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**Addis Ababa University
School of Graduate Studies
Faculty of Business and Economics
Department of Management
MBA Programme**

Determinants of Foreign Direct Investment Inflow to Ethiopia: Time Series Analysis

**“A thesis submitted in partial fulfillment of the requirements for the Masters
of Business Administration (MBA) degree”**

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October, 2018

Addis Ababa, Ethiopia



Declaration

I, the undersigned, declare that this thesis is my original work, and has not been presented for a degree in any other University, and that all sources of materials used for the thesis have been duly acknowledged.

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Certification

This is to certify that the thesis prepared by Solomon Berhanemeskel, entitled “*Determinants of Foreign Direct Investment Inflow to Ethiopia: Time Series Analysis*” and submitted in partial fulfillment of the requirements for Masters of Business Administration (MBA) degree complies with the regulations of the University and meets the accepted standards with respect to originality and quality.

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Acronyms

AfDB.....	African Development Bank
CPI.....	Consumer Price Index
CUTS	Consumer Unity and Trust Society
EIC	Ethiopian Investment Commission
EPA	Ethiopia Privatization Agency
ESA	Ethiopian Statistical Agency
FDI	Foreign Direct Investment
FDRE	Federal Democratic Republic of Ethiopia
GDP	Gross Domestic Product
GDPPC	Gross Domestic Product per Capita
MNCs	Multinational Companies
NBE	National Bank of Ethiopia
OECD	Organization for Economic Commissions and Dev't
RIOs.....	Regional Investment Offices
SADC.....	South African Development Countries
SSA.....	Sub-Saharan Africa
TNCs	Transnational Corporations
UNCTAD.....	United Nations Conference on Trade and Development.
WDI.....	World Development Indicators
WIR	World Investment Report

Abstract

This thesis focuses on the determinants of foreign direct investment inflows to Ethiopia. In an attempt to attract Foreign Direct Investment (FDI), most countries have liberalized trade and attempted to create enabling environment in recent decades. Ethiopia, like many African countries, took some steps towards liberalizing trade and the macroeconomic regime as well as introducing some measures aimed at improving the FDI regulatory framework. This paper attempts to study the determinants of foreign direct investment inflows to Ethiopia over the period 1991-2017. The study gives an extensive account of the theoretical explanation of FDI as well as reviewing the FDI regulatory framework of the country over the study period. It also undertakes empirical analysis to establish the determining factors of FDI inflows to Ethiopia. Our findings show that macroeconomic instability and financial health, among others, have negative impact on FDI. These findings imply that financial health and macroeconomic stability are essential to attract FDI to Ethiopia.

Key words: FDI, Determinants, Ethiopia

Chapter One

Introduction

This chapter being the precedent outlines defines and addresses the basic idea of the research. It gives a brief background of the study followed by statement of the problem and introduces the thrust of the research by identifying its main areas. The chapter also presents research question, objectives & significance & scope of the study and organization of the research report. In short it is the foundation upon which the rest of the research is lay on and guides the researcher through the research process.

1.1. Background / Rationale of the Study

In the world, there prevails difference in economic performance across different countries. Developed countries have excess capacity to invest, however, low level of investment due to lack of capital is the main obstacle for the economic growth of developing countries.

Investment whether domestic or foreign, is an essential ingredient for sustainable growth; productive investment translates in to increased output. Especially where domestic resources are insufficient to steer a country towards its long run potential growth path, the role of foreign investment becomes indispensable (Asian development bank, 2004).

Foreign direct investment is one of the most striking features of the global economy today. The rapid growth in FDI over the last few decades has spurred a large body of empirical literature to examine the determinants and the growth enhancing effects of FDI. The effects of FDI can be wide ranging since FDI typically encompasses packages of capital as well as technical, managerial and organisational know-how. FDI is particularly important for developing countries since it provides access to resources that would otherwise be unavailable to these countries. Its contribution to economic development and therefore poverty reduction comes through its role as a conduit for transferring advanced technology and organisational forms to the host country, triggering technological and other spillovers to domestically owned enterprises, assisting human capital formation, contributing to international trade integration, and helping to create a more competitive business environment (Ikiara, 2003).

As a result of these benefits of FDI, many developing countries are badly in need of higher economic growth and development. The need to meet the objective of faster economic growth and low level of capital accumulation are conflicting in nature; there exists wider saving-investment gap which means low level of saving and capital accumulations. To solve this problem, FDI served as a source of capital in most less developed countries. They are now actively seeking foreign investment by taking measures that include economic and political reforms designed to improve their investment environment.

In 1991, Ethiopia's transition to a market oriented economy started. Since then, the government has made a broad range of policy reforms, including liberalization of foreign trade regime, decentralization of economic & political power, deregulation of domestic price and devaluation of the national currency. In addition, the investment code has been amended several times in order to meet the demands of both domestic and foreign investors.

In Ethiopia, the gap between domestic investment and savings has remained wide due to the low levels of income and domestic savings. FDI as a source of capital and other business know-how is therefore desperately essential to finance growth and development. Between 1990 and 2017, gross domestic investment as a proportion of GDP rose from 13.81 per cent to 38.816 percent, while gross domestic savings rose from 7.15 percent to 25.7 percent (UNCTAD, 2017). This saving gap can be filled by loans and development assistance from multilateral agencies such as the World Bank or by private foreign investment. Given this, FDI is the most important alternative source of foreign capital for these countries. In view of this important role of FDI, it is essential to understand the principal determinants of FDI in these countries in Ethiopia.

1.2. Statement of the Problem

The Ethiopian economy has grown at least at annual growth rate of 10% for more than two decades so that the country can attain the per capita income level achieved today by average Sub-Saharan African (SSA) countries. However, Ethiopia's gross domestic savings as proportion of GDP is low, and it is unlikely to achieve this growth rate by mobilizing the meager domestic savings (EEA, 2016). The current government of Ethiopia has realized the inadequacy of the

domestic capital and opened several economic sectors to foreign investors. The government has also issued several investment incentives, including tax holidays, duty free importation of capital goods and export tax exemption to encourage foreign investment. Furthermore, Ethiopian Investment Commission (EIC) has been established to service investors and streamline the investment procedures.

Ethiopia named as the fastest-growing economy in the world in 2017 (World Bank, 2017). According to world bank, Ethiopia's economy was forecasted to expand by a further 9.6% during fiscal year (FY) 2018 (July 2017 to July 2018). A little earlier, the International Monetary Fund (IMF, 2016) had called Ethiopia the new economic giant of the East Africa region, after it had overtaken neighboring Kenya. Ethiopia's annual economic output for 2017 was expected to hit \$78 billion up from the \$72 billion recorded last year (IMF, 2016). The IMF pointed out that public-led spending on infrastructure and strong local demand was driving Ethiopia's economic growth, adding that it had also recently become the destination of choice for Foreign Direct investment. The IMF estimated that Ethiopia's economy grew 8.7% last year and agreed on a GDP forecast of 8.3% for 2017/2018.

