Article

Linkage between International Political Relations and Foreign Direct Investment: A Case Study of Afghanistan

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Abstract

Foreign direct investment is a critical and leading effective component of economic growth and is influenced by many economic and political, including international political relations. The main focus of this study is to investigate the impact of Afghanistan's international political relations on FDI inflows. To this end, an extensive theoretical and empirical analysis has been carried out over the period 2005-2018. The results reveal that U.S. policies produce no significant influence on long-term capital inflows to Afghanistan in the long-run. However, in the short-run U.S. diplomatic policies produces negative influence on inward FDI to Afghanistan. This implies that deterioration of U.S.-Afghanistan diplomatic relations exerts significant negative impact on capital inflows to Afghanistan in the short-run. The results also reveal that domestic investment; financial development, infrastructure and natural resource endowments exert significant positive impact on FDI in the long- as well as-short-run. Trade openness influences FDI inflows negatively in long-run, but produces no significant impact on FDI in short-run. Political risk related factors (i.e. political rights, civil liberties and political repression) produce no significant impact on FDI inflows to Afghanistan in the long-run. However, only civil liberties positively correlated with FDI in short-run. Therefore, policies aimed at strengthening resource based, such as encouraging domestic investment activities, continuity of liberalization policies, improvements of local infrastructure promote FDI inflows to Afghanistan. More importantly, Afghanistan may establish its political ties with major international power, particularly with the United Sates on the basis of mutual interests and dignity and those relations should be consistent, sustainable and predictable.

Keywords: *FDI, Afghanistan, International Relations, USA*

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Introduction

It is widely acknowledged in the literature that savings and investment are the key pillars of economic development. High level of savings and investment is necessary to accelerate the pace of capital formation and hence economic growth. However, in under developing countries the level of domestic savings falls below the desired level because of low per capita income (Khan, 2007). In case of Afghanistan, domestic saving accounts for less than - 4.42 per cent and domestic investment remains 19 per cent of GDP. This savings-investment gap can be filled by the transfer of foreign capital from abroad. Foreign direct investment (FDI)[1] is an important component of capital flows and is believed to be one of the most important channel through which financial globalization benefits the economy (Prasad, et al. 2003).

Although, the Afghan Constitution enshrines the free market, with minimal intervention by the state but Afghanistan is confronted by the problems of low growth, poor socio-economic conditions and sustained balance of payments deficits. The inflows of FDI in Afghanistan in 2005 was US$ 271 million and decreased to 190 million US$ in 2010. The pattern of inflows followed a zig-zag pattern as in the years from 2011 to 2014 the level of FDI surged significantly. In 2015, however the economy started flourishing and the level of FDI inflow was 169.15 million US$ before it dropping to US$ 139.20 billion in 2018 as shown in figure 1.

Figure 1: FDI inflow in Afghanistan (million U.S $, 2005-2018)
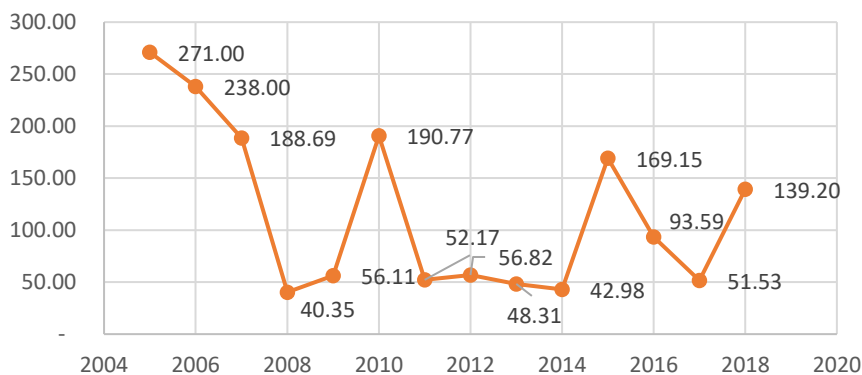
Source: Data collected form World Bank

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[1] *FDI may be defined as private capital inflow from a parent firm to a location outside of the parent's firm home nation. These investments consist of equity capital, inter-company debt, and reinvestment earnings. An investment is considered FDI, as opposed to portfolio investment, if it is large enough to give the parent firm some amount of control over the management of the enterprise — usually more than 10 percent of the firm (Jensen, 2003, p. 588). The motives of FDI vary across different types of FDI. The main motives are grouped under market-seeking, resource-seeking and efficiency seeking reasons (Akhtar, 2000).*

This decline in FDI could be due to the worsening effects of global financial crises which weakened the capacity of international investors to invest abroad on account of falling corporate profits, heightened risks and reduced access to financial resources. In Afghanistan, global financial crises and the unstable economy weakened the macroeconomic fundamentals and resulted in decline of FDI by 94.61 percent during 2005-2018. However, due to inconsistency of government policies the level of FDI remained low in Afghanistan as compared to other emerging regional economies.

One reason of low level of FDI could be the political risk which is associated to the quality of domestic institutions. Since the investment decisions are linked with socioeconomic, political and cultural factors in the host economy (Akhtar, 2000 and Busse and Hefeker, 2007).[2] These factors significantly affect the flows of FDI to developing countries. However, despite the presence of these favorable factors, FDI may not flow into a country, if the political risk rating of the host country is poor. An unstable political environment makes investment risky and erodes the investor's confidence. Hence, political environment, national as well as international vis-à-vis the country, which hosts the FDI, plays a crucial role in determining FDI inflows (Butler and Joaquin, 1998).

Afghanistan has experienced political instability more than four decades. The Political stability index of Afghanistan[3] is -2.78 points as per the data from Global Economy report, 2017 depicting that political instability as one of the basic glitches of Afghanistan. There have been opinions about the main sources of sustained political conflicts in Afghanistan and the factor which has been held responsible is poor leadership, bad governance which paved a way for the external interferences thus leading Afghan government to be responsible on foreign agents rather than on hosts[4]. Foreign investors are much sensitive to the quality of interstate political relations, as any deterioration may increase the risk of seizure of their business in the host country (Desbordes and Vicard, 2009).

In case of Afghanistan, the flows of FDI may partly depend on its political relations with investing countries. For example, the inflow of foreign capital

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[2]   *The returns on FDI depends on the profits of MNCs, expansion of business activities, market development, investment environment, macroeconomic factors, development strategy of host country, innovations, etc.*

[3]   *The index of Political Stability and Absence of Violence/Terrorism measures perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including politically-motivated violence and terrorism. The index is an average of several other indexes from the Economist Intelligence Unit, the World Economic Forum, and the Political Risk Services, among others.*

[4]   *<http://www.outlookafghanistan.net/editorialdetail.php?post_id=21559> (Last accessed: 11.16.2019)*

in to Afghanistan is heavily depending on the political relations with the United States and other major international powers. The history of capital inflows to Afghanistan stands witness, that whenever Afghanistan has had good relations with international powers, particularly with the United States, a surge in foreign capital inflows into Afghanistan is noticed.[5]

To the best of our knowledge no study so far has analyzed the link between FDI and Afghanistan's political relations with international powers. This study fills the gap. The study is designed to analyze the impact of Afghanistan's political relations with international powers on FDI besides the other factors, such as domestic infrastructure, financial development, trade openness and political instability over the period 2005-2018. Specifically, the study concentrates on the role of major international powers, particularly United States in the determination of FDI in Afghanistan. The above review of literature proves beneficial in identifying the research issues and the research gaps, which are mainly the edifices on which the objectives of the present study are based on. There is hardly any study in Afghanistan which has taken political variables in perspective like role of U.S. policies, diplomatic policies, Political risk related factors (i.e. political rights, civil liberties and political repression). The present study tries to include the variables in assessing the impact of international relations on FDI in Afghanistan at the macro – level. The present study differs from the early studies in many ways and enriches the existing literature in the following ways: Firstly, it has included variables other than the variables included by other scholars. Secondly, the present study documents the trends and patterns of FDI, analyze the political risks that affect the flows of FDI to Afghanistan and evaluate the role of United States policies in affecting the flows of FDI to Afghanistan.

