

Economic Instability in Pakistan: The Role of Governance Quality and Macroeconomic Management

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ABSTRACT:

The economy of Pakistan is at the brink of default. Currently Pakistan is facing intense economic instability that is characterized by high inflation, depreciating currency, declining foreign reserves and increasing dependence on debt. Whereas such type of crisis are not unprecedented in the history of country, the repetition of these issues points to profound structural challenges. This paper examines the main governance and economic-related factors that are contributing to persistent economic instability in Pakistan. Gathering secondary data from IMF, World bank, and Pakistan's economic survey, the study examines trends in tax revenue, investment, current account deficits and and governance indicators like government effectiveness, political stability and corruption. The findings of the study underline the interplay between poor macroeconomic management and weak institutional performance as an important drivers of instability. The study provides policy recommendations that are aimed at improving economic resilience, political stability and institutional accountability by giving a framework for informed policy-making and sustainable development.

Keywords: Economic instability; Economic Challenges; Governance Issues.

INTRODUCTION

The current state of the economy of Pakistan is critically unstable, and this is a recurring phenomenon that the country has experienced over the past decade. In 2013, the PML-N government took some stringent decisions in response to the same situation, which negatively affected the public by resorting to an International Monetary Fund (IMF) program. In 2017, the country's economy started to deteriorate once again. The depreciation of the Pakistani rupee was rapid, and the country was in a position where it did not have sufficient reserves to repay the loan installments, resulting in the necessity to seek another IMF program. In 2018, the new government coined the term 'ball-out package' for this IMF program. Pakistan has received loans from various international lending bodies such as the IMF, Asian Development Bank (ADB), World Bank (WB), and other countries and domestic banks. This practice started in 1952 with the first package of 27.2 million dollars from the World Bank.

Pakistan has a history of engaging with the IMF program for financial support since 1952. Whenever the country has faced resource shortages, it has tended to borrow from various sources. The high degree of economic uncertainty in Pakistan has made it unattractive to foreign investors, despite the country's position as the sixth largest population in the world. Currently, the economic indicators of Pakistan are all at their worst. The Sensitive Price Index (SPI) surged by 45.65% in the last week of March 2023 (PBS, 2023), which is the highest in the last 50 years. In the fiscal year 2021-22, the GDP was approximately 6%. However, the World Bank has forecast a GDP growth rate of only 2% for the fiscal year 2022-23, which accurately portrays the state of the economy of Pakistan. In February, foreign reserves slipped below the level of three

billion dollars and are continuing to decline (Siddiqui et al., 2023). The value of the Pakistani currency has dropped by almost half its worth. In 2022, the exchange rate was around 170-175, and in February 2023, it was around 270.

Figure 1 and Figure 2 show the history of Pakistan's reserves and exchange rate, respectively, which are the main indicators of the macro-economy.

Figure 1: Total reserves of Pakistan in US dollars

Source: World Bank databank

Figure 1 shows that Pakistan's reserves increase over time; however, from 2002 to 2022, reserves highly fluctuated. But if we compared it to neighboring countries, Pakistan's reserves are just

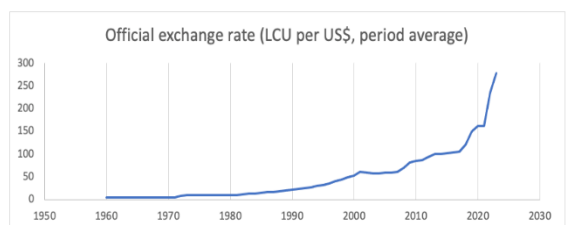


Source: World Bank databank

a few billion. In the current situation, it is continuously declining. Within one year, it declined from 22 billion US dollars to just three billion US dollars.

Figure 2: Pakistan's Rupee Exchange rate in terms of US dollar (period average)

Figure 2 depicts the depreciation of Pakistan's currency. Depreciation does not mean the economy is in too bad a condition; however,



sudden depreciation shows that there is some severe kind of issue. Because the decline of the dollar directly affects the value of the currency. In the last one-year the rupee has also declined as it was not declining before.

A Historical Overview of Pakistan's Economic Situation

The economic challenges faced by Pakistan today are not new, as the country has faced numerous economic issues since its independence. Following the partition of India and Pakistan, millions of people migrated to Pakistan, resulting in a division of resources that negatively affected the country's economy. The period from 1947 to 1957 was marked by political and economic instability, with constitutional crises, political unrest, and a shortage of resources leading to slow economic growth. The issue of Kashmir with India also contributed to the country's economic instability (shaikh et al., 2020).

