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Pakistan's Growth Empirics and Foreign Direct Investment: An Assessment of the Role of Domestic Financial Sector

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ABSTRACT

Purpose: This research endeavours to investigate the role of financial sector in determining the foreign direct inflows in Pakistan.

Design/Methodology/Approach: Autoregressive Distributed Lag Model is applied to conclude the nature of linear association among the variables, in this study, we have used time series data over the period 1980-2019 of Pakistan. A financial development index has been created to illustrate the financial development by using Principle Component Analysis (PCA). Robustness of the relation among variables is also checked, and incorporated this in the empirical model.

Findings: The findings described very interesting implications, by exhibiting a positive association among FDI and economic growth in the presence of financial sector indicators. These conclusions hold notwithstanding in the presence or absence of Financial development Index. Therefore, the presence of strong financial sector is necessary to attract FDI and to smoothen the economic growth process.

Implications/Originality/Value: The role of financial sector is indispensable in determining the economic activity. In addition to this, research at hand explore the inclusive nature of the relationships among foreign direct investment (FDI), Financial sector, and economic growth. It exhibits a reflection of the various sources of economic growth.

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Introduction

Foreign direct investment is an essential portion of an effective and open international system of economy and the main motivation for economic development. However, the advantages of foreign direct investment are not consistent through countries, sectors, and local societies (Liang et al., 2021). National policies are a matter of international investment for captivating foreign direct investment. Foreign direct investment (FDI) has developed significantly as the main system of capital transfer internationally. In past, the foreign capital flight has been moving towards the developed (Vernon 1966) while the transfer has turned towards the developing countries (Hussain et al., 2021). One must have anticipated variations in national competitive benefits to be reflected in additional sustainable developments. Seemingly, to scope that any developments occur rapidly (Gao, 2004).

Most of the developing countries depend essentially on foreign direct investment as it provides a basis to finance at an external level, for the reason behind that foreign direct investment energizing growth of the economy more rapidly (Ibrahim et al., 2021) specifically, Foreign direct investment is assumed to be rarely unbalanced in the allocation of technology, financial assets, managerial skills, and market access. Financial assets are mostly applied to expand the capacity of production through accumulative fixed investment, while technological transformation along with the skills develops creative ability. Foreign direct investment also increases domestic pressures for domestic firms that result in augmenting allocative productivity and technical proficiency in the recipient country of the FDI.

Like other developing countries, FDI flows are increasing in Pakistan, as being an important instrument of growth, in addition to this variation of growth-oriented policies in the financial sector that are compatible for foreign and local depositors, the more the chance to attract foreign direct investment as technology, capital source, market access, and managerial skills for the development of the economy. The economy of Pakistan offers the capability for placing business, and foreign investment is completely secure through law, as well as escaping double taxes. The international management policies deliberated through the government for captivating supplementary foreign direct investment has been attracted by accepting policies relating to denationalization and deregulation of economic movement and better reliance on market powers in the country.

Literature Review

Uddin and Aziz (2014) tried to find the part of public investment in the process of economic growth to the Bangladesh economy. Time series data was obtained from 1972-2011. Research used to co-integration test and Granger Causality to examine the relationship between variables. It used GDP as dependent variable and gross formation and public investment as independent variables. It argues that Public Investment had positive effects upon economic growth. When public investment enhance, economic growth also increased and will cause economic development in future days. Here, it should be highlighted that developed infrastructure and skilled labour and political stability was need for standard level of implementation of public investment. It was suggested that excessive public investment level with institutional sector boost up in Bangladesh because it is favourable for economy. Azam and Ahmed (2015) discussed effect of human capital and foreign direct investment upon economic growth. He studies the developed countries from 1993-2011 and used linear regression techniques to use the fixed-effect and random-effects model. In the host countries, FDI facilitate and provided better political environment, business policies and potential investors. Foreign direct investment and human capital were an important and positive effect on Gross Domestic Product. He recommended that the policy maker must do in favour of development in economic growth, domestic investment must be made better and the sector of health and education level must be improved. And improve the domestic investment so that enhance the FDI inflow.

