



Political Stability and Ease of Doing Business: Implications for Financial Sector Development in East Africa

Abraham Charles Nathanael^{1*}

Received 04/11/2025

Accepted : 21/12/2025

Published : 31/12/2025

<https://doi.org/10.52919/arebus.v6i2.112>

ABSTRACT

This study analyses the influence of political stability and ease of doing business on financial sector development in six East African countries. Focusing specifically on foreign direct investment inflows and domestic credit to the private sector, the research examines how established conditions shape financial deepening in a region characterized by dynamic yet uneven economic progress. A panel dataset that covering from 2008 to 2024 was collected, utilizing pooled OLS, fixed effects, and random effects strategies for quantitative examination. The Hausman test informed model selection to ensure robustness and address country-specific heterogeneity. The findings indicates that political stability significantly attracts FDI in cross-country comparisons, though its effect diminishes within countries over time. Conversely, it positively influences domestic credit extension when controlling for unobserved country effects. Ease of doing business robustly promotes FDI across all models, but its effect on domestic credit is inconsistent, suggesting deeper structural constraints in local financial systems. The results highlight the importance of political stability as a precondition for attracting foreign investment and of regulatory reforms in lowering transaction costs, while also underscoring the structural limitations of East Africa's domestic credit markets. The study contributes to the finance and development literature by contextualizing institutional and regulatory drivers of financial deepening in low-income, high-potential economies and offers policy recommendations for strengthening governance and financial intermediation. This study extends the finance governance nexus by providing new empirical evidence on how political stability and regulatory quality jointly shape financial deepening in East Africa an under-explored institutional context.

Keywords: Ease of Doing Business, Financial Sector Development, Political Stability

JEL Codes: O16, O17, G20, L51, H11

How to cite this article

Nathanael, A. C. (2025). Political stability and ease of doing business: Implications for financial sector development in East Africa. *Advanced Research in Economics and Business Strategy Journal*, 6(2), 391-406. <https://doi.org/10.52919/arebus.v6i2.112>

¹ Assistant Lecturer, Tanzania Institute of Accountancy, Department of Accounting and Finance. charlesabraham39@gmail.com

This work is an open access article, licensed under a [CC BY 4.0](https://creativecommons.org/licenses/by/4.0/)

1. INTRODUCTION

Financial sector development is widely acknowledged as a fundamental driver of economic transformation, capital allocation, and poverty alleviation across nations both developed and developing (M. Khan & Majeed, 2023). The evidence suggests a more complex relationship (Bijlsma et al., 2017) found that in a logarithmic specification, a 10% increase in private sector credit increases economic growth by only 0.09 percentage points. Cournéde & Denk (2015) further cautions that at current credit levels, further expansion may actually slow growth.). Yet, Sub-Saharan Africa's financial sector remains critically underdeveloped, with domestic credit to the private sector significantly lagging behind other developing regions (Asongu & Odhiambo, 2022).

East Africa's financial systems demonstrate significant structural weaknesses, characterized by shallow credit markets, limited financial inclusion, and inefficient intermediation. Multiple studies substantiate this assessment reveal that that private sector credit remains low relative to comparator countries, with government borrowing and poverty constraining credit expansion (Ndanshau & Semu, 2023). Less than a quarter of African adults historically had formal financial institution accounts, though this is rapidly changing. Multiple authoritative sources confirm this low financial inclusion rate (Klapper & Singer, 2015; Mani et al., 2024). However, recent data reveals significant progress: by 2018, financial inclusion in Sub-Saharan Africa had risen to 43%, with some countries like Kenya, Tanzania, and the Democratic Republic of Congo more than doubling their inclusion rates in just six years (Bille et al., 2018). This suggests a transformative period of financial access expansion, likely driven by digital financial services. Wokabi & Fatoki (2019) further highlighted that rural population and income levels significantly impact financial inclusion, with rural populations negatively correlating with financial system development. These combined features highlight that the development of the financial sector in East Africa is not simply beneficial but essential for sustained and inclusive economic growth.

However, the region's progress is constrained by intertwined institutional and structural challenges, including political volatility, regulatory inefficiency, and barriers to private enterprise. Political instability continues to pose significant economic costs according to the Worldwide Governance Indicators (2024), the average political stability index in EAC countries (-0.73) falls below the Sub-Saharan African mean (-0.46), reflecting elevated risks of policy uncertainty and conflict. Such instability erodes investor confidence, restricts long-term lending, and deters cross-border capital flows. Empirical studies affirm that a one-unit improvement in governance quality is linked to a significant increase in financial sector depth (Agyapong et al., 2025).

Political instability in the East African Community (EAC) significantly undermines economic growth by eroding investor confidence and disrupting capital flows. Multiple studies provide robust evidence of this economic toll. Achar et al., (2024) found that political stability critically moderates the relationship between capital formation and economic growth, emphasizing the need to prioritize political landscape management. Eshete (2018) demonstrated that political instability indices statistically significantly contribute to illicit capital flight, with poor governance and economic policies favouring foreign investors over local ones. Orayo &

Mose (2016) further confirmed that political instability negatively affects economic growth rates, recommending investments in institutions that foster national cohesion and reduce violence. These studies consistently show that political uncertainty creates a hostile investment environment, restricting long-term financing and cross-border capital movements in the EAC region.

