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An Empirical Investigation on The Effect of Business Environment Factors on The FDI Inflows in Pakistan: The Moderating Role of Political Stability

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Abstract

This study has examined the moderating role of Political Stability (PS) on the relationships between microeconomic variables, business environment variables and the Foreign Direct Investment (FDI) inflows in Pakistan.This study confined to the annual data for the period from 1991 to 2011 obtained from the authentic sources.The empirical analysis involved using the ADF test to check the stationary of the data, the EViewssoftware and hierarchal regression using the SPSS statistical software package. The statistical results of the study confirmed that that degree of openness, the Labor minimum wage and Infrastructure were significant predictors of FDI inflows. On the other hand, other variables such as GDP growth rate and the rule of law were not significant in determining the FDI inflows in Pakistan.However, the GDP growth rate tends to be a significant determinant of FDI inflows when the moderating effect of the Political stability is accounted for. These findings, thus, strongly suggested that political stability is crucial for the country's domestic and foreign investment in the future course of direction.

Keywords: FDI Inflows, Pakistan, Political stability, Macroeconomic variables, Business environment variables

1. Introduction

In the contemporary era, it has been widely discussed theoretically and practically that Foreign Direct Investment (FDI) confers numerous economic benefits to the host countries by providing foreign exchange, innovation, capital, transfer of technology, managerial skills, job expansion and increasing the exports of the country (Salman &Feng, 2010; Javed*et al*,. 2012). Some economists also pinpoint that foreign direct investment can stimulate the domestic activity in the host country (Awan, Khan, & us-Zaman, 2011; Brooks &Sumulong, 2003). By and large, to attract the foreign direct investment developed countries as well as developing countries are offering innumerable incentive attractive packages attract to the investors for choosing their location in their favor for investment. Besides in the new global economic era the foreign direct investment(FDI) is considered to be a major contributor to the economic growth of any developed and developing economy (see, World Development Report, 2011). Since foreign direct investment (FDI) is assumed to be a major source of foreign capital for industrialization and growth process in a developing country, it is virtually regarded as an engine of growth and economic expansion in the global economic arena. The IMF and the World Bank, thus, favor FDI rather than foreign Aid (FA) as a vital source of initiating or supporting development process, planning and programming by developing country under the dynamic move of globalization in the 21st century (UNCTAD, 2011).

On programmatic consideration, these are some basic reasons for developing countries to attract foreign direct investment. As a matter of fact, however, several developing countries and especially countries like Pakistan have been facing the difficulty of saving-investment gap as such foreign direct investment is assumed to be vitally influencing factor in the process of economic growth by filling up this gap through new technology transfer, job creation fact to the nationals and expansion of national output and growth level in these countries (Kobrin, 2005; Ataullah, Cockerill, & Le, 2004). Details in Table 1 reflect that in Pakistan the total investment, meaning capital formation, has been going down from 2008 to 2011(even in 2012) compared to other neighboring countries such as India, Sir Lanka and Bangladesh(UNCTAD, 2011).

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

Country's	2008	2009	2010	2011

Pakistan	22	18	15	13.4
India	35	36	35	35
Sir Lanka	28	24	28	28
Bangladesh	24	24	24	24

Source: World Bank Report (2011)

