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The Impact of Foreign Direct Investment on the Kenyan Economy

Laban M. Atemba*

Ph.D (Finance) Student, Masinde Muliro University of Science and Technology, Kenya

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Abstract

The researcher carried out a study which sought to analyze the impact of foreign direct investment on diverse economies in various countries of the world. The study reviewed a total of twenty journal papers obtained from credible peer review journals. Foreign Direct Investment (the independent variable) was measured in log form to enhance accuracy and the economy (the dependent variable) was measured by the gross domestic product, inflation rate, the balance of payment and poverty reduction. The author agreed that foreign direct investment affect host country's economic growth through physical capital accumulation, technology spillovers, creation of employment opportunities and enhancing productivity by bringing competition to the economy through skills and knowledge transfer and there is an indirect reduction of poverty. The review noted that no recent research has been done on the trends, determinants and pattern of foreign direct investment in Kenya and published in a credible peer reviewed journal. This study therefore recommends that a study should be done on the same to fill this glaring gap.

Keywords: *Foreign direct investment, economy, gross domestic product, inflation, balance of Payment, poverty reduction.*

Introduction

This study looked at the role played by foreign direct investment in the economy of various countries like India, Kenya, Nigeria, Pakistan, Australia, Turkey, Venezuela, Ireland, Poland and other European Union nations. The study sought to explore whether FDI has a positive or negative impact or no effect at all in the nations‟ economy. The key independent variable in the study was foreign direct investment which is made up of capital that foreigners invest in various sectors.

The economy was measured by a number of variables which for the purpose of this research was limited to gross domestic product, inflation, balance of payment and poverty reduction. The components of gross domestic product as used in the study are as shown below:

$$Y=C+I+G+(X-M)$$

Where, Y=GDP
I=Investment expenditure
C=Consumption expenditure
G=Government expenditure
(X-M)=Net imports

Various studies have been done on the relationship that exists between foreign direct investment and diverse economies in the world. After reviewing twenty papers published in peer reviewed journals, there was unanimous agreement by (Arisoy, 2012; Zorska,2005;Jaffri,Asghar,Ali & Rooma,2012) that foreign direct investment can affect host country's economic growth through physical capital accumulation, technology spillovers, creation of employment opportunities, enhancing productivity by bringing competition to the economy, skills knowledge transfer and reduction of poverty .The interest in foreign direct investment is generally attributed to its employment generation capacity, its effect on the productivity development growth and its dynamic link to competitiveness (Arisoy, 2012).

Foreign Direct Investment was defined by (Rizvi & Nishat, 2010) as not only a simple transfer of money but as a mixture of financial and intangible assets such as technologies, managerial capabilities, marketing skills and other assets. Multinational enterprise was identified by (Grosse, 1988) to be an important vehicle for effecting international transfer of funds, technology, management skills and products. He (Grosse, 1988) further noted that the impact of foreign direct investment is on employment, national income and balance of payment.

Developing economies are facing shortage of capital and are racing against each other to attract more and

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more of foreign direct investment (Ullah, Haider & Hashim, 2012).

In their ground breaking study on the impact of foreign direct investment on sectoral adjustment of the Irish economy, (Ruane & Gorg, 1997), underscored the fact FDI produced roughly 69% of the net output and 45% of jobs in Irish manufacturing industries in 1993.They further noted that in terms of regional employment, FDI became a vehicle for dispersing manufacturing employment across the country and away from the manufacturing bases in Dublin and Cork. The paper concentrated on the manufacturing sector as the sector where hitherto FDI has the most impact.

Problem specification

Kenya as a nation is endowed with various resources & minerals like oil in Turkana, natural gas in Kajiado, coal in Eastern & renewable energy. At the same time the country faces numerous problems like that of unemployment, inflation, slow economic development & inadequate distribution of wealth and bad politics.

These challenges were further aggravated by the enactment of interest cap law which has effectively denied local investors in Kenya access to cheap credit. These challenges have created a lacuna in the economy which ultimately requires a solution which should be thought outside the existing environment. Developing countries should aim to make the political and economic environment conducive to the inflow of foreign capital as this will contribute considerably to enhancing domestic employment opportunities (Mudida, 2002). According to a new Africa

Attractiveness Survey 2017 report by Ernst and Young, Kenya which is the region's anchor economy had its foreign direct investment projects drop by 57.9 per cent while capital investment declined by 55.5 per cent in 2016. Kenya should therefore move very fast to reclaim her position as the region's most attractive FDI destination hence the timeliness of this study.

