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**The impact of globalization on foreign direct investment in Kenya
and South Africa.**

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DECLARATION

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ABSTRACT

Given that emerging economies in Africa are becoming increasingly integrated into the global economy, it is foreseeable that shocks that occur within these developed economies could have an impact on their investment and other macroeconomic fundamentals. Using panel data, the study assesses Foreign Direct Investment (FDI) in Kenya and South Africa for the period between 1970 and 2014 to show that the level of globalization (as measured by the KOF Index of Globalization) of the United Kingdom, France and Germany do influence the level of FDI in Kenya and South Africa. Market size, trade openness, inflation rate and exchange rate risk are used as control variables in the study. The Random Effects model was utilized to estimate the parameters in the model and as a result, it was found that the level of globalization in the United Kingdom and in Germany do have an impact on FDI inflows into Kenya and South Africa. The level of globalization in France is, however, found to not be a statistically significant determinant of FDI in these two markets. The level of inflation was also found to be statistically insignificant in explaining the level of FDI in Kenya for the time span under analysis.

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List of Abbreviations

BIT	Bilateral Investment Treaties
BRICS	Brazil, Russia, India, China, South Africa
COMESA	Common Market for Eastern and Southern Africa
CIS	Commonwealth Independent States
GDP	Gross Domestic Product
IMF	International Monetary Fund
IPRs	Investment Policy Reviews
KNBS	Kenya National Bureau of Statistics
OLS	Ordinary Least Squares
UK	United Kingdom
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Fund
UNESCO	United Nations Educational, Scientific and Cultural Organization.
U.S.	United States

1. CHAPTER 1: INTRODUCTION

1.1. Background of the Study

1.1.1. Globalization

Globalization refers to the process by which businesses and organisations begin to work on an international scale. Seeing as globalization does not only take place on the economic front, there are various factors which influence globalization such as the political climate, legislation and technology, among others.

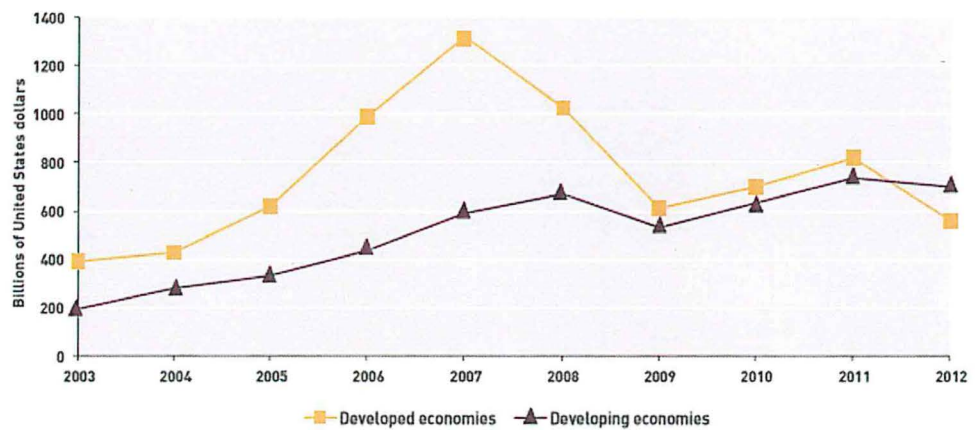
Economically, which is the focal point for this research; trade, foreign direct investment and capital flows are the major factors that facilitate and influence globalization. However, it is important to take into account the socio-cultural aspects of globalization such as migration and education, which are also pivotal to this research.

Intuitively, reverse globalization refers to reduced economic, social and political interconnectedness among various countries. Reverse globalization is more popularly known as de-globalization. According to Ghemwat and Altman (2013, p. 3), the level of globalization after 2007/08, i.e when the global financial crisis occurred, had a slow recovery in 2012, which resulted in the world being less intertwined in 2012 than it was in 2007. The explanation behind this phenomenon is believed to be macroeconomic fragility as well as more protectionist policies by the governments in countries all over the globe. The depth of FDI, moreover, plunged by 21% in 2012.

Figure 1 and 2 show the trend in inflows of Foreign Direct Investment (FDI) inflows as well as outflows of FDI both among developed and developing nations. It is evident that there was a general increase in both FDI inflows and outflows in the years preceding 2008, with the peak being in 2007. However, as of 2008, there was a severe reduction in FDI inflows and outflows in both developed

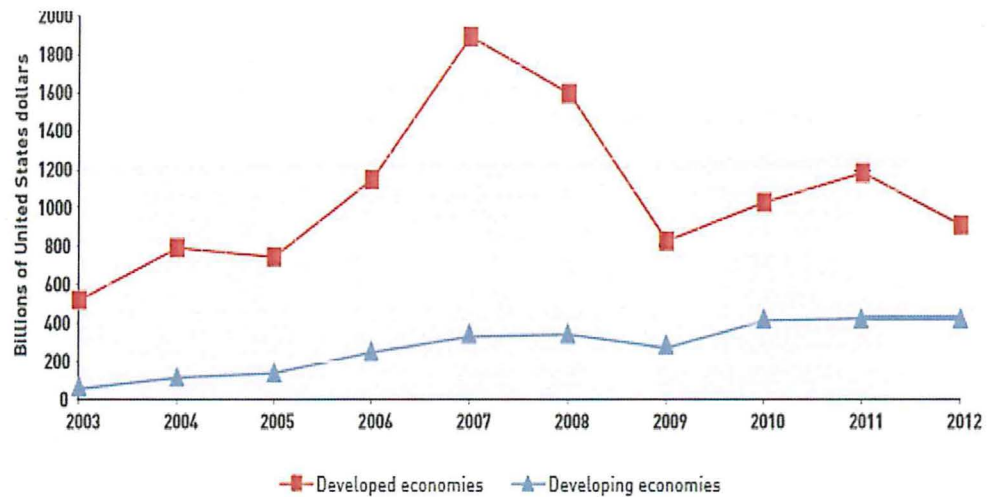
and developing nations alike but the greatest impact being seen in developed nations. It is arguable that a significant cause of this decline is due to the global financial crisis that began around 2007 and 2008.

Figure 1: Inflows of foreign direct investment in developed and developing economies between 2003 and 2012.



Source: ESCAP calculations, based on UNCTADStat.

Figure 2: Outflows from foreign direct developed and developing economies between 2003 and 2012



Source: ESCAP calculations, based on UNCTADStat

In order to measure the extent to which globalisation has reversed, there is a need to assess global interconnectedness over the years. As such, various indices have been developed and revised periodically to achieve this such as the KOF Globalization Index developed in 2002, the DHL Global Connectedness Index in 2011 and the Depth Index of Globalization in 2013 (Ghemwat and Altman, 2013).

