

Relationship between Foreign Direct Investment & Financial Market Development - Evidence from South Asian Markets

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ABSTRACT

This study examines the relationship between FDI and financial market development (FMD) in the existence of other aspects, i.e., governance, social, and macroeconomic variables. The study uses the annual panel data of four emerging South Asian countries, i.e., Bangladesh, India, Pakistan, and Sri Lanka, from 1994 to 2016. Panel ARDL model is used to examine the long run and short-run relationship, while correlation and causality analysis is used to examine the relationship between FDI and FMD variables. Results show that exchange rate, governance, inflation, and real GDP growth rate are the significant predictors of FDI in South Asian countries, while FDI, education, real GDP growth rate, balance, exchange rate, and inflation are the main determinants of FMD. A positive correlation exists between FDI and FMD variables. However, bi-directional causality exists between CREDIT and FDIGDP, while no causality exists between CCB and FDIGDP; however, one-way causality exists from STKMKRTCAP and STKVOLTRA to FDIGDP. Our study suggests that countries having better governance have an edge in attracting FDI to the country. However, we have not been able to exploit the benefits, and the policymakers need to devise appropriate policies to attract FDI in South Asian countries.

JEL Classification: F2, F21, G1, G17

Keywords: South Asia, Foreign direct investment, Financial market development

INTRODUCTION

Financial market development (FMD) is generally categorized into two parts, foreign direct investment (FDI) and economic growth. It is the engine that drives the economy, being a platform where surplus units meet deficit units and negotiate various kinds of financial agreements. The objective of financial market development is, therefore, to enhance the capability of the financial market to act efficiently as an intermediary.

Moreover, those countries having a rather weak economic position and lacking financial development have no potential towards FDI, even though the financial sectors of these countries have optimum performance. This is so because the scarcity of any assets besides weaker market power makes these countries uninviting (Soumare & Tchana, 2015). When considering a developed financial sector, FDI ensures a growth boost (Hermes & Lensink, 2003; Alfaro, Chanda, Kalemli-Ozcan & Sayek, 2004). Bekaert, Harvey and Lundblad (2005) demonstrate that either market independence or any financial segment that is well-performing may boost growth.

The literature gives a detailed discussion of the active role of FDI as a significant aspect of transferring new technology and thereby promoting FMD and its evolution in particular. In

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theory, a recipient country may face implications of FDI at both macro as well as micro-level (Ali & Javed, 2014). At the micro-level, FDI may impact the technical efficiency and management of local firms by promoting increased labor participation, technological transference, and finally producing efficient spillovers. At the macro-level, FDI can have an impact on real variables, including sustainable economic growth, increased domestic financial activity, improved exports, and reduction in imports and unemployment (Borensztein, Gregorio & Lee, 1998; Dunning, 1988, 1993; Kholdy & Sohrabian, 2008; Levine, 1997). FDI can also impact financial variables, including the balance of payment, foreign exchange rates, interest rates, and inflation. Some researchers have observed the link between FDI and market size of the host country being significantly positive, duly demonstrated by respective Gross Domestic Product and the Gross National Product (Culem, 1988; Globerman & Shapiro, 1999; Loree & Guisinger, 1995; Schneider & Frey, 1985).

Several researchers inspected the association between Financial Market Development (FMD) and FDI, and they have examined with a focus only on the importance of FMD or the importance of FDI towards economic advancement. However, very little attention has been paid to the directness of connection prevailing amid FDI and FMD for markets still undergoing the development process, as in the case of emerging South Asian economies. The objective of this study is to examine the relationship between FDI and financial market development (FMD) in the existence of other aspects, i.e., governance, social, and macroeconomic variables.

LITERATURE REVIEW

Hermes and Lensik (2003) investigated the role of financial systems in enhancing economic growth and FDI. The study stated that in order for FDI to positively affect financial development, there is an utmost need for the improvement of money related arrangements of the selected nations. A more facilitated and smooth monetary framework emphatically adds to the approach of innovative dispersion associated with FDI. Alfaro et al. (2004) examined the link between financial markets, financial development, and economic growth. The results of this study concluded that countries with well established financial markets have positive benefits from FDI. Casual connection amongst stock prices and macro variables of the economy like real and financial sector of an Indian economy were studied by Ahmed (2008) who incorporates the variables such as industrial production indices, net exports, FDI, the supply of money in the economy, rate of foreign currency exchange, interest rate, NSE Nifty and BSE Sensex in India. Long and short-run causality relationship among all variables was concluded as a result of the study. This relationship could be the result of the positive impact of FDI on the speculation with an effect on the developments in stock costs that appear to influence capital streams.

