*THE INTERNATIONAL JOURNAL OF BUSINESS & MANAGEMENT*

# The Effect of Foreign Direct Investment (FDI) on the Stock Market Development: Tanzania's Evidence

**Gidion Obeid**
Assistant Lecturer, Moshi Co-Operative University, Tanzania
**Lucas Patrick**
Assistant Lecturer, Moshi Co-Operative University, Tanzania
**Juliet Njau**
Assistant Lecturer, Moshi Co-Operative University, Tanzania

***Abstract:***
*This study examined the effect of Foreign Direct Investment in the stock market development in Tanzania from 1998 to 2008. In order to achieve intended objective the study used equation model and multiple regression analysis. The results show that there exists a relationship between, FDI, nominal exchange rate, financial Intermediary development, real income and stock market development. With exception of real income, other variables, which are; FDI, nominal exchange rate and financial intermediary development have shown the positive correlations with stock market development in Tanzania. While the variables that are positively correlated with stock market development are statistically significant, real income is statistically insignificant than zero. One thing worth discussing is the relevance of the data that have tested the hypothesis in this study. The study has followed a measure and determinants of stock market development recommended by (Garcia and Liu 1999). Despite of various measures of stock market development, it has been suggested that a good proxy measure of stock market development is market capitalization. Among other things, the results of this study reveal that FDI plays an important role in boosting the market capitalization. The policy implication of this finding is that, Tanzania should attract more FDI inflows to enhance the stock market development which in turn will develop further the financial market and economic growth of the country.*

***Keywords:*** *Foreign Direct Investment (FDI), Stock Market Development, Market Capitalization, Gross Domestic Product (GDP)*

## 1. Introduction

### *1.1. Background of the Study*

The stock exchange in the financial system is just as important as fuel in the motor engine because the motor engine cannot be efficient unless there is fuel to run it (Dar es Salaam Stock Exchange 2008). Stock exchange plays a role of financial intermediation to activate household and foreign savings for firm investments. What stock exchange does is to ensure that funds are allocated according to the most productive channels in order to mitigate investment risk whilst providing liquidity and efficiency in the firms' operations. The research conducted in Ghana from 1991 to 2006 showed that FDI is highly and positively correlated with stock market development (Adam and Tweneboah 2009). Similarly Jeffus (2004) found a statistical positive linkage between FDI and stock market development in the selected Latin American countries from 1988 to 2002.Finally, Claessens et.al (2001) using the sample size 77 countries argue that FDI and stock market development are complements and not substitutes on the grounds that FDI boosts the stock market capitalisation and value traded. Considering the previous results on the linkage between FDI and stock market development, this paper examines whether or not these findings exist in Tanzania.

### *1.2. Research Objectives*

The main purpose of this study was to examine the impact of Foreign Direct Investment (FDI) on the stock market development in Tanzania. Specifically the study explored determinants of FDI inflows in Tanzania and assessed the effect of FDI inflows on the market capitalization of listed companies in Tanzania.

*1.3. Significance of the Study*

The significance of attracting FDI inflows on financial market particularly stock market is obvious. For instance FDI to developing economies in West Africa was $16 billion in 2006 compared with $2 billion in 1995. As a result, this increase in FDI led to the increase of the market capitalization of those countries from around $2 trillion to $ 5 trillion, as from 1995 to 2006 respectively. The positive response of foreign investors on stock market has been emerged as a result of these investors to participate fully in purchasing domestic equity and trading their equity in capital market, but the effect of FDI flows on development of stock market has focused mainly on developing economies and developed economies. While FDI has increased, financial markets particularly stock markets have also flourished significantly in developed and developing countries over the last three decades. Such growth has been boosted up by fundamental motivations such as higher economic growth, and especially more macro stability, system reforms through privatization of state- owned enterprises and changes in specific policy or financial liberalization.

