THE RELATIONSHIP BETWEEN FOREIGN DIRECT INVESTMENT (FDI) AND ECONOMIC GROWTH IN KENYA, UGANDA AND TANZANIA

BY

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DECLARATION

This research project is my original work and has not been submitted for a degree in any other university.

Signed_____

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

Signed_____ 16/10/03

DR. MARTIN OGUTU

DEDICATION

To Our Lady Consolata

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ABSTRACT

Many developing countries continue to put in place policies that will attract Foreign Direct Investments (FDI). Such policies are based on positive hopes that FDI enhances economic growth. This study seeks to establish whether there is any relationship between FDI and economic growth for Kenya, Uganda, and Tanzania. The study further seeks to determine if the level of financial sector development influences such relationship. Empirical analysis using data between 1991-2000 shows that FDI positively and directly influences economic growth for Tanzania. No direct relationship between FDI and economic growth were observed for Kenya and Uganda. The test for influence of financial sector development on the FDI/ Growth relationship produced mixed results.

CHAPTER 1

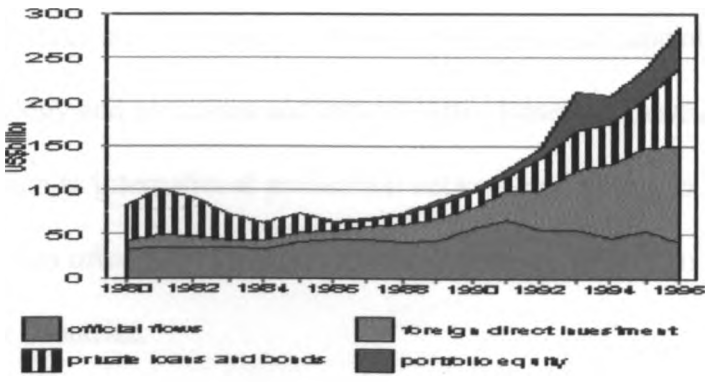
INTRODUCTION

1.1 Trends in Foreign Direct Investment (FDI)

The role of foreign direct investment (FDI) continues to attract a lot of attention among the policymakers, lobbyists, and investors. FDI, looked through the ever expanding role of Multinational Enterprises (MNE's) is largely viewed as the real face of globalisation. Recent estimates suggest that there are about 65,000 MNE's today with more than 850,000 foreign affiliates across the world. (UNCTAD 2002).

The increase of FDI flows to developing countries has been phenomenon with the share of FDI in the total financial flows to developing countries increasing from a low of 12% in 1970's to a high of 35% in 1990-6 (ODI 1997). The share of world total FDI that has been received by the developing countries has risen from around 16% in the 1980's to 28% in the 1990's (UNCTAD 1999a). (See figure 1)

Figure 1: Capital flows to developing countries.



Official Flows: including official grants and loans from bilateral and multilateral organisations.

Foreign Direct Investment: investment made to acquire a lasting management interest, usually at least 10% of voting stock, in an enterprise operating in a country other than that of the investor. This definition of FDI is adopted throughout this study.

Private Loans and Bonds: loans from private banks and other financial institutions and privately placed bonds.

Portfolio Equity Flows: the sum of country funds, depository receipts (US or global), and direct purchases of shares by foreign investors.

Source: ODI, Overseas development Institute, Briefing paper, September 1997 (3)

1.2 FDI and spillover effects

This growth of FDI has been synchronous with the shift in emphasis among policy makers in developing countries to attract more FDI especially after the crisis in emerging economies that was mainly attributed to volatility of capitals flows into those markets. The rationale for increased efforts to attack more FDI results from the belief that FDI has ability to deal with three major obstacles, namely, shortages of financial resources, lack of efficient technology and processes and lack of skills. Based on these and other spillover effects such as international production network and access to international markets, governments often have provided special incentives to foreign firms to set up companies in their countries.

Strangely, the empirical evidence of these benefits both at firm level and at the national level remains unclear. Görg and Greenaway (2002) in their study of literatures on spillover effects of FDI both at firm level and cross sectional level summaries that "Most work fails to find positive spillovers, with some even reporting negative spillovers on aggregate. Evidence on wages and export spillovers is also mixed." (Görg and Greenaway 2002, page 13). At macroeconomic level, result of a study by Carkovic and Levine (2002) indicate that exogenous component of FDI does not exert a reliable positive impact on economic growth.

Görg and Greenaway (2002) cited above assert that the spillover effects depend largely on some "absorptive capacity" of the domestic firms or country. At macroeconomic level similar arguments have been advanced by among others, Mello (1999), Mello (1997) and Borensztein et al (1998).

This study was to find out how economic growth has related to FDI in the three East African countries. While evaluating this relationship, the study sought to determine whether development of financial sector enhances this relationship by way of enhancing the absorptive capacity of each of the three countries.

1.3 East African Community (EAC) : Integration efforts

East Africa is credited with one of the longest experiences in regional integration. As early as 1900, Kenya and Uganda operated a Customs Union, which was later joined by Tanzania in 1922. However, more elaborate regional integration arrangements in East

Africa have included the East African High Commission (1948-1961), the East African Common Services Organisation (1961-1967) and the former East African Community which lasted from 1967 until its collapse in 1977.

With a mediation agreement in 1984, the three East African states, among other undertakings, agreed to explore ways to resume regional co-operation. This led to the 1993 Agreement for the Establishment of the Permanent Tripartite Commission for East African Co-operation. Full operations of the East African Co-operation, however, started on 14th March 1996 with the establishment of the Secretariat of the Permanent Tripartite Commission.

The three countries have now strongly committed themselves towards the revival of the East African community, which aims at integrating the three economies. (EAC Treaty, 2000, articles 82,85 and 86). The Treaty calls upon the member states to develop, harmonise and eventually integrate the financial systems of the partner states. The states are also called upon to facilitate trade and free movement of capital within the community. The community's commitment for a regional approach to both financial sector development and foreign investments is clearly spelt out (EAC Treaty 2000).

Regarding co-operation among the three states, there are already some notable achievements on the areas of investment, capital markets developments and banking. An association of investment promotion agencies (East Africa Association of Investments Agency) was established in May 1998 and some of its efforts are to harmonise the investment incentives and codes of the partner states. An investors guide to East Africa has also been published (EAC 2001).

