



**THE EFFECT OF MACRO ECONOMIC FACTORS ON PERFORMANCE OF FOREIGN DIRECT  
INVESTMENT IN KENYA**

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## THE EFFECT OF MACRO ECONOMIC FACTORS ON PERFORMANCE OF FOREIGN DIRECT INVESTMENT IN KENYA

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### Abstract

*Foreign Direct inflow has grown significantly over the last two decades, according to World Bank World Economic report 2014, foreign direct investment in Kenya has increased from as low as 50 Million Dollars in 2001 to 944.3 Million Dollars in 2014. From the analysis of previous researches, the relationship between FDI and Macroeconomic factors is inconclusive, mixed results have also been evident with some results indicating that macro-economic factors like interest rate has a positive impact on foreign direct investment. A Kenya specific research on the effect of macroeconomic factors on foreign investment is not clear. This paper investigated on the effect of macroeconomic factors on performance of foreign direct investment in Kenya. The researcher adopted, Inflation, interest rate, Exchange rate and money supply as independent variable and foreign direct investment inflows as the dependent variable. The study employed descriptive research design, which is designed to explain how one variable affects another. Secondary data was used in this study and the population consisted of all FDI data available in world development indicators report database from 1970 to 2014, the study considered all foreign direct investment inflow data, Interest rate, Inflation, Exchange rate and money supply from year 1995 to year 2014. This aimed at achieving comprehensive coverage and a decade will give a much accurate results. Year 1995 was specifically selected because that was the year when structural adjustment program implementation began; there was increase liberalization of interest rate and elimination of exchange rate control through repealing of the Exchange Control Act in December 1995. The study generated Quantitative data; this data was pre-analyzed using E-views. This was utilized in further analysis of data through use of descriptive statistics such as measures of central tendency. Regression analysis was conducted to find out the significance of the regression coefficients. The data was presented using tables and charts. The study found out that money supply and interest rate are the ideal factors that affect foreign direct investment in Kenya. From these findings, the study therefore asserts that there is a significant relationship between money supply and interest rate and foreign direct investment in Kenya. In addition, the study concluded there is no significant relationship between Exchange rate and inflation and foreign direct inflow. The study recommended that policy makers should adopt fiscal policies that spur the money supply. Interest rate is another significant determinant of FDI under this study. Interest rate adjusted for inflation is good measure and important variable of FDI inflows. Also central bank of Kenya to formulate policies that will stabilize exchange rate and reduce rate of inflation which are essential for attraction of FDI inflows in Kenya.*

**Key words:** FDI, Inflation, Interest rate, Exchange rate, Money supply.

## INTRODUCTION

### Background of the Study

The liberalization and globalization has revolutionized the Kenyan economy by permitted investments from abroad either in the form of direct investment in a Kenyan company or investment by foreign investors in the capital market. Foreign direct investment (FDI) constitutes long-term investment by a foreign direct investor in an enterprise resident in an economy other than that in which the foreign direct investor is based (Salvatore, 2008). Foreign direct investment is defined as investment in foreign assets, such as foreign currency, credits, rights, benefits or property, undertaken by a foreign national for the purposes of production of goods and services which are to be sold either domestically or exported overseas (Investment Promotion Centre Act, Chapter 518).

Kenya's Foreign Direct Investment has significantly grown over the last two decades, foreign direct investment in Kenya has increased from as low as 50 Million Dollars in 2001 to 944.3 Million Dollars in 2014 (World Bank World Economic report 2014). Various motives that account for FDI increase include attraction of new sources of demand for their products, penetration of markets where excessive profits are available, full benefit from economies of scale, use of cheap foreign factors of production such as labor and land (Czinkotaet, 2005). The latest increase in FDI in Kenya was attributed to the interest by the Chinese in not only the construction industry but also the shift to manufacturing and communications as witnessed in the setting up of Xinhua News and the China Central Television African headquarters in Nairobi (Ocharo 2014). The second reason for the latest upsurge is

exploration of oil activities in Turkana and the Titanium mining in Kwale (IMF, 2012).

Satomi , David and Nigel (2007), in their study on macro determinants of foreign direct investment inflows to Japan found a positive relationship between source country size and foreign direct investment because larger economies imply greater availability of capital resources and intangible assets for example technical knowledge and marketing expertise that can be used to establish foreign production to meet consumer demand in a target country. Therefore they suggest that countries with large number of multinational firms should be able to make large investment in the international market. With the increase in FDI Inflow, there is need to examine the effect of macro-economic factors on foreign direct inflow in Kenya, The findings informed policy regarding the relationship between various macroeconomic factors and foreign direct investment inflow, literature on the impact of inflation on economic growth present extremely diverse opinions.

