“MAJOR DETERMINANTS OF FOREIGN DIRECT INVESTMENT IN PAKISTAN AND THEIR IMPACT ON THE FLOW OF FDI”

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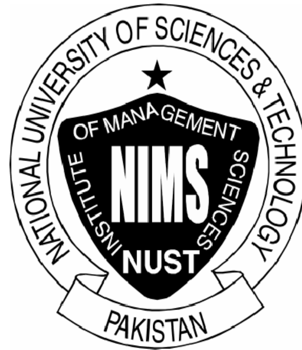

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All praise is for Almighty Allah, the most merciful most compassionate who help his poor creatures in the time of crisis and best owned upon it, his unfathomable kindness and guidance.

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ABSTRACT

Foreign Direct Investment (FDI) has been one of the most fascinating and intriguing topics amongst researchers in international business. It is one significant form of rapid international expansion to increase ownership of assets, derive location-specific advantages and acquire additional knowledge.

Emerging markets possess a lot for potential for Foreign Direct Investment (FDI). These markets enable investors to increase their profitability at a cost lower as compared to other markets. During the last two decades and specifically during the last eight to ten years Pakistan has undergone certain economic and policy changes which have enabled it to develop itself as a promising host nation for foreign investors. Efforts have been made not only to enhance economic growth but also to develop proper infrastructure, enhance the human resource availability, reduce factor cost and amendment of policies in order to render Pakistan as an investment friendly country.

The prospects of FDI in Pakistan have specifically improved in last three-four years. The factors which are favoring FDI are higher economic growth, macroeconomic stability, reforms, consistent policies and the political and law & order situations.

The study explores the main determinants of FDI in Pakistan with a particular emphasis on Economic factors and Investment Policy. Five important economic determinants along with a political determinant have been highlighted. These determinants have been stressed upon in coherence to previously conducted studies. The main determinants analyzed in the study are GDP, interest rate, inflation, labor force availability, exchange rate and liberal investment policy. The economic determinants have been empirically tested in order to identify the relationship between these variables and FDI inflow in Pakistan, where as descriptive analysis has been carried out to signify the relationship between FDI and a liberal investment policy.

1. OVERVIEW

1.1 SIGNIFICANCE OF THE STUDY

Globalization of the developing economies is on of the hot topics in the economic arena in recent times. This globalization and liberalization has enabled many economies to attract sturdy amount foreign capital in terms of foreign direct investment. Foreign Direct Investment (FDI) has become an eminent member of both developing and developed economies of the world. There are certain variables which enhance the attractiveness of a country for FDI; these can be social and economic factors and political factors. Pakistan over the past few years has undergone substantial economic and policy changes, rendering it as one of the attractive economies in the Asian continent. This study can contribute to highlight some of the factors (economic and political) which have enabled Pakistan to become a FDI friendly country; hence it will provide productive observations for understanding the economic and political determinants of FDI in Pakistan.

1.2 RESEARCH OBJECTIVES

The swift intensification of developing Asia has been engrossed and facilitated by FDI flows, which have increased substantially in current decades. Part of the reason for this is that the developing countries in Asia have removed precincts and restrictions, and implemented policies to magnetize FDI inflows to benefit from the investments and potential spillover possessions. Governments throughout the region have been striving to find an apposite policy mix for FDI that will maximize the net reimbursement for their economies.

Consequently, there is considerable variation in policies and practices with FDI across countries, reflecting enhanced economic, social, and political conditions. Pakistan being the important part of developing Asia is also facing such kind of tribulations. The challenge for Pakistan is precisely to develop a well balanced and preferably inimitable amalgamation of determinants of FDI, and to seek to match those determinants with the strategies, shadowed and pursued.

So the main objectives of study are

- To understand the role of FDI in a country's economy
- To determine the factors that effect the flow of FDI in Pakistan and to highlight the relationship between these determinants and FDI
- To find out how the flow of FDI can be increased in Pakistan
- To provide a certain direction for future research

1.3 Research Questions

This study aims to answer the following question:

- What are the factors that affect the flow of foreign direct investment in Pakistan?
- What measures government can take to increase foreign direct investment?

1.4 Problem Statement

The problem statement of the study is as follows:

"What are the chief determinants of Foreign Direct Investment (FDI) and their impact on the flow of FDI in Pakistan?"

2. INTRODUCTION

Foreign Investments are critical for both developed and developing countries. Foreign Direct Investment (FDI) has opened new arenas and opportunities for investors, enabling them to earn hefty returns upon their investment and also facilitating the host nations to explore their idle resources, resulting in more productivity.

The Second World War left many nations unstable and weak. In the years after the war as much of the world was focused on recovering from the destruction and havoc, the global FDI was dominated by the United States. During the era of 1945-1960 United States constituted around three quarters of new FDI, including reinvested profits. From then onwards FDI has become truly a global phenomenon and not only the brain child of the OECD countries. FDI has become an important aspect of different economies and today the global economy is dependent upon it, with FDI constituting 20 percent of global GDP. [1]

The economies of the world are truly becoming globalized, thus it is not simply the size of an economy that matters but also the flow of investments from different nations that support it. The GDP of a country enables us to comprehend the level of production of a country, but does not enable us to grasp the level of connectedness of a country with rest of the globalized nations. One way to do this is to focus on some components of GDP including exports and imports. However another increasingly important measure of global interconnectedness and economic prosperity is FDI.

While trade flows between two countries tell us the level of buying and selling between them, FDI statistics help us to analyze the economy from another perspective. On one hand FDI inflow facilitate us to visualize the level of attractiveness an economy has for foreign investors and on the other hand outward FDI show us how aggressive an economy is in tapping new opportunities. Basically these statistics tell us how appealing the people, resources, enterprises, markets and overall business environment of a

[1] http://en.wikipedia.org/wiki/FDI [May 2007]

particular country are to foreign investors. Eventually FDI are attracted to a particular country when these aspects depict a favorable picture to the foreign entity, which ensure the foreign entity a profitable investment and it is willing to bear the corresponding risks associated with investing in a foreign country.[2]

Growing FDI inflows can put a country in to economic development and promise a variety of potential benefits to poor country recipients. Due to the potential role foreign direct investment can play in accelerating growth and economic transformation, many developing countries seek such investment to accelerate their development efforts. As a result, FDI has become an important source of private external finance for developing countries.

Policymakers are of the view that FDI generates a healthy and constructive productivity effects for host countries. The basic methods for these externalities are the adoption of new technology and know how; this can be easily accomplished through licensing agreements, imitation, employee training, and the introduction of new processes. These benefits accompanied with the direct capital financing which FDI provide, deem the fact that FDI can play an important role in promoting economic development and initializing economic moderation and influx of new technology. Apart from this consistent influx of FDI in a country can also result in to efforts for better infrastructure development leading to overall national development.[3]

"It has been argued in the literature (Bosworth and Collins, 1999), that the ability to attract international capital can offer large potential benefits for developing countries. ***First*** *of all, foreign capital can be used to augment domestic savings (which is usually at the low level) and thus enable countries to increase the rates of capital accumulation.*

[2] http://www.dinarstandard.com/current/OIC_FDI040907.htm [May 2007]
[3] http://www.hbs.edu/research/pdf/07-013.pdf [April 2007]

Consequently*, this should improve long term growth prospects and increase wealth of the population, in other words, speed the development process."*[4]

Access to the international capital market provides the means to finance increased needs for resources in developing countries. Not only the fresh capital is relevant, both other, more intangible assets as well. Some types of foreign capital inflows, principally foreign direct investment, facilitate the transfer of managerial and technological know-how.

The benefits for the recipient are more or less straightforward. But, the decision to invest in the foreign country must also be grounded. Since it bears the risk for the investor, it must also offer at least some tangible prize. According to the traditional view, FDI are principally driven by the difference in prices of factors of production and the size of national market. Foreign investors move their production process to the developing countries aiming to exert advantages of cheaper factors of production and their strategy is de-localization of low-skilled production stages towards low-wage countries. The process is in economic literature known as vertical investments. The FDI inflows to advanced and developed countries are driven by market seeking strategy and represent relocation of production process towards a foreign country.

FDI has become an important source of private external finance for developing countries. It is different from other major types of external private capital flows in that it is motivated largely by the investors' long-term prospects for making profits in production activities that they directly control. While FDI represents investment in production facilities, its significance for developing countries is much greater.

Not only can FDI add to capital formation, but, perhaps more importantly, it is also a mean of transferring production technology, skills, innovative capacity, and organizational and managerial practices between locations, as well as of accessing

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[4] Paper prepared for the 2nd Euro frame Conference on Economic Policy Issues in the European Union "Trade, FDI and Relocation: Challenges for Employment and Growth in the European Union?", June 3rd, 2005, Vienna, Austria, Pg 2,3

international marketing networks. The first to benefit are enterprises that are part of transnational systems (consisting of parent firms and affiliates) or that are directly linked to such systems through non equity arrangements, but these assets can also be transferred to domestic firms and the wider economies of host countries if the environment is conducive.

The greater the supply and distribution links between foreign affiliates and domestic firms, and the stronger the capabilities of domestic firms to capture spillovers (that is, indirect effects) from the presence of and competition from foreign firms, the more likely it is that the attributes of FDI that enhance productivity and competitiveness will spread. In these respects, as well as in, inducing transnational corporations to locate their activities in a particular country in the first place, policies matter.[5]

"To explain the difference in the FDI performance among countries, it is necessary to understand how foreign investors choose their investment locations. The FDI usually goes to the countries where it is possible to combine the ownership advantages with the location specific advantages of the host countries through internationalization advantages of foreign investments (UNCTAD) The host country determinants of the FDI may be broadly grouped into three categories: policy framework for the FDI, economic conditions and business facilitations."[6]

[5] Padma Mallampally and Kar P. Sauvant, 1999, Foreign Direct Investment in Developing Countries
[6] Paper prepared for the 2nd Euro frame Conference on Economic Policy Issues in the European Union "Trade, FDI and Relocation: Challenges for Employment and Growth in the European Union?", June 3rd, 2005, Vienna, Austria, Pg 2,3

The table below summarizes the positive and negative aspects for both host nation and investor in typical FDI scenarios.

Positive & Negatives of FDI		
	Negatives	**Positives**
Host Country	• Foreign investor will crowd out local producers • Dependence on foreign technology and know how • Shift from domestic industrial/business to FDI-based development • Potential cultural dissonance between investor and host countries • Repatriation of earnings to origin country	• Increase in domestic employment • Domestic infrastructure development • Balance of Payments improvement • Development of local business clusters • Transfer of technology and expertise
Investor	• Has to deal with laws of foreign country • Nationalization Risks • Must contend with corruption in developing economies • May have to develop infrastructure	• Access to new markets • Low cost labor • New efficiencies from economies of scale

Source: Dina Standard

2.1 DEFINING FOREIGN DIRECT INVESTMENT (FDI)

FDI can be defined in numerous ways some common and most widely accepted definitions are as follows:

- FDI reflects the objective of obtaining a lasting interest by a resident entity in one economy (‘‘direct investor’’) in an entity resident in an economy other than that of the investor (‘‘direct investment enterprise’’). The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence on the management of the enterprise. Direct investment involves both the initial transaction between the two entities and all subsequent capital transactions between them and among affiliated enterprises, both incorporated and unincorporated.[7]

- FDI is investment of foreign assets into domestic structures, equipment, and organizations. It does not include foreign investment into the stock markets. FDI is thought to be more useful to a country than investments in the equity of its companies because equity investments are potentially "hot money" which can leave at the first sign of trouble, whereas FDI is durable and generally useful whether things go well or badly.[8]

- Direct investments in productive assets by a company incorporated in a foreign country, as opposed to investments in shares of local companies by foreign entities. An important feature of an increasingly globalized economic system.[9]

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[7] The Third Edition of the OECD Benchmark Definition, Pg 7,8 [June 2007]
[8] http://economics.about.com/cs/economicsglossary/g/fdi.htm [June 2007]
[9] http://www.investorwords.com/2042/foreign_direct_investment.html [June 2007]

- An investment made by a foreign person or organization in a particular country, or the total value of this type of investment.[10]

- FDI is defined as "investment made to acquire lasting interest in enterprises operating outside of the economy of the investor." The FDI relationship consists of a parent enterprise and a foreign affiliate which together form a *transnational corporation (TNC).* In order to qualify as FDI the investment must afford the parent enterprise control over its foreign affiliate. The UN defines control in this case as owning 10% or more of the ordinary shares or voting power of an incorporated firm or its equivalent for an unincorporated firm.[11]

- FDI is defined as investment that is made to acquire a lasting management interest (usually 10 percent of voting stock) in an enterprise operating in a country other than that of the investor (defined according to residency), the investor's purpose being an effective voice in the management of the enterprise. It is the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments.[12]

[10] http://encarta.msn.com/dictionary_561547130/foreign_direct_investment.html[June 2007]
[11] http://en.wikipedia.org/wiki/Foreign_direct_investment#_note-0 [June 2007]
[12] http://www.rrojasdatabank.org/sources2.htm

2.2 TYPES OF FDI

Broadly speaking, FDI can be categorized under five major heading:

1) Greenfield investment - (a new operation)
2) Brownfield investment (expansions or re-investment in existing foreign affiliates or sites)
3) Mergers & Acquisitions (M&As)
4) Privatization and equity investment
5) New forms of investment (joint ventures, strategic alliances, licensing and other partnership agreements)

The different types of FDI mentioned above each have their respective risks and rewards to both the investors and the host country. For example, Brownfield investments are made in existing projects which need to be revamped or expanded. Thus not only such investments ensure availability of funds but also provide means to avail new opportunities. Similarly Greenfield investments benefit a host nation in terms of creating job opportunities for the citizens and production capacity and also transferring technology and expertise. Technology has become an important tool for competition internationally in the business world. The transfer of technology and expertise benefits the host nation in the long term by enabling it to compete in the international arena. However such investments can also have a downbeat impact upon the indigenous industry of the host nation, due to the Greenfield investment's crowding out effect. In addition to this, decisions have to be made by the host nation regarding the taxation and repatriation of profits. These decisions will decide the government's level of direct revenue collection from the enterprises as well as the long term effects of reinvestment. [13]

[13] http://www.dinarstandard.com/current/OIC_FDI040907.htm [May 2007]

2.3 Promoting FDI – Inward and Outward[14]

Trade Promotion Organizations (TPOs) are government based entities which are tasked with the increasing exports and attracting FDI to host countries. According to Richard J. Hunter, Jr., Professor of Legal Studies at Seton Hall University, the role of TPOs in attracting FDI extends into a number of areas which include:

1) Generating foreign investment activity and interest by identifying suitable domestic partners
2) Providing professional management assistance
3) Pointing out specific FDI opportunities
4) Creating and fostering a favorable domestic climate for FDI
5) Monitoring and reporting on FDI activities
6) Providing the necessary "market entry" data
7) Providing necessary information on taxation, administrative regulations, and other legal and financial matters.

While the above list focuses on inward FDI flows, the United Nations Conference on Trade and Development (UNCTAD) also focuses on outward FDI trends. Similar to the relationship with imports and exports this categorization allows us to understand both how attractive a country is to foreign investors as well as how aggressively it is promoting its own industry in the global markets. According to UNCTAD, facilitating outward FDI requires TPOs to:

1) Provide information to prospective overseas investors
2) Act as match makers
3) Conduct feasibility studies
4) Provide legal support
5) Support training
6) Issue incentives for outward investment
7) Coordinate investment guarantees

[14] http://www.dinarstandard.com/current/OIC_FDI040907.htm [May 2007]

2.4 FDI IN GLOBAL PERSPECTIVE

In the past few decades the world has been encompassed by the concept of globalization. The world nations have formidably accepted the notion of globalization and have permitted different foreign enterprises to move in to their boundaries. This movement across national borders proves to be beneficial both for the host country and the foreign enterprises as well as the foreign nations.

The growth of FDI in the world has been significant in the past few decades. Between 1990 and 2000 world's FDI inflows increased more than five times, and after 2000 world's FDI inflows have declined. During the period of FDI expansion, growth has been especially strong since 1997. However, most of the FDI transactions were between the developed countries. The distribution of FDI is unequal and less developing countries face difficulties in attracting FDI. Despite the fact that FDI is increasingly important to developing countries, over the past few years the share of the developing countries in world's FDI inflows has been declining.[15]

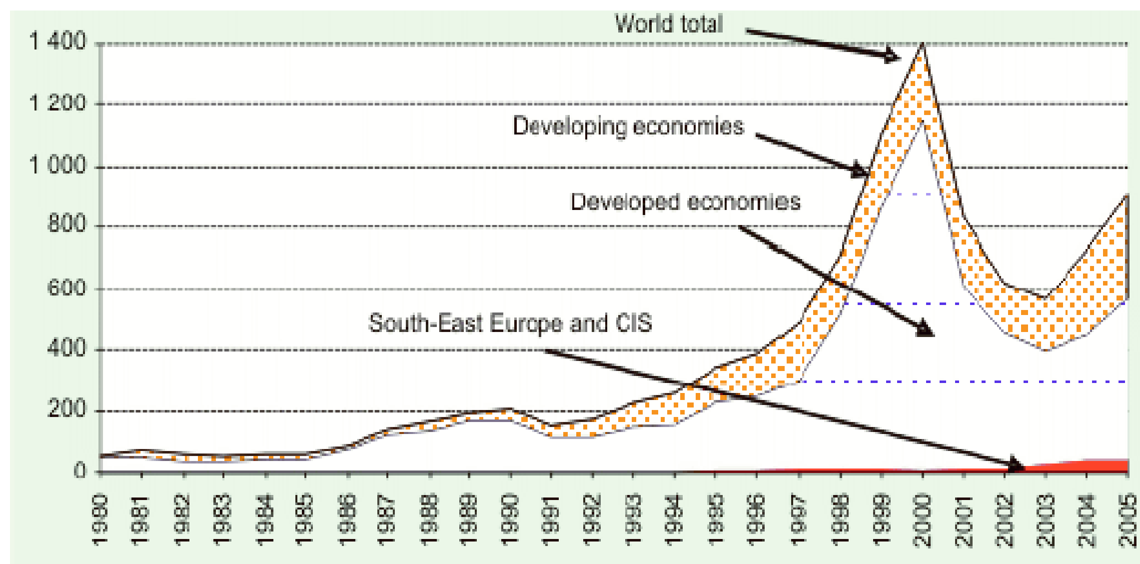
Inflows of FDI were substantial in 2005. They rose by 29% – to reach $916 billion – having already increased by 27% in 2004. Inward FDI grew in all the main sub regions, in some to unprecedented levels, and in 126 out of the 200 economies covered by UNCTAD (United Nations Conference on Trade & Development). Nevertheless, world inflows remained far below the 2000 peak of $1.4 trillion. Similar to trends in the late 1990s, the recent upsurge in FDI reflects a greater level of cross-border mergers and acquisitions (M&As), especially among developed countries. It also reflects higher growth rates in some developed countries as well as strong economic performance in many developing and transition economies. Inflows to developed countries in 2005 amounted to $542 billion, an increase of 37% over 2004, while to developing countries they rose to the highest level ever recorded – $334 billion. In percentage terms, the share of developed countries increased somewhat, to 59% of global inward FDI. The share of

[15] Paper prepared for the 2nd Euro frame Conference on Economic Policy Issues in the European Union "Trade, FDI and Relocation: Challenges for Employment and Growth in the European Union?", June 3rd, 2005, Vienna, Austria, Pg 1

developing countries was 36% and that of South-East Europe and the Commonwealth of Independent States (CIS) was about 4%.[16]

Fig1. FDI inflows, global and by group of economies, 1980–2005

(Billions of dollars)



Source: UNCTAD, based on its FDI/TNC database (www.unctad.org/fdi statistics).

