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Capital Inflows And Economic Growth: A Case Study of Pakistan

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ABSTRACT
This study examines the effect of capital inflows on Pakistan's economic growth during the period 1990-2023, focusing on three major inflows: Foreign Direct Investment (FDI), Official Development Assistance (ODA), and Personal Remittances (PR). By applying the Autoregressive Distributed Lag (ARDL) bounds testing method, the analysis confirms the presence of a long-run equilibrium relationship between the selected variables. The results show that both remittances and FDI are statistically significant and positively affect long-term GDP growth, highlighting their potential as future sources of stable economic progress. Conversely, ODA is observed to have a negative effect, indicating dimensions of aid dependency, inefficiency, and poor resource utilization. Contrary to expectations, Gross Fixed Capital Formation (GFCF) also reveals a negative long-run relationship with GDP, possibly indicating inherent structural and institutional inefficiencies in capital use. Trade openness is positively linked with growth in both the short and long run. Short-run dynamics also highlight foreign capital's volatility and mixed impact, with remittances consistently contributing positively. These findings emphasize the importance of specific policy reforms, better institutional arrangements, and increased absorptive capacity to channel foreign inflows into sustained and inclusive economic growth.

KEYWORDS: *Foreign Capital Inflows, Economic Growth, Foreign Direct Investment (FDI), Personal Remittances, Pakistan Economy*

Introduction

Economic development and external investment remain key concerns in development economics for developing countries like Pakistan since they face deficiencies in their structure and limited budgets as well as unstable growth patterns. The increase in real GDP serves as the main indicator of economic growth since capital accumulation stands among the vital factors that generate this expansion. Weak financial sectors coupled with low domestic saving rates cause these countries to use foreign investment for development and to bridge funding gaps and promote business improvements. Official development assistance (ODA), personal remittances (PR) and Foreign Direct Investment (FDI) make up the majority of foreign capital that flows into Pakistan according to its economic history. The process of creating sustainable world economy policies for Pakistan depends on understanding how different capital forms affect and obstruct economic development. The Pakistani economy remains highly dependent on foreign capital

since it serves as a crucial factor for achieving stable macroeconomic conditions along with long-term economic expansion. The entry of FDI provides productive capital and technological capabilities whereas remittances enable social advancement through consumption and ODA adds to public spending particularly in infrastructure development education systems and health systems. The economic dependence on external sources has grown intensely during the past few decades since Pakistan suffers from persistent fiscal imbalances and current account deficits and its manufacturing sector performs poorly and political instabilities persist (Javaid,2017; Azam, 2016).

Foreign capital injection into Pakistan's economy produces effects that differ throughout different economic indicators. The State Bank of Pakistan (2023) reports that Pakistan received a decreased amount of $1.9 billion in foreign direct investment (FDI) during FY2022 when compared to $5.4 billion from FY2008. The investment decline happened primarily because of negative investor sentiment which came from energy issues alongside institutional problems and geopolitical issues.

The telecommunications and electricity industries have received the majority of foreign direct investment (FDI). In contrast, remittances have steadily increased from $6.4 billion in 2008 to more than $31.6 billion in 2022, solidifying their position as the most dependable and substantial source of foreign currency. Despite becoming less erratic, ODA made up roughly $3.6 billion in 2022 and was mostly financed by bilateral donors and international organizations such as the Asian Development Bank and World Bank (World Bank, 2023; OECD DAC, 2023). Pakistan's relative performance in terms of FDI attraction, however, has been modest vis-à-vis regional comparators such as India and Vietnam. The nation was ranked 6th in the world in remittance inflows in 2022, an indicator of its sizeable diaspora base and increasing reliance on labor exports. Remittances now account for almost 9% of Pakistan's GDP, surpassing both foreign direct investment and official development assistance in terms of their ability to stabilize the country's economy (Migration and Development Brief, 2023, World Bank). ODA flows, worldwide amounting to $204 billion in 2022, still finance humanitarian and development priorities but have been only partially effective in the recipient countries such as Pakistan, because of control challenges and misallocation of aid (Bird & Choi, 2020).