This research study is significant in order to evaluate the role of international political relations in the inflow of foreign direct investment in Afghanistan. Furthermore, the results would help in justifying the role of U.S. policies, diplomatic policies, domestic investment, financial development, infrastructure, natural resource endowments and trade openness influence on long-term capital inflows or short term capital inflows to Afghanistan in the long-run or in short run. Political risk related factors (i.e. political rights, civil liberties and political repression) have been evaluated in order to strengthen the political environ in the country. The study will help policymakers devise such policies which help in promoting FDI inflows to Afghanistan. More importantly, Afghanistan will be in a

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[5]   *Examples include the period involving the Afghan War of 1980s and the War against Terrors.*

position to establish its political ties with major international power, particularly with the United Sates on the basis of mutual interests and dignity and those relations would be consistent, sustainable and predictable. The structure of the rest paper is such that after the introduction, in the second part, the review literature is presented, and then the methodology is discussed, followed by the results and discussions of the model expressed and finally, the last section presents the conclusion and recommendations.

2. Literature Review

The political economy literature rarely attempts to make an explicit connection between FDI and international political relations. Rather, most scholars tend to focus on how FDI has some direct or indirect effect on a set of international political policies, usually related to regulation or macroeconomic policy. But the implicit suggestion of these studies tends to be a positive relationship between FDI and political influence: greater amounts of FDI and the mobility of a foreign investor's capital enhance an investor's ability to influence political processes to reach their policy preferences. The actual mechanisms of influence, however, tend to be murky. In this section, the light is shed on the studies that lay the foundation in understanding the concept that how there is a connection between international political relations and foreign direct investment. In this regard some of the significant studies have been taken under study to evaluate the role of international political relations on foreign direct investment and evaluate the extent of association.

2.1 Review of FDI policy

As Afghanistan has been practicing marketing economic system since 2002. Since then the government has been initiating different policies and procedures, various incentives to attract FDI in the economy. Unfortunately, the results were not as expected due to several political and economic problems. Among all, the important one is policy of liberalization and allowing foreign direct investments (FDI). Global FDI flows decreased by 27 per cent in 2018 to USD 1,097 billion, largely due to the US tax reform. This continues the 2017 trend where FDI flows decreased by 16 per cent. Afghanistan economy is one of the developing economies from eras of war and conflict. This economy has remained dependent over foreign aids and investments since 2001 (Taliban regime). A lot of challenges has been faced in post-2014 era regarding transitions into security, economic and political aspects.

Afghanistan government encourages FDI focused on improving infrastructure, pursing engagement in bilateral and multilateral trade agreements and trade related reforms in construction, telecommunication, and transport and logistic. FDI investments decreased from 2005 to 2013 in Afghanistan due to lack of rule of law. Afghanistan ranks last globally and regionally on the strength of investor protection in World Bank doing business 2018 report. The major sector attracting FDI in Afghanistan was the service sector 89 per cent while manufacturing attracted 10 per cent and agriculture 1 per cent, this information is taken by AISA. Afghanistan has perceived major accomplishments in terms of regional integration, economic cooperation, and infrastructure development when it's concerned with FDI. Certain studies show that there was a decline in FDI in year 2011 till now, but the new strategies are projected to boost investors for investing that billions of dollars in foreign direct investment (FDI) and aid assistance, both foreigners and Afghan, to invest money into the economy. FDI in Afghan economy is covering 43 per cent of country GDP as there has been more than $83 million of foreign direct investment.

In 2018 the amount of FDI inflows to south Asia increased and the major destination was India and Bangladesh, with 44 and 2.2 billion US Dollar respectively. Meanwhile, FDI flows to central and north Asia continued to decrease due to political and economic instability. The most affected economy was Afghanistan because of political unrest as the economy attracted a meagre amount of 0.13 billion dollars (UNCTAD Report, 2018). The new constitution of Afghanistan considers Market Economy as economic system of the country, even though there is no consensus among the Afghan community about this choice (Fishstein and Amiryar, 2015). Moreover, some remarkable attempts have been done by initiating some democratic investment laws and imposing low tax on FDI.

Wani and Rehman (2017) have conducted their study on determinants of FDI in Afghanistan showing their capital inflow. There are investigations about the impact of FDI in Afghanistan economy in particular. Their research is supported by OLS method, for year (2005-2015) and the result of their study showed positive relation of FDI with determinants excluding inflation rate which showed negative impact.

Muhammad et al. (2013) showed nexus between interest rate and investment from Afghanistan prospective. These researchers have showed impact of interest rate for an investor, investing within country. They have used this method for year (1964-2012). The results of this study were that investment is one of the key determinants for GDP and it can cause an improved economy. They concluded that interest rate and investment are

directly related to one another; hence fluctuation in interest rate would either cause loss in investment or saving for Afghanistan economy.

Werker *et al* (2013) focused on the economy of Afghanistan showing that exchange rate is highly associated with growth rate. The result & analysis for this research study were that Afghanistan occupies greater import balances than export balances, which lacks improvements in goods that are being exported. The research concluded that there is difference between balance of payments and trade balance and therefore the economy shows negative result and growth rate remains low.

2.2 Relationship between Political Stability and FDI

Gangi and Ahmad (2015) examined the role of international relations on shaping the status of FDI inflow. It was found that international relations are one of the most important factors that can affect the inflow of the FDI. Sudan's good relations with East Asian countries (China, India and Malaysia) have contributed positively to the flow of FDI into Sudan. Contrarily, Sudan's bad relationship with U.S. and other western countries has contributed negatively to the FDI inflow to Sudan.

Francois and Thomas (2018) analyzed the relationship between foreign direct investment (FDI), political risk and economic growth in South Africa. Bounds test for co-integration, an ARDL model was utilized using time series data from 1995 to 2016. Findings of the study revealed that in both short and long run, political risk and economic growth affect the level of foreign direct investment. The political risk rating was found to have a higher impact on FDI flow if compared to GDP. Based on the study findings, it is imperative for the South African government to reduce the level of political risk in order to increase foreign investment into the country which, in return, could assist in economic growth and welfare.

Nazeer and Masih (2017) analyzed the impact of political instability on foreign direct investment and economic growth of Malaysia. Autoregressive distributed lag (ARDL) approach to co-integration proposed by Pesaran et al. (2001) was employed, based on a time series data over the period of 30 years ranging from 1984 to 2013. The empirical results revealed that there are both long and short run relationship between political instability, FDI and economic growth in Malaysia, with economic growth being the strongest driver for political instability and FDI.

Khan *et al* (2013) depicted the impact of political risk on foreign direct investment accounting for 94 countries over a span of 24 years from 1986-2009. It was found that most of the political risk indicators have a negative relationship with FDI for the world as a whole and also, the high-income

countries but the relationship was the strongest for the upper middle-income countries. Pandya (2016) reviewed scholarly research on the political economy of foreign direct investment (FDI) over the past 20 years. FDI research during this period reflects FDI's rapid growth, particularly in developing countries, and the emergence of intense competition among countries to attract investments. Countries have grown more open to FDI as evidenced by FDI deregulation, generous financial investment incentives, and the adoption of international agreements. Although extensive research shows that multinational corporations prefer to invest in countries with strong property rights protections, whether incentives and international agreements help countries attract FDI remains contested.

3. Foreign Direct Investment and Interstate Political Relations

Foreign Direct Investment varies across regions and time. In order to understand its main driver's scholars have tried to get answers for two main questions, what are the main factors that determine FDI inflow to and outflows of countries? And what are the appropriate policies that a country should adopt in order to attract the largest share of FDI? As FDI is determined by many factors such as economic, political, cultural and social. While all of these factors have been intensively studied in different regions, little work has been undertaken on political factors as general and international relations as specific. Researchers have examined the relationship between FDI flows and most of these factors using different methodologies and regions at length. However, few studies have been undertaken to examine the effect of the political factors on FDI flow (Buthe & Milner, 2008). Even these few studies focused mostly on political instability and political institutions and much less on international relations. One of the possible explanations for this situation is that international relations were ignored as one of the significant factor that may contribute in attracting FDI.

Recently some theoretical and empirical literature was developed on this issue. For example, Wang et al. (2012) have developed a conceptual framework that theorizes for the role of government in directing emerging market enterprises to invest in specific countries, which is the good relation-country. This model based on institutional theory which claims that firms are affected by institutions – defined as regulative, normative, and cognitive structure and activities. Based on this, they found it logical to extend the FDI determinants beyond the economic factors to include other factors such as political, legal, social and the broader political context that govern the decision to invest abroad. This study emphasizes the role of government on influencing enterprises decision to invest abroad. It affects the volume and

direction of outward foreign investment using its involvement in these enterprises through ownership of large share or taxes and other incentives.