Ilegbinosa *et al.* (2015) indicated that effect of domestic investment on growth of economy by applying time series data from 1970-2013. It was used Multiple Regression and co-integration technique to examine the relationship of the variables. This study divided into two government expenditure; productive and protective expenditure and found the effect of investment upon the private investment. They emphasized that private investment had optimistic and insignificant effect on growth of economy as the same time government investment had adverse and insignificant influence on growth of economy. They suggested that implementation of budget should improve.

Sothan (2015) examined that the causal influence of FDI and exports upon growth of economy over period 1980 to 2013 and observed 21 countries, using the panel co-integration and Granger causality. Outcome showed that there was long term steady-state correspondence among foreign direct investment, exports and GDP for the countries. There was found bidirectional causality between foreign direct investment and GDP in the long term. Foreign direct investment and exports were affected upon growth of long-run in the countries. Further government should facilitate political and economic stability, improve infrastructure, abolish all hurdles that connect with the foreign direct investment and encourage the financial sector.

Agrawal (2015) focused on correlation among foreign direct investment and economic growth. It was applied panel data from 1989-2012, used OLS (Ordinary Least square) method and co-integration method were used. Variables were used FDI, gross domestic product and growth of economy. It was founded bidirectional causality among FDI and growth of economy. Hussain and Haque (2016) indicated that there was relationship among FDI, trade, and GDP for the economy of Bangladesh used the annual time series data for time span 1973 to 2014. By using Vector Error Correction Model (VECM), that there was long run correspondence among these variables. The foreign investment variables and trade had significant effect upon the GDP per capita.

Makuyana and Odhiambo (2016) focused on the empirical evidence of public and private investment was important factor for economic growth of both developed and developing countries. It was used cross-sectional data that contain the sample of 24 countries. Public investment was very important for developed countries and focused on basic infrastructure caused private investment. In developing countries public and private investment were very significant but private investment more appropriate than public investment. And focused on the infrastructure that enhance the private investment. Solomon (2017) estimated that, in the host countries, how position of economic growth, human capital, financial development and economic and political environment had concurrent affected the FDI upon economic growth. It was used generalization methods of movements (GMM) with panel data from 1981-2005 of 111 countries. It was considered that FDI a way of technology in the host country from another country. Further, FDI had marginal effect upon economic growth was significant beyond a maximum point where the negative impact the quality of political environment, factor are constant. Outcomes explained that the position of economic development, human capital and political environment had significant impact the relationship between foreign direct investment and growth.

Mohamed *et al* (2017) focused on the casual correspondence among FDI, domestic investment and economic growth in Malaysia. It was collected the data from 1970-2008 and estimated the relationship of variables. It was applied Vector Auto-regression method. They used the independent variable were FDI, value of export, human capital development and real gross fixed capital formation and GDP as dependent variables. Outcomes were advocated, in the long run, that causality between economic growth and domestic investment and no causality among

FDI and economic development. On other side, FDI was crowded-in impact domestic investment in short run. Ameer and Xu (2017) approximated the influence of FDI upon growth of economy from the era 2005-2014. He used Ordinary Least square (OLS) and generalization method of moments (GMM) model. It was used gross capital formation, gross domestic savings, trade, inflation proxy variables for model estimation. Outcome was displayed that FDI outflow and inflow impression on growth of economy had positive and significant. His suggestion is for government to use significant techniques by which economic growth must be improved.

Faisal, Muhammad and Tursoy (2017) used the auto regression distributed lag approach (ARDL) over the period 1999-2015. And estimated the co-integration approach was applied time series data. He was focused on the relationship among GDP, foreign direct investment and domestic credit. Finding shows that, in the long run, stock prices had positive impact on foreign direct investment and financial development had negative effect on foreign direct investment. Results showed that if the government play significant role in the flow of FDI then economy can move towards development and growth. Bakari (2017) took annual time series data for duration of 1960-2015. Test was applied correlation analysis vector error correction model (VECM) and Granger causality test. Relationship was observed domestic investment and growth of economy in Malaysia. In long run, it was positively impact between domestic investment, export and labour upon growth of economy. In the short run, there was no relationship between domestic investment and growth of economy. He investigated economic policies of so many countries like India, china and Pakistan.