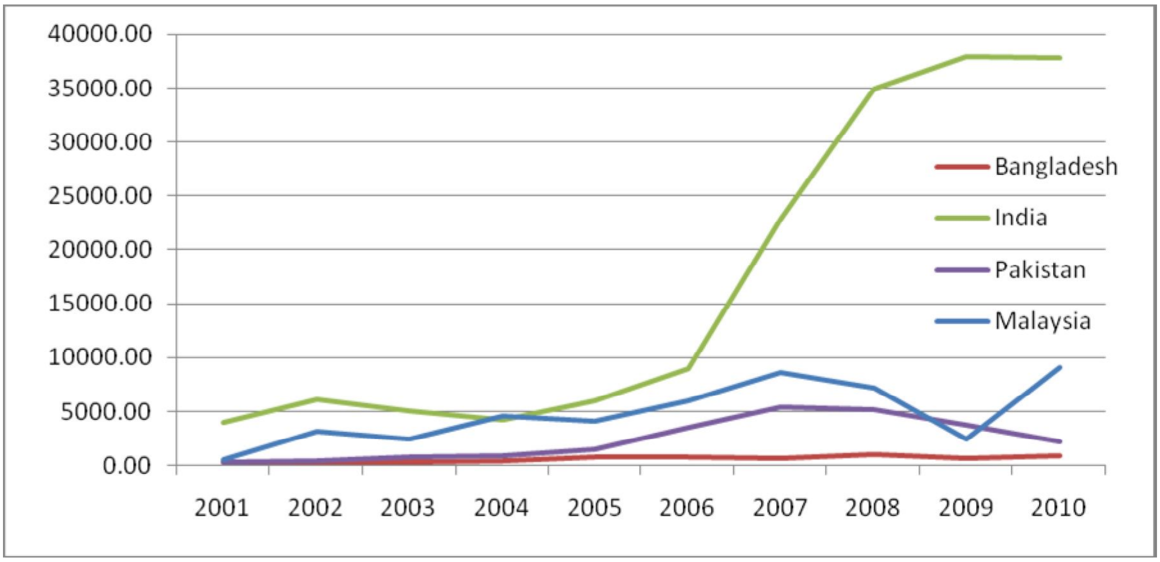
Moreover, Pakistan's economic growth rates have been a fluctuating phenomenon. After a remarkable economic GDP growth rate of 7.57 % in 1991, economic growth rate of Pakistan decrease to 2.1% in 2000. It, however, increased to over 8.96 % both years in 2003 and 2004 (Zaidi, 2005; Iqbal, Shaikh, &Shar, 2010). The country's GDP implied a decreasing trend during the period from 2007 to 2011. This is specifically due to the downfall of the nation's political stability and increased corruption in the government sector, leading to biggest security threats in the business environment in Pakistan. Among other dismal factors, inflation rate which was 3.6% in 2001 has tended to be 13.8% in 2011.

To Pakistani policy makers,other major issues for consideration includes poor state of infrastructure in the country,widespread energy shortages, low productivity and lack of competitiveness of the exports and miserable life of the majority of the poor strata of households. There is glaring research gap relating to in-depth analysis of the major issues and policy guidelines which the present study sought to fill up examine the case of developing countries such as Pakistan.

2. Motivation of The Study

The present study in general seeks to probe whether the economic growth rate scenario of the country truly reflects that the chosen reforms undertaken by the Pakistani policy makers over the years have gone into the right directions. It is disheartening to note that the economic growth rate of the Pakistani national economy had been receding since 2008 onwards due to several controllable and non-controllable interactive factors including biggest natural flood in the history of Pakistan, due to lopsidednen in the balance of payments the rising current account deficits (CAD), political party's rivalry issues and lack of competitively attractive economic policies. Pakistani currency has started depreciating since 2007 until today (2012). Incidentally, when the situation this has reflected a dent in the low level and declining trend of FDI in Pakistan economy. Incidentally, when the situation in Pakistan is compared to some neighboring Asian countries, the country's dismal picture is further disheartening.Figure1 depicts Pakistan's relative position in receiving the FDI inflows against selected Asian countries in the period of new millennium years.

It is interesting to note that in comparative basis, India has claimed a larger increasing share in the FDI inflows over the years.According to UNCTAD (2007), thus, India has come forward as one of the most attractive country for FDI after China, USA, Russia and Brazil. India had received large amount of FDI inflows in the last few years as shown in figure 1 compared to Pakistan.This may be attributed to the obvious fact that Indian policy makers have been continually making concerted efforts to pose India as an attractive destination for foreign direct investment. Pakistan needs to learn greatly from the Indian economic policies and vision.



Source: UNCATD, 2011

Figure 1. FDI inflows in 2001 to 2010: Pakistan in comparison with neighboring countries.

