



DETERMINANTS OF FDI INFLOW IN AFGHANISTAN DURING 2002-2016

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Abstract

There is significant empirical literature available that examines the determinants of FDI flow. Studies conclude that the determinants of inward FDI can be grouped into political factors, business environment, and economic factors. The objective of this paper is to examine the political and economic determinates of FDI inflow to Afghanistan. This study adopts the augmented gravity model on the bilateral FDI inflow data for the period of 2003 to 2016. Two stages least square (instrument) technique is used to estimate the Random Effect model results. The results of the study suggest that market size, FDI stock, infrastructure, political stability, sharing a border, and common language are the determinants of the FDI inflow in the interested period. Hence, the findings show that there is no evidence of the impact of distance, degree of trade openness, exchange rate, and inflation rates on the FDI inflow. The policy implications of the results suggest that to attract more FDI inflow to Afghanistan, we need to stimulate economic growth that will be translated into higher GDP, infrastructure enhancement, ensure relative political stability, and further focus on attracting FDI from the regional countries.

Keywords: FDI; Gravity Model; Random Effect, Determinants

INTRODUCTION

Foreign Direct Investment (FDI) inflow to a country not only provides much-needed capital for domestic investment but also creates jobs, facilitates the managerial and technological transfer, which plays a vital role in the economic growth and development of developing countries. The reduction of foreign aid after the Cold War caused developing countries to seek alternative

sources of foreign private capital. Developing countries substantially eased restrictions on the inflow of foreign capital to utilize various benefits FDI inflows.

In the past three decades, FDI has shown essential for accelerating economic development for all developing and emerging economies. Significant literature shows that FDI brings about new technology, assists human capital formation, employment opportunities, contributes to international trade integration, helps to enhance the competitive business environment, income growth, and ultimately economic development for both host and home countries (Dunning, 2000 and UNCTAD, 2002). Besides, empirical literature shows that FDI contributes more to both factor productivity and GDP growth in host countries as compared to what domestic investment usually would generate. FDI helps developing countries to experience higher economic growth that facilitates poverty alleviation. Moreover, apart from economic benefits, FDI may help the host country to improve environmental and social conditions importing “cleaner environmentally friendly” technologies and socially responsible corporate policies.

Political instability and conflicts in the 80s and 90s in Afghanistan made it unable to attract FDI at all. This period is characterized by severe living conditions of Afghan citizens, low income, higher unemployment rate, limited access to clean water, among other socioeconomic issues. Establishment of a new administration in 2002 with the support of the international community, revived the expectation for the reconstruction of Afghanistan through structural changes from planned to market economy articulated in the new constitution that guaranteed promotion and protection of private investment.

In the early years of the 21st century, Afghanistan was successful in providing business and economic environments to attract domestic and foreign private investment. In 2003 after the Afghanistan Investment Support Agency (AISA) established, the FDI inflow requirement decreased from 28 to 3 procedures, and duration decreased from 90 to 8 days. These efforts helped Afghanistan to be recognized as a favorable destination for foreign investors and companies. As a result, several multinational companies came and invested in Afghanistan from all around the world that created thousands of jobs and helped Afghanistan to experience double-digit growth over a decade.

This paper aims to examine the determinants of bilateral FDI inflow to Afghanistan during the 2002-16 period. The augmented gravity model is used to evaluate the determinants of FDI. This research adopted the instrumental variables of the fixed effect linear regression model to estimate the coefficient of the augmented gravity model.

LITERATURE REVIEW

There is significant theoretical and empirical literature available that explains the determinants of FDI flow. UNCTAD (2002) divided the determinants of FDI inflow into three categories: political factors, business-enabling, and economic factors (UNCTAD, 2002). Regardless of the economic and business environment in a country, political instability, frequently changing economic policy and conflict, depresses the FDI inflows (UNCTAD, 2002). Accordingly, Dunning (2000) categorized the motives of FDI inflow into four groups: 1) designed to access specific market or markets, marketing-seeking; 2) designed to access specific resources, e.g., mineral, agricultural or unskilled labor, resources-seeking; 3) designed to enhance division of labor or specialization, rationalized or efficiency-seeking; and 4) designed to protect or to augment existing of specific advantages of investing firm, strategic asset seeking (Dunning, 2000).

