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Impact of Macro-Economic Variables on Foreign Direct Investment in Pakistan

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Abstract

Pakistan is engaging and competing to pull in outside direct investment into its economy. The study shows the effect of Inflation, Exchange Rate, Trade openness on FDI Inflows in Pakistan. The objective of this research paper is to examine the effects of various economic factors on Foreign Direct Investment (FDI) inflow into Pakistan. For econometric analysis time series data from 2000 to 2021 have been used. Log linear regression model and the method of Least Square were used as an analytical tool for the empirical estimation. The result show that FDI is a negative relationship Exchange rate and Inflation rate. The result further shows the relation between FDI and Trade openness have significant and positive relationship. To enhance desirable amount of FDI into Pakistan, the least square estimates suggests that the government make sure constant economic environment,

provide a well-established infrastructure, encourage domestic investment, minimizing external debt burden, provide fiscal and financial incentives, and consistency in the government policy.

Introduction

Foreign direct investment has been acting as a catalyst for the economic growth around the world since past two decades. It is an essential part of international economic system and a major key to development (OECD, 2002). FDI is instant interests in productive resources by an organization/element in a distant nation. Since the last two decades, FDI has played a crucial role in the economic progress of nations all over the world. It is a crucial component of the global economic system and essential to development (OECD, 2002). Most, if not all, emerging nations are looking for foreign direct investment to supplement their domestic investment levels and gain access to overseas markets, which will create employment possibilities and raise people's living standards. In a 1999 UN report, "investment involving long-term relationships reflecting interest and control in one economy" is defined. Control and interest in the controlling party are key components of the FDI definition. Control refers to the ability to make decisions, whereas controlling interest refers to the advantages an investor may experience as a result of their investment and ownership. Investment in actual, tangible property is referred to as FDI. FDI alters a nation's economic situation. The majority of developing nations, including Pakistan, see FDI as a driving force for development. As FDI inflows expand employment prospects within the nation, they also bridge the gap between contemporary and old modes of production and introduce new ones. Because investment is a necessary component of growth, the modernizations theory views FDI as a growth element (Adams, 2009). Growth theories emphasize the transfer of technology through FDI (Calvo and Robles, 2002). More businesses will choose to relocate to nations with a wide variety of development prospects, which will raise the country's FDI inflation rate. Business

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encourages FDI primarily in situations where it is anticipated that the local currency will appreciate versus the foreign currency. They are then permitted to invest more money in that nation to launch their new company. The investor is constantly looking for fresh chances to diversify them. Due to the relative benefits of each nation, investors always seek to diversify their holdings in order to achieve their objectives at the expense of these nations. However, according to the International Theory Dunning's Eclectic Paradigm, this type of investment is based on the economic health of the majority of foreign nations. International businesses search for nations where land, labor, and capital are relatively inexpensive. Because their production costs are low, they can increase their profits and outbid their rivals by charging a lower price for their goods.

Companies frequently strive to create their products in nations where raw resources are readily and inexpensively available in order to save down on transportation costs when they have to export their finished items to other nations. Due to the ongoing advancement of technology, the majority of multilateral nations establish production facilities abroad to learn about other nations' technologies before applying those insights to their own manufacturing.

Additionally, Pakistan's economic growth rates have been a variable phenomenon throughout the past 20 years. Following a spectacular GDP growth rate of 7.57% in 1991, Pakistan's economic growth rate fell to 2.1% in 2000. The GDP of the nation suggested a downward trend from 2007 to 2018. Foreign commerce has consistently been unbalanced in Pakistan. The country's imports have been increasingly in excess of the exports leading to expanding current account deficits (CAD) in the Balance of Payment. As such, the government of Pakistan has consistently faced the problem of adverse balance of payment. A fuel to the flame is added when inflation rate which was 3.6% in 2001 has tended to be 13.8% in 2011 (Javed et al., 2012).

