THE INFLUENCE OF THE MACROECONOMIC VARIABLES AND BUSINESS ENVIRONMENT ON THE FOREIGN DIRECT INVESTMENT INFLOWS IN PAKISTAN: THE MODERATING ROLE OF POLITICAL STABILITY

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UNIVERSITI UTARA MALAYASIA
January 2013

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A Dissertation Submitted to
Othman Yeop Abdullah Graduate School of Business
Universiti Utara Malaysia,
in Partial Fulfillment of the Requirements for the Degree of Doctoral of Business Administration.

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ABSTRACT

The study has the attributes of pioneering attempt in examining the research gaps and evaluating the role of the moderating effect of political stability (PS) on the relationships between macroeconomic variables, business environment variables and the foreign direct investment (FDI) inflows in the case of promising nation such as Pakistan in the SAARC region. Indeed, the study poses a new stream of research in investigating the effect of political stability as moderating variable, recognizing the importance of PS as a critical variable in the course of foreign investment, thus, the research framework of this study was designed with integration of New Growth theory and firm theory in tracing the impact of political stability on foreign direct investment. This study was confined to the annual data for the period 1991 to 2011 obtained from the official sources such as SBP, UNCTAD, World Bank and IMF. In its empirical analysis, this study used the ADF test to check the stationary of the data using EViews and hierarchal regression using SPSS statistical software packages. The moderating effects of the determinants political stability on the relationships were empirically examined. The findings of this study revealed that GDP growth rate, degree of openness, inflation rate, corruption control index and political stability were significant predictors of FDI inflows; whereas, other determinants such as exchange rate and infrastructure were not significant in the case of Pakistan. These findings, therefore, strongly suggested that political stability is very important for the country's domestic and foreign investment in the future course of direction. The study makes several practical inferences for designing suitable macroeconomic policy and undertaking measures to promote a high economic growth with rising FDI inflows in the political economy of Pakistan.

Keywords: Macroeconomic Variables, Business Environment, Political Stability, Foreign Direct Investment, Pakistan

ABSTRAK

Kajian ini merupakan satu usaha rintis yang meneliti jurang penyelidikan dan menilai peranan kesan kesederhanaan kestabilan politik (*Political Stability*) ke atas hubungan antara pemboleh ubah makroekonomi, pemboleh ubah persekitaran perniagaan dan Pelaburan Langsung Asing (*FDI*). Kajian ini melibatkan kes negara yang berkeupayaan seperti Pakistan dalam lingkungan rantau negara-negara di Asia Selatan. Sesungguhnya, kajian ini menonjolkan satu aliran baru penyelidikan dalam menyiasat kesan kestabilan politik sebagai pemboleh ubah sederhana. Selain itu, kajian ini cuba menyerlahkan kepentingan kestabilan politik sebagai pemboleh ubah kritikal di dalam pelaburan asing. Oleh itu, rangka kerja penyelidikan kajian ini telah direka dengan mengintegrasikan teori Pertumbuhan Baru dan teori Pelaburan dalam menjejaki kesan kestabilan politik ke atas pelaburan asing secara langsung. Kajian ini terbatas kepada data tahunan bagi tempoh 1991 hingga 2011 yang diperolehi daripada sumber-sumber rasmi seperti Bank Negara Pakistan, UNCTAD, Bank Dunia, IMF dan tinjauan ekonomi Pakistan. Dalam analisis empirikal, kajian ini menggunakan ujian ADF untuk memeriksa data yang pegun menggunakan EViews dan regresi hierarki dengan menggunakan pakej perisian statistik SPSS. Kesan-kesan kesederhanaan penentu kestabilan politik dalam hubungan juga diperiksa secara empirik. Hasil kajian ini menunjukkan bahawa kadar pertumbuhan Keluaran Dalam Negara Kasar (KDNK), tahap keterbukaan, kadar inflasi, indeks kawalan rasuah dan kestabilan politik merupakan peramal yang signifikan bagi aliran masuk pelaburan langsung asing. Manakala penentu lain seperti kadar pertukaran dan infrastruktur adalah tidak ketara dalam kes negara Pakistan. Oleh itu, penemuan ini dengan jelas mencadangkan kestabilan politik amat penting bagi pelaburan domestik dan asing di negara ini dalam menentukan hala tuju masa depan. Kajian ini membuat beberapa kesimpulan praktikal untuk mereka bentuk dasar makroekonomi yang sesuai dan melaksanakan langkah-langkah untuk menggalakkan pertumbuhan ekonomi yang tinggi dengan peningkatan aliran masuk pelaburan langsung asing dalam ekonomi politik Pakistan.

Katakunci: Pemboleh Ubah Makroekonomi, Persekitaran Perniagaan, Kestabilan Politik, Pelaburan Langsung Asing, Pakistan

ACKNOWLEDGEMENTS

In the name of ALLAH, the most gracious, the most merciful. Praise be to ALLAH, the creator and custodian of the universe. Salawat and Salam to our Prophet Muhammad, peace and blessings of ALLAH be upon him and to his family members, companions and followers.
First and foremost, I would like to express my heartfelt thanks and gratitude to Allah S.W.T for His blessing and allowing me to complete this project.

My foremost gratitude goes to my supervisor, Prof. Madya Dr. Faudziah Hanim Bt Fadzil and Prof. Dr. Dawood Ali Mohamed Ali Mithani, for their professional guidance and devoting their expertise and precious times to guide me to reach this level. Thank you, for all that you did.
Additionally, I would like also to express my gratitude and thanks to Prof. Dr. Rosli B Mahmood and Prof. Dr. Nor Hayati Bt Ahmad for their constructive comments and invaluable suggestions during and after the proposal defense session.

Additionally, I would like to extend my thanks and gratitude to the top management of the R & D SerindIT.com UUM Sdn. Bhd for the support and encouragement.

To my father, mother, brothers, sisters and all my family members, thank you so much for your support and prayers. Moreover,I would like to extend my special thanks and appreciation to my wife Seemab Kurshed for her support and incouragement .

To all my friends Prof. Dato Dr. Syed Mushtaq Hussain, Prof. Madya Abd. Ghani Golamdin, Visiting senior lecture Dr. Abdullah Swidi, Dr. Abdulshukur Shamsuddin, Dr. Bayar, Dr. Shivan, Dr. Zeravan, Wan Hafizi staff SerindIT, Puan Nurul Syifa' and Norshaifulhady for invaluable time we spent together on discussion and mutual support throughout the tenure of our study.

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LIST OF ABBREVIATIONS

ADF	Augmented Dickey Fuller
ARDL	Autoregressive Distributed Lag Model
BOP	Balance of Payments
CCI	Corruption Control Index
CEEC	Central and Eastern European Countries
CRP	Commodity-Producing Sector
DOP	Degree of Openness
ECM	Error Correction Model
EXCHRATE	Exchange Rate
FA	Foreign Aid
FDI	Foreign Direct Investment
GCI	Global Competitiveness Index
GDPGR	Gross domestic production growth rate
HRM	Human Resource Management
INFRAS	Infrastructure Index
INFRATE	Inflation Rate
LBC	Labor Cost
MENA	Middle East and North Africa

NPV	Net Profit Value
PSI	Political Stability Index
SBP	State Bank of Pakistan
SSA	Sub-Saharan Africa
UNCTAD	United Nations Conference of Trade and Development
USD	United States Dollar
WIR	Word Development Report

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CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

It has been widely acknowledged in theory as well as in practice that Foreign Direct Investment (FDI) leads to several economic benefits to the recipient country by providing capital, foreign exchange, transfer of technology, organizational framework and managerial skills, infusing competition and facilitating exports by enhancing her access to foreign markets (Brooks & Sumulong, 2003; Gorg & Greenaway, 2004; Crespo & Fontura, 2007; Salman & Feng, 2010; UNCTAD, 2011; Javed *et al*,. 2012). Some economists have opined that FDI can also induce increase in the domestic investment through its backward and forward linkages involved in the process of infusing innovation and boosting economic growth in the host country (Brooks & Sumulong, 2003; Awan, Khan, & us-Zaman, 2011).

By and large, the significance of FDI flows for both the developing and developed countries is widely recognised in the economic literature. Over the last decade of the twentieth century, FDI inflows have increased at least double than the trade flows in the world economy (Sinani & Meyer, 2003; Rajana *et al*., 2008). During the first decade of the 21st century, thus, FDI in the world economy has grown very fast. Developing countries have tended to enhance their capital formation in their industrialization process by seeking the help of foreign capital through FDI. The process is encouraged since marginal productivity of capital is presumed to be high in these countries, so that investors from the developed world would estimate high returns for their capital invested in developing economies. In

short, international mobility of capital in the garb of FDI is supposed to confer mutual benefits to the concerned partners and beneficiaries in global transactions.

Ostensibly, FDI is considered to be the most important source of external resource for industrial expansion and growth of real income sought by the developing countries in recent years. In fact, the ensuing benefits of the FDI have been widely recognized as an expansion of the economic growth in the developing nations (Khan, 2007). The contribution of foreign direct investment in the host country's national economy assumed to exert its positive influence in adding to the employment opportunities, enhancing the managerial productivity of capital in the industrial sector of the country, rise in foreign trade and economic growth with increased dose of technology transfer (Ifaro *et al*., 2004; UNCTAD, 2011). The benefits of the FDI on the host country economy further refer to facilitating the optimal use of available raw materials, inject the novel method in management and marketing approaches, providing access to modern technologies, enhancing the human capital of the developing country through on the job training and Human Resource Management (HRM) strategy. Besides, foreign money inflows in the reserves can be utilized for financing current account trade deficits of Balance of Payments. Unlike external debt, money inflows through FDI do not involve debt redemption and interest liabilities. Over the years, several developing economies adopted sweeping reforms towards liberalisation that have induced fierce competition among these countries on the global platform. Entry barriers and controls towards business activities of foreign entrances in these countries are dismantled to give way to certain incentives and business facilitating policies such as tax rebates, creation of export zones, and so on. A tough competition for attracting the FDI inflows among the developing countries has emerged as new

challenges in reality seizing the growth opportunities under the economic dynamism the 21st century. Developing countries are offering attractive packages of incentives to lure the foreign investors. World over the countries are also seeking to improve their economic fundamentals with a focussed approach of their macroeconomic policies (UNCTAD, 2010; Pajunen, 2008).

The role of FDI in economic growth has been analysed by many researchers in several countries to examine the nexus between investment and growth. The FDI is presumed to be a crucial source for solicitating capital, advanced technology, managerial skills, improved marketing know-how and output for non-traditional exports. The link between FDI and trade moves through two main channels in the host countries. First, the countries with high degree of openness are obviously tended to be attracting more FDI inflows. Here, technically, the degree of openness is measured in terms of the trade GDP ratio. Secondly, the FDI flows can influence trade flows through technology transfer and expansion of industrial output in export sector (Chowdhury & Mavrotas, 2006).

As mentioned earlier, foreign direct investment (FDI) is widely recognized as a major source of foreign capital for industrialization and growth process in a developing country, thus, assumed to be an engine of growth and economic expansion in global arena. The IMF and the World Bank also favor of FDI as a vital source of development process, planning and programming of developing country under the dynamic move of globalization in the 21st century.

World Investment Report (WIR) published annually by the UNCTAD, time and again examines and analyzes the role and issues pertaining to the foreign direct investment flows in the world economy. As such, on the basis of data reported in

the WIR issues, it is worthwhile to review the growth trend of FDI inflows and outflows in the world economy as well as major global economic segments, such as developed and developing economies as reported in Table 1.1.

During the last two decades, the worldwide growth of FDI in collective terms and in economic significance has been unique, growing faster than trade flows, in particular among the world's most superior industrial nations. The sweeping growth of FDI in the last few decades tended to have inspired led to an extensive research on the determinants of this type of investment. The vast amount of theoretical and empirical literature on FDI catalogues a long list of determinants in tracing direct investment undertaken by multinational companies in specific regions and location (Hansen & Rand, 2006; Mahmood, Ehsanullah & Ahmed, 2011; Bogdanovska, 2011). Among these determinants the spotlight is flashed on those factors associated with the location dimension of the OLI (Ownership, Location and Internalization) paradigm (infrastructure, human capital, economic stability and production costs), on the institutional approach (corruption, political instability and institutional quality, and financial and fiscal incentives), and on the new growth theory (land, labor, capital and enterprises) and firm investment theory (future profit of the firm , risk premium).

Table 1.1

Foreign Direct Investment Inflows during the Period of 1991– 2011(Millions of U.S. dollars)

	1991 2001	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
World	869,122	817,574	716,128	559,576	710,755	958,697	1,411,018	1,833,324	15,294,653	17,950,498	19,140,603
Developed countries	491,856	571,483	547,778	366,573	396,145	611,283	940,861	1,247,635	10,616,230	12,263,733	12,501,569
Developing countries	172,364	219,721	155,528	172,033	275,032	316,444	412,990	499,747	4,441,301	5,060,116	5,951,203
Asia	97,502	111,966	92,009	107,278	156,622	210,572	274,291	320,489	608,492	769,542	916,972
ASEAN	24,391	19,601	14,507	17,364	25,666	39,091	51,243	60,514	173,976	220,008	260,980
Pakistan	2082	484	798	949	1524	3521	5410.20	5139.6	3719.9	2205.7	1739

Sources: IMF (2003) p.10, and UNCTAD, World Investment Reports, 2011, SBP, Handbook of Statistics on Pakistan Economy, 2011 p.556.

Several empirical studies have been carried out to assess which key determinants explain the investment of multinational firms in a given spot, but they have not obtained consonance in empirical consensual results. In fact, many researchers revealed by the literature surveys have failed to detect any statistically significant functional relation for certain determinants such as, infrastructure, financial and fiscal incentives, market growth, and openness of the economy with the growth of FDI inflows in the case of selected developing nations. Furthermore, notwithstanding the quantity and quality of studies on FDI determinants, there are some important factors, for examples, human capital, production costs and factor endowments (in particular natural resources) have received no adequate attention of the researches. Besides, it has been observed that most of the studies had their focus on very specific regions and countries, such as Sub-Saharan Africa (SSA) (Asiedu, 2006), the Middle East North Africa (MENA) countries (Mohamed & Sidiropoulos, 2010), India (Kumar & Chadha, 2009), China (Cheung & Qian, 2009), Hungary, Poland and the Baltic states (Deichmann, Karidis, & Sayek, 2003), the Southern African Development Community (Mhlanga, Blalock, & Christy, 2010), and BRICS (Vijayakumar, Sridharan & Rao, 2010). Only a very few studies cover a wider range of countries and determinants. In the SAARC region covering Pakistan, Sri Lanka, Bhutan, India, Nepal and Bangladesh, however, least attention is paid by the researchers in providing comprehensive analytical studies.

There are key reasons why developing countries are keen to attract foreign direct investment. Several developing countries and especially countries like Pakistan have been facing the difficultly of closing saving-investment gap and foreign direct investment can influence the process of economic growth by filling

up this gap, new technology transfer for country, job creation to the nation and expansion of national output and growth level in these countries (Kobrin, 2005; Ataullah, Cockerill, & Le, 2004). In view of the benefits associated with the use of foreign capital in the growth process developing nations have tended to liberalise their foreign direct investment policies in order to increase the FDI inflows in their favour. In economic literature, a plethora of studies are available in identifying such benefits of FDI and also tracing the effects of FDI on economic growth. By and large, however, empirical analyses and theories in effect have turned out to be providing mixed results concerning the influence of FDI on economic growth in developing countries.

Over the last two decades, there has been an amazing expansion of foreign direct investment inflows and outflows in the global arena. The world FDI inflows are estimated to be around 4.4 per cent in year 2011(UNCTAD, 2011). In the south-east region Pakistan is considered to be a promising developing nation in the world trade economy. According to Pakistan Statistical Book (2011) with launching of market oriented economic policy and reforms introduced in 2000 onwards Pakistan has become an attractive growing nation in the South East spot for investment opportunities to foreign investors in allied fields of the country's economy ranging from agriculture to industrial finance. The Pakistani government, thus, should be more attentively interested in reforms of the domestic economy; and speedily seeking the opening up of external trade economy and investment towards its growth process.

Viewing the recent economic environment of the country, however, Pakistan's GDP growth rate is estimated to be 2.1 per cent in the year 2011. Nonetheless, the country's total trade in 2010 was measured to be 25.56 times

more as compared to that of 1990. Total registered capital of FDI in Pakistan in 2001-2011 was estimated to be about 20.74 times of that in 1991-2000 periods. Pakistan has been showing the signs of improvements in FDI flows, trade and economic growth, yet in the existing literature hardly there is any research study confined to provide a comprehensive analysis and investigation of the nexus relationship between FDI toward growth with influencing macroeconomic factors in the country's political economy. On this count, there appears to be a glaring research gap as one may observe from the literature review contained in the thesis to follow. The present study, thus, attempted to fill up the gap and seeking to examine the relationship nexus between foreign direct investment, macroeconomic variables and business environment in Pakistan by empirical and analytical approach.

Incidentally, to analyse the economic environment of the country it can be said that the policy strategy of Pakistan had changed from a highly regulated to a market oriented economy since December 1996. Over the years, the country had seen remarkable economic growth in terms of rising GDP and GDP growth rate which can be attributed to foreign direct investments to an extent. From 1991 to 2010, annual average growth rate of export of the country was estimated to be 21.22 per cent. The exports value in 2010 has increased 31.8 times that of 1991, since the value of exports 1991 was $6167 million which is estimated to be $19,290 million in 2010. The exports in total trade of the country increased steadily from 35.7 percent in the 1986-1990 up to 46 percent. The yearly average growth rate of imports in 1991-2011 was estimated to be 21.99 percent. Import value had increased from $7631.2 million in 1991 to $34,710 million USD in 2010 amounting to 18.02 percent average annual growth rate. The average growth rate

of imports in 1991-1995 was the highest at 24.3 percent, compared to other periods. The pace of export and import growth at different speeds had made the country's balance of trade more complicated phenomenon to the policy makers of Pakistan. Trade deficits were nearly unchanged during the period 1986-1990 and 1991-1995. Pakistan's trade deficit had become nearly double and fourfold compared to that of 1996-2010 and 1991-1995, respectively and inflation rate also estimated to be double digits, being 13.1 percent in 2011. However, the trade deficit ratio in each period compared to exports had steadily decreased, from 77.34% in 1991- 2000 to 61.17% in 2001-2010. This was attributed to the increasing pace of export's growth rate each year exceeding against the imports.

Pakistan's economic growth rates have been fluctuating. After a remarkable economic GDP growth rate of 7.57 % in 1991, economic growth rate of Pakistan decrease to 2.1% in 2000. It, however, increased to over 8.96 % both years in 2003 and 2004 (Zaidi, 2005; Iqbal, Shaikh, & Shar, 2010). The country's GDP decreased in 2007 and 2011 due to the downfall of the nation's political stability and increased corruption in the government sector, leading to the biggest security threats in business environment in Pakistan. The GDP growth rate was 7.57% in 1991 and 2.1% in 2011 report of SBP (2011). Asian financial crisis during the period of 1997-1998, led Pakistan GDP growth rates to decline to 5.8% in 1998 and lowest rate at 4.8% in 1999. The Pakistan economy positively improved after the economic crisis and came to a high level of 7.48% of growth rate under the five-year plan 2001-2005. Pakistan inflation rate drastically increased in last four years of the millennium first decade. The inflation rate in the year of 2001 was 3.6% and in the year of 2011 is 13.8%. Surmounting several problems and challenges in Pakistan, with 8.4% of economic growth rate in 2005,

thus, Pakistan had highest growth rate during the first five years in 21st century. The economic growth rate scenario, thus, reflect that the chosen reforms of Pakistan policy makers were going in the right directions. The economic growth rate of the national economy, however, started declining in 2007 and onward due to the biggest natural flood in history of Pakistan, political party's rivalry issues and lack of competitively attractive economic policies. It is noted that FDI also declined correspondingly.

Indeed, foreign direct investment has been seen as a crucial factor for the Pakistan economy and playing an important role towards the process of economic growth in the country. Pakistan received the 7279 FDI projects with total recorded capital amounting to 66244.4 million US dollar during the period 1991 to 2005. Foreign direct investment number of contracts during the period 2001-2005 was two-fold more than that of 1996-2000. Pakistan had attracted $8 billion US dollar during the period of 2004-2006. Most of the foreign investment inflows had moved into banking, telecom and oil and gas sectors primarily. Foreign direct investment flow, however, decrease in the country during the period 2007-2011.

Several studies have investigated that FDI is a fundamental factor in accelerating growth in developing countries, mainly when a certain minimum threshold for human capital and/or degree of openness is seen in the recipient countries (Borenzstein *et al*., 1998; Zhan, 2001; Blonigen & Wang, 2005). The study of Carkovic and Levine (2005), using new econometric techniques, however, saw no sign of a positive impact of FDI on GDP growth rate, whereas the study of Calderon *et al*., (2004) confirms that the causal relationship is positive in the other way, that is, GDP growth rate leads to FDI. Mencinger (2003) observed that in the case of transition economies of Eastern Europe, FDI had a negative impact on

GDP growth rate, attributing this finding to the occurrence of merger-and-acquisition FDI in that region. Few studies such as Chowdhury and Mavrotas (2006) found a bidirectional causal relationship between FDI and GDP growth rate in the case of Thailand and Malaysia, whereas in the case of Chile the direction of causality is found to be of reverse order from GDP growth rate to FDI. Loree and Guisinger (1995) argued that for obvious reason influence of FDI may be different between developing countries and developed countries. The research study of Castanaga, Nugent and Pashamova (1998) concluded that exchange rate distortions in the host country did not cause a negative effect on FDI flows. On the other hand, growth expectations have exerted a positive effect and while corruption implied negative effect.

In going through the current literature, we do find that some researchers have focused their investigation on export -FDI nexus in developing counties. It is conceptually understood that exports is a crucial variable for growth and economic expansion in the global setup. Zhang (2005) examining the role of FDI in China found that the FDI has a larger influence on performance of the exports to the country. In an empirical study literature, the evidence shows that there is bidirectional causality nexus of inward FDI and export performance in the host countries (Pacheco–Lopez, 2005).

Furthermore, in Pakistan the private sector of foreign direct investment can play a positive role in the economic growth and development of the country. The Pakistan government is playing strategic role in attracting the flows and correspondently benefits of foreign direct investment. Foreign direct investment in private sector of the country is seen to be of a low order. However, needless to say that good fiscal policy and vision of the policy maker of Pakistan can expose the

benefits of investing in Pakistani economy to foreign investors, thus, to attract the inward flows in favour of the country (Salman & Feng, 2010).

With considerations of all such significant facets of the envisaged investigation of the FDI issues relating to Pakistan, by and large, the present study will focus on the relationship among macroeconomic determinants, business environment on the FDI inflows and political stability.

1.2 Problem Statement

Because of global integration sought by the country the inflow of foreign direct investment is considered to be a major source of capital that is indispensable for growth and development in the developing country such as Pakistan. Economic policy makers of Pakistan duly recognize the need for increasing inflow of FDI in the country in order to meet their macroeconomic goals such as high growth rate, large and increasing national and per capital income, and eradication of poverty. Under the dimensions of business environment, Pakistan has major socio-economic political problems associated with physical infrastructure; political stability and corruption in the country need to be empirically investigated (Yousaf, Hussain, & Ahmad, 2008).

Over the years, developing countries such as Pakistan has thrown its doors wide open to FDI, which is expected to fetch large benefits. Nevertheless, there has been no successful consistent inflow of FDI in Pakistan. Besides, the meagre inflows that the country has received have not been utilised appropriately to enhance the economic growth (Ataullah *et al.,* 2004; UNCTAD, 2011). By and large, the country's experience related to FDI inflow is rather disappointing. As has been discussed in the background of the study and further illustrated in Figure

1.1, FDI inflows in Pakistan has witnessed a declining trend during the last four years of the first decade of the 21st century. In fact, the slow growth of the FDI inflow in Pakistan during the last two decades and the sudden drop during the last four years (UNCTAD, 2011; SPB, 2011, Javed *et al.,* 2012, Shahzad *et al.,* 2012) needs to be comprehensively studied and examined to identify the most influencing factors and the missing links. Therefore, needless to say that the policy makers of Pakistan not only need to pursue policies to attract foreign direct investment in appropriate channels, they should also create an encouraging atmosphere for such investments (Husain, 2009; Salman & Feng, 2010).

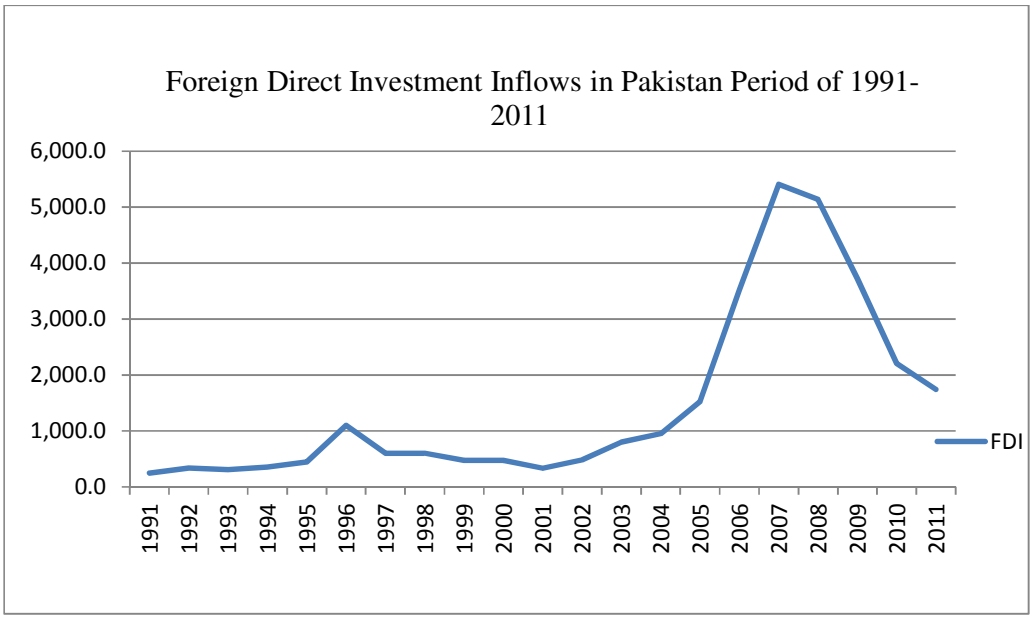

Figure 1.1
Pakistan FDI Inflow during the Period of 1991-2011
Source: SBP, Handbook of Statistics on Pakistan Economy, 2011 p.556.

In an attempt to explain this situation, many researchers for example, Yousaf *et al*. (2008) as well as international reports such as, UNCTAD (2010) and World Bank (2011) confirmed the undesirable effect of poor physical infrastructure, political instability and corruption on the FDI inflows in Pakistan.

However, the low level of FDI and the weak contribution to overall growth of the economy of Pakistan can be mainly attributed to many reasons (Borenzstein *et al*., 1998; Zhan, 2001; Blonigen & Wang, 2005; Husain, 2009; Salman & Feng, 2010; Shahzad *et al*., 2012), such as:

1. Low attention to improve degree of openness in Pakistan's context in the Asia region.
2. Neglecting the significant role of the macroeconomic policy in attracting the FDI inflows.
3. The lack of the political stability to enhance and support FDI inflows.
4. Low attention to the business environment in order to attract the desirable level of FDI inflows.
5. Insufficient development of infrastructure to attract the FDI inflows in Pakistan.
6. Increasing level of corruption index leading to adverse effects on the FDI inflows in Pakistan.

From a theoretical point of view, several studies have examined the role of FDI for the growth of the economy as well as the combination of FDI-attracting factors. In general, research studies have asserted that FDI essentially play a positive role in the process of economic growth in developing countries. In this context for instance, Thamos *et al*. (2008) have argued that foreign associates of TNCs (Transnational Corporations) do well in developing new products and faster adoption of technologies than local firms, thereby using modest competitive pressure and forcing the local firms to imitate and transform.

Reviewing the past literature regarding the relationship between some variables such as corruption index, business environment and political stability and

the FDI inflows inconsistent findings have been observed. For example, while Akcay (2001) failed to trace evidence of a negative relationship between FDI and corruption, Habib and Zurawicki (2002) have, however, traced that there is a negative impact of corruption on FDI. This was justified by the fact that foreign investors generally avoid investing in corrupted business environment since they feel unsecure and corruption may induce operational inefficiencies.

In studying the effect of the political instability on the FDI inflows, there have been mixed findings in the literature. For instance, Wheeler and Mody (1992) and Singh and Jun (1995) found that political instability and administrative efficiency are insignificant in determining FDI. Many other studies on the other hand, such as (Younis *et al.,* 2008; Shahzad *et al*., 2012) established that political instability have significant impact of FDI inflow. Similarly, other studies such as those conducted by Singh and Jun (1995) and Wei (2000) found that political stability has a positive effect on FDI inflow. Since investors are very sensitive to the political stability of the targeted countries, it is expected that the political stability of the country can attract FDI inflows. Some researches such as (Schneider & Frey, 1985; Kim, 2010) have contended in their studies on political system welcoming to a foreign investment suggested that property rights and civil rights play a pivotal role for attracting FDI to the host country.

On this count, the present study intends to resolve the issues for academic interest as well as understanding and appreciation of policy makers regarding major determinants of FDI in association with examining the effect of some macroeconomic variables and business environment under the political consideration and policy making on FDI inflows in Pakistan. This study eventually aims to examine the effect of business environment macroeconomic factors under

the various political regimes in enhancing the capability of the country to attract FDI inflows.

1.3 Research Questions

The present study, thus, focused to deal with the following research questions:

1. Is there any relationship between macroeconomic determinants (GDP growth rate, degree of openness, exchange rate and inflation rate) and FDI inflows?
2. What is the relationship between business environment (Infrastructure, corruption control and labor) and FDI inflows in Pakistan?
3. How does political stability relate to FDI inflow in Pakistan?
4. Does political stability moderate the relationship between macroeconomic determinants (GDP growth rate, degree of openness, exchange rate and inflation rate) and the FDI inflows?
5. Does political instability moderate the relationship between the business environment (Infrastructure, corruption control and labor) and the FDI inflows?

1.4 Research Objectives

The present study intended to provide a better insight to understand the phenomenon of FDI inflows in Pakistan economy, thus, the study is meant:

1. To examine the relationship between macroeconomic determinants (GDP growth rate, degree of openness, exchange rate and inflation rate) and FDI inflows in the developing economy of Pakistan.
2. To determine the relationship between business environment (Infrastructure, corruption control and labor) and FDI inflows in Pakistan.

3. To investigate the relationship between political stability and FDI inflows in Pakistan.
4. To examine the moderating effect of the political stability on the relationship between macroeconomic determinants (GDP growth rate, degree of openness, exchange rate and inflation rate) and the FDI inflows.
5. To investigate the moderating effect of the political stability on the relationship between business environment (Infrastructure, corruption control and labor) and the FDI inflows.

1.5 Scope of the Study

This study utilizes macroeconomic yearly time series data in Pakistan collected for the period 1991-2011. Apparently, the period chosen is pertaining to previous and post decades of the new millennium years 2000, thus, confined to the last decade of the 20th century and initial decade of the 21st century in the contemporary era. Seven independent variables will be used in this study, under the categories such as: economic determinants (including GDP growth rate, Degree of Openness, Exchange Rate, and Inflation Rate), Business Environment (including Infrastructure and Corruption Index and Labor Cost) and moderating variable referring to (Political Stability) interacting with FDI in Pakistan as dependent variable. In addition, the statistical tool that is used in this study is limited to the measuring of correlation coefficients and multiple regressions, by doing this, the short run and the long run relationship among the variables will be established in order to test the hypotheses envisaged for the current study.

By going through the literature review of Pakistan economy related to the FDI inflows, it cannot be denied that there is a glaring research gap in perceiving the overall economic and political situation of the country in the new millennium

era. The present study, thus, attempted to fill up the gap by providing a fresh comprehensive study of the FDI inflows and related issues pertaining to macroeconomic variables and business environment in the growth process of Pakistan as a developing country. The present study intended to analyze the investment behavior during the period (1991-2011), thus, covering last two decades pertaining to end of the 20th century and the promising decade of the new economic era of globalization in the 21st century.

1.6 Significance of the Study

The present study intended to contribute significantly to the existing literature by presenting a comprehensive approach in analyzing the issue of foreign capital and growth for Pakistan. The approach as well as the findings of the study was of great importance for academicians and decision makers by providing a better understanding of the factor that might influence the FDI inflows in a country like Pakistan. The study is based on analytical and empirical ground since it relates to the nexus of relationship between FDI and macroeconomic variables and business environment in developing economy of Pakistan. Moreover, this study contributed to the literature by uniquely examining the moderating effect of political stability on the relationship between macroeconomic variables, business environment and the FDI inflows. By and large, this study can be considered as an endeavor to expand the literature by exploring the effect influencing variables in the context of needful political stability and effective policy mode on enhancing the country's FDI attractiveness in developing economies with a focus on Pakistan.

Apparently, for the policy makers, this study was of a great value and can be used as a guideline on how Pakistan, as well as other developing countries, can facilitate the FDI inflows to their economy by creating stable political

environment, corruption less national environment and good infrastructure for the country. By and large, the results of this study suggested that the government of Pakistan can attract an increasing number of foreign investors by promoting an attractive business environment which is eventually characterized by meaningful political stability with good infrastructures in the country's business environment.

1.7 Organization of the Dissertation

Thesis is divided into six chapters as follows.

Chapter 1 elaborates on the background of the study, problem statement, questions and objectives of the research, significance of the research, scope of the research, and organization of the thesis.

Chapter 2 narrates the issues related to the FDI in Pakistan. Moreover, this chapter tries to identify the economic growth and investment policies in Pakistan and comparison with neighboring countries and doing business condition in Pakistan.

Chapter 3 reviews the literature related to the FDI and economic growth and determinant of FDI in Pakistan. Additionally, this chapter gives a significant attention to the relationship between macroeconomic variables and business environment variable, political stability with FDI inflows in the premises of new growth theory and firm investment theory. Thus, this chapter reveals the gaps in the literature and provides suggestions for this study.

Chapter 4 presents the methodology of the research. This chapter also provides detailed descriptions on unit of analysis and data collection method. Moreover, this chapter provides explanations on the statistical techniques used for

preparing data for the multivariate analysis and hypotheses testing. However, checks the data characteristic as stationary or non-stationary using the ADF test using EViews.

Chapter 5 contains the gist of the research binding. It provides a detailed description of variables data collected and descriptive analysis of variables used in the study. Further analysis corresponds to the regression estimation using SPSS 19.0. Due to the relatively small number of observations of the study, compared to the parameters to be estimated, regression analysis was considered more suitable to test the predictive power of the variables of the study as well as for testing the moderating effect of political Stability (PS) on FDI.

Chapter 6 summarizes the study, discusses the significant findings and pin-points the contributions of this study and indicates limitations encountered. This chapter also provides some suggestions for future research work.

CHAPTER TWO

THE HISTORICAL ACCOUNT OF THE ECONOMY AND FOREIGN DIRECT INVESTMENT (FDI) IN PAKISTAN

2.1. Introduction

An understanding of the historical roots of growth and development of Pakistan economy is worthwhile in order to meaningfully examine the growth trends of FDI inflows and its impact in the country over the years; as such, this chapter is addressed to provide an overview of the economic history of Pakistan in a nutshell. Besides, in this chapter a comparison of FDI inflows in neighboring countries and doing business environment is narrated. Finally, the chapter highlights the major issues pertaining to foreign direct investment policy in Pakistan in region of South East Asia.

2.2 Profile of Pakistan

Pakistan as an independent Muslim nation came into existence with the end of British rule and partition of India in 1947. The Muslim populous provinces of India (East Bengal, North-West Frontier Province, Punjab, Sind and Baluchistan) were constituted as Federation of Pakistan. But, within only twenty-five years of its inception, the eastern part of Pakistan separated away as another independent nation in 1971 following a yearlong civil war in the region. This may be attributed to unwarranted economic and political condition in East Bengal region that led to the breakup of Pakistan and the establishment of Bangladesh (Auspitz, Stephen, & Gustav, 1971; Rao, 1972; Bhatia, 1979; Khan, 1997) see, Figure 2.1. Besides this, unfair distributions of government budget and resources into province eventually created differences in infrastructure development causing lopsided economic

development and uneven distribution of growth of economic welfare of the state as a whole.

