RELATIONSHIP BETWEEN MACROECONOMIC VARIABLES AND FOREIGN DIRECT INVESTMENT

A CASE OF KENYA

LAAK KUCBANY WEEK

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DECLARATION

This research project is my original work and has never been presented to any other institution

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DEDICATION

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ACRONYMS

CGFS:	Committee on Global Financial Sector
FDI:	Foreign Direct Investment
FKE:	Federation of Kenya Employees
FY:	Fiscal Year
GDP:	Gross Domestic Product
IMF:	International Monetary Fund
LDC:	Less Developing Countries
MNCS:	Multinational Companies
NPV:	Net Present Value.
NSE:	Nairobi Stock Exchange
PPG:	Public and publicly Granted
REER:	Real Effective Exchange Rate
UNCTAD:	United Nations Conference on Trade and Development

ABSTRACT

The study aimed at determining the relationship between macroeconomic variables and foreign direct investment in Kenya. The objective was to assess how the selected macroeconomic variables such as exchange rate, inflation, interest rate, gross domestic product do relate or affect the inflows of foreign direct investment. The study adopted descriptive statistics as the appropriate research design for the study. Secondary data was collected on annually basis from Kenya National Bureau of statistics, central bank of Kenya, World Bank website, and UNCTAD Website. The period of the data collected range from 1970 to 2016, literally 47 years, SPSSS version 20 was used to analyse the data. The analysis found strong positive correlation between FDI and GDP and between FDI and exchange rate as well. However relationship between FDI and inflation rate as well as relationship between FDI and interest rate to be weak. Based on the results, the recommendation is that great deal of attention needs to be paid to fluctuation of macroeconomic variables, for they influence foreign investors' decision. This suggestion is derived from the that fact that findings shows selected macroeconomic variables relate or affect foreign direct investment in one way or another.

CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

FDI is punctuated by macroeconomics variables, it is undisputable that no investor would wish to invest in a country in which macroeconomic environment is unpredictable, the prior objectives of an investor is to earn profit for every coin invested in an investment as well as expanding, such premise can't be ascertained when macroeconomics variables are marked by irreversible and persistent fluctuations that would become a ticketing bomb to any investment, precautionary measures are required before undertaking any business.

Philosophy of macroeconomics dates back to 1960s and 1970s by monetarists led by Friedman and Keynesians, on the other hand Modigliani and Tobin, and as debate went on, set a new face known as macroeconomists. There are two school of thoughts about macroeconomics, one school of thoughts is of an idea that markets work best if left to themselves, the other one argues that government intervention can considerably improve the operations of the economy (Rudiger & Stanely, 2009).

Macroeconomic indicators are very crucial for they are the litmus test for measuring the performance of the economy. They directly impact on the socio economic status of the masses; governments pay great attention on how they playout in the events of economic growth and development. Decisions and economic policies made by the governments through ministry of finance and economic planning in conjunction with central bank's fiscal policies regarding adjusting macroeconomic variables based on the prevailing economic situations are so essential to the investment, investors regardless of their nature are always on the look for such vital information in the public domain. According to Merton (1973) asset pricing theory states that any

variable which influences consumption or investment opportunity cluster should be valued at equilibrium, this phrase links macroeconomic variables with foreign direct investment. There is no day that elapses when the citizens have not heard of the changes of inflation rate, interest rate, stock market, foreign exchange rate, gross domestic product, labour force and employment, and the most feared are the trickling down effects which the volatilities of macroeconomic variables might have on them.

Macroeconomics variables environment relays crucial information to the investment community, and it is upon which their investment decision is based, be it locals or foreign. In the words of Fama (1970), a market should fully reveals the required investment information (EHM). His efficient hypothesis is that the concept is observed if market asset prices from the onset fully disclose the necessary information which might reflect the investment opportunity

According to Petri et al. (2003), stock market announcement provides essential information to stock market investors who employ this information to re-evaluate pricing of stock. He argued volatility tends to be high given the uncertainty regarding the announcement

In a paper authored by Funk and Matsuda (2002) under International Monetary Fund, and a couple of other empirical studies, for example Hardouvelis (1986), Li and Hu (1998), and Sun and Tong (2000) were recognized to have given evidence on how stock reacts to news of financial or macroeconomic type. Foreign investors do always have interest in the country's stock market which could possibly be one of the economic arenas to invest in, foreign shares at some points tend to be part of the equation in stock market exchange.

Macroeconomic announcement changes are perpetrated by the need to adjust balance of payment deficits which performs a great role in determining asset prices Laopodis (2006). He emphasised that unfavourable tax regime with government's unhealthy spending reduce the anticipated return on assets which waters down investors' decision to undertake more investments. This is a proof that macroeconomics variables affect foreign direct investment and smart investors would probably shy away from areas with mediocritising macroeconomics variables that may decimate their capital.

Macroeconomic variables tend to fluctuate based on the performance of the economy, efforts to controlling or limiting these changes unfortunately tend to be futile in most cases this shows how tricky these variables are, and for that matter foreign investors are so cautious about their decision to invest in foreign country for their investment with the anticipated profits and growth could be at stake. Investment is a function of capital, opportunity, where to invest and the suitability of the economic environment, this is the underlying equation for any type of investment.

The Q- theory of investment by Tobin (1918-2000) links investment with the aggregate economic activity, in particular the stock market prices, where he stated that when the stock price hike, shareholder become wealthier and spend more, and decline in consumption is directly proportionate to stock price crashes.

Globalization has shaped investment environment given the aspects of liberalization and openness have had their toll on most of the economies. With current modernization, countries find themselves engaged in international trade either intentionally or by default, whether the country wants it or not, it has to put in place mechanisms that are geared towards attracting foreign direct investment because of

the perceived benefits that are attached to it, but unless macroeconomics environment is attractive to foreign investors. Foreign direct investment has been a game changer given it is now a days preferable as opposed to the previous economic mind-set whereby most of the economies relied on foreign aid from western governments, International Monetary Fund and World Bank. A shift in policy empirically points to the direction recommended by most of the economists in line with their findings. It is believed to be suicidal for a country to so much indulge herself into foreign aid rather than doing something on her own. Cost of servicing the debts has been so immense compounded with other polices that have potential danger of surrendering economic freedom. It would be unreasonable to ignore the importance of macroeconomics variables given prices of goods and services are a subject to them, the philosophy of forces of demand and supply is linked to macroeconomics and so as the FDI.

1.1.1 Macroeconomic Variables

Macroeconomic variables are the aggregate indicators that constitutes economic system, their primarily role is concerned with forecasting of national income through analysis of major economic factors that reveal predictable patterns and trends, and their influence on one another (Rudiger & Stanely, 2009)

Behavior of the whole economy is reflected in macroeconomics variables characterized by boom and recessions, the overall economic output of goods and services, the rate of inflation and unemployment, the balance of payment, and exchange rate (Abel, Bernake and Croushore, 2008).

Macroeconomics variables reflect both short run and long run volatility of the business environment, all economics issues are being anchored in macroeconomics variables. They influence fiscal and monetary policies, economic growth and

determination of consumption and investment level. Wellbeing of macroeconomic is being looked at from three wider perspectives, namely inflation rate, the growth rate and the rate of unemployment, the justification to why these variables stand out, is because they have a lot in common in the entire cycle of business of which FDI is not an exception. These three variables are being keenly watched given they affect lives daily on average. Inflation increase prices making investment difficult so it is always in the interest of foreign investors to know country's level of inflation as so as to the other variables (Brandley, 2008).

