

**RELATIONSHIP BETWEEN EXTERNAL FINANCIAL RESOURCE INFLOWS
AND ECONOMIC GROWTH IN KENYA**

BY

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MASTER OF SCIENCE IN COMMERCE (FINANCE AND ECONOMICS)

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**A DISSERTATION SUBMITTED IN PARTIAL FULFILLMENT OF THE
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DECLARATION

I declare that this Dissertation is my original work and has not been previously published or submitted elsewhere for award of a degree. I also declare that this contains no material written or published by other people except where due reference is made and author duly acknowledged.

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I do hereby confirm that I have examined the master's dissertation of

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ABSTRACT

Economic growth is about better standards of living, lower unemployment levels, reduced government borrowing and attracting investment. Kenya has employed a number of strategies to fulfill this objective. The purpose of the study was to investigate the relationship between external financial resource inflows and economic growth in Kenya. The specific objectives was to establish the relationship between official development assistance, foreign direct investment, diaspora remittances, external debt and economic growth in Kenya. The study adopted a descriptive research design. To realize the set objectives, data was collected on the rate of economic growth, official development assistance inflows, foreign direct investment inflows, remittances from the diaspora, net external debt inflows, gross domestic saving and population growth rate in Kenya. Secondary data from Kenya National Bureau of Statistics, Treasury bulletins, Central Bank of Kenya, International Monetary Fund and World Bank was used. The study used data from 1975 to 2015. The quantitative data was analyzed using stata statistical software. Econometric modeling was used to establish the relationship between the variables. Vector Error Correction Model (ECM) was fitted. Study results indicated that FDI had a significant relationship with GDP growth. However, findings revealed that ODA, diaspora remittances and external debt did not have a significant relationship with GDP growth. The following recommendations are made. First, the government should improve the ease of doing business, reduce regulation and licenses required to register businesses and ease the tax regulations to make the country able to attract more FDI. Secondly, the government should have effective policies to ensure that ODA is channeled to high growth sectors that can have a significant effect on GDP growth. Similarly, the study recommends to the government and financial sector to have effective regulations and policies to ensure that any remittances received into the country from diaspora are invested into productive sectors. Lastly, government should ensure that external debt is only sought as a last resort. Similarly, any borrowed funds should be invested in productive sectors that will generate revenue to enable repayment of such debt.

Keywords: External finance, economic growth, remittances, foreign direct investments, official development assistance, external debt.

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DEDICATION

This humble work is dedicated to the almighty God, my source of inspiration, wisdom, knowledge and understanding. I also dedicate this work to my dear wife, who has been a constant source of support and encouragement during the research period.

Finally, I dedicate this dissertation to my friends and classmates who have supported me throughout the process.

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ACRONYMS AND ABBREVIATIONS

EAC	East African Community
FDI	Foreign Direct Investments
GDP	Gross Domestic Product
IOM	International Organization of Migration
ODA	Official Development Assistance
OECD	Organization of Economic Corporation and Development
SAP	Structural Adjustment Programs
UNCTAD	United Nation Conference on Trade and Development

OPERATIONAL DEFINITION OF TERMS

Economic growth - Increase in the ability of the economy of the country to increase aggregate production of goods and services, related from one year to the next (Uwatt, 2003).

External debt - The part of the country's debt borrowed from foreign lenders including governments, commercial banks or international financial institutions (Chami et al., 2008).

External finance – these are funds that the country obtains from outside the borders of the country by the country's nationals or other non-nationals (Chami et al, 2008).

Foreign direct investments – Funds used in a business venture, business operations or in acquiring business assets by an individual, company or government of a foreign country into another country (Eifert & Gelb, 2008).

Official development assistance - Aid to the government by individuals, companies or foreign governments aimed at promoting the welfare and economic development of the country (Stojanov & Strielkowski, 2013).

Remittances – These are funds sent into the country by nationals of the country living in foreign countries for investment, payment for goods and services, savings or as gift to nationals in the country (Burnside & Dollar, 2012).

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

Developing countries require additional resources to support economic growth rates that are compatible with the achievement of the Millennium Development Goals (MDGs). External resource inflow may be termed as flow of capital, real and or financial resources into a country in form of aid, remittances, foreign direct investment and external debt (Martins, 2010). The evidence that inflow of financial resources is a constraint for growth and development is overwhelming. On a macroeconomic perspective, researchers have found a significant positive correlation between variables which capture the level of financial development in an economy, and the level of per capita income (Chami et al, 2008).

This suggests that a developed financial structure which provides financial services on a broad range is a key factor for achieving a higher per capita income growth rate and higher rates of economic growth. On the other hand, the per capita income of countries which fail to attain financial development remains low. The study by the International Bank of Settlements (IBS, 2014) identifies financial constraints as the key impediment to growth and sustainability of both startups and SMEs.

In contrast, Robinson (1952) declared that “where enterprise leads finance follows.” According to this view, economic development creates demands for particular types of financial arrangements, and the financial system responds automatically to these demands. Moreover, some economists underscore the relationship between finance and growth. Lucas (1988) asserts that economists “badly over-stress” the role of financial factors in economic growth. Similar concerns are raised by a study by the Organization for Economic Co-operation and Development (OECD, 2012) that places managerial weaknesses at the heart of SME failure.

Monetary resources are scarce in nature and therefore governments in developing countries face huge savings-investments gap, or the difference between financial resources available domestically and the budgetary needs are increasingly becoming bigger and bolder. For instance, a study by the African Economic Consortium (2010) places budgetary constraints as a key impediment to sustainable growth in sub Saharan Africa. Given this huge gap, various attempts have been made to attract and harness both domestic and international resources.

However due to scarcity and constraints encountered in mobilizing domestic resources, countries are increasingly shifting their attention to international avenues of raising the much-needed resources. This calls for the sourcing of cheap, efficient, flexible and reliable sources of funding. To do this effectively various policies and initiatives have been undertaken by developing countries to enhance their preference as destination of external financial resources. Various instruments are available to this end, key among them are: Foreign Direct Investments (FDI), Official Development Assistance (ODA), External Debt and Remittances from the Diaspora (Chami et al, 2008).

Globally, external financial flows have its attendant benefits and costs to countries. The increasing inflow of foreign capital has not only created wealth to countries but has also led to higher global financial systemic risks, and costs, especially in developing countries that are yet to fully develop their financial markets. Understanding the mechanism through which external financial flow affects economic growth is paramount for evaluating the costs and benefits of such transactions (Eifert & Gelb, 2008).

1.1.1 Trends in External Resource inflow in Kenya

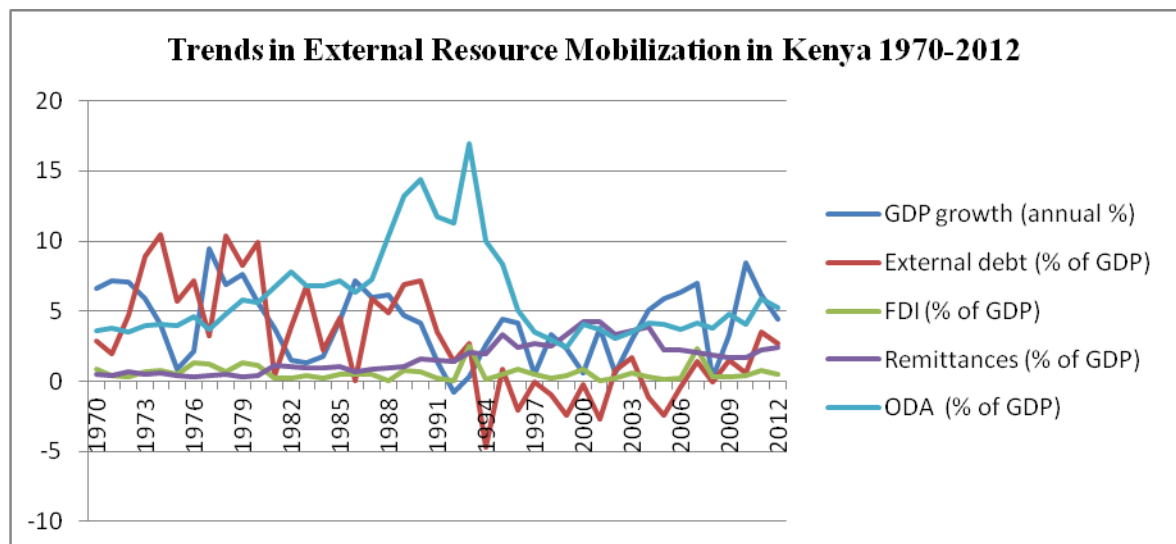
There are several external sources of financing development, in this study the following four was explored; Official Development Assistance (ODA), Foreign Direct Investment (FDI), Diaspora remittances and external debt. The Official Development Assistance (ODA)

includes grants and loans to developing countries which are given to public agencies mostly from the Organization for Economic Cooperation and Development (OECD) under the auspices of Development Assistance Committee (DAC).

Evident from Figure 1.1 below, the flow of foreign aid was highest in the period before 1990s but has dwindled in the budgets of many donor countries during the past several years, following the crisis of legitimacy of the ODA raised in mid 1990s. Noteworthy here, is that the rate of economic growth remained fairly the same even during periods of high ODA receipts. This is so despite that foreign aid receipts are an important source of revenue and thus constitute a key element in fiscal policy for developing countries. Aid may be an indispensable source of financing, in particular, for expenditures in areas, such as, health, education, and public investment that are essential to improve the living standards of poor people in developing countries (Burnside & Dollar, 2012).

FIGURE 1

Trends in External Resource inflow in Kenya from year 1970 to 2012



Source: WDI (2015)

Foreign direct investment is a type of cross-border investment which is made by a resident entity in one economy (the direct investor), with the aim of establishing a lasting

interest in an enterprise (the direct investment enterprise) being a resident in an economy other than that of the direct investor. FDI involves a long-term relationship between the direct investor and the direct investment enterprise and a significant degree of influence of the direct investor on the management of the enterprise. The ownership of 10 per cent of the voting power is regarded as a threshold allowing an investor to be referred to as a direct investor (OECD, 2008).

From Figure 1, Foreign Direct Investment (FDI) inflows have remained fairly stable but significantly low over the 1970 to 2012 periods with considerable increases during years of economic boom. This is because FDI is motivated by returns on investments which tend to be higher during economic boom (Stojanov & Strielkowski, 2013).

The International Organization of Migration (IOM) defines remittances as ‘the remittances that migrants make to their destination country’. Remittances have become a popular subject in the literature on external financing development and economic growth, because of their size and their potential to promote economic growth in developing countries. However, unlike other instruments of external finance, it has been argued that much attention has not been given to the flows of remittances in term of adequate statistics, policy formulation and eradication of barriers to actually buttress its relevance in the national development (Ramirez, 2014).

Although remittances from the diaspora were almost insignificant and the lowest source of external finance in 1970s, they have considerably grown to overtake foreign direct investment as well as a close competitor of official development assistance and external debt. Remittances have been increasingly important because they represent a steady source of funding to developing countries. Noteworthy from the figure above is the countercyclical nature of remittances where unlike FDI that increases during economic boom and decreases during recession, remittances are higher during recession as the remitters support their

families more during tough economic times acting as an economic stabilizer and consequently reducing the adverse effect of the recession.