Shamsuddin (1994) studied the economic determinants of private foreign direct investment of studied 36 in less developed countries using data for the year 1983. The study suggests that per capita GDP in the host country is the most important determinant of FDI inflow while wage cost, per capita debt, the inflow of aid, inflation, and ease of access to energy in the recipient country are also FDI attracting factors (Shamsuddin, 1994).

Lim (2001) surveyed recent findings on two aspects of the FDI: relationship with economic growth and its determinants. His finding suggests substantial support for a positive spillover of FDI on economic growth, but there is no consensus on causality. On FDI determinants, it concludes that market size, economic and political stability, infrastructure quality, free trade zones are essential for FDI, while for the openness, business/investment climate, fiscal incentives, and labor costs, the results are mixed (Lim, 2001).

Quazi & Mahmud (2006) studied economic and non-economic determinants of FDI in five South Asian countries - Bangladesh, India, Nepal, Pakistan, and Sri Lanka using 1995-2000 panel data. Their findings suggest that enabling investment climate, economic freedom, literacy rate economic prosperity, human capital, and economic openness and incremental lagged changes in FDI significantly boost the FDI inflow, while political instability depresses the FDI inflow. They conclude that a better understanding of FDI determinants helps not only these five countries in South Asia but also all developing countries to have better strategies for economic growth and development (Quazi & Mahmud, 2006).

Azam (2009), studied the significance of FDI in economic development in Pakistan and Afghanistan and employed data from 1991-2006. The study findings suggest that FDI has a spillover effect on economic development. Besides, he concludes that the energy sector, education, engineering information technology, and telecommunication, mining, construction, pharmaceutical, and power sector are the more profitable areas for FDI in Afghanistan and

Pakistan (Azam, 2009). Danish and Akram (2014) studied determinants of FDI inflow in Pakistan using time series data from 1990-2010. His findings suggest that capital formation, total external debt, total debt service, and electric power consumption has a strong positive while inflation showed a negative impact on economic growth in Pakistan (Danish & Akram, 2014).

Bayat and Askari (2015), in their study on the determinants of FDI in Afghanistan using data from 1993-2013, found that economic freedom, government guarantees, and insurances have positive and significant effects while inflation has adverse effects on the attraction of FDI inflows to Afghanistan (Bayat & Askari, 2015). However, there are limited empirical studies on FDI and its determinants in Afghanistan. Therefore, this paper aims to study the socioeconomic determinants of the FDI inflow to Afghanistan using bilateral FDI inflow from 2003-2016.

METHODOLOGY

Data

The present study uses panel data on FDI inflow from 2002 to 2016. The rationale for selecting this period is the data consistency and availability of bilateral FDI inflow to Afghanistan. The dataset includes 35 major countries (364 observations) that account for more than 99 percent of the FDI inflow to Afghanistan in the given time period. Bilateral FDI inflow to Afghanistan is obtained from the Afghanistan Investment Support Agency (AISA), data regarding GDP, per capita income, trade openness, and infrastructure (number of mobile subscribers as a proxy) is obtained from World Development Indicators. The exchange rate is retrieved from the Central Bank of Afghanistan and the distance from the CEPII database. Political stability is retrieved from the World Governance Indicators. Table 1 presents the detailed variable descriptions.