In the 1990s, many economists believed in permanent output-inflation trade-off due to Phillip curve. Contrarily, theoretical arguments from various researchers undermined the above opinion and believe. However, subsequent econometric investigations did not find any significant relationship between inflation and unemployment (Lucas 2008). However, recent empirical researches detected long-run nonlinear relationships between inflation, economic growth and FDI. The result of these empirical studies demonstrated that inflation has a negative impact on growth only if it exceeds a certain threshold. Otherwise, inflation has no adverse impact on growth nor accelerates growth. The level of threshold varies from various results obtained from various investigations, however, depending on a sample

of countries, time periods and estimation methods

Khan (2011) studied that exchange rate is a most important factor in an open economy it has direct effect on the macroeconomics factors like FDI and GDP. Economics, investor and Policy maker focused on the exchange rate of country and then make investment their money in that focused country. They have believed that increase in exchange rate creates competitive advantages in international trade. By increasing exchange rate of a country the domestic export goods become cheaper and it also increases the demand of export, it means international demand of goods will increase and import will be decreased. It impacts on FDI, all of these effects ultimately on GDP of the country.

Anna, (2012) and Singhanian, (2011) argued that interest rate is return on investment; investor will channel their investments from low interest rates to higher interest rate, because it provides incentive to foreign investors looking for higher returns therefore high interest rate can lead to increased FDI.

The purpose of this paper was to establish the effect of macroeconomic factors on the performance of FDI in Kenya.

### **Statement of the Problem**

Foreign Direct inflow has grown significantly over the last two decades, according to World Bank World Economic report 2014, foreign direct investment in Kenya has increased from as low as 50 Million Dollars in 2001 to 944.3 Million Dollars in 2014. The implementation of several institutional changes to strengthen the capital market and to improve its efficiency among other factors has also catalyzed FDI inflows. These changes include establishment of the Capital Markets Authority (CMA) in 1990 with

amendments of the Foreign Investment Protection Act (1964) in 1995 making it possible for foreign portfolio investors to buy government securities, repealing of the Exchange Control Act in December 1995 which ensured the removal of all exchange controls, introduction of Central Depository System (CDS) in November 2004 and Automation of Trading System in September 2006.

From the analysis of previous researches, the relationship between FDI and Macroeconomic factors was inconclusive; mixed results was evident with some results indicating that macroeconomic factors like interest rate had a positive impact on foreign direct investment, others found that interest rates had no significant impact on FDI inflow Chingarande (2011). Other previous researches dwelled mostly on the impact of FDI on economy growth. A Kenya specific research on the effect of macroeconomic factors on foreign investment is also not clear. This paper therefore sought to establish the effect of macroeconomic factors particularly Interest rates, Inflation, Exchange rate and Money supply on inflows of foreign direct investment in Kenya.

### **Research Objectives**

- i) To establish the effect of inflation on performance of foreign direct investment in Kenya.
- ii) To examine the effect of interest rate on performance Foreign Direct investment in Kenya
- iii) To establish the effect of exchange rate on the performance of Foreign direct investment in Kenya
- iv) To examine the effect of money supply on performance Foreign Direct investment in Kenya

## LITERATURE REVIEW

### Theoretical Framework

Dynamic macroeconomic FDI theory: The Dynamic macroeconomic FDI theory suggests that FDI is a long term function of multinationals' strategies. Time plays an important role and timing of investment depends on the macroeconomic environment at that particular period in the host country as well as its degree of openness and rate of economic growth. The macroeconomic environment consists of gross domestic product, domestic investment, real exchange rate, productivity and openness which are the determinants of FDI flows. This theory states that FDIs are a long term function of multinational companies' strategies. Similar to this theory is FDI theories based exchange rate which tried to show the relationship between FDI and exchange rate. The theory tried to explain how the flow of FDIs affects the exchange rates.

New Keynesian Theory of Inflation: Within this neo-Keynesian model of the macro economy, a Phillips curve represents the short-run response of wage inflation to cyclical variations in unemployment. Most prices are largely determined by the costs of inputs, the most important of which is labor. But the response of the average price level to cyclical fluctuations is magnified by the movement of volatile raw materials prices and by a small cyclical response of price-wage margins. The model also takes account of inertia in wage inflation and of some feedback from prices back to wages. Exogenous shocks to prices or wages are additive to the price or wage change generated by the Phillips curve-inertia mechanism.

### Empirical Review

The study of Awan and Zaman (2010) revealed that inflation rates caused positive significant effect of FDI inflows in Pakistan. Twimukye (2006) also finds the inflation rate to have a negative relationship with FDI flows into Africa. The findings from Asiedu (2006) shows that a low level of inflation has a positive effect on FDI inflow into SSA Onyeiwu and Shrestha, (2004) found out that inflation is a significant variable which influences foreign investors who wish to invest in Africa. Nonnemberg (2004), shows that FDI is correlated to the level of inflation in developing nations. A low level of inflation is likely to encourage more FDI inflows as it indicates that an economy has sound macroeconomic policies.

Uygur (2005) investigates the determinants and importance of FDI for Turkey for the period of 1992-2004 by employing the VAR model. In this study, he examines the inflation rate, real interest rate, investment atmosphere, export rate, growth rate and budget deficit rate and he found out that the real interest rate of official treasury department and consolidated budget balance are the main determinants of FDI for Turkey.

