Impact of Foreign Direct Investments on Exports in Kenya.

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DECLARATION

I, Mathew Kioko declare to the best of my knowledge that, this work is original and has not been published and or submitted for any other degree award to any other university.

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Mathew Kioko,

This thesis has been submitted for examination with the approval of the following supervisor:

Prof. Jong Hwan Ko

……

DEDICATION

This thesis is dedicated to my family and friends for their greatest support and encouragement they gave me all through the study. I also dedicate it to my dear Prof. Jong Hwan Ko for having faith in me and also inspiration he gave me to progress in spite of the challenges.

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LIST OF ABBREVIATIONS.

ADB: African Development Bank

ADF: Augmented Dickey-Fuller

AFIPEK: Association of Fish Processors and Exporter of Kenya

AMEGA: Association of Market Processors and Gifts and Allied Article of Kenya

ANER: Annual Exchange Rate

BOP: Balance Of Payments.

COMESA: Common Market for Eastern and Southern Africa

CBK: Central Bank of Kenya

CPI: Consumer Price Index

CIF: Cost Insurance Freight

CIMA: Community code of International conference and Insurance Market

EBA: Everything But Arms

EAC: East African Countries

ECM: Error Correlation Model

ERP: Economic Recovery Process

EPZ: Export Processing Zone

FDI: Foreign Direct Investment.

FEM: Fixed Effects Model

FG: Flying Geese Model

GDP: Gross Domestic Product.

GSP: Generalised System of Preferences

IGAAD: Intergovernmental Authority on Drought and Development

IMF: International Monetary Fund

IPC: Investment Promotion Centre

KBO: Kagera Basin Organisation

KIA: Kenya Investment Authority

KNBS: Kenya National Bureau of Statistics

KSH: Kenya Shillings

LDC: Less Developed Country

MNE: Multi-National Enterprises

MNC: Multi-National Companies

MUB: Manufacturing Under Bond

NIC: Newly Industrialised Countries

NTB: Non-Trade Barriers

NIFTZ: National Industrial Free Trade Zone

ICMU: International Code Management Unit

OLS: Ordinary Least Square

POLS: Pooled Ordinary Least Square

PGDP: Potential Output of Gross Domestic Product.

PLC: Product Life Cycle

PTA: Preferential Trade Agreement

REER: Real Effective Exchange Rate

RES: Random Effect Specification.

SAP: Structural Adjustment Program.

SME: Small and Medium Enterprise

TLI: Trade Liberalisation Index

UK: United Kingdom

US: United States

UNCTAD: United Nations Conference on Trade and Development.

VECM: Vector Error Correction Model

VAT: Value Added Tax

WDI: World Development Indicator

WTO: World Trade Organisation

ABSTRACT.

Foreign Direct Investment (commonly known as FDI) is considered to be a vital tool which influences the export performance of the host nations. Additionally, by encouraging access to the international market, FDI enhances a significant contribution to the host nation's exports. Several theoretical relationships such as Flying geese model, Vernon product life cycle model, and new growth model can explain the relationship between FDI and export growth performance with all agreeing that FDI has a significant influence on host nations.

Firstly the multinational companies take advantage of cheap factor endowments of the host nations such as labour and profuse resources which help them lower production cost so as to increase export competitiveness. Moreover, the supply capacity increasing effect from the expansion of host country's export is expected. Secondly, the domestic industries can increase host nation's export expansion through the spillover effects of FDI through technological transfer and skills which bring competition within the export market.

This study seeks to examine the potential impact of FDI inflows on export growth performance of Kenya for the period 1961-2014. The study separates the effects of FDI into host country's export expansion by MNE subsidiaries (supply capacity increasing effects) and domestic enterprises export expansion through the spillover effects such as competition and transfer of knowledge and

technology. By using the error correlation model (ECM), the results imply that inward FDI significantly influences the export growth performance in Kenya during the period of 1961-2014. Following these results, it is clearly evident that FDI has a lot of impact on export growth capacity and policies aimed at attracting foreign direct investment should highly be encouraged by the policymakers.

CHAPTER ONE: INTRODUCTION

1.1 Background.

The dramatic performance of the Kenyan economy in the last ten years has placed Kenya in a spotlight as the fastest growing nation in East and Central Africa. To understand the successful development of the Kenyan economy, first of all, we cannot ignore the importance of export performance. In accordance with the national economy transition, from agriculture to industry, trade policy of export expansion was implemented to focus on the international markets from the 1960s. Kenyan exports have been growing very fast than GDP in the last few decades. Marked exports have led to the accumulation of revenue which has facilitated an increase in the GDP of the country.

Kenya has experienced a stretched past of economic supremacy in Eastern Africa by becoming one of the biggest and largest advancing country. Due to, poor policies set by the government over the last couple of years, have contributed to an extended period of drop in the economic advancement of the country at a period when other countries in the region such as South Africa made a significant progress. In the early 1970s and 1980s when Kenya was considered as a prime choice for foreign investors who really wanted to set up their firms in East and South of Africa, poor economic procedures and unconditional efforts on structural reforms hampered the FDI inflows during that period. Deeply rooted corruption and poor government practices were also discouraging factors of FDI inflow during after independence.

There has been a rise in the active participation of most developing nations in the international trade due to recent growth in the globalization process. Recently the relationship between FDI and economic growth has created much attentions to the researchers as well as policymakers with FDI being regarded as the key to the international economic development.

For many years now, the crucial discussion or debate in the world of academics today on how the host nations react to foreign direct investment inflows has still been going on. The most important thought issue in this discussion is the influence of FDI on the host nation's export performance. Flying geese model, Vernon's (product life cycle) model and the new growth models can be used to explain whether FDI is a mean of instigating export performance of the host nation.

Foreign direct investment is likely to contribute positively the host nation's export performance although the three models or theories mentioned have a distinctive perspective of FDI inflows, with the direct and indirect effects providing the beginning point.

To start with, Foreign Direct Investment is considered to be an important tool for investment with the aim of reducing cost and the using of other host country's factors of production for example relatively profuse resources and cheaper labour costs directly minimize the foreign industries' cost of production and raising their competitiveness in exports.

With the rivalry of competition between the MNC's (commonly referred to as Multi-National Companies) and domestic production firms which raises the domestic enterprises export propensity to safeguard their market and sales. According to Zhang and Song (2000), spillover effects is expected to raise domestic export capability due to the transfer of knowledge, technology and skills from MNC companies to the indigenous industries.

Consequently, FDI both directly and indirectly enhances the host nation's export performance. The availability of empirical discussions on the importance of FDI inflows on export growth performance of the host nations is not clear. Numerous studies still hold on to the hypothesis of a negative relationship between FDI and export performance. (Jeon 1992, Alics and Ucal, 2003)

The study conducted by Sharma (2003) investigated the role of FDI on Indian exports. In his study does not pick out any statistically significant effect of FDI on Indian exports. Inversely, in other studies it shows that FDI has a positive impact on the export performance of host nations (Cabral, 1995; Blake and Pain, 1994; Liu and Shu, 2003; Metwally, 2004 Zhang, 2005) Kenyan exports have been growing steadily than the GDP in the last decade. For instance, According to World Bank 2013, her exports and GDP growth grew to over 10% and 3.5 % per year respectively over the period 1994-2013.

Numerous factors seem to be attributed to this occurrence which includes inwards FDI which has been increasing rapidly particularly from the mid-1990s. Therefore, there has been insufficient attempt to assess the increasing FDI inflows endeavors to Kenyans export performance as the transmission of export growth.

However, there is a limited discussion or no empirical study that distinguishes the possible effects of FDI into spillover effects and supply capacity-increasing effects (capacity effects). The supply capacity increasing effects occurs when inwards FDI raises the host nation's production capacity, which leads to increase in the export supply capacity. On the other hand, spillover effects caused by FDI increase because foreign capital inflows sometimes add to distinct competitive advantages, for example, classy knowledge and skills and hence increase the level of productivity, or better information about market exports against the local firms (Basu, 1997).

It is very crucial especially in terms of policy recommendation to differentiate between the two impacts of FDI on exports. As argued by many scholars, the remarkable FDI stimulating policies should steer up, a magnificent rise in the host nation's exports. Moreover, if evidence shows that foreign direct investment increases exports only by increasing export supply capacity, then FDI inwards are not appropriate in that policymakers could raise exports through different ways as well,

such as fostering local investment, other than FDI. Contrary, if by any chance there is evidence of positive spillover effects of inwards foreign capital on exports, this would mean that possible attempts directed at luring foreign direct investment would be acceptable.

1.2 Objective of the study

The key objective of this study is to examine the influence of FDI on supply increasing capacity effects and spill-over effects on the export growth performance of the Kenyan economy.

1.3 Scope

This study covers the Kenyan economy for the period of 1961 to 2014 which focusses on FDI, exports, real effective exchange rate (REER), trade liberalization index (TLI), GDP and market access indicator (MKT). A comprehensive discussion is made on the relationship between FDI and exports. The aim is placed on the relationship between foreign direct investment and export performance mostly because of the exclusive policies of the government directed towards attracting in FDI with several campaigns and incentives. Therefore, this research seeks to find out whether the improvement in export supply capacity and spillover effects can be attributed to the FDI inflows.

1.4 Significance

The research will help to shed some light on the factors that influence export performance especially effects caused by foreign direct investment. Therefore, this research will contribute to the body of knowledge and also help in the formulation of policies in Kenya. Furthermore, this research tends to show how FDI is absorbed into the export sector and how they engage with other key determinants of exports. This will help in the development of macroeconomic models and simulations which can be used as a basis for future research.

1.5 Outline of the study.

This thesis is organised as follows:

Chapter I gives a short background of the study; and then explains the problem statement, objectives, scope, hypothesis to be tested and significance of the study.

Chapter II gives a report of some salient features of marked features of inward FDI and the export growth performance of the Kenyan economy.

Chapter III gives a review of the both theoretical and empirical literature describing the relationship between exports, FDI, real effective exchange rate, GDP, and imports.

Chapter IV gives the details of the data collected and empirical model is presented.

Chapter V provides the description of the results of the empirical analysis and explains the meaning of the results.

Chapter VI provides the conclusion and policy recommendations according to the findings of our study and also shows the shortage and fields for further studies.

CHAPTER II: ECONOMIC POLICY REFORMS, FDI INFLOWS AND EXPORT PERFORMANCE IN KENYA.

2.1 Trade and Investment Policy Reforms in Kenya.

2.1.1 Trade Policy Reforms in Kenya.

At the time the second president of Kenya Daniel Toroitich Arap Moi came into power for the third time in a row in 1987, the government formalized an Economic Recovery Programme (ERP) introduced in 1989 after it agreed on a policy package with the IMF and World Bank in 1988. The crucial components were: export promotion, strong monetary policy, tight fiscal policy, foreign exchange reforms, financial sector reforms, price liberalization, conducive environment for private investment and savings, restructuring productive capacity to revive growth.

These policy reforms outlined above yield some macroeconomic results in the economy. Kenyan average GDP growth rates were 6.7% for the period 1986-1996 and 5.7% for the period 1996-2006 which is higher for African standards. The telecommunication sector has been quoted as one of the key attraction by the investors. The other economic variables have also improved largely. For instance, Kenya has seen a massive improvement in both its total investment rates and its total public deficit has reduced. There has also been a concrete and low single digit inflation mainly due to fiscal restraints policy which was implemented in the early 1990s together with series of foreign exchange reforms.

