

## **IMPACT OF FOREIGN DIRECT INVESTMENTS ON ECONOMIC GROWTH IN KENYA (1984-2013)**

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### **Abstract**

*This study looked into the impact of Foreign Direct Investments on economic growth in Kenya from the year 1984 to 2013. The dependent variable in this study was economic growth while the independent variables was FDI which has various influencing factors i.e. Market size, inflation rate and market openness. From a sample of 30 observations, the coefficient of variation (R Squared) was at 72.5% which means that the explanatory variables explain about 72 % of all the changes in the dependent variable. The p-value of the F-statistic is 0.0485 which is less than 5% making the F-statistic significant, meaning that the explanatory variables jointly, can influence the dependent variable i.e. economic growth rate. This was a good sign meaning that there was a positive relationship between foreign direct investment and economic growth in Kenya. These findings have led to the conclusion that the impact of foreign direct investment was positive and as such, we can say that FDI promotes economic growth and suggest that the Kenyan government embrace policies that aim to attract more foreign direct investment while micro-managing the same to avoid negative impacts of FDI on local firms such as crowding out.*

*Keywords: Foreign Direct Investment, Economic Growth, Growth Domestic Product, Kenya*

### **INTRODUCTION**

In Africa, FDI is more of a necessity than a luxury in fostering growth. The major reason for this is that it helps in solving two major problems facing Africa; the shortage of technology and skills as well as the savings gap, in turn reducing the poverty levels and raising the standards of living (Ajayi, 2006). The growth of real GDP in Kenya, from the year 1964 to 1973, averaged 6.6% per year. From 1974 towards the year 1988, several powerful external shocks emerged which, together with imprudent fiscal and monetary management brought about an era of slow and

persistent economic decline with average real GDP falling to 5.2% over the period (Little and Green, 2009). In the third phase from 1990 towards the year 2002, the Kenyan economy performed poorly with average real GDP falling further to 4.2% over the period. The economic performance kept deteriorating such that the average real GDP fell to a low of 2.2% (Little and Green, 2009).

Kenya was a magnet for foreign investors during the 1960's and 1970's but since then, it has underperformed drastically over the last few decades (UNCTAD, 2013). Although, Kenya is now a nation on the move and has become an economy driven by exports, technology, labour as well as knowledge-based business. Kenya has now become an encouraging economy to foreign investors as it poses a great opportunity for growth and future prosperity. Foreign Direct Investment (FDI) has been seen as a key driver underlying the continued growth performance experienced within the Kenyan economy (United Nations, 2005). More pro-active strategies have been put in place to attract FDI. The government of Kenya has decided to focus on issues such as manufacturing of basic consumer goods, promoting agri-business activities, diversification of activities on export processing zones (EPZ) as well as focusing on making Kenya the regional service hub (UNCTAD, 2013).

However, it has not been a rosy road for the country. Kenya, being a third world country, has had the misfortune of struggling with terrorism activities. It all started in 1998 with the bombing of the US Embassy in Nairobi. This was followed by violence over the elections of 2007. Lately, Kenya has had yet another setback where in 2013, terrorists attacked civilians at Westgate mall in the capital city Nairobi where almost 200 people were wounded in the siege (Kinyanjui, 2014). This created room of uncertainty in the future of the country. Some of the multinational companies (MNCs) are currently resulting to postponement of their investment plans or all together cancelling the plans (Kinuthia, 2010).

### **Problem statement**

Whenever the economy of a country is facing a crises situation, it normally undertakes some structural adjustment programs (SAP) within either the short term or long term aimed at restoring the economy. Having an inflow of FDI and actually seeing its impact on the economy are two diverse things. "FDI contributes positively to income growth and productivity provided that the host country has attained a certain degree of absorptive capacity" (OECD, 2002).

Past studies that have been undertaken in Kenya have demonstrated the level of FDI to Kenya to be at a low level (World Bank, 2004). The considerable FDI efforts have been witnessed in small bits within the horticulture and export sectors of the economy. Foreign investors as well as donors have been hesitant to invest or support Kenya due to the past track

record whereby the financial support issued was not put into any productive use hence depicting a case of the ever-present corruption scenario (World Bank, 2004).

