

To What Extent Foreign Direct Investment (FDI) Affect in Economic Development of Pakistan

Muhammad Mumtaz

MBA (Finance) Department of Management Sciences, The Islamia University of Bahawalpur, Pakistan
E-mail: mumtaz_ghallu@yahoo.com

Syed Shahzaib Pirzada

MBA (Finance) Department of Management Sciences, The Islamia University of Bahawalpur, Pakistan
E-mail: shahzaib86pirzada@gmail.com

Abstract

Foreign direct investment has an important substance for the economic growth those countries which are still devolving, the effects of the foreign direct investment on the economic growth by a continuous process like increasing domestic investment, human capital formulation and facilitating the transfer technology to the host countries. The core purpose of this study is to investigate the role and impact of foreign direct investment on the economic growth of the Pakistan from 1975 to 2010 and these results have support to this article that FDI has positive effect on the economy growth both short and long run.

Keywords: Foreign direct investment, Reserve, Inflation, Gross Domestic Investment, Economic Growth

Introduction

Foreign direct investment are the most important source of external resource flows for developing countries over the last many years and it has become a great significant part of capital formation in their countries. Despite it, their share in the global distribution of the foreign direct investment continuing decline or some time has small. The role of foreign direct investment has been very broadly recognized, it affects the economic growth by inspiring domestic investment. These effects of foreign direct investment in these host country are different like increase in the employment level, increase in the productivity, increase in the export, transfer of technology. The great advantage of the foreign direct investment in the host country and their economy to introduce new skill of marketing and management, utilization of local raw material and properly gain benefit, easy access new and different kind of technology, foreign investment can be used for payment of debt and it can be used for financing to current account deficit and can increase the stock of human capital (*Nuzhat fulki, 2009*).

Many researcher and academics resist that foreign direct investment has a great positive effect on the host country economy and development. Foreign direct investment a source of technology transfer and know how while raising link ages between local firms and their result economy rising boom and prosperity. That is reason, based on these argument industrialized and developing countries are offered and given the incentive to encourage foreign direct investment (*kashif yaseen, 2013*).

In recent survey of literature, foreign direct investment has great impact on different determinants, like the domestic capital stock, economic growth, employment protection, export, knowledge, location choice. At present, the majority of researcher say that, there is a positive relation between foreign direct investment inflows and growth provided, host countries have reached a minimum level of technology, educational and infrastructure development (*Ilhan –et al, 2007*).

Many researcher debates that on the economic growth and economic performance of any country. The good determinant to measure the economic growth and economic performance is foreign direct investment (FDI). The FDI is a positively effect on economic growth economic performance. Some researcher found that FDI is good impact on economic performance and economic growth. Some researcher debates that good relation between Foreign Direct Investment and output, and imports and output. These results indicate to the economic growth of any country. The main attract to foreign direct investment by adopt new technologies. By new technologies develop the productivity of country increase and also shown good results. Some researcher conducted many studies on foreign direct investment to measure the economic growth and economic performance. Some scholar debates on variables that use in foreign direct investment such as debt, domestic investment, trade and inflation. Different theories adopt on foreign direct investment (*Maryam*).it is truth that there is no universal agreement about the positive relationship between FDI inflows and economy growth.

Literature review

In this studies examined that the relationship between FDI inflows and economic growth, the main issue is settled in view of the mixed findings reached. Most of these studies have a typically adopted standard growth accounting frame work for analyzing and studying the effect of FDI inflows on growth of national income along with other factors of production (land, labor, capital, entrepreneur). Within the framework of the neo-classical

models, the impact of the FDI on the growth rate of output was constrained by the existence of diminishing returns in the physical capital. Therefore, foreign direct investment not applies the rate effect. FDI could only apply a level effect on the output per capita. In other words we can say that, it was not capable to Change the growth rate of output in the long run. It is not only surprising, thus that FDI was not considered seriously concern as a drive engine of growth by mainstream economics.