Political stability, nonetheless, cannot independently guarantee financial advancement. Its influence is largely conditioned by the ease of doing business (EDB) a reflection of the quality of regulatory institutions, administrative efficiency, and the openness of market entry procedures (Vogiatzoglou, 2016). Research indicates that the considerable administrative and procedural barriers confronting firms in East Africa systematically divert managerial attention away from productivity and innovation and toward compliance (Atwine et al., 2023; Drinkwater & Robinson, 2023). Weak contract enforcement, opaque taxation, and limited creditor rights constrain entrepreneurship and undermine credit market efficiency (Chletsos & Sintos, 2024). Conversely, transparent regulatory environments are associated with broader access to credit, higher savings mobilization, and enhanced integration between the financial and real sectors (Mwakalila & Kasongwa, 2024).

Despite this critical interdependence, systematic empirical studies linking political stability and ease of doing business to financial sector development in East Africa remain scarce. Previous investigations have largely approached financial development as an outcome of macroeconomic stability (Khan, 2022; Nicolae et al., 2016; Tadesse & Abafia, 2019) or analysed political risk only in relation to foreign investment (Erkekoglu & Kiliçarslan, 2018; Janačković & Janačković, 2019; Kruja & Dragusha, 2016). Few have integrated these institutional dimensions into a unified analytical framework capable of explaining how governance and regulatory quality jointly foster or hinder financial deepening in the EAC.

Accordingly, this study investigates the interplay between political stability and ease of doing business, and their combined effect on financial sector development within East Africa. Utilizing panel data from the World Bank (2008–2024), it assesses how these institutional dynamics influence financial depth, intermediation efficiency, and credit accessibility across member economies. The study offers three core contributions. First, it provides region-specific empirical evidence addressing a critical gap in African financial development literature. Second, it proposes an integrated institutional framework linking governance quality and regulatory facilitation to financial system performance. Third, it yields policy insights for strengthening financial resilience, improving investor confidence, and accelerating inclusive growth in East Africa.

The structural composition of this paper is organized as follows: the second section encompasses a comprehensive literature review, the hypothesized relationships, and the conceptual framework pertinent to the study; section three is dedicated to elucidating the methodological approach employed in this investigation; in part four, the results and discussions are articulated. The final section includes the conclusions and implications derived from findings of the study.

2. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

2.1.Theoretical Review

2.1.1 Law and Finance Theory

The Law and Finance Theory entail that the legal and regulatory environment plays a pivotal role in influencing the development of the financial sector. Specifically, this theory underscores that the robustness of legal frameworks including property rights, investor protection, and the enforcement of contracts dictates the efficacy of financial intermediation as well as the degree of financial inclusion (La Porta et al., 1997). Countries that have clear and reliable rules for business are generally better at drawing in both local and foreign investments, which helps in expanding financial markets (Beck & Levine, 2004; Loh, 2015). Considering East Africa, the ease approach of business operations is a sign of the strength of institutional arrangements that manage commercial endeavours, the efficiency of regulatory procedures, and the safeguards available for investors. A nurturing business context cuts down transaction costs, boosts cooperation between firms and their creditors, and supports financial organizations in granting credit with greater efficiency (Hou et al., 2024). Therefore, Law and Finance Theory serve as an invaluable framework for analysing how enhancements in regulatory efficiency and business environments may impact the advancement of the financial sector in the region.

2.1.2 Institutional and Political Economy Theories

Institutional and political economy frameworks entail the significance of governance frameworks and political stability in influencing economic and financial results (Acemoglu & Robinson, 2012; North, 1990). Effective political frameworks lower unpredictability, assure cohesive policies, and establish a stable setting that encourages long-term investment and financial facilitation (Chletsos & Sintos, 2024). In contrast, political instability exemplified by frail governance, recurrent policy shifts, or the potential for conflict erodes investor confidence and obstructs both domestic credit growth and foreign capital influx (Herrala & Ariss, 2013; Hussain & Shear, 2024). In uncertain institutional landscapes, monetary organizations could adopt conservative borrowing approaches, contributing to underdeveloped financial sectors. In the context of East Africa, where political volatility persists as a significant obstacle, the application of Institutional and Political Economy frameworks reinforces the assertion that stable governance is essential for the vigorous development of the financial sector. This theoretical lens directly guides the study's exploration of political stability as a pivotal factor influencing financial deepening within the region.

While the law and finance theory explains the microeconomic mechanisms of how regulations influence financial decisions, Institutional and Political Economy Theories explain the macro-institutional pre-condition of political stability necessary for those mechanisms to function. This study posits that the ease of doing business (EDB) drives financial development, while maintaining political stability is critical for the reliability and performance of those supportive policies.

2.2. Empirical Review

2.2.1 Political Stability and Financial Sector Development

The relationship between political stability has been discussed and noticed by various studies conducted in different economic contexts. However, literature entails that an economy

with stable political contexts creates an enabling environment for financial institutions to operate effectively. Stable governments tend to attract and protect investors, to enforce property rights, and ensure contract enforcement, thereby reducing uncertainty in credit markets (Kiptoo, 2024). On the other side of the coin, political instability brings higher capital flight, default risks, weaken institutions (Abdullah et al., 2022; Nguyen et al., 2025). Empirically, Chletsos & Sintos (2024) analyzed 123 countries from 1980-2017, finding that heightened political stability substantially fosters financial development, with effects particularly pronounced in countries with greater government effectiveness, financial liberalization reforms, and democratic structures. However, the direction of causality may vary by context, as Zehra (2019) found evidence of causality running from financial development to political stability in Turkey using data from 1970-2017. The research conducted by Ullah et al., (2024) reveals that political stability (PS) maintains a clear relationship with financial development (FD) in emerging economies, thereby affecting financial institutions and markets. Nonetheless, high political stability can decrease financial market efficiency, necessitating regulatory attention in stable contexts. Yildirim & Akdag (2023) concluded that increased political stability correlates with enhanced financial sector development in Sub-Saharan Africa, indicating that stable political environments strengthen financial institutions. However, the East African context remains underexplored, despite persistent challenges of political volatility and regulatory inefficiencies. Building on these insights, this study posits the following testable hypothesis.

