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Muhammad Azam and Hashim Khan and Ahmed Imran Hunjra and H. Mushtaq Ahmad and Muhammad Irfan Chani

Pakistan Institute of Development Economics Islamabad Pakistan, Iqra University Islamabad Campus, Pakistan, National College of Business Administration and Economics (NCBA&E), Lahore

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Muhammad Azam

M. Phill Scholar, Pakistan Institute of Development Economics, Islamabad, Pakistan

[muhammadazam.economist@gmail.com](mailto:muhammadazam.economist@gmail.com)

Hashim Khan

MS Scholar, Iqra University Islamabad Campus, Pakistan

Ahmed Imran Hunjra

MS Scholar, Iqra University Islamabad Campus, Pakistan

H. Mushtaq Ahmad

Bahria University Islamabad, Pakistan

Muhammad Irfan Chani

PhD Scholar, National College of Business Administration & Economics Lahore,  
Pakistan

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### **Abstract**

Recent economic literature suggests that institutional quality factors exerted positive effect on foreign direct investment (FDI) inflows. The main focus of this study is to examine the role of institutional factors and macro economic policy factors on FDI inflows in a panel data of seven South Asian countries over the period of 12 years since 1996-2007. This study implies that a good institutional quality plays a key role in attractiveness of FDI inflows. A poor macroeconomic policy situation produces negative impact on FDI. Good Institutional quality and macroeconomic policy generate negative in a combined form on FDI. This study further implies that poor economic policy deteriorates institutional quality and creates negative effect on FDI inflows. Incredibility in trade liberalization policy may be a part of poor macro economic policy.

**Keywords:** Institutional quality, Macro economic policy, Attractiveness, Incredibility, South Asia.

## Introduction

Foreign direct investment (FDI) inflow is one of the most important factor in globalization. FDI inflow has been widely received tremendous attention because of expanding production and financial markets. In previous century, FDI inflows have remained a major challenge for developing countries to build up their economies. It is generally argued that FDI is an engine of employment, productivity improvement through technological, management spillover and economic growth (Balasundram, 2000; Azmat, 1999 and Gordon, 2001).

A large number of developing countries heavily rely on FDI inflows because it is important source for external financing (Gao, 2004). According to UNCTAD report (2006), FDI inflows provide physical capital, employment possibilities and technological transfer and long term economic development among developing countries. Therefore, the main priority of developing countries **national** governments are is the attraction of foreign capital. in the country.

One of the major challenges for developing countries is to draw attention towards of FDI flows. In recent economic literature the importance of political environment in developing countries for FDI inflows have remained questionable? An extensive empirical literature has given substantial importance to political institutions variables for FDI attractiveness in host country including the work of (Kaufman et al., 1999; Altomonte, 2000; Bevan & Estrin, 2000; Mody & Srinivasan, 1998; Kinoshina & Campos, 2003). In contrast to this a mixed kind of arguments have been reported by a group of scholars (Dawson, 1998; Przeworski et al., 2000; Li & Resnick, 2003; Stein &

Daude , 2001). Lucas (1990) augmented the political factors and legal environments as an important determinant that can explained the FDI inflows from developed countries to developing countries. Levchenko (2004) considered that strong political institutions of developing countries had comparative advantage for FDI attractiveness. The strand of economic literature, the various channels have been identified Political institutions may might effect FDI.

Despite of political factors macro economic policy is considered as pre condition for FDI attractiveness (UNCTAD, 2006; Hadjmichael et al., 1996; Taylor, 2000; Kumar, 2002). A macro economic policy has three major contents like (1) monetary policy (2) fiscal policy (3) exchange rate or trade policy. A robust kind of arguments has been built to capture the impact of each contents of macroeconomic policy on FDI Inflows (Grubert & Mutti 1991; Loree & Guisinger, 1995). Most of the past studies have analyzed the effect of each policy separately in FDI perspective. Inflation targeting is one of major channel for monterey policy that effect FDI. It is generally argued that higher inflation will increase uncertainty about prices and make it more difficult for MNCs to predict host country (Fisher, 1993; Burdekin and Siklos, 2004). Fiscal policy adopted by host country government has got tremendous attention for MNCs concerning FDI decision. A fiscal spending and taxes are important theoretical channels that effect MNCs decision (Oman, 2000; Blomstrom et al., 2003). Similarly, trade openness policy is an important part of macro economic policy and its effect on FDI is ambiguous for developing countries.

