

Issues Relating to Investment in Pakistan and its Effects on Economic Growth

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Abstract

Recent researches have explored large differences among the countries where the ownership of the firms and multinational companies (MNC's) are legally protected. A study has been conducted to examine the current practices regarding the foreign direct investment and its regulatory framework in Pakistan. Concerns about the domestic as well as foreign direct investment have increased the attention with the economic growth. The authors look at the relationship between the foreign direct investment and growth rate of GDP using the time series analysis for the period of 1981-2011 for Pakistan. The observations show that Foreign Direct Investment (FDI) will in due course bring the economic growth. For the country, like Pakistan there is a need for the balanced laws which will protect the domestic as well as foreign investors. We have used the Granger Causality Ordinary Least Square (OLS) and the results favor the economic theory. This theory reveals that when a country follows the common law principles; then eventually foreign investors would be able to invest in different sectors of economy. This paper, inter alia, also highlights those issues which adversely affects the investment in Pakistan.

Key words:Economic growth, issues, Pakistan

Introduction

In recent past many countries facing the financial economic pandemonium due to the inefficient economic policies, bad economic environment and the terrorism

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which leads to the downturn in the economic growth. For the investment purpose, the investors see only the future financial conditions, risk and uncertainty (Byrani, 2001; Government of south Australia, 1999, New south wales, Total Asset Management, 2001; Queensland Government Public works, 2002). Many developing countries have taken some management policies into the considerations with regard to terrorism, inflexible laws and bad economic policies to overcome these issues (Duchene, 2000; Goodwin, 1999, Micahali et al., 2000). The aim of this paper is to examine the relationship between the foreign direct investment and growth rate of GDP. The FDI and domestic investment have a great role in trade. Larger inflows of the FDI will lead to the nourishment of the trade as well as the factor productivity (Aizenman and Novy 2004). Investment laws are also important for economic growth and development (Aviat and Coeurdacie, 2004).¹ The legal system of a country act as a catalyst for both decisions economic growth and investment, Moreover the legal framework will ultimately bring the financial development and enhance the efficiency (e.g. [Mahoney 2001] and [Ogus, 2003]).

A favorable governance structure will at the end of the day bring the FDI. An inward FDI would improve the productivity of the host country (Blomstrom et al., 2001). It is frequently remarkable conclusion that FDI is either skill-seeking, or efficiency-seeking, often leads to bring the high technology and ultimately brings the promotion of economic growth (Dunning, 1993). Free market, good governance, political stability, rigorous laws and good management will finally bring the foreign direct investment (Gray and Dunning 2000).

Enforcement of laws and protection of the investors related to the social and economic infrastructure leads to the economic growth (Hall and Jones 1999), and at last will reduce the poverty. Voice, political freedom, civil liberties, political stability, rule of law, market regulations, market openness including tariffs and imports controls and measure of government effectiveness and efficiency are the crucial factors for the country's economic growth and development (Kaufmaan et al. [1999a], [1999b]. For the investment inflows, there is a need of commercial based legal system that is rooted under common law which protects the capitalist class and investors opportunities (Djankov et al., (2002). In Pakistan, there is a mixed common

¹See Lipsey (2002) and Blonigen (2005)

(2) Other research papers that discuss financial flows or FDI more specifically are Agenor (2003), Blonigen and Wang (2004), Chan and Gemayel (2004), Harrison Love and Mcmillan (2004), Lane (2004), Razen, Rubinstein, and sadka, 2003.

(3) Shibata and Shintani (1998) use consumption output correlation to measure the degree of capital mobility. Their approach is based on formal intertemporal optimization model.

law, which is amalgamated with common law with the element of customary [Muslim] law. Moreover, the facilitating laws are required for promotion of any country's economic growth and investment i.e. [the investment inflows ultimately bringing the economic growth].

Literature Review

Regulatory laws are important for economic growth and investment. Investment is the process through which capital stock of an economy increases. Investment is more important for economic growth.² The policy makers and financial analyst try to reformulate their policies through the investment in human capital, physical infrastructure that leads to the economic growth. There are two channels of investment that brings a good economic system and promotion of the investment.

- a) Monetary policy
 - b) Legal framework
- a) Monetary Policy The monetary policy channel is to enhance the economic growth via the investment channel. The central bank basic objective is to enhance the employment and the price stability. The central bank when the money supply (MS) increases (↑); it will decrease the interest rate and boost up the investment (I).

$$MS \uparrow \rightarrow i \downarrow \rightarrow I \uparrow$$

In the closed economy we can show our investment channel through expenditure approach.

$$\uparrow Y = C + I \uparrow + G$$

This channel is rather hard and even tough for the policy makers to implement in the economy. This channel ultimate brings inflation to the economy. In the open economy we can show our investment channel through the balance of payment identity. Foreign direct investment means acquiring the investment from the other countries. It consists of inward and outward foreign direct investment. In the above channel we can say that when money supply increases ultimately it will bring

² See Supra note 7.

domestic investment via domestic investment while foreigners will not invest to the country. Because, the domestic interest rate will discourage the foreigners not to invest to the specific country. There will be the outward foreign direct³ investment. The great attention to this policy is to stimulate the investment and regulate the economic system that will bring ultimately investment to the country.

