

UNIVERSITY OF NAIROBI
INSTITUTE OF DIPLOMACY AND INTERNATIONAL STUDIES

IMPACT OF REGIONAL TRADE AGREEMENTS ON FDI INFLOWS
A CASE OF EASTERN AFRICAN COUNTRIES

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DECLARATION

This project is my original work and has not been presented for the award of a degree in this University or any other Institution of higher learning for examination.

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This project has been submitted for examination with my approval as the University Supervisor.

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DEDICATION

This project is dedicated to my family for their support and encouragement throughout the entire project duration.

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TABLE OF CONTENTS

DEDICATION	iii
ACKNOWLEDGEMENT	iv
LIST OF FIGURES	viii
LIST OF TABLES	ix
ABSTRACT.....	x
CHAPTER ONE.....	1
INTRODUCTION TO THE STUDY	1
1.1 Background to the Study	1
1.1.1 Africa’s FDI Inflows	5
1.1.2 FDI in Eastern African Countries	6
1.2 Statement of the Research Problem	8
1.3 Objectives to the Study	10
1.4 Research hypothesis	10
1.5 Literature Review	10
1.5.1 Market Size and Characteristics	13
1.5.2 Political and Institutional Variables	15
1.5.3 Population and Environmental Factors.....	17
1.5.4 Literature Gap.....	18
1.6 Significance of the Study	20
1.7 Theoretical Review	21
1.7.1 Eclectic Theory.....	21
1.8 Research Methodology.....	23
1.8.1 Research Design	23
1.8.2 Data collection.....	24
1.8.3 Data analysis.....	24

1.8.4 Scope of the Study	24
1.9 Outline of the Study	25
CHAPTER TWO	26
RELATIONSHIP BETWEEN REGIONAL TRADE AGREEMENTS AND FDI INFLOWS	26
2.1 Introduction	26
2.1.1 Regional Investment Rules and FDI.....	26
2.1.2 Regional Trade Rules and FDI	27
2.1.3 Other regional initiatives and FDI.....	30
2.1.4 Spatial distribution of FDI across region.....	32
2.3 Empirical evidences of FDI.....	33
2.4 Summary	37
CHAPTER THREE	39
PATTERN OF FDI INFLOWS AND ECONOMIC GROWTH IN EAST AFRICA.....	39
3.1 Introduction	39
3.2 FDI in Eastern Africa Overview	39
3.2.1 Foreign Direct Investment (FDI) in Tanzania	42
3.2.2 Foreign Direct Investment in Kenya	45
3.2.3 Foreign Direct Investment in Uganda	50
3.3 Summary of the literature.....	55
CHAPTER FOUR.....	57
MACROECONOMIC INSTABILITY ON FDI INFLOWS IN EASTERN AFRICAN COUNTRIES	57
4.1 Introduction	57
4.2 Key Emerging Issues on Regional Integration and FDI	57

4.3 Theoretical underpinnings on the Regional Trade Agreements on FDI Inflows in Eastern African Countries	61
4.4 Pattern of FDI inflows and economic growth in East Africa.....	64
4.5 Macroeconomic instability on FDI inflows in Eastern African countries.	67
CHAPTER FIVE	70
CONCLUSION AND RECOMMENDATIONS	70
5.0 Introduction	70
5.1 Conclusion.....	70
5.2 Recommendations	71
5.2.1 Recommendations for Policy.....	71
5.2.3 Recommendations for Practice	72
BIBLIOGRAPHY	73

LIST OF FIGURES

Figure 1.1: FDI in East Africa Community	7
Figure 4.2: FDI Inflows by RTA	59

LIST OF TABLES

Table 1.1: Trends of FDI inflows in Africa and across African sub-regions over the period 1970-2009	6
Table 4.2: Flow of FDI in the region	62

ABSTRACT

The East African Countries have employed policy incentives in order to encourage foreign direct investment (FDI) inflows into their countries. Despite these measures, FDI inflows into the country have continued to be characterized by fluctuations. These fluctuations have been more marked from 1980's onwards. The objective of the study was to explore the impact of regional trade agreements on FDI inflows in Eastern African countries. The study also set out to measure the relative effects of these RTAs and to give policy recommendations based on the study findings. The study established that investment is a forward-looking activity that is based on the anticipation of future returns. In the EA Countries, foreign investments are positively related to political stability. Foreigners are less willing to risk in a politically unstable environment, because it eventually reduces the rate of return on investment. In addition, it lowers the economic value of the firm's assets after a period of conflict, regardless of whether the conflict was internal or external. This is because the host economy's exchange rate becomes more volatile in the face of political instability. Greater political stability among the EA countries serves to increase the amount of FDI in the integrating economies. Any member state in the EA Countries whose degree of political risk goes below the region's average stands to experience an outflow of FDI from their economy to other destinations within the RIA. Based on the findings this study recommended that RTAs with more trade and investment provisions attract more inward FDI; it is thus sensible to negotiate more investment and trade provisions if the aim is to attract additional FDI. EA countries should strive to maintain a high level of political stability. Some of the components that should be targeted to achieve this are government stability, which indicates a government's ability and effectiveness in carrying out its programmes, observance of the rule of law and order, enhancement of security within the country to minimize the risk of internal conflict, elimination of corruption and promotion of transparency and accountability both within and outside government, and finally improvement in the quality of a country's bureaucracy.

CHAPTER ONE

INTRODUCTION TO THE STUDY

This chapter gives the background information of economic growth in Africa; it introduces the readers to the topic, which is referred to in the consequent chapters. Impact of regional trade agreements on FDI inflows being the main subject of study is well introduced and given a background to enable, the readers navigate throughout the study to grasp the main subject in study.

1.1 Background to the Study

These days, foreign direct investment (FDI) is playing a great role for economic development in developed and developing countries. The host country will benefit as FDI creates employment opportunities, promotes economic growth, and facilitates technology transfer.¹ In addition to these, the FDI is expected to fill the space between household speculations and investment funds in most developing nations as their pay and reserve funds are low. To gain the benefit most developing countries are trying to attract FDI by framing different policies such as trade liberalization and creating an attractive macroeconomic investment environment.²

Regional Trade Agreements (RTAs) are an important determinant of economic integration, since they institute free trade among a number of nations in a specific area or region. Nations with emerging economies and transitioning nations generally take an interest in RTAs. The current RTAs are being upgraded consistently and are keeping on expanding their enrolment.

¹ Girma, H. & Gorg, J. (2005). Foreign direct investment, spillovers and absorptive capacity: evidence from quantile regressions, *Discussion Paper Series 1: Economic Studies 2005, 13, Deutsche Bundesbank, Research Centre*.

² Medina, S. (2001). Is the Export-led growth hypothesis valid for developing countries? A case study of Costa Rica', *UNCTAD, Policy Issues in International Trade and Commodities, Study Series, No.7*.

The quantity of RTAs expanded altogether amid the previous periods. As per the WTO RTAs database, “by July 2010, 474 RTAs have been notified to the GATT/WTO”³. The general quantity of RTAs in power has been expanding relentlessly from that point forward. At present, all the world nations are individuals from no less than one RTA, and the larger part of them are individuals from a few such bargains.

RTAs generally achieve a few expenses however there are additionally various advantages connected with these sorts of assentions.⁴ To begin with, RTAs make facilitated commerce within a given coalition. Some different advantages incorporate expanded rivalry and more noteworthy effectiveness, which prompts the formation of a bigger business sector with economies of scale. Such adequacy of the business sector adds to the development of household and in addition outside venture. In this way, the outcome is expanded inflows of FDI into the economy. FDI itself is a urgent determinant of a nation's further development and advancement. For financial specialists, FDI for the most part means access to new markets that may be portrayed by lower work, crude material and data costs. FDI is exceptionally attractive for the host nation too, since it has a beneficial outcome on the beneficiary's parity of instalments and its export development. Moreover, FDI helps the residential nation to build its generation limit and make livelihood. FDI prompts a higher rivalry on the local business sector, which helps firms to build their proficiency, in the after effect of which uncompetitive local firms leave the business sector.⁵

3 WTO, Regional Trade Agreements, accessed April, 2011

4 Njong, A. (2008). Investigating the effects of foreign direct investment on export growth in Cameroon, *UNECA Ad-hoc Expert Group Meeting Addis Ababa*.

5 Pain, N. (2007). Continental Drift: European Integration and the Location of UK Foreign Direct Investment, *The Manchester School Supplement*, 65, pp. 94-117

As per the Eurostat yearbook 2010,⁶ FDI streams transforms rapidly on annual basis. Typically, they acclimate to the monetary development progress: FDI streams increment amid financial rises and diminishing amid downturns. The same yearbook expresses that in 2008, surges from the EU-27 to non-associate nations were esteemed at about EUR 347 667 million. The EU speculations abroad were higher than internal FDI streams to the EU, and in this manner the EU was a net financial specialist abroad with net surges of EUR 148 966 million." Transitioning states have been consistently drawing in an expanding offer of FDI: from 23.6 million USD in 1980 to about USD 70 billion in 2009. The significance of FDI for transition nations has likewise expanded from around 0.03% of GDP in 1980 to around 5.24% of GDP in 2008 and 3.87% of GDP in 2009.⁷

The most significant RTA to U.S. agricultural industries is the EU. The majority of agricultural FDI is bound for the EU. FDI into the EU has increased dramatically with the formation of the EU in 1992, with most of it (78 percent) coming from the United States and Japan⁸.

The EU has attracted FDI because its trade liberalization policies enhanced GDP growth and expanded market size. The EU transformed a group of fragmented markets into a single integrated market, and its size is still growing with the recent addition of several countries and more on the horizon. The formation of a common market is expected to add 5 percent to the average growth rate of the EU member countries for the next several years. A few research works have indicated that being a member in the EU is a major driving aspect in attracting FDI.

6 Ponce, P. (2006). Openness and Foreign Direct Investment: The Role of Free Trade Agreements in Latin America, *MPRA Paper 4187*

7 Sasidharan, M. & Ramanathan, K. (2007). Foreign Direct Investment and spillovers: evidence from Indian manufacturing, *International Journal of Trade and Global Markets, Vol.1, No. 1*

8 Buigues, P. and Alexis, J. (1994). Foreign Direct Investment and Exports to the European Community, in *Does Ownership Matter?* Mark Mason and Dennis Encarnation, eds, Oxford: Clarendon Press.

Jaumotte⁹ investigated whether the market size of an RTA was a determinant of FDI received by countries participating in the RTA. This was done by regressing the FDI received by a country against its market size as well as other determinants of FDI identified in the study. The study covered 71 developing countries involved in RTAs. This survey discovered that; RTA market size was an added advantage on FDI given to the member countries, the size of domestic population mattered because of effects on availability of labour supply and not all countries benefited equally from the RTA.

The removal of tariff or non-tariff barriers among RTA partners has the effect of motivating foreign firms to produce from their home countries and sell to the host countries. This is because of cost reduction resulting from removal of barriers put by countries to protect their markets. The tariff jumping FDI (FDI that primarily exists to avoid the extra cost involved in exporting goods to the host countries) would then shift to their home countries because producing from there would be more attractive than relocating to the host countries. This has the effect of reducing tariff-jumping FDI. On the other hand, the removal of barriers would lead to an increase in FDI especially for vertically integrated FDI, where one affiliate company provides inputs for the other, specialised according to their location factors. Resources often determine location of production. These resources could be natural or human resources. The natural resources could be minerals like copper, aluminium, oil etc, while human resources could apply to skills that are necessary in the production of goods or provision of services. The trade liberalisation element of RTAs is therefore generally expected to increase the flow of FDI to the region¹⁰

9 Jaumotte, F. (2004). Foreign Direct Investment and Regional Trade Agreements: The market Size effect revisited. *International Monetary Fund. Working Paper*. Middle East and Central Asia Department.

10 Yarbrough and Yarbrough (2007). Returns to Regionalism. An Evaluation of Non Traditional Gains From Regional Trade Agreements. The World Bank, International Economics Department, International Trade Division.

1.1.1 Africa's FDI Inflows

According to Sasidharan and Ramanathan, Africa's contribution of the universal stock of FDI diminished from about 5.3 per cent in 1980 to about 2.3 per cent in 2000.¹¹ Despite the fact that FDI has eventually increased for developing countries after the year 2000, Africa's share on a global scale has remained retarded. A consistent pattern of below 3 per cent has been visible in the year 2003 and 2004. For the year, 2005 there was a sharp increase of about 182 per cent. In this increase, South Africa was entitled to 21 per cent. The Barclays Bank (UK) attributed this to the acquisition of ABSA (South Africa). FDI inflow to Africa has been dominated by the OCED countries, which accounted for 83 per cent of FDI inflows from 2005 to 2010. China and India make up to 3 per cent of African FDIs. The other 14 per cent was shared between intra-African investments and the Middle East.¹²

During the period from 2007 to 2009, 60 per cent of investment in Africa was concentrated in South Africa, Egypt and Nigeria.¹³ The key investors have been OECD companies in the extractive industries from United Kingdom, France and the United States. South Africa has been a vital source of intra-African FDI. Its outward FDI stock in 2008 was at 22 per cent. The incidence of the global financial crisis has however retarded the growth to less than 10 per cent in 2009 and 2010 respectively. Morocco was also regarded to be a large source of intra- African FDI. In 2010 Morocco held 55 per cent of its outward FDI in North Africa and 84 per cent in Tunisia (WIR, 2011:88). Thus, intra- African FDI is regarded as a driver of regional integration and structurally balanced economic development in Africa.¹⁴

11 Sharma, K. (2000). Export Growth in India: Has FDI played a role?, *Yale University Economic Growth Centre Discussion paper, No. 816*

12 Vukšić, G. (2007). Foreign Direct Investment and Export Performance of the Transition Countries in Central and Eastern Europe, (Online), available at www.ijf.hr/eng/employees/vuksic.pdf.

13 Bandera, V. & White, J. (2008). U.S. Direct Investments and Domestic Markets in Europe, *Economia Internationalizionale, Vol.21, pp 117-133*.

14 Basu, G. & Srinivasan, H. (2010). Foreign Direct Investment in Africa-Some Case Studies, *International Monetary Fund working paper, Issues 2002-2061*.

According to Goldberg, inward FDI has mainly been in the extractive sector, which is the primary sector.¹⁵ This is a reflection of the investment in oil and mineral extraction. Angola, Equatorial Guinea, Nigeria, Egypt, Sudan and South Africa accounted for a larger portion of all inflows coming to Africa. Different types of FDI in Africa have been through a few mergers and acquisitions deduced in the mining business, saving money division and administration area. For the situation displayed in International Development Research Center, it was accounted for that maintained endeavors to advance political dependability and macroeconomic changes where essential components in charge of expansion in remote direct interest in Africa.¹⁶

Table 1.1: Trends of FDI inflows in Africa and across African sub-regions over the period 1970-2009

	1970-74	1975-79	1980-84	1985-89	1990-94	1995-99	2000-04	2005-09
	FDI inflows (million US\$)							
Africa	24.4	22.6	30.6	55.4	83.6	171	340	1,060
Sub-regions								
Central Africa	15.7	29.9	37.8	41.3	31.2	147	647	1,670
Eastern Africa	7.6	8.6	6.4	12.7	19.3	70.7	106	265
Northern Africa	35.1	26.3	74.4	224	278	392	807	3,420
Southern Africa	95.7	-11.8	62.6	-4.4	47.7	369	544	1,280
Westerns Africa	26.7	40.1	26.9	61.3	115	147	177	613

Source: FDI data from the UNCTAD (www.unctad.org/fdistatistics).

