Impact of Foreign Direct Investment on Economic of Afghanistan

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Abstract

The present study attempts the impact of foreign direct investment on gross domestic product (GDP) of Afghanistan by taking a time- series data for the period of 2001-2014. It is applied ordinary least square (OLS) method through simple regression. T-statistic is significant and P-value is also significant at 5% level. The F-test was also significant at 5% level so the overall model is significant. The results indicated that there is positive significance relationship between foreign direct investment and gross domestic product (GDP) in Afghanistan. The study suggests that Government may focus on to attracting foreign direct investment and improve its agriculture and mine sector latest technology and Machineries for better economic growth.

Keywords: Capital formation, GDP, FDI, Inflation

JEL Classification Codes: C10, D22, F62

1.introduction

Foreign direct investment (FDI) is a direct investment into production or business in a country by an individual or company of another country, either by buying a company in the target country or by expanding operations of an existing business in that country. Foreign direct investment is in contrast to portfolio investment which is a passive investment in the securities of another country such as stocks and bonds. (Kunle, 2014). Foreign direct investment concerned with fundamental factors such as stable macroeconomic and political situation as well as credibility of policy reforms. A stable and sustainable macroeconomic environment boosts the confidence of private investors. Reduction in debt burden is also critical not only for sustaining both external and fiscal balance but also for engendering confidence to encourage private sector investment (Dunning,1993).

FDI is defined according to residency the investors purpose being an effective voice in the management of earning either long term capital or short term capital as shown in the nations balance of payments account statement (Macaulay, 2012). Broadly, foreign direct investment includes mergers and acquisitions, building new facilities, reinvesting profits earned from overseas operations and intra company loans. In a narrow sense, foreign direct investment refers just to building new facilities. He believed that FDI encourages the inflow of technology and skills and fills the gap between domestically available supplies of savings, foreign exchange and government revenue. It also encourages the inflow of technology and skills. (Onu, 2012).Foreign Direct Investment is a component of a country's national financial accounts. Foreign direct investment is investment of foreign assets into domestic structures, equipment, and organizations. FDI occurs with the purchase of the "physical assets or a significant amount of ownership (stock) of a company in another country in order to gain a measure of management control. Afghanistan today is the land of countless business opportune (Rosen et al 2009)

1.1. Types of Foreign Direct investment

FDIs can be broadly classified into two types: outward FDIs and inward FDIs. This Classification is based on the types of restrictions imposed, and the various prerequisites required for these investments.

1.1.1. Outward FDI

Is backed by the government against all types of associated risks. This form of FDI is subject to tax incentives as well as disincentives of various forms. Risk coverage provided to the domestic industries and subsidies granted to the local firms stand in the way of out-ward FDIs, which are also known as 'direct investments abroad.' In this case it is the local capital, which is being invested in some foreign resource. Outward FDI may also find use in the import and export dealings with a foreign country. Outward FDI flourishes under government backed insurance at risk coverage. (Balasubramanayam et al.1996)

1.1.2. Inward FDI

Different economic factors encourage inward FDIs. These include interest loans, tax breaks, grants, subsidies, and the removal of restrictions and limitations. Factors detrimental to the growth of FDIs include necessities of differential performance and limitations related with ownership patterns. The idea behind this is that, the long run gains from such a funding far outweighs the disadvantage of the income loss incurred in the short run. Other categorizations of FDI exist as well.(Greenaway 2002)

1.1.3. Vertical FDI

It takes place when a multinational corporation owns some shares of a foreign enterprise, which supplies input for it or uses the output produced by the MNC. (Management parades.2016)

1.1.4. Horizontal FDI

It happens when a multinational company carries out a similar business operation in different nations. Some foreign direct investments involve the transfer of strategic assets. FDI activities may also be carried out to ensure optimization of available opportunities and economies of scale.FDI is especially critical in both emerging and transition economies. FDI helps to answer the question: “How do you create capitalism in a nation where there are neither capitalists nor capital?” A parent business enterprise and its foreign affiliate are the two sides of the FDI relationship. Together they comprise an MNC. The parent enterprise through its foreign direct investment effort seeks to exercise substantial control over the foreign affiliate company. 'Control' as defined by the UN, is ownership of greater than or equal to 10% of ordinary shares or access to voting rights in an in corporate firm. (Management parades.2016)