There is a very famous issue of any country's Central Bank that to target the interest rate and price stability in order to enhance the economic growth and development. There are two important role of the Central Bank, behind it there is expansionary and contractionary monetary policy. In recession period the bank basic objective is expansionary monetary policy in order to enhance the employment; while in contractionary monetary policy is to combat the inflation in order to stable the value of asset. The breakdown of the Bretton wood system in 1971 was the basic purpose to promote the monetary policy channel. The best system is organize in order to enhance the economic growth is monetary policy is by rule.

Legal system acts as catalyst for economic growth: There are many legal systems in the world; however, we have examined two major systems such as common law system and civil law system. These systems are briefly set out. The authors observed that the common law system more protective with respect to protection of investment of the rights of the investors as compared to civil law system; however the Pakistan legal system is the mixture of Common law and Muslim law.

Common Law System: Common laws are the law common to the whole kingdom. It contains the fresh legislations and good regulatory system. Common law legal systems are widely spread in the most well established economies. This law procures the foreigners rights and the domestic peoples. This system is widely acceptable. Common law courts tend to use an adversarial system, in which two sides present their cases to a neutral judge. In the common law there is only a relevant case are to be considered. The English common law system is one of the major high-ranking systems in the world. The main characteristic of this law is; it evolves from the particular historical events, a set of distinctive legal sources, ideologies, doctrines,

³see more debate on the investment and its legal framework visit

(Pragcap.com/quantitative-easing-3-another-monetary-non-event).

institutions and legal thoughts. The common law is initiated with the Anglo-Saxon legal tradition, that is comprises of the judicial decisions that will create the legal enforcement and binding. The most important point of this law regarding the investment is that it divided into sub-categories; mainly agency, bailment and sales of goods.

Most of the developed economies have adopted this common law and these economies currently rule over the world, regarding the management and economic policies.

Civil Law System: The civil law system that is the most prominent law and most of the countries has adopted this law after getting the independence. The most important point in this system that it contains the codes and this law is not visible in the most economies. The reason behind it; that it does not contain any legal issue through the good governance and protection rights to the domestic as well as the foreign investors.

Civil law is the part of the private law. Before enacting the codes the civil and the private laws were the same; after insisting the codes the private law and the civil law are different. It is pertinent to mention here, that civil law is not much favorable as compared to common law principles because the civil law principle to some extent ,for the reason that; it excludes the commercial and labor laws. The major portion of the investment regarding the regulation is the good labor laws and protective commercial laws. However; one can examines that there is a fundamental difference in the principles of common law and civil law legal systems; Common law countries have strong legal institutions, while civil law countries have weak legal institutions .For the growth and investment, there is a need of common law. Ge *et. Al.* (2012). The good governance, fair and strict implementation of laws shall in due course bring the investment and boost the economic growth.

Connotation of Trade and Investment in the Economy

The trade and investment play a very important role in economic growth of a country. It brings the new ideas, employment opportunities and provision of new technology. FDI is less volatile then portfolio investment and brings in the end economic growth and reducing the investment risk. There are different organizations namely United Nations Conference on Trade Development (UNCTAD) and The Organization for Economic Co-operation and development (OECD) which are promoting the investment opportunities and providing financial and technical

assistance to attract and facilitate the major stakeholders of trade and investment. There is another international organization namely International Center for Settlement of Investment Disputes (ICSID). The Millennium Development Goals (MDG's) main objective is to reduce the poverty; and this target eventually will be achieved; when the investment opportunities are created at a maximum level and it is only possible when there are strong legal institutions for the protection of foreign and local investors.

