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Original Article

Systematic Risk and Foreign Direct Investment in the East African Region: Moderating Role of World Governance Indicators

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Among the available international capital flows, foreign direct investment (FDI) inflows have been highly prioritised as they generate external finances, are stable over time, and are relatively permanent. Owing to the domestic savings-investment gaps in a majority of developing countries, FDI inflows have greatly helped reduce this. However, these countries, including the East African region, continue to experience challenges in attracting and retaining FDI. Among the attributable factors are systematic risk emanating from exchange rate volatility, interest rate changes, and inflation volatility. These volatilities create uncertainty, risk, and increased financing costs that deter foreign investors. The magnitude of the effect of systematic risk on FDI inflows has been determined by the quality of governance. Robust governance ensures transparency, minimises bureaucratic bottlenecks, and protects investor rights, while inadequate governance increases uncertainty and lessens the efficiency of monetary policies, which deters investor protection. Therefore, this study sought to analyse the moderating effect of governance on the relationship between systematic risk and FDI inflows in the East African region. The study was guided by the OLI framework, institutional FDI theory, and modern portfolio theory. The data was collected from 9 countries for a period of 28 years and analysed through a pooled OLS regression technique. The results showed that governance had a positive, statistically significant moderating effect on the relationship between systematic risk and FDI inflows in the East African region ($EXR \times WGI = \beta = 0.2615, p < 0.001$; $INF \times WGI = \beta = 0.1885, p = 0.008$; and $INT \times WGI = \beta = 0.1413, p = 0.003$). It is, thus, concluded that the strong governance quality lessens the negative effects of volatility in macroeconomic factors that pose systematic risk on FDI inflows. It is recommended that East African governments and policymakers develop strategies that focus on improving the quality of governance and allocate resources towards its reform to foster an environment favourable to stable and enduring foreign investments

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INTRODUCTION

Financial resources are crucial for businesses as well as economic sectors to invest, consume, and develop economies. On this note, foreign direct investment (FDI) has been considered an important part of international capital flows for both developed and developing economies. To the emerging and developing countries, it helps in supplementing the domestic investment-savings gaps, availing resources needed for business, infrastructure investment, production, and economic development (Nguyen, 2023; Sabir et al., 2019). FDI inflows also create employment and bring high technology, managerial expertise, and innovations that enhance productivity and efficiency. Businesses engage in FDI activities as part of their expansion and diversification strategies, which align with the portfolio theory, to earn optimal profits and help the various stakeholders receive higher benefits. To benefit from FDI inflows, both developed and developing economies compete to attract and retain these cash flows.

Despite these benefits, the global FDI dropped by 2%, lagging behind global economic growth and trade that grew by 2.2% and 2% respectively (United Nations Conference on Trade and Development, UNCTAD, 2024; 2023). The poor performance is more pronounced in a majority of developing countries, which continue to experience challenges in attracting material FDI inflows compared to developed economies (Oni et al., 2023). For instance, in reference to the international standards of investment promotion,

UNCTAD (2013), as cited in Bezuidenhout & Kleynhans (2018), notes that African countries, with the exception of South Africa, were missing from the list of top 20 prospects for FDI. Further, as observed in the 2020 Ease of Doing Business score by the World Bank (WB), only two African countries featured in the top 50 list, and eight made it to the top 100 out of 190 economies (World Bank, 2020).

Additionally, the East African region has been a low recipient of FDI inflows compared to other regions on the continent. In a study analysing the FDI inflows to Africa, Marandu et al. (2019) found that East African and Central African regions were at the bottom, with most FDIs concentrated in Southern Africa, West Africa, and North Africa regions. Additionally, a study by Hemed and Suleiman (2017) established that East African countries' FDI inflows had been comparatively lower than inflows into other regions in Africa. Additionally, the FDI inflows in the East African region fell by 3% (UNCTAD, 2024).

The debate on the determinants of FDI remains unresolved, and as a complex process, Edo and Nnadozie (2022) note that the flow of foreign investment involves multiple causative factors, both economic and non-economic, such as policy uncertainties, market size, exchange rates, interest rates, required rate of return, and geopolitical risks (Meyer & Habanabakize, 2018). These factors pose systematic risk, which is the risk inherent to the market, affects all players to a certain degree,

and cannot be diversified within the same market (Höge-Junge & Eckert, 2022). FDI investors are concerned about the macroeconomic fundamentals of the host country, such as the galloping inflation, because it could easily erode their investments and lead to poor returns and unpredictable interest rates (Hassan, 2022). Inflation rates among the East African states have been high, with some periods recording rates above the ceiling on headline of 8% needed for monetary union. Additionally, there are substantial discrepancies in inflation rates among the major states, which are linked to a decline in FDI (Kilic et al., 2014).

Similarly, investors monitor exchange rate movements as unstable rates create significant uncertainty for investment and lower profitability. The East African region experiences high exchange rate volatility, which is likely to affect investor confidence, money supply, and subsequently discourage FDI (Mosbei et al., 2021). The Institute of Public Finance (2023) notes that the increased public debts in the region, as governments borrow domestically, have increased the interest rates, making it difficult for private sector investment.