H₁: Political stability positively influences financial sector development in East Africa.

2.2.2 Ease of Doing Business and Financial Sector Development

The EDB index is a significant indicator of a nation's regulatory and institutional quality, influencing the business and investment climate. A robust body of literature establishes a positive interplay between EDB and financial sector development, operating primarily through two channels: attracting foreign capital and enhancing domestic credit.

A primary mechanism is through attracting Foreign Direct Investment (FDI). Consistently, studies reveal that improvements in EDB are a significantly determine FDI inflows. For instance, in developing countries, key indicators like resolving insolvency and efficient tax administration are particularly impactful (Femina et al., 2022; Xu et al., 2023). This relationship is further nuanced by the moderating role of EDB on FDI restrictions (Naushahi & Rehman, 2024). The evidence from Sub-Saharan Africa underscores this; Amponsah & Sarpong (2020) quantified that a 1% improvement in the “starting a business” indicator leads to a 0.79% increase in FDI.

Beyond FDI, EDB is intrinsically linked to the depth and efficiency of the domestic financial system, particularly through domestic credit to the private sector (DCPS). Antoine (2021) revealed a positive and significant correlation between EDB and DCPS, arguing that improved access to credit is a catalyst for entrepreneurship. This two-way relationship is reinforced by Deda et al., (2024), who found that DCPS itself has a statistically significant positive influence on EDB, suggesting a virtuous cycle where financial development and a better business environment reinforce each other. Ultimately, this synergy contributes to broader economic welfare, as ease of doing business can both substitute for and complement private sector credit depending on the economic context (Ofori-Sasu et al., 2023).

This global research indicates vital outcomes for developing territories, particularly East Africa, which aspires to elevate its investment and financial landscapes. Examining East Africa

reveals that its advantages stem from the complex interactions of regulatory success, foreign direct investment (FDI), and credit accessibility. Consequently, the following hypothesis is formulated.

H₂: Ease of doing business positively influences financial sector development in East Africa.

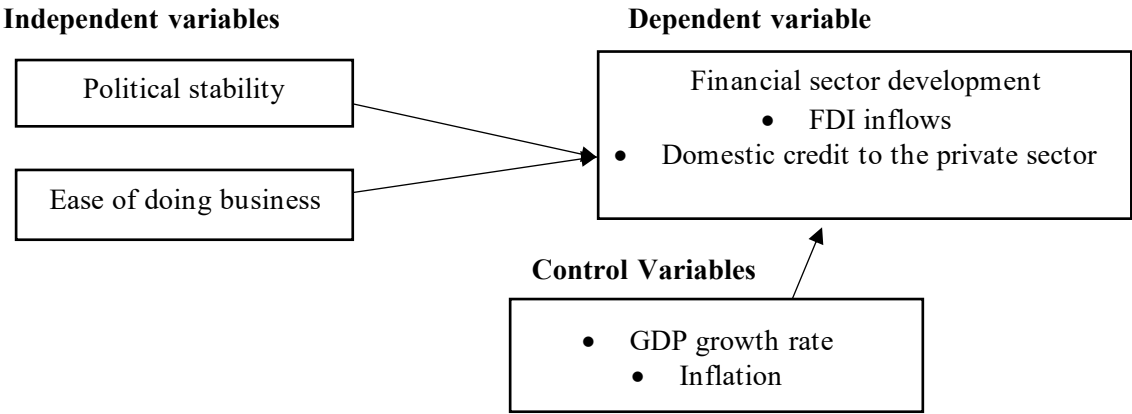


Figure 1. Research Framework

Source: Author (2025)

The focus of this study is to examine how financial sector development is influenced by political stability and ease of doing in East Africa. In this study, financial sector development is approximated through two widely recognized measures: Foreign Direct Investment (FDI) Inflows (net inflows as a percentage of GDP), capturing the extent of international capital mobilization, and Domestic Credit to the Private Sector credit to private businesses as a percentage of GDP, indicating the degree of financial intermediation and domestic financial depth. Derived from the World Bank's WDI database, both metrics ensure consistency and comparability among East African economies.

To strengthen the empirical model, the study incorporates key control variables that are known to influence financial development: GDP Growth Rate proxy for overall economic performance, inflation indicator of macroeconomic stability and services value added (% of GDP) reflecting the role of the services sector in economic transformation and financial activity.

The hypothesized model (Figure 1) posits that political stability and ease of doing business positively affect financial sector development, while the control variables account for macroeconomic and structural dynamics influencing financial flows and intermediation.

3. METHODOLOGY

This research utilizes a quantitative framework with a balanced panel dataset from six East African Countries (Tanzania, Kenya, Uganda, Burundi, Rwanda, and Ethiopia) spanning 2008–2024. The choice of East Africa is motivated by the region’s dynamic but uneven progress in financial sector development and the frequent institutional and structural challenges that affect economic performance. The timeframe of 2008–2024 encompasses significant regional integration efforts, business reform initiatives, and political stability since the 2000s, enabling thorough variable analysis. Furthermore, this period offers the most complete and

reliable data available for all member states, minimizing gaps that could arise from including countries with shorter membership or periods of significant conflict.

