AN ANALYSIS OF THE RELATIONSHIP BETWEEN MACROECONOMIC INDICATORS AND THE FLOW OF FOREIGN DIRECT INVESTMENTS IN KENYA.

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DECLARATION

I declare this project is my original work and has not been submitted for a degree in other university

Signed _____ 27.11.06

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This project has been submitted for examination with my approval as the university supervisor.

Signed _____ 27/11/06

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DEDICATION

To my family, especially my father whose wisdom and wise counsel have been the cornerstone in my quest for knowledge.

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ABSTRACT

The research sought to look at specific macro economic determinants that affect the Foreign Direct Investment (FDI) inflow to Kenya. The logic being that each country is structurally diverse and that there are substantial discrepancies in the basic macroeconomic variables that characterize an economy. The study therefore sought to determine the critical macroeconomic indicators and their relationship to the flow of FDIs to Kenya and to develop a regression model to predict the level of FDI based on the identified macroeconomic indicators.

The study was restricted to the Kenyan economy between the years 1990 and 2005, the period being judgmentally selected as it is more relevant to the current situation. Due to the fact that the FDI inflow depends on a number of macroeconomic determinants, multiple linear regression was used to determine the important variables that influence FDI inflow to kenya.

Research findings from the Data Analysis indicate that the main macroeconomic indicators that affect FDI inflow to Kenya include inflation, NSE Index, Annual GDP growth rate, total external debt, total exports, tax on International transactions and total imports. High Inflation and taxes on international transactions continuously created negative distortions to the Kenyan economy reducing FDI Investors. On the other hand, increased volumes of trade (import and export) have positively signaled to openness of trade and therefore more FDIs to Kenya. Similarly the findings reflect that higher external debt is positively related to FDI inflow to Kenya since increased multilateral donor funding to the Kenyan government helps to

boost investor confidence hence higher FDI inflows through Multinational Enterprises.

Contrary to the previous literature, the FDI inflow to Kenya has been negative to GDP growth. This is explained by the fact that the Kenyan government has tended to dispose its stake in parastatals to foreign investors in periods when the economic growth is low in order to get more funding to bridge the budgetary gap hence increased FDIs. The findings further reveal that high NSE Index levels negatively relate to the FDI inflow to Kenya.

The findings opens the way for further research on the impact of FDI inflows to reduction of poverty levels in Kenya as well as the impact of FDI inflows to the stock market in Kenya.

CHAPTER ONE
INTRODUCTION

1.1 Background

The movement of capital around the world has captured the attention of the policymakers and researchers in both developing and developed countries. Cross border capital flows have gravitated towards the destinations that are susceptible to lucrative opportunities (Zahir, 2003). This capital movement is known as Foreign Direct Investments (FDI) which refers to resources brought into a host country by Multinational Enterprises (MNE). FDI flows are basically in the following forms:

- Initial capital, equity capital or purchase of shares by investors in a host country including investment in plant and equipment,
- Reinvested earnings from the initial investment, and
- Intracompany loans and debt transactions or referred to as borrowings and lending of funds between parent and affiliate enterprises.

FDI stimulates domestic investments and facilitates improvements in human capital and institutions in the host country. Borenzstein et al (1998) examined the role of FDI in promoting economic growth using endogenous growth model and analyzed FDI flows from industrial countries to sixty-nine developing countries during the years 1970 to 1989. The results show that FDI is a more important vehicle of economic growth than domestic investment. FDI is also an important vehicle for technology transfer from developed countries to developing countries (Karbasi, et al 2005).

According to Meier (1994), FDI has played an important role in developing economies which are characterized by lack of skilled manpower, capital and infrastructure problems. They also suffer from high foreign debt repayment, poor primary commodity prices and fluctuations in official assistance restraining economic growth. This has an effect of reducing domestic savings level. These economies suffer foreign exchange and saving gaps that can be filled by foreign capital inflows.

FDI brings in an inflow of foreign exchange and new technology, generates local value added and employment, infuses labour, marketing and managerial skills, and contributes to taxes and royalties. For a developing country, the inflow of foreign capital may be significant not only in raising productivity and real wages of a given labour force but also increase the number employed (Ayanwale and Bamire,2000).

FDI is associated with diffusion of imported skills and efficiency. Domestic firms become more competitive as they become suppliers of foreign firms upstream and buyers of products downstream. It offers the most efficient way to take advantage of growth opportunities offered by the global economy where firms increase efficiency and have direct access to the global networks of their parent companies (Kaminski and Riboud, 2000). Successful MNEs have been shown to have significant demonstration and synergy effects on domestic firms. There exists spillover efficiency benefits from foreign owned firms to locally owned ones (Blomstrom and Persson, 1983).

FDI has been shown to have a positive relationship with GDP and thus the economic growth in the absence of financial repression and trade distortions (Fry, 1993). According to Kaminski et al (2000), FDI led restructuring contributed enormously to expand Hungarian exports which was crucial to tackle the serious balance of payments crisis in 1995.

Nevertheless, FDI has been noted to lower domestic savings by stifling competition through exclusive production agreements by the governments. In the long run, activities of foreign investments may reduce foreign earnings on both the current and capital accounts. The current account may deteriorate due to large importation of intermediate products and capital goods, while the capital accounts may worsen because of profit repatriation. Additionally, tax concessions, investment allowances, public subsidies and tariff protection often provided by the governments, may mean the public revenues from corporates may be less than expected (Wanjala, 2001).

The concern therefore is how to attract flows of FDIs to different countries because the benefits of the capital inflows outweigh the costs.

It has been argued that the economic reforms in many African countries, including Kenya, have been incomplete and thus have not fully convinced foreign investors. Kenyan economic survey (2002) notes that the lion's share of Kenyan's budgetary resources is gobbled up by public debt serviced at a rate of Kshs. 30 billion per year and thereby crowding out expenditure and creating a budget deficit. As a result, investment in development, infrastructure, or other productive areas, is inhibited. In order to cut on debt burden and budget deficits the government can invite foreign direct

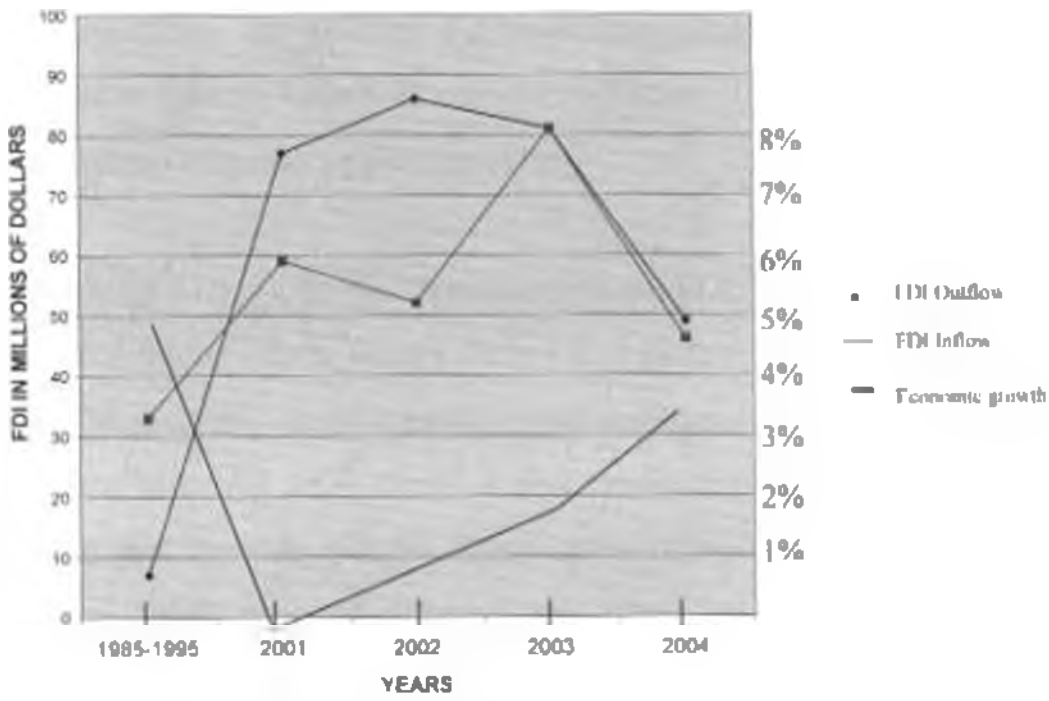
investment on a massive scale to create productive global scale capacity in infrastructure and industry and thus fill in the budget deficit gap.

Kenya's economic performance had weakened in the 1990s because of the failure by the government to sustain prudent macroeconomic policies, a slow pace of structural arrangements and persistent governance problems (IMF report, 2000).

The often lax fiscal policy on crucial macroeconomic indicators namely; taxation, money supply, interest rates and foreign exchange led to a rapid build up of short term government domestic debts from a low of just KShs. 100 billion in 1994 to KShs. 289.4 billion by June 2003, according to the Central Bank of Kenya (CBK) Annual report of the year 2004. This led to a decline in savings rate translated to lending rates of in excess of twenty percent in real terms. This together with other inflationary costs of doing business in Kenya brought about by corruption, a deteriorating infrastructure and an inefficient parastatal sector (utilities and transportation) depressed foreign confidence to do business in Kenya. Withdrawal of aid to the government by the main foreign donors such as the International Monetary Fund (IMF) and the World Bank slackened FDI flow and thus the economic growth fell from 4.8% in 1995 to a mere negative 0.2% in 2000 (IMF 2000). It then picked to a high of 5.2 percent in 2005. Reflected below is a graph showing the FDI status in Kenya between 1985 to 2005, against the growth pattern.

Graph 1.1.1

TREND OF FDI FLOW IN KENYA



Source: UNCTAD (2005) Flow overview, selected years

The graph indicates that FDIs were repatriated in the late 1990s as the economic growth deteriorated up to 2002 and improved as soon as the economic environment changed under new leadership which boosted foreign investors' confidence. As a result, FDIs to Kenya reached a peak of 81 million US dollars in 2003. Nevertheless, the situation seems to be deteriorating again.