At a theoretical level, some researchers start to provide strong scientific argument for the role that international relations could play in attracting FDI through what is known by economic diplomacy. Moreover, they argue that from the macroeconomic point of view, international relations between countries, could lead to smooth movement of capital and thus encourage transnational corporations to establish branches for their companies in good-relationship countries. Further, international relations could help to reduce adverse selection, in which it allows investors to better distinguish between good and bad investments. This can lead to higher expected revenues for the foreign investors and also increase the confidence of the investors toward the countries. Few empirical studied have been carried out to examined the relationship between FDI inflow and International relations.

Boehmer *et al.* (2001) show that how interstate linkages such as FDI serve as a costly signalling mechanism in conflicts. They argued that interstate economic link can serve as a mean of communication through which parties in disagreement signals their resolve by sending a credible signal. By reducing the uncertainty about the preferences of the state leaders, this signal fosters the emergence of a peaceful negotiated settlement (Desbordes and Vicard, 2009). Foreign firms are less inclined to invest in countries engaged in diplomatic disputes with their home countries, due to uncertainty over their future returns. This uncertainty constraint foreign investors to invest abroad. Conversely, good diplomatic relations foster inflows of FDI by reducing the risk of expropriation (Desbordes and Vicard, 2009). Following the Desbordes and Vicard (2005 and 2009) assertions we try to analysis how Afghanistan-US relations affect the inflows of capital to Afghanistan.

3.1 International Political Relations: United States and Afghanistan

Recent literature demonstrates that countries trading each other are likely to be less prone to engage into bilateral conflict. The liberal peace hypothesis is based on the idea that trade and conflict is the two alternative ways to ensure resources (Desbordes and Vicard, 2005). Hence, the more trade and investment between two countries, the less will be the probability of military conflict (Rosecrance, 1986). Secondly, trading relationship increases the contracts between governments and individuals from both countries and promotes political cooperation among the nations (Virner, 1951). Pigou (1921) argued that liberal peace hypothesis supports the view

of economic interdependence, which includes financial linkages. Similarly, Gartzke and Li (2003) related the probability of military conflict to the FDI and portfolio investment (FPI) and find that FDI dependence decreases the probability of conflict. In line with these arguments we analyze the diplomatic relations with the United States in terms of U.S. economic and military assistance to Afghanistan and trade relations between U.S. and Afghanistan.

3.1.1 U.S. Economic and Military Assistance to Afghanistan

Since 2002, foreign aid and foreign private investment are the two main sources of foreign capital inflows to Afghanistan. Afghanistan remains an important partner of the United States in the fight against terrorism. In order to strengthen Afghanistan's capabilities as a partner, and to improve the lives of the Afghan people, U.S. continued to invest in resources to help Afghanistan improve its security, governance, institutions and economy. Their strong bilateral partnership is guided by the Enduring Strategic Partnership Agreement between the Islamic Republic of Afghanistan and the United States of America (SPA) signed in May 2012, which outlines respective economic and political commitments, as well as by the Bilateral Security Agreement (BSA) signed in September 2014, which outlines mutual security understandings. In July 2012, following the entry into force of the SPA, President Obama designated Afghanistan a Major Non-NATO Ally (MNNA). President Trump's conditions-based South Asia Strategy, announced in August 2017, seeks to set conditions for a political process between the Taliban and the Afghan government that ultimately leads to a peace agreement and an end the conflict in Afghanistan. President Trump was clear that military power alone will not end the war but can set the conditions for a political process that leads to lasting peace.

Table 1: U.S. Economic and Military Aid to Afghanistan (millions of $, 2005-2018)

Year	Military. Assistance (in millions $ US) (%)	Economic Assistance (in millions $ US) (%)	Total Foreign Assistance (in millions $ US)
2005	715 (43)	946 (57)	1661
2006	1846 (55)	1510 (45)	3357
2007	3675 (75)	1225 (25)	4900
2008	6501 (78)	1833 (22)	8334
2009	5992 (70)	2568 (30)	8560
2010	4783 (61)	3058 (39)	7841
2011	8128 (71)	3320 (29)	11448
2012	6974 (69)	3133 (31)	10108
2013	7870 (79)	2092 (21)	9962
2014	4882 (69)	2193 (31)	7076
2015	6920 (76)	2185 (24)	9105

2016	2746 (65)	1478 (35)	4225
2017	3570 (73)	1320 (27)	4890
2018	0 (0)	1008 (100)	1008

Source: USAID. org

It can be seen from the Table 1 that the military assistance granted to Afghanistan during the period present peculiar trends. In year 2011, 71 percent of the total aid was in terms of military aid to combat against the terrorism. In 2018 no military aid has been granted to Afghanistan and US$ 1008 million were granted in terms of economic aid.

However, the 9/11 terrorist attacks once again changed the geo-strategic situation in favour of Afghanistan. The U.S. again needed Afghanistan's support to invade Afghanistan and dismantle the Taliban regime. Thus, Afghanistan joined the 'War against Terrorism' and support U.S. military actions against the Taliban in Afghanistan. Table 2 present the inflows of official development assistance (ODA) to Afghanistan from selected countries.

Table 2: ODA to Afghanistan from Selected Countries/Organizations (millions of US $)

Donor	EU	UK	Turkey	Germany	UAE	Canada	Japan	World Bank, Total	UNDP	United Nations, Total	United States
2005	256.62	219.92	28.56	99.23	19.73	89.47	71.05	282.08	7.08	41.27	1 318.30
2006	220.9	246.49	57.65	117.99	5.89	140.27	107.42	140.72	7.58	41.78	1 403.71
2007	307.46	268.71	71.61	217.15	1 000.63	345.39	101.01	442.24	11.35	47.69	1 514.28
2008	349.31	322.31	141.96	294.02	13.24	207.86	208.03	165.82	12.03	59.54	2 111.58
2009	395.36	324.39	96.46	337.34	46.84	232.58	335.93	299.74	19.24	67.77	2 979.93
2010	285.02	234.83	107.32	469.76	21.37	267.12	745.66	141.42	13.24	73.3	2 938.84
2011	363.47	423.42	130.89	539.3	38.16	225.15	751.43	152.37	14.67	67.33	3 054.95
2012	256.6	433.92	151.75	515.54	96.84	101.4	873.58	170.6	14.37	72.89	2 714.09
2013	250.14	331.23	89.73	548.69	59.64	122.12	718.53	182.88	13.17	69.02	1 694.07
2014	358.9	325.23	65.23	529.39	81.93	84.19	386.67	164.44	10.98	69.26	1 928.08
2015	192.28	458.25	56.78	362.07	56.77	148.08	317.2	125.2	8.39	65.55	1 631.47
2016	399.81	317.57	32.69	502.84	41.43	96.33	300.83	73.99	8.25	122.89	1 375.76
2017	414.86	292.23	36.52	478.43	29.37	68.46	233.69	149.57	7.58	91.74	1 215.11
2018	407.33	304.9	34.6	490.63	35.4	82.39	267.26	111.78	7.91	107.31	1295.43

Source: OECD, Geographical Distribution of Financial Flows to Aid Recipients

The numbers presented in Table 2 represents a drastic shift in policies. For example, in 2005 total U.S. aid to Afghanistan was US$ 1318.30 million; by 2006 the figure was US$ 1430.71 million and it was US$ 1295.43 million by the end of 2018. Similarly, there was reduction in UNDP aid in 2011 from US$14.67 million to US$ 7.91 million in 2018. By the end of 2018 EU institutions contribution was US$ 407.31 million. Talking about the rest

donors like UK, World Bank, Saudi Arabia, Turkey, Canada, ADB, Japan and UAE, the same story applies of decreasing the aid flow.

The United States is part of a coalition of more than 100 countries and organizations that provide both security and civilian assistance to Afghanistan. The United States and more than 30 other nations provide financial support to the ANDSF. The international community made almost $5 billion available for the ANDSF in 2019, with the United States providing the greatest share. At the Brussels ANA Trust Fund Plenary June 2019, NATO Allies and Operational Partners reaffirmed their commitment to financial sustainment of the Afghan forces through 2024.

Similarly, at the Brussels Conference on Afghanistan in October 2016, the United States and other international donors committed to provide Afghanistan $15.2 billion in civilian assistance through 2020. In its turn, Afghanistan committed to strengthen governance, rule of law, fiscal sustainability, and human rights. The United Nations hosted donors in Geneva in 2018 to assess Afghan progress on reform and re-affirm their Brussels commitments. In addition, donors at Geneva noted their intent to continue civilian assistance after a political settlement and agreed to urgently develop a post-settlement economic action plan to help prepare for an eventual peace agreement. Reform commitments are codified in the "Geneva Mutual Accountability Framework (GMAF).

