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**Foreign Direct Investment in Pakistan: The Role of  
International Political Relations**

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# Foreign Direct Investment in Pakistan: The Role of International Political Relations<sup>\*</sup>

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## Abstract

The main focus of this study is to investigate the impact of Pakistan's international political relations on FDI inflows. To this end, an extensive theoretical and empirical analysis has been carried out over the period 1972-2009. We find that U.S. policies produce no significant influence on long-term capital inflows to Pakistan in the long-run. However, in the short-run U.S. diplomatic policies produce negative influence on inward FDI to Pakistan. This implies that deterioration of U.S.-Pak diplomatic relations exert significant negative impact on capital inflows to Pakistan in the short-run. The results also reveal that domestic investment; financial development, infrastructure and natural resource endowments exert significant positive impact on FDI in the long- as well as short-run. Trade openness influences FDI inflows negatively in long-run, but produces no significant impact on FDI in short-run. Political risk related factors (i.e. political rights, civil liberties and political repression) produce no significant impact on FDI inflows to Pakistan in the long-run. However, only civil liberties positively correlated with FDI in short-run. Therefore, policies aimed at strengthening resource based, such as encouraging domestic investment activities, continuity of liberalization policies, improvements of local infrastructure promote FDI inflows to Pakistan. More importantly, Pakistan may establish its political ties with major international power, particularly with the United States on the basis of mutual interests and dignity and those relations should be consistent, sustainable and predictable.

Key Words: Foreign Direct Investment, International Political Relations, Political Risk, Cointegration, Pakistan

JEL Classification: F21, F59, P59, C20, R50

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Note: The views expressed in this paper are my own; Pakistan Institute of Development Economics, Islamabad (Pakistan) and Department of Politics and International Relations, University of Oxford, UK are not responsible.

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## Introduction

It is well documented in the literature that savings and investment are the key pillars of economic development and high level of savings and investment is necessary to accelerate the pace of capital formation and hence economic growth. However, in developing countries the level of domestic savings falls below the desired level because of low per capita income (Khan, 2007). In the case of Pakistan, domestic saving accounts for less than 15 percent and domestic investment remains 17 percent of GDP.<sup>1</sup> This savings-investment gap can be filled by the transfer of foreign capital from abroad. Foreign direct investment (FDI)<sup>2</sup> is an important component of capital flows and is believed to be one of the most important channel through which financial globalization benefits the economy (Prasad, *et al.* 2003). Many studies find supportive evidence that FDI exerts positive effect on growth via technology spillovers. FDI is also much sustainable than portfolio investment and making countries less vulnerable to sudden stop or reversals of flows (SBP, 2009 and Kose, *et al.*, 2003).<sup>3</sup> To increase the level of FDI, liberalization of trade and investment regime by relaxing controls and offering special incentives to foreign investors, such as tax concessions, tariff reductions or exemptions and subsidies for infrastructure is needed (Zaidi, 2004). Such policies have been instrumental in accelerating FDI inflows to developing countries like Pakistan. The domestic policies opted by the recipient countries have an important influence on the decisions of foreign investment. To attract FDI, the host country should adopt concrete and investor friendly policies and strong infrastructure are the pre-requisite to restore the confidence of foreign investors (Khan, 2007).

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<sup>1</sup> For the fiscal year FY08 national savings are 13.4 percent of GDP, while total investment is 22 percent of the GDP. For the FY09 national saving is expected to be 14.3 percent of GDP and total investment is 19.7 percent of GDP (SBP, 2009).

<sup>2</sup> FDI may be defined as private capital inflow from a parent firm to a location outside of the parent's firm home nation. These investments consists of equity capital, inter-company debt, and reinvestment earnings. An investment is considered FDI, as opposed to portfolio investment, if it is large enough to give the parent firm some amount of control over the management of the enterprise — usually more than 10 percent of the firm (Jensen, 2003, p. 588). The motives of FDI vary across different types of FDI. The main motives are grouped under market-seeking, resource-seeking and efficiency seeking reasons (Akhtar, 2000).

<sup>3</sup> FDI may also be defined as an investment abroad, usually where the company being invested in and is controlled by the foreign corporation.

Over the years, Pakistan followed market distorting policies, such as placing restrictions on foreign investment, barriers on trade, controlling production and distribution and administered price controls, etc. As a result, Pakistan was confronted by the problems of low growth, poor socio-economic conditions and sustained balance of payments deficits. Consequently, the government of Pakistan undertook structural reforms in the late 1980s.<sup>4</sup> The focus of these reforms was the gradual liberalization of trade and investment regime by providing various trade and fiscal incentives to foreign investors through tax concessions, credit facilities, tariff reductions and easing foreign exchange controls (Khan, 1997, Aqeel and Nishat, 2004 and Khan, 2007). This led to a substantial increase in the volume of FDI inflows into Pakistan. The inflows of FDI in Pakistan in 1970 was just US\$ 23 million and surged to over US\$ 5.4 billions in 2007-08 before it dropping to US\$ 3.7 billion in 2008-09 and further US\$ 2.2 billion in 2009-10. This decline in FDI could be due to the worsening effects of global financial crises which weakened the capacity of international investors to invest abroad on account of falling corporate profits, heightened risks and reduced access to financial resources (SBP, 2009). In Pakistan, global financial crises weakening the macroeconomic fundamentals and deteriorating law and order situation results in a decline of FDI by 51.1 percent during 2009. However, due to inconsistency of government policies the level of FDI remained low as compared to India and other emerging economies.

One reason of low level of FDI could be the political risk which is associated to the quality of domestic institutions. Since the investment decisions are linked with socioeconomic, political and cultural factors in the host economy (Akhtar, 2000 and Busse and Hefeker, 2007).<sup>5</sup> These factors significantly affect the flows of FDI to developing countries. However, despite the presence of these favourable factors, FDI may not flow into a country, if the political risk rating of the host country is poor. An unstable political environment makes investment risky and erodes the investor's confidence. Hence, political environment, national as well as international vis-à-vis the country,

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<sup>4</sup> The structural reforms include the liberalization of financial markets, deregulation and privatization of state-owned commercial banks and liberalization of trade and investment regime.

<sup>5</sup> The returns on FDI depends on the profits of MNCs, expansion of business activities, market development, investment environment, macroeconomic factors, development strategy of host country, innovations, etc.

which hosts the FDI, plays a crucial role in determining FDI inflows (Butler and Joaquin, 1998). Since political risk is related to the risk that a sovereign host government will unexpectedly change the environment under which business operates (Busse and Hefeker, 2007 and Bulter and Joaquin, 1998). Unexpected changes in government's policies and institutional setup could affect FDI flows, and therefore, location decision is also influenced by the political risk. In empirical studies, political risk effects have been found to be highly significant.<sup>6</sup> Political instability in Pakistan has been a frequent phenomenon. For example, military coup in July 1977, nine different governments ruled during 1988-1999<sup>7</sup> and judiciary crisis of 2007. During 1988-1999 the political instability was heightened. Political instability and frequent changes of the governments has created an environment of uncertainty and lack of creditability at national as well as international level (Hussain, 2009). The political conflict between Pakistan Muslim League (PML) and Pakistan Peoples Party (PPP) shocked investor's confidence and accelerate capital flight.

Another possible reason of low volume of FDI inflows to Pakistan could be the idiosyncratic risk which relates to the interstate political relations between host country and investing countries (Desbordes and Vicard, 2009 and Desbordes, 2010).<sup>8</sup> The role of interstate diplomatic relations as determinant of FDI has been globally ignored by the literature, and focused only on the impact of domestic factors, such as political instability and corruption. However, the recent literature suggests that in addition to the political risks, MNCs faces a specific political risk related to the diplomatic climate between the home and the host countries (Desbordes, 2010). Therefore, interstate political relations have significant effects on MNC's decisions to invest abroad and these effects may be positive or negative. After corruption, diplomatic pressure is an important means for MNCs to gain business advantages (Transparency International, 2002). Foreign firms

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<sup>6</sup> The behaviour of local variables (such as market structure, labour costs, market size, exchange rate risks, trade liberalization and development of institutional set up, particularly, development of domestic financial institutions) that determine FDI inflows in the host country will vary according to these motives (Akhtar, 2000). Other than the higher return motive, FDI will be largely affected by the political environment vis-à-vis recipient country.

<sup>7</sup> Four interim governments, four elected and one following the military coup of October 1999.

<sup>8</sup> For example, the British Oil multinational enterprises (MNEs) British Petroleum and the French retail MNE Carrefour have recently been the collateral victims of diplomatic tension between countries. Due to the United Kingdom's attempt to extradite an ex-KGB Russian or French protests about Chinese rule of Tibet, the consumer boycotts and retaliatory sanctions causing these MNEs to experience significant losses.

may suffer from the retaliatory consequences of deteriorating diplomatic relations between home and host countries (Boehmer *et al.*, 2001). Foreign investors are much sensitive to the quality of interstate political relations, as any deterioration may increase the risk of seizure of their business in the host country (Desbordes and Vicard, 2009). In the case of Pakistan the flows of FDI may partly depends on the Pakistan's political relations with investing countries. For example, the inflow of foreign capital in to Pakistan is heavily depending on the political relations with the United States and other major international powers. The history of capital inflows to Pakistan stands witness, that whenever Pakistan has had good relations with international powers, particularly with the United States, a surge in foreign capital inflows into Pakistan is noticed.<sup>9</sup> The U.S. policies do not only affect the flows of capital to Pakistan but in many times it influenced the policies of the other countries and bilateral and multilateral institutions towards Pakistan. For example, Dreher *et al.* (2009) rightly argued that World Bank has been used as a tool of foreign policy by the major shareholders —the United States, Japan, Germany, France and the United Kingdom. In Morgenthau (1962, P. 302) views, “the transfer of money and services from one government to another performs here the function of a price paid for political services rendered or to be rendered”. In 1991, the U.S. supported a World Bank loan for China in exchange for China's support of the Security Council resolution to deploy armed forces in Iraq (Dreher *et al.*, 2009). In recent invasion in Iraq, the U.S. tried to buy the votes of temporary UN Security Council members, who had not decided how to vote (i.e. Angola, Guinea, Cameroon Pakistan, Chile and Mexico). Similarly, U.S. foreign aid increases when countries serve on the UN Security Council (Kuziemko and Werker, 2006). Dreher *et al.* (2006) find that ten temporary members of UN Security Council are more likely to received IMF assistance than other countries. After the 9/11 terrorist attacks, U.S. threatened Pakistan with dire consequences if Pakistan does not provides logistic and military support to U.S. armed forces to take military action against Taliban in Afghanistan. Similarly, Kapur (2002) argued that U.S enjoys pre-eminence within the World Bank and Bank's policies are heavily influenced by a member of U.S.-based civil society actors. Furthermore, when Pakistan joined ‘War on Terror’ World Bank Official Development Assistance (ODA) tripled from US\$ 226

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<sup>9</sup> Examples include the period involving the Afghan War of 1980s and the War against Terrors.

million in 2001 to US\$ 860 million in 2002 (UN System Pakistan, 2004). This implies that how international powers influenced the policies of bilateral and multilateral international institutions and countries in achieving their political in and commercial interests in the past. Therefore, policies of the United States and other international players towards Pakistan are of crucial importance and needs investigation.

Extensive research work has been carried out with reference to Pakistan, *inter alia*, by Nishat *et al.* (1988), Akhtar (2000), Shah and Ahmed (2004), Aqeel and Nishat (2004), Khattak *et al.* (2005), Afza and Khan (2009), Yousaf *et al.* (2008) Awan *et al.* (2010), Khan and Samad (2010) and Hakro and Ghumro (2011) among others. These studies have concentrated on the economic and political determinants of FDI and ignored the role of diplomatic relations of Pakistan with major international powers as determinant of FDI. To the best of our knowledge no study so far has analyzed the link between FDI and Pakistan's political relations with international powers. This study fills the gap.

The study is designed to analyze the impact of Pakistan's political relations with international powers on FDI besides the other factors, such as domestic infrastructure, financial development, trade openness and political instability over the period 1972-2009. Specifically, the study concentrates on the role of major international powers, particularly United States in the determination of FDI in Pakistan.

The organization of the study is as follows: section 2 presents motivation and research questions. Section 3 presents the review of investment policies and FDI inflows to Pakistan. The link between interstate relations and FDI is discussed in section 4. A detailed descriptive analysis of the U.S. policies towards Pakistan is also carried out in this section. A brief review of literature is given in section 5. Model specification, data and methodology is discussed in section 6. Section 7 presents the empirical results, while concluding remarks are given in the final section.

## **2. Motivation and Research Questions**

Rather than analyzing the impact of economic determinants on FDI, this study mainly focuses on the role of two determinants of FDI inflows, namely impact of political risks (political repression) that matter for multinationals and Pakistan's political relations with major international powers. Particularly, the present study seeks to find answers to the following questions:

- (1) How political risks affect the flows of FDI to Pakistan?
- (2) How United States policies affect the flows of FDI to Pakistan?
- (3) What are the potential determinants of FDI for the economy of Pakistan?

The analysis is carried out in three phases. In the first phase a comprehensive analysis of FDI, U.S. policies towards Pakistan and their possible outcomes will be considered. In the second phase we will examine the effect of Pakistan's political relations with international powers along with economic factors on FDI. In the third phase we will use political rights and civil liberties separately to find their impact on FDI. In the fourth phase we will combine political rights and civil liberties (political repression) as determinant of FDI. In the final phase we will check the consistency of the estimates by adding polity IV data as proxy for political risk.

## **3 Review of Investment Policies and FDI inflows to Pakistan.**

### **3.1 Review of FDI Policy**

Pakistan has adopted somewhat restrictive trade and investment policy regime since its independence in 1947. However, in the early 1990 Pakistan has opened up and made FDI policy environments conducive to foreign investors. Initially, FDI was allowed in a restrictive manner and on mutually advantageous terms with the majority stake held by domestic firms (Sahoo, 2006). However, Pakistan had encouraged FDI more aggressively in the nineties. This section briefly reviews the investment policies of Pakistan.

### 3.1.1 FDI policy in Pakistan

Although the economy of Pakistan have been seen periods of high economic growth, but saving rate remained below 15 percent of GDP and investment rate staying around 17 percent of GDP (Mughal, 2008). As a result, there is huge gap between saving and investment. In order to bridge saving-investment gap the country has to rely on foreign capital inflows. In the 1950s, 1960s and 1970s Pakistan was pursuing import substitution industrialization (ISI) policies for the objective of self-reliance and relied mainly on foreign assistance to cover saving-investment gap. In that period private foreign investment remained negligible (Mughal, 2008).

