

**DETERMINANTS OF FOREIGN DIRECT INVESTMENT
GROWTH IN KENYA**

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DECLARATION

This thesis is my original work and has not been presented for a degree in any other University

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DEDICATION

This Thesis is dedicated to my parents; my mother Mary and my late father Njoroge Hunja who for all intent and purpose wished I get the best in all facets of my life. Encouraged by your enduring devotion I will always do my best.

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ABBREVIATIONS AND ACRONYMS

| | |
|------------------|---|
| ANOVA | Analysis of Variance |
| AIECGC | Arab Investment and Export Credit Guarantee Corporation |
| CBK | Central Bank of Kenya |
| CG | Corporate Governance |
| COMESA | Common Market for East and Central Africa |
| CPI | Consumer Price Index |
| EAC | East African Community |
| FDI | Foreign Direct Investment |
| FSA | Firm Specific Advantages |
| GCC | Gulf Cooperation Council |
| GDP | Gross Domestic Product |
| ICRG | International Country Risk Guide |
| IMF | International Monetary Fund |
| KAM | Kenya Association of Manufacturers |
| KENINVEST | Kenya Investment Authority |
| KIRDI | Kenya Industrial Research and Development Institute |
| KNBS | Kenya National Bureau of Statistics |
| M&A | Mergers and Acquisition |
| MENA | Middle East North Africa |
| MM | Modigliani-Miller |
| MNEs | Multinational Enterprises |
| MNCs | Multinational Corporations |
| OECD | Organization for Economic Co-operation and Development |
| OLI | Ownership, Location and Internalization |
| PRI | Political Risk Index |
| PRS | Political Risk Service |
| R&D | Research & Development |
| SPSS | Statistical Package for Social Sciences |
| TI | Transparency International |

| | |
|---------------|--|
| TNCs | Transnational Corporations |
| UN | United Nations |
| UNCTAD | United Nations Conference on Trade and Development |
| USA | United States of America |
| WDI | World Development Indicators |
| WGI | World Governance Indicators |

DEFINITIONS OF TERMS

Corporate Governance: Corporate governance is defined as the traditions and institutions by which authority in a country is exercised. This includes the process by which governments are selected, monitored and replaced (Kauffmann in World Bank Governance indicators, 2012).

Efficiency-seeking FDI: This type of investment requires host countries to offer advantages such as low-cost production or specialized expertise, as well as low-cost trade, as the output of efficiency seeking investment is mainly sold to other TNC affiliates or the parent firm (UNCTAD, 2010).

Foreign Direct Investment: FDI is net inflows of investment to acquire a lasting management interest taken as 10% or more of voting shares in an enterprise operating in an economy other than that of the investor (IMF, 2011).

Multinational Companies/Enterprises (MNC/Es): Multinational companies are those corporations or enterprises that manage production establishments or delivers services in at least two countries (UNCTAD, 2010).

Resource-seeking FDI: This type of investment is driven by the local availability of natural resources and low-cost labor (UNCTAD, 2010).

Strategic asset-seeking FDI: This type of FDI is driven by access to created assets such as special skills and technology (UNCTAD, 2010).

Transnational companies (TNC's): Transnational companies are those companies who operate outside the borders of their home country either through partnership, joint venture or whole established subsidiaries (UNCTAD, 2010).

ABSTRACT

The foreign direct investment (FDI) indicators in Kenya show a mixed signal and although institutional indexes for Kenya have been worsening over the years, FDI inflow though sluggish has been on the rise. This evidence poses a problem and necessitated the need to analyze what determines the growth of FDI in Kenya and to what extent. The purpose of this study was to examine and analyze the influence of a group of determinants of Foreign Direct Investment (FDI) in Kenya and present new evidence. The specific objectives of the study were; to examine the extent to which corporate governance elements, political governance, trade openness, market size, exchange rate, and inflation determine growth of FDI in Kenya. To achieve these objectives, the research questions interrogated the relationship between ownership, location and internalization (OLI) together with selected institutional determinants and growth of FDI in Kenya. The study adopted descriptive research design using primary data collected through a self-administered survey questionnaire and an interview guide administered to the respondents in the sample after the research instruments were pilot tested for validity and reliability by use of Cronbach's Alpha. The target population was 100 manufacturing firms with significant foreign ownership in Kenya. A sample size of 81 firms spread across the country was obtained for study using stratified random sampling. The methodology adopted involved the development of a multiple regression model to prove or disapprove the postulated hypotheses. The statistical tools of analysis that were used for descriptive data were the arithmetic mean and the standard deviation while the statistical tools of analysis used for inferential statistics were Pearson's product moment correlation and stepwise regression to find correlations among the explanatory variables. F-tests were used to test the hypotheses in the study. Tests of statistical assumptions were carried out before data analysis to avoid invalidation of statistical analysis. Corporate governance, political risk, the country's trade openness, exchange rate and size of gross domestic product were found to significantly determine growth of foreign direct investment, however GDP per capita and level of inflation did not significantly determine growth of FDI. It is recommended that to attract FDI in manufacturing

sector in Kenya, efforts should be made to improve on governance, manage the political risk and open the economy more to trade to attract FDI in dynamic products and sectors with high income elasticities of demand away from the primary sector. It is also recommended that a combination of traditional determinants of FDI and institutional determinants should be considered when formulating policies to attract foreign investment. Since this study delimited itself to the manufacturing sector, further research can be carried out to investigate the determinants of FDI in other sectors of the economy in Kenya.

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

The main argument of this research is that ownership, location and internalization (OLI) together with institutional determinants influences flow of Foreign Direct Investment (FDI) in a country. In the last two decades, FDI has been a major source of investment capital in developing countries and an important issue in international finance since the globalization of capital markets. FDI is defined as the net inflows of investment to acquire a lasting management interest taken as 10% or more of voting shares in an enterprise operating in an economy other than that of the investor. It is the sum of equity capital, reinvestment of earnings, long-term and short-term capital as shown in the balance of payments (World Bank, 2013).

In Kenya, the largest number of investment projects undertaken by Chinese, Indian and other investors is in manufacturing and infrastructure (UNCTAD, 2009); out of these investments 80 per cent are market-seeking which informed the study to concentrate on manufacturing sector. Increasing foreign investment in Kenya would lead to the attainment of sustained growth and development through mobilization of international financial resources (UNCTAD, 2012; World Bank, 2013). Given the unpredictability of aid flows, the low share of Africa in world trade, the high volatility of short-term capital flows, and the low savings rate in Kenya, the desired increase in investment could be achieved through an increase in FDI inflows, at least in the short-run.

1.1.1 Foreign Direct Investment Trends

Africa has never been a major recipient of FDI flows with the highest level observed in the period 2002-2003 where share of global FDI was 2.5% (UNCTAD, 2004). Inflows to Africa declined in 2011 to \$42.7 billion caused largely by the fall in North

Africa; in particular, inflows to Egypt and Libya, which though major recipients of FDI, came to a halt owing to their protracted political instability (UNCTAD, 2012). Kenya, the strongest and most diversified economy in the East African region has been a poor performer in attracting FDI over the past decade. However, all indications are that FDI will continue to flow and Kenya will catch up with its East African Community (EAC) partners (UNCTAD, 2012).

Kenya like most developing nations was very skeptical about the virtues of free trade and investment after gaining independence in 1963. Among other EA countries, she imposed trade restrictions and capital controls in 1970's and 1980's as part of a policy of import-substitution industrialization aimed at protecting domestic industries and conserving scarce foreign exchange reserves. This inward-looking development strategy discouraged trade as well as FDI and had adverse effects on economic growth (Rodrik, 1998). In the period between 1990 and 1999 average FDI inflows to Kenya was US \$17 million with a corruption index of 2.8. During the period between 2000 and 2007, average FDI inflows in millions of US dollars for Kenya rose significantly to \$119 million yet the corruption index had plummeted to 1.6 (TI, 2012). To attract more FDI, the Kenyan Government has made the attraction of FDI a clear policy priority and to this end established KENINVEST as a semi-autonomous agency in 2004. Since then, FDI inflows to Kenya have seen a steady increase, reaching US\$ 141 million in 2009 and US\$ 133 million in 2010 (UNCTAD, 2011).

1.1.2 Determinants of FDI in Kenya

There is a lot of literature written on determinants of FDI in Africa; however the present study focused on the extent to which a combination of institutional policy and traditional determinants of FDI determine growth of FDI in the manufacturing sector of the Kenyan economy. The studies done have not given enough emphasis to institutional determinants; the literature on FDI in Kenya is also fairly recent and limited (Ikiara, 2002; Kayonga, 2008; King'ang'i, 2003; Kinuthia, 2010; Kurui, 2008; Mutenyo, 2008; Ngowi, 2002; Sandra, 2005). Through review of earlier

literature the study identified and examined the extent to which trade openness, market size of the Kenyan economy and more distinctively, the effects of governance elements (taxation, democracy, political risk and political stability) and macroeconomic fundamentals (foreign exchange rate and inflation rate) determine growth of FDI inflows in the Kenyan manufacturing industry.

The literature on determinants of FDI does not say much about how institutional determinants like corporate governance might affect the FDI decision (Jackson, 2008; Piesse J. *et al*, 2008). In Sub-Saharan Africa, a large market has been seen as attracting FDI flows, while inflation has discouraged FDI flows (Obwona, 2001). Studies in other African countries show that trade openness play a positive role in attracting FDI (Aoki 2007; Busse, 2005). Recent studies have started to recognize the importance of non-traditional factors such as globalization and governance (Dikova, 2007) mainly because FDI in developing countries is shifting from market-seeking and resource-seeking which are horizontal to more vertical efficiency-seeking FDI (Campino, 2010). In all these studies, the role of governance elements still remains largely neglected mainly due to the lack of quality data on corporate governance measures and indicators. Analysis shows that corporate governance framework depends on the legal, tax, regulatory, and institutional environment in a country (IMF, 2011; UNCTAD, 2012).

Previous studies on determinants of FDI in developing countries including Kenya have largely tested Dunning's eclectic paradigm of ownership, location and internalization (OLI) advantages; (Asiedu, 2002; Kinuthia, 2010; Mutenyo, 2008; Musau, 2012; Ndung'u & Ngugi, 1999; Obwona, 2001; Onyeiwu, 2005; Opolot & Mutenyo, 2009). The studies have concentrated on analyzing the effects of ownership or firm specific advantages (both tangible and intangible) of multinational firms over the local firms on FDI inflows to a country. They emphasize how locational advantages of a host country such as market size, availability of natural resources, and macroeconomic stability, affect FDI inflow. Although the importance

of institutional determinants in FDI inflows cannot be underestimated, the studies done have not exhaustively investigated their contribution.

Aharoni, (1966), Basi (1963), Jensen (2003) show support for political stability and democratic governance as determinants of FDI. Campos and Kinoshita (2003) and Gastanaga *et al.* (1998) agree on the importance of quality of institutions in determining FDI. Studies show these institutional factors include political, legal, regulatory factors and global market interactions (Busse, 2003; La Porta, 1997; Makola, 2003; Rogoff & Reinhart 2003; Smarzynska & Wei, 2002; UNCTAD, 2003). The motivation of the research was to examine how FDI growth is determined by among others the institutional determinants like governance as supported by mentioned studies elsewhere. Better institutional functions (low corruption, political stability, and legal system reliability) influence on the different types of capital flows where examined was found to encourage FDI (Asiedu, 2006; Mishra & Daly, 2007; Naudé & Krugell, 2007). Other studies also found that the strength and impartiality of the legal system, popular observance of law, strength and quality of bureaucracy, and government stability have a direct effect on FDI. Sandra and Mutenyo (2005) in their Kenyan study show that corruption, market size and macroeconomic stability proxied by rate of inflation are significant determinants of FDI inflows.

Elsewhere in developing countries, Busse and Hefeker (2007) find that institutional functions, namely government stability, internal and external conflict, corruption and ethnic tensions, law and order, democratic accountability of government, and quality of bureaucracy, are highly significant determinants of FDI inflows. Daude and Stein (2007) find that better institutional functions have an overall positive effect on bilateral FDI. However, their study finds that some institutional functions have more influence on FDI than others; these include government stability, law predictability, and quality of regulations and policies. Wei (2000) focusing solely on corruption found that corruption acts as a tax deterrent to FDI. Campos (2003) observes that issues of property rights, rule of law, corruption, governance and political security are important factors in influencing foreign investment.

Alfaro *et al.*, (2008) conclude that low institutional quality is the leading factor in explaining the slow capital flows from rich to poor countries. Exploring the determinants of countries' external capital structure, Faria and Mauro (2009) find that the share of FDI and portfolio equity in countries' total external liabilities is positively influenced by quality of institutional functions. Kraay and Nehru (2006) posit that improvement in policies and quality of institutional functions largely reduces the probability of debt distress. Lane (2004) posits that better institutional function quality increases the level of external debt. Mina (2006) and Mina and Martinez-Vazquez (2006) show that better contract enforcement and institutional stability increase the level of international lending a country can attract. Institutions play an important role in supporting markets and transactions by protecting property rights, enforcing contracts, and facilitating collective action to provide physical and organizational infrastructure. They create order, reduce uncertainty in the exchange of goods and capital, and help determine transaction and production costs (Dixit, 2009; North, 1991; Rodrik, 2008).

Looking at market fundamentals, Onyeiwu (2003) argues that trade openness and privatization increase FDI flows, while corruption and bureaucratic red tape reduce flows. Kamaly (2000) posits that FDI is highly persistent, and that the rate of change and variability of the nominal exchange rate and democracy are not statistically significant. Focusing on fundamentals, Hisarciklilar *et al* (2006) in study of MENA region found that domestic market size and intra-region trade opportunities have a positive influence on the stock of inward FDI. Mina (2007) study of GCC countries found that the estimates show that while institutional quality, trade openness, and infrastructure development have encouraged FDI flows, human capital has significantly discouraged them. The findings elsewhere in the African countries show that institutional quality, trade openness, and infrastructure development encourage FDI inflows (Asiedu, 2006). In terms of macroeconomic stability, large structural fiscal deficits, erratic monetary exchange rate policies, untamed inflation and weaknesses in financial systems in many countries have contributed to high and variable inflation and interest rates and a high degree of variability in real effective

exchange rates; these factors have all worsened the general investment climate (Hines, 2004; Kransdorff, 2010).

The foregoing argument largely informed the need to test the extent to which macroeconomic fundamentals and specifically inflation and exchange rates intervene in influencing growth of FDI. Countries that have made some progress in reducing macroeconomic instability have been more successful in attracting FDI inflows (Bhattacharya *et al*, 1997). In fiscal governance, taxes affect the net return on capital and influence the capital movements between countries (Kransdorff, 2010). A generous tax policy could compensate for other obstacles in the business environment and, thus, attract multinational companies (Morisset & Pirnia, 2001).

Studies confirm that investors are mostly influenced in their decision by market factors, political factors and in some cases tax policy in FDI location decisions (Agodo, 1978; Lim, 2001; Root & Ahmed, 1978; Shah & Toye, 1978). Hines (2004) finds that on average 1% point reduction in the effective tax rate would increase FDI by approximately 2%. Efficiency seeking FDI in the export oriented manufacturing sector, is found more responsive to tax relief (Blomstrom & Kokko, 2003; Kransdorff, 2010).

Earlier studies (Globerman & Shapiro, 2003; Shleifer & Vishny, 1996; Talamo, 2011) show there is gaps in research done on corporate governance elements in the world although governance can be a major determinant of FDI in a country. The proposed study considers governance elements (legal, tax, regulatory, political and institutional environment) as determinants of FDI to be investigated. Studies elsewhere show that investors would be very keen to invest in countries where good governance is upheld (Globerman, 2003; Talamo, 2011; Wei Shang, 1997). This study emerged to fill the gap in the literature on the relationship between growth of FDI inflows and the FDI determinants and represented a real value added.

1.2 Statement of the Problem

Manufacturing in Kenya has been on the decline for a considerable period of time with its contribution to GDP stagnating at 10 % from 1960's. The performance of manufacturing sector is affected by low capital injection, limited access to finance and poor institutional framework which has resulted in limited FDI into the country (KNBS, 2013; UNCTAD, 2012). The challenge facing Kenya is how to attract more FDI in dynamic products and sectors with high income elasticities of demand away from the primary sector. Although institutional indexes for Kenya have been worsening over the years, FDI inflow though sluggish has been on the rise (TI, 2012; UNCTAD, 2012). This evidence posed a problem and necessitated an examination of what determines the growth of FDI in Kenya.

Earlier studies mentioned in the background have rarely included institutional determinants in their analyses as this study did. The importance of institutional determinants in FDI studies cannot be underestimated looking at research done elsewhere where political instability, democratic governance, taxation, legal environment and quality of institutions were found significant in influencing FDI (Aharoni, 1966; Basi, 1963; Campos & Kinoshita, 2003; Gastanaga, 1998; Jensen, 2003, OECD, 2012). This research differed from previous empirical studies for Kenya in examining both OLI and institutional determinants of FDI.

The Kenyan context was of particular interest for the development and testing of FDI theory due to its high level of governance risk, complex tax regime and the low levels of FDI attracted in the last ten years (UNCTAD, 2012). Evidence showed Kenya is a poor performer and laggard in FDI growth in EAC despite the fact that it is the strongest and EAC's most diversified economy. Kenya has not attracted much FDI (as a % of GDP) and has not outstripped both the developing-countries average and the sub-Saharan Africa average (Kenya's average was 7.1%; developing countries average was 29.4%; Africa average was 32% in the period 2008-2013 (UNCTAD, 2013; World Bank, 2013).

This observation was supported by the fact that extensive research had not been undertaken on determinants of FDI in the Kenyan manufacturing industry and where such research had been done; traditional determinants were mostly analyzed (Kinuthia, 2010; Mutenyo, 2008; Ngowi, 2002; Sandra & Mutenyo, 2005). Unlike the other countries in Africa (Nigeria, South Africa, Ghana, Egypt and Libya) which have benefited from extensive research on determinants of FDI in many sectors (Abdulla, 2010; Asiedu, 2002; Binh, 2009; Rogmans, 2011); Kenya and her manufacturing sector was lagging behind, this necessitated further analysis. This argument was supported by Akinlo (2004) who posits that extractive FDI might not be growth enhancing as much as manufacturing FDI. Research by UNCTAD (2010) also supports this view that FDI in manufacturing is under severe strain due to the drying up of international financial resources.

The distribution of FDI by industry shows a concentration in the mining industry in terms of value and although the manufacturing sector accounted for 41 per cent of the total number of investment projects during the period 2003–2009, it was of low value (UNCTAD, 2010). This called for examination of the extent to which FDI determines FDI inflows in Kenya as a different picture emerges, depending on whether the analysis is conducted with investment values versus investment cases (UNCTAD, 2010). The problem emanated from the fact that the literature available on the determinants of FDI had left gaps while addressing growth of FDI inflows in Kenya and more so in the manufacturing sector by leaning on traditional determinants in empirical analysis, this study sought to fill this gap.

1.3 Objectives of the Study

1.3.1 General Objective

The general objective of the study was to analyze the extent to which the determinants of FDI influence growth of foreign direct investment in the Kenyan manufacturing sector.

1.3.2 Specific Objectives

The specific objectives were;

1. To examine the extent to which corporate governance determines growth of FDI inflows in Kenya
2. To analyze the extent to which political governance determines growth of FDI inflows in Kenya
3. To examine the extent to which market size of Kenyan economy determines growth of FDI inflows in Kenya
4. To scrutinize the extent to which trade openness determines growth of FDI inflows in Kenya
5. To analyze the extent to which inflation determines growth of FDI inflows in Kenya
6. To examine the extent to which foreign exchange determines growth of FDI inflows in Kenya

1.4 Research Questions

To address the objectives, the research was guided by the following questions;

1. What is the relationship between corporate governance elements and growth of FDI in Kenya?
2. What is the relationship between political governance and growth of FDI in Kenya?
3. What is the relationship between market size of Kenyan economy and growth of FDI in Kenya?
4. What is the relationship between trade openness and growth of FDI in Kenya?
5. To what extent does inflation rate determine growth of FDI in Kenya?
6. To what extent does foreign exchange rate determine growth of FDI in Kenya?

1.5 Hypotheses

The hypotheses for testing in the quantitative research were all related to the determinants of FDI growth in Kenya, taking into account the main variables tested for in the mainstream literature as well as least tested variables related to governance.

Hypothesis H1: FDI inflows in Kenya is associated with the country's corporate governance (democracy and taxation infrastructure).

Hypothesis H2: FDI inflows in Kenya is associated with the country's political governance (political risk). According to these hypotheses, democracy and taxation infrastructure (H1) as elements of corporate governance may determine flow of international investment and that political governance (H2) represented by political risk and political instability may affect growth of FDI flows.

Hypothesis H3: FDI inflows in Kenya is associated with the country's GDP and GDP per capita. This hypothesis was broken down into hypotheses 3a and 3b (GDP and GDP per capita) during analysis. The hypotheses related to market size and market attractiveness, the most common relationship that is found between FDI and its determinants in the literature.

Hypothesis H4: FDI inflows is associated with the country's manufacturing exports. The measure for a country's openness to trade that is used is the amount of manufacturing exports as a proportion of GDP in a particular year. The testing of this hypothesis sought to clarify the association between the two variables.

Hypothesis H5a: FDI inflows is associated with the country's level of inflation.

Hypothesis H5b: FDI inflows is associated with the country's level of foreign exchange. Hypothesis 5a and 5b relate to stability in internal macroeconomic environment as intervening variables, which would influence growth of FDI in Kenya. The hypotheses were tested at 5% level of significance ($\alpha = 0.05$), this is the lowest significance level that the hypothesis were rejected.

