

## **Foreign Capital Inflows on market liquidity growth case of Nairobi Securities Exchange in Kenya**

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### **Abstract**

*The stock market provides a framework upon which investors can diversify their investments and a platform upon which corporate institutions can raise additional funds. The stock market is therefore an important component of the capital market that mobilizes surplus liquidity and attracts foreign investors which bring in cash flows from outside countries and ensures that funds are channeled towards productive corporate users. A well-developed market is expected to be liquid and therefore this paper sought to establish the effects of foreign capital inflows on market liquidity. The paper will do an empirical literature to evaluate the relation of foreign capital inflows on stock market liquidity. Foreign capital inflows will be measured as the total annual FDI that flows into the country. The market liquidity measures includes bid ask spreads turnover ratios and prices impacts measures. The empirical evidences showed a significant positive relationship on the FDI on the stock market liquidity in both developing and developed countries.*

**Keywords** . Foreign financial inflows, Stock Market liquidity

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### **I. Introduction**

Since turbulence engulfed financial markets in mature economies in autumn 1998, market liquidity has attracted increasing attention on the part of market participants, central banks and regulatory and supervisory authorities because of the multiples benefits they offer. In particular, perceptions of a persistent reduction in market liquidity in a number of segments of global financial markets (Rahman & Mustafa, 2017).

The composition of foreign capital inflows to Sub-Saharan Africa in 1990 was 62% Official Development Assistance and Aid (ODAA), 31% FDI and 7% Diaspora remittances. However by 2015 ODAA accounted for only 22% of the foreign capital inflow a share almost similar to the remittances that stood at 24%. The contribution of FDI had grown by 23% from 31% in 1990 to 54% by the end of 2015. This an indication that African countries were no longer dependent on foreign aid but were rather shifting towards attracting foreign direct investment which is triggering enlargement of the market size in the African stock markets (UNCTAD, 2016).

The increase in foreign capital inflows to the emerging African capital markets can be attributed to reduced tariff barriers and non-tariff barriers to trade that have significantly reduced cost of doing business. Further, the improved licensing and regulatory framework has reduced the bureaucratic cost and inspired foreign investor confidence hence growth of the stock market size is achieved due increase in number of investors (Yartey, 2008).

Foreign investors' participation in the stock market is an important source of stock market liquidity. This is attributed, but not entirely, to the fact that foreign investors, unlike the domestic investors who often buy and hold stocks, are likely to trade in the instruments thus improving the market liquidity and hence development of the stock market (Kumar & Devi, 2013). Moreover, the significant role of foreign financial inflows towards stock market development is attributed the fact that foreign capital inflows increases the depth and breadth of the stock market consequently enhancing stock market size and liquidity.

The Kenyan economic blue print of vision 2030 aims at transforming the country into a newly industrialized middle income country that provides high quality life to its citizens. Moreover, the vision 2030 envisions an efficient and transparent stock market. This huge milestone is to be achieved through the deepening of the financial markets by expanding the bond market, equity market and leveraging on remittances and other long term foreign capital inflows increasing the volumes of stocks trade on the floor of NSE (Republic of Kenya, 2007).

The amount of diaspora remittances invested in the stock market largely depends on the returns generated from other money market instrument (Kalim & Shahbaz, 2013). Whenever the returns generated from other money market instrument is low relative to stock market returns, diaspora remittances can be directed to the stock market through the purchase of equity instruments in listed companies. According to Njoroge (2014),

increased awareness by the Kenyans in the diaspora on the availability of investment opportunities and the high returns in the stocks market has led to increased amount of remittances investment in the Nairobi Securities Exchange market leading to increased stock market liquidity

### **1.1 Statement of the Problem**

Foreign capital inflows represent additional capital investment in the stock market leading to increased market value and liquidity (Kumar & Devi, 2013). Despite the theoretical link between foreign capital inflows and liquidity of stock markets, the nature of relationship in the context of NSE remains an issue of empirical investigation.

Empirical studies conducted globally on the effect of foreign financial inflows on stock market development (Arcabic et al., 2012; Adam & Tweneboah, 2009; Soumare & Tchana, 2011, Idenyi et al., 2016) Provided varied conclusions with some studies indicating significant effect while other studies indicating insignificant effect, therefore failing to provide unambiguous conclusions on the question of the effect of the various components of foreign capital inflows on Stock Market liquidity. Besides, a significant number of previous studies are conducted in developed capital markets (Malik, 2013; Raza and Jawaid, 2014; Kaleem & Shahbaz, 2008; Arcabic et al., 2012). Understandably, the context in these markets is different from the stock market context in the emerging African markets.

In Kenya, a few scholars' have attempted to study the effect of selected foreign capital flows on stock market liquidity (Koskei et al., 2016; Njoroge, 2014; Gachanja & Kosimbei, 2018; Githaiga & Kabiru, 2014; Nyangoro, 2013). Notably, previous studies have ignored the fact that stock market liquidity is a multi-faceted, long-term process measured by several factors. Equally, previous empirical studies tend to emphasize the direct effect of foreign capital inflows on stock market liquidity hence disregarding the moderating effect of political risk on the relationship between foreign capital inflows and stock market liquidity. This study therefore sought to fill the foregoing Knowledge gaps by establishing the effect of foreign capital inflows on stock market liquidity evidence at the Nairobi Securities Exchange.