High-quality governance has been associated with enhanced FDI inflows. In line with the institutional FDI theory, nations with good governance offer a favourable business environment that enhances investor confidence, leading to the attraction of more FDI (Nguyen, 2023). According to Qamruzzaman (2023), good governance creates a conducive environment that is predictable and stable for FDI. It lowers risks, including systematic risks, and enhances the predictability of economic policies, making it easier for MNEs to operate. Türedi (2018) adds that the presence of low systematic risk in the host country is not sufficient on its own to support the needed FDI, and thus, the governance quality influences investment decisions and consequently FDI inflows. With limited empirical studies on the effect of the interaction of selected systematic risk factors and governance on FDI, this study sought to evaluate how these factors together influence FDI inflows in East African countries.

LITERATURE REVIEW

Theoretical Review

This study was anchored on three theories that include eclectic paradigm theory, institutional FDI fitness theory, and modern portfolio theory. In 1977, Dunning proposed the Eclectic paradigm theory, also called ownership, location and internalisation (OLI) framework, to show factors that affect a foreign investor's decision to invest overseas (Batschauer da Cruz et al., 2022). Ownership considers the firm-specific capabilities such as its size, administration, and management systems. Location considers the host country's factors such as government policies, political stability, institutions, labour, and transportation costs (Atobatele, 2023). Internalisation concerns the ability of the management to exploit the ownership advantages in the expansion drive (Atobatele, 2023). Therefore, when entering foreign markets, investors are concerned about risk and return. This theory is the overriding theory for this study, supporting the systematic risk, governance, and FDI variables.

Institutional FDI fitness theory, advanced by Wilhems and Witter (1998), postulates that governments should have public policies and undertake economic measures that cultivate an environment that fosters foreign investment (Awadhi et al., 2022). The theory is based on four fundamental pillars that include social-cultural, education, government, and market (Aromasodun, 2022). This theory anchored the governance variable through the items of government and social-cultural factors, and the FDI inflows variable through the market, since growing economies are likely to offer higher returns, thus attracting more FDI.

The modern portfolio theory was developed by Harry Markowitz (1952), stating that investors undertake a combination of securities that offer the highest returns at the lowest risk level (Ilugbemi & Ogunlokun, 2020). This combination of securities is based on the concept of diversification to have investments that offer a more favourable risk-return profile. Thus, diversification by investing in overseas markets

helps foreign investors to maximise returns, thereby supporting FDI inflows.

Empirical Review

Effect of Systematic Risk and Governance on FDI

Belgacem et al. (2024) conducted a study to assess the moderating influence of governance on the relationship between financial development and FDI from 7 G7 countries to 45 developing host economies over the period 2002 to 2021. The governance was measured using the six World Bank's World Governance Indicators (WGI) (government effectiveness, voice and accountability, political stability and absence of violence, rule of law, regulatory quality, and control for corruption). They adopted the gravity model approach for analysis. The study established that governance infrastructure and better institutions positively affected FDI inflows. Whereas the current study also adopts governance as a moderator and measures it using the World Bank's WGIs, the results may be different as the two studies will be on different contexts. Belgacem et al. (2024) study covered 45 developing countries across the world, while this study looked at the Eastern Africa 9 countries, which follows that these results may not be generalised due to geographical and country-specific differences. Also, the gravity model approach used in this study may not be applicable to the current study; hence, a panel data regression model will be adopted.

Masengesho et al. (2025) studied the moderating influence of institutional quality on the relationship between monetary policy tools (monetary policy rate, exchange rate, and reserve requirements) and FDI inflows in seven East African countries (Comoros, Kenya, Mauritius, Rwanda, Seychelles, Tanzania, and Uganda) from 2003 to 2022. The researchers employed an ex-post facto quantitative research design and implemented a random-effects model (REM) for analysis. The findings demonstrated that exchange rate fluctuation had a negative effect on FDI (-0.0017), and not statistically significant. Further findings indicated that interacting

institutional quality with exchange rate volatility weakened the negative effect (-0.0007), but remained statistically insignificant. While Masengesho et al. (2025) used the World Governance Indicators as institutional quality measures, the current study used them as the governance variance and a moderator. In addition to exchange rate volatility, the current study adopted inflation and interest rate volatilities as elements of systematic risk and an independent variable. Even though Masengesho et al. (2025) used East African countries (Comoros, Kenya, Mauritius, Rwanda, Seychelles, Tanzania, and Uganda), the current studies considered East African region from the classification of UNCTAD in its investment reporting to include Kenya, Uganda, Comoros, Djibouti, Ethiopia, Eritrea, Mauritius, Madagascar, Somalia, Seychelles, and Tanzania. Further, while they used 7 countries, the current study used 9 countries, and the results may not be generalised.