1.6 Justification of the Study

FDI flows to Kenya compare unfavorably with flow to other developing countries of Africa and the world. The earlier research done on FDI determinants in Kenya dwelt

more on OLI determinants at the expense of institutional determinants like governance. These studies also concentrated more on the agricultural sector. A mixture of both OLI and institutional determinants of FDI and especially internal and external governance as variables were considered for analysis in the model for the study. The question that arose was; is there a linkage between the behavior of the selected determinants of FDI and the flow of FDI into Kenya? To answer this question, the researcher sought to establish the extent to which the OLI and institutional determinants contribute to flow of FDI in the Kenyan manufacturing sector.

This dissertation was a value added in that it contributed to the literature in several ways; it added knowledge to development finance literature and was of value addition to policy makers, investors and proponents of good governance and also formed a starting point for policy debates on growth of FDI inflows in Kenya. The study was of importance to investors in answering the question of how governance infrastructure matters in FDI decisions. It was expected that the empirical findings of the study would not only enhance the understanding of the determinants of FDI in Kenya but also stimulate further research in the country and other developing countries of the world.

1.7 Scope of the Study

This thesis covered the manufacturing industry in Kenya and specifically foreign firms with significant (over 10%) foreign ownership where most FDI was expected to flow through. The list of firms was compiled from the Kenya Association of Manufacturers (KAM, 2014) directory. The manufacturing firms were spread out and concentrated around Nairobi, Kisumu and Mombasa according to data available (KAM, 2014; KIRDI, 1997; Ondiek, 2012). The World Bank and United Nations reports provided secondary data on FDI and governance indicators. Foreign exchange rate, inflation rate and GDP came from Central Bank of Kenya (CBK) and Kenya National Bureau of Statistics (KNBS) reports. Political risk data was gotten

from international indices and specifically the International Country Risk Guide (ICRG) published by Political Risk Service (PRS). The time period in scope of the research was the period 2009 to 2013 which was long enough to encompass a number of years of low and high FDI flows as well as a variety of scores on the various potential determinants of FDI during the period.

1.8 Limitations of the Study

The main limitations of this study is time and cost. The researcher would have preferred to expand the scope of the manufacturing firms to include those in other areas of the country apart from the three main cities of Nairobi, Mombasa, Kisumu and their environs. The practicability of this was prohibitive due to constraints in resources. However to overcome these constraints, sampling from the population targeted for study was done; the sample size was large enough to represent the entire population. Additionally the sampling was done scientifically to ensure that the statistical principle of randomization was not compromised in the sampling frame.

The other limitation that was encountered was resistance from the respondents especially those that felt the data was very sensitive to disclose. To overcome this limitation, the respondents were contacted in advance before the actual data collection exercise and clearly informed that the data was intended for academic reasons only and the results was to be presented on aggregate only. The Kenya Association of manufacturers was also approached to talk to their member organizations that were sampled.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

The literature review is the foundation on which this research was based. In this chapter, the researcher reviewed and discussed the theories and relevant empirical evidence used in answering the research questions. The variables have been reviewed and research gaps identified leading to a summary at the end of the chapter. In the pages that follow, theories of the firm, Modigliani-Miller, agency, industrial organization, market imperfections, Eclectic paradigm (OLI), international trade, empirical evidence plus related thinking that explain determinants of FDI were extensively reviewed. This literature review focused on a mixture of OLI and institutional determinants in seeking to investigate the relationship between these determinants and the growth of FDI in Kenya. A theoretical framework of FDI theories was critically examined, critique of empirical research and identification of research gaps were done leading to a conceptual framework that shows the relationship between the variables that were hypothesized.

2.2 Theoretical Framework

Theoretically, the linkage between FDI, trade openness, capital formation and economic growth tends to be positive. This is supported by the neoclassical theories and endogenous growth theories that underline that FDI promotes economic growth in a capital scarce economy by increasing volume and efficiency of physical investment (Lucas, 1988; Romer, 1986). There is a variety of theoretical models explaining FDI and a wide range of factors that has been experimented within empirical studies in order to find the determinants of FDI. Casson (1990) has suggested that the theory of FDI is a logical intersection of three distinct theories: the theory of international capital markets, which explains the financing and risk-sharing

arrangements; the theory of the firm, which describes the location of headquarters and trade theory, which describes location of production and destination of sales.

Dunning and Rugman (1985) offer an elegant account of how early economic theory failed to deal with FDI; the explanation of international capital movements relied exclusively upon the neoclassical financial theory of portfolio flows, capital was assumed to be transacted between independent buyers and sellers, there was no role for the MNC and no separate theory of FDI. However the work of Hymer (1960) came in as a landmark and is influential in FDI studies. The theoretical models reviewed below present an attempt to explain FDI location determinants and provide information on the range of determinants that are likely to induce the flow and growth of FDI in Kenya.

2.2.1 Modigliani-Miller Theorem

The MM theory, proposed by Modigliani and Miller (1958 & 1963), forms the basis for modern thinking on capital structure. In their seminal article, MM demonstrate that, in a frictionless world, financial leverage is unrelated to value of a firm, but in a world with tax-deductible interest payments, firm value and capital structure are positively related. Miller (1977), added personal taxes to the analysis showing that optimal debt usage occurs on a macro level, but it does not exist at the firm level. Interest deductibility at the firm level is offset at the investor level.

Modigliani and Miller (1963) made two propositions under a perfect capital market condition. Their first proposition is that the value of a firm is independent of its capital structure. Their second proposition states that the cost of equity for a leverage firm is equal to the cost of equity for an unleveraged firm plus an added premium for financial risk. The M and M theorem leads to a theory of capital structure in terms of market imperfections, which can be extended by including the implications of the agency model. The question becomes one of how to finance a given stock of assets rather than a flow of investment, and the answer lies in some form of market imperfection.

This study benefited from this theory, the thinking and criticisms around it in understanding the preference for FDI rather than debt. The countries suffering from low levels of savings and capital are faced with choice between finding foreign debt and increasing FDI inflow (Sandalcilar & Altiner, 2012). Despite the positive influence of foreign debt in terms of capital inflow, it bears some risks of repayment and therefore, it is less preferable than FDI and only opted for when there is not any or enough FDI inflows.

2.2.2 Industrial Organization Theory

The reasons given by Hymer (1960) for the internalization of companies are of two kinds: variables related to the company's dimension and ownership of specific assets (scale economies, diversification and knowledge accumulation) and variables derived from the existence of market failures. From this classification of variables, two groups of theories can be distinguished in the literature: those formed within industrial organization (Caves, 1971; Hirsch, 1980; Kindleberger, 1969) and those focusing on the internalization process (Buckley & Casson, 2003; Hennart, 1982, 1989; Rugman, 1981, 1986; Teece, 1986). In spite of analyzing FDI from different perspectives, both approaches are complementary (Chang, 1995; José & Javier, 2001; Madhok, 1997).

The authors within the industrial organization school hypothesize that MNEs undertake FDI to benefit from the specific capabilities that they own, which give them certain monopolistic power (Kindleberger, 1969). Such power can become apparent in the form of innovative technological processes, patents, trademarks, financial resources, management abilities or exclusive distribution channels. According to Ohlin (1933), FDI is motivated by the possibility of high profitability in growing markets, along with the possibility of financing these investments at relatively low rates of interest in the host country, the necessity to overcome trade barriers and to secure raw materials. Caves (1971), considers the diversification of products as the main influencing factor and Hirsch (1980) emphasizes the importance of knowledge and capabilities generated from R&D activities. Caves (1982)

developed the rationale for horizontal integration and vertical integration (reduction of uncertainty and building of barriers to entry). This research immensely utilized this theory in identifying the macro-economic variables as determinants of FDI.

2.2.3 Market Imperfections Theory

Hymer (1960), argues that if MNEs are able to compete with local firms that have a much better knowledge of the local market and environment, it is because the MNEs present advantages ranging from imperfect competition due to a product differentiation, in the factor markets, access to capital and economies of scale. Hymer (1960) in his seminal paper moved economics and finance toward an analysis of the MNEs from the perspective of industrial organization theory and made it possible to understand why MNEs transfer intermediate products across borders while retaining control over production. Fundamentally, Hymer claimed that to explain FDI, one must explain control.

Hymer (1960) explained that among the reasons why a firm controls foreign operations are the removal of conflict and the exploitation of a particular country's advantage. With regard to the former, if markets are structurally imperfect, it is more profitable to have one centralized decision-making entity in one country, controlling all enterprises in different countries, rather than have separate structures in every country. With regard to the latter, structurally imperfect markets prevent owners of a particular advantage from wholly appropriating its returns, unless they retain control over its use through FDI (Hymer, 1960).

Other researchers have observed that, although Hymer's work was right to point out that MNEs will exist at least in part due to structural market failures, he neglected to observe that MNEs must resort to FDI because of transaction-costs (Dunning & Rugman, 1985; Lizondo & Saul, 1995; Navaretti & Venables, 2004). The study in its analysis of the macroeconomic stability as a driver of FDI was empowered by this theory.

2.2.4 International Trade Theory

Internalization theory was conceptualized by Buckley and Casson (1976) by extending Coase's (1937) explanation as to why multinationals internalize intermediate markets; they argued that internalizing intermediate production processes reduces uncertainty by circumventing market imperfections. According to Williamson (1975, 1985), the internalization theory is founded on transaction cost economies. Thus the company would incline towards internalization forms which involve a high degree of control, that is, it would prefer internalizing international activities through FDI rather than exporting or licensing (Lv Na & Lightfoot, 2006). According to Rugman (1981) internalization as an efficiency-based approach adopted by firms, can help to offset the hidden economic costs of protection and discriminatory regulations. The new internalization theory explained by Rugman and Verbeke (1992, 2003) makes explicit the need to model the MNE's internal organization, and its network capabilities, in addition to focusing on stand-alone FSAs such as strengths in R&D, manufacturing and branding. A great strength of internalization theory is that it provides clear conditions for the choice of entry mode.

FDI determinants are based on the transaction cost internalization (Buckley, 1985), due to imperfection of intermediate product markets with high transaction costs, integrating these markets by MNEs minimizes costs; this argument is in line with the study on the determinants of FDI that leads MNEs to set or invest in manufacturing firms in the target economies rather than portfolio investments or even exporting from their home countries. Internalization includes factors affecting availability of inputs like natural resources, the size of the market, geographical location, and the position of the economy, the cultural and political environment (Rugman, 1981); these were some of the variables that this study hypothesized.

2.2.5 The Resource- Based Theory

Summarizing multiple MNCs' incentives, Behrman (1972) proposed and developed a typology of FDI. This classification is based on industrial organization theory and corporate governance. Corporate governance was one of the hypothesized variables for the present study; this makes resource-based theory useful. According to

Behrman, MNCs are always seeking one of four types of results; resources, markets, efficiency (global sourcing FDI), and strategic assets. The resource-based theory of the firm (Barney, 1991; Davidow, 1986; Grant, 1991; Wernerfelt, 1984) creates a methodical basis for MNC investment strategy to achieve competitive advantage by understanding the external and internal forces that strongly affect an organization (Lofsten, 2004).

According to this theory, MNCs aim to possess resources that are rare, unique and limited so as to beat their competitors in various performance indicators. The resource-based theory explains how organizations achieve sustainable competitive advantage (Caldeira & Ward, 2003). In this way therefore, firms must look for unique attributes that may provide superior performance (Barney, 1991; Caldeira & Ward, 2003). This theory also focuses on the advantages associated with the complexity of managing a multiplicity of activities and functions in a volatile but innovatory global economy (Dunning, 1998). The reasoning behind MNEs market-seeking and resource-seeking FDI orientation was made clear in this study by relying on this theory.

2.2.6 Dunning's Eclectic (OLI) Paradigm

Dunning (1979, 1980) by bringing together the structural market imperfections, transaction-cost market imperfections, and location theory, developed the eclectic paradigm of international production. Dunning (1979, 1980) established that a firm engaged in FDI must satisfy three conditions: First, it must possess some ownership specific advantage. Second, it must be more advantageous to use rather than to sell or lease this advantage. Third it must be profitable to combine this advantage with some factors located abroad (Dunning, 1980).

Dunning (1980) argues that the reasons for investing abroad are search for resources, for markets, for efficiency and for new strategic assets; these reasons therefore determine where FDI will flow as was analyzed. FDI will take place when the three kinds of advantages come together (Dunning, 1997). All the advantages are

interconnected and affect indistinctly the likewise interconnected decisions of “why”, “how”, and “where” to internationalize (Buckley & Casson, 1998; Hennart & Park, 1994). José and Javier (2001) argues that ownership advantages mostly determine the “why” decision, internalization advantages mostly determine the “how” decision and location advantages mostly determine the “where” decision.

Dunning’s eclectic paradigm (Dunning, 1980) suggests that, when ownership, location and internalization advantages are high, firms will prefer an integrated entry mode for example FDI or joint ventures, versus export or licensing. Dunning (1998) argues that, in the former case strategic asset-seeking investments take place, in which FDI is used in mergers and acquisitions, seeking horizontal efficiency. In the second case, investments are characterized by the search for markets, and resources, thus being of vertical efficiency (Dunning, 1998; Dunning & Narula, 1996). The relevance of internalization advantages informed this research. Despite the criticism, the OLI paradigm is dynamic in understanding the determinants of FDI and their level of influence and therefore useful and relevant (Erramilli & Rao, 1993). This study considered OLI framework in hypothesizing the determinants of FDI inflows in Kenya.

2.2.7 Agency Theory

Agency theory, developed by Michael Jensen and William Meckling (1976), has been fruitfully applied in examining the nature of the relationship in a firm that exists between the principal and the agent (Bradley *et al.*, 1999; Denise, 2001). In an agency relationship, the principal hires and retains the agent because of the agent’s specific talents, knowledge and capabilities to increase the value of an asset. This encourages efficient allocation of resources. However, the agent enjoys only part of the outcomes of his efforts (Denise & McConnell, 2003). When shareholders are risk-averse, they should favor a less risky FDI portfolio of the firms they have ownership stakes in (Jensen & Meckling, 1976).

The theory is based on assumptions of goal incongruence between the principal and the agent (Jensen & Meckling, 1976). It is usually assumed that the interest of the principal is to maximize wealth (Denise, 2001) while the agent is interested in personal gain (Jensen & Meckling, 1976). A basic factor in the survival and success of the corporate form of organization is the control and monitoring of agency problems (Fama & Jensen, 1983). Agency theory is concerned with designing governance mechanisms that address the agency problem that stems from the goal conflict between the principal and the agent. Because it is empirically oriented, the positive agency theory is fruitful in analysis of corporate governance as determinant of FDI.

From a liberalist perspective, corporate finance and corporate governance are closely connected (Claessens, 2004). The function of effective corporate governance is to improve a firm's ability to access finance at a lower cost and generally improve its performance by enhancing the efficiency with which resources are allocated within the firm (CIPE, 2002; OECD, 1999). The ability of a firm and country to attract investments depends on the effectiveness of its corporate governance since this encourages investors to be confident that their investments will be protected and rewarded appropriately. Motivated by agency theory, the ownership structure of a company should play a non-negligible role for the risk involved in a firm's foreign expansion policy via FDI. Agency theory informed the investigation on how governance structure influences growth of FDI in Kenya.

2.3 Conceptual Framework

Arising from the above discussion on theories of FDI, a conceptual framework was formulated. The variables selected emanated from the gaps identified in the literature, the intended analysis of FDI flow in the manufacturing sector of Kenyan economy and the availability of data for analysis. The review that follows signifies the importance of the selected variables in determining the flow and growth of FDI in any country. Growth of market size of the economy is expected to bring in more investors to invest in an economy. Increase in openness denoted by total trade as a

percentage of the GDP, leads to increase in trade with other countries resulting in attraction of more foreign investment. Governance both corporate and political and management of macroeconomic stability indicators (exchange and inflation rates) decides the final value of the returns on the investment in a country and therefore very important determinants of FDI inflows.

The dependent variable was FDI inflows as a percentage of GDP in the country. The test variables (independent) were the determinants of FDI which were corporate governance, political governance, market size of the economy and openness of the economy. The intervening variables considered were inflation and exchange rates. Figure 2.1 in the next page shows the conceptual framework which depicts the relationships between the dependent variable, the independent variables and the intervening variables. The hypothesis for testing for each of the independent and intervening variables is also indicated. The variables were discussed in the empirical review of the determinants after the conceptual framework. The measurement of the identified variables is addressed in the methodology section of the study.

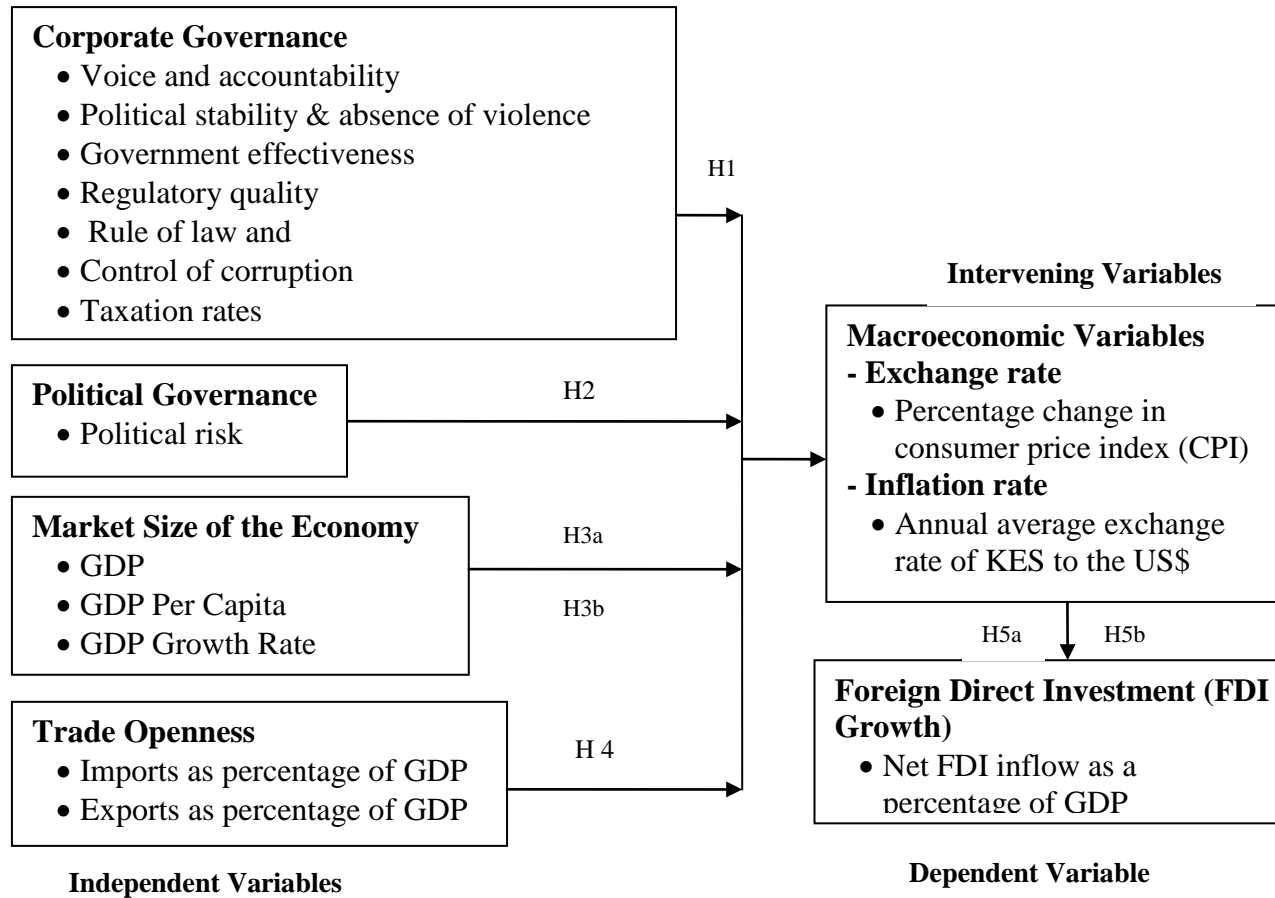


Figure 2. 1 Conceptual Framework

2.4 Review of Study Variables

A combination of locational and institutional variables was considered as determinants of FDI. Many econometric studies conducted has left broad consensus on the major determinants of FDI elusive. In addition to market and macroeconomic indicators, institutional variables to measure good governance were given preeminence. Consistent with the hypothesized variables, finance and international business literature has recognized the importance of country specific differences in political and institutional factors as determinants of FDI (Altomonte, 2000; Bevan & Estrin, 2000; Mody & Srinivasan, 1998; Morisset, 2000; Stevens, 2000; Tuman & Emmert, 1999; Wei, 2000); this necessitated testing the identified variables in Kenya.

2.4.1 Corporate Governance

Governance consists of the traditions and institutions by which authority in a country is exercised. This includes the process by which governments are selected, monitored and replaced; the capacity of the government to effectively formulate and implement sound tax policies; and the state for the institutions that govern economic and social interactions among the citizens (World Bank, 2010). Corporate governance is only part of the larger economic context in which firms operate that also includes macroeconomic policies (Owens & OECD, 2013). Hanson (2001) observes that corporate tax rates in Africa are not at variance with those in other regions. Globerman and Shapiro (2002) indicate that national political infrastructure and governance (political, institutional and legal environment) is a major factor influencing the flow of FDI and location's attractiveness.

