Determinants of Foreign Direct Investment Inflow in Tanzania

By Rashid Ismail Mfinanga

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Keywords: FDI, foreign direct investment, ordinary least square (OLS), unit root and Tanzania.

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Strictly as per the compliance and regulations of:

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Chapter One

I. Introduction

a) Background of the Study

Foreign direct investment is one of the key drivers of economic growth of a country as it can assist the transfer of new technology and also increase the domestic capital formation. Foreign direct investment strengthens the export capabilities of domestic economies and facilitates access to export markets (Ngowi, 2001). The presence of a foreign direct investment in the host country increases competition and thus encourage greater efficiency for domestic firms. It provides also good technologies and modern environment management system and enhances skills and management techniques (Mwega, 2007). Foreign direct investment has been considered as external sources of finance for under developing countries like Tanzania when the domestic resources are limited to finance development requirement (Asiedu, 2002).

There are several development challenges faced by most African countries including Tanzania and one of the challenges is to influence foreign direct investment inflow into the country. Despite the number of efforts that have been put forward by most African countries in the past to boost foreign direct investment inflow, did not make any significant impact. The reason for being unsuccessful was a failure to confront challenges posed by the globalization process towards foreign direct investment attraction to the country (Onyeiwu and Shrestha, 2004). Foreign direct investment requires a long run commitment as it include very high sunk costs and it is very difficult in a short term for foreign direct investors to recover their initial investment if there is a quick risk change that is related to their location. Therefore, the decision of foreign direct investors to enter into a host country mainly relies on the investment environment (Wheeler and Mody, 1992).

The flow of private capital in the form of foreign direct investment was among the main features of globalization in the 1990s. Foreign direct investment can also reduce balance of payments restrictions on growth as it acts as the source of foreign exchange as well as supplement the domestic investment resources. Many countries especially developing countries by considering foreign direct investment its economic benefits and importance for promoting economic growth, new national policies have been formulated so as to encourage more foreign direct investors. Better environment for investment is required to attract foreign capital in the country.

In most African countries, the improvement of investment climate has been influenced by recognition of foreign direct investment benefits over the past decades as it was considered as the key component for economic integration of the country and a source of finance for capital investment. Foreign direct investment became the key and more stable external source of finance compared to portfolio flows in most African countries. This has been proved by both theoretical and empirical studies which have been documented the positive significant impact of foreign direct investment inflows on economic growth of the country (Alfaro, 2003).

There are various significant steps that have been undertaken by Tanzania government to attract foreign direct investment. In order to support the investment related objectives, FDI specific regulatory

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frameworks have been adopted by Tanzania. According to United Nations Conference on Trade Development (UNCTAD), FDI specific regulatory framework has been established in 45 countries out of 50 in Africa and the changes include the establishment of the specialized scheme to attract investment such export processing zones (EPZs) and setting up of investment promotion facilities and agencies. Some African countries also signing an international investment agreement such as double taxation and bilateral investment treaties.

In the late period of 1980's and 1990's due to an adoption of economic liberalization policies, Tanzania was planning to use the private sector as the main key factor of economic development. In order to attract foreign direct investment inflow in Tanzania, the government set up the investment authority namely Investment Promotion Centre (IPC) in 1990. Investment Promotion Centre was operating for seven years until 1997 after the government changed to Tanzania Investment Centre (TIC) which acts as the primary agency of the government for promoting, encouraging, coordinating and facilitating investments environment in the country.

The aim of promoting investment was to reduce the level of poverty, to sustain the economic growth and to stimulate the smooth and favorable integration of country's economy into the global international economy. Tanzania has also been struggling to establish the openness clear policy to foreign investment that can create a better environment to invest for the development of the country (Tanzania Investment Report, 2009).

There are many benefits that foreign direct investment offers to host countries and therefore policy makers are naturally interested in knowing the foreign direct investment determinants or in other words what factors attracting FDI. According to Alfrao (2003), many academics and policy makers are suggesting that foreign direct investment can have important positive impacts on a host country is development effort. Several studies demonstrate factors that influencing the inflow of foreign direct investment but this study is different in a sense that it will help the policy makers in Tanzania to determine the factors influencing FDI inflows, difficulties faced by most countries to attract more foreign direct investment and solution to address the issue and to achieve the intended objectives.

b) Problem Statement

Foreign direct investment plays important role in bringing innovative technology, marketing techniques, up to date management and encouragement of national economic development. Foreign direct investment in East African Countries can never be underestimated (Mwega and Ngugi, 2007). Despite the efforts done by the government of Tanzania on creating jobs, alleviating poverty and growing the economy but still there is little

emphasis on definitive policy to create lucrative packages that would attract more FDI inflow. According to African Trade Policy (2005), foreign direct investment could push domestic firms into bankruptcy due to increased competition or could lead to loss of political sovereignty and environmental degradation.

Moss, Ramachandran, and Shah (2004) argued that much of African doubt toward foreign direct investment is rooted during post -independence period, history and ideology.

The role of foreign direct investment as the source of finance has increasingly become important to Tanzania government as the income level and domestic saving in the country are very low and therefore more external funds is needed to boost domestic savings so as to encourage investment and economic growth. Also for local Tanzanian entrepreneurs, foreign currency inflows from foreign direct investment have become a major concern as the high inflows of funds from foreign investors gives them a competitive edge in the economic activities of the country. This is because foreign direct investors are considered as the part of the large international organization with a huge capital base as in any form of market competition they are capable of pulling in more funds for the means of subsidizing operations.

Most African countries rely on two forms of foreign finance that are official loans such as the loan from World Bank and foreign direct investment because most they do not have entrance to the global international capital market. Since most foreign investors have a wide choice of locating their investment in developing countries, to attracting more FDI inflow depends on country's ability to provide a competitive factor of production such as labor and favorable foreign direct investment regime.

Most of the countries around the world have tried to make their investment environment-friendly for absorbing global opportunities by influencing more foreign investable funds into the country over the recent years. Foreign direct investment inflow determinants have become an important topic not only for policy makers and the government but also for academic researchers and this has arisen due to the failure performance of the previous policies which have been implemented to attract more foreign direct investment in the country. According to (Pigato, 2000), most foreign investors desire those countries or locations that are able to improve the quality of their productive factors, tackling competition, providing steady and clear rules for private businesses over time. Even though in most African countries there has been a significant improvement of foreign direct investment policy regime but still have not been significant enough to influence more foreign direct investment in larger shares.

The effort made to attract foreign investors in Tanzania has been ineffective. The investments authority

and institution that supporting foreign direct investment in Tanzania are weak, fragmented and uncoordinated as their services are quite basic which mainly focusing on short term basis. (Tanzania Investment Report, 2001), foreign direct investment inflows into Tanzania had not been given the attention they deserved as the lack of timely and reliable data on foreign capital inflow in the country making the evaluation and implementation of the macroeconomic policies that are related to capital inflow ineffective. The investment authority although have targeted many developed countries by extending their services but still their coverage has remained minimal and therefore much effort is needed to attract foreign direct investment so that at the end the country through FDI will attaining sustainable development.