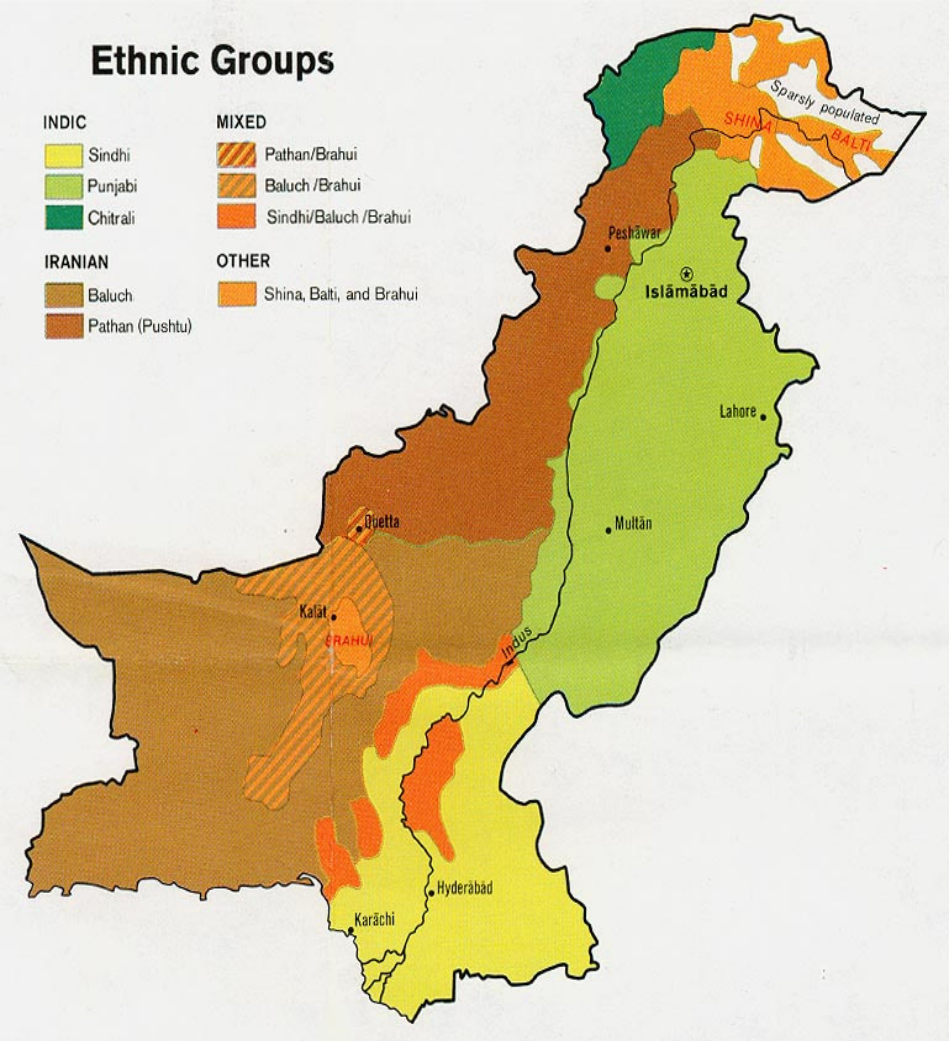

Figure 2.1
MAP of Pakistan

Astonishingly, the economy experienced remarkable economic progress during the army rule between the periods 1958-1970, 1977-1978 and 1999-2007. As a matter of fact, politically, during the sixty-six year's period (1947-2010), for 33(thirty-three) years the county was ruled by the military government and 32 (thirty-two) years ruled by the elected government as reported in Table 2.1. A run

through of data in Table 2.1 reveals time to time, political instability in the country over the years. Pakistan has been unevenly ruled on a short term basis by twenty-five Prime Ministers belonging to different political parties during the period 1947 to 2012. For the list of Prime Ministers details, see, Appendix 1.

Table 2.1
The Government of Pakistan: Political Regimes 1947- 2012

No	Pakistan Government	Years
1	First democratic (elected government) era	1947-1958
2	Army rule government era	1958–1971
3	Second democratic (elected government) era	1971-1977
4	Army rule government era	1977-1988
5	Third democratic (elected government) era	1988-1999
6	Army rule government era	1999-2007
7	Fourth democratic (elected government) era	2008 to present

Source: History of Government Pakistan, 2012 (www.cssforum.com.pk)

2.3 Pakistan Economy and FDI Flows in Historical Perspective

Foreign Direct Investment is unanimously regarded as an engine of growth in developing economies today. Pakistan being no exception needs to understand and examine the economic scenario of the country in historical perspective towards and effects of FDI inflows and related issues. By and large, it is worthwhile to review the growth of Pakistani economy since the last sixty six years to analyze its

strengths and weaknesses. This section highlights the 66 years of economic history of Pakistan with a view to get a better understanding about the political situation and growth of the economy.

2.3.1 Early Years (1947-1958)

The period of 1947–1958 is characterized by two major political distinctions. The central government of Pakistan was located in the Western part. The majority of the upper class Muslim Muhajirs migrated to the Western regions. Consequently, the Federal Government was controlled and ruled by the elite class of Punjabi and Muhajirs. Apparently, the civil and military bureaucracy was dominated by this group. Other tribal groups in such as Pathans, Sindhis, Baluchis and even West Pakistan had limited role in politics and political economic policy of the county (Kazi, 1994).

On the economic front, the Government of Pakistan realized the immediate distorting effects of partition, thus, recognized the urgent need and the importance of the economic development of the nation. Subsequently, the Government drafted the six year Colombo Plan for development to uplift the economic growth. It was made in the absence of basic statistics; thus, it was not grounded on a real assessment of the available human resources, physical and financial inputs and the growth requirements. Moreover, its implementation was not tuned on the indicated lines because of Korean War in 1950-1951. Its course was changed at the time of external economic fluctuations caused by this War. Obviously, the development process was not started properly and some maladjustment intruded in the economy of Pakistan (Husain, 1999).

In the impulsion of growth, though, there was some contribution from the private sector but the government involvement in the economic growth process was much higher. Majority of Karachi-based immigrants were businessman who came from India had brought huge capital with them. So they invested in many industries; especially, textiles were established that was induced by the high increase of cotton prices during the Korean War period. There were also considerable imports in consumer goods in the economy despite the setback of the Korean War. Later on, under the government policy, the private sector responded to protective tariffs, reduced tax rates and substantial depreciation allowances. The protection for consumer goods was specifically high because of an over-valued rupee. Consequently, the domestic production of consumer goods had been increased to 92 percent by 1960 which stood at 22 percent of the total supply in 1952. In a way the progress of the private sector may be attributed to the FDI in the Pakistan economy.

FDI Inflows: 1949-1958

Data in Table 2.2 and Figure 2.2 indicated the trend of FDI inflows in Pakistan during 1949-1958. It follows that foreign direct investment in Pakistan during the period 1949 to 1958 was not steady (Khan, 2007). Foreign direct investment tended to be at the bottom level in the year 1955 and 1958, besides, being at much lower levels specifically as 1.2 million in 1949 and 1.7 million USD in 1950. It may be mentioned that the political condition largely affects the growth of the country. Over the years, Pakistan's growth process was neither stable nor consistent.

Table 2.2
FDI inflows in 1949 to 1958 in Pakistan (Million USD)

Years	FDI
1949	1.2
1950	1.7
1951	4.1
1952	5.9
1953	6.8
1954	7.3
1955	1.8
1956	4.5
1957	5.9
1958	2.2

Source: *SBP, Handbook of Statistics on Pakistan Economy, 2011 p.556.*

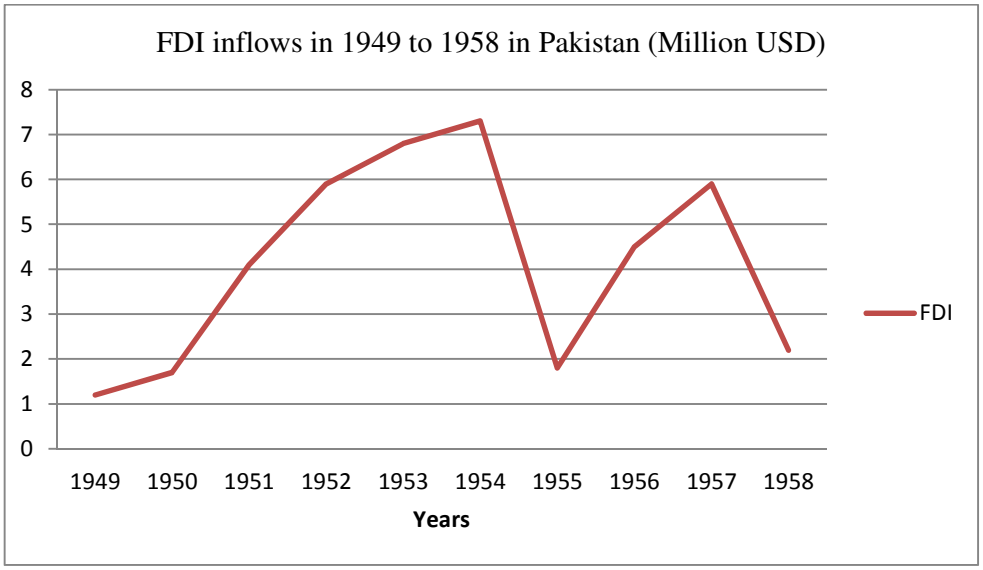

Figure 2.2
FDI inflows in 1949 to 1958 in Pakistan (Million USD)

The government of Pakistan did not take full use of the existing resources such as cheap labor force, and natural resources as well as capacities available in agriculture and industrial sectors.

Owing to the dominance of urban-and industrial-based interests confined to economic policies pursued by the government in the early years its attention to the need for development of agricultural sector remained somewhat neglected. The food exports surplus of rupees 14 million in 1952-1954 was turned into a trade deficit of rupees 220 million by 1957-1959. The pertinent value-added in agriculture estimated to be only1.3 percent into the GDP growth of the country.

Due to the high growth of population in Pakistan, the per capita income remained to be lower in the year of 1955. Although the value-added industry rose by 8.1 percent per annum over all, Pakistan GDP increased by only 2.5 percent in 1957 (Sadeque *et al*., 1957; Khan, 1999). The policy makers, however, gradually realized that agriculture sector should be given priority. For the industrial sector's growth, the growth of agricultural sector was a necessary prerequisite. But the government had little time to see the shift of its overall policy to put into practice. In October 1958, Pakistan military removed the parliamentary government and declared marshall law in to the county, thus, the nation entered into a distinct dictatorial phase of Pakistani political economy (Zaidi, 2004; Ahad *et al*., 2006; Zaidi, Karim, & Kefeli, 2009).

2.3.2 Years of Growth (1958-1969)

The era of 1960s was featured by personal, group, and regional rivalries and political instability resulted owing to military intervention by President Ayub Khan in 1958. A presidential form of government was introduced in the 1962

constitution and a national assembly was elected by an electoral college. Under the new political structure the existing political parties was ban (Jagoutz, 2009; Husain, 2009). As a matter of fact, the bureaucracy was given a freehand to act on the lessons learnt during the 1950s but the role of politicians remained peripheral in the policy and planning matters of the economy. The critics have observed that:

1. It was necessary that economic policies for the country should support the government for their successful application.
2. Implementation of policies became difficult in the absence of effectively organized administration machinery comprising qualified technicians and managers.
3. Provision of private sector initiatives induced by the government did not create much impact since there had been acute shortage of skilled staff.
4. The provision of incentives to private sector had been much below the expectation.
5. Development of agricultural sector was grossly neglected over the years.

In due course of time, major emphasis was placed by the policy makers towards the goal of self-sufficiency in food grains, improvements in the balance of payments (BOP), and growth in per capita income during the years to follow. The heavy investments devoted on irrigation reflected a greater concern for agriculture. Public sector involvement in industrial sector declined, and it was left to the private sector.

In the main production sectors, however, the economic policies largely stimulated the growth process. Major aspects of the economic growth policies in the 1960s can be stated as under:

1. Industrial exports were encouraged by the Export Bonus Scheme in the first half of the 1960.
2. Towards the end of the decade, the use of high-yielding varieties of wheat and rice, a rapid spread of private tube wells for irrigation, the increased use of fertilizers uplifted the growth in agriculture sector.
3. Government policies of price controls were changed for agricultural goods, restrictions on the movement of food-grains were lifted, fertilizer supply was located in private hands, and government involvement through price subsidies and lower export duties on cotton and jute helped in improving to some extent the growth of the farm income.

FDI Inflows: 1958-1968

The trend of FDI inflows in Pakistan during the period 1958-1968 is shown in Table 2.3 and portrayed in Figure 2.3. A number of problems emerged by the end of the decade, which specified that economic growth was not firmly established as had been expected. Despite the Export Bonus Scheme, exports began to experience serious difficulties, as industry's markets had been eroded by an overvalued rate of exchange that resulted in deceleration of the foreign direct investment. Table 2.3 and Figure 2.3 indicated that foreign direct investment declined in the period 1961 to 1963 (SBP, 2011).

Table 2.3

FDI Inflows in 1958 to 1968 in Pakistan (millions of USD)

Years	FDI
1959	3
1960	5.9
1961	2.3
1962	1
1963	2.5
1964	37.1
1965	3.9
1966	49.5
1967	37.1
1968	1.4

Source: *SBP, Handbook of Statistics on Pakistan Economy, 2011 p.556*

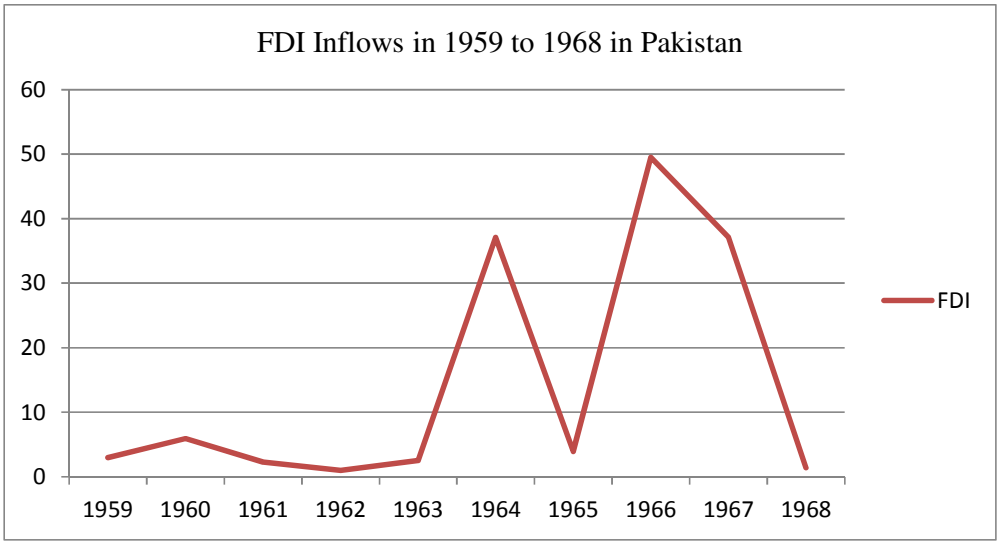

Figure 2.3

FDII Inflows in 1958 to 1968 in Pakistan (Million USD)

Foreign direct investment inflows were restricted during 1965-war with India as per the data showed in Table 2.3 in year 1965. During the 1960s, in Pakistan income-inequalities had widened. The Chief Economist of Pakistan categorically stated in April 1968 that: few families owned 66 to 87 percent national resources such as industrial wealth, banking and insurance in the country. These families have strong influence on the country's political parties. On the other hand, these families received undue favor from the government. There was also a widening gap of unequal economic progress and regional inequalities in the East and West Pakistan as revealed by the data contained in the Table 2.4 and Figure 2.4. Government of Pakistan's least concern for political instability, as such, carried adverse effect on implementation of economic policies in the country (Zakaria, 2008).

Data contained in Table 2.4 and Figure 2.4 reveal that the two wings of the nation had diverged significantly in economic outcomes. This may be attributed to the deliberate anti-East and pro-West wing policy being pursued by the Federal Government of Pakistan (Rao, 1972; Rahman, 1986). For example, despite inhabiting 60 percent of the population, East Pakistan's share of Federal Government development expenditure was as low as 20 percent during 1950-1951 to 1954-1955. The expenditure was raised at 36 percent during the period of 1965-66 to 1969-70. Unequal allocation of central government funds caused inequality to widen further in the provincial budgets. To facilitate the process of industrialization in the West Pakistan, the Central Government transferred productive resources from the East Pakistan with specific moves. Firstly, through inter-regional trade, secondly, the East region was allocated a meager fraction of the total foreign aid received, and thirdly, the economic policy was directed to

fully support the process of industrialization in the West Pakistan. In addition, under the fiscal management a complex system of taxes planned by the Central Government was meant to collect more revenue from East Pakistan (Feldman, 1971; GOP, 1970; Huq, 1973).

Table 2.4
Per Capita Income East and West Pakistan Period of 1949-1970 (rupees)

	1949-1950	1951-1958	1969-1970
Pakistan	312	318	423
West Pakistan	334	365	536
East Pakistan	283	279	330
East-west gap	51	88	206

Source: Federal Bureau of Statistics of Pakistan.1998

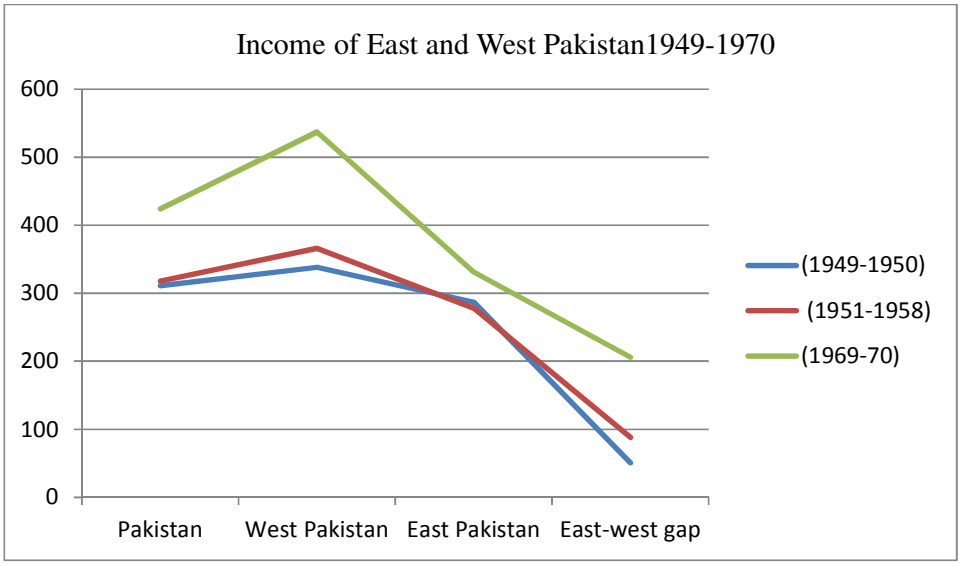

Figure 2.4
Per Capita Income East and West Pakistan Period of 1949-1970 (rupees)

By the end of the decade of 1970s, growing confrontation to the policy of basic democracy interacting with the social and economic problems resulted into augmentation of social and political instability in the country. It had cropped up in the sequence of events that ultimately lead to another war with India resulting into

the separation of East Pakistan, which implied creation of new nation referred to as Bangladesh in December, 1971.

2.3.3 Years of Nationalization (1972-1977)

The detachment of East Pakistan in 1971 politically implied a gloomy environment causing loss of confidence and moral death of Yahya Khan's anarchical regime. When Zulfiqar Ali Bhutto became the Prime Minister in December, 1971, the new government moved swiftly to tackle the anarchy and to restore confidence. The new government affirmed goal of restructuring the country's political and economic system, and molding a 'new Pakistan'. All the largest companies, life insurance, petroleum companies, vegetable ghee industry, banks and shipping and export trade of rice and cotton of Pakistan were nationalized during 1972 to 1974 (SBP, 2004; UNDP, 2004; Zaidi, 2005). The Government agency was established by which the pricing, production and other decisions of the firms were coordinated in 1972. The elite civil service was changed in 1973 and introduced the new administration system. The new government devalued the Pakistani rupee substantially (by over 100 percent) from Rs: 4.76 to one US dollar to Rs: 11.00 to one US dollar in 1972 and the export bonus scheme were terminated. The decline of Pakistani rupees (currency) external values against US dollar by more than 100 percent caused severe repercussions in the Pakistan economy. Moreover, there occurred a declining trend in FDI inflows in the country (see, data in Table 2.5 and Figure 2.5) as an adverse impact of nationalization. A bottom level at 0.5 million is remarkably seen in the year 1973 (SBP, 2011).

Table 2.5
FDI Inflows in 1969 - 1978 in Pakistan (Million USD)

Years	FDI
1969	59
1970	72.1
1971	90.1
1972	8.1
1973	0.5
1974	6.3
1975	14.9
1976	22.5
1977	10.7
1978	35.5

Source: *SBP, Handbook of Statistics on Pakistan Economy, 2011 p.556*

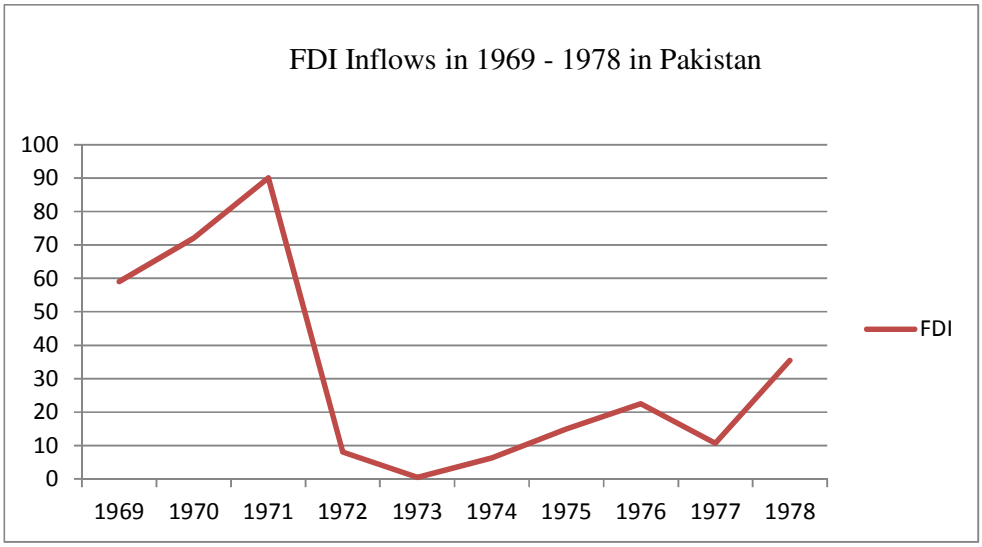

Figure 2.5
FDI inflows in 1969 - 1978 in Pakistan (Million USD)

Under the Bhutto regime, initially the Pakistan economy grew during the year 1971 but the year 1972 witnessed a marked turmoil. This may be attributed to

the unfavorable weather conditions so that the growth in the agricultural sector had fallen below the population growth rate. The resulting imbalance in food supply management, however, created administrative problems by government involvement in the supply of agricultural inputs.

Foreign direct investment as shown in Table 2.5 and private industrial initiatives were jeopardized under the fear of further nationalization along with a constantly declining profit margins and the temporary export boom of 1972-73. The Government assumed that foreign direct investment could be channelized to new intermediate and capital goods industries in the public sector investment and distributed in a wider basis without affecting growth (Ataullah *et al.,* 2004).

Among other things, thus, wages were increased, security of employment was established (e.g., pensions right for workers), the cost of human capital increased with new fringe benefits, and the trade unions were strengthened by a series of policy measures introduced in the country. The devaluation of the currency increased input costs of the foreign components and it also adversely affected the costs of materials supplied domestically and foreign loans as well as the burden of debt servicing. Overall income level declined, using the old equipment and obsolete technology in agriculture as well as in high tech industry, the overall efficiency was lowered, and investment in traditional industries such as textiles fell low below the replacement rates (Khan, 2007; Zaidi, 2005).

In short, nationalization scheme created a negative impact on foreign direct investment. The foreign investor was afraid to invest in Pakistan under such a threatening political environment. Nationalization in financial sector relating to banking and life insurance, devoid of planning and any groundwork, implied

intricate administrative programs of public sector management. During the period of seventies like other non-oil-exporting countries, Pakistan was further affected by the dent of international economic crisis, particularly, world inflation due to increased demand and energy sector prices.

It is disheartening to note that corruption rose to higher levels in Zulifqar Ali Bhutto's time. The defective policies of the government during period 1972-1977 resulted into constant stagnation in the economy's growth process. The government had promised unduly enlarged development projects, corresponding with rising non-development expenditures and unending subsidies. Slow growth of exports against rising imports caused deterioration in the BOP position and the monetary expansion had created economic and social conflicts. Pakistan was living beyond its resource capabilities during that time. The year 1977 witnessed watershed event in the economy of Pakistan. A complicated system of controls, unwarranted macro environment policy, and nationalization put the negative impact on the growth (Khan, 1997).

2.3.4 Years of Country's Economic Expansion (1978- 1990)

During the 1980s, the process of the country's economic progress was slow in pace but the government achieved some modest success. General Zia-ul-Haq ceasing the political power in July 1977, immediately embarked upon policy adjustments to accelerate the economy's developmental process. This policy process implied increased use of resources and control of government spending, decreasing huge investment program in the public sector, and establishment of a system to review the performance of the public sector industrial enterprises. The government also gave due importance to the private sector. The agricultural industries were denationalized, and the scope for foreign direct investment was

greatly extended. Under policy flexibility the government provided tax rebates, and other incentives were initiated to push exports under the perspective view of the policy makers in Pakistan.

FDI Inflows: 1978- 1990

Data in Table 2.6 and Figure 2.6 revealed that in the country with political stability tuned with dismantling all the old policies against investment lead to growing FDI. Indeed, data in Table 2.6 showed rising trend of foreign investment owing to the political stability of Pakistan over the years 1978 onwards (Khan & Kim, 1999).

Data in Table 2.6 and Figure 2.6 indicate that the FDI jumped from $10.7 million USD in 1976/19777 to $161.2 million USD in 1986/1985 and further to $217.4 million USD in 1988/1989. However, FDI was decreased by $7 million in year of 1990 as against that of 1989. The policy makers of Pakistan, nonetheless, failed to rectify the imbalances between saving and investment, imports and exports which eventually caused sizeable BOP and budgetary deficits, by the end 1990 year, despite remarkable growth in both agriculture and industrial sector. It follows that Pakistan's economy as such was in utter need of some major structural transformations (Nabi & Luthria, 2002).

Table 2.6
FDI Inflows in Pakistan 1977 – 1990 (Million USD)

Year	Total
1976/77	10.7
1977/78	35.5
1978/79	36.0
1979/80	28.2
1980/81	35.0
1981/82	98.0
1982/83	42.1
1983/84	48.0
1984/85	93.7
1985/86	161.2
1986/87	129.0
1987/88	172.7
1988/89	217.4
1989/90	211.5

Source: *SBP, Handbook of Statistics on Pakistan Economy, 2011 p.556.*

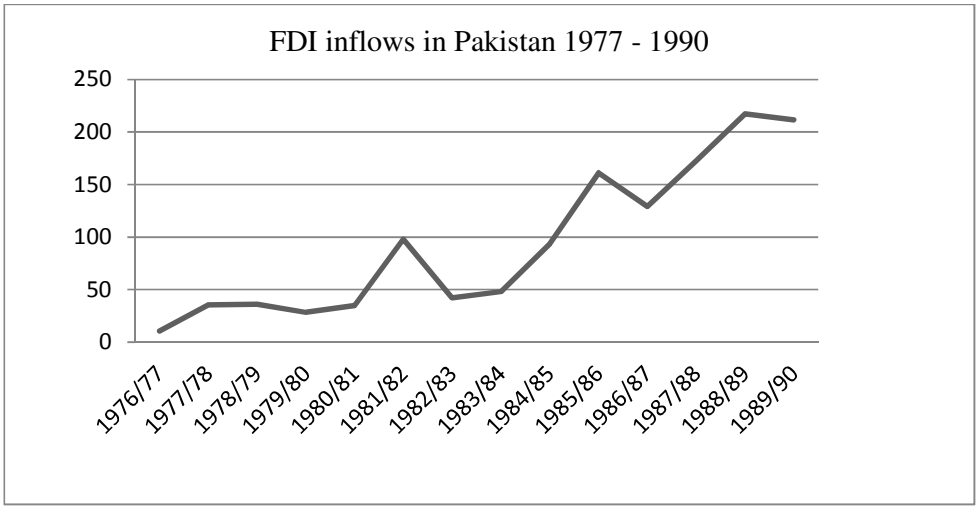

Figure 2.6
FDI Inflows in Pakistan 1977 – 1990(Million USD)

Damaging economic effects were created with increases in wages rates. Agriculture reforms were introduced at levels comparable to prevailing world trends. Also steps were taken to improve inputs availability to the farmers. Such measures lead to some success in strengthening the economy to an extent, nevertheless, gigantic efforts were still required and some policy changes were necessary for long term benefits to boost the economy (Akhtar, 1995, 2001).

Missing Links of Unfinished Agenda

Inspite of certain fundamental reforms and some growth achievements in the period 1978-90, Pakistan's economy has never come out-of the shell of certain key structural weaknesses. These weaknesses are identified as under:

- Very low government savings with a large budget deficit, a narrow and inflexible revenue base overly dependent on trade taxes, high intake costs, and poor development expenditures.
- A high liability on maintaining level.
- An incompetent financial sector with mostly public ownership, directed credit, underdeveloped markets, and weakness of commercial banks.
- A highly controlled economy with public ownership, industrial licensing, and price controls.
- A non-competitive and distorting trade regime with import licensing, imports bans, and high tariffs.

By the end of 1988, the recession caused financial crisis. Government of Pakistan’s budget deficit reached to the level of 8.5 percent of the GDP and the current account of BOP deficit doubled to 4.3 percent of the GDP. Inflation Rate went up to over 9 percent. Pakistan corruption level was also increasing (Zaidi, 2005). Pakistan’s foreign reserves depleted by half from $886 to $438 million,

amounting to less than 3 weeks of imports. The weakness of BOP of the country needed strategy to strengthen the system of the economy by way of:

- Exerting growth expansion;
- Limiting the domestic absorption of imports;
- Enhancing exports;
- Diversifying export trade;
- Stimulating remittance inflows; and
- Changing the character of external capital inflows by eliminating dependence on short term credits and simultaneously the raising the scope for enlarging the inflow of foreign direct investment.

2.4 Pakistan FDI inflows in the Asian Setting: A Selective Approach

For the sake of comparison, FDI inflows in India, Pakistan, Malaysia and Bangladesh are shown in Table 2.7 and Figure 2.7 for period 2001-2010. Based on the data in Table 2.7, India FDI inflows is increasing at a much faster rate compared to Pakistan. Among striking economic issues, however, the most remarkable one is the fact that inflation rate in Pakistan is much higher than that in the case of India.

2.4.1 FDI Gamut: India versus Pakistan

Time and again, India and Pakistan have not been maintaining cordial political relationships, thus, it is interesting to make an economic comparison between these two border nations detached in brotherhood and their distinct capabilities in attracting the FDI inflows.

Table 2.7

FDI Inflows in 2001 to 2011 Pakistan Comparisons with Neighbor Countries (million USD)

Years	Bangladesh	Malaysia	India	Pakistan
2001	354.50	553.9	4029.00	322.50
2002	328.30	3,203.40	6130.00	484.00
2003	350.30	2,473.20	5035.00	798.00
2004	460.40	4,624.20	4322.00	949.00
2005	845.30	4,065.00	6051.00	1524.00
2006	792.50	6,060.20	8961.00	3521.00
2007	666.40	8,594.40	22826.00	5410.20
2008	1086.30	7,176.90	34835.00	5139.60
2009	700.20	2,429.90	37838.00	3719.90
2010	913.30	9,103.30	37763.00	2205.70

Source: SBP annual report, 2011; UNCTAD, 2011
RBI, Handbook of Statistics on Indian Econom.2011

According to UNCTAD (2007), India has become one of the most attractive country for FDI after China, USA, Russia and Brazil. India had received a lot of FDI inflows in the last few years shown in Table 2.7 compared to Pakistan. India, with its comparatively strong industrial base, well-established financial sector, and critical mass of well skilled labor force, appears to be well suited to pick the benefits of FDI. In view of this, it is obvious that Indian policy makers are continually making concerted efforts to pose India as an attractive destination for

foreign direct investment. The Indian government is committed to provide both private and public companies a very favorable business environment to encourage FDI. India has highly liberalized the foreign investment rule over the last few years. FDI is permitted in a number of sectors under the automatic route, except a few, for which approval from the Foreign Investment Promotion Board (FIPB) is required. India's foreign trade policies were devised in order to attract foreign direct investment in India. The procedure of regulation and approval has been grossly liberalized. Important point to discuss with this present study to investigate why Pakistan FDI inflows is declining over the years since 2007 whereas FDI inflows in India are consistently increasing over last 10 years. Why in the same region India could attract the FDI inflows and Pakistan cannot attract the FDI in the same fashion for the economic growth.

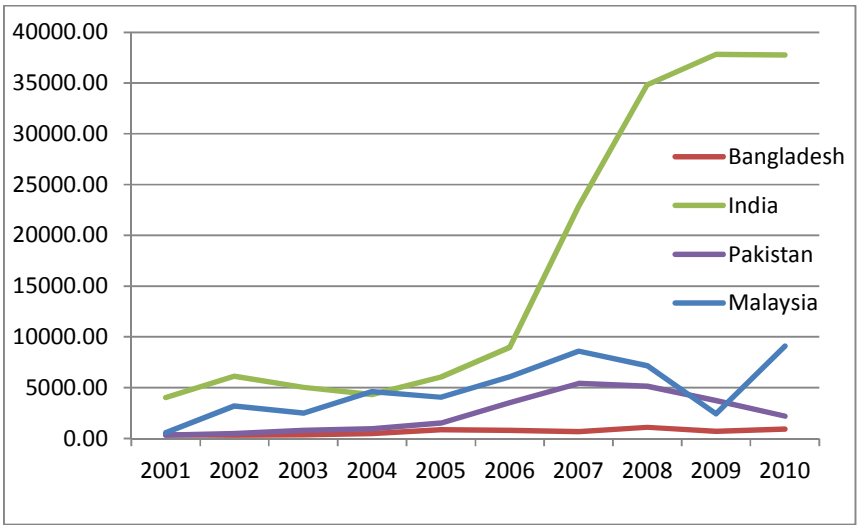

Figure 2.7
FDI Inflows in 2001 to 2010: Pakistan in Comparison with Neighboring Countries.
Source: SBP annual report, 2011; UNCTAD, 2011
RBI, Handbook of Statistics on Indian Econom.2011

There are few reasons for why India is regarded as a good place for foreign direct investment. India has a high spendable income, emerging middle class, low

cost competitive workforce; business friendly investment policies and progressive improvement process all contributing towards India being an appropriate choice for investors. A comparison of India and Pakistan on policy matter is worthwhile thus:

- India is now recognized as one of the world's rapid growing country, as well as the second most crowded next to China. Figure 2.7 shows in the beginning years of 2001 to 2005 the foreign direct investment inflows difference was not much between India and Pakistan. Thereafter, during 2006 to 2010, India attracted a quantum of FDI inflows at increasing rate, whereas, in the case of Pakistan during 2008-2011 the foreign investment has been constantly declining.
- Faster growth achievement enabled India to be a leading world exporter of certain products such as software, ICT equipment, vegetable oils and pulses. Pakistan's exports are comparatively much lower as compared to India with regard to these items.
- Despite a rich and extensive agricultural resource base and rising farm subsidies, agro sector investment and growth have remained sluggish in India, thus, creating pressure for reform of domestic agricultural policies.
- Inspite of difficulties in achieving overall consensus on the reform agenda, the measures to increase market orientation, promoting use of technology, and growth incentives for private investment are increasing in India.
- India has achieved GDP amount to 1,367.216 billion USD in the year 2010 (RBI, 2010). Indian's economic growth rate was measured to be around 7-8 percent per annum. In comparison, Pakistan's GDP growth rate is a much lower level than India showed in Figure 2.8 (SBP, 2011).

- India has relatively managed a better stable political environment that is facilitating inflows of foreign direct investment. On the other hand, Pakistan tends to have some problem with political stability. Pakistan's existing elected democratic government is virtually weak to sustain stable political situation in the existing circumstances.
- India relatively possesses a relatively well-established judiciary to enforce the law and order situation in the country which is better than that of Pakistan.
- In a way India is a land of rich natural resources and climatic conditions similar to Pakistan.
- Under the BRIC economy segment of the global arena, it is believed that India's growth is likely to overtake China within next three to five years and thus it will become the fastest growing large economy with 9-10% growth over the next 20-25 years (RBI, 2010).
- India has been consistently introducing investor friendly policies and incentive packages for FDI. Pakistan has not been offering similar packages.
- India has received a total of $37763.00 million USD FDI in 2010 which makes it a second favorite for foreign investors next to China (UNCTAD, 2011).
- India's investment rate was 37 percent in 2010 and 38.4 percent in 2011 while domestic savings rate is forecasted to be 34 percent in 2010 and 36 percent in 2011. On the other hand, Pakistan's total investment rate is estimated to be13.8 percent in the year 2011 and domestic saving rate at 9 percent (UNCTAD, 2011).

- India's core competitiveness is attributed to low labor costs. Pakistan also bears the same features.
- India's total labor force is estimated to be almost 530 million as against Pakistan's labor force of around 120 million.
- India has unique advantage of having a large pool of skilled labor force and strong knowledge base with IT skills and English speaking population. Pakistan is lacks this resources.
- There is huge untapped market potential in the India and Pakistan economy.
- India has moved towards simplification and rationalization of direct and indirect tax structures in an effective manner.
- India's GDP growth rate is higher than that of Pakistan. See, Figure 2.8.

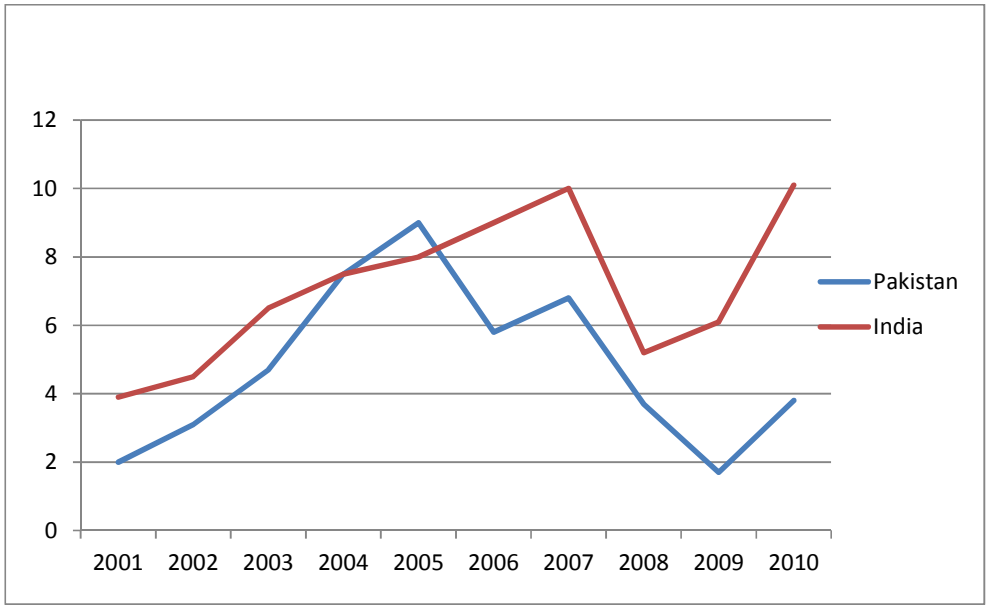

Figure 2.8
Comparison of GDP Growth Rate in 2001 to 2010 A between Pakistan and India
Source: SBP annual report, 2011, RBI, Handbook of Statistics on Indian Econom.2011

Figure 2.8 reported that the growth rate of GDP of India during the period of 2000-2010 is better than that of Pakistan (IMF, 2011). There has been a debate among economists centering on the growth performance of the economy in the

post reform period. While the more popular view holds that growth has accelerated after the implementation of the reforms package in India, no such observations are recorded for Pakistan.