During the 1960s a more liberal policy being adopted by the government where private sector was the main vehicle for industrial investment and the role of public sector was restricted to only three out of 27 industries (Khan, 1997).<sup>10</sup> During this period the economy is largely dominated by the private sector in the key areas like banking, insurance, basic industries and international trade in major commodities. Consequently, industrial production and exports registered a reasonable increase. However, FDI was not allowed in the field of banking, insurance and commerce and services sector was also reserved for local invertors (Zakaria, 2008). During 1970s the government switched over from liberal policies of the 1960s to nationalization policies by increasing the role of public sector in the economic activities.<sup>11</sup> There was acceleration of foreign investment by the state-owned new industries, such as manufacturing of steel, garments, breads, etc. During this period all kind of foreign investment exempted from the purview of nationalization (Khan, 1997 and Zakaria, 2008). However, foreign investors discouraged more due to nationalization move and excessive regulation of trade and commerce from the government.

After the unsatisfactory performance of the nationalized organizations, the government softened its stance on foreign investments and gradually allowing the foreign investment

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<sup>10</sup> The three basic industries were: (1) arms and ammunition, (2) generation of hydroelectric power, and (3) manufacturing of railway wagons, telephone, telegraph lines, and wireless apparatus. For further details see Khan (1997).

<sup>11</sup> During 1970s the Government of Pakistan nationalized major industries and financial institutions.

in the country. The first step towards the liberalization of FDI policy was taken in 1984 with the announcement of industrial policy statement giving equal plank to the public and private sectors (Sahoo, 2006). Foreign private investment was encouraged in the form of joint equity participation with local investors in the areas where advanced technology, managerial and technical skills and marketing expertise were involved (Atique *et al.*, 2004 and Sahoo, 2006). The role of public sector was restricted to consolidating the existing enterprise and further investment in this sector was strictly restricted (Khan, 1997). Industries like steel, fertilizer, cement, petroleum refining and petrochemicals, automotive equipments and engineering remained in the realm of public sector. The private sector was also allowed to participate in these sectors. An adequate legal framework for foreign investment was provided through the Foreign Private Investment Act 1976. The Act guaranteed the remittance of profit and capital and the appreciation of agreements on the avoidance of double taxation. In 1980s, the government has decided to pursue a pattern of mixed economy with the public-private sector partnership. At the same time the government began to adopt a more liberal foreign investment policy. To improve the business conditions and to attract FDI, a number of regulatory measures were taken. These measures include the liberalization of exchange rate regime, establishment of export-oriented industries and set up of export processing zones (EPZ) in Karachi. Furthermore, concessions and facilities offered by the EPZ include duty-free imports and export of goods, tax exemptions, etc. A one window facility was also established to overcome difficulties in setting up new industries (Zakaria, 2008 and Khan, 1997).<sup>12</sup> Despite these incentives, the highly regulated nature of Pakistan's economy constrained the inflows of FDI.

After following somewhat restrictive economic policies, the government of Pakistan (GOP) initiated market-based reforms in the late 1980s. These reforms includes gradual liberalization of trade and investment regime by providing various trade and fiscal

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<sup>12</sup> FDI was discouraged due to: (a) significant public ownership, strict industrial licensing and price controls, (b) inefficient financial sector with directed credit programmes and markets segmentation, and (c) non-competitive and distorted trade regime with quotas, import licensing, exchange controls and high tariffs (Zakaria, 2008 and Khan, 1997). Furthermore, The Board of Investment (BOI) was set up to help to generate opportunities for FDI and provide investment services. To facilitate foreign investment, Pakistan has signed bilateral agreements on the promotion of investment with 46 countries (Sahoo, 2006).

incentives to foreign investors through tax concessions, credit facilities, tariff reduction and easing foreign exchange controls (Khan, 1997, Aqeel and Nishat, 2004, Khan, 2007 and Khan and Khan, 2011). In the early 1990s, the GOP undertook a number of regulatory measures to improve the business environment and attract FDI (Anwar, 2002).<sup>13</sup> To encourage FDI, restrictions on capital inflows and outflows were also gradually lifted. Foreign investors were allowed to hold 100 percent of the equity in industrial project on a repatriable basis, without any prior approval (Khan, 2008 and Khan and Khan, 2011). Furthermore, investment shares issued to non-residents could be exported and remittance of dividends and disinvestment proceeds was permissible without any prior permission of State Bank of Pakistan. In 1994, restrictions on some capital transaction were partially relaxed and foreign borrowings, and certain outward investments, were allowed. Full convertibility of Pak-rupee was established on current international transactions. The establishment of an interbank foreign exchange market also marked an important step towards decentralizing the management of foreign exchange and allowing market forces to play a greater role in the determination of exchange rate and payment system (Khan, 2008). The government also offered extensive set of investment incentives including tax holiday for projects in rural and underdeveloped areas (Zaidi, 2005).

In November 1997, the GOP has announced new industrial policy that included major policy initiatives to attract FDI, which has earlier restricted to the manufacturing sector (Sahoo, 2006). Sectors like services and agriculture were now opened. The main objective of new industrial policy was to enhance the level of foreign investment in the fields of industrial base expansion, infrastructure and software development, electronics, engineering, agri-food, value added textile items, tourism and construction industries. Foreign investment on a repatriable basis was also allowed in agriculture, services,

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<sup>13</sup> These regulatory measures includes: (a) removal of the requirement for government approval of foreign investment, (b) permission of foreign equity participation up to 100 percent, (c) permission to negotiate the terms and conditions of payment of royalties and technical fees suited to foreign investors for transferring technology, (d) liberalizing the foreign exchange regime, (e) permission of remittances of principal and dividends from FDI and portfolio investment including an extensive set of fiscal incentives and allowances to foreign investors, (f) convertibility of Pak-rupee from July 1994, (g) liberalizing of import policy, (h) opening up of sectors like agriculture, telecommunications, energy and insurance to FDI in 1997, reduction of maximum tariffs and establishment of special industrial zones (see Anwar, 2002 and Khan, 2007).

infrastructure and social sectors, subject to the following conditions: (i) the basis for joint venture is (60:40), (ii) foreign equity will be at least \$1millions, (iii) foreign companies registered in Pakistan will be allowed to invest, (iv) for social sector and infrastructure projects, the joint venture requirement was waived and 100 percent equity may be allowed (Sahoo, 2006). Since 1997, attractive tariff and tax incentives have been given to foreign investors. Remittance of royalties, technical and franchise fees, capital, profits and dividends was allowed. Foreign investment is fully protected through the foreign investment Act 1976, Protection of Economic Reforms Act 1992 and Foreign Currency Accounts Protection Act 2001.

During 2000 and on ward, privatization, deregulation, fiscal incentives and liberal remittance of profits and capital were the key principles of investment policy (Zakaria, 2008). All economic sectors including services sector were open to FDI. Privatization of enterprise is fully protected. Neither it can be nationalized, nor can the government takeover any foreign enterprise (Khan, 2007). Today, FDI is not subject to taxes in addition to those levied on domestic investment. No requirement for obtaining no objection certificate (NOC) from provincial governments for locating the project anywhere in the country except for the areas that are notified negative areas.<sup>14</sup> To protect intellectual property rights (IPRs), Pakistan has updated IPRs laws to bring them in compliance with international requirements particularly, those mandatory under the Agreement on Trade Related Intellectual Property Rights (TRIPS) of the WTO (Khan 2007).

The above steps taken by the GOP implies that Pakistan has implemented proactive investment policies to encourage FDI in all sectors of the economy. However, FDI inflows are considerably hindered by institutional weakness, corruption, ineffective legal environment, political uncertainty and unsustainable diplomatic relations of Pakistan with major international powers. Table 1 highlights the liberal investment policies in Pakistan.

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<sup>14</sup> Further details can be examined on Pakistan's board of investment web site <http://www.pakboi.gov.pk/invest.pack.htm>

Table 1: Foreign Investment Policies in Pakistan

Policy Regime	Remarks
Restricted Sectors	<ol style="list-style-type: none"> <li>1. Arms and Ammunitions</li> <li>2. High Explosive</li> <li>3. Radioactive Substances</li> <li>4. Security printing currency and mint</li> <li>5. New units of alcohol manufacturing except industrial alcohol is band</li> </ol>
100 percent equity	Yes, for all sectors
Incentives	Incentives are industry specific but has local content requirement.
Restrictions on royalty or technology transfer payments	No
Performance requirements	No (only for eligibility of incentives)
EPZ incentives	Yes, complete exemption of taxation from federal, provincial and municipal bodies
Automatic Approval	Yes
National treatment	Yes
MIGA Signatory	Yes
Tax holidays	No, only custom duty and sales tax exemption

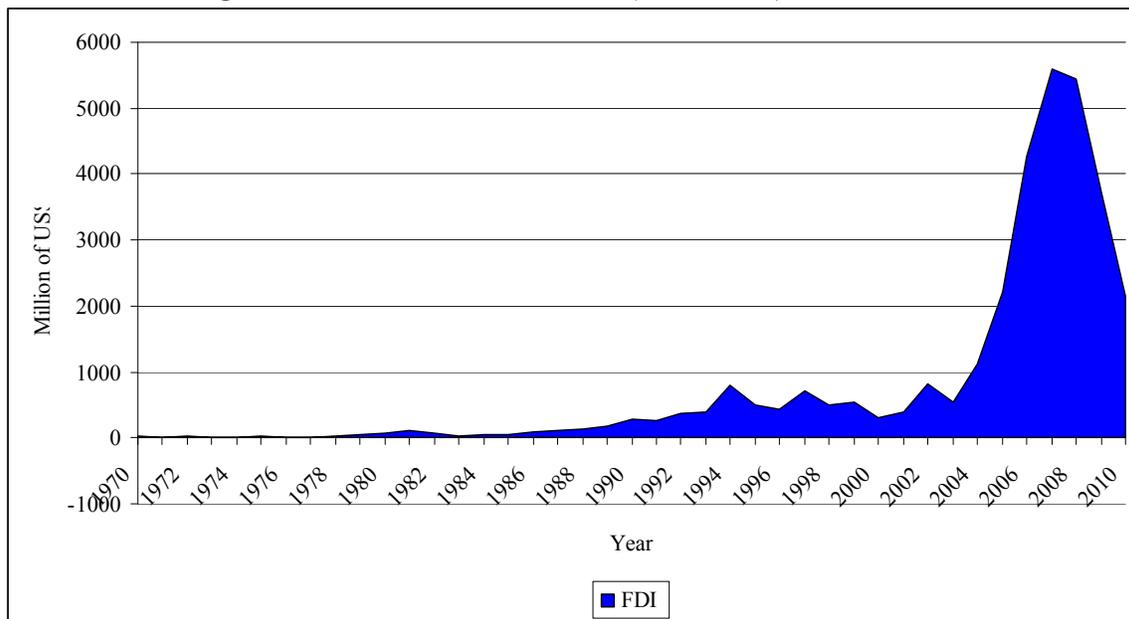
Source: Sahoo (2006) and Board of Investment Pakistan (<http://www.pakboi.gov.pk>).

### 3.2 Trends and Dimensions of FDI inflows to Pakistan

Pakistan has received comparatively higher amount of FDI over the past two decades, due to its market-oriented investment policies and enabling environment for investment. FDI inflows to Pakistan can be explained in terms of its size (Khan, 2007). Due to restrictive investment policies, the flow of FDI was insignificant until 1991; however, it steadily increased in the post-liberalization period (Khan, 2000). Figure 1 suggests that from 1970 until mid-1980s, the annual inflow of FDI was still modest. For example, Pakistan's FDI increased from US\$ 23 million in 1970 to US\$ 64 million in 1980. The low level of FDI could be attributed to political instability, threats due to nationalization process and the lack of government commitment to improve physical infrastructure and human capital (Le and Ataullah, 2002). The second phase started in the late 1980s when government abolished controls from capital flows, remittances transfer and ownership. Tax holidays and tariff concessions were also granted to investors. The post-1988 period is characterized by the process of liberalization and privatization which helped to accelerate the inflows of FDI from US\$ 110 million in 1987 to US\$ 711 million in 1997 (Husain, 1999 and Le and Ataullah, 2002). These FDI inflows saw a dip of US\$ 183 million in 2000. The decline in FDI after 1997 could be attributed to a number of problems like deterioration of Pak-U.S. ties, economic sanctions after the nuclear tests,

freezing of foreign currency accounts, the independent power producers (IPPs) disputes, etc. Furthermore, FDI decreasing trend was also exacerbated by deterioration of investor's confidence due to Asian Financial Crisis of 1997. To restore foreign investor's confidence, a number of policy measures, such as New Investment Policy of 1997 and the Corrupt Business Practice Ordinance of 1998 have been initiated (Le and Ataullah, 2002).

Figure 1: FDI inflows to Pakistan (1970-2009)



Source: UNCTAD <http://stats.unctad.org/fdi/>

Since 2004, there has been a significant increase in the net inflows of capital. Capital inflows included mainly one-off inflows such as US\$ 354 million through privatization, US\$ 600 million through sovereign debt issued internationally and an increase in concessional long-term loans from the World Bank and Asian Developmental Bank (Khan, 2007). FDI reached to US\$ 5.4 billion in 2008, a 443 percent higher than in 2004; however, only 0.26% higher than in 2007. FDI has showed a declining trend since 2007. This fall in FDI flows mainly owed worsening financial crisis with weakened capacity of the international investors on account of falling corporate profits, heightened risk and reduced access to financial resources (SBP, 2009). Furthermore, adverse impact of global financial crises on FDI was weakening the macroeconomic fundamentals and deteriorating law and order situation in the country. As a result, FDI which was US\$3.21

billion in 2009, showing 51.1 percent declined compared with 35.3 percent decline last year. Although the increase in FDI in 2006 can be significantly attributed to privatization proceeds; the increase in the subsequent years is primarily attributed to green-field investment. Pakistan lacks adequate infrastructure, the dominance of green-field investment in the composition of FDI signifies the creation of long-term jobs and influx of technology and knowledge, which improve the country's human capital. New FDI is concentrated in a few sectors such as telecommunication, finance and oil and gas exploration (Khan and Khan, 2011).

This increase in FDI seems insignificant when we compare it with other South Asian countries (Burki and Savitsky, 2000).<sup>15</sup> The reasons for a lower level of FDI inflows in Pakistan include the lack of political stability, slow bureaucratic process, inadequate infrastructure facilities, macroeconomic imbalances, inconsistent economic policies of successive governments, delays in the privatization of state-owned enterprises, past disputes between foreign investors and the government, piracy of intellectual property, arbitrary and non-transparent applications of government regulations, and inconsistent political relations with major investing countries (Khan, 2007).