It may be stated that the Indian government is committed to provide both private and public companies a very favorable business environment to encourage FDI. India highly liberalized the foreign investment rule over the last few years. FDI is permitted in a number of sectors under the automatic route, except a few, for which approval from the Foreign Investment Promotion Board (FIPB) is to be sought. India's foreign trade policies have been largely redesigned in order to attract foreign direct investment in India. The procedure of regulation and approval has been grossly liberalized.The present study, thus,seeks to investigate why Pakistan FDI inflows have declined over the years since 2008 and what policy strategy can be envisaged for the future course of direction.

3. Determinants of FDI Inflows

The past studies have examined the effect of determinants of FDI in the country analyzing FDI flows during the period (1972-1996). Initial study of Akhtar (2000) provided a valuable econometric analysis of macroeconomic variables influencing FDI in Pakistan. In a later study,Akhtar (2000) considered the empirical model to examine FDI in Pakistan determined by a mix variable and other independent variables such as GDP growth rate, Imports, Exports, Exchange rate, Interest rate, political instability and military rule. The study of Wang (2009) provides some more insights on inward foreign direct investment (FDI) and economic growth in 12 Asian economies referring to data over the period of 1987 to 1997 in the course of empirical investigation. This study, however, obtained same ambiguous results which might have been caused owing to the use of total FDI as a variable. Nonetheless, the meritorious point of the study is that it analytically detected that FDI in manufacturing sector has a significant and positive effect on economic growth in the host economies. On the other side, Wang (2009) also observed that FDI inflows in nonmanufacturing sectors do not play a significant role in enhancing economic growth.

3.1 GDP Growth Rate

The GDP growth rate is very important for any country in affecting the decision of foreign investors to invest. As such,the relationship between the GDP and FDI and vice versa is always a main track of focus assumed by the researches in economic literature. The study of Martinez-Zarzoso (2003) found that a high level of income in the host country implies a high level of production, which attracts the investors' confidence to invest in the host country. Likewise, the study of Martinez-Zarzoso and Nowak-Lehmann (2004) also confirmed that the higher income in home countries enabled and induced a large amount of source of funds to be invested in overseas business. Real GDP and its growth rate considered as the national income growth indicator of the economic performance of the country, which is reflected through production, consumption, and delivery of goods and other economic facilities provided in the country. GDP trend also indicates the level of the country's economic development vis-a-vis growth rate and potential domestic market opportunities for the investors. It has categorically observed that the GDP growth rate has been declining in Pakistan during the period 2001-2011(Qaiser*et al.*, 2011).

Essentially, macroeconomic conditions are expected to exert influence on FDI. Nevertheless, as Gross and Trevino (1996) had pinpointed countries possessing higher per capita GDP are expected to promote a large dose of FDI, inducing future Multinational Companies (MNCs) with high confidence to invest, especially, when growth trend is more consistent. High economic growth rates are likely to lure investors in finding the market potential for higher return values on investments which are confined to higher levels of FDI (Biglaiser&DeRouen, 2011).On this count, the following hypothesis is proposed to be empirically investigated.

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

3.2 Degree of Openness

The degree of openness is an indicator of the level of global integration of a nation. It is measured in terms of the trade ratio. A few research studies show that degree of openness affecting the inflow of FDI in an economy tend to vary as per the inspirations for the attractiveness of FDI in business activities (Navaretti, Venables, & Barry, 2004; Markusen&Maskus, 2002). Incidentally, the degree of openness (DOP) is commonly measured as follows:

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

Where, X is the annual export value, M is the annual import value, and GDP is the Gross Domestic Products.

Imperatively, we need to probe into the degree of openness of Pakistan As such, it is reasonable to propose the following hypothesis to be examined in the context of Pakistan:

H2. The degree of Openness has a positive effect on FDI inflows.