As a matter of clarity, macroeconomic variables comprise of DGP, inflation, GNP, investment level, interest rate, per capital income, exchange rate, employment, stock markets, balance of payment and so forth, these variables are very crucial for country's economic status quo, overall functionality and better performance of financial sector. However the variables whose impact is being investigated on the inflow of foreign direct investment are inflation, interest rate, exchange rate and GDP. Macroeconomic variables have a tendency of fluctuation, and tricky to pin them down, and that has been the case in the context of Kenya, previously years have been marked by the inconsistencies in these variables

1.1.2 Foreign Direct Investment

Foreign direct investment is undertaken by either company(s) or individual(s) in a foreign country with the objective which includes the need to acquire resources in a foreign country, expansion, producing, and the desire to increase sale volume resulting to more revenues to the firm, and growth or diversification, Wild and Wild (2012).

According to Ahmed (2005), foreign direct investment is defined as any investment by Multi-National companies (MNCs) or investment by a non-resident to a company of host nation whereby, they exercise control and earn returns on their investment. Growth of Foreign direct investment has been compounded by conducive investment atmosphere brought about by relaxed business conditions such as lower tax rate, tax holidays and unrestrictive access to market being initiated by economies which are pro capitalism.

Stephen Hymer (1974) argued that firms only invest abroad if they have attributes not possessed by local foreign rivals and barriers (market imperfections) that prevent these rivals from obtaining the attributes of the foreign company. The philosophy of foreign direct investment dates back to 2004 when committee on Global Financial (CGFS) sector did a study on the financial sector of the emerging economies, to which the report was entitled as foreign direct investment. The study aimed at how the demand for foreign direct investment in financial sectors of the developing economies could help to uplift and align financial systems of the emerging economies with that of the developed economies.

FDI takes forms like business acquisition in other countries, setting up businesses or buying stakes in companies (Mcgraw Hill, 2010). The inflow of foreign direct investment has greatly been boosted by the liberalization of the economies being undertaken by respective countries. Some countries have gone as far as privatising most of the state owned enterprises that has actually given foreign investors an upper hand in acquiring shares and stakes in those enterprises promoting FDI inflows. Foreign direct investment has been a hot cake and its controversy has been so immense in countries that have indulged themselves into given it is being looked into in terms of economics, political and international business.

FDI is being attracted by high returns which emanate from existing investment opportunities that tend to be green pastures to foreign firms (Charles and Arun, 2012). FDI is such a puzzling matter, and that nature ensues application of two distinctive methods of investigating its effects, namely macro and micro economics, however there exists correlation and divergence views in both approaches about foreign direct investment. From microeconomic view point, studying FDI is being focused on small economic units, whilst for macroeconomic approach, FDI is being tackled in the context of the entire economy.

1.1.3 The Macroeconomics Variables and Foreign Direct Investment

There has been a shift in policy from previous mind set of being protective of the economy towards liberalization and openness aimed at attracting foreign direct investment. And in that regards, developing and underdeveloped countries have of recent manoeuvred to lure more FDI given the economic benefits associated with it (Lensink, & Morrissey, (2001). FDI serves three main purposes, namely transfer of technology, skills and availing the needed funds, all these variables are ingredients for economic growth with enormous benefits which could be far reaching unless enabling environment is created for foreign direct investment, and the whole thing goes back to the macroeconomics variables.

Inflation, a lot of money is being pumped into economies of both underdeveloped and developing countries by foreign investors who tend to explore economic opportunities that might prevail, this money finds its way into financial institutions as savings with banks and part of it as shares in stock markets. Foreign shares are part of the equation of stock markets in many less developed economies which makes them liquid to facilitate buying and selling of stocks on the stock markets. However there is another angle in which too much money circulation in the economy results into inflation.

There has been surges in prices of goods and services which does not go down well with the livelihood of the locals and could possibly be linked with the amount of foreign direct investment that has been coming in on tremendous phase. Burda and Wyplosz (2009) defined inflation as an increase in the money supply. It is a situation whereby too much money in circulation tend to overrides the existing goods and services leading to increase in their prices.

Exchange rate, other currencies have continuously lost value to US dollars, this is so because governments attempt to attract foreign investment, and in that manner they find themselves devaluing their own currencies. It is a tradition that undertaking business in another country would require conversion of the local currency against the foreign currency (Todaro 2010), the American dollars has always been the preferable currency reason being, the United States of American leads the world in the economy though China is likely to overtake her (Todaro, 2001).

Interest rate, investors keep off from countries with unstable interest rate, this is so because returns are being affected by unfavourable fluctuation in interest rate, and for that matter respective central banks do try to deal with this variable to suit foreign investment, (Jching, 2011). The main objective of any investor is always geared towards profit and growth, that position is not comprised unless otherwise, critical analysis is being done with regards to risks and investment opportunity before any business is undertaken.

1.1.4 Macroeconomics and FDI in Kenya

As effort is being made towards diversification to reduce reliance on agriculture as an economic blood, but to rather promote manufacturing as the new direction of pursuing economic growth, Kenya is one of the countries in the region which is daring to

manage her macroeconomics environment with the objective of achieving economics sustainability (African Development Bank Report, 2016).

Kenya as any other country have had fairly fluctuating macroeconomic variables that might have impacted on the inflow of foreign direct investment, the trend is shown by the following statistics. GDP stood at 5.7% in 2013 but it dropped to 5.3% in 2014 owing to decline in tourism, whereas the 2015 estimate and the 2016 and 2017 forecasts indicate economic growth of 5.5%, 6.0%, and 6.4% correspondingly. Decline in GDP in Kenya provoked a retreat to a drawing board whereby Kenya lower middle income status with a GDP of US 52.8 billion and per capital of 1190 (Africa Economics Outlook, 2016)

Macroeconomic environment is believed to have been stable in 2014 and 2015. Inflation digit has continued to dwell around 10.0% brought about by depreciation of shillings in 2015. CBK policy has been to keep the inflation rate at 5%, this clampdown started shifting in July 2012, where CBK rate felt from 18.0% in June 2012 to 8.5% in January 2014. As current account deficit continuously deepened so as to depreciation of KES, coupled with voice to raise interest rate resulted to cautionary measures, and hence CBK rose to 11.5% in September 2015, again it tumbled by 7.1% in the first six month in 2015.

Previous studies revealed that Kenya's real effective exchange rate (REER) is overpriced by between 4.0% (CBK) and 20.0% (Renaissance Capital), this depreciation affected Kenya's liquidity resulting to a fall in IMF emergency support facility. Kenya debt ratio to GDP has been below 50.0% for 5 years all the way to December 2012. It hiked to 53.2% in October 2013. It is currently at 52.0% facilitated by debt-to-finance expenditure linked to devolved government

infrastructure investment. NPV of public and publicly guaranteed (PPG) external debt was expected to rise by 22.0% of GDP 2016-17. The ratio of debt to export is expected to shoot about 123.0% (Africa Development Bank Report, 2016).

Kenya account deficit is associated with rise in import against poorly growing export. In the first half of 2015 the average exports estimate was 10.0% when equated to the same period in 2014. Imports outclassed export by 0.2% prompting trade deficit of 5.3% over the same period. Kenya has been lagging behind her neighbours in terms of foreign direct investment; however investment levels were projected to have increased from $ 605million to $ 994 million in 2009. In 2012/2013 fiscal year (FY) FDI was projected to be $ 1.2 billion fiscal year 2013/14, this increase in FDI is linked to trade with BRICS, namely Brazil, Russia, China, India and South Africa, there is prediction of continuous growth in FDI. In 2014, agriculture contributed about 30.3% to GDP, followed by finance, real estate and business services at 15.7%

1.2 Research Problem

Macroeconomics variables have been such a puzzling matter, every aspect of the economy is being influenced by macroeconomics, and so as the FDI immune. The effects of macroeconomics variables are real and consequential, and hence should be investigated in the context of FDI, a lot is at stake as goods and services and capital are being traded across borders. As much the inflow of foreign investment has been so intense, raises the question about how it is being impacted by macroeconomics variables, having looked at the past researches done in Kenya, I have discovered that they had only focused on the effects of foreign direct investment on the economy, neglecting how FDI itself is being impacted by macroeconomic variables, and thus is the gap this research seeks to address.