2.4.2 Concluding Comments

The rising trend of FDI in Pakistan seems to be insignificant when we compare it with other countries such as India, Malaysia and Bangladesh. The reasons for a lower level of FDI inflows in Pakistan include: poor infrastructure, political instability, macroeconomic imbalance, inconsistent economic policies of successive governments, past and unsolved or unsatisfactorily solved disputes between foreign investors and the government, no protection of intellectual property, arbitrary and non-transparent applications of government regulations, and inconsistent political relations with key investing countries (Khan, 2007).

2.5 Sectoral Distribution of FDI Inflows in Pakistan

To examine the trends and structural pattern of FDI inflows in Pakistan; it is worthwhile to review its overall sectoral distribution pattern. The sectoral distribution of FDI inflows may reflect two points: on the one hand, it may reflect the preferential treatment given by the government to certain sectors while encouraging FDI, and on the other hand, it may also indicate the foreign investors' own preferences. Data in Table 2.8 showed related to the sectoral distribution of FDI inflows in Pakistan during 2001-2010.

Table 2.8
FDI in Sectorial distribution in Pakistan (Million USD)

Sector	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Oil & Gas	80.7	268.2	186.8	202.4	193.8	312.7	545.1	634.8	775.0	740.6
Financial Business	34.9	3.6	207.4	242.1	269.4	329.2	930.3	1864.9	707.4	163.0
Textile	4.6	18.5	26.1	35.4	39.3	47.0	59.4	30.1	36.9	27.8
Trade	13.2	34.2	39.1	35.6	52.1	118.0	172.1	175.9	166.6	117.0
Construction	12.5	12.8	17.6	32.0	42.7	89.5	157.1	89.0	84.4	74.6
Power	39.9	36.4	32.8	14.2	73.4	320.6	193.4	70.3	130.6	120.6
Chemical	20.3	10.6	86.1	15.3	51.0	62.9	46.1	79.3	74.3	112.1
Transport	45.2	21.4	87.4	8.8	10.6	18.4	30.2	74.2	63.2	132.0
Communication	-	12.8	24.3	221.9	517.6	1937.7	1898.7	1626.8	879.1	291.0
Others	140.9	66.2	90.4	170.1	274.0	285.0	1107.2	764.5	763.4	586.3

Source: Board of Investment, Government of Pakistan, 2011

Data in Table 2.8 reveal that the inflows of FDI up to 2003-07 were relatively broad-based, with almost all sectors witnessing an increasing trend in the country. However, during 2008 to 2011 FDI inflows have decreasing trend in communication, financial and business sector, oil and gas, textile, construction and other areas of business. The major sector receiving FDI inflows in Pakistan is power gas and petroleum, manufacturing, telecommunication, trade and commerce, textile industry, construction of power, chemical and other business. Pakistan is facing important issues concerning political instability, corruption and bad governance over the years. This will affect the overall growth of the country in the course of future direction as well.

2.6 Doing Business in Pakistan

FDI inflows depend on conducive business environment. Ease of doing business; thus, play a significant role. The present section will highlight the current business environment in Pakistan and comparing it with other countries.

Table 2.9 and Figure 2.9 represent the data of components of doing business showing Pakistan's rank (out of 180 economies) with selected countries, namely, India, Sri Lanka, Bangladesh and Malaysia.

Every year the World Bank conducts a study on "Doing Business" in several countries. As per the doing business report of 2010 and 2011, India is ranked 139 out of 180 economies and Pakistan ranked is 105 out of 180 countries and Sri Lanka 89 out of 180 countries and Malaysia ranked 23 out of 180 countries. The World Bank (2011) report is based on a series of annual records on investigating the regulations that enhance business activity and related constraints involved. Doing business report presents quantitative indicators on business regulations and the protection of property rights that can be compared across 180

economies-from Afghanistan to Zimbabwe-and over time. The World Bank report considers 10 indicators and they are fairly self-explanatory. The World Bank indicators are employing workers, dealing with licenses, trading across borders, protecting investors, paying taxes, starting a business, registering property, getting credit, enforcing contracts and closing a business. The report of doing business clearly indicated that Pakistan's rank was going down in 2011 at 105 comparing to that of the previous year's 96.

Table 2.9
Doing business in Pakistan comparing with other countries 2010 to 2011

Doing Business	**India**		**Malaysia**		**Sri Lanka**		**Pakistan**	
	2010	2011	2010	2011	2010	2011	2010	2011
Doing Business Ranking	139	132	23	18	98	89	96	105
Starting a Business	166	166	111	50	35	38	86	90
Dealing with Licenses	181	181	111	113	110	111	100	104
Employing Workers	98	98	60	59	97	95	170	166
Registering Property	97	97	59	59	158	161	125	125
Getting Credit	40	37	1	1	75	78	64	67
Protecting Investors	46	44	4	4	74	46	28	29
Paying Taxes	165	147	39	41	171	173	116	158
Trading Across the Borders	107	109	28	29	53	53	75	75
Enforcing Contracts	182	182	60	31	136	136	155	154
Closing a Business	128	128	57	47	44	42	71	74

Source: World Bank Report 2011

UNCTAD Report (2011) has pinpointed its concern regarding issues of consistent military role, higher inflation rate, increasing the corruption level, and inefficient bureaucracy, bad infrastructure of the country and political instability of the country, and inconsistent policy making as the most problematic factors in doing business in a developing country such as Pakistan.

2.6.1 Global Competitiveness Index: A Comparison

The Global Competitiveness Index (GCI) is a tool suggested by World Economic Forum to assess the competitiveness of nations. It measures the microeconomic and macroeconomic foundations of national competitiveness. The measured variables include as policies, institutions, and factors that determine the

level of productivity of a country. The level of productivity, in turn, determines the sustainable level of prosperity that can be earned by an economy. The productivity level also determines the rates of return fetched by investments in an economy. Because the rates of return are the fundamental determinants of the growth rates of the economy, a more competitive economy is one that is likely to grow faster over the medium to long run. Data in Table 2.10 and Figure 2.9 refer to the global competitiveness of Pakistan in comparison with other Asian countries such as India, Malaysia and Sri Lanka. The global competitiveness of India is better than Pakistan. Table 2.10 highlighted that global competitiveness of Pakistan was not changed from recent years. Comparatively, global competitiveness of Pakistan is lower than other Asian countries such as India, Malaysia and Sri Lanka.

Table 2.10
Global Competitiveness of Pakistan compared to other selected Asian countries: 2006 to 2011

Countries	2006	2007	2008	2009	2010	2011
India	4.4	4.3	4.3	4.3	4.3	4.3
Malaysia	5.1	5.1	5.0	4.9	4.9	5.1
Pakistan	3.7	3.8	3.7	3.6	3.5	3.6
Sri Lanka	3.9	4.0	4.0	4.0	4.3	4.3

Source: World Bank Report 2011

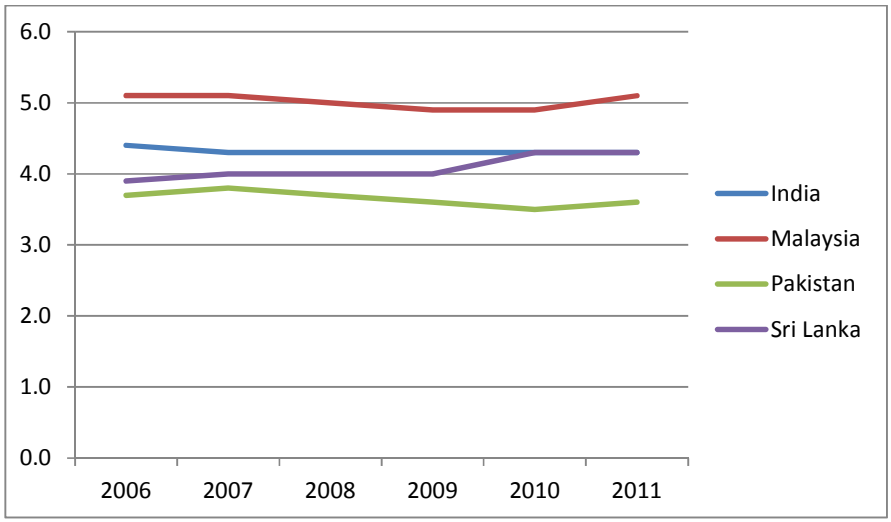

Figure 2.9
Global Competitiveness of Pakistan comparing with selected Asian countries 2006 to 2011

2.7 Pakistan Capital Formation: A Comparison

Data in Table 2.11 and Figure 2.10 related to capital formation as percentage of GDP to total domestic and foreign investment in the country for the recent years. It is revealed that, Pakistan had a capital-formation GDP ratio of 22 percent in the year 2008, 18 percent in the year 2009 and 15 percent in the year 2010, as compared to India having a capital formation of 35 percent GDP ratio in the year 2008, 36 percent in the year 2009 and 35 percent in the year 2010. It is observed that in Pakistan domestic and foreign investment is lower than that other countries India, Sri Lanka, and Bangladesh. Pakistan as a developing country needs to improve her overall investment activity. Evidently, Pakistan needs desperately the foreign direct investment to increase the investment level in the country for economic growth.

Table 2.11
Capital Formation (as percentage of GDP) in Comparison to Other Countries

Country's	**2008**	**2009**	**2010**
Pakistan	22	18	15
India	35	36	35
Sri Lanka	28	24	28
Bangladesh	24	24	24

Source: World Bank Report 2011

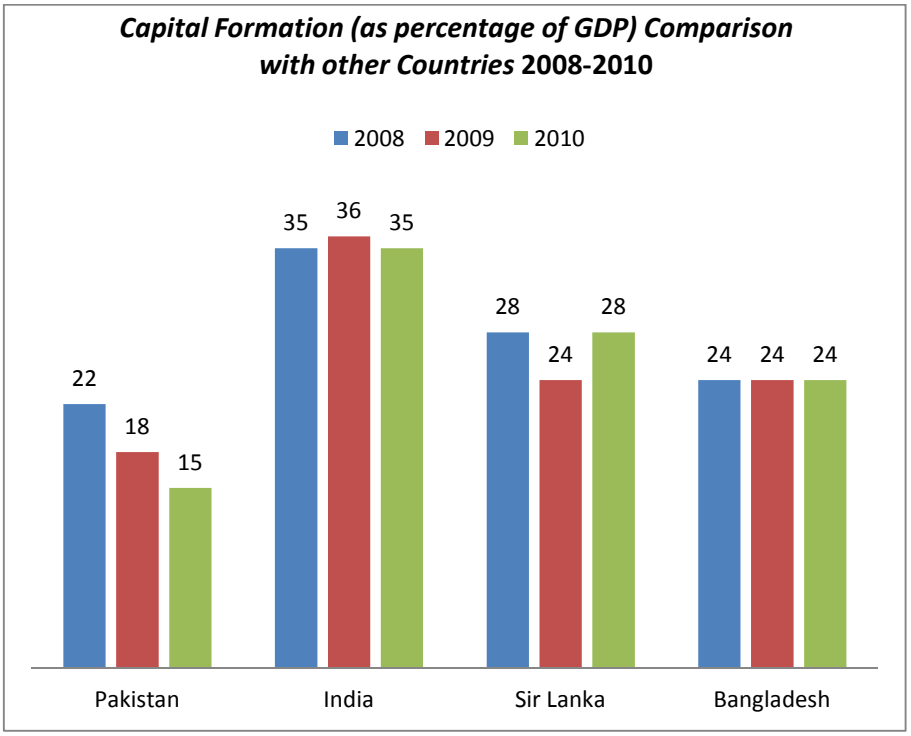

Figure 2.10
Capital Formation (as percentage of GDP) in Comparison to Other Countries

2.8 A Perspective on Reasons to Invest In Pakistan

In this section, an attempt is made to pin-point certain spots where foreign investments are possible and desirable. Pakistan can attract resource seeking FDI since it is endowed with a natural advantage, such as:

2.81 Abundant Land and Natural Resources

Pakistan is endowed useful with natural resources. The country possesses extensive agricultural land, having crop production such as rice, wheat, cotton, fruits, vegetables and livestock. It also has mineral reserves such as crude oil, coal, natural gas, iron ore, copper, gypsum, and fisheries. Pakistan produces world class cotton in the world economy. Foreign investors have incentives invest in Pakistan in the textile and agro-based industries.

2.8.2 Geo-strategic Location

Pakistan is located in the heart of Asian region. As a matter of fact, Pakistan is well integrated and linked to the energy rich Central Asian States, the financially liquid Gulf States and the economically advanced countries.

2.8.3 Potential in the SAARC Region

In the SAARC region, Pakistan can become strategic business center and marketplace filled with enormous possibilities and opportunities in the global economic arena.

2.8.4 Trained Workforce

In Pakistan people are hardworking and intelligent and mostly understand the English language. The country's human capital in companies comprising cost-effective managerial and technical workers, with relatively lower pay packages they bear lesser costs of expertise and are highly productive. Cheap labor force is also available in Pakistan.

2.8.5 Investment Opportunities in Pakistan

There are good investment opportunities available in the following sectors of Pakistan economy such as oil and gas sector, energy sector, information technology (IT), area of telecommunications, high technology, field of agricultures, construction, textile industries, building Infrastructure, health , tourism sector, mining and minerals, and services sector.

FDI can largely come in to these areas in Pakistan. Energy areas pose big demand for investment now days in Pakistan as there has been shortage of electricity roughly estimated to be more than 10 to 15 hours per day (UNCTAD, 2011).

2.9 Foreign Direct Investment Policy in Pakistan

Critics have remarked that government policies of Pakistan have not produced warranted effect on FDI inflows in the country. Some critics have argued that Pakistan policy makers can either assume policies of stimulating FDI or they can restrict and stop foreign participation in their economies in different ways (Zaidi, 2005; UNCTAD, 2000; SBP, 2009). Pakistani policies have affected the perception of political instability assumed by transnational corporations (TNCs) and thereby the amount of investment of these companies. Pakistani economic policies can channel investment flows toward sectors considered important to the country's development. For a better understanding of the significance of government policy on the FDI issues, below a brief account of Pakistan investment policies.

2.9.1 FDI Act of 1976

The Act is meant to give the support and security in Pakistan to FPI (Foreign Private Investment). This Act was called the FPI Act, 1976 which is applicable to all industrial deeds in Pakistan having FDI recognized with approval of FG (Federal Government) in September 1954. Under this Act, foreign private investment passes on industry, undertaking or institution measured in the production, distribution or processing of goods, and provision of services mentioned by the Federal Government.

2.9.1.1 Fields for FPI (Foreign Private Investment)

"The Federal Government may, consistent with the national interest, for the promotion of foreign private investment, authorize such investment in any industrial undertaking:"

- Pakistani economic policies in the opinion of the Federal Government are attractive.
- Pakistan will improve the country's economic policy for the social needs.
- FPI will help the nation in several ways such as: (i) Expiations of Pakistani Resources (ii) The channelization, recruitment or improved utilization (iii) Improving the BOP (Balance of Payments) (iv) Enhancement of economic growth of the country.

2.9.1.2 Approval of FPI

Federal Government authorizes an industrial responsibility to a firm having FPI, some of the order as it may identify in the terms of contract.

- Federal Government is responsible for the public benefit to take over the controlling of an industrial FPI to give shares to citizen of Pakistan and the

capital. Federal Government relating to such actions can enter into nexus of foreign businessman and none in Pakistan will be affected by such losses.

- FPI shall not be obtained except under the due process of law. That is to provide sufficient reward in the currency of the country of origin of the investment.

2.9.1.2 Repatriation Facilities

As per of the act repatriation is subject to foreign exchange regulation Act, 1947, thus:

- Federal Government provides the facilities to foreign investor since September, 1954 and authorizes to foreign investor at any time to send back money to the own country.
- Earnings of such asset.
- Extra amount from the reinvested profits or appreciation of capital investment.
- Federal Government will approve the foreign currency loans and interest.

2.9.1.3 Remittances

"Remittances by foreign employees foreign nationals employed with the approval of the Federal Government in any industrial undertaking having foreign private investment may make remittances for the maintenance of their dependents in accordance with the rules, regulations or orders issued by the Federal Government or the State Bank of Pakistan (BOI, 2011). "

2.9.1.4 Tax Concession and Escaping of Double Taxation

The following points have been stressed in this context:

- Federal Government may agree to such concessions to industrial undertaking having FPI.

2.9.1.3 Equal Treatment

Under the Act of 1976 for Industrial agreements for foreign private investment shall be accorded the same treatment as similar to industrial decision, having no such in the involvement application of laws, rules and regulation, relating to importation and exportation of goods.

2.9.2 FPI (Foreign Private Investment) Act 1992

This act served for requesting investment activity towards economic development of Pakistan. It implied that:

- It is warranted to create an open field environment for foreign investor to invest in Pakistan. When a number of economic development plans and policies have been introduced.

2.9.2.1 Short Title

The following points have been stressed in the Act:

- The name of this act called the Protection of Economic Development Act, 1992.
- Federal Government and the State Government will be included in the contract.
- Economic development polices and programmers, laws and rules announced, nationalized banks, promotion of savings investments, privatization of public sector enterprises, banking sector, finance, opening of economic incentives for economic development, exchange and balance of payments (BOP) systems, asset and transfer of currencies.

2.9.2.2 Over-ride other Laws

This Act will effect notwithstanding on controlled in the FER Act, 1947, the society Act, 1969 or any other law for the time being in force.

2.9.2.3 Autonomy to Bring (Foreign Currency)

The policy for foreign currency holder mention in policy board of investment in Pakistan "All citizens of Pakistan resident in Pakistan or outside Pakistan and all other persons shall be entitled and free to bring, hold, sell, transfer and take out foreign exchange within or out of Pakistan in any form and shall not be required to make a foreign currency declaration at any stage nor shall anyone be questioned in regard to the same (BOI, 2011) ".

2.9.2.4 Protection Policy of Foreign Currency Accounts

- All Pakistani resident inside and outside the country, foreign currency accounts in Pakistan, and all other people shall carry on to enjoy protection from the Income Tax or any other taxation authority.
- The foreign currency accounts and income continued to remain except from income tax and deduction of Zakat.
- In Pakistan all banks will confidentiality undertake transactions of the foreign currency accounts.
- State Bank of Pakistan or other banks will not enforce any restriction on running the foreign currency account.

2.9.2.6 Security of Economic Incentives for Setting-up of Firm

The economic incentives for investment provided by the Government through the legal orders listed in the schedule of the contract.

2.9.2.7 Protection of Transfer of Tenure to Private Sector

The tenure, management and control of any banking, commercial, manufacturing or other company, institution or enterprise transferred by the Government to any person under any law shall not again be compulsorily acquired or taken over by the Government for any reason whatsoever.

2.9.2.8 Protection of Foreign Investment

Foreign business recognized or owned in any form by a foreigner or Pakistani investor for private gain should be in accordance with law. No commercial financial institution established, owned or acquired by any foreign or Pakistani investor, shall be compulsorily acquired or taken over by the Government.

2.9.2.9 Privacy of Banking Transaction

Banking transaction privacy will be strictly observed by all banks and financial institutions, by whosoever owned, controlled or managed.

2.9.2.10 Protection of Financial Interest

All financial pressures bringing upon, those under any instrument, or any financial and contractual commitment made by the Government will remain in force, and will not be altered to the disadvantages of the stakeholder.

2.10 Summary

Above stated historical prospective is essentially meant to academically enlighten and understand of Pakistan economy and the inflows of FDI in the process of industrialization and economic growth of the country in contemporary era of the 21st century.

The major challenge faced by Pakistan is to moderate the inflation rate and how to boost business confidence to attract more FDI. Inflation rate in the country has accelerated in the last year owing to rising prices of the food and non food items. Besides, among other things political instability has, time and again, remained an unsettled issue in the country.

CHAPTER THREE

LITERATURE REVIEW

3.1 Introduction

This chapter synthesizes a broad review of the past literature pertaining to various aspects and issues of FDI flows and requirements in an economy. In addition, this chapter discusses the underpinning theory related to the various determinants of the FDI in a developing country such as Pakistan.

3.2 Foreign Direct Investment

3.2.1 Definition of FDI

By and large, in the absence of comprehensive study available directly on the pertinent issues in Pakistan, the present study confined to assimilate relevant studies available in current literature approach in order to draw some clues and provide a basic understanding towards the objectives envisaged in the course of investigation and analysis.

FDI has been defined differently in the economic and international business literature. The International Monetary Fund (IMF), however, categorically defined FDI as the "investment that is made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor. The investor's purpose being to have an effective voice in the management of the enterprise" (IMF, 1993). This definition fundamentally implies that foreign capital inflows into the host country through the concerned foreign investment is meant to acquire long lasting interest in the business enterprises to be conducted by the investor. Apparently, the investor's key reason is to acquire an effective control in the conduct of the concerned business.

In this regard, further, it may be clarified that the foreign body of linked entities that make such investments is referred to as the direct investor. Apparently, the subsidiary, multinational companies and TNCs, in that order, in which direct investment is made, regarded as a "direct investment enterprise". As Korpi (1989) mentioned, under the process of FDI, in the corporate sector, a single foreign investor either owns 10 percent shares or voting power in the decision making management. In general, FDI essentially relate to international capital inflows in real terms, thus, providing an external source of capital along with managerial and technical skills in the business operation confined to a host country.

3.2.2 Classification of FDI

It is interesting to state major types of FDI to get a better insight about the nature of foreign capital in real terms for practical considerations.

Inward Foreign Direct Investment: This refers to a part of long term capital inflows into a country apart from foreign aid, portfolio foreign investment or external borrowings. Inward FDI flows imply that the investment is done by an entity outside the host country from its home country.

Outward Foreign Direct Investment: This refers to a part of long term capital outflows in addition to aid, portfolio investment or a repayable external debt, by the entity from a home country to host country.

Horizontal Foreign Direct Investment: This refers to an investment undertaken by a multi-product firm in the same line of production plants located in different countries.

Vertical Foreign Direct Investment: Under this category, the real investment procedure is divided into upstream and downstream stages, after the complication stage, and then only transferred abroad. Here, the newly established assembly

plants' demand for parts and components is usually met by exports from home-country suppliers. Lipsey and Weiss (1984) stated that the aim of vertical FDI is to exploit scale economics at different stages of production arising from vertically integrated product relationship in view of the resource positions.

Greenfield Foreign Direct Investment: Greenfield FDI refers to the kind of investment where the MNC (Multinational Company) constructs entirely new facilities and production plants into the host country.

Brownfield Foreign Direct Investment: It is an outcome of mergers and acquisitions attributed to the foreign capital management. Brownfield foreign direct investment implies that the MNCs (Multinational Companies) or an associate of the MNCs tends to merge with or acquire an already existing firm in the host country, thus, constituting in a new MNCs affiliate.

3.3 FDI and Economic Growth

It is widely held in economic literature that foreign direct investment (FDI) is an engine of growth in a developing economy in modern times. Few studies (Kindleberger, 1969; Caves, 1971; Zaman *et al.*, 2011; Yousaf *et al.*, 2008), however, have been available in exploring and furnishing in-depth analysis in tracing the role of FDI in the case of a developing nation, such as, Pakistan in the SAARC region. In economic analysis nexus between FDI and economic growth is viewed as a bi-directional relationship: (i) Economic growth induces FDI; (ii) FDI promotes economic growth.

There is no consensus among the experts on this issue in conducting empirical studies in developing economies. A few studies such as (Grosse & Trevino, 1996; Sarno & Taylor, 1999; Kesteloot & Veugelers, 1995; Barrell & Pain, 1996) conducted to examine the effect of economic growth on FDI inflows

and observed the positive effect in host country. On the other hand, literature also contains the studies tracing the growth effect of FDI and has detected significant positive effect of the FDI on economic growth in the recipient countries under investigation (Borensztein, Gregorio, & Lee, 1998; De-Mello, 1999; Dunning, 1994). In some studies, such as (Mansfield & Reinhardt, 2008; Gala & Rocha, 2009) it was envisaged that outward looking developing countries have been more successful in attracting the FDI inflows. Fry (1993) examined macro impacts of FDI and concluded that unlike the Latin American countries, FDI inflows in the Asia region induced a direct increase in rates of domestic savings and investment together under the co-finance effects.

In the literature pertaining to the questions, such as: to whom, to what extent and how does foreign direct investment affect economic growth, it is argued that the FDI could carry direct influence on economic growth and development of process because it facilitates better resources utilization, transfer of the technologies and managerial skills to host countries. Besides, foreign investments indirectly boost the growth rate of the host countries through facilitating and training skilled labor, resources acquisition, and applying the new method of organizational planning (De-Mello, 1999).

Several studies on FDI have mainly featured three sets of macroeconomic factors that influence FDI, the first one is the cost reducing factors, second is business operation and industrial environment improving factors and lastly macroeconomic policies and developmental strategy factors of a nation. In view of studies pertaining to international business environment, however, some factor such as the political instability or security risk rating, corruption and poor infrastructure of the country that are very important to attract the FDI cannot be

ignored. Needless to say that the unstable political situation of the country makes investment riskier, thus, bring down investor's confidence. The political stability, quality of institutions, less corruption, good infrastructure and level of economic freedom of the host country play the encouraging roles mainly with regard to the mode of investment that has to be pursued. For instance, there may be a restrictive import-substitution strategy that induces investment geared for the domestic market through locally produced foreign oriented goods instead of their imports. Alternatively, there may be a direct export promotion strategy which tends to promote investment for exportable items to be produced by the foreign and other concerned domestic enterprises attached to the exporting industries (Azmat, 1999; Hakro & Ghumro, 2007; Chakrabarti, 2002; Gordon and Hanson, 2001; Ciruelos and Wang 2005; Sharma & Bandara, 2010). These studies have, thus, sought to explain as how the foreign direct investment is beneficial to the host countries for their economic growth process based on export-led growth strategy.

Some studies such as (Balasubramanyam, Salisu, & Sapsford, 1999; Ngowi, 2001) have specified the specific role of the FDI towards economic growth process in the developing country. It has been observed that developing countries widely recognized that FDI flows could mean additional sources of capital to their capital-deficient economies, technical know-how as well as transfer of technology potentials, and positive employment effect as well as improvement in the BOP (Balance of Payments) positions. Such awareness of the proven benefits of FDI eventually has resulted in softening of the hostile attitudes of the people in developing countries toward FDI and foreign enterprises. Consequently, in the contemporary era, there has been a trend of growing competition among the

developing countries to confer several benefits by offering various kinds of incentives to attract the inflows of FDI in their favor.

Few empirical studies such as Alfaro, *et al*. (2004), Borensztein, *et al*. (1998), Makki and Somwaru (2004), Campos and Kinoshita (2002) and Zhang (2001) have been found in tracing the relationship among the FDI and economic growth. The study of Zhang (2001), conclude that FDI support economic growth in countries where the infrastructure is well developed and degree of openness (DOP) and political stability and FDI policies are more attractive and liberal. Similarly, the study of Balasubramanyam *et al*. (1999) argued that the growth effects of FDI are stronger in countries where the labor force is well educated and there are good export polices better than import policies.

In detecting the role of political stability, Kadi (1999) observed that the lower percentage of FDI in the Middle East government intervention may be attributed to many issues including continuing political instability. The study showed evidence based on testing in cross sectional data of 59 countries. The study concludes that there existed positive relationships among FDI and economic freedom attributed to political stability is least in their countries. The research suggested that the country's GDP growth rate, exports, imports, political instability and infrastructure have significant influences on the decisions of multinational companies to invest there.

Dunning and Lundan (2008)'s study pertaining to institutional reform, foreign direct investment in European Transition Economies (ETE) stressed the significance of institutional infrastructure and increase in institutional reforms as major determinants of FDI inflows into the European Economies. Mickiewicz

(2005)'s study relating to FDI and employment nexus in EU (Central Europe) during economic recovery, investigated the importance of foreign direct investment in job preservation, job creation as well as their specific role in changing the employment structure. The study refers to the case of countries such as Hungary, Slovakia, Estonia and Czech Republic. The study presents descriptive stage model of FDI progression into the change of the economy. The study specifically examined the employment prospects of the growth model. It has been observed that the role of foreign direct investment towards employment creation and preservation has been highly successful in the case of Estonia and Hungary. The study also envisaged that widening differences in sectorial distribution of FDI across countries closely related to the FDI inflows per capita. There occurred great change that the FDI will lead to more diverse fund of spillover and skill transfers in a developing country. Furthermore, when the existing investment polices is not capable of soliciting a high order of foreign direct investment inflows then the policy makers need to pay more attention on attracting various types of FDI in allied sectors of the concerned economy.

Daniele and Marani (2006) have analyzed main factors determining FDI in MENA (Middle East and North Africa) countries. The main concluding suggestion of this study refers to the significant role of the quality of institutions and good infrastructure and political stability of the country in attracting FDI. On these counts, MENA experienced the growth effect of FDI inflows which tended to be remarkably inferior to that of recorded in the EU or in Asian economies, such as China and India. It has been inferred that institutional and legal reforms are primary steps required to improve the attractiveness of MENA in soliciting increased inflows of FDI. Several studies such as (Toda and Yamamoto, 1995;

Chaudhary, Iqbal, & Gillani, 2009) indicated that fastest economic growth is induced by foreign direct investment, along with other factors such as employed labor force, human capital index, domestic savings, and the balance of payments.

Mah (2010) empirically studied the influence of FDI inflows on economic growth of the Chinese economy and concluded that economic growth had caused significant impact on the FDI inflows into the Chinese economy rather than FDI turning out to be a growth inducing factor.

According to Ali *et al*. (2009) the developing countries have been struggling for the last two decades to increase the FDI inflows in their favour since FDI is seen as a catalyst agent for economic growth. The researchers specifically investigated the influence of FDI on economic growth of Pakistan by using Endogenous Growth Model. Incidentally, they identified the identical variables as have been viewed by Daniele and Marani (2006) in relation to the MENA countries affecting economic growth such as, FDI, Employed Labor Force, Human Capital Index, Domestic Savings, Capital Formation, and BOP.

The economic policies pursued by the host country have considerable influence on the decision of foreign investors. To attract FDI, thus, the host country should check-out concrete and investor friendly policies. A focus on providing well developed infrastructure is also important to restore the confidence of foreign investors (Zaidi, 2004; Khan & Khan, 2011).

3.3.1 Determinants of FDI

Akhtar (2000) provided valuable econometric analysis of macroeconomic variable of FDI in Pakistan. The past studies have examined the effect of determinants of FDI in the country analyzing FDI flows during the period (1972-

1996). In this study, the empirical model contained FDI as dependent variable and other independent variables such as GDP growth rate, Imports, Exports, Exchange rate, Interest rate, political instability and military rule. The study observed that during the chosen period, Pakistan economy's growth rate, as such, had no impact on the stock of FDI. However, the interest rate variable then tended to have positive impact on FDI. The study also, concluded that there is a need to improve location factors to attract the FDI in Pakistan. Further, high and stable GDP growth rate under exchange rate stability situation coupled with political stability in the economy should be major considerations for the policy makers of Pakistan in providing an attractive investment environment in the country.

The study of Wang (2009) on inward foreign direct investment (FDI) and economic growth in 12 Asian economies used data over the period of 1987 to 1997 in empirical investigation. This study obtained the same ambiguous results which might be caused by the use of total FDI as a variable. Nonetheless, the meritorious point of the study is that it strongly suggested that FDI in manufacturing sector has a significant and positive effect on economic growth in the host economies. On the other side, Wang (2009) also observed that FDI inflows in nonmanufacturing sectors do not play a significant role in enhancing economic growth.

Ates & Bolukbas (2011) specified the economic factors determining FDI in Turkey, such as, exchange rates, market size, labor costs, interest rates, economic growth rate, infrastructure, geographic location, and taxes. The researchers explained that FDI have increased fast in the world especially after 1990s. The FDI is received in both developing and developed countries as a source of capital. Specifically, the under developed countries are competitively offering a wider range of attractive packages to attract the FDI. It has been argued that the factors

that make attractive dimensions of business environment in the host country are becoming significant in attracting FDI. Among these are some of the virtually more important factors to attract the FDI are: well establish infrastructure, political stability and less corruption need to be examined by in-depth analysis under empirical studies in developing countries.

Shah and Ahmed (2004) studied macroeconomic variables influencing the FDI in Pakistan using time series data for the period 1961-2000. Their findings concluded that in Pakistan long-term relationship have existed between FDI flows and the determinant factors such as political stability, capital cost, corruption index, transport and communication expenditures and market size of the Pakistani economy. Zaman, Hashim and Awan (2006) empirically examined the influence of economic determinants of foreign direct investment in Pakistan for the period between 1971 and 2003. This study modeled FDI as a dependent variable with unit labor cost (ULBC), service sector (SS), trade balance (TB), market size (MS), inflation (INF), as explanatory variables. The study concluded that INF, ULBC, TB, and MS have significant impact on FDI. It is, however, observed that service sector (SS) is not significant with FDI in the case of Pakistan.

In a unique study, Safdari *et al.* (2011) analyzed the impact of foreign direct investment in Iran for the period 1973-2008. This study contained the model comprising six variables such as, Gross domestic product growth rate (GDPGR), Labor Force (LF), Export of the Iran, Government Expenditure, Internal Investment and FDI. The model used vector autoregressive model (VAR). It checked the stationarity of the data in the series and provided further analysis based on Johansen test. The study concluded that Government expenditure had

negative effect on economic growth in Iran. Variables such as of labor force, internal investment, foreign direct investment and export, however, caused positive effect on economic growth in to the country. This study recommends further study that includes variables such as political stability and infrastructure to examine the process of economic growth in a developing country.

Interestingly enough, Awan *et al*. (2011) also investigated the influence of the macroeconomic variables in determining FDI flows in Pakistan. This study was confined to time series data for the period of 1970 to 2003. The study used in its analysis the technique of Augmented Dickey Fuller Test (ADFT) as well as an Error Correction Model (ECM). It has been concluded that the Unit Labor Cost and Inflation rate have been statistically significant predictors of FDI with negative and positive signs respectively. Other variables such as Market Size (MS) and Trade Balance (TB) were also detected to be statistically significant with positive signs except the service sector (SS) factor that was found not to be a significant determinant of FDI.

In the same stream of research, Yousaf *et al*. (2008) conducted research on economic evaluation of FDI towards Pakistan using the time series for the data period 1973-2004. In their study the authors referred to the major determinants of FDI to be real GDP, exports and imports, GDP deflator, unit value of exports and unit value of imports. They confirmed that the GDP and export and imports trended to carry positive impact on FDI in Pakistan.

Despite some policy reforms in Pakistan, the country was comparatively unsuccessful in attracting FDI (Ahmad & OlDonoghue, 2010). In this study, focus has been especially on the location factor as a major determinant of FDI in

Pakistan. Pakistan has little GDP growth rate and it is not growing in keeping any pace in comparison to India and China. Likewise, Awan, us-Zaman and Khan (2010) investigated the impact of FDI into Pakistan economy using the time series data of the period 1971-2006. The study empirically found that determinants variables such as Degree of Trade Openness (DTO), Gross Fixed Capital Formation (GFCF) and Inflation rate (INF) are statistically significant with positive signs. Whereas, Current Account Balance (CAB) found to be statistically significant with negative sign. This study further revealed that the Debt Servicing and Gross Domestic Product found to be statistically insignificant as such these factors have been causing least impact on FDI inflows into Pakistan.

Rehman *et al*. (2011) conducted a study to analyze the role of infrastructure in attracting FDI in Pakistan. The study in particular sought to examine the effect of Pakistan economy's infrastructure, exchange rate and market size on inflows of FDI in the country. These researchers used time series data for the period 1975 to 2008 and had applied ARDL approach to cointegration in empirical analysis. Their findings confirmed the strong positive impact of infrastructure in attracting FDI in short and long run for Pakistan. Also, market size was detected to have positive impact on FDI inflows while exchange rate was found to have negative impact.

The latest available study, Qaiser Abbas *et al*. (2011) carried out an investigation of the major economic determinants of FDI inflows in the commodity-producing sector of Pakistan. This study used the time series data covering the period of 1996-2008. Under the study, ADF test was used to check the stationary characteristics of the data and co-integration and ECM were used for the estimation of the parameters. The study concluded that the GDP, GDP growth rate in CRP (Commodity-Producing Sector), Degree of Trade Openness (DTO),

FOREX (Foreign Exchange Reserves), GFCF (Gross Fixed Capital Formation) and PCI (Per Capita Income) are key determinants of FDI inflows in Pakistan. In the results of the study, all these variables were found to have positive significant effect on FDI inflows.

Similarly, Mahmood *et al,* (2011) have examined the relationship among FDI and macroeconomic variables in Pakistan. In their study, FDI has been tested as a DV (Dependent Variable) and population of country, democracy, real exchange rate, real exports, manufacturing products, import duty and enrollment at secondary level schooling (probably to reflect skilled labor force) were taken as independent variables. Moreover, the impact of democracy was also examined through representation by dummy variable. This study analyzed the time series data during the period of 1972-2005 using the ADF test and OLS regression analysis in tracing the importance of macroeconomic variables on FDI in Pakistan. The study concluded that population size; democracy and enrollment at secondary level schooling have a positive effect on FDI in Pakistan. Other variables such as real exchange rate, real export, manufacturing products, and import duty negatively affect FDI in country. Based on their findings, they recommended that further investigation should be exerted to other business variables such as infrastructure, political stability, law and order situation, economic policies and local business environment on FDI inflow in Pakistan.