Barro (1979) showed that the relationship between external debt and growth had an inverse relationship whereas Reinhart and Rogoff (2010) study showed that most governments tends to raise their taxes to achieve debt sustainability, the distortionary impact implies lower potential output. Governments sometimes tighten debt sustainability by reducing spending, which is a contractionary measure consequently hindering growth.

As is evident from figure 1, official development assistance and external debt have been the highest forms of external finance in Kenya, they have also been the most volatile, which is an indicator of their non-reliability in planning and effecting fiscal policies of a country.

1.1.2 Economic Growth in Kenya

Economic growth may be defined as the process by which the aggregate productivity of the economy is increased compared from one period to another to result in increased in national income. It can be measured in nominal or real terms (Uwatt, 2003). Economic growth may also be accelerated through technological advancement, physical capital formation, international trade, investment in education, human capital, external capital inflow, foreign direct investments, microeconomic policies and good governance (Akuwu, 2014).

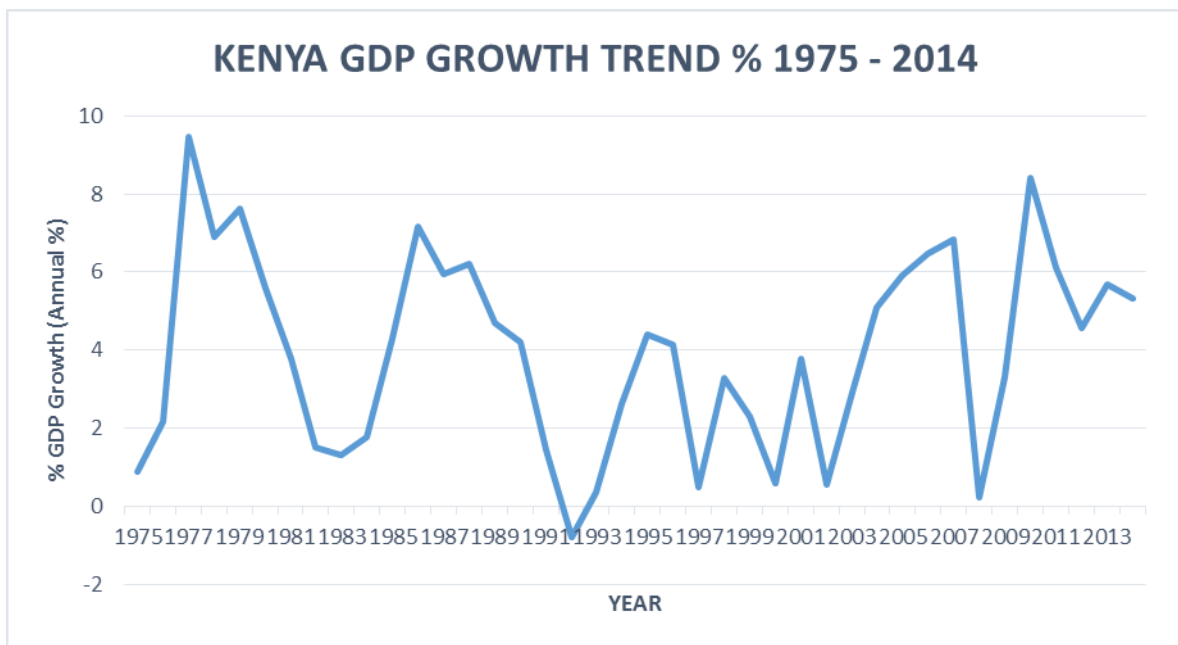
The rate of economic growth in Kenya has been fluctuating since independence. Beginning with an average real growth rate of 6 to 7 % in 1960s and 1970s as commodity prices were generally high and the country benefited from these high prices. In addition, the country was left with significant foreign exchange reserves and was therefore able to deal with macroeconomic instability. The first two decades after Independence was, therefore, a

period of economic prosperity and high aspirations. School enrolments grew by more than five times; life expectancy grew from 44 years in 1963 to 69 years by 1983 (KIPPRA, 2008).

The period 1980-2002 was characterized by slow or negative growth in real GDP which is attributed to among other factors severe droughts, increase in oil prices, aid embargo and unfavorable economic environment for investment. This is the period of structural adjustment programs (SAPs) which evolved in early 1980s initially focusing on eliminating fiscal and external imbalances and reviving growth however, they have been linked to the high rate of income inequality, inflation, unemployment, retrenchment, and poor economic performance which lowered living standards (KIPPRA, 2008).

FIGURE 2

Kenya GDP growth from year 1975 to 2014



Source: World Development Indicator (2016)

It was not until the regime change in 2002 and subsequent development of the Kenya Economic Recovery Strategy for Wealth and Employment Creation 2003 which was later succeeded by the Kenya Vision 2030, the country’s development blueprint; that Kenya began

to experience rapid economic growth of as high as 7 percent in 2007. The post-election violence and the global economic crisis impacted negatively on the economy decreasing its growth to 1.5% in 2008, since then the economy has been gaining momentum despite the challenges of insecurity due to terrorist attacks this momentum is driven by investments in infrastructure projects, low international oil prices and implementation of devolution (IEA, 2015).

The slowdowns of the global economy especially the 2008/09 global economic and financial crises have renewed the interest not only on availability but also reliability of various forms of external development finance. In the light of extensive globalization of the financial system and the economy at large, and the devastating effects of the recent global economic crises of 2008/09 that were transmitted to all sectors and countries majorly through the financial system and left international capital markets flagging to date and national markets in turmoil, these events have further refueled the debate on the reliability and efficiency of external sources of finance for development.

1.2 Problem Statement

The growth of any country's economy depends on numerous interventions by its government. The interventions are guided by different strategies and policies developed and employed. There is a growing contradiction on the impact of external financial resources inflows on economic growth. Higher external resource inflow has not always resulted to improved economic performance (Reinhart & Rogoff, 2010). To one extreme end, researchers contend that external financial resources flow play a key role in complementing the scarce domestic resources and scaling up the existing savings and trade gap, enhancing investments and better balance of payments. This view is supported by the works of: Sachs (2005); Roubini (2005); Singer (2009) and Diamond (2009). On the other extreme end is the

view that, external financial flow are an impediment to economic growth in developing countries as they tend to weaken taxation systems, support corrupt regimes and hinder growth of key institutions that are a prerequisite for sustainable growth and development. Major voices in this school of thought are: Hayter (1971); Bauer (1981); Easterly (2003); Moyo (2009) and Ngozi (2010).

Global and local studies tend to view and analyze the effect of each of the instruments of external resource inflow on economic growth separately or by source. The area of external finance resources inflow is well studied in the context of developed countries for instance: Barrell, Ray and Nigel (1997) study the role of foreign direct investment, technological change, and economic growth within Europe and find a positive effect on economic growth while Henry and Blair (2006) study the effect of Foreign Direct Investment and external debt in OECD countries and observed that Foreign Direct Investment plays a positive role while external debt has an overall negative effect on economic growth. These studies however did not consider the role of Official Development Assistance and remittances since most of OECD countries are donors and not recipients of development assistance.

In the case of developing countries, Raza, Sabir, and Mehboob (2015) investigate the effect of FDI and diaspora remittances on economic growth in Pakistan and their findings indicate that FDI and remittances have a robust positive connection with economic growth in the country. Okon (2012) observed that foreign aid has an inverse relationship with economic growth in the case of Nigeria. The study only considered Official Development Assistance (ODA) only in the analysis. Mckee and Bells (2013) investigate the effectiveness of aid and diaspora remittances in sub Saharan Africa and reports a positive relationship in both cases. These studies focused on a few of the external financial sources unlike this study which will focus on ODA, FDI, diaspora remittances and external debt.

Local studies have either concentrated on Foreign Direct Investment, Official Development Assistance or external debt separately for instance Mwega (2009) investigates the role of aid effectiveness in Kenya in the health sector and reports that aid positively affects the service delivery. Valedinah (2013) found out that development assistance impairs economic growth in Kenya. Ndulu, et al., (2007) investigates the effect of development assistance, foreign investment and remittances in Kenya and reports that remittances have an insignificant effect on economic growth while Foreign Direct Investment has a positive effect and Official Development Aid a negative effect. Their study however relies on data from 2000 to 2007 a significantly short duration.

Therefore, empirical evidence so far had remained either inconclusive or mostly contradictory. Internal analysis from Figure 1 shows that external resource inflow was increasing but economic growth was still slow hence the rationale and relevance of this particular study. In view of these developments therefore, the study sought to determine the relationship between external financial resource inflows and economic growth in Kenya.

1.3 Objective of the study

1.3.1 General Objective

The general objective of this study was to investigate the relationship between external financial resource inflow and economic growth in Kenya.

1.3.2 Specific Objectives

The specific objectives for the study were as follows:

- i. To determine the relationship between official development assistance and economic growth in Kenya

- ii. To determine the relationship between foreign direct investment and economic growth in Kenya
- iii. To determine the relationship between diaspora remittances and economic growth in Kenya
- iv. To determine the relationship between external debt and economic growth in Kenya.
- v. To explore the moderating role of exogenous macroeconomic factors in the relationship between external debt and economic growth in Kenya.

1.4 Research Hypothesis

The study tested the following research hypothesis:

H₀₁: Official development assistance inflows have no significant relationship with economic growth in Kenya

H₀₂: Foreign direct investment has no significant relationship with economic growth in Kenya

H₀₃: Remittance inflows has no significant relationship with economic growth in Kenya

H₀₄: External debt inflows has no significant relationship with economic growth in Kenya

H₀₅: Exogenous macroeconomic factors have no significant moderating effect on the relationship between external debt and economic growth in Kenya.

1.5 Significance of the study

This study is of great importance to policy makers and other government agencies in providing valuable information on key instruments relating to external resource inflow that

would foster growth of the economy. The study will also improve on the available empirical studies on the subject of external finances and economic growth in the country. Similarly, it will also be a benchmark study for other researchers and scholars to carry-out further research in the same area but employing different approaches.

1.6 Scope of the study

The study focused on specific variables relating to external financial resource inflow which may not necessarily provide conclusive evidence but rather provide some important insight for further comprehensive study on the topic as well as room for further studies using the omitted variables. The focus of the study was data collected between 1975 and 2015 in Kenya.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter contains review of books, education journals, newspapers, periodicals and the internet to secure available information in regard to the research topic. It explores the relevant literature and gives insight to theoretical review, empirical studies, conceptual framework, and summary of the literature review.

2.2 Theoretical Review

The relationship between economic growth and external resource inflow is well studied in literature. Several models and theories have been fronted to explain on the prerequisites as well as constraints to growth and development especially in developing countries. Key theories backing the need for external finance for development are anchored in the following works depicted herein.