According to African Trade Policy Centre (2005) for African countries to achieve the Millennium Development Goals set by the United Nations too many efforts are needed in improving economic policies so that to increase the macroeconomic level performance and reach the minimum economic growth rate. The sustainable economic growth and development in the country can be achieved through an increase in investment level by mobilization of both domestic and international financial resources. As the result of low share of African countries in global international trade, high risk of short term capital flow, the unpredictability of foreign aid inflow, at least in a short run the desired increase in investment has to be achieved through an increase in foreign direct investment inflows.

c) *Objectives of the study*

i. *Main objectives of this study*
- To examine the determinants of FDI inflows in Tanzania
- Suggesting policy recommendations based on study findings.

ii. *Specific objectives of this study*
- To examine the relationship between openness to trade and FDI inflows.
- To examine the relationship between exchange rate and FDI inflows.
- To examine the relationship between inflation rate and FDI inflows.
- To examine the relationship between market size and FDI inflows.

d) *Significance of the study*

This study is important as Tanzania have experienced a declining trend of foreign direct investment inflow over the years (UNCTAD, 2005). This study seeks to evaluate the determinants of FDI inflows and to see which factors are most significant in attracting FDI inflow into Tanzania. The study will also shed more light on the current state of the economy in Tanzania for foreign investors especially for those contemplating entry into the Tanzania market and also

provide useful understanding for current foreign investors operating in the country. This will helps investors when wants to make their investment decisions. The findings of this study will also make a significant contribution to knowledge for both the readers and policymakers as it identifies the role foreign direct investment inflow into Tanzania economy and Africa in general.

The study will also prevent the policymakers from wastage of resources by putting too much effort on unnecessary areas to attract foreign direct investment as the results will be used as the source of information for designation and implementation of national policies. Furthermore, this study will help Tanzania Investment Authorities to review their regulation and laws based on the results of this study so as to cope with the reality.

In order to achieve the outlined objectives, this study uses the extensive secondary method of research. The study utilized various data obtained by other scholars of the study. In short, by conducting this study readers and policymakers will be able to understand more about factors influencing foreign direct investment inflows into Tanzania.

e) *Scope of the study*

The main focus of this study is to make the investigation on the factors that attract foreign direct investment inflow into Tanzania over the period of 1990-2015. The reason for this chosen range of study was due to the fact that Tanzania has experienced a decline in the amount of foreign direct investment inflows even though various macro economics programs and reforms have been implemented by the government so as to promote and attract foreign investors to come and invest in the country. Also, this period of study is more beneficial especially for potential investors as they will have a critical look at the investment environment before taking the decision of investing or doing business in Tanzania. The data in this study were collected from different sources including the World Development Indicator which acts as the primary World Bank database.

f) *Limitations of the study*

One of the limitations of this study was lack of fund which makes the study to rely on secondary data as the collection of primary data needs more money and time. In reviewing literature, this research faced the problem of accessing journals with relevant materials as some websites could not be accessed as they were secured. Some journals, subscriptions were made so as to gain access to materials needed. The study also faced a big problem in acquiring the software used for data analysis and it took time (a month) for the researcher to learn the software and apply it to the work hence the timely aspect of the work was delayed. Another limitation faced by this study was the absence of specific data for some of the variables such as market

size and trade openness which made the researcher to use the proxy data to estimate these variables. Sometimes the use of proxy in the empirical tests may lead to inaccurate results. In this study, only four variables were included due to some reasons such as unavailability of data, limited time, among others but still, there are many macro economic variables which are influencing foreign direct investment inflow into the country and the inclusion of many variables will help in providing more accurate results of the research.

g) Organization of the study

This study is organized into six chapters in which the first chapter starts with the introduction part then followed by problem statement, objectives of the study (both the main and specific objectives), the significance of the study, scope of the study and organization of the paper. The purpose of this paper is to examine the relationship between trade openness, inflation rate, exchange rate and market size with foreign direct investment inflows into Tanzania. The second chapter discusses the economic background of Tanzania which includes some economic indicators such as export, imports, inflation rate, GDP per capita, foreign direct investment inflows, GDP annual growth rate and openness of the economy in doing business. The literature review which includes both theoretical and empirical review is being discussed in the third chapter. In this chapter, the study tries to provide the evidence from the other previous research regarding the determinant of foreign direct investment inflow both theoretical and empirical. The fourth chapter describes the model specification, estimation methods used and different sources in which the data for the variables have been collected. The fifth chapter discusses the

estimation results and interpretation of the findings. Lastly, chapter six includes the conclusions, relevant policy recommendation to be adopted by policy makers and government in general and suggestions to be considered for future researchers.

Chapter Two

II. Tanzania: Economic Overview

a) Introduction

Tanzania is the twelve largest economy in Africa and second largest in East Africa. The economy of the country largely depends on agriculture mainly for employment which accounts about 65% of the employed workforce and also provides about 85% of export. There has been a transition in the economy since 1985 from command to market economy. Important measures have been taken by the government in the liberalization of Tanzania economy since 1986 so as to encourage both foreign and domestic private investment. Tanzania also sustained its economic growth rates through the making of significant economic and structural reforms with the help of World Bank, International Monetary Fund and others partners over the last decades.

b) Easiness of doing business

In 2016, Tanzania has been ranked 132 among 190 economies in the ease of doing business compared to 144 ranks in 2015. It estimated an average of 133.63 during the year 2008-2015 for ease of doing business in Tanzania in which the low record was 125 in 2010 and the high record of all the time was the average of 145 in 2013. These data is according to the latest World Bank annual ratings.
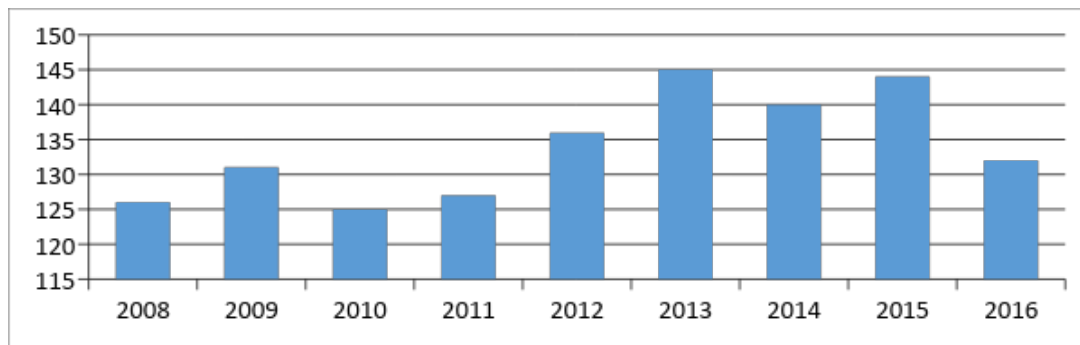