Inward FDI in *developed countries* had already started to increase in 2004, after three years significant decline between 2000 and 2003. That decline was mainly due to sluggish growth in the developed countries, in particular in the euro area and Japan. While developed countries other than those of the European Union (EU) contributed to the growth of inflows in 2004, the increase in 2005 was particularly marked in the EU (97%), most notably in Germany, the Netherlands and the United Kingdom, each of which experienced an increase of more than $40 billion (more than $100 billion in the case of the United Kingdom). The five largest host economies in 2005 – the United

[16] World Investment Report United Nations New York and Geneva, 2006 FDI from Developing and Transition Economies: Implications for Development, Pg 17

Kingdom, the United States, France, the Netherlands and Canada in that order – accounted for 75% of total FDI inflows to developed countries.[17]

According to the United Nations Agency UNCTAD (United Nations Conference on Trade & Development) Global foreign direct investment (FDI) inflows grew in 2006 for the third consecutive year to reach US$1.2 trillion. The United Nations Conference on Trade and Development (UNCTAD) says that the continued rise in FDI largely reflects high economic growth and strong economic performance in many parts of the world. Such growth has occurred in both developed and developing countries. Increased corporate profits (and resulting higher stock prices) have boosted the value of the cross-border mergers and acquisitions (M&As) that constitute a large share of FDI flows. Continued liberalization of investment policies and trade regimes added further stimulus, although in some countries in Africa and Latin America there were some notable changes in economic policy towards a greater role for the state, as well as changes in policies that directly concern foreign investors or industries, in particular the natural resources industry. FDI performance has varied greatly among regions and countries. FDI flows to developed countries in 2006 rose by 48%, well over the levels of the previous two years, and reached US$800 billion. The United States recovered its position as the largest single host country for FDI in the world, overtaking the United Kingdom, the top FDI recipient in 2005. The European Union (EU) as a whole continued to be the largest host region, accounting for 45% of total FDI inflows in 2006.

Economic growth in 2007 is projected to slow moderately. Continuing global external imbalances, sharp exchange rate fluctuations, rising interest rates, and increasing inflationary pressures, as well as high and volatile commodity prices, pose risks that may also hinder global FDI flows and could lead to a slowdown in the fast growth in global FDI registered over the past few years.[18]

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[17] World Investment Report United Nations New York and Geneva, 2006 FDI from Developing and Transition Economies: Implications for Development, Pg 17

[18] http://www.finfacts.com/irelandbusinessnews/publish/article_10008686.shtml [June 2007]

3. OVERVIEW OF ECONOMY OF PAKISTAN

3.1 PAKISTAN'S IMPROVING ECONOMIC CONDITIONS: A MAJOR FACTOR FOR ATTRACTING FDI

One Striking feature of the world economy in recent decades has been the growth of foreign direct investment (FDI), or investment by transnational corporations or multinational enterprises in foreign countries in order to control assets and manage production activities in those countries.

FDI has become an important source of private external finance for developing countries. It is different from other major types of external private capital flows in that it is motivated largely by the investors' long-term prospects for making profits in production activities that they directly control.

The significance of FDI for developing countries is much greater. Not only can FDI add to resources and capital formation, but, perhaps more important, it is also a means of transferring production technology, skills, innovative capacity, and organizational and managerial practices between locations, as well as of accessing international marketing networks.

Pakistan, like many other developing countries, has also initiated wide-ranging structural reforms in various sectors of the economy to restore macroeconomic stability and improve enabling environment to attract FDI. Higher foreign direct investment in Pakistan has relaxed the foreign exchange constraint for imports to a greater extent, and supported the increase in the investment-to-GDP ratio, necessary to deliver the higher growth rates.

Pakistan is now amongst one of the investment-friendly nations in South Asia. Business regulations have been profoundly overhauled along liberal lines, especially since 1999. Most barriers to the flow of capital and international direct investment have been removed. Foreign investors do not face any restrictions on the inflow of capital, and investment of up to 100% of equity participation is allowed in most sectors (local

partners must be brought in within 5 years and contribute up to 40% of the equity in the services and agriculture sectors).

Business regulations have been relaxed and now are deemed amongst the most liberal in the region. Incentives are being provided in terms of unlimited remittance of profits, dividends, service fees etc. World Bank's report published in late 2006 also confirmed this by ranking Pakistan (74th) well ahead of its neighbors like China (93rd) and India (134th) based on ease of doing business[19].

Various reforms have been brought forward. An average reduced rate of 16% has been achieved in term of tariffs with the maximum of 25% (excluding the car industry). Privatization operations which were initiated in the early 1990s have gained momentum. Most of the banking system is now being owned by the private sectors with a high potential for new entrants to yet to enter. Apart from this the oil sector is also under consideration which would be amongst one of the biggest privatization operations.

The international rating agencies such "Moody's and Standard and Poor's" also recognized the improving economic conditions and business environment of the country and declared a country risk upgrade at the end of 2003.[20]

Pakistan's economy has continued to perform strongly over the last several years with economic growth accelerating to 8.4 percent in 2004-05, its fastest pace in two decades. The strong economic recovery since 2002-03 accompanied by macroeconomic stability has been underpinned by prudent macroeconomic policies, wide-ranging structural reforms, fiscal discipline and consistency and continuity in polices. These policies have contributed to marked improvement productivity and in consumer and investor confidence leading to growing overall domestic demand, which should help to support growth at a robust level over the medium-term.[21]

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[19] http://en.wikipedia.org/wiki/Economy_of_Pakistan [May 2007]
[20] http://en.wikipedia.org/wiki/Economy_of_Pakistan [May 2007]
[21] Mid Year review of Pakistan's Economy FY 2005-06, Government of Pakistan, Finance Division, Economic Adviser's Wing, Islamabad, Pg 1,21

"Total foreign private investment amounted to US $ 1462.6 million during the months July –December of the fiscal year 2005- 06 as against US $ 504.3 million in the comparable period of last fiscal year, thereby registering an increase of 190.0 percent. Further disaggregating of foreign investment reveals that FDI has registered an increase of 147.9 percent, rising from $ 445.0 million to $ 1103.3 million and portfolio investment registered an inflow of $359.3 million as against $ 59.3 million in the comparable period of last year ***(See Table A)****. Energy sector (oil, gas and power), communication (including telecom), financial services and trade sectors have been the major recipient of FDI, accounting for almost 85 percent or $ 935 million.*

The United States ($467.2 million), the UK ($ 110.7 million), Saudi Arab ($268.1million), Hong Kong ($ 63.1 million) and Netherlands ($62.0 million) remained the major investors in Pakistan during the first six months of the fiscal year 2005-06."[22]

Table A. Foreign Private Investment (Net)

	July-December		
	2004-05	2005-06	% Change
Direct	445.0	1103.3	147.9
Portfolio	59.3	359.3	505.9
Total	504.3	1462.6	190.0

Source: Mid Year review of Pakistan's Economy FY 2005-06

Pakistan has undergone significant economic and political transformation. Sound macroeconomic management, backed by market oriented policies and a conducive incentive regime, together with political stability and effective regulatory framework have enabled Pakistan to emerge as a viable and investment friendly destination.

This remarkable success has been achieved owing to a vibrant process of economic reforms, introduced by the government under the leadership of President General Pervez Musharraf and Prime Minister Shaukat Aziz.

[22] Mid Year review of Pakistan's Economy FY 2005-06, Government of Pakistan, Finance Division, Economic Adviser's Wing, Islamabad, Pg 1,21

Investment and Privatization Minister said the government's economic policies are based on three pillars of *deregulation, liberalization and privatization* together with transparency, good governance and continuity and consistency of policies.

"Pakistan's economy continues to maintain a solid pace of expansion since the fiscal year 2002-03. The recovery has been strong, rapid and sustained. During the fiscal year 2005-06, Pakistan's economic fundamentals gained further strength. The year 2005-2006 has been deemed as a milestone of economic achievement. The most important achievements of this year included:

1) *A solid pace of economic expansion in an extra-ordinary environment, underpinned by weaker-than-targeted performance of large-scale manufacturing and robust performance of services;*
2) *Three or four years of strong economic growth has positioned Pakistan as one of the fastest growing economies in Asian region;*
3) *Real per capita GDP grew by 4.7 percent and per capita income incurrent dollar term was up by 14.2 percent, reaching $ 847;*
4) *A sharp pick up in overall investment reaching at a new height of 20 percent of GDP and most notably, private sector investment remained buoyant owing to a rare confluence of various positive developments in the economy;*
5) *A robust consumer spending ably supporting the ongoing growth momentum;*
6) *The credit to private sector continue to rise at the back of improving investment climate, the private sector has borrowed over Rs.1100 billion in less than three years (2003/04 and until April 22, 2006) while their cumulative borrowing in the previous eighteen years (1984 – 2003) have been Rs.921 billion;*
7) *A significant abatement of price pressure indicating a steady deceleration in overall inflation, especially food inflation, the overall inflation decelerating from 9.0 percent in July 2005 to 6.2 percent in July 2006 and food inflation decelerating from 9.7 percent to 3.6 percent in the same period;*
8) *Energy consumption, particularly electricity and gas continue to rise at double-digit level, reflecting strong buoyancy in the economy;*

9) *Despite pressure emanating from the earthquake-related expenditures the underlying fiscal deficit performed better than the target;*
10) *The Central Board of Revenue (CBR) collecting taxes more than the target;*
11) *A sharp reduction in public and external debt burden;*
12) *The record public sector development program (PSDP) remained on track despite massive spending on earthquake related activities;*
13) *Exports and imports continue to grow at high double-digit level;*
14) *Workers' remittances at around $ 4.5 billion continue to remain one of the largest sources of external finance for Pakistan;*
15) *A continued accumulation of foreign exchange reserves;*
16) *Exchange rate continued to remain stable despite extra-ordinary increase in imports and deterioration in trade balance;*
17) *Privatization program achieved unprecedented success with the strategic sale of some difficult and complicated public sector units;*
18) *Highest ever foreign direct investment flows, exceeding $ 3.0 billion;"*[23]

Economic activity has and will be further boosted by efficiency gains once the full impact of foreign investment is realized after the completion of projects financed by FDI. During FY04-06, Pakistan has cumulatively attracted $8 billion foreign investment flows – 26.5% was sale proceeds of public assets and 49.2% from FDI, with remaining coming from foreign portfolio investment. These foreign inflows have come into banking, telecom and oil and gas sectors primarily. Prospects are that Pakistan will attract about US$6.0 billion in FY07 – an all time high annual flow.

Going forward, foreign investment is expected to be more diversified and will support infrastructure development, manufacturing, tourism and hotel industry etc. *The strong interest in Pakistan stems from (i) growing investor confidence in the economy, (ii) comfort to foreign investors that they are treated at par with domestic investors (and in*

[23] Economic Survey of Pakistan 2005-2006 Pg I,II

some respects even better), (iii) high returns on investments as evident from exceptional corporate and banking profitability and (iv) supportive and stable policies.[24]

The vibrant reforms and policies which the government has pursued over the last seven years are now rendering fruitful results. Pakistan has become an attractive destination for foreign investors. In utter contrast to an average of $350-450 million per annum prior to 1998-1999, the total FDI inflow to the country has increased tremendously. During the first ten months (July – April) of current fiscal year 2006-07 it reached a total of $ 4160.2 million. This is the highest ever in the country's history and almost doubles the inflows of foreign investment of last year. **(*See Tables B, C*)**

Table B. Inflow of Net Foreign Private Investment (FPI)

(Million US $)

				July-April					
	2005-06			2005-06			2006-07		
Country	**Direct**	**Portfolio**	**Total**	**Direct**	**Portfolio**	**Total**	**Direct**	**Portfolio**	**Total**
USA	516.7	303.8	820.5	419.1	331.5	750.7	676.7	669.4	1346.1
UK	244.0	-19.5	224.5	151.4	-16.1	135.3	724.4	382.3	1106.7
UAE	1424.5	63.3	1487.8	1284.6	55.1	1339.6	364.2	19.5	383.8
Germany	28.6	-3.5	25.1	27.0	-4.2	22.7	30.0	6.9	36.9
Kuwait	21.0	2.9	23.9	15.2	2.1	17.2	61.8	18.3	80.0
Hong Kong	24.0	31.2	55.2	21.9	33.1	55.0	30.2	-93.8	-63.6
Norway	252.6	0.0	252.6	243.3	0.0	243.3	25.1	0.0	25.1
Japan	57.0	-8.7	48.2	37.3	-6.4	30.9	51.0	0.2	51.2
Saudi Arabia	277.8	0.8	278.5	273.7	0.8	274.5	91.7	0.1	91.8
Canada	4.8	0.2	5.0	3.9	0.2	4.1	10.5	0.1	10.6
Netherlands	121.1	-0.7	120.4	101.1	-0.8	100.4	753.4	5.7	759.1
Mauritius	87.0	-4.1	83.0	64.4	-4.1	60.3	63.4	9.7	73.1
Singapore	9.9	5.6	15.5	8.9	0.6	9.5	14.2	169.1	183.3
China	1.7	0.0	1.7	1.6	0.0	1.6	708.9	0.0	708.9
Australia	31.3	0.0	31.3	26.1	0.0	26.1	60.5	-5.9	54.6
Switzerland	170.6	11.6	182.2	161.5	-11.9	149.6	157.8	-85.7	72.1
Others	248.5	-31.3	217.2	197.2	-24.1	173.1	336.5	51.7	388.2
Total	**3521.0**	**351.5**	**3872.5**	**3038.2**	**355.8**	**3393.9**	**4160.2**	**1147.6**	**5307.8**

Source: Economic Survey of Pakistan 2006-2007

[24] Speech by Dr Shamshad Akhtar, Governor of the State Bank of Pakistan, at the Pakistan Investment Conference organized by Euro money, Islamabad, 22 February 2007.

Table C. Net Inflow of Foreign Investment

Million US$

	2005-06	July-Apr		% Change
		2005-06	2006-07	
Foreign Private Investment	**3872.5**	**3394.0**	**5307.8**	**56.4**
Foreign Direct Investment	***3521.0***	***3038.2***	***4160.2***	***36.9***
of which Privatisation Proceeds	*1540.3*	*1538.3*	*133.2*	*-91.3*
Portfolio Investment	***351.5***	***355.8***	***1147.6***	***222.5***
Equity Securities	45.7	355.8	847.6	138.2
Debt Securities	0.0	0.0	300.0	-
Foreign Public Investment	***0.0***	***655.0***	***671.4***	***2.5***
Portfolio Investment	***0.0***	***655.0***	***671.4***	***2.5***
Equity Securities	0.0	0.0	738.0	-
Debt Securities *	0.0	655.0	-66.6	-110.2
Total	**3872.5**	**4049.0**	**5979.2**	**47.7**

Source: Economic Survey of Pakistan 2006-2007

Thus it is evident from the above discussion that Pakistan's economy has significantly improved over past few years. It has grown from a trodden economy to one the most attractive investment arenas for foreign investors. A lot of policies have been changed and the industry has been highly de regularized promising investor's hefty profits, leading to a magnetizing market for investors.

4. LITERATURE REVIEW

One of the remarkable features of globalization in the 1990s was the flow of private capital in the form of foreign direct investment. FDI is an important source of development financing, and contributes to productivity gains by providing new investment, better technology, management expertise and export markets. Given resource constraints and lack of investment in developing countries, there has been increasing reliance on the market forces and private sector as the engine of economic growth. In the neoclassical growth model, FDI promotes economic growth by increasing the volume of investment and its efficiency. Therefore, all countries, particularly developing and least developed countries, seek to attract Foreign Direct Investment (FDI) for the package of benefits it brings along with it into the host country economy.

Foreign investment, especially FDI, not only supplements domestic investment resources but also acts as a source of foreign exchange and can relax balance of payment constraints on growth. Considering the economic benefits and importance of FDI for promoting economic growth, most of the countries have formulated wide-reaching changes in national policies to attract FDI.[25]

Consistent economic reform policy measures are being followed in all five South Asian countries (India, Pakistan, Bangladesh, Sri Lanka and Nepal). The reform policies are underlining the market economy and aim at integrating these emergent economies with the rest of the world. Consequently, all including Pakistan have experienced higher economic growth and an improvement in most macro economic indicators both in the domestic and external sector.[26]

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[25]Pravakar Sahoo, 2006; Foreign Direct Investment in South Asia: Policy, Trends, Impact and Determinants
[26]Pravakar Sahoo, 2006; Foreign Direct Investment in South Asia: Policy, Trends, Impact and Determinants

Numerous studies have been conducted world wide to identify factors (i.e. can be termed as determinants of FDI) which can reckon a particular economy as a FDI friendly economy. Descriptive as well as empirical studies have been conducted to prove the relationship between FDI and different determinants. These determinants range from economic factors to political factors and infrastructure availability to regulatory frame work.

