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Political Stability and the Foreign Direct Investment Inflows in Pakistan

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Abstract

Pakistan is a promising developing nation in South Asia region. Based on the World Bank report, Pakistan has the 105th rank in 2011 globally in terms of ease of doing business. The present study attempted to investigate major determinants which influence FDI inflows in Pakistan. More importantly, the inflows of FDI in Pakistan have declined since 2008. This study sought to analyze the role of Political instability in the country economic growth, thus, to explain that although Pakistan has many attractive natural resources for investment, the political instability situation has been one of the main causes affecting the FDI inflows in Pakistan. This study aimed at developing a research framework that can be studied empirically by other researchers.

Key words: FDI Inflows, Pakistan, Political instability, Corruption control index, Polices

1. Introduction

It has been widely exposed theoretically and practically that Foreign Direct Investment (FDI) leads to several economic benefits to the host countries by providing foreign exchange, innovation, capital, transfer of technology, managerial skills, increasing job and augmenting the exports of the country (Salman & Feng, 2010; Javed *et al*,. 2012). Some economists opine that foreign direct investment can also support the domestic's investments (Awan, Khan, & us-Zaman, 2011; Brooks & Sumulong, 2003). By and large, to attract the foreign direct investment developed countries and developing countries are offering lots of attractive packages to the investors choose their location for investment. In the new global economic era the foreign direct investment(FDI) is considered to be a major contributor to the economic growth of any developed and developing economy (World Bank, 2011; World Development Report, 2011). 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 the global arena. The IMF and the World Bank also favor FDI rather than foreign Aid (FA) as a vital source of initiating or supporting development process, planning and programming by developing country under the dynamic move of globalization in the 21st century (UNCTAD, 2011).

There are some basic reasons why developing countries are keen to attract foreign direct investment. As a matter of fact, several developing countries and especially countries like Pakistan have been facing the difficulty of 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). Details in Table 1 reflect that in Pakistan the total investment (capital formation) has been is going down from 2008 to 2011 compare to another country like India, Sir Lanka and Bangladesh.(UNCTAD, 2011)

Table 1: Capital Formation (as percentage of GDP) Comparison with other Countries

Country's	2008	2009	2010	2011
Pakistan	22	18	15	13.4
India	35	36	35	35
Sir Lanka	28	24	28	28
Bangladesh	24	24	24	24

Source: World Bank Report (2011)

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 registered decreasing trend during 2007 and 2011 due to the downfall of the nation's political stability and increased corruption in the government sector, leading to biggest security threats in the business environment in Pakistan. The inflation rate which in 2001 was 3.6% has tended to be 13.8% in 2011.

Table 12: Ease of Doing Business Indices in Selected ASEAN Countries

Economy	Ease of Doing Business Rank	Starting a Business	Dealing Construction Permits	Employing Workers	Registering Property	Getting Credit	Protecting Investors	Paying Taxes	Trading Across Borders	Enforcing Contracts	Closing a Business
Singapore	1	4	3	5	14	8	2	4	1	12	2
United States	3	13	17	17	16	4	5	72	20	7	15
United Kingdom	7	19	22	60	68	1	10	24	13	21	6
Japan	20	107	63	26	58	24	17	120	16	34	1
Thailand	17	78	14	9	28	67	13	100	17	24	51
Malaysia	18	50	113	59	59	1	4	41	29	31	47
China	91	151	179	115	40	67	97	122	60	16	75
Brunei	83	136	83	28	107	126	122	20	35	151	44
Vietnam	98	103	67	135	47	24	166	151	68	30	142
India	132	166	181	98	97	40	46	147	109	182	128
Pakistan	**105**	**90**	**104**	**166**	**125**	**67**	**29**	**158**	**75**	**154**	**74**

Source: Ease of Doing Business 2011

In general, the economic growth rate scenario reflects 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 biggest natural flood in the history of Pakistan, political party’s rivalry issues and lack of competitively attractive economic policies. Pakistani currency started depreciating since 2007 until today (2012).