In the 1960s to 1970s, Pakistan experienced a period of economic growth known as the "green revolution," with increased agricultural and industrial production. Despite the Marsalla administration, the GDP growth rate reached 11.35% by the end of this period. However, in 1971, the GDP growth rate dropped significantly to 0.46% due to the war and events that led to the separation of East Pakistan and West Pakistan (Zaidi, 2018). During the 1970s, GDP growth fluctuated between 0.46% to 8.04%, with numerous factors contributing to the high volatility. In the 1980s, Pakistan's GDP growth remained above 5.06% due to the country's intake of dollars in terms of grants. The 1990s were marked by significant economic challenges, with the GDP growth rate dropping to 1.01%. Political instability and the declaration of atomic power were among the main factors contributing to this decline.

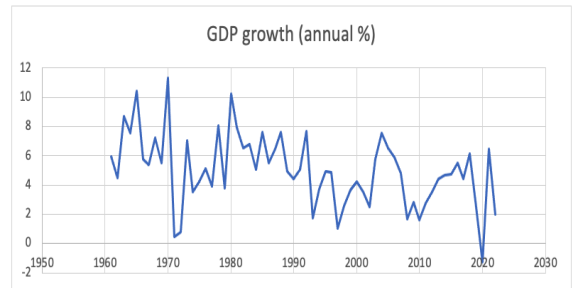
In the early 2000s, Pakistan's GDP growth improved, but political instability once again led to a decline in growth to 1.70% of GDP. From the 2010s to the 2020s, in 2010 and 2011, GDP growth was too low, and then it gradually started to increase. The war on terror was a main cause of low GDP in 2010 and 2011 (Zaidi, 2018). At the

end of this decade, GDP again started to highly fluctuated, and it went into negative in the first time in the history of Pakistan. The COVID-19 pandemic was one of the main causes of negative GDP growth.

Figure 3: Annual GDP growth of Pakistan in Percentage

Source: World Bank Data

Figure-3 depicts the fluctuation in the GDP growth,



Every economy goes through various stages of the business cycle. However, there are reasons behind all this. In recent years, Pakistan has been passing through another worse phase of economic situation. And this worst phase of the business cycle is not due to a single factor. This study is going to discuss the economic factors and governance-related issues that contribute to the economic instability in Pakistan. The result of this study became helpful for policymakers to find out the exact challenges and phases where true interventions are needed.

LITERATURE REVIEW

Fluctuations in the economic cycle/ business cycle of the economy are not because of a single reason. Multiple factors become the cause of economic fluctuation. Sometimes, a few steps by the government or sometimes the market conditions affect the economy. The fluctuation in the normal phenomena, but it becomes a curse when multiple economic indicators become worse, which is called the recession phase in the economy. Every economy is passing through

every phase of the business cycle. Previous literature explores multiple factors of economic instability.

Macroeconomic instability causes slow economic growth (Haghighi, Sameti, and Isfahani 2012). Low productivity in the economy is one of the reasons that disturbs the economy. When production using all means of production, such as land, labor, and capital did not used to the maximum potential, it becomes the cause of economic disturbance (Haghighi, Sameti, and Isfahani 2012). Low productivity, increased unemployment, and reduced output of production result in which export of the country remains low (MacBean, 2010).

With productivity, there is a need to increase investment, to increase exports to the country, and to balance trade. Multiple factors become the cause of low investment in the economy, whether it is investment from domestic entrepreneurs or foreign direct investment (FDI). Interest rates and uncertainty in the economy are the major factors for low investment. Several factors are causes of uncertainty, like security challenges, policy issues, high tariffs, and political instability (Serven and Solimano, 1992). Low tax generation and revenue are also the cause of economic disturbance. Low tax collection and revenue, and more expenditure are causes of the budget deficit (Arvin and Pradhan, 2021). Then, to remove the gap between government revenue and spending, governments take loans. The debt trap sometimes becomes a curse for the economy, especially when the country does not have enough reserves to pay back the installment of the loan. Pakistan's economy is passing through a situation where they don't have enough reserves to pay back loans, and in the past, Pakistan faced the same situation (Sheikh, Faridi, and Tariq 2010; Nadeem Iqbal, Azam, and Shinwari 2015).