The latest World Investment Report (UNCTAD, 2018) put Ethiopia as one of Africa's fastest growing economies, absorbed nearly half of the \$7.6 billion FDI in East Africa, attracting a total of \$3.6 billion such investments. The report identified Ethiopia as one of the top performers in efforts to diversify its economy and its FDI pool. It emphasized the diversification of inflow was expanding. According to Investment Commission of Ethiopia (EIC, April 2018) flow of foreign direct investment has significantly surpassed the plan set for the first half of the second Growth and Transformation Plan (GTP) period. The performance in attracting FDI in the past two and half fiscal years exceeded the national plan by over 2.52 billion USD.

Many authors tried to explain the determinants of foreign direct investment but; almost all of the studies do not incorporate the result of the five-year Growth and transformation plan (GTP 1 & 2). At this juncture, identifying the determinants of FDI in Ethiopia is a key step to know the factors responsible for the performance of Ethiopia in attracting FDI. Therefore, this study will try to fill this gap.

1.3. Research Questions

Therefore, this study has the following research questions;

- How does GDP affect the inflow of foreign direct investment in Ethiopia?
- How does infrastructure affect the inflow of foreign direct investment in Ethiopia?
- To what extent the existing human capital put its impact on the inflow of foreign direct investment?
- In what way the macroeconomic stability of the country affects the inflow of FDI?
- How does openness to trade affects the inflow of FDI?
- To what extent the financial health affects the inflow of FDI?

1.4. Objectives of the Study

1.4.1. General Objective

There exists a large body of theoretical and empirical literature on the determinants of FDI, as studies on determinants of FDI are important to diagnose the constraints to attract FDI in a country. Different factors including the level of economic development of an economy, the policy regime in place, social and political factors may play a role in determining the inflow of foreign direct investment. In recent years, Ethiopia has started encouraging the inflow of FDI by providing different incentive packages. However, there is a dearth of studies focus on the determinants of FDI in Ethiopia. The ultimate objective of this study is therefore identifying the major determinants of inflows of FDI in Ethiopia. The overall objective of this study is to analyze the determinants of foreign direct investment in Ethiopia

1.4.2. Specific objectives

The specific objectives of this study are;

- To examine the role of GDP on the inflow of FDI to Ethiopia.
- To examine the role of infrastructure on the inflow of FDI to the country.
- To critically analyze the contributions of human capital on the inflow of FDI to the

country.

- To investigate the impact of macroeconomic stability on the inflow of FDI.
- To assess the role of openness to trade on the inflow of FDI
- To analyze the effect of financial health on the inflow of FDI.

1.5. Scope / Delimitation of the Study

The horizon of the study relies on the macroeconomic determinants of FDI in Ethiopian economy.

1.6. Limitations of the Study

The study was limited to the macroeconomic determinants of FDI inflow. Since the topic is very vast, it is difficult to portray all the determinants of FDI inflows in the economy.

1.7. Significance of the study

Though the study is challenged by those aforementioned and other latent limitations and even if it may not give a complete picture of the sub sector, the study will be relevant for various reasons:

- ✓ It will point out the major areas where the government and other concerned parties have to give due emphasis to attract foreign capital.
- ✓ It will be of value to future researchers and scholars as the study will add on to the existing literature and may be used by future researchers and scholars who are interested in the study area. The study will also identify the existing knowledge gap and open more areas for further study.

1.8. Organization of the Research Report

This study is organized in four chapters. The second chapter provides the literature review which constitutes theoretical and empirical research. The third chapter which is about methodology of the research presents the research design employed, data collection methods, and the data analysis and findings of the study. Lastly, the fourth chapter presents summary of the study, concludes the investigation, forward recommendations and suggests areas for future research.

Chapter Two

Literature Review

2.1. Introduction

As noted in the introduction, the crucial role of FDI in terms of capital formation, spillover effects on trade and technological progress has led to the development of theoretical and empirical literatures which have focused on identifying the possible determinants of FDI. This section will provide a survey of the theoretical and empirical literature on FDI.

2.2. Definition

Foreign Direct Investment can be defined as an investment made by a firm or an entity based in one country, into a firm or entity based in another country. According to the World Bank, foreign direct investment is defined as “an investment made to acquire a lasting management in an enterprise operating in a country other than that of the investor.” According to the IMF (1993) Balance of payment manual, an investment by a foreign investor is regarded as FDI if the direct investor holds at least 10 percent of the ordinary share or voting power of a firm.

Countries differ in the threshold value for foreign equity ownership which they take as evidence of a direct investment relationship. This is the level of participation at or above which the direct investor is normally regarded as having an effective say in the management of the enterprise involved. The threshold value usually applied for FDI is 10%, for data on the operations of TNCs; it involves chosen ranges of between 10-50% (UNCTAD, 2011).

According to Chryssochoidis, Millar and Clegg (1997), there are five different types of FDI. The first type of FDI is made to gain access to specific factors of production, e.g. resources, technical knowledge, patent or brand names etc. owned by a company in the host country. If such factors of production are not available in the home economy of the foreign company, and are not easy to transfer, then the foreign firm must invest locally in order to secure access. The second type of FDI is developed by Raymond Vernon in his product cycle hypothesis. According to this model the company shall invest in order to gain access to cheaper factors of production, e.g. low cost labor. The government of the host country may encourage this type of FDI if it is pursuing an

export oriented development strategy. Since it may provide some form of investment incentive to the foreign company, in form of subsidies, grants and tax concessions. If the government is using an import substitution policy instead, foreign companies may only be allowed to participate in the home economy if they possess technical or managerial know-how that is not available to domestic industry. Such know how may be transferred through licensing. It can also result in a joint venture with a local partner.

The third type of FDI involves international competitors undertaking mutual investment in one another, e.g. through cross-shareholdings or through establishment of joint venture, in order to gain access to each other's product ranges. As a result of increased competition among similar products and R&D-induced specializations this type of FDI emerged. Both companies often find it difficult to compete in each other's home market or in third-country markets for each other's products. If none of the products gain the dominant advantage, the two companies can invest in each other's area of knowledge and promote sub-product specialization in production.

The fourth type of FDI concerns the access to customers in the host country market. In this type of FDI there is no observed shift in comparative advantage either to or from the host country. Export from the company's home base may be impossible, for example, certain services, or the capability to request immediate design modifications. The limited tradability of many services has been an important factor explaining the growth of FDI in these sectors.

