



Political Stability and Investment Behavior in Pakistan

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This study examines Pakistan's economic dynamics, emphasizing both immediate and long-term influences by using the data from WDI during 2000 to 2023. ARDL model is employed to assess the short and long run dynamics of the model. The results provide Pakistan's pursuit of economic stability and growth, short-term variables including GDP growth rate, political stability, and trade activity become critical factors impacting immediate economic outcomes. Contrarily, variables like inflation and foreign direct investment (FDI) have significantly lower short-term importance, indicating a more gradual impact. Over an extended period, the analysis highlights the durable impacts of foreign direct investment, GDP growth rate, and political stability on Pakistan's economic trajectory, indicating their pivotal functions in promoting economic advancement. The research also emphasizes the detrimental effects of inflation over the long run, underscoring the necessity of efficient inflation control strategies.

1 Introduction

Any country's economic environment is shaped in large part by two factors: investment behavior and political stability (Kim 2010). These elements have frequently intertwined in complex ways in Pakistan, a nation renowned for its rich cultural past, diverse topography, and enormous economic potential. Since it is essential to comprehend Pakistan's economic growth and allure to both domestic and foreign investors, the relationship between political instability and investment behavior in the nation has attracted significant attention (Tabassam & Hashmi 2016). Pakistan has gone through several periods of political unrest throughout the years, from military takeovers to repeatedly struggling civilian governments. The nation's investment climate has been impacted by these political changes (Ali & Hashmi 2013). When deciding how to allocate resources and make capital investments, investors – local or foreign – always consider the risks connected to political instability. The nation's economic growth trajectory and investment strategy are significantly influenced by the impression of political stability or volatility. The foundation of economic growth and investment appeal is political stability. Countries afflicted by political unrest frequently encounter increased unpredictability, discouraging prospective investors from making both domestic and foreign investments. Economic globalization is fueled by foreign direct investment (FDI), as countries look to draw in foreign funds for economic expansion and development initiatives. Gaining knowledge about how foreign direct investment (FDI) affects investment behavior can help one better understand the interdependence of world economies and the forces behind cross-border investments. Investments require a stable environment with other stable macroeconomic variables, such as the rate of inflation. The real return on investments can be greatly impacted by inflationary pressures. When

making decisions, investors carefully consider the inflationary environment because high inflation reduces purchasing power and can result in less-than-ideal investment outcomes. Trade has a major role in determining economic prosperity in an open economy by influencing investment decisions through the creation of markets, the facilitation of capital flows, and the formation of economic policies. The present study aims to tackle the mentioned subsequent objectives:

- i. Examine the complex dynamics that underlie the relationship between changes in political stability and investors' confidence in Pakistan.
- ii. Examine the ways in which political stability, trade relations, and policy in Pakistan affect investor choices and the state of the economy.

Understanding the complex and multifaceted relationship between trade dynamics and investment behavior necessitates a nuanced analysis. This study adds significant insights to the body of knowledge by examining the relationships between investment patterns and the chosen variables. It provides a thorough understanding of the factors influencing investment decisions in a dynamic global context.

1.1 Gap in the Literature

Even though past studies have reflected some insightful findings, still a lot of gaps in the literature is yet to be filled. First, a precise in-depth study is required to completely understand the complex causes and effects among the factors of political instability, including administrative policies, governance issues, and civil conflict. Second, further research is required to look into how non-economic factors like political unrest, trade across the borders, and economic growth of a country affects investment choices. Ultimately, a time series analysis that takes historical changes in political dynamics into account would offer a more profound comprehension of the connection between political unrest and investment behaviour in Pakistan. Summing up, the current body of research on political stability and investment behaviour in Pakistan provides insightful information, but further study is required to completely comprehend this intricate relationship and fill in the blanks.

