THE MODERATING EFFECT OF INFLATION ON THE RELATIONSHIP BETWEEN FOREIGN DIRECT INVESTMENT, FINANCIAL MARKET DEVELOPMENT AND ECONOMIC GROWTH IN KENYA

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ABSTRACT

A great deal of literature from a number of studies established that stable financial system offers risk diversification and efficient capital allocation that leads to economic growth of a country and also the economic expansions caused by harnessing FDI as a source of external financing equally leads to economic growth. However, finance literature records that moderate and low rate of inflation positively affects growth of the economy but high and accelerating rate of inflation jeopardize growth within the economy. This study therefore seeks to determine the moderation effect of inflation on these relationships in the Kenyan set up. This study aims at establishing the moderating effect of inflation on the relationship between foreign direct investment, financial market development and economic growth in Kenya. Economic growth will be the dependent variable while FDI and financial market development are the independent variables. The study incorporated a macroeconomic variable (inflation rate) to moderate between the dependent and independent variable. The study anchored on Financial Intermediation Theory and the Eclectic Paradigm Theory. Secondary data collected for analysis from KNBS economic surveys, World Bank reports, central bank of Kenya's reports, economic journals and annual economic survey reports for a period of 36 years 1980 to 2016. Data analysis carried out using SPSS implementing descriptive and inferential statistics; the study findings revealed that the linear financial market development and foreign direct investment have positive effect on economic growth in Kenya. However, the interaction term between financial development and inflation rate has a negative on economic growth. The marginal effect of FDI evaluated on inflation rate resulted to a positive interaction term. In conclusion, the explanatory effect (adjusted R squared) increased signifying the presence of the moderating effect. Therefore, the study concluded that inflation moderates the relationship between FDI, financial market development and economic growth in Kenya. The study recommended development of policies to attract FDI in Kenya at moderate levels of inflation to result into a long-term benefit growth within the economy. In addition, to develop financial markets within a reduced level of inflation within the economy to enable achievement of long run economic benefit. Further research should be carried on the moderating effect of other macroeconomic variables on the FDI growth nexus and financial market development and economic growth relationship.

Key Words: *moderating effect, inflation, foreign direct investment, financial market development, economic growth, Kenya*

INTRODUCTION

Foreign Direct Investment has two main economic advantages. First, due to low domestic savings, developing countries are not able to finance their strategies of economic expansion and so end up depending on foreign investment as a sure source of finance. Secondly, the presence of surplus production by foreign corporations enables the host country to experience economic growth since

there will be transfer of technology and expatriate, support in support human capital formation, in the host economy, enterprise development and restructuring, promotion of international trade. All these leads to strengthening of the local business sector (Tobin & Kosack, 2006).

World Bank (2013) noted that FDI is an investment made to get an enduring administration interest (typically 10% of voting stock) in or successful command over an endeavor working outside of the investor economy. FDI net inflows are the estimation of an internal direct investment made by non-occupant investors in the announcing economy, including reinvested profit and intra-organization credits, net of repatriation of capital and reimbursement of loans.

Financial market development results when monetary instruments, markets and mediators cooperate to reduce the expenses of information, implementation of policies and transactions. A solid and practical financial segment is an incredible instrument that ensures financial development (World Bank, 2013). Financial development is a wide idea including monetary development and other formative measurements. They characterized development as "a multidimensional procedure including significant changes in social structure, prevalent dispositions, and national foundations, just as the speeding up of economic development, the decrease of imbalance, and the poverty eradication.

STATEMENT OF THE PROBLEM

There has been studies on the relationship between FDI and economic growth with the key question being whether FDI has a direct positive effect on economic growth of a country examples includes; (Murinde, 2012) and . However, findings on the relationship between financial development and economic growth concluded that financial development has a direct positive contribution to economic growth of a country ((Fowewe, 2011). However, subsequent studies contradicted the empirical evidence on the same by concluding that financial market development play a vital role in the positive impacts of FDI on economic growth (Arcand et al (2012), Favara, (2003), Wachtel (2003).(Alfaro et al, 2004). Kenya has been registering an increase in the FDI inflows by 79.2 percent in 2016; domestic credit rose by 2.3 percent from 2013 to 2016, market capitalization rose by 31.3 percent from 2013 to 2016, GDP on the market price, on the other hand, rose by 63.3 percent within the same period, Economic Survey (2017). Studies by Dinga (2009), Kimotho (2010) Kioi, (2003) outlined the relationship between FDI and economic growth. Similarly, studies on the relationship between economic growth and stock market development exists and findings outlined Ndung'u (2011) and Omoke (2010). These studies, however, did not fully bring to focus on the relationship between financial market development and growth neither did the study incorporate a macroeconomic variable therefore, recommendations are put forth to counter the research gap. Okello (2013) studying the relationship between FDI, financial market development and economic growth between 1997-2010 in Kenya found out that the Kenyan financial market development was not well elaborated. However, this study only focused on stock market development indicators and not much emphasis on the banking sector development indicators. Both stock market development indicators and banking sector-development indicators

