

**THE IMPACT OF FOREIGN DIRECT INVESTMENT ON ECONOMIC GROWTH
IN KENYA**

BY:

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DECLARATION

Student's Declaration

This research project is my original work and has not been submitted to any other University or institution of higher learning for any academic award.

Signed í í í í í í í í í í í í í í í í Date í í í í í í í í í í í í í ..

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Supervisor's Declaration

This research project has been submitted for examination with my approval as the University Supervisor.

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Dedication

This research project is dedicated to my parents, Michael and Teresa, who have unwaveringly supported me during the time I developed this paper. I also dedicate it to my siblings, Solomon, Catherine and Romano for being there every step of the way.

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I have taken efforts in this project. However, it would not have been possible without the kind support and help of many individuals and organizations. I would like to extend my sincere thanks to all of them.

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Abstract

The general benefits of foreign direct investment (FDI) for emerging economies are well documented. Given the appropriate host-country policies and a basic level of development, various studies show that FDI results in technology spillovers, enables human capital formation, improves international trade integration, helps create a more competitive business environment and improves enterprise development. All of these result in higher economic growth, which is a crucial tool for alleviating poverty in developing countries. This study explores the impact of foreign direct investment on the Kenyan economy using FDI and GDP inflow data series from 1982 to 2012. The Statistical Package for Social Sciences was used to analyse the data where descriptive analyses, frequencies and trend analysis, as well as inferential analyses involving Analysis of Variance (ANOVA) and Correlation analysis to establish relationships between the variables.

Graphical trend analysis of FDI and GDP reveals a direct positive relationship between the two variables. The Pearson correlation was computed for GDP and FDI inflow data series resulting in a correlation coefficient of 0.565 at the 0.001 (2 tailed) significance level which indicates a strong positive correlation between the variables; this in turn means that there is a significant direct proportional relationship between foreign direct investment and economic growth in Kenya.

These findings have led to the conclusion that the impact of foreign direct investment on the Kenyan economy is a positive one. As such, we can say that FDI promotes economic growth and suggest that the Kenyan government embrace policies that aim to attract more foreign direct investment while micro-managing the same to avoid the negative impacts of FDI on local firms such as crowding out.

Table of Contents

DECLARATION.....	ii
Dedication.....	iii
Acknowledgements	iv
Abstract.....	v
List of Figures and Tables	vii
ABBREVIATIONS.....	viii
CHAPTER ONE: INTRODUCTION	1
1.1 Background of the Study.....	1
1.1.1 Foreign Direct Investment	1
1.1.2 Economic Growth	3
1.1.3 Foreign Direct Investment and Economic Growth	4
1.1.4 Foreign Direct Investment and Economic Growth in Kenya.....	5
1.2 Statement of the Problem	6
1.3 Objectives of the Study	8
1.4 Significance of the Study	8
CHAPTER TWO: LITERATURE REVIEW	9
2.1 Introduction	9
2.2 Theoretical Literature Review	9
2.2.1 Solow Type Growth Theory	9
2.2.2 Endogenous Growth Theory.....	10
2.2.3 Neoclassical Theory	10
2.2.4 Economic Geography Theory.....	11
2.2.5 The Eclectic Paradigm Theory.....	11
2.2.6 Conclusions	12
2.3 Empirical Literature Review	13
2.4 Conclusions	21
CHAPTER THREE: RESEARCH METHODOLOGY	23
3.1 Introduction	23
3.2 Research Design	23
3.3 Population	23
3.4 Sample.....	24

3.5 Data Collection	24
3.6 Data Analysis	24
3.7 Data Validity & Reliability	25
CHAPTER FOUR: DATA ANALYSIS, RESULTS & DISCUSSION.....	26
4.1 Introduction	26
4.2 Data Presentation	26
4.2.1: Descriptive Analyses.....	26
4.2.2: Inferential Analyses	28
4.3: Summary and Interpretation of Findings	32
CHAPTER FIVE: SUMMARY, CONCLUSIONS AND RECOMMENDATIONS	35
5.1: Summary	35
5.2: Conclusions	36
5.2: Policy Recommendations.....	37
5.3 Limitations of the Study.....	38
5.4 Suggestions for Further Studies.....	38
REFERENCES	40
Appendices.....	47
Appendix 1.1: Table 4.2.1.....	47

List of Figures and Tables

Figure 1 FDI inflow into Kenya.....	27
Figure 2 Trend Analyses for GDP & FDI.....	28
Figure 3 Curve fit for GDP & FDI.....	31
Table 1 Summary Statistics	26
Table 2 Descriptive Statistics.....	27
Table 3 Correlation analyses (GDP & FDI).....	29
Table 4 Correlation coefficients for the variables	30

ABBREVIATIONS

AERC ó African Economic Research Consortium

CBK ó Central Bank of Kenya

DWH ó Durbin-Wu-Hausman

FDI ó Foreign Direct Investment

FOE ó Foreign Owned Enterprises

GDP ó Gross Domestic Product

IMF ó International Monetary Foundation

M&A ó Mergers and Acquisitions

MDGs ó Millennium Development Goals

MNCs ó Multinational Corporations

MNEs ó Multinational Enterprises

NEPAD ó New Partnership for Africa's Development

OECD ó Organization for Economic Co-operation and Development

OLI ó Ownership, Location and Internalization

R&D ó Research and Development

SAPs ó Structural Adjustment Programmes

SPSS ó Statistical Package for Social Sciences

TNCs ó Trans National Corporations

UK ó United Kingdom

UNCTAD ó United Nations Conference on Trade and Development

US ó United States

VAR ó Vector Auto Regression

CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

Most countries strive to attract foreign direct investment (FDI) because of its acknowledged advantages as a tool of economic development. Africa and Kenya in particular, joined the rest of the world in seeking FDI as evidenced by the formation of the New Partnership for Africa's Development (NEPAD), which has the attraction of foreign investment to Africa as a major component (AERC Research paper 165).

Undoubtedly Africa and indeed Kenya is facing an economic crisis situation featured by inadequate resources for long-term development, high poverty level, low capacity utilization, high level of unemployment, and other Millennium Development Goals (MDGs) increasingly becoming difficult to achieve by 2020. Promoting and facilitating technology transfer through foreign direct investment (FDI) has assumed a prominent place in the strategies of economic revival and growth being advocated by policy makers at the national, regional and international levels because it is considered to be the key to bridging the technology and resource gap of underdeveloped countries and avoiding further build-up of debt (UNCTAD, 2005).

Given this development, Ikiara (2002), UNIDO (2002), UNCTAD (1997) recognize and emphasize the significance of FDI in providing technological know-how, capital, management and marketing skills, facilitating access to foreign markets and generating both technological and efficiency spillovers to local firms provided the right policy and business conditions are available. By facilitating access to the above, FDI is expected to improve the integration of the Kenya's economy into the global economy, and further spurring economic growth through technological advancement.

1.1.1 Foreign Direct Investment

Foreign direct investment is a phenomenon resulting from globalization, which involves the integration of the domestic economic system with global markets. It is accomplished through opening up of the local economic sector as well as domestic capital for foreign investors to establish business, within the economy. Historically, technological advancement led to the emergence of better means of transport and communication. These in turn led to the movement of investors beyond political boundaries, especially during the post-colonial

period (Pritchard, 1996). Even after nations acquired independence, globalization continued to influence trade between investors and foreign countries, whereby the less developed countries were supported by the developed nations to acquire materials and equipment to extract and utilize the available natural resources for economic development (Sacerdoti, 1997). However, the equipment needed the appropriate skills to ensure that less developed countries were able to utilize to their full potential. As economies expanded, trade grew and exchange of goods and services continued to advance. With the less developed economies possessing plenty of raw materials for industries abroad, foreign investment was inevitable, as industries from developed economies sought to establish in the less developed countries where raw materials were available (Sornarajah, 2004).

FDI is defined as a cross-border investment in which a resident in one economy (the direct investor) acquires a lasting interest in an enterprise in another economy (the direct investment enterprise). The lasting interest implies a long-term relationship between the direct investor and the direct investment enterprise and usually gives the direct investor an effective voice, or the potential for an effective voice, in the management of the direct investment enterprise. By convention, a direct investment is established when the direct investor has acquired 10 percent or more of the ordinary shares or voting power of an enterprise abroad.

The lasting interest in a direct investment enterprise typically involves the establishment of manufacturing facilities, bank premises, warehouses, and other permanent or long-term organizations abroad. This may involve the creation of a new establishment or investment (Greenfield investments), joint ventures, or the acquisition of an existing enterprise abroad (cross-border mergers and acquisitions). The investment can be incorporated or unincorporated and includes, by convention, ownership of land and buildings by individuals. Direct investment comprises not only the initial transaction establishing the FDI relationship between the direct investor and the direct investment enterprise, but all subsequent transactions between them and among affiliated enterprises. Thus, the direct investment relationship extends beyond the original direct investor and includes foreign subsidiaries and affiliates of the direct investor that are part of the ðparent group.ö

Once FDI is established, increases in FDI can take the form of injections of additional equity capital, the reinvestment of earnings not distributed as dividends by subsidiaries or associated enterprises and undistributed branch profits, and various intercompany claims, such as the

extension of suppliers' credits or loans, all of which represent FDI capital. These transactions cover only one aspect of financing available to direct investment enterprises that can also expand their operations by borrowing in local markets and in international capital markets (with or without the guarantee of direct investors).

Nevertheless, foreign investment does not come devoid of some negative aspects. There is normally the tendency for over utilization of the available natural resources, as the companies strive to maximize profits in their venture (Colen et al. 2009). The 'tragedy of the commons' whereby many organizations compete to utilize a shared resource leads to degradation of natural resources as well as environmental pollution, which have largely been associated with the issue of climate change (Sindre, 2011). Importation of capital intensive and outdated technology, Exploitation of local labour, Increase in local wage cost through payment of high wages by MNC affiliates, Contribution to economic leakage (and deterioration of balance of payments) through preference of imported inputs to local ones, Lack of linkages with local communities, that is, development of 'enclaves', Adverse effects on competition in the national market, Use of transfer prices to escape local taxes and to cheat local partners on returns, Encouragement of corruption, Pollution of the environment, especially in extractive and heavy industries, Social disruptions associated with accelerated commercialization and creation of tastes for expensive foreign consumer goods and Political dependency on FDI source countries and, therefore, loss of sovereignty.