1.2. Main Source of Revenue:

In a post-conflict environment, it is a top priority for the central government commences mobilizing revenue so it can quickly provide essential services from its own resources. Revenues in Afghanistan are from two principal sources customs from the international movement of goods, and domestic taxation. This plan is concerned with the second of these sources. It provides an outline of the key activities over the next 12 months to mobilize domestic taxation in Afghanistan.(Mof, 2016)

1.3.Benefits of foreign direct investment:

The current financial and economic crises have reanimated the debate on the importance of Foreign Direct Investment (FDI) for economic growth and poverty reduction in developing countries, especially in Africa. Many economists agree on the fact that the current financial crisis may have stronger negative repercussions on economic growth in many countries because of the potential reduction in foreign capital flows. (Issouf Soumaré et-al, 2009).

1.4. Infrastructure Development :

One of the many areas in which foreign direct investment can benefit a country or any entity, for that matter, is that of development of infrastructure. It has been observed over the years, that a lot of countries as well as other recipients of direct investment from overseas entities have used that money in order to develop the infrastructural facilities at their disposal. All the various types of infrastructure that are at the disposal of a country like health or education may enjoy the benefit of foreign direct investment (Economy Watch, 2010).

1.5. Growth and Employment:

Productive FDI usually brings long lasting and stable capital flows as they are invested in long Term assets. These funds are introduced into a country's economy contributing to the aggregate demand of the economy, and therefore to the growth of the economy of a country. Companies within the country, due to the competition brought in by FDI, tend to become more productive to effectively counter the threat of the competitor from abroad. Higher productivity of companies contributes to the growth of a country's economy (Baracaldo, 2005).

1.6. Business Environment:

Doing business in Afghanistan can be very rewarding. Even smaller investments may generate high profits in a short period of time. And yet, at least for the time being Afghanistan remains a challenging environment even to the most experienced professionals. Access to local know-how and to informal networks is decisive. Careful analysis of market potentials and best strategies for business development are strongly recommended before setting up operations, and sufficient time should be spent on networking to understand local business practices and to find the right partners.(asia., 2016)

1.7. Investment Opportunities:

Afghanistan has a total of 652864 Km2, about 12% of the country total land is arable 3% is under forest cover, 46% is under permanent pastures, and the remaining 39% is mountains and has estimated population of about 30 million including nomadic and returnees. The annual growth rate of population is about 2.03% while the GDP is estimated about US$10 billion and per capita income about US$ 415. Currently there is change in the structure of national domestic products; about 37% was the share of services in GDP while the share of agriculture was about 36% and the share of industry was about 24%. Due to the lack of skills, the domestic product is taken by the traders to Pakistan and sometime Pakistani traders take the afghan products to outside world.

As compare to the pre transitional government, fiscal, monetary, external sector and real sector are improved despite potential growth of the economy is challenged by security, corruption, and other obstacles. Afghanistan has great potential for further growth similar to the most developed nation of the world as it has the vast number of resources with high volume. To give a hint on the available opportunities, there is need to discus some sample.

(afgair, 2016)

1.8.Why Investment in Afghanistan?

Afghanistan is a fast growing emerging market of strategic importance close to some of the largest and fastest-growing markets in the world. Afghanistan is strategically located between the energy-rich republics of Central Asia and the major seaports in South Asia providing a key transit route for central Asian oil and gas to markets in South Asia as well as overseas. Also Afghanistan has natural access to markets of neighboring countries including important fast-growing markets such as China, India and Pakistan.

Afghanistan offers a pro-business minded environment with legislation Favorable to private investments. The principles of a free market economy are incorporated in the new Constitution just as the growth of the private sector is a cornerstone of the National Development Strategy. Consequently the President as well as the Government has focused intensely on removing obstacles to private sector development.