In the compare, the New Theory of Economic Growth, however, it concludes that FDI may affect not only the level of output per capita but also affect its rate of growth. This literature has developed several different arguments that explain why FDI may potentially increase the growth rate of per capita income in the host country, and these identified channels to boost economic growth which include increased capital accumulation in the recipient economy, improved efficiency of locally owned host country firms via contract and protest effects, and their exposure to aggressive competition, scientific change, and human capital growth and increased exports. However, the level to which FDI contributes to growth depends on the economic and social condition or in short, the quality of environment of the receiver country (Buckley, et al. 2002). This environment relates to the rate of savings in the receiver country, the degree of openness and the level of technological development. Receiver countries with high rate of savings, open trade system and high technological product would benefit from increased FDI to their economies.

FDI increases technical progress in the receiver country by means of an infection effect, (Findlay, 1978) which comforts the adoption of advanced managerial procedures by the local firms. Similarly, analyzed a board of 12 Latin American countries in the period 1950-1985. His results that suggest a positive and significant impact of foreign direct investment on economic growth. In the addition the study shows that the productivity of FDI are higher than the productivity of domestic investment. While, observed the role of FDI in supporting growth by using the framework of a macro-model for a collective time series cross section data of 16 developing countries for 1966-88 period. The countries included in the sample were Argentina, Brazil, Chile, Egypt, India, Mexico, Nigeria, Pakistan, Bangladesh, Sri Lanka, Turkey, Venezuela, and 5 Pacific basin countries viz.

Indonesia, Korea, Malaysia, Philippines and Thailand. For his sample as a whole he did not find FDI to exert a significantly different effect from domestically financed investment on the rate of economic growth, as the coefficient of FDI after controlling for gross investment rate, was not significantly different from zero in statistical terms. Foreign direct investment had a significant negative effect on domestic investment signifying that it crowds-out domestic investment. Hence here FDI appears to have been mesmerizing. However, this effect on varies across countries and in the Pacific basin countries FDI seems to have crowded-in domestic investment. FDI inflows had a significant positive effect on the average growth rate of the per capita Income for a sample of 78 developing and 23 developed countries. However, when the sample of developing countries was divided between two groups based on level of per capita income, the effect of FDI on growth of lower income group developing countries was not statistically significant although still with a positive sign. They argue that smallest developed countries learn very little from MNEs because domestic enterprises are too far behind in their technological levels to be either followers or suppliers to MNEs. In this regard, another study was conducted by (Borensztein, et al., 1998) in which included 69 developing countries in his sample. The study found that the effect of FDI on host country growth is dependent on stock of human capital. They conclude from it that flow of advanced technology brought along by FDI can increase the growth rate only by relating with country's absorptive capability. They also find FDI to be stimulating in total fixed investment more than proportionately. In other words, FDI crowds-in domestic investment. However, the results are not tough across specifications. Export-oriented strategy and the effect of FDI on average growth rate for the period 1970-85 for the cross-section of 46 countries as well as the sub-sample of countries that are deemed to pursue export oriented strategy was found to be positive and significant but not significant and sometimes negative for the sub-set of countries Following inward-oriented strategy.

Findings of (Xu, 2000) for US FDI in 40 countries for the period 1966-94 also support that the findings of De Mello that technology transfer from FDI contributes to productivity Growth in the developed countries but not in developing countries, because which they features to lack of adequate human capital. (Mortimore.M, 2000) analyzed the effect of lagged values of FDI inflows on investment rates in host countries to examine whether the FDI crowds-in or crowds-out domestic investment over the 1970-95 period. They are concluded that FDI crowds-in domestic investment in Asian countries crowds-out in Latin American countries, while in Africa their relationship is neutral (or one-to-one between FDI and total investment). Therefore, they are concluded effects of FDI have by no means always favorable and simplistic policies are unlikely to be optimal. These regional patterns tend to confirm the findings of (Fry, 1992) who also reported East Asian countries to have a complementarily between FDI and total investment. In another research they (Pradhan, 2001) found a significant positive effect of lagged FDI inflows on growth rates only for American countries. He used a board data estimation covering 1975-95 periods for 71 developing countries. The study sheds light that the effect of FDI was not significantly different from zero for the overall sample and for other regions.