3.3 Labor Cost (LBC)

Foreign investors mostly grab the opportunity to exploit the cheap labor in the production of labor intensive good (Andresosso-O-callagham & Wei 2003). Usually foreign companies and multinationals (MNC) are looking for cheaper labor, thus, the country having cheaper labor will be an important determinant in attracting the FDI. Poor countries alike are competing for FDI by opening to outside investors, through reform approval processes, opening sectors to foreign enterprise, and allowing external capital to enter freely with minimum official intervention cheap and skilled labor. According to Zou, Liu and Zhuang (2009) on this cunt confirmed that FDI has exerted important role in the fastest growth of the Chinese economy. The study of Ali and Guo (2005) also asserted that the costs of doing business are one of the major determinants of FDI, among which labor cost has been extensively investigated in the study of FDI. Incidentally, the study of Lieberthal and Lieberthal (2003) found that some goods such as electronic industry and telecommunication manufacturers industry in Hong Kong and Taiwan have confirmed mainly to adept at leveraging cheap labor from mainland Chinese. We, thus, resort to propose the following hypothesis.

H3. The Labor Cost (LBC) has a negative effect on FDI inflows.

3.4 Infrastructure Index

A well-developed Infrastructure can have a strong impact on the business expansion and growth process of developing and developed countries. Some researches such as(Khadaroo&Seetanah, 2008; Sekkat&Varoudakis, 2007) have argued that the infrastructure carries a significant influence in posing a conferrable business environment to attract FDI in developing countries. Addison *et al*. (2006), however, remarked argued that promotional impact an infrastructure is good only for developed nations but, such situations do not exist in the case of developing countries. Bae (2008), however, stated that in developed countries, infrastructure is not a motivator but an indicator to attract FDI in large emerging economies. In recent year, however, a significant portion of the rising FDI in the services sector has taken place in private capital flows towards infrastructure in development due to rising private sector investment in infrastructure development in developing nations.In the case of Pakistan, therefore, it is worthwhile to consider the stability of infrastructure development and FDI as hypothesized in the following.

H4. The Infrastructure has a positive effect on the FDI inflows.

3.5 Rules of Law (ROL)

Rules of Law are one of the most import factors for the smooth business operation in an economy. Foreign investor all the time worries about the safety of their life and property. The country‘s good rules of law, thus, favorably attract the foreign investment into the country (Khadaroo&Seetanah, 2008). Any lapses in the maintenance of law and order imply “breaks down trust, confidence and the rule of law,” causing deterioration in the morale of the citizens, thus, discouraging foreign investment in a developing economy (Klitgaard, 1988). A high crime rate also signals a lack of the rule of law and government effectiveness which are also thought to pose problems for FDI. The rule of law index (ROL) determines rates of countries on a scale from 0-100, where a higher rating, indicates a stronger rule of law and vice versa. Lower rules of law rating should attract less FDI into the country (World Bank,2011). It is reasonable to propose the following hypothesis.

H5. The Rule of Law has a positive effect on FDI inflows.

4. Political Stability and FDI Inflows

Political stability is very important for normal macroeconomic balance and conducive business environment in a country. Political risks largely depend on political stability and good governance of the government (Husain, 2009). Political stability enhances the probability of attracting more FDI inflows into the developing countries. Pakistan has been continually suffering from the instability of the political system. The ever changing political system and the unstable government can cause political risks which, in turn; will adversely affect the level of foreign and domestic investment in the country. Of course, Political instability is not good since it will adversely affect the country's economic development and growth process by its dent on the physical and human resources. If the country's Political Stability condition is not good, foreign investors will hesitate to bring any projects until they are assured that the business environment would to be conducive and favorable (Bradaet*al.*, 2005; UNCTAD, 2010; Word Bank, 2011). In the case of Pakistan, World Bank report, published in 2011 categorically mentioned that the private sector's low investment in the country is because of political instability and corruption.