Afghanistan is rich in natural resources Afghanistan is remarkably rich in mineral resources. There are currently more than 1,400 identified mineral deposits. These include energy minerals such as oil, gas and coal as well as iron and copper deposits of world quality. Furthermore known precious and semiprecious stones in Afghanistan include emerald, jade, amethyst, alabaster, beryl, lapis lazuli, tourmaline, ruby, quartz, and sapphire. Finally great opportunities for investments exist within the hydrocarbons industry. (trade, 2016)

1.9. Technology and Know How

FDI allows for the transfer of technology and specialized knowledge which in turns favors and increase in productivity (Ramírez, 2006). The significance of FDI is that such investments in the host country advance technology, management practices and assured markets. In due course there is a technology transfer as the local workforce gains knowledge of the manufacturing processes and management practices. The value added in these industries is a contribution to GDP and foreign exchange earnings. Therefore FDI contributes to foreign exchange earnings, employment creation and increases in incomes, especially of skilled and semi-skilled workers in these industries.(Nimal Sanderantne, 2011)

1.10. An overview of Afghanistan Investment& Opportunities:

The Government of the Islamic Republic of Afghanistan (GIRoA) recognizes that the development of a vibrant private sector is crucial to the reconstruction of an economy ravaged by decades of conflict and mismanagement. As such, it has taken significant steps toward fostering a business-friendly environment for both foreign and domestic investment. Security threats sometimes limit investors' opportunities to develop businesses in some regions, and certain sectors (such as mining and hydrocarbons) still lack a regulatory environment that fully supports investment. In the face of these challenges, Afghanistan's investment climate has shown surprising levels of dynamism in recent years.(afgair, 2016)

1.11. Economy and Overview:

Afghanistan's economy is recovering from decades of conflict. The economy has improved significantly since the fall of the Taliban regime in 2001 largely because of the infusion of international assistance, the recovery of the agricultural sector, and service sector growth.(mafhoum, 2016)

1.12. Political and Overview:

In 2001, after 23 years of war and civil war, Afghanistan was failed state, the industrial production was near to zero and the country was one of the poorest and most underdeveloped in the world. By no means, the new Government of Afghanistan was starting at point zero. It was a surprise for most of the western advisors how deep the newly installed government was rooted in old structures. But as new ideas, new approaches for the regulatory framework and also new personalities (in government and business) are entering the scene, different structures and realities are overlapping. (fas, 2016)

1.13. Gross Domestic Products

GDP is to the total market value of goods and services produced within country by anyone who lives inside the country in given period of time. It shows the country economy and is used as comparison tools to see how well a country is doing in economic terms. For example, the GDP of US was 13 trillion Dollars in second quarter of 2011 (Cunningham, 2012). There are three ways to calculate the GDP of country but all the three approaches are given the same result. The common and direct approaches which are used to calculate the GDP is summing the total outputs of every economic sector, which is known as product approach. The expenditure approaches is calculated as all products must be bought by people and then the value of total products must be equal to the total expenditures which is made by the people which leads to zero gain. The income approaches is on the principle that incomes of productive factors may be equal to the value of their products, by adding all the income of producer, the GDP will be derived (Kimel, 2010).

1.14. Strategies for Afghanistan's future:

The government wants to achieve a (legal) GDP/capital of 500 USD/year by 2015. This leads to an envisaged annual growth rate of app. 90%. The growth rate in the last years was about 20% but this will slow down as a first "peace dividend" is paid, the agricultural growth will slow down and donor's contributions will stay at the best at current levels. Therefore, the government and the international community have put in their joint strategic paper securing Afghanistan's Future broad based economic growth at the centre of the strategy. The private sector is in all papers called "the engine of growth. (afghanchamber, 2016)

1.15. Problem Statement

Three decades of war and destruction destroyed all infrastructures in Afghanistan and created many problems for economy, social and political systems. Despite having abundant of natural resource, the country is still dependent on foreign aid to run its economic and political activities. Foreign direct investment plays vital role in the economic development of Afghanistan. Previous studies not fully explained the relationship between FDI and GDP in content of Afghanistan so there is gap between in the literature review therefore the study examines the impact of FDI on GDP in Afghanistan.

1.16. Research Question

This study predominantly concentrates on some key research question are taken under consideration and to sort out the optimal approaches to finds the answer for this question; there for the following is specific question for study.

