



## Economic Determinants of Foreign Direct Investment in Pakistan

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### Abstract

Pakistan aims to increase the ratio of GDP to investment by attracting foreign direct investment (FDI). Foreign investors, mostly from developed dynamic centers, are enhancing international production by investing in resource-rich economies. By taking an overview of cross-border investment inflows, this paper attempted to empirically investigate the determinants of foreign direct investment in Pakistan. The analysis allowed us to identify some economic determinants of FDI in Pakistan, such as the GDP growth rate, the volume of exports, the human population, import duties, and the price index. The volume of exports has become the most powerful determinant of FDI. The government must make a paradigm shift in its investment policy to attract FDI. It should focus on export-oriented industries instead of promoting FDI for domestic consumption.

**Keywords:** Career orientation; Factors; New generation; Turkish human resource.

## 1. Introduction

The economic development of a country involves the use of resources to increase production capacity. In many developing countries, such as Pakistan, the use of resources is impossible due to the scarcity of domestic capital. Lizondo (1991), recognized developing countries as a better choice for foreign direct investment (FDI) than relying on bank loans and bonds. These countries could promote their economic growth by receiving FDI (China is a classic example, where in 1997 FDI contributed about 15% of domestic investment, 41% of total exports, 19% of industrial production, 13% of tax revenue. and 18 million works).

First, the FDI transfers financial resources to recipients or host countries which could be used to expand manufacturing facilities in host countries. Second, technology and managerial know-how, which play a crucial role in promoting economic growth, can be transferred to host countries to participate in various networks, such as sales and procurement networks of foreign investors. By using international networks, host countries could not only expand their ports, which in turn would improve productivity in host countries. On the other hand, those who criticize FDI argue that foreign investors monopolize resources, replace domestic companies and introduce inadequate products and technologies and add to the balance of payments problem with high remittances. They often use transfer pricing to minimize their tax obligations. They can also exert significant political influence, distort the development path, exacerbate income inequality and exploit weak environmental standards in developing countries

As a capital deficit country, Pakistan needs FDI. Since the late 1990s, the government of Pakistan has implemented several policy and regulatory measures to attract FDI. For example, the government approval requirement for foreign investment has been removed and foreign ownership is allowed, except for some projects. Foreign investments in agriculture, forestry, irrigation, real estate, insurance, health care, and related services are prohibited. In the oil sector, the government has implemented a new oil policy that greatly favors foreign investment.

One of the most important measures to attract FDI is the liberalization of the exchange rate regime. Pakistani and resident and non-resident foreigners can introduce, hold and withdraw foreign currency, open accounts and hold foreign currency certificates. Export incentives have been expanded. 55% income tax refunds are made for exports of high-value-added products and a 50% refund for all other products. The import policy was liberalized to attract FDI. The import of non-locally manufactured machinery is totally or partially exempt from import duties, depending on whether it is a project located in a rural area, an underdeveloped area, or an industrial area. A variety of other fiscal and monetary incentives have also been offered for projects in select industries such as electronics, tourism, pharmaceuticals, dairy, mining, engineering, fertilizers, and cement.

The largest foreign investor in Pakistan is Switzerland with 31.9 percent of total FDI in 2004-05. Then come the US and UK with 27.9 percent and 12 percent share of FDI in Pakistan (SBP, 2005). In a developing country like Pakistan, which has abundant natural resources, higher returns are obtained in resource-oriented industries, resulting in capital inflow into these industries. Pakistan's financial sector has absorbed the most FDI, after that oil and gas, and oil refining have taken 23.9 and 8.6 percent of FDI. Textiles are the largest manufacturing sector in the country, attracting the 4.2 percent of FDI that has the most absorbing capacity.

The construction industry is going through a boom in recent years. It has also taken a small portion of 3.3 percent of FDI (SBP, 2005). The classical theory of international capital flow asserted that FDI is a function of international differences in rates of return on capital. Empirical analysis of FDI from the United Kingdom and Canada to the United States during 1950-1970 by Blais (1975) supported the hypothesis. Contrary to this, Weintraub (1976) did not observe a significant relationship between the flow of US capital and relative rates of return.

Traditional factorial endowment theory assumes that factors are internationally immobile. This is an unrealistic assumption, as there are factors that move relatively freely. Therefore, it is necessary to distinguish between those factors that are mobile and those that are not. In this sense, the traditional theory must be modified, since it has a major impact on the decision to locate investments in a region and, therefore, influences the movement of mobile factors.

