The Behavior of FDI in South Asian Countries

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Abstract

This paper analyzes the behavior of FDI in South Asian countries using panel data for the period 1970-2004. Following panel data model we applied fixed effects model to clearly identify the factors affecting FDI. The analysis shows that GDP, trade openness, real exchange rate, labor force and health expenditures effect FDI positively and significant. The study finds that the effect of military expenditures and external debt on FDI is negative and significant. These variables reflect the non-productive use of resources and create a negative signal for foreign investors. The study further finds that the relationship between FDI and domestic investment is complementary but insignificant. This weak relationship explains the fact that domestic investment performance is poor in these countries. The effect of taxes is negative and insignificant. The negative relationship implies that lack of fisca incentives is a hurdle for FDI. However if overall investment climate is sound then MNCs overlook it.

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I. Introduction

All developing countries actively seek capital and technology from the advanced countries. Although private foreign direct investment is viewed with ambivalence by many developing countries, it is nonetheless true that direct investment remains a substantial source of capital and is sometimes the only source of specific technologies. Indeed, given slow growth in official external assistance, developing countries are becoming more, not less, dependent on foreign direct investment. As in developing countries, yearly foreign direct investment flows have increased from an average of less than $10 billion in the 1970's to a yearly average of less than $20 billion in the 1980's, to explode in the 1990's from $26.7 billion in 1990 to $179 billion in 1998 and $208 billion in 1999 and now comprise a large portion of global FDI. Driven by mergers and acquisitions and internationalization of production in a range of industries, FDI into developed countries last year rose to $636 billion, from $481 billion in 1998[1].

Pakistan, the world's 7th most populated country with 140 million people, a relatively high growth rate of GDP (averaging around 6 percent), with a significant stock of natural resources and a variety of investment provisions has remained unattractive for foreign direct investment inflows. Foreign loans, grants and foreign private investment are the major external sources of funds to meet the obligations of external resource gaps and developmental goals in Pakistan. Increasing external debt and declining share of official grants indicate that Pakistan will have to rely more on attracting private foreign investment inflows to meet its future requirements of sustained economic growth and to retire external debt.

Root & Ahmed (1997), seek to identify the empirical determinants of direct foreign investment flows in the manufacturing sectors by using multiple determinant analysis of data to a sample of 58 developing countries. They tested thirty-eight economic, social and political variables for their significance with respect to non extractive direct foreign investment .Out of which six variables, per capita GDP, GDP growth rate, economic integration, extent of

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[1] (Source: UNCTAD)

urbanization, regular executive transfers, commerce and communication, were selected as essential discriminators. These are found to be significant. The study finally concludes that for developing countries that want more no extractive direct foreign investment should increase their per capita income, infrastructure facilities and with stable government attracts higher inflows of investment.

Using single equation econometric model Shamsuddin (1994) has examined the economic determinants of private foreign direct investment, for 36 less developing countries for the year 1983. Author observed that most important factors in attracting foreign direct investment is the per capita GDP in the host country, followed by, in order of importance, wage cost, per capita debt, per capita inflow of public aid, volatility of prices, the regional dummy for Latin America and the availability of energy in the recipient country. All results are consistent with previous empirical work, with the exception of the effect of energy availability.

Why Sub Saharan African countries have been relatively unsuccessful in attracting foreign direct investment? Asiedu (2000) examines the above question. For this purpose the author finds the determinants of foreign direct investment to developing countries and analyze whether variables have a different impact on foreign direct investment flows to Sub Saharan African. Specifically author use cross sectional data on 71 developing countries to answer these questions (a) What factors derive foreign direct investment to developing countries? (b) Are these factors are equally relevant for foreign direct investment to sub Saharan African? (c) Why has sub Saharan African attracted so little foreign direct investment? (d) Why has sub Saharan African been relatively unsuccessful in attracting foreign direct investment despite policy reform? Is Africa different? For this purpose the selected variables are Real GDP per capita, infrastructure quality, labor cost, openness, taxes and tariffs, political instability. After applying OLS technique the results indicate that the factors that drive foreign direct investment to developing countries have a different impact on foreign direct investment to sub Saharan African. Specifically infrastructure development and a higher return on capital promote foreign direct investment to non-sub Saharan African countries. In contrast, these factors have no effect on foreign direct investment to sub Saharan African. Openness to trade promotes foreign direct investment to both sub Saharan African and non sub Saharan African countries, however, the marginal benefit from increased openness is less for sub Saharan African – suggesting that trade liberalization will generate more foreign direct investment to non sub Saharan African than sub Saharan African. This indicates that there is an "adverse regional effect" for sub Saharan African: a country in sub Saharan African will receive less foreign direct investment by virtue of its geographical location. These results suggest that Africa is different. In this paper three-policy implication is also discussed. First, to enhance foreign direct investment flows; African countries need to liberalize their trade regions. Second, policies should not be applied blindly. Thirdly, government should disseminate information about their countries.