- What is the impact of Foreign Direct Investment on economic growth of Afghanistan?

1.17. Objective of Study

The aim of the study is to discuss the Foreign Direct Investment in Afghanistan and the sources from where the foreign investment is pouring into Afghanistan and the sector wise utilization of the foreign direct investment. Moreover the aim is to discuss the reason to invest in Afghanistan, the benefits and opportunities for both investors and the revenues earned for Afghan Government.

1.18. Significance of the study

By studying of this research the readers will get significant information about the opportunities of investment in Afghanistan for both domestic and foreign investors and the effectives of foreign direct investment to the economics of Afghanistan This information can be used by the foreign and local investors by viewing the availability of strong low-cost and skilled human resources large and growing domestic markets availability of abundant land and natural resources low cost raw materials. The available market of Afghanistan and strategic location. This study highlights the foreign investment sources and makes a modest attempt towards depicting Afghanistan as potential for foreign direct investment

2. Data & Methodology

One of the important and key reasons of motivation for the study was to determine the impact of foreign direct investment on GDP in Afghanistan. As FDI is attracted properly, it direct or indirect affects GDP. It permits us to find the impact of FDI on economic growth of Afghanistan.

The data of FDI and GDP is taken from the World data Bank website. This study analyzes the impact of FDI on GDP of Afghanistan. Data is used on annual basis of time series secondary data and covered the period of (2001-2014).

The OLS model that is ordinary least square or least square errors regression or just least squares is one of the most basic and most commonly used prediction techniques among people and researchers in statistics, finance, medicine, economics, and psychology. It measures the accuracy which differentiates it from other forms of regression.

It was invented by the world's well known mathematician in 1795 and rediscovered by Adrien Marie Legendre in 1805. It is easy to implement and apply to problems. It can be easily analyzed mathematically and interpreted. When the distributions of random variables have same variance and zero mean then the least squares method is the best unbiased linear estimator of the model coefficients (Gauss-Markov Theorem).

This study applied log to normalize the data and analyzes the impact of Foreign Direct Investment (FDI) on Gross Domestic Product (GDP) in Afghanistan this study has applied simple regression through OLS model for the equation to determine the impact of Foreign Direct Investment(FDI) on Gross Domestic Product (GDP) in Afghanistan. The litterateur review supports the selection of ordinary least square model. (Olowe,S 2014).

For the purpose of empirical analysis through OLS methodology the following equation is estimated;

Equation:

$$\text{Log (GDPt)} = \beta_0 + \beta_1 \log (\text{FDIt}) + e$$

β_0 = Intercept

β_1 = Coefficient of Independent Variable

FDI = Independent variable foreign direct investment (FDI)

GDP = Dependant variable gross domestic product (GDP)

e = Random Error term

3. Results and Discussion

The results are outcomes of variable and applied simple regression through OLS model. Simple regression is used to check relationship the impact of Foreign Direct Investment (FDI) on Gross Domestic Product (GDP) in Afghanistan.

