



The determinants of financial cohesion and integration in East Africa: The case of Kenya and Uganda

Matthew Agaba Mugabi 138760

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DECLARATION

I declare that this work has not been previously submitted and approved for the award of a degree by this or any other University. To the best of my knowledge and belief, the Research Project contains no material previously published or written by another person except where due reference is made in the Research Project itself.

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.....Matthew Agaba Mugabi..... [*Name of Candidate*]

..... [*Signature*]

.....11/2/2025..... [*Date*]

This Research Project has been submitted for examination with my approval as the Supervisor.

..... [*Name of Supervisor*]

..... [*Signature*]

..... [*Date*]

Strathmore Institute of Mathematical Sciences

Strathmore University

Abstract

This study examines the determinants of financial cohesion and integration within the East African Community (EAC), focusing on Kenya and Uganda. Using a quantitative research design, secondary data from 2010 to 2022 was analyzed, with a Financial Cohesion and Integration (FIC) Index developed through Principal Component Analysis (PCA) and a fixed-effects panel regression model applied to identify key drivers. The findings reveal that capital account openness and weak governance negatively impact financial cohesion, while FDI inflows, trade activities, and domestic credit availability positively influence integration. Kenya exhibited higher financial cohesion than Uganda due to stronger governance and developed financial systems. The study recommends harmonizing financial regulations, strengthening governance, boosting trade and investment, and narrowing interest rate spreads to enhance financial cohesion and integration in the region.

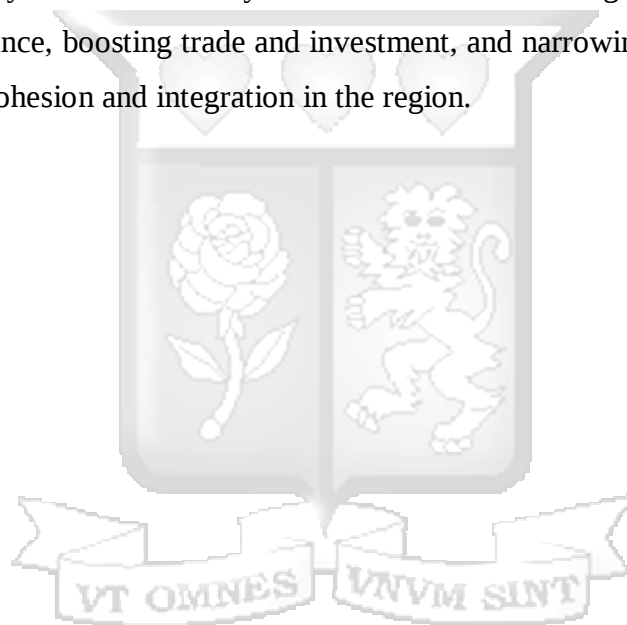


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Chapter 1: Introduction

1.1 Background of the study

1.1.1 Historical Context of Regional Integration in East Africa

The pursuit of economic and financial integration in the East African region has deep historical roots. Efforts towards the interconnection of East African states began during the early 20th century under British colonial rule, with the establishment of a currency union in 1905. This created a common currency, the *East African shilling*, shared by the East Africa Protectorate (present day Kenya), the Uganda Protectorate, and further on in time the states of Tanganyika and Zanzibar. This historical foundation demonstrates the early pursuit of financial integration, which serves as the base for modern integration efforts in the East African Community. This union collapsed in 1977 due to divergent economic policies, particularly concerning inflation and interest rates across member states (Drummond, 2015), disrupting efforts towards a large cohesive financial system

Despite the challenges posed by the collapse of the currency union, the region continued to strive for integration. The East African Community (EAC) was officially re-established in 1999, with a renewed commitment by member states (Kenya, Tanzania, Uganda, and later Rwanda, Burundi, and South Sudan (Community, 2024)) to pursue regional integration. The Customs Union Protocol was signed in 2005, followed by the Common Market Protocol in 2010, aiming to facilitate free movement of goods, capital, and labor across borders (Drummond, 2015) (Regional Integration, 2024)

1.1.2 Trends in Economic and Financial Integration

Since the reformation of the EAC, significant strides have been made toward achieving deeper financial and economic integration. The regional bloc has worked to remove tariff and non-tariff barriers, harmonize financial regulations, and implement cross-border infrastructure projects to promote trade and capital flows (Regional Integration, 2024). For example, the establishment of the Northern Corridor trade route has facilitated intra-regional trade. It is then critical to understand these trends to identify the drivers of financial cohesion and integration and assessing their role in shaping Kenya and Uganda's integration within the EAC, something this study aims to address.

One of the pivotal initiatives has been the development of a monetary union, with the long-term goal of adopting a single regional currency. The Monetary Union Protocol, signed in 2013, set the foundation for creating a regional central bank and harmonizing member states' monetary policies. Although the process is ongoing and complex, these steps highlight the region's commitment to fostering financial cohesion (Drummond, 2015)

In addition, efforts to integrate financial markets have been supported by the East African Development Bank (EADB), which has facilitated infrastructure development and supported the growth of cross-border enterprises. The EADB has played a key role in mobilizing resources for large-scale regional infrastructure projects, such as trade corridors, energy development, and transport networks. These projects have aimed to create an environment conducive to increased intra-regional trade and investment (Regional Integration, 2024)

1.1.3 Studies and Analysis on Financial Integration in the EAC

Numerous studies have explored the benefits and challenges of regional integration within the EAC. Research highlights that financial integration, particularly through the removal of trade barriers and the harmonization of policies, can enhance intra-regional trade flows by 30% to 200%, depending on the degree of integration (Drummond, 2015)

Regional trade and investment are not only driven by trade reforms but also by investments in infrastructure that enable the movement of goods and services across borders (Regional Integration, 2024). Moreover, financial integration is closely linked with the harmonization of banking regulations and the expansion of cross-border banking. Increased competition among financial institutions has led to lower interest rates, which benefit regional businesses and consumers across the region.

However, achieving full financial integration remains a challenge. Key obstacles arise in aligning fiscal policies and eliminating non-tariff barriers, which can hinder the smooth operation of the customs union (Drummond, 2015). While previous studies provide valuable insights into the benefits of financial integration, limited research has been conducted on how

regulatory frameworks and economic disparities specifically impact Kenya and Uganda. This study addresses this critical gap by examining these two economies in depth.

1.1.4 Financial Cohesion and Integration

Building on the trends and challenges discussed earlier, this section delves into the concepts of financial cohesion and integration, their significance, and the obstacles faced by the EAC in achieving these goals.. Over the years, these countries have made concerted efforts to enhance economic cooperation and integration, with the financial sector playing a pivotal role in this process. Financial cohesion and integration are critical for the success of the EAC's economic integration agenda, as they facilitate the smooth flow of capital, financial services, and investments across borders, thereby promoting economic stability and growth.

Financial cohesion refers to the harmonization and alignment of financial systems, policies, and institutions within a region. It ensures that financial markets and institutions operate in a coordinated and efficient manner, leading to a more stable and resilient financial environment. This process is characterized by consistent regulatory frameworks and high levels of cooperation among financial institutions. On the other hand, financial integration involves the unification of financial markets and institutions across different regions, allowing for the free flow of capital and financial services. It is typically measured by the convergence of financial indicators such as interest rates, stock prices, and the removal of barriers to cross-border financial activities (Espinoza, 2024).