According to UNCTAD (2005), most African countries, including Kenya, concentrated policies on adjustment programmes over the past two decades that failed to boost growth or reduce poverty levels, and by stalling

diversification and shrinking public investment, actually added to the reduction of FDIs.

A Study by Karbasi et al (2005) indicate that FDI flows, both in developing and developed countries, are affected by; economic growth, trade levels, and macroeconomic policy variables, namely; inflation, taxation, interest rates and government budgetary implementation.

A study by Wanjala (2001) on the determinants of FDI in Sub-Saharan Africa (SSA) with inferences to Kenya shows that factors like the returns (captured by GDP growth), taxation policy, and openness to economy are significant factors affecting FDI flows across developing countries. He further found out that country specific effects were relevant, which shows that FDI to real GDP ratio is affected by other individual country characteristics.

Wanjala (2001) concluded that there was need to do more studies on economic and social factors and how they impact on FDI flows in Kenya, and whether these capital inflows play any role on reducing poverty levels.

According to the CBK Annual report (2004), some of the major macroeconomic indicators monitored by the CBK that affect economic growth include inflation, GDP levels, foreign and domestic investment levels, trade level and government fiscal activities. This research paper will seek to identify the most important macroeconomic factors that impact on the flow of foreign direct investment to Kenya. It will seek to show that proactive economic policies can generate FDI interest

1.2 Statement of the Problem

According to CBK Annual Report (2004), the net inward FDI flows to Kenya sank to a low of US dollar 0.1 billion in 2003. Jiwaji (2004) noted that Kenyans had paid and continue to pay a very high price both in budgetary and economic costs for the financial indiscipline of the 1990s which was characterized by high fiscal deficits, excessive domestic borrowing that pushed interest rates up, and imprudent macroeconomic policies that drove the foreign investors away. Such condemnation assumes that an association exists between macroeconomic policy indicators and flow of foreign direct investments.

Wheeler et al (1992), Markowiski et al (1995), Chakrabarti (2001) have come up with results supporting the relevance of market related variables on FDI flows such as GDP, GDP per capita, inflation, government budgetary implementation, trade and interest rates. Econometric tests performed by UNCTAD (1998) reveal that the market size related variables remained the dominant influence on inward FDI even in the 1990s. Although many aggregate econometric studies have been conducted, a broad based consensus on the major determinants of FDI has been elusive. This lack of consensus can be partly attributed to the lack of reliable and accurate data on FDI flows and its potential determinants, particularly at country level and sectoral level and the fact that empirical work has analyzed FDI determinants by pooling a group of countries that may be structurally diverse, that is, there could be substantial discrepancies in the basic macroeconomic variables that characterize an economy. Further, little

research work has been done in Kenya on the determinants of FDI flow into the country.

Of concern to us, therefore, is the extent to which these macroeconomic indicators namely GDP, interest rates, inflation, exchange rate and government expenditure levels identified by various scholars have on the flow of foreign direct investment in Kenya. Do the changes in macroeconomic indicators have any foreign direct investment signal in the Kenyan environment?

1.3 Objectives of the Study

The broad objective of this study is to determine the relationship between the various macroeconomic variables and the flow of FDI in Kenya. Specific objectives will be;

- To determine the critical macroeconomic indicators and their relationship to the flow of the FDIs to Kenya, and
- To develop a regression model that could be used to predict the level of FDI based on the identified critical macroeconomic indicators identified above.

1.4 Justification of the study

A proper understanding of macroeconomic determinants is expected to enhance the capacity of policymakers to create a business friendly environment and attract higher FDI inflows with strong links to growth of domestic economy. The study will highlight the areas of focus in maintaining fiscal and monetary discipline in order to attract the much needed foreign investments thus help the government in identifying opportunities to expand its competitive strength to increase Kenya's share of global FDI. Financial intermediaries will appreciate the information contained within the document and utilize it to plan financial strategies based on shifts in the economic environment explained herein.

The study will be useful to international donors and organizations such as International Monetary Fund and the World Bank who are interested in the development of the emerging countries based on sound macroeconomic policies.

Finally the research will add to the body of knowledge not only in finance but in other areas of specialization and develop a better appreciation of the forces impacting on economic growth in Kenya.

1.5 Scope of study

The study will cover the Kenyan economy from 1990 to 2005.This period covers the era of distortions of macroeconomic policy variables brought about by changes in leadership, privatization of major state corporations

leading to increase in foreign investor interest and introduction of donor related structural programmes that impacted on policy issues in the management of the Kenyan government.

The early period of 1990s is noted to have been of mega corruption scandals that affected foreign investment confidence in the Kenyan economy. It was followed by the mid 1990s where structural adjustment programmes were introduced to the economy by the multilateral donors. The late 1990s reflects the period when the effects of the withdrawal of donor programmes and mismanagement of the economy were felt including capital flight. The year 2002 to 2005 on the other hand reflected leadership change that translated to macroeconomics policy changes and increased donor confidence that revived the economy though with mixed results.

CHAPTER TWO
LITERATURE REVIEW

The chapter will review previous theoretical and empirical literature on macroeconomic determinants of FDI, highlight the linkage between macroeconomic variables and foreign direct investments and conclude with a review of the model building approach using regression analysis.

2.1 Theoretical Literature

Neoclassical theory

This theory explains capital flows with differentiated rate of returns across countries leading to capital arbitrage where capital seeks highest returns. Cockcroft and Riddell (1991) argue that future capital flows depend on a package of direct incentives which influence return, security of investment, tax regimes, investment code or guidelines and overall macroeconomic policies including those relating foreign exchange, domestic borrowing by foreign firms, wages and employment regulations. The theory emphasizes that addressing the problem of legal infrastructure, labour, legislation and taxation policy, price controls and exchange rate levels will improve investment climate.

Portfolio theory

Portfolio theory takes into account the element of uncertainty that is missing in other theories. Investors are postulated to consider not only returns but

also the risk in selecting the portfolio to invest in. This theory is based on the fact that fluctuations in rates of returns on capital within and even more so between countries are not perfectly correlated. Risks may therefore be reduced by a diversification of portfolios, that is, diversification across countries.

Theory of Institutional FDI fitness

Wilhems (1998) stipulates that FDI is determined less by intransigent fundamentals than by institutional variables more amenable to change namely policies, laws and their implementation. The institutions that contribute to FDI fitness are governments, markets, education and socio-culture.

Organizational and Internalization Theory

According to this approach, foreign firms have oligopolistic powers on host county markets. Firms choose an investment location because of comparative advantage. Meier (1994) notes that foreign investment may also be taken to gain control, thus MNEs engage in FDI to get external markets, firm linkages, integration, transfer over inputs hence creating barriers of entry to new competitors.

According to internalization theory firms keep operations internal through a hundred percent subsidiary because they want to control risk and retain control, market share pricing and economies of centralization that reduce costs through FDI (Meier, 1994).

2.2 Empirical literature

According to Dunning (2002), FDI in developing countries has shifted from market seeking and resource seeking FDI to more (vertical) efficiency seeking FDI. Due to globalization-induced pressure on prices, MNEs are expected to relocate some of their production facilities to low cost developing countries with less inflation.

Ekpo (1996) incorporated uncertainty in his model to explain determinants of FDI in Nigeria. Variables considered included income per capita, credit rating, uncertainty (proxied by inflation), policy reversals (proxied by debt service), institutional and political factors and world rate of returns on investment (proxied by long term US interest rates. Political regime change, real per capita income, rate of inflation, world interest rates, credit rating and debt service explained the various FDIs in Nigeria.

Wilhems (1998) tested the Fitness theory using an econometric cross section analysis across 67 emerging economies. The analysis showed that the government and market variables were the most significant determinants of FDI inflows. Government fitness was reflected in economic openness with only minimal trade and exchange rate controls. The theory used, suggest that every nation has the opportunity to identify and expand its competitive strength to increase its share of global FDI. The more the government does to provide economic and infrastructural framework conducive to FDI, the more FDI will be obtained.

Lewis (1979) as quoted by Wanjala (2001) argues that the prime determinants of FDI are economic considerations and that political variables are of secondary importance. He tasted a model for 25 developing countries from Africa, Asia and Latin America for the period between 1965-1967 and found that the significant factors were GNP per capita, balance of payment and capabilities of the government (as measured by share of taxes).

Nunnenkamp (2002) in his empirical study on determinants of FDI in developing countries found that the traditional market related determinants are still dominant factors shaping the distribution of the FDI. Further, he noted that the non traditional determinants such as cost factors, complementary factors of production and openness to trade though mostly revealing the expected correlation with FDI, have typically not become more important with proceeding globalization. Noteworthy though, is that his results were supported by the findings of Noorbakshsi, et al (2001); that the availability of local skills has become a relevant pull factor of FDI in the process of globalization. Efforts to provide better education and training would not only enhance the economic growth efforts of FDI in developing countries as shown by Borrensztein, et al (1998) but are also likely to induce higher FDI inflows.

This paper will therefore dwell on the macroeconomic determinants that have been identified in previous literature with a focus on their importance to the Kenyan economy.

Taxation

The aim of government taxation policies has remained multi disciplinary with respect of attracting foreign investment at every stage. The main objectives are:-

- Transference of managerial skills and advance technology to accelerate pace of industrialization.
- Rural urban integration widening the process of development.
- Sectoral specific incentives to boost sectors strategically crucial like agriculture and tourism.
- Promotion oriented incentives that enhance, export orientation, employment generation, skill development and domestic value added activities.

Foreign investors are more concerned with higher rate of after tax returns and net worth of invested capital. Taxation measures directly affect the cost of capital and hence affect the incentive to invest in specific projects. The environment facing foreign firms will be different in each nation and therefore the FDI flow. Bigger taxation incentives as fiscal measures will attract FDIs through the MNEs.

To attract the foreign investors, successive governments in any country, offer various investments incentives in the form of tax concessions (tax expenditure) and direct expenditure on infrastructural provisions. The taxation policy of a host developing country has a great relevance for multinational enterprises (MNES) involvement in the production activities. It is perceived to be a significantly influential factor in determining the

inflow of foreign investment through the cost of capital and the resulting after tax return (Zahir, 2003).

