IMPACT OF POLITICAL INSTABILITY AND FOREIGN DIRECT INVESTMENT ON ECONOMIC DEVELOPMENT IN PAKISTAN

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ABSTRACT

According to economists, political instability is harmful for economic development of any Country. Pakistan is also facing the problem of political instability, since political instability causes a decrease in investment and rapidity of economic development process. This paper aims at analyzing the impact of political instability and foreign direct investment on economic development of Pakistan. The study also checks out what are the variables other than political instability and FDI that effect the economic development of the country. By using times series data from 1980 to 2013 taken from world data bank, an ARDL model is estimated. The estimation of short run result shows that political instability is insignificant, that is, it does not affect economic development in the short run, but in long run its effect on economic development is negative and significant. On the other hand foreign direct investment (FDI) has positive relationship in both short run and in long run. So government should improve political situations and should make strategies to attract FDI.

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Keywords: HDI, FDI, Inflation, Political instability, Population, Life expectancy.

Contribution/ Originality

This study contributes in the existing literature that has been discussed below in literature review section. This study uses new estimation methodology like ARDL model, Wald and LM Test. The paper's primary contribution is finding that political instability has negative impact and FDI has positive impact on economic development.

1. INTRODUCTION

Political instability and economic development are deeply interrelated to each other. Due to political instability, uncertainty comes in an economy and as a result investment decreases and economic development is also affected. Because of reduction in investment, the level of output correspondingly decreases. The powerless political society, instability of government and carelessness of political parties create the situation for a politically instable state. For economic development of any country political stability is required. Political stability has direct effect on the process of economic development and the progress level of a state. Foreign direct investment affects economic growth and development process because it supplies capital for developing nations for investment purpose. Foreign direct investment also helps in creating job opportunities which finally leads to a rise in economic growth. Pakistan

considered foreign direct investment as significant source of funding to meet tasks of resources gap. In developing countries, foreign direct investment (FDI) is found to raise the productivity level and build a competition among producers which results in a production of quality products (Yousaf *et al.*, 2008).

Pakistan has experienced rough growth pattern in its history. Until 1970s, GDP growth has been lower than 5%. During the last 45 years the average economic growth has been around 5.5%. Pakistan has been facing a lot of problems, such as external and internal threats. Pakistan has faced the problems related to financial markets, because the setup for financial markets is also not achieved suitably. Externally, Pakistan has faced the problem of exchange rate and imbalance between imports and exports. Pakistan has failed to build up a political power because of lack of stable popularity based government, financial problems and absence of social development. The local problems, conflict for an offer of force between the territories and border clashes with India and the financial gaps inside the nation are other main causes of instability in Pakistan (Hashmi *et al.*, 2012).

However, nowadays Pakistan is facing a lot of problems regarding investment, as investment situation is extremely changed, because of political instability, global recession, high interest rates, energy problem and poor law and order situation. Investors feel hesitant to invest in Pakistan (Attari *et al.*, 2011).

The present study is conducted to check the impact of political instability and foreign direct investment on economic development of Pakistan and what are the variables that affect economic development. The time period for this study is from 1980 to 2013 to examine the long run and short run relationship between political instability, foreign direct investment and economic development of Pakistan within last 33 years. Finally, the study has special motive to deliver active and efficient policy for future.

2. Literature Review

A number of studies has been conducted on the problem of political instability and economic development. This chapter presents a review of researches done on the impact of political instability and foreign direct investment on economic development of Pakistan.

Alesina *et al.* (1996) examine the role of political instability on economic development by using the data of 113 countries. Their aim was to measure economic growth and political instability by using Amemiya's Generalized Least Square technique. The researchers concluded that economic growth will decrease because of high chance of government collapse. In Froot and Stein (1989) Froot and Stein stated that when a country's currency diminish, it will reduce production cost. When it is measured in foreign currency the inflow of FDI will increase. So the wealth of foreign investors will grow.

According to Todaro and Smith (Iqbal et al., 2013) foreign direct investment (FDI) flows indicated the development of international activities of Multinational Corporations.

Barro and Lee (1994) conducted a study, to check the impact of political instability on economic development. They noticed the growth rates of 116 economies for the years 1965-1985. They concluded that political instability has negative effects on economic development. Haan and Siermann (1996) investigated that lack of political stability has negative relation with economic development. From the year of 1963 to 1988 they used the sample of 96 countries to check the relationship of political instability. Finally, they concluded that political instability hampered the investment in Asia and it also diminished the economic development.

