

**THE RELATIONSHIP BETWEEN FOREIGN DIRECT INVESTMENTS AND  
ECONOMIC GROWTH IN KENYA**

**BY:**

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## DECLARATION

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

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

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## **DEDICATION**

I dedicate this study to my family for their constant encouragement and patience throughout my academic period. God bless you abundantly.

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## **ABBREVIATIONS**

ANOVA	Analysis Of Variance
COMESA	Common Market for Eastern and Southern Africa
EAC	East African Community
FDI	Foreign Direct Investments
GDP	Gross Domestic Product
GNP	Gross National Product
GVA	Gross Value Added
MNCs	Multinational Corporations
MNEs	Multinational enterprises
IIP	International Investment Position
IMF	International Monetary Fund

## **ABSTRACT**

Foreign Direct Investments (FDI) is generally defined as capital flows resulting from the behavior of multinational companies while Economic Growth is defined as an increase in the production and consumption of goods and services. Investment is the most fundamental determinant of economic growth by being a source for building up physical capital, creating employment opportunities, developing productive capacity, and enhancing skills of local labor and managers through transfer of technology and integration with the rest of the world. The study sought to determine the relationship between foreign direct investment and economic growth in Kenya. This research was conducted through a descriptive survey research design. The descriptive survey research design was considered appropriate as it enables description of the characteristics of certain groups, estimation of the proportion of people who have certain characteristics and making of predictions. This study used quantitative, secondary data. The secondary data sources were obtained from the Central Bank of Kenya, World Bank and UNCTAD databases over a period of 15 years (1994-2014). The data was collected based on the information about the variables. Quantitative data was analyzed by descriptive analysis while qualitative data through content analysis. The study may provide information to policy makers, scholars, academicians and investors on the relationship between FDI and economic growth in Kenya. From the findings, the study established that FDI and exchange rates positively affected the economic growth while inflation rate and interest rates had an inverse relationship with the country's economic growth. The study concludes that there exists a positive relationship between FDI and the economic growth in Kenya. The study recommends that the government policy makers need to push reform agenda in the domestic market so as to attract more FDI in the Kenyan economy. The study also recommends the implementation of sound monetary and fiscal policies by the government to achieve a stable macroeconomic environment.

# CHAPTER ONE

## INTRODUCTION

### 1.1 Background to the Study

The majority of developing countries are facing deficiencies of national savings to finance their investments. In an effort to counter this phenomenon, they have been seeking foreign capital in forms of both direct and indirect investments. Initially, these states acquired loans from international commercial banks. However, in the 1980s the drying-up of commercial banks resulting from the debt crises pushed these states to restructure their investment policies in an effort to appeal to more stable forms of foreign capital. Consequently, Foreign Direct Investments (FDI) have been considered as better means of accumulating foreign capital and eventually minimizing the risks related to the debt. As a result, FDI is replacing the bank loans as a source of capital inflows (Agiomirgianakis, Asteriou and Papatoma, 2003).

The contribution of FDI to the economic growth of developing countries has been debated at length by a number of scholars (Borensztein, De Gregorio and Lee, 1998; Hermes and Lensink, 2003; Lall and Narula 2004). In such discussions, the main question debated is: “how can FDI help trigger economic growth in the receiving countries?” Some scholars have since suggested that FDI growth has mainly negative effects for developing countries while others argue the effects are mainly positive. The advocates argue that FDI provides developing countries with the needed capital for investment, along with employment opportunities, knowledge, skills and new technology. On the other hand, opponents suggest that the promised benefits of FDI have convinced many governments to remove restrictions on FDI inflows.

Consequences of these removals are that multinationals can exploit the local capabilities more freely. Similarly, many international donors promote private investments rather than public investments, leaving the country with no benefits once the companies leave.

### **1.1.1 Foreign Direct Investments**

For many developing countries, economic development depends to a large extent on profitable investments. The first theory about FDI is derived from Stephen Hymer's work (1976) which explicitly recognizes the concept of firm-specific assets. This theory argues that it is illogical to assume perfect competition because FDI can only take place in imperfect markets. Hymer (1976) argues that FDI has to do with the desire to gain control over certain trade situations. In this situation the control over the foreign enterprise is desired in order to remove or regulate competition between that foreign enterprise and the enterprises from other countries. Moreover, it is to benefit fully from the returns of certain skills and abilities.

FDI from the viewpoint of the Balance of Payments and the International Investment Position (IIP) share the same conceptual framework given by the International Monetary Fund (IMF) (2001). The Balance of Payments is a statistical statement that systematically summarizes, for a specific time span, the economic transactions of an economy with the rest of the world (transactions between residents and non-residents) and the IIP compiles for a specific date, such as the end of a year, the value of the

stock of each financial asset and liability as defined in the standard components of the Balance of Payments.

Direct investment reflects the aim of obtaining a lasting interest by a resident entity of one economy (direct investor) in an enterprise that is resident in another economy (the direct investment enterprise) (IMF, 2001; OECD, 1996). The “lasting interest” implies the existence of a long-term relationship between the direct investor and the direct investment enterprise and a significant degree of influence on the management of the latter. Direct investment involves both the initial transaction establishing the relationship between the investor and the enterprise and all subsequent capital transactions between them and among affiliated enterprises, both incorporated and unincorporated (Lipsev, 2001).

### **1.1.2 Economic Growth**

Economic growth is an increase in the production and consumption of goods and services and it occurs when there is an increase in the multiplied product of population and per capita consumption. Economic growth is often and generally indicated by increasing real gross domestic product (GDP) or real gross national product (GNP). Economic growth is a primary, perennial goal of many societies and most governments (Easterly et al., 1993).

According to Knack (1995) economic growth is an increase in the production and consumption of goods and services. It entails increasing population and/or per capita consumption. It is indicated by increasing gross domestic product (GDP). Economic

growth literally refers to an economy that is getting bigger, not necessarily one that is getting better.

### **1.1.3 Foreign Direct Investments and Economic Growth**

FDI is generally defined as capital flows resulting from the behaviour of multinational companies (MNCs) (Agiomirgianakis et al., 2003). Therefore, the factors that affect the behaviour of MNCs may also affect the magnitude and the direction of FDI. While MNCs expand their activities to a foreign country for a number of reasons including, advantages, often owing to a life-cycle pattern of their products or just because their competitors are engaged in similar activities, on the other hand, developing states are also engaged in a policy competition by changing key factors of their economic policies, such as domestic labor market conditions, corporate taxes, tariff barriers, subsidies, privatization and regulatory regime policies so as to improve FDI activity in their countries.

Theoretical literature largely links the impact of FDI on economic growth through various channels such as; technology transfers, investment and increased output. The Capital Arbitrage Theory linked to international trade postulates that prospective foreign investors move their capital resources in response to changes in rates of returns on investment. By this, capital is expected to flow from a capital surplus to a capital deficit country in response to a higher productivity of capital until the rates of returns are equalized. This theory also sees the existence of FDI from the ground that

investing enterprise has management skill or technological advantage, which it can exploit in the foreign economies (Hanushek et al., 1995).