Recently, a poor quality of institutional structure, high inflation rate, an increasing budget deficit and inconsistent trade liberalization are major problems that effect FDI in

South Asia. Therefore, it is essential to investigate the relationship among political factors, macro economic policy and FDI. Few studies in South Asia investigate the importance of political factors for FDI. These studies focus only on political factors and macro economic policy factors separately. in disaggregated form. These studies completely ignore the combined importance of political factors and macro economic policy factors for FDI.

Keeping this in view, the purpose of this study is to fulfill the gap in economic literature by analyzing the relationship among political factors, macro economic policy and FDI. This study focus on the following questions: Does institutional quality and macro economic policy effect FDI in disaggregated and combined form? What is the relationship among institutional quality, macro economic policy and FDI? Does macroeconomic policy depict a similar pattern as institutional quality factor for FDI?

### **Conceptual frame works**

In 19<sup>th</sup> century, FDI got a serious attention in theoretical economic literature. Classical economists predict that FDI increase efficiency and economic growth by gaining economies of scale in production process (Smith, 1776; Ricardo, 1817). Neoclassical economists argued that FDI expansion from home country to host country is because of interest rate differential characteristics. In this ideological framework, capital movements took place from low return on capital economies to high return on capital economies and helpful for technological spillover and productivity improvements (Bergten et al., 1978 and Reuber et al., 1973).

The product life cycle theory argued FDI flows process regarding products from home country to host country. Vernon (1966) explained that production process and sale of new products should be started in home country. The reason behind this argument is that product is not standardized, thereby per unit input requirement and cost is not uniform. The product will be standardized due to increase the local demand of product and generate demand of high income and labor saving product outside the home country. FDI decision took place where cost of production is very low and firm face competition towards maturing the products. When product reaches at maturity stage the skilled labor contribute in production, a high income and labor saving product will be produced and host country become attractive place.

Dunning (1988) developed “Eclectic or OLI paradigm theory” that FDI decision abroad depends upon following determinants. The term OLI refers to ownership, location and internationalization conditions accordingly. Firstly, the term (O) implies the ownership factors that matters for MNCs to take FDI decisions abroad. The ownership factor includes protection of property rights, enjoying monopoly power and controlling the supplies of outputs in that country. Secondly, another term (L) that belongs to Location factors that determine MNCs decision for FDI in developing countries. The location factors can be categorized on the basis of market seeking factors, efficiency seeking factors for MNCs. The market seeking factors include large market size. Large market size normally increases the productivity potential of MNCs by achieving of economies of scale in host country (Asiedu, 2002; Schneider & Frey, 1984; Eaton & Tamura, 1994). The efficiency seeking factors that matters for FDI include cheap and skilled labor force in host country. The infrastructure factors include railway and road networks,

communication system as well as the electric consumption capacity in host country are majors' determinants for FDI (DELBO, 2009).

In recent economic literature, an institutional approach has transformed categorical thinking of MNCs about FDI in host country. The institutional environment facing MNCs is very complex and conflicting in its nature (Henisz & Delios, 2001; Lu, 2002). According to North (1990) an institutional environment of host country includes rule and regulation, norms and customs, process and procedure that matters for MNCs. It is argued that government play an important role for MNCs by providing stable political and economic environments, contract enforcement, skilled workforce and sound infrastructure both at macro level and micro level. A country level institutional force can be conceptualized by including political influences and legitimate problems which can be categories; formal rules, taxation laws and rates, informal pressure groups, operating constraints and regulations (Brouthers & Brouthers, 2000; Guler et al., 2002; Goodrick & Salancik, 1996; Scott, 1995; Huang & Sternquist, 2007). The institutional importance cannot be ignored when MNCs decide about extension abroad in the form of subsidiary setup. It can be concluded that bad governance results in less attractive environments for MNCs and as a result FDI decreased (Mauro, 1998).

