Australasian Review of African Studies, 2024,45(2), 89-110 *AFSAAP*
http://afsaap.org.au/ARAS/2024-volume-45 *2024*
https://doi.org/10.22160/22035184/ARAS-2024-45-2/89-110

Determinants of Foreign Direct Investment Inflows in the East African Community States: the Roles of Political Stability, Economic Growth and Trade Openness

Osman Sayid Hasan Musse
SIMAD University, Somalia
osmansayid@gmail.com

Abdelghani Echchabi
International Agriculture University, Uzbekistan
abdelghani.mo@gmail.com

Abstract

This study explores the effect of political stability on foreign direct investment inflows in the East African Community (EAC), alongside other key macroeconomic factors (GDP, trade openness, exchange rate, and inflation). Using panel data models, we analyse annual data from seven EAC states over a 10-year period (2013–2022). Findings reveal that while political stability is positively correlated with FDI inflows, it lacks statistical significance. Economic growth, on the other hand, emerges as a key significant driver of FDI, confirming that a strong economy boosts investor confidence. Trade openness is also significantly and positively associated with FDI inflows, underscoring its role in attracting capital, facilitating technology transfer, and enhancing knowledge flows into the region. Exchange rates show a positive and insignificant association with FDI inflows, while inflation similarly exhibits a positive but insignificant correlation, suggesting that moderate inflation can attract investment, but prolonged high inflation may deter foreign investors. This study is unique in its focus on political stability as a determinant of FDI inflows within a region that includes Somalia, Congo and South Sudan, three of the thirteen most violence-affected countries globally. The study recommends ways that the EAC should address the root causes of political instability, including policies aimed at reducing poverty, combating corruption, and expanding opportunities for youth and marginalized communities. Member states should also advocate policies that facilitate movement of goods, services, and assets to enhance regional trade integration and attract foreign investments.

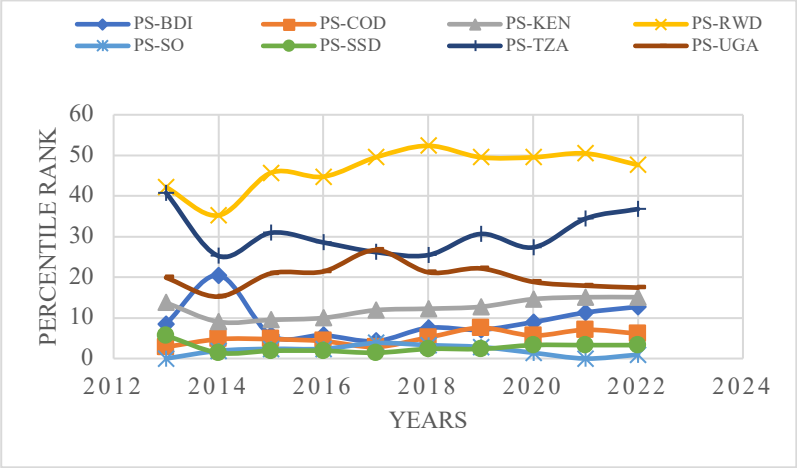
***Keywords*: p**olitical stability, foreign direct investment, East African Community, economic growth, Somalia, panel analysis

Introduction

Attracting foreign direct investment (FDI) is a crucial objective for countries seeking to enhance their economic development and global competitiveness (Bertrand et al., 2024). Several key factors influence a nation's capacity to attract FDI, with political stability and the absence of violence (PS), trade openness (TO), gross domestic product (GDP), inflation rate (Inf) and exchange rate (ER), standing out as the most impactful. Political stability and the absence of violence or terrorism are particularly important for attracting FDI (Ozbozkurt & Satrovic, 2019). They evaluated the risk of PS, all of which pose significant risks to potential investors. Instability often arises from factors such as failed transitions of power, armed conflicts, violent demonstrations, social unrest, and international tensions (Kaufmann et al., 2010). Additionally, internal conflicts, ethnic tensions, terrorism, and civil wars further contribute to political instability (Kaufmann & Kraay, 2023). As a result, states with stable political environments will attract FDI, offering investors greater security and promoting stronger economic growth and infrastructure development. This interplay between political and economic factors not only influences a country's ability to attract FDI but also shapes its overall economic landscape and long-term prospects for growth (Bertrand et al., 2024).

Globally, the rise of violent extremism has led to widespread loss of life across nations, faiths, and ethnic groups. Various countries have experienced over 500 deaths due to violence, with the number of affected countries rising from 5 in 2013 to 11 in 2014, representing a 120% rise compared to the previous year. Newly affected states included Somalia, Ukraine, Yemen, the Central African Republic, South Sudan, and Cameroon (UNDP, 2016). Among these, Somalia and South Sudan are members of the EAC region, underscoring the need to examine how PS impacts FDI inflows in the region. Moreover, political stability is essential for fostering business confidence, promoting social cohesion, and ensuring sustainable economic progress, especially in fragile or conflict-affected areas. Within the EAC region, countries such as Somalia, South Sudan, and Congo consistently rank among the lowest according to the PS metric data.

