

THE MODERATING ROLE OF INSTITUTIONAL QUALITY  
ON THE FINANCIAL DEVELOPMENT AND FOREIGN  
DIRECT INVESTMENT NEXUS:  
EVIDENCE FROM EAST AFRICAN COUNTRIES (EAC)

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**THE MODERATING ROLE OF INSTITUTIONAL  
QUALITY ON THE FINANCIAL DEVELOPMENT AND  
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By

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## **DEDICATION**

To my loving parents, James August Mosha and Martha Peter Mowo, my wife Frimina Hubert Temu, my daughter Joan and my son Jovin, who offer unconditional love and support and have constantly prayed for me. Thank you so much!

## **ABSTRACT**

### **THE MODERATING ROLE OF INSTITUTIONAL QUALITY ON THE FINANCIAL DEVELOPMENT AND FOREIGN DIRECT INVESTMENT NEXUS: EVIDENCE FROM EAST AFRICAN COUNTRIES (EAC)**

Joseph James Mapendo

The study examines the effect of financial development measured by banking services and stock market size on FDI inflows, with the moderated role of institutional quality (Corruption, government effectiveness, and political stability) in East African countries. The FDI inflows in EAC have been challenging as the level that flows to this region has been declining. The attraction of this crucial foreign-based investment is essential in the economic development of this region due to its beneficial spillover effects. The study considers financial development a critical aspect that is pivotal in enhancing the host country's investment climate. The study used panel data for twenty-six years, from 1995 to 2020. Similarly, the institutional FDI fitness, the Eclectic paradigm (OLI framework), and the Capital Market (currency areas) theories were employed to examine the relationship between banking services, stock market size, institutional quality, specified macroeconomic variables, and FDI inflows.

The study has been governed by five objectives, which include investigating the influence of banking services on the level of FDI inflow, investigating the influence of stock market size on the level of FDI inflow, investigating the influence of institutional quality (Corruption, Government Effectiveness,

Political stability) on the level of FDI inflow, investigating the moderating effect of institutional quality (Corruption, Government Effectiveness, Political stability) on the relationship between banking services and the level of FDI inflow, and investigating the moderating effect of institutional quality (Corruption, Government Effectiveness, Political stability) on the relationship between stock market size and the level of FDI inflow.

Using the Feasible Generalized Least Squares (FGLS) estimator as the main model and the Panel Corrected Standard Errors (PCSE) estimator for a robustness check, the study findings reveal a significant relationship between financial development and FDI. Specifically, banking services positively influence FDI inflows to the EAC, implying that stronger, more efficient banking sectors can attract more foreign investment. This suggests that improving financial infrastructure, such as increasing credit availability, enhancing financial transparency, and ensuring regulatory stability, can boost investor confidence and capital inflows. As a result, policymakers in this region may prioritize financial sector reforms to stimulate economic growth through increased FDI inflows. On the other hand, the stock market size negatively impacts FDI. The negative impact of stock market size on FDI reveals that underdeveloped stock markets may signal limited capital market depth, which can deter foreign investors. This highlights the importance of developing and strengthening stock markets to enhance investor confidence, improve financial transparency, and attract more stable, long-term FDI. The findings reflect that foreign investors in EAC are more attracted by the banking sector when they need financial support to finance their growth and expansion strategies. Again,

policymakers may need to focus on capital market reforms as part of a broader strategy to boost FDI inflows.

The results further reveal that institutional quality in EAC hurts FDI inflows. The findings reflect that poor governance, legal uncertainty, and a lack of regulatory enforcement deter foreign investors. This suggests that improving institutional quality, such as strengthening the rule of law, reducing corruption, and enhancing regulatory effectiveness, is critical for attracting and sustaining FDI. Policymakers should prioritize institutional reforms to create a stable and predictable investment climate. Additionally, the moderated institutional quality has a dual effect on the investment process, either positively or negatively altering the impact of banking services and stock markets on FDI. The findings imply that strong institutions enhance the positive impact of banking services and mitigate the adverse effects of underdeveloped stock markets on FDI. This dual influence suggests that institutional quality acts as a key enabler for financial development to attract foreign investment effectively. Thus, policymakers should focus not only on financial sector reforms but also on strengthening institutional frameworks to maximize FDI inflows.

However, the study has theoretical, practical, and policy implications regarding financial development and institutional quality practices for diverse parties, including investors, authorities, and scholars. The study suggests that to attract more FDI, EAC countries should pursue integrated reforms that develop both the financial sector through improved banking services and balanced stock market growth and institutional quality. Strong institutions enhance the positive

effects of banking development and help manage the mixed influence of stock market size on FDI inflows. Therefore, policymakers should focus on strengthening governance, legal frameworks, and regulatory effectiveness alongside financial sector reforms to create a stable, transparent, and investor-friendly environment that supports sustained foreign investment.

**Keywords:** Financial development, foreign direct investment, institutional quality, banking size, stock market development, FGLS, PCSE.

**Subject Area:** 0412-Finance, Banking and Insurance

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## **DECLARATION**

I, JOSEPH JAMES MAPENDO, hereby declare that the thesis is based on my original work except for quotations and citations which have been duly acknowledged. I also declare that it has not been previously or concurrently submitted for any other degree at UTAR or other institutions.

(JOSEPH JAMES MAPENDO)

Date: 10/10/2025

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## LIST OF ABBREVIATIONS

ARDL	Autoregressive distributed lag
DRC	Democratic Republic of Congo
DSE	Dar es Salaam Stock Exchange
DSUs	Deficit spending units
EAC	East African countries
EPZ	Export processing zones
FDI	Foreign direct investment
FEM	Fixed effects model
FGLS	Feasible generalized least squares
GDP	Gross domestic product
GMM	The generalised method of moments
GNP	Gross national product
ICTSD	International Centre for Trade and Sustainable Development
IQ	Institutional quality
M&A	Mergers and acquisitions
MNCs	Multinational companies
MNEs	Multinational Enterprises
OECD	Organisation for Economic Cooperation and Development
OLI	Ownership, location, and internalisation
OLS	Ordinary least squares
PCSE	Panel corrected standard errors.
RECs	Regional economic communities

REM	Random effects model
RFI	Regional financial integrations
SSUs	Surplus spending units
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNECA	United Nations Economic Commission for Africa
URT	United Republic of Tanzania
WB	World Bank
WTO	World Trade Organization

## **CHAPTER ONE**

### **1.0 Introduction**

This chapter provides an overview of the study's background, followed by a statement of the problem. The chapter outlines the research questions and objectives that guide the study's focus. This chapter also highlights the significance of the study, followed by its scope, and concludes with an overview of the organization of the remaining research structure parts.

### **1.1 Background of the study**

Foreign direct investment (FDI) is crucial for building stability and promoting economic growth in emerging countries. FDI has grown phenomenally since the early 1980s, making the global market much more competitive by influencing the economy's future direction through multinational companies (MNCs) that control assets in foreign countries. Investing through FDI for more significant economic benefits is no longer an option, as the maximum advantages from foreign investments can be achieved by linking investors' needs with host countries' available resources. Companies operating in developing countries require access to multinational funding and exposure to the international business arena to improve their sales and profitability. The findings of Pham et al. (2022) on the crucial role of FDI suggest that it is a pillar for economic development.

FDI is an essential aspect and form of international investment approach for multinational enterprises (MNEs) to take advantage of investment opportunities and resources available in foreign markets. Multinational Enterprises adopted FDI as their model of business, driven by the motives of seeking resources, acquiring strategic assets, achieving efficiency, and, additionally, expanding into new markets (Krifa-Schneider et al., 2022).

Over time, FDI has become a primary strategy and cornerstone for economic development in different countries (Appiah et al., 2023). FDI has been identified as a crucial driver of economic growth in integrated economies, such as the EAC, under the study. FDI is a fundamental pillar for economic development, driven by incentives such as the intensification of capital accumulation, creativity, and innovation. FDI inflows are associated with numerous economic benefits for host countries, including the introduction of new technologies, job creation, improved service delivery levels, economic growth promotion, and labour market stability (Lestari et al., 2022).

The FDI business strategy and its impact on the host country's economic environment have been extensively discussed. Nevertheless, the mechanism is not clearly understood as an aspect of prominence to most concerned parties, including researchers, policymakers, and even managers of international

businesses. The debate on the role of FDI and the factors influencing it is inconclusive due to the diversity of theories on which it is based.

The fundamental relationship between FDI and financial development lies in the role of financial systems as facilitators of investment, risk management, and efficient capital allocation (Majeed et al., 2021). Financial development through robust banking services and capital markets reduces transaction costs, improves access to credit, and enhances information transparency, all of which lower the barriers and risks associated with FDI (Pham et al., 2022). Well-functioning financial systems also complement FDI by enabling better integration into local economies, supporting domestic firm growth, and fostering spillover effects like technology transfer. Conversely, underdeveloped financial systems can limit these benefits, deter foreign investors, and hinder the full economic impact of FDI (Lestari et al., 2022). Thus, financial development is both a channel and a catalyst for maximizing the growth potential of FDI.

Additionally, FDI and banking services are closely related, stemming from the role of banks in reducing financial frictions and supporting investment activity (Jena & Seth, 2021). Efficient banking services improve access to credit, facilitate capital mobilization, and enhance financial intermediation, which lowers the cost and risk of doing business for foreign investors (Haque et al., 2022). A strong banking sector signals macroeconomic stability and institutional reliability, making a country more attractive for FDI. Moreover, banks support foreign firms by offering local financing, managing currency risk, and providing

payment and settlement systems (Jeanluc & Muiruri, 2022). In essence, well-developed banking services create a supportive financial infrastructure that enables and amplifies the positive economic impact of FDI.

Similarly, FDI and stock market size have a close economic association as the stock market shapes the role of capital markets in providing investment alternatives, liquidity, and financial transparency (Mapendo et al., 2025). A larger, more developed stock market can attract foreign investors by signaling economic maturity and offering opportunities for portfolio investment (Islam et al., 2020). However, it may also substitute for FDI, as investors might prefer liquid, short-term equity investments over long-term direct investment (Krifa-Schneider et al., 2022). Conversely, a well-functioning stock market can complement FDI by improving capital allocation, facilitating firm growth, and increasing market confidence (Cang & Alida, 2020). Thus, the relationship is dual as stock market size can both attract and divert FDI depending on market dynamics, investor preferences, and the broader financial and institutional environment.

At the same time, the relationship between FDI and institutional quality stems from the role institutions play in shaping the investment climate. High institutional quality, characterized by strong rule of law, effective governance, regulatory stability, and protection of rights, reduces uncertainty and transaction costs for foreign investors (Gupta et al., 2024). It enhances trust in a country's legal and economic systems, making FDI less risky and more attractive

(Ozekhome, 2022). Strong institutions also ensure better enforcement of contracts and reduce corruption, which are crucial for long-term investment decisions. In contrast, weak institutions deter FDI by increasing operational risks and reducing investor confidence (Fengju & Wubishet, 2024). Therefore, institutional quality is a foundational determinant of FDI inflows and their sustainable impact on the recipient economies.

In the same vein, the relationship between financial development and institutional quality is grounded in their mutual reinforcement in promoting efficient and stable economic systems (Kostova et al., 2020). Strong institutions through effective governance, legal enforcement, and regulatory frameworks create the foundation for well-functioning financial markets by ensuring transparency, protecting property rights, and reducing information asymmetries (Ozekhome, 2022). In turn, financial development enhances resource allocation, investment, and economic growth, but its effectiveness largely depends on the quality of institutions (Wang et al., 2023). Without strong institutions, financial systems may become prone to inefficiency, corruption, or instability (Jahanger et al., 2022). Thus, institutional quality is both a prerequisite for and a complement to sustainable financial development.

However, the relationship between financial development, institutional quality, and FDI is based on their interdependent roles in creating a favourable investment climate (An & Yeh, 2021). Financial development through efficient banking systems and capital markets facilitates access to capital, reduces

transaction costs, and supports business growth, all of which attract FDI (Silva et al., 2021). Similarly, the effectiveness of financial development in driving FDI depends heavily on institutional quality. Strong institutions provide legal certainty, enforce contracts, and ensure regulatory stability, which reduces investment risk and enhances investor confidence (Saleh, 2023). Together, financial development and institutional quality act as complementary forces: institutions enable the financial system to function efficiently, while financial development amplifies the economic impact of good institutions (Gupta et al., 2024). Haque et al. (2022) emphasize that this point effort is crucial for attracting and sustaining high levels of FDI in the developing economies.

It is worth noting that the African continent ranks FDI inflows as a significant opportunity for speeding up economic growth. The efforts to increase FDI inflows to the African continent have been aligned with reducing regulatory trading barriers and expanding the market for easy access across different countries and interaction among its economic regions. The African continent is divided into five economic parts: Northern Africa, Southern Africa, Central Africa, Western Africa, and Eastern Africa. Most of the FDI flowing to the African continent originates from European countries, followed by China. The FDI stock flowing from Europe to the African continent has declined over the past decade, while the direction has shifted to Asian countries, whose inward FDI share has increased (Morgan et al., 2022). Similarly, FDI destinations in Africa have turned to Northern and Southern Africa since the mid-2000s, at the expense of Eastern Africa, which has seen a decline in its share of FDI. Statistics reveal that the FDI inflows to Northern and Southern Africa have increased from

6% and 8.9% to 10.8% and 51.9% respectively (World Investment Report, 2022).

Most FDI received in Africa from foreign private investors is majoring in food and beverages, as these sectors are directly connected to economic development. Investment in food and drinks enhances the value of agricultural initiatives, promoting inclusive economic growth, increasing food security, and generating additional income from the food chain. Over the years, the African continent's traditional and dominant FDI attractions have been mining, oil, and metals under the greenfield FDI approach. Between 2014 and 2020, the rate of FDI inflows in this sector had already declined by 31%, amounting to \$109 billion. Following this massive loss in FDI stock, strategies have been formulated to create intra-continent FDI flows, the initiatives facilitated by the African continent's free trade area policy. The intra-African investment strategy has been an increasingly important source of FDI flows, and it has been pioneered by Mauritius, South Africa, Kenya, Nigeria, and Togo. Their contribution to the intra-continent FDI flows accounts for about 75%.

FDI inflows to the EAC carry the same significance for economic development as they do for the African continent. FDI growth in the EAC can be traced back to the 1980s, when the phenomenon emerged and became the most popular and strategic investment approach for many multinational enterprises, driven by increased trade competitiveness in the global market. The growth and development of the FDI business approach in EAC has passed through three

phases. The first phase occurred in the 1980s, when the FDI investment strategy gained direction for the region. In this period, the FDI inflows to the region remained low and almost negligible until the 1990s. The second phase was the 1990s, during which the EAC started experiencing FDI growth. However, at this stage, the growth rate was meagre, almost insignificant to the economy. The third phase began in the 2000s, when the growth rate increased and tripled to the level it had previously achieved. The FDI stock flowing to EAC continued to rise from the 2000s until 2010, when it peaked before experiencing tremendous fluctuations.

From 2010 onwards, FDI inflows to the EAC have varied substantially. UN investment statistics revealed that in 2010, the FDI inflows to EAC declined to 7%, far below the average of 15% of the common FDI share that used to flow to this region. Surprisingly, from 2013 to 2014, FDI inflows in the region increased due to the discovery of natural gas and oil reserves in Tanzania and Uganda. Contrary to this increase in FDI inflow, UNCTAD's (2019) statistical report showed that FDI inflows to EAC in 2016 declined by 14% of the earlier share received in 2015. Thus, the statistics suggest that the FDI inflow to EAC from 2010 onwards has no clear pattern.

The empirical study by Moh'd Hemed and Suleiman (2017) on FDI inflows to the EAC highlighted that the region's low FDI attraction is not balanced across its member states. This situation forces each member state to focus on strategies to attract more FDI inflows to their host countries at the expense of their

counterparts' partner states. The uneven distribution of FDIs flowing to the EAC region through the member countries is based on the size of the host country's economy, which is defined by its GDP level. Formulating international architecture for investment and national policies is necessary, as it can serve as a roadmap for balancing FDI inflows and attraction in the EAC region. Consequently, member countries can attract FDI inflows in proportion to their absorption capacity (Wilhelms, 1998).

In the continued efforts to attract more FDI inflows to the region, sectoral investment priorities have been established. The EAC investment guide provides information on the sectors requiring investment attention, including oil and gas, research and innovation, infrastructure, agriculture and agribusiness, manufacturing, mining and metals, energy, health, and education. The EAC investment priorities align with the United Nations' focus on investments that foster liaison within the country's active economic activities and lead to increased job creation (UN, 2022).

EAC needs active investment policies and strategic efforts to maintain the FDI inflows and attract further growth. The EAC's deliberate efforts to attract more FDI inflows to the region have been supported by a large market size, with more than 300 million people, and a growing GDP of over US\$240 billion. Moreover, the EAC region is unified by major global business languages; hence, there is an absence of a language barrier since English and French are used within the

member states. Furthermore, in the region, there is a provision of insurance services for risk sharing, customer loyalty, and hospitality to people.

Despite the crucial role of FDI in the development process, its flow pattern to EAC is unstable as it is affected by continuous dynamics caused by market forces. Different market forces create fluctuations in the FDI flows stemming from policies, strategies, and sectoral factors. The factors affecting FDI flows also affect investors' decisions regarding where to locate their investments. Factors such as banking services, stock market size, institutional quality, inflation, exchange rate volatility, trade openness, and GDP per capita influence FDI flows.

However, remarkable efforts are being made to enhance EAC's financial systems for ongoing improvements, aiming to achieve stability and growth, thereby serving a wide range of market participants. Strategies for improving the EAC business environment include emphasizing the rule of law, offering investment incentives to foreign investors, and establishing robust institutions. Additionally, it motivates companies that have met the listing requirements to register with the stock exchange, increases the availability of stock market products, and establishes friendly trading platforms for both existing and potential investors to participate in stock market activities.

At the sectoral level, financial development is among the factors influencing FDI inflows to host countries. The growth of the FDI business approach and the

increase in its flow to the host economy depend on the stability and strength of financial sector development. The development of the financial sector reflects the level of economic activity in the host countries or economic regions during a particular time interval (Rao et al., 2020). Countries with higher financial development could attract more FDI inflows to their economies.

The World Bank defines financial development as an increase in the allocation efficiency of financial resources and capital projects, achieved by encouraging competition and amplifying the role of the financial system. The World Bank further describes financial development as comprising financial institutions, such as banks and insurance companies, and financial markets, including stock markets and bond markets. Similarly, the World Bank classifies financial development into four measurement categories: depth, access, efficiency, and stability of the financial system. In this study, financial development is defined and measured by the banking sector's services and the size of the stock market. It is worth noting that banking services are based on financial institutions, while the stock market size originates from financial markets, providing a representative broad aspect of financial development, as reported by the World Bank.

Additionally, the study confines itself to in-depth measures of financial development, as it provides essential information to investors during the investment process, and also due to data limitations for the other measurements. In the same vein, the study considers the banking sector among the financial

institutions and stock market size from financial markets, leaving behind other categorical classification involvement such as insurance companies, central banks, credit unions, brokerage firms, mortgage companies, bond markets, derivative markets etc because of data challenges and study environment in which these financial development segments are less prominent. The financial development definition by the study provides sufficient information relating to financial development as banking sector services and stock market size describe the key functions of the financial system proposed by the World Bank covering (i) provision of information about possible investments and allocation of capital; (ii) Mobilizing and pooling savings; (iii) monitoring investments and exerting corporate governance after providing finance; (iv) Easing exchange of goods and services; (v) facilitating the trading, diversification, and management of risk.

Generally, banking services, the stock market, and FDI are closely associated, as market forces and major economic activities influence all three. The relationship between the banking sector, stock market activities, and FDI is built on three significant aspects. First, banking services and stock market operations attract FDI inflows, which increase fund availability in the economy. Secondly, banking services and stock market undertakings create favorable market regulations, which, from a practical point of view, result in attracting FDI, thus strengthening the relationship between the three sectors (Majeed et al., 2021). Thirdly, a well-functioning banking sector and active stock market attract FDI, which is considered a vital, friendly market environment, and trade openness.

Additionally, the development of the banking sector is influenced by stock market efficiency, which guides existing and potential investors on the financial services they can obtain from FDI recipient economies. The decision-making process concerning the international investments they wish to undertake is simplified in a way that a well-functioning banking sector and capital-supportive stock market could facilitate. The development of the banking sector and stock market activities is crucial in mobilizing capital through banking services and stock market trading operations, thereby meeting investors' needs for financial services (Irاندoust, 2021).

Consequently, FDI is influenced by banking services and stock market development, as multinational companies expect to receive the financial support required to enhance their business operations in host countries. Development in the banking sector, based on its level of assets and the flexibility to finance private sector business operations, influences FDI inflows (Jena & Sethi, 2021). Likewise, stock market development influences FDI inflows. Given the vital role of banking services and stock market development in influencing FDI inflows to the host country, the study considers these two financial development dimensions as significant factors that could affect FDI inflows to the EAC.

EAC member states are making deliberate efforts to create a suitable investment climate in which the government has the role of promoting availability of sound financial services by ensuring effective banking systems and stock market operations are put in place (Haque et al., 2022; Lestari et al., 2022; Pham et al.,

2022; Krifa-Schneider et al., 2022; Majeed et al., 2021; Cang & Alida, 2020; Khan et al., 2020; Islam et al., 2020; El Menyari, 2019; Jeanluc & Muiruri, 2022; Aibai et al., 2019; Sabir et al., 2019). The role of governments and their diverse institutions in creating a sustainable and good investment climate stems from exercising good political governance (political stability), accountability, good regulatory framework and adherence to enforcement of law (government effectiveness) and combating corruption (Lestari et al., 2022; Pham et al., 2022; Krifa-Schneider et al., 2022; Islam et al., 2021; Abdouli & Hammami, 2020; Khan et al., 2020; Islam et al., 2020; Sabir et al., 2019; Aibai et al., 2019).

At the same time, institutional quality (including corruption, government effectiveness, and political stability) affects FDI, as the quality of institutions in the FDI recipient economy influences the business environment and investment attractiveness (Pham et al., 2022). The study by Islam et al. (2021) argued that countries with strong institutional quality have a relative advantage of attracting more FDI to their economies. Similarly, quality institutions in host countries increase FDI attraction and absorption capacity, benefiting from the spillover effects. According to Wilhelms (1998), foreign investors are attracted to invest in economies with high-quality institutions, expecting their investments to be supported and protected against unexpected investment policy reversals.

Like any other economic region, the EAC recognizes the pivotal role of institutional quality in the investment process, a point also emphasized by Lestari et al. (2022). The investment policies need to be modelled with institutional

quality practices to develop stable FDI inflows to the host countries. The EAC region has been making deliberate efforts to improve the institutional quality environment to attract more FDI inflows. However, like any other developing economy, the EAC faces some institutional quality challenges, as Pham et al. (2022) postulate, including corruption, excessive bureaucracy, and political turbulence, which adversely impact FDI inflows.

The reflection of the EAC's institutional quality status, based on corruption, government effectiveness, and political stability, reveals challenges common to developing economies. Corruption has been a persistent problem, as noted by Krifa-Schneider et al. (2022), which suggests that it is part of the investment influencing factors in developing economies, as they are often tolerant of it. Similarly, government effectiveness deters investment because excessive bureaucracy intentionally focuses on corruption. In the same vein, political stability, which is usually disrupted by turbulence, especially during elections, has commonly affected the region's attractiveness for FDI, as expressed by Carino (2019).

The efforts exerted by the EAC member states to win the competition for attracting FDI inflows to their respective countries and the region have led EAC countries to develop diverse investment policies. Among the active initiatives are availing of tax incentives to foreign investors. Likewise, efforts have been made to build infrastructure that meets investors' investment needs and create special investment facilities, such as export processing zones (EPZs), as well as

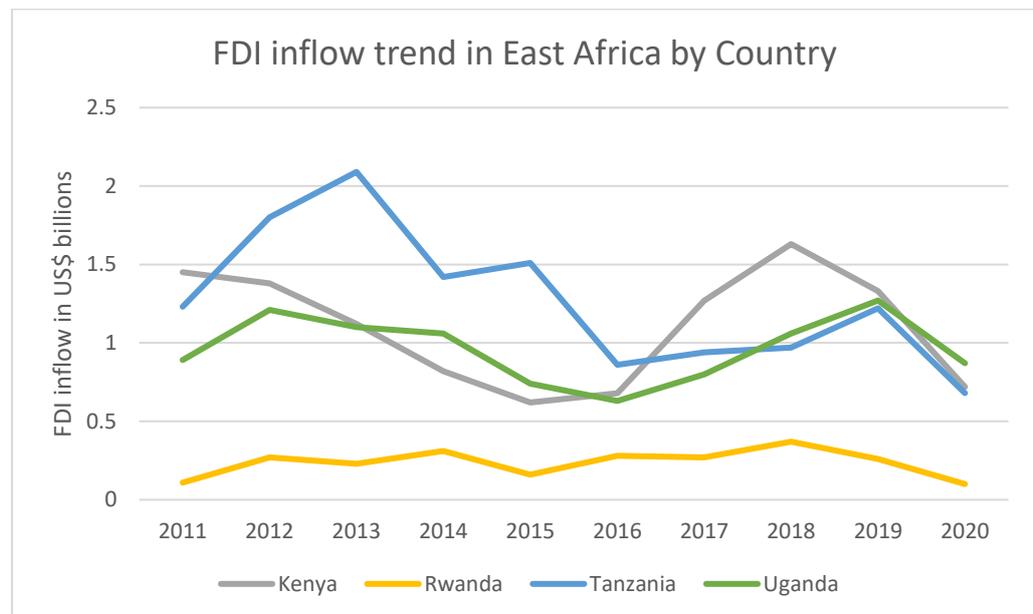
the provision of subsidies and free import duties (EAC Investment Guide, 2020). Taxation policies and infrastructural setups that meet investors' targets are more left to individual member states discretion.

However, EAC has four joint standard investment policies applicable to all member states. The policies include a customs union, a common market, a monetary union, and the harmonization of financial policies (Penev & Marušić, 2014). These policies aim to promote intra-regional business and investment flows. Likewise, the guidelines reflect trade openness for regional and foreign investors through FDIs. Of the developed policies, only two (2) customs unions and common markets out of the four (4) have been implemented as of 2023.

The monetary union and harmonization of financial policies are not yet in implementation. Delays in implementing these policies depend on the customs union's performance and adherence to standard market policies. Nontariff trade barriers still exist between EAC member states. Economic theories suggest that an integrated economy governed by a common market and customs union is an opportunity to increase the region's FDI inflows. It is expected that the common market will replace exports with FDI. Customs unions expedite consignment clearance between partner states, saving time and enhancing trading efficiency. Common markets increase location advantages by widening investment opportunities (Dunning & Rojec, 1993).

The FDI inflow trend in the EAC exhibits tremendous dynamics, with ups and downs. When FDI inflow declines, the impact is significant, as all plans and economic projections are distorted by the failure to achieve them. In 2016, the FDI flow to the EAC was significantly below the recorded figure in 2015 (UNCTAD, 2019). The decline of FDI inflow by 14% is a significant percentage change. As a result, the EAC region must increase its efforts to compete for the limited FDI flowing to Africa.

Figure 1. 1: FDI inflow in East Africa by country from 2011 to 2020



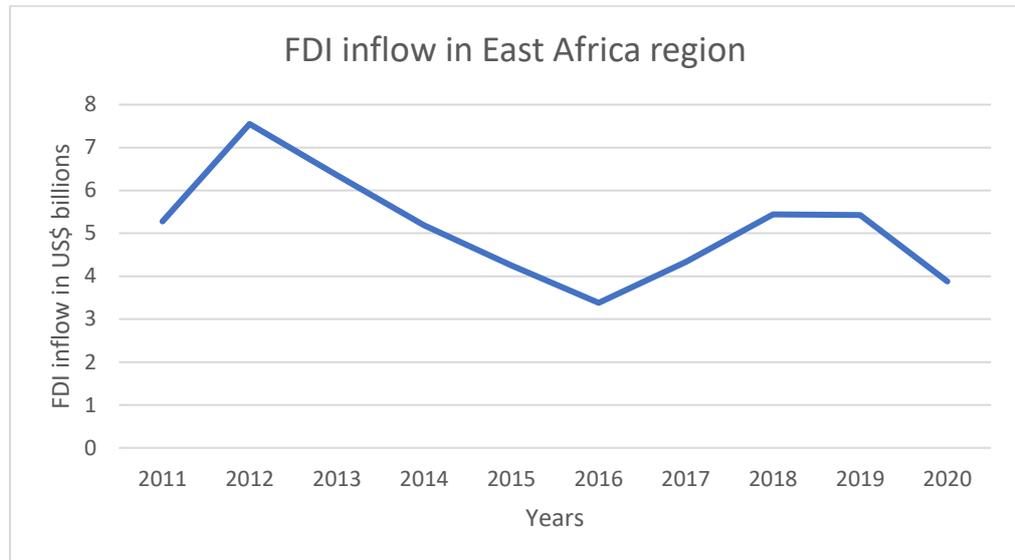
**Source:** UNCTAD Report 2021

Figure 1.1 shows the pattern of inward FDI flows to EAC member states characterized by the decline from mid-2013 to 2016. The decline of FDI inflows to EAC countries has been a long-term problem. In 2010, the UN revealed that the EAC region received only 7% of the total FDI allocated to Africa. The

decline in FDI inflows from late 2013 to 2016 can be supported by the earlier observation made by the UN, which noted low levels of FDI inflows to the EAC region. However, the exceptionally sharp and high rise in FDI inflows for Tanzania in 2013 resulted from the discovery and confirmation of a large volume of natural gas reserves stemming from an intensive exploration project that had been ongoing for an extended period.

Similarly, as shown in Figure 1.1, the increase in FDI inflows from 2011 to 2013 observed for Tanzania and Uganda was attributed to the discovery of natural gas reserves and oil fields in these countries (UNCTAD, 2019). On the other hand, Kenya has relatively stable FDI inflows compared to other EAC partner states due to its mature and experienced stock market, which dates back to 1954. Kenya exhibited the highest FDI inflows in 2018, a 27% increase attributed to the active marketing of its export processing zones (EPZs), which attracted many investors. Its manufacturing, oil and gas, chemicals, and hospitality sectors gained massive attention from domestic and foreign investors, accompanied by an investment philosophy that facilitates easy business operations (Igbadoo et al., 2023). Rwanda has the least FDI inflows compared to other EAC member states, and the reasons include political turmoil, the 1993/1994 genocide, low GDP, and an immature stock market.

Figure 1. 2: FDI inflow trend in the EAC region from 2011 to 2020



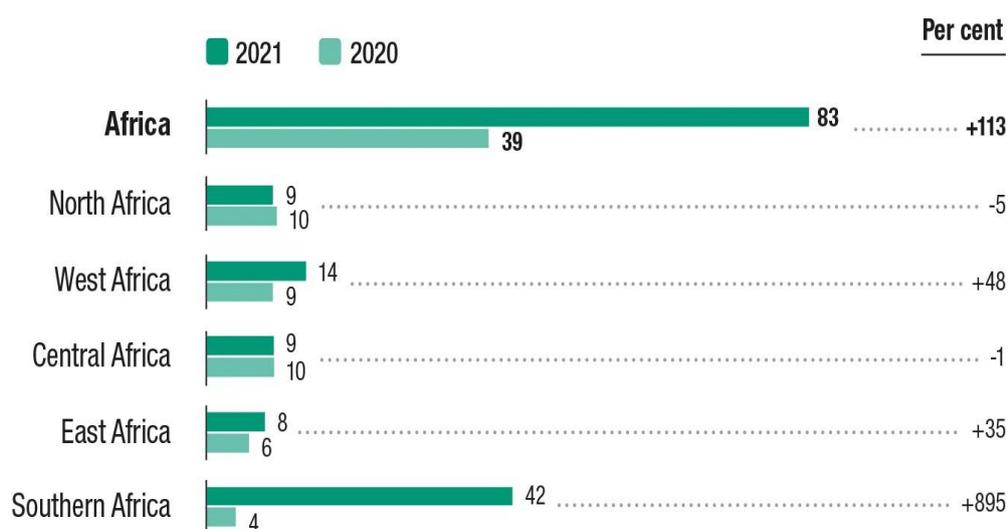
**Source:** UNCTAD Report 2021

Figure 1.2 above shows that FDI inflows to the EAC region declined from 2012 to 2016, due to an 18% decline in overall global FDI distribution, from US\$7.55 billion in 2012 to US\$3.38 billion in 2016. Despite the worldwide decrease in FDI distribution, the amount of FDI inflow received by the EAC region is low compared to other African regions, accounting for only 13% of the total FDI inflows to the African continent. In comparison, the remaining 87% went to the other four regions. The rise in the FDI inflow pattern exhibited in 2012 stems from strategic investments made in the gas and oil sectors in Tanzania and Uganda, respectively. Figure 1.2 shows that the FDI inflow pattern from 2017 to 2019 increased, primarily due to strategic investment initiatives and policies implemented by most EAC countries to ease the investment process. The efforts and strategies employed include creating special investment facilities, such as export processing zones (EPZs), and providing investment incentives, primarily in the form of tax benefits (Igbadoo et al., 2023). The FDI inflow trend declined

from 2019 onwards, primarily due to the COVID-19 pandemic, which had a negative economic impact globally. However, despite economic recoveries from the pandemic, EAC received the lowest FDI inflows in 2021 compared to other African regions (World Investment Report, 2022).

Figure 1.3 presents the statistics for FDI inflows to the EAC and Africa for 2020 and 2021. In 2021, FDI inflow to the EAC region was US\$8 billion, a 33% increase from the 2020 record (UNCTAD, 2021). Despite the reported rise in FDI inflow to the EAC for 2021, the amount received was the lowest, accounting for less than 10% of the total FDI inflows to Africa. However, FDI inflows to the African continent in 2021 reached a record of US\$83 billion, compared to US\$39 billion in 2020, representing an increase of 113%. Despite the FDI growth rate in 2021, the EAC was unable to attract a large share, ending up with only 9.6 per cent of the continent's FDI share.

Figure 1. 3: FDI inflows to the African continent and subregions, 2020-2021 (Billions of dollars)



Source: World Investment Report, 2022

Figure 1.3 above shows that FDI inflows to the EAC in 2021 totalled US\$8 billion, equivalent to 9.6% of the total FDI inflow to the African continent. The FDI inflow of US\$8 billion for 2021 is found to have increased by 33% from the 2020 base inflow of US\$6 billion. Despite a 33% increase in FDI inflow, the amount remains very low, accounting for just 3% of the EAC GDP, which exceeds US\$240 billion. The above statistics suggest that FDI inflows to the EAC do not accurately reflect the level of GDP and do not adequately reward the initiatives to ensure the region receives sufficient FDI. The analysis of FDI inflows to the EAC, based on a market population of more than 300 million people, shows that the FDI investment rate remains low. The FDI inflows to the EAC account for only 5.2% of the overall FDI that the African continent has attracted from the global investment market. Additionally, it is worth noting that FDI inflow to the EAC region was the lowest. Thus, this implies that there is a need to employ more competitive policies and strategies to attract more FDI inflows to the region by competing with other African regions.

Table 1: FDI inflow to the African continent and subregions in 2020-2021

SUBREGION	YEAR 2020		YEAR 2021	
	ANNUAL	GLOBAL	ANNUAL	GLOBAL
		4.1%		5.2%
East Africa	15.0%	0.6%	9.6%	0.5%
North Africa	26.0%	1.1%	10.8%	0.6%
West Africa	23.0%	0.9%	16.9%	0.9%
Central Africa	26.0%	1.1%	10.8%	0.6%
Southern Africa	10.0%	0.4%	51.9%	2.6%

**Source:** World Investment Report 2022

Table 1 presents the statistics on FDI inflows to the African continent and its subregions for 2020 and 2021. Data for other regions is also provided to simplify the analysis of the actual position of the EAC regarding FDI inflows compared to other African regions. The data above shows a decline in actual FDI inflows of 5.4% from 15% in 2020 to 9.6% in 2021. Likewise, the FDI inflows to the EAC at a global proportion declined by 0.1 percentage points from 0.6% in 2020 to 0.5% in 2021. The decline of FDI inflows to EAC is consistent with previous trends. As noted, EAC has the lowest FDI inflows compared to other African regions. In 2010, the UN reported that the EAC had the lowest FDI inflows, at only 7%, compared to 36% in Southern Africa, 30% in West Africa, and 27% in North Africa. The decline in FDI inflow to EAC is found to be a consistent problem.

Challenges that hinder the attractiveness of the EAC investment climate for FDI inflows can be viewed from different angles. The low level of FDI inflows to the EAC is attributed to the unavailability of affordable finance (high financing costs) from the banking sector and the central banks' strict credit policies imposed on commercial banks for providing credit to the private sector. Additionally, limited stock market products, low volume of stock market activities, low intra-regional trade, and excessive government bureaucracy in service provision all contribute to the problem. In connection with the challenges above regarding low FDI inflows to the EAC region, unpredictable investment

policies, such as tax holidays and other discretionary tax incentives, also have adverse impacts (UNCTAD, 2019). These factors hinder foreign investors when deciding on a location for their cross-border investments, as they pose location risks.

The region's financial sectors are facing challenges from economic and political inefficiencies, including irresponsible borrowings that fail to consider financing costs, their impact on domestic financial development, and repayment capacity based on internal resource mobilization. A lack of access to financial services, such as bank overdraft facilities, adversely impacts investors when deciding where to locate their investments (Pham et al., 2022). Additionally, the financial development of EAC countries, like that of other developing countries, is hindered by weak financial institutions and a riskier business environment (Jeanluc & Muiruri, 2022). The EAC financial sector development challenges include low turnover ratios, thin trading, and lack of market depth (Mutize et al., 2020). Likewise, growing stock markets lack experience, making it difficult to issue new shares and minimizing stock market trading activity (Cang & Alida, 2020).

At the same time, corruption is one of the factors that affect the investment climate, strongly distorting the pattern of capital inflows and negatively impacting the flow of FDI to the host country (Sabir et al., 2019). The emergence of corruption and its impact on the economy originates from inconsiderate political environments. Changes in political regimes associated with trading

mechanisms significantly impact the formulated policies that attract FDI to the host country (UNCTAD, 2019). When a reversal of investment policies accompanies changes in political regimes, it can adversely impact investors' investment potential. Other factors that negatively affect the EAC investment climate include a lack of good governance, insufficient alternative sources of capital, the need for regulatory reforms, and the quality of institutions.

In tackling the challenges facing the region that deter FDI inflows, the EAC has taken action and implemented measures to rectify the situation. Like other economic regions, EAC's financial development is affected by the diverse cultural systems of its member states (Bahri et al., 2018). The development of the financial sector is significant for economic growth and development (Matei, 2020). EAC financial development has been strengthening from time to time as a result of different institutional players covering central banks, commercial banks, non-bank financial institutions, mortgage companies, insurance companies, development finance institutions, microfinance institutions, building societies, social security funds, foreign exchange bureaus and stock markets (EAC Investment guide, 2020). Improvements are made to banking systems, stock markets, and financing strategies to cope with innovations and technological advancements in providing quality services. Over time, there has been an increase in the number of stock markets in EAC from one stock market in 1954 (Nairobi Securities Exchange (NSE), Kenya) to four (4). The EAC, for now, is pursuing the agenda of forming a monetary union and integrating the

regional member states' financial development to modernize the investment climate, thereby attracting more foreign investors.

The efforts to make the EAC's financial sector robust, effective, and more conducive to investment have resulted in a move toward market liberalization, making the region more attractive to foreign investors. The need for and strategic initiatives in financial development have recently led to significant changes in the EAC financial sector. There have been substantial changes from traditional banking systems to digital ones, with a focus on the role of capital markets in economic development. The changes in EAC's financial development resulted from continuous economic reforms, which are implemented periodically to create a favorable business climate. The establishment of stock markets, despite differing times across member states, has increased and improved financial operations. All the efforts to strengthen the financial sector are centred on attracting more FDI to the region and reaping the benefits associated with FDI inflows for economic growth.

To overcome the challenges highlighted, EAC needs a well-developed and functioning financial sector with a balance of banking services and stock market activities. Likewise, institutional quality aspects require appropriate attention. For that matter, the study aims to investigate the source of the region's low FDI inflow, focusing on the role of financial development in influencing FDI inflows. The FDI-financial development relationship will also be moderated by

institutional quality (corruption, government effectiveness, and political stability).

## **1.2 Problem Statement**

Financial development, institutional quality, and FDI are related on the basis that foreign investors expect access to better services in the host countries through banking services, stock market operations, and the presence of quality institutions. The three dimensions are not aligned based on the trend and volatile performance of FDI in the EAC, as well as the expected role played by financial sector development (including banking services and stock market activities) and institutional quality. While prior research explores FDI determinants, few studies examine how institutional quality moderates the influence of banking services and stock markets on FDI inflows in the EAC context.

The pattern of FDI drifting to EAC indicates that if efforts are not made to balance financial sector development by aligning the banking sector and stock markets while strengthening institutional quality practices, FDI inflows to EAC will remain low. As a result, the region will still face challenges of poor economic growth and natural development, which can raise the living standards of its people. An underdeveloped financial sector leads to unavailability of affordable finance (high costs of financing) from the banking sector, central banks' strict credit policies given to commercial banks on the provision of credit to the private sector, irresponsible borrowings that do not take into account the financing costs, limited stock market products, low volume of stock market

activities, unpredictable investment policies, low intra-regional trade, low-quality institutions which provide loopholes for corruption, political inefficiencies, and government excessive bureaucracy in service provision. These challenges will still foster the problem of low FDI inflows to the region.

The trend of FDI inflows to the EAC is not stable; instead, it is characterized by a decrease in the level of inflows for both individual countries and the region as a whole. The decline in FDI inflows to the EAC region is attributed to the region's relatively low FDI attraction compared to other African economic areas. The reduction in the level of FDI inflows to the EAC negatively impacts the region's potential for attracting foreign investors, influencing their decisions to invest in and contribute to economic development, especially in large-scale projects such as infrastructure.

The privatization project in developing countries did not solve economic challenges such as infrastructure, underdeveloped financial sectors, and low FDI inflows. The EAC did not benefit sufficiently from the privatization initiatives to strengthen its financial sector development and make its market more liquid and flexible for investors. Each EAC member state is now in a race to develop strategies, initiatives, and policies for its financial sector, aiming to keep up with the competition and attract more regional FDI inflows.

In efforts to alleviate the severe economic losses suffered by countries due to the effects of COVID-19, FDI is the most effective investment approach, as it is

associated with numerous benefits essential for each country's economic prosperity in such situations. If FDI inflows remain low, the economic downturn in the EAC region due to the pandemic will not be able to recover.

The concern over low levels of FDI inflows in the EAC has been a focus of each government of the member states, as they have made deliberate and outstanding efforts to formulate policies and strategic infrastructure initiatives, which can help attract more FDI inflows. Sensitivity towards FDI inflows is based on their diverse benefits and significant contribution to development. Given the shift in trade mechanisms, FDI has become the primary source of foreign capital, generating increased revenue for the host country and stimulating economic growth. An increase in FDI inflows to developing countries results in increased employment opportunities, the provision of adequate skills, and the development of human resources, as well as the enhancement of the host country's financial and technological sectors.

Likewise, FDI plays a crucial role in the industrial transformation process for emerging economies. The industrial economy has multiplier effects on development, such as increased market competitiveness for the goods produced, which are sold in the domestic market and exported abroad. Domestic production through FDI improves the host country's exchange rate stability and capital inflows and is also an essential revenue stream. Due to the significance of FDI inflows to host countries, persistent low FDI inflow problems cannot be left unaddressed.

The problem of low FDI inflows to the EAC affects various levels, including the regional level itself, member states, the country level, governments, economic sectors, society, and individuals. At the regional level, low FDI inflows to the EAC have slowed down the development level, which could have been attained had the challenge of declining FDI inflows not been present. The region has lost its competitiveness in attracting FDI, its share of FDI, and has failed to attract more foreign investors, which has shrunk its market. Low FDI inflows to EAC at the country level significantly impact economic growth and development. Low FDI inflows to the EAC region and its member states have adversely affected their development targets and investment in strategic projects. The member states have lost industrial benefits, production advantages, and the utilization of their resources for local production setups, which could have been achieved through FDI. The governments of member states have lost revenues from FDI projects, weakening their ability to provide good services and improve their people's living standards.

The impacts of low FDI inflows on the region have affected different sectors, especially the financial sector, manufacturing, technology, and innovation. The financial sector has been affected by the loss of foreign capital inflows, financial expertise, and the interconnection between financial, physical, and human capital. Society has been deprived of the overall FDI spillover benefits, which extend to the individual level. Social services have been reduced, and individuals

have lost income that could have been generated from employment opportunities created by FDI projects.

However, FDI inflows and the overall investment process are closely linked to access to banking services. Sound banking services in the host countries play a pivotal role in creating a conducive environment for FDI inflows. The development of the banking sector provides the financial infrastructure that investors need, including risk mitigation mechanisms, transaction facilitation services, increased investment trust, capital mobilization channels, financial expertise, and access to capital markets. All these essential roles of banking services for investors are among the key factors foreign investors consider when deciding where to locate their investments in foreign markets. In light of this study, banking services are considered a significant path-maker for FDI inflows, as the sector blocks all the barriers that affect investors' decisions, such as limited access to finance, capital flight, increased transaction costs and delays, undermining confidence, impeding economic growth, and restrictions on market access. All these challenges are resolved by banking services that enhance the attractiveness of the host country to foreign investors.

Similarly, the stock market is essential in shaping the host country's investment climate for inward FDI flows. Stock market activities influence investors' sentiment and confidence, reflect market attractiveness, provide access to capital, facilitate efficient allocation of funds between portfolio investment and FDI, support mergers and acquisition activities, and influence risk perception. Due to the significant role played by the stock market in the investment channels,

the stock market operations in the host country link FDI with the economic activities, financial system, and regulatory platform. Hence, the study finds it worth examining the role of the stock market in FDI attraction on the view that stock market operations increase investors' confidence, create liquidity in the economy, enhance access to capital, signal economic status, press company valuations, strengthen financial intermediation, and widens the competitiveness of the host country for more FDI and real sound investments.

At the same time, institutional quality is crucial in determining the FDI inflows attracted to host countries. Generally, institutional quality shapes the host country's regulatory environment, political stability, corruption prevention, governance effectiveness, policy stability, access to finance, infrastructure development, and human capital development. Therefore, the successful attraction of FDI inflows to recipient economies results from institutional quality, which continuously improves through reforms and the strengthening of governance frameworks. Similarly, institutional quality is a crucial factor of concern among investors, which supports sustainable FDI flows that link it to economic growth and enhance a competitive business environment. Given the pivotal role of institutional quality in FDI attraction, the study finds it necessary to investigate the impact of institutional quality on FDI and its moderating effect on banking services, stock market size, and FDI relations. This prior belief is grounded in the host country's institutional quality, which is expected to increase investors' confidence, enhance transaction transparency, and improve regulatory certainty and investor protection.

Therefore, the study brings novelty, which lies in its integrated approach to examining the dual impact of financial development and the moderating role of institutional quality on FDI inflows, a perspective that is often overlooked in existing literature, including the EAC. While previous studies have typically analyzed financial development or institutional quality in isolation, this study uniquely explores how institutional quality strengthens or weakens the relationship between financial sector development and FDI attraction. By highlighting this interaction, the study provides new insights into how the effectiveness of financial systems in attracting FDI is not merely a function of their size or depth, but also critically depends on the strength of governance, regulatory frameworks, and institutional credibility. This nuanced understanding is particularly relevant for developing regions like the EAC, where financial expansion without strong institutions may fail to yield the expected FDI benefits. The findings thus offer a novel framework for policymakers, emphasizing the need for coordinated reforms in both financial and institutional domains to maximize FDI potential.

Thus, the study aims to investigate the challenges of FDI inflow to the EAC region, focusing on the role of financial development gauged by banking services and stock market size. Likewise, the study utilizes institutional quality (measured by corruption, government effectiveness, and political stability) to moderate the relationship between banking services, stock market size, and FDI. Using scientific research approaches, FDI theories, a review of past studies and findings from the study, and an emphasis on the role of banking services, stock market operations, and institutional quality in attracting FDI inflows to the EAC

region can be elucidated and documented. The study can suggest improvements to the available investment policies and propose a formulation of inclusive investment policies that align with investors' expectations and achieve the economic targets set by the EAC region.

### **1.3 Research Questions**

To achieve the objectives of investigating the relationship between financial development (banking services and stock market size), institutional quality (corruption, government effectiveness, and political stability), and FDI, the study poses five research questions, as presented below.

1. Do banking services influence the level of FDI inflow in EAC?
2. Does stock market size influence EAC's level of FDI inflow?
3. Does institutional quality (Corruption, Government Effectiveness, and Political stability) influence EAC's level of FDI inflow?
4. Does institutional quality (Corruption, Government Effectiveness, and Political stability) moderate the relationship between banking services and the level of FDI inflow?
5. Does institutional quality (Corruption, Government Effectiveness, and Political stability) moderate the relationship between stock market size and level of FDI inflow?

## **1.4 Research Objectives**

For the study to be successful, it has been governed by five research objectives as outlined below.

1. To investigate the influence of banking services on the level of FDI inflow.
2. To investigate the influence of stock market size on the level of FDI inflow.
3. To investigate the influence of institutional quality (Corruption, Government Effectiveness, and Political stability) on the level of FDI inflow
4. To investigate the moderating effect of institutional quality (Corruption, Government Effectiveness, Political stability) on the relationship between banking services and the level of FDI inflow.
5. To investigate the moderating effect of institutional quality (Corruption, Government Effectiveness, Political stability) on the relationship between stock market size and the level of FDI inflow.

## **1.5 Significance of the Study**

The study makes a significant theoretical contribution to existing research on FDI. Unlike previous studies, which employed only banking sector variables, the study has used banking services and stock market size variables to give a broader definition of financial development. Likewise, institutional quality (corruption, government effectiveness, and political stability) has been examined to

determine its direct and moderating effects on the FDI-financial development relationship.

The conceptual framework in this study is formed by extending the institutional FDI fitness theory, which serves as the underpinning theory employed in the study. The theory is oriented towards a country's specific ability to attract, absorb, and retain FDI flowing to its economy. The theory considers only bank credit to the private sector in its concept of capital market fitness. To gain a broader scope of financial development, the study has expanded the capital market fitness concept by adding three additional variables. The first variable introduced to the theory is bank assets. The credit to the private sector variable, initially introduced in the capital market fitness concept, helps broaden the measurement of banking services. The other two variables added to the capital market fitness segment are stock value traded and market capitalization, which captures the aspect of stock market size, an element of the capital markets.

Adding the three variables proposed by the study has made the institutional FDI fitness theory unique in its ability to describe the FDI-financial development relationship. This theory has been capable of adequately explaining the dimensions and variables involved in the study. The dimensions include banking services (bank assets and bank credit to the private sector), stock market size (stock value traded and market capitalization), and institutional quality (measured by corruption, government effectiveness, and political stability).

The study has examined the relationship between institutional quality and FDI. According to the institutional FDI fitness theory, institutions play a more significant role in attracting FDI inflows to host countries than relying solely on resources. In ascertaining this proposition, the study employed institutional quality based on three dimensions (corruption, government effectiveness, and political stability).

The significant contribution of the moderation effect of institutional quality has been examined by interacting it with the FDI and financial development relation. Financial development and FDI are two major economic sectors requiring more attention, particularly in emerging economies. These sectors are highly influenced by a conducive business and investment climate built on strong, quality institutions. Quality institutions serve as a mechanism for controlling corruption, enhancing government effectiveness, and fostering stable political systems. Consequently, foreign investors' sentiment regarding the country's attractiveness for investment increases, hence, higher FDI inflows. Therefore, using institutional quality (corruption, government effectiveness, and political stability) as a conditional interactor in examining its moderation effect on the studied relations has provided a more robust explanation between the two sectors.

The findings of this study can assist the policymakers in developing sound, relevant, and up-to-date investment policies when planning, developing, and implementing strategies and initiatives for sustainable FDI inflow attraction to

the EAC region through (1) setting priorities to develop the financial sector (2) creating conducive investment climate (3) setting up robust, efficient, and quality institutions. The study findings can enhance policymakers' understanding of setting investment policies that attract foreign investors, thereby increasing the level of FDI inflows to the EAC region. The knowledge from the study is instrumental in providing advice on reviewing the EAC investment policies to fit the needs. The pivotal role played by the stock market and banking sector in financial development, as an inevitable tool required by the government in formulating policies to enhance FDI inflow and promote economic growth, has been made available to policymakers.

Through their investment advisors and policymakers, the EAC governments know that attracting more regional FDI inflows requires a well-developed and functioning financial sector with balanced banking services and stock market activities. The study has also provided insight into the importance of FDI as a primary source of external funding and capital investment. The information patterning of economic benefits from FDI has been highlighted, including new technologies, job creation, improved service delivery, economic growth, and labor market stability.

The findings of this study are beneficial to society, including academicians, students, and researchers, for future research in financial development and FDI in the EAC, which can contribute to a deeper understanding of the role of financial sector development in FDI and overall economic growth. The findings

are valuable to academics, as minimal empirical studies have examined the financial development nexus in the EAC. Additionally, using institutional quality to moderate the financial development and FDI nexus has been beneficial and further contributes to the body of knowledge.

### **1.6 Scope of the Study**

This study focuses on financial development and FDI in the East African Community (EAC). It aims to investigate the impact of financial development on the flow of FDI by utilizing bank assets, credit to the private sector, market capitalization, and value traded as independent variables. The study also examines the direct effect of institutional quality (corruption, government effectiveness, and political stability) and its moderating role in influencing financial development, which in turn affects FDI.

The study is confined to EAC for several reasons. First of all, EAC is an emerging market with the potential for more investments, such as FDI, for economic growth. In this region, FDI plays a crucial role in economic growth, technology transfer, and industrial development, making it an ideal region for assessing the effectiveness of financial and institutional frameworks in attracting foreign investments. Second, the EAC region has unique economic and institutional characteristics with diverse levels of financial system maturity and governance quality, making it suitable for analyzing how these factors influence FDI inflows. Third, this region has varying degrees of institutional strength, which offers natural variation for testing these theoretical models.

The fourth reason for choosing the EAC is based on practical considerations, which include data availability, the policy relevance of this research, and the presence of ongoing regional reforms in the areas of the financial sector and governance structures. The availability of data and the strategic importance of the policy transitions make the findings more impactful. Lastly, the EAC has been chosen as a focus for this study because the relationship between financial development, institutional quality and FDI is understudied, which enhances the originality of this research, contributing to closing gaps in the existing literature.

The study utilizes secondary data from EAC countries from 1995 to 2020. The data are obtained from published business and investment information for countries that form the EAC. The EAC members include Burundi, the Democratic Republic of Congo (DRC), Kenya, Rwanda, South Sudan, the United Republic of Tanzania, and Uganda. However, Burundi, the Democratic Republic of the Congo (DRC), and South Sudan, despite being member states of this economic region, are excluded due to the unavailability of data. Burundi and the DRC have no stock markets in their economies, while South Sudan is a relatively new state formed from the Republic of Sudan in 2011. Thus, the study will be confined to four (4) EAC member states, including Kenya, Rwanda, the United Republic of Tanzania, and Uganda.

## **1.7 Organization of the Research Structure**

The study is organized into five chapters. Chapter One introduces the study. Chapter Two is based on reviewing the findings of previous studies regarding FDI, its determinants, and the underlying theories. Chapter three describes the study's methodology, including research design, research hypotheses, conceptual framework, measurement of variables, and analysis methods. Chapter four presents the empirical results and the analysis of the findings. Chapter Five provides an in-depth discussion of the findings and concludes with a summary and implications of the study outcomes.

## **CHAPTER TWO**

### **2.0 LITERATURE REVIEW**

#### **2.1 Introduction**

This section describes various FDI theories and relevant past empirical studies, which serve as the focal point for the study's analysis. An in-depth review of FDI theories and the selection of the appropriate theory for the study has been provided. The relationships between financial development, institutional quality, and FDI have been constructed by reviewing various FDI theories and findings from past studies. The financial development variables are categorized into banking services (bank assets and bank credit to the private sector) and stock market size (value traded and market capitalization). Meanwhile, the institutional quality variable comprises three dimensions: corruption, government effectiveness, and political stability.

