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Analysis of the Short and Long-run Effects of Macroeconomic Variables on Foreign Direct Investment Inflows to Tanzania

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Abstract
This study assessed the effect of macroeconomic variables on foreign direct investment inflows to Tanzania for the period 1970-2021. To do this, the time series data were analysed by the Co-integration test for the long-run relationship and the ECM model for the short- and long-run effects. The co-integration test suggests that there is a long-run relationship between government expenditure, inflation rate, external debt, interest rate, exchange rate, and foreign investment inflows. The results of the ECM reveal that government expenditure has a significant positive effect on short and long-run FDI inflows, while the inflation rate has a negative and statistically significant effect on short and long-run FDI inflows. Moreover, the interest rate, exchange rate and external debt variables have a negligible effect on FDI inflows. On the other hand, the proxy variable for government regime and economic reforms before 2015 revealed a positive and statistically significant effect on FDI inflows at 1% in the short run and 10% in the long run, while it had a negative and statistically insignificant impact on FDI inflows after 2015. The study recommends that the government should adequately allocate resources to economic activities to stimulate macro variables, which will attract more FDI and enhance steady economic growth in the short and long-run.
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1. Introduction

Foreign direct investment (FDI) is a form of capital movement from high-income countries to high-yield sectors in low-income countries (Singhania & Saini, 2018). FDI plays a crucial element in globalization and the world economy as a driver of employment, technological progress, productivity improvements, and economic growth (Kuzey et al., 2021). It also plays a critical role in filling the development, foreign exchange, investment, and tax revenues gaps (Wondemu & Potts, 2016). It also provides the required capital for the development of the host countries and creates a market for goods and services produced (Anyanwu & John, 2021).

FDI flows in four different forms across borders: market-seeking investment, efficiency-seeking investment, strategic-asset-seeking investment and natural-resources seeking investment (Yakubu et al., 2020). The market-seeking FDI aims at penetrating the local markets of host countries and is usually connected with market size and per capita income, market growth, access to regional and global markets, consumer preferences and structure of the domestic market (Blonigen & Piger, 2019). This form of FDI inflows benefits the host country's economy by providing a market for produce, employment, sectoral development, and economic growth. The resource-asset seeking FDI seeks and secures natural resources, such as raw materials, lower unit labor cost of unskilled labor and the pool of skilled labour, physical infrastructure (ports, roads, power, and telecommunication), and the level of technology (Sodokin and Tozo, 2020). This enhances the flow of skills, technology, and employment creation and creates foreign currency for the host country.

FDI has become an important source of financing investment in developing economies in recent years. According to Chen et al. (2015), The flow of FDI in Tanzania and have created jobs in the manufacturing sector by nearly 43% and 30%, respectively. Over the past five years, global FDI flows declined from USD 1867.5 billion in 2016 to USD 1429.8 billion in 2017 (UNCTAD, 2018). The decline in FDI flows was mainly attributed to a fall in the rate of return on FDI caused by weak commodity prices and exacerbated by low demand for exports emanating from the economic slowdown in 2016. FDI inflows to Africa declined significantly by 21.5 per cent to USD 41.8 billion in 2017. Despite the fall of FDI in Africa, the East African region's inflows have increased from $ 2.6 billion in 2016 to $ 3.0 billion in 2017 (Kungu, 2019).

Tanzania is one of the preferred destinations for FDI in Africa and is among the largest recipients of FDI. FDI to Tanzania is mainly directed at the mining sector, the oil and gas industry and the primary agricultural sector. Recent data indicates that foreign direct investment inflows into Tanzania reached USD 1.013 billion in 2020, up from USD 991 million in 2019, but less than the 2015 record high of USD 1.561 billion (Kapingura, 2018). On the other hand, the average value of the FDI/GDP ratio for Tanzania from 1988 to 2020 was 2.42%, with a minimum of 0% in 1990 and a maximum of 5.66% in 2009. Other contributing sectors include

accommodation and food, financial services and insurance.