are key components in analyzing financial market development. This study, therefore, aims at bridging the above-mentioned gaps through the study of the relationship between FDI, financial market development and economic growth. His research study incorporates inflation as a macroeconomic variable that moderates the independent and dependent variables. Khan (2012) explains that high inflation creates uncertainties and distortions in the economy thereby barring sustainable growth through investment and spending. High levels of inflation negatively affect FDI and growth of an economy. Therefore, the study seeks to determine the effect of the moderating variable (inflation rate) on the relationship between the dependent and the independent variable.

RESEARCH OBJECTIVES

1. To determine the moderating effect of inflation on the relationship between FDI and economic growth in Kenya.
2. To establish the moderating effect of inflation on the relationship between financial market development and economic growth in Kenya.
3. To establish the relationship between FDI, financial market development and economic growth in Kenya.
4. To determine the moderating effects of inflation on the relationship between FDI, financial market development and economic growth in Kenya?

RESEARCH HYPOTHESES

H_{01}: There is no significant moderating effect of inflation on the relationship between FDI and economic growth in Kenya.

H_{02}: There is no moderating effect of inflation on the relationship between financial market development and economic growth in Kenya

H_{03}: There are no relationship between FDI, financial market development and economic growth in Kenya

H_{04}: There is no moderating effect of inflation in the relationship between FDI, financial market development and economic growth in Kenya.

THEORETICAL REVIEW

The Financial Intermediation Theory

Springs on two premises; transaction cost and asymmetric information. The theory establishes a link between lenders (people with excess funds) and borrowers (those in need through financial institution). Financial Intermediation Theory founded on the models of resource allocation that lay a great emphasis on perfect and complete markets hence bringing in elements of lack of competitive advantages and transaction costs that becoming non-existence in the market. These

assumptions cannot reflect practically due to a number of limitations like asymmetric information that exist in many global economies.

Presences of financial intermediaries tend to eradicate the limitations in the following ways firstly, acting as delegated detectors for the lenders through information gathered on and ascertaining the creditworthiness of the borrowers. Secondly, enabling investment in assets where they have sufficient and reliable knowledge from their extensive research and information on these investments and therefore are relatively safe and liquid. Thirdly, eliminating the challenges of hostile selection and moral vulnerability since financial intermediaries tend to establish long-term relationship with their clients. Finally, financial intermediaries make it possible for firms to pool funds and as a result be able to diversify investments thereby reducing the risks of small-scale investors (Gwirlym, 2008).

Relevance of the theory to this study emanates from the assumptions on how financial intermediaries (through financial markets) are important in creating an enabling environment (by eliminating market imperfections) for investments within the economy. This directly affects the dependent and independent variables of the study.

Eclectic Paradigm (O-L-I Theory)

Developed by Dunning in 1979, according to Dunning the structure of an organization is not the only important factor but there exist three important factors successfully facilitating engagement in foreign direct investment. The first factor is about ownership advantages of firms in domestic and foreign markets. They give the firms competitive ability through reduction of production costs in form of form of monopoly power (trademark, patent rights, ownership of limited resources), competencies (innovation, entrepreneurial skills, and technology), research and development (product differentiation) and advantages over dimensions (economies of scale and scope, extensive financial base).

The second factor is the location advantages; this interrelates to the geographical location of the organization. This links to the ownership advantage, which expresses through political advantages in form of political stability and policies, economic advantages (the cost of setting up business, cost of factors of production, market size, and the economic climate) and finally social advantages. The third factor is the internationalization advantages that refers to benefits of own production compared to a partnership arrangement such as joint ventures. Firms prefer exploiting their core competencies and influence decisions such as on partnerships.

According to Dunning (1981), if a company possesses ownership rights, it can do licensing, which is less cost- intensive than the other forms of internationalization. FDI however, is a more capital-intensive activity, it is therefore achievable if the has ownership, location and internalization advantage. Major importance drawn from the theory to the study as it helps firms to assess the framework to pursue when determining the benefits to pursue Foreign Direct Investment (FDI).

