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BUSINESS MANAGEMENT: DIRECTIONS AND STRATEGIES IN RESPONSE TO ASEAN ECONOMIC COMMUNITY 2015

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UNIVERSITY OF JEMBER
FACULTY OF ECONOMICS
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Movement Effects of Portfolio Investment against Real Effective

Exchange Rate Stability in ASEAN

Adhitya Wardhono, M. Abdul Nasir, Ciplis Gema Qori'ah, Sarwedi

ABSTRACT

Effort to attract foreign investment in form of portfolio is very important for developing countries. However, the portfolio investment establishment policies of financial liberalization in ASEAN can lead to real exchange rate appreciation and may have the effect of exchange rate competitiveness, harm exports and economic growth fluctuation. This research was intended to identify the performance and comparison of the movement of portfolio investment and foreign direct investment and to analyze portfolio investment linkage and real effective exchange rate in ASEAN. The analysis results by Generalized Method of Moment (GMM) provided an illustration that Indonesia, Malaysia and The Philippines had a positive significant impact on the real effective exchange rate stability. Meanwhile, Singapore and Thailand had a negative insignificant relationship. Portfolio investment flowing on the free floating exchange rate system causes an appreciation of real effective exchange rate which affects the rising price of domestic assets in the foreign exchange market. Government intervention in the determination of exchange rates on the floating exchange rate system causes less productive mechanism of inter-country trade. However, portfolio investment flows can be easily controlled, so the real effective exchange rate becomes uncompetitive against the currencies of other countries which are the main trading partners.

Keywords: portfolio investment, real effective exchange rate, GMM approach, ASEAN

1. Introduction

The flow of capital in the ASEAN region is increasingly higher by the increasingly more integrated finance in the region. This is reflected in the high capital flows to emerging markets, as well as indicators of region restrictions and transparency of capital flows (Chinn, 2006). In an effort to achieve a freer flow of capital, Aldaba and Yap (2009) classify two major initiatives for ASEAN countries, namely the strengthening the development of the ASEAN capital market integration and increasing the flow of capital in the region through liberalization process. These two issues are interrelated with each other considering that the development and integration of

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the ASEAN capital market is strongly influenced by policy climate that can potentially increase the magnitude of the capital flows in the region.

Although portfolio flows moving in ASEAN are more faster than the FDI, the monetary authorities still need to make policies which are appropriate and in accordance with the economic conditions of a country. The views of Combes, et.al. (2010) lead to the tendency that the exchange rate is an important economic indicator that has a strategic role in the economy. Therefore, the exchange rate movements widely affect the various aspects of the economy, including the development of prices (inflation), and the performance of export-import which in turn affects the economic output of a country, as emphasized by Copeland (1994). This proves that the economic development of a country each year also affects the exchange rate changes. The consequence of this is that, to look at the competitiveness of the exchange rate between countries, the real effective exchange rate (Real Effective Exchange Rate-REER) is used. By using the real effective exchange rate benchmark, it can be seen how much the competitiveness of the exchange rate between countries (especially developing countries) and its impact on economic fundamentals after the introduction of economic integration and the strong flow of investment portfolio (Jongwanich et.al, 2011; Rachdi and Saidi, 2011; Saborowski, 2009).

Based on the description above, economic factors and non-economic sustainability become very influential on portfolio capital flows. It is very important to consider, given the movement of portfolio investment flows may lead to volatility in the exchange rate. Instability of capital flows, especially in the form of portfolio, in turn, can lead to monetary instability and trade fluctuations that increase/decrease sharply and result in changes in competitiveness of the exchange rate (REER), which will greatly complicate the unexpected economic actors in policy making. The purpose of this study was to find out in details and to analyze the relationship between the performance of the investment portfolio and the real effective exchange rate in ASEAN from January 1994 until December 2012.