Like other African countries, Tanzania signed international agreements to deal with FDI issues. This includes bilateral investment treaties (BITS), Double Taxation Treaties (DTTs), and multilateral agreements. Despite all successful reforms and international agreements, the country's FDI share has never reached a sustainable figure compared to its comparative advantage of USD 1.8 billion (URT, 2021). Several factors cause this fluctuation of FDI inflows, including macroeconomic variables. The economist's eyes are targeting macroeconomic variables such as inflation, growth rate, unemployment, exchange rate, interest rate, export and import, the balance of payment, stock market and tax levels as they influence the market behaviours of the economy (Anyanwu & John, 2021). The justification for these variables is that they share common behaviour in the entire cycle of business in the economy, under which FDI is within. These variables play an important role in a country's economic performance, better financial sector and attracting FDI. Therefore, with this context, there is a need to shed the continuous effect of macroeconomic variables on FDI to develop a relevant policy recommendation.

2. Data and Methods

2.1 Data

This study used secondary time series data covering the period of 1970-2021 with six variables: government spending, inflation rate, exchange rate, interest rate, external debt and foreign direct investment inflows. The data was collected from the National Bureau of Statistics (NBS) and the Bank of Tanzania (BOT). The data was collected from Tanzania Mainland for the given study time. The selection of data from 1970-2021 aims to capture investment growth patterns during different government regimes and economic reforms undertaken during the regime. To correctly examine the relationship among the variables, the study employed a quantitative research approach in which the parameters were established and tested using econometric tools.

2.2 Estimation Techniques

In order to analyse the relationship between macro-economic variables and FDI inflows, the following estimation techniques were applied: Augmented Dickey-Fuller (ADF) and Phillips Perron for unit root test, Johansen co-integration test, Granger causality test and Error Correction Model (ECM) for the short and long-run relationship among the variable. The data were analysed by using EVIEWS version 12.

2.2.1 Test for Stationarity (Unit Root Test)

Both the Augmented Dickey-Fuller (ADF) and Phillip Perron test (Phillip, 1987) were used to test the level of stationarity among variables. The hypothesis tested were; Null hypothesis (H_0) - *there is a unit root in a time series sample* and the alternative hypothesis (H_1) - *no unit root in a time series sample.* The more negative it is, the stronger the rejection of the hypothesis that there are unit roots at some confidence level. The test involved the estimation of the following equations.

$$\Delta Y_t = \gamma Y_{t-1} + \sum_{j-1}^{p} \left(\delta_j \Delta Y_{t-j}\right) + e_t \quad (1)$$

$$\Delta Y_t = \alpha + \gamma Y_{t-1} + \sum_{j-1}^{p} \left(\delta_j \Delta Y_{t-j}\right) + e_t \quad (2)$$

Whereby

t is the time index, α is an intercept, γ is the coefficient presenting process root, p is the lag order of the first-differences autoregressive process, e_t is an independent identically distributes residual term, Δy_t is the first difference operator, y_{t-1} is one period lagged value of the variable y_t and ΔY_{t-j} is the difference of the lagged dependent variable.

2.2.2 Co-integration test

The Johansen co-integration test was used to determine whether variables have a long-run equilibrium relationship among variables. This test is employed because it performs better in multivariate models and when the sample is large (Mühl, 2014). The variables studied for the long-run equilibrium relationship were government spending, interest rate, inflation rate, external debt and exchange rate on foreign direct investment inflows in Tanzania. The simplified mathematical equation for co-integration is:

$$z_t = \sum_{i-1}^{M} A_i z_{t-1} + E_t \quad (3)$$

Whereby

Z_4 denotes all n variables of the model, and E_t is a vector of random errors, while A_t is the coefficient of the integration equation

2.2.3 Granger Causality test

The Granger causality test was used to establish a causal relationship between variables in the study. This test established the causal relationship between dependent (macroeconomic variables) and independent (FDI) variables. The test involves fitting the following regressions.

$$FDI = \beta_o + \sum_{i=1}^{p} \beta_1 FDI_{t-j} + \sum_{j=1}^{p} \beta_2 IR_{t-j} + \sum_{j=1}^{p} \beta_3 EXCH_{t-j} + \sum_{j=1}^{p} \beta_4 DEBT_{t-j} + \sum_{j=1}^{p} \beta_5 GS_{t-j} + \sum_{j=1}^{p} \beta_6 INFR + \varepsilon_t \quad (4)$$

Where;

P represents the maximum number of lags, IR is the inflation rate, EXCHR is the exchange rate, *IR* stand for interest rate, and FDI is the Foreign Direct Investment, β_0 is the intercept, $\beta_1 \beta_2 \beta_3 \beta_4 \beta_5 and \beta_6$ are coefficients and ε_t is an error term. The null hypothesis is that variable FDI does not granger cause variables IR, EXCHR, GS, DEBT and INFR individually.