Various theoretical explanations regarding the relationship between macro economic policy and FDI are documented. Monetary policy is considered as an important part of macro economic policy. Monetary policy effect FDI through credit rate channel (Kindleberger, 2000). A credit market has given substantial importance for explaining financial shocks that ultimately effect investment incentive (Gertle & Natalucci, 2003) for

MNCs cost of credit has directly restricts banks borrowing (Gorton et al., 2008; Lown & Morgan, 2005). These financial constraints restrict not only local investment decisions but **also** foreign investment decisions also (Xu, 2000; Kaplan & Zingales, 1997; Lamont, 1997). “Non Keynesian approach” has given prime importance to fiscal expansion for FDI attractiveness and better for economic activity (Alesina & Ardagna, 1998; Giavazzi & Pagano, 1990; Bertola & Drazen ,1993; Sutherland, 1997; Perotti,1999). Budget deficit result in terms of high taxation that effect MNCs decision (Oman, 2000). The budget deficit increase in developing countries reinforces the governments to impose high taxes both on local and foreign firms. MNCs investment decision is badly effected by the taxes imposed to finance the budget deficit. A competitive tax rate environment in a country also support FDI by providing economies of scale in production and access to foreign markets. There is no doubt regarding the importance of trade liberalization policy for economy and it is helpful for efficient use of natural resources and encourages foreign investment (Kumar, 2002). In contrast to this, trade liberalization policy also effect FDI negatively through credibility of policy channel in developing countries (Rehamn, 2003). The credibility of trade liberalization policy effect negatively FDI inflows through time inconsistency which means that differentiation between different strategies adopted by host country. A trade liberalization policy may become potential source for taxation that negatively effect FDI inflows (Mash, 1999). Inconsistent measures of liberalization policy may out weight the benefits of trade liberalization policy (Papageorgiou et al., 1986 and Aizenman, 1992).

A theoretical discussion identified that institutional quality matters for FDI. Institutional quality effect is transferred to FDI through contract enforcement, rules and regulation

and investment security channels. Macro economic policy including monetary, fiscal and trade liberalization policy effect is translated to FDI through cost of credit channel, tax channel and credibility of trade openness policy channel. There is strong possibility that institutional quality has positive impact on FDI and macro economic policy impact FDI negatively.

## **Empirical Literature Review**

### **Economic determinant and FDI**

Mottaleb (2007) incorporated the market size variable by analyzing the data of 60 developing countries over the period of 2003-2005 and used GDP as proxy for market size and study further explored the corruption deteriorate FDI inflows toward developing Countries. Din (1994) used per capita GDP as a proxy for market size by empirically estimating the data of 36 lower developing countries for the year of 1983 and found that large market size increase FDI inflows (Lankes & Venables, 1996; Resmini, 2000; Garibaldi, 2002; Khan & samad, 2010; Nunes et al., 2006 and Sahoo, 2006)

Sahoo (2006) analyzed the data for five South Asian countries and highlighted the importance of economic factors for FDI flows and used panel co integration technique to examine long run relationship between economic variables and FDI inflows and identified that market size; trade openness, infrastructure index and labor force growth rate were major determinants. For infrastructure the previous studies proved the same (Wheeler and Mody, 1992; Kumar, 1994; Loree & Guisinger, 1995; and Asiedu (2002).

Hailu (2010) identified the demand side factors importance for FDI inflows over the period of 1980 to 2007 for 45 African countries. The study utilized fixed effect least

square dummy variable (LSDV) model for estimation and revealed that trade openness, Market size and infrastructure in host country exerted positive effect on FDI inflows. Furthermore, the findings of this study also highlight the significant of political factors and natural resources for FDI. The results suggest that a sustainable political condition in host country facilitate foreign investors regarding business expansion, property right protection, etc. that play crucial role for FDI attractiveness to African countries.