Three of the most important factors in developing countries' economic growth—ODA, FDIs, and remittances—have historically helped the country. Industry, macro-level infrastructure, and regional infrastructure will all be strengthened by these infusions, and the gap between savings, investment, and foreign exchange will be filled. However, in spite of all these inflows, Pakistan’s economic growth is choppy at best, fluctuating and experiencing periods of severe external deficits and an increasing dependency on foreign debt. These inflows are expected to yield as positive productivity, technological enhancement, and sustainable development with the economy’s productive capacity, but that is not happening. The above mentioned and other factors create voids and risks in the economy’s absorptive capacity, foreign resource zoning as well as policy mechanisms in place. The ineffective institutions and incoherent policy frameworks, unconstructively delayed within each sector, have overshadowed the benefit of foreign deposits, making their impact ambivalent. Consequently, the purpose of this research is to analyze the impact of foreign direct capital inflows on Pakistan's GDP development, the

reasons behind its underperformance, and potential alternatives to FDI in order to sustain the country's current rate of economic progress.

Literature Review

Particularly, the effects of foreign inflows on economic development in developing countries like Pakistan have been the subject of much academic study. Pakistan is a developing nation that relies on remittances, official development assistance (ODA), and foreign direct investment (FDI) to sustain its economy. The country is heavily indebted, has almost no local savings, a chronic problem of fiscal deficits and can do very little to change its situation. This chapter reviews theoretical theories and gives empirical insights into these three broad categories of foreign inflows for the remaining chapters. This paper examines FDI and its effect on technical and industrial development, ODA and its funding for development, and remittances and its effect on welfare of the households as well as macroeconomic stability in line with the topics sectioned in this paper.

FDI and Economic Growth

Studies across Pakistan explore FDI effects on GDP growth but show conflicting results based on time periods industry analysis and research strategies. Research results demonstrate that FDI increases overall economic progress. Over 1980-2017 Sibt e Ali et al. (2021) found both increases in financial sector activities and foreign direct investments boost Pakistan's economic development.

Ahmad & Khan (2021) also supported such evidence, as they demonstrated how long-term ties among FDI, remittances, and GDP ensure enduring growth, thus calling for uninterrupted FDI inflow policies. Ali & Shaheen (2019), employing ARDL-ECM on 1971–2018 data, held that FDI significantly and positively impacts short- as well as long-run economic growth, in large part through technology transfer and human capital development.

Foreign direct investment (FDI) does not always have a good effect, according to other studies. While foreign direct investment (FDI) might create employment in the automotive sector, policy misalignment and structural inefficiencies limited FDI's overall contribution to economic development, according to Waqar et al. (2023). Ashraf et al. (2019)**,** based on VECM between 1987–2017, concluded that FDI inflows were statistically insignificant in promoting growth due to Pakistan having poor absorptive capacity to deploy foreign capital effectively. Yasir et al. (2023) further indicated that increases in oil prices can cancel out the advantages of FDI, and ineffective sectoral targeting decreases its overall contribution to growth. These studies have shown that foreign direct investment (FDI) does not guarantee economic development on its own and requires a conducive environment in order to provide sustainable benefits.

ODA and Economic growth

There has been some usual disagreement on the estimated impact of Official Development Assistance (ODA) on economic growth of Pakistan in variscite. More specifically, following the argument in the previous section, this study has shown that both ODA and FDI had significant short- and long-run effects on the GDP in Javaid (2017) employing ARDL and ECM analysis on the data obtained from the yearly average of 1973-2014. This means that if implemented right, aid can continuously be in a position to fund other sectors of development for the benefit of Pakistan. In the same vein, Bashir et al. (2023), through the ARDL model 1972–2021, also managed to infer that although ODA positively contributes to GDP in the short run, its long-term

impact relies on the health of the economy and institution reforms. This points to the need for stability in a macroeconomic setting in order to be in a position to tap into the opportunities that are derived from aid. In other studies, Khan et al. (2024) focused on human capital development and found ODA had little but positive engagements with GDP in the presence of remittances and urbanization. This study identifies that ODA can carry beneficial effects but that these effects become magnified in their influence when other factors like remittances and urbanization are combined. Zeb (2017) also highlighted the need for structural alignment in her results, which revealed that both ODA and FDI are major long-term determinants of Pakistan's economic growth. With correct structural alignment, ODA can be an effective economic stimulus and a growth catalyst.