2.2.4 Error Correction Model (ECM)

Error Correction Model (ECM) was used to determine whether long-run or short-run relationships exist among the variables in a specified model and foreign direct investment inflows in Tanzania. The regression equation form of the ECM model was presented as follows:

$$\Delta FDI = \beta_o + \beta_1 ECT_t + \sum_{i=1}^{n} \beta_2 \Delta IR_{t-1} + \sum_{i=1}^{n} \beta_3 \Delta EXCH_{t-1} + \sum_{i=1}^{n} \beta_4 \Delta DEBT_{t-1} + \sum_{i=1}^{n} \beta_5 \Delta GS_{t-1} + \sum_{i=1}^{n} \beta_6 INFR + Dummy_1 + Dummy_2 + \varepsilon_t \quad (5)$$

Where n is the maximum number of lags, β_0 stands for the intercept of the ARDL, β_1 represents the coefficient of error correction term, ECT represents the error correction term which must be negative and significant, β_2, β_3, β_4, β_5 and β_6 represent the coefficient of variables and ε_t stands for the error term.

2.3.5 Dummy Variables

For the case of this study, two dummy variables were used. The first one (DUMMY 2015-2020) had 1s from 2015 to 2020; otherwise, 0s' and the second dummy variable (DUMMY 2006-2015) had 1s from 2006 to 2015, otherwise 0s'. The two Dummy variables 1s indicate that some changes of structural adjustments in the economy are applied in selected years for the specific regime to attract investors in the country.

2.3 Model Specification

This study adopted the econometric model from the investment theory developed by John Keynes in the early 1930s. The mathematical model used to assess the selected macroeconomic variables of foreign direct investment inflow in Tanzania is specified:

$$FDI = F(INFR, EXCHR, IR, GS, DEBT) \quad (6)$$

Where;

FDI	=	Foreign Direct Investment Inflows (% GDP)
EXCHR	=	Exchange Rate
INFR	=	Inflation Rate
GS	=	Government Spending (% GDP)
DEBT	=	External Debt (% GDP)

3. Results and Discussions

3.1 Unit Root Test Results

For the co-integration tests to be carried out, it is required to test the order of integration of the data series used. Results in Table 1 show that the series were stationary at first differences both for ADF and PP test, meaning that the series were integrated at first order, I (1).

Table 1: Unit Root test at 95% level of Confidence

Variables	Augmented Dickeys-Fuller test statistic (with interception and no trend)		Phillips-Perron test statistic (interception and no trend)	
	I (0)	I(1)	I(0)	I(1)
External Debt to GDP Ratio	-0.45573	-11.9917	-2.2327	-12.6412
	0.8909^{NS}	0.0000***	0.1976^{NS}	0.0000***
Foreign Direct Investment to GDP Ratio	-1.5160	-8.9610	-1.3435	-9.0419
	0.5176^{NS}	0.0000***	0.6023^{NS}	0.0000
Government spending to GDP ratio	-1.5867	-6.8340	-1.5593	-6.9964
	0.4820^{NS}	0.0000***	0.4958^{NS}	0.0000***
Inflation rate	-2.2543	-8.9829	-2.3604	-8.9316
	0.1905^{NS}	0.0000***	0.1579^{NS}	0.0000***
Interest rate	-1.4427	-3.2576	-1.5641	-6.18357
	0.5542^{NS}	0.0225	0.4934^{NS}	0.0000***
Exchange rate	-1.0065	-4.8227	-0.9581	-4.8506
	0.7443^{NS}	0.0002***	0.7612^{NS}	0.0002***

Note: *** *significant at 1%;* ** *significant at 5%,* * *significant at 10% and NS not significant at all levels.*

