

## **FOREIGN DIRECT INVESTMENT, FINANCIAL DEVELOPMENT AND ECONOMIC GROWTH IN PAKISTAN**

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**ABSTRACT**-The objective of this study is to examine the effects of foreign direct investment and financial development on Pakistan's economic growth. We used time series secondary data for the period 1980-2018. GDP was taken a proxy variable of economic growth while independent variables included industrialization, FDI, Financial development, Exchange rate and foreign remittance. In order to check stationarity, we used KPSS and NG Person unit root test. The ARDL Approach and Error model were applied to determine long run and short run relationship between dependent and independent variables. The results show that there is positive relationship between industrialization, financial development, foreign direct investment, foreign remittance and economic growth.

**Keywords:** economic growth, Financial development, exchange rate, FDI.

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## **1. INTRODUCTION**

This research paper has investigated relationship between industrialization, foreign direct investment, financial development efficiency and economic growth in Pakistan. The process of industrialization is good for any economy and it creates job opportunities and reduces poverty level. The function of FDI is like a benchmark to fill the saving-investment gap. The financial development efficiency depends on the growth and improvement of financial markets because developed and well-established financial markets play crucial role in the financial development as well as in economic growth. A well-established financial system provides risk diversification and efficient allocation of financial resources. The Real effective exchange rate should be set optimally in the longer period. Remittance means the money sent by overseas Pakistanis and it is used to fill budgetary and trade gap.

### **1.1. Objectives of study**

- To examine relationship between industrialization, Financial Development efficiency, Foreign Direct Investment, real effective exchange rate, remittance and Economic growth in Pakistan.
- To analyze that which variable has more effect on the economic growth of the Pakistan.
- To suggest some policy implication to accelerate pace of economic development in Pakistan.

## **2. LITERATURE REVIEW**

Adeniyi et al. (2012) investigated direct foreign investment (FDI), economic growth (EG) and financial development in minor exposed under developed states. The secondary data is from 1975 to 2015 was used and methodology used was Granger tests of Causality in Vector error correction

(VER). The outcomes show that direct foreign investment (FDI) has a significant influence on growth in Ghana, Gambia, and Sierra Leone. While no empirical evidence found on casual flow of FDI to growth in Nigeria.

Ranjan and Agrawal (2011) explored direct foreign investment (FDI) inwards elements in BRICs countries. The dependent variable of this study was Log of FDI net inflow and the independent variables were GDP, Inflation with respect to CPI, cost of labour, openness of trade, index of infrastructure, working force and formation of gross capital. The secondary annual data from 1975 to 2009 was employed in all countries except Russia where data started from 1990 because of unavailability of data from 1975. The random model effect was implemented on the statistics of panel. The findings show that size of market (GDP), openness of trade, cost of labour, infrastructure and stability of macroeconomic and prospects of growth are possible elements of inflows of FDI in BRIC countries while formation of gross capital and labour power are in-significant, though stability of macroeconomic and prospects of growth have very small influence.

Chee and Nair (2010) examined the influence of foreign direct investment and financial area development on the growth: proof from Asia plus Oceania. The objective in the study were to assess whether foreign direct investment and development of financial sector had separately and/or corresponding influence on growth and to differentiate the corresponding influence of foreign direct investment and financial institutions development in less developed and under developed countries of Asia and Oceania. The variables of this study were: direct foreign investment (FDI), development of financial institutions (FD) and economic growth. The statistics from 1996 to 2005 was used in this study. The Panel statistics method (fixed effects method

and random effects method) were applied to analyze the association among direct foreign investment (FDI), financial institutions development and the economic growth in a model of 44 economies. The results show that the involvement of direct foreign investment (FDI) in economy's growth increases through financial institutions development. The character of direct foreign investment (FDI) and financial institutions development on growth for developing economies is most important.

