European Union with the largest portfolio investment fund flow.

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KEYWORDS: Corruption, Exchange Rate, Foreign Portfolio Investment, GMM, PVECM.

1. INTRODUCTION

Financial liberalization and economic globalization have erased all economic sector boundaries between countries and positively influenced economic activity and capital turnover through capital market openness (Bhanumurthy & Kumawat, 2020; Matyushok, Krasavina, Berezin, & García, 2020). Investment and economic integration as tangible evidence of the implementation of financial liberalization and economic globalization in various countries, investment in the private sector becomes a hot topic of discussion among economists regarding the impact of its implementation and its effect on the economy and capital reserves (Casagrande & Cerezetti, 2014; Laopodis, 2020). Investment and economic integration as tangible evidence of the implementation of financial liberalization and economic globalization in various countries, investment in the private sector becomes a hot topic of discussion among economists regarding the impact of its implementation and its effect on the economy and capital reserves (Waqas, Hashmi, & Nazir, 2015).

Foreign portfolio investment is a passive investment with minimal control over company decisions and affects the country's capital reserves (Broto, Díaz-cassou, & Erce, 2011; Garg & Dua, 2014; Sawalha, Elian, & Suliman, 2016). The foreign portfolio investment flow of each country is influenced by various factors, not only internal economic conditions but also the quality factor of government institutions, especially the effectiveness of government and the level of corruption that occurs in the country (Al-Smadi, 2018), institutional strength is an important factor for the state in attract investors by increasing transparency and increasing portfolio riskabsorbing capital reserves.

Research on the implementation of Foreign Portfolio Investment (FPI) is still quite by other researchers. Moreover, this research is carried out in the scope of Asia and the European Union and uses two different model analytical

methods that complement each other to add to the benefits of the findings of this study.

2. LITERATURE REVIEW

The debate of the results studies on the effect between macroeconomic and institutional conditions on foreign portfolio investment has yielded different results. Albulescu (2015) concludes in the long term, foreign portfolio investment will have a unidirectional impact on economic growth. In other words, the ability of the government and companies to maintain the level of return and risk will attract investors to continue investing their equity so that economic growth conditions will be stable. The increase in economic activity will reduce the company's cost of capital and increase the gross domestic product (Ahmad, Yang, & Draz, 2015; Chidinma, Chinaemerem, & Kingsley, 2018). The condition of the gross domestic product will describe the country's ability to absorb risk and the rate of return on investment (Samman & GabAlla, 2020; Usman & Siddiqui, 2019; Zaimovic, Arnaut-Berilo, & Mustafic, 2017). The debate of the results studies on the effect between macroeconomic and institutional conditions on foreign portfolio investment has yielded different results. Albulescu (2015) concludes in the long term. Foreign portfolio investment will have a unidirectional impact on economic growth. In other words, the ability of the government and companies to maintain the level of return and risk will attract investors to continue investing their equity so that economic growth conditions will be stable. The increase in economic activity will reduce the company's cost of capital and increase the gross domestic product (Ahmad, Yang, & Draz, 2015; Chidinma, Chinaemerem, & Kingsley, 2018). The condition of the gross domestic product will describe the country's ability to absorb risk and the rate of return on investment (Samman & GabAlla, 2020; Usman & Siddiqui, 2019; Zaimovic, Arnaut-Berilo, & Mustafic, 2017). The difference in the results of each indicator variable is caused by different economic structures. Besides that, risk factors also underlie differences in the main components of indicators that affect portfolio investment. Investment performance will affect capital flows which are included in Foreign Direct Investment (FDI) or Foreign Portfolio Investment (FPI) (Ahmed & Zlate, 2014; Kandil, 2015), Economic integration and efficient use of technological advances will also help maximize returns on foreign investment so that capital flows can run optimally (Indawan, Fitriani, Permata, & Karlina, 2013). Economic integration and efficient use of technological advances will also help maximize returns on foreign investment so that capital flows can run optimally.