### **An institutional quality and FDI**

The impact of institutional quality on FDI has been investigated on limited extent in South Asian countries. Globerman & Shapiro (1999) identified the importance of institutions quality for MNCs. They developed governance quality index using six governance indicators that include rule of law, corruption, etc of Kaufman et al. (1999). A good Governance effect positively FDI inflows. They used principal components methodology for this index development. Quéré (2005) found that good institutions are main source of attractiveness for FDI inflows. For empirical analysis they used data set of 52 countries. They also controlled the issue between institutions and market size. They evaluated good institutional quality raise bilateral FDI inflows. Hyun (2006) analyzed the short run and long run relationship between institution quality and FDI inflows by analyzing the data of 62 developing countries over the period of 1984 to 2003 .There is no short run causality between these two variables. Institutional quality effect positively FDI in long run and short run.

Wernick (2009) had estimated the relationship between institutional quality and FDI for the 64 emerging countries. It is evaluated that strong institutional quality creates a friendly environment and main source of attraction. FDI inflows took place comparative

to those countries having weak governments. In the strand of literature, Wei (2000) observed the data for 143 countries over the period of 1995 to 1997. He found that three main factors of institutional quality like regulating, legislation system and legal system are key determinants that attract FDI. Corruption factor is also observed that effect negatively to FDI inflows. They argued that a good quality of institutional condition in host country attract more FDI as well as create feasible condition for emerging of new MNCs in host country. Vadlamannati (2008) analyzed the data for South Asian countries over the period of 1975 to 2006, highlighted the importance of institutional quality, GDP growth rate, per capita GDP for FDI inflows.

### **Macro economic policy and FDI**

It is generally argued that macro economic policy plays an important role for FDI inflows (Hadjmichael, 1996). Macro economic policies effect FDI through market imperfections. The relationship of macro economic policy with FDI is ambiguous that may increase or decrease FDI inflows (Grubert & Mutti, 1991; Loree & Guisinger 1995; Taylor 2000; and Kumar, 2002). Ahnsy et al. (1998) explored the relationship between exchange rate, inflation and FDI over the period 1970 to 1981 for developing countries and found high inflation rate effect negatively to FDI inflows. He also observed that over valuation of exchange rate is the result of high inflation rate that adversely effect FDI inflows.

Ahlquist (2006) analyzed the data of 90 developing countries over the period of 1985 to 2002, investigate that FDI decision is sensitive to fiscal policy and political institution in

host country. Investors take investment decision on the basis of perceived risk and government policy adopted by host country and further evaluate that FDI inflows decision relative to portfolio investment have different nature of determinants. A FDI inflow is not sensitive to Fiscal policy but more sensitive to political factors in host country.

Desai et al. (2004) identified the role of taxes on FDI in host country. They found that high tax rate imposed on corporate sectors effect negatively to profit of firms through capital and labor market. Corporate tax depress capital labor ratio and decrease the profit margin. A high level of income tax helps in substitutions of capital with labor market. High income taxation rates appear to encourage firms to substitute labor for capital and to reduce levels of taxable income, whereas high rates of indirect taxation do not. Rehman (2003) argued that credibility of trade liberalization policy of host country is more important for FDI inflows by analyzing the data of 74 developing countries over the period of 1980-1998 and concluded creditability of trade policy concerned with export promotion efforts to attract FDI inflows in developing countries. Credibility of trade liberalization policy is important for FDI inflows relative to portfolio equity investment because FDI inflows are based on long term decision. Lack of creditability regarding policies in host country may generate risk for foreign investment.

