NEAR EAST UNIVERSITY
INSTITUTE OF GRADUATE STUDIES
BANKING AND FINANCE PROGRAM

THE IMPACT OF FOREIGN DIRECT INVESTMENT ON THE ECONOMIC GROWTH OF PAKISTAN

SUALEHA SULTAN

MASTER'S THESIS

NICOSIA
2021

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Asst. Prof. Dr. Ahmed SAMOUR

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ACCEPTANCE/APPROVAL

We as the jury members certify the ‘THE IMPACT OF FOREIGN DIRECT INVESTMENT ON THE ECONOMIC GROWTH OF PAKISTAN.’ prepared by the SUALEHA SULTAN defended on 2021/01/29 has been found satisfactory for the award of degree of Master.

JURY MEMBERS

....

Asst. Prof. Dr. Ahmad SAMOUR (Supervisor)

Near East University

Graduate school of Social Sciences

Department of Banking and Accounting

………………………………………

Assist. Prof. Dr. Turgut TÜRSOY (Head of Jury)

Near East University

Graduate school of Social Sciences

Department of Banking and Finance

....

Prof. Dr. Wagdi KHALIFA

Near East University

Graduate school of Social Sciences

Department of Banking and Finance

....

Prof. Dr. Hüsnü Can Başer

Director of Institute of Graduate Studies

DECLARATION

I **Sualeha SULTAN**, hereby declare that this dissertation entitled **'The impact of foreign direct Investment in the economic growth of Pakistan'** has been prepared myself under the guidance and supervision of **Dr. Ahmad SAMOUR**' in partial fulfillment of the Near East University, Graduate School of Social Sciences regulations and does not to the best of my knowledge breach and Law of Copyrights and has been tested for plagiarism and a copy of the result can be found in the Thesis.

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DEDICATION

This thesis and all my hard work are dedicated to my parents, to my sweet sisters, my little niece and my best friends.. Without their love and support nothing is possible.

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ABSTRACT

THE IMPACT OF FOREIGN DIRECT INVESTMENT ON THE ECONOMIC GROWTH OF PAKITAN

This research investigates the impact of Foreign Direct (FDI) Investment on the economic growth of Pakistan during the period of 2009-2018. The research intends to under the relationship between the dependent and independent variables. The relationship between economic growth Gross Domestic Product (GDP) data is used as the proxy Foreign Direct Investment (FDI) and financial development Domestic Credit to Private Sectors used as the proxy for it.

The methodology used for this research is the Auto-regression Distribution Lag approach is used. Unit roots tests are conducted to see the stationarity and non-stationarity of the variable. ARDL bound test for long run and bound test; and short run and ECM-Error Correction model and diagnostic tests are conducted. The data has been selected from world organizations like the International Monetary Fund (IMF) and the World Bank.

According to the empirical outcomes acquired policy proposals are advised to attract FDI in Pakistan. A developed financial system attracts FDI which results in the economic growth of a nation. FDI brings technology to the country, builds competition in the market, and generates revenue from the host country.

Keywords: FDI, DCPS, GDP, ARDL Bound-Test, Pakistan

ÖZ

DOĞRUDAN YABANCI YATIRIMIN PAKİTAN'IN EKONOMİK BÜYÜMESİNE ETKİSİ

Bu araştırma, 2009-2018 döneminde Doğrudan Yabancı Yatırımın (DYY) Pakistan'ın ekonomik büyümesi üzerindeki etkisini araştırmaktadır. GSYİH büyüme performansını değerlendirir ve DYY ve finansal gelişmenin tarihsel eğilimlerini değerlendirir. Ekonomik büyüme Gayri Safi Yurtiçi Hasıla (GSYİH) verileri arasındaki ilişki, Doğrudan Yabancı Yatırım (DYY) vekili olarak kullanılır ve bunun için vekil olarak Özel Sektörlere Verilen Finansal Kalkınma Yurtiçi Kredi kullanılır.

Bu araştırma için kullanılan metodoloji, kullanılan Otomatik Regresyon Dağılım Gecikmesi yaklaşımıdır.Değişkenin durağanlığını ve durağanlığını görmek için birim kök testleri yapılır.Uzun çalışma ve bağlı test için ARDL bağlı testikısa vadeli ve ECM-Hata Düzeltme modeli ve teşhis testleri yapılmaktadır.Veriler, Uluslararası Para Fonu (IMF) ve Dünya Bankası gibi dünya kuruluşlarından seçilmiştir.

Ampirik sonuçlara göre, edinilen politika önerilerinin Pakistan'da DYY'yi çekmesi tavsiye edilmektedir. Gelişmiş bir Mali sistem, bir ulusun ekonomik büyümesiyle sonuçlanan DYY'yi çeker. DYY, ülkeye teknolojiyi getirir, pazarda rekabet oluşturur ve ev sahibi ülkeden gelir elde eder.

Anahtarkelimeler: DYY, GSYİH, ARDL bağlıTesttir, Pakistan

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ABBREVATIONS

FDI	Foreign Direct Investment
EG	Economic Growth
GDP	Gross Domestic Product
OECD	Organization for Economic Cooperation Development
IMF	Internal Monetary Funds
CPI	Consumer Price Index
DCBS	Domestic Credit provided by Banking Sector
ARDL	Autoregressive Distribution Lag
SBP	State Bank of Pakistan
FD	Financial Development
FPI	Foreign Portfolio Investment
UNCTAD	United Nation Countries of Trade and Development Report
ECM	Error Correction Model
CPEC	China Pakistan Economic Corridor
GATT	General Agreement on Tariffs and Trade
WTO	World Trade Organization
SAER	South Asia Economic Report
CUSUM	Cumulative Sum

CHAPTER ONE:

GENERAL INTRODUCTION

1.1 Introduction

According to the weekly global economic brief (2010), FDI has a growing influence on the world's gross domestic product in 1970 it was 0.5% it grew to 3.0% in 2008. Report also mentioned that there is a threefold increment in the inflow of FDI since 2000 which is 37%. The effect of FDI can be seen through the different channels and that impact are considerably significance to understand.

Department (2006) foreign direct investment has come a long way in last four decades as it was seen as FDI bringing negative and improper technology to the underdeveloped and emerging nations. It has a very drastic and distinctive outlook now. Presently, countries are attracting the FDI by providing smooth and sound environment. Nations are growing to more understand the significance and importance of the impact of FDI on the economic growth and how it has influenced by the economic poleis and other applicable approaches.

Mankiw (2012)Mentioned that the economy as a whole can be determined by its GDP, it does not matter if the country is doing well or not, it is intrinsic to see the whole wage earned by everybody within the economy.

After many kinds of research and studies in micro and macro researchers like Ruxanda and Muraru (2010) went further and invested that the developing countries government should offer more stability in the Foreign Investment environment with favorable laws and regulation to benefit home countries. So the foreign companies can invest in their countries, according to the analysis which supports the affirmative spillover effects in the host companies by FDI.

In the late two decades for the development of the developing countries FDI is the factor which has helped them to accomplish great prosperity and growth in their country that is the major reason to attract the FDI in the developing countries. FDI is the combination of management, funds, marketing and technology. To attract more these factors developing countries has made this trade more suitable for foreign investors (M. A. Khan, 2015)

By utilizing the common and some specific policies by the host countries such as improving the ventures climate, exchange conditions, linkage program and human capital for the advancement of foreign direct investment. It also attempts to attract the strategic and efficient recourses bringing FDI (Te Velde, Trade, & Development, 2006).

According to Shah, Ahmad, and Ahmed (2016)stated that the unanticipated withdrawals or outflow of foreign portfolio investments (FPI) can bring strong variance in the economy. FDI on the other hand is not much volatile as compare to FPI and has more immovable and stable capital Baharumshah and Thanoon (2006). In long-run it has negative impact but in short-run, labor-intensive production techniques increases the employment. This helps the economy of that nation grow (Apergis, 2008) and (Djulius, 2018).

The main goal of the emerging nations is the development and growth of the country, the capital is organized by the various sources like foreign investments (Senadza, 2017). FDI brings the gains from technology and spillover effects which benefit the developing country with growth in their economy (L. Alfaro, Chanda, A., Kalemli-Ozcan, S., & Sayek, S., 2004);(Durham, 2004). One of the conclusions from the research of (Djulius, 2018) is that there is a positive influence of FDI on the economic growth of the host country in the short-term but it becomes negative in the long run.

(Khaliq & Noy, 2007) stated affect of FDI on the economic growth of Indonesia for some sectors it has positive impact and for some it has negative influence. Some of the negative impacts are the mining sectors in the Indonesia. Which means extraction of natural resources without their renewals, this might not help economic growth. In conclusion, the research found that there is positive effect on aggregate level and negative influence on the sectoral level. FDI attracting policies must be made the policy makers of Indonesia for it to be advantageous for all the sectors helping economic growth. The investigation was conducted by using Cobb-Douglas production function by annual time series data from 1997 to 2006 by the 12 sectors of Indonesia.

FDI can bring the financial steadiness, promote economic advancement and upgrade the well being of the society if the correct policy system has been set by the policy makers of that nation. We can say that the world economic integration is primarily driven by the foreign direct investment (*OECD Benchmark Definition of Foreign Direct Investment*, 2008).

The possession of foreign operating resources such as lands, companies, mines etc, is the estimation of the foreign direct investment. One measure of growing economic globalization is because of expanding foreign investments. Remarkable growth has been seen in the FDI during the last three decades trough worldwide. FDI shared the 6.59 percent of the world's gross domestic product in 1981, in 2004 FDI shred the 23.53 percent of world's GDP agreeing to the United Nation Countries of Trade and Development Report (UNCTAD 2004).

M. S. Khan and & Senhadji (2000) numerous latest studies has shown that the show that there is a relationship between financial development and economic growth through the endogenous growth theory. The common thought comprises of expecting that financial development progresses the proficiency of capital allotment, which within the setting of endogenous growth model, infers higher long-term growth. These theoretical expectations are affirmed by a huge body of experimental evidence.

Bencivenga and Smith (1991) stated that investing products within the economy are produced by labor and capital. A business person, who loans credit from the bank used for capital contributed within the trade, which he uses to utilize labor in regard to actuate merchandise & administrations for Economic Growth.

According to Bloch and Tang (2003), In East Asia growth brought the major changes in the living standards of the country, in context to the literature review. A potential of economy is driven by factors such as approach to credit can be seen amid the development of finance and growth of economy of a nation.

“Productivity is not everything, but in long run it is almost everything.” Paul krugman (1999)

In long run economy is controlled mainly by the factors which control productivity provisions, labor, level of technology, etc that might enhance the quality of outcomes or the productivity through converting it inputs into outputs.

Olowoteso, Emmanuel, Adeleke, udaji (2015) stated in their research that private sectors credit and economic growth has been economy’s major affair in all around the countries in the world. The empirical literature has been uncertain on this matter, but there is balance of evidence to approve.