3. METHODOLOGY

This study uses a quantitative approach to analyze secondary data obtained through financial publication reports of the countries studied. The number of samples of research objects is ten countries that join in all forms of economic integration, including the ASEAN Economic Community (AEC), the Asian Pacific Economic Cooperation (APEC), and the European Union with the most significant number of foreign investment flows. The study uses data from 2002 to 2019. The selection of vulnerable years follows the amount of research data available. It reviews various upheavals from the economic and social sectors, such as the 2008/2009 global financial crisis and the COVID-19 pandemic, which have caused changes and declines in various sectors— country, especially in economic activity.

The form of data used is panel data, which combines two forms of data: time series data with a research vulnerability of 18 periods and cross-section data of 10 sample countries with the largest investment flow criteria. This study also uses two analytical methods: the Generalized Method of Moment (GMM) and the Panel Vector Error Correction Model (PVECM). The GMM analysis method will form the condition of the population moment based on the assumptions of the economic model and minimize the objective function of parameter estimation (Abdal, Nur, & Abdal, 2020). The equation of this research model was adopted from the research model Al Smadi (2018) with several different variables, which can be written into the econometric model as follows:

	FPI	CORR	GDP	ER	REG
Mean	-0.049638	54.40415	3.564408	100.1971	102.2205
Median	0.000000	47.00000	3.265360	99.85597	71.22500
Max	13.00400	94.00000	19.02000	153.6103	9279.000
Min	-11.90739	19.00000	-14.25972	60.45035	4.14000
Std. Dev	10.09576	22.14562	3.58493	12.72481	518.265

Source: *Eviews 9 result*, 2021

$$FPI_{it} = \beta_1 ER_{it} + \beta_2 GDP\ aktual_{it} + \beta_3 REGULATION_{it} + \beta_4 CORRUPTION_{it} + \varepsilon_{it} \quad (1)$$

VECM is a dynamic panel estimation method based on a structural model and adjusting to actual economic conditions. VECM is another form of Vector

Autoregressive (VAR) devoted to nonstationary data, and there is a cointegration relationship between research variables (Chavleishvili & Manganelli, 2019). The equation model for the Vector Autoregression method can be written as follows:

$$FPI_{it} = \alpha_{10} + \alpha_{11} FPI_{it-1} + \alpha_{12} ER_{it-1} + \alpha_{13} GDP_{it-1} + \alpha_{14} REG_{it-1} + \alpha_{15} CORR_{it-1} + \varepsilon_{it} \quad (2)$$

$$ER_{it} = \alpha_{10} + \alpha_{11} FPI_{it-1} + \alpha_{12} ER_{it-1} + \alpha_{13} GDP_{it-1} + \alpha_{14} REG_{it-1} + \alpha_{15} CORR_{it-1} + \varepsilon_{it} \quad (3)$$

$$GDP_{it} = \alpha_{10} + \alpha_{11} FPI_{it-1} + \alpha_{12} ER_{it-1} + \alpha_{13} GDP_{it-1} + \alpha_{14} REG_{it-1} + \alpha_{15} CORR_{it-1} + \varepsilon_{i} \quad (4)$$

$$REG_{it} = \alpha_{10} + \alpha_{11} FPI_{it-1} + \alpha_{12} ER_{it-1} + \alpha_{13} GDP_{it-1} + \alpha_{14} REG_{it-1} + \alpha_{15} CORR_{it-1} + \varepsilon_{it} \quad (5)$$

$$CORR_{it} = \alpha_{10} + \alpha_{11}FPI_{it-1} + \alpha_{12}ER_{it-1} + \alpha_{13}GDP_{it-1} + \alpha_{14}REG_{it-1} + \alpha_{15}CORR_{it-1} + \varepsilon_{it} \quad (6)$$

4. DISCUSSION AND RESULTS

Descriptive statistics is the first stage in testing data analysis, both in the generalized method of moment method and the panel vector error correction model. Descriptive statistics aim to provide a comprehensive picture or description of research data. This study has five research variables, with one dependent variable and four independent variables as proxies for macroeconomic conditions and state institutions. Table 1 will show the results of descriptive statistics.