Table 1: Description of Variables

Variable	Description	Unit	Source
$LFDI_{ij,t}$	FDI inflows from country j to Afghanistan in the year t	Logarithm	Afghanistan Investment Support Agency (AISA)
$LGDP_{it}$	Afghanistan's GDP in the year t	Logarithm	World Bank (WDI Database)
$LGDP_{jt}$	GDP of country j in the year t	Logarithm	
$LDIST_{ij}$	The distance between the capital of country j and Afghanistan	The logarithm of (kilometers)	Head et al. (2010)
$OPEN_{it}$	Trade openness of Afghanistan: Sum of exports and imports	Ratio to GDP	IMF (WEO Database)

<i>EXCH_{ijt}</i>	Exchange rate in the year t	Afghani vs. US Dollars	World Bank (WDI Database)
<i>MOB_{it}</i>	The number of mobile phone subscribers in Afghanistan in year t	Per 100 population	World Bank (WGI Database)
<i>PSTAB_{it}</i>	Political Stability	WGI Rage (-2.5 to 2.5)	IMF (WEO Database)
<i>INFL_{it}</i>	Inflation, average consumer prices	Percent Change	Author
<i>BORD_{it}</i>	Shared Border	Dummy Variable	Author
<i>POST14_{it}</i>	Post-2014 years – political uncertainty	Dummy Variable	Author
<i>LANG_{it}</i>	The language spoken by at least 9% of the population in both countries	Dummy Variable	Head et al. (2010)
<i>LIND_{it}</i>	Linder Coefficient – economic similarity between Afghanistan and its investment country	Logarithm	$Ln(pci_i - pci_j)^2$

Table 1...

Source: Composite by author

Empirical model specification

The gravity model has been widely used in empirical researches to explain the bilateral trade and FDI flows and potentials between the two countries. Tinbergen (1962), for the first time, applied the gravity model of Newton from physics in international economics to explain the trade flows between two countries. The basic gravity model is as follows:

$$F_{ij} = G \frac{M_i M_j}{D_{ij}^2} \quad (1)$$

Where F_{ij} is the gravitational attraction, M_i and M_j are masses of the two objects, D_{ij} is the distance, and G is the gravitational constant. Krugman and Obstfeld (2005) provided a more general model to explain the trade flows as follows:

$$T_{ij} = A \frac{Y_i Y_j}{D_{ij}^2} \quad (2)$$

Where T_{ij} is the total trade flow from country i to destination country j ; Y_i, Y_j are the economic size of two countries i and j . Y_i, Y_j are usually GDP or GNP; D_{ij} is the distance between two countries i and j ; and A is a constant term. Subsequently, several researchers applied the gravity model to assess the trade flow between countries. This research adopts the work of Krugman and Obstfeld 2005, just by introducing FDI instead of general trade terms. To estimate the model, we need to transform equation (2) into logarithmic form as follows:

$$\ln FDI_{ij} = \beta_0 + \beta_1 \ln M_j + \beta_2 \ln M_i - \beta_3 \ln D_{ij} + e_{ij} \quad (3)$$

Equation (3) can be augmented to accommodate factors that also influence FDI flow to countries such as per capita income, trade openness, exchange rate volatility, infrastructure, economic similarity or difference, political risk, and other factors (i.e., Bhavan et al., 2011; Koojaroenpravit, 2013; Ramasamy & Yeung, 2010; and Demirhan & Masca, 2008). The final augmented gravity model is presented as follows.

$$\begin{aligned} \ln FDI_{ijt} = & \beta_0 + \gamma_1 \ln(FDI_{i,t-1}) + \beta_1 \ln(GDP_{it} * GDP_{jt}) + \beta_2 \ln DIST_{ij} + \beta_3 OPEN_{it} + \beta_4 LIND_{it} \\ & + \beta_5 \ln EXCH_{it} + \beta_6 \ln MOB_{it} + \beta_7 INFL_{it} + \delta_1 PSTAB_{it} + \delta_2 BORD_{it} + \delta_3 POST14_{it} \\ & + \delta_4 LANG_{it} + a_i + u_{it} \quad (4) \end{aligned}$$

To consider heterogeneity and individuality among selected countries, and provided that equation (4) includes some time-invariant variables there for it will be estimated by the random effect model using instrumental variable regression.