The East African Community (EAC) faces significant challenges in achieving financial integration due to disparities in financial development, inconsistent regulatory frameworks (Munzele, 2021), and varying levels of political commitment. Advanced markets like Kenya contrast with less developed ones such as Burundi, creating imbalances. Inconsistent cross-border banking regulations and limited policy harmonization further hinder progress. Addressing these structural disparities through coordinated reforms is essential to achieving a cohesive and fully integrated financial sector within the EAC.

1.2 Problem Statement

The East African Community's economic growth and stability depend on the integration and cohesion of its financial sector, which promotes capital mobility, investment, and access to credit. Despite various government interventions, financial integration remains fragmented due to disparities in regulatory frameworks, development levels, and political commitment, leading to inefficiencies and high transaction costs (Scott Jacobs, 2013). Moreover, existing studies overlook the role of emerging financial technologies, such as FinTech and blockchain, which could help address regulatory and infrastructure challenges. This study examines the effectiveness of these policy interventions and explores the potential of financial technologies in enhancing EAC's financial integration and cohesion.

1.3 Research Objectives

1.3.1 General Research Objective

To determine the factors affecting financial cohesion and integration within the East African Community (EAC), with a focus on understanding the dynamics that either promote or hinder this integration

1.4 Research Questions

1. What are the key financial factors that most significantly contribute to achieving financial cohesion and integration within the East African Community?
2. How do economic disparities between member states hinder financial integration efforts within the EAC?

1.5 Scope of the Study

This study focuses on Kenya and Uganda, two significant economies within the East African Community (EAC), to assess financial integration and cohesion. The research specifically examines the period from 2010 to 2022, providing a 10-year timeline that captures the implementation of key policy interventions, such as the EAC's Monetary Union Protocol (2013). The selection of Kenya and Uganda enables an analysis of how disparities in financial development influence the success of integration efforts. The timeframe then allows for the analysis of trends related to financial cohesion, market depth, cross-border financial flows, and policy effectiveness. These countries were selected due to their significant roles in regional economic integration and their varying levels of financial development, which provide a comparative framework for analyzing financial cohesion. Kenya, with its advanced financial markets and digital financial services, contrasts with Uganda's growing but less mature financial system, allowing for a nuanced study of how disparities affect integration. Furthermore, Kenya and Uganda's strategic economic relationship, characterized by extensive cross-border banking activities and trade, makes them ideal for investigating how policy interventions influence financial cohesion within the region.

1.6 Significance of the Study

This study will provide actionable recommendations for policymakers and financial institutions, fostering a more unified and resilient financial sector across the EAC. It seeks to deepen understanding of the key factors driving or hindering financial integration and cohesion within the East African Community. By identifying the key challenges and opportunities associated with financial sector integration, this research will provide valuable insights for policymakers, financial institutions, and other stakeholders involved in the EAC's integration process. Additionally, the study will offer recommendations on how to optimize policy interventions to achieve a more cohesive and integrated financial sector, ultimately supporting the EAC's broader economic integration goals and promoting regional economic stability and growth. Finally, the insights from this study can serve as a blueprint for other regions aiming to achieve financial cohesion and integration, providing lessons on navigating structural disparities and enhancing cooperation.

Chapter 2: Literature review

2.1 Introduction

The purpose of this literature review is to critically examine how government policies have influenced the integration and cohesion of the financial sector within the East African Community (EAC). This review begins with an overview of the financial sector landscape in East Africa, highlighting the key economic players, particularly Kenya and Uganda. The theoretical review section will explore various frameworks that explain the relationship between financial sector development and economic growth, focusing on theories like the supply-leading and demand-following hypotheses. Following this, the empirical review will delve into past studies that have used econometric models, such as Principal Component Analysis (PCA) (Zakaria Jaadi, 2024) and Dynamic Ordinary Least Squares (DOLS) (Muhoza, 2019), to analyze financial integration in the region. The review will then identify gaps in the existing literature, particularly concerning the specific effects of government policies on financial cohesion and integration. By systematically examining these aspects, the review aims to provide a foundation for understanding how policy interventions have shaped the financial sector's evolution in East Africa.

2.2 Theoretical review

In the past, there have been a number of theories developed to understand the tendencies and behaviour of the financial sector, aiming to explain how markets interact. Among these, four hypotheses dominate the discourse.

The Supply-Leading Hypothesis a theory endorsed by numerous economists such as Demetriades and Hussein, suggests that financial intermediaries play a crucial role in mobilizing savings, attracting investments, and allocating capital efficiently, thereby stimulating economic growth (Demetriades, 1996). According to this theory, financial development precedes and leads economic growth by providing the necessary funds and financial infrastructure that fuel investment and innovation (Loo, 2024). Consequently, if this hypothesis holds true, efforts to strengthen financial institutions by improving regulatory frameworks and creating a conducive environment for financial innovation become essential. Investments in financial infrastructure, educational programs to encourage market participation, and technological advancements are critical to fostering the desired economic

growth. Policies might include enhancing the legal and regulatory environment to protect investors, establishing credit information systems to reduce information asymmetries, and encouraging the development of capital markets to provide diversified sources of funding.

The Demand-Following Hypothesis, also articulated by Patrick as a counterpoint to the supply-leading theory, posits that financial sector development is a response to economic growth rather than a driver of it (Demetriades, 1996). In this scenario, as the economy expands, the demand for financial services increases, which in turn spurs the development of the financial sector to meet these needs (Loo, 2024). Therefore, if the demand-following hypothesis holds true, the focus should be on stimulating economic growth through investments in infrastructure, education, and industrial development. As the economy grows, the financial sector will naturally evolve to accommodate the increasing demand for financial services. Ensuring that the financial sector can adapt at an equal pace to respond to the growing needs of the economy becomes crucial. Policy initiatives could include promoting industrial policies that drive growth in key sectors, investing in physical and human capital to support long-term economic expansion, and facilitating access to financial services in underdeveloped areas to ensure inclusive growth.

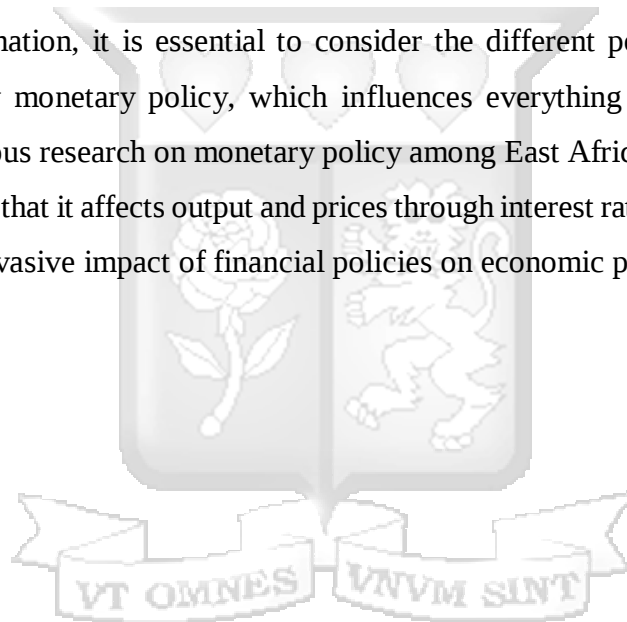
The Bi-Directional Causality Hypothesis builds on the ideas of mutual influence between finance and economic growth, suggesting that the relationship between the two is reciprocal. This theory, supported by various economists including Demetriades and Hussein (Demetriades, 1996), posits that finance and economic growth influence each other simultaneously. Improvements in the financial sector lead to economic growth, and as the economy grows, it further enhances the development of the financial sector. As a result, a feedback loop is created, requiring a holistic approach that simultaneously promotes both the development of the financial sector and economic growth. Continuous reforms and innovations are necessary to reinforce this positive feedback cycle. Policymakers should consider integrated strategies that include both financial sector reforms and broader economic policies. For instance, they could implement structural reforms that foster financial innovation while also promoting sectors that drive economic growth, such as technology and manufacturing. Additionally, coordinating monetary and fiscal policies to ensure they are mutually reinforcing can help sustain the positive interaction between financial development and economic growth.