Source: World Development Indicator (2017)
Figure 1: Ease of doing business in Tanzania (2008-2016)

c) GDP Annual Growth Rate

Tanzania GDP has been increased year by year over the last decades. It estimated an average annual growth rate of 6.70% from 2002-2016 in which 2.60% was the low record in 2009 and the high record of all the time was 11.90% in the first quarter of 2007. In 2015 the GDP growth was 5.75% in which Agriculture, mining and quarrying, real estate, education were the main sectors that led to its growth. National Bureau of Statistics (NBS)

in Tanzania is responsible for reporting the GDP annual growth rate.
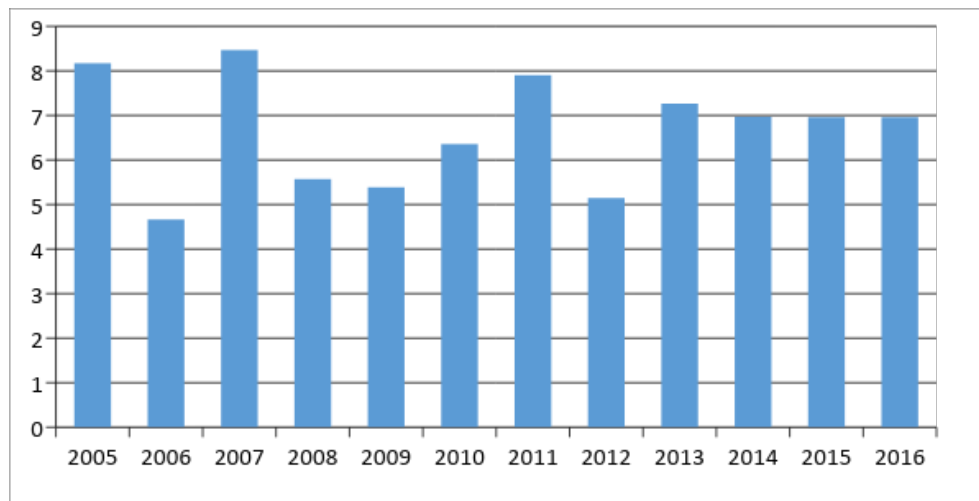
Figure 2: Tanzania GDP Annual Growth Rate (2005-2016)

d) *GDP per Capita*

In Tanzania, about US$872.294 was last recorded as the Gross Domestic Product per capita in 2015. It estimated that about 7% of the world average is equivalent to the GDP per capita in Tanzania. In 1994 according to the World Bank report, Tanzania record low GDP per capita with the average of US$159.636 and the high average of all time of US$872.294 in 2015. The GDP per capita average estimated from 1988-2015 in Tanzania was US$582.20. World Bank is responsible for reporting GDP per capita in Tanzania.
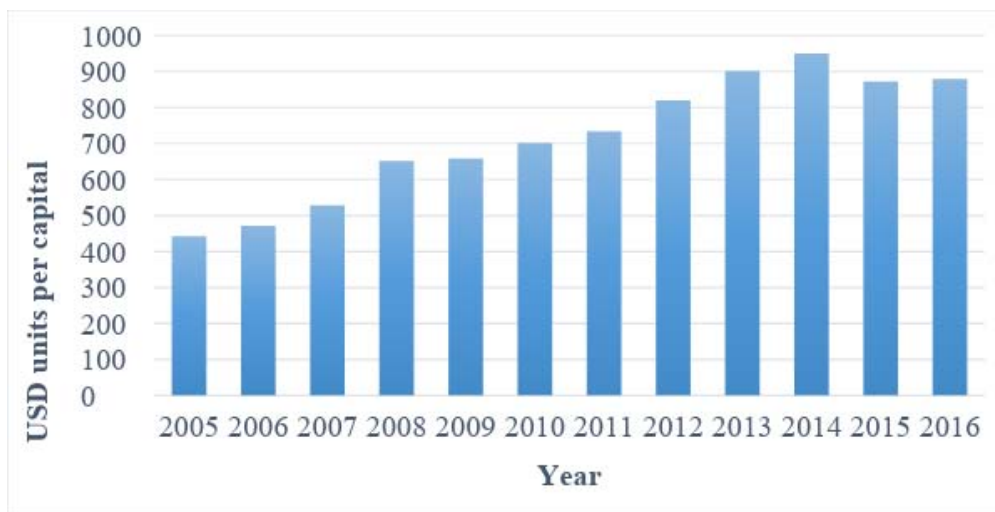
Figure 3: Tanzania GDP per capita (2005-2016)

e) *Imports*

It estimated an average of US$834.65 million that Tanzania imports for the period of 2006-2016 in which the low record was US$89.30 million in 2006 and the high record of all time were US$1339.30 million in 2011. In 2016 the average was increased to US$1030 million. Tanzania main partners countries for imports include China, India, Kenya, South Africa, UAE and among others. The imports mostly based on machinery, construction materials, oil, fertilizers, consumer goods and transport equipment.
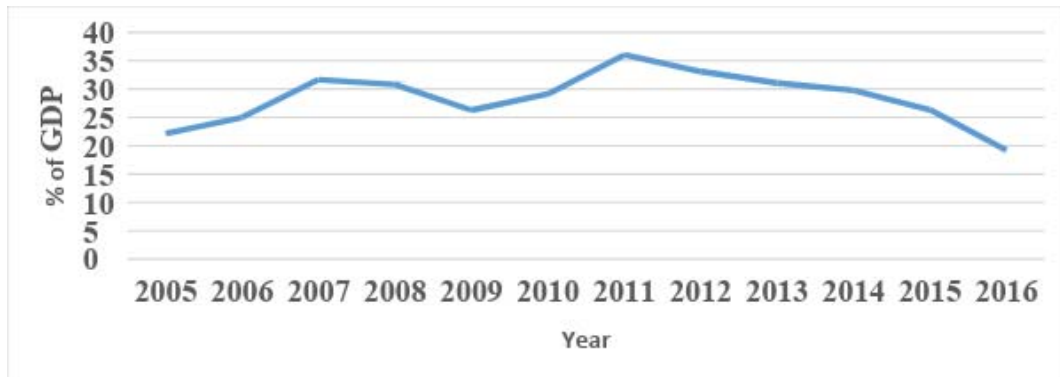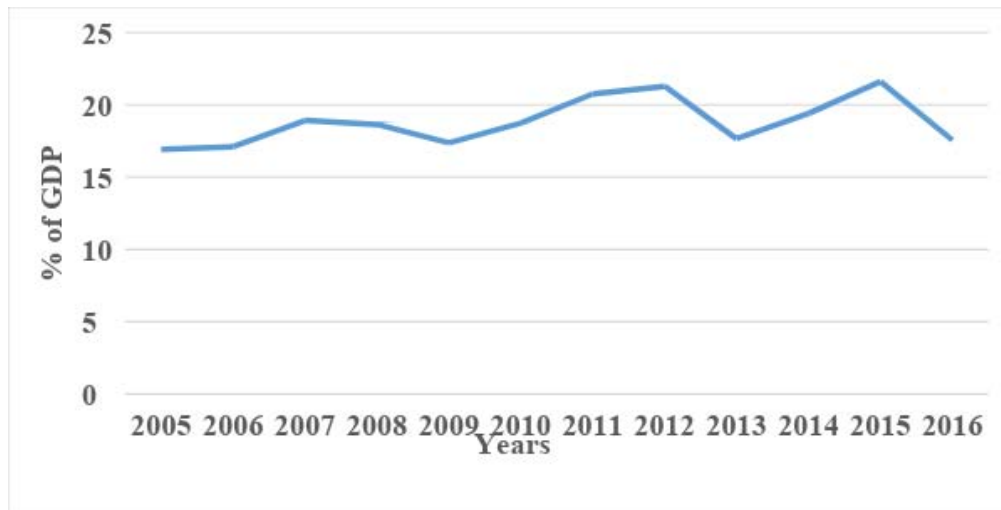
Figure 4: Tanzania Imports (2005-2016)

f)   Exports

In the period of 2006-2016, Tanzania's export average was about US$533.69 million. A low record was an average of US$228.70 million in 2006 and the high record of all the time was an average of US$995.30 million in 2016. Tanzania main partner countries for exports include Japan, India, UAE, Netherlands, German and China. Agriculture commodities are the main exports for Tanzania and it includes tea, tobacco, cashew nuts, coffee, cotton and among others.