Data and Methodology

a) Data Sources

This use the time series data of foreign direct investment, and analysed the role of domestic financial sector for Pakistan economy. This study used yearly time series data which covered the time period 1980-2019. The data of gross domestic product (GDP), inflation rate, and worker remittance, financial development taken from world development index, trade openness, labour force, manufacturing sector growth rate, exchange rate have been used for empirical analysis.

b) Model Specification

In this part we discuss the model specification of this study. We used two models to empirically analyse the problem statement. We analysis the Pakistan's economy hypothesis through co-integration inference differentiate like Auto regressive distributed lag (ARDI) method.

c) Model One: Economic Growth and Foreign Direct Investment

The model we explain growth of economy and FDI and macroeconomic variables in our research.

$$GDP = f(FDI, INF, TO, WR)$$

$$GDP = \beta_0 + \beta_1 (FDI) + \beta_2 (INF) + \beta_3 (WR) + \beta_4 (TO) + \varepsilon$$

ARDL form of model 1

$$\begin{aligned} \Delta GDP_t = & \mu_0 + \sum_{i=1}^p V_i \Delta GDP_{t-i} + \sum_{i=1}^p \pi_i \Delta FDI_{t-i} + \sum_{i=1}^p \omega_i \Delta TO_{t-i} \\ & + \sum_{i=1}^p \theta_i \Delta WR_{t-i} + \sum_{i=1}^p \vartheta_i \Delta INF_{t-i} + \sigma_1 GDP_{t-1} + \sigma_2 FDI_{t-1} \\ & + \sigma_3 WR_{t-1} + \sigma_4 INF_{t-1} + \sigma_5 TO_{t-1} + \mu_{1t} \quad (1) \end{aligned}$$

d) Model Two: Financial Sector and Growth Rate

$$GDP = f(FD4, WR, LF, MANU, EXR)$$

$$GDP = \beta_0 + \beta_1 (FD4) + \beta_2 (WR) + \beta_3 (LF) + \beta_4 (MANU) + \beta_4 (EXR) + \varepsilon$$

ARDL form of model 2

$$\begin{aligned} \Delta GDP_t = & \mu_0 + \sum_{i=1}^p V_i \Delta GDP_{t-i} + \sum_{i=1}^p \pi_i \Delta FD4_{t-i} + \sum_{i=1}^p \omega_i \Delta WR_{t-i} + \\ & \sum_{i=1}^p \theta_i \Delta LF_{t-i} + \sum_{i=1}^p \vartheta_i \Delta MANU_{t-i} + \sum_{i=1}^p \vartheta_i \Delta EXR_{t-i} + \sigma_1 GDP_{t-1} + \\ & \sigma_2 FD4_{t-1} + \sigma_3 WR_{t-1} + \sigma_4 LF_{t-1} + \sigma_5 MANU_{t-1} + \sigma_6 EXR_{t-1} + \mu_{1t} \quad (2) \end{aligned}$$

Results and Discussion

a) Descriptive Analysis of the Data

This segment deals through descriptive features of data. The analysis has been completed for all of the variables model one and model two separately in following.

Table 1: Descriptive Analysis

Variables	Mean	Median	Std.dev	Skewness	Kurtosis
GDP	678.729	2677.700	8563.900	1.427376	3.77034
FDI	70481.98	24327.10	97057.06	1.4742	4.00801
INF	8.40160	7.92108	3.802016	0.6623	3.8053
TO	24316.11	14593.70	20614.53	1.2079	3.50039
WR	50441.776	2389.05	5672.730	1.96713	6.29605
FD4	-0.9893	-0.9797	0.09828	0.0439	2.14135
LF	48.1000	49.9000	12.4000	-1.9966	7.58054
MANU	15.6204	15.8634	1.24379	-0.03358	2.4612
EXR	48.0150	45.0467	30.42669	0.444102	1.93814

Source: estimation by the author with E-views 9.

b) Correlation Analysis of the Data

The construction of oblique convinced below, checks pair wise correlation of selected sequence to make samples for this study.