Table 1. Statistic descriptive result

Variable	Nilai	
Foreign Portfolio Investment (FPI(-1))	Koef.	0.040626
	t-stat.	2.648468
	Prob.	0.0086*
Gross Domestic Product (GDP)	Koef.	0.077498
	t-stat.	2.815409
	Prob.	0.0052*

Table 1 shows the results of descriptive statistics data referring to the standard deviation, average (mean), median, maximum, and minimum values. The FPI variable has a minimum value of -11.90739, and the maximum value is 13.00400. This condition indicates the size of Foreign Portfolio Investment in the sample is -11.90739 to 13.00400, and the value of mean is -0.049638, and the standard deviation is 0.000000. The corruption variable (CORR) has a minimum value of 19.0000 and a maximum value of 94.000000. This condition indicates the amount of corruption in the sample is 19.000 to 94.000, and the value of mean is 54.40415, and the standard deviation is 22.14562. The standard deviation value is lower than the mean value, indicating that the data is normally distributed.

The Gross Domestic Product (GDP) variable has a minimum value of -14.25972 and a maximum value of 19.02000. This condition indicates the amount of Gross Domestic Product in the sample is -14.25972 to 19.02000, and the value of mean is 3.564408, and the standard deviation is 3.58493.

The Exchange Rate (ER) variable has a minimum value of 60.45035 and a maximum value of 153.6103. This condition indicates the amount of Gross Domestic Product in the sample is 60.45035 to 153.6103 value of mean 100.1971, and the standard deviation is 12.72481. a standard deviation value that is lower than the mean indicates that the data is normally distributed. Regulation variable (REG) has a minimum value of 4.14000 and a maximum value of 9279.000. This condition indicates the magnitude of regulation in the sample is 4.14000 to 9279. 000 and the mean is 102.2205, and the standard deviation is 102.2205.

After describing the condition of the research data, the cointegration test and the data stationarity test were carried out. The cointegration test is a test to see the relationship and the direction of the trend between variables by comparing the probability of the outcome and a significant degree of 0.05. If the probability condition is below 0.05, then there is no cointegration between variables and vice versa. Meanwhile, the unit root data test was carried out to see the level of stationary data, especially in the time series data due to the random walk trend. This test was carried out in several stages until all variables had a probability result below 0.05. the results of cointegration and stationarity testing of the data will be presented in table 2 and table 4.

Table 2. Stationary test on the level result

LEVEL		
Variable	Probability	Exp
FPI	0.000000	Stationer
GDP	0.00000	Stationer
ER	0.06150	Not stationer
CORR	0.0376	Stationer
REG	0.0009	Stationer

Source: *Eviews 9 result*, 2021

Based on table 2 in the stationarity test, one variable has a probability score above 0.05, namely the Exchange Rate (ER) of 0.06150, so it is necessary to do a stationarity test with a first difference level.

Table 3. Stationary test on first difference result

first difference		
Variable	Probability	Exp
FPI	0.000000	Stationer
GDP	0.00000	Stationer
ER	0.00000	Stationer
CORR	0.00000	Stationer
REG	0.00000	Stationer

Source: *Eviews 9 result*, 2021

Based on table 3 on the stationarity test, the variables are in a stationary condition. There is no unit root at the first difference level with a probability result of 0.00000 or below a significant degree of 0.05.

Table 4. Cointegration test result

Method	Statistic	Probability
Alternative Hypothesis (Ha) : Common AR Coefs		
Panel PP-Statistic	-9.728668	0.00000
	-10.78886	0.00000
Alternative Hypothesis (Ha) : Individual AR Coefs		
Group PP-Statistic	-14.72843	0.00000

Source: *Eviews 9 result*, 2021

Based on the presentation of the results of table 4 cointegration testing with the Pedroni Residual Cointegration Test method, as a whole, based on dimensions and between dimensions, it can be seen that the statistical probability value is below 0.05, so there is no relationship between bail variables between dimensions and dimensions.

