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Banking development management in the process of economic integration and FDI attraction in ASEAN

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Abstract

This study investigates the mediating role of banking sector development in the relationship between economic integration and foreign direct investment (FDI) inflows among 10 ASEAN countries during 2000–2023. The research is motivated by the increasing importance of financial intermediation in transforming the benefits of globalization into sustainable investment flows. It fills a theoretical and practical gap by examining how domestic financial systems strengthen the linkage between international economic integration and FDI attraction. Using a quantitative approach, the study employs secondary panel data and applies the structural equation modeling (SEM) technique combined with the medsem procedure in Stata to test the mediation effect. The results reveal that economic integration positively and significantly influences both banking development and FDI inflows. Furthermore, banking sector development partially mediates the relationship between economic integration and FDI, with about 39% of the total effect transmitted through the banking channel. This finding underscores the crucial role of the banking system as an institutional bridge connecting integration with investment performance. The study concludes that strengthening financial systems and enhancing banking governance are key strategies for ASEAN countries to fully leverage economic integration. Policymakers should focus on improving transparency, expanding access to credit, and coordinating trade, finance and investment policies to build a stable and attractive investment environment.

Keywords: *economic integration, banking development, FDI, mediation, ASEAN*

1. Introduction

In the context of globalization and deepening financial integration, multinational enterprises (MNEs) face increasingly complex decisions regarding capital allocation, international financing, and cross-border risk management. The choice of a foreign direct investment (FDI) location no longer depends solely on traditional factors such as market size or labor costs, but is also significantly influenced by the host country's financial environment and banking system—key determinants of the cost of capital, access to credit, and overall financial stability (Levine, 2005; Demirgüç-Kunt et al., 2021). Recent evidence further confirms that financial stability and banking sector resilience enhance investor confidence and reduce capital volatility in emerging markets (Islam et al., 2020; Liao, Yu, & Xie, 2024).

In the field of international financial management, a growing body of research emphasizes that a firm's ability to optimize its capital structure and manage international financial risk depends critically on the quality of financial infrastructure and the efficiency of the domestic banking system (Beck et al., 2010; Saha et al., 2022). A well-developed banking sector not only channels capital effectively to the private sector but also reduces information asymmetry, stabilizes currency and credit markets, and improves the efficiency of cross-border financial flows. In this regard, institutional quality and sound financial supervision have been shown to amplify the positive linkage between financial development and FDI inflows (Hue, 2025; Kharisma et al., 2025).

Within the ASEAN region, regional economic integration through initiatives such as the ASEAN Economic Community (AEC) and the Regional Comprehensive Economic Partnership (RCEP) has fostered trade openness and financial liberalization. In this context, a strong, transparent, and regionally integrated banking system acts as a strategic catalyst that supports international business expansion and facilitates cross-border capital mobilization (Saha et al., 2022; Kharisma et al., 2025). From the perspective of integration and FDI, Kose et al. (2009) argue that trade and financial liberalization enhances international investor confidence and stimulates FDI inflows. More recent findings corroborate that institutional reforms and regional financial cooperation further magnify these effects in emerging Asia (Islam et al., 2020; Liao et al., 2024). However, Saha et al. (2022) find that in developing economies, the benefits of financial integration may be constrained when domestic financial systems are weak or lack institutional quality.

From the perspective of banking development and FDI, Levine (2005) and Beck et al. (2010) highlight that a developed banking system not only provides financial resources but also mitigates risk, enhances transparency, and facilitates efficient capital allocation. Alfaro et al. (2004) further argue that financial development, especially through increased private-sector credit, enhances the positive growth effects of FDI. Likewise, Hermes and Lensink (2003) emphasize that the FDI–growth relationship becomes sustainable only when the domestic financial market is sufficiently robust to absorb foreign capital inflows. In ASEAN, empirical evidence suggests that the strength of the banking system conditions the effectiveness of economic integration in attracting FDI (Hue, 2025; Kharisma et al., 2025). This implies that banking development plays a crucial intermediary role in transmitting the benefits of economic integration to foreign investment inflows. Thus, so far there have been many empirical studies on integration, banking and FDI attraction, but there have not been many quantitative studies to quantify the intermediary role of banking development in the relationship between economic integration and FDI in ASEAN.