1.1.2 Economic Growth

Economic development is a process whereby an economy's real national income as well as per capita income increases over a long period of time. Here, the process implies the impact of certain forces which operate over a long period and embody changes in dynamic elements. It contains changes in resource supplies, in the rate of capital formation, in demographic composition, in technology, skills and efficiency, in institutional and organizational set-up. It also implies respective changes in the structure of demand for goods, in the level and pattern of income distribution, in size and composition of population, in consumption habits and living standards, and in the pattern of social relationships and religious dogmas, ideas and institutions. In short, economic development is a process consisting of a long chain of inter-related changes in fundamental factors of supply and in the structure of demand, leading to a rise in the net national product of a country in the long run.

The process of economic growth is a highly complex phenomenon and is influenced by numerous and varied factors such as political, social and cultural factors. As such economic analysis can provide only a partial explanation of this process. "Economic development has much to do with human endowments, social attitudes, political conditions and historical accidents. Capital is a necessary but not a sufficient condition of progress" Prof. Ragnar Nurkse. The supply of natural resources, the growth of scientific and technological knowledge-all these too have a strong bearing on the process of economic growth.

1.1.3 Foreign Direct Investment and Economic Growth

The main idea underlying the FDI liberalization policies of many developing countries and the FDI promotion efforts of international donors such as the World Bank and the IMF is the notion that FDI inflows foster economic growth. As FDI is a composite bundle of capital stocks, know-how, and technology, its impact on economic growth is expected to be manifold (De Mello, 1997; Dunning, 1992). In the ways through which FDI can affect economic growth we can distinguish direct and indirect effects.

Theoretical arguments assign a key role for FDI in economic growth. While these theoretical arguments are quite straightforward and widely accepted, the empirical evidence is much more ambiguous, or as De Mello (1997) puts it: "whether FDI can be deemed to be a catalyst for output growth, capital accumulation, and technological progress, seems to be a less controversial hypothesis in theory than in practice". The empirical macro-economic literature shows a clear link between FDI and GDP growth but the direction of causality is not always clear (Carkovic and Levine, 2002; Nunnenkamp, 2004). Also when the heterogeneity of the host economies is recognized in empirical studies, the link between FDI inflows and growth becomes ambiguous (Nunnenkamp and Spatz, 2004).

Economic theory predicts FDI to create growth multiplier effects through vertical and horizontal spillover effects; including the transfer of technology and know-how to domestic firms, the formation of human capital, etc. The empirical evidence casts doubt on the intensity of horizontal (or intra-industry) spillover effects but provides overall convincing evidence on the existence and the importance of vertical (or inter-industry) spillover effects, in the manufacturing as well as the agricultural sector (Liesbeth et al., 2008).

The consensus in the literature seems to be that FDI increases growth through productivity and efficiency gains by local firms. The empirical evidence is not unanimous; however,

available evidence for developed countries seems to support the idea that the productivity of domestic firms is positively related to the presence of foreign firms (Globeram, 1979). The results for developing countries are not so clear, with some finding positive spillovers (Blomstrom, 1986) reporting limited evidence. Still others find no evidence of positive short-run spillover from foreign firms. Some of the reasons adduced for these mixed results are that the envisaged forward and backward linkages may not necessarily be there (Aitken et.al. 1997). Further, the role of FDI in export promotion remains controversial and depends crucially on the motive for such investment (World Bank, 1998).

1.1.4 Foreign Direct Investment and Economic Growth in Kenya

Economists argue that FDI can help to fill an idea gap between developed and developing, or host, countries and provide greater opportunities for growth in the host markets (Romer 1993). In this regard, inward FDI represents a particularly important potential source of capital for developing countries and in particular Kenya, as FDI usually entails the importation of financial and human capital by the host economy with measurable and positive spillover impacts on host countries' productivity levels (Holland and Pain, 1998a).

The general benefits of FDI for emerging economies are well documented. Given the appropriate host-country policies and a basic level of development, various studies show that FDI results in technology spillovers, enables human capital formation, improves international trade integration, helps create a more competitive business environment and improves enterprise development. All of these result in higher economic growth, which is a crucial tool for alleviating poverty in developing countries. New data from firm surveys in Kenya, Tanzania, and Uganda suggest that there are important positive effects from FDI for both the host economies and the workers in foreign-owned firms (Todd et al. 2004).

FDI can contribute in significant ways to breaking of the growth-poverty vicious circle, and therein lies Africa's hope. The continent hopes that FDI can make up for domestic capital shortfalls; provide technology, management and marketing skills; facilitate access to foreign markets; and generate both technological and efficiency spillovers to local firms. By providing access to external markets, transferring technology, and building capacity in the local firms generally, FDI is expected to improve the integration of the continent into the global economy, spur economic growth and alleviate poverty (Ikiara, 2002).

1.2 Statement of the Problem

From a global perspective, the relationship between FDI and economic growth, and the stability of this growth, is a central consideration as host countries evaluate the trade-offs associated with foreign entry. This has been considered in the context of longer term performance, stemming from the argument by Romer (1993) that an idea gap has held back growth in emerging markets. If an idea gap has impeded growth, FDI can induce a catch-up process. The most robust evidence on FDI and aggregate growth is found in studies of developing countries. For example, analyses of inward investments to Greece, Taiwan, Indonesia, and Mexico show a significant positive contribution to these countries' growth. Research using detailed industry-level data finds that growth spillovers across industries depend on the industries into which FDI flows. The spillovers and growth ramifications are expected to be strongest when foreign affiliates and local firms compete most directly with each other, as may be the case in previously protected industries.

Borensztein, DeGregorio, and Lee (1998) find positive threshold effects between FDI and growth, with human capital accumulation in the host country needing to be sufficiently large before countries can reap the beneficial growth effects of the foreign inflows. Studies of financial sector FDI effects conclude that growth may expand both through the technology transfer channel and through improved intermediation of capital flows between savers and investment opportunities. Cross-country growth regressions reach the broader finding that financial development improves economic growth. Demirguc-Kunt and Maksimovic (2002), however, find no evidence that country differences in economic growth can be explained by distinguishing countries by financial structure (that is, bank-based versus market-based structures).

One key feature of today's globalization drive is conscious encouragement of cross-border investments, especially by Multinational corporations and firms (MNCs). Many countries and continents (especially developing) now see attracting FDI as an important element in their strategy for economic development. This is most probably because FDI is seen as an amalgamation of capital, technology, marketing and management. Sub-Saharan Africa as a region now has to depend very much on FDI for so many reasons, some of which are amplified by Asiedu (2001). The preference for FDI stems from its acknowledged advantages (Sjoholm, 1999; Obwona, 2001, 2004). The effort by several African countries to improve their business climate stems from the desire to attract FDI. One of the pillars on which the

New Partnership for Africa's Development (NEPAD) was launched was to increase available capital to US\$64 billion through a combination of reforms, resource mobilization and creating a conducive environment for FDI (Funke and Nsouli, 2003). Unfortunately, the efforts of most countries in Africa to attract FDI have been futile. This is in spite of the perceived and obvious need for FDI in the continent. The development is disturbing, sending very little hope of economic development and growth for these countries. Further, the pattern of the FDI that does exist is often skewed towards extractive industries, meaning that the differential rate of FDI inflow into sub-Saharan African countries has been adduced to be due to natural resources, although the size of the local market may also be a consideration (Morriset 2000; Asiedu, 2001).

In consideration of studies conducted in Kenya, whether foreign direct investment leads to economic growth is still a debatable one. What is clear is that the relationship may be significant or insignificant depending on the country under study, type of investments, the adjective of the donor country, the implementation policy of the recipient country, the methodology used, and the period of study (Musau, 2009). A sound industrial policy is necessary for economic growth and development; such a policy should encompass FDI policies (promotion and entrenchment) targeted at sectors where MNC presence would be advantageous to the country's industrialisation effort (Gachino, 2009). The impact of FDI on economic growth and, therefore, poverty reduction is not clear in Africa. Indeed, even managers of African investment promotion agencies do not fully understand how and why foreign investors make the choices they do (Ikiara, 2003).

This paper makes a number of contributions to the relevant literature. First, it explores the determinants of both inward and outward FDI in Kenya. Previous studies have focused exclusively on the determinants of inward FDI. Second, the sample of years under consideration is larger than in other studies that have examined the effects of FDI on Kenya's economy. Third, in seeking to identify the determinants of inward and outward FDI, particular attention is paid to measures of governance and institutional change, including privatization. In this respect, this study is distinguished from earlier studies. Nonetheless, this study examines the relationship between FDI inflows and Kenya's economic growth, hence addressing the country's specific dimension to the FDI-growth debate. In addition, the effect of the major components of FDI on economic growth is examined, thereby offering the

opportunity to assess the differential impact of Greenfield FDI and M&A FDI on Kenya's economic growth.

1.3 Objectives of the Study

The main objective of the study is to establish the relationship between Foreign Direct Investment and economic growth in Kenya.

1.4 Significance of the Study

This study will be significant in the sense that Kenya has experienced a decreasing trend of FDI inflows over the years. It should be noted that FDI inflows to Kenya is very crucial because it serves as a source of capital and given that foreign aid has been dwindling over the years. This study is important in the sense that FDI stimulates domestic investment, promotes economic growth and creates employment opportunities.

The findings of this study will be significant to both academicians and policymakers in the following way; first, it will add to the knowledge of the researchers in this field of study and secondly, it will serve as a guide to both policy makers and academicians.