The concept of tax expenditure is being used widely in the budgets of every country as an alternative tool to provide financial reliefs to an economic agent by increasing tax credits and tax relief (Ahmed, 1997).

Taxation therefore is a fiscal incentive that has a positive relationship with the FDI offered by the host country (Nishat and Anjum, 1998). Further, empirical studies have found a significant negative relationship between FDI and the cost of capital plus taxation in both developing and developing countries (Root and Ahmed, 1979). Overly, a lower tax burden would make the investments, both domestic and foreign more profitable.

Gross Domestic Product (GDP)

Gross Domestic Product (GDP) is the total market value of goods and services produced within a given country after deducting the cost of goods utilized in the process of production according to the New Zealand Institute of Economic Research (2006). It indicates at a glance, a country's market size.

Real GDP per capita is often used as an indicator of how well off a country is since it is a measure of average real income in the country. However, GDP only covers market sector activities and does not take account of negative effects of economic activity like environmental degradation. In Kenya, reflecting the impact of various policy and governance measures over 2003-

2005 periods, the economy recovered during the financial year with real GDP growth improving from 1.8% in 2003 to 5.2 percent in 2005. The economic growth is shown by the increase in real GDP. The CBK annual report 2004 notes that as a result the investor confidence was regained with the resumption of donor aid which is expected to impact positively to the FDI flows.

However, real GDP growth is expounded by the major underlying sectors of the economy. As noted in the monthly economic reviews published by Central Bank of Kenya, economic growth relies on the tourism, transport and communication, agriculture, manufacturing, trade, building and construction. For example, Central Bank of Kenya Monthly Economic Review for August 2005 notes that the GDP growth was 5.2 percent in 2005 up from 2.8 percent in 2003 mainly due to growth in tourism and transport and communication by 15.1 percent and 9.1 percent respectively. In the same period horticulture grew by 13.2 percent, the tea sector by 10.5 percent, manufacturing by 4.1 percent, trade by 9.5 percent and construction by 13.5 percent.

It's noteworthy that factors like drought can impact negatively on the GDP growth by affecting economic sectors especially agriculture. Terrorism affects tourism while a strong local currency affects exports like horticulture products. GDP growth rate is therefore an overall phenomenon explaining the entire economy and it is used by investors to study the suitability of the economic environment in terms of market size and returns.

Market size, measured as gross domestic product (GDP) or Gross National Income (GNI) per capita is probably the most important factor in explaining foreign direct investment (Chakrabarti, 2001). The size of a particular market may indicate the attractiveness of a specific location for the investment, in the case that MNEs aim to produce for the local market (market seeking FDI or horizontal). An overwhelming majority of empirical studies point to the importance of the linkage between GDP and FDI (Busse et al, 2005).

A positive GDP growth rate indicates a growing economic and a bigger market size hence. Likewise high (GDP or GNI) higher returns growth rates may signal high investment returns and hence may attract further foreign investment. Yet we have to keep in mind that high growth rates (and thus income levels) may be boosted by FDI, indicating the problem of endogeneity in the empirical analysis (Carkovic and Levine, 2002)

Trade

Another determinant that is likely to have an impact on FDI is openness to trade, usually measured by the ratio of imports and exports to GDP. This ratio is often interpreted as a quantification of trade restrictions (Gastanaga, 1998). According to Markussen (1995), trade barriers cause a substitution towards FDI and at the same time, they reduce the level of both trade and FDI.

In general the impact of openness to trade is linked to the type of foreign investment (Asiedu, 2002). Horizontal FDIs may be attracted by higher trade

barriers as they also protect the output of the foreign investor in the local market against imports of competitors (tariff jumping hypothesis). Conversely, MNEs engaged in export oriented investment (vertical FDI) may favour investing in a relatively open economy since trade barriers increase transaction costs. Also trade restrictions may be linked to other forms of policy imperfections, particularly in developing countries, such as exchange rate controls, leading to a reduction of foreign investment inflows.

Overall, openness to trade may thus be positively or negatively associated with FDI, depending on the country sample. The empirical evidence, on the other hand, suggests that a positive link can be expected (Chakrabarti, 2001).

Economic growth (changes in GDP levels)

Borensztain (1998) employed a data set of FDI inflows from the Organization for Economic Cooperation and Development (OECD) member countries to 69 less developed countries (LDC). The results indicate that FDI is an effective conduit of technology diffusion to LDCs as well as economic growth when there is a sufficient amount of human capital. Hence Borenzstein et.al (1998) found that FDI positively correlates with economic growth.

Similar studies by Campos and Kinoshita (2002) investigating the effects of FDIs on 25 transitional economies of the former soviet bloc indicate that FDI is a significant factor in economic growth. It must be observed that there is an endogenous problem between FDI and economic growth rate (Carkovic et al 2002).

Inflation and Interest rate

Economic survey of Kenya (2002) describes inflation as the sustained rise in money prices generally. The consumer price index (CPI) is the main estimator of the inflation rate. It is a macroeconomic indicator for general economic and social analysis and is a tool used in wage and tax negotiation and indexation. It is also a deflator of expenditure i.e. by deflating nominal values (current costs) of goods and services by the prevailing CPI, the real /constant value can be established.

The interest rates on the other hand have long been recognized as important for the economy. Periods of stable interest rates have generally been more favourable for both local and foreign investments. In Kenya, the base rate is the rate at which the Central Bank of Kenya lends to other financial institutions. Banks and other financial institutions usually follow the lead of the CBK by adopting the base rate and this in turn affects the price at which funds are made available to institutions and individuals and hence affects the investment levels by investors within Kenyan money and capital markets.

Interest rates are supposed to moderate so as to cool down inflation and also not to compromise the secondary trading of government securities. Inflation in Kenya has been on the increase from 2004. As a result of the sustained increase in fuel prices worldwide, a restructuring of the transport systems in Kenya and increases in food prices caused by drought, inflation stood at 19% by the end of March (The Standard Daily, March 31, 2005).

Monthly economic review (August 2005) notes that inflation can be controlled by stable domestic interest rates, stability of the world oil prices and good weather conditions to stabilize food prices. Inflation can also be checked by reduced growth in money supply which is expected to be closely matched with real economic growth and a government that is fully committed to a disciplined fiscal policy. High inflation leads to high exchange risk, uncertainity and macroeconomic instability.

According to Fisher et al (1978), the inflation rate is a key indicator of fiscal and monetary policies. Lower inflation means better climate for foreign investment, trade and economic growth and signals that macroeconomic policies are stable and disciplined.

Exchange rate

Cassel (1992) noted in the purchasing power parity theory that, the value of a foreign currency in terms of another depends mainly on the relative purchasing power of the two currencies in their respective countries. Thus, increased need of exportation, higher relative money income or GDP, interest rates and government expenditure will affect the foreign exchange rate. Foreign aid and the government's expenditure in Kenya for example will increase the demand for the local currency hence appreciation of the local currency (Samuelson et al, 1995).

Generally foreign exchange will be affected by the ratio of exports to imports signaling a surplus in the balance of payments if there is a differential advantage on exports to imports. Foreign and domestic

repayments will depreciate a currency while repatriation abroad of private capital will sustain depreciation. A favorable balance of trade and increased foreign exchange reserves will appreciate the local currency (Monthly Economic review, January 2006)

According to Central Bank of Kenya (CBK) report for 2004, the competitiveness of a country's exports is a function of money factors of which international value of its currency is one. If foreign demand is responsive to domestic prices, a strong currency lowers demand abroad for local goods while a weaker currency has the opposite effect. For FDIs to benefit from exchange rate differences will therefore depend on the whether the MNEs are export oriented (market seeking) or services oriented (efficiency seeking)

Trade restrictions may be linked to other forms of policy imperfections such as exchange rate controls leading to a reduction of the foreign investment inflows. A strong host country currency lowers the ability of exporting and thereby increases the chances of imbalance of trade of a nation due to a lower money reserve levels. Overall the importance of the exchange rate lies in the stability of the host country currency. Unusual appreciations and depreciations increases uncertainity on the value of goods being imported or exported hence reduced investor confidence .Exchange rate volatility has a negative influence to FDI inflow.

Government Budget Implementation

Developing countries, including Kenya, have severe debt problems which continue to depress both domestic and foreign investment. They spent significant amounts to service debt and thus end up with perennial budget deficits. These deficits are serviced by domestic and foreign borrowing that increase interest rates and uncertainties of doing business. These fiscal imbalances can be controlled by attracting FDIs to seal the deficit gap through investment in ailing public enterprises. The government can encourage more foreign investments in key sectors like transport and communication, health and education by facilitating a better business environment Strict fiscal policy can reduce government borrowing from domestic and foreign financiers which will stabilize interest rates and reduce uncertainties of doing business in Kenya.

Domestic Investments

One of the important questions often raised is whether FDI augments a host country's capital investment or crowds out domestic investment. Karbasi, et al found out that there is positive interaction between FDI and domestic investment which means that the domestic investment is not crowded out in developing countries which are usually in budget deficits and require assistance. This is a subject of scrutiny in future empirical studies.

2.3 Link between the Macroeconomic Indicators and FDI in Kenya

A considerable number of variables discussed above show relatively persistent results with respect to their influence to foreign investment. Market size, measured as Gross Domestic Product (GDP) or Gross National Income (GNI) per capita is probably the most important factor in explaining foreign investment (Chakrabati, 2001). The size of a market may indicate the attractiveness of a specific location for the investment, in the case of a multinational corporation aims to produce for the local market (horizontal or market seeking FDI). Likewise high GDP or GNI growth rates may signal high investment returns and hence may attract further foreign investment.