As regarding the area of capital markets, there are efforts towards harmonisation of policies, trading practices and regulations in the three countries' stock exchanges. This commitment to pursue a regional approach to capital markets development is clearly spelt out in the 1999 EAC treaty. The treaty encourages a move to a wider monetisation of the region's economies in a liberalised market. In particular, article 85 of the Treaty calls for the harmonisation of monetary and capital markets development. (EAC treaty 2000). These efforts are being pursued under the auspices of the East African Securities Regulatory Authorities (EASRA). Already, a capital markets development committee has been established to oversee development of the capital markets (EAC 2001). The treaty is equally not silent on the area of banking; It states that that the partner states shall harmonise their banking act and polices.

The motivation for the scope of this study stems from the initiatives detailed above to harmonise key policies in financial sector development and foreign investment in the three East African countries. The question that may be raised is whether the three countries stand to benefit equally from the regional approach to attract FDI and financial sector development. The scope of this study is far limited to answer that question fully. However, by looking at the past relationship between economic development and FDI and how that relationship has depended on financial sector development, the study may shed some light on the question.

1.4 Statement of the problem

Previous research has tried to establish whether indeed FDI contributes to economic growth of the host country. (See, UNCTAD 1999b & Durham 2000 for review). A generally accepted conclusion is that FDI plays a significant role in promoting economic growth in host countries because FDI represent a package to the host country of capital, managerial skills and technical skills. It is with such positive hopes that FDI will enhance economic growth that the three EAC countries have individually and jointly pursued policies to attract foreign investors. The joint efforts to attract FDI are spelt out in the EAC treaty of 1999 (EAC treaty 2000)

Various researchers have however argued that FDI by itself may not enhance economic growth. They argue that, there are certain factors specific to the host countries that allow a country to benefit more from the FDI inflows, a kind of "absorptive capacity" (Mello 1999 & Borensztein et al 1998). These factors enable the host country to efficiently allocate the capital and technology transfer within the country. Among such factors, the development of stock markets and banking sector plays a crucial role (Alfaro et al 2002).

Alfaro et al argue that spillovers will most often involve costly reorganisation of a firm's structures, purchase of better machines and hiring of new managers and skilled labour. Such improvements, he argues will most often require external financing which often is restricted to domestic sources. King and Levine (1993) and Levine (1997) underscore the importance of financial sector development in a country's economic growth. The latter shows the independent roles of stock market and banks in promoting economic growth.

Looking at the past data, one quickly realises that the three East African countries have experienced quite different levels of FDI flows and economic growth. The trend has a close linkage to political governance and liberalisation of the markets. Annual average net FDI figures between 1990 and 2000 indicate great disparities among the three states. (See graphs in appendix 1). During this period, Kenya's annual average net FDI has been the least at $ 32 million compared with Uganda's $ 87 million and Tanzania's $99 million. (ADI 2002, page 81). Among the three states, Tanzania's attraction of FDI has been the most dramatic. Its efforts to attract FDI started as early as 1985 when a move was made to start the process of moving towards a market driven economy. It was only in the second half of 1990's that the market driven economy started paying off and FDI picked up. During the period 1995- 2000 Tanzania received $1 billion in FDI compared to only $ 90 million it received in the previous six years (UNCTAD 2002). Over the same period, the three economies experienced quite different growth rates with Kenya's growing the slowest at an annual average of 2.1 % compared with Uganda's 6.9 % and Tanzania's 3.0% (ADI 2002, page 15).

In terms of financial institutions, Kenya currently has a more developed financial sector compared with the other two partner states. Kenya's Nairobi Stock Exchange has been in operation since 1954 while both Uganda and Tanzania established their stock exchanges in 1998. Between 1990 and 2000 total credit to the private sector declined in the three states but at different rates; that of Tanzania declined by 16%, Kenya's by 13% and Uganda's by 5% (ADI 2002, page 57).

The purpose of this study is to examine the empirical relationship between net FDI flows and per capita GDP growth rates in the three East African countries for the period

between 1991 to 2000. The study will also examine how that relationship is affected by the financial sector development as indicated by bank development and stock market development. The study seeks to determine whether FDI has significantly influenced growth and whether this relationship is equally significant for the three countries. Positive results would encourage common pursuit to attract foreign investors.

Likewise, given the importance of banks and stock markets to bring about the benefits of FDI to a country, this study seeks to determine if this influence holds for the three countries.

1.5 Research Objectives

The research objectives are to:

1. Determine if there is a relationship between FDI flows and economic growth for each of the three EA. countries.

2. Determine how the relationship is affected or moderated by financial sector development.

1.6 Importance of the study

1. To policymakers, the study sheds light on the importance of FDI on economic growth and whether FDI's effect on economic growth is equally significant for the three EA. countries. If the study results are positive, it will give more weight to the policy of active attraction of foreign investors as encouraged in the EAC treaty and by each of the three countries.

2. This study also determines if there is contribution so far by capital markets and banks in mobilising the capital flows from FDI towards economic development in the three countries. This is critical to policy makers as the three countries move closer to financial market integration.

3. For academic purposes, this research will help determine how similar or different is the relationship between FDI and economic growth in East Africa as compared to the rest of developing and least developed countries.

4. To foreign investors in the region, the study is useful in determining how their investments affect overall economic growth in the three countries. The study may help determine whether the incentive-based FDI attraction they enjoy has empirical support.

CHAPTER 2

LITERATURE REVIEW

2.1 Benefits of FDI

FDI is argued as the most favourable form of capital flows into a country other than donations. Three reasons support this view. First the contribution of FDI to economic growth is direct. Multinational Enterprises (MNEs) establish subsidiaries and affiliates in the host country and therefore increases the level of investment in a country by augmenting the host country's production capacity and creating employment. Second, FDI may exhibits positive externalities through the dissemination of advanced technological and managerial practices such as marketing skills to the host country. Lastly, FDI may also broaden the access of a host country to export market through channels established by the MNEs. (UNCTAD, 1999a Pg 23-24).

FDI is also argued to promote growth of the host country via specific productivity increasing activities such labour training and skills acquisition promoted by MNEs. (Buckely et al 2002). Another key advantage to the host country is that FDI is not easy to reverse and therefore gives several other advantages related to stability of capital flows.

2.2 Conflicting empirical evidence.

The empirical evidence of these benefits both at firm level and at the national level remains unclear. Görg and Greenaway (2002) in their study of literatures on spillover effects of FDI both at firm level and cross sectional level summarised that "Most work fails to find positive spillovers, with some even reporting negative spillovers on aggregate. Evidence on wages and export spillovers is also mixed." (Görg and Greenaway 2002, page 13).

While it seems obvious that FDI should raise productivity within the firms that receives the investments, it is equally likely that FDI has negative effect on productivity of domestically owned plants. Therefore looking at net effects, the results are likely to be mixed.