The study conducted by Mwanga, (2008) noticed that the trade policy of Kenya was protectionist with crucial non-tariff barriers (NTBs), earlier before 1990 with the fiscal structure having about more than 20 distinct taxes suitable to export and import goods at rates which a times arrive at 120% of the cost insurance freight (CIF) value . With the execution of the Structural Adjustment

Programme (SAP), the protectionism was declined in 1990. Quantitative restrictions along with price controls were steadily abandoned in 1994. At the same year, the important tax reforms proposed within the framework of the East African Countries (EAC) was implemented and finally eased the fiscal system to boost foreign investment so as to improve competitiveness. Devaluation of the Kenyan Shilling (kshs) further boosted the fiscal system. Market access conditions improved drastically in 1994 with steadily efforts by the involvement of Uruguay Round which comprised of limiting the use of national trading boards (NTBs) so as to avoid future increase in tariff protection and the decision to apply the most favoured country's clause giving the developing nations such as Kenya, several trade choices. At this adjustment period, the government of Kenya also implemented various sectoral reforms. (Mwanga, 2008)

Subsidies to boost farmers were totally or partially put to an end in the agricultural sector and agricultural enterprises were restructured, followed closely by privatization, outright closure, and liquidation. There was a simplification in the procedure for obtaining technical importation visas within the industrial sector. Liberalisation and openness to competition on banking and insurance services was placed under the authority of Central Bank of Kenya (CBK) and Insurance Authority of Kenya (IAK)

The Balance of payment was nearly linked to the exchange rate which is the main variable in emphasizing macro-economic stability. Kenya's exports have generally been growing rapidly and averaging 7% of GDP except for 1998 when Kenya experienced a coffee boom. Donor aid and private transfer inflows have offset the massive trade deficit. The falling coffee prices have been mitigated by the government policy efforts aimed at abolishing taxes on exports, deregulation of monopoly by the government in the export of agricultural products with the spread out of exports having influenced the steady rise in non-coffee export products. Improved confidence in Kenya's

economy has been noticed in the increase in private transfers and non-coffee exports. Nevertheless, the steady export bias, over- reliance on primary agricultural exports and protectionism in the potential market continues to weaken the balance of payment.

Kenya has linked its economy to international trade with regard to the trade policies which are argued to be the main character in boosting of foreign direct investment. Kenya has put the main focus on liberalization of the economy through the extensive trade reforms programmes geared to make the economy widely open and enhance its competitiveness. The trade openness of the economy began with the clearance of non-tariff barriers followed by reduction of tariffs at a low level within East and Central African regions. Necessary steps were taken to abolish export taxes and remove marketing boards' monopoly over cash crop exports. This created an opportunity for private sector participation and widely opened chances for inwards FDI towards export-oriented agribusiness.

Additionally, Kenya has taken necessary steps by signing several trade agreements with an intention of accessing wider markets and also to expand its market through these regional integrations. Kenya is a key member of the East African Community (EAC) and COMESA with a market of about 93 million people and 390 million people respectively. Kenya also has a preferential access to the European Union through the Everything But Arms (EBA) initiative with which all the exports to the EU from the least developed countries benefits from full duty-free and quota free with the exemption of armament. The preferential access to the US market through AGOA (African Growth Opportunities' Act) also benefits Kenya's export market. Kenya is also a member of PTA, Kagera Basin Organisation (KBO), Cotonou Agreement and the Intergovernmental Authority on Drought and Development (IGADD). All these development

depicts a commitment to compliance with liberal practices so as to bring about a thrust to continue with the process of liberalization in both FDI and trade

Kenya signed as a member of most international institutions such as ICSID, MIGA that deal with issues closely linked to FDI and the convention on the Recognition and Enforcement of the Foreign Arbitrary Awards which are key principal institutional conventions that are related to FDI. Kenya implemented its own investment code in 1991 in a bid to minimize the risk and rising cost of investing in a third world countries by offering security and incentives to its investors.

2.1.2 Investment Policy Reforms in Kenya

In 1970, Kenya began the import-substitution era with the formation of successive resolutions (Zisuh, 2003). Generally, the nation became a shareholder in a bigger investment in the private sector in accordance with the regulations, thereby creating joint ventures with the private sector. Foreign direct investment was only spread out to equity participation in joint ventures as the country was mostly involved in both private and public sectors under its policy of balanced development in early 1980. In the investment policy reforms, there was the emphasis on demand to process primary products before exportation and the idea of competition. The National Industrial Free Trade Zone (NIFTZ) and the Investment Code Management Unit (ICMU) are among the two structures formed to support the new investment policy. Any service or manufacturing industry permitted by the zones's administrative body, that can import the factors of production, licenses and customs control, raw material and equipment free of duty within the framework ensured more than 20 percent of the annual turnover of the industries crosses the zones boundaries in Kenya's customs territory (Mwanga 2008).

The members of these zones can freely export the returns of their investment and are removed from exchange control restrictions. Additionally, after a decade, enterprises operating within the zones are subjected to corporation tax but other zones tax exemption remains. All the overseas firms and foreign employees outside the industrial free zone are entitled to domestic income tax proceeds. Additionally, all returns can be freely transacted within the shillings zone and somewhere else in relation to the bloc mandate. The Investment charter was enacted by the parliament committee in 2001, which includes incentives to lure foreign investment capital (World Bank outlook, 2006). Within this charter, the country promises to ensure that exercise of justice, the expedition of hearing of court cases and to provide the safety of persons and properties through sensitization, fight against corruption, end of all kinds of harassments and bureaucracy, and banning of all sorts of discrimination.

Kenya Investment Authority is a statutory body started through an Act of parliament (Investment Promotion Act of 2004) to facilitate and promote private sector investment in Kenya. The body is aimed at providing assistance in the industrial land acquisition, help in obtaining work permits and crucial passes for investors and their expatriate staff, organize both contracts potential investors and itineraries for visiting foreign missions in the country, help in seeking joint venture partnership, funding, review and make policy recommendations to the government about investment. The agency was initially commissioned to produce first-hand information on investment opportunities in Kenya; issue on investment Licenses, help in securing other licenses and secondary approval for investors and also assist investors to implement their project ideas through assisting in locating relevant project support services.

Kenya Investment Authority (KIA) in line with its commission of both domestic and foreign investment came up with several incentives and investment protection measures for investors all

of which were aimed at making the country a preferred investment destination. These protection measures adopted include; investment Guarantees; Kenya is a key associate of the Multilateral Investment Guarantee Agency of the World Bank and the VAT deferred payment agreements.

Through Externalization of the funds, foreign investors are allowed to externalize funds for loan repayment system in foreign countries, payment of financial earnings to foreign personnel, payment of royalties or fees and payment of profits or proceeds on disposal of assets.

Additionally, safeguarding against compulsory acquisition, compulsory acquisition can only be made under the Kenyan constitution. Based on a fair market value of the enterprise, the foreign investors should be compensated if only this acquisition takes place.

The KIA came up with alluring incentives to inspire prospective investors. The investor attraction packages adopted were classified broadly as;

Section 1-Initial Investment allowances which are deductible once from the companies income. These initial allowances are based on the value of the plant and machinery. Import duty exemptions are issued which are applicable to motor vehicles, personal effects, plant and machinery in locations such as Nairobi, Mombasa, Kisumu, Nakuru and Eldoret areas.

Section 2-Deductible Annual Allowance; depreciable assets specified in four classes under declining balance method such as class computers, data handling equipment, automobiles, construction, and earth moving equipment.

Section 3- Other Annual depreciation Allowances such as industrial buildings materials, hotels, and hospitals. Assessed losses arising out of industrial operations including the loss from investment allowances can be carried forward indefinitely. In addition, Kenya's uniform corporation tax rate of 30% is one of the lowest in Africa. This allows losses to be carried forward

and therefore means that profit is not taxable till the losses from the previous year are recovered by the company. All plants and machinery are imported duty and tax- free. VAT refunds on all construction materials used on a project within a period not exceeding four years of project implementation are allowed to investors who register as VAT traders. Additionally, there are no taxes on all exports from Kenya. Kenyan exporters are also allowed duty draw back facilities on all taxes paid on raw materials used for the production of exports. A fully liberalized foreign exchange regime with no restriction on the movement of capital is employed in Kenya with 100 percent ownership of projects by foreign investors allowed.

2.2 Pattern of overall FDI Inflows in Kenya.

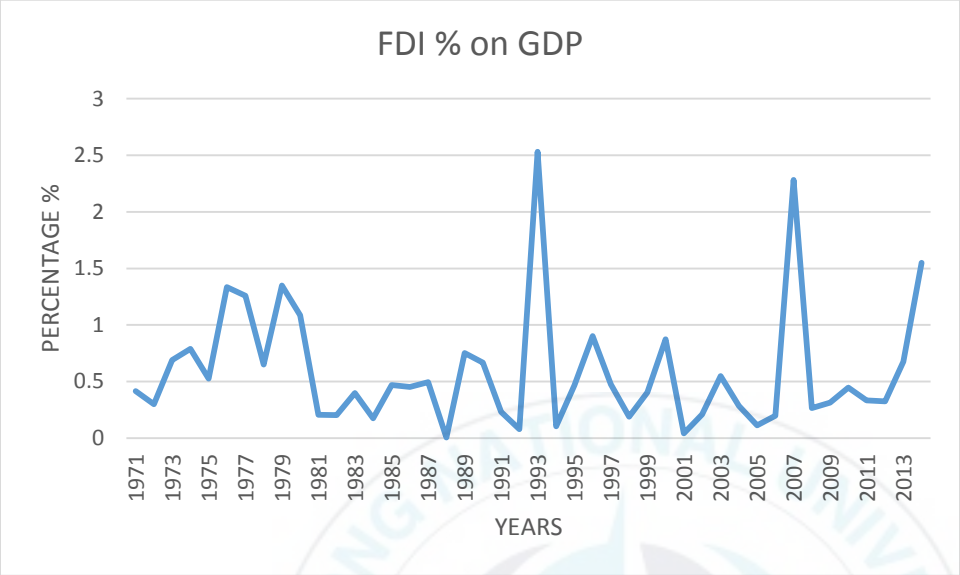
Multinational enterprises (MNEs) participation and foreign involvement in economic activity in Kenya can be tracked back from the 1950s with the British colonial regime in Kenya. At this period, British power masters saw third world nations as the origin of cheap resources and free market for their end products and services. It was noticeable in Kenya by the formation of Imperial British East African Company. This association was created so as to develop Africa trade in the areas controlled by British colonial power. The main trading commodities included gold, silver, tea, coffee, bananas, pyrethrum and cotton on a huge industrial plantations for export to Europe.

Foreign direct investment grew faster in the period of 1980s as Kenya became the perfect choice for foreign investors looking to start their enterprises within Eastern and Southern African soil. Somehow high level of development in terms of good infrastructure, market size growth and openness to FDI when other countries within Eastern and Central Africa region had somewhat closed regimes all contributed to foreign investors' confidence in selecting Kenya as their investment regional hub. FDI kicked out very slow of around US$4million annually back in the early 1970s before peaking up at US$10million in 1980s.

However, the attention did not move from full foreign control over the local economy and production and exportation of agricultural raw materials. Manufactured goods for local consumption and machinery for agricultural production were the main imports into Kenya. After the independence, FDI and Multinational enterprises were not fully welcomed as they were being seen as an evil that influenced negatively the internal decision-making processes, induced loss of control over local policies and importation of ancient technology (Zisuh, 2003). Later on, this led to the maximum state control of the public and private sectors of the economy and the naturalization of all foreign concerns. However, foreign investors still took part in several private enterprises in all forms of equity holding and joint ventures (Aladwa, 1993). This form of equity involvement included a certain kind of FDI inflow to the country up to the mid-1980s when the government allowed for the creation of foreign associates into the country. In Kenya today, the foreign investment is mainly in the form of direct investments with an insignificant amount of portfolio investments (World Bank outlook 2014).