A study by Onitekun and Ogun (2024) analysed the effect of macroeconomic and political uncertainties on FDI inflows in Sub-Saharan Africa. The selected countries were grouped into either resource-intensive, non-resource-intensive, or oil exporting SSA. Data was analysed using system GMM regression. Results showed that for oil-exporting SSA, inflation rate volatility had a negative and highly significant effect on FDI (-3.96e-06). Further results indicated that exchange rate volatility and political stability did not have a significant effect on FDI (0.63 and -0.90). For resource-intensive SSA, exchange rate fluctuations had a negative, highly significant effect (-1.04 in the short run and -1.30 in the long run), while inflation rate volatility had a positive, statistically significant effect (2.09e-05 in the short run, 2.6e-05 in the long run). Political stability did not significantly affect FDI in this region (1.15). For non-resource-intensive SSA, exchange rate volatility showed to have a negative, significant effect on FDI (-47.42 in the short run and -44.66 in the long run). Inflation rate volatility had a positive and significant effect (0.05 in both the short and long run), and political stability showed a positive and significant impact

(2.07 in the short run, 1.95 in the long run). Whereas this study sheds some important insights into the effect of inflation and exchange rate volatilities and political instability on FDI in SSA, these findings may not be generalised to the Eastern Africa region, even though a subset of the former. Further, Onitekun and Ogun grouped the countries of study into either resource-intensive, non-resource-intensive, or oil exporting while the current study did not consider the countries based on their resource-endowment, meaning that the results could differ. Conceptually, the current study added interest rate volatility to inflation and exchange rate volatility and treated them as elements of systematic risk. In addition, political uncertainty was adopted in the current study as an item of governance to act as a moderator. Further, while Onitekun and Ogun used system GMM regression, the current study adopted a panel regression model in an attempt to account for variation over time and across countries.

Another study focusing on 47 SSA countries was conducted by Ojeka et al. (2024), who assessed the moderating effect of governance on the association between debt and domestic investment in this region over the period 1996-2021. To deal with endogeneity, heterogeneity across countries, dynamic effects, cross-sectional dependence, and threshold effects, they used a number of methods, such as two-step System GMM, Dynamic Panel Threshold Estimator, Generalised Panel Quantile Regression, and Driscoll and Kraay Robust Estimator. Results showed that external debt had a negative, statistically significant effect on domestic investment (-0.117) while governance had a positive and significant effect (2.444). After interacting with governance and debt, results indicated a significant, positive effect (0.044) on investment, which means that quality governance lessens the bad effects of external debt on domestic investment. Similar to Ojeka et al. (2025), the current study adopted governance as a moderator. However, for the independent variable, it used systematic risk composed of inflation rate volatility, interest rate volatility, and exchange rate volatility. Further, instead of

focusing on the domestic investment as the dependent variable, the current study used FDI. Such differences in the variables, coupled with the differences in contexts, hinder generalisation of findings.

Fiona and Laulita's (2023) study aimed at establishing the moderating role of corruption index on the effect that inflation rate, exchange rate, and interest rate volatilities had on FDI in six ASEAN countries during the period 2002 to 2021. The panel data regression analysis technique was adopted to establish the variable's relationship. Study results indicated that the corruption index manifested a negative and significant moderating influence. Results also showed that inflation and interest rate volatilities had a negative and insignificant influence on FDI inflows. In contrast, exchange rate fluctuations had a positive and statistically significant effect on FDI. The current study adopts corruption index among other governance elements to constitute the governance variable, and exchange rate volatility, interest rate volatility, and inflation rate volatility as systematic risks. In addition, whereas Fiona and Laulita (2023) focused on FDI inflows in six ASEAN countries, the current study focuses on 10 East African countries. Besides the differences in geographies, the study areas are also different in terms of their institutional and governance quality. Therefore, it is important that this study in Eastern African countries is conducted.

Focusing on Nigeria and using the Discrete Threshold Regression model, Odionye et al. (2023) sought to assess the moderating role of political stability on the effect of exchange rate changes and interest rate differentials on FDI inflows. The authors anchored their study on portfolio theory and covered interest rate parity and uncovered interest rate parity models. The findings indicated that political stability had a positive and significant moderating effect on the association between interest rate and exchange rate fluctuations and FDI inflows. Whereas Odionye et al. (2023) focused on one country, the current study focused on many countries in the Eastern Africa region. Additionally, their study used only political stability, while the current

study will adopt the other five elements of WGI. In addition, the results of one country cannot be generalised to a region.

Faruq (2023) adopted a panel data analysis approach in assessing the influencers of FDI in emerging Asian economies for the period 2002–2018. The study was based on a number of theories that include Heckscher–Ohlin Model, Theory of the Production Cycle, Internalisation Theory, and Eclectic Paradigm. They used panel data analysis with multiple regression models and found that inflation influenced FDI inflows negatively. Similarly, changes in lending rates had a statistically significant negative effect on FDI (0.027, $p = 0.024$). By adding the governance factors, it was seen that political stability had a significant positive influence of 0.600, while rule of law had a counter-intuitive negative coefficient of -1.213 and was significant at the 10% level. Owing to the differences in the economic and institutional differences between the emerging Asian economies and East African countries, the results cannot be generalised. Additionally, Faruq looked at inflation and lending rate and their effect on FDI, while the current study analysed from the risk perspective by using their volatilities and added interest rate volatility. Whereas Faruq used the elements of governance separately and as independent variables, the current study adopted them as a composite index and treated governance as a moderating variable. Just like Faruq, the current study also used the panel regression method, but shifted from the random effect to the pooled OLS as suggested by specification tests. The current study also used different theories of FDI (institutional fitness theory, modern portfolio theory, eclectic paradigm, and EMH), which best show the motivation for investors' interest in internationalising investments.