The KOF Globalization Index was among the first indices developed to measure the degree of globalization among countries in the world. This index, developed by Axel Dreher, analysed globalization on three fronts: social, political and economic. The index assessed globalization based on various metrics such as personal contact, cultural proximity, actual economic flows, and economic restrictions among others. Despite covering only 122 countries and up to 2002 at first, updates have been made annually to the index to cover up to 207 countries and extended until 2014.

The DHL Global Connectedness Index of 2011 assessed 10 diverse types of flows such as foreign direct investment, merchandise trade, services trade and international internet bandwidth from 125 countries across the globe that contributed to 98% of the world's Gross Domestic Product (GDP) and 92% of the universal population. This index measured global connectedness based on the depth and breadth of the incorporation of a nation with the global economies. The Depth Index of Globalization 2013, on the other hand, compares to the DHL Global Connectedness Index 2011 in that it also considers shift in flows to and from emerging markets as a factor that affects globalization.

1.1.2. Foreign Direct Investment

According to Organization for Economic Cooperation and Development (2008), foreign direct investment is a reflection of the intention of developing a long-term interest by a resident enterprise in one economy in an enterprise that is not within the economy of the direct investor.

With reference to International Monetary Fund (2003), global foreign direct investment flows experienced a sharp increase in the 1990s due to the assimilation of global capital markets at rates that are well higher than those of international economic growth or international trade. Between 1990 and 1997, the amount of international inflows that were recorded increased by an average of 13 percent per annum. The aggregate increase in FDI flows was at an aggregate of about 50% within the years of 1998 and 2000, which was propelled by huge cross-border mergers and acquisitions. In 2001, the level of FDI inflows reduced to US\$729 billion in 2001 due to a significant reduction in the cross-border mergers and acquisitions.

The net result of foreign direct investment inflows into African nations has been positive, with the creation of jobs, growth of financial markets and development of local industries. However, political risk, corruption and poor infrastructure are

among the reasons as to why several foreign investors prefer to invest in emerging markets in other continents.

1.1.3.1. FDI in Kenya and South Africa

Kenya has experienced turbulent times since it attained independence in 1963. Corruption, poor governance, political risk and crime have ravaged the country and made the nation infamous around the world. As such, investors have in the past shied away from putting any stake in the country. However, improved infrastructure, liberalization of markets, trade openness and better governance have reversed the status quo, resulting in improved foreign investment.

The Quantum Global Research Lab (2017) developed an indicator that assess the attractiveness of investment in African countries based on growth, risk, liquidity, business environment, demographic and social capital factors. The findings of their most recent study are that Kenya's rankings for 2016-based on economic growth, credit rating, exchange rate risk and doing business were 6th, 11th, 42nd and 13th respectively out of the 54 African countries. Overall, Kenya was ranked 15th on its attractiveness to foreign investors, which is an improvement on the three-year average ranking of 20 for the period between 2013 and 2015.

Delloite (2016) finds that the amount of FDI in Kenya has increased steadily in recent years (an increase by almost 100% between 2012 and 2013). Research by StratLink Africa point to the fact that between January and August 2016, Kenya entered into deals worth US\$85m. fDi Intelligence (2016), additionally, finds that Kenya is one of the African markets with the greatest growths in FDI in terms of quantity of projects. These projects were worth US\$2.4bn in investments.

South Africa, on the other hand, has been at the top of the class in as far as economic growth and development in Africa is concerned. With vast mineral resources such as gold, copper, diamonds and iron as well as advanced

infrastructure and stable manufacturing industry relative to other African economies; South Africa has managed to attract significant levels of foreign direct investment over the years. According to Davis (1977), in 1975 the total stock of all foreign investment in South Africa had reached R16, 450 million. R7428 millions of that was in the form of direct investment, and an estimated R3566 million (21.6%) was derived from the Americas.

Foreign direct investment soon declined in South Africa in the 70s and 80s as the international community sought to fight against apartheid in South Africa. The United Nations, particularly, led in this fight by encouraging its member states to cut trade ties with South Africa and proposing economic sanctions on South Africa. In the earlier years, foreign direct investment inflows were predominated by inflows from the European Union, United States and the United Kingdom. However, over the years, China has challenged this space; majorly as a result of the BRICS association in 2010.

1.2. Problem Statement

Research as to what impacts foreign direct investment into Africa has mostly been geared towards factors such as real exchange rates, economic growth, inflation, risk factors such as political risk; and natural resource endowment.

However, what this research seeks to analyse is whether globalization, and for that matter reverse globalization, may have a stake in foreign direct investment as well. Given that African nations tend to be net importers and that they are heavily reliant on the advanced economies in the West and, more recently, the East; it is important not to overlook the fact that there could be a significant relationship between reverse globalization and foreign direct investment.

Kenya and South Africa have been at the forefront of attracting as well as actively seeking for foreign investment inflows to their economies. As a consequence, these two markets have become increasingly susceptible to global shocks and

positive externalities as well. It is important to address whether any of these shocks may be influencing the rate at which developed nations are investing in developing countries and emerging markets as well as the impact of any of these changes to macroeconomic variables in the host country.

For example, Van Rijckeghem and Di Mauro (2013) finds that the level of international banking shrunk prior to the 2007/08 financial crisis. Commercial banks pulled out from foreign operations, reducing cross-border assets and shutting down international branches. With reference to Van Rijckeghem and Di Mauro (2013), during the episodes of the greatest shocks in the banking system, the flight home effect was high. As such, a degree of precaution ought to be taken by, not only Kenya and South Africa, but all developing nations alike as to whom they forge investment agreements with. The introduction of the KOF Globalization Index to the equation will facilitate the assessment of how deeply integrated various advanced economies are, particularly prior to the global financial crisis in 2007/08 as well as any impact the shift in flows to emerging markets may be having on globalization.

1.3. Research Objective

To identify the impact of globalization in advanced markets on foreign direct investment in the emerging markets of Kenya and South Africa.

1.4. Research Question

Does globalization in advanced economies have an impact on foreign direct investment in Kenya and South Africa?

1.5. Scope of the Study

Kenya and South Africa were chosen on the premise of them being among the emerging markets in Africa.

Emerging economies are those with features such as: good growth forecasts, extraordinary rates of return, high levels of risk and volatility, and lack of a

history in foreign investment (Mody, 2004). The Emerging Markets Index (2008) developed in MasterCard Worldwide (2008) classified 65 countries in the world as emerging economies, of which only Egypt, Kenya, Morocco, Tunisia, Senegal and South Africa were African countries. These countries were assessed based on economic growth, business environment, education and IT connectivity, risk as well as quality of urban life. Kenya and South Africa were chosen on the premise that of the three sub-Saharan countries in the index, they were the emerging economies with the top two-largest GDP values in millions of dollars as per the World Bank (\$63,398 million and \$314,572 million).