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

Indeed, determinants of political risks such as change of regime, government intervention in the economic situations, property rights legislation, and red tape may adversely affect the decision process of foreign investments (Frey & Schneider, 1979). However, the international investors and the international organizations give high importance for their FDI decision process on how good is the governance index of each country such as: fighting corruption; transparency of the administration processes; and violence free environment (World Bank, 2006). According to Shahzad et al. (2012),Pakistan Rule of Law index and the political stability index have tended to be worse than other South Asia countries.Thus, the following hypotheses are formulated:

Business and Economic Research
ISSN 2162-4860
2012, Vol. 2, No. 2

H6: Political Stability moderates the relationship between GDP growth rate and the FDI inflows .

H7: Political Stability moderates the relationship between degree of openness (DOP) and the FDI inflows.

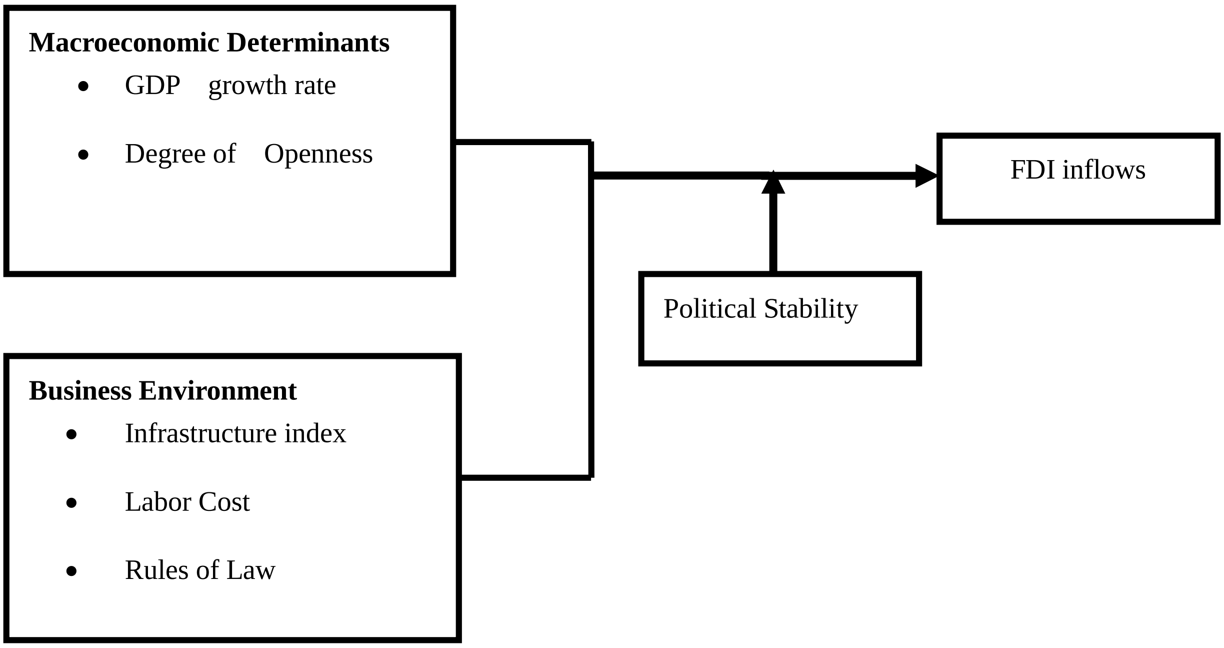
H8: Political Stability moderates the relationship between LBC and the FDI inflows.

H9: Political Stability moderates the relationship between Infrastructure (INFRAS)and the FDI inflows.

H10: Political Stability moderates the relationship between Rule of Law (ROL) and the FDI inflows.

5. Research Framework and Variable Measurements.

For determining the course of empirical investigation, the following research framework is devised to tracing the impact of various types of selective Macroeconomic variables and Business environment variables to attract FDI in Pakistan moderating role of political stability during 1991–2011.



In the following, the variables incorporated in the empirical investigation process of the study.

FDI inflows = Foreign Direct Investment inflows on a yearly basis (data will collected from the State Bank of Pakistan).

GDPGR = Gross domestic production growth rate (data will be collected from the Stat bank of Pakistan).

DOP = Openness measured as exports plus imports as a percentage of GDP (Exports, imports and GDP data will be collected from the UNCTAD reports).