The traditional relationship among securities exchange improvement in Ghana was studied by Adam and Tweneboah (2009). The study was conducted on quarterly information from 1991:1 to 2006:4. For this, the co-integration examination was done, and error revision models were employed. The results showed a long-run link between foreign direct inflows, the nominal exchange rate, and stock market development in Ghana. The finding showed that even a small shift in FDI inflows significantly affects the improvement of securities exchange in Ghana. The study also demonstrated the vital role that stock market development plays in attracting FDI inflows. Financial market progress, FDI, and different political weaknesses were also

examined by Dutta and Roy (2011). The result showed that financial development affects FDI negatively after a threshold level, while political factors significantly affect the threshold level. Samad and Akhtaruzzaman (2014) empirically investigated the short-run and long-run relationship among foreign direct investment (FDI), financial development, and economic growth in ten East and Southeast Asian countries. The vector error correction model (VECM) and Granger causality/Wald Exogeneity tests were employed. They concluded that in Singapore, Malaysia, and China, GDP growth Granger causes FDI, while financial market development (FMD) Granger causes FDI in Singapore, Malaysia, and Sri Lanka.

Bekhet and Al-Samadi (2015) examined the short-run and long-run relationship between FDI inflows and their determinants in Jordan from 1978 to 2012 by using the bounds testing approach. They found that there are long-run and short-run linkages among FDI and its contributing elements in Jordan. Park and Shin (2017) examined the relationship between financial development and income inequality. They found that financial market development contributes to lower inequality up to a certain level, but when financial development increases, it facilitates higher inequality. Shahbaz, Hoang, Mahalik and Roubaud (2017) investigated the asymmetric link between energy consumption and economic growth by allowing for financial development, capital, and labor into production function covering the Indian economy from 1960Q1–2015Q4. The result showed that negative shock to financial development and energy consumption affect economic growth. Batuo, Mlambo and Asongu (2018) explored the linkages between financial instability, financial liberalization, financial development, and economic growth in 41 African countries for the period 1985–2010. They found that financial liberalization and financial development positively have a positive effect on financial instability.

Madsen, Islam and Doucouliagos (2018) examined the channels through which inequality transmits to education, savings, knowledge production, investment, and growth. Results demonstrated that inequality is an obstacle to growth at low to moderate levels of financial development but has a small impact on growth at higher levels of financial development. Mahmood and Alkhateeb (2018) explored the effect of human resources and financial market development (FMD) on the economic growth of Saudi Arabia by using data from 1970 to 2017 and by applying the autoregressive distributed lag (ARDL) cointegration methodology. Their study suggests that the interaction between human capital and FMD positively impacts the economic growth in Saudi Arabia. Ouyang and Li (2018) studied the endogenous relationships among financial development, energy consumption, and economic growth in China by applying a GMM panel VAR approach with a panel data of 30 Chinese provinces for the period 1996Q1–2015Q4. They also hold for regional heterogeneity by dividing their sample of China into three regions. They found that financial development negatively and significantly affect economic growth.

Examining the influence of foreign capital on economic progress has significant strategic consequences. In case FDI has an optimistic influence on economic progress, after making full control over endogeneity and the rest of the evolution causes, this situation would weaken the limitations to foreign investment. However, in case we observe that FDI does not apply a positive influence on progress, this would propose a reassessment of the swift developments of tax enticements, infrastructure subsidies, exclusions pertaining to the import duty, and other measures that the conventional wisdom proposes. This signifies that financial development is

a significant factor contributing to economic development. A developed financial system ensures conducive grounds for resource allocation, fewer information asymmetries, economic progression, and better monitoring (Shen & Lee, 2006). The financial system can make contributions toward the economic arena in two ways. Firstly, an excellent financial system mobilizes the reserves; this usually upsurges the share of the resources accessible for financial investment. Secondly, it performs screening and monitoring of the investment projects, which indicate lowering information acquisition costs. In this way, it increases the effectiveness of projects (Greenwood & Jovanovic 1990; Levine 1997). In other words, we can say that a developed domestic financial system enables mobilization of savings and performs screening and monitoring mechanism for the investment projects, which ultimately contributes towards higher economic progression.