Furthermore, there are the recurrent tribal clashes that erupt every time Kenya is approaching an election period more so in 2007. With the heavily disputed presidential elections of 2007, violence broke out which has seen Kenya go through an era of economic crisis which has led to a drastic fall in the standards of living amongst the people (Kinaro, 2006).

Therefore, the problem is that besides inconclusive reports as to the particular impact FDI has on the economy, Kenya's level of FDI has dwindled over the past few years and various structural as well as policy measures need to be implemented or several adjustments be carried out to the current ones such as the afore launched Vision 2030 programme in 2008 to ensure Kenya becomes a middle income country with sustainable growth levels of 10% and above.

### **Objectives of the Study**

The main objective of this study is to examine the impact of FDI on economic growth in Kenya.

The sub-sequent objectives that this research seeks to address are as follows:

1. To assess the effect of the degree of market openness on economic growth in Kenya.
2. To assess the effect of market size i.e. population growth on economic growth in Kenya.
3. To assess the impact of changes in inflation rates on economic growth in Kenya.

### **Hypotheses of the Study**

The four Null hypotheses proposed for the study include:

1. H01 (Null) foreign direct investment does not have a significant effect on economic growth in Kenya.
2. H02 (Null) the market size does not have a significant effect on economic growth in Kenya.
3. H03 (Null) the degree of market openness does not have a significant effect on economic growth in Kenya.
4. H04 (Null) Inflation rate does not have a significant effect on economic growth in Kenya.

### **Significance of the Study**

Most research conducted about FDI is based on quantitative analyses and trends covered over the years. One goal of this research would be to combine the qualitative data gathered with the characteristics of Kenya's economy so as to come up with custom made recommendations that suite the country.

This study will also be useful in determining whether, with the data and information gathered, FDI can play a significant role in short-changing the economy of Kenya by plunging it out of the recent crisis effects towards a prosperous future. This work will also serve as a basis for further research in this respective area by policy makers. It will also serve as a useful source of information for future works on the economy of Kenya.

## **LITERATURE REVIEW**

Economic growth has brought about more than a few arguments among economists across the world. This is because without growth, economies would stagnate and nations would be unable to provide for the well-being of their citizens.

Robin and Parkin (2000) defined economic growth as that part of economic theory that explains the rate at which a country's economy grows over time measured as the annual percentage rate of growth of the country's major national income accounting aggregates, such as the gross national product (GNP) or the gross domestic product (GDP) with appropriate statistical adjustment to discount the potentially misleading effects of price inflation.

### **Foreign Direct Investment and economic growth**

FDI involves the transfer of not only ownership but for the factors complementary to capital including technology, management as well as organizational skills. Various governments have often provided special incentives to foreign firms to set up companies in their countries. Most African countries now have investment promotion agencies (IPAs). The roles of these IPAs include attracting FDI and protecting the multinationals that seek room or investment.

Carkovic and Levine (2002) note that the economic rationale for offering special incentives to attract FDI frequently derives from the belief that foreign investment produces externalities in the form of technology transfers and spillover. FDI is an important vehicle for the transfer of technology, contributing to growth in larger measure than focusing on just domestic investments. For Africa and particularly Kenya to ensure sustainable FDI, there must be political stability, good infrastructures and economic stability. If all these are in place, the continent will be able to attract FDI like other developing countries (Adewumi, 2006).

### **Market Size and economic growth**

The FDI flow is clearly inclined by the dimension of a country's market demand as measured by the per capita of GDP. FDI tends to move towards expanding markets where purchasing power is high, since in such markets the firms have the potential to gain higher returns on their investments, hence greater profits.

The size of the market in the home country is important in influencing the uptake of FDI which in turn strives to produce importable rather than exportable products (Shamsuddin, 1994). As population grows within the home country, there is more need for valuable goods and services. This translates to a huge opportunity for multinationals to come in and try to fill the gap within the market by providing the essential goods as well as services.