At microeconomic level, studies also point to mixed results on the positive effects of FDI. In one of the most recent studies on the topic, Carkovic and Levine (2002) finds that FDI has no robust, independent influence on economic growth. Similarly Mbekeani (1997) studied the role of FDI in the growth process of developing countries and found no strong evidence to suggest that FDI has effect on GDP in the short run. He got mixed results on the effect of FDI on economic growth in the long run. In one case, (Malaysia) he found that FDI raises growth more through domestic capital formation while for Mexico the effect of FDI on economic growth is direct (but marginal). Mbekeani finds no effect at all in the case of South Africa. He however concludes that foreign direct investment promotes exports, domestic investment and trade.

Conversely, numerous empirical evidence exists to positively relate the economic growth of a host country with FDI flows. In a study involving cross-country data on eight Asian countries between 1976 and 1997, Ito (1999) finds a positive econometric link between annual economic growth and FDI when lagged one year. Ito's methodology controlled only for contemporaneous expansion in United States and Japan by including their exchange rate and economic growth rates. He argued that these two countries are important trade partners with the Asian countries he studied.

2.3 Case for host country factors.

While Ito (1999) finds unqualified relationship between FDI and economic growth, it seems natural to expect that a country's capacity to take advantage of FDI may be limited by the local conditions. Indeed most of studies with augmented growth (and FDI) have found no significant statistical relations between FDI and the real growth but rather, these studies suggest that FDI depend on a host of other variables to impact growth. For example Mello (1999) shows that the extent to which FDI is growth enhancing depends on the degree of complementary and substitution between FDI and domestic investment. Also, FDI is shown to be more growth enhancing in technological followers than leaders and sensitive to other unobservable country-specific effects. These host country factors affect the "absorptive capacity" of a country to successfully harness FDI towards economic growth.

In an earlier work Mello (1997) argues that an increase in productivity of FDI can only be achieved if there is already a sufficiently high level of human capital in a recipient country. Borensztein et al (1998) similarly highlights the twin role of introduction of new

advanced technology and the absorptive capability in the host country as determinants of economic growth.

There are no definite conclusions as to which local conditions are really important or necessary to enhance a country's absorptive capacity. While looking at the effects of FDI on economic growth within China's 29 provinces, Buckley et al (2002) found no evidence of human capital thresh-hold effect for FDI as posited by Mello (1997), the results of their study rather suggested that FDI favour growth in economically stronger provinces. That is to say, already economically stronger countries are set to gain more from FDI than less stronger countries.

Buckley et al developed their model of analysis from the conventional approach to investigating the relationship between growths and FDI that involves running regressions for the rate of growth on the rate of FDI growth. By adding additional explanatory variables, they constructed their models as follows:

$$Y = a + ß_2C + ß_1K + ß_2L + ß_3H + ß_4M + ß_5E + ß_6I + e$$

Where Y is the growth rate of GDP, C is the growth rate of domestic capital stock; and K is the rate of growth of the FDI stock; L is the growth rate of labour force; H is the human capital. M was supplementary variable representing marketisation ; E representing the growth rate of exports and I being the growth rate of imports. Finally, **a** represented the unobserved inputs that are province-specific while **e** is the white noise error term.

Using a similar model, Lensink and Morrissey (2001) observed a similar finding against the existence of a thresh-hold level of human capital. They arrived at a consistent finding that FDI has a positive effect on growth and further concluded that the evidence for a

positive effect of FDI was not sensitive to whichever other explanatory variables are included. In particular, the positive effect of FDI in economic growth was found not conditional on the level of human capital.

2.4 The role of financial sector in enhancing FDI benefits

The role of well developed financial markets and institutions in enhancing the FDI-growth relationship might be much more visible. There are different ways that well developed financial market may be important. First, it is important to note that for local firms to take advantage of technology transfer it may be necessary that they purchase new machines, hire new managers and skilled labour. More often they may also need to make extensive restructuring of their organisations. Such restructuring exercises are normally expensive.

Not all local firms may be able to finance these new requirements from internal resources only; they must often rely on external financing. The need for external financing becomes even more when the technological gap is wider. This need for external financing applies to both the local affiliates of MNE's as well as other competing domestics firms.

When Vodafone, a European based mobile network operator, acquired a 40% stake in Safaricom, a Kenyan based mobile phone operator, the new Kenyan affiliate needed external financing from the local markets to finance the affiliate's ambitious network expansion program. In 2001, it issued a bond worth Ksh. 4 billion; twice bigger than the largest corporate bond at Nairobi Stock exchange at that time (NSE 2001). Such ambitious financing would not have been possible in absence of a strong capital market.

The potential of FDI to create backward linkages may as well be severely impeded in absence of well-developed financial markets. Creation of new firms that may be encouraged by backward linkages may not be achieved without external financing.

As seen from the example of Safaricom above, it is not just easy availability of loans that is important but also the existence of a well functioning stock market matter. Stock market increases the options for external financing to entrepreneurs and in particular way enhances the linkages between foreign and domestic investors.

Although the role of FDI in economical growth may still be debatable from the empirical evidence, the evidence on influence of financial markets on growth itself has been extensive and a conclusion that indeed, well-developed financial markets promote economic growth has been reached more positively. King and Levine (1993) found that various measures of financial development are positively correlated with economic growth. They further found that a predetermined component of financial development is also robustly correlated with future levels of economic growth. A similar conclusion was arrived at from a wider study covering Dutch republic, US, Japan, German, France and England. In that study, Rousseau and Sylla (2001) arrived at results which suggest that, the growth and increasing globalization in these economies might have been "finance-led".

Levine (1997) singles out the role of stock markets and banks in influencing economic growth. He shows that Stock markets liquidity and banking development provide different services that independently promote growth.

Despite the strong theoretical support on the role of well-developed financial sector in mobilising capital flows from FDI, and positive empirical evidence on the role of financial markets in economic growth, not many studies have considered its impact on FDI –growth relationship. The basis of such hypothesis is that financial sector is key in determining the "absorptive capacity" of a country.

Alfaro et al (2002) did a closely related study to what we endeavour here. In their study they examined various linkages between FDI, financial development and economic growth. The results of their study showed that FDI alone play an ambiguous role in economic development. They however found that countries with well-developed financial markets gained significantly from FDI. To determine the role of FDI on growth through financial markets, Alfaro et al run the following regression :

Growth = ß0 + ß1FDI + ß2(FDI* FINANCE) + ß3 FINANCE + ß4CONTROLS + e

Where, FINANCE represented a measure of financial sector development proxied by banks developments and capital market measures.