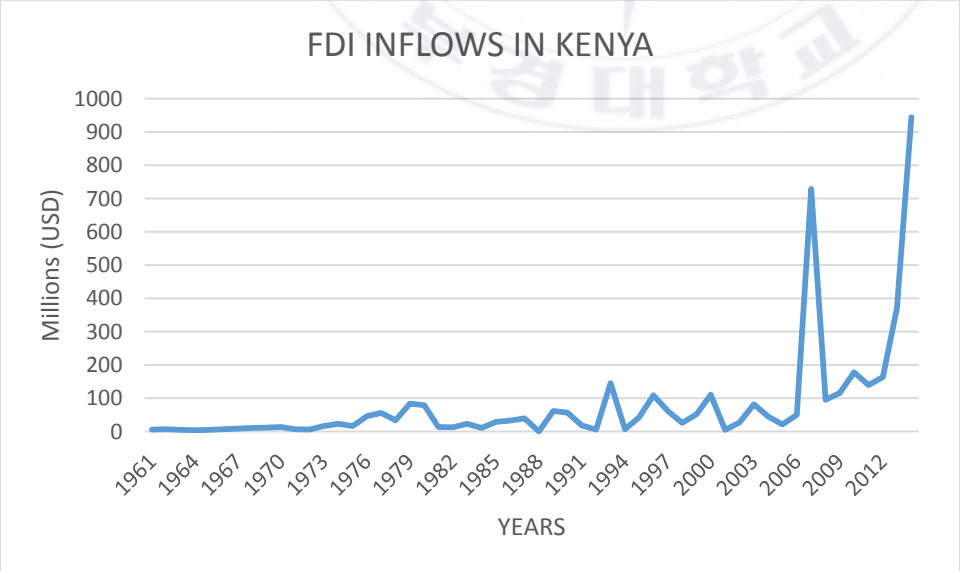
The study conducted by UNCTAD (2000), until the early 2006s, FDI in Kenya was still insufficient but rising which resulted to Kenya becoming one of the lowest receiver of FDI among developing nations. FDI inflow stocks rose to 23 million US dollars or 0.05 percent of GDP in 2006 with many policymakers arguing the reason for this low level of FDI coming from the government interference in owning the largest share in big business concerns thereby preventing foreign shareholding of equity. Long approval process and regulation of foreign participation in most field particularly utility industries might also appear to restrict foreign investment. Although the total value of FDI inflow stocks gained steadily in the 2006s comparing it with previous periods, its share of GDP hasn't made any successful progress.

Graph 1: Share of FDI on GDP



Source: World Bank Development Indicator.

Graph 2: Foreign Direct Inflows in Kenya



Source: World Bank Development Indicator.

In Graph 2 it is clearly evident that only after 2006 was when Kenya experienced a remarkable inflow of FDI which has been on the rise till today. Although Kenya is second to South Africa but not anywhere near most developed nations in luring FDI, it has done perfectly well in previous years comparing it with its own late performance (Mwanga, 2008).

We observe that in Graph 1 show that inwards FDI arrived at US$750 million in 2012 just from over US$100 million during 2003. The share of FDI in GDP rose from less than 0.4 percent to over 2.5 percent in 2001. The rapid increase in FDI inflows seems to be as a result of the opening up of the Kenyan economy since 2003. Kenya's FDI inflows performance index increased from 0.4 percent to 0.5 percent over the period 1987-99 and 1988-2000 respectively, while potential FDI inflows also rose from 0.16 to 0.28 showing that massive progress was taking place (INS, 2005). Despite Kenya's remarkable economic performance in Sub-Saharan Africa, foreign investors assume the country a potential threat to investments when political and economic conditions weaken. This was clearly evident during the year 2007 due to post-election unrest affecting foreign investment inflows into the country.

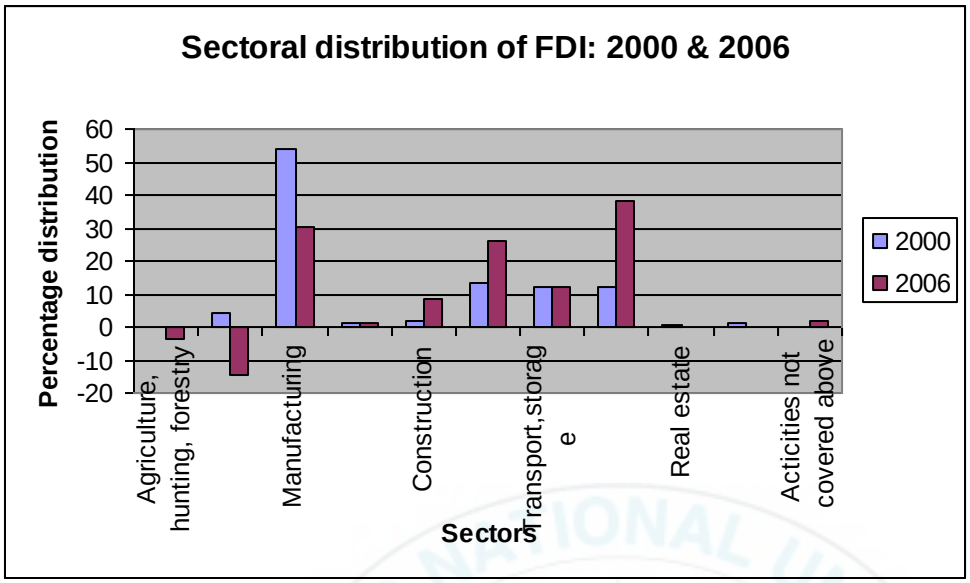
Global FDI flows play a very pivotal role not only in the transfer of knowledge and technological but for the integration of host countries and domestic enterprises businesses into global production networks and value chain. Through this foreign-owned domestic distribution networks, they also promote market access for imported products. Inward FDI often lead to an increase in the level of imports both directly and indirectly. In most cases, inwards FDI come in the form of imports of machinery and facilitate the increase in imports of merchandise for processing. Due to their production capacity, foreign subsidiaries are more likely to import more than the local firms. Foreign- owned enterprise is often better informed of the potential to acquire inputs from abroad even if in the same industry both supply only the local market.

2.3 Distribution of FDI by Sector and Industry

According to data from private capital inflows survey by Central Bank of Kenya (CBK), Kenya National Bureau of Statistics (KNBS) and Kenya Investment Authority (KIA), total FDI inflows to Kenya comprised of 51 percent equity capital, 37 percent net inter-company borrowing and 12 percent reinvested earnings by 2000. Foreign investment in the form of inter-company loans adds to the biggest share of total FDI amounting to about 60% of the total inflows compared to 38% from equity capital. This is possibly due to the higher returns associated with it. Inward FDI has been growing steadily over the past twenty years from 55 million dollars in 1993 to 222 million dollars in 2004. Since 1999, Inward FDI has increased over 7 percent each year. Most of the foreign direct investment has fallen into manufacturing-mainly sugar, textiles, beverages, footwear, cement, plastics, packaging and food processing for the domestic market. Investment into agro-business targeted the tea, coffee, and cotton sub-sectors.

The most evident recent trends in the sectoral concentration of FDI are investments in the floriculture, horticulture and garments fields, adding up to overflowing investment in tourism. The continued interest in horticulture and floriculture has been in contributed by conducive climatic conditions and favourable market abroad. Under the African Growth and Opportunity Act (AGOA) garment investments have been in response to the United States issuing preferential access to its market.

Figure 1: Sectorial Distribution of FDI: 2000 and 2006



Source: Kenya Investment Authority (KIA)

Kenya doesn't keep a complete data on the absolute value of foreign investment by sector and industry. According to UNITAD (2000), the sectoral analysis of the 600 projects with the foreign participation that the Investment Promotion Centre (IPC) registered between 1997 and 2004 does not show the list of all foreign investment in the nation. Foreign investors are not allowed to liaise with the IPC and many of these projects are not well implemented. Foreign participation in the economy has been separated with other manufacturing in other sectors amounting to half of foreign investment recorded by IPC. Other manufacturing includes a wide variety of basic consumers and investment products. Other sectors include services such as assembly and trading, transport and construction. The biggest sectors to note are in tourism, power generation, agriculture, and agro-processing.

With close to 70 percent of flower production owned by foreign nationals, foreign investors play a very key role in horticulture and floriculture. Foreign Investors have also been in the best part

and applauded for the remarkable progress of the sector. A Dutch company, Dansk Chrysanthemum and Kultuur (DCK), previously one of the largest producer of chrysanthemum cuttings, was the first to set up a large flower firm in 1969. With the benefit of the government incentives and Dutch government grant, this Dutch company now stands as a leading horticulture player with over 4000 workers.

FDI in manufacturing has concentrated a lot on consumer goods sectors, such as the food and beverage industry. Due to preferential treatment from AGOA, there has been the rapid growth of garment sector in the recent year with out of 30 companies producing garments for the US market, 20 are fully owned foreign investments. 80 percent of FDI in the past several years has been represented by around five AGOA-related investments. The dominance of garments- related FDI is of big concern as it may not be sustainable although these investments have increased employment and exports as we think. Foreign firms have entered to take advantage of the quota and duty-free access to the United States which is said to be available. With the clearance of remaining quotas in 2004 and trade integration in textile and clothing under the normal World Trade Organisation (WTO) rules, China, and other Asian nations are likely to supply a large part of the US apparel market owing to their cost and quality advantage over many nations including Kenya.

A good number of foreign investors have long established their enterprises in Kenya. Most of these firms were created basically to provide services to goods producing and to capture domestic market opportunities. Due to its higher quality of human resources, it must be noted that a group of service providers comprising in the accounting, auditing, taxation, banking, consulting, advertising, construction, legal and architecture sectors use Kenya as their investment regional hub. With the latest global drive in the service industry, Kenya's mighty strength in the region in terms of skills

and human resources has led to a significant opportunity for foreign investors willing to invest in the country. At first, market seeking has likely contributed to FDI in service industry while Kenya is well situated to serve as regional efficiency and excellence center which might also help in attracting some globally efficiency-seeking FDI in different fields, particularly under its Export Processing Zones (EPZ) Schemes. Due to the high demand of foreign investment in the service sector, Tourism, Financial and Business services, Telecommunication, Banking services has been a key concentration of FDI in service sub-sectors. Tourism has been a magnet for foreign investment due to its diversified investment fields within the sub-sector. Tour companies are dominated by foreign investors such as United Touring Company (UK), Express Travel (US), Abercrombie and Kent (UK) and Pollmans (Germany). The biggest projects are in the establishment of hotels and lodges for safari and coastal tourism. A number of major international hotel chains are present, including Hilton, Intercontinental, Serena, Block hotels and Holiday Inn with new trends have been timeshare holidays and ecotourism.

Kenya has also attracted foreign investors in banking and professional services. Companies such as Deloitte Touche Tohmatsu, Ernst and Young and KPMG base their main East African operations in Kenya. Thirteen of the 43 banks in Kenya are foreign, controlling 51 percent of total banking assets in the country. The biggest are Barclays (UK) 21 percent of assets, Standard Chartered (UK) 14 percent, Citibank (US) 7 percent and Stanbic (South Africa) 2 percent. Two of these international banks (Barclays and Standard Chartered) dominate commercial banking along with the state-controlled Kenya Commercial Bank.

Foreign Investors have been involved in the telecommunication sector through their shareholding in the two mobile phone operators and the purchase of licenses in1999 and 2000. Safaricom is 40 percent owned by Vodafone of the United Kingdom.

There have been several initiatives aimed at investment for export purpose mainly by foreign enterprises. In 1987 and 1990, the government introduced a Manufacturing Under Bond (MUB) scheme and created EPZs respectively. These schemes lured little foreign investment until the accession of Kenya to AGOA in 2001. However, by 2003 it has been confirmed that most foreign investment in manufacturing since 2001 has been in the EPZs with the majority having 60 percent of total EPZ investment in AGOA related textiles. There were 55 foreign or joint-venture enterprises as well as 11 fully domestic companies operating in EPZs in 2003. EPZs have expanded from their initial textiles focus to also produce a number of other goods although the domination of garment remains very strong.

The impact of foreign direct investment is clearly evident in different sectors of Kenyan economy with FDI playing a vital role in introducing knowledge and technology in the floriculture and horticulture. This has enabled the sector to become a key leading exporter of high-quality products to the European market. Farms have invested a large amount of capital required estimated at US$50000 per hectare to create a world class facilities. Basic costs entail land preparations, creating irrigation schemes, greenhouses, refrigerated storage and staff welfare facilities. Processes are becoming increasingly complex. Steel and aluminum greenhouse structures are rapidly replacing wood, and growers are paying more attention to the use and quality of inputs.