1.1.2 FDI in Eastern African Countries

Since 1980's most African nations had been striving to bring political steadiness and monetary advancement. For the vast majority of them, the total national output per capital had indicated huge augmentation. Obwona demonstrated that African nations have had

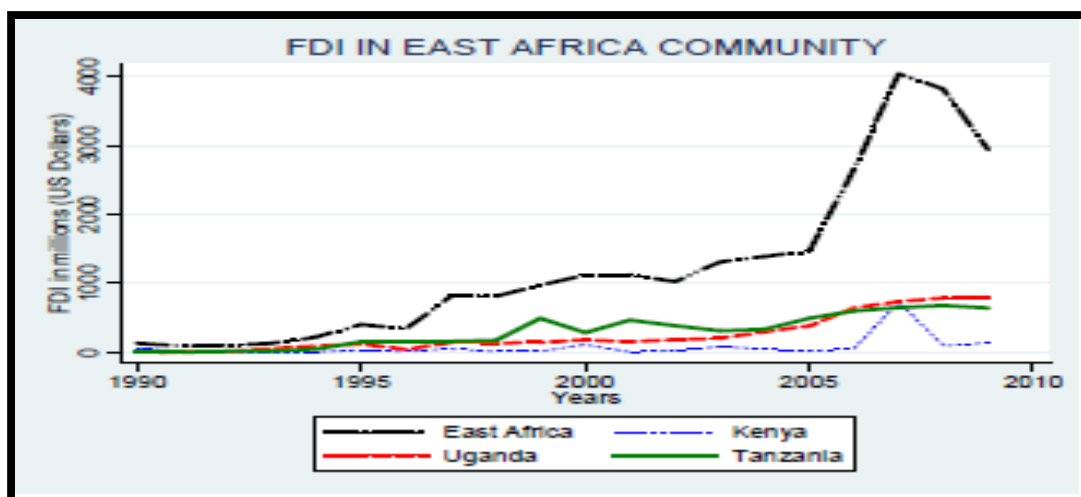
¹⁵ Goldberg, B. (2010). Determinants of U.S Direct Investment in the EEC: Comment, *American Economic Review*, Vol.62, pp.692-699

¹⁶ International Development Research Centre (2012). Economic adjustment and long term development in IMF, *A report of the IMF Economic Study Team, Ottawa*.

strategy changes from the late 1980s and thereafter.¹⁷ The FDI strategy changes incorporate political and financial change, for example, macroeconomic adjustment, exchange and venture liberalization, privatization, diminishment of organization. Amid 1988 the Eastern African Countries had done FDI arrangement change. What's more, they got to be open for global exchange and outside venture by making business benevolent environment. Subsequently, the FDI inflow expanded amid 1990's contrasted with 1980's. It is trusted that FDI has critical commitment for financial improvement in Eastern African nations.

Like other African countries, Eastern African countries signed international agreements to deal with FDI issues.¹⁸ This includes bilateral investment treaties (BITS) (assent between the host and remote nation to put terms and condition that both districts take after to make smooth relationship), Double taxation treaties (DTTS) (to avoid double taxation), and multilateral agreements (to settle investment disputes and FDI protection).

Figure 1.1: FDI in East Africa Community



17 Obwona, M. (2009). Determinants of Foreign Direct Investments and their impact on Economic Growth in Africa, *African Development Review*, vol. 13.

18 Pain, N. & Wakelin, K. (2007). Export performance and the Role of Foreign Direct Investment, *National Institute of Economic and Social Research, United Kingdom*.

1.2 Statement of the Research Problem

The terrible picture of Africa because of civil war, political shakiness, poor financial execution, destitution, ailment, had negative effect on FDI inflow. Because of these reasons, multinational undertakings did not consider African nations as positive area for speculation regardless of the way that most nations find a sense of contentment and political dependability. The Eastern African nations government has attempted endeavors to change exchange, upgrade universal intensity and advance outside venture. This has been accomplished through various components, including bringing down taxes, annulling most essential controls, privatization and transforming the administrative environment.¹⁹

In spite of all these components, Eastern African nation's monetary development has been languid throughout the years, posting a general development rate of under 4% from 1999 to 2007, falling to 3.1% in 2008 and 1.8% in 2009 before a slight recovery of 4.6% during the first quarter of 2010.²⁰ Thus, the country faces daunting challenges as it competes with other emerging market countries for foreign investment. The inflow of foreign direct investment to Eastern African countries is very low compared to other part of the world. The concern for this very low investment could be investigated from the aspect of regional trade agreements in Eastern African countries on the perceived FDI inflows. By doing panel data analysis, it is important to find out which determinants are most significant.

Chen²¹ examined the investment diversion effect of an RIA, with the different productivity and income between countries based on a three-country footloose capital model. He found

19 Romer, P. (2003). Idea gaps and Object gaps in Economic development, *Journal of Monetary Economics*, 32, pp 543-73

20 World Bank (2008). World Development Indicators, Washington DC: Eastern Africa Department, The World Bank

21 Chen, L., Yu, C. and Huang, J. (2010). How The Regional Trade Agreement affects FDI. Based on Three-Country Footloose Capital model, School of International Business, Southwest University of Finance and Economics (SWUFE), Chengdu, China.

that the formation of an RTA induced strong investment diversion effect. More FDI was found to flow into the RTA but also possible FDI flew out of the RTA within some ranges of productivity difference between members and non-members. When trade got freer, the difference between member and non-member became larger; the amount of FDI among RTA became greater. Freund and Ornelas held that trade diversion could make a trade agreement harmful for both members and non-members alike.

In Kenya, studies conducted on FDI revealed that institutional factors were important in attracting FDI into the country. These are law and order, corruption, political stability, internal conflict and civil liberties among others. The other major drivers of FDI were the macroeconomic environment, a conducive business environment, market size and trade agreements²². The most serious impediments to attracting FDI were identified as political instability and corruption.

Empirical studies like Baltagi²³, indicate that regional trade agreement had a positive impact on FDI flow among members in a number of regional agreements. However, studies in individual EAC countries such Mwega and Ngugi²⁴ have focused on identifying the determinants of FDI. Others such as Obwona²⁵ have identified the effects of FDI. Little research effort has been directed at understanding the relationship between regional integration and FDI. Therefore, this study sought to empirically establish the relationship between regional trade agreement and FDI in EAC countries.

22 Mwega, F.M. and Ngugi, R.W. (2007). Foreign Direct Investment in Sub Saharan Africa: Determinants, Origins, Targets, Impact and Potential. African Economic Research Consortium. Pp 119-143

23 Baltagi, H.B., Peter, E. and Pfattermayr, M. (2005). Estimating Regional Trade Agreement Effects on FDI in an Interdependent World. Syracuse University Center for Policy Research. Maxwell School of Citizenship and Public Affairs.

24 ibid

25 Obwona, B.M. (2002). Determinants of FDI and their impact on Economic Growth in Uganda. *African Development Review*. Vol. 13 Issue1, Pp 46-81.

1.3 Objectives to the Study

The main objective of the study was to explore the impact of regional trade agreements on FDI inflows in Eastern African countries.

The Specific objectives were as follows:

- i. To examine relationship between regional trade agreements and FDI inflows.
- ii. To analyse the pattern of FDI inflows and economic growth in East Africa
- iii. To ascertain the Macroeconomic instability on FDI inflows in Eastern African countries

1.4 Research hypothesis

- i. Regional trade agreements influence FDI inflows in Eastern African countries
- ii. Pattern of FDI inflows affects the economic growth in East Africa

1.5 Literature Review

Blömstrom and Kokko examine the investment effects of regional integration in the case of three regional trade agreements: the Canada-U.S. FTA, NAFTA, and MERCOSUR.²⁶ The authors hypothesize that the FDI process for a country in the context of regional integration can be mapped onto a basic template with the level of environmental change (degree to which trade and investment flows are liberalized by the agreement) as weak or strong and the advantage of location (the degree to which it is more profitable to locate a firm's economic activity in a location) as weak or strong. In this observational study, the authors do not run regressions, but conclude that the evidence from the three agreements supports their rough hypothesis that an agreement in a strong position of both environmental change and

²⁶ Blomström, M. & Kokko, G. (2007). Regional Integration and Foreign Direct Investment. Working Paper no. 6019, National Bureau of Economic Research.

advantage of location is more likely to lead to inflows of FDI from countries both outside and within the agreement.

Later studies have moved beyond theoretical and observational examinations to empirical research. One of the most important contributions to this line of research is that of Adams who examine the trade and investment effects of PTAs.²⁷ These authors use a gravity model in which the dependent variable is the regular logarithm of the supply of outward speculation from home nation to host nation in various created and creating nations from 1988 to 1997. Their results show that six of the nine PTAs were investment creating, one was investment-diverting, and two showed no clear impact. They also conclude that most of the investment impact from the agreements comes from their non-trade provisions.

Medvedev notes that the Adams study is useful in determining the net FDI effect of a particular PTA, but it cannot establish the impact of preferential liberalization on a net FDI position of a particular country.²⁸ Jaumotte tries to address this concern in a study of developing countries from 1980 to 1999.²⁹ She finds that the business sector size because of the PTA toward the start of a period has a critical and beneficial outcome on the level of FDI stock toward the end of the period. She concludes that, overall, her evidence is insufficient to support a claim that PTAs are desirable since it is unclear whether the costs associated with trade diversion are outweighed by the benefits of increased FDI. In a study of aggregate FDI

27 Adams, R. (2003). The Trade and Investment Effects of Preferential Trading Arrangements. Old and New Evidence. Productivity Commission Staff Working Paper, Canberra. May 2003.

28 Medvedev, D. (2006). Beyond Trade: The Impact of Preferential Trade Agreements on

Foreign Direct Investment Inflows. Working Paper no. 4065. Policy Research, World Bank (April 2006): 1-39.

29 Jaumotte, F. (2004). Foreign Direct Investment and Regional Trade Agreements: The Market Size Effect Revisited. Working Paper no. 04-206. International Monetary Fund (November 2004): 1-31.

flows from 1980 to 2000, find that the expectation of joining a PTA in the next two years is associated with a one-third increase in FDI flows.

The most recent studies on the association between PTAs and FDI flows have expanded on the original studies through changes in model specifications and by including more countries and PTAs. Hicks, for instance, improves the model specification by including a variable to account for the type of PTA: preferential trade area, free trade area, customs union, common market, monetary union, single market, or economic and monetary union. He shows that, across a small sample of 25 PTAs, higher levels of PTA economic scope (the number of financial, fiscal, and monetary stipulations the PTA can enforce upon its member countries) and independence (the legitimate supranational power of the PTA) are associated with higher inward FDI flows.³⁰

Medvedev provides perhaps the most comprehensive study to date on the correlation between PTAs and increased FDI flows.³¹ He builds upon the Lederman et al. model, using a panel of 143 countries from 1980 to 2003 and examining, by far, the most comprehensive list of trade agreements of any study in the literature.³² His baseline model, which serves as a starting point for this paper, includes FDI flows as the dependent variable and an array of time-specific independent variables: GDP, GDP growth, a measure of the country's openness to trade, inflation, the change in the exchange rate, the level of world FDI, the world's GDP growth, the combined GDP of the countries involved in the PTA when in force, and the distance between the countries in the PTA. This model leads to several important

30 Krishna, P. (1998). Regionalism and multilateralism: A political economy approach. *Quarterly Journal of Economics* 113, no. 1 (1998): 227-51.

31 Medvedev, D. (2006). Beyond Trade: The Impact of Preferential Trade Agreements on Foreign Direct Investment Inflows. Working Paper no. 4065. Policy Research, World Bank (April 2006): 1-39.

32 Lederman, D., William, M. & Luis, S. (2005). Lessons from NAFTA for Latin America and Caribbean Countries: A Summary of Research Findings. (Washington, DC: World Bank, 2005).

conclusions: 1) FDI flows from PTAs increase with the size of PTA members and their proximity to the host country; 2) the relationship between PTAs and FDI flows was strongly driven by the developing countries in the model; and 3) the link between PTAs and FDI flows is strongest in the late 1990s and early 2000s, the period when most of the new deep integration agreements were signed.

The extensive literature on the many potential determinants of FDI flowing into a country can be broken down into the three categories of market size and characteristics, political and institutional variables, and population and environmental factors. Dunning contributes a model for FDI determinants that has been cited often in the literature: his OLI (ownership-location-internalization) model.³³ According to Dunning, FDI occurs when three conditions are met: 1) a multinational company (MNC) has an ownership advantage through which it is competitive in that market where it wants to invest; 2) one place has to have a location advantage (a large domestic market for the investing company's goods) over another for an MNC to invest there; and 3) there has to be an internalization advantage where owning a plant in another country is better than licensing agreements with a firm based there.

1.5.1 Market Size and Characteristics

The literature on FDI determinants supports a strong relationship between the size of the host country market and the amount of FDI that market receives. According to the UNCTAD, larger markets are better able to accommodate increased investment, both domestic and foreign, because they have large numbers of firms, and because firms have more opportunities to develop scope and scale economies.³⁴ In a literature review of surveys and econometric studies, Lim notes that the most robust determinant of FDI is the size of the

33 Dunning, J. (1998). "Location and the Multinational Enterprise: A Neglected Factor?" *Journal of International Business Studies*, 19, 1 (First Quarter 1998): 45-66.

34 UNCTAD (1998). Trends and determinants, *World Investment Report*.

market. Market size proxied by real GDP is highly significant and positive in virtually all the studies. Lim further describes the effect of market size in terms of the intended effect of FDI by showing that larger host markets will likely attract horizontal FDI (entire production process in a new country), but they will be indifferent to vertical FDI (part of the production process in a new country).³⁵

UNCTAD proposes a slightly different explanation of FDI based on the motives of the company.³⁶ Still, one of the economic determinants is market-seeking (horizontal FDI that includes market size and per capita income in the list). Larger market size allows firms to grow larger than they would have in purely national markets, which could permit the organizations to put resources into more R&D and advertising, which may prompt the formation of new immaterial resources that motivate FDI, within and also outside their own locality. Another market characteristic in the FDI determinants literature is the geographic distance between the country markets. Models of bilateral FDI flows, such as the one used by Adams, find a significant negative impact of distance between recipient and sending countries on FDI stocks.³⁷ However, if trade and FDI are treated as substitutes by firms, there could be a positive relationship between distance and FDI. Blonigen literature review on FDI determinants shows that the gravity specification generally used to foresee exchange streams between nations is basically an element of the GDP of every nation and the separation between the two nations likewise fits examples of FDI sensibly well.³⁸ However, there is no support for a model of FDI flows with gravity variables as the sole determinants since instinct

35 Lim, E. (2009). Determinants of, and the Relation Between, Foreign Direct Investment and Growth: A Summary of the Recent Literature.. IMF Working Paper no. 01/175.

36 UNCTAD. (1998). World Investment Report: Trends and Determinants. New York. <http://www.unctad.org/Templates/WebFlyer.asp?intItemID=2426&lang=1> (accessed March 25, 2009).

37 Adams, R. (2003). The Trade and Investment Effects of Preferential Trading Arrangements. Old and New Evidence. Productivity Commission Staff Working Paper, Canberra. May 2003.

38 Blonigen, A. (2008). A Review of the Empirical Literature on FDI Determinants. Working Paper no. 11299, National Bureau of Economic Research (April 2005): 1-37.

and hypothesis recommends that FDI conduct is likely considerably more convoluted to demonstrate than exchange streams.