2. Literature Reviews

Based on Bakardzhieva, et al (2010) studies that compared the effects of six types of capital flows and foreign currency flows on the real exchange rate of 57 developing countries covering Africa, Europe, Asia, Latin America, and the Middle East. The results of this study indicate that portfolio investment, foreign loans, foreign aid, and income have influence to

appreciate real exchange rate and may have a competitive effect on the competitiveness of the exchange rate, as well as the effect on export and economic growth, while remittances have different effects across the region. Foreign direct investment (FDI) has no effect on the real exchange rate. Similar results are also shown in research by Combes, et.al. (2010) who analyze the impact of capital flows and the exchange rate regime on the real effective exchange rate in developing countries (42 countries) using estimates based on panel cointegration techniques. The results show that the capital inflows lead to changes in the real effective exchange rate. Among these inflows, portfolio investment has the greatest influence on the changes in the real effective exchange rate, nearly to seven times the direct foreign investment. The results of the effect of portfolio investment and FDI that have an impact on economic growth are not congruent with the research conducted by De Vita and Kyaw (2009) in countries with small and medium income. The result of this study is that FDI has a positive relationship to economic growth and investment in the country which has a negative relationship portfolio in countries with small and medium income. In addition, the liberalization of capital is often regarded as an important way in order to boost economic growth in both industrial and developing countries.

Congruent with the results of the research of De Vita and Kyaw (2009), the result of the research conducted by Rachdi and Saidi (2011) is the same which examines the liberalization of capital often regarded as an important way in order to boost economic growth in both industrial and developing countries. For this reason, Rachdi and Saidi (2011) wanted to identify the impact of economic growth due to the influence of foreign direct investment (FDI) and portfolio investment. The study was based on a sample of 100 developing countries over the period 1990-2009. The estimation results of the study showed a statistically significant association between the positive and FDI and output growth.

3. Methodology
3.1 Data Resources

The data used in this study were secondary data from time series data. The period of data used was monthly data from 1994M1 to 2010M12 periods. Countries that would be analyzed in this study were ASEAN by including five major ASEAN countries, that is, Indonesia, The Philippines, Malaysia, Singapore, and Thailand. The data used in this study were obtained from

the Coordinated Portfolio Investment Survey, International Financial Statistics, the ASEAN Secretariat data, and the Bank for International Settlements.

3.2 Model Specification and Data Analysis Tools

Generalized Method of moment method is one of the methods commonly used to estimate the parameters in the regression (Bond, et al, 2001). The underlying reasons for the use of this method rather than ordinary least squares (OLS) are common GMM estimators and provide a more useful framework for comparison and assessment as well as provide a simple alternative to other estimators, especially on maximum likelihood. GMM provides the flexibility to address the problem of heteroscedasticity that always appears in data. The GMM estimation method suggested by Kelejian and Prucha (1999) and Saavedra (2003) for the data deals with problems of spatial autocorrelation.

Generalized Method of moment departs from the theory of error term examining empirical data whether they would be the same as the real theory (Hansen, 2007). Testing in the GMM method is moment condition. In statistics, there are the four moments i.e. mean, variance, skewness and kurtosis (Emerson, 2010). Suppose we have a set of the theoretical moment conditions where the parameters of observation θ must be met. Then the moment condition is written as follows:

$$E\,(\,m\,(y,\theta)\,) = 0 \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots (1)$$

Estimates of the method of moments are defined by placing the moment conditions with the sample analogue.

$$\frac{\left(\sum_t m\,(y_t,\theta\,)\right)}{T} = 0 \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots (2)$$

However, the above conditions cannot be met for each θ when there are more obstacles than the parameter θ m. To keep this function, GMM estimators will be defined by minimizing the following function:

$$\sum_t m\,(y_t,\theta)\,A\,(y_t,\theta)m\,(y_t,\theta) \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots (3)$$

which measures the distance between m and 0. A is a weighting matrix weighting each moment condition. Every symmetric-positive defined by A will produce consistent estimates over θ. In GMM, the instrument variables need to minimize the errors occurred. Instrument variables derive from the independent variables, assuming an endogenous variable that has a relationship with an error. Briefly, GMM method in the models used in this study is as follows:

$$REER_t = \beta_0 + \beta_1 PORT + \beta_2 GCON_t + \beta_3 OPEN_t + \beta_4 PROD_t + e \quad ....(4)$$

where:

REER = *Real Effective Exchange Rate* (Index)
GCON = *Government Consumption* (Current US$)
TOT = *Term of Trade* (Index)
OPEN = Trade Openness (% GDP)
PROD = real GDP per capita (current US$)

In the model, the moment is

$$E(ei) = 0 \dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots (5)$$
$$E(REER_t - \beta_0 - \beta_1 PORT_t - \beta_2 GCON_t - \beta_3 OPEN_t - \beta_4 PROD_t - \beta_5 TOT_t) = 0 \dots(6)$$

and if the variable $PORT_t$, $GCON_t$, $OPEN_t$, $PROD_t$, TOT_t are not correlated with the residuals e, the moment is

$$E(PORT_t, GCON_t, OPEN_t, PROD_t, TOT_t, e_t) = 0 \dots\dots\dots\dots\dots (7)$$
$$E[PORT_t, GCON_t, OPEN_t, PROD_t, TOT_t (REER_t - \beta_0 -$$
$$\beta_1 PORT_t - \beta_2 GCON_t - \beta_3 OPEN_t - \beta_4 PROD_t - \beta_5 TOT_t)] \dots\dots (8)$$

Equations (6) and (8) are population moments. While the sample second moment equations are as follows:

$$REER_t - \beta_0 - \beta_1 PORT_t - \beta_2 GCON_t - \beta_3 OPEN_t - \beta_4 PROD_t - \beta_5 TOT_t) = 0 \dots\dots\dots\dots(9)$$

Equation (9) is the method of moment estimator of β0, β1, β2, β3, β4, and β5. The equation can be solved to obtain that

$$\sum REER_t = n\,\hat{\beta}_0 + \hat{\beta}_1 \sum PORT_t + \hat{\beta}_2 \sum GCON_t + \hat{\beta}_3 \sum OPEN_t + \hat{\beta}_4 \sum PROD_t + \hat{\beta}_5 \sum TOT_t \qquad\qquad\qquad\qquad\qquad \dots\dots\dots\dots.(10)$$

10) will be obtained from the equation which is the value of the parameter estimator and the GMM method can be seen for the relationship or the estimation of the model used in this study.

4. Results Analysis and Discussion

Based on Table 1, it can be seen that in general the whole Indonesian macroeconomic variables are gained fairly significant responses from the real effective exchange rate variable with a value of adjusted R squared of 0.728. Meanwhile, the value of j-statistic to test over identified restriction was accepted, provided that the critical value of the distribution of X2> j-

value statistics. With the X2 value of 218.145 then 218.145> 1.10e-25, so the value of j-statistic for overidentified restriction examination was acceptable. While the macroeconomic variables of Malaysia obtained significant responses from the real effective exchange rate variable with a value of adjusted R squared of 0.671007. Meanwhile, the value of j-statistic for overidentified restriction test was accepted, with the result 218.145> 5.38E-19.

The whole Philippines macroeconomic variables were also significantly responded by the real effective exchange rate variable with a value of adjusted R squared of 0.670836. Meanwhile, the value of j-accepted statistics, and the critical value of the distribution of X2> J-statistic value was 218.145>1.52E-24. For Singapore, it can be seen that all variables got fairly significant responses from the real effective exchange rate with the adjusted R squared value of 0.871121. Meanwhile, the value of j-statistic was accepted with value of 218.145> 6.97E-22. Furthermore, for Thailand, all macroeconomic variables were also significant to be responded by the real effective exchange rate variable with a value of adjusted R squared of 0.751936. At the same time, the value of j-statistic of Thailand was accepted, with the result of 218.145> 2.65E-30.