Devolution in Kenya had been billed to be a success story for counties which efficiently utilized the devolved funds for spurring economic growth. However, on the other hand it has turned out to be a den of impunity effectively devolving corruption to the grassroots level grossly undermining its objective of bringing equity in wealth distribution. It is against this background that this study is seeking to explore the role that foreign direct investment in Kenya can play in addressing the aforementioned challenges of unemployment, inflation, slow economic growth hand inequality in wealth distribution and reduction of poverty.

Objectives of the study

i) To explore the impact of foreign direct investment on the economy of Kenya.
ii) To identify existing study gaps and recommend areas for further study.

Significance of the study

This research will seek to compliment the literature available on the impact of foreign direct investment on the Kenyan economy. This study will also fill the gap on the trends, patterns and determinants of foreign direct investment in Kenya as the empirical literature reviewed hereafter show that no research study had been done on the same in Kenya and published in reputable peer reviewed journals. This study will explore the advantages and disadvantages emanating from Greenfield investments thereby increasing the knowledge of economic policy makers. This will help them make sound economic policy decisions as they seek for solutions to the challenges facing our developing nation of Kenya. Exploring the impact of foreign capital on economic growth has important policy implications i.e. if FDI is found to have a positive impact on growth, then this will weaken arguments for restricting foreign investment (Jimborean & Kelber, 2017). If, however, FDI is found not to exert a positive impact on growth, then this would suggest the need to reconsider the measures adopted by countries to attract FDI (Jimborean & Kelber 2017). If FDI is mainly driven by domestic factors, policy makers are better able to affect it, whilst if FDI mainly reacts to global factors, recipient countries are vulnerable are vulnerable to global shocks even if domestic policy makers maintain prudent macroeconomic policies (Jimborean & Kelber, 2017).

The global economy is in turbulence due to various reasons some of which are unrest in the Middle East (Syria, Iraq, and Yemen), the zika virus in Brazil and the slowdown in the economic growth of China. Kenya too has not been left out and as correctly pointed out by various citizens in the country; there is a popular view among the people that the much touted economic growth has not translated into jobs for the common citizens. This study therefore seeks to look at the significance of foreign direct investment in relation to the role it can play in the creation of job opportunities and poverty reduction.

Kenya has got one of the highest unemployment rates in the world which is currently standing at 40 %(economics, 2017).Unemployment comes with numerous effects to the economy and the society as it reduces the purchasing power of an individual & the community at large (I economics, 2017). The unemployed youth tend to look for alternative sources of income like crime. Unemployment also leads to distrust in the administration and the government which can in turn lead to political instability. Foreign direct investment will address this and therefore the importance of this study need not to be overemphasized.

Kenya is currently experiencing a very high inflation rate which is slowing down the economic growth of the nation. As was observed by (Focus Economics, 2017), Kenya's inflation rate climbed to 9.0% in February 2017 from 7.0% marking the highest level in over five years.

This figure went above the Central Bank's inflation target range of 5.0% plus/minus 2.5percentage points (Focus Economics, 2017). The prices of goods and services are rapidly on the rise and as a result of this the purchasing power of the Kenyan shilling is falling. For the economy to run smoothly the inflation rate should be checked by the Central Bank of Kenya (Focus Economics, 2017).

The Kenyan president, signed the 2015 Banking (Amendment) Bill into law on August 24, 2016 (Simiyu, 2016). On the streets, Kenyans felt liberated. At the Nairobi Securities Exchange (NSE) investors were gnashing their teeth as all the 11 counters dropped in prices and bled a record Shs.45 billion in one trading session (Alushula, 2017). Even the Central Bank of Kenya's monetary policy committee admits that this law has complicated its work. Currently, credit to the private sector is at a 10-year low (Alushula, 2017). The private sector in Kenya plays a very important role in the growth of the gross domestic product which is a pointer to growing economy. Reduction of profit to the private sector implies that there is very little or no capital at all. This therefore leaves a big gap that can only be bridged by the foreign direct investments.

Kenya still suffers from inadequate distribution of wealth because the good intentions of sessional paper number 10 of 1965 which aimed to adequately address it were marred by endemic issues (Gates, 2007). Even though the government has made great progress in tackling this issue, foreign direct investment through the establishment of special economic zones will crown it with success. This study will demystify avenues that the government can explore to provide an out of the existing environment solution to the perennial problems of unemployment, inflation, slow economic growth, inadequate capital to the private sector and unequal distribution of wealth. This was also intended to be solved when we enacted the 2010 Constitution and introduced devolution.