According to Central Bank of Kenya Annual report (2004), the Kenyan economy has experienced a swing in its growth rate. In 1995, the real GDP rate for Kenya stood at 4.8 percent, it slowed down to a negative 0.2 percent in 2000 and then picked up to 5.2 percent in 2005. The changes are mainly explained by the loss of donor confidence in the economic management of Kenya between 1995 and 2001. The change of leadership in 2002 experienced variations in various economic policy measures and introduction of Economic Recovery Strategy for Wealth and Employment Creation (ERSWEC). The growth to 5.2 percent is according to the CBK reports attributable to the restoration of the relationship with the development partners and resumption of a poverty reduction facility programme with the International Monetary Fund which revamped the sectors of education, health and agriculture. It will therefore be of interest in this study to see whether the GDP growth has been matched with an increase or decrease in the FDI flow.

Another determinant that is likely to impact on FDI is openness to trade measured by the ratio of imports and exports to GDP. This ratio is often interpreted as a quantification of trade restriction (Gastanaga, 1998). Horizontal FDIs may be attracted by higher trade barriers as they also protect the output of the foreign investor in the local market against imports of competitors (tariff jumping hypothesis). On the other hand, MNEs engaged in export oriented investment or vertical FDI may favour open economy since trade barriers increase transaction costs. Further trade restrictions may be linked to policy imperfections such as exchange rate controls. Openness to trade may therefore be either positively or negatively associated to FDI (Chakrabati, 2001).

As per the leading Economic Indicators Booklet for Central Bureau of Statistics Kenya (2006), trade opportunities have been extended with the opening to the American market for textile products under the African Growth Opportunity Act (AGOA) till 2007. The expansion of the European Union Market to include ten other countries hence the largest market bloc has similarly provided export opportunities to Kenyan products which are not charged any duty. Other positive developments likely to attract FDIs are the reversal of the adverse travel restrictions by the UK and the downgrading of the negative advice by the USA. The regional integrations like COMESA and East Africa Cooperation (EAC) have increased exports from Kenya to the regions by 55 percent or KShs 66 billion in 2005, an attractive aspect for FDIs (Daily Nation, April 22 2005).

Further, the government of Kenya has reduced the number of licenses required by foreigners to invest in Kenya. It is noteworthy though that in the years 2004/2005 the exports of goods grew by 8.4 percent while the imports grew by 19.1 percent. This narrowed the surplus in the balance of payments and as per Gastinaga (1998), a higher ratio of imports to exports may reflect a trade restriction which is inhibitive to FDI flow.

Further market attraction is enhanced if a country has consistent macroeconomic policy in place. Of importance are boosting of the growth rates of an economy by small budgets, low trade deficits, low inflation and stable interest rates in order to reduce the risk premium for foreign investment decrease transaction costs and hence boost FDI inflows.

As per the CBK annual reports, inflation rose from 2.28 percent in 2003 to 8.18 percent in 2004 and currently is 19.9 percent. This negative impact is attributable to drought that increased food prices and persistent increases in world oil prices. High inflation rate and interest rates will be expected to impact negatively on the FDI flows especially given that it increases the risk premium to FDIs.

On the fiscal front, the government has in the period 2002-2005 increased revenue collection from KShs. 160 billion to over KShs. 240 billion in 2005 which have accompanied increases in both development and recurrent expenditure. There also has been a reduced pressure on external debt servicing following a rescheduling of the debt owed to the Paris club creditors from KShs 30 billion in 2002 to 22.5 billion in 2005 (Central Bank of Kenya annual reports 2004). This is expected to create space for more

resources to be directed to infrastructure so as to attract FDIs in Kenya. The study will thus check how annual surplus or deficit as a percentage of the GDP impacts on the FDI flows in Kenya.

The research therefore will look at the following explanatory variables in a regression model: GNI per capita, stock market indices, ratio of imports and exports to GDP, inflation, interest rates, fiscal balance, external debt, degree of openness, debt service and taxation.

CHAPTER THREE

RESEARCH DESIGN AND METHODOLOGY

3.1 Research Design

This is a quantitative research utilizing secondary data sourced from;

- Economic Survey and Statistical Abstracts for the Republic of Kenya
- Central Bank of Kenya Publications
- United Nations Conference on Trade and Development(UNCTAD) Reports for 2005 and previous years
- World Bank and International Monetary Fund Publications.

The data sourced was annual in nature.

3.2 Population and Sampling Procedures

The population consists of the data of the variables identified in the literature review for Kenya. This includes GDP Data, Real exchange rate, fiscal balance, external debt, and taxation, degree of openness, debt service and stock exchange index. The Data was in Kenyan shillings and sourced annually.

The study was restricted to the Kenyan economy for the period between 1990 and 2005. This period has been judgmentally selected as it is more relevant to the current situation

3.3 The Model

Due to the fact that FDI flow depends on a number of variables, multiple linear regression is considered the best technique in determining the most important variables that influence the flow of FDI in Kenya. The model to be developed will reveal the existing relationship between the macroeconomic predictors and the flow of FDI. The model follows that of Levine and Renelt (1992) who used the initial level of income, investment rate, the secondary school enrollment rate and rate of population growth as standard variables in their regression model.

Generally, in multiple linear regression, the first step is the selection of potential predictor variables (Hanke et al, 2003). Any variable that might add to the accuracy of the model is included. After a seemingly complete list of potential predictors has been compiled, the next step is to screen out the predictor variables since a predictor variable;

- May not be fundamental to the problem, that is, there may be no plausible relationship between the predictor and the response variables,
- May be subject to large measurement errors,
- May duplicate other predictor variables thus creating the problem of multicollinearity, or

- May be difficult to measure accurately or accurate data may be unavailable or costly.

The final step is to shorten the list of predictor variables so as to obtain the best selection of variables. The calculations in multiple regression analysis are ordinarily performed using statistical software such as SPSS.

The general regression model has the response variable related to the predictor variables by;

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + ... + \beta_k X_k + \varepsilon$$

Where;

i) for the ith observation, $Y = Y_i$ and $X_1, X_2, ..., X_k$ are set values $X_{i1}, X_{i2}, ...X_{ik}$

ii) the ε's are error components that represent the deviations of the response from the true relation. They are unobservable random variables accounting for the effects of other factors on the response. The errors are assumed to be independent and each is normally distributed with mean zero and unknown standard deviation σ.

iii) the regression coefficients $\beta_1, \beta_2, ... \beta_k$ that together locate the regression function are unknown.

Given the data, the regression coefficients can be estimated using the principle of least squares.

From the predictor variables identified in the preceding sections we have the regression model expressed as;

FDI – f(Market Size, Real Exchange Rate, Fiscal Balance, External Debt, Taxation, Openness, Debt Service , Stock Exchange Index)

This can therefore be expressed as;

$FDI = \beta_0 + \beta_1$ Market Size $+ \beta_2$ Real Exchange Rate $+ \beta_3$ Fiscal Balance $+ \beta_4$ Total External Debt $+ \beta_5$ Taxation $+ \beta_6$ Openness $+ \beta_7$ Debt Service $+ \beta_8$ Stock Exchange Index $+ \beta_9$ Annual Inflation $+ \beta_{10}$ Tax from International.

Explanatory Variables

Market size

Real GDP is used as proxy. Foreign firms choose investment in countries with a bigger market and hence high returns. A positive GDP growth rate indicates a growing economy and bigger market size hence high returns.

Real Exchange Rate

Real Exchange Rate (RER) is defined as the nominal exchange rate adjusted for inflation. Exchange rate is expected to affect FDI on the firm's cash flows, expected profitability and attractiveness of domestic assets to foreign

investors. Devaluation affects profitability of local firms by raising the price levels and raising the cost of imported inputs.

Exchange rate volatility leads to high exchange risk, uncertainty and macroeconomic instability. On the other hand devaluation will increase FDI if investment is export oriented. The effect of RER cannot be determined before the data analysis.

Fiscal Balance

This refers to either surplus or deficit in the government budget. If the budget deficits are financed by domestic borrowing they will reduce FDI by increasing the opportunity cost of retained earnings through increased real interest rates. FDI will be encouraged by the deficit expansionary effects.. The effect can not be postulated till after the study.

External Debt

Most African countries have severe debt problems which depress both domestic and foreign investments .FDI can be used to substitute external borrowing to fill the gap of savings and foreign exchange. High debt will reflect need for foreign exchange through FDI.

Taxation

Taxation policy is important in the initial investment among countries. Tax revenue from international transactions as proportion of total tax revenue is

used to reflect tax burden imposed on foreign investors. The higher the taxation levels the lower the FDI. A negative relation is postulated.

Degree of Openness

Ease of investment is related to fewer restrictions of trading. Openness is the total of exports and imports. The higher imports and exports the higher the FDI thus a positive correlation is postulated.

Debt Service

Debt service can be seen to discourage both domestic and foreign investment through crowding out effect on government expenditure. There is considerable uncertainty when debt is being serviced from the countries own resources. Debt service is used capture the liquidity and solvency constraints imposed by the debt burden. The higher Debt service the greater the uncertainty and therefore less FDI.A negative correlation is postulated.

Stock Exchange Index

It is widely believed that stock market activities reflect a country's market size and growth status. It also signals to the government and investors the "feel good" factor prevailing in the economy. Annual percentage growth rates of the NSE-20 INDEX as proportion to GDP will be used. A higher ratio will be postulate greater investor confidence and therefore higher FDI.

3.4 Data Analysis Procedure

Multiple linear regression was used in the analysis of the data. SPSS version 12 software was used to carry out the analysis. Multiple linear regression is ideal in the situation where many predictor variables are considered. The challenge was to reduce the number of variables to only those which have significant influence on the response variable. The principle of least squares was used to determine the unknown coefficients in the regression model.

A thorough residual analysis was carried out to ensure that the basic assumptions of regression analysis are not violated. This includes the assumptions of independence of the error term; homoscedasticity, which refers to the error term exhibiting constancy of variance; and normality of the error term. Further, the variance inflation factors (VIF) was be used to check on the existence of multicollinearity. Multicollinearity refers to the linear relationship between two or more predictor variables. This phenomenon is not desirable in regression analysis. The F-test was used to test the relationship between the key independent and dependent variables.