Financial liberalization and political stability of the developing economies in Africa and other continents have led to emergence of Foreign Direct Investment (FDI). To encourage FDI flows, most of the countries have pursued policy reforms like privatization of the state owned enterprises, strong macro stability, strengths of domestic financial sectors, tax incentives, and decentralization and investment subsidies (World Bank 2008).Although Tanzania is not considered as part of the emerging markets, it's considered as a low income developing country as most of Sub Saharan Africans countries are, in the recent years Tanzania has recognized and benefitted from FDI inflows. Some of the advantages of FDI inflows to the financial market of Tanzania include; efficiency, employments, technology transfers, and managerial skills (Tanzania Investment Centre 2008).

**2. Literature Review**

*2.1. Financial Sector Development, FDI and Economic Growth: Theoretical and Analytical Issues*

Development of financial system plays a significant role on economic growth because the efficient financial system boosts its GDP growth rate. No wonder, studying relations between financial systems and economic growth has been a topic of interest among researchers, policy makers and other various individuals around the world. Claessens et.al (2001) advice that the key functions of financial systems are; security trading, hedging, diversification and mitigating of risk, allocation of resources, managers and corporate control, encouraging savings, facilitation of transactions of goods and services.

Gorg and Greenway ( 2004) assert that the economic growth of any country is positively affected by the size of financial institutions with respect to GDP, banks including the central bank, the level of credit allocations especially private institutions, the ratio of private institutions to GDP that have been allocated credits. In a similar way, Rousseau et.al (2000) confirmed that financial indicators have a positive impact on economic growth, using data of 47 countries from 1980-1995. The view is that economic growth is associated with components of financial intermediary advancement. Furthermore, Ozturk (2007) used stock market indicators to assess the link between financial market development and economic growth. It appeared that liquidity in stock market which is associated with both trading value and market size, correlates positively and significantly with economic growth. Also it was realized that as banks develop, that is high level of allocating bank loans to private firms, economic growth improves as well. Hondroyiannis et al. (2004) also assessed the effects of stock market development and banking system on economic growth in Greece from 1986-1999. Employing VAR models, they found an existence of bi-directional causality for finance and progress in the long- run, similarly an error-correlation model showed a long-run economic growth to have been influenced by stock market development and banks.

Empirical evidence and theories have focused more on a direct relation between financial development and economic growth, however much has to be done to establish a direct link between FDI and financial development especially stock exchanges. FDI inflows affect financial factors because the latter depend on investment projects. There are two contradicting opinions on the link between FDI and financial development. At some point it's argued that, FDI does not affect financial development. Hausmann and Fernández-Arias (2000) investigated whether adequate FDI flows were affecting growth in developing country. The analysis showed that FDI flows tend to be larger in countries whose risk is high, financial system is inefficient, financial institutions are poor. This view sees FDI flows where capital market is less developed. In the case where capital markets are not good enough for investment, FDI may be substitute for financial market development (Claessens et al 2001).Another argument admits that FDI is directly linked with development of financial market. Claessens et al (2001) analyzed the effects of developing migration of stock market movement to international financial centers on 77 countries as from 1975 to 2000. The argument is that there must be good institutions whenever FDI inflows are, so that FDI can develop further financial system. Therefore FDI is directly related with market capitalization and stock trading in the host country, meaning that FDI should not be considered as a substitute, rather is complement for stock market development. Agarwal and Mohtadi (2004) assessed the effects of financial market development on specific firms of 21 developing countries from 1990 to 1997.They found that both FDI and investment as percentages of GDP are positively correlated with banking and stock exchanges variables. Jeffus (2004) assessed the relationship between FDI and stock market development from 1988 to 2002 on four Latin American countries, on which the result show a strong positive relationship. From the most recent study, Adam and Tweneboah (2009) use multivariate cointegration and error correlation model to assess the effects of FDI on stock market development in Ghana. The findings suggest that there are long run relationship between FDI, nominal exchange rate and stock market development in Ghana.

*2.2. Motivations for Foreign Direct Investments*

Conventional theory views FDI as an opportunity to utilize foreign market in terms of specific assets of a firm (Merriden 1998).FDI is advantageous not only to the host country but also foreign investors are beneficiary and no wonder such investments have dominated movements of resources internationally. For the host country FDI net inflows creates job opportunities in a direct way through establishments and expansion of activities and indirectly FDI brings efficiency through competition within domestic market and transfers technology and knowledge from developed country to the host country (Crone and Roper 1999). Ngowi (2002) studies the implications of FDI and the findings show that FDI in the short- run and long- run induces positive effect in Tanzania particularly on financial sectors and investments, employments, technology, efficiency in domestic firms, managerial skills, exportation markets and market structure.