Understanding these hypotheses is crucial for policymakers as they decide the most effective strategies for fostering financial sector integration and cohesion. Depending on which

hypothesis is most applicable to the context, tailored economic policies could promote financial development, support economic growth, and address other critical factors influencing the economy.

Taking these theories into account, different approaches to achieving financial cohesion can be considered. For example, if the supply-leading hypothesis is validated, policy interventions should prioritize the development of financial institutions and infrastructure. Conversely, if the demand-following hypothesis is more relevant, the focus should be on economic growth initiatives that will naturally drive financial sector expansion. Meanwhile, the bi-directional hypothesis would suggest that an integrated approach is necessary, with concurrent efforts to stimulate both the financial sector and the broader economy.

In light of this information, it is essential to consider the different policies that impact the economy, particularly monetary policy, which influences everything from interest rates to exchange rates. Previous research on monetary policy among East African Community (EAC) countries has revealed that it affects output and prices through interest rates and credit channels, demonstrating the pervasive impact of financial policies on economic performance.



2.3 Empirical review

This empirical review explores how the financial integration within the East African Community (EAC) has been influenced by various factors, particularly government policies, the role of financial institutions, and monetary policy interventions. This review builds on theoretical frameworks, such as the Bi-Directional Causality Hypothesis, Supply-Leading Hypothesis, and Demand-Following Hypothesis, linking them to empirical findings within the region.

Global Studies on Financial Integration and Cohesion: Global studies have demonstrated the importance of financial integration for promoting regional stability and growth. For instance, research conducted by the International Monetary Fund (IMF) highlights that financially integrated regions tend to experience higher capital mobility, greater financial inclusion, and improved macroeconomic stability (Espinoza, 2024). Studies have also shown that integration facilitates more robust risk-sharing mechanisms, which can reduce the impact of asymmetric shocks across member countries (Mr. Hirwa Amatus, 2015).

2.3.1 African Studies on Financial Integration:

In Africa, financial integration has gained increasing attention as a mechanism for accelerating growth. Research on the Southern African Development Community (SADC) and the West African Economic and Monetary Union (WAEMU) illustrates that deeper financial integration can lead to more dynamic financial sectors and stronger economic growth (Nene, 2016). However, these studies also highlight challenges such as divergent regulatory frameworks and varying degrees of financial market development, which mirror issues faced in East Africa (Kelly, 2016).

2.3.2 East Africa Specific Studies:

In East Africa, financial integration has been a focus of various studies, particularly within the context of the East African Community (EAC). Employing Dynamic Ordinary Least Squares (DOLS) and Fully Modified Ordinary Least Squares (FMOLS) models to analyze the relationship between financial integration and economic growth in the EAC, finding a positive correlation between the two (Muhoza, 2019). However, empirical evidence suggests that

significant disparities between member states, particularly in regulatory frameworks and market depth, have slowed the pace of integration (Scott Jacobs, 2013)

2.3.3 Impact of Government Policies on Financial Integration:

Empirical studies utilizing models like Dynamic Ordinary Least Squares (DOLS) (Muhoza, 2019) and Fully Modified Ordinary Least Squares (FMOLS) (Muhoza, 2019) have provided robust evidence supporting the Bi-Directional Causality Hypothesis. These studies indicate that financial development and economic growth reinforce each other over time, suggesting that sustained policy interventions by EAC governments play a crucial role in strengthening financial sector integration. By implementing consistent policies aimed at enhancing financial development, governments can foster an environment where economic growth and financial integration go hand in hand.

In addition, Principal Component Analysis (PCA) (Zakaria Jaadi, 2024) has been employed to create a comprehensive financial development index, reflecting the multifaceted nature of financial systems. This index aggregates various indicators such as access to credit, market depth, and efficiency, aligning with the Supply-Leading Hypothesis. The index allows for the identification of areas where financial development is lagging, enabling policymakers to target specific interventions to enhance financial integration across the EAC.

2.3.4 Role of Financial Institutions in Promoting Cohesion:

Financial institutions are central to promoting cohesion within the EAC by facilitating cross-border transactions and aligning financial systems across member states. The Supply-Leading Hypothesis, which posits that financial development drives economic growth, is supported by empirical studies showing that strong financial institutions, underpinned by consistent regulatory frameworks, contribute significantly to financial cohesion. The application of DOLS and FMOLS models in these studies confirms the critical role of well-functioning financial institutions in achieving seamless financial integration within the region.

Empirical Evidence on Monetary Policy Interventions:

Monetary policy interventions also play a vital role in shaping financial integration and cohesion within the EAC (Espinoza, 2024). The Demand-Following Hypothesis, which suggests that financial sector development is a response to economic growth, is exemplified in studies utilizing Recursive Vector Autoregressive (R-VAR) models. These models analyze how changes in monetary policy, such as interest rate adjustments, influence other economic variables like inflation and exchange rates. The findings suggest that monetary policy transmission channels indirectly create an environment conducive to financial integration by maintaining macroeconomic stability (Aikaeli, 2020).

However, the use of Structural Vector Autoregression (S-VAR) models, which analyze dynamic causal relationships between endogenous variables, may not be as directly applicable to studying the impact of policy interventions on financial integration. While S-VAR models provide valuable insights into broader macroeconomic dynamics, they are less focused on the specific mechanisms through which policy interventions influence financial sector integration. Nonetheless, these models still offer supplementary evidence on the role of macroeconomic stability in fostering a favorable environment for financial integration within the EAC (Ebenezer Olamide, 2022).

2.4 Summary of literature and research gaps

Existing literature highlights the importance of financial integration and cohesion for regional stability and growth, particularly in emerging economic blocs like the East African Community (EAC). Numerous studies, such as those conducted by (Aikaeli, 2020) and (Munzele, 2021), have explored the impact of traditional policy interventions on financial sector development within the EAC. These studies underscore the role of government actions—such as regulatory reforms, monetary policy coordination, and trade liberalization—in promoting capital mobility and cross-border financial flows.

Despite these findings, the region continues to struggle with fragmented financial systems. Disparities in regulatory frameworks, levels of financial market development, and political will among member states contribute to ongoing challenges in achieving seamless financial integration (Regional Integration, 2024). Kenya, for instance, has more advanced financial

infrastructure compared to South Sudan or Burundi, resulting in uneven benefits from regional policies and even with Uganda there are substantial differences in the economic and financial performance between the benchmark that Kenya and the rest of the East African Society

While the traditional policy interventions are well-studied, there is a significant gap in the literature regarding the role of emerging financial technologies (FinTech), digital payment systems, and blockchain technology in enhancing financial integration within the EAC. With the rapid adoption of these technologies in global financial systems, particularly in other African regions such as Nigeria and South Africa, the potential of FinTech to overcome traditional barriers—such as regulatory inconsistencies and infrastructural limitations—remains underexplored in the East African context.

Furthermore, while several global and African studies have focused on financial integration, they have generally emphasized the role of government interventions and regulatory harmonization, overlooking how financial innovations can be a catalyst for deeper financial cohesion. As technology becomes increasingly embedded in financial systems worldwide, its potential to reduce transaction costs, enable seamless cross-border transactions, and improve financial inclusion demands closer attention. Studies such as those by Claessens (2016) have found that FinTech can significantly reduce the operational inefficiencies inherent in traditional banking systems, yet few empirical studies have examined its application within the EAC.