Figure 1 Historical data on political stability across the EAC

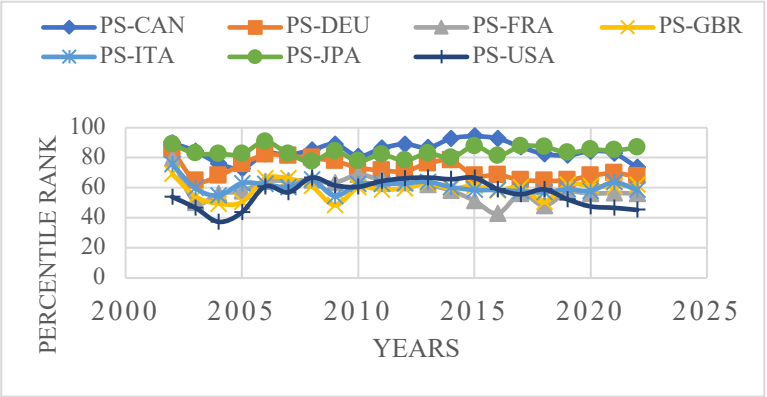


Source: World bank database: World Development Indicators

As Figure 1 shows, Rwanda has outperformed the other EAC members, maintaining an average percentile rank of 46 and surpassing the 50th percentile between 2021 and 2022. Tanzania follows with an average of 30, reaching its highest rank of 37 in 2022. Uganda comes in third, with an average percentile rank of 17, though it has shown a decline over the past four years. Somalia holds the lowest position within the EAC, with a percentile rank of 1.9 out of 100, showing a steady decline from 2020 to 2022. This is attributed to the persistence of terrorism and frequent terrorist attacks. South Sudan follows closely, averaging a 2.12 percentile rank, largely due to its ongoing civil war, although it has shown slight improvement between 2020 and 2022. The Congo holds a 4.8 percentile rank due to similar factors of internal conflict and political instability. Burundi, with a 9 percentile rank, has seen improvements over the past three years, while Kenya ranks fourth in the region with 12 percent, showing gradual progress and reaching its highest rank of 15 percent in the past three years. The data suggest that the EAC will continue to face challenges in attracting FDI, a critical driver of economic growth and infrastructure development. To provide a broader perspective on political stability in the EAC, it is useful to compare its Political Stability (PS) metric with that of the G7 nations—

Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States. While the two regions differ significantly in various economic, social, and political aspects, this comparison serves to contextualize the EAC's stability within a global framework. Figure 2 shows the percentile rankings for political stability in the G7 over a 21-year period (2002–2022).

Figure 2 Historical data on political stability for the G7 nations



Source: World bank database: World Development Indicators

In the G7, Canada and Japan maintain the highest rankings, averaging over 80 percent in PS metric, based on a percentile scale out of 100. Germany follows with an average of 72 percent. The USA ranks lowest among the G7, with an average of 56 percent, due to factors such as the September 11 attacks, protests following the murder of George Floyd in 2020, and political violence after the 2020 presidential election. France and the United Kingdom hold similar rankings, both averaging around 60 percent, influenced by events such as the terrorist attacks in 2015–2016 in France and the London and Manchester bombings in the UK. Italy ranks slightly higher, averaging 61 percent on the 100-percentile scale for PS. Overall, G7 countries maintain PS levels significantly above 50 percent, demonstrating a stark contrast to the EAC region. Therefore, examining the impact of PS on FDI inflows, alongside other key macroeconomic variables, is essential, especially given that the region includes countries like Somalia, South Sudan, and Congo, which rank among the lowest globally in terms of

political stability and are significantly affected by political instability and terrorism. Furthermore, the study highlights a scarcity of research directly linking political stability to FDI inflows—a crucial resource for economic development. Thus, this study aims to examine the influence of PS on FDI inflows in the EAC, while also considering other key economic indicators i.e., economic growth, trade openness, exchange rates, and inflation. The paper is structured as follows. Section 2 presents the literature review. Section 3 outlines the methodology. Section 4 analyses the findings and the final section concludes the paper.

Literature review

Political Stability and FDI

Political stability and the absence of violence (PS) are critical factors in attracting foreign direct investment (FDI) inflows and promoting economic development (Okara, 2023; Weerachai, 2024). Numerous studies suggest that nations with high ratios of PS tend to attract more FDI, and it has been revived as a key driver of economic development, while those with significant political risk may experience reduced FDI inflows (Weerachai, 2024). Political instability creates an environment of uncertainty, deterring investors who fear for the safety of their investments and the potential return on investment (Saurav & Kuo, 2020).

Korsah et al. (2022), in their study of FDI drivers in West Africa from 1989 to 2018, used fixed- and random-effects econometric regression models but found that PS was not a significant determinant of FDI inflows in that region. In contrast, Chandra and Handoyo (2020) examined the determinants of FDI inflows in 31 Asian countries between 2002 and 2017, considering factors like political stability, inflation rate, trade openness, exchange rate, market size, and interest rate. Using the Generalized Method of Moments (GMM), they suggested that PS has a positive effect on FDI inflows. Brada et al. (2003) studied the impacts of political instability and economic transition on FDI in Central Europe and the Balkans. Their research revealed that both political instability and economic transition negatively impacted FDI inflows. They concluded that the restoration of peace and the reduction of tensions in these regions would likely result in increased FDI inflows, highlighting the importance of PS in attracting investment. Supporting Chandra and Handoyo's (2020) findings, Meressa (2022) analysed FDI inflows to 17 COMESA member countries from 2002

to 2016, using panel data estimators, and found that political stability had a positive and significant impact on FDI inflows.

Conversely, Le et al. (2023) examined the relationship between PS and FDI inflows in 25 Asia-Pacific countries the period from 1990 to 2020 and using dynamic system GMM, and found a negative impact of PS on FDI inflows in this region. Similarly, Maulidiyah and Fuddin (2024) investigated the role of political stability and macroeconomic factors in attracting FDI inflows to five ASEAN nations (Indonesia, Malaysia, Vietnam, Laos, Cambodia) over a 20-year period using panel data regression. Their findings revealed that PS is positively and significantly correlated with FDI inflows in these nations. Drawing from these varied results, the following hypothesis was developed: Political stability is positively correlated with foreign direct investment inflows in the EAC.