Adrian notes that forms of corporate governance are shaped nationally by economic, political and legal backgrounds, and by sources of finance in the countries concerned (Adrian, 2004). Corruption and low transparency has been found to hinder FDI inflows (Habib & Zurawicki, 2002; Kersan-Skabic & Orlic, 2007; Voyer & Beamish, 2004; Zhao & DU, 2003). In examining the impact of governance on FDI inflows, Khamfula's (2007) shows that corruption is more harmful in an import substitution

world like Kenya than in an export promotion one. Mweha and Rose (2007), using panel data of 43 countries with a Kenyan dummy found that FDI is determined by growth rates and quality of institutions. Mkenda and Mkenda (2004) find that governance though not significant is positively related to FDI inflows in Africa. According to Addison and Heshmati (2003) democracy increases FDI flows in developing countries.

Athukorala (2003) finds that lack of improved investment climate such as good governance, accountability and political instability hinders FDI and growth. Countries and firms can attract international investors and effectively compete by improving their governance (Wheller & Mody, 1992) and quality of taxation infrastructures (Wei Shang, 1997). Efficient legal systems, low levels of corruption and high degree of transparency enable quantitative impact on a country's ability to attract FDI (Alesina & Dollar, 2000; Hausmann *et al.*, 2000; La Porta *et al.*, 1998; Shatz, 2000). Taylor (2003) argues that the African governments can mitigate investment risks in Africa by changing their investment environment characterized by poor governance, limited rule of law and corruption.

Talamo (2011) agrees that each country must establish a fair and transparent legal and judicial system in order to attract FDI. Stein and Daude (2000) evidence show that the quality of institutions has a positive effect on FDI flows and that countries that want to attract FDI should improve the quality of their institutions. Hausmann *et al* (2000), agree that better institutions lead to a reduction of share of FDI inflows and conclude that in comparison to FDI, other forms of capital flows are more sensitive to the quality of institutions. Reisen & Soto (2010) argue that the equity portfolio flows provide benefits such as lowering the cost of equity, increasing market liquidity and decreasing the agency costs by stimulating better corporate governance

Countries with responsible business practices and good corporate governance contributes to a healthy business climate that encourages domestic and foreign

investment (CIPE, 2008). Thugge (2010) posits that governance concerns remain an obstacle to Kenya fully exploiting its growth potential through FDI. Poor institutions lead to poor infrastructure (public goods) and a fall in FDI into a market (Blonigen, 2005). However some studies show that a weak corporate governance environment implies the presence of profit opportunities for domestic and foreign investors (Strange & Jackson, 2008; Sudarat *et al.*, 2006). The relationship between corporate governance and FDI was expected to show a positive sign indicating that greater transparency, rule of law and good quality of institutions leads to more FDI inflows. Democracy and tax rate policy as a proxy for governance were used in this research.

2.4.2 Political Governance

Political instability reduces a country's attractiveness as a location of FDI; according to Dupasquier *et al.*, (2008) political stability is inversely related to FDI inflows. Political events can disrupt the economic order, eliminate markets or even put past investment at risk, as in the case of nationalization and expropriation of foreign owned assets. Even in less radical situations investment is likely to suffer, because instability makes it difficult to predict cash flows (Iskander & Chamlou, 2000). Political risk is identified to be at the top of the managers' concerns prior to and after investment (Akhtar, 1999; Tu & Schive, 1995). However some studies have failed to establish a relationship between political risk and FDI flows (Chase *et al.*, 1988; Flamm, 1984). Tu and Schive (1995) conclude that political stability is precondition for FDI. This is consistent with Lucas' (1993) suggestion that events which generate political instability do reduce FDI. Kinuthia (2010) observes that the three main impediments to FDI inflow to Kenya are political instability, crime and insecurity, and institutional factors most notably corruption.

Political tensions have significant negative effects on trade (Longo & Sekkat, 2004). According to Taylor (2003) political risk is the primary reason more capital is not flowing to Africa despite the incredible potential in terms of low cost labor and vast natural resources. Busse and Hefeker (2005) show in their study that some aspects of political stability like government stability and the absence of internal and external

conflicts, matter significantly in determining FDI inflows. Busse and Hefeker (2005) posit that foreign investors are susceptible to changes in political stability of an economy. According to Dutta and Roy (2008), political stability is absolutely necessary for attracting foreign investors for it will ensure that there are less expropriation risks.

Nwankwo (2006) states that, political instability and transition to democracy discourages FDI inflows. Nunnenkamp and Spatz (2002) argue that FDI flows and political risk show significant correlation. Obwona (2001) agrees that political stability is a parameter in determining the flow of FDI. Ngowi (2001) points out that the main factors preventing an increased inflow of FDI in Africa is that most countries are regarded as high risk because they are characterized by a lack of political and institutional stability. The works of Edwards (1990), Loree and Guisinger (1995), Hanson (1996), Jaspersen *et al.* (2000) and Asiedu (2002) all showed political instability as a determinant of FDI. Political instability creates an unfavorable business climate which seriously erodes the risk-averse foreign investors' confidence in the investment climate and thereby repels FDI (Schneider & Frey, 1985). Wheeler and Mody (1992) found political risk to be statistically insignificant. The infrastructure in place in terms of managing political and economic risk in Kenya is high and in most of the cases scares away investors (Njoroge & Okech, 2011).

Alesina and Dollar (2000) however found that FDI responds to economic incentives such as trade regime more than political incentives. Rogoff and Reinhart (2003) found that wars are more likely to occur in Africa than in other regions. The study also showed that there is a statistically significant negative correlation between FDI and conflicts in Africa. Sachs and Sievers (1998) have also argued that political stability is one of the most important determinants of FDI in Africa. A political risk index (PRI) developed by political risk group (PRS) was employed to measure political governance.

2.4.3 Market Size of Economy

There are two general hypotheses concerning the domestic market, namely, the market size hypothesis and the growth hypothesis (Tsai, 1991). The market size hypothesis states that when the size of the market of a particular host country has grown large enough, the host country can become the target for the inflow of FDI. On the other hand, the growth hypothesis states that as GDP grows, the market size will inevitably grow, and foreign firms will start investing and increasing their investment with the expansion of the market (Torrise, 1985). Kenya's estimated GDP (market prices) is \$32.2 billion against a population of 40.5 million in 2010 (EAC Facts & Figures Report, 2011). A small market size implies that much economic activity cannot reach the minimum efficient scale of production, resulting in high unit costs of production (UNCTAD, 2010).

Resmini (2000) show that, a statistically significant positive relation between FDI and market size exists. Mkenda and Mkenda (2004) observe that, population size (a proxy of market size) is important for attracting FDI. According to Ajayi (2007) market size and growth, country risk, openness, institutional environment and macroeconomic policies determine FDI inflows. Opolot *et al* (2008) specifically presents findings that market size (GDP) and openness to trade positively affect FDI inflows to Sub-Saharan Africa with macroeconomic instability been disincentive to FDI. The larger the market size of a particular country, the more FDI a country should attract (Agiomirgianakis *et al*, 2006; Asiedu, 2002; Elbadawi & Mwega, 1997; Onyeiwu, 2003). Others (Blomstrom & Lipsey, 1991; Kravis & Lipsey, 1982) have identified market size as having a positive impact on FDI.

Ayanwale (2007) suggest that the determinants of FDI are market size, infrastructure development and stable macroeconomic policy. In their studies for developing countries, Petrochilas (1989), Root and Ahmed (1979), Schneider and Frey (1985), Torrise (1985), and Wheeler and Mody (1992) all found market size to be significant in attracting FDI. According to Kinuthia (2010), most of the foreign firms in Kenya are market-seeking with market size, political and economic stability as important

determinants. Market-seeking FDI is likely to benefit from a large market (Morisset, 2000). The size of the market, proxied by GDP and considered for the study was consistent in earlier studies. Gross domestic product is used as an explanation of the economic size of countries (Martinez-Zarzoso, 2003; Martinez-Zarzoso & Nowak-Lehmann, 2004; Pelletiere & Reinert, 2004). Pelletiere and Reinert (2004) argue that a high level of income in the host country indicates a high level of production, which increases the availability of investment.

In the long term, a strong and stable GDP should secure FDI and attract new investors to a country (Thanyakhan, 2008). Many studies show possible correlation between the market size and the volume of inward investment (Anderson, 1979; Buch *et al.*, 2003; Dunning, 1980; Kim, 2000). Kim (2000) employing GDP as the proxy of market size to represent the location or internalization advantage of the host countries found that GDP was significant as a determinant of FDI in the host countries. The market size also represents the location specific advantage of the host countries.

Moreover, market size and the national income level are important to consider for the host country, especially for market-seeking FDI (Guerin, 2006; UN, 1998). The developing countries' FDI is widely seen as market-seeking rather than resource-seeking (Dunning, 1998). Market size and its potential were expected to be strongly significant for the inflow of foreign investment to Kenya. However other studies show that market size of the economy does not determine FDI inflows (Edwards, 1990; Jaspersen *et al.*, 2000). A positive relationship was expected between FDI inflows and market size of the Kenyan economy. Gross Domestic Product growth (annual %) and GDP per capita was used to measure market size.

2.4.4 Trade Openness

Trade and FDI are the principal mechanisms linking national economies in order to create an international economy by reinforcing each other (Rugman, 1991). The trade effects of FDI depend on whether it is undertaken to gain access to natural resources,

to consumer markets or whether the FDI is aimed at exploiting locational comparative advantage or other strategic assets such as research and development capabilities (Recep & Ersoy, 2009). Rojid *et al* (2006) in their study of select African economies conclude that, openness had a positive impact on FDI and that an efficient environment that comes with more openness to trade is likely to attract foreign firms. How easy or difficult it is to start and run a business can influence how quickly firms are able to seize new opportunities (World Bank, 2012). Opolot *et al* (2008) posits that openness to trade positively affect FDI inflows to Sub-Saharan Africa.

Obwona (2001) however notes that openness is not FDI inducing. Collier and Patillo (1999) argue that investment is low in Africa because of the closed trade policy. Open export-oriented economies may be more successful in encouraging FDI flows in manufacturing (Cantwell, 1997; Lall, 2004). Hein (1992) and Dollar (1992) have found that outward-oriented developing economies have been relatively successful. Lucas's (1993) also show evidence of the importance of outward-oriented policies and specifically observe that FDI is relatively more elastic with respect to demand for exports than with respect to aggregate domestic demand. Empirical literature does not establish whether FDI flows are attracted by economies that are already export-oriented (exports precede FDI flows) or whether multinational investment causes exports to increase (FDI precedes exports). Chen (1994) correctly points out the overall contribution of foreign firms to the export sector. According to World Bank (2012) Kenya has business-friendly regulations for dealing with permits but slow in starting a business. Trade has lower risk but higher liquidity problems compared with FDI, but Guerin (2006) argues that the developed countries may prefer FDI to trade when access to larger markets is the key motivation.

Trade was expected to be highly sensitive to changes in market size of Kenya. Openness seen through multilateral trade was used to examine whether; trade complements FDI activity (when the coefficient of trade is significantly positive) or supplements FDI activity (when the coefficient of Trade is significantly negative) building on earlier studies by Stone and Jeon (1999) and Bergstrand (1985). The

degree of openness includes both trade and capital flows. The former refers to the free movement of goods and services, while the latter suggests fewer restrictions on capital repatriation (UNCTAD, 2012). Consequently, it was expected that the higher the level of openness of the economy, the easier it is for investors to invest in Kenya.

2.4.5 Macro-economic Variables

Internal macroeconomic stability is critical to attracting FDI (Rose, 2000). One indicator of a stable macroeconomic environment is a record of price stability which shows a history of low inflation and prudent fiscal activity, this signals to investors that the government is committed and credible (Campos & Kinoshita, 2003). A classic symptom of loss of fiscal or monetary control is unbridled inflation according to Cardoso de Mendonca and Nonnemberg (2002). Nwankwo (2006) observes that macroeconomic stability promote FDI inflows into a country. The macroeconomic variables considered for this thesis as intervening variables were inflation and foreign exchange rates.

(a) Inflation

Inflation rate is considered a proxy for the quality of macroeconomic management and fiscal governance. The inflation rate is measured by the changes in the consumer price index which is a weighted average of price of goods and services consumed (CBK, 2013; Nwankwo, 2006). A high inflation rate indicates high economic tension in a country, and reflects the inability or unwillingness of the government to conduct a stable economic policy. It can be argued that if foreign investors are risk-averse (or risk-neutral); a higher inflation rate may lead to a reduction in FDI in the host country, because investors will not risk profits expected from investment (Asiedu, 2002; Kadongo, 2011).

As long as there is uncertainty, foreign investors will demand a high price to cover their exposure to inflation risks, and this, in turn, will decrease the volume of investment. Thus, to encourage investment, the stability of the inflation rate is important (Emmert & Tuman, 1999). Lyakurwa (2003) has stressed macroeconomic policy failures as deflecting FDI flows from Africa; he posits that, irresponsible

fiscal and monetary policies have generated unsustainable budget deficits and inflationary pressures, raising local production costs, generating exchange rate instability and making the region too risky a location for FDI. Instability in macroeconomic variables as evidenced by high inflation and excessive budget deficits, limits the country's ability to attract FDI (Onyeiwu & Shrestha, 2004).

High and unstable inflation increases the cost of businesses and negatively affects long-term planning by investors; this reduces current and future profits (Campos & Kinoshita, 2003). Low and stable inflation are more appealing to investors, as monetary stability influences FDI inflows (Rolfe & Woodward, 1992). In line with previous studies, the annual change in consumer prices to approximate inflation was used (Asiedu, 2002; Campos & Kinoshita, 2003; Emmert & Tuman, 1999; Mixon & Trevino, 2004; Onyeiwu, 2003). Low inflation was anticipated to have a positive relationship with FDI flows.

(b) Foreign Exchange

Exchange rate is an essential component affecting FDI. The eventual importance of exchange rates to the location of FDI was first suggested by Aliber (1970). Aliber argued that the existence of different currency areas would generate FDI. Dunning considered that the greater the fixed capital stake of an investment, the more important it is to take account of possible movements in future exchange rates (Dunning, 1993). Goldberg and Kolstad (1995) agree that exchange rates volatility impact location decisions of MNEs. Other research indicates that exchange rate risk contributes significantly in explaining FDI (Grosse & Trevino, 1996; O'Sullivan, 1993).

Exchange rate volatility may negatively affect and reduce direct investment. Garibaldi *et al* (2001) based on an analysis of macroeconomic factors, institutional and legal frameworks and risk in determining FDI, proved that market size, fiscal deficit, inflation and exchange regime and trade openness all were significant. According to earlier research, exchange rate movements have shown to be relevant

and significant to FDI because exchange rate volatility directly contributes to uncertainty on the returning transaction plan from the investing countries (Guerin, 2006; Hubert & Pain, 2002; Rose, 2000). The exchange rate affects the relative currency prices of closely matched manufactured goods produced in different countries.

In terms of trade, an increase in the value of an importing country's currency implies depreciation of the Kenyan currency and was expected to have a positive impact on exporting products that are produced in Kenya. A higher value investing partner currency will enable investors to invest in Kenyan economy more inexpensively, thus the amount of FDI will rise. A higher value currency from an investing partner will make exporting products more expensive to Kenyan purchasers, so again FDI in Kenya would be stimulated to overcome this cost disadvantage building on earlier studies (Grosse & Trevino, 1996; Isard, 1977).

Kadongo (2011) contends that the nature of the relationship between capital flows and exchange rate fluctuations has received attention in Africa though not extensively. Kasekende *et al.* (1998) observe that private capital inflows, though predominantly short-term, have led to short-term exchange rate appreciations in all countries in his sample which included Kenya. Froot and Stein (1991) argue that a currency appreciation may increase foreign investment by a firm. Osinubi *et al.* (2009) however found that depreciation of the currency in Nigeria lead to increase in inward FDI). Stable foreign exchange rate was anticipated to have a positive relationship with FDI flows.

2.5 Critique of Existing Literature Relevant to the Study

The literature reviewed revealed the following points relevant to the present research study. First, key determinants of FDI have consistently been considered in literature on FDI, the combination of determinants considered is diverse, however institutional determinants have not been researched on extensively and exhaustively in literature

on FDI studies. The reviewed literature has also shown that the research done on determinants of FDI in Kenya have dwelt more on OLI determinants (Kinaro, 2006; Kinuthia, 2010; Mwege & Ngugi, 2007; Kareithi, 1991; Obwona, 2001). A mixture of institutional and OLI determinants were therefore considered for the present study.

Given that the literature's leans mostly on traditional determinants of FDI, it would be reasonable to say that much needed to be done in considering the proposed combination of determinants of FDI inflows in Kenya. Governance elements have also not been widely investigated mainly due to challenges of measurement and data constraints. This confirms earlier observations that the literature reviewed is not exhaustive especially in looking at determinants of FDI inflows to a country (studies shows significant determinants in a country may present different results in another country); this presented a significant research gap which the research attempted to fill. Second, the discussion about FDI inflows and economic growth process without looking at institutional determinants would not suffice. It is clear from the literature reviewed that more understanding of both OLI and institutional determinants of growth of FDI in Kenya is needed.

2.6 Research Gaps

The research studies done so far in Kenya on determinants of FDI do not suffice; further macro-level analysis of combined OLI and institutional determinants of FDI is needed. In order to address the growth of FDI inflows in Kenya the extent of the relationship between FDI and its determinants needed further analysis. Since no single set of determinants can contribute to FDI inflows as reviewed in the literature, other combinations of determinants needed to be analyzed to add to the literature on FDI decisions. Analysis of the relationship between determinants of FDI including governance mechanisms was advocated as it is clear from the literature reviewed that it has not received adequate attention by researchers. The study sought to contribute to filling the identified gaps in literature by finding any dynamic relationship between FDI and selected determinants.

The available research tended to investigate OLI determinants and mainly in the agricultural sector with only a few in the manufacturing sector of the Kenyan economy. The studies done before on determinants of FDI were not exhaustive. The studies done according to literature reviewed is on the basis of either the transaction costs approach or the OLI framework. A study on combination of OLI framework and institutional determinants of FDI arose from this gap. In relation to areas of research that have been inadequately covered in the existing literature, this dissertation aimed at contributing and adding to academic theory by empirically investigating the determinants of FDI flows by combining the OLI framework and institutional determinants of FDI. The dearth of literature on the exact nature of the FDI flows and the determinants thereof in Kenya was found worrying UNCTAD (2011). The study was an attempt at filling these significant research gaps that researchers seem to have denied adequate attention.

2.7 Summary

This chapter has looked at the theoretical framework and empirical review that gave guidance in investigating what determines growth of FDI as a preferred form of investment. The chapter has presented a critique of empirical studies and developed the conceptual framework showing the relationship between the variables. Considering the literature reviewed, this research complemented the existing literature on determinants of FDI by considering institutional determinants of FDI inflows like governance elements. The macroeconomic fundamentals were also considered as intervening variables. Despite evidence of the importance of all the determinants of FDI analyzed in this chapter, it is clear that the determinants may not all be simultaneously relevant. It was implicit in the earlier studies (and sometimes explicit) that the relevance of each determinant depended on the home and host countries, industry characteristics, and the type of FDI being analyzed; this necessitated the need for research in the Kenyan manufacturing industry.

Researchers have not reached consensus on the main determinants of FDI. However, there is general agreement on a number of determinants including: the size of the host economy which acts as an indicator of the local market; the availability of raw materials; per capita income as an indicator of the nature of the local market; and the investment environment, which constitutes the prevailing social, political, economic, financial, legal, administrative and institutional conditions that tend to promote the chances of success (or otherwise) of investment in a country. The degree of economic openness, the availability and skills of the labor force, the infrastructure including the legislation and policies that organize and motivate the investment process constitute the most important elements that provide a suitable investment environment (AIECGC, 1987).

There are two distinct schools of thought in relation to the interpretation of the determinants of the FDI. The first school emphasizes the determinants at the microeconomic level focusing on individual companies (Caves 1974; Hymer 1976; Kindleberger, 1969). These studies attempted to interpret the purpose behind MNEs expanding their activities beyond their national borders (Aliber, 1970; Buckley & Casson, 1976; Grosse & Trevino, 1995). By contrast the second school of thought emphasizes the determinants of FDI at the macro-economic level taking into account the economies of the host countries upon which this study leaned.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter discusses the research design; strategies and the general methods which were used, as well as the analysis of data that were gathered from the population sample of manufacturing firms in Kenya. The target population of the study, the sampling frame and technique are discussed in this chapter. The methods that were employed to conduct the interviews for collecting both primary and secondary data are also discussed. The data processing and analysis is well detailed including sections on model specification and measurement of variables.

3.2 Research Design

The study employed a combination of quantitative and qualitative techniques in response to the aims of the research and questions intended to be answered. This research was descriptive in nature and addressed the determinants of growth of FDI in Kenya. The research design was mixed descriptive and analytical survey intended to evaluate the determinants of FDI in Kenya. The use of mixed design gave the study reliability and consistency of research results sought for (Brewer & Hunter, 1989). The chosen design was intended to produce descriptions of sought for aspects of the target population, determine the relationships of the variables and generalize the findings descriptively to the target population. This design facilitated testing of the hypotheses that stimulated this thesis in the first place. The temporal time perspective was cross-sectional and unit of analysis was a firm. This design was expected to provide greater confidence in explaining relationships between variables and for making inferences to the population (Alain & Kraemer, 1993; Gill & Johnson, 2002).

Survey was chosen because it is supported by earlier studies on FDI; the UN report states that survey based studies (questionnaire and/or interview) have played a useful role throughout the history of formal analysis of the determinants of FDI decision making (UN Statistical Institute, 2011). A combination of quantitative and qualitative research designs was used. Qualitative design relied on the interview schedule and informed the pilot testing of the questionnaire for validity and reliability. Quantitative research design focused on the designs, techniques and measures expected to produce discreet numerical and quantifiable data (Kothari, 2007).