Economic growth Levine also argues that there has been that there is a positive influence of correlation amid economic growth and credit from private sectors. According to Levine (1997) allocative efficiency of capital inside the economy encourages notable positive impact on the economy from the financial intermediation since early 1990s.

Gerschenkron (1962) argues that the economic growth from financial development can be determined by the backwardness of an economy. Economically backward nations should have a more active and developed financial system.

Financial affects the economic growth in four ways which are: Financial sectors stimulates productivity development by selecting good quality of entrepreneurs and projects, congregating the finance for these entrepreneurs, encouraging innovative activities by diversifying the risk through superior vehicles for diversification and uncovering more precisely the possibly large benefits related to unpredictability of innovative business projects.

FDI has been rising since the last few decades. The control of Multinationals Companies (MNC) oversea is known as the FDI. These companies must have the 10 percent control more for it to be called FDI.

In the beginning of FDI foreign investor would search for local partners in the host country for their investments, because their help in sorting the phenomena occurring in the host country. Corporation of local partner was considered to be favorable for the home country, trust from in the local market and competitions were gained through the local partners.FDI was always seen as the mean of transfer of knowledge, capital and innovation in technology which helps to boost the economic condition of that country positively. FDI was always attracted by the developing nations.

FDI can be in form of mergers, acquisition or Greenfield (by opening a new company or a subsidiary company). According to its types they have different characters and attributes.

The purpose of FDI for the home country is to target their international customers in their own country and make more profits out of it. That helps to save the transportation cost; sometime the availability of raw material reduces the exporting time and duty charges. Home countries also gets the benefits from the low labor cost that will lower their production cost, but the lower cost must also help the production some countries might have large low wages labor in their country but their ways might suit FDI production. To do FDI home countries also consider the other variables in the area of required labor. More overly foreign investors do FDI get more profitability by reducing the cost of production, transport cost and many other costs.

Host countries markets benefits from the FDI by learning the new methods of management and adopting new technology to use these techniques in their own productions and improve their productivity with lower host’s high techniques which will eventually raise their sales and profitability. More capital will be generated and spend in the economy, which gives the boost to a host in my ways like micro Marco economic, socio- economic and many other. It is also important for developing countries to make good policies for these investment for not to get involved in the inside activities of the country. That can be considered as the negative impact of FDI on the economy. By involving in the inside activities they can influence the government decision and turn it to get more favorable for them by affecting the countries income.

1.2 Definitions of Variables

ECONOMIC GROWTH

“Historically nothing has worked better than economic growth in enabling societies to improve the life chances of their members, including those at the very bottom.” (Rodrik, 2008)

“Economic growth occurs whenever people take resources and rearrange them in ways that are more valuable. A useful metaphor for production in an economy comes from the kitchen. To create valuable final products, we mix inexpensive ingredients together according to a recipe. The cooking one can do is limited by the supply of ingredients, and most cooking in the economy produces undesirable side effects. If economic growth could be achieved only by doing more and more of the same kind of cooking, we would eventually run out of raw materials and suffer from unacceptable levels of pollution and nuisance. Human history teaches us, however, that economic growth springs from better recipes, not just from more cooking. New recipes generally produce fewer unpleasant side effects and generate more economic value per unit of raw material…” (P. Romer, 2007)

“Economic growth is an increase in the production of economic goods and services, compared from one period of time to another. It can be measured in nominal or real (adjusted for inflation) terms. Traditionally, aggregate economic growth is measured in terms of gross national product (GNP) or gross domestic product (GDP), although alternative metrics are sometimes used.”("Investopedia," 2021)

FOREIGN DIRECT INVESTMENT (FDI)

“Foreign direct investment (FDI) is a category of investment that reflects the objective of establishing a lasting interest by a resident enterprise in one economy (direct investor) in an enterprise (direct investment enterprise) that is resident in an economy other than that of the direct investor. The lasting interest implies the existence of a long-term relationship between the direct investor and the direct investment enterprise and a significant degree of influence on the management of the enterprise. The direct or indirect ownership of 10% or more of the voting power of an enterprise resident in one economy by an investor resident in another economy is evidence of such a relationship. Some compilers may argue that in some cases an ownership of as little as 10% of the voting power may not lead to the exercise of any significant influence while on the other hand, an investor may own less than 10% but have an effective voice in the management. Nevertheless, the recommended methodology does not allow any qualification of the 10% threshold and recommends its strict application to ensure statistical consistency across countries.”

(*OECD Benchmark Definition of Foreign Direct Investment*, 2008)

“A foreign direct investment (FDI) is an investment made by a firm or individual in one country into business interests located in another country. Generally, FDI takes place when an investor establishes foreign business operations or acquires foreign business assets in a foreign company. However, FDIs are distinguished from portfolio investments in which an investor merely purchases equities of foreign-based companies.”

(James, 2020)

FINANCIAL DEVELOPMENT

“Financial development is part of the private sector development strategy to stimulate economic growth and reduce poverty. Overcoming costs incurred in the financial system. This process of reducing costs of acquiring information, enforcing contracts, and executing transactions results in the emergence of financial contracts, intermediaries, and markets. Different types and combinations of information, transaction, and enforcement costs in conjunction with different regulatory, legal and tax systems have motivated distinct forms of contracts, intermediaries and markets across countries in different times.”
(Filiz, Hasan, & Mehmet, 2015)

“Financial development means some improvements in producing information about possible investments and allocating capital, monitoring firms and exerting corporate governance, trading, diversification, and management of risk, mobilization and pooling of savings, easing the exchange of goods and services. These financial functions affect savings and investment decisions, and technological innovations and hence economic growth.”
(Çetin, Ecevit, Seker, & Günaydin, 2015)

These definitions will be used throughout this thesis

1.3 Objectives/Aim of the Study

The main objective of this thesis is to investigate observe the influence of the economic growth of Pakistan by investigating the impact of FDI from 2009-2018.

The research explains in detail the empirical and theoretical framework and also the literature review from the previous research. It discuss the means and impact of FDI from different countries and world organizations.

The existing empirical studies and theoretical framework on Pakistan from different methodology and time period is also explained. It also mentions the brief history of Pakistan and weakness and strength of foreign direct investment.

It closely explains the relationship amid foreign direct investment and economic growth theories like, neoclassical and endogenous growth theory by mentioning the previous frameworks.

It also focuses on the financial development in Pakistan and how it advances the economic growth.

One of the objectives is also to explain the explanatory variable and how they are related to the dependent variables.

1.4 Research Question

1. To investigate the effect of FDI on Economic Growth GDP of Pakistan by using ARDL bound-test for the period of 2009-2018.

2. To investigate the relation between FDI and other variables such financial development has the effect on GDP that causes the economic growth in Pakistan

1.5 Research Hypothesis

H1: Foreign Direct Investment has a positive impact on the economy of Pakistan.
H2: Financial Development has a positive impact on the economy of Pakistan.

1.6 Limitation of the Study

There was some limitation while doing this research is that the data on the variables were not available so we had to use the proxy for the economic growth and for financial development. It is difficult to understand the context of the phenomenon.

For doing the investigation in more depth there were difficulties and limitation concerned with the difficulty of money constraint and time constraints.

1.7 Summaries of Chapters

CHAPTER ONE: Starts with the general introduction and definitions about the foreign Direct Investment and the economic growth. Furthermore the first chapter gives the brief explanation about the aim and objects of the research. It also mentions the research questions and hypothesis also states the scope and limitation and summaries of the chapters

CHAPTER TWO: Starts with the overview of Pakistan's economic growth and Foreign Direct Investment begins with the brief introduction about Pakistan and the main attraction and obstacles of foreign Direct Investment inflow in Pakistan.

CHAPTER THREE: Starts with the theoretical literature review and framework of the study. Furthermore it consists of empirical studies of FDI and GDI overview and about Pakistan.

CHAPTER FOUR: Is about methodology that consists of Research design, Research Data and briefly explained ARDL econometric methods that are used in this investigation.

CHAPTER FIVE: Includes the Results and the discussions of the result from descriptive statistic, unit root tests, ARDL and F-bound test for long run and bound test and for short run and ECM- Error Correction Model. Tests like Diagnostic, Normality and Stability are also included in this chapter.

CHAPTER SIX: Last chapter is about brief conclusions and recommendation to government of Pakistan.

CHAPTER TWO:

ECONOMIC GROWTH AND FOREIGN DIRECT INVESTMENT IN PAKISTAN

2.1 Introduction

In 1947 the Islamic Republic of Pakistan was born after the section broken from the Hindu majority. Which is positioned in the most traveled placed in the history. The ancient Indus Valley of the Middle East, settlements in the region, amid Khyber Pass, Himalayas, and Arabian Sea from some of the most traditional and oldest locations in the world.

The capital of Pakistan is Islamabad located in the South Asia with the population of 212,215,030 within the area of 796,095 SQ.KM.According to the data by the World Bank the population of Pakistan is 216,565,318 in 2019)

Pakistan is house to 220 million people by Purchasing Power Parity (PPP), Pakistan ranks 23rd largest economy in the world in 2017 according to data provided by bureau of statistics. Pakistan stands on 42nd rank in the matter of Nominal GDP.