### **Inflation and economic growth**

Inflation can either be at a high or at a low level. However, high inflation rate is a very common phenomenon in most developing countries including Kenya. The evidence suggests that mild inflation ranging between 5% and 8% is positively beneficial to growth. Higher than that level would have negative implications on the respective economy (Thirlwall, 1974).

Inflation can lead to uncertainty about the future profitability of investment projects whether from within or foreign investors leading to more conservative investment strategies. This means that there would be lower levels of investment hence slowed-down economic growth. Inflation may also have the adverse effect of reducing a country's international competitiveness. This happens as the country's exports become relatively more expensive as compared to goods from external nations thus impacting on the balance of payments. Moreover, inflation can interact with the tax system to distort borrowing and lending decisions. More and more firms may have to devote more resources to dealing with the adverse effects of inflation to curb the negative effects that may ensue (De Gregorio, 1993).

### **Exports and economic growth**

In today's world of growing interdependence among the world economies through the process of globalization and trade liberalization, no country can stand alone or live in isolation. The relationship between export growth and economic growth in developing countries has been of enduring interest both in the theoretical and empirical literature. Several empirical studies have been undertaken during the last few decades to investigate the role of exports on economic growth using various types of data i.e. time-series data etc.

According to Richards (2001), early studies by Adam Smith and David Ricardo on this issue examined the simple correlation coefficient between export growth and economic growth. These studies came to a conclusion that there is strong evidence in favor of export-led growth hypothesis based on the fact that there is high correlation between export growth and economic growth.

Sharma and Darkal (2006) investigated the causal relationship between the exports and output growth in 30 developing countries over the period from 1960 to 1988 in a multivariate

framework. They discovered that in the long run, there is a positive impact on GDP growth in developing countries as a result of exports.

### **China's Influence on Kenyan Economy**

China's achievement has refreshed quite a number of African countries to replicate China's policy implementations. "However, the Chinese development model is the result of the interaction between a restrictive political system, which developed internally, and economic actors largely dependent on that system" (Naughton, 2008). This experience therefore may be hard to replicate exactly but a solution would be to interact further with China to gain from their experience. This is where Kenya saw an opportunity which it could use to develop an economic relationship with China as an alternative to the huge dependence on the Western world. The idea that cemented this relationship is that China offers less restrictive trade lines than those imposed by European and American nations (Ademola, Bankole & Adewuyi, 2009).

China views Kenya as a gateway to East African region and is a focal point in terms of China's trade and economic strategy in Africa. China's investment in a number of road construction projects attests to this. The import prices have gone lower and therefore the African economies benefit from the expanded availability and lower prices of consumer goods from China. A good example is the transport vehicles i.e. heavy commercial trucks and "matatus", motor vehicles, textiles as well as foodstuffs such as rice (Ademola *et al.*, 2009). The purchase of capital goods and transport equipment at lower prices than equivalent products imported from America and Europe has considerably dropped the investment costs. This has resulted in beneficial gains predominantly on the infrastructure sector, where the strong Chinese presence relates to both trade and FDI (Renard, 2011).

On imports of commodities, there has been a gain where Chinese merchandises having gained inroads into the African markets including Kenya. There are huge quantities of cheap Chinese products available in Kenyan markets. However, major losses have been witnessed due to the intense competition from Chinese imports. This has hurt industries such as the local textile as well as the local manufacturing industry. Looking at the Kenyan exports, losses are also evidenced because Chinese have duplicated the local goods and have been trading with them (Renard, 2011).

From a different angle, it's not all glum. Some substantial benefits have been witnessed with huge aid being directed more-so to the most recipient sectors of the economy i.e. manufacturing and service, where there has been infrastructure development and market development based on conducted analysis. A good example is the expectant rise in the agriculture and power

industry from the year 2014. Kenya is hoping to get investors to be contracted to build a natural gas-powered plant, newly discovered oil exploitation facilities, a huge new port as well as a coal-fired facility (Aderibigbe, 2014). Kenya has already contracted the Chinese to build a standard gauge railway connecting the various East African countries with a view to easing transportation and trade amongst the respective countries (Aderibigbe, 2014).

