TERRORISM AND POLITICAL INSTABILITY
IMPLICATIONS FOR FOREIGN DIRECT INVESTMENT:
A Case Study of South and South East Asian Countries

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In the late 20th and at the onset of 21st century the concept of capital-flow in the form of both, portfolio investment and foreign direct investment (FDI) flourished across many countries. This tendency became an important debate for researchers as to what are the factors responsible for such flows and what are the benefits associated with these flows, to the hosting countries. Much emphasis has however been placed on the economic factors, whereas, the non-economic determinants have generally been bypassed. The present study is an attempt to bridge the gap by emphasizing on both, the economic and non-economic factors with special focus on political instability and terrorism. The countries of South Asia and Southeast Asia are targeted for analysis. A panel data is employed for the period 1996-2010 covering most countries of the region. Findings of the study reveals that market size, exports of the host country, rising prices, and hence, the implicit profits, the level of human capital and financial sector development are important factors in attracting the FDI. In contrast, the dependency ratio, military expenditures, real exchange rate, high rate of domestic investment and high taxes are prominent impediments in the way of FDI flows to developing countries. In addition to these, the major findings of the study indicate that political instability and terrorism adversely affect the flow of FDI to the region. In other words, countries with stable political system and better law and order situation have succeeded in attracting large volume of the FDI flows.

I. Introduction

The modern era of globalization is accompanied by enormous flows of private capital across the developed and developing countries, all over the world. These flows are classified into two main categories, namely, the Foreign Direct Investment and the Portfolio Investment. The difference between the two categories is that portfolio investment refers to purchase of shares and bonds of local companies by the foreign investors, whereas, the foreign direct investment involves the building-up of real estates, import of machinery and equipment, as well as, transfer of technology and know-how from abroad, into the host country. This study focuses on the later category.

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Foreign Direct Investment (FDI) is crucial for developing countries in many ways. The evidences suggest that:

- FDI bridges the gap between investment requirement and the domestic savings; and therefore, enhances economic growth in the host country.¹
- FDI promotes exports and facilitates improvement in the balance of payments if exports-oriented policy prevails in the host country.²
- FDI contributes to local exchequer in the form of taxes as also to employment generation and indirectly to raise living standards in the host country.

The spill-over effect is among the indirect advantages (pecuniary benefits), which cannot be easily computed. For instance the FDI implies the economies of scale in the host countries. The multinational corporations (MNCs) introduced new and advanced technology in the recipient country which not only increases the productive capacity but also enhances quality of the products. FDI is also helpful in upgrading the managerial skills. It is worth mentioning that existence of foreign firms helps to expand the infrastructure (roads, communication), which makes it easier and lucrative for local firms to crowd-in.

The critics are however skeptical about the benefits claimed to be associated with FDI. According to their point of view, the infusion of MNCs may be harmful for developing countries, since they reduce space for local companies. The domestic firms are generally poor competitors to multinationals, and hence, their profits are reduced due to crowding out effects, thereby leading to reduction in domestic investment. The foreign companies can motivate an inappropriate consumption pattern using the media. They can monopolize domestic resources because of their capital richness and can influence political decision making.

The economic determinants of FDI have been widely discussed by researchers but little attention was paid to socio-political determinants like political stability/instability, terrorism, cultural values, etc., which are important for economic factors to attract or repulse the FDI. The present study intends to focus on the non-economic determinants of FDI in South Asia and South-East Asia with the objective to find explanation of huge differences in the flow of FDI to different countries of Asian region under reference. The study would come up with helpful suggestions for the policy-makers in developing countries to formulate and implement better strategies to attract FDI flows by facilitating foreign investors, removing the economic and non-economic barriers and appropriating the maximum benefits for their countries.

¹ See, Sathe and Schachler (2006) for details.
² See, for instance, Liuyung and Yanping (2006).
1. Global Trends in FDI Flows

The net FDI flows to different countries over time are not uniform. We observe huge ups and downs with years of massive increase followed by sharp decline, both globally as well as regionally. Many factors are responsible for the fluctuations, for instance the Global Financial Crisis during 2008-09. The South Asian and South East Asian countries have mixed performance, as the net FDI flows are concerned. During 1996, these countries attracted about 8 per cent of the Global FDI, which sharply and continuously declined during the next few years and hit the minimum level of per cent (approx.) 1.96 per cent in 1999, despite the fact that the FDI flows across countries were flourishing world over in these years. From the year 2000 onward, recovery took place and the FDI flows reached the high record of 8.23 per cent in 2010. FDI flows (to the region under reference as percentage) of net FDI inflows to developing countries are also volatile showing significant ups and downs.

The data suggest that Singapore is the dominant country in the region in terms of FDI inflows, receiving more than 50 per cent of total inflows to the region in earlier years of the 21st century. The share of India is ever increasing with the passage of time rising from merely 9 per cent in 1996 to 46 per cent by 2009. Similarly, Malaysia, Thailand and Vietnam are also important to attract foreign investors in the region. Philippines received 9.23 per cent of the total net flows in 1999, but it could not sustain in subsequent years. The performance of Pakistan is also poor in this regard, except for three years (2006-08) amounting to 5 per cent of the total FDI flow to the Asian region. The net FDI flow to Indonesia is extremely volatile and was recorded with negative sign for few years. In contrast, Bangladesh, Cambodia, Papua New Guinea, Maldives, Sri Lanka, Nepal and Laos received very low share in the total net FDI flows to the region.³

2. Objectives and Rationale of the Study

Keeping in view the large differences in the net FDI inflows across developing countries of South and South East Asian region and also the fluctuations that can be seen over different years for particular countries of the region, it seems appropriate to enquire the reasons for such inequalities.

The mounting financial problems like persistent deficits on the current account of BOP, low investment to GDP ratio, non-availability of easy loans in the international markets and decline in official development assistance from donor agencies, etc., made it necessary for developing countries to seek alternative sources of financing, particularly the FDI. However, the foreign investors have to consider a

³ Necessary information about the flow of FDI to the region under reference is given in the Appendix.
number of factors in the host countries before deciding to intervene. These include the infrastructure facilities, market size, labor force capabilities, business environment, investment incentives, and law and order situation, etc. Most of the developing countries are gradually liberalizing their systems and implementing FDI seeking policies over the past two decades. The data however suggest that some countries of South Asia and South-East Asia have received more doses of FDI than others. Therefore, it seems appropriate to explore the factors, both economic and non-economic, which make some countries more attractive and preferable for foreign investors than others in the same region. The specific objectives of the study may be stated as under:

- To investigate the key economic determinants and their relative importance in explaining the FDI inflows to selected developing countries of the Asia and South East Asia.
- To check if the non-economic factors like political instability, deteriorating law and order situation and phenomena like terrorism have a significant impact on FDI flows to the countries concerned.
- To find the common grounds/factors responsible for the promotion of FDI flows to developing countries with special reference to Pakistan.

The following hypotheses are tested in particular:

- Political instability has a significant negative impact on FDI. The fluctuations in the political situation are responsible for difference in the FDI flows across different countries.
- Peace and tranquility in the host countries are pre-conditions for FDI inflows. Countries subject to frequent terrorist activities in the region are likely to receive smaller doses of FDI.