Many several early studies have generally reported a minor effect of FDI on growth in developing host countries.

FDI may have negative effect on the growth prospect of the recipient economy if they give rise to aim portent reverse flows in the form of remittances of profits, particularly if these resources are remitted through transfer pricing and dividends and if the transnational corporations (TNCs) obtain or received substantial or other concessions from the host country. For instance, Singh, (1988) found FDI penetration variable to have a little or no consequences for economic or industrial growth in a sample of 73 developing countries. In the same way (Hussain, Ishrat) reported an insignificant effect of FDI inflows on medium term economic growth of per capita income for a sample of 41 developing countries. For this studies conducted in Pakistan, a study by (Shabir and Mahmood, 1992) analyzed the relationship between the foreign private investment FPI and economic growth in Pakistan. The study used the data for 1959-60 to 1987-88; the study concluded that, tenet foreign private investment (FPI) and payments of grants and external loan (DISB) had a positive impact on the rate of growth of real GNP. However they did not treat in the way FDI as a separate variable. Similarly (Ahmed, et.al, 2003) examined that the causal relationship between FDI, exports and output by employing Granger non-causality procedure over the period 1972 to 2001 in Pakistan. They found significant effect from FDI to domestic output, in contrast to the above following studies.

An important study is that by (Khan, 2007) examines the link between FDI and economic growth by including the role of domestic financial sector, Khan argues that introduction of financial sector indicator that is expected to improve and reinforce the link between FDI and economic performance, as well as reflect the level of absorptive capability of a recipient country in enjoying the benefits embodied in FDI inflows. The study covers the time period from 1972-2005, and to examine the long run relationship between variables i.e. growth rate of real GDP, ratio of FDI to real GDP, financial sector development, labor, and physical capital the study uses the Bound testing approach to co-integration within the framework of Autoregressive Distribute slag(ARDL).

The findings of the study suggest that Pakistan will effectively transform benefits Embodied in FDI inflows, if the evolution of the domestic financial sector has aimed at certain development level. The interaction term between FDI and financial development indicator is positive, while the coefficient of FDI is negative in the case of Pakistan. This suggests that FDI will have a positive impact on growth performance only if the domestic financial sector is well developed and functioning efficiently, otherwise the effect of FDI on economic growth will be negative. The study also provides the evidence that the link between FDI and growth is causal, where FDI promotes growth through financial sector development.

Methodology

The study utilizes the data from Pakistan from 1975 to 2010. The researchers used the sources such as World Bank National Accounts data base and OECD National Accounts Data base. The study uses the time series analysis to find the results because our research is going to find the results of different variables in years from 1975 to 2010. The purpose of our study is to evaluate the performance of difference variables in different time periods to check the relationships. The model consists of four variables including foreign direct investment per capita (FDI), and Gross Domestic Saving as percentage of GDP (GDS), Inflation GDP (INF), and total reserve. In above all variables, FDI as a dependent variable and remaining all three are the explanatory/independent variables.

Variable	Expected Sign	Proxy	Data Source
Dependent Variable: Economic Performance		GDP Per Capita at PPP (\$)	World Bank database
Explanatory Variable: Foreign Direct Investment	-	Foreign direct investment, net inflows (% of GDP)	World Bank database
Total Reserve	+	Total reserves (includes gold, current US\$)	World Bank database
Gross Domestic Investment	+	Gross Domestic Savings as Percentage of GDP	World Banks National Accounts data, and OECD National Accounts data Files
Inflation	+	Inflation, GDP Deflator	World Bank database

Dependent Variable: FDI

Method: Least Squares
 Date: 01/11/14 Time: 14:55
 Sample: 1975 2010
 Included observations: 36