There have been whole a lot of economics initiative and activities that have taken place owing to post independence that have shaped Kenya to what it is today. After independence in 1963, Kenya as paranoid as any other state which had just emerged from colonial error was very protective of her economy, a move that was meant to shield her infant economy from external predators. She was very vocal about opening up to free trade and decided to impose trade barriers and capital inflows in 1970s and 1980s, a strategy which curtailed trade and kept FDI in check.

According to Rodrick (1998) the in word- looking strategy development discouraged trade, controlled FDI and affected economic growth. However there was a shift in the policy when Kenya became aware about the benefits of FDI, and thus opened up to attract FDI. There have been economic reforms which have given space to foreign investors facilitating attraction of foreign direct investment.

In the period between 1990 and 1999 Kenya's FDI inflows stood at average 17 $ million whereas the corruption index of 2.8. In 2007 and 2008 the inflow of FDI inflows to Kenya hiked to $119 million whilst the corruption dropped to 1.6 (TI, 2012). To lure in a considerable amount of FDI Kenyan government had to re-strategize resulting into formation of KENIVEST agency in 2004 to be overseeing issues of FDI. This led to gradual increase in the inflow of FDI which amounted to $ 141 million in 2009, it declined to 133 million in 2010 (UNCTAD, 2011).

This improvement has continued to improve prior to the recognition of the benefits of FDI, and of recent there has been considerable influx of foreign direct investment into Kenya which has made her catch up with other countries in the region attracted by her openness and liberalized economy that offers conducive environment for foreign

investors making her investors' preferred destination for foreign investment in the region.

According to UNCTAD (2012) indications of continuous inflow of FDI shows that Kenya will catch up with East Africa members. The ingredients that have continued to promote FDI in particular are low tax rate of 16%, tax holidays, nonetheless Kenya's strategic location has made her to be an economic hub for the entire East Africa. Mombasa Seaport plays a great role in attracting foreign direct investment, issues to do with transportation cost, customs duties , time for delivery and safety of goods on board are very crucial aspects that are being taken into account before venturing into Foreign Market.

1.3 Research Objective

The objective of this study is to determine the relationship between macroeconomics variables and foreign direct investment in Kenya, and below are the specific objectives

i. The effect of exchange rate volatility on foreign direct investment in Kenya
ii. The impact of inflation on foreign direct investment in Kenya
iii. The impact of GDP growth on foreign direct investment in Kenya
iv. The impact of interest rate fluctuation on FDI in Kenya

1.4 Value of the Study

The research project would be a valuable asset to the School of Business of the University of Nairobi as it is tasked with contributing to the world's scholarly excellence, for it is the inputs we as the family of the University of Nairobi do collectively generate, be it from our beloved prolific professors, Lecturers and students which makes the university of Nairobi a marvellous academic beast, and as the region's cash cow whose position shines ever amongst the World's academia family, informed by the enormous professional manpower graduates of this very institution contribute to the universe economies.

I would also like to state the fact that this crucial material is not only confined to the University of Nairobi, it will also serve as a potential tool and a reference to policy makers, financial gurus and corporate world as it has ascertained the relationship between macroeconomics variables and FDI. The research project would also serve as a part and partial of the researches done in the same area to boost the knowledge with respect to the area of the study

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter revisits the concept, examines and summarises the literature related to the study, it seeks to revisit all the researches done by other researchers in relation to the topic.

2.2 Theoretical Review

The concept of foreign direct investment, macroeconomics and theories were viewed substantively to fully equip the study with the required information from authentic and trusted sources. To begin with, developing countries previously used to heavily depend on foreign aid which comes from developed countries, World Bank and International Monetary Fund , foreign aid at times comes with strings attached, for example high cost of servicing the debts and polices that do not actually go down well with the developing countries. And with that, there has been a shift from dependence on foreign aid to liberalization and openness of the economies aimed at attracting foreign direct investment in developing countries, however there are concerns about the effect of macroeconomics variables on foreign direct investment. From international expertise' perspective, there are important elements that need to be taken into account that range from security, accommodative economic policies, competitive market, favourable legal environment and regulations towards businesses and conducive tax system to be able to attract foreign direct investment.

According to Ahmed (2005), foreign direct investment (FDI) is defined as any investment by Multi-National Companies (MNCs) or investment by a non-resident to a company of host nation whereby, they exercise control and earn returns on their investment.

2.2.1 Market Imperfects Theory

According to market imperfection theory by Canadian economist Stephen Hebert Hymer (1974), states that when an imperfection in the market makes transaction less efficient than it could be, a company will undertake foreign direct investment to internalize the transaction and thereby removes the imperfections. There are issues that make market imperfect and unattractive for investment, these begin with restrictive trade policies and high taxes imposed on the businesses by the governments which at times slim the chances of profiting besides rendering business environment unconducive. Kenya has done away with such clampdowns in anticipating the inflow of foreign direct investment; access to Kenya’s market is now easier compared with the old days.

2.2.2 Product Life Cycle Theory

According to Raymond Vernon (1966), a product goes through four stages, new product, growth, maturity and decline, a company will begin by exporting its products and later undertakes foreign direct investment as the product moves through its life cycle. Kenya imports some products and services she does not produce due to surging population with the needs that cannot be met locally. There is also general perception whereby goods and services produced outside the country are preferable than the domestic ones due to their standard, low prices and exclusive features, and as this trend gained ground, some foreign firms decided of locating near their customers encouraging the inflow of goods and services into Kenya promoting foreign direct investment.

2.2.3 Market Power Theory

Joe Staten Bain (4 July 1912, Spokane, Washington – 7 September 1991, Columbus, Ohio.), according to market power theory, a firm tries to establish dominant market power presence in an industry by undertaking foreign direct Investment. As the need to attract foreign direct investment surfaced, Kenya decided to liberalize her economy as well as opening up which triggered the inflow of foreign investment, and giving foreign firms access to amassing a lot of capital as they indulge themselves in existing local business opportunities setting a precedent of venturing into acquiring shares in important financial sectors such as the Nairobi Security Exchange, besides there is no restriction to property acquisition in Kenya as long the process is legally binding.

2.2.4 Eclectic Paradigm Theory

According to professor Dunning (1995), Eclectic theory states that firms undertake foreign direct investment when the features of a particular location combine with ownership and internationalization advantages to make location appealing for investment. Kenya has become a preferred destination for foreign direct investment due to her strength in connectivity with most parts of the continent and the world as well. This is so because of her geographical location, in particular Mombasa Seaport which is preferred by most of the investors as reliable and secure in all other aspects to satisfying the shipping needs, transport is one of the essential aspects of business given the cost involved.

Nonetheless, Kenya has got the best fibre optic cable in the region that also facilitates communication and connectivity, world has become so dynamic in the sense that services such as effective networks and telecommunication are so important to the business. These facilities have brought about businesses opportunities such as the

ecommerce amongst others which have also become avenues to exploit by foreign investors leading to more attraction of foreign direct investment. There is a lot to mention that has made Kenya a hot cake to foreign investors in the region, she has the best skilled workers who are able to take on any task assigned to them on spot

Infrastructure, Kenya tops the list in the region in terms of physical infrastructures, roads, airport and railways are fairly well paving large coverage of most parts of the country, and thus promoted foreign investors to flock into these areas, and hence the basis of foreign direct investment. Mobility of goods, people and services are very important, which cannot be grantee without the existence of such essential infrastructures.

2.3 Determinants of Foreign Direct Investment

Foreign direct investment is being influenced by various macroeconomics factors that can at times cause fluctuation in its inflows. As much a lot of studies have been done on these variables, still views are very divergent. Kinuthia (2010), stated that various methods of investigating factors that influence FDI do not cancel out each other but rather look into various scenarios of the same phenomenon.