The study is organized as under. Section II provides a brief overview of the socio-political and economic conditions prevailing in the region. Section III comprises a brief review of the literature highlighting the economic and non-economic determinants of FDI. Section IV discusses the model, methodology and data sources and Section V provides the empirical results and analysis. The conclusion and policy recommendations are discussed at the end (Section VI) of the paper.

II. Socio-Political and Economic Overview

It seems appropriate to provide a brief overview of the economic, socio-political and security situation prevailing in these countries to understand the factors responsible for such disparities before confronting the data to empirical investigation.
1. South Asia

This region includes Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka. India is the largest country in the region by area and population. It is politically stable and has succeeded in demonstrating democratic norms. Although, ethnic riots are reported in some states but the overall law and order situation is satisfactory. India has received the bulk of FDI during the period under review. Pakistan has received substantial inflows of FDI in the 21st century up till 2008 but thereafter, witnessed sharp decline due to increasing number of terrorist incidents, poor security situation across the country, especially in Karachi, accompanied by power shortages.

Sri Lanka has also failed to attract significantly the FDI due to ethnic tension which resulted into insurgency by the Liberation movement of Tamil Tigers against the government from 1983 onwards. After failure of several peace talks the Armed Forces of Sri Lanka finally defeated the Tamil Tigers in 2009 and took control of the whole country. Sri Lanka is now politically stable and its Human Development Index ranks it higher than other the South Asian countries. Bangladesh and Nepal have a volatile political situation and therefore both are not much preferred by the foreign investors.

2. South-East Asia

The area is geographically located in the south of China, east of India, to the north of Australia and west of Papua New Guinea. Furthermore the South-East Asia comprises two sub-regions, namely, Mainland Southeast Asia and Indochina. The region includes Indonesia, Malaysia, Brunei, Papua New Guinea, Vietnam, Thailand, Cambodia, Philippines, Laos, Myanmar and Singapore.

Singapore, Malaysia, Thailand and Vietnam are the most attractive places for foreign investors as compared to other countries in the region. Countries successful in attracting significant FDI are both politically and financially stable, and can guarantee a peaceful environment to foreign investors to operate business activities. Indonesia has shown mixed performance in this regard. The FDI inflow is heavily volatile for few years as witnessed by capital outflow, whereas, other countries received very low doses of FDI inflows.

Obviously, the countries which have failed to attract considerable FDI inflows are either politically unstable or they reflect domestic tensions, ethical riots along with unsatisfactory law and order situation. One prime example is Myanmar, which has a tragic history of political instability, ethnic riots and violence. The government is directly or indirectly under the military rule since 1964 and recently in 2010, the country moved towards democracy. The military rule is greatly accused for human rape, child soldiers and labor, genocide, human trafficking and lack of freedom of speech. The ethnic tensions and conflicts have displaced millions of people. Re-
cently the conflict between Muslims and Buddhists has displaced almost 90,000 people and killed thousands.

Similarly, Papua New Guinea is not politically stable. Frequently, the government was changed through electoral process and the vote of no confidence, which obstructed the routine legislation process. Ethnic riots between Chinese and New Guineans in 2009 claimed hundreds of lives.

Philippines is trying to combat Islamic insurgency of Moro National Liberation Front and Moro Islamic Liberation Front which was initiated in 1969 with killing of 60 Muslims Filipino. The conflict has caused 6015 casualties, so far.

III. Literature Review

The boom in FDI during 1990s following globalization has attracted researchers to analyze reasons and factors responsible for the implied capital inflows and outflows. The pull and push factors are called determinants of FDI. Studies on these determinants can be classified into two main streams. One, the stream focus on economic factors while, the other focus on non-economic determinants.

1. Economic Determinants of FDI

Researchers have pinpointed different economic determinants of FDI. A brief account/summary is provided in the Table A-1 (Appendix).

a) General Studies on Developing Countries

Shamsuddin (1994) performed an analytical study to explore determinants of FDI in less developed countries. For this purpose cross sectional data of 36 countries was used for the year 1983. The main findings suggested that GDP of the host country was the most important factor in this regard. The cost factor (wage) and investment climate represented by per capita debt were also important determinants. Higher cost and poor investment climate discouraged the FDI inflow. Higher per capita public aid attracted more FDI while price volatility depressed the inflows.

Demirhan and Masca (2008) conducted a study on determinants of FDI flows on developing countries by taking cross sectional data of 38 countries for the period of 5 years (2000-2004). The analysis concluded that growth rate (proxy for market size), infrastructure and economy’s degree of openness (trade) had a positive and significant impact on FDI. However, inflation, which shows the macro-economic stability/instability of a country, had a negative impact; besides being significant, which means that low level of inflation is key determinant in attracting FDI for developing world. Tax rate also has a negative impact on FDI. Wage rate and Risk both appeared with a negative sign but were not significant.
Majeed and Ahmad [(2008), (2009)] conducted two independent studies to analyze the impact of human capital development on FDI inflows, besides other characteristics of the host countries. The first study (2008) used panel data of 23 developing countries for the period 1970-2004. Fixed effects model and GMM techniques were used for estimation. The results revealed that human capital development\(^4\) had a significant positive impact on FDI inflows while improved transportation facilities also encouraged the foreign investment.

The second study (2009) used panel data of 72 developing countries for the period 1970-2008. The study concluded that GDP and its growth rate were significant determinants of FDI because of their association with high profitability of MNCs. Economic growth, openness of the host country economy, as well as, remittance also contributed positively in attracting the FDI, and these determinants were statistically significant. On the other hand BOP deficits and inflation discouraged the signs for FDI inflows. Infrastructure facilities (communication measured in terms of the number of telephones) had significant positive impact on FDI inflows. The research also concluded that military expenditure adversely affected the FDI in the host country and appeared with a negative significant sign. Likewise, an appreciation of the domestic currency discouraged foreign investors to step in.

Udoh and Egwaikhide (2008) scrutinized the effect of both the exchange rate volatility and inflation uncertainty on FDI inflows to Nigerian economy, using GARCH model. The period of analysis was from 1970 to 2005. The empirical results suggested that exchange rate instability and inflation uncertainty have a significantly negative impact on FDI. The findings also showed that government consumption, infrastructure development and international competitiveness were crucial determinants of FDI. They recommend that the government and policymakers should ensure macro-economic and exchange rate stability to have more FDI in Nigeria.

Vijaykumar, et al. (2010) carried out research on determinants of FDI in BRICS\(^5\) countries. They used panel data from 1975 to 2007 and employed the random and fixed effects models for estimation. The results showed that market size and infrastructure were positively significant while labor cost was significant with a negative sign. The Economic Stability and Growth Prospects measured by Inflation and Industrial production had negative but insignificant impact on determining the FDI inflows, while the trade openness (measured by ratio of total trade to GDP) had positive but insignificant impact. A depreciation of domestic currency positively affected the FDI inflows to selected countries.

\(^4\) Two variables were used for human capital development, namely health expenditures and illiteracy rate; while the health expenditure appeared with a significant positive sign, the illiteracy turned out to be negative and was not highly significant.