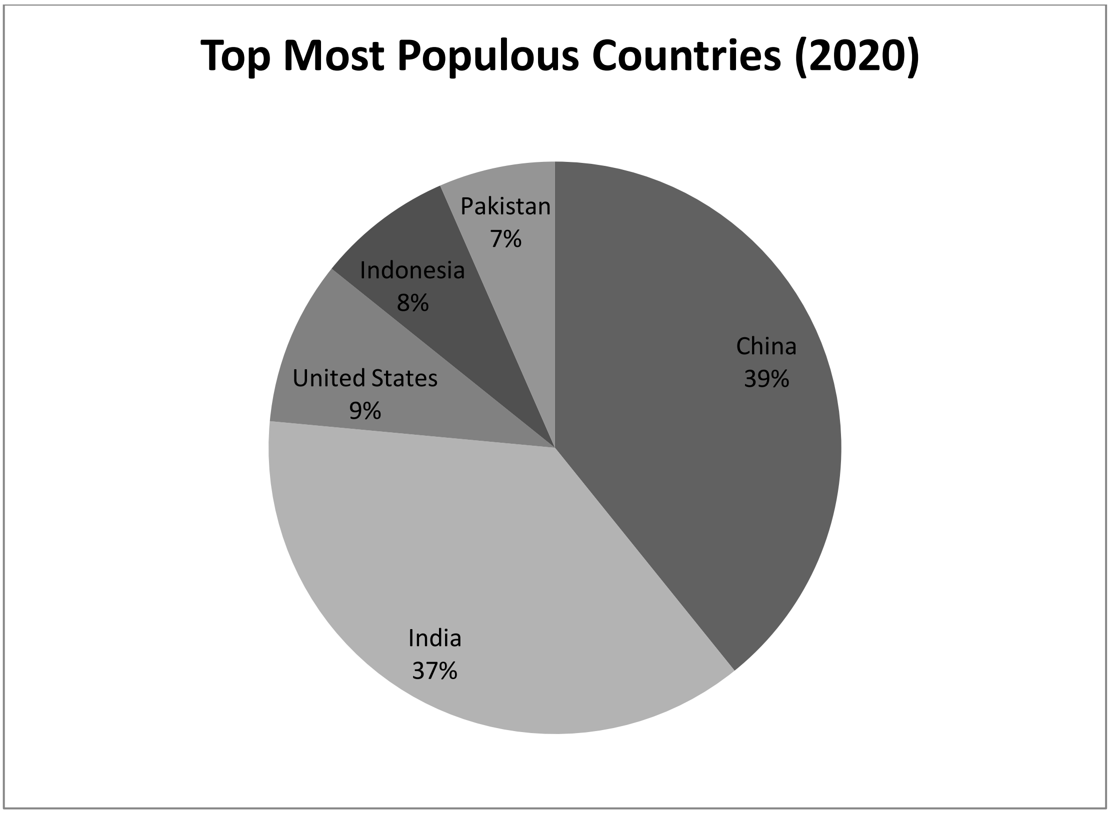

Figure 1: Top most populous Countries (2020)

Source:

International organization membership includes the United Nation the World Trade Organization and the International Monetary Fund's (IMF).In 2013 one of the largest investment in Pakistan deemed of $62 billion which is partnership between China and the name of the project is called China-Pakistan Economic Corridor (CPEC) the main object of the project is to modernize the Pakistan's infrastructure and economic sectors (U.S. News).

2.2 Economic Growth of Pakistan

Pakistan is a nation who is overcoming corruption, electricity shortage, overpopulation, poverty, illiteracy rate and debt, because of it Pakistan has to face lots of challenges like low tax income the mainly because of the high corruption no documentation the income generated by the population is very low. Due to low tax income Pakistan needs to takes loans and pay high interest rates.

Half of the loan and income from the country goes to pay loans and other half of it to the military of Pakistan that means there is few amount to be spend on the education, health, infrastructure and other sectors.

The main reason of tax corruption is that also that direct tax income is very low because of not proper registrations and legal documentation, but the indirect taxes like sales tax income is more as compared to the direct income. This means rich are not paying their part of share to the country and rich and poor are paying same amount. Big part of the GDP is also generated by the agriculture which is also facing the water crisis. Daily overly increasing population, resource extraction programs are not enough.

In order to examine a country's economic growth, GDP plays a key role. In term of monetary value of finished goods and services made within a country (Tayeb, 1992).

The independence Pakistan's main source of income was agriculture. In comparison with other nations Pakistan economic growth rate was remarkably high during the first 5 decades. In the report ease of doing business list 2020 provided by World Bank and international financial corporation (IFC), Pakistan rank is on 108 among 190 nations around the world. The top five nations were New Zealand, Singapore, Denmark, Hong Kong, and South Korea.

Since 1947, Pakistan has averaged 5 per cent annually, GDP growth rates were 6.8 per cent within 1960s, 4.8 per cent within 1970s, and 6.5 per cent in 1980s. Which is nothing less than achievement, despite of various bundles faced by Pakistan after independence GDP indicates the real improvement in economic growth in contrast with the other nations.

Figure 2 shows the GDP growth (annual %) of Pakistan from 1961 to 2019. The average percent between this period is 5.13 percent with the lowest percent of 0.47 and highest of 11.35 percent in 1970 that is the time when Pakistan was at its peak years before the war of 1971 with India, after that Pakistan most extraordinarily doing country hit its newest lows and has been struggling since then, the average of 2019 is 0.99 percent where the global average is 2.77percent.

The economic growth of Pakistan continued to reinforce. Progressed energy supply, investment correlated to the China-Pakistan Economic Corridor, influential credit development, and maintained speculator and consumer assurance, have been supporting development, which seem to reach 5.6 percent this fiscal year inside an affirmative inflation environment.

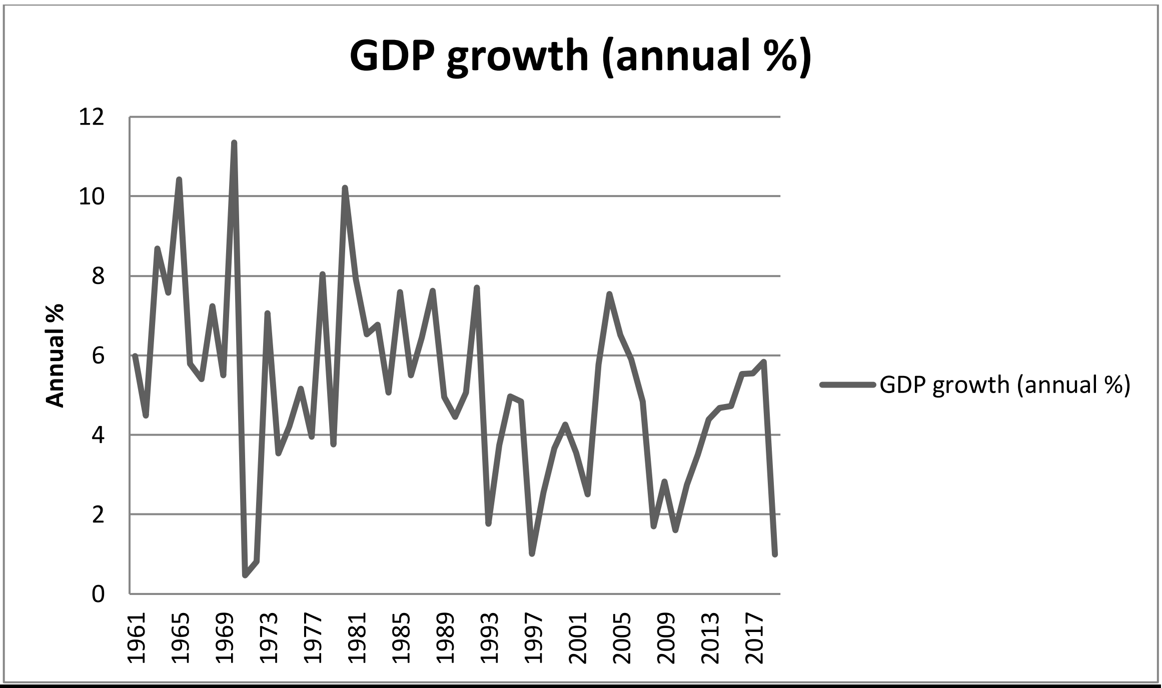

Figure 2: Pakistan: Economic growth: the rate of change of real GDP

(Source: The World Bank)

Economic increasing policies, Pakistan should reform the financial sector make policies and restrictions that make people save their money in the banks from where it can be charged legally. Pakistan should also encourage small and medium enterprises to register it so government can generate taxes from them Pakistan needs to boost its agriculture sectors, and attract more FDI industrialization in the country. Pakistan should add value to their raw material and export them rather than exporting raw material it will help Pakistan to decrease it current account deficits.

2.3 Foreign Direct Investment Inflow in Pakistan

At its most essential, economic trade over national borders has taken place for many hundreds of years. Besides, one of the foremost exceptional angles of economic life these days is the way in which all nations progressively discover themselves an essential portion of the global economy as reported by (Auerbach, 1996).

Pakistan, since coming into being, has been an impassioned supporter of open, straightforward, and rules-based multilateral exchanging framework and hence a originator constituent both of GATT and the WTO. In the developmental stage, different necessities like an assurance of early industry and strain of foreign exchange save constrained the pace of liberalization, the method within the genuine sense begun in the ’80s; it picked up energy since at that point. Annulment of permitting administration, evacuating restrictions on the stream of capital, and move to float trade rate instrument were a few steps in that direction.

Figure 3 shows the data of FDI inflow of Pakistan to its percentage of GDP. The is been taken from the World Bank during the period of 1970 to 2019, where the lowest average is -0.06 percent in 1973 after the war with India and highest of 3.67 percent in 2007. The average in 2019 is 0.8 percent as compared to the globally 97 nations is 4.17 percent.

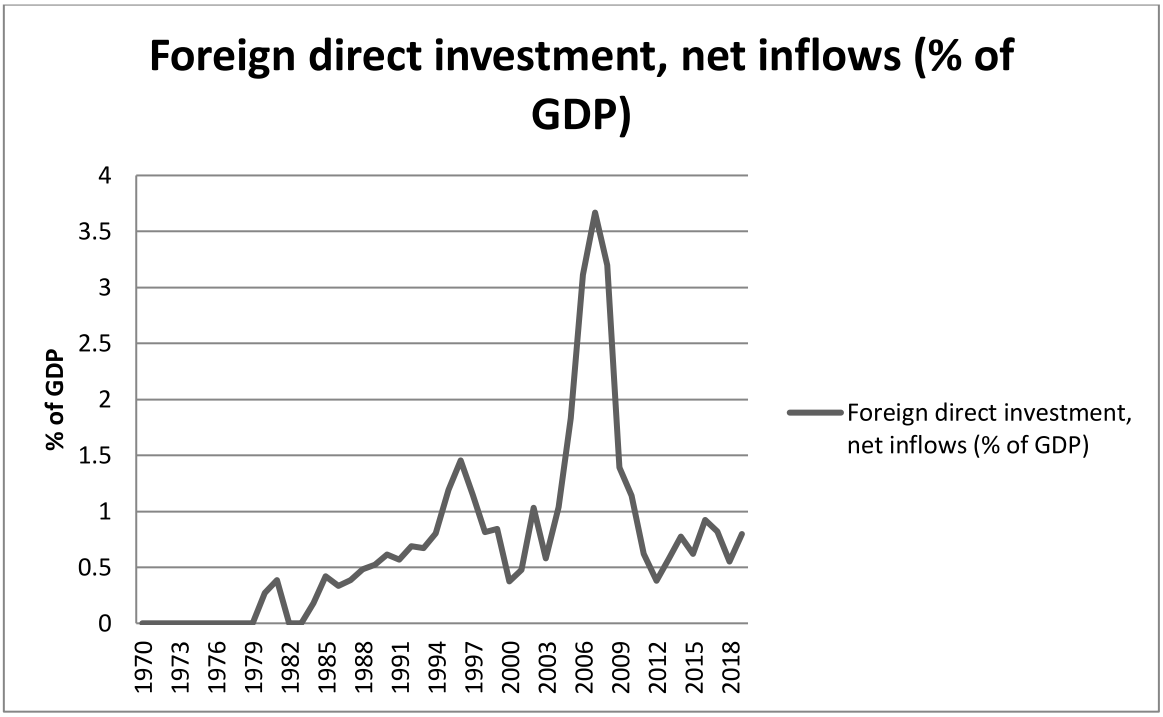

Figure 3: Pakistan: Foreign Direct Investment, percent of GDP

(Source: The World Bank)

Pakistan is a part of worldwide organizations, counting the United Nations, the World Trade Organization, and the International Monetary Fund. In 2013, the nation became part of the China-Pakistan Economic Corridor (CPEC), an organization with China that points at modernizing Pakistan's foundation and financial divisions. At up to $62 billion, this has been considered one of the biggest foreign investments in Pakistan (U.S. News).

