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ST. MARY'S UNIVERSITY

SCHOOL OF GRADUATE STUDIES

THE DETERMINANTS AND TREND OF FOREIGN DIRECT INVESTMENT IN
ETHIOPIA

BY

ASHENAFI BEZA

ID NO: SGS/0143/2008

JUNE 2018

ADDIS ABABA, ETHIOPIA

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A THESIS SUBMITTED TO ST. MARY'S UNIVERSITY, SCHOOL OF GRADUATE STUDIES IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE AWARD OF DEGREE OF MASTER OF ARTS IN DEVELOPMENT ECONOMICS

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ACRONYMY:

ADBG	African Development Bank Group
CSA	Central Statics Agency
EIC	Ethiopian Investment Commission
EPA	Ethiopian Privatization Agency
EPRDF	Ethiopian People Revolutionary Democratic Front
FDI	Foreign Direct Investment
GNI	Gross Net Investment
IMF	International Monetary Fund
LDC	Least Developed Countries
MoFED	Ministry of Finance and Economic Development
MNC	Multinational Corporation
OECD	Organization for Economic Cooperation and Development
ODA	Overseas Development Aid
PPESA	Privatization and Public Enterprises Supervising Authority
SBIC	Schwarz's Bayesian Information Criterion
SSA	Sub-Saharan Africa
SAP	Structure Adjustment Program
TNC	Transnational Corporation
UNCTAD	United Nations Conference on Trade and Development

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ABSTRACT

Many developing countries are competing to attract foreign direct investment with a belief that it can be a tool for poverty reduction. However, developing countries are not only lagging behind in attracting FDI, but also the pattern of FDI inflow to the developing countries is highly uneven. Numerous studies in recent years have focused attention on the determinants and trends of foreign direct investment in developing countries; however, previous studies conducted in Ethiopia were not adequate when it compared with the importance of the issues. This paper assessed the determinants and trend of Foreign Direct Investment (FDI) in Ethiopia. The study employed time series data from the period 2000 – 2017 to identify and assess the trend and potential determinants of FDI inflow, such as, market size, market potential, macro–economic instability, infrastructural facilities, trade openness, exchange rate and government expenditure. The data were collected from relevant sources such as, Ministry of Finance and Economic Cooperation (MoFEC), National Bank of Ethiopia (NBE), Ethiopian Investment Commission (EIC) and Central Statistics Agency (CSA). The study first discussed the trend of FDI growth rates. In addition, data were also analyzed using regression analysis to identify the cause - effect relationship of dependent and independent variables. The result disclosed that there is no consistent growth of FDI in the country. Hence, inflow of FDI to the country can easily be affected by various macroeconomic variables. It is observed that FDI is distributed unevenly throughout the different sectors of the country with the highest share going to the manufacturing sector (68%). The evaluation of the regional distribution of FDI shows that despite the many reforms made to encourage FDI flow to less developed regions, the performance of these regions in attracting FDI is quite low and high number of FDI is concentrated in Addis Ababa city administration and in proximity town around Addis Ababa. The findings of the study further showed that economic growth, Trade openness, exchange rate and infrastructural development have significant positive impact on FDI inflows, while macroeconomic instability such as, inflation, government expenditure, and low level of market size have negative impact on FDI inflow. The study recommended that it requires a thoughtful commitment to address all variables having negative impact on the inflow of FDI, as these factors increase the transaction costs of doing business in the country and affect the image of the country in the eyes of potential investors. As a satisfied investor is an important

promoter for potential investors, the government should also support the existing investors by introducing an aftercare program aims to identifying and resolving the problems encountered by the existing investors.

Keywords: Foreign Direct Investment (FDI), Market Size, Trade Openness, Macro-economic Stability, Exchange Rate, Ethiopia.

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

The global economic integration which gained momentum since the beginning of the 1990's has led to a significant flow of foreign direct investment towards developing countries. Following the decline in Overseas Development Aid (ODA) flows, many developing countries are increasingly aware of the role of foreign direct investment (FDI) as an engine of growth in their economies (IMF, 2011). Investment is one of the primary engines of growth in all economies. Countries that devote high proportion of output to investment may sustain more rapid growth than countries that invest less.

Among several benefits of FDI, the host country will benefit as FDI creates employment opportunities, promotes economic growth, and facilitates technology transfer. According to Bouoiyour, (2003) FDI fill the gap between domestic investments and savings in most developing countries as their income and savings are very low. Although world FDI flows have increased rapidly in recent years, roughly three quarters of such FDI flows went to advanced countries, notably the US and the European countries and only the rest went to developing countries. Among developing countries, a large proportion of FDI was concentrated in a small number of countries showing that developing countries face difficulties in attracting foreign investors (United Nations Conference on Trade and Development (UNCTAD), 2004). Moreover, in the process, many developing countries are now actively seeking foreign investment by taking measures that include economic and political reform designed to improve their investment environment.

Though countries are tried to gain the benefit of FDI through designing different types of policies, however, there are several determinant factors that hindered the flow of FDI. Edward (2012) outlines six motives (Macro – economic determinant factors) for a firm to engage cross border investment, such as, access to resources, access to markets, access to finance, infrastructural facilities, attractive regulatory frame works and stable political situation. In addition to the mentioned macro-level determinant of FDI, numerous other

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factors are mentioned as host country determinants of FDI in the literature. Some of them are: contract law, the image of the host country, availability of investment fund, governance, human resource development, degree of openness, urbanization, coherent and stable macro & sectorial policies, (UNCTAD, 1998).

Developing countries are not only lagging behind in attracting FDI, but also the pattern of FDI inflow to the developing countries is highly uneven. A few developing countries enjoy massive FDI inflow, whereas other developing countries even face the problem of FDI outflow (negative FDI inflow). An analysis of the UNCTAD (2007) report reveals that lower income countries that is developing countries with per capita GNI less than US$ 755 are comparatively less likely to be successful in attracting FDI; and as per country level, most of Sub Saharan African Countries take a lead. However, there are 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. In addition to those countries compared to other parts of Africa, the performance of East African countries in attracting foreign direct investment is becoming improved, its FDI flows increasing by 15% from 2013 to 2016 (World Investment Report, 2016). This is because; in East Africa a great economic change took place because of the economic liberalization adoption policies in which these countries with respected governments tried to use the private sector as it is the major economic growth engine. This economic reform changes the government focus towards the need of capital, need of new technology, need of skills to be injected in private sector to make the sector manage the FDI attraction.

Likewise, Ethiopia, in an attempt to accelerate economic growth and development, encouraged FDI through the introductions of different incentive packages and liberalization of investment policies especially post 1991. However, the FDI inflow of Ethiopia were not keep its constant growth throughout the years such as, starting 2013 the growth of FDI

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constantly decreased until 2017. this implied there are determinate factors that determine the inflow of FDI in the country. Therefore, in this study attempts will be tried to identify determinant factors level of effect on the inflow of FDI.

1.2 Statement of the Problem

In recent years, most developing countries have liberalized their trade and attempted to create enabling environment to attract Foreign Direct Investment (FDI). Ethiopia, like many developing countries, have taken remarkable measures towards liberalizing trade and the macroeconomic regimes as well as introduced some measures aimed at improving the structural and regulatory framework of FDI. Several incentives structures were introduced by the current government, including tax holidays, duty free importation of capital goods, providing industrial parks and export tax exemption are the major areas (IMF, 2011). However, the performance of FDI inflow of Ethiopia is not remarkable compared with many African Countries. The trend of foreign direct investment in Ethiopia shows fluctuating values even though the recent one is the highest of the previous 38 years. The net inflow of foreign direct investment in 2011 was 2.07%. Its highest value over the past 39 years was 5.45 % in 2003 (EIA, 2012). Still the trend is factoring between these percentage level, and when it is compared with the average annual growth rate of Eastern African countries (15%), Ethiopia's performance of attracting FDI is by far behind the region average growth rate. Because of this at the current time, government of Ethiopia has opened several economic sectors to foreign investors. At this juncture, identifying the determinants of FDI in Ethiopia is a key step to know the factors responsible for the poor performance of Ethiopia in attracting FDI.

Numerous studies in recent years have focused attention on the determinants of foreign direct investment in developing countries; however, previous studies conducted in Ethiopia were not adequate when it compared with the necessity of the issues. For instance, there was a study conducted by Yonas (2016) on the determinants of FDI in Ethiopia based on assessing macro-Economic variables. The apparent limitation of the study was that it concentrates on macroeconomic variables focusing on financial analysis than sectorial FDI. Therefore, the study tried to fill this gap in addition to macroeconomic effect attempt were done to analysis

sectorial effect of FDI. Similarly, a study conducted by Liya, (2016), focused on inferring the trend of FDI inflow and its performance rather than identifying how factors are determining the flow of FDI. A study was conducted by, Solomon, (2008). However, its time difference may not explain the current situation and trends. Therefore, this paper contributed to this body of knowledge by filling a noticeable gap. Principally, this paper examined the determinants and trend of foreign direct investment in Ethiopia for the period, 2000 – 2017.

1.3 Objective of the Study

General objective:

The general objective of this study is to analyze the determinants and trend of foreign direct investment in Ethiopia.

Specific objective:

To review the trend of foreign direct investment in Ethiopia throughout the years.
To analyze the determinant factors that affect the FDI inflow in Ethiopia from 2000 – 2017.
To propose possible recommendations that could help the improvements of FDI inflow based on the findings.

1.4 Basic Research Questions

In view of the above objective, the study addressed the following specific research questions
1. What is the trend of FDI inflow from 2000 - 2017 in Ethiopia?
2. What are the determinant factors that affect the FDI inflow in Ethiopia?
3. What can Ethiopia do to attract more FDI inflow?

1.5 Significance of the Study

The finding of this study which deals with the determinants of FDI in Ethiopia are beneficial for different stakeholders such as, for academicians, policy makers, as well as several responsible bodies work on Ethiopian Investment Commission (EIC). In addition, since such investigation has policy implication, the finding of this study might be used as a directive input in developing regulatory standards regarding and attracting FDI inflow.

1.6 Limitation of the Study

The apparent limitation of the study is that it concentrates on secondary data sources of FDI. the study didn't consider potential experts, policy makers as well as sectorial leader's opinion and this condition may lead to disaggregated research results.

1.7 Scope of the Study

The study focused on the determinants of Foreign Direct Investment (FDI) in Ethiopia, based on the secondary sources of data obtained from National Bank of Ethiopia, Ethiopian Investment Commission, and CSA. Principally, this paper analysis also delimited in examining the determinant of foreign direct investment in Ethiopia for the period, 2000 – 2017, this is because to compare the trend of FDI inflow from the starting period of liberalization of market under Ethiopian People Revolutionary and Democratic Front (EPRDF) government till the present time.

1.8 Organization of the Study

The study organized under five chapters. Chapter one indicates introduction of the study which consists of background of the study, statement of the problem, research questions, objective of the study, and significance of the study and limitation of the study. Chapter two consists, the review of related theoretical and empirical literatures. Chapter three comprise of research methodology including data type and sources, method of data collection, method of data analysis, sample size and sampling techniques. Chapter four consists the findings and discussions of the study. The last chapter provides the conclusion and recommendation part of the study.

CHAPTER TWO
REVIEW RELATED LITERATURE

2.1. Literature Review

This chapter started with presenting the basic concept of Foreign Direct Investment. Besides, theories related to FDI, determinant factors of FDI, and FDI trends in Ethiopia has been reviewed. In addition, models, concepts and empirical studies has been revised and discussed both cross countries as well as studies conducted in Ethiopia.

2.2. Theoretical Review

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's (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.