1.5.2 Political and Institutional Variables

Quéré et al. are exclusively concerned with institutional determinants of FDI.³⁹ They find that institutions matter independently of GDP level and that public efficiency is a major determinant of FDI. The authors suggest three general reasons why institutions could matter for attracting FDI: 1) good governance raises productivity prospects, which is attractive to investors; 2) poor institutions are associated with problems such as corruption that would bring extra costs for investors; and 3) since there are high sunk costs involved with FDI, any type of instability originating from poor government proficiency, arrangement inversions, join or frail requirement of property rights and of the legitimate framework when all is said in done. is especially harming to FDI. The creators build a gravity model with two-sided loads of FDI as the indigent variable, and observe that organizations, for example, charge frameworks, simplicity of making organizations, level of defilement, straightforwardness, contract law, security of property rights, and effectiveness of equity and prudential guidelines are every single key determinant for FDI. Other studies, including one by Globerman and Shapiro, come to the same conclusions about the importance of institutional variables for FDI flows. All of these studies, however, note the important caveat that data for institutional variables is notoriously difficult to capture.⁴⁰

UNCTAD states that exchange-rate policy is related to security and may impact FDI choices by influencing the costs of host nation resources, the estimation of exchanged benefits, and

39 Quéré, F., Agnès, C., Maylis, G. & Thierry M. (2007). Institutional Determinants of Foreign Direct Investment. *The World Economy* (2007): 764-82.

40 Globerman, F. & Shapiro, F. (2002). National Political Infrastructure and Foreign Direct Investment. Working Paper no. 37, Industry Canada Research Publications Program (December 2002): 1-60.

the intensity of outside partner exports.⁴¹ In addition, Froot and Stein, using annual U.S. aggregate FDI data in an empirical study, show that currency depreciation is associated with higher inward FDI.⁴² This depreciation will increase the relative wealth of foreigners and increase the relative rate of return for foreign firms investing in domestic assets since they can avoid paying a domestic monitoring penalty, thereby further encouraging additional FDI. Finally, the positive link between foreign exchange rate depreciation and FDI, reasoning that if foreign firms purchase another country's assets, they can generate returns from those assets to their benefit in currencies other than those used for the purchase. Conversely, lower trade protection may benefit vertical FDI because the easier it is to enter the country the more a firm can take advantage of lower transportation costs and cheaper resources. In addition to this difference related to openness, FDI and trade protection may be endogenous because a nation's policies for trade protection could explicitly target certain import sectors where FDI is less likely.⁴³

A growing literature also focuses on the impact on FDI of countries joining institutions, such as PTAs. Bütte and Milner, for example, study the impact of signing bilateral investment treaties, joining the GATT/WTO, and joining a PTA.⁴⁴ They claim that joining these treaties and organizations requires countries to undergo economically liberalizing reforms, as well as making it much less likely that a country will renege on an economic commitment since there

41 UNCTAD. (2008). World Investment Report: Transnational Corporations and the Infrastructure Challenge. United Nations Conference on Trade and Development. New York.

42 Froot, A. & Jeremy, C. (1991). Exchange Rates and Foreign Direct Investment: An Imperfect Capital Markets Approach.. *The Quarterly Journal of Economics* (1991): 1,191-217.

43 Blonigen, A. (1997). "Firm-Specific Assets and the Link Between Exchange Rates and Foreign Direct Investment." *American Economic Review* 87, no. 3: 447-65.

44 Bütte, T. & Milner, H. (2004). "The Politics of Foreign Direct Investment into Developing Countries: Increasing FDI through Policy Commitment via Trade Agreements and Investment Treaties." *Paper presented at the annual meeting of the American Political Science Association, Hilton Chicago and the Palmer House Hilton, Chicago, IL: August 8, 2004.*

are now enforceable rules and another country or countries (in the case of the WTO, potentially over one hundred countries) can punish the offending country.⁴⁵

1.5.3 Population and Environmental Factors

Population and environmental factors may also play a role in determining the level of a country's FDI. Kolstad and Tøndel note, for example, that MNCs could be attracted to areas with low levels of social development and equality if the labor is cheap.⁴⁶ They could be attracted to areas with high levels of human capital accumulation if this condition is associated with higher levels of productivity. Therefore, proxy variables to account for the level of social development of a country's population, such as the percentage of people who have completed secondary education, are frequently used in the FDI-determinants literature, and research indicates that their impact depends on the industry in which the investment is made.

Aside from the social or human development characteristics of a country's population, other factors that are almost entirely country-specific that can be associated with FDI flows. For instance, historically, the most important determinant of FDI was the level of a country's natural resources. Although this factor has declined in significance as the importance of the primary sector in world output has declined, it can still explain a significant portion of inward FDI in natural resource-rich developing countries. In addition, Adams find that a number of country-specific variables are significant in their bilateral FDI model, such as how similar the two countries languages are (positive correlation with FDI), whether they have colonial ties (positive), whether they share a border (positive), and whether one or more of the countries is

45 Hicks, B. (2007). Regional Trade Agreements and Foreign Direct Investment. Thesis, Texas Tech University, 2007.

46 Kolstad, I. & Line T. (2002). Social Development and Foreign Direct Investments in Developing Countries. Development Studies and Human Rights, Chr. Michelsen Institute.

landlocked (negative).⁴⁷ Investors also perceive potential threats to their investment from the political environment and act accordingly. As intrastate conflict rises, whether in the form of political turmoil or, more significantly, actual combat, the level of FDI flows to the host country drops. Conversely, some evidence indicates that if the host country is a developed nation military conflicts fought on foreign soil might encourage FDI since they have the financial capacity to fight the war and potentially need FDI to help fund it.

1.5.4 Literature Gap

Ayanwale investigated the empirical relationship between non-extractive FDI and economic growth in Nigeria. The study went further and examined the determinants of FDI into the Nigerian economy. An augmented growth model was used to estimate via Ordinary Least Squares and Two Stage Least Squares to ascertain the relationship between FDI, its components and economic growth. Results suggested that determinants of FDI in Nigeria were market size, infrastructure development and stable macroeconomic policy. Openness to trade and available human capital were not FDI inducing. Generally, FDI did not have a significant effect on growth but components of FDI had a significant impact. FDI in the communications sector had the potential to grow the economy while manufacturing FDI negatively the economy and reflected poor business environment in the country. The available human capital was low and there was need to develop it through education and training to raise its potential to contribute to economic growth.

Obwona and Semwanga⁴⁸ in two similar studies investigated the Ugandan experience with FDI, with the aim of establishing the FDI-growth nexus. To pull in FDI, macroeconomic and

47 Adams, R. (2003). The Trade and Investment Effects of Preferential Trading Arrangements. Old and New Evidence. Productivity Commission Staff Working Paper, Canberra.

48 Obwona, B.M. (2002). Determinants of FDI and their impact on Economic Growth in Uganda. *African Development Review*. Vol. 13 Issue1, Pp 46-81.

political solidness and approach consistency were more imperative than motivation plans, for example, assessment occasions and exceptions. Institutional and infrastructure bottlenecks were found to act as deterrents to FDI. Results from both studies confirmed that FDI had an impact on economic growth in Uganda. Achandi⁴⁹ found that FDI inflows increased exports in Uganda and recommended that the Ugandan government maintain its policy of attracting FDI and undertake policy interventions that boost the linkage between FDI and exports to realise the optimal benefits from the inflows of FDI.

Blomstrom and Kokko⁵⁰ managed the venture impacts of RTAs and how such courses of action influenced internal and outward stream of FDI. Their discoveries were that the reaction to RTAs relied on upon the ecological change achieved by the understanding and locational points of interest of the taking part nation. Further, the most positive impact on FDI occurred when RIA agreements coincided with liberalisation and macroeconomic stabilisation in member countries

None of the research works exhibited above, consider RTAs' individual procurements likely in light of the fact that the quantity of RTAs when all is said in done is changing consistently. An enormous measure of exchange understandings are upgraded seriously every year. Accordingly, it could be hard to investigate the subtle elements of these exchange assentions and, especially, to examine their individual articles and procurements. Thus, the greater parts of the studies regard such procurements as "secret elements" and basically take a gander at the aggregate number of exchange understandings a nation is occupied with.

49 Achandi, E.L. (2011). Effect of FDI on Export Performance in Uganda. Makerere University, Kampala Uganda.

50 Blomstrom, M. and Kokko, A. (1997). Regional Integration and Foreign Direct Investment. Working Paper series in Economics and Finance No. 172

Numerous studies have investigated the determinants of FDI inflows in Africa, including the contribution of aggregate investment expenditure on growth.⁵¹ Few have addressed the impact of regional trade agreements on FDI inflows. Hence this study aimed to fill the gap by investigating the impact of regional trade agreements on FDI inflows by the Eastern African countries

1.6 Significance of the Study

This study contributes towards the on-going debates on the impact of foreign direct investments on economic growth. Accordingly, this study seeks to establish to what extent does foreign direct investment impact growth both in the short run and long run in East Africa. The results of this study will provide policy makers at all government levels as well as commercial organizations with a piece of research that could stimulate the attraction of foreign direct investment in East Africa. Furthermore, the government will be in a better position to determine whether to pursue policies meant to support domestic investment or foreign direct investment.

The present study, not at all like the past ones, will cover late information on monetary development in East Africa locales and investigate the open doors and difficulties in the local exchange. The purpose behind the decision of Eastern Africa nations to be concentrated on is managed by the accessibility of long haul time arrangement information and by the certainties that the nation's financial development is equivocal and besides, that there is a need to lead comparative studies on nations at diverse phases of improvement. In this manner, it is important to lead comparative studies in nations at diverse phases of improvement with a specific end goal to achieve a more legitimate conclusion in regards to the effect of territorial exchange concessions to FDI inflows, particularly in creating nations.

51 Wang, Z. & Swain, J. (1995). The Determinants of Foreign Direct Investment in transforming economies: Evidence from Hungary and China, *Weltwirtschaftliches Archiv*, 131, pp359-82

Having said this, this study was unique in relation to numerous others with respect to the contentions already specified. Moreover, it is not regular to consider the development of the monetary development of one nation over a long stretch, which is the goal of the present study. On the other hand, the point of this study, as with numerous different studies that have been directed in this field, is to demonstrate African nations another path in which to center their financial targets, and to distinguish regardless of whether approach producers of the these nations ought to equip their arrangements towards concentrating on the open doors and chip away at the present difficulties to empower monetary development.

1.7 Theoretical Review

This study was anchored on Eclectic Theory since it captures well the FDI and the variables of this study.

1.7.1 Eclectic Theory

The hypothesis is proposed by Dunning and looks to offer a general system for deciding examples of both remote possessed creation attempted by a nation's own endeavors furthermore that of residential generation claimed by outside undertakings. As indicated by Dunning, there are two sorts of speculation that a firm can decided to embrace. That is, Foreign Portfolio Investment (FPI) and Foreign Direct Investment (FDI). FPI is characterized as the inactive possessions of securities and other money related resources, which don't involve dynamic administration or control of securities backer. FPI is absolutely impacted by high rates of return and decrease of danger through geological broadening. The arrival of FPI is regularly as interest installments or non-voting profits. FDI is characterized as the procurement of outside resources with the end goal of control.

The eclectic hypothesis subsequently calls attention to that for an outside firm to be focused in a remote nation, it must have some sort of interesting preferences that can help them defeat

the expense connected with working in the new nation. These preferences are called possession or firm specific advantages (FSAs) or center skills and they help the remote firm in producing high incomes for the same cost, or lower expenses for the same incomes contrasted with residential firms. Dunning recognized three principle sorts of possession focal points for multinational ventures. These incorporate; Knowledge/innovation characterized to incorporate all types of creative thoughts, Economies of vast size incorporate economies of scale, extension, learning and more extensive access to monetary capital and expansion of benefits and dangers and monopolistic favorable circumstances happen as advantaged access to data and yield markets through patent rights and responsibility for regular assets.⁵²

The eclectic theory points out that the existence of a special knowhow or core skill is an asset that can generate economic profits to a foreign firm. These profits can be earned by licencing the Firms Specific Advantage (FSA) to another firm, exporting products using the FSA as an input or setting up subsidiaries abroad. Furthermore the theory provides that a hierarchy (vertically or horizontally integrated) is a better method of organising transactions than the market (trade between unrelated firms) whenever external markets are nonexistence or imperfect. Thus internalisation advantages lead to preferentially wholly owned subsidiaries by MNEs over arm's length transactions. However in setting MNEs abroad Dunning (1997) identified the following difficulties; Natural Market failure (natural imperfections). lack or insufficient information on pricing, costs and benefits, transaction costs under conditions of risk, uncertainty, moral hazard and adverse selection, structural market failure due to imperfections created by MNEs, monopoly power exertion using oligopolistic methods, predatory pricing, cross subsidization, market cartelization and market segmentation and

52 Chowdhury, A. and Mavrotas, G. (2006). FDI and Growth: What Causes What?. *The World Economy* 29, no. 1 (January 2006): 9-19.

arbitraging government regulations and exploiting regulations in terms of tariffs, taxes, price controls and non- tariff barriers.⁵³

Moreover, Kumar highlighted that FDI in creating nations is moving from business sector looking for and asset looking for FDI to more effectiveness looking for FDI.⁵⁴ This is because of financial weights impelled on costs, along these lines MNEs are relied upon to migrate some of their creation offices to minimal effort developing nations. In spite of these improvements, FDI in developing nations is still coordinated at surveying natural assets and national or local markets.

1.8 Research Methodology

East Africa is considered as an economic possibility to strengthen the capacities of communities laying emphasis on continental resources. It focuses on impact of regional trade agreements on FDI inflows as a means to identify new opportunities, create jobs, income and develop local infrastructure. In this light, this research work strived to present the research design, which seeks to investigate the research question.

1.8.1 Research Design

This study sought to achieve both a more complex and fuller explanation of the impact of regional trade agreements on FDI inflows. The study received a cross sectional review. Cross-sectional overviews endeavor to go more distant than simply giving data on the recurrence (or level) of the property of enthusiasm for the study populace by gathering data

53 Moosa, I.A. *Foreign Direct Investment: Theory, Evidence and Practice*. New York: Palgrave Macmillan, 2002.

54 Kumar, A. (2007). Does Foreign Direct Investment Help Emerging Economies? Federal Reserve Bank of Dallas. *Economic Letter-Insights from the Federal Reserve Bank of Dallas* 2, no. 1.

on both the characteristic of interest and potential risk variables. In this study, the populaces of interest were authorities from the 11 Eastern African nations chose for this study.

1.8.2 Data collection

The study used both secondary and primary data. The study utilized both secondary and primary information. Secondary information was acquired from the International Monetary Fund's International Financial Statistics, the Central Banks of Africa, the World Bank, UNDP and the site. Secondary information was gathered utilizing a interview aide. The inquiries were utilized to evoke more data from respondents to finish any missing connections. The interview guide went for noting the study inquiries and it meets the examination goals. The decision of this device of information gathering was guided when accessible and the destinations of the study. Interview guide gave a high level of information institutionalization and appropriation of summed up data amongst any population.

1.8.3 Data analysis

Data analysis answered the research questions and assisted in determining the trends and relationships among variables. Descriptive statistics were used to analyze the data. Findings from the analysis were used to compile the report.⁵⁵

1.8.4 Scope of the Study

The scope of the study entailed an investigation of the effect of regional trade agreements on Foreign Direct Investment in East Africa Community countries. The study specifically looked at the theoretical underpinnings on the regional trade agreements on FDI inflows, the pattern and macroeconomic instability on FDI inflows in Eastern African countries. Moreover, the study was carried out on the East African countries who are members of the EAC.

⁵⁵ Preece, R. (1994). *Starting Research – An Introduction to Academic Research Dissertation Writing*. Great Britain. Pinther.