The Theory of the Firm assumes perfect market conditions and also postulates that transactional corporations invest abroad when their investments at home have reached an optimal level and hence any further investments are likely to suffer from diminishing returns to scale. Therefore, FDI is a function of market factors and marginal efficiency of capital (Borensztein et al., 1998).

Foreign Direct Investment (FDI) is considered to be an important source for building up physical capital, creating employment opportunities, developing productive capacity, and enhancing skills of local labour and managers through transfer of technology, and integration with the rest of the world. Foreign direct investment has been argued to play a key role in accelerating growth in developing countries. Over the past two decades, world saving as a proportion of world income has fallen. As a result, real interest rate has declined and inflation rate has risen in the world. It is against this background that foreign direct investment (FDI) has appeared increasingly attractive to developing countries facing declining domestic investment and higher costs of foreign borrowing (Perkins, 2001).



#### **1.1.4 Foreign Direct Investment and Economic Growth in Kenya**

Over the period 1985-2010, the performance of the Kenyan economy has been mixed over time. There has been various GDP growth trends: a) a period of declining growth rates from the 1985 up to 2002; b) a period of growth from 2002 to 2007; c) a sudden fall in 2008 and 2009 partly due to both internal and external shocks and; d) signs of recovery in 2010 with a slight drop in 2011. The trends show that Kenya has not been able to attain and sustain high economic growth rate. The improved growth performance of the economy, particularly between 2003 and 2007, is a result of adoption of sound macroeconomic policies in the country. Even though the Kenyan economy experienced growth in 2010, it was below the year's growth target of 10 per cent (Republic of Kenya, 2011). If past trend in economic performance is anything to go by, then a target growth rate of 10 percent is over-optimistic and there is need to diversify the economy through enactment of sound macro and microeconomic policies (Republic of Kenya, 2014).

According to UNCTAD (2006) FDI in Kenya grew steadily from 1970s due to its relative high level of development, improved infrastructure, larger market size, economic growth and openness to foreign direct investment. FDI started at a low of around \$10 million a year in the early 1970s before peaking at \$80 million in 1979-80. Despite economic reforms and the progress made in improving the business environment, the relative level of FDI inflows into Kenya has never been high by developing countries standards: over 1997–2001, net FDI was about 0.6% of GDP, well below the African average of 1.9%; and by 2003 it was only 7.5 percent of GDP

compared with 25.3 percent for Africa as a whole and 31.5 percent for developing countries (UNCTAD, 2006).

Despite economic reforms and the progress made in improving the business environment, the relative level of FDI inflows into Kenya has never been high by developing countries standards: over 1997–2001, net FDI was about 0.6% of GDP, well below the African average of 1.9%; and by 2003 it was only 7.5 percent of GDP compared with 25.3 percent for Africa as a whole and 31.5 percent for developing countries (UNCTAD, 2006). In addition, over the period 2006-2010, there have been increased capital outflows through acquisition of assets abroad by residents and the global financial crisis experienced from 2008 to early 2010. A comparison of trends in net FDI inflows with economic growth trends shows growth in real GDP and upsurge of FDI inflows in the years 1993 and 2007; the growth in FDI inflows is attributed to removal of capital controls in 1993 and in 2007 it was due to entry of a third mobile phone operator and privatization of Telkom Kenya (UNCTAD, 2013).

## **1.2 Research Problem**

Productive FDI usually brings long lasting and stable capital flows as they are invested in long term assets. These funds are introduced into a country's economy contributing to the aggregate demand of the economy, and therefore to the growth of the economy of a country. Companies within the country, due to the competition brought in by FDI, tend to become more productive to effectively counter the threat of the competitor from abroad (Baracaldo 2005). Employment generation is another

positive effect of FDI (Castilla, 2005). FDI allows for the transfer of technology and specialized knowledge which in turns favors and increase in productivity. The significance of FDI is that such investments in the host country advance technology, management practices and assured markets (Ramírez, 2006). All the various types of infrastructure that are at the disposal of a country like health or education may enjoy the benefit of foreign direct investment (Economy Watch, 2010).

According to De Mello (1999) FDI has positive effects on capital accumulation lending support to some degree of substitutability hypotheses between FDI and domestic investment. Blomstorm, et al., (1992) argues that inflows of FDI have significant effect on growth in higher income developing countries, suggesting that countries have to pass a minimum income threshold in order to benefit from FDI. Balasubramanyan, *et al.*, (1996) revealed that FDI had more impact on economic growth in export-promoting than import-substituting countries. They also found that it is FDI that acts as a driving force in economic growth process and not domestic investment in export oriented countries. Carkovic and Levine (2002) indicated that FDI shows marginal macroeconomic impacts on economic growth, and found no evidence that FDI depends on certain level of human capital stock, economic development, and trade openness to positively impact on the economy. On the other hand Ramírez (2006) postulated that by altering a country's comparative advantages and improving its competitiveness through technology transfer and the effects of myriad externalities, foreign as well as domestic investment can alter a country's economic volume and pattern of trade in many income-enhancing directions.

While these studies were significant in showing the relationship between FDI and economic development, they were conducted in the final years of the 20<sup>th</sup> century and since then a lot of aspects have changed in the country including a change in government. A study by Kurui (2008) found out that Chinese companies have made a contribution to the economy of Kenya but indicates that more research needs to be done looking at a greater scope of foreign investors and picking bigger field of study. In similar studies, scholars have either looked at the determinants of FDI (Wanjala, 2001), impact of FDI on local private investment (King'ang'i, 2003) or researched on the greater regional implications without looking at the specific Kenyan economy (Kayonga, 2008 and Kurui, 2008). This study sought to fill the gap by exploring the relationship between FDI and economic growth in Kenyan and looking at both the positive and the negative implications of the two variables on each other.

### **1.3 Research Objective**

To determine the relationship between foreign direct investment and economic growth in Kenya.

### **1.4 Value of the Study**

This study sheds light on the importance of FDI on Economic Growth. The study would be significant to the government in the sense that Kenya has faced fluctuating economic growth. Understanding the significance of foreign direct investments on economic growth is thus vital for policy formulation regarding interactions between the local economy and foreign investors.

The findings of this study would add knowledge to the existing body of literature and thus be significant to future researchers who would wish to carry out research in this field of study. Researchers may borrow from the findings of this study as well as varying the various variables used in order to get more precise results.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.1 Introduction**

This chapter presents review of empirical literature on the relationship between foreign direct investment and economic growth.

#### **2.2 Theoretical Review**

The study will be guided by the location theory of international investment, neoclassical theory and industrial organization and internalization theories.

##### **2.2.1 Location Theory of International Investment**

Location Theories argued that location theory, if extended across national boundaries, could explain why multinational enterprises (MNEs) emerge (Parry, 1980). Location theory is of two kind; "supply oriented location theory" explains that production takes place where the factor costs for production (including distribution) are the lowest (Dunning, 1973). Conversely, "demand oriented location theory" asserts that the location of a firm is governed by the location of its market and competitors (Dunning, 1973). Bringing the two theory together four main locational factors; raw materials, cheap labor, protected and untapped markets, and transportation costs are believed to give rise to the emergence of MNEs (Buckley, 1985). Although this approach provided valuable insights as to geographical distributions of MNEs, it fell short to explain "how it was that foreign owned firms could outcompete domestic firms in supplying their own market" (Dunning, 1979:273), neither did it give any hint about the origin countries of MNEs.