Figure 5: Tanzania Exports (2005-2016)

g)   Inflation

Most countries including Tanzania measured inflation rate by looking at the consumer price index changes in percentage from one year to another year. The inflation rate around 2-3 percent per year considered to be very low to cause any problems for household and businesses in general so countries try to keep inflation somewhere around these percent. In 2015 the inflation value was 5.59% (consumer price annual %) and the high value of inflation of 36.15% in 1984 was the maximum value over the past 49 years and the minimum value was 3.49 % in 1970.
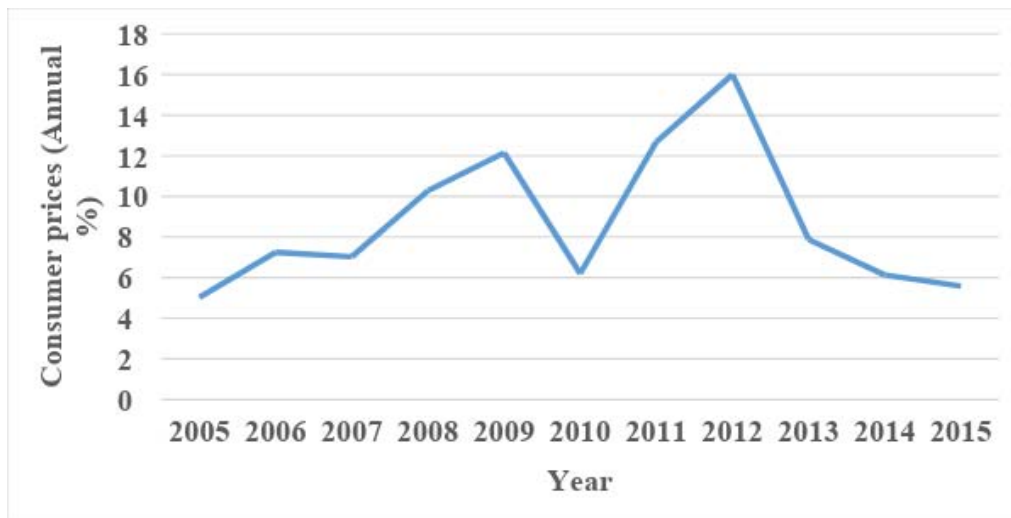
Figure 6: Tanzania Inflation rate (2005-2015)

h) FDI Inflows

There is a decrease of foreign direct investment inflow by 34 percent in Tanzania in 2015 from US$2.04 billion in 2014. In East Africa, Tanzania still remained the first receiver of foreign direct investment over the past two years. Recently due to the discovered of natural gas, the investment in Tanzania has largely increased across the country. South Africa, United Kingdom, Canada, and China are the most providers of foreign direct investment in Tanzania.
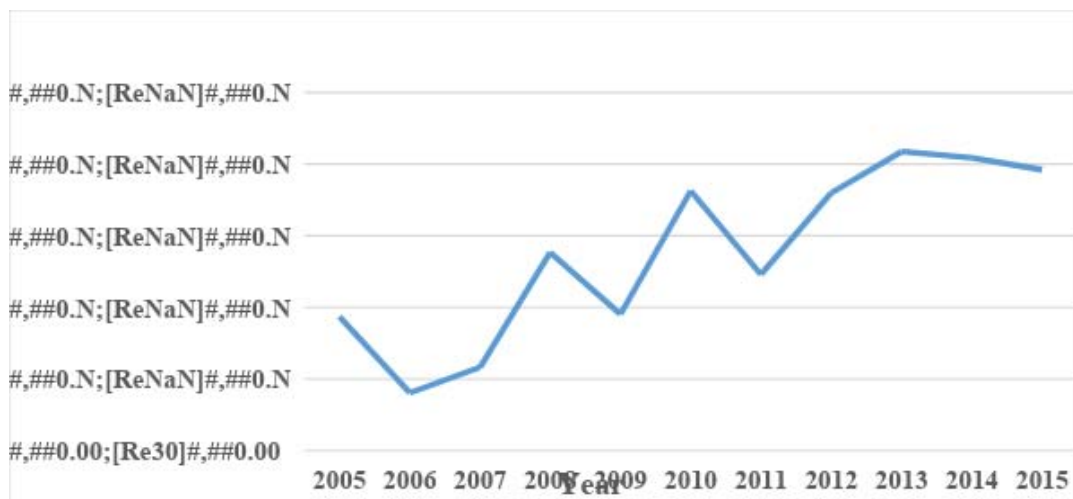
Figure 7: Tanzania FDI net inflows (2005-2015)

Chapter Three

III. Literature Review

a) Introduction

Several theories have explained the reasons why firms choose to locate in certain geographic areas but the lack of generally accepted theoretical framework has led many researchers to rely on empirical evidence for describing FDI's emergence. (Hymer 1960, Caves 1982 and Ajayi 2006) argue that there is no agreed model providing the basis for empirical work even if there has been considerable theoretical work on foreign direct investment.

b) Determinants of FDI: Theoretical overview
i. Eclectic Paradigm Theory

A most popular conceptualization and theoretical framework for determinants of foreign direct investment is the 'Eclectic Paradigm Theory' assign to Dunning (1993). It provides a framework for explaining and analyzing the determinants of international production. The framework proposes that firms invest abroad to look for three sets of advantages namely; Ownership advantage, the Internalization advantage, and the Location advantage. Location advantage theory provides a framework using three main categories that are economic, social or cultural factors and political

environment to identify important variables that attract foreign direct investment. Regardless of the disadvantage of being a foreign firm, Ownership specific advantages allow the firm to compete with others in the market it serves because it is able to have access to and exploit and export the resources based products and natural resources. Internalization advantage emerges from exploiting imperfection in the external market including reduction of transaction costs and uncertainty so as to generate knowledge effectively more together with the reduction of state generated imperfection such as foreign exchange control, tariffs, and subsidies.

Dunning (1998) also identified four types of motives for foreign direct investment that is resources seeking, market seeking and efficiency seeking. The market-seeking is concern about market growth, market size and per capita income which means that foreign direct investment is expected to go to those host countries that have high per capita income, large market size, and market growth. Resources -seeking means investors tend to invest their businesses abroad where there is the availability of cheap labor, raw materials, and natural resources in order to reduce the cost of production. Investors seek to maximize profit, therefore, FDI efficiency seeking is more likely to bring in technology and know-how which is well matched to the level of development of the host country so as to enable competitors and local suppliers to benefit from imitation and adaptation.

ii. *Product life cycle theory*

Product life cycle theory (Vernon 1966) gives a clear understanding on how and why export is replaced by foreign direct investment. The theory provides the significant contribution for the analysis of FDI as it analyzed four production stages that beginning with the creation of new product. His work was based on the United States companies for the domestic market and later on moved to international market. He tried to understand the reason for companies to shift to the international market and international investment. At the initial stage, firms try to focus more on the domestic market and when the product get matures, firms start exporting to developed countries. Firms standardized its product when the demand increases and in this stage, companies think to expand more of its production in less developed countries. Labour cost, transportation, economies of scale are among of determinant factors for location choice. According to Vernon, not only low-cost location is leading firms to decide and invest in other countries as he argued that any threat to the companies can be seen as the stimulating forces for the action.