This study endeavoured to find out the relationship of FDI and economic growth in the three East African states. It further sought to investigate if that relationship is influenced by the financial sector development as proxied by banking and capital markets development.

CHAPTER 3

METHODOLOGY

3.1 Research Design

This is a case study of Kenya, Uganda and Tanzania covering the period from 1991 to 2000. The statistics will be composed of data on GDP growth rate, nominal GDP, net FDI flows, credit to private sector by financial intermediaries, and Stock markets. The data that will be used will be annual average figures.

Due to the short period that stock markets have existed in Uganda and Tanzania, the stock market data for those two countries is not available for the entire study period. For Tanzania the stock exchange started operating in 1998 and therefore the stock market data of interest is only available for 3 years. Uganda stock exchange started operating in 1998 but it was only in January 2000 that it listed the first equity product. This limits the available data for Uganda stock market to only one year. For Kenya the data is available for the study period of 1991 to 2000. This study therefore excluded the analysis of stock market influence on any FDI-growth relationship for Uganda and Tanzania.

3.2 Data description and collection

All the data used in this study is from various published secondary sources.

The FDI growth indicator used in this research is ratio of net FDI flows into the country to the country's GDP. Data on net FDI flows shall be obtained from World Bank publication "Africa development indicators" (ODI) 2002. Our analysis is based on net FDI inflows. This research adopts the World Bank definition of net FDI as the "net amount invested or reinvested by non-residents to acquire a lasting interest in enterprises

in which they exercise significant managerial control. Investments include equity capital, reinvested earnings, and other capital. The net figures subtract the value of direct investment abroad by residents of the reporting country". (ODI 2002 page 147).

The GDP data used to arrive at the net FDI inflows to GDP ratio is also obtained from the same World Bank publication and given as nominal gross domestic product.

The definition of GDP adopted in this study is the measure of the total output of goods and services for final use produced by residents and non residents, regardless of the allocation to domestic and foreign claims. It is made without making deductions for depreciation of man-made assets or depletion and degradation of natural resources.

The factor representing banking is proxied by the value of total credit to private sector by financial intermediaries divided by the GDP. (*Henceforth referred to as BANK*). Both the data on credit to private sector and the GDP are obtained from World Bank's publication, Africa Development Indicators 2002. (ODI 2002). The data for credit to private sector is calculated from the annual percentage changes and the 1995 figures available from the same source.

Factor representing capital market development is proxied by two indices:

a) The stock market capitalisation divided by the GDP ratio (*henceforth CAPITALISATION*) and
b) The value of the stocks trading i.e. turnover (sales) relative to size of the market (*henceforth TURNOVER*) which is given by the ratio of traded volume in sales to the GDP.

Data on Kenya's capital market was obtained from published publications of the Nairobi stock exchange (NSE 2002). While for Kenya this data is available for the period under study, that of Tanzania and Uganda is available for a relatively short period; 1998- 2002 for Tanzania and 2000-2002 for Uganda, since the stock markets in those countries are relatively young. Due to this shortcoming, it was considered not useful to carry out the regressions against stock market development for both Uganda and Tanzania.

The instrument for collecting the required data for this study is shown in appendix 2.

3.3 Data analysis

To investigate the relationship between growth and FDI the study run multiple regressions of the model described below.

The model is of the form:

$$G = a + ß_1 FDI + ß_2(FDI * FINANCE) + ß_3 FINANCE + E$$

Where,

G is the average annual growth rate of the country's GDP

FDI is the ratio of net Foreign Direct Investment in the country to the country's GDP

FINANCE represents a factor of financial sector development first as represented by the stock market and then by banks development.

a captures country-specific parameter of the unobserved inputs

E is a white noise error term representing the failure to include all possible factors in the model.

Buckely et al (2002) constructed and used a similar model in their study of relationship between FDI, economic growth and influence of regional differences in China's 29 provinces. Buckely et al model did not however included financial sector development indicators. Such factors are not expected to differ significantly within a country since financial markets generally serves the whole country.

The model adopted in this study was developed by Alfaro et al (2002). In this model, FDI is interacted with financial market indicators and used as a regressor to test the significance of the financial market in enhancing the positive spillovers associated with FDI flows. Both the FDI and financial market indicator variables are also included in the regression independently.

This study does not employ lagged growth rate of FDI since it is assumed that current FDI affects current GDP because investment expenditure is obviously a component of GDP. Similar approach is used by Buckely et al (2002).

If indeed FDI positively influences economic growth, we expect the coefficients $ß_1$ to be positive and significant. Similarly if FDI's impact on economic growth is dependent of financial sector development we expect coefficient $ß_2$ to be positive and more significant than $ß_1$. Coefficient $ß_3$ is expected to be positive and significant if the respective financial factor by itself positively impacts on economic growth.

The following hypothesis will be tested.

H_0 : $ß1 = ß2 = 0$, (i.e. FDI and the interaction factor FDI*FINANCE do not affect economic development)

H_1 $ß1, ß2, > 0$, (i.e. FDI and the interaction factor FDI*FINANCE, positively influences economic development)

CHAPTER 4

DATA ANALYSIS AND FINDINGS

STATISTICA computer package was used to analyse the research data. The data was analysed in two stages. First, a set of descriptive statistics was analysed to determine the general tendencies of growth, FDI, and the financial sector development for each of the three countries over the study period. A multiple regression model was then run in the form of:

$$G = a + ß_1 FDI + ß_2(FDI * FINANCE) + ß_3 FINANCE + E$$

Where,

G is the average annual growth rate of the country's GDP

FDI is the ratio of net Foreign Direct Investment in the country to the country's GDP

FINANCE represented a factor of financial sector development. For Uganda and Tanzania this was the ratio of Private Credit to the GDP (i.e. *BANK*) For Kenya, the model was run also for two other factors representing stock market capitalisation and turnover. Market capitalisation factor is give by the ratio of average annual stock market capitalisation dived by the GDP (i.e. *CAPITALISATION*). The factor representing stock market turnover is given by the ratio of annual stock market turnover divided by the GDP (i.e. *TURNOVER*)

a captures country-specific parameter of the unobserved inputs

E is a white noise error term representing the failure to include all possible factors in the model.