Conversely, some studies have also expressed concern regarding the adverse or mixed impact of ODA on Pakistan's economy. Anwar et al. (2024), using ARDL models, identified that foreign aid always deterred Pakistan's GDP growth from 1985 to 2019, both short and long run. Their results support dependency theories, which imply that heavy dependence on foreign aid can hamper economic growth. Similarly, Zaidi et al**.** (2024) contended that the advantages of ODA are usually offset by inefficiencies and political conditionalities. They suggested a move towards trade liberalization and FDI rather than dependence on aid, proposing that sustainable growth can be better promoted through economic liberalization and foreign investment attraction.

2.4 Remittances and economic growth

Most research has shown that remittances have an effect on GDP growth and macroeconomic stability, hence they are clearly a key factor in Pakistan's economic situation. Munir et al. (2016) used a multivariate cointegration methodology over the period of 1980–2014 and determined that individual remittances, FDI, and human capital have a remarkable impact in adding to Pakistan's long-run economic growth. Khan et al. (2019) confirmed these results with the ARDL model for the period 1976-2016, showing that remittances are positively correlated with GDP growth, mainly through investment-based uses and not consumption. They contended that the official remittance channels must be widened to enhance their developmental role**.** Tahir et al. (2015) considered the external flows of capital—remittances, FDI, and imports—over the period of 1977 to 2013 and determined that the remittances exert a statistically significant positive impact on economic development and thus advocated the formulation of targeted government policies for inducing greater remittances through proper channels.

However, not every research supports remittances as a magic bullet for sustainable economic development. Afrin et al. (2018) tested remittance flows in Bangladesh, India, and Pakistan with Granger causality and Johansen cointegration methods and determined a unidirectional causality in Pakistan from GDP to remittances, suggesting that economic growth leads to remittance inflows instead of vice versa. This indicates a restricted proactive contribution of remittances to economic development. Javaid (2017) employed ARDL models during 1973–2014 and arrived at the conclusion that, in contrast to FDI and Official Development Assistance (ODA), remittances lack a statistically significant contribution to GDP. This was due to inefficient use and poor financial channels in Pakistan. Asad et al. (2016), studying the data during 1975–2010, argued that remittances pay for the consumption rather than investment so that economic activity receives short-term gains without triggering long-term productivity.

Data and Methodology

This study analyzes yearly secondary datasets from 1990 until 2023 in Pakistan. Based on previous research, it utilizes Foreign Direct Investment (FDI), Official Development Assistance (ODA), and personal remittances (PR). Trade openness (TO) and Gross Fixed Capital Formation (GFCF) as the explanatory variables to estimate the long run economic growth (log of real GDP per capita) of Pakistan. The data for the variables have been collected from World Development Indicators (WDI).

Foreign Direct Investment is measured as net FDI inflows as a percentage of GDP. Official Development Assistance represents total development assistance received by Pakistan. Personal remittances are measured as remittance inflows as a percentage of GDP. Trade openness is calculated as the ratio of exports plus imports to GDP, while Gross Fixed Capital Formation represents investment in physical capital and infrastructure.

The study follows a functional relationship between economic performance and foreign capital inflows as follows:

LGDPPC = f(FDI, ODA, PR, TO, GFCF)

The econometric model can be written as:

$$LGDPPC_t = \beta_0 + \beta_1 FDI_t + \beta_2 ODI_t + \beta_3 PR_t + \beta_4 TO_t + \beta_5 GFCF_t + \epsilon_t$$

Before estimating the model, stationarity properties of the variables were examined using the Augmented Dickey-Fuller (ADF) test and Phillips-Perron (PP) test. Testing stationarity is important because non-stationary variables may produce spurious regression results.