3.4 Towards Literature Review of Macroeconomic Variables and Business Environment

In the present study, the DV (Dependent Variable) is constructed mainly from the gross inflows of FDI in Pakistan for the period 1991-2011 as reported in the World Investment Reports, published by the UNCTAD. Literature review of

macroeconomic variables and business environment variables was discussed, thus, follows as under.

3.4.1 Gross Domestic Product Growth Rate (GDPGR)

Functional relationship between the GDP and FDI and vice versa is always a main line of focus assumed by the researches in economic literature. Using the extended Gravity Model, where GDP is incorporated as an explanatory variable to identify economic size of countries in many studies such as Martinez-Zarzoso and Nowak-Lehmann, 2004 and Martinez-Zarzoso, 2003. The study of Martinez-Zarzoso (2003) found that a high level of income in the host country implies high level of production, which attracts the investors' confidence to invest in the host country. The study of Martinez-Zarzoso and Nowak-Lehmann (2004) concluded that the higher income in home countries enabled and induced a large amount of source of funds to be invested in overseas business. Real GDP and GDP growth rate is the national income growth indicator of the economic performance of the country, which is reflected through production, consumption, and delivery of goods and facilities provided in the country. GDP trend also indicates the level of the country's economic development vis-a-vis growth rate and potential domestic market opportunities for the investors.

Essentially, macroeconomic conditions are expected to exert influence on FDI. Nevertheless, as Grosse and Trevino (1996) had pin-pointed countries possessing higher per capita GDP are expected to promote the FDI, inducing future multinational companies with great confidence to invest, especially, when growth is more consistent. High economic growth rates are likely to lure investors in finding the market potential for higher return values on investments which are

confined with higher levels of FDI (Birch & Halton, 2001; Tuman & Emmert 2004; Biglaiser & DeRouen 2006).

According to the report of UNCTAD (2000, 2005) it has been observed that some of the FDI trend in developing countries are generally serving to host country market. Evidently, domestic market size and market should be regarded as the major determinants in attracting such group of foreign investors. Empirical studies conducted by many researches such as (Singh & Jun, 1995; Root & Ahmed, 1979) have demonstrated the nexus among the size of the market, GDP and GDP growth rate. These studies have traced that GDP growth rate have significantly affected FDI inflows in several countries in reality.

Holland and Pain (1998) in their study investigated the influence of business environment and the privatization process as primary determinants of FDI in CEECs (Central and Eastern European Countries). The study of Nunnenkamp (2004) provided a comprehensive overview of the FDI determinants, thus, highlighted the traditional drives, such as population of the host countries, GDP growth rate, administrative barriers, entry restrictions and risk factors to be significant in developing economies at large. The researchers also did not overlook the significance of non-traditional factors as well. They asserted that, in modern times, such factors as the degree of openness and local skills can enter in the category of major traditional FDI driven elements. Besides, the researchers have agreed with Blomstrom and Kokko (2003) on the policy matter that in contemporary era, incentives tend to be increasingly significant FDI driving factors.

According to Fernajndez and Hausmann (2000), however, it is equally true that the poor-performers, in terms of lower GDP per capita and more

macroeconomic stability, too have attracted more foreign investment. They have provided evidences that countries with poorer institutions did attract more FDI inflows as a share of total private capital flows in their economies. Furthermore, literature also pinpointed that through FDI generally helps to increase the marginal productivity of capital, this may not be true in the case of low-skill labor intensive countries, where FDI is mostly attracted owning to low pay packages to the workers and the focus is on producing labor intensive goods (Chantasasawat & Institute, 2005).

Mencinger (2003) conducted a research in eight transition countries namely, Estonia, Hungary, Slovakia, Slovenia, Czech Republic Poland, Latvia and Lithuania, for the period 1994-2001. The study observed that a negative correlation between real GDP growth and FDI inflow. Their findings were opposite to the findings of the studies conducted by Billington (1999); Cheng & Kwan (2000), where they found that the market size measured in term of real GDP and GDP per capita in most cases found to have a significant positive influence on FDI.

Uppenberg and Riess (2004), however, posed a dilemma regarding foreign investment and domestic economic growth, by referring to it as the growth-FDI nexus. They mentioned that a strong positive correlation between inward FDI and economic growth does occur but, it is not precisely clear whether the causality really runs from FDI to growth. They, however, concluded that economic growth, in general, is a crucial determinant of FDI rather than as policy strategies just devised to attract FDI inflows. This vitally significant study was pertaining to the case of European countries. Uppenberg and Riess (2004) study, however,

empirically established that domestic economic growth is a key factor among the determinants of FDI inflows into a country.

Fedderke and Romm (2006) have referred to the case of South Africa during the period 1956-2003, and observed that GDP growth rate of market size, as long as there is integration into the global economy, is crucial in determining the levels of FDI in this promising African nation. In a recent study, Mitze (2011) found that host country's GDPGR and trade openness have positive effect on direct foreign investment flows. This study covered 27 (West and Eastern European countries) using data over a time of 1994-2000. It has been observed that the trade openness and GDP have positive significant impact on FDI. Following the traditional line of analysis in the case of a developing country such as Pakistan, the present study treats GDP to be a prominent factor and sought to examine the GDP impact on Pakistan's FDI.

3.4.2 Exports

Jayachandran and Seilan (2010) have investigated the relationship between import and exports, FDI and economic growth of India during period of 1970-2007. They found that the FDI, imports, exports and economic growth posited to have a positive causal relationship. As per the studies of (Bucley *et al*., 2007; Liu, Burridge, & Sinclair, 2002) the relationship between FDI, GDP, exports and imports in China using the methods developed by Hall and Milne (1994) have confirmed positive relationship between FDI, GDP, exports and economic growth.

In a study Alia and Ucal (2003) examined the relationship between inward FDI, exports and economic growth in Turkish economy for the period of 1987-2002. The study concluded that the connection of FDI led export growth was not

found in Turkey. FDI and output nexus analysis for the same period was undertaken by the study to detect the inter-relationship of trade, FDI and growth. In concluding remarks the authors have argued that the integration of the Turkish economy with the world economy should be through the policies devised to attracting more FDI in order to gain the spillover effects of FDI to output and FDI-led export growth. Metwally (2004) empirically examined the relationship among FDI, exports and economic growth in three Arab (Egypt, Jordan and Oman) countries, for the period 1981-2000. The study result showed that export and services are strongly influenced by the FDI inflows in Egypt, Jordan and Oman. Similarly, Baliamoune–Lutz (2004) study investigated the relationship among FDI, exports and economic growth in Morocco during the period 1973-1999. It is found that relationship between FDI and exports is positive and significant in Morocco.

Zhang (2005), traced the role of FDI on Chinese export performance. The study found that the FDI inward has carried a significant influence on export performance in China. Similarly, Pacheco-Lopez (2005) studied the relationship among FDI and exports in Mexico. The study result showed that there is bidirectional causality among inward FDI and export performance in Mexico.

Likewise the relationship between FDI and export growth was examined by Njong (2008) using the data of Cameroon during the period 1980-2003 by employing the flying geese model, Vernon's product life cycle hypothesis and the new growth model in a mix. The major hypothesis of the study was that FDI causes a positive sign on export performance of Cameron. It was found that FDI inflows led to higher supply capacity and spillover effects in Cameroon, which resulted in causing higher export growth during the concerned period of study.

Duenas-Capara (2006) examines firm-level characteristics pertaining to the export performance of firms in three main manufacturing sectors in the Philippines. The new econometric model was tested for foreign affiliation in this regard and detected that, among other variables, firm's export capacity trends to be significant factors at micro level investment flows. Rodríguez and Pallas (2008) utilized a panel data in tracing the determinants of FDI in Spain for the period 1993-2002. Their study considered that, by and large, human capital and the export potential of the sector tend to be the most significant determining factor.

3.4.3 Imports

In the economic literature, it is presumed that countries with high imports from abroad tend to attract FDI (Mundell, 1957). The USA study of Aizenman and Noy (2009) found a positive relationship of between Imports and FDI inflows. It is argued that imports in the host country considered being a pointer of the potential market for the intended exports of the home country firms. It follows, thus, that larger imports in the host country economy encourage the Transnational Corporations to produce locally under the investment strategy of market-seeking ventures (Culem, 1988). Indeed, such an approach become more warranted when there are high trade barriers on imports in host country. In fact, the companies may assumed that it is worthwhile to produce locally in order to satisfy domestic demand of the host country markets. Indeed, foreign entries might visualize the various routes of servicing the host country's market before undertaking FDI decision ultimately.

Wang and Swain (1995) in their study on FDI and joint ventures (JVs) in the case of Eastern Europe and China have resorted to empirical quantitative research in testing the determinants of FDI in these transforming nations during the

period of 1978-1992. This study tested the relationship between independent variables such as, including cost of capital, market size, tariff barriers, exchange rates, labor costs, imports volumes as well as political stability and economic growth in China. The study found that imports have positive and significant impact with FDI in economic growth.

Aizenman and Noy (2006) argued that, it is easy to expect a relationship between FDI and imports. However, it is difficult to indicate that inflows of FDI have different effects on imports in different types of goods. Their study inferred that there is a strong relationship between FDI inflows and imports, mainly in industrialized goods in the case of USA.

The present study considered consumer goods imports in Pakistan as an explanatory factor instead of total imports in the gamut of determinant variables for two reasons. Firstly, Pakistan economy is attributed with market imperfections, such as, import quotas, tariffs and restrictions, resulting from the policy of import-substitution in the set of consumer goods, thus, foreign firms might considered that it is lucrative to produce these goods locally in the country to capture the share in domestic demand. This in short implies attracting more FDI in the consumer goods industry in Pakistan. Another point of view, imports include the capital goods import as well, the major part of which is provided by the transnational corporations leading to the fact that capital goods imports might be a package of FDI. Apparently, consumer goods imports, as a per cent of total imports, are justifiably included in the analyses of FDI determinants in Pakistan.

3.4.4 Degree of Openness

There are many studies conducted on the influences of degree of openness

on FDI. Literature on nexus of FDI and trade has mainly confined to export-substituting or export-complementary nature of foreign direct investment. However, the connection among FDI and degree of openness tends to be complex a phenomenon in the contemporary era wherein several developing countries have initiated import liberalization and entered into bilateral and multilateral trading arrangements the world.

Indeed, consideration for specific markets are perceived by their size and growth, however, domestic market factors are of no much less relevance to export oriented foreign firms. A range of surveys suggested widespread view that open economies do solicit more FDI. A major indicator of trade openness of a nation is the relative size of its external sector and exports size composition. Singh and Jun (1995) have shown that exports, particularly manufacturing exports, are a significant determinant of FDI flows and their empirical tests indicated that there is strong evidence in proving that exports precede FDI flows. China specifically was found to have attracted much foreign investment into the export sector. FDI signify investors control on production as well as quantum of the flow of capital and it is influenced by server factors in turn, such as technology and firm-specific assets (Markusen & Venables, 1999).

Leichenko and Erickson (1997) considered the effects of FDI on the foreign trade of America. They investigated the relationship among manufacturing export performance and FDI involved in manufacturing sector of the American economy for the period of 1980-1991. A few research studies showed that the degree of openness affecting the inflow of FDI in an economy tend to vary as per the aspiration for the attractiveness of FDI in business activities (Brainard, 1997; Dunning, 1994; Navaretti, Venables, & Barry, 2004; Markusen & Maskus, 2002).

Foreign investors seeking expanded markets hold the view that in the face of a high degree of openness, less restrictions and lower trade cost, the market could be better served in a better way through exports entry rather than FDI. Consequently, a high degree of openness can be associated with low level of FDI. Nonetheless, market-seeking horizontal investments can also tend to exploit markets of (i.e. export oriented FDI), in this situation greater degree of openness causes a positive effect on FDI inflows. Other research studies have, however, traced a positive relationship among the degree of trade openness and FDI inflows in the developing countries (Chakrabarti, 2002; Morisset, 2000).

Bevan and Estrin (2004) have apprised the freedom of trade all over with the potential export propensity of the multinational firms in the host country in view the degree of openness of its economy. They looked into imports the European Union (EU-15) countries while considering exports being subjected to both domestic and EU-15 trade policy regulations. Higher degree of openness is the cause of the higher flow of FDI in the country. The key reason underlying is the fact that more MNCs are export oriented. The MNCs seeking the gain through the benefits of export expansion policies and import of machinery's for production process in the home country. A study conducted by Majeed and Ahmad (2006, 2007) has traced the expected positive effect of this variable on FDI. The studies of Kravis and Lipsey (1993) also have positive influence of a country's degree of openness of the micro and macro level of economic arena on the FDI.

Few studies have examined the impact of specific policy variables such as degree of openness, tariffs, taxes and exchange rates on FDI in the host countries. The study conducted by Asiedu (2006) focused on policy reforms in developing countries in probing the determinants of FDI inflows. Its results found that tax

rates plus the degree of openness of the trade economy tend to be significant determinants of FDI inflows. Likewise, other researchers also highlighted the positive effect on FDI in the context of vertical specialization and horizontal expansion assumed by the MNCs (Ethier, 1994; Markusen, & Maskus, 2002).

According to Binh and Haughton (2002), countries with a higher level of international trade captured more FDI inflows. The reason is when these countries imports a lot of goods and services it means there is a good purchasing power in the economy. Grosse and Trevino (1996) conducted in Ghana a study where they found that imports and exports affected FDI inflows. The study in Malaysia on the degree of openness confined it to be a determining factor the process of economic growth and FDI inflows in Malaysia (Baharom, Habibullah, & Royfaizal, 2008).

Haile and Assefa (2006) examined the determinant of FDI in Ethiopia by using the time series data for the period 1974-2001. They found that the degree of openness was significant and positively related with FDI inflows in Ethiopia. Seim (2009), however, investigated the association of trade openness and FDI in a series of countries and his results confirmed that variations in the degree of openness caused differences in the proportions of FDI inflows into these countries.

3.4.5 Exchange Rate

These days, exchange rate is one of the most significant issues tackled in economic research (Mohammad *et al.,* 2010). It has been acknowledged that there is an association between FDI and exchange rate. If the currency of a country is devalued, there is a chance for foreign investors to invest in that country to buy assets at lower price. This is especially seen in the case of foreign firms having

identified specific potentiality in their targeted markets envisaged (Blonigen & Ma, 2011).

Dumludag (2009) investigated determinants of FDI in institutional context in Turkey, and found that Exchange rate, market size, GDP growth rate and GDP per capita have positive impact on FDI. Similarly, another researcher Kaya and Yilmaz (2003) used data from 1970-2000 in order to investigate GNP per capita and exchange rate as the determinants of FDI in Turkey. Their study confirmed that GNP per capita and exchange rate have a positive impact on FDI inflows in Turkey.

The relationship between exchange rate and FDI inflows was traced by Froot and Stein (1991) and found that FDI inflows are negatively correlated with the external the value of the US dollar. This suggests that a depreciated currency can stimulate the purchase and controlling power of productive corporate assets. Examining the effects of EXR (Exchange Rate) risk and expectations on FDI inflows, however, it has been observed that significant reductions in US direct investment were found to be associated with increases in the current real value of foreign exchange and very strong reductions tended be have associated with the expected appreciation of real foreign exchange. Few other researchers (such as, Blonigen, 1997; Kiyota & Urata, 2008) confirmed the similar findings. Theoretical considerations based on the real wealth and real labor cost effect suggested that a stronger US dollar may deter FDI into the US economy.

Maniam (2007) tried to examine the determinants of FDI inflows in Latin America over the time of 1975-2003. The study observed that foreign direct investment has increased speedily in Latin America and he confirmed the strong relationships among the macroeconomic variables and investors' expectations. The

study of Jeon and Rhee (2008) looked towards the determinants of Korea's FDI inflows from the US for the time of 1980 to 2001. The study confirmed that Korea's FDI inflows from the US have a significant relationship with real exchanges rates, real wage costs and interest rate.

In going through the literature to show that the exchange rate affect the FDI inflow to the countries, Bleaney and Greenaway (2001) have examined the influence of the level and volatility of real effective exchange rate on investment and growth for 14 SSA (Sub-Saharan Africa) countries. They found that exchange rate volatility produced a strong negative effect on FDI. Some research on AERC (African Economic Research Consortium) such as by (Ajayi, 2006; Khan & Bamou, 2006; Mwega & Ngugi, 2006) have recognised the potential effect of exchange rate instability on FDI, but they did not openly sought to trace the relationship empirically.

The outcome of exchange rate on FDI inflows is a fairly well studied topic in the current literature , such as (Foot & Stein, 1991; Mowatt & Zulu, 1999; Erdal & Tatoglu, 2002; Love & Lage- Hidalgo, 2000; Jenkins & Thomas, 2002) have found that exchange rate can fluctuation FDI by affecting the cost of acquiring foreign, that is because a decrease in domestic currency value against foreign currency value or depreciation of domestic exchange rate will make it less expensive for a foreign investor to invest in to the developing country. Thus, deprecation exchange rate of a country will effect to the inflows of FDI. In the study of Kumar and Joseph (2009) the data of the period 1980-1990, their regression results suggested a positive significant influence of the exchange rate level on the rate of FDI.

3.4.6 Inflation Rate

Rate of inflation is a crucial factor in influencing the FDI inflows. The high rate of inflation signifies economic instability or peril and confusion associated with internal economic tension and of the inability or indisposition of the government as well as central bank of the country to balance the budget using money supply. High rates of inflation are associated with the lesser FDI inflows. A negative relationship is expected between these two variables. By and large, the investors would like to invest in economically more stable countries that would imply a lesser chance of uncertainty, as such, it is reasonable to expect that inflation tend to cause a negative effect on FDI. However, a few studies have examined the effects of inflation rate movements on FDI, and there has been less attention paid to the interaction of these variables. In the context of Sayek (1999) examined the relationship between FDI and inflation in Canada. The study found that the results obtained from an impulse response analysis did support the theoretical model involved. It is detected the increase in Canadian inflation tended to be reduce USA FDI in Canada and increase the USA domestic investment. The study also showed that a 7% increase in Turkey leads to reduction of USA FDI in Canada by 1.9% and increasing US domestic investment by 0.3%.

The study of Akinboade *et al* (2006) stated that low inflation is sign of internal economic stability in the country. High inflation rates reflect inability of the government to balance its budget and the failure of the central bank to conduct appropriate monetary policy. The inflation rate can be used as an indicator of the economic and political situation of the host country, but the differences between "high" inflation and "low" inflation is not distinct when inflation is just viewed as a monetary phenomenon (Ahn, Adji & Willett, 1998).

From multinational companies point of view, however, high inflation rate tend to create uncertainty in the case of the net present value (NPV) of a costly, long-term investment project. For this reason, usually companies are likely to avoid undertaking investments in countries experiencing in high inflation. Schneider & Frey (1985) conducted a study on the American countries that made significant reforms. Li and Liu (2005) also presented a post study on the same line. These studies have concluded that companies tended to invest less in developing countries suffering with high inflation rates. Frage (2008) argued that macroeconomic policy that has generated increased inflation have chased inflows of FDI and further, in the past in Latin America, inflationary problems have caused financial collapse and capital flight. Naude and Krugell (2007) studies used the cross-country data to identify the determinants for foreign FDI in the African region. This study used independent variables such as government consumption, inflation rate, investment, political stability, accountability, regulatory burden, rule of law and dependent variable FDI. The study concluded that inflation rate have negative significant relationship between FDI inflows in Africa.

Ehimare (2011) traced the effect of inflation rate and exchange rate on foreign direct investment and its relationship with economic growth. This study's main purpose is to find the effect of exchange rate and inflation rate on FDI and economic growth in Nigeria using the thirty year time series data using linear regression analysis. The research found that inflation rate has significant effect on FDI inflows and economic growth in Nigeria.

Awan *et al*, (2010) empirically examined the trends of FDI inflows into Pakistan during the period 1971-2008, and sought to explain how different variables affected the FDI inflows in the country's economy. In the study FDI

inflows in Pakistan is considered as a dependent variable associated with determinants such as Degree of Trade Openness (DTO), Gross Fixed Capital Formation (GFCF), Inflation Rate (INF), GDP, Current Account Balance (CAB) and Gross Domestic Product at Factor Cost (GDPFC) as independent variables. The study found that DTO, GFCF, INF tended to be statistically significant with positive signs in affecting the FDI inflows. The research suggested that inflation rate is positively significant with FDI inflows in the case of Pakistan given the opportunity to foreign investor to invest.

3.4.7 Interest Rate

It has been observed that real interest rate differentials between host and source countries carry a positive impact on inward FDI. This is attributed to the fact that foreign investors who raise relatively cheap capital funds in the source country face high degree of competition rivals from the countries in the concerned host country. Grosse and Trevino (1996) observed that the relatively high real interest rate in the host country has a positive effect on inward FDI. The direction of the impact, however, could be in reverse when the foreign investors depend on the host country's capital markets for obtaining the required funds. Similarly, interest rates serve as the measure of the capital cost. Some empirical studies such as (Love & lage-hidalgo (2000); Erdal & Tatoglu (2002); Zaman, 2006) confirmed that rising interest rates implied a decreasing FDI. A higher interest rate apparently means more expensive investment. As such, the higher the interest rate, the more is chance to defer FDI thus, the relationship between interest rate and FDI tends to be negative. The study of Akhtar (2000), however, empirically found that the interest rate have positive insignificant effect on FDI in the case of Pakistan.

3.4.8 Infrastructure

A striking feature of the growth in FDI has been the rise in the infrastructure services sector, making it a dominant sector of the global economy. In the case of developing countries, FDI in services expanded at an annual rate of 28% during 1988 to 1999 which accounted for 37% of total foreign investment inflows in the world economy.

Infrastructure can have strong impact on the business expansion and growth process of developing and developed countries. As some researchers (Khadaroo & Seetanah, 2010; Asiedu, 2006; Sekkat & Varoudakis, 2007) have argued that infrastructure carries a significant influence attracting FDI to developing countries. Addison *et al*. (2006) remarked that promotional impact a infrastructure is good only for developed nations but, such situations do not exist in the case of developing countries. Bae (2008), however, stated that in developed countries, infrastructure is not a motivator but an indicator to attract FDI in large emerging economies.

Fung *et al*. (2011) investigated the infrastructure pertaining to more highways and rail road network, overall good infrastructure implying rising FDI flows in turn. The study related to infrastructure development attracting the respective FDI from countries such as Japan, Korea, United States, Hong Kong, and Taiwan to the regions of China. It is found that infrastructure has a positive significant effect on the FDI inflows in China.

Globerman and Shapiro (2003) examined how the infrastructure of a country tends to affect the possibility of its share receiving the FDI inflows. The study found that poor infrastructure of countries showed a positive relationship

with the FDI. Countries aspiring development of infrastructure in areas of communication, energy capability, and transportation attracted increased levels of FDI inflows. In analyzing the determinants of FDI into USA during the period 1981-1983, Coughlin, Terza and Arromdee (1991) found that more extensive transportation infrastructures had attracted increased level of FDI. Wheeler and Mody (1996) have found that the quality of infrastructure is a vital factor for developing countries in attracting FDI from the United States; this has not been so significant in the case of those nations which already possessed high quality infrastructures.

Pakistani policy makers' main headache is the poor state of infrastructure. Energy shortages are widespread and take a heavy toll on productivity and competitiveness of the exports and on the quality of life for the majority of the households. This is a research gap which the present study sought to investigate that is the importance of infrastructure on foreign direct investment inflows in the developing country such as Pakistan.

3.4.9 Corruption Control Index

The corruption index is inversely correlated to FDI. If corruption keeps increasing in the country, then reputation of the country in the eyes of foreigner investor is receding. The study of Aburime (2010) probed the influence of corruption in FDI inflows in Pakistan putting the bad impact on the country growth. Indeed, several studies have endorsed that corruption is a major issue in the development of Pakistan economy (Shahbaz, Ahmed, & Ali, 2008; Shahbaz & Rehman, 2010).

Akcay (2001) traced the evidence showing a negative relationship among FDI and corruption index. This study suggested that corruption has much significant impact on FDI. Habib and Zurawicki (2002) also supported the view of the negative influence of corruption on FDI. The study showed that foreign investors normally avoid themselves from corruption because it threatens their business and can lead to operational inefficiencies. Larran and Tavares (2004) in considering the issues of reverse causation estimated the influence of FDI inflows on corruption at the country level. They found that FDI as a share of GDP is significantly tuned with lower level of corruption, irrespective of import intensity situation. Egger and Winner (2006) studies analyzed the effect of corruption control on foreign direct investment (FDI). This studies used the data 59 developed and undeveloped host countries for the period from 1983-1999. The study confirmed the result of a negative relationship between corruption and FDI. Mathur and Singh (2007) found that the corruption perception played a major role in investor's decision of choosing the country to in.

Zhou (2007) found that the overall effect of corruption is significantly negative on the probability of FDI inflows. Meaning that, the high level of corruption is negatively associated with low level of FDI inflows. Al-Sadig (2009) using a cross-sectional as well as a panel data analysis traced the effects of the levels of corruption on FDI for 117 countries during the period 1984 to 2004. The study found that for all these countries corruption implied a negative effect on FDI inflows. Similarly, Kardesler and Yetkiner (2009) found that corruption caused negative effects on FDI inflows in the EU countries. This finding suggests that investors are not willing to undertake FDI in countries that experience high levels of corruption in the EU (European Union). Kyung (2009) studied the effect of

corruption on FDI and concluded that corruption has an adverse effect on the economy of the corrupt nation.

3.4.10 Labor Cost

Foreign investors usually aim to take benefits of cheaper labor in the production of labor intensive good (Andresosso-O-callagham & Wei 2003). Foreign investors look for cheaper labor force; the country having cheap labor will be an important factor to attracting the FDI. Poor countries alike are competing for FDI by opening to outside investors, reform approval processes, opening sectors to foreign investors, and allowing autonomy of capital and cheap and skilled labor and minimum of official intervention. The four factors attracting FDI into country such as market factor, the trade barrier, cheap labor cost factor and the investment climate. The World Investment Report (1998) mentioned that the determinant of FDI inflows to the host countries was very important cheap labor.

Zou, Liu and Zhuang (2009) on China performed the policy of reform and opening-up 30 years ago, FDI has exerted important role into the fast growing economy. The study referred to GDP, labor cost, import, export and DOP as independent variables and FDI taken as a dependent variable. Empirically the method for this study used co-integration to analyze the economic factors attracting FDI in West China in the past 30 years since reform and opening-up. The study indicates that quicker economic growth in China, good policy, higher degree of openness and cheap labor are major determinants.

The study of Ali and Guo (2005) on firms that take benefit of emerging foreign opportunities, especially, through foreign direct investment has been much documented. China, as a major emerging market, has attracted significant flows of

foreign investments, to become the largest recipient of foreign investment in the world. This study examined the literature on FDI and focuses on likely determinants of FDI in China. The study conducted investigation on twenty two firms operating businesses in China on what they see as the important motivations for them to undertake FDI. The study finds that export-orientation, cheap labor and market size are a major factor for FDI coming from the US firms to China. The study concluded that cheaper labor and export-orientation positive significant impact on FDI.

Costs of doing business are one of the major determinants of FDI, among which labor cost has been extensively investigated in the study of FDI. The foreign firms can take benefits from cheap labor by investing in poor countries (Miller, 1993). The study of Swain and Wang (1995) concluded that a positive significant relationship between the cheap labor and inward FDI in China. Similarly, Liu *et al* (1997) also argued that the cheap labor were one of the most important attracting factors for FDI inflows. Both Zhang and Yuk (2000) concluded that cheap labor very much encouraged the HK (Hong Kong) MNCs to invest in China. Zhang (2001) confirmed that the labor cost factor hardly had any influence on US MNE decisions to invest in China. On the other hand low labor cost was the key location factor for foreign investors in China (Wei and Liu, 2001), mainly in manufacturing industries such as telecommunication equipment and automobile assembly.

The study of Lieberthal and Liberthal (2003) found that some of goods such as electronic industry and telecommunication manufacturers industry in Hong Kong and Taiwan have confirmed mainly to adept at leveraging cheap labor from mainland Chinese. However, the cheap labor-cost advantage of China may not be sustainable as China is now facing competition from its neighboring countries such

as India, Laos, and Vietnam claiming cheap labor advantage and have adopted various policies to attract FDI.

Most of the literatures stressed that the labor cost is one of the major components of business environment attracting FDI to the developing countries. As a result, usually, the expected sign for this variable is negative. Few researches such as (Kravis & Lipsey, 1993; Barrell & Pain, 1996) conclude that no significant or negative relationship between wage and FDI inflows. On the other hand, some researchers have found that wages do not always deter FDI in all sectors and shown a positive relationship between labor costs and FDI (Love & Lave-Hidalgo, 2000).

Wei and Liu (2001) concluded that FDI was positively influenced by attractive investment policy and skilled and cheap labor in China. Most of studies confirmed that the investment policy is the most important institutional variable, and location, infrastructural development, labor quality are the most significant variables, showing a positive correlation with FDI distribution in the world economy. Illiteracy was the chosen labor quality variable in Coughlin and Segev (2000) and was found to be negatively associated and significant. The study of Bevan, Estrin and Institute (2000) has empirically investigated that FDI inflows are significantly influenced by risk, cheaper labor, and market size.

3.4.11 Political Stability

Political stability is very import for normal macroeconomic and business environment in a country. Political risks largely depend on political stability and good governance of the government (Husain, 2009; Javed *et al*., 2012; Shahzad *et al.,* 2012). Political stability enhances the probability of attracting FDI inflows in

to the developing countries. Of course, political instability in not good since it will adversely affect the country's economic development and growth process by its dent on the physical and human resources. If a country's political stability condition is not good, foreign investors will delay to bringing in any projects until they are assured that the business environment would to be conducive and favorable (Word Bank, 2011; UNCTAD, 2010). In the case of Pakistan, World Bank (2011) categorically mentioned that the low investment of the private sector in the country is because of political instability and corruption.

Many studies conducted examined the relationship between political stability and FDI (Buss & Hefeker, 2007). Most of the studies conclusions generalized the positive impact of political stability on FDI. Kobrin (1984), however, concluded that the empirical findings implied inconsistent and mixed results regarding the effect of political instability and the FDI flows. Schneider and Frey (1985) observed a negative effect of political instability on FDI flows in a cross sectional analysis of FDI flows in the case of selected 36 countries for the period between 1977 and 1982. Knack and Keefer (1995) found effects of political instability on the level of economic growth and investment and also argued that property rights are not enforced in politically unstable environments. It has been asserted that adverse effect on property rights led by political instability tends to reduce both growth and investment.

Factors such as political risks, investment environment, insufficient infrastructure, regulatory framework bureaucratic hurdles and red tape, lake of judicial transparency, and the degree of corruption in the host country are observed to have mixed influence when their influence on FDI inflow was examined. While some studies, such as (Singh & Jun, 1995; Wheeler & Mody, 1992), observed that

political risk was insignificant in affecting the FDI inflows. The studies such as (Root & Ahmed, 1979; Schneider & Frey, 1985), however, traced that political instability and riots and regular constitutional changes in government significantly affected FDI inflows in the developing country. These mixed results might attribute to the problems of setting reliable proxies for the reflection of qualitative factors, like as political instability in empirical analysis (Lim, 2001; Alam, Mian, & Smith, 2006; Kafi *et al*., 2008). Political instability is essentially a qualitative element of a research. Several studies also explained the infrastructure, business environment, and political instability as restrictions towards the inflow of FDI. According to Musila, Jacob and Sigu (2006) it is important to realize that the political stability, sound macroeconomic stabilization and attractive investment policy will carry to increase FDI in to the host country.

Fry (1995) studies discovered the factors that influence the FDI inflows to a country. The researcher argued that political risk is an important factor in limiting capital flows. Foreign capital in many developing countries is exposed to large political risks, so FDI inflows are largely doubtful for politically unstable countries. Singh and Jun (1995) also showed that political stability and business environment have been important determinants of FDI inflows for countries. The studies of Chan and Gemayel (2004) observed that the bad laws and unstable political situation associated with investment risk is a much more critical determinant of foreign investment in the Middle East countries and North Africa region.

Kim (2010) examined the relationship between the foreign direct investment (FDI) and political stability by investigating the FDI inflows in terms of FDI inward performance and political stability measures. The researcher argued

that countries with good political situation have higher FDI inflows. Another way he explained that countries with high level of corruption and bad governance will adversely effect FDI inflows. It is thus concluded that the political stability is very important in FDI inflows to a country. The researcher empirically found that corruption has a negative relationship with FDI and political stability has positive impact on with FDI inflows.

The study of Wang and Swain (1995) related to the determinants of FDI in transforming economies and empirically investigated the situation in Hungary and China for the period 1978 to 1992. The study found that political instability was negatively related to inward FDI in China. Some companies consider political stability as one of their highest concerns to investment in China. The study of Lankes and Venables (1996) empirically found that host country political stability influences FDI inflow in a transition economy. In the case of China, as a matter of fact, the Communist Party is in firm political control and could be seen as a sign of stability.

Kholdy and Sohrabian (2005) investigated the foreign direct investment (FDI) inflows in 22 developing countries, over the period of 1976-2003. The study revealed that financial markets have not been expanded in many developing countries despite their proven positive effect on economic growth. The researchers investigated the impact of financial markets, FDI, and political corruption on economic growth. The study concluded that the FDI stimulate financial development in developing countries. Its empirical results indicated that most of the fundamental links are found in developing countries which experienced a higher level of corruption in the form of excessive sponsorship, nepotism, job reservations, “favour-for-favours”, secret party funding, and suspiciously close ties

between politics and business. The researchers suggested that further theoretical and empirical research is needed to explore whether FDI inflows are affected by the political stability in to the country.

A number of studies examined the effect of transition and of political instability on FDI flows to the transition economies of Central Europe and the emerging CIS countries (Russia, Ukraine, Kazakhstan, Belarus, Azerbaijan, Uzbekistan, Turkmenistan, Georgia, Armenia, Tajikistan, Kyrgyzstan, and Moldova) (Brada, Kutan, & Yigit, 2005). It is observed that investment environment and political stability and other factor is better in Central Europe than CIS countries. Under improved situation, FDI inflows would have made significant contribution to economic growth process.

According to Younis, Lin and Sharahili (2008), political stability is played a crucial role in affecting economic growth in Asian economies. There is a relationship, however, both direct and indirect between political stability and levels of economic growth. As a matter of fact, political stability carries its impact on growth process in both ways directly through sources of capital accumulation and indirectly by influencing the moderating effects of factors, such as, labor, human capital and economic freedom. The study concluded that political stability had a positive and significant influence on FDI in the MENA (Middle East and North Africa) region. Biglaiser and DeRouen (2011) assessed the impact of political stability on FDI in Latin America and found cannot solicit high FDI inflows. By and large, economic reforms towards domestic financial liberalization, trade flows, and privatization can enhance foreign investor's interest towards the concerned country under the normal condition of political instability.

The study of Khan (1997) analyzed the factors responsible for lower level of FDI in Pakistan. The researcher identified that some of the factors are very important for developing countries like Pakistan to attract the investment from the overseas. The factors highlighted are the lack of political instability, law and order situation, economic strength, government's policies for investors, government bureaucracy, and local business environment, infrastructure of the country, skilled labor force, quality of life and the welcoming attitude in general.

Some studies suggested that the Political stability need to test as moderator variable with macroeconomic variables and business environment (Shahzad *et al., 2012*; Javed *et al.*, 2012; Shahzad *et al., 2012*). The present study intended to highlight the significance of political stability as moderator variable in governing the business environment in the developmental process of Pakistan on the basis of foreign direct investment inflows.

3.5 Underpinning Theory

The major purpose of this study is to examine the foreign direct investment and growth nexus in Pakistan. In view of the nature of the variables used in the present study, some major underpinning theories can be cited in determining the analytical framework of the study. The following sub-sections are meant to outline these theories and provide supportive arguments. To recapitulate, the present study has attempted to integrate major thoughts on new growth theory with the Firm Investment theory to substantiate the analytical framework of the study.

3.5.1 FDI Theory

In economic literature, FDI theories have sought to explain various perspectives on foreign direct investment (FDI) in the contemporary era. One set

of FDI theories seeks to explain why a firm will favor direct investment as a mode of entering a foreign market when two other alternatives solution are available such as, exporting and licensing. Exporting involves producing goods at the home and then shipping them to receiving country for sale. Licensing involves granting a foreign entity the right or permission to produce and sell the firm's goods to the recipient countries. Limitations of exporting are the constraints posed by transportation costs and trade barriers. The transportation costs increase the production costs, it becomes unprofitable to ship some goods over a long distance. This is mostly true of those products that have a low value-to-weight ratio and that can be produced in almost any location (e.g., cement, soft drinks, etc). For such products the attractiveness of exporting decreases relative to either FDI or licensing. For products with high value-to-weight ratio, the transportation costs are normally small, such as (e.g. electric components, personal computers, software, medical equipment and high tech, etc.) have little impact on relative attractiveness of exporting, licensing, and FDI.

The problem is that licensing does not give a firm tight control over the manufacturing, marketing, and strategy in a foreign country that may be required to maximize its profitability. Through French chaise (franchised) business, foreign firms are scared to lose the secret of technology. In a country like Pakistan, corruption and political instability affect the control of firms. Similarly, by limiting import through quotas, government increases the attractiveness of FDI and licensing. The foreign direct investment generally goes to the countries where it is possible to join the ownership advantages, with the location specific advantages of the host countries through internalization advantages of foreign investments

(UNCTAD, 1998). Pakistan is an attractive place for foreign investment because of its big market size due to around 180 million populations.