Over the past three decades, FDI has changed the shape and structure of the contemporary global economy. Grossman and Helpman (1991), found that small developed countries such as Sweden and Switzerland are more likely to invest abroad, suggesting an inverse relationship between FDI and donor GDP. The determinants of FDI supply and demand were theoretically explained along with empirical evidence. (Lucas, 1993) (work for East and South Asia) and Jun and Singh (1996) for developing economies) focused on the business environment, trade integration, labor costs, and the form of the privatization process. Shamsuddin (1994) studied the effects of per capita income, host country GDP, wage rate, per capita debt, per capita inflow of public aid, the validity of prices, and availability of energy in FDI recipient country for 36 developing countries using cross-sectional data (for 1971-81) through the single equation econometric model. Garribaldi *et al.* (1999) and Resmini (2000) focused on market access, along with other variables. These studies concluded that political and economic factors, the form and timing of the privatization process, and the need to ensure market access are the main determinants of the allocation of FDI. For Central and Eastern Europe, Bevan and Estrin (2000) found that FDI inflows are significantly affected by risk, unit labor cost, and target market size and severity factors. In the second phase of the analysis, they identified that private sector development, industrial development, government balance, gross reserves, and corruption are significant determinants of risk. Urata and Kawai (2000), examined host country factors that attract FDI from Japanese small and medium-sized enterprises. Supply-side factors include an abundance of low-wage labor, the availability of well-developed infrastructure, and good local government governance, while an important demand-side factor is the presence of a local market. Considerable Asiedu (2002) focused on political reforms in developing countries as determinants of FDI inflows. The study found that corporate tax rates and the degree of openness to foreign direct investment are important determinants of FDI. Bolingen (2005), examined the empirical evidence of transnational FDI and suggested further research be conducted in this regard direction.

The literature on the determinants of FDI in Pakistan is still young enough that most theoretical hypotheses are still in vogue. This is why Chakrabarti (2001) concluded that most of the determinants of FDI between countries are statistically quite fragile. Khan (1997), analyzed the factors responsible for the lower level of FDI in Pakistan. The study identified several factors, namely lack of political stability, law and order situation, economic strength, government policies, government bureaucracy, the infrastructure of the local business environment, quality of the workforce, quality of life, and welcome attitude.

Shah and Ahmad (2002), found that fiscal policy and high investment returns played an important role in attracting FDI to Pakistan. Using a dataset from 1960 to 1999, the study concluded that the cost of capital has a significant impact on investment. The study proposed to minimize costs and maximize FDI returns to attract FDI to Pakistan.

The determinants of FDI in Pakistan are estimated by Shah and Ahmad (2003) taking as determining variables the size of the market, the cost factor, and the political and social factors. They applied OLS and the cointegration method with error correction (ECM) on data from the period 1980-1999. The model is a supply-side model, while the demand aspects are ignored

However, Ahmed *et al.* (2003) applied Granger's concept of causality to data corresponding to the period 1972-2000, to examine the effect of exports, production, domestic production, foreign income, and the exchange rate on the inflow of FDI into Pakistan. They concluded that domestic production is the most powerful determinant of FDI. Domestic production is a micro-level concept, so Pakistan should emphasize the microeconomic approach, which would increase domestic production on an international level. Aqeel and Nishat (2004) identified the determinant of FDI in Pakistan focusing on tariff, exchange rate, price index, wage rate (proxy of labor demand), and GDP using the ECM in data for the period 1960-61 to 2003-04.

For South Asia, [Sahorr \(2006\)](#) analyzes the determinants and trends of FDI. The study explored

Whereas the sharp increase in private capital flows to developing countries occurs despite the uncertainties caused by high oil prices, rising world interest rates, and growing global payments imbalances. the increase in capital flows to developing economies was essentially due to abundant global liquidity, steady improvement in credit quality in developing countries, lower performance in rich countries, and expand investor interest in emerging market assets. The empirical literature on Pakistan has pointed to several determinants of FDI. They mainly deal with the political and business context and macroeconomic variables. We analyze the economic determinants of FDI with a new data set for the past 35 years

## 2. Material and Methods

FDI linkage can be analyzed in different ways according to the type of FDI, the strategy of transnational corporations, the sector of economic activity, and a group of countries and their level of development.

There could be several variables that can determine FDI in Pakistan and other developing countries, such as exports of goods and services, daily wages, imported energy, energy price, per capita debt, public debt per capita, aid, external income, exchange rate, human population, quality of the workforce, inflation rate, tariff, degree of openness to FDI, privatization, GDP growth rate, the political condition of the country, political relations between countries, countries' credit ratings (as a measure of political and institutional performance), infrastructure, welcoming attitude, returns to FDI, national GDP and donor country's GDP.

