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DETERMINANT OF FOREIGN DIRECT INVESTMENT IN TANZANIA

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Abstract

This study examined the determinants of foreign direct investment (FDI) in Tanzania from 1991 to 2021 using time series data from the Tanzanian Central Bank. The Auto Regressive Distributed Lag (ARDL) co-integration test established long-run relationships, while the Error Correction Model (ECM) estimated both long-run and short-run coefficients. The findings indicate that GDP, openness, exchange rate, and inflation significantly impact FDI. The 69% speed of adjustment suggests a quick recovery from short-term shocks. Long-run structural stability was observed in these variables' contributions. Policy implications highlight the need for the Tanzanian government to enhance GDP, promote openness, manage exchange rates, and control inflation to attract more FDI. While these factors explain 95% of FDI variations, additional variables could further optimize inflows, necessitating continuous policy refinement.

Keywords: Autoregressive, Exchange rate, Foreign Direct Investment, Inflation rate, Trade openness.

JEL Code: F21, G11, O16.

1.0 Introduction

Foreign Direct Investment (FDI) serves as a critical driver of economic development in any country, including Tanzania. FDI plays a vital role in enhancing investment levels, which is a prerequisite for economic growth and development (Suresh & Ramakrishna, 2013). It contributes to economic advancement through two primary channels. First, by facilitating capital accumulation, FDI introduces new inputs and advanced technologies

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into the host country's production processes. Second, it transfers new knowledge by enhancing labor skills through training, managerial expertise, and technological acquisition, a phenomenon known as the positive spillover effect of FDI (Toulaboe, Terry & Johansen, 2009).

However, the impact of FDI on economic growth varies across host countries. While FDI has yielded positive outcomes in many countries that have embraced it (Toulaboe et al., 2009), the volume and direction of FDI inflows differ across regions, raising concerns about sustainability. These variations can be attributed to differences in institutional frameworks and country-specific factors such as human capital, trade openness, infrastructure investment, financial structures, and natural resource endowments. Other determinants include political and social stability, export shares, population growth, inflation rates, and government expenditures (Toulaboe et al., 2009).

Empirical evidence supports the role of FDI in stimulating economic growth, which depends on a favorable business environment and the host country's capacity to absorb new technologies. UNCTAD (2006), as cited in Toulaboe et al. (2009), noted that only one-third of FDI inflows in 2006 were directed toward developing countries. However, following the 2008 global financial crisis, Tanzania experienced a significant improvement in FDI inflows. Reports from the Bank of Tanzania (BoT), National Bureau of Statistics (NBS), and Tanzania Investment Centre (TIC), cited in Ngowi (2012), indicate that FDI inflows surged sixteenfold from USD 47 million in 2009 to USD 768 million in 2010.

Tanzania has emerged as one of Africa's top FDI destinations, ranking among the ten largest recipients of FDI on the continent (UNCTAD, 2022). According to the 2022 World Investment Report, FDI inflows into Tanzania increased from USD 685 million in 2020 to USD 922 million in 2021. The total stock of FDI in 2021 stood at USD 17.1 billion, accounting for approximately 24.4% of Tanzania's GDP. The manufacturing, mining, and energy sectors have been the primary beneficiaries of FDI, with agriculture, tourism, and infrastructure also attracting significant investments. Major investing countries include India, Kenya, China, the United Kingdom, Mauritius, Oman, the United Arab Emirates, Canada, the United States, the Netherlands, South Africa, and Germany (Invest Tanzania).

Given these trends, it is essential to examine the determinants of FDI in Tanzania using cointegration and the Vector Error Correction Model (VECM). This analytical approach effectively identifies both long-run and short-run factors influencing FDI inflows. With the recent surge in investor interest in Tanzania, as highlighted by the Tanzania Investment Centre (TIC), such an analysis will provide valuable insights for policymakers and investors.

The remainder of this study is organized as follows: Section Two reviews the relevant literature, Section Three outlines the methodology used in estimating the econometric

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model, Section Four presents data analysis and interpretation, and Section Five concludes with recommendations.

2.0 Literature review

The determinants of FDI inflows in developing countries vary significantly across nations and are influenced by multiple factors, including population growth, inflation, exchange rates, infrastructure quality, market size (proxied by GDP or RGDP), trade openness, political and social stability, institutional frameworks, natural resource endowments, energy sources, and government expenditure. However, empirical findings on these determinants have yielded conflicting results, with certain factors proving more influential in some countries while being less significant in others. The reasons for these variations remain unclear in the literature and require empirical investigation.

