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Examine the effect of market size on Foreign Direct Investment inflow: Evidence from Afghanistan economy

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ABSTRACT

This study was conducted to scrutinize the effect of market size on Foreign Direct Investment (FDI) inflow in Afghanistan (2001-2023) and employed an autoregressive distributed lag (ARDL) model for estimation. This study found that GDP per capita, financial development, inflation rate, population growth (POP), and political stability (PS) have an optimistic and significant effect of FDI inflow in the long run (LR). However, all the variables included in the model have insignificant effect on FDI in the short run (SR). The ECM value shows the 57% rate of convergence to LR equilibrium and the bound test rejects the null hypothesis (H_0), meaning that there is an exit from the LR cointegration. Therefore, the market size has significantly contributed to the FDI inflow. Based on the result, this study recommended, to enhance FDI, the government should expand market size (MSz), and financial development, while, lower inflation and political instability in order to attract FDI.

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1.0 Introduction

The increasing importance of FDI in the global economy over the last thirty years has sparked a variety of debates and extensive study on the link between FDI and GDPpc. The accessibility of capital and the level of practical technology distinguish industrialized countries from developing and transitional ones. Domestic savings are unquestionably a significantly more serious development issue for emerging and transitional economies. To make up the difference between the amount of local savings and the requirement to FDI, emerging and transitional nations are obliged to seek extra funding from outside. The transfer of capital via FDI provides important assistance in their development exertions and catching up to wealthy countries. Furthermore, the significance of FDI as long as financial support for the creation of new manufacturing capacity. Consequently, it is not unexpected that attracting FDI has become a significant part of emerging and transitional nations' development strategies (Petrović-Ranđelović *et al.*, 2017).

However, despite the fact that researchers agree that FDI brings a variety of developmental reimbursements to the host country, "*the major reasons behind foreign investors seeking a country in which to invest and the uneven spatial distribution of FDI across countries are still unanswered questions in both the theoretical and empirical international business literature*" (Polat, 2015). Essentially, the goal is to explain why corporations from some nations choose to locate their industrial operations in other countries. One of the primary motivations for pursuing market-seeking FDI faces obstacles in the nation where it invests, as well as excessive transaction costs. Though, in general, they are taken to gain market access and a favorable position in the host country, particularly in those with good prospects for future dynamic growth, so that the host country's market size (MSz) and growth play an vital role in determining inward FDI flows (Petrović-Ranđelović *et al.*, 2017).

Many academics and policy analysts contend that inward FDI can have a substantial optimistic effect on a host economy's GDPpc struggle. It is seen as the most dynamic source of foreign resources for developing economies over the past few decades and has unquestionably become an indispensable part of capital accumulation in host economies. The IMF reported that FDI inflows have become a central source for poor countries. Since the early 1980s, FDI has increased dramatically, and the global market for it has become increasingly competitive. Less developed economies are fetching increasingly attractive investment locations, thanks in part to their ability to provide investors with a variety of "created" assets (Mallampally & Sauvant, 1999). Globalization significantly has an optimistic impression on FDI by enhancing economic integration, minimizing trade barriers, and expanding market opportunities for multinational companies. Globalization has an optimistic and substantial impression on FDI that leads to the development and growth of a nation (Modugu & Dempere, 2021). Globalization not only enhances FDI but also ensures energy sustainability through diverse energy sources (Qamruzzaman, 2022). Improvements in social conditions, political stability, and institutionalization bring more FDI into the recipients (Aluko *et al.*, 2023). Therefore, interdependency between countries, technology, and communication is the most important way to increase cross-border investment. According to Lee *et al.* (2024), the effect of social indicators (education level, health standards, political stability,

governance, income equality, etc.) is more significant than economic indicators (GDP growth, inflation, interest rates, trade openness (TO), etc.) that enhance foreign direct investment. Therefore, considering globalization as an imperative indicator for cumulative FDI inflows and economic growth.