2.2.1 The Two Gap Theory

The two-gap theory also known as the dual gap theory of economic development is founded on the principles of post Keynesian growth models, specifically anchored on the works of Harrod (1939) and Domar (1946). In the simple Harrod- Domar model, growth is proportional to the rate of savings and investment. The higher the savings/investment rate, the higher the growth rate. Several problems are associated with the Harrod-Domar model—it's a very simple production function with fixed proportions between capital and labour. In their opinion total production that might lead to economic growth is dependent on the level of capital accumulation which includes external financial flows in a given economy. The model reserved that the steady state equilibrium of economic growth primarily is dependent on

individual country strategies to increase investment flows, and proficiently use those finances to enhance efficiency and promote economic growth.

However, in the context of developing countries the argument is that due to low saving rates internally (domestically) and savings translate to investment, there emerges an investment gap which can be reduced by foreign direct investment or external debt while externally, due to high rates of imports as compared to low export earnings results to foreign exchange deficit known as the trade gap which may be corrected using official development assistance or diaspora remittances (Thirlwall, 2006).

According to Thirlwall (2006), developing countries often run into foreign-exchange gap which can be resolved by either an increase in the use of unused domestic resources to earn foreign exchange through FDIs or improve on effectiveness of imports. Hansen and Tarp (2001) in their study found that aid inflow led to increase in aggregate savings, investment and therefore positive effect on growth. Similarly, Doucouliagos and Paldam (2009) found that external resource inflow had a positive impact on economic growth. It is therefore important to analyze the relationship between official development assistance, foreign direct investment and economical growth considering the effect as explained by Thirlwall and Doucouliagos. Jones (2013) applied the two-gap theory in the study on foreign aid-led growth hypothesis in west Africa. This theory was used in this study to inform the relationship that is expected between ODA and economic growth and also to measure ODA and economic growth.

2.2.2 Endogenous Growth Theory

Through the works of Kaldor (1962), Arrow (1962), Lucas (1988) and Romer (1986), the economic thought has moved beyond the neoclassical growth model of exogenous technical progress, which failed to explain continuing divergence among many countries of the world,

and more basically how exogenous technological progress happens. These have led to models of “endogenous” growth - in which the process of technical progress is entrenched. Essentially, endogenous growth models “personify” technical progress in the rate of investment, instead of assuming that it falls like rain as a free good for all countries, rich and poor alike (Tiwari & Mutascu, 2011). Therefore, investment progressively promotes improvements based on new knowledge and skills so that each generation of capital equipment and machinery is more productive than previous generations.

Moreover, investment here is more broadly conceptualized to comprise not only capital equipment and machines, but also knowledge. The Lucas’s human capital model notes that the enhancement of a nation's human capital will lead to economic growth by means of the development of new forms of technology and efficient and effective means of production. Robelo’s model and Lucas’s model holds that investment in human capital, innovation, and knowledge are significant contributors to economic growth. They also focus on positive externalities and spillover effects of a knowledge-based economy which will lead to economic development. These spillovers may easily be transmitted through financial systems especially by foreign direct investment or official development assistance if offered as technical support rather than just material assistance. Endogenous growth theory advocates for policies that promotes growth by embracing openness, competition, change and innovation (Barro & Xavier, 2003).

Trade openness and innovation may attract foreign investments through foreign direct investment or diaspora remittances which according to endogenous growth theory will lead to economic growth. This shows how important foreign direct investment and diaspora remittances play a critical role in the domestic economy of a developing economy. This theory informed the study on how policies that embrace openness, competition, change and innovation promote growth. This indicates that when the economy is opened up for external

capital to flow in, it will grow. It hence informs how financial flows from diaspora, FDI and aid can enhance human capital and innovation in the country and hence stimulate economic growth.

2.2.3 Debt Overhang Theory

Debt overhang is defined as a state in which creditors do not expect full settlement of debt owed to them by a debtor because of the presence of a large debt stock. According to Krugman (1988); a country experiences debt overhang problem when the expected present value of potential future resource transfer is less than its debt. Debt relief may be an incentive to both creditors and debtors in a condition of huge debt stock (Krugman, 1988).

In situation of huge debt stock, the creditor could have an incentive to keep on lending with the hope of improved economic condition of debtor and finally repayment of claims. The debtor on the other hand will keep on borrowing to avoid losses. The debt laffer curve shows the possibility of this double benefit. When the debtor country is on the right side of the curve, a debt reduction increases the likelihood of the repayment. When the stock of debt is higher than the critical value both the creditor and the debtor will be well off after debt relief.

When the face value of debt rises beyond this point, the market value begins to rise more slowly. The reason for this divergence is the fact that the more a country accumulates debt, the harder it becomes to finance it because of the increased servicing obligations that effectively act as a tax on investment, policy reforms or activities that require up-front costs in exchange for future benefits (Pattillo, Ricci & Poirson, 2002).

The theory further suggests that external debt may have non-linear effect on growth, either through capital accumulation or productivity growth (Clements, Bhattacharya & Nguyen, 2005). The theory was applied in this study as it explains that both the stock of

external debt and repayment of interest and principal affect growth by discouraging private investments or altering the composition of public spending. Higher interest payments can increase a country's budget deficit thereby reducing public saving if private savings do not increase to offset the difference, this in turn may either drive up interest rates or crowd out the credit available for private investment, depressing economic growth. Moreover, the theory informed the study on how debt servicing can discourage growth by squeezing the public resources available for investment in infrastructure and human capital.

2.2.4 Modernization and Dependency Theories

The modernization theory argues that since capital investment is a prerequisite for economic growth, then Foreign Direct Investment will serve as an engine of economic growth especially in the context of developing countries that have a capital investment deficit. The theory contends that the key impediment to economic growth in developing countries is the inadequacy of knowledge, technological transfers and capital gap that FDI can bridge thereby enhancing both capital accumulation and increasing total factor productivity. On the other hand, the international dependency theory faults the modernization theory and argues that if the economy of a nation is over reliant on foreign funding mostly FDI and ODA may result to deleterious effect on the rate of economic growth. This is the case if the economy is dominated by foreign firms that threaten the survival of domestic industries (Saqib et al, 2013). In the context of this study both the modernization and international dependency theories are realistic in defining the relationship between FDI and ODA inflows on economic growth in Kenya. The theory informs the study on how external financial flows enables a country to build up the capital required for economic growth. It hence explains the expected effect of ODA, FDI and diaspora inflows on economic growth.

2.3 Empirical Review

The empirical evidence on the role of external financial resources inflows on economic growth is fragmented and given that most of the studies concentrate on one or two instruments, this section reviews the findings of these studies based on individual instrument.

2.3.1 Official Development Assistance and Economic Growth

Early research on official development assistance, dating back to the 1950s, was consistent with the optimism of effectiveness of ODA to the recipient country. The research works provided a conceptual foundation for advancement of the principles of official development assistance (Burnside & Dollar, 2000). According to Burnside and Dollar (2000) ODA was analyzed in the context of the two-gap model, which is much of the Harrod-Domar growth prospects. However, study by Mosley *et al.* (1987) found that ODA did not lead to improved growth and may have even negatively influenced recipients' economic performance.

Boone (1996) investigated the impact of foreign aid on investment, consumption and measures of well-being. He also examined whether aid effectiveness was conditional on the political regime. Results indicated that foreign aid leads to increases in government consumption rather than increasing investment or benefiting the poor. In a research carried out by the World Bank (1998) developed an argument in favor of the fact that aid works, but only when policies are right. This shifted the debate to aid effectiveness rather than just quantity.

Burnside and Dollar (2000) concluded that ODA had a positive impact on growth for developing countries with good fiscal, monetary and trade policies in place, but had little impact for those countries with poor policies. A few studies have investigated the patterns of aid flows and have found these flows to be rather volatile. Lensink and Morrissey (2005) investigate the impact of volatile aid flows on the effectiveness of aid. In their analysis, the

volatility of aid is seen as a measure of the uncertainty of aid flows of a recipient country. While, Liew et.al (2012) in a study of five East African countries (EAC) over the period of 25 years from 1985 to 2010, showed that foreign aid negatively impacts on economic growth in EAC.

Makori, Kagiri, and Ombui, (2015) examined the effect of external capital inflows on the economic growth in Kenya from 1970 to 2013. By using ordinary least squares tests, the study sought to establish the effects of external capital on economic growth. The study further applied Augmented Dickey Fuller to test for stationarity of the time series data. The results revealed that foreign direct investments and gross domestic product and economic growth do not have a significant relationship. The study findings further showed that ODA had a positive significant relationship with GDP. The study concluded that FDI, ODA and migrant remittances are key aspects of economic growth of any country.

Veledinah (2014), also examined the impact of ODA on economic growth in Kenya. The study applied Vector Error Correction Model (VECM) estimation technique and time series data for the period from 1970 to 2012 to investigate the ODA-Growth relationship. Solow growth model was used to establish the link between theoretical and empirical expectations. The findings from the study showed a long run causality between ODA, private external resource flows, gross domestic capital formation, final government consumption expenditure, trade openness, broad money, and inflation; and GDP growth per capita. While ODA seems to contribute to economic growth in the short run, its effect was not statistically significant. A statistically significant negative effect in the short run of private external resource flows and trade openness was established.

Trinh, (2014) in her study investigated the relationship between foreign aid and economic growth in Vietnam. The data used in the study span from 1991 to 2012. Methodology employed to analyze the data was the Autoregressive Distributed Lagged

(ARDL) approach. The study concluded that foreign aid had a significantly positive role in promoting economic growth in Vietnam.

Mbah and Amassoma, (2014) looked at the linkage between foreign aid and economic growth in Nigeria. The study employed econometric techniques such as; Ordinary Least Square, Augmented Dickey Fuller (ADF) test, Johansen Co-integration test using data spanning from 1981 to 2012. The result showed a negative and non- significant relationship between foreign aid and GDP in Nigeria.

2.3.2 Foreign Direct Investment and Economic Growth

Unlike in the case of ODA where the evidence is highly inconclusive, in the case of FDI, majority of studies such as Landes (1997); Henry (2000); Bekaert, Harvey and Lundblad (2001); Klein, Michael and Olivei (2001) found a positive link between FDI flows and economic growth both in developed and developing countries. Abbas (2006) in a literature review of the anti FDI proponents concludes that by rejecting FDI as effectual and with negative results is at best ambiguous. This is in agreement with both the endogenous growth theory as well as the two-gap theory of economic development. Apart from providing the much-needed financial resources, FDI also plays a critical role in technology transfer and facilitate access to export markets (Borensteinz et., al, 2001).

Wai-Mun et al (2008) carried out a study to establish the relationship between FDI and Economic Growth in Malaysia. Employing Augmented Dickey-Fuller (ADF) Unit root tests and Phillips-Peron (PP) test and with an aid of Ordinary Least Square (OLS) regression analysis, their results show that there is a positive and significant relationship between FDI and economic growth in Malaysia. They recommend that government should therefore encourage FDI but should encourage adoption of policies to encourage domestic producers to adopt the technology brought in through FDI.

Saqib et al (2013) in their empirical study to investigate the impacts of FDI on economic growth in Pakistan adopting GDP as the independent variable and FDI, inflation, gross domestic savings and total debt service as explanatory variables report a negative effect of FDI on economic growth and a positive one with gross domestic savings. Hence, their policy recommendation is domestic savings should be mobilized at the expense of foreign direct investment.