Propensity for investment is another view of FDI, as FDI inflows often although not all deals with Multinational Enterprises (MNEs).There has been a question of interest as why MNEs engage in FDI particularly involves exporting contrary to some other forms of foreign investments (Buckley and Casson1998). Joshi (2006) advises that Dunning's Electric Theory is probably one of the best theories explaining reasons behind propensity for investment. In this theory there are three preconditions that should be satisfied before a firm gets involved in international production. Dunning (1993) introduced a theory which is called electric theory' or Dunning's OLI theory to explain motivations behind firms which engage in foreign markets. Dunning's OLI theory argues that firms consider three factors before investing abroad: ownership advantageous, location advantages and international advantages.

Firstly, firms will only involve in multinational business if there are ownership advantages in terms of both tangible benefits like fixed assets and intangible benefits such as goodwill. Such ownership advantages should be relatively higher than those firms of other nationalities but affiliated with foreign market. Secondly, the firm must add value to shareholders by being profitable. Lastly, these advantages must be of beneficial to the enterprises that own them instead of selling them or having the right to utilize them to a foreign firm. Some researchers have explained motivations for FDI looking at joint ventures versus direct investment. What researchers have done is to seek advantages of foreign investment over exporting by carrying out studies on firms who deal with joint ventures and those who either takeover subsidiary or involve in a Greenfield site. Buckley and Casson (1998) explored these differences and concluded that joint ventures are suitable and a reasonable entry mode for distribution companies on the grounds that learning by experience incurs high costs as a result discourages Greenfield distribution whilst building trust is expensive and will discourage acquisition as well.

For production companies, joint ventures are considered as a kind of inefficient because only integrated joint that involves production joint venture is efficient as it can handle distribution effectively. Availability of technology is also one of reasons that lead investing firm to determine the degree of ownership (Moosa 2000). Apart from technology it has been asserted that some foreign markets could be entered through national partnership due to the fact that such markets are too competitive or saturated to accept a new investor. Threats and opportunities have also been considered as motivations over FDI. Considering FDI in its broader perspective, one reason for MNEs to engage in FDI is whereby the existing market is nearly saturated. Normally when the markets are saturated, players or participants are likely to seek opportunities in new market (Billington 1999). In other words problems in the domestic market can drive investors to consider foreign mats. Clegg (1998) found out that investors can also be interested in the foreign market to reduce transport costs whist increasing technology intensity in the industry. In particular, Tanzania has attracted FDI inflows because of trade barrier reductions and good infrastructures.

*2.3. Summary of Literature Review*

The literature review has considered theoretical perspectives and empirical evidences .The reason why firms invest abroad has been explained by electric theory. Electric theory emphasizes on ownership advantage, location advantage and internationalization advantage as the main factors that motivate investors to channel their portfolios abroad. This theory holds true in Tanzania because most of FDI inflows in Tanzania's market have emerged through mergers and acquisitions or joint ventures. While motivations seem to drive foreign investors, determinants are also crucial when choosing FDI locations. FDI adds value to shareholders (foreign investors) if the market structure of the host country is efficient and stable. Some of the determinants of FDI are: availability of resources and notably raw materials and skilled labor, access to technology, transaction costs and size and growth of the host market. Economic policy reforms such as investment incentives and privatizations have been evidenced as the main determinants of FDI inflows in Tanzania. Political stability is also an important factor that comes into the mind of foreign investors before they decide or consider where to invest. For instance Tanzania has attracted FDI inflows not only through economic reform policies but political stability plays an important role in its investments and economic growth.