The exchange rate has also been considered to be important in determining FDI flows into a country. Kandiero (2006) looked into the relationship between real exchange rates and FDI in 38 African countries. They find an inverse relationship between real exchange rate appreciation and FDI inflows. Coleman (2008) agrees that exchange rates play an important role in attracting FDI. The aim of their paper was to examine how exchange rate volatility impacts FDI inflows into Ghana. Their research concludes that the real exchange rate volatility has a negative influence on FDI inflows. This means that exchange rate volatility, which is a measure of risk, decreases FDI inflows. Both Nabende

(2002) and Twimukye (2006) find exchange rates to be important in influencing FDI flows into Africa.

Prasert and Chukiat (2008), investigate the short-term and long-term relationships between international tourism demand and the most popular explanatory variables such as GDP, jet fuel prices, the exchange rate, exchange rate risk, and temperature during 1997(Q1)-2005(Q2). The autoregressive distributed lag (ARDL) approach to cointegration was utilized to estimate international tourism demand in Thailand. The short-term and long-term relationships results indicated that growth in income, the high jet fuel prices, exchange rate variations, exchange rate risk, and temperature in Thailand affected the number of international visitor arrivals to Thailand

After reviewing existing literature, the researcher found out that most of the past studies relating to macro-economic factors and FDI relates to the effect of FDI on various macro-economic factors but not the effect of macro-economic factors on Foreign Direct Investment. Kandiero (2006) looked into the relationship between real exchange rates and FDI in 38 African countries. They find an inverse relationship between real exchange rate appreciation and Foreign Direct Investment inflows. Coleman (2008) agrees that exchange rates play an important role in attracting Foreign Direct Investment. The aim of their paper was to examine how exchange rate volatility impacts FDI inflows into Ghana. Their research concludes that the real exchange rate volatility has a negative influence on FDI inflows.

Usman (2014) empirically examined the effect of money supply, foreign exchange on Nigeria economy, secondary data were obtained from central bank of Nigeria statistical bulletin

covering the period of 1988 to 2010. In concluding the analysis, all it was found that money supply and foreign exchange has significant effects on the Economics Growth. Chingarande (2011) examined the impact of interest rates on foreign direct investment in Zimbabwe; the paper found that interest rates had no significant impact on FDI inflows and hence cannot be used for policy making purposes. Some of the studies relation the correlation between Foreign Direct Investment and macroeconomic factors as brought in mixed results. The scarcity of local research and inconclusive findings of other researchers forms a research gap. Another gap arises from the observation that local studies on this area are inconclusive. The aim of their paper was to examine the effect of macro-economic factors on performance of FDI in Kenya

## **RESEARCH METHODOLOGY**

The researcher adopted descriptive research design. Descriptive design was used because it focused on complex analysis to bring out the correlation of variables. Descriptive design was preferred because the study needed to establish the relationship between the macro economic factors and performance of foreign direct investment in Kenya. The research population consisted of all foreign direct investment inflow data in World Bank world development indicators report which was available as at 31<sup>st</sup> December 2014. FDI data was available in the World Bank world development indicators report database from the year 1970 to 2014. The study considered all foreign direct investment inflow data, Interest rate, Inflation, Exchange rate and Money supply data from year 1995 to year 2014. Year 1995 was specifically selected because that was the year when structural adjustment program implementation began.

Secondary data was used in this study. The data was collected from year 1995 to 2014 (20 years). Foreign direct investment inflow data in this paper was collected from World Bank world development indicators report. The inflation rate data which is a proxy for inflation was obtained from the Kenya National Bureau of Statistics. 91 day Treasury bill rate which was taken as the proxy for interest rate was obtained from central Bank of Kenya. USD/KES exchange rate was collected from the central Bank of Kenya and M3 money supply data was also collected from the Central Bank of Kenya. The data was obtained in soft copy and accuracy was observed.

The study conducted pre-estimation tests such as Multicollinearity and unit root test. Unit root tests were conducted using the ADF test to establish whether the variables were stationary or non-stationary. The purpose of this was to

avoid spurious regression results being obtained by using non-stationary series. First differencing of the non-stationary variables was used to make them stationary. The study also conducted post-estimation tests such normality test on the residuals, test for heteroskedasticity and serial auto-correlation tests. The study used Jargue-Bera to test for normality, Breusch–Godfrey test was used to test for heteroskedasticity and serial auto-correlation. This was done to meet the assumptions of using regression model. The research process used econometric views (e-views) for empirical analysis of the data.

## FINDINGS AND DISCUSSIONS

### Descriptive Statistics of the Study Variables

Prior to data analysis the descriptive statistics of the variables was conducted. The Table 1 shows the mean, standard deviation, minimum and maximum of the variables.