Generalized Method of Moment

This study uses one lag variable for Foreign Portfolio Investment to see the relationship between moment conditions between Foreign Portfolio Investment variables. The test results are attached in the following table:

Table 5. Generalized method of moment result

Exchange rate (ER)	Koef.	-0.114709
	t-stat.	-11.15989
	Prob.	0.0000*
Corruption (CORR)	Koef.	-0.132700
	t-stat.	-2.359033
	Prob.	0.0190*
Regulation (REG)	Koef.	0.032588
	t-stat.	0.328931
	Prob.	0.7425

To see how each of the influences of the above variables, it is necessary to compare the results of each t statistic with at table at the 0.05 level, which is 1.969237. Based on the results of table 1, it is concluded that the foreign portfolio investment of the previous period has a significant positive effect on the foreign portfolio investment of the next period. Furthermore, GDP has a positive and significant effect on FPI. Exchange rate and corruption have a significant negative effect on foreign portfolio investment. Regulation has no effect on foreign portfolio investment based on the generalized method of moment test results.

Panel Vector Error Correction Model (PVECM)

Before testing the panel vector error correction model, it is necessary to carry out optimum lag testing aimed at determining the optimum lag length so as not to be affected by the autocorrelation problem specified in the five assessment criteria, namely Akaike Information Criteria (AIC), Final Prediction Error (FPE), Schwarz Information Criterion (SC) and Hannan-Quinn Information Criteria (HQ).

Table 6 will describe the optimum lag results in this study.

Table 6. Lag optimum test result

Lag	FPE	AIC
3	6.45e+10*	39.07621*

Source: *Eviews 9 result*, 2021

Based on the optimum length test results, it is concluded that in this study, the maximum level of lag used is three so that the data conditions are not in an autocorrelation condition. Furthermore, a stability test is needed in the VAR/VECM test to determine that the model used is stable. The VAR model is said to be stable if the modulus value is taken to 1 so that the estimation of the IRF and VD analysis is stable and able to be used to explain the results. The results of the stability test are presented in table 7.

Table 7. VAR stability test result

Root	Modulus
0.982166	0.982166
0.739331	0.739331
0.612723 - 0.007745i	0.612772
0.612723 + 0.007745i	0.612772
-0.365207	0.365207
0.014290 - 0.194642i	0.195166
0.014290 + 0.194642i	0.195166
0.121494	0.121494
-0.068625	0.068625
0.043616	0.043616

Source: *Eviews 9 result*, 2021

Based on the results above, it can be seen that the overall modulus value is below 1, so it can be concluded that in this study, the VAR model was in a stable condition. In the results of table 7 that the above analysis method can conclude that there is a consistency of results on two indicators, namely macroeconomics and institutions have an influence on foreign portfolio investment, the generalized method of moment test and the long-term model vector error correctio conclude that gross domestic product has a positive effect on the level of the foreign investment portfolio.

Table 8. Results of Vector Error Correction Model Longterm

Variable	Coefficient	t-statistics
FPI(-1)	1	
GDP(-1)	5.773971	[3.28757]
ER(-1)	-2.250616	[-5.01793]
CORR (-1)	-0.943141	[-1.86465]
REG(-1)	1.58590	[1.98590]

Source: *Eviews 9 result*, 2021

To see how each of the influences of the above variables, it is necessary to compare the results of each t statistic with at table at the 0.05 level with a value of 1.969237. Based on the results above, it is concluded that GDP has a positive and significant influence on FPI. Exchange Rate and Corruption have a significant negative effect on foreign portfolio investment. In contrast, regulation has no effect on foreign portfolio

investment based on the Long-term Vector Error Correction Model test results.

Table 9. Results of Vector Error Correction Model Shortterm

	D(FPI)
D(FPI(-1))	[-9.92416]
D(GDP(-1))	[-0.33767]
D(ER(-1))	[-1.50854]
D(CORR(-1))	[-0.42803]
D(REG(-1))	[1.27852]

Source: *Eviews 9 result,* 2021

Table 9 presents the results of the VECM panel test in the short term that Foreign Portfolio Investment (FPI) in the previous period had a negative effect on Foreign Portfolio Investment (FPI) in the current period. Variables Gross Domestic Product (GDP), an exchange rate (ER), corruption (CORR), and regulation (REG) do not affect Foreign Portfolio Investment (FPI) in the short term. This is due to the condition of the results statistic, which has a smaller result value than the t table.