The fifth type of FDI relates to the trade divisionary aspect of regional integration. This type occurs when there are location advantages for foreign companies in their home country but the existence of tariffs or other barriers of trade prevent the companies from exporting to the host country. The foreign companies therefore jump the barriers by establishing a local presence within the host economy in order to gain access to the local market. The local manufacturing presence need only be sufficient to circumvent the trade barriers, since the foreign company wants to maintain as much of the value-added in its home economy.

2.3. Theoretical Literature

2.3.1. The theory of portfolio investment

The theory of portfolio investment (the neoclassical financial theory of portfolio flows) is one of

the earliest explanations of FDI. The basis for this explanation lies in interest rate differentials between countries. Capital, according to this explanation, moves in response to changes in interest rate differentials between countries/regions and multinational companies are simply viewed as arbitrageur of capital from countries where its return is low to countries where it is high. This explanation, however, fails to account for the cross movements of capital between/across countries. In practice, capital moves in both directions between countries. In addition, that capital is only a complementary factor in direct investment and that this theory does not explain why firms go abroad contribute to the criticism of the neoclassical theory of portfolio investment (Harrison et al, 2000).

2.3.2. The international model of Uppsala school

This model introduced by Johnson and Wiedersheim-Paul (1975) from the University of Uppsala (Sweden) states that generally a multi-national corporation (MNC) does not commence its activities by making gigantic FDIs. It first operates in the domestic market and then gradually expands its activity abroad. They called this gradual mutation the establishment chain. The establishment chain is comprised of four stages. During the first stage, the MNC – to be just produces and sells its goods and services at home. It does not undertake any regular export activity because of lack of expertise and a tendency to avoid risk. During the second stage, the firm starts its international involvement by exporting its goods and services to neighboring countries and countries it knows well via independent representatives (agents). The psychic distance between the firm's home country and a given country, via, differences in language, culture, political system, level of education, level of industrial stage, and the size of the potential market is expected to be playing a less important role compared to its psychic distance. The firm enters the third stage of the establishment of when it begins establishing sales subsidiaries. The firm may decide to start selling in small markets that are similar to the domestic one or in larger markets. The fourth stage is the setting up or the acquisition of manufacturing facilities abroad. The establishment of manufacturing facilities abroad is influenced by several forces; psychic distances, tariffs, nontariff barriers, transport costs etc. It follows that it is hard to observe any correlation between manufacturing facilities establishment and psychic distance. 15

Johnson and Wiedersheim- Paul (1975) made it clear that firms especially those with extensive

experience from other foreign market are not expected to follow the whole four stages to become MNCs skips in stages can be observed.

However, the firm's internationalization models are also criticized in that they do not explain why firms go multinational. They merely, describe how they go multinational (Accolley. D. et. al., 1997)

2.3.3. Vernon's Product-Cycle Hypothesis

Vernon's product life cycle theory is another explanation of FDI worthy of some discussion. This theory focuses on the role of innovation and economies of scale in determining trade patterns. It states that FDI is a stage in the life cycle of a new product from its invention to maturity. A new product is first manufactured in the home country for the home market. When the home market is saturated, the product is exported to other countries. At later stages, when the new product reaches maturity and loses its uniqueness, competition from similar rival products becomes more intense. At this stage producers would then look for lower cost foreign locations. This theory shows how market seeking and cost reduction motives of companies lead to FDI. It also explains the behaviors of multinational companies and how they take advantage of different countries that are at different levels of development. Additionally, it has been noted that Vernon's theory perceives foreign direct investment as a defensive strategy by firms to protect their existing market position (Dunning, 1993). Knickerbocker (1973), following Vernon's theory, argues that there is follow-the-leader type of defensive FDI especially in industries characterized by oligopoly. His argument relies on uncertainty and risk aversion behavior of oligopolists.

This theory suggests that firms go abroad because of oligopolistic reaction which is "an interactive kind of corporate behavior by which rivals in industries composed of a few large firms counter one another's moves by making similar moves themselves" (Knickerbocker, 1973). However, this theory does not explain why FDI is more efficient than exporting or licensing for expanding abroad. (Getinet A. and Hirut A, 2006)

2.3.4. Industrial organization theory of FDI

Hymer's (1976) pioneering study on multinational companies draws attention to the role of

multinational companies as global industrial organisations. Hymer's major contribution was to shift attention away from neoclassical financial theory. He argued that the need to exercise control over operation is the main motive for FDI than the mere flow of capital. Capital is used to facilitate the establishment of FDI rather than an end in itself. He states that for firms to engage in cross border activities, they must possess some kind of monopolistic advantages. The advantages result from a foreign company's ownership of patents, know how, managerial skills and so on and these advantages are unavailable to local companies. His argument relies on the existence of market imperfections, such as difficulty of marketing and pricing know how, or in some cases markets may not exist for such products, or if they exist, they may involve huge transaction costs or time-lags. In such cases it would be more efficient for the company to engage in direct investment than exporting or licensing. FDI will allow the companies to control and exploit their monopoly power to the full. Hymer's argument led the way to the development of internalisation theory. According to this theory the firms internalise their activities whenever there are inefficiencies in dealing with the external market and FDI would occur when this internalisation involves operation across countries (Harrison et al, 2000).

2.3.5. Dunning's Eclectic theory of FDI

By incorporating Hymer's explanations and various other theories of FDI, Dunning's eclectic paradigm provides a general explanation for the determinants of FDI. Dunning (1993) identified three factors which must be satisfied before engaging in cross border activities.

- ✓ The ownership advantages of a firm: These advantages are firm specific as they are assumed to be exclusive to the firm that owns them. These advantages arise from firms possessing proprietary technology or other unique intangible assets, and the firm's ability to coordinate complementary activities such as manufacturing and distribution. These kinds of advantages give foreign firms more power over their local counterparts.
- ✓ Internalisation advantages: These advantages refer to the firm's ability to internalise its activities, which can be done through market transactions. Through internalisation, the firm can reduce its transaction costs. Moreover, the firm can retain exclusive rights to its assets and it maintains its competitive advantage.
- ✓ Location specific advantages: these advantages include host countries natural resource

endowments, superior infrastructure, and macroeconomic stability. These location advantages determine the profitability with which the ownership advantage and internalisation advantage of the firm should be combined.