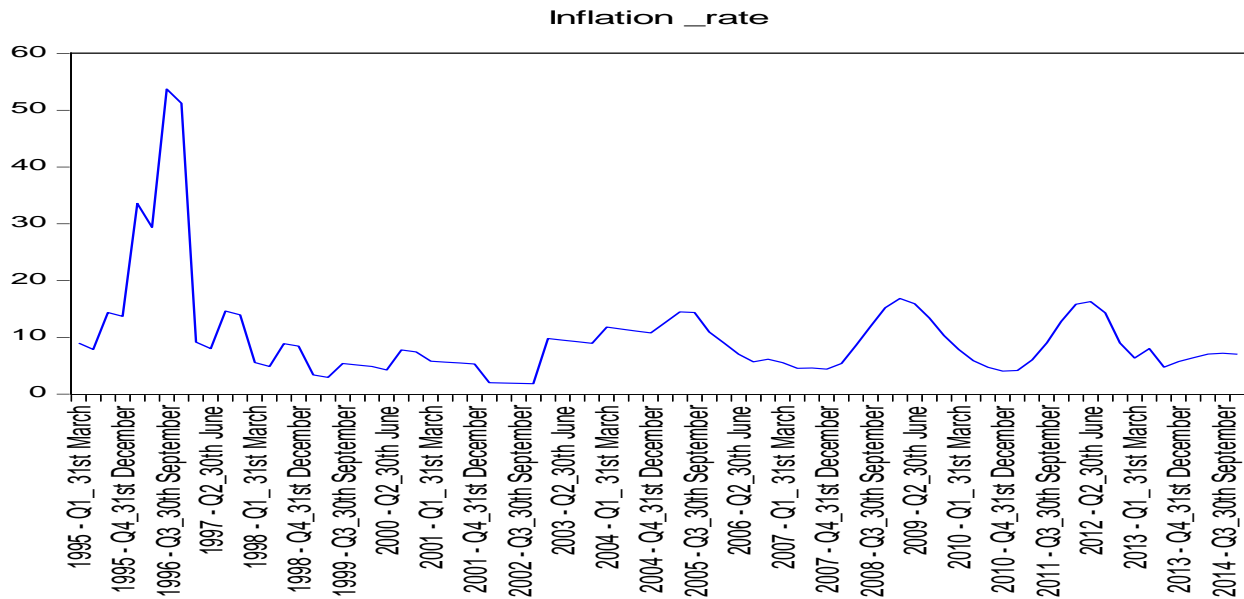
**Table 1: Descriptive Statistics**

| Variable               | Observation | Minimum | Maximum   | Mean      | Std. Deviation |
|------------------------|-------------|---------|-----------|-----------|----------------|
| Inflation rate         | 80          | 1.8253  | 53.7456   | 9.987433  | 8.6595771      |
| Interest rate          | 80          | 0.0296  | 1.0200    | 0.088328  | 0.1508299      |
| exchange rate(USD/KSH) | 80          | 44.138  | 93.8697   | 73.883652 | 10.448191      |
| Money supply(m3)       | 80          | 354384  | 1723781.3 | 740987.28 | 372317.87      |
| Foreign direct inflow  | 80          | 3711836 | 944327305 | 168336162 | 243524529      |

### Trend Analysis

Figure 1 indicates that the general trend of inflation rate has been fluctuating. Between the year 1995 and 1996, there was a sharp increase in inflation rate. From the year 1996 to 2002 there was a decline. This was attributed to tightened monetary policy by the central bank. From the year 2002 to 2005, inflation rate rose

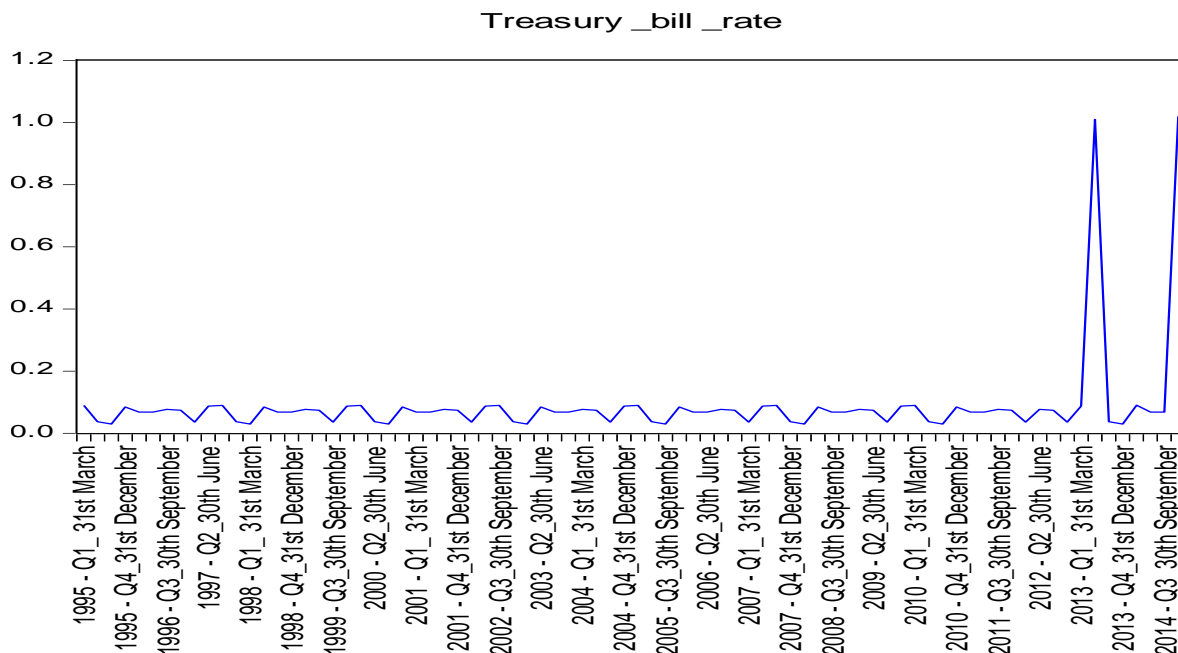
gradually then declined and stabilized between the year 2006 and 2007. There was a sharp increase in inflation rate in the year 2008 to 2010 and this was associated with the post-election violence which destabilized the county's economy. Tightened monetary policy together with an easing in global food and fuel prices, have brought inflation under control and stabilized the economy in 2014.