Sivakumar Venkataramany in the paper: *Determinants of Foreign Direct Investment in India: An Empirical Analysis of Source Countries and Target Industries* discuss certain factors which have proven to be fruitful for India to attract FDI and whether those determinants/ variables do really influence the flow of FDI in India. The study encompasses the time frame of 1992-2001, studying the flow of FDI in India and other developing countries like China, Mexico, Singapore, and Brazil. According to the study the movement in the macroeconomic factors of GDP, inflation rate and international trade plays a fundamental role in a country's FDI and thus these factors were used in the empirical analysis. Another important variable which has been considered is the interest rates available to foreign investors. It is apparent that lower interest rates will always be an attractive factor for the foreign investors. The empirical analysis of the study focuses on explaining the determinants of FDI in India rather than predicting them.

The basic model used in the study yielded positive results proving a relationship between the highlighted determinants and the inflow of FDI to India. GDP turned out to be a significant factor with a positive sign, depicting that an improving GDP is an encouraging factor for foreign investors. Similarly a negative relationship was identified between FDI and inflation, illustrating the adverse affects which it can have on the inflow of FDI. The analysis of the study basically reinforced previous related theories and studies conducted on determinants of FDI such as GDP, inflation, interest rate, profitability and trade.[27]

[27] Sivakumar Venkataramany Ashland University, USA; Determinants of Foreign Direct Investment in India: An Empirical Analysis of Source Countries and Target Industries

Humayon a Dar, John Presley and Shahid H Malik in their paper "*Determinants of FDI inflows to Pakistan"* summarize the findings of causality and long term relationship between foreign direct investment, economic growth and other socio political determinants. The paper considers economic growth, exchange rate and level of interest rates, unemployment and political instability as determinants of the level of FDI inflows to Pakistan over the period 1970 to 2002.

The paper is primarily concerned with different economic and political events occurring both in the region and in the country post nineties. It was during this time period that a lot of economic changes took place in the Asian region. These changes were the outbursts of the Asian currency crisis that took seed from Thailand in July 1997.

The method used was regression. A regression analysis was run on the empirical data for the last 33 years to look into what factors could affect the inflow of FDI to Pakistan. Different explanatory variables have been used to analyze their attributes in affecting the inflows of FDI to a host country.

In the study they have concluded that the level of FDI is influenced by exchange rate, the degree of openness of the economy and unemployment rate as well as political risk index. The results support the hypothesis that a FDI inflow to Pakistan is dependent on the major economic factors, along with the most important socio political determinants known as PRI (political risk index). [28]

In the study *The Determinants of FDI in Pakistan* by Anjum Aqeel and Mohammed Nishat submitted in Pakistan Development Review 2004 certain significant factors of FDI inflow in Pakistan have been analyzed. The study was built on previous studies conducted by different authors in the same context, numerous empirical studies such as by [Agarwal (1980); Gastanaga *et. al.* (1998); Chakrabarti (2001) and Moosa (2002)] on the determinants of FDI lead the authors to select a set of explanatory variables that are widely used and found to be significant determinants of FDI.

[28] Humayon a Dar, John Presley and Shahid H Malik, 2002; Determinants of FDI inflows to Pakistan

The major variables selected and analyzed in this study were GDP, Exchange rate, corporate tax, and wage rate.
The study apprehensions were that a positive coefficient would be achieved between GDP and FDI since foreign investors are only attracted to those economies where they have a big market for their product. The coefficient for exchange rate (EX) is ambiguous in many studies. As it could be positive if foreign investors are considering it as lower cost of capital and negative if they are expecting a higher return on their investments.[29]

In interpreting the FDI phenomenon ,ECLAC (Economic Commission for Latin America) has sought to look beyond the traditional determinants (such as market size, output growth, regulatory frame work, macroeconomic situation, patterns of competition) in order to take better account of the profound changes that have been occurring in the international economy. At present FDI flows, and thus the strategies of transnational companies, are the outcome of a combination of three sets of factors: the international environment, national policies (of both FDI recipient countries and countries of origin) and the strategies of business concerns.

The new national policies, and the results of these- macro economic stabilization, the opening up of trade and finance, economic deregulation, large scale privatization programs, the liberalization of regulations applying to private investments and the regional integration processes- have substantially changed the business environment in Latin America and the Caribbean, providing an incentive for investment decisions both by companies already operating in the region (whether domestic or international) and by new entrants. (ECLAC, 1999)

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[29] Anjum Aqeel and Mohammed Nishat, 2004; The determinants of foreign direct Investment in Pakistan; The Pakistan Development Review 43 : 4 Part II (Winter 2004) pp. 651–664

The international experience for industrialized nations has shown that most of the time a host country with a volatile exchange rate is negatively affected in its FDI inflows.
On the other hand, it has been demonstrated that ER affects FDI into LACs (Latin American Countries) depending on whether the firm decides to serve the local market or it decides to re-export although most of the time it is not a very powerful explanation of FDI into these countries. The most significant factors explaining FDI in LACs are GDP; the number of privatizations within each country and the main nominal variable is the inflation. Others are international environment, national policies and the strategies of business concerns (ECLAC 1998).

Exchange Rate as a Determinant of Foreign Direct Investment: Does it Really Matter, by Isabel Cristina Ruiz 2005. This paper re-examines the role of exchange rates as determinant of FDI. It extends the analysis to include the issue of how exchange rates determine the decision of invest in one country depending on whether the firm is deciding to invest on the country to service the local market or to invest on the country in order to re-export.[30]

The determinants Foreign direct investments in Developing Countries, by Marcelo Braga Nonnemberg and Mario Jorge Cardoso de Mendonça. The study was focused on shedding light on the fact that what can be the possible determinants of FDI in developing countries. In order to do so analysis was conducted on panel data of 38 developing countries including transition economies for the period 1975-2000. In this paper the importance of determinants is measured by identifying correlation of the various determinants with the foreign direct investment. Factors as size and pace of growth of economic activity, friendly policies towards foreign capital, country risk and market size has been concluded as the main determinants of FDI. The study concludes that both, the size of the economy as measured by GDP and the average rate of growth in previous years positively affected the flow of FDI and thus can be deemed as significant determinants of FDI. Further more the study highlights that though inflation appears to be

[30] Marcelo Braga Nonnemberg and Mario Jorge Cardoso de Mendonça 2004; The determinants Foreign direct investments in Developing Countries

an indicator of macro economic stability (presenting a negative sign in the larger sample); however in the smaller sample it did not materialize as a significant element.

The study has also undertaken the economy's degree of openness i.e. the willingness of a country to accept FDI as a determinant of FDI. This basically focuses on the prevailing Investment Policy in the country which highlights investment incentives, tax relief, cost of doing business, legal frame work required to set up an establishment, regulations regarding repatriation of profits etc. The results reveal that a significant relationship exists between the economy's degree of openness and the flow of FDI to the developing countries.

Finally the study also highlights an interesting factor as the determinant of FDI. According to the study the growth of capital markets also reveals to be a strong determinant of FDI.

Abdel-Hameed and M. Bashir are of the view that the rapid growth of foreign direct investment (FDI) and its overall magnitude had sparked numerous studies dealing with the channels of transmission from FDI to growth. The new developments have indicated the volatility of FDI and called for important macroeconomic and financial adjustments. This paper has examined the relationship between foreign direct investment and economic growth theoretically and empirically. The review of the literature and findings suggest that, by and large, foreign direct investment leads to economic growth. In this very paper the empirical relationship between FDI and per capita GDP growth is determined for the years 1975-1990. The results of this research indicate that the correlation between growth and FDI is positive. This certainly contradicts previous studies, which showed a strong and positive correlation between growth and foreign investment.

Mohammad H. Akhtar in his study *"The Determinants of Foreign Direct Investment in Pakistan: An Econometric Analysis"* contributes to an understanding of determinants of FDI in Pakistan Economy level. Analyses are carried out to explore the determinants of FDI through multivariate regression analysis. The results of the multivariate regression

analyses reveal that market size, relative interest rates and exchange rates are the major determinants of FDI in Pakistan. The variables such as market growth and political instability were consistently insignificant in the analyses. However, mixed findings were revealed by the variables such as consumer goods imports and the political regime in Pakistan.

The findings of this study suggest that economic variables are more significant and consistent determinants of FDI in Pakistan than political ones. The study conforms to the earlier findings in the literature on the market size, relative interest rates and exchange rates as the determinants of FDI. [31]

In his paper Petros E. Ioannatos *The Demand Determinants of Foreign Direct Investment: Evidence from Nonnested Hypotheses* has developed an economic model which is consistent with the existing theories of international production where the demand for inward FDI depends on a variety of characteristics of the recipient country. This model follows a prototype specified by Dunning (1981). This model distinguishes three types of influences on inward FDI. First, domestic market characteristics expressed by the market size and the direction of trade flows. The market size is measured by the host country Gross Domestic Product (GDP) and emphasizes the importance of a large market for efficient utilization of resources and exploitation of economies of scale. Second, host country cost considerations in terms of the unit cost of labor (hourly wages corrected by hourly productivity) [Culem (1988)]. However, due to insufficient data, labor productivity is used instead. The latter is measured by value added per worker. Third, factors expressing the overall financial performance of the host country such as the inflation rate and the effectiveness of the service sector. High inflation indicates inability of the government to balance its budget, and failure of the central bank to conduct appropriate monetary policy [Schneider and Frey (1985)]. Thus, it is expected that high inflation will inhibit inward FDI.[32]

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[31] Mohammad H. Akhtar; The Determinants of Foreign Direct Investment in Pakistan: An Econometric Analysis

[32] Petros E. Ioannatos; The Demand Determinants of Foreign Direct Investment: Evidence from Nonnested Hypotheses

Determinant of foreign direct investment can be determined by analyzing them empirically as well as descriptively. These factors include political risk, political instability as well as some others macro economic factors. Results of research shows that qualitative index of political risk is a significant determinant of FDI flow for countries. (Kwang W. Jun, Harinder Singh, 1995)

Elizabeth Asiedu & Hadi Esfahani, 2004 in their paper *"The determinants of foreign direct investment restrictive policies*" develops a theoretical political economy model of foreign direct investment policies and empirically analyzes the extent to which the economic, political and institutional characteristics of a country determine the country's FDI policies. It shows that the level of exports, employment and local inputs preferred by the government exceeds the level preferred by the TNE. The divergence in preferences motivates the government to impose restrictions on FDI.

The paper places FDI policies into an appropriate context by identifying clear reasons for government interventions. Furthermore it analyzes three FDI policies. The study examines the roles played by the political and institutional characteristics of the host country in the formation of FDI policies.

The literature review enabled me to extract certain possible determinants which can have an impact upon FDI inflow in Pakistan, although the list contains numerous variables, however only certain variables will be tested in accordance to the scope of the study.

Yuko Kinoshita Nauro F.Campos in their paper: '*The location determinants of foreign direct investment in transition economies"* probe the determinants of FDI inflow in transition economies during 1990 and 1998. Extensive work has been done in order to stipulate the determinants of FDI in transition economies. The study is unique because it undertakes the location determinants of FDI in 25 transition economies by utilizing the data between 1990 and 1998. In the empirical analyses, they have taken into account both host country characteristics and agglomeration economies as determinants of FDI location. They classified the location determinants into three categories: the first is country-specific advantages such as low-cost labor, large domestic market, skilled labor

force, adequate infrastructure, and proximity to the Western European markets. The second are institutions, macroeconomic policy and other policies that facilitate business-operating conditions. The third is the persistent pattern of FDI driven by agglomeration economies.

The determinants which have been considered in the study have been undertaken based on Dunning's study which proposes the OLI paradigm model. According to this model a firm becomes multinational mainly for three reasons: as **O**wnership advantages, **L**ocation-specific advantages and **I**nternalization. Firms endowed with ownership advantages or intangible assets expand operations abroad to internalize the benefits arising from ownership advantages and to match their strengths with location-specific comparative advantages.

This study focuses on the location specific advantages of the host country as the determinants of FDI. Large market size, proximity to home market, low-cost labor and favorable tax treatment in the host country are all considered as location advantages and have been undertaken in the study. The study is encircled around both the OLI model as well the transition specific issues such as changes in macro economic and institutional environment.[33]

"Determinants of Foreign Direct Investment: An Institutionalist Approach" by Devrim Dumludag, Ercan Saridogan, Serdar Kurt is an interesting study which examines the determinants of FDI in emerging markets. The basic aim of the study is to analyze the relationship between FDI and institutions in emerging markets.
The authors have adopted the panel data regression method to analyze the impact of institutions on FDI. Six countries have been selected in total: Argentina, Brazil, Hungary, Mexico, Poland, and Turkey. These countries are at the list of emerging markets. Especially Argentina, Brazil, Mexico and Turkey are very familiar when economic development policies are considered. Poland, Hungary and Turkey are very close to each

[33] Yuko Kinoshita Nauro F.Campos, 2002; The location determinants of foreign direct investment in transition economies

other, especially when the role of institutions as determinants of FDI is considered. In order to conduct the analysis the study uses dependent variables (FDI), independent macroeconomic variables (such as inflation, exchange rates, GNI per capita, labor force, interest rates, openness of the economy), and social-political independent variables (such as Juridical system, corruption, investment profile, economic, government stability, social and political risks). The data set is comprised of records from 1992 to 2004.
The results indicate that institutional variables as major determinants of FDI inflow. These include low level of economic risk (i.e. a growing economy with a healthy growth rate), low level of social and political risk (i.e. openness of the economy and a friendly investment policy), and security of property rights.

"Foreign Direct Investment in South Asia: Policy, Trends, Impact and Determinants" by Pravakar Sahoo. The study encompasses the fact that how all five South Asian countries (India, Pakistan, Bangladesh, Sri Lanka and Nepal) have been following consistent economic reform policy measures emphasizing the market economy and aiming at integrating their economies with the rest of the world. The major focus of the study is to reveal that how the FDI policy in these countries has evolved over the past few years resulting in augmented FDI inflow.

The study concludes that a positive change in the policies regarding FDI has been undertaken in the discussed South Asian Countries. It has been highlighted that these emerging economies have comprehended that FDI play a major role in enhancing economic development. The FDI policies have been revamped with the focus on designating these countries as FDI friendly destinations. Along with this the ongoing initiatives such as simplification of rules and regulations and enhancement of infrastructure are expected to provide the necessary impulsion to increase the flow of FDI in future.[34]

[34] Pravakar Sahoo, 2006; Foreign Direct Investment in South Asia: Policy, Trends, Impact and Determinants

"FDI, Human Capital, and Education in Developing Countries December" 2001 by Ethan B. Kapstein. The paper was presented to the *OECD Conference on FDI, Human Capital, and Education in Developing Countries.* The basic intention of the study is to highlight the role of human capital in economic development. It has been said in the study that development of human capital enables developing countries to attract more private investment both foreign and local.

TNCs place high importance in certain variables before they decide to enter in to a new market. The firms may choose from a set of alternative sites depending upon the host country's political and economic stability, language, level of income per capital, available natural resources and the quality of infrastructure available. Apart from all these factors on of the most important determinant to which TNCs assign high priority is the availability of adequate human capital.

Noorbakhsh, Paloni and Youssef (2001) have stated, "the hypothesis that human capital in host countries is a determinant of foreign investment in developing countries has been embodied in the theoretical literature. In their contribution, Noorbakhsh, Paloni and Youssef (2001) perform regressions using a large sample of developing countries, in an effort to test the major factors that motivate FDI. They find that human capital plays a significant role and this leads them to the policy recommendation that "developing countries formulate policies that improve local skills and build up their human resource capabilities. This is necessary to raise not only the volume but also the quality and sophistication of the FDI that a country can attract."

A study for the World Bank by Kamal Saggi (2000) reached similar policy conclusions. He found that "Without adequate human capital or investments in R&D, spillovers from FDI will fail to materialize. This finding underscores the importance of countries' policies toward education, accumulation of human capital, and R&D."

In its World Investment Report (1999), the United Nations provides another supporting lesson. It states that "Evidence also suggests that TNCs react to the availability of skills in host economies by raising technological content and upgrading their investments, in turn contributing to skill upgrading, the extent of training and collaboration in much higher in countries with advanced educational system."

The lack of human capital, in turn, may be a significant deterrent to foreign investors. As early as 1990, Robert Lucas was arguing that the shortage of human capital discouraged foreign direct investment in developing countries.[35]

"Is Human Capital a significant determinant of Portugal's FDI attractiveness?" by Ana Teresa Tavares and Aurora A.C. Teixeira, the paper discusses the importance and relevance of human capital in Portugal for attracting FDI in the country. It is and empirical study based on primary data collected through questionnaires from 703 companies located in Portugal. Out of these 703 companies the usable sample constituted of 475 firms. The results declare that availability of skilled human capital is a major determinant for attracting FDI in the country. The results of the study also highlight important policy implications, regarding the policies which are intended to stimulate human capital formation and FDI focused policies.

"Foreign Direct Investment in Pakistan: Policy issues and operational implications" by Ashfaque H. Khan and Yun-Hwan Kim. The study has carried out an in depth analysis of the FDI policy of Pakistan starting from 1950s till 1990s. It basically represents a chronological explanation of the FDI policy of Pakistan and how it has evolved since the 1950s. It has been highlighted that the FDI has improved manifold and these improvements have lead to an increase in FDI inflow in the country. The study also analyzes the trend of FDI inflow in the country and economic impact of FDI. When evaluating the economic impact of FDI the study highlights that FDI has a positive overall effect on economic growth but the magnitude of this effect depends on the stock

[35] Ethan B.Kapstein, 2001; FDI, Human Capital, and Education in Developing Countries

of human capital available in the host economy, exchange rate stability, GDP growth rate and available infrastructure.[36]

Valerija Botrić and Lorena Škuflić in their study: *"Main Determinants of Foreign Direct Investment in the South East European Countries"* have highlighted the importance of FDI for South East European developing countries and have studied the different determinants of FDI in such countries. The study focuses on testing GDP, population, inflation, investment policy and openness to foreign investment, external debt and some constituents of infrastructure; as the main determinants of FDI in these countries. A well explained descriptive analysis has been conducted along with the empirical testing of the above mentioned determinants.