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Statement of Problem

Pakistan is engaging and competing to pull in outside direct investment into its economy. FDI inflows are consider as continually confided in help the financial development an achieve a manageable improvement of the country. policy designer and government experts may expect to pull in foreign direct interests in the economy. They will essentially need to know how to make a reasonable area for FDI. Consequently, private investor's and government authorities will want to recognize the elements that impact the FDI inflows into their economies. The aim of this present paper is to evaluate empirically the effect of different demand side determinants on the inflow of FDI into Pakistan. Though there are various qualitative and quantitative factors determining the inflow of FDI but this study considers only economic factors such as market size of the host country, Exchange rate, inflation rate and unemployment rate on the other.

Objective of the Study

- To investigate for the impact of macro-economic variables on Foreign Direct Investment in Pakistan

Significance of Study

IMF (2003) defined direct investment is a long-term commitment to engage in economic activities in the host country and has been proven to be less volatile compared to other forms of international capital flows. Also foreign investors are not reacting as drastically to changes in the investment climate as others do. They usually aim at long-term profit and are unlikely to withdraw investment in short period due to high transaction costs. Generally, FDI made by large multinational corporations (MNCs) through a merger and acquisition, or through the construction of a new facility. The FDI suffered the same effect on an economy as it is a powerful drink on the human body. This country provides employment, technology transfer and foreign exchange reserves. Countries such as Pakistan, where both the politicians and the security conditions can change on both day and

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day, such institutions are the result of nature's nature. Cross border firm, who has a major political security emergency in the country, has set a multi-million-dollar control of plants in Pakistan. Additionally, the country regularly exploits the current account deficit that requires substantial foreign exchange reserves. With the lines, the importance of FDI in Pakistan is before the limit of any financial estimation, is too high.

Pakistan foreign direct investment for 2021 was $2.15B, a 4.38% increase from 2020. Pakistan foreign direct investment for 2020 was $2.06B, a 7.92% decline from 2019. Pakistan foreign direct investment for 2019 was $2.23B, a 28.61% increase from 2018. (Pakistan Economic Survey, 2021).About 70 percent of FDI has come into oil and gas, telecom sector; chemicals, textile, power sector and banking and finance. Almost 60 percent of FDI has come from USA, UK, Switzerland, Japan, UAE and Netherlands.

Literature Review

Zamir et.al (2017) describes that among developing countries, Pakistan experienced a unique down trend in rupee exchange rates and repeated transactions. These special features make an interesting case studying the Indian economy for an experimental examination of exchange rates and its role in financial policy and economic performance. In this study exchange rate as dependent variable and some selected macroeconomic variables as independent variables.

According to Rauf et al. (2016), FDI is a key idea in understanding the significance of economic development in underdeveloped nations. In addition to providing the necessary capital, FDI boosts managerial capabilities, technology transfer, and job creation, all of which contribute significantly to the improvement and expansion of the economic situation. The FID has eschewed the tools to restrain the third world countries in favor of bolstering their domestic markets. As a result, the majority of emerging nations, including China, India,

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Bangladesh, Singapore, and the Philippines, are chasing after India to encourage the largest foreign investment in Pakistan. Over the past 20 to 25 years, there has been remarkable expansion in global FDI. Due to its investment environment environment and market strategy, during the last decade, Pakistan achieved relatively high FDI revenue. After 1991, due to the efforts of market liberation, the FID increased $ 23 million to $ 64 million (UNSDD, 2011) in 1980.

O'Meara (2015) used data from the World Bank and other sources to research the key FDI determinants on a cross-country premise. The OLS model was employed by the researcher to estimate the data. The study's findings demonstrated that traditional characteristics such as the scale and intensity of economic activity in the host economies were more important than tax incentives, economic growth, and human capital in defining foreign direct investment streams.

Obeid Gharaibeh (2015) investigates the crucial FDI inflow factors in the host economy. Research used regressions implied by ordinary least square to identify correlations between FDI and explanatory variables that are expected to limit FDI inflows to Bahrain in the future. the 1980–2017 time period covered by the time series data. The study's findings indicate that there is a statistically significant relationship between Bahrain's population and the country's benefits, as measured by government spending, inflation, economic stability as measured by interest rates, labor force, trade openness, and public education. Export possibility signified by country export value index, market size characterized by gross domestic product growth, and exchange rates, on the opposite side, it was established to have positive but statistically insignificant relationships with FDI inflows.