Secondary data were sourced from the World Bank's World Development Indicators and Trading Economics. Financial sector development is represented by FDI inflows (% of GDP) and domestic credit to the private sector (% of GDP), with political stability and ease of doing business as independent variables, and GDP growth and inflation as controls. Panel regression methodologies (pooled OLS, fixed effects, and random effects) were utilized, with the Hausman test informing the selection of the model. The chosen methodology guarantees the recognition of differences between countries and the dynamics of time, thus delivering significant insights regarding the influence of political stability and regulatory efficiency on the financial sector's evolution in East Africa.

Model Specification

The general panel regression models are specified as follows;

$$FDI_{it} = \beta_0 + \beta_1 PS_{it} + \beta_2 EDB_{it} + \beta_3 GDP_{it} + \beta_4 INFL_{it} + \epsilon_{it} \dots \dots i$$

$$DC_{it} = \beta_0 + \beta_1 PS_{it} + \beta_2 EDB_{it} + \beta_3 GDP_{it} + \beta_4 INFL_{it} + \epsilon_{it} \dots \dots ii$$

$$FSD_{it} = \alpha_i + \beta_1 PS_{i,t-1} + \beta_2 EDB_{i,t-1} + \beta_3 GDP_{it} + \beta_4 INFL_{it} + \epsilon_{it} \dots \dots \dots iii$$

Where; FDI stands for foreign direct investment inflows of country i in year t ; DC stands for Domestic credit to the private sector of country i in year t ; PS stands for Political stability of country i in year t ; EDB stands for ease of doing business of country i in year t ; GDP stands for gross domestic product growth rate of country i in year t ; INFL stands for inflation of country i in year t ; and ϵ_{it} stands for Idiosyncratic error term.

Table1. Description of Variables and Data Sources

Variables	Description	Measurement	Expected sign	Data Source
Dependent Variable				
Foreign Direct Investment Inflows (FDI) (Dependent)	Cross-border capital investments where an investor establishes a lasting interest in an enterprise operating in another economy	Net inflows (% of GDP)	N/A	World Bank Group
Domestic Credit to Private Sector (DCPS) (Dependent)	Financial resources provided by banks and other institutions to private firms for investment and expansion	Domestic Credit to Private Sector (DCPS)	N/A	World Bank Group
Independent Variables				
Political Stability (PS) (Independent)	Political Stability and Absence of Violence/Terrorism index from WGI	A scale from - 2.5 (weak) to +2.5 (strong).	Positive	World Bank Group
Ease of Doing Business (EDB)	Business regulations and their enforcement across economies.	Overall Doing Business index	Positive	Trading Economics

(Independent)					score (0–100 scale).			
Control Variables								
GDP Rate (%) (Control)	Growth	Capture the effect of economic performance.			GDP rate	growth	Positive	World Bank Group
Inflation (%) (Control)		Account for	macroeconomic stability		Inflation, consumer prices (annual %)		Negative	World Bank Group

Dependent Variables: Financial Sector Development (FSD)

FSD involves enhancing the financial sector's ability to allocate resources, provide services, manage risk, and drive economic growth. However, the development of the financial sector represents a complex, multifaceted phenomenon. This investigation utilizes two distinct proxies to encapsulate its various dimensions. Inflows of Foreign Direct Investment (FDI) as a percentage of GDP serve to assess the economy's allure for international investors, functioning as a gauge of external confidence in the financial and institutional robustness of the nation (Simachenya & Haabazoka, 2025).

Meanwhile, Domestic Credit to the Private Sector (DCPS) expressed as a percentage of GDP quantifies the extent of financial intermediation and the efficacy of the banking sector in redirecting domestic savings towards productive private investments, thereby reflecting the internal progression of the financial system (Simachenya & Haabazoka, 2025). Data pertaining to both variables are derived from the World Bank's World Development Indicators (WDI).

Independent Variables

The principal independent variables encapsulate fundamental dimensions of institutional quality. Political Stability (PS) is quantified utilizing the Worldwide Governance Indicators (WGI) index, which encapsulates perceptions concerning the probability of political instability and violence. An elevated score denotes a more stable environment, which is posited to diminish investment risk and cultivate financial development (Yildirim & Akdag, 2023; Zehra, 2019).

The Ease of Doing Business (EDB) is represented by its historical score, which aggregates metrics pertaining to the regulatory ease for business operations (e.g., initiating a business, procuring credit, enforcing contracts). A higher score signifies a more favorable business environment, which diminishes transaction costs and is vital for the advancement of the financial sector (Amponsah & Sarpong, 2020; Xu et al., 2023).

Control Variables

To delineate the impact of the independent variables, two pivotal macroeconomic factors are accounted for. The annual GDP Growth Rate (%) is incorporated, as economic growth intrinsically stimulates demand for financial services and can affect investment inflows (Ghazalian, 2023; Levine, 1997; Rahman & Alam, 2021). Inflation, represented as the annual percentage change in consumer prices, is controlled for due to its potential to undermine the real value of financial assets, engender uncertainty, and distort financial decision-making,

thereby obstructing financial deepening (Ibrahim et al., 2022; Zermeno et al., 2018). Data for these control variables are likewise sourced from the WDI database.

4. RESULTS AND DISCUSSION

This section presents and discusses the empirical findings on the relationship between political stability and ease of doing business, and financial sector development in East Africa, drawing on the estimated regression results.

