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Political instability and FDI inflows in Pakistan: An empirical analysis

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Abstract

During the past couple of decades, the process of globalization, through the cross-countries investment and trade, play a vital role in uplifting many of the emerging economies from the vicious circle of poverty and economic development. However, FDIs (foreign direct investments) are the kinds of fixed investments, which are irreversible during the short-run, and are affected by the socio-political environment of the host countries. Pakistan passed through a series of political crisis; the results may be expected negative for foreign investment. We find that Pakistan with long term military based political stability attract a large amount of foreign capital. The findings suggest that 1% political stability contribute about 3.55%

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increases in the FDI. This study is an attempt to explore the relationship between political instability and FDI in Pakistan.

Key words: political instability, FDI inflows, Pakistan

1. INTRODUCTION

The process of globalization has encouraged many of the emerging economies to attract foreign capital and get the benefits of global value chains. At present, countries are interconnected economically with each other through openness, FDI and foreign trade. This spurred a heated discussion among the policymakers and academia to examine the potential drivers of FDI (foreign direct investment). Pakistan, one of the emerging economies, passed through a series of political crisis since its independence. There are many factors which are affecting FDI inflow to Pakistan among which political instability is one of the most serious issue. Unlike the other investments, FDI is a fixed investment and cannot be reversed in a short period of time.
In developing countries, like Pakistan, FDI is an important mean of capital inflow, economic development and technological progress. It has been shown that the economic miracle in East Asian countries gained a lot from the inflows of foreign firms. Through, the forward and backward linkages, FDI helps the domestic investment to learn from it. Similarly, FDI inflows enable the mobility of labor, which enables them earn capital and thus improve their life standard.

There are many factors that can affect the inflow of FDI. The market seeking foreign firms look into the purchasing power of the residents of the host countries. Efficiency seeking motive may drive the activities of foreign investor to invest in the host countries. The foreign firms create joint ventures and cross-countries mergers &acquisitions and may take advantage from the domestic firms.

Previous studies mainly focused on the different aspects of the location choice of FDI. There is scarce literature on the political instability as the driver of the foreign capital inflows. Moreover, the previous studies were conducted in cross-counties framework, which may not portray a clear picture of the true mechanism. Pakistan, one of the emerging countries, has undergone through the political and

economic crisis during the last couple of decades. Therefore, it seems interesting that how FDI responds to the political instability. Therefore, This study is looking into the political instability in Pakistan in relationship with FDI.

2. POLITICAL INSTABILITY AND FDI INFLOWS IN PAKISTAN

Pakistan has the immense potential for Foreign Direct Investment, but due to political instability missing the opportunities of attracting FDI. He landscape shows the preference of transnational corporations for investment in specific sectors(Khan, 1997). Political stability is most volatile component in terms of FDI inflows. Foreign Direct Investment is not only affect the economic stability but its declining in national levels is also a challenge to state (Buffie, 1993).

Political fluctuation is a hurdle for investors, so business friendly environment is required to attract Foreign Direct Investment in Pakistan (Najaf & Najaf, 2016). Pakistan is one of the emerging countries, since independence, go through transitions and political instability. Soon after the independence, military started interfere in the political affairs of Pakistan. In 1958,the democratic government under the constitution 1956 was overthrown by marshal law administrator Ayub Khan. The Ayub's government is very important for Pakistan due to the five years plan and liberalized policies. Some of the critics claims about the income inequality has risen in that times, which leads to the division of Pakistan into two parts. It was the most important factor of political instability of that time which made the liberalize policies more unattractive. After that, the Bhutto's government focused on nationalization policies, which had a significant negative impact on Pakistan liberalized polices (Husain 2009). The Zia-ul-Haq era (1977-88) viewed as the economic liberalization by providing friendly policies along with the privatization of the government sector industrial enterprises (Mohiuddin 2007).