3.3 Target Population

The population comprised foreign controlled firms operating in Kenya in the manufacturing sector that met the designated set of criteria. Target population is the members of a real or hypothetical set of people, events or objects the researcher wishes to generalize the results of the research (Mugenda & Mugenda, 2003). The study targeted a population of 100 firms in the manufacturing sector with significant (over 10%) foreign investment where one respondent in each firm was interviewed.

According to earlier studies, the number of manufacturing firms with lasting foreign interests is large and no comprehensive study has been undertaken in Kenya to establish the actual number of such firms (Kinaro, 2006; Kinuthia, 2010; Ondiek, 2012). The formula for inclusion in the target population was determined by level of investment in the firms most of which is in public domain. These criteria generated a target population of foreign controlled manufacturing firms relevant for the study. The target respondents were chief finance officers and finance professionals in the ranks running the finance departments of these firms.

3.4 Sampling Frame

The source of firms for study was the Kenya Association of Manufacturers directory (KAM, 2014). The directory provided the target 100 manufacturing firms. These

firms made up the sampling frame which was organized alphabetically to select the sample; 100 firms were considered representative and large enough for sampling. The choice of this sampling frame was because the study was predominantly interested in determinants of FDI in Kenya and mostly to the manufacturing sector of the economy. According to World Investment Report (UNCTAD, 2011), the share of manufacturing FDI rose to almost half of all FDI projects and data on FDI projects (both cross-border M&A's and Greenfield investment) indicating that FDI in the manufacturing sector was good ground for advanced analysis and research. The sampling frame which constituted a representative subset of the population from which the sample was drawn was adequately representing the unit of analysis.

3.5 Sample and Sampling Technique

The sample size was picked through stratified random sampling, to make it representative (Cooper & Schindler, 2010). The scientific guideline for sample size decision and sample criteria to determine the appropriate sample size was considered and applied (Israel, 1992). The level of precision or sampling error was taken as $\pm 5\%$ and the level of confidence was 95% which is within two standard deviations of the true population value. Since this sample size was conservative, the degree of variability was a proportion of 50% (P-value = 0.5) which indicates the maximum variability in a population (Yamane, 1967). The scientific guideline recommends a sample size of ≥ 81 firms for a population of 100 firms at ± 5 percent level of precision. The formula used to calculate the above sample is;

$$n = \frac{N}{1 + N(e)^2}$$

Where n is the sample size, N is the population size, and e is the level of precision.

The stratified random sampling technique was used to select the sample whereby each of the three cities (Nairobi, Kisumu and Mombasa) in the country formed a stratum. The sample size was 81 firms as per the sample distribution table (appendix 5) which lists the firms sampled.

Table 3. 1 Sample Firms Distribution

| Strata | Cities | Total Firms | Number of Firms- Sample |
|---------------|---------------|--------------------|------------------------------------|
| 1 | Nairobi | 74 | 60 |
| 2 | Mombasa | 21 | 17 |
| 3 | Kisumu | 5 | 4 |
| | Total | 100 | 81 |

This sample was derived from the target population of 100 firms drawn from the KAM directory as explained in the earlier section after eliminating those firms which did not meet the 10% foreign investment criteria. The number of firms sampled from each city under survey was based on the number of manufacturing firms in that city and its environs as a percentage of the total manufacturing firms who were members of Kenya association of manufacturers in 2014 (KAM,2014). The sample size as far as possible represented the population of the foreign controlled manufacturing firms operating in Kenya and upon which the data collection tools were administered to the research participants.

3.6 Data Collection Methods

Primary and secondary data were utilized. The collection methods applied for each set of data is as discussed below. Having decided on the use of a survey, the question of whether to use questionnaires or interviews was addressed. In this case both interview guide and questionnaire were chosen since according to Bryman (1989), if the research problem invites a combined approach, there is little to prevent such a strategy, other than time, cost and possibly inclination. Multiple methods of data collection and analysis are recommended for a survey (Alain & Kraemer, 1993). The questionnaires were accompanied by a cover letter explaining the need for and treatment of information collected in meeting the purpose of the study. A

questionnaire is considered an appropriate yet inexpensive survey instrument to use when substantial information is sought through structured questions from a large sample that is widely dispersed geographically (Pearce *et al*, 1992). These factors influenced the selection of the questionnaire as the survey instrument employed in the primary collection of data. The secondary data obtained from UN, World Bank and PRS was analyzed into summary statistics and organized into a set of observations

3.6.1 Primary Data

The main instrument of primary data collection was a semi-structured questionnaire which sought to confirm open and closed ended questions; the close-ended questions were on a five-point Likert scale. An interview guide was also used to collect primary data. A questionnaire and interview schedule was produced (Appendix 2 and Appendix 3) and potential respondents identified. The questionnaire contained open and close-ended questions organized into four main sections, the first of which had general questions intended to collect data on personal characteristics and demographics of the primary respondents. This section consisted of two sub-sections; the first gathered information from the respondent on their nationality, education, experience and occupation; the second gathered information on the firm's operational status.

The second and third sections collected data on the research questions with a view of meeting the research objective; these sections of the questionnaire investigated the views of the firm's officers on issues pertaining to investment climate in Kenya. The survey questions were developed by the researcher and administered to the respondents in the sample through visits. Questionnaire and interviews were chosen as the data collection methods of survey due to their validity, reliability and relevance in collecting the data that was required. Earlier research on FDI using a survey in literature includes the study on choice of foreign market entry mode: impact of ownership, location and internalization factors (Agarwal & Ramaswami, 1992; Brouthers, 2002; Brouthers & Nakos, 2002).

A questionnaire is good due to its application in a wide scope because a great deal of information can be obtained from a large sample, and it is economical in comparison with other data collection methods. The main drawback of surveys is often the relatively low response rate. Geringer (1989) states that the average response rate is about 30%, to counter low response rates, the sample chosen was large enough. Although surveys lead to statistical analysis, the results obtained remain difficult to be generalized; this called for face to face interviews with managers in the ranks of administration and finance departments allowing for a much broader and deeper discussion on the consideration the firms made when making complex decisions on FDI.

3.6.2 Secondary Data

Secondary information on the variables was obtained from published data from the World Bank, PRS, CBK, KNBS and the UN databases. In addition to being authoritative sources, these data sets were readily accessible. Secondary data on inflows of FDI in millions of US dollars was obtained from several relevant reports by UNCTAD for the period 2009 to 2013. Political risk data was gotten from international indices which offer independent international investor risk services and specifically International Country Risk Guide (ICRG) published by Political Risk Service (PRS). Corporate governance data was gotten from world governance indicators (WGI) published by World Bank (Kaufmann *et al*, 2010). The world development indicators (WDI) provided information on percentage growth of GDP (World Bank, 2011). The Central Bank of Kenya and Kenya National Bureau of Statistics were the source of CPI data, inflation and foreign exchange rates for the period under study.

3.7 Data Collection Procedures

Primary data pertaining to the hypothesized variables was collected through survey and interview questionnaire designed by the researcher and administered to the respondents. The data collection procedure entailed administering of questionnaires

to the finance and administration officers in the ranks of each organization sampled. The filling of questionnaires was followed by an interview session conducted by the research assistants. A five point Likert scale of perceived agreement to the questions relating to the relationship between determinants and growth of FDI was used. The questionnaire contained both close and open-ended questions; the questionnaires were presented in person to all the firms that constituted the sample after piloting was done.

3.8 Pilot Testing

The quality of research instruments determines the outcome of the study (Bryman & Bell, 2011). In this study, the researcher pilot tested the research instruments. To check for the validity of the research instruments, expert opinion was sought. While testing for the reliability of the research instruments, questionnaires were administered to ten respondents constituting 10 percent of the total target population. The respondents were picked conveniently. Six respondents were picked in Nairobi, three in Mombasa and one in Kisumu from the list of manufacturing firms prior to the actual data collection exercise. The respondents who participated in the pilot testing of the research instruments were exempted from participating in the main study to eliminate biasness in the research results based on prior knowledge of the contents in the research instrument. The aim of pilot test was also to determine effectiveness of the questionnaire in collecting the intended data and for refining of the questionnaire (Cooper & Emory, 1995; Mugenda & Mugenda, 2003).

Interview was used to pre-test the instruments due to its convenience. Another advantage of the interview-based pilot scheme is that it allowed the evaluation of whether the questions were clearly understood by the respondents. The research tool for pilot testing was the developed questionnaire. The respondents were asked to provide a summary of their assessment of the survey questions. The respondent officers were requested to fill out a pilot questionnaire in the presence of the interviewer in describing what they perceived determines foreign investment in Kenya.

3.8.1 Validity

Testing the validity of research instruments helps the researcher to be sure that the instrument measures what is intended to be measured. The validity of the research instruments in this study was tested through the content-related method. This test of validity method was so selected because it was consistent with the objectives of the study. To test for validity of the research instruments in this study, expert opinion from two experts in finance was obtained and followed, this is widely acceptable in research (Kombo & Tromp, 2006; Kothari, 2007).

3.8.2 Reliability

Testing reliability of research instruments helps check for internal consistency of scores obtained by a research instrument. Kombo and Tromp (2006) define reliability of research instruments as the consistence of scores obtained considering stability and equivalency aspects. Reliability then is said to be achieved if it gives consistent results with repeated measurements of the same object with the same instrument. Equivalency is the measure of how much error gets introduced by different investigators or different samples of the items being studied. To measure the reliability coefficient of the research instruments, Cronbach's (Alpha) reliability coefficients were obtained for all the variables in the study. Cronbach's Alpha reliability coefficients range between zero and one. A coefficient of zero implies the tool has no internal consistency while that of one implies complete internal consistency.

The acceptable alpha is 0.7 which is widely offered as a rule of thumb (Mugenda & Mugenda, 2003; Nunnally, 1978; Nunnally & Bernstein, 1994; Kothari, 2007). Where alpha was found to be < 0.7 , the research instruments were revised to acceptable levels before collecting data. The composite Cronbach Alpha reliability coefficient for the research instrument was $0.6642 \approx 0.7$. The formula used to calculate this alpha is;

$$\alpha_{standardized} = \frac{K \cdot \bar{r}}{(1 + (K - 1) \cdot \bar{r})}$$

In the formula, K is the number of variables, and r-bar is the average correlation among all pairs of variables (Cronbach, 1951). Cronbach's Alpha is applicable for an estimate of internal consistency of items in a model or survey (Nunnally, 1978). Hatcher (2013) indicates that Cronbach coefficient is used to test internal consistencies of samples of a given population when research instruments with Likert type scales with multiple responses are used for data collection.

3.9 Data Analysis and Presentation

Descriptive method was used to analyze the data collected. The data was averaged annually to generate cross sectional indices for use with OLS. The data was checked for errors and missing values were assigned an appropriate code. Qualitative analysis involved coding and organizing collected data into themes and concepts that address the research questions (Mugenda & Mugenda, 2003). Quantitative analysis consisted of measuring values which were analyzed using descriptive analysis which is measures of central tendencies like mean, median and mode and measures of dispersion such as range, standard deviation and variance (Kothari, 2007). The aim of descriptive analysis was to provide an accurate and valid representation of the variables chosen for the study.

The analysis was done using SPSS and STATA statistical software, in order to get the outcome of the multiple regression model developed and which was used to identify statistically significant determinants of growth of FDI in Kenya. The primary premise of the study was that the strength of the linear relationship improved when the determinants showed positive signs. The best possible linear model was estimated using the ordinary least square (OLS) methodology which was expected to have the best linear unbiased estimators of the true value of the parameters of the independent variables without misrepresentations (Gujarati, 2004; Woodridge, 2009). An analysis of variance (ANOVA) was undertaken to decompose the total

variability into the variability explained by the regression model and a table generated. Tests of statistical assumptions were carried out before data analysis to avoid invalidation of statistical analysis. In presenting and describing the results, frequency distributions tables and charts were used.

3.9.1 Tests of Hypotheses

The overall model fit involved testing the hypotheses (H1, H2, H3a, H3b, H4, H5a and H5b), that the independent and intervening variables were to explain FDI growth against the alternative that the regression model was adequate. There are various tests used to test hypotheses like Pearson's Product Moment Correlation Coefficient (r), Stepwise Regression (R^2), the Student t-Tests, adjusted R^2 and F-Tests. Moriya (2008) argues that in practice, F-Tests are the most commonly used to test confidence intervals and hypotheses. If for a given sample, $F(r)$ is the Fisher transformation of r , and n is the sample size, then $F(r)$ approximately follows a normal distribution given the assumption that the sample pairs are independent and identically distributed and follow a bivariate normal distribution. Thus an approximate r -value can be obtained from a normal probability table. For a large enough sample where $n > 30$ as was the case in this study, then F -values were obtained using Fisher transformation and the hypotheses tested normally by use of F -Tests (Moriya, 2008). The hypothesis that $b_0 = 0$ and vice versa was tested.

3.9.2 Statistical Model and Specification

To facilitate analysis a multiple regression model was built by bringing together the dependent variable which is growth of FDI inflows, independent variables which were determinants of FDI (corporate governance, political governance, market size of the economy and trade openness) and intervening variables (inflation and exchange rates) as reviewed in the literature. This model was used to empirically test the level of influence the variables have on growth of FDI inflows in Kenya. This model included relevant factors as reviewed in the literature while managing the risk of multicollinearity.

The statistical model developed was $Y = f$ (Corporate governance; political governance; Market size; Trade Openness; Inflation rate; Exchange rate). This was shortened to linear form of the equation thus:

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \varepsilon_1 \dots\dots\dots 1$$

$$Y = \beta_0 + \beta^1_1 X_1 + \beta^1_2 X_2 + \beta^1_3 X_3 + \beta^1_4 X_4 + \beta^{11}_5 X_5 + \beta^{11}_6 X_6 + \varepsilon_2 \dots\dots\dots 2$$

$$I = \beta_0 + \alpha_1 X_1 + \alpha_2 X_2 + \alpha_3 X_3 + \alpha_4 X_4 + \alpha_5 X_5 + \alpha_6 X_6 + \varepsilon_3 \dots\dots\dots 3$$

Where: X_1, X_2, X_3, X_4 were the independent variables (corporate governance, political governance, market size of the economy and trade openness respectively), X_5 and X_6 were the intervening variables (inflation and foreign exchange respectively), Y was the dependent variable (growth of FDI). I represented the two intervening variables, $\beta_0, \beta_0, \beta_0$ are the sample regression intercepts in equations 1, 2, and 3, respectively, β represents the relation between the independent and dependent variables in equation 1, β^1 represents the relation between the independent and dependent variables adjusted for the effects of the intervening variable in equation 2, α represents the relation between the independent and intervening variables in equation 3, β^{11} represents the relation between the intervening and the dependent variables adjusted for the effect of the independent variables in Equation 2, and $\varepsilon_1, \varepsilon_2,$ and ε_3 are the residuals in equations 1, 2, and 3, respectively. The explanatory ability of the model was tested through R^2 and F test. Then predictor ability of each X on Y and whether the coefficients are economically important was done using Student T-test.

The predictive ability of the regression equation constructed was checked by examining the coefficient of determination (R^2) which lies between 0 and 1. The closer R^2 is to 1 the better the model and its prediction. Violations of linearity, normality, outliers, heteroscedastic variance, autocorrelation and multicollinearity which would lead to faulty conclusions was tested for and controlled. The presence of correlations between more than two predictors is termed multicollinearity (Chatterjee & Hadi, 2012). A severe multicollinearity problem exists if the variance

inflation factors (VIF) for the β 's are greater than 10. This was addressed by calculating the coefficient of correlation between each pair of numeric independent variables in the model. If one or more correlation coefficients are close to 1 or -1, the variables are highly correlated and a severe multicollinearity problem may exist. Appropriate responses to multicollinearity may include removing some of the highly correlated predictors (Chatterjee & Hadi, 2012; Theresa, 2012). The analysis showed that none of the independent variables in the model needed to be removed for the VIF values for all the independent variables were below 10 indicating that no multicollinearity existed among the variables.

In some cases, the results of a regression analysis may be strongly influenced by individual members of the sample that have highly unusual values on one or more variables under analysis. Several diagnostics are available to identify outliers (Cohen *et al.*, 2003); when outliers are excluded, it may be useful to present results both with and without outlier exclusions (Stevens, 1984). Alternatively, the use of robust regression methods helps to reduce the influence of outlying observations (Montgomery *et al.*, 2001).

According to Osborne and Waters (2002) regression assumes that variables have normal distributions; they imply that multiple regression requires that the predictor and/or response variables be normally distributed. Specifically, this study assumed that errors were normally distributed for any combination of values on the predictor variables. This is why it is plausible to say that regression is relatively robust to the assumption of normally distributed errors. To enhance normality this study applied a square root transformation; where the square root of every value was taken. Where there were negative numbers and since square root of a negative number cannot be taken, a constant was added to move the minimum value of the distribution to 1. Shapiro-Wilk Test of normality was conducted.

The errors were assumed to have a mean of zero for any given value, or combination of values, on the predictor variables (Weisberg, 2005). When the conditional means of the errors are zero (and the other assumptions are also met), the desirable

properties of OLS estimators will apply regardless of whether the X values are fixed, as in an experiment, or random, as in sampled from a population (Berk, 2004). The errors were assumed to be independent (Chatterjee & Hadi, 2012; Weisberg, 2005). Breach of this assumption leads to biased estimates of standard errors and significance though the estimates of the regression coefficients remain unbiased yet inefficient (Chatterjee & Hadi, 2012). The model errors are generally assumed to have an unknown but finite variance that is constant across all levels of the predictor variables. If the errors have a variance that is finite but not constant across different levels of the predictor/s (heteroscedasticity is present), ordinary least squares estimates is unbiased and consistent as long as the errors are independent, but will not be efficient (Weisberg, 2005).

When heteroscedasticity is encountered, several alternatives are available to the researcher. This research was checked by visual examination of a plot of the standardized residuals (the errors) by the regression standardized predicted value. This option is available in the statistical packages that were used for analysis. The researcher also conducted variance stabilizing transformations as suggested in previous research (Weisberg, 2005) and estimation via weighted least squares (Chatterjee & Hadi, 2012). The study also conducted Breusch-Pagan / Cook-Weisberg test for heteroskedasticity which showed absence of heteroskedasticity.

3.9.3 Operationalization and Measurement of Variables

The study involved operationalization and measurement of the variables identified in the model. Operationalization is the process of strictly defining variables into measurable factors (Shuttleworth, 2008). Measurements from different sources were employed in the research. The development of the variables and measurements was supported in empirical studies reviewed in the literature. The dependent variable (FDI growth) measurement was the annual net FDI inflow (unit million) as a percentage of GDP which is a widely used measure in FDI studies (Asiedu, 2002; Goodspeed *et al.*, 2006; Quazi, 2005). The level of annual economic activity (GDP,

GDP Per Capita and GDP Growth Rate) was used to measure the market size of the economy in million of US dollars.

The GDP growth rate can be characterized as FDI-led and it is often used as proxies for the size and growth of market demand and supply. FDI investment will be done in Kenya with a stable and high level of GDP growth rate and GDP (market size) and was expected to be positive in the model meaning it influences FDI inflows into the country. To measure degree of trade openness, the sum total of annual imports and exports as percentage of GDP (percent) to and from Kenya was used. Gross domestic product affects FDI positively if trade and FDI are complementary. Countries that export more may also attract foreign manufacturers that aim to export their products (Rogmans, 2012). The theoretical literature suggests that both FDI and trade can be complementary or supplementary to each other depending on the nature of investment (Botero, 2004; Djankov, 2007). Hence, the trade coefficient in the model was expected to be positive.

International Country Risk Guide (ICRG) developed by political risk group (PRS) was employed in measuring political governance. Low political governance risk and instability was postulated to have a positive relationship with FDI inflows. The expected sign was positive showing political governance determines FDI inflows. Corporate governance was measured by use of world governance indicators (WGI) developed by World Bank (Kaufmann *et al*, 2010) for each of the 2009 to 2013 years considered.

These governance indicators are voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law and control of corruption. Taxation rates were also used as a measure of governance; how easy the investors understand the tax system is a sign of good fiscal governance. A positive relationship between FDI and good corporate governance rating was expected. The measure of foreign exchange rate was taken as the official exchange rate of Kenya shilling to the US\$ (annual average). The coefficient of foreign

exchange rate was expected to be positive because investors take advantage of the depreciation of the currencies to reduce their costs of investment; this measure is standard in literature of FDI (Bajo- Rubio & Sosvilla-Rivero, 1994; Blonigen, 2005; Froot & Stein, 1991).

The inflation rate was measured by the changes in the consumer price index (CPI) which is a weighted average of price of goods and services consumed. Inflation rate was calculated as percentages change in consumer price index (CPI in percentage); the annual inflation rate. The expected sign for inflation rate was positive which implies an increase of the average price level and the purchasing power in the country's economy. The description of hypothesized variables is summarized in Table 3.2 below.