Table 2: Correlation Analysis

Model 1				
Variables	FDI	INF	TO	WR
FDI	1.00			
INF	0.41315	1.00		
TO	0.5118	0.21211	1.00	

<div>WR0.56190.03130.93141.00</div>						
Model 2						
Variables	GDP	FD4	LF	MANNU	WR	EXR
GDP	1.00					
FD4	0.358	1.000				
LF	0.024	0.1213	1.000			
MANU	0.674	0.3168	0.1056	1.000		
WR	0.975	0.3309	0.2865	0.63821	1.000	
EXR	0.923	0.1313	0.2138	0.62955	0.857	1.000

Source: estimation by the author with E-views 9

c) Unit Root Test Analysis

Augmented Dickey -Fuller Test (ADF)

Dickey and fuller (1989) presented a test to verify the unit root in the data i.e. stationary or non-stationary of a time series. The method verify the data series as difference stationary or not (I(0) and I(1)). The test is essential to make out the order of integration. The lag time of these variables has been choosen with the Akaike Information Criteria (AIC), IM test and Schwartz Bayesian Criteria (SBC).

Table 3: Unit Root Test

Variables	Intercept	Intercept and trend	None	Conclusion
GDP	-1.60041 (0.04718)	-3.75597 (0.0314)	-0.8284 (0.0349)	I (0)
FDI	-6.063218 (0.0000)	-7.73624 (0.0000)	-6.16251 (0.0000)	I (0)
INF	-3.72789 (0.004)	-3.590076 (0.0034)	-3.6290 (0.0004)	I (0)
TO	-4.557209 (0.0009)	-4.49528 (0.0053)	-4.6578 (0.004)	I (0)
WR	0.7079 (0.0990)	-0.7756 (0.0554)	1.1878 (0.0395)	I (1)
FD4	-5.8742 (0.0000)	-3.5285 (0.0043)	-5.5873 (0.004)	I (0)
LF	-6.18870 (0.0000)	-6.08863 (0.0001)	-6.07887 (0.0581)	I (0)
MANU	-2.1703 (0.0790)	-4.49864 (0.00062)	-0.9697 (0.3798)	I (1)
EXR	-3.676730 (0.0098)	-4.49864 (0.00062)	-0.88376 (0.3247)	I (1)

than we applied Auto regressive distributed lag (ARDI) test. In current study, the result indicate the mixture of level I(0) and I(1) series. Therefore, the long-run impact through the Auto regressive distributed lag model and short run impact through the Error correlation model (ECM) is appropriate to apply.

d) Bound Testing

Table 5.3 establishes bound test assessment. The thumb rule of bound test is F-statistic is superior than upper bound value so, long run occurs in model, and value of F-statistic is decline upper bound than long run does not occur in model.

Table 3: Bound Testing for Co-integration

Models	F-Statistic	At 5% Significance level		At 10% Significance level	
		Lower bound	Upper bound	Lower bound	Upper bound
Models 1	11.47813	2.56	3.49	2.2	3.09
Models 2	8.54821	2.08	3.09	2.3	3.49

Source: estimation by the author with E-views 9.

In model one F-value is 11.478 and upper bound value is 3.49 at 5% and upper bound value of 10 % is 3.09. In model two F-value is 8.54821 and upper bound value is 5 percent and 10 percent is 3.09 and 3.49. The conclusion displays that F-value is bigger than upper bound value of 5 percent and 10 percent. In model one long run relation occurs in it.

Autoregressive Distributed IAG Model (ARDL)

The usually used methodologies as Engle-Granger (1987) and Johansen-Juselius (1990) and Johansen (1991; 1995) approaches. The main conclusion of ARDL method lies in its suppleness that it can be worn while the variables are of different assemble by Pesaran and Pesaran 1997 of integration. So, declared prior to, the variables used in this study are a blend of level and 1st difference. The test methods of co-integration based on Johansen (1991; 1995) Johansen-Juselius (1990) involve that every variables with comparable order of integration like 1st difference. Therefore, these methods of co-integration are not appropriate and cannot work in this case. So, we execute the Auto regressive distributed lag approached for co integration in this study.

e) Long Run Analysis of Data

The long run of assessment is explaining in this part by Auto regressive distributed lag model (ARDL). We applied two models and GDP applied dependent variable and all further variables like INF, FDI, WR LF, TO, EXR, MANU applied is independent variables.