Sujit et al.'s (2020) study assessed the effect of macroeconomic, governance, and risk on FDI inflows in the US market over the period 1960–2019. The study was anchored in investment portfolio theory and industrial organisational theory and adopted regression methodology. Among other macroeconomic factors, the author used inflation, which was shown to have a

negative influence on FDI ($\beta = -0.06$). Further findings showed that when interacting with governance, especially rising corruption, there was a higher and statistically significant drop in FDI inflows ($\beta = -0.33$). Additional results showed that improved governance was associated with a higher propensity to attract FDI. Whereas the reviewed study presents important insights, it presents various gaps. First, there is a contextual gap in that it was conducted in the US and a single country, while the current study focused on a number of nations, the East African region. Secondly, the current study addressed the conceptual gap by increasing the systematic risk factors by adding interest and exchange rate volatilities. Third, while Sujit et al. (2020) used a multiple regression approach, the current study adopted panel regression methodology, which provided more variability and less collinearity among independent variables, leading to more efficient as well as reliable estimates.

In examining the factors responsible for the declining trend in FDI in the Central African Republic, Pacific and Magalie (2023) considered the moderating influence of political governance on the association between financial instability and energy production and FDI. They divided the study period into short-run and long run by focusing on 1977–2007 and 1977–2017, respectively. The authors used ARDL for analysis, and findings showed that political governance had a positive influence on FDI in the short run, but a negative effect in the long run. The current study will adopt political stability as an element of the WGI, add the institutional FDI theory, and use a regression equation for model presentation. The study also appreciates that the Central African Republic has differences in the operating climate and economic environment from those in East African countries. In addition, the authors used different independent variables from the systematic risks that will be used for this study. Additionally, the study adopted the ARDL model, which might not be useful for the panel data; thus, the current study uses a panel data regression approach.

METHODOLOGY

Study Design

The study adopted an explanatory longitudinal research design, which helps in understanding the change in the outcome variables due to a change in independent variables (Cockcroft et al., 2019). It supported tracking changes over time of the systematic risk, governance, and FDI, and understanding how they evolve over multiple points in time.

Study Population and Sample

The study was conducted in the East African region, as grouped by the UNCTAD (2023) investment report, which includes 11 countries: Kenya, Uganda, Comoros, Djibouti, Ethiopia, Eritrea, Mauritius, Madagascar, Somalia, Seychelles, and Tanzania. Through purposive sampling, 9 countries were studied based on the availability of data and being relatively stable for the entire period.

Data Collection

Data was collected from the World Bank database and the respective country's Central Banks using a data collection checklist. The study period was 1996-2023, and across the nine countries, resulting in 252 observations.

Data Analysis

Data analysis was done to make meaning out of the collected data. The study used descriptive statistics to get the summary of the study variables. These statistics were the means, standard deviation, skewness, and kurtosis. Correlation analysis was also conducted to assess the degree and nature of association between the variables, while panel data regression analysis was conducted to establish the effect of explanatory variables on the outcome variables. The panel data regression model for the moderation was as follows:

$$\ln FDI_{it} = \alpha + \beta_1 INTV_{it} + \beta_2 EXV_{it} + \beta_3 INFV_{it} + \beta_4 G_{it} + \beta_5 INTV_{it} * G_{it} + \beta_6 EXV_{it} * G_{it} + \beta_7 INFV_{it} * G_{it} + \varepsilon_{it}$$

Where, $\ln FDI_{it}$ - natural log of FDI inflows in country i at time t , α is constant, $\beta_1 - \beta_7$ is respective coefficients, $INTV$ is interest rate volatility, ERV is exchange rate volatility, $INFV$ is the inflation rate volatility, G is governance, $INTV * G$ is interaction term between interest rate volatility and governance, $ERV * G$ is interaction term between exchange rate volatility and governance, $INFV * G$ is interaction term between inflation rate volatility and governance, i is 1,2,... 9 countries, t is 1,2,...28 years, and ε is the error term. Data analysis was aided by statistical software, R, R Studio and SPSS version 28 analysis software. The outputs were presented in tables and charts.

Ethical Consideration

Since the study used publicly available information, it is implied that there was permission for its further use and analysis, though the sources were acknowledged. Additionally, the needed data was only collected from credible databases such as the World Bank and respective country's Central Banks, which greatly enhanced data accuracy and integrity. The researcher avoided academic fraud by conducting the appropriate data analysis without engaging in any fabrications. The researcher also obtained clearance from the University's Ethics Committee and applied for a research permit from the National Commission for Science, Technology and Innovation (NACOSTI) to get the authority to conduct the study.

RESULTS, FINDINGS, AND DISCUSSION

Descriptive Results for Governance Index

The governance was operationalised using the World Governance Indicators, which are measured using six items: political stability, control of corruption, voice and accountability, rule of law, regulatory quality, and government effectiveness. The descriptive statistics for these elements as represented in Table 1.

Table 1: Descriptive Statistics for Governance

	Minimum	Maximum	Mean	Std. Deviation	Skewness	Kurtosis
Voice and accountability	-2.23	1.01	-0.48	0.77	-0.291	0.006
Political stability	-2.18	1.28	-0.35	0.83	0.183	-0.976
Government effectiveness	-1.81	1.15	-0.50	0.72	0.512	-0.350
Regulatory quality	-1.55	1.2	-0.44	0.60	0.667	0.312
Rule of law	-1.34	1.02	-0.41	0.63	0.965	-0.165
Control of corruption	-1.31	1.7	-0.47	0.61	1.27	1.063
Composite mean			-0.44	0.69	0.551	-0.018

N = 252

On average, results in Table 1 show that the world governance index was -0.44, indicating poor governance in the studied East African countries and had a standard deviation of 0.69, further showing that no country recorded a governance index value that significantly deviated from the regional mean. The negative averages across all indicators, varying from -0.50 for government effectiveness to -0.35 for political stability, show that these countries have governance scores that are lower than the global mean, which is standardised to zero.