Regression analysis has been conducted in order to determine the relationship of the different determinants with FDI. Regression analysis has been conducted using different specifications and mixed results have been attained. However it has been highlighted in the study the GDP proves to be a significant and momentous determinant of FDI in the South East European countries. The results showed that inflation did not turn out to be a significant determinant however openness to foreign investment and a well planned investment policy has been affirmed.[37]

[36] Ashfaque H. Khan and Yun-Hwan Kim, 1999; Foreign direct investment in Pakistan: Policy issues and operational implications; Edrc report series no. 66

[37] Valerija Botrić and Lorena Škuflićl; Main Determinants of Foreign Direct Investment in the South East European Countries

5. HYPOTHESIS DEVELOPMENT

The literature review depicts that various factors are considered as determinants of foreign direct investment in any country. However the variables tested in this study are:

- GDP
- Exchange Rate
- Interest rates
- Inflation
- Skilled Labor Availability
- Investment Policy

In accordance to the objectives of the study the following are the hypothesis tested in this study:

1) $H_0: \ p = 0$ there is no significant relationship between GDP and FDI inflow in Pakistan.

   $H_1: \ p \neq 0$ there is a significant relationship between GDP and FDI inflow in Pakistan

2) $H_0: \ p = 0$ there is no significant relationship between exchange rate and FDI inflow in Pakistan.

   $H_1: \ p \neq 0$ there is a significant relationship between exchange rate and FDI inflow in Pakistan.

3) $H_0: \ p = 0$ there is no significant relationship between lending interest rate and FDI inflow in Pakistan.

   $H_1: \ p \neq 0$ there is a significant relationship between lending interest rate and FDI inflow in Pakistan.

4) $H_0: \ p = 0$ there is no significant relationship between inflation and FDI inflow in Pakistan.

$H_1: \ p \neq 0$ there is a significant relationship between inflation and FDI inflow in Pakistan.

5) $H_0: \ p = 0$ there is no significant relationship between skilled labor availability and FDI inflow in Pakistan.

$H_1: \ p \neq 0$ there is a significant relationship between skilled labor availability and FDI inflow in Pakistan.

6) $H_0: \ p = 0$ there is no significant relationship between FDI (in Pak.) and its economic determinants (GDP, interest rate, inflation, exchange rate, skilled labor availability).

$H_1: \ p \neq 0$ there is a significant relationship between FDI (in Pak.) and its economic determinants (GDP, interest rate, inflation, exchange rate, skilled labor availability).

7) $H_0: \ p = 0$ there is no significant relationship between Liberal Investment Policy and FDI inflow in Pakistan.

$H_1: \ p \neq 0$ there is significant relationship between Liberal Investment Policy and FDI inflow in Pakistan.

6. METHODOLOGY

The overall factors affecting the flow of FDI in Pakistan are classified into **two** broad categories in order to conclude the most imperative determinants:

- Economic determinants
- Political determinants

Empirical analysis of economic factors (GDP, inflation, exchange rate, skilled labor availability and interest rate) has been discussed in the next chapter.
A descriptive analysis of the most important political determinant (Investment Policy) has been conducted in order to identify the relationship between the policy and the FDI inflow. Results have been discussed in the next chapter.

6.1 Sources of Data

The metric data was obtained from economic survey of Pakistan 2005-06 and annual reports of state bank of Pakistan. Figures of FDI, GDP, labor force and inflation were taken from economic survey of Pakistan. Exchange rate and weighted average rates of return on advances (taken as representative of interest rates in the study) have been acquired from annual reports of State Bank of Pakistan.
The information regarding the investment policy pertaining to FDI has been attained from Privatization Commission of Pakistan and Board of Investment.

6.2 Instrument and Measures

In order to conduct the empirical analysis, firstly Correlation is used to measure the type of relation between the variables and in order to measure the goodness of fit, Regression analysis has been performed. The results are discussed in next chapter.

6.3 PROCEDURE

6.3.1 RATIONALE OF THE SELECTED VARIABLES

The choice of the explanatory variables was largely affected by the existing literature on FDI determinants taking into account the trends and policies towards economic development and FDI in Pakistan over time.
Most of the studies in the case of Pakistan have tested the relationship of economic development and FDI in the scenario of GDP growth, exports etc.

The aim of international investors in gaining higher returns along with the security of the assets, leads them to look into macroeconomic determinations. Most of the previous studies have analyzed quite a number of macro economic factors e.g. GDP, exchange rate, exports, imports, trade balance, balance of payments, openness of economy, interest rates etc.

The primary measure of an economy's performance is its annual output of goods and services or aggregate output i.e. GDP
GDP of a host country indicates the economic strength of the country. A profit rational investor will always seek investment in a country, which has an acceptable growth rate (Khan -1999). The strength of economy in reference to the GDP growth rate also indicates stable economic health of the country.
GDP is a primary indicator of the growth of an economy. It represents the total monetary value of all goods and services produced over a specific time period. GDP basically represents the size of the economy. It indicates the growth of the economy over a particular time period.
Taking into account the growth record of Pakistan and existing theoretical strands, it seems plausible to test the influence of GDP in attracting FDI. Real GDP is used to test the proposition that a growing Pakistani market attracts FDI. Therefore, Real GDP according to factor cost has been used to test the hypothesis.

While looking into stable financial health, the ***exchange rate*** of the country plays a key role in financial and economic stability. An investor will not like to invest in a country with an unstable exchange rate. (Lucas- 1993) exchange rates may affect FDI through several channels.

The exchange rate variable has been widely debated in the literature on FDI determinants with some heterogeneous evidence with regard to its impact. An economy (being served through exports from the home country) with a depreciating currency attracts more FDI as exporting from abroad to it becomes expensive, while it becomes cheaper to produce locally. Hence, exports by the home country are replaced through local production in the host country. Devaluation in the host economy also makes it cheaper to export from this base, adding to the competitiveness of TNCs. Such a situation is attractive for the firms looking for an export base, reducing their production costs and earning higher profits. It also increases the local value of assets (financial and real) of TNCs held in foreign currency.

However, there are certain costs associated with such a scenario of devaluation. Firstly, a devaluing currency lowers the potential for profit repatriation by shrinking the real volume of profits in terms of home currency. Secondly, depreciation of the host currency makes imports expensive; bidding up the prices of necessary inputs imported by affiliates of the TNCs. Thirdly, devaluation also reduces the book value of real assets considered in terms of the home currency, lowering the assets side of the balance sheet of TNCs. This suggests that the impact of the exchange rate varies across the motives, nature and origins of FDI. In addition, currency fluctuations impel TNCs to guard against losses arising from such swings.[38]

Exchange rate fluctuations are expected to play a greater role in determining or deterring the flows of FDI in future. The variable is used to test for the effect of changes in the value of the rupee against that of the US dollar. Average exchange rate for each year is used in the analysis.

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[38] Dennis J. O'Conner & Alberto T.Bueso, 1990; International Dimensions of Financial Management, New York: Macmillan Publishing Company

The use of the ***lending interest rate*** variable as the determinant of FDI has not been quite common in previous studies. However, attention of researchers is gradually increasing to use this variable as a financial determinant of FDI. A higher interest rate can lead to a higher cost of capital for the investors, thus rendering the environment unfriendly. Weighted Average Lending Rate on advances has been used as a representative of interest rate in the study.

High ***inflation*** indicates inability of the government to balance its budget, and failure of the central bank to conduct appropriate monetary policy [Schneider and Frey (1985)]. Thus, it is expected that high inflation will inhibit inward FDI. Inflation may significantly depreciate the value of money; rapid decline in value of a currency can hinder investments. It is due to this reason that inflation has been tested as a determinant of FDI inflow in Pakistan. The measure of inflation rate is taken by CPI (consumer price index).

Availability of skilled labor force plays an eminent role in economic development. In the past few years policy makers have significantly highlighted the role of human capital in the development and growth of an economy. Human capital has been recognized as a relevant location advantage for TNC's. The level of education and skills of the labor force available in the host country considerably influence the enormity of FDI in the country and the activities or business operations undertaken by the transnational corporations. Scarcity of human capital accompanied with inadequate skills can be a deterring for the TNC's thus leading to decreased level of FDI.

The final variable under discussion in this research study is the ***FDI Investment policy*** prevailing in country. From an investment point of view the investment policy plays an eminent role in determining the friendliness of host country for FDI.

The investment policy encircles numerous parameters which enable the foreign investors to make their investment decisions. The policy elucidates the rules and regulations applicable to investments made in the country.

It highlights parameters such as: minimum investment required, extent of government permission required, tax relief available to foreign investors, custom duties applicable on import of (plant, machinery and equipment), protection of copy rights and royalties and most importantly the extent of remittance of capital, profits and dividends etc allowed to the foreign investors.

The investment policy also underlines the industries in which the foreign investors are allowed to invest. Thus all in all the investment policy defines the openness of country to foreign investments. A liberal investment policy propels a welcome note towards the foreign investors thus leading to increased FDI, where as a stringent investment policy despite of stable economic conditions hampers the flow of FDI to a country.

6.3.2 TESTS USED IN EMPIRICAL ANALYSIS

In order to test the established hypotheses the following statistical tools were used:

1) **Pearson Correlation:** Firstly correlation of each determinant was calculated with FDI. This was done in order to test the nature and significance of the relationship of each variable with FDI.

2) **T-test:** In order to verify the significance of relationship of each determinant with FDI t- statistics has been used. This test is used because some times a variable/determinant may depict a weak relationship with the dependent variable (FDI) which may be caused due to certain errors in data. However the t- statistics signifies the relationship between the two variables. It also illustrates that a determinant when compared with FDI stand alone may not represent a significant relationship, however when tested in coherence with other variables its magnitude may be different or even enhanced.

3) **Regression:** Finally a multiple regression analysis was conducted in order to identify and signify learn more about the relationship between several independent or predictor variables and a dependent or criterion variable. In this case the ***dependent variable is FDI*** where as the ***independent variables (determinants) are GDP, Inflation, Exchange rate, Interest rate and labor force availability.***

   In accordance to the above mentioned dependent and independent variables the following regression equation has been constructed

   The Regression Equation:

$$Y = \beta 0 + \beta_1 X_1 + \beta_2 X_2 + \ldots\ldots\ldots\ldots + \beta_n X_n + \varepsilon$$

Y= is the dependent variable

β_0 = is the actual constant

ε = is the error term

X_i = independent (explanatory) variables

β_i = is the actual coefficient of the independent variable

Y = FDI

β_0 = is the actual constant

X_i = Labor Force (Millions), Interest Rate (%), Inflation (%), Exchange Rate, GDP (Million Rs)

ε = is the error term

β_i = is the actual coefficients of Labor Force (Millions), Interest Rate (%), Inflation (%), Exchange Rate, GDP

$$FDI = \beta_0 + \beta_1 (GDP) + \beta_2 (Interest\ Rate) + \beta_3 (Inflation) + \beta_4 (Labor\ Force) + \beta_5 (Exchange\ Rate)$$

7. OUTCOMES & ARGUMENTS

7.1 TEST OF HYPOTHESIS

The hypothesis have been tested by applying Pearson Correlation, where by the relationship between the variables has been identified.

If the significance value of Pearson Correlation happens to be below α (0.01) and (0.05), then it shows that there may be some significant relationship between two variables being analyzed. So in that very situation there is sufficient evidence to reject the null hypothesis.

7.2 EMPIRICAL ANALYSIS

Table 1: Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
FDI (Million US $)	16	246.00	3521.00	782.17	808.26
GDP (Million Rs)	16	446005.00	890138.00	629202.25	127280.39
Inflation (%)	16	3.10	13.02	8.12	3.51
Exchange Rate	16	22.42	61.43	43.98	14.42
Interest Rate (%)	16	7.01	15.64	12.27	2.80
Labor Force (Millions)	16	31.50	50.50	39.32	5.73

Table 1 shows the descriptive analysis, in which standard deviation and mean is measured for both, dependent variable (Foreign direct investment) as well as independent variables (GDP, inflation rate, exchange rate interest rate and labor force). The data is taken of last sixteen years (1990-91 to 2005-06). So the total number of observation is 16

and 'N' denotes it. The minimum value of FDI is 246, which was during the year 1990-91 and the highest is 3521, this figure was attained in year 2005-06. The year 2005-06 has been deemed as one of the most successful years for the economy of Pakistan over the past two decades and also the best economic year under the current government.

It is also palpable from the results that the highest GDP in last 16 years has also been attained in 2005-06, thus rendering the fact that the Pakistan economy has considerably grown and has become one of the attractive economies in the Asian Continent. As evident from the figures of Exchange rate, the Pakistani Rupee has depreciated further during the last sixteen years. However upon scrutinizing the data it can be deduced that a certain level of stability in the exchange rate has been attained from 2002-2006, and a stable exchange rate is attractive for FDI.

Similarly it can also be seen that the level of labor force available in the country has increased manifolds during the past decade. The lowest level in the data under consideration was 31.5 million which was in 1990-91, however now it has increased up to 50.5 million. The availability of a profound skilled labor force in the country leads to more attractiveness for foreign investors.

Table 2 shows the Pearson Correlation Coefficient results, which is a numerical measure of strength in linear relationship between the variables.

Table 2: Pearson Correlation/ Correlation Matrix

		FDI (Million US $)	GDP (Million Rs)	Inflation (%)	Exchange Rate	Interest Rate (%)	Labor Force (Millions)
FDI (Million US $)	Pearson Correlation	1.000	.751**	-.042	.448	-.580*	.686**
	Sig. (2-tailed)	.	.001	.876	.082	.019	.003
	N	16	16	16	16	16	16
GDP (Million RS)	Pearson Correlation	.751**	1.000	-.555*	.902**	-.673**	.985**
	Sig. (2-tailed)	.001	.	.026	.000	.004	.000
	N	16	16	16	16	16	16
Inflation (%)	Pearson Correlation	-.042	-.555*	1.000	-.807**	.190	-.655**
	Sig. (2-tailed)	.876	.026	.	.000	.480	.006
	N	16	16	16	16	16	16
Exchange Rate	Pearson Correlation	.448	.902**	-.807**	1.000	-.468	.943**
	Sig. (2-tailed)	.082	.000	.000	.	.067	.000
	N	16	16	16	16	16	16
Interest Rate (%)	Pearson Correlation	-.580*	-.673**	.190	-.468	1.000	-.630**
	Sig. (2-tailed)	.019	.004	.480	.067	.	.009
	N	16	16	16	16	16	16
Labor Force (Millions)	Pearson Correlation	.686**	.985**	-.655**	.943**	-.630**	1.000
	Sig. (2-tailed)	.003	.000	.006	.000	.009	.
	N	16	16	16	16	16	16

** Correlation is significant at the 0.01 level (2-tailed).
* Correlation is significant at the 0.05 level (2-tailed).

A. The correlation coefficient between FDI and GDP is 0.751 which depicts the strong positive relationship between the variables. The significance is 0.001 which is less than 0.01, which means the relationship is significant and linear.

The linear relationship depicts that with the increase in GDP i.e. increase in the over all performance of an economy- FDI has increased in Pakistan. The correlation is further verified through t-test statistics. The t- stat value between FDI and GDP is 4.545 ***(See table 5: Coefficients)***, which is greater then 2.5 thus rendering the fact that a significant relationship exists between FDI and GDP and that the correlation results are correct.

Therefore, the null hypothesis 1 (developed in chapter 5) is rejected and following conclusion is made:

1) $H_1: p \neq 0$ there is a significant relationship between GDP and FDI inflow in Pakistan

B. The correlation coefficient between FDI and exchange rate is 0.448, which represents positive relationship between the (dependent and independent) variables. The significance level is 0.082 shows the relationship is in significant. However the t-statistics indicate a value of 3.138 which is greater then 2.5, and therefore it can be said that the insignificance in relationship fabricated in the correlation was probably due to the randomness of the data and that a significant relationship exists between FDI and exchange rate.

Therefore, the null hypothesis 2 is rejected and following conclusion is made:

2) $H_1: p \neq 0$ there is a significant relationship between exchange rate and FDI inflow in Pakistan.

C. The correlation coefficient between FDI and Interest rate is -0.580, which is a strong negative correlation. The correlation illustrates that an increasing Interest rate in the country would lead to increasing cost of capital for the foreign investors, thus becoming an inhibiting factor for the foreign investors. The significance level is 0.019 which is less then 0.01 and therefore the relationship is significant. In addition to this the t-statistics value is 3.810, thus rendering the relationship significant as it is greater than 2.5. Thus the null hypothesis 3 is rejected and the following conclusion can be made:

3) $H_1: \ p \neq 0$ there is a significant relationship between interest rate and FDI inflow in Pakistan.

However the fact needs to be addressed that the relationship is not linear.

D. The correlation coefficient between FDI and Inflation is -0.042. This represents a very weak negative correlation between the two variables. The significance level is 0.865, which deems it to be insignificant. However the t- statistic value is 3.831 according to which the relationship can be termed as significant. Therefore the null hypothesis 4 is rejected and the following deduction can be made:

4) $H_1: \ p \neq 0$ there is a significant relationship between inflation and FDI inflow in Pakistan

E. Finally the correlation between FDI and labor force availability is 0.686. Representing a strong positive correlation between the two variables. Positive correlation between the two variables indicates that an in increase in the available labor force in the country would result in amplification of FDI inflow to the country. The relation is highly significant as it stands at 0.003 which is also depicted by the t-value which is 3.676. In accordance to this the null hypothesis 5 can be rejected leading to the acceptance of the alternate hypothesis and the following conclusion:

5) $H_1: \ p \neq 0$ there is a significant relationship between skilled labor availability and FDI inflow in Pakistan.