Based on a study by Philip et., al. (2005), FDI provide positive spillovers and externalities that make investments in recipient country more profitable and that way spur economic growth and development in those countries. This view is supported by the studies of Raza et., al (2011) in their study of Pakistan. Bengoa et. al., (2003), by using data on Latin American economies also reach similar conclusion. A study by Adhikary (2011) of Bangladesh also points to the same direction that FDI has a positive and significant relationship with economic growth.

Ocharo, Wawire, Ng'ang'a, and Kosimbei (2014) investigated the causality effect between foreign direct investment, portfolio investment and cross-border interbank borrowing and economic growth; and analyzed the effect of foreign direct investment, portfolio investment and cross-border interbank borrowing on economic growth in Kenya. The study found that there was a unidirectional causality from foreign direct investment to economic growth and from economic growth to cross-border interbank borrowing. The coefficient of Foreign Direct Investment as a ratio of Gross Domestic Product was positive and statistically significant, and the coefficients of portfolio investment as a ratio of gross domestic product and cross-border interbank borrowing as a ratio of domestic product were positive and statistically insignificant.

Bolanle, Fapetu, and Olufemi (2015) in their study on external debt or foreign direct investment assessed the significant economic impact of external debt and foreign direct investment on the growth of Nigeria for a period stretching from 1990 to 2013. The model applied in the study specified gross domestic product (economic growth) as dependent on outstanding value of external debt and foreign direct investment inflows. The model was estimated using the error correction modelling (ECM) approach. The study found that external debt is negatively but insignificantly related to economic growth while foreign direct investment is also negatively but significantly related. Foreign direct investment was found to be significant to economic growth; therefore, inflows through foreign direct investment tend to have more impact on the Nigerian economy than inflows from external debt. Annual time series data was retrieved from Central Bank of Nigeria (CBN) and Statistical Bulletin.

Mohammed et al in their study on impact of Foreign Aid and Direct Investment on Economic growth of sub-Saharan African countries sampled data from 41 countries covering period from 1998 to 2010. The data were obtained from the World Bank's World Development Indicator and UNCTAD Online Database. The study employed AK growth model in evaluating the data. The results suggest that while foreign aid had negative effect on growth, the impact of FDI was positive but statistically insignificant. The study further found evidence that foreign aid from different bilateral donors may have different effects on economic growth of any country.

2.3.3 Diaspora Remittances and Economic Growth

The rise of international migrants has caused transfer of funds to their home countries a vital source of external financial resources to developing countries including Kenya. Remittance from the diaspora contributes to the economic growth both at the micro and macro levels in

the beneficiary countries' economies. Remittances indisputably represent an important channel of reducing unemployment and boosting welfare (Katsushi et al, 2012).

Several studies argue that remittances are usually spent on consumer goods. For example, Durand et al. (1996) found that 10 percent of their sample of Mexican migrants to the United States who sent remittances or brought savings back with them spent at least some of the remitted funds productively. Remittances contribute to an increase of recipient affluence and have growth impact on local scale together with related multiplier effects. Additionally, remittances are used for investment on infrastructure, schools, and houses among others and contribute to improvement or modernization of local economic activities or give rise to small enterprises. These serve as a key impulse to start or keep growth on local and regional level (Stojanov et.al, 2011).

Further, Adams and Page (2005) base their studies on macro-data comparison demonstrating that international migration and remittances considerably reduce the echelon, intensity, and cruelty of poverty in low-income and middle-income developing countries. Moreover, even though a small proportion of remittances may be invested directly by migrants or their families, remittances can be channeled into productive use by the financial institutions.

Chigbu, Ubah, and Chigbu (2015) in their study on the impact of Capital Inflows on economic growth of developing countries considered data from Nigeria, Ghana and India. The study examined data from the three Countries from year 1986 to 2012. The study employed Augmented Dickey Fuller unit root test to evaluate the stationarity of the data while Johansen Co-integration was used to estimate the long-run equilibrium relationship among the variables. The casual relationship was tested using Granger Causality and Ordinary Least Square method was used to estimate the model. The set of time series data used in the study was from secondary sources. The study used real gross domestic product for

economic growth, while capital inflows included foreign direct and portfolio investment, foreign aids, workers' remittances and foreign borrowings, collected for the period of 1986 to 2012 for the three Countries. The data were obtained from World Bank databank economic indicators. The findings revealed that capital inflows have significant impact on the economic growth of the three Countries. In Nigeria and Ghana, foreign direct and portfolio investment as well as foreign borrowings have significant and positive impact on economic growth. Workers' remittances significantly and positively related to the economic growth of the three countries.

Meyers and Sherab, (2015) study whose aim was to examine the impact of remittances on economic growth used panel data set from six high remittances receiving countries, Albania, Bulgaria, Macedonia, Moldova, Romania, Bosnia Herzegovina during the period from 1999 to 2013. The data for all variables was collected from the publications of World Bank data set "World Development Indicators". The study employed multiple regression analysis in its methodology. The results of the study showed that remittances have positive impact on growth and that this impact increases at higher levels of remittances relative to GDP.

Kifle, (2014) analyzed the role of international remittance on economic growth in Ethiopia. The time series data was used in the study which was obtained from World Bank Development Indicators database from 1981 to 2012. The methodology used an auto regressive distributed lag (ARDL) model or Bound Testing approach to co integration. The study concluded that the long run growth impact of international remittance during the study period was positive and significant. However, the short run effect was found to be negative and statistically significant, showing the consumption smoothing role of remittance income in the short run.

Bett (2013) analyzed the effect of diaspora remittance on economic growth in Kenya. The study employed Panel data from 2003 to 2012. The secondary data was used and sourced from Central Bank of Kenya and IMF's World Economic Outlook Database (2013). Methodology used to analyze the data was multiple linear Regression method. The findings of the study using multiple regression analysis showed that the impact of diaspora remittances not only related to the economic growth, but they also influence the economic growth in Kenya significantly. The results also revealed that the growth of an economy is thought of not only as an increase in productive capacity but also as an improvement in the quality of life of people of that economy.

Ahmad, Ahmad and Hayat (2013) investigated the impact of foreign remittances on economic growth of Pakistan. The researchers' used secondary time series data for the period from 1978 to 2011 obtained from official economic survey of Pakistan and world development indicator. Methodology employed was multiple regression analysis which was used to identify the relationship among the variables further, they used Augmented Dickey Fuller (ADF) test to check for stationarity of variables and all variables were found stationary at level and Ordinary Least Squares technique was applied to check the relationship among the variables. The findings of the study showed that foreign remittances have positive and significant affect on economic growth of Pakistan.

Nyeadi, Yidana and Imoro (2014) study explored the causal link between remittances and economic growth in three of the leading remittances recipients in West Africa, that is, Nigeria, Senegal and Togo. The time series data used in the study was from 1980 to 2012 sourced from International Monetary Fund (IMF) website and United Nations Conference for Trade and Development (UNCTAD) website. The study used Granger-causality and co-integration tests under the Vector Autoregressive Regression (VAR). The study revealed an existence of unidirectional causal link between remittance and economic growth in Nigeria

and Senegal. Remittances were found to lead to economic growth while economic growth does not lead to remittances inflows. There was however no causal link between remittances and economic growth in Togo.

2.3.4 External Debt and Economic Growth

Many studies have confirmed the negative relationship between external debt and economic growth. Cunningham finds an inverse relationship between debt burden and economic growth in sixteen countries. Ali and Mustafa analyzed the long run and short run impact of External Debt on economic growth of Pakistan for the period 1970 to 2010. The result of the study indicated that higher external debt discourages economic growth (Ali & Mustafa, 2011).

Samer (2013) in a study focusing on external debt and economic growth in Jordan during the period of 1990 to 2011 found that external debt is a significant source of external resource for less developed countries as it helps to finance saving- investment gaps and balance of payment deficit. The findings of the study showed that there was positive and significant relationship between external debt and economic growth. Debt servicing had a negative and significant relationship to economic growth.

Fincke and Greiner (2015) explored public debt and economic growth in emerging markets. They looked at the relationship between public debts for selected emerging markets economies namely Brazil, India, Indonesia, Malaysia, Mexico, Thailand, South Africa and Turkey covering the period 1980 to 2012. The findings of the study revealed a statistically significant positive correlation between public debt and growth of per capita gross domestic product.

Makori, Kagiri, and Ombui, (2015) examined the effect of external capital inflows on the economic growth in Kenya. The study examined the effects of external capital on economic growth in Kenya and used a structural growth model involving gross domestic

product, official development assistance, foreign direct investments and migrant remittances variables for the period 1970 to 2013. The data was sourced from secondary sources like Kenya National Bureau of Standards, Central Bank of Kenya, OECD and World Bank. By using ordinary least squares tests, the study sought to establish the effects of external capital on economic growth. The study further applied augmented dick fuller test to test for stationarity of the time series data. The results revealed that foreign direct investments and gross domestic product and economic growth do not have a significant relationship. The study findings further showed that ODA had a positive significant relationship with GDP. The results also revealed a positive and significant relationship between migrant remittances and GDP. The study concluded that FDI, ODA and migrant remittances are key aspects of economic growth of any country.

Siddique and Malik, (2001) in their study on debt and economic growth used data for three South Asian countries estimated the growth model. The data sources for the study were International Financial Statistics Yearbook-2000 published by International Monetary Fund, Global Development Finance-2001 and World Debt Tables (various issues), published by the World Bank. The time period covered was 1975 to 1998. The methodology used in the study was OLS and Fixed Effects Models. The findings of the study showed that the impact of foreign debt on economic growth was positive and statistically significant for Sri Lanka, Pakistan, and India.

Barik (2013) study analyzed the relationship between Government debt and economic growth. The study employed annual data series for the period from 1981 to 2011 from Indian Public Finance Statistics and Economic Survey published by Ministry of Finance, Government of India. The methodology employed was regression analysis of the variables. The findings of the study showed strong evidence that there is an indirect connection between public debt and economic growth in India. Public debt appears to be positively related to both

investment and output growth and thus has an indirect positive effect on economic growth through its positive influence on investment.

Nkoro and Uko (2013), examined the nature of causality between foreign capital inflows components and real GDP (economic growth) and the impact of foreign capital inflows on economic growth in Nigeria. The study employed gross domestic production as a dependent variable while foreign aid (official development aid), remittance, foreign direct investment and external debt as independent variables in the model. The data are sourced from Central Bank of Nigeria (CBN) statistical bulletin, OECD Statistics, Global Development Finance Statistics, International Development Statistics and Nigerian Capital Market Statistical Bulletin. The data covered the period from 1981 to 2010. The researchers employed Error-correction modeling (ECM) for analysis. The findings of the study showed that there was a significant positive, negative, positive and negative effect of foreign aid, remittance, FDI and external debt on real GDP respectively.

2.3.5 Exogenous Macroeconomic Factors

Sheffield Political Economy Research Institute- SPERI (2013) conducted a study in UK to explore the relationship that exists between population growth and economic growth. The study applied secondary data between 1964 and 2012. The study results established that the trend of population growth was significantly related to the trend of economic growth. the study further established that high population growth rates in 1960s matched with high economic growth in the same period. Moreover, low population growth in 1970s was also matched by low economic growth in the same period. The findings also established that during the 1980s up to the 1990s when recession was experienced, both economic growth and population growth were high and had significant relationship.