The United States uses the bilateral Afghanistan Compact and the multilateral GMAF to hold the Afghan Government accountable to mutually agreed reform commitments. We focus our development assistance on promoting peace, self-reliance, and stability including through programs to increase economic growth via an export-oriented trade strategy, capacity of civilian institutions, improving the performance of the justice system, and helping the government maintain and improve upon the gains made over the last decade in health, education, and women's rights. The United States also provides support for Afghan civil society, promotes increased respect for human rights, helps to fight the illegal trade in narcotics, and continues to provide significant humanitarian support. Since 2001, the United States has allocated approximately $29 billion in civilian assistance for Afghanistan.

Table 3: Comparison of Military Assistance, Economic Assistance with Official Development Assistance by U.S. to Afghanistan

Year	Military. Assistance (in millions $ US)	Economic Assistance (in millions $ US)	Total Foreign Aid (in millions $ US)	ODA to Afghanistan by U.S.
2005	715	946	1661	1 318.30

2006	1846	1510	3357	1 403.71
2007	3675	1225	4900	1514.28
2008	6501	1833	8334	2 111.58
2009	5992	2568	8560	2 979.93
2010	4783	3058	7841	2 938.84
2011	8128	3320	11448	3 054.95
2012	6974	3133	10108	2 714.09
2013	7870	2092	9962	1 694.07
2014	4882	2193	7076	1 928.08
2015	6920	2185	9105	1 631.47
2016	2746	1478	4225	1 375.76
2017	3570	1320	4890	1 215.11
2018	0 (0)	1008	1008	1295.43

Source: From Table 1 and 2

It can be seen from the Table 3 that economic and military aid to Afghanistan follows the similar patterns and each component of official development assistance exhibiting strong positive co- movement. This co-movement reflects that how U.S. policies towards Afghanistan affect the flows of total aid to Afghanistan. Since 9/11 there have been major changes in aid allocation. Table 4 reports the net change is USAID since 2005-2018.

Table 4: Net Change in Allocation USAID, 2005-2018

Country	Total Aid (million US $)		
	2005-11	2012-2018	% change
Afghanistan	4610. 49	5049.31	0.09
Egypt	1354.19	467.22	-0.65
Iraq	4410.26	1124.00	-0.74
Israel	2195.73	1966.87	-0.10
Jordan	580.55	874.55	0.50
Pakistan	925.79	6,32.66	-0.31
Turkey	16.64	32.71	0.96

Source: Calculations based on the data from <https://explorer.usaid.gov/data>

These changes in aid allocation mainly reflected post-9/11 security realities, particularly the demand for War on Terrorism rather than economic considerations. Looking through the prism of Security Support for Afghanistan the United States military has been engaged in Afghanistan since shortly after the 9/11 attacks in 2001. In 2003, NATO assumed leadership of the United Nations-mandated International Security Assistance Force Mission (ISAF). At its height, ISAF included more than 130,000 troops from 51 NATO and partner nations. ISAF forces fought alongside the Afghan National Defence and Security Forces (ANDSF) as the international community worked to improve ANDSF capabilities. U.S. force levels peaked at roughly 100,000 in 2011, and began to decrease through 2014, as the ANDSF gained strength. There have been more than 2,400 U.S. military deaths in Afghanistan since 2001, and over

20,000 U.S. service members have been wounded in action. U.S. casualties in Afghanistan peaked at 499 in 2010 and dropped sharply after January 2015, when Afghan forces assumed full responsibility for combat operations against the Taliban.

ISAF officially ended on December 31, 2014, with the ANDSF taking over full responsibility for security in Afghanistan on January 1, 2015, when the United States and NATO formally ended their combat role in Afghanistan and transitioned to a new mission. On January 1, 2015, NATO launched the Resolute Support Mission (RSM), a non-combat mission focused on providing train, advise, and assist support to the ANDSF. In addition to the United States, there are 39 NATO Ally and partner nations contributing troops to RSM and helping Afghan forces become more effective, professional, and sustainable. The BSA and a NATO Status of Forces agreement signed in September 2014 provide the legal basis for U.S. and NATO forces to remain in Afghanistan.

The United States has approximately 14,000 troops in Afghanistan engaged in two missions: 1) a bilateral counterterrorism mission in cooperation with Afghan forces; and 2) participation in RSM. U.S. troops in Afghanistan serve alongside almost 8,000 troops from NATO allies and partners. U.S. forces continue to disrupt and degrade the Taliban's combat operations, ISIS-K, and al-Qaeda activities in Afghanistan, through partnered operations with Afghan forces, as well as unilateral operations. The United States is committed to maintaining military pressure on the Taliban to reverse their battlefield gains and provide leverage at the negotiating table. Additionally, combatting ISIS-K and the remnants of al-Qaeda continues to be a priority for the United States. Based on the above discussions one can easily expect that how U.S. aid inflows to Afghanistan have always been subjected to conditionality's and vulnerable to geo-political and geo-strategic interests of international powers, particularly the United States.

3.1.2 *Trade between Afghanistan and United States*

It can be argued that trade promotes economic ties and defuses diplomatic tension between the nations. In the case of Afghanistan, United States imposed military sanctions on Afghanistan in 2008, 2012, 2015 and 2016. But during the period of sanctions, flows of trade between U.S. and Afghanistan does not disrupted. The United Sates policies towards Afghanistan worked only to influence official flows in terms of military assistance. The patterns of trade between the United States and Afghanistan is presented in Table 5.

Table 5: U.S. Goods Trade with Afghanistan (millions of U.S. $, 2005-2018)

Year	Exports	Imports	Total Trade
2005	26.21	6.76	32.98
2006	41.76	4.58	46.34
2007	48.87	7.68	56.55
2008	48.16	8.69	56.85
2009	151.14	12.41	163.55
2010	215.14	8.74	223.88
2011	292.18	2.66	294.84
2012	152.15	3.79	155.94
2013	140.96	4.63	145.59
2014	79.23	7.28	86.51
2015	47.88	2.44	50.33
2016	91.38	3.44	94.83
2017	94.20	1.46	95.67
2018	122.68	29.79	125.66

Source: From the office of the United States Trade Representative

NOTE: No services trade data with Afghanistan are available.

It is visible from Table 5 that there is a substantial increase in exports from U.S. to Afghanistan, while as in case of imports the trend is reverse. It is only recently that U.S. imported 29.79 million US $ from Afghanistan. As a result of increase in exports and imports, total volume of trade between U.S. and Afghanistan showed increasing trend between 2008-2018. From the analysis of trade relations between U.S. and Afghanistan, we come to the inferences that sanctions diplomacy against Afghanistan does work only to influence official flows, such as economic and military but no or very little effect has been seen on the trade and private inflows.

Table 6: Balance of Trade of Afghanistan

Year	2005	2006	2007	2008	2009	2010	2011
Balance of Trade (X-M)	-262.8	-342.89	-420.69	-4.66.770	-5.46.87	-7.00.48	-8.00.65
Year	2012	2013	2014	2015	2016	2017	2018
Balance of Trade (X-M)	-873.14	-731.16	-729.9	-632.04	-693.03	-796.1	-832.19

Source: Calculations based on the data from UNCOMTRADE

Overall, from the above analysis we obtain some interesting conclusions: First, U.S. aid has been subjected to conditionality's and vulnerable to geo-politics and geo- strategic interests. Second, U.S. sanctions against Afghanistan affect only the official capital inflows (economic aid and military aid) and have no obvious effect on the private capital inflows (i.e. FDI) to Afghanistan. Third, U.S. economic sanctions against Afghanistan have no influence on the trade relations between the U.S. and Afghanistan. These finding are in sharp contrast with the thinking of general public in

Afghanistan. The important implications from these results are that U.S. policies influences Afghanistan-U.S. diplomatic relations, but these policies do not influence public relations among both countries.

4. Methodology, Results and Discussions

The prime objective of multinational corporations (MNCs) is to maximize the profits from their investment. They have no keen interest to invest in countries having no or limited profit opportunities. In general, MNCs prefer countries with stable governments, sound economic policies, good infrastructure, well-developed domestic financial and democratic institutions and greater economic freedom in terms of political rights and civil liberties (Hermes and Lensink, 2003; Durham, 2004; Alfaro et al. 2004 and Busse and Groizard, 2005 among others). These factors allow MNCs to establish new businesses and expand the existing one in recipient countries. In this way, recipient countries benefit inward investment to achieve higher economic growth.