Additionally, the empirical evidence on the effectiveness of these policy interventions is often limited to short-term observations or isolated case studies, lacking a comprehensive, data-driven analysis that tracks the evolution of financial integration over time. This study aims to fill these gaps by examining not only the impact of policy interventions but also the adoption and effectiveness of emerging technologies in overcoming barriers to integration.

Thus, the research will focus on:

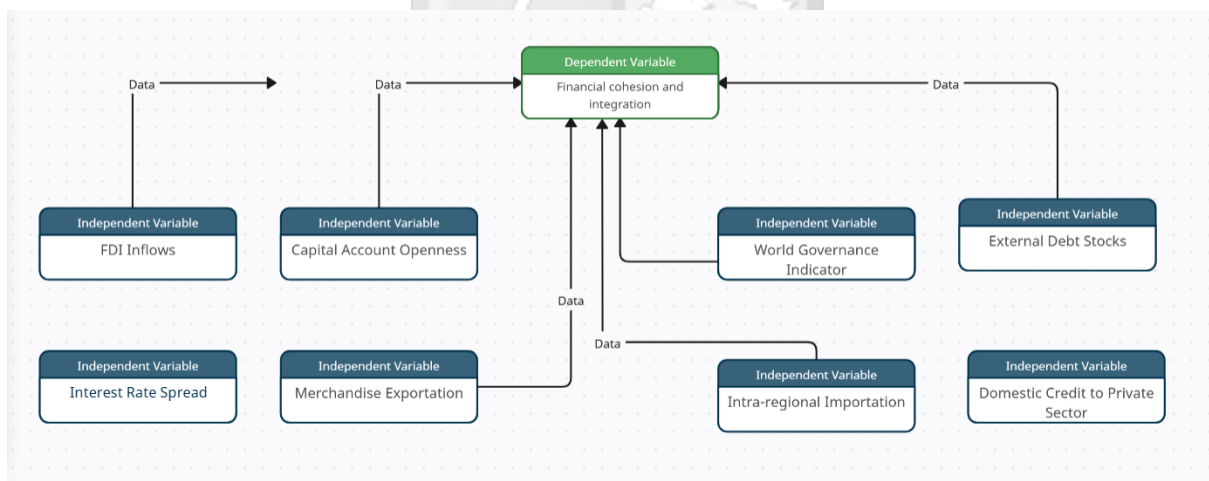
Identifying measurable factors that affect financial integration and cohesion within the EAC, including regulatory quality, financial market depth, and the adoption of financial technologies.

Assessing the effectiveness of traditional policy interventions alongside newer technological innovations, aiming to provide actionable insights for optimizing integration strategies.

Bridging the gap in the literature by providing a robust analysis of how technological innovations can facilitate financial cohesion in a fragmented regulatory landscape, addressing the challenges that traditional policy reforms have not fully resolved.

Focusing on these gaps, this research contributes to the understanding of both traditional and emerging factors that can accelerate financial cohesion in the EAC, providing a comprehensive framework for policymakers and financial institutions seeking to enhance regional economic stability.

2.5 The Conceptual Framework



Chapter 3: Research Methodology

3.1 Introduction

This chapter outlined the methodological approach employed in this study to explore the impact of government policy interventions on financial integration and cohesion within the East African Community (EAC). The research methodology was structured to ensure a systematic investigation of financial sector integration by first constructing a robust dataset and then analyzing it using panel data techniques. The study employed a quantitative research design, utilizing secondary data from reputable financial institutions such as the World Bank, IMF, and WTO. The chapter detailed the dataset construction, normalization of financial variables, application of Principal Component Analysis (PCA) to create the Financial Integration and Cohesion (FIC) Index, and subsequent regression analysis to determine key financial drivers. It also addressed the research design, sampling strategy, data collection methods, and analytical techniques employed, while highlighting the ethical considerations necessary to maintain research integrity. Through this meticulously executed methodology, the study provided insights aimed at supporting efforts to strengthen financial cohesion and integration in the region.

3.2 Research Design

This study adopted a quantitative research design (Bhattacharjee, 2012). By relying on numerical data, by systematically examining financial trends, policy effects, and their implications over time. The research design incorporates a panel data approach, which is particularly useful for analyzing changes and trends while controlling for country-specific effects. The study's empirical foundation is built on constructing a comprehensive index through Principal Component Analysis (PCA) and applying panel regression techniques to assess the impact of policy-driven variables on financial integration.

3.3 Population and Sampling

The study focused on the financial sector within the East African Community, specifically examining financial integration between Kenya and Uganda. The dataset included financial indicators from 2010 to 2022, forming a balanced panel dataset with 26 observations, evenly distributed across the two countries over a 12-year period. The study employed purposive sampling, selecting Kenya and Uganda based on their economic influence and availability of financial data. The sampling strategy ensured a comprehensive analysis of financial sector integration dynamics within the EAC.

Identification of Relevant Financial Indicators:

First, the study identified key financial indicators that reflect the integration and cohesion of the financial sector. These might include cross-border capital flows, interest rate convergence, banking sector stability, and financial market depth.

3.3.1 Data Sources

The study primarily relied on secondary data from reputable international financial organizations, ensuring accuracy and reliability. Key data sources include:

- World Bank: Capital account openness, financial market depth, and regulatory indicators.
- IMF (International Financial Statistics and Global Financial Stability Reports): Interest rates, macroeconomic variables, and financial sector policies.
- World Trade Organization (WTO): Trade indicators relevant to financial sector integration.
- East African Development Bank (EADB) and EAC Reports: Regional financial statistics.
- Central Banks of Kenya and Uganda: Country-specific financial indicators, including credit and trade balances.

Collection of Country-Specific Data:

For each of the six EAC member countries, data was collected for the identified financial indicators over a specified period (e.g., the past decade). The time frame was consistent across all countries to allow for meaningful comparisons.

3.4 Data Collection Methods

The dataset was systematically constructed to facilitate the development of the FIC Index and subsequent panel regression analysis. The process followed these key steps:

1. **Collection of Historical Data:** Financial indicators were obtained for the period 1995–2022 to construct a sufficiently large dataset for PCA.
2. **Panel Data Construction:** Data was reorganized to fit the panel format, ensuring consistency across years and countries.
3. **Normalization of Variables:** Using min-max scaling, all variables were normalized to ensure comparability in the PCA process.
4. **Principal Component Analysis (PCA):** Applied in Stata to generate factor loadings, which were then used to compute the FIC Index.
5. **Final Panel Structuring (2010–2022):** After calculating the FIC scores, the dataset was trimmed to the target study period to align with panel regression analysis.

The structured dataset captures a comprehensive 12-year timeline, allowing for meaningful economic and financial trend analysis.

3.5 Data Analysis/ Model Specification

For this study, panel data analysis was appropriate to explore how different factors influence our variables over time across multiple entities. This approach was well-suited for the kind of data I'm working with, as it allowed for the examination of changes and trends while accounting for differences that may exist between the entities. Ensuring that the analysis is thorough and that the results are both accurate and meaningful for understanding the patterns in the data

3.5.1 Model Specification

-Having chosen Panel Data Analysis using Fixed Effects Model as the way to run a regression in order to define financial cohesion and integration.

$$\begin{aligned} FIC_{it} = & \alpha_i + \beta_1(\text{Capital Account Openness}) + \beta_2 (\text{Financial Regulatory Quality}) \\ & + \beta_3 (\text{Cross-Border Banking Flows}) + \beta_4 (\text{Net FDI Inflows}) + \beta_5 (\text{Intra-Regional FDI}) + \\ & \beta_6 (\text{Intra-EAC Trade Balance}) + \beta_7 (\text{Financial Market Depth}) + \beta_8 (\text{Interest Rate Spread}) \end{aligned}$$

Where:

FIC_{it} = Financial Integration and Cohesion index for country i at time t.