Governance issues are other factors that become

the cause of economic instability and low economic growth (Nawaz, Iqbal, and Khan 2014). Political instability in the country is one of the major reasons for economic instability (Zubair and Khan, 2014). The higher the political instability in the country, leads to lower the GDP growth of the country (Ari Aisen, 2013). Political instability has an inverse relationship with direct and foreign direct investment (FDI), and low investment causes low economic growth (Alesina and Perotti, 1996). The study conducted in Bangladesh by Shonchoy and Tsubota (2016) reveals that the manufacturing cost of the product 1.17% due to political disturbance. Political strikes in Bangladesh decreases 4.5% firm export (Ahsan and Iqbal, 2015). Pakistan faces a loss of 2.7% GDP due to political unrest in the country (Matta, Bleaney, and Appleton 2022). In terms of political stability, Pakistan ranks in the fifth percentile when compared to other South Asian countries, with a percentile rank of 30th on a scale of 0 to 100, where zero is the least desirable and 100 is the most desirable (Hussain et al., 2025). Corruption is another cause of economic instability in the country. A study conducted by Mo (2001) reveals that a one-unit increase in the corruption index leads to a decrease of 0.5% economic growth. Corruption negatively affects trade openness (Farooq et al., 2013). and the economic growth of the country. According to the findings of Mo (2001), corruption affects economic growth through political instability. Another study found that a one-standard-deviation increase in the CPI (Corruption Perception Index) reduces 17% of the per capita GDP (Gründler and Potrafke, 2019). Corruption is also a cause of low investment due to a trust deficit issue (Gründler and Potrafke 2019; Mo 2001). Corruption is also one of the causes of inflation (Gründler and Potrafke, 2019). There is a need for accountability; when the government is accountable for its public spending

to the public, it increases the trust of the public in institutions, which positively affects the economic growth of the country (Morozumi and Veiga, 2016).

The law and order situation of a country is also an important factor in economic instability. The study conducted by MengYun et al. (2018) in Pakistan found that during the security issues in the country, the GDP growth goes down. Low voice and accountability lead to low innovation, which is ultimately the cause of low investment and slow economic growth in the country (Nadeem et al., 2020). The literature depicts that economic and governance-related challenges are the main cause because these countries have faced the issue of economic instability. The multiple macroeconomic factors and governance indicators of word bank become the cause of economic instability. This study is going to find out the situation of these variables from the perspective of Pakistan. Additionally, it supplies the ground on which to intervene in the process for the betterment of the economy.

METHODOLOGY

Figure 4: Factors of economic instability

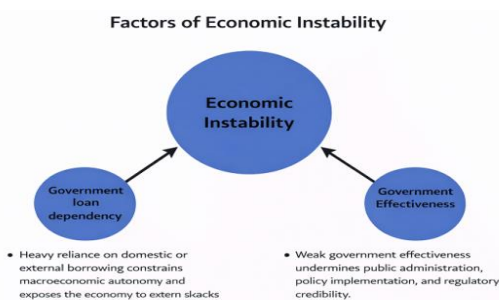


Figure 4 presents the conceptual synthesis of the key factors contributing to economic instability in Pakistan. These factors were identified through a comprehensive review and analysis of the existing literature. Since the primary objective of this study is to identify and examine the major determinants of economic instability, the conceptual framework was developed by integrating evidence from

previous empirical and theoretical studies. The framework illustrates the relationships between the identified factors and economic instability, providing a structured basis for understanding the phenomenon within the Pakistani context.

Secondary data sources become helpful during the study. Previously published data from the websites World Bank and the Finance Ministry of Pakistan (Economic Survey of Pakistan) were used in the study. Through a descriptive analysis of data, and with the help of earlier studies, we reached the point to find out today where Pakistan actual stand. What kind of factors are the main contributors to the economic instability of Pakistan?

The data on macroeconomic variables are abstracted from the data bank of the World Bank and multiple economic surveys of Pakistan. This data becomes helpful to depict the situation of macroeconomic variables in Pakistan.

The data on the governance indicators are abstracted from the World Bank's data bank, and this data is from 1996 to 2020. In Governance indicator, main indicators on which the data is abstract are Corruption Control Indicator, Government Effectiveness, Political instability, Regulatory Quality, Rule of Law, and Voice and Accountability.

Data on demographic trends is also taken from the word bank's data bank.