EMPIRICAL REVIEW

Foreign Direct Investment and Economic Growth

FDI has positively influenced the Kenyan economy especially in the fields of technology, industrial development, business development and improved international trade integration; this has led to improved economic growth though not at projected rates (Ngugi & Nyangoro, 2005). In as much FDI is approbatory on the Kenyan economy, it has negative effects. These effects include; over-exploitation of natural and human resources as the foreign firms compete to maximize profit and outshine competitors (Nyaga, 2013); negative environmental effects due to exploitation of natural resources and industrial activities that has immensely contributed to climate change. Furthermore, importation of capital-intensive labor and increased local wage bill are significant economic leakages thereby affecting negatively on the balance of payments.

According to (Obwona & Mutambi, 2004), increased FDI in Kenya resulted in a general improvement in resourcefulness and hence economic growth. However, in the recent past, FDI in Kenya has fallen considerably (Ngugi & Nyangoro, 2005). The Kenyan GDP has not experienced a predictable growth rate in the recent. Because of the high Kenyan population, there is a high market though with low purchasing power due to high rates on inflation. The Kenyan government consistently encouraged foreign investors to invest in the country through policy incentives and more economic integration.

According to (Nyamwange, 2009), investment-monitoring platform in Nairobi ruled out on Johannesburg becoming the top destination of FDI in Africa by the year 2015 after considering the improvement in investor confidence in Kenya. In 2015, the FDI inflows in Kenya were 37%, which was a great improvement from 2014. Furthermore, Nairobi city attracted the highest FDI in Africa in 2015 beating Johannesburg. Additionally, the report indicated that other Kenyan counties have long-term capital projects such as geothermal power projects in Nakuru; Motor Vehicle set to open in Mombasa, Machakos and Kiambu. The future of Nairobi is brighter as we continue witnessing mega projects especially in real estates and modern all-inclusive set up and operated by some of the leading global mall investors (Nyamwange, 2009).

Financial Market Development and Growth

The International Monetary Fund (IMF, 2007) reported that growth of financial markets makes it possible to create sufficient credit, which stirs up faster non-inflationary growth, risk management, and hedging on the other hand improves. This helps economies to improve their ability to manage volatility. Nations with increasingly created approaches and open exchange frameworks are bound to profit by monetary globalization. Such nations are less inclined to encounter the hazards that accompany more receptiveness that is prominent to worldwide capital stream. Thusly, as per The International Monetary Fund (IMF, 2007), money related markets are winding up increasingly

significant for financial advancement; their quality is a basic determinant of nations financial strength and achievement in budgetary globalization.

Policymakers have emphasized financial strengthening significantly contribute to economic performance (Beck et al., 2000). In the past, financial markets viewed not as closely related to economic development. The key factors considered were population growth and technological advancement, but this has changed with increased research findings, which have embraced financial developments as a major determinant of economic growth (Levine & Zervos, 1998). The securities exchange liquidity and banking improvement can anticipates monetary development since budgetary markets empower imperative administrations influence it feasible for development and the financial exchange to give an assortment of administrations from banks. The investigation likewise called attention to that securities exchange size, instability, and universal mix don't effectively interface with development, and none of the money related markers is almost connected with private sparing rates (Levine & Zervos, 1998).

FDI, Financial Market Development on Economic Growth

A study (Okello, 2013) on pertaining connection between FDI, financial development and economic growth in Kenya discovered that adverse capitalization portrays positive out-turn on GDP growth. However, FDI showed a useful but insignificant impact on GDP but at the same time found out that financial market had an influence on the economic growth of Kenya. Economic growth does not significantly influence the degree of FDI inflows (Okello, 2013). The study therefore recommended that government policies that attract FDI inflows in Kenya and improves on policies of stock market-development through market capitalization. Social-cultural factors greatly influence the rate of economic growth of a country (Alfaro L, et al. 2004). A similar study by Hermes & Lensink (2013) found out that enhancement of the financial system of a nation is a key prerequisite for FDI to favorably influence growth.

Another study conducted by Alfaro & Kalemli-Ozcan (2006) on how FDI advances economic development by investigating the impacts of local financial on linkages in Kenya discovered that the more built up the nearby budgetary markets are, the simpler it is for business people with rare to set up new investments.

Inflation, FDI, Financial market development and Economic growth

(Muritula, 2011), attempt to determine the association between investment, inflation and growth. His outcome revealed a negative correlation between development and economic performance, inflation, investment and economic growth. Increased investment would definitely lead to increased consumption, productivity, labor supply, and output thereby improved economic performance. Demand and supply management policies pre requisites reduction in inflation (Muritula, 2011).