Economic Growth and FDI

Economic growth, typically measured by gross domestic product (GDP), is a key driver of foreign direct investment (FDI) inflows, as it presents location advantages and builds investor confidence. Strong economic performance signals to foreign investors that a country has a stable and expanding market, which enhances the potential for profitable investments. Ghazalian (2023) examined the short-run and long-run effects of economic growth on FDI inflows using the Generalized Method of Moments (GMM) system estimator for dynamic panel models. His study revealed that economic growth is positively and significantly affected FDI inflows. He emphasized the importance of growth-enhancing policies that align with the economic and geo-economic contexts of host nations to encourage increased FDI inflows, aligning with Othman's (2022) findings on the positive relationship between GDP growth and FDI inflows in the Arab region. Supporting this view, Chandra and Handoyo (2020) also found a positive relationship between economic growth and FDI inflows in their study of 31 Asian countries from 2002 to 2017. Using the GMM method for dynamic panels, they concluded that economic growth is crucial factor in attracting FDI. Similarly, Demirhan and Masca (2008) investigated the drivers of FDI inflows in 38 developing countries between 2000 and 2004. Their results suggested that economic growth is positively and significantly correlated with FDI inflows. Meressa (2022) reached the same conclusion in a study of 17 COMESA member countries from 2002 to 2016, suggesting that higher economic growth leads to increased FDI inflows.

In the context of Central Asia, Ashurov et al. (2020) studied FDI determinants in Central Asia Countries, covering the period from 2000 to 2017, also using the GMM system. They found that economic growth positively and significantly correlated with FDI inflows in these nations, further supporting the notion that strong economic performance attracts foreign investment. Given the consistent evidence from these studies, this hypothesis is formulated: Economic growth is positively correlated with foreign direct investment inflows in the EAC.

Trade Openness and FDI

Trade openness, measured by the total value of a country's exports and imports as a percentage of its GDP, is a critical factor influencing the economic dynamics of modern nations (BIS, 2015; Musse et al., 2024). The relationship between trade openness and FDI inflows is particularly crucial, with studies suggesting that trade openness tends to benefit countries with higher initial income per capita, higher levels of FDI, and greater gross fixed capital formation (Wiredu et al., 2020).

Chandra and Handoyo (2020) examined the determinants of FDI inflows in 31 Asian countries from 2002 to 2017, considering factors such as political stability, inflation, trade openness, exchange rates, market size, and interest rates. They discovered a positive association is recorded between trade openness and FDI inflows. Supporting this conclusion, Demirhan and Masca (2008) investigated FDI drivers in 38 developing countries from 2000 to 2004, finding that trade openness is positively and significantly correlated with FDI inflows. Similarly, Meressa (2022) studied the factors influencing FDI variability in 17 COMESA member countries from 2002 to 2016. The results aligned with previous studies, indicating that trade openness is positively and significantly correlated with FDI inflows.

In the context of Central Asia, Ashurov et al. (2020) investigated the determinants of FDI in Central Asia Countries from 2000 to 2017, using the GMM system. Their findings confirmed that trade openness has a positive and significant effect on FDI inflows. Further support for this positive correlation was found by Le et al. (2023), who examined the effects of political stability and FDI inflows in 25 Asia-Pacific countries from 1990 to 2020, using a dynamic GMM system. They concluded that trade openness positively influences FDI inflows in the Asia-Pacific region. Additionally, Asbullah et al. (2022), in their study of FDI determinants from previous literature, reached a similar conclusion, affirming that trade openness significantly boosts FDI inflows.

However, in contrast to above findings, Mudiyanselage (2021) explored the relationship between trade openness and FDI in Romania over the period from 1997 to 2019. The results showed that trade openness had a negative and significant relationship with FDI inflows in both the short and long term, contradicting the conclusions of earlier studies. This finding is consistent with the research conducted by Musse et al. (2024) on the East African Community (EAC), although their results were not statistically significant. In light with the majority of evidence from selected studies, the following hypothesis is formulated: Trade openness is positively correlated with foreign direct investment inflows in the EAC.

Exchange Rate and FDI

Exchange rate fluctuations significantly influence FDI inflows (Tan et al., 2021). A depreciation of the domestic currency can make local assets cheaper for foreign investors, thereby encouraging FDI inflows by lowering the cost of investment (Bayoumi, 1996). This suggests that exchange rate volatility will have a positive impact on FDI inflows. Asiamah et al. (2018) studied the factors determining FDI inflows in Ghana from 1990 to 2015, using Johansen's cointegration approach within a vector autoregressive framework. Their findings reveal that exchange rate fluctuations have a statistically significant negative effect on FDI inflows in both the short and long term, consistent with results observed in East African countries (Tegegne, 2024). They suggest that the government should employ pragmatic measures i.e., exchange rate targeting strategies, to stabilize the exchange rate and enhance FDI attraction.

Conversely, Korsah et al. (2022) explored the drivers of FDI inflows in West African regions from 1989 to 2018, using fixed and random effects econometric models. Their research found that exchange rate volatility is positively and significantly correlated with FDI inflows, implying that exchange rate depreciation could stimulate an increase in FDI inflows. They recommend adopting a stable exchange rate regime to attract FDI. Therefore, this hypothesis is formulated: Exchange rate is positively correlated with foreign direct investment inflows in the EAC.

Inflation Rate and FDI

The inflation rate is a critical macroeconomic variable that can significantly impact foreign direct investment (FDI) inflows (Islam and Beloucif, 2023). It reflects the general rise in prices of goods and services over time, which can affect a country's economic stability and attractiveness

to foreign investors (Oner, 2024). High inflation often signals instability, reducing investor confidence and deterring FDI.