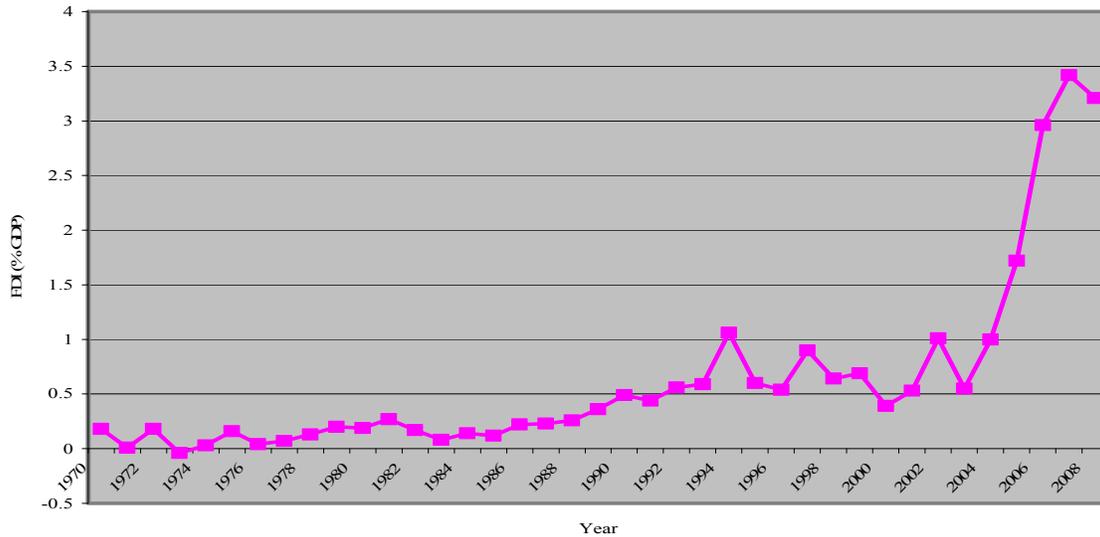
### **3.3 Dimensions of FDI in Pakistan**

The dimensions of the FDI flows into Pakistan can be explained in terms of its growth and size, sources and sectoral compositions. The growth of FDI in Pakistan was not significant until 1991 due to the regulatory policy framework. However, under the more liberal policy regime, it has played a significant role in the development of Pakistan's economy, as shown in Figure 2. It shows that over the post-liberalization era, there has been a steady build up in the actual FDI inflows, which increased from US\$ 278 million in 1990 to US\$ 2201 million in 2005. The decline to US\$ 309 million and US\$ 383 million in 2000 and 2001 respectively can be attributed to many factors including the US sanctions imposed in the aftermath of the nuclear tests, the East Asian financial crisis and political instability (Khan, 2007 and Khan and Khan, 2011).

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<sup>15</sup> For example in 2008 the net inflows of FDI to Pakistan was US\$ 5.4 billion. Whereas in India it was US\$ 41.17 billions, in China it was US\$ 147.79 billions and in Hong Kong it was US\$ 59.61 billions.

Figure 2: Trends of FDI as percentage of GDP



Source: UNCTAD <http://stats.unctad.org/fdi/>

The flow of FDI picked up after 2001, due to the revival of closer US-Pak ties and the liberalized foreign investment environment. In the year 2007, FDI was US\$ 5590 million. Since 2003, Pakistan has registered an increasing trend of FDI inflows and the FDI-GDP ratio (Figure 2), except for the year 2008. This decrease was as a result of the global economic slowdown, caused by the financial crisis, fears of Pakistan running bankrupt and the deteriorating security conditions as fallout of the ‘War on Terrorism’ (Khan and Khan, 2011).

The U.S., UK and UAE remain the major sources of FDI inflows to Pakistan despite considerable fluctuations in their shares. Table 2 and Figure 3 indicates that over 78 percent of the FDI shares to Pakistan collectively originated from the U.S., UK, UAE, Switzerland, China, Norway, Saudi Arabia, Hong Kong and Japan. The top three investors during the period 2000-01 to 2008-09 in Pakistan were U.S., which accounted for nearly 28 percent, UAE and UK respectively accounted for nearly 14.3 and 13.4 percent of FDI inflows to Pakistan. Switzerland, Norway, Saudi Arabia, China, Japan, Hong Kong, and Germany accounted for 5.70, 5.14, 4.3, 2.08, 1.99, 1.92 and 1.66 percent

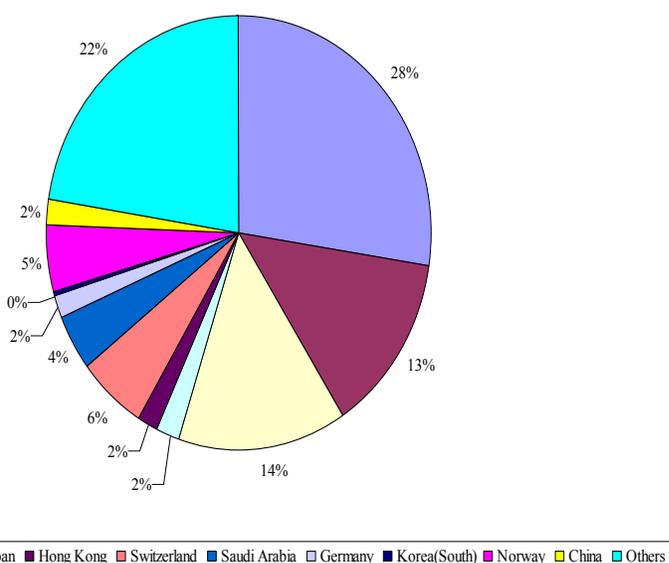
of FDI flows to Pakistan, while all other sources amounted to about 22.5 percent (Table 2).

Table 2: Country-wise Shares of FDI Inflows in Pakistan (in % of Total FDI Inflows)

Country	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	Average (2000-01 to 2008-09)
USA	28.75	67.34	26.50	25.12	21.39	14.67	17.77	25.41	23.39	27.82
UK	28.07	6.25	27.49	6.81	11.91	6.93	16.73	8.93	7.08	13.36
U.A.E	1.61	4.44	15.00	14.18	24.12	40.46	12.87	11.42	4.79	14.32
Japan	2.82	1.32	1.77	1.59	2.97	1.62	1.25	2.55	2.00	1.99
Hong Kong	1.12	0.58	0.70	0.66	2.12	0.68	0.63	6.59	4.20	1.92
Switzerland	1.12	1.53	0.39	21.63	9.02	4.85	3.40	3.29	6.11	5.70
Saudi Arabia	17.56	0.27	5.45	0.76	1.21	7.89	2.01	0.90	2.48	4.28
Germany	4.81	2.31	0.46	0.74	0.86	0.81	1.54	1.35	2.07	1.66
Korea(South)	1.15	0.08	0.03	0.11	0.09	0.05	0.03	0.02	0.06	0.18
Norway	13.00	0.02	0.04	15.45	2.06	7.17	0.49	5.34	2.72	5.14
China		0.06	0.38	1.51	0.03	0.05	13.85	0.27	2.73	2.08
Others		15.80	21.79	11.44	24.23	14.82	29.42	33.94	52.80	22.69
Total	100	100	100	100	100	100	100	100	100	

Source: Board of Investment, Government of Pakistan, available at <http://www.pakboi.gov.pk>

Figure 3: Country-wise Share of FDI Inflows, 2001-2009



Source: Based on the information given in Table 2.

The inflows of FDI up to 2008-09 were relatively broad-based, with almost all sectors witnessing an increasing trend (Tables 3). During 2000-01 to 2009-10, US\$ 17.1 billion of FDI inflows in Pakistan has been seen in few sectors including oil and gas exploration,

power, communications and business finance. These sectors received 71 percent of total FDI.

Table 3: Foreign Direct Investment by Economic Group (million US \$)

Sector	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	Total (2000-01 to 2009-10)	Share in Total FDI
Oil & Gas	80.7	268.2	186.8	202.4	193.8	312.7	545.1	634.8	775.0	740.6	3940.1	16.40
Financial Business	34.9	3.6	207.4	242.1	269.4	329.2	930.3	1864.9	707.4	163.0	4752.2	19.79
Textile	4.6	18.5	26.1	35.4	39.3	47.0	59.4	30.1	36.9	27.8	335.1	1.40
Trade	13.2	34.2	39.1	35.6	52.1	118.0	172.1	175.9	166.6	117.0	923.8	3.85
Construction	12.5	12.8	17.6	32.0	42.7	89.5	157.1	89.0	93.4	101.6	648.2	2.70
Power	39.9	36.4	32.8	14.2	73.4	320.6	193.4	70.3	130.6	120.6	1032.2	4.30
Chemical	20.3	10.6	86.1	15.3	51.0	62.9	46.1	79.3	74.3	112.1	558.0	2.32
Transport	45.2	21.4	87.4	8.8	10.6	18.4	30.2	74.2	93.2	132.0	521.4	2.17
Communication (IT & Telecom)	-	12.8	24.3	221.9	517.6	1937.7	1898.7	1626.8	879.1	291.0	7409.9	30.85
Others	140.9	66.2	90.4	170.1	274.0	285.0	1107.2	764.5	763.4	586.3	4248.0	17.69
Total	322.4	484.7	798.0	949.4	1523.9	3521.0	5139.6	5409.8	3719.9	2150.8	24019.5	100.00

Source: Board of Investment available at <http://www.pakboi.gov.pk/foreign-invest.htm>

Table 4 indicates that the services sector attracted the major chunk of FDI. The significant increase of FDI in the services sector has enhanced its contribution towards GDP by 75 percent. Within the services sector, Telecommunications sector remained most dominant, as depicted by the US\$ 7.4 billion investment in it. During 2000-01 to 2009-10, the contribution of Telecommunications in total FDI exceeded 30%.

Financial Sector is the second major area of interest, followed by the communication sector in attracting FDI. More than 800 percent growth of FDI in the financial sector over the last four years is due to the financial sector reforms. Liberalization and privatization of the financial sector appears to be the main factor responsible for a massive inflow of foreign capital. FDI inflows in this sector increased up to US\$ 1,864.9 million at the end of 2007-08, as compared to US\$ 930.1 million in 2006-07. This trend is likely to discontinue due to the global financial crisis and the exclusion of Pakistan from the Emerging Markets Index (MSCI). Moreover, setting a floor for stock prices at the Karachi Stock Exchange in 2008, to halt a plunge, has further weakened investor confidence in Pakistan's financial markets. If the government wishes to keep foreign

investment inflows high, serious actions need to be taken to regain investor confidence in the financial sector of Pakistan (Khan and Khan, 2011).

Table 4: Sector-wise Share of FDI (in percent)

<i>Sectors</i>	<i>FY04</i>	<i>FY05</i>	<i>FY06</i>	<i>FY07</i>	<i>FY08</i>
<b>I. Manufacturing</b>	<b>17.9</b>	<b>16.8</b>	<b>7.1</b>	<b>18.8</b>	<b>11.9</b>
1. Transport equipment	0.3	2.2	0.9	1	2.2
2. Cement	0.2	0.9	1.1	0.7	2
3. Chemicals	1.6	3.3	1.8	0.9	1.5
4. Textile	3.7	2.6	1.3	1.2	0.6
5. Others	12	7.9	2	15.1	5.6
<b>II. Non-manufacturing</b>	<b>82.1</b>	<b>83.2</b>	<b>92.9</b>	<b>81.2</b>	<b>88.1</b>
<b>A. Extractive Industries</b>	<b>21.4</b>	<b>12.8</b>	<b>9.2</b>	<b>11.2</b>	<b>13.2</b>
1. Oil and Gas Explorations	21.3	12.7	8.9	10.6	12.3
2. Others	0.1	0.1	0.3	0.6	0.8
<b>B. Other Services</b>	<b>60.6</b>	<b>70.4</b>	<b>83.7</b>	<b>69.9</b>	<b>75</b>
1. Communication	23.4	34	55	37	31.5
(a) Telecommunication	21.8	32.4	54.1	35.6	27.9
(b) IT	1.4	1.5	0.9	1.4	3.5
2. Financial Business	25.5	17.7	9.3	18.2	31.2
3. Trade	3.8	3.4	3.4	3.4	3.4
4. Construction	3.4	2.8	2.5	3.1	1.7
5. Transport	0.9	0.7	0.5	0.6	1.4
6. Power	-1.5	4.8	9.1	3.8	1.4
7. Others	5.2	7	3.8	3.9	4.3

Source: State Bank of Pakistan, Annual Reports 2007-08 and 2008-09.

Power generation is a sector that attracted significant FDI due to its immense potential for investment; however, in 2007-08 this sector experienced a steep decline in investment. In 2005-06 and 2006-07, investment in this sector was US\$ 320.6 million and US\$ 193.4 million respectively, and it declined to US\$ 120.6 million in 2009-10. This decline can in part be attributed to the decrease in oil prices and in part to the poor line of management that results in considerable power theft. Another important sector is Oil and Gas Exploration. Pakistan has the fifth largest reservoir of coal (184 billion tons) in Thar but only 4.5-5.0 million tons is mined annually, representing significant upside potential for the industry. The flow of FDI in this sector is continuously increasing and reached US\$ 740.6 million in 2009-10. Other sectors, such as trade attracted US\$ 117 million,

transport US\$ 132 million, chemical US\$ 112 million and construction US\$ 101.6 million during the year 2009-10.

On the whole, Pakistan has a lot of potential to attract foreign investment. Although the rising trend of FDI in various sectors reflects the success of policy; however, FDI inflows are considerably hindered by institutional weakness, corruption, ineffective legal institutions, political uncertainty, poor laws, weak regulatory systems, deteriorating law and order situation, labour productivity and unsustainable international political relations.

#### **4. Foreign Direct Investment and Interstate Political Relations**

Desbordes and Vicard (2005 and 2009) argued that foreign investors may suffer from worsening diplomatic relationships between host country and investing countries. Boehmer *et al.* (2001) show that how interstate linkages such as FDI serve as a costly signaling mechanism in conflicts. They argued that interstate economic link can serve as a mean of communication through which parties in disagreement signals their resolve by sending a credible signal. By reducing the uncertainty about the preferences of the state leaders, this signal fosters the emergence of a peaceful negotiated settlement (Desbordes and Vicard, 2009). Foreign firms are less inclined to invest in countries engaged in diplomatic disputes with their home countries, due to uncertainty over their future returns. This uncertainty constraint foreign investors to invest abroad. Conversely, good diplomatic relations foster inflows of FDI by reducing the risk of expropriation (Desbordes and Vicard, 2009). Following the Desbordes and Vicard (2005 and 2009) assertions we try to analyze how Pak-US relations affect the inflows of capital to Pakistan.