In Dutt (1997) conducted a study and found negative relationship between foreign direct investment and economic development, whereas in 1996, he turned out the same relation to positive.

Gyimah-Brempong and Traynor (1999) studied the link between political instability and economic growth. They used sample of 39 African countries. For the estimation they used simultaneous equations model and a dynamic panel estimation method. He used time series data from the time period of 1975 to 1988. His findings show negative relationship between political instability and economic growth. In Zhang (2001) Zhang showed the link between

economic development and foreign direct investment in case of China. He used annual secondary data from the year 1960 to 2001. By using Granger causality test and Johansen Co-integration technique, he concluded that there is positive relationship between economic development and foreign direct investment. He stated that foreign direct investment encourages economic growth. To test the impact of political instability on economic growth of United Kingdom.

Anyamele (2010) conducted a study on economic expansion in Sub-Saharan African countries. He found that foreign direct investment had positive impact on economic growth.

To find the impact of political instability and economic growth of Argentina, Campos and through literature review, we know that political instability always hampers economic development of any country. Nowadays Pakistan is also facing this problem. As there is negative relationship between political instability and economic development, whereas the relationship between economic development and foreign direct investment (FDI) is positive. Foreign direct investment can raise economic growth.

3. METHODOLOGY AND DATA SOURCE

This chapter discusses the model used to check the impact of political instability and foreign direct investment on economic development of Pakistan. To analyze the model of this study, ARDL estimation technique has been used.

It is believed that FDI has a strong positive impact on economic development because FDI can promote output growth and encourage economic development. A politically stability economy can ensure a smooth pace of economic growth and development, so that it allows producers and investors to take long term decisions, which leads to long term growth and development in the country. High economic growth with low inflation is main aim of macroeconomic policy makers, as inflation is harmful for economic growth.

To attain require result following model has been proposed.

HDI = f (inf, pop, life, pi, fdi)

For the above equation, econometric model can be written as:

$HDI_t = \alpha o + \alpha 1 Inf_t + \alpha_2 Pop + \alpha_3 Life + \alpha_4 Pi + \alpha_5 Fdi + \mu$

Where Dependent variable is,

HDI=Human Development Index (HDI)

While Independent variables are:

Inf= Inflation

Pop=Population

Fdi= Foreign Direct Investment

Pi=Political instability

Life = life expectancy

α= Coefficient of variables

μ = Error term

Following model is estimated to apply bound test approach,

$\Delta Hdi_t = \alpha_o + \alpha_1 Hdi_{t-1} + \alpha_2 inf_{t-1} + \alpha_3 pop_{t-1} + \alpha_4 life_{t-1} + \alpha_5 pi_{t-1} + \alpha_6 fdi_{t-1} + \sum \delta 1 \Delta Hdi_{t-i} + \sum \delta_2 \Delta inf_{t-i} + \sum \delta_3 \Delta pop_{t-i} + \sum \delta_4 \Delta life_{t-i} + \sum \delta_5 \Delta pi_{t-i} + \sum \delta_6 \Delta fdi_{t-i} + \mu_t$ (1)

α_1 = long run multipliers

$\delta 1$= short run dynamics

Optimal lag order of the above model is selected, on the basis of Akaike information criteria. The null and alternate hypothesis to test are given below,

H0: $\alpha_1 = \alpha_2 = \alpha_3 = \alpha_4 = \alpha_5 = \alpha_6 = 0$

H1: $\alpha_1 \neq \alpha_2 \neq \alpha_3 \neq \alpha_4 \neq \alpha_5 \neq \alpha_6 \neq 0$

H0 is rejected when the computed value of F-statistic exceeds upper bound value, the conclusion is that there is a long run relationship and vice versa.

To find the long run parameters of the dynamic model next step is to run equation (2)

$$Hdi_t = \theta_o + \theta_1 inf_t + \theta_2 pop_t + \theta_3 life_t + \theta_4 pi_t + \theta_5 fdi_t + \mu_t \quad (2)$$

By using unrestricted Error Correction Model, in equation (2), the long run coefficients can be estimated as under,

$$\theta_o = -\alpha_o/\alpha_1, \quad \theta_1 = -\alpha_2/\alpha_1, \quad \theta_2 = -\alpha_3/\alpha_1,$$

$$\theta_3 = -\alpha_4/\alpha_1, \quad \theta_4 = -\alpha_5/\alpha_1 \text{ and } \quad \theta_5 = -\alpha_6/\alpha_1$$