In theory, high inflation can discourage foreign investment, as it often leads to local currency depreciation, reducing the value of assets tied to the local currency compared to foreign currencies (Takefman, 2022). Asiamah et al. (2018) examined the factors influencing FDI inflows in Ghana from 1990 to 2015 using Johansen's cointegration approach within a vector autoregressive framework. Their findings indicate that inflation has a negative and significant impact on FDI inflows in Ghana.

Similarly, Chandra and Handoyo (2020) studied FDI determinants in 31 Asian countries from 2002 to 2017 using the Generalized Method of Moments (GMM) and found that inflation negatively affects FDI inflows, deterring foreign investors. Demirhan and Masca (2008) also supported these findings in their analysis of 38 developing countries from 2000 to 2004, concluding that higher inflation rates are negatively correlated with FDI inflows. Further supporting this view, Asbullah et al. (2022) reviewed literature on FDI determinants, emphasizing that high inflation erodes returns on investments, leading to reduced FDI inflows.

However, Maulidiyah and Fuddin (2024) presented a contrasting view in their study of five ASEAN countries (Indonesia, Malaysia, Vietnam, Laos, and Cambodia) over 20 years, finding that inflation positively affected FDI inflows in these countries. This divergence suggests that the effect of inflation on FDI may differ based on regional and economic contexts. Given the majority of findings, this study proposes the following hypothesis: Inflation rate is negatively associated with foreign direct investment inflows in the EAC.

Research methodology

This section outlines the data collection process, target population, and sample selection procedure.

Data and study period

This study utilizes yearly base data sourced from the World Bank's database, focusing on six key variables: Foreign direct investment (FDI) inflows, political stability and absence of violence (PS), economic growth (GDP), trade openness (TO), exchange rate (ER), and inflation rate (Inf). FDI and GDP data are kept in absolute numerical values without scaling, while TO, ER, and Inf are expressed as percentages or ratios. The analysis spans

from 2013 to 2022, chosen based on data availability. The data can be freely downloaded in Excel format from the World Bank's website.

Sample size

The population for this study includes all eight member countries of the EAC region. However, South Sudan is dropped from the sample due to limited data availability on adopted economic indicators i.e., GDP, inflation rate, and trade openness. Consequently, the final sample comprises seven countries—Congo, Burundi, Kenya, Rwanda, Somalia, Uganda, and Tanzania—representing 87% of the target population (Musse et al., 2024).

Methodology

The study employs a balanced panel data, a cross-sectional time-series dataset. It also known as longitudinal data (Musse et al., 2024). This approach is advantageous as it increases the sample size and enhances the ability to analyse changes over time with the purpose of identifying the factors affecting foreign direct investment inflows, specifically examining the impact of political stability, economic growth, trade openness, exchange rate, and inflation rate on FDI inflows of the EAC. The study utilizes pooled ordinary least squares (OLS), random and fixed effects models. Diagnostic tests are performed to determine the most suitable model. The Breusch-Pagan Lagrange Multiplier (LM) test is used to choose between the random effects model and pooled OLS, while the Hausman test assists in selecting between fixed and random effects models (Gujarati, 2009). Based on these diagnostics, three models are formulated for analysis.

Model 1: Pooled OLS

$$FDI_i = \beta_0 + \beta_1 \mathrm{PS}_{i1} + \beta_2 \mathrm{GDP}_{i2} + \beta_3 \mathrm{TO}_{i3} + \beta_4 \mathrm{ER}_{i4} + \beta_4 \mathrm{Inf}_{i4} + \varepsilon_i$$

Model 2: Random Effects Model

$$FDI_i = \beta_0 + \beta_1 \mathrm{PS}_{i1} + \beta_2 \mathrm{GDP}_{i2} + \beta_3 \mathrm{TO}_{i3} + \beta_4 \mathrm{ER}_{i4} + \beta_4 \mathrm{Inf}_{i4} + \mu_{it} + \varepsilon_i$$

Model 3: Fixed Effects Model

$$FDI_i = \beta_0 + \beta_1 \mathrm{PS}_{i1} + \beta_2 \mathrm{GDP}_{i2} + \beta_3 \mathrm{TO}_{i3} + \beta_4 \mathrm{ER}_{i4} + \beta_4 \mathrm{Inf}_{i4} + \mu_{it} + \varepsilon_i$$

Where $\mu_{it} + \varepsilon_i = \omega_{it}$. ω_{it} is the error component which consists of cross-section error component and time series error component (Gujarati, 2009).

Table 1 summarizes the variable names, symbols, and their corresponding measurements

Variable Names	Symbols	Measurements
Foreign direct investment inflows	FDI	It is referred to direct equity investment flows in the economy.
Political stability and the absence of violence	PS	It assesses the likelihood of PS. The percentile rank represents the country's standing relative to all other countries, with 0 indicating the lowest rank and 100 representing the highest.
Gross domestic product	GPD	It is calculated by dividing the gross domestic product by the midyear population.
Trade openness	TO	It is the total of exports and imports as a percentage of GDP.
Exchange rate	ER	It is the exchange rate that is set by national authorities, calculated as an annual average derived from monthly averages.
Inflation rate	Inf	It is the annual growth rate of the GDP implicit deflator, reflects the overall rate of price change within the economy.

Source: World bank database: World Development Indicators

Results

Descriptive statistics

This section presents the descriptive statistics, covering the explanatory and response variables across the EAC. The variables analysed include FDI inflows, PS, GDP, TO, ER, and Inf. Table 2 displays the number of observations, means, standard deviations, and minimum and maximum values for each variable, based on a dataset comprising 70 observations per variable (Nigussie, 2016).