2.3.1 Exchange Rate Changes

Exchange rate is one of the key elements which influence FDI. Asiedu (2002) found the impact of exchange rate on the level of FDI. He testified that FDI is affected by conversion of different currencies. Dunning (1993), argued that further analysis of the changes in exchange rate is carried out in the events when one owns more equity share capital in investment, meaning such investment can be affected in its entirety by macroeconomics variables.

Goldberg (2011) concurs with the view that exchange rate fluctuation affects location decision of MNES. Some researches argue that exchange rate risk is an attribute to explaining foreign direct investment (Gastanaga et al., 1998). According to Gastanaga, changes in exchange rate negatively impact FDI causing it to decline. The findings on the analysis of macroeconomic variables, institution and legal environments and risk justified market size, fiscal deficit, inflation, exchange regime and unrestrictive trade policies to be significant. Whereas the previous researches found exchange rate variations applicable and important to FDI given the unpredictability of the reward to host countries when exchange rate fluctuates (Beshera, 2008).

2.3.2 Inflation

Given exchange regime is always marked by uncertainties, foreign firms always seek high values to shield themselves from inflation, this is because inflation affects foreign direct investment. Nwanwo (2006) and Kadongo (2011) discovered that failure by the economies in Africa to introduce rigorous macroeconomic policies, has led to the decline in the amount of FDI inflows. He argued that Africa is regarded as being dangerous given unsuitable monetary and fiscal policies that have caused increase in production overheads. According to Kadongo (2011) inconsistency in macroeconomic indicators characterized by consistent hiking prices, plus deficit in budgets diminishes the level of foreign direct investment that comes into Kenya.

Exchange regime in which currency frequently fluctuates triggers long lasting inflation leading to high pricing of goods and services scaring away investors, and hence loss of the benefits associated with FDI (Muema, 2013). Low level of changes in exchange rate attracts foreign direct investment (Gastanga et al., 1998). FDI

inflows are expected to be correlated with low level of inflation (Madura & Fox, 2011).

2.3.3 Economic Growth

Economic is the power house for foreign direct investment, for it is the kind of economic policies which are in place that attract foreign direct investment (Charkrabarti, 2001). Growth hypothesis initiated by Lim (2001) justified that rigorously growing economy yields considerable benefits compared to a relatively growing one.

Mishkin and Eakins (2009) found positive relationship between economic growth and FDI significantly positive. Aoki (2007) study also revealed positive link between FDI and developed economies and mile negative relationship for the case of undeveloped economies negative.

2.4 Empirical Studies

This looks into the empirical studies done both locally and internationally. Empirical studies on FDI in local and international contexts. There are mixed opinions on the FDI inflows and their relationship with macroeconomic variables according to the studies that were done in the local context in the past which discovered Kenya to be behind Uganda and Tanzania in attracting foreign direct investment but has of late changed

Kinuthia (2010) undertook a study to investigate factors impacting foreign direct investment in Kenya. His conclusion was that political stability and policy framework attract foreign direct investment.

Kayonga (2008) stated that investment in developing countries is mostly affected by political unrest, lack of clear economic policies, corruption , clampdown on businesses to suit political interest, reliance on foreign aid, inflation, excessive fluctuation of exchange rate, limited level of international trade involvement, poor labour regulations and rogue financial system. He emphasized the importance of policy framework in administering operation of foreign investors.

Burning issues such as civil wars, dictatorship, religious differences and ethnic tensions have also been identified to be major barriers to developing better policy framework that would govern foreign investment inflow and its operationalization. Only then when mechanisms are in place combined with liberalization and openness will the FDI's benefits be realized substantively in Africa. Astonishingly, liberalized economies were found to be under performing in terms of creating investment environment compared to open economies, economic freedom assessment (2007).

Kim (2011), in his study investigated the relationship between foreign direct investment and economic growth in Kenya using the data from 2000 -2009 to examine the causality, the objective was to ascertain whether changes in macroeconomics variables will have proportionate change in FDI inflows. The conclusion was that, current economic growth in Kenya considerably correlates with FDI inflows. He recommended that, a composition of effective administration of foreign aid and strategic improvement of investment could improve Kenya's economic growth.

Alba, Wang and Park (2005) did a study to investigate the impact of currencies conversion on the inflow of foreign investment into America by using a model that could permit the researcher to examine how foreign direct investments at different

times can overlap each other as time goes on. Two Markov processes were employed to test the correlation between foreign investments at different times. These two Markov processes were purported to be some industries and were categorized on grounds of conducive or unconducive environment for foreign direct investment. A disproportionate industrial data was collected from America's wholesale business. Two findings from the study were arrived at, one was that foreign direct investments at different times overlap as time goes on. The second finding was that exchanges indeed had considerable effect and especially when the environment was conducive for foreign direct investment.

Weeks and Mungule (2013) conducted a study and their remarks were that foreign direct investment in the developed and developing countries is affected by exchange rate and institutional instability. They empirically investigated the phenomenon in a number of countries for a period of more than two decades, both at individual firm's level and nationwide this was tested using partial equilibrium model of remote entry.

The scenario was presented by applying partial equilibrium model of FDI based on oligopolistic industry, where foreign businesses had to figure out whether they should venture into countries marked by fluctuating exchange rate and political instabilities. The findings were that, both exchange rate volatility and political instability had diminishing effect on foreign direct investment inflows, and that the interface was negative, implying the effects in both cases shoulder one another. On sectorial basis, the evidence could show effect in specific industry with regards to interest rates and wages. The study concluded having examined the influence of exchange rate fluctuation, and institutional risk with other important issues taken into account, factors like financial, depository, trade and services have effect on the inflows of FDI.

Oganda (2012) authored a study to investigate correlation between FDI and exchange rate in the horticulture sector in Kenya. 30 horticulture companies with their transactions ranging from 2000 to 2010 were targeted. Data was gathered and was applied to determine and analyse export of goods and service as well as the import of goods and services, interest rates, GDP, exchange, openness of the economy and wages. The study found the link between FDI and the export of goods and services. The whole affair is possibly bound with the conversion of currencies, interest rate, GDP growth and the conduciveness of the economic environment.

Muema (2013 studied causes of foreign direct investment in Kenya when the following trends in exchange rate volatility were recorded, the average exchange rates of the Kenyan shillings against the dollar was 7.66%. The highest fluctuation in exchange rates was 80.03% in 1992 when the shillings depreciated against dollar from sh.58 to sh. 32.22. While on the other hand the least volatility was recorded in 1994 when the value of shillings appreciated against dollar to sh.56.05 from sh.51.43.

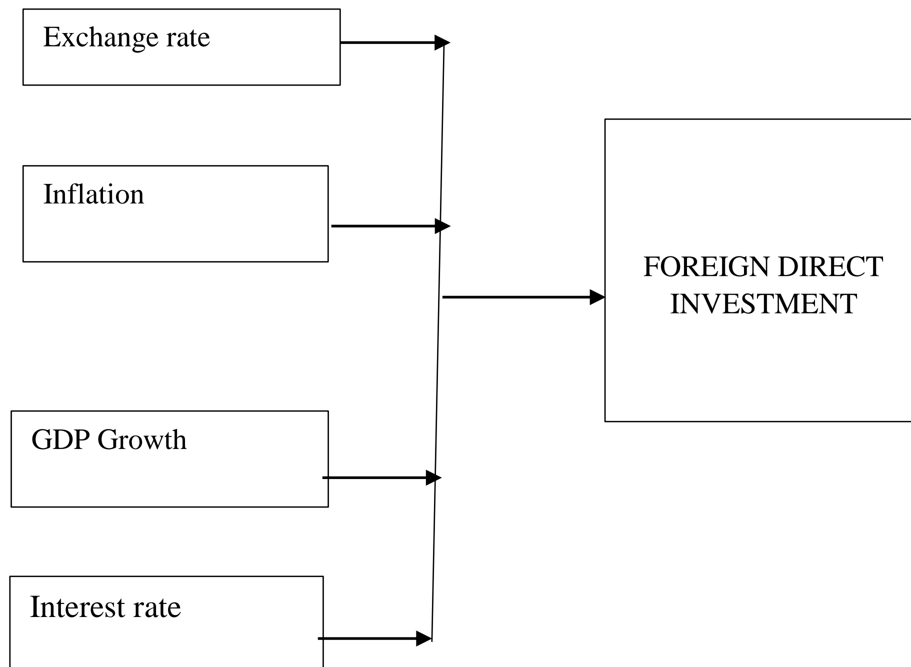
He confirmed the existence of considerable positive correlation between the level of foreign direct investment and exchange rate volatility whereby the then depreciating shillings was linked to increased inflow of FDI. His conclusion was that variations in FDI inflow into Kenya were as a result of shillings conversion into other currencies, especially dollars which is the commonly used currency in the world.