This study employs the Autoregressive Distributed Lag (ARDL) bounds testing approach developed by Pesaran et al. (2001). The ARDL method is appropriate because it can estimate both short-run and long-run relationships among variables integrated at I(0) and I(1). It also performs efficiently with small sample sizes.

The general ARDL model is specified as:

$$\begin{aligned}\Delta(\boldsymbol{lnGDP_t}) = {} & \boldsymbol{\alpha_0} + \boldsymbol{\gamma_1}\ln(\boldsymbol{GDP_{t-1}}) + \boldsymbol{\gamma_2}\ln(\boldsymbol{FDI_{t-1}}) + \boldsymbol{\gamma_3}\ln(\boldsymbol{ODA_{t-1}}) + \boldsymbol{\gamma_4}(\boldsymbol{PR_{t-1}}) \\ & + \boldsymbol{\gamma_5}(\boldsymbol{FDI_{t-1}}) + \boldsymbol{\gamma_6}(\boldsymbol{TO_{t-1}}) + \sum_{i=1}^{p} \boldsymbol{\beta_1}\,\Delta(\boldsymbol{lnGDP_{t-i}}) + \sum_{i=1}^{q} \boldsymbol{\beta_2}\,\Delta(\boldsymbol{lnFDI_{t-i}}) \\ & + \sum_{i=1}^{q} \boldsymbol{\beta_3}\,\Delta(\boldsymbol{lnODA_{t-i}}) + \sum_{i=1}^{q} \boldsymbol{\beta_4}\,\Delta(\boldsymbol{PR_{t-i}}) + \sum_{i=1}^{q} \boldsymbol{\beta_5}\,\Delta(\boldsymbol{TO_{t-i}}) \\ & + \sum_{i=1}^{q} \boldsymbol{\beta_6}\,\Delta(\boldsymbol{GFCF_{t-i}}) + \boldsymbol{\varepsilon_{1t}}\end{aligned}$$

The ARDL bounds test is used to determine the existence of cointegration among the variables. If the calculated F-statistic exceeds the upper critical bound value, a long-run relationship exists among the variables.

Results and Discussion

The summary statistics of the study's variables may be found in Table 2. The Jarque-Bera test (p = 0.30) indicates normalcy, and the log of real GDP per capita (LGDPPC) logarithm is 7.10 with minimal fluctuation. LFDI is also normally distributed and fluctuates considerably (p = 0.18). The p-values for PR and LODA are 0.39 and 0.59, respectively, indicating that they are normally distributed. GFCF and TO have greater dispersion but also meet normality assumptions with p-

values of 0.22 and 0.44. In general, all variables have nearly normal distributions, making it appropriate to use parametric statistical procedures in the analysis.

Table 1: Descriptive Statistics

	Mean	Median	Maximum	Minimum	Std. Dev.	Jarque-Bera	Probability
LGDPPC	7.09	7.12	7.40	6.85	0.16	2.43	0.29
LODI	21.27	21.28	22.16	20.05	0.53	1.04	0.59
LFDI	-0.23	-0.36	1.11	-1.17	0.55	3.40	0.18
PR	4.36	3.52	8.98	1.08	2.08	1.89	0.38
GFCF	15.08	14.55	19.11	12.82	1.76	3.03	0.21
TO	30.74	31.31	38.49	21.45	4.78	1.64	0.43

The implementation of regression analysis needs stationarity tests for all model variables to avoid incorrect results. All variables' level and difference forms were evaluated for stationarity qualities in the unit root tests that were carried out by ADF and PP. The report of the findings is shown in Table 3. The results in Table 3 indicate that not all variables are stationary at level, indicating a mix of stationarity at level I(0) and I(1), but neither variable is stationary at I(2).