\(^5\) BRICS stands for Brazil, Russia, India, China and South Africa.
Wafure and Nurudin (2010) examined the determinants of FDI in Nigeria over the period 1977-2006 by using the error correction model. The study found that market size (GDP), deregulation of the economy, depreciation of exchange rate and political stability were statistically significant and had a positive effect on FDI flows to Nigeria. However, openness of economy, inflation and infrastructure development were insignificant in determining the FDI. The authors suggested an expansion of GDP via production incentives, and to further deregulate the economy by means of privatization. The government should also go for gradual depreciation of local currency and spending more on infrastructure development in order to attract foreign direct investment in the country.

b) Studies on South Asian and South-East Asian Countries

Azam and Lukman (2006) highlighted the economic factors of FDI inflow to three selected countries, namely Pakistan, India and Indonesia by using data from 1971 to 2005. Estimation was carried out by using a log-linear regression model. The results showed that the market size, external debt, trade openness, physical infrastructure and domestic investment are the most important determinants of FDI inflows. Moreover, the study demonstrated that economic determinants were same for India and Pakistan but different in case of Indonesia. The study suggested that policy makers should ensure economic and political stability, improvement of infrastructure, peace and security, and encourage domestic investment and equal attention to appropriate fiscal and monetary policy in order to attract more FDI.

Sahoo (2006) tried to explore the trends, impacts and determinants of FDI in seven South Asian economies by using the co-integration technique and employing panel data from 1975 to 2003. The results confirmed that GDP, labor force growth rate, trade openness and infrastructure were positively significant, but more influential factors were market size and labor force growth rates. In contrast, the literacy rate, total debt (as per cent of GDP) and total reserves were sufficient for imports and appeared to be less important in this regard. The study emphasized that governments should ensure rapid and sustained economic growth rate, develop and upgrade infrastructure, and adopt more open trade policies to promote FDI inflows.

Ang (2008) used annual time series data from 1960 to 2005 to investigate determinants of FDI in Malaysia. The error correction and 2-SLS models were used for analysis. The results suggested that a higher rate of financial sector development is linked with increased FDI because it facilitated the adaptation of new technology. GDP (a proxy for market size) was an important factor to attract FDI to Malaysia, one per cent increase in real GDP cause 0.95 per cent increase in FDI inflow. Trade openness and infrastructure development, both contributed positively and, a high corporate tax rate and appreciation of domestic currency negatively affected the FDI inflows.
Pradhan and Saha (2011) conducted a panel study to evaluate determinants of FDI in seven SAARC6 countries using data from 1980 to 2010. Panel VAR model was employed for estimation purpose. They concluded from the results that per capita GDP, exchange rate, inflation, merchandise trade balance, current account balance, long-term outstanding debt and labor force were significant determinants of FDI in selected countries. The Granger causality test identified a bi-directional relationship between FDI and economic growth, as well as, FDI and exchange rate.

c) Studies on Pakistan

Aqeel and Nishat (2004) conducted a study to identify the main determinants of FDI in Pakistan. Utilizing the co-integration and error correction techniques on annual data for the period 1961 to 2003, they found that GDP growth and depreciation of Pakistani currency were dominant factors in explaining FDI in Pakistan, while high inflation, taxes and tariffs had an adverse impact on FDI inflows and vice versa. The study also concluded that government reforms had a positive and significant effect in attracting FDI to Pakistan.

Khan and Nawaz (2010) used OLS technique to find the main determinants of FDI in Pakistan over a period of 35 years (1970-2005). The findings implied that coefficient of the GDP growth rate was positive, confirming that large market size provided more chances of sales and profits for foreign investors. A depreciation of Pakistani currency encouraged the FDI. Furthermore, the volume of export appeared prominent among the determinants. The study recommends that the government should concentrate on optimization of the use of resources in order to enhance the economic growth, and that it should design appropriate exports and imports supporting policies to attract more FDI.

Awan, et al. (2011) carried out the study to explore determinants of FDI in commodity producing sector of Pakistan by using time series quarterly data for 12 years (1996-2008). The Co-integration and Error Correction models were used for estimation. The main finding revealed that GDP, Foreign Exchange Reserves, Gross Fixed Capital Formation were the main determinants of FDI in this sector which were significant. The degree of trade openness, per capita income and real rate of GDP growth in commodity sector were also statistically significant with a positive sign.

2. Socio-Political Determinants of FDI

A brief discussion of relevant studies follows, while the summary is provided in Table- A-2 (Appendix). Kahai (2004) performed a study to probe non-traditional de-
terminants of FDI, besides the traditional ones for a sample of 55 developing countries over the years 1998 and 2000. OLS estimates suggested that GDP per capita, exports, real GDP growth rate, infrastructure (proxy telephone lines) were all significant at one per cent level with positive signs. Exchange rate appeared insignificant while labor cost and inflation negatively affected FDI at 10 per cent level. The non-traditional factors such as economic freedom,\(^7\) corruption (index of Transparency International) and business regulation were found important as determinants of FDI.

Sathe and Schachler (2006) carried out a study to see the impact of social and cultural factors on FDI inflow in different Indian states. The first part of the study found that FDI was economically beneficial and had positive effect on economic growth of India. Results of the second part implied that urbanization was the most influential factor in attracting the FDI. The Indian states characterized by surplus labor attracted more FDI (although this factor was not highly significant). Literacy ratio also turned out to be insignificant. Likewise, religious and cultural variables had only a minor role in determination of FDI for different states.

Azam and Rehman (2006) examined the social and political effects on FDI in case of Pakistan by considering time series data for the period 1971 to 2005. Human capital (primary school enrollment) and political stability (dummy, one for democracy and zero for dictatorship) were considered. The empirical results identified that human capital, as well as, political stability are significant which means that skilled and trained labour force and political stability are obligatory to attract large doses of FDI.

Sakka (2007) carried out a research to check possible impact of terrorism on FDI inflows in selected panel of 136 less developed countries of the world, using the data from 1975 to 2006. Co-integration method was used for the analysis. The results suggested that trade barriers (tariffs and non-tariff) had a significant negative impact on FDI inflows. A high tax rate policy may discourage FDI as expected. Similarly, the troublesome business regulations also affected the FDI inflows adversely. Population and GDP had significant positive impact on FDI inflows, which is consistent with the market-size hypothesis. Finally, terrorism\(^8\) had major negative impact on FDI inflows in developing countries. Foreign investors generally avoid intervention in countries which are subject to frequent terrorist attacks.

Moniruzzaman (2010) employed the random and fixed effect panel technique on panel of 36 countries for the period 1975 to 2006, out of which 12 were MENA\(^9\) countries.\(^{10}\) The purpose of the study was to find any new evidence on the determin-

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\(^7\) Economic Freedom indicator is taken from Heritage Foundation. It is an average value of ten factors namely corruption, the fiscal burden of government, rule of law, regulatory burdens, non-tariff barriers to trade, restrictions on banks, labor market regulations and black market activities.

\(^8\) Number of terrorists' incidents during one year is used to represent the severity of Terrorism.

\(^9\) Middle East and North African countries.

\(^{10}\) Fuel exports as a percentage of merchandise trade was used as a proxy for Natural Resources.
nants of FDI in developing countries. The results verified that GDP, infrastructure, natural resources, market size and growth potential all positively affected FDI. The institutional quality appeared to be a non-economic important factor with positive impact, while financial sector development stood as insignificant.