Shah and Ahmed (2003) empirically investigate the determinants of foreign direct investment in Pakistan. The selected explanatory variables of foreign direct investment are Real FDI annual flows in Pakistan, cost of capital for foreign firms, per capita GNP in terms of us dollars, change in real GDP, tariff, real expenditures on transport and communication by the public sector, dummy variable of democratic government (if 1). Author hypothesized that the size of the market and the expected growth potentials in output and its absorption might have positive effects on inward foreign direct investment. It also indicates that the public sectors developmental expenditures, specifically in providing good infrastructure, can attract more foreign direct investment. Finally, a democratic and stable government seems to have the capacity to get attention of transnational producers. The Authors apply Co-integration technique advanced by Johansen and Juselius (1990) on the time series data from 1960-61 to 1999-00 and finally concludes that all variables are highly significant and positive.

Ahmad, et al (2003) tests the hypothesis of export led growth and the existence of causality between export, FDI and domestic output. For this purpose they use the time series data from 1972 to 2001 and include the following variables: total exports, manufacturing production as a proxy of domestic output, foreign direct income, foreign income and real exchange rate. The paper not only support the export led growth hypothesis but also the existence of foreign direct investment-growth nexus.

By applying econometric approach, Akhtar (2000) contributes to an understanding of location determinants of FDI in Pakistan. The hypothesis if the study is that all variables i.e. stock and inflow of FDI, GDP, imports of consumer goods, exchange rate, interest rate, except dummy variables (political instability & military rule) have positive impact on Real stock and Real inflow of foreign direct investment. The results of the study indicate that

there is a great need for improving the location factors in Pakistan to attract the market-seeking foreign direct investment.

Khan (1997) finds the reasons why Pakistan has not been able to attract sufficiently large foreign direct investment despite liberalization measures. The purpose of that paper has been to review the investment policies over the last 50 years and discuss the trends in foreign direct investment in Pakistan. Despite offering competitive incentives over the last 50 years, geographical location, and relatively large size of population, Pakistan could not attract foreign direct investment like those of many East and Southeast nations. These include the lack of political stability, unsatisfactory law and order situation, macroeconomic imbalances, slowing down of economic activity together with inconsistent economic policies, slow bureaucratic process, inappropriate business environment, inadequate infrastructure facilities, and lack of trained, educated and disciplined labor laws. Like previous investment policies, the investment policy of 1997 is also highly incentive oriented with the exception that it opens agriculture and services sectors to foreign investors, relaxes visa policy, reduces multiplicity of taxes, and revises labor laws so as to improve working relations between employers and employees .All these recommendations are directed towards improving the enabling environment for investment which, in turn, is represented by the four 'Cs' that cost, convenience, capability and concession. Pakistan has so far concentrated mainly on one 'C' that concessions but has paid little or no attention to the other three 'Cs'. Unless these three 'Cs' are improved no amount of concessions will attract foreign direct investment of comparable magnitude of East and South-East Asian nations.

The objective of this study is to analyze the behavior of FDI by investigating empirically the determinant of foreign direct investment using pool data for South-Asian countries. The remainder of the study is organized as follows: Section II elucidates the methodological framework. Section III describes the data and estimation procedure. Section IV presents the empirical results and interpretation. Section V concludes the main findings.

II. Methodology

In this chapter, we formulate a framework analysis to determine the effects of various factors on foreign direct investment. In determining the factors that affect foreign direct investment, it is useful to distinguish between two types of foreign direct investment: market – seeking and non- market seeking. The main objective of market-seeking foreign direct investment is to serve domestic markets. Here goods are produced in the host country and sold in the local market. As a consequence, this type of foreign direct investment is driven by domestic demand such as large markets and high income in the host country-suggesting that foreign direct investment in small and poor countries is less likely to be market seeking. For non-market seeking foreign direct investment, goods are produced in the host country but sold abroad. Hence demand factors in the host country are less relevant. A more pertinent factor for this type of investment is the case with which firms can export their products. Nevertheless; factors that increase the productivity of capital are relevant for both types of foreign direct investment the published source.