4.1 Descriptive statistics

Table 2. Descriptive Statistics

Constructs	Obs.	Mean	Std.d ev	Min	Max	Skewness	Kurtosis
FDI inflows	102	2.42	1.69	-.01	8.12	0.67	3.29
Domestic credit to the private sector	102	19.78	7.84	11.16	48.77	1.49	5.03
Political Stability	102	-.94	0.63	-2.18	.10	0.03	1.95
Ease of Doing Business	102	116.66	42.75	29	177	-0.65	2.24
GDP Growth Rate	102	5.59	2.96	-3.9	12.55	-0.38	3.89
Inflation	102	10.05	8.48	-2.82	44.36	1.59	5.59

Source: Author (2025)

Table 2 above provides a summary of the central tendency, dispersion, and distribution of the key variables for 102 country-year observations in East Africa. The mean value for Foreign Direct Investment (FDI) inflows is positive (2.42), indicating a general trend of net investment into the region, though the high standard deviation (1.69) reveals significant volatility and disparity across countries and years. Similarly, Domestic Credit to the private sector shows a mean of 19.78% of GDP, suggesting active financial intermediation, but the wide range (11.16% to 48.77%) and high standard deviation (7.84) highlight substantial variation in financial depth across the region. The noted positive skewness highlights a dominant presence of significant values as opposed to smaller values for each variable.

The data confirms the challenging operational environment in the region. The negative mean for Political Stability (-0.94) squarely places the average East African country in this sample in the bottom half of global rankings, signifying pervasive issues with political risk and governance. This is compounded by a relatively poor ease of doing business score (mean of 116.66), indicating cumbersome regulations and weak institutions. While the average GDP Growth is strong at 5.59%, the minimum value of -3.9% shows the economy contracted in at least one period, likely due to a significant shock. Finally, the high average Inflation of 10.05% well above typical developing economy targets coupled with its very high standard deviation and positive skew, points to periods of severe macroeconomic instability and soaring price levels in some countries.

4.2 Unit Root Test

The study employed the Im-Pesaran-Shin (IPS) unit root test. The results as shown on table 3 reject the null hypothesis of a unit root for all variables at the 5% significance level,

with p-values under 0.05. This demonstrates that all series FDI Inflows, Domestic Credit, Political Stability, Ease of Doing Business, GDP Growth, and Inflation are stationary. Therefore, the variables maintain constant mean and variance over time, justifying their application in level form for regression analysis without concerns of spurious results due to non-stationarity.

Table 3. Panel Data Unit Root Test

Test	Variable(s)	Test Statistic	p-value	Decision (5% level)	Interpretation
Unit Root (IPS Test)	FDI Inflows	-2.87	0.002	Reject H_0	Stationary
	Domestic Credit	-1.45	0.014	Reject H_0	Stationary
	Political Stability	-3.21	0.001	Reject H_0	Stationary
	Ease of Doing Business	-2.95	0.002	Reject H_0	Stationary
	GDP Growth	-4.12	0.000	Reject H_0	Stationary
	Inflation	-3.56	0.000	Reject H_0	Stationary

Source: Author (2025)

4.3 Multicollinearity, Heteroscedasticity and Hausman Tests

Table 4. Multicollinearity, Heteroscedasticity and Hausman Tests

Test	Variables	Test Statistic	p-value	Decision (5% level)	Interpretation
Multicollinearity (VIF)	All Regressors	Mean VIF = 3.8	-	< 10 = OK	No serious multicollinearity
Heteroscedasticity		$\chi^2(1)$	0.135	Fail to reject H_0	No heteroscedasticity problem
Hausman Test (FE vs RE)	FDI model	$\chi^2 = 16.84$	0.00	Reject H_0	Fixed Effects model is preferred
	Credit model	$\chi^2 = 14.22$	0.04	Reject H_0	Fixed Effects model is preferred

Source: Author (2025)

The preliminary tests results shown on table 4 above indicates that the regression models are statistically robust and well-specified. The results show no serious multicollinearity among the independent variables (mean VIF = 3.8) and heteroscedasticity is not a concern in the model, confirming the reliability of the coefficient estimates. Furthermore, the Hausman tests for both the FDI and Credit models significantly rejected the null hypothesis, providing strong evidence that the Fixed Effects model is the appropriate and preferred choice to control for unobserved, time-invariant characteristics, thereby ensuring consistent and unbiased results.

4.4. Regression Analysis Results

Table 5. Regression Results

Variable	Pooled OLS	Fixed Effects (FE)	Random Effects (RE)	Pooled OLS	Fixed Effects (FE)	Random Effects (RE)
	FDI Inflows	FDI Inflows	FDI Inflows	Domestic credit to Private Sector	Domestic credit to Private Sector	Domestic credit to Private Sector
Political Stability	1.056** (0.330)	0.859*** (0.716)	0.946*** (0.557)	-6.007** (1.407)	5.591** (2.602)	0.235*** (0.171)
Ease of Doing Business	0.012** (0.004)	0.013** (0.008)	0.012** (0.007)	-0.093** (0.019)**	- (0.029)	0.075** (0.148)
GDP Growth Rate	0.114** (0.056)	-0.001** (0.065)	0.003** (0.019)	0.175* (0.238)	-0.142** (0.238)	0.065** (0.120)
Inflation	0.009* (0.021)	0.001* (0.02)	0.003*** (0.019)	0.059*** (0.090)	0.173** (0.737)	0.243* (0.126)
Constant	1.259** (0.021)	1.692** (1.075)	1.757* (1.014)	28.179** (2.579)	26.048* (3.910)	-0.812*** (0.528)
Observations	102	102	102	102	102	102
R-squared (Overall)	0.552	0.335	0.278	0.521	0.269	0.247
Number of Countries	6	6	6	6	6	6
Hausman Test (p-value)	-	0.000		-	0.037	