iii. *Internalization Theory*

The functions and existence of Multinational companies have been briefly explained by Buckley and Casson in 1976 who has developed the theory called Internalization Theory. According to his theory, some transaction costs can be reduced by producing within a company rather than between companies, in other words, internalized operations. Through this, the return on assets (ROA) of the company will increase with fewer costs. The other reason of internalization is to replace the external markets which are imperfect. For example, Multinational companies from developed countries invest in developing markets where there is lack of skilled personnel. According to Krugman (2003), sometimes internalized operation may create conflict between buyer and producer especially when each party has the monopoly position and different ideas on product price setting.

iv. *Early Neoclassical Theory*

According to this theory of foreign direct investment, multinational companies (MNCs) relocate to capital-poor and backward technology countries from capital rich and advanced technology countries. Early neoclassical work on foreign direct investment allows the movement of international capital as the theory simply assume that the outflow of capital from a labour scarce and capital surplus economy like the United States to a labor surplus and capital scarce economy like Mexico will eventually lead to the development of both economies through equalization of interest and wages.

v. *Other Theories*

Aliber (1970) presented his theory of foreign direct investment on the basis of the strength of different currencies. It is one of the early attempt to explain foreign direct investment on the basis of the strength of currencies. Aliber forwarded his theory in term of currencies strength differences in host and source country. He suggested that in order to take advantage of the market capitalization rate, weaker currencies when compared with stronger investing country currencies, has higher opportunity to attract foreign direct investment. After tested his hypothesis he found the result to be constant with United States, United Kingdom, and Canada. Also the recent theoretical model of economic geography discussed by Amiti and Wei (2005) and Head and Mayers (2001) as quoted by Castro et al, (2007) which tries to explain the spatial location of foreign direct investment assume that Trans National Corporation (TNC) decides to locate its investment on certain province depending on some characteristics ofthat province in affecting firm's revenue or costs such as market size, income per capital, skilled labour, availability of public infrastructures and among others.

Also, other theoretical models which described the importance of foreign direct investment to the host country includes the Solow growth model as it suggests that foreign direct investment allows host country's

economies to increase investments which are higher than local saving and hence stimulating capital formation. This theory also explains that foreign direct investment has a positive impact on economic growth in a long term but only limited in a short run due to marginal diminishing returns to physical capital as the economy of the country would experience stable growth rate and appear as if foreign direct investment did not take place with no significant impact on growth (De Mello, 1999). The endogenous growth models also explain that it is important to improve technology, efficiency, and productivity in order for the foreign direct investment to be beneficial to growth the rate in generating the increased return through spillovers and externalities (Barro and Sala Matrin, 1997).

In short compared to other mainstreams theories such product life cycle theory, internalization theory etc. OLI theory provides more a comprehensive explanation of foreign direct investment as the theory combine ownership specific, location specific and internationalization factors to provide logic and benefits of international production. According to Shenkar (2007), the eclectic theory is still able to explain the patterns of foreign direct investment despite the difference of the modern multinational enterprise behavior and the international business environment from what they were in several decades ago. Therefore the empirical part of this study mainly relies on OLI paradigm theory as it is most recent and covers all the mainstream theories of foreign direct investment. In addition to that, the benefit of using Dunning's theory as the framework for empirical studies of foreign direct investment is due to its flexibility as it allows different factors to be considered as determinants of foreign direct investment depending on the investment decision of multinational enterprises.

c) Determinants of FDI: Empirical Overview

There have been many empirical studies on the determinants of foreign direct investment covering various scope. Researchers have used different sample countries, period, variables and methods in examining the factors that attract foreign direct investment. Some studies in order to get a deeper understanding of the factors influencing foreign investors decisions used macro firm level data while others have tried to look into bilateral foreign direct investment flows between countries. Also, some studies tried to look at whole or aggregate foreign direct investment inflows into a host country or a panel data of countries. The use of different methods or approaches mainly depended on the availability of data, time etc. Scholars tested different variables such as market size, trade openness, inflation, exchange rates, infrastructure, government policies, natural resources among others to see whether these variables have positive or negative significant or insignificant effect to FDI inflow into the host country but

some of their empirical results are conflicting each other. The aim of this study is not to resolve the conflicting empirical results but to examine the extent to which the variables that were included in previous studies explain the difference in foreign direct investment for my sample and analyze whether these variables have the different effect on FDI inflow into Tanzania.

i. *Trade Openness*

Several empirical studies find that country with higher degree of trade openness attracts more foreign direct investment. Chakrabarti (2001) found that openness to trade which is measured by imports plus exports to GDP has been positively correlated with foreign direct investment. For a sample of 29 African countries, Morisset (2000) found a positive and significant correlation between the investment climate and trade openness. Bende-Nabende (2002) by studying the most factors that significantly influence long-term investment decision process of investors in 19 SSA countries found that trade openness, market growth and liberalization as the most important long-term determinants of FDI.

Kandieru and Chitiya(2003) also found that there is a significant relationship between FDI inflows and openness to trade after analyzing the impact of openness on foreign direct investment in 51 African countries. Salisu (2003) found that trade openness has the positive and significant effect on foreign direct investment in Nigeria. Asiedu (2002) also comes to the same conclusion for SSA countries by using import and export to proxy openness to trade. Vijayakumar et al. (2010) found that trade openness has a significant impact on FDI inflows into BRICs. Therefore the empirical evidence supportsthe openness to trade as an important determinant of FDI inflow.

ii. *Exchange Rate*

The exchange rate has also been considered to be an important variable in determining the inward foreign direct investment into a country. Kandiero and Chitiga (2014) found a negative correlation between foreign direct investment inflows and real exchange rate appreciation after examined 38 African countries. Coleman and Tettey (2008) tried to examine the relationship between exchange rate volatility and foreign direct investment inflows in Ghana. Their empirical results found that volatile exchange rate has a negative effect on FDI inflows which means that volatility of exchange rate which is a measure of risky reduces the inflow of foreign direct investment into the country. They conclude that exchange rate plays an important role in attracting foreign direct investment. Also in the analysis of 11 Sub Saharan African countries (Yasin, 2005) found that exchange rate has a positive and significant effect on FDI flows. Bende-Nabende (2002) after investigating the macro locational determinants of foreign direct investment for the case of 19 SSA countries his findings

suggested that the real effective exchange rate hasa positive co-integration with the inflow of foreign direct investment.

Another recent study done by Vijayakumar, Sridharan and Rao, (2010) when tried to examine the factors influencing the inflows of foreign direct investment into BRICs countries found that currency value is among of the important factor of FDI inflows.

iii. *Inflation*

As foreign companies enter into a long-term contract in the host country, high rate of inflation can be a cost of doing business. Foreign firms may lose out when actual rate of inflation turned to be very different from the anticipated rate of inflation as their purchasing power declines. Hailu (2010) found that high rate of inflation has a negative effect on attracting inflows of foreign direct investment. Twimukye (2006) also found that high rate of inflation has a negative relationship with foreign direct flows into Africa. Naude and Kruggell (2007), as well as Onyeiwu and Shrestha (2004), found that inflation is among of the significant variable which attracts foreign investors who want to invest in Africa.