FDI and Poverty Reduction

According to Marias Obwona and Benon Mutambi (2004), FDI has no direct link to poverty reduction, but, there are four possible indirect links. FDI contributes to export growth, productivity growth and finance for balance of payment, which supports an increase in national income that offers potential benefits to the poor. It improves the economic environment; FDI increases employment hence making a section of the population to move out of poverty.

Foreign firms pay higher wages than local firms for workers with similar qualifications. Presence of foreign companies raises the tax base in the host country. Increased domestic revenues may be used o build infrastructure and can also be spent on health, education and training.

Scope of the study

This paper has only one independent variable i.e. foreign direct investment and four dependent variables namely the gross domestic product, inflation, balance of payment and poverty reduction which was used to measure the topic of the "economy". The word economy is very wide and the study has narrowed down to use the four variables which can efficiently and conveniently measure it. This study was done in Kenya and the data was obtained from twenty papers published in various journals. The study involved panel data spanning forty years i.e. from1976 to 2017 that will be analyzed using regression analysis. Statistical analysis software E views version eight will be used. Both the independent and dependent variables shall be used in their log forms to enhance accuracy and efficiency.

Limitations of the study

This study will be very complex and it will require a lot of time and financial resources to conduct it to its final conclusion. As these limitations are anticipated, the researcher will develop a thorough and comprehensive implementation schedule and budget to carry out the same. The issue of time will also be addressed by setting aside four hours every day for the study until final completion, submission and publication of this independent study paper.

Review of conceptual literature

Foreign Direct Investment

Foreign direct investment is derived from the idea of a company redirecting a portion of its activities/capital to a chosen foreign country (Blackhurst & Otten, 1996). It is an investment made by an entity or a person in business concerns in another country in the form of either establishing business operations or acquiring business assets in the other country such as ownership or controlling interest in a foreign country (Aminews, 2014). It involves capital investment, transfer of management skills or technological expertise (Aminews, 2017). It can take various forms which include opening a subsidiary or associate company in a foreign country, acquiring a controlling interest in an existing foreign company or by means of amalgamating (merger, acquisition) with a foreign company(Investopedia,2017). As per the guidelines of of Economic Cooperation and Development (OECD), controlling interest is achieved by acquiring at least 10% of ordinary shares in a foreign company (Investopedia, 2017).

There are various categories of foreign direct investment; FDI can either take the form of horizontal foreign direct investment which occurs when a company establishes a similar business in a foreign land (FDI Report, 2016). Another category is the vertical form which occurs when different but related business activities from the investor's core business are established or acquired in a foreign country (FDI

Intelligence, 2016). The importance of the Greenfield sector as a factor influencing economic growth and development need not to be over emphasized. According to (Fingar, 2016) a total of 1.89 million jobs worldwide were created by FDI alone in 2016. This therefore implies that Greenfield investments are a big time employer that needs to be tapped. Unemployment is a major problem in Kenya because the progressive economic growth is not translating in to jobs for the citizens. A solution outside the existing environment required to tackle this issue and hence foreign direct investment can help provide a solution for this menace.

FDI has the most tangible impact on economic development and is the most solid indicator of a country's competiveness. FDI may boost the productivity of all firms not just those receiving foreign capital (Jimborean & Kelber, 2017). In 2015, FDI injected 713 billion dollars into the global economy with India taking 63 billion dollars worth of FDI projects (FDI Report, 2016).

In 2016, India became a big story in the FDI industry after trailing China for a long period of time. India has developed friendly tax policies, streamlined permit requirements, easened land acquisition rights, provided affordable labour and adequate infrastructure to international investors. Of significance is that these investor friendly policies were accelerated by the current premier Narendra Modi who formed the government in 2013. Kenya too underwent political transition around this time hence the relevance of this study. What is it that is attracting foreign investors to India? According to the FDI report of 2016, investors were interested in coal, oil, natural gas and renewable energy sectors. This strikes attention because Kenya too is well endowed with these resources. The government should intensify her efforts of aggressively marketing Kenya as a destination for foreign direct investment. Foreign Direct Investment is important because it is considered to be a catalyst for future economic growth (FDI Report, 2016).This form of investment is also less volatile as income compared to other forms of investments(FDI Report,2016). Inflows from FDI provide a valuable source of foreign exchange and long term capital to finance the balance of payments (FDI Report 2016).

