

CAPITAL UNIVERSITY OF SCIENCE AND
TECHNOLOGY, ISLAMABAD



**Relationship between FDI and
Financial Market Development:
An Evidence from South Asian
Markets**

by

Hadeeqa Nadeem

A thesis submitted in partial fulfillment for the
degree of Master of Science

in the

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This thesis is dedicated to my parents, my friends, my sister and to my husband.



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CERTIFICATE OF APPROVAL

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Abstract

This study examines relationship between FDI and financial market development. For this purpose, we hereby considered 4 emerging markets of South Asia. We used indicators from the growth of both stock market as well as banking sector. The data ranges from 1996 to 2016. We used Granger Causality as well as Regression analysis. We observe positive relationship between FDI and stock market development indicators while when we study the development indicators in banking sector, the causality seems inconclusive and unclear. We use Unit root test to check the stationarity of the FDI and FMD variables. There exist a positive correlation between FDI and FMD variables. We do not rely on correlation of variables further statistical test are implied draw a meaningful conclusion. In order to check casual relation between FDI and FMD variables we use Granger Causality test. Our study suggests that countries rich in natural resources are taken edge in attracting FDI to the country. Pakistan is rich in natural resources. The decision makers should use it to device monetary and fiscal policies to attract FDI in Pakistan.

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Abbreviations

FDI	Foreign Direct Investment
FMD	Financial Market Development
SMD	Stock Market Development
BSD	Banking Sector Development
ARDL	Autoregressive Distributed Lag
STKMKTCAP	Stock Market Capitalization
GDP	Gross Domestic Product
GSP	Generalized System of Preferences
FGLS	Feasible Generalized Least Square
MNC	Multinational Corporation
UNCTAD	United Nations Conference on Trade and Development
MENA	Middle East and North Africa
OLI	Ownership, Location and Internationalization

Chapter 1

Introduction

1.1 Background of the Study

Financial market development (FMD) connection is generally categorized in two parts based on literature, foreign direct investment (FDI), and the economic growth. When considering a developed financial sector along with a few prominent conditions, FDI ensures growth boost ([Hermes and Lensink, 2003](#); [Alfaro et al., 2004](#)). Whereas [Bekaert et al. \(2005\)](#) demonstrates that either market independence or any financial segment that is well performing may boost growth. In this research, we empirically test relationship between FDI and FMD, i.e. whether it exists or not? For observational evaluation of the concerned relationship, Panel data technique was used from South Asian developing markets. Our research targets at the achievement of four different benefits by focusing on emerging markets in South Asia. Primarily, attain ease of access of the concerned data relating to almost every country existing in our sample. After the previous step, aforementioned countries possess various institutions containing lower level of deviation.

At this point, our goal of focusing on South Asian developing economies facilitates us to examine the connection amongst growth variables of a financial market and FDI frequently discussed in literature. At last, insofar as our extent of research is concerned, emerging markets are a considerably suitable sample, nevertheless, fully developed markets might not be as such beneficial and those countries having

rather poor economic position and lacking economic development have no potential towards FDI, although financial sectors of these countries have optimum performance. This is so because scarcity of any assets besides weaker market power makes these countries uninviting (Soumare and Tchana, 2015). The best way to research the bond between FDI and FMD is alongside with a system panel technique whereas both FDI and FMD are key variables. To test existence of any bond between FDI and FMD, the approach used by Levine (2000) has been amended.

This approach contains panel techniques and an assembly comprising determinants of FDI and FMD through simultaneous calculations. There exists no pragmatic work that focuses on the actuality of any instantaneous bond between FDI and FMD, to the extent of our understanding. For instance, a persistent relationship amongst development of financial markets in Ghana and FDI has been observed by Adam and Tweneboah (2009). Similarly, Al Nasser and Soydemir (2010) concentrated on Latin American countries and conducted Granger Causality trials between development of financial markets and FDI. In accordance with their discoveries, there exists unidirectional bond from the banking industry growth to FDI as an alternative of the reverse. Moreover, there also exists a bidirectional association amongst development of financial markets and FDI. Their elucidation proves that FDI can formally endorse financial markets development due to scenarios for investment that are ordinarily formed by the spillover effects relating to FDI. Consequently, developed financial markets will have improved likelihood for FDI. Both of these researches grant consideration to one of many countries or a single country partaking indistinguishable geographical existence.

Political economy has been focused by few other researches having relevance with our area of research (Rajan and Zingales, 2003; Kholdy and Sohrabian, 2008; Dutta and Roy, 2011) and these researches take capital market liberalization as substitution for FMD (Desai et al., 2006; Henry, 2000). Rajan and Zingales (2003) claim concerning the political economy is that, the political economy is the only genuine power that may establish financial elites who select better market responsive regulations for foreign capital and goods. Similarly, risk issues related to politics make a difference in the link between FDI and FMD (Kholdy and Sohrabian, 2008;

[Dutta and Roy, 2011](#)). They additionally burst out the fact that development of financial market can be amplified through FDI if corrupt top notch is pushed rigorously for the minimization of protocols regarding the financial system along with engaging greater competition in the sector.

Advanced financial markets should be existent beside political loyalty towards the economy for understanding the benefits of the FDI ([Dutta and Roy 2011](#)). Yet, researches do not concentrate on developing markets undeniably appealing. Moreover, they merely exploit few signs of the financial development, same might affect their results. In actual fact, the option for the indicator of FMD is important for bond's nature as perceived by someone between FDI and FMD. Generally, FMD is pursued by an elevation in progression rate of both FDI and private investment ([Henry 2000](#)). The development of financial market might have been significantly linked to some other having influence on functional risks related with multinationals from foreign countries in conjunction with capital cost, is one of the reasons behind the upsurge in FDI. Bidirectional bond amid constraints for the development of financial markets and FDI has been inspected. (In this fashion, different researches focused on stock market development in conjunction with both FDI and FMD particularly, with the aim of discovering impacts of bidirectional association between FDI and FMD. They also considered managing those aspects having substantial influence towards the enhanced inflow of FDI as well as introduction of different segments of financial markets, we choose to use simultaneous equations).

The concept of 'Economic Development' has spread into two different aspects during the last few decades: first is foreign technology and the other is domestic factor benefaction. The neoclassical model of economic progression contains well defined reviews according to which upon gaining access to cutting edge technologies, the developing countries would swiftly merge with developed countries. Commonly known, however, developing countries has a slender use of modern technologies on specific industries based on foreign arrangements/patterns and codification of technology into blueprints that permit easy application, is still not viable. Furthermore, while technology related techniques being utilized are translucent, there will be need of adaptations with ambiguous level towards being successful as per

local factor benefaction for the transference of technology to new institutional and economic atmospheres. Role of domestic/local tampering is important for a prolific acceptance of the foreign technology.

The literature has discussed the active role of FDI as significant aspect for transferring new technology and thereby promoting economic evolution. In theory, a recipient country may face implications of FDI at both macro as well as and micro level. At the micro-level, FDI may impact technical efficiency and management of local firms by using labor preparation, technological transference and finally producing efficient spillover. While considering macro-level, FDI can have impact on real variables, including economic growth, domestic investments, exports and imports and employment (Dunning 1988; Levine 1997; Borensztein et al. 1998). FDI can also impact financial variables including balance of payment, foreign exchange rates, interest rates and inflation. Many researchers have worked to inspect implications of FDI towards economic development, though with various deductions. In this regard, few researchers have observed that relationship between foreign direct investment and market size of the host country is significantly positive, duly showed by GDP and/or GNP (Globerman and Shapiro, 1999).

However, some researchers have found totally reverse outcomes. The researchers observed positive impact of foreign investment on domestic reserves and economic progress; however, bond is only significant for the economic progress. In addition, they also contained that there is positive but insignificant association between foreign aid and evolution but there is negative impact in case of local savings. In this regard, Schive and Majumdar (1990) observed effect of foreign direct investment on privately made fixed investment, progress, exports/ imports and private intake. They have contained that private fixed investment and exports may be a key role in relationship between economic performance and FDI, and not via private intake and imports. Effect of FDI towards development might be held via private investment levels and exports, further encouraging an advanced technological efficiency. On the contrary, it may be stated that if foreign direct investment crowds out local/domestic reserves and probably give escalation to enclave economies; it may

have reverse outcomes on progress. Being a well-recognized fact, economies having higher percentage of productivity towards investment, may withstand more rapid progress than economies with less investment. In specific, latest progression philosophies disclose the association between progress and investment both domestic and foreign, and same may be further strengthened by technology improvement, expenditure of the capital goods and finally human resources development (Borensztein et al., 1998) pertaining to the host nations. In several circumstances, recipient countries may not be able completely engross benefits allowed through FDI inflows due to absence of fundamental groundwork, legal foundations, technological competency and awareness, effective investment strategies and human capital development (Borensztein et al., 1998).

In addition, as per Blomstrom et al. (1994), less developed nations can only get a little through MNCs as domestic firm's share are far short as compared to corresponding technology levels (pp. 250–251). Henceforth, inputs from human capital development are necessarily required in order to absorb management skills along with latest technology, caused by FDI inflows. There should a balance in advanced capital goods and trained workforce to perform good using new technologies (Hermes and Lensink, 2003). Apparently, this shows that local firms may take benefits of technological spill-over only if there is threshold level of human capital expansion in host countries (Borensztein et al., 1998). This also shows that FDI and human capital are entirely complementary in the process of spill-over efficiency.

Some researchers talk about existence of cutting edge technology via FDI as significantly related with the formation regarding intellectual property rights (Balasubramanyam V.N. and Dapsford, 1996). More focus of recipient country towards devising legal strategies in order to safeguard property rights leads foreign firms to make more technological investments. Resultantly, such accomplishments would really uplift potential for spill-over impacts and also encourage yield of the local companies (Hermes and Lensink, 2003). Latest studies about endogenous progress model, have primarily targeted local financial sector's role as mechanism for shifting technology between economic progress and global capital inflows. The

development of domestic financial sector will have impact on speed of technological accumulation/innovations and modify economic performance pattern. The more emphasize towards the role of financial sector development shows that development of aforesaid sector may be regarded as important predictor regarding economic performance in future. The argument about networks that promotes financial progress to improving economies is unsettled yet.

Commonly stated, two substitute schools of thought exist towards assigning linkage amid financial sector development and the economic performance. [Schive and Majumdar \(1911\)](#) proposed initial concept emphasizing role of banking sector in supporting innovations by technology as ‘financial mediators’. Being established institutions in accumulating savings pertaining to excess units, assessing lucrative investment plans, observing management and assisting transactions, the banks are capable to amass thorough details regarding companies using very low cost. Allocation of assets and yield progress may have a link with lower informational costs delivered by aforesaid ‘financial intermediaries’ ([Dutta and Roy, 1990](#)). In this way, different organizations perform as ‘financial intermediaries’ for allotting their savings towards more productive companies in the society. The Schumpeterian’s view corroborates direct impact of progress of financial intermediaries in encouraging technical change along with yield evolution, which feeds through overall harvest progress. Nevertheless, the view states that progress of the financial intermediaries doesn’t necessarily affect saving rates. Problem Statement There are different ways to show two-way relationship between FDI and financial market development. On the one side, the investment spill-over results from foreign investments assist in the development of local markets. This ensues for the reason that such investment surges the likelihood of multinational affiliates performing FDI inflow actions being added to the list of stock contributors in the local market. Multinational establishments initiate from countries based on industry where finance is carried out by tradition through financial markets.

It is also debatable that FDI pressures the political cream in a country to impose the regulations for foreigners and make them friendlier. Such actions include the establishment of better strategies of governance and security for the stakeholder

resulting in an overall expansion in the stock market. On the contrary, a financial market which has under gone some development comparative to others offers a beneficial field of play for foreign investors. This is based on the discernment formed due to the presence of such markets—that the government bodies in the country are supportive of development and encourage a market-friendly in the country. This holds true in particular for developing markets in contrast to evolving ones. We want to examine which association is dominant within our selected market which is South Asian developing economies.

Previous work has looked at the relationship of FDI with several macroeconomic variables. Some that might be thought to have a connection to FDI flows are the size and growth potential of the host market, economic stability, the degree of openness of the host economy, and income level, as well as the quality of institutions and level of development

1.1.1 Market Size and Growth Potential

Larger host countries' markets may be associated with higher foreign direct investment due to larger potential demand and lower costs due to scale economies. For example, [Resmini \(2000\)](#), looking into manufacturing FDI, finds that countries in Central and Eastern Europe with larger populations tend to attract more FDI.

1.1.2 Openness

On one hand, a decrease in openness might be associated with more horizontal FDI, as investing firms might benefit from circumventing trade barriers through building production sites abroad. But [Resmini \(2000\)](#), studying manufacturing investment in Central and Eastern Europe, finds that these largely vertical FDI flows, benefit from increasing openness, as might be expected in a sector for which international trade flows in intermediate and capital goods are important. [Singh and Jun \(1999\)](#) also find that export orientation is very important in attracting FDI, and link this to the rising complementarity of trade and FDI flows.

1.1.3 Exchange Rate

A weaker real exchange rate might be expected to increase vertical FDI as firms take advantage of relatively low prices in host markets to purchase facilities or, if production is reported, to increase home-country profits on goods sent to a third market. [Froot and Stein \(1991\)](#) find evidence of the relationship: a weaker host country currency tends to increase inward FDI within an imperfect capital market model as depreciation makes host country assets less expensive relative to assets in the home country. [Blonigen \(2005\)](#) makes a “firm specific asset” argument to show that exchange rate depreciation in host countries tend to increase FDI inflows. But on the other hand, a stronger real exchange rate might be expected to strengthen the incentive of foreign companies to produce domestically: the exchange rate is in a sense a barrier to entry in the market that could lead to more horizontal FDI. However, this hypothesis does not appear to have attracted much support in the empirical literature

1.1.4 Institutions

Institutional quality is a likely determinant of FDI, particularly for less-developed countries, for a variety of reasons. First, good governance is associated with higher economic growth, which should attract more FDI inflows. Second, poor institutions that enable corruption tend to add to investment costs and reduce profits. Third, the high sunk cost of FDI makes investors highly sensitive to uncertainty, including the political uncertainty that arises from poor institutions. Unfortunately, it is hard to measure institutional factors, and empirical results are vague. For example, regulatory framework, bureaucratic hurdles and red tape, judicial transparency, and the extent of corruption in the host country are found insignificant by [Wheeler and Mody \(1992\)](#) in their analysis of firm-level U.S. data

1.2 Research Objectives

This research has the following research objectives:

1. This research aims at defining the aspects inducing the Foreign Direct Investment inflows.
2. In specific, the aim of the research is to answer that how FDI inflows is effected with financial market development and other aspects economic evolution, trade openness and governance. Secondly the research also explores that how FDI and FMD influence FDI inflows in the existence of other aspects economic growth, trade openness and governance.

1.3 Research Question

This research has the following research questions:

1. How are FDI inflows linked with financial market development?
2. Is there any association between FDI inflows with financial market development?

1.4 Significance of the Research

Several researches inspect the association between Financial Market Development (FMD) and FDI has been examined with a focus only towards importance of FMD in the FDI-Economic Advance association. No specific attention has been paid to the directness of connection prevailing amid FDI and FMD for markets still undergoing the development process, as in the case of emerging South Asian markets.

1.5 Contribution

This research targeted the understanding of the direct relation based on causality present amid FDI and FMD. An evaluation based on empirical data was accomplished through the use of panel information from the South Asian developing

marketplaces. A minimum of four different benefits can be consequent from paying specific attention to such markets. Initially, within our sample, the data for all nations was easily available. Next, the establishments in such countries are spread over a less various fields of diversity and standing. Then, developing markets are most appropriate for the test as compared to developed marketplaces. This is due to the fact that developed markets are insignificant for the reason that less or under-developed countries own smaller markets and may experience struggle in appealing FDI inwards despite the presence of a proper operation sector of finances. The inquiry also intended to discover and recognize additional regions of enhancement in the investment strategies for South Asia, particularly Pakistan and propose new regions of research on this concern for the researchers to probe in the predictable future.