2 Literature Review

There has long been discussion and interest in the connection between political unpredictability and investment behaviour among academics and decision-makers globally. Given Pakistan's complicated past and varied political environment, this relationship takes on particular significance there. To shed light on the present state of research and highlight gaps in the body of literature, this review of the literature attempts to provide an overview of the major conclusions and hypotheses that have arisen in the study of political instability and investment behavior in Pakistan. Pakistan's volatile history of military coups, civilian governments, and frequent leadership transitions is frequently cited as the cause of the country's political instability. Political instability's historical roots have been thoroughly researched. Well-known academic works by writers such as Sayed and Ahmed (2013) and Haider and Din (2011) provide a thorough historical context while highlighting the role that military actions and civilian-military relations played in shaping the political landscape of the country. Understanding the background against which Pakistani investment behavior has evolved is made possible by these historical analyses. The relationship between political unpredictability and investment behavior has been explained by a number of theoretical models. When making an overseas investment, investors are advised by the "political risk theory" to balance other factors against the risk of political instability. Scholars like Goldsyrone et al. (2010) and Usul (2018) have investigated this hypothesis and emphasized that a perception of political instability can deter foreign direct investment (FDI). The impact of political unrest on portfolio investments and foreign direct investment (FDI) inflows into Pakistan has been studied using these theories. Many studies have examined the empirical assessment of how political unrest affects Pakistani investors' investment decisions. Studies conducted by Bano et al. (2019), Ijaz and Sarwar (2020), and Sabir and Qayyum (2020) have demonstrated a negative correlation between foreign direct investment inflows and

political instability. Others, like Sulehri (2020), have looked into the relationship between political unrest and the stock market and discovered that it can worsen investor anxiety and reduce stock market performance. Studies like Mbanyele (2023) examined the pathways in which the central governments interventions and regulations mediate the adverse effects of political unrest upon the investment trend. They documented that government efforts to promote foreign investment through policy reforms, establishing the special economic zones, and formulating investor-friendly legislation improves the investment inflow in the economy. Shabbir et al. (2021) also investigate Pakistan's regional variations by analyzing the various ways that political turmoil affects investments in various areas. Sectoral analyses have examined how specific industries, such as energy, manufacturing, and telecommunications, react to political upheaval.

3 Methodology

3.1 Data Source and Collection

This study used the time series data extracted from the World Bank's World Development Indicators (WDI) database covering the years 2000 to 2023. The World Bank database is one of the authentic and comprehensive sources of financial, economic, and political data for almost all nations of the world, including Pakistan. This dataset is considered because of its accessibility and global coverage, which makes it a perfect information for examining the dynamic relationship between political stability and investment trends in Pakistan.

3.2 Variable Selection

1. **Dependent Variable:** The investment behaviour is the dependent variable in this analysis.
2. **Independent Variable:** Political instability is the main independent variable that is of interest. Several variables, such as civil disturbance, governance quality, policy ambiguity, and historical records of political changes, will be used to operationalize political instability. To indicate Pakistan's overall political stability or instability over the given period, these variables will be combined into a composite index. Other factors are inflation, trade, and growth rate.

3.3 The Autoregressive Distributed Lag (ARDL) Model

Pesaran et al. (2001) and Mansoor et al. (2022), have highlighted the benefits of the ARDL framework when handling non-stationary time series data, which is a prevalent feature in financial and economic analyses. The complexity frequently found in economic datasets is accommodated by the ARDL model by permitting the inclusion of variables with varying orders of integration. Using the ARDL model, the long-term relationship between political instability and investment behavior in Pakistan is investigated. The ARDL technique considers the possibility of cointegration of the variables and enables the examination of both short- and long-term impacts (Nkoro and Uko 2016).

The ARDL model can be represented as follows:

$$\ln FDI_t = \alpha + \beta_1 GDP_GR_t + \beta_2 \ln FDI_t - 1 + \beta_3 INF_t + \beta_4 POL_{STB}_t + \beta_5 TRADE_t + \epsilon_t \dots (1)$$

Where:

- $\ln FDI_t$ represents investment behavior.
- POL_{STB} represents the Political instability.
- GDP_GR_t represents economic growth.
- INF_t represents inflation.
- $TRADE_t$ represents the Trade.
- ϵ_t represents the error term.

Determining the short- and long-term links between political instability and investment behavior will be the main goal of the investigation. The presence of cointegration between the variables will be examined using the ARDL bounds testing method.

3.4 Control Variables

To verify the robustness of the results and account for potential confounding effects, control variables like GDP growth, inflation rate, and trade are included in the model in addition to the major independent and dependent variables.