Ethiopian investment code defines a foreign investor as "… a physical or Judicial person of foreign nationality which has invested imported capital" (Investment Proclamation No.15/1992, article 2) (Yonas, 2016). There are different types of FDI. These include Greenfield investment, cross border merger and acquisition, and reinvested earnings. Greenfield investment refers to the establishment of a new firm that in turn enables to create productive assets in a host country. Usually, it is financed by capital coming from the investor's country. A transfer of ownership of local productive assets to a foreign investor is referred as international or cross border merger and acquisition. Reinvested earnings refer part or all of the profit that is not repatriated to the investor's country but reinvested in the host country (UNCTAD, 1998).

FDI can also be classified into market-seeking, export- oriented and government initiated FDI.A market-seeking FDI is highly determined by the growth potential and the size of

national market, access to regional & global markets and country-specific consumer preferences. When a foreign firm produces raw materials, intermediate and final goods and sells these products form on-local market, this FDI is referred as export-oriented FDI. An investment is called government initiated FDI, when governments of developing countries invite and give incentives to direct foreign investors to invest in specific sectors and industries with a view to addressing socio-economic problems like unemployment, regional disparities and deficits in the balance of payment (Accolley et al, 1997). In a similar vein, again based on the primary motives of the direct foreign investors, FDI can also be classified into the following three groups: Market seeking, resource/asset-seeking and efficiency seeking (UNCTAD, 2007). A resource/asset seeking FDI is attracted by availability of low-cost unskilled & skilled labor, strategic natural resources and raw materials. An efficiency-seeking FDI is significantly determined by productivity of labor resource, costs of inputs and intermediate goods (UNCTAD, 1998).

2.3. Theories of FDI

Theories of FDI can be split into two groups: micro-level determinants of FDI and macro-level determinants of FDI. The micro-level theories of determinants of FDI try to provide answer the questions why multinational companies prefer opening subsidiaries in foreign countries rather than exporting or licensing their products, how MNCs choose their investment locations and why they invest where they do. The macro-level determinants deal with the host countries situations that determine the inflow of FDI.

2.3.1 Micro-level Theories of FDI

1. The Early Neoclassical and Portfolio Investment Approaches

According to the early neoclassical approach, interest rate differentials are the main reason for the firms to become a multinational company. In this line of arguments, capital moves from a country where return on capital is low to a place where return on capital is high. This approach is based on perfect competition and capital movement free of risk assumptions (Harrison et al, 2000). According to Alemayehu, (1999), The portfolio approach to FDI reacted to this early theory of FDI by emphasizing not only return differentials but also risk.

However, the movement of capital is not unidirectional. Capital moves from countries where return on capital is high to countries where return on capital is low and vice versa.

2. The Product Life Cycle Theory of FDI

This theory was first developed by Vernon in 1966. A new product is first produced and sold in home market. At the early stage, the product is not standardized. i.e. per unit costs and final specification of the product are not uniform. As the demand for the product increases the product will be standardized. When the home market is saturated, the product will be exported to other countries. The firm starts to open subsidiaries in locations where cost of production is lower, when the competition from the rival firms intense and the product reaches its maturity. Therefore, FDI is the stages in the product lifecycle that follows the maturity stage (Dunning, 1993). Vernon's product life cycle theory is a dynamic theory because it deals with changes overtime. However, it seems that the theory is not confirmed by empirical evidence, as some multinational companies start their operations at home and abroad simultaneously (Chen, 1983).

3. Internalization Theory of FDI

To increase profitability, some transactions should be carried out within a firm rather than between firms and this is one of the reasons why multinational companies exist. In other words, there are transactions that should be "internalized" to reduce transaction costs and hence increase profitability. This theory may answer the question why production is carried out by the same firm in different locations. One of the reasons of internalization is market imperfection. Any kind of economically useful knowledge can be called technology. Mostly, technologies or knowhow can be sold and licensed. However, sometimes, there are technologies that are embodied in the mind of a group of individuals and not possible to write or sale to other parties. This difficulty of marketing and pricing know how forces multinational companies to open a subsidiary in a foreign country instead of selling the technology. In addition, a number of problems may arise if an output of a firm is an input to other firm in other country. For instance," if each has a monopoly position, they may get into a conflict as the buyer of the input tries to hold the price down while the firm that produces input tries to raise it" (Edward, 2012). Nevertheless, these problems can be avoided by

integrating various activities within a firm rather than subcontracting the activities (Krugman and Obstfeld, 2003).

4. **The Eclectic Theory of FDI**

John Dunning developed an eclectic theory of FDI, which is called *OLI paradigm*. O, L and I refer ownership advantage, location advantage and internalization conditions, respectively. Operating in a foreign country market has many costs and these "costs of foreignness" include a failure of knowledge about local market conditions, cultural, legal and many other costs. Therefore, foreign firms should have some advantages that can offset these costs. Ownership advantage is a firm specific advantage that gives power to firms over their competitors. This includes advantage in technology, in management techniques, easy access to finance, economies of scale and capacity to coordinate activities. Unlike ownership advantages, location advantages are country specific advantages. Transnational Companies (TNCs) in order to fully reap the benefit of firm specific advantages, they should consider the location advantage of the host country. This includes accessibility and low cost of natural resource, adequate infrastructure, political and macroeconomic stability. As a consequence, the location advantage of the host country is one essential factor that determines the investment decision of TNCs. Internalization is multinational companies' ability to internalize some activities to protect their exclusive right on tangible and intangible assets, and defend their competitive advantage from rival firms Accordingly, all the three conditions must be met before transnational companies open a subsidiary in a foreign country (Soderstein 1992;), Laar, (2004)).

2.3.2 Macro level Determinants of FDI

The macro level determinants of FDI include any host country's situations that affect the inflow of FDI; like market size, the economic growth rate, GDP, infrastructure, natural resource, the political situation etc.

1. The size of Domestic Market

The size of the domestic market is a fundamental determinant of FDI**.** The wealth and development of a country can be used as proxy to measure the size of the domestic market. Most commonly, per capita income (PCI), which is an indicator of effective demand, is used

to measure the size of local market. In addition to per capita income (PCI), the RGDP of a country are also used as an indicator to measure the size of local market. However, if a firm is export-oriented and not market seeking, the size of domestic market will not be an important determinant of FDI (Root and Ahmed, 1979). A large market can help firms producing tangible products to achieve scale and scope of economies. The domestic market growth rate which is measured in terms of population and GDP growth rate also determines the inflow of FDI into a country (UNCTAD, 1998).

2. Natural Resources

Natural resources, historically, are the most important determinants of FDI. From the 19th century up to the eve of the Second World War about 60% of the world stock of FDI was in natural resources. The need to secure economic and reliable sources of mineral and primary products for the (then) industrializing nations of Europe and North America, natural resources were the major reason for the expansion of FDI (Dunning, 1993), Yonas (2016) noted that countries that have sufficient deposit of some minerals can attract foreign investors particularly those involved in exploitation of natural resources.

3. Level of Infrastructure

In today's globally competitive business environment, absence and lack of efficient infrastructure means not only high transaction costs for those that are already in business but also a barrier to entry for new firms. Infrastructure development has high importance for the expansion of FDI because efficient and adequate infrastructure implies better access to natural resources and potential market. According to Yonas (2016) availability and reliability of telecommunication services, developed and adequate road and air transport services, reliable water and electricity supply facilities have paramount importance for the profitability of foreign companies and in attracting FDI.

4. Low Labor Cost

As noted by neo-classical economists' labor cost is one of the factors that affect the investment decision of foreign investors and this fact has been proven in numerous locations. (UNCTAD 2004a) reported that availability of cheap labor in China is taking jobs from

Europe and United States. In addition to cheap labor, the out-put labor ratio (labor productivity) also determines the inflow of FDI.

5. Inflation

Through its effect on the cost of inputs and the price of outputs, inflation reduces the real return on investment and firms' competitiveness. Hence, countries that pursue policies that reduce inflation rate have better chance in attracting FDI. Low and predictable inflation rate is central for the long-term investment of both domestic and foreign companies. Therefore, higher and unpredictable inflation will decrease the inflow of FDI (Birhanu, 1998; Yonas, 2016).

6. Exchange Rate Variability

Frequent and erratic changes in exchange rate of the domestic currency affect the inflow of FDI (Goldberg and Klien, 1997). Exchange rate devaluations have a twofold role in explaining variations in FDI. On the one hand, the real value of foreign investors' capital increases when the host country's currency is devalued. On the other hand, frequent and continuous declines in the value of host country's currency would decrease FDI inflow, as it creates high uncertainty (Accolley et al, 1997).

7. Foreign Debt

Excessive foreign debt is one source of instability and uncertainty in macroeconomic environment of underdeveloped countries and hence this foreign debt is likely to affect adversely the inflow of FDI. Excessive foreign debt may signal imminent fiscal crises and foreshadow the future economic situation in a county (Serven and Solimano, 1992).

8. Fiscal Deficit

The fiscal deficit of a government, whether it is financed through printing additional bank notes or through taxation (which equally leads to inflation), decreases the real return on investment (Serven and Solimano, 1992). Moreover, in many developing countries it is apparent that due to excessive government borrowing the financial resources available for the private sector are limited and the interest rate is high. On the other hand, expansionary fiscal policy may be important for the expansion of public sector investments on infrastructure (UNCTAD, 1998). In general, the overall impact of fiscal deficit as empirically tested by

different studies is ambiguous. However, the theory postulates that there is a negative relationship between fiscal deficit and FDI inflows (Accolley et al, 1997).

9. Geographical Proximity

Jinayu (1997) noted that in the current global economic structure, geographical proximity and cultural and linguistic affinities are becoming one important determinant of foreign direct investment. The IFC & FIAS (1997) study as well confirmed that FDI from developed to developing countries are influenced by geographical proximity. For instance, while Japanese firms tend to open subsidiaries in China and newly industrialized Asian countries, the West European firms tend to open their subsidiary in East Europe.

10. Real GDP Growth

It is well known that there is no single way to bring about development. This implies that sources and ways of economic development differ across countries. Governments in different countries take different policy measures in order to accelerate their economic development. Economic development is one of the main objectives of every society in the world and other things being equal, economic growth is fundamental to economic development. There are many variables that contribute to economic development. Theoretically, FDI in the neoclassical growth model promote economic growth by increasing the volume of investment, in the endogenous growth model, FDI raises economic growth by generating technological diffusion from developed countries to developing countries where lack (Aseidu, 2003).

11. Legal and Regulatory Framework

While stable, transparent and reliable legal and regulatory frameworks promote both domestic and foreign investment, an inefficient and ineffective legal system is an impediment to enforce laws and contacts (Liya, 2016). However, UNCTAD (1999) indicated that an efficient and transparent legal system, and in particular LDCs, does not automatically make a country more attractive for FDI.

12.Privatization

Privatization provides a concrete vehicle for TNCs to invest in a country. It has generated substantial amounts of FDI in many developing economies. Sound privatization programs have three main characteristics: political commitment, business orientation, and transparency. Large-scale privatization programs send a signal to foreign investors that a government is taking steps to create a climate conducive to FDI. Thus, FDI in privatization of infrastructure enterprises (e.g. telecommunications) and industrial enterprises would have great impact on other FDI flows (IFC & FIAS, 1997).

13.Regional Integration (Access to Regional Markets)

Regional trade agreements can play an important role in terms of enhancing FDI inflows to member countries, through creating access to regional markets. Thus, strong regional integration through trade agreements can influence the investment decisions of TNCs. Mwilima (2003) point out that regional integration is a determinant of market-seeking FDI. The benefits of regional integration depend on a respective country's domestic market size, level of infrastructure development and availability of skilled and cheap labor force compared to other member countries.

2.4. Overview of Ethiopian Economy and FDI Performance

In this part, the political regimes of Ethiopia and corresponding FDI policies, regional and sectorial distributions of the country have been reviewed. It looks at Ethiopian Economy and FDI performance from 1974 to 2011. The first part of this period, 1974 -1991 (pre -1991), was the time of socialist and military government. The second part of the period, from 1991-present (post 1991) is a civil government and it started with liberalization and the introduction of market based economic policies. The current government considers FDI as part of the national investment strategy.