Variables Description

Economic Variables

Market Size: Masses of the economies can be represented by proxy variables, which include Gross Domestic Product (GDP), GDP and population, Per capita and GDP, and per capita GDP (Khan & Khan, 2013). The current study uses GDP and per capita GDP for representing the market size of the economy of Afghanistan and its trade partner. Empirical studies show that GDP and PCI are important determinants of FDI flow between countries. The higher the value of these variables, particularly in the recipient country, the higher the inflow of FDI. Therefore, it is expected that these variables will have a positive sign in the model.

Openness: Trade openness refers to the degree of cross border trade as compared to the GDP of a country. This ratio is often considered as the quantification of trade restrictions. Literature shows that there is mixed evidence of openness impact on the FDI inflow to a country. The effect of openness on FDI depends on the type of investment, if a market is seeking investment, there is a negative relationship between openness and FDI, while if it is an export-oriented investment, there will be a positive relationship. Besides, states that trade openness can have implications on FDI inflows, mainly in two opposing directions. A decrease in openness might be associated with more horizontal FDI (import substitution), as investment firms might benefit from avoiding trade barriers through building production sites abroad. On the other hand, increasing openness might benefit multinationals engaged in export-oriented investment through investing in a relatively open economy and decreasing trade costs (Busse & Hefeker, 2007).

Exchange Rate: The effect of the exchange rate on FDI inflow has been studied from two perspectives: changes in the bilateral exchange rates and exchange rates volatility (Blonigen, 2005). The theoretical and empirical literature suggests a negative relationship between a country's exchange rate and level of FDI inflow. This implies that the depreciation of the host country's currency can increase FDI inflows while the appreciation of the host country's currency can depress FDI inflows (Abbott, Cusham, & De Vita, 2011). This paper uses the local currency exchange rate to the US dollar.

Infrastructure: The availability and amount of quality supportive infrastructure are instrumental in lowering overhead costs and considered the key drivers of investors' location decisions (Khan & Khan, 2013). In FDI literature, infrastructure is captured through different indicators such as the total length of the metal road, rail networks, reliable power and water supply, the number of international seas and airports, and the number of fixed-line telephones and mobile phone subscribers or internet access facilities (Shah, 2014). Functional and developed infrastructure in the host country leads to attracting more FDI (Asiedu, 2002). This research uses the number of mobile subscribers.

Linder Coefficient: The economic similarity between the two countries can also influence the amount of trade and FDI flows into the countries. Linder coefficient is a measure that shows the similarity between the two countries, which is usually the log of squared differences in PCI of two countries. There are two different theories, Heckscher-Ohlin (1933) and Linder (1961). The first claim that countries with differences tend to do more trade, while the former theory claims that countries with economic similarities tend to do more trade (Lai & Lai, 2015). Therefore, the result is expected, both positive or negative.

Inflation: Price stability shows macroeconomic stability in a country. A high rate of inflation shows internal economic tension due to the unalignment of fiscal and monetary policies of a country (Scheider & Frey, 1985). History of low inflation rates accompanied by sensible fiscal policy signals investors about the commitment and credibility of the government in maintaining a stable macroeconomic environment. Therefore, it is assumed that the inflation rate is negatively related to the FDI decision-makers to engage in the country. This study also hypothesized a negative relationship between inflation and FDI inflow.

Political Variables

Political Stability: Political instability may disrupt the economic process and affect, in particular, the FDI decision-makers' engagement in the country. Internal political instability in terms of internal conflicts, government stability, ethnic tensions, social tensions ... are increasing the cost of doing business and, therefore, negatively affecting FDI inflow to a country. This study

adopted the Political Stability and Absence of Violence indicator from Worldwide Governance Indicators (WGI) for political stability. It is hypothesized that increased political stability induces marginal decision-makers to undertake more direct investment. Besides, in order to account for the major political development in Afghanistan, which is the withdrawal of international troops and the 2014 election crisis, a dummy variable (Post-14) is also introduced to account for that in the model.