**Figure 1: Quarterly trend for Inflation Rate analysis from 1995 to 2014**

Figure 2 show that interest rates have been stagnating though with a negligible declining trend from the year 1995 to 2004. This decline was associated with the loosening of monetary policies by the central bank between the year

2005 and 2011, interest rate rose gradually and reached its peak in the year 2013. The peaking of interest rate in the year 2013 was associated with the general election. The high interest rate in the year 2013 cooled the economy.



**Figure 2: Quarterly trend for Interest rate analysis from 1995 to 2014**

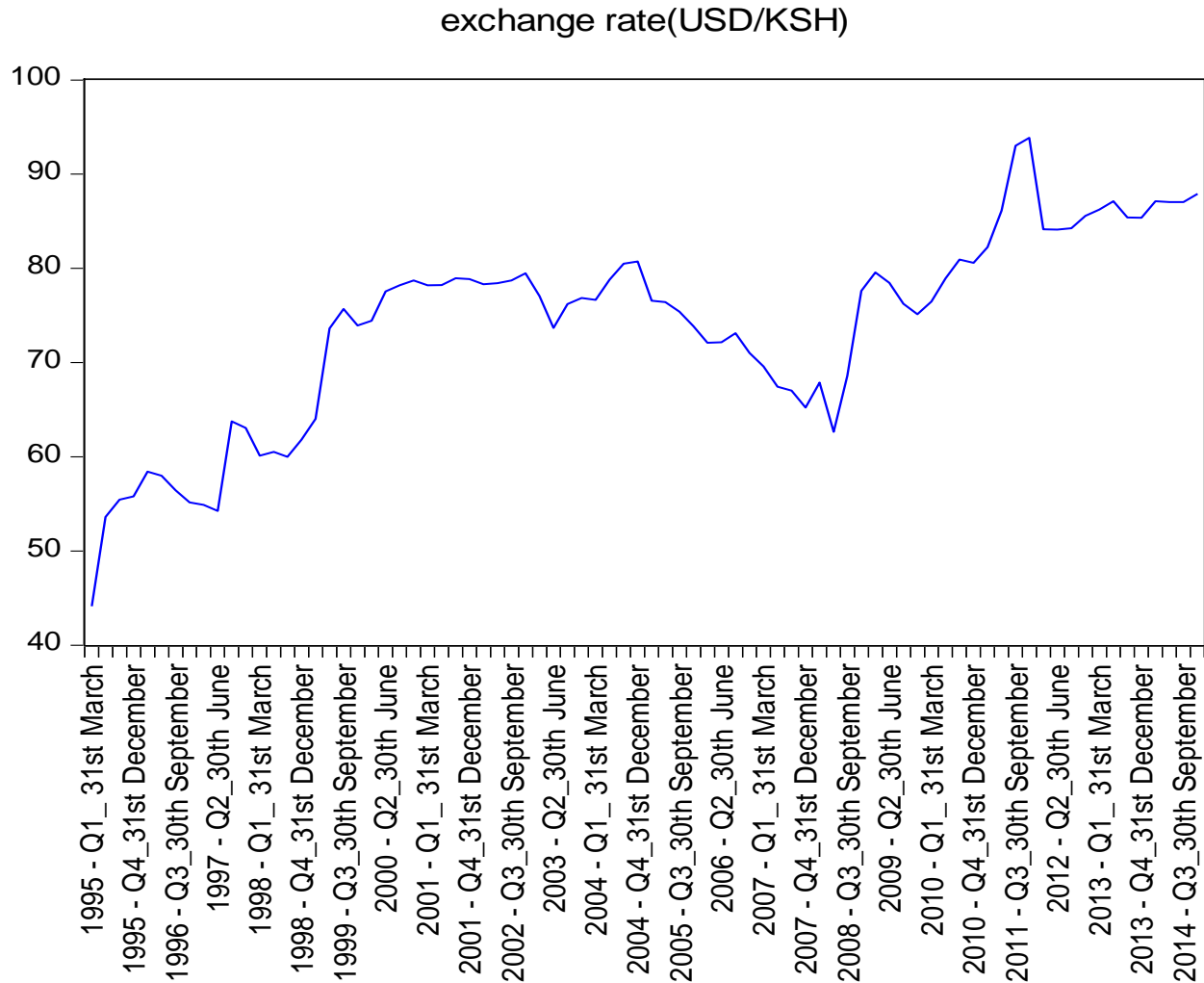
The Figure 3 indicates that Exchange rates increased from the year 1995 to 2000. It

remained steady from 2001 to 2003. In the subsequent year from 2004 to 2008 the



Exchange rates gradually dropped. This gradual decline in the exchange rate volatility was mainly attributable to the favorable economic factors experienced in the economy and thus this positively impacted on the performance of the