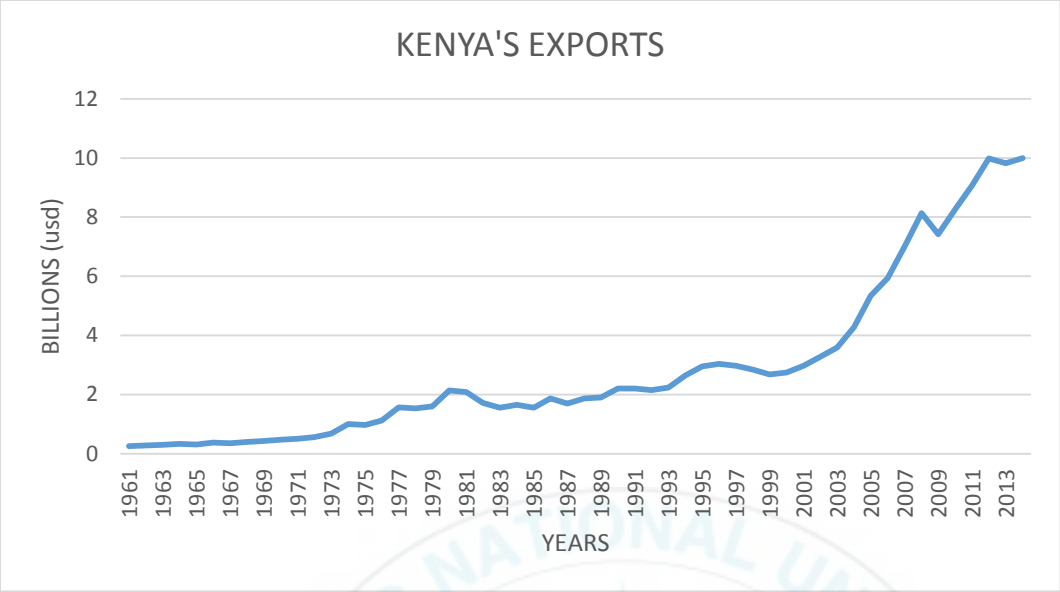
FDI has been the source of transfers of skills to domestic workers. This has been possible due to the reliability of high level of general education leading to good trainability of employees. The government imposes an understudy programme for each foreign employees recruited by foreign investors with the objective of replacing the expatriate with a local employee in the medium term. Foreign firms have often moved beyond the local requirements and initiated training to their employees on a wider basis. There is a high level of responsibility given to local staff by providing

ongoing training programmes in order to enable them to occupy top management position. Multinational Corporations in the country are attributed to having only a few appointments often managing directors or chief executive officers and finance directors occupied by expatriates.

2.4 Export Performance in Kenya.

The following key issues can be attributed to the export growth performance of the Kenyan economy such as; Kenya benefits a lot from its different categories of export items although it depends highly on primary products. Second, exports grew steadily since 1990s whereby they can be characterized by numerous factors such as devaluation of Kenyan currency in the 1990 which allowed exports to become more competitive. Liberalization in the investment policy, as well as liberalisation of the market after 1992, lured local and foreign private investment which assisted in the reduction of biases against exports. Partly due to economic crises and poor government practices in the mid-1980s and 1990s that became unfavourable to export production, the growth of Kenya's exports became very slow.

Graph 3: Trend of Kenya's exports



Source: Data collected from World Bank Development Indicator.

According to UNCTAD (2002), this may be attributed to improved earnings from Tea and coffee boosted increasing global prices. The non-manufactured good mainly dominate Kenya's exports which account for over 20 percent of Gross domestic product (World Bank, 2005).Six major items includes Coffee, tea, Horticulture , Pyrethrum, limestone, leather, cotton and soda ash which dominate primary exports. It is very crucial to mention that climate changes may also significantly influence the output variation for the primary agricultural goods since Kenya is a typical agricultural nation. Growth in merchandise exports has been the key influence in the growth in Primary exports which stood over $8000 million in 2008 up from around US$2000 million in US$2000 1995-1996.

Additionally, goods manufactured for export in Kenya is still at its early stage representing less than 10 percent of the GDP (World Bank, 2014). The modernization and growth industrial manufacturing sector has been hindered by key factors such as; lack of capital, poor and limited

infrastructure, and inadequate skilled labour and above all administrative malpractices thereby, the manufacturing sector has mostly concentrated on food processing, chemicals, textile and leather, electrical industries, brewery, wood and rubber, metal and mechanical engineering on a light and intermediate scales. Heavy firms like automobiles are missing.

As already noted, Kenya has acquired reasonable success in penetrating regional markets. The nature of exports to market is in correspondence with Kenya's industrial aspirations. Participation in export activities has become more coordinated than before. Through improved coordination and harmonization of trade related activities country wide, trade organisations that form the Kenya trade network such as Kenya Association of Manufacturers, Kenya National Chamber of Commerce and Industry, Fresh Produce Exporters Association of Kenya and others work very closely together in order to ensure greater discipline and enforcement of industry codes of practice. The Export Promotion Council (EPC) continues to aid set up sector trade organizations.

The most recent include the Association of Fish Processors and Exporters of Kenya (AFIPEK) and the Association of Makers and Exporters of Gifts and Allied Articles of Kenya (AMEGA). The EPC in conjunction with other stakeholders continue to encourage and promote the development of sector specific codes of practice for the purpose to ensure effective adherence to ethical business practices. The nation has developed comparative advantage relative to her neighbours and regional trading partners in areas such as machinery, steel and iron products, clothing, cotton fabrics, footwears, glassware, polishes, creams, and plastics. The rapidly growing 'Jua Kali' sector (informal sector) demonstrates the nation's entrepreneurial talent and the potential small and medium enterprises (SME's).

According to Export Promotion Council (EPC)' 2012. Kenya's main export markets are in Europe in general and the European Union in particular. The two account for about 58 percent and 33

percent of the exports respectively followed by COMESA with 27 percent, the rest of Africa with 17 percent, the East Asia with 3 percent, North America with 1 percent and the rest of the world with 15 percent.

There have been restless efforts to diversify export markets and some products have successfully penetrated these markets. United Kingdom is the biggest destination of Kenya's exports, although new markets have emerged such as South Korea, Middle East region, Japan, Austria, Singapore, South Africa, USA, and North African region. Regional markets are becoming increasingly vital especially for the low-value crops (beans, maize, bananas, and dairy products like cheese, milk, butter, manufactured goods including plastics, batteries, textiles, bicycles, aluminum products, school materials, and mattresses etc.

Kenya has acquired reasonable success in penetrating regional markets. The nature of exports to this market (manufacturer) is in conformity with Kenya's industrial aspirations. Participation in export activities has become more coordinated than before. Through improved coordination and harmonisation of trade related activities nationwide, trade organisations that form the Kenya trade network such as Kenya Association of Manufacturers, Kenya National Chamber of Commerce and Industry, Fresh Produce Exporters Association of Kenya and others, work very closely together. In order to ensure greater discipline and enforcement of industry codes of practice, the EPC continues to help set up sector based trade associations.

The most recent include Association of Fish Processors and Exporters of Kenya (AFIPEK) and the Association of Makers and Exporters of Gifts and Allied Article of Kenya (AMEGA). The EPC in conjunction with other stakeholders continue to encourage and facilitate development of sector specific Codes of practice for the above purpose to ensure effective adherence to ethical business practices.

The focus on Kenya's export strategy at the present moment revolves around the following vital issues such as targeting of investment to increase supply constraints and frequent price volatility in the world markets, sustainable attraction of FDI and greater output of high quality manufactured export goods to promote gradual shift from reliance on inelastic commodity markets and addressing issues of quality and value addition on one hand and cheap substandard imports that continue to flock in the market affecting manufacturing sector.

Generally, Kenya has two different market positions in her export initiative. First, to the EU, Asian markets and the rest of the developed world countries, it is a key supplier of food and agricultural products, while to the Comesa region and neighbouring countries, it is an industrial exporter.

The country has developed comparative advantages relative to her neighbours and regional trading blocs. The connection with foreign investors has been most significant between agro-processing investors and the huge local agricultural sector. Out-growers are used extremely by horticultural packages. Exported fresh vegetables and exported fresh fruits account for 25 percent and 85 percent respectively of the purchases by leading exporters from shareholders.

The nation's leading horticultural producer such as Homegrown for instance, uses around 1,000 out growers. Due to its good support policy, the company provides it's out growers with the seeds in order to produce more for export purpose. It also provides technical expertise and training necessary to produce a more high-quality product and supplier linkages in manufacturing,

2.5 Platform FDI on exports.

Generally speaking, there are three distinct export-platform FDI which shed some light on the motivation of FDI and their intention in exporting. According to Mwanga, 2002, the situation where MNEs subsidiaries export their products back to their home countries is defined as a home

nation export platform FDI. Moreover, the situation where foreign production is only exported to developing countries and the situation where foreign production is exported back to both home and developing countries is called a third-nation export-platform and global export-platform FDI respectively.

The concept of home nation export-platform FDI is quite straightforward, Home-nation export-platform FDI occurs when the final good producer is located in the home country and their production unit of intermediate inputs is located in different countries. Additionally, exports of intermediate good are created which flow from the host nation to the home nation (Antras and Helpman, 2004). This type of activity forms the vertical-type FDI (backward linkage of resource-supplying).and intra-firm trade. The vital point to note is that the intra-firm trade accounts for one-third of the world's trade (Pugel, 2004). The volume of exports from the host country may be significantly large when MNEs take integration strategies between parent and affiliate firms (UNCTAD, 1999).

The difference in behavior between the home-nation export-platform FDI, third-nation export – platform FDI and global export-platform FDI can clearly be separated by adopting three-region model which is developed by Ekholm et al 2005. The three-region models are developed based on two settings of external condition that is free trade agreement and trade costs of intermediate products. Moreover, in this three- region model there are two similar regions with large markets and their firms A and B are collectively referred to as North (north). The third region is a small and low-cost nation which is represented by S (south) and there is a free trade agreement between firm A and the small and low-cost country in the south.

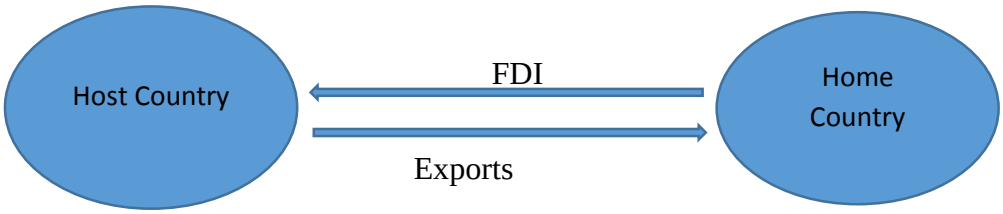
The model shows that firm B has a strong ability to export final products from the South compared with firm A. In other words, firm B's production and their exports from the South can indirectly

enjoy the preferential treatment from the free trade agreement between the South and other countries. Therefore, firm B's investment (final goods production) in the South is inclined to be a home- country export-platform FDI for producing intermediate products rather than producing final products in the South because they face a higher cost to trade with the third-country.

Additionally, two firms export activities (home, third or global markets) are different when taking the trade cost of intermediate products and assemble final products into account. Firstly both firms A and B are likely to undertake third-country export-platform FDI in the South when the South country has a relative cost advantage. Secondly, the two firms will undertake the global export-platform FDI once the trade cost is quite low, which is a large cost advantage in the South.

How Kenya fits into any of these three export-platform FDI models is subject to the different nationality of FDI. Overall, FDI inflows in Kenya is inclined to the third or global export-platform FDI because the intention of foreign companies production in Kenya is to acquire cheaper labour for lower manufacturing cost in the infant stage of Kenya's economic development. Consequently, foreign firms have generally used Kenya as an export platform in their worldwide network (Schive and Tu, 1991).

