

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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By

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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

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TABLE OF CONTENT

| | Page |
|--|-----------|
| TITLE | |
| TITLE PAGE | i |
| CERTIFICATION OF THE THESIS | ii |
| PERMISSION TO USE | iii |
| ABSTRACT | iv |
| ABSTRAK | v |
| ACKNOWLEDGEMENTS | vi |
| TABLE OF CONTENT | vii |
| LIST OF TABLES | xiii |
| LIST OF FIGURES | xv |
| LIST OF ABBREVIATIONS | xvii |
| LIST OF APPENDICES | xix |
| | |
| CHAPTER ONE | |
| INTRODUCTION | 1 |
| 1.1 Background of the Study | 1 |
| 1.2 Problem Statement | 12 |
| 1.3 Research Question | 16 |
| 1.4 Research Objective | 16 |
| 1.5 Scope of the Study | 17 |
| 1.6 Significance of the Study | 18 |
| 1.7 Organization of the Dissertation | 19 |
| | |
| CHAPTER TWO | |
| THE HISTORICAL ACCOUNT OF THE ECONOMY AND FOREIGN DIRECT INVESTMENT (FDI) IN PAKISTAN | 21 |
| 2.1. Introduction | 21 |
| 2.2 Profile of Pakistan | 21 |

| | |
|---|----|
| 2.3 Pakistan Economy and FDI Flows in Historical Perspective | 23 |
| 2.3.1 Early Years (1947-1958) | 24 |
| 2.3.2 Years of Growth (1958-1969) | 27 |
| 2.3.3 Years of Nationalization (1972-1977) | 33 |
| 2.3.4 Years of Country's Economic Expansion (1978- 1990) | 36 |
| 2.4 Pakistan FDI inflows in the: A Comparison with Selected Asian Countries | 40 |
| 2.4.1 FDI Gamut: India versus Pakistan | 40 |
| 2.4.2 Concluding Comment | 46 |
| 2.5 Sectorial Distribution of FDI Inflows in Pakistan | 46 |
| 2.6 Doing Business in Pakistan | 48 |
| 2.6.1 Global Competitiveness Index: A Comparison | 50 |
| 2.7 Pakistan Capital Formation: A Comparison | 52 |
| 2.8 A Perspective on Reasons to Invest In Pakistan | 54 |
| 2.8.1 Abundant Land and Natural Resources | 54 |
| 2.8.2 Geo-strategic Location | 54 |
| 2.8.3 Potential in the SAARC Region | 54 |
| 2.8.4 Trained Workforce | 54 |
| 2.8.5 Investment Opportunities in Pakistan | 55 |
| 2.9 Foreign Direct Investment Policy in Pakistan | 55 |
| 2.9.1 FDI Act of 1976 | 56 |
| 2.9.1.1 Fields for FPI | 56 |
| 2.9.1.2 Approval of FPI | 56 |
| 2.9.1.2 Repatriation Facilities | 57 |
| 2.9.1.3 Remittances | 57 |
| 2.9.1.4 Tax Concession and Escaping of Double Taxation | 57 |
| 2.9.1.3 Equal Treatment | 58 |
| 2.9.2 FPI (Foreign Private Investment) Act 1992 | 58 |
| 2.9.2.1 Short Title | 58 |

| | |
|--|----|
| 2.9.2.2 Over-ride other Laws | 59 |
| 2.9.2.3 Autonomy to Bring (Foreign Currency) | 59 |
| 2.9.2.4 Protection Policy of Foreign Currency Accounts | 59 |
| 2.9.2.6 Security of Economic Incentives for Setting-up of Firm | 59 |
| 2.9.2.7 Protection of Transfer of Tenure to Private Sector | 60 |
| 2.9.2.8 Protection of Foreign Investment | 60 |
| 2.9.2.9 Privacy of Banking Transaction | 60 |
| 2.9.2.10 Protection of Financial Interest | 60 |
| 2.10 Summary | 60 |