Justification of FDI determinants: We justify the determinants of foreign direct investment in the following lines.

Market Size: As received theory suggests that the absolute size of the host market is positively related to the level of FDI because of economies in transaction cost and the benefits of a foreign production location. (Root 1979) A large market size enables TNCs to produce and diversify their products according to local taste and demands. Real GDP is used as a proxy to estimate the impact of existing market size in Pakistan on FDI as it reflects the demands potential in the economy. (Farmer/Richman 1972).

Openness: In the literature, the ratio of trade (imports + exports) to GDP is often used as a measure of openness of an economy. This ratio is also often interpreted as a measure of trade restrictions. The impact of openness on foreign direct investment depends on the type of investment. When investments are market seeking,

trade restriction (and therefore less openness) can have a positive impact on foreign direct investment. The reason stems from the "tariff jumping" hypothesis, which argues that foreign firms that seek to serve local markets may decide to set up subsidiaries in the host country if it is difficult to import their products to the country. In contrast, multinational firms engaged in export-oriented investments may prefer to locate in a more open economy. Since increased imperfections that accompany trade protection generally imply higher transaction cost associated with exporting.

Military Expenditure: Large part of budget on defense expenditures reveals uncertainty about future, cut in development expenditures and wastage of resources. Such factors create an adverse climate for investment. Moreover weapon accumulation race adversely effect the foreign relations. So we expect a negative influence of military expenditures on FDI.

Exchange Rate: The exchange rate variable has been widely debated in the literature on foreign direct investment determinants with some heterogeneous evidence. An economy (being served through exports from the home country) with a depreciating currency attracts more foreign direct investment as exporting from abroad to it becomes expensive, while it becomes cheaper to produce locally. Hence, exports by the home country are replaced through local production in the host country. Devaluation in the host economy also makes it cheaper to export from this base, adding to the competitiveness of TNCs. Such a situation is attractive for the firms looking for an export base, reducing their production costs and earning higher profits. It also increases the local value assets (financial and real) of TNCs held in foreign currency. (Akhtar (2000)) .The use of real exchange rate variable in the analyses, as compared to nominal exchange rates, is justified on methodological grounds as the latter is affected by inflationary impacts. In this case, the inclusion of a nominal exchange rate variable would result in spurious correlations among some of the explanatory variables, which entail inflationary impacts, leading to the problem of multicollinaerity [Ragazzi (1973]. Countries with imports from abroad will attract foreign direct investment. Imports in the host economy serve as an indicator of the existing market for the exports of the home country firms. Higher imports in the host economy encourage the TNCs to produce locally for market seeking ventures. Such ventures become more desirable when there are high trade barriers (both tariff and non-tariff) on imports. Thus, TNCs find it attractive to produce locally in order to satisfy domestic demand. Along many other reasons, one of the reasons of budget deficit is high government expenditure. Foreign firms avoid investing in these countries. Because it creates macroeconomic instability as well as increase interest rate which crowd out foreign investment. Hence, we expect negative sign of this variable.

Political instability is a qualitative phenomenon exact measurement of which is a complex issue in terms of what investors perceive as politically risky and a constraint to their investment. It's essential to attract foreign direct investment because it creates confidence in the foreign investors. In the absence of political there would be political turmoil, which could wipe out Overnight even the most lucrative investment the lives of personnel. Many investors have paid a heavy price for overlooking or ignoring this factor in other parts of the world.

External Debt: External debt burden shows the imbalances in a country. It has an inverse relation with FDI. Higher debt burden creates constraints in terms of new private lending and FDI. (Nunnenicamp,1991).

Labor Force: Another determinant is the growth rate of the labor force. This variable measures the availability of labor as being particularly imported for labor-intensive, efficiency seeking foreign direct investment- rather than the cost of labor. Nevertheless, it may be taken as assumption that a natural consequence of the abundance of this sense implies not only abundance but also low cost relative to productivity. Hence, we expect positive relation with FDI.

Health Expenditures: High health expenditure is an indicator of healthy people, healthy labor force. MNCs attract more towards a country making high health expenditure. It reduces their much other expenditure related with poor labor health. Hence, we expect positive relation with FDI.

Domestic Investment: Foreign investors avoid investing in those countries, in which domestic investment is already high. Therefore, we expect inverse relation with FDI.

On the basis of the arguments above, we can specify the behavior of FDI as follow.