Evidently, several economic theories are attributed to explore the complexities of the FDI in reality. The present study is, on the whole, specifically confined to a major and most significant FDI theory in focus. With location-specific advantages, the multinational firms by establishing a physical presence in other countries. FDI undertaken by many of world's oil companies have invested where oil is located in order to combine their technological and managerial capabilities with these valuable location-specific resources. Another obvious example is valuable and potential human resource, in terms of low cost and highly skilled labor. This theory explicitly implies that the countries endowed with plentiful natural and human resource, will easily attract FDI looking for cheap labor. On this count, there is great potential and scope for the FDI in Pakistan, because it is a land of cheap labor with under-exploited natural resources.

To continually attract huge amount of FDI in Pakistan, there is a dire need to improve the macroeconomic discipline and policy reforms and measures towards market liberalization. Multinational companies would be more confident and happy to invest in Pakistan if there is political stability. Foreign direct investment needs to be based on sound monetary and economic policies, stable political environment, strong institutional framework, and availability of skilled and productive labor force, good quality of infrastructure and consistency in policies.

3.5.2 Eclectic Theory

It is equally interesting to consider Eclectic theory of FDI as a common research framework on FDI inflows on a broader perspective. Eclectic theory, propounded by Dunning (1994), is a holistic analytical approach for foreign direct investment covering organizational issues of the multinational companies relating to foreign business. Eclectic paradigm considers significance of a host of factors, pertaining to Country-specific and Company-specific determinants and internalization variables relating to trade and FDI. The country-specific location variables refer to: (i) the geographical environment, (ii) the political environment, (iii) the government's regulatory framework, (iv) taxation and fiscal policy, (v) production and transportation costs (vi) cultural environment, and (v) infrastructure advantages. The company-specific paradigm relates to ownership and managerial variables such as, managerial efficiency, organizational structure, production process, and technology advantages. The internalization variables refer to the firm's inherent flexibility and output market capabilities.

Above all, as Drucker (1992), the management guru, stated that it is simply not possible to gain substantial market standing in an important area unless one has physical presence as a producer in a global economy

3.5.3 Harrod–Domar Model: Basic Foundation towards Growth theory

The model was propounded by Sir Roy F. Harrod in 1939 and Evsey Domar in 1946. The Harrod-Domar growth model focuses basically on the growth of capital stock as a determinant of economic growth rate. Harrod-Domar Model contains:

$$Y = \Delta I / S \qquad \text{---------- (1)}$$

$\Delta Y = \sigma I$ ---------- (2)

Where,

Y = output

I = net investment

S = the marginal propensity to save

σ = the productivity of capital measured through marginal output-capital ratio

In Harrod-Domar model, the warranted rate of growth is obtained by

$\Delta Y = \Delta (Yp)$

That is to say, change in actual output (ΔY) is equal to the change in potential in capacity output (ΔYp). This implies, thus, that the required rate of growth of both net investments (I) and actual output (Y) should be equal to the product of two parameters S and σ (Mammer, 1999).

New development economic theories that have emerged following the Harrod-Domar model also emphasizes the need for capital formation such as the building up of infrastructure of basic services and civic amenities that support the productive investment and business activity in the country in the long run. The need for a minimum quantum of investment for economic expansion is argued out by the modern growth theorists. In growth process, experts have placed heavy emphasis on the need for boosting the investment into the developing economies. The investment gaps can be smoothly filled up by the adequate inflows of FDI in the absence of enough savings and lack of domestic capital. In short, FDI is

regarded as a major source to overcome the deficiency of capital in the growth process of a developing country.

3.5.4 Investment Theory of Firm

The set of investment theory of the firm consists of a number of economic theories to explain the nature of the firm or company including its existence, behavior, structure, and relationship to the markets in the process of investment criteria determination and decision making. In economic parlance, any establishment which produces good and service is called the firm. The theory of the firm is based on the assumption that the goal or objective of the firm is to maximize the profit. A microeconomic concept founded in neoclassical economics states that firms or corporations exist and make decisions in order to maximize profit. The investment theory of the firm explaining the condition of profit maximization has already been the subject of a research, such as Barney (1991), Williamson and Masten (1995), and Buckley and Michie (1996, 1998) and Christie, Joye and Watts (2003). In the capital budgeting process, as explained in investment theory of the firm, however, the business firms on practical consideration are often observed to sacrifice short-term profits for the sake of increasing future or long term profits. This is given by the present value of all expected future profit of the firm. Future profits must be discounted to the present because a rupee of profit in the future is worth less than a rupee of profit today.

Formally stated, the value of the firm is given by

$$\mathrm{PV} = \frac{\pi 1}{(1+r)^1} + \frac{\pi 2}{(1+r)^2} + \ldots\ldots\ldots + \frac{\pi n}{(1+r)^{\mathrm{n}}} \qquad (1)$$

Where PV is the present value of all expected future profit of the firm, $\pi 1$, $\pi 2$,….., πn representing the expected profits in each of the n years considered, and r is the appropriate discount rate used to find the present value of future profits. In the country, the more uncertain the stream of expected future profit is, the higher is the discount rate that the firm will use, and, therefore, the smaller is the present value of firms The following factors are considered by the firm in perceiving the course of future profits, such as:

1) Opportunity cost of money
2) Risk premium

The discount rate (r) depends on the perceived risk of the firm and on the cost of borrowing funds. Political instability of the country reduces the firm's perception of future profit. Political instability, bad governance, risk of life and unfavorable economic policy increase the cost of doing business. The firm's future profit expectations will be lower. A tradeoff between governance and transaction costs clearly emerges: operating cost alone entails the cost of managing a larger enterprise, while partnering with an independent supplier exposes the multinational firm to the risk of underinvestment, due to hold up concerns (Feenstra & Hanson, 2004). In this regard, the factors to be considered include: the host country's political and government system, the degree of integration into the world system, regional security; and key macroeconomic indicators. Theory of the firm highlights the importance of risk factors that will reduce the net profit expectations the business ventures.

3.5.5 New Growth Theory Model towards FDI

New growth theory as considered in the present study essentially pertaining to the neo classical model and the new growth model. The neo classical model is

essentially built-up on the tenets of the basic model of the old classical theory of growth which essentially provides a base to the new growth theory. The Solow's (1956) growth model virtually is the neo classical model that has been recognized in the economic literature as the standard theory of economic growth (Ireland, 1994). Solow's neo-classical growth theory essentially considered that economic growth is associated with accumulation of capital among the other factors of production that are subjected to diminishing returns to scale.

In theoretical frame-work envisaged under the present study, however, in the context of neo-classical or new growth models, it is presumed that the economic growth in the host countries is effectuated through FDI inflows. In the external sector based neo-classical growth model essentially the country's economic growth is exalted by growth phenomenon in the case of an open and not a closed economy model. FDI in the concerned model of economic growth pertaining to host country, linked with traditional growth theory also confined to the hypothesis that FDI inflows tend to affect the short run income levels. While, few latest researchers have stressed more on endogenous long-run role of FDI in determination of economic growth in a developing country. The neo classical model, however, indicates that FDI can affect growth in the short run only since there tend to be the operation of diminishing returns of capital in the long run (De-Mello, 1999).

The new growth theory of neo-classical model, however, put forward that long run growth can only be attributed to the growth of exogenous labor force and technological progress available in the economy. It, thus, follows that as a crucial factor in promoting economic growth even in the long run it can be presumed that FDI can provide the permanent knowledge transfer (Barrow, Mankiw, & Sala-i-

Martin, 1995). An externality condition such as knowledge transfer, with other externalities, will account for the non- diminishing returns in causing long run growth in effect (De-Mello, 1999). As such if growth determinants, including FDI, are made endogenous in the economic growth model, long run effects of FDI can be traced, which, signifies particular channel whereby technology spills over from the advanced countries to the lagging countries (Bengoa & Sanchez-Robles, 2003).

The Solow (1956) model assumes that in a production function output is technically the function of input of capital and labor attributed to a parameter under the given state of technology. This production function is assumed to be degree-one homogeneous in nature. Under this model the saving rate and the rate of population growth are taken to be exogenous variables. Under these assumptions it can be said that the steady-state growth rate in the economy is equal to the rate of population growth. As such, the rate of growth of per capita income is assumed to be zero. By adding technical change in the model, the per capita growth rate can be assumed to measure the rate of technology growth.

To put it in a nutshell, the neoclassical model suggested that all per-capita growth in the long run were largely attributed to productivity or technology growth. Of course, the saving rate essentially affects the level of income, but has no leaning effect on growth. Another implication of the neoclassical model is that countries tend to converge over a time span. That means, poor countries during the transition period tends to grow faster than rich countries; hence per capita incomes tend to be more equal. Since the capital-labor ratio (K/L) is smaller in lower income nations, marginal productivity of capital tends to be greater, as such these countries tend to invest more and, during the period of transition to steady state, a faster growth would be seen. The theoretical framework, in our study, thus, tends

to emphasize only transition to steady state growth rate in the country. In the long run, thus, if the rate of technical progress remains the same, then the country would grow at the same rate.

$$Y = f(N, L, K, E) \quad \text{---------- 1}$$

Where,

N = Natural Resources

L = Labor

K= Capital

E = Enterprise

Y = Output

$$Y = f(L, K) \quad \text{---------- 2}$$

$$Y/L = f(K/L) \quad \text{---------- 3}$$

The model further implies that, in open economies, capital would tend to flow from rich countries to poor ones, on account of the differential returns to capital in these two types of countries. Poor countries have less capital, tend to have relatively higher return, and this will attract foreign capital inflows. In this model there is no relation indicated between population growth and the long-run per-capita growth rate. However, countries having higher rates of population growth would simply accumulate more capital, so the K/L ratios tend to be equalizing in the long run.

In view of possible diminishing returns to capital, Solow's neo-classical theory suggests that a faster rate of growth occurs in the economies starting further

below their steady-state positions. The determinants of the steady-states positions to be fixed, the neo-classical model justifiably tend to predict faster per capita growth rate in less developing countries (Barrow, Mankiw, & Sala-i-Martin, 1995).

In their analysis of neo-classical theory, Barrow, Mankiw and Sala-i-Martin (1995), however, agreed with the neo-classical model when patterns of conditional convergence come up in their own diffusion of technology model (when two economies' technological gaps tend to be narrow owing to blending). It is argued that in the initial stage there tends to be relatively lower cost of imitation, thus, follower nations tend to grow faster to cope up with leader nations. However, when the pools of available resources are depleted, the costs of imitation will tend to go up and follower's growth rate will tend to fall implying diminishing returns of capital.

The neo-classical model further recognized technical progress only as an exogenous variable that has caused sustainable growth in national income per capital at a steady rate (Ireland, 1994). In considering FDI as an addition to the capital stock of the host countries, neo-classical model categorized capital as externalities subject to diminishing returns producing only a term effect and not a permanent influence on the growth rate (Campos & Kinoshita, 2002).

A major drawback of the neo-classical model is that it hinges on its treating capital as an exogenous production variable with diminishing return, thus, considering capital's short term effect, as such, disregarding its lasting long run growth effect on the working of the economy. The model also ignores the widely

observed variation in long-term growth-rates both within the countries over a period of time and across countries at any given point of time (Ireland, 1994).

These shortcomings of neo-classical model have tended to inspire economic research scholars to search for alternative models that would account for variation in long-run growth as well as consider technological progress ascribed to knowledge-based capital with at least constant return attributes. In essence, the new growth theory, however, should be an alternative to, not a replacement for, the neoclassical theory.

Of course, the new growth theory assumes a wider definition of capital to include both physical and human capital, land, and scientific knowledge, thus making capital endogenous with increasing returns to scale in contrast to diminishing returns base of the neo-classical theory. With the all-inclusive approach of the new theory in broader sense of defining capital, the idea is to capture the reality of technological change and approaches of knowledge management in arresting diminishing returns and soliciting increasing returns in to the production functions one should envisage a new growth theory suitable for the 21st century phenomena. The new growth theory, thus, asserts long-run growth effects of FDI in the developing economy which the neoclassical theory actually failed to recognize. By expanding the definition of capital, thus, to include knowledge development as a key factor the new growth theory essentially holds that knowledge and technology are featured by increasing returns in driving the process of economic growth (Cortright, 2001). This major distinction between the two theories, namely, capital as a factor of production subject to diminishing returns of neoclassical theory and the modern idea that capital as knowledge and technology is subject to increasing returns as contained by the endogenous model

in the new growth theory, is critical to the theory of FDI. The two theories namely old neo-classical and new growth theory model essentially focus on capital as the central theme of their expositions, however, their method and approaches implied different course of outcomes and effects.

A major implication of these theories pertaining to capital in production and growth is that when capital is exogenous as in the neo-classical model, then government's policies have no relevance as influencing factor in economic growth. The new growth model suggests that knowledge and technology are recognized as endogenous variables then government policy turns out to be a crucial factor in influencing economic growth process which is envisaged to be affected by the foreign capital infused through FDI in the developmental strategy of the country.

3.6 Summary

The crux of the matter in this discussion is that in a developing economy government policy and intervention have positive role to play in determination of attracting FDI inflows and moderating the economic growth. In the present study, thus, while tracing the role and impact of the major determinants of FDI inflows in the Pakistan economy the focus is also on the role of the government policy and realities of the political environment in association with the modes of political stability over the period of study is considered. In effect, the present study is devoted in tracing the impact of the course of political stability or instability time to time in Pakistan as major moderating factors among determining variables in attracting the FDI inflows in the country's economy as a crucial factor in persuasion of economic growth and prosperity over the years. As a matter of fact, it follows from the literature surveyed and reviewed above that due consideration of the role of government policy persuasion tuned with political stability is

conspicuously absent in the available studies on the issues of FDI and growth phenomenon in Pakistan. In view of the dearth of a comprehensive research study with a focus on political stability, the present study instfied to endeavor as a fresh look towards the issues of FDI and economic growth in Pakistan.

CHAPTER FOUR

RESEARCH DESIGN AND METHODOLOGY

4.1 Introduction

This chapter spells out the theoretical framework for the hypotheses envisaged under the study. Specifically, this chapter outlines the relevant hypotheses concerning the relationship between FDI inflows in Pakistan. It also reports the data collection procedures and the techniques of analysis. Finally, this chapter explained the statistical techniques are used to pursue the mode of analysis to fulfill the objectives of the study.

4.2 Theoretical Framework

In the light of the literature review and the subsequent theoretical gaps identified in the previous chapter, research design and methodological framework of the present study has been crafted. In specific terms, the theoretical research framework was designed to illustrate the variables incorporated in this study trace their relationship to detect their influences on FDI inflows in Pakistan. Figure 4.1 pertains to the research framework model envisaged for the present study.

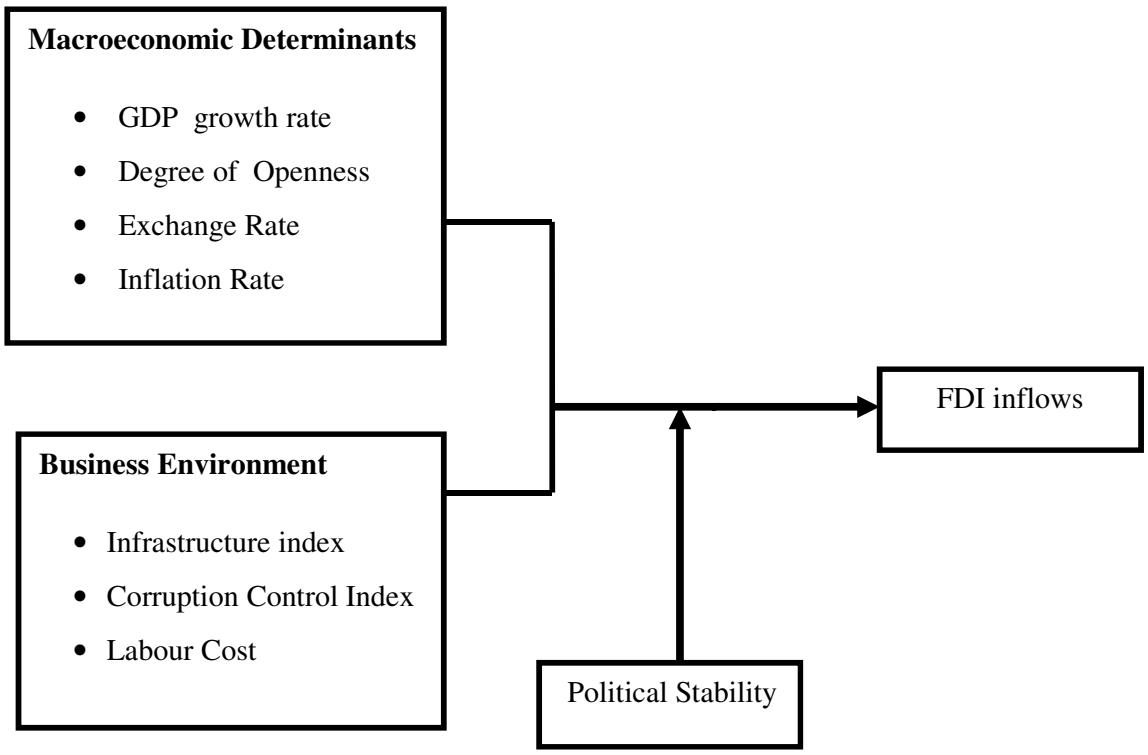

Figure 4.1
Research Framework

4.3 Hypotheses Development

Referred to the research framework model mentioned above, corresponding to the research design envisaged, the mode of investigation in the present study is confined to certain major hypotheses pertaining to empirical economic relations narrated as under:

4.3.1 GDP Growth Rate and FDI

The FDI and GDP growth rate nexus in the developing countries has been studied by several researchers in last few years. On this account most of the studies such as (Root & Ahmed, 1979; Martinez-Zarzoso, 2003; Martinez-Zarzoso & Nowak-Lehmann, 2004) found that GDP growth rate have significant influence on FDI in developing countries. In contrast, however, Carkovic and Levine (2005), adopting new econometric techniques, saw no evidence of a positive relationship

between FDI and GDP growth rate, but Calderan *et al*.,(2004) found that the causal relationship goes in the opposite direction: GDP growth rate leads to increase in FDI. Astonishingly, the study conducted by Mencinger (2003) revealed that in the case of transition economies of Eastern Europe, FDI inflows rate had a negative impact on GDP growth rate. Choe (2003), however, found evidence of a bidirectional correlation between FDI and GDP growth rates, and pointed out that the strongest effects have occurred from GDP growth rate to FDI. The present study examines empirically the impact of growth rate of FDI, thus, the first hypothesis of this study as follows:

H1: GDP growth rate has a significant effect on the FDI inflows in Pakistan

4.3.2 Degree of Openness

The studies provided by Haile and Assefa (2006), Singh and Jun (1995) and Asiedu (2006) traced that degree of openness is a significant determinant with positive signs to FDI inflows in Ethiopia and Singapore. Other studies also argued that the degree of openness affects the FDI inflows in the developing countries positively (Seim, 2009; Baharom, *et al*, 2008). As such, several studies have found a positive relationship between trade openness and FDI inflows (Chakrabarti, 2002, Morisset, 2000). While, few researchers have traced the negative effect of degree of openness on FDI (Ethier, 1994; Brainard, 1997). A recent study, however, has shown that degree of openness has significant positive relationship with FDI inflows in Pakistan (Awan *et al*., 2010). Therefore, the second hypothesis is described as below:

H2: Degree of Openness (DOP) has a significant effect on the FDI inflows in Pakistan

4.3.3 Exchange Rate and FDI

Blonigen and Ma (2011) and Froot & Stein (1991) detected negative significant relationship among exchange rate and inward FDI; whereas, some studies depicted insignificant impact between exchange rate on inward FDI (Kyereboah & Osei, 2008; Blonigen, 1997). The study of Rehman *et al*. (2011) relating to Pakistan found that exchange rate has a significant positive impact on FDI inflow. Goldberg and Kolstad (1995) in their study referred to the economic effect of short-term exchange rate variability on FDI flows and supported the hypothesis that volatility of exchange rates contributes largely to the internationalization of production. Bleaney and Greenaway (2001) observed that exchange rate distortions in the host country do not cause a negative effect on FDI flows, whereas growth expectations exert a positive effect and corruption a negative one. It is, thus, worthwhile to test the following hypotheses with latest data:

H3: Exchange rate has a significant effect on the FDI inflows in Pakistan.

4.3.4 Inflation Rate (INFRATE) and FDI

Generally, the inflation rate is used to measure the level of price stability and economic stabilisation. The inflation rate has negative significant relationship betweend FDI inflows in Africa (Naude & Krugell, 2007). In similar view of research, Sayek (1999) found that the relationship between inflation rate and FDI is significantly negative. Regarding Pakistan, however, the study conducted by Awan *et al*. (2010) has shown that inflation relationship with FDI inflows has been positive and significant. A study conducted by Zaman *et al*. (2006), however, the found that inflation rate has significant impact on FDI in Pakistan. Therefore, the fourth hypothesis is described as below:

H4: Inflation rate has a significant effect on the FDI inflows in Pakistan.

4.3.5 Infrastructure

Wheeler and Mody (1992) have concluded in their studies that infrastructure has a crucial role to play in attracting FDI. Few recent studies also confirmed this phenomenon. For example, Khadaroo and Seetanah (2010) used 20 economies as a sample from Africa where they found that infrastructure is crucial in attracting FDI inflows. Similarly, Kok and Erosoy (2009) used cross sectional data of 24 developing countries and found that infrastructure has significant positive impact on FDI. Other studies such as Bae (2008) also acknowledged the above result pertaining to 36 emerging economies, Li and Park (2006) for China and Asiedu (2006) for SSA. In general, the significant impact of infrastructure on FDI has been widely acknowledged (Quazi, 2005). Despite that the literature confirmed the significant effect of infrastructure in inviting inward FDI flows to the countries, studying this relationship in the developing countries, such as Pakistan has been still largely neglected. Indeed, infrastructures are important for FDI inflows to developing countries. Empirical finding shows that infrastructure is significant for FDI inflows to developing countries (Onyeiwu, 2003). Due to the importance of infrastructure to attract FDI into the host country, this study seeks to examine the following hypothesis:

H5: Infrastructure has a significant effect on the FDI inflows in Pakistan.

4.3.6 Corruption Control Index

Reviewing the past literature regarding the relationship between corruption index and FDI inflows studies showed inconsistent findings. While Akcay (2001) failed to find evidence of a negative relationship between FDI and corruption, Habib and Zurawicki (2002) found that there is a negative impact of corruption on

FDI. This was justified by the fact that foreign investors generally avoid investing in corrupted business environment since they feel insecure and corruption may cause operational inefficiencies. Moreover, Mathur (2007) found that corruption perception played a crucial role in investors' decision of where to invest. Similarly, Zhou (2007) found that the overall effect of corruption is significantly negative on the FDI inflows to the country. In their study, Bahmani-Oskeooee and Nasir (2002) analyzed a cross-sectional data of 65 countries and found that countries with more corruption level have experienced declining FDI inflows. In a similar stream of research, Egger and Winner (2005) detected a negative relationship between corruption and FDI inflows. In general, corruption control is generally associated with better institutions of the country, it is reasonable to propose the following hypothesis in the context of Pakistan, thus:

H6: Corruption control index has a significant effect on the FDI in Pakistan.

4.3.7 Labor Cost (LBC) and FDI

Foreign investors basically want to take benefits from cheap labor where the cost of production will be less (Andresosso-O-callagham & Wei 2003). The study of Lan and Yen (2009) on China found that labor cost are positive and significant with FDI inflows. Similarly, the study of Ali and Guo (2005) on firms which take advantage of low labor costs as the main factor in China has positive significant impact on FDI. Cost factors are one of the major determinants of FDI, among which labor cost according to Wang and Swain (1995) is significant as they found that there was a positive relationship between the relatively cheap labor in China and inward FDI. The point was also endorsed by the study conducted by Zhang (2001).

Few researchers such as (Kravis & Lipsey, 1993; Barrell & Pain, 1996), however, conclude there is that no significant or a negative relationship of labor cost and FDI. On the other side, some research found that labor cost have positive relationship with FDI inflows (Love & Lave-Hidalgo, 2000). It is, thus, worthwhile to test the following hypotheses with latest data:

H7: Labor Cost (LBC) has a significant effect on the FDI inflows in Pakistan

4.3.8 Political Stability and FDI

In studying the effect of the political instability on the FDI inflows, there have been mixed findings in the literature. For instance, Wheeler and Mody (1992) and Singh and Jun (1995) found that political instability and administrative efficiency are insignificant in determining FDI. Many other studies such as (Schneider & Frey, 1985; Korbin, 1981; Lim, 2001) found that political stability have significant impact of FDI inflow. Similarly, other studies such as those conducted by (Singh & Jun, 1995; Wei, 2000; Kwang & Singh, 1996) found that political stability has a positive effect on FDI inflow. Since investors are very sensitive to the political stability of the targeted countries, it is expected that the political stability of the country can affect FDI inflows. Meaning that whatever the favorable determinants of FDI the country possesses, it will not be able to attract investors if the political situation is not stable. These arguments and other supporting ones lead to the following hypotheses:

H8: Political stability has a significant effect on the FDI inflows in Pakistan

H9: Political Stability moderates the relationship between GDP growth rate and the FDI inflows in Pakistan.

H10: Political Stability moderates the relationship between EXCHRATE and the FDI inflows.

H11: Political Stability moderates the relationship between degree of openness (DOP) and the FDI inflows.

H12: Political Stability moderates the relationship between inflation rate (INFRATE) and the FDI inflows.

H13: Political Stability moderates the relationship between Infrastructure (INFRAS) and the FDI inflows.

H14: Political Stability moderates the relationship between corruption control (CCI) and the FDI inflows.

H15: Political Stability moderates the relationship between LBC and the FDI inflows.

The following model devised to test the hypotheses (H1-H15) in the present study.

$$FDI_{it} = a_0 + a_1 GDPGR_{it} + a_2 DOP_{it} + a_3 EXCHRATE_{it} + a_4 INFRATE_{it} + a_5 INFRAS_{it} + a_6 CCI_{it} + a_7 LBC_{it} + a_8 PSI_{it} + a_9 GDPGR_{it} * PSI_{it} + a_{10} DOP_{it} * PSI_{it} + a_{11} EXCHRATE_{it} * PSI_{it} + a_{12} INFRATE_{it} * PSI_{it} + a_{13} INFRAS_{it} * PSI_{it} + a_{14} CCI_{it} * PSI_{it} + a_{15} LBC_{it} * PSI_{it} + e_{it}$$

FDI_{it} = Foreign Direct Investment inflows on the yearly basis

a_0 = Model intercept

$GDPGR_{it}$ = Gross domestic production growth rate on the yearly basis

DOP_{it} = Openness measured as exports plus imports as percentage of GDP on the yearly basis

$EXCHRATE_{it}$ = Real exchange rate on the yearly basis

$INFRATE_{it}$ = Inflation Rate on the yearly basis

$INFRAS_{it}$ = Infrastructure Index rank using yearly data

CCI_{it} = Corruption Control Index ranking using yearly data

LBC_{it} = Labor Cost Wages set by the government yearly data

PSI_{it} = Political Stability Index rank on the yearly basis

4.4 Data Collection Procedures

The present study is based on the compilation of secondary data. The concerned data for analyzing the determinants of FDI and relevant issues presumed under the study have been obtained from various authentic sources. The data used in this study are the annual data for the period 1991 to 2011. The main sources of the data are State Bank of Pakistan (SBP), UNCTAD Reports, World Bank Report, and Economic Surveys of Pakistan. In particular, the macroeconomic variables such as: inflation rate (INFRATE), exchange rate (EXCHRATE) and FDI inflows data are collected from SBP (State Bank of Pakistan) reports. The GDP growth rate (GDPGR) is collected from the UNCTAD reports. The business environment such as Infrastructure (INFRAS) and Corruption Control Index (CCI) and Political Stability Index (PSI) data were collected from the World Bank Governance Indictor Reports. The variable definition and method of construction are given in Table 4.1.

Table 4.1
The Sources of Data Collection for Each Variable

Variables	**Description**
FDI inflows	FDI inflows Data in Pakistan during the period of 1991-2011. Data collected from annual reports of State Bank of Pakistan. Total FDI inflows received by the Government of Pakistan.
GDPGR	GDPGR growth rate data collected from the annual report of Pakistan State Bank of Pakistan (SBP, 2011) and Investment Board of Pakistan.
Exchange Rate(EXCHRATE)	Pakistan exchange rate against US dollar annual data collected from the State Bank of Pakistan for the period 1991-2011.
Degree of Openness(DOP)	Exports, Imports and GDP (Gross Domestic Product) data collected from the UNCTAD report and IMF reports. The DOP is calculated by using the following formula. DOP= (Imports + Exports) / GDP.

Inflation Rate (INFRATE)	Measured in terms of Consumer Price Index (CPI). Data also collected from State Bank of Pakistan.
Infrastructure Index (INFRAS)	Infrastructure rank data is obtained from the World Bank Reports.
Corruption Control Index (CCI)	Collected from World Bank reports, Indicator Corruption Control Index.
Labor Cost (LBC)	Collected from the Labor Department, Government of Pakistan - Wages set by the Government.
Political Stability Index (PSI)	Collected from World Bank reports Pakistan political stability ranks.

4.5 Operational Definitions

The variables used in the present study are conceptualized for an understanding as follows. This section will describe how to measure the variables or describe operational definition. Table 4.2 summarizes the operation definition for the variables used in this study.

Table 4.2 *Measurement of the Variables*

Variables	**Operational definition**	**Authors/Agency**
Political Stability Index	Measured by the discernment of the likelihood that the government will be destabilized or overthrown by unlawful or violent means, armed conflict, violent demonstrations, social unrest, international tensions and terrorist threat, orderly transfers, government stability, internal conflict, external conflict, ethnic tensions as well as domestic violence and terrorism in the country and ranges between 100 (highly political stability) and 0 (low political stability)	(World Bank, 2011; UNCTAD, 2011).
FDI Inflows	Refer to quantum of foreign investment come into the country	UNCTAD (2011)
GDP growth rate	Describe as the changes in the gross domestic between year	SBP (2011)
DOP	Measured by the trade to GDP ratio	SBP (2011)
Exchange rate	Refer to the price of one currency expressed in terms of another currency	UNCATD (2011)
Inflation rate	Measured by the average of percentage increased in the price of good and services comparing between two years	SBP (2011)
Infrastructure	Measured by the billing collection rates	Bank (2011)

Index	and country overall infrastructure, electricity consumption, excessive losses from the network in power, gas, roads, telecommunication, ports etc.	
Corruption Control Index	Corruption control index relates to view of the degree of corruption as seen by business people and country analysts, and ranges between 100 (highly clean) and 0 (highly corrupt)	World Bank (2011)
Labor cost	Measured by salary decided by the government of Pakistan. This means minimum level of gross amount, that is before deduction of income tax and social security contributions and which is established by law for work performed per month.	(SBP, 2011).

4.6 Data Analysis

The data for the present study were analyzed using the Statistical Package of Social Sciences (SPSS) and EViews software. However, the data were statistically analyzed through the following process in the first step; data were summarized and initially analyzed through descriptive statistics. The second step continued to check the stationarity of data to the multiple regression assumptions. Finally, the hypotheses were tested through Pearson correlation of multiple regression analysis.

4.6.1 Stationarity Analysis of the Data

At this stage, the data were prepared to check the stationary or non-stationary of data analysis through ensuring the fulfillment of the stationarity analysis assumptions. Under the present study this empirical investigation on the determinants of FDI in Pakistan adepts to time series data for the period of 1991-2011. First to determine the order of the integration of the variables, Augmented Dickey Fuller (ADF) test for unit roots has been employed to find out that the variables are concluded to be integrated of the same order. Time Series data has the property of non-stationary in levels. First Unit Root Tests are performed for the stationary in the levels and in first/second difference of the variables.

In order to avoid spurious regression, we begin with an investigation of the properties of the time series data that we are dealing with to determine if the variables are stationary or nonstationary in nature. The procedure used here is the Augmented Dickey Fuller (ADF).

4.6.1.1 Augmented Dickey Fuller (ADF)

Using the time series data in analysis has preliminary steps. First step we should determine the form in which the series can be used for any subsequent estimation. For example, the non-stationary data will affect the regression issues; the time series data trend showing growth or decline over time which must be removed prior to undertaking any estimation procedure.

In the present study, the Augmented Dickey Fuller (ADF) unit root tests are used to examine the stationary feature of the series used and integration order of non-stationary time series. All the variables has been checked one by one to see either they are stationary or non-stationary. Table 4.3 reported that 0 stands

for non-stationary and S stands for stationary. Using the method unit root in level, 1st difference and 2nd difference with trend and intercept equation with lagged difference 1 or 2. Table 4.3 showed that the result of ADF test for the variable FDI inflows is stationary at the 2nd difference at 2 lagged. Some variables such as GDPGR, INFRAS, CCI and LBC are stationary at 2nd difference with lagged two also. Other variable such as DOP and PSI are stationary at 1st difference with lagged one other variable such as EXCHRATE and INFRATE are stationary at 2nd difference with lagged one. Table 4.3, implies that after checking the ADF test all the data series are stationary, there is no issues with data.

Table 4.3
ADF unit root test result using the Trend and intercept

	Variable	Level	1st Diff	2nd Diff	Lagged
1	FDI	0	0	S	2
2	GDPGR	0	0	S	2
3	DOP	0	S	-	1
4	EXCHRATE	0	0	S	1
5	INFRATE	0	0	S	1
6	INFRAS	0	0	S	2
7	CCI	0	0	S	2
8	LBC	0	0	S	2
9	PSI	0	S	-	1

4.7 Preparing data for Multiple Regression Analysis

There are four main assumptions that should be met prior to conducting the regression analysis. These assumptions are: linearity; homoscedasticity, normality and no serious multicollinearity problem, and finally independence of residuals (Coakes & Steed, 2003; Hair *et al*., 2010). According to Hair *et al*. (2010), sample size has a direct impact on the power of the multiple regressions. Therefore, there has been no hard rule to determine the observation independent variable ratio. To ensure valid and reliable results, some researchers claim that ideally there should be 15 to 20 observations for each independent variable (Hair *et al.,* 2010). The coefficient of determination, R^2, is the measure of the goodness of the model where it indicates the variance of the dependent variable that was accounted for by the independent variables (Hair *et al*., 2010). In our estimation, thus, enough care is taken abide to the econometric norms in the empirical measurement and analysis.

Before proceeding to carry out the multiple regression analysis, the presence of outliers and multicollinearity were examined. It was found that the data have no serious issues related to multicollinearity. In addition to that, the performed investigations revealed that all the necessary conditions to conduct the regression analysis were satisfied. The procedures used by this study are reported in the following sub-sections.

4.7.1 Detecting Outliers

Outliers are defined to be the observations that have unique characteristics and differ distinctly from others (Hair *et al*., 2010). Moreover, outliers can be detected using univariate, bivariate and multivariate techniques based on the

number of variables. Among the commonly used method to detect outliers is Mahalanobis distance measure. This method, according to Hair *et al.* (2010), measures the distance of each observation from the mean center of all observations in multidimensional space. In detecting the outlier observations, Mahalanobis distance values were examined and compared to the critical values in Chi-square distribution table. The results of this study showed that Mahalanobis distances of all the observations ranged between 1.9945 and 12.9760. Referring to the Chi-Square distribution table, the critical value at 0.001 level of significance and 9 degrees of freedom was found to be 27.877.

In order to identify the outlier observations, a further examination of the SPSS package results saved in the data as Mahalanobis distance was compared to using the Chi Square value of 27.877, we concluded that there are no outliers in this study. So the next step is to examine other assumption of the regression analysis.

4.7.2 Multicollinearity Check

Multicollinearity check is the indicator of the existence of a high order of linear correlation amongst two or more predictor variables in a multiple regression. In any practical check, the correlation between explanatory variable will be no-zero, although this will generally be relatively benign in the sense that a small degree of association between explanatory variables will almost always occur but will not cause too much loss of precision.

Multicollinearity is defined as the level to which the effect of any variable can be accounted for by other variables (Hair *et al*., 2010). The increase of multicollinearity raises the difficulty of interpretation of different variables' effects. The present study used the tolerance value and Variance Inflation Factor

(VIF) to examine the presence of multicollinearity issue among the variables of the study. The tolerance is defined, according to Hair *et al.* (2010), as the variability in a variable that is not accounted for by other variables. Moreover, the VIF indicator is the reciprocal of the tolerance variable.

Data in Table 4.4 indicate that in the case of Pakistan the independent variable of LBC explained by other variables since its very VIF is 22.220. Labor Cost (LBC) variable has the issues of multicollinearity with other variables such as exchange rate (EXCHRATE) and political stability index (PSI). LBC variable needs to be dropped from the model, to avoid the multicollinearity issues. After dropping labor cost (LBC) from the model the multicollinearity issue was resolved as shown in Table 4.4.

Table 4.4
Multicollinearity Test with all variables

Variables	Tolerance value	VIF
GDPGR	.678	1.474
DOP	.611	1.636
EXCHRate	.056	17.760
INFRATE	.146	6.833
INFRAS	.309	3.238
CCI	.365	2.741
LBC	.045	22.220
PSI	.092	10.874

After dropping the labor cost (LBC) variable form the model, the VIF Value was 9.131 of Political Stability (PSI). However, data in Table 4.5 showed that the tolerance values of all variables ranged between 0.110 and 0.759. Moreover, the values of VIF for all the variables were found to range between 1.317 and 9.131. These results indicated that the tolerance values of all the variables of this study were more than 0.1 and consequently the VIF were below the threshold value of 10 as suggested by Hair *et al*. (2010). In other words, the tolerance and VIF values of the variables included in this study were within the recommended threshold values, indicating that the issue of multicollinearity issue was not present in this study.

Table 4.5
Multicollinearity Test after Dropping (LBC)

Variables	Tolerance	VIF
GDPGR	.759	1.317
DOP	.611	1.636
EXCHRATE	.139	7.217
INFRATE	.300	3.335
INFRAS	.364	2.749
CCI	.378	2.647
PSI	.110	9.131

After dropping the variable of LBC from the model, thus, it can be confidently concluded that this study contained no serious outlier observations and the multicollinearity was not a concern.