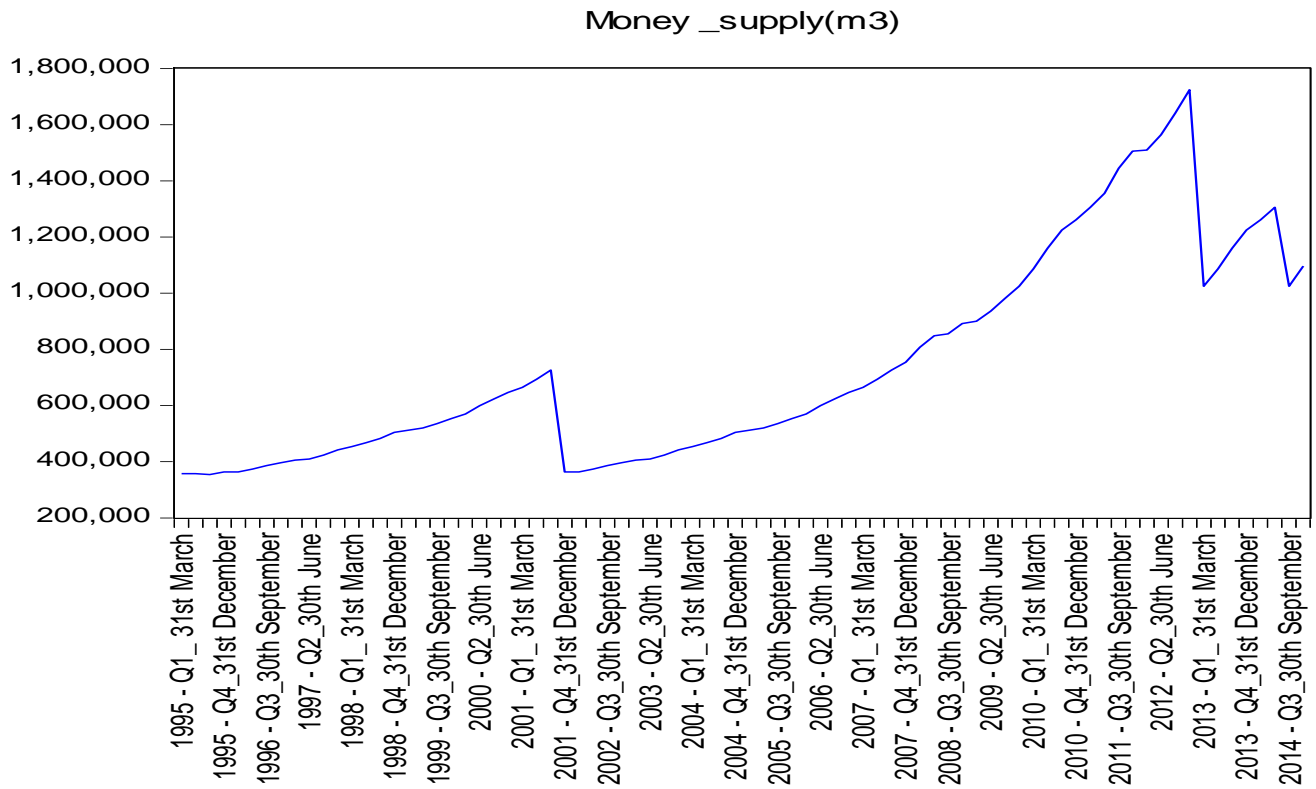
exchange rates as well. With the depression in the economy the exchange rates increased in 2008 to 2014 and this was attributable to the weak economy of the country during the period 2008 to 2014.



**Figure 3: Quarterly trend for Exchange rate analysis from 1995 to 2014**

The Figure 4 indicates that money supply gradually increased from 1995 to 2000. The results further indicated that in the subsequent year that is from 2001 to 2002, the money supply significantly dropped. Then it steadily rose again up to the year 2012 where it peaked. A drastic