#### **2.2 Underlying Theories of FDI**

Due to the significant contribution of FDI in accelerating economic development, various countries, through their governments, have been found to exert considerable effort in attracting FDI by improving and shaping their investment climate. Countries have continuously been creating a conducive business environment in their economies in an attempt to reap the benefits associated with the FDI, especially technology, capital flow, and knowledge-

based human capital (Krifa-Schneider et al., 2022; Pham et al., 2022; Rao et al., 2020; Jeanluc & Muiruri, 2022; Sabir et al., 2019; Osei-Attakora, 2022; Kingori, 2022). Since the 1950s, investments in FDI have gained interest. They took arms operationally, stemming from the increased volume of capital flow from foreign investors when locating investments across the border from their domestic countries (Veeramani et al., 2020). Globalization and trade liberalization in the 1960s created a need for new policies and strategies in international trade. During this period, FDI gained momentum and expanded significantly, becoming one of the primary channels for global trade arrangements (Tennakoon, 2022; Kashyap & Salunkhe, 2022; Gorus et al., 2022; Hossain et al., 2022). The growth of FDI drew the attention of many researchers. From that point, economists began examining how the FDI trading mechanism affected MNCs and capital flows in international markets. Different studies have revealed that the challenges of information flow in the FDI mechanism, particularly in cross-border business operations, have led to the development of an FDI theoretical view (Brakman et al., 2022; Coveri & Zanfei, 2022; Arikan et al., 2022; Jursa, 2022).

The FDI concept gained focus and started to grow in the 1960s. Its noted literature on FDI theories does not provide information as to when researchers actively started making sound developments on FDI theories and even of the developed theories, neither were in a position to capture all the FDI characteristic features (Kashyap & Salunkhe, 2022; Gorus et al., 2022; Hossain et al., 2022; Tennakoon, 2022). FDI theories have been classified into two main categories:

macroeconomic and microeconomic factors, and push and pull factors. On the other hand, Veeramani et al. (2020) noted another FDI theory classification based on diversification and exchange risk, but both are based on stock market efficiency. This classification alleviates the concern of financing by multinationals when operating in host countries, making it less of an issue in FDI location decisions. The growing literature of financial theories on FDI phenomena aims to determine the impact of capital market imperfections on FDI. Regardless of the difference in classification, FDI theories are generally built up by integrating the theory of international trade, the theory of the firm, and the theory of international capital market while centering on location enhancers for MNCs during the decision-making process (Rahman & Semenovskiy, 2022; Li et al., 2022; Verbeke & Yuan, 2022; Paul & Feliciano-Cestero, 2021; Oviatt & McDougall, 2018). The occasional developments in FDI theories suggest that no single theory can fully explain FDI. Instead, each theoretical argument contributes to further defining and understanding existing theories (Majeed et al., 2021; Islam et al., 2021).

The following section discusses various FDI theories and their potential to address the study's research questions and objectives, assist in developing hypotheses, and inform the conceptual framework. Additionally, the justification for the relevant and appropriate theory used in this study, among the discussed theories, is provided.

### **2.2.1 Capital Market Theory**

The capital market theory is sometimes referred to as currency areas theory. The idea was developed by Aliber (1970) and is one of the oldest financial theories explaining the behavior of multinationals, focusing on the impact of currency appreciation and depreciation on the direction of FDI flows. Aliber (1970) opined that currency exchange risk can influence the FDI pattern. When the host country's currency depreciates, it attracts FDI inflows, while its appreciation supports more FDI outflows.

The argument behind the capital market theory is that financial development is irrational towards appreciating (strong) currencies, as it tends to underestimate their exchange risk. This permits firms from strong (appreciating) currency areas to access financing in weak (depreciating) currencies at a lower cost. From the theory, it is observed that firms from countries with strong currencies have a better competitive advantage in borrowing capital in host countries, even at higher interest rates, and still make profits, compared to their counterparts from countries with weaker currencies. This observation was supported by Abbas et al. (2021), who argued that in countries with strong currencies, their firms tend to prefer making investments in other countries. In contrast, firms from countries with weak currencies do the opposite.

When the currency of a particular country depreciates, the expected returns on assets held in that economy decrease due to the price decline of such assets. Upon extending the exchange capital market theory, Froot and Stein (1991) and

Blonigen (1997) explained the influence of currency depreciation on FDI flows. Froot and Stein (1991) argued that lenders in imperfect capital markets charge premiums as a cost for monitoring financial credits extended to borrowers, which results in costlier external financing. Under these circumstances, firms with more assets in the strong (appreciating) currency outbid domestic firms in terms of wealth accumulation, as they accrue more gains from their investments. However, Blonigen's (1997) arguments focused on how firm-specific assets influence acquisitions in cross-border investment arrangements. He argued that in capital markets where foreign and domestic firms have access to raise capital but differ in their opportunities to generate returns from assets held in foreign markets, acquiring a foreign firm boosts the profitability level for all multinational branches. In this situation, the decline in value of the currency to which capital is intended to flow affects the relative asset valuations, amplifying FDI inflows.

FDI flows to host countries with depreciating currency based on the investor's future expectations of currency exchange rate movements (Liu & Lee, 2022; Jamal & Bhat, 2022; Zaytsev & Loschenkova, 2022; Takawira & Motseta, 2021; Lin & Chen, 2022; Latief & Lefen, 2018; Oladeji & Musa, 2022; Kafula, 2022; Heroja, 2022). The argument is that if investors expect the foreign currency to appreciate in the future after a vast devaluation, the value of their profits repatriated from FDI investments held in such foreign countries will be more valuable in their domestic currency. The term 'significant devaluation' (depreciation) of a currency contradicts the traditional exchange rate movement stipulated under the random walk hypothesis. Instead, the focus is on the mean

reversion theory, where the equilibrium price is expected to be attained over time. Relative to wealth theory, FDI investments carried out by foreign investors from appreciating currencies are found to be more effective at accruing wealth, contrary to their domestic counterparts, which operate in imperfect capital markets and are hindered by significant devaluation of the local currency (Froot & Stein, 1991).

The more the host country's currency depreciates (or devalues), the more the assets held in the economy become temporarily cheaper. This results in a fire sale for a short period in which foreign investors with strong (appreciating) currencies readily buy them under the expectation of a gradual price regain. Consequently, their FDI projects generate valuable future profits by reversing the theory of expectation (Veeramani et al., 2020). In the case of export-based FDIs, the currency's depreciation lowers the investment cost in the host country. The appreciation of the currency in the future discourages this type of FDI, as costs rise more than revenues, thereby lowering both the expected level of profits and the rate of return (Okafor et al., 2022; Sarnstrom & Ryan, 2022; Morshed & Hossain, 2022).

The limitations of capital market theory stem from (1) exchange rate variables and (2) exchange rate systems. The exchange rate variables are factored into the heterogeneity of the theoretical level of currency appreciation or depreciation, the lack of a clear definition regarding volatility, and biases in the aggregate of future expectations, focusing on the type of FDI, such as import or export FDI.

Since the response of FDI to exchange rate variables depends on different FDI motives, firm-level and industry-level responses to exchange rate fluctuations and FDI flows remain debatable (Doytch, 2022; Liu & Zhang, 2022; Joshua et al., 2021). Regarding the exchange rate system, there is no clarity on which exchange rate regime is more proper and appropriate for influencing FDI inflows. There is no clarity as to which exchange rate system is more important, either fixed or flexible. A flexible exchange regime determines the real exchange rate, which is used for investment decisions. Policymakers cannot control exchange rate volatility, which is expected to influence FDI flows (Huawei, 2022; Duan et al., 2022; Balomenou & Pajollari, 2022; Liu & Lee, 2022; Latief & Lefen, 2018). Similarly, the benefits expected to be brought about by increased FDI inflows arising from a fixed exchange rate regime are offset by the effects of exchange rate volatility on FDI flows (Tien et al., 2022; Zaytsev & Loschenkova, 2022; Kafula, 2022; Moraghen et al., 2021).

Thus, it has been noted that the capital market theory does not provide explanations and reasons for the FDI flows existing between developed countries with equal currency strength (Bussiere et al., 2022; Eren & Malamud, 2022; Candian & De Leo, 2022; Jiang et al., 2021; Bacchetta & Van Wincoop, 2021; Corsetti et al., 2021). Such a tendency contradicts the proposition put forward by currency capital market theory, which suggests that FDI moves from strong currency economies to weak currency economies. The same scenario can be argued to indicate that the capital market theory does not explain how a firm from a developing country with a weaker currency invests in a developed country with a stronger currency. The theory failed to explain the influential

effects of FDI location and the currency value level, which can significantly influence the attraction of FDI flows.

Consequently, the idea that internationalization minimizes exchange rate volatility making the capital market theory to be effective in its possibility to influence FDI inflows through financial development was criticized on the ground that internationalization increases exchange rate exposure which in return lowers the value of the firm and deter FDI flows (Tahir et al., 2022; Asif & Frömmel, 2022; Lin & Chen, 2022; Li et al., 2022; Xing & Wang, 2022; Korsah et al., 2022). The criticism of capital market theory aimed to challenge the notion on which the theory is based, namely, that internationalization through investing in different countries worldwide reduces exchange rate volatility due to correlations in exchange rate differentials across these countries.

However, the capital market theory is further criticized on the argument that the more firms internationalize, the more they are exposed to exchange rate risk and the more they can be adversely affected by exchange rate volatilities (Salomao & Varela, 2022; Latief & Lefen, 2018; He et al., 2022; Qureshi et al., 2022; Van Cauwenberge et al., 2021; Taylor et al., 2021). The implication is that the impact of risk intensity arising from exchange rate exposure is greater for internationalized firms than for purely domestic firms. This criticism pertains to capital market theory, specifically regarding multinationals establishing production facilities in foreign markets to mitigate exchange rate volatility. Reflecting on the critics over the argument that firms with production facilities

in different countries have profitability advantages compared to purely domestic firms has mixed implications. Based on the risk exposure created by internationalization, the argument that purely domestic firms have less of an advantage than internationalized firms does not hold.

Another criticism of capital market theory was made on the notion that internationalization reduces exchange rate risk by matching revenues and costs (Sokhanvar & Bouri, 2022; Iyke et al., 2022; Jiang et al., 2022; Jamal & Bhat, 2022; Chandrarin et al., 2022; Adam et al., 2022; Itskhoki, 2021; Saidi et al., 2021). The opinion is that since costs incurred on investments occur at different time intervals until revenues are generated from the investments, the matching principle of revenues and expenses is an ineffective strategy for reducing exchange risk. Internationalization of a business strategy is used as a hedging tool, in which matching revenues with costs in a particular foreign market decreases the risk of exchange rate volatility. Since the revenue and cost matching strategy is based on future outcome expectations, it does not hold water in explaining FDI flows being influenced by exchange rate movements.

Based on capital market theory, it is argued that exchange rate volatility increases uncertainty in investment returns when deciding where to locate an investment in a foreign country, given that such an investment is long-term and irreversible (Liu & Lee, 2022; Feng et al., 2021). The uncertainty surrounding exchange variation affects most investors' decisions, as they opt to hold onto their investable resources before deciding to execute their investment plans. This

delay in making investments caused by hold-on decisions affects the flow of FDI during periods of high exchange rate volatility. When exchange rate volatility exists in the economy, potential investors who wish to invest in foreign markets wait for some time. This decision affects even the firms that are neutral to exchange rate fluctuations and hinders the flow of FDI. The resolution to this challenge is holding production facilities in different countries through multinationals, which can minimize the exchange rate uncertainties stemming from exchange rate fluctuations. Firms that are neutral to exchange rate volatility can adopt holding production facilities in different countries for a better relative advantage than domestic firms.

Investors typically carry out foreign investments under the risk aversion criterion, knowing that exchange rate volatility arises because of differing times between when the investment is undertaken and when profits are realized. Then, the investment decision should focus on whether the expected returns are sufficient to cover costs incurred, plus a risk premium for offsetting the possible risk of losses arising from unfavorable exchange rate movements (Gallati, 2022; de Jong & Swinkels, 2022). The expected profit function for risk-averse firms indicates that today's decisions to invest in an exchange-volatile environment result in a lower expected return level (Irwin et al., 2022; Fabozzi et al., 2021). From this perspective, unless operating costs are reduced, the loss on repatriated profits arising from exchange rate volatility cannot be offset, which deters FDI flows. Diversification by multinationals who hold an investment in different countries reduces uncertainties on their future expected profits as they exploit exchange rate correlations between countries, making them continuously invest

in foreign economies; hence, steady FDI flows (Contractor et al., 2021; Albertus et al., 2022; Su et al., 2021; Canh et al., 2020).

When investing in foreign markets, whether analysis is based on exchange rate volatility or a risk aversion approach, there is a need to consider the duration of exchange rate volatility, whether short-term or long-term. The decision to invest in such markets should be aligned with the cost factors attached to the investment, including production costs. When long-term exchange rate volatility persists, regaining asset prices in the future under the expectation of attaining equilibrium prices does not occur, affecting the investor's expected returns in the short term. In this situation, holding on to the resources before committing them to executing the investment is proper. In the case of short-term exchange rate volatility, investors' decision to proceed with the investment plan under the expectation of future stability is appropriate. The essence is that asset prices soon fetch their fundamental values, and investors' expected future returns from the investment will not be affected by other constant factors.

When considering foreign market investments, it is also necessary to evaluate the nature of the FDI involved, specifically whether it is import or export FDI. In the case of import FDI, the impact of currency depreciation on host countries is more severe than that of export-based FDIs. The reason is that payment for imports erodes much of the expected profit due to unfavorable exchange rate movements. The exchange rate volatility and FDI location in foreign markets are also influenced by the degree of volatility, the source of the fluctuation, and the

extent to which the host country is developed (Duan et al., 2022; Tahir et al., 2022; Oladeji & Musa, 2022; Moraghen et al., 2021; Ashraf & Nagia, 2021; Latief & Lefen, 2018).

Studies that have provided empirical evidence and support the argument that depreciation of the host country's currency influences inward FDI flows include Heroja (2022), Morshed & Hossain (2022), Boburmirzo & Boburjon (2022), Liu et al. (2022), Kafula (2022), Adikari (2022), Piteli et al. (2021), Moraghen et al. (2021), Ashraf & Nagia (2021), Mandigma (2021), Pečarić et al. (2021), and Rathnayaka et al. (2021). However, the results reported by other scholars found no significant association between the exchange rate movement and FDI flows (Mesagan et al., 2022; Kisswani et al., 2022; Okonkwo et al., 2021; Raksong & Sombatthira, 2021; Qamruzzman et al., 2021; Lee & Brahmasrene, 2020).

Furthermore, Huong et al. (2020) provide empirical evidence of an adverse effect on FDI flows upon domestic currency appreciation. On the other hand, Tiwary et al. (2022), Duan et al. (2022), and Mesagan (2022) found a positive effect between FDI and exchange rate volatilities. Not surprisingly, Nguyen & Do (2020), Moraghen et al. (2021), and Boubakri et al. (2019) found no linear relationship between FDI and exchange rate volatility, while Eregha (2019) found no significant effect between the two. It can be observed that the expectation of appreciation of the host country's currency decreases FDI inflows, while devaluation (or depreciation) of the host country's currency

results in increased FDI inflows (Li & Nakagawa, 2022). This tendency is based on the expectation that asset prices will regain their value in the future.

In examining the determinants of FDI inflows to emerging economies, Wilhelms (1998) noted that market size, political stability, and general institutional fitness influence inward FDI flows. He argued that a lack of a competitive and attractive investment climate, combined with low institutional quality, hinders FDI attraction. Likewise, in the assessment of location advantages for FDI attraction, Kamal et al. (2022), Islam et al. (2020), Sethi et al. (2019), and Awadhi et al. (2022) noted that trade openness, market size, and financial development, human capital, GDP growth, and infrastructure development are crucial determinants for FDI inflows to the developing countries. Given that this study focuses on examining the impact of financial development and the moderating effect of institutional quality (corruption, government effectiveness, and political stability) on inward FDI flows, this theory cannot fully explain the relations and the variables involved. In this regard, there is a need to consider other FDI theories.

### **2.2.2 The Eclectic Theory**

Before the development of the location-based theory, various empirical studies had already been conducted on country-specific features that influence FDI location, including the work of Dunning (1958). The impact of the social and economic structuring of business enterprises on managerial capitalism was

identified as vital for large corporations in concentrating and centralizing capital. Likewise, economic restructuring influenced capital concentration by dictating its direction and facilitating its movement through investments.

The location-based FDI theory was subsequently proposed by Dunning (1973), drawing on orthodox neoclassical economic theories. The idea focused on the factors (advantages) influencing host countries' FDI inflows. Such advantages were identified as ownership, location, and internalization (OLI framework). The setting up of the OLI framework, which explains FDI flows, is a result of a successful series of research conducted by Dunning (1958), Caves (1971), Hymer (1976), Buckley and Casson (1976), Rugman (1980) and Hennart (1989) as pioneers for the formulation of theories which explain FDI phenomena.

Growth and continued developments on the location-based FDI theory are the results of combining the main economic theories: (1) the macroeconomic theories of trade, (2) the macroeconomic theories of industrial organization and innovation, (3) international capital movement and location, and (4) the microeconomic theories of the firm (Dunning & Cantwell, 1987). Ownership, internalization, and location factors in the location-based FDI theory, also known as the OLI framework, are synthesized by macroeconomic theories to elaborate on location advantages. On the other hand, mesoeconomic and microeconomic theories are used to develop the concept of ownership and internalization advantages. The OLI advantages were later elaborated upon by Dunning (1980), who argued that for a firm to have an advantage in competing with rivals in the

foreign market, it should possess a competitive edge in terms of technical know-how, firm brand name, and patents. A firm that decides to operate in foreign countries benefits from lower production marginal costs due to economies of scale, monopoly, and possession of technology, which serve as its operational advantages. The previously outlined competitive advantages position the firms to reap higher profits.

FDI flows are influenced and dominated by capital market development, whereby MNEs from developed capital markets are found to be pioneers in international business, utilizing FDI strategies (Gutola & Milos, 2022; Arikan et al., 2022; Nguyen, 2020; Papanastassiou et al., 2020; Mishra & Jena, 2019). Buckley and Casson (1976) noted that after experiencing growth and saturation in their domestic markets, the next stage for further development and expansion was to undertake FDI to explore and exploit the unsaturated foreign markets. The immediate advantages possessed by firms that entered foreign markets were their ability to produce different products that were perceived as unique and competitive in those markets (Hymer, 1976). It can be conceptualized that the competitive advantage of MNEs in foreign markets is created by their ability to develop new products, leverage location advantages, and exploit financial market imperfections, which serve as tools to encourage them to undertake FDI.

For MNEs to win in foreign markets through FDI, they should have effective financing strategies that involve adhering to good accounting standards and disclosure practices. Such achievement can be attained by running cross-border

equity and debt swap arrangements and listing on reputable stock exchanges to sell equity stocks in both domestic and foreign financial markets. The implication is that a solid and active financial strategy enables firms to lower their capital costs and increase their capital availability compared to their competitors in both domestic and global markets. When a firm has a lower cost of capital, the discounting factor for its investment projects increases the likelihood of project acceptance in both domestic and foreign markets, thereby putting the firm in a better position to engage in FDI. Kingori (2022) suggests that a firm should focus on finance-specific strategies when deciding on its investment pattern and location, whether domestically or globally, through the FDI approach.

The finance-specific strategies that MNEs can use in influencing their decisions for FDI locations are classified into two main categories: (1) proactive strategies controlled by MNEs and (2) reactive strategies that deal with the financial market imperfections (Jiang et al., 2022; Jamaleh & Shukla, 2021; Cooper & Nguyen, 2020; Pearce & Tang, 2019). The reactive financial strategies that respond to financial development imperfections were accommodated in the OLI framework for FDI influential factors, such as accounting practices, involvement with capital markets for selling financial assets, including equity stocks, listing on stock exchanges in both domestic and foreign markets, and establishing good relationships with financial institutions. Proactive financial strategies for attracting FDI inflows are designed to provide ownership, location, and internalization advantages, such as unique technology and the development of innovative products that are not common to competitors (Ghahroudi et al., 2018).

MNEs from emerging capital markets need to develop finance-specific strategies. They must compete with MNEs from developed capital markets to win foreign market share. The reason is that it is customarily considered that MNEs from liquid and developed markets have relative advantages in terms of a lower cost of capital and readily available additional capital offered by their domestic developed capital markets. It is also a notion that MNEs from the developed markets can absorb financing costs from the host countries in which they locate their FDIs, giving them a financing advantage (Farah et al., 2021; Paul & Feliciano-Cestero, 2021; Irandoust, 2021; Lee et al., 2020; Tripathi & Thukral, 2018). The need for MNEs from developing economies to develop proactive finance-specific strategies is inevitable to provide a level playing field for competition with MNEs from developed markets. It is well known that MNEs from developed economies already possess competitive advantages in terms of lower capital costs, greater financing flexibility, and the ability to raise additional funding from both domestic and foreign financial markets. Firms with established financing strategies have a competitive edge in international business through FDI (Vargas-Hernández, 2023; Peng et al., 2023; Zhang & Colak, 2022; Reurink & Garcia-Bernardo, 2022).

Financial development provides a suitable platform for MNEs to implement proactive financing strategies for FDI flows (Srinivasan & Eden, 2021; Van Tulder et al., 2021; Adams et al., 2019). Financial development is among the advantages of ownership, location, and internalization proposed by the OLI

framework for accelerating FDI flows, enabling firms to win foreign market competition relative to domestically based firms (Dunning, 2001). Dunning and Rojec (1993) argued that a developed and well-functioning financial sector is the source of financial asset advantages to MNEs, as it provides superior knowledge on how to access capital in foreign markets for additional funding to finance investments held in host countries under FDI arrangements. Dunning further argued that the financial asset advantage brought by the development of the financial sector is essential for increasing a firm's size and efficiency and gaining knowledge of foreign markets for smooth FDI activities. From this perspective, firms that engage in FDI tend to be large, symbolized by financial strength and creativity, which involve finance-specific factors. The finance-specific advantages pave the way for such firms to pursue successful FDIs as they win competition in the foreign markets by outweighing the domestic firms in the host countries.

However, firms with unique financial strategies not yet known to their competitors are identified as financial assets (Mondal et al., 2021). Those advantages align with the OLI framework's concept of competitive edge, such as the adoption of new technology in the banking sector. Financial institutions and portfolio investors have financial asset advantages that give them more access to foreign markets during investment decisions under FDI arrangements (Dunning & Dilyard, 1999). Non-financial firms can also benefit from financial assets in terms of ownership advantage by developing new technology that competitors cannot easily copy. Firms that use financial innovation to invest in developing markets have a relative competitive advantage over their peers in

developed markets. This strategy helps them create ownership advantages and eliminate ownership disadvantages that may deter their FDI flows to host countries.

After studying the factors of production that influence international trade advantages, such as skilled labor and availability of raw materials, Abbas et al. (2021) supported the location-based FDI theory. The author highlighted why FDI occurs, attempting to capture immobile advantages in the international market arena. MNEs are compelled to expand their business investments through cross-border investments to benefit from factors of production, such as skilled labour, low production costs, and the availability of raw materials. The OLI framework for MNEs' decisions to locate their FDI clearly describes the motive for participating in foreign markets.

According to Dunning (1980), internalization is a means by which a firm can benefit from market imperfections, maintain its sales level, and protect its reputation. Additionally, internalizing is a strategy where a firm can fully utilize its spare organizational and entrepreneurial capacity at a minimal additional cost to produce goods similar to those already circulating in the market.

The location-based FDI theory is limited by the assumptions put forward, as it considers a model of two countries (Krifa-Schneider et al., 2022). The world comprises many countries with distinct characteristics in terms of resources, technology, labor, geography, and various infrastructural differences, which no

two countries can fully represent. The real world, with its diverse countries, provides MNEs with more internationalization advantages than their domestic competitors. The assumption of two countries deprives MNCs of the benefits of selling products to different countries and other parts of the world, spreading fixed costs and maximizing contribution margins. Another limitation of this theory is the assumption that a single product will be produced and distributed by MNEs to compete in foreign markets. Dealing with only one product is riskier regarding decline or loss of demand, especially when consumers' tastes or fashion change, giving competitors a chance to win large market shares or control the market pattern. The production of a single product can also increase the chances of the firm's failure, as it lowers the fixed production and distribution costs.

The study by Dunning (2001) criticized the location-based FDI theory for its static analytical approach, which assumes that the variables involved are interdependent, as they are typically gathered and displayed. Findings from the same study observed that location-based FDI theory failed to give a detailed and sufficient explanation of how international production influences decisions for FDI location. Although location-based FDI theory helps provide a specific model to explain foreign direct investment (FDI) location, the author later realized that it could not fully explain the decisions behind FDI location. Apart from the challenges Dunning (2001) posed for the location-based FDI theory, the literature identified three central oversights. First, the theory did not explain the economic effects exerted by FDIs in which they are located. Second, the theory did not analyze the OLI advantages of greater importance in influencing

FDI. Third, the location-based FDI theory failed to provide an acceptable level for OLI advantages to be captured, thereby failing to attract FDI flows.

Different studies have also criticized the location-based FDI theory, arguing that it does not account for finance-specific factors crucial to FDI location advantages (Veeramani et al., 2020; Cooper & Nguyen, 2020; Kottaridi et al., 2019; Cai et al., 2019). Most MNEs struggle to lower their financing costs and share financial risks by raising additional capital from the host country's economy, as facilitated by its financial sector. Some suggestions were put forward that, in considering finance-specific factors, the theory needs to include finance strategies such as debt-to-equity swaps and cross-listing between MNEs' home countries and the host countries. Furthermore, most MNEs used to explain FDI flows under the location-based FDI theory were from liquid markets in the USA, UK, and Japan.

The recent criticism by Lestari et al. (2022) argues that location advantages do not matter, as some countries without directly identifiable specific-location advantages attract more FDI to their host countries. They say that FDI attraction is a function of institutional quality, especially in combating corruption and promoting the rule of law practices. The criticisms of the location-based FDI theory are based on the argument that the theory does not fully describe FDI phenomena. According to Majeed et al. (2021), no single theory can adequately explain the concept of FDI, including its determinants, level of sensitivity to influential factors, motives, and direction of FDI flows.

Despite criticism of the theory, it remains one of the most widely used theories in the context of FDI phenomena. The application of the location-based theory emerged in response to criticisms of the neoclassical economics theory, which recognized the impact of transaction costs and location advantages available worldwide (Verbeke & Yuan, 2022; Chewaka & Zhang, 2021; Wagner, 2020; Asongu et al., 2018). Neoclassical economic theories believed that markets are the primary focus for business location in foreign markets. Contrary to that notion, the location-based FDI theory identifies transaction costs as another valuable factor in investment location decisions. Dunning's critics, from time to time, contributed to the development of the location-based FDI theory by challenging the variables included in the theory.

The location advantages proposed in the OLI framework, which are found to influence FDI flows, are categorised into economic, political, social, and cultural benefits. Economic factors include transportation costs, market size, and telecommunications, while political factors are based on good government policies. On the other hand, social factors depend on the distance of social interactions between host and domestic countries, and the cultural aspect is taken into account in attitudes towards foreigners. Trade openness is among the political location advantages that influence FDI inflows, depending on the government's policies. Other location advantages represented in the OLI framework included macroeconomic environment, financial development status, level of infrastructural development, and political stability.

Ownership-specific (firm-specific) advantages are characteristics that enable a firm to compete in domestic markets and transfer these competitive advantages to foreign markets. Firm-specific characteristics are know-how qualities that are collectively in (1) economies of scale and scope, (2) managerial and marketing expertise, (3) advanced technology stemming from extensive research, and (4) differentiated products. The economies of scale and scope refer to financial strength, an advantage of MNEs to locate their investments in well-developed financial sectors with sufficient liquidity and unsegmented markets with unlimited capital access (Li et al., 2019; Dunning, 1993). The ownership-specific advantages imply that transaction costs are reduced when an MNE has total ownership of foreign subsidiaries.

The location-specific advantages reflect the decision on where FDIs are to be located in a particular market. The FDI location decisions can be based on a behavioral approach (Koleša et al., 2022; Xie et al., 2022; Buckley et al., 2018). Network theory explains that FDI location decisions are influenced by behavioral aspects and competition for power between MNEs and their subsidiaries during the internationalization process, particularly in reinvestment decisions (Saikia et al., 2020; Verbeke & Yuan, 2022).

Some FDIs are motivated by financial market imperfections (Temouri et al., 2022; Buckley et al., 2018; Tang, 2021; Sahin et al., 2022). Dunning (1993) recognized the possibility of market imperfections and suggested that MNEs have income-generating assets (financial assets such as equity stock) in foreign

markets, taking into account exchange rate variables that have an economic impact on the profit-generating potential of the firm. One of the mechanisms that was found to be best in controlling exchange rate volatilities is locating production facilities in the host countries (Aziz et al., 2022; Nor et al., 2020; Rapetti, 2020). Market imperfections in exchange rate volatilities and political risk affect location advantages but are not among the crucial financial solid factors affecting FDI location. These factors can be reviewed for foreign investment location decisions during the risk diversification assessment stage.

The internalization advantages flowing to MNEs depend on their capabilities to synthesize information for proper and timely business decisions and develop and control human capital, valuable tools for a perpetual succession of business operations (Sethi et al., 2022). Internalization provides justifiable reasons why MNEs utilize FDI to operate business activities in foreign markets by having sufficient, relevant, and reliable information and properly developed human capital. These factors help them use ownership-specific and location-specific advantages to maximize the firm's value while creating owners' (shareholders') wealth.

Trade openness, economic growth rate, infrastructure development, market size and inflation influence FDI inflows in developing countries (Sinha & Sengupta, 2022; Asamoah et al., 2019; Su et al., 2021; Nketiah et al., 2019; Sabir et al., 2019). On the contrary, high interest and continuous inflation rates deter FDI inflows (Rafidi & Verikios, 2022; Okafor et al., 2022). Generally, the common

host country economic factors influencing FDI inflows include growth rate, interest rate, previous FDI inflows, and trade rates, while inflation rates have an inverse effect (Azam & Khan, 2022; Su et al., 2019). The FDI inward influencing factors are location advantages.

Despite the location-based FDI theory providing a good explanation of FDI phenomena, it still cannot be used as the leading underpinning theory for this study. The reason is that, apart from the theory recognizing the role of political systems, government policies, and financial development on FDI inflows, no highlight has been made on the impact of institutions and institutional quality on inward FDI flows. Given that this study employs institutional quality (corruption, government effectiveness, and political stability) as a moderator, this theory cannot correctly explain the variables involved. The deficiency of the OLI framework allows for other FDI theories to be considered, which can provide an appropriate explanation of the institutional quality, financial development and FDI nexus.

### **2.2.3 The Institutional FDI Fitness Theory**

The institutional FDI fitness theory is among the less-debated FDI theories developed by Wilhelms (1998). The author elaborates on the concept of FDI fitness, meaning a country's specific ability to attract, absorb, and retain FDI flowing into its economy. Its primary focus is on the role played by institutions in attracting FDI inflows. The theory is built on the principle of survival of the stronger in the sense that the question of attracting FDI inflows to the host

countries does not depend on the size of the country, geographically or by population. What matters is the ability of the country to fit into the struggle for developing favorable policies and strong institutions for influencing and attracting inward FDI flows.

The institutional FDI fitness theory postulates that some prior host country conditions are supposed to be in place before decisions are made to locate FDI projects in that particular environment. These primary conditions include political stability, infrastructure, and economic systems. Once these preconditions are in place, government investment policy reforms will be a green light for investors, especially foreign investors who regard the country as a potential FDI location.

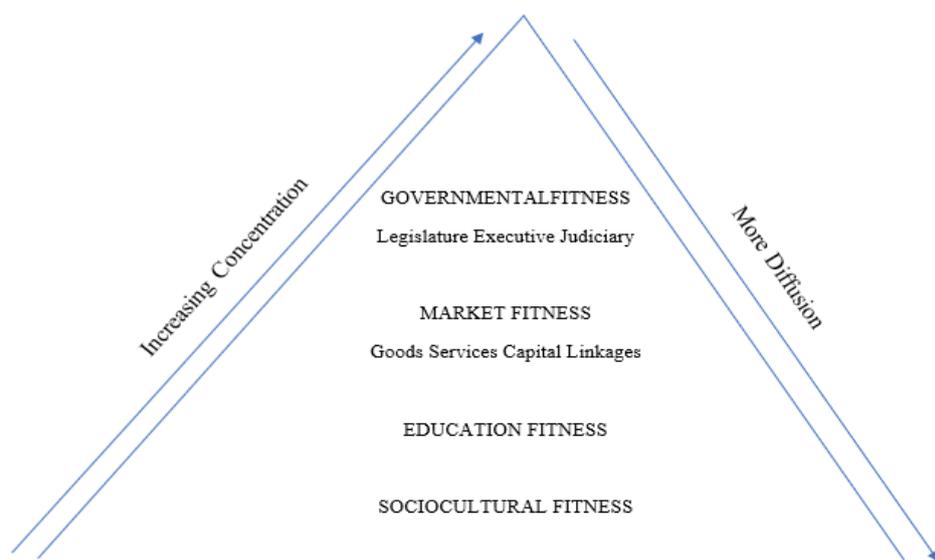
The institutional FDI fitness theory took arms for its development as a result of the emergence of the need for institutions to adapt and take part in attracting FDI flows by the movement which originated in Western Europe in the 1990s (Luo & Witt, 2022; Šćepanović & Bohle, 2018). The argument put forward by the theory's founder is on the importance of government in taking active and continuous initiatives by formulating effective strategies for motivating foreign investors to invest in their domestic countries in the form of FDI. Illustrating the theory's applicability in African countries, Wilhelms (1998) argued that what matters in attracting more FDI inflows is not the traditional determining factors but institutional variables such as legal practices and enforcement pieces of machinery, which governments can manage for implementation in achieving the targeted outcomes.

Based on this theory, FDI inflows are determined by macroeconomic factors rather than microeconomic factors. When country factors are regarded as attractive for investment, investors ponder how their investment strategies materialize through industry and firm factors, which can be accommodated in the country-level factors. Without FDI-attractive country factors stemming from quality institutions and efficient and dynamic investment strategies, investors find the FDI business mechanism very difficult, with roadblocks limiting entry to the host countries and the growth of their investments (Rygh et al., 2022). The theory emphasizes the significant role of increasing FDI inflows to developing countries, positively impacting budgetary and socioeconomic aspects, and improving living standards (Zafar et al., 2020).

The institutional FDI fitness theory has four categoric fitness levels: sociocultural, government, education, and market linkages. The four fitness dimensions are aligned in a pyramidal hierarchy where sociocultural forms the base, and the government is at the top. The Government's fitness is weighed by corruption control, economic openness, transparency, and non-intervention in exchange rate movements and trade. In contrast, market fitness is traced to low costs, easy and fast financial access, generated trade volume, physical capital (machinery), financial (credit) fitness, and energy access, which are key for FDI attraction (Wilhelms, 1998). Educational fitness is concerned with the development of human capital, while sociocultural fitness deals with cultural systems. Government fitness manages market fitness by adopting protective

regulations (Younas & Ogli, 2021; Sauvant, 2021). The uneven distribution of FDI inflows across different countries stems from the aforementioned institutional parameters that act as internal and external pillars for economic propellants (Hoang et al., 2022; Kim, 2022).

Figure 2. 1: Pyramid of FDI fitness institutions



**Source:** Institutional Fitness Pyramid: Adopted from Wilhelms (1998)

From the pyramidal Figure 2.1, sociocultural fitness forms the base since all institutions are derived from this permeating oldest institution, which diffuses and accommodates all other forms of institutions. The ease with which citizens in a particular country welcome investors from different sociocultural and varied business practices is a sign of educational attainment, cultural exposure, and openness to integrate into the global economy (Wilhelms, 1998). The transparency to multicultural receptiveness indicates the host country's capacity

to attract inward FDI to their economies. The education fitness in the pyramid provides flexibility on sociocultural fitness by enhancing the capacity of human capital for processing information, patterning investment projects. Education and cultural fitness influence FDI inflows by allowing foreign investors to enter the economy and seed their capital, letting it grow and bear optimal returns.

On the other hand, market fitness reflects financial and physical capital readiness, and the logic is that competitive markets with laws protecting investors' rights are more attractive to FDI locations (Contractor et al., 2021). However, the government's fitness in the pyramid comes last at the cone, meaning it is responsible for all other institutions. Wilhelms argued that investors rely on government policies and actions to create a conducive investment climate, thereby shaping FDI direction. The relationship among all the institutional fitness levels in the pyramid interchange by influencing one another. For example, the government impacts socio-cultural fitness, the market, and educational institutions, and vice versa.

The extent to which one institution can influence the other reflects the ease and time required to absorb the impact and changes. The government can be changed in a short time. Even if the government is long-lived or formed by dictatorship, it can be changed shortly by revolution or by a pre-planned single cause of action. Likewise, markets can be temporarily distorted or made competitive by government policies upon implementation. On the other hand, the education system that impacts human capital cannot be changed quickly. It takes a long

time for the educational impact to be reflected in human capital in acquiring the necessary skills for performing specific jobs and developing technology to fit the aspects needed. Similarly, sociocultural systems and practices cannot be changed abruptly within short dynamics because they are built on deep roots. Sociocultural changes take a long time because they are evolutionary, multicausal, and unplanned.

For a country to attract more FDI inflows, it must have proper and interconnected functional institutions (Wilhelms, 1998). The formulator of the theory argued that countries with quality institutions have the fitness advantage of attracting and retaining FDI inflows. Countries with a relative advantage in attracting more FDI inflows are the ones that can adjust abruptly to the changing environment, taking opportunities as they emerge, increasing their creativity, controlling threats, overcoming competition, and seeking proper and appropriate FDI locations for survival.

In an environment where a particular country's investment policies are not attractive and unfriendly, such an economy is unfavourable to investors. In that case, MNCs leave such countries to avoid the burden of political risk on their investment (Liu et al., 2022). Emphasizing the vital role played by the government in formulating suitable policies and forming quality institutions to create a conducive investment climate, Wilhelms and Witter (1998: p 2) wrote: "Without a green welcome light, namely strong policies and institutions,

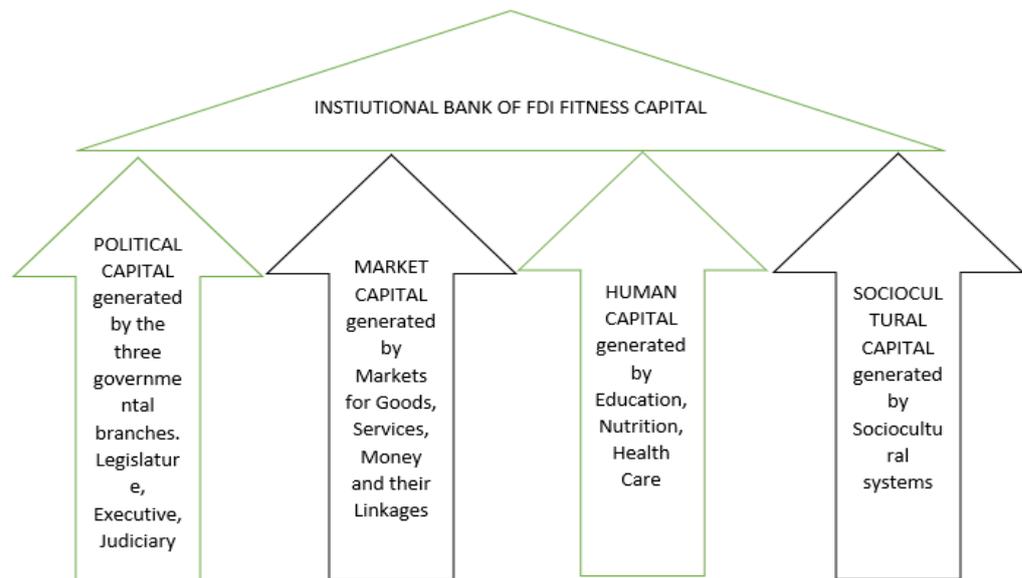
investors find the road to FDI rather rocky due to an array of roadblocks and unfavourable entry and driving conditions.”

The institutional FDI fitness theory denotes that foreign investors rely on institutional structures that provide access to financial services and assure political stability, quality education, and good health for human capital. The higher the degree of institutional development in the host countries, the more flexible and readily investors are attracted to undertake FDI projects in the economy. The argument under the theory is that domestic private investments pave the way for FDI, as high domestic investments indicate the availability of a stable investment climate and viable investment opportunities. The presence of foreign investors in the host countries’ economies improves the business environment for the whole private sector (Stack & Amisah, 2022).

It is further postulated under the institutional FDI fitness theory that, other factors remaining constant, FDI inflows to the host countries are influenced by the quality of their institutions, their policies, and implementation (Qamruzzaman, 2022; Mariotti & Marzano, 2021; Sabir et al., 2019). The interaction between institutions, policies, and implementation procedures is crucial in increasing the level of FDI inflows to the host countries. Countries with high institutional fitness are deemed to have higher FDI inflows than others. The strength of institutional fitness of a particular country is reflected in its institutions’ transparency, reliability, well-functioning, and predictability in supporting investments (Larsson & Grimes, 2022; Kaasa & Andriani, 2022).

The institutional FDI fitness theory can further be conceptualized as the bank of FDI fitness capital. When comparing the two, institutional fitness and institutional capital, institutional fitness is more flexible in describing the attraction of FDI since it is a dynamic process rather than a static and pre-existing state. Attracting FDI to the host countries requires active efforts rather than passively relying on already established industries and natural resources (Wilhelms, 1998). Achieving high institutional fitness while increasing FDI inflows is a continuous process rather than a capital requirement. The notion of institutional capital reflects the nation's assets and their capacity to attract and absorb FDI. In contrast, institutional fitness goes beyond considering the retention of the FDI after attraction and absorption.

Figure 2. 2: Bank of FDI Capital

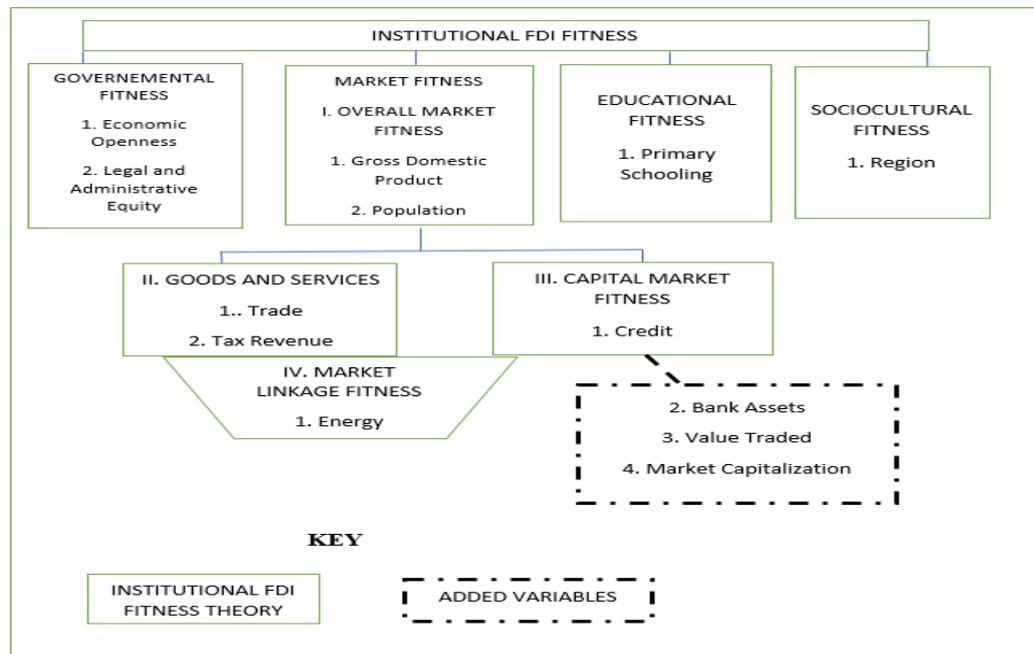


**Source:** FDI fitness capital adopted from Wilhelms (1998)

The institutional capital opens the host country to foreign investors, and its impact keeps attracting inward FDI to the economy. Well-functioning institutions improve FDI location advantages. Market fitness, which results in open markets, increases FDI attraction and facilitates higher FDI inflows. Government systems and policies that provide a green light for FDI inflows continue to attract FDI and make the country more FDI-welcoming.

The institutional FDI fitness theory encompasses four main variables: (1) governmental fitness, (2) market fitness, (3) educational fitness, and (4) sociocultural fitness. These key constructs are further described: Governmental fitness is defined by economic openness and legal and administrative equity. Market fitness is defined at four levels: (I) overall market fitness described by gross domestic product (GDP) and population, (II) goods and services defined by trade and tax revenue, (III) capital market fitness defined by credit provision, (IV) market linkage fitness combining (II) and (III) described by energy. Educational fitness is defined by primary schooling, while sociocultural fitness is defined by region.

Figure 2. 3: Key variables of Institutional FDI fitness theory



**Source:** Wilhelms (1998) and author owns compilation (-----)

From the institutional FDI fitness theory, FDI is the endogenous variable determined as net FDI inflows. Net FDI inflows are the appropriate measure of FDIs flowing to the host countries, representing the amount received in the host economies. Four explanatory or independent variables are traced from the model above. Details of the subconstructs are given below.

Governmental fitness involves the legislature, executives, and judiciary. High governmental fitness is built on the legislature, executives, and judiciary from the involvement of all top governance hierarchies in governmental policymaking, decision-making, and implementation. High governmental fitness means transparency, independence, equity, reliability, and fairness in legal, financial, and economic decision-making. Strong government fitness increases

FDI inflows and reduces economic and financial instability and investment risk. Governmental fitness comprises economic openness, legal and administrative impartiality, and transparency. Economic openness is described by the exchange rate, which reflects the currency's actual value and reduces uncertainty and transaction costs to foreign investors. The implication is that a free market is built on market forces of demand and supply. On the other hand, law enforcement describes legal and administrative impartiality and transparency.

Market fitness refers to moving foreign and local capital, services, and goods. High market fitness is reflected by well-developed market systems for domestic and international markets linked by infrastructures, allowing the flow of goods, services, and capital. Market fitness is measured by four variables: overall market fitness, goods and services market fitness, capital market fitness, and market linkage fitness. Overall market fitness is defined by GDP per capita (for economic development) and population (for market size and population density between urban and rural). On the other hand, the goods and services market fitness is measured by foreign trade (trade volume) and tax revenue (taxation of the private sector). In contrast, capital market fitness is given by credit to the private sector. The market linkage fitness is measured by energy (commercial energy use for indicating the development of energy infrastructure).

Educational fitness is a tool for human capital development. The country's workforce competitiveness internationally in terms of productivity and education reflects high educational fitness. High educational fitness is expected

to increase the level of FDI inflows to the economy. Education exposes individuals to diverse ways of doing things, including business. It also helps holders to increase interaction with foreign investors for more expanded business opportunities. An educated society with a knowledgeable workforce facilitates inward FDI flows.

Sociocultural fitness refers to increased interaction in the global business markets and practices without adopting other people's sociocultural practices. High sociocultural fitness denotes a country's flexibility towards international markets and openness to FDI inflows. Sociocultural fitness minimizes the rise of local attitudes and behaviors, that harm inward FDI flows.

The relationship between financial development and FDI can be explained based on the physical and financial capital market fitness components. The explanations align with the argument made by Ezeoha and Cattaneo (2012) that the availability of capital creates liquidity easing, economic efficiency, and allocation efficiency, which are essential for attracting foreign investments. Countries with allocation efficiency and well-developed and functioning financial systems have a better advantage in attracting foreign capital and allocating it to viable and productive projects that generate higher returns. Economies with market fitness regarding absorption and retention of FDIs benefit from location advantages. Most of the investors prefer holding their investments in such countries (Munjal et al., 2022; Vicard, 2022; Arikan et al., 2022; Duramany-Lakkoh et al., 2021; Soh et al., 2021). One of the open roles of

a well-developed and functioning financial market is to facilitate the attraction of FDI inflows and simplify access to low-cost external funding for both individuals and corporate concerns (Chitranka, 2022; Yiadom et al., 2022; Tri, 2022).

Wilhelms and Witter (1998) argued the importance of financial intermediation in attracting inward FDI flows, in which banks and other financial institutions facilitate the flow of credit services to the private sector. Financially strong banks move up FDI investment projects, as noted from the investigation carried out for US banks on the firms owned by Japan in the US (Wijoyo, 2021; Kong, 2019; Das & Chaudhuri, 2018). Flexibility in accessing credit to finance investment in foreign countries is the source of foreign investors in locating their investments in economies with developed financial sectors.

However, the main limitation of the institutional FDI fitness theory is the scope of its empirical testing, which relies on the African context and foregoes other economies with similar characteristics (Makoni, 2021). The theory has been tested mainly in the emerging economies, covering African countries, thereby providing an imbalance in geographic and economic development levels and their impact on FDI attraction. There is a need for the theory to be also tested in other economies of Europe, the USA, Asia, and Latin America to come up with a wide range of literature and a broader scope of applicability. Applying the theory in emerging economies revealed that some nations have more country risk, implying challenges to governmental fitness and overall quality of

institutions (Makoni, 2021). The observations that have been made regarding this theory are essential as they raise the need for the theory to be tested in other economies with different political systems, different socio-cultural and education systems, different market niches, and so on.

As pointed out earlier in the theories section, this theory is less debated among FDI theories, making it less criticized. It is criticized that, although the pyramid of the institutional FDI fitness theory is orderly arranged from sociocultural fitness, education fitness, market fitness, and government fitness at the top, the order does not matter since the institutions are interconnected and they interchangeably influence one another (Makoni, 2021). The institutional influence of one on the other is random and does not follow any systematic pattern as proposed in the theory. For example, education influences sociocultural systems, market power, and government efficiency. Likewise, the government influences sociocultural practices and the education system while it protects, regulates, and empowers markets. The same is done by the market and sociocultural fitness in exerting their impact on the other institutions.

Assunção et al. (2011) observed that the institutional mechanism in attracting FDI that the government practices under governmental fitness is not applicable for congruent regional goals, such as the EAC economic region, since the process involves one government competing against other governments to attract FDI inflows to its respective country. The theory considered only the power of institutions in attracting FDI flows but ignored the impact FDI exerts in

influencing the institutional setups in the host countries, such as channeling funds to political parties for political movements and changes in government regimes.

Recent studies on FDI have widely applied institutional FDI fitness theory (Osei-Attakora, 2022; Kingori, 2022; Awadhi et al., 2022; Matima & Gossel, 2023; Bhandari, 2022; Takawira & Motseta, 2021; Khalfaoui & Derbali, 2021; Matthew et al., 2021; Renzi, 2021; Janda & Nuangjammong, 2021). Of those studies, very few have concentrated on investigating the FDI-financial development relationship. One of the recent studies on financial development and FDI utilizing the institutional FDI fitness theory is the one conducted by Takawira and Motseta (2021). Their study focused on credit ratings and capital flows (FDI) in South Africa. The findings from the study revealed that a higher credit rating leads to higher capital flows (FDI). The implication is that countries rated high regarding credit are perceived as safer for investment by investors, increasing FDI inflows.

However, in recent studies on FDI, the institutional FDI fitness theory has been based on diverse factors. Some studies have examined infrastructure development's role in FDI (Kingori, 2022; Matthew et al., 2021). These studies' findings expressed a significant relationship between infrastructure development in general and FDI flows. Contrary to the general findings, Kingori (2022) noted that different infrastructural sectors have a mixed relationship with FDI inflows in Kenya. For example, the communication sector had a positive significant

relationship with inward FDI, while the transport sector had an insignificant adverse effect on FDI inflows.

Using institutional FDI fitness theory, Corekcioglu (2020) and Sooreea-Bheemul et al. (2020) studied the role of economic freedom on FDI. The findings from their studies indicated that an increase in economic freedom parallels the rise in FDI inflows. Matima and Gossel (2023) and Osei-Attakora (2022) examined the role of politics and political risk on FDI based on the same theory. Their findings highlighted that FDI inflows increase with decreased political risk, while corrupt politics deter FDI. On the other hand, weak laws hurt FDI flows, similar to the effects of corrupt politics (Osei-Attakora, 2022).

Other studies that have devoted attention to FDI using institutional FDI fitness theory have navigated the role of institutions and institutional quality (Awadhi et al., 2022; Matthew et al., 2021; Makoni, 2018). The findings from these studies reported that strong institutions characterized by growth and governed by institutional quality significantly impact FDI. Awadhi et al. (2022) noted that the rule of law and government effectiveness have vital roles in FDI attraction compared to other institutional components. Moreover, good governance is also found to significantly impact FDI inflows as it strengthens the institutions (Narayanan et al., 2020; Makoni, 2018; Awadhi et al., 2022).

Wilhelms (1998), in the hierarchy of FDI institutional fitness, the market fitness segment contains the capital market fitness component, which provides banks'

role in intermediation by giving credit to the private sector. Wilhelms argued that intermediate services offered by banks and other financial institutions are critical in creating the availability of credit and circulation in financial development. The author further argues that the strength of the financial development in the supply of credit influences FDI flows by attracting the latter to domestic economies. The provision of credit through intermediation creates assurance to MNCs regarding the availability of capital, which induces them to locate their investments in such countries. While testing the theory's applicability in emerging economies, Wilhelms and Witter (1998) noted a significant relationship between credit provision to the private sector and FDI flows. The implication is that investors can raise capital in the host countries and their home countries.

The findings from the use of institutional FDI fitness theory in East African countries, covering Kenya, Tanzania, and Uganda, using data from 1995 to 2007, noted that FDI is influenced by financial, social, political, economic, and market factors. The study revealed that the government has a significant role in institutionalizing attraction for FDI inflows (Musonera et al., 2010). The study by Muthoga (2012) carried out in Kenya noted that GDP growth rate, economic openness, internal rate of return, and credit availability are institutionally driven factors influencing FDI inflows. These factors are also known as proponents of governmental economic policies for attracting investors (Makoni, 2021).

Asongu et al. (2018) argue that financial development largely contributes to how much a host country benefits from FDI inflows, particularly in emerging economies. Financial development paves the way for allocating financial resources to profit-maximizing projects and facilitating timely financial services such as loans and foreign currency transactions. Developed and well-functioning stock markets increase market interactions between domestic and foreign investors through the reduction of entry and exit market barriers (Dada & Abanikanda, 2022).

Sabir et al. (2019) noted the power of quality institutions in attracting FDI rather than economic factors such as low labor costs and market size. The role played by institutions in influencing FDI flows is not only in the attraction of inward FDI but also in increasing the level of inflows. Quality institutions ensure the attraction of significant, quality, and the most needed FDIs to the host countries (Ullah & Khan, 2017). Based on the focus of institutional FDI fitness theory, variables involved, and explanations concerning FDI, financial development, and institutional quality, the theory acquires merit as the underpinning theory for this study.

#### **2.2.4 Appropriate Theory for this Study**

The primary focus of this study is on financial development and FDI inflows to EAC, moderated by institutional quality (corruption, government effectiveness, and political stability). The underpinning theory used in this study is institutional FDI fitness theory. The theory was developed by Wilhelms (1998), and it is used

to study the determining factors for FDI inflows to emerging markets. This theory indicates that the decisions of foreign investors to carry out cross-border investments in emerging markets are influenced by country factors (macroeconomic) rather than firm and industry-level factors (microeconomic). As applied to this study, it is expected that bank assets level, credit to the private sector, stock market capitalization, and stock value traded influence FDI inflows, and this theory is the most appropriate and relevant FDI theory for this study. This theory considers both capital market aspects, host countries' location advantages, and the vital role of quality institutions in FDI attraction.

The financial development variables employed by the study can be clearly explained by the theory under capital market fitness, which contains only one variable, the credit provision to investors. Bank assets, value traded, and market capitalization variables can be added as an extension to the theory on capital market fitness. The institutional quality (corruption, government effectiveness, political stability) can also be explained well by the theory, as it focuses on the role of institutions in inward FDI attraction.

The analysis of FDI inflows to EAC is a macroeconomic scope. In achieving the objectives of this study, attention to FDI theories has been based only on macroeconomic theories, which can better explain the FDI-financial development nexus. The reviewed theories are based on the capital market, location-based advantages, and institutional fitness. The capital market theory offers less explanation for this study, as it concentrates on currency areas across

countries as a significant factor for FDI flows. The capital market theory highlights that FDI flows from strong currencies to weak currencies. The capital market theory cannot explain the movement of FDIs flowing across equal currency strength in emerging economies or FDIs flowing from weak currency countries to strong currency economies. Since this study focuses on examining the influence of financial development and the moderation effect of institutional quality in FDI attraction, the capital market theory cannot fully explain this phenomenon.