α_i = Country-specific fixed effects.

$\beta_1, \beta_2, \dots$ = Coefficients representing the impact of each independent variable.

ϵ_{it} = Error term.

Explanation of Variables:

- 1) Capital Account Openness Index: Degree of openness of a country's capital markets to cross-border capital flows.
- 2) Financial Regulatory Quality: Index measuring the strength and quality of financial sector regulations.
- 3) Cross-Border Banking Flows: Measures the volume of banking transactions and investments between EAC countries.
- 4) Net FDI Inflows: Total net foreign direct investment into the domestic economy, representing cross-border financial flows.
- 5) Intra-Regional FDI: FDI between EAC countries (e.g., Kenya's investments in Uganda), reflecting regional financial integration.
- 6) Intra-EAC Trade Balance: Measures trade between the two countries, influencing financial flows and banking activity.
- 7) Financial Market Depth: Volume of financial assets (e.g., stocks, bonds) available in a country, showing financial sector development.
- 8) Interest Rate Spread: Difference between lending and deposit rates, indicating market efficiency and access to credit.

3.6 Ethical Issues in Research

Ethical considerations are integral to ensuring the integrity and responsibility of this research, particularly as it involves the use of secondary data from reputable sources such as the World Bank, IMF, and EAC reports. Although the use of secondary data reduces some ethical risks associated with primary data collection, important considerations such as confidentiality and data protection remain. The study will handle any sensitive financial data with care, ensuring that it remains anonymized and used solely for the purposes of this research.

The research will adhere to ethical standards by securing data through encryption and restricted access, maintaining confidentiality, and ensuring that all data handling complies with relevant ethical guidelines. While formal ethical approval may not be required due to the nature of the data, the study will seek confirmation from the relevant academic or institutional bodies to ensure full compliance.

Chapter 4 : Presentation of Research Findings

4.1 Introduction

The goal of this chapter is to present the findings of this research focusing on the possibility of financial cohesion and integration within the East African Community (EAC). Having developed the Financial Cohesion and Integration (FIC) Index and the application of a fixed effects model to the dataset containing information on Uganda and Kenya, this study and consequently this chapter evaluates what are the key factors influencing integration and what it implies for economic development within the region with Kenya and Uganda, as two leading economies in the EAC. A comparative framework for examining financial disparities and integration dynamics.

The results address two critical research questions:

1. What are the key financial factors that most significantly contribute to achieving financial cohesion and integration within the EAC?
2. How do economic disparities between member states hinder financial integration efforts within the EAC?

4.2 Sample representation

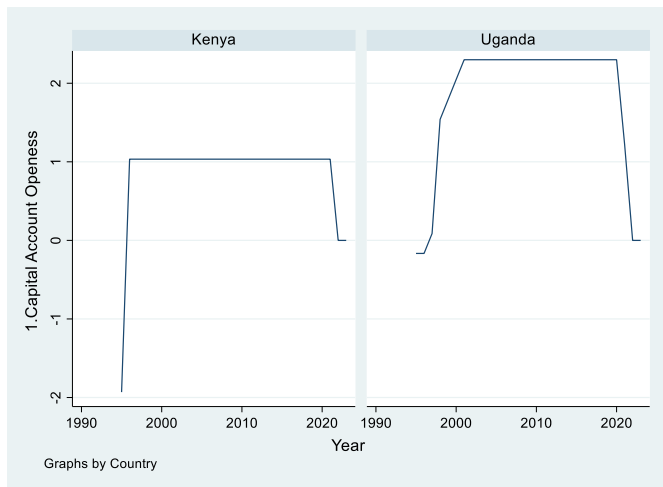
This section describes the nature and scope of the dataset used in the analysis, which consists of two East African countries, Kenya and Uganda, over the period 2010-2022. This provides a balanced panel dataset with 26 observations evenly distributed across the two countries, spanning 12 years each. The dataset incorporates all eight variables chosen for this research as well as the newly created FIC Index values.

Variable	Mean	Std. Dev.	Min	Max	Skewness
Capital Account Openness	1.58	0.63	1.03	2.3	0.29
World Governance Indicator	-0.92	0.69	-1.97	0.12	0.08
External Debt Stocks (\$M)	177,000	11,500	2,970	41,200	0.83
FDI Inflows (\$M)	962	558	178	2,950	1.68
Merchandise Exportation (\$M)	12069	4953.78	4815	20483	0.02
Intra-regional Importation(\$M)	378529	217648	0	768691	-0.46
Domestic Credit to PS (%)	21.69	10.16	11.66	36.69	-0.1
Interest Rate Spread (%)	7.12	3.79	0	12.49	-0.73

Sources; World Bank, International Monetary Fund (IMF), and World Trade Organization(WTO)

Diagram 4.1

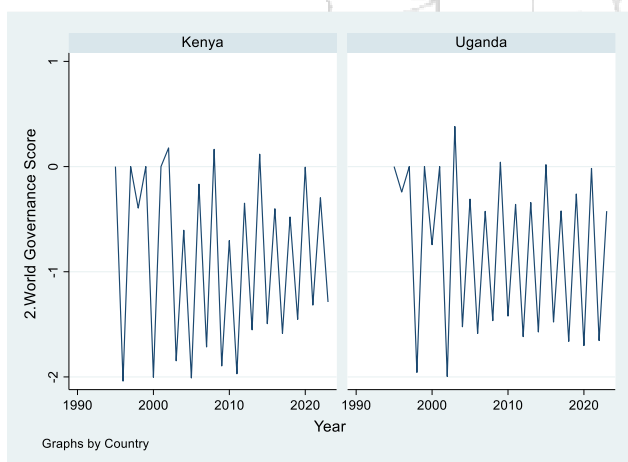
Capital Account Openness over 25 years+



This diagram illustrates the trend of capital account openness in Kenya and Uganda over the study period. Kenya demonstrates higher and more consistent openness, reflecting its advanced financial systems and liberalized economy. In contrast, Uganda exhibits lower openness with occasional fluctuations, indicative of its more restrictive financial policies and less integrated capital markets.

Diagram 4.2

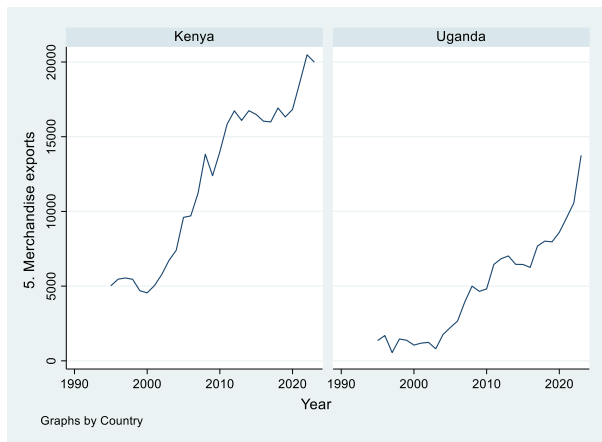
World Governance Indicator over 25 years+



The interest rate spread graph shows significant volatility in Uganda compared to Kenya. Kenya's lower and relatively stable spreads point to a more efficient financial market, while Uganda's higher spreads highlight inefficiencies and increased transaction costs, potentially hindering financial cohesion and integration.