The trend of the variables is shown by plotting and observing how FDI drift/move with other macroeconomic variables in the model, as shown in Figure 1 and 2. Figure 1 shows that selected macroeconomic variables were not stationary, while Figure 2 shows all macroeconomic variables were stationary after the first difference. From the plots, FDI inflows positively correlate with government spending, external debt and exchange rate. As expected, FDI inflows are negatively correlated with inflation and interest rate

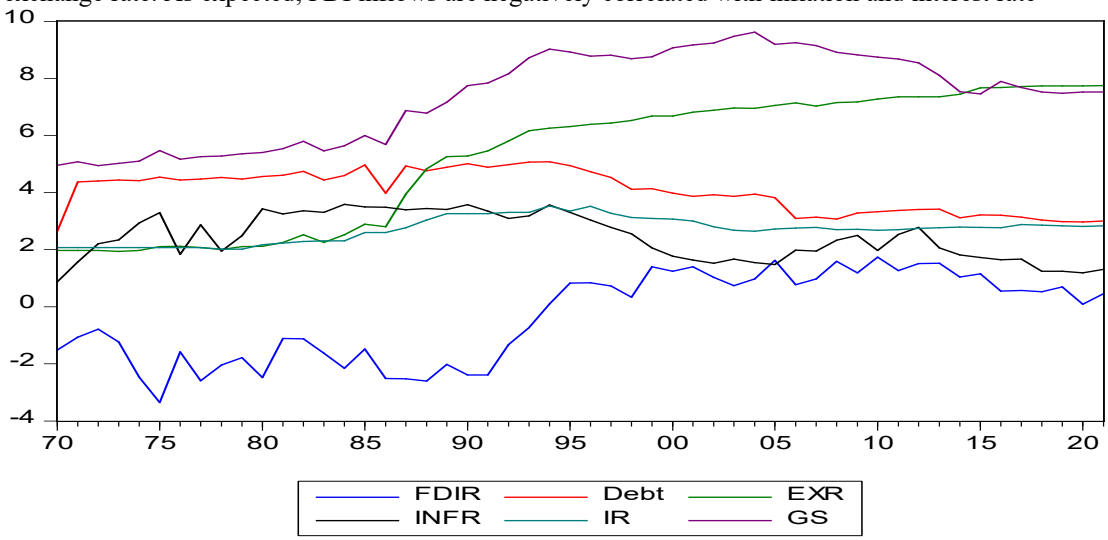

Figure 1: Line graph for non-stationary data

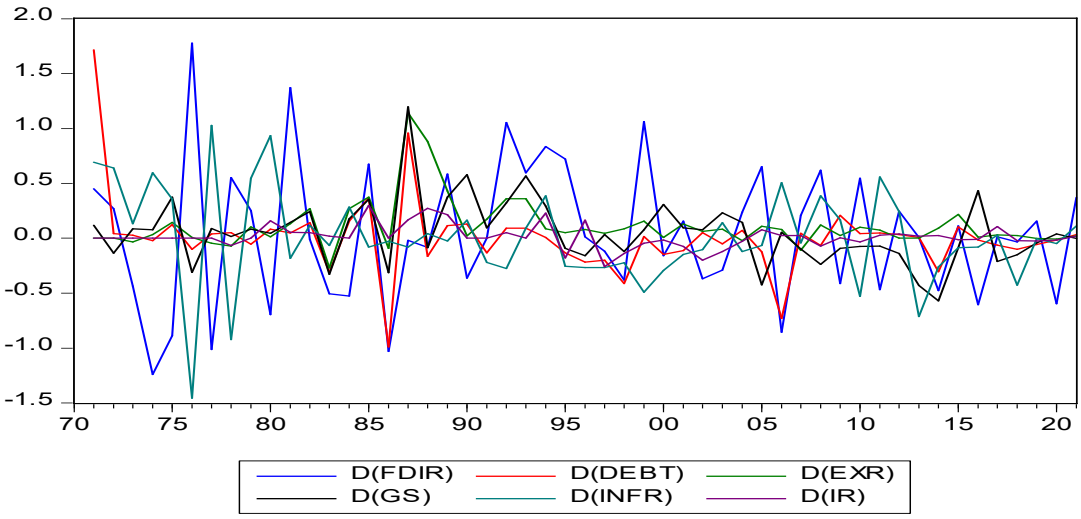

Figure 2: Line graph for stationary data

3.2 Co integration Test Results

The result in Table 2 shows the Johansen likelihood ratio tests for co-integration. The two common likelihood ratio tests: the trace and maximum Eigen value (λ-max), were used to determine the number of co-integrating relations in the time series. The null hypothesis of no co-integration between the series is rejected at the 5% significance level based on the Trace and Maximum-Eigen statistics and favours the alternative hypothesis that there is co-integration. In this context, it is evidenced that there are, at most, three (3) long-run equilibrium relationships among the selected macroeconomic variables. Hence, the ECM is appropriate for modelling the relationship between FDI inflow, external debt, exchange rate, inflation, interest rate and government spending. Further, the ECM also reports the short-run relationship among selected macroeconomic variables and how they adjust towards long-run equilibrium.

Table 2: Test for Co-integration Relationship

Hypothesized	Eigenvalue	Trace Statistic	Critical Value	Prob.**
None*	0.583346	124.397	95.75366	0.0001***
Atmost1*	0.451428	81.49748	69.81889	0.0044***
Atmost2*	0.36308	52.07607	47.85613	0.019**
Atmost3*	0.29923	29.97163	29.79707	0.0477^{NS}
Atmost4	0.187331	12.54844	15.49471	0.1325^{NS}
Atmost5	0.047494	2.384301	3.841466	0.1226^{NS}

Note: **** significant at 1%; **significant at 5%; *significant at 10%, and NS not significant.*

3.3 The Short-run Effects of Macro-economic Variables on FDI Inflows in Tanzania

Results for short-run effects are presented in Table 3. The R-squared of 0.90783 indicates that the variables explain 90.78 % of the variations in FDI inflows entered in the model. The coefficient of the error correction term in the first co-integration equation measures the speed of adjustment. The -0.712625 indicates that about 71% departure from long-run equilibrium is corrected in each period. Put differently, the previous period's deviation from long-run equilibrium is corrected in the current period at an adjustment speed of 71%. The p-value of 0.000, which was less than the alpha value of 0.01, shows that the speed of adjustment was statistically significant at 1%, meaning that the selected macroeconomic variables diverged from equilibrium in the short-run towards the long-run relationship even though they were insignificant.