On the other hand, the location-based FDI theory (OLI framework), which considers the role of host countries' available advantages in influencing FDI inflows, partially explains this study. However, it does not consider the role of quality institutions in attracting inward FDI. The location-based FDI theory cannot explain why countries with fewer or no specific country advantages attract more FDIs than countries with such advantages. The institutional FDI fitness theory best explains why countries with less specific advantages can attract more inward FDI.

It follows that the institutional FDI fitness theory focuses on FDI attraction to emerging markets, drawing attention to the role of quality institutions in this process. The institutional FDI fitness theory has governmental fitness, market linkage fitness, sociocultural fitness, and education fitness. All these dimensions form the basis for a good investment climate in emerging economies. Developing countries such as EAC face institutional quality challenges that hinder FDI inflows. The theory suggests that the attraction of FDIs to emerging

economies can be fostered by ensuring that institutional quality is put in place. Based on this study environment, which intends to examine the influence of financial development gauged by banking services and stock market size on FDI moderated by institutional quality, institutional FDI fitness theory provides a better explanation than the other theories.

The institutional FDI fitness theory provides the best explanation for the study variables covering financial development as defined by the banking services (bank assets, credit to private) and stock market size (stock value traded, market capitalization), moderated by institutional quality (corruption, government effectiveness, political stability), and FDI measured by net FDI inflows. The institutional FDI fitness theory explains the studied variables in which the financial development proxies are covered under capital market fitness. In contrast, institutional quality variables are described under the governmental and sociocultural segments.

This study uses the institutional FDI fitness theory as the most relevant theory among the reviewed theories because of its power to explain all the variables involved in this study. Financial development is influenced by capital market fitness, while institutional quality results from governmental fitness, all under the institutional FDI fitness theory. This theory provides a theoretical rationale for the relationship between financial development, FDI, and institutional quality, facilitating solid ground for developing the research hypothesis.

The formulation of this study's conceptual framework has been based on the relationship described by the institutional FDI fitness theory. Financial development is linked with FDI inflows, which is explained by market linkages. In contrast, institutional quality is presented by the role of government in overseeing all institutions and economic operations in the country, fostered by sociocultural practices. Since the theory focuses on macroeconomic factors, the conceptual framework appropriately contains control variables.

The limitations surrounding the institutional FDI fitness theory, which are major in its scope of testing and applicability being confined to the African continent and precisely for the emerging markets, cannot affect this study's objectives. The study focuses on EAC, which belongs to the emerging markets economic region. Since emerging economies are facing challenges in the extent to which the financial sector is developed, including the role of quality institutions in the attraction of FDI inflows to their host countries, institutional FDI fitness theory is the relevant and appropriate theory to explain the relationship between financial development and FDI moderated by institutional quality (corruption, government effectiveness, political stability).

The institutional FDI fitness theory is relevant for this study as it can answer the research questions to achieve its objectives. The use of institutional FDI fitness theory by this study can also be substantiated by heavy application of this theory by most of the recent FDI studies (Osei-Attakora, 2022; Kingori, 2022; Awadhi et al., 2022; Matima & Gossel, 2023; Bhandari, 2022; Aromasodun, 2022;

Takawira & Motseta, 2021; Khalfaoui & Derbali, 2021; Matthew et al., 2021; Renzi, 2021; Janda & Nuangjamnong, 2021; Corekcioglu,2020; Sooreea-Bheemul et al.,2020; Narayanan et al., 2020; Makoni, 2018).

### **2.3 Review of Relevant Past Studies**

The debate on the factors influencing FDI flows, the role of financial development, and how it influences FDI inflows is inconclusive. This study reveals a literature gap by explaining the FDI-financial development nexus in emerging markets. To the researcher's knowledge, there are scant studies that relate financial development and FDI cover the EAC countries under this study. The available studies on financial development and FDI relations have been conducted more in developed countries than in emerging markets such as the EAC. The few studies on financial development available in emerging markets have concentrated on economic growth rather than FDI. Likewise, empirical studies linking FDI and financial development are very few.

This study has also noted the existence of a knowledge gap in the role of quality institutions in attracting FDI inflows to developing countries. Institutional quality plays a significant role in business interaction, in which higher institutional quality promotes international trade, which could enhance FDI inflows for developing countries (Fon et al., 2021). In developing economies, including EAC and its partner states, studies on FDI linked with financial development and the moderating effect of institutional quality have not yet gained the appropriate attention.

The literature and knowledge gap allow this study to examine the relationship between these two economic sectors and contribute further to the limited literature on this sphere. Discussions and findings from the study contribute to the existing literature, which can be used for future research references. The study also closes the knowledge gap on the significant role of quality institutions in attracting FDI inflows in emerging economies through the moderation effect of institutional quality (corruption, government effectiveness, political stability) on the FDI-financial development relationship. Discussion on the moderation effect of institutional quality provides further understanding of the role of quality institutions for FDI attraction in line with the proposition put forward by the institutional FDI fitness theory. The identified literature gap in this study can be addressed by reviewing relevant past studies that link financial development and FDI inflows to the host countries.

### **2.3.1 Financial Development and FDI**

The FDI-financial development relationship is asserted to evolve in different ways, like mitigating transaction costs, enforcing financial contracts, allocating financial resources, and upgrading liquidity in the economy (Ezeoha & Cattaneo, 2012). Intermediation services offered by the financial sector provide risk diversification by reducing investment process costs and directing the resources to profitable investment activities. Financial sector development enables foreign and domestic firms to access external funding at low financing costs, which is crucial for attracting FDI.

The literature on the FDI-financial development nexus generally supports the view that financial development plays a crucial role in attracting FDI (Olorogun, 2022). Well-functioning financial systems through improved credit access, risk management, and the presence of financial intermediaries reduce transaction costs and uncertainties for foreign investors (Islam et al., 2021). This is particularly true in middle-income countries where developed financial institutions can stimulate both short-term and long-term FDI inflows. Moreover, the availability of capital and efficient banking systems encourages the formation of industrial clusters, which further enhances the appeal of a host country to multinational corporations (Jena & Sethi, 2021).

However, the relationship is not always straightforward. Some studies suggest that highly developed financial systems may increase domestic competition, which could discourage certain types of foreign investment (Alfaro & Chauvin, 2020; Majeed et al., 2021). Additionally, financial development might encourage foreign firms to engage in outsourcing rather than establishing a full presence in the host country, reducing the expected benefits of FDI (Donaubauer et al., 2020). There is also evidence of bidirectional causality; FDI not only benefits from strong financial systems but can also help strengthen them by stimulating reforms, increasing demand for financial services, and improving institutional quality (Saud et al., 2019).

Importantly, the benefits of FDI are often conditional on a country's level of financial maturity and institutional quality (Pham et al., 2022). Financial

development amplifies FDI's positive effects on growth only when the host country has reached a certain threshold in financial sophistication (Irandoost, 2021). Moreover, governance factors such as regulatory quality and corruption control significantly influence this relationship (Sabir et al., 2019). Weak institutions can undermine the gains from FDI, even if financial systems are relatively advanced (Islam et al., 2020).

Despite the largely positive link, recent findings caution against potential downsides (Appiah et al., 2024). In some developing countries, FDI may crowd out domestic investment, especially when financial resources are reallocated towards foreign firms (Magbondé et al., 2025). Country-specific evidence shows that FDI's contribution to growth is most effective when it complements domestic financial and labor market conditions (Sahoo & Dash, 2022). These variations highlight the importance of local context in shaping the FDI-financial development nexus.

Overall, the relationship between financial development and FDI is multifaceted and context-dependent (Abor & Bekoe, 2025). While financial maturity and strong institutions typically enhance FDI inflows and their development impact, outcomes can vary based on sector, country, and policy environment (Bhasin & Gang, 2020).

The FDI flows across countries, and the overall trading mechanisms of this approach largely depend on the availability of timely and quality information.

The financial sector provides the information foreign investors require regarding opportunities and possible risks that can be encountered in foreign markets to avoid an unfair market competitive environment with domestic investors (Kinda, 2010). Therefore, developments in the financial sector are essential in providing sufficient financial and market information to enhance investors' ability to make informed, sound, and viable investment decisions. Investors' transaction and information costs on services, industries, and markets are reduced by the efficiency and development of the financial sector in the host country (Bartels et al., 2009). Consequently, financial development reduces information asymmetry, which induces mobility for international capital and improved investment returns.

The efficiency of the banking system, for instance, reduces the cost of capital to foreign enterprises by providing them with financial services such as working capital, bank overdraft facility, and long-term financing for expansion (Agbloyor et al., 2013). Similarly, the developed banking sector facilitates fast access to key investment services such as funding availability, quick services, lower transaction costs, and competitive foreign exchange, all influential factors for inward FDI attraction (Kaur et al., 2013). The underdeveloped financial sector is reflected in fragile and inefficient banking services and deters foreign investments (Ezeoha & Cattaneo, 2012). The implication is that strong financial development eliminates the possibilities of business distress by providing quality financial intermediation between domestic and foreign trading activities, thus attracting FDI inflows.

Considering the case of MNEs, they prefer to invest in host countries with well-developed and functional stock markets to introduce their products, promote their brand name, and increase their capital (Otchere et al., 2016). The developed financial sector should support a conducive business environment with friendly markets. Foreign investors can access multiple financial products and services to support their investments. Weak financial institutions result in inefficient stock markets characterized by speculative activity, high volatility, and asymmetric information. Under such a stock market environment, foreign enterprises cannot list on the stock markets for fear of losing the share price value and the inability to raise the financing needed. Therefore, inefficient stock markets discourage foreign firms from investing in the host countries, resulting in low FDI inflows.

Well-functioning and developed financial sectors are the primary ways the benefits associated with FDI are channelled to the host country's economy (Rao et al., 2020). The nature and extent of the financial system maturity of the host country dictate how they benefit from FDI inflow (Pham et al., 2022; Islam et al., 2021; Irandoust, 2021; Cang & Alida, 2020; Bahri et al., 2018; Jeanluc & Muiruri, 2022). For an active and functional economy, there is a need for a well-established financial system that promotes investments by facilitating the circulation of funds. This process is achieved by the flow of funds from the economic surplus spending units (SSUs) to the economic deficit spending units (DSUs), thereby mediating lenders, investors, and borrowers (Pham et al., 2022;

Irاندoust, 2021; Islam et al., 2021; Majeed et al., 2021; El Menyari, 2019; Jeanluc & Muiruri, 2022; Aibai et al., 2019). Investors who hold their investments abroad with developed financial systems are assured of getting good financial services for routine business transactions and external financing needed (Krifa-Schneider et al., 2022; Pham et al., 2022; Islam et al., 2021). Foreign investors' financial needs are met if the host country has a developed financial system (Jeanluc & Muiruri, 2022; Aibai et al., 2019).

Recent studies on the FDI-financial development nexus have stressed the vital role of financial development in attracting inward FDI. Pham et al. (2022) noted that a well-developed financial sector influences more inward FDI flows. The well-developed financial sector positively and significantly impacts FDI inflows to the host countries (Lestari et al., 2022). Majeed et al. (2021) revealed that the impact of financial development on FDI involves other economic factors, such as trade openness and inflation. Emphasizing the crucial role of financial development in FDI attraction, Islam et al. (2021) regarded financial development as a symbol of trust and greatness in driving the attention of potential investors and a channel through which existing investors have allocated their valuable financial resources. The findings from the study by Islam et al. (2020) indicated a significant impact on FDI attraction being influenced by financial development. Bahri et al. (2018) examined the influence of financial development on FDI. They highlighted that financial development must grow to a certain level to exert its impact on inward FDI attraction. Other studies that have related financial development and FDI include (Samour et al., 2022; Shahbaz et al., 2022; Nguyen & Lee, 2021; Ahmad et al., 2020; Islam et al.,

2020; Aibai et al., 2019; Jeanluc & Muiruri, 2022; Cang & Alida, 2020; Irandoust, 2021).

The stability of FDI inflows to a particular country or region is based on a conducive investment environment created by an efficient, integrated, developed, and competitive financial sector. On top of that, the financial sector has to be built on quality and strong institutions (Krifa-Schneider et al., 2022; Pham et al., 2022; Majeed et al., 2021; Islam et al., 2021; Cang & Alida, 2020; Islam et al., 2020; El Menyari, 2019; Bahri et al., 2018; Nkoa, 2018). Also, the attraction for foreign investors in the form of FDI results from a pre-established good investment climate fostered by attractive policies such as investors' rights protection (Rao et al., 2020). Different theoretical and empirical studies have shown the crucial role played by financial sector development in stimulating investments for stable economic growth (Lestari et al., 2022; Krifa-Schneider et al., 2022; Pham et al., 2022; Islam et al., 2021; Liu et al., 2020; Khan et al., 2020; Sabir et al., 2019; Aibai et al., 2019; Pradhan et al., 2019).

Different studies reveal that the FDI-financial development linkage is mixed; Ngo et al. (2022), Shahbaz et al. (2021), Pham et al. (2022), and Saud et al. (2019) reported a bidirectional linkage between financial development and FDI. The implication is that financial development influences FDI, and FDI also impacts financial development. Contrary to their findings, Majeed et al. (2021) indicated a unidirectional relationship between the two economic sectors. Financial development is the one that influences FDI attraction in the reported

unidirectional relationship between the two (Bayar & Gavriletea, 2018). However, Lee et al. (2022) reported a negative FDI-financial development nexus. The findings are contrary to the majority of the reported results on the positive and significant impact of financial development on FDI (Pham et al., 2022; Lestari et al., 2022; Islam et al., 2021; Islam et al., 2020; Bahri et al., 2018; Aibai et al., 2019; Jeanluc & Muiruri, 2022; Cang & Alida, 2020; and Irandoust, 2021).

On the other hand, Gebrehiwot et al. (2016) could not establish relations between financial development and FDI using data sets from 1991 to 2013 for eight Sub-Saharan African (SSA) countries. Their study used Granger causality tests and two-stage least squares. Gebrehiwot et al. (2016) noted that discussions on FDI-financial development linkages are inconclusive. The study results did not provide any evidence of the impact of financial sector indicators on FDI. However, Sahin and Ege (2015) obtained mixed results for different countries on the relationship between the two sectors. Their study involved three countries (Bulgaria, Greece, and Turkey). Their results identified Bulgaria and Greece as having a unidirectional linkage between financial development and FDI, while Turkey showed a bidirectional linkage between financial development and FDI.

However, Hajilee and Al Nasser (2015) explained the bidirectional linkage between the two sectors and argued that financial sector development attracts foreign investors by creating a conducive investment environment. The more inflows of foreign investors and the establishment of investments under the FDI

mechanism expand the base of economic activities in the host countries and, in turn, push growth in the financial sector. Later on, Otchere et al. (2016) further explained the reason behind the bidirectional linkage between the two industries based on the impact of FDI on the host's economy. Otchere et al. postulated that FDIs are attracted to the host countries once the financial sector is developed. The effects of FDIs attracted to the economy create liquidity through the profits generated from the investments that led to financial development in the host countries.

The influence of FDI inflows on the host countries towards financial sector development occurs with other economic factors. While investigating the relationship between financial development and FDI, Pradhan et al. (2019) concluded that trade openness and FDI stimulate financial development. The study used a dataset from 1988 to 2013 for 19 Eurozone countries. The authors highlighted that strong financial development, economic growth, and trade openness contributed to the host countries' capacity to attract FDI inflows. In a later study by Pradhan et al. (2019) for G-20 countries, they narrated that more functional and efficient financial sectors create better chances for foreign investors to raise much-needed funds from the host countries to support their business growth and expansion.

The FDI flow pattern across borders depends on the financial sector development of the countries involved. The argument patterning, which country, either the host country or the domestic country of the foreign investors, should the financial

sector be developed to attract FDI flows, was investigated by Desbordes and Wei (2017) using data for 83 countries from 2003 to 2006 and 3919 companies. Their findings revealed that the source and host countries' financial sector development are essential for FDI inflows. They indicated that the more a source country's financial sector is developed, the more firms in those economies are motivated to carry out FDIs under mergers and acquisitions (M&A) arrangements.

Similarly, in examining the importance of the host country's financial development towards FDI attraction, Nkoa (2018) demonstrated that financial development is a key to attracting FDI inflows. The study employed the GMM model and data set from 1995 to 2015 for 52 African countries to examine the FDI determining factors. From the findings, it was argued that financial development plays an intermediation role for both domestic and foreign firms in accessing different financial services such as foreign exchange services, overdraft facilities, global trading systems, payment of workers' salaries, and deposit services regarding their investments in the host countries.

On the other hand, Irandoust (2021) examined the FDI-financial development relations using the bootstrap panel Granger causality method. The study used data from 1990 to 2016, covering eight post-communist countries. The study's findings revealed a unidirectional linkage between financial development and FDI. The explanation for the observed tendency is that financial development exerted an impact on FDI because of financial services received by foreign firms

from the host country's financial growth, in support of their investments. On top of that, the perception placed by foreign investors on a well-developed financial sector, patterning a strong regulatory set-up and good governance for protecting investors' rights, is a pillar that creates attractiveness for more FDI inflows to the host countries.

FDI flows across countries are also influenced by institutional quality. Pham et al. (2022) argued that institutional quality is the background for enhancing foreign investors' confidence. Quality institutions of the host country improve the products and services offered by local banks and stock markets to attract FDI inflows. Likewise, the display of institutional quality induces cross-border investments in the host countries because of the assurance of banking and stock market services. Aibai et al. (2019) expressed that countries with better institutional quality attract more FDI inflows, influenced by financial development. Pham et al. (2022) indicated that strong institutional quality minimizes investment risks in the host countries. Risk reduction stemming from quality institutions encourages banks and stock markets to improve the quality of their services and the range of financial products they offer to their customers to fulfil the expectations of diverse investors, including foreigners.

Moreover, Krifa-Schneider et al. (2022) reveal that investment-friendly factors form institutional quality. Best institutional quality enables host countries to create a conducive investment climate that attracts inward FDI (Otchere et al., 2016). Therefore, FDI-recipient countries with better institutional quality can control corruption, which hurts FDI inflows (Wang et al., 2020). When

corruption is controlled, other institutional quality variables, such as political stability and government effectiveness, prevail. Likewise, the rule of law should be adhered to protect investors' property rights.

On the other hand, Le et al. (2016) highlighted that financial development, a key factor for FDI attraction, is fostered by institutional quality prevailing in the host countries. As a result, institutional quality reduces market imperfections, promotes investments, and becomes a mechanism for monitoring economic and financial activities (Pham et al., 2022). The implication is that quality institutions create a conducive and fair competitive business environment for all domestic and foreign investors.

Mapendo et al. (2025) postulate that the participation of foreign investors in the host country's stock markets is contributed to by the influence of institutional quality within the economy in bringing about reforms that can accommodate investors' needs. Such reforms are aligned with operational competence, quality trading regulations, investor protection, and information disclosure. However, an increase in the level of FDI inflows to the host countries resulting from institutional quality leads to the development of the overall financial system and the expansion of their products and services (Otchere et al., 2016; Agbloyor et al., 2013). In line with earlier studies, Hajilee and Al Nasser (2015) highlighted that more attraction of FDI inflows results from financial sector reforms catalyzed by quality institutions.

Similarly, the findings from the study conducted by Pham et al. (2022) reported that the performance of banks and stock markets in influencing inward FDI flows is stimulated by institutional quality. The results support the earlier observation made by Law and Azman-Saini (2012). The impact of institutional quality on banks and stock markets development in exerting influence on FDI inflows stems from an effective legal system, motivation to participate in financial development, efficient financial regulations, and protection of investors' property rights. Consistently, quality institutions are revealed to be against corruption and enhance the safety of investors' rights (Le et al., 2016; Feng & Yu, 2021).

Contrary to the findings from other studies, Aluko and Ajayi (2018) noted an insignificant impact of institutional quality on the banking sector in Sub-Saharan African countries. The findings align with the prediction made by David et al. (2014). They argued that the influence of Institutional quality on the banking sector and overall financial development is weakened by low protection of property rights, weak regulations, and insufficient supervisory capacity. Given these institutional weaknesses, the banking system cannot be improved in developing countries. Unlike Aluko and Ajayi's findings, Pham et al. (2022) established a strong relationship between institutional quality and the development of stock markets. Similarly, Billmeier and Massa (2009) expressed that institutional quality increases stock market participation due to information transparency, protection of investors' interests, and less corruption.

In placing further emphasis, Rehman and Islam (2022) and Sabir et al. (2019) have strongly argued that the influence of banks and stock markets in attracting inward FDIs relies on institutional quality in strengthening infrastructures for this sector. The authors further indicated that improvements are required for the quality and quantity of financial products and services offered, including international trading services, payment systems, information disclosure, savings, and lending products. On top of that, Feng and Yu (2021) emphasized that stronger institutions improve banks and stock market infrastructures, which can accommodate the needs of foreign investors for more inward FDI flows to developing economies.

While demonstrating the crucial role of institutional quality in financial development, Lestari et al. (2022) noted that the future direction of FDI flows should be modelled on institutional quality and financial sector development. The opinion is that the focus of developing countries in attracting FDI to their economies should be based on the enforcement of institutional quality. The findings from the study by Lestari et al. are consistent with previous studies, which revealed that weak institutions harm both financial sector development and FDI (Islam et al., 2020; Feng & Yu, 2021).

However, Krifa-Schneider et al. (2022) expressed that developing countries are relaxing their rules to attract FDIs to their economies despite the low institutional quality they have in place. They warned that diluting the institutional quality standards cannot be a permanent solution for FDI attraction, but rather a

relatively temporary one. The only way for developing economies to create sustainable FDI inflow mechanisms and establish stable financial developments is through quality institutions and walking on the culture of institutional quality (Lestari et al., 2022; Krifa-Schneider et al., 2022; Zhang & Zhou, 2021; Nguyen et al., 2018; Yudaruddin, 2022).

Remarkably, Lestari et al. (2022) provided that institutional quality has to be a priority for each country wishing to attract FDI supported by financial sector development to their economy. This observation is consistent with earlier findings, which narrated that the ultimatum of host countries in attracting or deterring FDI inflows and financial sector development is vested in their national policies toward philosophical stance on institutional quality (Nguyen et al., 2018; Yudaruddin, 2022).

### **2.3.2 Institutional Quality and FDI**

The influence of institutional quality on attracting or deterring FDI was initially highlighted by Dunning (1980) in the eclectic paradigm theory. Subsequently, numerous researchers have addressed this issue, often illustrating that strong institutions in the host countries lead to higher FDI inflows (Islam et al., 2021; Sabir et al., 2019). Pham et al. (2022) noted that disparities in institutional quality across countries can serve as a basis for comparative advantage, as certain activities rely more heavily on institutional support, potentially resulting in increased trade and capital movements. In most cases, MNCs tend to leverage

the aforementioned comparative advantage of a specific country, thereby contributing to the expansion of FDI (Aibai et al., 2019).

The consensus across numerous empirical studies reveals that better institutional quality significantly boosts FDI inflows (Gupta et al., 2024). This holds especially in developed countries where measures such as control of corruption, government effectiveness, rule of law, political stability, regulatory quality, and voice and accountability are strong predictors of FDI (Ozekhome, 2022). In developing economies like EAC, these institutional factors may have a dual impact, either positive or negative, due to the structural fragility of institutions (Fengju & Wubishet, 2024).

Not all institutional dimensions are equally influential, and their relative importance varies by context (Kostova et al., 2020). For lower-income countries, corruption control, government effectiveness, and political stability stand out as compelling drivers of FDI, whereas the impact of rule of law, regulatory quality, and voice and accountability is more conditional, requiring high GDP per capita to become effective, rendering them more practical and effective in developed economies (Jena & Sethi, 2021). Regional and economic context thus shape which institutional components most matter (Rodríguez-Pose & Ketterer, 2020).

Recent contributions by Mapendo et al. (2025) add nuance by highlighting moderating mechanisms between stock market development, institutional quality, and FDI. Institutional improvements foster trade openness, industrial

development, and technological innovation, all of which in turn encourage FDI inflows (Wang et al., 2023). Moreover, financial development and natural resources abundance tend to amplify the institutional influence on FDI (Jahanger et al., 2022).

Temporal and threshold dynamics also play a role in determining the FDI pattern (An & Yeh, 2021). Before the 2008 Global Financial Crisis, institutional indicators broadly had a positive effect on FDI (Silva et al., 2021). However, post-crisis volatility attenuated their significance, suggesting that during crisis periods, institutional quality becomes less of a consideration for investors (Saleh, 2023). Similarly, several studies indicate that FDI only yields substantial growth benefits when host countries surpass a certain institutional quality threshold, particularly in the rule of law and property rights protections (Ozekhome, 2022).

The quality of institutions greatly influences the nature of business and FDI attraction as they establish the framework within which economic activities occur (Krifa-Schneider et al., 2022). The implication is that the host country's institutions play a crucial role in determining the location decisions of FDI. Similarly, Aibai et al. (2019) argue that countries aiming to attract more FDI should strive to create a favorable institutional environment, which includes factors such as government effectiveness, political stability, corruption prevention, protection of property rights, and reduced business uncertainty and risk. Additionally, Islam et al. (2021) stressed that higher institutional quality

indicates a more active and efficient consumer market in the country, leading to increased profitability of investment projects undertaken in that country.

However, inadequate institutional quality can hinder the flow of FDI as it risks investments and raises the costs associated with conducting business (Ashraf et al., 2022; Rao et al., 2020). Foreign investors perceive the absence of issues related to regulations, bureaucracy, judiciary, property rights, enforceable contracts, and performance and content requirements as favorable (Nguyen et al., 2018; Yudaruddin, 2022). Nevertheless, it is important to acknowledge that corruption, government ineffectiveness, and political instability are significantly more prevalent in emerging markets than in developed economies (Krifa-Schneider et al., 2022; Pham et al., 2022).

The flow of FDI to different locations across countries and markets involves risk assessment regarding the investment and the perpetual succession of the projects built on financial development and institutional quality in the host countries (Ross, 2019). The risks involved in choosing an appropriate FDI location in foreign markets are low information about foreign markets, the uncertainty of returns from their investments, and the low possibility of securing additional financing for the growth and expansion of their investments (Kurtović et al., 2020). Likewise, fear of an unfair competitive business environment, unpredictable political systems, and unreliable investment policies can be reversed anytime upon changes in political regimes (Sabir et al., 2019). All the uncertainties mentioned above lower investors' confidence, and potential

investors cannot even be attracted or build up the self-motivation to make cross-border investment decisions readily (Zou et al., 2022). In light of the need to increase host countries' attractiveness for FDI inflows, Ali et al. (2020) and Zhang and Zhou (2021) expressed the significance of linking the quality of institutions, financial development, and FDI attraction policies.

In developing the financial sector to attract investments from foreign investors in the form of FDI, the initiatives must be aligned with the institutional quality and investment policies of recipient economies put in place (Fon & Alon, 2022; Silajdzic & Mehic, 2022). Thus, financial development is influenced by formulated policies and adopted institutional quality practices (Ferrara & Sattler, 2018). On the other hand, weak financial systems, poor institutional quality, and bad investment policies characterized by inconsistencies and the possibility of short-term reversal deter FDI inflows (Bhasin & Garg, 2020; Carino, 2019). The underdeveloped financial sector results in the instability of financial asset prices, thereby increasing the risk of realizing the expected return from investment in those assets (Pham et al., 2022). The price stability of financial assets increases investors' confidence and reliability in the worthiness of such assets (Lestari et al., 2022). Any investor or reputable institution can invest or raise funds from the financial markets as they expect them to have low transaction costs, which is stimulated by quality institutions in the host countries (Hrnjic et al., 2019). A clear understanding of this relationship is paramount, given the importance of financial development and institutional quality toward FDI attraction (Islam et al., 2020).

### **2.3.3 Financial Development, Institutional Quality and FDI Linkage**

In East African countries, the relationship between financial development and FDI is heavily contingent on institutional quality due to persistent structural and governance challenges (Fengju & Wubishet, 2024). A recent study by Mapendo et al. (2025) focusing on Kenya, Tanzania, Uganda, and Rwanda reveals that while financial sectors in the region have expanded significantly through mobile banking and fintech innovations, their ability to attract and retain FDI remains limited without corresponding improvements in institutional governance. For example, improved financial access in Kenya has not consistently translated into higher FDI inflows due to concerns over judicial independence, regulatory enforcement, and political risk (Osuma et al., 2024). Fengju and Wubishet (2024) emphasize that in East Africa, institutional quality, measured through indicators like control of corruption, regulatory quality, and government effectiveness, plays a critical moderating role in ensuring that financial development creates a stable investment climate. Countries like Rwanda, which have made significant institutional reforms, demonstrate the need for quality institutions in catalyzing the role of financial development in attracting FDI inflows (Umutoniwase, 2023). This underscores the importance of tailored institutional reforms in the region to leverage financial sector advancement for fully sustainable FDI attraction.

Studies carried out in different economic regions with diverse levels of financial and economic development reveal that institutional quality significantly

moderates the financial development-FDI relationship (Islam et al., 2020; Pham et al., 2022; Majeed et al., 2021). In sub-Saharan Africa, for instance, Githaiga and Kilong'i (2023) and Appiah et al. (2024) highlight that institutional quality plays a more decisive role due to historically weaker governance structures and less mature financial markets. These studies find that improvements in institutional effectiveness, such as anti-corruption efforts and legal reforms, are crucial for financial development to translate into higher FDI inflows. In contrast, Almounsor and Mensi (2024) note that in high-income and upper-middle-income countries, where financial markets and institutions are relatively developed, institutional quality has a subtler but still statistically significant influence. Meanwhile, Ahmić and Isović (2023) demonstrate that in Eastern European economies, institutional reforms post-EU accession have considerably strengthened the link between financial development and FDI, suggesting that regional integration and harmonization with international standards amplify institutional effects. These geographic distinctions suggest that while institutional quality is universally relevant, its moderating impact varies based on local economic maturity, political history, and regional policy frameworks.

The review of literature reveals that numerous studies converge on the findings that institutional quality significantly enhances the positive impact of financial development on FDI inflows (Pham et al., 2022; Lestari et al., 2022; Islam et al., 2020). For instance, Majeed et al. (2021) and Aibai et al. (2019) demonstrate that well-functioning financial systems, coupled with strong institutions, create an enabling environment for foreign investors by reducing transaction costs, information asymmetries, and risks associated with policy unpredictability.

These studies used panel data across multiple countries and concluded that financial development is most effective in attracting FDI when accompanied by a stable rule of law, transparent regulatory frameworks, and effective governance. These consistent results suggest a complementary interaction where institutional quality acts as a catalyst in transforming financial development into tangible FDI gains.

Despite the prevailing consensus, some scholars challenge the moderating role of institutional quality. For example, Feulefack and Ngassam (2020) find that the impact of financial development on FDI is largely independent of institutional strength, especially in resource-rich or politically strategic economies where FDI is driven by natural resources or political considerations rather than institutional quality. Similarly, some empirical results in post-conflict or transitional economies suggest that FDI may be attracted by high returns, regardless of poor institutional frameworks (Moore, 2021). These contradictions point to the need for a more context-specific understanding of how institutional quality influences the finance-FDI nexus.

The inconsistencies in the literature often stem from methodological variations (Abaidoo & Agyapong, 2022), including the choice of proxies for financial development (banking sector, stock market, insurance, social schemes), institutional quality (corruption indices, rule of law, governance indicators), and estimation techniques (OLS, Fixed effects, FGLS, GMM). For instance, Sabir et al. (2019) used a different institutional index than Abdouli & Hammami (2020)

and reported divergent outcomes. The period covered and the heterogeneity across country samples (developed vs developing) also contribute to differences in findings. These methodological disparities raise questions about the comparability of results and underline the importance of robust, consistent measurement and modelling approaches.

Some studies, such as Majeed et al. (2021) and Lee et al. (2022), uncover a unidirectional causal relationship where financial development influences FDI, moderated by institutional quality, but not vice versa. For example, Irandoust (2021) applied Granger causality techniques and showed that financial development, when filtered through the lens of high institutional quality, drives FDI inflows. However, the reverse, that FDI drives financial development, is not supported in his model. This unidirectionality implies that institutional quality acts primarily to unlock the potential of financial systems in attracting FDI, rather than being transformed by the FDI itself.

Conversely, other studies argue for a bidirectional relationship, suggesting that FDI can enhance financial development through spillovers and technology transfer, and this interaction is further intensified by institutional quality (Shahbaz et al. 2021; Pham et al. 2022; Saud et al. 2019). Ngo et al. (2022) find that countries with robust institutional frameworks experience a reinforcing loop where financial development attracts FDI, which in turn strengthens financial institutions through demand for more sophisticated financial products. This

perspective positions institutional quality not just as a moderator but also as a facilitator of mutual reinforcement between FDI and financial development.

A minority of the literature posits no significant relationship between financial development and FDI, even when institutional quality is considered (Aluko and Ajayi, 2018). For example, the study by David et al. (2014) on the emerging markets suggests that institutional reforms and financial sector development have not translated into higher FDI inflows, possibly due to deeper structural issues such as infrastructure deficits, political instability, or macroeconomic volatility. This view is echoed by Rehman and Islam (2022), who argue that financial and institutional reforms in isolation are insufficient to attract FDI without broader economic transformation.

Despite variations, a robust strand of literature strongly supports the moderating role of institutional quality (Ashraf et al., 2022; Rao et al., 2020; Nguyen et al., 2018; Yudaruddin, 2022). Krifa-Schneider et al. (2022), using panel data and econometric models, show that institutional quality not only enhances the attractiveness of financial systems but also significantly reduces the risks faced by foreign investors. These findings are particularly compelling in regions such as East Asia and Eastern Europe, where improvements in institutional governance coincide with both financial development and sharp increases in FDI inflows. These results underscore the importance of institutional reforms as a strategic policy lever in maximizing the benefits of financial development for FDI attraction.

## **2.4 Research Gap in the Literature and Its Significance**

A comprehensive set of literature for the recent studies on FDI has focused on outward FDI flows aiming to seek the influence of home-based companies in foreign markets (Wang & Tao, 2023; da Silva-Oliveira et al., 2021; Dai et al., 2021; Chen et al., 2020; Ren et al., 2022; Tang & Buckley, 202) but little attention was given to FDI inflows which are essential sources of capital and financial sector development in emerging economies (Pham et al., 2022; Krifa-Schneider et al., 2022). Nevertheless, few studies have linked financial development and FDI inflows. Most prior studies have investigated the impact of FDI on economic growth and vice versa (Rao et al., 2023; Wei et al., 2022). According to the findings given by Islam et al. (2021), financial development is a fundamental aspect of FDI inflows, which is associated with economic growth in the host countries. Therefore, more research must be directed to investigate further the significance of linking financial development and FDI inflows to the recipient economies (Lestari et al., 2022). Thus, it is crucial to address this gap, particularly in developing countries where FDI flows are much needed as a backup source for financing development projects and enhancing financial and economic activities. This study, therefore, focuses on investigating the impact of financial development gauged by banking services and stock market size on the emerging economies of EAC.

According to Gomber et al. (2018), banking services are the channel through which investors are expected to get different financial services. The services include bank deposits, facilitation of local and international payments, and short-

and long-term financing. In other words, the sensitivity of banking services on the day-to-day activities in facilitating business transactions can raise foreign investors' motivation to locate their cross-border investments in a certain economy. Banks are also involved in the underwriting process while raising funds from the public through issuing shares and bonds, and in intermediation roles for collecting and disbursing investors' returns from dividend distribution. Similarly, according to Nkoa (2018), an economy with well-established stock markets creates liquidity in the market and dramatically attracts FDI inflows to the host countries. Islam et al. (2021) argued further that stock markets add value to the economy by improving the efficiency of financial systems. Therefore, given the importance of banking services and stock market operations in investment, the study investigates their role in FDI attraction in the regression model.

Literature has also paid little attention to the impact of institutional quality on FDI attraction, particularly in emerging economies. A scant number of studies have shown the relationship between institutional quality and influencing inward FDI (Aibai et al., 2019; Ismam et al., 2020; Pham et al., 2022). On the other hand, literature has acknowledged the existence of a direct association between institutional quality proxies and FDI (Rao et al., 2020). Accordingly, the level of investor protection is comparatively higher, with quality institutions prevailing in the FDI recipient economies (Ashraf et al., 2022). Hence, institutional quality practices in the host countries restrain foreign investors from being affected by corruption challenges, government inefficiency, and the political environment when acting on investment policies (Carino 2019). Thus,

based on the above findings, this study utilizes institutional quality indicators (corruption, government effectiveness, and political stability) to examine the impact of institutional quality on inward FDI attraction.

In addition, past studies have shown a significant impact on the relationship between institutional quality, financial development and FDI (Krifa-Schneider et al., 2022; Lestari et al., 2022; Pham et al., 2022). However, most studies have focused on relating institutional quality and FDI, leaving behind its relationship with financial development (Aibai et al., 2019). According to Islam et al. (2020), research on institutional quality and its effect on the relationship between financial development and FDI has yet to receive adequate empirical attention, especially in emerging economies, including EAC, under the study. Notably, most prior studies have addressed the impact of institutional quality on FDI using the institutional quality index. However, this study intends to examine the effects of individual, institutional quality proxies on FDI and the moderated function of the FDI-financial development nexus, similar to those of Islam et al. (2020) and Pharm et al. (2022). The study provides new evidence of a moderated role of institutional quality in the relationship between financial development and FDI in developing countries.

Furthermore, studies investigating the impact of financial development and institutional quality on FDI attraction are mostly limited to data from developed countries. Acknowledging likely differences with developing countries, such as cultural dimensions that affect financial sector development, institutional

environment, and economic and legal frameworks, are among the determining factors that influence the association between banking services, stock market operations, institutional quality, and FDI (Colonnelli & Prem, 2022; Wilhelms, 1998).

Consequently, the role of financial development and institutional quality on FDI attraction can vary according to country-level-specific factors (Majeed et al., 2021). For example, the concern over investor protection, institutional context and economic development differs between developed and developing countries, thus increasing the chances of dissimilar findings. Like other emerging countries, EAC has some challenges with economic growth patterns, less developed financial factors, and institutional quality practices, which adversely affect the investment climate. Therefore, this study focuses on data from EAC member states to establish evidence of the effect of financial development and institutional quality on FDI, with the moderated role of institutional quality proxies on the FDI-financial development nexus.

## **2.5 Research Hypothesis**

The FDI concept as a tool of economic growth and development, and how it affects the host country's economic environment, has been extensively discussed. This phenomenon has acquired attention from different parties, including researchers, policymakers, and even managers of international businesses (Barnard & Luiz, 2018). The role of FDI and factors influencing FDI stems from the diversity of theories on which FDI is built, as it involves the

theory of the firm, international capital market theory and international trade theory (Popovici & Călin, 2014). The FDI investment approach has been growing remarkably because of the advantages of diverse business locations, such as the existence of natural resources or artificial resources in the form of well-established infrastructure, skilled labour, and an attractive business environment (Dunning, 1973).

Foreign investors use the FDI strategy as their model of business across borders, driven by the motives of seeking resources, seeking strategic assets, seeking efficiency, and, on top of that, seeking markets (Krifa-Schneider et al., 2022; Kamal et al., 2019; Bahri et al., 2018). Likewise, different governments are found to set strategies and policies to attract FDI inflows to their countries or economic regions. FDI has been considered a primary strategy and cornerstone of economic growth at a national level or even for economic integrations such as the EAC covered in the study (Pradhan et al., 2019; Rao et al., 2020). The reason for FDI to be an essential and fundamental pillar for economic development is based on capital accumulation made by multiple foreign investors individually or through corporate arrangements (Pham et al., 2022).

The FDI tendency as a modern and practical approach to undertaking investments away from home to host countries has increased tremendously in recent years. The growth of FDI flows worldwide has been accompanied by a significant increase in the financial resources invested, reaching billions and trillions of dollars (UNCTAD, 2017). FDI inflows are the primary source of

investment flows and economic growth in emerging markets. This supports the propositions proposed by neoclassical, modernization, and endogenous growth theories, highlighting the crucial role of FDI for developing countries (Sabir et al., 2019). The FDI investment approach is consistent with the modernization theory, which suggests that economic growth and sound investment require substantial capital investment. Foreign investors usually facilitate this (Lee et al., 2022; Muhammad et al., 2020; Kilicarslan, 2019). The impact of FDI on emerging markets is positive and significant in boosting economic growth. It is associated with many benefits, such as technology transfer, relaxation of market conditions, infrastructure development, innovation, and managerial skills.

With the growing importance of FDI as an appropriate approach for foreign investors and emerging economies in boosting their economies and speeding up development, understanding this theme is inevitable. On this ground, the purpose of this study's overall objectives and focus is to investigate the impact exerted by financial development on FDI. The influence of financial development on the attraction of FDI leads to economic growth through the associated benefits that are grabbed by host countries when FDI inflows are attracted to their respective economies. The study utilizes nineteen (19) hypotheses to examine the FDI-financial development nexus. Also, the hypotheses involve the direct and moderating effects of institutional quality (corruption, government effectiveness, and political stability) on FDI and the FDI-financial development nexus. The hypotheses are classified into five categories covering direct and indirect relationships between the explained and explanatory variables.

### **2.5.1 Financial Development Relationship with FDI**

Usman et al. (2021) and Ji and Zhang (2019) assert that financial development and FDI are highly associated as they all get involved in speeding up economic growth. The prior belief is that a developed and well-functioning financial sector increases the host country's capacity to absorb the economic benefits of FDI inflows. This is achieved by maximizing the efficient allocation of investments (Chen et al., 2021). This assertion is consistent with the findings reported by Bayar et al. (2018), who noted that the financial sector must develop significantly to influence and facilitate FDI inflows to host countries. Likewise, Agyapong and Bedjabeng (2019) stressed that FDI is influenced by the development of the financial sector, thereby speeding up the rate and ability to capture the spillovers attached to FDI, including technology transfer, innovation, and economic growth.

The strong relationship between financial development and FDI is built on three significant aspects. First, financial development attracts FDI inflows, which increase fund availability in the economy, strengthening financial intermediation through banking services and stock market movement (Desbordes & Wei, 2017). Secondly, a developed financial market creates friendly market regulations, which, from a practical point of view, results in FDI attraction, thus strengthening the financial sector. Thirdly, a well-functioning financial system attracts FDIs because of its vitality of investment attraction, friendly market

environment, and trade openness (Sharma & Kautish, 2020; Otchere et al., 2016).

Developing the host country's domestic financial sector creates flexibility and alternative sources of financing needed for growth and expansion (Li et al., 2018). A well-developed and functional financial sector provides an avenue for foreign investors to undertake sound FDIs by getting access to borrow from the local markets through financial debt instruments (bond market) offered by the capital markets (Morrison, 2019). Accessing financing from the host country's financial development is advantageous to investors as it boosts their funding adequacy for investment and operational efficiency. The opinion is consistent with the argument put forward by Aibai et al. (2019), who noted that the efficiency of financial development resulting from financial sector development plays a vital role in attracting FDI to the host countries. Financial sector development lowers financial transaction costs, reduces investment risks in foreign countries, and simplifies access to financial resources. The developed financial sector supports MNEs in satisfying their investment financial requirements in case they need additional funding from money markets, bond markets, or stock markets (Juasrikul et al., 2018).

The flow of foreign capital for international investments and the banking sector is found to play a facilitation role in cross-border capital movement to the host countries (Zhen & Luu, 2020). Studying the role of the banking sector in international capital flows, Bailliu (2000) expressed that the domestic banking

system is an essential channel through which global capital flows to the host countries. Bailliu's study ignored the stock and bond markets, contrary to different studies recognizing the overall financial sector as a mechanism through which international capital can flow to host countries via the stock market, bond market, and banking sector (Rillo, 2018).

Donaubauer et al. (2020) revealed that financial development is a key sectoral aspect of creating an attractive investment environment for undertaking FDI operations by removing market distortions, facilitating knowledge transfer across firms, and creating a competitive edge. This opinion supported the argument made by Ferras-Hernandez and Nylund (2019) that the financial sector has a crucial role in FDI attraction as it is involved in speeding up innovation and technology advancement and its spillovers. The financial sector development helps foreign investors increase their business ventures by providing them with the financial support they need to expand and soften up their business operations (Zarrouk et al., 2021). Based on these arguments, it is hypothesized that.

H1: Financial development is positively related to FDI.

The banking system's efficiency in providing services is a channel through which investors are expected to get different financial services (Gomber et al., 2018). The services include bank deposits, facilitation of local and international payments, and short- and long-term financing. Banks are also involved in the underwriting process while raising funds from the public through issuing shares

and bonds, and in intermediation roles for collecting and disbursing investors' returns from dividend distribution. According to Pham et al. (2022), bank services facilitate savings from surplus spending units regarding deposit collections and make them available to deficit spending units regarding overdraft facilities and short-term and long-term bank loans. This means that banks' roles are to facilitate the productive use of financial resources by assisting net savers in channeling their funds to more profitable investments. Empirical studies carried out to examine the role of the banking sector in FDI attraction noted a significant impact exerted by banking services in influencing FDI inflows to the host countries (Tongurai & Vithessonthi, 2018; Sethi et al., 2020; Jena & Sethi, 2021). The observation is that the banking sector contributes to economic prosperity in developing countries. At the same time, Tongurai and Vithessonthi (2018) noted a negative relationship between banking sector development and agriculture in developed economies. Contrary to this finding, the positive impact of banking sector development has been indicated in enhancing FDI attraction through the acceleration of economic growth (Sethi et al., 2020; Jena & Sethi, 2021).

Qamruzzman and Wei (2019) pointed out that the development of the banking sector attracts FDI inflows as it assures foreign investors access to quality financial services. One of the aspects of the bank sector that can create investors' confidence is the level of assets held, as it forms the basis of financial resources available for extending credit to private investors (Anvarovich, 2022). The extent to which banks have a high level of assets is a symbol of liquidity, efficiency in providing services, lower transaction costs, and quick and short-

term service provision, accompanied by competitive foreign exchange services. On top of that, it indicates the availability of funds for smooth credit provision, which attracts foreign investors to invest in the host countries in the form of FDIs (Duffie, 2022). However, a weak, inefficient, and uncompetitive bank system characterized by illiquidity discourages foreign investors from flowing and making investments in such economies, thereby receiving low FDI inflows (Viktorov & Abramov, 2020). Thus, the influence of banking services on FDI inflows, particularly its level of assets held, forms the basis for hypothesis H1a.

H1a: Bank assets level is positively related to FDI.

According to Islam et al. (2020), banking sector development, which facilitates credit provision to the private sector, plays a significant role in attracting FDI inflows as foreign investors are convinced by access to finance, particularly additional funding, during the expansion of their investments in the host countries. Despite the crucial role of the banking sector's credit provision to the private sector in attracting FDIs, Islam et al. (2021) reported that credit to the private sector has been negatively associated with FDI in BRIC countries (Brazil, Russia, India, and China). This implies that more credit is provided to foreign investors as a sign of lowering their returns through compensation for the financing costs and loss of financial control. Hence, foreign investors are influenced by the low level of credit financing by the host countries' banking system to protect their profit margins from their investments in FDI projects. Credit offering to the private sector is a mechanism for risk sharing, and for that matter, it is essential for attracting investors, especially foreigners, for inward

FDI. A similar proposition was made by Nkoa (2018), who noted a significant positive impact of private credit on FDI inflows.

The examination of the determining factors for FDI inflows to the host countries reveals that bank sector development, currency appreciation, reduction of corporate tax rate, import tariffs, and reforms in the financial sector have significant and positive impacts on FDI inflows to the host country (Sadiq et al., 2021; Shafiq, 2021). The provision of credit to the private sector simplifies the need for additional capital during the growth and expansion stage. The emphasis on the pivotal role of bank credit to the private sector in attracting FDI inflows leads to hypothesis H1b.

H1b: Credit to the private sector is positively related to FDI.

The higher the value of stock traded in the stock market, the more foreign investors are attracted to invest in the economy in the form of FDI (Sabir et al., 2019). This indicates that the investors consider the market attractiveness for them to register, get listed, and trade their equity stocks. According to Nkoa (2018), an economy with well-established stock markets and the stock value being traded is significant; it creates liquidity in the market and dramatically attracts FDI inflows to the host countries. Performing stock markets adds value to the economy by improving the efficiency of financial development (Islam et al., 2021).

Aibai et al. (2019) noted the significant role of a well-developed and efficient stock market based on its stock value traded, as it influences the attraction of FDI to such economies. The attraction of FDI inflows to countries with performing stock markets is defined by the value traded, resulting from foreign investors (customers) demanding the products and services offered by such stock markets (Pham et al., 2022). The value of stock traded provides investment flexibility to the investors to hold or not to hold the stocks for future expectations, since investors can sell their shares and create liquidity or buy shares for future profit. The sensitivity of value traded in making the stock market attractive for inward FDI governs the development of hypothesis H1c.

H1c: Value traded is positively related to FDI.

High stock market capitalization reflects the liquidity and efficiency of the stock market and its contribution to financial development (Sharma & Bardhan, 2018; Pradhan et al., 2019). According to Pham et al. (2022), high stock market capitalization is a valuable tool for investors to assess the unsystematic risk affecting their return from an equity interest to realize the anticipated profit. Stock market capitalization is used to predict profit-making or loss-making stocks. In the case of loss-making stocks, the immediate financial advice on the investment is to sell them, while in the case of profit-making stocks, the decision is to keep or buy more for better expected future returns.

Omar et al. (2022) observed that high stock market capitalization indicates the performance of the stock market and the protection of investors' equity interest,

attracting FDI inflows to the host countries. Likewise, the argument Islam et al. (2021) put forward, patterning the impact of stock market capitalization is that the relationship between the two is positive. On top of that, the findings of Nkoa (2018) reported that when examining the impact of financial development on FDI for African countries, a positive relationship was found between stock market capitalization and FDI. These empirical arguments on the essential role of stock market size based on market capitalization in attracting FDI lead to hypothesis H1d.

H1d: Market capitalization is positively related to FDI.

### **2.5.2 Effect of Institutional Quality on FDI**

The study investigates the impact of different dimensions of institutional quality (IQ) on FDI. The institutional quality dimensions covered by this study (corruption, government effectiveness, and political stability) play a crucial role in attracting foreign investors and FDI at large (Ashraf et al., 2022; Islam et al., 2020). Attractive institutional qualities create efficient, integrated, competitive financial development. The quality attached to the institutions in the host countries provides a good investment environment that attracts foreign investors and projects in the form of FDIs (Aibai et al., 2019; Rao et al., 2020).

In creating a suitable investment climate that can attract foreign investors, the government has to promote financial development by setting up effective banking systems and well-functioning stock markets among the key initiatives (Krifa-Schneider et al., 2022). The government has a regulatory role in the

provision of quality services by creating strong and sustainable quality institutions, exercising good governance through political stability and accountability, reasonable regulations through government effectiveness, and enforcing the law through minimizing and ultimately eliminating corruption (Nguyen et al., 2018; Yudaruddin, 2022).

Countries with either solid or weak institutions and developed or underdeveloped financial sectors, as long as they are in economic transition, both benefit from all spill-over effects attached to FDI inflows (Ross, 2019). The reason behind equity in benefiting from FDI inflows is that countries with underdeveloped financial sectors, while in economic transition, depend more on FDI inflows for investment in their host countries than countries with developed financial systems and still in economic transition. Zou et al. (2022) highlighted that developing countries need capital for investments, and such capital is less costly when they receive inward FDI. Institutional quality is a crucial aspect of FDI attraction, and on this premise, hypothesis H2 is developed.

H2: Institutional quality is positively related to FDI.

Corruption negatively affects institutional quality by distorting the pattern of capital inflows and also affects FDI inflows to the host country (Lestari et al., 2022). Various literatures investigating the effects of corruption on FDI and financial development reveal that political environments, lack of good governance, lack of alternative sources of capital, need for regulatory reforms, and lack of quality institutions are the leading causes of corruption (Ali et al.,

2020; Zhang & Zhou, 2021; Lestari et al., 2022). The corruption growth rate is usually minimized by the rule of law, government effectiveness, and suitable governance structures (Khan et al., 2019; Islam et al., 2020). This argument enables the formulation of hypothesis H2a.

H2a: Corruption is negatively related to FDI.

Government effectiveness promotes financial sector development by creating a smooth banking and stock market operations environment. Since the government is involved in establishing policies and all economic development initiatives, it is in an excellent position to facilitate the development of the financial sector to attract investors and sound investments. In countries where government institutions are effective, a good investment climate prevails. This also entails the rate of FDI inflows attracted to the economy (Fon & Alon, 2022; Silajdzic & Mehic, 2022). Government effectiveness reflects the absence of excessive bureaucracy in the economy. Excessive bureaucracy is among the sources of corruption as it creates difficulties in accessing services, which pollutes the business environment, making it unattractive for investors, hence low FDI (Bhasin & Garg, 2020). Excessive bureaucracy is also created by changes in political regimes (Carino, 2019). The mixed views on the role of government effectiveness on FDI lead to hypothesis H2b.

H2b: Government effectiveness is positively related to FDI.

Political stability is critical for inward FDI attraction and financial sector development for individual countries and economic regions such as the EAC

(Olorogun, 2022; Alshamlan et al., 2021; Fernandez & Joseph, 2020). A suitable investment climate depends mainly on the political stability required for calm business operations for domestic and foreign investors and is essential in deciding on FDI locations in the host country (Dada & Abanikanda, 2020; Munjal et al., 2022). A conducive investment climate comprises quality institutions capable of controlling corruption, standing for accountability, insisting on the rule of law, and maintaining political stability. Likewise, these institutions ensure the effectiveness of government activities (Sabir et al., 2019). Quality institutions help the host country attract more FDI inflows (Aibai et al., 2019). Hypothesis H2c is developed to reflect the influence of political stability on FDI inflows.

H2c: Political stability is positively related to FDI.

### **2.5.3 The Moderating Effect of Corruption on the Relationship between Financial Development and FDI**

The perception of the existence of corruption in the economy has a significant impact on inward FDI flow (Bawole & Langnel, 2023). Corruption is perceived to exist in the economy where there is no enforcement of the law, no protection for investors' rights, and poor institutional quality (Islam et al., 2020). When the country's economy is characterized by a developed financial sector with quality institutions, the perceived rate of corruption is low, and investors' confidence is high (Kaidi et al., 2018; Khan et al., 2018; Khan et al., 2019). Countries with reasonable control of corruption due to quality institutions in place are found to

attract more foreign investors as they have promising financial developments that can absorb the needs of multiple investors when deciding on their FDI locations (Lestari et al., 2022). Reliability of the financial transactions and transparency play a pivotal role in developing the country's financial system (Islam et al., 2020). Because of this significant role, control of corruption and its perceived existence depend on quality institutions that can moderate these two sectors (Aibai et al., 2019).

Lower corruption level helps foreign investors hedge against investment risks (Pham et al., 2022). Scholars highlighted that corruption misleads investors to invest their financial resources in unproductive sectors (N'dri & Kakinaka, 2022; Chen et al., 2022). Consequently, the misallocation of these resources results in financial distress. Corruption and its impact deter inward FDI flows and shrink the financial sector (Pham et al., 2022; Song et al., 2021). Institutional quality is the only tool that can be used to mitigate the effects of corruption and limit the same from further deepening roots (Feng & Yu, 2021). Given this adverse impact of corruption on FDI inflows, the relation between the two is negative (Krifa-Schneider et al., 2022).

Lestari et al. (2022) elucidated that corruption's impact on financial development and FDI varies across countries, with negative and positive effects. The observation made by Krifa-Schneider et al. (2022) is that developed countries have a lower rate of corruption relative to developing economies. The reason behind this variation in corruption levels between developed and developing economies is institutional quality. Developed countries have more

vital institutions that adhere to regulatory systems than emerging economies (Wang et al., 2020). Fighting against corruption is critical for FDI attraction (Krifa-Schneider et al., 2022; Heo et al., 2020; Mauro et al., 2019). Countries free from corruption tend to attract more FDI under foreign investors' perceptions that the economies have a safe investment environment (Lestari et al., 2022). However, the high corruption level discourages investors and makes them hesitant towards the country's attractiveness for investment.

The location-based FDI theory postulates that for a country to gain location advantages for FDI attraction, it should have a well-developed financial sector supported by a low corruption level. Lestari et al. (2022) noted that, even if the country has a sound financial development system, the prevalence of corruption deters FDI inflows. Lestari et al. (2022) stressed that a country that is corruption-free with vibrant financial developments attracts inward FDI flows to the economy. On the other hand, Ali et al. (2020) reported a non-linear relationship between corruption, financial development, and FDI. These contradicting findings lead to hypothesis H3.