We have included the annual GDP growth rate (as a measure of market size), the average annual exchange rate, the index of total sales prices, and customs duties on imports and exports of goods as explanatory variables that affect FDI. In Pakistan, The data sets for the years 1970-71 to 2004-05 were taken from various sources, e.g. The amount of FDI, GDP growth rate, and customs duties were obtained from Pakistan's fifty years in the Federal Bureau of Statistics (FBS) statistics and the International Financial Commission International Financial Statistics, the exchange rate, and exports by the State Bank of Pakistan (SBP) Economic Surveys and Wholesale FBS Pakistan Statistical Yearbook of Price Index. Our analysis is based on time series data, so the stationary properties of the variables would be taken into account. A regression of one non-stationary series to another non-stationary series can generate a so-called spurious regression and lead to erroneous statistical inference.

An important indicator of spurious regression is that Durban Watson's statistics are still below the coefficient of determination for FOREIGN DIRECT INVESTMENTS. If such a problem does not arise in our model, we will feel comfortable using the OLS model, instead of the cointegration technique. In OLS regression, we use linear combinations of predictive (independent) variables to calculate the values of the response (dependent) variable.  $\mu, \beta$

These expected values are conditional on the independent variables. The complete OLS model includes both structural and systematic components,  $\beta$

These expected values are conditional on the independent variables. The complete model for OLS includes both the structural or systematic component and a random component  $\beta \hat{\alpha}$

We proposed the following empirical model for determinants of FDI in Pakistan.

Where is it

FDI = Annual foreign direct investment in dollars

GDP = annual GDP growth rate

EXR = average annual exchange rate in rupees/dollar

EXP = Pakistan's exports of goods and services

TAR = customs duty on import in the country

WPI = General Country Wholesale Price Index

Foreign investors transfer part of their production to the country where the market is large to absorb a substantial part of their production. To examine this type of effect, we include the GDP growth rate as an indicator of the market size (the other measures of market size can be GDP per capita and the size of the middle-income bracket). We assume that the GDP growth rate coefficient should be positive because foreign investors are interested in where there is a larger market for their production. Until 1996, it was generally believed that changing the level of the exchange rate did not alter a donor's decision to invest in a foreign country. In general, while an appreciation of the domestic currency would lower the cost of assets, the nominal (expected) return also decreases in the domestic currency, leading to an identical rate of return

[Froot and Stein \(1991\)](#), presented an imperfect capital market history of why a currency appreciation can increase a firm's foreign investment. An imperfect capital market means that the internal cost of capital is lower than that of borrowing from external sources. Therefore, an appreciation of the currency leads to an increase in the wealth of the company and provides the company with higher low-cost funds to invest than counterpart companies in the foreign country that suffer from a devaluation of their currency. Another case could be that companies are interested in export production. Depreciation of a host country's currency increases that country's attractiveness as a recipient of FDI because depreciation tends to improve the export competitiveness of products produced in that country. In this case, the exchange rate would have a positive coefficient. We assume that the exchange rate for Pakistan would be negative, i.e. foreign investors are interested in obtaining high returns on their investments.

In theory, there may be two possibilities for foreign investors to choose the host country depending on the trade policy of the host country. The two broader categories of policies represent the export promotion regime and the import promotion regime. In the export promotion regime, foreign investors use lower labor costs and availability of raw materials at low prices. On the other hand, in the import promotion regime, the host country has no advantage which generates additional profits and rent-seeking activities.

Trade openness generally positively affects export-oriented FDI in an economy. This is why investors like to invest in countries that have regional trade integration and where there are multiple investment provisions in their trade agreements. The export report is expected to be positive for Pakistan, i.e. the country's investment policy is export-oriented and foreign investors invest where there is a high export potential. Most business economists believe that the link between FDI and trade protection in the form of a tariff is sufficiently clear, as increased trade protection should increase the likelihood that firms will replace domestic consumption with production in a foreign country to avoid the cost of trade protection. This is commonly known as FDI with rate increases. It is speculated that if foreign investors are interested in goods for domestic use, there should be a positive relationship between import duties and FDI. Generally, it has been observed that foreign investors in Pakistan are investing in small units to meet domestic demand. Some examples are the automotive industry, the chemical industry, and the household appliance industry. The relationship can be positive. The sign of the wholesale price index would be positive, as it represents the movement of the economy towards the boom, along with the increase in demand for goods and services. Foreign investors are concerned about the country's hot investment climate