DATA AND METHODOLOGY

This study uses the annual panel data of four emerging South Asian countries, i.e., Bangladesh, India, Pakistan, and Sri Lanka, from 1994 to 2016. We use the two most common FDI indicators: 'FDIGDP,' i.e., Ratio of FDI to GDP and 'FDIGCF,' i.e., Ratio of FDI to gross fixed capital formation. In this regard, relevant data has been obtained using the 'World Development Indicators Database' of the World Bank. Regarding FMD, we made two subgroups of leading five indicators through division: Stock market development (SMD) and Banking sector development (BSD). Stock market development indicators comprise the ratio of stock market capitalization to GDP (STKMKT CAP), and the ratio of the stock value traded as a percentage of GDP (STKVALTRA). Banking sector development indicators comprise the ratio of private credit by deposit money banks and other financial institutions to GDP (CREDIT) and the ratio of commercial bank assets divided by commercial banks plus central bank assets (CCB). World Bank's Global Development Finance database and the International Monetary Fund's International Financial Statistics database have been used to obtain relevant data.

The explanatory control variables have been chosen after studying the available literature regarding the determinants of FDI and FMD. We have used the following control variables for the estimation: Economic and policy variables: 'EDUCATION' refers to the gross enrolment ratio pertaining to all educational levels. Quality of a country's human capital can be gauged by checking the level of education. Similarly, 'INFRAS' is the infrastructure measure equal to Log, i.e., the number of phones/1000 residents. In this regard, the infrastructure development level of a country is a vital determinant of FDI inflows. 'NATRES' refers to natural resources, measured through considering a portion of minerals and fuel in the country's exports. As regards to the countries having substantial reserves of natural resources, 'NATRES' is the primary determinant of FDI. 'EXHRATE' refers to the exchange rate variable, which shows domestic currency value and primarily utilized as a proxy for a country's potential and attractiveness towards macroeconomic stability and foreign investment.

In addition, 'INFLATION' refers to the rate of inflation calculated through percentage change in the GDP deflator and is a sound proxy towards macro-economic stability. Inflation has a negative impact on BSD indicators as the same harms cost of capital and borrowing rates. By considering a high inflation scenario, inflation might be comparatively cheaper for the companies towards raising money via stock markets instead of bank loans, so its effect on SMD indicators can be positive. 'INTRATE' is the actual interest rate that is primarily

calculated by lending interest rate adjusted against the inflation (measured via GDP deflator). 'INTRATE' might be taken as a proxy for the magnitude of lending from financial institutions. The higher actual interest rate may hamper the entire lending activities of the banks, thus, increasing banks' liquidity by creating disequilibrium among credit and deposit initiatives. 'BALANCE' refers to the current account balance over total Gross Domestic Product and a simple indicator showing the strength of the macro-economic environment. 'OPENNESS' is the degree of openness that equals to imports plus exports over Gross Domestic Product. As per literature about determinants of FDI, 'OPENESS' is regarded as a significant determinant for the country's attractiveness towards FDI. Hence, it can be contained that 'OPENESS' can impact FDI significantly and positively. Governance and institutional quality variables: Governance refers to the magnitude of the quality of the country's institutions. KKM Index is used to measure governance, developed by Kaufmann et al. (2009). This Index uses an average of six (06) different indicators measuring (a) voice and the accountability (b) stability of political systems and absence of violence (c) quality of regulatory system (d) government effectiveness (e) the rule of law and (f) control over corruption.

Hence, this study estimated the following econometric models to examine the long run and the short-run relationship of FDI and FMD with major macroeconomic variables as:

$$FDI_{it} =$$

$$\alpha_0 + \alpha_1 FMD_{it} + \alpha_2 Education_{it} + \alpha_3 Inflation_{it} + \alpha_4 Exhrate_{it} + \alpha_5 governance_{it} + \alpha_6 LOG(GDP_{it}) + \alpha_7 NATRES_{it} + \alpha_8 INFRAS_{it} + \epsilon$$

$$FMD_{it} = \beta_0 + \beta_1 FDI_{it} + \beta_2 Education_{it} + \beta_3 Inflation_{it} + \beta_4 Exhrate_{it} + \beta_5 governance_{it} + \beta_6 LOG(GDP_{it}) + \beta_7 Balance_{it} + \beta_8 Intrate_{it} + \epsilon$$

Where FDI is foreign direct investment as a percentage of GDP, FMD is financial market development, education is gross education enrollment at all levels, inflation is annual change in GDP deflator, exhrate is exchange rate, governance he quality of institutions, natres is natural resources, infras is infrastructure, balance is current account balance, and intratelending from financial institutions.