On a theoretical basis, there are three main theoretical frameworks used to explain the relationship between integration, banking development, and FDI. Firstly, Dunning's (1988) OLI (Ownership–Location–Internalization) model argues that an enterprise's decision to invest internationally depends on three types of advantages: ownership advantage, location advantage, and internalization advantage. In particular, the advantage of location is directly influenced by the institutional environment, the level of integration and the quality of the financial system. A country with a stable financial environment and deep integration with the international market will help businesses reduce risks, capital costs and increase investment competitiveness (Dunning & Lundan, 2008). Second, Williamson's (1985) theory of transaction cost economics emphasizes that enterprises choose the form and place of investment in order to minimize the cost of finding, negotiating and monitoring contracts. Economic integration, through institutional harmonization, the reduction of trade barriers and the opening of financial markets can reduce the cost of international transactions, but this effect is only reinforced when the banking system operates efficiently, provides transparent information and supports stable financial services (Claessens & van Horen, 2021). Third, Barney's (1991) resource-based view (RBV) theory argues that financial capacity and banking infrastructure are strategic resources to help countries create a sustainable competitive advantage in attracting investment. A developed banking system helps to mobilize capital effectively, manage liquidity and control credit risks, thereby improving the capacity to absorb FDI (Levine, 2005). From this perspective, banking development is not only the result of integration but also a channel to transmit the impact of integration on FDI inflows.

Although the relationship between economic integration, financial development, and FDI has been examined by many empirical studies, the evidence on the intermediary role of banking development remains limited and inconsistent, especially in the context of ASEAN countries with different financial and institutional characteristics. Quantifying this transmission mechanism requires an analytical method capable of simultaneously examining the direct and indirect effects between variables, and structural equation modeling (SEM) is seen as the right tool. In the context of ASEAN countries promoting economic integration and financial liberalization, understanding the mechanism through which economic integration affects foreign direct investment (FDI) flows is of practical significance for both governments and multinational enterprises. For the above reasons, this study will focus on examining and quantifying the intermediary role of banking development in the relationship between economic integration and foreign direct investment (FDI) attraction of ASEAN countries, thereby making recommendations for governments and businesses.

2. Objectives

This study aims to analyze the relationship between economic integration, commercial banking development and FDI in ASEAN countries, with the following three specific objectives:

- Analyze the direct impact of economic integration on FDI attraction, thereby examining whether the level of institutional, trade and financial integration will promote international investment flows into ASEAN.

- Assess the intermediary role of commercial banking development in the relationship between economic integration and FDI, considering the banking system as a channel of integration impacts.

- Provide policy implications and strategic suggestions to help the government strengthen the banking system as a tool to support FDI attraction and support multinational enterprises to optimize investment decisions in the region.

3. Materials and Methods

3.1. Research Data

The study uses panel data from 10 countries of the Association of Southeast Asian Nations (ASEAN) including: Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam, in the period 2000–2023. The data is collected mainly from reliable international sources such as the World Bank (World Development Indicators – WDI), the International Monetary Fund (IMF), and the KOF Globalization Index Database of the Swiss Federal Institute of Technology (ETH Zurich). All data is processed and analyzed using STATA 17 software.

3.2. Research model

The research model is built on the mediation model with the structure of two equations in the SEM model as follows:

$$\begin{cases} \text{Banking}_{it} = \alpha_0 + \alpha_1 \text{Integration}_{it} + \alpha_2 X_{it} + \alpha_3 Trend_t + \mu_i + \varepsilon_{it} \\ \text{FDI}_{it} = \beta_0 + \beta_1 \text{Integration}_{it} + \beta_2 \text{Banking}_{it} + \beta_3 X_{it} + \alpha_2 X_{it} + \alpha_3 Trend_t + \nu_i + \xi_{it} \end{cases} \quad (1)$$

In which:

i denotes the country and year, respectively,t

X_{it} is a vector variable controlled,

μ_i and are country fixed effects,ν_i

ε_{it} and is a random error.ξ_{it}

$Trend_t$ is the time variable

The dependent variable of the study is foreign direct investment, which is measured in the natural logarithm of the value of net FDI inflows (lnFDI). This method of measurement helps to standardize the data, reduce the influence of external values, and allows the interpretation of the results in percentage change, in accordance with modern models of econometric analysis. FDI data is collected from the World Development Indicators (WDI) published annually by the World Bank.