Masron and Abdullah (2010) tried to analyze the importance of institutional quality in determining the FDI inflows to ASEAN countries from 1996 to 2008. Results from the regression analysis suggested that market size and institutional quality have positive and significant impact on FDI inflow. Literacy ratio was however found less influential while the real wage had a significantly negative impact on FDI inflows. The level of human capital development was also less significance in this regard. In general, the ASEAN countries failed to attract the high-tech Multinational Corporations.

Samimi, et al. (2011) conducted the study to investigate the impact of political stability on FDI for a sample of 12 selected economies of the Organization of Islamic Countries (OIC) for the period 2002 to 2009. The empirical results revealed that trade openness; population size and GDP had positive impact on FDI inflows while political instability affected the FDI inflow to these countries, adversely.

It is clear from the above studies that economic factors have attracted overwhelming attention of the researchers while non-economic factors have not been analyzed thoroughly. The present study, therefore, intends to evaluate the determinants of FDI in the South Asian and South-East Asian region with particular focus on the impact of political instability and the terrorism. Although, the impact of these factors has been checked in some studies but no in-depth study was conducted for countries under reference. The two regions comprise the developing countries that are suffering from the two ailments over the past several years. Given the importance of FDI for countries that lag behind in the pace of development, the study is worthwhile particularly when socio-political factors are some time stronger and serious than the pure economic factors, to influence FDI.

IV. Model, Methodology and Data

It is commonly believed that MNCs invest in developing countries expand their network, production, and ultimately, to increase their market share and profits. They exploit different opportunities in those countries where low cost labour, tax exemptions and economies of scales, etc., are accessible on the other hand, foreign investment is also vital for such economies, to fill-up the gap between investment requirement and domestic resources. These countries constantly formulate policies to invite more FDI to get maximum benefit. It is clear that a competition does exist

\[11\text{ Market potential means the volume of sales and population used as proxy for this variable.}\\ \[12\text{ The Association of South East Asian Nations, various issues.}\\]
in the global market for FDI. From amongst the developing countries of the South Asia and South-East Asia, few countries were successful in receiving more doses of foreign investment. The present study is an attempt to explore the important question as to why foreign investors prefer some countries over the others, in the same region.

1. The Empirical Model

The following model has been used to test the hypothesis. After going through the literature, it follows an encompassing approach to sort, both the economic and socio-political factors having significant impact on the FDI flows. After excluding the weaker and least important determinants, the final general model is proposed:

\[
FDI_{it} = f(PGDP_{it}, DI_{it}, TAX_{it}, FDEV_{it}, INFL_{it}, RER_{it}, EXP_{it}, MILEX_{it}, HDI_{it}, DEPR_{it}, PINS_{it}, TERR_{it})
\]

Equation (1) may be written in the linear form as:

\[
FDI_{it} (net) = \alpha_0 + \alpha_1 PGDP_{it} + \alpha_2 DI_{it} + \alpha_3 TAX_{it} + \alpha_4 FDEV_{it} + \alpha_5 INFL_{it} + \alpha_6 RER_{it} + \alpha_7 EXP_{it} + \alpha_8 MILEX_{it} + \alpha_9 HDI_{it} + \alpha_{10} DEPR_{it} + \alpha_{11} PINS_{it} + \alpha_{12} TERR_{it} + e_t
\]

where, subscript \( i = 1, 2, 3 \ldots 12 \) stands for countries, while \( t = 1, 2, 3 \ldots 15 \) stands for time period (years). The symbols and abbreviations denote the following variables:

- FDI\( (net) \): Foreign Direct Investment (net flows) to the country concerned as ratio of total FDI flows to the region.
- PGDP: Per Capita Gross Domestic Product (used as proxy for Market Size).
- DI: Domestic Investment as a per cent of GDP.
- TAX: Tax Revenue as per cent of GDP.
- FDEV: Financial Sector Development. (Commercial Bank Credit to Private Sector as per cent of GDP used as proxy).
- INFL: Inflation Rate in the Host country.
- RER: Real Exchange Rate.
- EXP: Exports of the Host country as per cent of GDP.
- MILEX: Military Expenditure as per cent of GDP.
- HDI: Human Development Index (Proxy for Human Development).
- DEPR: Dependency Ratio in Host Country.
- PINS: Political Instability (Index of Freedom House).
- TERR: Number of Terrorist incidents per year (Proxy for Law and Order situation).

\(^{13}\) For details, see Tables A-3 and A-4 (Appendix)
The dependent variable is the net FDI flow to the concerned country, over the period 1996 to 2010. The explanatory variables include eight (8) purely economic and four (4) socio-political factors. The rationale for including these variables can be discussed briefly, as under.

a) Market Size

The market size hypothesis postulates that FDI inflow is positively affected by market size of the host country. GDP or population is often used as proxy for market size and its per capita is used as preferable variable for the purpose. It has also been used by many other researchers.

b) Domestic Investment

Domestic investment and FDI can be a substitute or a compliment, depending on the nature of Foreign Direct Investment and investment climate of the host country. The literature provides mix results in this regard. However, a higher rate of domestic investment can be viewed as a discouraging sign for foreign investors, if domestic market is small and limited opportunities prevail for exports [Ahmad and Majeed (2008), Azam and Luqman, (2006)].

c) The Taxation Structure

Taxes are anticipated to have a negative impact on FDI inflows because it increases the cost of production on one hand and reduce profits of corporations on the other hand, that’s why most countries choose policies of tax exemptions or tax holidays to attract more FDI. Demirhan and Masca (2008) concluded that low tax rates encourage FDI. Aqeel and Nishat (2004) also confirmed an adverse and negative effect of taxes on Foreign Direct Investment. Ang (2008) stated that a high corporate tax rate is not a good policy to attract Foreign Direct Investment.

d) Level of Financial Development

(Domestic Bank Credit to Private Sector)

A more developed financial sector will provide a good platform for domestic investment which in turn will shrink space for foreign investment, implying negative association with FDI inflow. Ahmad and Majeed (2009), Aqeel and Nishat (2004) and Elija and Festues (2008) obtained the mentioned result in their research work.
e) **Inflation Rate**

A high inflation rate is an indication of macro-economic instability on one hand and reduction of purchasing power of the consumers on the other hand. Due to this reason it is considered that an obstacle to and a negative impact of inflation rate is anticipated on FDI flows. Sufyan and Sidirpoulos (2010), Shahmoradi (2011), Ismail and Camurdan (2007) all confirmed negative relationship between inflation and the FDI flows, in their studies.

f) **The Exchange Rate**

Exchange rate influences the FDI inflow in several ways. A depreciation of host country currency allows home investors (Foreign) to purchase more assets in the host country, which otherwise would not be possible without depreciation, and thus, it encourages the FDI inflow. The other way is that a real depreciation of host country currency decreases labor cost which allows foreign investors to increase their production and reduce per unit cost. Previous studies confirm that an appreciation of domestic currency will discourage the FDI inflows and vice versa [see, Aqeel and Nishat (2004), Khan and Nawaz (2010), and Pradhan and Saha (2011)].

g) **Exports of the Host Country**

The Exports of host country is an important factor in determination of the FDI. Countries with higher exports will attract most part of the exports-oriented FDI and vice versa, thus, a significant positive impact of this variable is anticipated on net FDI inflows.

h) **Military Expenditures**

Increase in military expenditures mean that more resources are diverted to non-developmental projects, and thus, can be a discouraging sign to inflow of FDI. Similar results were found by Ahmad and Majeed (2009).

i) **Human Capital Development**

The availability of skilled labor at cheap rates would encourage foreign investment in these countries [Sahoo (2006), Azam and Rehman (2006)]. All MNCs aim to hire competent workers at low rates to have maximum profit, and thus, this variable is expected to have a positive impact on inward FDI flows. This study will employ Human Development
Index value while previous studies used literacy ratio\textsuperscript{14} as a measure for human capital development.