Cultural and Gravity related Variables

Language: Language is a proxy of the cultural aspect of international transactions and is an indicator of ease of doing business across borders. Sharing the common language reduces the costs of investment, and therefore, it is expected that common language would have a positive effect on the inward FDI.

Distance: Distance between home and the host countries is considered as a proxy for cost in international trade and the flow of goods and commodities, which is measured in kilometers between the capital of two economies. The main implication is that the more the distance of the countries with Afghanistan, the less FDI inflow from those countries is expected. Therefore, the expected sign of this variable is negative, since the larger the distance between the two countries would result in less trade among them.

Border: The border effect refers to adjacent countries sharing common borders. The literature on the gravity models suggests that adjacency has a positive effect on international trade and investment. Therefore, it is assumed that inward FDI would be higher from the adjacent countries as compared with the rest of the world.

EMPIRICAL RESULTS

The results of the random effect model (REM) are reported in Table 3. The goodness-of-fit of the model shows that more than 29.92 percent of the variation in the bilateral FDI inflow to Afghanistan in the period of 2003-16 is explained. The estimated results of the model indicate that the majority of the coefficients hold the expected signs and are statistically significant and economically large. Figure 1 shows that the residuals of the model are also normally distributed at the 0.05 level. Hence, the Durbin Watson statistic reported in Table 3 confirms that the model is not suffering from serial correlation as well. Therefore, we can conclude that our model is well-behaving.

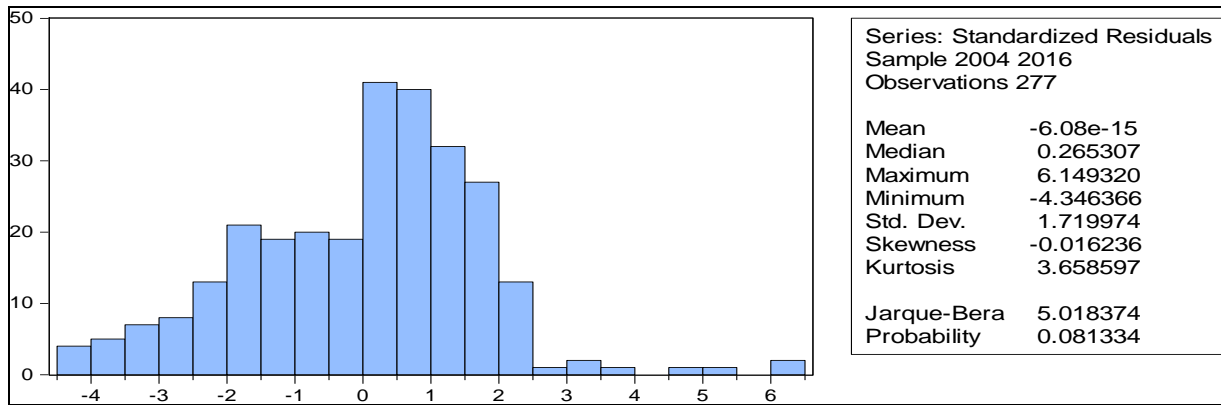


Figure 1: Normality Test of Residuals

The incremental lagged of the FDI inflow (incremental changes) is turn out to be positive and statistically significant at 0.01 level. It shows that FDI inflow is influenced by the previous inflows of FDI. The coefficient of the first lag of FDI shows that almost 32% of the inward FDI in a year from a specific country is driven by the previous year's FDI inflow to Afghanistan. It implies that Afghanistan is experienced higher inward FDI from countries that have FDI stock in the country.

The estimated coefficient of the product of GDP or market size is positive and statistically very significant. This confirms the gravity assumption of the market size effect on the inflow of bilateral FDI to Afghanistan. Hence, it implies that Afghanistan is receiving higher inward FDI on average as it's market size grows and also from the large economies. The data in Figure 2 shows that in recent years, the overall investment trend, mainly FDI inflow, is consistently decreasing while GDP is slightly increasing; however, this is offset by the origin country of FDI with very large economies. The top ten economies that Afghanistan has been receiving inward FDI from in the interested period are presented in Table 2, which consists of large economies such as the United States, China, the UK, Canada, France, and Turkey.