Regarding the effect of government spending, results indicate that government spending (0.402278) has a positive and statistically significant effect on FDI inflow at a 1 % significance level. This means that a one per cent increase in government spending would increase 40.2 per cent of FDI inflow in the GDP ratio. This positive relationship implies that, as long as the government increases the spending on both recurrent and development expenditures, it contributes to a rise in FDI in the country. Moreover, Government policies focusing on expansionary fiscal policies have more impact on the infrastructural expansion and quality public services provision and this act as a catalyst to attract more foreign investments. Fiscal policies may also target lowering taxes if the aim is to increase FDI inflows. Similar results were obtained by Wijaya et al. (2020), who suggested that increasing government expenditure, such as investment in infrastructure and reducing taxation attract FDI.

Also, studies by Groh and Wich (2012) and Othman et al. (2018) found that good governance and conducive infrastructure are also important for FDI inflows. Further results from developed countries show that conducive fiscal policy positively affects FDI flows into emerging European economies (Göndör & Nistor, 2012). The same observations were made by Yinusa (2013), who found that FDI attraction in the Southern African Development Community (SADC). An empirical study by Yuan et al. (2010) showed that increasing government spending positively affected FDI inflows, especially among developing countries.

Also, as expected, the inflation rate (-0.891043) has a negative and statistically significant effect on FDI inflows at a 1% significance level in the short run, indicating that a unit increase in the inflation rate would result in a reduction in FDI inflow by (0.89). The negative and significant effect of inflation on FDI inflows implies that high levels of inflation might cause a downturn in foreign investments, as high levels of inflation can lead to a depreciation of the local currency, risking reductions in the value of assets pegged to the local currency relative to foreign currencies. Furthermore, the rapid and unpredictable price increases that come with high levels of inflation may also increase friction within the operations of businesses, as businesses will need to update product prices and wage costs frequently. However, low inflation levels are often a sign of economic stability, while high inflation levels can signal uncertainty and economic instability. Similar results were reported by different studies, such as include Omankhanlen (2011), Andinuur (2013) and Xaypanya et al. (2015).