The development of Pakistan the CPEC project the biggest FDI in Pakistan done by china will play an important role in the economic growth of Pakistan. This investment will not only benefit Pakistan but it is a corridor to the development of 170 countries more by taking advantages from the CPEC belt or roads. However, it is the biggest project in Pakistan and one of the biggest projects in world as well. The benefits initially will be seen in Pakistan which is employment, contractions of roads, metro buses, hotel, and electric plants etc.

In its first phase it has already impacted the Gawadar City of Pakistan by constructions of port, one belt road, electric plants, Gawadar International Airport, hospitals, hotels and has worked on the water supply of the city. Which are made for the businessmen and for tourists. The train tracks have been made to resolve the traffic issues that will speed up the supply of goods and services and save time for the travelers.

In its second phase it intends to attract more FDI through this investment Pakistan will attract more inflow of FDI. There is a great scope in the industrialization in Pakistan which Pakistan has not taken full advantage. Gulf countries like Saudi Arabia, Qatar, Kuwait and also Malaysia and America and many others have shown their interest to bring their FDI in the nation. These FDI will bring the capital inflow in the country that will generate the income for the government of Pakistan and will raise the living standard of the nation by providing new technology and decreasing the unemployment rate and will help to reduce poverty in the nation.

SUMMARY

Through my research I have come across that the fact there are several impact of FDI on a host country. Some of them are, resources transferred through the FDI which are technology, capital and management. For the Emerging country like Pakistan it can be very beneficiary, it can take advantages from these by modernization and new and more advanced ways of managements. Some of the direct and indirect effect from the employment can also be seen as the benefit of FDI in the host developing country, that are it employs numerous people from the host country that decreases the level of employment families gets wages to invest and their contribution in the economy raises the economy of the host country it is known as a direct effect from the FDI. The indirect effect is that when these investments start investing in the local market of the host country. Direct and indirect impact of Employment effect from the FDI influences the living standard of the host country.

It also brings the healthy competition to the market which helps in advancement in innovations that then in results helps the prices to go down because of the competition in the market by pushing producers to make more products with new technology and budgetary to them and for their customers.

It comes with its own disadvantages as well which most of them can be seen in the long-term developing nations like Pakistan are eager to attract FDI in their nation must also consider its long-term downsides. As it benefits the local market by bringing the competition to it, it also be the threat to domestic small businesses. Small local business may not be able to face FDI competition and might go bankrupt. By purchasing the lands and properties in host country they also raise the prices of it this can be good for people who already owns it but not good for new companies and individuals who were willing to buy these lands and properties. One of its downside can also be that the importing buy transferring the price, it can be very hard to keep a track of FDI. One of the biggest threat we can say that it can be threat to the political sovereignty of the host country, because of the big size of FDI it tends to bring international power with it by getting favorable tax incentives and subsidiary policies, that eventually reduces the government income. With the international power they can influence the political decisions in the host developing country.

All these has a negative impact on the host country especially developing countries like Pakistan with the few practice of Human Rights, Environmental laws it can be hazard to the pollution of the developing host nations they do the extraction without setting renewal programs of the natural resources.

2.4 Financial Development in Pakistan

“banks are the happiest engines that ever were invented for creating economic growth”-Alexander Hamilton (1781)

According to the State Bank of Pakistan annual report 2015, part of private division credit in advancing investments and economic movement can barely be over-emphasized in a developing nation like Pakistan. As in a bank-dominated monetary segment, commercial banks are a primary source of subsidizing for private division businesses; the bank-credit-to-GDP proportion in this manner gets to be one of the key pointers that fittingly captures the importance and significance of credit in economic activities. With macroeconomic steadiness, enhancement in security circumstance, the government expanded center on advancement ventures (in specific arranged venture beneath the China-Pakistan Economic Corridor), and generally good faith on Pakistan gives a culminate environment for private segment to require off, and push GDP growth to a greater trajectory. In the event that adequate supply of stores is made accessible and banks diversify their loaning, at that point credit-to-GDP proportion would move forward impressively in coming years.

As (Lall, 2001) argues that high skills like engineering and technical skills helps to in increase the FDI in the country. It attracts the technology intensive investment, for example East Asian countries. How they have attracted and benefited from the FDI. Pakistan should also focus on the high technical skills and promote more technical education.

Shahid, Saeed, and Tirmizi (2015), the financial sector and growth of economy is connected to each other. For the growth of economy it is important for a country to have a well-organized and well-functioning financial system. Financial sectors are 85%-90% of the bank accounts of Pakistan. Through their research they found that for the advancement and economic growth of Pakistan there should be solid banking framework.

The condition of Pakistan's financial system is that it is still on its developing stage financial markets of Pakistan includes of types of financial markets that includes money market and capital market. Furthermore these markets are categorized into two categories according to their function that is primary and secondary functions.

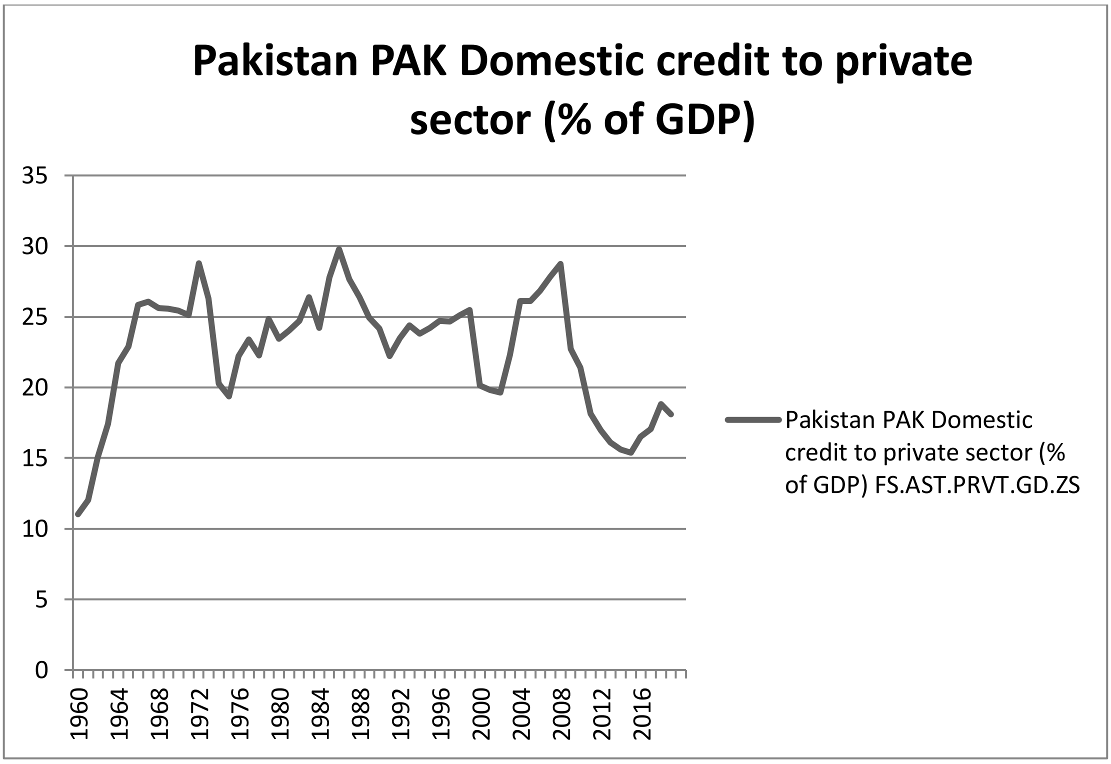

Figure 3: Domestic Credit to Private Sector of Pakistan, percent of GDP

(Source: International Monetary Fund , International Financial Statistics and data files, and World Bank and OECD GDP estimates.)

The role of financial system of Pakistan is to turn its short term liabilities into long term investments. By smoothing the consumptions that helps people to save and have productivity increasing the savings that help benefit the development.

The growth in financial development helps countries to collect the money from the individuals which they are not using and invest in the productivity for profits. More savings means more money to lend and more tax is generated. Developing nations like Pakistan does not even have 20 percent people put their savings in the banking system. It is said that Pakistan is a poor nation with the rich individuals and army. Development of financial sectors will increase the positive impact on the economy. Many economic empirical investigations provided the evidence of the impact of financial development to be significant and have positive effect on economy. One of the reasons for the backwardness of the economic growth is that its financial system is not helping the poor people it is only helping the rich individuals and most big corporations.

The economy will grow if they make policies and attract the saving from all of the individuals in the nation. By getting saving system will loan money to more individuals and medium and small size corporation which will create jobs, taxes will be generated and will raise the per capita income which will help country to reduce its poverty and unemployment.

2.5 Factors Impacting FDI in Pakistan

According to the third issue of the south Asia economic report (SAER), the principal key messages of this third SEAR are that there's a great development track in south Asia. The key components required for sustainability is the FDI for the financial development within the locale. The endeavors made by the region to the liberalization of its approaches that have made the increment within the influx have been increment. The FDI is still under as compared to the other creating locale of Asia. The most obstacles in affecting the FDI are the powerless trade environment. Other than that South Asia has extraordinary openings to extend the FDI within the locales and the recognition of the foreign ventures is growing more positive. Macroeconomic and political steadiness, appropriate policy and administrative systems, framework advancement, accelerated advancement of small and medium-sized ventures, change within the quality of neighborhood laborers, and upgrade of the territorial association are all required to assist advancement of FDI in South Asia (ASIAN DEVELOPMENT BANK, 2008).

2.5.1 The Main Attraction of FDI Inflow in Pakistan

According to the World Bank report on doing business Pakistan was ranked 108th position, 28 positions up from the 2019 that is mainly because of the improvement in the power supply.

According to (Import Export Solutions) some of the main attractions of FDI inflow in Pakistan are:

2.5.1.1 Huge Domestic Market

The main strength of FDI in Pakistan is because it has a big domestic market with a populous of 212.2 million (2018) according to World Bank. There is a stronger middle class and also a decreasing level of poverty. Buyer's with developing salaries moving to modern utilization habits.

