

Foreign Direct Investment and Balance of Payments in Kenya

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Abstract

Foreign direct investment play a key role in accelerating growth in developing countries. Over the past two decades, world savings as a proportion of world income has fallen. As a result saving, real interest rate has declined and inflation rate has risen in the world. It is against this background FDI has appeared increasingly attractive to developing countries facing declining domestic investment and higher costs of foreign borrowing. The objective of this study was to determine the relationship between foreign direct investment and balance of payments in Kenya. The study used a correlation design and collected secondary data from the World Bank database, Central Bank of Kenya, and the Kenya National Bureau of Statistics for a 10-year period from 2008 to 2018. The data was analyzed using descriptive analysis as well as OLS regression analysis after testing for non-stationarity of data using Augmented Dickey-Fuller test. The study found that the relative price of imports had a positive and significant impact on imports at the 1% level of significance while GDP and FDI were not significant in the model. The study concludes that the relative price of imports affects imports and that the relative price of exports and GDP also impact on exports. The study also concludes that FDI does not impact on exports, and did not found any significant impact on balance of payments in Kenya. The study recommends that since FDI inflows have not been large enough to have a significant influence on balance of payments, it is important for policies to be instituted to attract more FDI inflows in Kenya in order to gain from the advantages that come with FDI inflows.

Keywords: FDI inflows, balance of payments, relative price, real interest rates, tax vacation, comparative costs.

1. Introduction

One of the economic problems of developing countries is that they do not have enough national savings to finance their investments. They are in constant need of foreign capital in forms of both direct and indirect investments. Initially, they took loans from international commercial banks. But in the 1980s the drying-up of commercial bank lending, because of debt crises, forced many countries to reform their investment policies so as to attract more stable forms of foreign capital, and FDI appeared to be one of the easiest way to get foreign capital without undertaking any risks linked to the debt (Kumar, 2007). Thus, it became an attractive alternative to bank loans as a source of capital inflows in the emerging economies (Agiomirgianakis et al, 2003).

FDI is mostly defined as capital flows resulting from the changed behaviour of multinational companies (MNCs) in transferring their assets and other income generating activities to other countries (Yabs, 2006). Thus, the factors to affect the behaviour of MNCs may also affect the magnitude and the direction of FDI. MNCs expand their activities to a foreign country for a number of reasons including, advantages, often owing to a life-cycle pattern of their products or just because their competitors are engaged in similar activities. On the other hand, governments are also engaged in a policy competition by changing key factors of their economic policies, such as domestic labour market conditions, corporate taxes, tariff barriers, subsidies, privatization and regulatory regime polices so as to improve FDI activity in their countries. Every country try to provide incentives to attract investors and to improve business environment.

Foreign Direct Investment (FDI) is considered an important source to build up physical capital, create employment opportunities, develop productive capacity, and enhance skills of local labour and managers through transfer of technology, and integration with rest of the world (Cockcroft et al, 1991). Foreign direct investment play a key role in accelerating growth in developing countries. Over the past two decades, world saving as a proportion of world income has fallen. As a result saving, real interest rate has declined and inflation rate has risen in the world. It is against this background that foreign direct investment (FDI) has appeared increasingly attractive to developing countries facing declining domestic investment and higher costs of foreign borrowing (Perkins, 2001).

2. Literature Review and Research Problem

Empirical literature finds mixed evidence on the existence of positive spill-over effects of FDI for a host country. Yet, according to the mainstream economics positive direct and spill-over effects of FDI are taken as granted. Most studies on FDI have been concerned with how to attract FDI and not with the consequences of FDI. The benefits of FDI are considered to be confirmed by actual development which ignores inconclusive academic literature (Lipsey, 2006), positive externalities have remained to be publicized by international financial organizations, and FDI has stayed the pillar of the development strategies of most developing countries in Africa and Asia. Indeed, to attract FDI, developing countries have been willing to use various forms of subsidies: tax

vacations, adaptations of the legal system, or even direct financial assistance to multinationals. In a decade, foreign ownership of productive assets has become major and in some sectors (financial services, telecommunications, retail trade) predominant or even exclusive type of ownership in developing countries (Njoroge et al, 2015).

Revolutionary changes in technologies have provided the mechanisms that propel the growth of international business. The intensification of competition at both domestic and international levels has driven firms to look beyond their domestic markets for new opportunities. The progressive removal of barriers to trade and capital movements has stimulated greater flows of exports, imports and foreign direct investment (FDI). Multinational enterprises have emerged as the key agents of international economic coordination (Prachi, 2013). They provide the capability to generate innovations and deliver new goods and services to the market; they also provide the capability to exploit these technological advances at a global level; and they are a depiction of the capacity of international managerial co-ordination to operate efficiently across international boundaries. Furthermore, the growing economic strength of the newly-industrializing countries (e.g. Taiwan, Hong Kong, Singapore, Korea) and the opening up of China and Eastern Europe have provided an additional stimulus to international business activities (Munteanu & Tudor, 2009).