The study is in line with Meurer (2016) and Tiberiu (2015). They conclude that gross domestic product and foreign portfolio investment have a positive influence, meaning that an increase in the value of gross domestic product will increase the value of the country's foreign investment portfolio. The increase in Gross Domestic Product indicates considerable economic activity on both the demand and supply sides to increase state income. The upward trend in economic growth can be of added value for the country to attract investors. The higher the economic activity, the greater the opportunities obtained by investors. The economy's strength becomes an important factor for investors as a form of analysis before deciding to invest. On the theoretical side, the results of this study are also in line with the explanation of the theory of economic growth by Harrod Domar, which explains that the level of economic growth will encourage an increase in the investment sector. An increase in portfolio investment will increase the amount of state capital reserves so that the country's development activities will run efficiently. On the other hand, an increase in portfolio investment will lead to the development of economic sectors and make the demand and supply sides of the market run efficiently.

The exchange rate has a significant negative effect on foreign portfolio investment, as shown in table 6 and table 7 from the GMM and PVECM analysis results. The existence of a negative relationship indicates a unidirectional relationship between the exchange rate and foreign portfolio investment. These findings are in line with the findings of Ekeocha et al. (2012) and portfolio theory and asset approach theory which conclude that portfolio investments in the form of financial assets are sensitive to changes in exchange rates. Fluctuating exchange rate conditions will cause asset values to decline so that efforts to strengthen the exchange rate will affect increasing assets and encourage investors to increase investment of capital resources.

Corruption has a significant negative effect on the level of foreign portfolio investment. Based on the results of the GMM test, a negative relationship indicates a nonunidirectional relationship between corruption and foreign portfolio investment. This finding is also in line with the findings of Jain et al. (2016), who found that the level of corruption has a negative effect on foreign portfolio investment. The high level of corruption in investment destination countries causes the condition of national market equity to decline so that it will impact investment value. The high level of corruption in a country will cause transparency of all activities to below, limited information for investors in accessing information concerning all activities, causing the cost of information to increase. The availability of information is important because investors can predict the possible risks and benefits that can be obtained with this information. Regulation has a positive effect on foreign portfolio investment based on the results of the GMM and PVECM tests, and a positive relationship indicates a unidirectional relationship between regulation and foreign portfolio investment. These findings are also in line with Smadi (2018) findings, which describe a positive relationship between regulation through government effectiveness on foreign portfolio investment. The high level of effectiveness of government regulations indicates that the country has a high level of transparency and the ability to respond to changes efficiently. In addition, countries with a high level of effectiveness of government regulations will make it easier for investors to reduce monitoring costs and lower information costs. Monitoring costs and high information asymmetry will reduce the return level so that investment acceptance will be lower. On the other hand, high regulation in the destination country will be able to reduce the condition of the level of corruption where corruption will significantly affect the level of investment, strengthening policies and regulations in investment activities and strengthening corruption laws and regulations will provide a positive value to the level of investment, both domestic and foreign.

5. CONCLUSION

Based on the results of testing the influence of macroeconomic policy and institutional strength using two analytical tools, it can be seen that there is consistency in the results of each independent variable on the dependent variable. GDP has a significant positive effect on FPI based on the GMM and PVECM test results, and Exchange Rate has a negative effect on foreign portfolio investment based on the GMM and PVECM test results. In contrast, corruption has a negative effect on foreign portfolio investment based on the GMM test results. Regulation has a positive effect on foreign portfolio

investment based on the results of the PVECM test in the long term. However, in the short term, there is no significant independent variable on Foreign Portfolio Investment. Any changes in macroeconomic indicators will cause portfolio volatility conditions that can affect the return on investment.

On the other hand, regulatory factors such as the level of transparency and the ease with which investors can access information positively affect the flow of investment portfolio funds. The balance between macroeconomic policies that are balanced with the alignment of government institutions in implementing regulations, either through legislation and other forms of activity investment, is one of the values considered by investors in addition to the availability of raw materials because for investors, the expected return is an essential thing in making investment decisions. The existence of various economic and political turmoils will certainly have an influence on investment returns, the need for collaboration in various economic sectors and policies. It can certainly help the government in attracting investors. Besides that, the weak legislation on corruption in most Asian countries and the European Union and the high number of corruption cases can also be a major concern to attract investors to these countries.

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