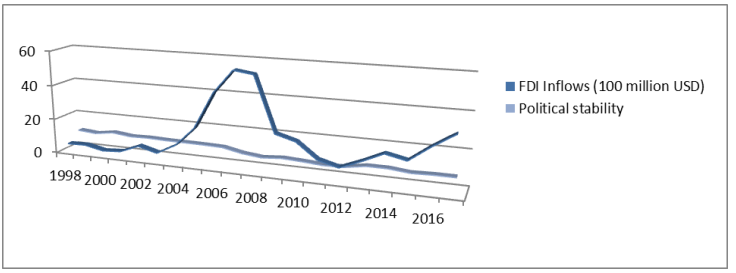
FDI got a remarkable position in terms of inward and outward flows in 1990s (Villaverde & Maza, 2015). FDI flows to Pakistan grew on average at an annual rate of 30.7 % from 1990 to 2007, but it dramatically declined thereafter, from 5.59billion dollar in 2007 to

0.86 billion dollars in 2017 (Bano, *et al.,* 2019).In the wake of 1990s policy reforms, Pakistan did well and attracted relatively higher amount of FDI, but the flow of incoming FDI to Pakistan soon lost pace mainly because of mounting political uncertainties in late 1990s when Military take over and dismiss democratic government. The better performance during 2000-2008 was due to the liberalization policies carried out by the military government of General Pervaiz Musharraf. During that period, FDI inflows increased to a great extent leading to improvement in economic indicators in Pakistan and making it third fastest growing economy after India and China in the region. Though during the period from 2000 to 2008 FDI inflows increased to Pakistan but unfortunately once again the period onward 2009 Pakistan faced a deadly decrease in FDI inflows (Bano, *et al.,* 2019).But FDI inflows fell during the period of 2009-2013 because of bad governance, poor law and order conditions and especially because of high terrorist activities. Again, the success government Muslim League (PML-N) government tried to strengthen the civilian government but the government had continued his duration along some retrains, such as the problem of corruption and anti-government movement by Pakistan Takhreek-e-Insaf(PTI) and later on judicial inquiries against it top leadership on the account of corruption. These were challenge to the sitting government as well as to the investors into the country. Moreover, Zarb-e-Azb operation against terrorism in 2014, energy shortages and security are the problems faced to the government in this regard (Bano, *et al.,* 2019).It is fact that FDI inflows is a key factor for improvement in economic development but the situational factor of Pakistan such as political instability, poor law and order situation, energy crisis and security conditions have a negative effect on it. But another good thing happen in 2015 to increase FDI inflows to Pakistan in shape of CPEC.FDI inflows are now increasing in Pakistan due to the creation of environmental background for China Pakistan Economic Corridor project (Ali & Gang, 2016). Political instability also creates numerous complications for investor like delaying the decision by the government in terms of tax rates and changing their trade and macroeconomic policies (Minhas &Ahsan, 2015).

Regime type is another factor which has effect on FDI of a country especially in Pakistan. Different studies indicate that FDI inflows in Pakistan are higher in autocratic as compare democratic era. The actual reason was that there had no political instability in the autocratic regime of Pakistan while the democratic governments faced many kinds of challenges leading to instability. In democratic governments, the political chaos, disagreements of ruling and opposition parties, no proper vision regarding their policies and corruption are the major issues of democratic governments.

Fig. 1 shows the political stability and FDI inflows in Pakistan. It is evident that the military government under the leadership of Pervez Musharaf, foreign investor attracted towards the stable investment environment of Pakistan. The restorations of democracy, in 2008, lost the investors' confidence and deter FDI.

Figure 1. FDI inflows and political stability in Pakistan



Data sources: ICRG and UNCTAD. Authors' calculations.

3. LITERATURE REVIEW

Kaufman, *et al.* (1999)reviewed different measures and described that FDI has several significant institutional factors which include political instability, regulatory burden, crime, policy effectiveness, rule of law and corruption by using the data from World Bank, United Nations Development Program (UNDP), and Environmental Sustainability Index. Stein and Daude(2002) identified that inward FDI mostly affected due to violence, political instability, rule of law, regulatory burden, and government effectiveness. Rehim and Munir (2004) argued that political instability leading to a decline in FDI inflows. With an increase risk, foreign companies will be discouraged to invest in the host country. Lemi and Asefa (2003) concluded that

the effects of violence are significant, but political instability and government policies are important. Additional economic variables such as size of the market, trade and labor also influence FDI inflows. The authors used Generalized Autoregressive Heteroscedastic (GARCH) on data for 29 African countries during 1987-99 to address the relationship between economic and political instability. Fedderke and Romm (2004) identified that the elements in attracting FDI include political risk, property rights, market size, labor costs, transparency and corporate tax rates.Asiedu (2006)demonstrated that weak institutions such as political instability, corruption, absence of rule of law are the deterrents of FDI inflows. Gani (2007)suggested that the rule of law, bribery regulation, quality regulatory, government efficiency and political stability had positive effects on FDI. Globerman and Shapiro (1999, 2002) examined that the failure of quality or week institutional systems, including legislation and order, political stability, the security of creditors, government policies and formal and informal codes of conduct could have a negative effect on flows of FDI.