Table 2 Descriptive statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
FDI	70	715,000,000	534,000,000	55420.36	2,090,000,000
PS	70	18.02403	15.25695	0	52.35849
GDP	70	814.625	467.2208	216.8274	2099.302
TO	70	48.34875	18.84684	22.24029	95.83957
ER	70	4726.872	7810.882	86.12288	26009
Inf	70	6.635204	7.001374	-2.850859	43.06866

Source (s): Authors' calculation

FDI inflows within the region exhibit an average of 715 million USD, with a significant standard deviation of 534 million. The FDI values range from a minimum of 55.42 million USD to a maximum of 2.09 trillion USD, indicating considerable volatility and variation in FDI levels across member states. This disparity can be attributed to a combination of political, economic, and social factors. Political stability and the absence of violence (PS) are measured by percentile rank, where 0 represents the lowest level of stability and 100 the highest. The region's average PS is 18.02, with a standard deviation of 15.26, reflecting notable disparities in political stability across member countries. Somalia ranks the lowest, with an average PS of 1.89, attributed to internal conflicts, terrorism attacks, and tensions between the central and state governments. The Congo follows closely, with an average PS of 4.83, due to ongoing internal civil and political instability. Rwanda, in contrast, exhibits the highest average PS at 46.69, surpassing 50 percent in 2018 and 2021, demonstrating strong political stability and serving as a model for the region. Tanzania ranks second, with a PS average of 30.64, reflecting relatively stable governance. The average GDP per capita for the EAC is 814.63 USD, with a standard deviation of 467.22. GDP values range from 216.83 USD to 2,099.30 USD, illustrating significant disparities in economic growth across the region.

Trade openness (TO) averages 48.35 percent of GDP, with a standard deviation of 18.85 percent. The minimum TO is 22.24 percent, while the maximum is 95.84 percent, indicating substantial differences in trade openness levels across the region. Exchange rates show significant variation, with an average of 4,726.87 per USD and a high standard deviation of 7,810.88. Exchange rates range from 86.12 per USD to 26,009 per USD, highlighting the differences in currency strength and valuation across the member states. Inflation rates within the region average 6.64 percent, with a standard deviation of 7.00 percent. The inflation rates range from -2.85 percent to 43.07 percent, pointing to considerable inflationary volatility in the region. This analysis highlights the significant diversity in economic performance, political stability, and macroeconomic conditions across the EAC members, reflecting both opportunities and challenges for the region.

Correlation Matrix and Multicollinearity Analysis

The correlation coefficient varies from -1 to +1, with -1 indicating a perfect negative correlation, +1 representing a perfect positive correlation, and 0 signifying no correlation (Team, 2024). The table also includes the findings of the multicollinearity test, which employs the Variance Inflation Factor (VIF) to identify any multicollinearity among the explanatory variables. (Oliveira et al., 2022). Multicollinearity arises when explanatory variables are highly correlated, potentially skewing the accuracy of regression estimates. The VIF measures the extent to which the variance of a regression coefficient is inflated due to this multicollinearity (Hair et al., 2018).

In the test results, the exchange rate (ER) has the highest VIF at 1.64, indicating a relatively low level of multicollinearity compared to typical thresholds. Inflation (Inf) shows the lowest VIF at 1.06. The average VIF for the variables is 1.45, indicating that overall, the multicollinearity among the independent variables is modest. This level of correlation does not require any corrective action, as it is within acceptable limits for regression analysis. Overall, the correlation matrix and VIF analysis confirm that while some relationships exist between the variables, multicollinearity is not significant enough to impact the reliability of the regression model.

Table 3 Correlation matrix & multicollinearity analysis

Variables	ln_FDI	ln_PSP	ln_GDP	ln_TO	ln_ER	ln_Inf	VIF
ln_FDI	1						
ln_PS	0.1037	1					1.53
ln_GDP	0.6269	0.3978	1				1.53
ln_TO	0.4159	-0.469	-0.1132	1			1.46
ln_ER	-0.0325	-0.3886	-0.504	0.3808	1		1.64
ln_Inf	-0.0355	-0.1067	-0.0861	0.1167	-0.0803	1	1.06
Mean VIF							1.45

Source (s): Authors' calculation

Regression analysis

This section presents the regression analysis conducted to assess the determinants of FDI in EAC. To achieve this objective, the study utilizes panel methods, including pooled OLS, fixed effects, and random effects. The focus is particularly on examining the impact of PS on FDI inflows, alongside other key variables i.e., GDP, TO, ER, and inf, covering the period from 2013 to 2022. Table 4 presents the regression results for the various models. The pooled OLS model shows an R-squared value of 0.6652 and an adjusted R-squared of 0.6368, indicating a strong fit to the data. This suggests that 66.52% of the variation in FDI inflows can be attributed to the independent variables. In contrast, the random effects model has an overall R-squared value of 0.6302, while the fixed effects model yields an R-squared value of 0.2558. These findings indicate that 63.02% and 25.58% of the changes in FDI inflows can be explained by the explanatory variables in the random and fixed effects models, respectively (Musse et al., 2024). The Breusch-Pagan Lagrange Multiplier (LM) test indicates that the random effects model is more suitable than the pooled OLS, with a p-value of 0.0000, well below the 0.05 significance level. Additionally, the Hausman test yields a p-value of 0.3191, suggesting that the random effects model is preferable

over the fixed effects model. Therefore, the random effects model is chosen as the most appropriate method for analysing the impact of political stability and other economic factors on FDI inflows in the EAC region (Musse et al., 2024).