Table 3: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.940	.884	.826	337.58

a. Predictors: (Constant), Labor Force (Millions), Interest Rate (%), Inflation (%), Exchange Rate, GDP (Million Rs)

Table 4: ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	8659787.513	5	1731957.503	15.198	.000
	Residual	1139582.782	10	113958.278		
	Total	9799370.294	15			

a. Predictors: (Constant), Labor Force (Millions), Interest Rate (%), Inflation (%), Exchange Rate, GDP (Million Rs)
b. Dependent Variable: FDI (Million US $)

Table 5: Coefficients

Model		Un standardized Coefficients		Standardized Coefficients	t Absolute Values
		B	Std. Error	Beta	
1	(Constant)	-7527.059	2516.421		(2.991)
	GDP (Million Rs)	8.488E-03	.006	1.337	(4.545)
	Inflation (%)	8.671	61.895	.038	(3.831)
	Exchange Rate	-93.672	29.851	-1.671	(3.138)
	Interest Rate (%)	67.412	47.405	.233	(3.810)
	Labor Force (Millions)	157.424	137.184	1.117	(3.676)

a. Dependent Variable: FDI (Million US $)

F. Table 3 shows the model summary of the results obtained from regression analysis. Model summary indicates the strong relationship between the variables with a multiple correlation coefficient (R) equals to 0.940. The value of R-square (i.e. 0.884) suggests that 88.4% of total variation in FDI is explained by the model with a standard error of 262.9935. Table 4 (ANOVA) shows Significance of results. The significance value of F statistics in less than 0.01 i.e. 0.000 and also F value should be greater than 5 in order to declare significance, where as in this case it is 15.198. So it shows that there is significant relationship and thus the null hypothesis 5 is rejected and following conclusion is made:

6) $H_1: p \neq 0$ there is a significant relationship between economic determinants (GDP, interest rate, inflation, labor force availability and exchange rate) and flow of FDI in Pakistan.

7.3 Descriptive Analysis

In order to verify the final hypothesis a descriptive analysis has been conducted. The final hypothesis embarks upon the investment policy prevailing in Pakistan. In order to test and verify this hypothesis a comprehensive review of the FDI policy/investment policy of Pakistan over the past years has been undertaken.
In order to understand the significance of the investment policy let us review it briefly over the past decades

7.4 Chronological Review of Pakistan's FDI Policy

7.4.1 Era of 1950s, 1960s & 1970s[39]

The era of 1950s and 60s sighted profound private industrial investment; the prevailing policy was liberal in terms of involvement of private sector in different segments of the industry. The public sector was confined to three out of twenty seven basic industries. These three industries were: arms and ammunition, generation of hydroelectric power and manufacturing of railway wagons, telephones, telegraph lines, and wireless apparatus. However it was also laid down that incase if adequate private capital was not available for the development of any particular industry of national importance, the public sector would be allowed to intervene and set up a certain number of standardized units.

By the late 1960s the private sector was the main driver of eminent industries like insurance, banking and international trade in major commodities. An important point to be mentioned here is that the services sector (like banking, insurance, commerce, etc) was dominated by the local investors; foreign investment was not allowed to invest in these areas, thus depicting a stringent and restrictive FDI policy.

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[39] Ashfaque H. Khan and Yun-Hwan Kim, 1999; Foreign direct investment in Pakistan: Policy issues and operational implications; EDRC Report Series No.66

The 70s however brought upon a new drift in the investment arena of Pakistan. This drift was brought about because of the initiation of Government of Pakistan's Economic Reform Order in 1972. The order proposed the taking over of ten major categories/ industries by the Government of Pakistan.

These industries included the following: iron and steel, heavy engineering, assembly and manufacturing of motor vehicles, assembly and manufacturing of tractors, heavy basic chemicals, petrochemicals, cement, public utilities, gas, and oil refineries.

Along with that control of commercial banks, development financial institutions (DFIs) and insurance companies was also under taken by the government. This sudden move from privatization to nationalization illustrated a highly stringent investment policy, which completely demised the confidence of both foreign and local investors leading to an all time lowest level of FDI in the country. Figure 2 also briefly states how the matters changed during this era:

Fig2. From Privatization to Nationalization during the 70s

Dec-71	Bhutto Takes over as President of Pak
Jan-72	Public Take Over of 31 large firms (iron steel basic metal motor vehicles chemicals cement utilities etc)
Mar-72	Land Reforms
Mar-72	Mgt & Control of 32 Life Insurance co.
May-72	Banking Reforms(SBP reorients policy towards small farmer and small industry)
May-72	Devaluation of Rs
Jun-72	Labour Reforms
Aug-72	Public Health Programe
Sept-72 to Sept-74	Nationalization of Educational Institutes
Jun-73	Nationalization of Trade in cotton & rice
Sep-73	Nationalization of vegetable oil petroleum and shipping
Jan-74	nationalization of all pvt & domestic banks
Aug-76	nationalization of cotton ginning, rice husking and flour mills

Source: Dinar standard

7.4.2 ERA OF 1980S[40]

The rapid nationalization during the 70s did not have a positive influence upon the over all Pakistan market. Thus during the late 1970s and early 1980s the government revisited its policies regarding the investment arena of the country, thus leading towards a changed stance towards role of the public and the private sector. In 1984 the industrial policy statement was articulated which stated that the government would pursue a mixed economy system with the public and private sector supporting each other. Thus for the very first time the private sector was allowed to participate in fields such as: fertilizer, cement, steel, petroleum refining and petrochemicals, and automotive equipment engineering which were initially under complete control of the public sector.

However even still the policies were restrictive due to which privatization could not be initiated leading to potential loss of foreign investment.

The government still played a central role in determining the level of privatization in each sector. Heavy regulations were imposed, which involved acquiring permission from the government to setup a project in any sector. This was a lengthy and complex procedure leading to discouraged investors.

Government's approval was also required for setting up projects which involved foreign investment; in addition to this all those projects which involved foreign investment had to be filed with the Investment Promotion Bureau (IPB). Although privatization had been initiated but still foreign investors were not allowed to invest solely, joint equity participation was encouraged.

However the existing investment regime was better than the previous administrations. The reason being that a proper legal frame work was brought in to action in order to protect the rights of the foreign investors, the frame work was known as the Foreign Private Investment (Promotion and Protection) Act 1976. The act guarded the rights of foreign investors against expropriation and also assured relief from double taxation (See appendix 11.1), and remittance of profits and capital.

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[40] Ashfaque H. Khan and Yun-Hwan Kim, 1999; Foreign direct investment in Pakistan: Policy issues and operational implications; EDRC Report Series No.66

Another initiative taken to attract FDI, especially in export oriented industries, was to set up an Export Promotion Zone (EPZ) in Karachi. The EPZ was attractive because it allowed duty free imports and exports and tax exemptions. Over sees Pakistani's were also encouraged to invest in the industrial projects in the EPZ.

Although the above mentioned efforts did seem encouraging for foreign investors however still Pakistan was not able to draw the amount of FDI which it could have attracted in contrast to the changing FDI conditions of the global economy. This discouraged flow of FDI resulted because:

1) The public sector was still at large in all the major industries and the government's stringent licensing policies and lengthy processes to acquire government sanction to set up new projects.
2) The financial sector was inept with the public sector still reigning.
3) The trade management was also ineffective because of high tariffs and trading bans.

In the late 80s the government finally started realizing the importance of private sector and foreign investment in the country. Certain steps were taken to encourage the flow of FDI in the country. A Board of Investment (BOI) was set up to generate opportunities for FDI and provide investment service.

7.4.3 ERA OF 1990S

The Era of the early 1990s sighted for the first time the liberalization of the investment policy of Pakistan. One of the most important steps undertaken was that separate authorization required for foreign investments was eliminated in 1991 and same regulations were applicable to foreign investors as that of domestic investors[41]. With the exception of few industries such as:

[41] Ashfaque H. Khan and Yun-Hwan Kim, 1999; Foreign direct investment in Pakistan: Policy issues and operational implications; EDRC Report Series No.66
Board of Investment Pakistan

- Arms and ammunition
- High explosives
- Radio active substances
- Security Printing, Currency and Mint

Government consent of foreign investment was no longer required. Even till today these industries are not open for investment for both Foreign and domestic private investors with out the approval of the government.[42] Apart from the above mentioned industrial sectors foreign investors were allowed 100% equity participation, where as in non industrial sectors such agricultural land, forestry, real estate (like land, housing etc) and irrigation foreign investment was still not allowed.

Previously private investors whether foreign or domestic required a No Objection Certificate (NOC) from provincial governments regarding the location of their projects, thus the physical location of the projects was under the provincial government's control which proved to a bottle neck in the industrialization process. However during the 90s this aspect was dealt with and provincial government's NOC was required only for industries which were in the exempted list of the provincial government such as mentioned above. Another important step taken by the government was the liberalization of the foreign exchange regime. This measure enabled both resident and non resident Pakistani's and foreigners to deal freely in foreign currency i.e. they could bring in to the country, take out of it, posses foreign currency and open foreign currency accounts at ease. Previously permission was required to issue shares of Pakistani companies to foreign investors however the new reforms uplifted this restriction as well. This was a major step taken by the government which enabled foreign investors to freely access the capital markets, resulting in both foreign direct and portfolio investment. Apart from this the government also provided certain fiscal incentives to allure foreign investors to invest in Pakistan. The import policy was also revisited and the tariff rates were reduced from 225% in 1986-87 to 45% in 1996-97.[43]

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[42] Board of Investment Pakistan
[43] Board of Investment Pakistan
Ashfaque H. Khan and Yun-Hwan Kim, 1999; Foreign direct investment in Pakistan: Policy issues and operational implications; EDRC Report Series No.66

7.4.4 THE IMPACT OF INVESTMENT POLICY LIBERALIZATION ON FDI

In order to understand the importance and significance of a liberal investment policy on FDI let us consider the inflow of foreign investment in Pakistan over the past few decades in accordance to the changes in policy:

Fig3. Inflow of Foreign Investment in Pakistan: 1976-1997
(Million US $)

				Percent of Total	
Year	Direct	Portfolio	Total	Direct	Portfolio
1976/77	—	—	10.7	—	—
1977/78	—	—	35.5	—	—
1978/79	—	—	36.0	—	—
1979/80	—	—	28.2	—	—
1980/81	—	—	35.0	—	—
1981/82	—	—	98.0	—	—
1982/83	—	—	42.1	—	—
1983/84	—	—	48.0	—	—
1984/85	70.3	23.4	93.7	75.0	25.0
1985/86	145.2	16.0	161.2	90.0	10.0
1986/87	108.0	21.0	129.0	83.7	16.3
1987/88	162.2	10.5	172.7	93.9	6.1
1988/89	210.2	7.2	217.4	96.7	3.3
1989/90	216.2	-4.7	211.5	102.2	-2.2
1990/91	246.0	-9.0	237.0	103.8	-3.8
1991/92	335.1	218.5	553.6	60.5	39.5
1992/93	306.4	136.8	443.2	69.1	30.9
1993/94	354.1	288.6	642.7	55.1	44.9
1994/95	442.4	1089.9	1532.3	28.9	71.1
(1994/95*)	(442.4)	(227.8)	(670.2)	(66.0)	(34.0)
1995/96	1090.7	205.2	1295.9	84.2	15.8
1996/97	682.1	267.4	949.5	71.8	28.2

Source: State Bank of Pakistan

Liberalization of investment policy is recognized as an important variable to attract FDI in the country (see Haque, Mathieson, & Sharma, 1997; Schadler, Carkovic, Bennett, & Kahn, 1993). Also Ahmed Nawaz Hakro and Akhtiar Ahmed Ghumro in their paper: Foreign direct investment, determinants and policy analysis; case study of Pakistan have also tested the importance of a liberal investment policy to attract FDI. The results conclude that the liberalization of Pakistan's investment policy has been a major determinant of FDI in the country.

Figure 3 depicts the flow of foreign investment in the country from 1976-1997. The success of the liberalization of the FDI policy is evident from the increase in the flow of FDI to the country. It can be seen the foreign investment inflow has increased from a mere US $ 10.7 million in 1976 to an astounding figure of US $ 1295.9 million in 1996. From 1980 onward when the government started making sincere efforts to attract FDI, it can be seen that the inflow of FDI in Pakistan has shown an average growth rate of 19.58%. Though there has been decrease in FDI inflow as well in few years, however the over all trend shows increment in the flow of FDI.

According American Business Council of Pakistan (ABC) a Formal Association of American conglomerates operating in Pakistan majority of the foreign investors declared that the liberalization efforts taken by the government from 1980 on wards have increased their level of interest to invest in Pakistan. It was stated in the report that investors feel more comfortable in terms of setting up a new project and they are at ease in terms of repatriation of profits and re investment in the country. It has also been discussed in the report that a liberal investment policy depicts the openness of the market to foreign investors, which encourages them to invest in the country. The less restrictive policy enables investors to think over a broad spectrum facilitating them in their investment decision.

Thus both figures of FDI over the past decades and the viewpoint of foreign investors indicate and signify the importance of a liberal investment policy to attract more FDI to Pakistan.

7.4.5 CURRENT INVESTMENT SCENARIO

In order to further analyze the importance of a liberal investment policy for attracting FDI, the current investment policy of Pakistan has also been analyzed. The prevailing investment policy in the country is the most liberal and lenient policy then has ever been practiced before. The current government under the leadership of President Musharraf has taken numerous measures in order to ensure an investment friendly environment in the country. President Musharraf came to power on 12th October 1999 and since then the economic condition of the country has improved manifold. Foreign investor confidence has been generated by the stability and sound policy agenda provided by the government. In 2000 the total FDI inflow in the country was US $ 322.4 million, which soared up to US $ 3521 million in 2006 and up to US $ 4160.2 million during the first ten months of 2007. The figures are highest ever in the history of the country.

The current investment policy has opened new doors for foreign investors. Major changes were brought in the investment policy in year 2000 which are applicable to date and have comfortably declared the investment policy of Pakistan a liberal one. The prevailing investment policy can be compared with the previous policies on some major heads which typically decide the openness of the market and the liberal attitude of the government towards FDI inflow. These heads include:

1) ***FDI Entry*****:** Entry of FDI is now allowed to all economic sectors including the service sectors. Now foreign investors can even invest in the agricultural sector which was previously prohibited.

2) ***Ownership Regulation:*** Foreign investors are allowed to have 100% ownership and government permission is not required except for four specified industries. As mentioned earlier previously government sanction was required and foreign investors were not allowed 100% ownership.

3) ***Limits on Project size:*** Previously government sanction was required was required in case of a certain project size, however now investors are free to invest and there no limits.

4) ***List of restricted industries:*** The list of restricted industries has been reduced to only four, thus encouraging foreign investment in all areas.

5) ***GOP Permission required for capital / raw-material imports:*** The limitation of government permission required for capital/ raw material imports has also been uplifted.

6) ***Royalty, Tech. Fee etc:*** Previously there were restrictions and government approval was required, however now there are no more restrictions and investors are allowed to negotiate terms and conditions regarding royalties and technical fee suitable to them.

7) ***Repatriation of Capital:*** Repatriation of capital is allowed 100% now. Investors are free to move any amount of money in and out of the country. It is solely up to the investor's discretion to reinvest the earnings in Pakistan.

8) ***Export FDI:*** Three more export promotion zones have been established.

9) ***Locational Clearance:*** The requirement of NOC by the provincial government to setup a project has also been uplifted. (See appendix 11.5)

Apart from above mentioned aspects the current investment policy has also reduced custom duty on import of plant, machinery and equipment significantly. The import duty that was 45% in 1997 has now been reduced to mere 5%, thus rendering more attraction for foreign investors.

The current Investment Policy can be summarized as follows:

Fig4. Investment Policy Pakistan at a glance

Policy Parameters	Manufacturing Sector	Non -Manufacturing Sectors		
		Agriculture	Infrastructure & Social	Services including IT & Telecom Services
Govt. Permission	Not required except 4 specified industries *	Not required except specific licenses from concerned agencies.		
Remittance of capital, profits, dividends, etc.	Allowed	Allowed		
Upper Limit of foreign equity allowed	100%	100%	100%	100%
Minimum Investment Amount (M $)	No	0.3	0.3	0.15
Customs duty on import of PME	5%	0%	5%	0-5%
Tax relief (IDA, % of PME cost)	50%	50%		
Royalty & Technical Fee	No restriction for payment of royalty & technical fee.	Allowed as per guidelines - Initial lump-sum up to $100,000 - Max Rate 5% of net sales - Initial period 5 years		

* Specified Industries:
- Arms and ammunitions
- High Explosives.
- Radioactive substances
- Security Printing, Currency and Mint.

No new unit for the manufacturing of alcohol, except, industrial alcohol

PME= Plant, Machinery and Equipment
IDA= Initial Depreciation Allowance

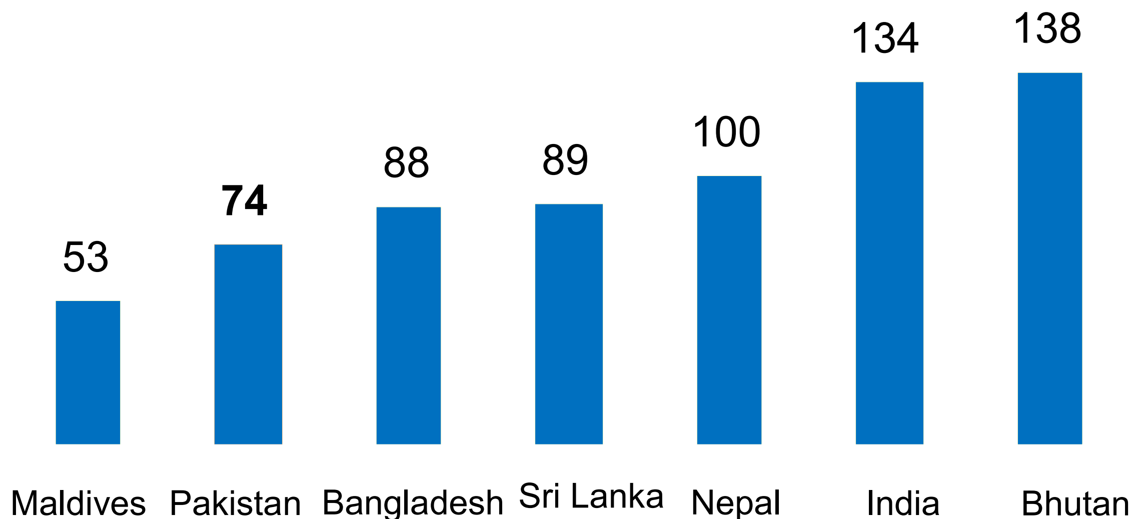
Source: Board of Investment Pakistan

The inflow of FDI has considerably increased with the advent of the liberal investment policy which is visible from the figures mentioned below:

Fiscal year	FDI (Million US $)
1998-99	376
1999-00	469.9
2000-01	322.4
2001-02	484.7
2002-03	798
2003-04	949.6
2004-05	1524
2005-06	3521
2006-07 (April)	4160.2

Pakistan has become on of the most investment friendly countries in the South East Asian region. It is ranked 74th out of 175 countries in terms of ease of doing business. It is way ahead as compared to its neighbors China (ranked 93) and India (ranked 134). See figure below.