Table 3. 2: Operationalization of Variables

| Variables | Description | Measurement | Expected Relationship | Measuring Scale | Statistical Analysis | Tool of Analysis |
|----------------------------|--|----------------------------------|------------------------------|------------------------|-----------------------------|-------------------------|
| Growth of FDI | <ul style="list-style-type: none"> • Net FDI inflow as a percentage of GDP | The strength of the relationship | Positive (+) | Ratio | Parametric | Regression Analysis |
| Corporate Governance | <ul style="list-style-type: none"> • Voice and accountability • Political stability & absence of violence • Government effectiveness • Regulatory quality • Rule of law and Control of corruption • Taxation rates | The strength of the relationship | Positive (+) | Ratio | Parametric | Regression analysis |
| Political governance | <ul style="list-style-type: none"> • Political risk | The strength of the relationship | Positive (+) | Ratio | Parametric | Regression analysis |
| Market size of the economy | <ul style="list-style-type: none"> • GDP • GDP Per Capita • GDP Growth Rate | The strength of the relationship | Positive (+) | Ratio | Parametric | Regression analysis |
| Trade openness | <ul style="list-style-type: none"> • Imports as percentage of GDP • Exports as percentage of GDP | The strength of the relationship | Positive (+) | Ratio | Parametric | Regression analysis |
| Inflation rate | <ul style="list-style-type: none"> • Percentage change in consumer price index (CPI) | The strength of the relationship | Positive (+) | Ratio | Parametric | Regression analysis |
| Exchange rate | <ul style="list-style-type: none"> • Annual average exchange rate of KES to the US\$ | The strength of the relationship | Positive (+) | Ratio | Parametric | Regression analysis |

The study did not give rise to any particular ethical issues because the data on FDI flows was readily available from secondary sources and specifically from the relevant UNCTAD world investment reports and World Bank reports on world development Indicators. The risk rating data from ICRG/PRS and data from CBK and KNBS was freely available. Corporate governance data was obtained from World Bank Governance Indicators (WGI) which was also freely available. Qualitatively with respect to interviews and questionnaires, care was taken not to divulge any information that was considered proprietary, confidential or sensitive. Where required, the identity of respondents was hidden to enable reporting results of significance without compromising confidentiality. The chapters that follow present the findings and proceed to give conclusions and recommendations.

CHAPTER FOUR

RESEARCH FINDINGS AND DISCUSSION

4.1 Introduction

This chapter is on data analysis, presentation, interpretation and discussion. The data analysis was in harmony with the specific objectives where patterns were investigated, interpreted and inferences drawn on them. The first section in this chapter is on the response rate of the respondents. The second section presents the profiles of respondents. The third section presents tests of statistical assumptions and usage of the Likert-type scales in data analysis. The fourth section gives the analysis, presentation, interpretation and discussion.

Since mixed descriptive and analytical survey research design approaches were used in this study, descriptive statistical analysis was carried out in this chapter in a cross-sectional manner. For each research objective, descriptive analysis was first done by use of the arithmetic mean and the standard deviation followed by inferential analysis by use of Correlation and Stepwise Multiple Regression analysis to test the relationships under study. Discussion was derived from the analysis and interpretation of descriptive and inferential data.

4.2 Response Rate

The number of questionnaires, administered to all the respondents, was 100. A total of 55 questionnaires were properly filled and returned from the manufacturing firms' target respondents. This represented an overall successful response rate of 68% out of the expected 81 questionnaires as per the sample. According to Mugenda and Mugenda (2003), a response rate of 50% or more is adequate. Babbie (2004) agrees that return rates of 50% are acceptable to analyze and publish, 60% is good and 70% is very good.

Table 4. 1: Response Rate

| Response Rate | Frequency | Percent |
|----------------------|------------------|----------------|
| Returned | 55 | 68% |
| Unreturned | 26 | 32% |
| Total | 81 | 100% |

4.3 Demographic Information

This section presents the demographic characteristics of the respondents such as job group, age bracket, the level of education and job experience of the respondents.

4.3.1 Distribution of Respondents by Job Group

The respondents were asked to indicate their position in the organizations. Majority of the respondents were in middle management as represented by 53%. 40% were in junior management while only 7% were in top level management.

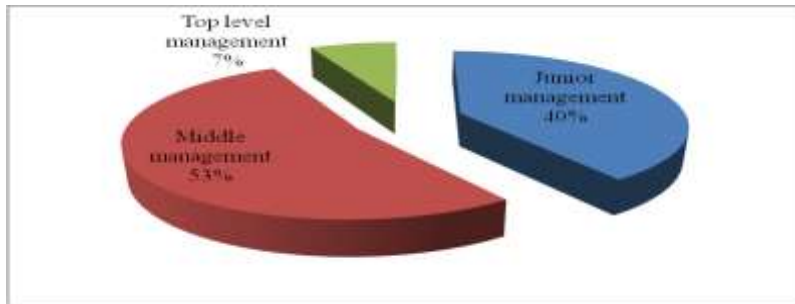


Figure 4. 1: Job Group

4.3.2 Distribution of Respondents by Level of Education

The respondents were asked to indicate their highest level of education. Figure 4.2 illustrates that 49% of the respondents had reached graduate level and 42% had attained post graduate degrees level. The findings imply that most of the respondents had high level of education which could have contributed to accurate responses.

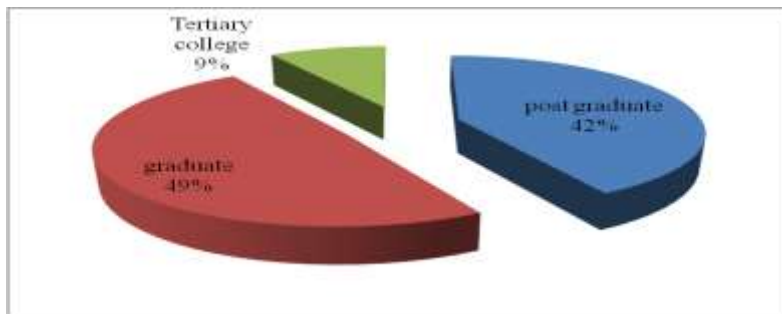


Figure 4. 2: Level of Education

4.3.3 Distribution of Respondents by Age Bracket

The respondents were asked to indicate their age bracket. Figure 4.3 illustrates that 29% of the respondents were between 41 to 50 years while 25% were between 51 to 60 years old.

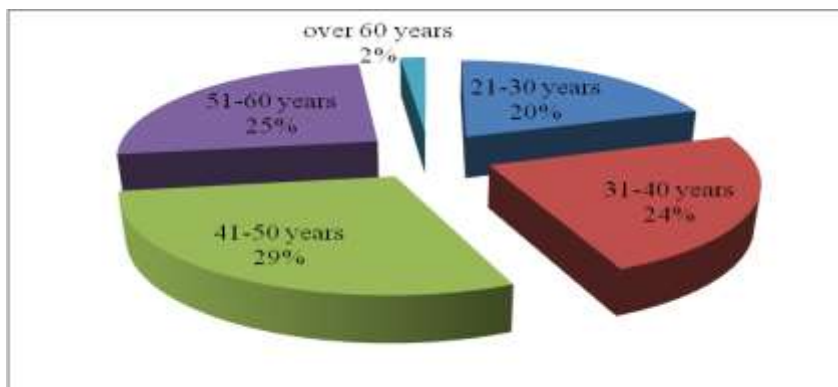


Figure 4. 3: Age Bracket

4.3.4 Distribution of Respondents by Job Experience

The study sought to find out the years the respondents had worked in the organization. Figure 4.4 shows that 27% of the respondents indicated they had worked for 16-20 years and above while 21% indicated between 11 to 15 years and 21% indicated 1 to 5 years. The findings imply that the respondents had worked long enough in their various industries and hence had knowledge about the issues that the researcher was looking for.

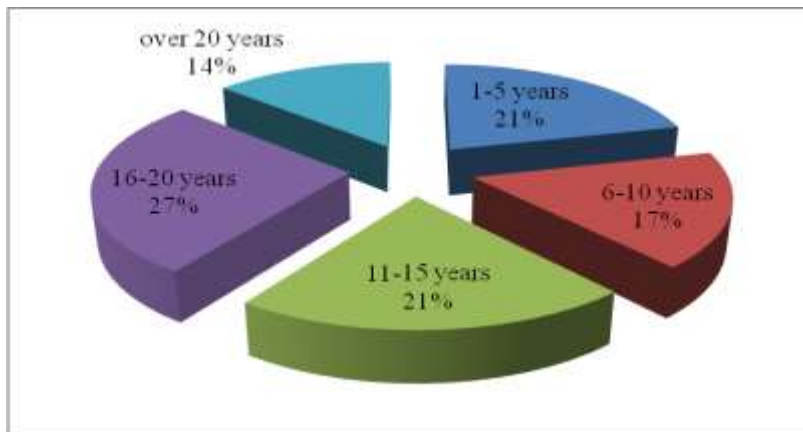


Figure 4. 4: Years of Experience

4.3.5 Distribution of Firms by Years of Operation

The respondents were asked to indicate for how long their organizations had been in operation. 72% indicated that their organizations had been in operation for over 15 years while 14% indicated 11-15 years.

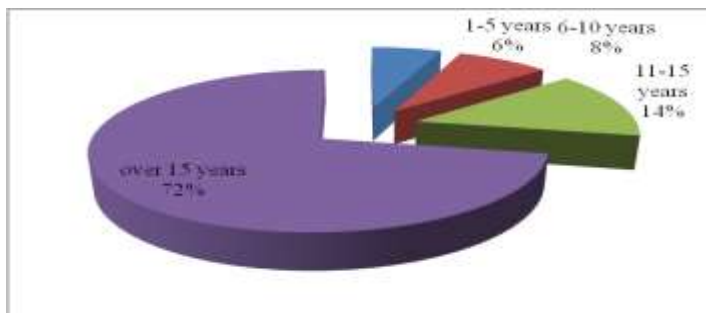


Figure 4. 5: Years of Operation

4.3.6 Distribution of Firms by Product Manufactured

The respondents were asked to indicate the kind of products they manufacture. Table 4.2 shows that majority of the firms manufactured food stuff as represented by 36.4% while 30.9% manufactured pharmaceuticals. The category of others included firms that manufactured ceramics, mattresses and travel and work bags.

Table 4. 2: Manufacturing Sector

| Product | Percentage |
|-----------------------------------|-------------------|
| Foodstuffs | 36.4 |
| Pharmaceuticals | 30.9 |
| Engineering | 23.6 |
| Agricultural | 10.9 |
| Automotive parts | 3.6 |
| Beauty products/clothing/footwear | 18.2 |
| Other | 7.2 |

4.4 Descriptive Analysis

This study employed regression analysis to empirically examine the extent to which the selected variables determine FDI inflows in Kenya with a bias to manufacturing sector of the economy. Before embarking on this analysis, however, it was useful to summarize the statistics on net inflows of foreign investment, corporate governance indicators, political risk rating, GDP growth rates and GDP per capita, inflation and exchange rates for Kenya for the period 2009 to 2013. These data, presented in Table 4.3 to Table 4.6, revealed a few points of interest.

First, it was clear that the corporate governance indicators for Kenya deteriorated between 2009 and 2013 as measured by the six indicators; however there was recorded some growth in net FDI inflows in the same period though sluggish. Within the period, the political risk rating for the country worsened as compared to the Sub Saharan Africa average at 67 compared to 65. The GDP growth rate for the country rose within the period between 2009 and 2013 from a low of 3% to an average of 5.6%. Taxes on international trade were stagnant at 10% across the period. The manufacturing trade contribution to the economy was basically stagnant during the period. The inflation rates during the same period measured in consumer prices reduced considerably from a high of 14% to an average of 8.5%; however the exchange rate worsened against the US dollars during the same period from a low of KES 77/USD to an average of KES 83/USD.

Table 4. 3: Kenya Governance Indicators

| Years | 2009 | | 2010 | | 2011 | | 2012 | | 2013 | |
|------------------------|----------|-------|----------|-------|----------|-------|----------|-------|----------|-------|
| Indicator | Estimate | Rank | Estimate | Rank | Estimate | Rank | Estimate | Rank | Estimate | Rank |
| Political | | | | | | | | | | |
| Stability/absence of | | | | | | | | | | |
| violence | -1.43 | 9.48 | -1.17 | 13.21 | -1.24 | 12.74 | -1.32 | 10.43 | -1.15 | 13.74 |
| Govt. effectiveness | -0.60 | 33.01 | -0.54 | 36.36 | -0.57 | 35.55 | -0.55 | 35.41 | -0.49 | 36.84 |
| Regulatory Quality | -0.13 | 48.33 | -0.07 | 50.24 | -0.21 | 45.50 | -0.31 | 41.63 | -0.35 | 38.76 |
| Rule of law | -1.05 | 16.11 | -0.99 | 17.06 | -0.95 | 17.37 | -0.86 | 22.75 | -0.74 | 27.96 |
| Control of corruption | -1.08 | 11.96 | -0.94 | 18.57 | -0.95 | 18.48 | -1.10 | 11.96 | -1.06 | 12.92 |
| Voice & Accountability | -0.34 | 35.55 | -0.23 | 39.81 | -0.27 | 38.97 | -0.30 | 39.34 | -0.24 | 41.23 |

Source: World Governance Indicators

Estimate: The estimate of governance (ranges from approximately -2.5 (weak) to 2.5 (strong) governance performance. Rank: The percentile rank among countries (ranges from 0 (lowest) to 100 (highest) rank).

The Political Risk Index (PRI) Table ranked from low to high risk as shown below. The PRI is the overall measure of risk for a given country, calculated by using all 17 risk components from the PRS Methodology including turmoil, financial transfer, direct investment, and export markets.

Table 4. 4: Kenya Political Risk Rating

| Years | 2009 | 2010 | 2011 | 2012 | 2013 |
|----------------------------|-------------|-------------|-------------|-------------|-------------|
| Global Averages | 72 | 72 | 72 | 72 | 72 |
| Sub-Saharan Africa Average | 66 | 66 | 66 | 65 | 65 |
| Kenya | 66 | 70 | 66 | 67 | 67 |

Source: PRS Group

Table 4. 5: FDI Inflows (Millions of Dollars) 2009-2013

| Years | 2009 | 2010 | 2011 | 2012 | 2013 |
|----------------------|---------------|---------------|---------------|---------------|---------------|
| World | 1,221,840.10 | 1,422,254.76 | 1,700,082.35 | 1,330,272.88 | 1,451,965.38 |
| Developing economies | 532,580.06 | 648,207.58 | 724,839.92 | 729,449.23 | 778,372.35 |
| Africa | 56,042.58 | 47,034.11 | 48,020.94 | 55,180.20 | 57,238.85 |
| East Africa | 3,928.32 | 4,510.53 | 4,778.02 | 5,378.42 | 6,210.23 |
| Kenya | 114.97 | 178.06 | 335.25 | 258.61 | 514.39 |

Source: World Development Indicators (WDI), September 2015

Manufactures comprise commodities in SITC sections 5 (chemicals), 6 (basic manufactures), 7 (machinery and transport equipment), and 8 (miscellaneous manufactured goods), excluding division 68 (non-ferrous metals).

Table 4. 6: Kenya's Macroeconomic Indicators

| Indicator Name | 2009 | 2010 | 2011 | 2012 | 2013 | Average |
|---|-------------|-------------|-------------|-------------|-------------|----------------|
| Manufactures exports (% of merchandise exports) | 37 | 35 | 36 | 36 | 37 | 36 |
| Manufactures imports (% of merchandise imports) | 60 | 63 | 61 | 60 | 62 | 61 |
| Official exchange rate (LCU per US\$, period average) | 77 | 79 | 89 | 85 | 86 | 83 |
| Inflation, GDP deflator (annual %) | 11.64 | 2.09 | 10.78 | 9.32 | 5.74 | 7.92 |
| Inflation, consumer prices (annual %) | 9.23 | 3.96 | 14.02 | 9.38 | 5.72 | 8.46 |
| Foreign direct investment, net inflows (% of GDP) | 0.31 | 0.45 | 0.80 | 0.51 | 0.93 | 0.60 |
| GDP per capita (current US\$) | 929.61 | 977.77 | 998.26 | 1165.74 | 1245.51 | 1063.38 |
| GDP growth (annual %) | 3.31 | 8.41 | 6.12 | 4.45 | 5.74 | 5.61 |
| Exports of goods and services (% of GDP) | 20.03 | 20.66 | 21.63 | 19.85 | 17.73 | 19.98 |
| Imports of goods and services (% of GDP) | 30.83 | 33.57 | 38.82 | 35.46 | 33.17 | 34.37 |
| Trade (Total) (% of GDP) | 50.86 | 54.23 | 60.45 | 55.30 | 50.90 | 54.35 |
| Taxes on international trade (% of revenue) | 10.62 | 10.12 | 10.61 | 10.40 | 10.01 | 10.35 |

Source: World Development Indicators (WDI), September 2015

4.4.1 Corporate Governance in Determining Growth of FDI

The first objective of the study was to find out the extent to which corporate governance determines growth of FDI inflows in Kenya. Table 4.7 shows that 100% of the respondents agreed that good corporate governance can lead to growth of FDI inflows. 40.8% disagreed that there are generally good practices of corporate governance in the Kenya while 40% were uncertain. Regarding the rule of law, 75% disagreed that rule of law in the Kenya is fully developed.

The respondents were asked whether the laws governing transfer pricing by foreign investors is not well laid down in Kenya; 58.3% were uncertain while 37.5% agreed. 81.2% agreed that governance and quality of institutions have a positive effect on FDI flows. 95.8% agreed that democracy as proxy of governance can foster development of stable ground rules for FDI inflows while 77.1% also agreed that corporate tax rate in Kenya is high and can discourage investors. When asked whether corruption in Kenya hinders FDI growth, 97.9% agreed.

Table 4. 7: Corporate Governance

| | SD | Disagree | Uncertain | Agree | SA |
|--|--------|----------|-----------|--------|--------|
| Good corporate governance can lead to growth of FDI inflows | 0.00% | 0.00% | 0.00% | 55.60% | 44.40% |
| There is generally good practice of corporate governance in the Kenya | 9.30% | 31.50% | 40.70% | 18.50% | 0.00% |
| The rule of law in the Kenya is fully developed | 41.70% | 33.30% | 16.70% | 6.20% | 2.10% |
| The laws governing transfer pricing by foreign investors is not well laid down in Kenya | 2.10% | 2.10% | 58.30% | 25.00% | 12.50% |
| Governance and quality of institutions have a positive effect on FDI flows | 0.00% | 4.20% | 14.60% | 47.90% | 33.30% |
| Democracy as proxy of governance can foster development of stable ground rules for FDI inflows | 0.00% | 0.00% | 4.20% | 60.40% | 35.40% |
| The corporate tax rate in Kenya is high and can discourage investors | 0.00% | 0.00% | 22.90% | 47.90% | 29.20% |
| Corruption in Kenya hinders FDI growth | 2.10% | 0.00% | 0.00% | 8.30% | 89.60% |

The respondents were also asked whether corporate governance infrastructure is poor and a great deterrent to attracting foreign investment in Kenya. 95% of the

respondents said yes. Those who said no indicated that steps have been taken to improve corporate governance and that not all companies have poor corporate governance

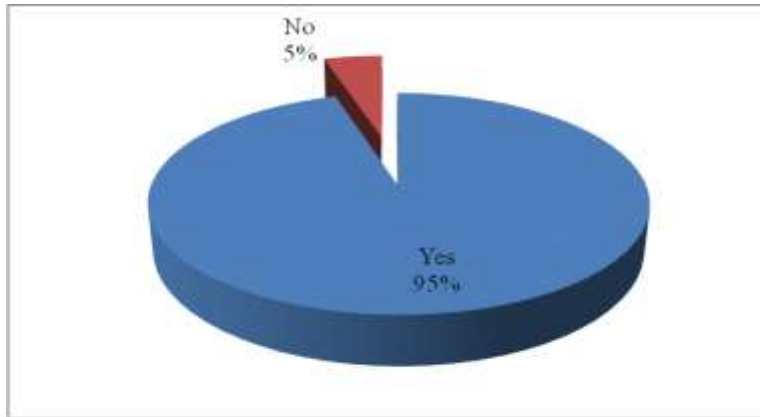


Figure 4. 6: Corporate Governance

The respondents were further to indicate what factors determined the decision to invest in Kenya. 58.8% indicated that the fact that Kenya is an established democracy influenced their decision. 58.8% also indicated that the political stability in Kenya influenced their decision while 40.0% indicated that the Kenyan regulatory framework attracted them to Kenya.

Table 4. 8: Corporate Governance Indicators

| Factors | Percentage |
|---|-------------------|
| Established democracy | 58.2 |
| Political stability/absence of violence | 58.2 |
| Government effectiveness | 34.5 |
| Regulatory framework | 40.0 |
| Rule of law | 20.0 |
| Control of corruption | 1.8 |
| Tax policies | 2.5 |

4.4.2 Political Governance (Risk) in Determining Growth of FDI

The second objective of the study was to find out the extent to which political governance (proxy of political risk) determines growth of FDI inflows in Kenya. Table 4.9 shows that 83.3% of the respondents agreed that Kenya enjoys political stability compared to other East African countries. All respondents (100%) agreed

that aspects of political stability like an efficient law and order system are important in determining FDI inflows into Kenya. 87.5% of the respondents also agreed that stability in political environment has positively impacted foreign investment in Kenya.

The respondents were asked whether political instability reduces a country's attractiveness as a location of FDI; 98.2% agreed with the statement. 38.2% of the respondents agreed when asked whether Kenya has high political risk where investors' assets can be taken over by the government whilst 34.2% were uncertain. 89% agreed that high level of crime hinders foreign investors from setting up ventures in the country while 83.6% agreed that the Kenyan environment is characterized by tension around election time, which deters investment. Finally, all the respondents agreed that political instability creates an unfavorable business climate which erodes the risk-averse foreign investors' confidence

Table 4. 9: Political Governance (Risk)

| | SA | Disagree | Uncertain | Agree | SA |
|--|-------|----------|-----------|--------|--------|
| Kenya enjoys political stability compared to other East African countries | 0.00% | 10.40% | 6.20% | 70.80% | 12.50% |
| Aspects of political stability like an efficient law and order system, are important in determining FDI inflows into Kenya | 0.00% | 0.00% | 0.00% | 52.10% | 47.90% |
| Stability in political environment has positively impacted foreign investment in Kenya | 0.00% | 0.00% | 12.50% | 50.00% | 37.50% |
| Political instability reduces a country's attractiveness as a location of FDI | 0.00% | 0.00% | 1.80% | 40.00% | 58.20% |
| Kenya has high political risk where investors' assets can be taken over by the government | 3.60% | 23.60% | 34.50% | 25.50% | 12.70% |
| High level of crime hinders foreign investors from setting up ventures in the country | 0.00% | 1.80% | 9.10% | 34.50% | 54.50% |
| The Kenyan environment is characterized by tension around election time, this cycle deters investment. | 0.00% | 10.90% | 5.50% | 29.10% | 54.50% |
| Political instability creates an unfavorable business climate which seriously erodes the risk-averse foreign investors' confidence | 0.00% | 0.00% | 0.00% | 43.60% | 56.40% |

The respondents were asked whether political governance infrastructure is poor and a great deterrent to attracting foreign investment in Kenya, 92% of the respondents

said yes. Those who said no argued that politics has no effect on operations and that with the coming of the new constitution; significant steps have been taken to ensure good political governance. They also claimed that proper infrastructure reduces political influence; besides, the Government has sought FDI vigorously.