The results would encourage policy makers to design and to follow the pro-FDI policies in developed, developing and the least developed countries. The results would also provide strong evidence to policy-makers to work for a better institutional quality for growth and development.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

The empirical evidence on FDI and economic growth is ambiguous, although in theory FDI is believed to have several positive effects on the economy of the host country (such as productivity gains, technology transfers, the introduction of new processes, managerial skills and know-how, employee training) and in general it is a significant factor in modernizing the host country's economy and promoting its growth. Especially for the developing countries, the recent global changes in the 1990s, have led them to look favourably at the various FDI's because it is believed that they can contribute to the economic development of the host country. Hence, we focus on this subject in our present study to investigate further the effects of FDI on the host country's growth.

2.2 Theoretical Literature Review

2.2.1 Solow Type Growth Theory

The role of foreign direct investment (FDI) in stimulating economic growth is one of the controversial issues in the development literature. In the standard Solow type growth model, FDI enables host countries to achieve investment that exceeds their own domestic saving and enhances capital formation. According to this theory, the potential beneficial impact of FDI on output growth is confined to the short run. In the long run, given the diminishing marginal returns to physical capital, the recipient economy could converge to the steady state growth rate as if FDI had never taken place leaving no permanent impact on the growth of the economy (De Mello, 14).

Mankiw (2003) applying the Solow growth model argues that private businesses invest in traditional types of capital such as bulldozers and steel plants and newer types of capital such as computers and robots. On the other hand, government invests in various forms of public capital, called infrastructure, such as roads, bridges and sewer systems. Mankiw further argues that policy makers trying to stimulate growth must confront the issue of what kinds of capital the economy needs most. In other words, what kind of capital yields the highest marginal products?

2.2.2 Endogenous Growth Theory

On the other hand, endogenous growth models (e.g. Romer, 28; Lucas, 24; and Barro and Sala-i-Martin, 7) that highlight the importance of improvement in technology, efficiency, and productivity suggest that FDI can positively influence the growth rate in so far as it generates increasing returns in production via externalities and production spillovers.

On further theoretical arguments why developing countries may not gain from FDI; Krugman, argues that the transfer of control from domestic to foreign firms may not always be beneficial to the host countries because of the adverse selection problem. FDI undertaken within a crisis situation under "Fire Sale" may transfer ownership of firms from domestic to foreign firms that are less efficient. This concern is particularly important to the developing countries including the Sub Saharan African countries, where, as part of privatization, state owned enterprises are sold to foreign firms simply because foreign firms have more available funds than domestic ones. As pointed out by Salz, Agosin and Mayer, FDI may also "crowd out" domestic firms through unfair competition. There is also a concern that the enclave nature of many foreign owned firms and their minimal linkage to the rest of the economy could reduce the potential spillover contribution to the national economy. Moreover, the potential subsequent outflow of foreign firms' subsidiary earnings to their parent companies could also cause deterioration in the balance of payments. It is also argued that foreign corporations tend to produce inappropriate goods that are tailored to satisfy the wealthy portion of the host country's consumers, thereby increasing inequality and engaging in transfer pricing.

2.2.3 Neoclassical Theory

According to neoclassical theory, FDI influences income growth by increasing the amount of capital per person. It spurs long-run growth through such variables as research and development (R&D) and human capital. Through technology transfer to their affiliates and technological spillovers to unaffiliated firms in the host economy, MNCs can speed up the development of new intermediate product varieties, raise product quality, facilitate international collaboration on R&D, and introduce new forms of human capital (Ikiara, 2003).

Bajona & Kehoe (2006) discussed explanations of multinational production based on neoclassical theories of capital movement and trade within the Heckscher-Ohlin framework.

However, they criticize these theories on the basis that they were founded on the assumption of existence of perfect factor and goods markets and were therefore unable to provide satisfactory explanation of the nature and pattern of FDI. In the absence of market imperfections, these theories presumed that FDI would not take place. Nevertheless, they argue that the presence of risks in investing abroad implies that there must be distinct advantages to locating in a particular host country.

2.2.4 Economic Geography Theory

Yarbrough & Yarbrough (2002) discuss recent theoretical models of economic geography that attempt to explain the spatial location of FDI. They assume that the decision of a Trans National Corporation (TNC) on which province to locate investment depends on a set of characteristics of the host province affecting firm's revenue or costs such as factor endowments, market size, income per capita, skilled labour and availability of public infrastructure, among others.

Aiello et al. (2009) argue that other things being equal, a change in infrastructure expenditure influences the cost faced by the firm in adjusting its current capital stock to the target level. They argue that this is a reasonable assumption, given that the adjustment costs depend not only on the firm's internal characteristics, but also on external factors, such as the provision of public infrastructure.

2.2.5 The Eclectic Paradigm Theory

The eclectic paradigm of Dunning (1988) provides a framework of three sets of advantages to analyze why, and where, MNEs would invest abroad. This is the famous ownership, location and internalization (OLI) paradigm (or eclectic paradigm). In this context, investment could be; natural (resource) seeking, market seeking, efficiency seeking or strategic asset seeking.

The ownership advantages refer to firm-specific features sometimes called competitive or monopolistic advantages which must be sufficient to compensate for the costs of setting up and operating a foreign value-adding operation, in addition to those faced by indigenous producers. Such features include things like brand, patents, market access, research and development, trademarks and superior technology. These may be deficient in the host country. When foreign firms use such features in exploiting host country opportunities, they

employ adverse selection in an imperfect market situation in fostering their activities. Consequently, due to information asymmetry and limitation of the features possessed by host country firms, competition with MNCs is difficult. The ownership specific advantages, being superior, to home country firms, may make foreign investors to crowd out domestic investments (Miberg, 1996).

The Locational advantage strand of the eclectic paradigm is concerned with the *where* of production. These include host country-specific characteristics that can influence MNCs to locate an economic activity in that country. They include economic factors such competitive transportation and communications costs, investment incentives, availability of comparatively cheap factors of production, policy issues such tariff barriers, tax regimes, access to local and foreign markets, among other factors (Buckley & Casson, 1998).

The third factor is the internalization advantage which explains *why* a MNE would want to exploit its assets abroad by opening or acquiring a subsidiary versus simply selling or licensing the rights to exploit those assets to a foreign firm. Yarbrough & Yarbrough (2002) report that though this theory has been criticized for only listing the conditions necessary for FDI without explaining its phenomenon, it has widely contributed to international production theory.

2.2.6 Conclusions

In reconciling the pros and cons of the role of MNCs who provide foreign direct investment (FDI) capital Todaro (1985) and Todaro and Smith (2003) asserts that while the above list provides a range of conflicting arguments, the real debate ultimately centers on different ideological and value judgments about the nature and meaning of economic growth and development and the principal sources from which it springs. However, the only valid conclusion is that foreign private investment may be an important stimulus to economic growth and social development as long as the interest of MNCs and host countries government coincide and that MNCs who provide FDI capital adopt a long-run perspective by adapting their technologies of production to the resources of developing nations.

2.3 Empirical Literature Review

The evidence from a few studies addressing the link between FDI and technology transfer in Africa: Wangwe (ed., 1995) covering firms in six African countries: Zimbabwe, Tanzania, Nigeria, Kenya, Ivory Coast, and Mauritius; Biggs and Srivastava (1996) covering Ghana, Zimbabwe, and Kenya; Lundvall et al. (1999); Gershenberg (1997) on Kenya; Phillips et al. (2000) on Mauritius, Uganda and Kenya suggests that there may be limited technology transfer and spillovers to the domestic firms. Phillips et al. (2000) report that a 1% increase in FDI/GDP leads to a 0.8% increase in future domestic investment in Africa compared to 1.17% in Latin America. Many exporting firms are found to locate foreign partners and either form joint ventures with them or hire them as agents for specific technology and/or marketing tasks. In Mauritius, foreign investment has played a positive role in building local technological capabilities. In some countries, MNCs bought out the local firms affected by competition and monopolized activities. Previous experience either through trade or association with MNCs and foreign technical assistance contribute to export success. In MNC affiliates and firms in which foreign partners play important technological functions, accumulation of indigenous or local technological capabilities is limited, except in cases where the affiliate is engaged in activities that the parent is not engaged in (for example, Del Monte of Kenya). Interactions with foreign partners enhance managerial and technological capabilities but only under certain circumstances: when the top managers and entrepreneurs have some previous experience, when the firms are targeting export markets, and when the top positions are not reserved for expatriates.

Evidence on the link between FDI and economic growth is inconclusive. Bosworth and Collins, Blomstrom *et al.*, Borensztein *et al.*, Zhang, DeMello, Balasubramanyam *et al.*, and Obwona provide evidence on the positive effects of FDI on economic growth. Growth enhancing effect of FDI is not, however, automatic, but depends on various country specific factors. UNCTAD, Blomstrom *et al.*, and DeMello indicate that the positive effect of FDI is stronger the higher the level of development of a host country. Higher level of development allows countries to reap the benefits of productivity fostered by foreign investment. For similar reasons, Bronsznestein *et al.* have found that significant relations between FDI flows and economic growth depend on the level of human capital. Host countries with better endowment of human capital are believed to benefit more from FDI induced technology transfer as spillover-effects than others with less human capital. More recently, Balasubramanyam *et al.* and UNCTAD suggest that the positive effects of FDI also depend on

openness to trade. FDI can broaden access to export markets as transnational corporations often serve as channels for the distribution of goods from one country to other markets located in another country. Similarly, Nair-Reichert and Weinhold, using a mixed fixed and random panel data estimation method to allow for cross country heterogeneity in the causal relationship, find some evidence that efficacy of FDI in raising future growth rate, although heterogeneous across countries, is higher for more open economies. Alfaro *et al.* examines the role of financial market in FDI-growth nexus. Their empirical evidence indicates that FDI plays an important role in contributing to economic growth. However, the level of development of local financial markets is crucial for the positive effects to be realized.