The standard deviations, which range from 0.600 to 0.827, show that the countries and the time periods have some differences. The standard deviation for voice and accountability is 0.77, while that of political stability is 0.83, indicating that there were countries and periods when the region experienced periods of high inconsistent democratic practices and sharp instabilities. Overall, this shows that the quality of governance is lower in the sampled countries, with citizens having less freedom to participate, express themselves, and hold the government accountable. On the other hand, control of corruption (SD = 0.610) and regulatory quality (SD = 0.600) had relatively lower levels of variability, which means that the results were more consistent, though still weak.

The skewness values for the different indicators show that the distribution of governance scores is not perfectly symmetrical. Voice and accountability had a negative and slightly skewed score (-0.291), which means that more country-year observations are closer to the top (less

negative governance scores). However, regulatory quality (0.667), rule of law (0.965), political stability (0.183), government effectiveness (0.512), and control of corruption (1.270) were all positively skewed. This means that most scores are closer to weaker governance, and there are not many observations that show higher quality governance. The fact that control of corruption has a relatively high positive skew (1.270) means that very few country-years showed strong control of corruption, while the majority had scores that were more negative than positive.

The kurtosis values show how "peaked" the distributions are. Political stability had a negative value of -0.976, which means that the scores are more spread out and the distribution is flatter. This shows that the political conditions in the countries and the time period were different. Government effectiveness and the rule of law also had negative values of -0.350 and -0.165, respectively. On the other hand, with positive values, regulatory quality (0.312), voice and accountability (0.006), and control of corruption (1.063) mean that in some cases, scores were clustered around the mean with a few extreme values.

These results are in line with Makalima et al. (2024), who found that African countries experience common governance weaknesses such as weak institutions that cannot take legal actions against lawbreakers, institutional corrupt practices, lack of political will, and incapacity or inability to enforce corporate governance regulations. These results also corroborate the study of Mini et al. (2025) on 35 African countries, where all six governance indicators had negative values and standard deviations ranging

from 0.556 to 0.902, highlighting disparities across countries and periods. These findings also reflect the persistent challenges in political stability, control of corruption, rule of law, voice and accountability, government effectiveness, and regulatory quality, thus aligning with Loots (2022) that Africa is characterised by political instability and governance failures.

Exploratory Factor Analysis for Governance

Exploratory factor analysis (EFA) is a statistical approach that uses observed items/variables to uncover underlying latent variables. It helps in identifying items that contribute most to the structure/factor/component or composite, instead of having too many items that might be unimportant (Sürücü et al., 2022). The

factorability was assessed using the Kaiser-Meyer-Olkin (KMO) and Bartlett's Test of Sphericity. KMO helped in the determination of whether the whole sample was adequate to compute the EFA. Baistaman et al. (2022) advise that if the KMO values are above 0.60, then EFA can be used. The Bartlett's Test of Sphericity is important in assessing the freedom of data from single response bias, and the variables in the dataset are not correlated, and the p-value should be below 0.05 (Baistaman et al., 2022; Shrestha, 2021). Therefore, as shown in Table 2, the KMO value was 0.796, and Bartlett's Test of Sphericity sig value was 0.000, indicating the test was significant and the researcher should further proceed with the data reduction procedure.

Table 2: KMO and Bartlett's Test

Kaiser-Meyer-Olkin Measure of Sampling Adequacy.		.796
	Approx. Chi-Square	1590.906
Bartlett's Test of Sphericity	Df	15
	Sig.	.000

Factor extraction is conducted to determine the least number of items to be used to best represent the interrelationships among a number of variables (Shrestha, 2021). For the extraction of factors, principal component analysis (PCA) was adopted because it creates a model that is more organised and accessible for interpretation (Hair Jr. et al., 2019). For rotation in the bid to improve interpretability, orthogonal rotation through varimax was adopted. It is widely used for its ability to produce more interpretable factors (Hair Jr. et al., 2019). PCA results in Table 3 indicated

one dominant component with an eigenvalue of 4.529 and accounting for 75.481% of the total variance. Hair Jr. et al. (2019) state that variables with values less than 0.05 should be removed from the component. Therefore, with all six dimensions of governance loading strongly on this factor, as shown in Table 4 and suggesting a unidimensional structure, none was dropped. Additionally, following Kaiser's (1960) criterion that only components with eigenvalues greater than 1 should be retained (Field, 2024), and the scree plot, Figure 1, no other factors were retained.

Table 3: Eigen Values and Total Variance Explained

Component	Initial Eigenvalues			Extraction Sums of Squared Loadings		
	Total	% of Variance	Cumulative %	Total	% of Variance	Cumulative %
1	4.529	75.481	75.481	4.529	75.481	75.481
2	.586	9.759	85.240			
3	.485	8.091	93.330			
4	.254	4.236	97.566			
5	.094	1.564	99.130			
6	.052	.870	100.000			

Extraction Method: Principal Component Analysis.