International trade is not limited to commodities that some countries produce and others do not. Countries sometimes import goods that they themselves could produce more cheaply than the countries from which they get them. It has been claimed, for example, that Britain could raise dairy produce more cheaply than Denmark. But Britain nevertheless imports part of its supplies from that country and devotes its main energies to producing machinery, electrical equipment, motor vehicles and other manufactures, because its advantages over Denmark in producing these things are greater than its advantages in producing dairy produce (Yabs et al, 2016). This concentration on manufacturers involves what is known as the principle or the law of comparative costs, or simply comparative advantages in this theory of international trade. As applied to international trade this means that a country tends to concentrate on producing those things that will give it the best return for any given investment of its productive resources. The law of comparative costs is an extension of the principle of division of labor to the international field (Gartside, 1987). The theory of international investment explains international capital movements in the context of international production and trade. International investment creates international production and is integrated via international trade. Knowledge, know-how and technology are generally transferred between countries along with financial capital

3. Methodology

For balance of payments purposes, foreign direct investment (FDI) is defined as the holding of 10 per cent or more of the voting stock of a foreign enterprise (IMF, 1993). It takes the form of equity capital retained earnings and loans from a parent company. Direct investment is a unique form of capital inflow in that, unlike commercial lending, it comprises part of a package of technology and management, both of which can enhance the productivity of the capital transfer. Direct investment also shares in both the risks and the rewards associated with the project financed. It is these three factors - technology, management and capital - that commend FDI for financing in developing countries.

FDI inflow is accounted as credit entry in the financial account of balance of payment (BOP) thus having direct positive impact on BOP. However, increasing volume of FDI also increases the size of imports and profit repatriation. There is a large body of empirical literature showing positive effects of FDI on receiving country's economy including transfer of technology, employment creation, growth enhancement and tax collection. However, relatively less focused area is related to problems resulting due to FDI inflows in small open economies like Kenya. FDI inflows in developing countries may cause exchange rate appreciation (Dutch disease), trade and income account balance worsening thus having serious implications for overall balance of payments and foreign exchange reserves (Sarno and Tayler, 1999).

Systemic changes in developing countries have brought substantial net capital inflows mainly in the form of Foreign Direct Investment. A natural consequence of these inflows has been also large current account deficits, as the burden of investment income and principal repayment increases over time. For example, Average yearly FDI in New Member States of the European Community in the period 1996-2015 were approximately 20 billion €, with the exemption in 2003 when they halved. In the same period, the outflow of profits from NMS was much smaller; indeed it started with 2.5 billion Euros in 1996 but increased rapidly to 20 billion Euros in 2005. Though the inflow of capital through FDI in the period 1996-2006 far exceeded the outflow of profits the situation has been changing rapidly. Namely, the accumulated liabilities created by FDI have not been stabilized by trade surpluses. On the contrary, and with exemption of Czech Republic in 2005 and 2006, trade deficits have been enhancing current account deficits in most NMS and they have been even growing in the Baltic countries (Mencinger, 2003).

The overall short and long run effects of FDI on current account balance vary in time and may differ from country to country; they depend of the effects, FDI has on domestic savings and economic growth. Indeed,

though acquisitions of the existing assets were the predominant type of FDI in NMS, FDI was accompanied by deterioration rather than improvement in current account balance. A large share of the financial means obtained by selling the existing capital stock to foreigners was namely used to increase consumption and imports rather than capital formation. This explains why there is no positive relationship between the share of FDI and the share of gross fixed investments in GDP, why there is a strong contemporaneous negative relationship between FDI and current account balance, and, at least partly, why there is a negative relationship between FDI and growth (Mencinger, 2003).

According to Meyer (2003), foreign direct investment comes with several advantages to developing countries. Foreign direct investment is considered a large and growing source of finance that may help developing countries close the technology gap with high income countries, upgrade managerial skills, and develop their export markets and this could lead towards a spill over effect in form of improving productive efficiency in the economy. That could be the reason as to why FDI over the last decade have grown at least twice as rapidly as trade. Governments try to attract FDI for expected beneficial effects on employment, wages, balance of payments, technology and growth. It is worth looking over how far the positive effect offsets the cost of the allowance, which comes forward in the host country during the investment (Sass, 2003).

The earnings from foreign direct investment are related to the activities of transnational companies (TNCs). More than any other component of international transactions, they represent a strong inter-temporal as well as international dimension of those activities. The current values of investment income credits from FDI related to the overall stock of capital invested abroad in previous years. The history of foreign involvement by a particular country plays a crucial role in its current flow of earnings and, through them, in the structure of its balance of payments. For some countries their FDI history is linked to their colonial past as stated by Petri (1994) that those countries that rank high on FDI intensity - measured as ratio of FDI to GDP - are those with long colonial roots.

4. Data Collection, Analysis, and Results

The study collected secondary data. This was collected from the World Bank database, Central Bank of Kenya as well as the Kenya National Bureau of Statistics on all the variables under review. The data was collected for a 20 year period from 1997 to 2017. Annual data was used in this study. The data collected in this regard was imports data, exports data, current account balances, prices of imports, GDP, and FDI. The data so collected was organised in an Excel spreadsheet and prepared for analysis. Descriptive analysis was performed on the data to show the trends on the variables as well as the mean, median, standard deviations, minimum and maximum values. The stationarity of the variables was examined to avoid the existence of spurious estimation results. For this purpose Augmented Dickey Fuller (ADF) test was used for observing the order of integration of the variables. Long-run relationship was tested by applying Ordinary Least Square (OLS) method. The results were presented in tables and charts.

5. Conclusion

The study concludes that the relative price of imports affects negatively or positively amount of imports. This means that the rise in the relative price of imports leads to a rise in imports. The study also concludes that the relative price of exports impacts on exports. Therefore, as the relative price of exports rises, so does the value of exports. The study also concludes that FDI does not impact on exports, or imports. There is therefore no evidence of FDI having a significant impact on balance of payments in Kenya as per this study. The study found that the relative price of imports has a positive and significant impact on imports and that the relative price of exports and GDP had positive and significant impacts on exports. Finally, the results showed that FDI did not have a significant impact on exports.

6. References

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