From these three advantages if only one is met, then firms will rely on exports, licensing or the sale of patent, to service foreign markets. Thus, the generalized predictions of the eclectic theory are that a firm can only capture a foreign market through FDI if it has the capacity to exploit simultaneously all the three advantages. In Dunning's eclectic theory, the ownership and internalisation advantages are firm specific features whilst the location advantages are country specific characteristics which the host country can influence directly. In general, countries that have location advantages can attract more FDI. But firms do not undertake FDI only for the presence of location specific advantages in the host country. Their location choice decisions consider the profitability with which the ownership and internalisation advantage can be combined with the location ones. Dunning (1993) pointed out that the principal objective of firms in undertaking foreign production is to advance their long-term profitability. In addition to the profitability motives, some firms may undertake FDI as part of their corporate strategies. For instance, firms may try to spread or reduce risks, and to match competitors' actions. In general Dunning (1993) identified three possible motives for FDI:

- *Market seeking FDI*: refers to FDI for the purpose of serving local and regional markets. Host countries' characteristics that can attract market- seeking FDI include market size of the host country, per capita income and growth (potential) of the market.
- *Resource/asset seeking FDI*: refers to FDI for the purpose of acquiring resources which are not available in the home country. Such resources include natural resources, availability of raw materials, and productivity and availability of skilled and unskilled labour.
- *Efficiency seeking FDI*: This kind of FDI occurs when the firm can gain from the common governance of geographically dispersed activities, especially in the presence of economics of scale and scope and diversification of risk.

The above three motives of FDI are categorised under economic determinants of FDI. Besides these economic determinants, there are also two other crucial determinants of FDI:

host country FDI policy framework and business facilitation. According to the 1998 World Investment Report, the policy framework for FDI includes: economic, political and social stability, rules regulating entry and operation of FDI, standard of treatment of foreign affiliates, policies on functioning and structure of the markets, international agreement on FDI, privatization policy, trade policy and tax policy. Business facilitation refers to the ease with which business can be conducted in the host country. The most important business facilitations include investment promotions and incentives, hassle costs related to corruption and administrative efficiency, development of financial institutions, enforceability of contracts and protection of property rights, and quality of life (UNCTAD, 1998).

2.4. Empirical literature

Empirically, according to many studies conducted on the determinants of FDI in Africa argue that FDI inflow is attracted largely by natural resource endowments. In Africa almost 40 percent of FDI has been in the primary sector, particularly oil and mineral extraction business. Countries like Angola, Botswana, Namibia and Nigeria who are endowed with oil and mineral resources have received foreign investment targeted at the oil and minerals sectors of their economy (Basu and Srinivasan, 2002). Morisset (2000) indicate in his study that, on a survey conducted on 29 African countries, there is a high correlation between FDI inflows and total value of natural resources in each country (Getinet A. Hirut A., 2006).

As stated on UNCTAD world investment report(2004) though natural resource abundance is a common factor explaining much of the FDI inflows, the few successful African countries have also put particular attention to the creation of favorable economic, social and political environment for FDI. Other countries, such as Mauritius and Seychelles have managed to attract FDI by tailoring their FDI policies through liberalization, export orientation, tax and other investment incentives. Moreover, some countries like Lesotho and Swaziland have attracted FDI because they are near to South Africa and investors wishing to serve the large market in South Africa have located their subsidiaries in these countries.

According to Musila and Sique (2006) and Dupasquier and Osakwe (2006), FDI in Africa is dependent on the development of infrastructure. Also, other studies on developing countries (Mengistu and Adams, 2007; Cotton and Ramachandran, 2001); emerging economies (Zhaing,

2001); Western Balkan Countries (Kersan-Skabic and Orlic, 2007) and Southeast European Countries (Botric and Škuflic, 2006) show the significant role of infrastructure development in attracting the inflow of FDI. However, the results of a study on US FDI flow to Africa by Nnadozie and Osili (2004) find less robust evidence on the role of infrastructure on foreign direct investment. Results from Anyanwu and Erhijakpor (2004) indicate that telecommunications infrastructures economic growth, openness and significantly increase FDI inflows to Africa while credit to the private sector, export processing zones, and capital gains tax have significantly negative effect.

Gholami et. al., (2006) uses a sample of 23 developed and developing countries observed for the period 1976–99 based on ICT data availability to show that in developed countries, existing ICT infrastructure attracts FDI; a higher level of ICT investment leads to a higher level of FDI inflows but in developing countries the direction of causality goes instead from FDI to ICT. Findings by Sekkat and Veganzones-Varoudakis (2007) indicate that infrastructure availability, openness, and sound economic and political conditions are important for South Asia, Africa, and the Middle East in attracting FDI. In a study of South East European Countries (SEECs), Dauti (2008) identifies ICT infrastructure market as the major factor positively influencing FDI inflows while seeking factors (GDP growth, GDP per capita, GDP level) have perverse signs, showing significantly negative effects on FDI inflows.

Using panel data, Root and Ahmed (1979) have also investigated the determinants of non-extractive direct investment inflows for 70 developing countries over the period 1966-70. Their analysis focuses on testing the significance of the economic, social and political variables in explaining the determinants of FDI. They found out that developing countries that have attracted the most non-extractive direct foreign investment are those that have substantial urbanization, a relatively advanced infrastructure, comparatively high growth rates in per capita GDP, and political stability. Asiedu (2002) has also expressed a similar view analyzing the impact of natural resources, infrastructure and openness to trade on FDI flows to Sub-Saharan Africa. Her findings indicate that FDI in Africa is not solely determined by availability of natural resources and that governments can play an important role in directing FDI through trade reform, macroeconomic and political stability, efficient institutions and improvement in infrastructure. Several other studies find that countries that have a higher degree of openness attract more FDI.

Chakrabarti's (2001) finds openness to trade, measured by exports plus imports to GDP, being positively correlated with FDI.

Morisset (2000) finds a positive and significant correlation between trade openness and the investment climate for 29 African countries. Their findings indicate that FDI responds significantly to increased openness in the whole economy and in the services sector in particular. In general, the empirical evidence supports the theoretical argument in favor of favorable government policies and liberal trade regimes as important determinants of FDI. It has been argued that macroeconomic stability, government policies and political variables are more important determinants of FDI in Africa than the market variables. Lemi and Asefa (2001) also arrive at similar conclusions. Their study examines the impact of economic and political uncertainty on foreign direct investment flow to 31 African countries. Their study indicates that for U.S. manufacturing FDI in particular, Political stability and government policy commitment are the most important factors. Moreover economic factors such as labor, trade connection, size of the export sector, external debt, and market size of the countries are found to be significant determinants of FDI flows to African countries. Empirically, Salisu (2003) analyses the impact of corruption on FDI in Nigeria and finds corruption having a significant detrimental effect on FDI. In general, greater red tape, more restrictive performance requirements, an unstable political situation, or economic instability would make the host country less attractive for FDI.

