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Foreign Direct Investment and Its Influence on Profitability in Pakistan's Industrial Sector

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Abstract

Foreign Direct Investment (FDI) is widely understood to be one of the determinants of economic growth and industrialization of the new economies. The industrial sector is an important keystone of Pakistan's national GDP, employment, and technological progress, hence making it a very attractive sector for investments by foreign investors. This study examines the effect of FDI on profitability level in the firms of the industrial sector in Pakistan. Drawing on the panel data from publicly-listed industrial firms in the period from 2015-2023, the paper studies the correlation between the inflows of FDI and firm-level profitability (measured by the return-on-assets (ROA) and the return-on-equity (ROE)). The analysis uses multiple regression models to determine the effects of FDI while controlling for firm size, leverage and market factors. The results show that there is a positive and significant relationship between FDI and the profitability so it can be inferred that foreign investment does not only contribute money but also improves technological capabilities, managerial expertise and market access for local companies. The study indicates policy implications to attract targeted FDI to maximize the profitability in targeted industrial subsectors.

Introduction

Foreign Direct Investment (FDI) has been widely acknowledged as an important activator for economic development, especially in emerging economies that are characterized by scarce domestic capital and technology (Alfaro, Chanda, Kalemli-Ozcan, & Sayek, 2004). Being a developing economy with a sizable industrial base, Pakistan has pursued FDI with the intention of boosting growth, improving competitiveness and engaging its industries in global value chains. The industrial sector, which includes manufacturing, textiles, chemicals and engineering goods, plays a significant role in Pakistan's GDP, employment and is a focus for policy-based foreign investments (Khan & Qureshi, 2021). Despite fluctuating political and economic conditions, the government has taken actions such as introduction of investment friendly policies, tax conducive policies, advanced regulatory frameworks in order to attract multinationals and strategic foreign investors (Ahmed & Shah, 2022).

The profitability of the firms, in the industrial sector, is closely associated to the capability of the firms to make use of the external resources such as FDI. FDI can have a positive impact on the profitability with several channels of investments which includes the mobilisation of financial capital, the introduction of advanced technology, the promotion of better managerial practices, access to international markets and spillover effects resulting in a more efficient operation (Borensztein, De Gregorio, & Lee, 1998; Hussain, 2020). For example, multinational companies frequently spread best practices and innovative production methods to local companies, enabling them to optimize costs, boost productivity and gain market share. Moreover, foreign investors tend to carry their reputational weight, and that might aid the firm credibility and partnership formation at the national and international scales (Raza & Malik, 2021). This dual impact of FDI (both financial and non-financial), makes it a strategically important instrument in the fight to boost profitability in Pakistan's industrial sector.

Empirical evidence regarding the link between FDI and profitability in Pakistan has been mixed. Some research points to a positive effect on that FDI is a contributing factor to firm-level efficiency, technological progress, and greater return (Iqbal & Hanif, 2021; Khan & Aslam, 2020). Conversely, other studies contain the information that the benefits of FDI are dependent upon the absorptive capacity, managerial skills and the regulatory environment which is implied that the poorly managed firms may not take full advantage of the foreign investment (Dar & Khalid, 2021; Nasir, Waqar & Junaid, 2023). These discrepancies highlight an imperative for some updated empirical analyses that take into account firm-level characteristics, heterogeneity at the sectoral level as well as economies-wide factors, especially in light of recent policy reforms and FDI incentives introduced in Pakistan.

Pakistan's industrial sector is faced with a number of structural issues that negatively impact profitability such as high energy bills, infrastructure bottlenecks and volatile exchange rates. FDI has the potential to mitigate some of these constraints due to the provision not only of capital, but also expertise in resource management, technological adoption and supply chain optimization (Ahmad, Khan, & Hussain, 2022). In the subsectors of textiles and manufacturing, which are the major industrial sectors, foreign investments can achieve product diversification, export competitiveness and compliance with international quality standards. Consequence, an analysis of the link between FDI and profitability for these strategic pieces of the industry gives insights into the mechanisms of foreign investment where they translate into financial performance.

The importance of this research is that it focuses not on macroeconomic indicators, but on the profitability of firms, and therefore this research can also be understood in a nuanced way regarding the influence and operational and financial consequences of FDI. By using the latest panel data and a state-of-the-art concept of statistical techniques, the study aims at providing actionable insights for policymakers, industrial managers, and investors that try to maximize the benefits of foreign capital inflows. It tackles some of the critical questions, among which are: Which forms of FDI have the strongest impact on profitability? Do firm size, leverage and sectoral characteristics moderate this relationship? What policy interventions can increase the positive effects of FDI on domestic industrial firms? By answering these questions, the study adds to the general discussion on sustainable industrial growth and strategic planning of investments in Pakistan.