The panel unit root test is applied to check the stationarity properties of a variable. Levin, Lin & Chu (LLC), Im, Pesaran, and Shin (IPS), and Fisher-ADF Fisher tests are applied to check the unit root of the data. For the estimation of nonstationary dynamic panels, Pesaran and Shin (1995) and Pesaran Shin and Smith (1999) came up with the methodology of Pooled Mean Group (PMG) or Panel Autoregressive Distributed lag (ARDL). This study applies the Panel Autoregressive Distributed lag (ARDL) model to estimate the long run and short-run relationship. Further, we have applied the correlation analysis as well as the Granger causality test to determine the relationship among different definitions of FDI and FMD.

RESULTS AND DISCUSSION

Figures 1 to 5 present the sum of the critical variables of the selected South Asian countries. Figure 1 shows the sum of the education parameter for the selected four countries. India is having the highest score, followed by Pakistan. Bangladesh and Sri Lanka demonstrate the lowest score.

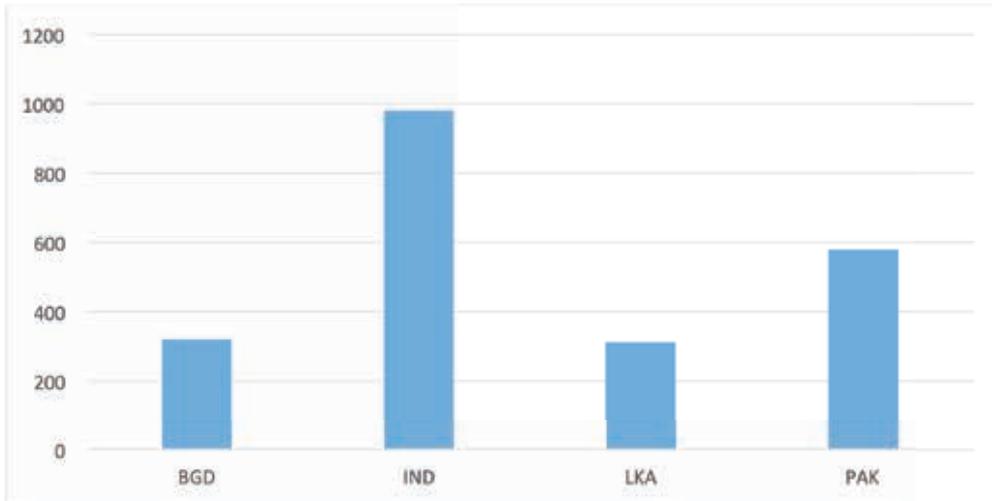


Figure 1: *Sum of Education by Country*

Figure 2 shows the sum of inflation in selected countries. Pakistan shows the highest inflation, followed by Sri Lanka, Bangladesh, and India. However, India has the lowest inflation from 1996 to 2016.

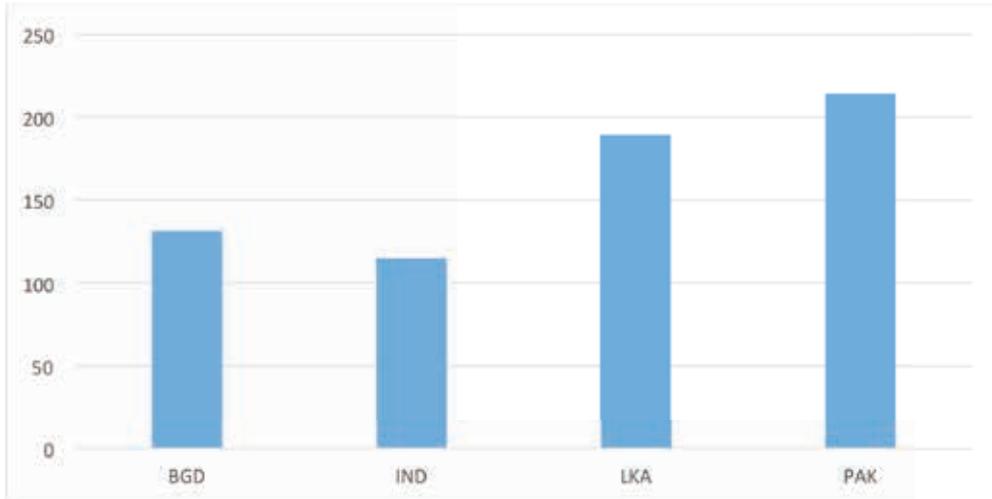


Figure 2: *Sum of Inflation by Country*

Figure 3 shows the trend of market openness in the selected countries. Sri Lanka shows the highest market openness value, while India and Bangladesh are almost at the same level of market openness. Pakistan shows the lowest level of market openness.