1. The pre-1991 / The Socialist (Derg) Regime/

Immediately after Emperor Haile Selassie was overthrown; in September 1974, a Military Committee (known as Derg) was established from several divisions of the Ethiopian Armed forces. The government installed a socialist\Command\ economic system where market

system was deliberately repressed and socialization of the production and distribution process followed. This led Ethiopia into the Socialism system. The land reform policy of Derg was the major success history that earned credit to the socialist government and that was honored by the masses. The Derg did not give any opening for privatization to domestic and foreign investors, so the gap between domestic investments and saving remained wide in the pre-1991 period. According to UNCTAD (2002) investment policy review in Ethiopia report, in between 1990 to 1997, gross domestic investment as proportion of GDP rose from 11.9 percent to 19.1 percent, while gross domestic saving remained the same rate. It would appear therefore, there is a need of to fill this saving gap. This can be done by loans and development assistance from multilateral agencies such as World Bank or private foreign investors. According to Haile and Assefa (2006), the financial sources from multilateral agencies to Sub-Saharan Africa have fallen. It has been reported that development assistance to Sub-Saharan Africa declined from $ 17 billion to $ 10 billion (Haile and Assefa (2006)). Given this FDI is the most important factor of foreign capital for these countries.

The economic performance of the pre 1991 period was characterized in three phases.

- The first phase of the regime, 1974-1978, economic performance was poor due to the emerging of new polices and the nationalization measures.
- The second phase of the regime, 1978-1980, the economy began to recover and the growth rate increased. This period was characterized by stability and benefited from good weather. Agriculture product was increased.
- The third phase of the regime, 1980-1985, the economy performed badly again. Agricultural and manufacturing sectors were decline because of severe drought that affected almost all regions of the country in between 1984-1985. The Economy continued stagnates.

FDI plays an important role for economic growth of one country (Geda (2005)). However, in 1975 the Ethiopian regime had nationalized major industries. This scared off foreign private investors had a great impact on the country's economy (UNCTAD (2002)). In addition, the problem of political instability, insecurity and the nationalization of major industrialization severely discourage FDI inflow in to the country in these periods.

Realizing the importance of FDI, in 1983, Derg attempted the Joint Venture Proclamation (JVP). The proclamation offered incentive such as, five years' period income tax relief for

new project, import and export duty relief, tariff protection, and repatriation of profit and capital. However, the proclamation failed to attract foreign investment, largely because foreign businesses were uncertain to invest in a country whose government recently had nationalized foreign industries without appropriate compensation. In 1989 the government revised the 1983 proclamation by allowing majority foreign ownership in many sectors, except in those related to public utilities, banking and finance, trade, transportation and communication. Even though Derg regime decreed this opportunity and mixed economy in 1990, the political instability and extended civil war at the time further discourage the inflow of FDI to the country. The political instability got worse and led to the over thought of the regime in 1991.

2. Post -1991 (EPRDF Regime)

The post-1991 period begun, with the coming to power of Ethiopian People Revolutionary Democratic Front (EPRDF) and the government removed the Derg regime that had ruled the country for seventeen years. In contrast to the previous policy regime of hard and command control, EPRDF initiated a wide range of reforms that covered the exchange rate, interest rates, liberalization of trade, domestic production and distribution, devaluation of currency, eliminating structural distortion, improving the country's human capital and infrastructure as well as poverty reduction.

In 1991 the regime adopted Structure Adjustment Program (SAP) as per recommendation of the World Bank (WB) and International Monetary Fund (IMF). The government promised to implement a series of policy reform measure in order to remove and change the command economic system with market based economy, to open the economy into the world economy and to encourage the wider participation of the private sectors in the development process of the national (ADBG (2000)). Under SAP the country become more attractive for FDI and made the domestic investors competitive.

The main objectives of the government were increasing the role of the private sector in the economy and the privatization program was started in February in 1994. Since then, Ethiopian Privatization Agency (EPA) has become the lead agency in carrying out the

process of privatization of public enterprises. One of the objectives of the EPA is to promote the country's economy development through encouraging the expansion of the private sector and the transferring of the state owned enterprises to the private ownership. According to Privatization and Public Enterprises Supervising Authority (PPESA) report, 14 enterprises were privatized in 2007 in sector such as tourism, mining industry and agro-industry by bringing the total number of public enterprises privatized to 247.

The promotion of small and micro finance enterprises is also critical to private sector development. The government has been providing support to such enterprises in several areas such as training, business skill, development, micro credit and information and marketing, (AFDB/OECD (2008)). Haile and Assefa (2006) described the specific measures taken to promote the export sector and participation of the private sector include:

- Deregulation of domestic prices
- Devaluation of the national currency from 2.07 birr to 5 birr per dollar
- Liberalization of trade and the foreign exchange rate.
- Eliminating of export taxes except coffee
- Lowering of maximum import duties from 230% to 60%
- Simplification of export regulation and procedure
- Provision of adequate incentives, strengthening and enhancing institutional support for the export sector.

3. Regulatory and institutional framework of FDI in Ethiopia

Implementing market oriented development strategies encourages the role of the private sector involvement in the development process. In order to encourage, promote and expand private investment in the country; the Ethiopian government has set out some private sector development initiatives. These initiatives are about enabling the enhanced utilization of the country's resources through the growth of private businesses by providing predictable and enabling environment MoFED, (2002). The programme highlights the importance of competitiveness as a key to success for sustained economic development in the country. Some of the important factors mentioned as a basis for competitiveness include conducive investment climate, which focuses on macro-economic stability, sound policy and regulatory

framework for the private investment sector and strong institutions that run and support the system.

There is also a continuous review of the investment code regarding the sectors excluded from FDI. For example, the revised investment proclamation No.116/1998 has opened up the hydropower generation to local and foreign investment. The 1998 investment code also allowed private-government joint investment in defense and telecommunication. The main business sectors which are open and in which the country is currently seeking foreign investment 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
- Real-estate development
- Education and health services
- Grade 1 construction contract
- Mining and quarrying of gold, marble and granite and
- Engineering and management consultancy.

Since 1996, with the objective of promoting private investment and the inflow of foreign investment, a series of investment proclamations have been issued. These proclamations impose some requirement and ownership limitation. There is a minimum entry capital for FDI for both wholly-owned operations and joint ventures with Ethiopian companies or individuals. In the case of joint venture, the investment proclamation requires that domestic partners must hold a minimum of 27 percent equity ownership interest. Moreover, both FDI and domestic investors are required to submit progress reports every six months. Apart from these requirements, investors are not required to meet specific goals like local content requirement or operational guidelines (UNCTAD-ICC, 2004). The investment legislation has also attempted to provide a favorable investment climate by offering fiscal incentives and investment guarantees to foreign and domestic investors engaged in new enterprise development and expansion. The major investment incentives for FDI include: 100 percent exemption from payment of import duties and import taxes levied on all capital equipment's; exemption from payment of export taxes (except for coffee); income tax holidays varying

from one to five years; tax deductible research and development expenditure; no taxes on the remittance of capital; the carrying forward of initial

operating losses and investor choice of depreciation model of capital assets. The Ethiopian investment codes also provide guarantees to create a reassuring business environment for potential foreign investors. Specific investment guarantees that have been issued for FDI include: full repatriation of capital and profits including dividends and interest payment on foreign loans; payments for technology transfer and management agreements; full repatriation of proceeds from sale or transfer of shares or liquidation of enterprises. Moreover, the investment proclamation No.37/1996 provides investment guarantees against measures of expropriation and nationalization, except in major cases of public interest when full market value will be paid promptly (UNCTAD-ICC, 2000).

4. Empirical Study

Previous studies by different scholars have revealed several determinants of FDI inflow. Blonigen (2005) identified determinants of FDI inflow in a partial equilibrium framework and a general equilibrium framework i.e. factors that affect FDI at firm level and country level. Some determinants which are covered by Blonigen (2005) are exchange rate, tax, institutions and trade protection (Blonigen 2005). Tsen (2005) stated that education, infrastructure, market size or current account balance leads to an increase in foreign direct investment. Other scholars' empirical study presented as follow.

In their study Mahmood and Ehsanullah (2011) assessed the impact of macroeconomic variables on FDI in Pakistan. They have done time series analysis based on annual data from 1972- 2005. Augmented dickey fuller test and OLS regression method were used to analyze the relationship between macroeconomic variables and FDI. The dependent variable was FDI and population, democracy, manufacturing products, real exchange rate, real exports, import duty and enrollment at secondary school lever were used as independent variable. The variable population was used as the size of economy. Their findings show that population growth, democracy and enrollment at secondary school have positive impact on foreign direct investment. On contrary, manufacturing products, real exchange rate, real exports and import duty have negative impact on foreign direct investment. And they suggested that to bring more foreign capital positive macroeconomic indicators should be improved.

Liargova and Skandalis (2012) studied the relation between FDI and trade openness including other variables: exchange rate stability, nominal GDP, GDP per capita and political risk. FDI were taken as dependent variable and other variables were independent variables. 36 developing countries all over the world selected for the study (12 Latin American, 10 Asian, 4 African, 4 Common wealth of independent states and 6 Eastern European countries). The study covers the period from 1990 – 2008. Fixed effects model which is one of Panel regression analysis methods were employed to analyze the data. The results disclosed that political stability, exchange rate stability, market size, trade openness are the factors that affect FDI inflow positively. More specifically, trade openness has positive impact on inflow of FDI in the long run.

The study by Frenkel et al., (2004) examined the determinants of FDI using panel data analysis based on gravity model. The study focused on bilateral FDI flow between 5 home countries (largest industrial countries worldwide) and 22 emerging economies from Asia, Latin America and Central and Eastern Europe. Since the study included both home and host counties, it analyzed push and pull factor of FDI outflow and inflow. FDI is dependent variable and distance between host and home countries, GDP growth, market size, inflation, risk, trade openness, are used as independent variables.

The result revealed that economic development which is indicated by GDP growth rate is important factor for FDI inflow to host countries. In addition to this, market size which is represented by GDP has significant role for FDI inflow. Trade Openness which is computed as export plus import divided by GDP had positive effect on FDI inflow to the host country. Inflation which is indicator of economic stability has negative effect on FDI inflow. In addition to these, distance between host and home countries is inversely related to FDI flow

Asiedu (2002) assessed the determinants of FDI in developing countries. The main objective of the study was figuring out whether the factors that affect FDI in developing countries affect African countries specifically Sub-Saharan African. There were 71 countries selected for this study (32 were Sub-Saharan African countries and 39 were non Sub-Saharan African countries). Cross sectional data were used for the period from 1988 to 1997. OLS method was employed to analyze the data. The variable FDI was used as dependent variable and

return on investment, infrastructure development, openness of the host country, political risk, financial depth, size of government, inflation rate, and GDP growth rate used as explanatory variables. The study result shows that trade openness has positive impact on both Sub-Saharan and non-Sub-Saharan Africa. However, Sub-Saharan Africa received less FDI than non-Sub- Saharan African. This is because, as Asiedu (2002) argued, Sub-Saharan Africa countries are less open than other regions. While infrastructure development has positive impact on the FDI inflow in non-sub-Saharan Africa, it has no significant effect on sub-Saharan Africa. The study suggests that the same policy cannot be effective in different regions.

Bende –Nabende (2002) examined the factors that influence the decision of MNC's in sub-Saharan Africa countries. In this study 19 Sub-Saharan African countries were sampled. The co-integration analysis method used to analysis the data. The variables that are used in this study were real wage rates, interest rates, foreign exchange rates, openness, liberalization, current market size (GDP), market growth, human capital, export oriented policy. These variables are explanatory variables. FDI is dependent variable. Market growth, export orientation policy, and FDI liberalizations are the main factors that are suggested to be the dominant long run determinants of FDI inflow in Sub-Saharan Africa.