2.5.1.2 Inexpensive and Abundant Workforce

There is a very low priced workforce available which exists in large quantities, that gives an appropriate establishment for business development, due to Pakistan's youthful, energetic and talented workforce with bilingual abilities.

2.5.1.3 Government Policies

The government policy makers of Pakistan have preceded along FDI attraction policies by guaranteeing the equal treatment between foreign investor and domestic investors. The policies are modified by opening up other economic sectors to FDI and by gathering domestic financial resources to promote investment (IPTU, 2011).

(U.S. DEPARTMENT of STATE) “The legal protection is given to the foreign investors and investment in Pakistan by the law of, The Foreign Private Investment Promotion and Protection Act, 1976, and the Furtherance and Protection of Economic Reforms Act, 1992.”

“Incentives introduced through the 2015-18 Strategic Trade Policy Framework (STPF) and Export Enhancement Packages (EEP) remain in place. These incentives are largely industry-specific and include tax breaks, tax refunds, tariff reductions, the provision of dedicated infrastructure, and investor facilitation services.”

2.5.1.4 Local Business Environment

This covers numerous variables, counting the accessibility of local legal counselors, secretarial services, accountants, architects, and building contractors, nearby experts, etc.—all needed both before and amid the life of a project.

2.5.1.5 Natural Resources

(Ali & Gang, 2016)Pakistan has great economic and investment potential because she is enrich with natural resources like coal, natural gas, vast irrigation system and green lands, copper, iron, gold and salt mines, forests and mountains, deep sea, four weathers, good infrastructure and institutions

2.5.2 The Main obstacles of the FDI inflow in Pakistan

Due to Pakistan's unsecure environment it is behind India in gaining the trust in the international market it cannot break-even with Sri-Lanka. Foreign Investors, needs stability and manmade resources like electricity, water supply etc. Pakistan lacks to offer these resources to FDIs. (Nordea, 2020).

Some of the main obstacles of FDI inflow in Pakistan are:

2.5.2.1 Security Issue

Security uncertainty foreign investors hesitating to invest in Pakistan and same time the domestic investor were taking out their capitals from the country. After 2013, when government of Pakistan and Pakistan army took serious actions against terrorism for making investment environment favorable and reviving economy of Pakistan and those actions have improve country's security conditions, foreign capital inflows and economic conditions. It is improving gradually but still it is one of the obstacles for FDI in Pakistan (Ali & Gang, 2016).

2.5.2.2 High Degree of Corruption

Besides other components deciding net FDI, corruption moreover gravely influences internal FDI to any nation. Corruption is a genuine economic, social, political, and ethical disease, especially in numerous developing nations. It may be an issue that influences companies, especially in international commerce, finance, and technology transfer. It is getting to be a universal event in scope, substance, and results (Argandoña, 2007)

CHAPTER THREE:

THEORETICAL AND EMPIRICAL STUDIESREVIEW

3.1 Theoretical Literature Review

The impact of FDI on economic growth of any country is still open for discussion. Much research has been conducted on this. Some research suggests that there is a significantly positive relationship between FDI and economic growth (GDP) some found that there is a negative relationship. Some of the researchers went further and stated that the effect of FDI can be seen in the countries where policies and resources are helping them to increase for new inventions by making new connections.

(L. Alfaro, Chanda, Kalemli-Ozcan, & Sayek, 2004), Stated that the country is not able to take the full advantage of the FDI benefits due to the undeveloped domestic financial markets and human capital. According to (Iamsiraroj & Ulubaşoğlu, 2015) Government of the host country should make policies for the improvement and betterment of the conditions, to increase the inflow of FDI. By liberalization not only foreign companies will also be able to take full advantage of FDI. If the financial markets are not working well and international trade is not good FDI might increase in the growth but the benefits will not be noticed.

The theoretical impact of FDI on growth is discussed by(Moosa & Cardak, 2006), who directs the country's capability to procure the advantages of the investments. He claims that the effect on growth is profoundly subordinate on the macroeconomic policy functioning within the nation of interest. He finds that FDI can have an assertive influence on growth, on the off chance that excess resources can be ingested or capability expanded through reallocations.

According to the research conducted by (Mansfield & Romeo, 1980), In their research they have mentioned that FDI is the easiest way to transfer the technology to the developing countries. Countries like China has taken most advantages from it and the inflow of FDI has helped China in many ways by increasing the per capita income, which is one of the direct employment effect of FDI on a host country. The article also mentions that FDI benefits both home and host countries. Home countries benefits, by low production value, large market of customers willing to spend their incomes, and also the low wages labors. In conclusion, research stated that to make a nation full of technology and with new innovations and more advanced way of management FDI is a fastest track and its impact can be seen through the GDP of the nation to understand the estimation of its economic growth.

Some of the researches like (Durham, 2004), found that the FDI can have negative influence on the emerging nations. The time series data was selected from the 80 developing nations and results were insignificant and states that FDI is impacting the economy of these nations in a negative way. Research also states that to take the advantage from the FDI country must have some well developed precondition and potential to understand its benefits, that how and in what ways it can be affective for the economy.

3.2 Theoretical Framework

Figure 4 illustrates the relationship between the variables, Economic Growth as the dependent variable and, FDI and FD as independent variables. This is the basic theoretical framework for this research.

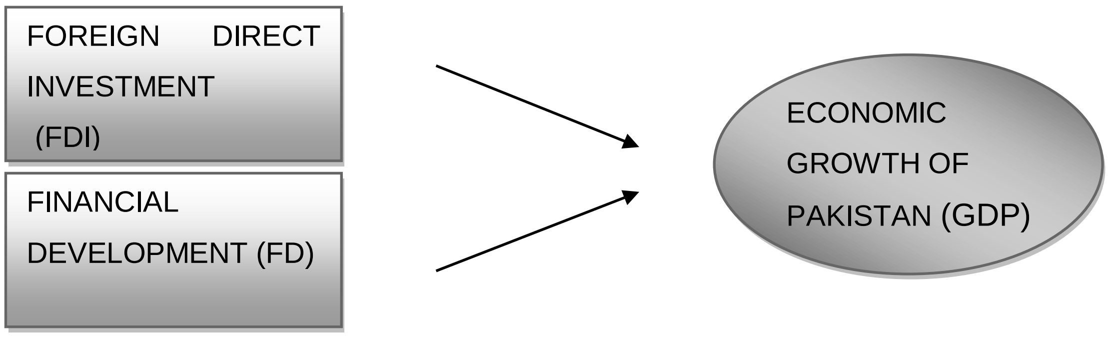

Figure 4: Theoretical framework of the study

Growth has proceeded on several levels of abstraction of model constructing and theorizing. Some of the explanatory values are negligible because of that the work is of little practical value. Researches like that however may help other work to understand the growth procedure. Some models while being the realistic may not be helpful or applicable to all economies (Cornwall, 2018).

Neoclassical Growth Theory the theory was introduced by the Robert Solow and Trevor Swan in 1956. There are three driving force of economic growth of neo classical theory which is labor, capital and technology .Furthermore they have stated that the economy has limited labor and capital but the contribution to economic growth from technology is boundless.

The theory contends that the technological improvement has a vital influence on economic growth and it is not possible to have development in economy of a country without the technological advancement. The theory also indicates that the short term equilibrium is different from the long term equilibrium. Which means the impact of three factors Labor, capital and technology can only be seen in short term not in long term.

The theory also argues that the collection of the capital inside the economy and how that capital has been utilized by the individuals plays a vital role for economic growth. Furthermore, the connection between capital and labor of an economy is directs the output. In last technology is consider increasing the labor productivity and augments the output skills of labor.
Consequently, the production function of neoclassical growth is utilized to estimate the growth equilibrium of economy (BANTON, 2020).

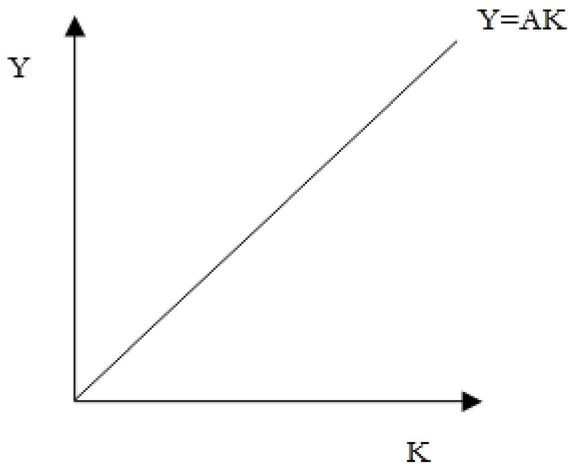

Figure 5: Production function with constant marginal product of capital

That function is:

$$Y = AF(K, L)$$

Where,

Y= Economy’s Gross Domestic Product (GDP)

K= Share of Capital

L= Amount of labor in economy

A= Determinant level of technology

(De Jager, 2004)Clarifies that FDI brings the advancement in the technology which helps in improving and increasing the labor and capital productivity of outcome which furthermore leads to the steady returns on the investments and makes labor grow exogenously.

The neo-classical growth models incorporate that for the duration of the evolving between secure states; exogenous saving rates, technology, technical advance, and populace development are since of higher growth levels (Solow, 1956).

Endogenous Growth theory, Contrast to neoclassical growth theory the Endogenous Growth theory by the economist Paul Romer argues that the economic process is especially the results of the interior forces instead of external forces. More precisely the event of country’s human capital will accelerate the economy to grow alongside the development of latest configuration of technology systematic and constructive means of production.

It also argues that more capital from the state and private sectors leads to faster innovation and more investment in human capital through advancement in productivity.

Furthermore the theory argues that the technology advancement can not only be by the exogenous factors. The theory proves that it can also be determine state’s government policies, along with investment in R&D and intellectual property laws, which will help the endogenous innovation and will be seen in economic growth (Hayes, 2019).

Nair-Reichert and Weinhold (2001) Contend that the new endogenous growth model takes long-run into account as the function of technological advancement. They offer the structure of framework where FDI rise in the economic growth via technology transfer, spillover effect and diffusion.

An endogenous growth model which is started by P. M. Romer (1986) and Lucas Jr (1988) declared that a lasting rise in growth rate depends on the suspicion of expanding capital and constant capital returns. Prior growth theories were based on the presumption of constant return to scales. But due to human capital (HC) headway and technological advancements, efficiency is expanding, which demonstrates that more investment in investigation and advancement (R&D) violates this presumption.

3.3 Empirical Studies

2.3.1 Previous Empirical studies on FDI and Economic Growth overview

Alfaro, Kalemli-Ozcan, and Sayek (2009), paper explained that the FDI on the economic growth and other FDI and financial markets supports each other and compliments to boost their influence on the economic growth. The development of FDI is interrelated to the financial system of the economy to see the full potential of FDI the country's financial markets must be at threshold level. Not only accumulation of factors like physical and human capital but well organized and developed financial system takes full advantages at its full potential from the FDI via Total Factor of Production.