The literature review has also looked at the impact of FDI in the host country. While the study focuses the impact of FDI on the financial development, one should bear in mind that the impact of FDI is not only reflected in financial sectors in Tanzania. FDI has been of importance in Tanzania in terms of technology spillover, creating employments, managerial skills, efficiency in domestic firms and domestic firms gain a 'global exposure' which makes them compete in both domestic and foreign market. The only disadvantage of FDI happens when domestic firms shut down because they cannot compete with foreign firms. The situation becomes even worse at a time of capital flight, because a country like Tanzania does not have a strong legal structure that could prevent foreign investors not to withdraw all their investments at once. Finally the literature review has identified a quadruple relationship, in the sense that FDI develops stock market, which in return develops financial sectors and eventually economic growth.

**3. Methodology**

The analysis method used in this paper is multiple regression analysis. This analysis method has been used by researchers to analyze time series data. While the measure of stock market development will be used as a dependent variable, the FDI, along with the other three variables will be used as independent variables. The inclusion of the three variables is important with respect to minimizing the effect of misspecification, as these variables have been proved to be the determinants of stock market development. The statistical package for social science known as SPSS was used in this study. The sign of slope coefficient determined how a particular variable affects stock market development. For example if a sign is positive, it means that a particular variable has a positive relationship with stock market development, in contrast if a sign is negative then there is a negative relationship. Thereafter, the coefficients will be tested to find out whether or not they are statistically significant than zero. Also, an overall equation will be tested to asses if it's statistically significant as well. The coefficient of determinants, also known as 'goodness of fit' will be used to assess if the regression model fits the data. As far as the statistical tests, especially the t-test and the F-test are concerned, they might be biased which raises a need to investigate the presence of autocorrelation and heteroscedasticity.

*3.1. Model Specification and Estimation-the one Equation Model*

Turning to the empirical evidence regarding the effect of FDI on stock market development in Tanzania the hypothesis has been specified and tested by multiple regression analysis. Relevant variables have been fitted into the equation. The linear and log-linear functions have been set up to analyze relations between variables. Neither linear nor log-linear relation function would be deemed to have been favored, though one might prefer log-linear due to the importance of elasticity with respect to economic variables, especially in the long- run. Considering variables and their movement periods, the normalizing effect can be reduced by log-linear formulation. However, statistical criteria could help too in choosing an appropriate function. Sargan (1964) asserts of making a comparison between standard error estimates following OLS application and we should choose the function with the lowest standard error of estimate. Unfortunately, standard errors and coefficient of determination of the two functions could not be compared directly; it is advised to weigh the standard error of the estimate of the log- linear function by employing geometric mean of the dependent variable for appropriate comparison.

Given that $\sigma_u$ is the standard error of log-linear form and $\sigma_v$ is the standard error of linear form while $u_t$ and $v_t$ are the error terms of the two functions respectively, and suppose that the standard errors of estimates are distributed normally and independently with means zero and constant variances, thus the Sargan function is shown below:

$$S = (\sigma_{u/} g\sigma_v)^n$$

Where the dependent variable has the geometric mean $g$ and number of samples is indicated by n. The linear form should be chosen only if $S$<1, otherwise log-linear form would be preferred. Assuming error terms to be normally distributed raises questions on the validity of Sargan criterion. Moreover Shapiro-Wilk (S-W) is the best statistical approach that uses the residuals of OLS estimates to test non-normality. Therefore S-W can be used along with Sargan criterion to find out the proper function. Another drawback of S-W test is that when both forms are not appropriate, Sargan criterion will not reveal the problem. Aneuryn-Evans and Deaton and Godfrey and Wickens developed an approach to overcome Sargan criterion drawback. Amongst others, the approach tests of suitability between linear and log-linear forms whilst both functions can be rejected if not appropriate. These tests involve Lagrange multipliers but they are very demanding as special sub-routines have to be inserted into the computer programmes. In most practical purposes and especially if one is merely concerned with whether linear or log-linear function, which of them should be selected, Sargan criterion is still convincing, on the other hand Aneuryn-Evans and Deaton with Godfrey and Wickens approach have to be used when developing forms of equations for analysis.