Several studies have examined the relationship between FDI and exports in Tanzania (see Fintan, 2014; Mbelle, 2016). Fintan (2014) analyzed the long-term relationship between FDI and export performance using co-integration analysis and found evidence of a bi-directional causality between the two. Similarly, Mbelle (2016) explored the transformation of Tanzania's manufacturing sector within the broader context of global development paradigms and national policy. His findings indicate a positive relationship between FDI and the value of manufacturing exports.

Empirical research has also shown a steady increase in FDI inflows across many African countries over the years (Dupasquier & Osakwe, 2005; Ndikumana & Sarr, 2016; Gamariel & Hove, 2019). In Tanzania, FDI inflows rose significantly from less than $2 million between 1986 and 1991 to $6 billion between 2000 and 2011. Since then, annual FDI inflows have continued to grow, with a notable increase of 46.4 percent in 2012, reaching USD 1,799.6 million from USD 1,229.4 million in 2011. This made Tanzania the leading FDI destination in the East African Community in 2012. By 2018, FDI inflows stood at USD 1.1 billion (Tanzania Investment Report, 2013; World Investment Report, 2019). The key sectors attracting FDI over the past decade have been mining and quarrying, manufacturing, gas and electricity, as well as finance and insurance.

Several studies have cited the market size of the host country which is measured by the Gross Domestic Product (GDP), this is because GDP is an important determinant of FDI inflows (Raggazi, 1973; Moore, 1993; Wang & Swain, 1995; Chakrabarti, 2001 and Masayuki & Ivohasina, 2005). However, the market size may be less influential if the host country is only used as a production base due to the low cost of production for export purposes or for her home market (Agarwal, 1980). Bajo-Rubia and SosvillaRivero (1994) and Yin Yun Yang et al. (2000) found that inflation is also a factor that influences FDI. Another factor that determines FDI inflows is exchange rate. Foreign investors can take advantage of a country's exchange rate. For instance, if the foreign exchange of a country depreciates, this would attract FDI since foreign firms

may merge with or acquire domestic industries (Masayuki & Ivohasina, 2005). However, Benassy-Quere, Lionel & Lahreach-Revil (2001) argued that the effects of the level of exchange rates on FDI inflows are rather ambiguous. According to Harvey (1990), in the long-run, exchange rate volatility has more negative effect than positive effects in attracting FDI. Goldberg and Kolstad (1994) discovered that high exchange rate variability inhibits FDI inflows between the United States and Canada, and Japan and United Kingdom.

Focusing on the East African countries like Kenya, Elijah (2006) employed the use of an econometric model to regress FDI on explained variables that include human capital, real exchange rate, annual inflation and openness of the economy. In the short run, the author found that economic openness and human capital have a positive impact on FDI inflows. Conversely, inflation and real exchange rates negatively affect FDI inflows in the short and long run, respectively.

Fuat and Ekrem (2002) analyzed location-specific factors influencing FDI inflows into the Turkish economy. Their study revealed that the size of the host country's market, infrastructure (measured by the share of energy, transportation, and communication expenditures in GDP), and economic openness (proxied by the ratio of exports to imports) are positively associated with FDI inflows. However, their findings also indicated that exchange rate instability and overall economic instability (measured by interest rates) have adverse effects on FDI.

As pointed out by Masayuki and Ivohasina (2005), other determinants of FDI inflows are cost of establishing Greenfield plants and the cost of acquiring firms established inside the host country, and the price of land (measured as stock price).

In Nigeria, Ekpo (1997) examined the relationship(s) between FDI and some macroeconomic variables for the period 1970-1994. The author's results showed that the political regime, real income per capita, rate of inflation, world interest rate, credit rating, and debt service explained the variance of FDI inflows to Nigeria. Obadan (1982) argued that market size, trade policies and raw materials are very important determinants of FDI in Nigeria.

Anyanwu (1998) maintained that domestic investment, openness and indigenization policy are very important determinants of FDI in Nigeria. According to Ajakaiye (1995), the high bank lending rate that existed during the early days of deregulation (1987-1990) has affected internal rate of return (IRR) on investment negatively, thereby boosting investment inflows. However, Aremu (1997) opined that the host country's FDI make credit available to investors in a form of subsidized loans, loan guarantees as well as guaranteed export credits. He observed that these credits are provided directly to foreign investors to support their operations, particularly in covering inevitable costs that immediately impact cash flow and liquidity. In a related discussion, Olatunji (2001) argued that despite government efforts to provide incentives for investors, many remain

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reluctant to invest in Nigeria. This hesitation may be linked to persistent challenges such as poor infrastructure, widespread insecurity, sectarian violence, armed insurgency in the Niger Delta, and a general lack of discipline in the economy.