Table 4 Regression results

Models	Pooled OLS	Random effects Model	Fixed effects Model
Variables	FDI	FDI	FDI
C	-8.14212(-2.93) ***	-4.86765(0.91)	1.314532(0.17)
ln_PS	0.2170574(1.19)	0.4252577(1.39)	0.7098206(1.75) *
ln_GDP	2.423643(7.91) ***	1.836803(2.90) ***	2.099665(1.70) *
ln_TO	2.498292(5.21) ***	3.036188(4.99) ***	2.805573(4.01) ***
ln_ER	0.2595861(2.1) ***	0.011515(0.04)	-1.051927(1.28)
ln_Inf	0.002021(0.01)	-0.1130841(0.83)	-0.0612319(0.42)
R-squared	0.6652	0.6302	0.2558
Dj R-squared	0.6368		
Prob > F	0.0000	0.0000	0.0008
Mean VIF	1.45		
B-P-ML Test: Random Vs. Pooled	Prob > chibar2=0.0000		
Sigma_u		1.0203101	2.4065924
Sigma_e		0.83233066	0.83233066
Rho		0.60043171	0.89316393
F-Test			
Hausman-Test FE vs. RE		Prob>chi2 =0.3191	
Chosen Model		Random Effects Model	

Source (s): Authors' calculation

The random effects model reveals a positive but statistically insignificant correlation between political stability (PS) and foreign direct investment (FDI) inflows in the EAC. This outcome can be attributed to the region's diverse political landscape. While countries such as Kenya, Tanzania, Rwanda, and Uganda enjoy relatively stable political environments, the EAC also includes fragile states like Somalia, the Democratic Republic of Congo, and Burundi, which face political instability, ongoing civil conflicts, and violence and terrorism. This disparity in political stability across member states may explain the statistically insignificant effect, despite the overall positive trend.

While the findings suggest that the region can still attract FDI, they also underscore the vulnerability of economic development to various forms of political violence and instability (Okara, 2023). This result aligns with previous studies by Chandra and Handoyo (2020), Meressa (2022), and Maulidiyah and Fuddin (2024), all of which found a positive and significant relationship between PS and FDI inflows. However, it contradicts Le et al. (2023), who identified a negative and significant relationship between the two variables. Overall, the result supports the hypothesis that political stability is positively related with FDI flows in the EAC. Economic growth often serves as indicators of political stability, which is a crucial factor in attracting FDI. Investors seek environments where their capital is secure, regulatory frameworks are predictable, and the risk of policy reversals, conflicts, or expropriation is minimal. Therefore, foreign investors are generally hesitant to invest in politically unstable countries due to the associated risks (Takefman, 2022).

The results also indicate that GDP is positively and significantly correlated with FDI inflows in the EAC region under the random effect model. This indicates that economic growth is primary driver of FDI inflows, as robust economic performance instils confidence in foreign investors about market stability and profitability. This finding aligns with the conclusions of studies by Demirhan and Masca (2008), Ashurov et al. (2020), and Ghazalian (2023), all of which observed a similar positive and significant relationship between economic growth and FDI inflows, supporting the hypothesis that economic growth positively influences FDI inflows in the EAC.

In terms of trade openness, the random effect findings show a positive and significant correlation with FDI inflows among EAC member states. Trade openness enhances the transfer of technology, knowledge, and capital, contributing to economic growth by leveraging comparative advantages through exposure to international competition (Nketiah et al.,

2020). This result is consistent with the findings of Demirhan and Masca (2008) and Le et al. (2023), who also reported a positive and significant impact of trade openness on FDI inflows. However, it contradicts Mudiyanselage (2021), who found a negative and significant relationship between the two variables. Nonetheless, the current study supports the hypothesis that trade openness is positively associated with FDI inflows in the EAC.

Regarding the exchange rate, the random effect findings reveal a positive, insignificant relationship with FDI inflows in the EAC. Exchange rate fluctuations can encourage foreign investment by making domestic assets more affordable (Sadewa, 2000). This finding echoes Korsah et al. (2022), who found a positive and significant relationship between exchange rates and FDI inflows in West African regions, but it contrasts with Asiamah et al. (2018), who reported a negative relationship. The result supports the hypothesis that exchange rate movements are positively associated with FDI inflows in the EAC.

Finally, the inflation rate shows a positive but insignificant relationship with FDI inflows in the EAC, suggesting that moderate inflation can be attractive to investors, while only prolonged high inflation levels pose a risk to FDI inflows (Takefman, 2022). This finding is consistent with Maulidiyah and Fuddin (2024), who found that moderate inflation had a positive and significant effect on FDI inflows in five ASEAN countries. However, it contradicts Asiamah et al. (2018), who concluded that inflation negatively and significantly affects FDI inflows in Ghana. Finally, the findings offer insights into the complex relationships between FDI inflows and political stability, economic growth, trade openness, exchange rates, and inflation in determining FDI inflows to the EAC region.

Conclusion and Policy Recommendations

This study utilized panel data techniques to assess the effect of political stability and other macroeconomic variables on FDI inflows in the EAC between 2013 and 2022. The findings reveal that although political stability is positively correlated with FDI inflows, the relationship lacks a significance. This suggests that while political stability contributes to attracting investment, the region remains vulnerable to internal conflicts, war, terrorist attacks, and challenges in the orderly transfer of power. These persistent issues hinder the EAC's full potential to attract foreign investment. Economic growth, as measured by GDP, emerged as a significant driver of FDI, confirming that a robust economy fosters investor confidence. Trade

openness is significantly and positively linked to FDI inflows, highlighting its importance in facilitating technology transfer, capital, and knowledge into the region, thus driving economic development. Exchange rates show a positive but insignificant relationship with FDI inflows, indicating that currency fluctuations may encourage investment but are not a decisive factor in the EAC. Similarly, inflation displays a positive but insignificant correlation with FDI inflows, suggesting that while moderate inflation can attract investment, sustained high inflation could deter foreign investors.