1.9 Outline of the Study

Chapter one provides an introduction and background to the study. A problem statement, research methodology, and significance of the study are also provided in the chapter. Chapter two provides a discussion on the theoretical and empirical literature review of the theories of economic growth and foreign direct investment. Chapter three provides an overview of FDI inflows and economic growth in East Africa. The analysis also provides an assessment of the determinants of FDI inflows in East Africa. Chapter four provides a report and interpretation of empirical findings. Chapter four discusses the key emerging issues from the study and are critically analysed. Chapter five presents a summary of the main findings, conclusions and policy recommendations.

CHAPTER TWO

RELATIONSHIP BETWEEN REGIONAL TRADE AGREEMENTS AND FDI INFLOWS

2.1 Introduction

The organization of this Chapter is as follows: Section 2.1 outlines the Regional Investment Rules and FDI. Section 2.2 reviews the Regional Trade Rules and FDI. Section 2.3 concentrates on other regional initiatives and FDI. Section 2.4 focuses on the empirical evidences of FDI and economic growth. Section 2.5 provides a summary of the literature reviewed in this chapter. There are various ways through which RTAs can influence FDI and vice versa. They are distinguished among investment rules, trade rules and other links.⁵⁶

2.1.1 Regional Investment Rules and FDI

Investment rules govern cross-border investment in the region and usually consist of rules on treatment and protection of FDI contributing to the “investment climate.” Investment rules exist in a handful of RTAs although they are not as common as trade rules, particularly amongst the poorer developing countries. Some regions include voluntary principles (for example APEC) while other regions include rules with effective dispute settlement procedures.⁵⁷ Several studies⁵⁸ discuss a number of investment provisions in regional treaties (scope, standard of treatment, performance requirement, expropriation, and dispute settlement

56 Blomström, M. and Kokko, A. (1997). Regional Integration and Foreign Direct Investment, *NBER Working Paper 6019*; Dunning, J. (1997a). The European Internal Market Programme and Inbound Foreign Direct Investment, *Journal of Common Market Studies*, 35, pp. 1-30; Dunning, J. (1997b). The European Internal Market Programme and Inbound Foreign Direct Investment, *Journal of Common Market Studies*, 35, pp. 189-223.

57 Markusen, J.R. and Venables, A.T. (1997). The Role of Multinational Firms in the Wage-Gap Debate, *Review of International Economics*, 5(4), pp. 435-451.

58 Brainard, S. L. (1997). An Empirical Assessment of the proximity-Concentration Trade-Off Between Multinational Sales and Trade, *American Economic Review*, Vol. 87, No. 4, pp. 520-544; Barrell, R. and D.W. te Velde (2002). European Integration and Manufactures Import Demand, *German Economic Review*, 3, pp. 263-293.

mechanisms) and their expected effects on the volume of FDI. The provisions sometimes apply to regional investors and sometimes to extra-regional investors.

There is a heated discussion on how investment rules (bilateral, regional, and multilateral) affect investment decisions. Generally, a predictable investment climate can be in the interest of investors when they were previously disadvantaged by unpredictable investment conditions. It is not clear whether this would lead to *additional* FDI or simply to more comfort for the investor. It is, however, clear that surveys reveal that investors want a predictable investment climate (e.g. CBI position paper for WTO negotiations, EU survey of MNEs), although not necessarily at the cost of other policy liberalisation (further trade liberalisation). The predictability of the investment climate may be enhanced when domestic policies are enshrined or locked into regional treaties. Much will also depend on existing treatment. If treatment of existing investors is already good in practice, new (regional) rules may add little to generating new investment or a better investment climate, other than offering a little more long-run security. There seems to be no empirical evidence that addresses the effects of individual investment provisions on FDI.

2.1.2 Regional Trade Rules and FDI

The elimination of intra-regional tariffs will affect trade *vis-à-vis* the level of sales by multinational subsidiaries depending on the importance of transport (for instance tariff) costs and plant-level and firm-level costs in setting up multinational subsidiaries.⁵⁹ Hence, the type and motive of investment plays an important role in understanding how tariffs and trade affect FDI. To reflect this, we distinguish between intraregional and extra-regional FDI and between horizontal (market seeking: subsidiaries selling similar products) and vertical

59 Carr, D.L., Markusen, J.R. and Maskus, K. (2001). Estimating the knowledge-capital model of the multinational enterprise, *American Economic Review*, 91, pp. 693-708.

(efficiency and natural resource seeking: subsidiaries exploiting efficiencies or control over inputs) FDI.

Regional tariff preferences can decrease *horizontal* (tariff-jumping) intra-regional FDI because it may now become cheaper to serve the partner country by trade rather than to establish a subsidiary and incur plant-level costs more than once and firm-level costs only once. Of course, when firm level and plant-level fixed costs are zero, there will be no trade and no concentrated production facility or FDI – just national production. However, on the other hand, regional tariff preferences encourage *vertically-motivated* intra-regional FDI, because lower trade costs will provide incentives to establish international production networks and establish an efficiency seeking subsidiary in a partner country that can process imports for re-export.

Extra-regional FDI can also be affected by declining regional tariff preferences in different ways. First, by lowering tariffs amongst parties to the RTA, it may become profitable for an extra-regional investor to avail of an effectively larger market (horizontal market-seeking FDI) from one or more locations in the region (export platforms). If individual countries of a region are previously served by trade, this may then raise inward FDI (export platforms or beachhead locations).⁶⁰ However, if the member countries of a region were already served through sales of a multinational subsidiary, concentration of production may occur in one or a few countries in the region, with ambiguous or negative effects for the volume of extra-regional FDI in each country. The combination of lower internal tariffs and significant plant fixed costs would lead to a consolidation of several plants in several members of the region into one or a few plants, used by the parent to serve the region as a whole. This may also induce FDI inflows to the most cost-efficient location (usually nearest to the largest market),

60 Ethier, W. J. (1998). "Regionalism in a multilateral world", *Journal of Political Economy*, 106, pp. 1214-1245.

possibly at the cost of FDI to other members in the same region. This could be the case for market-seeking multinationals. The effects of regional trade preferences for extra-regional vertical (or efficiency-seeking) FDI is likely to be small, though lower regional preferences may lower costs and raise efficiency in the vertically motivated subsidiary when it uses inputs from more than one country in the region (regional enterprises in ASEAN, ANDEAN or SAARC).

There are various effects of regional tariff preferences on inward FDI. However, in the context of developing country regions, where most inward FDI is inter-regional (even though South Africa is an important investor in SADC), the market size argument would be the most important, and apart from other factors regional tariff preferences would tend to raise inward FDI. It must be noted, however, that the strength of this argument depends on the difference between tariffs applied regionally and tariffs applied to others on an Most Favoured Nation (MFN) basis. Indeed, the market size gained as a result of regional integration needs to be the total market size of the region corrected for initial MFN rates, as this will indicate the maximum scope of the market size gained. Hence, the higher the MFN rate and the larger the market size, the more likely it is that market-seeking investors will respond. Accounting for this, it emerges that regions in Africa such as COMESA and SADC have as much to offer as ANDEAN not because of their similar market size but because of similar regional market size corrected for MFN tariffs.

Rules of origin constitute another trade rule that can affect location decisions. The effects of rules of origin (RoO) on investment can vary depending on the type of investment as well as the interaction with regional tariff preferences. The RoO can encourage the use of intra-regional inputs diverting away from extra-regional inputs, even if these were more efficient. However, a stricter and more costly RoO would stifle intra-regional trade favouring extra-regional imports (which are likely to face the MFN tariff). The higher the difference between

MFN tariffs and regional tariffs, the higher the incentive to comply with the RoO by importing regionally using good certificates (see Estevadeordal and Suominen, 2003).⁶¹

Non-tariff barriers to trade can also affect investment. NTBs include voluntary export restraints; the threat of imposing EU quotas and using anti-dumping against Japanese exports motivated the Japanese to set up operations inside the EU. Barrell and Pain⁶² found that after controlling for relative labour costs and market size, Japanese investment flows to EC countries over 1980–91 were significantly influenced by antidumping activities taken in the EC.

On balance, RTAs should lead to increased extra-regional FDI, but there are results that are more ambiguous for intra-regional FDI. An important reason for the ambiguity of the effects of trade rules is that MNEs are motivated by exploiting firm-specific assets (firm-specific fixed costs) and hence want to enjoy economies of scale and scope, in addition to simply jumping trade barriers.

2.1.3 Other regional initiatives and FDI

There are various other links between RTAs and FDI. Many provisions are region specific and cannot be easily categorized. For example, provisions other than the trade and investment rules include free movement of people (CARICOM) and free transfers of profits, which can all facilitate the establishment of intra-regional FDI. Taking another example, some regions (ANDEAN, ASEAN, and MERCOSUR) have cooperation schemes, which aim to establish regional enterprises by promoting joint ventures. The ASEAN region seems to be one of the most advanced in this area. The ASEAN Industrial Cooperation scheme (AICO Scheme) seeks to promote joint manufacturing industrial activities between ASEAN-based companies.

61 Estevadeordal, A. and Robertson, R. (2002). “Do Preferential Trade Agreements Matter for Trade? The FTAA and the Pattern of Trade.”, *draft paper*.

62 Barrell, R. and Pain, N. (1999). Trade restraints and Japanese direct investment flows, *European Economic Review*, 43, pp. 29-45.

More than 100 projects have been selected for special tax and tariff incentives. The ASEAN secretariat has also begun various activities in the area of investment facilitation, by providing information through portals, databases, publications, and statistics. It can thus be said that a region can do much more to try to promote investment than design and implement trade and investment rules. They can put in place the regional infrastructures (legal, institutional etc.) to deal with investment issues at a regional level.

Some argue that the effects of RTAs on FDI are not so much about trade and investment rules, but about the increased predictability of the investment climate by locking in general reforms (regulation, competition policies, property rights, contract enforcement, guaranteed access to members' markets and stable trade policies) in a wider context. The fact that national policies are "locked" in regional treaties should give investors additional security in that policy reversals are less likely, reducing non-commercial risk. In practice, this argument would depend on how strong the region is *vis-à-vis* individual members. The argument is also related to signalling, in that signing an RTA signals an intention that can be regarded as favourable to investors; this would apply equally to intra and extra-regional investors.

Many argue that important effects of RTAs on FDI are dynamic, with competition creating a more efficient industry and growth, which in turn can affect FDI. Neary⁶³ includes dynamic effects in a theoretical model of describing MNEs. First, there is the tariff-jumping motive as discussed before: FDI is favoured over exporting the higher the external tariff and the lower the fixed costs of a new plant. Second, the export platform motive could affect FDI, as lower intra-regional tariffs would favour a single plant in the region. Finally, lower intra-regional tariffs would lead to increased competition from stronger domestic firms and hence lower FDI. On the other hand, a more efficient private sector can raise efficiency-seeking

63 Neary, J.P. (2001). "Foreign Direct Investment and the Single Market", Draft paper CEPR and University College Dublin.

investment by becoming efficient regional suppliers, and raise strategic asset-seeking investment.

Blomstrom and Kokko⁶⁴ also argue that regional integration leads to efficiency gains and higher growth, and thus further FDI. FDI can actually be such a catalyst through spillovers in terms of technology transfer and other linkages with local firms. There can thus be long-lasting effects on growth and productivity as opposed to a one off effect based on a more efficient allocation of resources. Schiff and Wang (2003) show that NAFTA imports have raised productivity (between 5.5-7.5%) in Mexico in the form of imported knowledge stocks, while other imports did have no effects. Apart from trade and investment rules and regional institutions, regions can also decide to harmonize fiscal and monetary policies. For instance, the Euro area (within the EU), the UEMOA, and four out of five SACU members (within SADC) have common currencies. This reduces intra-regional exchange-rate variability and may reduce cross-border transaction costs, which are amongst the factors contributing to investment. Because the EU, SADC, and SACU are incomplete currency areas, there should be implications for which parts of the region are influenced.

2.1.4 Spatial distribution of FDI across region

While regional integration can lead to more extra-regional investment for the region as a whole, this may not lead to more FDI in each individual member country. While peripheral countries to the EU, such as Ireland, have caught up in terms of productivity levels with other members of the EU – apparently through trade and FDI spillovers, there has been a degree of divergence and agglomeration in developing regions such as the East African Community and the Central American Common Market, both dating back to the 1950s and 1960s.

64 Blomström, M. and Kokko, A. (1997). “Regional Integration and Foreign Direct Investment, *NBER Working Paper 6019*.

Agglomeration effects can enhance an uneven spread of benefits amongst members.⁶⁵ Agglomeration effects refer to a spatial clustering of economic activities. Agglomeration can occur within a county (cities) or across countries. Clusters of economic activities can lead to efficiency gains, for instance, because a pool of specialized support services is feasible owing to economies of scale.⁶⁶ If relocation effects occur within a region, this may lead to efficiency gains, which may reinforce further relocation effects. This would lead to further divergence or convergence, which could affect the distribution of gains from and ultimately the motives for regional integration processes. On the other hand, as argued in Ethier⁶⁷ smaller (and possibly poorer – though this is obviously not the case in regions such as ASEAN) countries may actually have incentives to form a region in order to attract investment away from other members, particularly extra-regional FDI.

This may be the case when regional tariff preferences allow foreign investors to set up beachhead locations in a small (or poor) country to serve the entire regional market. Hence, the spatial distribution of FDI is an empirical question and depends on factors such as the level of external MFN tariffs, strictness of RoO, market size and agglomeration effects in individual member countries.

2.3 Empirical evidences of FDI

The role of foreign direct investment (FDI) flows within the developing countries has grown dramatically since globalization and a rapid expansion in the world's economy in the 1980s. FDI flows to developing countries have increased rapidly from US\$7.5 billion in 1980 to US\$35.1 billion in 1990 and by 2000 and 2007 they reached US\$256.5 billion and US\$564.9

65 Venables, M. (1999). Integration Agreements: A Force for Convergence or Divergence? *Proceedings of World Bank ABCDE Conference*, Policy Research Working Paper Series no. 2260, World Bank.

66 Porter, M. (1998). "Clusters and the new economics of competition", *Harvard Business Review*, 76, pp. 77-90.

67 Ibid, p 31

billion, respectively.⁶⁸ Furthermore, FDI flows to developing economies in 2009 account for 84 percent (US\$478.3 billion) of total world FDI flows, thus overtaking the traditional dominance of developed economies. In 2009 Asian developing countries accounted for nearly 63 percent of total FDI flows to developing countries, whilst the small island developing states accounted for only one percent of total FDI flows⁶⁹

Kevin⁷⁰ board information investigation demonstrates the impact of FDI on financial development in 47 African nations in the course of the most recent two decades (1980–2000) and shows FDI applies a positive effect on development in Africa. He likewise clarified the reasons for the stream of FDI in host nations like: prepared human capital and an alluring venture atmosphere originating from a created foundation, lower nation hazard and stable full scale environment in nations. These outcomes affirm his theory that remote guide and additionally household and outside speculation is powerful and development improving just in a decent strategy environment. But, because Africa receives only a small portion of FDI, foreign aid and domestic investment still account for a greater effect on growth.⁷¹ Regression results reveal that corruption does not matter in the case of FDI: nations where corruption is seen to be high still profit by a positive effect of FDI on development. FDI inflows are all the more firmly absolutely identified with change in human advancement when FDI arrangement limits foreign financial specialists from entering some monetary areas and when it oppresses outside speculators in respect to local speculators. The relationship between FDI and change in human improvement is additionally all the more emphatically positive when corruption is low.⁷² Lumbila⁷³ argued also the amount of FDI directed to Sub-Saharan Africa (hereafter,

68 United Nations Conference on Trade and Development. (2010). World foreign direct investment flow 2010. <http://www.unctad.org/fdistatistics>.