Now a day's many developing countries have been facing tariffs and non tariffs barriers on the way of trade and investment; and these barriers can be detached if the proper economic rationalizations, strong, effective and transparent principles of law have to adopt. According to the "Competitive Neutrality" principle government can reduce these challenges. Healthier economic environment, modern infrastructure, easy taxation system and protection of property rights can increase the domestic as well as foreign investment and trade. Therefore, a country can search out maximum benefits of investment opportunities and minimize the threats through introducing the strong legal system, independent judicial system and good economic policies.⁴

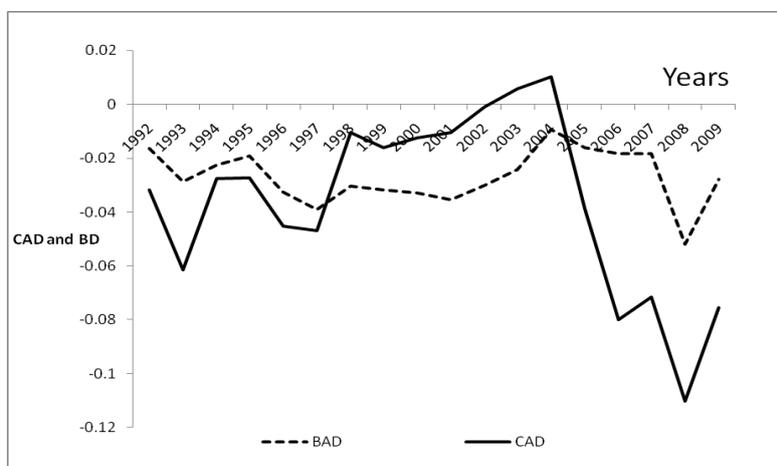
Challenges in Trade and Investment Sectors

Pakistan is developing country and has been facing many challenges; since after its independence. The political instability, lack of good governance, bad economic policies and inefficient utilization of the resources are the contributing factors which are discouraging for the key players of the international, domestic traders and service providers. More than 150 top corporate leaders have visited in February 2012 in Pakistan, including the trade Minister of India visited. However, bad economic policies and terrorism factors cause for the reluctance to invest in Pakistan. Critical issues for the investors in Pakistan the security of life and property protection. Pakistan has made the bilateral investment agreement with 46 countries from 1959-2004; but owing to the potential threats, and lack of economic laws and bad governance, Pakistan has suffered the trade deficit problem. Moreover, the trade deficit problem faced by Pakistan is also creating twin deficit issue.

Figure 1.1: Budget deficit and current account deficit of Pakistan (1992-2009)

⁴See on the more topic of investment visit www.state.gov/e/rls/rmk/2010/146894.htm.

Budget deficit and current account deficit are related with each other. The balance of payment is the equality of the current, capital and financial account. It shows the equilibrium positions on the identity, like the (Kirchhoff’s current law) shows the equilibrium position. The major part of the country’s share regarding the economic growth is the export promotion and export oriented policies. The legal framework is necessary for the countries to enhance the economic growth and stability in the economic environment. The improvement in the economy is related with the laws.⁵ The laws protects the investor basic rights, brings the efficiency in the markets, utilization of the resources, poverty reduction , employment opportunities, incentive to move the high globalized economy and different other objectives. Here, observations can be examine with respect to deficit problems in Pakistan from figure 1, which depicts that Pakistan have faced the current account deficit. In (2004), the Musharraf era, Pakistan made the progress and this analysis shows that in 2002-2004 Pakistan foreign direct investment flow was good because of the good economic system and good governance and good policies. Azam and Naeem showed in their Article “Trend of Foreign Direct investment in Pakistan 1971-2005” that FDI inflows in the year of 2003-2004 reached U.S1524\$ million as the highest peak point compare to the previous years.



(BD, budget deficit, CAD, current account deficit)

Figure:1 Budget Deficit and Current Account Deficit

⁵ See Ricardian Equivalence Approach: Consumption and Budget Account Deficit are negatively related

Debt Neutrality Approach

5 The data of current account and budget deficit is derived from WDI

These observations highlight the points where for the foreign investors, it is advisable to invest in the energy sector which is the major problem facing by the Pakistan. More than 30000 companies including the NGO's are working in Pakistan out of which 700 foreign companies are working in Pakistan. After 2005 Pakistan made regress in the development sectors, the reason is that law and order is disrupted after the Bombay attack and Pakistan is facing the terrorist attacks. Domestic as well as multinational investing companies that were working in Pakistan feel insecurity in Pakistan. The large portion of the investment outflows from the Pakistan creating a lot of problem in the stock market, and many other financial markets.