### **2.2.2 Neoclassical Theory**

Economic development and growth are key themes in the studies of Neoclassical Theorists. They consider production to be interwoven with reproduction, distinguishes saving from consumption and accounts for depreciation and technological progress to develop a model of physical capital accumulation. They hold that one part of the surplus value created in one period is consumed, while the other part becomes next period's capital; thus concluding that after each turn, "capital has produced capital. Neoclassical theories explain international capital flows with differentiated rates of return across countries that lead to capital arbitrage, with capital seeking the highest return.

The future investment flows are directly related to the package of incentives, which influence the expected rate of return; the security of the investment; the scope and speed with which companies are able to disinvest (Cockcroft and Riddell, 1991). Neoclassical theories examine FDI from the perspective of free trade. The tax regime; investment code or guidelines; and overall macroeconomic policies are all elements affecting FDI. Despite these changes, there is still need for action for improvement of factors that inhibited investment.

### **2.2.3 Industrial Organization and Internalization Theories**

Industrial Organization and Internalization Theories address FDI determinants from the viewpoint of the firm. These theories assume that foreign companies have oligopolistic power in the host countries (Cockcroft and Riddell, 1991; Meier, 1994).

The theories hold that micro and macro-economic factors responsible for the real life deviations from the perfect market model. According to this approach, firms choose an investment location because of its comparative advantage in terms of low inflation rates, availability of raw materials, good infrastructure, adequate labor force and low cost of capital. According to Meier (1994), FDI may also be taken to gain control over inputs thus creating a barrier of entry to new competitors.

Industrial organization and internalization theories hold that firms keep operations internal through a hundred percent subsidiary because they want to control the risk and retain control and market share. Multinationals engage in FDI to secure internalization advantages. (Meier, 1994) mentioned that compared with external markets, the firm's linkages, integration, transfer pricing and economies of centralization allow costs to be reduced through FDI.

### **2.3 Determinants of Economic Growth**

Investment is the most fundamental determinant of economic growth identified by both neoclassical and endogenous growth models (Podrecca and Carmeci, 2001). However, in the neoclassical model investment has impact on the transitional period, while the endogenous growth models argue for more permanent effects. The importance attached to investment by these theories has led to an enormous amount of empirical studies examining the relationship between investment and economic growth (Easterly, 2002; Bond, 2002).



Human capital is the main source of growth in several endogenous growth models as well as one of the key extensions of the neoclassical growth model. Since the term 'human capital' refers principally to workers' acquisition of skills and know-how through education and training, the majority of studies have measured the quality of human capital using proxies related to education e.g. school-enrolment rates, tests of mathematics and scientific skills. A large number of studies have found evidence suggesting that educated population is key a determinant of economic growth (Hanushek and Kimko, 2000). Innovation and R&D activities can play a major role in economic progress increasing productivity and growth. This is due to increasing use of technology that enables introduction of new and superior products and processes. This role has been stressed by various endogenous growth models, and the strong relation between innovation/R&D and economic growth has been empirically affirmed by many studies (Lichtenberg, 1992; Ulku, 2004).

Economic policies and macroeconomic conditions have, also, attracted much attention as determinants of economic performance since they can set the framework within which economic growth takes place. Economic policies can influence several aspects of an economy through investment in human capital and infrastructure, improvement of political and legal institutions (Dollar and Kraay, 2000).

Openness to trade has been used extensively in the economic growth literature as a major determinant of growth performance. There are sound theoretical reasons for believing that there is a strong and positive link between openness and growth.

Openness affects economic growth through several channels such as exploitation of comparative advantage, technology transfer and diffusion of knowledge, increasing scale economies and exposure to competition. Openness is usually measured by the ratio of exports to GDP. A large part of the literature has found that economies that are more open to trade and capital flows have higher GDP per capita and grew faster (Dollar and Kraay, 2000). On the other hand, several scholars have criticized the robustness of these findings especially on methodological and measurement grounds (Vamvakidis, 2002).

## **2.4 Empirical Review**

Blomstorm, et al., (1992) explains the importance of income threshold. They applied ordinary least squares (OLS) technique to examine the influence of FDI on growth. Using data from 78 developing countries over the period 1960-1985, they did regression analysis with real GDP per capita growth as dependent on FDI and other variables such as imports, education investment, price and labour participation rate. They found that inflows of FDI have significant effect on growth in higher income developing countries, suggesting that countries have to pass a minimum income threshold in order to benefit from FDI.

Borenstein, *et al.*, (1995) studying human capital stock, applied three-stage least squares (3SLS) technique on panel data from 69 developing countries over the period 1970-1989 to; empirically analyze the impact of FDI on economic growth, examine whether FDI interacts with stock of human capital to affect growth rates and test

whether level of FDI has effect on the overall level of investment in the country and on efficiency of investment. They formulated a growth model which included FDI among the determinants of initial GDP per capita. They found that FDI has a positive overall effect on economic growth, although the degree of such effects depends on the stock of human capital available in the host economy.

According to Balasubramanian, *et al.*, (1996) highlighted the openness of the trade regime and its influence on FDI's impact on growth. They applied OLS and Generalised Least Square Estimates (GLS) to empirically examine the role FDI plays in economic growth in export promoting countries. Using cross-section data from 46 developing countries over period 1970-1985, they found that FDI had positive impact on all sampled countries. However, FDI had more impact on economic growth in export-promoting than import-substituting countries. They also found that it is FDI that acts as a driving force in economic growth process and not domestic investment in export oriented countries.

On degree of development, De Mello (1999) applied instrumental variable (IV) technique on data from 15 OECD and 17 non-OECD countries from 1970-1990 to ascertain the impact of FDI on output, capital accumulation, and total factor productivity. Using panel and time series data, de Mello regressed output on; a vector of variables, FDI and individual country time-invariant effect. De Mello found that the long run effect of FDI on growth is heterogeneous across countries; there is generally weak effect of FDI on economic growth which is positive for OECD but negative for non-OECD. He also found FDI has positive effects on capital

accumulation lending support to some degree of substitutability hypotheses between FDI and domestic investment.

Phillips, et al., (2001) applied Least Square Dummy Variable technique to analyze the effects of FDI on economic growth in Kenya, Uganda and Mauritius. Using both annual and five year averages for period 1970 to 1996, they estimated two systems of equation for growth determinants and FDI. They concluded FDI has a strong stimulus effect on economic growth but it is not a universal remedy in overall improvement of economic growth. It also stimulates domestic investment with one percent increase in the FDI/GDP ratio followed by as much as a 0.80% increase in future domestic investment/GDP ratio in Africa.

A study by Carkovic and Levine (2002) applied Generalized Methods of Moments analysis to estimate effects of FDI inflows on economic growth using data from 72 countries over the period 1960-1995. They also examined whether the growth effects of FDI depend on the host country's investment conditions such human capital stock, financial deepening and level of economy openness. They did a regression analysis of real per capita GDP growth on; gross private capital inflows (FDI) and a vector of conditioning information. They found that FDI shows marginal macroeconomic impacts on economic growth, and found no evidence that FDI depends on certain level of human capital stock, economic development, and trade openness to positively impact on the economy. In fact, their results showed FDI is growth enhancing in countries with low education attainment.