2.1 FDI Inflows in Pakistan in Historical Perspective

Foreign Direct Investment is generally regarded as an engine of growth in developing economies today. Pakistan is no exception, we need to understand the historically FDI inflows data and issues.

2.1.1 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 wing. Data in Table 2 shows that the 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 in 1949 and 1.7 million USD in 1950. It may be mentioned that the political condition largely affects the growth of the county. Over the years, Pakistan’s growth process was neither stable nor consistent.

Table 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: *State Bank of Pakistan (SBP), Handbook of Statistics on Pakistan Economy, 2011 p.556.*

2.1.2 Growth Period (1958-1969)

The era of the 1960s was featured by person, group, and regional rivalries and political instability 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 “a new political structure", the ban on political parties was lifted with putting some restrictions (Husain, 2009). The trend of FDI inflows in Pakistan during the period 1958-1968 contained in Table 3 indicates that foreign direct investment declined in the period 1961 to 1963 (SBP, 2011).

Table 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*

2.1.3 Nationalization Period (1972-1977)

The detachment of East Pakistan in 1971 politically implied a gloomy environment causing loss of confidence and ringing the death bell 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 the 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). Moreover, there occurred a declining trend in FDI inflows in the country (see, Table 4) as an adverse impact of nationalization. A bottom level at 0.5 million is remarkably seen in the year 1973 (SBP, 2011).

Table 4 *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*

2.1.4 Economic Expansion Period (1978- 1990)

During the 1980s, the process of the country's economic progress was slower in a 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 development process. Data in Table 5 reveals that in the country with political stability tuned with dismantling all the old policies against investment lead to growing FDI inflows. Indeed, data in Table 5 show rising trend of foreign investment owing to the political stability of Pakistan over the years 1978 onwards (Khan & Kim, 1999).

Table 5. *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*

3.0 Determinants of FDI inflows

The study of Akhtar (2000) provided a valuable econometric analysis of macroeconomic variables influencing 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). Akhtar (2002) considered the empirical model examined FDI in Pakistan determined by a mix variable and other independent variables such as GDP growth rate, Imports, Exports, Exchange rate, Interest rate, political instability and military rule. The study of Wang (2009) provides some more insights on inward foreign direct investment (FDI) and economic growth in 12 Asian economies referring to data over the period of 1987 to 1997 in the course of empirical investigation. This study, however, obtained same ambiguous results which might be caused owing to the use of total FDI as a variable. Nonetheless, the meritorious point of the study is that it analytically detected 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.

3.1.1 GDP Growth Rate

The GDP growth rate is very important for any country for foreign investors to invest. The relationship between the GDP and FDI and vice versa is always a main track of focus assumed by the researches in economic literature. The study of Martinez-Zarzoso (2003) found that a high level of income in the host country implies a high level of production, which attracts the investors' confidence to invest in the host country. Likewise, the study of Martinez-Zarzoso and Nowak-Lehmann (2004) also confirmed 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 its growth rate considered as the national income growth indicator of the economic performance of the country, which is reflected through production, consumption, and delivery of goods and other economic 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. The GDP growth rate has been declining in Pakistan during the later part of the period 2001-2011(Qaiser *et al.*, 2011).

Table 6: Pakistan GDP growth rate, 2001-2011

Year	GDP Growth Rate
2001	3.60%
2002	5.10%
2003	6.40%
2004	8.40%
2005	6.60%
2006	7.00%
2007	5.80%
2008	2.10%
2009	4.10%
2010	4.10%
2011	2.40%

Source: Euromonitor International-Statistics, UNCTAD 2011

Essentially, macroeconomic conditions are expected to exert influence on FDI. Nevertheless, as Gross and Trevino (1996) had pinpointed countries possessing higher per capita GDP are expected to promote a large close of FDI, inducing future Multinational Companies with high 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 to higher levels of FDI (Biglaiser & DeRouen 2011). Based on the previous arguments, it is expected that the following causal relationship is confirmed.

H1. There is a positive relationship between GDP growth rate and FDI inflows.