In contrast, Aitken and Harrison, and Carkovick and Levine argue that there is no significant positive relation between FDI and economic growth. Even when the relation is positive, the effects tend to be weak. Rodrick for example argues that much of the correlation between FDI and economic growth is driven by reverse causation. Few studies such as Salz, find a negative relationship between FDI and economic growth. De Mello (1997) surveys the developments in the literature on impact of foreign direct investment (FDI) on growth in developing countries. He asserts that FDI is thought of as a composite bundle of capital stocks, know-how, and technology, and that its impact on growth is manifold and vary a great deal between technologically advanced and developing countries. He concluded that the ultimate impact of FDI on growth in recipient economy depends on the scope of efficiency spillovers to domestic firms. Lahiri and Ono (1998) in their investigation on foreign direct investment (FDI), local content requirement and profit taxation in developing countries posited that host countries must strike a balance between costs and benefits of FDI in formulating appropriate policies. The efficiency level of domestic firms must play a role and that a host country should make use of non-tax instruments such as specification on local content of inputs to enhance benefits from FDI.

In Nigeria, significant scholarly effort has gone into the study of the role of foreign direct investment (FDI) in the Nigerian economy. Such studies include Langley (1968) who posited that FDI has both benefits and costs or repercussions in the context of Nigeria's economic growth and development. He said while FDI could engineer or accelerate gross domestic product growth (GDP) via the infusion of new techniques and managerial efficiency, Langley warns that it could also worsen the balance of payments position (Akinlo, 2004). Oseghale and Amenkhienan (1987) examined the relationship between oil export, foreign borrowing

and direct foreign investment in Nigeria on one hand and economic growth on the other hand, and the impact of these on sectoral performance between 1960 and 1984. They concluded that foreign borrowing and FDI impacted negatively on over-all GDP but positively on three principal sectors (manufacturing, transport, communication and finance and insurance). Chete (1998) and Anyanwu (1998) separately examined the determinants of FDI in Nigeria using error correction model. Chete concluded that the growth of the economy proxied by GDP growth rate exerts positive effect on FDI but became significant only at the third lag. While Anyanwu identified the size of the domestic market, openness of the economy and exchange rate as the core determinants of FDI flows into Nigeria. He concluded that there is a positive relationship between the growth of the Nigerian economy and foreign direct investment.

Renewed research interest in FDI stems from the change of perspectives among policy makers from "hostility" to "conscious encouragement", especially among developing countries. FDI had been seen as "parasitic" and retarding the development of domestic industries for export promotion until recently. However, Bende Nabende and Ford (1998) submit that the wide externalities in respect of technology transfer, the development of human capital and the opening up of the economy to international forces, among other factors, have served to change the former image.

Caves (1996) observes that the rationale for increased efforts to attract more FDI stems from the belief that FDI has several positive effects. Among these are productivity gains, technology transfers, the introduction of new processes, managerial skills and know-how in the domestic market, employee training, international production networks, and access to markets. Borensztein et al. (1998) see FDI as an important vehicle for the transfer of technology, contributing to growth in larger measure than domestic investment. Findlay (1978) postulates that FDI increases the rate of technical progress in the host country through a "contagion" effect from the more advanced technology, management practices, etc., used by foreign firms. On the basis of these assertions governments have often provided special incentives to foreign firms to set up companies in their countries. Carkovic and Levine (2002) note that the economic rationale for offering special incentives to attract FDI frequently derives from the belief that foreign investment produces externalities in the form of technology transfers and spillovers.

The empirical evidence of these benefits both at the firm level and at the national level remains ambiguous. De Gregorio (2003), while contributing to the debate on the importance of FDI, notes that FDI may allow a country to bring in technologies and knowledge that are not readily available to domestic investors, and in this way increases productivity growth throughout the economy. FDI may also bring in expertise that the country does not possess, and foreign investors may have access to global markets. In fact, he found that increasing aggregate investment by 1 percentage point of GDP increased economic growth of Latin American countries by 0.1% to 0.2% a year, but increasing FDI by the same amount increased growth by approximately 0.6% a year during the period 1950-1985, thus indicating that FDI is three times more efficient than domestic investment.

A lot of research interest has been shown on the relationship between FDI and economic growth, although most of such work is not situated in Africa. The focus of the research work on FDI and economic growth can be broadly classified into two. First, FDI is considered to have direct impact on trade through which the growth process is assured (Markussen and Vernables, 1998). Second, FDI is assumed to augment domestic capital thereby stimulating the productivity of domestic investments (Borensztein et al., 1998; Driffield, 2001). These two arguments are in conformity with endogenous growth theories (Romer, 1990) and cross country models on industrialization (Chenery et al., 1986) in which both the quantity and quality of factors of production as well as the transformation of the production processes are ingredients in developing a competitive advantage. FDI has empirically been found to stimulate economic growth by a number of researchers (Borensztein et al., 1998; Glass and Saggi, 1999). Dees (1998) submits that FDI has been important in explaining China's economic growth, while De Mello (1997) presents a positive correlation for selected Latin American countries. Inflows of foreign capital are assumed to boost investment levels.

Blomstrom et al. (1994) report that FDI exerts a positive effect on economic growth, but that there seems to be a threshold level of income above which FDI has positive effect on economic growth and below which it does not. The explanation was that only those countries that have reached a certain income level can absorb new technologies and benefit from technology diffusion, and thus reap the extra advantages that FDI can offer. Previous works suggest human capital as one of the reasons for the differential response to FDI at different levels of income. This is because it takes a well-educated population to understand and spread the benefits of new innovations to the whole economy. Borensztein et al. (1998) also

found that the interaction of FDI and human capital had important effect on economic growth, and suggest that the differences in the technological absorptive ability may explain the variation in growth effects of FDI across countries. They suggest further that countries may need a minimum threshold stock of human capital in order to experience positive effects of FDI.

Balasubramanian et al. (1996) report positive interaction between human capital and FDI. They had earlier found significant results supporting the assumption that FDI is more important for economic growth in export-promoting than import-substituting countries. This implies that the impact of FDI varies across countries and that trade policy can affect the role of FDI in economic growth. In summary, UNCTAD (1999) submits that FDI has either a positive or negative impact on output depending on the variables that are entered alongside it in the test equation. These variables include the initial per capita GDP, education attainment, domestic investment ratio, political instability, terms of trade, black market exchange rate premiums, and the state of financial development. Examining other variables that could explain the interaction between FDI and growth, Olofsdotter (1998) submits that the beneficiary effects of FDI are stronger in those countries with a higher level of institutional capability. He therefore emphasized the importance of bureaucratic efficiency in enabling FDI effects.

The neoclassical economists argue that FDI influences economic growth by increasing the amount of capital per person. However, because of diminishing returns to capital, it does not influence long-run economic growth. Bengos and Sanchez-Robles (2003) assert that even though FDI is positively correlated with economic growth, host countries require minimum human capital, economic stability and liberalized markets in order to benefit from long-term FDI inflows. Interestingly, Bende-Nabende et al. (2002) found that direct long-term impact of FDI on output is significant and positive for comparatively economically less advanced Philippines and Thailand, but negative in the more economically advanced Japan and Taiwan. Hence, the level of economic development may not be the main enabling factor in FDI growth nexus. On the other hand, the endogenous school of thought opines that FDI also influences long-run variables such as research and development (R&D) and human capital (Romer, 1986; Lucas, 1988).

FDI could be beneficial in the short term but not in the long term. Durham (2004), for example, failed to establish a positive relationship between FDI and growth, but instead suggests that the effects of FDI are contingent on the 'absorptive capability' of host countries. Obwona (2001) notes in his study of the determinants of FDI and their impact on growth in Uganda that macroeconomic and political stability and policy consistency are important parameters determining the flow of FDI into Uganda and that FDI affects growth positively but insignificantly. Ekpo (1995) reports that political regime, real income per capita, rate of inflation, world interest rate, credit rating and debt service explain the variance of FDI in Nigeria. For non-oil FDI, however, Nigeria's credit rating is very important in drawing the needed FDI into the country. Furthermore, spillover effects could be observed in the labour markets through learning and its impact on the productivity of domestic investment (Sjoholm, 1999). Sjoholm suggests that through technology transfer to their affiliates and technological spillovers to unaffiliated firms in host economy, transnational corporations (TNCs) can speed up development of new intermediate product varieties, raise the quality of the product, facilitate international collaboration on R&D, and introduce new forms of human capital.

FDI also contributes to economic growth via technology transfer. TNCs can transfer technology either directly (internally) to their foreign owned enterprises (FOE) or indirectly (externally) to domestically owned and controlled firms in the host country (Blomstrom et al., 2000; UNCTAD, 2000). Spillovers of advanced technology from foreign owned enterprises to domestically owned enterprises can take any of four ways: vertical linkages between affiliates and domestic suppliers and consumers; horizontal linkages between the affiliates and firms in the same industry in the host country (Lim, 2001; Smarzynska, 2002); labour turnover from affiliates to domestic firms; and internationalization of R&D (Hanson, 2001; Blomstrom and Kokko, 1998). The pace of technological change in the economy as a whole will depend on the innovative and social capabilities of the host country, together with the absorptive capacity of other enterprises in the country (Carkovic and Levine, 2002).

Other than the capital augmenting element, some economists see FDI as having a direct impact on trade in goods and services (Markussen and Vernables, 1998). Trade theory expects FDI inflows to result in improved competitiveness of host countries' exports (Blomstrom and Kokko, 1998). TNCs can have a negative impact on the direct transfer of technology to the FOEs, however, and thereby reduce the spillover from FDI in the host

country in several ways. They can provide their affiliate with too few or the wrong kind of technological capabilities, or even limit access to the technology of the parent company. The transfer of technology can be prevented if it is not consistent with the TNC's profit maximizing objective and if the cost of preventing the transfer is low. Consequently, the production of its affiliates could be restricted to low-level activities and the scope for technical change and technological learning within the affiliate reduced. This would be by limiting downstream producers to low value intermediate products, and in some cases crowding out local producers to eliminate competition. They may also limit exports to competitors and confine production to the needs of the TNCs. These may ultimately result in a decline in the overall growth rate of the host country and worsened balance of payment situation (Blomstrom and Kokko, 1998).