Beyond these concerns, a significant deterrent for investors is the state of Nigeria's stock exchange market—its level of development, structure, operational efficiency, and expertise of its personnel. Soludo (1998) further emphasized that what attracts investors is not merely the profitability of investments in the short term, but the stability of such profits over time. In an environment of high socio-political and economic volatility, investors may prefer to delay their investments or opt for short-term projects that can be easily exited. He also stressed that while macroeconomic stability, competitive exchange rates, and an export-oriented economy are essential for attracting investments, they alone are not sufficient conditions.

Ekpo and Egwaikhide (1998) highlighted the critical role of public investment in influencing private investment. They argued that government investment in infrastructure creates an enabling environment for private investors, ultimately facilitating FDI inflows into Nigeria. Based on a review of relevant literature, this study identifies key variables that influence FDI in Nigeria. The significance of this research lies in the fact that empirical studies examining deregulation as a crucial determinant of FDI in Nigeria remain scarce.

Study Gap

Related available literature on the determinant of FDI in Tanzania is very scares and this has created a need for carrying out this research. This time gap is the main thrust of carrying out a current investigation on the challenges of FDI in Tanzania, this will aid policy makers to formulate the best policies to tackle these challenges.

3. Methodology

This study adopts multiple regression model and an Auto regressive Distribution lag model as the correct estimation technique. This is due to the mixed order of integration from the test for stationarity. The model expresses FDI as a function of the market size of the host country (GDP), Openness of the economy to foreign trade (OPN), rate of inflation (INFL), Exchange rate of the host country's currency (EXR). Following Abubakar and Abdullahi (2013) and Maghori (2014), this study presents the model as appropriate for the study:

$$lnFDI = \beta_0 + \beta_1 lnGDP_t + \beta_2 OPN_t + \beta_3 INFL_t + \beta_4 EXR_t + U_t \quad \ldots\ldots\ldots\ldots\ldots\ldots (1)$$

Where $\beta_0, \beta_1, \beta_2, \beta_3,$ and β_4 are coefficients or elasticities, the natural log is represented with ln, and U represents the the disturbance term. Our apriori expectation indicates that FDI would be positively related to the host country's market size and openness of the

economy to foreign trade. However, FDI is expected to be negatively related to inflation and exchange rate. The choice of these variables is informed by the literature.

4. **Results and discussions of results**

An expo factor was adopted through the use of secondary data from the Central Bank of Tanzania. Some of the variables were log so as to achieve a uniform unit of measurement across the variables in (1).

Table 1 shows all the variables and unit of measurement that would be used as proxy to some of the variables in the model

Table 1: variables and unit of measurement

Variables	Unit of measurement (Proxy)
Foreign Direct Investment	FDI
Market Size	Gross Domestic Product (GDP)
Trade Openness	Export to Import (EXPIMP)
Inflation rate	INFL
Exchange rate	EXR

Source: Author's computation (2024)

Table 2: Result of ADF Unit Root Test of the variables

Augmented Dickey-Fuller Unit Root Test					
	At Level			**At 1st Differencing**	
VAR	**ADF Stat**	**5% Critical Value**	**ADF Stat**	**5% Critical Value**	**Order of Integration**
LNFDI	-4.653697	-2.963972			I(0)
LNGDP	-0.863715	-2.963972	-4.198131	-2.967767	I(1)
OPN	-0.288548	-2.963972	-3.903870	-2.967767	I(1)
INFL	-2.556829	-2.963972	-6.656649	-2.976263	I(1)
EXCH	0.232656	-2.963972	-4.133311	-2.967767	I(1)

Source: Author's computation (2024).

To further identify the trend movements of the variables according to econometric standards, the Augmented Dickey-Fuller unit root test was performed. The apriori expectation when using the ADF is that a variable is stationary when the value of the ADF test statistic is greater than the 5% critical value. Some of the variables became stationary at level, Thus, Augmented Dickey-Fuller unit root tests showed that the log of the variable, FDI (lnFDI) was stationary at level. Furthermore, The Log of Gross Domestic Product (lnGDP), Trade openness(OPN), Inflation rate (INFL) and Exchange rate (EXR) are all stationary at the first difference, (ADF Statistics> 0.05 critical value)

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i.e there is a mixed order of integration. Due to this mixed order of integration, the Augmented Distribution Lag Model (ARDL) will be used as the most appropriate estimation technique in this study.