##### **4.1 International Political Relations: United States and Pakistan**

Recent literature demonstrates that countries trading each other are likely to be less prone to engage into bilateral conflict. The liberal peace hypothesis is based on the idea that trade and conflict is the two alternative ways to ensure resources (Desbordes and Vicard, 2005). Hence, the more trade and investment between two countries, the less will be the probability of military conflict (Rosecrance, 1986). Secondly, trading relationship

increases the contracts between governments and individuals from both countries and promotes political cooperation among the nations (Virner, 1951). Pigou (1921) argued that liberal peace hypothesis supports the view of economic interdependence, which includes financial linkages. Similarly, Gartzke and Li (2003) related the probability of military conflict to the FDI and portfolio investment (FPI) and find that FDI dependence decreases the probability of conflict. In line with these arguments we analyze the diplomatic relations with the United States in terms of U.S. economic and military assistance to Pakistan, U.S. FDI inflows to Pakistan and trade relations between U.S. and Pakistan.

#### **4.1.1 U.S. Economic and Military Assistance to Pakistan**

Over the past half century, foreign aid and foreign private investment are the two main sources of foreign capital inflows to Pakistan. During 1960s and 1970s foreign aid remained an important source of foreign capital and Pakistan was one of the largest aid recipients in the Asia (Khan, 2007). However, in the mid-1970 gross disbursement of foreign aid fell to Pakistan due to its covert nuclear activities (Malik, *et al.* 1994).<sup>16</sup> The Carter Administration imposed the Symington Amendment<sup>17</sup> on Pakistan in April 1979, thereby cutting off most economic and military aid. However, in the later half of 1979, sudden changes in the geo-political scene forced the United States to change its foreign aid policies towards Pakistan. Due to Islamic Revolution in Iran and Soviet invasion of Afghanistan dramatically changed the strategic significance of Pakistan. The United States needed Pakistan's support as a front-line ally in the effort to block Soviet expansion in the region. Consequently, the United States dramatically changed its policies and increased aid to Pakistan because of its front-line role in the America-Soviet conflict over Afghanistan (Khan and Ahmed, 2007). In December 1979, all sanctions against Pakistan were lifted and replaced with generous aid (Institute of Policy Studies, 2009). In 1981, the Reagan Administration pledged for Islamabad a five year, US\$ 3.2 billion aid package. By 1985, Pakistan was the fourth largest recipient of U.S. bilateral

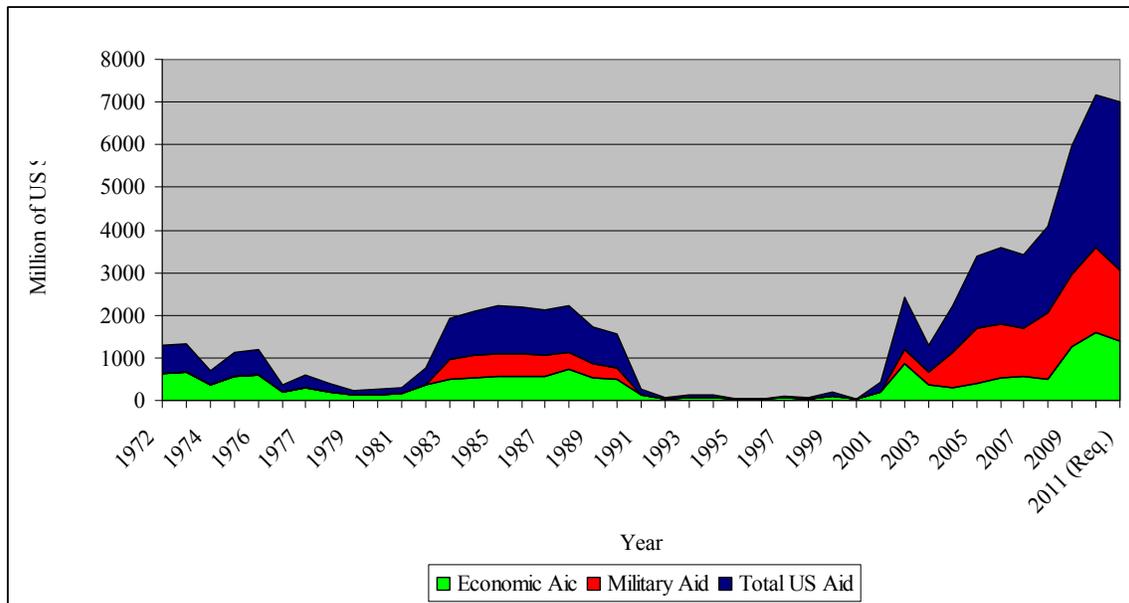
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<sup>16</sup> During the 1970s Pakistan pursued restrictive investment policies and FDI does not play an effective role in the development process. However, in early 1980 Pakistan has realized the importance of FDI in the development process and gradually liberalized its investment regime.

<sup>17</sup> The Symington Amendment prohibits most forms of the U.S. assistance to countries that are found to be trafficking in nuclear enrichment equipments or technology outside of international safeguard (Fair, 2009).

military assistance, after Israel, Egypt and Turkey. With the approval of US\$ 4.02 billion military and economic aid package, Pakistan becomes the second largest recipient of American aid after Israel (Institute of Policy Studies, 2009).<sup>18</sup> Between 1981 and 1990, U.S. has granted huge economic and military assistance to Pakistan. Figure 4 presents the trends of economic and military aid to Pakistan over the period 1972 to 2010.

Figure 4: U.S. Economic and Military Aid to Pakistan, 1972-2010



Source: Data from USAID, Greenbook Database available at <http://gbk.eads.usaidallnet.gov/index.html>

It can be seen from the Figure 4 that before 1981 no military aid has been granted to Pakistan and only US\$ 0.8 millions were granted from 1972-1981. But between 1982 and 1992, U.S. granted US\$ 8.4 billions of which US\$ 4.8 billions economic aid and US\$ 3.5 billions for military aid to Pakistan due to its front-line role against Afghan War.

When Afghan war was over, the United States once again focused on Pakistan's nuclear programme. The United States changes its bilateral aid policies towards its former close ally. Washington slapped the Pressler Amendment and Brown Amendment along with severe sanctions against Pakistan and all channels of bilateral aid to Pakistan were shut

<sup>18</sup> Because of the strategic importance of Pakistan on Cold War, U.S. ignored Pakistan's nuclear programme, democracy and violation of human rights of its military regime.

down.<sup>19</sup> Between 1991 and 2000, United States provided negligible economic aid (i.e. US\$ 530.4 million) and almost no military aid to Pakistan (Figure 4). The U.S. economic aid fell from well above US\$ 500 millions in 1990 to less than US\$ 100 millions in 1999. However, in 1992, Congress partially relaxed the scope of sanctions to allow for food assistance and continuing support for non-governmental organizations (NGOs). In 1995, USAID closed its mission and pulled out Pakistan. In May 1998, Pakistan conducted nuclear tests, international community including the U.S. deplored these steps, bilateral relations between the U.S and Pakistan deteriorated further, and severe sanctions on Pakistan were imposed.

However, the 9/11 terrorist attacks once again changed the geo-strategic situation in favour of Pakistan. The U.S. again needed Pakistan’s support to invade Afghanistan and dismantle the Taliban regime. Thus, Pakistan joined the ‘War against Terrorism’ and support U.S. military actions against the Taliban in Afghanistan. All international sanctions against Pakistan were immediately lifted. Since then, the volume of economic and military aid has increased significantly (Figure 4). Responding U.S. policy other U.S. allied governments and bilateral and multilateral agencies rescheduled Pakistan’s debts and increased the flows of economic assistance to Pakistan. The U.S., UK, Japan and a host of other donors again support Pakistan, which prior to 2002 had been isolated because of its nuclear tests in 1998. Table 5 and Figure 5 present the inflows of official development assistance (ODA) to Pakistan from selected countries.

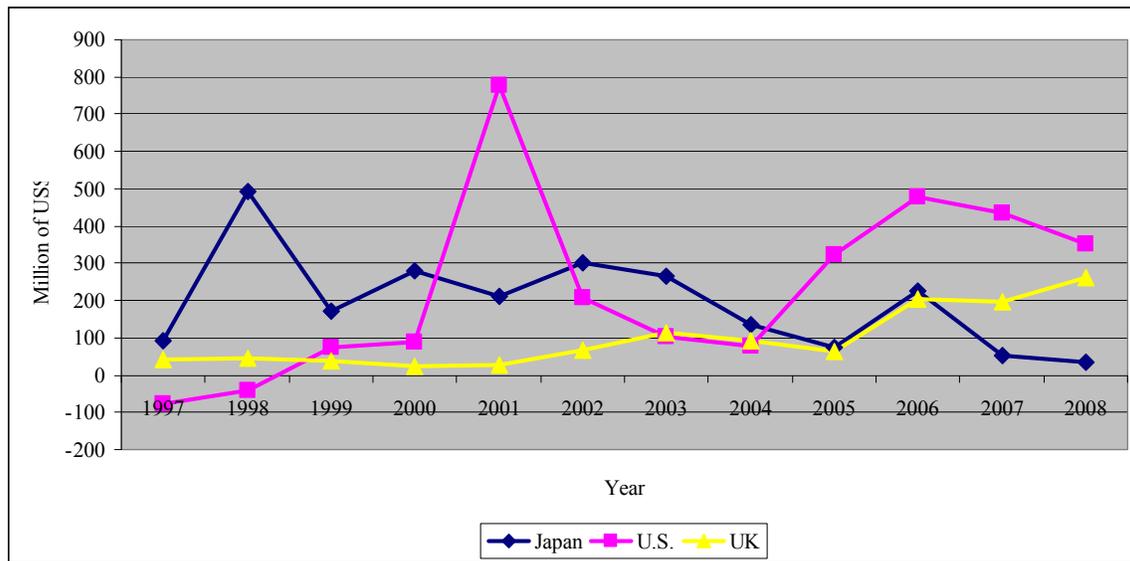
Table 5: ODA to Pakistan from Selected Countries (millions of US \$)

Donor	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Japan	92.2	491.5	169.7	280.4	211.4	301.1	266.22	134.11	73.78	225.02	53.24	34.24
U.S.	-76	-40.7	75	88.5	775.6	209.0	102.28	76.91	323.07	477.72	433.57	350.63
UK	42.5	46.4	39.5	23.7	27.4	66.9	112.12	90.82	63.12	203.17	197.84	260.30

Source: Aning (2007) and OECD, Geographical Distribution of Financial Flows to Aid Recipients

<sup>19</sup> In 1985, Congress passed the Pressler Amendment concerning about the Pakistan’s nuclear policy. According to this Amendment the US president required to certify that Pakistan did not have a nuclear weapon for the fiscal year in which aid was to be provided. From October 1990 to 2000 US president denied to confirm that Pakistan did not have nuclear technology, triggering wide-ranging sanctions against Pakistan.

Figure 5: Trends of ODA to Pakistan from Selected Countries



Source: Based on Table 5

The numbers presented in Table 5 represents a drastic shift in policies. For example, in 2000 total U.S. aid to Pakistan was US\$ 88.5 million; by 2001 the figure was US\$ 775.6 million and it was US\$ 350.6 million by the end of 2008. Similarly, there was reduction in UK aid from US\$ 39.5 million to US\$ 23.7 million in 2000. By 2002 there was a substantial increase from US\$ 23.7 million to US\$ 66.9 million. By the end of 2008 UK contribution was US\$ 260.3 million. These patterns are applicable not only for Denmark, Canada, and the U.S. and UK, but also for the IMF and the World Bank (Aning, 2007). However, the trends presented in Figure 5 gives an indication that Japan has not following U.S. policy.

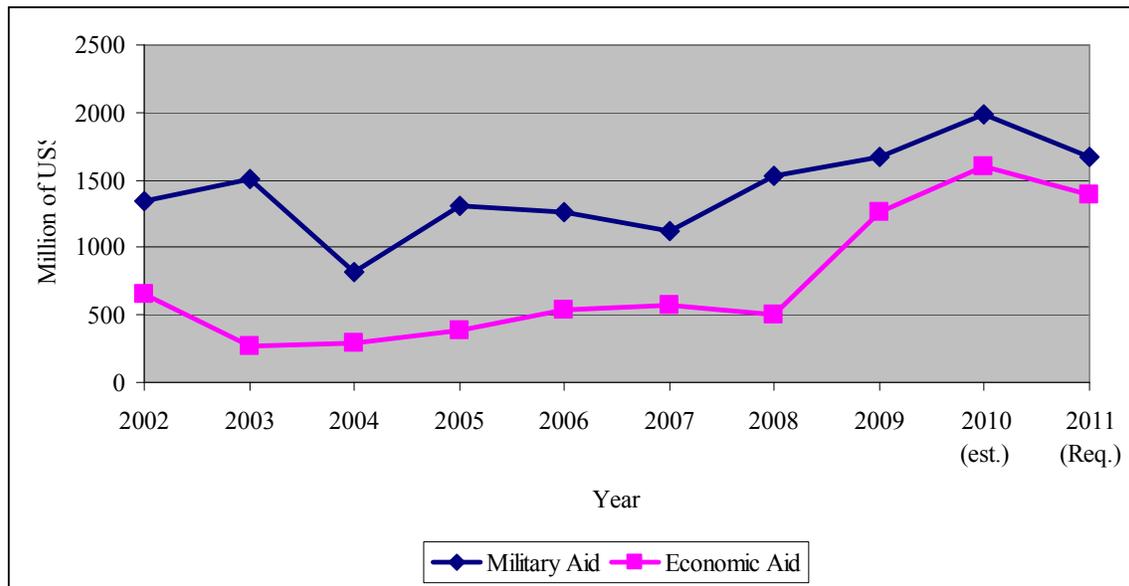
In June 2004, President Bush designated Pakistan as a major non-NATO ally of United States. Since fiscal years 2002-2009, the United States granted over US\$15 billion to Pakistan including US\$8.95 billion to security-related matters including coalition support fund (CSF) and US\$3.23 billions to economic aid. Table 6 and Figure 6 give the breakdown of U.S. economic and military aid inflows to Pakistan after 2001.

Table 6: U.S. Economic Aid and Military Imbursement to Pakistan (million of \$)

Fiscal Year	2002	2003	2004	2005	2006	2007	2008	2009	2010 (est.)	Total (2002-2010)	2011 (Req.)
Military Aid	1346	1505	818	1313	1260	1127	1536	1674	1983	12562	1665
Economic Aid	654	274	296	388	539	576	507	1265	1595	6094	1389
Total U.S. Aid	2000	1779	1114	1701	1799	1703	2043	3039	3578	18756	3054

Source: Kronstadt (2009)

Figure 6: Patters of U.S. Economic and Military Aid since 2002-2010



Source: Based on data presented in Table 6.