The main independent variable is the level of economic integration, measured by the KOF Globalisation Index – de jure. The index reflects the country's level of formal commitment to globalization and institutional integration, including trade liberalization, financial integration, and participation in international agreements (Gygli et al., 2019). The use of the de jure index helps research focus on the policy and institutional framework aspects of integration, rather than just reflecting actual outcomes such as trade flows or investment.

An intermediate variable in the model is commercial banking development (Banking), which is represented by the ratio of private sector credit to GDP (BankCredit/GDP). This indicator shows the level of development and capital supply capacity of the banking system for the private sector, reflecting the role of banks in allocating financial resources to the economy. The data was taken from the IMF Financial Development Database (Svirydzenka, 2016).

We include a linear time trend (Trend =1,2…24 for 2000, ..., for 2023) to control for common time-varying factors that may simultaneously affect banking development and FDI inflows across ASEAN countries, such as global financial cycles, regional integration milestones, or technological advancements in financial services. This helps isolate the ceteris paribus effect of economic integration from broader temporal trends.

In addition, the study also used a number of control variables to ensure comprehensiveness and minimize bias in the model. These variables include: GDP growth rate (%), reflecting market attractiveness and growth potential; inflation (CPI), a measure of macroeconomic stability; real exchange rate (EX) an expression of trade competitiveness and international investment costs; logarithms of GDP per capita, reflecting economic development and average income; and finally trend variable to control the influence of general trends in the ASEAN region over time.

Table 1 Variables used in the research model

Variable Name	Code	Variable Definition	Data Sources
Total outstanding loans of commercial banks compared to GDP (%)	banking	The ratio of total credit outstanding of the commercial bank system to nominal GDP, calculated annually.	International Monetary Fund (IMF)
Level of global economic integration	integration	kofgidj- KOF Economic Globalization Index- The index shows the level of global economic integration, including trade integration and financial integration, on a yearly basis	KOF Institute
FDI (USD)	lnFDI	FDI in 10 ASEAN countries is measured in the natural logarithm of FDI, measured annually	UNCTAD
GDP per capita (0.01USD)	gdp_capital	GDP per capita of 10 ASEAN countries, in years	WB
Gross domestic product growth rate (%)	GDP	Gross domestic product growth rate of 10 ASEAN countries, in terms of year	WB
Exchange Rates	ex	The official exchange rate is the annual average, reflecting the amount of USD exchanged from a national currency.	WB
Time	Trend	=1 if it is 2000|=24 if it is 2023	

3.3. Estimation method

The study uses the structural equation modeling (SEM) model to simultaneously analyze the direct and indirect relationships between economic integration, commercial banking development and foreign direct investment (FDI) flows in ASEAN countries. The SEM method allows to examine the intermediary role of the banking system in the mechanism of the impact of economic integration on FDI, and at the same time overcome the limitations of traditional regression models when dependent variables are interrelated. The model was estimated using the maximum likelihood robust (MLR) method combined with bootstrap, to ensure reliable results even when the data were not standardly distributed (Preacher & Hayes, 2004; Hayes, 2018).

4. Results and discussion

The descriptive statistics table shows that the data sample includes 240 observations. The average value of FDI (lnfdi) is 21.09, indicating that the level of foreign investment attraction is relatively high but there is a big difference between countries. The Economic Integration Index (intergration) averaged 60.39, reflecting a fairly strong level of integration in the region. Bank credit (Banking) account for an average of 56.40% of GDP, but the large standard deviation shows a clear disparity in financial development. Other macroeconomic variables such as GDP, GDP per capita and exchange rates also fluctuate significantly.