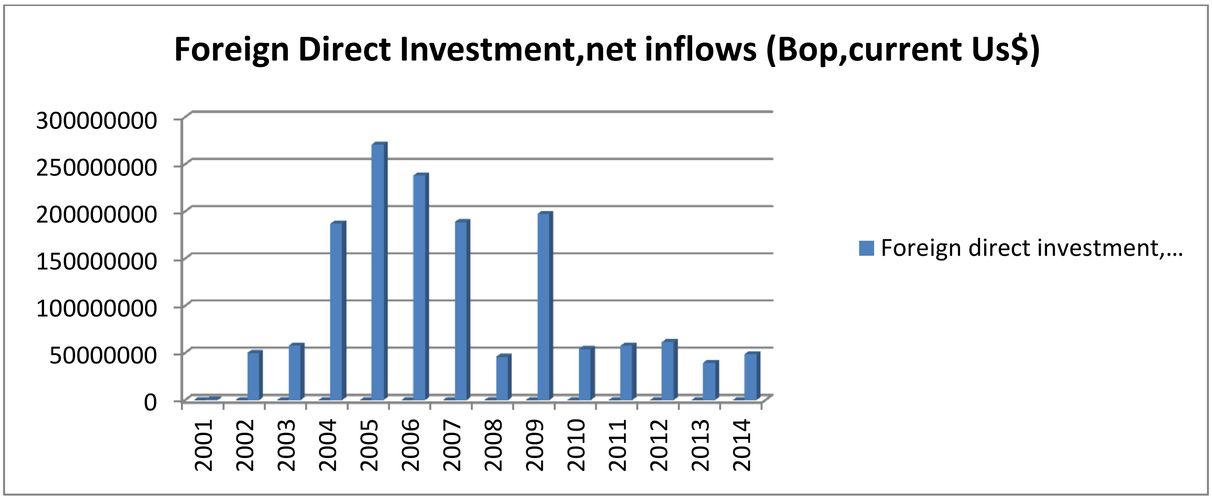

Figure 4.1 Total Foreign Direct Investment, net inflows in Afghanistan

Figure 4.1 shows the graphical representation of total foreign direct investment on gross domestic product (2001-2014), it shows increased annually (2001-2004) and in 2005 increased to the highest peak.

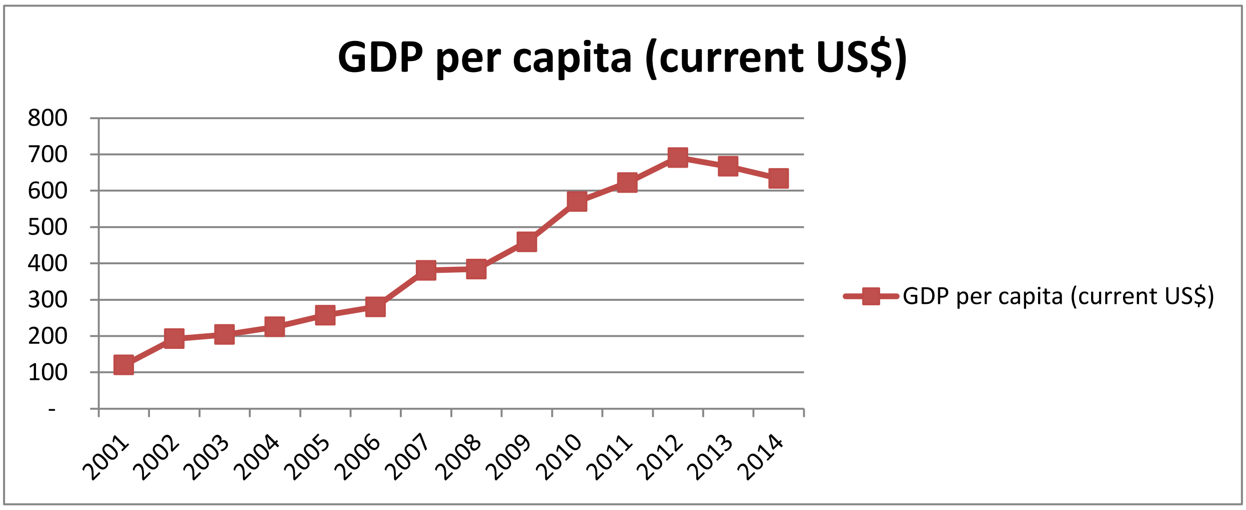

Figure 4.2 Total Gross Domestic Product of Afghanistan

Figure 4.2 shows the graphical representation of total gross domestic product. It is shown that there is consistently increase in GDP (2001-2012).