Researchers such as Findlay, Lall, Loungani and Razin, and Romer, among others, note that FDI brings much needed physical capital, new technology, managerial and marketing talents and expertise, international best practices of doing business as well as increased competition. These resources may have the potential to be diffused into indigenous firms thereby creating more innovation and productivity growth. FDI contributes more jobs to the local economy by directly adding new jobs and indirectly when local spending increases due to purchases of goods and services by the new increase in employees. All of these in turn are expected to have positive multiplier effects for an economy. The benefits from the balance of payments effects include improvement in the capital account due to the inflows of new capital into the host country and improvements in the current account balance because of possible decline in imports of goods and services which would otherwise have been imported. The additional taxes from multinational corporations also have the potential to improve the budget situation of the host country.

Hymer, suggested that the technological transfer benefits included, among other things, the direct benefits from adopting the product, process and organizational innovations initiated by the parent company which he named as "firm-specific assets", and the indirect spillover effects on the rest of the economy. Although economists agree regarding the direct benefits of technological transfer on the host country firms, the measurement of indirect spillover effects is shrouded with difficulties. As a result, the evidence is mixed. For example, an extensive review by Blomstorm, Globerman and Kokko, both at aggregate and cases studies levels, finds no strong consensus on the magnitude of spillover effects. A study of UK-owned 20

manufacturing industries by Harris and Robinson concludes that 'inter-industry spillovers are just as likely to be negative as positive' . and so there is clear evidence of an overall beneficial effect on UK manufacturing industries resulting from supply side linkages associated with FDI. Using a World Bank survey of 1500 firms in five Chinese cities, Hale and Long found evidence of positive spillover effects for more technologically advanced firms but none or even negative spillover effects for relatively small firms. From this, they concluded that a well functioning labour market facilitates FDI spillover by creating network externalities among highly skilled workers.

In a panel study of China, Japan, India, South Korea and Indonesia using data for 1993 to 2011, Agrawal and Khan (2011) investigated the impact of FDI on GDP Growth and report that 'FDI promotes economic growth, and further provides an estimate that one dollar of FDI adds about 7 dollars to the GDP of each of the five countries'. Similarly, Rabiei and Masoudi (2012) examine FDI growth nexus in D8 countries namely; Bangladesh, Egypt, Indonesia, Iran, Malaysia, Nigeria, Pakistan and Turkey. Results shows FDI have positive effect on growth in D8. Furthermore, Li and Liu (2005) examines whether FDI affects the economic growth of the host economy. The study utilize data from 84 countries over the period 1970 to 1999 and employ single as well as simultaneous equation techniques in order to test the relationship between FDI and economic growth. In order to achieve the desired result endogeneity is tested using the Durbin-Wu-Hausman (DWH) test, and result show for the sample as whole endogeneity is not significant but when the period is split, 1985 to 1999 show a significant relationship between FDI and Gross Domestic Product (GDP). Further, Phillips Perron (PP) was employed to test for stationary of the variables and the variables were found to be stationary. The study suggests a strong complimentary connection between FDI and economic growth.

Using univariate and panel cointegration for 1970- 2007, Pradhan, (2009) study the relationship between foreign direct investment (FDI) and economic growth in the five ASEAN countries namely: Indonesia, Malaysia, Philippines, Singapore and Thailand results reports evidence of positive relationship between FDI and economic growth at both panel and individual level for the countries though with exemption of Indonesia, Malaysia and Philippines at individual level. However, when Granger causality test was done and results show evidence of bidirectional causality both at individual and panel level with exception of Malaysia.

In a survey by Ilhan (2007) of over 50 empirical investigations on the relationship between FDI and economic growth, 40 of such studies have showed a positive relationship with only 2 reporting negative and the rest demonstrating no effect. These empirical evidences point to the fact that most FDI's are associated to growth. Furthermore, Lumbila (2005) test a hypothesis whether FDI has an overall effect on economic growth and the results revealed a statistically significant difference that a 10 percent increase in FDI can bring about 0.34 percent growth. In another study, Feridun and Sissoko (2006) examines the relationship between FDI and economic growth for the period 1976 to 2002 in Singapore using Granger causality and vector auto regression (VAR). Their findings revealed a unidirectional causation running from FDI to economic growth.

Apergis *et al.* (2004) used a panel data set covering 27 transitional economies over the period 1991 to 2000 to investigate the direction of the relationship between FDI and economic growth in transitional economies by applying what they call the "novel methodology of panel co-integration and causality" because of the belief that there is significant heterogeneity in cross country economic growth so as to allow them estimates presence heterogeneity in the parameters and dynamics across countries. Their findings suggest that FDI has a significant positive relationship with economic growth in the case where all countries are included in the sample. On the other hand, when sample were split into high income countries and countries with successful privatization and those without successful privatization programmes, and the findings are the same.

2.4 Conclusions

The impact of FDI on host economies is complex as foreign investors interact with, and thus influence, many local individuals, firms and institutions. Local firms benefit potentially in many ways: learning from example, labour mobility, export market access, improved supply bases, or direct relations as suppliers or customers. However, these effects with the characteristics of the FDI project, in particular its development of local supply networks, its investment in human capital, employee mobility, and the value added in local operations.

The impact of FDI varies moreover with the ability of local stakeholders to take advantage of the potential benefits of FDI. In particular, the local regulatory framework has to provide for competitive conditions that are conducive to local entrepreneurship, while avoiding undue

market power of the foreign investment firm. Moreover, local individuals and firms need to have the ability to learn from foreign partners.

Moreover, the criteria for judging the success of FDI by host governments have changed over the years and these have led to a less confrontational and a more cooperative stance between host countries and foreign investors. More particularly emphasis in evaluating inbound Multinational Corporations (MNCs) over the past three decades has switched from the direct contribution of foreign affiliates to economic growth and development to their wider impact on the upgrading of the competitiveness of host countries, indigenous capabilities and the promotion of their dynamic comparative advantage (Anyanwu, 1998; World Bank, 2003).

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

A methodological research approach and design is a framework that binds research together so that the research questions can be analyzed effectively (Edmunson & McManus, 2007). The Impact of FDI on Economic Growth in Kenya will be analyzed through a quantitative research method which will entail the generation of data in quantitative form which will then be subjected to rigorous quantitative analysis in a formal and rigid fashion. This approach will further be sub-classified into inferential research; the purpose of this is to form a data base from which to infer characteristics or relationships of the population. This means a sample of population will be studied to determine its characteristics, and it will then be inferred that the population has the same characteristics. Selection of this method is appropriate for the study as it involves an empirical exploration of quantitative aspects of the effects of FDI on Economic Growth in Kenya. Graphs and charts will be used to present the results, followed by an analytical discussion of the findings.

3.2 Research Design

Research design encompasses the conceptual structure within which research will be conducted; the preparation of which is to facilitate research to be as efficient as possible, providing for the collection of relevant evidence with minimal expenditure of effort, time and money. The design in this study will be one to explore the causal link between Foreign Direct Investment (FDI) and Economic Growth in Kenya which comprise the two main variables of this study. The real Gross Domestic Product (GDP) is used as the proxy for Economic Growth Rate measured in Kenyan Shillings. The aim will be to examine the long-term and causal dynamic relationships between the level of FDI inflows to Kenya and Economic Growth.

3.3 Population

All the items under consideration in any field of inquiry constitute a "universe" or "population". All sectors of the Kenyan economy, which entails the population, for data relating to economic growth and foreign direct investment (FDI) inflows will be examined. The two main variables of this study are economic growth and FDI. The real Gross Domestic Product (GDP) is used as the proxy for economic growth in Kenya and economic growth rate

is represented by using the constant value of Gross Domestic Product (GDP) measured in Kenyan shillings.

3.4 Sample

Sampling has a direct impact on the representation of the study (Yin, 1994). The sample will be taken from the above-mentioned population. Deliberate sampling also known as purposive or non-probability sampling technique will be employed. This sampling method involves purposive or deliberate selection of particular units of the universe for constituting a sample which represents the universe. Time series data for the period 1982 - 2012, which includes the 30 annual observations, will be used to analyze the relationship between FDI and economic growth in Kenya. The choice period covered by the study, 1982 ó 2012, is informed by the developments in the Kenyan economy. In the second half of 1980s, there was a change in public policy and the government started implementing Structural Adjustment Programs (SAPs). One of the major objectives of SAPs was restoration of internal and external balances through a strong policy of export promotion coupled with drastic reduction in public spending and expenditure switching. There was a strong recommendation towards institutional reforms; for the purpose of encouraging FDI inflow, exports and industrial capability development.

3.5 Data Collection

Secondary data was used in this study. The data was obtained from the Central Bank of Kenya (CBK) Statistical Bulletin and Financial review for the various years, the International Monetary Fund's *International Financial Statistics* and the World Bank's *World Development Indicators*.

3.6 Data Analysis

The analysis of data entails a number of closely related operations such as establishment of categories, the application of these categories to raw data through coding, tabulation and then drawing statistical inferences. The research will use the Statistical Package for the Social Sciences (SPSS 17.0) to estimate the result of the correlation between the variables.

