The Determinants of Foreign Direct Investment in Pakistan

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Abstract

This study was conducted to investigate the various economic factors which were effect Foreign Direct Investment (FDI) inflow into Pakistan from 1991 to 2010. In this study the researcher has taken five independent variables which are Gross Domestic Product, Interest Rate, Domestic Investment, Inflation Rate and Tax Rate, and one dependant variable which is Foreign Direct Investment. Data were collected from the annual report of State Bank of Pakistan, Economic Survey of Pakistan, Income Tax law ordinance of 1979 and 2001and other Publications of the State Bank of Pakistan.

KEY WORDS: FDI, GDP, Interest Rate, Inflation Rate, Domestic Investment, Tax Rate

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This study inspects the diverse economic aspects outcomes lying on foreign direct investment inflows in to Pakistan during 1991 to 2010. The word investment may be invested in several ways. It can be used in the purchase of stock or bonds to fulfill certain financial goals, it can be used in the purchase of physical assets for instance an instrument attains to create as well as trade a produce. Indolent hard cash is not a speculation; the identical cash positioned in a bank account prospective well thought-out an investment, if the bank account makes available an encouraging return. There are two type of investment one is real investment and the other is financial investment. Real investment is to augment the corporal reserve or funds for instance equipment, building and the like. Whereas financial investment implies to investment which do not enlarge the productive capability of financial system for instance procurement of running plants, or purchasing shares of existing company and acquiring of bonds etc.

The shifting methods of worldwide business and the cross border mobilization of factor wealth in hunt of transactional manufacture, novel proportions for unrelenting financial development. Globalization has opened the boundaries of different countries for foreigners to avail opportunities in the host countries. Foreign Direct Investment is characterized as the foundation of acquirement of administrative power via a trade venture of overseas nation over a trade commotion into a host nation.

Foreign direct investment is a section of a nation's countrywide monetary accounts. It’s the outlay of alien resources interested in national compositions, apparatus, along with businesses. It doesn’t incorporate foreign investment into the stock markets. Foreign direct investment is consider to be further dynamic to a nation than reserves in the equity of its businesses for the reason that these reserves be likely to be the "hot money" which can abscond on the foremost indication of danger (short term), but FDI is enduring as well as in the main, helpful whether thing goes sound otherwise deficiently in the long run.

The report of foreign office of Pakistan (2007), FDI reached to US $3481.6 million throughout the initial 10 months of the recent fiscal year as against US $4180.8 million in the same interlude last year in addition it is revealing a decline of 16.7 present. Approximately 57 present of FDI have approached via three countries i.e. the UAE, USA and UK investor with 33.4

Present investments are on the peak throughout the initial 10 months.

Distinguished by Lee (1999), quantitative research is predominantly sound matched whilst the research aim is to express, deduce and give details, the same as is the case at this juncture. Though this study is exploratory in temperament, precedent research on country risk analysis, bargaining theory, as well as FDI as it narrates to these matters makes available essential theoretical fundamentals and assistance for sample selection. The consequence of trade directness in case of Pakistan has been noteworthy and it shows liberalization, which are contributing to in affecting FDI inflow, on the other hand and some variable like (law in orders, culture) in case of Pakistan i.e. inflation and government utilization have been found inconsequential, although it does not signify, so as to these variable have been set up insignificant, however it does not indicate that these variable have no part to impinge on FDI inflow. The experiential outcome of India harmonized with the outcome of Pakistan exclusive of to determinants, whereas the outcomes of Indonesia do not go with the financial determinants of FDI for Pakistan and India (Azam, 2008).

Objectives of Study

This study has the following objectives:

1. To investigate the factors which affect Foreign Direct Investment?
2. The affects of Foreign Direct Investment upon Pakistan Financial situation?
3. Providing a clear picture to potential investors before they decide on using their investment in such country?
4. To identify the risks if which the foreign investors bear while investing in Pakistan?

Literature Review

Political and financial proceedings within a host nation are able to have a significant outcome on the long-term effectiveness of foreign direct investment (FDI) ventures. Foremost threats are usually created on the state-run rank inside the host nation along with are the consequence of the action (or inaction) of the central government, Also called sovereign risks, these key risk proceedings consist of vicious conflicts, expropriation of foreign assets, ‘grand’ corruption (i.e. demands intended for bribes from higher-ranking officials as well as politicians en route for win contracts), political aggression and currency inconvertibility (Henisz and Zelner, 2004). Efforts are repeatedly ready to enumerate the likelihood (or probability) that economic, financial or political proceedings will shape the industry atmosphere in such a manner that investors will lose capital or not make as much money as they originally expected (Howell, 1998).