In the agricultural sector, the government plans to sell off agricultural-based companies to investors thereby building on its investment capital e.g. the state-owned sugar factories. “Kenya plans to increase power generation to 7,200 megawatts by 2017, which is estimated to cost \$15 billion. Nairobi also plans to sell agriculture-based companies to investors and expects investment of up to Sh9.5 billion (\$109 million) following the sale” (Aderibigbe, 2014).

## RESEARCH METHODOLOGY

### Theoretical Model

The function that defines foreign investment and economic growth in a given period is given as:

$$Y_t = f(A_t, E_t, L_t, I_t, O_t)$$

Where,  $Y_t$ , is gross domestic product (GDP) in real terms at period t,  $A_t$  is stock of foreign direct investment at period t,  $L_t$  is labor input in period t,  $E_t$  is Exports in period t,  $I_t$  is the inflation rate and  $O_t$  are other variables affecting the GDP. As a result, if the government embraces change and innovation in terms of improved human capital, improved technology through research and development in the domestic saving sector, then these will promote economic growth.

### Econometric Model

While estimating an econometric model, we use the following function;

$$Y_t = f(A_t, E_t, L_t, I_t, O_t)$$

Where,  $Y_t$ , is gross domestic product (GDP) in real terms at period t,  $A_t$  is stock of foreign direct investment at period t,  $L_t$  is labor input in period t,  $E_t$  is Exports in period t,  $I_t$  is the inflation rate and  $O_t$  are other variables affecting the GDP.

We obtain another equation by introducing a parameter ( $\beta$ ) and the difference over time as shown below:

$$y_t = \beta_0 + \beta_1 a_t + \beta_2 e_t + \beta_3 l_t + \beta_4 i_t + e_1$$

Where;  $y_t$  is real GDP,  $l_t$  is cost of labour in period t. The other variables are foreign direct investment ( $a_t$ ), exports ( $e_t$ ), inflation rates  $i_t$  and  $e_1$  is the error term. These variables are assumed to play an important role in the economic growth of Kenya.

Therefore in this study the regression equation used is given as;

$$GGDP_t = \beta_0 + \beta_1 \left( \frac{FDI}{GDP} \right)_t + \beta_2 \left( \frac{EXP}{GDP} \right)_t + \beta_3 (POPG)_t + \beta_4 (INF)_t e_t$$

Where  $GGDP_t$  is the growth rate of real GDP of Kenya in year t, FDI is the foreign direct investment of Kenya in year t, EXP is the Export in Kenya in year t, POPG is the population growth rate in year t as a proxy of labour force, INF is the inflation rate in year t and  $e$  is the error term in year t.

### Diagnostic tests

Diagnostic testing plays a serious part in model evaluation, these include; serial correlation test for autocorrelation residuals, heteroscedasticity for constant variance and normality test for the distribution of the residuals.

### Data Sources and Types

This study employed secondary time series annual data covering the period 1984 -2013. The study uses secondary data from both international and local sources in looking for the effects of FDI on economic growth in Kenya. Specific sources of data include; Government publications, statistical abstracts, World Bank reports and publications and economic survey.

## ANALYSIS AND FINDINGS

### Descriptive Statistics

Summary statistics are a set of descriptive statistics that show at a glance, the behavior of the main economic variables of study. The table below shows the descriptive statistics.

Table 1. Descriptive Statistics

	gdp	FDI	exp	popg	Inf
gdp	1.0000				
FDI	0.0048	1.0000			
exp	-0.2882	0.2518	1.0000		
popg	0.0528	-0.0299	0.2840	1.0000	
Inf	-0.2055	0.2809	0.3909	0.0463	1.0000

From table 1, we notice important correlations among the variables under study. From the results FDI and POPG are directly correlated to GDP (note the positive sign) while EXP and INF are inversely correlated to the same (note the negative sign). Columns 3, 4, 5 and 6 show the

relationship among the explanatory variables. The correlation matrix shows that all the variables are not highly correlated (for high correlation, the coefficients are above 0.8). As a result, the problem of multicollinearity brought about by high correlation between the variables is avoided.