The literature suggests that FDI inflows depend on key macroeconomic factors like domestic investment (Haile and Assefa, 2006), infrastructure, such as roads, ports, telecommunication, power, railways, etc. (Vadlamannati,[6] 2009, Wani and Rehman, 2017[7]), financial development (Hermes and Lensink, 2003, Alfaro et al., 2004 and Asiedu and Lien, 2004), natural resources endowments (Campos and Kinoshita, 2010), trade openness (Aseiedu, 2002 and Mhlanga et al., 2010) and real exchange rate.[8]

Keeping in mind the above cited factors/variables, we specify the following baseline model (Compos and Kinoshita, 2010 and Khan and Samad, 2010):

$$FDIY_t = \alpha + \beta_1 IY_t + \beta_2\, FD_t + \beta_3 TOP_t + \beta_4\, INFRS_t + \beta_5\, NRS_t + \beta_6\, REER_t + u_t \qquad (1)$$

Where, *FDIY* is annual net inflows of foreign direct investment as a percent of *GDP*, *IY* is domestic investment as percentage of *GDP*. *FD* is measure of financial development, *TOP* is the trade openness, *INFRS* is the infrastructure, *NRS* is the natural resource endowments and *REER* is the real effective exchange rate, while *u* is the error term.

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[6]   *Like Campos and Kinoshita (2010) we use three broad categories of the determinants in modelling FDI. First, we include classical factors such as infrastructure. Second, we include policy related factors, such as financial markets development and trade openness. Third, we include the institutions and democracy related factors, such as political rights, civil liberties and political repression. Finally, we question whether Afghanistan's political relations with United States play any role in the determination of FDI.*

[7]   *Wani, Nassir Ul Haq & Rehman, Noor, 2017. "Determinants of FDI in Afghanistan: An Empirical Analysis," MPRA Paper 81975, University Library of Munich, Germany, revised 03 May 2017.*

[8]   *The literature also identified inflation rate, external debts, government expenditures, etc. as determinants of FDI. However, our sample size is small and not permits us to include too many variables in the model.*

It is well documented in the literature that Political instability and political repression are other important factors influencing FDI (Aharoni, 1966). However, evidence related to the effects of this variable remained inconclusive (Wang and Swain, 1995 and Jun and Singh, 1996 among others). Political instability is expected to produce negative impact on FDI because risky political environment adversely affects the Transnational Corporation's (TNCs) decision to invest abroad (Singh and Jun, 1995 and Quazi and Mahmud, 2004). To examine the impact of political instability on FDI, the model incorporates political rights (PR) and civil liberties (CL) in the following specification form:

$$FDIY_t = \alpha + \beta_1 IY_t + \beta_2 FD_t + \beta_3 TOP_t + \beta_4 INFRS_t + \beta_5 NRS_t + \beta_6 REER_t + \beta_7 PR_t + \beta_8 CL_t + u_t \qquad (2)$$

There is possibility of multi-collinearity among *PR* and *CL*, therefore we use *PR* and *CL* alternatively. Further to avoid the multi-collinearity we do not included market size because FDI, IY, FD and TOP are expressed as percentage of GDP (see Dutta and Roy, 2010).

There is general perception among the public in Afghanistan that foreign policy of United States is based on its political and security interests. United States extended its diplomatic, economic and military support to Afghanistan when there is a threat to its interests e.g. Afghan War and 9/11 Terrorist attacks in 2001. But when there is no threat to its political and security interests, United States has changed its policies (e.g. conditionality's and sanctions on Afghanistan from 1991-2000). These inconsistent and unsustainable policies of United States badly affect the confidence of the public in Afghanistan and expected to affect capital flows negatively.

To capture the role of Afghanistan's political relations with the United States we extend equation (1) by adding the variables *DIPR*. Now equation (1) can be rewritten as:

$$FDIY_t = \alpha + \beta_1 IY_t + \beta_2 FD_t + \beta_3 TOP_t + \beta_4 INFRS_t + \beta_5 NRS_t + \beta_6 REER_t + \beta_7 PR_t + \beta_8 CL_t + \beta_8 DIPR_t + u_t \quad (3)$$

Where *DIPR* is a dummy variable used as proxy to capture the Afghanistan's diplomatic relations with the United States.

To examine the impact of political repression (PREP) on FDI equation (3) can be rewritten by incorporating the average of *PR* and *CL*:

$$FDIY_t = \alpha + \beta_1 IY_t + \beta_2 FD_t + \beta_3 TOP_t + \beta_4 INFRS_t + \beta_5 NRS_t + \beta_6 REER_t + \beta_7 PREP_t + \beta_8 DIPR_t + u_t \qquad (4)$$

Based on the above model we mainly concentrate the following set of empirical hypothesis:

Hypothesis 1: Bad political relations between the United States and Afghanistan adversely affect the inflows of FDI to Afghanistan.

Hypothesis 2: Political repression/political risk negatively affect the flow of FDI to Afghanistan.

Besides the hypothesis variables we consider other variables as control variables in the equation.

4.1 Data Description and Sources

The present study is based on the annual data covering the period from 2008-2018. As standard in the literature, the dependent variable (*FDIY*) is the net foreign direct investment as percentage of (GDP *IY*) measured by the gross fixed capital formation as percentage of *GDP* , financial sector development (*FD*) is proxied by the private sector credit as percentage of *GDP* , trade openness (*TOP*) is measured as a percentage of the sum of exports of goods and services, imports of goods and services to *GDP* , natural resources (*NRS*) is measured by the share of fuel and minerals in exports (in percent) and real effective exchange rate (*REER*). The data on these variables are retrieved from *UNCOMTRADE, Trading Economics,* World Bank, and *World Development Indicator (WDI) 2018.* The infrastructure development (*INFRS*) is proxied by the number of telephone main lines per 100 people and the data on this variable is taken from *Afghanistan Economic Survey*. The institutions and political instability related variables, such as civil liberties (*CL*) and political freedom (*PR*) indices is obtained from *Freedom House*.[9] The scores range from 1 to 7. The score 1 is high respect for civil liberties and political rights, while 7 being no respect. The variable political repression (*PREP*) is calculated by taking the sum of civil liberties and political rights divided by two [(*CL* + *PR*) / 2] following Harms and Ursprung (2002) and Mhlanga *et al*. (2009). The variable polity (*polity*) which is used as alternative measure of political risks and the data on this variable is taken from the *polity IV project* (Centre for Global Policy, George Mason University).[10]

The data on Afghanistan's political relations with United States is not readily available.[11] Therefore, we generate the variable *DIPR* representing

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[Political freedom implies the people's ability to participate freely in the political process, while civil liberties means freedom to develop views, institutions, and personal autonomy apart from the state (Harms and Ursprung, 2002, p. 653). Data on Civil Liberties and Political Rights are available at: <http://www.freedomhouse.org> (Last accessed: 10.06.2020)]

[10] Except FDI as percentage of GDP, gross fixed capital as percentage of GDP, private sector credit as percentage of GDP, volume of trade as percentage of GDP and polity other variables are in logarithmic form, whereas DIPR is a dummy variable.

[11] Although Desbordes and Vicard (2009) have utilized data associated to military conflict or events of severe tension among the countries. However, in the case of Pakistan and United States there is no such

the political relations of Afghanistan with United States as proxy for interstate political relations. The variable *DIPR* is generated based on available information on U.S. economic and military sanctions imposed on Afghanistan from time to time and other published information including press briefings and newspapers reports. *DIPR* is scaled between 0 (no sanctions) and 1 is used for partial sanctions (i.e. sanctions on military aid but not on economic aid). Table 7 summarizes the details of events since 2005.