The study recommends that the EAC should address the underlying causes of low political stability by promoting good governance, collaborating with faith-based organizations and religious leaders, and fostering conflict resolution and internal peace (UNDP, 2016). Prioritizing efforts to alleviate poverty, combat corruption, and provide equal opportunities for youth and marginalized communities is essential for creating a stable and inclusive environment, which is crucial for attracting FDI. Additionally, EAC member states should adopt policies that enhance trade openness and facilitate the movement of goods, services, and assets. In order to boost investor confidence and reduce uncertainties, member states should focus on maintaining stable exchange rates and controlling inflation within manageable levels. This will help mitigate the risks related with currency volatility and high inflation, making the region more attractive for foreign direct investment. The study also recommends that future research expand the sample size by including other Sub-Saharan African countries and consider additional factors, such as lending rates, that may influence FDI inflows. Comparative studies analysing stable countries separately from highly unstable ones could provide valuable insights. The future studies also should conduct comparative studies, analysing more stable countries as a category, while comparing the results of highly instability countries. The study emphasizes the future studies should include interviews as part of the research methodology can also provide deeper insights into the root causes of political instability, violence, and terrorism in EAC.

Funding: This study is funded by SIMAD University, Mogadishu, Somalia.

References

Asbullah, M.H., Shaari, M.S., Abidin, N.Z., & Radzi, S.N.J.M. (2022). Determinants of Foreign Direct Investment (FDI). *International Journal of Academic Research in Economics and Management and Sciences, 11*(3), 151–168.

Ashurov, S., Othman, A.H.A., Rosman, R.B. and Haron, R.B. (2020). The determinants of foreign direct investment in Central Asian region: A case study of Tajikistan, Kazakhstan, Kyrgyzstan, Turkmenistan and Uzbekistan (A quantitative analysis using GMM). *Russian Journal of Economics, 2020*(6), 162–176. https://doi.org/10.32609/j.ruje.6.48556.

Asiamah, M., Ofori, D., & Afful, J. (2019). Analysis of the determinants of foreign direct investment in Ghana. *Journal of Asian Business and Economic Studies, 26*(1), 56-75. https://doi.org/10.1108/JABES-08-2018-0057.

Bayoumi, T. (1996). Foreign Direct Investment and the Exchange Rate, Exchange Rate Movements and Their Impact on Trade and Investment in the APEC Region. *International Monetary Fund*, 1-68. https://doi.org/10.5089/9781557756008.084.

Bertrand, J., Lemoine, J., Negrea, D., & Perrin, C. (2024). Attracting foreign direct investments: how Economic Freedom, Strong Institutions, and the Rule of Law Make a Difference. *Atlantic Council for Freedom and Prosperity Center*. https://www.atlanticcouncil.org/in-depth-research-reports/report/attracting-foreign-direct-investments/.

BIS. (2015). Openness to trade: exports plus imports as a share of GDP, ranked against major competitors. *UK Department of Business, Innovation and Skills*. https://assets.publishing.service.gov.uk/media/5a75c35240f0b6488c78ec45/

Brada, J.C., Kutan, A.M., & Yigit, T.M. (2003). The effects of transition and political instability on foreign direct investment: Central Europe and the Balkans. ZEI Working Paper 28. https://hdl.handle.net/10419/39650.

Chandra, T.A., & Handoyo, R.D. (2020), Determinants of Foreign Direct Investment in 31 Asian Countries for the 2002-2017 Period. *Contemporary Economics, 14*(4), 563-578.

Demirhan, E., & Masca, M. (2008). Determinants of foreign direct investment flows to developing countries: a cross-sectional analysis. *Prague Economic Papers, 2008*(4), 356-369.

Fatehi-Sedeh, K., & Safizadeh, M.H. (1989). The Association between Political Instability and Flow of Foreign Direct Investment. *Management International Review, 29*(4), 4-13. https://www.jstor.org/stable/40227943

Ghazalian, P.L. (2024). Does Economic Growth Attract FDI Inflows? A Dynamic Panel Analysis. *Economies, 12*(1). https://doi.org/10.3390/economies12010001.

Gujarati, D.N. (2009). *Basic Econometrics*. Tata McGraw-Hill Education, Uttar Pradesh.

Hair, J.F., Black, W.C., Babin, B.J., & Anderson, R.E. (2018). *Multivariate Data Analysis (8th ed.)*. Pearson Education.

Islam, M.S., & Beloucif, A. (2023). Determinants of Foreign Direct Investment: A Systematic Review of the Empirical Studies. *Foreign Trade Review, 59*(2), 309-337.

Kaufmann, D., Kraay, A., & Mastruzzi, M. (2010). The Worldwide Governance Indicators: Methodology and Analytical Issues. *World Bank Policy Research Working Paper No. 5430*. https://ssrn.com/abstract=1682130.

Kaufmann, D., & Kraay, A. (2023). *Worldwide Governance Indicators 2023 Update*. www.govindicators.org.

Korsah, E., Amanamah, R.B., & Gyimah, P. (2022). Drivers of foreign direct investment: New evidence from West African regions. *Journal of Business and Socio-economic Development*, (Ahead-of-print). https://doi.org/10.1108/JBSED-12-2021-0173.