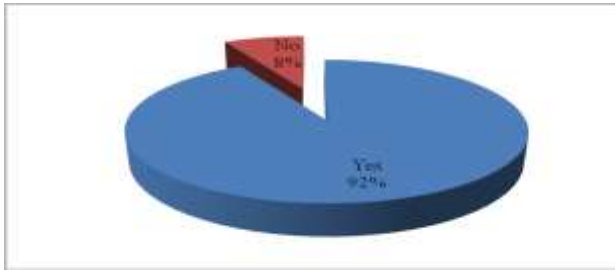


Figure 4. 7: Political Governance (Risk)

4.4.3 Market Size of the Economy in Determining Growth of FDI

The third objective of the study was to find out the extent to which the market size of the economy determines growth of FDI inflows in Kenya. Table 4.10 below shows that 100% of the respondents agreed that the level of economic development in a country may affect growth and sustenance of FDI. 98.2% agreed that the broadening of financial markets to facilitate trading in financial instruments can accelerate FDI inflows.

The respondents were asked whether Kenya's potential in terms of low cost labor and vast natural resources can encourage FDI; 66.8% agreed while 31.5% were uncertain. 94.5% agreed that when the size of the market of host country has grown large enough, the host country can become the target for inflow of FDI while 65.4% agreed that Market size (GDP size) directly affects the expected revenue of the foreign investment. Finally, 61.9% of the respondents agreed that the market size of Kenyan economy (in GDP measure) is too small to warrant growth of foreign investment.

Table 4. 10: Market Size of the Economy

| | Strongly disagree | Disagree | Uncertain | Agree | Strongly agree |
|--|-------------------|----------|-----------|--------|----------------|
| Level of economic development in a country may affect growth and sustenance of FDI | 0.00% | 0.00% | 0.00% | 51.90% | 48.10% |
| Broadening of financial markets to facilitate financial instruments can accelerate FDI inflows | 0.00% | 0.00% | 1.90% | 42.60% | 55.60% |
| Kenya incredible potential in terms of low cost labor and vast natural resources can encourage FDI | 1.90% | 1.90% | 31.50% | 33.30% | 31.50% |
| When the size of the market of host country has grown large enough, the host country can become the target for the inflow of FDI | 0.00% | 0.00% | 5.60% | 42.60% | 51.90% |
| Market size (GDP size) directly affects the expected revenue of the foreign investment | 0.00% | 3.60% | 30.90% | 34.50% | 30.90% |
| The market size of Kenyan economy (in GDP measure) is small to warrant growth of Foreign investment | 5.50% | 18.20% | 14.50% | 36.40% | 25.50% |

The respondents were asked whether the growth of the Kenyan economy (in GDP measure) is too low to attract major foreign investments; 73% said yes; those who said no argued that the Kenyan GDP is generally doing well. They also claimed that Kenya’s GDP figures are fairly high and is still capable of attracting investors

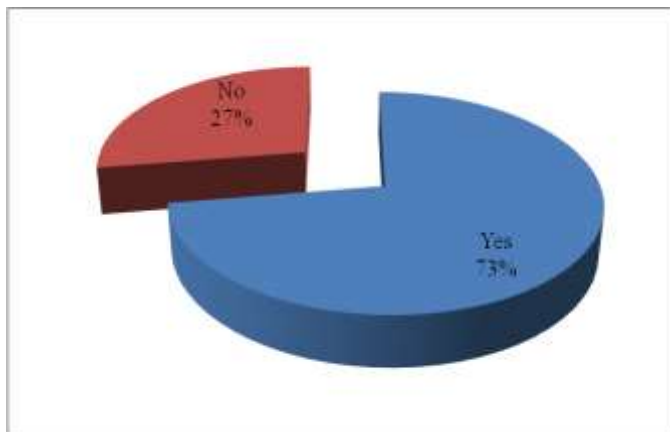


Figure 4. 8: Market Size

4.4.4 Trade Openness in Determining Growth of FDI

The fourth objective of the study was to find out the extent to which trade openness determines growth of FDI inflows in Kenya. Table 4.11 shows that 98.2% of the

respondents agreed that more FDI can be attracted in Kenya through liberalizing trade to attract foreign investment; 91% of the respondents agreed that how easy or difficult it is to start a business, influence speed of seizing new opportunities in investment in a Country; 98.7% of the respondents also agreed that more global integration can drive growth of foreign investment inflows in Kenya. 88.9% of the respondents agreed that the Kenyan economic environment is open to global integration which can lead to FDI growth. The respondents were asked whether Kenya has good trade policies that allow free movement of goods and services; 50.16% agreed with the statement. When asked whether the Kenyan economy has few restrictions on capital repatriation by foreign investors; 45.5% were uncertain while 45.4% agreed.

Table 4. 11: Trade Openness

| | Strongly disagree | Disagree | Uncertain | Agree | Strongly agree |
|--|-------------------|----------|-----------|--------|----------------|
| More FDI can be attracted in Kenya through liberalizing trade to attract foreign investment | 0.00% | 0.00% | 1.80% | 41.80% | 56.40% |
| How easy or difficult it is to start a business, influence speed of seizing new opportunities in investment in a Country | 0.00% | 3.60% | 5.50% | 25.50% | 65.50% |
| More global integration can drive growth of foreign investment inflows in Kenya | 0.00% | 0.00% | 1.80% | 45.50% | 52.70% |
| The Kenyan economy is export-oriented and openness may be successful in encouraging FDI flows | 0.00% | 0.00% | 45.50% | 32.70% | 21.80% |
| The Kenyan economic environment is open to global integration which can lead to FDI growth | 0.00% | 0.00% | 11.10% | 53.70% | 35.20% |
| Kenya has good trade policies that allow free movement of goods and services | 0.00% | 3.70% | 29.60% | 50.00% | 16.70% |
| The Kenyan economy has few restrictions on capital repatriation by foreign investors | 0.00% | 9.10% | 45.50% | 30.90% | 14.50% |

The respondents were asked whether the Kenyan economy is open to trade but its trade policies are weak; 92% of the respondents said yes. Those who said no claimed that the Kenyan economy is open and has some of the best trade policies.

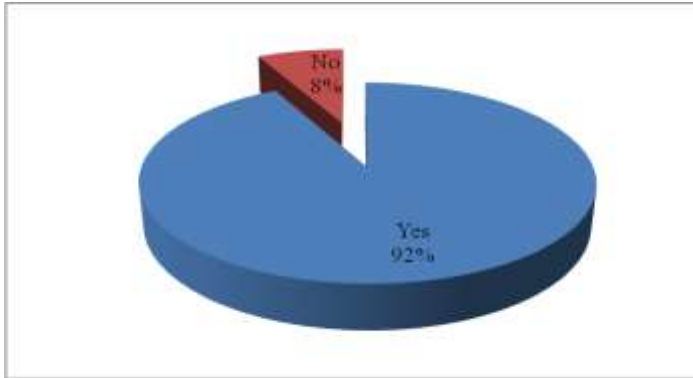


Figure 4. 9: Trade Openness

4.4.5 Macro-economic Stability in Determining Growth of FDI

The fifth and sixth objectives of the study sought to find out the extent to which macroeconomic stability tested through inflation and exchange rate variables determine growth of FDI inflows in Kenya. Table 4.12 shows that 100% of the respondents agreed that unstable inflationary trend can discourage FDI inflows. 96.4% agreed that a high inflation rate indicates unstable economic policies; and may lead to a reduction in FDI inflows.

The respondents were asked whether low and stable inflation are more appealing to investors, as monetary stability influences FDI inflows; 98.2% agreed. 94.5% agreed that high and unstable inflation increases the cost of businesses and negatively affects long term planning by investors while 89.1% agreed that exchange rate volatility contributes to uncertainty which can affect FDI growth negatively. 69.1% of the respondents agreed that exchange rate risk can contribute significantly in explaining FDI growth and finally, 61.8% of the respondents agreed that unstable exchange-rate has negative consequences on the trade sector (exports and imports) of the Kenyan economy.

Table 4. 12: Macro-economic Stability

| | Strongly disagree | Disagree | Uncertain | Agree | Strongly agree |
|---|-------------------|----------|-----------|--------|----------------|
| Unstable inflationary trend can discourage FDI inflows | 0.00% | 0.00% | 0.00% | 47.30% | 52.70% |
| A high inflation rate indicates unstable economic policies; and may lead to a reduction in FDI inflows | 0.00% | 1.80% | 1.80% | 36.40% | 60.00% |
| Low and stable inflation are more appealing to investors, as monetary stability influences FDI inflows | 0.00% | 0.00% | 1.80% | 29.10% | 69.10% |
| High and unstable inflation increases the cost of businesses and negatively affects long term planning by investors | 0.00% | 0.00% | 5.50% | 34.50% | 60.00% |
| Exchange rate volatility contributes to uncertainty which can affect FDI growth negatively | 0.00% | 0.00% | 10.90% | 29.10% | 60.00% |
| Exchange rate risk can contribute significantly in explaining FDI growth | 0.00% | 0.00% | 30.90% | 40.00% | 29.10% |
| Unstable exchange-rate has negative consequences on the trade sector (exports and imports) of the Kenyan economy | 3.60% | 14.50% | 20.00% | 49.10% | 12.70% |

The respondents were asked whether the macro-economic instability in Kenya seen through unstable inflation and unstable foreign exchange rates discourage investors from increasing investment in Kenya. 94% of the respondents said yes. Those who said no indicated that inflation levels are not high and investors are still coming in.

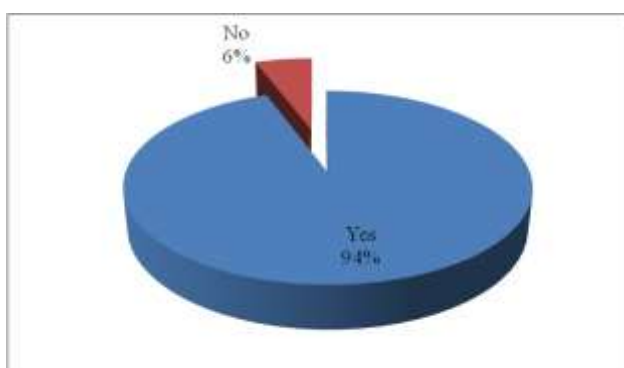


Figure 4. 10: Macroeconomic Stability

4.5 Summary Statistics

Table 4. 13: Summary Statistics

| Variable | N | Mean | Standard Deviation | Min | Max | Skewness | Kurtosis |
|----------------------------|----|-------|--------------------|-------|-------|----------|----------|
| Foreign Investment | 55 | 3.679 | 0.403 | 2.667 | 4.833 | 0.152 | 3.461 |
| Corporate governance | 55 | 3.673 | 0.324 | 3 | 4.375 | -0.305 | 2.909 |
| Political governance | 55 | 4.21 | 0.281 | 3.375 | 4.875 | -0.386 | 3.151 |
| Market size of the economy | 55 | 4.127 | 0.514 | 2.5 | 5 | -0.586 | 3.034 |
| Trade openness | 55 | 4.131 | 0.374 | 3.429 | 5 | 0.647 | 2.940 |
| Inflation rate | 55 | 4.573 | 0.413 | 3.5 | 5 | -0.647 | 2.144 |
| Exchange rate | 55 | 4.1 | 0.359 | 3 | 4.75 | -0.234 | 3.038 |

The average number of firms was uncertain about FDI growth at about 3.7. The minimum disagreed at about 2.7 level and the highest at agreed at 4.8 level. The firms were uncertain about the influence of corporate governance at a level of 3.6 with the minimum uncertainty at 3 and a maximum agreement at 4.4. A majority of firms agree that political governance determines FDI inflow at a mean of 4.21 with a minimum of 3.4 and a maximum of 4.9.

The mean perception of market size among firms was that it determines FDI inflow at 4.12 agreement. This had a minimum of 2.5 and a maximum strong agreement of 5. Firms also agreed that trade openness determined FDI inflow with an agreement level of 4.1 whose minimum is 3.4 and maximum of 5. Equally, there was a relatively strong agreement at 4.6 that inflation rates did not determine FDI inflow. Lastly, there was an agreement at 4.1 level that exchange rates determined FDI among firms with a minimum of 3 and a maximum of 4.75.

Furthermore, only FDI and trade openness were positively skewed while the rest of the variables were negatively skewed this is because when the skewness is less than -1 or greater than $+1$, the distribution is said to be highly skewed. The kurtosis of corporate governance, market size, trade openness and exchange rates were about level 3 meaning that these variables were normally distributed; this is in line with the reference standard which is a normal distribution with a kurtosis of 3. FDI and political governance were heavily tailed (lepto kurtic) while inflation rate was lightly tailed (platy kurtic).

4.5.1 Diagnostic Tests

(a) Multicollinearity

Table 4. 14: Multicollinearity

| Variable | VIF | 1/VIF |
|----------------------------|-------------|--------------|
| Market size of the economy | 2.57 | 0.389786 |
| Inflation rate | 2.07 | 0.482144 |
| Trade openness | 1.61 | 0.621314 |
| Corporate governance | 1.35 | 0.742148 |
| Political governance | 1.29 | 0.776676 |
| Exchange rate | 1.25 | 0.801424 |
| Mean VIF | 1.69 | |

All the VIF values for all the independent variables were found to be below 10 indicating that no multicollinearity existed among the variables. The mean VIF was also below 10 at 1.69.

(b) Correlation Results

Table 4. 15: Correlation Results

| | FDI | Corporate governance | Political governance | Market size of the economy | Trade openness | Inflation rate | Exchange rate |
|----------------------------|---------|----------------------|----------------------|----------------------------|----------------|----------------|---------------|
| Foreign Direct Investment | 1.0 | | | | | | |
| Corporate governance | -0.0863 | 1.0 | | | | | |
| Political governance | 0.2898 | -0.1380 | 1.0 | | | | |
| Market size of the economy | 0.1463 | -0.0686 | 0.4230 | 1.0 | | | |
| Trade openness | 0.0298 | 0.1634 | 0.0847 | 0.4822 | 1.0 | | |
| Inflation rate | 0.0781 | 0.2817 | 0.3217 | 0.6097 | 0.2230 | 1.0 | |
| Exchange rate | 0.0662 | 0.1417 | 0.0071 | 0.2727 | 0.4065 | 0.2469 | 1.0 |

Results in the table above proved that no correlation existed between independent variables. The highest relationship existed between inflation rates and market size at 0.6097 units.

(c) Normality Test

Table 4. 16: Shapiro-Wilk Test for Normal Data

| Variable | Observation | W | V | z | Prob>z |
|----------------------------|-------------|----------------|--------------|---------------|----------------|
| Foreign Direct Investment | 55 | 0.99355 | 0.327 | -2.396 | 0.99171 |
| Corporate governance | 55 | 0.98036 | 0.996 | -0.009 | 0.50348 |
| Political governance | 55 | 0.98266 | 0.879 | -0.275 | 0.60853 |
| Market size of the economy | 55 | 0.95323 | 2.372 | 1.852 | 0.03200 |
| Trade openness | 55 | 0.96778 | 1.634 | 1.053 | 0.14615 |
| Inflation rate | 55 | 0.92812 | 3.645 | 2.774 | 0.00277 |
| Exchange rate | 55 | 0.97613 | 1.210 | 0.409 | 0.34117 |
| Residual | 55 | 0.99078 | 0.467 | -1.631 | 0.94859 |

Comparing the calculated p-values with the critical p-value of 5% (0.05), FDI, corporate governance, political governance, trade openness and exchange rates were normal as their p-values were greater than 0.05. Only market size of the economy and inflation rate was found not to be normal. However, all variables were assumed to be normal because the residual value was normal.

(d) Heteroscedasticity Results

Breusch-Pagan / Cook-Weisberg test for heteroskedasticity

Ho: Constant variance

Table 4. 17: Variables: Fitted Values of Average_FDI

| | |
|-------------|---------|
| chi2(1) | =0.91 |
| Prob > chi2 | =0.3408 |

From the Breusch-Pagan results, we failed to reject the null hypothesis and declared that all variables are homoskedastic (reject presence of heteroskedasticity).

(e) Cronbach Alpha Results

Table 4. 18: Cronbach Alpha Results

| Item | Obs. | Sign | Item-test correlation | Item-rest correlation | Average inter item covariance | Alpha |
|----------------------------|------|------|-----------------------|-----------------------|-------------------------------|---------------|
| Foreign Investment | 55 | + | 0.3932 | 0.1385 | .0370573 | 0.6674 |
| Corporate governance | 55 | + | 0.2911 | 0.0816 | .0397404 | 0.6696 |
| Political governance | 55 | + | 0.4844 | 0.3242 | .0337636 | 0.6528 |
| Market size of the economy | 55 | + | 0.7877 | 0.5899 | .0188245 | 0.6502 |
| Trade openness | 55 | + | 0.6226 | 0.4344 | .0280082 | 0.6761 |
| Inflation rate | 55 | + | 0.7299 | 0.5572 | .0230877 | 0.6689 |
| Exchange rate | 55 | + | 0.5433 | 0.3441 | .0311106 | 0.6641 |
| Test scale | | | | | .0302275 | 0.6642 |

The results from the table 4.18 indicated that the research instruments had internal consistency and were reliable for data collection with a composite Cronbach Alpha (α) reliability coefficient of $0.6642 \approx 0.7$ which is widely acceptable as a rule of thumb.

(f) Tests of Hypotheses

In testing these hypotheses, levels of significance of F statistics and Correlation were considered since the relationship between the dependent and independent variables was linear. Where $p < 0.05$, the null hypothesis was rejected and it was concluded that a significant relationship existed between the variables under consideration. For the strength of the established relationships, r values were considered while interpreting results. Where $r < 0.1$ was obtained, the relationship was considered too weak to be statistically significant. For $0.1 < r < 0.3$, the relationship was considered weak; for $0.3 < r < 0.5$, the relationship was considered moderate; and for $0.5 < r <$

1.0, the relationship was considered strong. The positive or negative sign of the 'r' values denoted the direction of the relationship under investigation. Tests of statistical assumptions were carried out before data analysis to avoid invalidation of statistical analysis.

Out of the seven hypotheses tested in the study, five were accepted while two were rejected. With $r = 0.003$, $F = 0.001$ at $p = 0.04 > 0.05$, H1 was accepted and concluded that corporate governance significantly determine growth of foreign direct investment. With $r = 0.232$, $F = 3.358$ at $p = 0.03 > 0.05$, H2 was accepted and it was concluded that political governance (risk) significantly determine growth of foreign direct investment. With $r = 0.058$, $F = 0.612$ at $p = 0.02 > 0.05$, H3a was accepted and it was concluded that gross domestic product significantly influence growth of FDI. With $p = 0.087 < 0.05$, H3b was rejected and it was concluded that GDP per capita does not significantly determine growth of FDI. With $R^2 = 0.094$, $F = 18.470$ at $p = 0.035 > 0.05$, H4 was accepted and it was concluded that the country's trade openness significantly determine growth of FDI. With $R^2 = 0.057$, $F = 5.315$ at $p = 0.139 < 0.05$, H5a was rejected and it was concluded that level of inflation does not significantly determine growth of FDI. With $R^2 = 0.118$, $F = 11.864$ at $p = 0.002 > 0.05$, H5b was accepted and it was concluded that the exchange rate significantly determines growth of FDI.

In testing these hypotheses, the existence of a regression model that included the variable under investigation was done. If the variable under consideration was excluded from the model, the null hypothesis was accepted and it was concluded that a relationship did not exist between the dependent variable and the independent variable(s). Where the regression model was found to exist, the strength of the relationships under investigation was arrived from the final regression model realized in stepwise regression. In situations where the null hypothesis was rejected and a relationship was established, the strength of the relationship between the independent variable and the dependent variable was determined by the R^2 values. Table 4.19 presents a summary of the results of the tests of hypotheses.