CHAPTER FOUR

DATA ANALYSIS AND FINDINGS

4.1 Introduction

In this chapter, quantitative data were analysed with regard to the variables namely; FDI Inflow, GDP Growth rate, GDP Absolute Market Value, Exchange rate, Base lending rate, Fiscal Balance Total External Debt, Total Tax Revenue, Tax from International Transactions, Total Exports, Total Imports, Debt Service, NSE Index, and Annual Inflation. Data were analyzed using the SPSS version software. The backward regression approach was used in the model building. This approach allows us to evaluate all possible regression model for the given set of independent variables. The criterion used in selecting the best regression model is the one with the highest adjusted (Levine et al 2003). The findings are presented below:

4.2 Means and Standard Deviations of Variables

Table 4.2.1: Descriptive Statistics on FDI Inflows and specified macroeconomic variables.

	Mean	Std. Deviation	N
FDI Inflow	2,800,727,000.0000	2,583,721,091.63808	16
GDPGrowth Rate	2.6625	1.76404	16
GDP Absolute	682,352.3625	380,092.24620	16
Exchange Rate	61.2444	18.38213	16
BaseLending Rate	23.6113	12.84137	16
Fiscal Balance	-14.3757	11.66493	16

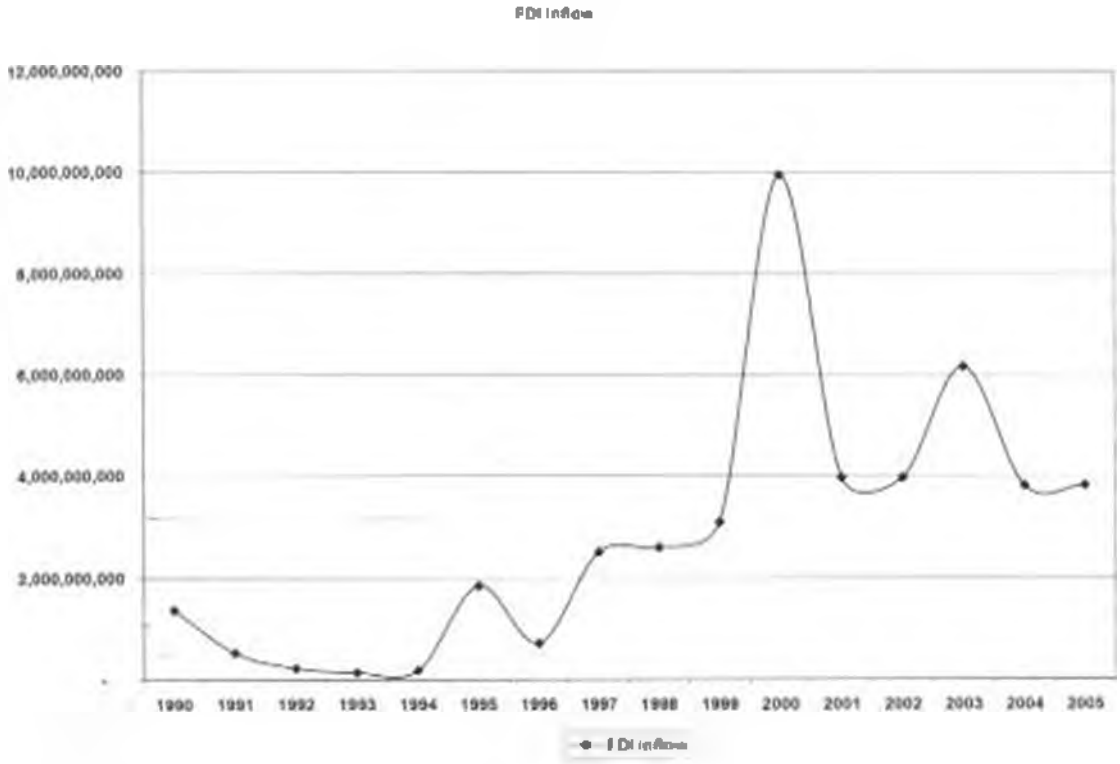
Total External Debt	316.2234	111.48933	16
Total Tax Revenue	143.8813	48.67957	16
Tax Inter Trans	36.9256	18.62165	16
Total Exports	114.2981	65.29106	16
Total Imports	179.9375	96.70157	16
Debt Service	25.1563	8.85141	16
NSE Index	2455.73938	1254.35290	16
Annual Inflation	15.25000	10.60321	16

Table 4.2.1 above shows that the data was taken through a descriptive statistics model where the mean and standard deviation of both the predictor variable and explanatory variables was done.

According to the analysis, the FDI inflow has a mean figure of Ksh 2,800,727,000.00 against a standard deviation of Kshs 23,583,721,091.63 reflecting a high variance of the data generally. This can be attributed to the volatile nature of the inflow of FDI in Kenya, in the period of study. For example in 1999, the FDI inflow to Kenya was Ksh 3,091, 200,000 while in the following year. It shot up to Kshs 9,933,378,000 according to the International Monetary Fund statistics (2003).

4.3 FDI Inflow Analysis

Graph 4.3.1 FDI Inflow to Kenya 1990 to 2005.



Graph 4.3.1 indicates the pattern of the FDI inflow over the years 1990 to 2005. Noteworthy observation here include the fact that FDI inflow tended to be low in the pre-election years of 1991, 1996 and 2001 then rose steeply in the post election years of 1995, 1999 and 2003.

These tends to reflect the fact the International Donors like IMF and World Bank the MNEs through FDIs have tended to reduce their funds flow into the country in the years prior to election because of the general fear that a lot of this funding may be relocated to support the elections rather than the funds objective. These sentiments then tend to affect the FDI inflows in the year 1991, 1996 and 2001 when the flow deteriorates drastically. This points to the direction that the FDI inflow is also strongly affected by the political atmosphere.

4.4 Correlation Analysis of the variables

Appendix I attached explains the correlation results of the variables after the analysis. According to the table, the GDP growth rate in Kenya has a negative correlation to the FDI inflow of approximately -9.3%. This is contrary to the cross-county studies done showing that GDP growth rate is a positive factor to the FDI inflow. This can be attributed to the fact that low growth rate reduces investors confidence to the government and in a desperate step to increase investors inflow and reduce budgetary gaps, the government disposed its assets in parastatals.

It's noteworthy that in the year 2000 for example, the government of Kenya disposed off 40% of its stake in Safaricom to Vodafone. Vodafone as a result paid Ksh 1.543 billion as a licence fee to Communications Commission of Kenya. Further, in the same year the government was paid by Kencell a license fee of Ksh 3.0 billion, by Kencell being a French investor in Kenya. This inflow of foreign exchange to Kenya helped to fill the budget deficit gap the government had in 2000. Further the disposal of 40% Safaricom equity to Vodafone increased FDI inflow in that year, hence the high figure of FDI inflow of kshs 9,933, 378,000 in the year 2000

Further the correlation analysis shows that, FDI inflow is positively correlated to the Total External Debt, Total imports and Total exports while it is negatively correlated to Tax on International transactions, Inflation and NSE Index.

Foreign Direct Investments (FDI) is however also negatively correlated with economic adversities like high inflation as suggested by Table 2. This results match with that identified by Wheeler (1992), Makiniski (1995) and Chakrabati (2001). This is built from the fact that inflation increases the cost of doing business and the related risks hence a disincentive for investing FDIs to Kenya.

Foreign Direct Investments is negatively related to NSE Index levels because investors are shy to invest on overpriced shares in the NSE index symbolized by the growth in the Index levels. The foreign investors will tend to buy when the prices are low and the index low, hence the low FDI in relation to NSE Index.

Table 4.4.1: Variables picked for the model

Model	Variables Entered	Variables Removed	Method
1	Annual Inflation, , NSE Index, Annual GDP in %, Total External Debt, Total Exports, Tax on International Transactions, Total Imports(a)		Enter
2		Fiscal Balance	Backward (criterion: Probability of F-to-remove >= .100)
3		Lending Rate	Backward (criterion: Probability of F-to-remove >= .100)
4		Exchange Rate	Backward (criterion: Probability of F-to-remove >= .100)
5		Absolute GDP	Backward (criterion: Probability of F-to-remove >= .100)
6		Total Tax	Backward (criterion: Probability of F-to-remove >= .100)
7		Total Imports	Backward (criterion: Probability of F-to-remove >= .100)
8		Total Exports	Backward (criterion: Probability of F-to-remove >= .100)
9		Tax on International Transactions	Backward (criterion: Probability of F-to-remove >= .100)
10		Annual GDP in %	Backward (criterion: Probability of F-to-remove >= .100)
11		Annual Inflation	Backward (criterion: Probability of F-to-remove >= .100)

a All requested variables entered
b Dependent Variable: FDI Inflow

Table 4.4.1 above presents the variables that have been analyzed that affect the FDI inflow to Kenya. Out of the eleven variables, seven variables were picked out that explain the FDI inflow to Kenya. They are inflation, Absolute GDP NSE Index, Total External Debt, Tax on International transactions, Total Imports, and Total Exports and GDP growth rate.

4.5 The Model

Following the correlation analysis done in Appendix 2 and the subsequent variables picked out, the analysis came up with the following model summary:-

Table 4.5.1 Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.906(a)	.820	.101	2449376481.466
2	.905(b)	.820	.324	2123542476.667
3	.902(c)	.813	.440	1933450859.831
4	.898(d)	.806	.515	1800092625.095
5	.894(e)	.800	.571	1691928190.175
6	.891(f)	.794	.613	1606961351.031
7	.844(g)	.712	.521	1788950419.511
8	.843(h)	.710	.566	1702892183.315
9	.812(i)	.659	.535	1762664131.983
10	.795(j)	.632	.540	1753098450.128
11	.731(k)	.534	.463	1893624099.306

The best model is the model with the highest value of the adjusted R square. Therefore model 6 has been selected

The model's predictor variables are; the Constant, Annual Inflation, NSE Index, Annual GDP in %, Total External Debt, Total Exports, Tax on International Transactions, Total Imports

The R Square value for the selected model is 0.794 which is the best among the twelve models. This implies that the model's predictor variables explain approximately 79.4 percent of the variances in FDI inflow.