Astatike and Assefa 2005 did time series analysis to assess determinants of FDI in Ethiopia. The data covered the period over 1974 - 2001.The study focused on market size (Real GDP per capita and real GDP growth rate are included as a measure of market attractiveness), export orientation (export as a percentage of GDP), macroeconomic stability (rate of inflation based on consumer price index), infrastructure (gross fixed capital formation and number of telephones), Human capital (rate of adult illiteracy) and trade liberalization. There are four regression models. The sign and significance of the variables; GDP per capita (positive but not significant), Growth rate of GDP (positive and significant in three models out of four), export orientation (positive and significant in all models), inflation (negative and significant), trade liberalization dummy (positive and significant), telephone per 1000 (negative and significant), gross fixed capital formation (negative and insignificant) and illiteracy (negative but insignificant). The study findings show that the growth rate of real GDP, export orientation and trade liberalization are found to have positive impact on FDI inflow to

Ethiopia. Macroeconomic instability and poor infrastructure have negative impact on FDI. The result suggests that in Ethiopia, trade liberalization, stable macroeconomic and political environment and good infrastructure are essential to attract more FDI.

5. Conceptual framework

In the following section, the important linkage between theory and practice has been developed as well as the approach is applied to answer the research question. The study focused to analyzed trend analysis as well as to indicate how independent variables affect the dependent variables. Accordingly, there are different determinant variables that affect the dependent variables. FDI can be assumed to be directly affect growth through, Market Size of the host country, Market Potential, Infrastructural facilities, government expenditure, Market openness, and Macro economic instability. The relative importance of these impacts however depends on the nature of FDI, the host country's level of economic development, government policies, industrial characteristics, etc. (Alfaro, 2003).

Figure 2.1: Thesis Analytical Framework
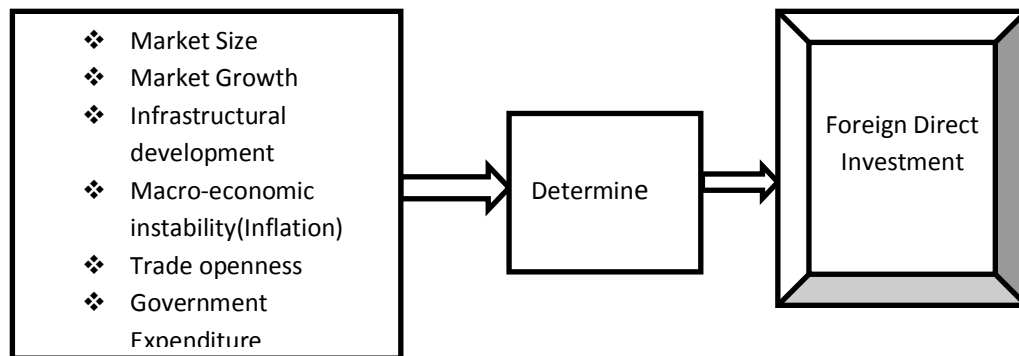
Source: Developed based on Alfaro (2003)

CHAPTER THREE

RESEARCH METHODOLOGY AND DESIGN

3.1 Introduction

This study designed to examine the determinants of Foreign Direct Investment (FDI) in Ethiopia. Accordingly, this chapter discusses the research procedure which used to carry out the study. Therefore, it started by discussing research design and approach followed by the study, elaborates the nature and instruments of data collection and sampling design. The subsequent section presented and discussed method of data process and analysis.

3.2 Research Design and Approach

The study employed both time series and descriptive research design. A time series is a research design in which measurements of the same variables are taken at different points in time. For this reason, such designs are sometimes also known as trend designs and are distinguishable from 'one shot 'cross-sectional designs in which measurements are taken once. In addition, using descriptive research design the existing phenomena described briefly to have a clear picture of the time series data and with the intent of employing data to justify current conditions and whenever possible to draw valid general conclusions from the facts discovered (Koul, 2006). A quantitative research approach is adopted for this study.

3.3 Variables and Source of Data

This paper is entirely dependent on secondary data. The major data sources are Ministry of Finance and Economic Development (MoFED), Ethiopia Investment Commission (EIC), Central Statistics Authority (CSA), National Bank of Ethiopia (NBE) and country reports published by the United Nations Conference on Trade and Development (UNCTAD) and The World Bank Development Indicator. The data collected focused on six variables such as, Market size (Per-capita GDP), Market growth (Average GDP growth rate), Macroeconomic instability (Inflation and Exchange rate) Trade openness (Export and Import Ratio), Infrastructural facilities (Telephone proportion per 1000 people) and Expenditure of

Government (Corruption trend) for the independent variables' while Gross Capital formation of the country is an indicator of FDI.

The population target for this study is the entire economy of Ethiopia. The samples that have been used are based on time series data starting from 2000 to 2017 in yearly basis. The data collected were related to Market Size, Infrastructure Development, Trade Openness, Macro-economic Instability, Market Growth, Government Expenditure. The dependent variable of foreign direct investment is measured by inflow of foreign direct investment (FDI). All the variables are in terms of United State Dollar (USD).

3.4. Variable Definition & Hypotheses of the Study

According to Creswell (2009), the variables need to be specified in quantitative researches. so that, it is clear to readers what groups are receiving the experimental treatment and what outcomes are being measured. Consequently, the study identified both dependent and independent variables, defined and discussed each variable.

Foreign Direct Investment (FDI):

According to World Bank development indicator (2015), FDI is defined as the net amount invested or reinvested by non-residents to acquire a lasting interest of 10 percent or more of voting stock in enterprises in which they exercise significant managerial control. There are a number of FDI variables included in World Development Indicators data set: net FDI, BOP in current U.S.$; net FDI inflows as percent of gross capital formation; net FDI inflows BOP in current U.S $and net FDI inflows as percent of GDP. In line with the approach used in the FDI literatures (Adeisu, 2002, Quazi, 2005, Abiyot, 2013), the dependent variable used in this study is the net foreign direct investment inflows as a percentage of GDP. Gross capital formation (GCF) Changes in economic structure may improve the investment climate which may result in higher capital formation. Higher capital formations will in turn results in higher economic performance and higher inflow of FDI.

Market Size (MAR):

Market size (MAR) is one of key determinant that is widely used in most of the empirical studies. Investors are normally attracted to countries where market size is large compared to countries with low market size. So, the higher the market size, the higher the investment flow. Generally, the market size is measured in terms of GDP per capita. It is expected to have a positive and significant influence on FDI inflows (Yasin; 2005, Razafimahefa *et al.* 2005, Krugell, 2005; Sidiropolos *et al.,* 2010).

Macro-Economic Instability (INF):

Macroeconomic stability is very important for attracting investment especially when the interest of foreign investors is concerned. Unstable economic environment, which is characterized by high inflation and interest rates will raise the cost of investment and affect the return of FDI in a negative way (De Mello, 1997). On the other hand, lower inflation would result in higher FDI inflows (Aseidu, 2006; and Ismail, 2006). The attraction of a particular market is further enhanced if the country has a consistent macroeconomic stability. This stability implies small budgets and trade deficits, low inflation and interest rates which is likely to reduce the risk premium for foreign and domestic investment and most importantly decrease transaction costs (Busse & Hefeneker, 2005). Therefore, as a proxy for macroeconomic stability we added annual inflation rate for the sample period, as it can be expected to be closely linked to policy distortions such as fiscal and monetary imbalances. It is expected a negative sign. Therefore, inflation rate is used as a proxy for macroeconomic stability and is expected to have negative sign.

Infrastructure development (INFD):

Infrastructure has been widely acknowledged as one of the key factors that could influence the flow of FDI into the host country. A country that is well equipped with infrastructures such as airports, water supply, power supply, roads, telephone, and internet would be able to minimize the cost of doing business for the investors and allow them to maximize the rate of return on their investments. For the purpose of the present study, used telecommunication consumption for every 1000 peoples the proxy for infrastructure and it is expected to have a positive sign (Onyeiwu *et al*., 2004; Asiedu, 2002 and 2004).

Market Growth (GDP):

The market growth rate of the country measured by GDP growth rate of the economy. Among other key economic location variables, the rate of the economy growth is especially stressed in the literature. A sustainable moderate-to-high rate of growth makes the host country particularly attractive for foreign investment because it reflects through GDP growth and accordingly higher market potential. The other important economic factor – macroeconomic stability, which is reflected through a relatively stable exchange rate, low rates of inflation, etc., attracts foreign investors and improves competitive position of a host country. Although there are controversial opinions about the influence of FDI on economic growth, some results from Deutsche Bank involving state-of-the-art statistical techniques and the most recent database suggest that on average FDI lies behind 74% of all growth achieved in the transition countries since their emergence as market economies (Richard, 2012). Therefore, the study expects positive sign.

Trade Openness (EXP):

The ease of capital movement to and out of the country and the trade openness of the country affect the flow of FDI. The standard way of thinking is that countries with capital control and restrictive trade policies discourage business, compared with countries with liberal policies. Openness of a country could be expressed in different ways. Among others, trade restrictions, tariffs, and foreign exchange control law could be mentioned. Since the data for variables that measure capital account openness are not readily available, this study has used the ratio of trade to GDP. As openness of an economy is believed to foster the level of FDI, the more open an economy is, the more likely it would grow and attract FDI. Thus, we expect a positive relationship between openness and level of FDI.

Exchange Rate (EXGE):

No one can predict what the exchange rate will be in the next period, it can move in either upward or downward direction regardless of what the estimates and predictions were. An appreciation of exchange rate can have mixed effects. It may weaken the competitiveness of export-oriented firms and adversely affect their ability to pay their debts (Fofack, 2005). However; it may improve the debt servicing capacity of borrowers whose loans are in foreign currencies. So, the relationship between EXR and NPL may be mixed. An increase in the ER

is expected to decrease nonperforming loan ratio. The results of the study trend analysis also implied this, accordingly the fig below portray the increment trend of foreign exchanges.

Government Expenditure (GEPD):

Government spends expenditure for several purpose including strengthen of institutional capacity. Among the most important institutional determinants are; the rule of law, regulation on private property rights and property of intellectual capital, quality of bureaucracy, level of corruption, and also ethnic tension in the host country. Since it is supposed that in the developed countries there is a high level of law enforcement (the rule of law), and protection of property rights as well as intellectual capital, restitution of basic market institutions, and enforcement of law is more important for the less-developed countries. For testing government expenditure effectiveness, the study refers several similar studies. (Gichamo & Tesfanesh (2012), Hasen (2014) they were used corruption, in terms of illegal payments that can appear in the form of bribes to measure expenditure risk and its impact on FDI. Therefore, this study also used the variable and the study expects negative sign on FDI.

3.5 Methods of Data Analysis

In this study two type of statistical analysis have been used. These are; trend analysis using percentage ratio and inferential statistics. Multiple regression analysis will be estimated to see the cause - effect relationship between independent and dependent variables over the sampled periods. This helps to convert the raw data in to a more meaningful form which enables the researcher to understand the ideas clearly. And then interpret with statistical description including standard deviation and mean. Then, a multiple linear regression analysis was used to determine the relative importance of each independent variable in determining the Foreign Direct Investment (FDI).

3.5.1 Model Specification

The model to indicate the impact of each individual factor on the FDI inflows to Ethiopia was analyzed in order to get a micro view about the individual factors determining the FDI inflows and their level of significance. The Model was used by Richard, (2015) to examine Determinants of Foreign Direct Investment in Kenya.