Figure 3: Home country Export-Platform FDI

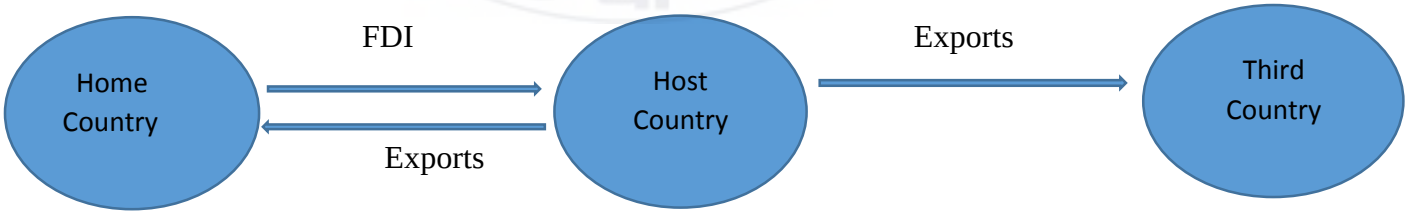


Source: Shao-Wei Lee (2007)

Figure 4: Third country Export-Platform FDI

Source: Shao-Wei Lee (2007)

Figure 5: Global Export-Platform FDI



Source: Shao-Wei Lee (2007)

2.6 Determinants of Exports

According to UNCTAD 2014, a number of factors affect export performance in third world countries. These are discussed as follows;

Foreign market access which represents the foreign market potential of a nation and is larger than market access relates directly to the features of the trading partner nations such as the market size and infrastructure facilities. Foreign market access also positively depends on the size of the export basket and the group of diversified items and their prices which are caused by the market entry condition. The impact of foreign market access is negatively affected by trans-border cost which includes both tariff and non-tariff barriers.

Supply capacity is also one of the reasons as to why the third world nations are often not able to take up chances for trade under preferential trading systems such as the Generalised System of Preferences (GPS). The key features of supply capacity include factors affecting the cost of production and internal transport costs. The latter are strongly linked to local market and the institutional structure. The macroeconomic indicators including factors such as GDP also have a vital role in modeling supply capacity of the economy. The main determinant of supply capacity can be split down into four different elements as discussed below;

Firstly; the size and the growth of the supply capacity of the nation and the local transport infrastructure depend critically on the availability of physical infrastructural development, all the way from roads, rails and ports to energy and telecommunication. From the study conducted by UNCTAD by using internal transport infrastructure as a proxy for infrastructure as a whole concluded that internal transport infrastructures are likely to play a key role at the infancy stage of the export sector development. Many African nations are faced by poor infrastructural development and are found in all years to perform very poorly in the export of good and services

to other countries. This clearly shows that by investing more in infrastructural development, African nations could raise their supply capacity.

According to the study conducted by Limao and Venables (2001), they observed that some analysis showing that the levels of trade flows for African nations are extremely low especially due to poor infrastructural development particularly for landlocked nations due to their geographical settings. Simply because there has not been a considerable investment in the infrastructure in these nations for a very long time could explain their very low upward movement in export performance.

The effective exchange rate which indicates the relative movement of prices at home and abroad has important effects on the export growth performance of the lowest performers. Results from many scholars for all periods found that an overvalued real effective exchange rate is harmful to export performance while on average a 1 percent depreciation in real effective exchange could raise exports by 6 to 10 percent. This results to the significance of the pursuit of productive gains to maintain outside competition. The study found out that an over-valued currency resulting from fixed exchange rates that are used as a nominal anchor to control economic pressures as a result of inflation converted into a direct loss of price competitiveness for exporting firms.

This was notably important for labour-intensive commodities which are important components of the export baskets of weak export performers denoting the likely overvaluation of their real effective exchange rate. Good export performers, on the other hand, are more dependent on capital-intensive production relative to weak performers. Good export performers, therefore, are in a strong position to produce diversified product due to sophisticated capital intensive good and may face lesser aggressive competitors than exporters in more labour-intensive product markets. This competitiveness within the market can be expected to be less sensitive.

Dierk Herzer et al in examining the long-run relationship between exports and imports in Chile from the period 1975-2004 using the unit root tests and cointegration techniques that allowed for endogeneity determining the two variables. His findings show that there exist a long run relationship between Chilean exports and imports.

The results from UNCTAD (2002) indicated that Foreign Direct Investment is likely to positively affect export performance in every nation. This is also likely to be true in most levels of export performance and for every period under consideration. The investigation carried out in a number of countries argued that FDI strongly contributes to the changes in the composition of exports. For example China and Singapore have added to significantly increase the technological content of exports through foreign direct investment inflows by strongly encouraging the development of export supply capacity such as knowledge-based industries.

Consistently for all these experiences, the relationship between FDI inflows and export performance to capital formation is found to be positive and significant at all levels of export performance in studying third world countries. At infancy stage of export development, FDI relates closely to exports but the relationship later becomes weaker as export development advances only to become stronger again at later stages of export development. The structure of the sector is a vital ingredient of export performance both at the infancy stage of development of the export sector and a later stage where FDI promotes the technological upgrading and structural evolution of the export sector. It could, therefore, be said that inter-sectoral diversification among poor performers and intra-sectoral diversification among better performers positively affect export performance in a case whereby FDI would seem to direct towards innovative activities within an already existing sector.

Secondly, some studies assessed institutional factors and found out that an important role for institutional quality could have been expected at an infancy stage of export sector development but it found this to have been true only for the period 1988-1991. This might have been explained by the problems in isolating the promotion of institutional factors such at such a stage due to the likelihood of their being closely related to the general macro-economic environment and the promotion of FDI, although there was no concrete statistical evidence of multi-colinearity among independent variables. The analysis of the findings, however, seems to show that institutions are very important at a higher level of export performance. The results suggested that what seems to be vital in the overall growth process was only partially true for export performance. This evidently seems to suggest in export development processes, institutions, and macro-economic variables are likely to be substitutable.

2.7 FDI and Export Performance

Besides reforms on the economic front carried out by nations in Africa and the immense increase in the inwards FDI, countries from Africa have been experiencing growth in the exports value during the nineteenth century. Although Uganda and Kenya arrived at an impressive growth in exports during that last decade, with other countries in Africa such as South Africa improved their export performance during the nineties in contrast to the eighties. In the recent years, Kenya's economy has been doing well, although she had inferior export growth during the nineties owing to the economic recession.

According to the UNCTAD (2002), success in export-related industries of the East African countries submit that FDI inflow is an influential tool for promoting a nation's exports because the relative technology dominance of MNCs helps local companies either directly or indirectly, mostly when it comes to technological advancement and offers access to the international market to export.

However, the achievement efforts of these countries can't be generalized to nations of the East Africa due to the slow market reforms, inappropriate infrastructure and poor structural reforms (Srinivasan, 2008). The key guideline of inward FDI in the promotion of exports depends highly upon the purpose of the investment. If the purpose of investment is to secure local market because of the high cost of trade and tariffs, then rise in the host country's export may not be realized due to the rise in FDI inflow. Additionally, if FDI is driven by make use of cheap inputs such as labour or comparative advantage of the host country, then the increase in inward FDI causes the increase in the level of export by capitalizing on those factors of production.

Experiential valuation of the role that FDI inflows play to the export performance of the host country is vital. As a result it evident for a very long period that exports of products is the basis of economic growth. This is a broadly collected evidence that FDI promotes exports of host nation by increasing domestic capital for exports, help in technology transfer and new products for exports, upgrading in the field of technology and management, enabling easy entry to the new and huge global markets and lastly offer training for the local workforce.

Conversely, the critics of FDI argue that FDI could possibly substitute domestic savings and investment, knowledge and technology transfer that are not suitable for the host nation's factors endowments. Many target largely the domestic market of the host country and therefore do not lead or promote export growth, with other FDI hindering the growth of infant domestic companies that might have become exporters and finally they don't aid to develop the host country's dynamic relative advantages because they focus especially on cheap labour and raw materials from the locals. Whereas extra hypothetical comprehensions would be valuable with experimental studies of the issue being desirable as well for the improved understanding of the link between FDI and Export (Blomstrom, Kokko, and Zejan, 2010).

According to Hoekman and Javorcik (2006), the merits of global economic integration have become progressively manifest over the last times. The augmented flow of goods, services, people, and investments transversely international borders had promoted many third world countries to realize fast and constant economic growth. Many economic observers argued that FDI has been a vital component in promoting economic growth for the third-world countries by facilitating the transfer of knowledge and technology that is techniques and skills from industrialized nations.

According to Blomstrom and Kokko (2003), if the MNEs introduce either process of manufacturing or new commodities in the host nation, local firms and even some other MNEs benefits from a rapid dissemination of new technology because of labour movement between multinational enterprises and other domestic firms. There is always employees' turnover for every organization and when these employees move from this MNEs to other companies, they move with their experts, knowledge, and skills obtained from the other MNEs. This results in a greater competition in the market. When MNEs cannot realize all the benefits as a result of the activities they engage in, in a foreign nation owing to the public upright moral traits of their company's exact assets then this results in a spillover effect (Srinivasan, 2008)

Naughton, (2006) conducted a study on the relationship between FDI and exports and it was discovered that export campaign though FDI is one of the main reasons as to why the government aspires to attract FDI. Inward FDI can direct capital to advance industries with the prospective ability to compete globally. The productivity spillovers to the firms that are supplying the goods and services might result in the exportation of products of higher value. These MNEs have the availability of inputs with higher-quality which results from FDI spillovers which is caused by growing of supplying firms which also benefit domestic manufacturers of final products and services and enabling them to uplift their exports.

A study conducted by Harding and Javorcik (2011) shows that there is corresponding evidence that suggests that FDI can aid un-developed-country faster with the world frontier. They argued that there are various explanations to why FDI contributes to upgrading the exports of the host nation. Firstly, the product that conglomerates exports have greater value, this is due to the fact that many MNE's have superior technology and superb technique in marketing and branding their goods.

Local firms operating in the same country learn a lot from these multinational companies thereby uplifting their technologies and ways of marketing thus upgrading their produce value leading to the upgrading of the value of the exports. According to Caves (2006), MNEs are well thought to be the linkage of the promote access to the global market by adding value to the export thus upgrading the export thus host nations may improve on its volume and value of exports by hosting FDI.

In the popular view, foreign investors in third-world nation mainly focus vividly on simple and low –added tasks so as to capture cheap labour cost and liberal controlling government. Others argue that this could widely open the gap of income earners between third-world nations and developed nations rather than reduce it.

Moreover, Srinivasan (2008) presented data showing that this argument is not short and clear. He demonstrated that the greater part of firm based FDI go into further radical industrial zones rather than the best common products, for example, these products include; shoes, clothing, and other operations which don't demand complex and more advanced skills.

In the real sense, those sectors that demand medium skilled techniques like automobile and automobile accessories, medical tools, scientific tools, industrial equipment, plastic products,

household electronics and electrical products attract up to about 17 times more FDI inflows than low skilled and labor-intensive industrial sector every year from 2002 to 2007. This high proportion of FDI in more skilled-intensive manufacturing had also increased for years. Inward FDI could then lead to the development of technological advancement in developing nation thus inspiring the growth of exports in medium-skilled sectors.

According to the study conducted by Kariuki (2008) confirms that inward FDI increases exports by improving and promoting the level of exports and that there exists a positive correlation between inward FDI and the level of the host country's exports.

The levels of corruption, low growth, and rising operation costs have hindered foreign investment in the past decades although the stamina and level of development of Kenya's economy relative to its neighbours attracted market-seeking FDI until the early 1980s. Nevertheless, due to industrial sector that remains more developed and has a longer history than in neighbouring nations, Kenya has the potential to draw on its assets, including a relative high level of human capital, financially strong and globally competitive companies, and one sound infrastructure network to lure higher levels of FDI and sustain strong economic growth. However, this is unlikely to happen without forceful and sustained economic reforms.