Table 2 Statistics describing variables in the model

Variable	Obs	Mean	Std. dev.	Min	Max
lnfdi	240	21.09	4.133	0	25.796
integration	240	60.39	12.160	29	82
Banking	240	56.4	41.971	2.459	227.154
gdp	240	5.03	3.863	-12.016	14.519
gdp_capita	240	10.55	15.197	0.142	88.429
ex	240	4491.83	6554.22	1.249	23787.32
trend	240	11.5	6.937	0	23

The variables in the model all have large fluctuations, reflecting diversity and unevenness among ASEAN countries. This confirms the appropriateness of using panel data and controlled regression models to deeply analyze the relationship between economic integration, the banking system, and FDI attraction. Therefore,

in order to control the influence of national and annual factors, the SEM model is extended in the direction of Medsem on panel data, in which clustered errors by country to overcome within-country correlation.

The data in the study had a non-standard distribution characteristic, so the SEM model and Medsem validation were estimated using the maximum likelihood robust (MLR) method in combination with a bootstrap of 5,000 samples to ensure the stability and reliability of the intermediate coefficients. This method allows for the testing of indirect effects without requiring the assumption of a standard distribution.

Table 3 Estimation results of the structural model

	Model 1	**Model 2**
Variables	**Banking**	**lnfdi**
banking		0.0265***
		(0.00903)
integration	1.847***	0.0765***
	(0.638)	(0.0270)
ex	1.337	-0.00398
	(1.266)	(0.0296)
gdp	1.192	0.259**
	(0.773)	(0.102)
gdp_capita	0.839*	0.0130
	(0.467)	(0.0180)
trend	0.704	0.0662
	(0.672)	(0.108)
_cons	-84.13***	13.07***
	(30.98)	(1.749)
var(e.Banking)	783.8***	
	(188.5)	
var(e.lnfdi)	13.26**	
	(6.416)	
N	240	
Mediation Test		
Economic integration → Bank development (a)	0.535***	
Bank development → FDI inflows (b)	0.269***	
Economic integration → FDI inflows (Path c' (direct))	0.225***	
Indirect effect (a × b)	0.144**	
RIT = (Indirect effect / Total effect)	0.39	
RID (Indirect effect / Direct effect)	0.64	

*Note: *, **, and *** indicates significant level of 10%, 5% and 1%, respectively*
Standard errors in parentheses

Table 3 summarizes both the estimation results of the structural model and the mediation analysis using the *medsem* procedure. The estimated results clearly reflect the relationship between economic integration, commercial banking development, and foreign direct investment (FDI) inflows in ASEAN countries in the period 2000–2023.

Specifically, the estimated results of model 1 show that, in the period 2000–2023, the economic integration (integration) has a positive and statistically significant impact on the development of the commercial banking system in the ASEAN region ($\beta = 1{,}847$; $p < 0.01$). This shows that as the level of international economic integration of a country increase, the scale of bank credit (total outstanding loans compared to GDP) also increases accordingly. This finding is consistent with previous theory and experiment on the relationship between financial integration and development. According to Alfaro et al. (2004), Hermes and Lensink (2003), and Levine (2005), economic openness and globalization promote foreign capital inflows, increase competition, improve capital

allocation efficiency, and thereby enhance the financial intermediary capacity of the domestic banking system. Countries with a high degree of integration tend to attract more capital, technology, and international governance standards, which in turn encourages banks to expand credit and develop modern financial services. Similarly, Beck et al. (2010) argue that financial globalization improves the depth of the banking system by expanding access to capital and improving market liquidity. The results of this study further reinforce the empirical evidence that integration not only affects economic growth but also promotes financial development, especially the banking sector, which is a major intermediary in developing economies.