Carolline (2015) used the settled impacts model to separate annual data for 35 African countries from 1984 to 2010 and looked at the factors that affect FDI streams into those countries. The findings of the study showed a crucial and

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important correlation between FDI inflows and each of the product value file executions, the superior of stock market display, the advancement of the foundation, and the development in unmistakable quality to exchange of a nation.

In order to determine how foreign direct investment affects the following variables—unemployment, corruption, inflation rate, and population size—Zaib et al. (2014) conducted a study. The 1995 to 2011 period was covered by the data that was looked at for this purpose. In order to ascertain the link between the aforementioned dependent and independent variables, they employed the multiple regression approach to data analysis. The analyses' findings supported the notion that foreign direct investment is crucial to Pakistan's efforts to lower unemployment.

Rehman (2014) investigated the effects of FDI on Pakistan's financial situation from 1981 to 2010.The analysis estimated the data using a multiple regression model. Additionally, in his research, the consumer price index and foreign direct investment were treated as independent variables, while the gross domestic product was maintained as a dependent variable. The analysis's findings revealed a favorable association between foreign direct investment and the main domestic product with a negative relationship between foreign direct investment and the consumer price index.

Hajra et al. (2013) used time series data from 1991 to 2013 to study the effects of macroeconomic variables on FDI inflows in Pakistan. For the regression analysis, the author employed the GDP, the inflation rate, the interest rate, the conversion rate, and foreign direct investment. The study employed Ganger casualty and the ADF examinations to verify the stationery data. According to the study's findings, Pakistan's foreign direct investment is significantly impacted by the GDP's growth rate and interest rate. Further study demonstrates that inflation and currency rates play a significant role in determining FDI revenue in the nation.

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Chi (2013) used data from the World Bank's database for the years 1980 to 2010 to investigate the long-term relationship between macroeconomic variables and foreign direct investments in Nigeria. The two basic economics techniques for data analysis were VAR and continuous function, which were applied to root testing and co-integration. As a result, there are now clear indications that FDI and GDP in the region are not positively correlated. In addition, it is recommended that the government rates interest rates and inflation. It can be stated that FDD is strong in the context of GDD, Exchange Rate, and Regulated Money. processing techniques or methods to improve foreign investment in Nigeria.

The impact of foreign direct investments in Pakistan was investigated by Gudaro et al. in 2012. The author's goal is to analyze the effects of FDI from 1981 to 2010. They examined the historical trends of Pakistan's consumer price index and other immediate investment as well as the country's major domestic product growth. They estimated the correlation between GDP, FDI, and inflation using multiple regression models. They preserved the consumer price index and foreign direct investment as independent variables while keeping the gross domestic product as a dependent variable in the model. According to the study's findings, there is a positive association between GDP and foreign direct investment, but a negative relationship between GDP and inflation. Omankhanlen (2011) investigated how FDI affected inflation, economic growth, and the exchange rate. The study's objective was to identify the connections between the exchange rate, inflation, and the reciprocal effects of economic growth and foreign direct investment in Nigeria using data from the years 1980 to 2009. According to the study, while currency rates had an impact on foreign direct investment, inflation had no bearing on it.

Brief Summary of the Literature Review

Prior studies have attempted to quantify GDP growth, the consumer price index, and human capital. None of the experts or researchers make an effort to identify

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all of the purely macro-economic elements or factors in a single study that influence FDI flows. The primary goal of the current study is to analyze the macroeconomic factors that have an impact on FDI in Pakistan. The study investigates macroeconomic aspects such as the average income tax rate, exchange rate, inflation rate, and unemployment rate. In our analysis, we largely concentrated on macroeconomic variables that affect FDI.

Research Methodology

In this section of the study, the focus will be on descriptive and empirical analysis to capture the relationship between foreign direct investment (FDI) and macroeconomic variables. Time series data are used in period of 1998 to 2021 and estimate the data using Ordinary Least Square (OLS) test were applied to find the final solution for research problems and their nature of the relation. The dependent variable is FDI while independent variables are Exchange rate, inflation rate and trade openness. The results for time series data were previously discovered by numerous researchers using multiple regression models, such as Obeid Gharaibeh (2015), Zaib et al. (2014), Abbas et al. (2011), and Saleem et al. (2013).