CHAPTER THREE

| | |
|--|-----------|
| LITERATURE REVIEW | 62 |
| 3.1 Introduction | 62 |
| 3.2 Foreign Direct Investment | 62 |
| 3.2.1 FDI Definition | 62 |
| 3.2.2 Classification of FDI | 63 |
| 3.3 FDI and Economic Growth | 64 |
| 3.3.1 Determinants of FDI | 69 |
| 3.4 Towards Literature Review of Microeconomic Variables and Business Environment | 74 |
| 3.4.1 Gross Domestic Product Growth Rate (GDPGR) | 75 |
| 3.4.2 Export | 78 |
| 3.4.3 Imports | 80 |
| 3.4.4 Degree of openness | 81 |
| 3.4.5 Exchange Rate | 84 |
| 3.4.6 Inflation Rate | 87 |
| 3.4.7 Interest Rate | 89 |

| | |
|--|-----|
| 3.4.8 Infrastructure | 90 |
| 3.4.9 Corruption Control Index | 91 |
| 3.4.10 Labor Cost | 93 |
| 3.4.11 Political Stability | 95 |
| 3.5 Underpinning Theory | 100 |
| 3.5.1 FDI Theory | 100 |
| 3.5.2 Eclectic Theory | 103 |
| 3.5.3 Harrod–Domar model: Basic Foundation towards Growth theory | 104 |
| 3.5.4 Investment theory of Firm | 105 |
| 3.5.5 New Growth Theory Model towards FDI | 107 |
| 3.6 Summary | 112 |

CHAPTER FOUR

| | |
|--|------------|
| RESEARCH DESIGN AND METHODOLOGY | 114 |
| 4.1 Introduction | 114 |
| 4.2 Theoretical Framework | 114 |
| 4.3 Hypotheses Development | 115 |
| 4.3.1 GDP growth rate and FDI | 115 |
| 4.3.2 Degree of Openness | 116 |
| 4.3.3 Exchange Rate and FDI | 117 |
| 4.3.4 Inflation Rate (INFRATE) and FDI | 117 |
| 4.3.5 Infrastructure | 118 |
| 4.3.6 Corruption Control Index | 118 |
| 4.3.7 Labor Cost (LBC) and FDI | 119 |
| 4.3.8 Political stability and FDI | 120 |
| 4.4 Data Collection Procedure | 122 |
| 4.5 Operational Definitions | 124 |

| | |
|---|------------|
| 4.6 Data Analysis | 126 |
| 4.6.1 Stationary Analysis of the Data | 127 |
| 4.6.1.1 Augmented Dickey Fuller (ADF) | 127 |
| 4.7 Preparing data for Multiple Regression Analysis | 129 |
| 4.7.1 Detecting Outliers | 129 |
| 4.7.2 Multicollinearity Check | 130 |
| 4.7.3 Testing the Normality of the Error Terms | 133 |
| 4.7.4 Testing the Linearity, Homoscedasticity and the Independence of Errors | 135 |
| 4.7 Summary | 136 |
| | |
| CHAPTER FIVE | |
| DATA ANALYSIS AND RESULTS | 138 |
| 5.1 Introduction | 138 |
| 5.2 Descriptive Analysis | 139 |
| 5.3 Pearson Correlation Analysis | 139 |
| 5.4 Multiple Regression Analysis Results | 142 |
| 5.5 Hierarchical Regression Analysis Results | 144 |
| 5.5.1 The moderating effect of the Political Stability on the Macroeconomic Variable and Business Environment, FDI Inflows in Pakistan | 145 |
| 5.6 Summary of the Findings | 151 |
| | |
| CHAPTER SIX | |
| DISCUSSION, CONCLUSION AND RECOMMENDATIONS | 154 |
| 6.1 Introduction | 154 |
| 6.2 Summary of the Study | 154 |
| 6.3 Discussion | 160 |
| 6.3.1 Relationship between Macroeconomic Determinants and FDI | |

| | |
|--|------------|
| Inflows in Pakistan | 160 |
| 6.3.2 Relationship between Business Environment and FDI inflows in Pakistan | 164 |
| 6.3.3 The Relationship between Political stability and FDI Inflows in Pakistan | 167 |
| 6.3.4 The Moderating effect of the Political stability on the Macroeconomic variables FDI inflows Relationship. | 172 |
| 6.3.5 Moderating Political stability with business environment and FDI inflows | 173 |
| 6.4 Contributions of the study | 174 |
| 6.4.1 Contribution to the Literature | 174 |
| 6.4.2 Practical Contribution | 177 |
| 6.5 Policy Implications | 179 |
| 6.6 Limitations of the Study | 185 |
| 6.7 Directions for Future Research | 186 |
| 6.8 Concluding Remarks | 187 |
| REFERENCES | 189 |
| APPENDICES | 217 |