Table 1: Unit Root Tests

	ADF		**PP**	
variables	**t-stat**	**p-value**	**t-stat**	**p-value**
At levels				
GDPPC	-2.1639	0.4925	-1.8269	0.6687
FDI	-3.0808	0.1278	-1.9354	0.6136
ODI	-4.4193	0.0073***	-2.782	0.2137
PR	-2.6404	0.2663	-5.1831	0.001***
GFCF	-2.1969	0.4756	-2.3484	0.398
TO	-2.1353	0.5081	-2.252	0.447
At 1st difference				
GDPPC	-4.2511	0.0105**	-4.2742	0.01**
FDI	-3.7889	0.0304**	-3.6487	0.0412**
ODI	-5.5244	0.0005***	-6.5283	0.000132***
PR	-4.6615	0.004***	-8.4179	0.00313***
GFCF	-4.8088	0.0027***	-4.8093	0.0027***
TO	-5.5804	0.0004***	-5.5792	0.0004***

Note: ****(**) statistically significant at 1% (5%)*

Source: *extract from estimation output using E-views 09*

4.4 Cointegration Test Results

The long-term relationship between the variables may be found using the ARDL bounds testing approach. The ARDL method, which was developed by Pesaran and Shin (1999) and subsequently confirmed by Pesaran, Shin, and Smith (2001), has become a popular and effective technique for evaluating cointegration in econometric research. Table 4 presents the ARDL bound test and F-test confirms the existence of long run relationship among the variables. The value of F-stat is

7.15 which is higher than upper bound critical value of 3.38 at 5 % level of significance, resulting in rejection of null hypothesis of no cointegration.

Table 2:Bound Test Results

Test Statistic	Value	Signif.	I(0)	I(1)
F-statistic	7.15	10%	2.08	3.00
K	5	5%	2.39	3.38

4.5 Long Run Results

After confirming the existence of co-integration, the next step in ARDL is to estimate the long run relationship among the variables. The results are presented in Table 4.

Table 3: Long Run Estimates

Variable	Coefficient	SE	t-statistic
LFDI	0.04	0.01	3.06
lnODA	-0.52	0.02	-23.04
PR	0.10	0.003	28.11
GFCF	-0.06	0.004	-14.77
TO	0.01	0.002	4.97
C	18.33	0.46	39.32

Foreign direct investment (FDI) has a positive and statistically significant coefficient of 0.041 at the 1% level. Over time, a 1% increase in FDI results in a 0.041% growth in GDP. This result lends credence to the idea that FDI boosts Pakistan's economy by bringing in capital, technology, and knowledge that may increase output and efficiency. Malik (2015) and Siddique et al. (2017) established that foreign direct investment plays an important contribution to Pakistan's GDP, and it supports the development of capital as well as technical progress. With a value of -0.525, the ODA coefficient is negative and has a statistical significance. It indicates that a longer-term association exists between increased foreign aid and a 0.525% decline in GDP. The results show that official development aid given to Pakistan fails to achieve its intended benefits. The results show that foreign aid does not work well because aid delivery processes are flawed and funds are not managed correctly when handling importance economic matters. According to Anwar et al. (2024) official development assistance from foreign nations does not help Pakistan achieve economic growth. According to Shah et al. (2022) foreign aid causes harm to South Asian economies including Pakistan. The expenditure of borrowed funds as ODA results in economic slowdown for Pakistan according to Rauf and Khan (2017). The implications of these results are that the coefficient value of the personal remittances is 0.103 at 1% level and thus our hypothesis is accepted since it is positive and statistically significant. The above expression points to the fact that remittances lead to a positive increase in the development of a country's Gross Domestic Product as its value will rise by 0.1103 percent for each one percent improvement in the level of remittance received.

The coefficient value of -0.066 indicates a negative connection between GFCF and the result. Over the long term Gross fixed capital creation rises by 1% simultaneous to a GDP decrease of

0.066%. With a value of 0.012, trade openness is a significant and positively associated variable. More trade openness increases GDP growth in the long term, as this illustrates.
Short run results are shown in table 6.
Table 4: Short Run Results