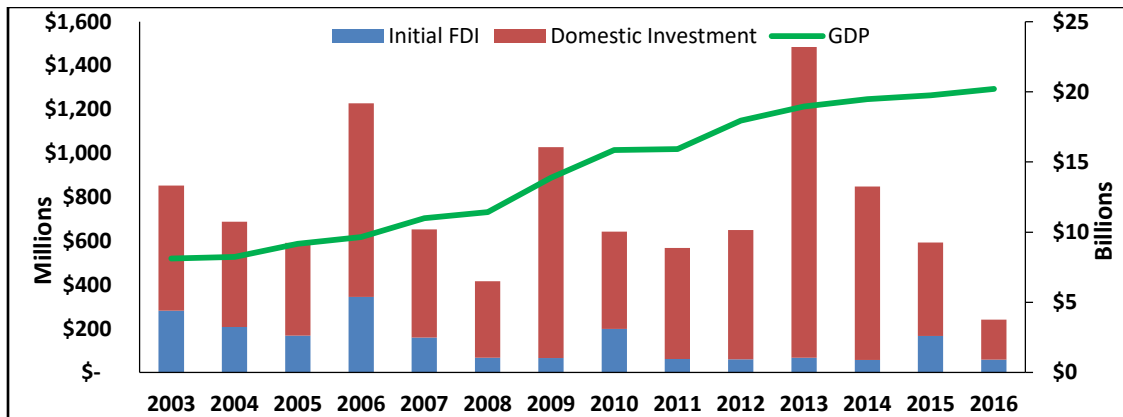


Figure 2: Initial FDI, Domestic Investment and GDP of Afghanistan (2003-2016)

Source: AISA 2016

The estimated coefficient of Linder's is coherent with Linder's hypothesis. This means that Afghanistan is receiving more FDI from the countries which are structurally similar to Afghanistan. Though, considering the list of top ten origins of FDI inflow to Afghanistan (Table 2), which accounts for almost 75% of overall bilateral inward FDI, the absolute majority of these countries are structurally different from Afghanistan. However, the coefficient is not statistically significant at the conventional levels.

Table 2: Top Ten Initial FDI Origins to Afghanistan between 2003-16

No	Country	Total Investment Between 2003-16 (Million USD)
1	United States of America	351.53
2	Turkey	203.16
3	Lebanon	155.82
4	Uzbekistan	133.36
5	Canada	127.66
6	Iran	122.04
7	Pakistan	111.45
8	France	105.26
9	China	88.12
10	United Kingdom	65.07

Source: AISA 2016

The estimated coefficient of the exchange rate is negative, as expected. It shows that appreciation of domestic currency leads to higher inward FDI. This means that since the depreciation of local currency will decrease the return on the investment and, therefore, will negatively affect the investment-decision of foreign investors. However, it turns out that the effect of the exchange rate is not statistically significant. This implies that the exchange rate is not among the determinants of the FDI inflow in the given time period.

Table 1: Estimated Results of the Random Effect Model for the 2002-16 period
(Dep. Variable = Logarithm of FDI)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Constant	5.0569	4.0363	1.2529	0.2114
One-year lag of FDI	0.3200	0.0683	4.6865	0.0000
Log of Product of GDPs	0.4106	0.0520	7.8901	0.0000
Log of Distance	-0.2402	0.2116	-1.1352	0.2573

Trade Openness	0.0081	0.0075	1.0866	0.2782	Table 3...
Linder Coefficient	-0.0287	0.0426	-0.6732	0.5014	
Log of Exchange Rate	-0.3800	1.0615	-0.3580	0.7207	
Inflation	-0.0055	0.0073	-0.7522	0.4526	
Log of Mobile Subscribers	-0.4480	0.1043	-4.2956	0.0000	
Political Stability	0.8239	0.4225	1.9500	0.0522	
Border	0.5049	0.2694	1.8745	0.0620	
POST-2014	0.4814	0.2391	2.0134	0.0451	
Language	1.2818	0.4804	2.6681	0.0081	
Observation	277				
R-squared	0.2992				
Prob(F-statistic)	0.0000				
Durbin-Watson stat	1.9320				