Table 7: Summary of U.S. Aid Policies towards Afghanistan

Time Period	Nature of Relations	U.S Policies	Aid Flows	Weight assigned to *DIPR*
2005	Good	No sanctions	Economic aid, military aid	0
2006	Good	No Sanctions	Economic and military aid	0
2007	Partial Deterioration	Minor sanctions	Economic aid and less military aid	1
2008	Partial Deterioration	Minor sanctions	Economic aid and less military aid	1
2009	Good	No sanctions	Economic and military aid,	0
2010	Good	No sanctions	Economic and military aid,	0
2011	Good	No sanctions	Economic and military aid,	0
2012	Partial Deterioration	Minor sanctions	Economic aid and less military aid	1
2013	Good	No sanctions	Economic and military aid in terms of training	0
2014	Good	No sanctions	Economic and military aid in terms of training	0
2015	Partial Deterioration	Less sanctions	Economic aid and less military aid	1
2016	Partial Deterioration	Less sanctions	Economic aid and less military aid	1
2017	Good	No sanctions	Economic and military aid,	0
2018	Good	No sanctions	Economic and military aid,	0

Source: Based on the newspapers reports, press briefings

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tension that leads military conflict. Therefore, taking lead from Desbordes and Vicard (2009) we generated data for diplomatic relations using sanctions on economic and military aid imposed by the United States on Pakistan and other available sources such as, press briefings and newspapers reports.

The variables infrastructure, natural resources, real effective exchange rate, political rights, civil liberties and political repression are expressed in logarithmic form.

4.2 Methodology

This study employs Autoregressive Distributed Lag (ARDL) bounds testing approach to co-integration advanced by Pesaran *et al.* (1999, 2001). The main advantage of this methodology is that it allows testing for the existence of co-integration irrespective of whether the variables are I (0) or I (1). ARDL approach is more appropriate than the Johansen-Juselius multivariate approach to co-integration when the sample size is small (Pesaran *et al.*, 2001). This technique generally provides unbiased estimates of the long- run model and valid t-statistics even when some of the regressors are endogenous (Harris and Sollis, 2003). The estimation procedure involves two steps. First, long-run relationship between the variables under consideration is tested by computing F-statistics. If the evidence of long-run relationship is found, then at the second stage the short-run and long-run parameters are estimated using autoregressive distributed lag (ARDL) method. The final equation is selected based on the acceptability of various diagnostics.[12]

4.3 Empirical Analysis

4.3.1 The Unit Root Test

Before the implementation of the autoregressive distributed lag (ARDL) bounds test to co-integration, we first determine the order of integration of individual time-series, using Augmented Dickey-Fuller (ADF) test. The bounds test to co-integration does not require any pre-testing of unit roots. However, it is not necessary that all the series are I (0) and I (1). If any of the series are I (2), then the ARDL procedure gives spurious results. Hence, testing of unit root for each series is an important before the implementation of the ARDL co-integration method (Ouattra, 2004 and Khan, 2008). Table 8 reports the results of the unit root test.

Table 8: Results of the Unit Root Test method.

Series	Constant/Trend	Level	First Difference	Decision
$FDIY_t$	C	-1.329 (0)	-3.930(0)*	I (1)
IY_t	C	-3.241 (0)**	-3.570 (0)*	I (0)
FD_t	C	-2.091 (0)	-4.567 (1)*	I (1)
TOP_t	C and T	-0.652 (1)	-4.208 (1)*	I (1)
$INFRS_t$	C	-1.525 (1)	-3.448 (1)*	I (1)

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[12]   *Since Bounds testing approach to co-integration is well established methodology in the literature. Therefore, there no need to discuss the detailed methodology.*

REER$_t$	C	-1.093 (1)	-4.656 (0)*	I (1)
NRS$_t$	C	-1.844 (1)	-3.377 (1)*	I (1)
PR$_t$	C	-2.081(1)	-3.947 (1)*	I (1)
CL$_t$	C	-3.922	-5.592 (0)*	I (0)
PREP$_t$	C	-3.306	-4.870 (1)*	I (1)
Polity$_t$	C	-2.185	-3.577 (1)*	I (1)

Critical Values at 5% level with constant = 2.9327;   Critical Values at 5% level with constant = -2.962

* indicate significant at the 1 percent level.

It can be seen from the Table 8 that except domestic investment as percentage of *GDP* (*IY$_t$*) and civil liberties (*CL$_t$*), all other variables are non-stationary at their level and stationary at their first difference. Domestic investment as percentage of *GDP* (*IY$_t$*) and is stationary at their level. Thus we conclude that *IY$_t$* and *CL$_t$* is integrated of order zero i.e. I (0) while all other series are integrated of order one i.e. I (1) and no series is integrated of order two i.e. I (2). These mixed results from unit root test justify the application of bounds testing approach to co-integration.

4.3.2 Co-integration Analysis

The co-integration test based on the ARDL procedure is employed by estimating equation(s) (1-4) for Afghanistan using annual data over the period 2005-2018. The number of lags on the first differenced variables is selected using Schwarz Bayesian Criterion (SBC). However, the final lag length is selected when the estimated equation satisfied all the diagnostic checks including CUSUMSQ test of stability.[13] On the basis of this criterion, 2 lags were selected to carry out ARDL co-integration test.[14] The results of the co-integration test are reported in Table 9.

Table 9: Bound Test of Co-integration

Model Type	Variables included	Test Statistics	Decision
Benchmark Model	F (*FDIY$_t$* | *IY$_t$* , *FD$_t$* ,*TOP$_t$* , *INFR$_t$* , *NRS$_t$* , *REER$_t$* , *DIPR*)[a]	8.32	Co-integration
Political Rights	F (*FDIY$_t$* | *IY$_t$* , *FD$_t$* ,*TOP$_t$* , *INFR$_t$* , *NRS$_t$* , *REER$_t$* , *DIPR*)[b]	5.21	Co-integration
Civil Liberties	F (*FDIY$_t$* | *IY$_t$* , *FD$_t$* ,*TOP$_t$* , *INFR$_t$* , *NRS$_t$* , *REER$_t$* , *DIPR*)[c]	6.78	Co-integration
Political Repression	F (*FDIY$_t$* | *IY$_t$* , *FD$_t$* ,*TOP$_t$* , *INFR$_t$* , *NRS$_t$* , *REER$_t$* , *DIPR*)[d]	4.52	Co-integration

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[13] *Diagnostic checks include, Langrange Multiplier (LM) test for autocorrelation, Normality test and ARCH for heteroscedasticity.*

[14] *We have tried various specifications by adding the different variables like interest rate, labour force, government consumption, government investment and infrastructure proxied by the road length. None of these variables remains significant. Therefore, we present most parsimonious results here. For the selection of the parsimonious model we use PcGets software.*

Polity IV	$F (FDIY_t \mid IY_t, FD_t, TOP_t, INFR_t, NRS_t, REER_t, DIPR)^e$	9.26	Co-integration

Note: Two lags were selected on the basis of SBC. The critical values are given by Pesaran et al. (2001).

a= unrestricted constant, no trend and number of regressor k=7.

b= unrestricted intercept, no trend and number of regressor k=8.

c= unrestricted intercept, no trend and number of regressor k=8.

d= unrestricted intercept, no trend and number of regressor k=8.

e= unrestricted intercept, no trend and number of regressor k=8.

It is evident from the Table 9 that the calculated F-statistics lie above the upper bound of the critical values, supporting the evidence of co-integration between the foreign direct investment as percentage of GDP, share of investment as percentage of GDP, financial sector development, trade openness, infrastructure, natural resources, real effective exchange rate, political rights, civil liberties, political repression and Afghanistan's political relations with United States for each specifications. Thus we got the supportive evidence that in the long-run the share of investment to GDP, financial development, trade openness, infrastructure, natural resources, political rights, civil liberties, political repression and Afghanistan's relations with United Sates are jointly determines the behavior of FDI in Afghanistan.

After obtaining the supportive evidence of co-integration between FDI and its determinants, we now obtain long-run and short-run coefficients by estimating equation(s) (1-4) using SBC for the selection of lag length. The estimated long-run parameters are reported in Table 10 The first model is the baseline model dealing with general determinants of FDI including the role of international relations of Afghanistan with United States. Model from 2 to 4 captures the effect of political rights, civil liberties and political repression. The last model includes polity IV as proxy for political risk to check the robustness of the results. The short-run diagnostic statistics are presented at the end of the Table 10 suggest that there is no major problems with the estimated results.[15]

It is evident from the Tables 10 that FDI is positively and significantly correlated with domestic investment for all the cases and the coefficient varies between 0.32 and 0.35. This implies that in the long-run FDI produces crowding-in effects on domestic investment. The reason could be that when the recipient countries provides conducive environment for business and investment, such as infrastructure facilities, availability of inputs and skilled labor, technologies, etc., it not only effects the domestic investment but

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[15] *Although the estimated equation does not pass the normality test, this could be possible in case of small sample size.*

also provides incentives to foreign investors to invest more in the host country. This result is in line with the earlier findings of Khan and Samad (2010).