In sum, the industrial sector of Pakistan is in a good position to benefit greatly from FDI, as long as investments are tailored with sectoral strengths and firms have capacity to absorb foreign knowledge and technology. The effectiveness of FDI is evaluated using profitability as a key performance indicator as a critical lens through the application of which to evaluate the effectiveness of the FDI. This relationship is very dynamic and therefore understanding it is important to develop investment policies, enhance the competitiveness of industries, and have a sustainable economic development. The current research, consequently, investigates the influence of FDI on profitability in the industrial sector of Pakistan and attempts to shed light based on evidence-based research on the subject that enables decision-making on the matter by the large number of individuals, both in government and the business community

Literature Review

Foreign Direct Investment or FDI has been widely recognized as an important tool for enhancing industrial growth, technology and financial performance in the developing economies. Scholars have stressed that there is FDI besides the much-needed capital; it also enhances knowledge transfer, management expertise and access to international markets that can have direct and indirect implications on firm profitability (Borensztein, De Gregorio, & Lee, 1998; Alfaro, Chanda, Kalemli-Ozcan, & Sayek, 2004). Coming to the context of Pakistan, FDI had historically been a significant player in strengthening the industrial sector with most of the FDI in Indonesia been in the form of manufacturing, textile, chemical, and engineering goods sector because of the lack of capital on the domestic level and technological capabilities of local firms that often hinder firms level of growth (Khan & Qureshi, 2021; Ahmad, Khan, & Hussain, 2022).

Empirical studies suggest that FDI drives its profitability to the firm through several channels. First, the foreign investors bring advanced technologies and production techniques that make production more efficient and less expensive (Hussain, 2020). This technological spillover is essential in helping domestic firms enhance their productivity and competitiveness which is especially important in sectors such as textiles and chemicals where international standards and export requirements are stringent (Iqbal & Hanif, 2021). Second, FDI brings managerial knowledge transfer which exposes local firms to best practices in strategic planning, marketing, supply chain management and human resource management (Dar & Khalid, 2021). Firms with better absorptive capacity can use these capabilities to improve profitability (showing that benefits of FDI are conditional on firm level characteristics).

Several studies that focused on Pakistan have shown the evidence about positive association between FDI and profitability to the industrial sector. Khan and Aslam (2020) have proved that the foreign investment has received firms demonstrated an increase in their return on assets (ROA) and return on equity (ROE) more than non-FDI firms indicate that the foreign

ownership and collaboration enhance the financial performance. Similarly, Raza and Malik (2021) reported that foreign investments help improve the capital efficiency of the firms and assist firms to broaden their expansion into high-value markets thus improving net profit margin. These findings conform with international literature which is consistent in proving that FDI in emerging markets accounts for firm level productivity and profitability (Borensztein et al., 1998; Alfaro et al., 2004).

However, there is also literature which points the limitations and conditions under which FDI may not result in significant improvements in profitability. According to some scholars the benefits of FDI are conditional on the absorptive capacity of the host firm in terms of managerial competence, organizational structure and existing technological base (Nasir, Waqar, & Junaid, 2023). In scenarios where the domestic companies are not possessing sufficient know-how or are unable to integrate the foreign knowledge to great extent, then the FDI may not convert in profitable gains. Moreover, structural challenges within the industrial sector of Pakistan, including high energy costs, poor infrastructural settings, volatile macroeconomic conditions, etc., can limit the extent to which foreign capital influences the financial outcomes positively (Ahmed & Shah, 2022; Hussain, 2020). These findings bring out the importance of complementary policies, firm-level preparedness and strategic convergence of policies in maximizing benefits of foreign investment.

Sector specific studies in Pakistan have added more details on the factors in which FDI is influencing profitability. In the textile industry, one of the largest recipients of foreign investment, FDI has been linked to improved export competitiveness, use of modern machinery and compliance with international quality standards (Khan & Aslam, 2020). Similarly, in the chemical and engineering subsectors, FDI supports innovation, product demarcation, and process improvement, resulting in increased profit margins (Raza & Malik, 2021). These sectoral analyses highlight the fact that the effects of FDI are not uniform across sectors and depend on the absorptive capacity, regulatory environment and characteristics of the markets in which the specific industries are located.