Prior to conducting the regression analysis, this study devoted the following sub-sections to examine the assumptions of multiple linear regressions

through the residual analysis (Hair *et al*., 2010). More specifically, the proceeding sections discussed the assumptions of normality, linearity, homoscedasticity, and finally the independence of error terms.

4.7.3 Testing the Normality of the Error Terms

The normality assumption of the error terms was examined through the normal probability plots of the residuals. The histogram and the normal probability plot (P-P Plots) of the regression standardized residual was the tool based on which the normality was confirmed. The Figures 4.2 and 4.3, relating to the data showed that the behavior of the data distribution did not deviate substantially from the normal curve associated. Thus, it can be concluded that the data approximately followed normal distribution.

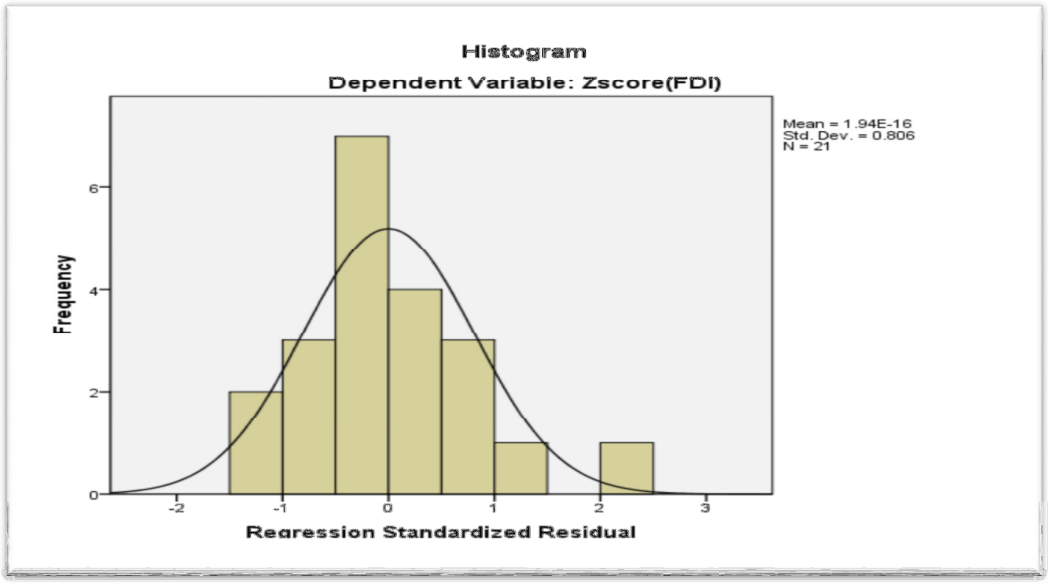

Figure 4.2
Histogram of the Regression Residuals

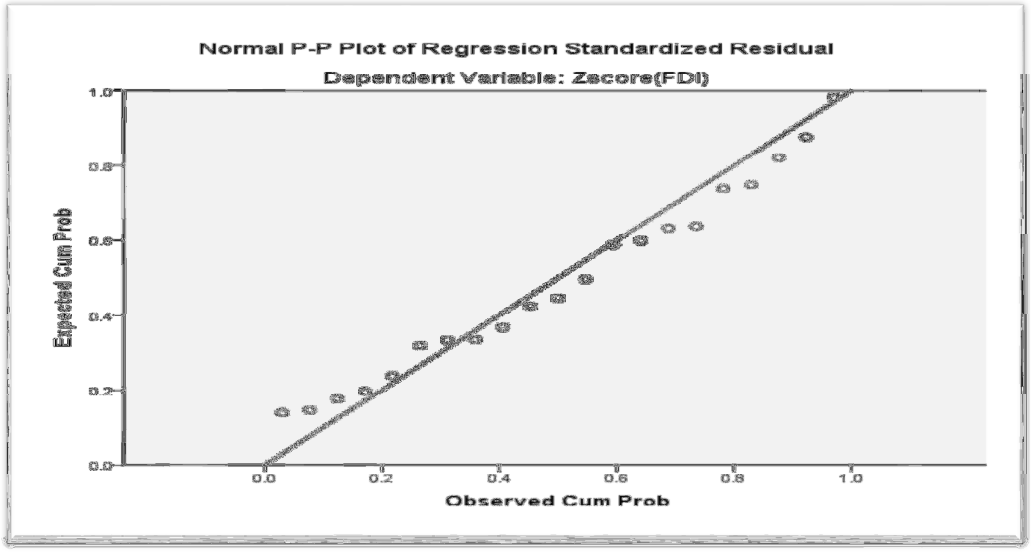

Figure 4.3
Testing Normality using Normal Probability Plot

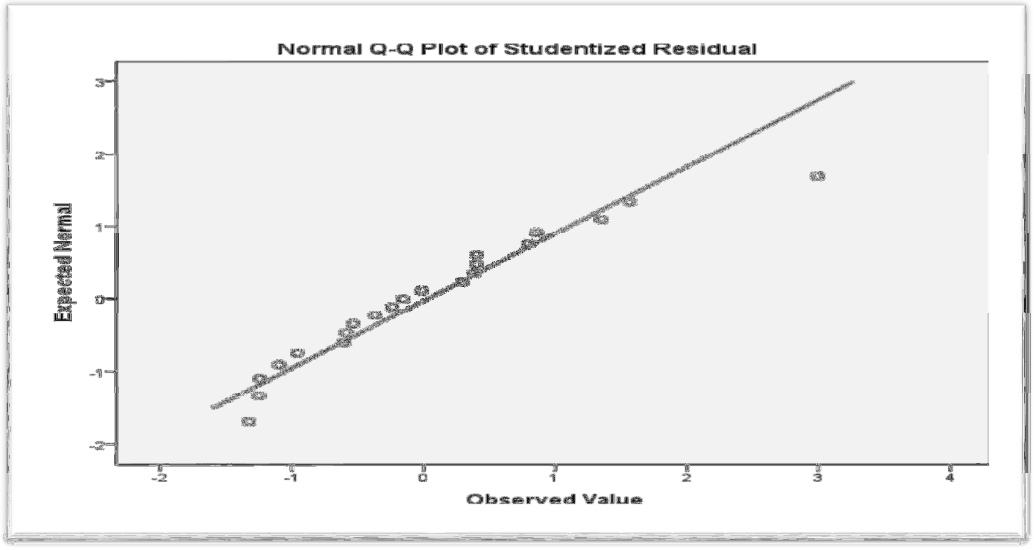

Figure 4.4
Testing Normality using Q-Q Plot

The assumption of normality was also confirmed by examining both P-P Plot and Q-Q plot. The two plots showed that the data lie on the strait lines in both graphs indicating that the data were approximately normally distributed as depicted in Figure 4.3, and Figure 4.4. As a confirmation, the normality of the data was examined by testing the normality of the residuals. The results of residual

analysis, however, showed that there are no major deviations from the normality assumption.

Additionaly, the assumption of normality was confirmed by employing the Kolmogrov-Smirnov and Shapiro-Wilk tests. The results depicted in Table 4.6 showed that the assumption of normality was not rejected at the 0.01 level of significance. In fact, Kolmogorov-Smirnov and Shapiro-Wilk tests the hypothesis that the error terms are normally distributed. As shown in Table 4.6, the P values for both tests were not significant indicating that the normality assumption of the error terms cannot be rejected.

Table 4.6
Normality test of the Residuals

	Kolmogorov-Smirnov			Shapiro-Wilk		
	Statistic	df	Sig.	Statistic	df	Sig.
Standardized Residual	0.127	21	0.200*	0.928	21	0.123 *

*: P< 0.10

Based on the previous discussion, it can be concluded that the normality of the error terms was confirmed. Having confirmed the assumption of normality of the error terms, the process should follow to test the linearity, homoscedasticity and independence of the error terms as discussed in the following sub-section. The analysis of the normality of the independent variables is presented in the Appendix 4. The results, however, showed that all the variables were normally distributed according to the Kolmogrove Sminrov and Shapiro-Wilk tests.

4.7.4 Testing the Linearity, Homoscedasticity and the Independence of Errors

This study examined the linearity, homoscedasticity and the independence

of the error terms through examining the scatterplot of the residuals. The scatter plot in Figure 4.5 showed that there was no clear relationship between the residual and the predicted value. Following the suggestion of Hair *et al.* (2010), since the scatterplot showed no clear relationship between residuals and predicted values, it proves the linearity, homoscedasticity and the independence of residuals. Moreover, the linearity assumption was also examined through the scatterplots of each independent variable with the dependent variable or partial correlation plots between each independent variables and the dependent variable.

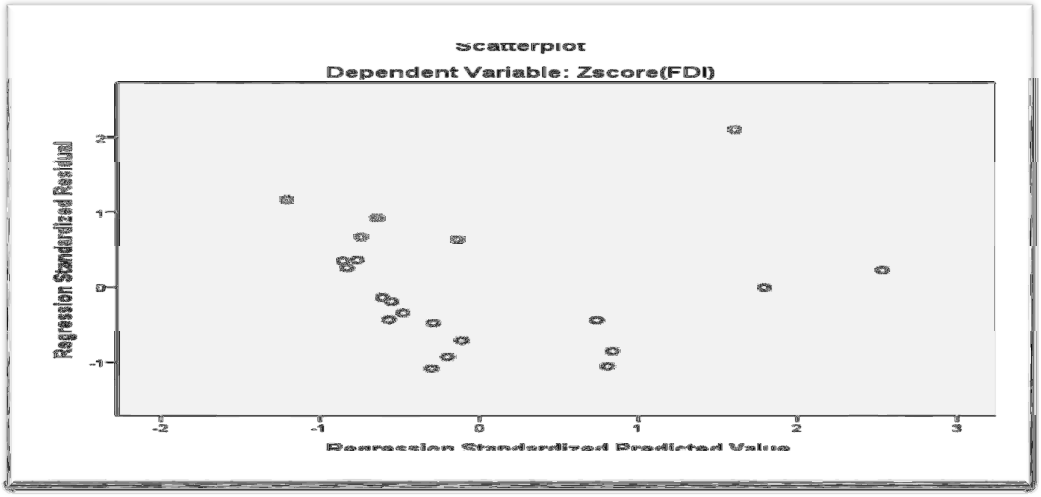

Figure 4.5
The Scatterplot of Residuals

4.7 Summary

By and large, the study is intended to be a mix of descriptive and analytical approach probing into the determinants of FDI flows in Pakistan in perceiving the due significance of political stability as moderating factor.

Besides providing empirical insights on the inflows of determining factors in the trends of FDI inflows in Pakistan over the years during last two decades. The analysis also intended to infer pragmatic policy oriented recommendations for

the considerations of the policy makers of Pakistan as well as other developing countries in similar situation.

CHAPTER FIVE

DATA ANALYSIS AND RESULTS

5.1 Introduction

This chapter reports the results of the data analysis pertaining to the hypothesized model. The chapter is divided into three main sections; the descriptive analysis, model estimation, and a summary. The moderating effects of the political stability on the relationships were examined. Before undertaking the hypotheses testing procedure, this study performed the descriptive analysis to have an initial summary of the level of FDI inflows, macroeconomic variables (GDPGR, DOP, EXCHRATE and INFRATE), business environment variables (INFRAS, CCI and LBC) and Political Stability Index (PSI) in Pakistan.

5.2 Descriptive Analysis

In the initial summary of the data, a descriptive analysis was conducted to describe the general situation of FDI inflows, macroeconomic variables such as GDPDR, DOP, EXCHRATE and INFRATE and business environment variables such as INFRA, CCI, LBC and moderating role of political stability in Pakistan. Table 5.1 reports the mean, standard deviation, maximum and minimum of the values of the variables. These results reflect the level of FDI inflows and Political Stability in the country. These results indicate the maximum and maximum value of variables such as FDI inflows, macroeconomic variable such as (GDPGR, DOP, EXCHRATE, INFRATE) and business environment variable such as(INFRAS, CCI, LBC) and Political Stability, see, Appendix 3.

Table 5.1
Descriptive Statistics of the Constructs (n=21)

	Unit	Minimum	Maximum	Mean	Std. Deviation
FDI	Million $	271.90	5410.00	1461.12	1609.04
GDPGR	Percentage	1.70	8.96	4.61	2.02
DOP	Index	0.28	0.43	0.33	0.03
EXCHRATE	RS = $	23.80	90.00	53.20	20.03
INFRATE	Percentage	3.20	13.10	8.51	3.54
INFRAS	Rank	2.26	4.50	3.28	0.71
CCI	Rank	7.50	28.30	15.48	6.28
LBC	RS	1500.00	7000.00	3076.19	1893.12
PSI	Rank	0.5	15.00	8.23	5.16

5.3 Pearson Correlation Analysis

To show the relationships between FDI inflows, macroeconomic variables and business environment variables and moderating variable of political stability, the Pearson correlation analysis was used. More specifically, the purpose of using Pearson correlation analysis (PCA) was to investigate the relationships between FDI inflows, macroeconomic variables and business environment variables in affecting investment in Pakistan.

As illustrated in Table 5.2, all the relationships between the dimensions of FDI inflows, macroeconomic variable such as (GDPGR, DOP and EXCHRATE), business environment variable (LBC) and the moderating variables of political

stability on Pakistan were found to be statistically significant at the 0.01 and 0.05 level of significance.

Table 5.2
Pearson Correlation Analysis

	FDI	GDPGR	DOP	EXCHRATE	INFRATE	INFRAS	CCI	Labor Cost	PSI
FDI	1	.460*	.525*	.496*	.173	.129	.413	.641**	.630**
		.036	.015	.022	.453	.578	.063	.002	.002
	21	21	21	21	21	21	21	21	21
GDPGR	.460*	1	.335	-.139	.192	-.121	.036	.049	-.005
	.036		.138	.547	.405	.602	.877	.831	.983
	21	21	21	21	21	21	21	21	21
DOP	.525*	.335	1	-.097	.472*	-.301	-.175	.148	-.047
	.015	.138		.675	.031	.185	.447	.523	.839
	21	21	21	21	21	21	21	21	21
EXCHRATE	.496*	-.139	-.097	1	-.050	.181	.364	.887**	.846**
	.022	.547	.675		.830	.431	.105	.000	.000
	21	21	21	21	21	21	21	21	21
INFRATE	.173	.192	.472*	-.050	1	-.608**	-.652**	.335	-.317
	.453	.405	.031	.830		.003	.001	.138	.162
	21	21	21	21	21	21	21	21	21
INFRAS	.129	-.121	-.301	.181	-.608**	1	.523*	-.089	.541*
	.578	.602	.185	.431	.003		.015	.701	.011
	21	21	21	21	21	21	21	21	21
CCI	.413	.036	-.175	.364	-.652**	.523*	1	.126	.569**
	.063	.877	.447	.105	.001	.015		.587	.007
	21	21	21	21	21	21	21	21	21
Labor Cost	.641**	.049	.148	.887**	.335	-.089	.126	1	.691**
	.002	.831	.523	.000	.138	.701	.587		.001
	21	21	21	21	21	21	21	21	21
PSI	.630**	-.005	-.047	.846**	-.317	.541*	.569**	.691**	1
	.002	.983	.839	.000	.162	.011	.007	.001	
	21	21	21	21	21	21	21	21	21

** : p< 0.01 (2-tailed) , *: p<0.05 (2-talied).

In determining the strength of the relationships between each independent and the dependent variable, Hair *et al.* (2010), suggested that while the correlation of 0 indicates that there is no relationship, the correlation of ±1.0 indicates the existence of perfect relationship. In interpreting the correlation between 0 and 1.0, Cohen (1988) criterion was followed. When the correlation (*r*) is between ±0.1 and ±0.29, the relationship is said to be small, when r is between ±0.30 and ±0.49, the relationship is described as medium. Finally, the relationship is said to be strong when the correlation is above ±0.50.

Based on the results in Table 5.3, some of the Pearson correlation coefficients were found to be significant at the 0.01 and 0.05 level of significance. In other words, the data under the present study supported the existence of significant relationships between FDI construct and its factors and political stability of Pakistan.

Table 5.3
Summary of the Correlation Analysis

Hypothesized Relationship	**Correlation Coefficient (r)**	**Decision**
1. There is a relationship between GDPGR growth rate and FDI inflow in Pakistan.	0.460*	Significant
2. There is a relationship between Degree of Openness and FDI inflow in Pakistan.	0.525*	Significant
3. There is a relationship between EXCHRATE and FDI in Pakistan.	0.496*	Significant
4. There is a relationship between Inflation Rate and FDI in Pakistan.	0.173	Not Significant

5. There is a relationship between infrastructure development and FDI inflows in Pakistan.	0.129	Not Significant
6. There is a relationship between corruption control and FDI inflows in Pakistan.	0.413	Not Significant
7. There is a relationship between LBC and FDI inflows in Pakistan.	0.641**	Significant
8. There is a relationship between Political stability and FDI in Pakistan.	0.630**	Significant

** : p< 0.01 (2-tailed), *: p< 0.05 (2-tailed).

5.4 Multiple Regression Analysis Results

After all the regression assumptions were checked and found to be satisfied, this study ran the regression analysis using SPSS 19.0 to examine the predictive power of the hypothesized model. In other words, the main purpose of the multiple regression analysis was to determine the predictive power of each independent variable toward the dependent variable. Moreover, it was used to identify and compare the predictive power of the dimensions of macroeconomic variables (GDPGR, DOP, EXCHRATE, and INFRATE), business environment (INFRAS and CCI) variables and political stability toward the FDI.

According to the hierarchical regression performed and its results reported in Table 5.4, it can be concluded that GDGDR (β=0. 0.239, t= 2.238, p<0.05), DOP (β=0.318, t=2.677, p<0.05), INFRATE (β=0.448, t=2.640, p<0.05), CCI (β=0.457, t=3.019, p<0.05), PSI (β=0.733 t=2.607, p<0.05) have significant positive impact on FDI inflows at 0.05 levels of significance. Additionally, the results revealed that GDPGR, DOP, INFRATE, CCI and PSI had greater impact on the FDI inflows in Pakistan. These results, however, supported the hypotheses

H1, H2, H4, H6 and H8 in which the impact of GDPGR, DOP, INFRATE, CCI and PSI on the FDI inflows were claimed to be significant at the 0.05 level of significance. The variable of EXCHRATE and INFRAS were not significant in case of Pakistan.

Table 5.4
Examining Variables' predictive power

	Model	
Variables	Predictors	T value
GDPGR	0.239**	2.238
DOP	0.318**	2.677
EXCHRATE	-0.185	-0.742
INFRATE	0.448**	2.640
INFRAS	-0.085	-0.554
CCI	0.457**	3.019
PSI	0.733**	2.607
F value		14.657
F Sig.		0.000
R^2		0.888
Adjusted R^2		0.827
Durbin Watson		2.090

* Significant at the 0.1 level;
** Significant at the 0.05 level;
*** Significant at the 0.01 level

In addition to that, results in Table 5.4 revealed that only Exchange Rate (EXCHRATE) (B=-0.185, t=-0.742, p >0.05) and Infrastructure (INFRAS) (β=0.038, t=0.249, p>0.05) were not found to be significant predictors of FDI inflows to Pakistan. These results, however, did not support the hypotheses H3

and H5.

To summarize the results regarding the hypotheses related to the predictive power of macroeconomic variables, business environment variables and political stability and their dimensions towards the FDI inflows, it can be concluded that the given hypotheses H1, H2, H4, H6, and H8 have been supported. Detail of predictor coefficient test regression, be given in Appendix 5.

5.5 Hierarchical Regression Analysis Results

As stated earlier, this study employed hierarchical multiple regression to examine the moderating effect of political stability on the macroeconomic variables and business variables in FDI inflows in Pakistan. The hierarchical regression results were reported according to the analysis stage. First, this study examined the moderating effect of Political stability on the above mentioned relationships following the method of Frazier, Tix, and Barron (2004). Before proceeding to get the interaction terms to measure the moderating effect, all the variables meant to be used were standardized. This means that the mean of each variable was subtracted from all the values of that variable and subsequently all the values of the variable were divided by its standard deviations.

As suggested by Baron and Kenny (1986), the regression analyses were performed in several blocks. The first block includes only the control variables and the dependent variable. In the second block, the independent variables were included to examine their predictive power against the dependent variable. The third block includes the moderator variable while the fourth block includes the interaction terms. This implies that the fourth block includes all the variables and the interaction terms.

According to the analysis of hierarchical multiple regressions, the results were reported in the following fashion:

5.5.1 The Moderating Effect of the Political Stability on the Macroeconomic Variable, Business Environment and FDI inflows in Pakistan

The analysis of this part is reported in the following order:

The Moderating Effect of Political Stability (PS)

According to the regression results depicted in Table 5.5 the analysis was processed through the following three models:

Model 1: In this model the predictors namely, macroeconomic variables such as (GDPGR, DOP, EXCHRATE and INFRATE) and business environment variable such as (INFRAS, CCI) were introduced to the model. This model was found to be significant at the 0.001 level of significance with an R^2 of 0.829 and significant F change at the 0.000 level of significance as illustrated in Table 5.5. In addition to that, four predictors was found to be significantly different from zero. More specifically, GDPGR (β=0.284, t=2.269, $p<0.05$), DOP (β=0.417, t=3.109, $p<0.001$), EXCHRATE (β=0.0.4, t=3.086, $p<0.001$) and CCI (β=0.0.45, t=2.501, $p<0.05$) had positive impact on the FDI inflows in Pakistan. Other predictors such as, INFRATE and INFRAS were not significant with FDI inflows respectively.

Model 2: In this model the moderating variable namely political stability (PSI) was introduced. However, this model was proven to be significant at the 0.000 level ($F=14.657$, $P<0.001$). In this model macroeconomic variable such as (GDPGR, DOP, EXCHRATE, and INFRATE) and business environment variable such as (INFRATE,

CCI) and moderating variable PSI. The variable of was found to be a significant with FDI inflows. GDGDR (β=0. 0.239, t= 2.238, p<0.05), DOP (β=0.318, t=2.677, p<0.05), INFRATE (β=0.448, t=2.640, p<0.05), CCI (β=0.457, t=3.019, p<0.05), PSI (β=0.733 t=2.607, p<0.05) On the other hand, Exchange rate (EXCHRATE) and INFRAS were not found to be significant predators of FDI inflows in the presence of political stability.

Model 3: In this model, the interaction terms between the macroeconomic variables, business environment variables and political stability were examined to test the moderating effect. The results in Table 5.5 indicated that GDPGR was a significant predictor of the FDI inflows at the 0.001 level of significance (β=0.382, t=3.953, p<0.001).

The interaction terms between of political stability and macroeconomic variable, business environment were examined. It was found, however, that while the interaction term between GDPGR and PSI was found to be significant at the 0.001 level of significant (β=0.39, t= 3.607, p<0.001), the interaction terms between business environment variables and political stability were not significant. These results indicated that political stability positively and significantly moderate the effect of GDPGR on FDI inflows at the 0.001 level of significance. This result, supported the hypothesis H9. Details of the interaction term, see, Appendix 6.

Table 5.5

Examining the Moderating Effect of Political Stability

	Model 1		Model 2		Model 3	
Variables	Predictors	T value	Moderated	T value	Interactions	T value
GDPGR	0.284**	2.269	0.239**	2.238	0.382***	3.953
DOP	0.417***	3.109	0.318**	2.677	0.396	1.826
EXCHRATE	0.4***	3.086	-0.185	-0.742	0.436	1.281
INFRATE	0.314	1.630	0.448**	2.640	-0.174	-0.629
INFRAS)	0.136	0.889	-0.085	-0.554	-0.268	-1.598
CCI	0.45**	2.501	0.457**	3.019	0.169	0.886
PSI			0.733**	2.607	0.515*	1.910
GDP_PSI					0.39***	3.607
DOP_PSI					0.051	0.355
Exchrate_PSI					0.208	0.910
INFrate_PSI					-0.365	-1.743
InfraS_PSI					-0.228	-1.193
CPI_PSI					0.284	1.547
F value		11.293		14.657		15.599
F Sig.		0.000		0.000		0.001
R^2		0.829		0.888		0.967
Adjusted R^2		0.755		0.827		0.905
R^2 change		0.829		0.059		0.079
Significant F change		0.000		0.021		0.105

* Significant at the 0.1 level;

** Significant at the 0.05 level;

*** Significant at the 0.01 level

The graph in Figure 5.1 illustrated the moderating effect of PSI on the relationship between GDPGR and the FDI inflows. It can be concluded from the graph that GDPGR leads to higher FDI inflows if political stability of the country is higher than that in low political stability. Generally, based on the results it is reasonable to confirm that GDPGR is higher depending on political stability of country. In other words, if the political stability is bad in the country, it will lead to slow rate of FDI inflows into the country when compared to high political stability.

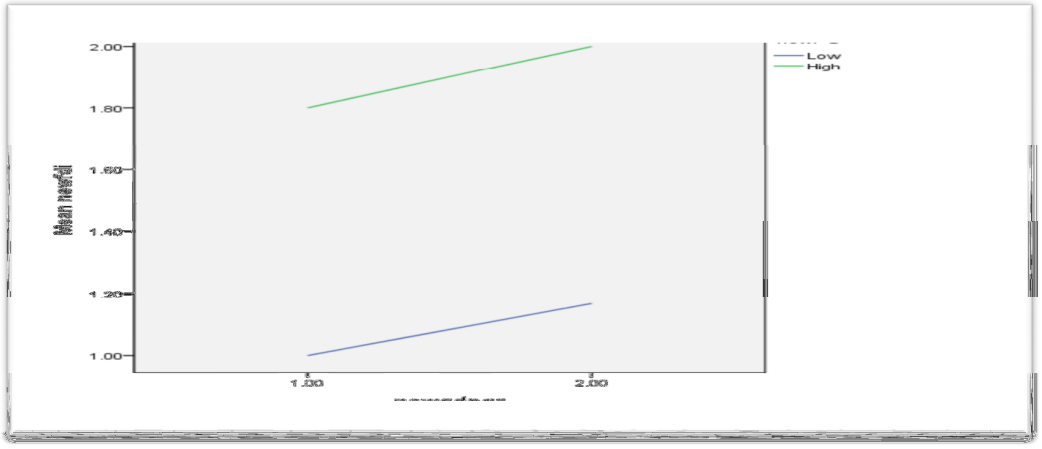

Figure 5.1
The Moderation effect of PSI on GDPGR- FDI relationship

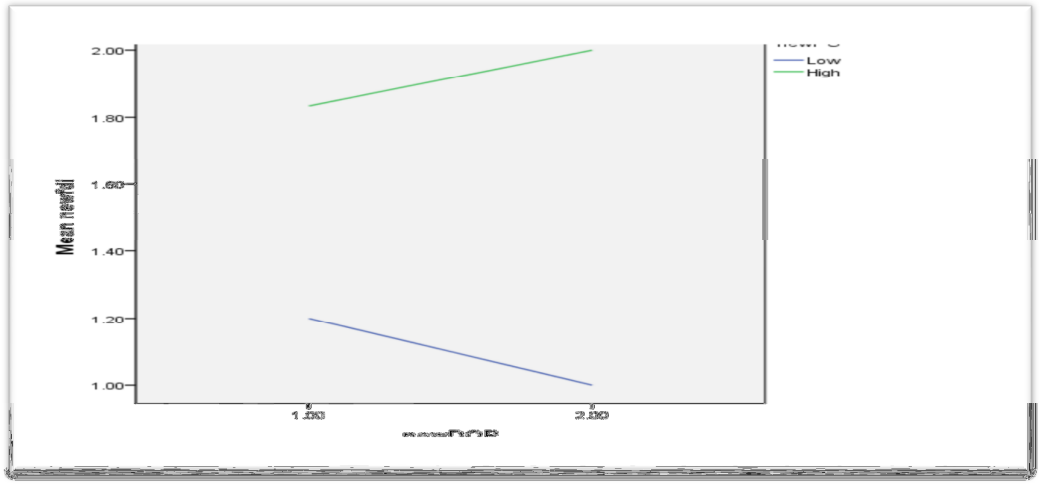

Figure 5.2
The Moderation effect of PSI on DOP-FDI relationship

With regard to the findings related to the degree of openness (DOP), Figure 5.6 shows that the higher political stability helps to attract more FDI inflows into the country. As illustrated in the graph in Figure 5.2, in a low political stability situation the higher the degree of openness of the country, it will attract a higher level of FDI inflows. Whereas, in a high political stability situation, the higher the degree of openness will not attract high level of FDI inflows.

Similarly the findings related to the exchange rate (EXCHRATE), Figure 5.3 shows that in higher political stability situation a higher exchange rate will increase dramatically the FDI inflows. If the political situation of the country is poor, the increase of exchange rate will not succeed to attract FDI to the country. Hence, foreign investor will look to currency exchange rate in making decisions regarding the investment.

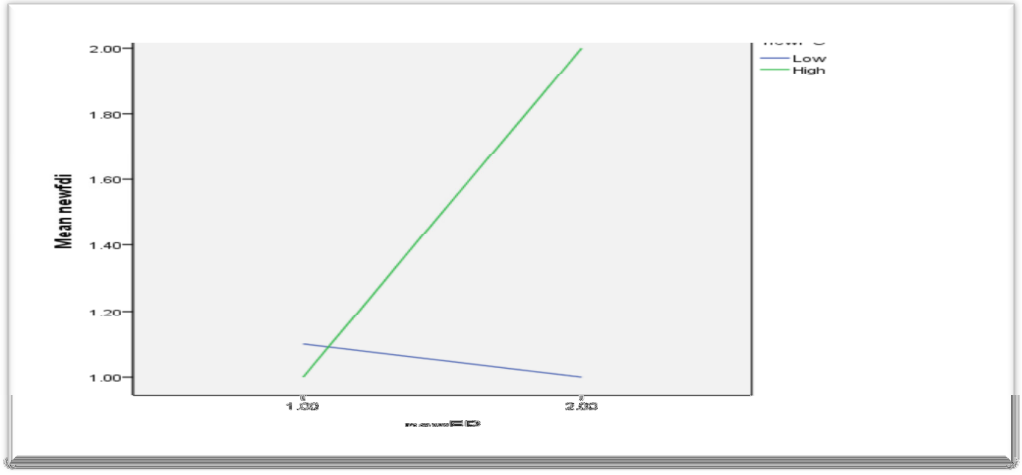

Figure 5.3
The Moderation effect of PSI on Exchange Rate-FDI relationship

With regard to the finding related to the inflation rate (INFRATE) Figure 5.4 shows that the relationship between the inflation rate and the FDI inflows to the country will not be affected by the political situation. The results,

however, show that high inflation rate leads to high FDI inflows to the country. Cost of doing business will tend to increase due to inflation (prices fluctuation) raw markets materials cost.

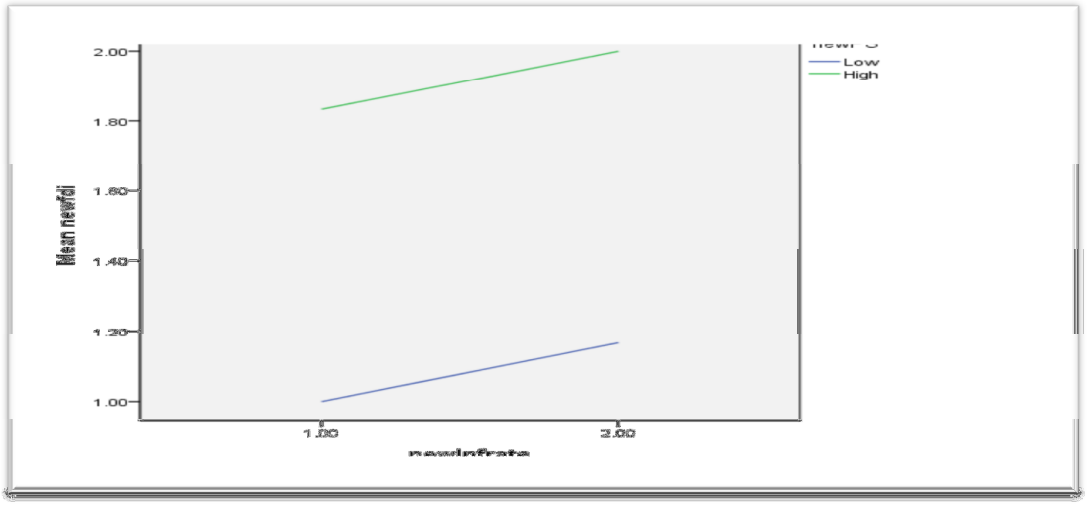

Figure 5.4
The Moderation effect of Inflation Rate on FDI relationship

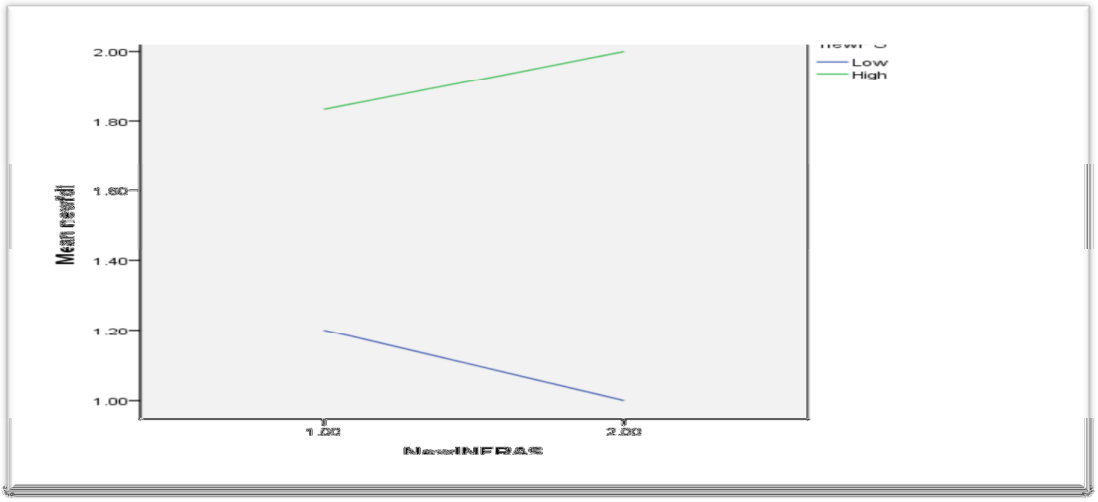

Figure 5.5
The Moderation effect of PSI on Infrastructure-FDI relationship

More importantly, the results related to the moderating effect of political stability (PSI) on the relationship between infrastructure and FDI inflows to Pakistan, showed how important is the Political stability in attracting foreign investors. More specifically, as illustrated in the graph in Figure 5.5, with high

political stability, a better infrastructure can lead to more foreign investment in the country. On the other hand, if the political situation is unstable, whatever the attractive infrastructure the country has, the FDI inflows will be decreasing.

5.6 Summary of the Findings

This chapter reported the findings of this study. This study is based on the time series data for the period of 1991 to 2011. The beginning is made by checking the data to be stationary or non-stationary, using the EViews software and then further analysis with SPSS version 19.0. As a next step, a detailed discussion on the construct validity was provided to ensure the quality of the model that was undertaken later towards the hypotheses testing procedures.

In the process of empirical analysis, however, some limitation may be attributed to the time length of the data which is pertaining to only 21 years. To test the hypotheses of this study, in particular Pearson correlation and hierarchical multiple linear regression was employed. The results of this study supported some of the hypotheses; apparently, the findings did not support all the hypotheses in the testing. In the course of above discussion, tables and graphs in the preceding sub-sections were devoted to examine the obtained results of the statistical techniques that have been used. However, data in Table 5.4 and Table 5.5 summarily reported the findings of the study obtained from the moderated models discussed in this chapter.

Based on the findings from the Pearson correlation analysis and hierarchical regression analyses conducted in the chapter, Table 5.6 summarized

the findings related to the hypotheses testing procedures at the 0.001, 0.01 and 0.05 levels of significance.

Table 5.6
Summary of the hypotheses testing results

Hy no	Hypothesis statement	Decision
H1	GDPGR has significant effect on FDI inflow in Pakistan	**Supported**
H2	Degree of Openness has a significant effect on the FDI inflows in Pakistan.	**Supported**
H3	Exchange Rate has a significant effect on FDI inflow in Pakistan.	Not Supported
H4	Inflation Rate has a significant effect on FDI inflow in Pakistan.	**Supported**
H5	Infrastructure has a significant effect on FDI inflows in Pakistan.	Not Supported
H6	Corruption Control index has a significant effect on FDI inflows in Pakistan.	**Supported**
H8	Political Stability has a sinficant effect on FDI inflows in Pakistan.	**Supported**
H9	Political stability moderates the relationship between GDPGR and the FDI inflows.	**Supported**
H10	Political stability moderates the relationship between DOP and the FDI inflows.	Not supported
H11	Political stability moderates the relationship between	Not

	EXCHRATE and the FDI inflows.	supported
H12	Political stability moderates the relationship between INFRATE and the FDI inflows.	Not supported
H13	Political stability moderates the relationship between INFRAS and the FDI inflows.	Not supported
H14	Political Stability moderates the relationship between Corruption Control and FDI inflows.	Not supported

In conclusion, the results of this study obtained from Pearson correlation and hierarchical multiple linear regression analyses revealed that while certain hypotheses were supported by the empirical results, and the rest were found not being supported. In specific terms, Table 5.6 showed that H1, H2, H4, H6 and H8 and H9 were supported. Whereas, H4, H5, H10, H11, H12, H13 and H14 were not supported.

The hypothesis supported variable like GDP growth rate, degree of openness, inflation rate, corruption control index and political stability are very important in the case of Pakistan. Political stability is crucial for the country's growth and macroeconomic stabilization. The result of the study, as such, is substantially support with new growth theory and investment theory of firm in the case of Pakistan for the country's growth phenomenon.