Asiedu (2006) evaluated the general view that FDI is manually driven by natural and market sizes in African countries. So, given the importance of FDI in the region, the author uses a panel of 22 SSA countries over the period of 16 years (1984-2000) to explore the impact of natural resources and market size vis-a-vis government policy, institutional quality and political instability in attracting FDI. The results indicated that SSA economies are more likely to encourage FDIs, with more natural resources or large markets. If a country remains economically and politically stable, then it can also effectively attract FDI. Fedderke and Romm (2006) studied the core drivers of FDI. The authors argued that the determinants fall into two classes, i.e., the rates of return and risk factors. The rate of return has a positive effect and the risks carries negative effects. Political instability can significantly affect the FDI as indicated by many researches. It shows a negative relationship. The authors observed the reaction of other variables and found that FDI takes more time to reach the normal position while the political instability have a very slight level of variation. They argued that FDI is most susceptible to change away from equilibrium with the variable, political instability.

Pakistan attracted foreign investors after following the1991/92 government liberalization program. It allowed businessmen to send money out of the country without any constraint. And permitted 100% foreign ownership of capital, to run the firms without registry on local bonds. Any time, the investors could withdraw their investment. Being a populous state, Pakistan offering direct marketing opportunities and affordable products. The location of Pakistan is more favorable geographically but has still not attracted FDIs into its country like some other underdeveloped regional states such as Hong Kong, Thailand, China, and, Malaysia. The political uncertainty, rule of law, bad government economic reforms, bureaucracy, bad infrastructure, political uncertainty are apparent factors discouraging foreign investors to invest in Pakistan (Khan, 1999).Shah and Ahmed (2003)observed that FDI inflow to Pakistan mainly effected by the impact of the cost issue, market size and social and political aspects. duty barriers, transportation, currency factors, and political stability. Azam and Rehman (2006)examined that when there is a political instability in a state, foreign investors are unwilling to invest in that country. Ahmad, Maryam, Reza and Azizi (2011) concluded that political instability adversely affects the FDI inflows to certain countries of OIC. Akhtar & Yasin (2015) argued that political stability create variance in the flow of investment across states. The flows of FDI will be naturally towards those states which are politically stable in the region. Likewise, Méon and Sekkat (2012) described that it is the political uncertainty which hesitate investors from investing in long-term projects. Argued that undependable policies can affect the profit of the investors. Political instability is one of the main causes of declining Foreign Direct Investment inflows to Pakistan.

Pakistan is considering the seventh attractive position in the world which can be built quickly, for a strong FDI based on its location. But Pakistan still has less attracted FDI while comparing with other developing states in the region. Pakistan has a considerably higher number of FDIs in the 1990s but due rising political challenges in the end of 1990s, the flow of FDI gradually decreased to the country(UNCTAD, 2012).

4. DATA AND METHODOLOGY

The purpose of the study is to examine the relationship between political instability and FDI in Pakistan. Foreign direct investment, net inflows (% of GDP) is extracted from World Bank database. It is the sum of reinvestment of earnings, other long-term capital, and short-term capital equity capital, as shown in the balance of payments. The data of political instability is derived from the ICRG (International Country's Risk Guide). The selection of the other variables is based on the broader set of previous literature. The control variables consist of trade share as a percent share of GDP, domestic investment, and human capital. We use gross fixed capital formation as percent of GDP as a proxy for domestic investment. Secondary school enrolment is used as a proxy for human capital.

Keeping in view the methodological concerns, our study relies on the ARDL (autoregressive distributive lag) model to know the short- and long-run dynamics, developed by Pesaran, et al., 2001. The approach is equally feasible for large and small samples. The technique gives unbiased results irrespective of the order of the integration of the underlying variables. Moreover, it is also applicable in case some of the repressors are endogenous.