In addition, the positive coefficient of GDP per capita ($\beta = 0.839$; $p < 0.10$) indicates that countries with higher income levels tend to have more developed banking systems. This finding is consistent with the findings of Levine (2005), who emphasized that as incomes increase, so does the demand for formal financial services, encouraging the banking sector to expand its operations. In contrast, exchange rate variables (ex), GDP growth rate (GDP) and time trends are not statistically significant. This implies that the development of the banking system in ASEAN countries is not merely driven by economic growth or time factors. but mainly by the level of international integration and the improvement of financial institutions. This result is consistent with Claessens & van Horen's (2021) assessment, that financial reform and opening up of international markets are more decisive for banking development than short-term economic fluctuations. The finding of a positive relationship between banking integration and development is also compatible with Dunning's (1988) OLI theoretical framework, in which the "Internalization" element emphasizes the importance of cross-border integration of financial and investment activities. As countries increase financial liberalization, the domestic banking system will become a bridge between international capital flows and the domestic economy, thereby improving the efficiency of resource allocation.

Estimates from model 2 show that the development of the banking system (Banking) and the level of economic integration (integration) are two factors that have a positive impact on the attraction of foreign direct investment (FDI) of ASEAN countries. The estimation coefficient of the variable banking positive and statistically significant ($\beta = 0.0265$; $p < 0.01$) underscores the central role of the banking sector in absorbing, allocating, and sustaining FDI inflows. This result is consistent with the argument of Alfaro et al. (2004), which emphasizes that the effect of FDI on economic growth and vice versa critically depends on the development of domestic financial markets. A well-developed banking system serves as a macro-regulatory instrument that mitigates financial risks for foreign investors. When banks maintain high lending capacity and liquidity, FDI enterprises gain easier access to credit, can manage exchange rate risks more effectively, and are able to expand investment projects. Additionally, the level of banking development reflects a country's institutional governance and financial supervision capacity. A transparent, stable banking environment capable of providing modern financial services signals reliability to international investors (Islam et al., 2020; Liao, Yu, & Xie, 2024). These findings align with the perspectives of Hermes & Lensink (2003) and Beck et al. (2010), who argue that financial development is not only foundational for economic growth but also serves as a strategic governance factor that enhances a country's competitiveness in attracting international investment. Similarly, Hue (2025) and Kharisma et al. (2025) demonstrate that countries with resilient and well-integrated banking systems experience stronger transmission of integration benefits to FDI inflows. From a theoretical perspective, these results are consistent with the resource-based view (Barney, 1991), which considers financial capacity a strategic national resource for attracting international investment. They also support Levine (2005) and Beck et al. (2010), who argue that financial system development improves economic efficiency, facilitates international financial integration, and enhances the absorptive capacity for foreign capital. Collectively, these studies emphasize that banking development is not merely a consequence of integration but also a vital intermediary channel through which economic integration translates into tangible FDI inflows.

The integration variable has a positive regression coefficient and is statistically significant at 1% ($\beta = 0.0765$; $p < 0.01$), confirming that economic integration exerts a strong influence on FDI inflows. As countries deepen trade, finance, and institutional cooperation, they become more attractive to international investors. This finding reinforces Dunning's (1988) OLI theoretical framework, in which a country's "location advantage" is enhanced when its institutional and financial environment is well-integrated into the global economy (Dunning & Lundan, 2008). It is also consistent with the empirical evidence of Kose et al. (2009), who argue that financial liberalization and economic openness positively impact the ability to attract international capital flows. More recent studies provide additional support: Islam et al. (2020) and Liao et al. (2024) demonstrate that financial stability and resilient banking sectors in emerging Asia amplify FDI inflows, while Hue (2025) and Kharisma et

al. (2025) find that ASEAN countries with higher institutional quality and deeper integration experience more sustainable and stable FDI flows.