4.1 Descriptive statistics

Table 1a. Descriptive Statistics: Kenya (1991-2000)

	Mean	Std. Dev.	Min	Max
Growth	0.017	0.017	(0.008)	0.044
FDI/GDP	0.003	0.003	0.000	0.012
CAPITALISATION	0.181	0.083	0.057	0.341
TURNOVER	5.609	2.883	1.363	9.858
BANK	0.247	0.034	0.197	0.292

Table 1a shows that Kenya over the study period had an annual average growth rate of only 1.7%. At its slowest growth Kenya recorded a negative growth of 0.8%. The net FDI flow has been significantly low at an average 0.3 % of the GDP and with a recorded peak of only 1.2%. Kenya's stock market on the other hand shows an active performance. The average market capitalisation over the period was 18% of the GDP.The market also recorded an average annual turnover of more than 5 times the GDP. The credit advanced to private sector was equally significant at an average 24.7% of the GDP.

Table 1b. Descriptive Statistics: Uganda (1991-2000)

	Mean	Std. Dev.	Min	Max
Growth	0.066	0.026	0.034	0.115
FDI/GDP	0.015	0.016	0.000	0.040
BANK	0.046	0.008	0.034	0.058

Table I b indicates that Uganda recorded a substantial growth rate at an average of 6.6% over the study period. The net FDI was at an average of 1.5 % of the GDP with a minimum and a maximum of 0 and 4% respectively. The average credit to private sector was at average of 4.6% of the GDP.

Table 1c. Descriptive Statistics: Tanzania (1991-2000)

	Mean	Std. Dev.	Min	Max
Growth	0.030	0.015	0.006	0.051
FDI/GDP	0.016	0.007	0.002	0.022
BANK	0.070	0.038	0.025	0.140

Table 1c presents the descriptive statistics for Tanzania. It indicates an average growth rate of 3%. The average level of FDI was 1.6 % of the GDP while the credit to private sector was at an average of 7% of the GDP.

In general, tables 1a, 1b, and 1c shows that there is considerable variation in the share of FDI in GDP across the three countries, ranging from Kenya's share with an average of 0.3% to 1.6% for Tanzania's. GDP growth also shows considerable variations, ranging from 1.7% for Kenya to 6.6% for Uganda. Financial sector variables also range extensively. The common financial sector development indicator among the three countries is the private credit variable; it ranges from 4.6% for Uganda to 24.7% for Kenya. Tanzania's private credit variable lies in between at 7% of the GDP.
Kenya, the data shows has a significantly superior financial sector evidenced by significance of the private credit variable and also the presence of a comparatively strong capital market. Both Uganda and Tanzania had very young capital markets to be included in the study.

4.2 Results of multiple regression analysis

Table 2: FDI, GDP growth, and private credit

	Tanzania			Uganda			Kenya		
	Parameter estimate (Beta Standardised)	T-values	P-level	Parameter estimate (Beta Standardised)	T-values	P-level	Parameter estimate (Beta Standardised)	T-values	P-level
Intercept	**-0.051**	-1,972	0.096	0.004	0.038	0.971	-0.89	-1.221	0.268
FDI	**2.486**	4.025	0.007	-0.128	-0.032	0.976	7.81	0.989	0.361
FDI* BANK	**-1.196**	-3.656	0.011	-0.640	-0.152	0.885	-8.51	-1.046	0.336
BANK	**1.348**	2.471	0.0482	0.516	0.612	0.563	0.918	1.523	0.179
R^2	0.895			0.149			0.325		
F-statistics	**17.018**		0.002	0.349		0.792	0.961		0.470

Notes:

1. The dependent variable is GDP growth
2. Significant beta and F values are in bold
3. Critical values for F(3,6) is 4.757 at 5% and 3.288 at 10% level
3. Critical value for t(6) is 2.447 at 5% and 1.943 at 10% level

The regressions in table 2 examine the role of FDI on growth. Independent variables of FDI and bank development are included in the regression to test their specific significance in enhancing development. FDI was interacted with the bank development indicator and also used as a regressor to test the significance of banks in enhancing positive externalities associated with FDI flows.

As shown in table 2 the model turns out to be significant for the case of Tanzania. The model, as indicated by the F statistics holds at 5% level and with significantly low p-value of 0.002. In case of Tanzania all the three coefficients are significant at 5% level

with low p-values. The intercept is significant at 10% level. The null hypothesis that the beta values for FDI and the interaction term between FDI and BANK are zero is rejected outright for Tanzania. The model as indicated by the R^2 explains about 90% of the variance of growth for Tanzania.

The null hypothesis cannot however be rejected for both Uganda and Kenya.

Tables 3a and 3b show results of other regression tests for Kenya using stock market capitalisation and turnover respectively as the indicators of financial market development.

Table 3a: FDI, GDP growth and stock market capitalisation in Kenya

	Parameter estimate (Beta Standardised)	T-values	P-level
Intercept	**0.012**	1.969	0.097
FDI	-0.026	-0.206	0.844
FDI* CAPITALISATION	**1.160**	6.870	0.000
CAPITALISATION	**-0.339**	-1.990	0.094
R^2	0.916		
F-statistics	**21.681**		0.001

Notes:

4. The dependent variable is GDP growth
5. Significant beta and F values are in bold
6. Critical values for F(3,6) is 4.757 at 5% and 3.288 at 10% level
4. Critical value for t(6) is 2.447 at 5% and 1.943 at 10% level

The results in table 3a indicate that that the coefficients for the interaction term between FDI and CAPITALISATION is positive and significant at 5%. On the other hand, FDI coefficient by itself is insignificant and negative. The CAPITALISATION is by itself

significant but negative at 10% level. A test for joint significant for the model variable shows strong significance as indicated by the F-test results.

Table 3b: FDI, GDP growth, and stock market turnover in Kenya

	Parameter estimate (Beta Standardised)	T-values	P-level
Intercept	-0.012	-0.833	0.437
FDI	0.876	0.781	0.465
FDI* TURNOVER	-1.343	-1.079	0.322
TURNOVER	**1.171**	2.250	0.065
R^2	0.600		
F-statistics	3.005		0.117

Notes:

7. The dependent variable is GDP growth
8. Significant beta and F values are in bold
9. Critical values for F(3,6) is 4.757 at 5% and 3.288 at 10% level
5. Critical value for t(6) is 2.447 at 5% and 1.943 at 10% level

When FDI is interacted with the stock market turnover, the results in table 3b indicates that the F-test for joint significant of the variables indicates failure even at 10%. The model is therefore not plausible.

CHAPTER 5

CONCLUSION

5.1 Summary, Discussions and Conclusions

The first objective for of this study was to determine if there is a relationship between FDI flows and economic growth for each of the three EA. Countries. The results show that there is indeed a strong and positive relationship between FDI and economic growth in case of Tanzania. For Kenya and Uganda, the results shows that FDI has no direct relationship to economic growth.