FDI inflows are frequently regarded as a vital factor in driving GDPpc by contributing technology, capital, knowledge, and employment, all of which are expected to benefit the host country(Cambazoglu & Karaalp, 2014). As a result, many emerging and least-developed nations' governments have firmly delegated responsibility for transforming their economies and accelerating GDPpc. As a result, many nations throughout the world are invite FDI, reforming and liberalizing their FDI regimes but fail due certain reasons (Islam & Beloucif, 2023). When a nation adopts open trade policies, it enhances foreign investors to develop businesses, benefiting from lower tariffs and more competitive environment. Trade openness fosters technology transfer, increase productivity and strengthen global value chains making the host countries more attractive for FDI inflow. Increase in TO is an improved choice for sustained FDI inflows and also improving over well-being of the people (Donghui *et al.*, 2018). The increase in foreign trade enhances economic growth that leads to reduce income inequality (Khan *et al.*, 2021) and significantly improve economic development of an economy (Wang *et al.*, 2023).

Afghanistan is a rapidly rising emerging market of strategic status, located near of the world's largest economies. Afghanistan also has natural access to neighboring nations' markets, especially key fast-growing economies like China, India, and Pakistan. Afghanistan has a business-friendly climate, with laws that encourages private investment. The ideals of a free-market economy are included into the new constitution, and the expansion of the private sector is a key component of the national development strategy. As a result, both the President and the Government have worked hard to remove barriers to private-sector development (Wani & Rehman, 2017).

Existing observed studies place a larger importance on some of the influences like MSz, infrastructure, on FDI remains unknown. Future study should focus on numerous factors that influence FDI, relative access to financing, and regional expertise of host nations (Islam & Beloucif, 2023). As much as researchers are interested in the field of FDI and the country's economy, there are very few research studies in considered FDI in Afghanistan, which is a much-needed study for the country, especially for a developing country, so that future researchers can contribute to the country and used the large data period and other variables (Wani & Rehman, 2017). But the Afghanistan economy negligible by the academic’s due certain reasons like law-and-order situation and non-availability of data etc. this study will be significantly contributed in the existing body of literature and used updated data from 2001 to 2023. Unlike the previous, this study also used the sole combination of the variables and used ARDL techniques for estimation to provide the valid and reliable results. Therefore, this study is conducted to investigate the effect of market size on FDI inflow in the case of Afghanistan economy.

2.0 Litrature review

Hennart (1982), and Rugman (1986) proposed Internalization Theory as an explanation for

FDI. This theory suggests that Multinational Enterprises (MNEs) internalize intermediate markets due to market imperfections. They argue that the price mechanism is not efficient in smoothing transactions for intermediate goods and knowledge. However, the main challenge lies in empirically testing the theory, as Buckley (1993) noted that it can only be tested in limited forms, possibly at the industry level. Furthermore, the classical approach views FDI as a result of international variations in capital rate of return (Mundell, 1957), emphasizing the rate of return. The portfolio theory of FDI describes how the risk element is linked to investment, claiming that when picking an investment portfolio, investors evaluate both risk and rate of return (Agarwal, 1980). Additionally, Vernon (1992) major work, the product life cycle theory, serves as a foundation for FDI and international trade: phases include product development, maturity, and standardization. However, Clegg (1987) argued that this theory is flawed since it does not define ownership of production. Furthermore, investors in foreign nations sometimes have a monopolistic edge over local competitors. The industrial organization theory Hymer (1976) supports the notion that foreign enterprises have clear advantages and competitive supremacy over local firms owing to their high management skills and sophisticated technology. Caves (1971) associated the same notion with horizontal and vertical FDI integration, describing horizontal FDI as a firm's entry into a foreign product market and vertical FDI as a firm's entry into a different stage of production within the same product market. Furthermore, according to Buckley and Casson (2016) internationalization theory, intermediary products are defective due to an information gap. As a result, foreign acts conducted through these marketplaces require significant time gaps and transaction costs. According to the resource-based/raw material paradigm, multinational corporations operate in other nations to get lower-cost input suppliers (Cantwell, 1989). Furthermore, the MSz hypothesis implies that growing MSz creates potential for large profits, attracting both domestic and international investment (Agarwal, 1980). The existing literature reveals that the FD has an excessive contribution to the smooth functioning of the contemporary economy and is signified by the effective of financial-institutions, particularly the banking industry. A well-established domestic financial system might help international firms increase finance to extend investment-activities in the host-country (Esew & Yaroson, 2014; Vinesh *et al.*, 2014). According to Williamson (1993), the theory of FDI is founded on transaction cost (TrC) assessments. According to the notion, corporate entities engage in activities depending on TrC. The TrC hypothesis is concerned with the expenses of conducting a business as opposed to the costs in overseas markets (Williamson, 2007).