Bilawal et al. (2014) undertook a study to determine whether unpredictability in exchange rate impacted Macro economy in Pakistan, where he applied a 32 time series secondary data of FDI and exchange rate collected from the website of state

Bank of Pakistan from 1982 to 2013. He tested correlation between exchange rate and FDI by regression analysis model using SPSS software. The conclusion justified significant relationship between exchange rate and FDI.

2.5 Conceptual Framework

Conceptual framework explains the relationship between the independent and the dependent variables



2.6 Summary of Literature Review

This is a synopsis of theories and empirical studies regarding the concept of macroeconomic variables and their relationship and impact on foreign direct investment. From theoretical perspective, the theory of Eclectic power by Professor Dunning (1995), in which he emphasised about the importance of location's features, internationalization, and ownership for the country to attract foreign direct investment concurs with the concept of FDI and what ought to be done. In my view these location features without proper attention paid to macroeconomic variables, then the location won't be attractive for investment in whatever the case

Kenya could have not come this far in attracting FDI if she had not put the required conducive economic policies and infrastructures in place, plus the aspect of openness which all together necessitate foreign investment. There will always be deficiencies of which nations that fall in that category would seek a lot from outside, mostly from powerful nations, be it in terms of technology, resource endowment, relevant skills and cheap labour which all together combine to produce goods and services that must cross borders bringing about foreign direct investment.

Among empirical studies, Oganda (2012) conducted a study on horticulture sector in Kenya to investigate relationship between foreign direct investment and exchange rate, and his findings was that exchange rate, interest rate do affect FDI. This proved how activities of macroeconomic variables influence FDI. Alba, Wang and Park (2005) did a study to investigate the impact of currencies conversion on the inflow of foreign investment into America, his findings confirmed the link between macroeconomic variables with FDI given currency conversion was found to be having an effect on FDI.

In a study conducted by Weeks and Mungule (2013) found that FDI is affected by exchange rate and institutional instability. From the literature review, there is some degree of relationship between macroeconomic variables, FDI, economy and financial sector. The review of the literature, however identified gaps given the researches done in the past in Kenya about FDI had only focussed on the effects of FDI on general economic growth neglecting the relationship of specific macroeconomic variables such as inflation, exchange rate, interest rate, and GDP growth with FDI.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This chapter takes into account the research methodology that was used in the study to determine the relationship between macroeconomics variables and foreign direct investment in Kenya

3.2 Research Design

This part in particular tackled research design, population, data collection, data analysis, conceptual model, analytical model and the test of significance. The study applied descriptive research design to analyse the relationship between macroeconomic variables and foreign direct investment. The study used secondary data about the inflow of foreign direct investment into Kenya on annually basis for a period of 47 years which was obtained from World Bank website Kenya. Nonetheless the second portion of the data on macroeconomic variables trends was extracted from Central Bank of Kenya and Kenya National Bureau of Statistics .The study was also enriched by visiting other sites such as IMF website , UNCTAD website , and other material such as business reports, business journals and any other relevant sources that was deemed important to revealing much information about the inflow of Foreign Direct Investment into Kenya and how it has been impacted by macroeconomics variables, the objective was to garner as much as possible literature related to the study.

3.3 Population

The study utilized aggregate data, and therefore the unit analysis is Kenya.

3.4 Data Collection

Secondary data was applied in this study, where 47 years period data was collected on annually basis from the informed and trusted sources such as Kenya National Bureau of statistics, Central Bank of Kenya, World Bank website, UNCTAD website and IMF website

3.5 Data Analysis

Analysis was done using multiple regression technique to determine the correlation between macroeconomic variables and foreign direct investment. Reason being to measure the influence of individual independent variable against its dependent variable in line with its covariance.

Below is the multiple linear regression model which was applied to model the data.

$y=\beta 0+\beta 1X1_{it}+ \beta 2X2_{it}+\beta 3X3_{it}+ \beta 4X4_{it} +\acute{\varepsilon}$

Where,

Y = FDI

Variables	**Measure**
Exchange rate	USD
Inflation	Inflation indexes
GDP growth rate	GDP growth indexes
Interest rate	CBK rate

3.6 Diagnostic Test

Autocorrelation and serial correlation diagnostic tests were used to test relationship between macroeconomics variables and FDI given secondary data is involved in the study

CHAPTER FOUR: DATA ANALYSIS, FINDINGS AND DISCUSSION

4.1 Introduction

This chapter focused on the analysis of the collected data from Central Bank of Kenya, World Bank website, Kenya National Bureau of Statistics, UNCTAD website and IMF website to establish the relationship between Macro-Economic variables and Foreign Direct Investment in Kenya for the period between1970 and 2016.The results were analysed using descriptive statistics, tabulated and graphically presented as shown in the following sections.

4.2 Findings

This section presents the descriptive results of this study which includes measures of central tendency, the trends analysis for annul FDI net inflows, Annual GDP growth rate, annual exchange rate, annual inflation rate and annual interest rate percentage.

4.2.1 Descriptive Statistics

From the analysis of descriptive statistics the finding clearly reveals that Annual FDI net inflows has a mean of 1.114 with a maximum of 944.33, minimum of 0.39 and standard deviation of 193.314, Annual GDP growth has a mean of 5.54, maximum of 22.17, minimum of -4.66, and standard deviation of 4.23, annual inflation rate has weighed mean of 10.064, maximum of 41.99, minimum of -9.22 and standard deviation of 7.79. Annual interest rate has a weighed mean of 126.459, maximum of 834, minimum of 67.20 and standard deviation of 109.583, whereas annual exchange rate has a weighted mean of 699.923 with maximum of 1218.05, minimum of 304.56 and standard deviation of 239.791

Table 4.1: Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
Annual FDI Net Inflows	47	.39	944.33	111.3485	193.31416
Annual GDP Growth	47	-4.66	22.17	4.5423	4.23236
Annual Inflation Rate	47	-9.22	41.99	10.0639	7.79519
Annual Interest Rate	47	67.20	834.00	126.4594	109.58269
Annual Exchange Rate	47	304.56	1218.05	699.9234	239.79140
Valid N (listwise)	47				

4.2.2 Correlation Analysis

Correlation analysis is used to establish if there exists a relationship between two variables which lies between (-) strong negative correlation and (+) perfect positive correlation. Five variables were generated using SPSS (annual foreign direct investment net inflows, annual GDP growth, annual inflation rate, annual Interest rate, annual inflation rate and annual exchange rate)