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-0.721	0.439919	-1.63893	0.111
RESERVE	1.14E-10	2.29E-11	4.98776	0
INFLATION	0.05364	0.025662	2.090291	0.0446
GDS	0.054914	0.027507	1.996365	0.0478

R-squared	0.584997	Mean dependent var	0.889
Adjusted R-squared	0.54609	S.D. dependent var	0.924089
S.E. of regression	0.622585	Akaike info criterion	1.994566
Sum squared resid	12.40359	Schwarz criterion	2.170512
Log likelihood	-31.90219	Hannan-Quinn criter.	2.055976
F-statistic	15.03596	Durbin-Watson stat	0.823243
Prob(F-statistic)	0.000003		

Interpretation

The result of the impact is generated with the help of statistical software Eviews. The result shows that all of the variables are very much significant with 1% to 5 % level of significance. Result shows that all variables are positively correlated with the dependent variable that is FDI. I.e. reserves of Pakistan are showing positive correlation with FDI that shows if there is one percent increase in reserves there will be 1.14 percent increase in FDI and the same effect in case of reserves decrease. Other variable is inflation in this study. The study showing that with the one percent increase in inflation FDI has a very narrow but a significant positive impact of 0.05 percent. GDS is also positively correlated with FDI of Pakistan. In case of one percent increase in GDS there will be increase in FDI of the country and with the same pattern FDI will be affected in case of decrease in GDS.

Conclusion

In this paper we are study about the impact of FDI on economic growth. For our research paper, we collected data from the World Bank. The core purpose of this study is to investigate the role and impact of foreign direct investment on the economic growth of the Pakistan from 1975 to 2010 and these results have support to this article that FDI has positive effect on the economy growth both short and long run. By the technology gap the negative effect of FDI on economic growth in some countries. Our results are satisfactory.FDI inflows had a significant positive effect on the average growth rate of the per capita. The economy growth depends on the quality of environment. In Pakistan if Greenfield more investment then we can improve in exports then this is better as well as FDI.

FDI believed on:

- Good technology
- Human skills
- Train labor

If Pakistan improves above condition then create the positive results. For creating good framework of microeconomic then also should be improved above three conditions. Pakistan is improving in technology and macroeconomic framework.

References

- Ahmad M.H., Alam S. And Butt M.S. 2003 "Foreign Direct Investment, Exports, and Domestic Output in Pakistan" *The Pakistan Development Review*, Vol 42, no.4, pp. 715-723
- Awan M. Mahmood (1980) 'The role of Foreign Capital in Pakistan's Development- in Contemporary Pakistan' (eds), in *Politics, Economy, and Society* (editor Ahmad. M.).Royal Book Karach,