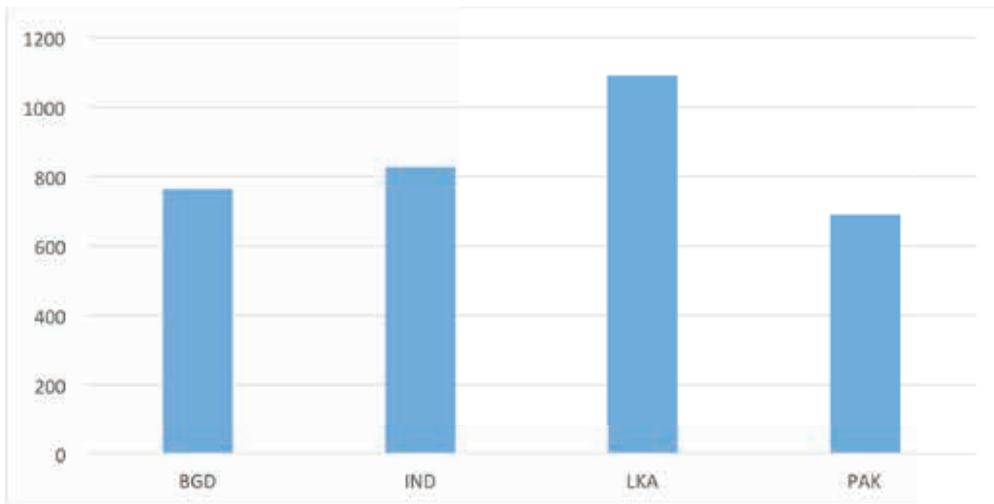


Figure 3: *Sum of Openness by Country*

Figure 4 reveals the sum of governance in selected countries. India and Sri Lanka show the highest governance value, while Pakistan and Bangladesh show a lower value over the course of 1996 to 2016.

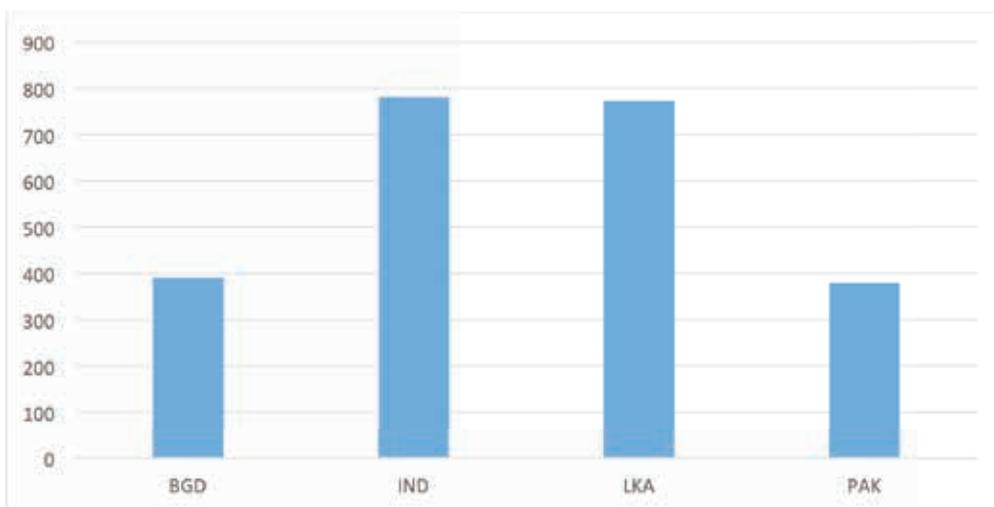


Figure 4: *Sum of Governance by Country*

The figure shows the sum of infrastructure in the selected countries. Sri Lanka leads the other countries with the highest infrastructure value, followed by Pakistan, India, and Bangladesh over the period of 1996 to 2016.