Sridharan, Kumar and Rao (2009) examined the causative association among direct foreign investment (FDI) and economic growth of the Brazil, Russia, India, China and South Africa (BRICS) countries. The dependent variable was economic growth proxy as industrial production index (IPI) and independent variable was foreign direct investment (FDI) in US\$, the secondary three-monthly statistics from 1996 to 2007 for Brazil, for Russia the data from 1994 to 2007, from 1992-2007 for India, from 1999-2007 for China and for South Africa from 1990-2007. The stationarity of the statistics was checked by Augmented Dickey Fuller (ADF) Test and tested for the presence of co-integration. Johansen model of Co-integration found that the Brazil alone co-integrated among the selected countries at levels. The Vector Error Correction Model (VECM) was employed to detect the presence of long term affiliation. The outcomes of VECM initiate that economic growth leads foreign direct investment bi-directional association for Brazil, South Africa and Russia and FDI leads economic growth unidirectional for India and China correspondingly.

Saiyed (2012) explained the effect of direct foreign investment (FDI) on economy's growth (EG) in India. The purpose of the study was to analyze the character of direct foreign investment (FDI) in the economic growth (EG)

and to check the connection among direct foreign investment (FDI) stock and economic growth level in Indian economy. The variables were direct foreign investment (FDI) and economy's growth. The dependent variable was domestic gross product (GDP) as a mean of economic growth (EG) and foreign direct investment (FDI) was taken as an independent variable. The secondary data of post reform period from 1990-91 to 2011-12 was used in the analysis. The Simultaneous Autoregressive Equation test modeling technique was used in the study. The results show a positive strong correlation among foreign investment (FDI) and growth of domestic gross product (GDP). The expansion of foreign direct investment (FDI) causes annual output to increase.

Ahmad et.al (2012), investigates the impact of foreign direct investment and economic growth in Pakistan. The dependent variable was gross domestic product and the exogenous variables were labour, domestic capital investment and foreign direct investment along with data range 1971 to 2007 and time series econometric technique was applied. To check the stationarity of the data, Augmented-Dickey Fuller test was also applied. The outcomes show a positive connection among FDI and gross domestic product.

Baharom, Habibullah and Royaizal (2008) investigated the character of openness of trade and direct foreign investment in prompting the growth of Malaysian economy. The objective of above literature was to estimate the character of openness of trade on economy's growth. The per capita real domestic gross product (RGDPC) was employed as a measure of economy's growth (dependent variable). The independent variables were openness of trade (TOP), effective real exchange rate (REER), and real direct foreign investment (FDI). The yearly statistics for the period of 1975 to 2005 was used and autoregressive distributed lag (ARDL) model was applied for econometric

analysis. The findings show that the positive and significant association between openness of trade and factor of growth, both in the short period and in the long period. The effect also suggests the positive relationship in the short period among foreign direct investment and negative connection in the long term, but both are significant. Exchange rate is significant in the short period and in the long term and is used as control variable.

### **3. THEORETICAL FRAMEWORK**

In neoclassical growth models, extra methods for production and higher creation of stock of capital are boosted through FDI and in the end it contributes to economic growth of an economy. The effectiveness of foreign capital is thought to be same as local with lower spillover effect. While a lot of literature claims that the performance of FDI flows is more than the domestic capital performance, the reason is more superior technologies. So the FDI effect is not shown in the short run but also in the long run. (Roman 2012). The positive effect of FDI is explained through technological diffusion begins from firms receiving foreign capital and expanding to related companies in the shape of suppliers of technical support and business surroundings. Technical diffusion is related to positive outward effect of FDI. Literature also opens up many channels for the FDI spillover.

**Table 1 Channels of FDI spillover**

<b>Backward linkage</b>	Local firms with FDI combined with domestic suppliers and may shift inventory techniques and quality, also giving technical help to improve intermediary product supplies.
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<b>Forward linkage</b>	The development of sales network can take by foreign investors.
<b>Training of local employees</b>	Technical and managerial assistance may also provide through foreign investor to spread its effect on domestic firms.
<b>Demonstration and competition impact</b>	FDI can also increase the quality of locally produced goods by domestic firms.

Source: Blomstrom and Kokko (1997).