Using a panel of 97 countries, Dutta and Roy (2008) investigates the role of political risk in the association of FDI and financial development and show that the impact of financial development on FDI becomes negative beyond a threshold level of financial development while political risk factors affect the relationship by altering the threshold level of financial development. Quazi (2007) estimates the determinants of FDI to nine Latin American countries, with emphasis on the investment climate, and finds that FDI inflow is significantly boosted by foreign investors' increased familiarity with the host economy, better infrastructure, higher return on investment, and greater trade openness, but the inflow is significantly depressed by lack of economic freedom. Also, FDI inflow is negatively correlated with policy changes that result in higher trade barriers, more repressive taxation, more restrictive foreign investment code, more repressive financial system, and further price and wage controls. The study identifies two factors, namely, excessive bureaucracy and inefficient financial markets, which act as locational disadvantages

for Mexico in comparison to its regional “rival” countries.

Chowdhury and Mavrotas (2006), using data for three countries - Chile, Malaysia and Thailand – find that GDP causes FDI in Chile and not vice versa while in the case of both Malaysia and Thailand, there is strong evidence of a bi-directional causality between GDP and FDI. Klein and Rosnegren (1994), Jeon and Rhee (2008) find strong evidence that relative wealth significantly affects inward foreign direct investment while Brahmasrene and Jiranyakul (2001) find that real income is a significant factor determining the inflow of FDI. However, Nnadozie and Osili (2004) find less robust evidence on the role of GDP per capita on FDI inflow but GDP growth is found to have significant impact. Market size is found to play an important role in FDI inflows (Barrell and Pain, 1996; Nigh, 1986; Anyanwu, 1998; Fedderke and Romm, 2006;).

Inflation as a proxy for economic instability has been found to negatively affect FDI inflows (Nnadozie and Osili, 2004; Khair-UZ-Zaman et. al., 2006) though the findings of Brahmasrene and Jiranyakul (2001) indicate otherwise. Trade openness has also been found to be positively associated with FDI inflows (Yih Yun et al., 2000; Asiedu, 2002; Feils and Rahman, 2008).

Human capital, both in terms of quantity and quality, is another important factor in promoting labour intensive and export oriented FDI in particular. Noorbakhsh et al (2001), using secondary school enrolment ratio and the number of accumulated years of secondary and tertiary education in the working age population as a proxy to human capital, find human capital to be a significant determinant of FDI inflows for 36 developing countries. Lewis (1999) also provides support to the proposition that human capital in host countries is a key determinant of foreign direct investment in developing countries. He notes that education, especially in technical discipline, provides least developed countries with the skills that are required by the multinational companies. Nunnenkamp (2002) has analysed globalisation-induced changes in the relative importance of foreign direct investment in developing countries. His findings indicate that traditional market-related determinants are still dominant factors but the availability of local skills has become a relevant pull factor of FDI in the process of globalisation. Salisu (2003) also finds low level of human capital, as measured by the illiteracy rate, having a discouraging effect on FDI in Nigeria.

2.5. FDI in Ethiopia

2.5.1. Overview

The Ethiopian FDI performance over the study period can be reviewed on the basis of the two regimes that have been in place in the country. The first period, the pre-1991 period relates to the period when policies that were in place were more or less in line with the command system of economic management. The second period, the post-1991 period, signify some move away from the command system and commenced with the stabilization and adjustment programs (SAP) of the World Bank (Geda and Degefe, 2002).

The pre-1991 period marked the introduction of the command system of economic management in 1974. The mainly liberal policies of the pre-1974 Imperial/feudal era were replaced with centralized policies that discouraged market economy and private property. The land reform measure that was undertaken in 1975 was one of the major policy reforms that took place immediately. Land was nationalized and private ownership of land ceased. Medium-size and large enterprises were also nationalized.

The government also nationalized and subsequently reorganized private banks and insurance companies. In general, the economic performance of the pre-1991 period was characterized by three phases. During the first phase of the regime 1974-78, economic performance was poor due to the emerging new policies and the nationalization measures. Average annual growth rate of GDP was 0.3 percent while per capita growth was negative. During the second phase of the regime, 1978-80, the economy began to recover and the growth rate increased to 4.6 percent. This period was characterized by stability and it also benefited from good weather. Agricultural production increased at an average annual rate of 3.6 percent. But in the third phase 1980-1985, the economy performed badly again. The major reason for this was the severe drought that affected almost all regions of the country. After this period the economy continued to stagnate. To tackle the structural problems of the country the government eventually adopted a long-term plan (the Ten Year Perspective Plan). The aim of the plan was to reduce the share of agriculture in GDP, increase the share of industry, increasing foreign exchange earnings, diversification of the country's export sector and real GDP growth of 6.9 percent per annum during the target period. However, most of the targets were not realized. Growth remained at about 2 percent and

GDP per capita was negative during the pre-1991 period (Geda and Degefe, 2002).

The investment climate in general and FDI in particular was not encouraging during this period. The problems of political instability, insecurity, and the nationalization of major industries severely discouraged foreign private investment. Realizing the importance of FDI, the government then attempted to revive FDI through the 1983 Joint Venture Proclamation. The proclamation offered incentives such as a five-year period of income tax relief, import and export duty relief, tariff protection and repatriation of profits and capital. However, the proclamation failed to attract foreign investors. In 1989, the government revised the 1983 proclamation by allowing majority foreign ownership in many sectors. It also attempted to provide more protection to investors. However, the political instability and the prolonged civil war at the time further discouraged FDI. The political instability got worse and it consequently led to the overthrow of the regime in 1991.

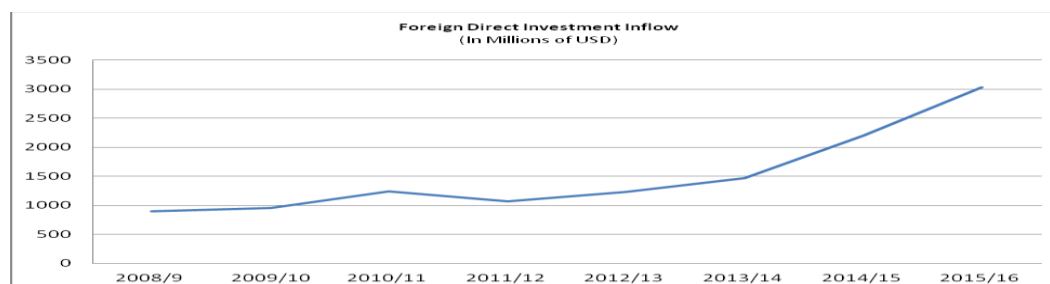
After the downfall of Derge regime in 1991, Ethiopia has been trying to attract foreign investments in many economic sectors by taking the following measures:

- Deregulation of domestic prices
- Devaluation of the national currency by 141.55 percent, from 2.07 birr per dollar to 5 birr per dollar;
- Liberalization of the foreign exchange market;
- Elimination of Export taxes except for coffee;
- Lowering of Maximum import duties from 230 percent to 60 percent;
- Simplification of Export licensing regulation and procedure;
- Provision of adequate incentives, strengthening and enhancing institutional support for the export sector.