The annual time series data for the period 1998-2008 were fitted into linear and log-linear functions as shown respectively below:

$$Y_t = \beta_0 + \beta_1 X_{1t-1} + \beta_2 X_{2t-1} + \beta_3 X_{3t-1} + \beta_4 X_{4t-1} + u_t$$

$$Y_t = AX_{1t-1}^{\beta_1} X_{2t-1}^{\beta_2 v_t} X_{3t-1}^{\beta_3 v_t} X_{4t-1}^{\beta_4 v_t}$$

Where $u_t$ and $v_t$ are assumed to have means zero and constant variances, as they are normally and independently distributed. The other symbols and their meaning are shown below:

$Y_t$= market capitalization as a proportion of GDP in period t
X1t = Foreign direct investment, lagged by one period
X2t = Nominal exchange rate, lagged by one period
X3t = Domestic credit to the private sector as percentage of GDP
X4t = GDP growth (annual %)

In the first instance the GRETL statistical programme was used to derive OLS estimates of time series data in which results of the two equations were shown in the tables. Perhaps S-W column needs more explanations, it's a computed Shapiro-Wilk statistic based on residuals and it measures the degree of normality of the distributed error terms. Referring to computed values, S-W appears to be 0.962 and 0.981 at the 50% and 90% level respectively. Therefore S-W test indicates that non-normality does not exist in the log-linear formulation which simply reflects that the log-linear formulation should be preferred to linear formulation one. Also Sargan

criterion provides further evidence on selecting log-linear formulation because the dependent variable showed, after computation, geometric mean of about 1545.67 and S-test indicates the value of S to be greater than 1, meaning that, log-linear equation is more appropriate one.

While the log-linear formulation of the model has been statistically chosen, other observations seem to be apparent as they are narrated in the table. For example coefficient of determination for an adjusted degree of freedom appears to be high and the overall equation is significant because the computed F-ratio is higher than the tabulated one. Efforts were also made to check the availability of serial correlation in the error term due to the fact that time series data is likely to be auto correlated (Gujarati and Porter 2009) .Durbin-Waltson (D-W) statistic test accepts the null hypothesis and thus the first order autocorrelation is absent in the disturbance. Despite of D-W statistic being used, but one should bear in mind that this test only investigates the availability of first order auto correlated disturbances. In using the D-W test there conditions that must hold. Firstly, independent variables must be non stochastic in the sense that their values are fixed in constant sampling. Secondly, normal distribution must accompany error terms. Lastly, lagged values of dependent variable must not be included in the regression model.

When these conditions do not hold true and especially when dependent variable includes lagged value of regressors, the DW test is not appropriate as, DW is around 2 which suggests that there is no evidence of autocorrelation. Such situation has led to the utilization of Durbin's h test. In such cases we use Durbin's h test as shown below:

$$Durbin's\,h = (1-\frac{dw}{2})(\frac{n}{1-n(se(\alpha))^2})^{\frac{1}{2}}$$

Where $se(\alpha))^2$ is the estimated variance of the OLS estimator $\alpha$ , the coefficient of the lagged dependent variable. $dw$ is the DW, Durbin-Watson value and $n$ is the number of observations. The estimated value of Durbin's h lies between ± 1.96 and therefore we can accept the null hypothesis implying that there is no evidence on autocorrelation.

**4. The Results and Their Interpretations**

Turning now to the results, one might ask whether or not the sign of slope coefficients support prior expectations. Since the log-linear model has been chosen as a correct function form, interpretations throughout this study focuses on log-linear results. The sign of FDI, nominal exchange rate and domestic credit to the private sector as percentage of GDP are positive; the result which is consistent with a prior grounds. Interpretations of this sign is that ; if the slope coefficient of independent variable is positive or negative then the relationship is positive or negative respectively with dependent variable. In this study three variables are positively correlated with market capitalization in Tanzania.

The intercept value is positive, which has feasible economic interpretation. Literally interpreted, it means that if the change in FDI, nominal exchange rate, domestic credit to the private sector as percentage of GDP and GDP growth were zero in Tanzania, the average level of market capitalization as proportion of GDP would be a positive change of about 1.39. Slope coefficients of the log-log model measures elasticity of dependent variable with respect to independent variable, that's the percentage change in dependent variable for a given small percentage change in independent variable, and it has made it popular in applied work. As GRETL results show, the elasticity of stock market development with respect to FDI in Tanzania is about 0.51, suggesting that if FDI goes up by 1 percent whilst other variables included in the regression are constant; stock market development goes up by around 0.51 percent. Thus, stock market development is responsive to changes in FDI. This could explain a reason why stock exchanges keep a keen eye on changes in FDI.