From the results of adjusted R square of each country, it can be seen that the most influential macroeconomic variables on the real condition of effective exchange rate were those in Singapore by 87.11%, while the smallest influence was in the country of the Philippines at 67.08%. By these results, it can be seen that the variable investment portfolio, the terms of trade, trade openness, government consumption, and GDP per capita major highly affected REER stability in the ASEAN 5 countries.

Table 4.1 shows the level of investment portfolio in Indonesia with a large enough coefficient indicating that an increase of 1% from the level of the investment portfolio would be responded by an increase in the REER by 2.39%. It is in line with the GDP per capita variable where an increase of 1 % would be responded by an increase in the REER by 1.06%. However, in contrast to the variable terms of trade, trade openness, and government consumption had a negative coefficient value and impact on the decline in REER variable rate if there were an increase in the amount of 1%. Variable investment portfolio and GDP per capita had a positive and significant relationship. This is indicated by the probability value of the investment portfolio which was less than α 5 = % (0.0184 < 0.05) and probability value of a GDP per capita of 0.0000>0.05. Nevertheless, for the variable terms of trade, trade openness, and government consumption had a negative but significant relationship demonstrated a probability value of each

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variable which was less than α=5%. The coefficient of the investment portfolio showed a high level of positive significance than any other variable that is equal to 2.39. This suggests that capital flow liberalization policies implemented ASEAN has a positive influence on the response of the change in the value of REER value of the investment portfolio in Indonesia.

The level of portfolio investment in Malaysia had a fairly large coefficient which means that an increase of 1% from the level of the investment portfolio would be responded by an increase in the REER by 2.39%. Similar with the GDP per capita variable where an increase of 1 % would be responded by an increase in the REER by 1.06%. Unlike Indonesia, Malaysia variable in terms of trade had a positive relationship, that is, each increase of 1% would be responsed by REER rise by 1.39%. In contrast, the variable trade openness and government consumption had a negative coefficient value and impact on the decline in REER variable rate if there were an increase in the amount of 1%. Variable investment portfolio, GDP per capita, and the terms of trade in Malaysia had a positive and significant relationship. This is indicated by the probability value of the investment portfolio which was less than α 5 = % (0.0000 < 0.05), GDP per capita probability value of 0.0000 < 0.05 , and the probability of the terms of trade value of 0.0000<0.05. But the variables of trade openness, and government consumption had a negative but significant relationship which demonstrated a probability value of each variable less than α = 5 %.

In the Philippines, the level of investment portfolio with a large enough coefficient indicates that an increase of 1% from the level of the investment portfolio will be responded by an increase in the REER by 9.26%. In contrast to Indonesia and Malaysia, the Philippines government consumption variable had a positive relationship that can be seen from the value of the variable coefficients. If there was an increase in government consumption by 1%, it would be responded by an increase in the REER by 4.76 %. In contrast, the variable terms of trade, trade openness, and GDP per capita had a negative coefficient value and impact on the decline in REER variable rate if there was an increase by 1 %. Variable investment portfolio in the Philippines had a positive and significant relationship. This is indicated by the probability value of the investment portfolio which was less than α 5 % (0.0184 < 0.05). However, the government consumption variable had a positive but insignificant relationship by 0.0683>0.05. Variable terms of trade and government consumption had a negative but insignificant relationship shown

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by a probability value of each variable α over 5%. Meanwhile, trade openness variable had a negative and significant relationship.