These results indicate that banking development and economic integration are not only macroeconomic and policy concerns but also directly influence the governance strategies of multinational enterprises. FDI enterprises prioritize investment in countries with dynamic banking systems that provide easy access to capital, digital financial services, and efficient payment and risk management mechanisms (Saha et al., 2022; Kharisma et al., 2025). In this context, the development of the banking sector acts as a strategic intermediary, enabling the benefits of economic integration to be effectively transmitted to FDI inflows, thereby enhancing both the attractiveness and stability of investment destinations within the ASEAN region. Another factor that also had a significant impact was the GDP growth rate ($\beta = 0.259$; $p < 0.05$), indicating that fast-growing economies are often attractive to foreign investors due to their large market potential and high profitability. This finding is consistent with classic studies by Dunning (1988), which emphasized the role of market size and potential in the OLI (Ownership–Location–Internalization) model. In contrast, the exchange rate (ex), GDP per capita (gdp_capita) and trend variables are not statistically significant, suggesting that in the ASEAN region, FDI is not significantly influenced by short-term fluctuations in exchange rates or incomes, but depends on long-term structural factors such as financial integration and development. This is consistent with the conclusion of Capannelli & Menon (2010) that financial and economic integration in Asia has a more far-reaching effect on FDI flows than short-term macro factors.

Mediation testing using the Sobel and Bootstrap methods with 5,000 replicates confirmed that the indirect impact of integration through banking development was statistically significant, accounting for about 28–35% of the total impact of integration on FDI. This result clarifies the role of the financial intermediation channel – whereby economic integration improves the legal and institutional environment, thereby promoting the development of banks, and ultimately spreading the impact on investment capital flows. This is compatible with the findings of Alfaro et al. (2004), who argue that financial development amplifies the positive impact of FDI on growth, and Hermes & Lensink (2003), that FDI only really contributes to growth when the domestic financial system is strong enough to absorb capital. The results of the medsem inspection showed that the development of banks (Banking) plays an intermediate role partly in the relationship between economic integration and FDI attraction. The indirect effect of integration on FDI through banking reached 0.144 ($p = 0.022$; $p = 0.026$ according to Sobel and Monte Carlo), while the direct effect remained significant (0.225; $p = 0.020$). In total, 39% of the impact of integration on FDI was transmitted through the banking channel (RIT = 0.390), indicating that banks are an important intermediary link. This reflects that as the level of integration increases, the development banking system helps to transform international opportunities into actual FDI flows, through credit, guarantees, payments and risk management, contributing to the reduction of transaction costs and institutional uncertainty. The results of the study are also consistent with many international empirical evidence. Alfaro et al. (2004) and Hermes & Lensink (2003) point out that the developed financial system allows countries to leverage FDI more efficiently through optimal capital allocation and minimized investment risk. Kose et al. (2009) also emphasized that financial globalization only produces growth benefits when supported by a healthy banking sector and effective financial governance capacity.

5. Conclusion

This study empirically investigates the impact of economic integration on foreign direct investment (FDI) inflows in ASEAN countries, highlighting the mediating role of commercial bank development. Using panel data from 10 ASEAN economies for 2000–2023 and applying the structural equation modeling (SEM) with the Medsem procedure, the results show that economic integration positively affects both banking development and FDI inflows. Moreover, commercial bank development acts as a complementary mediator, transmitting about 39% of the total effect of integration on FDI. This finding implies that a stronger and more efficient banking system enhances the benefits of economic integration by improving credit access, reducing financial risk, and strengthening investor confidence.

From the perspective of international business governance, this result implies that the country's banking and financial capacity is an important component of the strategy to attract and retain FDI. ASEAN governments should view the banking system as a macrofinancial management tool to increase investment attractiveness, through strengthening credit capacity, enhancing information transparency and improving financial risk management capacity. For multinational enterprises (MNEs), the study's findings suggest that an assessment of

the host country's banking environment should be incorporated into an international financial governance (IFM) strategy, helping businesses optimize their capital structures, control financing costs, and mitigate risks when making cross-border investment decisions.

Future research could expand this study by including other mediating factors such as financial inclusion, institutional quality, or capital market development. Although we employ structural equation modeling (SEM) with country-clustered standard errors and a linear time trend to partially account for panel structure, we acknowledge that SEM is primarily designed for cross-sectional or repeated-measures data and does not fully address unobserved country-specific effects, time-specific shocks, or dynamic feedback mechanisms inherent in panel data. Future research could apply dynamic panel mediation models to further validate these findings.

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