International literature also makes out the role of macroeconomic and institutional factors in moderation of the relationship between FDI and profitability. In this regard, Alfaro et al (2004) notes that the existence of well functioning financial markets enhances the benefits of FDI as the markets can make it easier for the firms to mobilize efficiently capital for investment purposes and manage during the risks associated with investment. Borensztein et al. (1998) further emphasize the importance of human capital development in the host country in boosting the productivity spillovers of FDI boosting profitability. In Pakistan, policies that facilitate investor confidence, protection of intellectual property rights, and industrial infrastructure development are crucial for ensuring that foreign investment does not mean financial gains for domestic companies (Ahmad et al., 2022; Khan & Qureshi, 2021).

Recent researches have also focused on the relationship between FDI, firms' size and leverage in determining how profitable a firm is. There is evidence of greater benefits of FDI to larger firms, given their higher availability of resources, higher capacity to absorb FDI, and their established market presence (Iqbal & Hanif, 2021). Conversely, smaller firms may experience difficulties in incorporating foreign technologies or in gaining access to complementary finance, which limits the profitability results of FDI. Leverage plays a moderating role as well, whereby the firms with optimal capital structures are better positioned to exploit foreign investment to operational expansion as well as to enhance profits (Dar & Khalid, 2021).

While most of the literature suggests that FDI brings superiority to profitability, some research calls for not to rely heavily on foreign capital. Excessive reliance on FDI without developing the domestic capacity could result to external shocks vulnerability, repatriation of foreign investments profits and lack of autonomy in strategic decision making (Hussain, 2020; Nasir et al, 2023). Therefore, on the part of the policymakers as well as firm managers, there is need to balance the foreign investment with programs that help to create local technological, managerial and financial capacity in order to ensure long term profitability.

The industrial sector in Pakistan is encountering numerous structural and financial challenges which in turn have a direct impact on the performance of the firms and the effectiveness of the Foreign Direct Investment (FDI). According to several studies, firm-scale barriers like insufficient access to finance, technological adoption and managerial skill set impede the capacity of firms to harness the opportunities in FDI inflows to their full potential (Malik & Usman, 2021; Nawaz, 2022; Rehman & Zubair, 2021). Additionally, technological and operational inefficiencies at the small industrial level make them less competitive and profitable, especially in the high-value industries such as texts and chemicals (Saeed & Jamil, 2020; Saleem, 2022). The role of financial literacy and decision making skills among firm managers also play a huge role as well, as informed financial strategies are crucial to the deployment of foreign capital for productive investments (Shah & Rafiq, 2021).

At the macro level, policy frameworks and institutional support are crucial in creating an extremely conducive environment for growth in FDI. Reports by the Small and Medium Enterprise Development Authority (SMEDA, 2023) and the State Bank of Pakistan (SBP, 2022) emphasize on regulatory clarity, financial accessibility and sector-specific incentives so as to attract

foreign investment. National industrial data has been obtained by Korean Industrial Technology Center and Resources (KIT) team from the Pakistan Bureau of Statistics (PBS 2023) which has also highlighted vanishing disparities among regions and subsectors, recommending a policy intervention. Several global evidences support that structured financial inclusion and digital financial services can significantly improve the performance and profitability of small and medium enterprises (SMEs) (World Bank, 2022; Younis & Tariq, 2023; Zahid & Akram, 2020) and thus the importance of combination of firm's level and institutional level strategies is necessary for sustainable industrial growth in business context in Pakistan.

In conclusion, the literature clearly shows that FDI has potential to improve the profitability situation in the industrial sector of Pakistan in terms of supplying capital, technology, managerial knowledge, and opportunity to penetrate international markets. However, to what extent these can influence the competitive outcome is conditioned by the absorptive capacity of the firm, the characteristics of the sectoral contexts and the general institutional and economic context. In doing so, this study adds to the current body of knowledge by empirically investigating the impact of FDI on the firm-level profitability in Pakistan, including the moderating factors to determine the impact such as firm size, leverage, and sectoral factor. The review highlights the importance of strategic investment policies and firm level preparedness to optimize the financial benefits of foreign investment for a sustainable industrial growth in Pakistan

Methodology

Research Design

This study adopts quantitative and explanatory research design to determine the impact of Foreign Direct Investment (FDI) on the profitability of firms of the industrial sector of Pakistan. The purpose of this study is to investigate the relationship between FDI and profitability of firms, based on financial performance indicators (return on assets, ROA, and return on equity, ROE) while controlling for firm-specific characteristics. The research design is selected so as to permit empirical examination of hypotheses and determination of cause and effect relationships between the FDI inflows and the profitability results in several different firms at various times.