LIST OF TABLES

| Tables | Page |
|---|------|
| Table 1.1 Foreign Direct Investment inflows during the Period of 1991– 2011 (Millions of U.S. dollars) | 5 |
| Table 2.1 The Government of Pakistan: Political Regimes 1947- 2012 | 23 |
| Table 2.2 FDI inflows in 1949 to 1958 in Pakistan (Million USD) | 26 |
| Table 2.3 FDI inflows in 1958 to 1968 in Pakistan (million of USD) | 30 |
| Table 2.4 West and East Pakistan income period of 1949-1970 | 32 |
| Table 2.5 FDI inflows in 1969 - 1978 in Pakistan Million USD | 34 |
| Table 2.6 FDI inflows in Pakistan 1977 – 1990 Million USD | 38 |
| Table 2.7 FDI inflows in 2001 to 2011 Pakistan comparisons with neighbor countries (million USD) | 41 |
| Table2.8 FDI in Sectoral distribution in Pakistan (million USD) | 47 |
| Table 2.9 Doing business in Pakistan comparing with other countries 2010 to 2011 | 50 |
| Table 2.10 Global Competitiveness of Pakistan comparing with selected Asian countries: 2006 to 2011 | 51 |
| Table 2.11 Capital formation (as percentage of GDP) comparison with other countries | 53 |
| Table 4.1 The Source of Data Collection for Each Variable | 123 |
| Table 4.2 Measurement of the Variables | 125 |
| Table 4.3 ADF unit root test result using the Trend and intercept | 128 |
| Table 4.4 Multicollinearity Test with all variables | 131 |

| | | |
|-----------|--|-----|
| Table 4.5 | Multicollinearity Test after dropping (LBC) | 132 |
| Table 4.6 | Normality test of the Residuals | 135 |
| Table 5.1 | Descriptive Statistics of the Constructs (n=21) | 139 |
| Table 5.2 | Pearson Correlation Analysis | 140 |
| Table 5.3 | Summary of the correlation analysis | 141 |
| Table 5.4 | Examining Variables' predictive power | 143 |
| Table 5.5 | Examining the Moderating effect of Political Stability | 147 |
| Table 5.6 | Summary of the hypotheses testing results | 152 |
| Table 6.1 | Overall Infrastructure Quality Ranking | 166 |
| Table 6.2 | List of Pakistani Prime minister during the period 1988-2012 | 171 |

LIST OF FIGURES

| Figures | | Page |
|-------------|--|------|
| Figure 1.1 | Pakistan FDI inflows during the period of 1991-2011 | 13 |
| Figure 2.1 | MAP of Pakistan | 22 |
| Figure 2.2 | FDI inflows in 1949 to 1958 in Pakistan (Million of USD) | 26 |
| Figure 2.3 | FDI inflows in 1958 to 1968 in Pakistan (million of USD) | 30 |
| Figure 2.4 | West and East Pakistan income period of 1949-1970 | 32 |
| Figure 2.5 | FDI inflows in 1969 - 1978 in Pakistan Million USD | 34 |
| Figure 2.6 | FDI inflows in Pakistan 1977 – 1990 Million USD | 38 |
| Figure 2.7 | FDI inflows in 2001 to 2010: Pakistan in comparison with Neighboring countries | 42 |
| Figure 2.8 | GDP Growth Rate in 2001 to 2010 Pakistan comparisons with India | 45 |
| Figure 2.9 | Global Competitiveness of Pakistan comparing with selected Asian countries 2006 to 2011 | 52 |
| Figure 2.10 | Capital formation (as percentage of GDP) comparison with other countries | 53 |
| Figure 4.1 | Research Framework | 114 |
| Figure 4.2 | Histogram of the regression residuals | 133 |
| Figure 4.3 | Testing Normality using Normal Probability Plot | 134 |
| Figure 4.4 | Testing Normality using Q-Q Plot | 134 |

| | | |
|------------|---|-----|
| Figure 4.5 | Scatterplot of the residuals | 136 |
| Figure 5.1 | The Moderation effect of PSI on GDPGR- FDI relationship | 148 |
| Figure 5.2 | The Moderation effect of PSI on DOP-FDI relationship | 148 |
| Figure 5.3 | The Moderation effect of PSI on Exchange Rate-FDI relationship | 149 |
| Figure 5.4 | The Moderation effect of Inflation Rate on FDI relationship | 150 |
| Figure 5.5 | The Moderation effect of PSI on Infrastructure-FDI relationship | 150 |

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 |

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| 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 | World Development Report |

LIST OF APPENDICES

| Appendix | | Page |
|------------|--|------|
| Appendix-1 | List of Pakistani Prime ministers during the period 1947 -2012 | 217 |
| Appendix-2 | Political stability Index Measure | 220 |
| Appendix-3 | Descriptive Statistics, Skewness and Kurtosis of Constructs | 222 |
| Appendix-4 | Test of Normality for Independent Variables | 231 |
| Appendix-5 | Predictor's Coefficients Test | 235 |
| Appendix-6 | Interaction Value | 236 |

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

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