With higher economic conditions, in fact, economic variables of Singapore had little difference from those of Indonesia, Malaysia, and the Philippine. The level of investment portfolio in Singapore with coefficients that are quite large and negative indicating that an increase of 1% from the level of the investment portfolio will be responded by a decrease in the REER by 6.71%. It is similarly with the trade openness variable where an increase of 1% would be responded by a decrease of 0.15% REER. In contrast to the variable terms of trade, government consumption, and GDP per capita had a positive coefficient value and impact on the rise in REER variable rate if there was an increase by 1%. Variable investment portfolio and trade openness in Singapore had a negative and insignificant relationship. This is indicated by the value of the probability of an investment portfolio of more than 5% α (0.3991>0.05) and the probability value of trade openness of 0.6343 > 0.05 level. But the variable government consumption and GDP per capita had a positive relationship but did not show significant probability value of each variable α over 5 %. Meanwhile, the terms of trade variable had a positive and significant relationship. Unlike Indonesia, Malaysia, and the Philippines, Singapore coefficients portfolio investment showed a significant negative relationship than any other variable that is equal to 6.71. This suggests that capital flow liberalization policies implemented in ASEAN have less influence on the response of the REER value of the change in value of the investment portfolio in Singapore.

Similiar with Singapore, the condition of macroeconomic variables in Thailand also appeared different from Indonesia, Malaysia, and the Philippines. The level of the investment portfolio with a large enough coefficient indicated that an increase of 1% from the level of the investment portfolio would be responded by a decrease of 1.19 % REER. It is similar with the variable trade openness and government consumption where an increase of 1% would be responded by a decrease in the REER of 2.97% and 1.56 %. In contrast, the variable terms of trade and GDP per capita had a positive coefficient value and impact on the rise in REER variable rate if there was an increase of 1%. Variable portfolio investment in Thailand had a negative and not significant relationship. This is indicated by the value of the probability of an investment portfolio of more than 5% α (0.0661>0.05). Meanwhile, the variables of trade openness and government consumption had a negative and significant relationship. This is

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indicated by the value of trade openness probability α less than 5% (0.0006<0.05) and the value of government consumption per capita probability of 0.0013>0.05. However, the terms of trade variable had a positive but not significant relationship indicated by the probability value of 0.7179>0.05 and the variable GDP per capita had a positive and significant relationship shown by variable probability value of less than α=5%. As with Singapore, Thailand coefficient of portfolio investment showed a significant negative relationship than any other variable that is equal to 1.19. Nevertheless, the coefficient of portfolio investment in Thailand was lower than Singapore. This suggests that capital flow liberalization policies implemented in ASEAN have less influence on the response of the REER value of the change in the value of portfolio investment in Thailand.

The REER stability in response to several macroeconomic variables in Indonesia, it shows that the change is clearly visible REER stability in response to fluctuations in the development of macroeconomic variables. At the time of the 1997 crisis Indonesia, many investment portfolios were drawn out (400-500 million dollars per month) with very low exchange rate competitiveness index which reached 40-50. Compared with the previous year's portfolio investment, Indonesia experienced inflows of 200-400 million dollars per month with fairly high rate competitiveness index of 100-112 per month. With the liberalization of capital flows that proclaimed ASEAN in 1997 to overcome the negative sentiment of the investors, a change in the actual value and prediction value is seen. Movement patterns of investment portfolios and some other macroeconomic variables seemed looser. It is intended to create stability in supporting the restoration of confidence of foreign investors to invest their portfolios in ASEAN, especially in Indonesia.

In Malaysia, REER stability changes were very clearly seen in response to fluctuations in the development of macroeconomic variables. The same as Indonesia, during the 1997 crisis, many Malaysian investment portfolios were pulled out, the competitiveness index of the exchange rate was very low, the index reached 30-50. Compared with the previous year, after the liberalization policy in ASEAN, investment portfolio in Malaysia experienced inflows of 200-400 million dollars per month with the competitiveness index fairly high rate of 100-112 per month. The existence of capital flow liberalization policies launched by ASEAN to overcome the negative sentiment of investors, there had been changes in the actual value and prediction value. Movement patterns of investment portfolios and some other macroeconomic variables looked

looser. It is in contrast to what happened in the Philippines. Crisis of 1997 had little impact on residual values. This indicates that there is little difference between the predicted value with the actual value in achieving stability of the real effective exchange rate. After the early 2000, residual values stagnated long enough, and in 2008 the global crisis certainly left the sharpl decline. This decrease indicates that the liberalization of capital flows in the new ASEAN appeared this year due to changes seen in actual value and enormous prediction value.