The results for dummy variable 2 (1.099349), a proxy for government regime and economic reforms before 2015, show a positive and statistically significant effect on FDI inflows at 1% in the short run. This implies that government regimes and economic reforms before 2015 were more favourable to attracting FDI inflows. Before 2015, Tanzania experienced macroeconomic stabilization and significant structural. Real GDP per capita nearly

doubled in the last forty years. This economic success was largely fostered by sound macroeconomic policies and waves of structural reforms that began in the mid-1980s and accelerated from the mid-1990s to the mid-2000s and to 2010. These reforms aimed at reducing the state's role in the economy and offered fertile ground for private sector development and FDI inflows, and were strongly supported by donors. In addition, in this period, increased public investment in infrastructure, energy, and other sectors provided a platform for productivity growth and expansion of exports.

Furthermore, the results show that the interest rate (-0.070183) and the dummy variable 1(-0.077269) (a proxy for government regime and economic reforms after 2015) have negative effects on FDI inflows. Still, their effects are not statistically significant, whereas external debt (0.359097) and foreign exchange (0.155973) show positive effects on FDI inflows but were not statistically significant at any significance level. This may be due to the ineffectiveness of its targeting project, which may significantly affect FDI inflows and misuse of the available resources in the planned projects and programs in a short period.

Table 3: Short-run ECM model results

Variables	Coefficient	Std. Error	t-Statistic	Prob.
Constant	-3.453115	1.000586	-3.451095	0.0013**
GS	0.402278	0.175930	2.286578	0.0273**
INFR	-0.891043	0.186122	-4.787422	0.0000***
IR	-0.070183	0.614851	-0.114146	0.9097^{NS}
DEBT	0.359079	0.353761	1.015030	0.3159^{NS}
EXR	0.155973	0.226001	0.690142	0.4939^{NS}
DUMMY1	-0.077269	0.399608	-0.193363	0.8476^{NS}
DUMMY2	1.099349	0.305638	3.596897	0.0008***
ECM(-1)	-0.712625	0.117254	6.077637	0.0000***
R-square				0.90783
Adjusted R-square				0.89023
SE of regression				0.510418
Durbin-Watson stat				1.6551
Akaike info criterion				1.6516

Note: **** significant at 1%; **significant at 5%; *significant at 10%, and NS not significant.*

3.4. The Long-run Effects of Macro-economic Variables on FDI Inflows in Tanzania

Table 4 presents the results of the Error Correction Model (ECM). The coefficient of the interest rate (IR), external debt (DEBT), and exchange rate (EXR) was not significant at all conventional levels. Given insignificant coefficients, the study failed to reject respective null hypotheses for these variables. Correspondingly, the study findings gave reasonable grounds to infer that interest rate (IR), external debt (DEBT), and exchange rate (EXR) have no significant influence on foreign Direct Investment inflows in the long run. The discussion of the influence of interest and exchange rates on FDI inflows has always been inconclusive. For instance, the current study's findings contradict Rădulescu & Druica (2014), who examined and found a positive influence of interest and exchange rates on FDI in Romania. The findings contradict Wijaya et al. (2020), who found a positive long-run relationship among these variables. Despite such differences in inferences, the study findings remain valid based on the available information and the macroeconomic performance of the area.

The coefficient of government spending (GS) was positive (0.492) and significant at 5 per cent (P-value = 0.0370). The null hypothesis, "government spending does not influence FDI inflow in the long run", was rejected. The study, therefore, found evidence that government spending influences FDI inflows in the long run, and for every unit increase in government spending, FDI inflow increases by 0.4921 units. This conforms with Tanaya et al. (2012). Using a panel data set of seven countries from 1982 until 2016, the author showed that government spending significantly influences FDI inflows in the long run. The results are further in conformity with Othman et al. (2018), who confirms that government spending contributes positively toward FDI inflows in the long run in ASEAN-5, China and India.