CHAPTER III: LITERATURE REVIEW, THEORETICAL CONSIDERATION, AND HYPOTHESIS.

3.1 SURVEY OF THE LITERATURE

In order to attain the truth to support the theoretical relationship between FDI inflows and the host nation's export performance, various attempt have been made in the scholastic world to show the relationship from the host nation aspect. Since the results may vary across distinct geographical settings according to the regional, social and economic units, the review of literature in this section can be discussed below in the order of the year of publication.

The study conducted by Hood and Young (1979) investigated the role of multinational enterprises in exporting manufactured goods from Less Developed Countries (LDCs) in the 1960s. They argued that there is a mixed relationship between FDI inflows and exports in the LDCs and developed nations. Multinational companies' exporting capabilities in the developed nations is stronger than in the developing countries. In other words, multinational enterprises help the host nation to expand their manufactured exports in developing nations, but this ability is relatively smaller as compared to the ability of MNEs in the developed countries. They further argue that the extent of the contribution of FDI inflows on the host nation's export performance is dictated by the host nation's government policy but does not simply depend on FDI itself.

Kojima (1985) is one of the earliest Japanese scholars to investigate the difference between Japanese FDI and American FDI in for Newly Industrialised Countries (NICs) i.e. Taiwan, South Korea, Hong Kong and Singapore and four large ASEAN countries in population i.e.s Indonesia, Philippines, Malaysia, and Thailand. He later found out that Japanese-type FDI is trade-oriented (export creating) because the main objective of the Japanese FDI is international division of the

production process. This is especially true in the Newly Industrialised Countries (NICs). On the other side, American-type FDI is MNEs-type FDI which is relatively opposite of trade-oriented. This is because many large American conglomerates prefer to invest in profitable industries in the host country which aim at global operation and seek global profits.

Moreover, Okello (1994) on Japanese-type FDI and American-type FDI in Kenya is criticizing that both American-type FDI and Japanese-type FDI have a positive impact on exports by looking at the high export ratio created by both Japanese and American FDI at around 40 to 50 percent. This high exporting ratio by Japanese FDI and American FDI is due to the highly selective regulations on FDI. Nevertheless, export-oriented foreign investment is especially welcome for the Kenyan government because they utilize the plentiful supply of Kenya's labour force and they view Kenya as an export hub.

According to the study by Lin (1995) in the investigation of bilateral trade effect of FDI between Taiwan and each of the four ASEAN nations (Indonesia, Malaysia, Thailand and Philippines) from 1981 to 1992. Lin noticed that cumulative FDI from Taiwan to those ASEAN nation increase their export back to Taiwan.

Jun and Singh (1996) analysed the determinants of FDI for 31 Less Developed Countries (LDCs) from 1970-1993 using pooled cross-country ad time series model together with Granger Causality test to test to examine the causal relationship between FDI and exports for part of sample countries. The key results is the opposite of much other empirical evidence. They argued that the direction of causality is mainly from exports to FDI particularly for high FDI recipient nations. They further suggest that export orientations particularly from manufacturing exports are ranked as the strongest explanatory variables for attracting FDI.

According to Leichenko and Erickson (1997) in the investigation of the causal relationship between inward FDI in manufacturing sectors and manufacturing export performance based on the US states level during the period 1980-1991. The analysis shows that FDI inflows has a positive impact on the future state manufacturing exports performance.

Seo (1997) investigates the causal relationship between FDI inflows and export performance in South Korea and Taiwan from 1952-1994 respectively by using granger causality test. The results shows that there is no causal relationship between FDI inflows and exports at all levels of all industries and all manufacturing industries in South Korea, On the other hand, Taiwan shows one way causal relationship which flows from inward FDI to export performance is confirmed at all industrial level and two-way causality between FDI inflows and export performance is found at all manufacturing industries level.

Khan and Leng (1997) examines the interaction among FDI inflows, export and economic growth for Taiwan, Singapore, and South Korea respectively at the aggregated level during the period of 1965-1995 by using Granger Causality test. They noted that there is no evidence to support the causal relationship between FDI and exports in South Korea and Taiwan. Nevertheless, one-way causal relationship which flows from exports to FDI inflows is found in Singapore.

Mucchielli and Soubaya (2000) investigates the determinants of the volume of trade of the French multinational enterprises. The main findings suggest that FDI inflows have a positive influence on foreign trades which includes exports and imports and this positive influence is stronger for exports compared with imports.

Zhang and Song (2000) examines the performance of FDI inflows on Chinese manufacturing exporting companies at the provincial level during the period 1986-1997. The findings show that

FDI has a stronger influence on the export performance. Zhang and Felmingham (2001) examine the causal relationship between inward FDI and export performance based on Chinese national and provincial level including Chinese coast, central China, and Western China regions from 1986-1999. The results point out that there is a two-way causality between inward FDI and exports at the national level. Similar results of b-directional causal relationship are illustrated in the coastal region and Western China which are high FDI recipients and low FDI recipients respectively. Moreover, the existence of one-way relationship which flows from exports to FDI s found in Central China a medium FDI recipient.

Hejazi and Safarian (2001) illustrated the relationship between international trade and FDI between the US and 51 economies from 1982 to 1994 by using the Gravity model. The findings show that US exports performance is positively explained by inward FDI. Additionally, Liu et al (2001) investigate the causal relationship between inward FDI and foreign trade including both exports and imports between China and 19 economies using the Granger causality test in the period of 1984-1998. He discovered that the growth of imports in China leads to growth of inward FDI in China which in turn leads to the growth of exports from China to the home nation of FDI.

Sun (2001) investigates whether FDI encourages China's export performance at the provincial level across these different regions by using the Time-Series and Cross- Section models for the period 1984-1997. Right from what had been discovered by Zhang and Felmingham (2001), Sun points out that inward FDI plays a vocal role in the coastal region than the Central and Western China. Liu et al (2002) examines the causal relationship between FDI inflows, trade and Economic growth in China at the aggregate level from 1981-1997 on a quarterly basis. A two-way causal relationship between FDI inflows and Exports is found.

Liu and Shu (2003) examines the determinants of China's export performance by testing FDI inflows, firm size and labour cost based on cross-sectional data at the industry level. They argue that China's export performance at the sectoral level is significantly influenced by those independent variables. Sharma (2003) investigates the inwards FDI on Indian export performance during 1970-1998 by using the Two-stage Least Square (2SLS) model. Sharma argues that FDI in India has no significant impact on exports. Alici and Ucal (2003) examines the causal link among inward FDI, exports and economic growth in Turkish economy during the period of 1987-2002 on a quarterly basis. He didn't find the linkage of FDI-led export growth in the case of Turkey.

Ekanayake et al (2003) investigated the relationship between output level, inward-FDI and exports across the developed and developing nations (Canada, Chile, Brazil, Mexico and the US from 1960-2001 by using Granger causality test. There was no consistency across these nations in his findings. Moreover, a two-way causal relationship between inward FDI and exports is found in the US and the existence of the one-way causal relationship which flows from the exports to FDI is found in Mexico and Brazil.

According to Metwally (2004) test on the relationship between FDI, exports and economic growth in the three Arab League countries including Jordan, Oman, and Egypt respectively from 1981-2000 by using Simultaneous equation model. The findings suggest that the export of goods and services is strongly determined by the FDI inflows in these three countries.

Baliamoune-Lutz (2004) tests the causal relationship between FDI, exports and economic growth in Morocco from 1973-1999 by using the Granger causality test. The findings show that there is a two-way causal relationship between FDI and exports at a national level.

One may notice that most of the studies conducted in China show that there is a causal relationship which flows from FDI inflows to exports. However, this results is argued by Zheng et al (2004). They examine the impact of FDI on the export performance of Chinese indigenous firms and all firms (both indigenous and foreign) respectively at the provincial level from 1985-1999. By using three statistical models, Pooled ordinary least square (POLS), Fixed Effect Model (FES) and Random Effects Specification (RES), the results imply that; FES model suggests there is no evidence to support their major hypothesis that FDI promotes export performance at the level of all provinces and coastal province. The reason is suggested to be the uneven distribution of FDI throughout the provinces and the nature of the model.

Pacheco-Lopez (2005) illustrates the causal relationship between FDI inflows and export performance in Mexico by using the Granger causality test. The results show that there is a bi-directional causality between FDI inflows and export performance. Zhang (2005) investigates the role of FDI on Chinese export performance. The examination is not only the estimates of the full sample of companies but also labour intensive and capital intensive industries. The results imply that FDI has a strong influence on export performance in China at the industrial level. Additionally, export performance in labour-intensive industries is positively and largely affected by FDI inflows and export performance from capital-intensive industries is less affected by FDI.

Vuksic (2006) investigates the impact of FDI inflows on 21 branches of Croatian manufacturing industries from 1996-2002 by taking into account local investment, FDI stock, and other explanatory variables. The results show that FDI positively affects Croatian manufacturing export performance, however, the effect is relatively low compared with the other explanatory variables.

It is clearly evident that theories such as the Flying Geese (FG) model, Vernon's Product Life Cycle (PLC) model and new growth model are devoted to explaining the phenomenon of the FDI

inflows and its positive attributes on the host country's export performance. First and foremost, the flow of FDI in the FG model reflects a host country's comparative advantages of plenty of cheaper labour and resources. The cheaper manufacturing costs of foreign firms' production in the host country enhances their exporting capabilities since the price of goods and services is competitive in the global market. Secondly, although low wage labour is attractive for FDI, not all foreign firms will undertake FDI in those countries for domestic consumption. In the meantime, the surplus of production will be able to serve the emerging market outside the host nations including foreign firms' home nations as well. Lastly, FDI is considered as a catalyst and a tool for local investment. FDI stimulates domestic industries to inject more investment to the country in order to reduce inefficiency and improve the quality of products. Consequently, the host nation's export expansion is expectable through tangible and intangible advantages of FDI.

In harmony with theoretical consideration of the relationship between FDI inflows and the host country's exports, a positive attribute of FDI inflows on host country's export performance is widely accepted (Vuksic, 2006; Zhang, 2005; Metwally, 2004; Liu and Shu 2003; Sun, 2001; Hejazi and Safarian, 2001; Liu et al, 2001; Mucchielli and Soubaya, 2000; Zhang and Song, 2000; Leichenko and Erickson, 1997; Seo 1997; Liu, 1995). The relationship between FDI and exports may appear to be a two-way causality (Pacheco-Lopez, 2005; Baliamoune-Lutz, 2004; Ekanayake et al, 2003; Liu et al, 2002; Zhang and Felmingham, 2001; Seo, 1997) and it is possible to have one-way causal relationship which flows exports to FDI inflows (Ekanayake et al, 2003). Zhang and Felmingham, 2001; Khan and Leng, 1997; Jun and Singh, 1996. However some evidence have taken a position declaring that the positive relationship between FDI inflows and exports is not yet found.

Most studies examined here generally lean towards a positive impact of FDI on the host nation's export performance but inconsistency in time and nation furnishes a barrier against the positive relationship flowing from FDI inflows to exports. The results on this issue are mixed and inclusive (Zhang and Felmingham, 2001, Zhang, 2005). In the case of Taiwan, several studies Chien, 2001; Seo, 1997; Khan and Leng, 1997) have examined the linkage between FDI inflows and exports. However, these studies do not produce a uniform result of the causality. Moreover, the time period of all these examinations is up to the early 1990s. No empirical study has been done on the causal relationship between FDI and exports for the period 1952-2005

While the positive influence of FDI benefits to the host nation's, the introduction FDI policy and trade reforms may create some other benefit to the Taiwan market economy as a whole, In the next chapter we will present the discussion of the Kenyan economy including the complete economic performance since 1961, with the main vital macroeconomic indicators and some social indicators as well.