Omran and Bolbol (2003), absorptive capacities mainly financial variables development is the precondition for the impact of FDI to be positive on the economic growth. At required threshold level of financial development will have conductively positive influence of FDI. On the economic growth of Arab countries, finally the study established that nations should make policies for liberalization of commerce. Policies for financial development should be made for approaching more FDI in the nation.

Sghaier and Abida (2013), they have conducted their research by using the Generalized Method of Moment (GMM) panel data analysis, by taking the four countries of North Africa which are Tunisia, Morocco, Algeria and Egypt. The data has been collected from the period of 1980-2011. The research has discussed the channels by which FDI has influences the economic growth of these nations. The study found that there is a well built relationship between FDI and economic growth and furthermore they found that to take full benefits from FDI. Countries financial development is the prime condition for FDI's positive impact on economic growth.

Azman-Saini and Law (2010), they have used the threshold regression model. They found that the FDI impact is only seen when the financial market development to its level of intensity.

Hermes and Lensink (2003)), to FDI to have positive influence on the economic growth, the development of the financial system of that nation is an essential condition. According to the empirical investigation financial development magnifies the influence of FDI and economic growth. This article is conducted their research 67 nations in Latin America and Asia, 37 countries in which are financial develop and have adequate financial system, which complements the effect of FDI on the economic growth.

Lee and Chang (2009), the annual data taken from 37 nations from the period 1970-2002, panel co integration and panel error correction models has been set. They found that in long-run relationship between the variables. FDI, FD and economic growth is very strong. They also found the FD has the more influence on the economic growth of these 37 nations. The findings of short-run are opposite to the long-run, as long-run relationship between variable is indubitable. In conclusion, they discovered the financial developed and foreign direct investment when they are linked together they emphasize the potential in progressively global economy.

Chee and Nair (2010), in their research they have shown that how the growth of the endogenous theory have the impact on the FDI and FD. In their empirical studies they have found how FDI and FD have the positive impact on the economy growth. By taking the sample of 44 Asian and

Oceania countries during the 1996-2005 they found that the contribution of the FDI on the economic growth is on its own, better the developed financial system boosts and encourages more FDI inflow in the country. They have also found that both variables compliment the economic growth. For the least developed countries the influence of this complimentary can be seen most in the growth of economy.

Choong (2012), by using the GMM panel data analysis has given well built evidence on the strong connection between FDI and the economic growth. The research has been estimated on the 95 developed and developing countries from 1983-2006. To favorable and advantages of the FDI the financial system of the countries must be establish, well sound to see the full effect of FDI and the economic growth of that country. The article also mentioned that nation should make advancement will benefit if to take all valuable impact of FDI a growth by increasing the economy.

Sirag, SidAhmed, and Ali (2018), the evidence from co integration results explained that in long-run although after the accounting for structural break, the existence of variables is there. In Sudan between 1970-2014 data taken annually, there is positive and significant impact of financial development and foreign direct investment on the economy of Sudan, which shows by evidence growth in it. Through financial development accomplishments can be seen from FDI on economic growth. The article also implicated that corporative environment must be promoted to enhance the FDI. For the estimation of long-run results Ordinary least squares and dynamic ordinary least squares techniques were used.

Sokang (2018) According to its literature review all of the previous studies have the evidence of the statistically significant and a positive influence on the economic growth on their in their respective research nation(s). Multiple analyses estimated that one unit increment in FDI raised the GDP of Cambodia by 7.500 in units. The outcomes of this research are very significant and show the positivity between FDI and GDP of Cambodia which is used as the proxy of the economic growth. Research was conducted by using the time series of 2006-2016 data and multiple regression techniques and correlation matrix were used for the estimation of the results.

Moudatsou (2003), stated in this paper includes an empirical assessment of the growth influences of foreign direct investment (FDI) within the European Union (EU) nations when measuring for other development determinants. Utilizing data over the interval 1980-1996, we received valuations of the development impacts of FDI for each nation in isolation and by combining the data for the entire Union. Country-specific estimates propose that growth determinants vary over EU members which as it were past FDI inflows have a significant impact on growth. Captivatingly, when data are pooled, the empirical outcomes appear that FDI features a positive impact on the growth rate of EU economies both directly and indirectly (through exchange support). Moreover, not at all like past empirical discoveries concerning developing economies, we gotten prove that the development impact of FDI isn't conditional upon the level of human capital in developed host nations.

Frimpong and Oteng-Abayie (2006), reported the consideration of the research is that there is no causality between FDI and growth for the full test period and the pre-SAP period. FDI be that as it may cause GDP growth amid the post-SAP period.

CHAPTER FOUR:

METHODOLOGY

4.1 Introduction

The study will investigate the impact of foreign direct investment on economy of Pakistan, along with other variable that would also affect the economy growth, the researcher will exert a statistical analysis on time series data of the period between (2000 – 2018), by the mean of E- views in order to obtain the econometric model that reflects the actual relationships between the proposed factors and the Pakistan’s economy growth which represent the gross domestic products (GDP).

4.2 Research design

The study is exploratory in nature by using the quantitative approach and running the econometric equations in Eview for ARDL method.

More adequately explanatory variables are selected for this research. Relationship between variable is that they all compliment each there and are interrelated to each other. For Foreign Direct Investment (FDI), Financial Development (FD) is the precondition for it to work at its full potential on the economic growth of Pakistan to get more high statistically significant results.

4.3 Research data

From the period of 2009-2018 for analyzing the outcome this time series and secondary data has been collected from World Bank and International Monetary Fund's (IMF).

4.4 VARIABLE DISCRIPTION

Table 3 Variable description and expected signs

VARIABLE	DISCRIPTION	EXPEXPECTED SIGN
GDP	Economic Growth	Positive
FDI	Foreign Direct Investment	Positive
FD	Financial Development	Positive

Source: Adapted from literature review Author's table

4.5 Descriptive Statistics

Descriptive statistic is used to analyze and understand the idea more precisely, that how the variables are distributed. It consists of mean, median, minimum, standard deviation, skewness, kurtos and jarque-bera statistic.

For mean is checked for the average value of the series. Median is the middle value of the series it can also be the average of two middle values. Min and max shows the minimum and maximum value. Standard deviation is shows the spreadness of the data. The value of 0 shows that skewness is normally distributed, if the value is positive it is considered to have right tail and vice versa. To understand it peakness, talliness or flatness of the distribution we look at kurtosis value. There are three types of kurtosis, mesokurtic, lepokurtic and platykurtic. If kurtosis is 3 it is considered as the mesokurtic the normally distribution of data, if it is less than 3 it is called platykortic and greater than 3 lepokurtic.

For testing whether the series is distributed or not we look at that jarques-bera test and understanding more about it statistically. For testing the normality of the distribution of the series null hypothesis is considered to be the normality of distribution of variables. Alternative hypothesis is considered for no normality in the distribution of variables.

Std. Dev. (standard deviation) equation:

$$s = \sqrt{\left(\sum_{i=1}^{N} (y_i - \bar{y})^2\right) / (N-1)}$$

Where:
N: # of observations , ȳ: mean of series.

Skewness equation:

$$S = \frac{1}{N}\sum_{i=1}^{N}\left(\frac{y_i - \bar{y}}{\hat{\sigma}}\right)^3$$

$\hat{\sigma}$ is the standard deviation estimator based on biased estimator for the variance $(\hat{\sigma} = s\sqrt{(N-1)/N})$

Kurtosis Equation:

$$K = \frac{1}{N}\sum_{i=1}^{N}\left(\frac{y_i - \bar{y}}{\hat{\sigma}}\right)^4$$

$\hat{\sigma}$ Based on the biased estimator for variance

Jarque-Bera equation:

$$\text{Jarque-Bera} = \frac{N}{6}\left(S^2 + \frac{(K-3)^2}{4}\right)$$

Where S is skewness, and K is kurtosis.

.4.5 Model specification

For creating an econometric model for the study GDP proxy of economic growth has been taken as the dependent variable, for the independent variables FDI and Domestic Credit to Private Sectors (DCPS) as a proxy for FD.

GDP= F (FDI, FD)

The following multivariate regression model based on OLI theory by

(Dunning, 1993)(Dunning, The eclectic paradigm as an envelope for economic and business theories of MNE activity, 2000), and also used by prior studies including Mohamed and Sidiropoulos (2010); and Peres et al. (2018) is used and can be written

To adopt the econometric shape the equation will be expressed as

$$\text{GDP}= \beta_0 + \beta_1 FDI + \beta_2 FD + \varepsilon$$

Where:

GDP=	Gross Domestic Product proxy for Economic growth
FDI=	Foreign Direct Investment (% of GDP)
FD=	Domestic Credit to Private Sectors (% of GDP) proxy for Financial Development
ε =	Error term

β_0 Represents a constant term, slope and coefficients parameters to be measured are represented by β_1 andβ_2.

4.4 Econometric Methods

Firstly time series data has been checked for the stationarity of the data for this research then, Autoregressive-Distributed Lag (ARDL) bound tests are conducted to check the significance of the variable in long run and short run. Finally, diagnostic test were run to checked normal distribution of the data.

4.4.1 ADF Test for Unit Root

Dickey and Fuller (1979) Augmented Dickey Fuller test is known as the ADF test it has been used to know the sationarity and non-stationarity of the time series. The design of stationarity goes around the idea of steadiness or it being constant. There is no independence in time series. For the creation of model stability and its constistency it required. Stationarity can be strong or weak but it does not implicit that if there is a strong stationarity there is a weak stationarity. For stationarity to be weak finite variance is required which are not found in strong variables, they are bit of a complex.

The stationarity of data is required for the forcastation of the data. Some of the data are non stationarity in nature. For its stationarity mean and variance of time series should be constant for its stationarity. ADF unit root test is performed by testing it on different levels, intercept trend and intercept or none to include in the equation by lag length to be Akaike Into Criterion AIC and selecting max lags. To look at its stationarity absolute values are considered not the negative values. More tests were performed at different level to reject the null hypothesis. For rejecting the null hypothesis the ADF test must be higher than absolute critical value at 5% level. By rejecting the null hypothesis series is considered to be as stationary.

The Dickey-Fuller test can be estimated after both sides subtracted by $y_t - 1$

$$\Delta y_t = a y_{t-1} + x_t^{'} \delta + \epsilon_t$$

We can write the null and alternative hypotheses as:

Where $\alpha = p - 1$

$$H_0: \alpha = 0$$
$$H_1: \alpha < 0$$

Estimate by using the traditional t-ratio for :

$$t_\alpha = \hat{\alpha}/(s\epsilon(\hat{\alpha}))$$

Where, α is the estimation of $\hat{\alpha}$ and coefficient Standard Error$s\epsilon(\hat{\alpha})$

4.4.2 ARDL Bounds Testing Approach for Co integration

Auto regressive distribute lag model (ARDL) the model consist of the dependent variable's lagged value(s), as the explanatory variable the current and lagged value of regressor. Combination of variables like exogenous and endogenous are utilized for the ARDL model.