DISCUSSION AND ANALYSIS

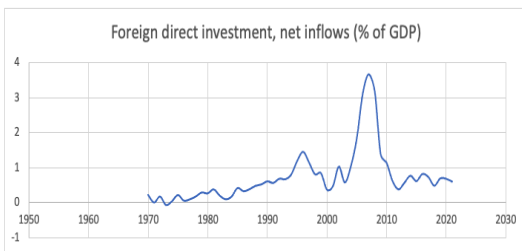
There are several reasons for economic instability in Pakistan, including: Economic, and Governance related factors.

Economic indicators

Low Investment

Low investments lead to low productivity in the country. Pakistan is the country that is dealing with the issue of low investment, either it is local or foreign investment. After the 75 years of independence Pakistan is still relying on imports for fulfilling the basic needs. There are several reasons of low investment in the Pakistan some are related to governance and policy issues, and some are related to market issues. The neighboring country of Pakistan, India is attracted foreign investment from the world and make their multi trillion economy even though they get independence with Pakistan. The GDP of India in fiscal year 2022-2023 is 3.49 trillion (ESI, 2022-23) US dollar while the GDP of Pakistan is only 353 billion US dollar (ESP, 2022-23).

Figure 5: Foreign Direct Investment, net inflow (% of GDP):



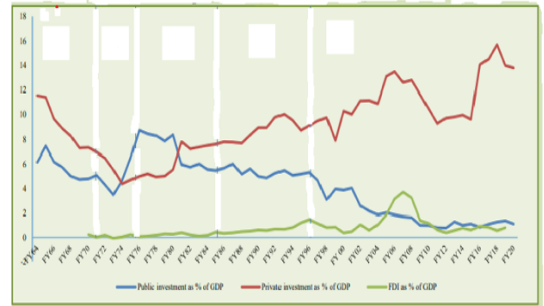
Source: World Bank Data Bank

Figure five, depicts the data of foreign direct investments (FDI) and it seems through the graph that FDI is too low in Pakistan. The highest FDI was 3.66% of GDP in 2007. The average FDI in the Pakistan is less than 1% of GDP, which shows the true picture of FDI in Pakistan.

Figure 6: Public, Private and FDI (% of GDP)

The situation of other investments like public and private is not different in Pakistan. In the 1960s the private investment was around 12% of GDP, then slowly it started to decline, in 1970s due to nationalism policy of Pakistan people party government the private investment was reduced.

Then in the 1980s private investment started to



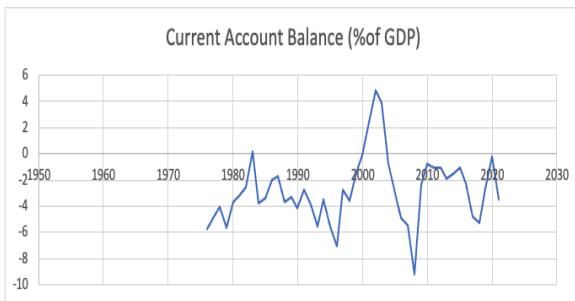
increase with fluctuation. In the cope of 1998, the Musharraf cope the investment suddenly declined then again started to increase with fluctuations. While in 2006-07, the sudden drop was seen in private investment, and it was due to war on terror situation in the country (Hina, 2021). As terrorism declined private investment started to rise again. And the CPEC (China-Pakistan Economic Corridor) was the main booster in 2014 in the increase of investment (Hina, 2021). The economic condition, security situation and the governmental policies are the main cause of low private investment in the country. In 2018, the PTI (Pakistan Tahreek-e-Insafe) had come into power, the liberalize the trade, adopt the market-based exchange rate policy, due to uncertainty in the market inflation started to increase so the policy rate- discount rate increases, these factors became the cause of decrease in private investment in the country. In a nutshell every government policy, and external factors are the main cause of low investment in the country (Hina, 2021).

In Pakistan, the public investment was increased in the 1970s that was due to nationalism policy of the government, after that it slowly declined in the FY 20 it was even less than 2% of GDP. The government usually does not have resources to invest to increase productivity. There is the need to increase private investment, and FDI in the country to increase productivity in the country.

Current Account Deficit

Current Account Balance is the country's financial inflow and outflow of money. Pakistan's current account most of the time was in negative, which means outflow of money is more than inflow of money. The figure below depicts that the CA (Current Account) is in deficit. The current account deficit means the outflow of money in dollar term is more than the inflow of money in dollar term which means Pakistan is in the situation where they import more as compared to export. The countries increase in the exports of the country brings stability in the economy.