FDI = f (MAR, EXP, INFD, GEPD, GDP, INF, EXGE) …………………………… (1)

Log FDIt = (β_0 +β_1 MAR$_{i1}$ + β_2 EXP$_{i2}$ +β_3 INFD$_{i3}$ + β_4 GEPD$_{i4}$ +β_5GDP$_{i5}$ + β_6INF$_{i6}$ + β_7EXGE$_{i7}$) + ε_i

The model undertook test of correlation coefficient which measures the linear association between independent and dependent variables. The coefficient changes from +1 to -1. Coefficient of determination which is denoted by R^2 can be used to test the entire regression of the equation. The value of R- square is range from zero to one. If the value is close to zero, it indicates a weak relationship between dependent and independent variables and if it closes to one there is strong relationship between dependent and independent variables. If the value is 1, it indicates that all changes in the dependent variables are explained by the variation in independent variables included in the regression. Test of significance using T-test and F-statistics are presented under chapter four. T-Statistic is used to determine if there is a significant relationship between the independent variable and dependent variable. In order to test the significant of T-Statistics, the comparison between the absolute value of the T-Statistics to the tabulated value of T-distribution table with degree of freedom (df) will be done. Normally it is calculated at 5% level of significance (95% of confidence interval). The formula used is as follows: df = n-k-1. Where, df = degree of freedom, n = no of observation, k = no of independent variable. Therefore, the decision rule is at 95%, confidence interval;

Computed T-value > Critical T-value, reject Ho

Computed T-value < Critical T- value, accept Ho

If the calculated T-value is greater than the critical T-value, the independent variable is said to be statistically significant. If the calculated T-value is less than the critical T-value, the independent variable is said to be statistically insignificant. This study will also use the F-test in order to analyze how reliable the overall model is. It provides an overall appraisal of the regression equation to evaluate the significance of each individual component to the entire regression model. In other words, it is used to test the hypothesis in which variation in independent variable explained a significant proportion of the variation in the dependent variable. The formula of F-Statistics is defined as follows:

$$F = [R^2 / k-1] / [(1 - R^2) / (n - k)]$$

Where; F: F-statistics, R²: Coefficient of Determination, n: no of observation, k: no of independent variable. Otherwise, the critical value of F is defined as: F = _ (k – 1, n – k – 1), Where; _ = Significant level at 0.05, k = no of independent variable, n = no of observation. Therefore, the decision rule is;

Calculated F-value > Critical F-value, reject Ho

Calculated F-value < Critical F-value, accept Ho

If the calculated f-statistic is higher than the critical value of f, the overall model has significant relationship between all of the independent variables together with the dependent variable.

CHAPTER FOUR
RESULT AND DISCUSSION

4.1 Introduction

This core chapter deals with the discussion and analysis of data collected from Ethiopian Investment Commission (EIC) as well as publications of the National Bank of Ethiopia (NBE). Essentially, the study analyzed and discussed in to three parts. in the first part; the study analyzed trend of FDI in terms of average growth of the industry, employment absorbed under the projects of FDI, regional variation of FDI, as well as the types of project trends between the years 2000 to 2017, followed by trends of determinant variables of FDI discussion, such as, effect of market size, inflation, infrastructures, trade openness, internet rate and political situation. In the second section the study examined regression analysis and in the 3rd section the study discussed regression results based on others literatures.

4.2 Trend of FDI from 2000 – 2017

Since 1992, following the power transition from former socialist and military regime to current government, the climate for foreign investment has improved dramatically (UNCTAD 2017). The regulatory regime undertook major reforms of investment proclamations from the year 1992 to 2008. The government of Ethiopia has recognized the importance of FDI for the country and opens many economic sectors for foreign investors. Despite the numerous attempts by the government to encourage foreign investors, the inflows of FDI are still low. The average annual FDI flows to Ethiopia from 2000 to 2017 were only $910 million, which is only 4.56% of FDI flows into Africa. Ethiopia accounted for only 1% of Africa's inward FDI stock, while representing close to 9% of the population of the continent. Generally, the below figure implied the general annual flow of FDI and its contribution to the Growth Domestic Product (GDP).
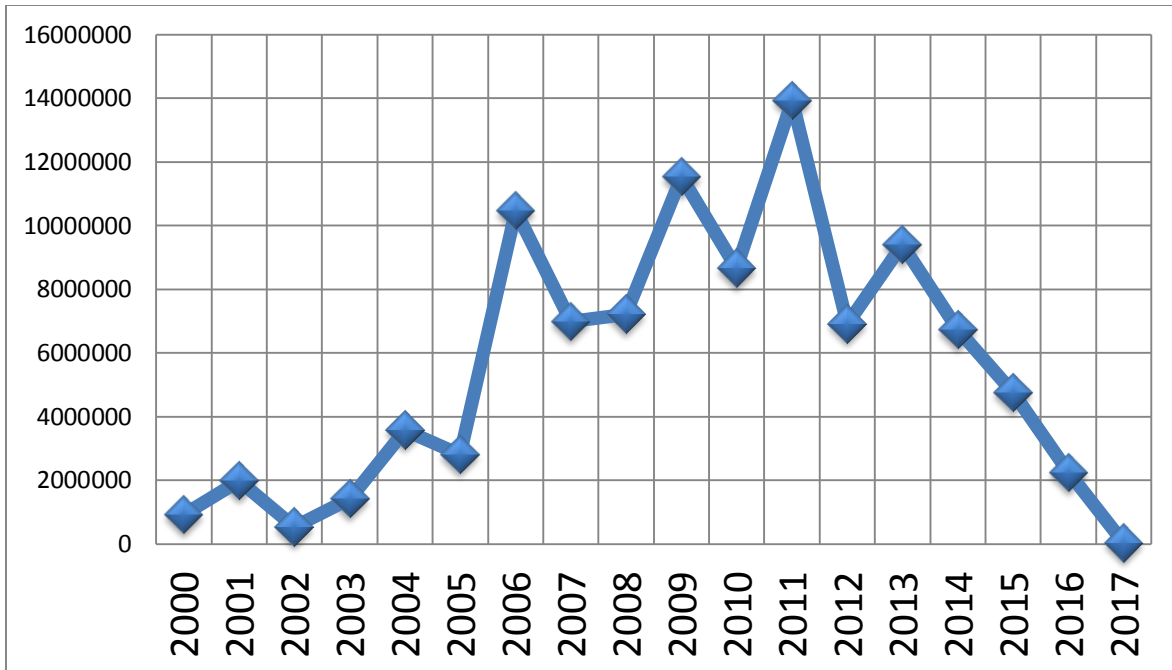
Avg. FDI Growth of Capital in '000' birr 2000 – 2017

Source: Own computation, data from EIC (2018)

As the trend indicates, the FDI inflow of Ethiopia is not consistent. Accordingly, the trend showed that, the lowest FDI inflow was recorded in 2017 which is below 2 million Birr while the highest FDI was observed in 2011 which is 14 million birr. The total FDI inflow into Ethiopia has increased from year 2000 to 2011 though there is in slight ups and downs trend. However, after, 2013 the FDI trend of Ethiopia began continuously decline up to 2017. The unstable political environment of the country might be one of the reasons of the variations. As we can see from the above figure, during the Ethio-Eritrea war (1998 -2000) the inflow of FDI had fallen to a large extent. Besides, during the country's election in 2005 and the crisis following the election, the FDI flows declined to $221 million from $545 million in the preceding year of 2004. Recently, as a result of the Ethiopian political instability from 2013 to 2017, the FDI trend constantly declined.

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4.3 Sectorial and Regional Distribution of Foreign Direct Investment

4.3.1 FDI Distribution by Sectors

The inflow of FDI in Ethiopia is distributed to different sectors of the country, ranging from primary (agricultural activities and mining) to secondary sectors (industrial activities) to the tertiary sector including electricity generation, construction, real estate, trade, hotel and tourism, transport service, education and health service EIC, (2017) has processed and licensed a total number of 5,193 FDI projects, of which 2,280 have become operational while other 1,006 FDI projects are not implemented. The rest 1782 FDI projects are approved and waiting for implementation. Out of 2,280 FDI projects that have been operational, the manufacturing sector accounted for the highest share in FDI inflow followed by the service sector. Below the table implied the leading sectorial FDI of the country between the years 2000 – 2017.
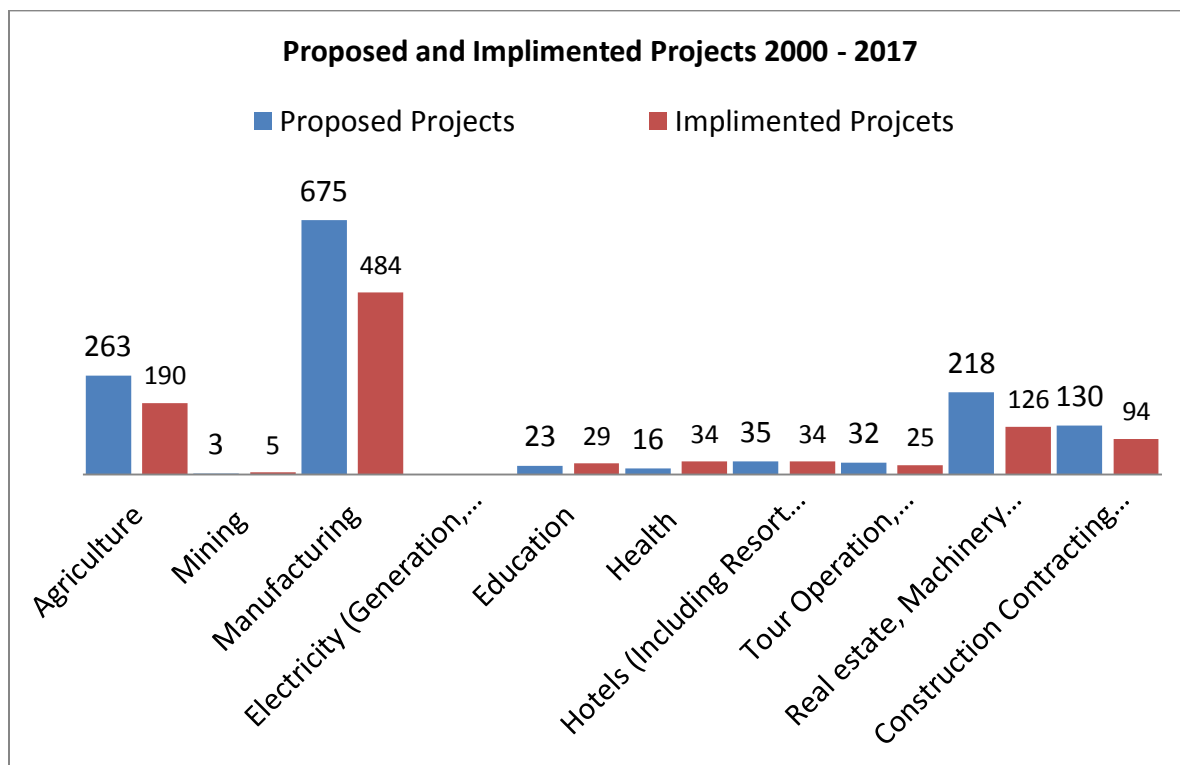

Fig.4.2 Trend of projects implemented in the country

Source: (EIC, 2018)

As implied from the above figure, the sectorial distribution of FDI flows to Ethiopia was not 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. Accordingly, manufacturing accounted for 42.9% of the total FDI followed by agriculture which accounted for 26.5% from 2000 - 2017 and real estate, machinery and equipment rental and consultancy service constitutes 13.86% of the total FDI flows to Ethiopia. Construction contracting, including water well drilling constitutes 11.73%. However, the mining, health and tourism industries are areas that have not received much FDI in the country with each accounting for less than 1% of the total inflow. In addition, the study also disclosed the comparison between the proposed and implemented sectorial FDI inflow. in all of the sectorial FDI, there were no implementation of projects as number of proposed. for instance, in the year 2000, there were 263 FDI proposal in the agriculture sector. However, only 193 FDI were implemented on the sectors. this trend was similar in the rest of sectorial FDI Inflow. This implied that the bureaucracy and unattractive works of the related areas, and lack of several infrastructural as well as political instability of the country might be some of the problem.