Although there are some fluctuations, the inflow of FDI to Ethiopia has increased from an annual average of \$75.3 million in 1990-2000 to \$404 million in 2001-2006. The total FDI inflow into Ethiopia has increased continuously from US\$ 134.6 Million in 2000 up to US\$ 545.1 Million in 2004. Since then, up to 2016 the yearly FDI inflows have varied between US\$ 265.1 Million and US\$ 3,196.4 Million (UNCTAD, 2017). After 2013, the amount of FDI flow to the country

registered a sharp increment. The following figure depicted the FDI inflow trend between 2008 - 2016.

Figure 2.1 FDI Inflows in Ethiopia



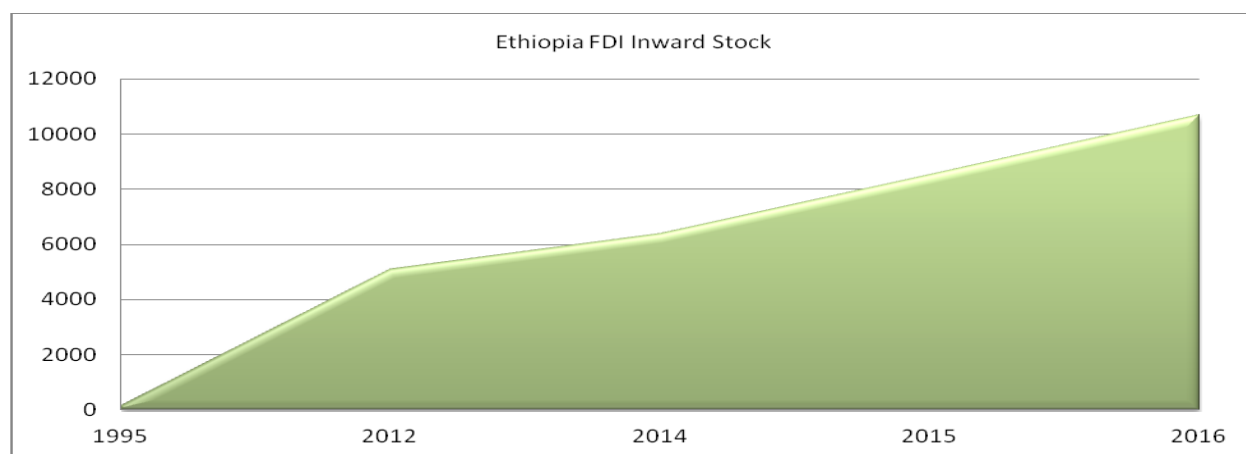
Source: UNCTAD World Investment Report 2017

The high level of economic growth, the provision of better infrastructure, the successive growth of market sizes and the government's openness for FDI contributed to high profile investors targeting Ethiopia in the past few years. Hence, in 2014-15, Ethiopia rose to be included in the Top-10 investment destinations in Africa - recording 100% change in FDI flow (The African Investment Report, 2015). Ethiopia also doubled its registered growth in manufacturing projects, in addition to parallel increases in manufacturing value added growth from 12 to 17 percent. FDI inflow to Ethiopia showed a continuous increase of more than 12% per annum, a fact which could be attributed to the country's favorable investment climate.

According to Ethiopian Investment Commission Ethiopia's impressive domestic and foreign direct investment (FDI) performance in recent years started from very low track record. From 2009 to 2013, Ethiopia recorded a positive growth trend in domestic savings with tremendous boost from 5.2% to 17.7% of GDP. However, the investment gap remained wide. Similarly, FDI inflows to Ethiopia during the five years preceding the start of GTP I showed very limited increase (with the notable exception of year 2011), accounting among the least share in Sub-Saharan Africa. In 2012, the FDI inward stock as a percentage of GDP was as low as 11.8%, which fared poorly against East Africa's average of 18.8%.

Meanwhile, ambitious growth goals were set under GTP I and II which required significant investments. FDI, along with other measures, was regarded as essential tool to finance the national growth and development plans. The result was a significant increase both in the volume/size of FDI inflows as well as the number of projects initiated or implemented.

Table 3.1 FDI Stock, 1995-2016



Source: UNCTAD World Investment Report, various years

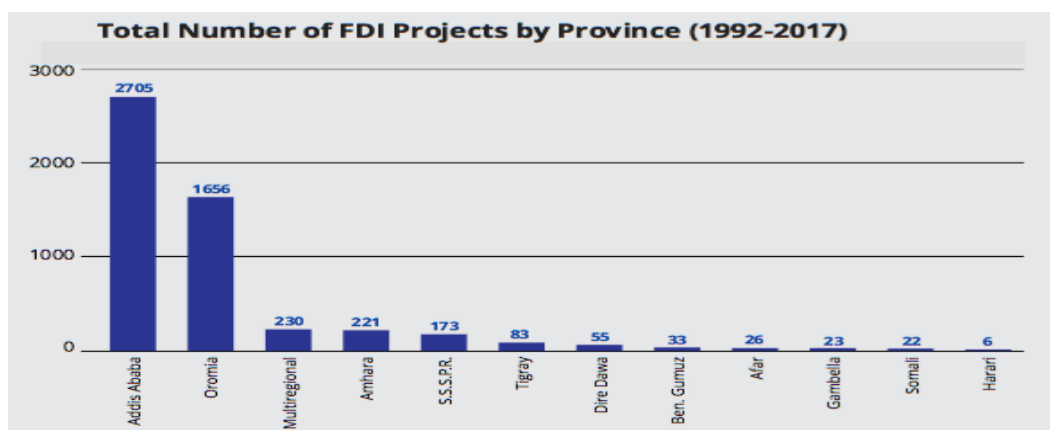
2.5.2. Regional Distribution of FDI

Although there is an incentive system encourages foreign investors to invest in the least developed regions (Gambella, Afar, Somali and Benishangul-Gumuz) of the country by providing especial benefits including provision of land free of any charge, their performance in attracting FDI is very poor (EIA, 2008 and Tagesse, 2001). This makes the flow of FDI to Ethiopia has been unevenly distributed among the various regions.

As it is shown in table 3.2, most of the FDI is destined in Addis Ababa, the capital. Over the period (1992-2017), 2,075 transactions took place in Addis Ababa, representing 51.7% of total transactions, while Oromia accounted for 31.7% of all investments (eight times more than the next region, Amahara). This is because of the regions' better infrastructure, stable political environment and better supply of trained man power. Oromia Region has attracted sizable amount of FDI with respect to the amount of capital invested. That is, of the total FDI operating in Ethiopia during 1992-2017, 31.7% of the capital was invested in Oromia. This may be due to the regions proximity to Addis Ababa, availability of natural resource (arable land and favorable climate) and large market size as it is the most populous region in the country. About 4% of the total FDI was invested in the Amhara region.