Chapter 2

Literature Review

[Hermes and Lensink \(2003\)](#), remote direct speculation, budgetary advancement and monetary development were investigated. 37 out of the 67 created nations in information set in year of 1970 to 1995, were appropriately created money related structure .It was established by keeping in mind the expected goal which was to observe if FDI contributes distinctly to Financial development. The major part of these nations elected was from Latin America and Asia. The study stated that in order for FDI to positively affect financial development, there is an utmost need in improvement of money related arrangements of the selected nations.A more created money related framework emphatically adds to the approach of innovative dispersion associated with FDI. Hermes and Lensik paper experimentally investigates the role, the monetary framework improvement plays towards improving positive association between FDI & financial development. Similarly [Alfaro et al. \(2004\)](#) focused the same through exploring FDI and monetary development: The study was conducted to observe the different links among outside direct speculation, money related markets and development.

Hermes and Lensik explain an economy with an extent of specialists ordered by their own level of volume. Two opinions were generated: to win an arrival thet utilize their riches and work for the distant organization on FDI division or to an altered expense embrace entrepreneurial exercise. In order to exploit information overflows from FDI, a better budget markets allows specialists to do so. The results in this study concluded that to improve the monetary development FDI

plays an important role. The traditional relationship among securities exchange improvement in Ghana was studied by [Adam and Tweneboah \(2009\)](#). The study was conducted on quarterly information from 1991:1 to 2006:4. To study if there is any long-run relationship between FDI inflows, nominal exchange rate and stock market development, co-integration examination was done and mistake revision models were employed.

The results proved that there is a long-run relationship between FDI inflows, nominal exchange rate and stock market development in Ghana. The finding showed that even a small shift in FDI inflows significantly effects the improvement of securities exchange in Ghana. The study also demonstrated the vital role that stock market development plays in attracting FDI inflows. [Al Nasser and Soydemir \(2010\)](#) broke down the household and global sources of outside direct interest in Latin America. The residential and global determinants of FDI inflows in 14 Latin American nations from the periods of 1978 to 2007 were investigated in this study. Inspection was done to observe which variables promoted the increase in FDI inflows? If it is possible for the nations with budgetary markets to attract more FDI inflows? The study explored that both local and worldwide components had been crucial determinants of FDI inflows to Latin America. The bearing of causality was from managing an account part improvement markets to FDI and not the converse. Therefore the results concluded that there was a unidirectional connection between FDI and managing an account division. There was bidirectional connection amongst FDI and securities exchange advancement pointers, explaining that initially FDI could improve securities exchange if speculation that FDI - related overflows impacts and therefore, has an ability to pull in more FDI. Financial market progress, FDI and different political weaknesses were also examined by [Dutta and Roy](#).

In the year of 1984 to 2003 OLS pooled estimation of 97 nations was absent. Power examination Feasible Generalized Least Square (FGLS) was utilized and result showed that there was non-direct relationship amongst the two. The result also showed that there was negative impact on FDI related to improvement of monetary levels and also the profitless relation was observed among financial

market development and FDI inflows for each level of political danger. Prosperous advantages of FDI inflows were observed in the financial market if there was an increase in the political soundness. Again the relationship between FDI and financial development was studied in seven nations, Bangladesh, India, Maldives, Bhutan, Sri Lank, Nepal and Pakistan in this study given variables were put to use exchange rate, current Account Balance, Inflation labor population, trade balance, long term debt outstanding and GDP as the determinants of FDI inflows for the period of (1980-2010) For the study of the relationship between FDI. Financial development, panel VAR Model was utilized.

The foreign direct investment is majorly effected by 18exchange rate, inflation, labor population, per capita gross domestic product, merchandise trade balance, current account balance and long term debt outstanding. In order to get more FDI in the economy, we need higher monetary development, soundness in 18exchange rate and inflation rate, more work populace development, better exchange openness, and steadiness in current account balance and long term debt outstanding. The deprivation of these might affect the FDI inflows in the economy. Casual connection amongst stock prices and macro-economic variables like real and financial sector of an Indian economy was studied by [Kholdy and Sohrabian \(2008\)](#) who incorporates the variables as index of industrial production, exports, foreign direct investment, money supply, exchange rate, interest rate, NSE Nifty and BSE Sensex in India. For the period of (1995-2007) the Quarterly time arrangement information was observed. Long and short run causality relationship among all variables was concluded as a result of the study. This relationship could be the result of effective impact of FDI on the speculation with an effect to the developments in stock costs appear to influence sent out streams, perhaps through its impact on conversion standard. It should also be observed the advancement in Sensex and Nifty are resulting in about changes in swapping scale at any rate in the short run.

2.1 Background (Theoretical)

Hypothetically, three different aspects have been used to clarify underlying relationship between FDI and FMD inflows. Firstly, the expansion in net flows of FDI is straightforwardly identified with the assets available in economy and the reason behind money related intermediation through money markets or (Desai et al., 2006; Henry, 2000). Organizations which required in FDI are likewise list their shares on the neighborhood securities exchange, as they by and large begin from industrialized nations where stock exchange financing is an unquestionable requirement towards an organization indispensable to be considered as important. Kholdy and Sohrabian (2008) along with broke down the foreign direct investment, budgetary markets, and political debasement. The reason for this study was to examine if remote direct venture (FDI) may empower improvement in different countries on the basis of money while deteriorating predominant elites. Albeit three voluminous along with the parallel exploration lines study the impact of money related FDI, and subsequent political defilement towards the monetary growth, till now no study could have analyzed the joined effect of remote speculation & debasement on budgetary improvement.

The study demonstrated some preparatory proof that FDI may kick off money related developments towards creation of the nations. Besides, outcomes reveal that majority of the causal connections have been found in creating nations which encounter an increased amount of debasement as extreme nepotism, support, “support for-favors”, work reservations, mystery party financing, and suspiciously close ties amongst governmental issues and business. Political economy investigation has been used by Rajan and Zingales (2003) for contending that enhanced FDI diminishes exclusive class related force throughout the economy along with driving exclusive class to affirm market-accommodating arrangement of laws that make more grounded the development of money related markets. Third, a moderately well-working financial market can be a center for remote speculators, who see such a market as an indication of impressiveness, openness with respect to nation powers and a market-friendly environment.

A generally very much created securities exchange builds the liquidity of recorded organizations and may in the long run diminish the expense of capital, constantly rendering the nation alluring to outside venture (Desai et al., 2006). Apparently, Pakistan, India, Sri Lanka, Nepal and Bangladesh have adapted 'Policies for Economic Reforms' since long and continuously focusing market economy along with integrating economy with other countries. Consequently, an increased level of economic development has been witnessed in all South Asian countries except Pakistan during 1990s, following broader macroeconomic policies and particularly focusing export promotion. During aforesaid decade, higher GDP growth rates have been observed in Nepal, Sri Lanka and Bangladesh as compared to the era of 1980s. On one side, India achieved higher growth rate during 1991-2002 by promoting service sector along with marginal development in agricultural sector, whereas higher industrial & service sector growth has been the key factor for the growth in Nepal, Sri Lanka and Bangladesh.

However, in case of Pakistan, political instability, interrupted business climate, social insecurity and internal conflicts caused decline in GDP growth rate. Unlike Pakistan where a decline in per capita income has been observed during 1990s, there has been an upward trend in Sri Lanka, Bangladesh, Nepal and India. Similarly, substantial improvement has been observed in different key macro indicators including gross domestic capital formation along with savings in aforesaid economies excluding Pakistan. It can be observed that South Asian economies except Pakistan have experienced improvement towards major 'macroeconomic' indicators (local as well as external sector) and higher economic growth. In fact, this part of the world has been among the fastest growing business regions during recent times. As a whole, there has been a very substantial change in FDI environment in South Asian countries, particularly from 1990 to 2000 and even much more during the recent era. Owing to the liberal approach & policies towards FDI along with persistent positive changes regarding related policy framework, South Asia has become an attractive investment destination. Hence, we can conclude that South Asian countries has been successful towards ensuring provision of investment incentives to the foreign investors and bilateral trade agreements

through appropriate changes in FDI related policies.

Nevertheless, there still exist some procedural delays and ‘Reserved Industries’ denying investment opportunities to the foreign investors. In order to make South Asia an attractive investment destination, it is highly indispensable to expedite economic reform process, bring political stability in economies and get rid of internal conflict. In this regard, most basic indicator of infrastructure reveals acute lack of adequate related facilities and governance in all five South Asian countries. Thereby, more attention towards economic and social infrastructure through heavy investments accompanying by stable economic policies would be a source of foreign direct investment. According to an analysis, an increasing & positive trend of FDI has been observed towards South Asian economies. Nevertheless, except India, absolute volume along with share of inflows of FDI to South Asian economies has been comparatively nominal. FDI is mostly concentrated in services and manufacturing sectors in South Asia. According to an overview regarding FDI inflows into various sectors, FDI has been observed to be based on domestic market in Pakistan and India, whereas, same has been observed to be concentrated in some export-oriented business units in Bangladesh and Sri Lanka.

Economic growth is conditional with the persistent growth of the productive capacity in any country, supported by investments and savings. In developing as well as least developed countries, lower levels of investments and savings results into reduced economic growth and capital stock level. According to earlier ‘Growth Models’ of [Harrod \(1939\)](#); [Domar \(1946\)](#), formation of the capital causes rise in living standard that results in more development & growth. However, [R. \(1956\)](#) criticized aforesaid growth models relying upon the ‘fixed proportion’ of all the factors relevant to production along with substitutivity between labor and capital, and also stated that formation of the capital is a source of increasing workforce efficiency working in dynamic cycle of the investment growth. Few latest growth related theories including [Lucas \(1988\)](#); [Rebelo \(1991\)](#) maximized the scope of capital through the inclusion of human capital along with knowledge accumulation. In the same way, [Romer \(1986, 1990\)](#); [Grossman and Helpman \(1991\)](#) have used knowledge capital acquainted by R&D towards explaining growth and other

variables. Growth related literature highlights role of capital (human/knowledge capital) towards enhancements in the economic development. Recognition/acknowledgement regarding role of 'Knowledge Capital' towards economic development provides foundation towards identifying role of foreign direct investment that ensures new knowledge, technology as well as capital. During recent era, there has been increased demand of FDI inflows as MNCs have categorically assumed key position as the main source of economic growth and development ([Bajpai and Sachs, 2000](#)).

Through providing new knowledge and complementing domestic investment, FDI may help developing or lower income countries in South Asia, hence, it is worth analyzing empirical association in between foreign direct investment and the economic growth from the perspective of 'Growth Accounting Framework'. In this regard, FDI growth has been primarily studied firstly by considering growth determinants, secondly studying FDI determinants and thirdly MNCs role in the recipient nations. There exists significant number of micro as well as macro studies analyzing impact of FDI on economic growth. However, findings obtained from both the country based as well as cross-sectional study failed to establish the aforesaid relationship.

Previous research analyzing relationship of Foreign Direct Investment and the growth pertaining to developing countries postulated negative findings ([Fernandez-Arias and Hausman, 1950](#); [Griffin, 1970](#)) on the basis that FDI was mainly concentrated on low-priced primary exports in developed countries and caused adverse effects on overall growth. On the contrary, [Rodan \(1961\)](#) reported favorable implications on productivity along with the due to FDI in aforesaid developed economies. In addition, [Grossman and Helpman \(1991\)](#) argued that FDI generates increasing returns through technology along with knowledge transfers and hence has long term positive impact. Reviews by UNCTAD on investment policy provides proof regarding advantages of FDI in terms of employment generation, wages, linkages with local firms, range of new products and services, increases in technology-intensive exports etc. Furthermore, FDI has significantly positive

effect towards growth however contains different values on the basis of country under consideration (UNCTAD, 2003a).

Previous studies suggest that growth through FDI contributions depends upon formation of the capital along with technology shift (Borensztein et al., 1995; Blomstrom M. and Zejan, 1996) and finally knowledge accumulation owing to workforce training and further acquisition of skills (Chenery and Strout, 1999). Hence, the main advantages of FDI include 'Productivity Spillovers' for recipient country, further bringing high growth. It follows the pattern that FDI strengthens main factors of production i.e. labour and capital through the provision of knowledge capital stock to developing or less developed nations. In this way, most studies reported positive effects of FDI towards recipient economy (Chenery and Strout, 1999; Xu, 2000). Nevertheless, subject effects are country based (UNCTAD, 2003b; Borensztein et al., 1998). In addition, positive impacts of FDI towards enhancing growth along with growth per capita has been reported in studies including Caves (1974); Globerman (1979).

From macro level perspective, existing literature demonstrates positive effect of FDI, depending upon country and primarily relying on subsequent conditions. In case of rich countries, Blomstrom et al. (1994) have stated positive effects of FDI towards growth. Borensztein et al. (1998) reported a positive effect of the FDI inflows towards GDP growth, per capita, with the condition that recipient country possesses highly qualified manpower. Alfaro et al. (2004) observed positive impact of towards in well developed economies. Likewise, Balasubramanyam V.N. and Dapsford (1996) emphasized positive effects of FDI towards growth through trade reforms. On the basis of an analysis, Wang (2002) found that FDI caused significantly positive effect on the growth in manufacturing sector. Bende-Nebende and Ford (1998) has reported that findings from under developed nations have been more positive as regards to FDI. Borensztein et al. (1995) stated that FDI significantly contributes to growth as compared to the domestic investment because of the transfer of technology. Bashir (1999) demonstrates improvement in growth in MENA countries due to FDI, although the impacts/implications vary as per country-wise scenario. Chowdhury and Mavrotas (2003) found one-sided

causality from growth towards FDI as in the matter of Chile however found two-way causality in case of Malaysia and Thailand.

In addition, FDI gives surge to need of intermediate goods pertaining to local firms, allowing increased entry to new firms, a rise in national welfare, industrial growth and competition (Markusen and Venables, 1999; Haaland and Wooton, 1999). However, theoretically, externalities tied to the FDI can cause a rise or reduction in national welfare of that country. This depends if magnitude of positive spillover as caused by FDI surpasses adverse externalities including reduction of profit ratio for crowding out local investment or otherwise. Welfare of host country depends upon effect of MNCs towards profitability of local firms. In certain circumstances, where MNCs' labor requirement is weaker than already working local firms, same can lead towards decreased national welfare as well. In addition, profit repatriation can cause drain of the capital from recipient country. In this way, implications of FDI towards economic development and further national welfare may be adverse. Carkovic and Levine. (2002) found that generally FDI inflows do not independently impact economic development. Likewise, Ericsson and Irandoust (2001) failed in finding connection between FDI & subsequent growth for Finland and Denmark however, in case of Norway, found causality i.e. from FDI towards GDP growth. Germidis (1977); Haddad and Harrison (1993); Lucas (1980) found that growth is not primarily accelerated by FDI. Furthermore, studies by Aitken et al. (1997) and De Mello Jr. (1997), couldn't lend any support/ground towards positive role of FDI for economic growth.

According to Blomstrom and Kokko (2003), potential gains of FDI can only be realized if domestic firms can absorb foreign skills and technologies. Indeed, it has been empirically established that implications of FDI towards development are far meaningful in host countries having stable economic conditions and well-developed infrastructure (Balasubramanyam, 1998; Blomstrom et al., 1994). On the contrary, large MNCs has the ability to 'drive out' domestic companies due to their technological superiority and strong financial powers. Empirical evidence is mixed as regards to the spillovers type & level coming from FDI towards local companies. The spillover impact relies upon technological gap in between domestic

and foreign firms. From Indian perspective, previous studies found no positive impact of FDI towards growth (Chakrabarti and Basu, 2002).

According to De Mello Jr. (1997); Kokko (1996), negative relationship has been found between total factor productivity and FDI. But, Sahoo and Mathai (2003) succeeded in finding a positive relationship between FDI and overall growth. Some other studies also found positive relationship among liberalization, productivity growth and finally foreign companies (Basant and Fikkert, 1996; Kathuria, 1998, 2000). As a whole, effect of FDI towards growth is vague and country specific under various economic conditions. As South Asian economies have surplus in labour market, FDI may enhance growth by rising employment. Nevertheless, such countries have relatively lower infrastructure facilities and educational level and thus are relatively closed economies. Therefore, it is quite difficult to make inferences regarding potential effects of FDI towards development without any appropriate empirical examination. During 1990s, a substantial increase in FDI to developing countries has been observed. In this regard, South Asian nations received comparatively low FDI inflow and hence lagged behind. Hence, it is quite important to understand FDI flows in the South Asian region. As a matter of fact, Foreign Direct Investment flows into a country primarily rely upon 'ROR' on the investment and secondly those certainties and uncertainties associated with aforesaid returns. That's why, the private investors always make comparison of potential returns and subsequently degree of risks associated with their investments from the perspective of different investment options.