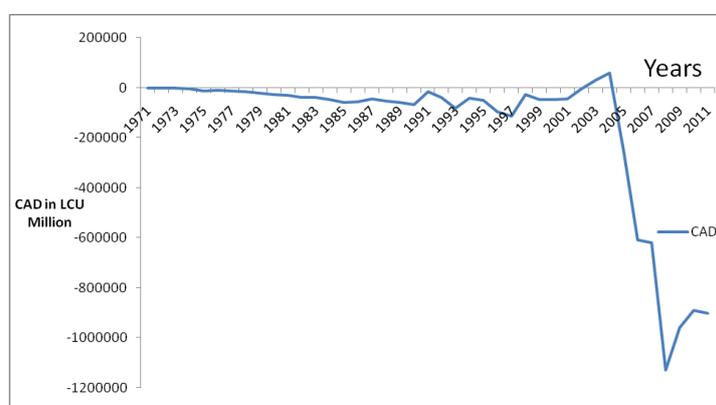


Figure: 2 Current Account Deficits

Non-tariff Barriers to Trade: Non-tariff barrier to trade includes, import quotas, special licenses, unreasonable standards for the quality of goods, export restrictions, technical barriers to trade, rules of origin and export subsidies. These measurements create a lot of trouble regarding the investment opportunities and trade barriers and create potential threats for the domestic as well as foreign investors. As for as Pakistan is concerned which is agro-based country, and less industrial country, currently facing the problems regarding the investment opportunities.

Non-tariff barrier includes other than tariffs to protect the domestic investors and by imposing the levy taxes to on goods and services to discourage the imports. In Pakistan non tariff barriers is because of lack of information, lack of sufficient banking dealings and visa restrictions.

Nationalism in Pakistan: Liah Greenfeld, Professor of Sociology at Boston University has defined nationalism as "an image of a social order, which involves the people as a sovereign elite and a community of equals". Various definitions are

quoted in the nationalism however, the way to define the nationalism is the patriotism, and it evolves different behavior of the people. The behavior of human being is not constant (Robert. E.Lucas Noble Laureate. "Econometric Critique"). It is the human nature that sometimes feelings, sentimental, grievance and sometimes sorrow, rejoicement.⁶ Nationalism is the promotion of the culture of any region of the residence. Nationalistic sentimental approach creates a lot of trouble in bringing the investment.⁷ On the ideology basis Muslim League is consider as a nationalistic ideology. The nationalism is the one of the trade barriers in Pakistan. Pakistan is the Islamic state in which the rules and regulations are implemented according to the western laws, some people opposed these laws and opposed the foreign investors and companies. Saleem Qureshi (2002), showed in his article "Islam and development: The Zia regime in Pakistan" that the main cause of lack of investment is the bad political system. Jonathan Paris showed in his article "Prospects for Pakistan" that the Pakistan major financial crisis is because of severe nationalism, U.S.A intervention through the Afghanistan. India is also demolishing the Pakistan sovereignty and its economic efficiency; however, some remedial measurement is taken by the Pakistan government.

Religious Response: The major problem in Pakistan is the lack of good governance, inefficient political and economic system, and religious sentiment. Pakistani peoples are so intelligent said "Rusley Walker" the student of philosophy in America. He has analyzed that the major problem in Pakistan with U.S.A is the religious sentiment. The most historical events in Pakistan are: bloodbaths and rapes in Bangladesh, or, Zia's dark era, judicial murder of Zulfiqar Ali Bhutto, killing of Benazir Bhutto, recent assassination of Salmaan Taseer, kidnapping of his son, Shahbaz Taseer, Christian Shahbaz Bhatti cold blooded killing, or home-grown "strategic depth" proxies like Let deadly attacks on Mumbai. All these activities are relating to the religious or nationalistic approach. These are the major issues and are creating the hurdles for the future investment in Pakistan.⁸ Anti-Hinduism is another major problem. Pakistan has faced this problem in (1971) of the Bangladesh Pakistan segregation. According to the sustainable development policy report the hate of

⁶See more issue regarding the Nationalism debate: [Embodied spaces: religion, sex and nationalism in public and in court: a response to Sallie A. Marston](#). Original Research Article Political geography, volume 23, issues 1 January 2004 p.p 17-25 Janet. R. Jacobson.

⁷⁷ Sec Supra note 23, at 10

⁷R. H Folsom et.al "International Business Transactions" 906-907 (1999)

⁸See the complete review of Rusley Walker "[Why I wrote about Pakistan and why anti-American sentiment...](#)"

Hinduism by the Pakistani people is the ideological creativity. This hate is the trade barriers between two countries and the major cause of financial turmoil in Pakistan.

Political Victimization: Political victimization is the serious issue in Pakistan. There are many reasons of this victimization. The most serious issues are the religious issue, inefficient government policies, poverty, income inequality, financial turmoil, sentimentalism and so many issue that are the main reasons for the political victimization. Law and order situation delay in disposal of cases in lower judiciary and violation of the rule of law. These all issues are the most confrontational issues concerning the economic growth, investment opportunities and investment in Pakistan. Barslund and John (2007) showed in their article that the major cause of the victimization is the poor management and poverty. The major determinants of the victimization are attractiveness, exposure, proximity and guardianship.