- Khan H. Ashfaqe (1997) 'Foreign Direct Investment in Pakistan: Policies and Trends' the Pakistan Development Review 36:4
- Khan, A. H. and Yun-Hwan Kim (1999), foreign direct investment in Pakistan: policies, Issues and Operational Implications. *EDRC Report Series* No. 66
- Awan, M., Khan, B. & Zaman, K. (2010) A Nexus between Foreign Direct Investment & Pakistan's Economy. *International Research Journal of Finance and Economics*. Issue 52, page 1450-2887.
- Khan, M. S. and Senhadji, A. (2001) Threshold Effects in the Relationship between Inflation and Growth, *IMF Staff Papers*, 48:1
- Khan, A. H. and Yun-Hwan Kim (1999), foreign direct investment in Pakistan: policies, Issues and Operational Implications. *EDRC Report Series* No. 66.
- Khan Arshad M. and Khan Ali Shhjat (2011). Foreign Direct Investment and Economic Growth in Pakistan - A Sectoral Analysis PIDE Working Paper No 2011:67 Pakistan Institute of Development Economics, Islamabad
- Khan, A.H. and Y. H. Kim, (1999): *Foreign Direct Investment in Pakistan: Policy Issues and Operational Implications*, EDRC Report Series No. 66, Asian Development Bank, Manila.
- Khan, A. H. (1997) Foreign Direct Investment in Pakistan: Policies and Trends. *The Pakistan Development Review* 36:4, 959– 985.
- Khan, M. A. (2007) Foreign Direct Investment and Economic Growth: The Role of Domestic Financial Sector. (PIDE Working Papers 2007:18).
- Khan, M. A. (2008) Financial Development and Economic Growth in Pakistan:
- Shabbir, T. & Mahmood, A. (1992) the Effects of Foreign Private Investment on Economic Growth in Pakistan. *The Pakistan Development Review*, Vol. 31(4) pp.831-841
- Ozturk, Ilhan and kalyoncu (2007) 'Foreign Direct Investment and Growth: An Empirical Investigation Based on Cross Country Comparison' *Economia Internazionale* 60:1
- Buckley P., Clegg J., Wang C. 2002, "The impacts of FDI on the performance of Chinese Manufacturing Firms", *Journal of International Business Studies*, Vol.19. no. 2, pp 55-67.
- Borensztein, E., De Gregorio, J. & Lee W. 1998,"How does foreign direct investment affects economic growth?" *Journal of International Economics*, Vol.45, No 1, pp.115- 135.
- Awan, M., Khan, B. & Zaman, K. (2010) A Nexus between Foreign Direct Investment & Pakistan's Economy. *International Research Journal of Finance and Economics*. Issue 52, page 1450-2887.
- Xu, B. 2001. "Multinational enterprises, technology diffusion and host Country productivity growth", *Journal of Development Economics*, vol 62, pp.477-494.
- Hypothesis 5* (credit): FDI is affected positively by credit (Beck, Levine and Loayza, 2000). This is a common hypothesis in papers on the finance-growth nexus (Baltagi, Demetriades and Law, 2009).
- Mortimore, M. (2000), Corporate Strategies for FDI in the Context of Latin America's New Economic Model. *World Development*, Volume 28, No. 9, pp. 1611-26.
- Fry, Maxwell J. 1992 "Foreign Direct Investment in a Macroeconomic Framework: Finance, Efficiency, Incentives and Distortions", PRE Working Paper, Washington DC: The World Bank
- Pradhan, Jaya Prakash.2003. Foreign Direct Investment and Economic Growth: The Case of Developing Countries, Unpublished M.Phil Dissertation submitted to Jawarhlal Nehru University, New Delhi
- Hussain, Ishrat (2003), Economy of Pakistan: Past, Present and Future Perspective. A paper presented at the Seminar on Pakistan Ideology held by the Pakistan Study Center, University of Karachi.
- Shah and Ahmed (2003) 'the Determinants of Foreign Direct Investment in Pakistan: an Empirical Investigation' the Pakistan Development Review 42:4
- Falki, N. (5sep2009). *Impact of Foreign Direct Investment on Economic* (Vol. 5). 110-120.
- yasin, K. (MARCH 2013). *The Impact of Foreign Direct investment on Pakistan Economic Growth* (Vol. 4).

The IISTE is a pioneer in the Open-Access hosting service and academic event management. The aim of the firm is Accelerating Global Knowledge Sharing.

More information about the firm can be found on the homepage:
<http://www.iiste.org>

CALL FOR JOURNAL PAPERS

There are more than 30 peer-reviewed academic journals hosted under the hosting platform.

Prospective authors of journals can find the submission instruction on the following page: <http://www.iiste.org/journals/> All the journals articles are available online to the readers all over the world without financial, legal, or technical barriers other than those inseparable from gaining access to the internet itself. Paper version of the journals is also available upon request of readers and authors.

MORE RESOURCES

Book publication information: <http://www.iiste.org/book/>

IISTE Knowledge Sharing Partners

EBSCO, Index Copernicus, Ulrich's Periodicals Directory, JournalTOCS, PKP Open Archives Harvester, Bielefeld Academic Search Engine, Elektronische Zeitschriftenbibliothek EZB, Open J-Gate, OCLC WorldCat, Universe Digital Library, NewJour, Google Scholar