INFRAS = Infrastructure Index (Infrastructure Index Ranking data will be collected from the World Bank).

LBC = Labor Cost Monthly Wages set by the government (Collected from the Government labor department of Pakistan).

ROL = Rules of Laws ranking index (collected for the World Bank governance indicator report).

PSI = Political Stability Index (collected from the World Bank Indicator reports).

6. Data Analysis and Results

To investigate the effects of macroeconomic variables and business variables on the FDI inflows in Pakistan as well as the moderating role of political stability as discussed in the hypotheses development and illustrated in the research framework, this study followed the following steps.

6.1 Units Root Tests (ADF test)

In order to avoid spurious regression, we begin with an investigation of the properties of the time series data that we are dealing with to determine if the variables are stationary or nonstationary in nature. The procedure used here is the Augmented Dickey Fuller (ADF). Table 2 shows that all the variables of macroeconomic variables (GDPGR, DOP), business environment variable (LBC, INFRAS and ROL) and Political stability (PSI)are stationary.

Table 2. ADF unit root test results using the Trend and intercept

	Variable	1st Diff	2nd Diff	Lagged
1	FDI	0	S	2
2	GDPGR	S	-	1
3	DOP	S	-	2
6	LBC	S	-	1
7	INFRAS	0	S	2
8	ROL	S	-	1
9	PSI	S	-	1

6.2 Regression Analysis Results for Predictor Power

After all the regression assumptions were checked and found to be satisfied, this study ran the regression analysis using SPSS 19.0 to examine the predictive power of the hypothesized model. Moreover, it was used to identify and compare the predictive power of the dimensions of macroeconomic variables (GDPGR, DOP), business environment (Labor, Rule of Law and INFRAS) and political stability toward the FDI.Based on the results in Table 3, it can be concluded that DOP (β=0.452, t=3.740, p<0.001),Labor cost (β=0.508, t=3.557, p<0.001),Infrastructure index(β=0.300, t=2.134, p<0.05)have significant positive impact of the FDI inflows at 0.05 levels of significance.Additionally, the results revealed that DOP andInfrastructure index had greater impact on the FDI inflows in Pakistan. These results, however, supported the hypotheses H2 and H4in which the impact of Degree of Openness and infrastructure on the FDI inflows were claimed to be significant at the 0.05 level of significance.However, the Labor cost was found to have a positive and significant effect on the FDI inflows. This result, thus, does not support the H3. TheGDP growth rate and rules of the Law were not significant determinants of the FDI inflows in case of Pakistan.

Table 3. Examining Variables' predictive power

	Model	
Variables	Predictors	T value
GDPGR	0.063	0.453
DOP	0.452***	3.740
LBC	0.508***	3.557
ROL	0.300**	2.134
INFRAS	-0.215	-1.436
F value		11.982
F Sig.		0.000
R^2		0.800
Adjusted R^2		0.733
Durbin Watson		1.150
* Significant at the 0.1 level; ** Significant at the 0.05 level;		
*** Significant at the 0.01 level		

6.3 Hierarchical Regression Analysis to Examine the Moderating Effect of Political Stability

The hierarchical regression results were reported according to the analysis stages. First, this study examined the moderating effect of Political stability of the above mentioned relationships following the method of Frazier, Tix, and Barron (2004). In this model, the interaction terms between the macroeconomic variables, business environment variables and political stability were examined to test the moderating effect.The results in Table 4 indicated that GDPGR and Labor variables were significant predictors of the FDI inflows at the 0.001 level of significance.

The interaction terms between of political stability and macroeconomic variable, business environment were examined. It was found, however, that while the interaction term between GDPGR and Political Stability and the Labor and Political Stability were found to be significant at the 0.001 level of significance (β=0.344, t= 3.614, $p<0.001$) and (β=0.715, t= 3.783, $p<0.001$) respectively. These results indicate that political stability positively and significantly moderates the effect of GDPGR and Labor cost on FDI inflows at the 0.001 level of significance. These results, however, supported the hypotheses H6 and H8. On the other hand, The results of the study did not support the hypotheses articulated in H7, H9 and H10 as illustrated in Table 4.