Low level of inflation has a positive impact on foreign direct investment flows into Sub Saharan Africa according to the finding from (Asiedu 2006). Also, Nonnemberg and Mendonca (2004) found that there is a correlation between foreign direct investment and level of inflation in developing countries as the country with a low level of inflation is likely to attract more foreign investment inflows because it indicates an economy has sound macroeconomic policies. Wadhwa and Reddy (2011) focused on three motives of investment in examining the determinants of foreign direct investment in 10 Asian countries and results suggest that efficiency seeking factors which include inflation positively affect FDI inflows.

iv. *Market Size*

If foreign investors want to sell their products in the host country, large domestic markets are found to be important in encouraging the inward of foreign direct investment. Market seeking foreign direct investment has been increased over the years. In African countries due to increase in population as well as economic growth become an incentive for foreign companies to make market seeking investment in the continent. Ezeoha and Cattaneo (2012), as well as Asiedu (2006), found that large local market issignificant in encouraging foreign direct investment into SSA countries. Tarzi (2005) who made a research on foreign direct investment into developing countries found that market size is considered to be an important factor for foreign investors. Any anwu (2012) found positive relationships between market size and flow of foreign direct investment into Africa which was measured by using urban population size.

Mohamed and Sidiropoulos (2010) also found that the size of the economy attracts foreign direct investment flows into the Middle East and North African (MENA) by using the panel of 36 countries. Nabende (2002) finds that in Sub Saharan African growing markets are the long run- determinant of foreign direct investment based on analysis of 19 countries. Chakrabarti (2001) after investigating the determinants of foreign direct investment in developed and developing countries conclude that market size of the host country measured by GDP per capita has a positive and significant impact on FDI. Vijayakumar, Sridharan and Rao (2010) the annual data set to examined the factors determining the inflow of foreign direct investment into BRICs countries and they found market size to have a positive significant impact on foreign direct investment inflow into those countries and also similar results have been obtained by Ranjan and Agrawal (2011) who studied the same issue in BRICs countries.

d) *Other determinants of FDI*
i. *Infrastructure*

Infrastructure is also among of the important factor that influencing FDI flows in the host country as it reduces the operating costs of doing businesses. Bartels, Alladina, and Lederer (2009) find that infrastructure is one of the motivating factors that encourage FDI inflow in Sub Saharan African countries and also the study conducted by Asiedu (2006) find the similar result to the same countries. In addition, in order to cut down the transaction costs faced by foreign investors, the host country government needs to improve the quality of its infrastructure as Dupasquier and Osakwe (2006) find that one of the reasons Africa to receive low levels of foreign direct investment compare to other developing countries is due to poor infrastructure. Not all researchers, however, find infrastructure to be a significant factor. Onyeiwu and Shrestha (2004) after examining 29 African countries found that infrastructure has an insignificant impact in attracting FDI flows. They find that factors such as natural resources, openness to trade and other macroeconomic factors may be more significant to attract foreign investors.

ii. *Natural Resources*

There are several studies found natural resources to be one ofthe factor the that attracting foreign direct investment inflow into the country. For example, in Africa, natural resources attracted many foreign investors and this can be supported by the research which was undertaken by Asiedu (2006) who find the natural resources availability encourage foreign direct investment inflows into Sub Saharan Africa countries. He also finds that countries with limited availability of natural resources must improve their institutions by ensuring that laws are well enforced so as

to obtain inward foreign direct investment. Also, Mohamed and Siridipoulos (2010) find that natural resources are an important factor of foreign direct investment inflow into the Middle East and North Africa. Another study conducted by Anyanwu (2012) who examined fifty-three African countries finds that oil which is part of country's natural resources attract foreign direct investment inflow into Africa. According to Hailu (2010) after examined the determinant of FDI inflows into the African nation found natural resources to be a significant factor.

iii. Government Policies

Government policies have been also considered as the factor that attracting foreign direct investment inflow into a country. This can be supported by Asiedu (2010) who finds that government policy is an important determinant of foreign direct investment inflow into Sub Saharan Africa countries. Tax rebates, tax holidays, infrastructure investments are among of incentives that government can offer to potential foreign investors. Also, government policy that aims to improve the skills of labor through training attracts foreign investors. The government must also ensure that there is transparency in the economy.

There are many factors that encourage the inflow of foreign direct investment into the host countries and different results have been obtained from different empirical studies. The most measured variables include market size, infrastructure, trade openness, labor costs, foreign aid, human capital, financial development, exchange rate, market stock, inflation, international interest rate, government policy, total factor productivity and economic growth. Each of these variables according to the evidence from empirical review varies across the countries, regions, methodology and time. According to Ericsson and Iran oust (2010), there are very few studies that are relating to the group of countries that belong to economic blocs in Africa region, therefore, this study intends to accompany the existing literature by examining the determinants of foreign direct investment inflow into Tanzania.

Chapter Four

IV. Research Methodology

a) Model Specification

The time series data issued in this study to represent both independent and dependent variables. The multiple- regression model is used to analyze the time series data. The study analyses the relationship between foreign direct investment inflow and its determinants. The study model demonstrates foreign direct investment inflows (FDI) as the function of the exchange rate (EXCHR), inflation rate (INFL), openness to trade (OPEN) and market size (MRT). In order to avoid the problem of heteroscedasticity, both the

Below is the multiple regression models estimated to test the mentioned-hypotheses in this study.

$$FDI = f(EXCHR, INFL, OPEN, MRT,) \dots\dots\dots\dots\dots\dots\dots \quad (1)$$

$$FDII = \beta_0 + \beta_1 EXCHR + \beta_2 INFL + \beta_3 OPEN + \beta_4 MRT + \mu \dots\dots (2)$$

Where:
β_0: Constant amount
$\beta_1 - \beta_4$: Coefficients of the variables
μ: Error term
FDII = Foreign direct investment inflows
EXCHR = Exchange rate
INFL = Inflation rate
OPEN = Openness to trade
MRT = Market size

b) Variable Definition

i. Independent Variables

Independent variables are those variables that can influence the dependent variable in two ways that are either in a negative or positive way which implies that the dependent variable variance is considered for by the independent variables so in such case it gives a casual relationship between the two variables. In this study exchange rate, inflation rate, market size, and openness to trade are independent variables that influencing the dependent variable which is foreign direct investment.

ii. Dependent Variable

The dependent variable is considered as the variable of primary interest to the researchers because it is possible to find out the solutions of a certain problem through its analysis. A foreign direct investment inflow is the dependent variable which is attracted by the independent variables mentioned above.

c) More Explanation of the Independent Variables

i. Openness to trade (OPEN)

The inflows of foreign direct investment into host country depends upon the openness of the economy as the more open the economy of the country become the more easily to do business and thus enhance foreign direct investment inflows. Countries that are practicing the free trade policies will encourage more foreign capital inflows compared to those countries that implement restricted policies on trade as will eventually discouraging foreign direct investment inflows.

ii. Exchange rate (EXCHR)

Exchange rate volatility in the host country makes the foreign investor's decisions more difficult due to the increases in exchange rate risk. This is because the volatility increases the exchange rate risk. Therefore exchange rate volatility reduces the inflows of foreign direct investment into the host country.

iii. Inflation (INFL)

Inflation is also considered as one of the factors of foreign direct investment inflow by many previous

research studies. A country with the higher level of inflation will find it difficult in attracting foreign direct investment inflow compares to the country with minimum inflation rate level. Most foreign investors prefer those countries with the low inflation rate.

iv. *Market size (MRT)*

Most foreign investors are more attractive to countries with the large market size compare to those with small market size. For example countries like India, Nigeria and China managed to influence the foreign capital inflow into their economy due to large market size. The size of the market in the country can be measured in term of GDP per capita.

v. *The Study Hypotheses*

In order to examine the determinants of foreign direct investment inflows into Tanzania, the following hypotheses were designed and will be used for testing:

H1: There is a positive significant relationship between openness to trade and foreign direct investment inflows.

H2: There is a positive significant relationship between inflation rate and foreign direct investment inflows.