Table 4. 19: Summary of Tests of Hypotheses

| Research Objective | Hypothesis | Results | Remarks |
|--|---|---|----------------------|
| To examine the extent to which corporate governance determines growth of FDI inflows in Kenya | H1: FDI inflows in Kenya is associated with the country's corporate governance | $r = 0.003, F = 0.001$ at $p = 0.04 > 0.05$ | Accepted |
| To analyze the extent to which political governance determines growth of FDI inflows in Kenya | H2: FDI inflows in Kenya is associated with the country's political governance | $r = 0.232, F = 3.358$ at $p = 0.03 > 0.05$ | Accepted |
| To examine the extent to which market size of Kenyan economy determines growth of FDI inflows in Kenya | H3a: FDI inflows in Kenya is associated with the country's GDP H3b: FDI inflows in Kenya is associated with the country's GDP per capita | $r = 0.058, F = 0.612$ at $p = 0.02 > 0.05$ $r = 0.058, F = 0.612$ at $p = 0.087 < 0.05$ | Accepted Rejected |
| To scrutinize the extent to which trade openness determines growth of FDI inflows in Kenya | H4: FDI inflows is associated with the country's manufacturing exports | $R^2 = 0.094, F = 18.470$ at $p = 0.035 > 0.05$ | Accepted |
| To analyze the extent to which inflation determines growth of FDI inflows in Kenya | H5a: FDI inflows is associated with the country's level of inflation | $R^2 = 0.057, F = 5.315$ at $p = 0.139 < 0.05$ | Rejected |
| To examine the extent to which foreign exchange determines growth of FDI inflows in Kenya | H5b: FDI inflows is associated with the country's level of foreign exchange | $R^2 = 0.118, F = 11.864$ at $p = 0.002 > 0.05$ | Accepted |

4.6 Multiple Regression

Multiple regressions were used to model the relationship between the dependent variable (FDI growth) and the independent variables and the mediating effect of intervening variables. Table 4.19 illustrates the model summary used in this study and indicates the R Squared value which gives the most useful measure of the success of the model; from the results it was evident that the model had accounted for 72.4% of the variance in FDI growth in Kenya.

Table 4. 20: Model Summary

| Model | R | R Square | Adjusted R Square |
|-------|-------|----------|-------------------|
| 1 | .746a | 0.724 | 0.6896 |

Analysis of Variance (ANOVA) assessed the overall significance of the model. According to the table 4.20, $p < 0.05$ (0.000), the model of the study sufficiently or significantly explained the variation in FDI growth in Kenya.

Table 4. 21: ANOVA Test Results

| | Sum of Squares | Df | Mean Square | F | Sig. (p) |
|--------------|----------------|-----------|-------------|---------|----------|
| Regression | 29.8607 | 6 | 4.97679 | 20.9903 | 0.000 |
| Residual | 11.3808 | 48 | 0.237099 | | |
| Total | 41.2415 | 54 | | | |

A multiple regression was used to model the relationship between the independent variables and dependent variable, each of the two intervening variables was added using step-wise regression. From the results in Table 4.21 above a model equation was derived as presented below:

$$Y = 0.979 + 0.082X_1 + 0.137X_2 + 0.070X_3 + 0.071X_4 - 0.521X_5 + 0.30X_6$$

Where;

Y= Growth of FDI; X1= Corporate governance; X2= Political governance (Risk); X3= Market size of the economy; X4= Trade openness; X5= Inflation rate and X6= Exchange rate respectively

Table 4. 22: Multiple Regression Results

| | Unstandardized Coefficients | | Standardized | Sig. (p) |
|----------------------------|-----------------------------|------------|-------------------|----------|
| | Beta | Std. Error | Coefficients Beta | |
| (Constant) | 0.979 | 0.53 | | 0.000 |
| Corporate governance | 0.082 | 0.1 | 0.078 | 0.041 |
| Political governance | 0.137 | 0.112 | 0.155 | 0.03 |
| Market size of the economy | 0.07 | 0.107 | 0.074 | 0.02 |
| Trade openness | 0.071 | 0.107 | 0.077 | 0.035 |
| Inflation rate | -0.521 | 0.103 | -0.748 | 0.139 |
| Exchange rate | 0.30 | 0.09 | 0.36 | 0.002 |

Results in table 4.21 above indicate that on average, FDI inflows amount to 0.979 units holding other factors constant. Subsequently, a unit increase in inflation rates decreases FDI growth by 0.521 units. Furthermore, it was not significant at 5% level using the p-value. Equally, a unit increase in exchange rates increases FDI inflow by 0.30 units. Exchange rate was also significant at 5% level using the p-value. A unit increase in corporate governance increases FDI by 0.082 units as per expectation. Furthermore, it was significant as its p value was greater than 0.05. Political governance as similar to corporate governance increases FDI inflow by 0.137. This is also as per expectation. Additionally, it was significant as its p value was greater than 5%. Any unit increase in market size increases FDI inflow by 0.07 units and it was significant using the p value. Lastly, trade openness as expected increased FDI inflows by 0.071 units. It was also significant using the p value which is greater than 5%.

4.7 Discussion of Research Findings

Research findings indicated that the model accounted for 72.4% of the variation in FDI growth in Kenya. This finding implies that 27.6% of FDI growth was accounted for by factors outside the model. Findings also indicated that there was sufficient evidence that the model is useful in explaining the variation of FDI growth as it was significant at 95% confidence level ($p=0.000$). A positive significant relationship existed between corporate governance, political governance (political risk), market size, trade openness, exchange rate and FDI growth. Inflation rate was found to negatively influence FDI inflows.

The findings of this study were found to be in agreement with other studies (Fazio & Talamo, 2008; Talamo, 2011) that empirically investigated the role of corporate governance in attracting FDI compared to forms of incentives, such as lower taxes and wage costs and shows that corporate governance and institutional quality are important attractors of FDI. Other studies were not in line with the findings of this study; they showed that a weak corporate governance environment implies the presence of profit opportunities for domestic and foreign investors (Strange &

Jackson, 2008; Sudarat *et al.*, 2006). This study's finding on high tax deterring growth of FDI and low tax rates as important in determining growth of FDI was in agreement with other studies (Kemsley, 1998; Masca *et al.*, 2008). On the contrary other studies did not agree with the findings of this study (Root & Ahmed, 1979; Wheeler & Mody, 1992). The study finally agrees with the economic theory that less open countries are characterized by stronger restrictions and a weak corporate governance mechanism.

The indicators of trade openness in this study were imports as percentage of GDP and exports as percentage of GDP. Trade openness had a positive relationship with regard to the inflow of FDI in Kenya; this is in agreement with other studies (Collier & Patillo, 1999; Edwards, 1990). However, other studies findings were in the contrary (Charkrabarti, 2001; Obwona, 2001). The findings on foreign exchange rate showed a significant positive relationship with growth of FDI inflows which was in line with other studies done previously (Kadongo, 2011; Rose, 2000) that showed that the impact of exchange rate on FDI is positive. However Osinubi *et al.* (2009) study does not agree with these findings. Lado (2015) observed that inflation as a proxy of macroeconomic instability does not influence flows of FDI which is supported by the findings of this study, however according to Asiedu (2002) inflation determines FDI inflows.

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter presents summary of findings, conclusions and recommendations. In the summary of findings, the results and remarks for each of the six research objectives is presented. The conclusions presented in this section were guided by the research objectives and informed by the findings, analysis, interpretation and discussions in the study. Based on the conclusions made, the contribution of the study to knowledge was examined. Recommendations based on the conclusions for policy and practice and suggestions for further research are presented.

5.2 Summary

The FDI indicators in Kenya show a mixed signal and although institutional indexes for Kenya have been worsening over the years, FDI inflow though sluggish has been on the rise. This evidence posed a problem and necessitated the need to analyze what determines the growth of FDI in Kenya and to what extent. The purpose of this study was to examine and analyze the influence of a group of determinants of Foreign Direct Investment (FDI) in Kenya and present new evidence. The specific objectives of the study were; to examine the extent to which corporate governance elements, political governance, trade openness, market size, exchange rate, and inflation determine growth of FDI in Kenya.

To achieve these objectives, the research questions interrogated the relationship between ownership, location and internalization (OLI) together with institutional determinants selected and growth of FDI in Kenya. The study adopted descriptive research design using primary data collected through a survey questionnaire and an interview guide administered to the respondents in the selected sample after the research instruments were pilot tested for validity through the content- related method and reliability by use of Cronbach's Alpha. The target population was 100

manufacturing firms with significant foreign ownership (>10 %) in Kenya. A sample size of 81 firms spread across the country was obtained for study using stratified random sampling.

The methodology adopted involved the development of a multiple regression model to prove or disapprove the postulated hypotheses. The statistical tools of analysis that were used for descriptive data were the arithmetic mean and the standard deviation while the statistical tools of analysis used for inferential statistics were correlation and stepwise regression to find correlations among the explanatory variables. F-tests were used to test the hypotheses in the study.

5.3 Conclusions

This section presents the conclusions made in the study. In conclusion, foreign direct investment continues to play a key role in the Kenyan economy. The macro data for Kenya during the period 2009-2013 indicated growth in net FDI inflows from 114.97 Millions of US\$ to 514.39 Millions of US\$ (WDI, 2015). Through the empirical analysis, the findings showed that there were positive relationships between growth of FDI and good governance, whether institutional governance or political governance. The relationships between market size, trade openness and growth of FDI were further found to be significant. The exchange rate which was taken as an intervening variable was also found to be significant in determining growth of FDI, however another intervening variable, the inflation rate was found not to be significant in determining growth of FDI inflows in the Country.

Research objective one in this study was to examine the extent to which corporate governance determines growth of FDI inflows in Kenya. The indicators of corporate governance were voice and accountability, political stability & absence of violence, Government effectiveness, regulatory quality, and rule of law, control of corruption and level of taxation. The indicator for FDI growth was the net FDI inflow as a percentage of GDP. Corporate governance was found significant in determining growth of FDI in Kenya; this was in agreement with other studies (Globerman &

Shapiro, 2002; Mkenda & Mkenda, 2004; Talamo, 2011). The findings Mwega and Rose (2007) was that governance though not significant was positively related to FDI inflows.

That corporate governance influenced the growth of FDI in the manufacturing sector, it was therefore concluded that good governance influences growth of FDI inflows in Kenya. To improve corporate governance, it was therefore concluded that the pace of democracy should be enhanced because it influenced many firms in their decision to invest in the Country; this was in line with governance indicators for Kenya (Kauffmann *et al.*, 2009). Further, since respondents indicated that corporate governance determines FDI inflows, then to address any negative influence of corporate governance on flow of FDI, it was concluded that corporate tax rate in Kenya was high and can discourage investors. In addition, it was concluded that the laws governing transfer pricing by foreign investors in Kenya needed to be simplified.

Research objective two in this study was to analyze the extent to which political governance determines growth of FDI inflows in Kenya. The indicator of political governance was political risk. Results from the regression modelling indicated that political risk significantly influenced growth of FDI inflows in the manufacturing sector of the Kenyan economy. It was therefore concluded that political risk determines the inflow of foreign direct investment in Kenya. That means that aspects of political stability like an efficient law and order system are important in determining FDI inflows into Kenya.

The findings of this study was that there was a positive relationship between political governance (political risk proxy) and FDI flows. This was in concurrence with Schneider and Frey (1985), Busse and Hefeker (2005), Dutta and Roy (2008), Nwankwo (2006) and Njoroge and Okech (2011) who found an inverse relationship between political risk and FDI inflows. However, the findings were different from studies by Edwards (1990), Hausmann and Fernandez-Arias (2000) and Wheeler and

Mody (1992) who found no relationship between FDI flows and political risk. The political risk rating for Kenya was confirmed to have worsened as compared to the Sub-Saharan average (PRS, 2015). Since the respondents from the firms also agreed that the Kenyan environment is characterized by tension around election time, which deters investment, it was concluded that laws governing electioneering period should be tightened and implemented to avoid eroding investors' confidence.

Research objective three in this study was to examine the extent to which market size of Kenyan economy determines growth of FDI inflows in Kenya. The indicators for market size of the economy were the size of GDP, the GDP Per Capita and the GDP Growth Rate. Descriptive analysis showed that GDP per capita in Kenya does not significantly influence growth of FDI inflows. Inferential analysis indicated that the strength of the relationship between market size of the economy and growth of FDI inflows in Kenya does not depend on GDP per capita. It was therefore concluded that GDP per capita does not significantly influence growth of FDI in the manufacturing sector and by extension in Kenya.

However, the size of the GDP and GDP growth rate were found to be significant in determining growth of FDI in the manufacturing sector and in Kenya. Market size had a positive relation with regard to the inflow of FDI in Kenya, although other studies were contrary to this finding (Edwards, 1990; Jaspersen *et al.*, 2000). Moreover, the assumption that market size is a crucial factor that determines FDI inflow did not hold either according to (Waheeduzzman & Pradeep, 2006). However the findings of this study were in agreement with Lado (2015) that market size (proxied by GDP) is a significant determinant of FDI inflows. The findings were also in agreement with other studies (Ajayi, 2007; Asiedu, 2002; Mkenda & Mkenda, 2004; Opolot *et al.*, 2008; Resmini, 2000). This is probably because of high levels of openness and the access to free trade that mitigate the importance of market size in the host country.

Given that the respondents agreed that when the size of the market of host country has grown large enough, the host country can become the target for the inflow of FDI, it was concluded that growth of the market size measured in GDP terms should be accelerated. In addition, since all the respondents agreed that the level of economic development in a country may affect growth and sustenance of FDI, and that the market size of Kenyan economy (in GDP measure) is too small to warrant growth of foreign investment; the growth in GDP for Kenya during the period 2009-2013 was an average of 5.6% (WDI, 2015), it was concluded that growth of the economy should be given preeminence.

Research objective four in this study was to scrutinize the extent to which trade openness determines growth of FDI inflows in Kenya. The indicators of trade openness in this study were imports as percentage of GDP and exports as percentage of GDP. Trade openness had a positive relationship with regard to the inflow of FDI in Kenya; this is in agreement with other studies (Collier & Patillo, 1999; Edwards, 1990). However, other studies findings were in the contrary (Charkrabarti, 2001; Obwona, 2001; Jordaan, 2004). The respondents from the firms agreed that how easy or difficult it is to start a business, influence speed of seizing new opportunities in investment in a Country and that FDI can be attracted in Kenya through liberalizing trade to attract foreign investment, it was concluded that despite the Kenyan economy been open and having some of the best trade policies, ease of doing business and the speed of facilitating new investments needed to be improved.

In addition, given that the respondents agreed that Kenya has good trade policies that allow free movement of goods and services, it was concluded that the pace of liberalization should be sustained. Whereas taxes on international trade were stagnant at 10% across the period 2009-2013, the manufacturing trade contribution to the economy did not grow during the period (WDI, 2015). It was further concluded that trade openness determines growth of FDI in the manufacturing sector and by extension determines growth of FDI in Kenya. Descriptive analysis showed that global integration had a significant relationship with FDI inflows in the

manufacturing sector of the Kenyan economy. Therefore to increase FDI inflows, it was concluded that the manufacturing sector should integrate more with the world and by extension the Kenyan economy should seek more global integration.

Research objective five in this study was to analyze the extent to which inflation determines growth of FDI inflows in Kenya. Inflation rate was considered as an intervening variable in this study where the respondents agreed that high and unstable inflation increases the cost of businesses and negatively affects long term planning by investors, it was concluded that stable inflation is more appealing to investors. The inflation rates for Kenya during the period 2009-2013 measured in consumer prices reduced considerably from a high of 14% to an average of 8.5% (WDI, 2015)

However, results from the regression modelling indicated that level of inflation does not significantly determine growth of FDI; this is in line with study by Lado (2015) who observed that inflation as a proxy of macroeconomic instability does not influence flows of FDI in Sudan in the long run. Other studies however gave different empirical findings that inflation determines FDI inflows (Asiedu, 2002; Lyakurwa, 2003; Onyeiwu & Shrestha, 2004). It was therefore concluded that inflation rate does not determine the growth of FDI inflows in the manufacturing sector of the economy and in Kenya.

Research objective six in this study was to examine the extent to which foreign exchange determines growth of FDI inflows in Kenya. The indicator for exchange rate was annual average exchange rate of Kenya shillings to the US dollar. The exchange rate for Kenya worsened against the US dollars during the years 2009 to 2013 from a low of KES 77/USD to an average of KES 83/USD (WDI, 2015). The descriptive analysis indicated that respondents had positive attitude towards exchange rate risk as contributing significantly in explaining FDI growth. The results of foreign exchange rate showed a significant positive relationship with growth of FDI inflows which was in line with other studies done previously (Guerin, 2006;

Hubert & Pain, 2002; Kadongo, 2011; Rose, 2000) that showed that the impact of exchange rate on FDI is positive. However Osinubi *et al.* (2009) study was divergent. Jaratin *et al.* (2014) also found negative relationship between FDI and exchange rate implying that the appreciation (a fall in the exchange rate indices) of the local currency has a positive impact on FDI inflows.

Since the respondents agreed that unstable exchange rates have negative consequences on the trade sector (exports and imports) of the Kenyan economy, it was concluded that exchange influence the relationship between trade openness, market size of the economy, governance and growth of FDI in Kenya. Since Exchange rate volatility was shown as contributing to uncertainty which can affect FDI growth negatively, it was therefore concluded that the Government of Kenya should ensure that the exchange rate is stable by putting in place necessary interventions to enhance investors' confidence.

5.3.1 Contribution of the Study to Knowledge in Foreign Direct Investment

This study relied on both OLI framework and agency theory since the flow of FDI in Kenya is shown by other studies to be favourably determined by traditional determinants. Results from this study indicate that growth of FDI cannot entirely be explained by traditional determinants only. For instance, although OLI framework emphasis is on possession of all the advantages which are interconnected and which affect indistinctly the likewise interconnected decisions of “why”, “how”, and “where” to internationalize as argued by other studies (Buckley & Casson, 1998; Hennart & Park, 1994), findings from this study indicate that growth of FDI can still be attained in the absence of all the advantages so long as governance determinants are combined with one or two of the advantages.

Given that both corporate governance and political risk as independent variables were shown to be significant determinants of FDI growth, then the findings of this study vindicated agency theory utilized in this study. Agency theory advances that the ability of a firm and country to attract investments depends on the effectiveness

of its corporate governance since this encourages investors to be confident that their investments will be protected and rewarded appropriately (Claessens, 2004; Jensen & Meckling, 1976). In view of the fact that governance systems determined growth of FDI implies that OLI framework whose emphasis is on ownership, location and internalization advantages that must come together for FDI to take place should incorporate governance measurements in pursuit of growth of FDI.

Despite OLI framework as key in studies of FDI as postulated by Dunning (1980), this study indicated OLI factors alone cannot determine flow and growth of FDI in a country without including institutional determinants. This finding therefore requires an integration of both traditional determinants of FDI and institutional determinants and compares favourably to the findings by Thugge (2010), Uwubanmwun et.al (2012), Antwi et.al (2013) among others in the developing economies. Better still the results also showed agreement with studies from developed world among them Stein and Daude (2000), which confirms that governance is a significant determinant of the investment flows in both groups. However the findings were in departure from some studies done both in Africa and elsewhere that show that even if governance both political and corporate influence FDI inflows, the influence is not significant (Kuzmina *et al.*, 2014; Saidi et. al, 2013).

5.4 Recommendations

This section presents recommendations made in the study that were based on the research findings, analysis, interpretation, discussion and conclusions. Recommendations for policy and practice were examined in this section.

5.4.1 Recommendations for Policy and Practice

Trade openness, market size of the economy (measured in GDP), political risk and corporate governance were found in this study to be the main predictor variables of growth of FDI. Exchange rate was found to mediate in the relationship between the determinants and growth of FDI. The implication of these findings for policy and practice is that to attract FDI in manufacturing sector in Kenya, good governance,

opening up the economy to international trade, growing the GDP and maintaining stable exchange rates is significant.

The findings of this study imply that Kenya and by extension other developing countries should pursue liberal trade regimes, promoting the reduction in import protection and deal with trade barriers as suggested by Baldwin and Forslid (2000). Moreover, trade openness enables the host country to utilize its comparative advantage. Trade openness as recommended will enhance the productivity and the capacity to engage in export activities. In line with the conclusions of this study, it is not only sufficient to be open, but also to be pro-active. Being more open inevitably means that governments can exert less control. Less control in turn means that monitoring and control issues become more important. Moreover, the policy makers should be aware that stimulating trade openness for an economy like Kenya can help to develop a liberal market as proposed by Buckley and Howarth (2010). As such open economies can attract FDI and help to develop a stable investment climate, the presence of foreign firms can stimulate competition and can pressure the government to liberalize and remove trade restrictions.

It was also recommended that a combination of traditional determinants of FDI and Institutional determinants should be considered when formulating policies to appeal to investors to invest into the country. The manufacturing industry and its stakeholders in Kenya should ensure that they put in place good governance practices in place to appeal to foreign investment. This implies that in the selection of persons to serve in the governance structure, proper research should be undertaken in consultation with both local and foreign investors to ensure that the governance structure enhances and does not inhibit flow of FDI.

The policy implication of the findings is substantial for the government policy makers, the political actors and the governance structures within the county. The findings further emphasize the need to have proper and working governance structures in the endeavour to attract more FDI inflows and especially in the

manufacturing sector. Creating conducive environment for attracting FDI in the manufacturing sector and by extension the country will increase the pace of economic development through creation of employment, creating markets for local raw materials, improvement of infrastructure and transfer of knowledge and skills to the sector and the country.

However there are negative effects to the local manufacturers who may lose the market to the foreign investors through creation of monopolistic tendencies in the market. This indirectly will make the domestic producer facing the difficulties to survive in the market in the long term as foreign companies can achieve economy of scale with advance technology. The government should come up with relevant policies which will ensure that FDI continues to flow while at the same time creating room for the local producers to benefit. Such policies could be in the line of joint ventures with foreign investors making it possible for transfer of skills and technology and sharing out the benefits.

The government should as well enact policies geared towards maintaining political stability such that foreign investors do not have to keep adjusting their strategies every time a new political dispensation ensues. This would mean that the election cycle would not unnecessarily interfere with the running of manufacturing firms as well as attraction of new ones. Good governance to this end will enable fairly simple tax regimes to be put in place at all levels of government eliminating delays in setting up of foreign firms and to a greater extent eradicating bribery and corruption in whole which are high costs for investors.