There is plenty of literature support regarding determinants of FDI. The private investors build expectations in a host country on the basis of institutional, economic infrastructure and regulatory related factors. Period investing, investors particularly consider major economic policy issues, governance, regulatory bodies framework, presence of physical as well as social infrastructure and labor. Few basic determinants of Foreign Direct Investment like market size, resource endowment and finally geographical location are beyond control of the policies, formulated and followed by a country (UNCTAD, 2003b). However, different macro-level economic

level policies may play important and active role in creating conducive environment for investments, particularly investment framework, and thus may support FDI inflows to be aligned with the economic prospective. Different countries may also workout on relevant economic determinants in order to enhance their economic prospective. It can be learnt from the FDI boom in East Asian countries prior to 1997, whereby accrual of FDI benefits mainly depends upon factors including growth, income, appropriate labor and infrastructure policy. Besides this, investors take help from macroeconomic fundamentals and other factors including stable policies regarding exchange rate, sustained growth and low inflation.

In this regard, several well-established theories may explain why FDI takes place and what are the potential determining factors, including market imperfection hypothesis by Hymer (1976), internalization theory by Rugman (1986), and eclectic approach by Dunning (1988). FDI flows may be vertical as well as horizontal. Specifically stating, Vertical Foreign Direct Investment takes place whereby factor prices are not generally equalized across countries. Stronger firm level scale economies and higher trade costs encourage FDI as compared with the exports. In this way, horizontal foreign direct investment takes place due to costs related to the trade (Markusen and Venables, 1999). As per Dunning (Dunning, 1988, 1993), MNCs attain three different kinds of benefits in producing abroad. Firstly, ownership gains, secondly locational benefits and finally internalization advantages. Broadly talking, ownership advantages include intangible assets of the firm like familiarity with production, a patented process/design, technology, marketing or management, or a registered brand. On the basis of such benefits, firm can decide whether to internalize the activities due to any failure of the market, connected with the transactions at arm's length, as in the case of intangible assets. Hence, operating abroad enables a company towards achieving less transaction related costs along with an increase in the productive efficiency. Locational advantages refer to (OLI) paradigm i.e. the eclectic ownership, location & finally internalization, that is mainly used for explaining foreign investment in the shape of FDI. While considering capital supply into a specific location, like South Asian economies, the

locational advantages holds a significant role. Locational advantages can influence the choice of location through a multitude of relevant factors. Nevertheless, they may be categorized into five groups: (a) macro-economic fundamentals (b) infrastructure facilities (c) availability & costs of inputs (specific) (d) market size & prospects for the growth and (e) FDI and trade related regulatory policies.

Till now, explaining determinants of FDI has a lot of literature support (Dunning, 1993; Globerman and Shapiro, 1999). FDI determinants may be categorized into two (a) economic conditions (b) host country policies. The firstly stated group i.e. economic conditions entail prospects for the growth, ROR, market size, labor cost, urbanization/industrialization, physical infrastructure, human capital and lastly macro-economic fundamentals such as external debt, inflation, tax regime etc. Similarly, recipient country's policies involve efficient financial market; trade policies/free trade policy/regional trade agreements, promotion of private ownership, FDI policies, and perception of country risk, legal framework, and quality of bureaucracy. As per researchers, FDI is crucial towards recipient country's economic policies like tax related policy. During 1990s, flow of private capital in the form of foreign direct investment has been among the remarkable features of globalization. FDI is regarded as a significant source of financing, development, and helps contributions towards productivity gains through the provision of better technology, new investment, export markets and management expertise.

Given shortage of the investment in different developing economies and resource constraints, market forces along with the private sector have attained more consideration as engine of the economic growth. According to neoclassical growth model, FDI increases volume of investment and its efficiency and thus promotes economic growth. Hence, all countries make efforts to attract FDI owing to the benefits for host country economy, it entails. Foreign investment, particularly FDI supplements sources for local investment and also performs as means for foreign exchange that may offer relaxation in the balance of payment constraints on the growth. Keeping in view importance and economic benefits of FDI towards economic growth, countries are mostly formulating changes in their policies in order

to gain FDI. According to studies, FDI elevates national welfare through augmenting volume and further efficiency of the investment via technology related diffusion, enhanced competitiveness, accumulation of human capital and finally implications of the accelerated spillover (Borensztein et al., 1998; Chakrabarti, 2001). As a whole, FDI flows into developing countries causes' growth via two different mechanisms, firstly, increasing total investment in the host country and secondly increasing productivity through technology and management spillover (De Mello Jr., 1999).

East/Southeast Asian countries and China have rapidly improved macro-economic conditions, employment, exports and investment from 1980s to 1990s by using large volumes of FDI. Likewise, private capital is now-a-days considered to be a source of investment and economic growth in South Asia. Just similar to developing countries, South Asian countries emphasize investment incentives through foreign firms. From 1980s till end of 1990s, trade liberalization, market reforms and massive competition regarding FDI have brought leverage in restrictions towards foreign investment. Besides, same also expanded FDI scope in all major sectors. Nevertheless, South Asian economies are unsuccessful as a whole in getting FDI. Volume of FDI towards these countries is low as compared to China, Singapore, Brazil and other East/Southeast Asian countries. South Asia could secure only 3% of the total FDI (the smallest FDI flows among developing Asian countries). Except India, all South Asian countries could attract negligible FDI inflows. Policy makers of these countries understand that in case of South Asia, sincere efforts and planning towards economic reforms should entail technology up-gradation, scale of the production and lastly appropriate connections towards globalized production system, with increasing integration, mainly by the participation of large MNCs. This region possesses many advantages for potential investors like single-digit inflation, high but relatively steady economic development, large local markets, increasing number of skilled labor, emerging entrepreneurial group and lastly consistently developing financial systems such as expansion of the capital markets. On above, South Asian countries are making efforts towards appropriate & compatible policies formulation along with provision of incentives to FDI in

different ways. Recently, impact of FDI on economies has been discussed at a very large scale. Opponents of FDI argue that MNCs bring Foreign Direct Investment and thus creates monopoly of the resources, introduce inappropriate technology, supplant domestic enterprises and cause balance of payments related problems through huge volumes of the remittances thereby. Following these facts, current study is an effort to check implications of FDI towards domestic investment, economic progress and exports in Pakistan, India, Nepal, Sri Lanka and Bangladesh. Remaining portions of this paper have been prepared as per followings: Section II covers macro-economic reforms in the South Asian countries; Section III checks policy framework of Foreign Direct Investment; Section IV analyzes sources, prevailing practices and finally FDI inflows patterns in South Asian economies and lastly Section V analyses effects and subsequently determinants of foreign direct investment in the South Asia.

Effects of the infrastructure availability accompanied by other different potential factors towards on FDI inflow has been a major topic of study, owing to its importance. In the context of economic development, FDI has been regarded as highly indispensable. The influence of the financial development towards FDI inflows may be negative beyond a critical level. However, role of political stability deems significant in the same context. There exists a concave association between financial development and FDI for each level of political risk. Yet, financial development may attain advantages of FDI inflows more efficiently, with higher levels of political stability. Hence, every level of financial development can be seen to be linked with higher FDI inflow levels. More precisely, greater political stability means threshold level that may correspond to the much higher levels of financial progress. As compared to the others, some factors such as investment profile, socioeconomic condition and stability of government are relatively more important. Hence, decreased political stability cannot allow an efficient financial infrastructure to gain more benefits in terms of attracting foreign investment. To examine the relationship held between (FDI) Foreign Direct Investment and the Financial Development and further to lend more support to the regression results, we examined the Granger causality between FDI and financial development.

Our empirical evidence shows direction of causality ‘from banking sector development indicators towards Foreign Direct Investment’ and thereby not the reverse. Hence, there exists unidirectional causal bond between FDI and growth of the banking sector. We also provide evidence of bi-directional link between FDI & stock market growth indicators indicating that FDI preliminary may increase & further growth of the stock market with different investment opportunities generated by FDI-related spillover and reciprocally development of the stock market attracts increased FDI. FDI can be defined as an investment made to acquire lasting interest in enterprises operating outside of the economy of the investor.

The role of FDI has been largely known as growth-enhancing factor in case of the developing nations. In this regard, FDI can enhance economic development in recipient country through many different channels by providing incentives for competition, different innovations and finally economic progress. In addition, FDI leads towards the transfer of managerial skills and technological knowledge. Technological advances implemented by multinationals may spill over to the rest of the economy, giving rise to beneficial externalities and encouraging domestic private activity (Borensztein et al., 1998). FDI played and still can play a crucial role in the economic development process in Latin American countries, the disappointing trend of FDI inflows in recent years has become a major concern of researchers and policymakers. Unfortunately, there has been little attention paid to the understanding of what determines FDI in Latin America. Hence, an important policy question is what key forces stimulate FDI in Latin America. An in-depth analysis of the aspects determining FDI inflows is needed, not only to understand the reasons why some countries are more successful in appealing FDI, but also to provide policymakers with guidelines on how to appeal more FDI inflows and hence economic growth. It distinguishes between the domestic and international determinants of FDI flows. There are many variables, such as market size, macroeconomic stability, openness to international trade, financial liberalization, quality of infrastructure, human capital, etc. as key determinants of FDI. However, global factors, for example international interest rates, impart really significant role towards determining FDI flows in the developing countries.

The role of international aspects on determining FDI flows to developing countries has been confirmed by a number of studies ([Chuhan et al., 1993](#); [Calvo et al., 1996](#); [Fernandez-Arias, 1996](#); [Bank, 1997a](#)). Regrettably, these researches fail to make a clear distinction whether FDI flows to developing countries are being determined by domestic or international aspects. Examining the relationship between FDI and financial development, the empirical discoveries provide evidence in support of a highly developed financial sector, as same can bring absorptive capacity in recipient nation, thus allowing these economies to absorb positive impacts of FDI, and promote their economic performance ([Claessens et al., 2001](#)). The evidence points out that policy formulation at either level (i.e. national, regional and international) should be based for attracting long-term flows. Specifically, reforming investment regulatory framework should be focused in order to diminish FDI limitations, implement such policies that may bring economic stability at macroeconomic level and improve educational as well as physical infrastructure.

Higher volumes of FDI may be ensured through consistent support towards FDI liberalization by means of both bilateral/ multilateral approaches, implementation of apposite monetary policies to bring economic reforms along with integration with global economy and continuing of the privatization process, hence, making a country more attractive for FDI. In the context of financial growth's role towards FDI, the evidence shows that FDI doesn't get directed in the dangerous countries, being financially underdeveloped as well as institutionally weak, however, FDI is positively interlinked with stock markets and growth in banking sector in Latin America. Consequently, the evidence proposes that Latin American economies must try to continue to inspire financial sector development in the economy to make it more appealing for foreign investors. Although financial development is not an easy task to achieve because it depends on regulatory capacity, investment culture and ownership structure of firms, [Levine and Zervos \(1998\)](#) noted that the policy of liberalizing international flow of the capital limitations can impact functioning of developing stock markets through increasing the integration with the world capital markets. This in turn may inspire developing markets to alter legal financial systems to support more trading and present greater variety of financial

instruments. Consequently, it could be easier for Latin American countries in the short and medium term to appeal more FDI if financial development is supplemented macroeconomic stability and open trade policies, together with a liberalized environment (Omran and Bolbol, 2003).

Theory provides contradictory expectations regarding the progress effects of FDI. Economic justification for proposing exceptional enticements to appeal FDI is based on the notion that technology transferences and spillovers can be obtained from foreign investment. For instance, Romer (1993) states that significant “idea gaps” exist between poor and rich nations. He observed that transmission of business and technological know-how towards poorer countries can be made possible only through foreign investment. Subject transfers can have considerable spill-over implications towards economy. In this way, foreign investment can enhance yield of all companies, leaving those which are in possession of foreign capital (Rappaport, 2000). In comparison, some philosophies foresee that FDI, in the presence of pre-existing trade, financial, price and different other distortions would slow down the growth through significant damage to the resource allocation (Brecher and Diaz-Alejandro, 1977; Brecher and Findlay, 1983). Accordingly, philosophy yields vague prophecies about the progress effects of FDI and some models suggest that FDI will only encourage progress under certain policy circumstances.

Examining the influence of foreign capital towards economic progress has significant strategy consequences. In case FDI has an optimistic influence towards economic progress, after making full control over endogeneity and rest of the evolution causes, this situation would arguments weaker for limiting foreign investment. However, in case we observe that FDI doesn't apply a positive influence on progress, this would propose a reassessment of the swift development of tax enticements, infrastructure subsidies, exclusions pertaining to the import duty, and other measures that the conventional wisdom proposes that financial development is a significant element and a significant contributor towards economic development for some reasons. Firstly, a developed financial system ensures conducive grounds towards resources allocation, fewer information asymmetries, economic progression and better monitoring. Financial system can make contributions towards the

economic in two ways. Firstly, financial system mobilizes the reserves; this usually upsurges share of the resources accessible for finance investment. Secondly, it performs screening and monitoring of the investment projects which indicates towards lowering information acquisition costs. In this way, it increases effectiveness of projects (Dutta and Roy, 1990). In this way, we can assume that a developed domestic financial system enables mobilization of savings and perform screening/monitoring of the investment projects, ultimately contributing towards higher economic progression.

Subsequently, credit rationing is dependent upon the financial system in economic markets and compels potential entrepreneurs that further determine economic progression. Same is particularly true upon arrival of a totally new technology, that brings enormous potential for tapping both domestic as well as export markets (Alfaro et al., 2004). Thirdly, financial sector may determine the level of borrowings by foreign companies to prolong their innovative activities in host country, thus, increasing scope for technological spillovers to the local firms. In this way, dispersion process can be more proficient if financial markets of host country are well developed, as it permits subsidiary of a MNC to intricate on investment upon arriving into the host country (Hermes and Lensink, 2003). A sound financial sector is a prerequisite for a country for materializing new innovations and to further exploit its resources proficiently. In this approach, finance deems to be a facilitator for development rather than as a main factor for progress. Finally, the effectiveness of financial market bears sound value towards economic development. Indeed, researchers have contained that level of vulnerability to the risk is less in those countries with effective financial systems (Beck et al., 2000).

Certainly, countries having strong institutions and financial markets that efficiently channel savings of the society for most beneficial use, usually enjoy rapid economic development (Bekaert et al., 2005). According to Blejer (2006), countries having effective financial systems are no more prone to banking and currency predicaments and less suffer in case of a predicament. Empirically, positive role of financial system on relationship between FDI and economic progression is already a stylized fact. In order to inspect whether 'financial development' supports a country to

get benefit from FDI, the researchers cooperated Foreign Direct Investment with diverse measures of the financial market growth. As per the outcomes, collaboration terms are commonly optimistic and substantial when FDI is interrelated with financial development indicators, highlighting role of financial development in profit making from FDI. A well-developed domestic financial system can impart important role in maximizing the influence of FDI towards economic growth i.e. countries having better-developed financial sectors observe rise in their evolution rates. Foreign Direct Investment, in case of economically developed countries, has matured swiftly following both political as well as financial changes. To upturn their portion regarding FDI flows, majority countries comfort limitations towards FDI, privatized state- owned enterprises, put efforts to strengthen macro stability, local financial reforms, liberalization of capital account, subsidies and instituted tax encouragements ([Bank, 1997b](#)). Furthermore, stock markets are settled & established to intermediary funds for different investment plans.

It is quite easy to observe positive implications of aforesaid structural changes towards gaining more FDI its further implications towards financial markets particularly stock market. For example, FDI to West African developing nations is amplified from 1.9to15.8 billion (approx) in 1995 & 2006 respectively. Market capitalization of developing countries got thrice time expansion from 2trillionto5 trillion approx during same era. These foreign investment groups have arisen as the main players in developing stock markets via purchasing of prevailing equity or by the recovery of the investment through selling of the equity in the capital market, However, degree of relative influence on evolving stock market progress of the nations has received quite less consideration. Financial Development of an economy is an important segment of the progress process.