### **1.2 Objective of the study**

The Specific objectives of the study were to assess the effects of Foreign Direct Investment and Foreign Equity Portfolio on stock market liquidity at the Nairobi Securities Exchange.

## **II. Theoretical Literature Review**

These sections provide a review of relevant theories that support the relationship between foreign financial inflow and development of stock markets. Hence, the following theories were applied to explain the study relationship:

### **2.1 Base Broadening Theory**

The Base Broadening theory was proposed by Merton (1987). The theory contends that expanding the number of investors, through the liberalization of the financial markets, to include investors from foreign countries would lead to increased diversification. Therefore according to Base Broadening theory, if both the domestic and foreign investors from the diaspora share the same information sets they will invest equivalently (Merton, 1987). The Kenyan government through the Kenya Foreign Policy and the Vision 2030 economic blue print recognizes the important role of played by foreign capital flows towards stock market development and the general economic growth. Harnessing of foreign capital flows, diverse skills and expertise from foreign development partners is one of the objectives of the economic pillar in the vision 2030 (Republic of Kenya, 2007). Moreover, increasing capital inflows through robust economic engagement with partner states is the main objective in the economic pillar of the Kenyan foreign investment policy. Further the policy aims at promoting the country as a favorable investment destination for foreign investors (Republic of Kenya, 2014).

### **2.2 FDI Dependency Theory**

The theory, formulated by Todaro & Smith (2003), contends that excessive reliance on foreign direct investment leads to FDI dependency. The theory is premised on the fact that foreign firms, often from advanced markets, possess superior advantage over the domestic firms in developing markets. Multi-National Companies (MNCs) have a greater competitive advantage due to greater technological Knowledge, managerial skills, industrial organization and product knowledge. Equally, MNCs will enjoy greater economies of scale as compared to local firms (Idenyi et al., 2016). Economies of scale enhance the reduction in the cost per unit of services such as financial services, marketing, and cost of technological research. Foreign plants often produce similar products to the domestic market. Thus multi-national companies can even out the effects of economic cycles in various markets by reorganizing the sales across the various destinations in foreign countries (Shenkar, 2007). Therefore foreign firms are able to operate more profitably than the domestic firms and hence have the

ability to drive the out the small and medium local enterprises characterized with inferior technology. FDI dependency makes the developing capital markets entirely depend on multinational enterprises from developed capital markets to meet their capital and liquidity needs

### **2.3 Pure Self-Interest Theory**

The theory was triggered by Lukas and Stark (1985). According to the Pure Self Interest Theory an emigrant sends remittances with the aspiration to inherit or makes investments for the future with the intention to return home in future and derive benefits from such investments. Emigrants send money home because they expect to return home and can expect to receive family gratitude for having sent remittance (Vargas & Huang, 2006).

There is a direct link between increased diaspora remittances and stock market development (Njoroge, 2015). Thus if the remittances are invested in the securities market then there would be increased market capitalization leading to the development of the market. The theory of Pure Self Interest aids in explaining the effect of Diaspora remittances on stock market development in Kenya.

### **2.1 Empirical literature**

Adam and Tweneboah (2009) did a study on Foreign Direct Investment and Stock market Development Ghana's with an objective to determining the Impact of FDI on stock market development in Ghana. The study adopted Explanatory design, linear least squares model and Secondary data was used. The study found that There was a significant short term relationship on FDI and stock market liquidity so recommend for study that can measure a long term relationship

A study by Chauhan(2013) on Effects of capital cash inflows on the stock market development, in Turkey .the objective of the study was to determine impacts of capital inflows on the stock market development. The Ordinary least squares (OLS) model, Secondary data was used in the study and Multivariate co integration to test for correlation of variables. The study found a positive significance effect on the market capitalization development.

A study on Effects FEP on the development of capital markets in Nigeria was done by Boboye (2017) the objective of the study was to establish impacts of FEP on the Nigerian capital market development. The study used Secondary data and linear least squares model. It was found that there was a positive relationship FEP on development of capital markets.

Idenyi (2016) did a study on the effects of FDI on the stock market development, in Nigeria, with an objective of establishing the impacts of FDI on the development of the stock markets in Nigeria. the study used secondary data, ordinary least squares (OLS) model and Descriptive research .it was found that there was a positive significant effect of FDI on market development in short and long term.

Koskei (2016) study on Effects of (final prediction error) FPE flow on the stock market returns of listed banks with an objective of establishing the effects of FPE flows on the stock markets returns of the listed banking institutions in Kenya and The study used a two stage least square regression model was used in the tests for correlation of variables and secondary data. The study showed significant positive effects of FPE on the stock returns and recommended that more study can be done to test how foreign capital inflows can affect the growth of capital.