In their recent study that looked the foreign direct investment drivers and growth in Central and Eastern Europe in the aftermath of global 2007 financial crisis (Jimborean &

Kelber, 2017) showed that FDI inflows are driven by both external (i.e. macroeconomic and financial conditions in the euro area, global macroeconomic conditions and global risk environment and domestic determinants (past FDI, human capital, market size, infrastructure, competitiveness, corporate tax system, risk premium, trade openness, geographical proximity to Western Europe, access to the European Union and progress in implementing structural reforms).By using panel data analysis they (Jimborean & Kelber, 2017) also found out that FDI has a positive impact on economic growth. This study although it is good, relevant and recent, it looked at the foreign direct investment drivers and determinants in the European Union which is a more developed region compared to Africa. This therefore shows that there is need for replicating the same study in Kenya which is an upcoming middle class economy and also underwent a post election crisis in 2007 and is yet to recover after 2017 elections.

For FDI to occur the firm must have both ownership advantage and internalization advantage while the foreign market must offer locational advantage (Jimborean & Kelber, 2017).

According to existing literature, the main determinants of foreign direct investment are past foreign direct investment, human capital, market size, infrastructure, competiveness, the corporate tax system, risk premium, trade openness, progress of implementation of structural reforms and the growth potential of recipient countries (Jimborean & Kelber, 2017).

The conceptual background

The International Monetary Fund (IMF) defines foreign direct investment as "… investment made to acquire lasting or long term interest in enterprises operating outside of the economy of the investor."It is an important source of external finance which implies that Kenya with its limited amount of capital can receive foreign exchange beyond her national borders from wealthier nations.FDI will be the an independent variable.

Gross domestic product is the dependent variable implying that it will measure the economy which is considered to be a very broad topic. Mudida (2003) defines Gross Domestic

Product as the "total monetary value of all final goods and services produced within the geographical boundaries of a country".

Theoretical background

Ricardo's theory of comparative advantage

In his theory of comparative advantage, David Ricardo imagined two countries; England and

Portugal producing two commodities cloth and wine using labour as the sole unit of production.

Ricardo further assumed that the productivity of labor varied between industries and across countries. This theory is all about two countries and two trade items that make it not to be in line with common sense because several countries and items are involved in international trade.

Production Cycle Theory of Vernon

This theory was developed by Vernon in 1966 and he used it to explain certain types of FDI made by US companies in Western Europe after the Second World War (Denisia, 2010).This investment was done in the manufacturing industry. Vernon believed that innovation, growth, maturity and decline are the four major stages of production life cycle (Product Life Cycle Stages, 2017). According to him, first, the United States transnational companies created new innovative products for export and the local market. Vernon further hypothesized that as the

American products landed in the foreign markets other companies imitated them and supplied the same in the local markets. They were thus forced to build production facilities in these countries to maintain their market shares. This theory has a loophole because America is not a sole player in international trade as there are over 200 countries engaged in same including even underdeveloped countries.

The theory of exchange rates on imperfect capital markets

Informational imperfections cause external financing to be more expensive than internal financing so that the changes in wealth translate into changes in the demand for direct investment (Froot & Stein, 1991). When the wealth of domestic agents goes down, that depreciation of the domestic currency can lead to the acquisition of domestic assets by foreign companies.

Review of empirical literature

The fact that foreign direct investment has a positive influence on various sectors of the economy was noted by (Sharma & Satinderpal,2016:Makki & Somwaru,2004) who found out that there is a positive correlation between wages paid and foreign direct investment inflow and that one per cent change in wage rate causes positive changes in FDI. The fact there is a negative elasticity coefficient between FDI and deficit in balance of position means that one percent increase in the deficit level in the balance of payment causes a reduction in percentages of FDI inflows in the country (Sharma & Satinderpal, 2016). Chege, 2015 carried out a study on the impact that foreign direct investment has on economic growth in Kenya based on a sample of thirty observations and noticed that there is a positive relationship between foreign direct investment and economic growth in Kenya. From a sample of 30 observations, he further opined that the coefficient of variation (R squared) was at 72.5% which means that the explanatory variables explain about 72% of all changes in the dependent variable (Chege, 2015). The p value (f statistic) was found to be 0.0485 which was less than 5% making it significant meaning that explanatory variables jointly influence the dependent variable (Chege, 2015).