Ahmad, et al., (2003) applied common effect, fixed effects and random effects models to examine the impact of FDI among other variables on economic growth. Using cross-sectional data from 32 countries Kenya inclusive over 1965-1992. They expanded the classical production function by applying Taylor series approximation and incorporating depreciation of both domestic and foreign investment. They found impact of FDI on real GDP to be generally positive though the relationship was not significant with Kenya having negative effect of 3.60.

Kimotho (2010) did a study on the relationship of FDI and economic growth in Kenya. The study found that there was a strong and significant relationship that exists between FDI and economic growth in Kenya. His study justified that the positive relationship depicts that there is direct proportionate relationship which exist between FDI and economic growth. The researcher further provided that both inflation and trade term play important role in explaining changes in growth and foreign direct investment. Accordingly, improve inflation rate and better term of trade to foreign investors would go long way in improving the level of foreign direct investment and economic growth.

Kirwa (2013) investigated the impact of FDI volatility on economic growth in Kenya for the period 1970-2011. Using bounds testing approach, it shows that FDI volatility retards long-run economic growth in Kenya. Results suggest that FDI has a positive result on growth whereas FDI volatility has a negative impact on growth. Trade openness is not FDI inducing, thus affecting growth negatively. Labour force has a

positive impact on growth. Foreign Direct Investment in Kenya contributes positively to economic growth, although its overall effect on economic growth may not be significant.

Ng'ang'a (2013) researched on the impact of FDI on economic growth in Kenya. Based on these findings, the study suggests that Kenya should embark on policies that promote sound macroeconomic policies to: increase and diversify exports; to provide avenues of utilising the idle or unproductive labour and; to reduce the cost of capital. In addition, the study recommends further research on: whether the source of FDI matters and; the effects of incentives offered so as to capture all the dynamics associated with FDI and economic growth in Kenya.

### **2.3 Summary of Literature Review**

While the above studies specify that FDI promotes growth only under very specific conditions, other economists have considered the possibility that not all types of FDI affect growth equally.

Nunnenkamp and Spatz (2003) outline a few different objectives for which multinational corporations invest outside of their home countries. Resource-seeking objectives are evident when firms invest in countries with a key resource (such as oil or cocoa); efficiency-seeking objectives are evident when firms invest in countries with comparative advantages (lower labor costs, for example); and market-seeking objectives are evident when firms invest in countries in order to access local markets for example, investments in telecommunications or banking.

## **CHAPTER THREE**

### **RESEARCH METHODOLOGY**

#### **3.1: Introduction**

This section contains the research methodology adopted for this study. It is subdivided into, research design, study population, sampling design, the data collection model and the analytical model adopted to analyze the data obtained from the records of the foreign companies that have been investing directly in the Kenyan Business Market. These companies were drawn from the banking sector i.e. the Barclays Bank, Standard Chartered and Equatorial Bank.

#### **3.2: Research Design**

This study adopted a descriptive survey research design. This is because descriptive survey research design is appropriate where the study seeks to describe the characteristics of certain groups, estimate the proportion of people who have certain characteristics and make predictions (Cooper and Schindler, 2003). The primary purpose of the study was to study the relationship between foreign direct investment and economic growth in Kenya.

#### **3.3: Study Population**

Target population in statistics is the specific population about which information is desired. According to Denscombe (2008), a population is a well-defined or set of people, services, elements, events, group of things or households that are being investigated. The study population was the FDI flows to the Kenyan Economy as provided by the World Bank and UNCTAD database.

### 3.4: Data Collection

The study used secondary data in assessing how foreign Direct Investment impacts on Kenya's economic growth. A time series data over the period 1994 to 2014 for the following variables; FDI, inflation rates, exchange rates and interest rates which were collected from World Bank database and UNCTAD database.

### 3.5: Data Analysis Model

Data collected was edited, coded and classified into different components to facilitate a better and efficient analysis.

The analytical model specification was as follows;

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon.$$

Where;

$Y$  = is the dependent variable (economic growth in Kenya) which was measured using Gross Domestic Product (GDP). FDI inflows were calculated using inflation rate, exchange rate and real interest rate.

$X_1$  = FDI = Natural log [equity capital + long term capital + short term capital]

$X_2$  = inflation rate =  $([\text{current Consumer Price Index} - \text{old CPI}] / \text{CPI old} * 100)$

$X_3$  = exchange rate =  $([\text{Nominal exchange rate} * \text{domestic price}] / \text{foreign price})$

US dollar (\$) versus the Kenyan shilling exchange rate will be used.

$X_4$  = interest rate =  $(A/P)^{1/t} - 1$

$\varepsilon$  = error term  $\beta$  = coefficient of independent variable  $\alpha$  = constant



The multiple linear regression model and t-statistic were used to determine the relative importance (sensitivity) of the independent variable (FDI inflows) in affecting the economic growth in Kenya which was measured using GDP. The results were said to be statistically significant within the 0.05 level, which means that the significance value must be smaller than 0.05. The significance was determined by the t-value, which indicates how many standard error means the sample diverges from the tested value (Kothari, 2004).

## **CHAPTER FOUR**

### **DATA ANALYSIS, INTERPRETATION AND PRESENTATION**

#### **4.1 Introduction**

This chapter presents data analysis, presentation and interpretation. The objective of the study was to determine the relationship between foreign direct investment and economic growth in Kenya. Data was collected from the World Bank and UNCTAD databases from 1999 to 2014. Data was collected based on the variables of the study, that is, economic growth in Kenya depicted by FDI, inflation rate, exchange rate and real interest rate.

#### **4.2 Descriptive Statistics**

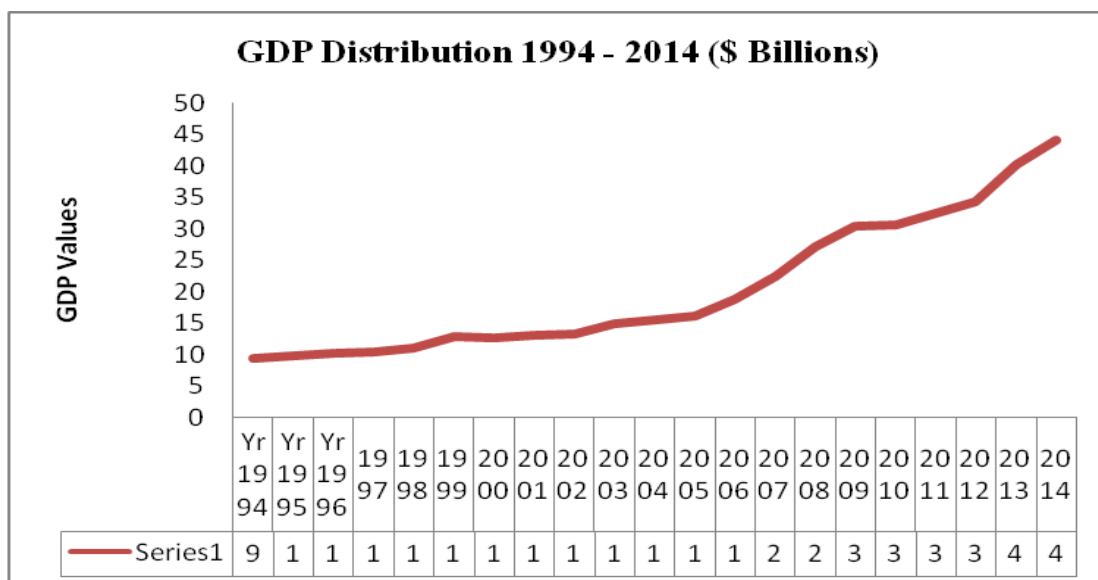
##### **4.2.1 GDP, FDI, Inflation rate, Interest rate and Foreign Exchange Rate**

According to Knack (1995) economic growth is an increase in the production and consumption of goods and services and entails increasing population and/or per capita consumption. The study findings on GDP, FDI, Inflation rate, interest rate and Foreign Exchange rate are as presented in the Table 4.1 below.