Conversely, Harari, Gambella, Afar, Somali and Benishangul- Gumuz's performance in attracting FDI has been very poor. For example, there is only six projects in Harari Region since the country opened its door to foreign investors.

Table 3.2 Summary of Licensed FDI Projects by Region since 1992-2017

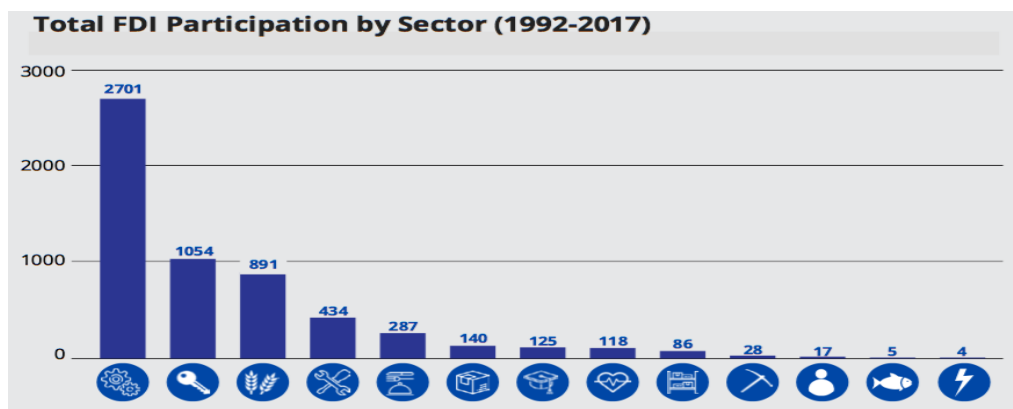


Source: Ethiopian Investment Commission

2.5.3. Sectoral Distribution of FDI

The distribution of FDI flows to Ethiopia is fairly diversified into various sectors ranging from the primary including all types of agricultural activities and mining & quarrying to secondary sector or the industrial activities to the tertiary sector including electricity generation, construction, real estate, trade, hotel and tourism, transport service, education and health service. As can be seen from Table 3.3, manufacturing accounted for 35.16% of the total FDI followed by real estate, renting and business activities which accounted for 17.89.5% from 1992-2017 and agriculture, construction, Hotel and Restaurant, and Transportation constitutes 29.74% of the total FDI flows to Ethiopia. Education, Health, Wholesale, Mining & Quarrying, other services, Fishing, and Electricity constitutes 6.5%. However, the mining, fishing, electricity and other service industries are areas that have not received much FDI in the country with each accounting for less than 1% of the total inflow.

Table 3.3 Summary of Licensed FDI Projects by Sector since 1992 – 2017



Source: Ethiopian Investment Commission

2.5.4. FDI Flows by Country of Origin

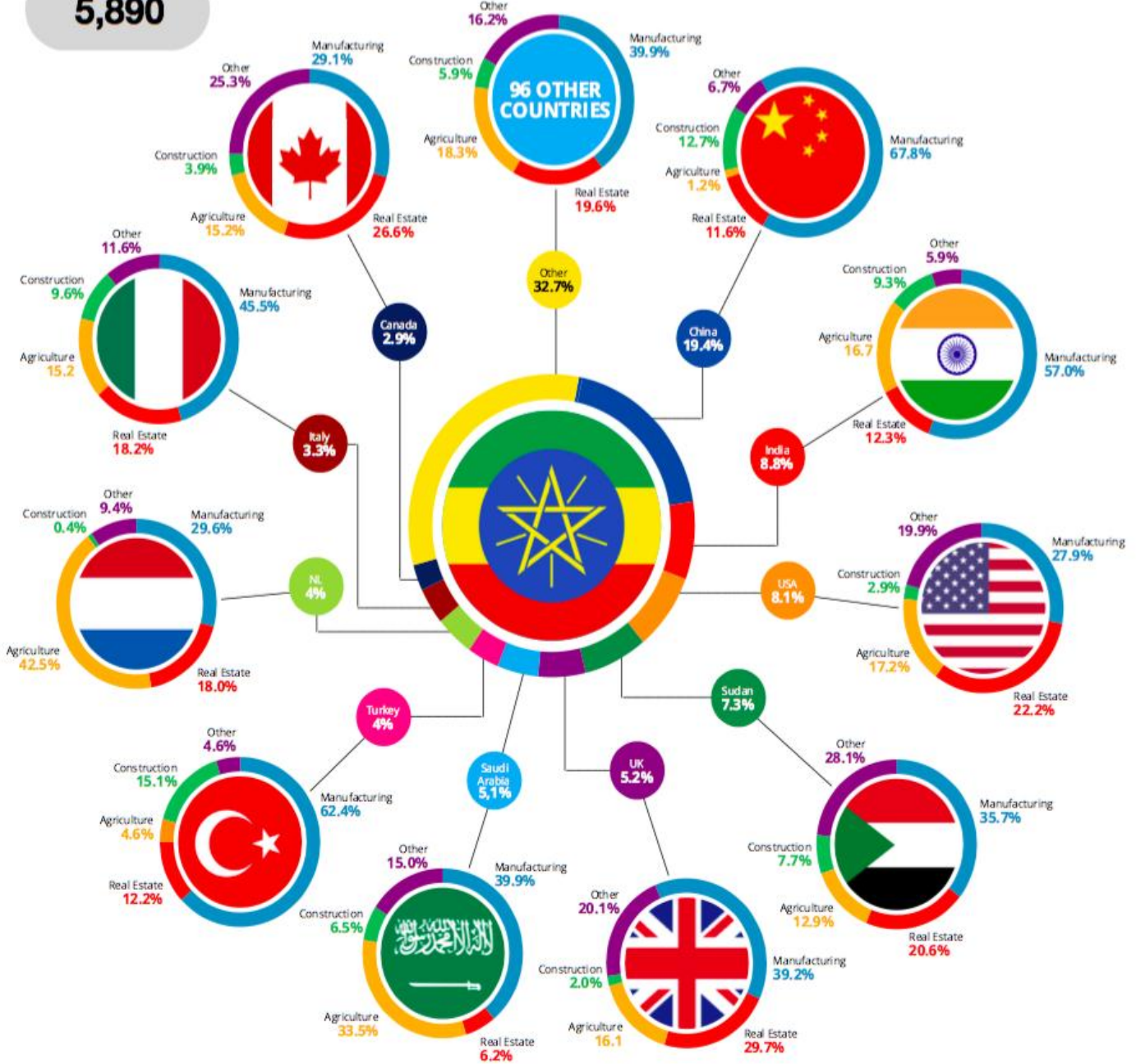
Breaking down investor participation over time demonstrates the clear emergence of China as Ethiopia’s most participant investor. Outside of the top ten, the overall number of countries represented in total FDI flows has increased from only two countries in 1992, South Korea and Uganda, to 96 countries by May 2017.