Table 10: Long-Run Co-Integration Results Dependent Variable: $FDIY_t$

Model Type	Benchmark	Political Rights	Civil Liberties	Political Repression	Polity
	(1)	(2)	(3)	(4)	(5)
IY_t	0.32(2.42)*	0.34(2.28)*	0.35(2.76)*	0.38(2.46)*	0.52(2.11)**
FD_t	0.35(2.52)*	0.36(2.43)*	0.39(2.85)*	0.39(2.53)*	0.29(1.92)**
TOP_t	-0.33(-1.89)	-0.34(-1.83)**	-0.35(-2.13)*	-0.34(1.89)**	-0.30(-1.57)
$INFRS_t$	0.92(2.11)**	0.89(1.97)**	0.74(2.03)**	0.74(1.78)	0.81(1.75)
NRS_t	0.67(2.04)*	0.59(1.58)	0.60(2.10)**	0.42(1.25)	0.14(0.30)
$REER_t$	-2.09(3.78)*	-2.20(-3.27)*	-2.68(-3.75)*	-2.69(-3.15)*	-2.43(-3.15)*
$DIPR_t$	-0.82 (-1.31)	-1.01 (-1.76)	-1.12 (-1.47)	-1.26(-1.46)	-1.05(-1.44)
PR_t	-	0.26 (0.29)	-	-	-
CL_t	-	-	3.07 (1.65)	-	-
$PREP_t$	-	-	-	1.82(1.24)	-
$POLITY_t$	-	-	-	-	-0.06 (-1.21)
Short-run Diagnostic Statistics					
$\chi^2 SC(1)$	0.06[0.808]	0.05 [0.821]	0.58[0.447]	0.09[0.676]	1.24[0.265]
$\chi^2 NO(2)$	7.49 [0.024]	10.37 [0.006]	5.92[0.052]	18.40[0.000]	20.07[0.000]
$\chi^2 HET (1)$	0.17[0.684]	0.09 [0.765]	0.06[0.808]	0.08[0.928]	0.001[0.973]

*Note: *, ** indicates significant at the 1% and 5% level significantly. The estimated results of equation 3 are available from the author. The $\chi^2 SC$, $\chi^2 NO$ and $\chi^2 Het$ are Lagrange multiplier statistics for test of residual correlation, non-normal errors and heteroscedasticity, respectively. These statistics are distributed as Chi-square values with p-values are in parentheses.*

The coefficient of financial development proxied by the private sector credit as percentage of GDP is positive and significant in the long-run for all the cases. This suggests that a well-developed financial market creates larger incentives for foreign firms to invest abroad. Prasad *et al.* (2003) argue that FDI can boost growth only when recipient country's financial markets developed enough to channel foreign capital efficiently to finance productive investment. A well-developed financial market is also pre-requited for the positive effect of FDI on economic growth (Hermes and Lensink, 2003, Alfaro, *et al.*, 2004 and Khan, 2007).

This result could be further justified on the grounds that when the country has well-developed financial markets, it is more likely that local suppliers can invest in upgrading technology and machinery to provide better inputs. Thus, financial development can be a good signal for the availability of potentially good supplier (Campos and Kinoshita, 2008).

Interestingly, trade openness exerts negative impact on FDI for all the specifications in the long-run. One way to explain the negative relationship between FDI and trade is on the basis of foreign firm's investment motives in the host country. One motive of the foreign firms is to invest in host country on the basis of cost cut incentives. If trade costs in the host country is greater that discourages FDI. Faini (2004) argued that increasing restrictions on trade increases trade costs that provides disincentives to foreign firms and discourages FDI. The negative effect of trade openness could also be justified on the grounds that risk and uncertainty factor affects the investor's decisions. Rehman (2003) argued that lack of credibility regarding the consistency of trade liberalization policies is one of the main reasons that adversely affect investor's decisions about the long-run investment. Thus, due to the risk and uncertainty and lack of credibility regarding the liberalization policies, foreign investors save the cost by taking decisions not to invest in risky countries as compared to domestic investment costs in the host country (Lehman, 1999). Besides these reason, in Afghanistan the negative relationship between trade liberalization and FDI could be possible because the major chunk of FDI goes to non-manufacturing and services sectors. The other reason could be the increase in imports due to reduction in tariffs and elimination of other trade barriers especially after signing the TRIPS agreement under WTO regimes which makes overall impact of trade on FDI negative. The existence of monopolies of MNCs could be another reason for the negative relationship in Afghanistan.

The infrastructure carries positive sign and statistically significant in first three cases suggesting that infrastructure plays an important role in attracting FDI. However, infrastructure exerts insignificant influence on FDI as political repression is included in the analysis. This could be due to the high correlation between infrastructure and political repression indices. The international financial variable, real effective exchange rate influences FDI negatively in the long-run. This implies that depreciation of domestic currency raises transactions and input costs and decreases FDI in the host country. Another variable that might exert great impact on the inflows of FDI is the natural resource endowments. The positive association between FDI and natural resources implies that in Afghanistan FDI is partly resource seeking type.

The Afghanistan's political relations with United States (*DIPR*) exerts negative and but insignificant effects on FDI for each specification in the long-run. This implies that the economic sanctions imposed by United States during the 2007-2008 and then in 2012, 2015 and 2016 (see Table 7) can affect

only the official inflows (i.e. economic and military aid flows) in the long-run. This result further implies that unsustainable Afghanistan -U.S. diplomatic relations do not disrupt the flows of private capital to Afghanistan in the long-run.[16]

The democracy related variables, such as political rights and civil liberties remains insignificant. This implies that political freedom and civil liberties produces no significant impact on the inflow of FDI to Afghanistan. These results are consistent with the earlier findings of Alesina and Dollar (2000). The hypothesized variable political repression which is used as proxy for political risk is appeared to be insignificant. This means that political instability exerts no impact on the inflows of FDI in Afghanistan. These results confirm the previous findings of Akhtar (2000) and Khattak *et al.* (2005). The reason could be the weaker democratic institutions, high level corruption, and weak concentration of capital and enforcement of labour laws, inefficient bureaucracy and insecurity of property rights (Quere, *et al.*, 2007). To check the robustness of the results we use data from polity IV as measure of political risk (democracy), but it does not change the results in terms of signs.

On the whole, the domestic investment, financial development, infrastructure and natural resources are the major factors exerting positive impact on FDI in Afghanistan. Trade liberalization and real effective exchange rate deter FDI in the long-run. Institutional factors, such as political rights, civil liberties and political repression produce no significant impact on FDI inflows to Afghanistan. These results are consistent with the findings of Akhtar (2000). Furthermore, the impact of diplomatic relations of Afghanistan with international powers (i.e. USA) on FDI is though negative but insignificant in the long-run.

To examine the short-run dynamics we have estimated the error-correction model and Table 11 reports the results. The results show that domestic investment, financial development, infrastructure, and natural resources exert positive and significant impacts on FDI inflows in the short-run. This implies that growth of domestic investment, financial liberalization and exploitation of natural resources would accelerate the growth of FDI in Afghanistan. The share of investment to GDP influences FDI positively in the short-run. This means that FDI produces crowds-in effect on the domestic investment. This result could be justified on the ground that FDI may exerts

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[16]   *Anwar and Michaelowa (2006) also find that the effects of US business interests based on FDI and exports appeared to be comparatively small.*

positive impact on domestic investment because of the generation of backward linkages (Adam, 2009 and Kumar and Pradhan, 2002).