The advanced economies that are of interest in this study are those that have significant foreign direct investment flows into Kenya and South Africa. These are United Kingdom, France and Germany. The period of study is between 1970 and 2014 so as to adduce enough evidence to show the FDI trends in both Kenya and South Africa and the impact of external shocks on FDI in both countries. During this period, both countries transition from colonies to independent states to emerging markets in Africa. As such, FDI trends must have shifted along the way.

1.6. Significance of the Study

If advanced economies have become more vigilant in who they trade with and where they invest in, shouldn't African economies follow suit?

This study is aimed at assessing further how susceptible African markets are to the actions of advanced economies and it will show to what extent this is. The study will also allow policymakers to further their scope when assessing the factors that affect foreign direct investment to Kenya and South Africa.

The research will also guide further research on the subject as markets continue to change and interact over time.

2. CHAPTER 2: LITERATURE REVIEW

There are various factors that have an impact on foreign direct investment. This study seeks to discuss these factors on a global scale and narrows it down to Africa and other developing regions and finally to Kenya and South Africa.

2.1. Theoretical literature

Over the decades, several theories have been developed to underpin FDI. These theories have formed the bases for a myriad of research on FDI in the world and shaped the outlook on the cause, effect and sources of FDI. This study will highlight some of these key theories.

2.1.1. Production Cycle Theory

This is a concept that was advanced by Raymond Vernon in 1966 in a bid to explain the forms of FDI made by United States (U.S.) companies in Western Europe post World War 2 in the manufacturing industry. Vernon and Wells (1966) postulates that the country with the comparative advantage in the production of the product changes from the innovating (developed) country to the developing economies. Furthermore, products are divided into three categories based on how they behave in the international market and the stage they fall in within the production life cycle. These stages are: new product, maturing product and standardized product.

2.1.2. Theory of Exchange Rates on Imperfect Capital Markets

This theory seeks to show a linkage between FDI and exchange rate fluctuations. Contradicting views have been made by researchers who have carried out this study, both as to the impact and the direction of this relationship. Cushman (1985) found that the amount of FDI made in USD was motivated by an increase in the real exchange rate, while the appreciation of a foreign exchange resulted in the decline in FDI in America. The study concludes that the dollar appreciation led to a decline in U.S. FDI by 25%. Blonigen (1997), similarly, finds that fluctuations in the exchange rate may affect the attainment of FDI since acquisitions involve

firm-specific assets which can produce returns in money other than that used for purchase. As such, real dollar depreciations result increased likelihood of U.S. firms being acquired by foreign firms (particularly Japanese firms, as per the study).

2.1.3. Monopolistic Theory of Advantage

The theory postulates that an enterprise which invests in a particular economy different from its country of origin gains a relative monopolistic upper hand against the local firms in the host country. It is an extension of Stefan Hymer's study that reasoned that a direct foreign investor owns some form of exclusive or monopolistic lead that is not obtainable by local firms. This monopolistic advantage is obtained on two avenues: superior knowledge and advance technology; and economies of scale. Superior knowledge is all the intangible skills owned by the firm that give it a competitive advantage. This allows the firm to generate distinctive product differentiation. The marginal cost of the transfer of this superior knowledge asset to foreign countries will be much lower than the cost incurred by the local firms in the host country.

2.1.4. The Eclectic Paradigm

The eclectic paradigm theory developed by Professor Dunning in Dunning (2000) is a combination of three different theories of direct foreign investments denoted as (O-L-I).

The "O" in this case refers to ownership advantages, which are the intangible assets that are in the short- term exclusively owned by the company and is transferrable within transnational companies at minimal costs. This may lead to an increase in revenues or a reduction in expenses.

However, the operations performed by transnational corporations in different countries result in incurring extra expenses. Consequently, in order to effectively penetrate a foreign market, a company should possess specific features that

would trump over the operating overheads on a foreign market. These benefits are the competences of the company. The firm has a monopoly over its own particular advantages and using them abroad results in higher marginal profitability or lower marginal cost than other competitors.

“L” refers to Location. When the initial condition is fulfilled, then, the company that possesses an advantage in as far as location is considered should maximize on the same as opposed to selling them to a foreign firm. Economic benefits (i.e. the quantitative and qualitative factors of production, transportation overheads, telecommunications, market size etc.) political advantages; and social advantage are the particular advantages that each country possesses.

Assuming the “O” and “L” conditions are achieved, it must be advantageous for the company the use of these advantages, in association with some features outside the country of origin. This necessitates the “I” from Internalization. This is an outline for looking at the various ways in how the company will maximize its powers from the sale of goods and services to various agreements that might be signed between the companies.

2.2. Empirical Literature

2.2.1. Factors Affecting Foreign Direct Investment in the World

Brewer (1993) broadened the popular belief that the policies set by the government of the host government resulted in imperfections in the market that, then, rationalized FDI as an alternative for domestic firms. As such, the study highlights the assortment of government policies and the diversity of their effects on market imperfections and the foreign direct investment behaviour of a firm. Government policies affect foreign direct investment either directly or indirectly. Monetary policies regarding money supply, money demand and interest rates are among the factors that indirectly affect FDI. FDI may be changed if and when these government policies lead to extensive deviations from the purchasing

power parity and real exchange rates. Capital controls, labour relations policies and intellectual property laws are among the factors that affect FDI directly.

According to Brewer (1993), the effect that a government policy has on foreign direct investment is as a result of the scope of the said policy, referring to the relative variances in cross-national policies of one country as likened to those of comparable countries. It is evident that the conclusions of Brewer (1993) are relatively applicable to various countries all over the world regardless of the extent to which they are developed.

Economic growth in the host country is seen as both a cause and a consequence of foreign direct investment in Ram and Zhang (2002). The use of cross-country research in the study provided a global view of the affiliation between economic growth and FDI. The study concluded that the link between FDI and the economic growth of the host country appears to be mostly positive for the 1990s.

This conclusion is intuitive considering the fact that any form of investment-foreign or domestic- into a country, industry, firm or business tends to result in positive effects on the beneficiary. However, it is worth noting spill over effects of FDI on the host country such as weakening of local industries due to competition, repatriation of profits to donor's home country as well as cultural erosion.

Hsiao and Shen (2003) carries out a panel data analysis of the determinants of FDI flows across developing countries between 1976 and 1997. Both time series data and panel data for 23 developing countries were assessed and the coefficients of explanatory variables estimated using three-stage least squares for this study. The study concludes that economic growth, predictable behaviour, trustworthiness and commitment from government institutions, infrastructural development of cities, and a reduction in the tax rates are vital in attracting FDI.