[Beck et al. \(2000\)](#) argued that financial growth indicators are source to identify and further measure size, activity and effectiveness of financial mediators and markets. Economists including Schumpeter [Schive and Majumdar \(1911\)](#), have accepted the crucial role of financial system. According to Schumpeter [Schive and Majumdar \(1911\)](#), “The banker doesn’t mean to be the middleman in commodity buying power, being main producer for the subject commodity, the banker stands among

those intending to create new combinations along with possessors of different productive means. The banker is primarily phenomenon of the growth, although only under the circumstances whereby no central authority directs the social process and further ensures execution of new combinations, empowers masses using name of the ‘society’ as it were, to create them. The banker is the exchange economy ephor”. [Levine \(1997\)](#) re-established significance of effective financial markets in modern era. Besides carrying 1st order impact on progress, financial development also has a direct impact towards different other factors of economic development. Financial development may ensure to take more benefits from foreign aid in case of aid beneficiary countries ([Mwanza and Sayek, 2004](#)). In addition, according to [Beck et al. \(2003\)](#), countries having ‘efficient’ financial sector enjoy relevant proportional advantage mainly in the manufacturing industry. As per the approved preview regarding functions of financial development, channelizing resources proficiently, reducing information asymmetry problem, mobilizing savings enabling trading, supporting goods/services exchange, continuously mentoring the supervisors through corporate control, hedging, pooling and divergence of risk, are the main functions.

We reconsider relationship between financial development and FDI. In this regard, existing studies indicate aforesaid association from the perspective of progress ([Hermes and Lensink, 2003](#)). Besides this, another segment of the literature has linked ‘uneven dispersal’ of financial growth with concerned nation’s political stability ([Roe and Jordan Siegel, 2007](#)). They emphasize about importance of the political stability owing to its role towards building institutions like investor protection, beneficial for financial sector. Financial Development causes and brings greater FDI inflows, but up to a specific level and afterwards, aforesaid relationship becomes negative. However, existence of high political stability causes a favorable taste to all relationships as adverse effects set in at relatively more high level of financial progress. Hence, in order to materialize benefits of FDI, simultaneous existence of political stability and competent financial markets is indispensable. Financial development leads towards FDI Inflows, till a certain extent. After that the association tends to develop negative relationship. But Political stability adds

up a different dimension. The probability of developing economy, primarily like emerging markets and developing world rely upon ability to ensure profitability in investments and accumulating of the capital. In case of scarcity of the resources and necessary infrastructure facilities, foreign capital deems lonely to be option for such countries. However, few types of capital investments i.e. portfolio investments and short-term credits are more risky as these cannot recover back at once particularly during hard financial crisis and in this situation, foreign direct investment has the greatest advantage so nations must make efforts to attract such investment (Kose et al., 2003). Due to this fact, developing countries along with transition economies have rapidly responded since 1990s era and since then, FDI have reached good figures. As per IMF, FDI inflows have increased up to 23% during 1990s in developing countries. With developed financial infrastructure, the foreign companies can evaluate up to what extent they may borrow for the innovative activities and can ensure effective investment planning. Financial growth also augments Liquidity, hence, trading for the financial instruments, timing and subsequent settlement for such trades becomes relatively easy (Levine, 1997) which ultimately leads towards greater FDI inflow. Rioja and Valev (2004) established presence of a non-linear connection between FDI and development. Aforesaid bond between FDI inflows and financial growth is observed to be positive up to a certain extent of the financial growth.

Good financial institutions try to attract much foreign capital. However, regarding relatively higher levels of the financial growth, there is an adverse effect. Once a country attains higher financial development level, less foreign investment is required for boosting economy. Local investment can sufficiently sustain and further gear up economy growth rate. Levine (1997) states a close relationship between financial markets and institutions owing to important role of the later towards performance of the financial markets. On the basis of cross country regressions, Kapuria-Foreman (2007) found positive relationship between certain components of economic freedom and FDI. By considering aforesaid observations, we delve deeper into role of political risks towards either degrading or enhancing relationship between financial development and FDI. Different cross-country researches

have been based on the international data about impact of the variables related to policy i.e. protection of the intellectual property, uncertainty among institutions towards FDI inflows and corruption (Lee and Edwin, 1996; Brunetti and Weder, 1998; Wei, 2000).

Many studies have examined the effect of democratic institutions towards FDI inflows. However, one segment of the thought reveals that such relationship is positive. Democratic right can positively affect FDI inflows through improvement in property rights protection. Busse and Hefeker (2005) stated that few dimensions of political stability such as basic democratic rights, absence of both internal & external conflicts, efficient law & order system and governmental stability, plays significant role in determining FDI inflows. According to the literature on finance & law, those institutions have been regarded as important for financial growth that provide protection to the investors. According to Roe and Jordan Siegel (2007), political stability supports the economy for developing and fostering investor protection. An efficient financial market may be vital towards determining volume of FDI inflows to an economy however not necessarily sufficient. Besides this, political stability is significant with financial capability to attract foreign investors.

A proactive level of financial growth, while facing high political instability, would gain less as regard to FDI inflows. They have cited different evidences extracted from the available data, supporting our research hypothesis. Chile possesses sound economic infrastructure. However, during mid of the 1980s, Chile had comparatively higher political risks due to an unstable government, higher investment related risks and finally strong military involvement in politics. Resultantly, Chile could secure low FDI inflows during that era. Consequent upon political stability, greater influx of FDI was observed in the country. Similarly, in case of Malta, financial growth level and political stability deems essential towards FDI. The FDI amount rose from 2.46 units (1984) to 20.16 units (2003) as a percentage of GDP. There was substantial development in the financial infrastructure however same era also witnessed greater political stability. In this way, investment profile rose up i.e. from 7 to 11 as government stability shown upward trend from

7 to 10.5. During 1990s, through adapting economic reforms, specifically trade-related in aforesaid countries, they have attained substantial growth in imports & exports. In addition, Nepal, Bangladesh, India and Sri Lanka have significantly improved during the post-reform period in the external sector front including capital account, current account balance, foreign exchange reserves and a positive development improvement in balance of payments. Macro indicators have also experienced certain improvements excluding fiscal deficit, on domestic sector as well as external sector. In fact, South Asian market remained among the rapidly growing business regions during recent years. According to the aforesaid analysis, South Asian countries, excluding Pakistan, have significantly experienced much higher export growth during the period of 1990s as compared to 1980s. Although Pakistan could not achieve exports growth during 1990s, however, it has maintained a persistent rise of exports, in absolute value. All other countries have also followed more open macroeconomic policies, particularly emphasizing export promotion and thus experienced much higher financial growth during the era of 1990s. South Asian nations suffered a relatively tough regime during early years just after getting independence. It could be possible only during last decade for them to establish FDI policy environments, fairly conducive towards foreign investment.

At the outset, South Asian countries allowed FDI in a very restrictive manner and often on mutually advantageous terms with the majority stake held by local companies. However, with the passage of time, particularly during 1990s, South Asian countries made macro-level changes towards economic, trade and FDI policies and thus adapted more aggressive approach to encourage FDI. Through initiating economic reforms and bringing political stability along with getting rid of internal conflicts, South Asian region has become an attractive investment destination for FDI. Besides this, other ongoing measures like further simplification of rules/regulations and developments of infrastructure are easily expected to provide the necessary impetus to increase FDI inflows in the future. However, as an additional measure towards paving the way for FDI, the negative image of South Asian countries due to corruption, non-compatible labor laws and further law & order issues need to be addressed.

Chapter 3

Research Methodology

3.1 Data Description

Sample has been taken from following four emerging South-Asian economies: Bangladesh, India, Pakistan and Sri Lanka. Our data covers 1994 to 2006. We use under-mentioned two most common FDI indicators: ‘FDIGDP’ i.e. Ratio of FDI to GDP and ‘FDIGCF’ i.e. Ratio of FDI to gross fixed capital formation. In this regard, relevant data has been obtained using ‘World Development Indicators Database’ of World Bank. Regarding FMD, we made two subgroups of main five indicators through division: Stock market development (SMD) and Banking sector development (BSD). Stock market development indicators comprise of ratio of stock market capitalization to GDP (STKMKT CAP) and ratio of stock value traded as a percentage of GDP (STKVALTRA).

Banking sector development indicators comprise the ratio of private credit by deposit money banks and other financial institutions to GDP (CREDIT) and ratio of commercial bank assets divided by commercial bank plus central bank assets (CCB). World Bank’s Global Development Finance database and International Monetary Fund’s International Financial Statistics database has been used to obtain relevant data, Model Specifications, Cross-sectional analyses, panel procedures, along with simultaneous equations system for FDI and FMD determinants has been used in the methodology.

$$\begin{aligned}
 \text{FDI}_{it} &= a_0 + a_1 \text{FMD}_{it} + a_2 \text{EDUCATION}_{it} + a_3 \text{INFLATION}_{it} + a_4 \text{EXHRATE}_{it} \\
 &+ a_5 \text{GOVERNANCE}_{it} + a_6 \text{LOG}(\text{GDP}_{it-1}) + a_7 \text{OPENNESS}_{it} + a_8 \text{NATRES}_{it} \\
 &+ a_9 \text{INFRAS}_{it} + \epsilon_{it}, \quad (1) \\
 \text{FMD}_{it} &= b_0 + b_1 \text{FDI}_{it} + b_2 \text{EDUCATION}_{it} + b_3 \text{INFLATION}_{it} + b_4 \text{EXHRATE}_{it} \\
 &+ b_5 \text{GOVERNANCE}_{it} + b_6 \text{Log}(\text{GDP}_{it-1}) + b_7 \text{BALANCE}_{it} + b_8 \text{INTRATE}_{it} + \nu_{it}. \quad (2)
 \end{aligned}$$

The explanatory control variables have been chosen after studying the available literature regarding determinants of FDI and FMD. We have used following control variables for the estimation of determinants: Economic and policy variables: ‘EDUCATION’ refers to (GER) i.e. gross enrolment ratio pertaining to all educational levels. Quality of a country’s human capital can be gauged by checking the level of education. Similarly, ‘INFRAS’ is the infrastructure measure equal to Log i.e. number of phones/1000 residents. In this regard, infrastructure development level of a country is key determinant of FDI inflows. ‘NATRES’ refers to natural resources, measured through considering portion of minerals and fuel in country’s exports. As regards to the countries having substantial reserves of natural resources, ‘NATRES’ is the main determinant of FDI. ‘EXHRATE’ refers to exchange rate variable which shows domestic currency value and primarily utilized as proxy for a country’s potential & attractiveness towards macroeconomic stability and foreign investment.

In addition, ‘INFLATION’ refers to the rate of inflation calculated through %age change in the GDP deflator and sound proxy towards macro-economic stability. Inflation has a negative impact on BSD indicators as same has a negative effect on cost of capital and borrowing rates. By considering a high inflation scenario, inflation might be comparatively cheaper for the companies towards raising money via stock markets instead of bank loans, so its effect on SMD indicators can be positive. ‘INTRATE’ is actual interest rate that is primarily calculated by lending interest rate adjusted against the inflation (measured via GDP deflator). ‘INTRATE’ might be taken as proxy for the magnitude of lending from financial institutions. Higher actual interest rate may possibly hamper entire lending activities of the banks, thus, increasing banks’ liquidity by creating imbalance between credit and deposit activities.

‘BALANCE’ is current account balance over total Gross Domestic Product and a simple indicator showing strength of the macro-economic environment. ‘OPENNESS’ is degree of openness that equals to imports plus exports over Gross Domestic Product. As per literature about determinants of FDI, ‘OPENNESS’ is regarded as a significant determinant for country’s attractiveness towards FDI. Hence, it can be contained that ‘OPENNESS’ can impact FDI significantly and positively. Governance and institutional quality variables: Governance refers to level of the quality of the country’s institutions. KKM Index is used to measure governance, developed by Kaufmann, Kraay and Mastruzzi (2009). This Index uses average of six (06) different indicators measuring (a) voice and the accountability (b) political stability and absence of violence (c) quality of regulatory system (d) government effectiveness (e) rule of the law and (f) control over corruption.

3.2 Estimation Techniques

Unit root test is applied to check whether a time series data possess unit root or variables is non stationary. Levin, Lin & Chu, Im, Pesaran and Shin W-stat, ADF - Fisher Chi-square PP - Fisher Chi-square test are applied to check the unit root of the data. Further we have applied the correlation analysis to determine the correlation of the FDI and FMD variables. Correlation only determine the interdependence of variables but it does not imply the causality among the variables, to determine the causal relationship we have applied Granger causality test.

To determine the relationship among the variables we have applied least square regression analysis. Detail results of the test are explained in chapter 4. While the following equations are estimated through regression analysis.

$$1 \text{ FDI}_{it} = a_0 + a_1 \text{ FMD}_{it} + a_2 \text{ EDUCATION}_{it} + a_3 \text{ INFLATION}_{it} + a_4 \text{ EXHRATE}_{it} + a_5 \text{ GOVERNANCE}_{it} + a_6 \text{ LOG (GDP}_{it-1}) + a_7 \text{ OPENNESS}_{it} + a_8 \text{ NATRES}_{it} + a_9 \text{ INFRAS}_{it} + \epsilon$$

$$2 \text{ EQ } 2\text{FMD}_{it} = b_0 + b_1 \text{ FDI}_{it} + b_2 \text{ EDUCATION}_{it} + b_3 \text{ INFLATION}_{it} + b_4 \text{ EXHRATE}_{it} + b_5 \text{ GOVERNANCE}_{it} + b_6 \text{ Log(GDP}_{it-1}) + b_7 \text{ BALANCE}_{it} + b_8 \text{ INTRATE}_{it}$$

Furthermore Autoregressive distributed lag (ARDL) model is applied to determine the long run relationship of the variables. It includes the lag of variables too.

Chapter 4

Results and Discussion

4.1 Graphical Representation of Data.

This section includes the graphical representation of sum of variables for four selected countries from the period 1996 to 2016.

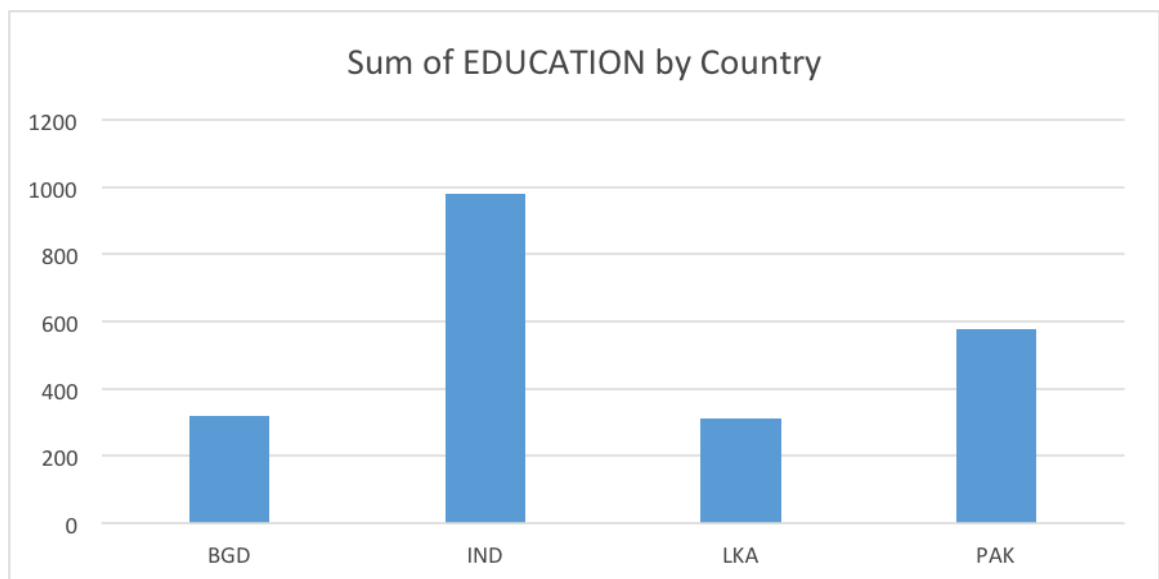


FIGURE 4.1: Sum of education by country

The above table shows the sum of education parameter for the selected four countries. India having the highest score followed by Pakistan. Bangladesh and Sri Lanka shows the equal trend.