Figure5. Top ranked countries in the region for Ease of doing business 2006



Source: Board of Investment Pakistan

The comparison of the investment policy of Pakistan with the other Asian countries like India, Nepal, Sri Lanka, Malaysia, Thailand and Indonesia also depicts a more liberal attitude thus explaining the profound influx of FDI in the country. (See appendix 11.6)

The above mentioned arguments clearly signify the importance of a liberal investment policy and also help us to establish that the liberalization of the investment policy has enabled Pakistan to attract more FDI over the past few years. Thus the null hypothesis 7 is rejected and alternate hypothesis is accepted leading to the following conclusion:

7) $H_1: \; p \neq 0$ there is significant relationship between Liberal Investment Policy and FDI inflow in Pakistan.

8. SUMMARY & CONCLUSION

FDI inflow in developing counties has undergone tremendous changes in the past few two decades. FDI inflow is now not only limited to developed countries, rather investors have realized the potentials of developing economies and thus have directed their resources towards them. A rational investor always focuses on reducing cost and increasing efficiency and productivity. These aspirations can be fulfilled by targeting developing countries, since the factor costs such as labor, utilities etc are comparatively lower in such countries and can enable the foreign investors not only to increase their returns but also diversify their portfolios by entering into different markets.

The study has been conducted in order to identify certain variables which can influence the inflow of FDI in Pakistan. The determinants studied are GDP, exchange rate, inflation interest rate, labor force availability and liberal investment policy. These determinants have been identified based on the findings and results of previous studies conducted in similar environment or with in Pakistan as well. The FDI inflows in the country and the variables affecting the inflow have been accounted for a period of 16 years i.e. 1990-2006. The data set was constituted over this time period because with in these years certain economic have changes taken place, which involve both policy change as well as increase in economic output and efficiency.

The relation ship between FDI (dependent variable) and GDP, exchange rate, inflation, interest rate and labor force availability (independent variables) has been determined by the empirical analysis. So it is concluded that relation ship between GDP and inflow of FDI is strongly positive, relationship between exchange rate and flow of FDI is moderately positive, relationship between FDI and labor force is strongly positive, relationship between inflation rate and flow of FDI is negative, and finally relationship between interest rate and flow of FDI is also negative.

The relationship of FDI is significant with all the tested determinants this conclusion is based on the regression results and the t- statistics.

The literature review revealed that many studies had been conducted in context of Political Stability and Government as one of the determinants of FDI in a country.

It has been observed that political instability and inconsistency of policies have negative effect on investors; they loose the confidence because of instability and stringent investment policies. Everyone has a firm belief that Pakistan and every other developing country needs foreign direct investment in order to boost the economy and thus the government has to indulge in to these matters to ensure a consistent and hefty flow of FDI to the country.
Not only the political aspects but the government also has to ensure sound monetary and fiscal policies along with policies to enhance economic growth to guarantee its share in the FDI inflow.

The study also highlights the importance of a liberal investment policy to attract FDI. This determinant has been analyzed descriptively. The analysis revealed interesting results declaring a liberal investment policy a very significant determinant of FDI in Pakistan.

Over all the results can be concluded as: GDP, exchange rate, inflation, lending interest rate, labor force availability and liberal investment policy are all very crucial determinants of FDI in Pakistan.

9. RECOMMENDATIONS AND SUGGESTIONS

FDI can be an influential factor for a growing economy and therefore efforts should be made by host nations to make the local environment conducive enough to attract sturdy FDI resulting in economic growth and exploitation of new opportunities. Thus FDI should also be encouraged in Pakistan to increase economic growth, reduce unemployment, to raise living standards and to get benefit of innovative technology and services ideas but at the same time all measures should also be taken to save sovereignty of the country.

There is an immense covet to improve the macroeconomic discipline and persist with the market liberalization measures and procedures to magnetize and sustain superior sum of FDI in Pakistan.

If Pakistan incorporates financial incentives such as grants and preferential partisan loans (having low interest rate) to MNCs, FDI in Pakistan can be increased. It has been seen that interest rate is an important determinant of FDI in Pakistan and lower interest rates can spawn a direct influence upon attracting FDI, since lower interest rate means decreased cost of capital, thus highlighting one aspect of investment friendly environment.

Considerably high and inconsistent rate of inflation, fallouts due to an inadequacy of fiscal and monetary policies and a weakness in the financial system which discourage and dispirit foreign investors to invest in the country. These tribulations need to be resolved if the government wants to magnetize more foreign investment.

If the government is enthusiastic and passionate to attract more and more FDI, competence and consistency of the policies has to be guaranteed and assured on long-term basis. This assurance is required because unstable policies would lead to discouraged investors.

The government should join hands with private sector veterans in order to promote and attract future investments in the country. Although the privatization commission and the Board of Investment have been constituted for such a purpose; however the commission is only concerned with the privatization of national assets, where as the board though is concerned directly with investment promotion, still lacks the attitude that best suites private investors. Therefore a quasi governmental agency or organization should be constituted. This organization should constitute of members from both the public and private sector. Private sector involvement will ensure the availability of the skills and expertise required to carry out the activity properly and in a beneficial manner.

Efforts should be made to enhance the development of infrastructure with in the country. The government should focus on developing well maintained and updated water, power, transportation and telecommunication networks through out the country.

Structural reforms already initiated in various sector of the economy should be focused on and further efforts should be made by commencing wide range reforms in various sectors of the economy. This would lead to the restoration and endorsement of macro economic stability thus promoting an investment friendly environment in the country.

It is high time that the government recognized the need to address certain fundamental issues to combat foreign investor's reluctance. The government should take some stern steps in order to improve the law and order situation in the country. The recent terrorist attacks have yet again shaken the foundation of trust and confidence of foreign investors. The over all image of Pakistan needs to be improved; the already running privatization program has shown to foreign investors that Pakistan is serious about promoting a market based economy. Efforts should be made to maintain this image

Another important aspect to be taken under consideration is the improvement of risk management frame work in the country. Development of qualitative modeling techniques to enable the simulation or analysis of the effects of changes in economic and business environment in order to conduct better risk management. Banks and insurance companies should be regulated in order to introduce well developed risk management techniques.

Worldwide conglomerates and Multinational Corporations would be more convinced and happy to invest in Pakistan if there will be a pro-FDI regime in the financial system of the economy. Such an investment administration needs to be based on

- Reverberation financial and economic policies
- Unwavering political milieu
- Policy consistency
- Responsive environment
- Incentives for prospective investors

10. FUTURE PROSPECTS

Due to the limited time period and scope of the study certain aspects have not been dealt with and thus still there is room for future enhancements in the study. Previous studies have highlighted numerous variables which can be deemed as determinants of FDI in developing countries.

One of the important factors which can have a major influence upon FDI inflow in a country is the prevailing political conditions of the country. Problems of law and order inexorably create an apprehensive investment environment, delaying the implementation of development projects, and affect the location and scale of new inward investments. Ethnic and racial as well as domestic regional rivalries have ignited the law and order problem in Pakistan and consent on development policies has been delayed. Thus this determinant and its impact on FDI inflow need to be studied.

The current political scenario of the country is dwindling between extremes. Either democracy will rule or dictatorship would strength its roots in the political arena of Pakistan. The current political uncertainty and coming election are bound to have an impact upon the existing economic conditions of the country and the policies being maintained currently. The existing political situation can sprout roots in different directions:

1) If a deal is not struck between the current government and Peoples Party and the chance of re election of President Musharraf are meager, it will probably lead to declaration of emergency in the country or the imposition of Martial Law. Such a situation can lead to dire consequences. The trust of foreign investors could be shattered, the relationship with many countries may impede, and thus Pakistan may once again loose its image as an investment friendly country.

2) Secondly if the elections are held fair then either democratic parties can come to power of fundamentalists can. However the chances of democratic parties to be successful are pretty high. The change of government can lead to copious changes in the existing policies, which can further hinder the inflow of FDI in the country.

Majyd Aziz, President of the Karachi Chamber of Commerce and Industry, is also not so optimistic as he fears the "political uncertainty to become more pronounced in coming weeks which is bound to have impact on the national economy".

He says: "We are getting disturbing signals from foreign and local investors in Pakistan,". "But with this negative perception, he saw light at the end of the tunnel. Almost all relevant political parties have, by and large, the same economic programme and that judiciary is all set for a more proactive role in enforcing rule of law. These two factors speak a lot about future course of economy".[44]

"A slowdown in FDI is expected in the near future due to the political uncertainty without substantial withdrawal of foreign capital from the country, as most investments have been attracted through the FDI route which should keep forex reserves and the exchange rate stable, finds Merrill Lynch report published on Pakistan Economy.

The report titled "The slow will go on" revealed that there would be no continuation of the key economic achievements of the past five years - deregulation, privatization, structural reforms, a free press, and importantly, an independent judiciary - to be reversed.

Report disclosed that dramatic changes in politics increases uncertainty which has raised several questions on the outlook for Pakistan. Both foreign and local investors are being raised some quarries about the impact of the political uncertainty on FDI and what will be the source of current account financing and will public spending on developmental

[44] http://www.dawn.com/2007/09/03/ebr1.htm [September 2007]

projects like to sustain? This is an election year, so large public outlays are expected that should sustain domestic demand.

Report reiterates that risks related to President Musharraf's re-election are likely to prevail in the short term. It is also believed that markets will find it hard to decouple elections and performance. Hence, we expect a volatile market in the next few months, which is a negative at the margin. While the entire political focus would be on the re-election issue, it would be best for the powers that be to send out the right messages on economic programs and stress upon the continuity of structural reforms at every opportunity."[45]

Even though slight optimism may exist regarding the economic future of Pakistan, however the current elections and the impact of these elections upon the economic front of Pakistan is a mind boggling aspect which will definitely have an impact upon the FDI inflow in the country and should be taken under consideration in future studies.

Another important area which can be touched for future studies is the detailed analysis of the impact of FDI on the economy of Pakistan. For now the study only focuses on the fact as to which determinants assist in attracting FDI in the county. For future studies analysis of the fact as to how the FDI influence the Pakistan economy, how FDI can manipulate the way of living of the people, whether or not FDI lead more technological advancement, does FDI help in increasing the skill level of workforce and to what extent the abundant flow FDI affect the domestic industry.

Finally more determinants can also be taken under consideration for future studies, determinants such as privatization, external debt, infrastructure availability and development of financial sectors. These determinants have been tested in numerous studies and can lead the research to new grounds.

[45] http://www.nation.com.pk/daily/sep-2007/5/bnews2.php [September 2007]

11. APPENDICES

11.1 AGREEMENT ON AVOIDANCE OF DOUBLE TAXATION

The Government of Pakistan has signed agreements on Avoidance of Double Taxation with a large number of countries including almost all the developed countries of the World. List of countries having agreements with Pakistan for Avoidance of Double Taxation is as under:-

COUNTRIES HAVING AGREEMENT WITH PAKISTAN FOR AVOIDANCE OF DOUBLE TAXATION

S.No.	Name of Country	S.No.	Name of Country
1	Austria	27.	Malta
2.	Bangladesh	28.	Mauritius
3.	Belarus	29.	Netherlands
4.	Belgium	30.	Nigeria
5.	Canada	31.	Norway
6.	China	32.	Oman
7.	Denmark	33.	Philippines
8.	Finland	34.	Poland
9.	France	35.	Qatar
10.	Germany	36.	Romania
11.	Greece	37.	Saudi Arabia
12.	Hungary	38.	Singapore
13.	India	39.	South Africa
14.	Indonesia	40.	Sri Lanka
15.	Iran	41.	Sweden
16.	Ireland	42.	Switzerland
17.	Italy	43.	Syria
18.	Japan	44.	Thailand
19.	Jordan	45.	Tunisia
20.	Kazakhistan	46.	Turkey
21.	Kenya	47.	Turkmenistan
22.	Republic of Korea	48.	U.A.E.
23.	Kuwait	49.	U.K.
24.	Lebanon	50.	U.S.A.
25.	Libyan Arab Republic	51.	Uzbekistan
26.	Malaysia		

Source: http://www.pakboi.gov.pk/intl-agree.htm [August 2007]

11.2 MNC'S VIEWS OF BUSINESS ENVIRONMENT IN PAKISTAN[46]

The American Business Council of Pakistan (ABC) a Formal Association of American conglomerates operating in Pakistan, conducts in-formal business survey annually to assess how their members view investment climate in Pakistan. Most recent survey was completed a few days ago and the feed back is promising. Following are the key excerpts of the Survey:

- 93% respondents reported improvement in Domestic Economy.
- 90% reported increase in their gross revenues in Dollar terms while 84% in rupees.
- 88% were optimistic about Pakistan's overall prospects.
- 86% indicated increase in their pre-tax profits.
- 78% indicated improvement in external political situation.
- 77% reported planning investment in Pakistan.
- 63% were optimistic about Business Climate in Pakistan.
- 34% observed improvement in law and order situation

[46] http://www.pakboi.gov.pk/Success_stories/mnc_s_views_of_business_enviro.html [July 2007]

11.3 ECONOMIC INDICATORS - PAKISTAN (2006-2007)

Indicators	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-2007	+ (-) %
Exports (Billion $)	9.20	9.13	11.16	12.31	14.39	16.47	17.01	3
Imports (Billion $)	10.72	10.34	12.22	15.59	20.60	28.58	30.54	9
Trade Balance (Billion $)	(1.52)	(1.20)	(1.06)	(3.28)	(6.21)	(12.11)	(13.53)	12
Net Revenue (Billion Rs.)	393.9	404.1	460.6	518.8	590.39	712.61	841.4	18
FDI (Million $)	322.40	484.70	798.00	949.40	1524	3,521	5,125	46
Foreign Investment (Million $) (FDI+ Public & Private Portfolio)	182.00	475.00	820.00	922.00	1677	3,872	8,417	88
Workers Remittances (Billion $)	1.09	2.39	4.24	3.872	4.17	4.60	5.49	19
Forex Reserves (Billion $)	3.22	6.43	10.72	12.33	12.61	13.14	15.18	16
Exchange Rate (Rs./ US$)	58.4	61.0	57.7	57.92	59.66	60.16	60.5	1
Stock Exchange Index	1300	1520	3402	5279	7450	9,989	13,772	38
GDP Growth	2.6%	3.6%	5.1%	6.4%	8.4%	6.6%	7.0%	
Inflation	4.4%	3.4%	3.3%	3.9%	9.3%	8%	7.9%	

Credit Rating:

Moody's B 1

Standard & Poor (S&P) B+

Source: http://www.pakboi.gov.pk/eco-ind.htm [September 2007]

11.3 Country wise Foreign Direct & Portfolio Investment in Pakistan in Detail (2006-2007)

Country	2006-2007				2005-06			
	Direct	Portfolio		Total	Direct	Portfolio		Total
		Private	Public			Private	Public	
USA	913.1	853.4	-	1,766.5	516.7	303.8	-	820.5
UK	860.1	960.1	-	1,820.2	244.0	-19.5	-	224.5
UAE	661.5	14.9	-	676.4	1,424.5	63.6	-	1,487.8
Germany	78.9	7.0	-	85.9	28.6	-3.5	-	25.1
France	-0.1	1.5	-	1.4	3.2	0	-	3.2
Hong Kong	32.6	-72.6	-	-40.0	24.0	31.2	-	55.2
Norway	25.1	0	-	25.1	252.6	0	-	252.6
Japan	64.4	3.9	-	68.3	57.0	-8.7	-	48.3
Saudi Arabia	103.5	0.1	-	103.6	277.8	0.8	-	278.6
Canada	10.7	0.1	-	10.8	4.8	0.2	-	5.0
Netherlands	771.8	6.2	-	778.0	121.1	-0.7	-	120.4
Korea	1.5	0	-	1.5	1.6	0	-	1.6
Singapore	20.9	118.2	-	139.1	9.9	5.6	-	15.5
China	712	0	-	712.0	1.7	0	-	1.7
Australia	72	-6.4	-	65.6	31.3	0	-	31.3
Switzerland	174.7	-127.4	-	47.3	170.6	11.6	-	182.2
Luxembourg	13	-0.4	-	12.6	23.5	-1	-	22.5
Others	609.2	61.8	-	671.0	328.1	-31.2	-	296.5
Debt Securities	-	-	733.0	733.0	-	-	613.0	613.0
GDRs	-	-	738.0	738.0	-	-	-	-
Total	5,124.9	1,820.4	1,471.0	8,416.3	3,521.0	351.5	613.0	4,485.5

Source: http://www.pakboi.gov.pk/forign-invest.htm [September 2007]

11.4 SECTOR WISE FDI INFLOWS (MILLION $)

Sector	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
Oil & Gas	80.7	268.2	186.8	202.4	193.8	312.7	545.1
Financial Business	-34.9	3.6	207.4	242.1	269.4	329.2	930.3
Textiles	4.6	18.5	26.1	35.4	39.3	47	59.4
Trade	13.2	34.2	39.1	35.6	52.1	118	172.1
Construction	12.5	12.8	17.6	32	42.7	89.5	157.1
Power	39.9	36.4	32.8	-14.2	73.4	320.6	193.4
Chemical	20.3	10.6	86.1	15.3	51	62.9	46.1
Transport	45.2	21.4	87.4	8.8	10.6	18.4	30.2
Communication	NA	12.8	24.3	221.9	517.6	1937.7	1898.7
Others	140.9	66.2	90.4	170.1	274	285	1092.5
Total	322.4	484.7	798	949.4	1523.9	3521	5124.9

Source: http://www.pakboi.gov.pk/forign-invest.html [September 2007]