Figure 1: Scree plot for Governance

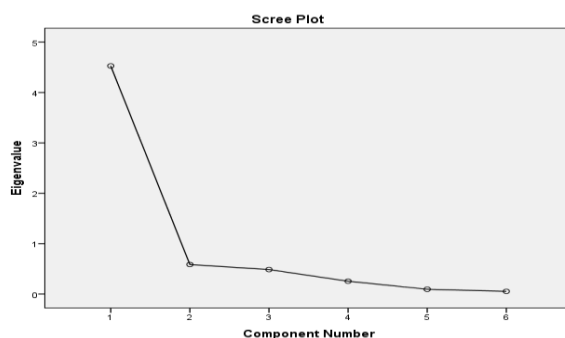


Table 4: Rotated Component Matrix of Governance

	Component 1
Voice and accountability	.789
Political stability	.781
Government effectiveness	.928
Regulatory quality	.878
Rule of law	.961
Control of corruption	.861

Extraction Method: Principal Component Analysis.^a

a. 1 components extracted.

A composite score for governance was computed through the summation method, as Sabir et al. (2019) and Sayari (2019) also did. According to Lundberg et al. (2021), this method is appropriate if a latent variable is defined in such a manner that building the sum scores map on this definition well. Additionally, the sum score is important, where the total score reflects the cumulative effect

of the latent construct (Babbie, 2020; Schuberth et al., 2025). Therefore, summing up the six elements of governance was necessary as it reflected their total intensity.

Correlation Analysis

Table 5 presents the correlation analysis output for the study variables.

Table 5: Correlation Analysis

		Foreign direct investment	Exchange rate volatility	Inflation volatility	Interest rate volatility	Capital account liberalisation	World Governance Index
Foreign direct investment	Pearson	1					
	Correlation						
Exchange rate volatility	Sig. (2-tailed)						
	Pearson	-.429**	1				
Inflation volatility	Correlation						
	Sig. (2-tailed)	.000					
Interest rate volatility	Pearson	.051	-.022	1			
	Correlation	.423	.732				
	Sig. (2-tailed)						
	Pearson	-.320**	.026	-.015	1		
	Correlation						
	Sig. (2-tailed)	.000	.683	.810			

		Foreign direct investment	Exchange rate volatility	Inflation volatility	Interest rate volatility	Capital account liberalisation	World Governance Index
World Governance Index	Pearson Correlation	.643**	.006	-.031	.003	.002	1
	Sig. (2-tailed)	.000	.920	.625	.966	.973	
	N	252	252	252	252	252	252

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

Results in Table 5 show that the Pearson correlation coefficient between the governance index and FDI inflows is positive and statistically significant ($r = 0.643$, $p < 0.01$), based on 252 observations. This indicates a moderately strong linear association between better governance quality and higher FDI inflows across the sampled countries. Since the governance index used in this study is an aggregate measure derived from the six dimensions of governance (voice and accountability, political stability, government effectiveness, regulatory quality, rule of law, and control of corruption), the result suggests that countries with stronger institutional and governance frameworks tend to attract more foreign investment. This positive association aligns with past empirical studies by Abdul-Rahman et al. (2024), Bouchoucha and El Fakiri (2022), Bhujabal et al. (2024), Cieslik and Khdir (2023), Li et al. (2023), and Tabash et al. (2024), which found that control of corruption, regulatory quality, government effectiveness, political stability, and rule of law were positively associated with inward FDI. Sujit et al. (2020) note that a higher perception of governance directly leads to greater attraction of FDI inflows. This means that good governance reduces transaction costs, strengthens property rights,

enhances investor confidence, and improves the predictability of economic policy, all of which are critical factors in foreign investment decision-making.

Further results show that governance quality has no statistically significant correlation with any of the three systematic risk elements: exchange rate volatility ($r = 0.006$), interest rate volatility ($r = 0.003$), or inflation volatility ($r = -0.031$). This suggests that systematic risk emanating from macroeconomic volatility is not directly associated with institutional quality in East African countries, though governance might influence other aspects of economic policy or structural stability over the long term.

Diagnostic Tests

Test of Normality

To evaluate whether the residuals from the regression model are normally distributed, the Shapiro-Wilk test was applied. The null hypothesis (H_0) assumes that the residuals follow a normal distribution, which is a key assumption for valid hypothesis testing in linear regression. A failure to reject H_0 supports the assumption of normality, while rejection indicates potential bias in statistical inference due to non-normal errors.

Table 6: Shapiro-Wilk Test (Normality of Residuals)

W Statistic	p-value	Decision ($\alpha = 0.05$)
0.99598	0.7634	Fail to reject H_0

The p-value of 0.7634 exceeds the 0.05 significance threshold, indicating no significant departure from normality. Thus, the assumption of normally distributed residuals is satisfied.

Linearity Test

To check for possible functional form misspecification in the regression model, such as omitted nonlinear relationships or missing variables, the Ramsey RESET was employed. The null hypothesis (H_0) asserts that the model is correctly specified, while the alternative hypothesis (H_1) suggests specification errors.

Failure to reject H_0 indicates that the current model form adequately captures the true underlying relationship.