For specification of the model integration of variables to, be of different orders. Amalgamation of the variables by I/(1) and I/(I) order of integration. Testing of the stationarity is prime requirement that ascertain of the integration of order 2 in no variable.

Stationary at level first can also be used if the integration of variable is order one, ARDL model can be used in this case also, when the variables are co integrated.

The advantage of using ARDL model is that is can be utilized even when there is a case of small and finite sample size. This technique is applied to estimate the unbiased long-run.

Basic ARDL regression model:

$$y_t = \beta_0 + \beta_1 y_{t-1} + \ldots\ldots + \beta p y_{t-p} + \alpha_0 x_t + \alpha_1 x_{t-1} + \alpha_2 x_{t-2} + \ldots + \alpha_q x_{t-q} + \epsilon_t$$

ϵ_tIs the random disturbance term

4.4.3 Diagnostic Tests

We check for autocorrelations by applying the diagnostics, which includes serial correlation, Heteroskedasticity and normality. Breusch-Godfrey is used for serial correlation Lagrange Multiplier test, which includes the presences of serial correlation by testing them as they are not included in the model structure proposed. The statistical model Autoregressive Conditional Heteroskedasticity (ARCH) is utilized for the analyzation of the volatility in time series for forecasting future volatility. To test the goodness and the normality of the model, the Jarque-Bera (1987) has been used.

CHAPTER FIVE:

RESULTS AND DISCUSSION

Introduction

The chapter represents the results and discussions of the study. The chapter includes descriptive statistics, unit root tests, ARDL and F-bound tests, diagnostic tests, normality test, and stability tests to demonstrate the reliability of the proposed model.

5.1 Descriptive statistics

Table 1 illustrated the descriptive statistics summary of the variables. Descriptive statistics help to get a clear understanding of the economic variables prior to estimation.

Table 4: Descriptive statistics

The descriptive statistics include mean, median, maximum and minimum of the variables. It also includes Jarque-Bera test for normality values. The results of the descriptive statistics show that the mean of GDP of Pakistan from 2009-2018 is $5.3 Billion. The mean of FDI is 21.7 Billion for period 2009-2018. The mean of FD for period 2009-2018 is 28.6 Billion.

Table4: Descriptive statistics

	GDP	FDI	FD
Mean	5.037789	21.7690	28.6238
Median	5.675381	20.9480	26.6650
Maximum	11.61793	39.8760	50.4000
Minimum	-6.008884	12.8630	10.6100
Std. Dev.	4.107604	68.89848	12.2245
Skewness	-0.917727	0.648804	0.242420
Kurtosis	3.884290	2.631712	1.797174
Jarque-Bera	8.993532	3.942078	3.644032
Probability	0.011145	0.139312	0.161699
Sum	261.9650	11375.99	14852.44
Sum Sq. Dev.	860.4928	242097.0	774398.0
Observations	52	52	52

1. Unit Root Test

The Unit Root Test was applied to demonstrate co-integration among the variables and the results are presented in Table 2.

Table 2: Unit Root Test

AIC criterion was used to select the lag length of ADF. Maximum lag length was determined as. *, **, *** are statistically significant at level 10%, 5%, and 1% respectively. The GDP was significant at level but the independent variables FDI and FD were not stationary at level. However, the variables GDP, FDI and FD were observed to be stationary at first difference.

	At Level			
		GDP	**FDI**	**FD**
With Constant	t-statistics	-3.4463	3.5808	1.8874
	Prob.	***0.0139***	***1.000***	***0.9998***
		**	no	no
With Constant & Trend	t-statistics	-3.3712	5.9147	-1.9619
	Prob.	***0.0672***	***1.0000***	***0.6075***
		no	no	No
Without Constant & Trend	t-statistics	-2.1008	3.3888	11.5064
	Prob.	***0.0354***	***0.9997***	***1.0000***
		**	no	no

	At First Difference			
		D(GDP)	D(FDI)	D(FD)
With Constant	t-statistics	-4.7674	3.4525	-6.7519
	Prob.	***0.0003***	***0.010***	***0.034***
		***	**	**
With Constant & Trend	t-statistics	-4.7018	2.4785	-7.2489
	Prob.	***0.0023***	***0.0010***	***0.020***
		***	***	**
Without Constant & Trend	t-statistics	-4.7992	2.3930	-0.673905
	Prob.	***0.0000***	***0.025***	***0.049***
		***	**	**

5.3 Auto Regressive Distributed Lag (ARDL)

ARDL model was employed for estimating co-integration among the economic variables of the proposed study. ARDL is used for spurious and non-spurious regression in the time series data. The optimal lag lengths for the model were determined through AIC criterion. The ARDL model shows that 2,1,1,2 are the optimal lag lengths for the proposed model. The results of the ARDL model are shown in Table 3.

Table 6: ARDL Model

Dependent. Variable: GDP

Model: ARDL

Selected model: ARDL (2, 1, 1, 2)

Variable	Coefficient	Std. Error	t-Statistic	Prob.*
GDP(-1)	1.093561	0.103009	10.61617	0.0000
GDP(-2)	-0.295530	0.112702	-2.622214	0.0123
FDI	-0.121769	0.082181	-1.481715	0.1463
FDI(-1)	-0.239461	0.118927	-2.013508	0.0508
FD	0.032726	0.037176	0.880291	0.3840
FD(-1)	0.090177	0.044622	2.020930	0.0500
FD(-2)	-0.164371	0.048623	-3.380533	0.0016
C	8.032507	2.284868	3.515523	0.0011
R-squared	0.919125	Mean dependent var		4.948014
Adjusted R-squared	0.900928	S.D. dependent var		4.165003
S.E. of regression	1.310967	Akaike info criterion		3.556263
Sum squared resid	68.74535	Schwarz criterion		3.938668
Log likelihood	-78.90658	Hannan-Quinn criter.		3.701885
F-statistic	50.50976	Durbin-Watson stat		1.935441
Prob(F-statistics)	0.000000			

*Note: p-values and any subsequent tests do not account for model selection

1. Long Run and Bound Test

To determine if there is any long-run relationship between the GDP, Foreign direct investment and financial development, bound tests were conducted with the quarterly data. The long-run and bound test results are presented in Table 4.

Table 4: Long-run test

ARD Long. Run Form and Bounds Test
Dependent. Variable: D(GDP)
Selected. Model: ARDL(2, 1, 1, 2)
Case 3: Unrestricted. Constant. and No. Trend
Sample: 2006Q1 2018Q4
Included observations: 50

Conditional Error Correction Regression

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-8.032507	2.256438	3.559817	0.0010
GDP(-1)*	-0.201969	0.052587	-3.840683	0.0004
FD(-1)	-0.041468	0.023917	-1.733817	0.0907
D(GDP(-1))	0.295530	0.122246	2.417505	0.0203
D(FDI)	0.197555	0.066961	2.950289	0.0053
D(FD(-1))	0.164371	0.052735	3.116952	0.0034

* p-value incompatible with t-Bounds distribution.

The results show that there is a long-run relationship among the dependent and independent variables. The results show that the both independent variables have a relationship with GDP in the long-run at lag 1.

Table 5: F-Bounds Test

F-Bounds Test		**Null Hypothesis: No levels relationship**		
Test Statistic	**Value**	**Signif.**	**I(0)**	**I(1)**
			Asymptotic: n=1000	
F-statistic	8.895980	10%	2.72	3.77
K	3	5%	3.23	4.35
		2.5%	3.69	4.89
		1%	4.29	5.61
Actual Sample Size	50		Finite Sample: n=50	
		10%	2.873	3.973
		5%	3.5	4.7
		1%	4.865	6.36
		Finite Sample: n=50		
		10%	2.57	3.46
		5%	2.86	3.78
		1%	3.43	4.37

The results show that F-bound statistics is 8.89 that is higher than the Upper Bound Critical value of 4.3 at 5% level. Hence, the null hypothesis of no co-integration will be rejected. Thus, the F-statistics show that there is a long-run relationship among economic growth, foreign direct investment and financial development during the time 2009-2018 in Pakistan.

5.5 Short Run and ECM – Error Correction Model

ECM that is Error Correction Model from ARDL was used to investigate if there is any continued existence of co-integration among GDP, Foreign Direct Investment and Financial Development. The results of the ECM show that only FDI has a relationship with GDP in the short-run whereas, financial development has only long-run relationship with GDP but not in the short-run. The coefficient of FDI is

1. **Error Correction Model Regression**

Table 6 ARDL Error Correction Regression

ARDL Error Correction Regression
Dependent Variable: D(GDP)
Selected Model: ARDL(2, 1, 1, 2)
Case 3: Unrestricted Constant and No Trend
Sample: 2006Q1 2018Q4
Included observations: 50

ECM Regression
Case 3: Unrestricted Constant and No Trend

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	8.032507	1.563636	5.137068	0.0000
D(GDP(-1))	0.295530	0.103971	2.842434	0.0070
D(FDI)	0.197555	0.048730	4.054090	0.0002
D(FD(-1))	0.164371	0.043550	3.774295	0.0005
CointEq(-1)*	-0.201969	0.032655	-6.184878	0.0000

R-squared	0.642137	Mean dependent var	-0.166426
Adjusted R-squared	0.592202	S.D. dependent var	1.980000
S.E. of regression	1.264409	Akaike info criterion	3.436263
Sum squared resid	68.74535	Schwarz criterion	3.703946
Log likelihood	-78.90658	Hannan-Quinn criter.	3.538198
F-statistic	12.85961	Durbin-Watson stat	1.935441
Prob(F-statistic)	0.000000		

* p-value incompatible with t-Bounds distribution.

The error correction term is referred to the speed of adjustment. It represents the speed of converging variables for the long-run equilibrium after any shock. The results of the ECM show that the ECM is statistically significant at 5% level with a negative sign. This means that the variables are stable and converging for the long-run equilibrium. The ECM coefficient (-0.201) demonstrate the economy converge to equilibrium state in the long-run by 20.1% in the subsequent quarter.

5.6 Diagnostic Tests

Diagnostic tests were performed to analyze the performance of ARDL model in long-run for co-integration and short-run of the proposed research model. Diagnostic tests include serial correlation, heteroskedasticity and normality values shown in Table 7, 8 and 9 respectively.