In Uganda, Klasen and Lawson (2013) explored the impact of population growth on economic growth. The study was informed by the fact that though Uganda had experienced vibrant economic growth in the early years of the new millennium, it had also reported huge population growth rate. The study established that the high population growth rate experienced in Uganda had put a significant constraint on per capital GDP growth rate. This had seriously dented the efforts to reduce poverty in the country. Trang and Hieu (2015) investigated the effect of population growth on economic growth in Asian countries. The study applied pooled ordinary least squares regression. The study results established that population growth was negatively associated with economic growth. In Asia, countries with high economic growth had poor economic growth and vice versa.

In Iran, Najarzadeh, Reed and Tasan (2014) explored the relationship between Savings and Economic Growth. The authors noted that achieving stable and high economic growth is critical for the continued advancement and development of any country. The study assessed the relationship between savings and total and non-oil economic growth for Iran. The authors also investigated the long run causality between savings and economic growth. The study applied annual data for the period between 1972 and 2010. The autoregressive distributed lag model was used to analyze the data. Study results indicated that there was a positive and significant effect of savings on non-oil economic growth.

Jagadeesh (2015) conducted a study with the aim of assessing the impact of savings on economic growth in Botswana. The study applied the Harrod –Domar growth model and data analysis was done through the autoregressive distributed lagged model. The study further applied DOLS approach to assess the existence of dynamic long run cointegration between savings and GDP growth. The study applied data from 1980 to 2013. Study results established that there was significant relationship between savings and economic. These results supported the Harrod Domar growth model.

2.3.6 Summary of Literature Review

In view of the studies reviewed in this section, it is evident that the relationship between various forms of external resource inflows and economic growth is highly contradictory, further there is dearth of research to investigate the relationship between economic growth and various instruments of external resources inflows collectively. It is this gap that this study intends to bridge.

2.4 Knowledge Gap

Scholars have differing and sometimes contradicting arguments relating debt to economic growth. For instance, Burnside and Dollar (2000) concluded that ODA had a positive impact on growth for developing countries with good fiscal, monetary and trade policies in place, but had little impact for those countries with poor policies. Contradicting results were provided by Nkoro and Uko (2013) in Nigeria who examined the nature of causality between foreign capital inflows and debt on economic growth. The study established that there was a significant positive effect of ODA and real GDP. This is despite Nigeria ranking poorly in policies and governance (Olubiyi, 2014).

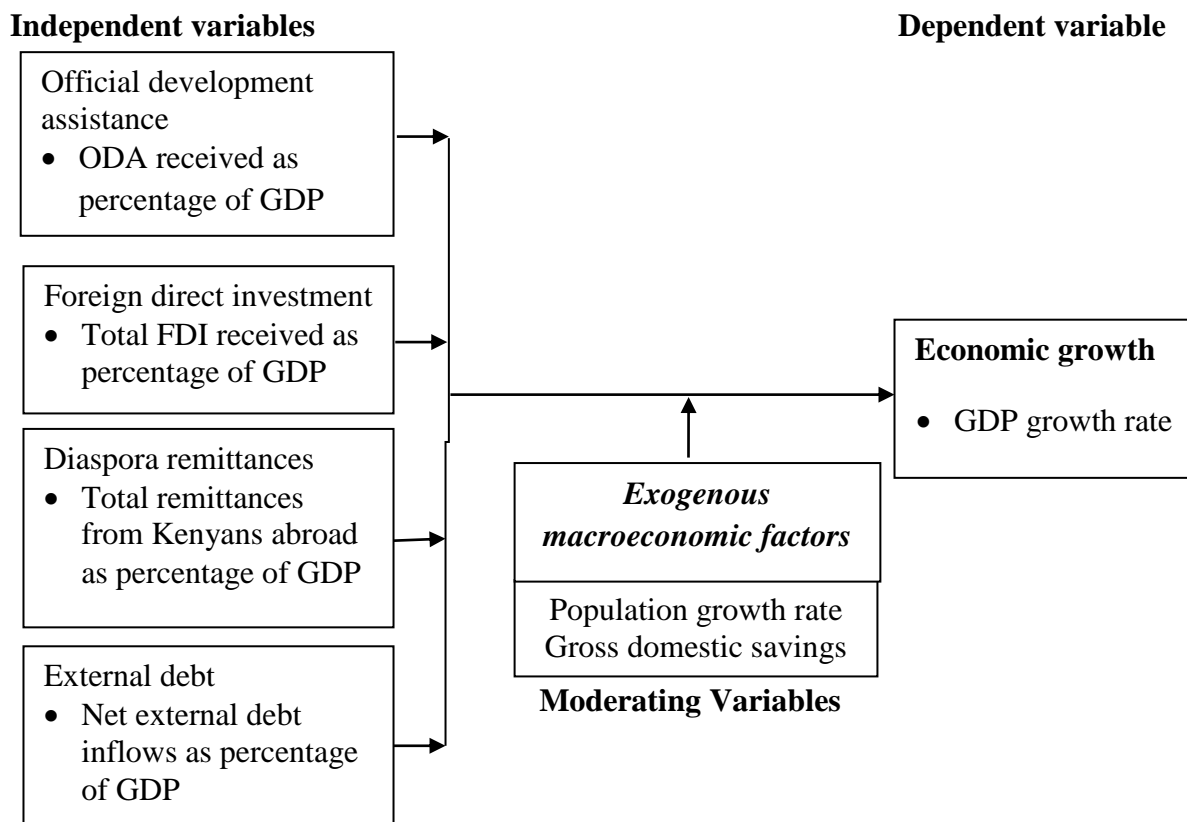
The nature of public debt, ODA and diaspora remittances have changed in terms of volumes in developing countries like Kenya (Ratha et al., 2014). There have been few studies on sub-Saharan Africa on the relationship between external financial resource inflow and economic growth. Most of the studies reviewed have focused on public debt, Nigeria (Olubiyi, 2014), and other developing countries of Asia and the Americas (Saqib et al., 2013; Ramirez, 2014; Raza et al., 2015).

2.5 Conceptual Framework

The relationship between external financial resources and inflows is a complex and multifaceted one. The dependent variable for this study was gross domestic product growth rate which is a measure of economic growth while independent variables was official development assistance, foreign direct investment, diaspora remittances and external debt which was measured using the criteria as shown in Fig.2.1. Since the study follows the Harrod-Domar model, gross domestic savings and population growth rate are included as moderating variables.

FIGURE 3

Conceptual framework



Source: Author (2016)

2.6 Operationalization of Variables

Table 1 below explains the variables, indicators and how the variables was measured.

TABLE 1
Description and Measurement of Variables

Objective	Variable	Indicators	Measurement
	Dependent GDP growth rate	It represents the change in total value of all goods and services produced in the country from one year to another.	measured as percentage change in GDP growth
To determine the effect of official development assistance on economic growth	Independent ODA	Represents all inputs and resources which are provided to developing countries, by foreign donors including grants for the purpose of development financing.	measured as total ODA received as percentage of GDP
To determine the effect of foreign direct investment on economic growth	Independent FDI	All investments done by nonresident entities in Kenya in order to acquire a lasting interest in that enterprise.	measured as total FDI received as percentage of GDP
To determine the effect of diaspora remittances on economic growth	Independent Remittances	Inflow of resources from Kenyan citizens residing in other countries.	measured as total remittances received as percentage of GDP
To determine the effect of external debt on economic growth	Independent Net External Debt	Total of a country's debt borrowed from foreign lenders less interest paid to foreigners in that particular year. Figures less than zero indicate years where interest paid was higher than borrowed amount in that year.	Measured as net external debt inflows as percentage of GDP
To control for population changes	Moderating Population growth rate	Annual changes in population of a country	Percentage change in population from one year to another
To Control for Domestic resource mobilization	Moderating Gross domestic savings	The share of income of the population that is saved annually. Since savings translates to domestic investments.	Measured as gross savings as a percentage of GDP

Source: Author (2016)

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

The chapter articulates criteria for determining the appropriate methodology to be used by the researcher to unearth answers to research questions of the study. The section describes the research design adopted, procedures to be conducted, methods of collecting data and the method of analyzing the data collected.

3.2 Research Design

The study adopted a descriptive research design. Mugenda and Mugenda (2003) describe this design as a systematic, empirical investigation where the researcher does not have direct control of independent variable or they cannot be manipulated (Mugenda & Mugenda, 2003). Descriptive design was more appropriate since the research sought to investigate the relationship between external financial resource inflow and economic growth.

3.3 Data and Data Collection

To realize the set objectives, the population of interest comprises of data on the rate of economic growth, official development assistance inflows, foreign direct investment inflows, remittance from the diaspora inflows, net external debt inflows, gross domestic saving and population growth rate in Kenya. The researcher employed secondary data from Kenya National Bureau of Statistics, Treasury bulletins, Central Bank of Kenya, International Monetary Fund and World Bank to achieve the objectives. The study used data from the year 1975 to 2015.

3.4 Data Analysis Techniques

To achieve the objectives set for this study, annual time series data from 1975 to 2015 was used. This quantitative data was analyzed using stata statistical software. Econometric modeling was used to establish the relationship between the variables.

3.4.1 Model Specification

In order to estimate the relationship between external resource inflow and economic growth we specify a model based on the Harrod-Domar framework discussed earlier which assume that the rate of economic growth is dependent on capital and labour; we further assume again in line with the Harrod-Domar model that there is plenty of labour so capital is the limiting factor.

Therefore;

$$GDP_{gt} = \beta_0 + \beta_1 ODA_t + \beta_2 FDI_t + \beta_3 REM_t + \beta_4 EXDT_t + \beta_5 GDS_t + \beta_6 POP_t + \varepsilon \dots\dots\dots (i)$$

Where GDP_g is rate of GDP growth, ODA is official development assistance, FDI is foreign direct investment, REM is remittances from the diaspora, EXDT is external debt, GDS is gross domestic savings, t is the time frame (1975 – 2015), Pop is population growth rate, ε is white noise and $\beta_0, \beta_1, \beta_2, \beta_3, \beta_4, \beta_5, \beta_6$ are coefficients estimated.

3.4.2. Linear Regression

Regression analysis was used to explore the relationship between the variables. In this context, a multivariate linear regression model was fitted using the acquired data and the results obtained tested for the violations of Classical Linear Models assumptions to ensure that the results are not biased. The following tests were carried out.

Heteroskedasticity: in testing for heteroskedasticity, the Breusch-Pagan-Godfrey test was used. The null hypothesis of homoskedasticity was tested against the alternative that the

error term is heteroskedastic. Violation of this assumption meant that although results obtained are unbiased, the significance test could be misleading as the standard errors are either overstated or understated. If this assumption is violated then, a heteroskedastic conditioned model may be adopted. This will be tested at 5% significance level.

Serial correlation: the Breusch-Pagan test was used to ensure that the data used does not violate the assumption of no serial correlation. The null hypothesis of no serial correlation was tested against the alternative that there is serial correlation. This will be tested at 5% significance level.