69 Ibid, p26.

70 Reiter, S. and Kevin, S. (2010). Human Development and Foreign Direct Investment in Developing Countries: The Influence of FDI Policy and Corruption. *World Development*, 38 (12), 1678-1691.

71 Lumbila, K. (2005). What Makes FDI Work? A Panel Analysis of the Growth Effect of FDI in Africa. African Region Working Paper Series No. 80.

72 Ibid, p40.

Africa) also increased significantly, reaching US\$148 billion in the year 2000 against only US\$32 billion in 1980. Admas⁷⁴ analyze by his study on impact of foreign direct investment (FDI) and domestic investment (DI) on financial development in Sub-Saharan Africa for the period 1990– 2003 that DI decidedly and altogether related with Economic development. His study additionally found that FDI at first has negative impact on DI and in this manner beneficial outcome in the recent periods for the nations being studied. He inferred that the determinants of the FDI have the net 25 swarming out impact.

The survey of the writing and discoveries of the study show that the continent needs a focused on way to deal with FDI, expand ingestion limit of neighborhood firms, and participation between government and multinational enterprise (MNE) to advance their common advantage. By concentrating on the impact of foreign direct investment (FDI) on financial development in a cross-country relapse system, using information on FDI streams from modern nations to developing nations in the course of the most recent two decades, Borenszteina, De Gregoriob and Lee⁷⁵ investigated that, FDI is a critical vehicle for the exchange of innovation, contributing moderately more to development than local venture. Their study recommended that the host nation ought to have adequate absorptive capacity of the propelled advances accessibility for FDI commitment to host nation.

Agrawal and Khan⁷⁶ undertook a time series study on impact of FDI in China and India shows a positive impact in economic growth. According to the suggested result, growth in India and China is mainly depending on trade liberalization policy by each country made in 1990s and the consequent upsurges inflow of foreign capital to both these countries. In 1975,

73 Ibid, p40.

74 Adams, S. (2009). Foreign Direct investment, domestic investment, and economic growth in Sub-Saharan Africa. *Journal of Policy Modeling* 31 (6), 939–949.

75 Borensztein, E., De Gregorio, J. and Lee, J-W. (1998). How Does Foreign Direct Investment Affect Economic Growth?. *Journal of International Economics*, 45 (1), 115-135.

76 Agrawal, G. and Khan, M. (2011). Impact of FDI on GDP: A Comparative Study of China and India. *International Journal of Business and Management*, 6 (10), 71-79.

China was at comparability with India in GDP, yet 33% lower in its GDP per capita (\$146 versus \$220). Nevertheless, throughout the years China grew more quickly than India and surpassed India as far as GDP per capita in 1984. The study likewise researches the reasons how china has become more quickly than India by using FDI. In the wake of dissecting the information from 11 nations in East Asia and Latin America, utilizing econometric strategies, for example, unit root and co incorporation tests, Ram and Zhang⁷⁷ gives prove that FDI advances monetary development in nations with a changed exchange administration, and a workforce with higher employment aptitudes and instruction. As indicated by Ram and Zhang⁷⁸, FDI gives prepared access to the world markets and goes about as a course for the host nation to partake in the globalization process.

Utilizing board information on 84 nations covering the time of 30 years from 1970 to 1999, Li and Liu⁷⁹ find that it is an undeniably endogenous relationship in the middle of FDI and development, particularly since the mid-1980. By utilizing cross-segment information identifying with an example of forty-six creating nations Balasuramanyam, Salisu and Sapsford researches that, FDI plays in the development process in the differing so as to set of creating nations portrayed exchange approach administrations. The paper 26 tests the speculation progressed by Jagdish Bhagwati, and they inferred that, as per which the advantageous impact of FDI, regarding improved financial development, is more grounded in those nations which seek after an ostensibly arranged exchange approach than it is in those nations receiving a deep down.

77 Ram, R. and Zhang, K. (2002). Foreign Direct Investment and Economic Growth: Evidence from Cross-Country Data for the 1990s. *Economic Development and Cultural Change*, 51 (1), 205-215.

78 Ibid, p42.

79 Li, X. and Liu, X. (2005). Foreign Direct Investment and Economic Growth: An Increasingly Endogenous Relationship. *World Development*, 33 (3), 393-407.

Borensztein, De Gregorio, and Lee⁸⁰ used cross-country data for 1970–79 and 1980–89 to study the FDI to growth connection and the possible complementarities between FDI and the host country’s human capital. They investigated that the higher productivity of FDI holds only when the host country has a minimum threshold stock of human capital and suggested “FDI contributes to economic growth only when a sufficient absorptive capability of the advanced technologies is available in the host economy.”

2.4 Summary

The economic benefits of FDI are many, but one of the most common justifications is the notion that foreign investments bring foreign capital, new knowledge, and managerial skills, in addition to creating employment and it can generate high levels of national income. FDI, as key capital resources, have promoted large theoretical and empirical studies. The effects of FDI on growth have produced mixed results and therefore these studies have noted country specific variables, in order to estimate its impact on growth. Given the importance of FDI, most countries continue to actively seek to attract FDI, by offering generous incentives with a number of investment promotion policies. When examining FDI’s impact on growth, many supporters of the neoclassical growth and the new growth models have incorporated FDI, with varying outcomes.

Concerning the empirical tests on the linkage between FDI and economic growth, the studies can be summarized into three mainstream groups. The first stream examines the impact of FDI on economic growth and it has expanded the growth models to include various economic and political variables.⁸¹ The second stream focuses more on the determinants of FDI and it is comprised of a variety of economic, political, and institutional variables. The final stream

80 Ibid, p40

81 Balasubramanyam, V., Salisu, M., and Sapsford, D. (1996). Foreign direct investment and growth in EP and IS countries. *The Economic Journal*, 106, 92-105; Borensztein, E., Gregorio, J. and Lee, J. (1998). How does foreign direct investment affect economic growth? *Journal of International Economics*, 45, 115-135.

focuses on the productivity effects of FDI on the main sectors, in particular, primary, manufacturing, and services sectors. These theoretical and empirical studies have offered valuable insights into the nature of FDI and its potential contribution to economic growth.

CHAPTER THREE

PATTERN OF FDI INFLOWS AND ECONOMIC GROWTH IN EAST AFRICA

3.1 Introduction

This chapter provides an overview of FDI inflows and economic growth in East Africa

3.2 FDI in Eastern Africa Overview

In 1970 (the first year for which FDI data were available), the total amount of Foreign Direct Investments (henceforth, FDI) inflows in Africa was US\$1.26 billion, and it rose to US\$55.04 billion in 2010. Thus, between the two periods, FDI inflows have increased by 4,247%, and one can say that Africa has done well in attracting FDI.

Asiedu⁸² analyses the relative influence of natural resources and market size *vis-à-vis* government policy, host country's institutions and political instability in attracting FDI to EA. The main result is that countries that are endowed with natural resources or have large markets will attract more FDI. However, good infrastructure, an educated labour force, macroeconomic stability, openness to FDI, an efficient legal system, less corruption and political stability also promote FDI. According to the author, her findings suggest that small countries and/or countries that lack natural resources in the region can also attract FDI by improving their institutions and policy environment.

Asiedu⁸³ explores whether factors that affect FDI in developing countries affect countries in EA differently. The author finds that EA is different from other developing regions as far as FDI attractiveness is concerned. Indeed, the paper finds that: (a) a higher return and better

82 Asiedu, E. (2006). "Foreign Direct Investment in Africa: The Role of Natural Resources, Market Size, Government Policy, Institutions and Political Stability," *World Economy* 29 (1): 63-77.

83 Asiedu, E. (2002). "On the Determinants of Foreign Direct Investment to Developing Countries: Is Africa Different?," *World Development* 30 (1): 107-19.

infrastructure have a positive effect on FDI to EA; (b) trade openness promotes FDI in EA countries, but the marginal effect of openness is lower for EA. This is a cross-sectional analysis with data from 71 developing countries (32 SSA and 39 non-SSA countries), and the data are averaged over the 10-year period, 1989-1997.

In the same line, Bende-Nabende⁸⁴ analyses the relative performance of EA compared to other developing regions in attracting FDI, as well as in improving the environment for FDI. The author argues that EA's share of FDI to developing countries has declined over time, because of less attractiveness of EA for FDI over time, relative to other developing regions. The main finding is that, with regard to FDI determinants, EA's experience can be characterized as absolute progress but relative decline. Indeed, from 1980-89 to 1990-99, EA has reformed its institutions, improved its infrastructure and liberalised its FDI regulatory framework. However, compared with other developing regions, the degree of changes in EA has been meagre. The analysis focused on policy-related factors like openness to FDI, infrastructure and quality of institutions. This is not an econometric analysis, but a statistical analysis comparing the average performance of EA to other developing regions.

Lemi and Asefa⁸⁵ examine the impact of economic and political uncertainty on FDI flows to African economies. Total FDI flows from all source countries, total U.S. FDI, U.S. manufacturing FDI, and U.S. nonmanufacturing FDI flows to sample host countries in Africa are analyzed. Generalized autoregressive heteroscedastic (GARCH) model is used to generate economic uncertainty indicators of the inflation rate and the real exchange rate. The results of the study are as follows: (a) The impact of uncertainty on the flows of FDI from all source countries is insignificant. (b) For aggregate U.S. FDI, economic and political uncertainties are

84 Bende-Nabende, A. (2002). "Foreign Direct Investment Determinants in Sub-Saharan Africa: A Co-Integration Analysis," *Economics Bulletin* 6 (4): 1-19.

85 Lemi, A. and Asefa. S. (2003). "Foreign Direct Investment and Uncertainty: Empirical Evidence from Africa," *African Finance Journal* 5 (1): 36-67.

not major concerns. (c) For U.S. manufacturing FDI, only political instability and government policy commitment are important factors, whereas for U.S. non-manufacturing FDI, economic uncertainties are the major impediments only when coupled with political instability and debt burden of host countries. Other economic factors such as labour, trade connection, size of export sector, external debt, and market size are also significant in affecting FDI flows to African economies. The period of analysis for the flows of FDI from all source countries is 1987-1999; whereas for U.S. FDI flows available data spans from 1989-1998. The analysis covers 32 African countries including Kenya, Uganda and Tanzania.

Yasin⁸⁶ empirically investigates the relationship between official development assistances and FDI flows using panel data from EA countries for the period 1990-2003. The results show that bilateral official development assistance has a significant and positive effect on FDI flows. The results also show that trade openness, growth rate in the labour force, and exchange rates have a positive and significant effect on FDI. However, multilateral development assistance, the growth rate in GDP per capita, the country's composite risk level, and the index for political freedom and civil liberties do not have a statistically significant effect on FDI.

Anyanwu⁸⁷ analyses factors that influence FDI inflows in EA. The paper finds that market size, openness to trade, rule of law, foreign aid, natural resources, and past FDI inflows have a positive effect on FDI inflows. However, higher financial development has a negative effect on FDI inflows. The paper also finds that East and Southern African sub-regions appear positively disposed to obtain higher levels of inward FDI. The paper uses cross-country data from 53 countries for the period 1996-2008.

86 Yasin, M. (2005). "Official Development Assistance and Foreign Direct Investment Flows to Sub-Saharan Africa," *African Development Review* 17 (1): 23-40.

87 Anyanwu, J. (2012). "Why Does Foreign Direct Investment Go Where It Goes?: New Evidence From African Countries," *Annals of Economics and Finance* 13 (2): 433-70.

Dupasquier and Osakwe⁸⁸ examine the performance, promotion, and prospects for FDI in EA. Factors such as political and macroeconomic instability, low growth, weak infrastructure, poor governance, inhospitable regulatory environments, and ill-conceived investment promotion strategies, are identified as responsible for the poor FDI record of the region. The paper emphasises the need for more trade and investment relations between Africa and Asia. It also argues that countries in the region should pay more attention to the improvement of relations with existing investors and offer them incentives to assist in marketing domestic investment opportunities to potential foreign investors. Finally, the paper emphasises the need for concerted efforts at the national, regional, and international levels in order to attract significant investment flows to Africa given the intensification of competition for FDI among developing countries.

3.2.1 Foreign Direct Investment (FDI) in Tanzania

FDI is still in its infancy in Tanzania. It is still a relative new Concept in this country which had a socialist orientation until in recent past years. Efforts in the past have been made by the Tanzanian government to attract more investments from abroad. The early intention of the government was shown in 1963. Foreign Investment Act was passed in order to attract FDI in the new independent Tanganyika, then name of mainland Tanzania before the 1964 union with the Island of Zanzibar.⁸⁹ Such efforts were somewhat unsuccessful since the government opted for socialist path of economic development in 1967 following the Arusha Declaration.

The Arusha Declaration pronounced a socialist policy that was to be followed by the country. The ministerial order under the industrial (Acquisition) Act Number 5 of 1967 required all MNEs operating in the country as well as big private businesses owned by Tanzanians in Mainland Tanzania to make the government of Tanzania majority shareholder of such

88 Dupasquier, C. and Osakwe, P. (2006). "Foreign Direct Investment in Africa: Performance, Challenges, and Responsibilities," *Journal of Asian Economics* 17 (2): 241-60.

89 Ngowi, H. (2000). "FDI Determinants: Can sub-Saharan Africa Increase its Global FDI share?"

companies. The majority of the MNEs and big local companies operating in Tanzania were nationalized. The public corporation Act 17 of 1969 was created to put all nationalized companies under the government control and management.⁹⁰ The revival of the foreign direct investment attraction came in 1985 when among other things; Tanzania found that it could not cope with the ailing and ill-managed public enterprises and companies. Deliberate economic liberalization policies were initiated and implemented. Reforms in the financial institutions, public sector, civil service and other areas were made and are still under way to fine-tune the attraction of FDIs in the country. The National Investment Act of 1997 was passed in order to promote local and foreign investments in the country.

According to The World Economic Forum's Africa Competitiveness Report 2000-2001, published in conjunction with the Harvard Institute for International Development has top-ranked Tanzania, in a survey of African nations' efforts to improve economic and investment conditions, out of twenty-four countries on its index for the correction of initial economic conditions in recent years. The report also ranked Tanzania number two after Nigeria in the African continent for optimism for future growth. It is however important to note that despite the progress made in improving the initial conditions, investment effort in Tanzania is still too low and a lot of improvements are still needed to make investment work for its development.⁹¹

FDI in East Africa have been increasing over time. Bank of Tanzania⁹² point out that monetary value of the FDI inflow into Tanzania increased sixteen-fold from US\$ 47 million

90 Ibid, p49

91 Tanzania Investment Report (2009), Report on Foreign Private Investment in Tanzania, Bank of Tanzania, PCF Project

92 Bank of Tanzania, Tanzania Investment Centre and National Bureau of Statistics (2001), "Tanzania Investment Report", Dar es salaam. Bank of Tanzania, Tanzania Investment Centre and National Bureau of Statistics.

in 1990 to US\$ 768 million by 2000. This is an increase by 15.3% over a decade or an average of 1.53% annual increase. There has been an increase in FDI stocks in Tanzania from 1985 to 1990. Then there was a dramatic decline in 1995, before peaking up in 1998 and 1999. FDI in flows into Tanzania have been increasing over time. The increase from 1996 is both in absolute terms and in relation to other countries, including Kenya. The increased inflows can be attributed to, inter alia, the far –reaching reforms that Tanzania has been undertaking and still at the midst of mainly from the mid-1980s.⁹³

Tanzania under Julius Nyerere attempted a socialist transformation that saw widespread nationalization of property, including the seizure of foreign assets. Foreign investment was legally and effectively banned. This was widened in the 1970s to include most Asian-owned businesses and an (unevenly enforced) expropriation of any property valued at greater than \$15,000. Capitalism and foreign capital in particular were considered UN African, whereas *ujamaa* was considered more “authentic” and appropriate. More recently the climate has changed considerably. Economic reforms began slowly in 1986, and accelerated after an economic crisis in the mid 1990s, substantially altering the government’s stance on foreign investment.