Further discussions and conclusions relating to these findings and their practical and theoretical implications have been elaborated in the next chapter.

CHAPTER SIX

DISCUSSION, CONCLUSION AND RECOMMENDATIONS

6.1 Introduction

This chapter is confined to summarize the study, discuss the findings and highlight the contributions of the study to the existing literature. It also pinpoints the future course of direction to macroeconomic policy that might help the policy makers of Pakistan and other developing countries to set up an attractive environment for foreign investors. This chapter, further, entails the limitations of the study and suggests future research avenues based on the encountered limitations. Finally, this chapter rings down the curtain tracing the concluding remarks of study.

6.2 Summary of the Study

Foreign Direct Investment leads to several economic benefits to the host country's economic growth by providing essential elements such as capital, foreign exchange, transfer of technology, organizational framework and managerial skills, facilitating exports by enhancing her access to foreign markets (Crespo & Fontura, 2007; UNCTAD, 2011). Over the last decade of the 21st century, FDI inflows have increased at least double than the trade flows in the world economy. Developing countries have tended to enhance their capital formation in their industrialization process by seeking the help of foreign capital through FDI. In short, international mobility of capital in the garb of FDI is supposed to confer mutual benefits to the concerned partners and beneficiaries in global transaction. There are several reasons why developing countries are interested to attract foreign direct investment.

A country like Pakistan has been facing the difficultly with investment activity which is very low in comparison to selected neighbouring Asian countries such as India, Sri Lanka and Malaysia. The domestic saving rate of Pakistan is very low at only 9 percent in the year 2011. Pakistan's total investment is 13.4 percent of GDP in 2011, and it is much lower when compared to India, Sri Lanka and Malaysia.The total investment has declined from 22.5 percent of GDP in 2006-2007 to 13.4 percent of GDP in 2010-2011.The foreign direct investment can influence the process of economic growth by providing new technology for the country, job creation to the nationals and expansion of national output and real income level.

The main objective of this study was to investigate the moderating effect of Political Stability (PS) on the macroeconomic variables and business environment on the trends of FDI inflows in the developing country such as Pakistan. Basically, this study was greatly motivated by the inconclusive findings in the recent relevant literature concerning the relationship between macroeconomic variables, business environment and the FDI inflows. The present study was inspired by the striking remarks made by Mahmood *et al,* (2011) that an in-depth study is required for meaningful further investigation relating to political stability, economic policies and local business environment on FDI inflows into Pakistan.

Generally, macroeconomic stability has been considered very important, in the last few decades, for the country's economic development and sustainable growth. All developed countries and developing countries try to stabilize the macroeconomic policies to attract more foreign direct investment. Moreover, globally an extensive research work has been conducted by researchers to examine the impact of the role of the macroeconomic policy on foreign direct investment

towards their competitive advantage. A few studies such as (Asiedu, 2006; Mohamed & Sidiropoulos, 2010; Cheung & Qian, 2009; Kumar & Chadha, 2009; Deichmann *et al*., 2003; Mhlanga *et al*., 2010; Ledyaeva, 2009; Vijayakumar *et al*., 2010), have been conducted on examining macroeconomic conditions that will affect the foreign direct investment leading to the country's economic growth.

However, on a comprehensive review of the economic growth of the country literature showed that the results regarding the relationship between macroeconomic and business environment and foreign direct investment tend to be inconclusive (Yousaf *et al.*, 2008; Zaman *et al.*, 2011). The majority of the research conducted to determine the relationship of the macroeconomic variables and business environment variables with foreign direct investment have reported positive relationship (Taylor and Sarno, 1999; Kesteloot and Veugelers, 1995; Barrell and Pain, 1996; Mansfield, 2008; Gala & Rocha, 2008 , Chakrabarti, 2002; Gordon 2001; Ciruelos & Wang 2005; Sharma & Bandara , 2010). Among the studies that were conducted to examine the effect of economic growth on FDI inflows have observed the positive effect in the host country.

Similarly, regarding the arguments related to the macroeconomic stability, the past relevant literature revealed that the business environment condition was reported to have a positive impact on foreign direct investment. Meaning that, foreign direct investment flows depend on the country's internal and external economic and political situation. Generally speaking, role of political stability (PSI) in any country is very important for their economic growth.

In addition, the present study was also motivated by the fact that, by and large, both macroeconomic and business environment practices share the same

objectives in enhancing the foreign direct investment into the host county. However, there has been a paucity of empirical research investigating the integrated role of good incentive system and attractive government policy on the FDI inflows into the developing countries. That is to say, a comprehensive review of the relevant literature revealed that although there has been an extensive research work regarding the separate impact of macroeconomic, business environment and political stability on the FDI inflows, the integrative impact has been greatly neglected. Additionally, there is also a need to trace the role that can be played by political stability (PS) and the form of this relationship.

Based on the problem statement of this study and the comprehensive review of the relevant literature reported in Chapter 1 and Chapter 2 and Chapter 3, the present study aimed to achieve the following objectives:

1. To examine the relationship between macroeconomic determinants (GDP growth rate, degree of openness, exchange rate and inflation rate) and FDI inflows in the developing economy of Pakistan.
2. To determine the relationship between business environment (Infrastructure, corruption control and labor) and FDI inflows in Pakistan.
3. To investigate the relationship between political stability and FDI inflows in Pakistan.
4. To examine the moderating effect of the political stability on the relationship between macroeconomic determinants (GDP growth rate, degree of openness, exchange rate and inflation rate) and the FDI inflows.
5. To investigate the moderating effect of the political stability on the relationship between business environment (Infrastructure, corruption control and labor) and the FDI inflows.

In order to achieve the aforementioned objectives of this study, a comprehensive review of the literature was conducted and reported throughout this study especially in Chapter 2 and Chapter 3. The review of past relevant literature, related to macroeconomic and business environment and political stability, reveals that the researchers have focused their attention on these factors in the context of foreign direct investment. In fact, as stated earlier, the majority of the previous studies related to the impact of macroeconomic variables on foreign direct investment and the country's growth. On the other hand, scanty research has been done on business environment under political situation and FDI inflows in developing countries, such as Pakistan.

In the present study we discuss that when political situation is not stable in the country it will adversely affect the macroeconomic and business environment. To resolve the inconsistent findings regarding the macroeconomic variables, business environment and FDI inflows relationship, many researchers asserted that political stability (PS), that stemmed from the national issues, in most of the developing countries might be one of the main factors that explain the interaction and needs to be further investigated (Hussain, 2009; Mahmood *et al.,* 2011). This study, in essence, was a response to that call, giving the necessary theoretical underpinning and data analysis, meant to examine the role of Political Stability (PS) on the articulated relationships in the context of FDI inflows.

According to the literature review conducted and reported in Chapter 1 and Chapter 3, four critical factors of macroeconomic behaviour and three dimensions of business environment have been identified. Specifically, this study recognized some Macroeconomic variables such as GDP growth rate (GDPGR),

degree of openness (DOP), Exchange rate (EXCHRATE), and inflation rate (INFRATE). Similarly, Infrastructure (INFRAS), corruption control index (CCI) were the two recognized dimensions of the business environment which have been the most commonly traced dimensions in the literature of business environment. Furthermore, in Chapter 3, many issues were raised indicating the existence of many future research opportunities. Firstly, for instance, the direct effect of macroeconomic variables on the FDI inflows that has been commonly supported by many researchers yet needs to be further examined in different contexts. Secondly, the inconsistent results regarding the business environment variables and FDI inflows performance relationship call for further examination to achieve the convergence desired. The role of Political stability in country implementation processes remains inefficiently explored. In the light of new growth theory, FDI theory in this crucial area of research offers a promising opportunity for in-depth research.

In the light of the objectives of the study and the discussions provided, in Chapters 1, Chapter 2 and Chapter 3 to extract the variables to be used for this study, the framework was formulated in Chapter 4. As it has been argued in Chapter 3, this framework could be theoretically grounded in the new growth theory and investment theory. In the view of the above, political stability (PS) is considered as one of the critical factors.

The present study used time series data from the period ranging from 1991 to 2011. Data collected from the authentic sources, such as, World Bank Report, International Monetary Fund, State Bank of Pakistan, UNCTAD, and Finance Ministry Economic Survey of Pakistan. After stationary check, using the software

of EViews, this study performed the hypotheses testing procedures employing hierarchical regression analysis using SPSS software package version 19.0. This analysis was used to examine the relationship between the macroeconomic variables and business environment variables and the FDI inflows. Also, this analysis was used to examine the moderating effect of Political stability and its dimensions on the aforementioned relationships. The findings of the analysis were reported in Chapter 5 to be further discussed in the following sub-sections. This study concluded with recommendations and suggestions for future research.

6.3 Discussion

The following sub-sections discuss the findings of the study in the same order as the objectives of the study.

6.3.1 Relationship between Macroeconomic Determinants and FDI Inflows in Pakistan

In order to achieve the first objective of this study regarding the effect of GDP growth rate, degree of openness, exchange rate, and inflation rate on the investment, the regression paths between macroeconomic determinants and foreign direct investment inflows were examined. The Pearson correlation analysis results reported in Table 5.3 revealed that some of the dimensions of macroeconomic had significant correlations with the FDI inflows at the 0.01 and 0.05 levels of significance. Nonetheless, the regression analysis results reported in Table 5.4 in Chapter 5 revealed that only three out of four macroeconomic determinant were found to be significant predictors of the FDI inflows in Pakistan. More specifically, while GDGDR (β=0. 0.239, t= 2.238, $p<0.05$) have positive impact of FDI inflows at 0.05 level of significance, the degree of

openness (DOP) (β=0.318, t=2.677, p<0.05) has positive impact of FDI inflows at level 0.05 of significance, the inflation rate (INFRATE) (β=0.448, t=2.640, p<0.05) has positive impact of FDI inflows in Pakistan. The non-significance of the other macroeconomic variable such as exchange rate needs future examination.

As illustrated in Table 5.4 in Chapter 5, the positive relationship between, macroeconomic variable of GDPGR with FDI inflows was found to be significant at the level of 0.05 of significance. This finding is consistent with the finding of the previous studies (such as Bandera & White, 1968; Schmitz & Bieri, 1972; Jun & Singh, 1996; Root and Ahmed, 1979; Torrisi, 1985; Petrochilas, 1989; Kokko, 2002; Fedderke & Romm, 2006; Mitze, 2011). This finding, in turn, emphasized the positive effect of GDPGR on FDI inflows that has been widely reported in the economic literature. As GDPGR of the country is very important to attract the FDI in to the developing country such as Pakistan, the country's consistent GDP growth rate will change the investors mind to invest in to that country (Martinez-Zarzoso & Nowak-Lehmann, 2004). Therefore, a high GDP growth rate can help Pakistan economy to attract more foreign investment in to the country. Macroeconomic stability, thus, plays a pivotal role in simulating economic growth and enhancing foreign investors' confidence in the economy (Kim, 1993). Support with the growth theory for the country's economic growth process capital is more important.

Degree of openness (DOP) is found to be a significant predictor of FDI inflows in Pakistan at the 0.05 level of significance. This finding is consistent with the observations of previous studies such as (Brainard, 1997; Dunning, 1993; Navaretti *et al.,* 2004; Markusen & Maskus, 2002; Chakrabarti, 2002; Baharom, *et*

al., 2008; Morisset, 2000; Seim, 2009). This finding, in turn, supported the effect of degree of openness on FDI inflows as has been widely reported in the business and economic literature. An increasing DOP means that the openness of the economy is important to attract the FDI into the country (Baharom *et al.*, 2008). In the case of Pakistan imports are more than exports. This implies that in the course of corrective measures of macroeconomic policy to be pursued toward the adjustments in the balance of payments, there will be greater emerging opportunities for foreign investor to invest in Pakistan. Pakistan is having problem most of the time with foreign reserves. To augment the foreign reserves, thus, Pakistan needs to increase the exports. Pakistan can increase her exports through export-led growth strategy and export oriented FDI policy, thus, inviting the multinational companies to invest in the export zones of the country. This implies that high degree of openness (DOP) and investment friendly macro policies and well established infrastructure are major determinants to attract FDI inflows into Pakistan (Awan *et al.,* 2010). The present study established this point.

Similarly, the inflation rate (INFRATE) was found to be statistically significant at the 0.05 level of significance with FDI inflows in Pakistan. This finding is consistent with the result of previous studies such as (Sayek, 1999; Zaman *et al*., 2006; Awan *et al.,* 2010). This finding, in turn, supported the effect of inflation on FDI inflows as has been widely reported in the business and economic literature. Usually, exports have opined that low mild inflation shows that the country has stable growth, high inflation shows that country is not stabilizing the process of economic growth (Akinboade *et al.*, 2006; Ahn *et al*., 1998). Paradoxically, in the case of Pakistan, however, increase in inflation rate also induces foreign investors to invest in as higher prices lead to increase in their

profit margin due to short supply in the market economy (Awan *et al.,* 2010). Foreign investors, thus, have lucrative opportunity to invest into the country like Pakistan in the sense that when inflation rate is high, the prices are increasing and sales revenues improve faster than the costs. The country immediately cannot increase the supply of goods during the short period of time, on account of the shortage of capital. In line with growth theory it follows that the shortage of capital leads to the slow pace of the economic growth of the country. Here lies the scope for the high profits for the efficient enterprises, thus, based on their comparative and competitive advantage foreign enterprises can seize the opportunities. In this way the existing gap of shortage of supply in the markets will attract the foreign enterprises to invest in the country such as Pakistan.

Despite the fact that Exchange Rate (EXCHRATE) has a significant positive correlation with the FDI as revealed by the results of this study, the causality relationship was not supported. In the case of Pakistan the exchange rate appeared to have non-significant negative sign with FDI inflows. But, usually, in some developing countries the exchange rate is significant such as in case of Turkey with respect to FDI inflows (Kaya & Yilmaz, 2003). Similarly, the exchange rate is found to be significant with FDI inflows in the case of Koreas (Jeon & Rhee, 2008). Bleaney and Greenaway (2001) have examined the influence of real effective exchange rate on FDI inflows for 14 SSA (Sub-Saharan Africa) countries. They found that exchange rate volatility produced a strong negative effect on FDI. In the case of Pakistan more FDI occurred only during the period 2003 to 2007 along with the exchange rate being 1$ equivalent to 57 to 60 rupees, after that during 2008 to 2011 the exchange rate is 1$ equivalent to 60 to 90 rupees, yet FDI has not improved SBP (2011). Recently, though Pakistan currency

is depreciating against the dollar, yet foreign investment had registered a down swing during the period 2008 to 2011. This paradox inspired the present study to probe into the situation as to why the foreign investment has been less during that period. Another reason is that exchange rate has been affected by the government polices in Pakistan. Due to high exchange rates, for domestic enterprises using the foreign components as inputs, the cost of doing business is getting higher in Pakistan. To infer in line with investment theory of firm, when the risk premiums are very high in the developing countries the value of the firms will go down (hence, creating a disincentive to invest).

In short, looking at the current scenario of Pakistan currency it is found that rupee is not stable against the US dollar. Pakistani currency's recent depreciations have some major reasons, one is government has been printing the money recklessly, second the country's exports are lower than imports resulting into continually rising current account balance of payments (BOP) deficits, thus, causing governments insatiable need to borrow money from the IMF and domestic loan from banks.

6.3.2 Relationship between Business Environment and FDI Inflows in Pakistan

In order to realize the second objective of the present study regarding the effect of business environment on the investment, the relationship between business environment and foreign direct investment inflows was examined. On the whole, the regression analysis results reported in Table 5.4 in Chapter 5 revealed that only one out of two business environment variable such as corruption control index were found to be significant in the case of the FDI inflows in Pakistan.

However, while corruption control index (CCI), CCI (β=0.457, t=3.019, $p<0.05$) have positive impact of FDI inflows at the 0.05 level of significance has positive impact on FDI inflows in Pakistan. This finding is consistent with the finding of the previous studies (Ahmad & Ali, 2010; Al-Sadig, 2009). This finding, in turn, supported the effect of corruption control index (CCI) on FDI inflows as has been widely reported in the economic literature. As such, in public administration, good governance like corruption control is very important for attracting the FDI into the developing country such as Pakistan. Corruption-less society tends to grow faster economically. In the case of Pakistan, thus, corruption control index (CCI) is very important for country's growth. Pakistan's public administration, thus, needs relationship and reforms in capturing the attributes of good governance.

The non-significance of the business environment variable infrastructure (INFRAS) factors needs further in-depth examination. In the case of Pakistan the infrastructure has non-significant negative sign with FDI inflows. Infrastructure can have strong impact on the growth process of developing and developed countries. In developing countries, the high qualities of infrastructure significantly attractive FDI inflows as observed in some studies (see, for instance, Khadaroo & Seetanah, 2010; Asiedu, 2006; Sekkat & Varoudakis, 2007). Infrastructure is very poor in the case of Pakistan. In most infrastructure services, Pakistan is highly poor as compared with many developing countries such as China, Malaysia and Korea that have attracted higher levels of foreign investment. It is found that infrastructure has a positive effect on the FDI inflows in China (Fung *et al*., 2011). The government of Pakistan has not been allocating budgetary provision on infrastructure development on par with other developing countries. The ranking of infrastructure quality of the country is also very low compared with other

developing countries such as Malaysia, Iran, Taiwan and China (UNCATD, 2011) as reported in Table 6.1. Generally speaking, India and Pakistan's infrastructure ranking given in the UNCTAD report are not different so much. But, India's investment polices and political situation is much better than those of Pakistan. The law and order situation facilitating foreign investment policies in India are also much better than that of Pakistan.

Table 6.1
Overall Infrastructure Quality Ranking (Selected Countries)

Country	**Score**
Pakistan	3.2
Malaysia	5.5
Singapore	6.6
Taiwan	5.9
China	4.9
Iran	4.0
India	3.9
Thailand	4.9
Turkey	5.1

Source: UNCATD, 2011

Under the lacuna of infrastructure development, the power sector such as electricity is one of the big issues of Pakistan. People usually tend to get electricity for more than 12-14 hours in cities and around 16 hours in rural areas. Opposition leaders in every city of Pakistan have protest demonstrations regarding the power problem. The media has also highlighted such issues globally. Even though the power problem is acute and persistent for last 11 years, the incumbent governments in Pakistan did not do much to deal with the situation. Even domestic

investors have no incentives to invest in the absence of required infrastructure. The government of Pakistan has grossly failed to solve the problem of power shortage. Likewise, the railway infrastructure also very bad in Pakistan with comparison to the neighboring country such as India and China. India is generating high budgetary revenue every year form railway and there is expansion of railway network in the country. On the other hand, Pakistan railway is going in loses very year. In short, it follows that in the case of Pakistan infrastructure development tend to be the key determinant to attract FDI inflows in Pakistan (Awan *et al.,* 2010).

6.3.3 The Relationship between Political Stability and FDI Inflows in Pakistan

In order to achieve the third objective of this study regarding the effect of political stability on the FDI inflows in Pakistan the regression analysis between political stability and foreign direct investment inflows were examined. Our findings show that the political stability index (PSI) (β=0.733 t=2.607, $p<0.05$) tend to have significant positive impact of the FDI inflows at the 0.05 level of significance. In line with investment theory of firm it follows that political instability and corruption caused increased cost of doing business in a developing country such as Pakistan.

Incidentally, Knack and Keefer (1995) have traced significant effects of political instability on the level of economic growth and investment. Some studies such as (Singh & Jun, 1995; Wheeler & Mody, 1992) observed that political risk is insignificant in affecting the FDI inflows. In the case of Pakistan, however, political stability for country's growth is an important factor. Pakistan is facing the political problems such as terrorism, unlawful constitutional changes, disregards for democracy when the army had been posing a threat of over-throwing the

elected government, unending interference of army in Pakistan involvement in government, conflicts among the States intensifying socio-political risks and untoward incidence such as kidnapping foreigner and occasional bombing risk in the country. The previous research done by Musila *et al,* (2006) revealed that political stability, sound macroeconomic stability and attractive policy are influencing factors to increase FDI inflows in the country. Lower private investment in Pakistan may be attributed mainly to the political instability (UNCTAD, 2011). The present study virtually substantiates these points through empirical findings.

Data in Table 6.2 clearly provides an evidence of political instability to an extent in Pakistan during the period 1988-2012, as the country has been ruled on a short term basis by fifteen Prime Ministers belonging to different political parties. It reveals that Pakistan's political situation has not been stable during the last 22 years. Political instability over the years adversely affected the country's economic growth and foreign investor's confidence. Benazir Bhutto was elected in 1988 as Prime Minister of Pakistan until 1992. The President of Pakistan dismissed the government in 1990 and called for new elections, because of innumerable cases of corruption and bad governance of Bhutto government. Nawaz Sharif was elected in 1990 as Prime Minister until 1995. Nawaz government was dismissed in year 1993, for the same reason of bad governance and high corruption in the country. In 1993 Benazir Bhutto was re-elected as Prime Minister but was again removed in 1996 and on similar charges of corruption and call for new election. Nawaz Sharif was again elected as prime minister in 1997.

Nawaz government established the bureau that suspended the operation of many foreign companies who had set up independent power plants to generate and

supply much needed electric power to the country. The reason for this was that the independent power plants (IPPs) had allegedly bribed officials in the previous Benazir Bhutto government for sanctioning their contracts. Indeed, the pattern of bribing high level associates of Bhutto during her term in office was not limited to the independent power plants, in fact, it was a common practice that prevailed for virtually any investor that needed government clearance. However, the net effect of the government's action against the independent power plants was to scare away the potential foreign investors who preferred not to risk their contacts being terminated at the whim of one or another government. Needless to say that the political instability and corruption tend to increase the cost of doing business in Pakistan.

Pakistan army took over the government in 12 October 1999 and suspended country law, putting up the elected Prime Minister into jail. Consequently, Pakistan again encountered unwarranted political and economic problems. On the whole, Pakistan's political instability adversely affected the economic growth of the country. Astonishingly, the present government of Pakistan that was elected in 2008, claiming to have a strong majority in the parliament, has grossly failed to establish political norms and stability in the country. Media have been spreading the news and highlighting the stories of corruption and bad governance which eventually has tarnished the image of the government and the reputation of the nation at the global level. Indeed, political instability shortens the horizon of the government, disrupts long-term economic policies resulting into failure in economic performance and sustainable growth process. Due to currently inconducive political and business environment in

Pakistan, the inflow of foreign direct investment has registered a declining trend over the last four last years since 2008 till this date (2012).

Political instability is linked with greater uncertainty regarding future economic policy of the countries, it certainly affects investment adversely, slows down the economic growth of the country, intensifies poverty and unemployment, which in turn, further adds fuel to the flame of political instability by promoting violence, civil unrest, and strikes. The country's higher degree of political instability is obviously attributed to lower productivity growth, low level of physical and human capital accumulation, thus, adversely affecting the base and chances for long-term economic growth and prosperity of the nation. Pakistan's current dismal state of the economy is essentially the outcome of the adverse consequences of political instability. Over the last four years (2008-2011), Pakistan witnessed its investment rate decelerating, economic growth slowed down, unemployment rate rising, thus, adding to the problem of poverty. Currently increasing inflation rate and currency depreciation are making the economic condition of masses to further deteriorate.

Table 6.2
List of Pakistani Prime Ministers during the Period 1988-2012

Name of Prime Minister	Date Joining	Date End	Days	Political Party
Benazir Bhutto	2 December 1988	6 August 1990	612 days	PPP
Ghulam Mustafa Jatoi	6 August 1990	6 November 1990		NPP
Nawaz Sharif	6 November 1990	18 April 1993	894 days	PML(N)
Balakh Sher Mazari	18 April 1993	26 May 1993		PPP
Nawaz Sharif	26 May 1993	18 July 1993	967 days	PML(N)
Moeenuddin Ahmad Qureshi	18 July 1993	19 October 1993		Independent
Benazir Bhutto	19 October 1993	5 November 1996	1113 Days	PPP
Malik Meraj Khalid	5 November 1996	17 February 1997		PPP
Nawaz Sharif	17 February 1997	12 October 1999	967 days (Total: 1934)	PML(N)
Zafarullah Khan Jamali	21 November 2002	26 June 2004	569 days	PML(Q)
Chaudhry Shujaat Hussain	30 June 2004	20 August 2004	51 days	PM(Q)
Shaukat Aziz	20 August 2004	16 November 2007	1183 days	PML(Q)
Muhammad Mian Soomro	16 November 2007	25 March 2008	130 days	PML(Q)
Yousaf Raza Gillani	25 March 2008	26 April 2012	1493 days	PPP

22 June 2012	Incumbent	8 days	-	PPP

Source: Department of Prime Minister in Pakistan

6.3.4 The Moderating Effect of The Political Stability On The Macroeconomic Variables FDI Inflows Relationship

In order to achieve the fourth objective of this study regarding the moderating role of political stability (PS) on the relationship between macroeconomic variables and FDI inflows in Pakistan, interaction terms between the macroeconomic variables and political stability were examined in particular to test the moderating effect. As reported in Chapter 5 Table 5.5, the interaction term between macroeconomic variable of GDP growth rate was found to be significant at the 0.001 level of significant (β=0.39, t= 3.607, p<0.001). These results indicated that political stability being positive significantly moderates the relationship at the 0.001 level of significance. Also, the graph in Figure 5.1 in Chapter 5 illustrates the moderating effect of Political Stability on the relationship between GDP growth rate and the FDI inflows. The results conclude from Table 5.5 and Figure 5.1 that GDP growth rate leads to higher foreign direct investment inflows when political situation of the country is higher. That means that GDP growth rate of the country is highly dependent on political situation of the country. It follow that the moderator role of political stability is well established in the case of Pakistan. Support by the investment theory of firm it follows the risk premium caused increased cost of doing business.

The moderating effect of political stability on degree of openness on the FDI inflows is traced. The result of interaction terms, however, did not show significant degree of openness (DOP). But still implies the moderating effect see Figure 5.2 in Chapter 5 indicating that the higher degree of political stability

helps to attract more FDI inflows in to the country. Similarly, the moderating effect of political stability with exchange rate (EXCHRATE), see Figure 5.3 in Chapter 5, showed that the higher political stability will attract more FDI inflows to the country. When political situation of the country is of lower order then depreciation of the increasing the exchange rate (EXCHRATE) will not succeed to attract FDI to the country. Another moderating effect of political stability with inflation rate (INFRATE), as indicated by the Figure 5.4 in Chapter 5, showed that the relationship between the inflation rate and the FDI inflows to the country will not be affected by the political environment.

6.3.5 Moderating Political Stability with Business Environment and FDI Inflows

In order to achieve the fifth objective of this study regarding the moderating role of political stability (PS) between business environment and FDI inflows in Pakistan, the regression result interaction terms between the business environment and political stability was examined. The moderating effect on business environment can be seen clearly but the role of political stability on the relationship between infrastructure and FDI gives some more insights as illustrated in Figure 5.5. The results showed how important is the political stability in attracting foreign investors. More specifically, as illustrated in the graph in Figure 5.5 in Chapter 5, in high political stability situation a better infrastructure can lead to more foreign investment in the country. It suggests that Pakistan needs to focus on infrastructure developing for the creation of conducive business investment towards growth and prosperity. Last but not the least, it is observed that corresponding to the moderating political stability effect on the relationship between the corruption control index (CCI) and FDI; the results do not support the hypothesized moderating effect.

6.4 Contributions of the study

Throughout this study, many insights have been provided regarding the issues related to the foreign direct investment in the country. This study is one of the pioneering studies in a developing country in tracing the effects of macroeconomic variables and business environment on the FDI inflows. In addition, this study attempts to expand the boundary of the current literature as it investigated the moderating effect of the political stability on the relationship of macroeconomic variables governing business environments and the FDI inflows by using the hierarchical regression analysis. By integrating the effect of macroeconomic factors, business environment and political stability, the present study can claim significant relevant contributions to the literature besides entailing pragmatic suggestions for the considerations of the policy makers as well. The gist of the contributions of this study is presented in the following sub-sections.

6.4.1 Contribution to the Literature

As it has been discussed in the significance of the study in Chapter 1, the contributions of this study are in several dimensions as narrated below.

First, from the theoretical perspective, this study demonstrated the importance of Political Stability in to the country, particularly for the foreign and domestic point of view investors. Moreover, it contributed to the macroeconomic literature by reexamining the relationship between macroeconomic variables and foreign direct investment. In particular, the glaring disagreements in the literature regarding the macroeconomic variables such as GDP growth rate, degree of openness, and exchange rate and inflation rate on foreign direct investment called for further in-depth investigation under the present study. This study, thus,

significantly contributed to the existing literature by integrating the effect of macroeconomic variables to the FDI inflows in the growth process of developing economy such as Pakistan. It is observed that the macroeconomic variables such as GDP growth rate, degree of openness, and inflation rate are significant with FDI inflows into the country. Exchange rate is, however, not significant with FDI inflows in Pakistan.

Second, this study highlighted the importance of business environment situation for the foreign direct investment in a developing country such as Pakistan. In addition, this study contributed to the management and economic literature by examining the impact of infrastructure and corruption control and cheap labor phenomenon on the foreign direct investment inflows. A review of the literature concerning this relationship revealed that the empirical results were inconsistent. Notwithstanding the extensive research work in the literature that examined the infrastructure and corruption control and FDI inflows, there has been glaring disagreements. Due to these inconclusive results, many academics and practitioners have questioned the appropriateness of business environment such as infrastructure and corruption control that will affect the foreign direct investment inflows in to the country.

Third, the results of this study revealed that the joint effect of macroeconomic and business environment on the FDI inflows was evidently stronger than otherwise. Moreover, the results of this study suggested that macroeconomic stability and attractive business environment will attract more foreign direct investment in to the developing countries. This was clear from the GDP growth rate, degree of openness, exchange rate and inflation and infrastructure, corruption control and political stability showing positive evidence

as influencing determinants of FDI. Besides, comparing the effects of macroeconomic and business environment was tested individually in tracing the effects of their dimensions on investment suitable policy orientation is recommended.

Fourth, this study emphasized a significant role of political stability with FDI inflows. The results of this study revealed that the stable political situation should be the first step in the country for attracting foreign investment. The lack of country's political stability condition may lead to unsuccessful economic growth of the country. These results were support with the investment theory and growth theory that was considered as change initiatives aiming to change the investment activity, when investment growth from domestic saving is low and this gap should be filled up with foreign direct investment.

Fifth, contribution of the present study is that having been concentrated on the FDI inflows with GDP growth, degree of openness, exchange rate and inflation rate, this study scholarly extended the existing literature concerning business environment such as infrastructure and corruption control and political stability on the economic growth in Pakistan. Moreover, this study on the Pakistan foreign direct investment inflows has been an attempt to provide empirical insights in revealing that political stability for Pakistan is very important to enhance the foreign capital and domestic investment in to the country.

Last but not the least; in addition to testing the postulated hypotheses, this study conducted a rigorous goodness of the fit with sounds analysis to validate the model. By and large, on research methodology criterion this study rigorously validated the research instrument to ensure valid and reliable results since poorly

validated measures often yield erroneous conclusions.

6.4.2 Practical Contribution

The results of this study have important contributions and policy implications for the consideration of practitioners and policy-makers. This study particularly provided scholarly practical insights on how macroeconomic factors business environment and political stability can enhance the overall foreign direct investment in to the country. Some of these contributions and insights are indicated in the following order.

Firstly, the findings of this study can raise the awareness among policy makers and the government of Pakistan to bring more foreign investment in to the country. Moreover, the results also improved and lucrative business environment is one of the main characteristics to attract foreign investment to the country. Taking the clue from these findings, the policy makers of Pakistani should make effective plans to enhance business opportunities in the country. A specific set of short term and long term rolling FDI plans may be spelt out referring to policies, opportunities, approaches and incentives that are needed to attract FDI inflows.

Secondly, the study highlighted more important macroeconomics factors for foreign investor. The findings of this study revealed that, in line with the new economic growth theory, the degree of political stability (PS) in the country can facilitate or impede macroeconomic and business environment change initiatives. Therefore, policy makers can ensure the success of macroeconomic and business environment through the establishment of a supportive political stability. In other words, the finding of this study suggests that policy makers and politicians in

Pakistan should vigorously seek to improve and maintain political stability (PS) of the country.

Thirdly, the findings of this study suggested that the government of Pakistan should establish in the country several economic zones to provide attractive packages to foreign investors adopt low tax strategy and construct good infrastructure with highly secured zone to protect the life and properties of the foreigner investors. The government should also enact new laws to protect the foreign investment activity constitutionally. The change of political situation in the country should never affect the foreign investment company's law. FDI economic zone areas should provide the facilities comparable to developed countries. Pakistan policy makers should provide the incentive packages similar to other developing neighboring countries such as China, India and Malaysia. Policy makers should invite the multinational companies to invest in Pakistan with confidence under the given full government support and creation of conducive business environment. In short, the Pakistan policy-makers should endeavor to establish a more friendly and reliable business environment in the country.

Fourthly, the findings of this study confirmed that political stability (PS) positively moderates macroeconomic variables such as GDP growth rate and FDI inflows relationship. It follows that GDP growth rate is a crucial factor to the developing country such as Pakistan to attract the foreign capital (Hussain, 2009). This suggests that the Pakistan policy-makers should develop a good business environment, and check out market-friendly and growth-oriented economic policy that is less based on the orthodox philosophy, which is virtually designed to be in a good alignment and consistent with the cultural values of the country. During the short period of time government should construct the area of economic zone

with full security and support to facilitate investment activity in industrial arena. Finally, this study is also of a great value to other developing countries as well as for policy-makers and academia.

As it is the case of research work, the following sub-section discussed the policy-making contribution of this study.

6.5 Policy Implications

A well thought out FDI policy will be beneficial to the country in years to follow.

A major shift in macroeconomic policy towards economic development rather than just growth through capital accumulation supported by the FDI inflows and policy induced sectorial investment flows is essential for the political integration and stability coupled with human dignity and fairness in enhancing harmonious relationship among the people of Pakistan.

Unlike, big countries such as China and India, in a smaller country such as Pakistan the issues of trade liberalization and degree of openness can deem to be a real starter not just an academic exercise in her policy strategies. In order to attract foreign capital into the country on a large scale, interest rate in the financial sector of Pakistan should be globally competitive.

Pakistan should endeavour to improve its rate of absorption of the foreign technology depending on the availability of both trained manpower and entrepreneurship. An effective programme of manpower planning and entrepreneurship should be envisaged and implemented in the country.

It should be well understood by the Pakistan's policy makers that though FDI inflows are essential for the country's economic growth; it is always volatile in quantum and growth, hence, FDI should never be encouraged at the cost of

domestic investment. That is to say, for avoiding the crowding out effects foreign investment should supplement rather than supplant domestic investors. A well-balanced programme and incentive packages should be envisaged to boost up overall investment and business activity in the country.

The policy makers and the government of Pakistan should visualize general minimum programmes with the integrated terms of monetary-fiscal policy mix in devising the macroeconomic policy with the following key ingredients:

- Substantial infrastructure development and rural development through appropriate public sector investments.
- Stimulating and facilitating investments on nation-wide scale.
- Attracting foreign direct investment (FDI) in a pre-defined way.
- Containment of fiscal and current account trade deficits.
- Stabilizing the exchange rates.
- Moderating the inflation rates.

There is obviously a need for proactive policies to soften the downswings and uplift the FDI inflows to Pakistan. In this section of the study, we evaluate the government's policy response to the global economic shocks and identify critical areas for policy making, based on the findings of macroeconomic determinants and business environment, especially, political stability on FDI inflows in Pakistan. Pakistan has to make concrete efforts to attract as much domestic and foreign investment in the foreign exchange growth oriented exports sector and earn more at least in the short run, to improve its balance of payments position. To encourage domestic and foreign investment, Pakistan should revamp the macroeconomic policy in the future course of direction. Following Barrow (1999) and Przeworki (2004), we may pinpoint some practical measures for consideration of the

government of Pakistan and it should take certain steps on priority basis to enhance both domestic and foreign investment activity in the country, such as:

Political Stability*:* The political leadership in Pakistan should urgently take necessary practical steps to improve law and order situation particularly in the major "growth poles" of the country including Lahore, Karachi, Islamabad, Faisalabad, Multan, Peshawar and industrial areas. Pakistan should provide strong security and full support to multinational companies. Satisfactory political stability is also a critical factor to attract foreign investment. Pakistan government needs to develop political relationship by making good friend ship with neighboring countries like Afghanistan, India, Iran and China. Policy makers should suggest to the government of Pakistan to enter in trade and investment agreements with India. This will reduce the political conflicts between both countries. The present study found that the Political stability is very important for Pakistan's future economic growth. Pakistani policy-makers should learn lessons from the developing countries such as China in managing peoples and having a peaceful political life.

Macroeconomic Stability**:** Pakistan's fiscal and BOP situations and foreign exchange reserves position is under considerable strain over the years. Lack of macro balancing and unconducive macroeconomic environment discourage foreign investors for business ventures into the country. Certain drastic and far reaching measures, thus, urgently required in the country to reduce the fiscal deficit, on the one hand, and to raise trade surplus and foreign exchange reserves, on the other. Policy makers should promote the exports of the country's products. The present study also suggests that the higher GDP growth rate and degree of openness is important for Pakistan.

Credit Facilities*:* Foreign firms doing business in Pakistan are recently facing cash flow problems. This is become their borrowing capacity is limited to their equity capital and this lead to aggravate the cash flow problem (for example, current Power elective city companies). There is a need to review credit facilities given to investors.

Transfer of Technology*:* For smoother transfer of technology no restrictions should be put on payment of royalty and/or technical service fees for the manufacturing sector. In the country intellectual and industrial property rights should be assured in conformity of WTO Agreements. Pakistan needs to acquire, adopt and improve technology for acceleration of economic growth.

Labor Laws: There is a need to rationalize the labor laws and scrape multiple levies on employment that are impeding business expansion and job creation. Overprotective and empowering labor laws do not necessarily encourage productivity. On the contrary, it might discourage much needed productive investment in the economy on a wider scale.