Normality: Lastly, the normality of the residuals was tested using the Jarque Bera statistic and histogram of the residuals, this was to ensure that the interpretation of both t-test and F-test could be applied using the statistical tables as they are based on asymptotic assumptions. If the data does not meet the CLM assumptions above, then time series analysis was conducted. This will be tested at 5% significance level.

3.4.3 Time Series Analysis

In order to adequately use time series analysis various preliminary tests were carried on the data obtained to ensure that the results are not spurious. The following tests were conducted:

Unit Root Test: Stationarity or non-stationarity of a time series highly determines its properties. For instance, if a shock is introduced to a non-stationary time series variable it persists for a very long time, but if a similar shock is introduced to a stationary data it eventually dies away. Regression of a non-stationary variable on another variable will result to a spurious regression, attaining a high Coefficient of Determination (R^2) even if the variables are not related at all. This means that the standard assumptions for asymptotic analysis are invalid. To test for Stationarity of the variables used, the Augmented Dickey Fuller test (1979) was used:

$$\Delta y_t = \beta y_{t-1} + \sum_{i=1}^p \alpha_i \Delta y_{t-i} + \mu_t \dots\dots\dots$$

(ii)

Where Δy_t is change in time series under consideration with respect to time, β denotes vector coefficient of lagged y_t , p is the number of lag difference, α_i is the lag and Δy_{t-i} are lagged changes while μ_t is the error term.

Lag Length Selection: To avoid error term misspecification, it was important to determine the optimal number of lags to be included. Several lag length selection criteria was used. These are sequential modified Likelihood Ratio, Final prediction error, Akaike information criterion, Hannan-Quinn information criterion and Schwarz information criterion. Where they are inconsistent a correlogram of the residuals was used.

3.4.4 Cointegration test

To determine the long run relationship among the variables the cointegration test was done based on the Johansen procedure that is based on the following vector autoregressive model.

(Johansen and Juselius, 1990, 1992)

$$Z_t = \phi_1 Z_{t-1} + \dots + \phi_p Z_{t-p} + \mu_t \dots\dots\dots(iii)$$

Where Z_t denotes an $(n*1)$ vector of both endogenous and exogenous variables, ϕ is an $(n*n)$ matrix of parameters and μ_t is an $(n*1)$ matrix of white noise.

3.4.5 Vector Autoregressive/ Error correction Model

If the variables are cointegrated then, an Error Correction Model (ECM) was fitted since it is a multiple time series model that provides information on the adjustment speed of a

dependent variable after being influenced by an independent variable (Granger, 1969). If no cointegration, then, a Vector Autoregressive (VAR) model was fitted.

CHAPTER FOUR

DATA ANALYSIS, FINDINGS AND DISCUSSION

4.1 Introduction

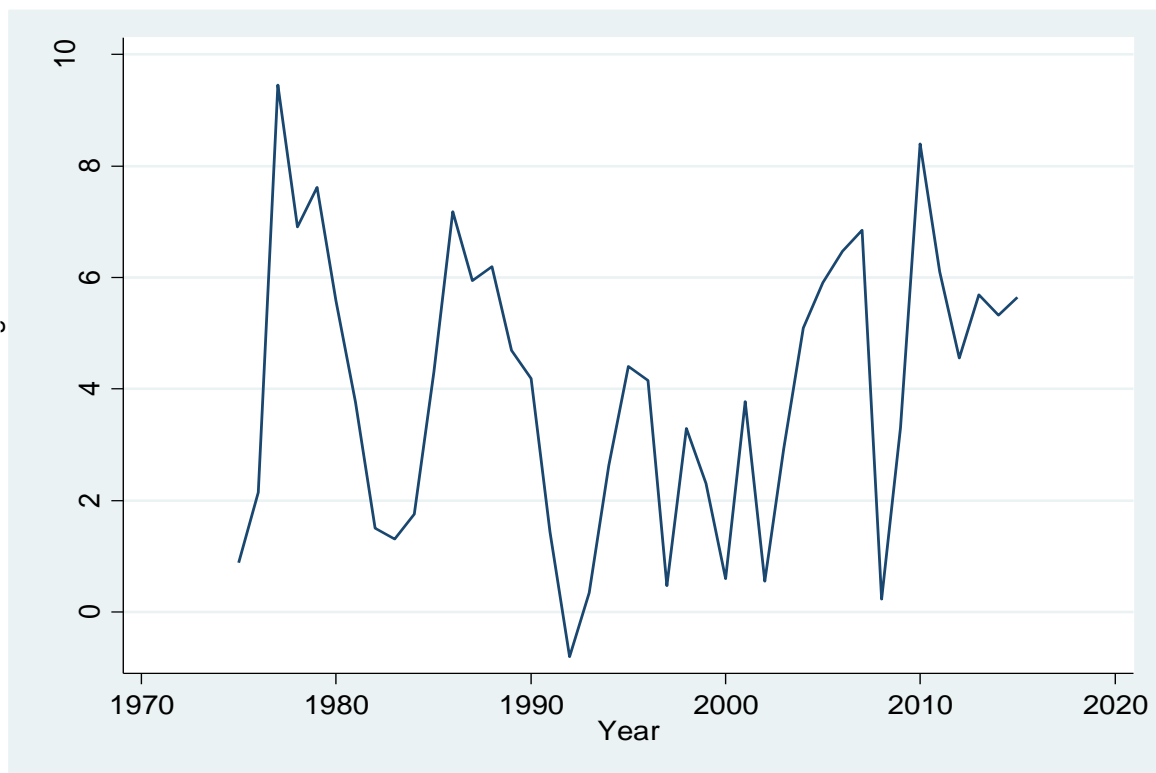
Presented in this chapter are the pre-analysis tests, the data analysis, and also the post-analysis tests. Included in the data analysis is the exploratory analysis of both the dependent and the independent variables including the growth plots. The findings derived from the analysis are presented in figures and tables and an interpretation provided. The study results are then discussed whereby they are compared to results from previous studies. The discussion also includes a comparison of the results with the theories applied in the study.

4.2 Exploratory Analysis of GDP Growth

The study explored the trend of GDP over the study period from 1975 to 2015. Study results in Figure 4 indicate an erratic up and down movements implying that GDP growth varied greatly from year to year during the study period. Moreover, the findings indicated that GDP growth was lowest at -0.8% in 1992 while the highest growth was recorded in 1975 at 9.45%.

FIGURE 4

Trend of GDP Growth (1975 – 2015)



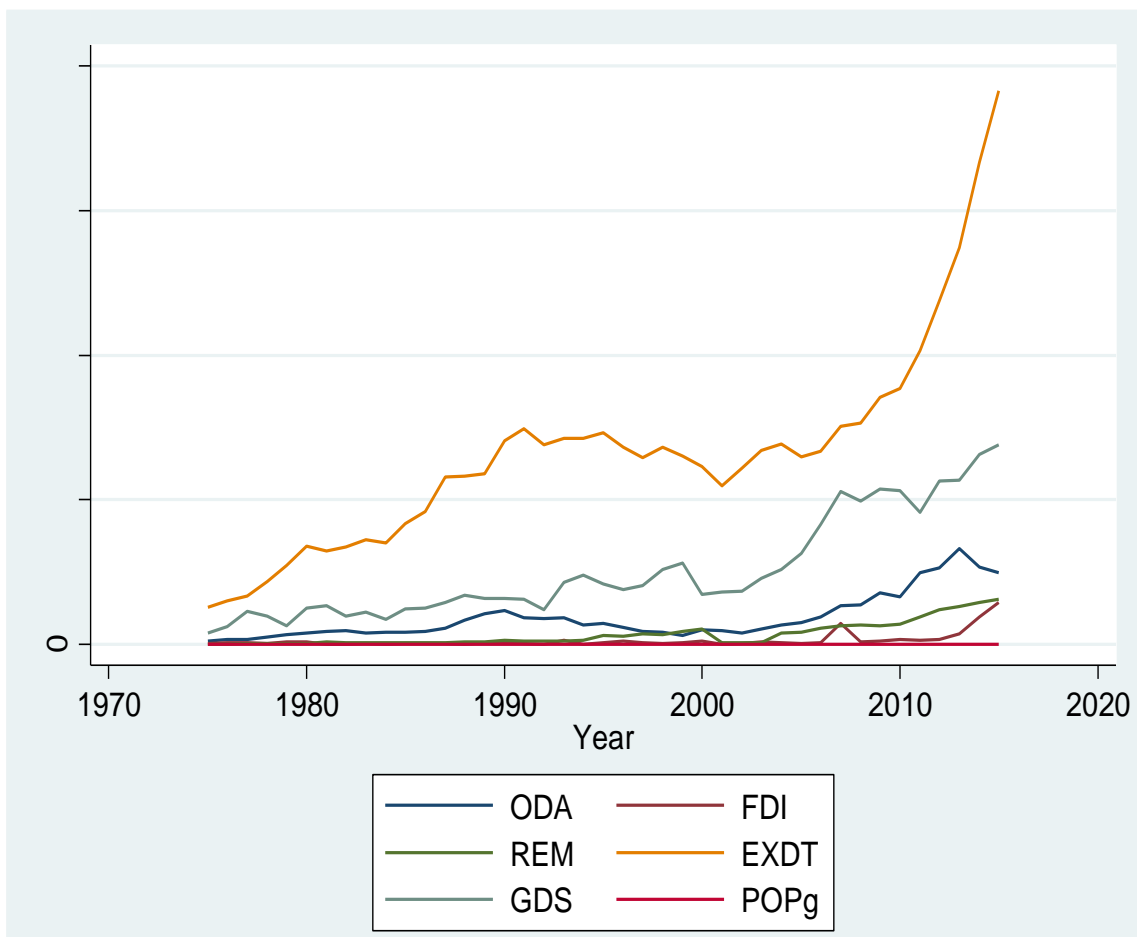
Source: Author (2017)

4.3 Growth Plot for Intervening and Independent Variables

The study also investigated how the four independent variables and the two intervening variables varied over time. The findings are presented in Figure 5 which presents the overlain plots for official development assistance (ODA), foreign direct investment (FDI), remittances from the diaspora (REM), external debt (EXDT), gross domestic savings (GDS) and population growth rate (POPg). The plots indicate that there were few up and down movements of the variables. Most importantly, the plots indicate that EXDT increased sharply from the year 2000 to a high of \$19.14 billion in 2015. Similarly, there were marked increases year on year for GDS and REM.

FIGURE 5

Growth Plots for Intervening and Independent Variables



Source: Author (2017)

4.4 Diagnostic Tests

Pre-analysis diagnostics included test of heteroscedasticity, serial correlation and normality. Test for heteroscedasticity was conducted using the Breusch-Pagan Cook Weisberg's. The null hypothesis in this test is that there is constant error variance (homoscedasticity). This implies that when p value is less than 0.05, there is evidence of heteroscedasticity but when the p value is above 0.05., there is homoscedasticity. The test was conducted by using GDP growth rate as the dependent variable and ODA, FDI, REM, EXDT, GDS and POPg as the independent variables in a multiple linear regression analysis. Results presented in Table 2

indicate that the null hypothesis of constant error variance could not be rejected as p value was above 0.05 (Chi squared = 0.01; p value = 0.9407).