The privatization program, which included many nationalized firms previously owned by foreign companies, facilitated the return of foreign firms back into the country. Mining reforms in the early 1990s allowed major new investment by foreign firms, especially Ghana’s Ashanti Goldfields and South Africa’s AngloGold. Foreign banks were allowed entry after 1993 and several large South African and British banks began operations soon thereafter. Legal changes in 1997 lifted most of the remaining sectoral restrictions on foreign investment on the mainland (although many regulations remain in place in semi-autonomous Zanzibar). Previous demands of government equity have also been lifted for all sectors,

93 Ibid, p49

except for petroleum.⁹⁴ Otherwise, foreign investors are mostly afforded national treatment, including protection of fiscal incentives, guarantee of repatriation, and importation of expatriate staff.

FDI and Growth in Tanzania

Kabelwa⁹⁵ studied the potential impacts of FDI on economic development of Tanzania based on few case studies. The study employed qualitative analysis of particular aspects of FDI (like capital formation, employment generation, international trade, technology transfer (spillovers) and fiscal revenue). The conclusion was that, there was a strong need for effective policy to attract and make FDI work for economic development, also urged to foster domestic private investment in general development agenda.

Bomani⁹⁶ studied the relationship between foreign direct investment, exports and economic growth in Tanzania: a time series analysis. His study revealed that FDI have a direct and indirect causality to GDP growth rate. This observation necessitated the special consideration for making FDI working for growth. Likewise for total exports which had positive and significant relationship to economic growth.

3.2.2 Foreign Direct Investment in Kenya

FDI inflows to Kenya have been highly volatile. After rising steadily from US\$17.3 million in 1973 to the peak of US\$84.0 million in 1979, they generally fluctuated in the 1980's and 1990's despite the economic reforms that took place and the progress made in improving the business environment during the period. The worst year of fluctuation in the 1980's was

94 UNCTAD (1998). Foreign direct investment in Africa: Performance and potential

95 Kabelwa, G. (2006). *Potential Impacts of FDI on Economic Growth in Tanzania, Policy Dialogue for Accelerating Growth and Poverty Reduction in Tanzania*, ESRF, Dar.

96 Bomani, A. (2013). Relationship between foreign direct investment, exports and economic growth in Tanzania: a time series analysis. *Unpublished MSC Thesis*. Mzumbe University.

1988, when the FDI inflows as a percentage of gross national products (GDP) were zero. According to the FDI net inflows increased to US\$110.9 million in the year 2000, but declined to US\$ 5.3 million in the year 2001. The highest inflows were US\$ 729 million in the year 2007 which declined to US\$95.6Million in 2008 before increasing to US\$140.5 Million in the year 2009.The decline in the year 2008 could be attributed to the political instability in the country resulting from the outcome of the December 2007 general elections, which caused lots of uncertainty among the investors.⁹⁷

In 1970's, although the country suffered from macro-economic instability, it received relatively high capital inflows to the peak of US\$84.0 million in 1979. This was partly due to Kenya's market size and her central position in the larger East African Community (EAC). However, the EAC collapsed in 1977,⁹⁸ putting in jeopardy this attraction.

The investment climate in Kenya deteriorated rapidly in the 1980's. The decade that saw sharp fluctuations in net FDI inflows as a percentage of GDP, where it declined to US\$0A million in the year 1988. In addition to the collapse of EAC, this decline was attributed to several factors such as, uncertainty from policy reversals and the shift from import-substitution strategy to export-oriented industrialization, the oil crisis of 1980-1983, the attempted coup of 1982 and introduction of single party state which reduced the level of democracy in the country in the same year.⁹⁹ The period was also characterized by high levels of corruption and deterioration in balance of payments (BOP), made worse by the decision of the multilateral agencies like the International Monetary Fund (IMF) and World Bank to cut off donor funding.¹⁰⁰

97 Republic of Kenya, (2007). *Kenya Vision 2030*, Nairobi, Government Printers.

98 Ajayi, (2007). *Foreign Direct Investment in Sub-Saharan Africa. Determinants, Origins, Targets, Impact and Potential*. Nairobi. African Research Consortium.

99 Republic of Kenya (1986). *Sessional Paper No.1 of 1986: On Economic Management for Renewed Growth, which emphasized export promotion*; Nairobi; Government Printers.

100 Ibid, p52

The 1990's decade was a period that the country experienced political instability due to land clashes of 1992 and 1997 and uncertainties during the electioneering years. This period also experienced the reintroduction of multi-party elections and high levels of insecurity with the bombing of American Embassy in Nairobi and the Israeli tourists at the Coast. These incidents played a major role in scaring away investors. The country also experienced other economic problems during this period. For example, the increase in money supply to finance 1992 elections led to severe inflation. The rate of inflation increased to more than 60 percent in 1994. The inflationary pressure was also accelerated by 1994 drought and famine. The 1990's saw the county's economic performance severely weakened accompanied by a major decline in FDI inflows.¹⁰¹

Due to pressure from the IMF and World Bank, the 1990's also saw the initiation of the comprehensive reform process in the economy, including liberalization of interest rates (1991), floating exchange rates (1993) and abolition of capital controls in 1995. During the same period (1990's) various incentives were introduced, including the establishment of the Export Processing Zones (EPZs) in 1990. As part of the reform programme the government removed foreign exchange controls and privatized a range of publicly owned companies.¹⁰²

Kinaro¹⁰³ using time series analysis finds that FDI in Kenya is determined by economic openness, human capital, real exchange, inflation, and FDI in the previous periods. Opolot et al.,¹⁰⁴ find using panel data for Sub Saharan African countries, Kenya included that market potential, openness to trade, infrastructure, urbanization, and rate of return on investment positively affect foreign direct investment inflows to Sub-Saharan Africa, while macroeconomic instability is a disincentive to foreign direct investment. Other variables such

101 Muthoga, S. (2003). Determinants of FDI in Kenya. Unpublished M. A. Project, Kenyatta University.

102 Republic of Kenya, (2001). *Kenya Investment Guide*. Nairobi, Government Printers.

103 Kinaro, E. (2006). "Determinants of Foreign Direct Investment in Kenya" Institute African de Development Economique et de planification. Dakar.

104 Opolot, J., Mutenyo, J. and Kalio, A. (2008). Determinants of foreign direct investment: evidence from sub-Saharan Africa using a generalized method of moments dynamic panel estimator

as government consumption, financial development, natural resources, wage and political rights are found to be insignificant.

Mwega and Rose¹⁰⁵ using panel data of 43 countries with a Kenyan dummy find that Kenya is not different from other countries and that FDI is determined by growth rates, terms of trade shocks, external debt ratio and quality of institutions. UNCTAD¹⁰⁶ argue that Kenya's inability to attract FDI is due to growing problems of corruption and governance, inconsistencies in economic policies and structural reforms, deteriorating public service and poor infrastructure.

FDI and Growth in Kenya

Foreign direct investment is important to the Kenyan economy for various reasons: It brings investable financial resource, provides new technologies and improves the efficiencies of existing technologies.¹⁰⁷ The government of Kenya has been making efforts through institutional and legal frameworks, forums and promotional campaigns to encourage FDI. Many macro-economic reforms and policy incentives have been adopted and implemented to promote foreign investment. Some of the reforms include the shift from import substitution strategy to export-oriented industrialization, liberalization of exchange rates and interest rate, introduction of export processing zones (EPZ) and elimination of price controls.¹⁰⁸

UNCTAD¹⁰⁹ Foreign firms in Kenya since the 1970s have invested in a wide range of sectors. Most notably, they played a major role in floriculture and horticulture, with close to 90 percent of flowers being controlled by foreign affiliates. In the Manufacturing sector, FDI has

105 Mwega.F. and Rose, W. (2007). *Foreign Direct Investment in Sub-Saharan Africa. Determinants, Origins.Impact and Potential.* Nairobi. African Research Consortium.

106 UNCTAD (2005): "Economic Development In Africa: Rethinking The Role Of Foreign Direct Investment", UNCTAD/GDS/AFRICA/2005/1, United Nations, Geneva.

107 Ibid, p52.

108 Republic of Kenya (1986). *Sessional Paper No.1 of 1986: On Economic Management for Renewed Growth, which emphasized export promotion;* Nairobi; Government Printers.

109 UNCTAD, (2005). *Investments Policy Review, Kenya,* published by United Nations, Geneva 2005.

concentrated on the consumer goods sector, such as food and beverage industries. This has changed in the recent years with the growth of the garment sector because of African Growth and Opportunities Act (AGOA). Of the 34 companies involved in AGOA 28 are foreign most of them concentrated in the Export Processing Zones (EPZs). FDI is also distributed to other sectors including services, telecommunication among others. 55 percent of the foreign firms are concentrated in Nairobi while Mombasa accounts for about 23 percent, thus Nairobi and Mombasa account for over 78 percent of FDI in Kenya. The main form of FDI establishment has been through the form of green fields establishments and Kenya has in total more than 200 multinational corporations. The main traditional sources of foreign investments are Britain, US and Germany, South Africa, Netherlands, Switzerland and of late China and India.

Kinano¹¹⁰ using time series analysis finds that FDI in Kenya is determined by economic openness, taxation, human capital, real exchange, inflation, and FDI in the previous periods. Other variables such as government consumption, financial development, natural resources, wage and political rights are found to be insignificant. In his conclusions, he states that FDI affects economic growth positively if there is a positive increase in the FDI inflows.

Gachino¹¹¹ after land resettlement between 1962 and 1964, the Kenyan government prevented foreign firms from purchasing more land and as a result, foreign ownership in agriculture was greatly reduced. In commerce and industry by contrast, virtually all the expansion, which took place, that is a 50 percent increase in output between 1964 and 1970 and 100 percent increase in the annual level of investments, was foreign owned. At first much of it involved capital transfer out of agriculture, especially following the introduction of exchange controls in 1965. But two years later after the initial period of uncertainty as to the government

110 Ibid, p52

111 Ibid, p57

development strategy, a substantial inflow of foreign direct investments and its diversification to other sectors occurred.

Nyamwange¹¹² did a study on foreign direct investments in Kenya. The purpose of this study was to identify the key factors that influence FDI decisions in Kenya and to explore the empirical relationship between FDI and economic growth in Kenya. The findings of the study revealed that the main determinants of FDI in Kenya are market size (proxied by GDP), taxation, stable macroeconomic policies and a level of human capital that is tolerable by investors. There is no significant relationship of human capital to overall economic growth which suggests that there is a shortage of skilled labour in the Kenya.

Njeru¹¹³ did a study on the impact of foreign direct investment on economic growth in Kenya. The purpose of this study was to establish the relationship between Foreign Direct Investment and economic growth in Kenya. In his study he concludes that with constant and positive growth in FDI in Kenya between 1982 and 2012 there was a positive growth in economic growth in the country.

3.2.3 Foreign Direct Investment in Uganda

Until 1990s, factors that influenced FDI in Uganda included agro economic and political instability; complex administrative bureaucracies; undeveloped physical, human and financial assets; high global market competition; narrow markets most of which in their nascent stages; credibility of the bilateral relations with foreign states; and negative investor perceptions.¹¹⁴ In fact, like other African nations political leaders in Uganda had hostile policies regarding private sector development and FDI in particular. There was widespread concern about the

112 Nyamwange, M. (2009). *Foreign direct investments in Kenya*. Unpublished MBA project.

113 Njeru, B. (2013). The impact of foreign direct investment on economic growth in Kenya. Unpublished Msc. UoN Thesis. Reliable Accounting, Research and Development Consultant

114 Obwona, M and B. Mutambi (2004). "Foreign Direct Investment in Africa: Trends, Determinants and Linkages with Growth and Poverty" Paper presented at the Policy Seminar on Growth and Poverty reduction in Kampala, Uganda.

loss of control over major enterprises especially if foreigners are involved. Aside from the lack of macroeconomic stability and economic growth, many other structural rigidities and institutional factors kept FDI away from Uganda. It was not until the second half of the 1990s that large-scale privatization programs were initiated.

Since the liberalization of Uganda's economy in the early 1990s, Uganda has made considerable efforts to improve its investment climate by liberalizing its investment regulations and offering incentives to foreign investors.¹¹⁵ More importantly, the country has initiated economic reforms aimed at increasing the role of the private sector, for example, through the privatization of state owned enterprises and other programmes to encourage commercial activity. In addition, steps have been taken to among other things improve infrastructure facilities, restore and maintain macroeconomic stability through the devaluation of overvalued national currencies, the reduction of inflation rates and budget deficits. For example a joint survey by the BOU, UIA and UBOS¹¹⁶ on firm level investment: determinants and constraints, the analysis revealed that turnover, profit and credit are significant determinants of firm level investment. On the basis of the study findings, a number of strategies were suggested one which among other factors involved improvement in the infrastructure services to reduce transactions costs that affect investors in the Ugandan economy.

Specifically, the survey showed that power supply is the most recognized critical and daunting constraint to investment and the growth of firms. The share of production lost due to power outages and fluctuations average 6.3 percent in manufacturing. It was therefore recommended that the government needs to fast track policies to increase power generation, transmission and distribution as a matter of urgency. Other key services such as water and

115 UNCTAD (1998). Foreign direct investment in Africa: Performance and potential

116 BOU, UBOS and EPRC (2006) Firm Level Investment: Trends, determinants and constraints. *Research Series* No.47

sanitation, telecommunications and transportation and storage were also seen as constraints to the operation and growth of firms.¹¹⁷ In particular, the quality and price of these services was emphasized as key factors hampering profitability and expansion of existing firms. Thus, once transactions costs are reduced productivity at firm level will rise and it would be possible to unleash a new growth spurt that the economy needs. In the same way, the survey recommended that the poor ratings of Uganda's investment climate at the global level need to improve to reduce the costs of doing business, reflecting administrative procedures, licensing, lack of transparency and predictability of tax and other regulatory obligations which were perceived as being high.¹¹⁸

In the 1990s, Uganda took a major economic stride to remove exchange controls and freed both the current and capital accounts thus, fully liberalizing both the domestic and external sectors of the economy. This resulted into increased influx of private investment to take advantage of the economic stability and growth.¹¹⁹ Since the liberalization of the economy in the 1990s, the growth of private sector investment in Uganda has been driven by foreign inflows in the form of either FDIs or portfolio investments.¹²⁰ Uganda has actively promoted the private sector as an engine of economic growth and development. This sector continues to benefit from the overall macroeconomic stability resulting from formulation of appropriate domestic and external sector policies.

117 Seetanah, B. and Khadaroo, A. (2005). Foreign Direct Investment And Growth: New Evidences from Sub-Saharan African countries

118 Ssemogerere, G., Kalema, J. and Kakonge, J. (2000). "Managing the transition from aid dependency in SSA: Opportunities and challenges in the case of Uganda." *African Economic Consortium, Collaborative Research Report* April, 2000.

119 Obwona, M. (1999). "Foreign Direct Investments Growth Linkage and Institutional Constraints in Sub-Saharan Africa: A case of Uganda". *African Review of Money, Finance Banking*. Supplementary issue of Savings and Development, Pp. 99-126.