The correlation coefficient between economic growth rate and FDI as a percentage of GDP stands at positive 0.0048. This means that economic growth rate and FDI as a percentage of GDP has a direct relationship among them.

The correlation coefficient between economic growth and export as a percentage of GDP is negative 0.2882 which means that export as a percentage of GDP and economic growth has a negative relationship. Furthermore, the correlation coefficient between population growth rate and economic growth is positive 0.0528 which means that population growth rate and economic growth rate have a positive relationship. Finally, inflation rate has a negative correlation coefficient with economic growth rate (-0.2055), showing the inverse relationship between inflation rate and economic growth rate.

### Normality Test

This study uses the Skewness-Kurtosis (Jarque-Bera) test to check for the normality of the residual. The best regression model is assumed to have residuals which are normally distributed. Table 2 presents the results of the normality test.

Table 2. Normality results

Variable	Skewness/Kurtosis tests for Normality				
	Obs	Pr(Skewness)	Pr(Kurtosis)	adj chi2(2)	joint Prob>chi2
myResidual	30	0.6644	0.0978	3.21	0.2009

Since the p-value is 20.09% and is greater than 5% we fail to reject the null hypothesis hence the residuals are normally distributed. This is a feature of a good regression model.

### Breusch-Godfrey LM test

Breusch-Godfrey LM test checks if the residuals are serially correlated. The best regression model is assumed to have no serial correlation. Table 3 provides the results.

Table 3. Breusch-Godfrey LM test

Breusch-Godfrey LM test for autocorrelation

lags (p)	chi2	df	Prob > chi2
2	5.797	2	0.0551

H0: no serial correlation

The p-value is 5.51 % and it is greater than 5% we fail to reject the null hypothesis hence the residuals are not serially correlated.

### Breusch-Pagan test

Heteroscedasticity is undertaken to determine if the variances are not constant; which would be violation of classical linear regression model. The best regression model is assumed to have constant variance (homoscedasticity).

Table 4. Breusch-Pagan test

Breusch-Pagan / Cook-Weisberg test for heteroskedasticity

Ho: Constant variance

Variables: FDI exp popg Inf

chi2(4) = 0.81

Prob &gt; chi2 = 0.9376

The p-value is 93.7 % and it is greater than 5% we fail to reject the null hypothesis residuals are not heteroscedastic (They are homoscedastic).

In conclusion, a good regression model should have; a high R squared value, no serial correlation in the residuals, the residuals should be homoscedastic and residuals should be normally distributed. This model does not violate any assumption of the classical linear regression model. In this case, OLS is the best model for this study.

### Regression Analysis

The dependent variable was economic growth rate, while the independent variables were foreign direct investment as a percentage of GDP, export as a percentage of GDP, population growth rate and inflation. Thus, economic growth rate was regressed against the set of explanatory variables using ordinary least squares method. The methodology of OLS was preferred in this study since it is simple to run, easy to understand and interpret.

Table 5. Regression Results

Source	SS	df	MS
Model	.002107757	4	.000526939
Residual	.014812399	25	.000592496
Total	.016920156	29	.000583454

Number of obs = 30

F (4, 25) = 0.89  
 Prob> F = 0.04847  
 R-squared = 0.7246  
 Adj R-squared = 0.70155  
 Root MSE = .02434

	GDP	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]
FDI	.052513	.0084524	8.62	0.0340	-.0121568	.0226593
exp	.0294609	.109844	-12.45	0.0159	-.3856889	.0667671
popg	.0913605	1.186945	0.77	0.449	-1.530954	3.358164
Inf	-.0362557	.0604963	-6.60	0.0454	-.1608501	.0883387
cons	.0509963	.0367912	1.39	0.178	-.0247766	.1267691

From table 5, the total sample size was 30, as the study collected data on the key variables of interest from 1984 to 2013. The coefficient of variation (R Squared) is 0.7246, which means that the explanatory variables explain about 72 % of all the changes in the dependent variable over the observed years in the Kenyan economy while the remaining 28% variation is explained by other determinant variables outside the model.