Table 4.2: Correlation Analysis

Correlations

		ANNUAL FDI NET INFLOWS	ANNUAL GDP GROWTH RATE	ANNUAL INFLATION RATE	ANNUAL INTERESTRATE	ANNUAL EXCHANGE RATE
ANNUAL FDI NET INFLOWS	Pearson Correlation	1	.084	-.034	-.032	.542**
	Sig. (2-tailed)		.575	.823	.829	.000
	N	47	47	47	47	47
ANNUAL GDP GROWTH RATE	Pearson Correlation	.084	1	-.414**	.017	-.161
	Sig. (2-tailed)	.575		.004	.911	.279
	N	47	47	47	47	47
ANNUAL INFLATION RATE	Pearson Correlation	-.034	-.414**	1	-.048	-.070
	Sig. (2-tailed)	.823	.004		.748	.641
	N	47	47	47	47	47
ANNUAL INTEREST RATE	Pearson Correlation	-.032	.017	-.048	1	.179
	Sig. (2-tailed)	.829	.911	.748		.227
	N	47	47	47	47	47
ANNUAL EXCHANGE RATE	Pearson Correlation	.542**	-.161	-.070	.179	1
	Sig. (2-tailed)	.000	.279	.641	.227	
	N	47	47	47	47	47

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

The above table is meant to show the relationships between FDI and macroeconomic variables, and as per the analysis, there is some degree of correlation between the selected macroeconomic variables such as GDP, Inflation rate, interest rate and exchange rate. The analysis also discovered both strong and weak correlations between dependent variables themselves. There exists a strong positive correlation between FDI and GDP growth ($p=.084$, $p>0.05$), this implies growth in GDP has a bearing on foreign investors' decision either to invest or choose not to. Foreign investors are very keen about the dynamics of macroeconomics environment given

their capital and the investment itself could be at stake. There is also strong positive correlation between foreign direct investment and exchange rate (p= .542, p>0.05). This is an indication that foreign investors are concerned about the fluctuation of exchange rate. Currency conversion matters a lot given profit can be lost in the events of currencies conversion, and as such, an investor looks critically at the exchange regime of the country before venturing into that particular investment. However the analysis found relationship between foreign direct investment and inflation to be weak (p= -.034, p>0.05). But still inflation hurts the economy, and no investor would wish to invest in a country which is unstable economically and Kenya is not an exception. Inflation rate needs to be kept minimal as possible. This study also found that there exist a negative correlation between annual interest rate and FDI, (p= -0.32,p>0.05) meaning foreign investors won't bother so much about the lending rate of central , while the correlation between exchange rate and inflation rate was found to be strongly week (p= -.070, p>0.05).

Table 4.3: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.592[a]	.351	.289	162.98048

a. Predictors: (Constant), ANNUAL EXCHANGE RATE, ANNUAL INFLATION RATE, ANNUAL INTEREST RATE, ANNUAL GDP GROWTH RATE

Table 4.3 above indicates that there is an R value of 59.2%. This value indicates that the four dependent variables explain 59.2% of the variance in the foreign direct investment with R square of 35.1% and adjusted R2 of 28.9%. It's very clear that these dependent variables influence to a large extent foreign direct investment. It is therefore sufficiently to conclude that they significantly influence foreign investors decision given the unexplained variance is less than average.

Table 4.4: ANOVA Analysis

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	603405.933	4	150851.483	5.679	.001[b]
	Residual	1115630.747	42	26562.637		
	Total	1719036.681	46			

a. Dependent Variable: ANNUAL FDI NET INFLOWS

b. Predictors: (Constant), ANNUAL EXCHANGE RATE, ANNUAL INFLATION RATE, ANNUAL INTEREST RATE, ANNUAL GDP GROWTH

Given 5% level of significance, the numerator df =1 and denominator df =5, critical value 2.74, table 4.4 shows computed F value as 5.679. This affirms that the overall multiple regression model is statistically significant in that it is the appropriate prediction model which clarifies how the selected macroeconomic variables influence foreign direct investment inflows.

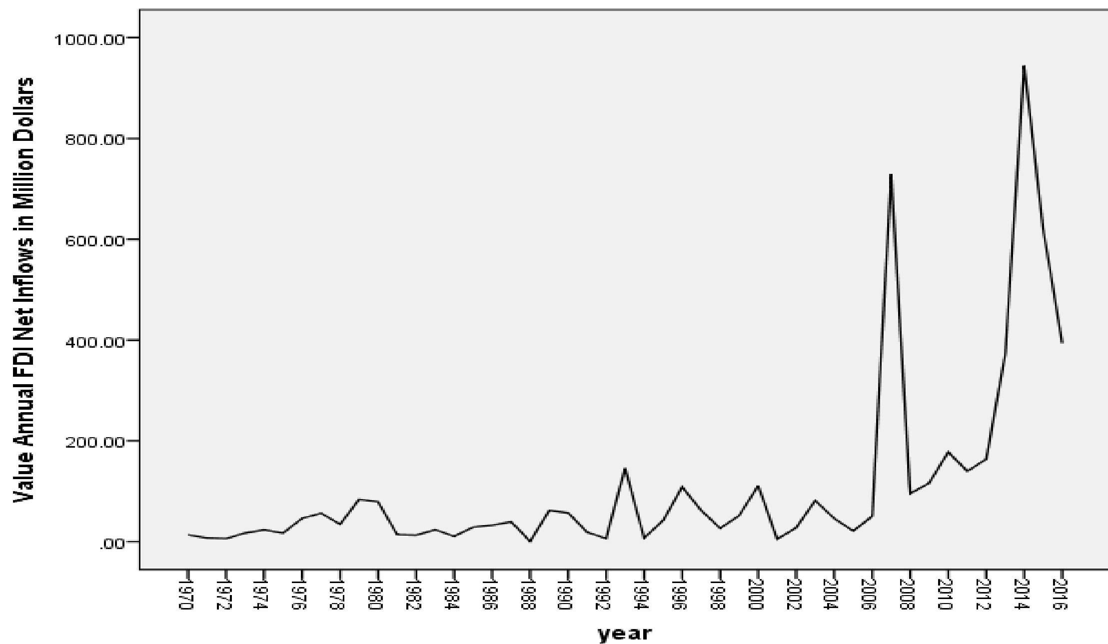
Table 4.5: Regression Analysis

Model		Un-standardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	-271.685	102.325		-2.655	.011
	ANNUAL GDP GROWTH RATE	10.225	6.383	.224	1.602	.117
	ANNUAL INFLATION RATE	2.355	3.427	.095	.687	.496
	ANNUAL INTEREST RATE	-.249	.223	-.141	-1.115	.271
	ANNUAL EXCHANGE RATE	.492	.104	.610	4.710	.000

a. Independent Variable: ANNUAL FDI NET INFLOWS

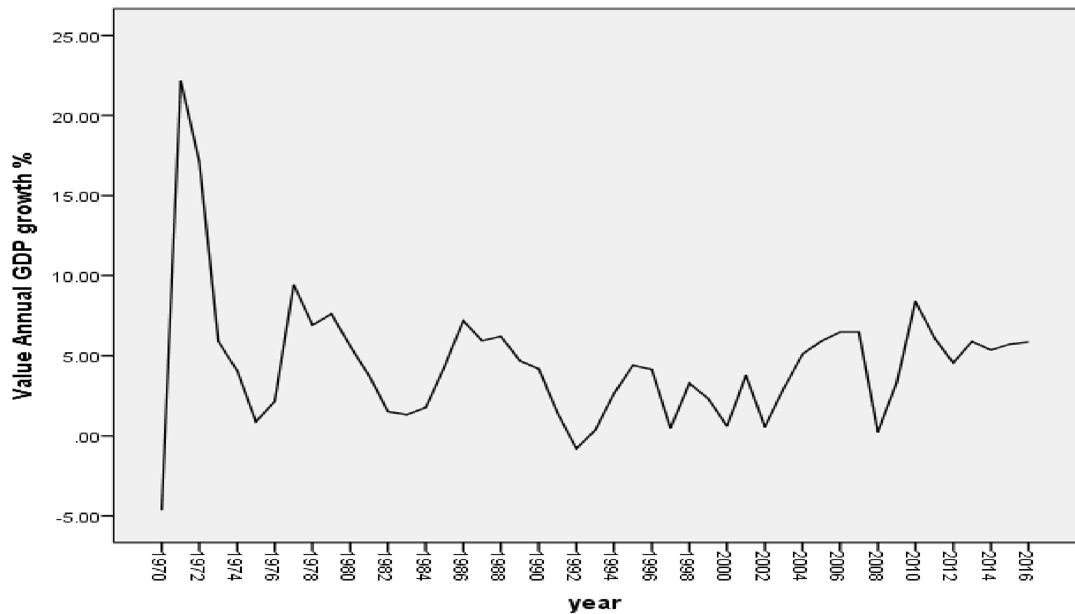
Using a significance level of 5%, any variable having a significant value greater than 5% is considered not statistically significant. This study found annual exchange rate to be statistically significant, with annual interest rate, annual GDP growth and annual inflation rate having a value of more than 5% not statistically significant