The results suggest that benefits derived from FDI by host countries can be quite diverse and the actual effect of FDI on the economic growth of the host countries may vary greatly from one country to the other. The case of host country conditions affecting the contribution of FDI on economic growth of a country is therefore strong.

While the positive spill over effects of FDI may seem obvious to the host country, it is equally likely that FDI has negative effect on productivity of domestically owned firms. It is therefore plausible, theoretically, to have mixed results on the overall effect of FDI on the economic growth of the host country.

This study confirm the finding of other studies such as Mbekeani (1997) which found FDI raising economic growth in some countries (e.g. Malaysia) while finding no effect of FDI on growth in the case of South Africa.

From this study it can therefore be concluded that the effects of FDI on economic growth for the three EA. Countries; Kenya Uganda and Tanzania have not been the same. It is only Tanzania that seems to have directly benefited economically from FDI.

The second objective of this study was to determine how the relationship between FDI and economic growth is affected or moderated by financial sector development. The results of this study show that in case of Kenya, the interaction between FDI and stock market capitalisation raises economic growth. Strangely, the study shows that the interaction between FDI and level private credit in Tanzania has a negative effect on economic growth while both FDI and the level of private credit have independently positive impact on economic growth. The interaction between FDI and level of private credit had no significant effect on economic growth in case of Kenya and Uganda. Similarly the effect of stock market turnover and FDI interaction had no significant effect on economic growth for Kenya.

The positive results for Kenya stock market capitalisation and FDI interaction demonstrates that broadly, stock markets may be a positive means of enhancing FDI benefits in a country. It is therefore no surprise that among the top ten companies by market capitalisation at Nairobi Stock Exchange as at 31st December 2001, only one was not foreign controlled or had foreign equity of less than 15%. Indeed, only 3 of the top 10 companies by market capitalisation were not under foreign control (NSE 2002). It is therefore safe to broadly conclude that most of the economic benefits that may have come from Kenya's stock exchange may indeed have come from FDI. The result suggests that FDI may have positive effects over and above its direct role in capital accumulation.

The failure of the model between FDI, turnover, and economic growth to confirm the same finding may in part be due to the extremely low liquidity of the Kenya's stock exchange like many other African stock markets. The low levels of liquidity may not be sufficient enough to spur efficient allocation of capital that would in turn enhance prospects of long-term economic growth. This findings concurs with those arrived at by Alfaro et al (2002) who found that among a group of countries, it is only at the maximum level of financial development that the effects of FDI seem to be positive and significant. Otherwise, the effects of FDI remained negative for most of the financial indicator variables chosen.

The result for Tanzania where the interaction between FDI and credit to private sector appears to negatively influence economic growth could be explained in part due to the fact that FDI and banks have direct and independent impact on growth. This is shown by the fact that both the coefficients of FDI and bank development are positive and significant.

Generally the results indicates that even after interacting FDI with financial development variables the net effect of FDI remains mixed. This inconsistent on the contribution of FDI to economic growth is consistent with findings of Mbekeani (1997) and Alfaro et al (2002). Some countries like Uganda do not seem to benefit from FDI either directly through capital accumulation or through the financial markets. In others like Tanzania the positive effect of FDI is direct. Yet in other countries such as Kenya, the spillover effects

of FDI seems more evident through capital markets. This makes the case for studying effect of FDI among the three countries rather than just one.

5.2 Limitations of the study.

The regression analysis used in this study suffers from inherent limitations from the assumption of linearity of the model. Apart from this limitation the study also covers a period of ten years, which is relatively short to capture any of longer-term benefits of FDI. The timings of the study between 1991 and 2001 may also have cut-off some of the effects from some policies of late 90's especially the privatisation programmes in the three countries. Lastly, the study also considers only financial sector development variables in accessing the effects of FDI on economic growth. A wider study covering other factors such as human development may yield more accurate results.

5.3 Recommendations for further research.

Further empirical investigation into the relationship between FDI and economic growth should be conducted incorporating other variables such as levels of human development. An industry level study may also provide more accurate insights into the benefits of FDI to a host country. Since benefits of FDI differ from country to country, it is important that legal and policy structures operating in the host country be incorporated in future studies of FDI.

5.4 Implications for policy and practise

The findings of this study like those of many others on FDI underscores the need to have well thought policies towards FDI. The fact that the effect of FDI on economic growth is not equally significant even for countries that are actively pursuing regional integration and harmonisation of foreign investment policies is a critical one. It calls for the three East African countries to re-look at the worth of giving incentives to foreign firms seeking to invest locally. Especially where such foreign firms may hurt domestic firms through direct competition any active FDI seeking policy should be scrutinised before adoption. This is in direct conflict with the ongoing harmonisation of foreign investment policies among the three countries. On the other hand, the study finds no support for blanket anti-globalisation policies.

Another key policy implication is that some channels through which FDI is expected to exert positive spillovers such as banks and capital markets, do not necessary perform this role. This may in part be due to their low level of development for the three countries studied. Regional integration of these channels may however boost their performance and in turn mobilise the capital from FDI much more efficiently to impact on economic growth.

An another implication is that foreign investments may not necessarily be beneficial to the host country. An assessment on country per country basis is always necessary. MNE's seeking to invest in another country should always be ready to accept a case per case analysis of the mutual benefits to both the firm and host country. Such analysis should be based on the unique characteristics of the host country environment.

The three East African countries like most developing countries have continued to put in place policies to attract FDI. In theory FDI conclusively has several positive spillover effects on the recipient country. Several of these benefits such as introduction of new processes and technologies to the domestic market, exposure to international market networks, and training in labour force seem laudable to a developing country. However FDI has different impact to different economies. Some countries seem to have the necessary local environment to convert the benefits of FDI into real economic growth. On the other hand some countries seem to derive no positive effect from FDI.

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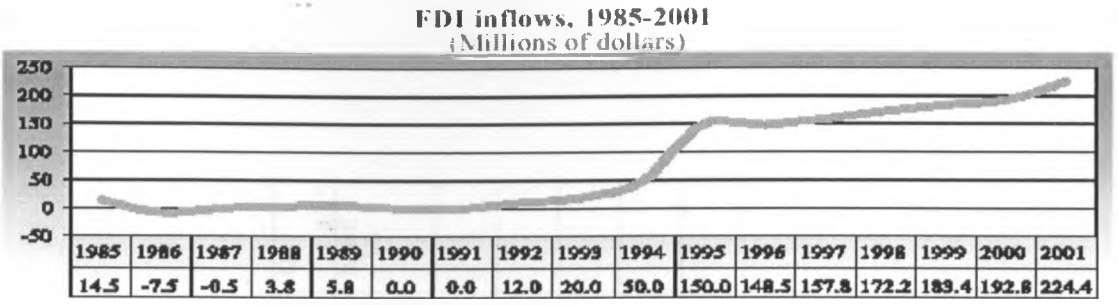
APPENDIX 1 FDI INFLOWS IN EAST AFRICA.