3.1.2 Degree of Openness

The degree of openness is an indicator of the level of global integration of a nation. It is measured in terms of the trade ratio. 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 found to have attracted much foreign investment in the export sector. FDI signifies investors' control of production as well as quantum of the flow of capital and it is influenced by several factors particularly, technology and firm-specific assets (Markusen & Venables, 1999). A few research studies show that degree of openness affecting the inflow of FDI in an economy tend to vary as per the inspirations for the attractiveness of FDI in business activities (Navaretti, Venables, & Barry, 2004; Markusen & Maskus, 2002). Incidentally, the degree of openness (DOP) is commonly measured as follows:

$$DOP = ((X+M)/GDP) * 100$$

Where, X is the annual export value, M is the annual import value, and GDP is the Gross Domestic Products. Data in Table 4 shows that, Pakistan economy lacked consistence regarding the degrees of Openness (DOP) during the period 2001-2011 as illustrated in Table 7.

Table 7: Pakistan Degree of Openness 2001-2011

Year	Degree of Openness
2001	28.00%
2002	29.00%
2003	28.00%
2004	31.00%
2005	32.00%
2006	38.00%
2007	43.00%
2008	32.00%
2009	34.00%
2010	34.00%
2011	33.00%

Source: UNCTAD, 2011

Based on the arguments provided earlier, it is reasonable to propose the following hypothesis:

H2. There is a relationship between Degree of Openness and FDI inflows.

3.1.3 Inflation Rate

Inflation rate is an important aspect of a country's good economic fundamentals. Rate of inflation is a crucial factor in influencing the FDI inflows. The high rate of inflation signifies economic instability and source or peril and confusion associated with lapse appropriate government policies, especially the monetary fiscal policy mix. By and large, the he high rates of inflation are associated with the lesser FDI inflows. Data in Table 8 refer to the inflation rates for the period of 2001-2011. The study of Akinboade *et al* (2006) stated that low inflation is a sign of internal economic stability in the country. High inflation rates reflect the inability of the government to balance its budget and the failure of the central bank to conduct appropriate monetary policy. Another way, 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). As such we propose the following hypothesis in the context of Pakistan for investigation.

Table 8: Inflation Rate in Thailand, 2001-2011

Year	Inflation Rate
2001	3.40%
2002	3.30%
2003	3.90%
2004	9.30%
2005	8.00%
2006	7.90%
2007	10.30%
2008	13.10%
2009	12.90%
2010	12.10%
2011	11.40%

Source: Annual rates of inflation: Euromonitor International from International Monetary Fund (IMF), International Financial Statistics and World Economic Outlook/UN/national statistics. Thus the following hypothesis is deemed appropriate

H3. There is a relationship between Inflation rate and FDI inflows.

3.1.4 Corruption Control Index

The Corruption index is inversely correlated to FDI. If the Corruption keeps increasing in the country, then the reputation of the country in the eyes of foreign investors is receding. Aburime (2010) probed into the influence of corruption in FDI and effectiveness in the case of Pakistan. The study observed that Pakistan economy is haunted by the hovering clouds of corruption causing adverse effects. Indeed, several studies have endorsed that corruption is a major issue in the development of Pakistan economy (Shahbaz, Ahmed, & Ali, 2008; Shahbaz & Rehman, 2010). Data in Table 9 related to corruption control indexes of Pakistan for the period (2001-2011). It follows that in Pakistan the corruption control index is ranking decreasing, mean that going to the most corrupted country. This is not a good sign for investors. Table 9 show that the Pakistan control of corruption also not good. We, thus, formulate the following hypothesis for investigation.

Table 9: The Control of Corruption Indexes Pakistan, 2002-2011

Year	**Control of Corruption Index (0-100)**
2001	22.4
2002	22.4
2003	27.3
2004	12.7
2005	13.7
2006	23.4
2007	24.3
2008	21.8
2009	12.4
2010	12.0

2011	15.6

Source: *Worldwide Governance Indicators (WGI*), 2012

H4. There is a relationship between Corruption control index and FDI inflows.