The basis of the research model is the Augmented Cobb-Douglas production function with FDI incorporated as one of the factor inputs; which takes the form:-

$$GDP = f(FDI) \text{-----} (1)$$

The functional relationship between the variables and proxies can be expressed as:-

$$GDP = f(FDI, INF, FDBT, ER, HCAP) \text{-----} (1.2)$$

The model employed includes the following:-

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \epsilon$$

$$\text{That is, } Y = \beta_0 + \beta_1 FDI + \beta_2 INF + \beta_3 FDBT + \beta_4 ER + \beta_5 HCAP + \epsilon$$

Where:

Y = Gross Domestic Product

X1 = Foreign Direct Investment

X2 = Inflation

X3 = Foreign Debt

X4 = Exchange Rate

X5 = Human Capital

ϵ = stochastic error term

$\beta_1, \beta_2, \beta_3, \beta_4, \beta_5$ = Slope of the regression equation

The link between Economic Growth and FDI is then described in linear form as:-

$$\ln GDP_t = \beta_0 + \beta_1 FDI_t + \beta_2 INF_t + \beta_3 FDBT_t + \beta_4 ER_t + \beta_5 HCAP_t + \epsilon_t \text{-----} (1.3)$$

3.7 Data Validity & Reliability

According to Trochim and Donnelly (2006), validity refers to the best estimate of the truth of any proposition or conclusion or inference described in the research. On the other hand, Reliability refers to the measurement of the quality of the data collected in any research; it is a measurement of the consistency of the data with the research background, and is also a measurement of the suitability of the data for analysis (Behling & Law, 2006). In this study, during the process of analysis, relationships or differences supporting or conflicting with original or new hypotheses will be subjected to tests of significance to determine with what validity data can be said to indicate any conclusion(s). Moreover, status checks of the data collected will be carried out to determine if they are valid and reliable. The sources for the historical quantitative research taken from official company/ organizational websites and peer reviewed journals are to ensure that the information used in the literature review was accurate and valid.

CHAPTER FOUR: DATA ANALYSIS, RESULTS & DISCUSSION

4.1 Introduction

The Statistical Package for Social Sciences (SPSS) Version 20 computer package was used for data analysis. The raw data obtained from the World Bank's World Development Indicators and cross-checked with figures from the Kenya National Bureau of Statistics library on their Economic Surveys for the various years were entered into a data matrix with two dimensions. The number of years under consideration, 1982 to 2012, were entered in the columns and the number of variables entered into rows. The valid varied analyses, frequencies and correlations between the variables were then executed using the analyze option on the software to give an assortment of output which are presented in the subsequent subheadings below.

4.2 Data Presentation

Table 4.2.1: Appendix 1

Table 4.2.1: Shows GDP per capita (PPP) and FDI inflow data series from 1982 to 2012 as well as for the other variables: inflation, foreign debt and human capital. The Human Capital figures were obtained from the percentage of the gross population enrolled in tertiary institutions.

4.2.1: Descriptive Analyses

Table 1 Summary Statistics

Descriptive Statistics					
	N	Minimum	Maximum	Mean	Std. Deviation
GDP	30	5751.79	33620.68	14026.4310	8658.54387
FDI	30	.39	729.04	84.5217	139.30826
INFLATION	30	1.55	45.98	13.1293	9.36788
FOREIGN_DEBT	30	3367.82	10257.88	6471.0087	1529.76635
EXCHANGE_RATE	30	10.92	88.81	51.2957	26.56416
HUMAN_CAPITAL	21	0	1603491	367741.24	484027.762
Valid N (listwise)	21				

Table 4.2.1.1: Summary Statistics of Included Variables

Graph 4.2.2.2: FDI inflow into Kenya, 1982 ó 2012

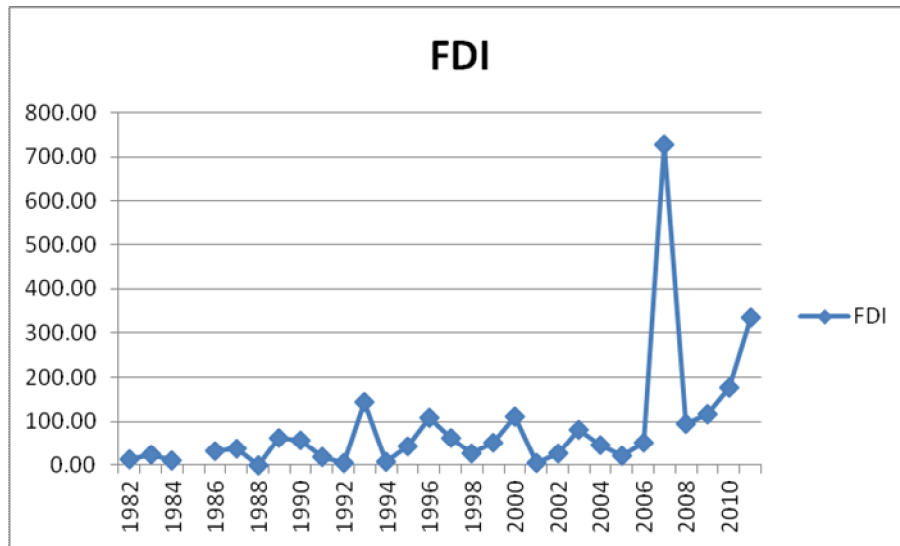


Figure 1 FDI inflow into Kenya

The graph above illustrates the trend of FDI inflow into Kenya from 1982 to 2012. It shows the low levels of the inflows during the early 1980s during which time the Structural Adjustment Programs (SAPs) were implemented to counter the trend. There is a spike between 1992 and 1993 when the country embraced multiparty politics. The pattern thereafter is erratic with the highest figure recorded being 2007.

Table 4.2.1.3

Table 2 Descriptive Statistics

Descriptive Statistics					
	N	Minimum	Maximum	Mean	Std. Deviation
GDP	30	5751.79	33620.68	14026.4310	8658.54387
FDI	30	.39	729.04	84.5217	139.30826
Valid N (listwise)	30				

Source: SPSS Spreadsheet

Table 4.2.1.3: Shows that GDP figures fluctuate between a high of US\$ 33,621 (million) in 2011 and a low of US\$ 5,752 (million) in 1982 averaging at US\$ 14,026 (million) for the period. On the other hand, FDI for the time span ranges between a maximum of US\$ 729

(million) to a minimum of US\$ 0.39 (million) with a mean of US\$ 84.5 Million for the 30 years. The standard deviation for both GDP and FDI are high at 8,658 and 139 respectively implying disbursements of FDI that fluctuate sporadically for the duration as observed from the data with a low of around US\$ 400,000 in 1988.

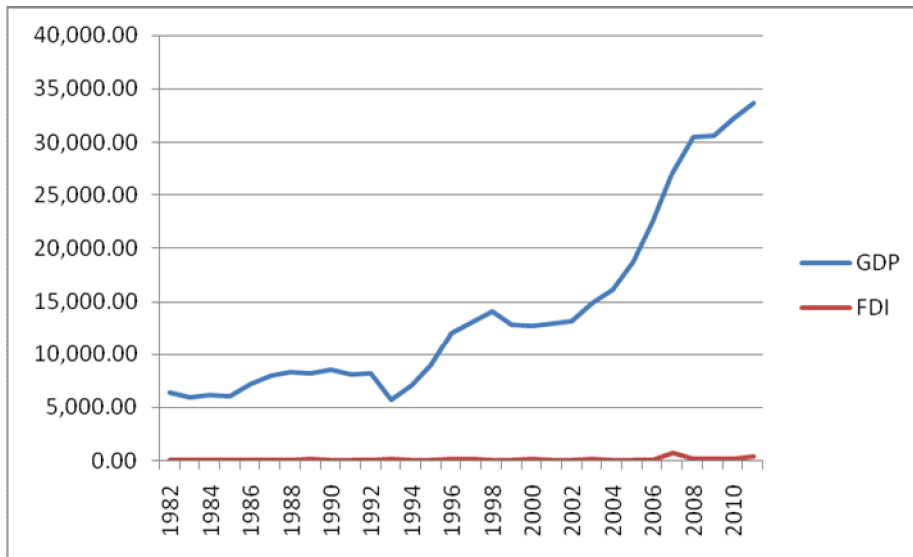


Figure 2 Trend Analyses for GDP & FDI

Graph 4.2.1.4: Trend Analyses for GDP and FDI

Graph 4.2.1.4 shows that the figure for GDP increases steadily for the 30 year period despite the dips in the early to late 1980s then experiencing a steady but slow upward trend in the subsequent years culminating in a peak value at the end of the duration. A passing glance at the graphical depiction of the two variables also indicates that they have a positive direct relationship over the period.

4.2.2: Inferential Analyses

Inferential statistics is concerned about making predictions or inferences about a population from observations and analyses of a sample.

Correlation analyses were conducted on the data to establish relationships between the variables; analyses were done first between GDP and FDI then between GDP and all the other variables (FDI, Inflation, Foreign Debt, Exchange Rate and Human Capital).

4.2.2.1: Correlations

Table 4.2.2.2: Correlation analyses between GDP and FDI

Table 3 Correlation analyses (GDP & FDI)

Correlations			
		GDP	FDI
GDP	Pearson Correlation	1	.565**
	Sig. (2-tailed)		.001
	N	30	30
FDI	Pearson Correlation	.565**	1
	Sig. (2-tailed)	.001	
	N	30	30

** . Correlation is significant at the 0.01 level (2-tailed).

The Pearson Correlation was computed for GDP and FDI inflow data series resulting in a correlation coefficient of 0.565 at the 0.001 (2-tailed) significance level which indicates a strong positive correlation between the variables; this means that there is a significant relationship between foreign direct investment and economic growth in Kenya.