An unrestricted Error Correction Model (ECM) is used to find short run estimation of model. So the equation is identified and given below,

$$\Delta Hdi_t = c + \sum \gamma_1 \Delta Hdi_{t-i} + \sum \gamma_2 \Delta inf_{t-i} + \sum \gamma_3 \Delta pop_{t-i} + \sum \gamma_4 \Delta life_{t-i} + \sum \gamma_5 \Delta pi_{t-i} + \sum \gamma_6 \Delta fdi_{t-i} + \psi ECT_{t-i} + \varepsilon_t \quad (3)$$

Where,

$$ECT_{t-i} = Hdi_{t-i} - \theta_o - \theta_1 inf_{t-i} - \theta_2 pop_{t-i} - \theta_3 life_{t-i} - \theta_4 pi_{t-i} - \theta_5 fdi_{t-i} \quad (4)$$

In above equation (4) ψ measure speed of adjustments.

Adequate source of data is necessary for the empirical analysis as well as important for the validity of research. Times series data is used for this study from the period of 1980 to 2013. The data is collected from different sources and these variables have been taken in the form of percentage.

S.no	Variables	Time period	Data source
1	HDI	1980-2013	UNDP
2	Inflation	1980-2013	World data bank
3	Life expectancy	1980-2013	World data bank
4	Population	1980-2013	World data bank
5	FDI	1980-2013	World data bank
6	Pi	1980-2013	World data bank

For this study ARDL estimation technique is used. To achieve the empirical results and they are shown in next sub-heading. This examines the long run relation between HDI and other variables by applying Wald test. Short run relationship examines after generating residual by applying OLS. After that, different tests are applied like histogram test and serial correlation LM test.

4. RESULT AND ESTIMATION

This chapter provides result and interpretation of results. Unit root test is used to check whether the variables are stationary or not? After examined the stationary value of variables we come to know that which model we use, if some variables are stationary at I(0) and some variables are stationary at I(1) then we use ARDL technique.

Unit root test: The main purpose to run unit root test is to check the stationary values of variables.

Table-1. Result of unit root test

Variable	ADF	Critical values			Conclusion
		1%	5%	10%	
HDI	-5.867830	-3.653730	-2.957110	-2.617437	I(1)
Political instability	-5.258416	-3.653730	-2.957110	-2.617434	I(1)
Life	-5.548252	-3.661661	-2.960411	-2.619160	I(0)
Inflation	-2.763210	-3.646342	-2.954021	-2.615817	I(0)
FDI	-3.298903	-4.273277	-3.557759	-3.212361	I(0)
Population	-4.710862	-4.273277	-3.557759	-3.212361	I(1)

(Calculated in Unit Root Test)

Table 1 shows results of unit root test. Above results showed that variables are stationary at different level.

ADF Augment dickey fuller test gives that some variables are stationary at level and some are stationary at 1st difference. So because of this ARDL technique is used.

5. RESULTS OF ARDL MODEL

An ARDL model is applicable when all the variables are stationary at different levels. In this approach variables can be stationary at level and first difference.

The following results shown in the tables below are calculated in Eviews. The formula that has produced the results below is:

d(hdi) c d(fdi) d(pi) d(life) d(pop) d(inf) d(fdi(-1)) d(inf(-1)) d(pi(-1)) d(life(-1)) d(pop(-1)) d(hdi(-1)) d(inf(-2)) d(pop(-2)) d(fdi(-2)) d(hdi(-2)) d(life(-2)) d(pi(-2)) hdi(-1) pi(-1) fdi(-1) life(-1) inf(-1) pop(-1).

In order to reach the following results initially we got data from World Data Bank and UNDP. Rest of the calculation of data in Eviews is discussed below in details.