3.2. Theoretical discussions of the impact of FDI on exports.

In this chapter, a number of theoretical frameworks entailing the possible impact of FDI inflows on the exports of host nations will be discussed

3.2.1 Flying Geese (FG) Model

The flying geese model was first initiated in the early 1930s and brought into the study in early 1960 by Akamatsu (Lee, 2007). According to the study conducted by Asian Development Bank (ADB, 2005) suggested that trade openness and labour cost are the most crucial elements in this model. Asian Development Bank (1999) argues that FDI has moved to lower labour cost host nations from higher labour cost home nations. This can also be referred to as resource seeking FDI

which explains the idea of investing in a host country's market in order to achieve cost-minimization motives by obtaining resources which are either too costly to obtain or unavailable in the home-market of the multinational enterprise. This implies that as the lowest labour cost host nations develop and they become high labour cost countries for a new creation of low labour cost host nations (Lee, 2007). The explanation of this model is that Multinational companies' subsidiaries use the host nation's factor endowments to produce at a lower cost thereby raising the host nation's export performance. According to ADB (2005), the enhanced export competitiveness of the MNEs subsidiaries directly increases the recipient nation's export supply capacity. Nevertheless, the transfer of Foreign Direct Investment also comes with the capital equipment, new knowledge and technology and manufacturing expertise into the host nations which has resulted in the provision and quality of factor endowments (Kwan, 1996). Therefore, according to this model, spillover effects of FDI are likely to contribute to the local firm's ability in order to produce more.

3.2.2 Product Life Cycle (PLC) Theory.

The product life cycle model commonly known as PLC was initiated by Vernon (1966) so as to provide a structure to discuss the rising FDI inflows from US multinational companies and its contribution on trade flows. PLC model is comprised of four levels of production which include innovation, growth, maturity, and decline. He argues that at the first level of production, US multinational companies tend to produce newly innovative products in the US mainly for consumption back at home without undertaking any FDI and the rest of the products are exported to serve the market abroad. Well, as the product advances to the growth stage and becomes high in growth and demand, the US Multinational companies start to undertake FDI and are inclined to enter into a joint venture investment so as to begin production in other countries. Consequently,

multinational companies' production at the growth level of the product life circle tends to seek domestic markets while in the meantime, foreign competitors begin to enter the market (Mwanga, 2008). Therefore the demand for exports of products from the US declines and the US consumers begin to purchase some of the good and services from the newly industrialised nations (NIC). At the maturity stage of production, the conflict emerges from cost-reduction for the producers. Most of the FDI which was allocated at the beginning in the advanced nations is shifted to other lower cost NICs. Apart from the domestic consumption, part of the production output is exported to serve the US and other global markets. Therefore the US and other developed nations have changed from being key exporters to importers. At the final level of production, minimizing the cost becomes the main effort for the MNCs production and the allocation of FDI will be vital to the countries having lower and even with the minimum production costs. MNCs production at this final stage of production captures not only the domestic market but also the US and worldwide.

3.2.3 New Growth Theory

This theory comprises of two vital components which include; First and foremost it shows technological advancement as an output of economic activities. Secondly, the new growth theory argues that increasing returns determine knowledge and technology and with these increasing returns enhance growth process. (Cortright, 2001). As a result, growth is endogenous in the new growth model rather than exogenous in the old growth model. It is argued that investment in human capital leads to increasing returns in the production function (Meier and Rauch, 1995). The more resources employed to the research and development, the faster the rate of innovation leading to higher rate of growth (De Castro, 1998).

The study conducted by Shan et al (1997), the capital accumulation FDI is expected to generate nonconvex growth by encouraging the incorporation of the new inputs and foreign skill and

technology in the production function of the FDI recipient countries. Additionally, the transfer of more sophisticated technology strengthens the host country's existing stock of knowledge through skill acquisition, labour training and the introduction of alternative management practices and organizational arrangements (De Mello and Sinclair, 1995). Consequently, inward FDI increases productivity in the recipient economy and FDI can be regarded as the catalyst for domestic investment and technological advancement (Shan et al, 1997).

3.3 Hypothesis

FDI inflows have a positive influence on the export growth performance of the Kenyan economy over the period of 1961-2014.

CHAPTER FOUR: MODEL SPECIFICATION AND DATA

4.1 Model specification

Following from literature review, we adopt selected variables as main factors or determinants of exports. This research adopts foreign direct investment because of deliberate government policy in attracting FDI inflows with the view of uplifting economic growth in general. The main interest is to find out whether FDI inflows have a positive effect on export performance. The study adopts supply capacity as a determinant of export performance measured by proxy of GDP because it is able to capture the productive capacity of the economy. The study also adopts from the macroeconomic environment, the real effective exchange rate which reflects the underlying movement of prices at home and abroad. This will help in understanding the changes in the value of the domestic currency affect exports.

Specification of the following models showing the relationship between exports and its selected determinants is crucial at this point.

$$\text{Log } EXP_t = \beta_0 + \beta_1 \log PGDP_{t-1} + \beta_2 \log REER_t + \beta_3 \log TLI_t + \beta_4 \log MKT_t + \beta_5 \log EXP_{t-1} + \varepsilon_t \quad \text{..... (i)}$$

$$\text{Log} EXP_t = \beta_0 + \beta_1 \log PGDP_{t-1} + \beta_2 \log REER_t + \beta_3 \log TLI_t + \beta_4 \log MKT_t + \beta_5 \log EXP_{t-1} + \beta_6 FDI_{t-1} + \varepsilon_t \quad \text{..... (ii)}$$

This study tries to take into action the impact of FDI on export performance using these empirical models. In these two models, this study tries to include proxy of the supply capacity for the recipient country that affects export supply capacity. Inward FDI data is used to factor in the spillover effects. The study also tries to include both variables in the same specifications to check whether FDI has an additional impact on exports beyond its impact on exports through the local

supply capacity variable. So as to check the impact of FDI inflows on exports, it is crucial that to control all other major determinants of exports in Kenya. The study uses a parsimonious model which takes into account some trade reform indicators.

The study employs the following model specification accordingly where; subscript t represents time and ε represent the error term. Within the two equations, the dependent variable is the real exports (EXP). The study estimates the models using Error Correlation Method procedure, simply because of dealing with time series data.

PGDP refers to the potential output which is considered to be the trend of real GDP and in this case is used as a proxy for the supply capacity of the country. This important variable is expected to take into account the impact of increased supply capacity as a result of FDI inflows. This indicated that an increase in the supply capacity of this year is likely to increase export performance (ceterius paribus). In adopting PGDP as an influencing variable of export, comes from Njong (2008) who investigated the impact of FDI on the export performance of Cameroon by using potential output which is the trend of real GDP in determining exports. The PGDP variable is used in the regression with one year lag because it is considered that it takes time before additional supply capacity is reflected in rising exports. It is expected that the coefficient $\boldsymbol{\beta_1}$ will be positive.

Supplementary regression of PGDP on FDI stock used to test whether and to what extent, FDI promote increase supply capacity.

Moreover, the standard macroeconomic theory argues, relative prices are vital in defining the nation's exports. Real effective exchange rate index is represented by REER. An increase in the real exchange rate means a real appreciation of the local currency; which makes the country's exports more expensive on the world market and leads to a fall in exports while a depreciation of

the real exchange rate will lead to exports being cheaper and increase a country's exports. It is believed that real effective exchange rate is the good predictor that would take into account the competitiveness of the Kenyan economy. Therefore, the empirical model includes REER to take into account the contribution of relative prices. Thereby, it is expected that the coefficient $\boldsymbol{\beta_2}$ will be negative.

TLI denotes the Trade Liberalisation Index which is calculated as the ratio of imports to total international trade (Bamou et al, 2006). Kenya depends highly on imports of capital goods and raw materials for its productions process and therefore imports have a strong effect on the export performance of the nation. Whenever there is the shortage of these import goods, then the export market suffers severely. Market Access Indicator is represented by MKT which is promoted by the export growth penetration index calculated as the share of exports to total international volume. These two trade related variables helps us to capture the potential impact of trade liberalization measures undertaken by the country. It is expected that the coefficients $\boldsymbol{\beta_3}$ and $\boldsymbol{\beta_4}$ in the equation to be positive.

EXP (t-1) represents lagged exports. The key reason of including this variable is to capture the fact that the export performance in one year would basically act as a good predictor of exports in the next year. The first equation is the benchmark equation and in the second model FDI inflow (FDI) is added to the first equation so as to test the spillover effects on exports.

The FDI variable is represented in the model with a one-year lag. According to the empirical results by Girma et al (2007) which show lags in the impact of FDI on adopted local companies explains the idea behind the variable. It also suggested that even for an export-oriented foreign investment one can assume that constructing a new plant and arriving at a desired level of production takes time. According to Barrios et al (2005) emphasises that the inward FDI are perfect choice than

aggregate FDI stock. Therefore it's the inward FDI that matters a lot. The same impact could possibly be arrived by using FDI stock but this would require using few lags of FDI variables thereby reducing the number of observation. Consequently, using FDI inflow with one year lag should help to alleviate the problem endogeneity when regressing exports on inward FDI (Girma et al, 2007). Therefore, it is expected that $\boldsymbol{\beta_6}$ will be positive.

4.2 Model

Johansen cointegration test

In testing for cointegration, the residual-based cointegration test of Engle and Granger (1987) and the likelihood ratio test of Johansen (1991, 1995) are the most used in applied econometrics. However, Engle-Granger is criticized because it assumes only one cointegrating relation between the variables. We therefore use the Johansen procedure which is based on a VAR model and assumes the possibility of more than one cointegrating relations between the variables. The Johansen cointegration test is a sequence of tests. The null hypothesis of rank (r) = 0 (i.e. no cointegration relationship) is first tested and, if rejected, subsequent null hypotheses (Ho: r = 1, Ho: r = 2, etc.) are tested until a null can no longer be rejected. The procedure implies enquiring whether any cointegrating relation exists at all, and in the affirmative finding out exactly how many can be identified.

Error Correction Model

After unit root and cointegration tests, we estimate the following error correction model;

$$\Delta EXPORT_t = C + \sum_{i=1}^{k} \alpha_i \Delta FDI_{t-i} + \sum_{i=1}^{k} \beta_i \Delta M_{t-i} + \sum_{i=1}^{k} \delta_i \Delta CPI_{t-i} + \lambda RE_{t-1} + \varepsilon_\gamma$$

Where RE_{t-1} is the error correction term (the speed of adjustment).

From this estimation, we draw a conclusion on the significance of the coefficient of FDI, which is our primary variable of interest.

4.3 Data

Data from a secondary source are used in this study. Most of these data are retrieved from numerous sources including; World Bank Development Indicators, the IMF International Financial Statistics, UNCTAD Handbook of Statistics, and Kenya National Bureau of Statistics (Department of the Ministry of Planning).

The period covered in the study is 1961-2014 using time series data so as to take into account the trade and investment policy reform measures undertaken by the nation since independence until the year 2014.

CHAPTER 5: ESTIMATIONS AND RESULTS

5.1 Results and Analysis.

Before progressing with the estimation, it's crucial to analyse the time series properties of the in each individual series. The most commonly used test for unit root in time-series is the Augmented Dickey-Fuller test (ADF, 1981). Firstly it is also important to substantiate the order of integration (or stationary) of the each variable using the Augmented Dickey- Fuller (ADF) unit root tests. If the absolute critical value is less than absolute test statistic then null hypothesis can be rejected. This means there is the presence of unit root or not stationary, thus accepting the alternative hypothesis means there is the presence of unit root meaning stationary. Therefore, the results of the ADF test and the statistical significance levels of the unit root test are shown in the table below.