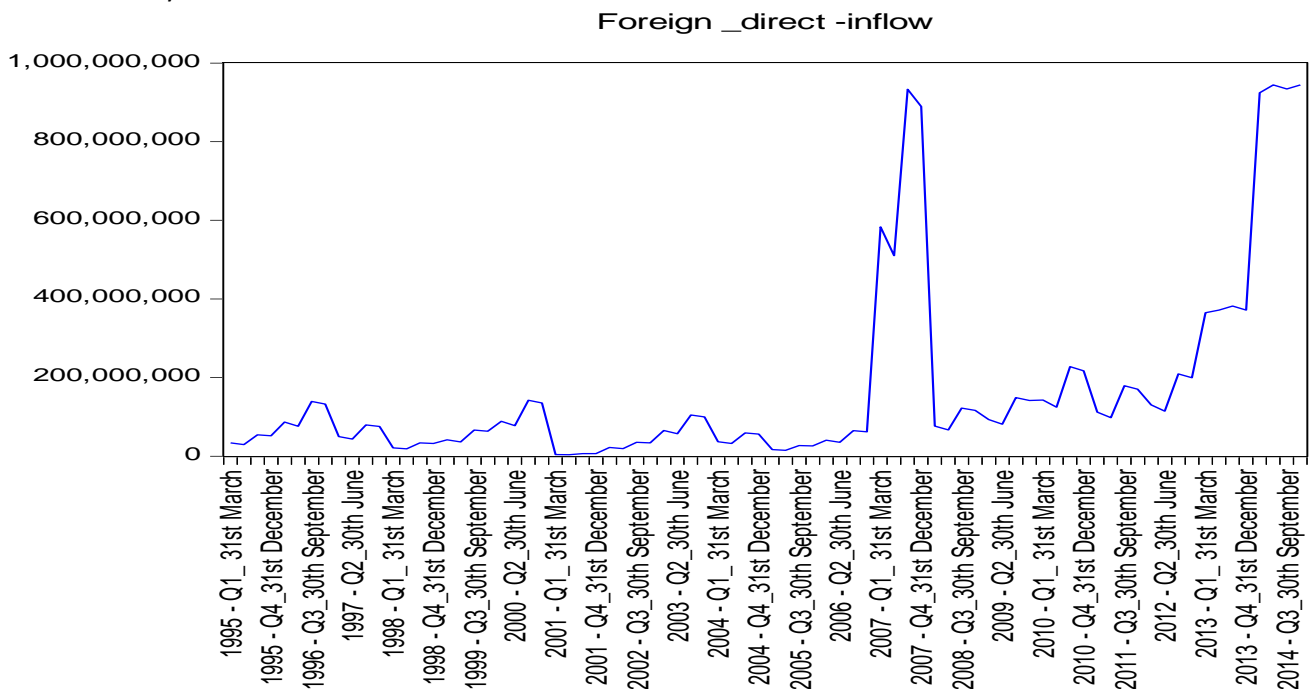
drop was witnessed in the year 2013. This drastic decline in the money supply was mainly due to the 2013 general election.



**Figure 4: Quarterly trend for money supply analysis from 1995 to 2014**

Figure 5 indicate the trend analysis for foreign direct inflow for the period between 1995 and 2014. The foreign direct inflow trend stagnated between the year 1995 and 2006. It then rose to

peak in the year 2007 before declining in the year 2008. It then rose gently in the mid of the year 2008 reaching its peak in the year 2014.



**Figure 5: Quarterly trend for FDI from 1995 to 2014**

**Correlation Analysis**

Table 2 below presents the results of the correlation analysis. The results revealed that inflation rate and foreign direct inflow are negatively and insignificant related ( $r=-0.125$ ,  $p=0.270$ ). This implies that an increase in inflation rate in the country leads to a decrease in foreign direct investment. The results also revealed that interest rate and foreign direct inflow are positively and significant related ( $r=0.324$ ,  $p=0.003$ ). This implies that an increase in interest rate in the country leads to an increase in foreign direct inflow. In addition, the

results revealed that exchange rate and foreign direct inflow are positively and significant related ( $r=0.279$ ,  $p=0.012$ ). This implies that an increase in exchange rate in the country leads to an increase in foreign direct inflow. Money supply and foreign direct inflow are positively and significant related ( $r=0.403$ ,  $p=0.000$ ). This implies that an increase in money supply in the country leads to an increase in foreign direct inflow.

**Table 2: Correlation matrix**

|   |                     | Foreign direct inflow | Inflation rate | Treasury bill rate | exchange rate | Money supply |
|---|---------------------|-----------------------|----------------|--------------------|---------------|--------------|
| Foreign direct inflow                                       | Pearson Correlation | 1.000                 |                |                    |               |              |
|   | Sig. (2-tailed)     |                       |                |                    |               |              |
| Inflation rate  | Pearson Correlation | -0.125                | 1.000          |                    |               |              |
|   | Sig. (2-tailed)     | <b>0.270</b>          |                |                    |               |              |
| Interest rate   | Pearson Correlation | .324**                | -0.035         | 1.000              |               |              |
|   | Sig. (2-tailed)     | <b>0.003</b>          | 0.755          |                    |               |              |
| exchange rate   | Pearson Correlation | .279*                 | -.336**        | 0.204              | 1.000         |              |
|   | Sig. (2-tailed)     | <b>0.012</b>          | 0.002          | 0.069              |               |              |
| Money supply  | Pearson Correlation | .403**                | -0.132         | 0.145              | .665**        | 1.000        |
|   | Sig. (2-tailed)     | <b>0.000</b>          | 0.244          | 0.200              | 0.000         |              |
| ** Correlation is significant at the 0.01 level (2-tailed). |                     |                       |                |                    |               |              |
| * Correlation is significant at the 0.05 level (2-tailed).  |                     |                       |                |                    |               |              |

**Pre and post-estimation tests/equation diagnostics**

Prior to running a regression model pre-estimation tests were conducted. The test indicated that there is no Multicollinearity.

