

Deeper Regional Integration and Foreign Direct Investment in the East African Community (EAC): Testing the Market Size Hypothesis

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Abstract

The relationship between deeper integration and foreign direct investment remains one of interest to development experts around the globe. Different theoretical perspectives have been developed on this subject, some testing the advantages of Preferential and other regional trade agreements that promote deeper regional integration. Some studies point to a negative effects of Preferential trade agreements on FDI (see Rao, 1999: UNECA 2004b, Emran and Stieglitz 2003: Grunberg, 1998) while others make the argument that it depends on a range of contextual pre-existing factors, including the quality of certain economic and political institutions. This study examines the relationship between Regional integration and FDI inflows in East African Community (EAC). Both short and long-run relationships are examined making use of a panel ARDL method. The results demonstrates that there is a long run relationship between aggregate GDP for the EAC Partner States, openness index, business regulator environment and Tanzania FDI inflows. This suggests that a deeper integration process through PTA will generate more FDI inflows into the region in the short run and Tanzania is expected to enjoy more benefits from the EAC integration process in the long run than the short run.

Furthermore, Tanzania interest rate with interest rates of other EAC Partner states relate positively with FDI inflows of Tanzania. Furthermore, Tanzania Openness index and the openness index of other EAC Partner state at equilibrium level have positive relationship with FDI inflows in Tanzania, since openness provide the measure of the level of liberalization done in the EAC integration process from Customs Union, Common Market and Monetary union, which is a typical milestone of the deeper integration process. This evidence demonstrates that in the long run the pattern of FDI inflows of Tanzania from EAC will be more based on the deeper integration aspect provided for by the creation of Common market and Monetary union. The results further suggest that the pattern of FDI inflows into the EAC will shift from resources seeking FDI to efficiency and market seeking FDI, which supports the hypothesis of the beneficial effect of the creation of PTA on FDI inflows into regional economic communities.