On a similar basis if other variables are held constant, the elasticity of stock market development with respect to nominal exchange rate is about 0.77, suggesting that if nominal exchange rate goes up by 1 percent; stock market development goes up by around 0.77 percent. Likewise, the elasticity of stock market development with respect to domestic credit to the private sector is around 0.45, suggesting that if domestic credit to the private sector goes up by 1 percent whilst other variables are constant, stock market development goes up by around 0.45 percent.As for GDP growth, the elasticity of stock market development with respect to GDP growth is about minus 1.34, suggesting that if GDP growth goes up by 1 percent, the stock market development goes down by about 1.34 percent, a result which is not consistent with economic theory given earlier. As previously shown, real income and income growth rate also known as change in GDP and the percentage rate of growth have a positive impact on stock market size.

As far as the coefficient of determination: a measure of 'goodness of fit' is concerned its value is around 0.69. This suggests that the sample regression line fits the data by about 69 percent, In other words the proportion of the total variation in market capitalization explained by the regression model is about 0.69.Considering the goodness of fit can at most be 1, hence the value obtained is quite reasonable to draw a conclusion that there is a relationship between the regress and the regressors. With regards to the significance of these coefficients it is observed that at the 95% and 99% confidence level, the coefficients of FDI and nominal exchange rate are significantly different than zero. On the other hand the coefficients of domestic credits to the private sector and GDP growth are statistically insignificant, though domestic credit to the private sectors is about significant at the 95% confidence level.

In summary, the analysis has shown that the stock market development as measured by market capitalization as proportion of GDP in Tanzania during 1998-2008 has been advanced by FDI, nominal exchange rate and financial intermediary development as measured by domestic credit to the private sector. In contrary to previous findings, real income as measured by percentage change in GDP seems to have negative impact on stock market development. The results can be considered satisfactory given the data limitation and consequent restriction of the analysis.

It's clear that only 11 annual observations that have been used for analysis are small sample size and perhaps the findings would have been improved if the sample size were large (notably 60 observations). The reason why the sample size used is small it's because Tanzania Stock Exchange was established in 1998 and therefore the market capitalization of listed companies was not found until 1998. Similarly, other data was available until 2008.
Apart from small sample size, probably the analysis suffers from misspecifications in the sense that there could be omissions of relevant variables in the regression model. Things like a degree of political stability, corruption and savings and investment may affect stock market development as well.

**5. Conclusion and Recommendations**

*5.1. Conclusion*
The objectives of this study have been met through theoretical level and empirical evidences in the literature review along with the analysis of annual data from 1998 to 2008 to assess the effect of FDI on stock market development in Tanzania. One important point that could be learnt from the literature review is that the effect of FDI in the host country is not only reflected in the financial market, it's also reflected other aspects such as technology spillover, employment and managerial skills. Going back to the main objective, the multiple regression analysis reveals the existence of relationship between stock market development, FDI, nominal exchange rate, financial intermediary development and real income. Contrary to previous studies which found that FDI is the substitute of stock market development, this study has empirically examined that FDI is a complement of stock market development. In other words, FDI has proved to have a positive impact on stock market development in Tanzania. The fact that FDI and stock market development are rather complements and not substitutes emphasizes the role of FDI on advancing stock market development. Given that stock market development is a fundamental part on the financial system development and interestingly financial system development is a precondition of economic growth, basing on this study it's obvious that FDI inflows have boosted economic growth in Tanzania.
The study has also tried to explore the determinants of stock market development in Tanzania from 1998 to 2008. It's clear from the results that FDI, nominal exchange rate and financial intermediary development are the determinants of stock market development. Real income (also known as percentage change in GDP) has shown a negative relationship with and stock market development. With exception of real income, all explanatory variables were significant and therefore the result of real income is inconclusive in the sense that it's statistically insignificant than zero. One important thing worth addressing is FDI plays an important role in increasing market capitalization. Since market capitalization as proportion of GDP measures stock market development and the fact that this study points out FDI is positively correlated with stock market development in Tanzania, therefore this study can be used as evidence asserting the relevancy of FDI on boosting market capitalization.
FDI flows enter in a country whose financial intermediary is efficient of which FDI flows develop the financial systems further. Economic policy reforms such as financial liberalization have attracted FDI inflows. For example FDI inflows were large due to mass privatization and the effect of winding down privatization policy seems to have caused adverse changes on FDI inflows.