The development of cities promotes the exchange of information among economic agents, innovation as well as facilitating the value-addition process of goods and services. Lower tax rates and other government policies, as factors that influences foreign direct investment, are in tandem with Brewer (1993), as mentioned earlier. Economic growth was also found to be a determinant of FDI as was in Ram and Zhang (2002).

2.2.2. Factors Affecting Foreign Direct Investment in Emerging Markets and Developing Nations

The volatility of markets that characterize developing nations and emerging markets has a huge impact on the attractiveness of these markets to foreign investors.

Bajo-Rubio and López-Pueyo (2002) studied the features of FDI in the manufacturing industry in Spain between 1986 and 1992. Spain at this point in time was gaining its footing as an industrialized nation, receiving significant FDI inflows. As such this study provides insight as to the characteristics of FDI inflows to emerging markets, frontier markets and developing nations-countries that are undergoing integration with other relatively developed nations. The study assessed 20 companies within the manufacturing industry, with the regressand as FDI inflows as a percentage of sales.

Ordinary Least Squares (OLS) was used to estimate the significance of variables such as labour skills, economies of scale, trade performance and technological differentiation. The study finds that the quality of labour skills, product differentiation and level of economies of scale have a substantial influence on the FDI in the manufacturing industry in Spain during the study-period.

Political risk is a major factor that characterizes emerging markets and developing nations. As such, foreign investors have shied away from placing their resources in emerging markets. Jensen (2008) states that democracy may either increase or

reduce political risk in an economy. However, empirical results of the study indicate a strong positive correlation between lower levels of political risk and democratic institutions. Low levels of political risk in an economy, albeit it being developed or developing, attracts foreign direct investment as evidenced in various studies such as Hsiao and Shen (2003) as well as Ram and Zhang (2002).

Liargovas and Skandalis (2012) postulates that trade openness (measured by export-led growth and openness to imports) is another element that influences foreign direct investment inflows to developing nations. The study assessed developing economies in Africa, Latin America, Asia, Eastern Europe and Commonwealth of Independent States (CIS). The use of panel data caters for the data limitation, reduces collinearity among the variables employed and controls for individual heterogeneity in the study. To estimate the coefficients of the variables in the model, a panel least squares regression is carried out.

As such, countries that have minimal trade barriers are more attractive to foreign investors as compared to countries with trade restrictions. The study also finds a relationship between FDI and other factors such as exchange rate stability, market size and political risk- similar to Jensen (2008).

An analysis of the factors that influence foreign direct investment in developing economies was also carried out in Yasmin, Hussain, and Chaudhary (2003). This research evenly grouped fifteen developing nations into three categories based on their income levels: upper middle income countries, lower middle income countries and lower income countries.¹ The model in the study was estimated

¹ The countries with per capita GNP greater than US \$ 2,895 but less than US \$ 8,956 in 1998 were classified as the upper middle-income countries. The countries of Argentina, Brazil, Korea, Malaysia and Mexico are included in this group. The lower-middle income countries are those with a GNP per capita of more than US \$ 725 but less than US \$ 2,895 in the same period of time. The countries chosen for analysis are Columbia, Indonesia, Papua New Guinea, Peru and Thailand.

The low-income category comprises of those countries that had a GNP per capita of US \$ 725 or less in 1998. The sample countries included Pakistan, Sri Lanka, Kenya, Zambia and India. The countries of India,

using panel data approach for the three categories. The Hausman Specification Test is also utilized to ensure that there exists no correlation between explanatory variables and cross-sectional characteristics utilized in the model. The Random Effects Model was also vital to this research because it views the observations included as randomly sampled from a larger population, such that inferences can be applied to the entire population.

The research findings are that urbanization and labour force are common factors influencing FDI across the three categories. Standards of living, wages and current account are shared factors in lower income and lower-middle income countries while inflation is seemingly unique to lower income countries. Trade openness, as in Liargovas and Skandalis (2012), labour force and external debt are shared factors between upper- and lower middle-income countries.

Evidently, most research seems to find that urbanization, labour force, government policies, political stability and trade openness are chief among the factors that determine the level of FDI inflows to developing nations. Governments in these nations ought to put in measures to ensure a proper combination of these factors to optimize attraction of FDI and economic growth.

Given the factors that attract foreign direct investment into developing nations, there are several reasons as to why investors shy away from investment into developing and emerging markets.

Abdulai (2007) finds that Sub-Saharan Africa, as compared to other developing and emerging markets in South East Asia and Latin America, receives little FDI. The study suggests that bias about the political stability as well as generalization of the poor socio-economic conditions in African countries by foreign investors

Thailand and Mexico are taken as the base countries for the lower, lower middle and upper-middle income countries chosen for the analysis.

discourages them from investing in Africa. Physical, financial and institutional infrastructures in general are relatively underdeveloped in Sub-Saharan African countries. Roads, telecommunications, ports and airports are poor or undeveloped and consequently hinder business growth and efficiency. Lobbying power of local industries and stakeholders also restrict FDI by pushing for limiting measures to be placed on foreign investors. Poor judicial and legal systems also impede FDI because the interests of the foreign investors are not protected especially in matters pertaining to labour upheavals and wage disagreements. Furthermore, the size of the market is a vital determining factor of FDI. However, most domestic markets in Sub-Saharan Africa are fragmented and small and cannot effectively demand goods produced by the multi-national corporations.

As such, Abdulai (2007) suggests that policy makers should not only introduce but also ensure implementation of policies that will reverse the effect of repulsion of foreign investors against Sub-Saharan African markets. This can be achieved by initiating Investment Policy Reviews (IPRs) in collaboration with United Nations Conference on Trade and Development (UNCTAD) as well as their bilateral partners. IPRs would help Sub-Saharan African countries to advance their investment climates and permit the international private sector to become conversant with the investment climates in their individual countries.

Such policies include: signing of Bilateral Investment Treaties (BITs) that state clear terms as to how FDI would take place between the foreign investor and the host country; ensuring peace, stability and conflict prevention in the country; investment in the building of communications, roads and technology infrastructures or forming partnerships with the private sector in their various countries and in the region so as to develop these infrastructures.

2.3. Factors Affecting Foreign Direct Investment in Kenya and South Africa

Kenya

According to Bandiera, Kumar and Pinto (2008), political risk has been prevalent in Kenya over the decades, with poor transition of power and ethical clashes being some of the reasons why. Unfortunately, this has stunted economic growth due to soaring inflation, corruption and by reducing the country's attractiveness to investors.