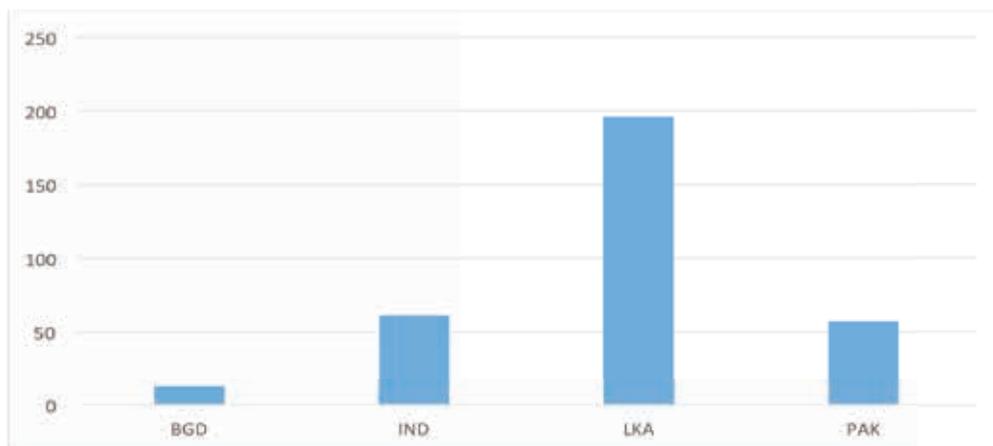


Figure 5: Sum of Infras by Country

Levin, Lin, and Chu (LLC), Im, Pesaran, and Shin (IPS), and Fisher-ADF (F-ADF) panel unit root tests are applied to check the order of integration of the variables. Schwarz information criteria (SIC) is used to find the lag length criteria. Results of the unit root test depicted that variables have a different order of integration.

Table 1:
Results of Panel Unit Root Test

| Var | LLC | | IPS | | F-ADF | | Order of Integration | | |
|------------|------------|----------------|------------|----------------|-----------|----------------|----------------------|------|-------|
| | Level | 1st difference | Level | 1st difference | Level | 1st difference | LLC | IPS | F-ADF |
| FDI | 1.0426 | -2.0004** | 0.4671 | -2.3894*** | 4.2464 | 18.566** | I(1) | I(1) | I(1) |
| FMD | -3.587*** | -8.122*** | -1.3752* | -5.7367*** | 12.4977 | 44.220*** | I(0) | I(0) | I(1) |
| Educ | 0.1034 | -6.1389*** | 0.7205 | -3.1142*** | 3.2434 | 42.602*** | I(1) | I(1) | I(1) |
| Infl | 2.1438 | -5.9068*** | 0.3149 | -2.6541*** | 4.3759 | 20.505*** | I(1) | I(1) | I(1) |
| Exhrate | -2.2893** | -4.394*** | 0.3757 | -4.0435*** | 4.1869 | 30.855*** | I(1) | I(1) | I(1) |
| Governance | 7.7747 | -8.739*** | 0.8031 | -5.6750*** | 3.2518 | 43.728*** | I(1) | I(1) | I(1) |
| Openness | 1.12459 | -3.557*** | 2.2708 | -0.5348* | 0.8442 | 20.4572*** | I(1) | I(1) | I(1) |
| Natres | -0.7512 | -4.7701*** | 1.2731 | -3.7570*** | 2.2469 | 27.6761*** | I(1) | I(1) | I(1) |
| Infrasit | -2.5881*** | -3.0089*** | 1.0500 | 0.6863* | 10.2954 | 17.2126** | I(1) | I(1) | I(1) |
| Balance | -3.2915*** | -10.2123*** | -2.4622*** | -8.1829*** | 18.0717** | 6.18180*** | I(0) | I(0) | I(0) |
| Intrate | 1.80682 | -16.5130*** | -0.14714 | -15.5918*** | 6.02805 | 124.521*** | I(1) | I(1) | I(1) |

Table 2 reports the result of the panel ARDL model for FDI and demonstrate the long run and short-run dynamics. Panel A of Table 2 reports the long-run coefficients. FMD has a negative and insignificant relation with FDI, which shows that FMD does not affect the growth of FDI, whereas the exchange rate has a negative and significant effect on FDI. It depicts that when there is an increase in the exchange rate, then the income from abroad decreased. Governance has a negative and significant relation to FDI. Moreover, inflation has also a negative and significant effect on FDI, which depicts that foreign direct investment brings the inflationary phenomenon in the economy. The real GDP growth rate has a negative effect on foreign direct

investment. It means that when there is more growth in the economy, then FDI decreases. It is necessary to transform the panel ARDL model into an error correction model. The error correction term is the rate of adjustment, which shows how the variables are quickly adjusted towards the equilibrium level. Panel B of Table 2 reports the error correction term and shows that the long-run relationship exists between the variables.