4 Political Stability and FDI Inflows

Political stability is very important for normal macroeconomic and business environment in a country. Political risks largely depend on political stability and good governance of the government (Husain, 2009). Political stability enhances the probability of attracting more FDI inflows into the developing countries. Pakistan has been suffering from the instability of the political system, this in turn; may adversely affect the inflow of FDI into Pakistan and discourages the international investment. The ever changing political system and the unstable government can cause political risks which, in turn; will adversely affect the level of foreign and domestic investment in the country. 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 the country's Political Stability condition is not good, foreign investors will hesitate to bring any projects until they are assured that the business environment would to be conducive and favorable (Brada *et. A.l*, 2005; Word Bank, 2011; UNCTAD, 2010). In the case of Pakistan, World Bank report, published in 2011 categorically mentioned that the private sector low investment in the country is because of political instability and corruption.

In today's world there are many features that are considered to be significantly important for investors to establish their business in any environment, one of these is the degree of the political stability of the country in which they are planning to enter for business. This is the more significant factor in determining the flow of FDI into any country(Lambsdorff, November 1999). Few studies, such as (Singh & Jun, 1995; Wheeler & Mody, 1992), observed that political risk is insignificant in affecting the FDI inflows. The studies such as (Root & Ahmed, 1979; Schneider & Frey, 1985; Tuman & Emmert, 2004), however, traced that political instability and riots and regular constitutional changes in government significantly affected FDI inflows in the developing country. Political stability is essential for the country's smother economic growth. Recently in Pakistan since the year 2008, political stability has registered a declining trend. As a result, foreign investments are declining in Pakistan. The report of UNCATD (2011) in Pakistan less domestic sector investment the main reason is the political stability of the county. Data in Table 10 highlights that Pakistan political stability index is going down, this is obviously critical for foreign investors to invest.

Table 10: The Political stability Indexes Pakistan, 2002-2011

Year	Political stability Ranking (0-100)
2001	14.4
2002	5.8
2003	6.7
2004	6.7
2005	5.7
2006	2.4
2007	1
2008	1
2009	0.9
2010	0.5
2011	0.5

Source: *Worldwide Governance Indicators (WGI*), 2012

Determinants of political risks such as change of regime, government intervention in the economic situations, property rights legislation, and red tape may adversely affect the decision process of foreign investments (Frey & Schneider, 1979). However, the international investors and the international organizations give high importance for their FDI decision process on how good is the governance index of each country such as: fighting corruption; transparency of the administration processes; and violence free environment (World Bank, 2006). Table 11 show that the cross sectional data Pakistan comparison with South Asian countries.

Table 11. Cross Sectional data Pakistan comparison with South Asia countries year of 2010

Country	Capital formation (% of GDP)	FDI (% of GDP)	GDP growth rate	Degree of Openness	Inflation Rate	Control of Corruption	Political Stability
Pakistan	15	1.09	4.1	0.34	13.9	12.0	0.5
India	35	1.48	8.8	0.33	12.0	35.9	10.8
Malaysia	21	3.9	7.2	1.52	1.7	61.2	51.9
Thailand	26	3.0	7.8	1.12	3.3	46.9	12.7
Indonesia	32	1.9	6.1	0.41	5.9	27.3	18.9
Sir Lanka	28	1.2	8	0.44	7.3	40.7	21.2

Source: Word Bank, 2011; UNCATD, 2011; Sate Bank of Pakistan, 2011

To sum up the result, the cross sectional data year 2010 in Table 11 indicates that the Pakistan control of corruption index and the political stability index is worse than other South Asia countries. We, thus, formulate the following hypothesis:

H5. Political stability moderates the effect of macroeconomic and business environment factors on the FDI inflows.

6.0 Conclusion

This study reviewed the historical prospective 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 developing economy such as Pakistan by discussing the importance of the political stability. The study suggests that policy-makers of Pakistan need to revamp the FDI policy to attract more investment into the country. In addition to that, based on the previous literature, this study developed some hypotheses to be empirically examined in the future research endeavors. One of the main suggestion for future research is to examine the moderating impact of political stability on the relationship between macroeconomic and business environment factors and FDI inflows.

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