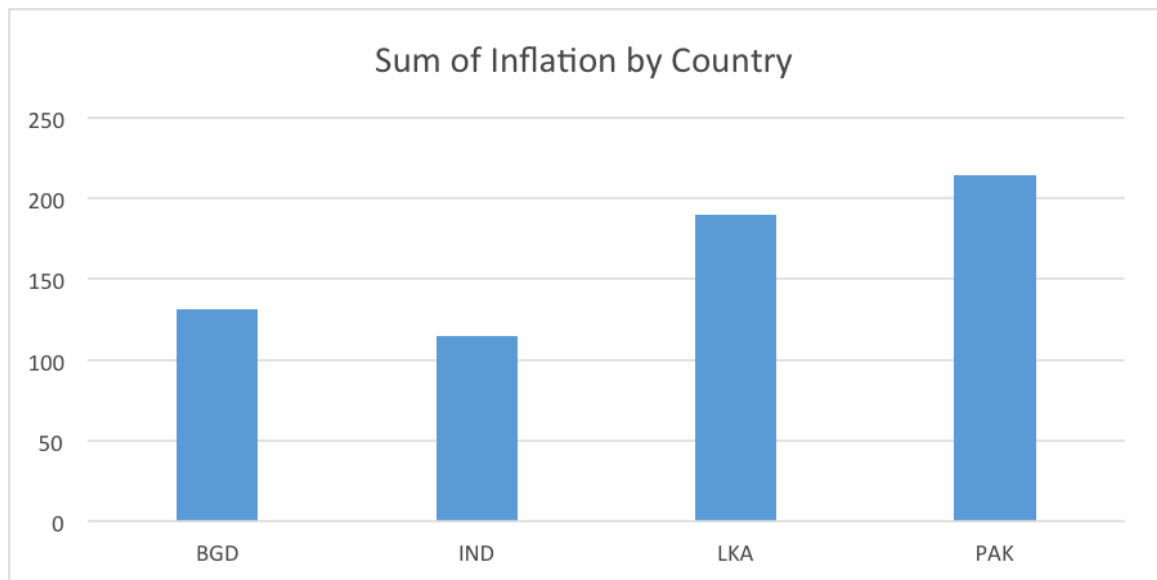


FIGURE 4.2: Sum of inflation by country

The above bar graph shows the sum of inflation in selected countries, Pakistan being the highest followed by Sri Lanka, Bangladesh, and India. From the above graphical representation, India is the country that has the lowest inflation over the period of 1996 to 2016.

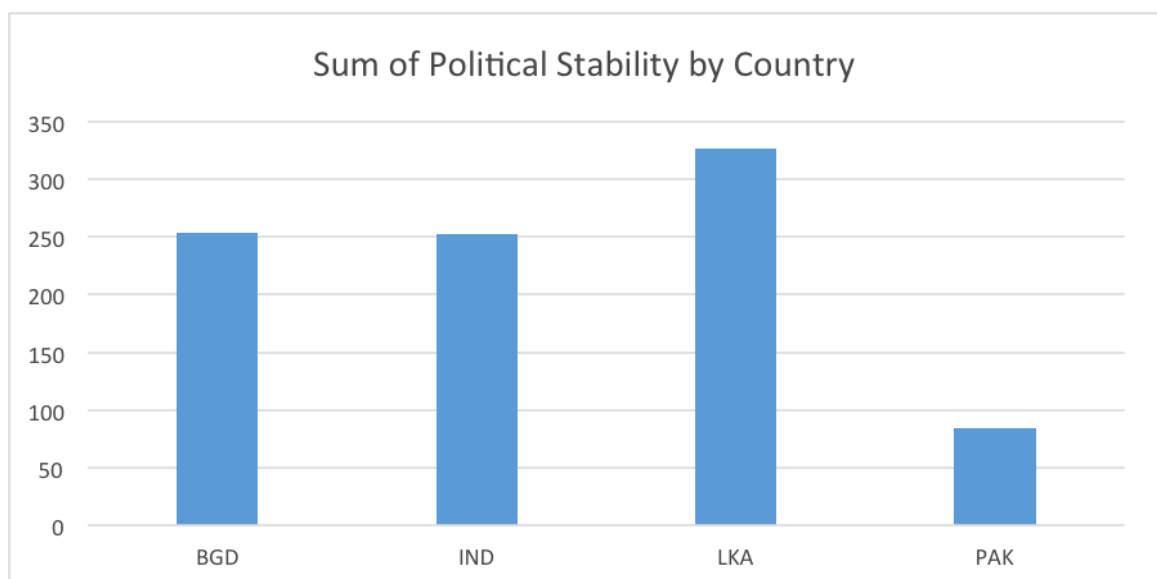


FIGURE 4.3: Sum of political stability by country

The above graph shows the political stability sum in the selected countries, highest political stability is in Srilanka while Bangladesh and India at same level followed by the lowest political stability in Pakistan from 1996 to 2016.

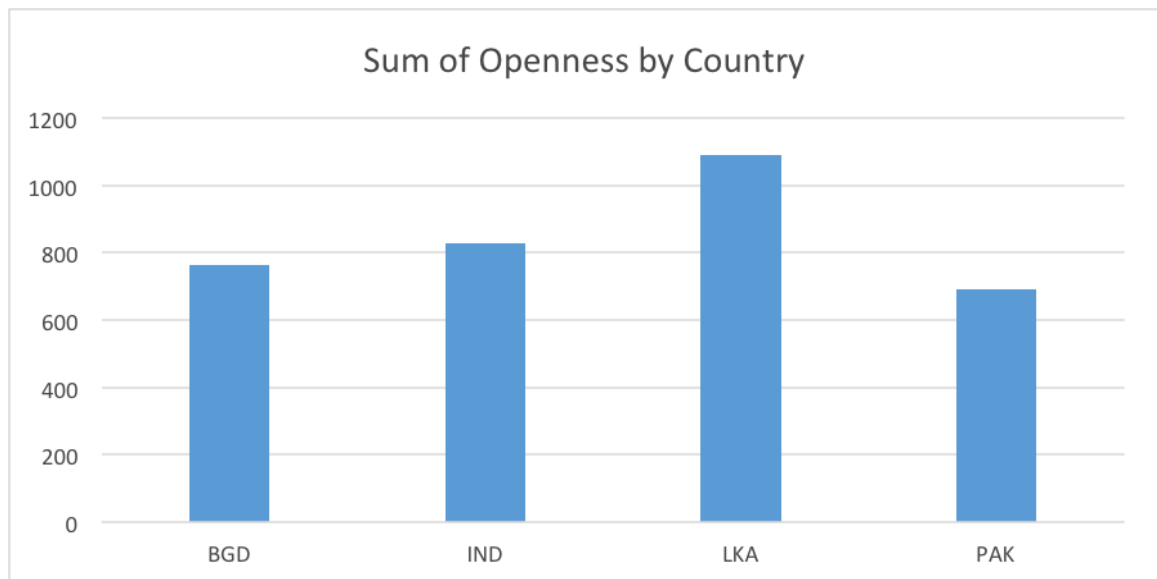


FIGURE 4.4: Sum of openness by country

The above graph shows the trend in market openness in the selected countries. Srilanka shows the highest market openness value while India and Bangladesh at almost same level. Pakistan shows the lowest level of market openness.

The above graph shows the sum of governance in selected countries, India and Srilanka shows the highest governance value while Pakistan and Bangladesh shows same low value as compare yo India and Srilanka over the course of 1996 to 2016.

The above mention graph shows the sum of Infrastructure in the selected countries, Srilanka leads the other coubtries with the highest infrastructure value followed by Pakistan, India and Bangladesh over the period of 1996 to 2016.

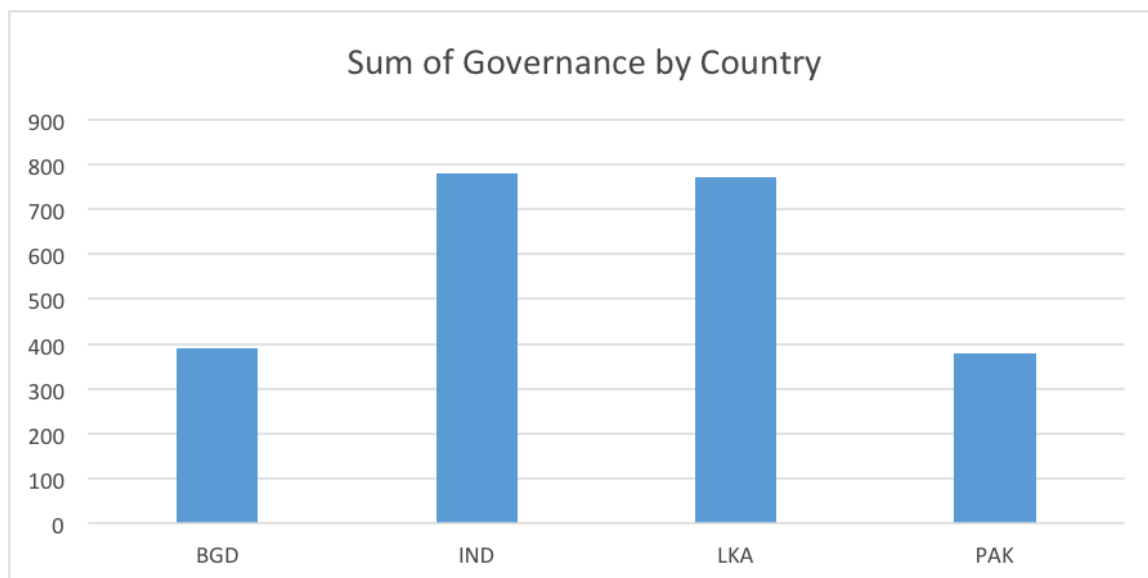


FIGURE 4.5: Sum of governance by country

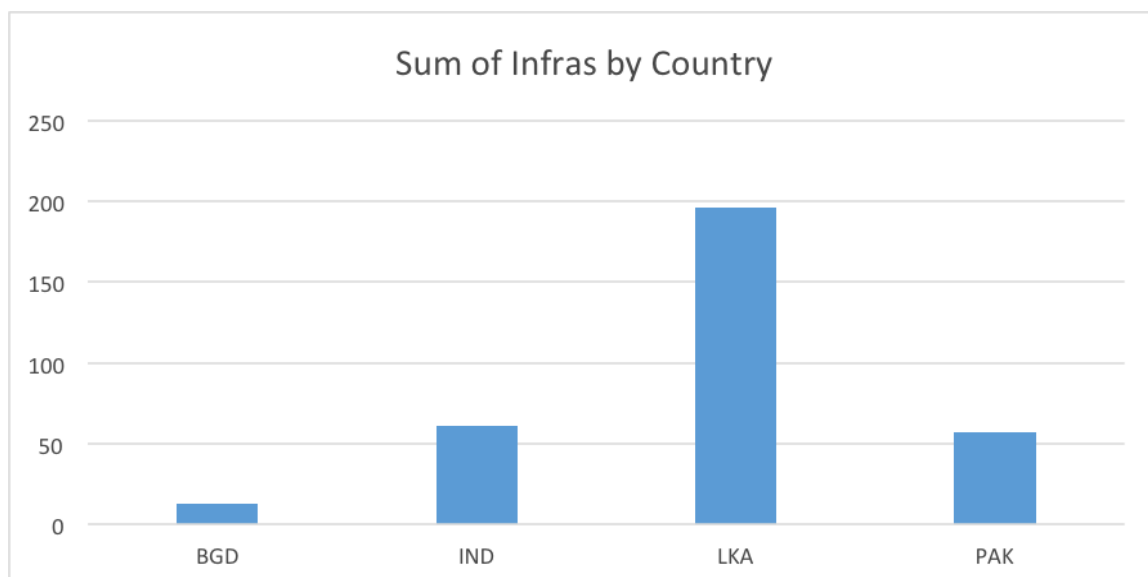


FIGURE 4.6: Sum of infras by country

4.2 Unit Root Test

Unit root test is performed to check the stationarity of FDI and FMD variables. For heterogeneous panel data, we use Levin, Lin and Chu (2002) and Im, Perasan and Shin (2003) tests. In addition, we also use Dikey-Fuller (ADF) and Phillips-Perron (PP) unit root tests.

Table 4.1 shows the results of Unit root test of FDI and FMD variables. According to all panel unit root tests, FDIGDP is stationary. While Credit, STKMKRTCAP,

TABLE 4.1: Results of Unit root test

Method	Credit		STKMKRTCAP		STKVOLTRA		FDIGDP		CCB	
	Statistic	Prob.**	Statistic	Prob.**	Statistic	Prob.**	Statistic	Prob.**	Statistic	Prob.**
Levin, Lin & Chu t*	-0.6534	0.2567	-1.64774	0.0497	-1.2675	0.103	-2.0535	0.020	-2.052	0.020
Im, Pesaran and Shin W-stat	0.52256	0.6994	-0.52451	0.3000	-1.1091	0.134	-1.5654	0.059	-0.663	0.254
ADF - Fisher Chi-square	5.94708	0.6532	8.23762	0.4106	11.1299	0.194	16.914	0.031	9.029	0.340
PP - Fisher Chi-square	2.97709	0.9358	9.73360	0.2842	9.72698	0.285	16.079	0.041	7.656	0.468
First Difference										
Levin, Lin & Chu t*	-1.8856	0.0297	-6.57696	0.000	-4.7103	0.000	-2.3469	0.010	-6.3695	0.000
Im, Pesaran and Shin W-stat	-1.8077	0.0353	-5.0423	0.000	-3.0281	0.001	-3.6783	0.000	-4.9222	0.000
ADF - Fisher Chi-square	15.2072	0.0552	38.274	0.000	23.8895	0.002	28.428	0.000	37.358	0.000
PP - Fisher Chi-square	27.5891	0.0006	66.8194	0.000	44.9343	0.000	135.32	0.000	73.807	0.000

STKVOLTRA and CCB are non stationary at level, so we take first difference test and at first difference level all of the panel unit root test depicts that it become stationary.

4.3 Correlation Analysis

TABLE 4.2: Correlation between FDI and FMD variables.

Correlation	CREDIT	CCB	FDIGCF	FDIGDP	STKMKRTCAP	STKVOLTRA
CREDIT	1.000000					
CCB	0.174379	1.000000				
FDIGCF	0.098152	0.280126	1.000000			
FDIGDP	0.472010	0.368394	0.480101	1.000000		
STKMKRTCAP	0.678958	0.241011	0.064658	0.446897	1.000000	
STKVOLTRA	0.361420	0.274858	0.163065	0.509917	0.690059	1.000000

Table 4.2 represents the correlation between FDI and FMD variables. The results show that there exist a positive correlation between FDI and FMD variables with the highest value of 69%. We have also observed positive correlation between FDIGDP and five FMD variables.

4.4 Causality Test

To check the causal relationship between FDI and FMD variables we perform Granger Causality test. We have categorized the FMD variables into two categories: Stock market development (SMD) indicators (STKMKRTCAP and STKVALTA)

and Banking sector development (BSD) indicators (CREDIT, and CCB). Depending upon the Unit Root test we have taken the first level lag for CREDIT, STKMKRTCAP, STKVALTA and CCB. Further we denote these variables as DSTKMKRTCAP, DSTKVALTA, DCCB and DCREDIT

Causality test between FDI and SMD

DSTKMKRTCAP TO FDIGDP

Pairwise Granger Causality Tests

Sample: 1996 2016

Lags: 1

TABLE 4.3: Causality test between FDI and SMD

Null Hypothesis:	F-Statistic	Prob.
STKMKRTCAP does not Granger Cause FDIGDP	15.97	0.0002
FDIGDP does not Granger Cause STKMKRTCAP	2.083	0.1534

Table 4.3 shows the results of Granger causality test of STKMKRTCAP on FDIGDP. As per the null hypothesis of aforesaid test, STKMKRTCAP does not granger cause the FDIGDP. The probability value is less than 0,05 which implies that we cannot accept null hypothesis rather we accept alternative hypothesis which implies that DSTKMKRTCAP granger cause the FDIGDP. While there is no bidirectional causality at difference level 1.