H3: There is a positive significant relationship between market size and foreign direct investment inflows.

H4: There is a positive significant relationship between exchange rate and foreign direct investment inflows.

This study hypothesizes the expectation of positive significant relationship between foreign direct investment inflows into Tanzania and the market size, trade openness, exchange rate and inflation rate.

d) Technique of Data Analysis and Sources.

This study uses annual time series data for the figure related to foreign direct investment inflows together with the macro- economic variables covering the period between1990-2015. The study selects the four important variables based on availability of data for the period covered and to include many variables does not mean the model will be the best as sometimes more variables can make it difficult in getting the dynamic relationships of the most significant variables. Also, most of these data in this study were collected from the World Bank Development Indicators.

Data related to foreign direct investment inflows into Tanzania is measured by the current price in US dollars which is proxied by the natural logarithm of total annual foreign direct investment net inflows. Market size (MRT) is proxied by the GDP per capita for the period of study. Openness to foreign trade is captured by the ratio

of imports plus exports to GDP which is denoted as (OPEN). Exchange rate (EXCHR) is stated by conversion rate from Tanzania shillings to US dollars. The inflation rate (INFL) is captured by changes in consumer price level annually in percentage.

First, unit root test is used to check the stationary nature of the variables used for this study. The unit root test shows how variables have to be a difference in anumber of times so as to come to a stationary state. According to classical economic theory variables that are to be differenced in order to achieve the value of stationary are known as 1 (1) and those which are stationary are known as 1 (0) series.

Ordinary least square (OLS) multiple regression analytical method will also be used to estimate the equation. The reason of using this technique is due to its unbiasedness, simplicity, efficiency, minimum variance and it has been used by many researchers in their previous studies and results were meaningful.

The ordinary least square technique is considered as the simplest technique of linear regression to use and easy to understand. The aim of ordinary least square technique (OLS) is to fit the function with the data and minimization of the sum squared errors from the data. The correlation matrix is also employed in this study so as to test if the selected variables are correlated.

Chapter Five

V. Data Analysis

a) Empirical Results and Discussion

The study will use correlation analysis, descriptive analysis, unit root testing and regression analysis so as to come up with the concluding results.

b) Descriptive Statistics

The Table 1 below indicates the descriptive statistics of both variables (independent and dependent). The descriptive statistics in this study indicates the mean, median, maximum, skewness values, minimum and standard deviation of the 26 observation related with each of the variables (both dependent and independent) selected in the study. All figures indicated are not shown with their exactly amounts as they are all plotted in natural logarithms of the original amount in thousands and in millions.

Table 1: Descriptive Statistics of the variables

	FDII	EXCHR	INFL	MRT	OPEN
Mean	19.008	6.731	2.382	5.913	3.843
Median	19.931	6.909	2.197	5.754	3.869
Maximum	21.459	7.596	3.578	6.856	4.18
Minimum	9.210	5.273	1.555	5.047	3.511
Std. Dev.	3.190	0.624	0.675	0.600	0.183

Skewness	-2.279	-0.854	0.408	0.126	0.186
Kurtosis	7.517	2.931	1.729	1.687	2.416
Jarque-Bera	44.619	3.166	2.471	1.935	0.520
Probability	0.000	0.205	0.290	0.379	0.770
Sum	494.219	175.013	61.947	153.759	99.934
Sum Sq. Dev.	254.473	9.760	11.411	9.009	0.839
Observations	26	26	26	26	26

Positive and negative skewness in the above table indicates that the results or outcomes are almost or not normally distributed and the low standard deviations indicate that variables are largely in the same range of value.

c) Correlation Analysis

In this study, the correlation coefficient analysis will help to determine the relationship between the dependent and independent variables so as to test the hypotheses. The correlation coefficient will measure the degree of multi co linearity of the variables that are selected in this study. According to Gath go and Ragui (2014), the correlation matrix is used also to determine the most significant variables among the hypothesized selected independent variables. Therefore the correlation test in this study will help to determine which variables are more significant to the dependent variable.

Table 2: Correlation Analysis

Correlation					
t-Statistic					
Probability	FDII	EXCHR	INFL	MRT	OPEN
FDII	1.000				

EXCHR	0.902	1.000			
	10.210	-----			
	0.000	-----			
INFL	-0.674	-0.738	1.000		
	-4.468	-5.365	-----		
	0.000	0.000	-----		
MRT	0.680	0.893	-0.597	1.000	
	4.541	9.696	-3.647	-----	
	0.000	0.000	0.001	-----	
OPEN	-0.132	-0.138	0.614	-0.109	1.000
	-0.653	-0.683	3.814	-0.536	-----
	0.520	0.501	0.000	0.597	-----

Sources: Calculated from data used for analysis

The above Table shows that Exchange rate (EXCHR) has the most positive significant correlation with foreign direct investment inflows (FDII). Market size (MRT) also found to have the strong correlation with foreign direct investment inflows. Inflation rate (INFL) found to have the highest negative correlation with FDI inflows. Lastly, openness to trade has seemed to also have a negative correlation with foreign direct investment inflows. The problem of multi co linearity arises only when there is the existence of the high correlation between two independent variables and the result of this problem will make the significant variable to be insignificant as it will increase the standard error of the variable. In such case if the standard error goes up, t- value will go down and hence come up with the high p-value. Therefore that particular variable becomes insignificant but in a real situation, it is not insignificant. It is bad to have a relationship between independent variables but it is good to have a relationship between dependent variable and independent variables. Only two variables (exchange rate and market size) were found to have a high positive correlation with foreign direct investment inflows. The exchange rate has 90 percent correlation with FDI which is the very strong relationship while market size has almost 68 percent correlation with FDI which is considered as the strong relationship.

d) Unit Root Test

In order to test the significance of the independent variables in this study, we used the technique which was done by Dickey Fuller in 1976. There might be autocorrelation problem for the case of Dickey Fuller Test therefore in order to tackle the problem of autocorrelation Dickey Fuller developed a test called Augmented Dickey Fuller Test (ADF). This helps to know whether the variable is stationary or not stationary. The null hypothesis indicates no stationary of the variable which means the variable has a unit root while the alternative hypothesis indicates the variable is stationary. Also, the ADF test statistics will be compared with the critical value. In this case, we will only reject the null hypothesis if the t-statistics is more than the critical value. On the other hand, if the probability value (p-value) is greater than the critical value which usually at level 5% it means we cannot reject the null hypothesis of non-stationary.

Table 3: Augmented Dickey Fuller tests for stationary at level

Variables	P- value	Nature
Exchange rate (EXCHR)	0.0924	Non stationary
Inflation (INFL)	0.4028	Non stationary
Market size (MRT)	0.9410	Non stationary
Openness to trade (OPEN)	0.2039	Non stationary
FDI inflow (FDII)	0.9119	Non stationary

The unit root results from the above table indicat hat all the variables are not stationary which means each variable got a unit root therefore in order to achieve the stationary of the variable we tested for the unit root in first and second difference.