Manufacturing attracted the highest investor participation over the period by far, with China contributing to almost 30% total participation in the space. Almost half of the participation in Real Estate, the second most popular sector for investors, can be attributed to China, India, USA, Sudan, and UK. Dutch investors led in the agriculture market, participating in 99 investments of a recorded of 891 – China participated in just 14. During the period 1992-July 2005 Saudi Arabia accounted for half of the FDI flows to Ethiopia. Ethiopian Economic Association (2007) reported that one company- MIDROC group investment, highly dominates FDI flows originating from Saudi Arabia. Other than this company Saudi was followed by the United Kingdom, accounting for 9.4%. France, USA, China and India were the other major source countries during that period. However, as picture 3.4., now china has the largest investment in the country followed by India, USA and Sudan.

Figure 2.2. FDI Flows by Country of Origin

Total FDI Participants

5,890



Source: Ethiopian Investment Commission

2.5.5. FDI Regulatory Framework in Ethiopia

After the fall of the socialist, Derg regime, Ethiopia has adopted a market-oriented economy in

1991. The national investment code has been amended several times since then. The Government initiated a privatization programme in 1995/96. So far over 170 enterprises and units have been privatized. Most of the smaller enterprises and units were sold to domestic investors, whilst a number of the larger enterprises have been acquired by foreign investors. These include a gold mine, Coca-Cola and Pepsi Cola bottling companies, a brewery, meat processing and canning plants, and a tannery. Over the coming years the Government plans to privatize a further 120 enterprises (EIA, 2008).

After obtaining an approval from Ethiopian Investment Authority or regional investment authorities to invest, foreign investors can invest in all economic sectors other than some sectors exclusively reserved for national investors and the government. To encourage indigenous entrepreneurship and the domestic private sector, the financial sector, import trade, small air transport (less than 20 passengers), commercial water & road transport and several small businesses are reserved for national investors (UNCTAD, 2002).

However, now foreign investors are allowed to jointly invest and work with the government in basic infrastructures. For instance, foreign investors are now particularly sought to set up hydroelectric power plants in the country and the government has now liberalized the telecommunication services sector, allowing foreign investors to participate in telecom activities jointly with the government. Some of the sectors which are open for foreign investors and in which the country is currently seeking include: Manufacturing industries (including food, beverages, chemicals and, pharmaceuticals, plastics, metallic and non-metallic products, paper products, leather and leather products, textiles and garments); Agriculture, including agribusiness and processing for exports; Grade 1 construction contract Real-estate development; Engineering and management consult; Education and health services; and Mining and quarrying of gold, marble and granite.

The initial capital requirement for a wholly foreign-owned enterprise is a minimum of USD 100,000. But wholly foreign-owned consultancies and publishing companies can obtain the investment license with USD 50,000. To invest jointly with Ethiopian investors, foreign investors should invest a minimum of USD 60,000 and the national investors should acquire at least 27 percent of the equity. To encourage export-oriented FDI, foreign enterprises that export

at least 75% of their output are not required to meet the minimum capital requirement. Nevertheless, the investment code does not indicate the initial investment is whether in cash or in kind (UNCTAD, 2002).

There are various incentives given to foreign direct investors. These include: exemption from payment of export custom duties, income tax holidays from 2 to 7 years depending on the region and the sector of the investment. All imported capital goods and spare parts worth up to 15% of the value of the capital good are exempted from import tariffs and custom duties. In addition, the foreign investors can carry forward their initial operating losses and apply any depreciation methods for their financial statement.

Besides, all foreign investors are exempted from profit tax for two years. This exemption is extended to 5 years for investors exporting at least 50% of their product and supply 75% of their product as input to exporters. With regards investment guarantees, the investment code provides guarantee for repatriation of capital, interest payments on foreign loans, profit, dividends, asset sell proceeds and technology transfer payments. Except in major cases of public interest, the investment code also provides guarantee against expropriation (EIA, 2008; EEA, 2007).

2.6. Summary and Literature Gap

Natural resource is the chief determinant of FDI in Africa, particularly in least developed African countries. Nevertheless, the natural resource base of Ethiopia is not attractive for foreign investors, as Ethiopia does not have sufficient stock of minerals and petroleum, the most important natural resources that attract FDI in Africa.

Although natural resource endowments of the host countries the most common explanation of FDI flows to Africa, Egypt, Morocco, and Tunisia have managed to attract a non-resource seeking FDI or diversified FDI. Ethiopia is far behind these countries in terms of the purchasing power of the people, infrastructure development, existence of skilled manpower, availability of stable political and hospitable business environment.

As regards the business environment, the liberalization measures that have been undertaken so far are not sufficient. The government has still restricted private investment in the telecommunications sector, and the banking and insurance businesses are exclusively reserved to

the local investors. This deters not only FDI flows into these sectors but also FDI flows to the other sectors, as they are the major indicators of the government overall openness to foreign investors. The inefficient government bureaucracy, corruption and the terribly slow judicial process are the other factors that hinder FDI flows into the country. They are serious disincentives for the existing the investors doing business in the county to re-invest their profit. The dissatisfaction of the existing investors may deter the FDI flows further, as bad news and impressions spread faster than good news. Nevertheless, a liberalized, hospitable and predictable business environment may not increase FDI flows unless the recipient countries attain a certain minimum level of economic development. In other words, a hospitable business environment is secondary to the recipient countries' levels of development.

In addition, only the middle income African countries are able to attract a diversified FDI or non-resource seeking FDI. The implication of this is that countries should achieve a certain minimum level of development to draw sizable non resource-seeking FDI. This is because the costs of doing business and the profit possibilities of investments are highly determined by the levels of economic development of the host countries. In least developed countries, there is no adequate supply of infrastructure & skilled labor and the purchasing power of the people is very low. As a result, the cost of doing business is very high and the productivity & the profitability of investments significantly very low.

From the studies reviewed, it is evident that most of the studies in Ethiopia did not include the results of the five years' growth and transformation plan (GTP 1 & 2) to examine the determinants of FDI inflows to Ethiopia. This study, therefore, sought to examine the determinants of FDI inflows to Ethiopia considering the recent results of GTP to attract foreign direct investment.

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