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Foreign Remittances, Foreign Direct Investment, Foreign Imports and Economic Growth in Pakistan: A Time Series Analysis

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ARTICLE INFO

Article history:

Received 11 November 14

Received in revised form 20 May 15

Accepted 01 June 15

Keywords:

External determinants
Remittances
Foreign direct investment
Imports
Growth
Pakistan

ABSTRACT

This empirical research paper focuses on establishing a relationship between external determinants and economic growth of Pakistan economy. Empirical analyses are carried out with time series econometric techniques using data over the period of 1977–2013. The main finding is that external determinants such as foreign remittances, foreign direct investment, and foreign imports matter from a growth perspective. Foreign remittances and foreign direct investment have a significant positive role in the growth process of Pakistan economy. Furthermore, it is found that foreign imports have adversely influenced the economic growth of Pakistan. The study recommends that policy makers shall take appropriate steps to increase the inflow of both foreign remittances and foreign direct investment in order to achieve the long run economic growth.

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1. Introduction

Introducing Pakistan, like all developing countries, is striving hard to achieve and sustain the long run economic growth. In a globalized world, it becomes even more complicated to answer the question: ‘what actually determines economic growth’. Economic growth can be influenced by various factors because of its complex nature. Domestic factors such as savings and human capital are considered important for achieving high economic growth (Solow, 1956; Romer 1988). However, external factors such as foreign remittances, foreign direct investment, and imports from foreign countries are also equally important for improving economic growth especially for developing countries (Erik and Ruiz-Arranz, 2006; Barajas et al., 2009; Azman-Saini et al., 2009; Almfirsi and Almsafir, 2014). Economic growth is important because a growing economy is in a much better position to improve the standard of living of its people, which is possible through better educational and health facilities. Contemporary research shows that economic growth promotes human development (Nourzad & Powel, 2003). Human development is indeed the goal of all economic activities around the globe.

The present study examines the impact of external determinants on economic growth. It will also provide an empirical investigation to an important research question: ‘Do external factors like foreign remittances, foreign direct investment and foreign imports, affect the economic growth process of Pakistan?’ In doing so, the paper used observations on foreign remittances (remittances hereafter), foreign direct investment (FDI hereafter), and foreign imports (imports hereafter) on Pakistan economy during the period 1977–2013. The economy of Pakistan is receiving a handsome amount of

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Peer review under responsibility of Holy Spirit University of Kaslik.

remittances from its overseas residents. In 2014, it received around \$16 billion; such inflows have financed 38 percent of the country's import bill, 95 percent of the overall trade deficit, and contributed over 6 percent in Pakistan's national income (State Bank of Pakistan, Annual Report 2014). The economy of Pakistan has attracted a sizable amount of net foreign inflows in recent years, however, due to the fragile recovery of the world economy and domestic security concerns, the flows of foreign investment reduced to its regular patterns. Besides, imports also play a significant role in the growth process. Therefore, establishing a relationship between remittances, FDI, imports, and economic growth may be useful for policy makers. Policy makers could initiate appropriate policy actions towards external determinants considering their importance for economic growth.

This paper is organized in the following manner. Section two of the paper discusses relevant literature. Modeling and empirical strategy are explained in section three. Models are estimated and results are presented in section four. In the penultimate section, the long - run and short - run co-integrating relationship is discussed. Section six concludes the paper along with policy recommendations.

2. Literature Review

The relationship between external determinants and economic growth has been examined in the literature by various researchers. For example, remittances-growth nexus has been tested extensively in the literature and the results of the studies reveal significantly positive relation between flows of remittances and economic growth, but in some cases it is null like Barajas et al., (2009) who found that workers' remittances have no impact on economic growth. However, studies that support positive relationship between remittances and economic growth are many like (Erik and Ruiz-Arranz, 2006; Ahmed et al., 2011; Khathlan 2012; Shafiq et al., 2012; Driffield and Jones, 2013; Nwaogu and Ryan 2015). A relatively important study on the determinants of remittances is carried out by Kock and Sun (2011) in the context of Pakistan. In this study, they find-out the reasons that despite global economic slowdown and specially the economic downturn in the Gulf Cooperation Council (GCC) and other important host countries for Pakistani workers, the flows of remittances towards Pakistan are persistent and even growing. Their main findings were (i) increase in the labour migration that boosted the growth in the inflow of workers' remittances to Pakistan; (ii) skilled immigrants, investment returns in the host country, stable exchange rates and improvement in Pakistan's economic conditions play a strong role in explaining more resilient flows of remittances; (iii) other determinants of strong remittances flows to Pakistan are agriculture output and the relative yield on investments in the host and home countries.

As far as the impact of FDI on economic growth is concerned, Almfrsji and Almsafir (2014) have reviewed an extensive amount of literature on the relationship between FDI and economic growth for a period of 1994 to 2012. Their main findings show that the impact of FDI on economic growth is significantly positive, but in some cases it is null or even negative. However, the relationship between FDI and economic growth heavily depends on the moderating factors like the level of development of financial markets, the adequate levels of human capital, complementarities between domestic and foreign investment, open trade regimes, exchange rate policies, legal framework etc. Blonigen and Piger (2011), in the scope of a seminal article, worked-out the determinants of FDI activities. They found out about the traditional gravity variables such as cultural, distance factors, per capita GDP, relative labor endowments, and regional trade agreements. Other determinants include trade openness, host country business facilitations and ease of business, host-country infrastructure, mainly financial institutions at the level of development, and host-country institutions. Khathlan (2012) reported a positive relationship between FDI and economic growth in the short-run as well as in the long-run in the context of Pakistan economy during the period 1976-2010. Siddiqui and Iqbal (2010) used historical data from 1972 to 2008 and showed that there is a negative relationship between FDI and economic growth. FDI can influence economic growth of the host economy through multiple channels. Tahir and Imran (2014) results suggest that trade openness has contributed significantly to the growth process of the developing countries and also found that domestic investment play an important role in the process of economic growth.

The impact of imports on economic growth critically depends on the nature of imports i.e. if imports are eatable, then it is less likely that they are going to boost economic activities in the host country; however, if imports contain capital goods and new technologies, this may help to augment growth process in the importing country. Zhang and Zou (1995) investigated the relationship between technology imports and economic growth in developing countries; they found that foreign technology transfers boost income growth rates. Moreover, the nature of economic growth differs between developing and developed countries, for developing countries importing foreign plants and equipment, and borrowing foreign technology play a major role. On the other hand, the study conducted by Siddiqui and Iqbal (2005) has found that imports, exports, and economic growth are insignificantly related. However, imports are indeed important for a growing economy. Advanced technologies and equipment for the development of domestic industrial sector can only be accessed through increased imports.

These recent studies have not provided consistent evidence in favor of a robust relationship between external determinants and economic growth for Pakistan economy. The results of some of the studies show that external determinants influence economic growth positively while some others show that external determinants adversely influence economic growth. Therefore, empirical investigation of the relationship between external determinants and economic growth is indeed necessary.

3. Model and Methodology

3.1. The model

The objective of this research paper is to examine the impact of external determinants on economic growth. Based on data availability, remittances, FDI, and imports are considered in the analysis. Empirical analysis is carried out using 37 annual observations over the period 1977-2013. The following model is specified for the empirical analysis:

$$\ln zgd p_t = b_0 + b_1 \ln rem_t + b_2 \ln fdi_t + b_3 \ln imp_t + U_t \quad (1)$$

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