Appendix II attached presents the coefficients for the model.

From the analysis of the *t* statistic of the individual predictor variable, it is seen that the Total Exports and Total Imports are not relevant in the model (*t*

values of -1.783 and 1.776 respectively) and hence these variables have been eliminated. (t critical = 1.860).

The selected model therefore becomes;

FDI inflow = $8.17E+10^{9}$ – $1.14E+10^{9}$GDP growth rate + $3.35E+10^{7}$ Total External Debt – $1.784E+10^{8}$Tax on International Transactions – $1.265E+10^{6}$NSE index – $2.219E+10^{8}$ Inflation rate

Table 4.5.2: ANOVA Analysis for the model

Model		Sum of Squares	df	Mean Square	F	Sig.
6	Regression	7947562192007590000000	7	1135366027442513000000	4.397	.027(f)
	Residual	2065859826965610000000	8	258232478370701300000		
	Total	10013422019063200000000	15			

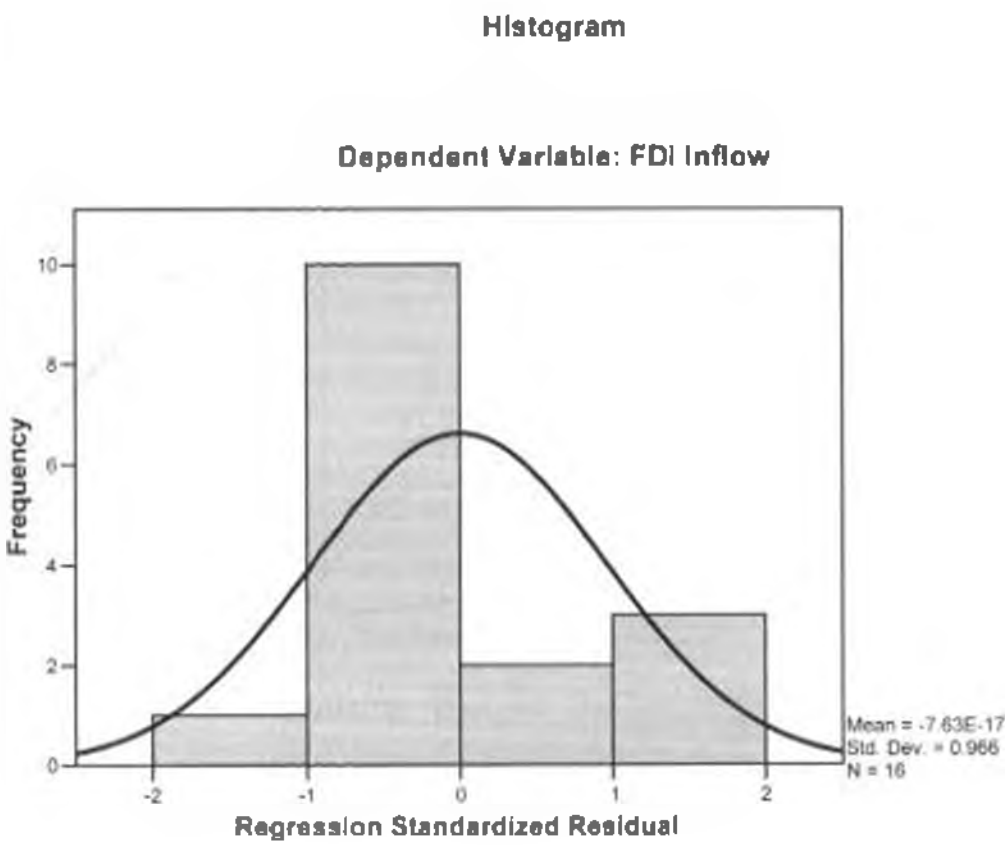
Predictors: (Constant), Annual Inflation, NSE Index, Annual GDP in %, Total External Debt, Total Exports, Tax on International Transactions, Total Imports

From the ANOVA table, it is clear that the regression model selected is significant. This is because the F value for the model (4.397) is greater than F critical (3.505). Note that $\alpha = 0.05$.

4.6 Multi-colinearity, Homoscedasticity and Heteroscedasticity

A residual analysis was arrived out to ensure that the basic assumptions of regression analysis are not violated. This includes assumptions of independence of error term, constancy of error term and normality of the error term.

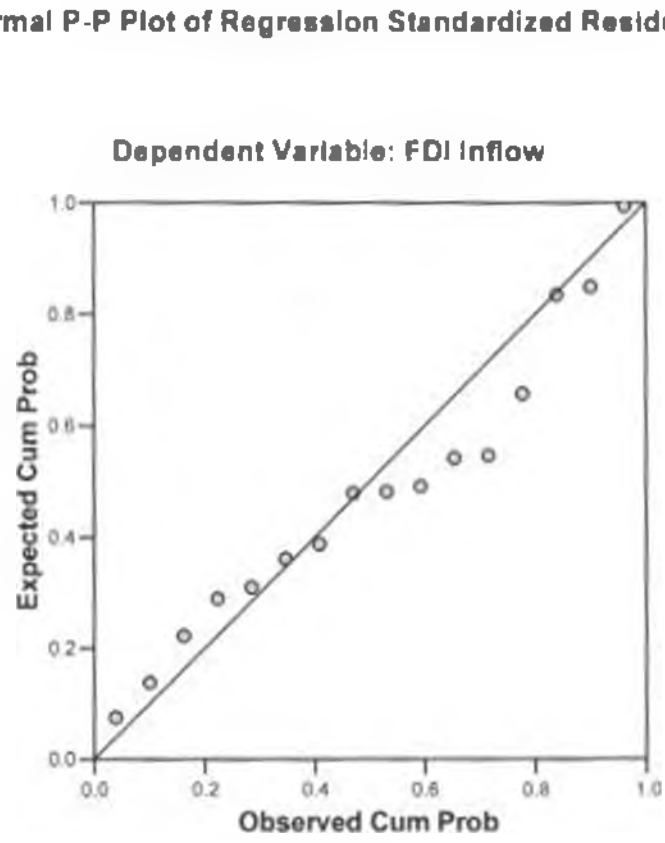
Graph 4.6.1: Normality of the Error term



The histogram shows that the assumption of normality of the error term has not been violated. This is further supported by the normal probability plot shown below. The multicolinearlity assumption has therefore not been

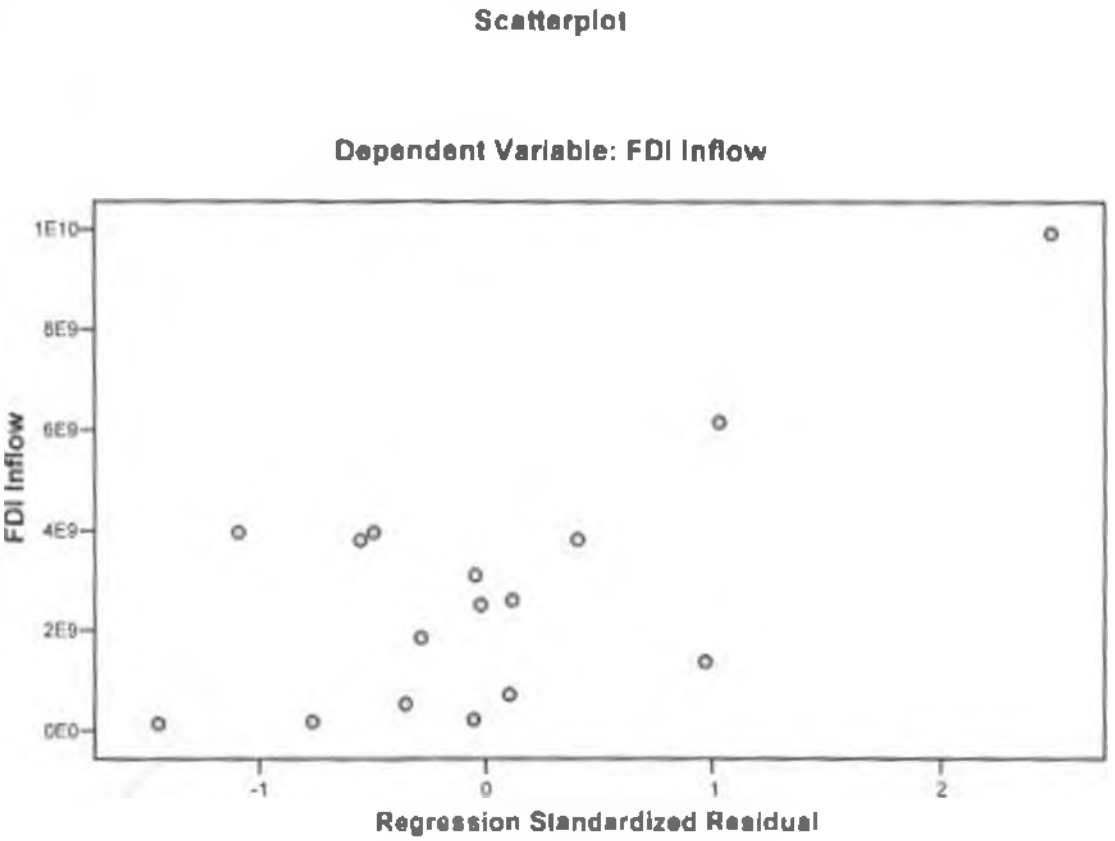
violated where there is a linear relationship between two or more predictor variables.