It can be seen from the Figure 5 that economic and military aid to Pakistan follows the similar patterns and each component of foreign aid exhibiting strong positive co-movement. This co-movement reflects that how U.S. policies towards Pakistan affect the flows of total aid to Pakistan.

Since 9/11 there have been major changes in aid allocation. Table 7 reports the net change is USAID since 1998-2005.

Table 7: Net Change in Allocation USAID, 1998-2005

Country	Total Aid (million US\$)		
	1998-01	2002-05	% change
1. Iraq	0	5710	571000
2. Afghanistan	45	1793	3884
3. Turkey	11	1173	10564
4. Pakistan	18	1136	6217
5. Jordan	589	1544	162
6. Israel	3790	1868	-50.70
7. Egypt	2651	2081	-21.50

Source: Moss, *et al.* (2005).

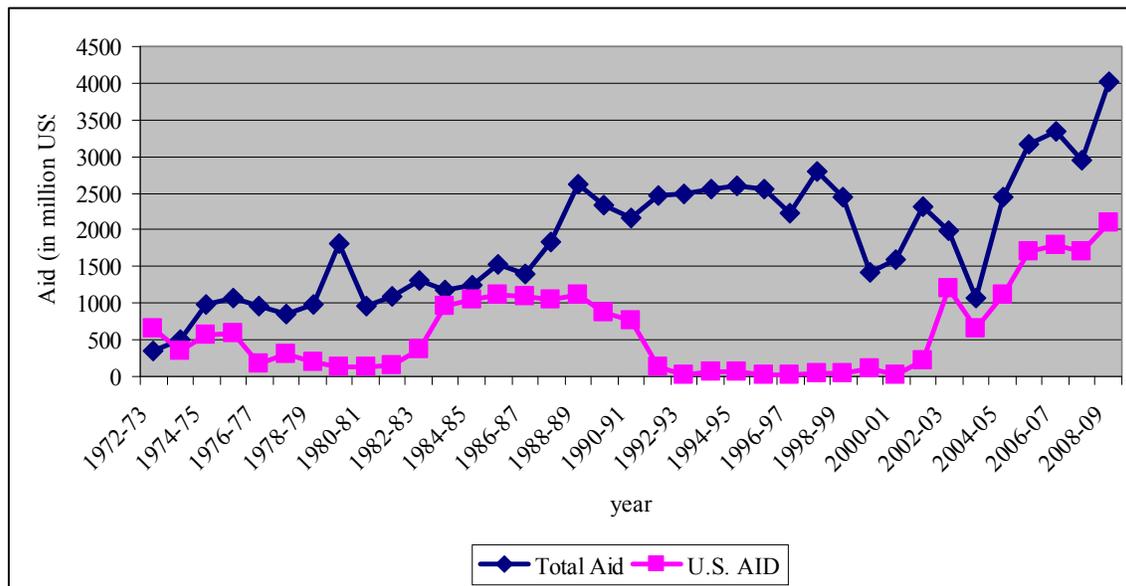
These changes in aid allocation mainly reflected post-9/11 security realities, particularly the demand for War on Terrorism rather than economic considerations.

In 2009, US\$ 1.5 billions annually granted to Pakistan after Kerry-Luger legislation. Today, U.S. diplomatic engagement with Pakistan continues to be deep and multifaceted. In December 2008, President Obama stated his intension to create an effective strategic partnership with Pakistan that will make both countries safer. These policy initiatives of U.S. signal international donors and bilateral and multilateral financial institutions regarding the foreign assistance policies towards Pakistan.

Based on the above discussions one can easily expect that how U.S. aid inflows to Pakistan have always been subjected to conditionalities and vulnerable to geo-political and geo-strategic interests of international powers, particularly the United States (Khan and Ahmed, 2007).

However, if we compare the overall inflows of foreign aid with U.S. bilateral aid inflows to Pakistan we come to the conclusions that despite the variations in U.S. aid policies, there is little effects of U.S. policies on the overall flows of foreign aid to Pakistan. Figure 7 compares the overall aid inflows to Pakistan and U.S. aid inflows to Pakistan.

Figure 7: Comparison between Total Aid Inflows and U.S. Aid Inflows to Pakistan, 1972-73 to 2008-09.



Source: Pakistan Economic Survey 2009-10 and Greenbook Database.

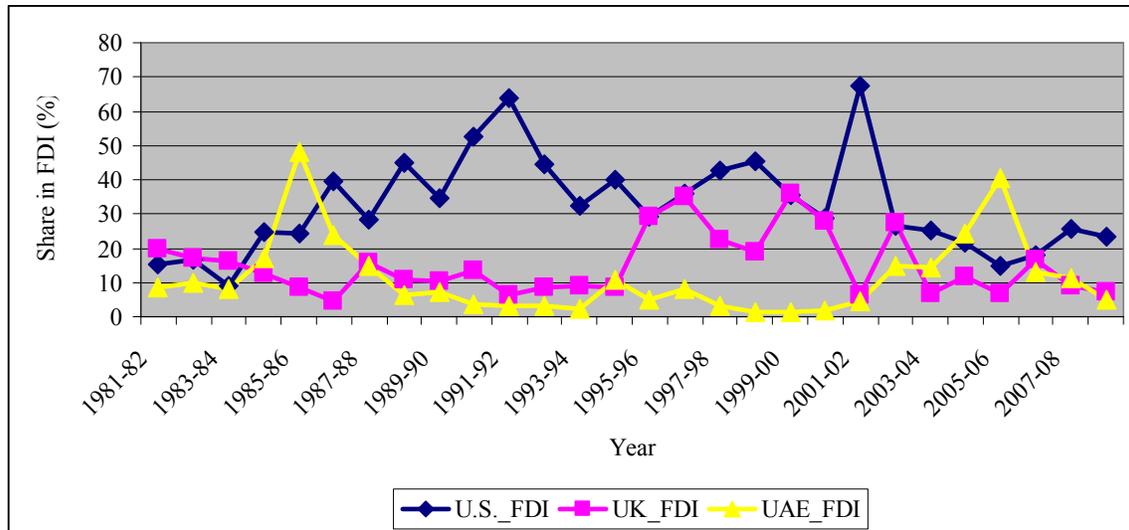
It is evident from the Figure 6 that 1976-77 to 1981-82 and 1991-92 to 2000-01 are the periods when U.S. imposed sanctions on Pakistan on account of nuclear programme and nuclear tests of 1998. But despite the sanctions on economic and military aid, aggregate inflows of foreign aid have not disrupted; rather in some period it seems to be increases. This gives an indication that the U.S. aid policies do not significantly correlate the policies of the other donors.

#### 4.1.2 U.S. Foreign Direct Investment to Pakistan

Besides foreign economic assistance, an inflow of foreign private investment is another important source of foreign capital. Increase in FDI during the last two decades justifies the assertions that foreign private investment may be substitute for foreign aid (Le and Atallah, 2002). The U.S., UK and UAE are the major investing countries in Pakistan. The U.S. share in FDI inflows to Pakistan was only 15.5 percent in 1980-81, which was touched to 63.7 percent in 1991-92 (see Figure 8). On the other hand, the U.S. share in total aid disbursed to Pakistan was only 7.72 percent in 1981-82, was touched to 31.9 percent in 1988-89 and was 30.17 percent in 1989-90. This was the period when Pakistan was playing a front-line role in the Afghan War. Between 1981-82 and 1991-92, no significant co-movement between the U.S. share in FDI and UK share in FDI inflows has

been seen. Also except for the period 1984-85 to 1985-86 no co-movement has been observed between U.S. share in FDI and the UAE share in FDI (Figure 7).<sup>20</sup> This implies that U.S. policies have little or no influence on the policies of other countries and foreign private investor does not necessarily respond to U.S. government's policies.

Figure 8: Trends of U.S., UK and UAE Share of FDI Inflows to Pakistan



Source: Based on data reported in Table 2, Khan (1997) and Khan (2007).

The average share of U.S. in FDI inflows to Pakistan was 32.14 percent as compared to 12.35 percent share of UK and 13.67 share of UAE between 1981-82 and 1991-92. In 1992 the U.S. share in FDI was at its peaked level, i.e. 63.7 percent. Similarly, the average share of U.S. aid was 20.71 percent. After 1992 the U.S. share in FDI continuously dropped down and was reached to 28.75 percent in 2001-01. This could be due to the deterioration of U.S.-Pak ties, economic sanctions, deterioration of law and order situation in Pakistan and effects of global financial crises.

To support the findings that U.S. policies has no impact on the policies of other investing countries, we perform a simple correlation analysis for the period 1981-82 to 1991-92,

<sup>20</sup> Since the U.S., UK and UAE are the major investors in Pakistan over the years therefore, we are concentrated only on the share of these countries in FDI.

1993-93 to 200-201 and 1981-82 to 2008-09.<sup>21</sup> Table 8 reports the correlation between the U.S., UK, and the UAE share in FDI.

Table 8: Correlation between the U.S., UK and UAE Percentage Shares in FDI

	1981-82 to 1991-92			1992-93 to 2000-01			1981-82 to 2008-09		
	U.S.	UK	UAE	U.S.	UK	UAE	U.S.	UK	UAE
U.S.	1.00	-0.66	-0.28	1.00	-0.42	0.06	1.00	-0.15	-0.42
UK	-0.66	1.00	-0.33	-0.42	1.00	-0.13	-0.15	1.00	-0.33
UAE	-0.28	-0.33	1.00	0.06	-0.13	1.00	-0.42	-0.33	1.00

Source: Based on data presented in Table 2 and Khan (1997) and Khan (2007)

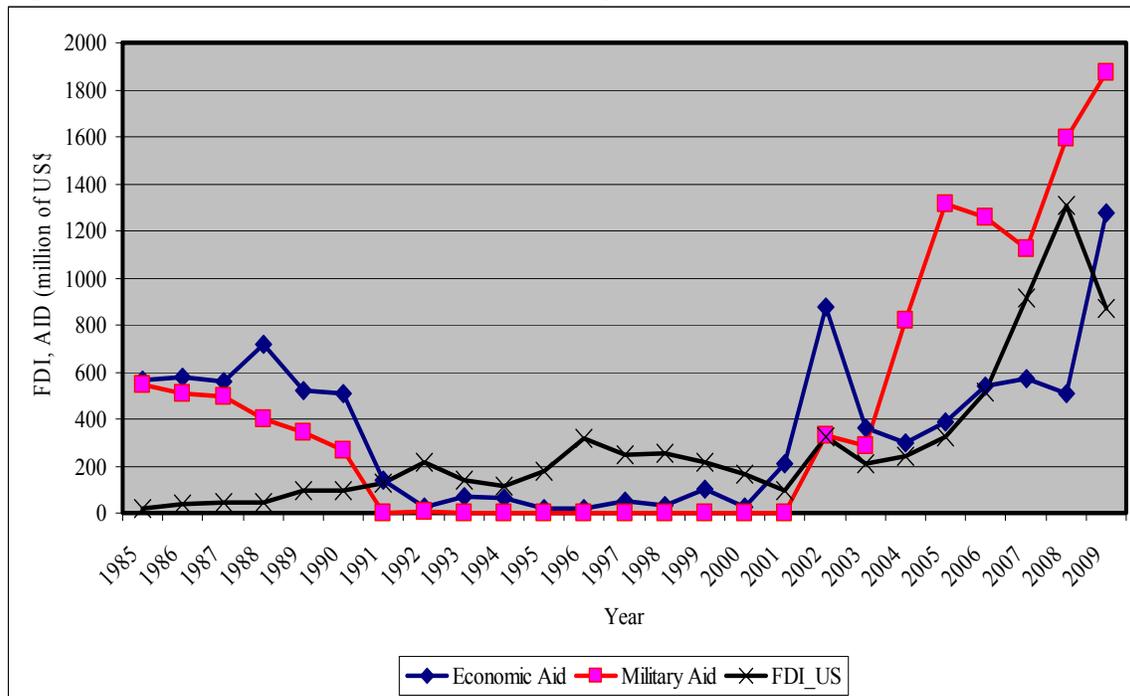
It is evident from the Table 8 that the correlation coefficient between the shares of FDI remains negative for the periods 1981-82 to 1991-92 and 1981-82 to 2008-09. However, we obtained positive correlation between the share of U.S. FDI and UAE FDI for the period 1992-93 to 2000-01. However, the size of correlation coefficient is weak and negligible (i.e. 0.06). This evidence supports our earlier findings that U.S. policies towards Pakistan have not significant influence on the policies of other investing countries and multinational firms.

In addition, the co-moments of U.S. FDI and U.S. economic and military aid can be depicted in Figure 9.

<sup>21</sup> We have regress the percentage share of U.S. FDI to Pakistan on the (%) share of U.K. FDI , (%) share of UAE FDI and share of U.S. aid and we got a significant and positive relationship between U.S. FDI share, UK. FDI share and (%) share of U.S. aid. The UAE share of FDI is negative and insignificantly related to the U.S. share of FDI. The results are given below:

U.S. share in FDI = 0.78UK share in FDI-0.27UAE share in FDI+1.24 U.S. share in total aid  
t-values (2.95) (-0.91) (4.24)  
sigma = 17.66 RSS= 7795.06 D.W = 1.32 sample 1982-2009

Figure 9: Trends of U.S. share in FDI and Foreign Aid (%)



Source: Greenbook database and data for FDI is retrieved from UNCTAD <http://stats.unctad.org/fdi/>

It can be seen from the Figure 9 that economic sanctions against Pakistan (i.e. 1991-2001) disrupted only the flows of economic and military aid; however, these sanctions exerts a very minor effect on FDI inflows to Pakistan. This implies that U.S. policies influence only the official capital flows but not private capital flows to Pakistan. To confirm this result we perform correlation analysis and Table 9 presents the results.