In their study on foreign direct investment and current account balance of Pakistan that employed the use of autoregressive distributive lag model over a period of twenty eight years,

(Jaffri, Asghar, Ali & Asjed, 2012) postulated that in the case of Pakistan, foreign direct investment has worsened current account excluding current transfers (CABECT). They (Jaffri et al: Grosse, 1988) further observed that foreign direct investment helps to build up capital, create employment, develop productive capacity, enhance skills of local labour and managers through transfer of technology and helps the country integrate with the rest of the world. In their unique study that looked at the trends, patterns and determinants of Australian direct investment,

(Sharma & Bandara, 2012) found out that countries which are open, have large domestic market and have a similar language and culture to Australia's; attract most of its foreign investment. Countries in regional blocks tend to attract Australian investments (Sharma & Bandara, 2012).

Foreign direct investment is positively associated with currency (Rupee) depreciation and exchange rate volatility deters Greenfield investment as was found out by (Ullah, Haider &

Hashim, 2012) in their research that looked at the impact of exchange rate volatility on foreign direct investment in Pakistan. Foreign direct investment affects host country's economic growth via two channels which are technology spillovers and physical capital accumulation as was argued by (Arisoy,2012) when he published his study that dwelt on the impact of foreign direct investment on total factor productivity and economic growth in Turkey. He (Arisoy, 2012) further reasoned that the interest in FDI is generally attributed to its employment generation capacity, its effect on productivity development growth and its dynamic link to competitiveness.

Some drawbacks in foreign direct investment have been seen as was concluded by (Rizvi & Nishat, 2010) that whatever other benefits which may accrue from FDI, it should not be expected to create employment opportunities in any of the three countries i.e. Pakistan, India & stimulate employment growth. It has been noted that in terms of regional employment, foreign direct investment can be used as a vehicle for dispersing manufacturing employment across the country and away from the manufacturing bases in Dublin and Cork (Ruane & Gorg, 1997).

Foreign direct investment brought transition and transformation to the Polish economy (Zorska, 2005). When labour management bargaining industry is wide, (Zhao, 1998) identified two effects of foreign direct investment which are the collusion effect and the threat point effect. He

(Zhao, 1998) further stated that foreign direct investment reduces the negotiated wage, union employment and competitive wage if the union cares more about employment than wages.

(Barrel & Pain, 1997) found out that the acquisition of knowledge based specific assets to be an important factor behind the growth of foreign direct investment suggesting that investments are likely to be an important channel for the diffusion of ideas and technologies.

There is no generally accepted foreign direct investment theory with every new evidence adding some new elements and criticisms to the other ones (Denisia, 2010). The extent to which foreign direct investment is growth enhancing depends on the degree of complimentarily and substitution between FDI and domestic investment (De Mello Jnr, 1999).

Emerging Issues

Research on foreign direct investment, its trend, determinants and impact on the Kenyan economy is relatively new and out of the papers reviewed only four were from Kenya. There is an urgent need to carry out a current study on the same. It was noted in the review that research on the topic has been done extensively in the developed countries like United Kingdom, Australia, China, Poland, Ireland & India making them not very suitable in understanding the Kenyan situation.

Conclusion

The review found out that foreign direct investment has positive influence on economic growth as it leads to creation of job opportunities, physical capital accumulation and improvement of production courtesy of technological spillovers and diffusion of ideas (Chege, 2016; Arisoy, 2012; Rizvi & Nishat, 2010; Grosse, 1988; Ruane & Gorg, 1997; Zorska, 2005; Makki & Somwaru, 2004; Zhao, 1998). It was also noted that multinational companies tend to pay better salaries than indigenous firms and that there is a positive correlation between wages paid and foreign direct investment inflow (Sharma & Satinderpal, 2016). This in turn leads to improved living standards of the population hence reduction in poverty. Foreign direct investment also brings competitive advantage to the host nation.

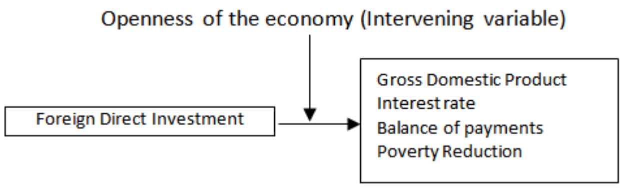

Figure 1 Proposed Research framework

As had been mentioned earlier, most of the studies on foreign direct investment have been extensively done in developed nations like United Kingdom, Australia, Ireland, Poland, India & China. This leaves a gap in emerging middle income economies like Kenya hence the review is recommending that an immediate study be done on the same to seal this gap. It has also been noted with serious concern that no study has been done on the trends, patterns and determinants of Greenfield investment on the Kenyan economy.

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