### **The Model Specification, Methodology and Data**

There are different empirical models specified in economic literature for identification of economic determinants for FDI. There is no unanimous ideology accepted theoretically for FDI determinants (Kamaly, 2004). A recent economic literature highlighted that

market size (Buckley et al., 2007) labor force, a good institutional quality and macro economic policy are main important variables for determining FDI. For purpose of empirical analysis of different factor s on FDI, the study used model as follows:

$$FDI_{it} = f(Y_{it}, LF_{it}, PI_{it}, IQ_{it}, INU_{it}, ).....1$$

Where

$FDI_{it}$  = Foreign Direct Investment Inflows

$Y_{it}$  = GDP per capita

$LF_{it}$  = Labor Force

$PI_{it}$  = Macro economic Policy Index

$IQ_{it}$  = Institutional Quality Index

$INU_{it}$  = Internet Users (per 1000 people)

A panel data is an appropriate methodology used for time specific and cross section specific Analysis (Beven et al., 2000). In panel data analysis, a time and space dimensions are covered by surveying cross section units over time. A balanced panel data has been used because each cross section units contained equal number of observations. Panel data estimation methodology is helpful in reducing econometrics problems and omitted or miss measured variables have strong correlation with explanatory variables (Hsiao, 1989). The econometric equation applied in this study can be specified as:

$$y_{it} = \alpha_{1i} + \sum_{j=2}^9 \beta_j x_{jit} + \varepsilon_{it}.....2$$

In the above equation, (1),  $y_{it}$  is dependant variables that is FDI Inflows for  $i^{th}$  country and  $t^{th}$  years. (2) The number of cross section countries are represented by  $i = 1,2,.....N$

Where the value of  $N = 7$  or seven countries (Pakistan, Bangladesh, India, Afghanistan, Srilanka, Maldives and Bhutan) and time period  $t = 1, 2, \dots, T$  where  $T = 12$  years of Data. (3)  $\alpha_{it}, i = 1, 2, \dots, N$  represent the intercept term that remained constant over time but varied across countries. (4)  $\beta_j, j = 1, 2, \dots, J$  represent the slope coefficient and it remained constant overtime and across countries (5)  $x_{jit}$  it captures the  $j^{\text{th}}$  explanatory variable for  $i^{\text{th}}$  country at  $t^{\text{th}}$  years. A set of explanatory variables include GDP (Lankes & Venables, 1996; Resmini, 2000; Garibaldi, 2002; Bevan & Estrin, 2000; Nunes et al., 2006; Sahoo, 2006) infrastructure. The previous studies of Wheeler & Mody (1992), Kumar (1994); Loree & Guisinger (1995) and Asiedu (2002) included market size, institutional quality index and policy variables. (6)  $\varepsilon_{it}$  is stochastic random term for  $i^{\text{th}}$  country and  $t^{\text{th}}$  years with its mean is independent and identically distributed (iid) with zero mean value and constant variance. A fixed effect and random effect Model can be specified for regression Analysis that depend upon the assumptions made about  $\alpha_{it}$ . A country specific effect can be captured by fixed effect model that includes  $N-1$  countries specific dummies. It is assumed that  $\alpha_{it}$  remained fixed.

A general equation for fixed effect model can be written as:

$$y_{it} = \sum_{k=1}^N \alpha_{1k} D_{ki} + \sum_{j=2}^9 \beta_j x_{jit} + \varepsilon_{it} \dots \dots \dots 3$$

Where in above equation,  $D_{ki}$  is a dummy variable that take value 1 for  $k$  country and zero observations for other countries. A fixed effect model can be specified in our study as for estimation:

$$NFDI_{it} = \sum_{k=1}^9 \alpha_{1k} D_{ki} + \beta_1 y_{it} + \beta_2 LF_{it} + \beta_3 INU_{it} + \beta_4 IQ_{it} + \beta_5 PI_{it} + \beta_6 IQ * P.I_{it} + \varepsilon_{it} \dots 4$$