**Table 4.1 GDP, FDI, Inflation rate, Foreign Exchange Rate and Interest Rate**

<b>Year</b>	<b>Actual GDP Values (\$ 'billion')</b>	<b>FDI Values (\$ 'millions)</b>	<b>Annual Average Inflation rate Values (%)</b>	<b>Annual Average Foreign exchange rates (Kshs/1\$)</b>	<b>Annual Average Interest Rates (%)</b>
<b>Std. Dev</b>	0.853	2.8.2	1.71	0.701	1.466
<b>Lowest</b>	9.4	5.3	1.55	65.54	12.5
<b>Highest</b>	44.1	729.0	45.98	88.81	24.4
<b>Mean</b>	20.47	142.6	11.9	75.3	18.01

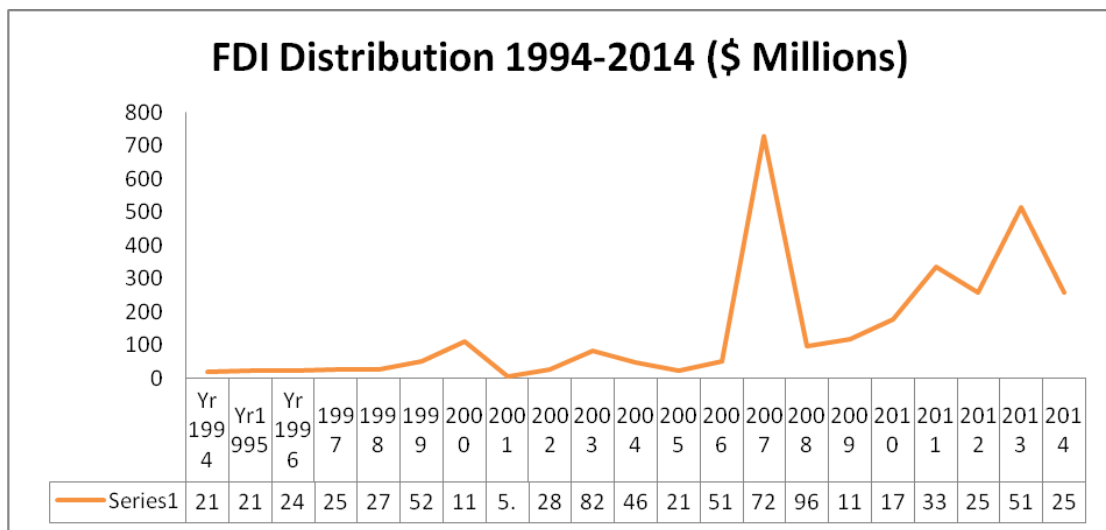
**Figure 4.1 Gross Domestic Product (GDP) Distribution**



The findings as shown in Table 4.1/Figure 4.1 indicate the trend of Gross Domestic Product (GDP) values over the 20 year period. The lowest value for GDP was US

\$9.4 billion in year 1994 while the highest value for GDP was US \$44.1 billion in year 2014. This represented a positive change in the GDP values of US \$ 34.7 over the 20 year period. The steady rise in GDP values over the 20 year period indicates that the economic growth of Kenya has been on the increase over the last 20 years.

**Figure 4.2 Foreign Direct Investments (FDI)**

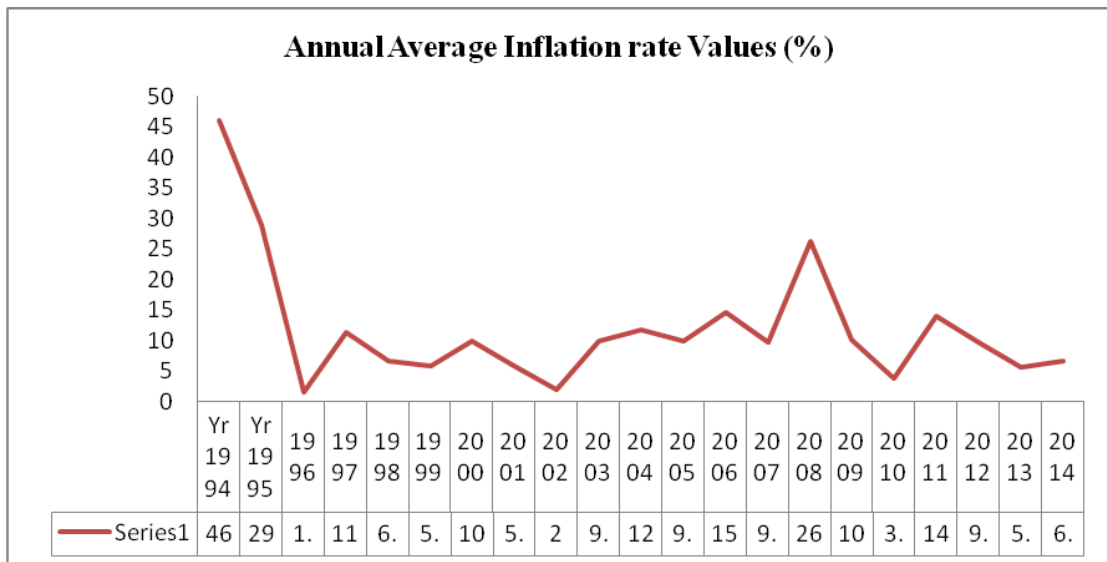


The findings as shown in Table 4.1/Figure 4.2 above indicate the trend of Foreign Direct Investments (FDI) values over the 20 year period. The lowest value for FDI was US \$5.3 million in year 2001 while the highest value for FDI was US \$729.0 million in year 2007. The findings indicate rising and falling FDI values with huge variations over the 20 year period. On the other hand, high scores of standard deviation indicate variation in the yearly FDI values of Kenya over the 20 year period. However, the findings indicate that there has been higher FDI values in the latter years [2007-2014] compared to the former years [1994-2006].

### 4.2.3 Inflation Rate

The findings on the inflation rate values are as presented in the Table 4.1 above and Figure 4.3 below.