Contracts Sanctity and attitude of Ruling Government: Major problem faced by Pakistan after its independence is the bad policies of the ruler. Currently U.S.A is facing the financial turmoil, and the American citizen blame that current U.S.A president is responsible. This statement seems to be awkward and fallacy. The reason behind it that according to the economic policy point of view; the government basic objective is to enhance the employment and to boost the economic growth. The government takes the action to bring the expansionary monetary policy in order to enhance the employment. For the new election winning strategy is; to increase the money supply. The long run effect is ultimate brings the inflation (Milton Friedman Monetary Policy reaction). When new government is come into the era, people blame that this government has taken bad economic policies that is the reason of the poverty and financial disaster and unemployment.

After the Musharraf renunciation and the new ruler of Pakistan; there is a tremendous situation of the Pakistan regarding the economic, political, and religious issues. The main reason of the outflow of the foreign investors is the terrorism and religious issues in Pakistan. Before the Zardari's government the previous government taken the action regarding the energy policy, economic policy and different banking policies in which some were fruitful and some outcomes proved to be a horrible for the country. The legal issues and economic issues are the most important factors to execute the governmental policies. The most critical issue which is faced by the traders and investors is threat to their contracts, when there are unstable governments in these countries. At times when the change of the government takes place the incoming regime may wish to change or abolish the previous contracts and agreements made with the foreign investors by earlier governments such as "The

Pyramid arbitration case” from Egypt describes the way in which chauvinistic feelings may wheedle foreign investment clash. The patriotic approach and opposing the foreign investors brings impediment in economic growth and development. [Haque and Naeem, 2009]

Law and Order Situation: Law and order is very important for any country’s economic growth. Protection of laws and security enhances the investment opportunities. Pakistan is currently facing the problems of terrorism, general massacre, unemployment, brain drain and lack of investment. In 2007 LAL Masjid (Red Mosque) attack, after it there is a tremendous situation of Pakistan due to the terrorist attack. Pakistan has a potential of investment, but no international investors willing to put their investment. According to the section 80 of the police order in provincial level there is a duty of the police department to protect the citizens from terrorist or any illegal activities. Currently, there is a great potential of natural resources in different provinces of Pakistan especially Balochistan. The law and order situation is very bad, due to this reason we are deprived of the natural resources.

Lack of Good Governance: Good governance is the most important factor to attract the local and foreign investment in different sectors of economy. In Pakistan, the management and administration of the department is not up to the certain mark, and the situation is becoming good, however the pace is slow. Finally, the objective of the Pakistani government is to reduce the unemployment, poverty reduction and good management of the tax collection. However, the role of the governance is not up to the mark. Pakistan is currently facing the budget deficit because of the excessive borrowing from the central bank and excessive defense expenditure. The Pakistan Public Procurement Regulatory Authority (PPRA) was created in 2002, because to work with a good and systematic way. Pakistani government is taking some remedial measure against the lack of governance. A united nation development program (UNDP) is basic objective is to secure the citizen from the potential threats of terrorist activities and bad rules, promotion of the secured laws and accountability. Another program in Pakistan is to promote the justice and equality is “The Meezan-e-Adal Program (MAP)”. The major issue in Pakistan is lack of good governance and corruption. UNDP shows in their synopsis under heading 3 to promote and procure the investors. The government of Pakistan is currently needs the good governance in order to accumulate the financial regulatory framework.

Non-Compliance of Courts Order: The court order is must comply with the citizen of the country. It is responsibility of the citizen to obey and to follow the rules sanctioned by the courts. The individual have no right to disobey the rules or any

other option that which rules to follow and which rules to disregard. There is a worse situation in Pakistan courts system; Yousuf Raza Gilani non compliance action the Switzerland case of Zardari. The court was given the order to Prime Minister of Pakistan on to reopen the corruption case that is currently proceeding in Switzerland. Yousuf Raza Gilani committed a court of contempt, because of not obeying the order of courts. To promote the healthy economic policies and to protect the foreign investors from the potential threats, like terrorism and abduction there is a need to follow the rules and to obey the court orders.

Courts attitude in Pakistan: In Pakistan there are some certain restrictions by the foreign investors, the attitude of courts in Pakistan with respect to the enforcement of international contracts is to some extent is patriotic, however the situation is evolving in positive direction but the pace is slow. Recently Pakistan Supreme court has declared that “No international arbitration until case decided in Pakistan. International center for settlement of investment dispute (ICSID) which resolves the dispute of investment disaggregation. Pakistan Chief. Justice Iftikhar Muhammad Chaudhry declared that Baluchistan Reko Diq case is only settled by the national level and international investors are not allowed to enter in this territory (Baluchistan). The various cases including the HUBCO’s case (The Hub Power company case and WADPA case) and ECKHARDT’s case are the bad character by the courts to the foreign investors at last creating the problems to the Pakistan in the investment and trade sectors.