*5.2. Recommendation*
First, it is suggested that the policy makers- Tanzania Investment Centre (TIC) should ease restrictions and offer more incentives to investors (i.e. one who are not Tanzanian and who live abroad) who wish to hold up to 10 percent of listed share companies in Tanzania. Since Tanzania Investment Centre is the primary government agency, they should advise the government to ease restrictions on foreign capital and offer more tax incentives as a way of attracting foreign investors. Ngowi (2001) investigated the role of tax incentives on attracting FDI inflows in Tanzania and the findings show that tax incentives attracted massive FDI inflows in Tanzania. The importance of attracting FDI inflows is crucial to all sectors of economy as they will receive adequate number of investments which in turn can lead to growth in the financial institutions and the economy at large.
Second, policy makers and specifically the Dar es Salaam Stock Exchange (DSE) should establish strategies in order to encourage domestic companies to list on stock market in Tanzania. Currently there a few listed companies in Tanzanian stock market and probably the reason of such small number could be due to a number of factors including bureaucracy and corruption. Having a large number of companies listed in stock market will not only increase market capitalization but also transparency among companies will be increased so that foreign investors can be attracted by making informed decisions.
Third, the DSE and Capital Market and Securities Authority in Tanzania should create an opportunity that will lead to tightly linkage between local trading system and global market. For instance, improving shareholder rights and quality of legal system can increase efficiency in shares trading system. This will boost liquidity of stock exchange and financial intermediary development.
Finally, policy makers particularly government should not only focus on attracting FDI through economic reforms, but also the issue of government stability is essential on attracting FDI. Political stability of host countries sends signals to foreign investors, when chaos occurs in a country; foreign investors withdraw their investments in order to avoid risk that might adversely affect their investments. Investors take assets out of a country when they lose confidence in its political stability on the grounds that the economic strength in that country is at risk as well. For instance what happened to Kenya in 2008 was the consequence of unstable government after the general election in 2007 which was associated with political instability. As previously explained Kenya's FDI inflows dropped to $95 million in 2008 from $ 729 million in 2007, such incredible 'capital flight' left the worse impact in Kenya's economy history. Therefore a country that seeks to attract more FDI inflows should be stable government accompanied by economic policy reforms like privatization, financial liberalization and trade opening.