H3: Corruption moderates the relationship between financial development and FDI.

The level of banking assets used as reserves for operational and transactional requirements highly influences financial development, thereby impacting FDI inflows to the host countries (Donaubauer et al., 2020). The effect of corruption on financial development has the same magnitude on the banking sector,

particularly for its growth and attainment of high levels of assets (Lestari et al., 2022). The effects of corruption on bank performance render its efficiency in a devastating state, towards the capacity to meet customers' credit needs in doubt, discouraging foreign investors.

Banking sector development, its contribution to facilitating capital movement locally and internationally, and attracting domestic and foreign investments depend on the country's regulatory system (Fant et al., 2022; Liu et al., 2020; Sharma & Paramati, 2021). A country governed by law enforcement and strict anti-corruption policies has well-established financial developments since norms and culture are embedded in formulating financial policies, rules, and regulations (Lestari et al., 2022). When quality institutions are implemented, the positive relationship between financial development and FDI prevails as institutional quality already contains corruption (Bilir et al., 2019).

For a country to be better positioned to attract FDI inflows, establishing quality institutions is key (Islam et al., 2020; Khan et al., 2020). Corruption hurts financial development and FDI (Martins et al., 2020). It is essential to consider its effects when developing financial sector strategies to attract more FDIs to the host countries (Krifa-Schneider et al., 2022).

H3a: Corruption moderates the relationship between bank assets and FDI.

The development of the financial sector, including the banking system, depends on institutional quality (Zhang & Zhou, 2021). FDI attraction is influenced by the control of corruption through quality institutions so that FDIs can flow to the economy (Yudaruddin, 2022). Regardless of how the banking sector is developed, if the country has no mechanisms for controlling corruption, banks cannot provide credit to the private sector smoothly and equitably. This tendency of uncertainty of accessing financing from the host country's financial developments discourages foreign investors, leading to low FDI flows (Lestari et al., 2022).

According to Krifa-Schneider et al. (2022), financial development reflects the financial sector's capability to provide financing to investors through credit for their business growth. The financial sector development provides the funding needed by investors through banking services at a low cost. When the country has a system of controlling corruption, the provision of credit by banks to the private sector is made possible and efficient (Islam et al., 2020). Without corruption, the banking system becomes functional by providing quality services to investors (Sharma & Paramati, 2021). The quality of services banks offer to investors influences FDI inflows and reflects the host countries having a low level of corruption stemming from institutional quality (Liu et al., 2020; Aibai et al., 2019).

H3b: Corruption moderates the relationship between credit to the private sector and FDI.

The development of the financial sector in conjunction with stock market growth impacts FDI inflows (Krifa-Schneider et al., 2022). Well-developed stock markets are avenues for the provision of good services to investors in attracting FDI to the hosting economy. The efficiency of the stock markets in providing services to investors without corruption intervention increases investors' confidence and trust in the stocks traded (Liu et al., 2020). According to Sharma and Paramati (2021), the development of the stock markets encourages saving tendencies by surplus spending units, in which the saved financial resources can be invested in profitable securities traded in the stock exchange markets. When the economy is affected by corruption, the growth and performance of the stock markets cannot be achieved, and the stock value traded is low (Islam et al., 2020). The higher the value of the stock traded, the better it attracts investors since it symbolizes well-functioning performance (Islam et al., 2021). The existence of corruption negatively affects the stock markets and its influence on FDI (Krifa-Schneider et al., 2022).

H3c: Corruption moderates the relationship between value traded and FDI.

The higher the stock market capitalization, the higher the value the investors place on the stock markets in a given country, with a view to its liquidity and performance (Pradhan et al., 2019). Stock market capitalization positively influences FDI inflows, but when corruption occurs, the impact is negative (Islam et al., 2020). According to Pham et al. (2022), stock market capitalization assists investors in assessing the unsystematic risks affecting investment in stocks at a given time. Higher market capitalization contributes to the financial

development and attraction of FDIs (Bardhan, 2018). In an economy with corruption, the contribution of stock market capitalization in attracting FDI to the host country is withered by adverse effects of corruption on investors' rights (Krifa-Schneider et al., 2022; Islam et al., 2020).

H3d: Corruption moderates the relationship between market capitalization and FDI.

#### **2.5.4 The Moderating Effect of Government Effectiveness on the Relationship between Financial Development and FDI**

Government effectiveness is one of the key components of institutional quality. It plays a significant role in attracting FDI inflows to the host countries in the developing economies, resulting from less developed institutions, including the financial sector (Peres et al., 2018). In developing strategies and formulating policies while setting up initiatives for attracting FDI inflows to developing countries, government effectiveness is the precondition that has to be in place to minimize the challenges brought by excessive bureaucracy (Sabir et al., 2019). The institutional quality indicators are closely related, but government effectiveness influences the others (Karim et al., 2022; Barbier & Burgess, 2021). Different studies reveal that quality institutions have a positive impact on both economic development and FDI inflows (Aziz, 2022; Huang et al., 2022; Duodu & Baidoo, 2022; Khan et al., 2022; Van Bon, 2019; Hayat, 2019). The country with poor institutions experiences low FDI inflows. This indicates that weak institutions harm attracting FDI inflows to the host country (Beazer &

Blake, 2018). Foreign investors' confidence to carry out investment in host countries is found to be higher in countries where the government is stable. Since government effectiveness is an essential indicator of institutional quality and positively impacts FDI, it is used in the study to moderate the impact of financial development on FDI (Islam et al., 2020; Sabir et al., 2019).

The government's proper use of public funds reflects its effectiveness in controlling financial resources (Bani-Mustafa et al., 2022; Musau, 2022). Albassam (2022) opined that government effectiveness influences financial sector performance towards providing financial services. This results in economic development, solid financial developments, a conducive investment climate, and the attraction of foreign investors. The effectiveness of the government leads to control of corruption and inflation. These factors adversely affect the investment climate and discourage foreign investors, deterring inward FDI flows (Pham et al., 2022). When government effectiveness prevails in the economy, entrepreneurial activities promote growth in international trade and FDI flows (Fon & Alon, 2022; Farooq, 2022). This makes the government's effectiveness positively related to FDI inflows (Islam et al., 2020; Pham et al., 2022; Feng & Yu, 2021).

H4: Government effectiveness moderates the relationship between financial development and FDI.

Islam et al. (2020) observed that the moderating effect of government effectiveness on financial development positively influences FDI, although the

impact is not very strong. On the other hand, Sabir et al. (2019) revealed that the effects of government effectiveness on FDI attraction are higher in developed countries than in emerging economies. The rationale behind government effectiveness in having a diverse impact in attracting FDI inflows across different countries is based on institutional quality established in the developed economies relative to the emerging markets (Sabir et al., 2019). When the government is ineffective in having strong institutions, FDI inflows are low (Sabir et al., 2019).

The level of bank assets reflects its sectoral efficiency in providing quality services to investors in the economy (Tahir & Alam, 2020; Aibai et al., 2019). Koop and Hanretty (2018) indicated that government effectiveness captures the process of quality service provision in the economy by making the services required independent from political pressure. Through government effectiveness, financial development is strengthened, and the banking sector grows by offering quality services to the public. The central role played by the banking sector is intermediation, in which the collection of deposits in the form of savings is made, and such savings are lent to borrowers. The impact of government effectiveness in quality service provision is the same across countries regardless of income level (Sabir et al., 2019). Du & Zhang (2018) opined that government effectiveness attracts foreign investors more than policy uncertainty when investing their capital in host countries. Under government effectiveness and sufficient bank assets supported by quality services, more foreign investors will be attracted to invest in host countries in the form of FDI.

H4a: Government effectiveness moderates the relationship between bank assets and FDI.

Sabir et al. (2019) reported a positive and statistically significant impact exerted by government effectiveness in attracting FDI inflows. The relationship observed is powerful, implying that quality institutions matter for inward FDI flows. Privatization is deemed a key factor for government effectiveness, in which the more the financial sector is privatized, the higher the level of FDI inflows (Ofoeda et al., 2022; Olorogun et al., 2022; Lestari et al., 2022). Availing credit to the private sector is among the vital banking services that reveal the development of the financial system. As Kemoe and Lartey (2022) highlight, all the services provided to the economy are captured by government effectiveness. Hence, credit provision by banks to the private sector to facilitate FDI inflows is enhanced by government effectiveness. Likewise, government effectiveness is vital in the privatization process as it influences the flow of credit to the private sector and smoothens out investment platforms. Bank credit to the private sector is the measure of the financial sector development in facilitating funding availability to support the private sector investment regarding financial needs (Appiah-Otoo & Song, 2022). Certainty of credit to foreign investors becomes a catalyst for inward FDI attraction.

H4b: Government effectiveness moderates the relationship between credit to the private sector and FDI.

Jeanluc and Muiruri (2022) noted that stock value traded is essential in financial sector development. The authors elucidated that the stock value traded has a significant positive relationship with FDI inflows. The influence of the stock value traded in the economy creates financial market liquidity, increasing investors' confidence and attraction to FDIs. Stock value traded positively impacts inward FDI flows in developed countries (Jeanluc & Muiruri, 2022). However, in the same study, Jeanluc and Muiruri (2022) failed to establish a relationship between stock value traded and FDI inflows for developing countries.

Despite the crucial role of stock markets in attracting inward FDI to host countries observed in developed economies, the situation can be different for emerging markets because of multiple factors stemming from the development status of these markets. First, the stock markets in emerging economies are less significant in attracting FDI due to their small size and liquidity constraints compared to those in developed economies, which create challenges for foreign investors to enter smoothly and consequently reduce the attractiveness of FDI. Secondly, emerging economies may have less developed regulatory frameworks and transparency standards for their stock markets, making them less robust, which in turn deters foreign investors who prioritize stability and predictability in the investment environment. Thirdly, emerging markets are generally perceived to have higher risks due to political instability, currency volatility, and shallowly grounded legal systems, which increase the perceived risk premium for investing in stocks in these markets, thereby discouraging FDI inflows.

Other factors that make stock markets in emerging economies less attractive to foreign investors compared to developed markets include market efficiency, which could lead to inefficient price discovery; market infrastructure, which may pose challenges to the trading platforms, settlement systems and intermediation process; lack of alternative investment avenues, and currency risk where fluctuations in the local currency can affect returns for foreign investors when repatriating funds. Despite the challenges facing the stock markets in emerging economies, government effectiveness strengthens the services provided to the public, which can also be seen through the high value of stocks traded. Consequently, the moderating effect of government effectiveness on the two sectors reveals a positive influence of stock value traded on FDI (Islam et al., 2020). Governments and market regulators in these economies continuously implement reforms to improve market transparency, investor protection, and operational efficiency to attract more FDI through stock markets over time.

H4c: Government effectiveness moderates the relationship between value traded and FDI.

The moderating effect of government effectiveness positively impacts FDI (Islam et al., 2020). The efficiency of the government through the established institutions increases the stock market services (Purewal & Haini, 2022). The stock market capitalization reflects the performance of the capital markets and the financial development in general (Omodero, 2020; Garcia et al., 2019). The author expressed that stock market capitalization is an appropriate measure of

the availability of financing in the economy. Government effectiveness creates a conducive environment for stock market activities (Ali & Ramakrishnan, 2022). A host country with an effective government attracts more foreign investors since the stock market capitalization level reflects the stock market's ability to mobilize funds for investments through interaction with the market participants (Pham et al., 2022).

H4d: Government effectiveness moderates the relationship between market capitalization and FDI.

### **2.5.5 The Moderating Effect of Political Stability on the Relationship between Financial Development and FDI**

Political stability has an influence on FDI inflows to the host countries since the government is in control of the political pressure (Forte & Abreu, 2022; Farooq et al., 2022). This is a sign of government effectiveness in creating a conducive investment climate by encouraging investors to locate their investments in their countries (Othman, 2022; Nkansah-Dwamena & Yoon, 2022; Nhung & Quang, 2022; Ramasamy & Yeung, 2022). Foreign investors are more confident to invest in countries with political stability characterized by a stable government, as there is no possibility of sudden change or reversal in foreign and local investment policies (Sabir et al., 2019). Politically stable countries are found to be suitable locations for FDI by foreign investors since democracy is assumed to prevail in such countries. In such countries, the reliability and transparency of transactions are high, thereby rendering less fear to foreign investors (Simbi et al., 2022; Burchill et al., 2022). Wilhelms (1998) argued the importance of

political stability when developing the institutional FDI fitness theory, noting it to be one of the preconditions when deciding where to locate FDI in the host country. Politically stable countries simplify the risk and return analysis to be carried out by the investor during the assessment of the viability of the investment in the foreign markets (Wang et al., 2022). Based on the empirical findings, Sabir et al. (2019) reported on the positive significant relationship between political stability and FDI inflows. The study intends to use the same to moderate the impact of financial development on FDI.

Political stability is instrumental in financial development (Khan et al., 2022). Political stability creates competitive markets where all interested investors can interact freely under fair treatment. Political stability accelerates financial development, improving the business environment for FDI attraction (Muye & Muye, 2017). Aibai et al. (2019) revealed that political stability is essential for attracting FDI and utilizing the benefits of FDI. On top of that, Irandoust (2021) stressed that political stability is the most critical location-specific advantage for FDI attraction. Given its economic impact, political stability and FDI are positively related (Islam et al., 2020; Kaufmann et al., 2011; Aibai et al., 2019).

H5: Political stability moderates the relationship between financial development dimensions and FDI.

Political stability is an essential factor in developing a conducive investment climate. Pham et al. (2022) and Islam et al. (2020) expressed that political stability results from quality institutions. Political stability builds up a well-

ordered society, which is one of the critical location advantages when foreign investors decide where to locate their investments in host countries. Islam et al. (2020) postulated that political stability enhances government stability, socioeconomic conditions, and investment profile. All these factors contribute to inward FDI attraction. The moderating role of political stability on the relationship between bank assets and FDI is significantly positive (Pham et al., 2022; Islam et al., 2020).

H5a: Political stability moderates the relationship between bank assets and FDI.

Political stability is built on better institutional quality, making host countries attractive for FDI inflows (Pham et al., 2022). Otchere et al. (2016) elucidated that political stability fosters FDI inflows to the host countries by ameliorating the investment climate. This is achieved through attractive economic policies, enforcement of contracts, protection of property rights, and an improved regulatory environment. Political stability strengthens the market's competitive position for all investors. The moderating role of political stability on bank credit to the private sector positively impacts FDI inflows as investors become confident in the financial developments (Pham et al., 2022; Islam et al., 2021; Islam et al., 2020).

H5b: Political stability moderates the relationship between credit to the private sector and FDI.

Audi et al. (2022). Khan et al. (2022) and Mertzanis and Allam (2018) indicated that political stability is the basis for legal stability and the performance of the

stock markets. Investors are motivated to invest in a stable legal environment (Islam et al., 2021). Political stability has been revealed to increase capital inflows across the border and enhance trade (Li et al., 2021; Anthony-Orji, 2018). The authors further argued that stock value traded contributes to FDI inflows in host countries where political stability exists. The moderating effect of political stability on stock value traded has a significant positive impact on FDI inflows (Islam et al., 2020; Pham et al., 2022; Sabir et al., 2019; Islam et al., 2021; Irandoust, 2021).

H5c: Political stability moderates the relationship between value traded and FDI.

Bahri et al. (2018) noted that political stability increases freedom in the capital markets. Consequently, capital markets influence FDI inflows by increasing the flow of financial capital. Political stability strengthens the ability of inward attraction of FDIs to the host countries and widens the loops for benefiting from FDIs received (Aibai et al., 2019). In host countries with political stability, the local markets and international interactions function properly (Krifa-Schneider et al., 2022). Functional markets are crucial location advantages for FDI attraction (Islam et al., 2020; Krifa-Schneider et al., 2022). The moderating role of political stability on stock market capitalization has a positive impact on inward FDI flows (Irandoust, 2021; Islam et al., 2020; Pham et al., 2022; Sabir et al., 2019; Islam et al., 2021).

H5d: Political stability moderates the relationship between market capitalization and FDI.

## **2.6 The Conceptual Framework**

This section provides the suggested conceptual framework for the study. The set-up of this conceptual framework is based on the pieces of literature reviewed from past empirical studies and the theoretical underpinnings conceptualizing the FDI phenomena. Generally, the focus is on investigating whether financial sector development impacts inward FDI flows to the host countries and, in this case, the EAC countries from the emerging economies.

The study employs developments of integrating theoretical rationale and empirical underpinnings when setting up the conceptual framework, which provides guidance and a roadmap in giving proper direction for the ongoing study. The study utilizes the institutional FDI fitness theory to examine the impact of financial development on FDI. The theory considers the role of quality institutions. Likewise, overall location advantages of the host countries are identified as preconditions for foreign investors when deciding where to locate their investments (Wilhelms, 1998).

The relationship between financial development and FDI can be adequately explained using the framework proposed by Ezeoha and Cattaneo (2012), Agbloyor et al. (2013), Otchere et al. (2016), and Ho and Gan (2021). The model is appropriate for studying the long-run linear relationship between financial development and FDI (Nguyen & Cieřlik, 2021). This model addresses financial development's impact on FDI and its role in facilitating international capital flow to the host countries.

The development of the financial sector in the host countries is structured under market fitness. Likewise, institutional quality is a significant location advantage for both FDI and financial sector development (Krifa-Schneider et al., 2022; Lestari et al., 2022). In conjunction with other conceptual underpinnings, the institutional FDI fitness theory is relevant in describing and conceptualizing the FDI phenomenon. Therefore, the proposed conceptual framework is embedded in previous studies' theoretical rationale and empirical analytics.

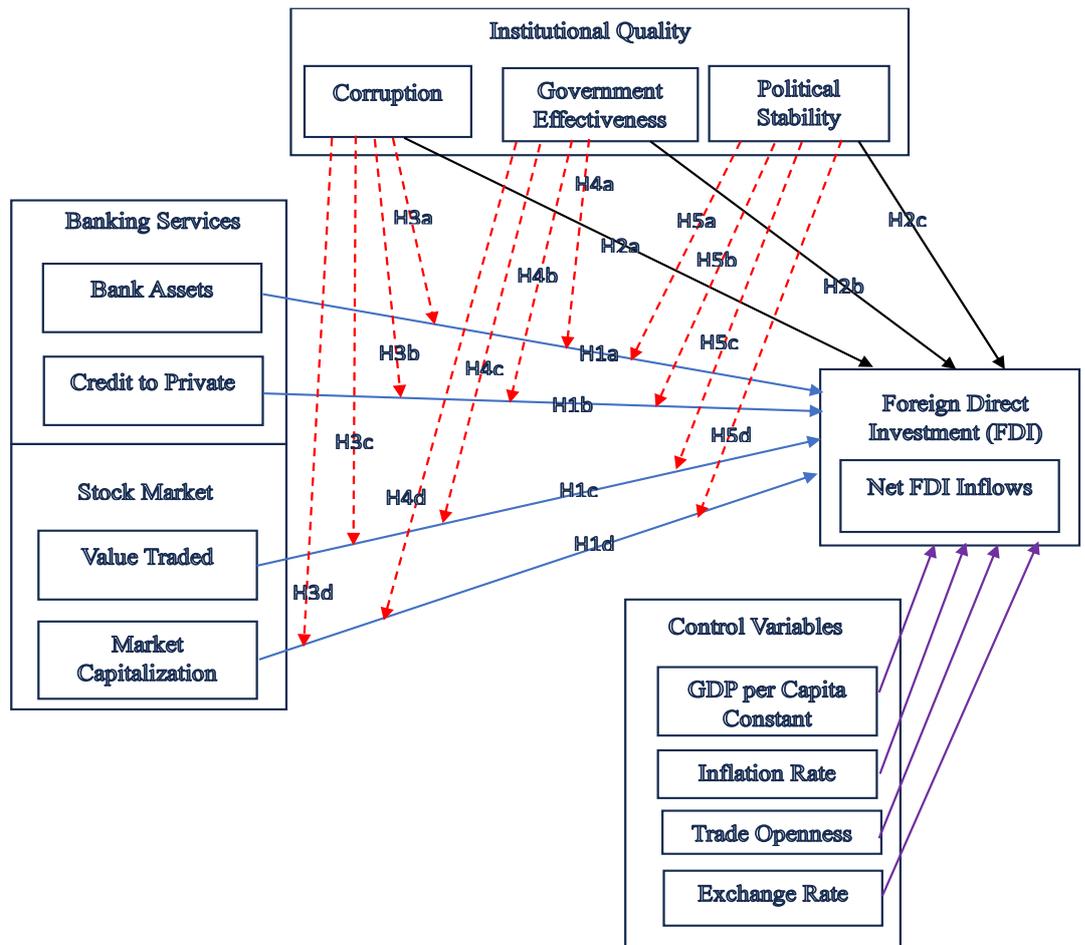
Most previous researchers on the FDI concept have considered only banking sector proxies and ignored the broad aspect of financial development (Anton & Nucu, 2020). Contrary to the earlier studies, the study uses banking and stock market proxies to capture a broader scope of the financial sector. Likewise, bank assets, value traded, and market capitalization variables can be added to the institutional FDI fitness theory on capital market fitness to accommodate all the model components.

The proposed conceptual framework considers the positive relationship between financial sector development and its impact on FDI, as supported by theories and past empirical studies. Most of the studies on financial development that have examined its effects on FDI have reported a significant positive relationship in attracting FDI to the host countries by increasing the absorption rate and capacity for foreign investments (Lee et al., 2022; Samour et al., 2022; Islam et al., 2020). Financial development is significant when focusing on FDI in such a way that

FDI and its associated spillover benefits start flowing in the host countries only when the financial development reaches a certain minimum level (Shahbaz et al., 2021; Lee et al., 2022; Nguyen & Lee, 2021; Nasir et al., 2019). Due to the crucial role played by financial sector development in influencing FDI inflows to host countries, economies with underdeveloped financial systems cannot wholly reap the FDI benefits because of market shallowness (Magbondé & Konté, 2022).

Financial development is a prerequisite condition to be in place when formulating FDI policies. Financial sector development is the channel through which foreign capital is directed for investment in host countries. The host country's financial sector development makes it an attractive environment for FDI inflows and facilitates the host country to grab the FDI economic benefits (Islam et al., 2020). Based on theories and propositions and a growing body of related literature, the study attempts to investigate the direct and moderating effects of institutional quality on the impact of financial development on FDI. The suggested conceptual framework for the study is presented below.

Figure 2. 4: The conceptual framework



Source: Author's construct

## **CHAPTER THREE**

### **3.0 RESEARCH METHODOLOGY**

#### **3.1 Introduction**

This quantitative research aims to conceptualize FDI phenomena by examining the role of financial development on FDI attraction, which is an essential sector for economic growth and sustainable development in East African countries. It also examines the moderating effect of institutional quality (corruption, government effectiveness, and political stability) on the FDI-financial development nexus. Moreover, the study uses the institutional FDI fitness theory to investigate the influence of financial development, moderated by institutional quality, on FDI inflows to EAC. This study employs panel data from four (4) EAC countries from 1995 to 2020.

Studies on financial development and FDI relations have been conducted more in higher-income countries than in emerging markets, including the EAC. Most of the studies on financial development have concentrated on economic growth rather than FDI. So, few empirical studies link FDI and financial development, and the institutional quality's moderating effect has not yet gained the appropriate attention. Low FDI inflows to developing countries result from weak institutions, as institutional quality plays a significant role in business interaction. Higher institutional quality promotes international trade and FDI for

developing countries. In EAC and its partner states, studies on FDI linked with financial development have received insufficient attention. This allows the study to examine the relationship between financial development, institutional quality, and FDI, which will further contribute to the limited literature on this sphere.

### **3.2 Research Design**

The study is based on scientific research seeking to obtain an objective understanding using scientific inquiry methods. The study employs quantitative research to examine the relationship between financial development variables (bank assets, bank credit to private, value traded, market capitalization), institutional quality (corruption, government effectiveness, political stability), and FDI. The relationship between financial development, institutional quality, and FDI has been examined in previous years by scholars in different economies (developed and emerging) and in various parts of the world. Most of the earlier studies that investigated this phenomenon used a quantitative research method rather than a qualitative approach. Utilizing a quantitative research approach in this study enriches previous studies by increasing the representativeness of the approach and the power of generalization.

The study used panel data to examine the influence of financial development on FDI. The data employed in this study were collected from the World Development Indicators (WDI), the World Governance Index (WGI), and the stock markets of EAC partner states. The use of panel data aims to minimise, if

not eliminate, the econometric limitations and assumptions inherent in the cross-sectional approach.

The study period is from 1995 to 2020. The chosen period fits the study's expectations because it captures a broader EAC with more member states than the traditionally known EAC of three countries (the United Republic of Tanzania, Kenya, and Uganda). During this period, the EAC expanded by welcoming new member states like Rwanda, Burundi, South Sudan, and the Democratic Republic of Congo. From 1995 to 2020, the EAC financial sector went through remarkable development, such as implementing the stock market automated trading system and the growth of the banking sector. The automation of stock trading symbolized some development in the financial sector.

The scope of this study is EAC partner states; however, South Sudan is not included because of data challenges arising from gaining its independence from the Sudan Republic in recent years. Likewise, Burundi and the DRC are omitted because they don't have stock markets in their economies. The study has confined its scope to the EAC because of the challenges facing this economic region, thereby hindering FDI inflows. The challenges facing EAC include high financing costs, limited credit to the private sector, narrow stock markets with fewer products, inactive stock market operations with few participants, and low volume of intra-regional trade. These challenges affect financial sector development. Similarly, EAC has been the scope of the study because of the challenges stemming from poor institutional quality, such as excessive bureaucracy in service provision, corruption, and political instability. All these

challenges arising from financial development and weak institutions combined deter FDI inflows.

The relationship between financial development and FDI has been studied by different researchers using different methodological approaches. The variation in methodological aspects has been one of the reasons for arriving at different research findings and conclusions. Some studies have used the static panel method (fixed effects and random effects techniques), while others have employed OLS. Some studies also used the ARDL method. Surprisingly, different studies involving panel data and meeting the appropriate conditions, including  $N > T$ , have employed the GMM method, indicating its preference and superiority for predicting the relationship and consistency of the reported findings. However, FGLS-Parks and PCSE are used for panel data when the conditions are such that  $N < T$  and  $T/N$  is greater than or equal to 1.5 ( $N < T$ ;  $T/N \geq 1.5$ ) to produce efficient coefficient estimates and accurate confidence intervals for hypothesis testing.

Table 3.1: Past studies' methodology on financial development and FDI

S/N	Authors	Estimation methods	Variables
1	Kumari and Sharma (2017)	Static panel	Determinants of FDI Financial reforms and FDI determinants
2	Rjoub et al. (2017).	Static panel	Political, macroeconomic, and institutional factors of FDI
3	Yimer (2017)	ARDL	
4	Bahri et al. (2018).	Fully Modified Ordinary Least Squares (FMOLS)	The role of financial development on FDI
5	Nkoa (2018)	GMM	Impact of financial development on FDI

6	Pradhan et al. (2018)	Static ARDL	Financial development, FDI, and control variables
7	Saini and Singhania (2018)	GMM	FDI determinants
8	Sirag et al. (2018).	OLS and DOLS	FDI, financial development, and economic growth
9	Moundigbaye et al. (2018)	FGLS-Parks and PCSE	Which panel data should I use?
10	Aibai et al. (2019)	GMM	Impact of financial development on FDI
11	Jeanluc and Muiruri (2022)	OLS	The Impact of Financial Market Development on FDI
12	Nasir et al. (2019).	OLS, DOLS, and FMOLS	FDI, financial development, economic growth, and climate
13	Abdouli and Hammami (2020)	Simultaneous equation models	FDI, financial development, economic growth, and the environment
14	Cang and Alida (2020)	ARDL	The Impact of Financial Institution Development on FDI
15	Canh et al. (2020)	2SLS panel estimation	Uncertainty and FDI
16	Islam et al. (2020).	GMM	Financial Development and Foreign Direct Investment
17	Kurtovi'c et al. (2020)	GMM	FDI determinants
18	Ta, sdemir (2020)	Static panel	FDI determinants
19	Moundigbaye et al. (2020)	FGLS-Parks and PCSE	Bootstrap methods for inference in the Parks model
20	Irاندoust (2021)	The bootstrap panel Granger causality	FDI and financial development
21	Majeed et al. (2021).	Feasible Generalized Least Squares (FGLS)	The Impact of Foreign Direct Investment on Financial Development
22	Nguyen and Lee (2021)	GMM	FDI inflow, financial development, and uncertainty
23	Shahbaz et al. (2021)	ARDL	FDI determinants, financial development, transport infrastructure, education, and consumption
24	Smith (2021)	ARDL	FDI inflow, financial development, and uncertainty

25	Mkombe et al. (2021).	FGLS-Parks and PCSE	The effects of FDI on youth unemployment
26	Asamoah et al. (2022).	GMM	FDI, uncertainty, and financial development
27	Haque et al. (2022).	Panel ARDL	Sources of Financial Development and Their Impact on FDI Inflow
28	Krifa-Schneider et al (2022)	GMM	FDI, corruption and financial development around the world
29	Lestari et al (2022).	GMM	The impact of financial development and corruption on FDI
30	Pham et al. (2022).	GMM	Financial Development and FDI

**Source:** Author's compilation

FGLS-Parks and PCSE estimators are applied in this study to tackle the unobserved heterogeneity problems that cannot be controlled by OLS and traditional fixed effects to produce consistent and unbiased results. The unobserved heterogeneity occurs when country-specific characteristics correlate with the endogenous regressors, affecting FDI inflows. Country-specific characteristics include economic development and investment policies, which impact FDI inflows.

The FGLS-Parks and PCSE estimators are superior in controlling dynamic endogeneity, simultaneity, and unobserved heterogeneity when the conditions for panel data are aligned in such a way that  $N < T$  and  $T/N$  is greater than or equal to 1.5 ( $N < T$ ;  $T/N \geq 1.5$ ), making them most preferred than other panel data analysis models. Thus, the study employs the FGLS-Parks and PCSE estimators

to achieve its objectives by producing precise, consistent, unbiased results that can be generalized. Further descriptions for FGLS-Parks and PCSE estimators are provided in section 3.4.2.

### **3.3 Measurement of Variables**

This section comprehensively describes the measurements for FDI, financial development, institutional quality, and the control variables. Financial development is gauged by the banking sector, which is part of financial institutions and the stock market, which is part of financial markets.

The study employs FDI inflows as a dependent variable. The appropriate and common measure of FDI is the net FDI inflows (Wilhelms, 1998; Nguyen & Lee, 2021). The study uses net FDI inflows as a predominant measure of FDI inflows, as suggested by previous scholars and in the institutional FDI fitness theory (Wilhelms, 1998). The use of net FDI inflows to measure the amount of FDI received in a particular host country has dominated most studies.

Net FDI inflows are considered the best measure of FDI inflows because they are consistent with the definition of FDI inflows. FDI net inflows to the hosting economy are the appropriate measure since they cover various cash flow aspects involving incoming fresh investments, reinvestment of earnings from ongoing investments, net repatriation of capital, intra-company loans, repayment of loans, and purchase of the interest of existing firms in the form of Mergers and Acquisitions (M&A).

The independent variables used in the study are accommodated under a more comprehensive scope termed financial development. Financial development has a broader measurement aspect because of its importance in economic development. World Bank suggests that financial development can be measured based on different categories such as access, depth, soundness, and size of the financial development. Likewise, financial development can be estimated based on the country's financial development performance regarding service provision. The broader and more efficient the financial services provided, the higher and more robust the country's financial development degree.

Heaton et al. (2022) asserted that measuring financial development requires flexible rather than rigid measures, which can result in misleading results. The banking sector is one of the most flexible and essential dimensions in measuring financial development. Most countries trying to create a conducive investment environment rely on the banking sector because of its intermediary role of linking the savers and borrowers (Allen et al., 2019).

Stock markets play a significant role in the economy by bringing together buyers and sellers of financial assets in the interaction between surplus spending units (SSUs) and deficit spending units (DSUs). Stock markets, therefore, are vital sources for companies to generate funds for business purposes (Roy et al., 2022; Sadiq et al., 2022). The measure for financial development is based on the banking sector and stock markets.

For the banking sector, the study uses two indicators: bank assets over GDP and bank credit to the private sector over GDP. These indicators have been previously used in different studies (Kellard et al., 2022; Nyasha et al., 2022). The ratio of bank assets to GDP reflects the whole level of banking sector development relative to the economy (Huljak et al., 2022; Mansour et al., 2022). This indicator reflects the savings available in the economy and readiness to deposit them for accessible bank intermediation services between the savers and borrowers.

The bank credit to private sector ratio to GDP is a handy indicator of the financial sector development in reflecting the domestic and foreign services offered to the investors. The isolation of credit to the private sector makes it a precise measure of the financial sector development in facilitating funding availability to support the private sector investment regarding financial needs for growth and expansion (Li & Zhang, 2022; Thathsarani et al., 2021). Bank credit to the private sector is extensively used as the leading indicator for measuring financial sector development (Jena & Sethi, 2021; Anyanwu et al., 2018).

Pham et al. (2022) argued that bank credit to the private sector is highly employed as a primary financial development proxy because bank credit is the fundamental source of financing investments in developing economies (Jena & Sethi, 2021). Second, the private sector allocates funds objectively to more profitable investments for wealth maximization than the public sector (Anyanwu

et al., 2018). Third, bank credit indicates the ability of the financial sector to attract savings and allocate them to the most productive economic activities (Anvarovich, 2022; Turyakia et al., 2022).

The ratio of liquid liabilities to GDP cannot be used because of data challenges. The results are not affected based on Kagochi (2019), who noted that the liquid liabilities indicator does not provide a closely related reflection between financial sector development and services, such as information processing and risk management. Since the study focuses on the impact of financial development on FDI inflows, risk and information aspects are vital to investors, especially foreigners with little insight into host countries' markets. Such information is captured by the bank assets proxy and bank credit to the private sector.

Concerning stock market size, the study used two indicators, stock market capitalization over GDP and stock value traded over GDP, which have been commonly used. Different studies (Pham et al., 2022; Sharma & Bardhan, 2018; Pradhan et al., 2019) have used these indicators.

Stock value traded measures the stock market's liquidity (Pham et al., 2022). The stock value traded reflects investors' ability to purchase new shares or sell shares held and make profits for a more competitive and liquid market. The value traded shows the value of domestic shares transacted in the stock exchange (Saliya, 2022; Thaddeus et al., 2022). Stock value traded captures the volume of

domestic trading, reflecting the economy's liquidity (Chen et al., 2022; Ngene & Mungai, 2022). Stock value traded complements the market capitalization as it provides a broader picture of the market size by the volume of transactions carried out (Omar et al., 2022; Adjasi et al., 2022). In a study, Pham et al. (2022) indicated that the stock value traded reflects the stock market liquidity. In that case, it is superior to other stock market measures.

On the other hand, stock market capitalization has been used severely as an essential and appropriate component to measure financial sector development (Bibi et al., 2022; Inderst, 2021). The justification for using this indicator is that stock market capitalization is an appropriate measure of the availability of financing in the economy. Pham et al. (2022) indicated that stock market capitalization reflects the ability of the stock markets to mobilize funds for investments through the interaction of the market participants. Previous studies used stock market capitalization to measure stock market development (Nargunam & Lahiri, 2022; Jeanluc & Muiruri, 2022).

Moderating variables were employed in this study to strengthen the relationship between financial development and FDI. The moderators can also change the direction of financial development proxies towards FDI (Busenbark et al., 2022). These variables play a role in identifying whether different financial development variables employed in the study have the same relations with FDI. The moderating variables under this study are enveloped in a general term known as Institutional Quality.

First, the study uses institutional quality proxies for the moderation role to acknowledge the complexity that exists in the relationship between financial development and FDI (Khan et al., 2022; Wang & Anwar, 2022). Economic factors at the microeconomic and macroeconomic levels influence both variables, financial development and FDI. This complicates the relationship between the two economic sectors (Islam et al., 2020; Aibai et al., 2019).

Second, institutional quality increases the power of generalizing the results by maintaining the consistency of the relations and checking for any manipulation of unobserved interactions. Consequently, the moderators improve the results' accuracy and enhance the validity of the arrived conclusions (Krifa-Schneider et al., 2022; Cang & Alida, 2020).

Third, institutional quality helps improve the measurements and testing of the theory applied in the study. This increases the reliability and strengthens the measurement quality. The institutional quality can amplify the intensity of FDI inflows, thereby justifying the institutional FDI fitness theory by providing more robust evidence (Aibai et al., 2019; Islam et al., 2020).

Measuring a country's institutional quality is rugged (Aibai et al., 2019). To measure this aspect, there is a need to use various proxies emanating from legal systems, governance systems, and political systems. The authors argued that the

quality of the indicators precisely estimates the institutional quality, which also indicates the system's efficiency. Concerning this study, three variables are involved in estimating institutional quality: corruption, government effectiveness, and political stability among the institutional quality components suggested by Kaufmann et al. (2011). The picked-up variables are prominent proxies in the developing economies, making them appropriate estimators (Krifa-Schneider et al., 2022; Irandoust, 2021; Islam et al., 2020; Pham et al., 2022; Aibai et al., 2019; Islam et al., 2021).

Corruption is one of the indicators for estimating institutional quality proposed by Kaufmann et al. (2011). Corruption is the abuse of entrusted power for private gain. Corruption is measured by an index from Transparency International (TI).

Government effectiveness is an essential proxy for institutional quality (Kaufmann et al., 2011). Government effectiveness is the administration doing what should be done, making people work hard and well, following procedures in public organizations to achieve their objectives, and attaining all government missions. The average governance institutional quality index measures government effectiveness. Based on Worldwide Governance Indicators (WGI), government effectiveness is calculated by averaging information collected on the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.

Another moderating variable included in the indicators of institutional quality by Kaufmann et al. (2011) is political stability. Political stability is the degree to which formal roles and structures coincide with informal roles and structures within a political system. The average governance institutional quality index measures this proxy. According to Worldwide Governance Indicators (WGI), political stability is measured by averaging information collected on the absence of violence, government stability, freedom from armed conflict, terrorism, state fragility, public opinion surveys, and economic freedom. These measures generally combine quantitative data, expert assessments, and qualitative analysis to provide a comprehensive view of a country's political stability, which is helpful for informed decisions.

The study uses the GDP per capita constant, inflation rate, trade openness, and exchange rate as control variables. These variables can influence the relationship between financial development and FDI. The control variables have the power and ability to influence the financial sector development and the pattern of FDI inflows, but there is no correlation with the error term. The control variables have been included in the study for the following reasons.

First, control variables limit the bias effect caused by measurement error, omitted variables, and simultaneity. Employing control variables helps consider the dynamic endogeneity and heterogeneity caused by unobserved variables (Budziński & Czajkowski, 2022). Therefore, to critically examine the influence of financial development on FDI, control variables are included as in previous

studies (Pham et al., 2022; Krifa-Schneider et al., 2022; Irandoust, 2021; Islam et al., 2020; Cang & Alida, 2020; Aibai et al., 2019).

The second reason is associated with dynamic information across countries in the EAC region. Previous studies highlighted that using control variables helps limit the dynamic variations across countries, such as differences in income (Zhang et al., 2022). The control variables play a role in determining all possible slight variations that could influence the results. The control variables amplify the internal validity by limiting the influential confounding and extraneous variables to establish realistic and unbiased results. These control variables greatly influence financial development and overall provision of financial services and investment pull in the developing economies (Pham et al., 2022).

GDP per capita is a significant factor in attracting FDI inflows to developing economies (Pham et al., 2022). GDP per capita is the sum of the gross value added by all resident producers in the economy, plus any product taxes, divided by mid-year population. Higher GDP reflects the level of economic growth and purchasing power. Economic growth indicates the living standards for sustaining and affording high-quality goods and services that foreign investors provide (Ezeoha & Cattaneo, 2012; Kumari & Sharma, 2017).

The economic development reflected by the GDP per capita level strengthens financial development by providing financial services for meeting market demands (Lee et al., 2022; Chuc et al., 2022). Economic development is a

catalyst for speeding up financial services and intensifying the expansion of financial development for competitiveness and efficiency of the markets in meeting the growing customers' demands (Hatane et al., 2022). This establishes a positive relationship between GDP per capita constant and FDI. Substantial studies from different parts of the world reveal a significant positive relationship between GDP and FDI (Haque et al., 2022; Khan et al., 2019; Mousavian et al., 2021).

Inflation is another control variable that is used in the study. The annual percentage change in the consumer price index (CPI) is the basis for measuring inflation. Inflation reflects the average rate of increase in the price of a basket of goods and services. Rising inflation can prevent or delay foreign investors' decisions to invest in a country or retain their already established (existing) investments (Pham et al., 2022). The increase in the inflation rate indicates poor management of the monetary system and an unstable economic environment. High or increasing inflation rates hurt the investors' expected future profitability, and the impact is more intense for foreign investors when repatriating income to their countries (Emako et al., 2022; Yang et al., 2022). The increase in inflation implies high risks in financial development, which lowers the expected returns, discouraging investors from raising capital in the market because of uncertainties. Therefore, inflation has a significant negative relationship with FDI (Rafidi & Verikios, 2021; Asamoah et al., 2019; Smith, 2021; Canh et al., 2020; Nguyen & Cieřlik, 2021).

Trade openness influences financial sector development and the flow of investments, including FDIs. Trade openness is measured by the ratio of imports and exports to GDP (total trade over GDP). Trade openness increases competitive advantage by allowing foreign firms to import advanced and intermediate production inputs relatively easily. Countries with more trade openness have more entrepreneurial activities and are highly attractive to diverse investors in and from different business investment categories (Korsah et al., 2022; Bakar et al., 2022). Pradhan et al. (2019) revealed that trade openness influences financial development and economic growth and attracts FDI inflows. Trade openness has a positive relationship with FDI based on its positive influence on FDI, as empirically evidenced (Pham et al., 2022; Anyanwu, 2018; Epaphra, 2018). The critical role of trading activities in the economy results in trade openness having a statistically significant positive relationship with FDI (Smith, 2021; Maryam & Mittal, 2020).

Likewise, exchange rate volatilities influence the direction of investment flows and impact financial development. Market forces of supply and demand for foreign exchange measure the exchange rate. The most common approach to calculating exchange rates is a bilateral exchange rate system in which one currency is valued relative to another. Competitive foreign exchange services attract FDI inflows to the economy as they facilitate fast transactions at lower costs (Sasana, 2022; Bakar et al., 2022; Korsah et al., 2022). Inefficient foreign exchange services discourage foreign investors as they create a fear of unfair and uncompetitive foreign currency prices. Determining exchange rates through market forces indicates no control of capital movement and multiple exchange

rates in the economy. This motivates foreign enterprises to freely transfer capital from one country to another, which, in a real sense, increases FDI flows (Tan et al., 2019). Effective exchange rate systems increase FDI inflows, accelerating industrial and entrepreneurial activities. The empirical evidence from Asamoah et al. (2022) revealed a positive influence of exchange rates on stock markets and FDI. Hence, the exchange rate has a positive and significant relationship with FDI.

The measurements of the variables employed are further described below to reflect on how each item is calculated and the information they represent:

Net FDI inflows are measured as the net annual amount of investment made by foreign entities in the recipient economy (Net FDI inflows = Foreign investments into the host country - Domestic investments into foreign economies).

The bank assets are measured in billions of U.S. dollars, representing the total assets held by a country's entire banking sector, including commercial banks, savings institutions, and sometimes central or state-owned banks.

The bank credit to the private sector is measured in billions of U.S. dollars, referring to the total value of loans and credit extended by banks and similar financial institutions to households and private businesses within a country,

including loans, overdrafts, trade credit, and leasing, but excluding credit to the government and public sector.

The stock market capitalization is measured in billions of U.S. dollars by referring to the total market value of all publicly traded domestic companies listed on the country's stock exchanges. It is calculated by multiplying each company's share price by the number of its outstanding shares and summing across all listed firms.

Stock value traded is measured as a percentage of GDP by capturing the total value of domestic company shares traded on the country's stock exchanges during the year, relative to the country's nominal GDP. It is calculated by dividing the total value of shares traded by the GDP and multiplying by 100, providing a percentage that reflects the liquidity and activity level of the equity market.

The corruption perception index (CPI) is generally published by Transparency International, measuring the perceived level of public sector corruption in a country on a scale from 0 (highly corrupt) to 100 (very clean). It is based on multiple independent surveys and expert assessments from sources like the World Bank and Economist Intelligence Unit. Each country's score is an average of standardized results from at least three sources, providing a reliable composite measure used to rank countries globally and compare corruption perceptions across nations.

The government effectiveness index is measured by the World Bank's Worldwide Governance Indicators, measuring the quality of public services, civil service competence, policy formulation and implementation, and the government's commitment to policies. It combines data from multiple surveys and expert assessments using a statistical model to produce a score typically ranging from -2.5 (weak governance) to +2.5 (strong governance). This index provides a comprehensive measure of how effectively a government delivers services and implements policies.

The political stability index is measured by the World Bank's Worldwide Governance Indicators, which measure the likelihood that a country's government will be destabilized or overthrown by unconstitutional or violent means, including politically motivated violence and terrorism. The index is based on the perceptions gathered from multiple expert assessments and surveys conducted by various international organizations and private firms. Using a statistical aggregation method, the index combines these sources into a single score that typically ranges from -2.5 (least stable) to +2.5 (most stable). This measure reflects the overall political climate, including conflict risk, terrorism and threats to government continuity.

The GDP per capita (constant) is measured in U.S dollars and is calculated by dividing a country's inflation-adjusted GDP by its midyear population, with GDP expressed in the prices of a fixed base year to remove the effects of inflation.

This measure reflects the real economic output per person and allows for accurate comparisons of economic performance over time. It is widely used as an indicator of a country's standard of living and economic growth.

The inflation rate is measured as the percentage change in the average price level of goods and services over one year, typically using the Consumer Price Index (CPI). The CPI tracks the cost of a fixed basket of consumer goods and services, and the inflation rate is calculated by comparing the current year's index with that of the previous year. This measure indicates how quickly prices are rising and how the purchasing power of money is changing.

The trade openness is measured in percentage terms by the sum of a country's imports and exports of goods and services over GDP. This indicator reflects how actively a country engages in international trade relative to the size of its economy. A higher trade openness percentage indicates greater integration with the global market, while a lower percentage suggests limited trade activity or a focus on domestic production.

The exchange rate in EAC is determined by a free float exchange regime in which a country's annual exchange rate is measured as the average value of its currency against the U.S dollar. This rate is determined by market forces such as supply and demand, without direct intervention by the government or central bank. It is usually calculated by averaging daily or monthly exchange rates

throughout the year. The exchange rate fluctuates in response to economic factors like trade flows, interest rates, inflation, and investor sentiment.

Table 3. 2: Model variables definitions, measurements, and sources

<b>Variable Name</b>	<b>Symbol</b>	<b>Measurement</b>	<b>Measurement unit</b>	<b>Source</b>
Foreign Direct Investment	FDI	Net FDI inflows	Billion USD	WDI
Financial development	FDV			
Bank Assets	BAT	Bank assets	Billion USD	WDI
Bank Credit	BACRE D	Credit by banks to the private sector	Billion USD	WDI
Stock Capitalization	STCAP	Stock market capitalization (on listed companies)	Billion USD	WDI; Stock Markets of partner states
Stock Value Traded	STVAL	Stock market value traded over GDP	Percentage (%)	WDI; Stock Markets of partner states
Institutional Quality	IQ			
Corruption Perceptions	CORP	Corruption Perception Index	Perceptions Index (100 = no corruption)	WGI
Government Effectiveness	GEF	Effectiveness of the government index	Index (-2.5 weak; 2.5 strong)	WGI

Political Stability	PST	Political stability index	Index (-2.5 weak; 2.5 strong)	WGI
GDP per capita Constant	GDPC	Economic development (measured by real GDP per capita)	Per capita USD	WDI
Inflation Rate	INFL	Annual percentage change of the consumer prices index (%)	Percentage (%)	WDI
Trade Openness	TROP	Imports plus exports over GDP	Percentage (%)	WDI
Exchange Rate	EXR	Value of domestic currency per US Dollar	Exchange rate USD	WDI

**Source:** Author's compilation

The data are sourced from the World Development Index (WDI) and the World Governance Index (WGI). Because of the challenges of securing data from one source, some data were collected from the stock exchanges of EAC partner states.

### 3.4 Method of Analysis

The study employs panel data for four EAC countries covering 1995-2020. The data involved aims to establish relationships between independent variables (financial development indicators) and dependent variables (FDI inflows) using FGLS-Parks and PCSE estimators. The data analysis uses FGLS-Parks and

PCSE estimators to generate unbiased and consistent parameters that minimize the probability of reporting spurious results.

Two-panel data root tests have been carried out. These tests cover the panel unit root test and the panel cointegration test. The panel tests help perform valid and consistent regressions for proper analysis. The preference for panel unit root tests increases over time and becomes more preferred than standard time series unit root tests. The intention of using panel unit root tests is to examine data stationarity. With time-lapse, the preference for using panel root tests has outweighed standard time series unit root tests because of their high analytical power compared to time series. The incredible power of panel unit root tests stems from the broader information on the observations and variations relative to conventional time series data.

This study has employed the Im–Pesaran–Shin unit-root test to check for the stationarity of the data. Panel unit root tests are preferred over time series unit root tests based on the advantage that panel unit root tests have asymptotic standard and normal distribution created by repeated observations, unlike time series data, which have a non-standard distribution.

There is an implied condition that cointegration occurs when the data are stationary. Cointegration tests justify the long-run relationships among independent and dependent variables. Kao (1999), Westerlund (2008), and Pedroni (2004) are remarkable tests for measuring panel cointegration. These tests are based on residual statistics while using the null hypothesis of no

cointegration. The models are efficient in conducting panel cointegration because of their great statistical power, which relies on dynamic models.

The study presumes that countries are heterogeneous. Kao panel cointegration tests are employed, favoured by their consideration of dynamic models. Kao panel cointegration is preferred in this study context over other models because it is robust to cross-sectional dependence, which can handle interdependence among the panel units. Additionally, the Kao panel cointegration test allows for heterogeneous cointegration relationships across units, which can be more realistic in panel data settings where different units may have different long-run equilibrium relationships. Similarly, the Kao panel cointegration test best fits large panels based on its underlying assumptions of accommodating large panels like the one covered by this study.

### **3.4.1 Development of Empirical Model**

A linear relationship determines the influence of financial development on FDI. The primary panel data model is appropriate for studying this relation (Nguyen et al., 2021). The study employs the framework proposed by Ezeoha and Cattaneo (2012), Agbloyor et al. (2013), Otchere et al. (2016), and Ho and Gan (2021).

The model for estimating the relationship between FDI and its influencing factors is based on two underlying assumptions, which are (1) a linear

relationship and (2) the influence of previous FDI in the estimation of FDI. It is assumed that FDI and causal factors have a linear relationship because changes in these variables have a proportionate influence on FDI. The linear relationship provides the best estimates for large data sets. Since the study involves a large set of data for four countries over 26 years, considering the linearity between FDI and the exogenous variables assists in figuring out the relationship between them. The assumption of previous FDIs influencing the estimate of the FDI is based on the premise that previous FDIs have spillover effects on the economy and attract potential foreign investors.

Therefore, the empirical model for estimating the impact of financial development on FDI is given as follows:

$$I_{i,t} = \alpha + \sum_{j=1}^j \beta_j(L)I_{i,t-j} + \sum_{j=1}^K \phi_j \Psi_{i,t} + \zeta_{i,t} \quad (1)$$

Where:

$I_{i,t}$  is the FDI inflows in country  $i$  at the end of year  $t$ ,  $\Phi$  represents lag order of the series while  $L$  is the lag operator (With  $LI_{i,t}=I_{i,t-1}$ );  $\Psi_{i,t}$  represents a vector of the financial development, institutional quality, and macroeconomic variables;  $\beta_j$  is the coefficient of the lagged FDI and  $\phi_j$  is a vector of the explanatory variables;  $\alpha$  is the constant and  $\zeta_{i,t}$  is the error term.

To minimize the number of missing observations arising from logging series with negative numbers, the study introduces a log of 100%, GDP per capita constant, inflation rate, trade openness and exchange rate consecutively in the

model (Ezeoha & Cattaneo, 2012). Logging the variables reduces the degree of variation of the values and measures the variables to produce closer estimates.

Since some vectors  $\forall_{i,t}$  members are correlated with the error term ( $\zeta$ ) and are endogenous to  $I_{i,t}$ , the study uses FGLS-Parks and PCSE to estimate the regression parameters to produce efficient coefficients. Using OLS, fixed effects, or the traditional random effects models results in inefficient estimation of the coefficients. These models cannot control measurement error, simultaneity, and unobserved heterogeneity (Hill et al., 2021).

When we introduce the measures of financial development, institutional quality, and macroeconomic (control) variables in equation (1) above, the model expands as follows:

$$FDI_{i,t} = \alpha + \beta_1 FDI_{i,t-1} + \beta_2 BAT_{i,t} + \beta_3 BACRED_{i,t} + \beta_4 STVAL_{i,t} + \beta_5 STCAP_{i,t} + \phi_1 CORP_{i,t} + \phi_2 GEF_{i,t} + \phi_3 PST_{i,t} + \phi_4 GDPC_{i,t} + \phi_5 INFL_{i,t} + \phi_6 TROP_{i,t} + \phi_7 EXR_{i,t} + \zeta_{i,t} \quad (2)$$

Where:

BAT is bank assets, BACRED is bank credit to the private sector, STVAL is stock value traded, STCAP is stock market capitalisation, CORP is corruption perception, GEF is government effectiveness, PST is political stability, GDPC is GDP per capita constant, INFL is the inflation rate, TROP is the trade openness, while EXR is the exchange rate.

When the institutional quality proxies interact with the financial development parameters in playing a moderating role, three (3) more equations are developed.

Moderating role of corruption (CORP)

$$\begin{aligned}
 FDI_{i,t} = & \alpha + \beta_1 FDI_{i,t-1} + \beta_2 BAT * CORP_{i,t} + \beta_3 BACRED * CORP_{i,t} + \\
 & \beta_4 STVAL * CORP_{i,t} + \beta_5 STCAP * CORP_{i,t} + \beta_6 BAT_{i,t} + \beta_7 BACRED_{i,t} + \beta_8 STVAL_{i,t} \\
 & + \beta_9 STCAP_{i,t} + \phi_1 CORP_{i,t} + \phi_2 GEF_{i,t} + \phi_3 PST_{i,t} + \phi_4 GDPC_{i,t} + \phi_5 INFL_{i,t} + \phi_6 TROP_{i,t} \\
 & + \phi_7 EXR_{i,t} + \zeta_{i,t} \tag{3}
 \end{aligned}$$

Where:

BAT \* CORP is the interaction term between bank assets and corruption, BACRED \* CORP is the interaction term between credit to private and corruption, STVAL \* CORP is the interaction term between value traded and corruption, and STCAP \* CORP is the interaction term between market capitalization and corruption.

The moderating role of government effectiveness (GEF)

$$\begin{aligned}
 FDI_{i,t} = & \alpha + \beta_1 FDI_{i,t-1} + \beta_2 BAT * GEF_{i,t} + \beta_3 BACRED * GEF_{i,t} + \beta_4 STVAL * GEF_{i,t} \\
 & + \beta_5 STCAP * GEF_{i,t} + \beta_6 BAT_{i,t} + \beta_7 BACRED_{i,t} + \beta_8 STVAL_{i,t} + \beta_9 STCAP_{i,t} + \\
 & \phi_1 CORP_{i,t} + \phi_2 GEF_{i,t} + \phi_3 PST_{i,t} + \phi_4 GDPC_{i,t} + \phi_5 INFL_{i,t} + \phi_6 TROP_{i,t} + \phi_7 EXR_{i,t} + \\
 & \zeta_{i,t} \tag{4}
 \end{aligned}$$

Where:

BAT\*GEF is the interaction term between bank assets and government effectiveness, BACRED\*GEF is the interaction term between credit to private and government effectiveness, STVAL\*GEF is the interaction term between value traded and government effectiveness, and STCAP\*GEF is the interaction term between market capitalization and government effectiveness.