Figure 4.1: Foreign Direct Investment Trends



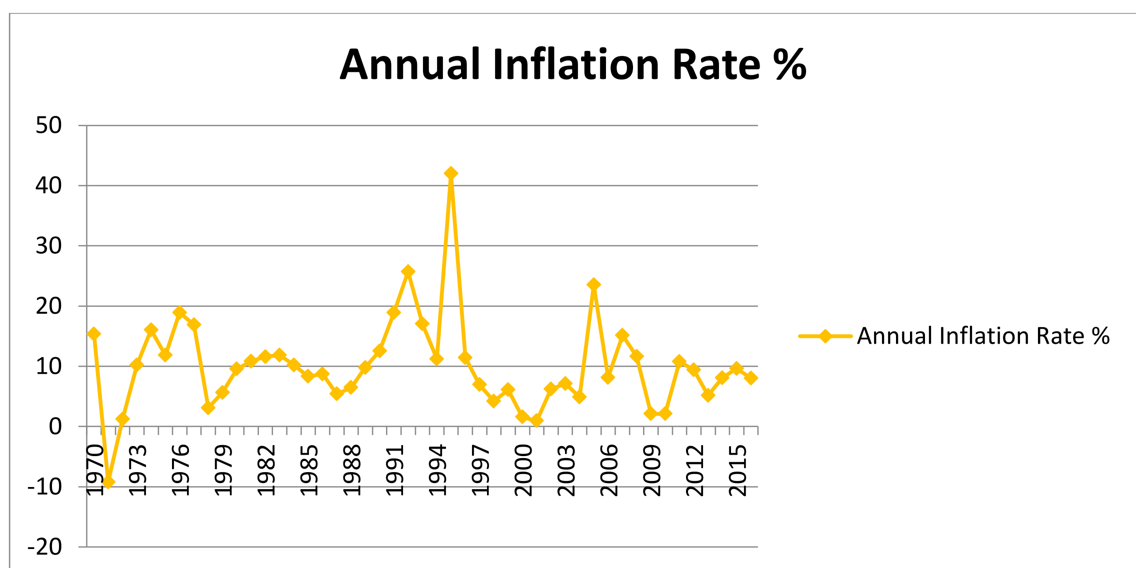
Foreign direct invest trend has been swaying between 2006 and 2016 , and as per the analysis it was found that the amount of FDI inflows has been slow and marked by fluctuation between 1970 and 2006. It increased sharply in 2007 with significant decrease in 2009 and then a bid of increase in 2010. FDI inflows increased significantly in 2013, then it reached its highest in 2014, and then dropped slightly in 2015 and dropped further in 2016.

Figure 4.2: GDP Growth Trends



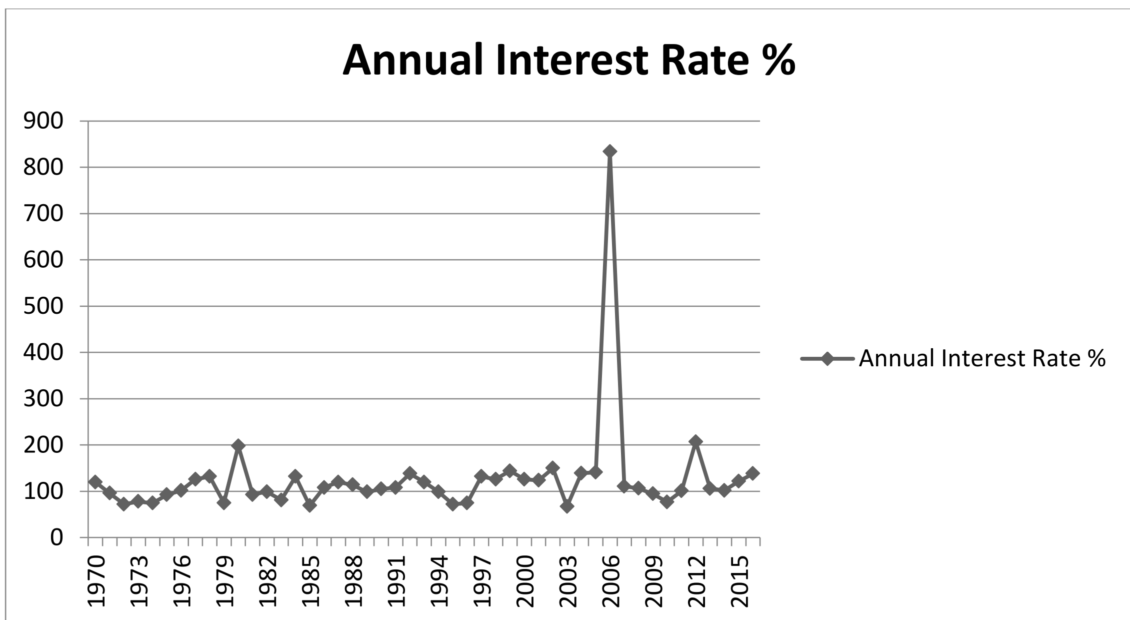
GDP growth rate was at its lowest in 1970, it then increased sharply in 1971 and in fact it was its highest, it declined slightly in 1972 and then it continued dropping in the subsequent years. It grew again in 1977, then felt in 1978 and picked again in 1979. It has been fluctuating in the years following 1979, and that has been the trend up to 2016.

Figure 4.3: Inflation Rate Trends



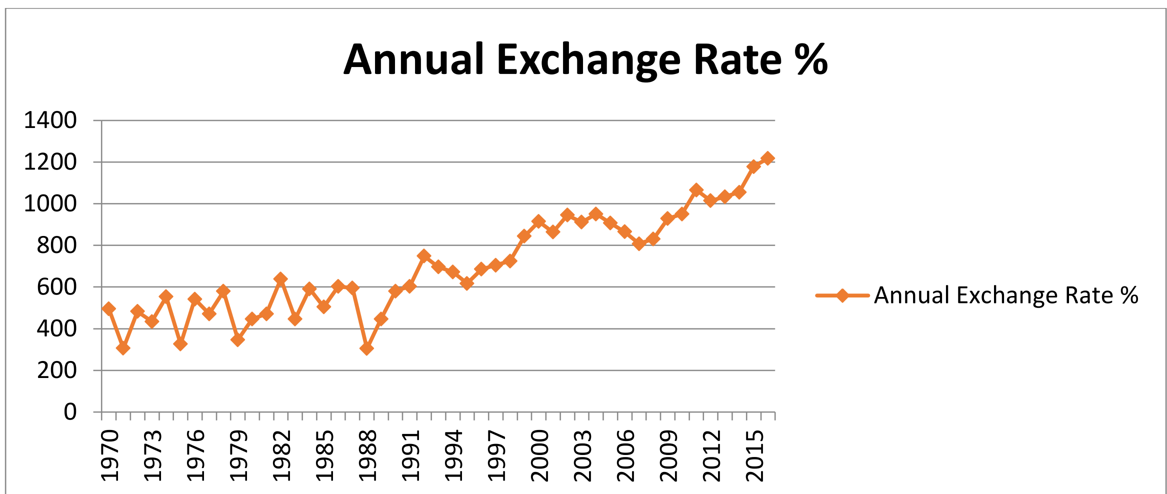
From the analysis of inflation rate between 1970 and 2016, the findings shows that inflation rate recorded a sharp decrease between 1970 and 1972 with a slight increase between 1972 and 1979 followed by a sharp increase in 1995. The rate dropped significantly between 1996 and 2003 with insignificant increase in 2006, followed by slight decrease towards 2016.