A study on Effects of FDI, FPI and remittance on the stock market development by Malik (2013) with an objective of determining the role of FDI,FPI and remittance on the stock market development in Pakistan .the study used a least square regression model, Heteroscedasticity Test auto correlation test, data schedules was used to collect secondary data.it was found that there was a positive significant relationship of FDI ,FPI and remittance on stock market developments

Raza and jawaid (2014) study on Impacts of FDI on the stock market development in Egypt with an objective of measuring the impacts of FDI, remittance on the stock market development Egypt .The study used a two stage least square regression model, secondary data, Descriptive study, auto correlation, heteroscedasticity test, descriptive design was used. it was found that FDI had a negative significant impacts on the stock market development while remittance had a positive significant effects on market development.

Nyangoro (2013) did a study on the Effects of foreign portfolio flows and stock market performance. Objective of the study was to investigate the effects of foreign portfolio flows and stock market performance. The study methodology was linear least squares model, a primary and secondary data was used. The study showed there was a significant positive relationship between the portfolio flow on the stock market performance.

Oziegbe (2013) study on effects of foreign financial resources inflow on development of security markets in Nigeria and Ghana .study objectives was to establish the effects of foreign financial resources inflows and development of securities markets in Nigeria and Ghana. The study used a linear least squares model, Descriptive data analysis was adopted and test for normality was done, secondary data was used. The

study showed there was a positive significant effects of foreign financial inflows on market development in Nigeria and there was insignificant effects in Ghana.

A study by Njoroge (2014) on Effects of diaspora remittance on the stock market performance in Kenya with an objective of determining the effects of diaspora remittance on the stock market performance in Kenya. An ordinary least squares model was used, both secondary and primary data was used Descriptive study was done, auto correlation test and normality test. Remittance was found to be having a positive and significant relationship with stock market development.

Ramirez (2018) study on Relationship between FDI flows and stock markets development, evidence from emerging economy had an objective of examining the impacts of FDI inflows on the size and liquidity of 14 developing countries stock markets Analysis. The study used a two stage least square regression model and secondary data. The test found that FDI and market size and liquidity indicators impacted one another. The findings might be depending on whether the variable used to determine causality indicated the stock market and banking sector development

Sourmare (2015) did a study Effects of FDI on stock markets size and liquidity and banking sectors the objective was To measure the effects of FDI on the stock market size and liquidity and banking sectors . The study used a two stage least square regression model and secondary data was used. The test found that FDI had positive significant effects on the market size and liquidity. The findings might be depending on whether the variable used to determine causality indicated the stock market and banking sector development.

Tekam (2018)study on the Effects of Capital Market Development and Foreign Direct Investment on the Entrepreneurial Process and Economic Growth had an objective of measuring how capital market development is affected by foreign capital inflows. The study used the Generalized Method of Moments (GMM) and the Calderon-Rossell model. The study found that capital market and capitalization initiatives had a positive significant relationship on an entrepreneurial process and economic growth in the CEMAC region.

Philip and Obiajulu, (2017) did a study on the impacts of foreign direct investment on development of market in Nigeria. The objective of the study was to measure The impacts of foreign direct investment on development of market in Nigeria. The study used a Vector Error Correction Model was used, and secondary data was used. The FDI has a positive significant effect on liquidity of the market in the short term while in the long run the effect is negative

## **2.2 Critic of the literature and research gap**

The study by various researchers addressed the relationship between dependent and independent variables from these topic effects of foreign capital inflows to the liquidity of the stock markets showed significant positive relationship of FDI on the market liquidity for both developed market and developing markets yet these markets are not the same in size and growth, hence more study need to be done to find out why market of different levels in growth would be responding the same to FDI on liquidity growth.

## **III. Findings of the study**

This paper examined the possible effects of foreign capital inflows on Stock Market liquidity by taking a look at worldwide developing and developed markets over the period 2007-2018. A study on effects of Foreign Direct Investment on Stock market Development by (Adam and Tweneboah , 2009 in Ghana;Idenyi ,2 016 in Nigeria ; Malik ,2013 in Pakistan; Raza & jawaid ,2014 in Egypt;Ramirez ,2018 in 14 developing markets in Africa; Tekam, 2018 in Nigeroia) found that there was a positive significant relationship of FDI on stock development in both developed and developing stock markets.

A study on the effects of remittance on the stock market development was done by (Malik, 2013 in Pakistan: Njoroge ,2014 in Kenya) Remittance showed a positive significant relationship with stock market development In both developing and developed markets.

Study by was done by (Boboye 2017) on the effects FEP coating market on the development of capital markets in Nigeria . The study showed a positive significant relationship of FEP coating market and stock market development in Nigeria.

Sourmare (2015) did a study on the Effects of FDI on stock markets size and liquidity and banking sectors. The test found that FDI had a positive significant relationship with market size and liquidity of the stock markets. Mandaci (2014) study on the determinants of stock market size and liquidity in Kenya, it was found foreign capital inflows, remittance and FDI showed a significant effects on the growth of the market.

Oziegbe (2013) study on the effects of foreign financial inflows on the market liquidity showed significant effects.so From the study above we can conclude that since majority of the study showed a significant relationship on the foreign capital inflow on the of stock market liquidity

#### **IV. Conclusion.**

So from the empirical literature we can conclude that FDI is having a positive significant effect on the stock market growth on liquidity in Kenya

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