Graph 4.6.2: Autocorrelation



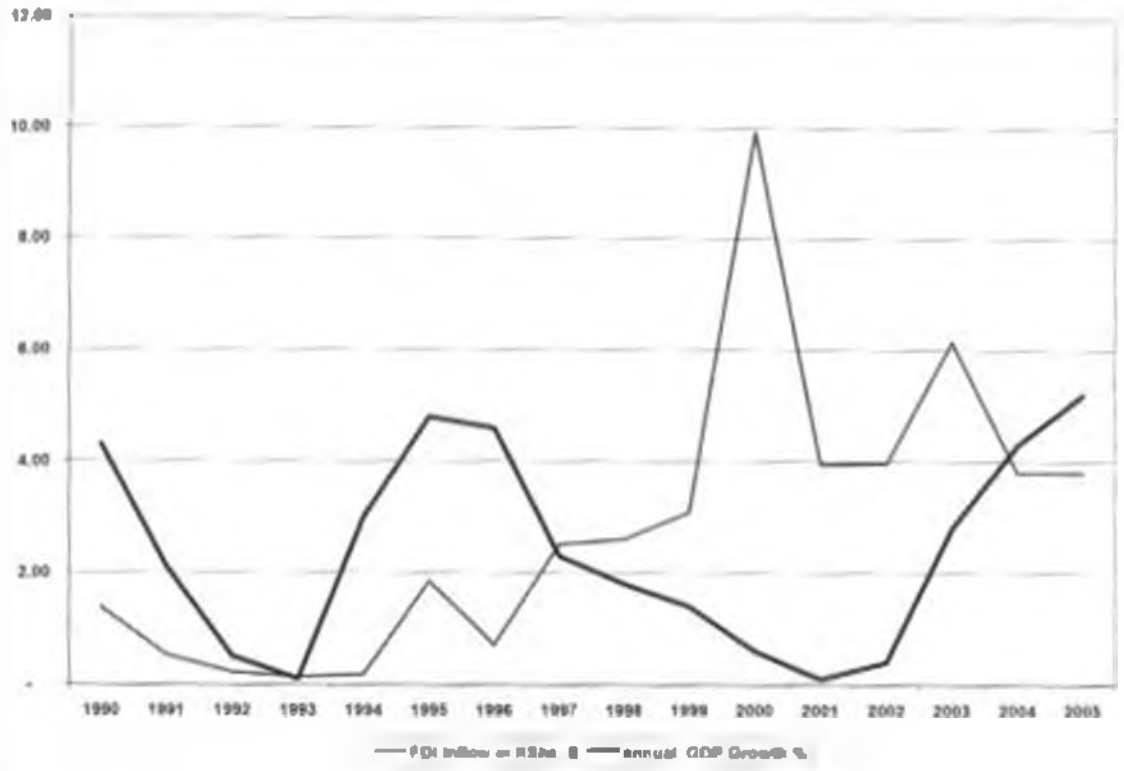
Graph indicates Normality plot of the regression model indicates the independence of the error term. It shows that the probability of the autocorrelation between the dependent variable (FDI) and the independent variables identified is low. This ensures that the problem of autocorrelation in the analysis is taken care of.

Graph 4.6.3: Scatter plot



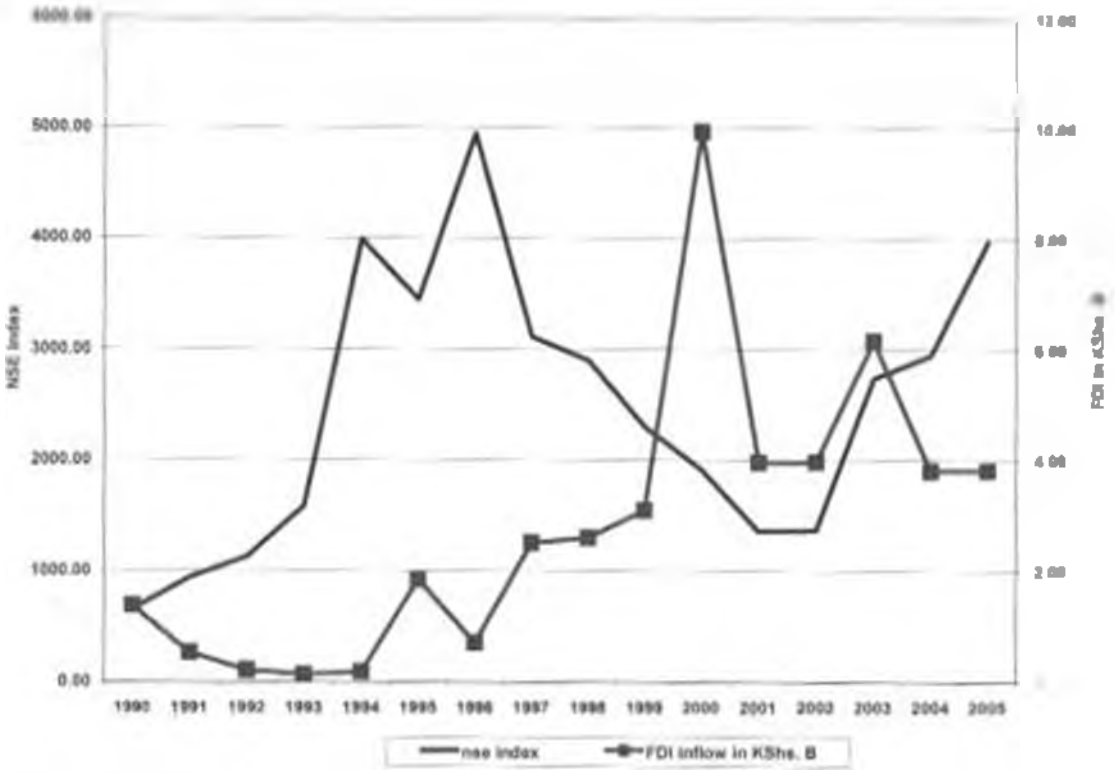
Graph 4.6.2 above indicates the residual plot does not seem to depict any apparent pattern. Thus, it can be assumed that the model has not violated the homoscedasticity assumption which refers to the error term exhibiting constancy of variance.

Graph 4.6.4 FDI Inflow and GDP growth rate



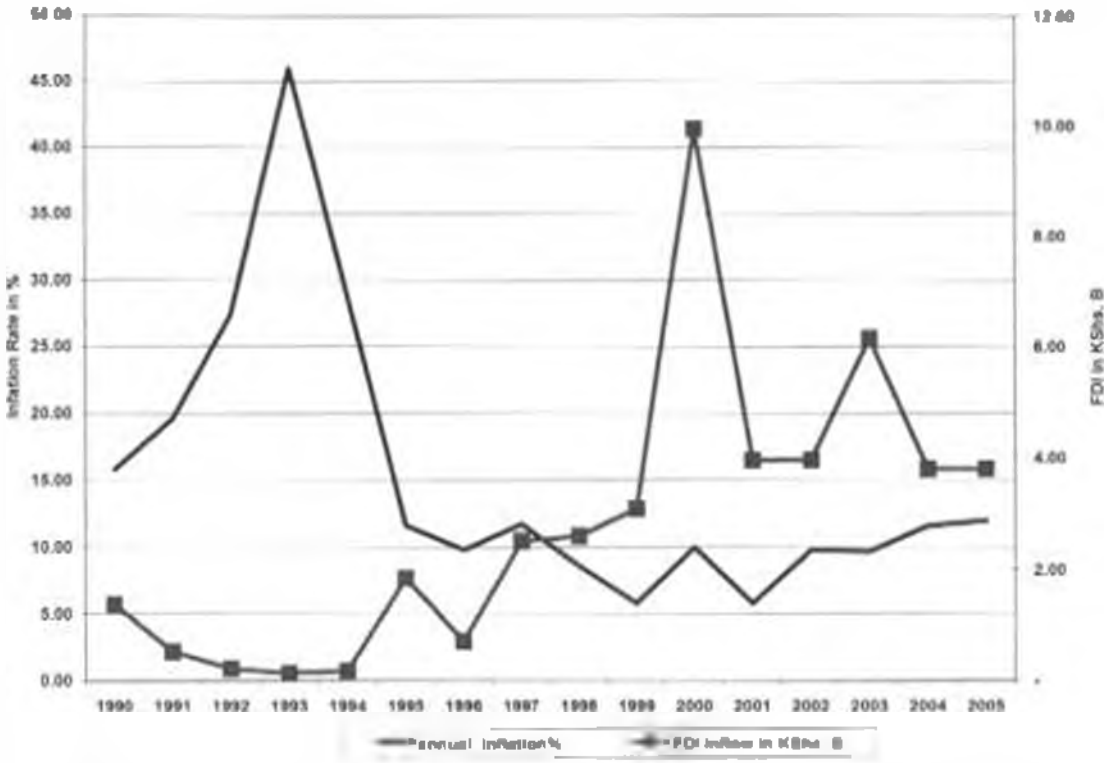
There is need for further research into the relationship between FDI inflow and GDP growth rate. This is because the relationship exhibited from this analysis seems not to be in line with expectations. FDI Inflow and GDP growth rate seems to be moving in opposite direction as can be seen from the regression equation sign.

Graph 4.6.5: FDI Inflow and the NSE Index



Graph 4.6.4 above indicates that FDI is negatively related to the rise in NSE index levels because investors are shy to invest in overpriced shares in the NSE index depicted by growth in the Index levels. The foreign investors will buy when the prices of shares are low or under-priced depicted by a low NSE Index figure. Hence the negative relationship.

Graph 4.6.6 FDI Inflow and inflation rate



From Graph 4.6.5, FDI is negatively related with economic adversities like high inflation. This is built from the fact that Inflation increases the cost of doing business and the related risks hence a disincentive for FDI inflows

4.7 Conclusions

In a nutshell, the data analysis brings out the fact that FDI Inflows to Kenya is negatively affected by high inflation figures, high taxation levels on international transactions and high NSE Index figures which depict over-priced shares. The research findings show that FDI Inflows are increased by high imports/exports levels. This is attributed to the fact that such increases depict openness to trade and markets. FDI Inflow is also positively related to increased Total external Debt attributable to the fact that increased loan facilities by the major multilateral agencies like IMF and World Bank

reflects increased confidence on the economy and hence the trickle down effect on foreign investors including MNEs which increases the FDI Inflows to Kenya. FDI inflows to Kenya are depicted as negatives affected the GDP growth rate. This is attributable to the fact that when GDP growth rate is low, there is less Donor confidence and therefore less funding from Multilateral Donors. This leads to budgetary deficit gap that pushes the government to sell its stakes on parastatals to MNEs in order to fill the budgetary gap. The trend therefore leads to higher FDI inflows to Kenya when GDP growth rate is low. An example is the year 2000 when the FDI Inflow was at a peak of Ksh nine billion while the GDP growth rate was at a low of 0.4%.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Summary

The two objectives of the study were to determine the critical macro economics indicators and their relationship to the flow of FDIs to Kenya and to develop a regression model that could be used to predict the level of FDI flow based on the identified macro economics indicators. To satisfy the objectives of the study, the secondary data was collected from established sources of Central Bank of Kenya and Central Bureau of Statistics. The data was analyzed using the SPSS software which brought out descriptive statistics, tables, histograms, means, standard deviations and a model which were used to draw conclusions on the findings.