Population and Sample

Population of this study is all the industrial firms who are listed in Pakistan Stock Exchange (PSX) during the period of 2015 to 2023. The main subsectors of the industrial industry are textiles, chemicals, engineering goods, and food processing. A technique of purposive sampling is adopted for the selection of firms having complete data on the indicators of profitableness as well as FDI exposure over the entire period of the study. The sample consists of representation at industrial subsector level while preserving data integrity and consistency.

Data Sources

Secondary data is collected from multiple reliable sources to ensure accuracy and completeness:

1. State Bank of Pakistan (SBP): Sector wise FDI flows and other macro-economic variables.
2. Pakistan Stock Exchange (PSX): Firm level financial statements: ROA, ROE, Total Assets, and Debt
3. Company Annual Reports: Further data on the operation of the firm, foreign investment accords, sectoral performance.
4. Pakistan Bureau of Statistics (PBS): Industrial sector data to provide background for firm level data.

Variables and Measurement

The research explores the relationship between FDI and profitability and has incorporated control variables in order to minimize the omitted variable bias.

Variable	Type	Measurement
FDI inflows	Independent	USD or share of sectoral FDI received by the firm/subsector
Profitability	Dependent	ROA (Net Income / Total Assets), ROE (Net Income / Equity)
Firm size	Control	Natural log of total assets
Leverage	Control	Total debt / Total assets
Sector	Control	Dummy variables representing industrial subsectors

Model Specification

The panel regression model is used in the study to capture both cross-sectional (between firms) and time-series (from year to year) variations. The general model is specified as follows:

Profitability_it = β0 + β1 FDI_it + β2 Size_it + β3 Leverage_it + β4 Sector_it + ε_it

Where:

- **i** = firm index
- **t** = year
- **β0** = intercept
- **β1–β4** = regression coefficients for the independent and control variables
- **ε_it** = error term

Estimation Technique

- Panel Regression Analysis: To take into account the unobserved heterogeneity across firms, the study uses Fixed Effect (FE) or Random Effect (RE) Regression Models.
- Hausman Test: Used to decide if the FE or RE model is more suitable model.

Diagnostic Tests:

- Multicollinearity - Variance Inflation Factor (VIF)
- Heteroskedastic, Breusch-Pagan test
- Autocorrelation: Durbin-Watson statistical test

The estimation method used ensures robust and reliable results, appropriately capturing the effect of FDI on profitability, controlling for firm level and sectoral factors.

Data Analysis and Findings

This research study used panel data for the period of years 2015 to 2023 for 45 industrial firm listed in the Pakistan Stock Exchange (PSX) and analyzed how the profitability of firm is affected by Foreign Direct Investment (FDI). Profitability was estimated with the help of two dependent variables viz, Return on Assets (ROA) and Return on Equity (ROE). FDI inflows were taken as the major independent variables. Firm size, leverage and sector dummies were taken into account as control variables. The data set contained 405 firm year observations, which allowed for strong panel regression estimation.

Descriptive Statistics

Table 1 shows the results of the descriptive statistics for the research variables used in the study. The average ROA was 7.85% indicating the opposite result of moderate profitability in industrial firms, and the average ROE was 12.34%. FDI inflows per firm averaged USD 4.5 million, but varied considerably on account of differences in the size and sector of the firms. The average leverage ratio was 0.42, which indicates moderate use of debt financing. Firm size (log of total assets) varied between 6.2 and 10.5, indicating the heterogeneity of the scale of the firms in industrial sector.

Table 1. Descriptive Statistics

Variable	Mean	Std. Dev	Min	Max
ROA (%)	7.85	3.12	2.1	15.6
ROE (%)	12.34	5.28	3.5	25.1
FDI inflows (USD million)	4.50	2.35	0.5	12.8
Firm Size (log Assets)	8.23	1.12	6.2	10.5
Leverage	0.42	0.18	0.1	0.85

Source: Author's calculations from PSX and SBP data (2015–2023)

Correlation Analysis

The correlation matrix (Table 2) is presented to show the relationship between FDI and profitability and control variables. FDI inflows are positively related with ROA (r = 0.42), and ROE (r = 0.38) which shows that firms with higher foreign investment get higher profitability rate. Firm size also shows a positive correlation with profitability, while harm correlation is observed with leverage, which has a negative correlation and thus shows that firms with greater level of debt may be associated with lower returns. No problems with multicollinearity were found because all the correlation coefficients were found to be below 0.7.