DSTKVOLTRATO FDIGDP

Pairwise Granger Causality Tests

Sample: 1996 2016

Lags: 1

TABLE 4.4: Granger causality test of STKMKRTCAP on FDIGDP.

Null Hypothesis:	F-Statistic	Prob.
STKVOLTRA does not Granger Cause FDIGDP	23.09	0.000009
FDIGDP does not Granger Cause STKVOLTRA	1.355	0.2485

Table 4.4 shows the results of granger causality test of DSTKMKTVALTRA to FDIGDP. With 23% confidence level results shows that DSTKVOLTRA Granger cause FDIGDP.

Whereas there is no bidirectional causality is observed at difference level 1.

So, from the above results we infer that SMD variables Granger because the FDIGDP at difference level one but FDIGDP does not Granger cause the SMD variables. It can be further investigate at difference level two.

Causality test between FDI and BSD

DCREDIT TO FDIGDP

Pairwise Granger Causality Tests

Sample: 1996 2016

Lags: 1

TABLE 4.5: Granger causality test of BSD variable

Null Hypothesis:	F-Statistic	Prob.
CREDIT does not Granger Cause FDIGDP	4.328	0.0412
FDIGDP does not Granger Cause CREDIT	11.32	0.0013

Table 4.5 shows the results of Granger causality test of BSD variable CREDIT to FDIGDP. It is evident from the above results that CREDIT Granger cause the FDIGDP. It is also observed here that FDIGDP Granger cause CREDIT as well. So there is a bidirectional causal connection amongst FDIGDP and CREDIT.

CCB TO FDIGDP

Pairwise Granger Causality Tests

Sample: 1996 2016

Lags: 1

TABLE 4.6: Causality test of CCB on FDIGDP.

Null Hypothesis:	F-Statistic	Prob.
CCB does not Granger Cause FDIGDP	0.00	0.9776
FDIGDP does not Granger Cause CCB	0.34462	0.5591

Table 4.6 shows the result of causality test of CCB on FDIGDP. The probability value implies that CCB does not Granger cause FDIGDP. Same result implies on bidirectional analysis at difference level one.

4.5 Regression analysis

In case of most of the FMD factors, our examiners countries of quick causality tests among FDI & FMD are dubious. To accomplish our target of concentrate the connection amongst FDI & FMD, along these lines we perform Least Square Regression investigation on following conditions.

$$\text{Eq1: } \text{FDI}_{it} = a_0 + a_1 \text{FMD}_{it} + a_2 \text{EDUCATION}_{it} + a_3 \text{INFLATION}_{it} + a_4 \text{EXHRATE}_{it} + a_5 \text{GOVERNANCE}_{it} + a_6 \text{LOG (GDP}_{it-1}) + a_7 \text{OPENNESS}_{it} + a_8 \text{NATRES}_{it} + a_9 \text{INFRA}_{it} + \epsilon$$

Dependent Variable: FDI

Method: Least Squares

Cross-sections included: 4

Total panel (balanced) observations: 84

TABLE 4.7: Regression analysis of Eq1.

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-0.341872	0.624294	-0.547614	0.5856
FMD	-0.012521	0.003488	-3.590006	0.0006
EDUCATION	0.001055	0.003427	0.307943	0.7590
INFLATION	-0.038268	0.015381	-2.488089	0.0151
EXHRATE	-0.020662	0.006341	-3.258542	0.0017
GOVERNANCE	-0.004693	0.002227	-2.107188	0.0384
OPENNESS	0.063349	0.010013	6.326740	0.0000
NATRES	0.358416	0.034671	10.33755	0.0000
INFRAS	-0.047432	0.054002	-0.878345	0.3826
R-squared	0.839534	Mean dependent var	1.194177	
Adjusted R-squared	0.822418	S.D. dependent var	0.473295	
S.E. of regression	0.199449	Akaike info criterion	-0.285562	
Sum squared resid	2.983484	Schwarz criterion	-0.025118	
Log likelihood	20.99362	Hannan-Quinn criter.	-0.180866	
F-statistic	49.04867	Durbin-Watson stat	1.870541	
Prob(F-statistic)	0.000000			

The Table 4.7 shows the results of Regression analysis of Eq1. Where FDI is dependent variable and FMD, EDUCATION, INFLATION, EXHRATE, GOVERNANCE, LOG(GDPit-1), OPENNESS, NATRES, and INFRAS are independent variable.

The results show that FMD, INFLATION, EXHRATE, NATRES and OPENNESS are the significant predictors for FDI. Whereas other predictors are insignificant. NATRES and OPENNESS show positive relation. The model fitness for the EQ1 is almost 83%.

$$\text{EQ 2 } \text{FMD}_{it} = b_0 + b_1 \text{FDI}_{it} + b_2 \text{EDUCATION}_{it} + b_3 \text{INFLATION}_{it} + b_4 \text{EXHRATE}_{it} + b_5 \text{GOVERNANCE}_{it} + b_6 \text{BALANCE}_{it} + b_7 \text{INTRATE}_{it}$$

Dependent Variable: FMD

Method: Panel Least Squares

Cross-sections included: 4

Total panel (balanced) observations: 84

TABLE 4.8: Regression analysis of EQ 2.

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-13.64145	13.50026	-1.010458	0.3155
FDI	11.37533	2.930590	3.881585	0.0002
EDUCATION	-0.301257	0.120927	-2.491227	0.0149
INFLATION	1.641300	0.734345	2.235054	0.0284
EXHRATE	0.198796	0.139360	1.426496	0.1578
GOVERNANCE	0.074741	0.104211	0.717210	0.4754
BALANCE	0.313404	0.882253	0.355231	0.7234
INTRATE	1.100881	0.806217	1.365490	0.1761

R-squared	0.310094	Mean dependent var	25.21716
Adjusted R-squared	0.246550	S.D. dependent var	10.70529
S.E. of regression	9.292349	Akaike info criterion	7.386653
Sum squared resid	6562.429	Schwarz criterion	7.618159
Log likelihood	-302.2394	Hannan-Quinn criter.	7.479716
F-statistic	4.879997	Durbin-Watson stat	0.925150
Prob(F-statistic)	0.000139		

Table 4.8 Shows the results of regression analysis of EQ 2 where FMD is the dependent variable and FDI, EDUCATION, INFLATION, EXHRATEit , GOVERNANCE, Log(GDPit-1), BALANCE, INTRATE are independent variables. The

results shows that FDI, EDUCATION and INFLATION are the significant predictors for FMD where as other are insignificant predictors.

4.6 Autoregressive Distributed Lag (ARDL) Model

$$1 \text{ FDI}_{it-1} = a_0 + a_1 \text{ FMD}_{it-1} + a_2 \text{ EDUCATION}_{it-1} + a_3 \text{ INFLATION}_{it-1} + a_4 \text{ EXHRATE}_{it-1} + a_5 \text{ GOVERNANCE}_{it-1} + a_6 \text{ OPENNESS}_{it-1} + a_7 \text{ NATRES}_{it-1} + a_8 \text{ INFRAS}_{it-1}$$

Dependent Variable: D(FDI)

Method: ARDL

Sample: 1996 2016

Included observations: 80

Maximum dependent lags: 1 (Automatic selection)

Model selection method: Akaike info criterion (AIC)

Dynamic regressors (1 lag, automatic): FMD EDUCATION INFLATION EXHRATE
GOVERNANCE OPENNESS NATRES INFRAS

Fixed regressors: C

Number of models evaluated: 1

Selected Model: ARDL(1, 1, 1, 1, 1, 1, 1, 1, 1)

TABLE 4.9: Results of ARDL model with 1 lag.

Variable	Coefficient	Std. Error	t-Statistic	Prob.
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Long Run Equation

FMD	-0.016734	0.002702	-6.194095	0.0000
EDUCATION	0.013758	0.003853	3.571168	0.0010
INFLATION	-0.224837	0.012439	-18.07515	0.0000
EXHRATE	-0.082625	0.003976	-20.78077	0.0000
GOVERNANCE	-0.049327	0.002532	-19.48274	0.0000
OPENNESS	0.117305	0.004378	26.79239	0.0000
NATRES	0.977622	0.025389	38.50598	0.0000
INFRAS	-0.286879	0.020696	-13.86182	0.0000

Short Run Equation

COINTEQ01	-0.815829	0.000000	NA	0.0000
D(FMD)	0.007710	0.000000	NA	0.0000
D(EDUCATION)	-0.004088	0.000000	NA	0.0000
D(INFLATION)	0.090250	0.000000	NA	0.0000
D(EXHRATE)	0.044370	0.000000	NA	0.0000
D(GOVERNANCE)	0.017691	0.000000	NA	0.0000
D(OPENNESS)	-0.004926	0.000000	NA	0.0000
D(NATRES)	-0.295365	0.000000	NA	0.0000
D(INFRAS)	-0.501139	0.000000	NA	0.0000
C	2.445953	0.000000	NA	0.0000

Mean dependent var	0.025886	S.D. dependent var	0.362723
S.E. of regression	0.038649	Akaike info criterion	-3.111524
Sum squared resid	0.053775	Schwarz criterion	-1.722486
Log likelihood	178.6840	Hannan-Quinn criter.	-2.553143

Table 4.9 shows the results of ARDL model with 1 lag. FDI is the dependent variable while FMD, EDUCATION, INFLATION, EXHRATE, GOVERNANACE, OPENNESS, NATRES and INFRAS are independent variable. The hypothesis of ARDL model are following. Ho=No integration equation.

H1= Ho is not true.

From the above mention results that, in long run relationship as well as short run relationship there exist a co integration among FDI and FMD variables.

$$2 \text{ FMD}_{it-1} = b_0 + b_1 \text{ FDI}_{it-1} + b_2 \text{ EDUCATION}_{it-1} + b_3 \text{ INFLATION}_{it-1} + b_4 \text{ EXHRATE}_{it-1} + b_5 \text{ GOVERNANCE}_{it-1} + b_6 \text{ BALANCE}_{it-1} + b_7 \text{ INTRATE}_{it-1}$$

Dependent Variable: D(FMD)

Method: ARDL

Sample: 1996 2016

Included observations: 80

Maximum dependent lags: 1 (Automatic selection)

Model selection method: Akaike info criterion (AIC)

Dynamic regressors (1 lag, automatic): FDIGDP EDUCATION INFLATION EXHRATE GOVERNANCE BALANCE INTRATE

Fixed regressors: C

Number of models evaluated: 1

TABLE 4.10: Results of ARDL model with lag 1

Variable	Coefficient	Std. Error	t-Statistic	Prob.
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Long Run Equation

FDI	-281.0467	423.7699	-0.663206	0.5109
EDUCATION	1.098267	4.181941	0.262621	0.7942
INFLATION	9.490517	10.41456	0.911274	0.3675
EXHRATE	-7.236139	12.45584	-0.580944	0.5645
GOVERNANCE	20.23812	27.74488	0.729436	0.4699
BALANCE	-57.35951	85.89148	-0.667814	0.5080
INTRATE	37.87986	54.25998	0.698118	0.4890

Short Run Equation

COINTEQ01	-0.067553	0.000000	NA	0.0000
D(FDIGDP)	3.096371	0.000000	NA	0.0000
D(EDUCATION)	-0.372382	0.000000	NA	0.0000
D(INFLATION)	0.420536	0.000000	NA	0.0000
D(EXHRATE)	-1.501139	0.000000	NA	0.0000
D(GOVERNANCE)	-0.703920	0.000000	NA	0.0000
D(BALANCE)	0.402888	0.000000	NA	0.0000
D(INTRATE)	-0.400455	0.000000	NA	0.0000
C	3.177057	0.000000	NA	0.0000

Mean dependent var	0.423737	S.D. dependent var	8.261119
S.E. of regression	3.808502	Akaike info criterion	5.637037
Sum squared resid	594.6923	Schwarz criterion	6.881383
Log likelihood	-193.7555	Hannan-Quinn criter.	6.137254

Table 4.10 shows the results of ARDL model with lag 1 where FMD is independent variable and FDI, EDUCATION, INFLATION, EXHRATE, GOVERNANCE, BALANCE and INTRATE. The results show that in long run relationship there is no co integration but if we see the results of short run relation the p value is less than 0.05 which clearly shows that there exist a co integration between FDI and FMD variables.

Chapter 5

Conclusion and Recommendations

This study empirically examines relationship between FDI and financial market development. For this purpose, we hereby consider (04) emerging markets of South Asia. The data ranges from 1996 to 2016, using indicators from the growth of both stock market as well as banking sector. We not only used Granger Causality but also used Regression analysis. We observe positive relationship between FDI and stock market development indicators whereas when we study the development indicators in banking sector, the causality seems inconclusive and ambiguous.

We use Unit root test to check the stationarity of the of FDI and FMD variables. Unit root test shows that FDIGDP is stationary while STKMRKTCAP, STK-VOLTRA and CCB are non-stationary at level but at first difference it becomes stationary. There exist a positive correlation between FDI and FMD variables. We donot rely on correlation of variables further statistical test are implied draw a meaningful conclusion. In order to check casual relation between FDI and FMD variables we use Granger Causality test. The SMD variables granger cause the FDIGDP at level but it is inverse in vice versa.The BSD variable DCREDIT granger cause the FDIGDP and vice versa but contrary to this CCB does not granger cause the FDIGDP and same result is for FDIGDP to CCB.

The regression analysis shows that the FMD, INFLATION, EXHRATE, NATRES and OPENNESS are the significant predictors of FDI. From this we can conclude that, at policy making level to attract FDI in our selected countries policy makers should focus on these variables. NATRES and OPENNESS shows positive relation with FDI which implies that market openness and investor friendly policies can attract FDI in country.

There is a room for further investigation that if we can apply the market openness model of European Union to our selected countries. Our study suggest that countries rich in natural resources are taken edge in attracting FDI to the country. Pakistan is rich in natural resources the decision makers should use it to device monetary and fiscal policies to attract FDI in Pakistan.

The results of FMD regression analysis shows that FDI, EDUCATION and INFLATION are positively significant indicators of FMD which implies that if we want to develop the financial markets GDP and NATRES should be given focus as explained earlier in case of FDI. From both of the result we can draw the conclusion that if GDP growth is increased and natural resources of countries are given focus we can develop the financial markets which can better attract the foreign direct investment. The ARDL model with lag 1 indicates that there exist a co integration between FDI and FMD in short and long run relationship.

Foreign investment, in one way, augments local stock markets through the impacts of its investment spillover. Obviously, it alleviates the probability of the affiliates to be listed on local stock markets which are already attached with the MNCs involved in different FDI activities. It is so because MNCs prefer to hail from 'Industrialized Countries' having the tradition of financing through the stock market. In addition, from the perspective of political economy argument, we can conjecture that political elite is highly encouraged to follow market-oriented regulations particularly better governance regulations and investor protection due to FDI inflows: thereby promoting stock market development. On the contrary, a comparatively more developed stock market better attracts foreign investors, being a market-friendly environment, vitality symbol and openness by country higher authorities. In case of emerging markets, this concept works even better where development

in stock markets is keenly focused as compared to the markets of other developing countries

5.1 Future Recommendations

Findings of this study recommend formulation of a key policy duly accompanied by a system of market-oriented regulations, particularly pertaining to stock market like procedures to protect investors and improve governance to attract more FDI. This would definitely enable other economies to attract maximum gains from spillover effects of FDI. Market openness also contributes to attract FDI in the emerging markets. Market openness allows to build domestic regulatory process to ensure the trade and investment friendliness of domestic markets. This research is limited to the selected emerging markets. Furthermore this study can be explored as a comparative study between different countries. As we have mention in the conclusion section European Union and emerging markets can be analyze at same pattern with different variables.

As the study suggest that market openness is positive indicator of financial market development this study can further be explore in the view of countries given GSP (Generalized System of Preferences) plus status, where tarrif subsidies are given to countries from the rules of world trade organization WTO.