Moderating role of political stability (PST)

$$\begin{aligned}
 FDI_{i,t} = & \alpha + \beta_1 FDI_{i,t-1} + \beta_2 BAT*PST_{i,t} + \beta_3 BACRED*PST_{i,t} + \beta_4 STVAL*PST_{i,t} + \\
 & \beta_5 STCAP*PST_{i,t} + \beta_6 BAT_{i,t} + \beta_7 BACRED_{i,t} + \beta_8 STVAL_{i,t} + \beta_9 STCAP_{i,t} + \\
 & \phi_1 CORP_{i,t} + \phi_2 GEF_{i,t} + \phi_3 PST_{i,t} + \phi_4 GDPC_{i,t} + \phi_5 INFL_{i,t} + \phi_6 TROP_{i,t} + \phi_7 EXR_{i,t} + \\
 & \zeta_{i,t} \tag{5}
 \end{aligned}$$

Where:

BAT\*PST is the interaction term between bank assets and political stability, BACRED\*PST is the interaction term between credit to private and political stability, STVAL\*PST is the interaction term between value traded and political stability, and STCAP\*PST is the interaction term between market capitalization and political stability.

However, the study will conduct further robustness checks using other proxies for banking services and stock market size. In particular, banking deposits, liquid

liabilities, stock turnover and the number of listed companies will be employed.

Four models will be used for the extended robustness checks as follows:

$$\begin{aligned}
 FDI_{i,t} = & \alpha + \beta_1 FDI_{i,t-1} + \beta_2 BDST_{i,t} + \beta_3 BLLBT_{i,t} + \beta_4 STMT_{i,t} + \beta_5 NLSTC_{i,t} + \\
 & \phi_1 CORP_{i,t} + \phi_2 GEF_{i,t} + \phi_3 PST_{i,t} + \phi_4 GDPC_{i,t} + \phi_5 INFL_{i,t} + \phi_6 TROP_{i,t} + \phi_7 EXR_{i,t} + \\
 & \zeta_{i,t}
 \end{aligned} \tag{6}$$

Where:

BDST is bank deposits, BLLBT is bank liquid liabilities, STMT is stock turnover, and NLSTC is the number of listed companies.

Robustness checks for the moderating role of corruption (CORP)

$$\begin{aligned}
 FDI_{i,t} = & \alpha + \beta_1 FDI_{i,t-1} + \beta_2 BDST * CORP_{i,t} + \beta_3 BLLBT * CORP_{i,t} + \\
 & \beta_4 STMT * CORP_{i,t} + \beta_5 NLSTC * CORP_{i,t} + \beta_6 BDST_{i,t} + \beta_7 BLLBT_{i,t} + \beta_8 STMT_{i,t} + \\
 & \beta_9 NLSTC_{i,t} + \phi_1 CORP_{i,t} + \phi_2 GEF_{i,t} + \phi_3 PST_{i,t} + \phi_4 GDPC_{i,t} + \phi_5 INFL_{i,t} + \phi_6 TROP_{i,t} \\
 & + \phi_7 EXR_{i,t} + \zeta_{i,t}
 \end{aligned} \tag{7}$$

Where:

BDST \* CORP is the interaction term between bank deposits and corruption, BLLBT \* CORP is the interaction term between bank liquid liabilities and corruption, STMT \* CORP is the interaction term between stock turnover and corruption, and NLSTC \* CORP is the interaction term between the number of listed companies and corruption.

Robustness checks for the moderating role of government effectiveness (GEF)

$$\begin{aligned}
 FDI_{i,t} = & \alpha + \beta_1 FDI_{i,t-1} + \beta_2 BDST * GEF_{i,t} + \beta_3 BLLBT * GEF_{i,t} + \beta_4 STMT * GEF_{i,t} + \\
 & \beta_5 NLSTC * GEF_{i,t} + \beta_6 BDST_{i,t} + \beta_7 BLLBT_{i,t} + \beta_8 STMT_{i,t} + \beta_9 NLSTC_{i,t} + \phi_1 CORP_{i,t} \\
 & + \phi_2 GEF_{i,t} + \phi_3 PST_{i,t} + \phi_4 GDPC_{i,t} + \phi_5 INFL_{i,t} + \phi_6 TROP_{i,t} + \phi_7 EXR_{i,t} + \zeta_{i,t} \quad (8)
 \end{aligned}$$

Where:

BDST\*GEF is the interaction term between bank deposits and government effectiveness, BLLBT\*GEF is the interaction term between bank liquid liabilities and government effectiveness, STMT\*GEF is the interaction term between stock turnover and government effectiveness, and NLSTC\*GEF is the interaction term between the number of listed companies and government effectiveness.

Robustness checks for the moderating role of political stability (PST)

$$\begin{aligned}
 FDI_{i,t} = & \alpha + \beta_1 FDI_{i,t-1} + \beta_2 BDST * PST_{i,t} + \beta_3 BLLBT * PST_{i,t} + \beta_4 STMT * PST_{i,t} + \\
 & \beta_5 NLSTC * PST_{i,t} + \beta_6 BDST_{i,t} + \beta_7 BLLBT_{i,t} + \beta_8 STMT_{i,t} + \beta_9 NLSTC_{i,t} + \phi_1 CORP_{i,t} \\
 & + \phi_2 GEF_{i,t} + \phi_3 PST_{i,t} + \phi_4 GDPC_{i,t} + \phi_5 INFL_{i,t} + \phi_6 TROP_{i,t} + \phi_7 EXR_{i,t} + \zeta_{i,t} \quad (9)
 \end{aligned}$$

Where:

BDST\*PST is the interaction term between bank deposits and political stability, BLLBT\*PST is the interaction term between bank liquid liabilities and political stability, STMT\*PST is the interaction term between stock turnover and political stability, and NLSTC\*PST is the interaction term between the number of listed companies and political stability.

### **3.4.2 The Feasible Generalized Least Squares (FGLS-Parks) and Panel Corrected Standard Error (PCSE).**

This study utilizes Feasible Generalized Least Squares (FGLS) as the main regression technique to effectively tackle issues related to heteroscedasticity, serial correlation, and cross-sectional dependence within the error terms. FGLS is selected for its superior ability to manage unobserved heteroscedasticity, as demonstrated by Bagh et al. (2024) in both “ESG Resilience” and “From Risk to Resilience”. Similar estimation strategies have been employed by other scholars, including Moundigbaye et al. (2020), Mkombe et al. (2021), and Mapendo et al. (2025), who underscore its suitability for dynamic panel data analysis and its robustness in handling complex data structures.

The study has employed Feasible Generalized Least Squares (FGLS), which is favored over other panel data estimation techniques such as OLS, ARDL, Fixed Effects (FEM), Random Effects (REM), and GMM due to several advantages. It is particularly effective for small sample panels and is capable of addressing issues like heteroscedasticity and autocorrelation. By incorporating fixed effects, FGLS accounts for unobserved, time-invariant characteristics across entities such as countries within the EAC, ensuring more reliable estimates. This approach is also flexible enough to capture unit-specific dynamics and temporal variations, making it especially suitable for datasets marked by substantial heterogeneity. Ultimately, FGLS enhances the precision of coefficient estimates

and better handles error structures unique to panel data, offering a strong foundation for examining intricate economic phenomena (Moundigbaye et al., 2020).

Panel data with lower multicollinearity among variables improves the depth and diversity of information available for analysis. To ensure robustness, the study applies Panel-Corrected Standard Errors (PCSE) as a supplementary estimation method. FGLS is specifically selected for dynamic panel analysis in contexts where the time dimension (T) is greater than the number of cross-sectional units (N), with a T/N ratio exceeding 1.5, aligning with the data characteristics of this study. This approach is consistent with the methodological recommendations put forward by Mkombe et al. (2021).

FGLS-Parks is an efficient estimator for dynamic panel data under two significant conditions. First, FGLS-Parks is the best dynamic panel data estimator when the period (T) is greater than the cross-sectional number of units (N) covered in a particular study ( $T > N$  or  $N < T$ ). The second condition for using FGLS-Parks for estimating dynamic panel data relationships is when the ratio between period and cross-sectional number of units is greater than or equal to 1.5 ( $T/N \geq 1.5$ ) (Mkombe et al., 2021; Moundigbaye et al., 2020). Using FGLS-Parks corrects for non-stationarity, autocorrelation, and heteroskedasticity, producing efficient coefficient estimates (Moundigbaye et al., 2018). Because FGLS-Parks is a poor estimator of hypothesis testing, panel-corrected standard errors (PCSE) can also be applied (Moundigbaye et al., 2020). Based on the

nature of the study's data, four cross-sectional units (four countries) and 26 time periods (26 years), FGLS-Parks will be employed to estimate the coefficients and PCSE to provide robust standard errors.

Panel data are usually affected by endogeneity problems associated with the series (Eugster, 2020). The existence of heteroskedasticity, autocorrelation and non-stationarity in the panel series means that the other dynamic panel models, such as GMM, FGLS and PCSE, could be used to estimate the coefficients. However, GMM cannot be employed since  $T$  is higher than  $N$ , a condition against GMM assumptions. Hence, the study uses FGLS-Parks and PCSE to examine the impact of financial development on FDI in East African countries (EAC). The FGLS-Parks is superior in controlling panel autocorrelation, nonstationarity of the series, heteroskedasticity and cross-sectional dependence in providing efficient estimates when  $T/N \geq 1.5$ . At the same time, PCSE is the best estimator for hypothesis testing as it gives an accurate confidence interval (Moundigbaye, 2018).

Based on the Gauss-Markov Theorem, studies using OLS to predict the relationship between independent and dependent variables require reliance on the assumptions of residual values. Those values include autocorrelation, homoscedasticity, and multicollinearity (Wooldridge, 2019; Sarstedt & Mooi, 2019).

OLS produces biased and inconsistent estimates when the residuals are correlated with the regressors due to endogeneity (Young, 2022; Chen et al., 2022; Ullah et al., 2018). The implication for this is that the endogeneity problems violate the condition of homogeneity stemming from the simultaneity causality, measurement error and the omitted variables (Wilms et al., 2021; Ullah et al., 2021; Hill et al., 2021; Barros et al., 2020; Sajons, 2020).

Applying the fixed effect model (FEM) increases the likelihood of facing the challenges posed by OLS as the model cannot accommodate measurement error, simultaneity, and unobserved heterogeneity (Hill et al., 2021). A simultaneity problem arises when two variables influence one another. This kind of relationship results in biases in the reported findings. When it stands alone, the fixed effect model cannot control the endogeneity problems, thus generating biased estimates (Zhang et al., 2022; McNeish & Kelley, 2019).

Some studies and their respective findings are affected by erroneous random terms from econometric estimators utilised for analysis. The use of inappropriate econometric estimators results in an endogeneity problem. The endogeneity problem originates from three significant sources: serial correlations due to unobserved heterogeneity, measurement errors, and simultaneity between variables.

The endogeneity problem arising from serial correlation occurs when there is a correlation between error terms and one or more explanatory variables

(Taşdemir, 2020). This problem is also called the omission of variable biases or the presence of unobserved heterogeneity (Zhang et al.,2022). This situation can be further explained by considering the following equation.

$$Y_{i,t} = \alpha + \sum_{i=1}^N x_{it}\beta + \varepsilon_{it} \text{ for } i= 1,2,3\dots N \text{ and } t= 1,2,3\dots T \quad (10)$$

$Y_{it}$  is the dependent variable,  $X$  is the explanatory variable, and  $\varepsilon_{it}$  is the error term, while  $\alpha$  and  $\beta$  are the constant and coefficient parameters.

From equation (10) above, if  $E(X_{it}, \varepsilon_{it}) \neq 0$ , the implication is that the error term and one or more explanatory variables are correlated. Under such a situation, an endogeneity problem exists in the model, thus producing biased estimators.

Measurement error is another source of endogeneity problems in econometric estimations. The problem is also caused by omitting some variables from the regression model. When some variables are omitted from the regression due to errors, it leads to misspecification of the model and likewise affects the results. The errors that result in some variables' omission can involve either measurable or non-measurable variables. The following equation can provide more reflection on this problem.

$$Y_{i,t} = \beta_0 + \beta_1 X_{1t} + \beta_2 X_{2t} + \beta_3 X_{3t} + \beta_4 X_{4t} + \varepsilon_{i,t} \quad (11)$$

Where  $Y_{it}$  is the dependent variable,  $X_{it}$  (for  $i=1,2,3$  and  $4$ ) are explanatory variables,  $\beta$ 's are the estimated parameters, while  $\varepsilon_{it}$  is the error term. From equation (11) above, misspecification of the model occurs when one or more of the explanatory variables are omitted from the regression. The error term leading to the endogeneity problem captures the omitted measurable variables.

Likewise, the impact of the non-measurable variables, even though they are not included in the model, is also captured by the error terms. The same effect of endogeneity is experienced in the estimators. These variables are also known as unobserved time-invariant. For instance, norms and culture across the EAC member states impact financial development.

The endogeneity problem's last primary source is the variables' simultaneity; as explained above, two or more variables influence and exert impact on one another. The causality between dependent and explanatory variables mainly causes this. For instance, in the case where  $Y_{it} = f(x_{it})$  and at the same time  $X_{it} = f(y_{it})$ . Interrelation between economic variables such as financial development and FDI leads to endogeneity problems and, thus, biased estimators.

The correlation problems associated with FEM between error terms and regressors can be tackled by many instrumental variables (IV). Increasing the number of instrumental variables to improve predictions made under the FEM

model has been cautioned that the process may result in difficulties in identifying the relevant instruments, which have an impact on both dependent and independent variables (Bonaccolto-Töpfer et al., 2022; Feyrer, 2019). Adding more instrumental variables to the model can result in significant bias in the sample (Yang et al., 2022; Leszczensky & Wolbring, 2022; McNeish & Kelley, 2019). Likewise, adding instruments to the model does not improve if the sample size is small. For efficient and unbiased parameters, using FGLS-Parks and PCSE estimators is recommended (Mkombe et al., 2021; Moundigbaye et al., 2020).

Literature on dynamic panel data models emphasises employing FGLS-Parks and PCSE estimators when  $T > N$  to fix the endogeneity problem, which FEM and REM models cannot capture (Agarwala et al., 2022). FGLS-Parks and PCSE estimators improve the OLS-FEM challenges by allowing past FDI inflows to explain the inward FDI. Previous FDI inflows address simultaneity contrary to the traditional FEM and OLS.

When FGLS-Parks and PCSE estimators are applied, the challenges of simultaneity on the independent and dependent variables are considered. The simultaneity arises when financial development influences FDI and FDI influences financial development. The stationarity of the control variables is found to be helpful in the identification of the exogenous variables. Different previous studies expressed that the occurrence of simultaneity is unavoidable because of exogeneity as variables depend on past and future values of the error

term (Ullah et al., 2021; Hill et al., 2021; Wilms et al., 2021; Barros et al., 2020; Sajons, 2020).

Given the challenges of static panel techniques and their possible solution, the study utilises dynamic panel FGLS-Parks and PCSE estimators. Using dynamic panel FGLS-Parks and PCSE estimators, overcome all the abovementioned constraints relating to endogeneity problems. This results in producing unbiased, consistent, and efficient estimators. The dynamic panel FGLS-Parks and PCSE estimators accommodate all the dynamic variations in the econometric model.

Let us consider the following research model:

$$Y_{it} = \alpha + \rho y_{it-1} + \beta_i X_{it} + \gamma_i Z_{it} + \lambda_i + \varepsilon_{it} \quad (12)$$

Where  $Y_{i,t}$  is the dependent variable, the Foreign direct investment for country  $i$  at time  $t$ ,  $y_{it-1}$  is the lagged FDI inflows,  $X_{it}$  represent the set of explanatory variables, from the banking sector (bank assets and bank credit to the private sector), stock market size (value traded and market capitalisation) the moderating role of institutional quality (corruption, government effectiveness and political stability);  $Z_{it}$  represent the control variables (GDP per capita constant, trade openness, inflation and exchange rate);  $\beta_i$  and  $\gamma_i$  represent vector coefficients for the explanatory and control variables respectively,  $\lambda_i$  denotes the inter-country fixed effects among the EAC partner states and  $\varepsilon_{it}$  represent the error term. In order to overcome the methodological challenges relating to inter-

country-specific effects being correlated with other variables in the model, the regression estimations are conducted by powerful estimators, the FGLS-Parks and PCSE.

Upon applying FGLS-Parks and PCSE estimators to equation (12) above, neither endogeneity nor explanatory variables correlate with the error term. Therefore, the study employs dynamic FGLS-Parks and PCSE estimators to produce unbiased, consistent, and efficient estimators.

### **3.4.3 Data Analysis Tool**

The study has employed Statistics and data (STATA) software to run and execute this quantitative study. STATA is a statistical software package that establishes a relationship between the variables under regression analysis. It is instrumental in making forecasts and handling panel data. STATA efficiently processes and produces high-quality graphics and tabular models' output, model specification, estimation output, and fitted residual values.

STATA is preferred because it offers many estimator choices that can control for the unobserved measures among the EAC partner states, such as cultural factors, differences in business practices across the countries, national policies, regulatory systems, and international agreements. All these factors have an impact on financial development and FDI attraction. However, using STATA controls these variables so that they do not impact the results, as it can consider

individual heterogeneity. STATA allows variability and less collinearity and can create more efficiency and a higher degree of freedom.

## CHAPTER FOUR

### 4.0 DATA ANALYSIS

#### 4.1 Introduction

This chapter focuses on data analysis and is subdivided into several sections. In carrying out an analysis of the data, different statistical measures are involved. The data analysis covers descriptive statistics, normality tests regarding data distribution, correlation analysis, and heteroscedasticity tests. Likewise, panel unit root tests, panel cointegration tests, and multicollinearity tests are carried out. Also, the data analysis involves regressions in estimating the coefficients in the primary model and the moderation effect.

#### 4.2 Descriptive Statistics

This section highlights the descriptive statistics focusing on the statistical behaviour of FDI inflows, financial development, and institutional quality variables. The statistics involve annual data for FDI (FDI net inflows: - dependent variable), financial development variables (bank assets, credit to the private sector, value traded, and market capitalization: - independent variables), institutional quality variables (corruption, government effectiveness, and political stability: - moderating variables) and macroeconomic variables (GDP per capita constant, trade openness, inflation rate, and exchange rate: - control variables). Table 4.1 below presents the statistical summary of the variables, as pointed out in this section.

Table 4.1: Descriptive Statistics

Variables	Obs	Mean	Std Dev	Min	Max
FDI (Billion USD)	104	0.51	0.51	0.00	2.09
BAT (Billion USD)	104	3.59	4.41	0.17	25.14
BACRED (Billion USD)	104	4.61	7.08	0.00	32.33
STVAL (%)	104	0.15	0.18	0.00	0.74
STCAP (Billion USD)	104	5.15	6.60	0.00	25.44
CORP (Index 1 to 100)	104	29.00	9.02	19.00	56.00
GEF (Index (-2.5 to 2.5))	104	-0.49	0.27	-1.19	0.34
PST (Index -2.5 to 2.5)	104	-0.85	0.54	-2.03	0.11
GDPC (USD)	104	827.23	333.52	296.73	1600.13
INFL (%)	104	7.44	4.91	-2.40	27.40
TROP (%)	104	41.53	10.41	23.98	71.75
EXR (EAC Currency Units/USD)	104	1069.36	965.75	58.85	3719.15

**Source:** Author's compilation

Representation of variables: FDI= Foreign direct investment, BAT= Bank assets, BACRED= Bank credit to private sector, STVAL= Stock value traded, STCAP= Stock market capitalization, CORP= Corruption perception, GEF= Government effectiveness, PST= Political stability, GDPC= GDP per capita constant, INFL= Inflation rate, TROP= Trade openness, and EXR= Exchange rate

The summarized information reported by the descriptive statistics in Table 4.1 above covers 26 years from 1995 to 2020 for four (4) EAC countries. The number of observations involved is 104. The above descriptive statistics analysis is based on annual data from different databases.

During the covered period for analysis, maximum FDI net inflows amounted to USD 2.09 billion and a minimum of zero (0), meaning there were some years in which no FDI inflows were received among the EAC member states. On the other hand, the average FDI net inflows to the EAC region were USD 0.51 billion. The maximum value of bank assets was USD 25.14 billion, meaning that the bank assets were more than ten (10) times the FDI inflows received in the EAC during that period. Similarly, the mean value of the bank assets (USD 3.59

billion) and the minimum value (USD 0.17 billion) were higher than the respective values for FDI inflows. The higher values of banking assets than FDI flowing to the EAC region imply that the banking sector can meet the additional financial needs of foreign investors. However, the maximum bank credit to the private sector was USD 32.33 billion, with a mean value of USD 4.61 billion and a minimum of zero (0). Credit to the private sector was fifteen (15) times higher than FDI inflows reported during this period. This indicates that credit supply to the private sector is very high compared to FDI inflows.

On the other hand, the value traded to GDP had a maximum value of 0.74% and an average of 0.15%. The descriptive statistics for value traded indicate that trading operations involving the stock market products have very little circulating capital relative to the GDP level in the region. The statistics revealed that the EAC market had a maximum stock market capitalization value of USD 25.44 billion and an average value of USD 5.15 billion. The EAC market's average market capitalization value of USD 5.15 billion is meagre compared to the region's GDP of over USD 240 billion (Ibrahim & Ajide, 2022). This implies that the EAC stock market is still unsaturated with vast investment opportunities for further growth and strong re-establishment in securities trading.

The relationship between FDI and financial development in this study has been moderated by institutional quality (corruption, government effectiveness, and political stability). The corruption perception index had a maximum value of 56, with a minimum of 19 and a mean value of 29. The maximum value of the

corruption perception index implies a 44% (44 scores below 100) chance for perceived corruption in the region. On the other hand, government effectiveness had a maximum value of 0.34, a minimum of -1.19, and an average of -0.49 scores. The average government effectiveness index of -0.49 is far below the benchmark of 2.5 scores. This implies that the EAC region is characterized by bureaucracy, which indicates governments have been ineffective in providing timely and quality services, including in the business and investment channels.

Regarding political stability, the maximum value is 0.11, with a minimum of -2.03 scores and an average of -0.85 scores. The average score of -0.85 is almost halfway to the significantly worse scenario regarding the political stability index, which has a benchmark of -2.5 scores. The scores indicate that the EAC region's political stability is volatile.

The study also involved macroeconomic variables, including GDP per capita constant, inflation rate, trade openness, and exchange rate, which were used as controls for stabilizing the regression model. The descriptive statistics revealed a maximum value of USD 1600.13 for the GDP per capita constant, with a minimum value of USD 296.73 and an average of USD 827.23. The maximum inflation rate reported was 27.4%, with a minimum value of -2.4% and an average of 7.44%. The inflation characteristics noted above imply that the EAC region has very volatile price fluctuations of goods and services, causing inflation movement ranging from 27.4% to -2.4% (deflation). On the other hand, the maximum ratio of trade openness to GDP was 71.75%, with a minimum

value of 23.98% and an average value of 41.53%. The implication is that, on average, trade openness in the EAC region was below 50% of the GDP level. Lastly, the exchange rate had a maximum value of 3719.15 units of currency per USD, a minimum value of 58.85 units per USD, and an average of 1069.36 units per USD. The exchange rate values describe the EAC region as composed of member states with varying currency values relative to USD.

#### **4.3 Normality Test and Data Transformation**

Data transformation was performed by modifying the data to fit the context of this study. The transformation process only aimed to enhance the quality and usability for more accurate analysis. The result of the transformation did not alter the information portrayed by the data. After the transformation exercise, the data were set to a statistically acceptable level of normal distribution for panel data analysis. The challenges faced by panel data, such as multicollinearity and spurious outliers, were resolved following the appropriateness of the data transformation techniques. This is revealed in the pairwise correlation matrix in Table 4.2 and the variance inflation factor (VIF), the confirmatory test for multicollinearity in Table 4.3.

Specific data transformation techniques were applied to individual variables to meet their suitability for analysis. Foreign direct investment (FDI), bank assets (BAT), market capitalization (STCAP), and Trade openness (TROP) were logged. On the other hand, corruption (CORP), government effectiveness (GEF), political stability (PST), and inflation rate (INFL) were inverted. The GDP per

capita constant (GDPC) was normalized through inversed cube values. The other variables, bank credit to the private sector (BACRED), value traded (STVAL), and exchange rate (EXR), retained their originality.

However, some of the data had to be winsorized to overcome the problem of spurious outliers. According to Chen et al. (2022), winsorization is averaging data with the most significant and minor observation values. Once winsorization is carried out, the data are restrained from closing deals, and the impact of outliers caused by data dispersion is substantially minimized or eliminated (Sharma & Chatterjee, 2021). The conclusion made by Boudt et al. (2020) regarding the efficiency of winsorization in data normalization is that all abnormal observations and specious outliers' problems are cleared out upon winsorizing the data.

The study employed winsorization on bank assets, corruption, government effectiveness, political stability, GDP per capita constant, inflation rate, and trade openness to tackle the problem of spurious outliers. This action creates an excellent improvement in the data fitness for analysis. Bank assets, corruption, and political stability were winsorized at the 2.5<sup>th</sup> and 97.5<sup>th</sup> percentile, while inflation rate and trade openness were winsorized at the 10<sup>th</sup> and 90<sup>th</sup> percentile. On the other hand, government effectiveness was honoured at the 5<sup>th</sup> and 95<sup>th</sup> percentiles.

It should be known and acceptably appreciated that all diagnostic tests involved in the analysis process such as Shapiro–Wilk W test for standard data, correlation analysis, multicollinearity test, variance inflation factor (VIF), panel unit root test, panel cointegration test, Hausman test, heteroskedasticity test, and the regression analysis including the primary model and the moderation effect of institutional quality (corruption, government effectiveness, political stability) were performed based on the statistically transformed data. The Shapiro–Wilk W test confirmed the data's normality. The results for the Shapiro–Wilk W test for data normality are presented in Table 4.2 below.

Table 4. 2: Shapiro–Wilk W Test for Normal Data

<b>Variable</b>	<b>W</b>	<b>V</b>	<b>z</b>	<b>Prob&gt;z</b>
e	0.99302	0.489	-1.57	0.94182

**Source:** Author’s compilation

The Shapiro–Wilk W test for normal data distribution hypothesizes under the null hypothesis that the data are typically distributed at 5%. From the results in Table 4.2 above for normality data distribution, the statistical results fail to reject the null hypothesis at 5% since the P-value (0.9418) is higher than 0.05. The Wilk value (W, which is 0.9930) is higher, indicating the means, variance, and covariance of the variables are independent of errors (e), which leads to the rejection of the alternative hypothesis. Therefore, the data are confirmed to be customarily distributed, making them suitable for analysis.

#### 4.4 Correlation Analysis

The correlation matrix provides the linear relationship between the variables. The correlation among the variables can be positive, negative, or no correlation. The minimum and maximum range of -1 and +1, respectively, portray the correlation. When the value is -1, it is a perfect negative correlation, while a +1 is a perfect positive correlation, and a zero (0) value means no correlation exists among the analyzed variables.

Table 4.3: Correlation Matrix

Variables	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
(1) FDI	1.00											
(2) BAT	0.18	1.00										
(3) BACRED	0.38	0.02	1.00									
(4) STVAL	0.00	0.11	0.62	1.00								
(5) STCAP	-0.22	0.35	-0.05	0.12	1.00							
(6) CORP	-0.22	0.21	0.03	0.39	0.21	1.00						
(7) GEF	-0.02	0.10	-0.11	-0.06	0.00	-0.24	1.00					
(8) PST	0.03	0.08	-0.03	-0.09	0.02	-0.25	0.13	1.00				
(9) GDPC	-0.50	-0.19	-0.50	-0.62	-0.15	-0.01	-0.04	-0.09	1.00			
(10) INFL	0.05	-0.12	0.02	-0.01	-0.11	-0.15	0.04	0.03	-0.05	1.00		
(11) TROP	-0.04	0.20	0.03	0.41	0.24	0.05	0.22	0.23	-0.58	-0.30	1.00	
(12) EXR	0.50	0.16	-0.23	-0.32	-0.05	-0.12	0.05	-0.01	-0.12	0.29	-0.22	1.00

**Source:** Author's compilation

From the correlation matrix displayed in Table 4.3 above, upon analyzing the linear relationship among the variables, no multicollinearity problem can be observed. The coefficients of almost all the independent variables are within  $\pm$

0.8, which does not exceed the statistically acceptable level (Gujarati & Porter, 2009 p338). Previous research studies have indicated that variables are free from multicollinearity problems if the correlation between the variables is less than 0.8 (Lestari et al., 2022). This implies that the study models will be stable, as the responsiveness of one independent variable in predicting the endogenous variable will cause almost no or zero movement with the other independent variables.

#### 4.5 Multicollinearity Test

A multicollinearity test has been conducted to confirm the inter-relationship between the variables. As reported by the correlation matrix in the correlation analysis section above, there is no clear inter-association between the variables, and particular attention has been paid to the independent variables. The statistical results in the correlation matrix implied that the independent variables are free from multicollinearity challenges. To confirm the results from the correlation matrix, the variance inflation factor test (VIF) has been used as a triangulation test. Table 4.4 below reports the results of the VIF test.

Table 4. 4: Variance Inflation Factor (VIF)

Variables	VIF	1/VIF
STVAL	4.04	0.25
GDPC	3.61	0.28
TROP	3.25	0.31
BACRED	2.94	0.34
CORP	2.20	0.46
EXR	1.94	0.52
INFL	1.38	0.73

GEF	1.30	0.77
BAT	1.26	0.80
STCAP	1.25	0.80
PST	1.22	0.82
Mean VIF	2.22	.

**Source:** Author's compilation

The variance inflation factor test (VIF) has been used as a triangulation test to confirm the multicollinearity results reported by correlation analysis in Table 4.3 above. The VIF test recorded a coefficient of 2.22, below the threshold value of 2.5 under the conservative approach recommended by Johnston et al. (2018). The VIF test results give confidence that the data are free from potential multicollinearity issues. The quality of the data aligns with Liu et al. (2023) on the realism that analysis and interpretation performed on regression results using data free from multicollinearity issues have higher reliability, adding more value to decision-makers.

#### **4.6 Panel Unit Root Test and Panel Cointegration Test**

In a study involving long-run models, it is essential to establish a long-run relationship between the variables. This vital step helps certify the viability of the regressions before running the models. In such a case, the objective is achieved by carrying out the panel unit root test followed by the panel cointegration test.

#### 4.6.1 Panel Unit Root Test

A panel unit root test was conducted to determine if the data were stationary or nonstationary. The first difference was also considered after the data was nonstationary at the level. Based on the nature of the data for this study, the Im–Pesaran–Shin unit-root test was used, which is appropriate for panel data. The Im–Pesaran–Shin unit-root test is the most relevant, given its flexibility in handling strong and strongly balanced panels. Table 4.5 below displays the Im–Pesaran–Shin unit-root test results.

Table 4. 5: Im–Pesaran–Shin Unit-root Test

Variable	Statistic	At level	At 1 <sup>st</sup> Difference
FDI	-5.1602	0.1070	0.0000***
BAT	-3.2703	0.0005***	
BCRED	-3.8293	1.0000	0.0001***
STVAL	-5.2831	0.4069	0.0000***
STCAP	-2.8356	0.0023***	
CORP	-6.1773	0.5786	0.0000***
GEF	-5.2447	0.1048	0.0000***
PST	-5.5005	0.0002***	
GDPC	-1.3450	0.0009***	
INFL	-3.3264	0.0004***	
TROP	-4.4617	0.9745	0.0000***
EXR	-5.0062	0.9999	0.0000***

**Source:** Author’s compilation

**Notes:** The asterisks \*\*\*, \*\*, and \* indicates significance levels at 1%, 5%, and 10% respectively

The Im–Pesaran–Shin unit-root test results reported in Table 4.5 above reveal that some of the data were stationary at a level while others were at first difference. All the data were stationary and statistically significant at 1%, either at the level or first difference. Stationarity of the data increases the predictive

power and simplifies the model by eliminating the trends and seasonality effects. Also, the data being stationary improves the performance and stability of the forecasting methods. It is worth acknowledging that analysis and interpretation performed on regression results using stationary data have higher reliability, adding more value to decision-makers (Liu et al., 2023).

#### 4.6.2 Panel Cointegration Test

A panel cointegration test was conducted after the panel unit root test to determine the long-run relationship among the variables. Once the data were confirmed to be stationary, a critical step was to find out how the series related. Panel cointegration test provided helpful information regarding the long-run association between the variables by determining whether the series shared the stochastic trends in the group of variables. The study has used the Kao panel cointegration test. The Kao panel cointegration test has been preferred over other tests (Pedroni and Westerlund ) for its capability of handling an extended model with more than seven variables, like in this case, where the involved variables are twelve (12). Table 4.6 below presents the panel cointegration results.

Table 4.6: Kao test for panel cointegration

Variables	Statistic	p-value
Modified Dickey-Fuller t	-5.7133	0.0000***
Dickey-Fuller t	-4.4871	0.0000***
Augmented Dickey-Fuller t	-4.7559	0.0000***

Unadjusted modified Dickey-Fuller t	-7.1294	0.0000***
Unadjusted Dickey-Fuller t	-4.7221	0.0000***

**Source:** Author's compilation

**Notes:** The asterisks \*\*\*, \*\*, and \* indicates significance levels at 1%, 5%, and 10% respectively

The Kao test for panel cointegration results above show that all the panels were cointegrated at a 1% significance level. The results indicate that the variables have a long-run relationship, and such an association is stable. The cointegration of the panels enables the current study to estimate the dynamic relation among the variables. Also, the cointegration of the panels helps identify the intensity of the long-run equilibrium and short-term dynamics.

#### 4.7 Methodology Selection

Before running the regression models, both the primary model and the moderating effect, deciding which methodology to use in the analysis is paramount. The Hausman test was conducted to determine the most appropriate and relevant method between the fixed effect and random effect models. The Hausman test is commonly used in panel data to determine the suitable model to be applied between fixed and random effects to minimize or eliminate the chances of committing type one or two errors. The possibility of committing these two errors stems from inappropriately rejecting or failing to reject the null hypothesis (Cohen, 1988). Table 4.7 below presents the results of the Hausman test.

Table 4. 7: Hausman Test Results

Chi2	P-value	Decision
1.28	0.2576	P>0.05, Random Effect

Source: Author's compilation

The decision for the Hausman test is based on 5% probability as a benchmark for either rejecting or failing to reject the null hypothesis. Under the Hausman test, it is hypothesized by the null hypothesis that the random effect is the preferred model, while the alternative hypothesis stands for the fixed effect model. The Hausman test results in Table 4.7 show that the null hypothesis cannot be rejected since the P-value>0.05. Therefore, the random effect is the relevant model for the analysis. However, the random effect model (RE) is rarely used because of its underlying assumption that covariates are independent of its residuals (Green, 2018). Since panel data suffers from cross-sectional dependence attributed to some unobserved common factors across the units, the RE model cannot handle the endogeneity problem. Hence, the study will use feasible generalized least squares (FGLS) and panel-corrected standard errors (PCSE) for better analysis stemming from these models' consistent and reliable results.

According to the study's data environment, which involves panel data characterized by a longer time than the cross-sectional number of units ( $T > N$ ), FGLS is the best estimator under these conditions. The FGLS produce more

efficient estimates than other OLS estimators (Bai et al., 2021). The estimation results produced by FGLS are more improved, efficient, and consistent. The efficiency of FGLS makes it capable of handling heteroscedasticity and autocorrelation problems encountered in panel data (Reed & Ye, 2011). However, PCSE is used for robustness checks because of its power to produce accurate confidence intervals and consistent standard errors. PCSE also considers cross-sectional and temporal dependences (Hoechle, 2007). However, further robustness checks are conducted to confirm the sensitivity of the results using other proxies for banking services and stock market size as proposed earlier in the methodology section.

#### 4.8 Heteroskedasticity Test

Although the methodologies employed by the study, FGLS and PCSE, consider the heteroskedasticity problem, White's test was also conducted to determine whether the variance from the regression errors is dependent on the independent variables. Table 4.8 below presents White's test results.

Table 4. 8: White's Test (Cameron & Trivedi's decomposition of IM-test)

Source	chi2	df	p
Heteroskedasticity	75.67	71	0.3301
Skewness	4.58	11	0.9500
Kurtosis	0.31	1	0.5796
Total	80.56	83	0.5556

**Source:** Author's compilation

The results from white's test above fail to reject the null hypothesis for homoskedasticity since the p-value is more than 0.05. Consequently, the alternative hypothesis for unrestricted heteroskedasticity is rejected at a 5% significance level. This implies that variance from the regression errors is not correlated with the independent variables, hence no heteroskedasticity problem. It should be appreciated that the application of FGLS and PCSE in this study could also capture the heteroskedasticity issue had it existed among the independent variables (Moundigbaye et al., 2018).

#### **4.9 Regression Estimation**

The regression estimation section has been divided into two main parts. The first part is the regression estimation of FDI and the employed explanatory variables (model 1). The second part (model 2) is the regression estimation relating FDI and the moderation effect of institutional quality (corruption, government effectiveness, and political stability) on financial development (bank assets, bank credit to the private, value traded, and market capitalization).

The regression estimations for this study are based on FGLS, the primary model employed to produce efficient coefficients. The panel-corrected standard error (PCSE) is also used to analyze the study results better. All the models are used to warrant the consistency of the results from the study. The PCSE estimator is used to confirm the robustness of the results. The preconditions of the FGLS of  $T \geq N$  or  $N \leq T$ , small-scale panel, and that  $T/N \geq 1.5$  have been satisfied in the panel throughout the study, which creates consistency and reliability of the

estimated results. The requirement for a higher ratio of T/N for the appropriate execution of PCSE has also been met.

The FGLS and the PCSE estimators account for heteroscedasticity and serial correlation in panel data regressions, aiming to adjust standard errors to provide efficient estimates but differing in their underlying assumptions and application (Reed & Ye, 2011). All models (FGLS and PCSE) rely on the same assumptions to estimate the regression coefficients, resulting in the same coefficient values.

The FGLS and PCSE often produce similar regression coefficients (Shahbaz et al., 2024; Nawaz & Rahman, 2023) for the following reasons: First, based on model specification, both FGLS and PCSE adjust for heteroscedasticity and serial correlation without altering the regression coefficient estimates. The two models primarily focus on adjusting the standard errors of the estimates to provide valid inferences. Second, the two models rely on similar adjustments. FGLS estimates the model parameters using a weighted sum of squares approach, where the weights are derived based on assumptions about the error structure. On the other hand, PCSE adjusts standard errors post-estimation using panel-specific correction factors derived from the variance-covariance structure of the data. Third, regarding the underlying assumptions, FGLS assumes a specific form of heteroscedasticity and often serial correlation. At the same time, PCSE adjusts for heteroscedasticity and serial correlation in a more robust model-agnostic way by using panel-specific standard error corrections.

The FGLS and PCSE estimators produce similar regression coefficients to achieve estimation efficiency. In the presence of heteroscedasticity and serial correlation, both FGLS and PCSE aim to produce efficient estimates of the coefficients because they focus on adjusting standard errors rather than coefficients themselves, thus maintaining similar or very close coefficient values. Lastly, based on small sample properties, when the assumptions about the error structure hold, FGLS and PCSE may converge to similar regression coefficients. In practice, the difference in coefficient estimates for panel data analysis between FGLS and PCSE tends to be negligible (Mkombe et al., 2021; Moundigbaye et al., 2020; Reed & Ye, 2011). Therefore, the primary focus of FGLS and PCSE in panel data regression analysis is on the precision of coefficient estimates rather than the coefficients themselves, which in most cases results in similar or very close regression coefficients as can be revealed from different studies which employed the two models (Basumatary et al., 2024, Appiah et al., 2019; Dabbous & Barakat, 2023; Thanh, 2022; Nguyen, 2022; Nawaz & Rahman, 2023).

Despite the coefficients being similar across FGLS and PCSE, the results are still consistent and reliable based on their differences in estimation efficiency, produced standard errors, and p-values. Similarly, all the estimation models have consistently maintained the coefficient sign, which reliably tells about the hypothesized relationship between the endogenous and exogenous variables. When the explanatory variables are not correlated with the unobserved common factors (error term), the coefficients from different estimates are consistent (Hoechle, 2007). FGLS and PCSE use the same assumptions to estimate the

coefficients to maintain consistent estimates (Lewis & Linzer, 2005). Likewise, Beck and Katz (1995) proposed that PCSE relies on coefficient estimates from FGLS for optimized standard errors, which is also supported by Hoechle (2007).

The results produced by FGLS are reliable because they are based on an efficient estimator, since the data environment satisfies the conditions of its application. FGLS produces consistent and efficient estimates, making it an appropriate primary regression model (Hoechle, 2007). PCSE is the relevant robustness model because of its accuracy in estimating confidence intervals and efficiency in estimating the covariance matrix (Hoechle, 2007). According to Zhang and Zhao (2014), PCSE produces reliable results due to its optimized standard error estimate. The model (PCSE) correctly estimates the standard errors and produces robust results (Lewis & Linzer, 2005). The reduction of estimation errors gives PCSE its relevance to be used for robustness checks. PCSE reliably confirms the hypotheses due to its consistent accuracy in estimating the confidence interval; hence, it is appropriate for robustness checks (Reed & Ye, 2011). Therefore, the same statistical magnitude of the regression coefficients across the two models serves as a basis for the results' robustness based on their similar relation signs and different standard errors and p-values.

#### **4.9.1 Regression Estimation of FDI and the Explanatory Variables**

Table 4.9 below presents the summary of the regression estimation results for FDI and explanatory variables, which are categorized into financial development (bank assets-BAT, credit to the private sector-BACRED, value traded-STVAL,

and market capitalization-STCAP, institutional quality variables (corruption-CORP, government effectiveness-GEF, and political stability-PST) and macroeconomic variables (GDP per capita constant-GDPC, inflation rate-INFL, trade openness-TROP, and exchange rate-EXR). The financial development variables explain the relationship between banking services and stock market size on FDI inflows. In contrast, the institutional quality variables play a double role as a direct relationship with FDI and as a moderator of the FDI-financial development nexus. However, the macroeconomic variables are the controls used to stabilize the model. The regression results are based on two estimation models: FGLS and PCSE.

Table 4.9: Regression results for the relationship between financial development, Institutional Quality and FDI

Variables	FGLS		PCSE	
	Coef. (SE)	P>Z	Coef. (SE)	P>Z
BAT	0.056** (0.025)	0.023	0.056*** (0.018)	0.002
BACRED	0.105*** (0.017)	0.000	0.105*** (0.017)	0.000
STVAL	-2.299*** (0.794)	0.004	-2.299*** (0.844)	0.006
STCAP	-0.064** (0.025)	0.010	-0.064*** (0.023)	0.006
CORP	-23.977** (11.892)	0.044	-23.977** (12.172)	0.049
GEF	-0.089** (0.044)	0.042	-0.089** (0.036)	0.013
PST	-0.010 (0.011)	0.331	-0.010 (0.008)	0.199
GDPC	-1.56E+07 (7.35E+07)	0.831	-1.56E+07 (5.15E+07)	0.761
INFL	-2.683** (1.061)	0.011	-2.683*** (0.978)	0.006

TROP	0.416 (0.624)	0.505	0.416 (0.518)	0.421
EXR	0.001*** (0.000)	0.000	0.001*** (0.000)	0.000
R-squared		68.49%		
VIF		2.22		
Kao Cointegration Test		0.000		
Im-Pesaran-Shin		0.000		
Heteroskedasticity		0.3301		
Hausman Test		0.2576		

**Source:** Author's compilation

**Notes:** FGLS represents feasible generalized least squares, and PCSE represents panel-corrected standard errors. The statistical values in the table are the regression results containing coefficients (Coef.) and the standard error (SE) values (in brackets). The asterisks \*\*\*, \*\*, and \* indicates significance levels at 1%, 5%, and 10% respectively. The table also reports R-squared.

The regression estimation results in Table 4.9 above indicate that FDI is significantly influenced by financial development, institutional quality, and macroeconomic variables. Based on financial development, both the banking sector and stock market development are statistically significant, which implies that they play an influential role in attracting FDI inflows. Hence, the hypothesized relationship between financial development and FDI is supported. In this case, a well-established banking sector and broader stock market catalyze the attraction of more FDI to the EAC. There is no doubt that foreign investors require support from the financial systems of the host countries in terms of quality banking services and efficient stock markets.

In assessing the role of the banking sector towards inward FDI attraction, it has been hypothesized that the level of bank assets (BAT) is positively related to FDI. The results from the study support the hypothesized relationship (H1a)

between FDI and this banking sector variable, which describes the financial sector development. Bank assets statistically influence FDI inflows at a 5% significant level under FGLS with a standard error of 0.025, which PCSE strongly confirmed at a 1% significant level and standard error (0.018). Bank assets positively impact the attraction of FDI inflows to the host countries, as revealed by its positive regression coefficient (0.056) and low estimation standard error (0.025). The results imply that every increase in bank assets by USD 1 billion in the host countries increases FDI inflow by USD 0.056 billion. The findings highlight the financial sector's role in attracting investment. Strong, well-regulated banks enhance investor confidence, reduce financing constraints, and signal macroeconomic stability. Policymakers should prioritize banking sector development as part of a broader strategy to improve the investment climate and attract sustainable FDI.

Similarly, bank credit to the private sector (BACRED), another measure of banking sector development, was hypothesized to be positively related to FDI. The study's results supported and confirmed this hypothesis (H1b). Bank credit to the private sector strongly influences the attraction of FDI inflows at a 1% significance level, as reported by FGLS. Still, PCSE consistently maintains it at the same significance level. The positive impact of credit provision on the private sector is revealed by the positive coefficient (0.105) and relatively high precision for its estimation at a standard error of 0.017 for both FGLS and PCSE models. The results suggest that every increase in USD 1 billion credit by banks to the private sector in the EAC leads to a rise in FDI attraction level by USD 0.105 billion. The indication is that banking operations in the EAC economies align

with the financial services expected by foreign investors. The findings further imply that foreign investors are more likely to be attracted to undertake FDI in economies with higher banking sector development. The study findings reflect the market's ability to mobilize funds for investments among the market participants.

On the other hand, the influence of stock market development in attracting FDI inflows to the EAC has been gauged by value traded and market capitalization. The study hypothesized that the value traded is positively related to FDI. The reported results from the study contradict the hypothesized relation (H1c) between value traded and FDI. The regression results show that value traded strongly but negatively impacts FDI attraction at a 1% statistical significance level as per FGLS with standard error (0.794) and confirmed by PCSE at the same significance level with standard error (0.844). The results reflect that (H1c) prior belief of a positive relationship between value traded and FDI is not supported. The coefficient value (-2.299) implies that every 1% change in value traded results in an FDI level decline of almost 2.3%. The results are unusual, but they do happen. The study expects that the value traded would positively motivate foreign investors to resolve their challenges of additional funding during their investments' growth and expansion stages by raising funds from the stock markets in the EAC. Unfortunately, the results are contrary to the expectations, similar to the findings reported by Hausmann and Fernandez-Arias (2000) on value traded being negatively related to FDI in Latin America. The results suggest that policymakers should make deliberate efforts to enhance

stock market development to exert a significant positive impact on the investment process.

In the same vein, it was hypothesized that market capitalization is positively related to FDI. The results from the study contradict the hypothesized positive relationship (H1d) between the two variables with a negative coefficient sign (-0.064); hence, (H1d) is not supported. The results from the study reveal that stock market capitalization negatively influences FDI attraction to the EAC at a 5% significance level per FGLS with a standard error of 0.025, which PCSE has also confirmed at a 1% significance level, and a standard error of 0.023. The results further indicate that every change in market capitalization by USD 1 billion results in a decline in the FDI level by USD 0.064 billion. Hausmann and Fernandez-Arias (2000) also reported this negative relationship for Latin American countries, in which they found market capitalization, the measure of stock market size, to influence FDI inflows negatively. Efforts need to be made regarding the formulation of policies for stock market development to make it impactful for investors' financing needs.

Sector-wise analysis of the influence of financial development on inward FDI attraction indicates that the banking sector positively influences FDI inflows to the EAC through the reported positive association for both bank assets and credit to the private sector. However, stock market proxies were found to negatively influence FDI inflows through a robust and significant association reported by value traded and market capitalization. The implication is that foreign investors

are more attracted to investing in EAC through banking sector development facilitated by banking services than stock market development. In EAC economies, thin stock markets, which increase risks and the uncertainty of raising sufficient funds, and high underwriting costs for stock issuing make the banking sector a preferable source of additional financing than stock market arrangements.

On the other hand, all the institutional quality variables were negatively related to FDI. The hypothesized positive association between institutional quality and FDI is not supported. The regression results indicate that EAC is experiencing low institutional quality affected by corruption, government ineffectiveness (excessive bureaucracy), and political turbulence. The results for the institutional quality reflect the findings reported by Beazer and Blake (2018), who argued that weak institutions harm the attraction of FDI inflows to the recipient economies.

Corruption acquired the predicted negative coefficient sign among the institutional quality variables used in the study. The regression results supported the hypothesis (H2a) that corruption is negatively related to FDI. Corruption acquired a negative coefficient sign (-23.977), which signifies the adverse effect brought by the same, as it pollutes the investment environment. The results from the study report a significant negative influence exerted by corruption on FDI inflows at a 5% level per FGLS with a standard error (11.892), which PCSE also confirmed at the same level of 5% significance and standard error (12.172). The

results reflect the actual negative impact exerted by corruption on FDI inflows as it distorts the investment climate. The regression coefficient value indicates that every rise in corruption by 1 point, according to the index scale, distorts the pattern of FDI inflows to the EAC. Corruption makes the FDI recipient countries less attractive, especially for foreign investors susceptible to higher market risks in foreign economies than their local investors. This calls for adherence to institutional quality practices to minimize the potential of controlling the adverse effects of corruption in the investment channels.

The results for government effectiveness are somewhat surprising as they indicate this variable is negatively related to FDI. The sign of the coefficient (-0.089) shows that government effectiveness has a negative statistical relationship with FDI inflows. Statistically, government effectiveness reveals a significant impact on FDI at a 5% level per FGLS with a standard error of 0.044, which is also consistent with the results produced by PCSE at the same significance level and standard error of 0.036. The results are contrary to the predicted positive influence of government effectiveness of the EAC in attracting FDI inflows. The hypothesis (H2b) that government effectiveness is positively related to FDI is not supported. The results imply that every increase in government effectiveness in EAC by one score led to a decrease in FDI inflows by USD 0.089 billion. These unusual results do happen and can be explained based on Bhasin and Garg (2020) and Islam et al. (2020). The authors stated that institutional challenges facing emerging economies result in the government's inefficient involvement in the investment process, which negatively impacts FDI attraction. There is a need to improve government

effectiveness, which is superior to other institutional quality variables, which could enhance the investors' confidence and open up the region's available investment opportunities.

Moreover, political stability is found to be correlated with FDI but not statistically significant, with a carrying coefficient of (-0.010) and standard error of (0.011) per FGLS and (0.008) as per PCSE. The negative and insignificant results for the impact of political stability on FDI reported above are average, as similar results were reported by Kariuki (2015) while studying the determinants of FDI inflows to the African Union (AU). Even though political stability did not produce statistically significant results, it is worth recognizing that it acquired unexpected negative signs contrary to the hypothesized positive relationship with FDI. Therefore, the regression results reveal that the hypothesis (H2c) that political stability is positively related to FDI is not supported. The negative relationship between political stability and FDI reported by the negative coefficient sign (-0.010) indicates the existence of several factors that may pose a risk to foreign investors and overall investment platforms despite the political stability existing in EAC, such as changes in political regimes (UNCTAD, 2019; Nguyen et al., 2018).

For the macroeconomic variables (control variables) employed in the study, the inflation and exchange rates were statistically significant, and the expected coefficient signs relating them to FDI inflows were acquired. The inflation rate reported a statistically significant influence on FDI at a 5% level according to

FGLS with a standard error of 1.061, which PCSE also confirmed at a 1% significance level and standard error (0.978). The results for the inflation rate indicate a negative relationship with FDI, as revealed by its negative coefficient sign (-2.683). A further implication of the inflation rate results is that every increase in the inflation rate by 1% leads to a decline in FDI inflows to the EAC. The findings suggest that rising inflation reduces FDI by increasing uncertainty, costs, and currency risk. Policymakers must ensure macroeconomic stability through sound monetary, fiscal, and structural policies to attract investment.

However, the exchange rate was found to strongly influence FDI inflows to the EAC at 1% statistical significance as per FGLS with standard error (0.000) and robustly confirmed by PCSE at the same significant level and standard error (0.000). The results reported a positive relationship between exchange rate and FDI, revealed by the acquired positive coefficient sign (0.001). The results imply that stable and competitive exchange rate systems positively affect FDI. The results indicate that FDI attraction increases by USD 0.001 billion when the EAC economies' exchange rates become more efficient by one unit between their local currency and the US dollar due to the flexibility of market forces. Therefore, foreign investors are attracted to foreign economies with relatively stable currencies and fair currency pricing mechanisms for smooth international capital movement.

The remaining macroeconomic variables, GDP per capita constant and trade openness, are not statistically significant. Unfortunately, the regression results

reported a negative coefficient for GDPC, which indicates that FDI inflows do not depend on the economic development level in the EAC. Two reasons could explain this: the first is that foreign investors do not consider the EAC economies' economic development level the only driving factor for FDI location (Sabir et al., 2019). Secondly, as economic development increases, it leads to higher income distribution, which raises the cost of doing business; hence, GDP negatively affects FDI inflows (Buchanan et al., 2012).

Apart from the financial development variables employed in the study and the institutional quality variables, it is worth acknowledging and appreciating that FDI is also influenced by other macroeconomic variables, including those used as control variables. Specifically, inflation and exchange rates are factors of concern for FDI inflows to EAC economies as they affect investors' profitability potential and international capital flow.

Additionally, the regression results can be explained briefly by the reported value of  $R^2$ . The regression estimation produced an  $R^2$  value (0.6849 or 68.49%), implying that the combination of financial development variables, institutional quality, and the macroeconomic variables employed in the study explains FDI inflows by over 68%. Consequently, the reported  $R^2$  indicates that the employed regression estimation model (FGLS) best predicts the studied relationship. The explanatory power reported by the  $R^2$  supports the relevance of FGLS in producing efficient coefficients under the study's data environment and preconditions of  $T \geq N$ ;  $T/N \geq 1.5$ . Indeed, the value of  $R^2$  provides evidence that

the model used for the robustness check, PCSE, is appropriate, as it confirms all the results produced by the primary estimation model, FGLS.

This relatively high explanatory power suggests that the financial and institutional environment plays a major role in determining its attractiveness to foreign investors. From an applied economics perspective, this means that policy reforms aimed at improving financial sector performance, such as expanding credit access, strengthening capital markets, and increasing banking sector efficiency, are likely to have a substantial and measurable impact on FDI. More importantly, the strong model fit implies that institutional quality, such as good governance, regulatory effectiveness, and the rule of law, is not only relevant but essential in amplifying and shaping the benefits of financial development in the investment process. Therefore, policymakers should view these findings as a clear signal that targeted improvements in both financial and institutional frameworks can yield significant contributions to FDI attraction. This also means that continued neglect in these areas may account for a large portion of unrealized foreign investment potential.

#### **4.9.2 Moderating Effects of Institutional Quality**

The relationship between FDI and financial development in this study is moderated by institutional quality, covering corruption (CORP), government effectiveness (GEF), and political stability (PST). The regression estimation for the moderating effect is performed to determine the tangential impact exerted by

the involved institutional quality variables on bank assets (BAT), bank credit to the private sector (BACRED), value traded (STVAL), and market capitalization (STCAP) in the estimation of FDI. The regression estimation results for the moderation effects are presented in Table 4.10 below, involving FGLS and PCSE estimation models.

Upon acting the institutional quality variables on financial development for moderation effect analysis, the generated variables include; CORP\_BAT (moderation effect of corruption on bank asset), CORP\_BACRED (moderation effect of corruption on credit to the private sector), CORP\_STVAL (moderation effect of corruption on value traded), CORP\_STCAP (moderation effect of corruption on market capitalization), GEF\_BAT (moderation effect of government effectiveness on bank asset), GEF\_BACRED (moderation effect of government effectiveness on credit to the private sector), GEF\_STVAL (moderation effect of government effectiveness on value traded), GEF\_STCAP (moderation effect of government effectiveness on market capitalization), PST\_BAT (moderation effect of political stability on bank asset), PST\_BACRED (moderation effect of political stability on credit to the private sector), PST\_STVAL (moderation effect of political stability on value traded), and PST\_STCAP (moderation effect of political stability on market capitalization).