Another determinant is lagged changed in the dependent variable. The presence of this variable can be rationalized in various ways. First, past foreign direct investment inflows embody information on operating conditions and the general quality of the business climate in a host country. This information shapes average perceptions about a country, leading potential investors to view particular locations favorably. Secondly, there is evidence that investors tend to favor familiar countries, and regard territories they do not know as risky. The lack of knowledge is thus strongly associated with the fear of negative possibilities. Third, some TNCs stagger their investments in nearly opened markets in order to test the ground before committing the full amount of capital funds. Thus, foreign direct investment flows are likely to require time to adjust to desire levels, depending on the specific constraints faced by TNCs.

$$FDI = \alpha + \beta_1 GDP + \beta_2 OP + \beta_3 RER + \beta_4 LF + \beta_5 ED + \beta_6 GE + \beta_7 DI + \beta 8 ME + \beta_9 HE + \beta_{10} T + \beta_{11} FDI_{-1} \quad (1)$$

Where,

FD1 =Foreign direct investment net inflow (% of GDP),

GDP = Gross domestic product (constant 2000 US $),

OPEN = Openness measured as export plus import as percentage of GDP,

RER = Real exchange rate. It is obtained by multiplying the nominal exchange rate with US CPI and then divided by domestic CPI

LF = Labor force, total,

ED = External debt, total (DOD, Current US$),

GE = Gross national expenditure (% of GDP),

DI = Gross capital formation (% of GDP),

ME = Military expenditure (% of GDP),

HE = Health expenditure, total (% of GDP),

T = Taxes on goods and services (% of revenue),

FDI (-1) = Foreign direct investment net inflow of previous year (% of GDP).

The data is obtained from the World Development Indicator (2005).

Description of Variables:

Foreign direct investment is net inflows of investment to acquire a lasting management interest (10 % or more of voting stock) in an enterprise operating in an economy other than that of the investor. It is the sum of equity

capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments. This series shows net inflows in the reporting economy.

GDP at purchaser's prices is the sum of gross value added by all resident producers in the economy plus any product taxes and minus any subsidies not included in the value of the products. It is calculated without making deductions for depreciation of fabricated assets or for depletion and degradation of natural resources. Data are in constant 2000 U.S. dollars. Dollar figures for GDP are converted from domestic currencies using 2000 official exchange rates. For a few countries where the official exchange rate does not reflect the rate effectively applied to actual foreign exchange transactions, an alternative conversion factor is used.

GDP is the sum of gross value added by all resident producers in the economy plus any product taxes and minus any subsidies not included in the value of the products. It is calculated without making deductions for depreciation of fabricated assets or for depletion and degradation of natural resources.

Exports of goods and services represent the value of all goods and other market services provided to the rest of the world. They include the value of merchandise, freight, insurance, transport, travel, royalties, license fees, and other services, such as communication, construction, financial, information, business, personal, and government services. They exclude labor and property income (formerly called factor services) as well as transfer payments.

Imports of goods and services represent the value of all goods and other market services received from the rest of the world. They include the value of merchandise, freight, insurance, transport, travel, royalties, license fees; and other services, such as communication, construction, financial, information, business, personal, and government services. They exclude labor and property income (formerly called factor services) as well as transfer payments.

Official exchange rate refers to the exchange rate determined by national authorities or to the rate determined in the legally sanctioned exchange market. It is calculated as an annual average based on monthly averages (local currency units relative to the U.S. dollar).

Total labor force comprises people who meet the International Labor Organization definition of the economically active population: all people who supply labor for the production of goods and services during a specified period. It includes both the employed and the unemployed. While national practices vary in the treatment of such groups as the armed forces and seasonal or part-time workers, in general the labor force includes the armed forces, the unemployed, and first-time job seekers, but excludes homemakers and other unpaid caregivers and workers in the informal sector.

Total health expenditure is the sum of public and private health expenditure. It covers the provision of health services (preventive and curative), family planning activities, nutrition activities, and emergency aid designated for health but does not include provision of water and sanitation.

Gross capital formation consists of outlays on additions to the fixed assets of the economy, net changes in the level of inventories, and net acquisitions of valuables. Fixed assets include land improvements (fences, ditches, drains, and so on); plant, machinery, and equipment purchases; and the construction of roads, railways, and the like, including schools, offices, hospitals, private residential dwellings, and commercial and industrial buildings. Inventories are stocks of goods held by firms to meet temporary or unexpected fluctuations in production or sales, and "work in progress."