Before, the application of the ARDL approach, the variables should be stationary. The method can be applied in case the variable I(0), I(1), and the mixture of I(0), and I(1). The method produce biased results in case the variables are integrated of I (2). For stationarity check, we use Augmented Dicky Fuller (ADF) and Phillips-Perron (PP) tests. Similarly, the derivation of ECT (error correction term) is comparatively easy in this approach.

To check the relationship between the underlying, our model takes the following form,

$$\Delta \ln FDI_t = \alpha_0 + \sum_{i=1}^{p} \psi_i \Delta \ln FDI_{t-i} + \sum_{i=1}^{p} \rho_i \Delta PS_{t-i} + \sum_{i=1}^{p} \Omega_i TRD_{t-i} + \sum_{i=1}^{p} \vartheta_i \Delta DI_{t-i} + \sum_{i=1}^{p} \vartheta_i \Delta HC_{t-i}$$
$$+ \lambda_1 \ln FDI_{t-1} + \lambda_2 PS_{t-1} + \lambda_3 TRD_{t-1} + \lambda_4 DI_{t-1} + \lambda_5 HC_{t-1} + \mu_{1t} \quad (1)$$

lnFDI is dependent variable in above equation. We use natural log of FDI. PS (political stability), TRD (trade share), DI (domestic investment). The subscript t shows the time dimension and Δ is the difference operator. Similarly, α denotes the drift component of ARDL

model. Ψ, ρ, Ω are the short-run coefficients while the long-run coefficients are denoted by λs.

To show the long-run relationship among the variables, Wald test of cointegration will be applied.

H0: $\lambda_1 = \lambda_2 = \lambda_3 = \lambda_4 = \lambda_5 = 0$ (cointegration doesn't exist)

H1: $\lambda_1 \neq \lambda_2 \neq \lambda_3 \neq \lambda_4 \neq \lambda_5 \neq 0$ (cointegration exist)

To identify the long-run relationship among variables; Pesaran, Shin, and Smith (2001) showed upper and lower bound values. The upper and lower bound shows critical values. Long-run relationship exist if the F-statistic value is above the upper bound value, while no cointegration exists if the F-statistics value falls below the lower bound value. The result will be inconclusive if the F-statistic value falls between the upper and lower bound values. If the long-run relationship exist (which is necessary condition for cointegration but not a sufficient condition), then under the VECM environment the error-correction representation is as follows;

$$\Delta FDI_t = \alpha_0 + \sum_{i=1}^{p} \psi_i \Delta FDI_{t-i} + \sum_{i=1}^{p} \rho_i \Delta PS_{t-i} + \sum_{i=1}^{p} \phi_i \Delta TRD_{t-i} + \sum_{i=1}^{p} \delta_i \Delta DI_{t-i} + \sum_{i=1}^{p} \delta_i \Delta HC_{t-i} + \xi_1 ECT_{t-1} + \mu_{2t} \qquad (2)$$

ECT is the error correction term. ECT is the term used for establishment of aquarium.

Results

In Table 1, the results show that the variables are I(0) or I(1) but none of them are I(2), therefore, the criteria paved the way for ARDL technique.

Table 1. Unit root results

Variable	ADF		Phillips- Perron	
	I(0)	I(1)	I(0)	I(1)
FDI	-2.88	-3.721**	-1.75	-3.691**
PS	-1.49	-5.13***	-1.754	-5.13***
TRD	−2.401	−6.345***	−2.539	−6.156***
DI	-2.38	-4.96***	-2.529	-4.94***
HC	-2.384	-6.92***	-2.456	-6.99***

Note: ***, ** and * show level of significance at 1%, 5% and 10%

The ARDL results are presented in Table 2. Wald-test is applied on the long-run coefficient and F-statistic (8.77) is derived, which is greater than the upper bound value of Narayan (2005). The null hypothesis of no cointegration is rejected. All the explanatory variables i.e., PS, TRD, DI, and HC affect the FDI. To identify the long-run elasticities; the long-run coefficient of the FDI is divided by the respective long-run coefficients of PS, TRD, DI and HC. Then the ratio of dependent to independent is multiplied by the minus sign. On the other hand, the first difference coefficients of the variables shows the short-run elasticities, however; if there are more coefficients then they are added and the joint significance is tested by applying the Wald-test.