A study by Vachani (1995) during which he confirmed the active nature of bargaining power and how it can revolutionize extensively at the end of the day. In particular, Multinational Enterprise with scrawny bargaining positions may perhaps come across themselves gradually more defenseless to political risk.

Subsequent to the opening investment has been completed; the bargaining power dynamics are anticipated to vary. As the business risk (involve the risk of the business' practicability) and insecurity decreases following thriving execution, the host nation will come across itself in an arrangement to renegotiate the preliminary contract consequential in the obsolescence of the original haggle. Researchers have argued so as to firms can condense their risk by mounting their bargaining power throughout lobbying pains or by leveraging their market power in the host nation (Henisz and Zelner, 2005)

Bargaining theory study has have a tendency to stress the perpendicularly incorporated extractive industries; infrastructure and convenience sectors and heavy manufacturing not as much of is well-known about the service and high technology sectors in addition to how these industries vary from the manufacturing as well as extractive industries (Bergara, Henisz, & Spiller , 1998).

Additionally, whereas former theoretical work illustrated the bargaining progression as well as the obsolescing bargain as vibrant in character, it is commonly tricky to take into custody this vigor in outsized scale empirical work as a large amount of this research has relied on pragmatic – bargaining - conclusion moderately than (Vernon, 1971).

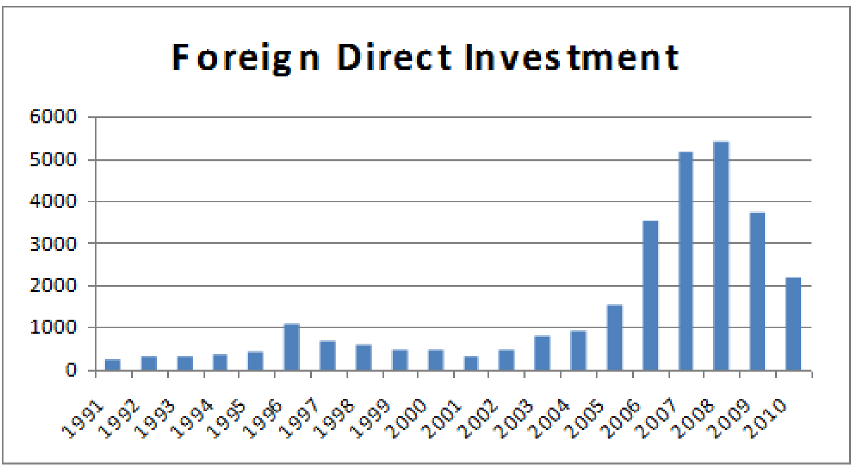

Figure 1. Foreign Direct Investment from 1991-2010

In the above chart the FDI flow is showed form 1991 to 2010 in dolor (million). From 1991 it gradually increased to till 1996, while from 1997 the FDI flow decreased to till 2001 and then increased and in 2007 and 2008 the FDI flow increased very much and then it came down. The Foreign Direct Investment inflows in Pakistan have declined considerably after 2008 from $5.590 billion to $2.016 billion in 2010, reveals World Investment Report (2011), released by United Nations Conference on Trade and Development. According to the report, the total FDI inflows in the economy declined from 5.590 billion dollars in 2007 to 5.438 billion dollars in 2008 and 3.812 billion dollars in 2009.

Research Methodology

This is a quantitative study which is based on the secondary data. The data which is utilized in this study is time series secondary data on behalf of the period as of 1991 to 2010. The data has been taken from the annual reports State Bank of Pakistan, the income tax ordinances and publications of the relevant departments' online sources. Keeping in sight the above literature review and plentiful citations in this study observes the effect of Gross domestic Product (GDP), Interest Rate, Inflation Rate, Domestic Investment and Taxation Rate on the Foreign Direct Investment in Pakistan. At first the individual effects of every mentioned independent variable were observed individually on foreign Direct Investment. Later on the combined effect of all the Independent variables was observed as a whole on Foreign Direct Investment. To assist our research and to run Regression which has been applied as an analytical technique for investing the impacts of variables on the FDI (foreign direct investment), SPSS software was used, and apply ANOVA test, variability. ANOVA provides a statistical test of whether or not the means of several groups are all equal, and therefore generalizes t-test to more than two groups. Doing multiple two-sample t-tests would result in an increased chance of committing a type error. For this reason, ANOVAs are useful in comparing two, three or more means. Variability refers to the extent to which these data points differ from each other. There are four commonly used measures of variability: range, mean, variance and standard deviation.