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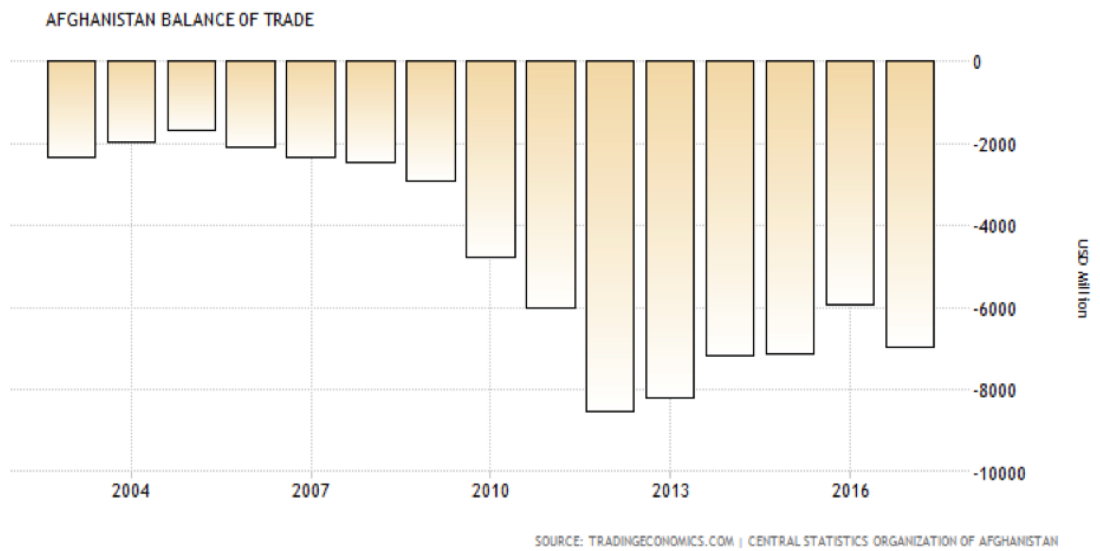
Appendix

Countries' Profile

Consequent upon end of the decades full of war, economy of Afghanistan is gradually recovering, particularly since 2001 i.e. after fall of Taliban regime. This happened due to infusion of global support, revival & subsequent growth of both agricultural as well as service sector. Despite recent progress, poverty level in Afghanistan is still alarming, and entirely at the mercy of external support. Majority of the masses are still suffering from starvation, lack of proper housing, electricity, clean water, medical facilities and employment. Lawbreaking, weak governance, lack of infrastructure, insecurity and government's struggle for outspreading rule of law throughout the country are all firm challenges for economic growth in future. Living standards of Afghani people are ranked at almost lowest level globally. Foreign supporters are committed for development in Afghanistan, promising above \$67 billion during nine different donors' conferences from 2003-2010. During July 2012, Tokyo conference vowed further \$16 billion in the shape of civilian aid through 2015. Despite aforesaid support, Afghanistan still needs to overcome several challenges, such as anemic job creation, high levels of corruption, weak government capacity, low revenue collection and finally poor public infrastructure (Figures reference [WorldBank \(2018\)](#)).



Afghanistan GDP from Agriculture



Afghanistan balance of trade

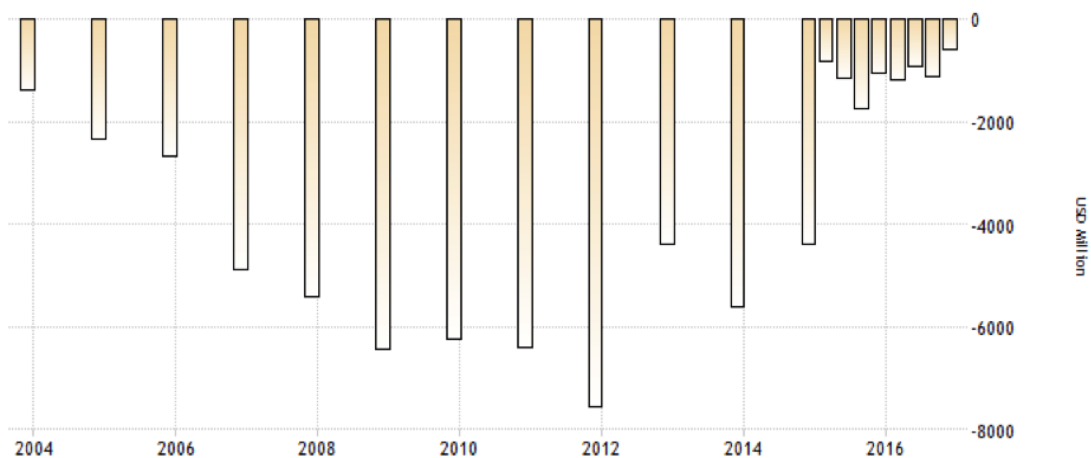
AFGHANISTAN EXPORTS



SOURCE: TRADINGECONOMICS.COM | CENTRAL STATISTICS ORGANIZATION OF AFGHANISTAN

Afghanistan exports

AFGHANISTAN CURRENT ACCOUNT



SOURCE: TRADINGECONOMICS.COM | DA AFGHANISTAN BANK

Afghanistan current account



Afghanistan imports

Bangladesh is among most populated countries of the world, while majority of the masses are crammed into ‘delta of rivers’ which finally get emptied into ‘Bay of Bengal’. Although poverty is widespread in Bangladesh, however, government has succeeded in population reduction during recent years along with attaining growth in education and health sectors. Once called East Pakistan, Bangladesh got independence during 1971 as a result of a bitter war, having roots in India and causing partition of Pakistan. Bangladesh spent 15 years under military rule and, although democracy was restored in 1990, the political scene remains volatile. A surge in Islamist extremism has been observed consistently during recent past. Floods and cyclones are common in low-lying country and severely affected due to rise in sea level.

BANGLADESH GDP

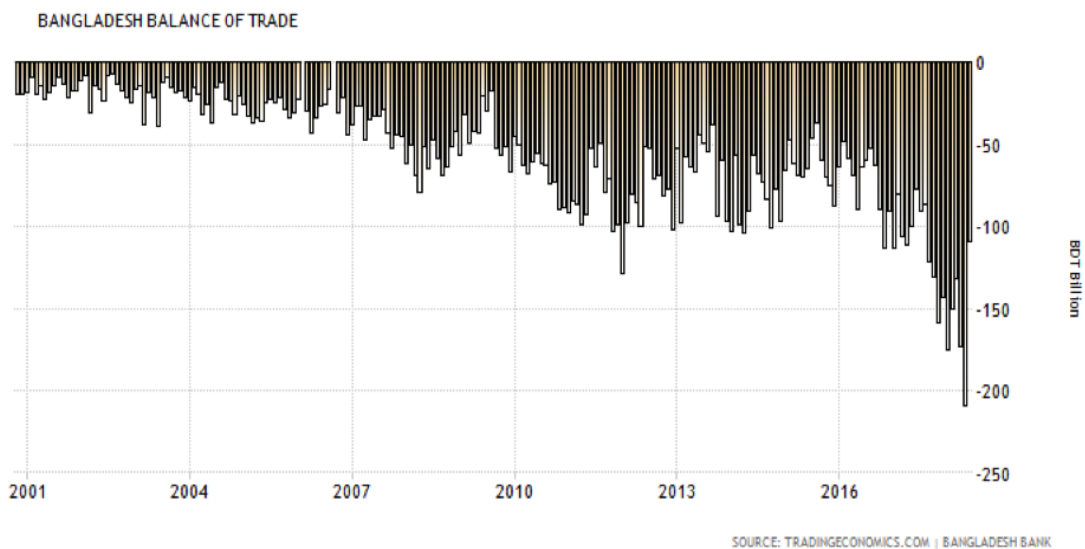


Bangladesh GDP

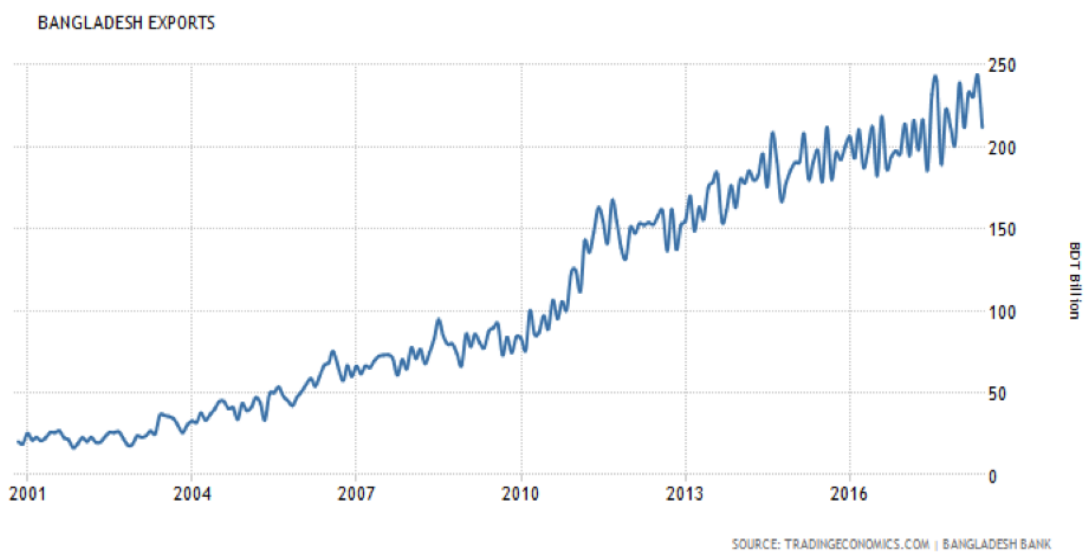
BANGLADESH GDP FROM AGRICULTURE



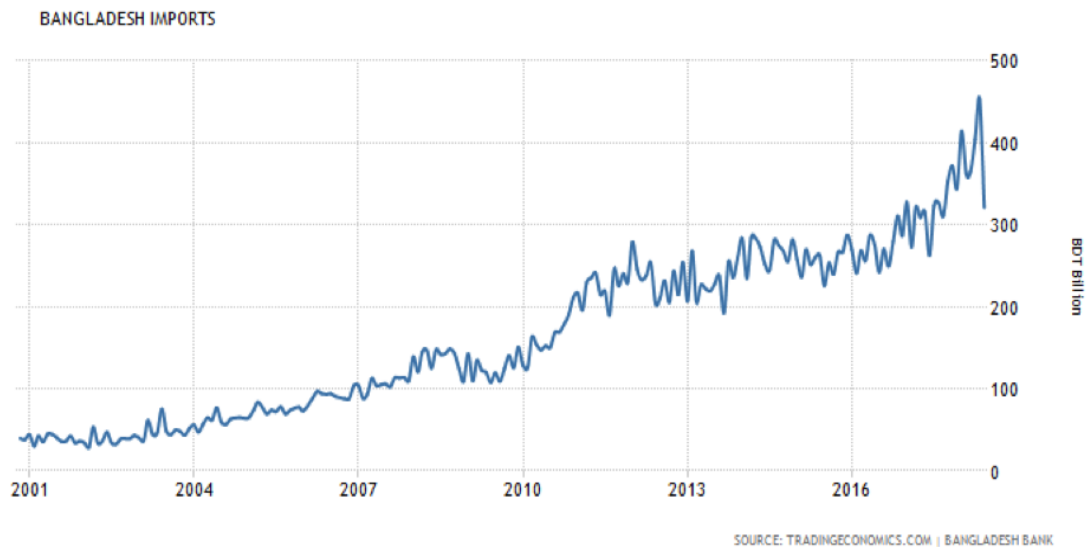
Bangladesh GDP from Agriculture



Bangladesh balance of trade



Bangladesh exports



Bangladesh imports

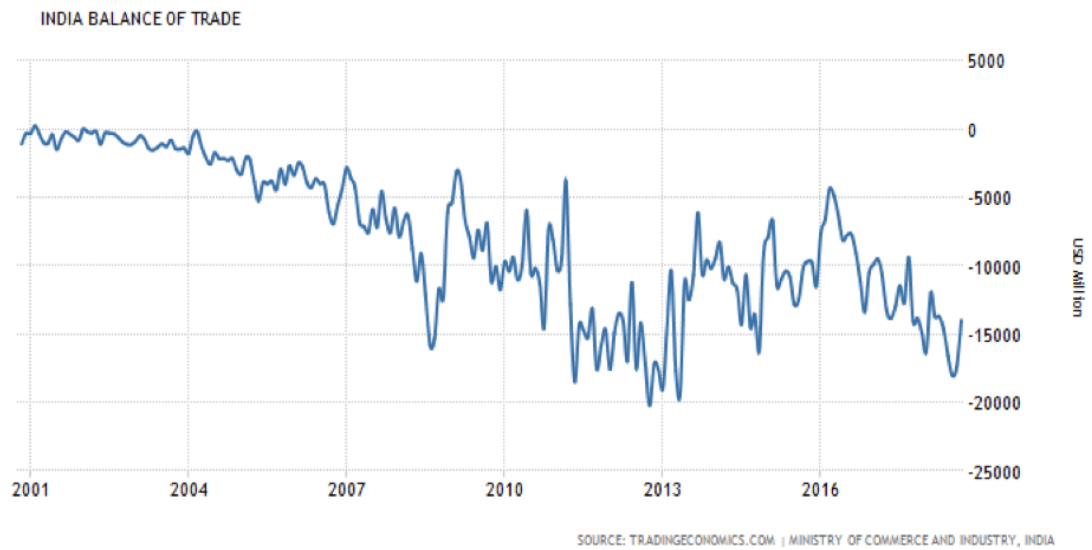
According to United Nation estimates, India is the largest democracy in the world and expected to surpass China in terms of population till 2028, thus becoming most populous country of the world. During last few decades, India has emerged as a key regional power on the basis of rapidly growing economy and nuclear power status. However, India has to undertake numerous, economic, social as well as environmental problems. Having roots to the world's most ancient surviving civilizations, and from mountainous Afghan frontier to Burma jungles, Indian subcontinent is both vast as well as diverse as regards to language, people and cultural traditions.

During 2017, Gross Domestic Product (GDP) of India has been \$2597.49 billion. In addition, GDP ratio of India represents 4.19 % of global economy. Average GDP of India has been \$545.81 billion during 1960 to 2017. It is pertinent to mention that India achieved all time high \$2597.49 billion during 2017. On the other hand, record lowest GDP has been \$36.54 billion in 1960.



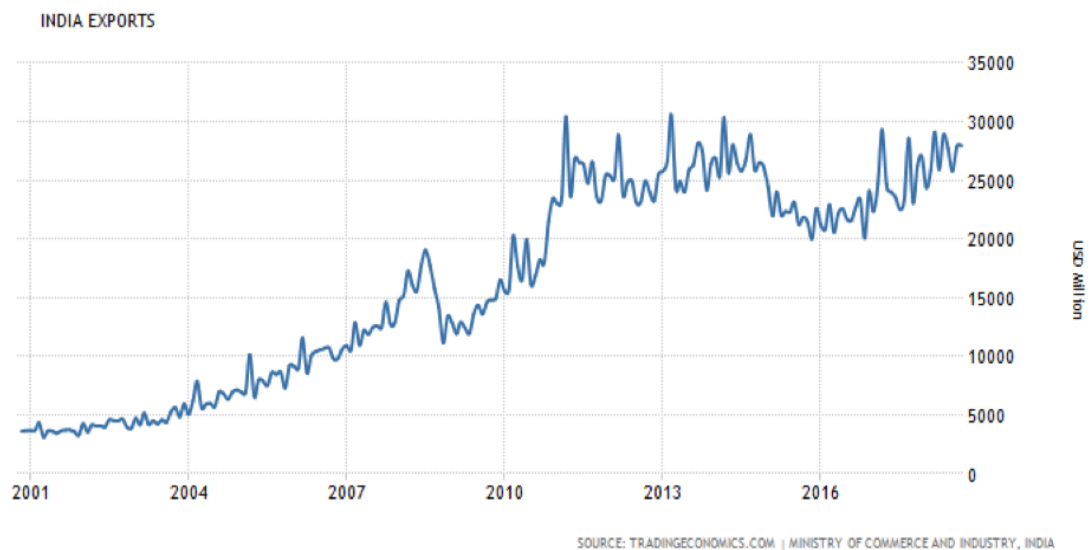
India GDP

Trade deficit of India was counted as \$9.4 billion during 2017 whereas same was recorded as \$13.98 billion during Sep, 2018. Indian exports also declined to \$ 27.95 billion (i.e. 2.2%). 28.2% rise in sales was observed in linoleum and plastics; 26.8% in petroleum sector, 16.9% in chemicals, 3.8% in pharmaceuticals and drugs and 3.6% in handloom and cotton. There has been 10.5% in imports attaining the level of \$41.9 billion, boosted by purchases of crude and petroleum (33.6%), coke, briquettes and coal (23.6%) electronic items (11.4%) and gold (51.5%). Even at this stage, non-seasonally adjusted trade deficit for the month of September has been lowest in last five months. Trade balance of India during the period from 1957 till 2018 has been average \$ -2473.96 million, with all time highest level of \$ 258.90 million during March, 1977 and record lowest level of \$ -20210.90 million during October, 2012.