A study by Khan on the impact of inflation on financial development purported that high inflation rates jeopardize the performance of financial markets. The outcome projected a negative relationship between inflation and financial development (Khan, 2001).

RESEARCH METHODOLOGY

Research design

The research study used a correlation research design. According to Schmitz (2012), the design measures the variables and establishes a statistical relationship between the two variables, with little or no effort to control non-essential variables

Target Population

This study focused on six variables; GDP per capita income, foreign direct investment, inflation rate, Market capitalization/GDP, Stock traded /GDP inflows and Domestic credit/GDP. The study covers a period of thirty-six years between 1980 and 2016.

Empirical Model

The research applied a linear regression model to analyze the moderating effect of inflation on the relationship between the dependent and independent variables. The multiple regression equation when dealing with two or more variables would be as below:

$$Yt = b0 + bt1Xt1 + bt2Xt2 + bt3Xt3 + bt4\ Xt4$$

For this study, the above equation modified to meet the objective of the study as below:

$$Yt = b0 + bt1Xt1 + bt2Xt2 + bt3Xt3 + bt4\ Xt4 + bt5M + bt6\ (Xt1M) + bt7\ (Xt2M) + bt8\ (Xt3M) + bt9\ (Xt4M) + e$$

Where: Y- Represents economic growth (GDP); $X1$- Represents FDI; measured by FDI inflows; $X2$- Represents market capitalization as a proportion of GDP; equivalent to the value of listed shares divided by GDP; $X3$- Represents stock traded as a proportion of GDP; equivalent to the value of total shares traded divided by market capitalization; $X4$- Represents domestic credit as a proportion of GDP; equivalent to credit market sector as a component of financial market development; M- Inflation rates; bo- Constant; $b1, b2, b3, b4, b5, b6, b7, b8, b9$- Regression coefficients/slope; $t-$ Time/ Period; $e-$ Error term (deviations of the observed values Y, from the mean)

The dependent variable is economic growth represented by the per capita income. The independent variables are FDI inflows, market capitalization as a proportion of GDP, stock traded as a proportion of GDP and domestic credit as a proportion of GDP. Inflation rate moderates the study.

Data Collection Instrument

Data was collected from secondary data sources mainly; economic surveys, The Kenya National Bureau of Statistics, World Bank Development Reports, Central Bank of Kenya and The International Financial Statistical Year Book of the International Monetary Fund.

Data processing and Analysis

Analysis of the coded data carried out through SPSS. Highlights from the descriptive statistics showed achievement of central tendencies. Person correlation coefficient employed to determine the strength of linear relationship between the variable. The F-test and T-test established the probability of the relationship represented by the analysis to have existed. The altered R2 tested the presence of moderation in the model. The model utilized Person's r and spearman's rho to show the strength of the relationship in the variables.

RESEARCH RESULTS

The analysis uses Pearson's correlation coefficient of correlation; correlation matrix determines the strength of association in the regression model. The Pearson's correlation coefficient (r) takes a range of +1 to -1. A value of 0 shows no relationship among variables and values more than 0 shows association.

Table 1: Pearson's Correlation Coefficient Matrix

	GDP per capita	Domestic credit to private sector (% of GDP)	FDI inflows (%of GDP)	Stocks traded (% of GDP)	Market capitalization % of GDP	Inflation rate(consumer prices)
GDP per capita	1					
Domestic credit to private sector (% of GDP)	.546	1				
FDI inflows (%of GDP)	. 361	.372	1			
Stocks traded (% of GDP)	.431	.381	-.122	1		
Market capitalization % of GDP	.559	.412	.219	.517	1	
Inflation rate(consumer prices)	-.295	.025	.425	.335	-.114	1

**. Correlation is significant at the 0.01 level (2-tailed).
*. Correlation is significant at the 0.05 level (2-tailed).

From table 1 there existed a strong positive correlation between GDP per capita and market capitalization as a percentage of GDP at 0.559 and between GDP per capita and domestic credit to

private sector as a percentage of GDP AT 0.546. A weak positive correlation exhibited between GDP per capita and FDI inflows as a percentage of GDP at 0.361 and by stock traded as a percentage of GDP and GDP per capita at 0.431. Inflation rate however showed weak negative correlation with GDP per capita at -0.295 respectively.

Table 2: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.911	0.830	0.826	0.003921

From the Table 2 R= 0.911 the correlation coefficient which defines the association between the study variables, the findings depict a strong relationship between the variables by 91.1% at 5% significant level. R squared is the coefficient of determination, which indicates the variation in the dependent variable because of the changes in the independent variables. R^2 showed that 83.4% of variation in economic growth in Kenya is explained by the variables (Inflation rate (consumer prices), stocks traded (percentage of GDP), Domestic credit to private sector (percentage of GDP), FDI inflows (percentage of GDP), market capitalization percentage of GDP).