Vijayakumar et al. (2010) found that MSz by GDP, gross capital formation, and labor cost significantly and positively contribute to FDI inflows into BRICS from 1975–2007, while the impacts of inflation and trade openness were insignificant. Jadhav and Katti (2012) found that sound inequality (InQ) have an optimistic effect on incoming FDI into BRICS, similarly, accountability, corruption, and PS have a positive impact. Using data from 22 countries, Shan *et al.* (2018) stated that MSz played a substantial and important role in attracting Chinese FDI (2008-2014). Among the institutional elements, only the "voice and accountability" variable had a substantial and positive influence on attracting FDI. PS and InQ have a large and negative

influence on FDI inflows. Moreover, Sabir *et al.* (2019) estimated using data from 1996 to 2016 and the system's GMM. They discovered that institutional quality, such as PS, had a beneficial influence on FDI across all groups of nations. However, GDPpc and inflation have an adverse influence on FDI inflows in wealthy nations, but GDPpc, and TO optimistic impact on FDI. Similarly, Wang and Bangash (2021) used panel data from 1997 to 2018 and OLS for estimate. Their findings demonstrate an optimistic and substantial relationship between ICT and FDI inflows, as well as other controllable factors such as MSz; nevertheless, the variable exchange rate has an adverse influence on FDI.

Asbullah *et al.* (2022) found that market size, corruption, and infrastructure may all have a favorable impact on FDI. However, TO has the potential to increase FDI. Moreover, inflation might have a detrimental impact on FDI. Higher inflation may produce a poorer return on FDI. As a result, FDI has dropped. Similarly, Bassem (2025) studies their interrelationship in 15 MENA nations from 1996 to 2022, employing OLS estimate. Their findings show that transportation is important component to attract FDI, with developments considerably increasing FDI. Likewise, air transportation helps favorably by improving access to global markets, hence increasing FDI. The factors influencing spatial disparities in FDI are examined by Khdir and Cieślik (2025). Using a negative binomial logit model and data from 2007-2021, and show that FDI concentration is significantly influenced by better infrastructure, and increased market accessibility. Tsiapa *et al.* (2025) utilized data from the European regions between 2010 and 2018. They make it clear that the MSz of the host economies has a big influence on FDI, highlighting its significance as a factor. Furthermore, proximity as measured by distance—emerges as another important factor influencing FDI destination decisions. At the regional level, the locational elements of FDI have been shown to be similarly important. The destination region's development level (GDPpc) and FDI have a positive correlation, which emphasizes how the region's buying power influences FDI attraction. Similarly, increasing outward FDI activity (inward for the host areas) is connected with better levels of development in the home region, indicating these regions' capacity for investment. To explore the study goal to scrutinize the effect of market size on FDI inflow in the Afghanistan economy.

Methodology

Used data from 2001 to 2023 of Afghanistan. The study selected the data period based on the data availability. This study collected data from World Development Indicators (2025).

Table 1: Variables description

S.No	Variables detail	Marks
1	FDI, net inflows (% of GDP)	FDI_t
2	GDP per capita growth (annual %)	$GDPpc_t$
3	Inflation, GDP deflator (annual %)	INF_t
4	Domestic credit to private sector (% of GDP) (for Financial Development)	FD_t
5	Population growth (annual %)	PG_t
6	Political Stability: Percentile Rank (1 to 100)	PS_t

Model specification

This study used GDP per capita as proxy for market size also used by Sabir *et al.* (2019) and Sethi *et al.* (2019). This study used the fallowing modified model which also used by Shan *et al.* (2018), Sabir *et al.* (2019) and Sethi *et al.* (2019).