The geographical variables, distance, and sharing borders are vague, although both hold the expected signs. The coefficient of distance, as expected, is negative and is coherent with the underlying logic of the gravity model. This implies that Afghanistan received, on average, less inward FDI from countries located far away. Thus, if we refer back to **Error! Reference source not found.**, the top ten home countries of Afghanistan's inward FDI, some of these countries located very far away from Afghanistan, but still due to political development (majorly the presence of their troops in Afghanistan) invested more and as a result, the coefficient is statistically insignificant. On the other hand, the adjacency effects hypothesis is supported by the result of the border coefficient. The coefficient is significant at the 0.1 level. It shows that, on average, Afghanistan has been receiving higher inward FDI from the neighboring countries as compared to the rest of the world.

The coefficient of openness is positive but statically insignificant and economically very small. Similarly, the sign of inflation is negative, as expected, but it is economically minimal and statistically insignificant. Surprisingly, the estimated coefficient of mobile subscribers, a proxy for infrastructure, is negative and statistically very significant. It implies that a one percent increase in mobile subscriptions is associated with a decrease of 0.45 percent in the bilateral FDI inflow over time.

Figure 1 illustrates that the number of mobile subscribers was consistently increased while the FDI flow in recent years slugged down. Though communication infrastructure is essential for investment, there are other infrastructure factors such as availability of land, electricity, water, and credit is also very important, which are very limited for businesses in

Afghanistan. Therefore, results suggest incorporating other infrastructure variables in the analysis to assess the impact of it on FDI inflow.

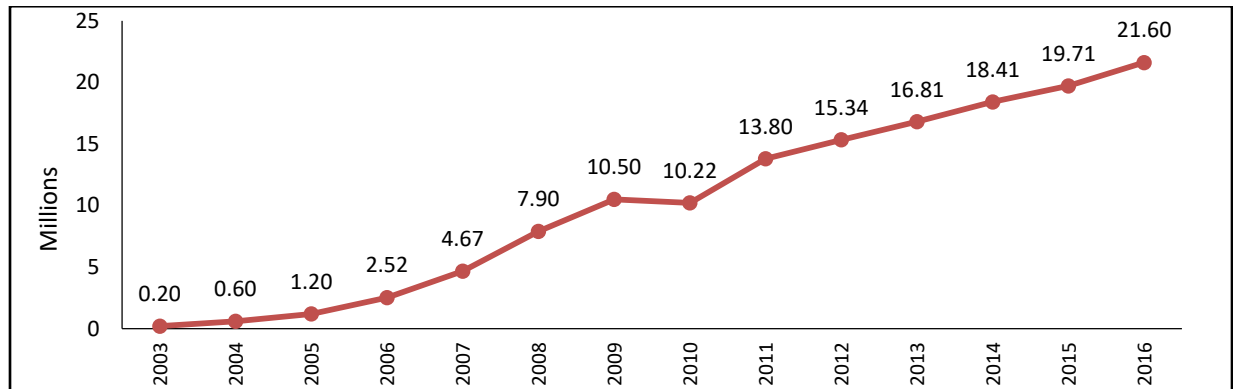
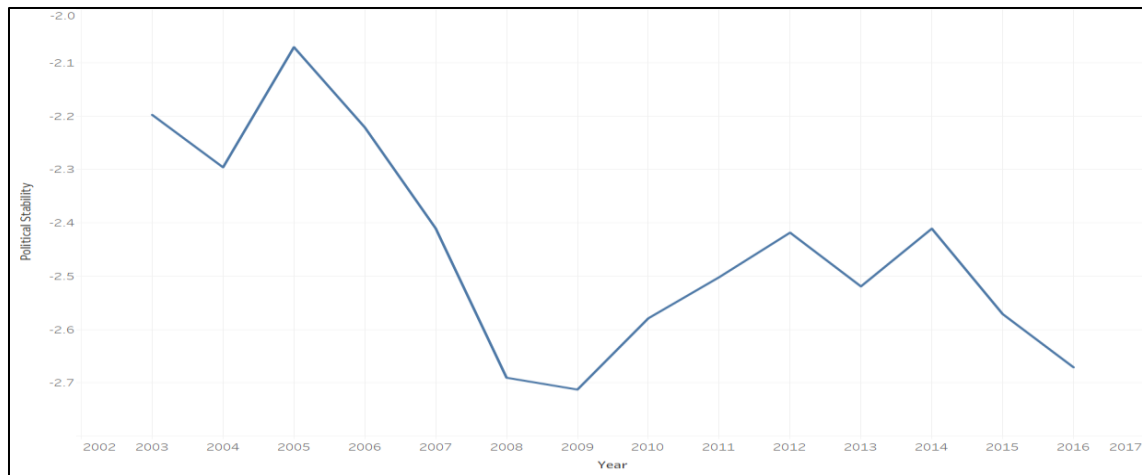