Table 9: Correlation between U.S. FDI, U.S Economic and Military Aid (%)

	1985-1992			1993-2001			1985-2010		
	Eco.	Mil.	FDI	Eco.	Mil.	FDI	Eco.	Mil.	FDI
Eco	1.00	0.89	-0.90	1.00	0.20	-0.75	1.00	0.77	0.38
Mil	0.89	1.00	-0.92	0.20	1.00	0.12	0.77	1.00	0.67
FDI	-0.90	-0.92	1.00	-0.57	0.12	1.00	0.38	0.67	1.00

Source: Based on Greenbook Database and Data for FDI is retrieved from UNCTAD <http://stats.unctad.org/fdi/>

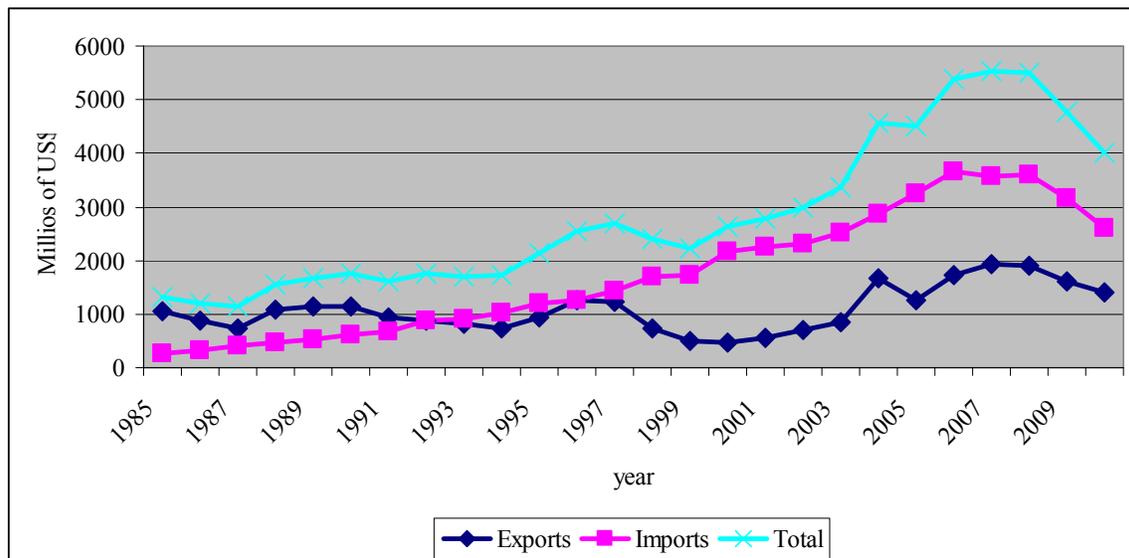
It can be seen from the results reported in the Table 9 that there is some positive correlation between economic aid, military aid and FDI for the period 1985-2010. The correlation between FDI and military aid is strong as compared to the correlation between

FDI and economic aid. However, for the period 1985 to 1992 the correlation between FDI and economic and military aid is negative and strong, while for the period 1993-2001 the correlation between FDI and economic aid is negative and strong. For the same period the correlation between FDI and military aid is though positive but very weak. These results again support our findings that in the long-run U.S. policies do not influence the inflows of private capital (i.e. FDI), while in short-run (sub-periods, 1982-92 and 1993-01) U.S. policies exerted negative effect on inflows of private capital to Pakistan.

### 4.1.3 Trade between Pakistan and United States

It can be argued that trade promotes economic ties and defuses diplomatic tension between the nations. In the case of Pakistan, United States imposed sanctions on Pakistan once in 1970-1979 and then from 1991-2001. But during the period of sanctions, flows of trade between U.S. and Pakistan does not disrupted. The United States policies towards Pakistan worked only to influence official flows. The patterns of trade between the United States and Pakistan can be seen in Figure 10.

Figure 10: Trends of United States Exports and Imports to Pakistan, 1985-2010



Source: US Census Bureau: Foreign Trade Statistics available at <http://www.census.gov/foreign-trade/balance/c5350.html>

It is evident from the Figure 10 that there is sustainable increase in imports between 1985 and 2007, while a moderate increase in U.S. exports has been seen between 1985 and 1997 and then was declined for a short period (i.e. 1998-2000). Exports were again followed increasing path since 2001. As a result of increase in exports and imports, total volume of trade between Pakistan and United States showing increasing trend between 1985 and 2007. From 2007 and onward, the volume of trade followed decreasing trend, but this may be due to global financial crises and it's after effects. From the analysis of trade relations between Pakistan and United States, we come to the conclusion that sanctions diplomacy against Pakistan does work only to influence official flows, such as economic and military aid but no or very little effect has been seen on the trade and private inflows.

Overall, from the above analysis we obtain some interesting conclusions: First, U.S. aid has always been subjected to conditionalities and vulnerable to geo-politics and geo-strategic interests. Second, U.S. sanctions against Pakistan affect only the official capital inflows (economic aid and military aid) and have no obvious effect on the private capital inflows (i.e. FDI) to Pakistan. Third, U.S. policies influence only the U.S. official inflows but do not have significant correlation with aid and investment policies of other donors and investing countries. Fourth, U.S. economic sanctions against Pakistan have no influence on the trade relations between the U.S. and Pakistan. These finding are in sharp contrast with the thinking of general public in Pakistan. The important implications from these results are that U.S. policies influences Pak-U.S. diplomatic relations, but these policies does not influence public relations among both countries.

## **5. Determinants of FDI: A Theoretical and Empirical Review of Literature**

Braunerhjelm and Svensson (1996) rightly argued that the theoretical foundation of FDI is fragmented and comprising bits and pieces with different field of economics. However, the idea that FDI can increases with the motives of economies of scale in production can be traced back to the classical economists Adam Smith (1776) and David Ricardo (1817). According to neoclassical economic theory MNCs expands their activities at international level because of interest rate differential. Under the neoclassical framework capital

movements take place from low return economies to high return economies under the assumptions of risk free and perfect competition (Harrison, 2000). The neoclassical theory reveals that foreign investment contribute positively to economic development by replacing inferior technologies, generating competition and productivity improvements, increasing foreign exchange and improving infrastructure of host country (Harrold and Lall, 1993). Vernon (1966) demonstrated that FDI takes place where cost of production is low and firm faces competition towards maturing the products. When product reaches at maturity stage and skilled labor contributes in production, a high income and labour saving product will be produced and host country becomes attractive place. Dunning (1993), Hymer (1976) and Caves (1996) identify ownership advantages, location advantages and benefits from internationalization are the main determinants of FDI.<sup>22</sup>

In addition, recent literature has proved the positive link between FDI and financial development (Hermes and Lensink, 2003 and Alfaro *et al.*, 2003). Hermes and Lensink (2003) investigated the association between financial development, FDI and economic growth and find a positive link between financial development and FDI. They justified their findings on the grounds that a well-developed financial system mobilizes savings efficiently which, in turn, expand the amount of resources available to finance investment. Furthermore, financial development also speeds up adoption of new technologies by minimizing the risk associated with it (Dutta and Roy, 2010). With the developed financial infrastructure, foreign firms are able to borrow for innovative activities. Better financial institutions attract greater foreign investment needed to boost the economy.

Trade openness is another key driver of FDI. A decrease in openness might be associated with more horizontal FDI, as investing firms getting benefits from trade barriers through building production site abroad. Bevan and Estrin (2000) and Resmini (2000) find that vertical inflows largely benefits from increasing openness. Singh and Jun (1995) also find that exports orientation is very important in attraction FDI. However, the

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<sup>22</sup> Ownership includes property rights protection, enjoying monopoly powers and controlling supply of inputs. Location factor includes market seeking factors (e.g. market size, openness and enabling investment environment) and efficiency seeking (e.g. cheap and skilled work force, availability of infrastructure, etc.). Internationalization factors include institutional and political factors.

impact of openness on FDI can have a positive effect if FDI is export-oriented and would be negative if the motivation for FDI is ‘tariff jumping’ (Aseiedu, 2002 and Mhlanga *et al.*, 2010).

Another strand of literature emphasizes on the quality of democratic institutions because the benefits of FDI to host country are smaller in the presence of weak democratic institutions. One strand of the literature shows that there is positive relationship between democratic institutions and FDI (Harms and Ursprung, 2002, Jensen, 2003 and Busse and Hefeker, 2005, among others). Thus quality of democratic institutions is the key differences in growth rates and per capita income across countries. Particularly, the efficient protection of civil liberties and property rights, extended economic and political freedom and low levels of corruption have been associated with higher prosperity (Kapuria-Foreman, 2007, Quere *et al.*, 2007 and Khan and Samad, 2010). There is growing agreement among the economists that economic freedom and good quality democratic institutions are supposed to exert positive influence on economic growth through the promotion of FDI (Bengoa and Sanchez-Robles, 2003, Brooks *et al.*, 2003, and Khan and Samad, 2010). Poor institutions lead to political uncertainty which ultimately exert negative impact on FDI inflows (Root and Ahmad, 1979 and Schneider and Frey, 1985).

More recently, Desbordes and Vicard (2005) demonstrated that interstates diplomatic relations have significant impact on the location of FDI in developing countries. They argued that foreign investors are sensitive to the evaluation of a country diplomatic relations with other countries because they may suffer retaliatory consequences of deteriorating diplomatic relations. They also argued that economic linkages, such as foreign aid, FDI and trade serve as political instrument for security. For example, United States threatened Yemen with dire consequences if it did not vote in favour of resolution No. 678 on the use of armed forces in Iraq in 1990 (Pilgar, 2002). Another example, before recent war against Iraq President Bush was going to take the vote to the United Nations Security Council (UNSC) even though he knew that French were going to vote. But he was lobbying some of the non-permanent members of the Security Council with aid packages in an attempt to win simple majority in the Council (Eldar, 2004 and Dreher *et*

*al.*, 2007). Similarly, like Yemen United States threatened Pakistan with dire consequences if it does not facilitates United States to war against terrorism after 9/11 event in 2001. This shows that the United States and other powerful countries influence the flows of foreign aid and FDI directly and indirectly through using their power at the World Bank and International Monetary Fund. The G-7 can use the institutions to influence recipient country's behaviour inline with their interests (Dreher *et al.*, 2007). Fleck and Kilby (2006) find that U.S. commercial interests influence the geographical distribution of total World Bank lending and this influence varies across different presidential administrations.<sup>23</sup> Similarly, Schraeder *et al.* (1998) find that political-interest variables are significant for U.S., Japan, France and Sweden in the allocation of aid. Alesina and Dollar (2000) find that political-interest variables are significant predictors for some countries, including the U.S., but not for others. Andersen *et al.* (2006) also find that the U.S. exerted a significant influence on IDA lending during the period 1993-2000. Anwar and Michaelows (2006) find that votes for the Pressler and the Brown Amendment confirm the significance of these political economic determinants. They also find that in case of Pressler Amendment the direct influence of population groups of Indian and Pakistani origins played a predominant role, while the role of ethnic business lobbies appeared to have dominated in the context of the Brown Amendment. Furthermore, the study suggests that the impact of US business interests based on FDI and exports appeared to be small. This implies that how international politics and capital inflows are jointly determined and how international politics influences the flows of foreign capital to recipient countries.

Nigh (1985) finds that U.S. manufacturing FDI tended to be higher in developing countries with which the United States entertained cooperative diplomatic relations during 1948-1978. This result is confirmed by Desbordes and Vicard (2009) for the period 1990-2000. Similarly, Biglaiser and DeRouen (2007) demonstrated that U.S. FDI (not multinational FDI) is attracted by countries hosting a large number of U.S. military forces and the presence of U.S. troops can be interpreted as a sign of good diplomatic relations between United States and host countries. Desbordes (2010) also find that both

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<sup>23</sup> Total World Bank lending measured as the sum of IDA, IBRD and IFC loans.

global and diplomatic political risks matters for U.S. MNEs investing in the developing countries.

This unsettled debate among the economist and political scientists regarding the determinants of FDI motivates us to revisit the subject. The empirical literature shed some light on the nexus between FDI and international political relations besides other factors. Therefore, research is needed to investigate the impact of U.S.-Pak political relations on FDI.

## **6. Model Specification, Data and Methodology**

### **6.1 Model**

The major objective of multinational corporations (MNCs) is to maximize the profits from their investment. They have no keen interest to invest in countries having no or limited profit opportunities. In general, MNCs prefer countries with stable governments, sound economic policies, good infrastructure, well-developed domestic financial and democratic institutions and greater economic freedom in terms of political rights and civil liberties (Hermes and Lensink, 2003; Durham, 2004; Alfaro *et al.* 2004 and Busse and Groizard, 2005 among others). These factors allow MNCs to establish new businesses and expand the existing one in recipient countries. In this way, recipient countries benefits inward investment to achieve higher economic growth.

The literature suggests that FDI inflows depend on key macroeconomic factors like domestic investment (Haile and Assefa, 2006), infrastructure, such as roads, ports, telecommunication, power, railways, etc. (Vadlamannati, 2009),<sup>24</sup> financial development (Hermes and Lensink, 2003, Alfaro *et al.*, 2004 and Asiedu and Lien, 2004), natural resources endowments (Campos and Kinoshita, 2010), trade openness (Aseiedu, 2002 and Mhlanga *et al.*, 2010) and real exchange rate.<sup>25</sup> Keeping in mind the above cited

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<sup>24</sup> Like Campos and Kinoshita (2010) we use three broad categories of the determinants in modelling FDI. First, we include classical factors such as infrastructure. Second, we include policy related factors, such as financial markets development and trade openness. Third, we include the institutions and democracy related factors, such as political rights, civil liberties and political repression. Finally, we question whether Pakistan's political relations with United States play any role in the determination of FDI.

<sup>25</sup> The literature also identified inflation rate, external debts, government expenditures, etc. as determinants of FDI. However, our sample size is small and not permits us to include too many variables in the model.

factors, we specify the following baseline model (Compos and Kinoshita, 2010 and Khan and Samad, 2010):

$$FDIY_t = \alpha + \beta_1 IY_t + \beta_2 FD_t + \beta_3 TOP_t + \beta_4 INFRS_t + \beta_5 NRS_t + \beta_6 REER_t + u_t \quad (1)$$

Where,  $FDIY$  is annual net inflows of foreign direct investment as a percent of  $GDP$ ,  $IY$  is domestic investment as percentage of  $GDP$ .  $FD$  is measure of financial development,  $TOP$  is the trade openness,  $INFRS$  is the infrastructure,  $NRS$  is the natural resource endowments and  $REER$  is the real effective exchange rate, while  $u$  is the error term.

It is well documented in the literature that political instability and political repression is another important factors influencing FDI (Aharoni, 1966). However, evidence related to the effects of this variable remained inconclusive (Wang and Swain, 1995 and Jun and Singh, 1996 among others). Political upheavals deprive or displace foreign investors. As a result FDI will decrease. Political instability is expected to produce negative impact on FDI because risky political environment adversely affect the Transnational Corporation's (TNCs) decision to invest abroad (Singh and Jun, 1995 and Quazi and Mahmud, 2004). In this study we measured political instability as average of political rights and civil liberties indices published by Freedom House. A higher score implies political instability and is expected to deter FDI (Mhlanga *et al.*, 2009). To examine the impact of political instability on FDI, the model incorporates political rights ( $PR$ ) and civil liberties ( $CL$ ) in the following specification form:

$$FDIY_t = \alpha + \beta_1 IY_t + \beta_2 FD_t + \beta_3 TOP_t + \beta_4 INFRS_t + \beta_5 NRS_t + \beta_6 REER_t + \beta_7 PR_t + \beta_8 CL_t + u_t \quad (2)$$

There is possibility of multicollinearity among  $PR$  and  $CL$ , therefore we use  $PR$  and  $CL$  alternatively.

