

**THE ROLE OF FINANCIAL DEVELOPMENT IN ENHANCING
DOMESTIC INVESTMENT IN ASIA**



THESIS

**PRESENTED TO THE FACULTY OF ISLAMIC ECONOMICS AND
BUSINESS
SUNAN KALIJAGA STATE ISLAMIC UNIVERSITY YOGYAKARTA
AS ONE OF THE REQUIREMENTS TO OBTAIN THE DEGREE OF
BACHELOR OF ISLAMIC ECONOMICS**

BY:

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**ISLAMIC ECONOMICS STUDY PROGRAM
FACULTY OF ISLAMIC ECONOMICS AND BUSINESS
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YOGYAKARTA**

2025

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To:

Dear Dean of the Faculty of Islamic Economics and Business

UIN Sunan Kalijaga Yogyakarta

In Yogyakarta

Assalamualaikum wr,wb.

After reading, researching, providing clues, and correcting and making corrections as necessary, I as a supervisor, am of the opinion that your thesis:

Name : Heni Engelica
Student Number : 22108010063
Thesis Title : The Role of Financial Development in Enhancing Domestic Investment in ASIA

It can be submitted to the Faculty of Islamic Economics and Business, Department of Sharia Economics Study Program, UIN Sunan Kalijaga Yogyakarta as one of the requirements to obtain a Bachelor of Science in Islamic Economics.

With this, we hope that your thesis can be immediately submitted. We thank you for your attention.

Yogyakarta, 09 December 2025

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STATEMENT OF AUTHENTICITY OF THESIS

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Name : Heni Engelica
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Faculty : Islamic Economics and Business

I declare truthfully that my thesis entitled: "The Role of Financial Development in Enhancing Domestic Investment in ASIA" is a personal work and as far as the author's knowledge does not contain material published or written by others, except for certain parts that the author takes as a reference.

If it is proven that this statement is not true, then it is entirely the responsibility of the complier,

Yogyakarta, 09 December 2025

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MOTTO

“Semua jatuh bangunmu, hal yang biasa, angan dan pertanyaan, waktu yang menjawabnya, berikan tenggat waktu, bersedihlah secukupnya, rayakan perasaanmu sebagai manusia”

-Hindia



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With all gratitude, I dedicate this thesis to:

-I dedicate this work to Ayah and Ibu, who have always been the foundation of strength in my life. Their prayers, support, and love never wavered, even when the research process brought pressure and fatigue. Every step I have taken in this academic journey stems from the sacrifices and trust they have given me from the very beginning, making the success of this thesis a testament to their long-standing dedication in shaping me-

-I also dedicate this thesis to myself and the future I am building little by little. This journey has taught me consistency, courage, and the ability to persevere in the face of challenges. May what I have achieved today serve as a stepping stone to a more mature, expansive, and opportunity filled future-



PREFACE

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ABSTRAK

This study analyzes the impact of financial sector development, trade openness, inflation, interest rates, and the COVID-19 pandemic on domestic investment in Asia during the period 2011–2023. The researchers used panel data from 12 Asian countries with domestic investment as the dependent variable, proxied by Gross Fixed Capital Formation, and panel data regression using the Fixed Effect Model approach corrected using Generalized Least Squares. The results of the analysis show that financial sector development, trade openness, and inflation have a positive and significant effect on domestic investment, while interest rates and the COVID-19 dummy variable have a negative and significant effect. Overall, these variables explain most of the variation in domestic investment in Asia and confirm the importance of strengthening the financial sector, targeted trade openness, inflation management, and interest rate policies that support the investment climate in order to achieve sustainable economic development.

Keywords: financial development, trade openness, inflation, interest rates, COVID-19, domestic investment.



CHAPTER I INTRODUCTION

A. Background Study

Domestic investment plays a crucial role in driving economic growth in various countries, including those in the Asia-Pacific region (Ahamed, 2021). In economics, domestic investment is considered one of the main components of aggregate demand and a driving force for sustainable development because it directly encourages increased labor productivity, production capacity, and added value in the domestic economy (Atabayeva et al., 2024). Therefore, countries that can manage and consistently increase their domestic investment levels will be better prepared to face global challenges, improve productivity, and strengthen national economic competitiveness.