4.3.2 Regional Distribution of FDI

It can be seen from the data that the flow of FDI to Ethiopia has been unevenly distributed among the various regions. below the graph indicated distribution of FDI at region level.
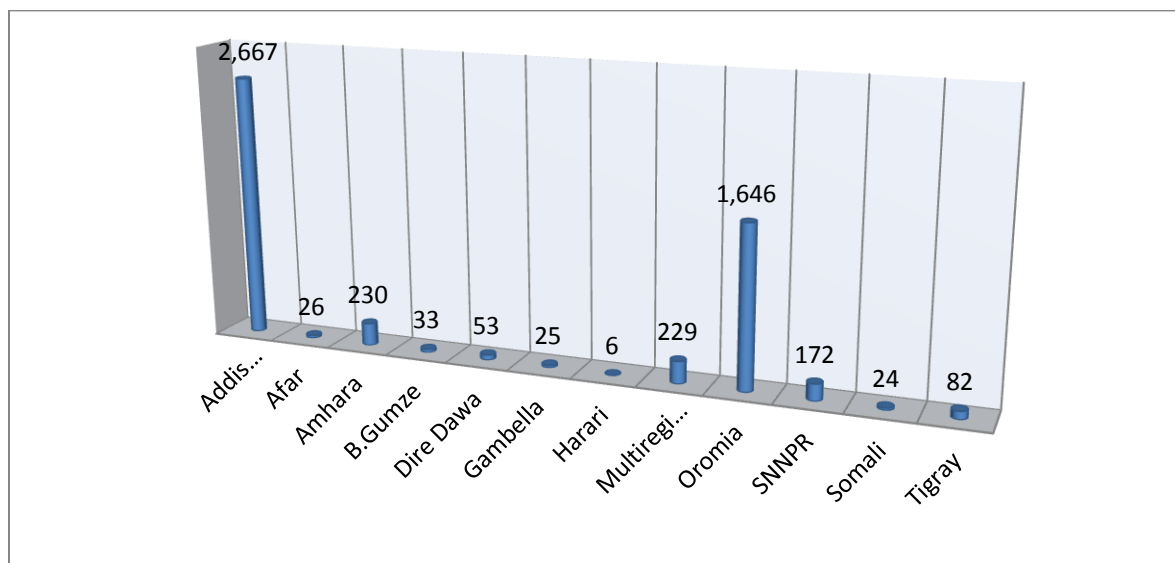

Fig 4.2.1 FDI distribution on region level

Source: (EIC, 2018)

Though there is an incentive system to encourage foreign investors to invest in the least developed regions (Gambella, Afar, Somali, Hareri, and Benishangul-Gumuz) of the country by providing especial benefits including provision of land free of any charge, still the performance of FDI in the regions are very low.). This makes the flow of FDI to Ethiopia has been unevenly distributed among the various regions. As it is shown in the figure above, the FDI is destined in the capital of the country, Addis Ababa. Out of the total 5636 projects (from 2000 - 2017), 2667 of the projects were located in Addis Ababa. This is because there is better infrastructure, stable political environment and better supply of trained man power in Addis Ababa compared with other regions across the country. 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 2000-2017, 36.9% 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.

4.4 The Factor of FDI on Employment Growth

One of the major factors that drives FDI is the cost differential between the host country and the source country. One of the main costs of any investment is the payment to employees.

Fig 4.4 The Effect of FDI on Absorbing Employee of the host country

Sources: own computation based on EIC (2018)

As it is found from figure 4.4 above, the FDI sector from year 2000 to 2005 were grew slightly. In 2007, it reached the maximum that hold hundred thousand permanent employees which FDI contribute 1% of the total sector employment. However, starting 2007, the FDI employee become sharply decreased till 2017. According to (UTACCA, 2015) Ethiopia is one of the least recipients of FDI in Africa. As a result, the amount of people employed in FDI related sectors is very small. During the period of the study, employment in FDI accounts for less than one percent of the total labor force in the country. Agriculture accounts for 64% of the total FDI employment and The manufacturing sector accounts for 18% of the total FDI employment in Ethiopia, followed by real estate services which includes machinery, equipment rentals and consultancy services and construction contracting including water well drilling account for 0.08% and 0.05% respectively. However, recent trend shows there is a growing interest from western developed economies. For instance, in 2012 the two largest FDI were from UK and Netherland represented by Diageo and Heineken (Asmelash, 2015).

4.5 Import and Export Trend of Ethiopia

Though there are some difficulties, the Import - Export program of the country has been improving throughout the years. Exporting allows firms in to enlarge their markets and benefits from economies of scale. The existence of FDI boosts a country's exports simply by exporting their production while their interaction with domestic firms increases the competitive capacity and provides access to large and new external market. The below table implied the trend of Ethiopian import - export practice and its contribution of the GDP in Millions of Birrs (2000 - 2017).
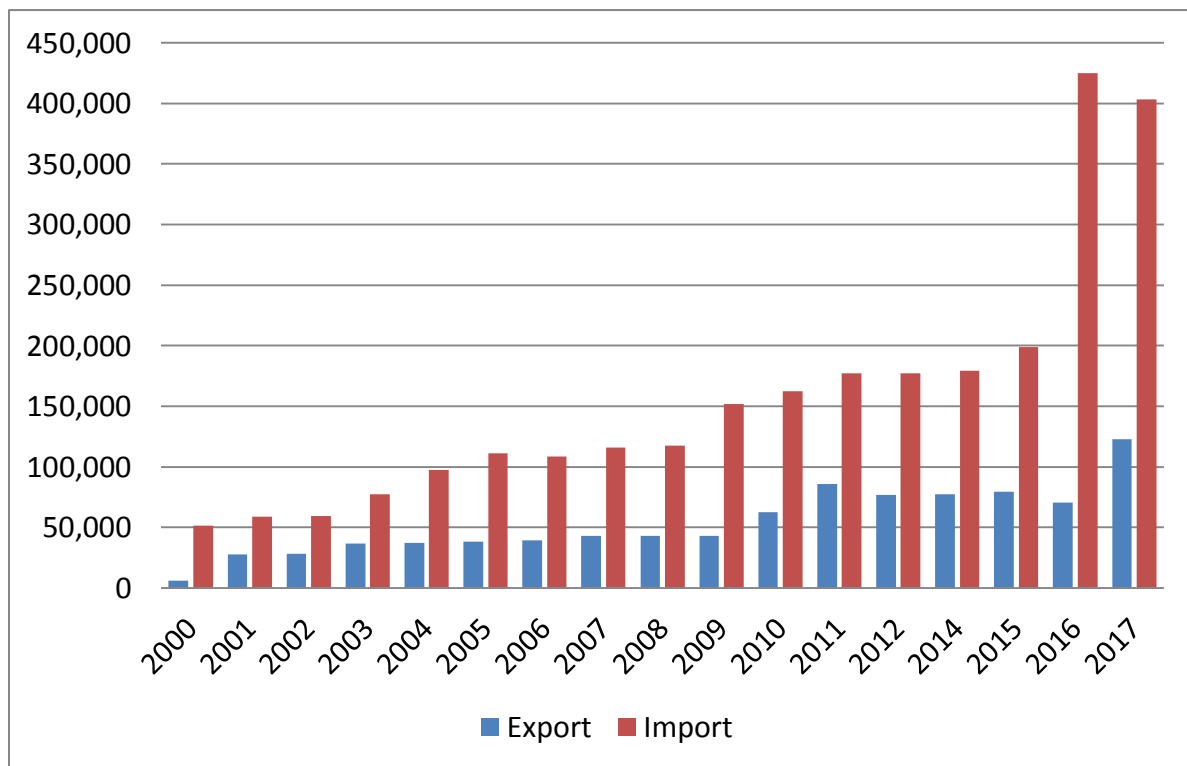

Fig 4.5 Import and Export of Ethiopia
Sources: own computation based on EIC data (2018)

As the above graph showed that both import and export activity of the country improved through the studied years. However, their trend implied that, import trend of the country highly growing than export of the country. Accordingly, the highest import of the country registered in 2016 and 2017. Whereas, the lowest were recorded in 2000. On the other hand, the export trend of the country is very steady. The increase in export performance of the country it is said to be incentive, because of the number of incentives employed throughout

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the years. These incentives, if thoroughly implemented also serve as incentives for foreigners to invest in Ethiopia. The incentives are fiscal and non–fiscal. Some of the fiscal incentives given to all exporters include: Duty drawback scheme which offers investors an exemption from the payment of customs duties and other taxes levied on imported and locally purchased raw materials used in the production of export goods. No export tax is levied on export products of Ethiopia (with the exception of few products). Duties and other taxes paid are drawn back 100 percent at the time of the export of the finished goods and Bonded Factory and Manufacturing Warehouse Schemes: producers not eligible for voucher scheme but having licensed for bonded are entitled to operate such factory or warehouse in importing of raw materials duty free.

4.6 The Impact of Inflation (FDI)

It is a situation in which the economies overall price level is rising. It represents sustained and pervasive increment in aggregate price of goods and services resulting decline in purchasing power of money. Accordingly, when inflation is high and unexpected, it can be very costly to an economy. At the same time, inflation generally transfers resources from lender and savers to borrowers since borrowers can repay their loans with birr that are worthless. It is determined as the general consumer price index. Through its effect on the cost of inputs and the price of outputs, inflation reduces the real return on investment and firms' competitiveness. Hence, countries that pursue policies that reduce inflation rate have better chance in attracting FDI. Low and predictable inflation rate is central for the long-term investment of foreign companies. Therefore, higher and unpredictable inflation will decrease the inflow of FDI. In Ethiopia the inflation trend become increasing throughout the years.
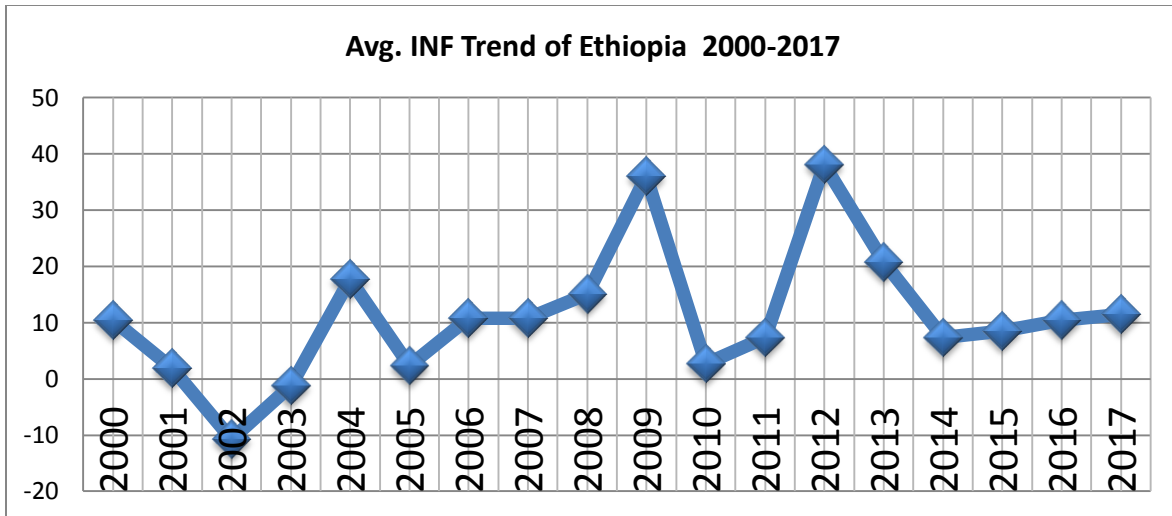
Avg. INF Trend of Ethiopia 2000-2017

Figure 4.6 Inflation Trend of the country and its effect on FDI

Source: MoFEC (2018)

Figure 4.6 above showed that, the trend graph of the inflation is unexpected in Ethiopia. Accordingly, in 2009 the inflation rate was reached 36% which was very high whereas in 2010 it falls down to 2.5%. This implied the trend of inflation on the economy is unpredictable and uncontrollable. On the other hand, the deflation was occurred in 2002 and scored -10.8 %.