Diagram 4.3

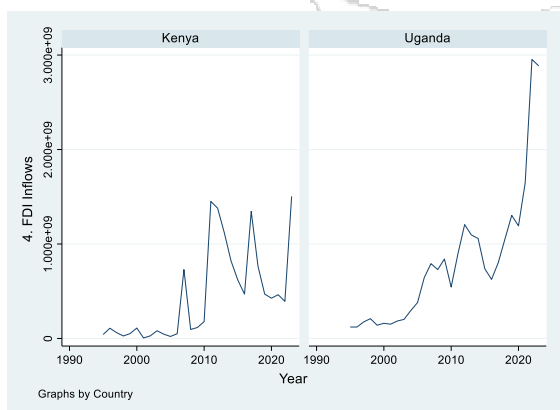
Merchandise Exportation over 25 years+



This graph highlights the disparity in domestic credit availability between Kenya and Uganda. Kenya shows a steady increase in credit to the private sector, reflecting its deeper financial markets and higher financial sector participation. Uganda, while experiencing growth, remains substantially behind, showcasing gaps in financial inclusion and market depth.

Diagram 4.4

FDI Inflows over 25+ years



The foreign direct investment (FDI) inflows graph depicts Kenya as the dominant recipient of FDI in the region, with a steady upward trend. Uganda, although showing some growth, lags significantly. This disparity underscores Kenya's stronger investment climate, possibly driven by better governance and trade infrastructure, compared to Uganda.

The summary statistics of the variables offer insights into the financial dynamics of the two countries. On average, Kenya demonstrates higher levels of financial openness and governance quality compared to Uganda, reflecting disparities in institutional and economic development. For instance, capital account openness, with a mean of 1.58, indicates moderate openness to cross-border flows, though variability is observed across the years. Similarly, governance quality, as measured by the World Governance Indicator, averages at -0.92, reflecting weak governance overall but significant disparities between the two nations.

Another notable observation is the reliance on external debt. The mean external debt stocks of \$17.7 billion highlight the financial dependence on foreign borrowing. However, the positive skew in debt distribution suggests that Kenya, with its relatively developed financial markets, borrows more than Uganda. This is further evidenced by the variations in domestic credit to the private sector, with Kenya exhibiting higher credit availability, indicative of a deeper financial system.

FDI inflows and merchandise exportation stand out as key drivers of economic integration. FDI inflows average \$962 million annually, as seen in the strong positive skew. This reflects occasional spikes in foreign investments, often concentrated in Kenya. Merchandise exportation also highlights robust trade activity, with an average of \$12,069 million, emphasizing Kenya's position as a regional economic leader.

Intra-regional importation, on the other hand, underscores the variability in trade dynamics within the region. The left-skewed distribution indicates that while some years or regions experience high import volumes, others remain stagnant, particularly in Uganda. Lastly, the interest rate spread, averaging 7.12%, reflects inefficiencies in the financial systems, with wider spreads hindering financial cohesion and market performance.

These observations underscore the disparities and challenges in achieving financial integration within the EAC, particularly between Kenya and Uganda. The variations across variables reveal key areas requiring policy attention, such as governance, credit availability, and trade facilitation, to foster a more cohesive financial ecosystem.

4.3 Index Creation

The process of creating the Financial Cohesion and Integration (FIC) index involved multiple steps to ensure the robustness and accuracy of the measure. This index serves as a composite metric capturing various dimensions of financial cohesion and integration across countries and time. Below is the detailed process of its implementation in this study:

4.3.1 Normalization

Once the panel data had all information, each variable was normalized to ensure comparability across the varying units and scales. This was possible by transforming raw values into a standardized range between 0 and 1 using the following formula

$$\text{Normalized Value} = \frac{X - \text{Min}(X)}{\text{Max}(X) - \text{Min}(X)}$$

Where:

- X represents the original value of the variable,
- $\text{Min}(X)$ and $\text{Max}(X)$ are the minimum and maximum values of the variable, respectively.

This step ensured that all variables contributed equally to the index creation process without being affected by differences in magnitude or units.

4.3.2 Principal Component Analysis (PCA)

The final step in creating the index, Principal Component Analysis (PCA) was applied to the normalized variables. PCA is a statistical technique that reduces dimensionality of data by summarizing the variation in multiple variables then into a smaller set of components. The first principal component (PC1) was used to generate the FIC index because it captures the largest amount of variance explained by the variables.

Table 4.3

Principal components/correlation	Number of obs	=	58
	Number of comp.	=	7
	Trace	=	8
Rotation: (unrotated = principal)	Rho	=	1.0000

Component	Eigenvalue	Difference	Proportion	Cumulative
Comp1	3.42618	1.64642	0.4283	0.4283
Comp2	1.77976	.575024	0.2225	0.6507
Comp3	1.20473	.441383	0.1506	0.8013
Comp4	.763351	.33069	0.0954	0.8968
Comp5	.432662	.182804	0.0541	0.9508
Comp6	.249857	.106399	0.0312	0.9821
Comp7	.143458	.143458	0.0179	1.0000
Comp8	0	.	0.0000	1.0000

Table 4.3 gives the results from the Principal Component Analysis(PCA) where, it revealed that the variation in the dataset explained by the Principal Component 1 (PC1) is 42.83% (This is in 4th column labelled Proportion in 1st row of Comp 1 in table 4.2) which can be seen in the diagram below – the proportion of comp1 is 0.4283. This thus revealed it to be the most significant dimension in summarizing financial cohesion and integration.

Diagram 4.5

Number of obs	=	58
Number of comp.	=	7
Trace	=	8
Rho	=	1.0000

Proportion	Cumulative
0.4283	0.4283
0.2225	0.6507

With the 8 variables normalized the PC1 figures and therefore the weightages of the FIC index were returned and therefore the scores for each country could be calculated

Table 4.4

Variable	PC1 weightages
Capital Account Openness (NormCapitalAccount):	-0.2086
World Governance Indicator (NormWorldGovernance):	-0.0471
External Debt Stocks (NormExternalDebt):	0.2480
FDI Inflows (NormFDIInflows):	0.4342
Merchandise Exportation (NormMerchandiseExports):	0.2524
Intra-regional Importation (NormDirectImportation):	0.3995
Domestic Credit to Private Sector (NormDomesticCredit):	0.4904
Interest Rate Spread (NormInterestRateSpread):	0.4904

The weightages were used to calculate the FIC Index Scores.

High PC1 scores represent strong financial integration, driven by factors such as higher FDI inflows, greater domestic credit availability, and lower interest rate spreads. Conversely, negative PC1 scores indicate weaker financial integration, often associated with poor governance quality and low trade activity. The presence of both positive and negative PC1 scores underscores the heterogeneity in financial integration levels across countries and years, reflecting disparities in policy, governance, and economic condition

The FIC index was then calculated by extracting the scores from the first principal component (PC1) of the PCA output. This step aggregated the normalized variables into a single measure representing financial cohesion and integration.

The resulting FIC index was a composite score for each country-year observation, summarizing the multiple dimensions of financial cohesion into a single metric.

4.4 Panel Regression Analysis

The fixed effects regression model was applied to the dataset to analyze the relationship between the FIC index and the independent variables.