Bandiera, Kumar, and Pinto (2008) find that after a successful transition of power after the 2002 elections, especially given the infamous Goldenberg scandal of 1992, political risk in Kenya declined. These, then, fuelled private investment in the country and improved sovereign creditworthiness. The study, at that time, proposed that in order to accelerate economic growth, Kenya ought to invest in social factors and infrastructure, which is in line with (Abdulai, 2007).

As per Kenya National Bureau of Statistics (2013), foreign direct investment inflows in Kenya has been on an upward trend, with a 38% increase between 2009 and 2011 from Kshs 143,503 million to Kshs 198,398 million. Common Market for Eastern and Southern Africa (COMESA) and the European Union (economic blocs) were the major sources of FDI inflows into Kenya whereas Mauritius and UK were the leading countries on the same. The study also finds that high interest rates charged on business operations, crime, corruption, politics and inefficient yet costly electricity are factors that deter FDI into Kenya.

The assessment of Nyamwange (2009) on whether FDI in Kenya has an impact on its economic growth also reveals the determinants of FDI inflows in Kenya. OLS method was the preferred method in this study. Aggregate FDI inflows was measured as a linear relation to factors that impact directly on economic growth i.e. trade openness, real domestic product, annual inflation rates and human capital. The logs of all the variables in the analysis were taken and the production

function differentiated with respect to time to yield the model used in calculating FDI.

The findings were that market size, stable macroeconomic policies and a level of human capital that is tolerable by investors contribute greatly to FDI inflows into Kenya. Contrary to Liargovas and Skandalis (2012), trade openness was found to not influence FDI in Kenya. Actually, a more open economy does not have an impact on FDI inflows in Kenya but would on the contrary result in negative pressure on FDI inflows into Kenya.

Through the use of a descriptive research and collection of data through questionnaires, desk reviews, interviews and observations, Muya and Mugambi (2015) found that the accessibility of resources, lack of insecurity in a location, government and other regulations, technology and corrupt governments were found to play a major role in deciding whether international investors will invest in Kenya. Therefore, policies should be set up to ensure corruption is reduced, technological progressions are made and security is enhanced within the country so as to create a conducive environment for FDI inflows.

South Africa

Özcalik and Gibson (2016) sought to determine the factors that determined FDI inflows into South Africa between 1970 and 2016. Firstly, unit root tests were conducted on the variables in the model to establish their whether or not they are stationary. Thereafter, a multiple regression analysis is carried out with FDI as the dependent variables and Gross Domestic Product, Real Interest Rates, Gross National Income, Gross National Expenditure, Official Exchange Rate and Gross Fixed Capital Formation as the explanatory variables. The findings were that Gross Domestic Products, Gross National Expenditure and Gross Fixed Capital Formation were substantial to the inflow of FDI in the South African economy during the period of interest.

Jadhav (2012) then analyses the determinants of FDI in BRICS² economies between 2000 and 2009. The Levin, Lin and Chut test was utilized to determine the existence of unit roots (non-stationarity) in the data set. This was then followed by a multiple regression analysis to estimate the coefficients of the independent variables in the data set. A significant portion of the FDI in BRICS economies were found to be driven by the market-seeking purpose (as indicated by market size, which is measured using GDP) while most of the institutional and political determinants were not statistically significant. This is contrary to Brewer (1993), Abdulai (2007), Jensen (2008) and a myriad of other research that depicts presence of a relationship between FDI and political risk and government policies.

2.4. Research Gap

Past studies have mainly assessed research on the determinants of FDI inflows in Kenya and South Africa based on risk factors, infrastructure and market size. This study begs the question of what impact globalization and reverse globalization, for that matter, may be having on FDI inflows in these two economies. As such, how do emerging markets need to adjust to the presence of such a relationship?

2.5. Conceptual Framework

The diagram below depicts the variables that affect FDI inflows in Kenya and South Africa, all of which will be taken into consideration in this study.