Not only competition improvement, managerial skills, capital acquisition and technological improvements is the way of FDI. It is also the scope of study because of following reasons. Firstly, undeveloped countries have narrow to credit market and the business in these countries also have limited access. Double digit interest rates, occasionally more than 20% per annum are caused through high country risk rankings. However, inviting new investors to invest into the business is a cheap way. The cheap loans are providing to those foreign investors who became the shareholder can guarantee of the loans from credit market. The FDI certainly at least one of above on micro level and hence is simple, but a powerful indicator on macro level.

#### **4. DATA AND METHODOLOGY**

##### **4.1. Econometric model**

The dependent variable of the model is economic growth while independent variables are industrialization, Financial Development efficiency,

Foreign Direct Investment, real effective exchange rate, foreign remittance.

The econometric model of this study is given below:-

$$\text{Economic Growth} = \beta_1 + \beta_2(\text{LINDUS}) + \beta_3(\text{LFD}) + \beta_4(\text{LFDICLCU}) + \beta_5(\text{LREER}) + \beta_6(\text{LREMIT}) + \mu$$

Where,

Economic growth = Log of gross domestic product per capita as a proxy of economic growth.

LINDUS = Log of industrialization

LFD = Log of Financial Development Efficiency

LFDICLCU = log of Foreign Direct Investment

LREER = Log of real effective exchange rate

LREMIT = Log of foreign remittance

#### **4.2. Source of Data**

We used time series data for the period 1980-2018, which was taken from WDI and IMF.

#### **4.3 Analytical techniques**

The objective of this paper is to explore relationship of economic with industrialization, Financial Development efficiency, Foreign Direct Investment, real effective exchange rate and foreign remittance. We check stationarity in the data through NG Perron unit root and KPSS unit root tests. If data is stationary on level, then we will apply OLS approach and if integration order is at I (1) level then we will apply Johansson Co-integration technique. But here is the mix order of integration, so we now apply ARDL technique.

## 4. RESULTS AND DISCUSSION

### 4.1 Descriptive Statistic

The results of descriptive statistics are shown in table 2:

Table 2: Results of descriptive statistics

	LGDPCLC U	LINDUS	LFD	LFDICLC U	LREER	LPREMT
Mean	29.38678	38.8230 1	-3.00919	41.8182 3	4.80762 6	22.0244 4
Median	29.3918	39.6348	-1.16337	42.6280 3	4.74870 7	21.6713 7
Maximum	30.20369	43.1134 2	0	46.1156 3	5.44813 4	23.7769 8
Minimum	28.43776	18.2663 9	-6.67795	21.2671 1	4.55671 2	20.7192 6
Std. Dev.	0.496974	4.09315 3	2.894976	4.09535	0.26171 1	0.95689 6
Skewness	-0.19284	-3.31478	-0.19231	-3.30664	1.25769	0.59698 6
Kurtosis	1.996329	17.3796 9	1.186842	17.3257	3.318	1.99724 9
Jarque-Bera	1.878672	407.430 8	5.582653	404.562	10.4459 3	3.95050 4
Probability	0.390887	0.6575	0.6134	0.1654	0.5391	0.13872 6
Sum	1146.085	1514.09 8	-117.358	1630.91 1	187.497 4	858.953

The descriptive results show that the mean value of all variables such as LGDPCLCU, LINDUS, LFD, LFDICLCU, LREER, and LPREMT are 29.38678, 38.82301, -3.00919, 41.81823, 4.807626 and 22.02444. The probability value of Jarque-Bera are insignificant so we can conclude that overall data is normal distributed.

## 4.2 Coefficient of Correlation and VIF

The results of correlation and VIF are shown in Table 3.

Table 3: Results of correlation and VIF

	LGDPCLC U	LINDUS	LFD	LFDICLC U	LREER	LPREMT
LGDPCLC U	-	-	-	-	-	-
LINDUS	1.188137	-	-	-	-	-
LFD	2.174561	1.13567 6	-	-	-	-
LFDICLCU	1.189458	6.04926	1.136421	-	-	-
LREER	2.901765	1.15439 8	2.320345	1.155257	-	-
LPREMT	2.273279	1.03774 1	1.101699	1.03815	1.09365 1	-

According to the rule of thumb if the result of correlation and VIF are less than 10 then there is no problem of multicollinearity. According to results all variables are less than the critical value, so there is no problem of multicollinearity.