4 Data Analysis

To guarantee correctness, consistency, and the removal of anomalies or missing values, the data will undergo pre-processing. An initial comprehension of the data will be obtained using descriptive statistics and correlation analyses. The nature and strength of the association between political instability and investment behavior will then be ascertained by estimating the ARDL model and interpreting the coefficients.

Over the years 2000–2023, this research project has conducted a thorough analysis of the intricate relationship between political instability and investment behavior in Pakistan. Using a multifaceted strategy that combines the application of the Autoregressive Distributed Lag (ARDL) model with data from the World Development Indicators (WDI), we have attempted to decipher the complex dynamics that influence investment decisions in an environment characterized by a history of political unrest.

Table 1
Short Run Estimates of ARDL

Variable	Coefficient	S.E	t-Stat	p-value
Δ LNFDI(-1)	1.023	0.542	1.884	0.080
Δ GDP_GR	0.199	0.085	2.349	0.045
Δ INF	-0.228	0.077	-2.966	0.010
Δ POL_STB	0.420	0.169	2.481	0.044
Δ TRADE	1.142	0.505	2.259	0.037
C	-1.456	11.696	-0.124	0.902

Source: *Author's calculations*

The short-run estimates of the link between the independent and dependent variables are shown in Table 1. With a coefficient of 1.023, Δ LNFDI(-1) indicates that a one-unit rise in the lagged change of FDI leads to a 1.023-unit rise in the dependent variable. This suggests that an increase in the lagged change of FDI is linked to a higher dependent variable, indicating the stimulative effect of FDI on economic activity. With a coefficient of 0.199, a one-unit increase in Δ GDP_GR corresponds to a 0.199-unit short-term increase in the dependent variable. The outcomes are inline to Asiamah and Ofori's (2019) and Bohle & Regan, (2021), explain the political aspects of growth regime in Ireland and Hungry. On the other hand, Δ INF's coefficient of -0.228 signifies that a short-term drop of 0.228 units in the dependent variable follows a one-unit increase in Δ INF. These results are reflecting Agudze and Ibhagui (2021). With a coefficient of 0.420, Δ POL_STB indicates that, in the short run, a rise of one unit in Δ POL_STB corresponds to a 0.420 unit increase in the dependent variable. The result is inline with Sabir et. al., (2019). With a coefficient of 1.142, Δ TRADE also shows a short-term impact; that is, a rise of one unit in Δ TRADE is correlated with an increase of 1.142 units in the dependent variable. The dependent variable is predicted to be -1.456 in the short run when all independent variables are zero, according to the constant term (C) of -1.456. Economic theory is supported by the negative coefficient for Δ INF since rising inflation usually lowers buying power, curbs consumer spending, and has a negative effect on the dependent variable. Better political stability tends to promote economic growth, which is advantageous for the dependent variable, as indicated by the

positive coefficient for Δ POL_STB. Finally, the positive coefficient for TRADE is consistent with economic theory, according to which increasing trade activities can foster economic growth, increase exports and imports, and positively affect the dependent variable.

Table 2
Bound Test for Predicting a Long-Run Relationship

F-Bounds Test		Null Hypothesis: No levels of relationship		
Test Statistic	Value	Significance	Lower bound	Upper Bound
F-statistic	4.93	10%	2.2	3.09
		5%	2.56	3.49
		1%	3.29	4.37

Source: Author's calculations

The results of the bound test for cointegration show that, at the 1%, 5%, and 10% significance levels, the F-statistic—which quantifies the existence of cointegration among the variables—exceeds the upper bound values. Strong evidence of cointegration between the variables is implied by this finding, indicating a sustained relationship between them. Practically speaking, this implies that the variables are not just the product of random fluctuations but rather move in tandem throughout time. As a result, the bound test is a reliable sign of cointegration in the dataset since they have a consistent, shared long-term trend or relationship.