Table 5: Long Run Analysis

Model 1: ARDL (4,4,0,3,4)		ARDL (3,2,4,4,4,4)	
Variable	Coefficient (P-value)	Variable	Coefficient (P-value)
FDI	0.04439 (0.0000)	FD4	3519.94 (0.0002)
INF	-7.66927 (0.00003)	LF	17.6320 (0.0005)
TO	0.12750 (0.0155)	MANU	230.897 (0.0100)
WR	0.20819 (0.0006)	EXR	-90.1198 (0.0400)

Source: estimation by the author with E-views 9.

Note: values in the parenthesis shows the respective probability values for the level of significance.

The model one is the independent variables is FDI and coefficient value is 0.0443 and there is statistically significant positively relation with Gross domestic product. The value foreign direct investment increase 1% in FDI that will increase in GDP by 0.04%. The reason behind that the foreign direct investment enlarge than that Gross domestic product will also increase. The results support Zeb *et al.* (2013). Inflation rates the vector is -7.66 and inflation rate is negatively associated and statistically significant. The value of 1% rise in inflation that will increase in gross domestic product by -7.66%. Inflation is main issue of the Pakistan's economy. Our results support Naz *et al.* (2015), Nuri *et al.* (2012). Trade openness coefficient value is 0.127 and there

significant and positive relationship with dependent variable. The value of trade openness is 1 % increase in trade openness that will boost in the GDP by 0.12%. The possible reason is trade openness is valuable for the growth of economics. Our result supports with the Falki (2009). The Worker remittance significantly related with Gross domestic product. It plays a role of protection in developing countries as well as Pakistan.

In the second model the independent variable is FD4 and coefficient value is 3519.94 and there is significant. The value of FD4 is 1 % rise in FD4 that will rise in dependent variable of GDP by 3519.9%. Financial sector plays a vital role in enhancing economic growth, for payments agreement financial sector support in expansion of the economy (Hussain, 2014). The variable labor force is 17.63 and the significant positively associated with GDP. The value of labor force is 1 % increase in labor force that will increase in GDP by 17.63%. Labor force and growth of economy were linked and it rise economic growth 5.6 Co-integration valuation of short run. The short run evaluation show that series amongst in short-run. The co-integration of short run feature should be important and necessity equivalent negative.

Short-Run Analysis			
Model I: ARDL (4,4,0,3,4)		Model II: ARDL: (3,2,4,4,4,4)	
Variable	Coefficient (P-value)	Variable	Coefficient (P-value)
D(GDP(-1))	-1.2237 (0.000)	D(WR)	0.01589 (0.7282)
D(GDP(-2))	-0.9910 (0.005)	D(WR(-1))	-0.10803 (0.0078)
D(GDP(-3))	-0.51178 (0.0029)	D(WR(-2))	0.01301 (0.7184)
D(FDI)	0.0068 (0.0001)	D(FD4)	9297.64 (0.0449)
D(FDI(-1))	0.01424 (0.000)	D(FD4(-1))	3357.35 (0.1354)
D(FDI(-2))	0.01105 (0.0001)	D(LF)	-1.26702 (0.8839)
D(INF)	48.6606 (0.001)	D(LF(-1))	3.0554 (0.7772)
D(TOT)	-0.6153 (0.0001)	D(LF(-2))	-8.1156 (0.4554)
D(TO(-1))	0.0204 (0.0001)	D(MANU)	-93.58 (0.3447)
D(TO(-2))	-0.0613 (0.000)	D(MANU(-1))	0.2261 (0.2735)
CoinEq(-1)	-0.43541 (0.0000)	D(MANU(-2))	0.1457 (0.6132)
		D(EXR)	9.3641 (0.7877)
		D(EXR(-1))	-0.0439 (0.8739)
		CoinEq(-1)	-0.0895 (0.0000)

Source: estimation by the author with E-views 9 using data extracted from the World Bank.

Note: values in the parenthesis shows the respective probability values for the level of significance.