² Brazil, Russia, India, China and South Africa

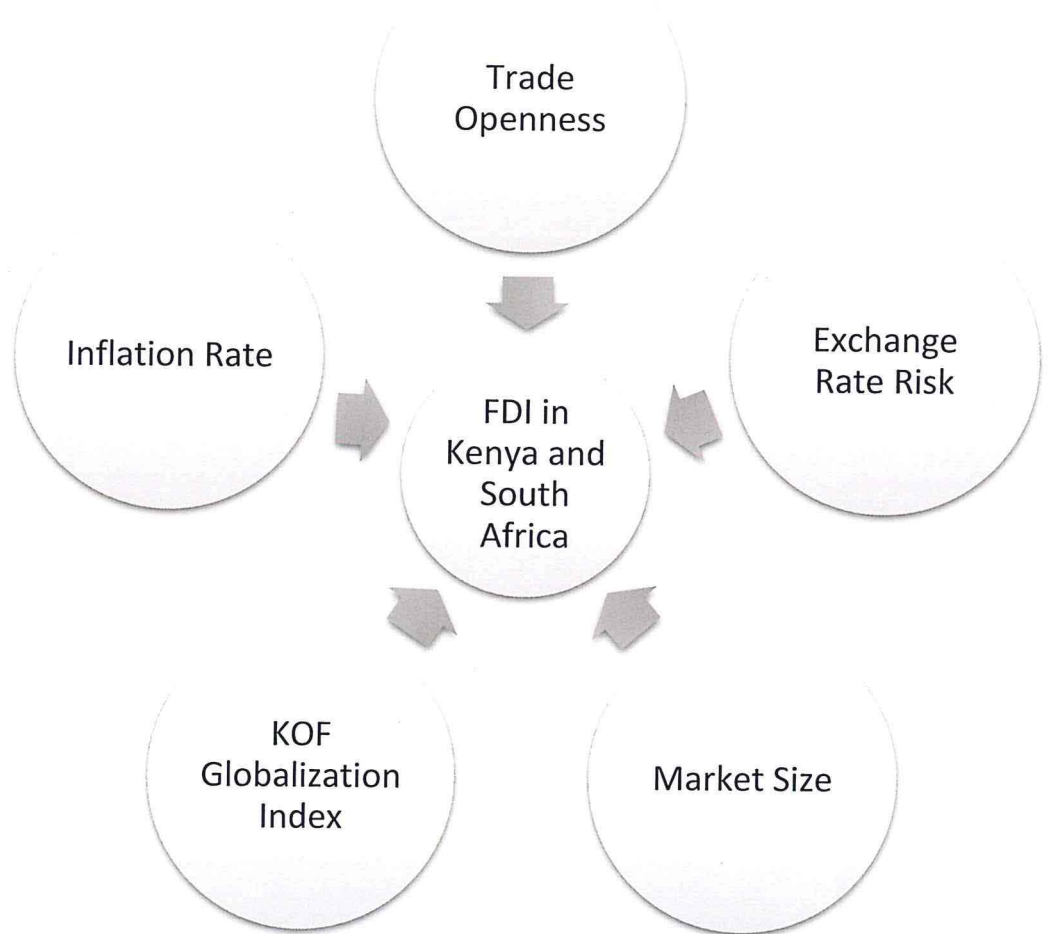


Table 1: Description of the variables that will be used in the study

Dependent Variable	Description
Foreign Direct Investment	This refers to an investment aimed at establishing a long-term relationship and that indicates a durable interest. (OECD, 1996)
Independent Variables	Description
KOF Index of Globalization (DIG)	The KOF Index of Globalization measures and analyses the globalization levels of 207 countries on three dimensions: social, political and economic globalization. The higher the value of the index, the more globalized the country is.
Market Size	This is proxied by real GDP.
Trade Openness	This refers to both export-led growth and openness to imports. This is measured by the ratio of the sum of exports and imports to real GDP. Liargovas and Skandalis (2012)
Inflation Rate	This refers to the percentage change of a price index over time.
Exchange Rate Risk	This is the financial risk of an investment's value changing due to the changes in currency exchange rates.

3. CHAPTER 3: METHODOLOGY

This chapter contains the empirical analysis of the variables that were required to assess the impact of globalization on foreign direct investment in Kenya and South Africa. It also contains the various tests that were conducted and panel data techniques utilized in order to measure the relationships between FDI in Kenya and South Africa and the various explanatory variables.

3.1. Research Design

This study followed a quantitative approach, while utilizing an explanatory research design. An explanatory research design seeks to explore the relationship between two or more variables and allows for inferences to be made about associations and causality.

3.2. Population and Sampling

The target population under review was the list of emerging markets in the world as determined by MasterCard Worldwide (2008). These countries include: Argentina, Brazil, Bulgaria, Chile, China, Colombia, Dominican Republic, Ecuador, Egypt, Hungary, India, Indonesia, Kenya, Lebanon, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Romania, Russia, Senegal, South Africa, Thailand, Tunisia, Turkey, Ukraine, Uruguay, Venezuela and Vietnam.

Given the above list of emerging markets, this study focused on Kenya and South Africa due to them being among the top emerging markets in Africa and the availability of data on these two countries.

The advanced economies under assessment (United Kingdom, France and Germany) were chosen on the premise that they are the greatest contributors of FDI inflows in Kenya and South Africa. Kenya National Bureau of Statistics (2013) found that in 2010, the United Kingdom accounted for 34.8% of total FDI inflows into Kenya. For South Africa, South Africa Reserve Bank (March 2017) indicated

that as of 2015, the main investing countries into South Africa are the United Kingdom (29.5%), Netherlands (24.2%) and Germany (3.3%).

As such UK, Germany and France were utilized for the analysis of the impact of globalization on FDI in Kenya and South Africa. Netherlands was omitted from the study due to lack of sufficient data on its level of globalization, as measured by the KOF Index of Globalization.

3.3. Data Collection

Secondary data was deemed appropriate due to the nature of this study. As such, secondary data was utilized from various sources. Given that the study assesses both Kenya and South Africa, panel data was utilized.

Data on FDI, real GDP, inflation rate, the level of imports and exports as well as exchange rates for Kenya and South Africa were obtained from the World Bank Open Data. Data on the KOF Index of Globalization was acquired from the Swiss Federal Institute of Technology Zurich. Data from these sources was obtained using surveys, questionnaires and interviews.

The analysis was carried out for the period between 1970 and 2014 for United Kingdom, France, Germany, Kenya and South Africa. This period allowed for sufficient analysis of the various variables and assessment of trends. The data was analysed on an annual basis. The use of secondary data over primary data in this study was due to its ease of accessibility, reliability based on its sources as well as the feasibility of both longitudinal and international comparative studies.

3.4. Data Analysis

The model utilized in this study utilized the log-normal values of some of the variables in the model because it allows for easier interpretation of data. Another advantage of utilizing logarithms is that the use of logarithms in econometric

models generates the desired linearity in parameters, considering linearity is one of the Ordinary Least Squares assumptions.

As such, the model was specified as:

$$\ln FDI_{it} = \alpha + \beta_1 \ln KOF_{it} + \beta_2 \ln GDP_{it} + \beta_3 \ln TOPEN_{it} + \beta_4 INF_{it} + \beta_5 XRSK_{it} + \mu_{it}$$

Where;

FDI_{it}: FDI net inflows by foreign investors in the reporting economy. This will be expressed as a percentage of GDP for country *i* at time *t*.

KOF_{it}: KOF Globalization index for country *i* at time *t*. The countries, in this case, refer to the advanced economies from whom Kenya and South Africa receive FDI. In this study, the countries were limited to United Kingdom, France and Germany.

GDP_{it}: real gross domestic product for country *i* at time *t*.

TOPEN_{it}: trade openness measured as the sum of imports and exports divided by GDP for country *i* at time *t*.

INF_{it}: the percentage rate of change of the price index in country *i* at time *t*.

XRSK_{it}: this is the annual percentage change in the exchange rate of the national currency against the USD for country *i* at time *t*. This will act as a proxy for exchange rate risk, similar to Liargovas and Skandalis (2012).

Each coefficient represents the change in the dependent variable (FDI) for every one unit change in the respective independent variable. ϵ_{it} is the error term of equation.

3.4.1. Unit root tests

It was, then, vital to this study to test whether the series is characterized by a unit root or not before applying the regression model. The presence of unit roots in data means that the data is non-stationary, thus would lead to spurious and unreliable results. Maddala and Wu (1999) assess and critique the various unit root tests that have been proposed over time for use with panel data.

The Levin-Lin test is one of the most used panel data unit root tests. This model incorporates a time trend as well as individual and time-specific tests. The hypotheses under this test are:

$$H_0: \rho_1 = \rho_2 = \dots = \rho_N = \rho = 0$$

$$H_1: \rho_1 = \rho_2 = \dots = \rho_N = \rho < 0$$

The main limitation of this test is that the ρ is the same value for all observations. This assumption is, however, too strong to be held in empirical cases. As such, this test tests a very restrictive hypothesis that is hard to use practically.

The Im-Pesaran-Shin (IPS) test relaxes the assumption under H_1 . Instead of pooling the data, separate unit root tests are carried out for the N cross-sections. Monte Carlo methods are used to find the estimates of the parameters of the model i.e μ and σ^2 . The IPS test is claimed to be a generalization of the Levin-Lin tests. One limitation of this test, however, is that it requires the study to have balanced panel data. If unbalanced panel data is used, more Monte Carlo simulations have to be carried out to get critical values.