**Figure 4.3 Inflation Rate**

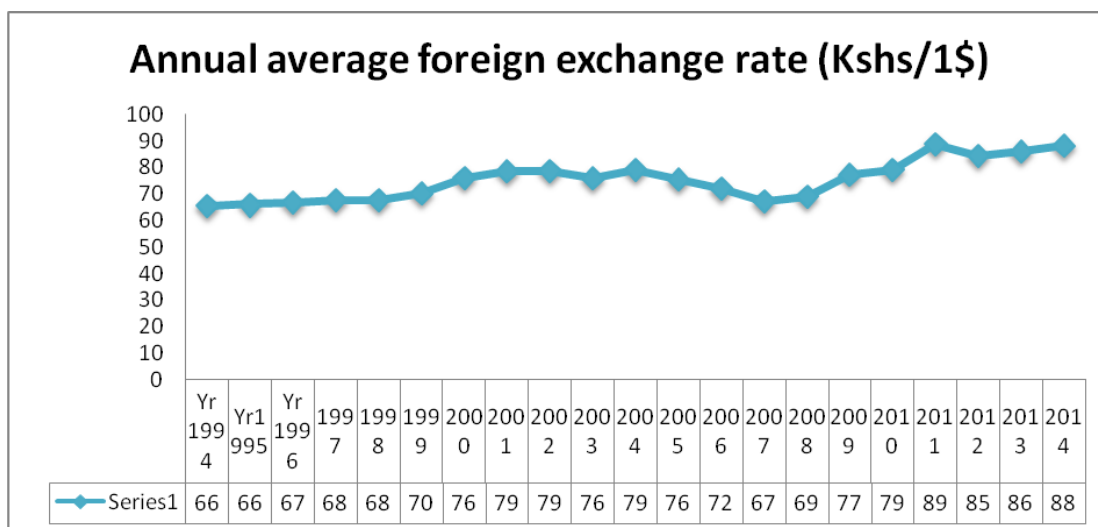


The findings as shown in Table 4.1/Figure 4.3 above indicate the trend of annual average inflation rate values over the 20 year period. The lowest inflation rate value was 1.55% in year 1996 while the highest inflation rate value was 45.98% in year 1994. The findings indicate rising and falling inflation rate values with significant annual variations over the 20 year period.

### 4.2.4 Exchange Rate

The findings on the exchange rate values are as presented in the Table 4.1 above and Figure 4.4 below.

**Figure 4.4 Exchange Rate**

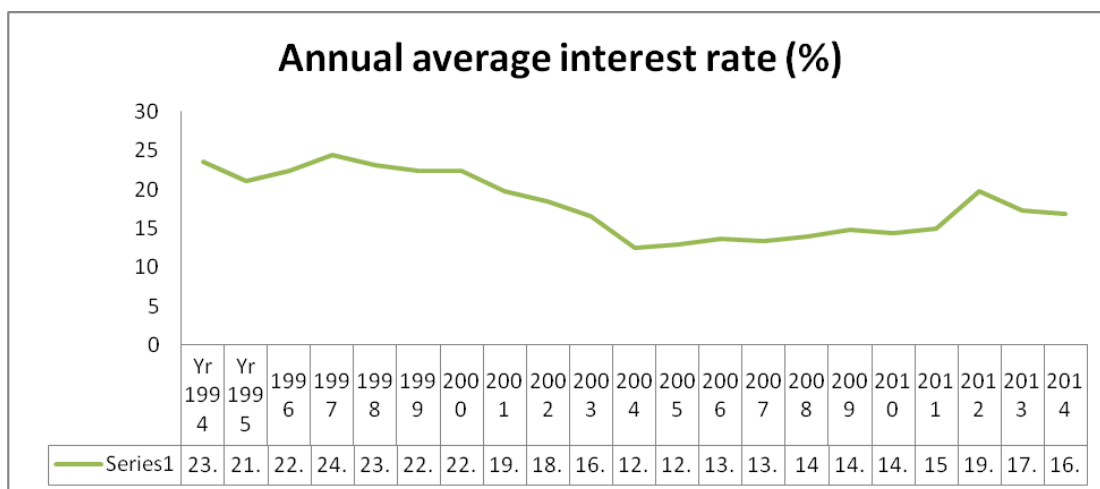


The findings as shown in Table 4.1/Figure 4.4 above indicate the trend of foreign exchange rate values over the 20 year period of Kenya Shilling relative to the US Dollar. The lowest exchange rate value was 65.54 in year 1994 while the highest exchange rate value was 88.81 in year 2011. The findings indicate fluctuating levels of exchange rate values with significant annual variations over the 20 year period. However, the findings indicate that there was a general steady rise in Kenya’s exchange rate values over the 20 year period.

**4.2.4 Interest Rate**

The findings on the interest rate values are as presented in the Table 4.1 and Figure 4.5 below.

**Figure 4.5 Interest rate**



The findings as shown in Table 4.1/Figure 4.5 above indicates the trend of interest rate values over the 20 year period. The lowest interest rate value was 12.5% in year 2004 while the highest interest rate value was 24.4% in year 1997. The findings indicate fluctuating levels of interest rate values with slight annual variations over the 20 year period. The findings indicate that there was a general steady decrease in Kenya’s interest rate values between 1994 and 2004 [24.4% to 12.5%], followed by a steady increase from 2005 to 2012 [12.9% to 19.7%] before a slight decrease in 2013 and 2014 [17.3% and 16.8%, respectively].

### 4.2.5 Correlation Analysis

**Table 4.2 Correlation Matrix**

	<b>GDP</b>	<b>FDI</b>	<b>Inflation rate</b>	<b>Exchange rate</b>
<b>GDP</b>	1.0000			
<b>FDI</b>	0.0465	1.0000		
<b>Inflation rate</b>	-0.4552	0.2893	1.0000	
<b>Exchange rate</b>	-0.7150	0.2701	0.3487	1.0000

Based on the correlation matrix on Table 4.2 above, FDI is positively related to GDP while Inflation and Exchange rate are negatively related to GDP.

### 4.3 Inferential Statistics

In determining the relationship between foreign direct investment and economic growth in Kenya, the study conducted a multiple regression analysis to determine the nature of relationship between the variables. The regression model specification was as follows;

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon.$$

Where; Y= economic growth in Kenya = Gross Domestic Product

X<sub>1</sub> = FDI, X<sub>2</sub> = inflation rate, X<sub>3</sub> = exchange rate and X<sub>4</sub> = interest rate

$\alpha$ =constant,

$\varepsilon$ = error term and  $\beta_1$ -  $\beta_4$  = coefficients of the independent variables.



This section presents a discussion of the results of the multiple regression analysis. The study conducted a multiple regression analysis to determine the relationship between foreign direct investments and economic growth in Kenya. The study applied the statistical package for social sciences (SPSS) to code, enter and compute the measurements of the multiple regressions for the study. The findings are as presented in the following tables;

**Table 4.3 Model Summary**

<b>Model</b>	<b>R</b>	<b>R Square</b>	<b>Adjusted R Square</b>	<b>Std. Error of the Estimate</b>	
1	.897 <sup>a</sup>	.8046	.765	0.0125	

a. Predictors: (Constant), FDI, inflation rate, exchange rate, interest rate

b. Dependent Variable: Gross Domestic Product [Economic growth in Kenya]

Coefficient of determination explains the extent to which changes in the dependent variable can be explained by the changes in the independent variables or the percentage of variation in the dependent variable (GDP) that is explained by all the four independent variables (FDI, inflation rate, exchange rate and interest rate).