TABLE 2
Test of Heteroscedasticity

Breusch-Pagan / Cook-Weisberg test for heteroskedasticity			
Ho: Constant variance			
Variables: fitted values of GDPg			
	chi2(1)	=	0.01
	Prob > chi2	=	0.9407

Source: Author (2017)

Test of serial correlation was also conducted. This was conducted through the Lagrange-multiplier test. The null hypothesis in this test is that there is no autocorrelation. This implies that when p value is above 0.05, there is no autocorrelation and when it is below 0.05, there is autocorrelation. The results of the test are presented in Table 3. Four lags were used and the results indicated that no serial correlation was detected as all p values for all the lags were above 0.05.

TABLE 3
Test of Serial Correlation

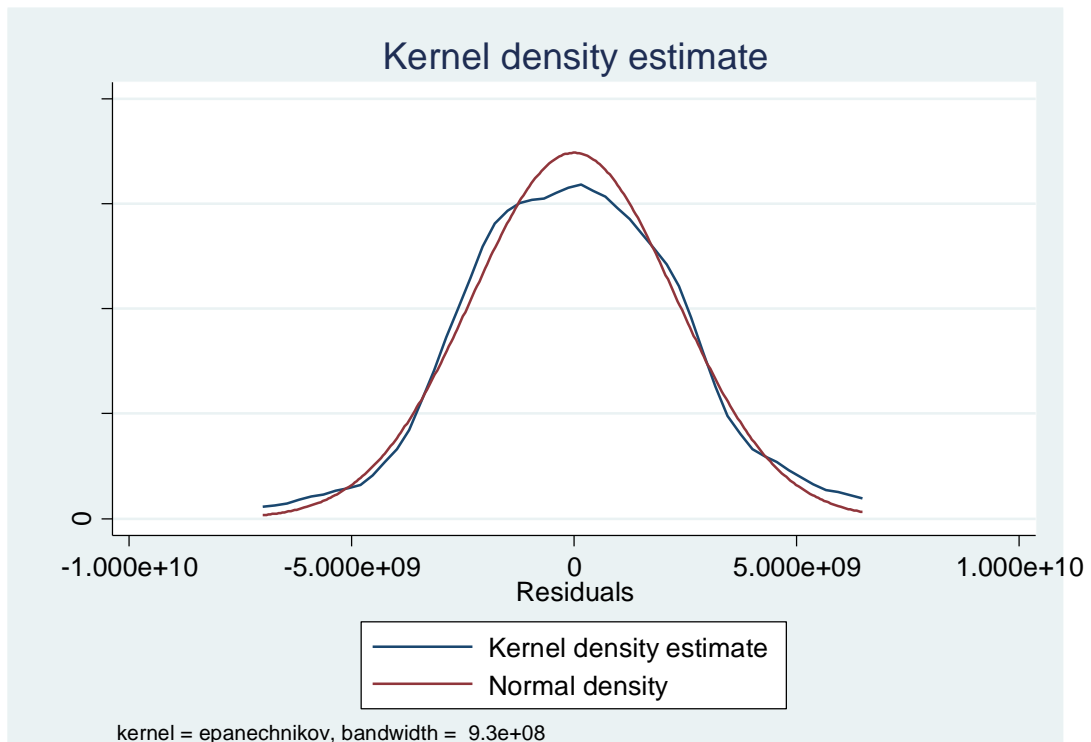
Lag	Chi square	df	Prob > Chi square
1	22.1383	49	0.19083
2	15.9027	49	0.30521
3	32.0712	49	0.14857
4	63.5235	49	0.07944

Source: Author (2017)

Lastly, test of normality of residuals was conducted. This was done by overlaying the residuals of errors over the normal distribution as indicated in Figure 6. The study results revealed that the errors did not diverge significantly from the normal distribution.

FIGURE 6

Test of Normality of Residuals



Source: Author (2017)

4.5 Selecting Number of Lags

The study used time series data from 1975 to 2015. After conducting the diagnostic tests, the study embarked on conducting timeseries analysis to enable testing of the research hypotheses. The study was to apply either the VECM or VAR time series models. The first decision that was to be made involved the appropriate number of lags to use. This was investigated using the VECM and VAR pre-estimation diagnostics command. The study results presented in Table 4.3 provides the Akaike's Information Criterion (AIC), Lag length (LL), the Final Prediction Error (FPE), the Likelihood Ratio (LR) and Hannan and Quinn information criterion (HQIC). The results indicated that using the LR, FPE, AIC, HQIC and SBIC indicated that the appropriate lag length was 1.

TABLE 4**Selecting Number of Lags**

Selection-order criteria

Sample: 1977 - 2015

Number of obs = 39

lag	LL	LR	df	p	FPE	AIC	HQIC	SBIC
0	-3406.27				6.5e+69	174.937	175.013	175.15
1	-3273.04	266.45	25	0.000	2.6e+67*	169.387*	169.846*	170.667*
2	-3249.32	47.453*	25	0.004	2.9e+67	169.452	170.294	171.798

*Source: Author (2017)***4.6 Unit Root tests**

The analysis involved using the Augmented Dickey Fuller (ADF) test to test whether the variables were stationary or had unit roots. This is important since when using timeseries models, one key assumption is that the variables considered are stationary and have no unit roots. This test was applied on all the variables and the study are as indicated in Table 5. The 5% critical value was applied to establish the stationarity of the variables. The results revealed that all the variables were not stationary (all the absolute test statistics were less than the 5% critical value). This indicated the need for first differencing to ensure that the variables were transformed to stationarity. After first differencing, the variables became stationary.

TABLE 5**Unit Root Test for Study Variables**

Variable	Test statistic	1% critical value	5% critical value	10% critical value
GDPg	-2.751	-3.675	-2.969	-2.617
ODA	-1.251	-3.675	-2.969	-2.969
FDI	1.352	-3.675	-2.969	-2.969
REM	2.096	-3.675	-2.969	-2.969
EXDT	1.538	-3.675	-2.969	-2.969
GDS	1.079	-3.675	-2.969	-2.969
POPg	-1.736	-3.675	-2.969	-2.969

Source: Author (2017)

4.7 Cointegration Tests

After subjecting the data to first differencing, the data was ready for analysis using either VECM or VAR models. Cointegration implies that those variables have a long-term relationship indicating that one variable can be used to explain another variable. The study applied the Johansen test for cointegration and the results are presented in Table 4.5. The results indicate that the hypothesis of no cointegration was rejected as the trace statistic of zero cointegration (90.3261) was greater than the 5% critical value (68.52). The results indicate that there was at least one cointegrating equation indicated by the (*). These findings implied that VECM was the appropriate model for the data.

TABLE 6**Johansen Test for Cointegration**

Trend: constant		Number of obs =		39	
Sample: 1977 - 2015		Lags =		2	
<hr/>					
				5%	
maximum			trace	critical	
rank	parms	LL	eigenvalue	statistic	value
0	30	-3294.4814	.	90.3261	68.52
1	39	-3269.7258	0.71903	40.8148*	47.21
2	46	-3260.8955	0.36418	23.1543	29.68
3	51	-3253.3529	0.32077	8.0691	15.41
4	54	-3249.3566	0.18530	0.0766	3.76
5	55	-3249.3184	0.00196		

Source: Author (2017)

4.8 Vector Error Correction Model

The error correction model was run with the first differenced variables. Two lags were used in the model based on earlier results on the appropriate lag length. The results of the VECM model are presented in Table 7. These study results reveal that there was one cointegration equation with a negative error correction term ($\beta = -.5493$). This error correction term was significant at 5% level ($z = -3.61$; $p < 0.05$). These results indicate that when there are structural changes in the independent variables and their lags (ODA, FDI, REM, EXDT, GDS and POP), GDP growth will converge towards equilibrium. Further, study results in Table 7 also indicate that lagged FDI had a positive short-term causality on GDP growth ($\beta = -9.84e-09$; $p < 0.05$). Moreover, EXDT had a negative and significant effect on GDP growth ($\beta = 2.21e-09$; $p < 0.05$). However, the other independent variables (ODA and REM) did not have any short-term effect on GDP growth since their p values were above 0.05.

TABLE 7

Vector Error Correction Model

Sample: 1977 - 2015	No. of obs	=	39
	AIC	=	207.8492
Log likelihood = -3984.06	HQIC	=	208.9053
Det (Sigma_ml) = 1.27e+80	SBIC	=	210.7925

Equation	Parms	RMSE	R-sq	chi2	P>chi2
D_GDPg	9	2.27248	0.4043	20.36375	0.0158
D_ODA	9	1.9e+08	0.5594	38.08804	0.0000
D_FDI	9	1.9e+08	0.2852	11.97249	0.2149
D_REM	9	1.1e+08	0.4339	22.99119	0.0062
D_EXDT	9	5.8e+08	0.6836	64.83112	0.0000
D_GDS	9	5.0e+08	0.2502	10.01248	0.3495
D_POPg	9	.022508	0.8989	248.5626	0.0000

	Coef.	Std. Err.	z	P> z	[95% Conf. Interval]	
D_GDPg						
_cel						
LD.	-.5492662	.1519785	-3.61	0.000	-.8471385	-.2513938
GDPg						
LD.	.3091718	.1785702	1.73	0.083	-.0408193	.6591629
ODA						
LD.	1.53e-09	1.84e-09	0.83	0.407	-2.09e-09	5.14e-09
FDI						
LD.	-9.84e-09	2.73e-09	-3.60	0.000	-1.52e-08	-4.49e-09
REM						
LD.	4.87e-09	3.60e-09	1.35	0.176	-2.18e-09	1.19e-08
EXDT						
LD.	2.21e-09	8.28e-10	2.67	0.008	5.90e-10	3.83e-09
GDS						
LD.	3.21e-10	9.11e-10	0.35	0.725	-1.47e-09	2.11e-09
POPg						
LD.	-1.709275	7.127875	-0.24	0.810	-15.67965	12.2611
_cons	.9951823	.5565293	1.79	0.074	-.0955951	2.08596

Source: Author (2017)

Lastly, the normalized cointegration equation was developed and it is presented in Table 8. The study findings indicate that in the long run, all the four independent variables (ODA, FDI, REM and EXDT) combined would have a causal effect on GDP growth (chi square = 29.3063; $p < 0.05$). Moreover, results in regard to the specific variables indicated

that only FDI had a long term causal effect on GDP growth ($\beta = -1.27e-08$; $p < 0.05$). The other three variables (ODA, REM, and EXDT) did not have any significant long term causal effect on GDP growth (p values > 0.05).

The study results also indicated that the two exogenous macroeconomic factors (gross domestic savings and population growth rate) have no significant moderating effect on the relationship between external financing and economic growth in Kenya (p values > 0.05).