Source: Author (2025)

4.4.1 Political Stability and Financial Sector Development

The results on table 5 indicate that political stability exerts a significant and positive influence on FDI inflows in pooled OLS and random effects estimations, but its effect is insignificant in the fixed effects model. This suggests that cross-country differences in political stability are more important for attracting foreign investment than within country variations over time. This is consistent with the Institutional and Political Economy frameworks (Acemoglu & Robinson, 2012; North, 1990) which posit that reliable political institutions mitigate uncertainty, enhance investor trust, and facilitate financial development. Consistent with empirical studies Chletsos & Sintos (2024); Yildirim & Akdag (2023), our findings highlight that politically stable environments in East Africa provide the institutional guarantees necessary for foreign investors to commit resources.

For domestic credit to the private sector, political stability demonstrates mixed effects: negative under pooled OLS, but positive and significant under fixed and random effects. This pattern suggests that once unobserved country specific characteristics are controlled for,

political stability indeed strengthens the capacity of financial institutions to extend credit domestically. This is consistent with Abdullah et al., (2022); Nguyen et al., (2025), who found that political instability undermines lending capacity through higher risks of default and weakened institutional enforcement. Strong governance in East Africa facilitates capital influx and allows domestic banks to embrace larger credit risks, bolstering the financial system.

4.4.2 Ease of Doing Business and Financial Sector Development

The results for the ease of doing business (EDB) are robustly positive and significant in relation to FDI inflows across all model specifications. This confirms Law and Finance Theory La Porta et al., (1997), which emphasizes the role of efficient legal and regulatory systems in attracting investment. Empirical studies (Amponsah & Sarpong, 2020; Femina et al., 2022; Xu et al., 2023), similarly find that reforms in business procedures, tax systems, and insolvency frameworks directly encourage foreign capital inflows. In the East African context, improvements in EDB indicators such as contract enforcement and property registration appear to lower transaction costs and enhance investor confidence, making countries more attractive to multinational enterprises.

In contrast, the effect of EDB on domestic credit to the private sector is less consistent: negative and significant under pooled OLS, insignificant under fixed effects, but positive under random effects. These findings indicate that regulatory efficiency attracts foreign capital, yet domestic financial intermediation is hindered by structural issues in East Africa's credit systems. This observation is in line with Antoine (2021); Ofori-Sasu et al., (2023), who argue that while EDB can improve access to credit, its effectiveness depends heavily on the underlying strength of financial institutions.

5. CONCLUSION AND IMPLICATION

This study employed panel data to evaluate the impact of political stability and ease of doing business on financial sector development in East Africa. Financial development was proxied by foreign direct investment (FDI) inflows and domestic credit to the private sector, with GDP growth and inflation as controls. The results show that both political stability and ease of doing business significantly attract FDI, while their effects on domestic credit are less consistent and context-dependent. These findings support the study's hypotheses.

Theoretically, the results affirm Institutional and Political Economy frameworks by demonstrating that political stability fosters investor confidence and financial deepening. They also validate the Law and Finance Theory, showing that regulatory efficiency is critical in shaping capital flows. Empirically, the paper contributes by distinguishing between the institutional drivers of foreign investment and those of domestic credit, thereby contextualizing global theories within the realities of East Africa.

For the purpose of boosting financial sector development, East African policymakers should consider a combined strategy that reinforces both macro-institutional and micro economic frameworks. First and foremost, endeavours ought to center around advancing political stability with transparent governance and credible policies, because these elements attract foreign direct investment. Secondly, to convert a favourable business environment into a more substantial domestic credit market, foundational reforms must be enacted. These reforms should include fortifying collateral frameworks and property rights to enhance loan

accessibility, improving judicial efficiency for contract enforcement to mitigate lender risk, and augmenting creditor protections. Moreover, advancing regulatory alignment within the East African Community (EAC) ought to be a priority to cut down on cross-border transaction costs and invigorate regional investment, thereby guaranteeing that progress in business facilitation truly aids the financial sector.

This study presents multiple prospects for future studies. Future studies may integrate a broader selection of variables to depict financial evolution, such as stock exchange valuation or financial participation metrics, to deliver a more rounded assessment. To enrich the understanding of context-specific impacts on domestic credit, qualitative case studies or the introduction of moderator variables like economic informality or banking sector competition could prove insightful. Utilizing a longitudinal research design would also be advantageous to examine the evolution of the relationship between institutional quality and financial development over time, particularly as EAC regional integration intensifies.

In summary, a comparative exploration with other developing zones could facilitate the identification of the specific institutional catalysts and issues inherent to the East African landscape.

This study contributes to institutional finance theory by empirically confirming that governance quality enhances both external and internal dimensions of financial development, underscoring the policy priority of institutional coherence in emerging economies

REFERENCES:

- Abdullah, M., Chowdhury, M. A., Karmaker, U., & Fuszder, H. R. (2022). Role of the dynamics of political stability in firm performance: Evidence from Bangladesh. *Quantitative Finance and Economics*, 6(4), 518–536.
- Acemoglu, D., & Robinson, J. A. (2012). Why nations fail: The origins of power, prosperity, and poverty. Crown Business. *Journal of Southeast Asian Economies*, 29(2).
- Achar, P. N., Otieno, L. O., Ondigo, H. O., & Oleche, M. O. (2024). Moderating Effect of Political Stability on Gross Fixed Capital Formation and Economic Growth of East African Community Member States. *International Journal of Business & Economics (IJBE)*, 9(2). <https://doi.org/10.58885/ijbe.v09i2.54.an>
- Agyapong, E. K., Ohemeng, W., Astu, F., & Boateng, S. S. (2025). The financial system and socio-economic development among emerging economies of Sub-Saharan Africa. *African Journal of Economic and Management Studies*. <http://dx.doi.org/10.1108/AJEMS-05-2024-0279>
- Amponsah, E. N., & Sarpong, B. (2020). Ease of Doing Business and Foreign Direct Investment: Case of Sub-Saharan Africa. *International Advances in Economic Research*, 26, 209–223.
- Antoine, N. (2021). Investigating Factors Related to Easy of Doing Business Score in Asian Countries. *Management and Economics Journal*, 5(1).
- Asongu, S., & Odhiambo, N. (2022). Financial Access and Value Added in Sub-Saharan Africa. *Social Science Research Network*. <https://doi.org/10.1177/00438200221080998>
- Atwine, B., Okumu, I. M., & Nyanzi, J. B. (2023). What drives the dynamics of employment growth in firms? Evidence from East Africa. *Journal of Innovation and Entrepreneurship*, 1–25. <https://doi.org/10.1186/s13731-023-00295-y>

- Beck, T., & Levine, R. (2004). *Legal Institutions and Financial Development*. <http://www.nber.org/papers/w10417>
- Bijlsma, M., Kool, C., & Non, M. (2017). The effect of financial development on economic growth: A meta-analysis. *Applied Economics*. <https://doi.org/10.1080/00036846.2018.1489503>
- Bille, F. S., Buri, S., Crenn, T., Denyes, L., & Hassam, C. V. (2018). Digital access: The future of financial inclusion in Africa. *Economies*.
- Chletsos, M., & Sintos, A. (2024). Political stability and financial development: An empirical investigation. *The Quarterly Review of Economics and Finance*, 94, 252–266.
- Cournède, B., & Denk, O. (2015). *Finance and Economic Growth in OECD and G20 Countries* [OECD Economics Department Working Paper]. <https://doi.org/10.2139/ssrn.2649935>
- Deda, G., Tërstena, A., & Krasniqi, S. (2024). Evaluation of influence of corruption, lending interest rate and other components on ease of doing business: A policy-making and legal implications. *Corporate Law & Governance Review*, 6(3), 8–16. <http://dx.doi.org/10.22495/clgrv6i3p1>
- Drinkwater, S., & Robinson, C. (2023). The impact of customs and trade regulations on the operations of African firms. *Journal of Business Research*, 165, 1–9. <https://doi.org/10.1016/j.jbusres.2023.114046>
- Erkekoglu, H., & Kiliçarslan, Z. (2018). Do Political Risks Affect the Foreign Direct Investment Inflows to Host Countries? *Journal of Business, Economics and Finance*, 5(2). <https://doi.org/DOI:%252010.17261/Pressacademia.2016219263>
- Eshete, Z. S. (2018). The Political Economy of Capital Flight: Governance Quality and Capital Flight in the East Africa Community. *International Journal of African and Asian Studies*, 49, 22–34. <https://doi.org/10.7176/jesd/10-11-02>
- Femina, M., Patil, A., Joseph, M. J., & Mary, J. (2022). *Impact of Ease of Doing Business on Fdi Inflows Across Different Economies*. 21(5). <https://scispace.com/pdf/impact-of-ease-of-doing-business-on-fdi-inflows-across-2isw77b0.pdf>
- Ghazalian, P. L. (2023). Does Economic Growth Attract FDI Inflows? A Dynamic Panel Analysis. *Economies*, 12(1). <https://doi.org/10.3390/economies12010001>
- Herrala, R., & Ariss, R. T. (2013). *Credit Constraints, Political Instability, and Capital Accumulation*. file:///C:/Users/H%20P/Downloads/_wp13246.pdf
- Hou, F., Mengistu, M. M., Ng, J., & Zhang, J. J. (2024). *Credit information sharing and investment efficiency: Cross-country evidence*. <https://doi.org/10.1111/1911-3846.12972>
- Hussain, S., & Shear, F. (2024). The Economic Costs of Political Instability: Evidence from Pakistan The Economic Costs of Political Instability: Evidence from Pakista. *Business Review*, 19(1).
- Ibrahim, M., Aluko, O. A., & Vo, X. V. (2022). The role of inflation in financial development–economic growth link in sub-Saharan Africa. *Cogent Economics & Finance*, 1. <https://doi.org/10.1080/23322039.2022.2093430>
- Janačković, M., & Janačković, T. (2019). The effect of political risk on foreign direct investment. *Ekonomski Signali*, 14(2), 15–30.