11.5 A COMPARATIVE REVIEW OF INVESTMENT POLICY OF PAKISTAN 1984 TO DATE

Year	1984	1988	1989	1991	1997	2000-02
FDI Entry	Industrial Sector only	Industrial Sector only	Industrial Sector only	Industrial Sector only. Non-Industrial sectors excluded	Industrial, Social, Infrastructure sectors, Agriculture and Selective activities of Service Sector under JV	All economic sectors including Service Sector
Ownership Regulation	GOP sanction required for Foreign Equity / JV promotion	GOP sanction except in key Industries	GOP sanction approval if foreign, equity 50% or more	Upto 100% allowed (No Permission)	Upto 100%* (No Permission)	Upto 100%** (No Permission)
Limits on Project size	GOP sanction for project size - Rs.300 m or more	GOP sanction for project size - Rs.700 m or more	GOP sanction for project size - Rs.1000 m or more	No limit	No limit	No limit
List of restricted industries	23	12	7	4	4	4
GOP Permission required for capital / raw-material imports	GOP Permission if: -PME cost Rs 50 m or more -60% raw-material imports	GOP Permission if -PME cost Rs 60 m or more -60% raw-material imports	No Permission	No Permission	No Permission	No Permission
Royalty, Tech. Fee etc.	GOP approval case to case	GOP approval case to case	Registration with SBP Conforming to standard guidelines	No restriction (Industry)	No restriction (all sectors) (Industry)	No restriction (all sectors)

Repatriation of Capital	Allowed (Act of 76)	Allowed (Act of 76)	Allowed (Act of 76)	Allowed (Act of 76)	Allowed (Act of 76)	Allowed (Act of 76)
Export FDI	KEPZ, NRI / OPs	-	-	NIZs	-	3 EPZs
Locational Clearance	NOC from Provinces	NOC from Provinces	NOC from Provinces	Not required	Not required	Not required

* Minimum FDI in Non-manufacturing: $0.5 million
** Minimum FDI in Non-manufacturing: $0.3 million

Source: Board of Investment Pak

11.6 Investment Policy: Comparison

Country	100% Foreign Equity	Govt. Sanction for FDI	Import Duty on PME (Rates)	Remittance of Royalty / Technical Fee and Applicable Tax
Bangladesh	Allowed	Required	2.5 – 7.5% 0% for export industries only	Yes 0 %
India	Subject to Govt. permission	Required	0% Export based and Fertilizer 20-48% other industries	Subject to Govt. permission 30%
Indonesia	First 15 years	Required	0%	Subject to Govt. permission 20%
Malaysia	Export projects only	Required	0%	Subject to Govt. permission 10%
Pakistan	Allowed	Not required	0 – 5 & 10 %	Yes (0% Agreement countries, 15% Others)
Sri Lanka	Allowed	Not required	0%	Subject to Govt. permission 15%
Thailand	Export industry only	Required	10% or more	Subject to Govt. permission 10%

PME= Plant, Machinery and Equipment

Source: Board of Investment Pakistan

11.7 Doing Business Ranking among 175 Countries- Pakistan in Comparison with India, Sri Lanka & Bangladesh

	Pakistan	**India**	**Sri Lanka**	**Bangladesh**
Ease of doing Business	**74**	134	89	88
Starting a Business	54	88	44	68
Dealing with Licenses	89	155	71	67
Employing Workers	126	112	98	75
Registering Property	**68**	110	125	167
Getting Credit	65	65	101	48
Protecting Investors	19	33	60	15
Paying Taxes	140	158	157	72
Trading Across Borders	**98**	139	99	134
Enforcing Contracts	163	173	90	174
Closing a Business	**46**	133	59	93

Source: Board of Investment Pakistan

11.8 VIEWS ON PAKISTAN'S ECONOMY FROM SOME OF THE REPUTABLE INTERNATIONAL INSTITUTIONS[47]

JP MORGAN

- Pakistan's economic performance in the past five years has been commendable. GDP growth is higher, poverty rates are down, inflation is lower, FDI is up, and fiscal deficits are down. Driving all of these improvements has been an environment of relative political stability under the pro-reform administration of President Musharraf and Prime Minister Shaukat Aziz. Its run of success brought Pakistan's stock onto the radar screen of foreign fund managers. Added to this, invisibility improved due to the increase in market capitalization, aided by higher free float through new stock market offerings. These favorable dynamics in the size and efficiency of both the physical and human capital stock make a 6-7% target range for medium-term growth seem very reasonable, in our view. The IMF, in its recently completed Article IV consultation, uses a baseline assumption for real GDP growth of 7%.

MERRILL LYNCH

- Pakistan's GDP growth in 2007 will range between 7-7.5%, based on recovery in agriculture sector and capacity expansions in the manufacturing sector. Merrill Lynch expects Pakistan to issue a Eurobond this year which it expects to be over-subscribed. Market capitalization surged 5.5 times from US$7 billion to US$46 billion over a period of four years, taking stock market capitalization to GDP from 9% at end-FY02 to around 36% at end-FY06.

ASIAN DEVELOPMENT BANK

- The economy has grown strongly over the past years, at an average pace of 7.5%. In recent years, the Government's strong macroeconomic policies, high growth rates, increases in pro-poor spending, and burgeoning workers'

[47] http://www.pakboi.gov.pk/intl-views.htm [August 2007]

remittances have all contributed to a steep decline in the incidence of poverty and the unemployment rate.

GLOBAL PROSPECTS REPORT

- Pakistan's GDP is expected to pick up to 7 percent in 2007 bolstered by an expansion in agriculture production and increased capacity following government infrastructure investments and private sector investments in the textile sector.

INDEX OF ECONOMIC FREEDOM

- The 2007 Index of Economic Freedom jointly conducted by the Heritage Foundation and the Wall Street Journal, has put Pakistan at the 89 th place, ahead of India (104) and China (119) out of 161 countries.

S&P ratings

- Standard and Poor's in December 2006 announced upgrades for credit ratings to:
    - B+ for foreign currency,
    - BB for local currency long-term ratings, and
    - B for short-term sovereign ratings.

MOODY'S INVESTORS SERVICE 2007-ANNUAL REPORT ON PAKISTAN

- The country's rating for foreign currency bonds and the government's rupee dominated debt reflect the significant improvement in Pakistan's external liquidity and the government's more efficient macro-economic management in the recent years. As a result of privatization, consolidation and restructuring. Moody's investor service upgraded Pakistan's foreign and local currency government ratings from B-1 to B-2.

DOING BUSINESS REPORT, 2007 BY WORLD BANK

- Pakistan was top reformer in 2006 and the runner up reformer in 2007. Recent reforms have resulted in a drop in the number of days required to import in Pakistan: from 39 to 19 days. Pakistan also reformed positively in the area of taxation by steadily reducing its corporate tax rate, from 39% in 2004 to 35% in 2006. Pakistan scores well on the indicators related to starting a business (54th out of 175) and protecting investors (19th out of 175).

GLOBAL COMPETITIVE INDEX & BUSINESS COMPETITIVE INDEX REPORTS

- Pakistan had a relatively good showing on the BCI, developed by Harvard Business School competitiveness expert, In the new BCI, Pakistan ranks 67th among 121 countries. On the GCI, Pakistan improved from last year's 94th place to 91st place out of 125 countries that participated in this year's survey. Pakistan’s gains take on added significance when compared to the drop in rankings experienced by many noteworthy emerging markets.

11.9 List of Countries / Organizations with which Pakistan has Bilateral Investment Agreements

S. No.	Name of Country	Signing Date	S. No.	Name of Country	Signing Date
1.	Germany	25.11.1959	25.	Indonesia	08.03.1996
2.	Sweden	12.03.1981	26.	Tunisia	18.04.1996
3.	Kuwait	17.03.1983	27.	Syria	25.04.1996
4.	France	01.06.1983	28.	Belarus	22.01.1997
5.	South Korea	25.05.1988	29.	Mauritius	03.04.1997
6.	Netherlands	04.10.1988	30.	Italy	19.07.1997
7.	Uzbekistan	13.08.1992	31.	Oman	09.11.1997
8.	China	12.02.1989	32.	Sri Lanka	20.12.1997
9.	Singapore	08.03.1995	33.	Australia	07.02.1998
10.	Tajikistan	13.05.2004	34.	Japan	10.03.1998
11.	Spain	15.09.1994	35.	Belgium	23.04.1998
12.	Turkmenistan	26.10.1994	36.	Qatar	06.04.1999
13.	United Kingdom	30.11.1994	37.	Philippines	11.05.1999
14.	Turkey	15.03.1995	38.	Yemen	11.05.1999
15.	Portugal	17.04.1995	39.	Egypt	16.04.2000
16.	Romania	10.07.1995	40.	OPEC Fund	24.10.2000
17.	Malaysia	07.07.1995	41.	Lebanon	09.01.2001
18.	Switzerland	11.07.1995	42.	Denmark	18.7.1996
19.	Kyrgyz Republic	23.08.1995	43.	Morocco	16.04.2001
20.	Azerbaijan	09.10.1995	44.	Bosnia	04.09.2001
21.	Bangladesh	24.10.1995	45.	Kazakhstan	08.12.2003
22.	U.A.E.	05.11.1995	46.	Loas	23.04.2004
23.	Iran	08.11.1995	47.	Cambodia	27.04..2004
24.	Czech Republic	07.05.1999	48.	Belgo-Luxemburg Economic Union	23.04.1998

Source: http://www.pakboi.gov.pk/intl-agree.htm [July 2007]

11.10 DISTRIBUTION OF FDI BY REGION AND SELECTED COUNTRIES, 1980-2005 (PER CENT)

Region	Inward stock				Outward stock			
	1980	1990	2000	2005	1980	1990	2000	2005
Developed economies	75.6	79.3	68.5	70.3	87.3	91.7	86.2	86.9
European Union	42.5	42.9	37.6	44.4	37.2	45.2	47.1	51.3
Japan	0.6	0.6	0.9	1.0	3.4	11.2	4.3	3.6
United States	14.8	22.1	21.7	16.0	37.7	24.0	20.3	19.2
Developing economies	24.4	20.7	30.3	27.2	12.7	8.3	13.5	11.9
Africa	6.9	3.3	2.6	2.6	1.3	1.1	0.7	0.5
Latin America and the Caribbean	7.1	6.6	9.3	9.3	8.5	3.4	3.3	3.2
Asia and Oceania	10.5	10.8	18.4	15.4	2.9	3.8	9.5	8.2
West Asia	1.4	2.2	1.1	1.5	0.3	0.4	0.2	0.3
South, East and South-East Asia	8.8	8.5	17.2	13.8	2.5	3.4	9.3	7.8
South-East Europe and CIS	..	0.01	1.2	2.5	..	0.01	0.3	1.2
World	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Region	Inflow				Outflow			
	1978-1980	1988-1990	1998-2000	2003-2005	1978-1980	1988-1990	1998-2000	2003-2005
Developed economies	79.7	82.5	77.3	59.4	97.0	93.1	90.4	85.8
European Union	39.1	40.3	46.0	40.7	44.8	50.6	64.4	54.6
Japan	0.4	0.04	0.8	0.8	4.9	19.7	2.6	4.9
United States	23.8	31.5	24.0	12.6	39.7	13.6	15.9	15.7
Developing economies	20.3	17.5	21.7	35.9	3.0	6.9	9.4	12.3
Africa	2.0	1.9	1.0	3.0	1.0	0.4	0.2	0.2
Latin America and the Caribbean	13.0	5.0	9.7	11.5	1.1	1.0	4.1	3.5
Asia and Oceania	5.3	10.5	11.0	21.4	0.9	5.6	5.1	8.6
West Asia	-1.6	0.3	0.3	3.0	0.3	0.5	0.1	1.0
South, East and South-East Asia	6.7	10.0	10.7	18.4	0.6	5.1	5.0	7.7
South-East Europe and CIS	0.02	0.02	0.9	4.7	..	0.01	0.2	1.8
World	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: UNCTAD, FDI/TNC database (www.unctad.org/fdistatistics) and annex tables B.1 and B.2.

11.11 COMPARATIVE REAL GDP GROWTH RATES (%)

Region/Country	2003-04	2004-05	2005-06	2006-07
World GDP	**4.0**	**5.3**	**4.9**	**5.4**
Euro Area	0.8	2.0	1.4	2.6
United States	2.5	3.9	3.2	3.3
Japan	1.4	2.7	1.9	2.2
Germany	-0.2	1.2	0.9	2.7
Canada	1.8	3.3	2.9	2.7
Developing Countries	6.7	7.7	7.5	7.9
China	10.0	10.1	10.4	10.7
Hong Kong SAR	3.2	8.6	7.5	6.8
Korea	3.1	4.7	4.2	5.0
Singapore	3.1	8.8	6.6	7.9
Vietnam	7.3	7.8	8.4	8.2
		ASEAN		
Indonesia	4.8	5.0	5.7	5.5
Malaysia	5.5	7.2	5.2	5.9
Thailand	7.1	6.3	4.5	5.0
Philippines	4.9	6.2	5.0	5.4
		South Asia		
India	7.3	7.8	9.2	9.2
Bangladesh	5.8	6.1	6.3	6.7
Sri Lanka	6.0	5.4	6.0	7.5
Pakistan	***7.5***	***8.6***	***6.6***	***7.0***
		Middle East		
Saudi Arabia	7.7	5.3	6.6	4.6
Kuwait	16.5	10.5	10.0	5.0
Iran	7.2	5.1	4.4	5.3
Egypt	3.2	4.1	4.5	6.8
		Africa		
Algeria	6.9	5.2	5.3	2.7
Morocco	5.5	4.2	1.7	7.3
Tunisia	5.6	6.0	4.0	5.3
Nigeria	10.7	6.0	7.2	5.3
Kenya	2.8	4.5	5.8	6.0
South Africa	3.1	4.8	5.1	5.0

Source: World Economic Outlook (IMF), April 2007

11.12 NET INFLOW OF FOREIGN DIRECT INVESTMENT (GROUP-WISE)

Million US$

S.N	ECONOMIC GROUP	2001-02	2002-03	2003-04	2004-05	2005-06	July-April 2005-06	July-April 2006-07
1	Foog, Beverages & Tobbaco	-5.1	7.0	4.6	22.8	61.9	56.2	492.3
2	Textiles	18.4	26.1	35.5	39.3	47.0	36.1	49.4
3	Sugar, Paper & Pulp	0.9	2.3	2.1	4.3	5.1	4.5	16.9
4	Leather & Rubber Products	0.8	1.2	3.5	6.5	8.2	7.2	6.7
5	Chemicals & Petro Chemicals	12.9	86.9	16.8	52.1	72.4	58.3	37.5
6	Petroleum Refining	2.8	2.2	70.9	23.7	31.2	24.4	114.6
7	Minning & Quarrying	6.6	1.4	1.1	0.5	7.1	5.2	21.0
8	Oil & Gas Explorations	268.2	186.8	202.4	193.8	312.7	243.3	449.4
9	Pharmaceuticals & OTC Products	7.2	6.2	13.2	38.0	34.5	27.4	28.9
10	Cement	0.4	-0.4	1.9	13.1	39.0	37.1	15.2
11	Electronics & Other Machinery	26.4	17.6	17.0	16.5	21.0	18.7	18.1
12	Transport Equipment(Automobiles)	1.1	0.6	3.3	33.1	33.1	26.3	41.1
13	Power	36.4	32.8	-14.2	73.3	320.6	309.6	136.2
14	Construction	12.8	17.6	32.0	42.7	89.5	58.7	117.1
15	Trade	34.2	39.1	35.6	52.1	118.0	108.3	133.9
16	Communications	12.7	24.3	221.9	517.6	1937.7	1720.7	1423.2
	1) Telecommunications	6.0	13.5	207.1	494.4	1905.1	1690.8	1359.9
17	Financial Business	3.5	207.6	242.1	269.4	329.2	289.7	871.4
18	Social & Other Services	10.2	19.7	16.4	24.7	64.7	51.2	77.3
19	Others	12.7	28.8	33.1	78.9	65.5	47.5	74.1
TOTAL		**484.7**	**798.0**	**949.4**	**1,524.0**	**3,521.0**	**3,038.2**	**4,160.2**

Source: State Bank of Pakistan

11.13 FDI INFLOWS, BY HOST REGION AND MAJOR HOST ECONOMY, 2004-2006 (BILLIONS OF DOLLARS)

Table. FDI inflows, by host region and major host economy, 2004-2006
(Billions of dollars)

Host region/economy	2004	2005	2006 [a]	Growth rate (%)
World	**710.8**	**916.3**	**1 230.4**	**34.3**
Developed economies	**396.1**	**542.3**	**800.7**	**47.7**
Europe	217.7	433.6	589.8	36.0
European Union	213.7	421.9	549.0	30.1
EU-15	*185.2*	*387.9*	*510.7*	*31.7*
France	31.4	63.6	88.4	39.0
Germany	- 15.1	32.7	8.1	- 75.1
Italy	16.8	20.0	30.0	50.2
United Kingdom	56.2	164.5	169.8	3.2
New 10 EU member states	*28.5*	*34.0*	*38.4*	*12.8*
Czech Republic	5.0	11.0	5.4	- 50.8
Hungary	4.7	6.7	6.2	- 7.3
Poland	12.9	7.7	16.2	109.9
United States	122.4	99.4	177.3	78.2
Japan	7.8	2.8	- 8.2	- 395.5
Developing economies	**275.0**	**334.3**	**367.7**	**10.0**
Africa	17.2	30.7	38.8	26.5
Egypt	2.2	5.4	5.3	- 1.9
Morocco	1.1	2.9	2.3	- 20.9
Nigeria	2.1	3.4	5.4	60.0
South Africa	0.8	6.4	3.7	- 42.7
Latin America and the Caribbean	100.5	103.7	99.0	- 4.5
Argentina	4.3	4.7	3.3	- 29.5
Brazil	18.1	15.1	16.0	5.9
Chile	7.2	6.7	9.9	48.4
Colombia	3.1	10.2	4.9	- 52.0
Mexico	22.3	18.9	18.9	0.0
Asia and Oceania	157.3	200.0	229.9	15.0
West Asia	18.6	34.5	43.3	25.5
Turkey	2.8	9.7	17.1	76.3
South, East and South-East Asia	138.0	165.1	186.7	13.1
China	60.6	72.4	70.0	- 3.3
Hong Kong, China	34.0	35.9	41.4	15.4
India	5.5	6.6	9.5	44.4
Indonesia	1.9	5.3	2.0	- 62.9
Korea, Republic of	7.7	7.2	0.5	- 92.6
Malaysia	4.6	4.0	3.9	- 1.6
Singapore	14.8	20.1	31.9	58.8
Thailand	1.4	3.7	7.9	114.7
South-East Europe and CIS	**39.6**	**39.7**	**62.0**	**56.2**
Russian Federation	15.4	14.6	28.4	94.6
Romania	6.5	6.4	8.6	34.1
Kazakhstan	4.1	1.7	6.5	275.5

Source: UNCTAD.
[a] Preliminary estimates.