These recommendations are in line with the facts from the government that manufacturing sector's contribution to Gross Domestic Product (GDP) has remained at an average of 10 per cent for more than ten years. However, the Vision 2030 stipulates that the sector should account for 20 per cent of GDP. Achieving this goal requires addressing some underlying constraints that hinder faster growth. These

include high input cost, decline in investment portfolio for some activities, transport infrastructure, high cost of credit and stiff competition from imports (GoK, 2015).

5.5 Suggestions for Further Research

In an effort to spur growth in the sector, the Kenyan Government has continued to invest in both infrastructure development projects and cheap energy supply mainly in geothermal and wind energy. Essentially, this will improve competitiveness of manufactured products in the domestic and global markets. Equally, the Government initiative to attract investors through the Special Economic Zones (SEZs) programme which allows lower levels of taxation and fewer regulatory hurdles is expected to boost the country's industrial output.

This study delimited itself to the determinants of FDI growth and the mediating influence of macroeconomic variables (inflation and exchange rates) on the relationship between the selected determinants of FDI on the growth of FDI in the Kenyan manufacturing industry. A study can be carried out to investigate how other factors like inadequacy of intellectual property protection, large external debt burdens, fiscal and monetary policies and technological infrastructure determines growth of FDI in the manufacturing industry. In addition, a study can still be done with the mediating variables in this study as the independent variables with governance systems both political and corporate as the intervening variable to ascertain the influence this would have on growth of FDI inflows in Kenya. Another area for further research would be the influence of trade openness, market size of the economy, governance on growth of FDI in other sectors of the economy like tourism, mining and financial markets.

Other quantitative studies could be devoted to go beyond this study by investigating the role of foreign capital as an important determinant of FDI. It could be that the presence of FDI is a signal of an infrastructure with high levels of quality. This means that the host country has well established transport and communication networks, vibrant legal services or other public supported services. As such services

are commonly used by all firms, the existence of FDI could be a signal that such services are well developed and therefore present opportunities to foreign firms. Future research could also consider different time frames other than the span considered by this study. This study, as well as most others, considers the relationship between FDI and its determinants consistent throughout a certain time period. However, it is likely that the direction of some relationships may change from negative to positive or positive to negative later on.

Studies on the importance of mediating factors and FDI heterogeneity are less conclusive and could benefit from greater convergence in methodologies and greater specificity in the spillover channels of interest (Smeets, 2008). There were some aspects in the study where inadequacy was noted in the use of self-administered questionnaires to collect intended data; these inadequacies were overcome through the use of the interview guide as a research instrument. The implication of these findings to research methodology is the need for future research to use triangulation in data collection procedures.

Another implication of the findings from this study for methodology is the growing need to conduct sectoral studies. Due to the extreme conflicting and varied views when considering the determinants of FDI on host economies, case-specific and sectoral studies are recommended as an adequate methodology to assess the determinants of FDI in any economy. The findings of this study showed the importance of institutional determinants of FDI and therefore recommend methodologies for future research to also include such determinants. Descriptive statistics revealed important aspects of respondents' attitude at firm level that have implications on foreign investment, future methodologies can seek to investigate more firm-level evidence of determinants of FDI in the economy, this is due to the fact that many methodologies adopted in past studies on FDI have focused on the country-level evidence at the expense of firm-level evidence.

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APPENDICES

Appendix 1: Introduction Letter



**JOMO KENYATTA UNIVERSITY
OF
AGRICULTURE AND TECHNOLOGY
DEPARTMENT OF ENTREPRENEURSHIP, TECHNOLOGY,
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OFFICE OF THE CHAIRPERSON
P. O. BOX 42005/01503
NAIROBI

DATE: 28TH May, 2015

JKU/6/HD433-1104/2010

To whom it may concern:

Dear Sir/Madam,

RE: PHD RESEARCH PROJECT FOR: SAMUEL NJORGE

This is to introduce to you **Mr. Njorge** who is a student pursuing Doctor of Philosophy degree in Entrepreneurship in the Department of Entrepreneurship, Technology, Leadership, and Management in the School of Entrepreneurship, Procurement and Management, College of Human Resource Development at Jomo Kenyatta University of Agriculture and Technology.

The student is currently undertaking a research proposal on: "**Determinants of Foreign Direct Investment Growth in Kenya.**" in partial fulfilment of the requirement for the programme.

The purpose of this letter is to request you to give the student the necessary support and assistance to enable him obtain the necessary data for the research. Please note that the information given is purely for academic purposes and will be treated with strict confidence.

Thank you.

Yours faithfully,

Alice Simiyu

Dr. Alice Simiyu
Postgraduate Research Coordinator
Department of Entrepreneurship, Technology, Leadership and Management



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Appendix 2: Questionnaire

This questionnaire is part of my PhD studies. It's for academic reasons only and intends to collect information on the determinants of Foreign Direct Investment (FDI) in Kenya and specifically in the manufacturing sector. The information and data collected using this questionnaire will strictly be confidentially coded and represented only on aggregate. This survey questionnaire is complex and should be completed by the Finance Director/Manager, Chief Accountant or any similarly qualified person in the ranks of the Finance/Administration departments. Kindly fill **all** the parts

Key:

Organization - Your place of work GDP- Gross domestic product

FDI- Foreign direct investment

Part A-(i): Research Participant General Information (Please tick appropriately)

1. Job group/employment category:

Junior management () Middle-level management () Top-level management ()

2. What is your highest level of education?

Post Graduate () Graduate ()
Tertiary College () Other (specify)

3. Your age bracket is

21- 30 yrs () 31- 40 years () 41-50 years () 51-60 years () over 60 years ()

4. Job experience 1-5 years () 6-10 years () 11-15 years ()
16-20 years () Over 20 years ()

PART A- (ii): Organization General Information (Please tick appropriately)

5. Name of the Organization (Optional).....

6. The Organization you work with can be categorized as;

Foreign Affiliate/associate (more than 10% shareholding) [] Joint Venture with a foreign Company [] Subsidiary (majority foreign shareholding) [] Multinational [] Other (specify)

7. Your organization has experience in international business in general and in Kenya in particular for how many years? 1-5 years () 6- 10 yrs () 11-15 years () Over 15 years ()

8. Your firm is involved in manufacturing of?

Food stuffs () Pharmaceuticals/Chemicals/Paints () Engineering products () Agri-products () Automotive parts () Beauty products/clothing/footwear () Other (specify).....

PART B: Growth of Foreign Direct Investment in Kenya

With respect to the growth of foreign direct investment in Kenya, kindly indicate (✓ tick) the extent to which you agree or disagree with the following statements in a scale of 1 to 5: (where 1 = strongly disagree, 2 = Disagree, 3 = Uncertain, 4 = Agree, 5 = Strongly Agree)

| | | 1 | 2 | 3 | 4 | 5 |
|----|---|-------------------|----------|-----------|-------|----------------|
| | Statement | Strongly Disagree | Disagree | Uncertain | Agree | Strongly Agree |
| 1. | Kenya has been sluggish in growing its foreign direct investment inflows | | | | | |
| 2. | The main inflows of FDI in Kenya has been directed to agricultural sector | | | | | |
| 3. | Kenyan has seen an increase in FDI in mining sector in the last 5 years | | | | | |
| 4. | Growth of FDI in the manufacturing sector has not picked as fast as agriculture and mining sectors | | | | | |
| 5. | Kenya is not highly endowed in minerals like other neighbouring countries which has led to slow growth in FDI | | | | | |
| 6. | Increase in FDI in Kenya can lead to attainment of sustained growth and development of the economy | | | | | |

7. What is the **most** significant obstacle to expanding your investment in Kenya?

Poor Corporate Governance ()

High Political risk ()

Low level of annual economic activity (measured in GDP & GDP Growth Rate)

High level of taxes ()

High level of interest rates ()

Unfavourable exchange rates (KES to other currencies) ()

Unfavourable inflation rates ()

Low level of exports ()

High level of imports ()

PART C: Corporate Governance in determining growth of FDI in Kenya

With respect to corporate governance and growth of FDI inflows in Kenya, kindly indicate (√ tick) the extent to which you agree or disagree with the following statements in a scale of 1 to 5: (where 1 = Strongly disagree, 2 = Disagree, 3 = Uncertain, 4 = Agree, 5 = Strongly Agree)

| | | 1 | 2 | 3 | 4 | 5 |
|----|--|--------------------------|-----------------|------------------|--------------|-----------------------|
| | Statement | Strongly Disagree | Disagree | Uncertain | Agree | Strongly Agree |
| 1. | Good corporate governance can lead to growth of FDI inflows | | | | | |
| 2. | There is generally good practice of corporate governance in the Kenya | | | | | |
| 3. | The rule of law in the Kenya is fully developed | | | | | |
| 4. | The laws governing transfer pricing by foreign investors is not well laid down in Kenya | | | | | |
| 5. | Governance and quality of institutions have a positive effect on FDI flows | | | | | |
| 6. | Democracy as proxy of governance can foster development of stable ground rules for FDI inflows | | | | | |
| 7. | The corporate tax rate in Kenya is high and can discourage investors | | | | | |
| 8. | Corruption in Kenya hinders FDI growth | | | | | |

9. The corporate governance infrastructure is poor and a great deterrent to attracting foreign investment in Kenya; Yes () No () if No explain

10. What factor(s) specifically determined your decision to invest in Kenya?

- Established democracy ()
- Political stability/absence of violence ()
- Government effectiveness ()
- Regulatory framework ()
- Rule of law ()
- Control of corruption ()
- Tax policies ()

PART D: Political Governance (Political risk) in determining growth of FDI in Kenya

With respect to the governance obstacles that investors face and policies deemed necessary for improving the Kenyan investment environment to help attract more FDI, kindly indicate (✓ **tick**) the extent to which you agree or disagree with the following statements in a scale of 1 to 5: (where 1 = Strongly Disagree, 2 = Disagree, 3 = Uncertain, 4 = Agree, 5 = Strongly Agree)

| | | 1 | 2 | 3 | 4 | 5 |
|----|--|--------------------------|-----------------|------------------|--------------|-----------------------|
| | Statement | Strongly Disagree | Disagree | Uncertain | Agree | Strongly Agree |
| 1. | Kenya enjoys political stability compared to other East African countries | | | | | |
| 2. | Aspects of political stability like an efficient law and order system, are important in determining FDI inflows into Kenya | | | | | |
| 3. | Stability in political environment has positively impacted foreign investment in Kenya | | | | | |
| 4. | Political instability reduces a country's attractiveness as a location of FDI | | | | | |
| 5. | Kenya has high political risk where investors' assets can be taken over by the government | | | | | |
| 6. | High level of crime hinders foreign investors from setting up ventures in the country | | | | | |
| 7. | The Kenyan environment is characterized by tension around election time, this cycle deters investment. | | | | | |
| 8. | Political instability creates an unfavorable business climate which seriously erodes the risk-averse foreign investors' confidence | | | | | |

9. The political governance infrastructure is poor and a great deterrent to attracting foreign investment in Kenya; Yes () No () if No explain.....

PART E: Market Size of the Economy (Measured by GDP , GDP per Capita & GDP Growth rate) in determining growth of FDI in Kenya

With respect to the Market size of the Kenyan economy in attracting more FDI, kindly indicate (√ **tick**) the extent to which you agree or disagree with the following statements in a scale of 1 to 5: (where 1 = Strongly Disagree, 2 = Disagree, 3 = Uncertain, 4 = Agree, 5 = Strongly Agree)

| | | 1 | 2 | 3 | 4 | 5 |
|----|--|--------------------------|-----------------|------------------|--------------|-----------------------|
| | Statement | Strongly Disagree | Disagree | Uncertain | Agree | Strongly Agree |
| 1. | Level of economic development in a country may affect growth and sustenance of FDI | | | | | |
| 2. | Broadening of financial markets to facilitate financial instruments can accelerate FDI inflows | | | | | |
| 3. | Kenya incredible potential in terms of low cost labor and vast natural resources can encourage FDI | | | | | |
| 4. | When the size of the market of host country has grown large enough, the host country can become the target for the inflow of FDI | | | | | |
| 5. | Market size (GDP size) directly affects the expected revenue of the foreign investment | | | | | |
| 6. | The market size of Kenyan economy (in GDP measure) is small to warrant growth of Foreign investment | | | | | |

7. The growth of Kenyan economy (in GDP measure) is very low to attract major foreign investments Yes () No () if No explain.....

PART F: Trade Openness (imports and exports as percentage of GDP) and Market Attractiveness in determining growth of FDI in Kenya

With respect to trade openness of the Kenyan economy and trade policies deemed necessary for improving the Kenyan investment environment to help attract more FDI, kindly indicate (✓ **tick**) the extent to which you agree or disagree with the following statements in a scale of 1 to 5: (where 1 = Strongly Disagree, 2 = Disagree, 3 = Uncertain, 4 = Agree, 5 = Strongly Agree)

| | | 1 | 2 | 3 | 4 | 5 |
|----|--|--------------------------|-----------------|------------------|--------------|-----------------------|
| | Statement | Strongly Disagree | Disagree | Uncertain | Agree | Strongly Agree |
| 1. | More FDI can be attracted in Kenya through liberalizing trade to attract foreign investment | | | | | |
| 2. | How easy or difficult it is to start a business, influence speed of seizing new opportunities in investment in a Country | | | | | |
| 3. | More global integration can drive growth of foreign investment inflows in Kenya | | | | | |
| 4. | The Kenyan economy is export-oriented and openness may be successful in encouraging FDI flows | | | | | |
| 5. | The Kenyan economic environment is open to global integration which can lead to FDI growth | | | | | |
| 6. | Kenya has good trade policies that allow free movement of goods and services | | | | | |
| 7. | The Kenyan economy has few restrictions on capital repatriation by foreign investors | | | | | |

8. The Kenyan economy is open to trade but its trade policies are weak
Yes ()

No () if No explain.

.....

PART G: Macro-economic Stability (inflation and exchange rates) in determining Growth of FDI in Kenya

With respect to the ability of Kenyan Government to manage Macroeconomic variables of exchange rate and inflation which will increase foreign investment, kindly indicate (✓ **tick**) the extent to which you agree or disagree with the following statements in a scale of 1 to 5: (where 1 = Strongly Disagree, 2 = Disagree, 3 = Uncertain, 4 = Agree, 5 = Strongly Agree)

| | | 1 | 2 | 3 | 4 | 5 |
|----|---|--------------------------|-----------------|------------------|--------------|-----------------------|
| | Statement | Strongly Disagree | Disagree | Uncertain | Agree | Strongly Agree |
| 1. | Unstable inflationary trend can discourage FDI inflows | | | | | |
| 2. | A high inflation rate indicates unstable economic policies; and may lead to a reduction in FDI inflows | | | | | |
| 3. | Low and stable inflation are more appealing to investors, as monetary stability influences FDI inflows | | | | | |
| 4. | High and unstable inflation increases the cost of businesses and negatively affects long-term planning by investors | | | | | |
| 5. | Exchange rate volatility contributes to uncertainty which can affect FDI growth negatively | | | | | |
| 6. | Exchange rate risk can contribute significantly in explaining FDI growth | | | | | |
| 7. | Kenyan exchange rate trends are unstable which may deter FDI flows | | | | | |
| 8. | Unstable exchange-rate has negative consequences on the trade sector (exports and imports) of the Kenyan economy | | | | | |

9. Macro-economic instability in Kenya seen through unstable inflation and unstable foreign exchange rates discourage investors from increasing investment in Kenya; Yes() No () if No explain

End of the questionnaire

I appreciate the time and effort you have put into completing this questionnaire

Thank you for your assistance

Appendix 3: Interview Guide

1. Earlier research has shown that Kenya has historically, favored portfolio investment (a passive investment in securities of another country like shares or bonds) rather than FDI (controlling ownership in a business enterprise in a foreign country). Why do you think that is the case?

.....
.....

2. Kenya is sometimes thought of having poor governance infrastructure in terms of legal systems, corruption levels and transparency. What is your view about this?

.....
.....

3. Kenya exercises inflation targeting policy using interest rate as a major control to monitor the inflation rate. In your view are inflation levels in Kenya conducive for growth of FDI?

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4. Pegging Kenyan shilling can reduce the volatility, but it is unfavorable for the country, which is a largely commodity export economy. Do you think that keeping floating currency in Kenya is a good policy?

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5. If unstable political events may hinder FDI flow into Kenya. Should Kenya, given its current economic condition, actively pursue FDI into the country?

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6. Kenya liberalized trade in the 1980s and 1990s. Trade liberalization was part of a broader push in Kenya to decrease the government’s role in the economy and give market forces greater influence. What is your opinion about opening up the economy? Can it lead to growth of foreign investment?

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Appendix 4: Secondary Data Sheet

1. Kenya's FDI Inflows (Millions of Dollars) 2009-2013- UNCTAD/World Development Indicators (WDI)
2. Kenya exchange rates 2009-2013- Central Bank of Kenya/Kenya National Bureau of Statistics
3. Kenya Governance Indicators 2009-2013- World Governance Indicators
4. Kenya inflation rates 2009-2013- Central Bank of Kenya/Kenya National Bureau of Statistics
5. Kenya Political Risk Rating 2009-2013- International Country Risk Guide (ICRG)- Political Risk Group (PRS)
6. Kenya's Macroeconomic Indicators 2009-2013- UNCTAD/ World Bank World Development Indicators (WDI)

Appendix 5: Sampling Distribution Table

| List of Firms | |
|---|--|
| 1. Allied East Africa Ltd | 51. Holman Brothers EA ltd |
| 2. Alpha Medical manufacturers Ltd | 52. Interconsumer products Ltd |
| 3. Assa Abloy East Africa Ltd | 53. JohnsonDiversey EA ltd |
| 4. Associated Battery manufacturers EA | 54. Kapric Apparels EPZ Ltd |
| 5. Athi River Mining Ltd | 55. Kenafric Industries Limited |
| 6. Atlantic Ltd | 56. Kenpoly Manufacturers Limited |
| 7. Automotive & Industrial Battery (K) | 57. Kenya Grange vehicle Industries Ltd |
| 8. Avery East Africa Ltd | 58. Kenya Trading EPZ Ltd |
| 9. Bamburi Cement Ltd | 59. Kikoy Mall EPZ Ltd |
| 10. Basco Products K Ltd | 60. Kim-Fay East Africa Ltd |
| 11. BASF EA Ltd | 61. L.G. Harris & Co. Ltd |
| 12. Bata Shoe Co. (K) Ltd | 62. L'oreal East Africa Ltd |
| 13. Baumann Engineering Limited | 63. LAB International Kenya Ltd |
| 14. Bayer East Africa Ltd | 64. Labh Singh Harnam Singh Ltd |
| 15. Beiersdorf east Africa Ltd | 65. Laboratory & Allied Limited |
| 16. BenMed Pharmaceuticals Limited | 66. London Distillers K Ltd |
| 17. Beta Healthcare International Ltd | 67. Louis Dreyfus Kenya Ltd |
| 18. Betatrad K Ltd | 68. Manson Hart Kenya Ltd |
| 19. Biodeal Laboratories Ltd | 69. Marshall Fowler (Engineers) Ltd |
| 20. Biopharma Ltd | 70. Mega Garments Industries Kenya EPZ |
| 21. BOC Kenya Ltd | 71. Nampak Kenya Ltd |
| 22. British American Tobacco Kenya Ltd | 72. Nestle foods Kenya Ltd |
| 23. C. Dormans Ltd | 73. Orbit Chemicals Industries Ltd |
| 24. Cardbury Kenya Ltd | 74. Pan Africa Chemicals Ltd |
| 25. Central Glass Industries Ltd | 75. PG Bison ltd |
| 26. Chemical & Solvents EA Ltd | 76. Pharmaceutical manufacturing Co. K ltd |
| 27. CMC Motors Group Ltd | 77. PolyChem East Africa Ltd |
| 28. Coca Cola East & Central Africa Ltd | 78. Procter & Gamble East Africa Ltd |
| 29. Cooper K-Brands Ltd | 79. Proctor & Allan EA Ltd |
| 30. Cosmos Ltd | 80. Pwani Oil Products Ltd |
| 31. Crown Paints Kenya Ltd | 81. PZ Cussons East Africa Ltd |
| 32. Dawa Limited | 82. Reckitt Benckiser EA Ltd |
| 33. Del Monte Kenya Ltd | 83. Regal Pharmaceuticals Ltd |
| 34. East Africa Foundry Works K Ltd | 84. Sadolin Paints EA Ltd |
| 35. East African breweries Ltd | 85. Saj Ceramics Ltd |
| 36. East African Cables Ltd | 86. Sandstorm Africa Ltd |
| 37. East African Packaging Industries Ltd | 87. SC Johnson and Son Kenya |
| 38. Edible Oil Products | 88. Sheffield Steel Systems ltd |
| 39. Ellys Chemical Industries Ltd | 89. Shin-Ace Garments Kenya EPZ Ltd |

List of Firms

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| 40. Equator Bottlers Ltd | 90. Socabelec EA Ltd |
| 41. Eveready Batteries | 91. SolvoChem East Africa Ltd |
| 42. Excel Chemicals Ltd | 92. Sproxil East Africa |
| 43. Future Garment EPZ Ltd | 93. Steel Structures Ltd |
| 44. Galaxy paints & Coating Co. Ltd | 94. Syngenta East Africa Ltd |
| 45. GE East Africa Services Ltd | 95. Tetra Park Ltd |
| 46. General Motors East Africa Limited | 96. The Breakfast Cereal Company K Ltd |
| 47. Glaxo Smithkline Kenya Ltd | 97. Toyota EA Ltd |
| 48. Global Apparels Kenya EPZ Ltd | 98. United Aryan EPZ Ltd |
| 49. Henkel Kenya Ltd | 99. Vivo Energy Kenya Ltd |
| 50. Highland Paper Mills Ltd | 100. Wildlife Works EPZ Ltd |

Source; KAM, 2014