5.2 Discussion

5.2.1 Total External Debt and Fiscal imbalance on FDI Inflow

The research findings are presented in chapter four and the following conclusions were drawn in the light of the objectives of the study.

According to findings in the previous chapter, developing countries including Kenya have severe debt problems which continue to depress both domestic and foreign investment. The Data analysis indicates that Foreign Direct Investments have been mainly attracted by a suitable business climate in Kenya i.e the importance of a suitable economic environment

The findings on this research postulate that FDI Inflow is heavily affected by the high inflation, high Taxation levels for international Transactions, high NSE Index figures which depict overpriced shares. The research findings show that FDI Inflows are increased by imports and exports figures showing increased openness to trade in Kenya.

The fiscal imbalances faced by the Kenyan government over the years has forced it to dispose its stake in the government owned parastatals to foreign investors, typical cases being Safaricom stake of 40% sold to an MNE Vodafone in 2000, Kenya Airways 50 percent state sold to KLM in 1995. This attracted huge capital flow to Kenya in 1995 of Kshs 1,846,020,000 and Kshs 9,933,378 in the year 2000, and is contrary to the theory that increased GDP growth increases FDI inflow. In the Kenya n scenario the GDP growth rate was 0.4% in 2000 while the FDI inflow was very high explained by the fact that the government when hard passed tend to dispose its stakes in parastatals to foreign investments.

Additionally the findings postulate that higher external debt levels from the major donor bodies like IMF and World Bank helps to boost the investors confidence hence higher FDI inflow through MNE'S. This is why there is a positive relationship between external debt levels and FDI inflow. For example bad relations with the World Bank and IMF between 1991 to 1994 led to low FDI flow in those years and subsequently the less FDI flow in those years.

5.2.2 Pre/post elections and FDI Inflow

It has also been noted from the study that FDI inflows tended to be going down in the pre-election period meaning that lack of investor confidence and uncertainties brought by leadership changes in the pre-election years 1991, 1976, and 2002 played a big role in the fall of the FDI inflow in 1992 to Ksh 217,260,000 from 527, 716,000 in 1991, fall of FDI inflows from Ksh 1,846,020,000 in 1995 to 715, 260,000 in 1996 and a fall in FDI levels from Ksh 9,933,378,000 in 2000 to Ksh 3,960,936,000 in 2001, all these being prediction years. The donors uncertainty and worries that much of the money borrowed by the government in the pre- election years might be used for election campaigns meant loss in IMF and World Bank support and hence this little investor confidence trickled down to less MNE's confidence to bring in FDI to Kenya. Indeed, the FDI inflow to Kenya has been highly twisted with election years. In immediate post election period of 1995 and 2003, it is noted that FDI inflow to Kenya increased to Ksh 1,846,020 and Ksh 6,150,330,000 respectively.

5.2.3 Government divestiture and FDI Inflow

Further it is noted from the FDI trend that in the latter years from 1995 onwards, the government with the assistance of world financial bodies came up with restructuring programs that emphasized in the need of the government to privatize most of their interest private investments and concentrate on provision of services. Subsequently the government in 1995 sold part of its shareholding in Kenya Airways to KLM of 50% stake hence the high level of FDI Inflow in 1995 of Kshs 1,846,020,000. in the subsequent years the government sold to the public including foreigners it

equity stake in Kenya Airways (1998), Mumias Sugar (2000), Kenya Commercial Bank (2001), KenGen (2006), Safaricom (2000). These investments in the aforesaid period increased the FDI Inflows to Kenya through equity investment by donors.

5.3 Conclusions

The Data Analysis has depicted that increased cost of doing business in Kenya through high inflation and taxation costs are the main impediment of reduced FDI inflows to Kenya. This is captured in the years 1991 to 1994 when the inflation reached a peak of 46% while FDI was at its lowest. Inflation and higher taxation are therefore a disincentive for FDI inflows to Kenya..

Further, the analysis has captured the fact that the other factors notably the pre and post election fever highly affects the flow of the FDIs i.e. the multilateral donors will tend to reduce their assistance before the elections in fear of misuse of funds and release them soon after. This had a trickle down effect on the MNEs confidence to bring in more funds hence the fall of FDIs in 1991, 1996 and 2002 and their rise in 1998 and 2003.

Also, it has been noted that through the government divestiture program, which started in 1995 improved the flow of FDIs to Kenya through agreements with MNEs i.e. Safaricom/Vodafone, Kenya Airways Commercial Bank and Kenya Airways. This distinctly improved FDI inflows figures in 1996, 1998 and 2002.

Its noteworthy though that the government divestiture program was driven by the fact that they had budgetary deficits rather than the fact that they were creating an environment to attract FDIs. Indeed the flow of FDI into Kenya according to the Standard Daily of 23 August 243 August 2006, has deteriorated in 2004 and 2005 to the advantage of the neighbours Uganada and Tanzania because of the poor state of the infrastructure and high cost of doing business through inflation and taxation which drives even Kenyan investors away to the negihbouring countries. The Daily paper reported that Kenya only attracted 46 new investors in 2005 compared to 237 of Uganda and 270 new investments in Tanzania.

In a nutshell, FDI inflow in Kenya has largely been dependent to a multifaced number of causes. The research draws the overall conclusion that high inflation and taxation causes lower FDI Inflow while higher imports and exports levels increase FDI inflow. This high FDI inflow however are fundamentally caused by underlying reasons notably, political reasons(pre/post election) government divestiture programs aimed at reducing budget deficits and improvement in the state of infrastructure that decreases the cost of doing business in Kenya.

The FDI inflow analysis further brings out the fact that high NSE Index figures do not translate to more FDI inflow rather they depict that the NSE market shares are overpriced and therefore most foreign investors will shy away and wait for a bearish market showing that they are looking for under priced shares.

Further it has been observed that FDI inflows to Kenya is positively related to imports and exports depicting that there is openness to trade and markets. Also higher total external debts attributable to increased loan facilities by the major multilateral agencies like IMF and World Bank reflects increased donor confidence to the economy and this trickles down to foreign investments through MNEs. Hence increased Multilateral lending increases FDI inflows in Kenya depicted by the periods 1995, 1996 and 2003.

5.4 Limitations of the study

The extent of the study was limited to varying data collected from different sources hence the reliability and accuracy of data on the variables was a major hiccup. Also, improperly kept data on the macro economic variables in the Central Bureau of Statistics meant that data collection took longer because it had to be cross checked to other sources of the same data. This time impediment limited the degree of analysis of the data.

5.5 Recommendations for further research

FDI inflows are very important in creating wealth in the country through job creation, a stable economy and poverty levels. Future research can be carried out on how various economic sectors like agriculture, tourism, transport and communication impact on FDI inflow to Kenya. The effect of corruption on FDI inflow to Kenya is also an area of probable study. Further research can be done on the relationship between FDI inflow to Kenya and the Stock market performance.

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Appendix I: Pearson Correlation Analysis of the variables

		FDI Inflow	Annual GDP in %	Absolute GDP	Exchange Rate	Lending Rate	Fiscal Balance	Total External Debt	Total Tax	Taxoninternation Transactions
Pearson Correlation	FDI Inflow	1.000	- 093	639	.673	- 439	- 310	573	509	556
	Annual GDP in %	- 093	1 000	284	017	- 404	004	.227	344	-.027
	Absolute GDP	639	284	1 000	.850	- 435	- 592	.790	885	505
	Exchange Rate	673	.017	850	1 000	- 097	- 431	929	887	758
	Lending Rate	- 439	- 404	-.435	-.097	1 000	015	-.091	- 231	- 163
	Fiscal Balance	- 310	004	-.592	- 431	015	1.000	-.251	- 344	030
	Total External Debt	573	.227	.790	929	-.091	-.251	1.000	927	708
	Total Tax	509	344	885	.887	- 231	- 344	927	1 000	665
	Tax on International Transactions	556	-.027	505	.758	- 163	.030	.708	665	1 000
	Total Exports	.635	.164	969	876	-.311	- 562	797	887	561
	Total Imports	622	257	947	889	- 308	- 498	836	924	663
	NSE Index	- 044	495	324	333	021	.089	573	621	270
	Annual Inflation	- 548	-.391	-.550	- 429	735	-.003	- 424	-.513	- 673

Appendix II : Coefficients for the model

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig	Correlations			Collinearity Statistics	
		B	Std. Error	Beta			Zero-order	Partial	Part	Tolerance	VIF
6	(Constant)	8171375870.995	3311724116.113		2.467	.039					
	Annual GDP in %	-1140385392.932	476826132.348	-.779	-2.392	.044	-.093	-.646	-.384	.243	4.110
	Total External Debt	33520421.075	12014502.625	1.446	2.790	.024	.573	.702	.448	.096	10.422
	Tax on International Transactions	-178390498.300	79731224.236	-1.286	-2.237	.056	.556	-.620	-.359	.078	12.805
	Total Exports	-85733967.736	48076870.330	-2.167	-1.783	.112	.635	-.533	-.286	.017	57.235
	Total Imports	58648270.010	33023916.650	2.195	1.776	.114	.622	.532	.285	.017	59.239
	NSE Index	-1265482.710	543604.390	-.614	-2.328	.048	-.044	-.635	-.374	.370	2.701
	Annual Inflation	-261851531.813	93034362.868	-1.075	-2.815	.023	-.548	-.705	-.452	.177	5.653

a. Dependent Variable: FDI Inflow