In case of random effect model,  $\alpha_{1i}$  is assumed to be random not fixed. It is also assumed that its mean is equal  $\bar{\alpha}_1$  to and its variance is  $\delta_{\mu}^2$ . In this way, generalized least square estimators are obtained in Random Effect or Error Component Model. A general form of equation in Random Effect Model can be specified as:

$$y_{it} = \bar{\alpha}_1 + \sum_{j=2}^9 \beta_j x_{jit} + \mu_i + \varepsilon_{it} \dots 5 \quad \text{Where } \alpha_{1i} = \bar{\alpha}_1 + \mu_i$$

A random effect model can be specified as in our Study:

$$NFDI_{it} = \bar{\alpha} + \beta_1 y_{it} + \beta_2 LF_{it} + \beta_3 INU_{it} + \beta_4 IQ_{it} + \beta_5 PI_{it} + \beta_6 IQ * P.I_{it} + \varepsilon_{it} \dots 6$$

In this study data set is balanced panel data set that consists of seven countries including Pakistan, Bangladesh, India, Afghanistan, Srilanka, Maldives and Bhutan for the period of 1996 to 2007. The data on FDI inflows have been taken from relevant countries central banks reports. Recently, institutional factors have got tremendous importance for FDI in most of the developing countries (Morrisey & Rai, 1995; Brenton et al., 1999; Meyer, 1998; Globerman & Shapiro, 2002, 2003). For institutional quality measurement, six indicators have introduced that include voice and accountability, political stability and absence of violence/terrorism, government effectiveness, regulatory quality, rule of law, and control of corruption Kaufmann et al. (2009). We used these indicators for institutional quality index. Macro economic policy variables

have their own significant importance for net FDI inflows. These macro economic policy variables include monetary policy, fiscal policy and trade liberalization policy. Inflation as GDP deflator has been used as a proxy for monetary policy. Budget deficit has been used as proxy for fiscal policy. The data source on budget deficit, inflation as percentage of GDP deflator trade openness, labor force and internet user is taken from relevant country data source and world development indicators respectively.

## Empirical Results

Before estimation of equation, we estimate the order of integration of each variable other wise econometric specification lead to spurious kinds of results (Asterieou & Hall, 2007). To check the stationary of variables so we have applied Hadri<sup>1</sup> unit root test approach. This test measure Z-statistics for unit root. Hadri test is performed on some conditions that include at level and 1<sup>st</sup> difference unit root testing. The results of Hadri test at level and first difference are reported in Table 1.

**Table 1: Hadri Panel Unit Root Test**

Variable Name	Hadri (Z-stat ) at 1st Difference	Hadri (Z-stat ) at 1st Difference
$FDI_{it}$	3.73 (0.000)*	4.90 (0.000)*
$Y_{it}$	4.80 (0.000)*	5.87 (0.000)*
$IQ_{it}$	2.54 (0.0055)***	2.10 (0.017)**
$PI_{it}$	4.79	2.70

<sup>1</sup>For detailed methodology Giulietti and Otero(2005) work can be concerned.

	(0.000)*	(0.0034)**
$LF_{it}$	5.09	5.75
	(0.000)*	(0.000)*
$INU_{it}$	4.47	3.67
	(0.000)*	(0.000)*

Note: \*,\*\*,\*\*\* indicate the significance at 1%,5%,10% respectively, The value in parenthesis are the p-value.

The results show that all variables included are stationary at level. This implies that the null hypothesis of unit root is rejected for all variables at level. Hence these variables are integrated of order zero i.e ( $I(0)$ ) or stationary at level. So we can estimate parameters of panel data by panel least square, fixed effect and random effect specification at level.

