ABSTRACT

This study aims to analyze the capital flow based on the synthesis between neoclassical theory and the Lucas paradox regarding the degree of economic freedom in investment inflows and currency stability and to identify factors that influence economic development. Based on The Heritage Foundation and the policy parameters built, the Economic Freedom Index (EFI) is used as an index measurement to determine economic freedom and investors' role in determining investment location.

According to Cole (2003), various theories of economic growth and analysis of the impact of economic freedom use the economic freedom index. This study uses inflows of Foreign Direct Investment (FDI) as the dependent variable and the index of economic freedom (EFI), the real effective exchange rate (REER), trade openness, inflation, interest rates, and relative wages as independent variables within five ASEAN countries using a fixed-effect regression model with annual data for the period 2000-2019.

The results find that the capital flows align with Lucas's thinking, where economic freedom as a representative of institutional strength has a significant and positive influence on FDI inflows. Among others, REER, inflation, and relative wages also affect FDI positively and significantly. It indicates that developing countries have the propensity to use Lucas's classification as an essential parameter in determining the flow of investment, where the institutions' scope will be more attractive to be used as a determinant of investment locations with a high degree of freedom in trade policy and countries with a more transparent and stable macroeconomic environment.

Keywords: *Fixed-effect Regression Model, Economic Freedom, Real Effective Exchange Rate, Foreign Direct Investment*

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