There is general perception among the public in Pakistan that foreign policy of United States is based on its political and security interests. United States extended its diplomatic, economic and military support to Pakistan when there is a threat to its interests e.g. Afghan War and 9/11 Terrorist attacks in 2001. But when there is no threat to its political and security interests, United States has changed its policies (e.g. conditionalities and sanctions on Pakistan from 1991-2000). These inconsistent and

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Further to avoid the multicollinearity we do not included market size because FDI, IY, FD and TOP are expressed as percentage of GDP (see Dutta and Roy, 2010).

unsustainable policies of United States badly affect the confidence of the public in Pakistan and expected to effect capital flows negatively. To capture the role of Pakistan's political relations with the United States we extend equation (1) by adding the variables *DIPR*. Now equation (1) can be rewritten as:

$$FDIY_t = \alpha + \beta_1 IY_t + \beta_2 FD_t + \beta_3 TOP_t + \beta_4 INFRS_t + \beta_5 NRS_t + \beta_6 REER_t + \beta_7 PR_t + \beta_8 CL_t + \beta_8 DIPR_t + u_t \quad (3)$$

Where *DIPR* is a dummy variable used as proxy to capture the Pakistan's diplomatic relations with the United States.

To examine the impact of political repression (*PREP*) on FDI equation (3) can be rewritten by incorporating the average of *PR* and *CL*:

$$FDIY_t = \alpha + \beta_1 IY_t + \beta_2 FD_t + \beta_3 TOP_t + \beta_4 INFRS_t + \beta_5 NRS_t + \beta_6 REER_t + \beta_7 PREP_t + \beta_8 DIPR_t + u_t \quad (4)^{26}$$

Based on the above model we mainly concentrate the following set of empirical hypothesis:

**Hypothesis 1:** Bad political relations between the United States and Pakistan adversely effect the inflows of FDI to Pakistan

**Hypothesis 2:** Political repression/political risk negatively affect the flow of FDI to Pakistan

Besides the hypothesis variables we consider other variables as control variables in the equation.

## 6.2 Data Description

The present study is based on the annual data covering the period from 1972-2009. As standard in the literature, the dependent variable (*FDIY*) is the net foreign direct investment as percentage of GDP and the data are taken from *Handbook of Statistics Pakistan Economy 2005*<sup>27</sup> published by State Bank of Pakistan (SBP) and updated from *Annual Reports* of SBP, 2009-10. The control variables includes, domestic investment

<sup>26</sup> Other variables such as interest rate, government consumption, inflation rate, external debt, etc. may not be considered because of small sample size.

<sup>27</sup> Handbook of Pakistan Economy is available at [http://www.sbp.org.pk/departments/stats/PakEconomy\\_Handbook/Index.htm](http://www.sbp.org.pk/departments/stats/PakEconomy_Handbook/Index.htm)

(*IY*) measured by the gross fixed capital formation as percentage of *GDP*, financial sector development (*FD*) is proxied by the private sector credit as percentage of *GDP*, trade openness (*TOP*) is measured as a percentage of the sum of exports of goods and services, imports of goods and services to *GDP*, natural resources (*NRS*) is measured by the share of fuel and minerals in exports (in percent)<sup>28</sup> and real effective exchange rate (*REER*). The data on these variables are retrieved from World Bank, *World Development Indicator (WDI) 2010*. The infrastructure development (*INFRS*) is proxied by the number of telephone main lines per 100 people and the data on this variable is taken from *Pakistan Economic Survey (supplement)*, 2009-10.

The institutions and political instability related variables, such as civil liberties (*CL*) and political freedom (*PR*) indices is obtained from *Freedom House*.<sup>29</sup> The scores range from 1 to 7. The score 1 is high respect for civil liberties and political rights, while 7 being no respect. The variable political repression (*PREP*) is calculated by taking the sum of civil liberties and political rights divided by two  $[(CL + PR)/2]$  following Harms and Ursprung (2002) and Mhlanga *et al.* (2009). The variable polity (*polity*) which is used as alternative measure of political risks and the data on this variable is taken from the *polity IV project* (Centre for Global Policy, George Mason University).<sup>30</sup>

The data on Pakistan's political relations with United States is not readily available.<sup>31</sup> Therefore, we generate the variable *DIPR* representing the political relations of Pakistan with United States as proxy for interstate political relations. The variable *DIPR* is generated based on available information on U.S. economic and military sanctions imposed on Pakistan from time to time and other published information including press

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<sup>28</sup> Natural resources are exogenous economic factors that may help a country attract higher level of FDI and are independent of political institutions and government policies (Jensen, 2003).

<sup>29</sup> Political freedom implies the people's ability to participate freely in the political process, while civil liberties means freedom to develop views, institutions, and personal autonomy apart from the state (Harms and Ursprung, 2002, p. 653). Data on Civil Liberties and Political Rights are available at <http://www.freedomhouse.org>

<sup>30</sup> Except FDI as percentage of GDP, gross fixed capital as percentage of GDP, private sector credit as percentage of GDP, volume of trade as percentage of GDP and polity other variables are in logarithmic form, whereas DIPR is a dummy variable.

<sup>31</sup> Although Desbordes and Vicard (2009) have utilized data associated to military conflict or events of severe tension among the countries. However, in the case of Pakistan and United States there is no such tension that leads military conflict. Therefore, taking lead from Desbordes and Vicard (2009) we generated data for diplomatic relations using sanctions on economic and military aid imposed by the United States on Pakistan and other available sources such as, press briefings and news papers reports.

briefings and news papers reports. *DIPR* is scaled between 0 (no sanctions) and 1(severe sanction), while 0.5 is used for partial sanctions (i.e. sanctions on military aid but not on economic aid). Table 10 summarizes the details of events since 1972.<sup>32</sup>

Table 10: Summary of U.S. Aid Policies towards Pakistan

Event	Nature of Relations	U.S Policies	Aid Flows	Weight assigned to <i>DIPR</i>
1972-1978	Deterioration	Sanctions	Modest economic aid, No military aid	0.5
April 1979– December 1979	Deterioration	Sanctions	No economic and military aid	1
1980-1990	Good	No sanctions	Economic and military aid.	0
1991-1997	Deterioration	Sanctions	Little economic aid and no military aid	0.5
1998-2001	Deterioration	sanctions	No economic and military aid	1
After Sept. 2001 to date	Good	No sanctions	Economic and military aid	0

Source: Based on the news papers reports, press briefings and CRS Reports for Congress

The variables infrastructure, natural resources, real effective exchange rate, political rights, civil liberties and political repression are expressed in logarithmic form.

### 6.3 Methodology

This study employs Autoregressive Distributed Lag (ARDL) bounds testing approach to cointegration advanced by Pesaran *et al.* (1999, 2001). The main advantage of this methodology is that it allows testing for the existence of cointegration irrespective of whether the variables are  $I(0)$  or  $I(1)$ . ARDL approach is more appropriate than the Johansen-Juselius multivariate approach to cointegration when the sample size is small (Pesaran *et al.*, 2001). This technique generally provides unbiased estimates of the long-run model and valid t-statistics even when some of the regressors are endogenous (Harris and Sollis, 2003). The estimation procedure involves two steps. First, long-run relationship between the variables under consideration is tested by computing F-statistics. If the evidence of long-run relationship is found then at the second stage the short-run

<sup>32</sup> Detailed analysis can be seen in section 4.

and long-run parameters are estimated using autoregressive distributed lag (ARDL) method. The final equation is selected based on the acceptability of various diagnostics.<sup>33</sup>

## 7 Empirical Analysis

### 7.1 The Unit Root Test

Before the implementation of the autoregressive distributed lag (ARDL) bounds test to cointegration, we first determine the order of integration of individual time-series, using Augmented Dickey-Fuller (ADF) test. The bounds test to cointegration does not require any pre-testing of unit roots. However, it is not necessary that all the series are I (0) and I (1). If any of the series are I (2), then the ARDL procedure gives spurious results. Hence, testing of unit root for each series is an important before the implementation of the ARDL cointegration method (Ouattra, 2004 and Khan, 2008). Table 11 reports the results of the unit root test.

Table 11: Results of the Unit Root Test

Series	Constant/Trend	Level	Fist Difference	Decision
$FDIY_t$	C	-1.7329 (0)	-3.1930(0)*	I (1)
$IY_t$	C	-3.1284 (0)**	-3.5570 (0)*	I (0)
$FD_t$	C	-2.7091 (0)	-4.8567 (1)*	I (1)
$TOP_t$	C and T	-0.7652 (1)	-4.6208 (1)*	I (1)
$INFRS_t$	C	-1.6525 (1)	-3.3448 (1)*	I (1)
$REER_t$	C	-1.0093 (1)	-4.4656 (0)*	I (1)
$NRS_t$	C	-1.4844 (1)	-3.6477 (1)*	I (1)
$PR_t$	C	-2.2081(1)	-3.9947 (1)*	I (1)
$CL_t$	C	-3.0922 (0)*	-5.5792 (0)*	I (0)
$PREP_t$	C	-2.4106 (1)	-4.8670 (1)*	I (1)
$Polity_t$	C	-2.1285 (1)	-3.5377 (1)*	I (1)
Critical Values at 5% level with constant		= -2.9472		
Critical Values at 5% level with constant and trend		= - 3.5426		

\* indicate significant at the 1 percent level.

It can be seen from the Table 11 that except domestic investment as percentage of  $GDP$  ( $IY_t$ ) and civil liberties ( $CL_t$ ), all other variables are non-stationary at their level and stationary at their first difference. Domestic investment as percentage of  $GDP$  ( $IY_t$ ) and

<sup>33</sup> Since Bounds testing approach to cointegration is well established methodology in the literature. Therefore, there no need to discuss the detailed methodology.

civil liberties ( $CL_t$ ) is stationary at their level. Thus we conclude that  $IY_t$  and  $CL_t$  is integrated of order zero i.e.  $I(0)$  while all other series are integrated of order one i.e.  $I(1)$  and no series is integrated of order two i.e.  $I(2)$ . These mixed results from unit root test justify the application of bounds testing approach to cointegration.

## 7.2 Cointegration Analysis

The cointegration test based on the ARDL procedure is employed by estimating equation(s) (1-4) for Pakistan using annual data over the period 1972-2009. The number of lags on the first differenced variables is selected using Schwarz Bayesian Criterion (SBC). However, the final lag length is selected when the estimated equation satisfied all the diagnostic checks including CUSUMSQ test of stability.<sup>34</sup> On the basis of this criterion, 2 lags were selected to carry out ARDL cointegration test.<sup>35</sup> The results of the cointegration test are reported in Table 12.

Table 12: Bound Test of Cointegration

Type of Model	Variables included	Test Statistics	Decision
Benchmark Model	$F(FDIY_t   IY_t, FD_t, TOP_t, INFR_t, NRS_t, REER_t, DIPR_t)^a$	9.54	Cointegration
Political Rights	$F(FDIY_t   IY_t, FD_t, TOP_t, INFR_t, NRS_t, REER_t, PR_t, DIPR_t)^b$	6.14	Cointegration
Civil Liberties	$F(FDIY_t   IY_t, FD_t, TOP_t, INFR_t, NRS_t, REER_t, CL_t, DIPR_t)^c$	7.68	Cointegration
Political Repression	$F(FDIY_t   IY_t, FD_t, TOP_t, INFR_t, NRS_t, REER_t, PREP_t, DIPR_t)^d$	5.43	cointegration
Polity IV	$F(FDIY_t   IY_t, FD_t, TOP_t, INFR_t, NRS_t, REER_t, POLITY_t, DIPR_t)^e$	11.37	Cointegration

Note: Two lags were selected on the basis of SBC. The critical values are given by Pesaran *et al.* (2001).

a= unrestricted constant, no trend and number of regressor k=7.

b= unrestricted intercept, no trend and number of regressor k=8.

c= unrestricted intercept, no trend and number of regressor k=8.

d= unrestricted intercept, no trend and number of regressor k=8.

e= unrestricted intercept, no trend and number of regressor k=8.

<sup>34</sup> Diagnostic checks include, Lagrange Multiplier (LM) test for autocorrelation, Normality test and ARCH for heteroscedasticity.

<sup>35</sup> We have tried various specifications by adding the different variables like interest rate, labour force, government consumption, government investment and infrastructure proxied by the road length. None of these variables remains significant. Therefore, we present most parsimonious results here. For the selection of the parsimonious model we use PcGets software.

It is evident from the Table 12 that the calculated F-statistics lie above the upper bound of the critical values, supporting the evidence of cointegration between the foreign direct investment as percentage of GDP, share of investment as percentage of GDP, financial sector development, trade openness, infrastructure, natural resources, real effective exchange rate, political rights, civil liberties, political repression and Pakistan's political relations with United States for each specifications. Thus we got the supportive evidence that in the long-run the share of investment to GDP, financial development, trade openness, infrastructure, natural resources, political rights, civil liberties, political repression and Pakistan's relations with United States are jointly determines the behavior of FDI in Pakistan.

After obtaining the supportive evidence of cointegration between FDI and its determinants, we now obtain long-run and short-run coefficients by estimating equation(s) (1-4) using SBC for the selection of lag length. The estimated long-run parameters are reported in Table 13. The first model is the baseline model dealing with general determinants of FDI including the role of international relations of Pakistan with United States. Model from 2 to 4 captures the effect of political rights, civil liberties and political repression. The last model includes polity IV as proxy for political risk to check the robustness of the results. The short-run diagnostic statistics are presented at the end of the Table 13 suggest that there is no major problems with the estimated results.<sup>36</sup>

It is evident from the Tables 13 that FDI is positively and significantly correlated with domestic investment for all the cases and the coefficient varies between 0.32 and 0.35. This implies that in the long-run FDI produces crowding-in effects on domestic investment. The reason could be that when the recipient countries provides conducive environment for business and investment, such as infrastructure facilities, availability of inputs and skilled labour, technologies, etc., it not only effect the domestic investment but also provides incentives to foreign investors to invest more in the host country. This result is inline with the earlier findings of Khan and Samad (2010).

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<sup>36</sup> Although the estimated equation does not pass the normality test, this could be possible in case of small sample size.