Stationarity was corrected by using variables at first differencing. Post estimation tests indicated that the covariance was Homoskedastic and there is no serial correlation of any order. This implied the model used was not biased.

**Regression Analysis**

After conducting the diagnostic tests, regression model was run. Inflation rate, exchange rate, money supply and interest rate were found to be satisfactory variables in foreign direct inflow performance. This is supported by coefficient of determination also known as the R square of 69.25%. The results indicated that the overall

model was statistically significant. Further, the results imply that the independent variables are good predictors of performance. This was supported by an F statistic of 32.884 and the reported p value (0.000) which was less than the conventional probability of 0.05 significance level. The Durbin Watson=1.999 indicated that there was no auto correlation between the error terms.

**Table 3: Model Fitness**

|                    |                 |                    |                 |
|--------------------|-----------------|--------------------|-----------------|
| R-squared          | <b>0.692529</b> | Mean dependent var | 1.70E+08        |
| Adjusted R-squared | 0.671469        | S.D. dependent var | 2.45E+08        |
| F-statistic        | 32.88412        | Durbin-Watson stat | <b>1.998536</b> |
| Prob(F-statistic)  | <b>0.000000</b> |                    |                 |

Regression of coefficients results in table 4 shows that exchange rate and foreign direct inflow are negatively and insignificant related ( $r=-1071716$ ,  $p=0.6506$ ). The table further indicated that inflation rate and foreign direct inflow are negatively and insignificant related ( $r=-247091.9$ ,  $p=0.9019$ ). It was further

established that interest rate and foreign direct investment were positively and significantly related ( $r=73016825$ ,  $p=0.0052$ ) while money supply and foreign direct inflow were positively and significantly related ( $r=43.70634$ ,  $p=0.00481$ )

**Table 4: Coefficients of Regression**

| Variable       | Coefficient | Std. Error | t-Statistic | Prob.         |
|----------------|-------------|------------|-------------|---------------|
| EXCHANGERATE   | -1071716.   | 2356292.   | 0.454831    | 0.6506        |
| INFLATION RATE | -247091.9   | 1996790.   | 0.123745    | 0.9019        |
| MONEY SUPPLY   | 43.70634    | 61.81482   | 0.707053    | <b>0.0481</b> |
| INTEREST RATE  | 73016825    | 1.13E+08   | 0.644433    | <b>0.0052</b> |
| C              | 82664579    | 1.58E+08   | 0.524352    | 0.6016        |

**Conclusions**

Based on the findings above the study concluded that money supply and interest rate are the ideal factors that affect foreign direct investment in Kenya. From these findings, the study therefore asserts that there is a significant relationship between money supply and interest rate and foreign direct investment in Kenya. In addition, the study concluded there is no significant relationship between Exchange rate and inflation and foreign direct inflow. Money supply arising from savings and investment is key to attracting foreign investment, an increase in money supply leads to economic expansion and domestic demand for commodities and services; these therefore will make the county more attractive to foreign investors.

With market-oriented FDI, production and sales are both in the country into which the investments flow. Investors are, therefore, entitled to the profits generated in the country and the appreciation of the currency in host country means increase in the wealth of foreign investors. However, with cost-oriented FDI, in order to reduce costs for foreign investors, production takes place in the country receiving the investment while sales take place in the investors' country or a third country. Hence, appreciation of the host country's currency

would lead to the rising of cost for foreign investors which inhibits capital inflows.

Exchange rate regime increases the flexibility of the regime and helps the regime to become more suitable for the needs of the development of Kenya's economy. Although the slight appreciation of exchange rate in the short term has caused fluctuations in commodity prices and trade volume of Kenya's imports and exports, in the long term, the proper valuation of the exchange rate and a more flexible exchange rate mechanism will impact on Kenya's currency and macro-control policies positively.

**Recommendations****Policy Recommendations**

The policy implication of this finding are relatively obvious, since money supply serves as determinants of FDI, government should encourage savings and investment especially in capital market, in order to improve money supply position in the country, therefore this will lead to increased foreign direct inflow.

The central government through the National Treasury should create the necessary policies that will regulate macroeconomic environment, they should consider coming up with fiscal policies like increased spending and reduced taxation, this will lead to increase level of money supply in the economy therefore attracting

foreign direct investment. Most importantly, as an import-dependent economy, the Kenyan government should also formulate export led fiscal and monetary policies that will stabilize and balance Kenya trade relationship with other countries.

The central Bank of Kenya through its monetary policy should be directed towards stabilizing the exchange rate and reducing the rate of inflation, these actions will be highly essential for the attraction of FDI inflows into the economy.

### **Managerial Recommendations**

Money supply is the main instrument that policy makers should aim at in monitoring the foreign direct investment. According to the results, money supply has a significant effect on foreign direct investment during the study period. An increase in money supply leads to an increase in foreign direct investment. Therefore the central bank advisory committee should adopt monetary policies that spur the money supply.

Regulatory bodies should come up with policies that will help to stabilize macro-economic factors thus creating investor confidence.

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