Table 1

Augmented Dickey-Fuller

(ADF) Test

Absolute values

Variables	Levels	1st Difference	2nd Difference
Log EXP	1.0000*	0.0000***	0.0001***
Log PGDP(-1)	1.0000*	0.0000***	0.0000***
Log REER	0.9745*	0.0000***	0.0001***
Log MKT	0.7899*	0.0000***	0.0000***
Log TLI	0.8979*	0.0000***	0.0000***
Log FDI(-1)	0.0467**	0.05645**	0.0001***

Source: Estimated by Author

***, **, * represents statistical significance at 1%, 5% and 10% respectively.

In the above table, it is important not to reject the presence of unit root in the variables in levels, except for log FDI based on 5% significance level. In the attempt to look for unit root test in the first difference of the series, the results show the presence of stationary for all variables since all the absolute values of ADF are found to be statistically significant at 1%, and 5% significance levels respectively. Therefore, because differencing once produces stationary, it is clear that the series are integrated of order one 1(1).

Additionally, we check whether the residual for the model is stationary and if so then the model is no longer spurious so we accept the model. This also means that variables in the model are co-integrated and have a long-run relationship or equilibrium relationship among them.

Table 2.

Unit Root Test for Residual and Diagnostic tests

Unit root test	Probability Value	Diagnostic test	Probability value
ADF	0.02367**	Breusch-Godfrey LM test	0.0345**
		Jarque-Bera test	0.05234**

Source: Estimation by Author.

***, **, * represents level of significance at 1%, 5% and 10* respectively.

The test for unit root on the residual from the regression shows that the model is stationary and therefore we can reject the null hypothesis of the unit root test. This is true because the test for unit root using ADF tests found the residual to be statistically significant at 5%. For this reason, therefore we can confirm that the variables are co-integrated meaning that there is the absence of spurious regression on the levels of all variables; and we don't lose any meaningful information which might occur if we had used the first difference.

On the other side, the diagnostic tests for the co-integration model are acceptable. Breusch-Godfrey Serial Correlation LM test shows absence of serial correlation among all the variable. The model also passes Jarque –Bera test which implies that the residual is normally distributed.

Due to the above results, we can reasonably progress with the tests for cointegration relationships among combinations of non-stationary series. In order for us to understand the nature and direction of the relationship, we adopt the Johansen co-integration test. This enables us to establish whether there is a long run relationship between variables in our time series analysis.

Table 3

Johansen cointegration test results

Hypothesized No. of CE(s)	Trace statistics	0.05 Critical value	Probability value
None*	58.07883	46.58797	0.0002
At most 1	27.65687	29.76947	0,06787
At most2	14.77975	12.78797	0.05879
At most 3	8.67687	6.76686	0.05435

Source: Estimation by the author.

Using the T-statistic value in the above results shows one cointegrating vector, we then conclude that there is a long-run relationship.

This step is of a profound importance because as pointed out by Gujarati D. (2004), conducting regression analysis based on non-stationary time-series can lead to the problem of spurious regression and the problem can persist even if the sample is very large. Co-integration among integrates variables of order 1(1) implies the presence of a linear combination that yields a stationary series. Since the variables are non-stationary but cointegrated, we assume that estimating the first equation using Error Correlation Model can also help us detect spurious regression. The symptoms of spurious regression occur if the R-square value is greater than Durbin-Watson statistic value.

Table 4

Error Correlation Method (ECM)

Benchmark regression

Dependent Variable: DLogEXP

Variables	Co-efficient	Probability value
DLogPGDP	0.03762	0.0013***
DLogREER	-0.62159	0.0471**
DLogMKT	0.54456	0.9005*
DLogTLI	0.32537	0.8339*
DLogEXP(-1)	0.34556	0.0003***
RESID(-1)	-0.08834	0.06099**
R-square	0.57322	
Adjusted R-Square	0.44665	
Durbin Watson stat	0.62573	

Source: Estimated by Author.

***, **,* represents level of significance at 1%, 5% and 10% respectively.

After estimating the model, the R-square value and Durbin-Watson statistics value stood at 0.548 and 0.720 respectively which shows that R-square value is lesser than Durbin-Watson statistic value hence there is no problem of spurious regression.

The above result takes into consideration the impact of FDI through the changes in the export supply capacity of the host nation. In this results, it is clearly evident that the potential output is significant with a positive sign which shows that it has an impact on export growth performance. The real effective exchange rate also shows significant with the expected sign. Both the trade

liberalization and market access indicator turns out to be insignificant in both the equations. It might be considered that due to factors such as aging equipment, the high cost of inputs and transactions, low utilization of existing capacities may cause problems in the competitiveness and effectiveness of the Kenyan firms. The results also show the supply capacity in positive and strongly affected by the exports from the previous year.

The study accepts the alternative hypothesis of the unit root problem due to the fact that error correction term or the unit root tests on the residuals from the regression test show stationary. From the test on co-integration in the model, it is clearly noticed that the residuals are integrated of order zero 1(0). This implies that the linear combination of variables is stationary from the first equation. The t statistics from the unit root test used on the residual using the ADF tests were found to be statistically significant at 5 percent. In this case, we can therefore confirm that the variables are co-integrated which means that there is no spurious relationship between variables and that the regression on all levels of variables is meaningful.

Table 5

ECM (Error Correlation Method)

Supplementary Regression.

Dependent Variable: DLogPGDP

Variable	Coefficient	Probability Value
C (Constant)	9.17859	0.0000***
DLogFDI(-1)	0.45363	0.04632**
RESID(-1)	-0.78909	0.03268**

Source: Estimated by Author

***, **,* represents level of significance at 1%, 5% and 10% respectively.

Results 2 captures the supplementary regression of whether and to what extent, FDI inflows promotes the proxy for the supply capacity of the country. It is clearly evident that FDI inflows significantly contributed to increasing potential output.

Table 6

Error Correlation Method (ECM)

Dependent Variable: DLogEXP

Variables	**Coefficients**	**Probability**
DLogPGDP	0.24569	0.0003***
DLogFDI(-1)	0.03456	0.04667**
DLogREER	-0.56541	0.0564**
DLogMKT	0.36737	0.3556*
DLogTLI	-0.49677	0.4365*
DLogEXP(-1)	0.24563	0.0056***
RESID(-1)	-0.55688	0.04687**
R square	0.66578	
Adjusted R square	0.54679	
Durban Watson	0.76993	

Source: Estimated by Author.

***, **, * represents level of significance at 1%, 5% and 10% respectively

From the table above, results 3 shows when FDI variable is added in the model which provides evidence whether FDI has both supply-increasing and spillover effects. For this to be the case, both supply capacity and FDI variables should be statistically significant and have positive signs.

The analysis of our variable of interest, that is, FDI shows that its coefficient is positive and statistically significant, implying that an increase in FDI inflows increases exports in Kenya. This may be because FDI does not only show the physical capital flow into the country but also consists of better managerial skills, knowledge of international marketing and a well-established distribution channel on the international market. These advantages may have generated the positive effect on the export sector. The result may also show that Kenya's policy of encouraging FDI inflows is yielding positive results. The FDI-led export hypothesis is therefore true for the Kenyan case.

The REER variable remains significant with the expected sign while the supply capacity variable is also positive and significant showing supply increasing effects of FDI on exports. Trade liberalization and market access indicators still remain to be insignificant.

The above results show that FDI has statistically promoted an increase in exports by enhancing supply capacity of the economy through the rising potential output. It is clearly evident that when the proxy of GDP is controlled, the contribution of FDI to the export performance is statistically significant at 10 percent. It also shows that 1 percent increase in FDI inflows leads to 0.2 percent increase in exports. This implies that the impact of FDI is beyond increasing supply capacity and that there are indirect positive effects that come with FDI inflows which possibly can help create higher levels of competitive advantages which can spread to the local producers.

Given the generous incentives provided by the government to boost the export performance in Kenya, the marginal influence of FDI is worrisome. According to the study by Mwanga (2006) on foreign investment in Kenya, several factors appear to explain the miserable performance of Kenyan economy in terms of FDI attraction which include lack of government commitment in customs and tax collection which has created a suspicious atmosphere and loss of confidence

between the government and the investors. It also appears that minimal autonomy and resources of the body in charge of free trade zones have caused the suffering of the economy. Social-political instability during the early 1990's, bad governance, administrative problems and rampant corruption are key factors leading to the deterioration of Kenyan exports. Finally, the silence of the government in regard to creation of companies and application to the investment charter has caused a lot of hiccups to the economic growth.

CHAPTER SIX: CONCLUSION AND POLICY RECOMMENDATION

6.1 General Summary

In this study, examining whether FDI inflows have positive effects on export growth performance in Kenya since her independence is very crucial. The study is a combination of three theoretical models which include Flying Geese theory, Product life cycle theory and new growth theory which gives an insight on how FDI inflows promote exports. Flying geese model explains how FDI inflows move to host nations where the factors endowments would minimize the production costs whereas the product life cycle and growth models explain the idea of inward FDI and its contribution to export performance. Within these three theories, the location of FDI changes over time in line with its nation's industrial development. Firms output from the host countries is expected to satisfy the foreign market whereas as for the inward FDI in product life cycle theory, the FDI influences the domestic consumption in the host nation. Emerging markets also benefit from the surplus output of the multinational enterprise subsidiaries in the host nation including the foreign industries home nations. FDI can be said to be the catalyst for knowledge and technology development within the new growth theory as well as in the domestic investment. This also shows that FDI does not only involve indirect impact of supply capacity but also the spillover effects that

helps to expand the host country's export growth through multi-national enterprises and the local firms.

Even though there is a small difference in illustrating the FDI inflows in the three theories, they all admit that FDI does promote the host nation's export performance. Firstly, FDI promotes export performance in the sense that host country's exports are expanded directly by the MNE's subsidiaries simply because they are able to exploit the cheap factor endowments in the host nation so as to minimize production costs and increase their exporting competitiveness to the global market. Additionally, the export performance in the host nation can be improved through spillover effects of FDI by the local firms. These spill-over effects related to FDI include; the transfer of advanced technology, knowledge, and skills. The strong competition between the multinational enterprises and the local firms causes these indigenous firms to produce high-quality products and increase their exports so as to safeguard their market share and earnings. The most likely way of the transfer of spillover effects is mainly joint venture and subcontracting between the multinational enterprises and domestic industries.

This study finds evidence that the period 1961-2014, FDI inflows promoted highly the supply capacity and spillover effects leading to the expansion of exports in Kenya. Moreover, the positive association between FDI inflows and export performance can be said to be true and has been confirmed in this study thus the study is an important tool for policy implication.

6.2 Policy implication

Policy makers need to provide more incentives to foreign investors and create conducive policies and reforms aimed at attracting foreign investors so as to encourage FDI inflows. In order to increase export competitiveness, the government should focus on the encouragement of FDI through export oriented foreign firms.

Additionally, the main factors such as road infrastructures, transport and telecommunication, electricity that affect transaction and production costs hinder the aggregate competitiveness of the economy. The government should promote strategies that would help the improvement of infrastructural developments, human resource, good governance and conducive business climate. By so doing this would create a conducive atmosphere for FDI which will help in the lifting of private investment and cost effectiveness in the total investment in the country.

6.3 Limitations of the study

Insufficient sectoral data has hampered the examination of the effect of FDI on Kenya's export growth allowing over dependence on the overall data. The unnecessary use of aggregated data assumes that the effect of FDI is uniform across all sectors.

The study assumes that the analysis of the linkage between FDI and export performance of the economy would be boosted by the disaggregated data that would determine how FDI invested in various sectors affects the export performance. The impact may not be clearly detected by use of aggregated data, therefore disaggregated analysis may have more policy implications for creating development strategies crucial for guiding FDI inflows into different sectors.

6.4 Suggestion for future research

The study focusses on examining the impact of FDI on export growth performance in the Kenya's economy cutting across all sectors leaving the impact of FDI on export performance in the specific sectors of the economy. There is need to explore the sectoral impact of FDI on exports in the country.

On the other hand, the study examines FDI, Real effective exchange rate, Imports and GDP as the factors that affect Kenya's exports yet there could be other factors affecting exports which have not been captured in the study, for instance, institutional and structural factors such as political situations, structural rigidity among others. This is an area that could be explored to determine the effects of FDI in the light of export performance in the country.

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