$$FDI_t = \beta_0 + \beta_1 GDPpc_t + \beta_2 INF_t + \beta_3 FD_t + \beta_4 PG_t + \beta_5 PS_t + \mu_t \quad \text{..... (1)}$$

Estimation Techniques

This study used ADF test to check the data behavior, which stated that the variables have mixed order of integration. In accordance to the ADF test findings, the ARDL approach is more suited for estimate since it can handle endogeneity and mixed integrated order data.

$$FDI_t = \beta_0 + \sum_{i=1}^{n} \beta_{1i} FDI_{t-i} + \sum_{i=0}^{n} \beta_{2i} GDPpc_{t-i} + \sum_{i=0}^{n} \beta_{3i} INF_{t-i} + \sum_{i=0}^{n} \beta_{4i} FD_{t-i} + \sum_{i=0}^{n} \beta_{5i} PG_{t-i} + \sum_{i=0}^{n} \beta_{6i} PS_{t-i} + \mu_t \quad \text{..... (2)}$$

$$\Delta FDI_t = \beta_0 + \sum_{i=1}^{n} \beta_{1i} \Delta FDI_{t-i} + \sum_{i=0}^{n} \beta_{2i} \Delta GDPpc_{t-i} + \sum_{i=0}^{n} \beta_{3i} \Delta INF_{t-i} + \sum_{i=0}^{n} \beta_{4i} \Delta FD_{t-i} + \sum_{i=0}^{n} \beta_{5i} \Delta PG_{t-i} + \sum_{i=0}^{n} \beta_{6i} \Delta PS_{t-i} + \gamma_1 GDPpc_t + \gamma_2 INF_t + \gamma_3 FD_t + \gamma_4 PG_t + \gamma_5 PS_t + \mu_t \quad \text{..... (3)}$$

Results and Discussions

Table 1 shows that all variables are normally distributed except IFDI and all the variables are positively correlated. Moreover, table 2, shows that all variables are stationary at level except financial development.

Table 2: Summary of Descriptive Statistics and Correlation Matrix

	Variables	**IFDI$_t$**	**GDPpc$_t$**	**FD$_t$**	**INF$_t$**	**PG$_t$**	**PS$_t$**
	Mean	0.3092	1.3148	5.9256	5.4072	3.1408	1.2789
	Median	0.2398	0.5407	4.4721	4.8228	3.1200	1.4218
	Maximum	1.2031	22.0202	11.5750	22.5278	6.1452	2.8571
	Minimum	-0.0134	-22.5845	3.0966	-11.7745	0.7620	0.4717
	Std. Dev.	0.3032	9.1774	2.9817	6.8691	1.1615	0.6623
	Skewness	1.3232	-0.0592	0.8856	0.1277	0.4657	0.5198
	Kurtosis	4.5983	4.1645	2.1674	4.2753	3.8746	2.7249
	Jarque-Bera (JB)	9.1599	1.3130	3.6704	1.6210	1.5643	1.1083
	p-value (JB)	0.0103**	0.5187	0.1596	0.4446	0.4574	0.5746
	IFDI$_t$	1					
	GDPpc$_t$	0.1857	1				
	FD$_t$	0.1190	0.5031	1			
	INF$_t$	0.1307	0.2149	0.1880	1		
	PG$_t$	0.1415	0.4567	0.3003	0.3137	1	
	PS$_t$	0.2425	0.1577	0.2605	0.3951	0.4788	1

Note: ** shows 5% level of significance.

Table 3: ADF Test Results

Variable	t-Statistic	Prob.*	Decision (H_0: Variable has a unit root)
$IFDI_t$	-3.3551**	0.0244	Reject H_0
$GDPpc_t$	-4.0600*	0.0053	Reject H_0
INF_t	-4.7066*	0.0012	Reject H_0
PG_t	-3.2026**	0.0358	Reject H_0
PS_t	-3.3049**	0.0271	Reject H_0
FD_t	-1.7890	0.3757	Sustain H_0
$D(FD_t)$	-4.6418*	0.0015	Reject H_0

Note: ** and * shows 5 and 1% level of significance.