## 4.3 Unit Root Test

Table 4: Results of Unit Root Test

KPSS Unit root Test				NG Unit root Test			
At Level		At 1 <sup>st</sup> difference		At Level		At 1 <sup>st</sup> difference	
Variable	LM- Test	Variables	LM- Test	variables	MZa	variables	MZa
LGDPCLCU	0.7654	DLGDPCLCU	0.315	LGDPCLCU	0.247	DLGDPCLCU	-
LINDUS	55	LINDUS	534	LINDUS	52	LINDUS	10.39
LFD		LFD		LFD		LFD	37

LINDU S	0.4891 48	DLINDU S	0.016 669	LINDU S	- 18.98 14	DLINDU S	- 14.11 36
LFD	0.1414 59	DLFD	0.082 985	LFD	- 4.698 19	DLFD	- 18.18 56
LFDICL CU	0.0934 09	DLFDICL CU	0.486 842	LFDICL CU	- 18.98 14	DLFDIC LCU	- 14.11 36
LREER	0.1879 34	DLREER	0.061 213	LREER	- 1.645 82	DLREER	- 13.51 71
LPREM T	0.1834 09	DLPREM T	0.085 673	LPREM T	- 1.799 53	DLPREM T	- 18.07 17
*KPSS (1992, Table 1) Asymptotic critical values*:				*NG Perron (2002, Table 1) Asymptotic critical values*:			
1% level		0.739	1%		-13.8		
5% level		0.463	5%		-8.1		
10% level		0.347	10%		-5.7		

**Explanation of KPSS unit root test:**

**At level:** Calculated value of KPSS unit root test, at level, if all variables are greater than the critical values (0.347) then we reject  $H_0$  and according to  $H_0$ , series has no unit root problem.

**At 1<sup>st</sup> difference:** Calculated values of KPSS unit root test of all variables are less than the critical values (0.347) so we accept  $H_0$ . But in the above table there exists stationary problem at first difference of some variables.

**Explanation of NG Perron unit root test:**

**At level:** if Calculated value of NG Perron unit root test, at level, of all variables is greater than the critical values (-5.7) than we reject  $H_0$  and according to  $H_0$ , series has no unit root problem.

**At 1<sup>st</sup> difference:** if Calculated values of NG Perron unit root test of all variables are greater than the critical values (-5.7) than we reject  $H_0$ . But in the above table there exists stationary problem at first difference of some variables.

**4.4. ARDL Bound Test Approach**

The results of Bound Test are shown in Table 5:

Table 5 : Results of ARDL Model

Estimated Models		LTD= f(DLREER, DOPENNESS, DLTP, DLGDPPC, DLREMIT)		
Optimal Lag		(1,0,0,0,0,1)		
F-Statistic		54.7104		
W-Statistic		328.2626		
Significance level	Critical bound for F-statistic		Critical bound for W-statistic	
	Lower critical Bound	Upper critical Bound	Lower critical Bound	Upper critical Bound
5%	2.7985	4.1892	19.5892	29.3247
10%	2.3499	3.5982	16.4495	25.1874
Diagnostic testing				
R <sup>2</sup>	0.99914	Serial correlation		1.4918[.222]
Adjusted R <sup>2</sup>	0.99897	Functional Form		0.95396[.329]

F-statistics	6001.0	Normality	0.12560[.939]
p-value[F-Stat]	0.0000	Heteroskedasticity	0.16875[.681]
DW-Statistics	1.5926	Durbin-H Statistics	1.2725[.203]

The estimated results show that the calculated value of F test is 54.7104 which is greater than its corresponding critical value 4.1892 at 5% level of significance, therefore, this confirms the evidence of long run Co-integration between Trade Deficit, Real Effective Exchange Rate, Remittance, Gross domestic product per capita, Total population and trade openness. The estimated probability values of the chi-square tests for all the diagnostics tests were not found to be significant which revealed that there are no serial correlation and Heteroskedasticity problems in this study. Moreover, the error term of the selected ARDL model is normally distributed and the functional form of the selected ARDL model is also correctly specified