Economic and Trade Policies: In Pakistan there are good economic policies but the problem is implementation. Rules of laws and good governance are a part of promoting the economic policies. Pakistan is currently facing severe inflation, twin deficit, inefficient management, corruption and poverty. Trickle-down theory by Nadeem Ul Haq, debt policy by Dr. Eatzaz Ahmed, thumb rule for monetary policy in Pakistan by Dr. Waseem Shahid Malik, energy and its impact on the economic health by Dr. Abdul Jalil, these are all the good policies for Pakistan but the problem is implementation. In 1980 the era of Zia was very admirable, because of the efficient economic system, stable prices, reduction in the budget deficit, subsidies in agricultural products and efficient management system. There is a currently need for the implementation of the economic laws and the policies to reformulate the economic system under the legal situation.

⁹**Table: 1** Snapshot of Regulatory Laws relating to Investment in Pakistan

<i>Sr.No</i>	<i>Law</i>	<i>Relevant Provision</i>	<i>Comments</i>
1	The constitution of Islamic republic of Pakistan (1973)	Article 4,25	The protection of law and to be treated in accordance with law is the inalienable right of every citizen. No action detrimental to the life, liberty, body, reputation or property of any person shall be taken except in accordance with law. All citizens are equal before law and are entitled to equal protection of law.
2	The Companies ordinance (1984)	Preamble	For the purpose of healthy growth of corporate enterprises, protection of investors and creditors, promotion of investment and development of economy.
3	The constitution of Islamic republic of Pakistan	Article 18	Subject to qualifications, as may be prescribed by law, every citizen shall have the right to enter upon any lawful profession or occupation and to conduct any lawful trade or business.
4	Board of Investment Ordinance 2001	Preamble	To encourage and facilitate the local and foreign investors in Pakistan.
5	The Competition Act 2010	Preamble	To, provide free competition in all spheres of commercial and economic activity to enhance economic efficiency and to protect the consumers from anti-competitive behavior.
6	Foreign Private Investment Promotion and Protection Act, 1976	Preamble	To provide for the promotion and protection of foreign investment in Pakistan.
7	Protection of Economic Reforms Act (1992)	Preamble	To provide legal protection to these reforms in order to create confidence in the establishment and continuity of the liberal economic environment created.

⁹See the root cause of the court system and ineffective polices on “The news, Wednesday February, 2012” See the Reko Diq case visit tuibute.com.pk/story.

Methodology

Tests for Stationary: In this section, the authors present methodology for testing unit root in the data. A time series is stationary when it has the following three characteristics: Has a finite variance that is time-invariant; and

- a) the basic property of the Stationary is that this shows the mean reversibility that is fluctuating around a constant long run mean;
- b) This has the theoretical correlogram that will dwindle as the lag length criteria increases.
- c) In its simplest terms a time series y_t is said to be stationary if:

$E(\Delta y_t) = \text{constant}$ for all t ; $\text{var}(y_t) = \text{constant}$ for all t ; and $\text{cov}(y_t, y_{t+k}) = \text{constant}$ for all t and all $k \neq 0$, or if its mean, its variance and its covariance remains over the time.

Shocks to a stationary time series are necessarily temporary, over time, the special effects of the shocks will disband and the series will slip back to its long run mean level. As such, long-term projections of a stationary series will congregate to the unconditional mean of the series.

Unit root tests based on Time Series:

a. Augmented Dickey –Fuller (ADF) test:

Dickey and Fuller in their paper of "Testing for Unit Roots in Autoregressive Moving Average Models of Unknown Order" (1984) extended their test procedure suggesting an augmented version of the test which includes extra lagged terms of the dependent variable in order to eliminate autocorrelation. The lag length on these extra terms is determined by the Akaike Information Criteria (AIC). The three possible forms of the ADF test are given by the following equations:

$$\Delta y_t = \alpha y_{t-1} + \sum_{i=1}^p \beta_i \Delta y_{t-i} + \epsilon_t \quad (1)$$

$$\Delta y_t = \alpha_0 + \gamma y_{t-1} + \sum_{i=1}^p \beta_i \Delta y_{t-1} + e_t \quad (2)$$

$$\Delta y_{t-1} = \alpha_0 + \gamma y_{t-1} + \alpha_2 t + \sum_{i=1}^p \beta_i \Delta y_{t-1} + e_t \quad (3)$$

The difference between these three equations is the inclusion of time, trend and intercept. Econometrician knows the actual data generating process, there is a question concerning whether it is most appropriate to estimate equations above. Test checks the significance of γ to check the existence of unit root in the data.