**Table 13: Long-Run Cointegration Results**Dependent Variable:  $FDI_t$ 

Type of Model	Benchmark (1)	Political Rights (2)	Civil Liberties (3)	Political Repression (4)	Polity (5)
$IY_t$	0.32 (2.42)*	0.34 (2.28)*	0.35 (2.76)*	0.38 (2.46)*	0.52 (2.11)**
$FD_t$	0.35 (2.52)*	0.36 (2.43)*	0.39 (2.85)*	0.39 (2.53)*	0.29 (1.92)**
$TOP_t$	-0.33 (-1.89)	-0.34 (-1.83)**	-0.35 (-2.13)*	-0.34 (1.89)**	-0.30 (-1.57)
$INFRS_t$	0.92 (2.11)**	0.89 (1.97)**	0.74 (2.03)**	0.74 (1.78)	0.81 (1.75)
$NRS_t$	0.67 (2.04)*	0.59 (1.58)	0.60 (2.10)**	0.42 (1.25)	0.14 (0.30)
$REER_t$	-2.09 (3.78)*	-2.20 (-3.27)*	-2.68 (-3.75)*	-2.69 (-3.15)*	-2.43 (-3.15)*
$DIPR_t$	-0.92 (-1.61)	-1.01 (-1.67)	-1.02 (-1.87)	-1.16 (-1.76)	-1.05 (-1.44)
$PR_t$	-	0.28 (0.39)	-	-	-
$CL_t$	-	-	2.10 (1.73)	-	-
$PREP_t$	-	-	-	1.68 (1.24)	-
$POLITY_t$	-	-	-	-	-0.07 (-1.19)
Short-run Diagnostic Statistics					
$\chi^2_{SC}(1)$	0.06[0.808]	0.05 [0.821]	0.58[0.447]	0.09[0.676]	1.24[0.265]
$\chi^2_{NO}(2)$	7.49 [0.024]	10.37 [0.006]	5.92[0.052]	18.40[0.000]	20.07[0.000]
$\chi^2_{HET}(1)$	0.17[0.684]	0.09 [0.765]	0.06[0.808]	0.08[0.928]	0.001[0.973]

Note: \*, \*\* indicates significant at the 1% and 5% level significantly. The estimated results of equation 3 are available from the author. The  $\chi^2_{SC}$ ,  $\chi^2_{NO}$  and  $\chi^2_{Het}$  are Lagrange multiplier statistics for test of residual correlation, non-normal errors and heteroskedasticity, respectively. These statistics are distributed as Chi-square values with p-values are in parentheses.

The coefficient of financial development proxied by the private sector credit as percentage of GDP is positive and significant in the long-run for all the cases. This suggests that a well-developed financial market creates larger incentives for foreign firms to invest abroad. Prasad *et al.* (2003) argue that FDI can boost growth only when recipient country's financial markets developed enough to channel foreign capital efficiently to finance productive investment. A well-developed financial market is also pre-required for the positive effect of FDI on economic growth (Hermes and Lensink, 2003, Alfaro, *et al.*, 2004 and Khan, 2007). This result could be further justified on the

grounds that when the country has well-developed financial markets, it is more likely that local suppliers can invest in upgrading technology and machinery to provide better inputs. Thus, financial development can be a good signal for the availability of potentially good supplier (Campos and Kinoshita, 2008).

Interestingly, trade openness exerts negative impact on FDI for all the specifications in the long-run. One way to explain the negative relationship between FDI and trade is on the basis of foreign firm's investment motives in the host country. One motive of the foreign firms is to invest in host country on the basis of cost cut incentives. If trade costs in the host country is greater that discourages FDI. Faini (2004) argued that increasing restrictions on trade increases trade costs that provides disincentives to foreign firms and discourages FDI. The negative effect of trade openness could also be justified on the grounds that risk and uncertainty factor affects the investor's decisions. Rehman (2003) argued that lack of credibility regarding the consistency of trade liberalization policies is one of the main reasons that adversely effect investor's decisions about the long-run investment. Thus, due to the risk and uncertainty and lack of credibility regarding the liberalization policies, foreign investors save the cost by taking decisions not to invest in risky countries as compared to domestic investment costs in the host country (Lehman, 1999). Besides these reason, in Pakistan the negative relationship between trade liberalization and FDI could be possible because the major chunk of FDI goes to non-manufacturing and services sectors, while the exports sector particularly textile sector has receiving a minimum share of FDI. The other reason could be the increase in imports due to reduction in tariffs and elimination of other trade barriers especially after signing the TRIPS agreement under WTO regimes which makes overall impact of trade on FDI negative. The existence of monopolies of MNCs could be another reason for the negative relationship in Pakistan. More recently Azam (2010) has also found the similar results between FDI and trade for a panel of selected SAARC countries.<sup>37</sup> Campos and Kinoshita (2010) also obtains similar findings for transition economies.

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<sup>37</sup> SAARC represents South Asian Association for Regional Cooperation.

The infrastructure carries positive sign and statistically significant in first three cases suggesting that infrastructure plays an important role in attracting FDI. However, infrastructure exerts insignificant influence on FDI as political repression is included in the analysis. This could be due to the high correlation between infrastructure and political repression indices. The international financial variable, real effective exchange rate influences FDI negatively in the long-run. This implies that depreciation of domestic currency raises transactions and input costs and decreases FDI in the host country. Another variable that might exert great impact on the inflows of FDI is the natural resource endowments. The positive association between FDI and natural resources implies that in Pakistan FDI is partly resource seeking type.

The Pakistan's political relations with United States (*DIPR*) exerts negative and but insignificant effects on FDI for each specification in the long-run. This implies that the economic sanctions imposed by United States during the 1979 and then in 1998-2001 (and tense diplomatic relations from 1972 to 1978 and 1992 to 2001) can affect only the official inflows (i.e. economic and military aid flows) in the long-run. This result further implies that unsustainable Pak-U.S. diplomatic relations do not disrupt the flows of private capital to Pakistan in the long-run.<sup>38</sup> These results are consistent with the descriptive analysis carried out in section 4.

The democracy related variables, such as political rights and civil liberties remains insignificant. This implies that political freedom and civil liberties produces no significant impact on the inflow of FDI to Pakistan. These results are consistent with the earlier findings of Alesina and Dollar (2000). The hypothesized variable political repression which is used as proxy for political risk is appeared to be insignificant. This means that political instability exerts no impact on the inflows of FDI in Pakistan. These results confirm the previous findings of Akhtar (2000) and Khattak *et al.* (2005). The reason could be the weaker democratic institutions, high level corruption, and weak concentration of capital and enforcement of labour laws, inefficient bureaucracy and

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<sup>38</sup> Anwar and Michaelowa (2006) also find that the effects of US business interests based on FDI and exports appeared to be comparatively small.

insecurity of property rights (Quere, *et al.*, 2007). To check the robustness of the results we use data from polity IV as measure of political risk (democracy), but it does not changes the results in terms of signs.

On the whole, the domestic investment, financial development, infrastructure and natural resources are the major factors exerting positive impact on FDI in Pakistan. Trade liberalization and real effective exchange rate deter FDI in the long-run. Institutional factors, such as political rights, civil liberties and political repression produce no significant impact on FDI inflows to Pakistan. These results are consistent with the findings of Akhtar (2000). Furthermore, the impact of diplomatic relations of Pakistan with international powers (i.e. USA) on FDI is though negative but insignificant in the long-run.

To examine the short-run dynamics we have estimated the error-correction model and Table 14 reports the results. The results show that domestic investment, financial development, infrastructure, and natural resources exert positive and significant impacts on FDI inflows in the short-run. This implies that growth of domestic investment, financial liberalization and exploitation of natural resources would accelerate the growth of FDI in Pakistan. The share of investment to GDP influences FDI positively in the short-run. This means that FDI produces crowds-in effect on the domestic investment. This result could be justified on the ground that FDI may exerts positive impact on domestic investment because of the generation of backward linkages (Adam, 2009 and Kumar and Pradhan, 2002).

The impact effect of financial development is positive and significant for all the specifications in the short-run. However, financial development lagged by one year exerts negative impact on FDI. One reason could be that the funds are not being used to promote investment activities. This is true for the case of Pakistan because in the pre-reforms period commercial banks in Pakistan have been allocating funds to selective peoples and sponsors of leading political parties. Thus credit disbursement to private sector is generally based on political considerations rather than on economic

Table 14: Short-Run Dynamics of FDI and Political Relations  
(Dependent Variable:  $\Delta FDI_t$ )

Model	Benchmark (1)	Political Rights (2)	Civil Liberties (3)	Political Repression (4)	Polity (5)
$\Delta Y_t$	0.13 (3.29)*	0.14 (3.21)*	0.15 (3.83)*	0.15 (3.63)*	0.19 (3.65)*
$\Delta FD_t$	0.07 (2.24)**	0.07 (2.22)*	0.08 (2.56)*	0.08 (2.43)*	0.07 (2.30)*
$\Delta FD_{t-1}$	-0.12 (-3.48)*	-0.12 (-3.41)*	-0.14 (-4.09)	-0.14 (-3.81)	-0.12 (-3.60)*
$\Delta TOP_t$	-0.04 (-1.11)	-0.03 (-0.95)	-0.03 (-1.04)	-0.03 (-0.73)	-0.03 (-0.37)
$\Delta INFRS_t$	0.37 (3.59)**	0.36 (3.00)*	0.32 (3.02)	0.29 (2.46)	0.29 (2.54)*
$\Delta NRS_t$	0.27 (2.81)*	0.24 (1.81)**	0.26 (2.78)*	0.17 (1.36)	0.05 (0.30)
$\Delta REER_t$	2.33 (2.04)**	2.39 (2.03)**	2.25 (2.07)**	2.45 (2.17)**	2.70 (2.20)**
$\Delta DIPR_t$	-0.38 (-2.09)*	-0.40 (-2.09)*	-0.45 (-2.47)*	-0.46 (-2.44)*	-0.38 (-2.00)**
$\Delta PR_t$	-	0.11 (0.40)	-	-	-
$\Delta CL_t$	-	-	0.90 (1.90)**	-	-
$\Delta PREP_t$	-	-	-	0.67 (1.39)	-
$\Delta POLITY_t$	-	-	-	-	-0.02 (-1.56)
$EC_{t-1}$	-0.41 (-3.12)*	-0.40 (-2.99)*	-0.43 (-3.44)*	-0.40 (-3.08)*	-0.36 (-2.61)**
$\bar{R}^2$	0.61	0.59	0.64	0.62	0.63
$F - stat$	8.11*	6.97*	8.39*	7.71*	7.83*
$DW - stat$	1.91	1.91	2.20	2.03	2.21

Note: \*\* and \* indicates significant at the 5 percent and 1 percent level respectively.

considerations. As a result, the vested group has accumulated huge amount of non-performing loans. The other reason could be the possibility that financial deepening means an increase in treasury operation of financial institutions rather than increase in the lending for investment activities (Khan, 2007). Furthermore, non-linearities may also make the relationship between FDI and  $FD_{t-1}$  negative.

In the short-run trade liberalization exerts no impact on FDI. The reason could be that in manufacturing sector, the inflows of FDI is very small, especially textile sector receiving

meager FDI inflows. This indicate that Pakistan has received little export-oriented FDI. Hence, there is limited role of FDI in export promotion (Khan and Khan, 2011).

Unlike the long-run, in the short-run Pakistan's diplomatic relations with international powers produces negative and significant impact on the FDI inflows. This suggests that economic sanctions imposed on Pakistan from time to time affect the short-term private capital inflows rather long-term capital inflows. This result also support our findings in section 4 that U.S. policies effect private capital inflows in the short, but exert no impact in the long-run.

The risk related variables, such as political rights, civil liberties and political repression produces no influence on the FDI inflows. However, when civil liberties is included in the model it produces significant influence on FDI in the short-run. This suggests that freedom to conduct business activities, etc. play a significant role in attracting FDI in the short-run. Besides civil libraries, external influences are important instead of internal risks for private capital inflows to Pakistan in the short-run. The error-correction term possess expected negative sign and ranged between -0.36 to -0.43 and statistically significant suggesting a moderate speed of adjustment to achieve long-run equilibrium path. The estimated error-correction model fit very well in terms of reasonable adjusted  $R^2$  with no evidence of autocorrelation as indicated by the DW-statistics. To check the robustness of the results we have used polity IV data as proxy of political risk. The introduction of alternative variable for political risk generally does not produce any major change in the estimated parameters in terms of signs in the short-as well as in the long-run.

## **8 Conclusions and Policy Implications**

This study developed a nexus between FDI and international political relations for Pakistan over the period 1972-2009. The main focus of the study is to examine how political relations of Pakistan with major international powers, particularly with the United States affect the inflows of FDI to Pakistan. On the basis of extensive theoretical and empirical analysis we obtain some striking results.

Our findings suggest that United States policies with respect to Pakistan influences only economic and military aid flows but not private capital inflows (i.e. FDI) in the long-run. We find that United States policies towards Pakistan do not much correlate with the policies of other donors and investing countries. Our findings also suggest that economic sanctions against Pakistan do not affect U.S.-Pak trade relations. These findings are verified by the results obtained using econometric analysis that U.S. sanctions policies produce no significant impact on FDI inflows to Pakistan in the long-run. However, in the short-run U.S. policies influences FDI inflows to Pakistan negatively.

The analysis further suggests that in Pakistan economic factors such as domestic investment, good infrastructure, and real effective exchange rate and natural resource endowments exert significant influence on FDI. Among the policy related factors, only financial development produces positive and significant effect on FDI inflows.

The institutional factors, such as political rights, civil liberties and political repression produces no significant impact on FDI in the long-run. However, in the short-run only civil liberties significantly influences the inflows of FDI.

The general conclusions emerges from this study is that deterioration of U.S.-Pak relations neither influences the flows of private capital nor bilateral and multilateral capital in the long-run. However, negative effects on the private capital flows have been seen in the short-run. Besides, economic and policy related factors play a significant role in the determination of FDI in Pakistan, while institutional factor exerts no significant impact on the FDI in Pakistan.

The findings have important policy implications in general and for Pakistan in particular:

- (1) International relations, particularly U.S.-Pak relations adversely influence inward FDI to Pakistan in the short-run. Therefore, measures should be taken to review foreign policy and establish close diplomatic relationship with

United States. However, these relations may be based on mutual respect, trustful and sustainable and predictable.

- (2) We obtain evidence that trade and FDI are substitutes rather than complements. Therefore, government may focus more on its liberalization and investor-friendly policies and remove bottlenecks hampering FDI. Furthermore, government may encourage export-oriented FDI.
- (3) FDI exerts crowding-in effects on domestic investment, therefore measures should be taken to encourage and facilitates local investors and broaden the circle of domestic investors by providing more infrastructure services, credit facilities and improve the physical infrastructure. These measures do not only further encourage the domestic investment but also help in attracting more FDI. It is also suggested that the exploration and up-gradation of natural resources play an important role in attracting FDI.
- (4) Institutional factors, such as political rights, civil liberties and political repression remains insignificant. Hence, there is need to strengthen the location factors like incentives, consistency and continuity of liberalization policies and liberal investment regime.

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