Table 3: Result of ARDL Model Estimation:

Conditional Error Correction Regression				
Variable	**Coefficient**	**Std. Error**	**t-Statistic**	**Prob.**
C	-33.36965	15.99185	-2.086666	0.0506
LNFDI(-1)*	-0.694604	0.040233	-17.26474	0.0000
LNGDP(-1)	2.073371	0.699272	2.965042	0.0080
OPN(-1)	-0.010453	0.016444	-0.635662	0.5326
INF(-1)	0.037582	0.028947	1.298273	0.2097
EXCH**	-0.001424	0.000354	-4.017820	0.0007
D(LNFDI(-1))	-0.150117	0.050196	-2.990625	0.0075
D(LNGDP)	0.130986	0.693845	0.188783	0.8523
D(OPN)	0.027266	0.016122	1.691204	0.1071
D(INF)	-0.007038	0.023623	-0.297943	0.7690
CointEq(-1)*	-0.694604	0.026153	-26.55974	0.0000

Source: Author's computation (2024).

$$EC = LnFDI - 2.985lnGDP - 0.15OPN + 0.051INFL - 0.0021EXR$$

The short-run coefficient results are presented in Table 3. The lagged value of Foreign Direct Investment (LNFDI) was negative and statistically significant (P(t) = 0.0000) after the first year. Similarly, the lagged value of Gross Domestic Product (GDP) was positive and statistically significant (P(t) = 0.0080), aligning with economic expectations, as GDP is expected to have a direct positive impact on FDI.

The relationship between Trade Openness (OPN) and FDI was positive but statistically insignificant in the current year (P(t) = 0.1071) at a 5% significance level. This may be due to weak interactions between export and import activities in Tanzania. A 1% increase in trade openness leads to a 0.027% increase in FDI. However, by the end of the first year, its significance declined further (P(t) = 0.5326).

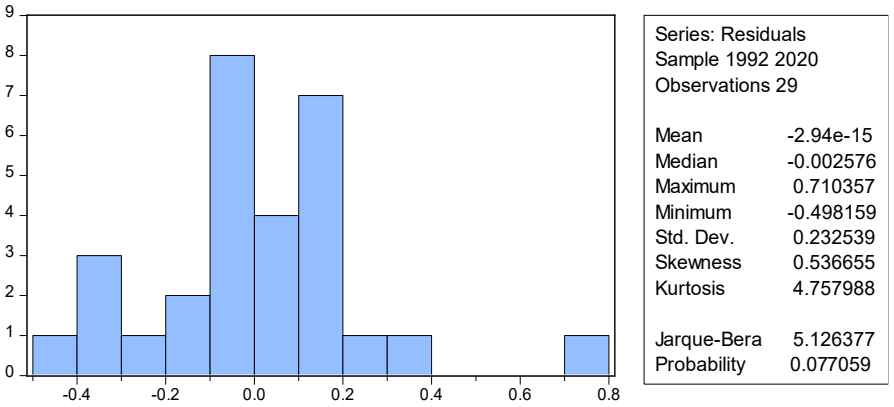
Inflation had a negative and statistically significant relationship with FDI (P(t) = 0.0075) at a 5% significance level, in line with economic expectations. High inflation discourages foreign investors due to economic instability.

The exchange rate also had a negative and statistically significant effect on FDI (P(t) = 0.0007) at a 5% significance level, which aligns with economic theory, as investors seek to exploit exchange rate declines when making investment decisions.

The error correction term (ECM) met economic expectations, being negative (-0.694604), fractional, and statistically significant (t-statistics = -26.56, P = 0.00). This indicates that 69.46% of short-term shocks in the system are corrected within a year.

Post Estimation test

Figure 1: Normality Test



Source: Authors' computation (2024)

A normality test is essential to determine the distribution of the dataset in the model. As shown in Figure 1, the null hypothesis, which states that the variables are not normally distributed, is rejected since the Jarque-Bera probability value (0.07705) exceeds 0.05. This indicates that the variables follow a normal distribution.