\textit{j) Dependency Ratio}

A high dependency ratio means that most of the population is not in the labor force which results in a low family income, and thus, low consumption. Therefore a low dependency ratio is considered to be a vital factor in pulling the FDI and vice versa [Ahmad and Majeed (2009)].

\textit{k) Political Stability (Instability)}

MNCs prefer areas with economic and political stability while making investment abroad, irrespective of type of government (democracy or dictatorship). Investors are mainly concerned with length of the government because quick change in government can be costly for them in the form of policy switching. Azam and Rehman (2006) found that when there is a political instability in a country, foreign investors are reluctant to invest. Ahmad, Maryam, Reza and Azizi (2011) also concluded that political instability adversely affects the FDI inflows to selected OIC countries. Thus, keeping previous literature in mind a negative impact of political instability is predicted on FDI inflows to Pakistan and India.

\textit{l) Terrorism: A proxy for law and order deterioration}

Terrorism has emerged as an extremely dangerous social evil that leads to immediate loss of both human and non-human capital. It generates uncertainty which affects customers and investors. Sakka (2007) found that foreign investors usually avoid areas which are subject to terrorists’ activities. The number of terrorist incidents in a year are therefore, anticipated to have a negative impact on inward flows of FDI.

2. \textit{Estimation Methodology}

This study uses panel data of the South Asian and Southeast Asian region analysing about 18 countries for a period of 15 years (1996-2010). Panel data provides some advantages over time series or cross-sectional data. The panel data frame-work reduces the endogeneity,\textsuperscript{15} and co-linearity among variables of the model. Due to larger sample size, it increases the degree of freedom and reduces

\textsuperscript{14}Sahoo (2006) used literacy ratio in his comprehensive research work. Azam and Rehman (2006) took primary school enrolment as proxy for human capital. Masron and Abdullah (2010) used literacy ratio and found it least influential factor in the determination of FDI.

\textsuperscript{15}It means that some of the explanatory variables may be endogenous to the model.
chances of omitted variable bias. Still further, panel analysis is a proficient way to control the residual (error) term. Despite numerous advantages, pooling of time series and cross section data has some short-comings, as well. First, some of the assumptions related to linear model may be violated. Second, the error terms may exhibit hetero-skedasticity and auto-correlation, which makes OLS estimators inappropriate. Under such circumstances, the GLS method of estimation gives us better results. The problem of hetero-skedasticity is eliminated by using ‘White’s’ hetero-skedasticity consistent standard error estimator. Endogeneity is bypassed by using the seeming unrelated regression (SUR) to obtain consistent empirical results. The model is estimated within the Panel GLS Cross-sectional SUR framework using the software EViews 5.

3. **Data Sources**

To investigate the determinants of FDI in South and South-East Asia, a comprehensive data set is required on different variables for the concerned countries. The study uses panel data from 1996 to 2010 for the selected region. The sources of data are briefly discussed below.

a) The data on dependent variable (net FDI inflow), is taken from the World Development Indicator (WDI) expressed in million US dollars.

b) The market size of the host country is generally represented by GDP or population, or per capita GDP. As stated above, we employ the per capita GDP (US $) as proxy for market size. The data is taken from WDI.

c) Domestic Investment as percentage of GDP is constructed by subtracting FDI from Gross capital formation, both taken as percentage of GDP. The data of Gross Capital Formation is obtained from the World Development Indicator (WDI).

d) The data for military expenditure as percentage of GDP is acquired from Stockholm International Peace Research Institute database, which maintains this information for 172 countries, since 1988.

e) The data on inflation (measured by Consumer Price Index) is taken from WDI.

f) The domestic bank credit to private sector as percentage of GDP was used to represent the Financial Sector development. The data is taken from WDI.

g) Taxes include both the direct and the indirect taxes (as per cent of GDP). The data is acquired from WDI and the World Economic Outlook (IMF). Different issues of Economic Survey of Pakistan, Nepal Economic Survey, Philippines
National Accounts Data, National Accounts of Thailand and Bengal Economic Review have been consulted for the data of concerned countries.

h) Data on merchandise exports was obtained from the World Trade Organization (WTO) statistics database. The real exchange rate variable is constructed by multiplying nominal exchange rate to the ratio of CPI of the host country and the CPI of USA. The relevant data on exchange rates and consumer price indices is acquired from the WDI for construction of variable.

The important non-economic factors considered in this study are dependency ratio, human capital, law and order situation and political stability/instability.

i) Data on dependency ratio (in percentage terms) was obtained from the WDI.

j) Human Development Index (HDI) is used as proxy for human capital development and its data is retrieved from different issues of Human Development Reports by the United Nations.

k) ‘Terrorism’ can be used as proxy for law and order situation prevailing in a country. The data on terrorist incidents per year is obtained from the Global Terrorism Database, which provide information on terrorist events for 194 countries from 1970. Each terrorist event is recorded with date of incident, location, weapon used, target’s nature, number of casualties and if possible the individuals or parties responsible for the incident. The data from 1970 to 1997 is based on the following definition of terrorism:

“The threatened or actual use of illegal force and violence by a non-state actor to attain a political, economic, religious, or social goal through fear, coercion, or intimidation.”

While the event should be an “intentional act of violence or threat of violence by non-state actor(s)” to be included in data from 1998 to 2010. The incident should also fulfill two out of three criterion.

l) The political stability (instability) index is obtained from ‘Freedom House’ which is a USA-based organization that conducts annual surveys about ‘Freedom’ in the world, since 1973. The term ‘Freedom’ includes two phenomena, namely, political rights and civil liberties, both of which are measured on a scale of

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16 The aim of the event should be the attainment of social, religious, cultural or political goal. The violent act included evidence of an intention to coerce, intimidate, or convey some other message to a larger audience(s) other than the immediate victims; and that the violent act was outside the precepts of International Humanitarian Law.

17 Include Electoral Process, Political pluralism, Participation and Functioning of the Government.

18 Include Freedom of Expression and Belief, Associational and Organizational rights, Rule of law, Personal autonomy and individual rights.
zero to seven. Based on the two variables, the countries are then divided into three categories like free, partly free and not free. A country falling near ‘zero’ represents politically free and near seven on the index means not politically free.\footnote{We constructed dummies based on scores allotted to each country; the dummy ‘zero’ is assigned if a country is not free and ‘one’ when a country is either partly free or completely free.}

V. Results and Analysis

The panel in the study which originally contained 18 countries but due to limited data for the period 1996-2010 the number of countries were reduced to 12 and Bhutan, Brunei Darussalam, Laos, Maldives, Myanmar and Vietnam were dropped from the analysis. Therefore, the model was empirically estimated via the Panel GLS Cross-sectional SUR framework using the software EViews 5.