- Khan, H. H. (2022). Bank competition, financial development and macroeconomic stability: Empirical evidence from emerging economies. *Economic Systems*, 46(4). <https://doi.org/10.1016/j.ecosys.2022.101022>
- Khan, M., & Majeed, M. T. (2023). Financial sector development and energy poverty: Empirical evidence from developing countries. *Environmental Science and Pollution Research*. <https://doi.org/10.1007/s11356-023-25585-6>
- Kiptoo, J. (2024). The Influence of Political Stability on Foreign Direct Investment (FDI). *International Journal of Developing Country Studies*, 6(1), 74–86.
- Klapper, L. F., & Singer, D. (2015). The Role of Informal Financial Services in Africa. *Journal of African Economies*, 24(1). <https://doi.org/10.1093/jae/eju027>
- Kruja, A., & Dragusha, B. (2016). The Impact of Political Risk on Foreign Direct Investment. *ILIRIA International Review*, 4(2), 73.
- La Porta, R., Lopez-de-Silanes, F., & Vishny, R. (1997). Legal determinants of external finance. *The Journal of Finance*, 52(3), 1131–1150. <https://doi.org/10.1111/j.1540-6261.1997.tb02727.x>
- Levine, R. (1997). Financial Development and Economic Growth: Views and Agenda. *Journal of Economic Literature*, 35(2), 688–726.
- Loh, C. (2015). Foreign Investments and the Rule of Law. *International Journal of Economics and Finance*, 7(7).
- Mani, P., Winnie, N., & Ondigo, H. (2024). Financial Inclusion and Human Development: Evidence from African Countries. *European Journal of Business and Management Research*, 9(3), 1–6. <https://doi.org/10.24018/ejbmr.2024.9.3.2274>
- Mwakalila, E., & Kasongwa, L. (2024). Financial sector development and inflation dynamics in Tanzania: An empirical assessment of macroeconomic stability. *African Journal of Empirical Research*, 5(4), 162–180. <https://doi.org/10.51867/ajernet.5.4.162>
- Naushahi, M. M., & Rehman, H. U. (2024). Examining the Moderating Role of Ease of doing Business with Foreign Restrictions on Foreign Direct Investment. *Pakistan Journal of Humanities and Social Sciences*, 12(4), 3052–3063. <http://dx.doi.org/10.52131/pjhss.2024.v12i4.2565>
- Ndanshau, M., & Semu, A. (2023). Determinants of Bank Credit Supply to the Private Sector in Tanzania. *African Journal of Economic Review*, 11(2), 92–115.
- Nguyen, M. H., Vuong, G. T. H., & Nguyen, T. D. (2025). Corporate Investment and Political Stability: Role of an Enormous Anti-Corruption Campaign, Ownership Structure, and Financial Constraints in An Emerging Economy. *SAGE Open*, 15(2). <https://doi.org/10.1177/21582440251340546>
- Nicolae, B. S., Codruta, M., Violeta, A. M., & Adriana, P. (2016). *Direction of Causality Between Financial Development and Economic Growth. Evidence for Developing Countries*. 26(2).
- North, D. (1990). *Institutions, institutional change and economic performance*. Cambridge: Cambridge University Press. <https://doi.org/10.1017/CBO9780511808678>
- Ofori-Sasu, D., Dzisi, S., & Odoom, F. D. (2023). Inclusive business, private sector credit and economic welfare: Evidence from Africa , Smile Dzisi, Franklin Dodzi Odoom. *International Journal of Emerging Markets*, 20(4), 1548–1568. <https://doi.org/10.1108/IJOEM-02-2022-0306>

- Orayo, J. A., & Mose, G. N. (2016). A Comparative Study on Contribution of Governance on Economic Growth in the East African Community Countries. *International Journal of Regional Development*, 3(2), 89–106.
- Rahman, M. M., & Alam, K. (2021). Exploring the driving factors of economic growth in the world's largest economies. *Heliyon*. <https://doi.org/10.1016/j.heliyon.2021.e07109>
- Simachenya, C. D., & Haabazoka, L. (2025). The effects of Financial Sector Development on the Foreign Direct Investment (FDI) inflows in Zambia, 1990-2022. *East African Finance Journal (Eafj)*, 4(2), 277–106. <https://doi.org/10.59413/eafj/v4.i2.5>
- Tadesse, T., & Abafia, J. (2019). The causality between Financial Development and Economic Growth in Ethiopia: Supply Leading vs Demand Following Hypothesis. *Journal of Economics and Financial Analysis*, 3(1), 87–115.
- Ullah, W., Zubir, A. S. M., & Ariff, A. M. (2024). The Impact of Political Instability on Financial Development, Economic Growth, Economic Growth Volatility and Financial Stability in Developing Countries. *Theoretical and Practical Research in Economic Fields*, xv(2(30)).
- Vogiatzoglou, K. (2016). Ease of Doing Business and FDI Inflows in ASEAN. *Journal of Southeast Asian Economies*, 33(3), 343–363. <https://doi.org/10.1355/AE33-3D>
- Wokabi, V. W., & Fatoki, O. I. (2019). Determinants of Financial Inclusion in East Africa. *International Journal of Business Management*, 7(1), 125–143. <https://doi.org/10.20472/BM.2019.7.1.009>
- Worldwide Governance Indicators. (2024). *Worldwide Governance Indicators-2024 Update*. The World Bank. <https://www.worldbank.org/en/publication/worldwide-governance-indicators>
- Xu, X., Hu, Y., & Tahir, S. H. (2023). Nexus between Ease of Doing Business and Foreign Direct Investment: Evidence from 130 Economies. *E3S Web of Conferences*. <http://dx.doi.org/10.1051/e3sconf/202340906015>
- Yildirim, H., & Akdag, I. (2023). *Are Political Stability and Democracy Effective on Financial Development? Evidence from Sub-Saharan African Countries*. 8(3). <https://doi.org/10.30784/epfad.1331138>
- Zehra, D.-Ç. (2019). Political Stability and Financial Development: Evidence from Turkey. *Fiscaoeconomia*, 3(3), 72–79.
- Zermeño, M. Á. T., Martínez, F. V., & Preciado, V. H. T. (2018). Effects of Inflation on Financial Sector Performance: New Evidence from Panel Quantile Regressions. *Investigación Económica*, 77(303), 94–129. <https://doi.org/10.22201/fe.01851667p.2018.303.64156>