Table 5: Serial Correlation LM test of the selected ARDL Model

Breusch-Godfrey Serial Correlation LM Test:			
F-statistic	2.904473	Prob. F(2,17)	0.0822
Obs*R-squared	7.385674	Prob. Chi-Square(2)	0.0249

Source: Author's computation (2024)

Serial correlation test was conducted using the Breusch-Pagan Serial correlation LM test. From Table 5, it can be seen that the probability, Chi-Square (0.0249) is less than 0.05 at 5% significant level. We therefore conclude that the residual in our short-run ADRL model is serially correlated.

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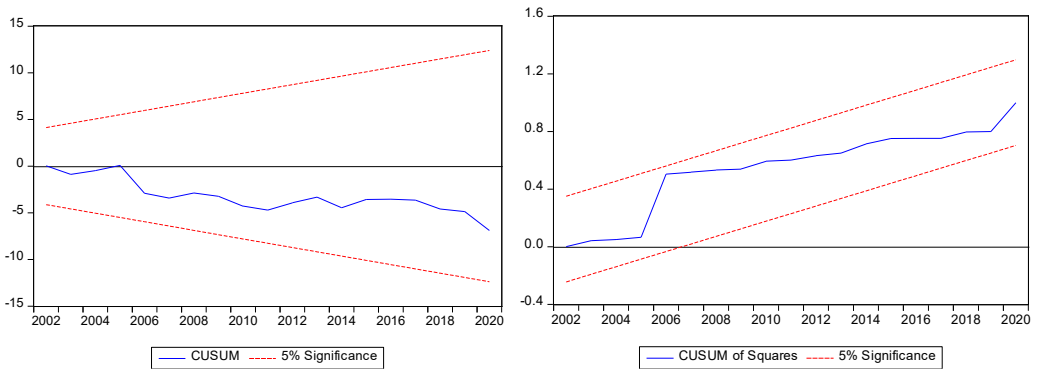
Table 6: ***Heteroscedasticity Test:***

Heteroskedasticity Test: Breusch-Pagan-Godfrey			
F-statistic	0.333446	Prob. F(9,19)	0.9525
Obs*R-squared	3.955703	Prob. Chi-Square(9)	0.9143
Scaled explained SS	3.190512	Prob. Chi-Square(9)	0.9563

Source: Author's computation (2024)

The Breusch-Pagan LM test was used to assess homoscedasticity. As shown in Table 6, the probability of the Obs*R-square (0.9143) exceeds 0.05. Therefore, the null hypothesis of homoscedasticity, indicating a constant variance of the residuals, is not rejected.

Table 6a and 6b: Stability Diagnostic Test



Source: Authors' computation (2024).

The stability of the short-run model was assessed using the CUSUM and CUSUM of Squares tests are presented in Tables 6a and 6b. The test criterion states that the alternative hypothesis is rejected if the blue line remains within the dotted red lines; otherwise, it is accepted. The results, presented in Figures 6a and 6b, show that the blue lines lie within the dotted red boundaries, confirming that the model is dynamically stable.

Table 7: Test for Model Specification

	Value	**Df**	**Probability**
t-statistic	1.635893	18	0.1192
F-statistic	2.676146	(1, 18)	0.1192
F-test summary:			

	Sum of Sq.	Df	Mean Squares
Test SSR	0.195971	1	0.195971
Restricted SSR	1.514088	19	0.079689
Unrestricted SSR	1.318118	18	0.073229

Source: Author's computation (2024).

To verify the correctness of the estimated model, this test was conducted using the F-statistic. The null hypothesis states that the model is correctly specified and is rejected if the F-statistic's probability value is less than 0.05. Conversely, if the probability value exceeds 0.05, the null hypothesis is not rejected. As shown in Table 7, the probability value of the F-statistic is greater than 0.05, confirming that the null hypothesis cannot be rejected at the 0.05 level. This indicates that the estimated model is correctly specified.

5.0. Conclusion and recommendations

In conclusion, this study highlights that, in the long run, Gross Domestic Product (GDP), openness, and inflation are key determinants of FDI in Tanzania. While GDP and exchange rate were statistically significant at the 5% level, openness and inflation were not, likely due to weak interactions between exports and imports. In the short run, only GDP and exchange rate significantly influenced FDI, while other variables had no measurable impact. The error correction term confirms a long-run relationship, as it is correctly signed and statistically significant at the 5% level.

Based on the empirical findings, the study recommends that the Tanzanian government prioritize GDP growth, openness, and inflation control to attract FDI. While these factors explain 95% of FDI variations, other elements such as infrastructure, labor force, and natural resources should not be overlooked.

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