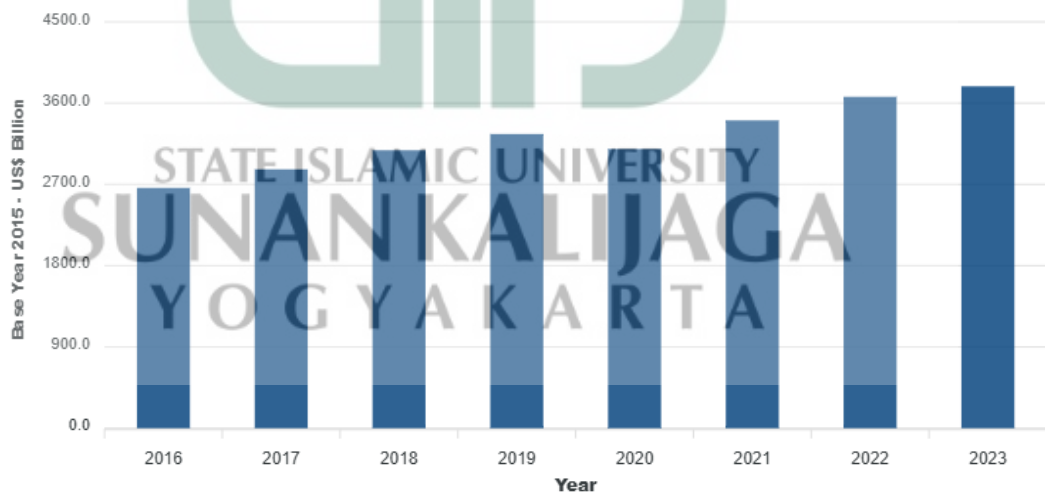


Figure 1.1 Trends in Domestic Investment in Asian Countries, 2016–2023.

Source: World Bank (2025)

Domestic Investment Trends (Gross Fixed Capital Formation, % of GDP) in Asian Countries, 2016–2023. The data shows consistent domestic investment levels above 25% of GDP in most Asian countries, indicating the important role of capital formation in supporting regional economic growth. Based on this data, through the Gross Fixed Capital Formation indicator, the value of domestic investment in the ASIA region shows a consistent upward trend over the past decade (World Bank, 2024). This increase in GFCF value indicates that governments and businesses in ASIA are actively expanding domestic production capacity and economic infrastructure.

According to a World Bank report, gross fixed capital formation in East Asian and Southeast Asian countries averages around 30% of GDP, demonstrating how much regional growth depends on domestic investment activity (World Bank, 2024). Increased domestic investment, particularly in the manufacturing, digital economy, and infrastructure sectors, directly enhances regional competitiveness and drives productivity and job creation in the Southeast Asian region (ASEAN Trade and Development, 2025). In general, the Economic and Social Community for Asia and the Pacific (2024) highlights that domestic investment is a key pillar in maintaining long-term economic resilience in the Asia-Pacific region, especially amid global fluctuations in foreign capital .

In the South and East Asia subregion, gross capital formation growth has been shown to enhance macroeconomic stability, expand the domestic industrial base, and reduce dependence on external financing (ESCAP, 2024). This means that increasing domestic investment is both an economic policy and a plan for regional development independence (ASEAN Secretary, 2023). However, domestic investment cannot be separated from the underlying macroeconomic conditions.

Macroeconomic factors such as financial development, trade openness, and inflation rates are important components in investment decisions (Wijaya et al., 2025). In the ASIA region itself, the development of the financial sector, trade openness, inflation, and interest rates are important factors driving the economy (C. Van Nguyen, 2025). By understanding the interaction between these three variables, we can obtain a comprehensive picture of how macroeconomic factors contribute to increased domestic investment, particularly in ASIA countries that are facing challenges and opportunities in sustainable economic development (Hossain et al., 2024).

Financial development is one of the main indicators used to measure a country's level of financial development. This indicator refers to the financial sector's ability to channel funds to the private sector, both households and companies. Domestic Credit to Private Sector (DCPS) describes the total credit provided by financial institutions to the private sector in the economy, which is often considered the main form of financing

to support economic activity. According to the IMF (2016), rapidly growing private sector credit contributes to the depth, accessibility, and efficiency of financial markets by providing more funds that are more easily accessible to economic actors.