Table 4. The Results of the Moderating Effect of Political Stability

	Model 1		Model 2		Model 3	
Variables	Predictors	T value	Moderated	T value	Interactions	T value
GDPGR	.063	.450	.063	0.434	0.235**	2.351
DOP	.452***	3.740	.453***	3.504	0.329***	2.823
LBC	.508***	3.557	.508**	2.161	-0.179	-0.734
INFRAS	.300**	2.134	.299	1.368	0.696***	4.920
ROL	-.215	-1.436	-.215	-1.247	-0.458***	-3.338
PSI			.001	0.005	0.299	1.38654
GDP_PSI					0.344***	3.614
DOP_PSI					0.056	0.498
LBC_PSI					0.715***	3.783
Infra_PSI					0.142	1.647
ROL_PSI					0.068	0.531
F value		11.982		0.000		9.694
F Sig.		0		0.996		0.002
R2		0.894		0.894		984
Adjusted R2		0.733		0.714		0.93
R2 change		0.800		0.000		0.169
Significant F change		0.000		0.996		0.002
* Significant at the 0.1 level;						
** Significant at the 0.05 level;						
*** Significant at the 0.01 level						

6.4 Discussions, Conclusion and Recommendations

The empirical findings of this study were based on the 21 years data for the period 1991 to 2011.In other words, this study examined the empirical parameters of the foreign direct investment inflows in Pakistan during the period 1990-2011. To test the hypotheses of this study, hierarchical multiple linear regression was employed. The results of the study imply that some of the hypotheses are supported. Table 3 shows that the effect of degree of openness as hypothesized in H2, Labor cost as hypothesized in H3 and the role of law as hypothesized in H4 on the FDI inflows in Pakistan were confirmed at the 0.05 level of significance.Other hypotheses regarding the effect of GDP growth and infrastructure on FDI inflows were not supported as hypothesized in H1 and H5 respectively.

As illustrated in Table 4, the moderating effect of political stability on the relationships between microeconomic variables , business environment variables and the FDI inflows was reported. While the results supported the hypotheses H6 and H8, other hypotheses such as H7, H9 and H10 were not.In words, the results show that the political stability is very important factors for foreign investment in the case of Pakistan since it enhances the effect of the FDP growth on the FDI inflows. Simply put, the effect of the GDP growth on the FDI inflows is contingent on the country's political stability.Similarly, the degree of openness is also an important determinant of the FDI. This effect could be enhanced if the country is politically stable. In general, Pakistan needs to the increase the exports for balance of payment and try to reduce the imports. To attract more export oriented FDI to the country, the country should enjoy the political stability to enhance the foreign investors' confidence in the business environment.

This study revealed that the infrastructure is a very significant determinant of the FDI inflows in Pakistan and the effect of the infrastructure even more significant when accounting for the effect of the political stability. The Pakistani policy makers need to develop good infrastructure to attract the foreign investment.

To rectify the declining trend of FDI in the country, many suggestions and recommendations may be offered to the Pakistani policy-makers. The policy –makers of Pakistan need to revamp the FDI policy to attract more investment into the country. Selective FDI policies may be spelled-out by the Pakistani Policy makers to channelize FDI inflows in much warranted direction by including a set of positive and negative lists. Positive list is meant to refer to sectors in which the FDI inflows are encouraged. Negative list implies indicating sectors in which the FDI inflows in need to be disallowed such as defense sector, for instance. The approval procedure and screening mechanism should be adequately decided to meet the FDI policy objective. A developing country such as Pakistan need to design its FDI policy contents thoughtfully well in promoting its goal of growth with macroeconomic balancing and policy flexibility, time and again, in pragmatic determination of FDI inflows in the further course of direction. One of the main suggestions for future research is to examine in-depth the moderating impact of the political stability on the relationship between various macroeconomic and business environmental factors and FDI inflows.

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