TABLE 8
Normalized Cointegration Model

Equation	Parms	chi2	P>chi2
_cel	5	29.30626	0.0000

Identification: beta is exactly identified

Johansen normalization restriction imposed

beta	Coef.	Std. Err.	z	P> z	[95% Conf. Interval]
_cel					
GDPg	1
ODA	2.12e-09	2.19e-09	0.97	0.332	-2.17e-09 6.42e-09
FDI	-1.27e-08	4.44e-09	-2.86	0.004	-2.14e-08 -4.01e-09
REM	-4.42e-09	2.81e-09	-1.57	0.116	-9.93e-09 1.09e-09
EXDT	8.59e-10	5.26e-10	1.63	0.102	-1.72e-10 1.89e-09
GDS	1.12e-09	6.74e-10	1.66	0.098	-2.05e-10 2.44e-09
POPg	2.632123	1.6734	1.57	0.116	-.6476815 5.911928
_cons	-15.99071

Source: Author (2017)

The resultant timeseries equation was;

$$GDP_{gt} = 15.99071 + 1.27e-9 FDI_t \dots\dots\dots (ii)$$

All the independent variables were excluded from the model except FDI which was the only significant variable at 5%. This model suggests that only FDI had a long term causal effect on

GDP growth ($\beta = -1.27e-08$; $p < 0.05$). The other three variables (ODA, REM, and EXDT) were omitted from the model since they had no significant long term causal effect on GDP growth (p values > 0.05).

4.9 Granger Causality Test

Lastly, granger causality test was conducted with the aim of establishing whether the lagged time series of the independent variables in the study (FDI, ODA, REM and EXDT) granger caused the GDP growth. The results are presented in Table 9.

TABLE 9
Granger Causality Test

Equation	Excluded	chi2	df	Prob > chi2
GDPg	ODA	.30194	2	0.860
GDPg	FDI	6.5486	2	0.038
GDPg	REM	5.3525	2	0.069
GDPg	EXDT	5.706	2	0.058
GDPg	GDS	.29033	2	0.865
GDPg	POPg	.08657	2	0.958
GDPg	ALL	23.634	11	0.014

Source: Author (2017)

The study results presented in Table 9 established that only ODA was not significant in granger causing GDP growth ($\chi^2 = 0.30194$; $p > 0.05$). This led to the acceptance of the first null hypothesis of the study which had indicated that official development assistance inflows have no significant relationship with economic growth in Kenya. These results contradict the study results by Burnside and Dollar (2000) who concluded that ODA had a positive impact on growth for developing countries with good fiscal, monetary and trade policies in place, but had little impact for those countries with poor policies. These findings

may therefore indicate that the reason why ODA does not have an effect on GDP growth in Kenya may be due to weak fiscal, monetary and trade policies.

Study results further implied that FDI granger caused GDP growth ($\chi^2 = 6.5486$; $p < 0.05$). This led to the rejection of the second null hypothesis of the study which had indicated that foreign direct investments have no significant relationship with economic growth in Kenya. These results support the two-gap theory (Harrod, 1939; Domar, 1946) which posits that total production that might lead to economic growth is dependent on the level of capital accumulation which includes external financial flows such as FDI in a given economy. The study results, however, disagree with the results by Makori et al. (2015) that foreign direct investments and economic growth do not have a significant relationship.

Moreover, study findings indicated that diaspora remittances did not granger cause GDP growth ($\chi^2 = 5.3525$; $p > 0.05$). This led to acceptance of the third null hypothesis of the study which stated that remittance inflows have no significant relationship with economic growth in Kenya. These results contradict the two-gap theory. The theory posits that due to lower saving rate in developing countries, these countries can experience low economic growth (Thirlwall, 2006). However, external financial inflows such as remittances from the diaspora can correct the problem. The study results however indicated that diaspora remittances had insignificant relationship with economic growth.

Further, study results indicated that external debt did not have a significant relationship with GDP growth ($\chi^2 = 5.706$; $p > 0.05$). These results led to acceptance of the fourth null hypothesis of the study which stated that external debt stock had no significant relationship with economic growth in Kenya. These findings do not support the debt overhang theory by Krugman (1988) which posits that when a country has a huge external debt stock, it can negatively affect its growth due to the burden of repayments and debt servicing. This study however established that external debt stock had insignificant effect on

GDP growth. Debt overhang theory holds that both the stock of external debt and repayment of interest and principal negatively affect growth by discouraging private investments or altering the composition of public spending. Higher interest payments can increase a country's budget deficit thereby reducing public saving while debt servicing may discourage growth by squeezing the public resources available for investment in infrastructure and human capital. However, the external debt in Kenya may not have reached the point to have such negative effects through it did not show any positive effect on GDP growth.

The study also established that GDS did not have a significant moderating effect on the relationship between external financing and GDP growth ($\chi^2 = 0.29033$; $p > 0.05$). Further results indicated that population growth rate also did not have a significant moderating effect on the relationship between external financing and economic growth in Kenya ($\chi^2 = 0.0866$; $p > 0.05$). These results are contrary to the two-gap theory which was derived from the works of Harrod (1939) and Domar (1946). This theory indicates that economic growth is proportional to the rate of savings and investment. The higher the savings/investment rate, the higher the growth rate. However, the study results indicated that GDS was insignificant in explain GDP growth.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter presents the summary of the findings, conclusion and recommendations. The conclusions provided in this chapter are in regard to the findings that were arrived after analysis of the data collected. Similarly, recommendations made in this chapter are in line with the gaps noted from the study findings.

5.2 Summary of Findings

5.2.1 Relationship between official development assistance and economic growth in Kenya

The findings from this study indicated that ODA did not have a significant relationship with GDP growth ($\chi^2 = 0.30194$; $p > 0.05$). These results led to the study accepting the null hypothesis (H_{01}) that official development assistance inflows have no significant relationship with economic growth in Kenya. These results are contrary to the endogenous growth theory (Kaldor, 1962; Arrow, 1962; Lucas, 1988) which posits that ODA creates positive spill overs which enhance the knowledge-based economy which leads to economic development. However, in this study, there was no such positive spill overs which indicates that the ODA received may have been applied inefficiently or applied in low growth sectors. However, the study results agree with the findings by Mosley et al. (1987) that ODA do not lead to improved growth and may have even negatively influenced recipients' economic performance.

5.2.2 Relationship between foreign direct investment and economic growth in Kenya

The results however indicated that FDI had a significant relationship with GDP growth ($\chi^2 = 6.5486$; $p < 0.05$). These results implied that the null hypothesis (H_{02}) that foreign direct

investments have no significant relationship with economic growth in Kenya was rejected. These results support the modernization theory (Saqib et al, 2013) which argues that since capital investment is a prerequisite for economic growth, then foreign direct investment will serve as an engine of economic growth especially in the context of developing countries that have a capital investment deficit. The theory contends that the key impediment to economic growth in developing countries is the inadequacy of knowledge, technological transfers and capital a gap that FDI can bridge thereby enhancing both capital accumulation and increasing total factor productivity. The findings from this study concur with that view by establishing that FDI had a positive causal effect on GDP growth. the findings in this study also concur with various other studies such as Landes (1997); Henry (2000); Bekaert, Harvey and Lundblad (2001); Klein, Michael and Olivei (2001) which found a positive link between FDI flows and economic growth both in developed and developing countries.

5.2.3 Relationship between diaspora remittances and economic growth in Kenya

The study results indicated that diaspora remittances did not have a significant relationship with GDP growth ($\chi^2 = 5.3525$; $p > 0.05$). These study results led to acceptance of null hypothesis (H_{03}) of the study which stated that remittance inflows have no significant relationship with economic growth in Kenya. These results contradict the results by Chigbu et al. (2015) and Meyers and Sherab, (2015) which had established that remittances have positive impact on growth and that this impact increases at higher levels of remittances relative to GDP. The implication of these findings however, can be that most of the remittances are used on consumer goods or that the level of remittances relative to GDP is still very small. It is also possible that some remittances were not captured in the official government records.

5.2.3 Relationship between external debt and economic growth in Kenya

Lastly, study results revealed that external debt did not have a significant relationship with GDP growth ($\chi^2 = 5.706$; $p > 0.05$). These results led to acceptance of the fourth null hypothesis (H_{04}) of the study that external debt stock had no significant relationship with economic growth in Kenya. The study results however indicated that external debt stock had a negative short-term relationship with economic growth. These results implied that external debt stock had negative disturbances on GDP growth in the short term but in the long term, the effect became insignificant. These findings contradicted the findings by Samer (2013) which had established that there was positive and significant relationship between external debt and economic growth. These results also disagreed with findings from many studies that had confirmed the negative relationship between external debt and economic growth (Ali & Mustafa, 2011).

5.3 Conclusion

The study concludes that ODA to the country had an insignificant long-term effect on GDP growth rate in Kenya. This may be due to weaknesses in trade, monetary and fiscal policies in the country that leads to application of the ODA inefficiently or sub optimally.

Secondly, the study concludes that FDI had a positive and significant effect on GDP growth rate. These results led to the conclusion that FDI is effectively applied in Kenya in sectors that have significant contribution to the economy.

Third, the study concludes that remittances from the diaspora did not have a significant effect on GDP growth rate. This finding can imply that most of the remittances are used in consumer goods thus denying the country the investments that would enhance economic growth.

Lastly, the study concludes that external debt stock did not have a significant long-term effect on GDP growth but had a significant short-term effect. However, the findings indicated that debt has a short term negative effect on economic growth. This implies that if external debt stock continues to accumulate unabated, this could finally have negative effects on the economy.

5.4 Recommendations

The following recommendations are made. First, the government should focus much on improving FDI into the country as this was noted to positively cause GDP growth rate which is critical for the economic advancement of the country. The country seems to be applied FDI in productive sectors which have resulted in have a positive causal effect on GDP growth. The government should therefore improve the ease of doing business, reduce regulation and licenses required to register businesses and ease the tax regulations to make the country able to attract more FDI.

Secondly, the government should have effective policies to ensure that ODA is channeled to sectors that can have a significant effect on GDP growth. Similarly, there should effective policies to ensure that any ODA received by Kenya is not misappropriated or inefficiently allocated into programs or sectors that have minimal causal effect on GDP growth and economic advancement of the country. This calls for policy makers in government, oversight bodies and the civil society to be more vigilant in ensuring that any ODA received is applied efficiently to the sector it was intended for.

Similarly, the study recommends to the government and financial sector to have effective regulations and policies to ensure that any remittances received into the country from diaspora is invested into productive sectors. The government need to create systems that will motivate those who reside outside the country to invest their money back into the

country. This means enhancing ease of doing business, having effective dispute resolution mechanisms, easing taxation regimes and enhancing integrity and transparency in business dealings which would market the country as a good place to do business.

Lastly, the government should ensure that external debt is controlled and managed effectively as there are benefits on economic growth that are derived from the increased external debt stock. Most importantly, government should ensure that external debt is only sought as a last resort. Similarly, any borrowed funds should be invested in productive sectors that will generate revenue to enable repayment of such debt.

5.5 Areas of Further Research

Since there is much debate on whether external financial sources to poor and developing countries influence economic growth, research should focus on providing causal estimates on how aid influences economic growth rather than showing correlation between external financing and economic growth. This is because study of correlations alone hardly provides critical insights which can be applied to aid effective channelling of external financial sources to sectors that would have a positive outcome. Moreover, studies should focus on sectoral effects rather than focussing on the overall economic growth of a country. A study on sectors such as agriculture or manufacturing and how external financing influences growth in these sectors can provide more critical information on sectoral effects. This is because external financing can be channelled to low growth sectors which can have an insignificant effect on the overall growth of the economy.

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