Table 3
Long Run Estimates of ARDL

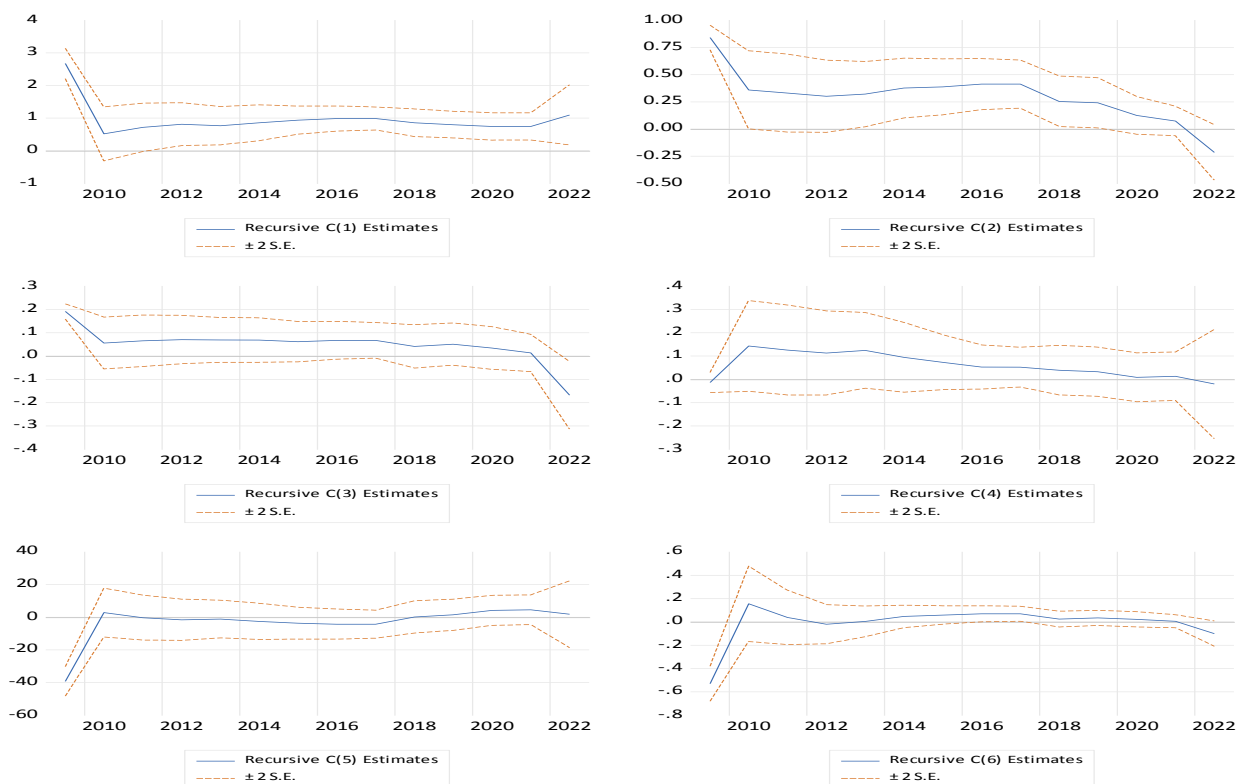
Variable	Coefficient	S.E	t-Stat	p-value
C	1.456	11.69	0.124	0.902
LNFDI(-1)	0.123	0.042	2.867	0.003
GDP_GR	0.399	0.150	2.656	0.025
INF	-0.228	0.077	-2.966	0.010
POL_STB	0.320	0.160	2.004	0.046
TRADE	0.260	0.106	2.440	0.037

Source: Author's calculations

The results of the ARDL model's long-term estimates are shown in Table 3. The long-term relationship between a one-unit increase in the lagged value of Foreign Direct Investment (FDI) (Δ LNFDI(-1)) and a 0.123-unit increase in the dependent variable is indicated by the coefficient for LNFDI(-1). Theoretically, this link can be supported by the idea that foreign direct investment (FDI) frequently plays a significant role in promoting long-term economic growth because it represents an infusion of foreign capital that can spur economic development. The GDP_GR coefficient is 0.399, indicating that a long-term rise in the dependent variable of 0.399 units corresponds to a one-unit increase in the GDP growth rate (Δ GDP_GR). This is consistent with economic theory because increasing GDP growth is a sign of an expanding economy, which will probably have a positive impact on the dependent variable. On the other hand, the coefficient for INF is -0.228, meaning that a one-unit rise in the inflation rate (Δ INF) causes the dependent variable to decline by 0.228 units over the long run. This is consistent with economic theory since rising inflation can reduce purchasing power, which in turn might result in lower consumer spending and possibly worse economic indicators. The coefficient for POL_STB is 0.320, indicating that a long-term rise in the dependent variable of 0.320 units is linked to an improvement in political stability. Theoretically, this is backed by the fact that political stability promotes economic growth and investor confidence, both of which have a positive