**6. References**


1. Adam, A.M and Tweneboah, G. (2009) 'Foreign Direct Investment and Stock Market Development: Ghana's Evidence'. .International Research Journal of Finance and Economics 26, 1450-2887
2. Agarwal, S and Mohtadi, H. (2004) 'Financial markets and the financing choice of firms: Evidence from developing countries'. Global Finance Journal 15, 57-70
3. Billington, S. (1999) 'The Location of Foreign Direct Investment: An Empirical Analysis'. Applied Economics 31(1), 65-66
4. Billington, S. (1999) 'The Location of Foreign Direct Investment: An Empirical Analysis'. Applied Economics 31(1), 65-66
5. Blonigen, B. (2005) 'A review of empirical literature on FDI determinants'. Atlantic Economic Journal 33, 383–403
6. Buckley, P. J. and Casson, M. (1988) 'Analysing Foreign Market Entry Strategies: Extending the Internationalization Approach'.Journal of International Business Studies 29(3), 539-561
7. Claessens, S., Daniela, K. and Schmukler. S, L. (2001) 'FDI and stock market development: complements or substitutes?'. Mimeo, World Bank.
8. Clegg, J. (1998) 'The Determinants of Intra-European Foreign Direct Investment Flows: Market Integration and Policy Issues'. Journal of Transnational Management Development 3(3/4), 89-129
9. Clegg, J. (1998) 'The Determinants of Intra-European Foreign Direct Investment Flows: Market Integration and Policy Issues'. Journal of Transnational Management Development 3(3/4), 89-129
10. Crone, M. and Roper, S. (1999) 'Knowledge Transfers from Multinational Plants in Northern Ireland'. NIERC Report Series: No.15, Northern Ireland Economic Research Centre, Belfast
11. Dunning, J.H. (1993) Multinational Enterprises and the Global Economy. Addison:
12. Garcia, V.F. and Liu, L. (1999) 'Macroeconomic Determinants of Stock Market Development'.Journal of Applied Economics 2(1), 29–59
13. Gorg, H. and Greenway, D. (2004) 'Much ado about nothing? Do domestic firms really benefit from foreign direct investment?'. World Bank Research Observer 19, 171-197
14. Gujarati, D. N. and Porter, D.C. (2009) Basic Econometrics 5th edn McGraw: Hill
15. Hausmann, R. and Fernández-Arias, E. (2000) 'Foreign Direct Investment: Good Cholesterol?'Working Paper 417, Inter-American Development Bank
16. Hondroyiannis, G., Lolos, S. and Papapetrou, E. (2004). 'Financial Markets and Economic Growth in Greece, 1986-1999'. Working Paper 17
17. Jeffus, W. (2004) 'FDI and Stock Market Development in Selected Latin American Countries'. International Finance Review 5, pp. 35-44
18. Merriden, T. (1998) 'US Investment in Europe'. Management Review 87(7), 26-29
19. Moosa, I.A. (2000). Foreign Direct Investment: Theory, Evidence and Practice. Houndmills, Basingstoke, Hampshire; New York: Palgrave.
20. Ozturk, I. (2007) 'Foreign Direct Investment – Growth Nexus: A Review of the Recent Literature'. International Journal of Applied Econometrics and Quantitative Studies 4, 79-98
21. Rousseau, P. L. and Paul, W. (2000) "Equity Markets and Growth: Cross Country Evidence on Timing and Outcomes, 1980–95'. Journal of Banking and Finance 24, 1933–57

**Appendix: Regression table**

| YEAR | MC%GPD | FDI | Exchange Rate | Credit To Private Sector | GDP Growth % | GDP | MC |
|---|---|---|---|---|---|---|---|
| 1998 | 2.82014600% | 172306244.9 | 0.0015135 | 4.3050449 | 3.708512 | 8.38E+09 | 2.36E+08 |
| 1999 | 2.09086766% | 516700641.7 | 0.00134575 | 4.6971736 | 3.52996 | 8.64E+09 | 1.81E+08 |
| 2000 | 2.56546185% | 463401000 | 0.0012545 | 4.585912 | 5.099475 | 9.08E+09 | 2.33E+08 |
| 2001 | 4.21642179% | 388800000 | 0.00114175 | 5.918788 | 6.24254 | 9.44E+09 | 3.98E+08 |
| 2002 | 7.24902594% | 387600000 | 0.00107225 | 7.5684711 | 7.241132 | 9.76E+09 | 7.07E+08 |
| 2003 | 6.40656204% | 308200000 | 0.00097955 | 9.1648874 | 5.667779 | 1.03E+10 | 6.59E+08 |
| 2004 | 5.89878417% | 330600000 | 0.0009498 | 10.4409629 | 6.731658 | 1.14E+10 | 6.7E+08 |
| 2005 | 4.15686670% | 494050000 | 0.000902425 | 10.1810517 | 7.369904 | 1.41E+10 | 5.88E+08 |
| 2006 | 3.77594076% | 596950000 | 0.00082285 | 12.7399986 | 6.7371 | 1.43E+10 | 5.41E+08 |
| 2007 | 3.27797843% | 646971529.1 | 0.000844825 | 14.8894011 | 7.148102 | 1.68E+10 | 5.52E+08 |
| 2008 | 6.31181190% | 744017258.5 | 0.00082965 | 16.25395 | 7.45645 | 2.05E+10 | 1.29E+09 |
|  | Y | X1 | X2 | X3 | X4 |  |  |