Table 4.5

Fixed-effects (within) regression		Number of obs	=	26
Group variable: country_id		Number of groups	=	3
R-squared:		Obs per group:		
Within	= 0.9991	min	=	6
Between	= 0.9999	avg	=	8.7
Overall	= 0.9958	max	=	13
corr(u_i, Xb) = -0.6799		F(8,15)	=	2082.32
		Prob > F	=	0.0000

FICIndexScore	Coefficient	Std. err.	t	P> t	[95% conf. interval]	
CapitalAccountOpeness	-.2269222	.0489339	-4.64	0.000	-.3312222	-.1226221
WorldGovernanceIndicator	-.1297454	.0180474	-7.19	0.000	-.1682125	-.0912783
ExternalDebtStocks	.0000452	3.01e-06	14.99	0.000	.0000388	.0000516
FDIInflows	.0005685	.0000425	13.38	0.000	.000478	.0006591
MerchandiseExportation	.0001014	.0000176	5.77	0.000	.0000639	.0001388
IntraregionalImportation	.000472	.0001287	3.67	0.002	.0001976	.0007463
DomesticCredittoPS	.0319321	.0037106	8.61	0.000	.0240232	.0398411
Interestratespread	-.1074169	.004384	-24.50	0.000	-.1167612	-.0980727
_cons	-1.18103	.1692197	-6.98	0.000	-1.541713	-.8203463
sigma_u	.13726116					
sigma_e	.04318769					
rho	.90992009	(fraction of variance due to u_i)				

F test that all u_i=0: F(2, 15) = 3.67	Prob > F = 0.0506
---	--------------------------

The table summarizes the fixed-effects regression analysis, demonstrating a strong model fit with high explanatory power. Key findings reveal that governance and capital account openness negatively impact financial cohesion, while trade, investment, and credit availability positively contribute. These results underscore the importance of addressing governance and market inefficiencies to enhance financial integration within the EAC

4.4.2 Key Variable Coefficients

Table 4.6

Variable	Coefficient	Std. Error	t-Value	95% Confidence Interval
Capital Account Openness	-0.227	0.049	-4.64	[-0.33, -0.12]
World Governance Indicator	-0.13	0.018	-7.19	[-0.17, -0.09]
External Debt Stocks	4.52E-11	3.01E-12	14.99	[3.88e-11, 5.16e-11]
FDI Inflows	5.69E-10	4.25E-11	13.38	[4.78e-10, 6.59e-10]
Merchandise Exportation	0.0001	0	5.77	[0.0001, 0.0001]
Intra-regional Importation	0.000000472	0.000000129	3.67	[1.98e-07, 7.46e-07]
Domestic Credit to PS	0.032	0.003	6.11	[0.024, 0.039]
Interest Rate Spread	-0.107	0.004	-24.5	[-0.12, -0.10]

The fixed-effects regression model highlights the relationship between the Financial Cohesion and Integration (FIC) Index and its explanatory variables. The results reveal critical insights into the factors influencing financial integration within the East African Community (EAC).

Capital account openness, with a coefficient of -0.2269 ($p < 0.01$), demonstrates a negative relationship with financial cohesion. This suggests that increased openness to cross-border flows may expose economies to external vulnerabilities, potentially disrupting financial integration efforts. This aligns with findings in the GCC integration study, where capital flow restrictions helped stabilize financial markets, indicating that unregulated openness could indeed increase exposure to external shocks (Espinoza, 2024).

Similarly, governance quality, as captured by the World Governance Indicator, exhibits a negative coefficient of -0.1297 ($p < 0.01$). Weak governance, therefore, undermines financial integration by fostering regulatory inefficiencies and reducing investor confidence. This observation is supported by research on the EAC's financial systems, which highlights governance gaps (Munzele, 2021) as a critical challenge to achieving effective financial integration.

On the other hand, foreign direct investment (FDI) inflows show a positive coefficient of 0.00005685 ($p < 0.01$), underscoring the strong role of foreign investments in promoting financial cohesion. Higher FDI inflows not only inject capital into the economies but also foster cross-border linkages, enhancing integration. The findings align with those from the GCC study (Espinoza, 2024), where FDI was shown to strengthen financial linkages and drive regional economic growth despite some institutional barriers.

Merchandise exportation and intra-regional importation further support financial integration, with coefficients of 0.00010168 ($p < 0.01$) and 0.000000472 ($p < 0.01$), respectively. These findings highlight the importance of trade activities in strengthening economic interconnections within the EAC. Similarly, the study on economic growth dynamics in East Africa identified trade as a fundamental driver for integration, emphasizing the role of export-led strategies in fostering regional interdependence (Muhoza, 2019).

Domestic credit to the private sector, with a positive coefficient of 0.031931 ($p < 0.05$), indicates that greater credit availability contributes to financial cohesion by supporting economic activity and investment. However, the interest rate spread, with a negative coefficient of -0.1074169 ($p < 0.01$), reflects inefficiencies within the financial markets. Wider spreads signal higher transaction costs and reduced financial accessibility, which hinder integration efforts. Similar results were highlighted in the East African monetary policy study (Aikaeli, 2020), where inefficient financial intermediation, reflected in wider interest rate spreads, was found to impede economic and financial integration.

Collectively, these results emphasize the multifaceted nature of financial cohesion, where governance, trade, investment, and market efficiency play fundamental roles. The need for policy reforms to address governance issues, trade barriers, and financial inefficiencies is echoed in both the GCC and East African studies, which underscore the critical role of institutional alignment and economic coordination in fostering integration. They also underscore the need for targeted policy reforms to address disparities and foster a more integrated financial system within the EAC.

4.5 Summary of findings

The Financial Cohesion and Integration (FIC) Index was constructed using Principal Component Analysis (PCA), combining eight key variables into a single composite metric. Normalization ensured comparability across variables, while PCA identified dominant patterns of variance. The index captures complex financial interrelations and provides a quantitative measure of financial cohesion and integration in East Africa, offering a comprehensive means to compare financial integration across countries and over time. Variability in the index reflects changes in regional financial integration dynamics influenced by policy, trade, and investment trends.

The regression analysis examined the determinants of financial cohesion, revealing that capital account openness negatively correlates with integration, likely due to external vulnerabilities. Governance quality also exhibited a negative impact, highlighting the importance of institutional stability in financial integration. On the other hand, FDI inflows and trade activities, including merchandise exportation and intra-regional importation, were strong positive contributors to financial cohesion. Domestic credit availability further supported integration, whereas higher interest rate spreads hindered financial cohesion by reflecting inefficiencies in financial markets.

These findings underscore the multifaceted nature of financial cohesion and integration, emphasizing the role of governance, investment, trade, and financial sector efficiency in shaping regional integration within the EAC. The results provide a basis for policy recommendations aimed at strengthening financial integration through targeted regulatory and economic reforms.

Chapter 5: Discussions, Conclusions, and Recommendations

5.1 Introduction

This chapter presents a summary of the findings of this study on financial cohesion and integration (FIC) in the East African Community (EAC), with a focus on Kenya and Uganda. The analysis bridges the empirical results with the theoretical and conceptual framework established in earlier chapters, providing a synthesis of the research contributions to the literature and practical applications. It also highlights the study's limitations, offers actionable recommendations, and outlines areas for future research.

5.2 Summary of Findings

5.2.1 Measuring Financial Cohesion and Integration

The Financial Cohesion and Integration (FIC) Index was developed using Principal Component Analysis (PCA), incorporating eight key variables: capital account openness, governance quality, external debt stocks, FDI inflows, merchandise exports, intra-regional imports, domestic credit to the private sector, and interest rate spreads. Normalization ensured comparability, allowing the index to serve as a reliable metric for financial cohesion and integration. Over time, the FIC Index demonstrated fluctuations, reflecting shifts in financial integration dynamics. Kenya consistently exhibited higher financial cohesion than Uganda, driven by stronger governance structures and greater FDI inflows.