The regression output is presented in Table1. All the relevant coefficients carry the correct (expected) signs where most variables are significant. On basis of these results, the significance of each variable that explains the FDI flows is discussed for different countries of the region.

TABLE 1

Regression Output (12 countries, 15 years, 12 variables)
Dependent Variable (Net) Direct Foreign Investment (Inflow)

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>Std. Error</th>
<th>t-Statistic</th>
<th>Prob.</th>
</tr>
</thead>
<tbody>
<tr>
<td>PGDP</td>
<td>0.340042</td>
<td>0.040621</td>
<td>8.371053</td>
<td>0.0000</td>
</tr>
<tr>
<td>DI</td>
<td>-0.153180</td>
<td>0.031881</td>
<td>-4.804727</td>
<td>0.0000</td>
</tr>
<tr>
<td>TAX</td>
<td>-7.114457</td>
<td>2.212414</td>
<td>-3.215698</td>
<td>0.0016</td>
</tr>
<tr>
<td>FDEV</td>
<td>7.697234</td>
<td>1.847403</td>
<td>4.166516</td>
<td>0.0000</td>
</tr>
<tr>
<td>INF</td>
<td>19.052460</td>
<td>3.134849</td>
<td>6.077632</td>
<td>0.0000</td>
</tr>
<tr>
<td>RER</td>
<td>-19.931280</td>
<td>2.091449</td>
<td>-9.529890</td>
<td>0.0000</td>
</tr>
<tr>
<td>EXP</td>
<td>0.020629</td>
<td>0.001686</td>
<td>12.232420</td>
<td>0.0000</td>
</tr>
<tr>
<td>MILEX</td>
<td>-487.841000</td>
<td>38.485450</td>
<td>-12.675990</td>
<td>0.0000</td>
</tr>
<tr>
<td>HDI</td>
<td>3.894228</td>
<td>1.061934</td>
<td>3.667108</td>
<td>0.0003</td>
</tr>
<tr>
<td>DEPR</td>
<td>-28.523890</td>
<td>3.715892</td>
<td>-7.676190</td>
<td>0.0000</td>
</tr>
<tr>
<td>PINS</td>
<td>-1858.513000</td>
<td>65.129370</td>
<td>-28.535720</td>
<td>0.0000</td>
</tr>
<tr>
<td>TERR</td>
<td>-0.485166</td>
<td>0.223700</td>
<td>-2.168823</td>
<td>0.0315</td>
</tr>
<tr>
<td>R-square</td>
<td>0.920093</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Durbin-Watson statistics</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
1. Economic Determinants of FDI

As discussed earlier, eight (8) variables in this category are included. The factual position with respect to their impact on FDI is discussed below.

a) Market Size (PGDP)

The market size hypothesis is confirmed from our empirical results. In simple words, the hypothesis suggests that there exist a positive relationship between the FDI inflows and market size of the host country (per capita GDP used as proxy). Market size is a natural pre-requisite for FDI and is consistent with findings of previous studies. Result of our panel confirm a positive and significant impact of per capita GDP on net FDI inflows, which means that countries with bigger market size will attract more FDI as compared to economies of smaller markets. Per capita GDP reflects both the purchasing power of most countries, as well, as the pace of economic growth in the recipient countries. It is obvious that investors will prefer large markets for absorption of their products when establishing their business. The results obtained are similar to Lewis (1998) and Chakarbati (2001) and Vijaykumar (2010).

b) Domestic Investment (DI)

The level of domestic investment is an important factor to determine the foreign direct investment. It can either be a substitute to or a compliment for, foreign investment depending on the size of economy, as well as, investment opportunities in the host country. However, the LDCs have limited business opportunities (because of smaller markets in general), so the substitutive possibility remains on the dominant side. The present study finds the level of domestic investment a substitute for FDI and therefore has a negative significant impact. This means that domestic investment has a crowding-out effect on foreign direct investment. Azam and Lukman (2006) show similar negative relation between domestic investment and the FDI for Indonesia. The results are also consistent with the findings of Majeed and Ahmad (2009). Thus, a country with higher domestic investment will receive lesser inflows of FDI and vice versa.

c) Domestic Taxes (TAX)

Taxes reduce profits of MNCs on one hand and on the other hand shrink the purchasing power of people in the host country. This double action of taxation adversely affects the FDI inflows. The previous studies on the subject also project taxation to have an adverse effect on net FDI inflow to the host country economy.
The results of this study reveal a highly significant negative correlation between taxes and the net FDI inflows, confirming the statement that a high corporate tax rate is not a good policy to attract FDI [Ang (2008)]. Aqeel and Nishat (2004) and Demirhan and Masca (2008) also states negative relation between FDI and taxes stating that investment will move to these countries where rate of taxation is low.

d) Financial Sector Development (FDEV)

In this study the volume of domestic bank credit is used in private sector as per cent of GDP as proxy for financial sector development of the host country. As stated earlier, a well established and developed financial sector provides opportunity for domestic investors and the enterprises to invest and carry on their business smoothly. Funds are provided by the banking sector to enterprises for their short-term working capital, as well as, for long term projects. Thus, a developed financial sector is considered an encouraging factor for FDI. Some studies, however, conclude with a negative or insignificant role of this factor for FDI inflows. For instance, Majeed and Ahmad (2009) showed that domestic bank credit to private sector is insignificant, while Aqeel and Nishat (2004), Sufyan and Sidiropoulos (2010) established a negative role of financial sector development in attracting the FDI. In contrast, studies like Ang (2009) also obtained a highly significant impact of financial sector development on FDI inflows to Malaysia. The findings of this study also indicate a significant positive impact of financial sector development on FDI flows, which apparently seems against the conventional wisdom. However one plausible explanation for this outcome may be that a developed financial sector reduces the transaction costs and ensures safe transfer of funds and minimizes the risk of default in contracts where banks serve as guarantors between the buyers and sellers (business firm).

e) Inflation (INFL)

Inflation erodes the purchasing power of consumers and restrict them to purchase high-valued products of multinational corporations. A higher inflation is also an indication of macro-economic instability in the country. The literature provides mix results about the relationship between FDI flows and inflation. Shahmoradi (2011), predicted a negative significant impact of inflation on net FDI inflows while Azam and Lukman (2006) found inflation to be insignificant. Based on findings of these studies, we also anticipate a negative relationship between the FDI and inflation. However, we discovered a positive significant impact of inflation on net FDI flows to the region. Still our findings are consistent with Rihab and Lofti (2011) and Khrawish and Siam (2010), who established inflation to be positively correlated with FDI inflows for transition economies. Bortic and Skuflic (2006) also obtained a similar relation between inflation and FDI flows for Southeast European countries.
A possible explanation for this result may be that high inflation in the host country gives a chance of high profits to MNC’s by charging higher prices for their products. Thus, a high inflation rate is an attracting sign for foreign investors.

\( f \) Real Exchange Rate (RER)

Real exchange rate appeared with a negative and significant impact on FDI as anticipated and arrived at by Wafuru and Nurudin (2010), Udha and Egwaikhide (2008). This means that an appreciation of local currency in the international market, adversely affects the FDI inflows, while depreciation acts conversely. This is understandable because an appreciation of local currency will increase the worth of assets-in domestic currency, which will make foreign investors worse-off as compared to the situation, as if there was no appreciation. Second, appreciation of local currency will increase the cost of production; both raw material as well as labor in terms of foreign currency and will reduce the profit margin of foreign investors. Third, appreciation can reduce exporting capacity of MNCs in the international market because this will make the domestic goods expensive in terms of foreign currency. Thus, depreciation of local currency can be desirable for foreign investors, to invest.