Table 4.2.2.3: Correlation Coefficients for the variables

Correlations							
		GDP	FDI	INFLATION	FOREIGN_DEB T	EXCHANGE_RA TE	HUMAN_CAPIT AL
GDP	Pearson Correlation	1	.565**	-.171	.715**	.710**	.838**
	Sig. (2-tailed)		.001	.367	.000	.000	.000
	N	30	30	30	30	30	21
FDI	Pearson Correlation	.565**	1	-.019	.443*	.339	.170
	Sig. (2-tailed)	.001		.922	.014	.067	.462
	N	30	30	30	30	30	21
INFLATION	Pearson Correlation	-.171	-.019	1	.097	-.138	-.382
	Sig. (2-tailed)	.367	.922		.610	.466	.088
	N	30	30	30	30	30	21

FOREIGN_DEBT	Pearson Correlation	.715**	.443*	.097	1	.685**	.253
	Sig. (2-tailed)	.000	.014	.610		.000	.269
	N	30	30	30	30	30	21
EXCHANGE_RATE	Pearson Correlation	.710**	.339	-.138	.685**	1	.667**
	Sig. (2-tailed)	.000	.067	.466	.000		.001
	N	30	30	30	30	30	21
HUMAN_CAPITAL	Pearson Correlation	.838**	.170	-.382	.253	.667**	1
	Sig. (2-tailed)	.000	.462	.088	.269	.001	
	N	21	21	21	21	21	21

** . Correlation is significant at the 0.01 level (2-tailed).

* . Correlation is significant at the 0.05 level (2-tailed).

Table 4 Correlation coefficients for the variables

From the table 4.2.2.3 above, it is evident that GDP has a strong positive correlation with FDI, Foreign Debt, Exchange Rate and Human Capital. However there is no correlation between GDP and Inflation evidenced by the negative value of ρ 0.171. Likewise, FDI has a strong correlation with foreign debt, exchange rate and human capital. This implies that an increase in foreign direct investment impacts positively on economic growth, more indebtedness to foreign establishments as well as a higher enrolment of the populace in tertiary institutions.

Using the results of the correlation analysis, the link between Economic Growth and FDI can then be described in linear form as:-

$$\text{LnGDP}_t = + 0.565\text{FDI}_t - 0.171\hat{\epsilon}\text{INF}_t + 0.715\hat{\epsilon}\text{FDBT}_t + 0.710\hat{\epsilon}\text{ER}_t + 0.838\hat{\epsilon}\text{HCAP}_t + \epsilon_t$$

4.2.2.4: Curve Fit for GDP and FDI

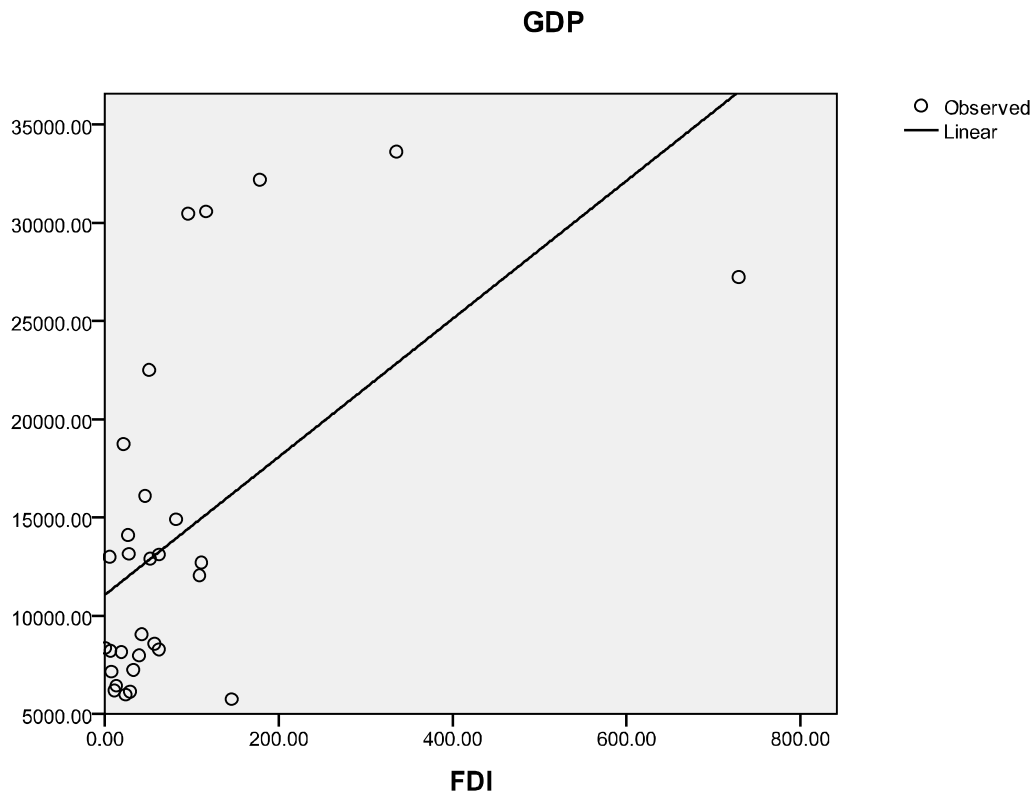


Figure 3 Curve fit for GDP & FDI

Graph 4.2.2.5: GDP plotted against FDI; Line of Fit

There is a linear relationship between GDP and FDI from the graph above curve fit for the data. We can then derive a simple linear function of the form:-

$$Y = aX + b \quad \text{where,}$$

$$Y = \text{GDP}$$

$$a = \text{gradient}$$

$$X = \text{FDI}$$

$$b = \text{y-intercept}$$

From the graph it can then be deduced that:-

$$Y = 33X + 11,500$$

This implies that if all other factors remain constant, an increase in foreign direct investment causes an increase in economic growth.

4.3: Summary and Interpretation of Findings

This study explores the impact of foreign direct investment on the Kenyan economy using FDI and GDP inflow data series from 1982 to 2012. Descriptive statistics were tabulated to give a brief summary of the variables under consideration. The data was then subjected to various inferential analyses to establish relationships between the variables such as Analysis of Variance (ANOVA) and Correlation analysis. On the basis of our findings, empirical results reveal a positive and statistically significant relationship between FDI and GDP Growth. Correlation analyses resulted in a correlation coefficient of 0.0565 at the 0.001 (2-tailed) significance level. Thus, it can be stated that the impact of foreign direct investment on economic growth in Kenya is a strong positive one. Correlation analyses between FDI and the other variables such as human capital and foreign debt also revealed a direct proportional relationship. On the other hand, an investigation on the relationship between FDI and inflation finds that it is an inverse one with a correlation coefficient of -0.171 being reported.

This result is also in agreement with the findings in earlier studies primarily on the direct positive relationship between FDI and GDP. In this regard, in a survey by Ilhan (2007) of over 50 empirical investigations on the relationship between FDI and economic growth, 40 of such studies have showed a positive relationship with only 2 reporting negative and the rest demonstrating no effect. These empirical evidences point to the fact that most FDIs are associated to growth. Furthermore, Lumbila (2005) test a hypothesis whether FDI has an overall effect on economic growth and the results revealed a statistically significant difference that a 10 percent increase in FDI can bring about 0.34 percent growth. In another study, Feridun and Sissoko (2006) examines the relationship between FDI and economic growth for the period 1976 to 2002 in Singapore using Granger causality and vector auto regression (VAR). Their findings revealed a unidirectional causation running from FDI to economic growth. It also concurs with the findings of Esso (2010) who reports in his investigation of ten sub-Saharan African countries on the relationship between FDI and economic growth, a positive and significant growth in Angola, Cote d'Ivoire, Kenya, Liberia, Senegal and South Africa.

Nonetheless, in contrast to our findings, Aitken and Harrison, and Carkovick and Levine argue that there is no significant positive relation between FDI and economic growth. Even when the relation is positive, the effects tend to be weak. Rodrick for example argues that

much of the correlation between FDI and economic growth is driven by reverse causation. Few studies such as Salz, find a negative relationship between FDI and economic growth. De Mello (1997) surveys the developments in the literature on impact of foreign direct investment (FDI) on growth in developing countries. He asserts that FDI is thought of as a composite bundle of capital stocks, know-how, and technology, and that its impact on growth is manifold and vary a great deal between technologically advanced and developing countries. He concluded that the ultimate impact of FDI on growth in recipient economy depends on the scope of efficiency spillovers to domestic firms. Lahiri and Ono (1998) in their investigation on foreign direct investment (FDI), local content requirement and profit taxation in developing countries posited that host countries must strike a balance between costs and benefits of FDI in formulating appropriate policies. The efficiency level of domestic firms must play a role and that a host country should make use of non-tax instruments such as specification on local content of inputs to enhance benefits from FDI.

Moreover, further empirical evidence on the cons of FDI posits that foreign direct investment does not come devoid of some negative aspects. There is normally the tendency for over utilization of the available natural resources, as the companies strive to maximize profits in their venture (Colen et al. 2009). The tragedy of the commons whereby many organizations compete to utilize a shared resource leads to degradation of natural resources as well as environmental pollution, which have largely been associated with the issue of climate change (Sindre, 2011). Importation of capital intensive and outdated technology, Exploitation of local labour, Increase in local wage cost through payment of high wages by MNC affiliates, Contribution to economic leakage (and deterioration of balance of payments) through preference of imported inputs to local ones, Lack of linkages with local communities, that is, development of enclaves, Adverse effects on competition in the national market, Use of transfer prices to escape local taxes and to cheat local partners on returns, Encouragement of corruption, Pollution of the environment, especially in extractive and heavy industries, Social disruptions associated with accelerated commercialization and creation of tastes for expensive foreign consumer goods and Political dependency on FDI source countries and, therefore, loss of sovereignty.

Empirical results reveal a direct proportional relationship between foreign direct investment and economic growth. These findings imply that FDI promotes economic growth and suggest that the Kenyan government embrace policies that aim to attract more foreign direct

investment while micro-managing the same to avoid the negative impacts of FDI on local firms such as crowding out, use of transfer prices to escape local taxes and contribution to economic leakage through preference of imported inputs to local ones. The results also emphasize the need for the government to weed out deep rooted vices such as corruption, reinforce security especially in the wake of terror attacks. We also need to channel investment into infrastructure and generally create an enabling environment to competitively garner more FDI funds to integral facets of our economy. Finally, recent developments in the mining sector notably titanium mining in the coast region and even more recently discovery of oil reserves in northern Kenya; projects which foreign affiliates are in the bidding for contracts, policies should be crafted to control the repatriation of profits from Kenya. Rather, a bulk of these funds should be reinvested in more needy sectors especially towards human development as growth in the GDP would be immaterial if the same doesn't reflect positively on the populace by translating to improved living standards which is in line with the vision 2030 that aims to transform Kenya into a newly industrializing, middle-income country providing a high quality of life to all its citizens by 2030 in a clean and secure environment.