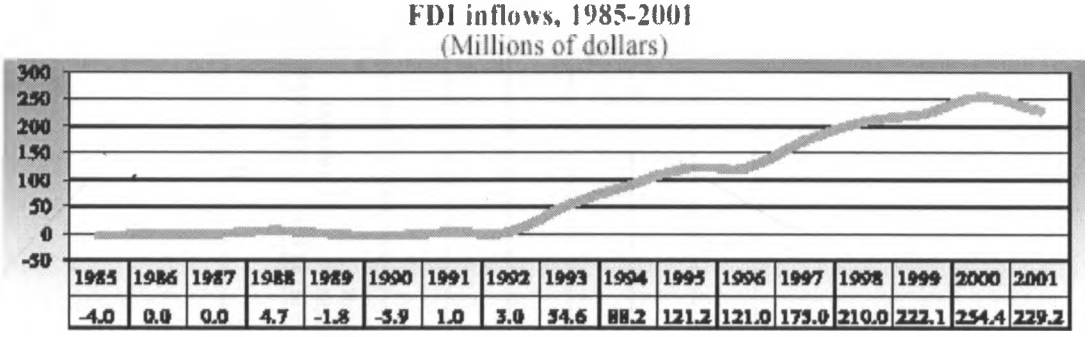
A) Tanzania



1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
14.5	-7.5	-0.5	3.8	5.8	0.0	0.0	12.0	20.0	50.0	150.0	148.5	157.8	172.2	183.4	192.8	224.4

Source: UNCTAD FDI in LDC at a glance 2002, United Nations Publication UNCTAD/ITE/IIA/6 ,2002

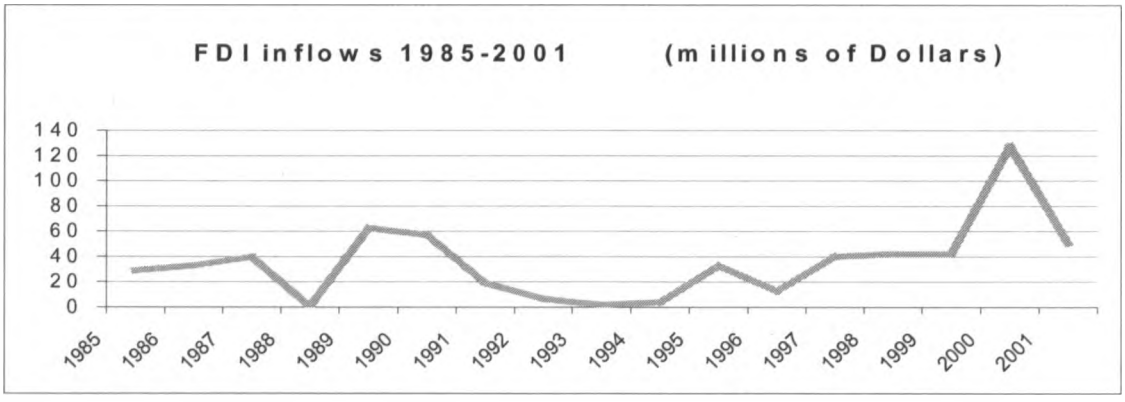
B) Uganda



1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
-4.0	0.0	0.0	4.7	-1.8	-5.9	1.0	3.0	54.6	88.2	121.2	121.0	175.0	210.0	222.1	254.4	229.2

Sources: UNCTAD: FDI in LDC at a glance 2002, United Nations Publication UNCTAD/ITE/IIA/6 ,2002

C) Kenya



Source: UNCTAD Hand Book of Statistic Online. www.unctad.org/statistics/handbook

APPENDIX 2 DATA COLLECTION FORM

DATA COLLECTION FORM (for each country)

A	B	C	D	E	F	G	H	I	J	K
Year	GDP, nominal	GDP growth rate	Net FDI inflows	Net FDI inflow/ GDP ratio	Market Capitalisation	CAPITALISATION = F/B	Stock market Turnover	TURNOVER = H/B	Credit to Private sector	BANK = J/B
1991										
1992										
2000										

APPENDIX 3 RAW DATA

A. KENYA

Year	GDP growth	Net FDI inflow/ GDP	CAPITALISATION = Market Capitalisation/ GDP	TURNOVER =Stock Market Turnover/ GDP	BANK = Credit to Private Sector /GDP
1991	0.014	0.002	0.057	1.363	0.202
1992	-0.008	0.001	0.089	1.493	0.227
1993	0.004	0.000	0.251	2.856	0.214
1994	0.026	0.001	0.341	7.671	0.197
1995	0.044	0.004	0.243	7.194	0.252
1996	0.041	0.001	0.190	7.538	0.278
1997	0.021	0.004	0.183	9.858	0.292
1998	0.016	0.004	0.186	6.619	0.266
1999	0.013	0.004	0.143	6.897	0.273
2000	-0.002	0.012	0.129	4.602	0.268

B. UGANDA

Year	GDP growth	Net FDI inflow/ GDP	BANK = Credit to Private Sector /GDP
1991	0.056	0.000	0.045
1992	0.034	0.001	0.034
1993	0.083	0.001	0.038
1994	0.064	0.001	0.045
1995	0.115	0.000	0.039
1996	0.091	0.018	0.051
1997	0.047	0.025	0.047
1998	0.056	0.028	0.051
1999	0.075	0.036	0.056
2000	0.035	0.040	0.058

C. TANZANIA

Year	GDP growth	Net FDI inflow/ GDP	FDI*BANK	BANK= Credit to Private Sector/GDP
1991	0.021	0.002	0.000	0.140
1992	0.006	0.003	0.000	0.097
1993	0.012	0.015	0.002	0.108
1994	0.016	0.014	0.001	0.097
1995	0.036	0.020	0.001	0.067
1996	0.045	0.021	0.001	0.031
1997	0.035	0.020	0.000	0.025
1998	0.037	0.020	0.001	0.042
1999	0.036	0.022	0.001	0.048
2000	0.051	0.021	0.001	0.046