Table 10:Breusch-Godfrey Serial Correlation LM Test:

Breusch-Godfrey Serial Correlation LM Test:

Null Hypothesis: No serial correlation at up to 1 lag

F-statistic	0.002911	Prob. F(1,38)	0.7490
Obs*R-squared	0.007546	Prob. Chi-Square(1)	0.6857

The results of the serial correlation show that there is no serial correlation among the variables as the P-value is greater than 5% level for the proposed model. Hence, the null hypothesis is accepted as there is no serial correlation among the variables.

Table 11Heteroskedasticity Test

Heteroskedasticity Test: ARCH

Null Hypothesis: Heteroskedasticity

F-statistic	0.655924	Prob. F(1,47)	0.4221
Obs*R-squared	0.674424	Prob. Chi-Square(1)	0.4115

The results of the Heteroskedasticity Test show that there is no Heteroskedasticity between the variables of the proposed model as the P-value is greater than 5% level. Hence, the model will accept the null hypothesis.

5.7 Normality Test

Figure 6: Normality Test

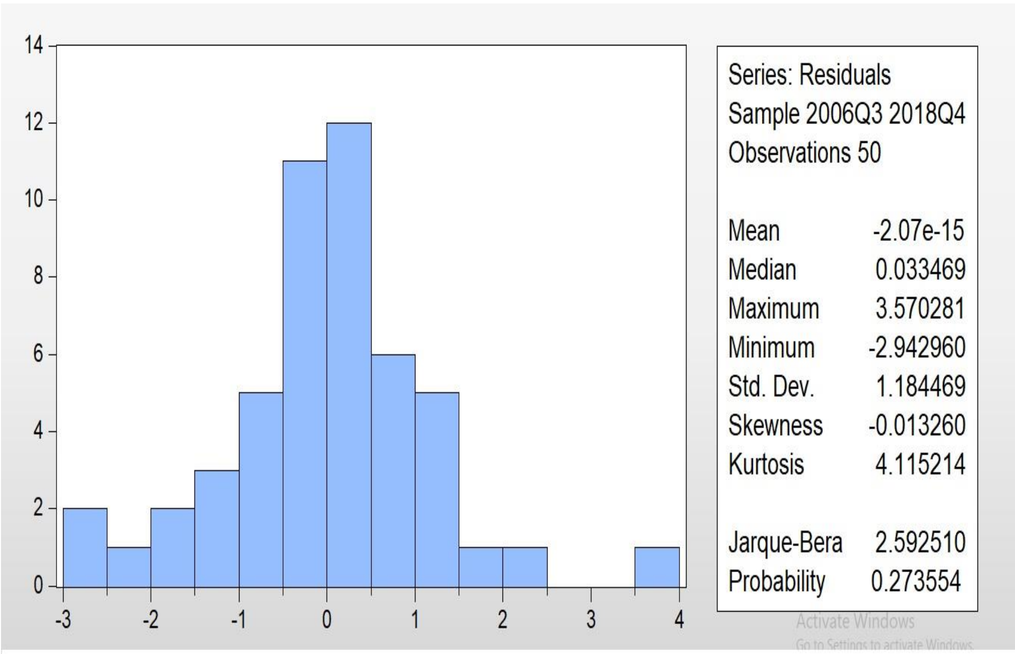

Figure 6: Normality Test

Furthermore, the probability of Jarque-Bera test is 0.29 which is greater than the 5% level. Hence, the null hypothesis (residuals are normally distributed) is accepted.

5.8 Stability Test

The stability of the proposed model was tested through CUSUM and CUSUMSQ tests as illustrated in Figure 2 and 3.

Figure 2: CUSUM

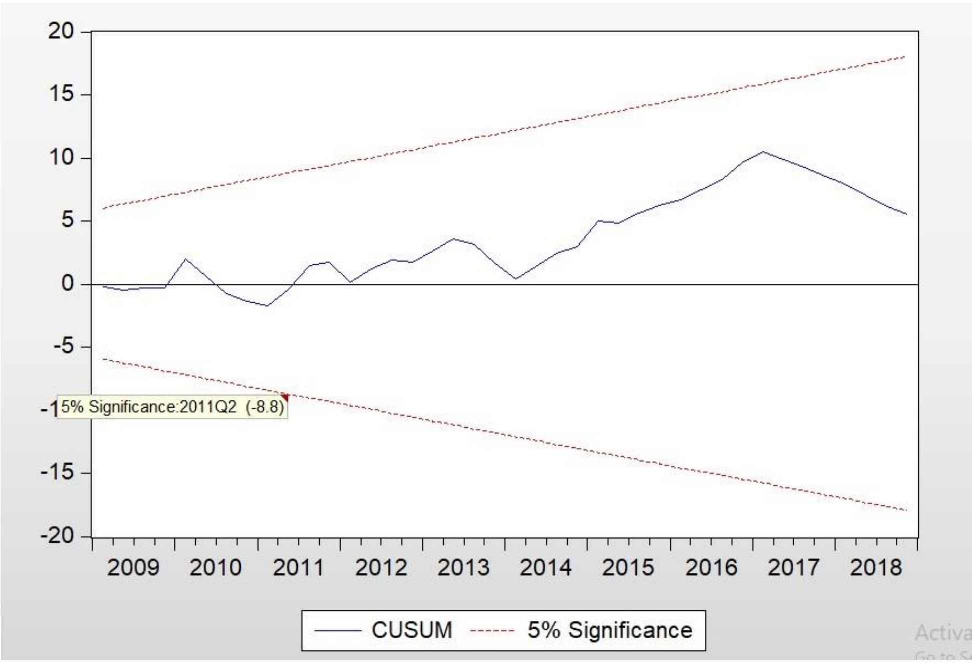

Figure 7: CUSUM

Figure 3: CUSUM of Square

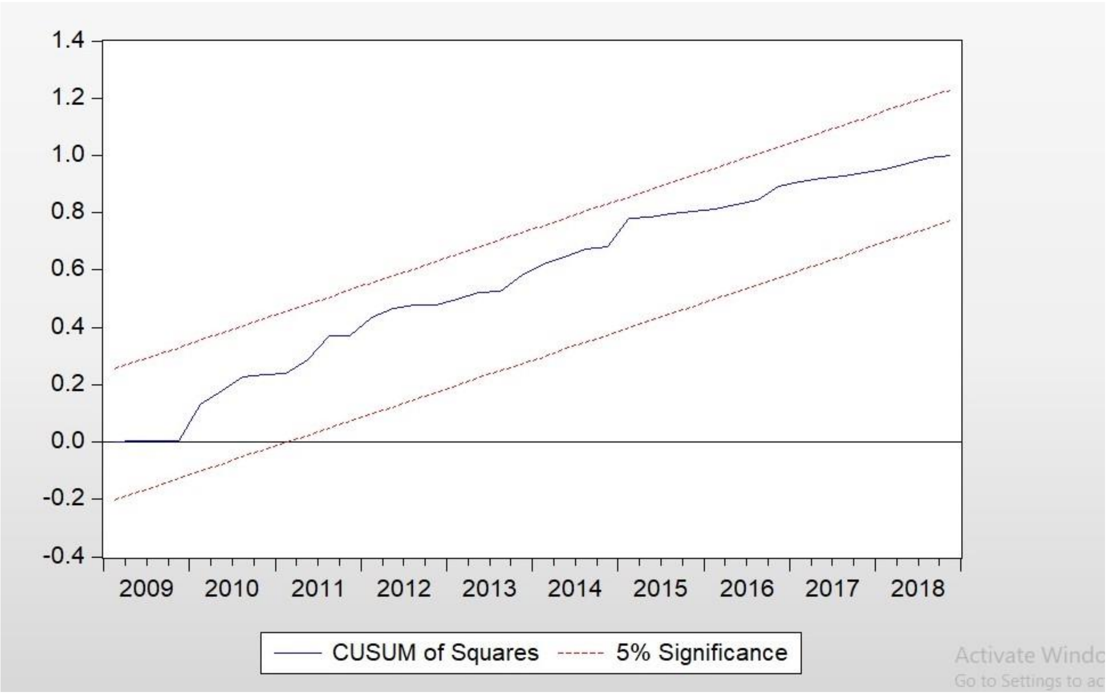

Figure 8: CUSUM of Square

The above stability tests show that ARDL model is stable as CUSUM and CUSUMSQ lines are within the upper and lower 5% level confidence bounds. Therefore, the results ensure that the short-run and long-run coefficients are stable for the ARDL model. There is no serial correlation, no heteroskedasticity as well as the residuals are normally distributed and the model is stable. Thus, it can be concluded that the model is reliable.

CHAPTER SIX:

CONCUSION AND RECOMMEDATIONS

6.1 Conclusion

In any developing country investments plays an important role in the economic growth. Direct investments are tending to have a positive impact on the economy by increasing its GDP which is also proved in the previous studies mentioned above in this thesis.

Long run relationship between dependent and independent variables have impact on GDP of Pakistan; one unit increase in FDI increases the GDP by 1.788 and FD increase in one unit GDP will increase by 0.205 units. The results ensure that the short-run and long-run coefficients are stable for the ARDL model.

The results of the ECM show that the ECM is statistically significant at 5% level with a negative sign. This means that the variables are stable and converging for the long-run equilibrium. The ECM coefficient (-0.201) demonstrate the economy converge to equilibrium state in the long-run by 20.1% in the subsequent quarter. There is no serial correlation, no heteroskedasticity as well as the residuals are normally distributed and the model is stable.

There's a positive relationship between FDI and GDP in Pakistan. The inflow of FDI in Pakistan is not so much significant but has generally grown considering Pakistan has embraced market-oriented policies.

Pakistan can make good policies and markets of Pakistan be more open-minded and welcoming it can help the country’s economy to grow and help Pakistan to adopt technology for its modernization. It can help speed up the work in construction, country’s administration system, education system and many other sectors.

6.2 Recommendations

The policy maker’s of Government of Pakistan should improve the domestic market in order to influence more foreign direct investment in Pakistan.

Even though Pakistan is rich in natural resources it has not achieved the requisite of the growth in its economy that is because of persist energy crises, political instability, and high illiteracy rate, war on terror, not existing the knowledge to drive the economy to its adequate success, corruption, not well constructed taxation structure and absence of sound governance.

Long term policies should be set by the policy makers to encourage the growth in Pakistan for example establishment of the modern financial institution and banking sectors.

Pakistan should introduce the market friendly environment for foreign investments. As stability attracts long term investments, Pakistan should make its political situations stable to attract more long term investments in the country.

Pakistan with a populace of more than 212.2 million (2018) may be an enormous market where the banking sector may present low-cost loan and venture plans to create more economic exercise in terms of more entrepreneurial enterprises, which are recognized as the spine for the socio-economic growth of the nation.

Financial development can boost economic growth by raising savings, promoting the assigned effectiveness of loan-able reserves, and increasing capital collection. In addition, a long arrangement of modern empirical investigations reveals that an variety of financial indicators is actively and positively related to economic growth (Gurley & Shaw, 1955).

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