An increase in DCPS reflects better development of the financial sector, which facilitates access to financing, improves market liquidity, and encourages domestic investment, ultimately contributing to overall economic growth. In the long term, progress in Domestic Credit to Private Sector will encourage domestic investment, as companies feel more secure to invest and expand their businesses thanks to better financing security. In addition, a strong and credible banking sector helps create a healthier investment climate, giving investors more confidence and supporting the growth of the private sector as the main driver of national economic growth (Tsaurai, 2022).

Trade openness reflects the extent to which a country is involved in the flow of goods and services across borders, which is usually measured by the ratio of exports and imports to Gross Domestic Product (GDP) (Safitri et al., 2024). Trade openness allows local companies to access broader international markets, thereby creating opportunities for increased production scale and operational efficiency through global competition. In addition, this openness also encourages technology transfer and increases human resource capacity through interaction with global economic actors (Huremovi et al., 2025).

In development economics literature, trade openness is often associated with increased domestic and foreign investment because it expands market access and creates incentives for production sector diversification (Fitriani & Hakim, 2021). However, openness that is not managed properly can also lead to external vulnerabilities, such as exchange rate volatility and dependence on global demand. Therefore, the role of adaptive trade policies and increased national competitiveness are key to ensuring that the benefits of trade openness can be optimized without sacrificing domestic economic stability.

Inflation, as a key indicator of price stability, has significant implications for investment decisions, both domestic and foreign. When inflation is high and unstable, the business world faces great uncertainty in cost and revenue projections, which ultimately hinders long-term investment planning (Tarkom & Ujah, 2023). This condition also encourages an increase in real interest rates as a monetary policy response to curb inflationary pressures, which causes capital costs to become more expensive and narrows the space for productive investment. In addition, high inflation erodes the real value of future profits, thereby reducing the attractiveness of investment projects. Conversely, low and controlled inflation is often associated with macroeconomic stability, creating a more predictable environment and increasing investor confidence (Ahiadorme, 2022).

In addition to macroeconomic factors such as interest rates, interest rates are also an important variable that influences domestic investment decisions. Interest rates reflect the cost of capital for companies, where high interest rates will increase borrowing costs and reduce incentives for businesses to expand or purchase productive assets (Nzeh et al., 2024). Conversely, low interest rates can encourage domestic investment because financing costs are more affordable and project risks are lower (Lydia et al., 2023).

In the context of Asian countries, the role of these four variables becomes increasingly relevant. These countries are in a stage of development that requires a sustainable increase in domestic investment (Chizema, 2025). In other words, studies on the influence of financial development, trade openness, and inflation on domestic investment can contribute scientifically and practically to the formulation of development policies in the region (Haque et al., 2022).

In line with this, the use of cross-country and cross-time panel data is an appropriate methodological approach to capture the complexity of the relationships between these variables. Panel data allows researchers to observe variations across time and countries simultaneously, as well as control for unobserved heterogeneity (Albar & Ratnasari, 2022). By analyzing data from 2011 to 2023, this study aims to capture the post-global financial crisis dynamics in ASIA countries.

The 2020–2022 period was chosen as the COVID-19 dummy because it covers the peak period of the pandemic's significant impact on the global economy. In 2020, lockdown policies and mobility restrictions caused a sharp decline in economic activity, followed by massive stimulus policies from the government to mitigate the negative impact (IMF, 2020). In addition, disruptions to global supply chains and rising inflation put additional pressure on the economy (World Bank, 2021). The selection of this period allows for analysis of changes in domestic investment dynamics and post-pandemic economic recovery (OECD, 2021).

Albahouth & Tahir (2024) studied global variables such as trade openness and inflation on domestic investment, but it was still general in nature and not segmented based on ASIA regional groups. In addition, many previous studies only focus on one or two macro variables such as financial development or trade openness without integrating the three main variables (financial development, trade openness, and inflation) simultaneously in one model to explain domestic investment, as seen in the study Haque et al. (2022) which has not expanded its scope to include inflation simultaneously. This also shows that investment is crucial to a country's economic development, whether it is domestic or foreign investment.

This research presents a novelty by specifically examining the relationship between financial development, trade openness, inflation, and interest rates on domestic investment in countries located in the ASIA region. Ajide & Lawanson (2025) in their study entitled "Modeling the Long

Run Determinants of Domestic Private Investment in Nigeria" used the ARDL approach and found that variables such as real GDP, real interest rates, and credit to the private sector play an important role in the long and short term in determining domestic investment. Research by Iheonu et al. (2020) examined the impact of financial sector development on domestic investment, which varies between indicators and countries, but without combining it with trade openness and inflation.