Table 2. Correlation Matrix

Variable	ROA	ROE	FDI	Firm Size	Leverage
ROA	1	0.79	0.42	0.35	-0.28
ROE	0.79	1	0.38	0.41	-0.30
FDI	0.42	0.38	1	0.29	-0.15
Firm Size	0.35	0.41	0.29	1	0.12
Leverage	-0.28	-0.30	-0.15	0.12	1

Source: Author's calculations from panel data (2015–2023)

Panel Regression Results

The research estimated the Fixed Effects (FE) and Random Effects (RE) models in order to establish the effects of FDI on profitability. The Hausman test preferred Fixed Effects model which implied that firm specific characteristics play an important role in determining profitability.

Table 3. Panel Regression Results (Fixed Effects)

Variable	Coefficient	Std. Error	t-Statistic	p-Value
Constant	2.15	1.02	2.10	0.037
FDI inflows	0.84	0.12	7.00	0.000***
Firm Size	1.12	0.28	4.00	0.000***
Leverage	-3.25	0.95	-3.42	0.001**
Sector Dummies	Included	–	–	–

*Dependent Variable: ROA; ***p<0.01, **p<0.05*

Interpretation of Results

These regression findings present a positive and significant association between the FDI inflows and profitability of the firm. In particular, a one unit rise in the inflows of FDI is correlated with 0.84% rise in ROA, holding other factors of firm size, leverage, and sector constant. This validates the fact that FDI is not just a source of capital but also managerial skills, transfer of technology and improvement in the efficiency of operations which translates to increased profitability.

Firm size too is positively significant so that larger firms are in a better position to exploit foreign investment since they have greater absorptive capacity and market accessibility. On the other hand, leverage demonstrates negative coefficient, which suggests that greater dependence on debt financing can decrease profitability, which could be because of a greater financial risk and interest payments. The sector dummies are used to capture the differences between the subsectors in the industry, so that the FDI-profitability relationship is strong.

In general, the evidence confirms the hypothesis of a positive impact of FDI on the profitability of industrial companies in Pakistan and agrees with previous literature (Khan and Aslam, 2020; Raza and Malik, 2021; Hussain, 2020). The findings also highlight the role of firm specificity in the establishment of the effectiveness of FDI in terms of converting FDI into financial performance.

Discussion

The results of this paper demonstrate that there is a positive correlation of significant positive relationship between Foreign Direct Investment (FDI) and firm profitability in the industrial sector of Pakistan. The companies that have been getting more FDI inflows had better Return on Assets (ROA) and Return on Equity (ROE) which confirmed that foreign investment does

not only inject capital but also comes with technology, managerial skills and access to global markets. This beneficial effect of the size of the firm on the profitability also outlines the fact that larger firms have a greater capacity to exploit foreign investment because they possess more absorptive capacity and flexibility of operations. On the other hand, the negative correlation between leverage and profitability indicates that over dependence on debt can contribute to the financial risk, which can counter the profitability of FDI. Such findings coincide with the rest of the literature (Khan and Aslam, 2020; Raza and Malik, 2021; Hussain, 2020) by stating that although FDI leads to financial performance, it is effective only under firm-specific factors and circumstances in the sector. Also, panel data was used to control the presence of unobserved firm heterogeneity, which further supported the validity of these results.

Conclusion

The study concludes that Foreign Direct Investment is essential towards improving the profitability of the industrial firms in Pakistan. The empirical data show that the inflows of FDI correlate with increased ROA and ROE, which means that foreign investment has a positive influence on the performance of a firm as it supplies companies with financial resources, advanced technology, and managerial knowledge. Another conclusion of the analysis is that the size of the firm contributes to the increase in the possibility to make use of FDI, whereas high leverage can decrease profitability because of the enhanced financial liability. On the whole, the research points out that FDI is a dramatic factor of industrial development in Pakistan, though the advantages of FDI are optimized when the firms have enough capacity to receive foreign knowledge and capital. These results highlight the value of strategic policies on investments and prudent financial planning on the company level.

Recommendations

According to the results, there are a number of policy and managerial suggestions that can maximize the advantages of FDI in the industrial sector in Pakistan. To begin with, the policymakers ought to promote foreign investment by offering incentives, simplified regulations, and enhanced ease of doing business to attract foreign investments. Secondly, companies are to center on enhancing internal strengths such as competent management, introduction of new technology, and efficiency to exploit foreign capital and foreign expertise. Thirdly, businesses ought to keep the leverage standards at the right level so that they do not take excessive risks that can offset the desirable impact of FDI. Lastly, it should adopt sector-specific strategies whereby FDI coincides with firm requirement and industry growth potential, especially on high value sectors such as textiles, chemicals and engineering. Such measures will help the industrial firms in Pakistan to attain sustainable growth and greater profitability due to foreign investment.

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