Table 4. 10: Regression results for the moderating effect

Variables	FGLS		PCSE	
	Coef. (SE)	P>Z	Coef. (SE)	P>Z
CORP_BAT	-2.875 (3.076)	0.350	-2.875 (2.067)	0.164
CORP_BACRED	7.563*** (2.796)	0.007	7.563*** (2.449)	0.002
CORP_STVAL	-239.443** (114.623)	0.037	-239.443** (97.836)	0.014
CORP_STCAP	-7.085** (3.217)	0.028	-7.085*** (2.552)	0.006
GEF_BAT	-0.020 (0.014)	0.159	-0.020** (0.009)	0.037
GEF_BACRED	0.105*** (0.029)	0.000	0.105*** (0.026)	0.000
GEF_STVAL	-2.970** (1.454)	0.041	-2.970** (1.330)	0.026
GEF_STCAP	-0.040* (0.022)	0.072	-0.040*** (0.015)	0.008
PST_BAT	0.003 (0.005)	0.581	0.003 (0.003)	0.431
PST_BACRED	0.016 (0.012)	0.172	0.016* (0.009)	0.071
PST_STVAL	-1.471** (0.665)	0.027	-1.471*** (0.492)	0.003
PST_STCAP	0.000 (0.013)	0.971	0.000 (0.008)	0.955
BAT	0.134 (0.102)	0.187	0.134* (0.069)	0.051
BACRED	0.061 (0.123)	0.619	0.061 (0.104)	0.555
STVAL	-0.153 (5.039)	0.976	-0.153 (4.182)	0.971
STCAP	0.189 (0.146)	0.196	0.189* (0.107)	0.078
CORP	-29.585* (17.088)	0.083	-29.585** (13.820)	0.032
GEF	-0.277*** (0.086)	0.001	-0.277*** (0.059)	0.000
PST	0.008 (0.053)	0.882	0.008 (0.041)	0.849
GDPC	-7.52E+07 (7.38E+07)	0.308	-7.52E+07 (5.17E+07)	0.146
INFL	-1.437 (1.008)	0.154	-1.437* (0.847)	0.090
TROP	0.178	0.747	0.178	0.662

	(0.553)	(0.408)		
EXR	0.000***		0.000***	
	(0.000)	0.000	(0.000)	0.000
R-squared		80.54%		
VIF		1.97		
Kao Cointegration Test		0.000		
Im-Pesaran-Shin		0.000		
Heteroskedasticity		0.2805		
Hausman Test		0.0608		

**Source:** Author's compilation

**Notes:** FGLS represents feasible generalized least squares, and PCSE represents panel-corrected standard errors. The statistical values in the table are the regression results containing coefficients and the standard error values (in brackets). The asterisks \*\*\*, \*\*, and \* indicates significance levels at 1%, 5%, and 10% respectively. The table also reports the value of R-squared.

The regression results for the moderation effect of corruption on bank assets did not turn out statistically significant. Therefore, the hypothesis (H3a) that corruption moderates the relationship between bank assets and FDI has not been supported. However, it was noted that the coefficient of the moderating variable CORP\_BAT acquired a negative sign (-2.875) at a standard error of (3.658), indicating the adverse impact of corruption on bank assets towards the influence of FDI inflows. The results for the insignificant effect of corruption on bank assets in attracting FDI can be explained based on the insignificant results of corruption on financial development reported by Krifa-Schneider et al. (2022). They opined that corruption impacts the financial sector depending on how well the host countries' financial systems are developed.

On the other hand, the results from the study support the hypothesis (H3b) that corruption moderates the relationship between credit to the private sector and

FDI. The regression results show that corruption strongly moderates the relationship between credit to the private sector and FDI at 1% statistical significance per FGLS with a standard error of 2.796, which PCSE also confirms at the same significance level and standard error of 2.449. The regression coefficient of the moderation effect (CORP\_BACRED) acquired a positive sign (7.563), which indicates that corruption exerts a positive tangential effect on credit to the private sector in attracting FDI inflows to EAC. The results for the moderation effect of corruption on credit to the private sector indicate that the intensity of influence exerted by bank credit to the private sector in the attraction of FDI inflows varies with the level of corruption existing and tolerable by the EAC countries. The tangential effect of corruption on credit to the private sector increases FDI inflows as the level of the moderated effect of corruption on the private sector increases. The unusual positive impact of corruption on credit to the private sector's influence on FDI inflows is also based on the capital conservatism approach generally adopted by foreign investors to protect their earnings against host countries' financial volatilities (Islam et al., 2021).

The regression results show that the moderating effect of corruption on value traded is statistically significant at a 5% level as per FGLS, which PCSE also confirmed at the same significant level. The hypothesis (H3c) that corruption moderates the relationship between value traded and FDI is supported. The moderating term (CORP\_STVAL) carried a negative regression coefficient sign (-239.443), which indicates that corruption negatively impacts the influence of value traded on inward FDI attraction to the EAC. The moderating effect of corruption on value traded acquired negative signs, reflecting its adverse impact

on stock market forces, the investment process, and investment location factors preferred by foreign investors. It can further be deduced that the regression results for the moderating effect of corruption on value traded towards FDI attraction to the EAC are influenced by corruption in such a way that an increase in level by 1 point for the moderating effect of corruption on value traded leads to a decline in the level of FDI inflows to the EAC.

Similarly, the regression results for the moderation effect of corruption on market capitalization revealed that corruption statistically moderates the influence of market capitalization on FDI inflows; hence, hypothesis (H3d) is supported. The results for the moderating effect of corruption on market capitalization towards FDI attraction are statistically significant at a 5% level as per FGLS with standard error (3.217) and robustly at 1% by PCSE with standard error (2.552). The moderation factor (CORP\_STCAP) carried a negative regression coefficient sign (-7.085). The increased interaction between corruption and stock market operations reduces FDI inflows to the EAC economies. The negative coefficient indicates that corruption hurts stock market trading activities in attracting FDI inflows. The moderating results also suggest that the impact of market capitalization on FDI inflows to the EAC countries varies with the level of corruption in the region. An increase in the tangential effect of corruption on market capitalization by 1 point distorts the attractiveness of the investment climate, resulting in a decline in FDI inflows.

Regarding the moderating effect of government effectiveness on financial development, the regression results for the moderating effect of government effectiveness on bank assets are statistically insignificant under FGLS with a standard error (0.014), but statistically significant at a 5% level under PCSE with a standard error (0.009), which suggests a correlation between the two variables. The FGLS results do not support the hypothesis (H4a) that government effectiveness moderates the relationship between bank assets and FDI. The regression coefficient of the moderated variable (GEF\_BAT) acquired a negative sign (-0.020), which means the conditional effect of government effectiveness on bank assets adversely affects FDI inflows to the EAC. Despite the insignificant moderating effect of government effectiveness on bank assets, it is worth appreciating that government effectiveness influences other institutional quality indicators, and foreign investors are more attracted by government effectiveness than policies (Du & Zhang, 2018).

Comparably, the regression results for the moderating effect of government effectiveness on credit to the private sector are enormously significant at a 1% level as per FGLS with a standard error of 0.029, and confirmed by PCSE at the same significance level and standard error of 0.026. The estimation results support the hypothesis (H4b) that government effectiveness moderates the relationship between credit to the private sector and FDI. The moderation effect (GEF\_BACRED) carried a positive coefficient sign (0.105). The results imply that an increase in the interaction between government effectiveness and credit provision to the private sector enhances FDI inflows to the EAC. The results support the premise that foreign investors prefer good financial services while in

foreign markets, including external financing, which supports their financial needs during growth and expansion (Krifa-Schneider et al., 2022; Pham et al., 2022; Islam et al., 2021). The positive and statistical significance of the conditional effect of government effectiveness on bank credit to the private sector towards FDI inflows reflects the role of governments in the EAC economies in creating a conducive investment climate in fitting the diverse needs of foreign investors (Sabir et al., 2019).

However, the results for the moderating effect of government effectiveness on value traded are statistically significant at a 5% level under FGLS with a standard error of 1.454, which PCSE confirms at the same significance level and standard error (1.330). The results support the hypothesis (H4c) that government effectiveness moderates the relationship between value traded and FDI. The moderated variable (GEF\_STVAL) acquired a negative regression coefficient sign (-2.970). The results for the moderating effect of government effectiveness on value traded suggest that the impact of value traded on FDI inflows varies depending on the level of government effectiveness in the EAC. The results further indicate that the negative sign of the moderation effect implies that increased interaction of government effectiveness on value traded lowers FDI inflows to EAC.

Similarly, the regression results for the moderating effect of government effectiveness on market capitalization are statistically significant at a 10% level as per FGLS with a standard error of 0.022. They robustly confirmed at a 1%

significance level under PCSE with a standard error of 0.015. The results support the hypothesis (H4d) that government effectiveness moderates the relationship between market capitalization and FDI inflows. The regression coefficient for the moderating effect of government effectiveness on market capitalization (GEF\_STCAP) acquired a negative sign (-0.040). Analysis of the estimation results for the moderation effect of government effectiveness on market capitalization also indicated that the impact of market capitalization on FDI inflows varies with the level of government effectiveness in the EAC. The results imply that increased interaction between government effectiveness and stock market operation deters FDI inflows to the EAC.

However, the moderating effect of political stability on bank assets turned out statistically insignificant under all models at a standard error of 0.005 and 0.003 for FGLS and PCSE, respectively. The hypothesis (H5a) that political stability moderates the relationship between bank assets and FDI is not supported based on the moderation regression results. The moderating effect of political stability on bank assets (PST\_BAT) carried a positive regression coefficient sign (0.003). The positive coefficient sign implies that bank assets positively relate to FDI inflows in the presence of political stability. The insignificant results for the moderating effect of political stability on bank assets also indicate that bank assets' impact on FDI attraction is not influenced by the level of political stability prevailing in the EAC region. Economic dynamics between net savers and bank mobilization for deposits more influence the relationship between FDI inflows and bank assets.

Similarly, the moderation effect of political stability on credit to the private sector turned out statistically insignificant under FGLS with a standard error of 0.012) but statistically significant at a 10% level as per PCSE with a standard error of 0.009). The regression results indicate that the hypothesis (H5b) that political stability moderates the relationship between credit to the private sector and FDI is not supported. The moderated variable PST\_BACRED acquired a positive coefficient sign (0.016), meaning that the conditional effect of political stability on credit to the private sector positively relates to FDI inflows to the EAC. Credit provision to the private sector in EAC is more influenced by the banking sector financing arrangements rather than fluctuations in levels of political stability experienced in the region. Despite the results from the FGLS being insignificant but statistically significant at 10% under PCSE, it is an implication that political stability is an essential factor for bank operations and financing availability to the private sector, particularly foreign investors who are not very familiar with the political dynamics in the EAC.

However, the moderating effect of political stability on value traded produced significant statistical results at a 5% level per FGLS with a standard error of 0.665, which was also strongly confirmed under PCSE at a 1% significance level and a standard error of 0.492. The regression estimation results for the moderation effect of political stability on value traded highly supported the hypothesis (H5c) that political stability moderates the relationship between value traded and FDI. Upon conditioning value traded with political stability, the

resulting moderated variable PST\_STVAL negatively impacts FDI inflows, carrying a regression coefficient value (-1.471). The results suggest that as the interaction between political stability and value traded increases, FDI inflows to EAC decline.

Unlikely, the moderating effect of political stability on market capitalization is statistically insignificant. Further, the regression models could not establish a linear relationship between the moderating effect of political stability on market capitalization and FDI. The results for the moderation effect did not support the hypothesis (H5d) that political stability moderates the relationship between market capitalization and FDI. These results imply that the influence of market capitalization on FDI inflows is independent of the levels of political stability prevailing in EAC.

Furthermore, the regression results for the moderating effect of institutional quality (corruption, government effectiveness, and political stability) can also be explained based on the explanatory power predicted by  $R^2$ . The moderation results produced an 80.54%  $R^2$  value, which reveals a very high explanatory power, implying that financial sector development, followed by institutional quality, explains the attractiveness of the host country for FDI inflows. The high value of  $R^2$  further explains the model fitness of the FGLS and PCSE employed for regression estimation, as well as the appropriateness of the moderation strategy execution.

The reported high value of  $R^2$  by the moderation results implies that institutional quality significantly shapes how financial development affects FDI. In practical terms, it means that even well-developed financial systems such as robust banking sectors or active stock markets may not attract substantial FDI unless supported by strong institutions, including effective governance, transparent regulations, and the rule of law. Conversely, improvements in institutional quality can amplify the positive impact of financial development on FDI inflows. The findings are crucial to policymakers in their efforts to deepen financial systems in which must be matched with institutional reforms to achieve all the benefits associated with FDI. In developing regions like EAC, this could guide comprehensive economic strategies that couple financial sector strengthening with governance, legal, and regulatory reforms to create a more investment-conducive climate.

Upon introducing the moderation effect in the primary model to investigate the moderating effect of institutional quality on financial development towards FDI attraction, the value of  $R^2$  increased from 68.49% to 80.54%. The moderation effect increased the explanatory level by about 12%. The increase in explanatory power indicates that the influence of banking services and stock market size on FDI inflows is responsive to levels of institutional quality prevailing in the EAC market, and further that FGLS and PCSE are the best fit estimators for this linear relationship.

The substantial improvement of the value of  $R^2$  by almost 12% increase highlights that institutional quality is not just an independent driver of FDI but a key enabler of financial development. In applied economic terms, financial reforms alone, such as banking sector expansion and capital market development, may not fully translate into increased FDI unless they are reinforced by strong institutions such as effective governance, regulatory quality, and the rule of law. The enhanced  $R^2$  confirms that institutional quality significantly influences the link between financial systems and FDI inflows. This provides information to policymakers that integrated reform strategies are essential. Improving financial systems without addressing institutional weaknesses will yield limited results. Therefore, to unlock the full potential of financial development for attracting FDI, governments in the EAC must prioritize simultaneous reforms in both financial and institutional sectors, ensuring that financial growth is supported by governance structures capable of sustaining investor confidence.

#### **4.10 Robustness Check**

Further robustness checks are conducted for this study using other proxies for banking services and stock market size. The robustness test uses different banking services and stock market size estimating variables. Banking deposits and liquid liabilities are used for banking services, while stock market turnover and the number of listed companies are used to proxy the stock market size. The robustness check aims to examine the responsiveness of the results when alternative measures are used in the primary model and the moderation effect.

#### 4.10.1 Robustness Check on Banking Services and Stock Market Size

As discussed earlier in Chapter 3, banking assets and credit to the private sector are the main proxies used to gauge banking services, while stock value traded and market capitalization have been used to describe the stock market size. However, the robustness check is performed using other measures of banking services and stock market size. Specifically, bank deposits (BDST) and bank liquid liabilities (BLLBT) are used for banking services. In contrast, stock market turnover (STMT) and the number of listed companies (NLSTC) are employed to gauge stock market size.

Table 4. 11: Robustness check results for the relationship between Financial Development, Institutional Quality, and FDI

Variables	FGLS		PCSE	
	Coef. (SE)	P>Z	Coef. (SE)	P>Z
BDST	0.932*** (0.246)	0.000	0.932*** (0.274)	0.001
BLLBT	0.068*** (0.020)	0.001	0.068*** (0.022)	0.002
STMT	-0.052 (0.036)	0.152	-0.052 (0.033)	0.116
NLSTC	0.578*** (0.192)	0.003	0.578*** (0.217)	0.008
CORP	5.300 (11.374)	0.641	5.300 (11.272)	0.638
GEF	1.846 (0.408)	0.000	1.846*** (0.407)	0.000
PST	0.132 (0.215)	0.540	0.132 (0.237)	0.578
GDPC	-0.345*** (0.093)	0.000	-0.345*** (0.095)	0.000
INFL	0.006 (0.017)	0.745	0.006 (0.019)	0.773
TROP	0.823** (0.398)	0.039	0.823** (0.366)	0.025

EXR	0.848*** (0.105)	0.000	0.848*** (0.101)	0.000
R-squared	83.04%			

**Source:** Author's compilation

**Notes:** FGLS represents feasible generalized least squares, and PCSE represents panel-corrected standard errors. The statistical values in the table are the regression results containing coefficients (Coef.) and the standard error (SE) values (in brackets). The asterisks \*\*\*, \*\*, and \* indicates significance levels at 1%, 5%, and 10% respectively. The table also reports R-squared.

As reported in Table 4.11, the coefficients of the banking services proxies remain positively related to FDI, similar to the results presented in Table 4.9. Similarly, the variables significantly influence FDI inflows, as reported in Table 4.9. The results suggest that banking services in the EAC economies are essential in the investment process and attract foreign investors to locate their cross-border investments in those markets. However, the relationship between stock market size and FDI is mixed, with stock market turnover being negative, similar to the value traded and market capitalization reported in Table 4.9. At the same time, the number of listed companies is positive. The findings indicate that thin stock turnover negatively impacts the market's attractiveness for FDI.

In contrast, increasing the number of companies listed on the stock exchanges attracts foreign investors to locate their investments in the EAC. It is worth noting that the alternative measures of stock market size are also statistically significant. Generally, the results reported using different measures of banking services and stock market size are consistent with the findings reported in Table 4.9. Therefore, the robustness test provides sufficient evidence that the banking

services and stock market size, which measure financial development, are essential to attract FDI inflows to the EAC.

A high value of  $R^2$  can also confirm the results for robust checks reported of about 83%. Compared with the reported  $R^2$  for the baseline model of around 68% suggests there is substantial improvement, suggesting that the relationship between financial development, institutional quality, and FDI is both strong and stable across different measurement approaches. In practical terms, it affirms that these two domains, finance and institutions, are central pillars of FDI attraction, and their influence is not sensitive to how they are specifically quantified. This has direct policy relevance that reforms in financial systems and institutional governance are consistently effective levers for increasing FDI, regardless of the specific channels through which they operate, such as banking depth, stock market size, and institutional governance practices.

For policymakers, this enhanced explanatory power validates the call for comprehensive, data-driven policy strategies. It emphasizes the need to diversify and refine the indicators used in assessing financial and institutional strength to design more targeted interventions. Ultimately, the results confirm that when institutional quality and financial development are jointly prioritized, the impact on attracting FDI is not only significant but also robust across contexts, offering a high degree of confidence in the effectiveness of coordinated investment reforms.

#### 4.10.2 Robustness Check on Moderation Effect

The robustness test on the moderation effect is performed by examining the conditional effect exerted by institutional quality (corruption, government effectiveness, and political stability) on the alternative measures of banking services and stock market size variables in influencing FDI inflows.

Table 4. 12: Regression Results for the Moderation Effect

Variables	FGLS		PCSE	
	Coef. (SE)	P>Z	Coef. (SE)	P>Z
CORP_BDST	-0.597 (12.592)	0.962	-0.597 (13.588)	0.965
CORP_BLLBT	1.721** (0.823)	0.036	1.721** (0.826)	0.037
CORP_STMT	0.003 (0.004)	0.520	0.003 (0.004)	0.500
CORP_NLSTC	6.785* (4.073)	0.096	6.785 (4.280)	0.113
GEF_BDST	-0.780 (0.967)	0.420	-0.780 (1.060)	0.462
GEF_BLLBT	0.375*** (0.119)	0.002	0.375*** (0.143)	0.009
GEF_STMT	-0.224 (0.240)	0.349	-0.224 (0.231)	0.331
GEF_NLSTC	1.993*** (0.628)	0.002	1.993*** (0.729)	0.006
PST_BDST	-0.562** (0.265)	0.034	-0.562* (0.304)	0.064
PST_BLLBT	-0.006 (0.008)	0.444	-0.006 (0.009)	0.465
PST_STMT	0.232** (0.099)	0.019	0.232** (0.093)	0.013
PST_NLSTC	0.184 (0.206)	0.372	0.184 (0.233)	0.429
BDST	-1.628 (1.170)	0.164	-1.628 (1.263)	0.198
BLLBT	-0.129** (0.050)	0.010	-0.129** (0.060)	0.034
STMT	0.093 (0.124)	0.453	0.093 (0.112)	0.405

NLSTC	0.720** (0.309)	0.020	0.720** (0.359)	0.045
CORP	-49.838 (30.680)	0.104	-49.838 (32.132)	0.121
GEF	-2.552 (1.796)	0.155	-2.552 (1.973)	0.196
PST	0.366 (0.773)	0.635	0.366 (0.766)	0.632
GDPC	-0.052 (0.120)	0.668	-0.052 (0.140)	0.711
INFL	-0.002 (0.016)	0.890	-0.002 (0.018)	0.902
TROP	0.880** (0.374)	0.018	0.880** (0.376)	0.019
EXR	0.675*** (0.207)	0.001	0.675 (0.203)	0.001
R-squared	88.10%			

**Source:** Author's compilation

**Notes:** FGLS represents feasible generalized least squares, and PCSE represents panel-corrected standard errors. The statistical values in the table are the regression results containing coefficients and the standard error values (in brackets). The asterisks \*\*\*, \*\*, and \* indicates significance levels at 1%, 5%, and 10% respectively. The table also reports the value of R-squared.

The results for the moderation effect presented in Table 4.12 are still identical to the findings reported in Table 4.10. The results revealed a mixed relationship between the tangential effect of institutional quality indicators on the employed alternative measures of banking services and stock market size, consistent with the reported results in Table 4.10. It is further revealed that all the employed institutional quality indicators (corruption, government effectiveness, and political stability) statistically impact the influence of banking services and stock market activities on FDI inflows to the EAC. The findings maintain that in EAC economies, the effects of institutional quality on the investment process are unpredictable, as they can pose a positive or negative impact. The results confirm the pivotal role of quality institutions in the EAC countries, such as banking

services and stock market size, the measure of financial development, and their influence on FDI, which varies with the level of institutional quality.

The high value of  $R^2$  reported for the robustness check for the moderation effect confirms the model's fitness and relevance of the different financial development proxies when conditioned with institutional quality dimensions, which significantly impacts FDI patterns. This enhancement confirms that the moderating effect of institutional quality is both significant and robust, regardless of how financial development or institutions are measured. From an applied economic perspective, it implies that countries with strong institutions can more effectively convert financial sector development into tangible gains in FDI. The results emphasize that the interaction between finance and institutions is a stable and reliable predictor of foreign investment flows.

The high value of  $R^2$  gives information to policymakers that reinforcement for creating a conducive environment for sustainable FDI attraction needs integrated economic reforms. Simply expanding financial services is not sufficient, as the governments must also strengthen institutional frameworks, focusing on good governance practices to ensure that financial development leads to real investor confidence and stable FDI inflows. The improved  $R^2$  in the robustness check offers empirical assurance that such coordinated efforts are likely to achieve consistently strong results across different economic measurements and environments.

#### 4.11 Summary of the Results in Response to the Hypotheses

The summary of the results and response to the developed hypotheses is based on the regressions performed using FGLS, the primary estimation model. The summary of the results is also centred on the categories covered by the study: banking services, stock market size, institutional quality, and the moderating effect of institutional quality on banking services and stock market size.

##### 4.11.1 Banking Services and FDI Inflow

The investigation of the influence of banking services on the level of FDI inflows attracted to the EAC is based on two banking variables: bank assets and bank credit to the private sector. Two hypotheses, H1a and H1b, were tested to respond to this objective, as summarized in Table 4.11 below.

Table 4. 13: Results of banking services towards FDI inflow

Hypothesis	Existence of		
	influence	Association	Decision
H1a Bank assets level is positively related to FDI	significant	positive	supported
H1b Credit to the private sector is positively related to FDI	significant	positive	supported

**Source:** Author's compilation

### 4.11.2 Stock Market Size and FDI Inflow

Two key variables were employed in investigating the impact of stock market size on FDI inflows: value traded and market capitalization. Two hypotheses, H1c and H1d, were tested to respond to the objective of investigating the influence of stock market size on the level of FDI inflow, as summarized in Table 4.12 below.

Table 4. 14: Results of stock market size towards FDI inflow

Hypothesis	Existence of influence	Association	Decision
H1c Value traded is positively related to FDI	significant	negative	not supported
H1d Market capitalization is positively related to FDI	significant	negative	not supported

**Source:** Author's compilation

### 4.11.3 Institutional Quality and FDI Inflow

The investigation of the influence of institutional quality on the level of FDI inflow was based on corruption, government effectiveness, and political stability. These are components of institutional quality that are involved in risk assessment, such as political risk during investment decisions in developing economies. Three hypotheses, H2a, H2b, and H2c, were tested to address this objective, as summarized in Table 4.13 below.

Table 4. 15: Results of institutional quality towards FDI inflow

Hypothesis	Existence of		
	influence	Association	Decision
H2a Corruption is negatively related to FDI	significant	negative	supported
H2b Government effectiveness is positively related to FDI	significant	negative	not supported
H2c Political stability is positively related to FDI	not significant	negative	not supported

**Source:** Author's compilation

#### 4.11.4 Effect of Institutional Quality on the Relationship between Banking Services and FDI Inflow

The moderation effect of institutional quality on the relationship between banking services and the level of FDI inflow was performed using corruption, government effectiveness, and political stability variables. Also, the moderating effect involved two banking sector variables: banking assets and bank credit to the private sector. Six hypotheses, H3a, H3b, H4a, H4b, H5a, and H5b, were tested to achieve this objective, as summarized below in Table 4.14.

Table 4. 16: Results of the effect of institutional quality on the relationship between banking services and FDI inflow

Hypothesis	Existence of		
	influence	Association	Decision
H3a Corruption moderates the relationship between bank assets and FDI	not significant	negative	insignificantly supported

H3b	Corruption moderates the relationship between credit to the private sector and FDI.	significant	positive	supported
H4a	Government effectiveness moderates the relationship between bank assets and FDI.	not significant	negative	not supported
H4b	Government effectiveness moderates the relationship between credit to the private sector and FDI.	significant	positive	supported
H5a	Political stability moderates the relationship between bank assets and FDI.	not significant	positive	insignificantly supported
H5b	Political stability moderates the relationship between credit to the private sector and FDI.	not significant	positive	insignificantly supported

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**Source:** Author's compilation

#### **4.11.5 Effect of Institutional Quality on the Relationship between Stock Market Size and FDI Inflow**

The moderating effect of institutional quality on the relationship between stock market size and the level of FDI inflow was performed on two stock market variables: value traded and market capitalization. In accomplishing this objective, six hypotheses, H3c, H3d, H4c, H4d, H5c, and H5d, were tested, as presented in Table 4.15 below.

Table 4. 17: Results of the effect of institutional quality on the relationship between stock market size and FDI inflow

Hypothesis	Existence of		
	influence	Association	Decision
H3c Corruption moderates the relationship between value traded and FDI	significant	negative	supported
H3d Corruption moderates the relationship between market capitalization and FDI.	significant	negative	supported
H4c Government effectiveness moderates the relationship between value traded and FDI.	significant	negative	not supported
H4d Government effectiveness moderates the relationship between market capitalization and FDI.	not significant	negative	not supported
H5c Political stability moderates the relationship between value traded and FDI.	significant	negative	not supported
H5d Political stability moderates the relationship between market capitalization and FD.	not significant	no relation	not supported

**Source:** Author's compilation

## **CHAPTER FIVE**

### **5.0 DISCUSSION OF FINDINGS AND CONCLUSION**

#### **5.1 Introduction**

This chapter focuses on the discussion of the findings from the study, drawing attention to the objectives set in the previous chapter, the theories involved, and the hypotheses developed in the earlier sections. The discussion considers the effects of financial development (bank assets, bank credit to the private, value traded, and market capitalization) on the inward attraction of FDI, moderating effect of institutional quality (corruption, government effectiveness, political stability) on financial development variables in influencing FDI inflows and the impact of macroeconomic variables (GDP per capita constant, inflation rate, trade openness, exchange rate) on FDI inflows. This chapter's organization involves five sections, including a discussion of the significant findings, contributions and implications, study limitations, further research, and conclusion.

#### **5.2 Discussion of the Significant Findings**

The discussion of the significant findings reported by the study is governed by the study's objectives, which include (i) investigating the influence of banking services on the level of FDI inflow, (ii) investigating the influence of stock market size on the level of FDI inflow (iii) investigating the influence of

institutional quality (Corruption, Government Effectiveness, Political stability) on the level of FDI inflow (iv) investigating the moderating effect of institutional quality (Corruption, Government Effectiveness, Political stability) on the relationship between banking services and the level of FDI inflow (v) investigating the moderating effect of institutional quality (Corruption, Government Effectiveness, Political stability) on the relationship between stock market size and the level of FDI inflow.

### 5.2.1 Banking Services and FDI Inflow

This section expounds on objective number one of the study, which aims to investigate the influence of banking services on inward FDI based on the research question, the hypotheses developed in earlier sections, and the findings summarized in Table 5.1 below.

Table 5. 1: Banking Services and FDI Inflow

<b>Research Objective</b>	<b>Research Question</b>	<b>Hypothesis</b>	<b>Supported/ Not supported</b>
To investigate the influence of banking services on the level of FDI inflow.	Do banking services influence the level of FDI inflow in EAC?	H1a Bank assets level is positively related to FDI	Supported
		H1b Credit to the private sector is positively related to FDI	Supported

**Source:** Author's compilation

It is hypothesized that financial development positively influences FDI inflows. The results for the banking sector services supported the hypothesized relation. Thus, the results support the hypothesis that financial development influences FDI inflows to the EAC. The results reveal that financial development through banking sector services strongly and positively influences FDI inflows to EAC as predicted. The results support the findings reported by Juasrikul et al. (2018), who highlight that financial development in the host countries assures investors that they can meet their financial requirements in their time of need while holding investments in foreign markets. The study's findings imply that foreign investors positively perceive the vital role of the developed financial sector in the FDI recipient economies, that transaction costs are low, access to financial resources is easy, and investment risks are reduced as the development of this sector is fostered by good governance and quality institutions, which together protect investors' rights.

In the same vein, it is hypothesized that both bank assets level (H1a) and credit to the private sector (H1b) positively influence the level of FDI inflows. The bank assets and the credit to the private sector proxies are used to gauge the banking sector as they appropriately provide relevant information on the services offered by banks, such as savings mobilization, which leads to forming a bank assets pool and credit supply to diverse customers, including the private sector. The findings from the regression estimations confirm the statistically significant positive impact of banking services on attracting FDI inflows to the EAC based on the employed data from 1995 to 2020, as presented in Table 4.9 and

summarized in Table 5.1. The hypothesized positive relationship between bank assets (H1a) and credit to private (H1b) with inward FDI is supported. Objective one is attained as the results from the study statistically supported the hypothesized positive relationship between banking services and FDI.

The findings from the studies by Lestari et al. (2022), Pham et al. (2022), Irandoust (2021), Jena and Sethi (2021), Sethi et al. (2020), Nkoa (2018), Tsauroi and Makina (2017), Shah (2016), Kaur et al. (2013), Manova (2013), and Al Nasser and Gomez (2009) posit that banking sector services positively influence FDI inflows to the host countries. Similarly, the present study came up with findings, as summarized in Table 5.1, that support hypotheses H1a and H1b, which state that bank assets and credit to the private sector positively influence FDI inflows to the EAC. However, the literature review shows these studies have examined the influence of banking sector services on FDI based on different methodologies, different data environments, varying proxies gauging banking services, diverse theoretical propositions, and varied economic development levels where such studies were conducted.

The EAC's competitive banking services between the government and private sector motivate foreign investors to locate their investments in this region in the same manner proposed by Fernandez et al. (2020). Similarly, foreign investors are attracted to the EAC because of the functional banking sector, characterized by quality services, enhanced financial system liquidity, deposit mobilization, savings culture, and overall banking sector performance (Islam et al., 2020). All

these quality attributes of the functional banking sector operations led to financial sector development, which plays a pivotal role in facilitating the flow of funds from the net savers and putting them at the disposal of the ultimate users to meet the financing needs of the most profitable business and investment activities.

As Wilhelms (1998) proposed, under the institutional FDI fitness theory, quality institutions in the FDI recipient economies increase absorption capacity for foreign investments because such institutions create a conducive investment climate. In the same vein, the findings from the study agree with the suggestion that foreign investors are attracted to invest in countries with well-established banking systems, with the expectation of meeting their financial needs reliably, promptly, and at a reasonable cost. The results align with the argument made by Pham et al. (2022) that a well-functioning banking sector through quality service provision to the business and investment channels is a crucial driver for financial sector development and its influential role in attracting foreign investors.

The analysis of the banking sector in EAC in connection to the study results is that among the key factors that lead the banking sector in the region to pose a positive impact on FDI attraction include the sector's market growth rate, expansion of overseas business operations, competition for market share between domestic and foreign banks, deregulation, economic integration, and liberalization of the domestic market and international market. The findings from the study reflect the argument made by Kaur et al. (2013) that the banking

sector facilitates fast access to crucial investment services such as funding availability, timely access to finance-related services at a reasonable cost, competitive foreign exchange, stock market intermediation services, global trading systems, payment settlements, and deposit services regarding their investments in the EAC countries. Thus, banking sector services in the EAC countries attract inward FDI as they facilitate financial transactions and link investors with their host country's financial system, as connoted by Gomber et al. (2018), Zhen and Luu (2020) and Rillo (2018).

Generally, the findings from the study align with the results reported by Lestari et al. (2022), Pham et al. (2022), and Nkoa (2018), who used the GMM estimation method to investigate the influence of financial development measured by banks on FDI inflows. The GMM estimation method utilized by these studies has the power to handle the endogeneity, heteroskedasticity, and autocorrelation in panel data similarly to FGLS employed in this study, making the comparison of the results interesting, sound and, above all, increasing the findings' consistency and reliability.

On the other hand, some previous studies used different estimation methods, such as FMOLS and DOLS employed by Jena and Sethi (2021) and Sethi et al. (2020), while Tsaurai and Makina (2017) used a dynamic panel threshold regression model, whereas Irandoust (2021), Jena and Sethi (2021), and Sethi et al. (2020) used Granger causality approach. Surprisingly, this study's findings are consistent with the results of previous studies. The similarity of the findings

based on different methodologies reflects the power and reliability of the estimation methods used in predicting the studied relations under the respective data environments. The findings also suggest that the estimation methodologies employed can handle complex variables. Thus, the study concluded that despite differences in estimation methods while examining the influence of banking sector services on FDI, the impact of the sector, as mentioned earlier in the investment process, is generally positive, suggesting that banking sector services catalyze the attractiveness of the EAC countries' investment climate for inward FDI projects.

Moreover, a literature review indicates that different studies investigating banking services' influence on FDI inflows employed other proxies to gauge this sector. Similar to this study, Pham et al. (2022), Lestari et al. (2022), Sethi et al. (2020), Nkoa (2018), Tsauroi & Makina (2017), and Al Nasser & Gomez (2009) utilized stand-alone indicators covering bank assets, credit to the private sector, and liquid liability among the parameters that describe the scope of the banking sector. In contrast, other studies employed financial development indexes in measuring the impact of the banking sector on FDI attraction, such as Irandoust (2021) and Jena and Sethi (2021). Consequently, the studies' findings are similar, notwithstanding their differences in the banking sector's measurement approach. It is worth appreciating that whether individual variables or a constructed index measures the banking sector, the rationale remains that variables are selected because they are essential in understanding the gauged parameter. After all, they are the basic units of the information studied and interpreted in the study.

Based on the fact that theories in research are used to establish the relationship among attributes, variables, or data, the study finds it suitable to compare the findings with earlier studies, which used different theoretical propositions in explaining the financial development and FDI phenomena. Unlike this study, which employed institutional FDI fitness theory, previous studies involved other theories such as the Eclectic paradigm theory (Lestari et al., 2022; Irandoust, 2021; Nkoa, 2018; Al Naser & Gomez, 2009), the accelerator theory of investment (Lestari et al., 2022), Economic theory (Sethi et al., 2020; Tsaurai & Makina, 2017) and the endogenous growth theory (Jena & Sethi, 2021). Despite differences in theories that have devoted attention to explaining financial development, the FDI concept, and the flow of FDI projects to different economies, the result from the study still aligns with previous findings. Accordingly, the study's conclusions confirm the institutional FDI fitness theory that the development of the banking sector, fostered by quality services provision and adherence to sound governance practices, positively influences FDI inflows.

In contrast to the positive relationship hypothesized between banking sector services and FDI, some previous studies reported negative significant results on the banking sector and FDI inflows (Tongurai & Vithessonthi, 2018; Jeanluc & Muiruri, 2022; Kaur et al., 2013). The presence of contradicting findings with the results from this study increases the inconclusiveness of the real impact of banking sector services on attracting foreign investments. However, the differences in these results can be due to the methodology employed, the sample

size used, the measurement of the variables, uncontrolled factors that affect the FDI-financial development nexus, inherent variability in the estimation system, and the existence of any other unknown effect which may impact the estimation process.

Accordingly, based on the estimation methods employed, this study utilized the FGLS, which is an efficient estimation model capable of resolving the endogeneity, heteroskedasticity, and autocorrelation in panel data, similar to Tongurai and Vithessonthi (2018) and Jeanluc and Muiruri (2022), who employed GMM in their studies. However, it is worth noting that the assumptions behind FGLS and GMM are different, and even the sample size that permits the execution of analysis using the two models is different. Due to the sensitivity of panel data in response to sample size and assumptions underlying a particular estimation model and data environment, it is not surprising to arrive at opposing results (Hill et al., 2021).

On the other hand, Kaur et al. (2013) employed Pooled OLS, fixed effect, and random effect models, reporting negative statistically significant results between the banking sector and FDI. These contradicting findings can be due to methodological challenges. According to Green (2018), Pooled OLS, fixed effect, and random effect models are less efficient estimators as they cannot handle the endogeneity issues suffered by panel data due to cross-sectional dependence attributed to some unobserved common factors across the units. In

this regard, results from FGLS utilized by the study can differ from those reported by the estimation mentioned in earlier models.

However, it can be appreciated that the banking sector in EAC, through the financial services offered to diverse customers, including foreign investors, remains a catalyst for investment as it plays a significant role in the international capital movement. The findings from the study support the argument made by Irandoust (2021) that financial development is essential in mobilizing capital through banking services to ease investors' needs for financial services. Consequently, the banking sector in the EAC region has been growing, offering a conducive and friendly investment climate to domestic and foreign investors at a reduced financing cost and a low possibility of business distress. In the same vein, the findings from the study align with the expression made by Agbloyor et al. (2013) that banking sector services in the host country attract inward FDI by providing capital to foreign enterprises under financial services arrangements such as availing them with working capital, bank overdraft facility, and long-term financing for expansion.

#### **5.2.1.1 Relationship between Bank Assets and FDI**

The relationship between bank assets and FDI is examined under hypothesis H1a, which postulates that bank assets positively influence FDI inflows. The results from the study reveal a significant positive relationship between bank assets and FDI, as reported in Table 4.9, which is similar to the summary in Table 5.1. The results indicate that banking services are vital in the investment

process, particularly for foreign investors who use this sector as a channel for financial services, similar to the observations made by Anyanwu et al. (2018). The findings, therefore, justify the generally expected and evidenced from the literature that banking sector services in most emerging economies, such as EAC, are the primary funding source to finance investment activities, as previously argued by Pham et al. (2022) and Jena and Sethi (2021).

The results from this study are consistent with the earlier findings reported by Anvarovich (2022), Duffie (2022), Korgaonkar (2012), Azmin-Saini et al. (2010), and Dutta and Roy (2009), who reported positive and significant influence exerted by bank assets in the attraction of FDI inflows to the host countries. The findings from the study indicate that foreign investors consider banks to be a significant channel for linking their investments and the market. Through banking systems, investors can benefit from three immediate services: raising capital, capital placement, and assessment of their creditworthiness. Similarly, the findings from the study align with the results reported by Amadi (2019) and Soumaré and Tchana Tchana (2015) that bank assets positively and significantly influence the FDI inflows to the recipient economies. The consistent positive relationship between banking sector services and FDI inflows reported by previous studies is evidence that this sector plays a pivotal role in the investment process by acting as a medium for most financial settlements.

The banking sector services highly influence foreign investors as this sector is closely involved in the investment process in financial settlement and trading

mechanisms (Anyanwu et al., 2018; Beck & Levine, 2004). Similarly, the positive association between bank assets and FDI inflows reflects the readiness of the banking sector to transact with the private sector because the private sector is more efficient in using capital resources for optimal production compared to the public sector. Therefore, foreign investors are attracted by the banking sector's performance through the services they offer as they reflect the banks' ability to mobilize savings and allocate them to the most productive economic activities, including financing of FDI projects taking place in the host countries (Pham et al., 2022).

In the same vein, the influence of banking sector services on inward FDI attraction through bank assets level supports the previous arguments in the literature that banking sector development creates investors' confidence through the level of assets owned (Hajilee & Al Nasser, 2015). Investors are more attracted to transact with banks that control large portfolios of assets because they provide them with financial safety, easy access to their funds, savings from check-cashing fees, and overall financial peace of mind (Islam et al., 2020).

Additionally, Anvarovich (2022) expressed that the portfolio of assets held by banks forms the basis of funding resources available to investors' financing needs under credit provision arrangements. The higher the level of bank assets, the more it symbolizes its liquidity, increasing its efficiency in service provision, reducing transaction costs, and facilitating competitive exchange rate services. All these factors from the banking sector attract foreign investors to carry out

investments in the EAC. Hence, through its services, the banking sector positively influences FDI inflows to the EAC region.

Moreover, the banking sector's stability, accompanied by optimal asset levels to meet customers' financial needs, indicates that credit provision can be made smoothly, attracting foreign investors to invest in the EAC economies in line with the proposition put forward by Duffie (2022). Likewise, the positive influence of bank assets on FDI inflows signifies the banking sector's strength by reflecting its efficiency and competitive bank operations characterized by good governance. Consequently, it attracts foreign investors to invest in EAC economies, thereby receiving FDI inflows, similar to the observation made by Viktorov and Abramov (2020). The statistically significant influence exerted by bank assets on the attraction of FDI inflows is evidence that the banking sector in the EAC has been growing since bank assets can influence FDI inflows, and the region can also benefit from its spillover effects, as previously argued by Omran and Bolbol (2003).

#### **5.2.1.2 Relationship between Bank Credit to Private Sector and FDI**

The hypothesis (H1b) that credit to the private is positively related to FDI has been used to examine the relationship between the two. The results reveal that bank credit significantly influences inward FDI, thereby supporting hypothesis (H1b) that bank credit to the private sector attracts FDI inflows to the EAC. The results support the findings reported by Pham et al. (2022) and Jena and Sethi (2021), who expressed that banking services in emerging economies play a

pivotal role in attracting FDI projects, such that foreign investors are highly motivated by credit offered by banks in the host countries.

The results are consistent with the findings reported by Lestari et al. (2022), Pham et al. (2022), Sadiq et al. (2021), Shafiq (2021), Nkoa (2018), Agbloyor et al. (2013), and Ezeoha and Cattaneo (2012), who found a positive and significant relation of credit to the private sector in influencing FDI inflows. Investors rely on credit from banks because of the attached benefits, such as funding their day-to-day business operations, settling their startup costs, a tool for working capital management, supplementing cash flow, and a model of short-term and medium-term financing strategy. According to Loayza and Ranciere (2006), credit to the private sector positively influences FDI inflows in emerging economies when there is no financial fragility. The findings suggest that higher credit provision to the private sector enhances FDI inflows to EAC. Likewise, when there is no environment of fear of financial crisis by foreign investors, an increase in credit to the private sector in the host economies enhances FDI inflows (Jeanluc & Muiruri, 2022).

Friendly interaction between local and foreign investors increases the chances for all market participants to benefit from banking services offered in the EAC economies. Pham et al. (2022) argued that credit supplied to the private sector in the host countries is more attractive to both domestic and foreign investors, leading to more FDI inflows. Likewise, more acceptance of credit supplied to the private sector in the EAC countries is a strategy adopted by foreign investors

to maintain liquidity and increase access to affordable financing sources. The availability of alternative financing sources that are readily accessible and convenient helps foreign investors undertake financial control of their capital invested in international markets to hedge against exposure to excessive financing costs. The results imply that the level of FDI inflow to the EAC region increases with the increase in the supply of credit to the private sector from the commercial banks in these countries.

Accordingly, the findings from the study showed that credit to the private sector significantly influences the level of FDI inflows to the EAC. The findings imply that foreign investors are attracted to utilize the credit provided by the EAC's banking sector, which satisfies their much-needed financing gap for growth and expansion. The results complement the expression made by Pham et al. (2022) that foreign investors utilize the financing opportunities available in the host countries' banking sector to maximize their returns while minimizing financing costs arising from issuing shares. Therefore, foreign investors prefer to rely on the credit extended by local banks to support their investments in EAC, which entails the influence of credit on private and inward FDI.

In contrast, the findings from the study patterning the influence of credit on the private sector contradict the empirical results reported by Islam et al. (2021), Jeanluc and Muiruri (2022), Kaur et al. (2013), and Hausman & Fernandez-Arias (2000), who obtained a statistically significant negative relationship between credit to the private sector and FDI inflows. A negative relationship between

credit to the private sector and FDI implies that more credit is provided to foreign investors as a sign of lowering their returns through compensation for the financing costs and loss of financial control. Even though credit offering to the private sector is a mechanism for risk sharing, giant foreign firms assess it with greater caution to protect their profit margins from their investments in FDI projects. Moreover, Claessens et al. (2001) and Al Nasser and Gomez (2009) highlight that, due to capital constraints and diverse investments in emerging economies such as EAC, FDI is a substitute capital flow. The substitution effect between FDI inflows and credit to the private sector in these economies could likely lead to a negative relationship between the two variables.

Generally, the reported findings on the influence of the banking sector on FDI attraction showed a positive relationship between bank assets and credit to the private sector. Bank assets and credit to the private sector provide information on the banking sector services' solid and positive, statistically significant influence on FDI inflows. Banking services are vital in enhancing investments both domestically and internationally. Local and foreign investors can access the host countries' banking sector financing. The banking sector's performance in facilitating financial service provision to investors is a critical factor in attracting FDI inflows to EAC and other emerging economies, as postulated by Pham et al. (2022). The implications of the findings from the study highlight that the banking sector is one of the strategic sectors that significantly impact FDI attraction to the EAC region. Hence, further efforts for its development are required to widen its scope of servicing more investments and a broader investor base.

### 5.2.2 Stock Market Size and FDI Inflow

This section addresses the study's second objective, which focuses on investigating the influence of stock market size on the level of FDI inflows. Two hypotheses, H1c and H1d, are developed and tested based on value traded and market capitalization. It is hypothesized that value traded and market capitalization positively influence FDI inflows. Table 5.2 summarises the findings in response to the developed hypotheses.

Table 5. 2: Stock market size and FDI inflow

<b>Research Objective</b>	<b>Research Question</b>	<b>Hypothesis</b>	<b>Supported/ Not supported</b>
To investigate the influence of stock market size on the level of FDI inflow.	Does stock market size influence the level of FDI inflow in EAC?	H1c Value traded is positively related to FDI	Not supported
		H1d Market capitalization is positively related to FDI	Not supported

**Source:** Author's compilation

The findings from the study reveal that stock market size, measured by value traded and market capitalization, negatively impacts FDI inflows to the EAC. Table 5.2 summary shows that hypotheses H1c and H1d are not supported, thus failing to confirm the hypothesized positive relationship between value traded, market capitalization, and FDI. The results from Table 4.9 reveal that stock market size strongly impacts FDI inflows to the EAC. More specifically, the

findings showed a negative relationship between stock market size proxies and FDI, affirming the results reported by Shahbaz et al. (2021), Umar et al. (2015), Lin and Ye (2018), Dutta and Roy (2009), Antras et al. (2009), Ang (2009), Loayza and Ranciere (2006), and Hausman and Fernandez-Arias (2000). That implies less developed stock markets in the EAC region deter FDI inflows, as such markets cannot support the financial needs of foreign investors. The findings indicate that foreign firms investing in EAC cannot rely on stock markets as an alternative source of capital in the short run. Still, as it grows, foreign investors are likely to benefit from this market in the long run.

Contrary to the expected positive influence of stock markets in driving inward FDI to the EAC, the negative association between the two sectors reflects that the stock market in this region is on the growth stage, posing a risk to foreign investors in raising funds to support their investment projects and consequently negatively impacting FDI. The findings further indicate that FDI inflows to EAC are a substitute for stock market investment. This detrimental and unnecessary competition makes the stock market less attractive to foreign investors. In that view, Jeanluc and Muiruri (2022) argued that FDI projects in emerging economies replace the roles of financial markets, thereby posing adverse effects. Thus, the findings from this study confirm the proposition made under the institutional FDI fitness theory that host countries characterized by unfit markets or weak markets negatively impact FDI inflows. Vulnerable markets built on low-quality institutions in the host countries lower the absorption capacity of FDI to their economies (Wilhelms, 1998).

Similarly, the reported impact of stock market size on FDI can be explained based on the findings reported by Nkoa (2018), who argued that stock markets in emerging economies are less liquid, making them unattractive to foreign investors to register and trade their equity stocks to raise additional capital during growth and expansion stages. The results support this argument as value traded and market capitalization proxies appropriately provide relevant information about the market size and the trading activity. These variables also reflect the stock market liquidity and provide information that helps investors to purchase and sell their shares competitively. The information portrayed by stock markets increases investors' incentives to engage in stock market operations, strengthening capital mobilization among the listed companies conducting business activities in the economy.

However, a plausible explanation of the relationship between stock market size and FDI in emerging economies is provided by Hausman and Fernandez-Arias (2000) and Dutta and Roy (2009), who state that the negative relationship between stock market size and FDI is highly associated with thin trading which lowers foreign investors' confidence to participate in the stock market to raise additional capital to support their investment activities held in foreign markets. Given the small size of the stock markets in EAC, foreign firms find it challenging to raise capital by issuing shares to these markets because they fear the possibility of diluting their share values.

Given the low level of stock market development in EAC, the results can be linked with the argument made by Tiwari et al. (2022) that developed stock markets defined by large size (volume of transactions) and a massive number of financial assets positively influence inward FDI. The study's findings refute this argument because EAC's stock markets are in the growth stage with less market experience and a low capability to absorb huge issues. The findings imply that foreign investors are motivated to invest in economies with competitive stock markets as they positively assess those markets as a potential and possible source for additional funding and capital enhancement through equity financing from the local capital markets.

Interestingly, the findings align with previous empirical studies that used different estimation methods, such as Shahbaz et al. (2021). Umar et al. (2015) used the ARDL, Antras et al. (2009), and Hausman and Fernandez-Arias (2000) applied OLS, Ang (2009) used VECM. In contrast, Lin and Ye (2018) employed Fixed effect and Random effect models, while Dutta and Roy (2009) used the FGLS model in their analysis. Reflection on the results shows that they produced similar results regardless of the differences in the estimation power and endogeneity handling capacity among these estimators. The findings suggest that the possibility of less developed stock markets exerting a negative impact on FDI inflows is high, notwithstanding the diversity of the methods used in estimating the relationship.

Unsurprisingly, even the study by Dutta and Roy (2009), which employed the FGLS estimation method similar to this study, reported the same findings of the negative relationship between stock market size and FDI. Therefore, the study's findings supporting Dutta and Roy's results build a basis for comparison with other studies because the two studies employed the same estimation method, and the findings are based on the same methodological assumptions.

On the other hand, the literature review reveals that the measurement of stock market size varies across different studies depending on the proxies used to gauge the stock market (Le & Gregoriou, 2020; PH & Rishad, 2020). However, it is worth acknowledging that the findings from the study are consistent with previous empirical studies that employed different measurements of stock market size, either using individual variables or the stock market index (Shahbaz et al., 2021; Lin & Ye, 2018). That implies the variables involved in describing stock market size captured the necessary information intended by the studies. Another reason for the studies using different measurement approaches and arriving at the same findings is adherence to standard research practices, appropriateness of the estimation method, and control for all possible factors that may affect the studied relation (Tan et al., 2021).

Unlikely, the results failed to exhibit the expression made by Pham et al. (2022) that developed stock markets boost host countries' investment climate, motivating foreign investors to locate their investments in such economies with the expectation of benefiting from easy access to alternative financing. In

examining the relationship between stock market size and FDI, the study employed the institutional FDI fitness theory by Wilhelms (1998), which propounds that solid institutions in the host countries enhance market linkages, attracting foreign investments.

Conversely, the results contradict previous studies that reported positive, significant results on stock market size and FDI inflows. A vast number of past empirical studies that examined the relationship between stock market size or financial development gauged by stock market and FDI reported a significant positive relationship between the two sectors, thereby opposing this study's findings (Lestari et al., 2022; Pham et al., 2022; Irandoust, 2021; Jena & Sethi, 2021; Sethi et al., 2020; Nkoa, 2018; Tsaurai & Makina, 2017; Shah, 2016; Kaur et al., 2013; Manova, 2013; Al Nasser & Gomez, 2009). Accordingly, it is worth appreciating that these studies employed different estimation methods that relied on various assumptions, varying efficiency in tackling endogeneity issues, and data environments. The estimation models utilized include the GMM, the FMOLS and DOLS, the dynamic panel threshold regression model, and the Granger causality approach.

One of the primary reasons for the observed contradictory results is the diversity of the level of stock market development between EAC and the economies where the studies, as mentioned earlier, were conducted. Most of the studies are from economies with relatively more developed stock markets compared to the development status of the EAC stock markets (Sethi et al., 2020; Islam et al.,

2020; Pham et al., 2022). The results align with the argument in the literature that economic development goes parallel to stock market development (Lestari et al., 2022). Thus, the stock market size in countries with higher economic growth relative to the EAC economies is likely to influence FDI inflows positively.

Alternatively, the EAC's stock market age can explain the contradictory results with earlier empirical findings. Nguyen et al. (2020) found that the age of the stock market contributes mainly to its development. Long-standing stock markets are strong enough to withstand the domestic, regional, and global economic dynamics. Unfortunately, the EAC stock markets are very young compared to other economic regions. For instance, the oldest EAC member state's stock exchange is the Nairobi Securities Exchange (NSE), based in Kenya, established in 1954, while the rest of the stock markets in other partner states were established around the 1990s. The young EAC stock markets lack securities market experience compared to older markets such as Alexandria in Egypt, which was established in 1888. As argued earlier, stock markets grow with economic development. On this ground, young EAC stock markets failed to positively impact FDI, as reported in Table 4.9, indicating the real impact of the less attractiveness of underdeveloped stock markets for FDI projects.

Similarly, economic volatility highly affects stock market development and its impact on FDI inflows in the EAC. Many economic dynamics, such as global financial waves, international trading patterns, global political tensions, and

exchange rate movements, largely shake the economic stability of the EAC in the same way as other emerging markets (Kohrt et al., 2024; Petry, 2021). All these factors pose tremendous economic instability to these markets compared to developed economies (Dorobat & McCaffrey, 2023). As a result of the financial fragility of these countries, the EAC region has managed to attract about 110 companies only listed on the stock exchanges (EAC Investment Guide, 2020). Conversely, even the considered low number of listed companies varies occasionally. Some companies are delisted and re-listed because of economic volatility, affecting the companies' listing qualification requirements (Adjasi et al., 2022). Alternatively, economic instability in EAC affects stock market development negatively, likely in the same way as companies operating in domestic and foreign economies.

Connecting the study results with the earlier argument by Jeanluc and Muiruri (2022), foreign investors consider stock markets as a source of funding for their businesses in foreign markets. The stock markets in EAC economies are likely to have a negative relationship with FDI inflows. The weight and treatment of the FDI projects received in these economies, as noted in earlier discussion, is that EAC economies value inward FDI as an alternative source of capital flow. This view and approach of regarding FDI inflows as a significant source of capital instead of the stock markets being an alternative source of capital to foreign investors has shrunk the EAC's stock market growth. In an environment where stock markets are substituted with FDI flows to the hosting countries, it is not surprising to find a negative relationship between the two sectors, as revealed in Table 4.9 by the stock market regression results.

In general, and specific impact analysis of the stock market influence in the investment process, the results from the study reported a negative relationship with FDI inflows, contrary to the hypothesized relations and existing literature, which reflect critical contextual, stage-of-development, and methodological differences. While many studies emphasize that developed stock markets signal financial maturity, transparency, and investor protection, which should attract FDI, this positive narrative often overlooks structural asymmetries, investment motives, and market distortions specific to emerging and transitional economies. These contextual and structural realities lead to the substitution of FDI by foreign portfolio investment (FPI), market inefficiencies, and investor responses to governance weaknesses masked by superficial market growth. Such findings underscore the need for a more nuanced understanding of financial development, one that distinguishes between quantitative expansion and qualitative maturity, and considers the strategic intentions of foreign investors in different governance environments.