Regression Results

Table 3 shows that in the LR, GDPpc has an optimistic effect of FDI. A % upsurge in the GDPpc will raise the FDI by 0.02%. Sabir *et al.* (2019) found that GDPpc and INF have a bad influence on FDI in rich nations, but GDPpc has an optimistic and noteworthy impact on FDI in underdeveloped countries. Similarly, financial development has an optimistic effect of FDI. A % upsurge in the financial development will raise the FDI inflow by 0.17 percent on average. Likewise, inflation rate has an optimistic effect of FDI inflow. A % upsurge in the inflation rate will raise the FDI inflow by 0.02 percent on average. Correspondingly, the population growth has an optimistic effect of FDI inflow. A % upsurge in the population growth will raise the FDI inflow by 0.21 percent on average. Similarly, PS has an optimistic effect of FDI inflow. A % upsurge in the political stability will raise the FDI by 0.02 percent on average. Many prior research shown that market size can favorably effect FDI (Amponsah *et al.*, 2020; Petrović-Ranđelović *et al.*, 2017). MSz may have a major beneficial impact on FDI (Asbullah *et al.*, 2022). Most research used panel data analysis to determine whether there is a momentous association between MSz and FDI. Like, Nasir (2016) utilized the OLS technique to study the impact of MSz on FDI in Malaysia between 1980 and 2010. In the short run, all the variables included in the model has insignificant effect on FDI inflow. The ECM value shows the 57% rate of convergence to LR equilibrium and bound test reject the H_0, means that there are exit the long run cointegration among the variables.

Table 4: ARDL Results

Variable	Coefficient	Std. Error	t-Statistic	Prob.*
LR Results				
$GDPpc_t$	0.0197**	0.0049	4.0098	0.0160
FD_t	0.1682*	0.0287	5.8634	0.0042
INF_t	0.0640*	0.0097	6.6083	0.0027
PG_t	0.2112**	0.0524	4.0348	0.0157
PS_t	0.1953**	0.0551	3.5473	0.0239
C	1.6290*	0.3259	4.9988	0.0075
Short Run Results				
$D(GDPpc_t)$	-0.0036	0.0043	-0.8398	0.4151
$D(FD_t)$	0.0165	0.0206	0.8000	0.4371
$D(INF_t)$	0.0029	0.0063	0.4673	0.6475

Variable	Coefficient	Std. Error	t-Statistic	Prob.*
$D(PG_t)$	-0.0726	0.0503	-1.4439	0.1708
$D(PS_t)$	-0.0897	0.0584	-1.5376	0.1464
ECM_{t-1}	-0.5737*	0.0794	-7.2300	0.0000
C	-0.0026	0.0428	-0.0606	0.9526
F-Bounds Test		**H_0: No levels association**		
Test Statistic	**Value**	**Signif.**	**I(0)**	**I(1)**
F-statistic	14.6583*	10%	2.080	3.000
k	5	5%	2.390	3.380
		1%	3.060	4.150

Note: ** and * shows 5 and 1% level of significance.

Conclusion and Recommendations

This study found that GDPpc, financial development, inflation rate, POP, PS has an optimistic effect of FDI inflow in the LR. The ECM value shows the 57% rate of convergence to LR equilibrium and the bound test rejects the $\boldsymbol{H_0}$, meaning that there is an exit from the LR cointegration. Therefore, the market size has significantly contributed to the FDI inflow. As a result, MSz can have a optimistic influence on FDI. This study recommended, to enhance FDI, the government should expand the MSz, financial development, and demographic base. However, the government needs lower inflation and political instability in order to attract FDI. This study implies that a larger market size will encourage foreign investors to produce more items. There are two limitations to this study like not considering the trade openness and small data period due to non-availability of data.

Contribution

Zia Ur Rehman: Problem Identification and Theoretical Framework
Muhammad Fayaz: Methodology and Drafting
Sania Zaheer Ali: Data Analysis

Conflict of Interests/Disclosures

The authors declared no potential conflicts of interest in this article's research, authorship,and publication.

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