\( g \) Exports of the Host Country (EXP)

The exports oriented FDI will move to countries with high export potentials. Such foreign investors would aim to exploit the economies available in the host countries like cheap raw material and low cost labour and cover the global market with their products. Thus, export can be considered an important determinant of FDI provided a liberal trade policy prevails in the host country. The findings of this study confirm the hypothesis that total merchandise exports are positively correlated with net FDI inflow and statistically significant. Exports are important in explaining difference in the net FDI flows across countries in the selected panel. Our findings are consistent with those of Kahai (2004), Wadhwa and Reddy (2011) and Khan and Nawaz (2010). The literature highlights 2-way causation between exports and the FDI.

\( h \) The Level of Military Expenditure (MILEX)

Military expenditure (per cent of GDP) indicates that host country gives priority to non-developmental activities and that it is not internally peaceful or politically stable, or some kind of tension prevails in its neighbors. It is expected to have a negative impact on net FDI inflows. The very act of storing arms by a country can be a disturbing factor for keeping good foreign relations with neighboring countries. Therefore, foreign investors will be reluctant to invest in such countries. Empirical
results of this study establish a statistically significant negative relationship between foreign direct investment flows and the military expenditures, which is similar to the findings of Majeed and Ahmad (2009). This means that high volume of military expenditure will be an impediment in the way of net FDI inflow.

2. Socio-Economic and Political Determinants of FDI

a) Human Capital Development (HDI)

The availability of high quality workers is essential for a productive and profitable business. Obviously, the productivity of educated, trained and skilled workers is higher than that of unskilled workers. Literacy rate is usually used to measure human capital development and this variable is important in context to FDI inflows shown by Sahoo (2006) and Azam and Rehman (2006). Majeed and Ahmad (2008) used health expenditure and literacy for human capital development, while the former was found significant, the later was not much important in attracting the FDI. In sum total, one would expect positive impact of human capital development on FDI inflows. The HDI was used as a proxy for human capital development in this study, which appear highly significant with positive sign, as it was expected. This leads to the conclusion that human capital plays an important role in attracting FDI in the selected regions.

b) Dependency Ratio (DEPR)

The dependency ratio, expressed as percentage of dependents of age below 15 and above 64 years to the total work force, appeared with a negative sign (and statistically significant) claiming that a higher dependency ratio is a discouraging factor as far as Foreign Direct Investment is concerned. It is quite appealing to the common wisdom of high dependency ratio as it is an indicator of low purchasing power of households and higher consumption of basic needs. This may affect profitability of MNCs via low sale of their luxury products. This, can avoid countries with higher dependency ratio for investment. The variable is negative in sign and statistically significant Therefore, it is indicative for impediment in the way of FDI. This result is also consistent with previous studies like Majeed and Ahmad (2009).

c) Political Stability / Instability (PINS)

Political stability is indispensable for stable growth and development of economy and other sectors of social structure of a country. The literature suggests that foreign investors take due care of the status of property rights, political violence, average length of governments, validity of their policies, internal conflicts, etc., while taking
investments in a particular country. In other words, they invest only when such factors are favorable. Keeping in view the findings of former studies, a strong negative impact of political instability on FDI flows could be foreseen in this study. The results obtained are as expected and, negative and strongly significant relationship appearing between the net FDI inflow and the political instability. It reveals that political stability makes a difference in the flow of investment across countries. The direction of flows will be natural towards those countries which are politically stable within a given region. The result is in line with findings of previous studies by Azam and Rehman (2006), Samimi, et al. (2011) and Udah and Egwaikhide (2008). Such a finding is the primary concern and a matter of interest for this study.

d) Law and Order Situation (TERR)

Terrorism has shaken the world economy in general and some economies in particular like Pakistan, Afghanistan, Sri Lanka, etc., as it involve the loss of precious human lives, besides the loss of physical capital and destruction of the infrastructure. Counter terrorism steps taken by government cost billions of dollars. It creates uncertainty among masses and severely disturbs business and investment. Terrorism and armed conflicts within a country are inimical to growth and development, and have a negative impact on FDI inflows. The results obtained are in line with the expectation and conclusion of other studies like Sakka (2007), showing a strong negative correlation between terrorism and the net FDI inflows. It means that foreign investors prefer peaceful environment and vibrant economies. They will be reluctant to move to countries which are plagued by terrorism. For establishing subsidiaries in the host countries, the multi-nationals will specially look at the law and order situation of the countries. Terrorism is thus concluded to be the major impediment to FDI flows.

VI. Conclusion and Recommendations

The effort made in this study is to identify and explore the main economic and socio-political determinants of foreign direct investment flows in developing countries. These flows have increased tremendously, over the last three decades with emerging and expanding concept of globalization. In addition to the economic determinants, the study has particularly focused on some socio-political factors like terrorism and political instability in the host countries. The study considers a panel of 12 countries in South Asia and Southeast Asia region for the period ranging from 1996 to 2010. Special efforts have been made to specify the model correctly and to include all important variables. Estimation of the model is carried out through Panel GLS and Seemingly Unrelated Regression (SUR) technique using the software EViews 5.
1. **Summary and Conclusions**

The empirical findings of this study suggest that both the economic and non-economic factors are important to determine the volume of FDI for different countries. Most of our findings are consistent with previous studies, carrying the correct signs. The per capita GDP, volume of exports, human capital development, inflation and financial sector development are all significant with positive signs, which means that these factors encouraged FDI flows to the region. On the other hand, domestic investment, taxes, real exchange rate, dependency ratio and military expenditures show negative signs and are prominent depressing factors in determination of the FDI flows.

The crucial finding of this study is the fact that law and order situation of any host country is an important factor, rather the pre-requisite for the FDI inflow to a country. In simple words, countries with better law and order situation attract bulk investment from abroad. This study has considered the converse case, i.e., deteriorating law and order is represented by the number of terrorist incidents taking place in a country during a year. This factor is highly significant with negative sign, which means that terrorism is a strong barrier for foreign investment flows. The result is particularly valid for Pakistan; the country has been trapped in this menace for over the past 30 years which gravitated after the 9/11 in particular. The terrorist attack on students in Peshawar has crossed all borders of humanity and compelled the nation to think seriously about this intolerable issue. Another key finding of this study is the importance of political stability, obviously leading to continuity of sound economic policies, attracting foreign investors. Political instability has a significant negative impact on net FDI flows to the South and South-East Asian countries. It implies that foreign investors give considerable weight to the political situation of the host country. They generally, avoid investment if the concerned country is politically unstable, and again, this factor is crucial particularly for Pakistan. The nation has observed the impact of political unrest created on the basis of rigging the general elections 2013. Other socio-political and economic factors which determine the volume of FDI inflows are the dependency ratio (negative impact) and the level of human capital (positive impact).