#### **5.2.2.1 Relationship between Value Traded and FDI**

The relationship between stock value traded and FDI is examined by hypothesizing (H1c) that value traded positively influences FDI. The results from the study reveal that the value traded significantly impacts FDI negatively, as reported in Table 4.9. The observed negative results of the association between value traded and FDI failed to confirm hypothesis H1c, as reported in Table 5.2 of the summary results. The results bolster the arguments from the

literature that foreign investors favour banking services to fund their FDI projects in emerging economies at the expense of weak stock markets (Areneke et al., 2022). Investors' confidence is low, and they do not even trust these markets because they fear the possibility of diluting their stock values (share price). The loss of trust in these markets stems from the low trading volume, thin market size, and weak competition among the market participants.

The relationship between stock value traded and FDI inflows in EAC is complex and context-dependent. Stock value traded might negatively impact FDI inflows to these economies because of several factors. The most common factors associated with the negative impact of stock value traded on FDI inflows in EAC include the perception of risk by foreign investors who regard the stock markets as highly volatile, indicating higher investment risk (Wagas et al., 2015; Solomon & Ruiz, 2012; Albuquerque, 2003; Kyereboah-Coleman & Agyire-Tettey, 2008). Based on foreign investors' perceived risk environment of the EAC's stock markets, the effect of stock value traded can be unattractive for sound capital sources, which can deter them from making long-term commitments. In the short run, foreign investors who are after immediate return from their investments might prefer more stable environments where the stock market risks are perceived to be lower (Huber et al., 2019; Marfatia, 2020).

Similarly, EAC stock markets and similar developing economies often involve short-term trading and speculation (Siegel, 2021; Hirota et al., 2022; Caporale et al., 2021). A significant portion of the stock trading activity in the EAC market

is driven by short-term speculation motives rather than long-term investment in productive assets, which signals to foreign investors that the market lacks stability or maturity. In the same way, market liquidity is a significant concern to foreign investors' decision to rely on these markets due to the fear that high trading volumes can sometimes lead to a negative impact on their capital tied up in local stock markets (Li et al., 2022; Mortazian, 2022; Mbanyele, 2023; Debata et al., 2021). Foreign investors, especially those considering substantial investments like FDI, may worry about their ability to enter and exit positions smoothly without significantly affecting market prices in the EAC's thinly traded markets.

Additionally, the impact on exchange rates in the EAC market lowers foreign investors' confidence in utilizing the stock markets, worrying that rapid movements in stock prices can influence exchange rates (Latif et al., 2021; Tian et al., 2021; Amewu et al., 2022). Foreign investors might be cautious if they perceive that exchange rate volatility in EAC could erode the value of their investments or complicate their financial planning. Likewise, macroeconomic instability alerts foreign investors that a booming stock market might be disconnected from broader economic fundamentals. The EAC's stock market lacks stability in terms of inflation, fiscal policy, and political factors. It may make foreign investors hesitate to commit FDI, resulting in them preferring other markets with a more predictable economic environment.

Also, sectoral imbalances are a concern that might negatively affect the influence of stock value traded on FDI inflows in the EAC. High stock market performance may sometimes be concentrated in specific sectors (such as natural resources or technology) that are not directly related to FDI opportunities in other sectors (Ali & Ramakrishnan, 2022; Jahanger et al., 2022; Tunyi & Ntim, 2016; Mahbub et al., 2022; Castellani et al., 2022). This has been a long-term problem in EAC as most of the sound FDI projects have been centred around natural resources, particularly minerals, gas, and petrol fields. This predominance of focus on highly demanded resources (energy and precious minerals) creates a mismatch between existing and potential investors regarding the availability of other investment opportunities.

Contrary to the stock markets as an alternative source of financing, most foreign investors, when deciding on the additional source of funding for their FDI projects held in EAC, mainly rely on the banking sector as the primary funding source to finance their businesses, as previously argued by Pham et al. (2022) and Jena & Sethi (2021). Foreign investors hold this view to rely on banking sector services rather than stock markets for additional funding sources, favouring the banking sector, which positively influences FDI inflows, as reported in Table 4.9. In contrast, the stock market is withered and negatively impacting FDI inflows, refuting the possible positive effects in the investment process, leading to the decision outlined in Table 5.2.

As described earlier, stock markets in EAC are narrow, with fewer products, few market participants, and a low volume of intra-regional trade, as also reported in similar emerging economies (Calderón et al., 2020; Kaplinsky & Kraemer-Mbula, 2022). All these challenges increase financing costs, contrary to investors' focus when choosing financing sources. Failure to meet their financing expectations under stock market arrangements leads to foreign investors' unwillingness to transact in this market to raise additional capital through equity financing in this region (Geddes & Schmidt, 2020). Liao et al. (2022) argue that one of the significant reasons foreign investors are reluctant to list their shares and trade them on the host countries' stock markets in emerging economies is based on the nature of this market, which is in the growth stage, similar to EAC.

Foreign investors are compassionate when deciding where to locate their investments in overseas markets by looking at factors such as accessing financing sources with lower costs and reducing the low return at the end of the accounting period. Based on financing cost consideration, finance theories such as the pecking order theory favour less equity financing under a stock market arrangement, which could make it negatively associated with the investment (Jansen et al., 2023; Power et al., 2022). Therefore, foreign investors are less attracted by the stock markets in EAC as an alternative source for financing their FDI projects, similar to the findings reported by Contractor et al. (2021) on the relationship between stock market size and FDI in the case of emerging economies.

### **5.2.2.2 Relationship between Market Capitalization and FDI**

It is hypothesized (H1d) that market capitalization positively affects FDI. However, the results from the study reveal that market capitalization significantly impacts FDI negatively, as shown in Table 4.9. Consequently, the observed negative relationship between stock market capitalization and FDI does not support hypothesis H1d, as reported in Table 5.2. The findings align with Pradhan et al. (2019) and Sharma and Bardan's (2018) argument that market capitalization provides reflective information to investors about stock market development, including trading mechanisms and the operational efficiency of the financial sector in the host countries.

The impact of stock market capitalization on FDI inflows in EAC varies substantially and might be perceived as negatively impacting the attractiveness of these markets for FDI projects (Horvat et al., 2021; Yero, 2023). The most common factors relating to the negative impact of stock market capitalization on FDI inflows in EAC include market immaturity perception, which negatively affects foreign investors' decision in locating their investments in this region on the view that these markets are less mature and cannot provide sufficient financial needed to support their investments (Mahlaole, 2017; Mahawiya, 2016; Akosah, 2016). Foreign investors, particularly those looking for a competitive investment climate, may prefer developed economies where there is a relatively higher advantage of factors of production such as skilled labour, stable energy supply, managerial expertise, technical support, highly demanded technology,

developed infrastructure networks, protection of property rights, and an interconnection chain of suppliers.

Similarly, foreign investors reflect valuation concerns that stock market capitalization in EAC could imply that stock prices have been bid up to levels that are perceived as overvalued (Aziza, 2020; Nkiwane, 2018; Kariuki, 2018; Raubenheimer, 2019; Faidah, 2020). The perceived stock valuation concerns in EAC can lead foreign investors to believe that the market is vulnerable to corrections or downturns, making it a less attractive destination for long-term FDI projects. In the same way, liquidity and alternative investment challenges could mean the EAC market is more receptive to local investors, thereby reducing the attractiveness of FDI opportunities. Some foreign investors' analysis of the EAC market and the available investment opportunities links them more relevant to local investors than could be diversely competed for among interested market participants (Kodzi, 2023; Ogola et al., 2015; Ong'oyi, 2021). This perception might reduce the attractiveness of FDI opportunities as local investors might already be effectively capitalizing on available opportunities.

Moreover, market concentration is a significant portion of the stock market capitalization in EAC, which may negatively impact access to investment diversity (Croquet et al., 2021; Githiaga, 2023; Albiman et al., 2022; Nyangu et al., 2022). EAC, like any other emerging economy, faces the challenge of market capitalization being concentrated in a few large companies or sectors, such as

natural resources or state-owned enterprises. This concentration can limit the diversity of investment opportunities available to foreign investors, especially if they seek to diversify across sectors or regions within the EAC community. Similarly, regulatory and institutional concerns perceived by foreign investors regarding stock market performance in the EAC are that stock market capitalization does not necessarily indicate a supportive regulatory environment for FDI (Binda, 2021; Kaahwa, 2017; Mziray, 2021; Shayo, 2024). Foreign investors often prioritize factors like legal protections, governance standards, and ease of doing business, which may not correlate directly with the stock market size or capitalization.

Furthermore, currency and exchange rate risks in the EAC negatively impact foreign investors' decisions in locating their cross-border investments as they consider these markets to be associated with currency exposure, which in turn adversely affects the value of their investments (Oloo, 2023; Bihkongnyuy, 2020; Abdulrasaq, 2021). Foreign investors who are very sensitive to economic instability in the EAC countries might be cautious if they perceive that currency fluctuations could adversely affect the value of their investments and possibly risk their capital and profit-generating potential.

The negative relationship between stock market capitalization and FDI inflows reported by the study indicates inefficient operations accompanied by unpredictable, inconsistent market performance and likely low protection of investors' rights (Omar et al., 2022). When the stock market's performance is

below the expectations of the investors, particularly foreign investors, it releases information perceived as riskier to the market. It should be remembered that market capitalization, the measure of the stock market size used in this study, is a handy indicator for investors in assessing the market size, trading activities, stock liquidity, and unsystematic risk, which may affect their equity interest and return from investment in financial assets (Pham et al., 2022).

According to Islam et al. (2021), stock markets attract foreign investors with increased financial assets (stock market products) offered in the economy and a friendly, interactive trading environment among the market participants. The reverse is also true, as weak stock markets negatively impact domestic and foreign investors. The stock markets in EAC need to grow until they attain a threshold level that positively impacts FDI inflows to the host countries. Knowing that stock markets provide essential information to investors on the status of financial sector development, which is a critical factor for FDI attraction to the host countries, the stability of this market reflects on how investors' equity interest may be protected upon deciding to invest in those markets. Therefore, linking the role of stock markets' influence on FDI inflows, the results signify that underdeveloped stock markets with volatile market capitalization adversely affect inward FDI attraction.

Morrison (2019) highlighted that developed stock markets enhance investments by facilitating the flow of capital from surplus spending units (net savers) to deficit spending units (ultimate users) through long-term financing

arrangements. However, equity financing under stock market arrangements has cost implications regarding dividend payment as compensation for the financing service extended to the user (borrower/investors) and underwriting costs. Thus, the negative results for the relationship between market capitalization and FDI inflows can be substantiated by investors' profit margin protection strategy, which aims to reduce equity financing costs.

However, the general view of the results for the effects of the banking sector services and stock market size on the measure of financial development reveals that both significantly influence FDI inflows. The results indicate that bank services positively affect FDI inflows to the EAC, while stock market size negatively impacts FDI inflows to this region. Li et al. (2018) expressed that the impact of the financial development of the host countries in attracting FDI inflows to their economies stems from the financial flexibility created by this sector in meeting investors' needs for additional financing required during the growth and expansion of their investments held in foreign markets.

Consequently, most of the studies on financial development and FDI reveal a significant influence exerted by the financial sector development on FDI attraction. Findings from this study indicate that financial development in EAC exerts a significant positive effect on inward FDI based on banking sector services, which is in line with previous findings (Lestari et al., 2022; Pham et al., 2022; Irandoust, 2021; Jena & Sethi, 2021; Sethi et al., 2020; Nkoa, 2018; Tsurai & Makina, 2017; Shah, 2016; Kaur et al., 2013; Manova, 2013; Al

Nasser & Gomez, 2009). On the other hand, financial sector development has also been found to negatively impact FDI inflows to EAC based on the results for stock market size and consistent with previous studies with similar findings (Shahbaz et al., 2020; Umar et al., 2015; Lin & Ye, 2018; Dutta & Roy, 2009; Antras et al., 2009); Ang, 2009; Loayza & Ranciere, 2006; Hausman & Fernandez-Arias, 2000).

To sum up, generally, the results from the study support the proposition made by Donaubaauer et al. (2020) that financial development is a critical sector in creating an attractive investment environment. Similarly, Ferras-Hernandez and Nylund (2019) argued that financial development is crucial in attracting FDI inflows as it supports innovation and technology transfer. In the same vein, the findings from the study provide investment information in line with the proposition that the developed financial sector, which influences FDI, offers necessary support to foreign investors in nurturing their ventures through soft financial linkage (Zarrouk et al., 2021). Therefore, financial sector development provides confidence to foreign investors regarding risk reduction and a higher possibility of their investments succeeding in the cross-border market (Pham et al., 2022).

The study argues that the contradictory results reported show that the banking sector positively influences FDI inflows, and at the same time, stock markets negatively impact FDI inflows, which can be explained in the context of structural weaknesses rather than investor preference patterns. Based on

structural weaknesses, the banking sector's strength in attracting FDI inflows in emerging markets such as the EAC lies in providing critical financial infrastructure, reducing information asymmetries, and offering institutional assurance. These factors collectively lower the entry and operating costs for foreign direct investors, making such economies more attractive destinations for FDI. On the other hand, stock markets may signal speculative activity, institutional weakness, or capital market volatility. These features can divert foreign capital away from long-term productive investment (FDI) toward more liquid and short-term financial instruments, thereby reducing the appeal of FDI.

Therefore, the banking sector, due to its long-term relationship orientation, regulatory stability, and ability to mitigate information gaps, complements the needs of FDI investors when carrying out their activities in foreign markets. In contrast, stock market size, when accompanied by structural weaknesses like volatility, opacity, and speculative tendencies, may undermine the attractiveness of long-term investment and even crowd out FDI in favour of short-term capital inflows. Thus, the structure and function of functional institutions in emerging economies like the EAC critically determine the direction and type of foreign capital they attract in supporting FDI projects.

### 5.2.3 Institutional Quality (Corruption, Government Effectiveness, Political Stability) and FDI Inflow

Table 5.3 below expounds on objective three and summarises the hypothesis results relating to institutional quality indicators and FDI.

Table 5. 3: Institutional quality and FDI inflows

<b>Research Objective</b>	<b>Research Question</b>	<b>Hypothesis</b>	<b>Supported/ Not supported</b>
To investigate the influence of institutional quality (Corruption, Government Effectiveness, and Political stability) on the level of FDI inflow	Does institutional quality (Corruption, Government	H2a Corruption is negatively related to FDI	Supported
	Effectiveness, and Political stability) influence the level of FDI inflow in EAC?	H2b Government effectiveness is positively related to FDI	Not supported
		H2c Political stability is positively related to FDI	Not supported

**Source:** Author's compilation

The study employed some institutional quality variables that are considered to have more impact on financial development and investment processes in EAC. The aim is to investigate the influence of institutional quality on the level of FDI inflows to EAC. It is generally hypothesized that institutional quality positively affects FDI. To investigate this relationship, hypotheses H2a, H2b, and H2c have been developed and tested based on corruption, government effectiveness, and political stability. However, the study's findings reveal that institutional quality's impact on FDI is detrimental based on all the institutional quality indicators

involved, failing to support the hypothesis that institutional quality is positively related to FDI.

Institutional quality in EAC hurts FDI inflows due to several factors. First of all, corruption has been one of the factors of concern among foreign investors as they perceive it reduces fair competition among the market participants while limiting access to financial services and available investment opportunities (Raubenheimer, 2019; Karau, 2014; Eurallyah, 2019). Therefore, high levels of corruption in institutions can deter foreign investors by increasing the costs of doing business in terms of bribes or informal payments and reducing trust in the legal and regulatory framework. In addition to that, political instability also contributes to institutional quality and harms FDI attraction. EAC often experiences political instability, including frequent changes in government, policy uncertainty, and inconsistent enforcement of regulations (Mbithi, 2019; Makungu, 2015; Ogutu, 2019). Such dynamics create a risky environment for foreign investors who seek stable and predictable conditions.

Similarly, a weak rule of law does affect EAC's attractiveness to foreign investors. In some cases, foreign investors may perceive some EAC institutions as lacking a solid rule of law that may fail to protect property rights, enforce contracts, or provide adequate recourse in case of disputes (Jayalo, 2021; Trouille, 2021). This uncertainty can deter foreign investors who rely on a fair and transparent legal system. In the same way, excessive bureaucratic procedures such as complex regulations, permits, and licenses can create delays

and increase costs for foreign investors. In such a situation, EAC may be identified as an investment region with bureaucratic red tape that can lead to inefficiencies and discourage FDI inflows.

Moreover, policy uncertainty can also contribute to institutional quality in EAC being adverse to FDI inflows (Matete, 2021; Ibrahim & Abdulmalik, 2023; Musili, 2023). Institutional quality influences the predictability and consistency of government policies. However, sudden changes in regulations, tax policies, or economic strategies can create uncertainty for foreign investors, making them hesitant to invest in this region (Li et al., 2021; Rashid et al., 2021; Li et al., 2022; Meyer & Nguyen, 2020). At the same time, EAC's infrastructure deficiencies negatively affect the region's attractiveness for FDI (Kimeu, 2020; Lwesya, 2022; Nyathi & Mlobane, 2024). Institutions responsible for infrastructure development, such as transportation and utilities, may be weak. Poor infrastructure can increase operational costs and reduce the region's attractiveness as an investment destination.

Additionally, currency instability, lack of investor protection, and social unrest will likely hinder institutional quality in EAC and negatively impact FDI inflows (Matima, 2021; Musili, 2023). Weak institutional frameworks in EAC may contribute to currency volatility, which can increase risks for foreign investors concerned about exchange rate fluctuations and their impact on return from their investments (Abdulrasaq, 2021; Wambua, 2023). Likewise, inadequate institutional mechanisms for investor protection, such as weak corporate governance frameworks or insufficient investor rights, can deter foreign

investors who require assurance against exploitation or expropriation. Similarly, social unrest stemming from inequality, unemployment, or tribal tensions can adversely affect the expected helpfulness of institutional quality in FDI's attraction to the EAC (Rwigema, 2020; Sumanyi, 2022; Vlamis, 2023). Such instability can disrupt business operations and deter foreign investors seeking a stable and calm investment climate.

The results support the findings from Beazer and Blake (2018), who argued that weak institutions harm the attractiveness of the investment climate and consequently deter FDI inflows to the host country. The findings indicate that institutional quality in EAC is still low, as Krifa-Schneider et al. (2022) noted that emerging economies have low institutional quality, affecting most of the investment channels. Krifa-Schneider et al. (2022) further argued that emerging economies such as EAC tend to relax the institutional quality standards to attract inward FDI. Still, they caution that the move will only last in the short run, but in the long run, the role of real quality institutions in catalyzing FDI inflows is inevitable. Therefore, the negative relationship between institutional quality and FDI is a reflection of the impact of weak institutions in the EAC, as highlighted by Nguyen et al. (2018) and Yudaruddin (2022) that low institutional quality leads to poor governance practices, political instability, and unaccountability, unreasonable regulations through government ineffectiveness, and prioritization of corruption in the investment process. All factors, as mentioned earlier, negatively impact inward FDI.

### **5.2.3.1 Relationship between Corruption and FDI**

It is hypothesized that corruption is negatively related to FDI. The results for the relationship between corruption, the institutional quality indicator, and FDI are presented in Table 4.9 and summarized in Table 5.3. The findings reveal that corruption is negatively related to FDI as predicted and significantly impacts FDI inflows. The studies by Karim et al. (2022) and Islam et al. (2020) find that corruption significantly and negatively impacts FDI inflows to the host countries. Consistent with their findings, the present study came up with similar results that support hypothesis H2a, which states that corruption negatively impacts inward FDI flows. The results support the propositions in the literature that corruption negatively affects the investment climate and further distorts the investment process. The results also align with Karim et al. (2018), Canare (2017), and Jain et al. (2017), who found a significant negative impact exerted by corruption on FDI inflows. In the same vein, the findings support recent studies by Gök (2023) and Cruz et al. (2023), which expressed that corruption pollutes the investment climate in the FDI recipient economies as it poses more risk for the investments in terms of change in investment policies, increased financing costs, and delayed investment decisions resulting from excessive bureaucratic procedures.

Corruption in EAC significantly deters FDI inflows due to several reasons (Jayalo, 2021; Nyathi & Mlobane, 2024). The first and foremost reason is that corruption increases business costs (Krifa-Schneider et al., 2022). Corruption often necessitates bribes or unofficial payments to facilitate business operations,

obtain permits, and secure contracts (Vu et al., 2024; Lassou et al., 2021; Bavington & Governance, 2021). These additional costs inflate the overall costs of doing business, reducing the region's attractiveness for foreign investors who prefer a transparent and fair investment climate. Similarly, corruption in EAC undermines the rule of law and weakens regulatory frameworks. Institutions responsible for enforcing contracts and protecting property rights may be compromised, leading to legal uncertainties and risks for investors. This lack of legal protection can deter foreign investors who require a stable and predictable legal environment.

Likewise, unfair competition leads to corrupt practices in EAC, which may hurt FDI inflows. Corruption distorts market competition by favouring firms that engage in bribery or have political connections (Manyasi, 2021; Moyo, 2024; Tsietsi, 2021). This unfair advantage can deter foreign investors who rely on fair market conditions and equal opportunities for all participants. On top of that, corruption practices lead to reputational damage internationally. Foreign investors, particularly those from countries with stringent anti-corruption laws, may avoid investing in the EAC to mitigate risks associated with unethical practices.

In the same vein, political instability and resource misallocation in EAC may be among the causes of corruption and its negative impact on FDI inflows (Idun et al., 2020; Admassu, 2020; Mogeni, 2021). Corruption is often intertwined with political instability and weak governance. Corruption increases political risks, including policy unpredictability and potential regime changes. Such

uncertainties deter foreign investors from being attracted by a stable and predictable political climate. On the other hand, corruption leads to the misallocation of resources as decisions are influenced by bribes or personal connections rather than economic efficiency. This inefficiency reduces the productivity and competitiveness of businesses operating in EAC, discouraging foreign investors.

Additionally, the negative effect of corruption on FDI in EAC can also be due to legal and regulatory compliance risks and impact on human capital development (Otiende, 2022; Abdulrasaq, 2021). Investors operating in EAC may inadvertently violate anti-corruption laws in their home countries. The repercussions for engaging in corrupt practices in their attempt to win available investment opportunities in the region can deter foreign investors from entering or expanding their operations to the EAC. Similarly, corruption in EAC can hinder human capital development by diverting resources away from education, healthcare, and infrastructure towards corrupt and unproductive activities. A poorly educated and unhealthy workforce diminishes productivity and innovation potential, further reducing the EAC's attractiveness to foreign investors.

Foreign investors are more affected by corruption in cross-border markets because they have less information about those markets than domestic investors, who are more tolerant of risks caused by corruption and have the advantage of knowledge in this market (Lestari et al., 2022). Based on the literature, the negative impact exerted by corruption on FDI inflows stems from the political

environment, lack of reliable alternative sources of capital, excessive bureaucracy, lack of good governance, weak regulatory systems, and low institutional quality among the government organs (Ali et al., 2020; Zhang & Zhou, 2021; Lestari et al., 2022). The results are also explained by the empirical exposition that corruption negatively impacts FDI inflows and affects institutional quality climate as it distorts the channels through which capital flows (Krifa-Schneider et al., 2022).

The impact of corruption on FDI inflows in EAC can further be explained in various aspects: (i) degree of tolerance, (ii) development of the financial systems, (iii) availability of information, (iv) cultural embedment, and (v) dual effect of corruption. FDI projects can keep flowing to economies in an environment where corruption is tolerated. Colonnelli and Prem (2022) portrayed that although corruption raises the costs of doing business in one part, it also leads to the existence of some businesses. The sensitivity of corruption and its impact on FDI attraction depend on how much it is tolerated in the host countries. Krifa-Schneider et al. (2022) postulate that investments can still flow to emerging markets even in a corrupt environment because those markets have a higher corruption tolerance than developed economies. Likewise, the effects of corruption on the investment process are more pronounced in highly developed financial systems than in emerging markets. Therefore, the response to the impact of corruption on FDI inflows depends on the investors' perception, the corruption's magnitude, and the tolerance level.

Corruption has dual effects on FDI and the overall investment process as a grabbing hand and, simultaneously, a catalyst. Colonnelli and Prem (2022) note that corruption has a dual effect, leading to an unpredictable or mixed impact on FDI. According to the sand and grease hypothesis, there are no clear boundaries when corruption has a negative or positive effect during the investment process (Martins et al., 2020). Some investors are willing to participate in corrupt practices to access highly competitive investment opportunities against their rivals (grease in the wheels). On the other hand, some foreign investors are discouraged from carrying out cross-border investments because they fear corruption will hurt their investments, significantly lowering the profitability potential and even the perpetual success of their projects (sand in the wheels).

Accordingly, investors who see corruption as a helping hand that can unlock the challenges of capital flows and fasten the investment procedures perceive it as grease on the wheels that lubricate and catalyze the investment process (Gök, 2023; Cruz et al., 2023). On the other hand, corruption is like sand in the wheels for those who view it as an impediment that increases costs and affects their investment decisions (Nutassey, 2020; Martins et al., 2020). Unfortunately, when investment opportunities in foreign markets are obtained through corruption, the investors will still bear the costs and consequences because such undertakings have no legal standing (Krifa-Schneider et al., 2022).

However, foreign investors are likely to continue to invest in EAC despite suffering from corruption, based on information available for risk assessment.

Given the importance of conducive investment in attracting FDI, Lestari et al. (2022) and Jain et al. (2017) opined that it is anticipated that emerging economies will have a low level of corruption, which acts as a sense of security to foreign investors. Unfortunately, the practice and reality are not the same as expected because of institutional quality challenges. In that case, corruption varies from one country to another and from one economic bloc to another. This diversity results in corruption being affected by cultural practices (Lestari et al., 2022). When corruption is embedded in the culture of a particular country, its impact on investment is difficult to control and even eliminate.

In contrast, the findings from the study refute previous empirical studies, which reported an insignificant effect of corruption on FDI. For example, Lestari et al. (2022) conducted a study relating financial development, corruption, and FDI in emerging markets. They found that corruption has a negative, insignificant impact on FDI. In the same vein, a vast number of past empirical studies relating corruption and FDI reported insignificant results (Krifa-Schneider et al., 2022; Martins et al., 2020; Kurul, 2017; Amarandei, 2013; Busse & Hefeker, 2008; Han, 2006; Zhao et al., 2003; Habib & Zurawicki, 2002; Gastanaga et al., 1989). Interestingly, all the studies established a negative relationship between the two, backing up the conventionally adverse impact of corruption on FDI inflows. The main reason for the insignificant effect of corruption reported in these studies is likely to be the difference in institutional quality level, which lowers corruption, and a culture that does not tolerate corruption practices in the economies where the studies were conducted.

### **5.2.3.2 Relationship between Government Effectiveness and FDI**

In examining the FDI-government effectiveness nexus, it is hypothesized (H2b) that government effectiveness is positively related to FDI. The results presented in Table 4.9 reveal that government effectiveness is negatively associated with FDI, contrary to the predicted relationship. The negative relationship between government effectiveness and FDI shows that the results failed to support the hypothesized positive relationship between the two variables, as shown in Table 5.3. The results confirm previous empirical studies, which found that weak institutions in the host countries negatively impact FDI inflows (Buchanan et al., 2012; Bénassy-Quéré et al., 2007).

Generally, an increase in government effectiveness in EAC improves overall governance and economic stability, and its impact on FDI can vary depending on how these improvements are implemented and perceived by foreign investors (Musili, 2023; Wambua, 2023; Rwigema, 2020). Thus, the effect of government effectiveness on FDI in EAC can sometimes be perceived by foreign investors as negative due to several factors (Musili, 2023; Muli et al., 2017; Kiburi, 2016). First of all, increased regulatory scrutiny may mean more stringent regulatory compliance requirements for foreign investors, which could increase operational costs and administrative burdens, potentially deterring FDI inflows. Strict law enforcement, which does not provide room for rational decisions and reasonable fines and penalties, may lead to business closure and even confiscation of investors' properties by the government. This practice is unfriendly to investors

who prefer a negotiation-based approach in resolving investment disputes rather than an iron hand, resulting in government effectiveness in deterring FDI.

Similarly, policy stability and predictability arising from government effectiveness may mean less flexibility in responding to changing market conditions or investor needs who prefer some degree of flexibility, especially in dynamic EAC markets, negatively impacting FDI (Taye & Abe, 2021; Bihkongnyuy, 2020; Ejones, 2020). Overly predictable policies may mean that the investment climate in EAC is rigid and less responsive to changes taking place around the globe, which have an impact on the investment channels. In this regard, foreign investors might prefer undertaking investments in economies with a greater degree of flexibility. Thus, higher government effectiveness can be a deterrent to FDI. Likewise, reduced investment incentives negatively impact the essential role of the government in the investment process.

In some cases, government effectiveness may lead to a reduction of subsidies that were previously used to attract foreign investments. For example, tax breaks or investment guarantees may be phased out as the economy stabilizes and matures (Sadeh et al., 2020; Braunerhjelm, 2022; Kim, 2020). Decreasing incentives to foreign investors could make EAC less attractive than other regions that are still offering such incentives. On this ground, an increase in government effectiveness in EAC could potentially deter FDI inflows. Additionally, market saturation concerns can reflect that government effectiveness can coincide with market maturity or saturation in specific sectors, which minimizes investment

opportunities and lowers investment returns, leading to a less competitive business environment in the EAC. The implication is that as the market matures, opportunities for high returns on business may diminish as competition increases, which could also result in government effectiveness in EAC hurting FDI.

However, currency and exchange rate stability stemming from government effectiveness may mean less opportunity for currency speculation or arbitrage that some investors rely on for short-term gains (Dominguez, 2020; Orhangazi & Yeldan, 2021; Obstfeld & Zhou, 2022). Despite the general benefits of currency risk reduction arising from a stable exchange rate, some investors find it a limiting factor in profiting from arbitrage opportunities in the forex market. In the same way, the impact on state-owned enterprises in EAC could reduce opportunities for foreign investors by strengthening the active management of these firms, which is supported by government effectiveness. Moreover, the imbalance of bureaucratic efficiency against speed in fast decision-making may deter FDI inflows to EAC, regardless of the efforts committed to attracting more FDI inflows to this region. Despite the role of government effectiveness in linking the bureaucratic process and timely decisions, foreign investors might still face delays or bureaucratic hurdles that can impact their investment timelines and returns.

The results from the study align with the expression made by Bhasin and Garg (2020) that an excessive bureaucratic system leads to government inefficiency, creating difficulties in accessing essential services required by investors.

Similarly, excessive bureaucracy facilitates a government-supported corruption system that affects the investment environment (Krifa-Schneider et al., 2022). Such undertakings create a negative perception of the host countries' attractiveness for investments and deter FDI inflows as foreign investors rely more on government effectiveness than formulated investment policies (Bhasin & Garg, 2020). From that point of view, government effectiveness is an essential factor that foreign investors consider when deciding on investment locations. Similarly, the results can be argued based on the view highlighted by Carino (2019) that weak institutional quality challenges pose more risk to foreign investors in the investment channels as they lack familiarity with the bureaucratic systems in the FDI recipient economies.

The findings can be linked with the justification by Du and Zhang (2018) that government effectiveness influences other institutional quality indicators. This implies that inefficient government negatively affects institutional quality, which is detrimental to FDI. Given the significant role of government effectiveness, foreign investors are more attracted to invest in economies with effective governments accompanied by attractive investment policies that are not altered upon a change in political regime (Carino, 2019). Thus, government effectiveness built on better institutional quality in the EAC improves the investment climate, such as the establishment of sound economic policies, contract enforcement, protection of property rights, and regulatory improvement that fosters FDI inflows (Pham et al., 2022; Otchere et al., 2016).

Likewise, the results of the examined relations validate the proposal posited by the institutional FDI fitness theory that the presence of high-quality institutions established in a practical government climate boosts the capacity of host countries to absorb inward FDI (Wilhelms, 1998). Therefore, low institutional quality prevailing in EAC leads to government ineffectiveness, negatively impacting FDI inflows. On this ground, Silajdzic and Mehic (2022) expressed that government effectiveness, an institutional quality indicator, helps execute investment policies and diminishes governmental interference to ensure transparency and efficiency throughout the investment process. At the same time, government effectiveness enhances the location advantages of host countries by increasing government efficiency, facilitating the development of the financial sector by providing reliable alternative sources of capital, fortifying regulatory systems, and promoting good governance practices.

The quality of government effectiveness in attracting inward FDI varies across countries depending on the level of economic development already attained. According to Sabir et al. (2019), government effectiveness exerts a more substantial impact on FDI inflows in developed countries than in emerging economies. The main reason for the differences in the effects of government effectiveness between developed and developing countries is the level of institutional quality in place. Sabir et al. (2019) conclude that institutional quality is higher in developed economies than in emerging markets and is a critical distinguishing factor as to why developed economies are likely to attract more FDI than emerging economies.

However, the results contradict previous studies by Khan et al. (2022), Uddin et al. (2019), Ross (2019), Sabir et al. (2019), and Nizam and Hassan (2018), which found that government effectiveness positively and significantly influences inward FDI to the host countries. The opposing results from the study with other studies can be explained by the argument made by Fon and Alon (2022) that countries with better institutional quality, fostered by government effectiveness, contribute to building solid government-based institutions, which are the backbone of a reasonable investment climate. Given the crucial role of government effectiveness in creating a conducive investment climate, Sabir et al. (2019) expressed that government effectiveness increases foreign investors' confidence, lowers financing challenges by facilitating financial sector development, and mitigates investment risks through law enforcement and protection of investors' rights. In other words, government effectiveness eliminates the fear of an unfair competitive business environment, unpredictable political systems, and unreliable investment policies that can be reversed anytime upon changes in political regimes (Buckley, 2018).

Unlike the studies by Islam et al. (2020) and Paul and Jadhav (2019), who found an insignificant FDI-government effectiveness nexus, the current study findings reveal that government effectiveness does influence FDI inflows. Although the study reported a significant negative relationship between the two variables, it is worth noting that the study supports earlier studies that reported significant results on the influence of government effectiveness on FDI inflows (Dhingra &

Sidhu, 2011; Singhania & Gupta, 2011; Zheng, 2013; Wei, 2005; Jadhav & Katti, 2012; Palit & Nawani, 2007; Mugableh, 2015; Blomkvist & Drogendiji, 2016; Alesina et al., 1996; Holland & Pain, 1998). Despite the difference in institutional quality level and other investment-driving factors, it can be appreciated that the studies found that government effectiveness plays a pivotal role in facilitating the investment process, especially cross-border investments.

Even though government effectiveness in the EAC region is negatively associated with FDI inflows based on the study results, this does not mean the area is not in a position to receive FDI projects. As argued in the previous literature, FDI inflows are influenced by multiple factors, including institutional quality, availability of investment opportunities in the FDI recipient economies, and level of economic development (Majeed et al., 2021). The interaction of diverse factors helps create an attractive investment climate for foreign investors in the EAC. Since attaining sound institutional quality and economic development is a process, EAC is open to FDI inflows as its institutional quality improves while strengthening its economic growth. This view is supported by Islam et al. (2020), who argued that institutional quality helps implement policies such as trade liberalization and privatization of organizations through government effectiveness, which reduces government intervention to ensure transparency and efficiency of the investment process.

### **5.2.3.3 Relationship between Political Stability and FDI**

The relationship between political stability and FDI is examined by hypothesizing a positive relationship between the two variables. The study employed political stability to explore the institutional quality environment in the financial development-FDI nexus, which is a crucial factor in the investment process, particularly in the EAC. The study by Kandiero and Chitiga (2006) found that political stability insignificantly influences inward FDI in emerging economies. Consistent with their findings, the present study came up with similar results, as displayed in Table 4.9, that failed to support the hypothesized (H2c) positive relationship between political stability and FDI inflows, as presented in Table 5.3. On top of that, the results reveal that political stability in EAC is negatively related to FDI, contrary to the predicted positive relationship.

Generally, political stability positively correlates with FDI inflows due to reduced risk and increased investor confidence (Jiang & Martek, 2021; Ajimobi, 2024; Khudari et al., 2021). However, there are some scenarios where political stability in EAC could potentially negatively impact FDI inflows, which have been attributed to the following factors. Political stability in EAC may be negatively correlated to FDI inflows due to over-regulation and excessive bureaucracy, which maintains a strict regulatory environment or bureaucratic inefficiencies that make it difficult for foreign investors to navigate and operate within the economy (Ekutu, 2021; Matiro, 2021). Similarly, over-regulation leads to excessive red tape, complicated licensing procedures, and regulatory hurdles that can deter FDI inflows despite the region being politically stable.

In the same vein, limited policy flexibility or resistance to necessary policy reforms stemming from a lack of responsiveness to changing economic conditions or global market demands can hinder investment attractiveness despite political stability prevailing in EAC (Soutar, 2021; Boys, 2022). Likewise, corruption and cronyism in EAC can persist and undermine the business climate even in a politically stable environment. Foreign investors perceive that such a location is a threat to investment due to the possibility of unfair competition, thereby being compelled to locate their investments elsewhere.

Additionally, social unrest or inequality, including tribal tensions, can create a volatile social environment that risks long-term investment stability despite political calm (Scheffran, 2020; Ide, 2023; Makdisi & Soto, 2023). In some cases, tribal tensions lead to social unrest, consequently deterring FDI inflows. An example of social unrest is the 1994 Rwandan genocide, which stemmed from tribal tensions, resulting in mass killings and significantly polluting the investment climate. Moreover, the lack of infrastructure and human capital necessary to support foreign investment negatively impacts FDI inflows to EAC, apart from the considerable level of political stability experienced in this region. The EAC, political stability does not guarantee sufficient infrastructure development and a skilled workforce, which may make investors hesitant to commit capital in this region.

Furthermore, currency volatility and economic stability are significant challenges in EAC despite the level of political stability experienced (Mosbei et al., 2021; Yabu & Kimolo, 2020; Otieno et al., 2022). Foreign investors perceive economies with currency volatility, high inflation rates, and other macroeconomic instabilities as posing higher risks and prefer to invest in countries with stable economic environments (Fania et al., 2020; Georgiadis & Zhu, 2021; Médici, 2020; Löscher & Kaltenbrunner, 2023). Similarly, monopoly or oligopoly in some sectors and investment channels deters FDI inflows to EAC despite the prevailing political stability, as foreign investors perceive these economies to lack competition, openness, and specific industries controlled by powerful local interests.

Despite the reported insignificant results, the study agrees with the argument expressed by Cherif and Dreger (2016) that foreign investors are more confident in investing in host countries with political stability than in politically unstable economies. Given the importance of political stability, Dutta and Roy (2009) pointed out that political stability is a pivotal factor in supporting economic activities in the FDI recipient countries, including financial sector development, motivation of foreign investors to undertake investments in the respective countries, and the creation of a conducive investment climate. Opio (2020) later supported this argument, highlighting that political stability lowers business costs, increases investors' confidence, reflects government effectiveness, and reduces investment risks in foreign markets.

Political stability in the host country increases the market competitive position in which investors can freely interact with minimal government intervention (Sabir et al., 2018). Prospective investors are very sensitive to political stability when deciding on the location for FDI projects, knowing that political instability intensifies market risks (Cherif & Dreger, 2016). Being aware of how difficult it is to deal with political risks, foreign investors find that one of the hedging mechanisms is to scan the political environment in the countries where they wish to launch FDI projects. The findings from the study support Carino (2019), who opined that political stability negatively impacts FDI because of low institutional quality, particularly political instability experienced during a change in political regime.

The results can also be explained based on another view that most FDI projects flowing to EAC are resource-seeking rather than market-seeking (Li, 2021). Foreign investors are willing to invest in EAC, even in an environment with political instability, to win the available natural resources. An example of this scenario is the case of the Democratic Republic of Congo (DRC). Despite political unrest in the DRC, the country has received FDI projects because of strategic investment in the Tenke Fungurume copper belt mining (EAC Investment Guide, 2020). Similarly, the increase in FDI inflows to Uganda and Tanzania in 2012 was not simply because of their political stability but rather the discovery of oil and gas in these countries.

Additionally, the findings from the study support the proposition put forward by the institutional FDI fitness theory that quality institutions built on a stable political environment increase the attractiveness of the host countries for FDI inflows. Wilhelms (1998) contended that countries with a government's fitness in pushing economic development are linked with a stable political climate. Political stability built on quality political institutions facilitates the implementation of investment policies and boosts the interaction between domestic and foreign investors in the local market. Therefore, politically stable economies have a high degree of transparency and efficiency in all the requirements of the investment process. Similarly, the findings from the study also support the eclectic theory (OLI framework) that political stability enhances the host countries' location advantages as it increases government effectiveness, facilitates financial sector development for easy access to financial services, strengthens the regulatory systems, stimulates good governance practices, and create a competitive interactive market with fair treatment for all market participants.

On the other hand, the results from the study contradict earlier findings, which reported significant findings on the impact of political stability on FDI inflows (Sabir et al., 2019; Gupta et al., 2023; Muiruri, 2016; Awan et al., 2014; Bartels et al., 2009; Bénéassy-Quéré et al., 2007; Bhavan et al., 2011; Dutta & Roy, 2009). The likely reasons for the reported opposing results can be the differences in the political environment in which the studies were conducted. Based on the reality that the political climate varies from one country to another, similarly, its influence on FDI inflows may vary, so it is no wonder that studies conducted in

different economies may come up with contradicting results. In the same way, the level of economic development, cultural practices, and institutional quality differ across countries, which may pose differences in the interaction between investment channels and political avenues.

Generally, the findings from the study indicate that institutional quality in EAC negatively impacts FDI inflows based on corruption, government effectiveness, and political stability. Both corruption and government effectiveness significantly influence FDI inflows. Similarly, the results reveal that political stability in EAC is negatively associated with FDI but is statistically insignificant. The findings suggest that the EAC region faces an institutional quality challenge similar to other emerging markets. The region's institutional quality is still low, negatively impacting FDI attraction. However, it should be no surprise that foreign firms may view the institutional challenges facing EAC as an advantage in exploiting the available natural resources and utilizing this market segment, which seems unsaturated because of technological issues and production efficiency (Chen et al., 2023; Zhang & Dilanchiev, 2022; Gammeltoft & Cuervo-Cazurra, 2021).

Further evaluation of the findings from the study may reflect on the argument that while the poor quality of institutions under capitalism may make overall investments and capital inflows smaller, it will force more of the flows to take the form of FDI (Huynh, 2022). Hence, countries with weaker institutions can still experience FDI inflows regarding mergers and acquisitions (Ashraf et al.,

2020). International firms can access better foreign institutions and markets, giving them the relative advantage to purchase and profit from them. For instance, Hausman and Fernandez-Arias (2000) revealed that the share of FDI in total flows tends to be larger in riskier, more distant, resource-rich, financially underdeveloped, and institutionally weak countries. Therefore, it is tough to argue that countries with weak institutions cannot attract some FDI projects to their economies.

Generally, the study finds a contradictory impact of the institutional quality dimensions employed, in which corruption negatively impacts FDI inflows as predicted by the hypothesized relationship and even the propositions from the literature, while government effectiveness and political stability negatively impact FDI inflows contrary to the hypothesized positive relationship. These unanticipated results can be explained by context-specific governance effects prevailing in the EAC and similar emerging economies.

While corruption tends to deter FDI as expected, paradoxically, higher government effectiveness and political stability can also reduce FDI inflows, contrary to conventional theory. This unexpected effect can stem from several context-specific dynamics, such as the type of FDI, investor motives, and the governance-performance paradox in different economies often shape these outcomes. Corruption imposes unpredictable costs and institutional inefficiencies that deter FDI. Corruption increases the cost of doing business

through bribes, delays, and informal payments, undermining contractual enforcement and distorting fair competition.

On the other hand, government effectiveness and political stability may deter certain types of FDI when they shift the investment calculus from opportunism to compliance. In a context where investors seek high returns through preferential access, deregulation, or resource extraction, strong governance may restrict these avenues, leading to a decline in FDI. Thus, the relationship between governance and FDI is nonlinear and context-dependent, requiring a nuanced understanding of investor motivations and the host country's political climate.

#### **5.2.4 Moderated Effect of Institutional Quality (corruption, government effectiveness, political stability) on the Relationship between Banking Services and FDI Inflow.**

Objective four of the study is focused on investigating the moderated effect of institutional quality (corruption, government effectiveness, and political stability) on the relationship between banking services and the level of FDI inflow. To achieve this objective, six hypotheses, H3a, H3b, H4a, H4b, H5a, and H5b, have been developed and tested, covering two hypotheses from each institutional quality variable employed. Hypotheses H3a and H3b examine the moderated effect of corruption on the relationship between banking services and FDI, while hypotheses H4a and H4b test the moderated effect of government effectiveness on the same relation. Likewise, hypotheses H5a and H5b

investigate the moderated effect of political stability on the relationship between banking services and FDI. Hypotheses H3b and H4b were supported, while the rest were not supported by the results, as reported in Table 4.10 and summarized in Table 5.4.

Table 5. 4: The moderating effect of institutional quality on the banking services and FDI Nexus

<b>Research Objective</b>	<b>Research Question</b>	<b>Hypothesis</b>	<b>Supported/ Not supported</b>
To investigate the moderating effect of institutional quality (Corruption, Government Effectiveness, and Political stability) on the relationship between banking services and the level of FDI inflow.	Does institutional quality (Corruption, Government Effectiveness, and Political stability) moderate the relationship between banking services and the level of FDI inflow?	H3a Corruption moderates the relationship between bank assets and FDI	Not supported
		H3b Corruption moderates the relationship between credit to the private sector and FDI.	Supported
		H4a Government effectiveness moderates the relationship between bank assets and FDI.	Not supported
		H4b Government effectiveness moderates the relationship between credit to the private sector and FDI.	Supported
		H5a Political stability moderates the relationship between bank assets and FDI.	Not supported

H5b Political stability moderates the relationship between credit to the private sector and FDI.	Not supported
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**Source:** Author's compilation

The findings from the study indicate that institutional quality influences banking sector services in attracting FDI inflows in the EAC. The results confirm the hypotheses that institutional quality moderates the relationship between banking services and the level of FDI inflows. The findings reveal that institutional quality stimulates the impact of the banking sector services on FDI inflows to the recipient countries, similar to the observations reported by Islam et al. (2020). Therefore, the level of FDI attracted to the EAC varies with the quality of financial services offered to investors through the banking sector under the influence of institutional quality.

Institutional quality in EAC has a significant moderation effect on the relationship between banking services and FDI due to different factors (Kwaw-Nimeson & Tian, 2023; Fengju & Wubishet, 2024; Matima & Gossel, 2023). The regulatory environment, legal system, political stability, transparency and accountability, financial sector regulation, infrastructure and technology, access to market information, and human capital development are essential factors that contribute to the significant interaction of institutional quality on the relationship between banking services and FDI.

Similarly, a clear and stable legal and regulatory framework around the banking sector contributes to enhancing investor confidence and strengthening the protection of property rights (Boulanouar et al., 2021; Sun, 2020; Van Greuning & Bratanovic, 2020; Arias et al., 2020). This stability encourages long-term investment in banking services. Similarly, stable political environments are less prone to sudden policy changes as transparent governance practices reduce corruption and promote accountability, which builds foreign investors' trust and reduces the risk associated with investing in banking services. In the same way, institutional quality contributes to adequate supervision of banks, which is critical for attracting FDI inflows in EAC.

Improvement in the institutional quality environment in the EAC economies intensifies the impact exerted by the banking services on inward FDI attraction. The findings from the study support the arguments made by Pham et al. (2022) and Law and Azman-Sain (2012) that improving institutional quality, such as improved property rights protection, an effective legal system, and efficient financial regulations, speed up mobilization of capital with a broader financial base which in turn strengthens investor's motives to participate in foreign markets. The results imply that foreign investors are attracted to invest in EAC, where the financial interests attached to their investments are considered and safeguarded through banking services channels.

Similarly, the findings from the study are consistent with Feng and Yu (2021), Pham et al. (2022), and Le et al. (2016), who conveyed that quality institutional

structures with effective anti-corruption laws, secure property-rights system, and generally regulatory solid quality can lead into a reduction of opportunistic behaviours and rent-seeking in the emerging markets. The results indicate that the banking sector attracts more savings and prudently allocates them to the most productive entrepreneurial activities available in the economy through institutional quality interaction.

The results support the argument that banking sector services built on robust financial systems with an active quality institutional background, such as prudent regulations, an efficient legal system, and intense supervision, foster investments, lower market imperfections, and enhance monitoring of the financial activities taking place in the economy (Pham et al., 2022). The results further reveal that institutional quality is critical in improving the investment climate as it contributes to developing the banking and financial sectors. Similar to previous studies by Le et al. (2016), Voghouei et al. (2011), and Law and Azman-Sain (2012), the findings from the study agree and emphasize that institutional quality is a catalyst for financial sector development, which is a focal point in FDI attraction to the EAC.

On top of that, institutional quality practices improve the EAC's banking sector, leading to increased domestic investments, encouraging the financial systems to improve their financial services, stimulating economic activities, and creating reliable funding sources to serve broader market participants driven by diverse demands. Customer financing needs are correctly identified and attended to

promptly by banks that adhere to institutional quality (Naceur et al., 2014). A banking sector that invests in institutional quality and allows the same to be one of its driving factors keeps on growing and achieving higher economic development. The attained economic development intensifies the expansion of the financial sector. Similarly, higher economic development catalyzes the provision of quality financial services, the proficiency of the financial sector in meeting customers' demands, and the creation of a platform for equitable competition among the market participants (Dutta & Mukherjee, 2015; Lin et al., 2013).

On the other hand, the results contradict Aluko and Ajay's (2018) findings, who reported an insignificant effect of institutional quality on the banking sector in 25 Sub-Saharan African countries using data sets from 1997 to 2014. According to David et al. (2014), the primary reason institutional quality has an insignificant impact on banking sector development in Sub-Saharan African countries is the challenge of low institutional infrastructure, propelled by weak regulations, insufficient supervisory capacity, and weak property rights protection. They further argued that given such institutional quality drawbacks built on an ineffective institutional structure, the banking sector of Sub-Saharan African countries will experience slow improvements compared to economies where institutional quality is high and of priority.

Upon evaluating the moderated effect of the individual, institutional quality variables employed in the study (corruption, government effectiveness, political

stability), the findings indicate that despite the overall impact of institutional quality on banking services on influencing the level of FDI inflows to EAC yet each individual, institutional quality variable responded in a different way as discussed in the following sections.

#### **5.2.4.1 Moderated Effect of Corruption on Banking Services**

The moderated effect of corruption on the banking sector services reported mixed results, showing an insignificant impact on bank assets while significantly responding to credit to the private sector. Regression results reveal that the effect of bank assets on FDI is independent of the level of corruption in EAC, as shown in Table 4.10. In contrast, the results indicate that bank credit to the private sector, followed by corruption, attracts FDI inflows to the EAC. Thus, the mixed results for the moderated effect of corruption on banking sector services do not support hypothesis H3a and simultaneously accept hypothesis H3b. However, the study agrees that corruption misleads investors to invest their financial resources in unproductive sectors (Chen et al., 2022). The results agree that economic corruption significantly negatively impacts inward FDI (Krifa-Schneider et al., 2022).

Corruption exerts an insignificant tangential effect on banking assets because the bank assets pool is contributed to by factors such as the banking regulatory environment, good governance practices, savings tendency or culture, customers seeking safety for their financial resources, marketing strategies, economic development, and strategic government support. All these factors, in one way or

another, outweigh the impact of corruption on the banking system's efforts to accumulate assets, which facilitate their operations in service delivery to diverse customers, businesses, and investment channels. Islam et al. (2020) opined that corruption deters FDI in the economy where investors' rights are not protected and institutional quality is poor. Given the adverse impact of corruption on banking sector services, Donaubauer et al. (2020) expressed that corruption negatively impacts the host countries' investment climate and deters inward FDI.

In the same vein, Martins et al. (2020) argued that corruption in emerging economies such as EAC has an insignificant conditional effect on the factors that attract FDI to these economies. They highlighted that foreign investors are more concerned with the available investment opportunities than with the prevailing corruption in those markets. The results also support the argument that corruption impacts the banking sector in influencing FDI inflows, but its impact varies from one economic bloc to another (Krifa-Schneider et al., 2022). It can be argued that, based on Krifa-Schneider et al. (2022), the effect of corruption on the development of the financial sector is higher in developed economies than in EAC, where it is more tolerated. Hence, its impact may be lessened to an insignificant level.

The negative relationship between the moderated impact of corruption on bank assets and FDI inflows was confirmed in Table 4.10. Despite the statistical insignificance of the moderated effect of corruption on bank assets, it can be conceptualized that the negative coefficient sign implies that corruption always

hurts banking sector services, such as the mobilization of financial resources in forming a bank assets portfolio for meeting customers' demand. According to Martins et al. (2020), corruption negatively impacts financial development, including the banking sector's role in attracting FDI inflows.

Even though the moderation effect of corruption was not statistically significant on bank assets, it is still essential to take preventive measures against its distortion of the investment climate and its impact on financial development when developing strategies for attracting more FDI inflows to the EAC. Moreover, institutional quality and adherence to good governance are vital in alleviating corruption and creating a conducive investment environment (Islam et al., 2020; Khan et al., 2020).

Corruption in the EAC and similar economies affects the attractiveness of the location for FDI inflows since it is considered one of the investment risks attached to political cover (Lestari et al., 2022). Given the burden (cost) imposed by corruption in the investment process, most investors hesitate to carry out investments in locations that are perceived to be corrupt (Krifa-Schneider et al., 2022). The ultimate resting point of investors' concerns over corrupt practices in EAC has delayed investment decisions or led to a deviation from this region to other relatively compatible locations. In reality, all these challenges deter FDI inflows to EAC.

On the other hand, credit to the private sector, when conditioned on corruption, significantly influences FDI inflows to the EAC. The findings suggest that the impact of bank credit to the private sector on FDI inflows is affected by the corruption prevailing in the EAC. The results support the positive effects exerted by corruption in attracting FDI inflows reported by Nutassey and Frimpong (2020) in Sub-Saharan African countries using data sets from 1996 to 2016 while studying the effect of corruption on the FDI-financial development nexus. The authors noted that corruption raises FDI inflows in Sub-Saharan Africa, contrary to institutional quality principles.

Credit to the private sector increases with increased corruption due to limited financing sources in EAC, similar to the argument raised by Pham et al. (2022) regarding the financing alternative challenge facing emerging markets. The findings from the study support the grease in the wheels hypothesis that corruption catalyzes credit availability to the private sector (Krifa-Schneider et al., 2022). On top of that, despite the adverse impact of corruption in the investment and financing process, credit offered by banks of the host countries to the private sector seems vital for business growth and risk sharing (Nkoa, 2018). The results further indicate that foreign investors in EAC are eager to access credit financing even under a corrupt environment.

The positive moderating effect of corruption on the relationship between credit to the private sector and FDI inflows to EAC can also be explained in different ways. When foreign investors need additional financing to support their business

growth and expansion through bank credit, they may be willing to engage in corrupt practices to facilitate business operations. Because of excessive bureaucracy, cumbersome regulations, and administrative delays, corruption can speed up the process of obtaining credit approvals, making it easier for investors to meet their financing needs promptly. Similarly, corruption can create informal networks between bank officials and foreign investors, providing additional support and resources to businesses, facilitating smoother operations, and attracting FDI inflows to the EAC.

Additionally, corruption in EAC positively moderates the effect of credit to the private sector on FDI inflows, reflecting that corruption in this region can incentivize investment. In some cases, corruption can facilitate more accessible access to bank credit for businesses, attracting FDI as investors see that the local banks have the financial resources to support their investments. However, because of risk-sharing motives, foreign investors find it better to access credit in the local market even under corrupt means if provided. Corrupt officials may offer favorable terms to foreign investors, such as low interest rates, loan repayments, holidays, and other preferential treatment, making the EAC attractive to FDI. Likewise, corruption can reduce competition among credit applicants, allowing firms that engage in corrupt practices to gain an unfair advantage, making the market more appealing to confident investors.

Liu et al. (2020) highlighted that banking services to foreign investors are affected by corruption when credit is offered based on familiarity with the client.

However, Sharma and Paramati (2021) revealed that the long-run effects of corruption distort the channels of international capital movement and discourage foreign investments. Logically, low-corruption countries have developed financial systems that attract inward FDI (Pham et al., 2022). Foreign investors are attracted to locate their investments in countries with low corruption and promising financial developments that can absorb their financing needs (Lestari et al., 2022). The findings from this study corroborate the results reported by Lestari et al. (2022), who found a significant moderating effect of corruption on the banking sector in emerging markets. Other previous empirical studies with similar findings for the significant moderating role of corruption on banking sector services include Aibai et al. (2019), Islam et al. (2020), and Petrou and Thanos (2014).