### 3. Results and Discussion

For the model, the estimated results are encouraging and show theoretically correct signs of the coefficients. Given that  $D > R^2$  for the model, we use the OLS model, although, in the previous literature, Shah and Ahmad (2003) and Aqeel and Nishat (2004) have used the cointegration and error correction technique. The Durbin-Watson values reject the existence of autocorrelation in the model. They fall into the area of non-autocorrelation that supports the model specifications. The econometric results are shown in Table 1. The value of  $R^2$  shows that 91 percent of the variation in FDI inflows to Pakistan is due to the variation in the GDP growth rate, the exchange rate, the index of total sales prices, the tariff rate, and exports. The T value is significant. All the variable coefficients have the expected theoretical signs.

We found the GDP growth coefficient positive, which confirms the purchasing power hypothesis, i.e. associated with a higher growth rate as a proxy of the purchasing power of the nation with the highest FDI inflow. I'll give you some tips to know that the current research team isn't investing in the new market opportunity. Explain that the purpose of foreign investors is to take advantage of the internal market and that the size of the internal market is important for investments in the internal market. The growth prospects symbolized by the GDP growth rate receive the largest FDI inflows compared to volatile economies (see also Dasgupta and Rath (2000) and Durham (2004). Wei (2000), concluded that the growth rate differs under different economic conditions.

Asiedu (2002), reported that economic growth has no impact on FDI. The exchange rate is negative as expected. The 1% decline in the Pakistani exchange rate is associated with a 0.41 percentage point increase in annual FDI. The depreciation of the country's currency would stimulate the inflow of FDI. It also confirms the hypothesis that foreign investors are very interested in obtaining high returns on their investments. Pakistan's trade policy focuses on increasing exports which is related to the country's export-led growth policy. We found that FDI is positively correlated with the volume of exports from the country. The results support the hypothesis that FDI earnings are higher under the export promotion regime than under the import promotion regime. In the export promotion regime, FDI uses low costs of labor and raw materials available for export promotion. It also explains that investors have investment incentives, where there is greater export potential. Initially, companies trade in the overseas market, and, after learning more about the economic, social, and governance conditions of their business partners, they can set up a subsidiary in the host country or can undertake joint ventures with local companies. This implies inflows of FDI and, after a period, these companies begin to export. Pakistan is at a point where foreign exports are linked with the additional capital, new technologies, and better management and marketing strategies they bring with them. There may be two possible two-way links between FDI and imports.

First, if imports are evidence of a market for a commodity, the host country can attract FDI to produce that commodity locally. In other words, an increase in imports into the host country justifies investment and production by foreign investors, so imports stimulate FDI inflows. Secondly, once foreign investors establish themselves in the host country, they import certain types of inputs (basic components and intermediate goods produced by the parent company) to meet the quality standards required by the international market, so FDI inflows increase. imports. Our results showed that import duties are positively affecting FDI. Confirm the assumption that the FOREIGN DIRECT INVESTMENT.

Table-1. Regression results of the OLS model (coefficient)

Model	Standardized Coefficient	t-values
Constant	Beta	2.055
GDP	-0.95	1.523**
EXR	-0.415	-1.923*
EXP	1.163	3.109*
TAR	0.991	5.777*
WPI	-0.76	1.159**

Dependent Variable: FDI

$R^2 = 0.914$

Number of observations = 35

\* and \* represents the level of significance at 5 and 10 Percent respectively.



Pakistan is absorbing FDI with tariff increases. Foreign investors are investing in the sector where domestic demand is met by domestic production rather than imports. The Total Sales Price Index represents the economic recovery from the recession along with strong demand for goods and services. We found that FDI in Pakistan correlated positively with the total sales price index.

## 4. Conclusion and Policy

### 4.1. Proposals

Our findings may provide an opportunity to frame some policy implications. The regression results confirmed that an increase in the GDP growth rate has a positive effect on FDI inflows into Pakistan. Therefore, the authorities should positively focus on maximizing the use of resources to increase the GDP growth rate. The important finding of the study is that the export demand shown by most exports is a determinant of FDI in Pakistan. National trade policy should focus on exports by increasing export processing zones, directing the world market and adjusting fiscal policies.

An import tariff coefficient suggested an important role for the government in promoting foreign investment in the country. Need for effective and encouraging public sector import policies to restore investor confidence.

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