**Table 2: A Panel Regression results for FDI Inflows**

Dependant Variable: $FDI_{it}$				
Independent Variables	Panel Least Square	Fixed Effect Model	Random Effect Model	
C	-9.000. (-6.65)*	-8.21 (-21.35)*	5.29 (5.29)**	
$Y_{it}$	8.49E-05 (7.23)*	6.08E-06 (5.15)*	4.67E-0.6 (3.290)**	
$LF_{it}$	1.87E-05 (7.62)*	1.47E-05 (14.33)*	1.40E-4 (3.37)*	

$INU_{it}$	0.17 (2.44)**	0.085 (2.50)**	0.21 (2.69)**
$IQ_{it}$	1.19 (3.05)*	1.46 (2.45)**	2.40 (2.37)**
$PI_{it}$	-0.26 (-3.40)*	-0.15 (-3.23)*	-0.28 (-2.06)**
$(IQ_{it} * PI_{it})$	-0.21 (-5.25)*	-0.15 (-4.73)*	-0.26 (-2.32)**
$R^2$	0.64	0.85	0.64
$\overline{R^2}$	0.62	0.80	0.62

A Hausmann test-  $\chi^2 = 0.0095(0.985)$

Note: \*, \*\*, \*\*\* indicate the significance at 1%, 5%, 10% respectively, The value in parenthesis are the t-value.

In table 2, the results are estimated by panel least square, fixed and random effect specification.<sup>2</sup> The results estimated from different panel estimation specification are almost same. A Hausmann test is used for more appropriate model specification. In our study the value of Chi –square statistics of Hausmann test is insignificant insignification suggesting that the results of random effect **fixed** model is more appropriate and efficient. How ever we have reported the results estimated from three specifications. GDP per capita used as proxy for market size exerts positive and significant effect on FDI inflows that is consistent to literature. This implies that a large market size generates more demand for goods and services and help MNCs to achieve

<sup>2</sup> The descriptive statistics of Political risk index as well as economic variables are given in Annex part respectively.

economies of scale in host country. We find labor force significant positive effect on FDI inflows. The labor force indicates that as population in host country increase that ultimately increase the demand of goods and services attract more FDI form outside the world. The results of internet users represent that as communication facility improves that provide a feasible facility for MNCs. It ultimately shows a positive effect on FDI. The institutional quality exerts positive and significant effect on FDI. The result implies that as political institutions quality improves this will attract more FDI. An improvement in rules of laws, deterioration of corruption and government stability etc provide a fair and friendly environment regarding investment protection point of view.

Macro economic policy is concerned it showed a negative effect and significant effect on FDI. The result of macro economic policy implies that increase in budget deficit, inflation and increase in lake of creditability of trade openness effect negatively to FDI inflows. Currently, it is argued that trade liberalization policy effect on FDI inflows through credibility channel in developing countries. The foreign investors are interested in policy consistency in long run. But developing countries have lack of creditability regarding policy inconsistency of trade openness. Similarly, an improvement in intuitional conditions exerts positive effect on FDI.

To capture the combined effect of macroeconomic policy and institutional quality, we include interaction term in our model specification. This term investigate the impact of institutional quality on FDI through macro economic policy channel. The relationship between interactive term and FDI is positive and significant. The result is little bit surprising, institutional quality effect negatively on FDI in south Asia only in case of

weak macro economic policy that includes mismanagement of budget deficit, a high inflation rate and incredible trade liberalization policy structure.

## **Conclusions**

FDI inflows have received considerable attention due to its undeniable importance for developing countries in form of industrial development and source of financing. The situation of FDI in South Asian countries is not satisfactory despite of a continuous process of FDI related policy relaxation. This study focuses the impact of institutional quality and macroeconomic policy on FDI. The coefficient of institutional quality is positive suggesting that an improvement in voice and accountability, political stability and absence of violence/terrorism, government effectiveness, regulatory quality, rule of law, and control of corruption indicators on FDI inflows. A macro economic policy exerts a negative effect on FDI inflows, suggesting that weak condition of fiscal policy, monetary policy and lack of credibility trade liberalization policy is not favorable for MNCs.

The interactive term suggest that a poor macro economic policy condition deteriorate the institutional quality and effect negatively to FDI. The main findings of present study suggest that macro economic policy including fiscal policy, monetary policy and trade liberalization policy deteriorate not only institutional quality but also reduce FDI in South Asia. The policy makers should also considered political and macro economic policy conditions when designing policy regarding FDI.

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