CHAPTER FIVE: SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1: Summary

The first chapter explores the background of this study by elaborating on what FDI entails, its impacts both positive and negative and various definitions. The second chapter goes into the theories I place regarding FDI and economic growth. The chapter then elaborates on the findings by other researchers on the subject. Chapter three details the research method to be applied in this study. The next part explains the research design. Based on the research questions, the methodology uses a quantitative research design that helps to identify the numerical characteristics of the effects of FDI on economic growth in Kenya. The chapter also details how data analysis will be performed. The target population has been explained as well as the sampling procedure. The survey instruments have been explained as well as validation and reliability check for the findings. The next chapter offers a detailed report of the findings in the case study.

Findings from chapter 4 show that there is a strong and significant positive relationship between foreign direct investment and economic growth in Kenya. This positive relationship means that there is a direct proportionate relationship between foreign direct investment and economic growth. The results show that other factors also played a role; in particular, the relationship between FDI and human capital is positive indicating a direct proportional association between the two variables. This means that more foreign direct investment leads to higher levels of enrollment in tertiary institutions and thus a higher level of human capital. Based on the above, we need to enhance more foreign direct investment in order to promote economic growth. Policy implications of these findings are that FDI is a prerequisite for economic growth in Kenya. The results also emphasize the need to invest in human development since growth in the GDP would be immaterial if the same doesn't reflect positively on the populace by translating to improved living standards which is in line with the vision 2030 that aims to transform Kenya into a newly industrializing, middle-income country providing a high quality of life to all its citizens by 2030 in a clean and secure environment.

5.2: Conclusions

Economic theories hold that FDI has the potential to be an important component of a nation's development strategy. FDI contributes to development in three major ways (Jacobs, 2001). First of all, capital inflows such as FDI enable countries to import more than they export, which enables them to invest more than they save and thus accumulate capital faster, boosting labor productivity and wages. FDI has the potential to absorb some of the surplus literate labor in the rural and urban informal sectors (Jacobs, 2001). Employment creation in industries with good productivity growth prospects is an important aspect of poverty alleviation strategies, which is good for local entrepreneurs (Watkins, 1998). Thirdly, FDI can transfer technology and expertise, stimulating the productivity of locally owned firms (Jacobs, 2001). This can occur through training, competition and emulation within industries where foreign firms are present, and through 'forward and backward linkages' with other industries (for example, foreign firms providing domestic enterprises with both inputs and output markets under more favorable terms than imports and exports). In the backdrop of our finding a direct proportional relationship between FDI and economic growth, the government should strive to attract more FDI but exercise strict rules and regulations regarding foreign investment and make every effort to micro-manage FDI, favoring it in some industries with targeted subsidies while forestalling it in other industries through legislation.

It's imperative that policies that promote economic growth be given adequate attention in order to increase economic growth so as to attract FDI, this is because it is established in the literature that most factors that increase economic growth also attract FDI. It is also observed from the trend of FDI in the literature that some countries attract higher FDI than others. Kenya has comparatively low levels of FDI and as such needs to improve its business environment by ensuring that administrative procedure, legal and judiciary system are improved so as to ensure property right, fight corruption and respect rule of law and due processes. All of these will see higher levels of much needed FDI channeled into the country.

In a nutshell, foreign direct investment that is channeled into the country ought to be well utilized towards the projects for which it's targeted considering recent horror stories of the mismanagement of funds meant for free primary and secondary education. In this regard, relevant bodies and authorities should vigilantly prosecute those in positions of leadership who don't walk the talk.

5.2: Policy Recommendations

Going by the findings and conclusions drawn from this study, the following recommendations are suggested. Policies such as opening up of the economy by engaging in more bilateral and multilateral trade agreements, improving the quality of infrastructure by way of channeling more resources to its development especially in marginalized regions of the country in the backdrop of the discovery of oil and water in Turkana, and demonstrating more political will in the fight against corruption so as to instill more confidence on foreign investors. These policies may enhance the attraction of FDI thereby increasing economic growth.

MNCs play a key role in foreign direct investment into the Kenyan market especially in the construction industry. One of the direct effects of this is the fear by locally owned businesses of losing control over the markets and industries to the expanding MNCs. To answer the question how national firms can survive and compete with MNCs, the government must revisit their policies concerning FDI and MNCs. In addition, due to the positive effects of FDI investment on the Kenyan economy, the government should continue to keep its open door policy to FDI and MNCs in the future. However, feasible measures should be taken to limit the disadvantages on domestic businesses. The foreign investment policy should be considered as a supplemental part of the domestic development policy. The opening to FDI and MNC investment should be carried out simultaneously. Special treatment should not be given to MNCs. Rather the local firms should be given the same treatment and the administrative constraints on the domestic state owned enterprises should be gradually eliminated.

The government also needs to go a step further and actively seek to attract FDI by marketing our economy and eventually set up national investment promotion agencies (UNCTAD, 2001). In a nutshell, regarding investment promotion policies, Kenya should adopt a proactive approach towards FDI promotion, and explicitly look for ways to increase its benefits in terms of technology, skills and market access. Under these types of policies, foreign investors are targeted at the industry/firm level in order to meet Kenya's specific needs that fit in with its developmental priorities.

5.3 Limitations of the Study

Limitations are the boundaries that restrict the research scope and may cause difficulty in completing the research (Cooper & Schindler, 2002). Obtaining data for the study was problematic in the sense that the Central Bank of Kenya (CBK) Statistical Bulletin and Financial review for the various years was only available for a few of the years under study. The central bank website also seems to experience perennial problems that make it inaccessible most of the time. Nonetheless, the data available at the Kenya National Bureau of Statistics is not in soft form so a lot of time was utilized going through heaps of publications.

The research study was conducted for a sample of 30 years and as such may not be an exact representative of the situation on the ground since a lot has been happening in Kenya during the duration under consideration such as the SAPs of the 1980s, adoption of multiparty politics in the early 1990s, the post election violence of 2007/2008 as well as the global financial crisis of 2009.

This project was conducted whilst in full time employment. While this has had the positive impact of having instilled in me a sense of discipline and responsibility, it has also meant higher levels of stress due to the inevitable need to put in extra hours to balance both tasks.

Some bias in research occurs when the researcher fails to take into account all of the possible variables. The findings of this study may also be subject to the researcher's bias. For instance, the results of the research might be subject to design and sampling bias whereby the process of sampling introduces an inherent bias into the study.

5.4 Suggestions for Further Studies

The present Kenyan constitution having been promulgated during the last three years introduced a devolved system of government. With this in mind, further studies should focus on analyzing sector and county specific cases so as to allow for specific policy recommendations and employ more robust econometric models. As such the impact of FDI on the economy might be made that more successful.

The backbone of the Kenyan economy is Agriculture; although there is presently a huge of quantity of FDI funds channeled towards farming, much of it is through foreign affiliates who have established subsidiaries here. An example is Del Monte based in Thika. In this regard, studies should be conducted into the feasibility of channeling FDI towards the small scale agricultural industry and with an aim to counter poverty.

In the wake of the recently vibrant mining sector wherein foreign affiliates with their superior knowhow and equipment being bound to lead exploration of natural resources in Turkana, studies should be conducted prior to breaking ground so that appropriate policies are put in place to hinder negative impacts on the local economy.

This study employs macroeconomic variables in investigating the impact of FDI on economic growth in Kenya. A study should be conducted on investor responses about the impact of various institutional variables to their businesses in that it would provide information on the other side of the coin; FDI viewed from the MNCs perspective.

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Appendices

Appendix 1.1: Table 4.2.1

	GDP – Millions of US\$	FDI - Millions of US\$	Inflation	Foreign debt – Millions of US\$	Human capital
Year					
1982	6,431.58	13.00	20.67	3,367.82	
1983	5,979.20	23.74	11.40	3,628.28	213,591
1984	6,191.44	10.75	10.28	3,511.51	232,163
1985	6,135.03	28.85	13.01	4,181.35	251,224
1986	7,239.13	32.73	2.53	4,603.59	
1987	7,970.82	39.38	8.64	5,783.68	308,878
1988	8,355.38	0.39	12.26	5,809.65	
1989	8,283.11	62.19	13.79	5,889.26	342,168
1990	8,572.36	57.08	17.78	7,055.60	
1991	8,151.49	18.83	20.08	7,453.51	
1992	8,209.12	6.36	27.33	6,898.20	
1993	5,751.79	145.66	45.98	7,111.50	
1994	7,148.15	7.43	28.81	7,124.41	
1995	9,046.32	42.29	1.55	7,309.19	
1996	12,045.87	108.67	8.86	6,813.76	
1997	13,115.76	62.10	11.36	6,465.19	
1998	14,094.00	26.55	6.72	6,824.08	
1999	12,896.01	51.95	5.74	6,525.71	
2000	12,705.35	110.90	9.98	6,189.02	860,270
2001	12,985.99	5.30	5.74	5,566.28	904,620
2002	13,147.74	27.62	1.96	6,177.28	930,984

2003	14,904.50	81.74	9.82	6,922.73	
2004	16,095.32	46.06	11.62	6,976.68	1,015,812
2005	18,737.90	21.21	10.31	6,482.90	1,059,365
2006	22,504.14	50.67	14.45	6,680.51	
2007	27,236.74	729.04	9.76	7,522.66	
2008	30,465.49	95.59	26.24	7,607.38	
2009	30,580.37	116.26	9.23	8,589.49	1,603,491
2010	32,198.15	178.06	3.96	8,801.16	
2011	33,620.68	335.25	14.02	10,257.88	
2012					