Military expenditures data from SIPRI are derived from the NATO definition, which includes all current and capital expenditures on the armed forces, including peacekeeping forces; defense ministries and other government agencies engaged in defense projects; paramilitary forces, if these are judged to be trained and equipped for military operations; and military space activities. Such expenditures include military and civil personnel, including retirement pensions of military personnel and social services for personnel; operation and maintenance; procurement; military research and development; and military aid (in the military expenditures of the donor country). Excluded are civil defense and current expenditures for previous military activities, such as for veterans' benefits, demobilization, conversion, and destruction of weapons. This definition cannot be applied for all countries; however, since that would require much more detailed information than is available about what is included in military budgets and off-budget military expenditure items. (For example, military budgets might or might not cover

civil defense, reserves and auxiliary forces, police and paramilitary forces, dual-purpose forces such as military and civilian police, security military grants in kind, pensions for military personnel, and social contributions paid by one part of government to another.)

Estimation Procedure.

The study uses time series data from 1970 – 2004 for a panel of South Asian countries. The model is estimated by using panel data approach for South Asian countries. Since the FDI is a long term phenomenon, its long term fluctuations caused by structural and political characteristics of different counties being analyzed can be effectively captured by this approach because it allows uniform shifts across cross sectional units while assuming the slope coefficients as common. Further, the panel data approach has the advantage of providing a large number of degree of freedom leading to efficiency gains of parameters. The above model can be applied in three forms. Namely common intercept model, fixed effects model and random effects model. However, relevance of these models depends on their power of explanation and accuracy of specification. Since the common intercept model does not include county specific and time specific factors, it does not provide much information about the effects of differences in structural factors of different countries. We applied Fixed Effects Model approach for the present study. It assumes common coefficients and country specific intercepts across the countries.

V. Empirical Results and Interpretation

The strength of econometric analysis largely depends upon the measurement of variables, model specification, data consistency, statistical and economic significance of variables in the analysis, number of observations and the fact that all the important variables are included in the analysis. A deficiency on any of these fronts is expected to jeopardize the reliability of estimates.

While regressing the explanatory variables against the dependent variable, an attempt has been made to take into account the number of degrees of freedom. Caution has been taken to avoid any inferior results by not overloading the equations with too many explanatory variables. An assessment of the tests of significance and the regression equations indicates that the results of the parameters in the equations are in line with conventional economic theory and are statistically significant. The coefficient of determination ($\bar{R}^2$), adjusted for the degrees of freedom, denotes the predictive power of the equations. The magnitude of the adjusted R^2 indicates the fact that the equations have performed reasonably well. The value of the F-statistics, significant at 1 per cent in the equation, allows us to reject the null hypothesis that all the estimated coefficients are not significantly different from zero. The Durbin-Watson statistic is in the acceptable range and there is no serious concern for the presence of positive or negative serial correlation. This indicates that there are no specification errors in the equations.

Gross domestic product (GDP) is used as a proxy for market size. It turned out to be highly significant. As, the higher GDP represents the stable economic environment and it also indicates higher aggregate demand. Large market size offers higher demand and absorptive capacity in an economy and therefore, foreign investors are attracted to put their stake in that concerned economy. Once these foreign firms get established they can take the oligopolistic advantages due to their large size, technical know-how and other facilities they possess. These relative advantages pay them in the form of higher profits. Thus, we can safely conclude that GDP play a crucial role in attracting FDI.

Trade openness shows a magnitude of trade liberalization. The effect of openness is significant with positive sign. The MNCs are attracted to the countries to take the location advantages with the motive of exporting their products to large markets. Less trade barriers make imports of raw material, such as plant machinery, convenient. On the other hand they can easily export their intermediate and final products. Moreover, due to

liberalization policy the MNCs also take advantage of export promotion facilities. With these factors in mind, we can conclude that our positive relation between openness and FDI is theoretically sound.

The variable domestic investment turned out to be positive and insignificant. Domestic investment is an indicator of investment climate in the economy. The country with high domestic investment will attract for MNCs. The real exchange rate appears significant with negative sign. Devaluation causes to increase the price of imports and decreases the price of exports. Therefore, devaluation raises the burden of foreign debt on a country. It shakes the confidence of foreign investors. Thus it decreases the foreign direct investment. The variable military expenditure is significant and has a negative sign. A country with high military expenditure will attract less FDI. High military expenditures indicate that a country is making less expenditure on economic development. Thus, it creates public unrest, a cut to development expenditure and macro economic instability. Foreign investors suspect hurdles and avoid investing in such countries.