The findings for the moderated effect of corruption on banking services support the institutional FDI fitness theory, which considers the role of quality institutions in limiting the adverse impact of diverse factors on the absorption of inward FDI in the host countries (Wilhelms, 1998). The findings indicate that the influence of bank services in attracting FDI inflows to EAC is mixed, whereas on one side, independent of the level of corruption prevailing in this region and, at the same time, partly catalyzed by corruption. The findings suggest that the banking sector is built on regulatory systems and good governance practices governing the banking sector.

Moreover, suppose corruption is considered a stable, predictable part of business. In that case, it may create a sense of stability for investors who can factor these costs into their business models and investment strategies. Despite the possible influence of corruption in accessing credit and overall business support, it is essential to note that corruption always has long-term, significant negative impacts on business and investment processes, including cost increases in doing business, creating unfair competition, and undermining long-term economic development. Therefore, apart from corruption, which might provide short-term incentives for investment, its overall impact on the economy and investment climate is generally detrimental.

#### **5.2.4.2 Moderated Effect of Government Effectiveness on Banking Services**

The moderated effect of government effectiveness on banking services produced insignificant results on bank assets but enormously significant results on credit to the private sector. The findings justified the study's gap by demonstrating that government effectiveness, one of the institutional quality indicators, moderates the relationship between banking sector services and FDI inflows. However, the increased interaction of government effectiveness on bank assets negatively correlates with FDI due to over-regulation and strict directives from central banks to commercial banks, since it controls and supports all economic activities (Wilhelms, 1998). On the other hand, the results indicate that the influence of bank credit on the private sector on FDI inflows varies with the level of government effectiveness built on institutional quality in the EAC. The mixed results of the moderated effect of government effectiveness on banking sector

services led to hypothesis H4a being unsupported and, at the same time, hypothesis H4b being accepted.

However, the moderated effect of government effectiveness on the relationship between bank assets and FDI inflows to EAC indicated that government effectiveness poses a negative conditional association between the two. The results reveal that government effectiveness in EAC negatively impacts the impact of bank assets on FDI. Excessive government bureaucracy creates difficulties in accessing services, which pollutes the business environment, making it unattractive for investors, hence low FDI (Bhasin & Garg, 2020). While emphasizing the pivotal role of government effectiveness in attracting inward FDI, Fon and Alon (2022) noted that the government is involved in establishing policies and all economic development initiatives. The implication is that government effectiveness is an excellent position to facilitate the development of the financial sector to attract investors and sound investments.

Further explanation of the moderated effect of government effectiveness on bank assets and FDI can be made based on the bank structure built on regulations and governance practices. Government monetary and fiscal policies impact bank performance based on asset pools, which are similar to the regulatory mechanisms that central banks implement. For example, Mkaro et al. (2023) found that the central bank's adoption of a single treasury account system under government directives leads to performance challenges in the short term and sometimes even in the medium term. Even though there is government

inefficiency in EAC, which stems from low institutional quality, the banking sector services depend on the market forces of demand and supply, in which financial resources flow from the surplus spending units (net savers) to the deficit spending units (net users).

The results confirm the findings reported by Sabir et al. (2019), who found that government effectiveness strongly influences FDI inflows and significantly moderates the FDI-financial development nexus in developing countries while evaluating the impact of institutional quality on FDI inflows in low, lower-middle, middle-income and high-income countries. The study utilized a panel data set from 1996 to 2016 and the GMM estimation model. It can be appreciated that the estimation model used, the GMM, has the power to handle endogeneity problems similar to the FGLS employed in this study. The significant role of government effectiveness in influencing the banking sector toward FDI attraction is also supported by Du and Zhang (2018), Koop and Hanretty (2018), Ofoeda et al. (2022), and Olorogun et al. (2022). The findings suggest that government effectiveness penetrates its impact on all sectors and activities taking place in the economy.

A further indication of the moderation results is that the impact of credit to the private sector on FDI inflows varies with the levels of government effectiveness prevailing in the EAC. The higher the government effectiveness in the EAC, the more FDIs will be attracted to the region, given that banks provide credit to the private sector. The increase in the conditional effect of government effectiveness

on credit to the private sector results in a rise in the FDI inflows. The moderation results further imply that, under government effectiveness, foreign investors are more willing to use credit provided by banks in the EAC to meet their financing needs. The results align with the proposition that all the services provided in the economy are captured by government effectiveness (Kemoe & Lartey, 2022).

In the same vein, Kemoe and Lartey (2022) highlighted that all the services in the economy are captured by government effectiveness, including the mobilization of savings under bank deposits and credit facilitation to the private sector. Their argument further explains why government effectiveness is a critical factor among the institutional quality indicators when evaluating the essential factors that drive inward FDI flows to the EAC. Additionally, Carino (2019) expressed that countries with effective governments motivate foreign investors to invest in their economies with confidence, as they expect that a stable and favourable business environment prevails in this region and further that there is no possibility of abrupt changes or reversals of investment policies.

Similarly, Sabir et al. (2019) stress that government effectiveness is superior when institutional quality indicators are compared for their impact on FDI attraction. Later studies by Karim et al. (2022) and Barbier and Burgess (2021) argued that there are many institutional quality indicators, but government effectiveness influences others. Their argument emphasized the distinctive role of government effectiveness on the banking services and FDI inflows, thereby supporting the views of Peres et al. (2018), who contended that government

effectiveness significantly influences the attraction of FDI inflows in developing countries, regardless of the low institutional quality experienced in these markets.

The results agree that government effectiveness entails the rate of FDI inflows attracted to the economy (Silajdzic & Mehic, 2022). Government effectiveness leads to establishing quality institutions, creating an interactive investment climate, and minimizing political risks by containing political pressure (Carino, 2019). Similarly, Pham et al. (2022) emphasize that government effectiveness results in economic development, solid financial sector development, service provision, and a conducive investment environment that stimulates foreign investors' attraction to locate FDI projects in the host economies.

Additionally, the findings back up the institutional FDI fitness theory proposition that quality institutions increase the absorption capacity of inward FDI to the host countries (Wilhelms, 1998). Sabir et al. (2019) further supported this argument, stressing that institutional quality propelled by government effectiveness is a precondition for FDI attraction as it positively influences FDI inflows. However, the results contradict the findings reported by Islam et al. (2020), who found an insignificant moderating role of government effectiveness on financial development while studying the moderating role of institutional quality on the influence of financial development towards FDI inflows along the Belt and Road Initiative (BRI) countries using the GMM estimator and panel data set for 79 countries from 1999 to 2017. However, it is worth noting that the

difference between BRI countries and EAC in adherence to institutional quality practices, economic development, technological aspects, and level of financial sector development is likely a significant reason for the opposing results.

The significant moderated effect of government effectiveness on the banking sector is an appreciation of the efforts made to develop the banking sector in the EAC. Kemoe and Lartey (2022) opined that government effectiveness is the channel through which all economic sectors are captured. Hence, these research findings reflect this. Undoubtedly, government effectiveness in the EAC region has been supporting the development of the banking sector and influencing FDI inflows. Government effectiveness contributes to the banking sector to gain institutional quality attributes, which are displayed by this sector in attracting FDI inflows (Aziz, 2022; Huang et al., 2022; Duodu & Baidoo, 2022; Khan et al., 2022; Van Bon, 2019; Hayat, 2019). The development of the banking sector through the support of government effectiveness reduces bureaucracy, resulting in smooth service provision (Carino, 2019). Consequently, institutional quality driven by government effectiveness indicators prevailing in the EAC region impacts financial development and FDI through banking sector services.

#### **5.2.4.3 Moderated Effect of Political Stability on Banking Services**

Political stability is among the indicators employed in the study to investigate the moderated effect of institutional quality on the relationship between the banking sector services and the level of FDI inflows to EAC. The results reveal that the influence of banking services on FDI is independent of the level of

political stability prevailing in the EAC region. The reported insignificant results for the moderated effect of political stability on banking services failed to support both hypotheses H5a and H5b, as reported in Table 5.4.

The statistical insignificance of the moderated effect of political stability on banking services is determined by various factors. The banking sector operates under regulatory supervision and good governance practices. Another reflection is that political stability possibly corresponds to the level of financial development prevailing in this economic zone. This view can be substantiated by the argument made by Dutta and Roy (2011) that political stability will significantly impact financial sector development in attracting FDI inflows only when better political stability is achieved. In other words, political stability in EAC is engulfed by the level of financial sector development already attained.

The results suggest that the EAC's government machinery protects investors' rights with joint compliance, and political pressure does not influence the development of the financial sector and the investment environment, as Carino (2019) opined. This argument supports the results of the insignificant impact of political stability in the relationship between banking services and inward FDI based on adherence to investors' protection rights. Similarly, the existence of courts and their power to settle investment arbitration disputes does matter in regulating the influence of political undertakings in the investment channels. If the legal systems operate on realistic rules in the EAC, the political state cannot adversely impact the financial sector development and investment process. In

the same vein, the availability of institutional regulators contains all the possible political impulses that could be exerted on the financial sector and investment channels. On top of that, attaining a relatively tangible level of institutional quality that liaisons financial sector development, political activities, and the investment arena controls most of the possible political risks that may impact the financial sector development and FDI inflows.

However, it is interesting to note that the association between FDI inflows and the moderated effect of political stability on banking sector services is positive for both bank assets (PST\_BAT) and credit to the private sector (PST\_BACRED), as can be confirmed by the positive regression coefficients reported in Table 4.10. The positive relation implies and supports the argument made by Busse and Hefeker (2005) that political stability motivates foreign investors to invest in the host countries under the belief that there is no sudden change or reversal of the investment policies. Similarly, Dutta and Roy (2011) emphasize that political stability is essential in attracting FDI inflows and facilitates financial sector development. The reflection of foreign investors toward political stability in the EAC is that the region has relatively stable governments with no internal or external conflicts, fundamental democratic rights prevail, and efficient law and order systems are in place.

Sabir et al. (2019) expressed that political stability increases investors' confidence as it reflects government effectiveness in the FDI recipient countries. The argument indicates that political stability is essential in developing a

conducive investment environment. Investors' confidence is enhanced by political stability as it builds up an ordered society that improves the market's competitive position for all investors. Hence, the conditional effect of political stability is positively related to FDI inflows, which also implies that foreign investors are more willing to invest in politically stable countries under the expectation that in such countries, there are attractive economic policies, enforcement of contracts, protection of property rights, and an improved regulatory environment.

On the other hand, the upbeat but statistically insignificant tangential impact of political stability on the banking sector obtained from the individual moderated effect on bank assets and credit to the private sector implied that, apart from political stability being an important factor in financial sector development in FDI attraction, its impact on the banking sector is less influential. The results suggest that the banking sector in EAC is somewhat free from political pressure. It could also be argued that EAC's banking sector services are based on economic forces rather than political pursuits.

Based on the results for the moderating effect of political stability on bank assets and its impact on FDI attraction to the EAC, the findings suggest that the banking sector in the EAC is independent of political turbulence. Despite the insignificant influence of political stability when conditioned on the bank sector, Matima and Gossel (2023) and Osei-Attakora (2022) argued that political stability is among the critical drivers for FDI attraction as it reduces political risks. Political

stability assures foreign investors of the unlikely chances for reversal of investment policies stemming from political pressure (Sabir et al., 2019). Political stability increases the reliability of transactions and transparency, reducing foreign investors' fear of undertaking cross-border investments (Simbi et al., 2022; Burchill et al., 2022).

A literature review observed that the study's findings contradict the empirical results of Islam et al. (2020) and Dutta and Roy (2011), which registered a significant moderated effect of political stability on banking sector services and FDI relations. Their results support the argument made by Sabir et al. (2019) that politically stable countries motivate foreign investors to invest in their economies with confidence that there is no sudden change or reversal of the investment policies because they have stable governments. Accordingly, Othman (2022) emphasizes that political stability plays a pivotal role in creating a conducive environment for financial sector development, but it is also essential in attracting FDI inflows.

Generally, the findings from the study can also be explained based on the banking sector development in EAC. The banking sector has progressed substantially with more significant support of economic growth, human capital development, and technological advancements such as Internet banking, mobile banking, and ATM services (Desbordes & Wei, 2017). Most banking services are now automated with less physical contact. Technological advancement and adherence to legal systems in the banking sector have reduced, to a large extent,

the loopholes for corruption in emerging economies (Krifa-Schneider et al., 2022). These developments in the banking sector reflect good governance practices that suppress the adverse effects of institutional quality challenges on the banking sector in influencing FDI inflows to the EAC.

Thus, in analyzing the role of banking sector services on inward FDI attraction, it is worth appreciating that EAC's banking sector has grown remarkably from monopolistic single banks to multiple competitive banks involving local, regional, and international banks. The development of the banking sector in EAC has been moving in parallel with economic growth, customer needs, technological advancement, adherence to the legal and regulatory framework governing good conduct of the banking sector operations, and adherence to good governance practices. All these aspects contribute to the banking sector's development and strongly influence FDI inflows to the EAC.

#### **5.2.5 Moderated Effect of Institutional Quality (corruption, government effectiveness, political stability) on the Relationship between Stock Market Size and FDI Inflow**

Table 5.5 summarises the results for objective five, which investigates the moderated effect of institutional quality (corruption, government effectiveness, political stability) on the relationship between stock market size and the level of FDI inflow to EAC. To achieve this objective, six hypotheses, H3c, H3d, H4c, H4d, H5c, and H5d, have been developed and tested, involving two hypotheses

from each institutional quality variable employed, categorized by corruption, government effectiveness, and political stability.

Table 5. 5: The moderating effect of institutional quality on the Stock market Size and FDI Nexus

<b>Research Objective</b>	<b>Research Question</b>	<b>Hypothesis</b>	<b>Supported/ Not supported</b>
To investigate the moderating effect of institutional quality (Corruption, Government Effectiveness, and Political stability) on the relationship between stock market size and the level of FDI inflow.	Does institutional quality (Corruption, Government Effectiveness, and Political stability) moderate the relationship between stock market size and the level of FDI inflow?	H3c Corruption moderates the relationship between value traded and FDI	Supported
		H3d Corruption moderates the relationship between market capitalization and FDI.	Supported
		H4c Government effectiveness moderates the relationship between value traded and FDI.	Supported
		H4d Government effectiveness moderates the relationship between market capitalization and FDI.	Not supported
		H5c Political stability moderates the relationship between value traded and FDI.	Supported
		H5d Political stability moderates the relationship between market capitalization and FD.	Not supported

**Source:** Author's compilation

The findings from the study reveal that institutional quality exerts a conditional effect on stock market size in influencing the level of FDI inflows in EAC. The results confirm that institutional quality moderates the relationship between stock market size and the level of FDI inflows attracted to the EAC based on corruption, government effectiveness, and political stability, respectively. However, the findings indicate that the moderated effect of institutional quality on stock markets negatively impacts FDI inflows to the EAC.

The results support the findings reported by Pham et al. (2022) that institutional quality affects the level of FDI inflows when conditioned on stock markets. The findings indicate that a small stock market size hurts FDI even when such a market is subjected to an institutional quality environment, since the market is inefficient and cannot meet foreign investors' long-term capital financing needs. Pham et al. (2022) highlighted that institutional quality stimulates stock market development, attracting more FDI to the recipient economies. If the stock market size is large enough to accommodate foreign investors' long-term capital needs, then, under the influence of institutional quality, it impacts the level of inward FDI.

Conventionally, institutional quality increases the efficiency of stock markets in attracting FDI inflows (Gupta et al., 2023; Nam et al., 2020; Islam et al., 2020; Ali et al., 2022). However, the institutional quality in EAC can have a negative moderating effect on the relationship between stock market size and FDI inflows

for several reasons. The regulatory environment in the region can be one of the factors in the sense that poor institutional quality leads to inconsistent enforcement of regulations. Foreign investors may perceive this as increasing the risks associated with investing in the stock market. Similarly, political stability in EAC can potentially hurt the influence of the stock market in attracting FDI, as institutional quality correlates with the political environment in this region. Due to political tensions during the change of regimes, the EAC experiences higher volatility risks in its stock markets and a higher perceived risk by foreign investors.

Moreover, corruption and transparency, market efficiency, contract enforcement, and property rights are also factors that are considered among the attributes of the negative moderating effect exerted by institutional quality on the FDI and stock market nexus in EAC (Khan et al., 2023; Arogundade, 2022; Ali et al., 2022; Musili, 2023). Corruption and lack of transparency increase the cost of doing business and reduce investors' confidence as they perceive corruption to be rampant in the investment channels, which local players could likely tolerate.

Similarly, EAC market inefficiency exerts a negative impact on the stock market itself and deters foreign investors who prefer investing in markets with friendly regulation, transparency, and precise pricing mechanisms (Hansen, 2020; Areneke et al., 2022; Clements, 2020; Peng et al., 2021). So, a less efficient stock market is unlikely to attract a significant amount of FDI. Additionally, weak

institutional challenges facing the EAC can undermine contract enforcement and property rights protection.

However, foreign investors require assurance that their investments in EAC will be safeguarded, but the lack of strong institutional frameworks discourages FDI inflows despite the stock market size (Ogbonna et al., 2022; Appiah-Kubi et al., 2020; Semenas, 2020). Therefore, apart from the generally expected positive effect of the stock market in attracting FDI, its impact depends mainly on the quality of institutions in the EAC.

High-quality institutions and large stock markets help investors minimize information asymmetry, thereby increasing the chances of identifying productive investment opportunities in the FDI recipient countries (Islam et al., 2020). Foreign investors are more attracted to invest in economies with developed stock markets supported by institutional quality environments. Billmeier and Massa (2009) also argued that better institutions, accompanied by improvement in shareholder protection, less government corruption, and information transparency, enhance the confidence of the stock market participants to purchase listed securities in developing countries. Therefore, institutional quality and stock market size can accelerate capital accumulation and investment in the form of FDI.

The more foreign investors participate in the host country's stock markets, the more regulatory reforms and institutional quality are enhanced. The joint effect

of institutional quality on the stock market and FDI attraction improves the quality of trading regulations, operational competence, information disclosure, and investor protection. When some foreign firms list on the host countries' stock markets, it inspires and increases other investors' confidence to participate in that market. Such an action accelerates trading volume and capitalization (Pham et al., 2022). In so doing, the quality of institutions in the host countries facilitates stock markets to adopt a friendly market environment that encourages trade, financial development, and industrial growth. Therefore, the presence of foreign firms in the FDI recipient economies significantly stimulates the stock market development since the foreign firms can list on the local stock market to boost their reputation and goodwill in that market.

The negative moderated effect of institutional quality on stock market size contradicts the previous empirical studies by Otchere et al. (2016) and Law and Azman-Saini (2012), who reported a positive impact exerted by institutional quality on the stock market in 55 emerging economies, including African countries. They argued that institutional quality makes stock markets more beneficial for FDI attraction. Local and foreign investors are more attracted to participate in stock markets nurtured by institutional quality, making them stand firm for property rights, sound accounting practices, and the enforcement of contracts. As a result, the level of FDI attracted to the recipient countries depends on the level of institutional quality that enhances the efficiency, value, and volume of capital market transactions offered by the host countries' stock markets. Likewise, quality institutions facilitate timely stock market information availability in the FDI recipient economies. Such information is vital for

investors' financial decisions, particularly foreign investors, who have few details on cross-border markets. Thus, improvement in the institutional environment amplifies the impact exerted by the stock market size on FDI inflows.

However, it is notable that the results for the individual moderated effect of each institutional quality variable on stock market size employed in the study, that is, corruption, government effectiveness, and political stability, influence the impact of the stock market on FDI. The findings indicate that the moderated effect of institutional quality on the stock market negatively affects FDI inflows to the EAC region, as discussed in the following sections.

#### **5.2.5.1 Moderated Effect of Corruption on Stock Market Size**

The results reveal that the moderated effect of corruption on stock market size negatively impacts FDI inflows to the EAC. The influence of the stock market, followed by corruption, hurts the EAC's investment channels. The results support the argument by Liu et al. (2020) that corruption pollutes the investment climate, lowering investors' confidence to locate investments in such economies. Corruption affects the flow of the market trading mechanism, disrupting the competitive and fair value of financial assets and affecting investors' interests.

Similarly, Islam et al. (2020) expressed that corruption risks the investment process, adversely affecting stock markets and their impact on FDI attraction.

Corruption-affected markets are less attractive for investment because investors' rights are less protected (Krifa-Schneider et al., 2022; Islam et al., 2020). Therefore, the insecurity of the investors' interests and property rights protection adversely affects stock market development and negatively impacts FDI flows to the EAC.

An overview of the observed impact of corruption on stock markets in influencing FDI inflows to the EAC is that stock markets are highly affected, with a negative impact on FDI attraction to this region (Mohammed, 2022; Gatimu, 2020; Matete, 2021; Wambua, 2023). Corruption distorts both the stock market development and the investment climate for FDI attraction, which in turn deters foreign investors from prioritizing investing in this region because of the perceived risks associated with corrupt practices (Shaari et al., 2022; Krifa-Schneider et al., 2022; Hanousek et al., 2021). This argument can be substantiated by the moderating results, in which the moderating effect of corruption on both value traded and market capitalization is statistically significant, showing how corruption adversely impacts the stock market's role in attracting FDI inflows to EAC.

The moderation effect on individual stock market proxies employed in the study reveals that the increase in corruption in stock value traded deters FDI inflows to the EAC due to the adverse impacts of corruption passed in the stock market activities (Zander, 2021; Hanousek et al., 2021; Guha et al., 2020) The findings reflect the previous argument by Islam et al. (2020) that corruption distorts the

supportive investment channels. The study findings imply that the influence of value traded in FDI attraction varies with the level of corruption prevailing in the EAC. This severe impact shows that foreign investors' willingness to raise capital through EAC's stock markets is very unlikely under these circumstances. In one way or another, corruption affects the flow of the market trading mechanism, disrupting the competitive and fair value of financial assets and affecting investors' interests (Liu et al., 2020). The negative impact of corruption on the influence of value traded towards the attraction of FDI inflows amplifies the notion of corruption being referred to as a pollutant of the investment environment, which lowers investors' confidence (Liu et al., 2020). The results also justify the argument made by Krifa-Schneider et al. (2022) that the effects of corruption become more severe and significantly impact the entire economic system as the markets tolerate it.

Similarly, the negative tangential effect exerted by corruption when conditioned on market capitalization towards attracting FDI inflows to the EAC reflects the reasons why most foreign investors delay or hesitate to consider raising additional capital through capital markets arrangements in developing economies (Erten et al., 2021; Lai, 2021). Corruption reduces the attractiveness of the affected markets for inward FDI flows based on the argument that investors' rights are less protected in a corrupt investment climate (Krifa-Schneider et al., 2022; Islam et al., 2020). The notion of insecurity by foreign investors in their interests and property rights stemming from corruption deters FDI inflows to the EAC.

The results support the argument that when the economy is affected by corruption, the growth and performance of the stock markets and their impact on FDI attraction cannot be achieved (Islam et al., 2020). In the same vein, Lestari et al. (2022) emphasized that corruption negatively affects the stock markets' influence on FDI attraction. Knowing the risks posed by corruption and financial restrictions in the investment process, particularly internationalized businesses, Liu et al. (2018) express that well-developed stock markets are avenues for the provision of good services to investors in attracting FDI as they increase investors' confidence and trust in multiple alternative financing sources. Therefore, quality institutions in the EAC economies will create a conducive environment facilitating interaction between investors, market patterns, access to financing services, and available investment opportunities.

Additionally, the findings by Lestari et al. (2022) support the results as they expressed that foreign investors are attracted to locating their investments in countries with low corruption and promising stock market developments that can meet their financing needs. Similarly, Pham et al. (2022) highlighted that low-corruption countries are in a better position to develop financial systems that entail economic development and stock market size, giving them a relative advantage of likely attracting more inward FDI to their economies. The negative conditional impact exerted by corruption on stock market size agrees with arguments in the literature that the adverse effects of corruption distort the investment climate, which in turn discourages foreign investments. From this point of view, Krifa-Schneider et al. (2022) revealed that stock market

development in low-corruption countries is an avenue for alternative long-term sources of capital in foreign markets that attract inward FDI projects.

Generally, corruption tends to block investments from the private sector (Krifa-Schneider et al., 2022). However, market growth increases investment initiatives when corruption is minimal. The fight against corruption encourages active investment and the spread of cutting-edge technologies and management expertise to domestic businesses in emerging markets such as the EAC (Aibai et al., 2019). In the same vein, the continued efforts to develop the financial sector led to stock market growth, providing a greater chance to encourage foreign investors to locate their cross-border investments in the EAC and similar emerging economies (Pham et al., 2022). Therefore, developed stock markets characterized by large size have greater chances to influence inward FDI to the EAC as efforts to fight against corruption continue, resulting in conducive business environments.

#### **5.2.5.2 Moderated Effect of Government Effectiveness on Stock Market Size**

The results for the moderated effect of government effectiveness on stock market size reveal a statistically significant and negative relationship with FDI inflows. The findings from the study indicate that stock markets in EAC are volatile and less stable in that their impact on FDI is negatively altered by government effectiveness. The results suggest that an increase in the influence of government effectiveness on stock markets in EAC results in a decline in FDI inflows. The results are contrary to the generally expected positive impact of government

effectiveness when interacting with stock markets on FDI inflows. However, these contradicting results can be explained as follows.

The effectiveness of government regulations and the ease of doing business are crucial in attracting foreign investors and smoothing the investment process (Ijirshar et al., 2023; Othman, 2022; Kumar & Kumar, 2020; Mohamed et al., 2020). The regulatory environment in EAC can be one factor that leads to an adverse moderation effect of government effectiveness on stock market size with the increase in its interaction. The regulatory environment in EAC, which is faced with challenges of ineffective regulations, bureaucratic hurdles, and less consistency in enforcing the same, can deter foreign investors despite the size of the stock market in this region. Similarly, political status in EAC also adds to the factors that lead to the adverse moderation effect of government effectiveness on the stock market. The political environment in EAC is less predictable, leading to policy fluctuations and weakening government support for enhancing investment channels. Consequently, misalignment between government effectiveness and political stability in supporting the stock market can deter FDI inflows to the EAC.

Similarly, corrupt practices in EAC undermine the government's effectiveness, resulting in high business costs, increased uncertainties, and erosion of foreign investors' confidence, ultimately deterring FDI inflows regardless of the stock market size (Bu et al., 2022; Panao, 2022; Nsor-Ambala & Coffie, 2022). Likewise, EAC's legal system does not appropriately uphold the investors'

property rights and proper adherence to contract essentials. Perceived less protection of investors' rights can deter FDI inflows to the EAC because of investment disputes and expropriation risks stemming from legal framework weaknesses.

Moreover, policy stability, quality of public services, and infrastructure development play a pivotal role in the interaction between government effectiveness and stock market size in influencing FDI inflows (Aziz, 2022; Musabeh & Zouaoui, 2020; Magbondé & Konté, 2022). When the government frequently changes its economic policies, it can create uncertainty for investors. The stability of the economic policies in EAC is a problem, as every change in political regimes is likely to lead to new policies. This inconsistency in policy implementation distorts the sustainable investment climate, thereby deteriorating the efforts to increase FDI inflows to the EAC. The adverse conditional effect of government effectiveness on the stock market in attracting FDI to the EAC can also be attributed to poor infrastructure development and low quality of public services. Inadequate infrastructure and public services that do not support foreign investors' needs reduce EAC's attractiveness for FDI despite the existing stock market conditions.

Additionally, EAC has been facing currency volatility challenges and monetary policy issues (Yabu & Kimolo, 2020; Mmari et al., 2022; Njagi & Nzai, 2022). Ineffective monetary policy and exchange rate management adversely affect stock markets, government financial strength, and the investment climate for FDI attraction (Anees, 2022; Nguyen, 2023; Alshubiri, 2022). In the same vein,

less financial sector development in EAC negatively impacts the depth of stock markets and influences FDI inflows for the government effectiveness prevailing in this region. The weaknesses stemming from governance and financial sector development can limit access to additional capital and financing options foreign investors need, which may deter FDI inflows to the EAC. Therefore, improvements in government effectiveness across all the dimensions above are essential for enhancing the attractiveness of FDI inflows to the EAC.

The results can further be explained based on the findings reported by Sabir et al. (2019), who argue that ineffective governments in the host countries reduce foreign investors' confidence in relying on the stock market for capital mobilization. From this point of view, it is no wonder that the conditional effect of government effectiveness on the stock market negatively impacts FDI inflows to the EAC because the market is less liquid, stemming from its small size, as it is in the growth stage.

Similarly, Pham et al. (2022) and Omar et al. (2022) argued that when the government is ineffective, excessive bureaucracy prevails, which reduces foreign investors' readiness to participate in the stock market. Government ineffectiveness affects the investment climate, so the privatization process in emerging markets does not support inward FDI (Sabir et al., 2019). According to Carino (2019), the moderate effect of government effectiveness on stock markets is expected to impact FDI positively. However, the results reveal that government effectiveness in EAC is not independent of political pressure. Some

challenges are posed in investment policy formulation and implementation, and above all, the government's credibility and commitment to enforcing the formulated policies are relatively low.

Accordingly, characterized by poor institutional quality and thin stock markets, EAC creates difficulties for MNCs to raise the long-term capital needed to support their FDI projects in those economies (Purewal & Haini, 2022; Ali & Ramakrishnan, 2022). Consequently, the lack of sufficient market information hinders foreign investors from making well-informed investment decisions and also from listing on local stock markets. The EAC and similar emerging markets have underdeveloped stock markets that offer limited information to foreign investors about the local markets. Thus, the interaction between government effectiveness and stock market size negatively impacts FDI, reflecting the low quality of public and civil services in the investment channels.

However, it is worth understanding that stock market development is an appropriate measure of the availability of financing in the economy (Garcia et al., 2019). In the same way, government effectiveness leads to a conducive environment for stock market activities (Ali & Ramakrishnan, 2022). Therefore, strengthening EAC's government effectiveness will increase its attractiveness to foreign investors since the stock market size reflects the stock market's ability to mobilize funds for investments through interaction with the market participants (Pham et al., 2022).

### **5.2.5.3 Moderated Effect of Political Stability on Stock Market Size**

The results for the moderated effect of political stability on stock market size reveal that the influence of stock market operations on FDI in EAC depends on the level of political stability prevailing in the region. The results confirm hypothesis H5c, that political stability moderates the relationship between value traded, the measure of stock market size, and the level of FDI inflows, as reported in Table 4.10. However, the summarized results in Table 5.5 reveal that hypothesis H5d was unsupported, implying that stock market capitalization is less responsive to political dynamics.

The conditional impact of political stability on the stock market revealed a negative relationship with FDI inflows to EAC (Alshubiri, 2022; Vasilyeva & Mariev, 2021; Okara, 2023). While political stability is generally beneficial for attracting FDI, an excessively stable political environment without corresponding economic dynamism, reform, or responsiveness to global changes can negatively affect stock value traded and FDI inflows (Khan et al., 2023; Ramzan, 2021; Krifa-Schneider et al., 2022; Hamdaoui, 2022). Investors typically seek stable, adaptive environments that offer growth opportunities and policy frameworks aligned with global economic trends. Similarly, a change in political regime significantly impacts the trading mechanisms and formulated policies for attracting FDI inflows when accompanied by policy alterations (UNCTAD, 2019).

When a country experiences long-term political stability without accommodating global economic changes or reforms, foreign investors may perceive the investment climate in such economies as stagnant (Abdulai et al., 2024; Zhang & Li, 2024; Kusek et al., 2020). Lack of flexibility can deter FDI inflows to EAC despite the political status in this region (Contractor et al., 2021; Vasilyeva & Mariev, 2021; Contractor et al., 2020). Similarly, political stability in EAC can be a factor that leads to stagnation of investment policy. Foreign investors may regard the economies as less attractive to FDI projects if policies are not responsive to global changes.

Additionally, political stability in EAC can negatively moderate the impact of stock value traded on FDI inflows as investors might become more risk-averse (Abban, 2020; Faidah, 2020; Lee & Amabo, 2021). Foreign investors may perceive that a stable political environment in EAC poses a risk to investment due to potential political landscape changes, which could significantly impact the success and return from their investment (Komuhangi, 2023; Rwigema, 2020; Wambua, 2023). Similarly, political stability can lead to increased corruption, lower foreign investors' confidence and hurt FDI inflows to the EAC. In most cases, a stable political environment in EAC is maintained through corrupt practices in leadership and securing power. Likewise, political stability in EAC may not support a culture of innovation and entrepreneurship, which might deter foreign investors from the attractiveness of this region for FDI inflows. In the same way, political stability in EAC can lead to currency overvaluation and economic inefficiency, which might negatively impact the stock market's influence on FDI inflows.

Political stability influences the attractiveness of an investment environment. This simplifies the risk and return analysis carried out by the foreign investors during the assessment of the location where their investments can be viable in foreign markets, depending on the political stability prevailing in the hosting economies (Wang et al., 2022). Political stability is one of the critical location advantages for FDI. In conjunction with stock market development and other influential factors for financial sector development, it influences FDI inflows to the host countries (BalaUmar et al., 2015).

The EAC's political stability has been fluctuating, especially during changes in political regimes, which affect the region's attractiveness for investment, trading mechanisms, and the formulated policies for attracting investors, particularly foreign investors (UNCTAD, 2019). The findings from the study support Wang et al. (2022), who emphasized that political turbulent poses a risk to investors, and such risk is susceptible to foreign investors who are faced with decisions as to where they should locate their investments in foreign markets. Therefore, any political instability experienced in the host countries, particularly in the emerging economies challenged by low institutional quality, adversely impacts stock markets and their influence on FDI inflows due to adverse information released to the market.

According to Khan et al. (2022), political stability creates a conducive investment climate by non-interference of the market mechanisms, leading to a

better stock market performance platform and attracting inward FDI. The negative impact of political stability on the interaction with stock market size also reflects its likely adverse effects on investment policies. However, in showing the importance of political stability in investors' decision process, Islam et al. (2021) argued that foreign investors are motivated to invest in a politically stable economy with a solid legal framework, with law enforcement and protection of investment and property rights, which strengthens foreign investors' ties with the FDI recipient countries.

In the analysis of the pivotal role of political stability in the investment process, Li et al. (2021) expressed that consistent maintenance of political stability in the FDI-recipient economies releases positive information to the market about the countries' attractiveness for investment, which also reflects the stock markets development leading to enhanced trade and increase in international capital inflows across the borders. The results indicate that the stock market size in EAC is still tiny and at the nascent stage, similar to the low level of political stability resulting from institutional quality challenges. Pham et al. (2022) expressed that political stability increases freedom in the stock markets, which influences FDI inflows by increasing the flow of financial capital. On the other hand, political instability and weak stock markets pose market risk and restrictive capital flow, respectively, which hurt FDI inflows.

Accordingly, it is essential to appreciate that political stability built on institutional quality and well-established stock markets stemming from financial sector development is a vital precondition for creating an attractive investment

climate for inward FDI projects. Islam et al. (2020) emphasize that functional stock markets are a crucial location advantage for FDI attraction as they indicate the presence of a calm business environment. In politically stable economies, the local markets and international interactions function correctly, and foreign investors' confidence in the stock markets is high (Krifa-Schneider et al., 2022). Given the sensitivity of political stability in the internationalization of businesses, different scholars such as Pham et al. (2022), Islam et al. (2020), and Sabir et al. (2019) were motivated to investigate the impact of political stability in the investment process at the same time used it to moderate the FDI-financial development nexus measured by stock market size and banking sector services.

### **5.3 Contributions and Implications**

In light of the findings reported, the study has implications for and makes several contributions to the banks' management, investors, stock markets, FDI literature, regulators, policymakers, and the general public. The following subsection addresses the contributions and implications of the study.

#### **5.3.1 Methodological and Theoretical Contributions**

This study provides a theoretical contribution to the existing body of literature. Given the current controversial findings in the literature on the relationship between banking sector services, stock market size, and FDI inflows, conducting this study in EAC countries helps to provide additional evidence for the ongoing debate. This study was conducted in an environment not reflected by prior

literature. The focus was on financial development measured by banking services and stock market size on inward FDI attraction, with the moderation effect of institutional quality (corruption, government effectiveness, political stability). Furthermore, unlike previous studies such as Collis et al. (2024), Camarero et al. (2021) and Haq (2023) that focused on developed economies such as Japan, the United States, the United Kingdom, and similar countries, this study has been confined to emerging economies characterized by less developed financial sectors and low institutional quality practices.

In addition, this study contributes to the institutional FDI fitness and the Eclectic paradigm (OLI framework) theories by adding a further understanding of the implications of stock market development and the role of institutional quality in driving FDI inflows to the host countries. The findings indicate that stock markets and institutional quality adversely impact FDI, increasing host countries' unattractive climate for FDI and discouraging foreign investors from locating their investments in such economies. The results for the adverse effect of the stock market and institutional quality reveal that the EAC stock market is still small, has less experience, and has fewer products. In contrast, the prevailing institutional quality level is relatively low. Islam et al. (2020) highlighted that countries with institutional quality challenges and less financial development will likely hurt inward FDI. The findings also indicate that the institutional quality level can influence banking services and stock market size in the FDI recipient economies.

The findings also have implications for other theories, such as the Capital market theory or the currency areas theory. The currency areas theory establishes whether the host countries' exchange rate volatility influences inward FDI. The positive relationship between exchange rate and FDI, similar to the positive association between trade openness and FDI and the antagonistic relation between inflation and FDI, proves that EAC countries allow exchange rate determination under supply and demand market forces. Thus, the findings imply that foreign investors wishing to invest in EAC will not be highly affected by exchange rate exposure. Instead, their cash flows will be aligned with the economic dynamics focused on trade openness and inflation control. Accordingly, foreign investors can use banking services provided in EAC countries as incentives for locating their FDI projects in this region. The findings reveal that banking services positively influence FDI inflows in EAC, which reflects that foreign investors are likely to be facilitated with good financial services, including a competitive exchange rate and credit, to meet their financing needs to expand and accelerate their investment growth. The findings support this argument as the results showed a significant positive relationship between credit to the private sector and FDI, similar to the exchange rate, implying that quality financial services attract inward FDI to the host countries.

### **5.3.2 Contribution to Banks' Management, Stock Markets and Authorities**

The findings from the study revealed evidence of contribution to the banking sector, stock markets, investment centres, and authorities in the EAC partner states. Analyzing the impact of financial development in the investment channels

and the role of institutional quality in the investment process provides information on the region's attractiveness for foreign investments. Recently, the EAC partner states have been witnessed to undertake several financial sector and investment policy reforms such as a uniform statutory tax rate of 30% for all members, tax incentives to foreign investors, the creation of special investment facilities such as export processing zones (EPZ), the provision of subsidies, free import duties, quality trading regulations, investor protection, operational competence, and information disclosure (Habimana, 2021; Otiende, 2022; EAC Investment guide, 2020). The abovementioned measures aim to incentivize foreign investors to choose the EAC region as their appropriate international investment location. However, the findings of this study show that stock market and institutional quality adversely impact FDI in the EAC region, providing a wake-up call to increase investment in stock markets and enhance institutional quality practices among the partner states' investment centres and the respective authorities.

The banking sector services reduce investors' financing uncertainty when approaching foreign markets. The challenges of accessing financing faced by the private sector are fostered by restrictive financing policies set by regulators, such as strict credit directives offered by central banks to commercial banks (Dikau & Volz, 2021; Mugarura & Namanya, 2020). Assurance of financial services is one of the limiting factors that practitioners need to address by increasing the banking sector services to the business environment, which will narrow the gap between FDI inflows and financing needs. When commercial banks can mobilize sufficient assets at their disposal and form large portfolios of financial

resources to extend credit to the private sector, once such information is released to the public, investors' confidence will increase, and they will be stimulated to invest in such economies. Therefore, bank managers and other financial service providers can use the study's findings to strengthen their banking services ties with foreign investors' financing needs to support their FDI projects. As a result, bank managers who initiate linking their banking services with diverse investors' capital demand not only enhance FDI inflows to the economy but also benefit from the FDI spillover effects, such as interest on borrowings and commissions on the facilitated financial transactions.

The region's bank regulators can require merging small banks to form extensive and competitive banks to undertake large business consignment that meets MNEs' financing needs. An increase in business links between local and international banks can speed up the growth of the banking sector. Moreover, the EAC stock market authorities can consider forming a typical stock market for joint capital mobilization. Common markets increase location advantages by widening investment opportunities (Dunning, 1993). This should contain clear terms and conditions, market information, and investor linkage, favouring investors flowing to this region. Thus, quality banking services and a large stock market will attract existing and potential investors.

Past studies show that stock market development is essential to attracting FDI (Bibi et al., 2022; Inderst, 2021). The findings from the study indicate that shallow and weak stock markets negatively impact the economy's attractiveness for FDI projects. Based on size, stock market activities complement the financial

sector development and significantly affect financing investments. The stock market operations create financial liquidity in the economy, providing an alternative funding source for FDI projects held in the host countries (Chen et al., 2022; Ngene & Mungai, 2022). However, studies (Mutize et al., 2020; Jeanluc & Muiruri, 2022) also indicate that an underdeveloped stock market, characterized by low turnover ratios, thin trading, and lack of market depth, poses a risk to the business environment. This challenge makes issuing new shares difficult and minimizes the stock market trading activity, negatively affecting investors' interest (Cang & Alida, 2020). This study evidenced that investors under FDI projects face similar challenges from the supply side in the developing markets.

On the other hand, the bigger and more experienced the stock market, the higher the volume of transactions carried out (Omar et al., 2022; Adjasi et al., 2022). Therefore, local and foreign market participants can quickly mobilize long-term financial capital by listing and trading financial assets in the stock exchange markets of the host economies. The stock market movers should make further efforts to speed up the development of this market so that it can attain an impactful size that will bridge the investors' financial gap for alternative funding sources in the FDI recipient economies. So, in such a situation, the stock market becomes a helping hand for investors to access additional funding to support their investments during the growth and expansion stages.

The EAC partner states must increase their support in the financial sector development and institutional quality environment. Policymakers should emphasize institutional quality practices for better service provision, including banking sector services and stock market operations (Wilhelms, 1998). Therefore, the EAC partner states should encourage the bank sector to strategize its services to align with investors' banking service needs. Similarly, the EAC governments should support a stock market platform that will attract foreign firms to list and trade their securities for long-term capital formation. Likewise, the EAC tax authorities should provide tax incentives to banks and stock market financing channels to motivate investors to utilize these sectors for financing arrangements.

### **5.3.4 Contributions to Foreign Investors**

The study's findings provide an analytical framework for foreign investors to help them enhance their investment decisions. The evidence obtained from the study, which reveals the existence of adverse impact exerted by the institutional quality and stock market size, provides valuable information to foreign investors in evaluating alternative financing sources and the quality of institutions in the FDI recipient economies. Furthermore, the evidence that institutional quality moderates banking services and stock market size will be helpful to foreign investors in evaluating the quality of the host countries' banking sector, stock markets, and the institutions involved in the investment process. This will help them make sound investment decisions by looking at the proper location and the possibility of using stock markets to raise additional funding or relying more on

banking sector services. Also, the reported evidence of the negative impact of institutional quality on FDI helps foreign investors assess the reliability of the advanced investment policies in the host countries.

Additionally, the findings provide reflective practical implications for protecting investors' rights. The adverse impact of institutional quality reveals the need for a robust legal system to protect investors' investment rights. Similarly, trade openness accompanied by financial development will help foreign investors reduce the information gap and increase friendly interaction with local investors. In contrast, poor investor protection, weak institutional quality, and low financial development will continue to hurt the EAC's attractiveness for sound FDI inflows.

### **5.3.5 Practical and Policy Implications**

The findings from the study will elevate concern over the role of financial development, keeping an eye on the pivotal role of banking services and stock market activities in linking investors to meet their financing needs. Similarly, the findings will provide insightful information on the significant role played by quality institutions in the host countries in paving the way for a timely and open interactive investment process. High-quality institutions are expected to assure foreign investors that they will get access to financial and non-financial services in the FDI recipient economies to support their investments. Likewise, it is worth appreciating that institutional quality does moderate the influence of banking services and stock markets on FDI attraction. So, high institutional quality

embedded in the institutions' practices will enhance the contribution of banking services and stock market operations in raising the inflow of FDI to EAC. Thus, the study will be helpful to investors, especially foreign investors, to evaluate the attractiveness of the EAC for FDI projects.

#### **5.3.5.1 For the Banking Sector**

The study's findings suggest that the banking sector plays a critical enabling role in attracting FDI. For banks, this underscores the importance of strengthening financial infrastructure, expanding access to credit, and enhancing efficiency in service delivery. Well-capitalized, stable, and transparent banking institutions provide foreign investors with confidence in the host country's financial system, reducing transaction costs and financial risks. Banks should prioritize digitalization, streamline loan processing, and ensure compliance with international financial standards to build credibility and attract investment-related financing needs.

Additionally, banks should develop tailored financial products and services that support foreign investors, such as trade finance, project loans, currency hedging tools, and advisory services for navigating the local financial environment. Collaborating with investment promotion agencies and government bodies can help banks align their services with national development and FDI strategies. By focusing on sector-specific financing, especially in infrastructure, manufacturing, and technology, banks can play a proactive role in channeling FDI into high-impact areas. Ultimately, strengthening the capacity and

responsiveness of the banking sector is vital for enhancing the overall investment climate and supporting long-term economic growth.

#### **5.3.5.2 For the Stock Market Regulators**

The study indicates that stock market development can positively influence FDI inflows by signaling economic maturity, providing investors with additional exit options, and enhancing capital market transparency. For policymakers and stock market regulators, this highlights the need to deepen and broaden domestic capital markets. Measures such as improving market liquidity, increasing the number of listed companies, and ensuring strong corporate governance can make the stock market more attractive to foreign investors and support their confidence in the overall investment climate.

In addition, enhancing regulatory frameworks, adopting international accounting standards, and promoting technological infrastructure in stock trading can further strengthen investor trust. Encouraging foreign portfolio participation and integrating regional stock exchanges may also improve visibility and access for international investors. By developing a robust stock market, policymakers can complement FDI strategies, making the country more competitive and providing diversified channels for foreign capital to enter and support long-term economic development.

### **5.3.5.3 For the Investment Analysts and International Policymakers**

The study's findings will also provide investment analysts and international policymakers with essential information to design appropriate strategies to address the financing and institutional challenges they might face when channelling cross-border investments to emerging economies. Specifically, the findings on the moderated effect of institutional quality on banking and stock markets will help the United Nations Conference on Trade and Development (UNCTAD) advance policy directives for international investments and trade. For instance, the growing global economic inequalities have led to calls for a change in policy direction, looking at the role of central banks, accompanied by institutional reforms. Research-based findings are helpful for policymakers in providing quality information for timely decisions. It is further argued that financial reforms must accompany the efforts of increasing more chances for FDI inflows to EAC and governments of the partner states taking actions to tackle inflation and interest volatility by using a balanced policy mix of fiscal, monetary, and supply-side measures to achieve financial stability and boost productive investment similar to the propositions given by UNCTAD (2023).

### **5.3.5.4 For the EAC Governments and Policymakers**

Additionally, the study's findings further explain the factors influencing the FDI inflows to EAC. The findings show that some of the factors that are expected to influence inward FDI to the region positively turn into hinders, and the reasons are their low levels, such that they don't provide the desired impact. This is

because negative institutional quality and weak capital markets harm the investment climate, posing high costs to investors, such as delayed investments due to excessive bureaucracy stemming from corruption and government ineffectiveness. Therefore, EAC organs involved in facilitating investment undertakings should improve their services and avoid any actions that will harm foreign investors' decisions not to consider EAC as one of their possible locations for international investment.

The EAC region should advocate investment policies that are market-friendly and centred on the protection of investors' rights. Such initiatives will align with the ongoing efforts to boost the region's economic growth through industrialization (EAC Investment Guide, 2020). The member states should strengthen their institutions and the institutional quality environment for smooth business interaction between the banking sector, the stock market, and investors. Feng and Yu (2021) expressed that institutional quality acts as software for ensuring the investment processes are carried out so that services offered to investors are of quality and quantity, including international trading services, payment systems, information disclosure, savings, and lending products.

Similarly, the EAC has to accelerate the regional investment promotion agenda of forming a single attractive investment destination. This will help partner states to envision a secure, prosperous, and competitive investment climate. Furthermore, there should be an openly increased active advertisement of the region's available investment opportunities from different sectors, including

infrastructure, agriculture and agribusiness, mining and metals, manufacturing, energy, oil and gas, education, health, tourism, research, and innovation. All these investment opportunities pose a location advantage. Kamal et al. (2022), Islam et al. (2020), Sethi et al. (2019), and Awadhi et al. (2022) argued that location advantages are crucial determinants for FDI inflows in developing countries. According to the institutional FDI fitness theory, the overall location advantages of the host countries are identified as preconditions for foreign investors when deciding where to locate their investments (Wilhelms, 1998).

Furthermore, the EAC should harmonize the incentives relating to the taxation of industries, standard market protocol among the partner states, protection of cross-border investments and returns to investors, removal of restrictions through operationalization, and rationalized investment initiatives on the free movement of capital within the region. It is worth noting that intra-regional capital flow is an increasingly important source of FDI flows. This will increase the region's trade volume, enhancing institutional quality by improving political stability, reducing corruption loopholes, eliminating excessive bureaucracy, and increasing the quality of service provided to foreign investors.

#### **5.4 Research Limitations**

Despite the broad sectoral classification of the financial development covering insurance, pensions, mortgage, leasing, money markets, foreign exchange markets, and collective investment funds, this study excluded them from achieving an impactful analysis of the phenomena based on the available

information for the studied relations and the economic region. It is worth noting that banking sector services and stock market operations, supported by its size, are the primary funding channels through which the private sector can access financing needs. This study did not examine other possible alternative fund providers that can support bridging the financing gap between foreign investors and FDI projects' financing needs.

Furthermore, this study did not explore the impact of taxation on FDI inflows, which remains a critical determinant of FDI location when assessing capital flow and expected returns from investment. Taxation plays a vital role in influencing investor decisions, particularly through tax rates, tax incentives, and the stability of tax policies in host economies. These factors directly affect profitability and risk assessments, making tax regimes an essential consideration in the investment process and strategic planning for multinational enterprises seeking long-term presence in a given foreign market.

However, different studies (Lestari et al., 2022; Krifa-Schneider et al., 2022; Zhang & Zhou, 2021; Nguyen et al., 2018; Yudaruddin, 2022) suggest that most of the financial development and institutional quality variables are affected by cultural practices, which vary from one country to another and from one economic region to another. Hence, well-established financial developments, institutional quality, and welcoming foreign investors are affected by norms and cultural practices embedded in formulating financial policies, rules, and regulations (Lestari et al., 2022). Thus, the study's findings can be comparatively

used in emerging economies, but some cautions are needed as they may not necessarily reflect the same in other economic regions (blocks).

The study was confined to EAC countries. The data corresponds to this economic region from 1995 to 2020, so that different results could be obtained under the same variables in other economic blocks. The employed variables have different scores in various economic zones, ranging from developed, middle-income, and emerging economies. The values of the variables utilized in this study vary according to other country-specific factors such as the level of FDI absorbed in the recipient country, bank assets size, the flexibility of credit provision to the private sector, stock market liquidity reflected in value traded, capital flow under market capitalization, institutional quality as defined by corruption index level, government effectiveness index, and political stability index. Thus, the findings from the study can be used for a specific range of time, but not a very long time in the future, because the data collected and employed describe the trend that has been taking place in the past. Financial sector development and institutional quality aspects are dynamic variables that keep changing from time to time. Therefore, up-to-date information on the analysis of the FDI-financial development relationship will depend on the most recently available data.

## **5.5 Recommendations for Future Research**

The study suggests future research to explore the highlighted limitations further. Specifically, future studies should examine the role of financial development on FDI inflows in EAC, considering all the banking sector and stock market

variables. This will help provide further in-depth information on the banking sector's impact and stock market proxies in the investment channels. In the same vein, other studies should consider all the financial development aspects proposed by the World Bank, thereby providing a broad sectoral classification of the coverage of insurance, pensions, mortgage, and lease financing. Moreover, the impact of culture is worth being included in further studies as it affects both financial development and institutional quality.

Similarly, future studies should examine the role of taxation, specifically tax incentives, statutory tax rates, and profit repatriation rules, because these factors significantly shape the attractiveness and feasibility of FDI. Tax regimes directly affect the expected return on investment and influence multinational firms' decisions on where to locate operations. Favorable tax policies can incentivize long-term investment, while complex or punitive regimes may deter it. Understanding how taxation interacts with other institutional variables is essential for crafting policies that effectively attract FDI while maintaining fiscal sustainability and economic nourishment.

Moreover, future studies should consider the role of culture in the attraction of FDI in EAC. It should be noted that culture is one of the essential factors that influence financial development and enhance institutional quality levels. Institutional quality influences all sectors; future research could further test the role of institutional quality on FDI inflows in EAC, as institutional quality improvement is a global focus that speeds up its growth and stability in the

investment process. This suggestion aligns with the observations that in emerging economies, including EAC, there are ongoing efforts to raise the institutional quality at the levels that will impact the economic means (Krifa-Schneider et al., 2022).

Finally, there is a need for future research that will highlight the demand side as to the extent foreign investors rely on financing provided in the FDI recipient economies to support their investments. The study could also be expanded to include other financial sector indicators excluded in this analysis, broadening the investigation and generalizing the current findings. The control variables can further be examined differently to deepen their impact on investment. Such initiatives will provide more insight into the factors influencing FDI inflows with substantive empirical evidence.

## **5.6 Summary and Conclusion**

The study augments the existing literature by bestowing evidence on the relationship between financial development and FDI, focusing on banking services and stock markets in the EAC partner states. The study also investigates the moderated effect of institutional quality by highlighting corruption, government effectiveness, and political stability among the institutional quality indicators. The methodological approaches employed in the study also contribute to the literature by dwelling on the different treatments of data environment over a longer time than the cross-sectional number of units. Similarly, the study employed the winsorization technique in data transformation

to eliminate possible outliers for more representative results and to provide precise estimations.

Theoretically, the study contributes to the Institutional FDI fitness, the Eclectic paradigm, and the Capital market (currency areas) theories by confirming the role of financial development, institutional quality, location advantages, and stability of the currency volatility, which influence inward FDI to the host countries. Moreover, the study documents evidence of the significant role of institutional quality in moderating banking services and stock markets. Additionally, the findings from the study have expressed practical and policy implications regarding the pivotal role of banking services, stock markets, and quality institutions to authorities, investors, practitioners, and all scholars in EAC countries.

The study encountered some limitations on data availability for all dimensions of financial development, leading to its confinement to banking services and stock markets in EAC partner states. The study has also been limited to data on cultural aspects affecting financial sector development and institutional quality. In the same vein, the study has been limited to three institutional quality indicators deemed to impact the investment process in emerging economies significantly.

Generally, the study aimed to examine the FDI-financial development nexus while investigating the moderated effect of institutional quality (corruption,

government effectiveness, political stability) on banking services and stock markets. The findings documented a significant relationship between banking services, stock markets, and institutional quality indicators. However, stock markets and institutional quality significantly negatively impacted FDI. Also, the findings for the moderated effect of institutional quality reveal that its influence alters the impact of both banking services and stock markets on FDI. Although the findings for the moderated effect of institutional quality produced mixed results with positive and negative significant impacts on FDI, contrary to the expected positive tangential effect, the significant results prove that institutional quality is an aspect of the relationship between banking services, stock markets, and FDI.

## RELEVANT PUBLICATIONS

As part of the mandatory requirements set by the university for the award of a PhD, three academic papers have been developed from the doctoral thesis. Of these, one has already been successfully published in a peer-reviewed journal by Emerald Publishing, demonstrating the scholarly quality and contribution of the research. The remaining two papers are currently under review, with reputable journals considering them for publication. This process not only fulfils the university's criteria for research dissemination but also reflects the candidate's commitment to advancing knowledge in the field of financial development, institutional quality, and FDI through rigorous academic engagement.

The already published paper in such a reputable peer-reviewed journal showcases the quality relevance of the research. The published article, titled "*Stock market development and foreign direct investment: the moderating role of government effectiveness*" by Mapendo J.J., Senadjki, A., and Choong, Y.O., appears in the *International Journal of Emerging Markets* (2025) and is accessible via the following DOI link: <https://doi.org/10.1108/IJOEM-04-2024-0597>. This publication further demonstrates the candidate's successful engagement with the research community and contributes to the broader discourse on economic development in emerging markets.

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