Figure 4.4: Interest Rate Trends



The findings on the interest rate movement show a flat fluctuation between 1970 and 2006 with a sharp increase between 2006 followed by a sharp decrease in 2007. Annual interest rate fluctuated slightly between 2007 and 2016 with a slight decrease in 2014.

Figure 4.5: Exchange Rate Trends



The exchange rate of shillings against the dollar has significantly been fluctuating, but marked by upward trends between 1970 and 1987, followed by a significant decrease in the year 1988. The results also reveal that annual exchange rate significant fluctuates upwards with the highest point recorded in 2015 and 2016

CHAPTER FIVE: SUMMARY, FINDINGS AND RECOMMENDATIONS

5.1 Introduction

Derived from the findings, this chapter intends to summarize, concludes, recommends, as well as suggesting areas of further studies

5.2 Summary

The purpose of this study was to establish how foreign direct investment relates with macroeconomic variables undertaken for this study for the period between1970 to 2016. The research adopted descriptive statistics as the appropriate model for the study, secondary data was collected from various institution websites, such as Kenya National Bureau of Statistic, Central Bank of Kenya website and World Bank website, and was analysed to determine how each of the selected macroeconomic variables relate or affect foreign direct investment. As for the trends of the variables, foreign direct investment was found to have decreased slightly between 2007 and 2008 followed by slight increase in 2009, while the GDP growth rate between 2007 and 2016 shows a significant drop between 2007 and 2008 with a sharp increase between 2008 and 2011.

Due to the 2007-2008 crisis and political pressure inflation rate recorded a sharp increase between 2007 and 2009 with a slight drop in 2010 followed by a slight increase in 2011. The rate dropped significantly between 2011 and 2013 with insignificant increase recently. Interest rate movement shows a flat decrease between 2007 and 2009 with a sharp increase between 2009 and 2012, followed by a sharp decrease between 2012 and 2015 with a slight increase towards 2016. For the case Exchange rate , and that is Kenyan shillings against the Dollar was found to have

slight increased between 2007 and 2010 followed by a flat increase towards 2015 with a sharp increase recorded in 2016.

5.3 Conclusions

The findings found there exists a strong relationship between FDI and GDP about 72.8%, and so as between FDI and exchange rate, 66.1%. However the study found weak correlation between foreign direct investment and inflation as well as between FDI and interest rate. The study also found the existence of a relationship between the dependent variables themselves.

This study concludes that the selected macroeconomic variables confirmed their link with FDI. And thus it is a substantive justification that they affect foreign direct investment, and would in no doubt influence foreign investors' decision. This indicates the overall multiple regression model is statistically significant, in that it is a suitable predictor for explaining how the selected macroeconomic variables such as GDP, exchange rate, inflation rate, interest rate which are very crucial ingredients for the economy do relate or affect foreign direct investment inflows

5.4 Recommendation

Having researched on the relationship between macroeconomic variables and foreign direct investment the findings and conclusions leads to the following recommendations; Ministry of Finance and Economic Planning in conjunction with Central Bank of Kenya, and so as the Ministry of Trade and Investment should design fiscal and monetary policies which suit investment environment so that more foreign investors are attracted into Kenya. Foreign investors do pay great deal of attention to how macroeconomic variables do play out, for they affect the returns they expect from investment. Life of the economy depends on good planning, proper utilization of

resources and keeping attention on fluctuation of macroeconomic variables. Foreign investors are risk averse, and hence attracting them requires playing ground to be properly labelled.

5.5 Limitation of the Study

The limitations of the study range from difficulties involved in accessing the data from various sources. Nonetheless, there was an intention to do the analysis on quarterly basis but given the data was given as aggregate or consolidated data could not allow the study to be done on quarterly basis, and as such forced the researcher to consider analysing the data on annually basis

5.6 Area of Further Studies

As this study was based on only four macroeconomic variables, it is recommendable to also investigate relationship of other variables with foreign direct investment so that their overall relationship with foreign direct investment is ascertained

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APPENDIX: SECONDARY DATA

year	Annual FDI Net Inflows in Million Dollars	Annual GDP growth	Annual Inflation Rate %	Annual Interest Rate %	Annual Exchange Rate %
1970	13,800,000	-4.655	15.316	120	495
1971	7,400,000	22.174	-9.219	96	306
1972	6,300,000	17.082	1.205	72	482.4
1973	17,260,000	5.897	10.204	78	434.4
1974	23,420,000	4.066	16.049	74.4	553.56
1975	17,158,747	0.882	11.835	92.4	325.8
1976	46,371,850.86	2.154	18.906	102	541.8
1977	56,545,225.67	9.454	16.9	126	471
1978	34,414,129.67	6.912	3.081	132	579.12
1979	84,009,903.28	7.615	5.639	75	346.8
1980	78,973,745.62	5.592	9.551	198	445.8
1981	14,147,557.18	3.774	10.853	93	470.76
1982	13,000,895	1.506	11.593	99	638.76
1983	23,738,842.68	1.309	11.838	81	446.88
1984	10,753,527.42	1.755	10.191	132	591
1985	28,845,949.04	4.301	8.306	69	504
1986	32,725,776.79	7.178	8.712	108	602.52
1987	39,381,344.20	5.937	5.402	120	595.44
1988	394,430.64	6.203	6.456	114	304.56
1989	62,189,917.27	4.69	9.769	98.64	446.76
1990	57,081,096.18	4.192	12.532	105	580.32
1991	18,830,976.84	1.438	18.897	108	603.36
1992	6,363,133.15	-0.799	25.698	138	748.32
1993	145,655,517.12	0.353	17.016	120	696.02
1994	7,432,412.60	2.633	11.221	99	672.5569
1995	42,289,248.46	4.406	41.989	72	617.158
1996	108,672,931.62	4.147	11.435	74.4	685.38
1997	62,096,809.78	0.475	6.931	132	704.782
1998	26,548,245.97	3.29	4.194	126	724.576
1999	51,953,455.95	2.305	6.08	144	843.88
2000	110,904,550.40	0.6	1.573	126	914.107
2001	5,302,622.94	3.78	0.933	123.6	863.791
2002	27,618,447.06	0.547	6.197	150	944.757
2003	81,738,242.64	2.932	7.127	67.2	911.26
2004	46,063,931.45	5.104	4.9	139.2	950.088
2005	21,211,685.40	5.907	23.53	141	906.595
2006	50,674,725.18	6.472	8.129	834	865.208
2007	729,044,146.04	6.472	15.151	110.75	807.813
2008	95,585,680.23	0.232	11.637	106.25	830.232
2009	116,257,608.99	3.307	2.094	94.5	928.224

2010	178,064,606.75	8.402	2.094	77	950.796
2011	139,862,091.10	6.112	10.792	100.75	1065.73
2012	163,410,210.30	4.563	9.38	207	1014.34
2013	371,846,696.37	5.88	5.169	106	1033.474
2014	944,327,305.01	5.352	8.068	102	1055.07
2015	619,724,465.02	5.713	9.623	121.5	1178.15
2016	394,006,495.16	5.849	8.026	138	1218.051

Source: Kenya National Bureau of Statistics, World Bank website and Central Bank of Kenya