Model Specification

According to Azam and Lukam (2008), the Foreigner Investor may be attracted to come in the host country to invest their capital. The main objective of the host country is to gain returns on these investment. There is no single theory suggesting explaining the FDI. Numerous researchers put forward a number of variables to explaining the inflow of FDI. They use the Model of their study the linear Regression Model. Hashim, Munir, & Khan (2008) in their study on telecom sector of Pakistan. They elaborate in their study that telecom sector started in 1990 and it will growth in the 2000.

The study utilizes the following model as per the above mention studies

$$Y(FDI)= \beta_0+ \beta_1(GDP)+ \beta_2(Inf)+ \beta_3(D.Inv)+ \beta_4(int.)+ \beta_5(T)+\varepsilon$$

According to the above equation FDI is the positive product of GDP, Inflation Rate, Domestic Investment, Interest Rate, and Taxation Rate.

Where

FDI= Foreign Direct Investment

GDP=Gross Domestic Product

Inf=Inflation Rate

D.Inv=Domestic Investment

Int= Interest Rate

T=Taxation Rate

Findings

The research study was carried out for time series data to investigate the impact on foreign direct investments and gross domestic product, interest rate, domestic investments, inflation rate and taxation. All these independent variables are linked with dependent variable and empirically tested.

Table 1

Combined Variability of all independent variable with dependent variable

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.746[a]	.557	.399	40.16640

a. Predictors: (Constant), GDP, Interest Rate, Domestic Investment, Inflation Rate, Tax Rate

Table 1 represents combined variability that is found positive, strong and significant with foreign direct investment. The value of R Square indicates that 55 percent of the variance in Foreign Direct Investment can be accounted for by Gross Domestic Product, Interest Rate, Domestic Investment, Inflation Rate and Tax Rate.

Table 2

Combined Association and ANOVA of independent variable with dependent variable

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	28427.133	5	5685.427	3.524	.029[a]
	Residual	22586.761	14	1613.340		
	Total	51013.894	19			

a. Predictors: (Constant), GDP, Interest Rate, Domestic Investment, Inflation Rate, Tax Rate

b. Dependent Variable: FDI

Table 2 represents combined association that is found positive, strong and significant with foreign direct investment. F is insignificant at .029 level which verifies that 55 percent of the variance in Foreign Direct Investment can be accounted for by

Gross Domestic Product, Interest Rate, Domestic Investment, Inflation Rate and Tax Rate.

Table 3
Regression Analysis

Model		Un standardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	84.174	130.763		.644	.530
	Gross Domestic Product	7.610	2.472	.652	3.078	.003
	Interest Rate	-1.234	3.298	-.076	-.374	.714
	Domestic Investment	4.104	1.066	.940	3.850	.002
	Inflation Rate	6.339	3.086	.405	2.054	.059
	Tax Rate	-1.283	2.563	-.104	-.501	.624

a. Dependent Variable: FDI

Table 3 represents that gross domestic product produces positive impact with unit value of 7.610 on foreign direct investment almost significant t-test. The interest rate produces negative impact on foreign direct investment with unit value of 1.234 with insignificant t-test. Domestic investment produces positive impact of 4.104 on foreign direct investment with significant t-test. The fifth independent variable is inflation Rate that is showing its impact value on foreign direct investment is positive 6.339 with significant t-test. The last independent variable impact value for foreign direct investment is found negative 1.283 with insignificant t-test. On basis of this empirical result GDP, Interest Rate, Domestic Investment, Inflation Rate and Tax Rate, have significant Effect on FDI in Pakistan accepted with gross domestic product, domestic income and inflation rate and with the interest rate and taxation is not supported.

Conclusion

The empirical results show that it is an important and helpful for the decision making of the investment policy. The attractive foreign direct investment inflow increases the economic growth of Pakistan. The foreign direct investment has brought the reimbursement for the host country by providing the capital, new technology, foreign exchange and to fill the gap between the domestic saving and investment. This study looked for the determinants of Foreign Direct Investment in Pakistan. The independent variables checked individually and then check all the independent variable as whole. The empirical result individually shown that all the independent variable is positive association to the foreign direct investment and the GDP, Interest rate, Inflation rate are insignificant and the domestic investment and tax rate is significant with foreign direct investment. The combined empirical results show that the variability is found positive, strong and significant with the foreign direct investment. To increase more FDI into Pakistan, the high authorities of the respective country need to sure the stable economic position, stable political environment, moderate or single digit inflation rate, encourage the domestic or local investment, reduce the tax burden on foreign investor, interest rate, secure the law and order and state of affairs stable and stability in the government policies for the reason that these be the main factors other than discussed economic factors for the prospective investor to make the investment option.

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