Table 11: Short-Run Dynamics of FDI and Political Relations (Dependent Variable: $FDIY_t$)

Model	Benchmark (1)	Political Rights (2)	Civil Liberties (3)	Political Repression (4)	Polity (5)
IY_t	0.13(3.29)*	0.14(3.21)*	0.15(3.83)*	0.15 (3.63)*	0.19 (3.65)*
FD_t	0.07(2.24)**	0.07(2.22)*	0.08 (2.56)*	0.08(2.43)*	0.07(2.30)*
FD_{t-1}	-0.13(-2.18)*	-0.12(-3.41)*	-0.14(-4.09)	-0.14(-3.81)	-0.12(-3.60)*
TOP_t	-0.04(-1.11)	-0.03(-0.95)	-0.03(-1.04)	-0.03(-0.73)	-0.03(-0.37)
$INFRS_t$	0.37(3.59)**	0.36(3.00)*	0.32(3.02)	0.29(2.46)	0.29(2.54)*
NRS_t	0.27(2.81)*	0.24(1.81)**	0.26(2.78)*	0.17(1.36)	0.05(0.30)
$REER_t$	2.33(2.04)**	2.39(2.03)**	2.25(2.07)**	2.45(2.17)**	2.70(2.20)**
$DIPR_t$	-0.38(-2.09)*	-0.40(-2.09)*	-0.45(-2.47)*	-0.46(-2.44)*	-0.38(-2.00)**
PR_t	-	0.11(0.40)	-	-	-
CL_t	-	-	0.90(1.90)**	-	-
$PREP_t$	-	-	-	0.67(1.39)	-
$Polity_t$	-	-	-	-	-0.02(-1.56)
EC_{t-1}	-0.41(-3.12)*	-0.40(-2.99)*	-0.43(-3.44)*	-0.40(-3.08)*	-0.36(-2.61)**
$\bar{R}^2$	0.61	0.59	0.64	0.62	0.63
$F - stat$	8.11*	6.97*	8.39*	7.71*	7.83*
$DW - stat$	1.91	1.91	2.20	2.03	2.21

*Note: ** and * indicates significant at the 5 percent and 1 percent level respectively*

The impact effect of financial development is positive and significant for all the specifications in the short-run. However, financial development lagged by one year exerts negative impact on FDI. One reason could be that the funds are not being used to promote investment activities. The credit disbursement to private sector is generally based on political considerations rather than on economic considerations. As a result, the vested group has accumulated huge amount of non-performing loans. The other reason could be the possibility that financial deepening means an increase in treasury operation of financial institutions rather than increase in the lending for investment activities (Khan, 2007). Furthermore, non-linearities may also make the relationship between FDI and FD_{t-1} negative. In the short-run trade liberalization exerts no impact on FDI. The reason could be the absence of manufacturing sector, as the inflows of FDI is very small. This indicate that Afghanistan has received little export-oriented FDI. Hence, there is limited role of FDI in export promotion.

Unlike the long-run, in the short-run Afghanistan's diplomatic relations with international powers produces negative and significant impact on the FDI inflows. This suggests that economic sanctions imposed on Afghanistan from time to time affect the short-term private capital inflows rather long-

term capital inflows. This result supports the nexus between Foreign Direct Investment and Interstate Political Relations that U.S. policies effect private capital inflows in the short, but exert no impact in the long-run.

The risk related variables, such as political rights, civil liberties and political repression produces no influence on the FDI inflows. However, when civil liberties are included in the model it produces significant influence on FDI in the short-run. This suggests that freedom to conduct business activities, etc. play a significant role in attracting FDI in the short-run. Besides civil libraries, external influences are important instead of internal risks for private capital inflows to Afghanistan in the short-run. Thus both the hypothesis is rejected.

Hypothesis 1: Bad political relations between the United States and Afghanistan adversely affect the inflows of FDI to Afghanistan is rejected.

Hypothesis 2: Political repression/political risk negatively affect the flow of FDI to Afghanistan is also rejected

The error-correction term possesses expected negative sign and ranged between -0.36 to -0.43 and statistically significant suggesting a moderate speed of adjustment to achieve long-run equilibrium path. The estimated error-correction model fit very well in terms of reasonable adjusted R^2 with no evidence of autocorrelation as indicated by the DW-statistics. To check the robustness of the results we have used polity IV data as proxy of political risk. The introduction of alternative variable for political risk generally does not produce any major change in the estimated parameters in terms of signs in the short-as well as in the long-run.

5. Conclusions and Policy Implications

With FDI's cosmic importance in the economics and business arena, numerous studies have been carried out to find the determinants. The current study was performed to shed light on a topic that has not received much attention. Political risk as a determinant of FDI has received attention only recently, though under the narrower meaning. Thus, this study presents the raison-d-etre for a detailed analysis of the impact of international relations on FDI, taking different indicators of the former, including civil liberties (CL), political rights (PR, political repression (PREP) and polity as an alternative measure of political risks. Political risk factors are difficult to quantify. However, using the data from Freedom House, this study has empirically deduced that political risk factors play an important role in determining FDI inflows. In this context, the government of Afghanistan should try to contain political risks to the furthest extent since the indicators conclude that the Afghanistan is prone to political risks and

uncertainties in short run. It is also important that political parties, other stakeholders and bureaucrats in these countries take into account the fact that aggravation of political situations in the countries would lead to an overall negative impact. The consensus, disregarding any region or country, should be to reduce political risks and uncertainties since political instability play an important role in the determination of FDI and consequently, the long-run economic performance of a country.

This study has examined how international relations affect FDI inflows into Afghanistan and the broader insight is that international relations matter in the international political economy in ways that go beyond their official mission or originally intended economic effects. One of those long-standing debates in the literature is how the economic and political dimensions are connected and their likely impact on FDI. Our findings support that these dimensions are complements. Finally, our research has important implications for scholars and practitioners interested in the politics of economic development. After years of apprehension, many developing countries have become interested in attracting FDI. Policymakers—not just at the World Bank and IMF, but also now in most developing country governments— consider FDI desirable because it provides much-needed capital and brings new technology as well as training for workers and managers to the country, and thus may contribute to economic growth (e.g., Farrell et al. 2003).[17] Yet, multinational corporations are often wary of investing in developing countries. We show that developing countries—if they want to attract more FDI—can make commitments to liberal economic policies more credible via international institutions, thus reassuring foreign investors and thereby increasing inward FDI.

This study developed a nexus between FDI and international political relations for Afghanistan over the period 2005-2018. The main focus of the study is to examine how political relations of Afghanistan with the United States affect the inflows of FDI to Afghanistan. On the basis of extensive theoretical and empirical analysis we obtain some striking results.

Our findings suggest that United States policies with respect to Afghanistan influences only economic and military aid flows but not private capital inflows (i.e. FDI) in the long-run. We find that United States policies towards Afghanistan do not much correlate with the policies of other

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[17] *Farrell, Diana, et al. (2003), New Horizons: Multinational Company Investment in Developing Economies. San Francisco: McKinsey Global Institute Farrell, Diana, et al. (2003), New Horizons: Multinational Company Investment in Developing Economies. San Francisco: McKinsey Global Institute*

donors and investing countries. Our findings also suggest that economic sanctions against Afghanistan do not affect U.S.- Afghanistan trade relations. These findings are verified by the results obtained using econometric analysis that U.S. sanctions policies produce no significant impact on FDI inflows to Afghanistan in the long-run. However, in the short-run U.S. policies influences FDI inflows to Afghanistan negatively.

The analysis further suggests that in Afghanistan economic factors such as domestic investment, good infrastructure, and real effective exchange rate and natural resource endowments exert significant influence on FDI. Among the policy related factors, only financial development produces positive and significant effect on FDI inflows.

The institutional factors, such as political rights, civil liberties and political repression produces no significant impact on FDI in the long-run. However, in the short-run only civil liberties significantly influences the inflows of FDI.

The general conclusions emerge from this study is that deterioration of U.S.- Afghanistan relations neither influences the flows of private capital nor bilateral and multilateral capital in the long-run. However, negative effects on the private capital flows have been seen in the short-run. Besides, economic and policy related factors play a significant role in the determination of FDI in Afghanistan, while institutional factor exerts no significant impact on the FDI in Afghanistan.

5.2 Policy Implications

The findings have important policy implications in general and for Afghanistan in particular:

- International relations, particularly U.S.- Afghanistan relations adversely influence inward FDI to Afghanistan in the short-run. Therefore, measures should be taken to review foreign policy and establish close diplomatic relationship with United States. However, these relations may be based on mutual respect, trustful and sustainable and predictable.

- We obtain evidence that trade and FDI are substitutes rather than complements. Therefore, government may focus more on its liberalization and investor-friendly policies and remove bottlenecks hampering FDI. Furthermore, government may encourage export-oriented FDI.

- FDI exerts crowding-in effects on domestic investment, therefore measures should be taken to encourage and facilitates local investors and broaden the circle of domestic investors by providing more infrastructure services, credit

facilities and improve the physical infrastructure. These measures do not only further encourage the domestic investment but also help in attracting more FDI.

- It is also suggested that the exploration and up-gradation of natural resources play an important role in attracting FDI.

- Institutional factors, such as political rights, civil liberties and political repression remains insignificant. Hence, there is need to strengthen the location factors like incentives, consistency and continuity of liberalization policies and liberal investment regime.

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