Le, A.N.N., Pham, H., Pham, D.T.N., & Duong, K.D. (2023). Political stability and foreign direct investment inflows in 25 Asia-Pacific countries: The moderating role of trade openness. *Humanities and Social Sciences Communications, 606*(10), 1-9 https://doi.org/10.1057/s41599-023-02075-1

Maulidiyah, I.N., & Fuddin, M.K. (2024). The Role of Performance Political Stability and Macroeconomic Attracting Foreign Direct Investment in ASEAN. *Ekuilibrium: J Ilmiah Bidang Ilmu Ekonomi, 19*(1), 107-121.

Meressa, H.A. (2022). Determinants of foreign direct investment inflows to COMESA member countries: an integration of institutional and socio-economic factors. *Journal of Innovation and Entrepreneurship, 68*(11), 1-16. https://doi.org/10.1186/s13731-022-00262-z.

Mudiyanselage, M.M.R., Epuran, G., & Tescașiu, B. (2021). Causal Links between Trade Openness and Foreign Direct Investment in Romania. *Journal of Risk and Financial Management, 14*(3), 1-18. https://doi.org/10.3390/jrfm14030090.

Musse, O.S.H., Sharofiddin, A. and Mohamed, M.A. (2024), "The impact of external debt stock on economic growth: ethical dilemmas and evidence from East African community bloc", International Journal of Ethics and Systems, Vol. ahead-of-print No. ahead-of-print. https://doi.org/10.1108/IJOES-06-2024-0178

Nigussie (2016), "The Effect of Exchange Rates on Economic Growth in Ethiopia", A Thesis Submitted for the Degree of Master of Science in Development Economics, Saint Mary's University. DOI: http://repository.smuc.edu.et/bitstream/123456789/3804/1/the%20effect%20of%20exchange%20rates%20on%20economic%20growth%20in%20ethiopia.pdf

Nketiah, E., Cai, X., Adjei, M., & Boamah, B.B. (2020), Foreign Direct Investment, Trade Openness and Economic Growth: Evidence from Ghana. *Open Journal of Business and Management, 8*(1). https://doi.org/10.4236/ojbm.2020.81003.

Okara, A. (2023). Does foreign direct investment promote political stability? Evidence from developing economies. *Economic Modelling, 123*(1), 106249, https://doi.org/10.1016/j.econmod.2023.106249.

Oliveira, L. K., Mello, C. A., Carneiro, C. M. O., Costa, T. E. R., Araújo, G. G. F. and Maia, M. L. A. (2022), "Identification of factors that influence the delivery fee pricing of on-demand delivery services", Frontiers in Future Transportation, Frontiers Media SA. DOI: https://doi.org/10.3389/ffutr.2022.1031021

Oner, C. (2024). *Inflation: Prices on the Rise, IMF's Finance Department*. International Monetary Fund. https://www.imf.org/en/Publications/fandd/issues/Series/Back-to-Basics/Inflation.

Othman, A. H. A. (2022), "The Role of Economic Freedom, Governance, and Business Environment in Attracting Foreign Direct Investment in the Arab Region", Arab Monetary Fund. https://www.amf.org.ae/en/publications/economic-studies/role-economic-freedom-governance-and-business-environment-attracting

Ozbozkurt, O.B., & Satrovic, E. (2019). Macropolitical stability and absence of violence/terrorism and foreign direct investments: Panel analysis. *The Journal of Social Sciences, 36*(6), 182-191.

Sadewa, P.Y. (2000), *The effect of exchange rate on foreign direct investment*. Purdue University. https://docs.lib.purdue.edu/dissertations/AAI3017862/.

Saurav, A., & Kuo, R. (2020). The Voice of Foreign Direct Investment Foreign Investor Policy Preferences and Experiences in Developing Countries. World Bank Group, Competitiveness and Innovation Global Practice. *Policy Research Working Paper 9425*. https://documents.worldbank.org/en/publication/documents-reports/documentdetail/587821601988275007.

Takefman, B. (2022). How does inflation affect FDI? Research FDI. https://researchfdi.com/resources/articles/how-does-inflation-affect-fdi/.

Tan, L., Xu., Y., & Gashaw, A. (2021). Influence of Exchange Rate on Foreign Direct Investment Inflows: An Empirical Analysis Based on Co-Integration and Granger Causality Test. *Mathematical Problems in Engineering*, *2021*, 1-12.

Team, W. (2024). Correlation Matrix. https://www.wallstreetmojo.com/correlation-matrix/.

Tegegne, H. G. (2024), "Outward looking foreign direct investment and its determinants in highly indebted Eastern African countries", *PLoS ONE, 19*(2): e0297142. DOI: https://doi.org/10.1371/journal.pone.0297142.

UNDP (2016). Preventing Violent Extremism Through Promoting Inclusive Development, Tolerance and Respect for Diversity: A development response to addressing radicalization and violent extremism. *https://www.undp.org/publications/preventing-violent-extremism-through-inclusive development-and-promotion-tolerance-and-respect-diversity.*

Weerachai, S. (2024), "Political Stability as a Driver of Economic Development: Empirical Evidence from Southeast Asia and Thailand", Research paper submitted in part-fulfilment of the master's degree in public policy, Graduate School of Public Policy, University of Tokyo. DOI: https://www.pp.u-tokyo.ac.jp/wp - content/uploads/2016/02/Political-Stability-as-a-Driver-of-Economic-Development-Empirical-Evidence-from-Southeast-Asia-and-Thailand.pdf

Wiredu, J., Nketiah, E., & Adjei, M. (2020). The Relationship between Trade Openness, Foreign Direct Investment and Economic Growth in West Africa: Static Panel Data Model. *Journal of Human Resource and Sustainability Studies, 8*(1). DOI: 10.4236/jhrss.2020.81002.