Model Description

$$(FDI) = \alpha + \beta_1 (ER) + \beta_2 (IR) + \beta_3 (TO) + u$$

Where,

FDI = Foreign direct investment

ER = Exchange Rate

IR = Inflation rate

TO = Trade openness

Definition of Operational Variables

Foreign Direct Investment, Inflows

According to IMF the foreign direct investment is "the skill of at least 10% of the ordinary share in public or private enterprises by non-resident investors". The

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United Nation World Investment Report (1999) defines FDI as "investment involving long term relationship reflecting interest and control in one economy". One indicator of economic development is the flow of FDI. FDI provides developing nations with the fundamental resources they need, including finance, entrepreneurship, and professional skills. These are crucial for increasing employment chances, which will lower the unemployment rate and lessen poverty (Athukorala, 2003). We are attempting to analyze how various macroeconomic variables affect FDI in Pakistan.

Inflation Rate

An essential indicator of a nation's sound economic fundamentals is its inflation rate. The rate of inflation is seen as a crucial variable in affecting FDI inflows. High inflation rates contribute to the nation's economic instability. In general, low FDI inflows and high inflation rates go hand in hand. Low inflation reflects the nation's internal economic stability, according to Akinboade et al. (2006). According to Awan and Zaman's (2010) analysis, Pakistan's FDI inflows had a significant positive impact on inflation rates.

Exchange Rates

The price of local currency relative to the value and excitability of foreign currency is known as the exchange rate. The higher exchange rate indicates that the value of foreign money has increased while the value of local currency has decreased. The cost of purchasing goods from abroad will go up if foreign currency rates rise, which would drive down imports. On the other hand, if rates fall, the process will reverse.

Trade Openness

Trade openness is the study of unrestricted import and export of goods without any restrictions on the exported or imported goods. Trade openness describes the economy of a certain country's outward or inward movement. FDI and trade

openness are directly related. Foreign direct investors now have greater opportunities thanks to increased trade openness.

Results And Interpretation

In this chapter, the study used data and applying the econometric models and some statistics test on the operational variables to find out the relationships of the variables.

Model Result

The empirical finding of the data by using regression analysis are following.

Table 1: Correlation Matrixes

Variables	FDI	ER	IR	TO
FDI	1.0	.13*	-.09*	.42*
ER	.13*	1.0	-.39*	.41**
IR	-.09**	-.39*	1.0	-.35**
TO	.42*	.41**	-.35**	1.0

** Show correlation is significant at the 0.01 level (1-tailed),

* Show correlation is significant at the 0.05 level (2-tailed).

Table 2: OLS Model

Dependent Variable: FDI
Method: Least Squares
Date: 06/29/22 Time: 04:19
Sample: 1998 2021
Included observations: 23”

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FDI	Description	OLS Method
_cons		{8.27} (-9.57) 0.26
LNER	Log Exchange rate	{-1.34} (0.66) 0.06**
LNIR	Log Inflation rate	{-0.21} (0.32) 0.52
LNTO	Log Trade Openness	{4.99} (2.35) 0.04**
Durbin-Watson		1.78
R-squared		0.41

*Note: The dependent variable Card amount spent denoted by CASPENT. Coefficients in bracket, Standard errors in parentheses are robust while significance indicated by number of stars consigned to it as; ** $p < 0.1$, * $p < 0.05$.*

Source: EViews Software

After assigning values to co-efficient of the variables of the linear regression, the above equation can be rewritten as under.

$$FDI = 8.27 - 1.34ER - 0.21IR + 2.35TO + u$$

Interpretation

First, we check estimated correlation Matrix; To find out that either the variables which we used in this study was interlinked in each other or not. Based on the results of the correlation matrix in table 1. It can be observed that the variable FDI has significant positive correlation with exchange rate (ER) and Trade openness

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(TO) and significant negative correlation with Inflation rate (IR). The variable exchange rate (ER) has strong positive correlation with Trade Openness (TO). Further inflation rate (IR) has significant negative correlation in FDI (-.09**) and trade openness (-.35**). While a strong positive correlation with trade openness and exchange rate as (.41**).