Table 7: Ramsey RESET Test – Model Specification Check

Test Name	RESET Statistic	df1	df2	p-value	Decision ($\alpha = 0.05$)
Ramsey RESET (1)	0.22445	2	242	0.7991	Fail to reject H_0
Ramsey RESET (2)	0.32206	3	241	0.8094	Fail to reject H_0

Both specifications of the Ramsey RESET test returned high p-values (0.7991 and 0.8094), suggesting no omitted nonlinear relationships or model misspecification. The linear model is appropriately specified.

Stationarity Test

Im, Pesaran-Shin (IPS) Unit-Root Test was used to estimate unit roots in heterogeneous panels through the t-bar statistic, and the results are shown in Table 8.

Table 8: Test for Stationarity

Variable	Test Statistic (Wt-bar)	p-value	Decision on H_0
logFDI	-6.2096	2.66E-10	Reject H_0 ($p < 0.05$)
logEXR	-6.1155	4.81E-10	Reject H_0 ($p < 0.05$)
logINF	-5.8465	2.51E-09	Reject H_0 ($p < 0.05$)
logINT	-6.4775	4.66E-11	Reject H_0 ($p < 0.05$)
logWGI	-4.391	5.64E-06	Reject H_0 ($p < 0.05$)

The stationarity test results in Table 8 show that every variable has significant test statistics with p-values below the 5% significance level. Therefore, the null hypothesis of non-stationarity is rejected, and concluded that the variables were stable over the studied period.

Serial Correlation

To test for autocorrelation in the residuals, the Wooldridge/Breusch-Godfrey serial correlation test was conducted. The null hypothesis (H_0) posits that there is no serial correlation among the residuals. Detecting serial correlation may indicate model misspecification or inefficiency in the estimated standard errors, thereby necessitating model correction or transformation.

Table 9: Wooldridge/Breusch-Godfrey

Statistic	df	p-value	Decision ($\alpha = 0.05$)
30.05	28	0.3608	Fail to reject H_0

With a p-value of 0.3608, there is no statistical evidence of autocorrelation in the residuals. This satisfies the assumption of independently distributed errors.

Multicollinearity

The multicollinearity among the systematic risk factors and governance was analysed, and the results are presented in Table 10. Results show that all the predictor variables had no collinearity problems as tolerances are over 0.20 and VIFs are below 5, and the regression coefficients would be reliable.

Table 10: Multicollinearity Test Results

Model	Collinearity Statistics	
	Tolerance	VIF
logEXR	.910	1.099
logINF	.959	1.043
logINT	.996	1.004
logWGI	.870	1.149

Test for Heteroskedasticity

To determine whether the variance of the regression residuals is constant across observations, the Studentized Breusch-Pagan test was applied. The null hypothesis (H_0) states that the residuals are homoscedastic - they have constant variance. Rejecting the null would

suggest heteroskedasticity, potentially biasing the standard errors and test statistics. A failure to reject H_0 supports the assumption of equal variance across observations. The test results are in Table 11.

Table 11: Studentized Breusch-Pagan Test (Heteroskedasticity)

Statistic (BP)	df	p-value	Decision ($\alpha = 0.05$)
5.5145	7	0.5974	Fail to reject H_0

The Breusch-Pagan test yielded a p-value of 0.5974, indicating constant variance of the residuals. Therefore, the assumption of homoskedasticity holds.

Lagrange Multiplier Test – Breusch-Pagan

To assess whether a random effects model provides a statistically superior fit over the pooled

OLS model, the Breusch-Pagan Lagrange Multiplier (LM) test was employed. The null hypothesis (H_0) posits that variances across entities are zero, i.e., there are no significant random effects, implying that the pooled OLS model is sufficient, and results are presented in Table 12.

Table 12: Lagrange Multiplier Test – Breusch-Pagan

Statistic	df	p-value	Decision ($\alpha = 0.05$)
1.9418	1	0.1635	Fail to reject H_0

Since the p-value (0.1635) is greater than the 5% significance level, there is insufficient evidence to reject the null hypothesis. This indicates that the inclusion of random effects does not significantly improve the model. Therefore, the pooled OLS model is deemed suitable for estimation, as it

provides a statistically adequate representation of the data.

Moderating Effect of Governance on the Relationship between Systematic Risk and FDI

Table 13: Pooled OLS Regression Output for the Moderation Effect of Governance on the Relationship between Systematic Risk and FDI

Y= logFDI	Coefficient	Std. Error	t-value	p-value
Intercept	18.8654	0.219	86.14	0.000
logEXR	-0.5914	0.0485	-12.2	0.000
logINF	-0.1516	0.0871	-1.74	0.083
logINT	-0.412	0.0552	-7.47	0.000
logWGI	0.7538	0.1893	3.98	0.000
Mod1	0.2615	0.0423	6.18	0.000
Mod2	0.1885	0.0707	2.67	0.008
Mod3	0.1413	0.0473	2.99	0.003
R-squared	0.6443			
F-statistics	101.476 (7,244) p = 0.000			

Results in Table 13 show that R-squared = 0.6443. This means that the model explains about 54.4% of the variation in FDI. F-statistic = 101.476 ($p < 0.001$) means that the model is statistically significant overall. Results show that exchange rate risk (logEXR) has a negative and significant effect on FDI ($\beta = -0.5914$, $p < 0.001$). Holding other factors constant, a 1% increase in exchange rate risk is associated with a 0.59% decrease in FDI. Further results show that inflation risk (logINF) had a negative, but marginally insignificant effect ($\beta = -0.1516$, $p = 0.083$). It means that a 1% increase in inflation risk reduces FDI by 0.15%, but this effect is insignificant (at 5% level). Additionally, interest rate risk (logINT) has a negative and significant effect ($\beta = -0.412$, $p < 0.001$) on FDI. A 1% increase in interest rate risk reduces FDI by 0.41%. With respect to governance (logWGI), its quality has a positive and significant effect ($\beta = 0.7538$, $p < 0.001$) on FDI inflows. Therefore, a 1% improvement in governance quality increases FDI by 0.75%, independent of risk factors.