Furthermore, by using a cross-country and time panel data approach, this study can capture medium- to long-term dynamics and inter-country heterogeneity that are often overlooked in individual time series studies. A similar approach has been applied to studies of other sectors, for example, Sugiharti et al. (2022) analyze the efficiency of the manufacturing sector using GMM and ARDL panel models, which demonstrate methodological advantages in dealing with heterogeneity and dynamic effects between countries. Furthermore, in the context of domestic investment studies, Iheonu et al. (2020) use panel data because it can reveal heterogeneous effects between countries as well as medium- and long-term impacts that cannot be uncovered through a single cross-sectional analysis of one country alone.

B. Problem Statement

1. Does financial development have a significant effect on domestic investment in ASIA during the period 2011–2023?
2. Does trade openness have a significant effect on domestic investment in ASIA during the period 2011–2023?
3. Does inflation have a significant effect on domestic investment in ASIA during the period 2011–2023?
4. Does interest rate have a significant effect on domestic investment in ASIA during the period 2011–2023?
5. Does covid pandemic have a significant effect on domestic investment in ASIA during the period 2011–2023?

C. Objectives and Benefits of the Study**1. Study Objectives:**

- a. To measure the effect of financial development on domestic investment in ASIA during the period 2011–2023.
- b. To measure the effect of trade openness on domestic investment in ASIA during the period 2011–2023.
- c. To measure the effect of inflation on domestic investment in ASIA during the period 2011–2023.
- d. To measure the effect of interest rates on domestic investment in ASIA during the period 2011–2023.
- e. To measure the effect of covid pandemic on domestic investment in ASIA during the period 2011–2023.

2. Benefits of the Study:

a. Theoretical Benefits

This study contributes to the development of economic science, particularly in macroeconomic and development economics studies related to investment in ASIA. By examining the simultaneous effects of financial development, trade openness, inflation, and interest rates, this study enriches the literature, which previously discussed these factors separately.

b. Practical Benefits

This research provides data-based information and recommendations to policymakers in ASIA countries for designing strategies to increase domestic investment. The findings of this study can be used in formulating policies that focus on strengthening the financial sector, increasing selective trade openness, and maintaining stable inflation control. Thus, this study supports efforts toward sustainable economic development that is in line with the macroeconomic conditions and institutional characteristics of these countries.

D. Systematic Discussion

Chapter 1, I Introduction, explains the background and importance of domestic investment in Asian countries, and the influence of factors such as financial development, trade openness, inflation, and interest rates. This chapter also presents the problem formulation, research objectives, research

benefits, scope limitations, and the writing structure as an overall guide for the thesis.

Chapter 2 outlines the theoretical basis of domestic investment, financial sector development, trade openness, inflation, and interest rates. In addition, it also presents a review of relevant previous studies, compiles a framework that connects the variables studied, and formulates hypotheses to be tested.

Chapter 3 explains the methods used in the research, including the research design (quantitative), sources, techniques for collecting secondary data from the World Bank, operational definitions of each variable, and panel data analysis techniques selected to answer the research questions and test the hypotheses.

Chapter 4, results and discussion, presents the findings from the panel data analysis, both partially and simultaneously, and provides an interpretation and discussion of the results obtained. Each finding will be discussed in depth and linked to theory and previous research results, thereby clarifying the empirical contribution of the research to the existing literature.

Chapter 5 contains conclusions formulated based on the results of the research conducted. In addition, it also presents the limitations of the research encountered in the study process, as well as suggestions for further research and practical policy recommendations that can be used in accordance with the topic discussed

CHAPTER V CONCLUSION

A. Conclusion

Based on the findings of the study presented on how financial development affects domestic investment in Asia. This study analyzes domestic investment as variable Y and financial development, trade openness, inflation, and interest rates as variables X. Twelve countries, namely Brunei Darussalam, Indonesia, Malaysia, Thailand, Timor Leste, Vietnam, Kyrgyzstan, Hong Kong, Macao, Bangladesh, Armenia, and Georgia, were examined in this study using panel data regression analysis and the Fixed Effect Cross-section Seemingly Unrelated Regression (SUR) model. The following is a summary of the findings:

1. Domestic investment is positively and significantly influenced by financial development, as determined by domestic loans to the private sector. This finding is in line with Tobin's q financial intermediation theory, which asserts that financial sector deepening facilitates savings mobilization, lowers capital costs, and increases the efficiency of fund allocation to productive projects (Jeenas & Ricardo Lagos, 2023).