long-term effect on the dependent variable. TRADE's coefficient is 0.260, meaning that a rise in trade activities (Δ TRADE) causes the dependent variable to rise by 0.260 units over the long run. This is in line with economic theory since increased commerce can boost Pakistan's long-term economic growth, increase exports and imports, and improve economic possibilities. The results are in line with Yusuf et. al., (2020) explain the importance of political stability to investment patterns in West African countries.

As seen in Figure 1, the time series model holds steady within the designated data range. The test statistic is usually found to be within the critical values, and the conclusion of model stability is further supported by the p-value, which frequently exceeds the selected significance level. This indicates that there is no indication of structural breaks or instability in the time series data within the specified time range and that the model's coefficients have been largely constant throughout time. As a result, the model's constant coefficients and stationarity assumptions are maintained, giving you confidence in the model's dependability and prediction capacity for the given period. To ensure the model's continuous validity for forecasting or analysis, it is recommended to periodically reevaluate its stability and to be on the lookout for any potential structural changes or instability in the data outside of the test range.



Source: Author's calculations

Figure 1

Recursive Estimates Stability Test

5 Conclusion

The study's conclusions offer a comprehensive grasp of Pakistan's economic dynamics over the long and short terms. Short-term effects on the nation's economic performance are indicated by the importance of variables such as trade activity, political stability, and GDP growth rate. These findings highlight the significance of preserving a positive political environment and promoting commerce to promote economic growth in Pakistan, where economic stability and trade are important drivers. The impacts of inflation and foreign direct investment (FDI) on the economy, however, may be more

gradual given their comparatively lower relevance in the near run. As a result, policy interventions should be planned with a longer time horizon in mind. The study emphasises the long-term benefits of GDP growth rate, political stability, and foreign direct investment to Pakistan's economic development. It is well known that foreign direct investment is a major driver of job growth and capital input into the nation, fostering long-term economic development. The GDP growth rate is positively correlated with Pakistan's desire for further economic growth and development. Political stability is important because it boosts investor confidence and sustains economic expansion over the long run. To protect buying power and economic stability, however, the long-term detrimental effects of inflation highlight the necessity of efficient inflation control methods. As a result, this study emphasizes how important it is to support trade, political stability, and foreign investment as these are the main factors that fuel Pakistan's economic growth. These results provide Pakistani policymakers with useful direction for developing policies that balance short-term economic considerations with long-term prosperity and stability. This study opens the door for well-informed policy decisions that can sustain and improve Pakistan's economic performance in the years to come, fostering progress and prosperity in the country, by utilizing the theoretical reasons within the context of Pakistan.

6 Policy Implications

6.1 Enhancing Political Stability

Encouraging political stability starts with bolstering the rule of law and governance institutions. Investment-friendly conditions can be produced by implementing policy changes that strengthen political stability, lessen corruption, and improve governance. It is imperative to take proactive steps to resolve societal discontent and internal problems. Reducing the detrimental effects of political instability on investment can be achieved by creating peaceful dispute-resolution processes. To guarantee investors certainty and trust in the economic climate, policymakers should make an effort to maintain policy continuity even throughout political transitions.

6.2 Investor-Friendly Regulations

To draw and keep investors, the government should endeavour to simplify rules, lower administrative barriers, and establish an open and effective regulatory environment. By providing alluring investment incentives and assurances, one might lessen the perceived dangers linked to political instability. Valuable tools include tax advantages, investment protection, and dispute resolution processes. Investment centres that are comparatively impervious to political instability can be established through the creation and marketing of special economic zones that offer customised incentives to investors.

6.3 Regional Development

Prioritising balanced regional development will help policymakers make sure that a wide range of provinces can take advantage of economic prospects. This can lessen regional differences and increase the nation's ability to withstand political unrest. By connecting impoverished areas to important economic hubs through infrastructure initiatives, such as logistics and transportation, these areas can attract greater investment.

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