Table-2. Result of ARDL model

Variables	Coefficient	Std. Error	t-statistic	Prob
C	-5.879457	1.480903	-3.970183	0.0016
D(PI)	-0.000547	0.000603	-0.907144	0.3808
D(POP)	0.004695	0.095707	0.049055	0.9616
D(LIFE)	-0.013061	0.229143	-0.057000	0.9554
D(FDI)	0.003368	0.004533	0.743156	0.4706
D(INF)	0.001184	0.000815	1.453173	0.1699
D(INF(-1))	-0.002036	0.001105	-1.842628	0.0883
D(HDI(-1))	0.598900	0.377858	1.584988	0.1370
D(INF(-2))	-0.000598	0.000732	-0.816781	0.4288
D(POP(-2))	-0.170004	0.094651	-1.796105	0.0957
D(HDI(-2))	0.304708	0.279614	1.089747	0.2956
D(LIFE(-2))	0.532571	0.257827	2.065615	0.0594
HDI(-1)	-1.750875	0.516920	-3.387131	0.0049
PI(-1)	-0.001447	0.000656	-2.205601	0.0460
LIFE(-1)	0.096888	0.024834	3.901366	0.0018
INF(-1)	0.004191	0.001973	2.124232	0.0534
POP(-1)	0.157931	0.040705	3.879858	0.0019
FDI(-1)	0.010055	0.003708	2.711782	0.0178
R-squared 0.774742		Durbin-Watson stat 2.437514		
Adjusted R-squared 0.480173		Prob(F-statistic) 0.041514		

(Calculations are conducted in Eviews)

All variable's life expectancy, population, foreign direct investment and inflation results are significant and positive except political instability. It has negative impact on human development index. Now Wald test is applied for estimating long run relation between variables and HDI.

Table-3. Result of Wald test:

Test statistics	Value	Probability
F-statistics	3.746238	0.0218
Chi-square	22.47743	0.0010

(Calculations are conducted in Eviews)

5.1. Long Run Analysis

Long term estimation shows that all the variables are significant and there is a long run positive relationship almost all variables with economic development except political instability. As results shows that political instability is -0.0008, so there is negative relationship between political instability and economic development of Pakistan.

Table-4. Long run estimation results:

Variables	Results
Political instability	-0.0008
Life	0.0553
Inflation	0.0023
Population	0.0902
FDI	0.0057

(Calculations are conducted in Eviews)

5.2. Short Run Analysis

Table 5 shows result of short run analysis, to check the short run relationship ECM (error correction model) is used. In short, run analysis, political instability is insignificant but long run results shows that it has negative effect on economic development. Foreign direct investment (FDI) has significant and positive impact on economic development in Pakistan. Foreign direct investment is beneficial for economic growth, as FDI supplies capital for developing countries which is needed for investment. It also create job opportunities for nation which leads to economic development.

Table-5. Short run result

Variable	Coefficient	T-statistic	Prob
C	0.000757	0.104975	0.9172
D(PI)	0.000448	1.001063	0.3260
D(POP)	-0.037549	-1.069922	0.2945
D(LIFE)	0.026284	0.884780	0.3844
D(FDI)	0.005873	2.099132	0.0457
D(INF)	0.000200	0.473485	0.6398
E(-1)	-0.924744	-4.522212	0.0001
R-squared 0.540456		Prob F-statistic 0.001411	
Adjusted R-squared 0.434407		Durbin-Watson stat 1.823926	

(Calculations are conducted in Eviews)

The value of ECT (error correction term) is 0.92 which shows that 92% of the adjustment in disequilibrium is taking place annually.

Histogram
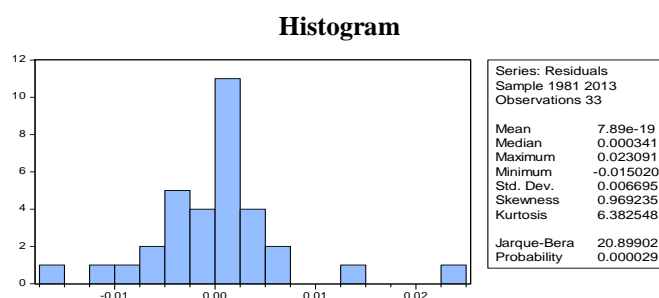
5.3. Serial Correlation LM Test

The results of serial correlation LM test shows that there is no problem of autocorrelation as the probability value is greater than 0.05 which leads to the acceptance of the null hypothesis. So there is no problem of autocorrelation.

Serial correlation LM test			
f- statistics	0.704847	Prob. F(2,24)	0.5041
Obs*R-squared	1.830794	Prob. Chi-Square(2)	0.4004

6. CONCLUSION

The objective of this paper is to check the impact of political instability and foreign direct investment on economic development of Pakistan. The result of this paper shows that the relationship between political instability and economic development is negative, but there is positive relationship between foreign direct investment and economic development. In Pakistan foreign direct investment is considered as major external sources of funding. FDI has played significant role in economic development of Pakistan. We come to know that economic development will reduce because of political instability. In Pakistan irregular of government change and non-stability of political system is most harmful for economic development. Durable economic policies are required for higher economic growth. Government should control political instability and increase foreign direct investment for economic development of Pakistan.

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