Case in Singapore will be different because it is the relatively highly developed country; so far, the crisis of 1997 turned out to have little impact on the overall condition of the real effective exchange rate. Responses of investors in Singapore tended to be strict and careful in making investment transactions. This turns out to have a positive impact on the country because of the tightening characterized by the occurrence of a clear change between the predicted value and the actual value impact on Singapore's economy would withstand the shock of the crisis.

While in Thailand, the case was the same as Indonesia and Malaysia, namely the crisis of 1997, Thailand's investment portfolio was much drawn out, compared with the previous year, after the liberalization policy in ASEAN, Thailand experienced investment portfolio inflows of large index competitiveness of the exchange rate which was quite high. Liberalization of capital flows that proclaimed ASEAN to overcome the negative sentiment of investors showed changes in the actual value and prediction value. Movement patterns of investment portfolios and some other macroeconomic variables also seemed looser.

5. Conclusion

The findings of the movement of the investment portfolio with the GMM method illustrates that Indonesia, Malaysia, and the Philippines have a positive and significant relationship over the stability of the real effective exchange rate. The positive response of the investment portfolio toward REER indicates that an increase in the investment portfolio in these countries will be responded by an increase in the REER. This reflects an increase in the REER depreciation of the real exchange rate and decreases the competitiveness index of the exchange rate. However, the estimation results were significant and have small coefficients; it can be said that the increase in the REER still has a quite highly competitive exchange rate.