120 BOU, UIA and UBOS (2008) Preliminary findings of private sector investment survey (PSIS) 2008

FDI and Growth in Uganda

Consensus in the literature, supported by empirical evidence stipulates that there is a positive relationship between FDI and growth. The spillover effects of FDI directly and indirectly have stimulated growth in African countries.¹²¹ For the last decade or so, African countries have made efforts to attract FDI by designing and implementing reform policies geared at attracting foreign capital. To a significant level, the continent has managed to revamp its capacity to absorb the spillovers generated by FDI and converting these dividends into growth and poverty reduction.

In Uganda, the Uganda Investment Authority (UIA) has kept Uganda's competitiveness on track by constantly refining its investment promotion strategy by maintaining an exemplary trend in attracting FDI within Africa mainly due to the political and economic stability. In 2001, Uganda was cited in the World Investment Report 2002, to be the 11th top investment spot in Africa, out of 53 countries. In 1999/2000, Uganda maintained a GDP growth rate of 5.9% in real terms and 5.7% in 2000/01. The infrastructural developments in Uganda maintained an upward trend over the last three years. The Transport and Communication sectors grew at a rate of 9.0%, which was mainly driven by the expansion of the fully liberalized and privatized telecommunication sector (which grew by 20.5% about the same period).¹²²

In 2001, Bank of Uganda in conjunction with the Uganda Bureau of Statistics (UBOS) and Uganda Investment Authority (UIA) conducted a survey on Private Capital Flows (PCF-2001 Survey) and the findings from the PCF-2001 Survey revealed that FDI forms an important part of Uganda's development, totaling to US\$0.96bn (19% of GDP) as at end of 2000. On a

121 BOU, UIA & UBOS (2003) private sector investment and investor perception in Uganda 2003 report

122 BOU, UIA and UBOS (2008) Preliminary findings of private sector investment survey (PSIS) 2008; BOU, UBOS and EPRC (2006) Firm Level Investment: Trends, determinants and constraints. *Research Series* No.47; BOU, UIA & UBOS (2003) private sector investment and investor perception in Uganda 2003 report

net basis, flows were roughly the same as earlier estimated. Foreign liabilities stocks recorded increased by 19.0% from US\$903m (16.0% of GDP) in 1999 to US\$1,072m (23.0% of GDP) in 2000.

The Private Sector Investment Survey (PSIS)¹²³ results revealed that, private sector investments in Uganda have continued to grow and provide impetus for sustained economic growth. The preliminary findings of the survey indicated that actual investments increased by 24.2 percent, entity turnover by 22.7 percent, employment by 10.6 percent, and compensation of employees by 18.9 percent between 2006 and 2007, all revealed positive trends. This is an indication that Uganda is a competitive investment destination and the private sector continues to contribute to economic growth. There is need to consolidate the achievements registered in the attraction and retention of private investments.

Over the two years surveyed (2006 and 2007) by BOU, UIA and UBOS¹²⁴, Uganda's economy experienced robust growth of 8.2% in 2007 up from 7.0% in 2006. This was a remarkable performance when compared with the average growth of 5.2% achieved by the non-oil producing African countries in 2006. Maintaining such robust growth was primarily attributed to sound macroeconomic policies; acceleration of supply-side reforms and removal of bottlenecks to private sector growth and competitiveness. With regard to FDI, the preliminary findings by BOU, UIA and UBOS¹²⁵ showed that the net FDI flows in terms of liabilities were dominated by equity flows which accounted for 72.8% or US\$90.9 million in 2006 when compared to net debt related inflows with US\$34.0 million or 27.2%. In 2007, net FDI flows increased to US\$253.8 million from US\$124.9 million registered in 2006. Net equity related flows in 2007 increased to US\$210.4 million (82.9%) of which, returned earnings was US\$153.9 million and new equity flows US\$56.5 million. The net transaction in

123 Ibid, p60

124 Ibid p60

125 Ibid, p60

form of long-term debt from related sources rose to US\$36.5 million in 2007 from US\$12.9 million registered in 2006. In Book Value (BV) terms, and on account of increase flows in 2007, FDI stock level increased from US\$1,143.5 million in 2006 to US\$1,397.0 million recorded in 2007.

Obwona¹²⁶ using both qualitative and quantitative data found that FDI affects on growth positively on economic growth. Oscar¹²⁷ looking at causality between FDI and Economic growth of Uganda, found evidence that there is a one way causality from FDI to GDP for Uganda and this implies that FDI impact positively on the economic growth. In Opolot, Mutenyio and Kanyilo¹²⁸ the number of telephone lines per 1000 people was positively and significantly related to FDI.

3.3 Summary of the literature

Indeed, FDI can stimulate domestic investment, facilitate technology transfer, create employment, promote exports and generate economic growth.² The role of FDI as a source of capital is particularly important to Africa, because FDI can fill the annual financings gap of US\$64 billion, or 12% of GDP that the continent needs to achieve the objective of halving poverty by 2015.³ Moreover, net official development assistance to Africa had declined from US\$17.8 billion in 1995 to US\$12.2 billion in 2000, a decrease of about 31% (World Bank, 2003). Net official development assistance will probably continue to decline given the recent global economic crisis, which reduces the capacity of developed countries to provide development assistance to developing world, including East Africa. Thus, East Africa needs to find other resources for financing its development, and FDI is one of those alternative financing sources.

126 Ibid, p58

127 Oscar, A. (2007). The quality of Foreign Direct Investment in Uganda: Does it matter for economic growth?. Un-published.

128 Opolot, J., Mutenyio, J. and Kalio, A. (2008). Determinants of foreign direct investment: evidence from sub-Saharan Africa using a generalized method of moments dynamic panel estimator

Existing empirical evidence, in contrast with more settled theoretical evidence, have shown mixed results about the FDI and economic growth of the host countries. Several reasons can be advanced to explain such disparity of empirical results. To mention a few, first, tests are traditionally conducted using data sets usually belonging to heterogeneous groups of countries. Second, previous studies have used a variety of theoretical models. Third, empirical studies have usually implemented a number of different econometric techniques in testing and estimation. Fourth, the role of regional trade agreements on FDI inflows in Eastern African countries is conspicuously missing. Available evidence for developed countries seems to support the idea that FDI is positively related to economic growth. For the case of developing countries, FDI's impact on growth remains ambiguous with some finding positive spillovers while others reporting limited evidence. Furthermore, a review of the literature reveals that empirical evidences from East African economies have been very scarce and moreover mixed results exist in the literature research of FDI and economic growth. In this study an attempt will be made to bring on new evidences from East African economies with particular reference to Kenya, Tanzania and Uganda on the impact of regional trade agreements on FDI inflows in Eastern African countries.

CHAPTER FOUR

MACROECONOMIC INSTABILITY ON FDI INFLOWS IN EASTERN AFRICAN COUNTRIES

4.1 Introduction

This chapter discusses the key emerging issues from the study and are critically analysed. The main objective of the study was to explore the impact of regional trade agreements on FDI inflows in Eastern African countries. The Specific objectives were: to examine theoretical underpinnings on the regional trade agreements on FDI inflows in Eastern African countries. To analyse the pattern of FDI inflows and economic growth in East Africa. To ascertain the Macroeconomic instability on FDI inflows in Eastern African countries. Regional cooperation leads to the creation and, at times, diversion of investment through restructuring within integrated groups. Regional integration efforts generally lead to increased FDI by opening sectors to investment and aligning policies for the treatment of investors. This is prompted by the indirect effect of trade liberalization and market integration, efforts to harmonize general policy frameworks in participating countries, including for investment (protection and liberalization), and direct cooperation on investment projects at the regional level.

4.2 Key Emerging Issues on Regional Integration and FDI

The adoption of the Lagos Plan of Action in 1980 marked the beginning of the renewed push towards enhancing cooperation across the continent. The Plan promoted a regional approach to furthering economic development, and therefore, the 1980s and 1990s saw a proliferation

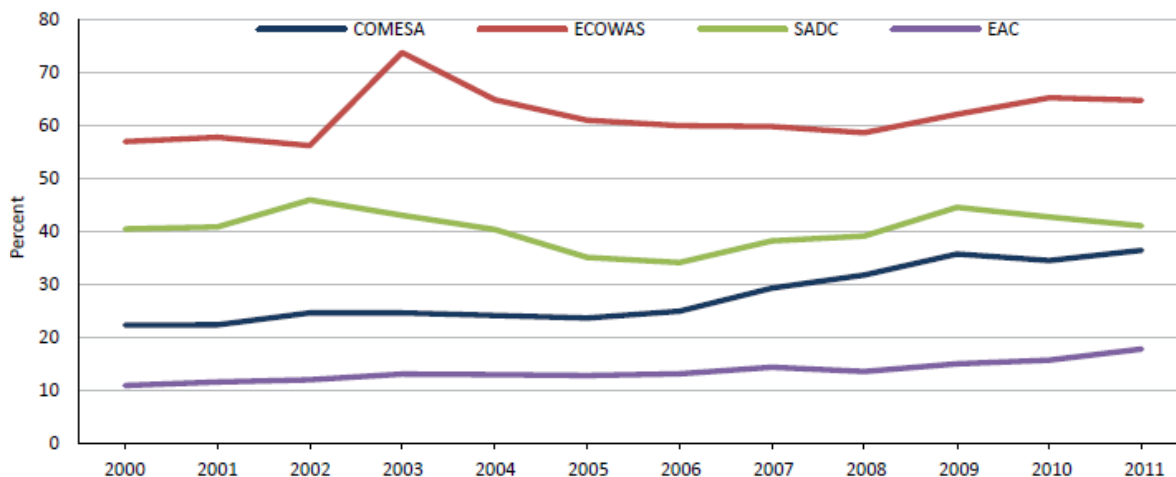
of REIOs on the continent.¹²⁹ Most of the 17 REIOs in force today were formed during these two decades. As a consequence of the number of REIOs, several African countries have become members of more than one group. In fact, only three countries (Algeria, Cape Verde, and Mozambique) are members of just one REIO, with the remaining breakdown as follows: 14 countries are members of two groups, 19 are members of three, and 16 are members of four and one (Côte d'Ivoire) are a member of five. In addition, African countries have concluded 19 RTAs with economies outside the continent.

Despite the large number of regional integration initiatives, their impact on generating or attracting more FDI has been, largely, limited. Focusing on the milestones in five of the main REIOs (COMESA, EAC, Economic Community of Central African States (ECCAS), Economic Community of West African States (ECOWAS) and SADC), using the crude method of comparing the average percentage of FDI relative to gross domestic product (GDP) reveals that in most cases FDI fluctuated and in certain cases such as the introduction of the COMESA Common Investment Area even declined. Intraregional FDI also remained at low levels, though its share in total FDI inflows rose over the past decade.¹³⁰

129 Kinuthia, K. B. (2010). *Determinants of FDI in Kenya: New Evidence*, Africa Studies Centre, Leiden, the Netherlands, University of Nairobi School of Economics, Nairobi. Paper Submitted for the Annual African International Business and Management (AIBUMA) Conference Nairobi, August.

130 Ngugi, R.W. and Nyangoro, O. (2005). *Institutional Factors and Foreign Direct Investment Flows: Implications for Kenya*. KIPPRA Discussion Paper No. 48, Nairobi: Kenya Institute for Public Policy Research and Analysis.

Figure 4.2: FDI Inflows by RTA



Source: UNCTAD

Studies on African REIOs have generally identified three issues that contribute to their relative ineffectiveness on FDI: The proliferation of REIOs has itself resulted in the inadequate payment of member contributions, low implementation of programmes, duplication, or implementation of conflicting programmes and low attendance at meetings. Furthermore, overlapping memberships have hindered the harmonization of policy and institutional frameworks and thus efforts towards deeper integration. There is limited coverage of investment issues.¹³¹ Even in REIOs that have relatively extensive coverage of investment-related issues, the provisions are often fairly general in formulation and application. A survey of the REIOs revealed that investment issues had lower priority than peace and security; free movement of persons, goods, capital, and services; agriculture; and infrastructure and energy.

According to Worth¹³² there is a general lack of progress in practical implementation. African REIOs have had a tendency to strive for far-reaching integration within overly ambitious periods. Therefore, the formation of free trade areas and customs unions has not always been

131 Venables, A.J. (2009). "Integration agreements: a force for convergence or divergence?", *Policy Research Working Paper Series*, No. 2260 (Washington, D.C.: World Bank).

132 Worth, T. (2008), *Regional Trade Agreements and Foreign Direct Investment*.

fully implemented and deadlines have often been missed. In order to address these weaknesses in past integration efforts, the creation of a pan-African REIO has long been on the agenda for African policymakers. The most significant step in this regard was the adoption of the Treaty Establishing the African Economic Community in 1991 (also known as the Abuja Treaty). The provisions of this treaty ensure the free movement of capital within the community through the elimination of restrictions on capital transfers.

Notwithstanding the limited impact of regional integration on FDI inflows to the continent thus far, there are reasons to be cautiously optimistic about future prospects. For instance, REIOs have made investment issues more prominent in their policies and pushed for greater harmonization of investment policies in recent years. The greater scale and scope of investment provisions in COMESA, ECOWAS, and SADC is one manifestation of this trend. There is also recognition that the multiple and overlapping memberships in regional blocs can hamper the potential gains from regional integration. Following on the aspiration expressed in the Abuja Treaty to create a pan-African bloc, the African Union decided in 2006 to suspend, until further notice, the recognition of new REIOs with the exception of eight (AMU, CEN-SAD, COMESA, EAC, ECCAS, ECOWAS, IGAD and SADC).

An interesting initiative in this context is the COMESA-EAC-SADC Tripartite, which seeks to enhance cooperation and harmonization among the three REIOs. This will include the formation of a free trade area among the triumvirate, negotiations for which got under way in mid-2011. The “Draft Agreement Establishing the COMESA, EAC, and SADC Tripartite Free Trade Area” currently under negotiation stipulates that members undertake to create a single investment area, develop policies and strategies, which promote cross-border investment, reduce the cost of doing business in the region, and create a conducive environment for private sector development. Since the Tripartite seeks coherence among three of the main REIOs, it is likely that it will contribute to progress towards an African

Economic Community. Another cross-regional initiative is the Minimum Integration Programme, which is a mechanism for convergence between REIOs and focuses on a few priority areas including investment. The objective of the first phase is to establish a regional and continental platform to promote investment. Doing so will entail establishing regional investment protocols, harmonizing them, formulating a continental investment code and accelerating the establishment of the African Investment Bank.

Making the coverage of investment provisions extensive and comprehensive and fully implementing these provisions are paramount preconditions for increasing the impact of regional integration on FDI flows to the countries concerned. A lack of coordination and consistency remain general problems in regional integration in Africa and particularly so for investment.

4.3 Theoretical underpinnings on the Regional Trade Agreements on FDI Inflows in Eastern African Countries

The East African Regional Integration Agreement (RIA) comprises five East African countries, namely: Kenya, Uganda, Tanzania, Rwanda, and Burundi, whose main priority is economic cooperation that will eventually form the basis of political cooperation in the long term. The Regional Integration development strategy in East Africa lays the foundation for the establishment of the organizations such as the EAC. This was done to avoid the shortcomings that led to the collapse of the earlier initiative in 1977. The EAC treaty was signed on 30 November 1999, but came into force on 7 July 2000 after ratification by Kenya, Uganda, and Tanzania. Later on, the protocol for the establishment of the EAC customs union was signed on 2 March 2004, but was launched on December 2004 and its implementation started in January 2005. Rwanda and Burundi who initially attended as

observers joined the community in 2007.¹³³ The 1st July 2010 marked the commencement of the East African Common market operationalization.¹³⁴

The EAC regional integration aims to widen and deepen cooperation among partner states in, among others, economic and social fields for their mutual benefit. One of the expected benefits of regional integration is increased FDI flow. Statistics show that, overall, there has been an increase in the flow of FDI in the region. When the treaty came into effect in the year 2000, the region received a total of US\$ 574million worth of FDI. With the signing of the customs union in 2005, the amount increased significantly to US\$ 895 million. By 2009 when the implementation of the common market was due in 2010, investments had reached US\$ 1,585 million. The region received an average of US\$ 1,242.65 million worth of FDI between 1990 and 2009, the minimum being US\$ 90 million while the maximum received was US\$ 4,030 million. However, the region, after having benefitted from a boom in FDI inflows, experienced a decline in 2009.¹³⁵

Table 4.2: Flow of FDI in the region

	2000	2005	2009
FDI inflow (in millions)	574	895	1,585

Source: FDI data from the UNCTAD (www.unctad.org/fdistatistics).