Diagnostic tests are applied to examine the applicability of the model. The results of serial correlation, heteroskedasticity, functional form of the model, and normality are presented in the lower panel of the Table 3. The Breusch–Godfrey LM result is significant at 10%. The normality of the residuals is verified by the results of Jarque-Bera statistic. Similarly, the Ramsey RESET test confirms the correct specification of the model. Breush-Pagan-Godfrey test for heteroskedasticity suggest that there is no heteroskedasticity problem in the model. CUSUM of squares and CUSUM results are shown in the figure 4a & 4b which identifies that the model is stable (see appendix).

Table 2. Estimated ARDL model (1,1,4,3,1)

Variable	*Coefficient*	*P-value*
C	-1.543*	0.05
*ln*FDI (-1)	-0.93***	0.00
PS (-1)	3.30***	0.001
TRD (-1)	0.190**	0.022
DI (-1)	1.031***	0.011
HC(-1)	0.43***	0.002
*Δ ln*FDI(-1)	0.4616***	0.002
ΔPS	1.756**	0.011
ΔTRD	1.92**	0.014
ΔTRD(-1)	0.87	0.210
ΔTRD (-2)	0.81	0.199
ΔTRD(-3)	0.72	0.228
ΔDI	0.79*	0.055
ΔDI(-1)	0.35	0.477
ΔDI (-2)	1.40***	0.006
ΔHC	0.81*	0.057

Estimated method: least squares	
Adjusted R-squared	0.57
DW Statisic	0.65
F-statistic	30.78
Prob (F-statistic)	0.0000
Diagnostic tests	
J–B normality	1.05 (0.60)
Breusch–Godfrey serial correlation LM test	2.0756 (0.1718)
Heterosckedasticity (Breush-Pagan-Godfrey)	0.81 (0.67)
Ramsey RESET test	0.23 (0.63)

Note: ***, ** and * show level of significance at 1%, 5% and 10% , Diagnostic tests results are based on F-statistic and figures in ( ) represent probability-values.

The long-run and short-run elasticities are given in the Table 3. 1% increase in the PS brings about 3.55% increases in the FDI. The results are consistent with the finding of Asiedu (2002). On the other hand, TRD also impact FDI. The results shows that an increase in 1% TRD leads to 0.20% increase in the FDI. Similarly, DI and HC are important determinants of the FDI. 1% increase in DI may induce investment by 1.10% FDI, and 1% increase in HC may enhance FDI inflow by 2.13%. Keeping in view the short-run dynamics, the results show that PS, TRD, DI, and HC positively influence FDI in Pakistan. 1 percent increases in PS increase the FDI by 1.75 percent. Similarly, an increase in TRD by 1% brings about 4.34% increases in FDI. On the other hand 1% increases in DI increase the FDI by 2.56%. Hence, the short-run and long-run results show that all the explanatory variables in this study affect the FDI inflow. The results identify that at 1% level of significance the coefficient of error–correction term (ECT) is significant and has negative sign.

Table 3: Short-run and Long-run Elasticity

Variables		
	Short-run	Long-run
PS(-1)	1.75**	3.54***
TRD(-1)	4.33*	0.20**
DI(-1)	2.55***	1.10***
HC (-1)	1.34***	2.13***
ECT(-1)		-0.93*** (0.0000)

Note: ***, ** and * show level of significance at 1%, 5% and 10%. The value in parenthesis denotes p-value

5. CONCLUSION

It is a fact that the uncertainty and risk arise due to political instability harm and deter FDI. The current study is an endeavor to investigate the role of political stability in FDI inflows in Pakistan. Keeping in view the shortcomings in the previous literature, the study is conducted to have in-depth insight of the mechanism. Using the ARDL methodology, we find that political stability positively influences FDI activities in Pakistan. The results of the control variables are robust to this analysis and enhance the overall goodness of fit.

The study carries some policy implications as well. First, political stability should be ensured to attract more FDI. Secondly, investment promotion, e.g., tax holidays should be in place. Moreover, the international organizations like World Bank and IMF should play their role by introducing investment promotion programs in the less developed countries like Pakistan.

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Appendices