Table 1: Estimates of Fixed Effects Model

Variables	
GDP	.00561 (2.95)*
OPEN	.029 (1.81)**
RER	-0.002 (-3.92)*
LF	.0468 (2.97)*
ED	-.377e (-4.75)*
GE	-.06 (-3.03)*
HE	.87 (2.61)**
DI	.012 (0.49)
ME	-0.3546 (-5.59)*
T	-.057 (-1.08)
Nep	-5.90E-11
Pak	1.53E-11
Sl	5.99E-10
Ind	-5.19E-10
Mal	-5.80E-11
Bun	4.88E-10

R^2	0.999995	Adjusted R^2	0.999953
F Statistics	234.14	D W	2.746647

Note: (a) The results in parentheses show t-values.
(b) The symbols *, ** and *** denote statistical significance at the 1 percent, 5 percent, and 10 percent levels, respectively.

Variable taxes turned out to be insignificant however the sign is negative. Due to higher taxes foreign investors will avoid making investment. Government expenditure is significant and has a reverse relation with FDI. High government expenditure results a budget deficit. This represents poor economic conditions. Thus MNCs do not attract towards these countries for investment. The effect of external debt on FDI is negative and significant. The debt burdens adversely affect the investment climate of a country. In the 1970s and in 1980s the world debt crisis went to its peak. The total foreign debt had increased 50 % since 1982. Beginning with Mexico, many developing countries of all stages of development had experienced severe problems in servicing their huge external debt burden. In turn, their credit problems have made it more difficult than in the preceding decade to finance development through debt. This situation has sparked new interest on the part of many countries in FDI as an alternate source of capital and technology. The FDI flows to the developing countries over the same period hold steady at an average of 11% of the total net inflows. However, as the term period for repayment came to its end the pace of FDI reversed and it fell from an annual average of $13 billion in 1978-1982 to less than US $ 10billion during 1983-86 [Clarke (1990)]. It means that in the long-run external debt discourages or at least hesitates foreign investors to invest, because their profits are expected to be taxed at high marginal rate to finance debt repayments. The pronounced reaction of investors from other capital exporting countries indicates that solution to debt burden is required in order to improve the developing countries access to FDI significantly.

The variable military expenditure is significant and has a negative sign. A country with high military expenditure will attract less FDI. High military expenditures indicate that a country is making less expenditure on economic development. Thus, it creates public unrest, a cut to development expenditure and macro economic instability. Foreign investors suspect hurdles and avoid investing in such countries. Variable taxes turned out to be significant with negative effect. Due to higher taxes foreign investors will avoid making investment.

The variable health expenditure has a positive relation with FDI. A country with high health expenditure will attract more foreign firms for investment. Because, due to it the learning capacity of workers increases, fewer working days are lost, decrease losses caused by their illness. Government expenditure is significant and has a reverse relation with FDI. Higher govt. expenditure results a budget deficit. This represents poor economic conditions. Thus MNCs do not attract towards these countries for investment. The variable labor force is an important determinant of FDI. It turned out to be positive. Higher labor force means MNCs can substitute labor with capital.

Conclusion:

As more and more countries change their attitude towards FDI from passive acceptance to active encouragement, it is desirable to discover the determinants of FDI. The main objective of the study was to empirically investigate the determinants of FDI. For this purpose we selected a sample of seven South-Asian countries over the period 1970-2004. The data have been derived from the world development indicator (WDI) 2005. The model is estimated using econometric models for pooled data, namely fixed effect model (country specific model). The analysis shows that GDP, trade openness, real exchange rate, labor force and health expenditures effect FDI positively and significant. The study finds that the effect of military expenditures and external debt on FDI is negative and significant. These variables reflect the non-productive use of resources and create a negative signal for foreign investors. The study further finds that the relationship between FDI and domestic investment is complimentary but insignificant. This weak relationship explains the fact that domestic investment performance is poor in these countries. The effect of taxes is negative and insignificant. The negative relationship implies that lack of fiscal incentives is a hurdle for FDI. However, if overall investment climate is sound then MNCs overlook it.

Thus, we can suggest that in order to attract FDI government should use those policies, through which a country can attain macroeconomic stability and investment climate. A stable exchange rate policy has to be ensured in order to avoid the exchange rate risk attached to the assets, import prices and profit considerations of direct investors in Pakistan. As the domestic and foreign direct investment is compliment of each other, government should follow such fiscal incentives that are supporting for both type of investment. From the results of the study we can also suggest that in order to attract FDI government, should divert its expenditure from non-productive sectors to productive sectors.

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