Variable	Coefficient	Std. Error	t-Statistic	Prob.
D (LGDPPC (-1))	0.52	0.04	10.92	0.0004
D (LGDPPC (-2))	2.23	0.08	27.51	0.0002
D(LFDI1)	0.01	0.001	12.37	0.0002
D(LFDI1(-1))	-0.06	0.003	-20.45	0.001
D(LFDI1(-2))	-0.08	0.003	-23.83	0.0007
D(LODI)	-0.06	0.003	-19.32	0.0005
D (LODI (-1))	0.08	0.003	22.32	0.0001
D (LODI (-2))	0.05	0.003	18.09	0.0001
D(PR)	-0.004	0.001	-3.24	0.031
D (PR (-1))	-0.0006	0.001	-0.58	0.588
D (PR (-2))	0.05	0.002	27.92	0.0032
D(GFCF)	0.003	0.0009	4.14	0.0143
D (GFCF (-1))	0.05	0.0024	23.21	0.0031
D (GFCF (-2))	0.03	0.001	17.59	0.0001
D(TO)	-0.002	0.0001	-11.79	0.0003
D (TO (-1))	-0.005	0.0002	-20.01	0.0002
D (TO (-2))	-0.007	0.0003	-23.61	0.0007
ECM (-1) *	-0.39	0.018	-21.79	0.0004

Source: *extract from estimation output using E-views 09*

A negative coefficient of -0.3989 is associated with the very important error correction term (ECM (-1)). It is shown that the variables have a stable long-run connection and that there is considerable convergence towards long-run equilibrium since each period
Table 7 diagnostic findings demonstrate the model's resilience in the residuals by confirming that it is free of heteroscedasticity, non-normality, and misspecification. The computed connections appear to be statistically trustworthy if these problems are not present.
Table 5:Diagnostic Test Results

Test	F-Statistic	Probability
Breusch-Godfrey Serial Correlation	4.33	0.1878
Breusch–Pagan–Godfrey Heteroscedasticity Test	0.51	0.8691
Jacque–Bera Normality Test	2.064	0.3562
Ramsey RESET Test	2.04	0.2487

Source: *extract from estimation output using E-views 09*

Additional verification of the model's robustness over time is provided by the CUSUM (figure1) and CUSUMSQ (figure 2) tests. By remaining within the 5% crucial bounds, the recursive residual plots demonstrate that the model's structure and coefficients remain stable during the estimating period.

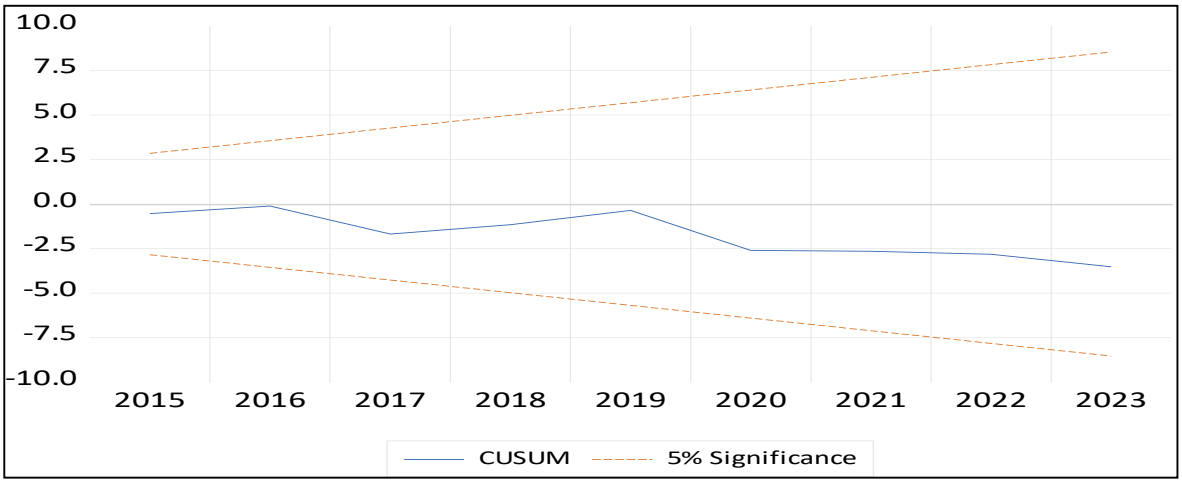

Figure 1:CUSUM TEST (5% significance)