A higher ratio of bank credit to the private sector reflects the availability of medium- to long-term financing, reduces liquidity constraints, and ultimately drives an increase in domestic investment (Rostow, 2014). These results are also consistent with cross-country evidence on economies with predominantly bank-based financial systems where macro stability is maintained, credit expansion to value-

added sectors lowers capital costs, strengthens competitiveness, and accelerates capital accumulation (Yizhou & Hwan, 2024).

2. With a coefficient value of 0.389 and a p-value of $0.000 < 0.01$, it indicates that trade openness has been proven to have a positive and significant impact on domestic investment. Mechanically, an increase in exports and imports relative to GDP reduces capital costs, lowers tariff and non-tariff barriers, and reduces the cost of importing capital goods and inputs, all of which improve project viability and encourage companies to expand their production capacity (Wen et al., 2023; World Trade Organization, 2017). Of course, this will also have an impact on domestic investment within a country.

This impact is reinforced by broader access to technology, larger markets, and intense competition that drives the modernization of production processes. Theoretically, these findings are consistent with the endogenous growth literature, including the idea of *learning by exporting*, that openness accelerates technology diffusion, deepens specialization, and enlarges market scale, all of which are conducive to domestic capital accumulation (Romer, 2010).

3. Theoretically, the positive and significant effect of inflation on domestic investment is consistent with the accelerator principle and q-theory. Controlled inflation usually comes with an expansion in aggregate demand, raising sales expectations and cash flow so that the marginal q value of capital relative to its replacement cost improves, and companies

respond by expanding capital expenditure and production capacity. Thus, the coefficient of 0.304 (p-value 0.0000) can be interpreted as a rational response to strengthening demand signals during the expansion phase of the business cycle in Asia (Amar et al., 2024).

The policy relevance emerges through monetary transmission and the financial accelerator. If inflation expectations are maintained and monetary policy is flexible, real interest rates do not spike, collateral values and nominal cash flows strengthen, and the external finance premium declines a combination that lowers the barriers to investment financing. In the context of open Asian economies, this framework helps explain why inflation often correlates positively with fixed capital formation, if macro stability is maintained and price pressures do not spiral out of control (Cili, 2022; Amar et al., 2024).

4. Based on Table 4.8, interest rates (X4) have a negative and significant effect on *domestic investment* with a coefficient of -0.361730 and a p-value of 0.0000 ($p < 0.05$). Empirically, a one-unit increase in interest rates is associated with a decrease in domestic investment of approximately 0.362 units. Where more expensive financing costs lower q and increase the cost of using capital, making projects less feasible, while monetary tightening also increases the option value of waiting, causing companies to postpone capital expenditure (IMF, 2015; Romer, 2010).

Monetary policy is strongly transmitted through the interest rate channel and the credit/balance sheet channel. In the context of Asia's banking-based economies, investment decisions are affected by increases in policy interest rates because this raises lending rates, tightens lending rules, devalues collateral, and limits the availability of credit. The negative coefficients found are consistent with this transmission pattern, and regional data show that the banking credit channel plays a significant role in amplifying the impact of high interest rates on investment (Asri & Alrasyid, 2024; Iddrisu & Alagidede, 2020).

B. Research Limitations

Based on the results of the research conducted, the researchers are aware that there are limitations in conducting this research. Therefore, this becomes the focus for researchers to improve future research. The following are some of the limitations experienced by the researchers:

1. The first limitation in this study is the data period used, which is from 2011 to 2023.
2. The research subjects included 12 countries, considering the availability of data for all variables used.

C. Recommendations

Referring to the research that has been conducted, there are several recommendations that can be used by policymakers and investors. The following are some recommendations that can be used and are related to domestic investment:

1. The government, as a policy maker, is expected to be able to establish appropriate policies to increase domestic investment, control inflation, and improve financial inclusion to encourage financial access for the community. These policies can have a positive impact if they are made with careful consideration and the right decisions.
2. For future authors who are interested in writing about domestic investment or financial development, it is hoped that they can expand their research by adding new variables beyond those already covered in this study, thereby broadening the findings and knowledge related to domestic investment.

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