Table 2:
Long Run and Short Run Dynamics for FDI

| Dependent Variable: FDIGDP | |
|----------------------------|------------------------|
| Panel A : Long Run | |
| FMD | -0.0154 (0.0135) |
| Education | 0.0044 (0.0205) |
| Exhrate | -0.2452*** (0.0304) |
| Governance | -0.0709*** (0.0085) |
| Inflation | -0.9056*** (0.1408) |
| Natres | 2.3435*** (0.3522) |
| Infras | 0.6149** (0.2500) |
| LGDP | -3.2709*** (0.6313) |
| Panel B: Short Run | |
| ECT | -0.0053*** (0.1346) |
| D(FMD) | -0.0053*** (0.1254) |
| D(Education) | -0.0025*** (0.2987) |
| D(Exhrate) | 0.1401*** (0.3478) |
| D(Governance) | 0.0160*** (0.1254) |
| D(Inflation) | 0.1834*** (0.2543) |
| D(Natres) | -0.0071*** (0.1567) |
| Infras | -0.8583*** (0.2467) |
| LGDP | 0.4838*** (0.3455) |

Note: *, **, *** shows the level of significance at 10%, 5% and 1% respectively. Standard error are reported in parenthesis.

Table 3 reports the result of the panel ARDL model for FMD and demonstrate the long run and short-run dynamics. Panel A of Table 2 reports the long-run coefficients. FDI has a negative and significant relation to FMD. Education, real GDP growth rate, and balance have a negative and significant relation with FMD. While the exchange rate and inflation have a positive and significant relation with FMD. Intrate has a negative and insignificant relation to FMD. It is necessary to transform the panel ARDL model into to error correction model for the estimation of short-run parameters. The error correction term is the rate of adjustment, which shows how the variables are quickly adjusted towards the equilibrium level. Panel B of Table 3 reports the error correction term and shows that the long-run relationship exists between the variables.

Table 3:
Long Run and Short-Run Dynamics for FDI

| Dependent Variable: FMD | |
|-------------------------|--------------------------|
| Panel A: Long Run | |
| FDIGDP | -11.7607* (6.8569) |
| Education | -0.8299*** (0.1997) |
| Exhrate | 2.3978*** (0.4740) |
| Governance | 1.4761*** (0.4316) |
| Inflation | 2.4816* (1.2525) |
| Intrate | -1.7688 (1.4217) |
| Balance | -11.7416*** (2.2038) |
| LRGDP | -64.5482*** (12.3676) |
| Panel B: Short Run | |
| ECT | -0.5964*** (0.1934) |
| D(FDIGDP) | -4.0883*** (0.1976) |
| D(Education) | 0.1677*** (0.1543) |
| D(Exhrate) | 0.3631*** (0.2576) |
| D(Governance) | -0.4719*** (0.1987) |
| D(Inflation) | 0.2042*** (0.1365) |
| D(Intrate) | 1.3003*** (1.7231) |
| D(Balance) | 0.5624*** (0.1236) |
| D(LRGDP) | 80.6569*** (13.455) |

Note: *, **, *** shows the level of significance at 10%, 5% and 1% respectively. Standard error are reported in parenthesis.

Table 4 represents a correlation between FDI and FMD variables. The results show that a positive correlation exists between FDI and FMD variables with the highest value of 69%. We have also observed a positive correlation between FDIGDP and five FMD variables.

Table 4:
Correlation between FDI and FMD Variables

| Correlation | CREDIT | CCB | FDIGCF | FDIGDP | STKMKRTCAP | STKVOLTRA |
|-------------|----------|----------|----------|----------|------------|-----------|
| CREDIT | 1.000000 | | | | | |
| CCB | 0.174379 | 1.000000 | | | | |
| FDIGCF | 0.098152 | 0.280126 | 1.000000 | | | |
| FDIGDP | 0.472010 | 0.368394 | 0.480101 | 1.000000 | | |
| STKMKRTCAP | 0.678958 | 0.241011 | 0.064658 | 0.446897 | 1.000000 | |
| STKVOLTRA | 0.361420 | 0.274858 | 0.163065 | 0.509917 | 0.690059 | 1.000000 |

To check the causal relationship between FDI and FMD variables, we perform the Granger Causality test. We have categorized the FMD variables into two categories: Stock market development (SMD) indicators (STKMKRTCAP and STKVALTA) and Banking sector development (BSD) indicators (CREDIT, and CCB). Table 5 reports the causality test between FDI and FMD variables. The result shows that there is bi-directional causality between CREDIT and FDIGDP, while no causality exists between CCB and FDIGDP. However, one-way causality exists from STKMKRTCAP and STKVOLTRA to FDIGDP in South Asia countries.