The four independent variables that were studied, explain 80.46% of variance in economic growth in Kenya as represented by the  $R^2$ . This therefore means that other factors not studied in this research contribute 19.54% of variance in the dependent

variable. Therefore, further research should be conducted to investigate the other factors that affect the economic growth in Kenya.

**Table 4.4 ANOVA**

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	1.323	5	.202	8.64	.004 <sup>a</sup>
	Residual	5.408	15	.246		
	Total	6.731	20			

a. Predictors: (Constant), FDI, inflation rate, exchange rate, interest rate

b. Dependent Variable: Gross Domestic Product [Economic growth in Kenya]

Analysis of Variance (ANOVA) consists of calculations that provide information about levels of variability within a regression model and form a basis for tests of significance. The "F" column provides a statistic for testing the hypothesis that all  $\beta \neq 0$  against the null hypothesis that  $\beta = 0$  (Weisberg, 2005). From the findings the significance value is .004 which is less than 0.05 thus the model is statistically significant in predicting how FDI, inflation rate, exchange rate and interest rate affect Kenya's GDP. The F critical at 5% level of significance was 3.23. Since F calculated (value = 8.64) is greater than the F critical (3.23), this shows that the overall model was significant.

**Table 4.5 Multiple Regression Analysis**

Model	Unstandardized Coefficients		Standardized Coefficients	t values	Sig.
	B	Std. Error	Beta		
(Constant)	4.678	.826		3.61	.000
Foreign Direct Investment	0.856	.0312	0.218	1.81	.008
Inflation rate	0.748	.864	0.359	8.41	.012
Exchange rate	0.682	.864	0.359	8.41	.018
Interest rate	0.453	.682	0.142	4.56	.022

From the regression findings, the substitution of the equation

$(Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \varepsilon)$  becomes:

$$Y = 4.678 + 0.856 X_1 + 0.748 X_2 + 0.682 X_3 + 0.453 X_4 + \varepsilon$$

Where Y is the dependent variable (GDP),  $X_1$  is the FDI,  $X_2$  is the inflation rate,  $X_3$  is the exchange rate and  $X_4$  is the interest rate.

According to the equation, taking all the factors (FDI, inflation rate, exchange rate and interest rate) constant at zero, GDP will be 4.678. The data findings also show that a unit increase in FDI will lead to a 0.856 increase in GDP; a unit increase in inflation rate will lead to a 0.748 increase in GDP; a unit increase in exchange rate will lead to a 0.682 increase in GDP while a unit increase in interest rate will lead to a 0.453 increase in GDP. This means that the most significant factor is FDI followed by inflation rate. At 5% level of significance and 95% level of confidence, FDI had a 0.008 level of significance; inflation rate had a 0.012 level of significance; exchange rate had a 0.018 level of significance while interest rate had a 0.022 level of significance, implying that the most significant factor is FDI followed by inflation rate, exchange rate and interest rate, respectively.

#### **4.4 Discussion of Research Findings**

The objective of the study was to determine the relationship between foreign direct investment and economic growth in Kenya. The objective was assessed by use of secondary data and the subsequent analysis based on the variables of the study.

The study findings revealed rising and falling FDI values with huge variations over the 20 year period with the lowest value for FDI being US \$5.3 million in year 2001 and the highest value for FDI being US \$729.0 million in year 2007. However, the findings indicate that there has been higher FDI values in the latter years [2007-2014] compared to the former years [1994-2006]. Given that there have been higher FDI values in the latter years [2007-2014] compared to the former years [1994-2006] and

the corresponding increase in Kenya's actual GDP values over the same period, there exists a positive relationship between FDI and the economic growth in Kenya.

From the findings, the economic growth in Kenya increased over the 20 year period. The increase in the actual GDP values from US \$9.4 billion in year 1994 to US \$44.1 billion in year 2014 indicates a steady increase in Kenya's economic growth over the 20 year period. These findings are consistent with Republic of Kenya (2011) report which observed that the improved growth performance of the economy, particularly between 2003 and 2007, is a result of adoption of sound macroeconomic policies in the country.

These findings are in line with Baracaldo (2005) who observed that productive FDI usually brings long lasting and stable capital flows as they are invested in long term assets. These funds are introduced into a country's economy contributing to the aggregate demand of the economy, and therefore to the growth of the economy of a country. The findings are also in line with Castilla (2005) who notes that employment generation is another positive effect of FDI while Ramirez (2006) noted that FDI allows for the transfer of technology and specialized knowledge which in turns favors and increase in productivity. The significance of FDI is that such investments in the host country advance technology, management practices and assured markets. Blomstorm, et al., (1992) argues that inflows of FDI have significant effect on growth in higher income developing countries, suggesting that it acts as a driving force in economic growth process. The findings are also consistent with Podrecca and

Carmeci (2001) who noted that investment is the most fundamental determinant of economic growth as identified by both neoclassical and endogenous growth models.

The study findings revealed rising and falling inflation rate values with significant annual variations over the 20 year period with the lowest inflation rate value being 1.97% in year 2002 and the highest inflation rate value being 26.20% in year 2008. However, the findings indicate that the annual average inflation rate values remained at single digits (and hence, low) for majority of the years in the period of study and hence there exists an inverse relationship between the levels of inflation rates and the economic growth in Kenya. These findings are in line with Dollar and Kraay (2000) who observed that economic policies and macroeconomic conditions have, also, attracted much attention as determinants of economic performance since they can set the framework within which economic growth takes place. They observed that economic policies can influence several aspects of an economy through investment in human capital and infrastructure, improvement of political and legal institutions. The findings are supported by Cockcroft and Riddell (1991) and Meier (1994) argument that firms choose an investment location because of its comparative advantage in terms of low inflation rates, availability of raw materials, good infrastructure, adequate labor force and low cost of capital.

The study findings revealed fluctuating levels of exchange rate values with significant annual variations over the 20 year period with the lowest exchange rate value being 67.32 in year 2007 and the highest exchange rate value being 88.81 in year 2011.

However, the findings indicate that there was a general steady rise in Kenya's exchange rate values over the 20 year period and hence there exists a positive relationship between the levels of exchange rate values and the FDI and consequently the economic growth in Kenya. These findings are in line with Balasubramanyan, *et al.*, (1996) who highlighted the openness of the trade regime and its influence on FDI's impact on growth. They found that FDI had positive impact on all sampled countries though FDI had more impact on economic growth in export-promoting than import-substituting countries. The findings are also collaborated by Dollar and Kraay (2000) who observed that there is a strong and positive link between openness to trade and growth performance.