Secondly using Simple Liner Regression model (OLS). where the result shows that the coefficients which are in fact the corresponding values of the bi(beta) of all the independent variables that capture the change in the dependent variable whenever a change occurs in the explanatory variables. The model shows the correlation coefficient and coefficient of determination for the regression model. As we have also seen R^2= .41 suggests that 41% of the variance in FDI can be explained by the above mention four Macro Economic indicators. The adjusted R^2 provides us idea how well our model generalized. In the above table the difference is a far bit (0.413-0.303= 0.11 or 1.1%). At the second last column we have Durbin Watson test. This test tells us first order linear autocorrelation in the data. The Durbin-Watson d = 1.78 is between the two critical values of $1.5 < d < 2.5$, therefore we can assume that there is no first order linear autocorrelation in the data The P-Value of Inflation rate is -0.21 and the T-Statistic is -0.64. Both indicate the negative but unimportant relationship between Inflation rate and FDI Inflows. Thus, in this case, the null hypothesis has to be accepted. Further the model shows that there is direct and significant relationship between trade openness on goods and services and the foreign direct investment inflows. If 1% increase the Trade openness it will increase 4.99% the foreign direct investment. The P-value (0.04) which is below 0.05 .The result also show that the exchange rate has highly negative relation to the Foreign direct investment. If 1% increase exchange rate ratio causes a -1.34% decrease a FDI.Therefore, the null hypothesis has to be rejected in this case.

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Conclusion & Recommendations

FDI plays a key role in the development of developing countries. One explanation is that FDI helps the host countries by increasing employment levels and transmitting advanced technology know-how. According to economists, FDI makes markets more competitive while putting pressure on indigenous firms through new technologies and high standard management. Additionally, FDI provides the developing economies with important and advantageous externalities like labor management and training possibilities, which raises the level of the production function. By technology transfer, it boosts the economies of the developing countries to stand there on feet"s by technology spill over. (Bauer, 1991; Easterly, 2006). Numerous elements are crucial for capital formation and economic expansion. Regarding geographic, geological, technical advancements, politics, and institutional frameworks, these elements may vary amongst nations. This research intends to empirically examine the effects of FDI on macroeconomic indicators in Pakistan between 1998 and 2021.To verify the relationship of the estimation model, use the OLS approach and correlation matrices. According to the study, there is little to no effect on inflation from FDI inflation on Pakistan's economy. Therefore, during the last decade, inflation was high with high inflation in the country. Trade openness has a positive but unusual effect on arrival of FDI. Due to positive tax impact on the FDI, corporate tax rates may be currently 35% and in 1997, for the first time in 1997 with 37% of it was implemented in 1997. In this way, instead of increasing the average tax rate and reducing the FDI, it increased from 1990 to 2007. The real exchange rate is not important at the rate of ten percent for Pakistan. Pakistan, if Pakistan stabilizes its exchange rate for the better view of foreigners. When the currency in the country is low, investors have tried to avoid these countries because these areas are not profitable or stable for long-term investments.

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However, to attract more FDI into Pakistan, the government should ensure stable economic environment, promote a well-established infrastructure including good quality telecommunication and information technology etc., maintaining inflation rate, encourage domestic investment, minimizing external debt, remove barriers and other restrictions on imports and exports to favor trade openness, fiscal and financial incentives, and consistency in the government policy.

When Pakistan gained its independence in 1947, its economy was primarily based on agriculture. When it came to processing locally generated agricultural raw materials, its industrial capacity was insignificant. However, several industrial strategies targeting either the public sector or the private sector have been put in place at various times to address this issue. First and foremost, increased efforts must be made to draw in as much FDI as feasible. The Macroeconomic stability plays a key role in boosting economic growth (Kim, 1993) and restoring foreign investors' confidence on the economy. In order to better utilize FDI while taking into account the trained and skilled labor force, it is necessary to improve the quality and quantity of human capital as well as human capital and skills through better education, health, and training.

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