While for Singapore and Thailand, the relationship between the investment portfolio and changes in the condition of the REER has negative and insignificant relationship. This indicates that the economy of Singapore and Thailand is vulnerable to an increase in the investment portfolio responded with a decrease in the value of the REER. The decrease in the REER reflects the real exchange rate appreciation and the impact on the competitiveness index rising exchange rate. However, the estimation results are not significant; it can be said that the decline in REER or condition that occurs within reasonable limits as the decline is not too high.
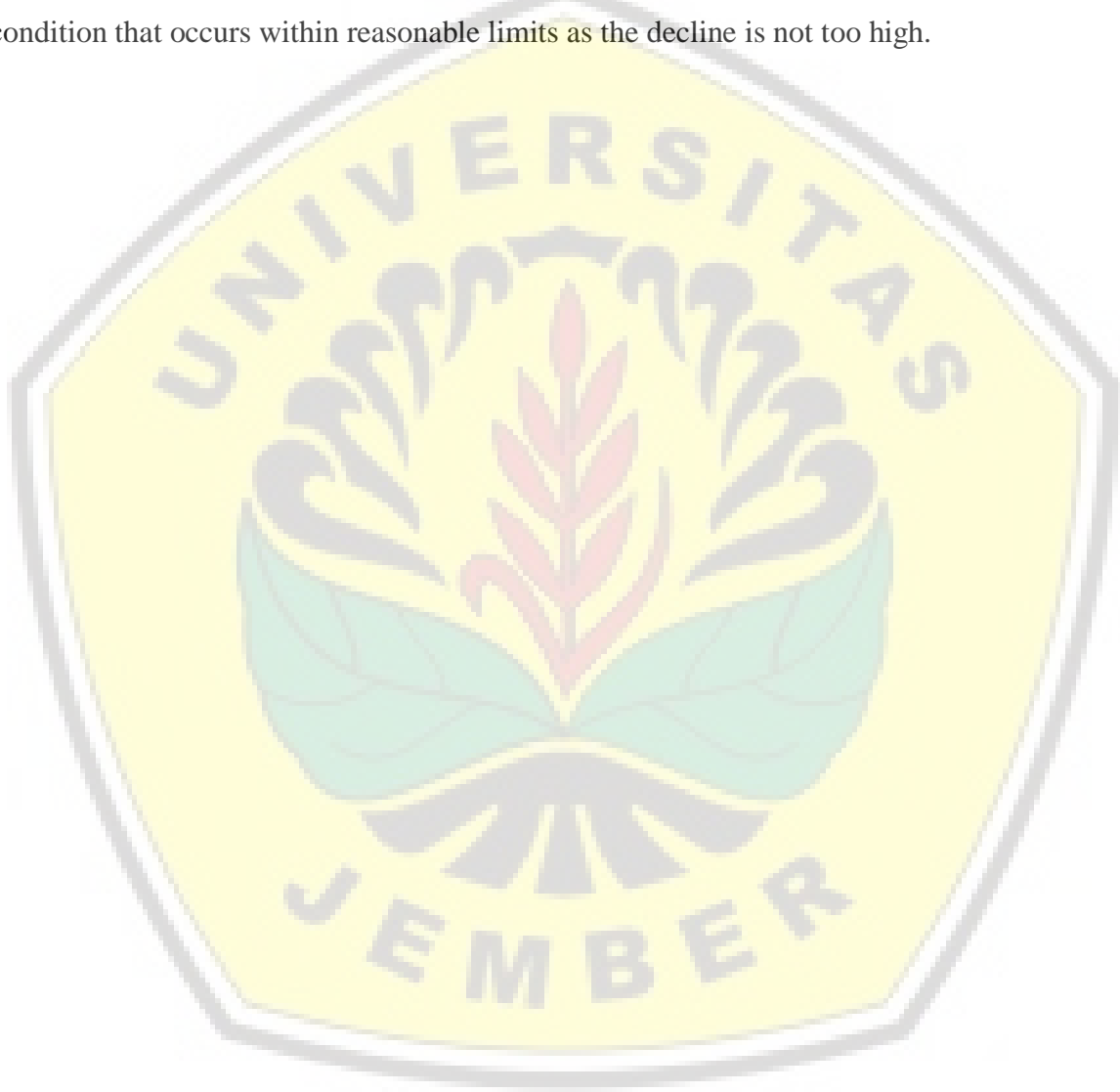
Table 1. Estimation Result for Model of *Generalized Method of Moment*

	C	b_o (Portofolio Invesment)	b_1 (Term of Trade)	b_2 (Trade Openness)	b_3 (Goverment Consumption)	b_4 (GDP per capita)	Adjusted R squared	J Statistict
Indonesia	105.3476 (0.0000)	2.39E-08 (0.0184)*	-0.762310 (0.5858)	-10.65475 (0.0001)*	-4.55E-08 (0.0000)*	1.060071 (0.0000)*	0.721577	1.10E-25
Malaysia	147.3119 (0.0232)	2.39E-09 (0.0000)*	1.387258 (0.7880)	-4.866885 (0.0013)*	-3.75E-08 (0.0000)*	0.145311 (0.0000)*	0.671007	5.38E-19
Filipina	151.8929 (0.0000)	9.26E-09 (0.0313)*	-2.285219 (0.3233)	-6.003198 (0.0007)*	4.76E-08 (0.0683)	-0.462227 (0.0548)	0.670836	1.52E-24
Singapura	-9.793816 (0.7510)	-6.71E-10 (0.3991)	11.65632 (0.0001)*	-0.147926 (0.6343)	1.08E-08 (0.1552)	0.003308 (0.2812)	0.871121	6.97E-22
Thailand	84.41303 (0.0002)	-1.19E-09 (0.0661)	0.767187 (0.7179)	-2.970876 (0.0006)*	-1.56E-08 (0.0013)*	0.244112 (0.0000)*	0.751936	2.65E-30

The (..) is the probability of value t statistict
*) significant level $\alpha = 5$