The study findings revealed fluctuating levels of interest rate values with slight annual variations over the 20 year period. The findings indicate that there was a general steady decrease in Kenya's interest rate values between 1994 and 2004 [22.4% to 12.5%], followed by a steady increase from 2005 to 2012 [12.9% to 19.7%] before a slight decrease in 2013 and 2014 [17.3% and 16.8%, respectively]. Thus, there exists an inverse relationship between the interest rate levels and the economic growth in Kenya. The findings are in line with Cockcroft and Riddell (1991) and Meier (1994) who argued that firms choose an investment location because of its comparative advantage in terms of low inflation rates, availability of raw materials, good infrastructure, adequate labor force and low cost of capital. The findings are in line with Ng'ang'a (2013) who suggested that Kenya should embark on policies that promote sound macroeconomic policies such as to reduce the cost of capital (lower interest rates) to attract FDI for enhanced economic growth.

## **CHAPTER FIVE**

### **SUMMARY, CONCLUSION AND RECOMMENDATIONS**

#### **5.1 Introduction**

This chapter presents the summary of the data findings on the relationship between foreign direct investment and economic growth in Kenya. The conclusions and recommendations are drawn there to. The chapter is therefore structured into summary of findings, conclusions, recommendations and areas for further research.

#### **5.2 Summary of Findings**

The study established that the the economic growth in Kenya as represented by actual GDP values steadily increased by US \$34.7 billion over the 20 year period. This is as represented by the difference between the actual GDP value of US \$9.4 billion in year 1994 and the actual GDP value of US \$44.1 billion in year 2014.

The study revealed rising and falling FDI values with huge variations over the 20 year period with the lowest value for FDI being US \$5.3 million in year 2001 and the highest value for FDI being US \$729.0 million in year 2007. However, the findings indicate that there has been higher FDI values in the latter years [2007-2014] compared to the former years [1994-2006].

The study revealed rising and falling inflation rate values with significant annual variations over the 20 year period with the lowest inflation rate value being 1.97% in year 2002 and the highest inflation rate value being 26.20% in year 2008. The



findings indicate that the annual average inflation rate values remained at single digits (and hence, low) for majority of the years in the period of study.

The study revealed fluctuating levels of exchange rate values with significant annual variations over the 20 year period with the lowest exchange rate value being 67.32 in year 2007 and the highest exchange rate value being 88.81 in year 2011. However, the findings indicate that there was a general steady rise in Kenya's exchange rate values over the 20 year period.

The study revealed fluctuating levels of interest rate values with slight annual variations over the 20 year period. The findings indicate that there was a general steady decrease in Kenya's interest rate values between 1994 and 2004 [45.98% to 12.5%], followed by a steady increase from 2005 to 2012 [12.9% to 19.7%] before a slight decrease in 2013 and 2014 [17.3% and 16.8%, respectively].

### **5.3 Conclusion**

Given that there have been higher FDI values in the latter years [2007-2014] compared to the former years [1994-2006] and the corresponding increase in Kenya's actual GDP values over the same period, the study concludes that there exists a positive relationship between FDI and the economic growth in Kenya.

Given that the annual average inflation rate values remained at single digits (and hence, low) for majority of the years in the period of study and the corresponding increase in Kenya's actual GDP values over the same period, the study concludes that there exists an inverse relationship between the levels of inflation rates and the economic growth in Kenya.

Given the general steady increase in Kenya's exchange rate values over the 20 year period and the corresponding increase in Kenya's actual GDP values over the same period, the study concludes that there exists a positive relationship between the levels of exchange rate values and the FDI and consequently the economic growth in Kenya.

Given the general steady decrease in Kenya's interest rate values between 1994 and 2004 and also between 2013 and 2014 and the corresponding increase in Kenya's actual GDP values over the same period, the study concludes that there exists an inverse relationship between the interest rate levels and the economic growth in Kenya.

Based on the correlation analysis, FDI is positively related to GDP while Inflation and Exchange rate are negatively related to GDP. From regression analysis, the most significant factor affecting economic growth is FDI followed by inflation rate, exchange rate and interest rate, respectively.

#### **5.4 Recommendations**

From the findings, the study revealed that FDI positively influences the the economic growth in Kenya. Therefore the study recommends that the government policy makers need to push reform agenda in the domestic market so as to attract more FDI in the Kenyan economy since a higher investor's confidence in domestic market acts as a stimulus in attracting FDI inflows.

From the findings, the study established that there exists an inverse relationship between the levels of inflation rates and the economic growth in Kenya. Therefore the study recommends that the government should implement sound monetary and fiscal policies to achieve a stable macroeconomic environment.

From the study findings there is a positive relationship between the levels of exchange rate values and the FDI and consequently the economic growth in Kenya. Therefore the study recommends that the government should ensure greater policy sensitivity towards the openness of the economy so that the traded commodities will be beneficial to the economy as a whole.

In light of the study findings, there exists an inverse relationship between the interest rate levels and the economic growth in Kenya. Therefore the study recommends adoption of a low interest rate regime by the commercial banks and all financial institutions.

### **5.5 Limitations of the Study**

In this study we limited our study to a regression analysis of the effect of FDI on economic growth, and it can be argued that given the negative impact of FDI on economic growth, Kenya should ensure it remains an attractive spot for foreign investors. However more in depth analysis of the process in which small amounts of FDI inflows have succeeded in promoting growth would help in understanding the condition for effective FDI in Kenya and help in building effective investment promotion policies. In considering FDI it may be useful to look at the country's share of FDI in global flows. The data used in the study did not address this issue.

### **5.6 Suggestion for Further Research**

Since this study explored the relationship between foreign direct investments and economic growth in Kenya, the study recommends that; similar study should be done in other countries for comparison purposes and to allow for generalization of findings on the relationship between foreign direct investments and economic growth.

Further research could be done to investigate empirically the effects of FDI on capital accumulation, and the role played by export orientation strategies in allowing effective FDI inflows in Kenya.

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## APPENDICES

### APPENDIX 1: STUDY RAW DATA

<b>Year</b>	<b>Actual GDP Values (\$ 'billion')</b>	<b>FDI Values (\$ 'millions)</b>	<b>Annual Average Inflation rate Values (%)</b>	<b>Annual Average Foreign exchange rates (Kshs/1\$)</b>	<b>Annual Average Interest Rates (%)</b>
1994	9.4	20.5	45.98	65.54	23.5
1995	9.8	21.2	28.81	66.21	21.1
1996	10.2	24.2	1.55	66.89	22.3
1997	10.5	25.4	11.36	67.77	24.4
1998	11.1	27.3	6.72	67.81	23.1
1999	12.8	52.0	5.75	70.33	22.4
2000	12.6	110.9	9.96	76.18	22.3
2001	13.0	5.3	5.73	78.56	19.7
2002	13.2	27.6	1.97	78.75	18.5
2003	14.9	81.7	9.81	75.94	16.6
2004	15.6	46.1	11.79	79.17	12.5
2005	16.1	21.2	9.87	75.55	12.9
2006	18.7	50.7	14.50	72.10	13.6
2007	22.5	729.0	9.80	67.32	13.3
2008	27.2	95.6	26.20	69.18	14.0
2009	30.5	116.3	10.10	77.35	14.8
2010	30.7	178.1	3.88	79.23	14.4
2011	32.4	335.2	14.00	88.81	15.0
2012	34.3	259	9.65	84.53	19.7
2013	40.2	514	5.72	86.12	17.3
2014	44.1	258.6	6.60	88.22	16.8