2. **Policy Implications**

The study proposes the following suggestions and recommendations for policymakers:

i) Per capita GDP appear as an important determinant of FDI inflows, therefore, economic policies which ensure high and sustainable GDP growth should be designed.
ii) The volume of exports has a significant positive impact on attracting foreign investment flows. The policymakers should therefore give proper attention to encourage and support domestic industry in general and exports-oriented units in particular. This is essential not only for attracting the FDI but also for improving the BOP situation.

iii) This study recommends an easy tax policy or specific tax holidays and exemption to attract the Foreign Direct Investment inflows.

iv) Financial sector development significantly promotes the FDI inflows. Therefore, the banking network and other financial institutions should be expanded and upgraded to fulfill all requirements of the modern days.

v) Military expenditure is found to be a barrier for foreign investment inflows. Policy managers should therefore think over this issue and should design policies to minimize tension within the borders and across, as far as possible, so as to cut down the spending.

vi) The governments, as well as the social sector of the country, have to work hard to promote literacy rate, technical education, vocational training, etc., and to organize special programs and workshops to improve skills and productivity of the labor force. This improvement in human capital can be helpful to attract foreign investment.

vii) The government and the law enforcing agencies must continue their struggle to ensure a peaceful environment conducive to economic development. The rule of law should be ensured and, militancy and insurgency should be eliminated at all costs, failing which attracting foreign investment will remain a dream. In simple words, peace and tranquility is the pre-condition for economic development.

viii) Political instability has a strong negative impact on the net FDI inflows, it is necessary for all stakeholders (governments, bureaucracy, national institutions and political leadership) to strive for a peaceful and progressive political democratic environment, which in turn, will encourage foreign direct investment and enhance economic growth of the country.

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International Islamic University, Islamabad.
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APPENDIX

1. The FDI Flows: A General Comparative Position

Table A-1 illustrate the net FDI flows to develop and developing countries. Last two columns of the Table shows the net FDI flows to South Asian and South East Asian region as percentage of the World’s total FDI flows and as percentage of net FDI flows to developing countries. These flows are somehow not uniform with years of massive increase followed by sharp decline, both globally as well as, regionally. Global FDI flows have rapidly increased for initial five years (1996-2000) followed by three consecutive years of huge turn down which is true for both the developed and developing economies. Recovery is reported in 2004 and gradual increase in the following years reached a record high value in 2007. Again a significant decline in 2008 was witnessed because of Global Financial Crisis which adversely affected nearly all countries. South Asia and South East Asia countries have mixed performance as far as the net FDI flows are concerned. The Global FDI (8 per cent) was attracted in 1996, which sharply and continuously declined for the next few years. It declined to minimum level of 1.96 per cent in 1999 although global FDI flows flourished during these years. From the year 2000 onward, recovery took place and FDI flows reached the record high value of 8.23 per cent in 2010. FDI flows to the region under reference as percentage of net FDI inflows to developing countries are also volatile with ups and downs. The high value was reported in 1996 as 21.2 per cent and in 2010 as 17.4 per cent.

2. FDI Flows to South and South-East Asian Countries

Table A-2 shows the share of each country in FDI as per cent of the total FDI flows to South Asian and South East Asian region that highlights the efficiency of each country in attracting FDI. Singapore, Malaysia, Indonesia and Thailand from among the South-East Asian region and India from the South Asian region receive the bulk of FDI flows, while Indonesia depicts the highly volatile and mixed performance in this regard. Other countries do receive the FDI but at lesser magnitude. The data suggests that Singapore is the dominant country in the region as FDI inflow is concerned. It received 53, 60 and 58 per cent of the total inflows, consecutively for 2000, 2001 and 2002, respectively but received only 9 per cent of the total inflows in 2008 and again reached 36 per cent in 2010. The share of India is ever increasing with the passage of time with an increase from merely 9 per cent in 1996 to 46 per cent by 2009. Similarly, Malaysia, Thailand and Vietnam are also important to attract foreign investors. However, it is worth noting that net FDI inflow to these countries is not constant but subject to huge fluctuations. Philippines received 9.23 per cent and 8.13 per cent of the total net flows in 1999 and 2001 but
for rest of the years. The flow was not of much significant. In this respect the performance of Pakistan is also poor, except for three years (2006-08) amounting to 5 per cent of the total FDI flow to the Asian region. The net FDI flow to Indonesia is extremely volatile which recorded with negative sign for few years. Bangladesh, Cambodia, Papua New Guinea, Maldives, Sri Lanka, Nepal and Laos received very low share from the total net FDI flows. It is evident from Table A-2 that huge difference exist among countries in the net FDI receipts even during different years for the same country.

### TABLE A-1

Trends in Net FDI Inflows to Developed, Developing and South and South East Asia

<table>
<thead>
<tr>
<th>Years</th>
<th>Developed Countries</th>
<th>Developing Countries</th>
<th>World Total</th>
<th>South Asia &amp; Southeast Asia</th>
<th>As per cent of the World's Total FDI</th>
<th>As per cent of Developing Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996</td>
<td>236034.9</td>
<td>148993.4</td>
<td>390899.52</td>
<td>31590</td>
<td>8.08</td>
<td>21.2</td>
</tr>
<tr>
<td>1997</td>
<td>285390.8</td>
<td>192113.3</td>
<td>487853.49</td>
<td>36509.4</td>
<td>7.48</td>
<td>19</td>
</tr>
<tr>
<td>1998</td>
<td>508744.7</td>
<td>189399.4</td>
<td>706265.93</td>
<td>24773</td>
<td>3.5</td>
<td>13</td>
</tr>
<tr>
<td>1999</td>
<td>852120.6</td>
<td>230710.7</td>
<td>1091438.7</td>
<td>31278.2</td>
<td>2.86</td>
<td>13.5</td>
</tr>
<tr>
<td>2000</td>
<td>1137996.2</td>
<td>255505.9</td>
<td>140540.5</td>
<td>27529.6</td>
<td>1.96</td>
<td>10.7</td>
</tr>
<tr>
<td>2001</td>
<td>601241.07</td>
<td>216865.1</td>
<td>827617.3</td>
<td>25878.9</td>
<td>3.12</td>
<td>11.9</td>
</tr>
<tr>
<td>2002</td>
<td>443431.7</td>
<td>173283</td>
<td>627974.7</td>
<td>23300.3</td>
<td>3.71</td>
<td>13.4</td>
</tr>
<tr>
<td>2003</td>
<td>376807.6</td>
<td>190124.8</td>
<td>586956.3</td>
<td>26990</td>
<td>4.5</td>
<td>14.1</td>
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<td>2004</td>
<td>422179</td>
<td>291866</td>
<td>744329.1</td>
<td>43837.1</td>
<td>5.88</td>
<td>15</td>
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<tr>
<td>2005</td>
<td>622625.4</td>
<td>327247.7</td>
<td>980727.1</td>
<td>51442.4</td>
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<td>2006</td>
<td>981869.3</td>
<td>427163.4</td>
<td>1463351.1</td>
<td>82011.1</td>
<td>5.6</td>
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<td>2007</td>
<td>1310425.4</td>
<td>574311.4</td>
<td>197537</td>
<td>107798.6</td>
<td>5.45</td>
<td>18.7</td>
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<td>2008</td>
<td>1019648</td>
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*Source: UNCTAD Statistical Database.*
### TABLE A-2

Country Specific FDI Share as a Percentage of Total FDI Flows to South Asia and South East Asia from 1996 to 2010

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*Source: World Development Indicators Database.*
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