This table illustrate that the one unit increase in gross domestic product with lag two have negative impact on foreign direct investment. In lag three the one unit increase negative impact on dependent variable and statistically significant. Foreign direct investment has positive impact and significant in lag two and three. Inflation rate with lag one positive impact on foreign direct investment. Trade openness is one unit increase in and positive impact on dependent variable. One unit increase in trade openness and negative impact on dependent variable. The value of

Coint-Eq (-1) factor are -0.43541 statistically significant and negative of the factors shows to it will converge toward long run equilibrium. The coefficient of financial development (FD4) is positive impact and no significant. In lag one the one unit increase in financial development (FD4) and have positive impact on dependent variable. In labor force one unit increase in dependent variable and positive impact on gross domestic product. One unit increase in labor force with lag two and positive impact on gross domestic product. The coefficient of manufacturing with lag one the one unit increase and have positive impact on dependent variable. One unit increase in manufacturing by lag two and have positive impact and do not significant. The coefficient of exchange rate is one unit increase and have positive impact but not significant. One unit increase in exchange rate by lag one and have negative impact on gross domestic product. The factor of the Coint Eq (-1) coefficient is -0.685 also negative sign of the factor explain to it will converge in extra six month. The essential sculpt exists in short-run.

Diagnostic Analysis of Models

This part display fitness of models diverse diagnostic technique has been applied to evaluate heteroskedasticity and auto-correlation models.

e) 5.7.1 Autocorrelation and hetroskedasicity diagnostic for model 1

Table 5.6 autocorrelation and heteroskedasticity for model 1

Name of test	F-statistics value	Probability
Model 1		
Breush-Godfrey correlation LM test	0.55317	0.8338
Hetroskedasticity	0.76126	0.7110
Model 2		
Breush – Godfrey correlation LM t	0.87753	0.4329
Hetroskedasticity	0.5754	0.8264

Source: estimation by the author with E-views 9.

Note: values in the parenthesis shows the respective probability values for the level of significance.

The null hypothesis is that there is no serial correlation. In model one Probability aspect is 0.8338 that is higher is 0.05 so we do not reject null hypothesis. The probability displays that we cannot reject null hypothesis and serial correlation does not exist. In model two P-value is 0.4329 and value is superior than 0.05. We cannot cast-off null hypothesis. The P-value displays that we do not cast-off null hypothesis and not any serial correlation occur. These results are displays in table 5.6 alternative and null hypothesis. In model one that value of probability as table 5.6 illustration that we cannot reject null hypothesis. So, sequences do not strive from Heteroskedasticity. The P-value of model one is 0.7710 is greater than 0.05 so we do not reject null hypothesis and in model there exist heteroskedasticity. In model two P-value is 0.8264 so value is superior than 0.05 its shows that cannot cast-off null hypothesis and there is heteroskedasticity occur in it.

Stability Analysis of Data

The analysis displays that CUSUM stability and CUSUM (cumulative sum of square of recursive residuals) chart through among limits of 5% level of significant.

f) Stability analysis for Model I **CUSUM SQUARE**

— CUSUM of Squares — 5% Significance

g) Stability Analysis for Model 2

CUSUM

— CUSUM — 5% Significance

CUSUM SQUARE

— CUSUM of Squares — 5% Significance

Source: evaluation through author with E-views 9.

In model one and model two both the graphs state that model is stable as CUSUM and CUSUMQ lies between critical limits.

Conclusion and Policy Recommendation

In underdeveloped countries and emergent economies, and nations in conversion stage have come progressively to understand FDI as a foundation of financial development and transformation, revenue generation and employment. States have opened their FDI administrations and followed other policies to entice investment. The issue of how best to pursue domestic strategies to exploit the benefits of FDI are better explored in the current analysis. The research of FDI for Expansion attempts principally to lighten the issue by focusing on the general consequence of FDI on macroeconomic growth and other welfare-enhancing processes, and on the channels through which these benefits take effect. In the study we have found a significant impact of FDI on Economic growth, furthermore, the development of the financial sector will enhance the overall economic growth in Pakistan. On the basis of the results it is recommended that the facilities may be provided to strengthen the domestic financial sector so that the FDI inflows can be attracted for economic growth.

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