Note: World FDI inflows are projected on the basis of 76 economies for which data are available for part of 2006, as of 7 November 2006. Data are estimated by annualizing their available data, in most cases the first two quarters of 2006. The proportion of inflows to these economies in total inflows to their respective region or subregion in 2005 is used to extrapolate the 2006 data.

Source: http://www.finfacts.com/irelandbusinessnews/publish/article_10008686.shtml [June 2007]

11.14 Speech by Dr. Shamshad Akhtar: Pakistan – an investment friendly destination

Speech by Dr Shamshad Akhtar, Governor of the State Bank of Pakistan, at the Pakistan Investment Conference organised by Euromoney, Islamabad, 22 February 2007.

I. Introduction

Pakistan has undergone significant economic and political transformation. Sound macroeconomic management, backed by market oriented policies and a conducive incentive regime, together with political stability and effective regulatory framework have enabled Pakistan to emerge as a viable and investment friendly destination.

Today, I propose to (i) review recent developments and their implications on macroeconomic stability, which has been the subject of much debate with the rising fiscal and current account imbalances; (ii) share the story of Pakistan's economic turnaround and transformation and the factors driving it – this turnaround has helped the country achieve a higher sustainable economic growth that has raised income levels while making some inroads into poverty reduction and employment generation; and (iii) finally offer a perspective on what lends confidence in sustainability of high economic growth, while underscoring that this is possible only if key challenges are effectively addressed to unleash the full economic potential of the country that offers lucrative opportunities for foreign investment.

II. Macroeconomic management

Macroeconomic stability is here to stay. After a period of low fiscal deficits which scaled down to its lowest level (2.4 percent of GDP) in FY04 and emergence of a surplus on external current account, of 4.9 percent of GDP, in FY03 Pakistan opted to concentrate on stimulating broad based growth and dealing with its increasing infrastructure and social constraints that, unless dealt with immediately, threatened growth prospects. To achieve these goals, Pakistan has had to offer fiscal and monetary stimulus over FY02-FY04, which did complicate macroeconomic management. Indeed, a widening of macroeconomic imbalances relative to the FY04 period was inevitable as the country had to break away from the past to put the economy on a more robust and sustainable path.

To set the economy on this course, the Government launched an all time high and aggressive public investment program of $7.3 billion (allowing it to grow by 32.2% in real terms) that constituted 28% of total expenditures. A significant part of these development expenditures was devoted to completing ongoing and launching new development initiatives for physical and social infrastructure. At the same time, liberal and diversified availability of private sector credit stimulated growth across the board in a number of sectors. The growing investment and consumption demands and requirements have widened trade deficit as imports grew by over 35% in the preceding two years (FY05-06). While macroeconomic imbalances enhanced demand pressures, they have stimulated economic growth to 7.4% on average over FY05-07.

Macroeconomic stability was managed by a combination of policies and availability of foreign inflows supported by enhanced investor confidence and presence of global liquidity. Firstly, the central bank has adopted a hawkish monetary stance for almost two years which has now paid dividends as inflationary pressures emerging from rising aggregate demand have been mitigated – CPI and core inflation on a year-on-year basis is down from 11.1% and 7.8% in FY05 to 6.6% and 5.3%, respectively effective January 2007 – an all time low relative to June 2004. Secondly, higher remittances inflows (rising from $1.1 billion in FY01 to $5.5 billion in FY07) have helped finance, on an average, 98% of trade deficit. Thirdly, the privatization program was pursued effectively along with a drive to attract foreign direct investment – both of which mobilized cumulatively $10.0 billion and helped finance 75% of the country's external current account deficit during FY05-FY07. Fourthly, the reduction in debt/GDP ratio in line with the dictates of the *Fiscal Responsibility Act* has helped enhance the sustainability of macroeconomic imbalances. Finally, due to strong foreign inflows coupled with effective reserve management Pakistan has, over 6 years, built up its SBP reserves, which are set to reach over $14 billion by end June 2007 thereby offering more than 6 months of import coverage. Positive economic developments over the past few years have facilitated Pakistan's return to international credit markets and all the sovereign issues have been over subscribed with tight spreads – enabling establishment of a yield curve in a remarkably short time.

Together, these developments have jolted up the investment/GDP levels, which are expected to grow to 21% in FY07, after stagnating at the level of 17% over the previous five years. These achievements appear more significant if viewed in context

of Pakistan's proven economic exogenous shocks such as the rising international oil prices which accounted for 1.9% of GDP (and 20% of the trade deficit), and expenditure demands for earthquake related relief and rehabilitation efforts that accounted for another 0.8% GDP. Continued economic vigilance on emerging trends is however critical to strike a balance between growth and macroeconomic sustainability.

III. Economic turnaround and transformation

High economic growth is accompanied by structural changes. Compared to the rest of Emerging Asia, recent economic growth track record puts Pakistan's GDP growth rate in the top half of the region's fast-growing economies. Underlying this has been a significant, albeit slow, structural transformation. The main features of this transformation have been:

(i) The emergence of a vibrant and buoyant services sector, which grew by 8.8% in FY2006 and now accounts for 52.3% of GDP – this has been led by developments in the finance & insurance, wholesale & retail trade, transport, storage and communication sub-sectors.

(ii) Growth in large scale manufacturing sector (over 14% on average over past three years compared to average growth of 3.5% in the 1990's) led by textile sector, which benefited from opportunities emerging from post MFA regime, 36.8% growth in automobiles, 45.5% in electrical goods, 19.6% in cement, and 32.1% in fertilizer etc. in the last three years. Besides new capacity additions, this growth was stimulated by rising real consumption expenditure and construction demand. Capacity enhancement and utilization is at an all time peak. Industrial growth is accompanied by a degree of industrial diversification and emergence of new entrepreneurial class, though more effort is warranted to move Pakistani industry away from its traditional dependence on resource-based and low technology based processes.

(iii) Having achieved self-sufficiency in major crops well in 1980's, Pakistan's agriculture sector has benefited from improvements in pricing regime for major crops, deregulation of inputs and trade liberalization. Excluding crop

failures due to bad weather, agriculture grew on average in last 3 years by over 3.8%. According to Food and Agriculture Organization (FAO) Pakistan is ranked 4th in cotton, 5th in sugar, 9th in wheat and 12th in rice production in the world. In addition, Pakistan is ranked among the top ten producers in several of the minor crops, which are mostly fruits and vegetables. The remaining half of the agriculture value addition is contributed by non-crop sector mainly livestock, which has helped Pakistan rank as the 5th largest producer of milk.

IV. Factors contributing to economic turnaround

Enhanced market orientation and openness. Opening its markets in late 1980s, Pakistan has amplified and deepened its structural reforms over the last 5 years. Keeping aside ideological or philosophical consideration and the Government's fiscal compulsions, industrial, trade and price liberalization has infused high degree of competition which is auguring well for efficient allocation and use of resources. Private sector is allowed in all strategic sectors such as oil, gas, telecommunication and other services sector on a competitive basis which are supported by sound sector policies.

Service providers in telecom are emerging as large giants and have enhanced country's wireless penetration to reach 29% in November 2006 with the total cellular subscribers at 46 million. Moreover, the intense competition has also reduced call costs, increased outreach and offered increased services to the customers. The increasing penetration will invariably play a part towards increasing the market potential of a host of other activities conducted through cell phones such as banking, remittances etc.

Since early 1990s, Privatization Commissions has processed 161 privatization transactions resulting in sell off of public assets of Rs. 378 billion. All manufacturing sector, 80% of the banking assets and strategic stakes of utility companies have been sold off to private sector. With scaling back of government's role, the share of private sector in investment has risen steadily from merely 7.8% of GDP in 1980's to over 13% of GDP in FY 2006. At the same time the share of public consumption expenditure has reduced over time to less than 10% and now private consumption expenditure accounts for more than 90%.

Banking sector is catalyzing real sector development. Banking sector reforms are far reaching. Aside from their impact on depth and efficiency of financial intermediation, the profitability of banks has allowed them to earn high returns, which has attracted foreign interest and encouraged existing owners to expand and/or strengthen their businesses. Banks have not only cleaned up their own balance sheets but have impacted real sector development in a number of ways. The private credit growth in last few years has been significant reaching over 30% in FY06. Private credit grew from insignificant levels to over Rs. 400 billion in FY06. The credit expansion fuelled economic activity, while reviving and enhancing industrial and other capacities. Credit diversification has helped achieve a degree of economic diversification too. While the corporate sector accounts for almost half, within it all segments of industry received higher credit. Of the total outstanding, agriculture credit constituted 6.4% but more phenomenally, it grew by almost 4-5 times. Credit was also made available to non-crop sector by laying down guidelines for promoting credit access to livestock, fisheries and dairy sector. Improved access to SMEs was also possible and its share in total outstanding grew to 16.1%. Consumer financing, which was not available in the past, rose to 14.3% of the total outstanding. Companies' access to required level of financing, foreign loans, swaps and derivatives etc. have all been accommodated to allow market to innovate and expand. There is considerable scope for banks to enhance their business through extending financial penetration and outreach both across country and sectors.

Banking sector has grown both in size and strength and is positioned well to meet economy's requirements as it grows. Ownership and structural changes in banking system will facilitate this process. Foreign interest and presence has grown and at present foreign stake comes to 47% of total paid-up capital of all the financial institutions regulated by State Bank of Pakistan. Structural changes have been significant. Besides higher standards of corporate governance at management and board level, the banks are adhering to SBP prudential regulations which are consistent with BIS standards. Technology is being fast adopted and over 45% of bank branches are connected with head office, along side growth in ATMs, debit and credit cards.

Foreign investment is flowing in. Economic activity has and will be further boosted by efficiency gains once the full impact of foreign investment is realized after the completion of projects financed by FDI. During FY04-06, Pakistan has cumulatively attracted $8 billion foreign investment flows – 26.5% was sale proceeds of public assets and 49.2% from FDI, with remaining coming from foreign portfolio investment. These foreign inflows have come into banking, telecom and oil and gas sectors primarily. Prospects are that Pakistan will attract about US$6.0 billion in FY07 – an all time high annual flow. Going forward, foreign investment is expected to be more diversified and will support infrastructure development, manufacturing, tourism and hotel industry etc. The strong interest in Pakistan stems from (i) growing investor confidence in the economy, (ii) comfort to foreign investors that they are treated at par with domestic investors (and in some respects even better), (iii) high returns on investments as evident from exceptional corporate and banking profitability and (iv) supportive and stable policies.

Besides full foreign ownership, investors can repatriate their capital, dividends and profits and there is no restriction on the level of royalty payments. Foreign investors are eligible for low import duties between 5 and 10% on plant and equipment and a first year tax allowance on profits of between 50 and 90% of the cost of plant and equipment. Measures have also been taken to introduce an Intellectual Property Rights regime compatible with the WTO. Rules governing FDI have been significantly liberalized. Furthermore, the investment climate has improved as a result of policy initiatives such as the streamlining of procedures required to start a business and the measures taken to minimize the time that businesses spend dealing with government inspections. To facilitate foreign portfolio investment, Special Rupee Convertible Account (SCRA) has been established to allow remittances and non-residents to bring money in and out of Pakistan. The amount accumulated in this account can be used for purchasing as well as trading shares quoted in the stock exchange as well as other approved securities. Foreign exchange regime has also been liberalized and exchange controls have been lifted.

Business processes are being rationalized and simplified. Reforms, both of incentive and administrative regime, have helped Pakistan to improve its ranking in the Survey conducted by the World Bank on 'Doing Business in 2007.' Pakistan now ranks 51 in the time to import (which has reduced from 39 days to 19 days) as trade logistics and customs procedures were streamlined and scores well on the indicators related to starting a business (54th out of 175) and protecting investors (19th out of 175).

V. Growth sustainability and prospects

Pakistan's real GDP growth rate has risen in recent years, averaging 7.4% in the preceding three years. This is well above the long-term (50 years) average growth rate of 5 percent. The strong growth momentum has stressed the productive capacity of the economy as evident in macroeconomic indicators such as rising inflationary pressures and a widening external current account deficit. These developments naturally raise questions regarding economy's potential to sustain this momentum.

The current growth momentum in the range of 7% can indeed be maintained, though this requires: careful calibration of macroeconomic management and removing bottlenecks that are impeding growth and economic diversification. With declining poverty[48] and growing employment opportunities, viability of Pakistani market is further enhanced as domestic private consumption has been supported by improved incomes and remittances.

To ensure sustainable economic growth, Pakistan will need to maintain macroeconomic stability by gradually reducing the twin deficits. Besides prudent expenditure management, this will require broadening of the tax base to effectively finance growing expenditure obligations. Sustainability of external current account deficit calls for raising exports earnings to finance the increasing imports requirement. Imports will remain strong as the economy's requirements for capital and intermediate goods for industry grow. Balance of payment position will benefit from industrial diversification which is critical for export diversification as well as for encouraging import substitution (particularly in food commodities) where Pakistan

[48] The overall poverty has reduced from 34.46% in 2001 to 23.90% in 2005. The percentage of population living below the poverty line in rural areas has declined from 39.2% to 28.1% while that in urban areas has declined from 22.7 percent 14.9 percent. In other words, rural poverty has declined by 11.2 percentage points and urban poverty has reduced by 7.8 percentage points.

has competitive advantages. Any pressures on aggregate demand because of slippages will need monetary tightening as central bank would remain committed to the objective of price stability.

To realize these goals, Pakistan needs to now direct investment flows, both domestic and foreign, to areas which can help stimulate industry and its diversification, and help remove gaps and bottlenecks in the infrastructure. Pakistan offers opportunities to exploit gas and coal reserves suitable for power generation and hydroelectricity generation. The geographical proximity to energy rich regions, Iran and Central Asia, position Pakistan to emerge as a regional hub for energy. The investment requirements for the development of energy sector are in the range of $20 billion in medium term to around US $150 billion by 2030. National Trade Corridor Plan (NTCP) equally offers opportunities to connect all major physical infrastructures such as ports, roads, railways, aviation etc. Besides connecting Pakistan with its neighbors it will enhance trade and improve market access, while saving fuel and transport costs. Pakistan has set up an infrastructure Project Development Facility to facilitate initiation of these projects through credit enhancement and financing institutions are geared up to adopt different approaches and modalities to leverage and intermediate financing flows for infrastructure.

Opportunities also exist to enhance production by enhancing productivity, efficiency and economic diversification. To diversify, Pakistan has to make inroads into the medium and high-end technology products such as electronic goods, automobiles, engineering goods etc. and to look for newer markets. In agriculture, implementation of mega water resources projects will enhance crop yields. Besides increasing value-addition, market-based pricing (e.g. as done for rice and wheat), improvements in transmission of pricing signals to farmers (e.g. through introduction of a commodity futures market), development of crop insurance (particularly to encourage the raising of new cash crops such as oilseeds) and improvement in transportation and storage infrastructure will contribute to enhancing agricultural productivity. Development of agro-based industry and processing and packaging of products would further stimulate export of these products to the neighboring Middle Eastern markets.

With a strong base of economically active population, Pakistan has an edge as it is a low wage economy – average wage is close to $75-$100 a month for unskilled workers, $100-$200 for skilled and for managerial workers, it ranges from $200-$500 a month. To enhance skills, an aggressive technical education and skill

development program exists under the Medium Term Development Framework. Investment climate will benefit further from the ongoing efforts and strong commitment to rule of law, developing a competent and efficient government sector, less cumbersome regulations and control of corruption.

Finally, besides banking sector, the large financing requirements of infrastructure and of agriculture sector (ranging above Rs130 b) can be met but require financial diversification. The long-term domestic debt market is still under-developed and corporate debt issues account for less than 1% of GDP. Similarly, Pakistan boasts an extremely liquid equity market but it remains dogged by high degree of speculative transactions that have led to periodic bouts of instability and claims of market manipulation. Given the importance of long-term debt markets to support investment, particularly in infrastructure projects, to increase domestic savings, and improve the risk profile of commercial banks (which currently face mismatches in lending and deposit profiles), Pakistan needs to foster development of long-term institutional savings industry (pension and provident funds, mutual funds, etc.), implement capital market reforms aimed at encouraging investment rather than speculation, and improve risk management in the financial sector to ensure financial sector stability.

Conclusion

In conclusion, Pakistan offers endless possibilities with its vast untapped resources. The country is set to grow at a rate of 7% per annum which should help to further raise its per capita income from US$847 per annum to US$ 1557 by 2015. Demand is expected to get stronger as incomes rise further and assuming current population growth trends persist. Pakistan's strategic geopolitical position, due to its proximity to India and China as well as to the oil rich Middle East and untouched central Asia with vast natural resources, potentially carries opportunities which to date have not been properly exploited. Promising for private sector would be the large infrastructure projects which would offer high return in long term but would help enhance access and efficiency in movement of goods within and outside Pakistan.

If done right, Pakistan can easily integrate itself into the export value added chain of the region as there is adequate room for further growth; investment in these sectors is thus highly feasible. For example, Pakistan still stands relatively low in terms of motorization when compared globally and even within the region. Automakers need

to take this into account as the demand clearly exceeds supply. Likewise the supply of electronic goods is still short of the potential demand and any increases will be absorbed by the population which is growing and expected to double over the next 25 years.

In future, the demand for energy, cement, fertilizer, and leather products is expected to increase. The energy demand over the next five years is expected to grow at a rate of 7.4 percent per annum and over the next 25 years it is expected to be 7 times the present demand.2 Thus the sectors, particularly those discussed above, remain attractive for foreign investors due to strong consumer spending patterns and rising industrial activity depicted by past trends and strong future demand. Likewise, banking sector has to position itself to extend its outreach, which will play a key role in sustainability and in diversifying risks. For long term sustainability and to maximize the development impact, small and medium enterprises should be encouraged and further developed as they will be able to fast restructure themselves as and when warranted and will play a more critical role in employment generation.

Besides bringing in much needed capital, increased foreign presence is expected to help Pakistan integrate better globally and regionally, enhance skills and techniques and transfer and increase usage of technology. It is our belief – so far reinforced by experience – which private sector participation and foreign investment are going to be the cornerstone of our future economic strategy.

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