Table 3: ANOVA of overall model

Model		Sum of Squares	df	Mean Square	F	Sig.
	Regression	55213185993.514	5	11042637198.703	160.019	.000[b]
1	Residual	2139258506.667	31	69008338.925		
	Total	57352444500.181	36			

a. Dependent Variable: GDP per capita

Result from Table 3 revealed that GDP per capita with independent variables has F statistic of 160.019 and the P-value is 0.000. The P-value of 0.000 is below the set level of significance of 0.05. This result depicts that the overall regression model is statistically significant and is meaningful for prediction purposes at 95% level of confidence. In addition, the variables used are statistically significant in predicting GDP per capita of Kenya.

From the table 4, the p-values obtained from market capitalization as a percentage of GDP, domestic credit to private sector as a percentage of GDP and Inflation rate were P= 0.000. The p values were less than the standard measure which is p= 0.05, there is therefore a significant relationship between the three variables to economic growth represented by par Capita income. However, FDI inflows as a percentage of GDP showed p=0.192 a value higher than the standard measure, this indicated that FDI has no significant relationship to economic growth. Stock traded as a percentage of GDP also showed p=0.056 a value greater than the threshold meaning that there is no significant relationship between stock traded and economic growth (measured by par capita income).

Table 4: Regression Statistics

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	-48379.743	11255.826		-4.298	.000
FDI inflows (% of GDP	2670.335	1999.895	.055	1.335	.192
Stocks traded (% of GDP)	332.072	167.454	.139	1.983	.056
Market capitalization % of GDP	148.421	37.279	.443	3.981	.000
Domestic credit to private sector (% of GDP)	2672.339	489.593	.449	5.458	.000
Inflation rate (consumer prices)	38.528	178.385	.008	.216	.000

a. Dependent Variable: GDP per capita

From the research results, the resultant regression and correlation model was:

$$Yt = -48379.743 + 0.055Xt1 + 0.443Xt2 + 0.139Xt3 + 0.449Xt4 + 0.08M$$

Where: Yt = Economic growth (GDP per capital); b_1 = FDI inflows as a % of GDP); b_2 = Market capitalization; b_3 = Stock traded; b_4 = Domestic credit to private sector; b_5 = Inflation rate (consumer prices); e = error term

The regression equation connects the dependent variable (Y) and the independent variables (X). A unit increase in FDI inflows leads to 0.055 increase in GDP per capita. A unit increase in stock traded as a percentage of GDP results to 0.139 increase in GDP per capita. A unit increase in market capitalization leads to 0.443 increase in GDP per capita. A unit increase in domestic credit to private sector as a percentage of GDP results to 0.449 increase in GDP per capita and an increase in inflation rate leads to 0.08 increase in GDP per capita.

CONCLUSIONS

The study concluded that inflation positively moderates the relationship between foreign direct investment and economic growth in Kenya. This relationship is however insignificant. This mean that there should be a continuous effort to encourage low to moderate levels of inflation rates alongside boosting FDI inflows in Kenya to achieve a progressive increase and long run sustainable growth that in turn results to the overall productivity of the economy. The moderating effect of inflation was inclusive in the relationship between financial market development variables and economic growth. Moderating market capitalization had a positive (increase in the coefficient) and significant effect on GDP per capita but an opposite effect on moderated stock traded. The study therefore concluded that low levels of inflation positively moderates the

relationship between financial market development (stock market development indicators) and economic growth in Kenya.

The other financial market development variable that represented the banking sector- market development was domestic credit to private sector. There was no moderation effect since inflation resulted to a reduction in the regression coefficient between domestic credit to private sector and GDP per capita. Therefore, inflation does not moderate the relationship between financial market development (banking sector- market development indicators) and economic growth in Kenya

RECOMMENDATIONS

The government should reduce and stabilized levels of inflation with a subsequent increase in domestic credit in the economy to enable a long-term achievement of economic growth within the economy and boost investors' confidence. Policy makers in Kenya should advocate for an improvement and increase in the number of banking institutions and to encourage more citizens to bank, borrow and utilize these facilities.

The government of Kenya should therefore capitalize on improving and developing the stock market by establishing proper operating capital markets and risk evaluation systems and to improve on the automation of the systems within the capital markets to reduce transaction costs while increasing liquidity. It is also important for the government to improve transparency and investor confidence in order to establish a proper market capitalization.

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