3.4.2. Fixed Effects and Random Effects Models

There are two categories of panel techniques: fixed effects estimator and random effects estimator. The fixed effects estimator is the estimator applied when fixed

effects models are used whereas the random effects estimator is used when the random effects model is used.

The fixed effects model for a variable y_{it} can be specified as:

$$y_{it} = \alpha + \beta x_{it} + \mu_i + v_{it}$$

where μ_i encapsulates all the variables that affect y_{it} across the cross-sections but do not vary over time.

The fixed effects model assumes that the marginal effects of the explanatory variables on the dependent variable are the same for all units. If the errors are serially uncorrelated, the fixed effects estimator is more efficient than the random effects model.

The Random Effects model, on the other hand, is utilized where the unobserved effect is uncorrelated with the explanatory variables in the model. Estimation of the random effects model is done using Generalized Least Squares.

The random effects model is specified as:

$$y_{it} = \alpha + \beta x_{it} + w_{it}$$

Where $w_{it} = \varepsilon_i + v_{it}$

If subjects change little, or not at all, across time, a Fixed Effects model may not be suitable. Also, the Fixed Effects model results in standard errors that are too large. The Random Effects model, on the other hand, results in smaller standard errors but the coefficients it estimates may be biased.

In order to distinguish between which of the two models to use, the Hausman specification test is carried out. The specified model will be used for the period spanning 1970 to 2014.

4. CHAPTER 4: RESULTS AND ANALYSIS

4.1. Unit root test

Before applying the regression model specified in chapter 3, it is important to assess whether the series is characterized by a unit root. If the series is characterized by a unit root, first differences will be taken to correct for this and to enable further analysis to be done. The results in Table 2 below represent the results of the Levin-Lin and Im-Pesaran-Shin unit root tests in level and first differences for the variables under analysis.

Table 2: Panel Unit Root Tests

Panel Unit Root Tests				
Variables	Levin-Lin (Level)	Levin-Lin (First difference)	IPS (Level)	IPS (First difference)
LN FDI	-1.8333 0.0334 ^{*3}	-8.5791 0.0000*	-1.8576 0.0316*	-9.5833 0.0000*
LN GDP	-0.9667 0.1668*	-6.5814 0.0000*	0.5743 0.7171*	-5.1883 0.0000*
INFL	-1.5364 0.0622*	-7.7686 0.0000*	-2.2999 0.0107*	-7.9311 0.0000*
LN KOFUK	-6.4555 0.0000*	-3.7215 0.0001*	-4.3552 0.0000*	-3.5094 0.0002*
LN KOFGE	-1.9605 0.0246*	-5.1349 0.0000*	-0.2275 0.4100*	-4.7518 0.0000*

³ * Refers to the probability value of the variable.

Variables	Levin-Lin (Level)	Levin-Lin (First difference)	IPS (Level)	IPS (First difference)
LN KOFFR	-2.2763 0.0011*	-92.9539 0.0013*	-0.3396 0.3671*	-2.9539 0.0016*
TOPEN	-2.2266 0.0130*	-6.4745 0.0000*	-2.4752 0.0067*	-6.2708 0.0000*
XRISK	1.2090 0.8867*	-7.2686 0.0000*	2.6593 0.9961*	-6.4032 0.0000*

The rejection criterion for both panel unit root test is that the null hypothesis of the presence of unit roots is rejected if the p-value is less than the level of significance or if the t-statistic is less than the critical value. For the purposes of this study, the level of significance is taken as 0.05. Given the findings of the panel unit root tests above, the level of globalization for UK and trade openness are stationary at level while FDI, market size, the level of inflation, exchange rate risk, the level of globalization of Germany and France are stationary at first difference. Thus, it is prudent to use the first difference of the variables in the model.

4.2. Fixed Effects and Random Effects model

The next step was to run a Fixed Effects and Random Effects model to determine the coefficients of the independent variables in the model. After running both the Random Effects and the Fixed Effects, it was found that both models are significant in explaining the model, with the p-values of the overall model being 0.0000 and 0.0006 respectively. Therefore, there was a need to perform the Hausman Specification test so as to determine which model to utilize.

The null hypothesis under the Hausman Specification Test is that the difference between the coefficients of the two models are insignificant. The alternative hypothesis is that there is a difference between the coefficients of the two models and that the fixed effects model should be chosen over the random effects model. The p-value obtained after running the Hausman Specification Test, as shown in Table 3 below, was found to be 0.9994. Therefore, we fail to reject the null hypothesis that the model is a Random Effects Model.

The Random Effects model also revealed that the unobserved, time-invariant variables in the model are statistically significant in providing an explanation of the model, given a null hypothesis that the random effects are insignificant and a p-value of 0.000.

Table 3: Hausman Specification Test Result

Variables	Coefficients		
	Fixed (b)	Random (B)	Difference (b-B)
LNGDP	1.2164	1.3802	-0.1637
INFLATION	-0.2883	-0.02281	0.00602
XRISK	-0.0129	-0.01733	0.004427
KOFUK	-13.6329	-15.3955	1.7626
KOFGE	9.5353	11.0176	-1.4823
KOFFR	-0.0868	-0.9684	0.8816
TOPEN	0.0678	0.05126	0.01657

The probability value of the chi-squared distribution in this test was obtained as 0.9994. Therefore, we fail to reject the null hypothesis that the model to be used is a Random Effects Model.

Table 4: Random Effects Regression Analysis

Given 90 observations, the results of the Random Effects regression are as follows:

<u>Variable</u>	<u>Coefficient</u>	<u>Standard Errors</u>	<u>P-Value</u>	<u>Z Statistic</u>
LN GDP	1.3802	0.2999	0.000	4.60
INFL	-0.02281	0.02388	0.339	-0.96
LN KOFUK	-15.3955	7.5836	0.042	-2.03
LN KOFGE	11.0176	4.6442	0.018	2.37
LN KOFFR	-0.9684	4.8561	0.842	-0.2
TOPEN	-0.05126	0.02192	0.019	-2.34
XRISK	-0.01733	0.0088	0.051	--1.95
CONSTANT	8.5618	11.6237	0.461	0.74

4.3. Interpretation of the regression results

The results of the Random Effects Model revealed that the market size, KOF index of globalization of UK and Germany, exchange rate risk and trade are significant determinants of FDI in Kenya and South Africa for the period between 1970 and 2014 at 5% level of significance. Inflation and the KOF index of globalization for France have been found to be statistically insignificant in determining FDI in Kenya and South Africa for the period under assessment.