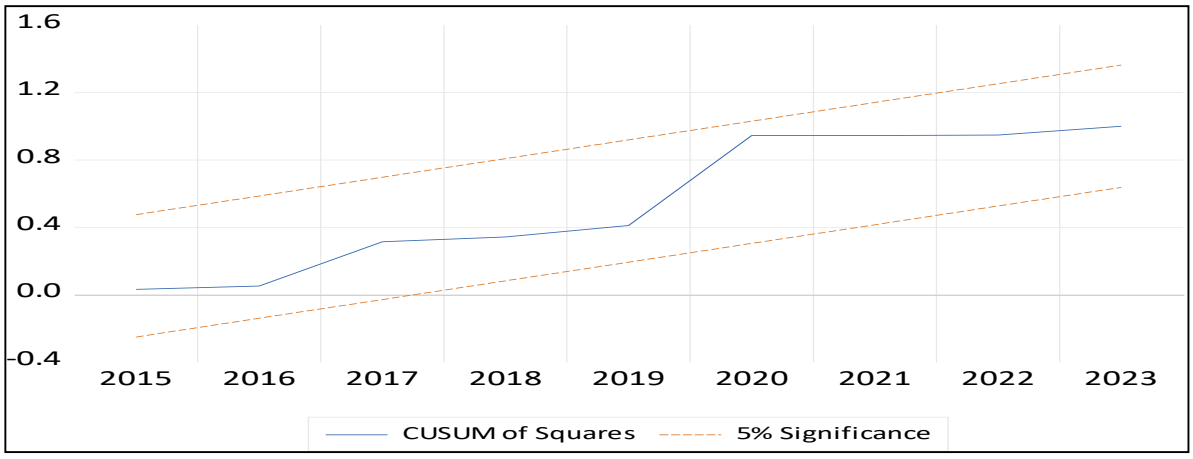

Figure 2:CUSUM SQURE TEST (5% Significance)

Chapter 5
Summary, Conclusion, and Policy Recommendations
5.1 Introduction

The results of the empirical investigation presented in the previous chapter are thoroughly examined in this chapter. It then draws appropriate inferences by comparing these results to what is known from the literature and what is expected theoretically. Additionally, this chapter delves deeper into the study's limitations, consequences, and suggestions for future research and regulation. Its goal is to synthesize the data in order to provide a clear picture of how FDI impacts Pakistan's economic development.

5.2 Discussion of Findings

The main objective of this research was to find out how different types of foreign capital inflows affected Pakistan's economic growth. Foreign capital inflows may stimulate economic development, according to this study, but the effect is conditional on the local institutional and macroeconomic environment. The impact of aid flows on GDP has been either small or negative, mostly due to inefficiencies and bad governance, in contrast to the positive benefits of remittances and FDI. Openness to trade continues to be a good growth driver, and GFCF, while positive in the short run, needs more effective implementation for long-run benefits. The findings support that capital flows alone are not a solution to economic growth. The policymakers need to follow a strategic, institutionally informed agenda for making such flows yield desirable effects on sustainable and inclusive development in Pakistan.

Several policy implications stem from the study's conclusions. The government should prioritize improving the investment environment in order to attract more consistent and productive FDI. These involve political stability, regulatory improvements, and infrastructure. Secondly, to reap maximum benefits from remittances, policies must induce their usage through official channels and encourage investment in productive industries like SMEs, education, and housing. Third, the detrimental effect of ODA necessitates enhanced governance of aid management, higher accountability, and harmonization with national development planning.

Although comprehensive, this study does have some drawbacks. It doesn't take into account variations in the effect of capital inflows on microeconomics or specific sectors as it relies only on secondary macroeconomic statistics. Because of data constraints, which might compromise the model's robustness, we omitted the institutional quality and political stability variables from the study. Also, structural discontinuities or changes in policy regimes throughout the research period cannot be accommodated by the time series approach, which limits the ability to investigate regional variance within Pakistan.

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