Figure 1: Number of Mobile Subscribers in Afghanistan

Source: ITU, 2016

Moreover, language a proxy for the cultural links is holding a positive sign as was expected and statistically significant at the 0.01 level. This means that FDI inflow from countries that Afghanistan has shared a language is significantly higher as compared with the rest of the world. It implies that investment-decisions are affected by the shared language since it decreases costs of investment and overall doing business. Therefore, it has a positive effect on the bilateral FDI inflow.

The estimated coefficient for political stability is positive and marginally significant at the 0.05 level. The political stability indicator is presented in Figure 4, demonstrates an overall downward trend, which is in line with decreasing inward FDI in the 2003-16 period. It implies that political instability has been a crucial factor in investment decisions, improvement in the political stability in Afghanistan, and has an economically strong positive impact on the FDI inflow. The policy implication of this is apparent that political stability will not only bring about more FDI inflow but also will motivate domestic investors to invest inside the country as well.



To further explore the consequences and the crisis of the 2014 election that lead the establishment of the unity government. Unexpectedly, the coefficient of post-2014 is positive and statistically significant at the 0.05 level. It implies that the withdrawal of international troops and the 2014 election crisis explicitly has not negatively affected FDI inflow to Afghanistan. However, to explore the FDI inflow statistics, there have been significant changes in the origin countries. It seems that after 2014, inward FDI from the regional countries has been significantly increased.

CONCLUSION

Considering the major theoretical and empirical determinants of inward FDI, this study adopted the augmented gravity model to analyze economic and non-economic determinants of FDI inflow in Afghanistan. The model is estimated using an instrumental approach to estimate the random effect model. The results of the study revealed that macroeconomic, adjacency effects, and political stability variables had been significant drivers of FDI in Afghanistan. The model fit is relatively good, qualitatively overall, the results of the model are in line with the theoretical and empirical settings. Furthermore, the results of the model diagnostic are evident that the augmented gravity model is well-behaving in explaining FDI inflow to Afghanistan.

Among the variables, market size, first lag of FDI, political stability, adjacency effect, and sharing common language are statistically significant while the exchange rate, Linder coefficient, inflation, and distance are revealed statistically insignificant. The policy implication of the results suggests that to attract more FDI inflow to Afghanistan, we need to stimulate economic growth to increase market size, and enhancing political stability will lead to more FDI inflow to the country. Besides, the result emphasizes the role of regional economic integration in boosting regional economic interactions.

Although the augmented gravity model performs very well in explaining variation in the bilateral FDI inflow in Afghanistan, one should consider the result of infrastructure with caution due to surprising results. In order to overcome this issue and account for recent developments, future researches should consider an alternative measure of infrastructure and extend time periods to account for the most recent time periods.

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