Table 5:
Causality test between FDI and SMD

| Null Hypothesis: | F-Statistic | Prob. |
|--|-------------|----------|
| STKMKRTCAP does not Granger Cause FDIGDP | 15.97 | 0.0002 |
| FDIGDP does not Granger Cause STKMKRTCAP | 2.083 | 0.1534 |
| STKVOLTRA does not Granger Cause FDIGDP | 23.09 | 0.000009 |
| FDIGDP does not Granger Cause STKVOLTRA | 1.355 | 0.2485 |
| CREDIT does not Granger Cause FDIGDP | 4.328 | 0.0412 |
| FDIGDP does not Granger Cause CREDIT | 11.32 | 0.0013 |
| CCB does not Granger Cause FDIGDP | 0.0001 | 0.9776 |
| FDIGDP does not Granger Cause CCB | 0.34462 | 0.5591 |

CONCLUSION AND RECOMMENDATIONS

Countries lacking financial development have no potential towards FDI, even though the financial sectors of these countries have optimum performance. The objective of this study is to examine the relationship between FDI and financial market development (FMD) in the existence of other aspects i.e., governance, social, and macroeconomic variables. This study uses the annual panel data of four emerging South Asian countries i.e., Bangladesh, India, Pakistan, and Sri Lanka, from 1994 to 2016. Panel ARDL model is used to examine the long run and short-run relationship, while correlation and causality analysis is used to examine the relationship between FDI and FMD variables.

Results of Panel ARDL show that exchange rate, governance, inflation, and real GDP growth rate are the significant predictors of FDI in South Asian countries. From this, we can conclude

that at the policymaking level in order to attract FDI in our selected countries, policymakers should focus on these variables. On the other hand, the main predictors of FMD in South Asian countries are FDI, education, real GDP growth rate, balance, exchange rate, and inflation. A positive correlation between FDI and FMD variables is present. We do not rely on the correlation of variables, and further implied statistical tests draw a meaningful conclusion. In order to check the causal relation between FDI and FMD variables, we use the Granger causality test. Bi-directional causality exists between CREDIT and FDIGDP, while no causality exists between CCB and FDIGDP; however, one-way causality exists from STKMKRTCAP and STKVOLTRA to FDIGDP.

Our study suggests that countries having better governance have an edge in attracting FDI to the country. The decision-makers should use it to devise investor-friendly monetary and fiscal policies to attract FDI. An easy-to-comply and transparent tax policy at both federal, as well as provincial levels, is very important. The current tax regime of the country is making it difficult for investors to comply with the many taxes that a business must pay.

The findings of this study recommend the formulation of a critical policy duly accompanied by a system of market-oriented regulations. Attention needs to be paid to the strengthening of stock markets in order to protect investors and improve fiscal governance to attract more FDI. Market openness also contributes to attracting FDI in emerging markets. Moreover, transparency must be there to contribute to building domestic regulatory processes to ensure the trade and investment friendliness of domestic markets. This would, in turn, enable to exploit maximum gains from spillover effects of FDI to the indigenous economy. It is pertinent to state here that the Special Economic Zones (SEZs) have a unique role of spearheading into the domestic economy. The new zones planned under the China Pakistan Economic Corridor shall provide a thriving gateway to not just China but other foreign investors as well. These include investors from Russia, Saudi Arabia, Kyrgyzstan, South Korea, Germany, etc. Immediate attention also needs to give to the prioritizing of sectors that require investment. For instance, Pakistan being an agrarian economy needs value-added chains to be formed in its agriculture sector. Therefore, the foreign investor must be channelized into sectors that will ensure maximum benefit to Pakistan's economy. This work would be done by a dedicated investment promotion agency that has access to reliable data and can quantify the priorities henceforth.

Since this study focuses on South Asia, it would be unfair not to discuss the role of SAARC (South Asian Association for Regional Cooperation). SAARC needs to be much more active and follow the EU (European Union) in bringing together the member countries for foreign trade enhancement. South Asia as a region has tremendous potential for FDI, and this can be best exploited if the SAARC trade secretariat were to encourage people to people and business to business contacts among member states. Unfortunately, past efforts to enhance the role of SAARC have been non-productive due to the tense relations between India and Pakistan. However, if trade and economic diplomacy between the two countries were to be strengthened, the pathway to thawing the tense relations could become more manageable.

As for the limitations of this study, it may be noted that this research is limited to selected emerging markets. Furthermore, this study can be explored as a comparative study between different countries. The European Union and various emerging markets can be analyzed on the same pattern with different variables.

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