5.2.2 Determinants of Financial Cohesion and Integration

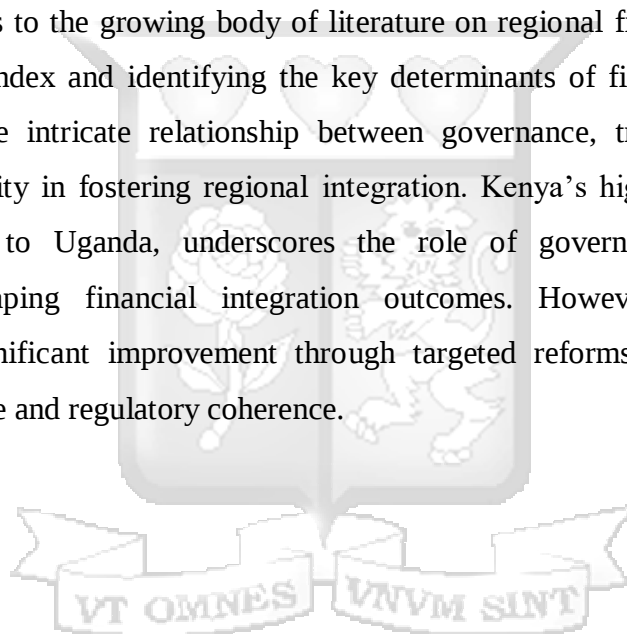
Regression analysis highlighted critical relationships between financial integration and its key determinants. Capital account openness was found to negatively impact financial cohesion, potentially due to exposure to external shocks. Conversely, strong governance quality and increased FDI inflows were identified as positive contributors to financial integration. Additionally, trade-related factors, such as merchandise exports and intra-regional imports, alongside domestic credit availability, were found to support financial cohesion. However, wider interest rate spreads emerged as a significant barrier, reflecting inefficiencies in financial markets that hinder integration.

5.2.3 Regional Integration and Policy Implications

The study underscored the importance of trade and investment as fundamental drivers of financial integration within the EAC. However, disparities in governance standards and variations in financial infrastructure between Kenya and Uganda continue to present significant challenges. The findings emphasize the need for harmonized policies and improved institutional coordination to enhance financial cohesion across the region.

5.3 Conclusions

This study contributes to the growing body of literature on regional financial integration by developing the FIC Index and identifying the key determinants of financial cohesion. The findings highlight the intricate relationship between governance, trade, investment, and financial sector stability in fostering regional integration. Kenya's higher level of financial cohesion, compared to Uganda, underscores the role of governance and investment attractiveness in shaping financial integration outcomes. However, Uganda presents opportunities for significant improvement through targeted reforms aimed at enhancing financial infrastructure and regulatory coherence.



5.4 Recommendations

The findings of this study point to several actionable recommendations aimed at enhancing financial cohesion and integration in the East African Community:

Aligning financial rules requires officials to make financial laws similar across countries, which helps reduce differences and facilitates the movement of money across borders. This involves creating standard legal systems, cutting unnecessary bureaucracy, and setting up shared financial rules to bring countries closer together. Better management is essential to improve how institutions function, helping financial systems work together more effectively by increasing transparency, holding individuals accountable, and enforcing regulations more efficiently to ensure smoother financial operations. Boosting trade and attracting foreign investment is also critical, as pushing for more regional trade and securing greater foreign investments will enhance financial integration. Governments can support this by offering tax incentives, simplifying investment processes, and building improved trade systems to encourage investments and foster greater cross-border business activity. Narrowing interest rate spreads will improve lending systems by closing the gap between interest rates. This can be achieved by encouraging more competition among banks, optimizing monetary policies, and improving methods for assessing credit risks, ultimately making borrowing more accessible and efficient. Finally, building skills within the finance sector is vital, and this can be done by introducing training programs, creating platforms for knowledge sharing, and encouraging collaboration among financial experts across different EAC countries to address the challenges of market integration.

5.5 Suggestions for Further Research

Future research should build on the insights from this study to deepen the understanding of financial cohesion and integration within the East African Community (EAC). One important area of study is the impact of financial technologies, such as blockchain and digital currencies, on financial cohesion. These emerging technologies have the potential to bridge gaps in financial systems and foster greater regional integration by enhancing transaction efficiency, reducing costs, and improving financial inclusion.

Comparative regional analysis is another area that could provide valuable insights. Conducting studies on other regional economic blocs, such as the Economic Community of West African States (ECOWAS) or the Southern African Development Community (SADC), would offer best practices and lessons that can be applied to the EAC. Understanding how these regions have approached financial integration can help policymakers develop more effective strategies tailored to East Africa's unique economic landscape.

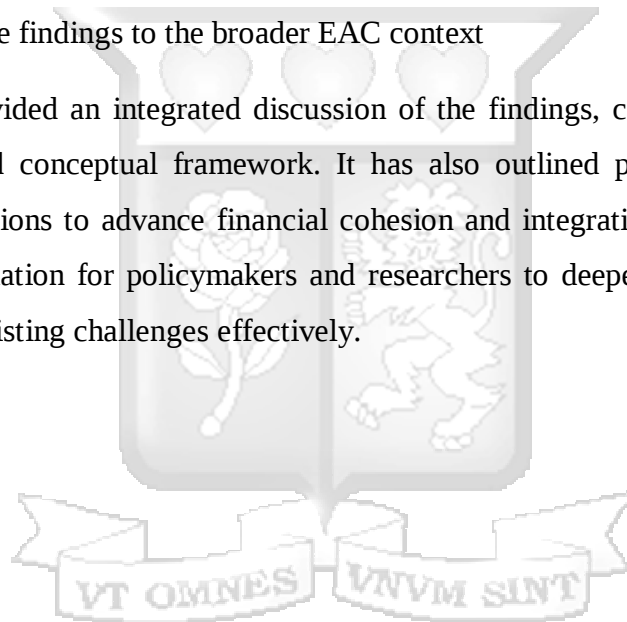
Another critical area for further study is the role of the informal financial sector, which plays a significant role in the East African economy. Future research should examine how informal mechanisms, such as mobile money, community savings groups, and non-traditional lending practices, interact with formal financial systems. Understanding these dynamics could offer new strategies for strengthening financial cohesion by integrating informal practices into formal regulatory frameworks.

Finally, expanding the geographic scope of research to include all EAC member states would provide a more representative picture of financial integration across the region. By including countries with varying levels of financial development, researchers could gain a more nuanced understanding of the barriers and opportunities that exist within different economic environments. Addressing these areas in future research can contribute to more effective policymaking and the sustained growth of financial integration in East Africa.

5.6 Limitations of the Research

This study faced several limitations that should be considered when interpreting the findings. First, the research relied heavily on secondary data, which, while comprehensive, may contain inconsistencies, missing values, or reporting errors that could influence the results. Incorporating primary data in future research would enhance accuracy and reliability. Additionally, the geographic scope was limited to Kenya and Uganda, which, while significant players in the East African Community, do not fully represent the region's financial dynamics or integration efforts. Expanding the scope to include other member states could provide a more holistic view of the EAC's financial cohesion. Furthermore, the study excluded informal sector activities, which are a critical component of the East African economy and play a significant role in financial systems. Addressing these gaps in future studies would improve the robustness and applicability of the findings to the broader EAC context

This chapter has provided an integrated discussion of the findings, connecting them to the broader literature and conceptual framework. It has also outlined practical and research-focused recommendations to advance financial cohesion and integration in the EAC. These insights offer a foundation for policymakers and researchers to deepen regional integration efforts and address existing challenges effectively.



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