b. The Phillips-Perron test

The distribution theory supporting the Dickey-Fuller tests is based on the assumption that error terms are statistically independent and have a constant variance. So when using the ADF methodology, we have to make sure that the error terms are uncorrelated and they really have a constant variance. Phillips and Perron (1988) developed a generalization of the ADF test procedure that allows fairly mild assumptions concerning the distribution of errors. The test regression for the Phillips-Perron (PP) test for the AR (1) process is as follow:

$$\Delta y_{t-1} = \alpha_0 + \gamma y_{t-1} + e_t$$

While the ADF test corrects the higher order serial correlation by adding lagged differenced terms on the right hand side, the (PP) test makes a correction to the t-statistic of the coefficient γ from the AR(1) regression to account for the serial correlation in e_t . So the (PP) statistics are just modifications of the ADF t-statistics that take into account the less restrictive nature of the error process.

We have used the data for the period of 1981-2009 to show the impact of the foreign direct investment on economic growth. All variables are taken from the world development indicator (WDI) and IFS. All the data we have used in the growth form. We have used the growth rate of GDP, growth rate of FDI, growth rate of exchange rate.

Table-2: Results of Stationary Tests for Pakistan.

<i>Tests</i>	<i>variable</i>	<i>No. of Lags</i>	<i>Specification</i>		<i>Values</i>	<i>Order of integration</i>
ADF-Test	GFDI	(1)	Constant	Level	-4.6723 (0.0010)*	(0)
PP-Test	GFDI	---	Constant	Level	-4.8058 (0.0007)*	(0)
ADF-Test	GGDP	(1)	Constant	Level	-4.5441 (0.0014)*	(0)
PP-Test	GGDP	---	Constant	Level	-4.5441 (0.0014)*	(0)
ADF-Test	GMS	(1)	Constant	Level	-4.9801 (0.0005)*	(0)
PP-Test	GMS	---	Constant	Level	-4.9923 (0.005)*	(0)
ADF-Test	INF	(1)	Constant	Level	-1.3403 (0.5898)*	(1)
	INF	(1)	Constant	First Difference	-4.1471 (0.0039)*	
PP-Test	INF	---	Constant	Level	-1.3923 (0.5703)	(1)
	INF	---	Constant	First Difference	-3.9234 (0.0063)*	
ADF-Test	GER	(1)	Constant	Level	-4.2533 (0.0025)*	(0)
PP-Test	GER	---	Constant	Level	-4.2684 (0.0024)*	(0)

*, **, *** significant at 1%, 5% and 10%, respectively. Values in parenthesis are p-values. Growth rate of Money supply (GMS): growth rate of GDP GGDP. Growth rate of FDI GFDI, Inflation IF Augmented Dickey Fuller Test (ADF), and Phillips-Perron test (PP-Test)

$$\text{Regression-I: } GFDI_t = \alpha_0 + \beta GGDP_t + \gamma INF_t + \delta GER_t + \mu_t \quad (4)$$

$$\text{Regression-II: } GGDP_t = \alpha_0 + \beta GFDI_t + \gamma INF_t + \delta GER_t + \mu_t \quad (5)$$

¹⁰**Table-3:** Results based on time series regression for Pakistan

¹⁰United Nations Millennium declaration stipulates that an increase in FDI to the poor countries will result in a remarkable reduction in the poverty.

(8) See Li and Resnick (2003) and Jensen (2003) for a detailed discussion about the theoretical impact of democracy on FDI.

(9) Economic intelligent unit report survey that the business environment and proper implementations of the law and good economic policies leads to the inward foreign direct investment.

<i>Variables</i>	<i>Regression values</i>	<i>2nd Regression values</i>
Constant	-2.3309 (0.0323)	0.3331 (0.4312)
GGDP	1.8554 (0.0511)*	----
GFDI	----	0.0832 (0.0023)*
GER	0.0031 (0.0084)*	0.0031 (0.0084)*
INF	1.4502 (0.0001)*	0.4625 (0.0003)*
D-W value	2.030	2.2803
R Squared	0.4166	0.6390
F-Stat	3.0352 (0.046)	8.4111 (0.000)*

*, **, *** significant at 1%, 5% and 10%, respectively. Values in parenthesis are p-values. Growth rate of Money supply (GMS): growth rate of GDP GGDP. Growth rate of FDI GFDI, Inflation IF, and Growth rate of exchange rate (GER).

Discussions

The authors executed two regressions to show the major impact of the foreign direct investment on economic growth. The regression one is basically used to implement some momentum tools of the money supply via inflation to show the impact of the foreign direct investment. The basic reasons for the inward foreign direct investment are to implement the good laws and good governance that leads to the promotion of foreign direct investment and economic growth. The good governance and the strong laws; like common laws which yields the good financial health of the country. The risk factor also involves towards the investment decisions and the political instability also the factor, which creates a hurdle towards the domestic as well as foreign investment (Byrne, 2001; Queensland Government Public works, 2002).