Infrastructure*:* If Pakistan wants to be on par with the development of the economies of East and Southeast Asia, it should invest more in the field of education and physical infrastructure. Specifically, policy makers should immediately suggest to government of Pakistan to solve the problem of energy crisis in the country. Alternative modern and potential sources of energy should be detected and exploited. Efforts on R & D should be addressed to coal and nuclear energy for industrial purposes.

Identification of Potential Investors and Sectors*:* To promote foreign investment the government and policy makers should identify and pursue investors from untapped potential countries. Pakistan government should shift its focus from

traditional investors from the countries such as Japan, USA, UK, and look towards upcoming UAE, Libya, China, Malaysia and Korea. The government should also identify, new sectors for investment (such as, mining and quarrying, tourism, new technologies, power sector and construction and building the infrastructure, etc.) rather than focusing on traditional sectors such as (financial business, oil and gas, textiles, etc.)

Improvement in Tax Structure*:* Government should reduce the unnecessary taxes and exorbitant tax rate, to simplify tax policy and modernize the tax administration. A high level tax reformation committee should be appointed to suggest the necessary actions on this front.

Investment Friendly Environments: Pakistani policy-makers should provide the investment friendly business and economic environment.

Attractive Packages to foreign companies**:** Pakistani policy makers should offer to multinational companies attractive packages toward investment opportunities. Foreign investors should be facilitated with special favorable policies in taxation, land use, and foreign currency exchange.

National Security**:** National security is also important for Pakistan. National security continues to be important; the specific sectors that are considered national security issues keep on changing. It should be noted that industries such as electric power, transportation, and communication have long been shaping the FDI polices in developing countries including Pakistan.

National industrial zones**:** Policy makers should create some industrial zones in the country. In these zone areas government should provide the facility same like the developing countries such as China, Malaysia, Korea and Japan covering (free trade, no shortage of electricity, and advance communication system like

developed country, no energy issues, security and good infrastructure like developing country).

***Human Resource*:** Policy makers and government of Pakistan should train the human resource to strengthen its capabilities and capacities. The literacy rate in Pakistan is 53 percent, school enrolment rate is grossly low and the quality of education provided by the public schools is rather poor. Policy makers of Pakistan should promote the education level at the same per as developed countries. Human resource development (HRD) should introduce proper manpower planning and vigorous training programmes.

***IT Sector Foreign Investment*:** Pakistan government should invite multinational IT companies to operate offices in the country. In this regard the policy makers should learn the lessons from neighboring countries such as India and China.

***Tourism sector*:** In Pakistan, the tourism sector is totally neglected. There are several historical places in Pakistan that need to be modernized in the process of development. Tourism ministry should promote these historical places to the western countries. The government should highlight the beauty of Pakistan snowcapped mountains in the north, with vast fertile plains of the Punjab, rugged land of the south, deserts and long seacoast. In short, Pakistan possesses all the hall-marks to develop it as a major tourist spot in the region.

***Agriculture Area*:** Policy makers should consider modernizing the area of agriculture. There is a need to introduce the new technology in agricultural sector and rural agro-based industries. FDI may be solicited in this direction.

As it is the case in any research work, the following sub-section admits the limitations of the present study.

6.6 Limitations of the Study

The research pertaining to business and economic studies are usually encountered with many limitations for the apparent reasons and the present study is no exception to the phenomenon. The present study has encountered some specific limitations, such as:

At various analytical stages, the study is marred by the paucity of data collected from the various reporting agencies. There has been a specific problem of finding and in comparing data from different sources. The time series data used for different variables and the averages have been lacking in homogeneity and accuracy to some extent.

Limitations of the studies regarding the time series data related to doing business, investor protection, investor confidence, starting business and other determinants related to doing business data are only available last five years. Sample size of data is not available for last 21 years related to doing business. There are no reporting agencies in Pakistan on several such issues. Statements that FDI has been the only source for development in the Pakistan economy in the post liberalized period can be a debatable issue. However, no proper methods were available to isolate the effect of FDI to support the validity of this statement.

This study looks at the Pakistan as a developing country in a macro sense only. Any consideration of a particular industry or multinational firm or product group in Pakistan economy at micro level is out of the preview of the present study. There is no restriction on the type of the FDI or the multinational companies covered in this study. Also the very inflow of direct investment is considered in broad sense in its context; it refers to the business scope, nature, activity or

function of the multinational companies doing their business in Pakistan in aggregative terms.

Above all, the study is solely confined to the secondary data. As such it is more in the nature of conceptual exploration and empirical measurements and its data analyses based on the information collected from the reports and authentic publications referring to macro variables and related issues. Apparently, any analyses of micro variables have remained out of the preview of the present study. In short, the study is broadly confined to the macroeconomic behavior of the country rather than entrepreneurial and business behavior of the companies in practice.

6.7 Directions for Future Research

This study provides much-needed analysis of the relationship between macroeconomic variables and business environment with foreign direct investment in Pakistan. Moreover in, this study focus has been on moderating effect of political stability on macroeconomic variables and business environment with foreign direct investment inflows in Pakistan.

There is a need to include other variables which are not included in this study. For example variables such as investor confidence, investor protection variables and the cost of doing business and related variables need to be investigated for further studies to trace their daunting economic effects and impact on the decision of the foreign direct investor. By and large, the missing link in the present study can inspire further in-depth and enlarge study on the issues of FDI and economic growth of Pakistan in the future course of direction. The issues of

political stability related problems in Pakistan can also be probed by the researchers in the gamut of public administration. The role of political stability and FDI may further be investigated in the context of uprising African nations.

6.8 Concluding Remarks

This study is a pioneering attempt to examine the impact of macroeconomic variables and business environment on FDI inflows in Pakistan in the context of moderating role of political stability using the data for the period 1991 to 2011. This study reviews the historical scenario of the foreign direct investment inflows in Pakistan. The study substantially contributes to the existing literature of macroeconomic variables and business environment and FDI inflows in the context of a developing economy such as Pakistan. The study suggests that policy makers and the government of Pakistan need to revamp the FDI policy to attract more investment into the country. The study is empirically examining the moderating impact of political stability on FDI by using the hierarchal regression analysis.

The present study's main finding is that the impact of political stability on FDI inflows in to Pakistan is very important. The study empirically traced that macroeconomic variables such as GDP growth rate (GDPGR), degree of openness (DOP), inflation rate (INFRATE) and exchange rate (EXCHRATE) and business environment variables such as infrastructure and corruption control index (CCI) variable and the moderating role of political stability effectuated the FDI inflows in Pakistan. Specifically, the study traced that over the years, variables, namely, GDPGR, DOP and inflation rate and corruption control and political stability indices produced positive and significant effect on the FDI inflows in Pakistan. The moderating role of political stability interaction terms with GDPGR is positive

and significant with FDI inflows in Pakistan. The study highlights the importance of GDP growth rate in Pakistan to attract the FDI inflows. The study also concludes that degree of openness (DOP) is very important for Pakistan to increase the foreign direct investment inflows into the country. The study suggests to Pakistani policy makers to draw a proper investment policy to attract the foreign investment in the country.

As a corollary of the study toward observations in the Pakistan's economy, it may be mentioned that the FDI in its pursuit has failed to address the poverty problem in the country. Apparently, this is because most of the MNCs who entered into the Pakistan's territories are profit-motivated enterprises and have been using capital intensive technology in the country's industrial expansion and as such also failed to generate substantial employment opportunities. Truly speaking, Pakistan's policy makers should invite FDI for rapid industrialization and growth of capital intensive and sophisticated products which the country is in need to improve the life style of the people who can afford besides production of sophisticated goods is also needed for the country's exports performance. As such, it is a wrong presumption that FDI is meant to eradicate poverty. As a matter of fact, the problem of poverty should be solved effectively by appropriate domestic investment and rural development programmes under the suitable public policy and redistribution of incomes through fiscal measures.

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Appendix-1

List of Pakistani Prime ministers during the period 1947 -2012

Name (Birth–Death)	Entered office	Left office	Days in office	Political party
Liaquat Ali Khan (1896–1951)	14 August 1947	16 October 1951	1524 days	Pakistan Muslim League
Sir Khawaja Nazimuddin (1894–1964)	17 October 1951	17 April 1953	548 days	Pakistan Muslim League
Muhammad Ali Bogra (1909–1963)	17 April 1953	12 August 1955	847 days	Pakistan Muslim League
Chaudhry Muhammad Ali (1905–1980)	12 August 1955	12 September 1956	397 days	Pakistan Muslim League
Huseyn Shaheed Suhrawardy (1892–1963)	12 September 1956	17 October 1957	400 days	All Pakistan Awami Muslim League
Ibrahim Ismail Chundrigar (1898–1968)	17 October 1957	16 December 1957	60 days	Pakistan Muslim League
Sir Feroz Khan Noon (1893–1970)	16 December 1957	7 October 1958	295 days	Republican Party
Nurul Amin (1893–1974)	7 December 1971	20 December 1971	13 days	Pakistan Muslim League
Zulfikar Ali Bhutto (1928–1979)	14 August 1973	5 July 1977	1421 days	Pakistan Peoples Party

Muhammad Khan Junejo (1932–1993)	24 March 1985	29 May 1988	1162 days	Independent (Pakistan Muslim League)
Benazir Bhutto (1953–2007)	2 December 1988	6 August 1990	612 days	Pakistan Peoples Party
Ghulam Mustafa Jatoi (1931–2009)	6 August 1990	6 November 1990		National Peoples Party
Nawaz Sharif (1949–)	6 November 1990	18 April 1993	894 days	Pakistan Muslim League (N)
Balakh Sher Mazari (1928–2011)	18 April 1993	26 May 1993		Pakistan Peoples Party
Nawaz Sharif (1949–)	26 May 1993	18 July 1993	73 days (Total: 967)	Pakistan Muslim League (N)
Moeenuddin Ahmad Qureshi (1930–)	18 July 1993	19 October 1993		Independent
Benazir Bhutto (1953–2007)	19 October 1993	5 November 1996	1113 days (Total: 1725)	Pakistan Peoples Party
Malik Meraj Khalid (1916–2003)	5 November 1996	17 February 1997		Pakistan Peoples Party
Nawaz Sharif (1949–)	17 February 1997	12 October 1999	967 days (Total: 1934)	Pakistan Muslim League (N)
Zafarullah Khan Jamali (1944–)	21 November 2002	26 June 2004	569 days	Pakistan Muslim League (Q)
Chaudhry Shujaat Hussain (1946–)	30 June 2004	20 August 2004	51 days	Pakistan Muslim League (Q)

Shaukat Aziz (1949–)	20 August 2004	16 November 2007	1183 days	Pakistan Muslim League (Q)
Muhammad Mian Soomro (1950–)	16 November 2007	25 March 2008	130 days	Pakistan Muslim League (Q)
Yousaf Raza Gillani (1952–)	25 March 2008	26 April 2012	1493 days	Pakistan Peoples Party
22 June 2012	Incumbent	8 days		Pakistan Peoples Party

Source: Department of Prime Minister in Pakistan

Appendix-2

Political stability Index Measure

Measures the perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including domestic violence and terrorism rank country between 0 to 100.

Representative Sources

Code	Concept Measured
BIU Economist Intelligence Unit Risk-wire & Democracy Index	Violent demonstrations Social Unrest International tensions / terrorist threat Orderly transfers
GCS Transparency International Global Corruption Barometer Survey	The threat of terrorism in the country imposes significant costs on business
HUM Cingranelli Richards Human Rights Database and Political Terror Scale	Frequency of political killings (CIRI) Frequency of disappearances (CIRI) Frequency of tortures (CIRI) Political terror scale (PTS)
IJT IJET Country Security Risk Ratings	Security Risk Rating
IPD Institutional Profiles Database	Conflicts of ethnic, religious, regional nature Violent actions by underground political organizations Violent social conflicts External public security

PRS Political Risk Services International Country Risk Guide	Government stability Internal conflict External conflict Ethnic tensions
WMO Global Insight Business Conditions and Risk Indicators	Civil unrest How widespread political unrest is, and how great a threat it poses to investors. Demonstrations in themselves may not be cause for concern, but they will cause major disruption if they escalate into severe violence. At the extreme, this factor would amount to civil war

Appendix 3

Descriptive Statistics, Skewness and Kurtosis of Constructs

Descriptive

			Statistic	Std. Error
FDI	Mean		1461.123	351.123
	95% Confidence Interval for Mean	Lower Bound	728.697990	
		Upper Bound	2193.5492	
	5% Trimmed Mean		1308.420	
	Median		711	
	Variance		2589006.84	
	Std. Deviation		1609.039	
	Minimum		271.9	
	Maximum		5410	
	Range		5338.3	
	Interquartile Range		1533.05	
	Skewness		1.583	0.501
	Kurtosis		1.366	0.972

Descriptive

			Statistic	Std. Error
GDPGR	Mean		4.605714	0.441229
	95% Confidence Interval for Mean	Lower Bound	3.685328	
		Upper Bound	5.526101	
	5% Trimmed Mean		4.528228	
	Median		4.18	
	Variance		4.088	
	Std. Deviation		2.021963	
	Minimum		1.7	
	Maximum		8.96	
	Range		7.26	
	Interquartile Range		2.91	
	Skewness		0.478	0.501
	Kurtosis		-0.457	0.972

Descriptive

			Statistic	Std. Error
DOP	Mean		0.332381	0.007461
	95% Confidence Interval for Mean	Lower Bound	0.316817	
		Upper Bound	0.347945	
	5% Trimmed Mean		0.33	
	Median		0.33	
	Variance		0.001	
	Std. Deviation		0.034191	
	Minimum		0.28	
	Maximum		0.43	
	Range		0.15	
	Interquartile Range		0.035	
	Skewness		0.97	0.501
	Kurtosis		2.287	0.972

Descriptive

			Statistic	Std. Error
EXCHRATE	Mean		53.20476	4.369823
	95% Confidence Interval for Mean	Lower Bound	44.08947	
		Upper Bound	62.32005	
	5% Trimmed Mean		52.79444	
	Median		57.8	
	Variance		401.002	
	Std. Deviation		20.02505	
	Minimum		23.8	
	Maximum		90	
	Range		66.2	
	Interquartile Range		27.4	
	Skewness		0.286	0.501
	Kurtosis		-0.609	0.972

Descriptive

			Statistic	Std. Error
INFRATE	Mean		8.514286	0.77279
	95% Confidence Interval for Mean	Lower Bound	6.902274	
		Upper Bound	10.1263	
	5% Trimmed Mean		8.555026	
	Median		9.5	
	Variance		12.541	
	Std. Deviation		3.541368	
	Minimum		3.2	
	Maximum		13.1	
	Range		9.9	
	Interquartile Range		7.35	
	Skewness		-0.381	0.501
	Kurtosis		-1.418	0.972

Descriptive

			Statistic	Std. Error
INFRAS	Mean		3.283333	0.154858
	95% Confidence Interval for Mean	Lower Bound	2.960304	
		Upper Bound	3.606362	
	5% Trimmed Mean		3.272249	
	Median		3.06	
	Variance		0.504	
	Std. Deviation		0.70965	
	Minimum		2.26	
	Maximum		4.5	
	Range		2.24	
	Interquartile Range		1.025	
	Skewness		0.532	0.501
	Kurtosis		-0.785	0.972

Descriptive

			Statistic	Std. Error
CCI	Mean		15.48095	1.370881
	95% Confidence Interval for Mean	Lower Bound	12.62134	
		Upper Bound	18.34056	
	5% Trimmed Mean		15.22249	
	Median		12.4	
	Variance		39.466	
	Std. Deviation		6.282167	
	Minimum		7.5	
	Maximum		28.3	
	Range		20.8	
	Interquartile Range		11.4	
	Skewness		0.543	0.501
	Kurtosis		-1.081	0.972

Descriptive

			Statistic	Std. Error
LBC	Mean		3076.19	413.113
	95% Confidence Interval for	Lower		
	Mean	Bound	2214.45	
		Upper		
		Bound	3937.93	
	5% Trimmed Mean		2945.77	
	Median		2000	
	Variance		3583905	
	Std. Deviation		1893.12	
	Minimum		1500	
	Maximum		7000	
	Range		5500	
	Interquartile Range		2400	
	Skewness		1.175	0.501
	Kurtosis		-0.02	0.972

Descriptive

			Statistic	Std. Error
PSI	Mean		8.231191	1.126055
	95% Confidence Interval for Mean	Lower Bound	5.882282	
		Upper Bound	10.5801	
	5% Trimmed Mean		8.251521	
	Median		9.11	
	Variance		26.628	
	Std. Deviation		5.160231	
	Minimum		0.5	
	Maximum		15	
	Range		13.9	
	Interquartile Range		11.1	
	Skewness		-0.255	0.501
	Kurtosis		-1.555	0.972

Appendix 4

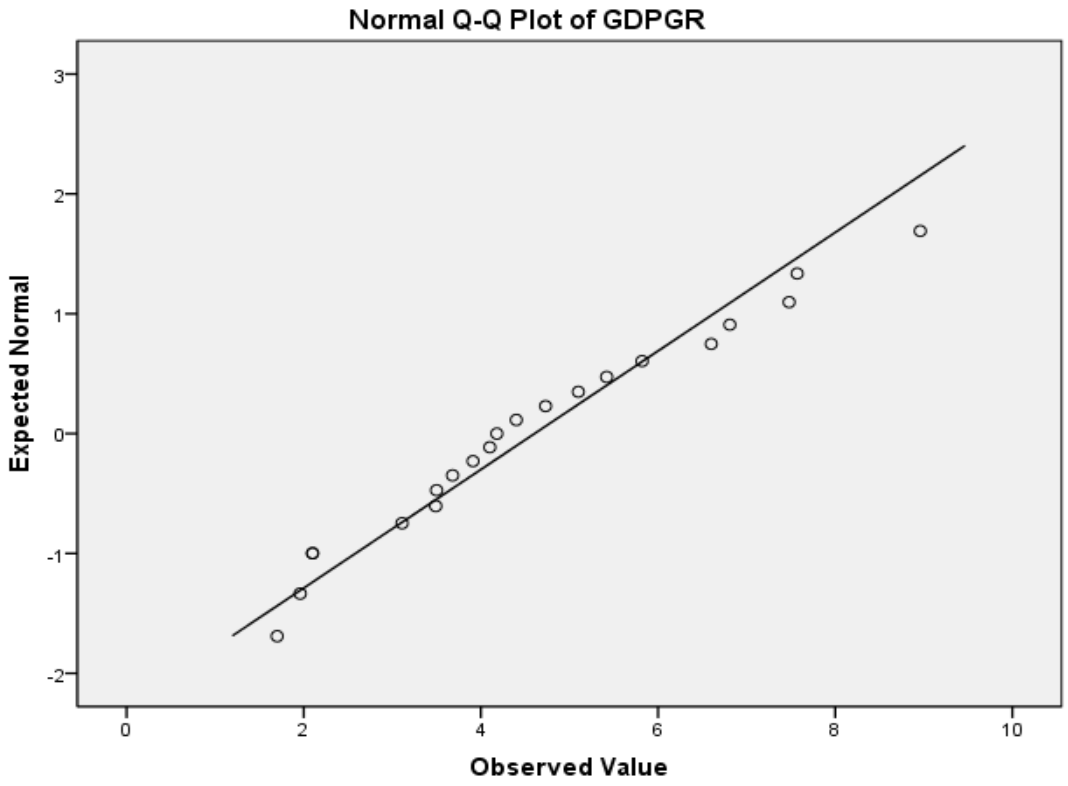
Test of Normality for Independent Variable

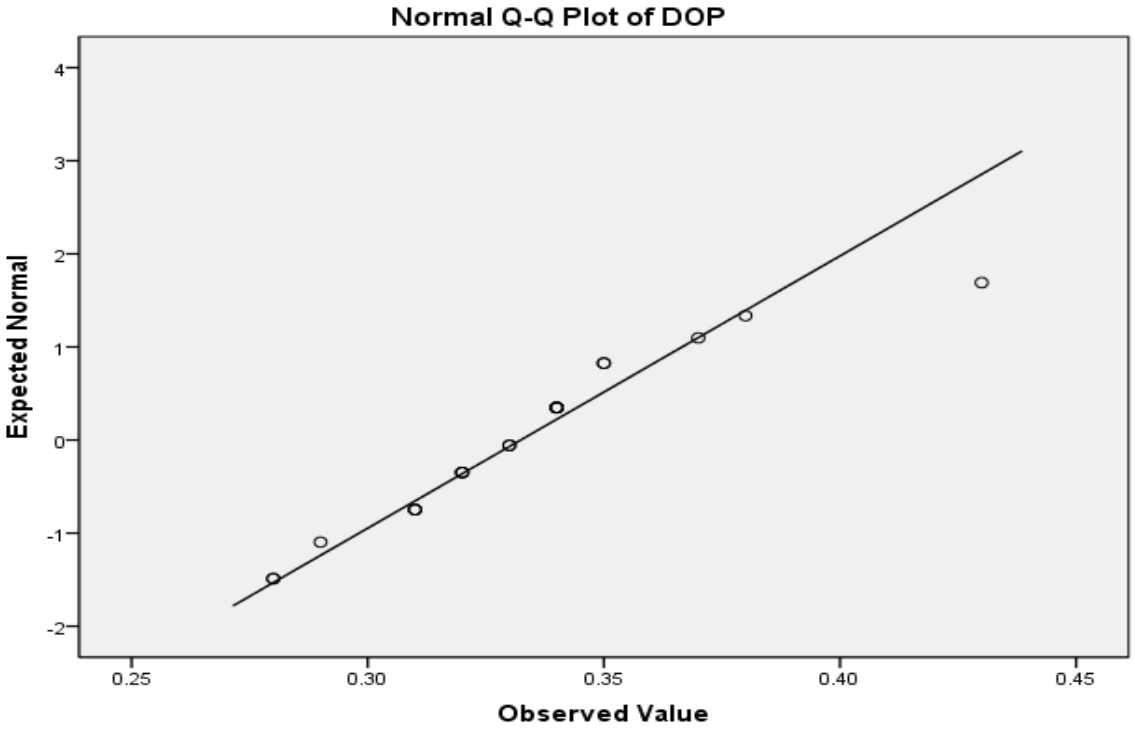
Tests of Normality

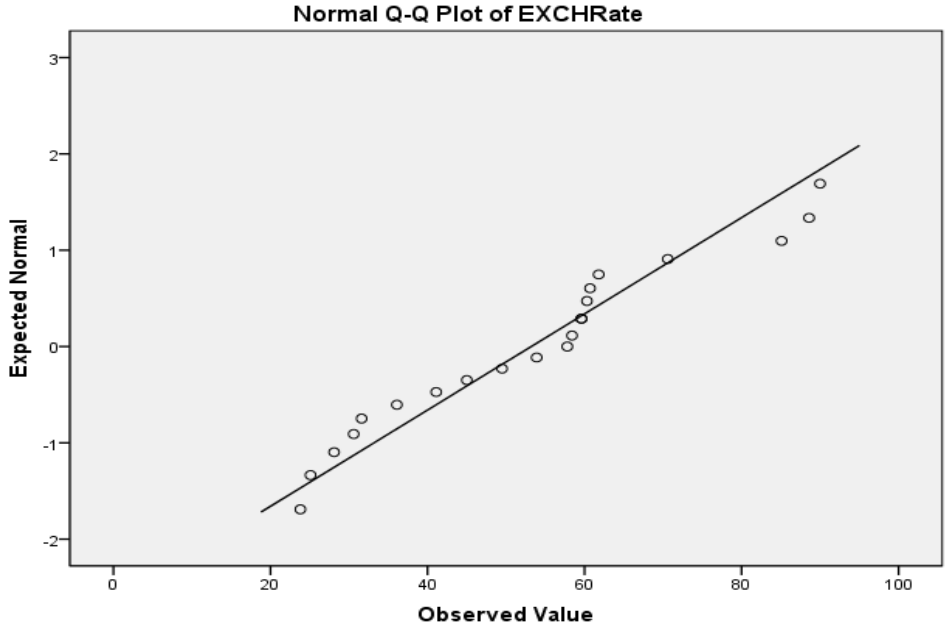
	Kolmogorov-Smirnov[a]			Shapiro-Wilk		
	Statistic	df	Sig.	Statistic	df	Sig.
GDPGR	.112	21	.200*	.957	21	.451
DOP	.174	21	.098	.924	21	.102
EXCHRate	.143	21	.200*	.937	21	.190
INFRATE	.163	21	.149	.887	21	.020
lnFRAS	.173	21	.099	.920	21	.089
CCI	.212	21	.015	.899	21	.033
PS	.180	21	.073	.877	21	.013

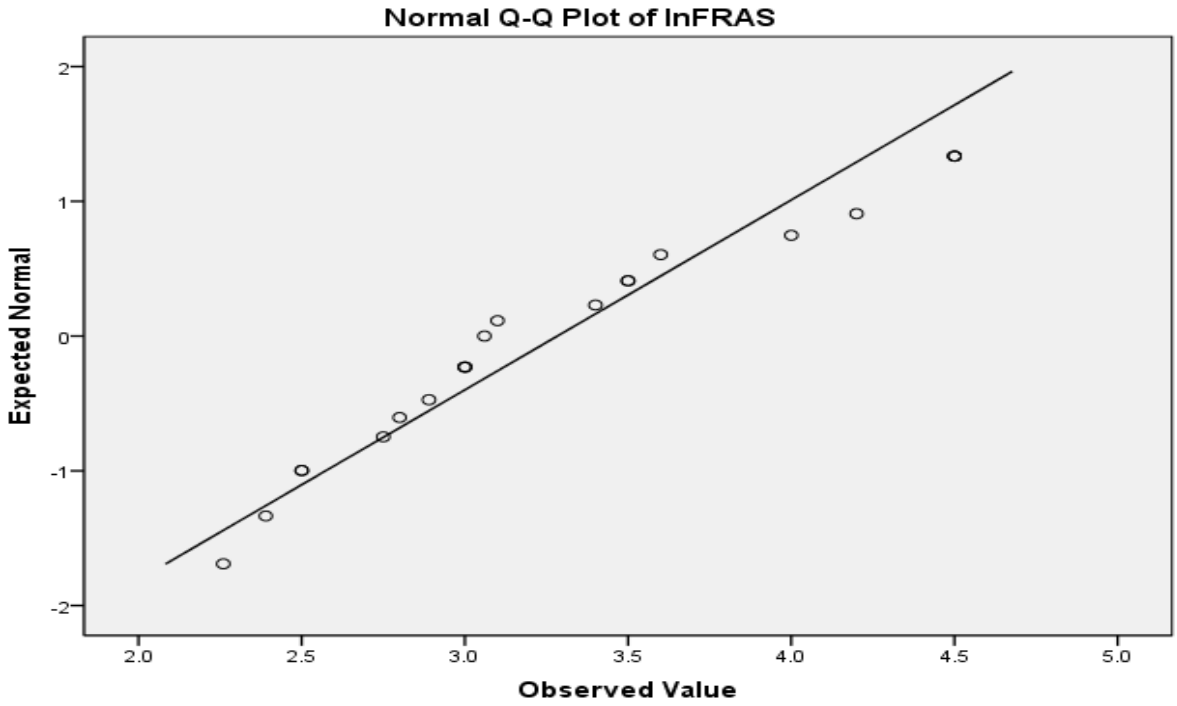
a. Lilliefors Significance Correction

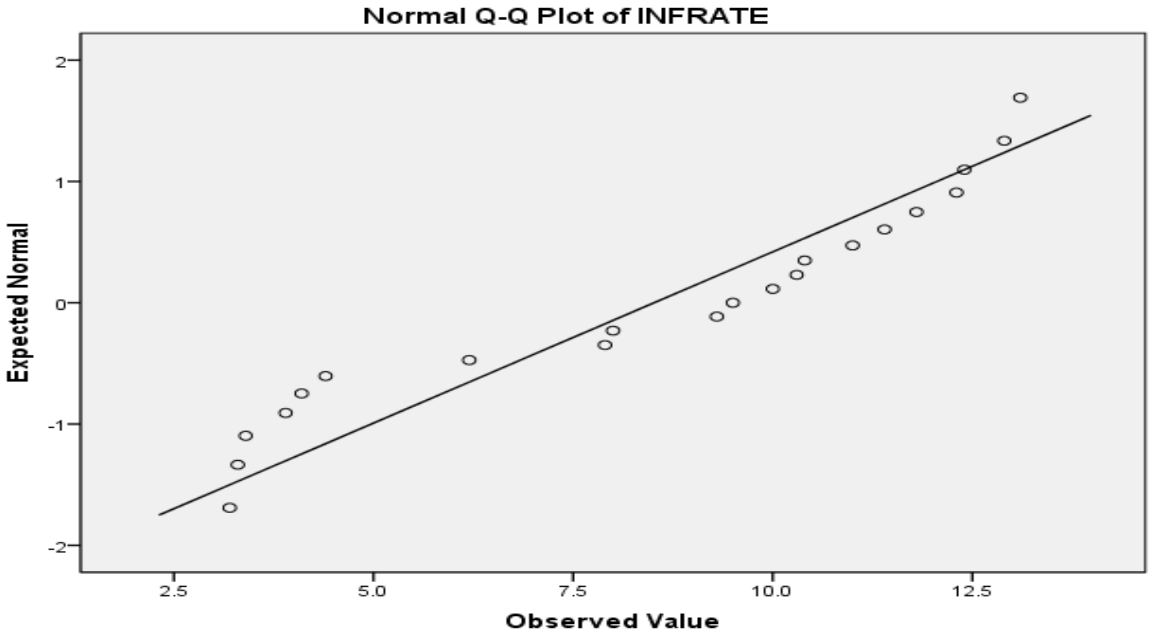
*. This is a lower bound of the true significance.

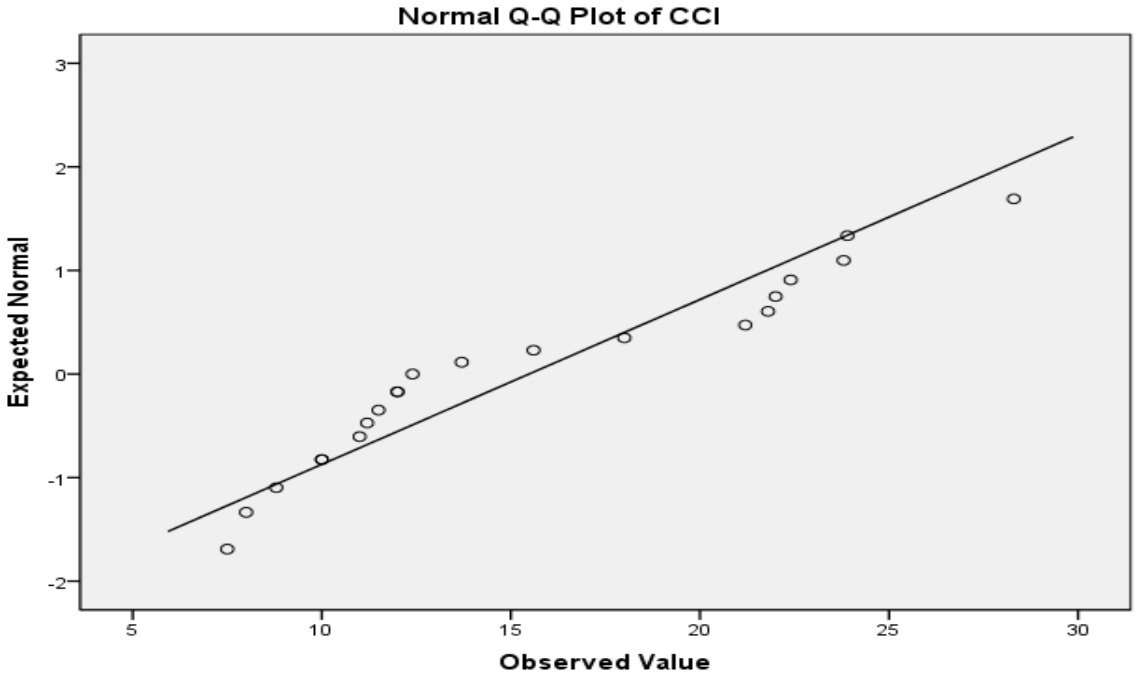


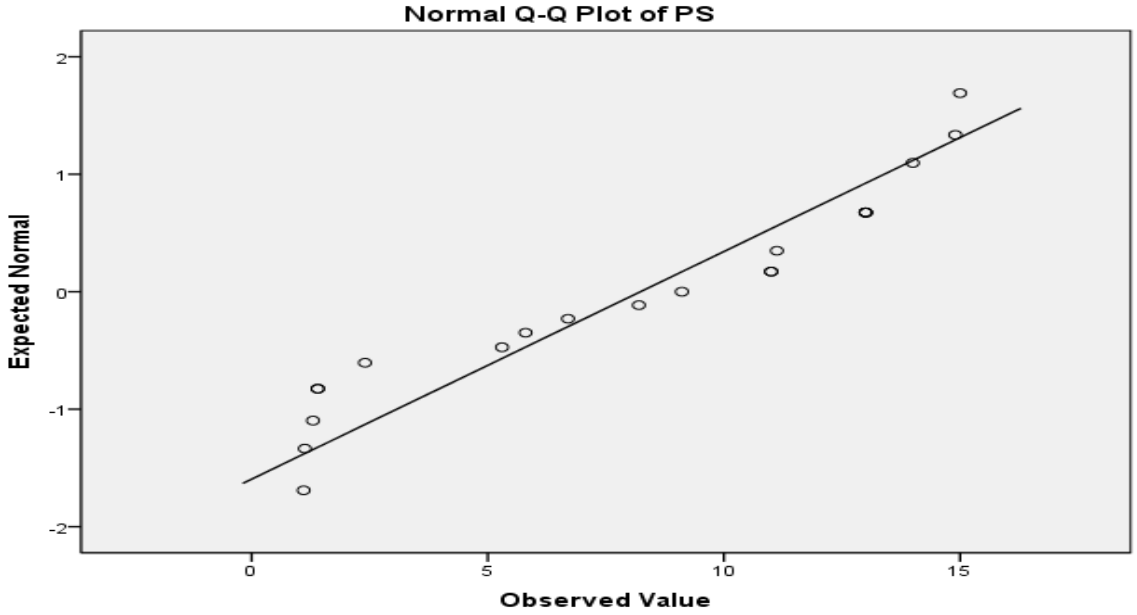

Normal Q-Q Plot of DOP
Expected Normal
Observed Value
4
3
2
1
0
-1
-2
0.25
0.30
0.35
0.40
0.45


Normal Q-Q Plot of EXCHRate
Expected Normal
Observed Value
3
2
1
0
-1
-2
0
20
40
60
80
100


Normal Q-Q Plot of lnFRAS
Expected Normal
Observed Value
2
1
0
-1
-2
2.0
2.5
3.0
3.5
4.0
4.5
5.0


Normal Q-Q Plot of INFRATE
Expected Normal
Observed Value
2
1
0
-1
-2
2.5
5.0
7.5
10.0
12.5


Normal Q-Q Plot of CCI
Expected Normal
Observed Value
3
2
1
0
-1
-2
5
10
15
20
25
30


Normal Q-Q Plot of PS
Expected Normal
Observed Value
2
1
0
-1
-2
0
5
10
15

Appendix 5

Predictor's Coefficients Test

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
		B	Std. Error	Beta			Tolerance	VIF
1	(Constant)	-2.746E-16	.091		.000	1.000		
	Zscore(GDPGR)	.239	.107	.239	2.238	.043	.759	1.317
	Zscore(DOP)	.318	.119	.318	2.677	.019	.611	1.636
	Zscore(EXCHRate)	-.185	.250	-.185	-.742	.471	.139	7.217
	Zscore(INFRATE)	.448	.170	.448	2.640	.020	.300	3.335
	Zscore(InFRAS)	-.085	.154	-.085	-.554	.589	.364	2.749
	Zscore(CCI)	.457	.151	.457	3.019	.010	.378	2.647
	Zscore(PSI)	.733	.281	.733	2.607	.022	.110	9.131

a. Dependent Variable: Zscore(FDI)

Appendix 6

Interaction Value

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-4.095E-16	.108		.000	1.000
	Zscore(GDPGR)	.284	.125	.284	2.269	.040
	Zscore(DOP)	.417	.134	.417	3.109	.008
	Zscore(EXCHRate)	.400	.130	.400	3.086	.008
	Zscore(INFRATE)	.314	.192	.314	1.630	.125
	Zscore(InFRAS)	.136	.153	.136	.889	.389
	Zscore(CCI)	.450	.180	.450	2.501	.025
2	(Constant)	-1.667E-16	.091		.000	1.000
	Zscore(GDPGR)	.239	.107	.239	2.238	.043
	Zscore(DOP)	.318	.119	.318	2.677	.019
	Zscore(EXCHRate)	-.185	.250	-.185	-.742	.471
	Zscore(INFRATE)	.448	.170	.448	2.640	.020
	Zscore(InFRAS)	-.085	.154	-.085	-.554	.589
	Zscore(CCI)	.457	.151	.457	3.019	.010
	Zscore(PSI)	.733	.281	.733	2.607	.022
3	(Constant)	-.393	.192		-2.042	.080
	Zscore(GDPGR)	.382	.097	.382	3.953	.006
	Zscore(DOP)	.396	.217	.396	1.826	.111
	Zscore(EXCHRate)	.436	.340	.436	1.281	.241
	Zscore(INFRATE)	-.174	.277	-.174	-.629	.549
	Zscore(InFRAS)	-.268	.168	-.268	-1.598	.154
	Zscore(CCI)	.169	.191	.169	.886	.405
	Zscore(PSI)	.515	.269	.515	1.910	.098
	GDPGR_PSI	.416	.115	.390	3.607	.009
	DOP_PSI	.050	.141	.051	.355	.733
	EXCHRATE_PSI	.296	.325	.208	.910	.393
	INFRATE_PSI	-.433	.249	-.365	-1.743	.125
	INFRAS_PSI	-.289	.242	-.228	-1.193	.272
	CCI_PSI	.356	.230	.284	1.547	.166