Malaysia

Filipina

Singapura

Thailand
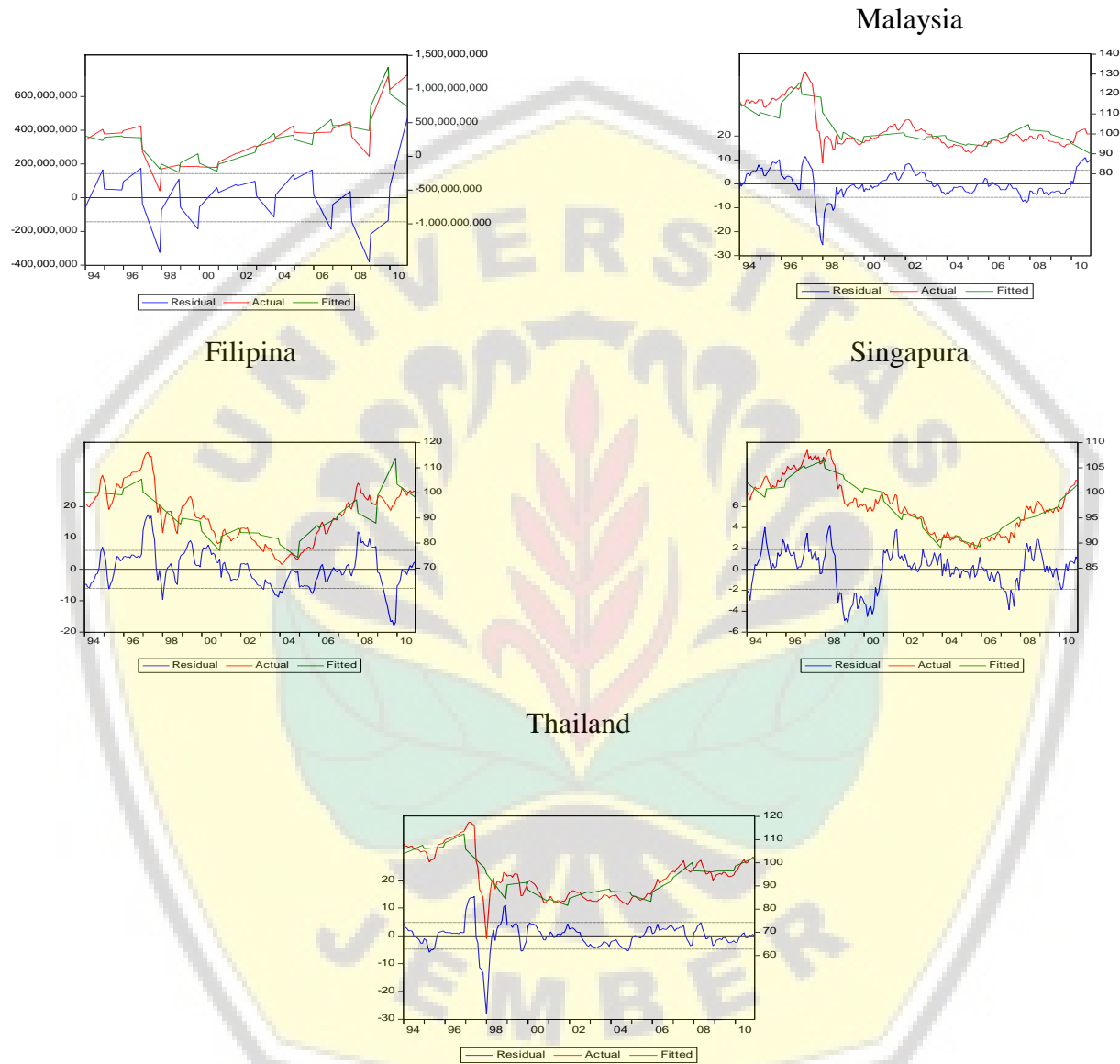
Graphic 1. Actual, Fitted, and Recidual Values from

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Membangun Generasi
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