An increase in the market size (as proxied by GDP) by 1 percentage point increases the FDI in Kenya and South Africa by 1.3802 percentage points. An increase in inflation by 1 percent reduces FDI by 2.281 percent. An increase in the level of globalization of UK by one percentage point reduces the FDI in Kenya and South Africa by 15.39 percentage points. An increase in the level of globalization in Germany by 1 index point increases the FDI in Kenya and South Africa by 11.0176 percentage points. An increase in the level of globalization of France by 1 index point reduces the FDI in Kenya and South Africa by 0.9684 percentage points. An increase in trade openness by 1 percent reduces FDI in Kenya and South Africa by 5.126 percent. An increase in exchange rate risk by 1 percent reduces FDI in Kenya and South Africa by 1.733 percent.

5. CHAPTER 5: DISCUSSIONS AND CONCLUSION

5.1. Discussion

The major objective of this study was to identify the impact of globalization in advanced markets on foreign direct investment in the emerging markets of Kenya and South Africa between the years of 1970 and 2014. Based on the analysis and empirical findings, market size (proxied by real GDP), the KOF index for the United Kingdom and Germany, exchange rate risk and trade openness were all found to be statistically significant determinants of FDI inflows into Kenya and South Africa. Inflation and the KOF index of France, however, are found to be statistically insignificant in determining FDI inflows in Kenya and South Africa.

The KOF index of globalization measures the degree of globalization among countries in the world. Based on the trend of the data as seen in the appendices, it was clear to see that there has been an upward trend in the level of globalization in the developed economies of France, United Kingdom and Germany. This, therefore, refutes claims globalization is going into reverse. In fact, Ghemawat and Altman (2016) reassesses globalization and find that despite a slowdown in globalization after the global financial crisis, it did not go in reverse. The study utilizes cross-border flows of trade, capital, information and people to measure the level of global interconnectedness for 140 countries and territories between 2005 and 2015.

Another point to note is that, the level of globalization in the United Kingdom and Germany were statistically significant determinants of FDI in Kenya and South Africa.

However, the relationship is negative for the United Kingdom and positive for Germany. The level of globalization of France, is however, not a statistically significant determinant of FDI in Kenya and South Africa. This implies that as

France becomes increasingly globalized, it sees Africa as a good area to invest its funds.

Similar to Liargovas and Skandalis (2012), the findings of this study are that trade openness is a significant determinant of FDI in Kenya and South Africa. However, the relationship between these two variables is positive, meaning that the more open the economy is in terms of exports and imports, the more FDI inflows are attracted into these two countries.

Asiedu (2002) sought to find and explain any contradictions in the factors that determine FDI in Africa as compared to other developing countries. The findings were that, in as far as trade openness is concerned, the marginal gain from trade openness is less for Sub-Saharan countries. As such, policies that are successful in other regions may not necessarily be successful in developing nations in Sub-Saharan Africa. The possible explanation explored in this study for this phenomenon is that foreign investors view trade liberalization in Sub-Saharan Africa countries as transitory and, as such, subject to reversal. That trade liberalization reforms may be implemented as an aid conditionality and as such when aid ends, there is little incentive for the country to continue to reform.

As in Liargovas and Skandalis (2012), exchange rate stability is a statistically significant determinant of FDI inflows. In fact, there is a negative relationship between exchange rate risk and FDI in Kenya and South Africa. The negative relationship can be explained by investors being less attracted to economies where the real exchange rate can appreciate or depreciate. As found in Cushman (1985), an appreciation in the U.S dollar results in a decline in FDI inflows in the country. Meanwhile, Dai (2015) finds that a depreciation in the real exchange rate can result in the tradable sector being increasingly profitable.

In line with Nyamwange (2009) but contrary to Yasmin, Hussain and Chaudhary (2003), the level of inflation in Kenya and South Africa is not a statistically significant determinant of FDI inflows in Kenya and South Africa. Reasonably though, there is a negative relationship between FDI and the inflation rate seeing as investors would be less attracted to countries with increasing and unstable inflation rates. Adisson and Heshmati (2003) also find a negative relationship between FDI and inflation. The explanation given is that a high rate or variability of inflation may be an indicator of volatile macroeconomic conditions in a country. This will result in uncertainty amongst investors, thereby, leading to contraction of FDI inflows.

In as far as market size is concerned, this study finds a strong positive relationship between market size and FDI inflows. This is similar to the conclusions of Adisson and Heshmati (2003). Investors, therefore, tend to be attracted to economies that are growing. This is due to an increase in the number of economic agents, opportunities for investment and potentially an increase in the purchasing power of these economic agents. Demirhan and Masca (2008) also finds a positive relationship between FDI and market size in the analysis of factors that determine FDI in developing countries between 2000 and 2004.

5.2. Conclusion

Given the results above, then, it can be concluded that FDI in Kenya and South Africa is in fact, impacted by the level of globalization in the countries from which it is attracted. Of importance, nonetheless, is that in the United Kingdom this relationship is negative. This could be interpreted as investors from the United Kingdom being less attracted to investing in Kenya and South Africa as they increase their connections with other countries in the world. On the other hand, Germany is more willing to invest in Kenya and South Africa as it becomes increasingly globalized. Seeing as the level of globalization of France is not a

statistically significant determinant of FDI in Kenya and South Africa, then Kenya and South Africa can be optimistic about the prospects of France being a strong source of FDI. That, regardless of France being increasingly globalized over the years, it considers Kenya and South Africa as beneficial areas of investment.

5.3. Recommendations

Seeing as there exists a link between FDI and the level of globalization in Kenya and South Africa, policymakers should observe the actions of foreign investors into these two countries.

Prudential measures should be put in place by the government to ensure that negative shocks that occur in the United Kingdom and Germany do not have a ripple affect into the economies of Kenya and South Africa. This could be through putting a ceiling on the level of FDI inflows into these countries from the United Kingdom and Germany or ensuring that the contractual terms set by foreign investors also favour local firms and businesses such that these investors do not easily pull out when conditions are not favourable for them . That local firms can seek legal assistance, through an effective and efficient judicial system, in case such contractual terms are breached.

5.4. Limitations of the study

The key drawback of this study was availability of sufficient data on factors such as the labour force in Kenya and South Africa, political risk and the KOF index for Netherlands, all of which are key variables in conducting a comprehensive study on FDI in Kenya and South Africa.

5.5. Recommendations for further research

This study could be improved by looking at other measures of globalization and perhaps introducing other countries that direct FDI into Kenya and South Africa. Also, introducing variables such as political risk, level of infrastructure may also enhance the findings of this study.

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7. APPENDICES

The trend of the level of globalization of UK, Germany and France as measured by the KOF Index of Globalization between 1970 and 2015.

**KOF Index of Globalization
1970-2014**