Table 6: Long Run and Short Run Coefficient

Estimated Long Term Coefficients using the ARDL Approach		Error correction estimates for ARDL Models	
D. variables LGDPCLCU		D. variables LGDPCLCU	
I. Variables	Coefficient [p-value]	Variables	Coefficient [p-value]
LINDUS	11.1614 [0.0000]	DLINDUS	.59219 [0.095]
LFD	.017107 [0.031]	DLFD	.9077E-3 [0.585]
LFDICLCU	.021526 [0.049]	DLFDICLCU	.0011421 [0.102]
LREER	-.33523 [0.426]	DLREER	-.017786 [0.544]
LPREMT	-.15791 [0.057]	DLPREMT	-.037839 [0.062]
C	1.2041[0.003]	ecm(-1)	-.053057 [0.051]

### **Interpretation of results**

**Industrialization:** If one unit increases in industrialization (LINDUS) it will increase in GDPPC (LNGDPPC) by 11.1614%. Industrialization (LINDUS) has significant but positive impact relationship with GDPPC (LGDPCLCU).

**Financial Development Efficiency:** If one unit increases in Financial Development Efficiency (LFD) it will increase in GDPPC (LNGDPPC) by .017107%. Financial Development Efficiency (LFD) has significant and positive relationship with GDPPC (LNGDPPC).

**Foreign Direct Investment:** If one unit increase in Foreign Direct Investment (LNFDI) it will increase in GDPPC (LNGDPPC) by .021526%. Foreign Direct Investment (LNFDI) has significant and positive impact with GDPPC (LNGDPPC).

**Real effective Exchange Rate:** If one-unit increase in real effective exchange rate (LREER) it will decrease GDPPC (LNGDPPC) by .33523%. Real effective exchange rate (LREER) negative relationship with GDPPC (LNGDPPC).

**Foreign Remittance:** If one unit increases in remittance (LPREMIT) it will increase in GDPPC (LNGDPPC) by .15791%. Remittance (LPREMIT) has significant positive relation with GDPPC (LNGDPPC).

### **Short-run and Long run relationship**

**Industrialization:** If one unit increases in industrialization (LINDUS) it will increase in GDPPC (LNGDPPC) by .59219%. Industrialization (LINDUS) has significant and positive relationship with GDPPC (LGDPCLCU) in the long run.

**Financial Development Efficiency:** If one-unit increase in Financial Development Efficiency (LFD) it will increase GDPPC (LNGDPPC) by

.9077E-3%. Financial Development Efficiency (LFD) has insignificant and positive relation with GDPPC (LNGDPPC) in the long run.

**Foreign Direct Investment:** If one unit increases in Foreign Direct Investment (LNFDI) it will increase GDPPC (LNGDPPC) by .0011421%. Foreign Direct Investment (LNFDI) has significant and positive relationship with GDPPC (LNGDPPC) in the long run.

**Real effective Exchange Rate:** If one unit increases in real effective exchange rate (LREER) it will decrease GDPPC (LNGDPPC) by 0017786%. Real effective exchange rate (LREER) has negative association with GDPPC (LNGDPPC) in the long run.