4.7 GDP growth rate and its effect on FDI

Gross Domestic Product (GDP) is an indicator of the economic health of a country as well as the instrument of a country's standard of living. It is the measurement of level of economic activity of a country. For the purpose of this study, GDP is measured by the annual real growth rate of gross domestic product. The below figure indicates the country's GDP for the last 17 consecutive years and the performance of FDI.
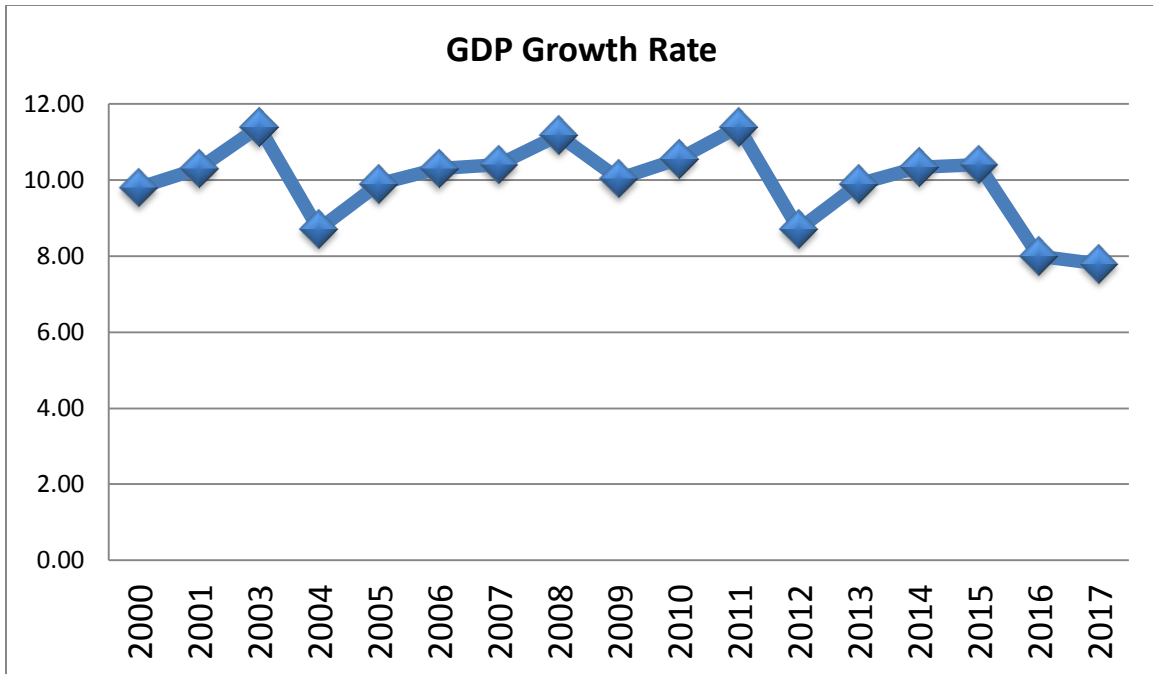
Fig 4.7(1) GDP Growth Rate and its effect of FDI

Source: banks annual Report (2018)

As indicated on the above figure, the minimum GDP growth rate were scored 7.8% in 2017, 8.0% in 2016, 8.7% in 2012 and 9.90% in 2013. Otherwise, the country's GDP Growth was in Double digit. According to the study outcomes, the GDP of the country specifically in the year 2016 and 2017 has been declined.

Exchange Rate

Exchange Rate Valuation A weaker real exchange rate might be expected to increase vertical FDI as firms take advantage of relatively low prices in host markets to purchase facilities or, if production is reported, to increase home-country profits on goods sent to a third market. Foot and Stein (1991) find evidence of the relationship. a weaker host country currency tends to increase inward FDI within an imperfect capital market model as depreciation makes host country assets less expensive relative to assets in the home country. Blonigen (1997) makes a "firm specific asset" argument to show that exchange rate depreciation in host countries tend to increase FDI inflows. But on the other hand, a stronger real exchange rate might be expected to strengthen the incentive of foreign companies to produce domestically. The exchange rate is in a sense a barrier to entry in the market that could lead

to more horizontal FDI. However, this hypothesis does not appear to have attracted much support in the empirical literature.
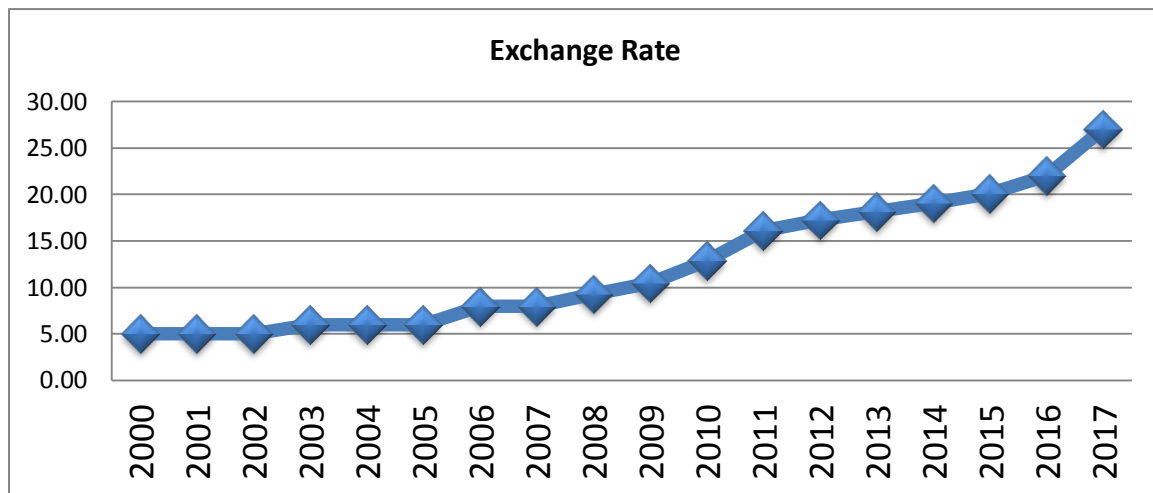
Exchange Rate

Fig 4.7(2) Trend of exchange rate and its effect on FDI

Source: Banks Annual Report (2018)

According to the above figure, the exchange rate of the country has been consistently increased from the year 2000 to 2017. Therefore, the minimum exchange rate observed in 2000 - 2002 was 5% and the maxim was 27% in 2017. This implies that the foreign exchange rate in Ethiopia during the study period remains high. Due to this reason, Ethiopia has devaluated its currency considering to increase FDI. Exchange rate might be expected to increase vertical FDI as firms take advantage of relatively low prices in host markets to purchase facilities.

4.8 Infrastructure Development

Infrastructure development is one of the well-recognized factors for attracting FDI. The main argument is a well-established infrastructure such as roads, airport, railways, electricity, water supply, telephones, and internet access will reduce the cost of doing business and help maximize the rate of return. It is suggested that the availability of a good quality infrastructure subsidizes the cost of total investment and increasing efficiency of production and marketing. Studies have indicated the presence of an advanced infrastructure like roads, ports, railways, telecommunication system, and other public institutions are indications that the host country has the platform to manage inflow of FDI. According to African project

Access, business monitor international (2014), Ethiopia's active infrastructure projects up to July 2017 ranks 15th in Africa by number of projects and 17th by capital allocation. From these power plants and transmission grids has a project number of six with capital value 3,827 in (USF$ m).
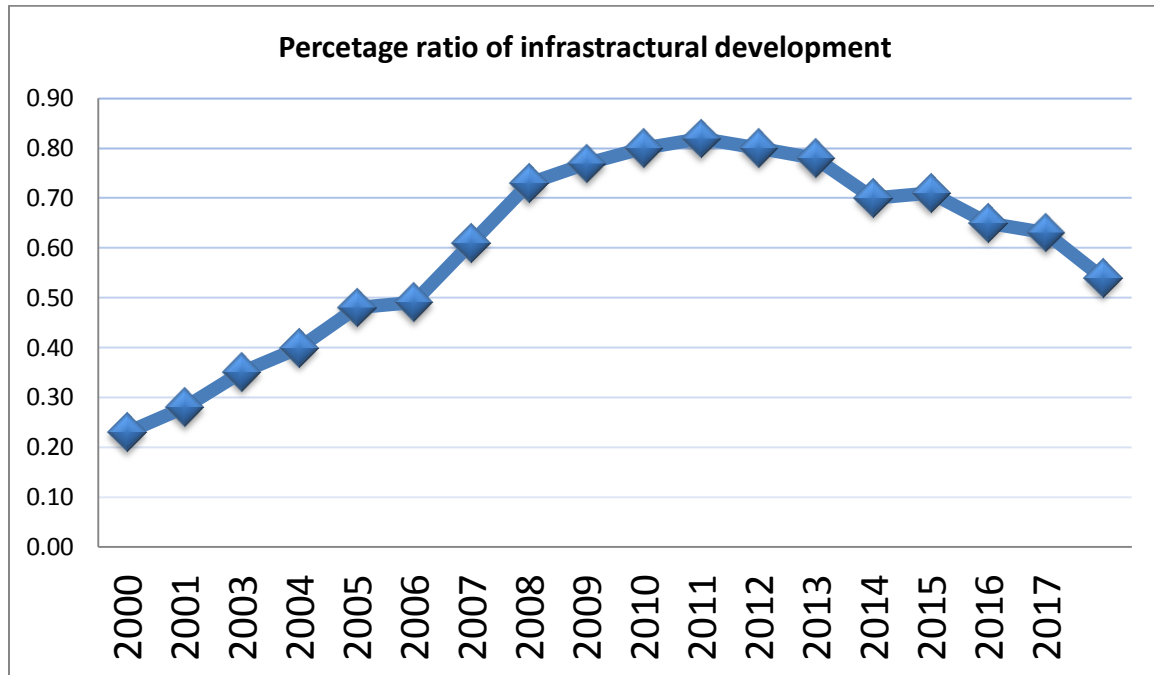

Percetage ratio of infrastractural development

Fig 4.8 infrastructure development

Sources: EIC (2018)

As the infrastructural development figure above indicated that, the country was constantly improving in the infrastructural development from 2000 – 2011. However, since 2011, the country's infrastructural condition became declined. one of the reason believed to contribute for the decline of infrastructure development is the country's political situation and instability. Therefore, the trend indicated that even though there is slight reduction of percentage growth rate, the trend is still positive and that can attract FDI positively**.**

4.9 Descriptive statistical analysis

In this part, a descriptive result of the study shown in Table 1 below and describes the mean, standard deviation, median, minimum and maximum values of each variable in the sample of the study. It describes the FDI inflow proxies' independent variable through indicators of Market size (MAR), Inflation (INF), Government expenditure of infrastructure (GEPD),

Trade Openness (EXP), Market Growth rate (GDP), and Exchange rate (EXGE) and INFD represent dependent variable of FDI sample data from several relevant sources such as Ministry of Finance and Economic Development (MoFED), National Bank of Ethiopia (NBE) and Central Statistics Agency (CSA) and other related areas from 2000 – 2017 Fiscal years.

4.9.1 Determinants of FDI in Ethiopia

The section covers the empirical regression model used in this study and the results of the regression analysis. Empirical model as presented in the methodological section of the study, it is used to identify the effect of the stated determinant variables on the FDI.