FDI is defined as an investment made to acquire lasting management interest (normally 10% of voting stock) in a business enterprise operating in a country other than that of the investor, defined according to residency. There are three major forms of FDI: market seeking, resource

133 Mugisa, E., Onyango, C. and Mugoya, P. (2009). An Evaluation of the Implementation and Impact of the East African Customs Union. East African Community.

134 EAC Secretariat (2010), East Africa Community, available at <http://www.eac.int/>

135 UNCTAD (2007), Africa Foreign Investor Survey 2005: Understanding the Contributions of Different Investor Categories to Development Implications for Targeting Strategies, 2nd Edition, Vienna: UNIDO.

seeking, and efficiency seeking FDI. The main form of FDI in Kenya is market-seeking FDI. This refers to FDI driven by location factors and the relevant dynamics and size of the market. The impact of FDI in the Kenyan economy can never be underestimated.¹³⁶ UNCTAD¹³⁷ found that FDI was important to the East African economy because it brought investable financial resources, provided new technology, and enhanced the efficiency of existing technologies. Furthermore, it facilitates exports to markets, therefore strengthening the export capabilities of the domestic economy. It also helped in enhancing skills and management techniques and provided better technologies and modern environment management systems.

The increase in the rate of technological progress takes place through contagion effect from more advanced technology and management practices used by foreign firms. Evidence on the impact of FDI in the Kenyan economy include development of the country's export oriented horticulture industry, which contributed to the revival of Kenya Airways and accelerated the development of the mobile telecommunications network in the country.

Evidence indicates that from the signing of the EAC treaty in the year 2000 to the implementation of the customs union in 2005, there has been an improvement in trade performance within the EAC. Examination of trade flows between the three countries reveals that there has been growth in imports and exports within the region.¹³⁸ This signifies that the East African integration process was functional, as shown by the growth in intra-regional trade volumes.

136 Mwega, F. M. and Ngugi, R. W. (2005), Foreign Direct Investment in Sub Saharan Africa: Determinants, Origins, Targets, Impact and Potential. African Economic Research Consortium.

137 Ibid p68.

138 Ibid, p68.

4.4 Pattern of FDI inflows and economic growth in East Africa

Evidences on FDI led economic growth of the host country have been mixed. Using Cobb-Douglas production function and 47 African countries for the period of 1990-2003, Sharma and Abekah¹³⁹ estimated the effect of FDI on the economic growth of Africa. Their result indicates that FDI has a positive effect on the growth of GDP in African countries. The key result shows one percent rise in the ratio of FDI to GDP leads to a rise in the growth of GDP by 0.71 percentage points. The study further indicates, FDI is more productive than Gross Domestic Capital Formation (GDCF) in East Africa.

Similarly, using an extended Cobb Douglas production function in 39 SSA countries for a period of 1980 -2000, the study found a statistically significant coefficient of 0.11 for the region.¹⁴⁰ The dynamic estimate shows a positive link between FDI and economic performance in the region. However, the result suggests, FDI's effect on the economy is relatively low compared to other studies done on different developing regions around the world.

Adams¹⁴¹ reviewed various empirical studies on the relationship between FDI and economic growth in EA countries and concludes that FDI is a necessary but not a sufficient condition for economic growth. He indicates that FDI contributes to economic growth through augmentation of domestic capital, enhancement of efficiency through the transfer of new technology, marketing and managerial skills, innovation, and best practices. The review noted that FDI has both benefits and costs and its impact is determined by the country specific conditions. The paper identifies the increase in FDI inflow into EA has not led to a

139 Sharma, B., & Abekah, J. (2007). *Foreign Direct Investment and Economic Growth of Selected African and South American Countries*. Paper presented at the International Trade and Finance Association Conference Papers.

140 Seetanah, B., & Khadaroo, A. (2007). *Foreign direct investment and growth: new evidences from Sub-Saharan African countries*. Paper presented at the Economic Development Africa 2007, CSAE Conference.

141 Adams, S. (2009). Foreign Direct investment, domestic investment, and economic growth in Sub-Saharan Africa. *Journal of Policy Modeling*, 31(6), 939-949.

corresponding increase or positive effect on economic development of the region. However, Adams went on to say, this is not to suggest that FDI is not needed in the EA region, but rather FDI's growth enhancing effect is possible only when it stimulates domestic capacity of the host country.

De Mello¹⁴² used both time series and panel data to estimate the impact of FDI on capital accumulation, output and Total Factor Productivity (TFP) growth in the recipient country economy. The author included a sample of 15 developed and 17 developing countries for the period 1970 to 1990. The time series estimations suggest the effect of FDI on growth or on capital accumulation and TFP varies greatly across the countries. The panel data estimation indicates a positive impact of FDI on output growth for developed and developing country sub-samples. The paper concludes FDI contributes to the economic growth of a country through skill acquisition, encouraging adoption of new technology and knowledge transfer.

Borensztein et al.,¹⁴³ empirically estimated the effect of FDI on economic growth of industrial as well as 69 developing countries, and the channels through which FDI may be beneficial for growth. The authors went further to see whether FDI affects growth by itself or through the interaction with other terms. All regressions for this study were based on panel data for two decades (1970-1989). The main result indicates FDI has a positive overall effect on economic growth, though the magnitude of this effect depends on the stock of human capital available in the host country. The result shows each percentage point increase in the FDI-to-GDP ratio increase the rate of growth of the host economy by 0.8 percentage points. However, the authors emphasized, the higher productivity of FDI holds only when the host country has a minimum threshold stock of human capital, i.e. 0.83. The paper indicates inclusion of an

142 De Mello, L. R. (1999). Foreign direct investment-led growth: evidence from time series and panel data. *Oxford economic papers*, 51(1), 133-151.

143 Borensztein, E., De Gregorio, J., & Lee, J.-W. (1998). How does foreign direct investment affect economic growth? *Journal of international Economics*, 45(1), 115-135.

interaction term between FDI and human capital improved the overall performance of the regression. It yielded a coefficient that is positive and statistically highly significant. All countries with secondary school attainment of 0.45 years of schooling (for male population above 25years) would benefit positively from FDI. It indicated strong complementary effects between FDI and human capital on the growth effect of income and that the direct effect of FDI may be quite different for countries with different level of human capital. For countries with very low level of human capital, the direct effect is negative. Moreover, the paper indicates, FDI has the effect of increasing total investment in the economy more than one for one, which suggests the predominance of complementarity effect with domestic firms. In other words, FDI crowds-in domestic investment. Simply put, the paper concluded that FDI contributes to economic growth through capital formation and technology transfers.

Human capital as a key determinant of FDI inflow has supporters from a more recent research papers. Njoupouognigni¹⁴⁴ investigated the long run relationship between FDI, foreign aid and economic growth in EA countries over the period of 1980 to 2007. The paper used panel data of mean group (MG), pooled mean group estimator (PMG), and dynamic fixed effect (DFE). The result shows a strong positive impact of FDI on economic growth in EA countries. It indicates, although the effect of FDI on economic growth is positive and statistically significant, human capital remains the key factor that can foster economic growth in SSA countries.

Adefabi¹⁴⁵ found a weak effect of FDI on economic growth. Using panel data of 24 countries in East and Central African Countries over the period of 1970 to 2006, Adefabi shows both FDI and the interaction term between FDI and human capital influenced economic growth

144 Njoupouognigni, M. (2010). Foreign Aid, Foreign Direct Investment and Economic Growth in Sub-Saharan Africa: Evidence from Pooled Mean Group Estimator (PMG). *International Journal of Economics & Finance*, 2(3).

145 Adefabi, R. (2011). Effects of FDI and human capital on economic growth in Sub-Saharan Africa. *Pakistan journal of social sciences*, 8(1), 32-38.

positively but not in a significant manner. The finding indicates economies with weaker initial labor skills likely to experience smaller inflows of FDI.

Gohou and Soumare¹⁴⁶ examine the relationship between FDI and poverty reduction (welfare) in Africa using sample of 52 African countries for the period of 1990 to 2007. Unlike most other studies, this paper used FDI net inflows per capita and the United Nation Development Program's Human Development Index as the principal variables. The result indicates FDI has positive and significant effect on poverty reduction in Africa. It pointed out FDI has a greater impact on welfare in poorer countries than it does in wealthier countries. Relatively, while FDI has positive and significant effect on poverty reduction in Central and East Africa, it is not significant in North and Southern Africa.

4.5 Macroeconomic instability on FDI inflows in Eastern African countries.

FDI had a mean value of US\$ 210.68 million, a minimum of US\$ -5.91 million in East Africa which was attributed to the net outflow of FDI from Uganda in 1990 as it was stabilizing from a period of internal conflict, and a maximum of US\$ 798.77 million, which was similarly received by Uganda in 2009. Political instability represented by the political risk index had a mean of 57.8, minimum of 37 scored by Uganda in 1991, 5 years after it emerged from a civil war and maximum of 68.08 percentage points scored by Tanzania in 1995.

GDP per capita had a mean of 336.95, a minimum of 181 scored by Uganda in 1990 and a maximum of 457 scored by Kenya in the year 2007, when the country experienced its highest economic growth in recent times. The real exchange rate had a mean of 699.20, a minimum of 5.4925 and a maximum of 2, 657.455. The infrastructure index, which measures the quality of infrastructure, had a mean of 3,340,400 and a minimum of -1.14, which indicated deterioration of infrastructure in Tanzania, and a maximum of 2.62 points attributed to the

146 Gohou, G., & Soumare, I. (2012). Does foreign direct investment reduce poverty in Africa and are there regional differences? *World development*, 40(1), 75-95.

Kenya government's heavy investment aimed at improving the country's quality of infrastructure.

The degree of openness had a mean of 36.91 per cent, a minimum of 20 and a maximum of 66 per cent. The quality of labour represented by the human development index had a mean of 0.38, minimum of 0.31 and a maximum of 0.42. GAPGDP had a mean of 1, minimum of -1 and a maximum of 3. GAPREER had a mean of 1, minimum of 0 and maximum of 2.8. GAPINFRST had a mean of 1, minimum of 0.26 and maximum of 2.01. GAPOPEN had a mean of 1, minimum of 0 and maximum of 2.1. GAPHDI had a mean of 0.33, minimum of 0.73 and maximum of 1.19.

The sample covered three East African countries, namely: Kenya, Uganda, and Tanzania during the period 1990-2009. Reports estimates of the model run via FGLS, with correction for panel heteroskedasticity. Results revealed positive and significant values for financial stability (1.098), proxied by the real exchange rate and the degree of political risk (0.113), as measured by the ICRG political risk ratings. The GAP in degree of political risk was found to be negative and significant, with a coefficient of -5.934. The dummy representing regional integration was insignificant, like the rest of the other variables, though positive.

The coefficient for financial stability was positive, indicating that an increase in the real effective exchange rate would lead to an increase in FDI flow within the EAC. These results suggested that if there was a 1 percentage change in the real effective exchange rate, there would be a 1.1 percentage change in FDI flow in the EAC. This variable took the positive sign as expected, and this finding was similar to results obtained by Jaumotte (2004), whose study revealed that a strong exchange rate reduced the amount of investment in the economy.

The degree of political risk was important in attracting FDI in the EAC. This variable was found to be positive and significant. The findings suggest that a 1percentage change in degree

of political risk would lead to an 11.9 percentage change in the net FDI inflow into the region. It should be noted that in the ICRG ratings of political risk, a country is considered high risk if it accumulates the least points in terms of political risk ratings: the closer a country is to attaining the maximum 100 percentage points, the more it is considered as low risk.

The GAP in degree of political risk was significant but negative. Therefore, a decrease in the country's political risk rating below the region's average would lead to a 99.7 per cent decline in net FDI inflow. This shows that countries whose political risk ratings deteriorate would lose FDI to their partner states, since the multinational firms will relocate to countries where there is political certainty and guaranteed security for their investments.

CHAPTER FIVE

CONCLUSION AND RECOMMENDATIONS

5.0 Introduction

This chapter concludes and makes recommendations on the findings.

5.1 Conclusion

Regional integration has had an impact on FDI flow into the region, according to the findings from this study. Other variables such as financial stability and degree of political risk played a greater role in attracting FDI into the East African countries. Depreciation of the real exchange rate plays a big role in attracting FDI, because it makes investing in the EA countries cheaper for the foreign companies. When a country's currency depreciates, it loses value with respect to the value of the other currencies. This country becomes attractive as an investment destination because both wage and production costs become cheaper compared to the other countries. This improves the firm's overall rate of return to multinational firms that are considering making investments into the country. However, long run exchange rate volatility may lead to risk aversion by foreign investors, as this worsens their position in terms of the expected future profits.

Investment is a forward-looking activity that is based on the anticipation of future returns. In the EA Countries, foreign investments are positively related to political stability. Foreigners are less willing to risk in a politically unstable environment, because it eventually reduces the rate of return on investment. In addition, it lowers the economic value of the firm's assets after a period of conflict, regardless of whether the conflict was internal or external. This is because the host economy's exchange rate becomes more volatile in the face of political instability. Greater political stability among the EA countries serves to increase the amount of FDI in the integrating economies. Any member state in the EA Countries whose degree of

political risk goes below the region's average stands to experience an outflow of FDI from their economy to other destinations within the RIA. This was evident from the coefficient of the GAP in degree of political risk as seen from the results.

5.2 Recommendations

5.2.1 Recommendations for Policy

Based on the findings this study recommends that;

RTAs with more trade and investment provisions attract more inward FDI; it is thus sensible to negotiate more investment and trade provisions if the aim is to attract additional FDI.

Countries that have larger economies or are geographically closer to other larger countries within a region can expect a larger increase in FDI because of joining than those countries that have smaller economies or are located in the periphery. However, on average, all countries in the seven key regional groupings benefited from additional FDI through regionalization.

EA countries should strive to maintain a high level of political stability. Some of the components that should be targeted to achieve this are government stability, which indicates a government's ability and effectiveness in carrying out its programmes, observance of the rule of law and order, enhancement of security within the country to minimize the risk of internal conflict, elimination of corruption and promotion of transparency and accountability both within and outside government, and finally improvement in the quality of a country's bureaucracy.

Financial stability should be maintained amongst the EA economies so that investors have confidence in their expected future profits. As much as countries experiencing real exchange rate depreciation have the advantage of attracting foreign investment, EA countries should

protect themselves against exchange rate volatility because this normally has the effect of reducing FDI. Exchange rate stability will attract risk averse investors who seek certainty in the expected future profits.

5.2.3 Recommendations for Practice

An important area for future work is to investigate who are the winners and losers of specific RI agreements and what determines whether a particular country wins or loses its capacity to attract and/or retain FDI as a result of the process of RI. Additionally, it might be interesting to discuss alternative types of regional groupings such as South-South integration, or the effects of North-South integration are becoming relevant (EU trade agreements with developing country regions).

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