APPENDIX 4 REGRESSION RESULTS

KENYA: FDI AND BANK

MULTIPLE REGRESSION RESULTS:

Variables were entered in one block

Dependent Variable: GROWTH
Multiple R: .569663501
Multiple R-Square: .324516505
Adjusted R-Square: -.013225243
Number of cases: 10
F (3, 6) = .9608421 p < .469669
Standard Error of Estimate: .017052401
Intercept: -.089271199 Std.Error: .0731197 t(6) = -1.221 p < .267924

STAT. MULTIPLE REGRESS.	Regression Summary for Dependent Variable: GROWTH R= .56966350 R²= .32451650 Adjusted R²= ----- F(3,6)=.96084 p<.46967 Std.Error of estimate: .01705					
N=10	BETA	St. Err. of BETA	B	St. Err. of B	t(6)	p-level
Intercpt			-.089	.0731	-1.22089	.267924
FDI	7.81199	7.899545	38.193	38.6208	.98892	.360892
FDI_BANK	-8.50662	8.128825	-152.643	145.8635	-1.04648	.335656
BANK	.91750	.602518	.455	.2985	1.52277	.178645

STAT. MULTIPLE REGRESS.	Durbin-Watson d (gdpken.sta) and serial correlation of residuals	
	Durbin-Watson d	Serial Corr.
Estimate	.998662	.490473

KENYA : FDI AND CAPITALISATION

MULTIPLE REGRESSION RESULTS:

Variables were entered in one block

Dependent Variable: GROWTH
Multiple R: .956840590
Multiple R-Square: .915543915
Adjusted R-Square: .873315872
Number of cases: 10
F (3, 6) = 21.68095 p < .001275
Standard Error of Estimate: .006029671
Intercept: .011883706 Std.Error: .0060360 t(6) = 1.9688 p < .096511

STAT. MULTIPLE REGRESS.	Regression Summary for Dependent Variable: GROWTH R= .95684059 R²= .91554391 Adjusted R²= .87331587 F(3,6)=21.681 p<.00128 Std.Error of estimate: .00603					
N=10	BETA	St. Err. of BETA	B	St. Err. of B	t(6)	p-level
Intercpt			.011884	.006036	1.96880	.096511
FDI	-.025678	.124909	-.125537	.610680	-.20557	.843925
FDI_CAP	1.160316	.168892	4.863610	.707933	6.87016	.000469
CAPITAL	-.338829	.170303	-.068979	.034670	-1.98956	.093773

STAT. MULTIPLE REGRESS.	Durbin-Watson d (gdpken.sta) and serial correlation of residuals	
	Durbin-Watson d	Serial Corr.
Estimate	1.444528	-.310117

MULTIPLE REGRESSION RESULTS:

Variables were entered in one block

Dependent Variable: GROWTH
Multiple R: .774837228
Multiple R-Square: .600372729
Adjusted R-Square: .400559094
Number of cases: 10
F (3, 6) = 3.004663 p < .116657
Standard Error of Estimate: .013116131
Intercept: -.012063646 Std.Error: .0144858 t(6) = -.8328 p < .436849

STAT. MULTIPLE REGRESS.	Regression Summary for Dependent Variable: GROWTH R= .77483723 R²= .60037273 Adjusted R²= .40055909 F(3,6)=3.0047 p<.11666 Std.Error of estimate: .01312					
N=10	BETA	St. Err. of BETA	B	St. Err. of B	t(6)	p-level
Intercpt			-.01206	.014486	-.83279	.436849
FDI	.87635	1.122163	4.28446	5.486240	.78095	.464522
FDI_TURN	-1.34282	1.244577	-1.23568	1.145273	-1.07894	.322068
TURNOVER	1.17129	.520606	.00688	.003059	2.24985	.065455

STAT. MULTIPLE REGRESS.	Durbin-Watson d (gdpken.sta) and serial correlation of residuals	
	Durbin-Watson d	Serial Corr.
Estimate	1.986402	-.071408

MULTIPLE REGRESSION RESULTS:

Variables were entered in one block

Dependent Variable: GROWTH
Multiple R: .385569453
Multiple R-Square: .148663803
Adjusted R-Square: -.277004295
Number of cases: 10
F (3, 6) = .3492482 p < .791586
Standard Error of Estimate: .029042162
Intercept: .004301008 Std.Error: .1133160 t(6) = .03796 p < .970954

STAT. MULTIPLE REGRESS.	Regression Summary for Dependent Variable: GROWTH R= .38556945 R²= .14866380 Adjusted R²= ----- F(3,6)=.34925 p<.79159 Std.Error of estimate: .02904					
N=10	BETA	St. Err. of BETA	B	St. Err. of B	t(6)	p-level
Intercpt			.0043	.1133	.037956	.970954
FDI	-.128318	4.074113	-.2031	6.4492	-.031496	.975896
FDI_BANK	-.639866	4.222739	-18.3395	121.0299	-.151529	.884525
BANK	.515653	.843319	1.7104	2.7972	.611456	.563332

STAT. MULTIPLE REGRESS.	Durbin-Watson d (gdpug.sta) and serial correlation of residuals	
	Durbin-Watson d	Serial Corr.
Estimate	2.069207	-.059845

MULTIPLE REGRESSION RESULTS:

Variables were entered in one block

Dependent Variable: GROWTH
Multiple R: .945958340
Multiple R-Square: .894837181
Adjusted R-Square: .842255772
Number of cases: 10
F (3, 6) = 17.01813 p < .002442
Standard Error of Estimate: .005900649
Intercept: -.050813570 Std.Error: .0257678 t(6) = -1.972 p < .096086

STAT. MULTIPLE REGRESS.	Regression Summary for Dependent Variable: GROWTH R= .94595834 R²= .89483718 Adjusted R²= .84225577 F(3,6)=17.018 p<.00244 Std.Error of estimate: .00590					
N=10	BETA	St. Err. of BETA	B	St. Err. of B	t(6)	p-level
Intercpt			-.0508	.02577	-1.97198	.096086
FDI	2.48638	.617759	5.0173	1.24658	4.02484	.006921
FDI_BANK	-1.19568	.327059	-39.5059	10.80624	-3.65584	.010632
BANK	1.34790	.545430	.5213	.21095	2.47126	.048375

STAT. MULTIPLE REGRESS.	Durbin-Watson d (gdptz.sta) and serial correlation of residuals	
	Durbin-Watson d	Serial Corr.
Estimate	1.943821	-.423610