All analysis is conducted in natural logs so the coefficients are interpreted in terms of elasticity's. In order to eliminate the trend from the data and to make the data stationary, we have used the ADF-test and PP-test to make the data stationary. All the variables are having the order of integration is (0), except the inflation, which order of integration is (1). We have simply used the Ordinary Least Square (OLS) to check the significance according to the law. We have not used the GMM-Estimator because we are unable to find the correct data for the Pakistan. However, to some certain extent; we have used the basic laws and their role in domestic as well as the foreign direct investment for Pakistan.

Regression (1) results showed that 1% increase in the growth rate of GDP will increase the foreign direct investment by 1.85%. A 1% increase in the growth rate of exchange rate will increase the growth rate of foreign direct investment by .03%. The exchange rate has infinitesimal effect on the foreign direct investment. When the exchange rate increases, it will ¹¹increase the exports and will lead to the economic growth and is ultimately caused to bring the FDI to the country. The most important issue here is the rules of laws and governance that is the most crucial factor to enhance or to shrink the FDI. We can also identify the inflation mechanism via the money supply process that inflation will cause to deprecate the local currency, exchange rate appreciation and bringing about the export enhancement and ultimately economic growth, that leads to the foreign direct investment.

Regression (2) results have the opposite issues, regarding the dependent and independent variables. A 1% increase in the foreign direct investment (FDI) will increase in the growth rate of GDP by .0832%. This means that the foreigners will be attracted when there is a good infrastructure, good governance, proper implementations of the laws and the legal protection of the investment will ultimately bring the foreign direct investment. If the central bank increases the money supply ultimately it will bring the demand for money, and will leads to the inflation. The inflation will cause to increase in the exchange rate and the domestic currency will depreciate and will increase the export. Ultimately it will increase the foreign direct investment. We have applied the OLS technique. There is no problem of the autocorrelation. The model is a good, because we have checked it by Ramsey-Reset model. We have used the double log functional form here. In this case our F-critical > F-statistics and we accept the null hypothesis of correct specification. The model is good and our results are reliable.

Conclusion

We have found the links between the FDI and economic growth under the common and civil law in Pakistan. We also observe that the growth is positively related with foreign direct investment. There is an imperative need to implement the laws in its true letters and spirit and to introduce friendly, moderate and transparent economic policies for the stockholders and participants of trade and investment in Pakistan. In Pakistan, there is a mixed common law, which is combination with

¹¹ See Granger Causality OLS [Vector Error Correction Model]
13 Co-integration test
14 Vector Autoregressive Model

common law with the element of customary [Muslim] law. However, to procure the domestic and foreign investors, government should take remedial measures; like interest rate is to be increased in order to enhance the foreign direct investment. If the domestic interest rate will increase then ultimately it will crowd out the private investors. So, in Pakistan there is no potential threat to the private investors and private investors are currently outflow their investment. The reason behind it; there is a threat regarding, energy shortage, terrorism, bad economic environment and poor laws. Stock market has a great role for the domestic as well as the foreign investors. The good and strong financial markets ultimately bring the foreign direct investment. The strong laws and the protection of the foreign investors as well as the domestic investors will ultimately bring the economic growth via FDI. (Duke/CFO Magazine survey, 2006; Lloyd's of London, 2007) showing that the credible threat to the potential investors is due to the uncertainty in future and lack of enforcement of laws that is the basic problem in the economic growth. For the Pakistan there is a need for the enforcement of the regulatory laws and very attractive public policy.

Pakistan is currently facing the financial turmoil due to the terrorist attack after Mumbai bomb blasting in India. These terrorist attacked have failed to govern the stock markets and creating the potential threats to the domestic as well as foreign investors. The recognizable effect for the investors is to invest in the domestic country to protect the investors (Bruno and Claessens, 2007). Cuervo and Cazorra (2004) found that the good governance will ultimately bring the investment to the country. Regarding the policy implications, there is a need of common laws in Pakistan which are more suitable for this country. The basic needs, to regulate the monetary policy by rule; and to regulate the financial framework with the proper and legal law enforcement. Pakistan is facing the terrorist attacks that are the leading to the trajectory of the financial turmoil. However up to some certain level, Pakistan is doing very well after 2011. After the examination of investment laws, the authors come to the conclusion that Pakistan having a beautiful collection of laws, however, the problem is the enforcement and there is a need to establish a task force which exclusively does this job with respect to this enforcement of the laws.

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Note: This article contains the personal views of authors and does not reflect the ideas of an organization in which they are attached.