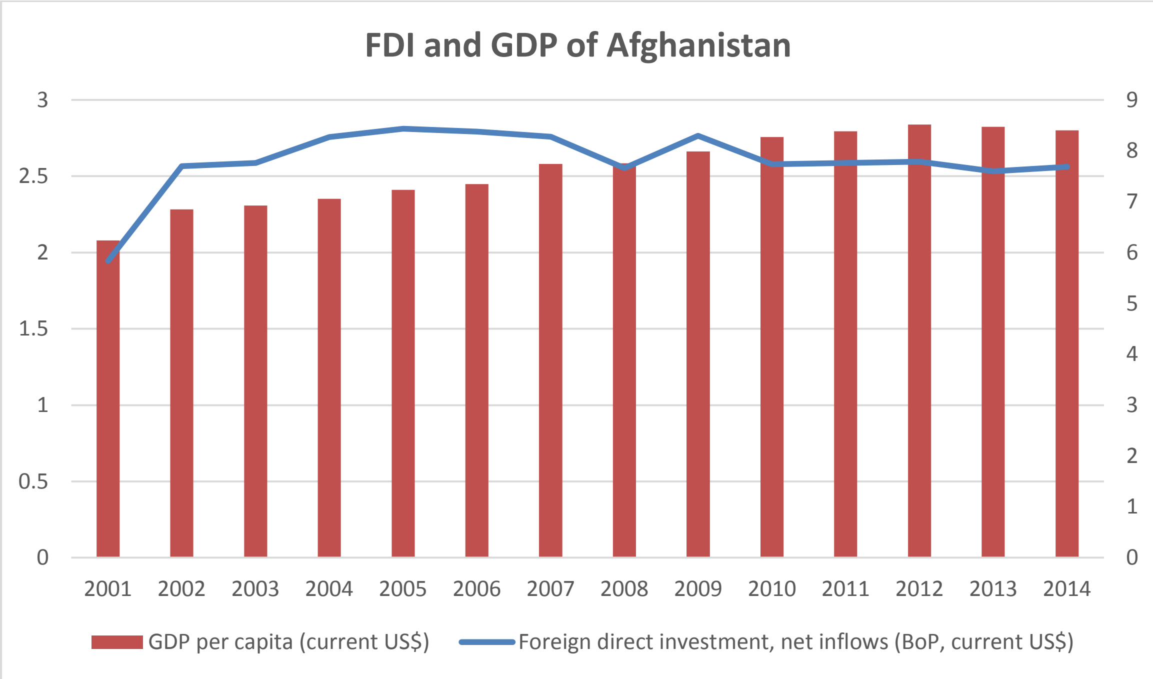

Figure 4.3 Total Foreign Direct Investment & Total Gross Domestic Product of Afghanistan

Figure 4.3 shows the graphical representation of total gross domestic product and total foreign direct investment. It is shown that FDI has contribution in economic growth.

1.1 Pre-Regression Analysis Test;

This section explains the tests which are necessary for the reliability of the data. For this purpose T-test is used to check the significance of a variable and P-value is used to show acceptance of hypothesis on economic theory. F-test is used to check the overall significance of the model. The result is shown in the following table.

Table #04: Model Summary

Variable	T-test	P-Value	F-test
Foreign Direct Investment	2.97336229	0.011628305	0.024164187

a. Independent Variable: FDI

The P value is 0.011628305 which is less than 5% level. So, variable is significant. T-test is 2.973 which is more than 2 theoretical value so variable is significant. F-test is 0.024 which is less than 5% level. So, overall model is significant at 5% level.

4.2 Regression analysis

Regression analysis represents a statistic method examining relations of dependencies among dependent and independent variables with the aim to determine the impact of independent variable changes on dependent variable. In general, it can be in the form of time series, cross-sectional or panel data analysis. It occurs very often that the data necessary for modeling are not sufficient, as in the different time (time series) and also in the different space (cross-sectional data). In this case, appropriate solution seems to be the utilization of panel data which represent data set including time series for each space unit.

Although statistical significance and the direction of impact between the dependent variable and independent variable are important with a similar analysis, the variables were transformed into log form because to avoid outlier/fluctuation in data.

Table # 02: Model Summary

R Square	Adjusted R square	Coefficients	T -test	P-value	F-test
0.112239528	0.038259489	5.520904098	2.97336229	0.011628305	0.024164187
a. Independent Variable: FDI					

Table # 2, model summary R square (R^2) is 0.112239528 It means that 11.22% variation is explained by independent variable (foreign direct investment) in the dependent variable (gross domestic product), which shows weak relationship between the variables.

Co-efficient is 5.52 which mean 1% increase in FDI and GDP is increased by 5.52 units, F-test value is 0.024 which is less than 5%. So, the overall model is significant. T-test value is 2.973 which is more than 2 theoretical value so variable is significant.