Table 4: Augmented Dickey Fuller tests for stationary at first difference

Variables	P- value	Nature
Exchange rate (EXCHR)	0.0005	Stationary
Inflation (INFL)	0.0011	Stationary
Market size (MRT)	0.0349	Stationary
Openness to trade (OPEN)	0.0058	Stationary
FDI inflow (FDII)	0.0006	Stationary

The results from the above table indicate that the Augmented Dickey Test statistics (p-value) for all the variables are less than critical value usually at level 5% meaning that we reject the null hypothesis of non stationary and accept the alternative hypothesis that the series is stationary therefore Ordinary Least Square (OLS) regression model can be conducted as the result will not be spurious

e) Regression Analysis

In order to estimate the relationship between dependent and independent variable, this study also employs the statistical tool called multiple regression analysis so as to determine the factors that influencing foreign direct investment inflows into Tanzania. R-square, Durbin-Watson, and P-value in this model are used for making a decision based on the results. P-value will be much used for testing the hypotheses in this study so as to know if the tested hypotheses must be rejected or accepted.

A p value less than or equal to 10 % indicates that the hypothesis is accepted at 10% level of significance. A p value less than or equal to 5% indicates that the hypothesis is accepted at 5% level of significance. A p value less than or equal to 1% indicates that the hypothesis is accepted at 1% level of significance. When the hypotheses are rejected, it implies that alternative ones have to be accepted. The adjusted R-square in this study is used to determine the goodness fit of the model. Durbin-Watson statistic in this study will help to test the serial correlation in the errors of a multiple regression model. The table below indicates the regression results of this study.

Table 5: Regression results by using Ordinary Least Squares Method (OLS)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-11.484	5.684	-2.020	0.0563
EXCHR	8.186	1.128	7.255	0.0000
INFL	0.801	0.806	0.993	0.3315
MRT	-3.503	0.870	-4.024	0.0006
OPEN	-1.509	1.981	-0.761	0.4545
R-squared	0.8944	Mean dependent var.		19.008
Adjusted R-squared	0.8743	S.D. dependent var.		3.1904
S.E. of regression	1.1310	Akaike info criterion		3.2551
Sum squared residual	26.864	Schwarz criterion		3.4971
Prob.(F- statistic)	0.0000	Durbin-Watson stat	istic	1.7990

Sources: Calculated from data used for analysis

i. Interpretation of Regression results

Based on table 5 above, it shows that the negativesignificant relationship exists between the dependent variable (FDII) and market size (MRT) with the p-value of 0.0006 at level 1%. This indicates that small market size decreases the amount of foreign direct investment inflows into the country. In this case, the third hypothesis (H3) that there is a positive significant relationship between market size and foreign direct investment inflow is rejected. In this situation also the variable found to be significant but with the negative sign so this implying that the sign might be caused by the proxy that was used to estimate the variable but since the variable found to be significant it indicate that the variable is still important for Tanzania as the determinant of foreign direct investment inflows.

Exchange rate (EXCHR) in this study shows the positive sign and significant relationship with foreign direct investment inflows into the country with the p-value of 0.0000 at level 1%. The fourth hypothesis that

there is a positive significant relationship between exchange rate and foreign direct investment inflow into the country is accepted. This can also be supported by some scholars such as (Yasin, 2005), Bende-Nabende (2002) and Vijayakumar, Sridharan and Rao (2010) who found the positive significant relationship between foreign direct investment inflows and exchange rate.

Inflation rate and trade openness to trade were all found to be insignificant and therefore the first and second hypotheses (H1 and H2) that there is the positive significant relationship between these two variables and foreign direct investment inflows are rejected. Since openness to trade and inflation are statistically insignificant therefore they will not be included as the determinant of foreign direct investment inflow into the country.

Also since the general Prob. F-Statistics found to be statistically significant at level 1%, therefore, this indicates that independent variables can jointly attract dependent variable. The Adjusted R- Squared value of 0.874325 implies the good fitness of the study model. Durbin- Watson value of 1.798977 also indicates the non-existence of autocorrelation in the data.

Chapter Six

VI. Conclusion and Policy Recommendation

a) Conclusion

The main reasons for conducting this study was after finding out that Tanzania has been experienced the high fluctuation of foreign direct investment inflows. Also, the high significance level of foreign capital inflows into other developing countries and some emerging economy such as India, China, and Nigeria is among of the reason for conducting this study. There are numbers of policies and programs that the government has been put in place and implemented since 1980 so as to promote and attract foreign direct investment inflow into the country but still, much effort is needed to be done by both policy makers and responsible authorities to ensure the investments environment are good for foreign investors.

By using the ordinary least square method to analyze the time series of 26 years data (1990-2015) the results showed that exchange rate (EXCHR) to be the key determinant of foreign direct investment into the country. Market size (MRT) found to be significant at level one percent but with the negative sign which was opposite to our expectation implying that the small market size reduces the inflow of foreign direct investment into the country.

The study also did not find any significant relationship between openness to trade with foreign direct investment inflows into the country and in such case, it implies that despite effort made by the government towards trade liberalization but still the policy did not play a significant role in attracting more foreign investors into the country. Inflation rate also found to be statistically insignificant though positive related to foreign direct investment inflows. In this study, many variables were dropped from the investigation list due to various reasons such as unavailability of data, limited time, variables similarity and some variables to be irrelevant to Tanzania.

b) Policy Recommendations

Foreign direct investment as already mentioned earlier play an important role in the economy in term of the creation of employment, transfer of new technology which in general enhance the economic growth and improve the living standard of the people in the country. The main recommended policies for the policy makers and the government include the following;

First after seen the exchange rate to have a positive impact on foreign direct investment inflow into the country, it indicates that fluctuated exchange rate policy adopted by the government increases the inflow of foreign direct investment for the period of the study, therefore, the policy makers should continue to adopt the effective policy measures so as to attract more foreign investors for generating new employment for the people in the country.

Second since the results found market size to be significant with foreign direct investment inflows to Tanzania but with the negative sign, it indicates that small market size discourage the inflows of foreign direct investment into the country, therefore, the government should make more efforts to ensure that the market size is expanded so as to attract more FDI inflows to Tanzanian economy.

c) For future research

This study used the ordinary least square (OLS) method which is the simple technique of estimation for about 26 years of the sample period of study. Therefore further research studies are needed on the determinant of foreign direct investment inflows by using other measuring methods or techniques and also because this study investigates only four variables towards foreign direct investment inflows, further studies should rely on other variables such as labour cost, infrastructures, political instability, natural resources, human capital development and taxation so as to ensure the maximum exhaustion and exploration of the factors that can give the strong results. These important variables were not included in this study due to some reasons such as unavailability of data,the reliability of data, limited time and sample period size used. All the mentioned reasons present the limitation of the study.

Also since the government of Tanzania have been adopted different macro economics reforms and programmes to promote foreign direct investment in the country, no or little research has been done so far to

assess the impact and significance of these promotional programmes as a key tool for influencing foreign direct investment inflow into the country, therefore, necessary research has to be done in this area of study by the other researcher in their future research.

VII. Declaration

I hereby declare that the work has been done by myself except quotation and citations, which have been duly acknowledged, and no portion of the work contained in this Thesis has been submitted in support of any application for any other degree or qualification on this or any other university or institution of learning.

Rashid Ismail Mfinanga

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Dedication

I dedicate this project report to my family and friends who have been a source of inspiration and support all through my life.

Abbreviation
ADF- Augmented Dickey Fuller
ATPC- Africa Trade Policy Centre
EPZs- Export Processing Zones
GDP- Gross Domestic Product
FDI- Foreign Direct Investment
OLS- Ordinary Least Square
TIC- Tanzania Investment Centre
IPC- Investment Promotion Centre
TNC- Trans National Corporation
MNCs- Multinational Companies
SSA- Sub Sahara Africa Countries
ROA- Return on Assets
UNCTAD- United Nations Conference on Trade and Development

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54

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