Figure 7: Current Account Balance (% of GDP)



Source: World Bank Databank

Loan Dependency

Pakistan is heavily reliant on foreign aid to finance its budget deficit and pay off its external debt. This dependence has made the country vulnerable to external economic shocks, including changes in aid policies by foreign donors.

Figure 8: Gross debt (% of GDP)



Source: IMF

Pakistan borrows from national and international institutions, and unfortunately Pakistan gets into

debt trap. The figure 8, shows the from 2007 to onward the tax to GDP ratio is in positive trend. In 2019 and 2020, the tax to GDP ratio was more than 75% of GDP, which is not sustainable. The main reason due to which the tax to GDP ratio was high in 2019 and 2020 was low GDP growth due to Pandemic and Pakistan was suffering from shut down of economy. Whenever the economy slows down it creates an effect in all macroeconomic variables. And unfortunately, still Pakistan Tax to GDP ratio is above 75% of GDP which should be concern for policymakers.

The tax collection system in Pakistan is weak and inefficient, which leads to low tax revenue collection. This creates a fiscal deficit, leading to inflationary pressures and a lack of funds for public investment.

According to World Bank, the tax to GDP ration above 15% is the key part in economic growth and poverty reduction in the country. While Pakistan's tax to GDP ratio is less than 15% of GDP. Even the below trend graph of tax to GDP ratio depicts Pakistan's tax to GDP ratio never reached at the 15% of GDP in the history. Moreover, the trend shows that the tax to GDP ratio of Pakistan is not in increasing trend, it depicts fluctuation in trend.

Figure 9: Tax Revenue (% of GDP)



Source: World Bank Databank, ESP 2008-2009, ESP 2022-23

Reasons of Economic Challenges

Pakistan has low private and FDI challenges, current account deficit, high loan dependency, and low tax revenue the main reasons of such type of challenges are security situation, political condition, political party policies while the other reasons are poorly designed economic policies

like tariff policies, tax, subsidies, monetary policy. Sometimes external shocks also become the cause of low investments, the need to borrow more, and current account deficits. However external shocks like pandemic (covid-19), floods, international market situations are not in the control of government.

Governance indicators-Political stability

Pakistan has a history of political instability, which has led to policy uncertainty, weak governance, and inconsistent economic reforms. Political instability has also deterred foreign investment and weakened investor confidence. Terrorism, election, regime and strikes are the major cause of political instability, and due to political instability there is high volatility in economic growth of the country (Tabassam and Rehman, 2016).

Political stability index (political stability and absence of violence/terrorism) shows that Pakistan is more instable after 2000, because after 9/11 terrorism increased in Pakistan (Shahzad et al., 2016). The below graph shows that the index is in negative as the normal distribution is between positive 2.5 to -2.5. while the maximum value of political stability index for Pakistan is -1.1 and minimum value is -2.80. in last three decades, the Pakistan was at the worst in 2011, and this is due to terrorism in Pakistan. The graph trend shows that the change in the government never created a worse situation in the economy as terrorism.

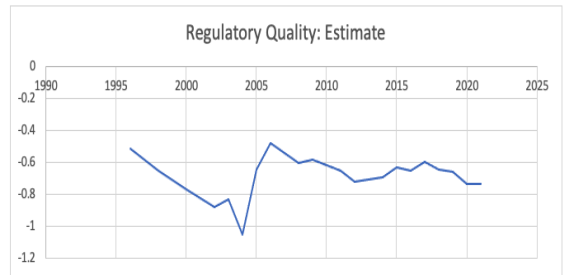
Figure 10: Political stability and Absence of Violence/Terrorism

Source: World Bank Databank

Corruption

Corruption is a significant challenge faced by Pakistan, which results in an inefficient use of public resources, leading to a lack of investment and economic instability (Khan, Rethi, and Szegedi, 2018). The corruption become the curse for the economic growth in Pakistan and main

cause of trade openness (Farooq et al., 2013).



The corruption control, governance indicator of world bank shows that corruption is not in control in Pakistan as it is needed. The value of corruption control indicator is in negative for three decades which means the governance is not able to control the corruption as it is needed. Normal distribution of corruption control index is between 2.5 to -2.5. while minimum control of corruption was in 1996 that was -1.22 and maximum control on corruption was in 2021 that was -0.7.