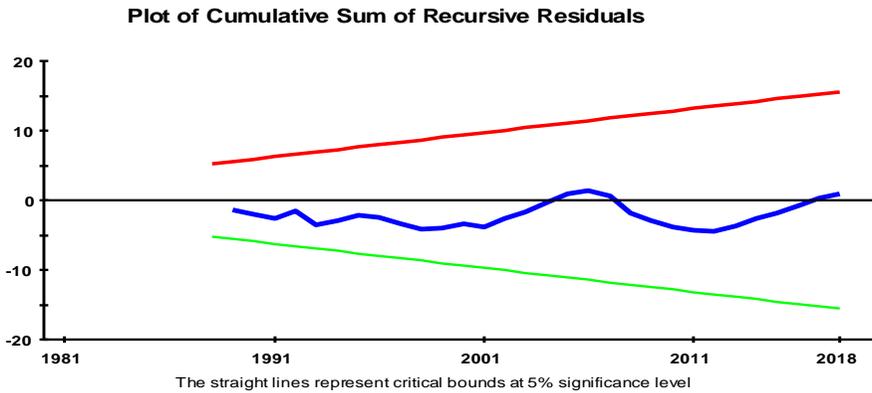
**Personal real Remittance:** If one unit increases in remittance (LPREMIT) it will increase GDPPC (LNGDPPC) by 037839%. Remittance (LPREMIT) has significant positive relationship with GDPPC (LNGDPPC) in the long run.

**ECM (-1):** the value of ECM (-1) is (coefficient -0.53057) negative and significant (p-value 0.051). If there is any shock in the data of the model, the model has the power to restore the equilibrium level in almost 23 months.

#### **4.5 Diagnostic Test**

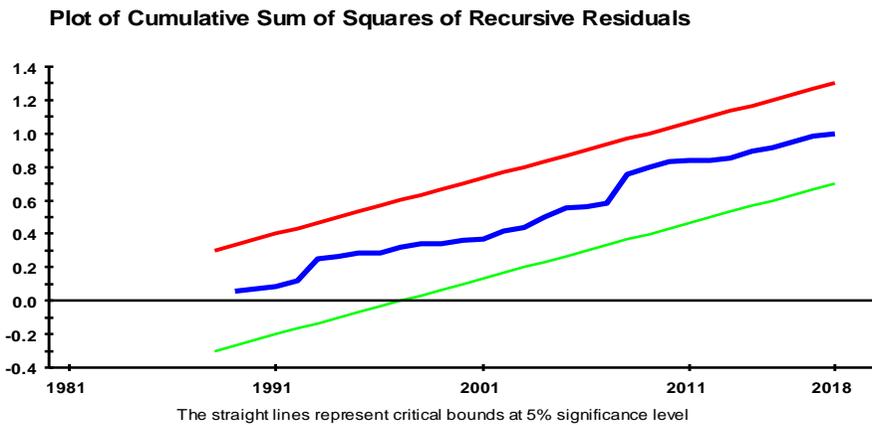
To find the reliability of the results we have checked the stability of the model and Figure 1 highlights the serial correlation & as well as for Heteroskedasticity the probability value of all test. In other word we can claim that model has no serial correlation and there is no problem of Heteroskedasticity.

Figure 1: Stability of Model



**Cusum stability test:** it tests the stability of mean of error term (structurally stable). Either it is normally distributed and stable or not. The diagram shows the stability of error term which means it is structurally not instable.

Figure 2: Stability of error term



**Cusum square stability test:** it tests the stability of variance of error term (structurally stable). Either variance of error term is stable or not. The diagram

shows that the variance of error term is stability which means it is structurally not instable.

## **5. CONCLUSIONS**

Our results show that industrialization Financial Development Foreign Direct Investment and foreign remittance have positive and significant relationship with economic growth so that the government should focus on improvement of these variables. However, real effective exchange rate has negative relationship with GDP growth rate in the long run so that the government of Pakistan should abandon devaluation policy because it has negative impact on economic growth. Remittance.

## **6. POLICY IMPLICATIONS**

We would like to give policy implications of our study in the light of our results and conclusions: -

- ▶ Government should take proper policy initiative to promote industrialization in Pakistan.
- ▶ Government should promote financial development because it was an imperative need to accelerate business activities in the country.
- ▶ Government should provide fiscal incentives to foreign investors so that they can make maximum investment. Foreign direct investment does not only bring capital but also technology which leads the country to become technologically strong. Similarly, foreign remittance may also be promoted.

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## CONTRIBUTION OF AUTHORS AND CONFLICT OF INTEREST

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This research work was carried between collaboration of four authors.

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All authors read the manuscript carefully and declared no conflict of interest with any person or institution.

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