The coefficient of inflation rate (INFR) was negative (-0.629) and significant at 5 per cent (P-value = 0.0109). A significant coefficient gave reasonable evidence against the null. Thus, the current study found a justifiable indication of the long-run relationship between the inflation rate and FDI inflows. The study findings show that for every unit increase in the inflation rate, FDI inflows increase by 0.4921 units. This is further in line with empirical literature by Wijaya et al. (2020), who found a long-run relationship between inflation and FDI in Indonesia. Similarly, Rădulescu & Druica (2014) documents the same in Romania.

On the other hand, the study introduced dummy variables, dummy1 covering 2005 to 2015 and dummy2 for 2015 to 2020. Among others, the major aim was to check changes in regimes had any influence on DFI inflow in the long run. While the coefficient of the 2005 to 2015 dummy was negative (-0.0144) and insignificant (P-value = 0.9788) at all conventional levels, the coefficient of the dumm2 was positive (0.768) and significant (P-value =

0.066) at 10 per cent level. Impliedly, the current study finds government policies introduced between the years 2005 to 2015 have no significant influence on FDI inflows. On the contrary, macroeconomic policies introduced from 2015 to 2020 improved FDI inflows.

Table 4: Long-run ECM model results

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Constant	-2.688833	1.194124	-2.251719	0.0294**
GS	0.492183	0.228777	2.151366	0.0370**
IR	-0.401048	0.642779	-0.623928	0.5359^{NS}
INFR	-0.629046	0.236692	-2.657651	0.0109**
DEBT	0.078068	0.346105	0.225560	0.8226^{NS}
EXR	0.160588	0.239889	0.669425	0.5067^{NS}
DUMMY1	-0.014454	0.540695	-0.026732	0.9788^{NS}
DUMMY2	0.768031	0.407340	1.885481	0.0660*

Note: **** significant at 1%; **significant at 5%; *significant at 10%, and NS not significant.*

4. Conclusions and Recommendations

The study examined the effect of macroeconomic variables on FDI inflows to Tanzania. Findings revealed no significant evidence to explain the effect of exchange rate, interest rate and external debt on foreign direct investment inflows in the short and long run. However, the study found that in the short and long run, there was significant evidence that government spending positively affects foreign direct investment inflows. In contrast, the inflation rate negatively affects foreign direct investment inflows. Furthermore, the results for dummy variable 2, which is a proxy for government regime and economic reforms before 2015, show a positive and statistically significant effect on FDI inflows at 1% in the short run and 10% in the long run. Furthermore, the results show that interest rate and the dummy variable 1 (proxy for government regime and economic reforms after 2015) have negative effects on FDI inflows, but their effects are not statistically significant. Also, external debt and foreign exchange positively affect FDI inflows, but their effects are not statistically significant at any significance level.

Based on the findings, it is recommended that government spending mainly be directed to productive economic activities because it increases the FDI inflows and stimulates economic activities in the country in the long run. Government policies focusing on expansionary fiscal policies have more impact on infrastructural expansion and quality public services provision, which act as a catalyst to attract more foreign investments. Fiscal policies may also target lowering taxes if the aim is to increase FDI inflows. Policymakers should continue strengthening financial policies to maintain economic stability in terms of moderate inflation, as moderate inflation can potentially be attractive and even beneficial for foreign investors. Inflation will only pose a risk of reducing FDI when high levels are sustained over a long period.

Furthermore, to attract more FDI inflows, different government regimes should be consistent in political and economic policies and regulations geared towards attracting foreign investors. These initiatives should include developing industry clusters, lowering taxes, enhancing education and research, providing venture capital and incentives, and preparing the workforce. The government should also prepare professionals at home and overseas to perform promotional activities and develop extensive ties with potential investors. In an increasingly interdependent world, it is no longer enough to maintain an "Open Door"' policy and reduce tariff and non-tariff barriers. To attract sizable FDI, the government must develop comprehensive, long-term-oriented public policies and individualized incentives that meet the needs of the investors and take advantage of the state's competitive advantages.

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