Log FDIt = (β_0 +β_1 MAR$_{i1}$ + β_2 EXP$_{i2}$ +β_3 INFD$_{i3}$ + β_4 GEPD$_{i4}$ +β_5GDP$_{i5}$ + β_6INF$_{i6}$ +β_7EXGE$_{i7}$ + ϵ_i

Table 1 Regression analysis result

FDI	Coefficient	Standard error	t-Statistic	Sign.
Constant	.073	.004	16.592	.000
Market size	-1.910**	.01106	.938	0.041
Trade openness	1.602*	.27202	.604	0.071
Infrastructure	1.390*	.88900	-1.355	0.032
Government expenditure	-1.302*	.14921	-2.154	0.091
Real GDP	.357**	.58932	-1.386	0.006
Inflation	-1.453**	.87644	-3.456	0.094
Exchange rate	1.605**	.09838	2.406	0.021

Adjusted R-squared   0.801334

F-statistic   2.658 Durbin- Watson stat   1.806052

Prob.(F-statistic)   0.000000

*Notes: *1% significance level; ** 5% significance level and *** 10% significance level*

In the above table; coefficient, standard error, t-value, and p-value for all explanatory variables and the value of adjusted R-squared, S.E of regression and F- statistics with p-value analyzed as follow:

The Adjusted-R squared statistics of the model was 80.13% which indicated that the changes in the independent variables collectively explain 80.13% of the changes in the dependent variable (FDI), 19.87% of changes is explained by other factors which are not included in the model. Thus, these variables collectively, are good explanatory variables of FDI of Ethiopia. The null hypothesis of F-statistic (the overall test of significance) that the R^2 is equal to zero was rejected at 1% as the p-value was sufficiently low. Prob. (F-Statistic) 0.000 indicates strong statistical significance, which enhanced the reliability and validity of the model.

The dependent variable (FDI) in this model is measured by the ratio of; Market size, Trade Openness, Government Expenditure of infrastructure development, Macro-economic instability (Inflation and Exchange rate) and market potential growth and GDP growth rate of the country. Accordingly, each of the results presented computing with similar theories and empirical findings as follows:

Market Size (MAR):

The explanatory variable market size that explained by Real GDP rapid income of the people, bears a statistically at 1 % significance level and it has a strong negative relationship with the FDI. The negative coefficient of this ratio which was also in line with the prior expectation. Coefficient of determination for this variable is 0.041, which means 4.1% of the change in inflow of FDI are explained by MAR variable. One possible explanation could be that the low level of per-capita income has a discouraging effect on market seeking FDI to Ethiopia. Based on the above result we can accept our null hypothesis of hypothesis 1.

TRADE OPPENESS (EXP):

The predictor variable of trade openness (Trade liberalization) was measured by, exports/GDP ratio). The relation between EXP and FDI was positive and at 1% significance

level. This finding suggests that FDI in Ethiopia is of the vertical type which is normally export oriented and tends to be unaffected by the market size of the host economy. The coefficient for liberalization dummy is 1.602 meaning that for a unit increase in trade liberalization leads to 1.602 increase inflows of foreign direct investment. This result suggests that liberalization of the Ethiopian economy has encouraged FDI inflows and it also supports the proposition that foreign investors are more likely to invest in the country have been opened up to the outside world. Based on this result the null hypothesis of hypothesis 2 is rejected.

Infrastructure Development (INFD):

The infrastructure indicating proxy variables, telephone lines per 1000 people and gross fixed capital formation are found to yield a positive and significant result at 1% significance level. This result may be explained by a better telecommunication facility and recent infrastructure performance made by the government across the country makes major determinant of FDI inflow rate to the country. However, UNCTAD (2002) pointed out that one of the specific economic challenges and constraints identified by private investors in Ethiopia is the poor infrastructure facilities, in particular in the areas of telecommunications, transport and power supply.

Government Expenditure (GEPD):

The explanatory variable Government Expenditure measured by corruption trend. Hence, the coefficient value of the regression results implied that, government expenditure negatively affects FDI at 1% Significance level. Accordingly, the coefficient signs of the regression implied by 0.0911, which means 9.11% indicated change of government expenditure at 0.0911 improve FDI inflow by 9.11%. The result displayed the high trend of corruption has negative effect on FDI. Therefore, the study accepts the previous expectation of the variable.

Market Growth (GDP):

As per the table 2 above, the potential market indicator variable growth rate of real GDP which measures the growth prospects of the economy/market, has a positive coefficient. This finding is in line with the hypothesis that a growing economy attracts more FDI. This regression estimation result is alike with (Abiyot (2013), Asmelash Berhane (2015), Getinet

Haile, Hirut Assefa (2006). This result strongly supports the study of Burcu Turkean, et al. (2008), that suggest economic growth stimulate growth rate of FDI inflow more than the growth rate of FDI stimulate economic growth. This result also supports the study of Gohou and Soumare (2012) that the impact of enhancement of RGDPC led more increase in FDI of developing countries as compared to developed countries. Hence, the more developed the country is the more it attracts FDI that again translate to higher economic growth. Accordingly, the null hypothesis expectation fit with the expected sign and it is accepted.

Macro-Economic Instability (INF):

There is a widespread perception that macroeconomic stability shows the strength of an economy and provides a degree of certainty of being able to operate profitably (Balasubramanyam, 2001). Inflation rates and exchange rates are used as proxy variables for macroeconomic stability. Low inflation and stable exchange rates are expected to have a positive impact on FDI. As pointed out earlier, data on real exchange rate is not readily available. As a result, only the rate of inflation (based on consumer price index) is included to capture the effect of Macroeconomic stability on FDI. Consequently, the coefficient result show that, inflation rate has a negative impact on FDI of Ethiopia at 5% significance level. This finding implies that macroeconomic stability is an important determinant of foreign direct investment inflows to Ethiopia. (Getinet Haile, Hirut Assefa (2006). And the process null hypothesis is as expected in the previous and accepted.

Macro-Economic Stability (EXGE):

The other macroeconomic stability predictor was exchange rate of the country. Accordingly, the coefficient value result implied that exchange rate (EXGE) has positive impact on FDI and the level of significance implied at 5%. The positive and significant relationship between exchange rate and FDI shows that the devaluation of the currency is stimulating foreign investors.

CHAPTER FIVE

CONCLUSIONS AND RECOMMENDATIONS

5.1 Conclusions of the study

This study designed to assess determinants of foreign direct investment (FDI) in Ethiopia using time series data. Accordingly, the study was assessed the trend of FDI from year 2000 – 2017. In doing so, different studies on the FDI have been reviewed and determinant factor of FDI has been identified. Thus, this study specified an empirical framework to investigate the determinants of FDI in Ethiopia from 2000 to 2017. The determinants of FDI used in this study were include variables such as, Market Size, Macro Economic instability, government expenditure, infrastructural development, Market Growth, Trade openness and Exchange Rate. Based on this determinant variables, the major findings of the study concluded as follow.

When evaluating the performance of Foreign Direct Investment (FDI) in Ethiopia, the study concluded that there is no consistent growth trend of FDI which means that the inflow of FDI to the country can easily be affected by various macroeconomic variables. It is observed that FDI is distributed unevenly throughout the different sectors of the country with the highest share going to the manufacturing sector (68%). The evaluation of the regional distribution of FDI shows that despite the many reforms made to encourage FDI flow to less developed regions in the country, the performance of these regions in attracting FDI is quite low and high number of FDI is concentrated in the highest developed regions of the country such as Addis Ababa city and Proximity town around Addis Ababa city.

The empirical analysis conducted and its findings disclosed that economic growth, export orientation (Trade openness), exchange rate and infrastructural development have a significant positive impact on FDI, while macroeconomic instability such as, inflation, government expenditure, and low level of market size have a negative impact on FDI inflow. Furthermore, the finding summarized as follow;

The Market Size (approximated by GDP Precipitate Income) has a negative relationship with FDI. This might be attributed to the fact even though GDP per-capita indicated slight growth rate, but still it is small size to attract foreign investors and it has not shown significant changes through studied period. Thus, GDP precipitate income negatively and significantly affect FDI inflow in Ethiopia.

Trade Openness explained by export has a positive and significant relationship with FDI. This indicates that an expansion of trade or adoption of more liberal trade policies would result in an increase in FDI inflow to the country.

The Infrastructure Development indicating proxy variables, telephone lines per 1000 people and gross fixed capital formation are found to yield a positive and significant result at 1% significance level. This result may be explained by a better telecommunication facility and recent infrastructure performance made by the government across the country.

The explanatory variable of Government Expenditure measured by corruption trend. Accordingly, the coefficient value of the regression results implied that, Government Expenditure negatively affected FDI at 1% significance level.

Potential Market indicator variable, growth rate of real GDP, which measures the growth prospects of the economy/market, have a positive coefficient. This finding is in line with the hypothesis that a growing economy attracts more FDI to the country.

Macro-Economic Instability (INF) negatively correlates with FDI at 5% significance level. This finding implies that macroeconomic stability is an important determinant of foreign direct investment inflows to Ethiopia.

Positive and significant exchange rate encourages the foreign direct investment by decreasing the cost of international investment and by increasing returns to foreign investment relative to exports. Overall, by depending on the analysis and results of the study, the performance of Foreign Direct Investment (FDI)remains poor.

5.2 RECOMMENDATIOS

- Significantly positive effect of liberalization on FDI indicates that an efficient environment that comes with liberalized economy is likely to attract foreign investors. To encourage inflow of Foreign Direct Investment to Ethiopia, the government needs to focus on improving the investment atmosphere through further measures as well as creating efficient bureaucracy that will facilitates entry and speedy operation of foreign investors. Further measures aiming to encouraging privatization and the promotion of the domestic private sector too is essential for the inflow of FDI depends on to a degree of how the domestic private sector is treated.

- Trade openness also plays a key role in attracting FDI inflow in to the country. As higher export is associated with positive net trade, governments should move the country towards industrialization that are based on export promotion strategy. In recent decades, it is observed that the country started to emphasize on industrialization and trade liberalizations to push the economy forward. Such a move would create a variety of employment opportunities that could help increase per capita income and domestic savings.

- Multinational Companies(MNC), still have small number of employee which is 1% of the total employee of the country. To tackle such types of the problem, concerned government bodies and policy makers should encourage Foreign Investors to invest on the manufacturing sector which would use extensive human capital.

- Though, Ethiopia scores remarkable activities in the sector of infrastructural development, still the sector is affected through corruption and its growth rate has impeded. To tackle this problem, the study recommends that, the government should take different remarkable measures. In addition, government should invite private investors in participate on telecommunication sector, hydro – electric building and on other mega projects.

- The negative and significant inflation coefficient suggests the importance of a more focused macroeconomic policy environment which will strengthen the economy and builds confidence for potential investors. Necessary steps have to be taken to control inflation and stabilize exchange rate through the adoption of sound fiscal and monetary policies.

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APPENDICES:

Table 1 Regression analysis result

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Adjusted R-squared   *0.801334*

F-statistic   *2.658 Durbin- Watson stat*   *1.806052*

Prob.(F-statistic)   *0.000000*

*Notes: *1% significance level; ** 5% significance level and *** 10% significance level*

Source: own computation, 2018

DECLARATION

I, the under signed, declare that this thesis is my original work, prepared under the guidance of Dr. Maru Shete. All sources of materials used for the thesis have been duly acknowledged. I further confirm that the thesis has not been submitted either in part or in full to any other higher learning institution for the purpose of earning any degree.

Ashenafi Beza   _____

              Name   Signature & Date

ENDORSEMENT

This thesis has been submitted to St. Mary's University, School of Graduate Studies for examination with my approval as a university advisor.

Maru Shete (PhD and Assoc.Prof.)   _____

Advisor   Signature & date