India balance of trade

Indian exports have been recorded at an average of \$ 5336.92 million during the period from 1957 to 2018, with all time high level of \$ 30541.44 million during March 2013 and record lowest as \$ 59.01 million during June 1958.



India exports

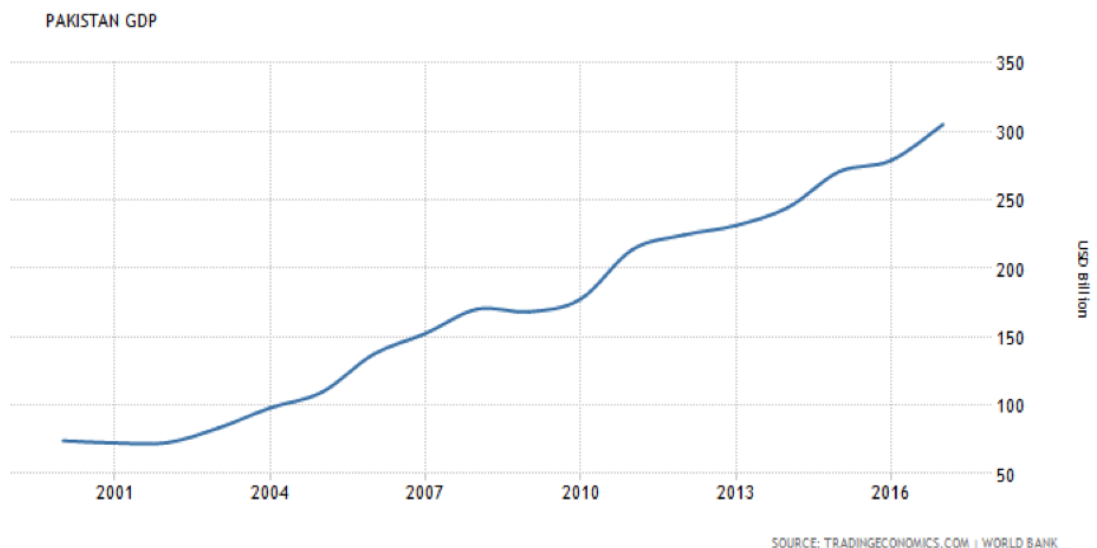
Indian imports rose up to 10.5% i.e. \$ 41.9 billion during September 2018 and boosted by purchases of crude and petroleum (33.6%), electronic items (11.4%), gold (51.5%) and coke, coal and briquettes (23.6%). Average imports by India

have been \$ 7810.88 million during the period from 1957 to 2018, with highest level at \$ 45281.90 million during May 2011 and record lowest at \$ 117.40 million during August 1958.



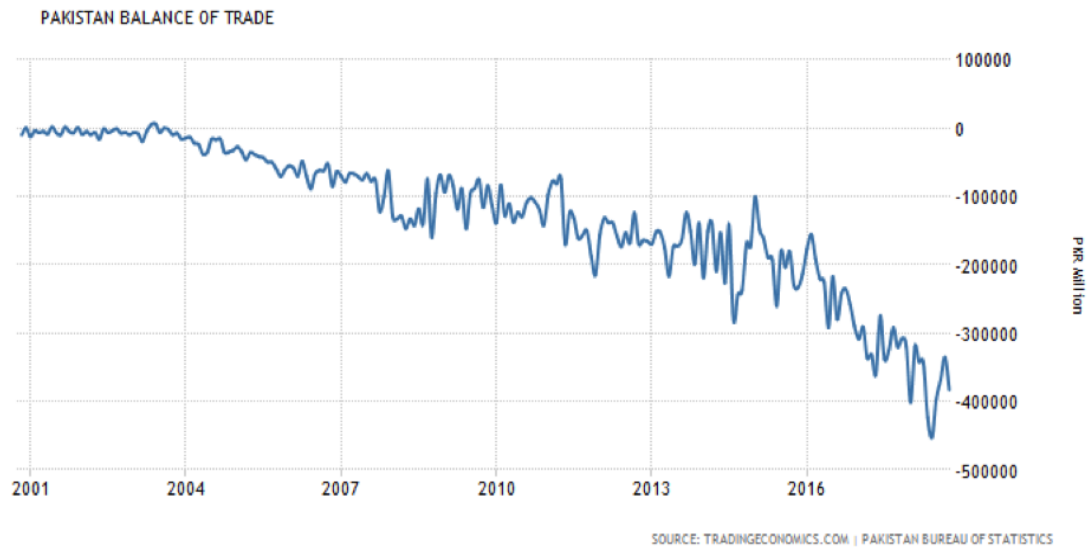
India imports

GDP of Pakistan has been \$ 304.95 billion during 2017, thereby representing 0.49 % of global economy. Average GDP of Pakistan has been \$ 71.19 billion during the period from 1960 to 2017, with highest value at \$ 304.95 billion during 2017 and record lowest \$ 3.71 billion during 1960.



Pakistan GDP

Recorded trade deficit of Pakistan has been PKR 383118 million during October 2018 whereas average trade balance has been PKR -38525.09 million during the period from 1957 to 2018, with highest value as PKR 6457 million during June 2003 and record lowest value as PKR -452668 million during June 2018.



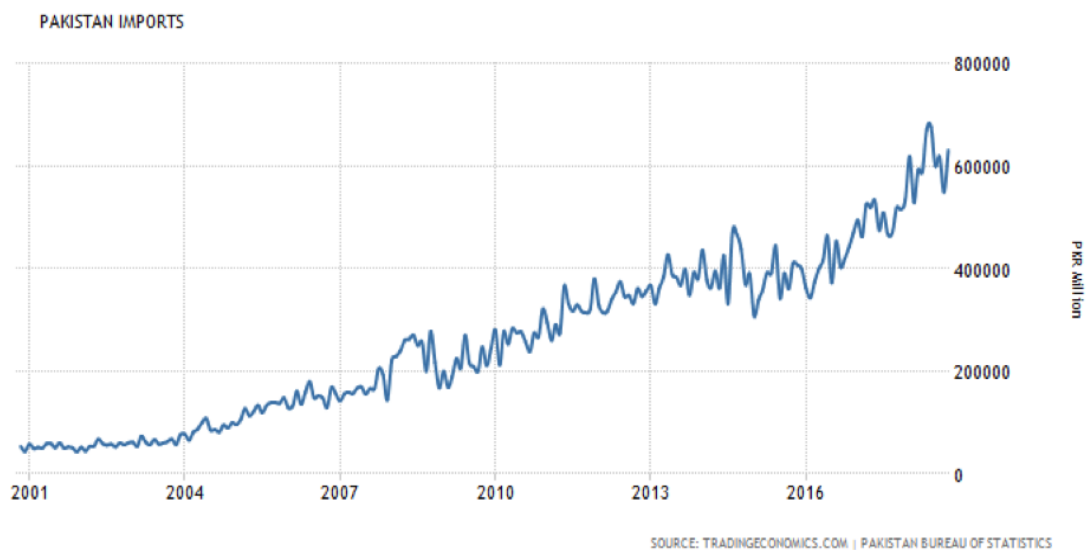
Pakistan balance of trade

There has been increase in Pakistani exports from PKR 214367 million during September 2018 to PKR 248128 million during October 2018. Average exports have been PKR 43621.33 million during the period from 1957 to 2018, with highest value as PKR 275483 million during September 2013 and lowest as PKR 51 million during April 1958.



Pakistan exports

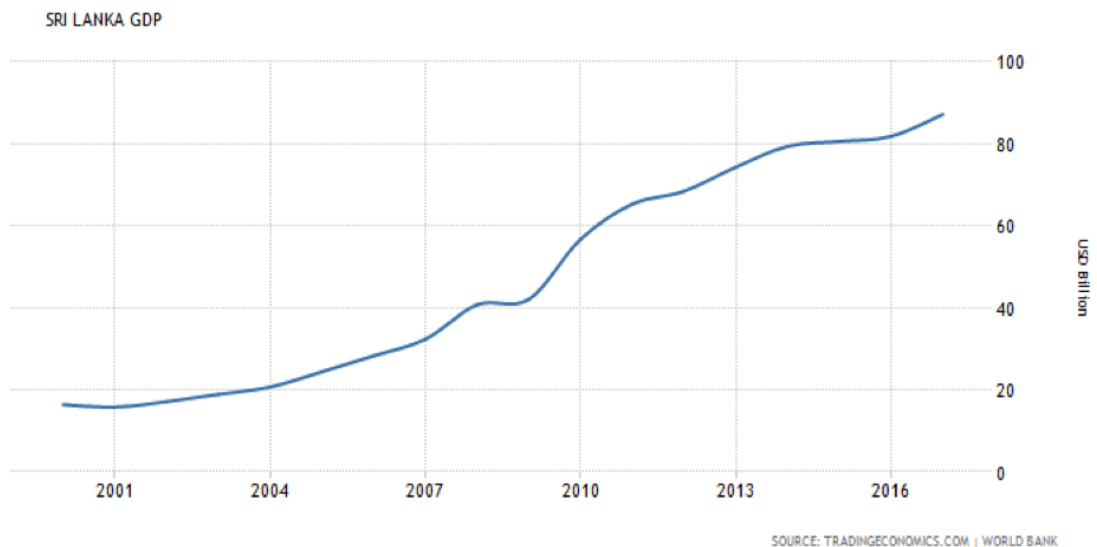
Pakistani imports surged from PKR 549708 million during September 2018 to PKR 631246 million during October 2018. Average figure of the imports have been PKR 82108.23 million for the period 1957 to 2018, with highest value as PKR 676992 million during June 2018 and lowest as PKR 96 million during April 1959.



Pakistan imports

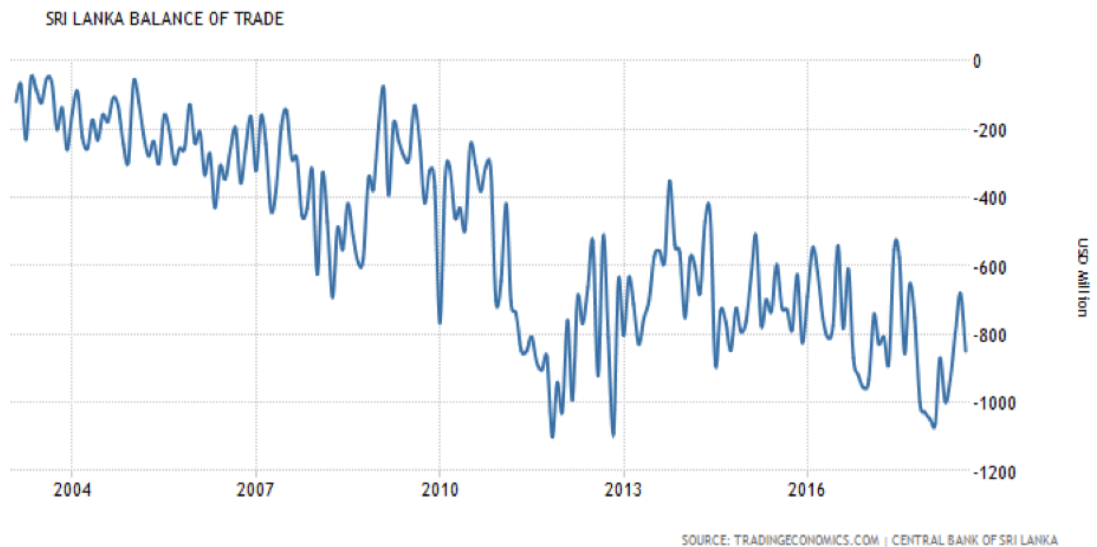
Sri Lankan GDP has been \$ 87.17 billion during 2017, representing 0.14% of global economy. Average GDP has been \$ 18.58 billion during the period from 1960 to

2017, with highest value as \$ 87.17 billion during 2017 and lowest value as \$ 1.41 billion during 1960.



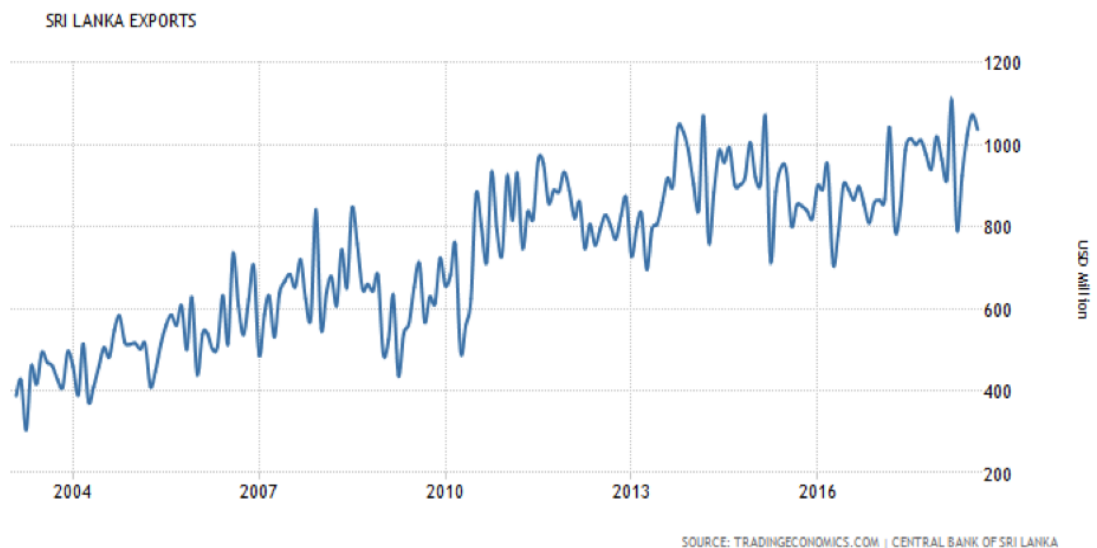
Sri Lanka GDP

There has been slight change in trade deficit of Sri Lanka that moved from \$ 856 million in 2017 to \$ 850 million during August 2018. Sri Lankan exports increased by 3.7 % i.e. from \$ 1,000 million to \$ 1,037 million, whereas the imports increased 1.6 % i.e. from \$ 1,857 million to \$ 1,887 million. Analyzing period from January to August 2018 of Sri Lankan economy, trade gap rose jumped 17.1% reaching up to \$ 7,240 million as compared with same months of previous year. During this period, country purchases increased by 10.9% to \$ 15,083 million whereas shipments went up by 5.8% to \$ 7,842 million. Trade balance averaged at \$ -516.01 million for the period 2003 to 2018, with highest value as \$ -50.10 million during May 2003 and lowest as \$ -1100.70 million during November 2011.



Sri Lanka balance of trade

Sri Lankan exports increased 3.7% year-on-year i.e. from \$ 1,000 million during 2017 to \$ 1,037 million during August 2018. Average Sri Lankan exports have been \$733.23 million during the period 2003 to 2018, with highest value as \$ 1108 million during March 2018 and lowest \$ 304.80 million during April 2003.



Sri Lanka exports

Sri Lankan imports rose 1.6 percent year-on-year i.e. from \$1,857 million during 2017 to \$ 1,887 million during August 2018. Average imports have been \$ 1193.61

million during period 2001 to 2018, with highest value as \$ 2048 million during December 2017 and lowest \$ 408 million during February 2002.



Sri Lanka imports