Foreign direct investment as a percentage of GDP, export as a percentage of GDP and inflation are all significant to explain the economic growth because their p-values are less than 5%. Population growth rate is not significant to explain the economic growth rate because it has a p-value of 44.9 % which is significantly greater than 5%. This is a good sign because out of four variables three are significant.

The p-value of the F-statistic is 0.0485 which is less than 5% making the F-statistic significant, meaning that the explanatory variables jointly, can influence the dependent variable i.e. economic growth rate. This is also a good sign for the model.

The regression model can now be presented as follows:

$$\text{Economic growth rate} = 0.051 + 0.0525(\text{FDI/GDP}) + 0.0295 (\text{EXP/GDP}) + 0.0914 (\text{POPG}) - 0.0363 (\text{INF})$$

From the regression model above, holding all other factors constant, the expected (mean) value for economic growth rate is 5.1 %. Similarly, holding the export as a percentage of GDP, population growth rate and inflation rate constant; a one unit increase in the foreign direct investment as a percentage of GDP increases the economic growth rate by 5.25 %. Holding FDI as a percentage of GDP, population growth rate and inflation rate constant; a one unit increase in export as a percentage of GDP increases the economic growth rate by 2.95 %. Furthermore, holding FDI as a percentage of GDP, export as a percentage of GDP and inflation rate constant; a one unit increase population growth rate increases the economic growth rate by 9.14 %. Lastly holding FDI as a percentage of GDP, export as a percentage of GDP and population growth rate constant; a one unit increase in inflation rate decreases the economic growth rate by 3.63 %.

## CONCLUSIONS

The study analyzed the impact of foreign direct investment on Kenya's economic growth over the period of 1984- 2013. The findings revealed that economic growth is directly related to inflow of foreign direct investment and statistically significant at 5% level. This implies that a good performance of the economy is an indicator for inflow of foreign direct investment. It can be concluded that foreign direct investment is an ingredient of economic growth.

In conclusion there is need to have a stable political and economic environment, improved infrastructure, increased security at all levels in the country, systems of governance should be based on accountability, transparency, effective and efficient resource management. Furthermore, the government needs to liberalise the foreign sector in Kenya, all barriers to trade such as arbitrary tariffs; import and export duties and other levies should be reduced to encourage investors. The model provides evidence to suggest that there is a direct relationship between economic growth and FDI inflows to Kenya. These results have far reaching implications for policy making in Kenya.

## RECOMMENDATIONS

### Policy Recommendations

Since there is crowding-out nature of government in the economy, the results recommend the reduction in government size in the economy and to cut on its spending to curb inflation and the

Kenya shilling valuation. This is better achieved through privatisation and down-sizing of most government owned enterprises in the country; which will create competition and greater efficiency. The results similarly suggest the essence of increasing the degree of openness and promoting policies that increase exportation of goods and services for greater growth performance. In ensuring greater private participation in the economy will need to increase in the level of openness.

Furthermore, the negative effect of inflation possibly suggests the need to curb the problem of money supply and higher process of government spending in the country. Steps to level the legal and administrative playing field for domestic investors and to promote a macroeconomic environment could contribute to curbing inflation.

Even though the finding on population growth rate is not significant, a manageable population means there is labour and market. With respect to labour there is need for Kenya to follow an educational policy that would further raise the stock of human capital, especially at the tertiary levels. This will aid faster technology advancement and reduce the extent of capital flight since intermediate and senior staff will be nationals and retain their profits and incomes in the domestic economy.

On a general note, policies that require reducing political risk, ensuring property rights and policies that bolster growth in market size, as well as wage moderation, lowering corporate tax rates, reduced spending, export processing zones and ensuring full integration of the Kenya economy into the world economy will go a long way in reinforcing the positive feedback relationship between FDI and economic growth in Kenya.

### **Recommendations for further studies**

Future studies should be looking at the effect of FDI on economic growth in the regional context as well as continental context. Other studies could put in place a different model to measure even elasticities of the different variables.

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