Interaction terms were analysed for the moderation effect. Results in Mod1 (logEXR $\times$ logWGI) indicate that the interaction between exchange rate volatility and governance has a positive and significant ($\beta = 0.2615$, $p < 0.001$) effect on FDI. These results mean that if governance improves by 1%, the adverse effect of exchange rate risk on FDI decreases by 0.26 percentage points. Therefore, strong governance reduces the negative impact of exchange rate volatility on FDI. In countries with better

governance, the deterring effect of currency volatility on FDI is lessened. Results further show that the interaction between inflation rate volatility and governance (Mod2-logINF $\times$ logWGI) has a positive and significant ($\beta = 0.1885$, $p = 0.008$) effect on FDI. A 1% improvement in governance softens the inflation risk effect by 0.19 percentage points. They suggest that although inflation volatility is generally harmful, strong governance can buffer or reverse its effects to some extent. Additional findings are that the interaction between interest rate volatility and governance (Mod3 - logINT $\times$ logWGI) has a positive and significant ($\beta = 0.1413$, $p = 0.003$) effect on FDI. Strong governance mitigates the negative effect of interest rate risk on FDI by 0.14 percentage points per 1% governance improvement. In well-governed environments, investors may feel more secure despite volatile interest rates.

These results echo the findings of Ramoni-Perazzi and Romero (2022), who established that the negative and statistically significant effect of exchange rate volatility on FDI diminished in low-corruption countries. The findings further align with Ojeka et al.'s (2024) study, which established that governance quality influences investors' confidence and their perceptions of risks, with countries with high governance quality being more attractive investment destinations. Such countries record higher FDI levels as the governments are able to implement prudent monetary and fiscal policies that support sustainable investment.

The ability of governance quality to dampen the negative effect of exchange rate volatility on FDI inflows was also documented in Bhujabal et al.'s (2024) study, which found that the interaction coefficient of exchange rate volatility and governance index was positive and significant. The authors noted that jointly, good governance and the exchange rate attract FD inflows. Additionally, Lemi and Asefa (2008) found that the detrimental effects of inflation and exchange rate volatility on US FDI into Africa are substantially mitigated when governance and political freedom levels are higher. The results further agree with the study of Nyuyen et al. (2021) that in the presence of strong macroeconomic factors and control of corruption, the ASEAN economies created a better investment climate that attracted FDI investors, among others.

The study findings are also consistent with Masengesh et al. (2025), who found that governance quality moderated the negative effect of exchange rate volatility and interest rate fluctuations on FDI inflows in the East African region. They noted that the presence of strong and efficient governance and legal frameworks created a more stable investment climate that increased investors' confidence. The results have also supported the study of Sabir et al. (2019), which established that the governance quality helped in reducing the negative effects of macroeconomic factors, including inflation, on FDI in both developed and developing countries. They, however, noted that the effect was greater in developed countries than in developing economies. Further, the findings on the moderating role of governance on the association between systematic risk and FDI inflows mirror the study of Magbondé and Konté (2022), who found that high quality of institutions minimised the negative effects of uncertainties around macroeconomic policies, including inflation, on FDI inflows in developing countries. The findings further agree with Asamoah et al. (2016), who found that the interaction of governance and foreign exchange volatility reduced the initial

negative effect of exchange rate volatility on FDI inflows in Sub-Saharan Africa.

The moderation effect of governance has also been confirmed in the study of Dong et al. (2025), who established that quality governance was an effective moderator that reduced the negative effect of economic policy uncertainties (which include, among other items, the monetary policy) on FDI inflows in China. Similarly, Bommadevara and Sakharkar (2021) established that strong governance moderated the deterrence effect of economic policy uncertainty on FDI inflows. However, these findings contradict the study of Ogbonna et al. (2022), which found that while the global uncertainty reduced FDI inflows in Africa, the continent's governance quality amplified these effects. The amplification of the adverse effect of global uncertainty was attributed to investors' expectations of transparency, policy consistency, and regulatory accountability. When uncertainty rises, these expectations are disrupted more significantly, prompting cautious investment behaviour or capital withdrawal.

CONCLUSION

The study concludes that governance is an important factor that enhances investor trust, leading to increased FDI inflows. This implies that even in the face of increased risks, the region's investment appeal can be improved by having strong governance quality, which can lessen the negative effects of volatility in macroeconomic factors that pose systematic risk on FDI inflows. The governance components of political stability, control of corruption, rule of law, voice and accountability, government effectiveness, and regulatory quality help in the creation of a stable environment that attracts FDI. Therefore, governments should enhance their countries' governance quality and safeguard FDI investors against systematic risks.

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