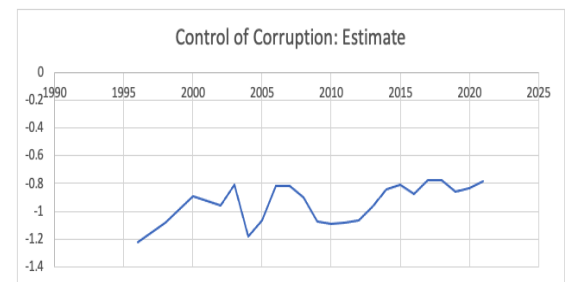


Figure 11: Control of Corruption

Source: World Bank Databank

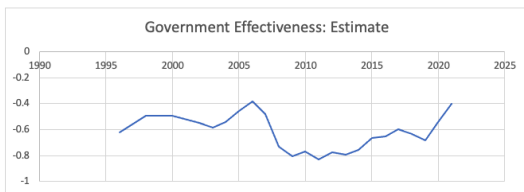
Government Effectiveness

Government Effectiveness is not good in Pakistan, our civil service is not ready to work as they needed. Bureaucrats of Pakistan took competitive pay and benefits. A study conducted by PIDE (Pakistan Institute of Development Economics), concludes that the 21st Bureaucrat of Pakistan taking more privileges than the UN secretary. The comfort of bureaucrats' costs Pakistan 3-5% of GDP in forgone investment, and millions of jobs (Haq, 2021).

The figure 12, depicts the condition of Government effectiveness in Pakistan. In the

graph government effectiveness “captures perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. Estimate gives the country's score on the aggregate indicator, in units of a standard normal distribution, i.e., ranging from -2.5 to 2.5”. while the graph Pakistan’s shows that the value of government effectiveness index in Pakistan from last three decades are in negative. Pakistan government is more effective in 2006 when the value of government index was -0.38, and worse in 2011 when it was -0.8.

Figure 12: Government Effectiveness



Source: World Bank Databank

Regulatory Quality

Regulatory Quality “captures perceptions of the ability of the government to formulate and implement sound policies and regulations that allow and promote private sector development. Estimate gives the country's score on the aggregate indicator, in units of a standard normal distribution, i.e., ranging from -2.5 to 2.5”.

Regulatory quality is the way of financial stability in the country (Quintyn and Chenard, 2004). Financial stability leads towards economic stability. Governance indicators like regulatory quality is one of the cause of economic growth (Nawaz, Iqbal, and Khan 2014). However, the Pakistan regulatory quality index trend shows that Pakistan regulatory index is in negative -0.4 to -1.04.

Figure 13: Regulatory Quality

Source: World Bank Databank

Voice And Accountability

Rule of Law captures perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence. An estimate gives the country's score on the aggregate indicator, in units of a standard normal distribution, i.e., ranging from -2.5 to 2.5.

Figure 14: Voice and Accountability



Source: World Bank Databank

CONCLUSION AND RECOMMENDATION

Economic stability leads towards the development of the nation. Pakistan is the facing the challenge of economic instability through decades. Several governance and macroeconomic factors handle economic instability in Pakistan. The major macroeconomic factors are low investment, low tax revenue, loan dependency and current account deficits. And these are the major concerns and need attention from policy makers. Other than that, from the governance indicator political instability is one of the major causes of economic instability in Pakistan. The other causes of governance indicators which needed attention from the side of the policy makers are corruption, voice and accountability, regulatory quality, and government effectiveness.

Recommendations:

- Enhancing political stability and internal security is important to attract domestic and foreign investment, encourage confidence of investor and decrease

uncertainty. Engaging constructively with stakeholders and opposition parties can forbid protests and disruptive strikes ensuring policy continuity.

- Government must implement transparent institutional framework and anti-corruption legislation to decrease the misuse of public resources. Public officials should be held responsible to improve credibility of institutions and build trust.
- Strengthen the tax system to increase revenue is crucial for dependency on loans and decreasing fiscal deficits. Broadening the tax base and digitalization of tax processes can improve the compliance by ensuring fair distribution of tax.
- Incentives like stable policies, tax benefits and protection of rights of investor must be offered to promote foreign and private direct investment. Removal of simplifying procedures and bureaucratic hurdles will support employment generation and higher productivity.
- Careful fiscal management, including decreasing unnecessary expenditure and rising efficiency of public spending, will help to decrease dependence on external borrowing. Fiscal discipline will improve macroeconomic stability.
- Building capacity of public institutions through merit-based appointment and training will improve the effectiveness of government. Institutions should ensure policy implementations that aligns with the development goals and decrease administrative inefficiencies.

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