4. Conclusion & Recommendations

This study examines the impact of foreign Direct Investment (FDI) on Gross Domestic products (GDP) of Afghanistan. Foreign direct investment (FDI) is a direct investment into production or business in a country by an individual or company of another country, either by buying a company in the target country or by expanding operations of an existing business in that country. Foreign direct investment is in contrast to portfolio investment which is a passive investment in the securities of another country such as stocks and bonds. (kunle, 2014). GDP is the total market value of goods and services produced within country by anyone who lives inside the country in given period of time. It shows the country economy and is used as comparison tools to see how well a country is doing in economic terms. For example, the GDP of US was 13 trillion Dollars in second quarter of 2011 (Cunningham, 2012).

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Afghanistan had very small amount $ 120 of the per capita income in 2001, it has been gradually increased with coming of the new government through direct support of the international community and throwing billions of dollar in forms of aid, in addition of that foreign direct investment (FDI) further support the overall economic situation of the country, which resulted with further increase of per capita income. The FDI has been increased gradually since 2001 from $ 0.68 million and it reach to the maximum amount of $271 million in 2005 and the big investment was in the telecom sector. Afterward it has been gradually decreased, while the per capita income increased and reached to the maximum amount of $ 691 in 2012 and afterward it has been decreased due to the withdrawal of NATO/ISAF and very lengthy election process with the transition of the political power to the new administration.

Role of government is very significant regarding policy formation and implementation for giving motivation or making a place to influence the foreign investor and make for having long life contract. And that role will prepare business approachable environment to fulfill the investment, FDI in making capital to develop their services, bring new technology, bring money and used for technological improvement. Foreign Direct investment is a cash movement of funds from one country to another. This technique play a very significant role to improve a development in the country, positively put impact on the GDP and improve the capitals throughout the country which can totally develop the natural resources as well as human capitals (Rahman Z, 2014).

Based on the literature review the results indicated that there is positive significance relationship between foreign direct investment and gross domestic product of Afghanistan.

4.1. Recommendations

Based on the observations and conclusions made during this study, it is recommended that policy makers should focus on the improvement of knowledge and capacity of the human capital. From my point of view, countries with low level of human capital will have low level of FDI effect relatively to countries with high level of human capacity, although it might be inconsequential in some instances.

The reasoning behind the improvement of the level of human capital is that, countries with improved human capital will be in better position to utilize the hi-tech spillover of FDI. Policy makers would allocate 20 percent of the national budget for improvement in the human capacity development in Afghanistan. Most multinational investors are attracted to countries that foster the protection of property and investment. In my view, lack of adequate contract and property rights enforcement can limit the interaction between foreign and local firms who will invest in an economy.

Following such development, it is recommended that the Afghanistan legal system should be strengthened to protect investors so as create room for economic growth. Other branches of Government interference with the judiciary operations undermine the fair ruling and at such, individual investors, institutional investors and other multinational investors would prefer countries with high judiciary credibility for investment.

5. Limitations

The study used secondary data sourced from the World Bank data bank for period (2001-2014). This study was limited to the degree of accuracy though the data was sourced from reliable sources. There was lack of uniformity in how the various organizations capture and maintain their data hence the research could not analyze all the variables in details.

There was lack of sufficient data on some foreign direct investment. Therefore, the researcher was unable to accurately analyze all the foreign direct investment. There are so many other factors that affect GDP growth rate some which are quantifiable and others not. This study only focused on one variable (foreign direct investment on services) which had been identified for analysis.

This research has focused on foreign direct investment and gross domestic production from economic growth of Afghanistan from 2001 to 2014. Therefore, further researcher can take the period from the beginning of the foreign direct investment in Afghanistan up to the current period for the analysis which study can bring the final findings on the topic of the research as well as researcher may consider other economic indicators of the country for the improvement of the country.

As much interest researcher in the field of foreign direct investment and economy of the country, there are very few research studies in the field of foreign direct investment in Afghanistan which related study much needed for the country especially for under developed country due to that the further researcher can do their study in the field of foreign direct investment to contribute to the country. The future researches they may consider the same research topic with similar country as comparative study. The future researches can do the research in the same heading in other countries to improve the knowledge in the field.

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