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EFFECT OF SOVEREIGN CREDIT RATINGS ON FOREIGN DIRECT INVESTMENT TO KENYA: THE MODERATING ROLE OF INSTITUTIONAL QUALITY.

RITA GAKII NJERU

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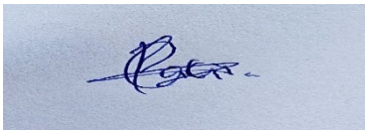
A RESEARCH DISSERTATION SUBMITTED TO THE STRATHMORE BUSINESS SCHOOL IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE DEGREE OF MASTER OF SCIENCE IN DEVELOPMENT FINANCE OF STRATHMORE UNIVERSITY.

JUNE 2026

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 dissertation contains no material previously published or written by another person except where due reference is made in the dissertation itself.

..... Rita Gakii Njeru



..... 12 May 2026

Approval

The dissertation of **Rita Gakii Njeru** was reviewed and approved by the following:

Name of Supervisor: Dr Muli Maingi

 12-05-2026

LECTURER

STRATHMORE UNIVERSITY BUSINESS SCHOOL

DEDICATION

I thank the Almighty God for giving me strength and resilience throughout this course. To my family, for their unconditional love, patience, and endless support that gave me the strength to push ahead. To my lecturers and classmates, for walking this journey with me and inspiring me through their individual journeys and stories. It was a pleasure.

ACKNOWLEDGEMENT

I am deeply grateful to Almighty God for His grace, strength, and guidance throughout this journey. A huge thank you to my supervisor, Dr. Muli Maingi, for his patience, guidance, encouragement, and timely and invaluable insights. My lecturers at Strathmore University Business School, who laid the foundation for the courses that got me here.

Most of all, I thank my husband and babies for their endless love, patience, encouragement, and for supporting me in pursuit of the best version of myself.

ABSTRACT

Foreign direct investment (FDI) plays an important role in the economic growth of nations through capital inflows, technology transfer, and job creation. However, FDI to Kenya has remained relatively low and volatile. This study examined the effect of sovereign credit ratings and rating outlooks on FDI into Kenya, with the moderating role of institutional quality. The study also controlled for macroeconomic factors, including GDP growth, inflation and trade openness. Using annual time-series data for the period 2006 to 2023, the study employed a quantitative explanatory design and employed Ordinary Least Squares (OLS) regression analysis to examine the effect of sovereign credit ratings and rating outlooks on foreign direct investment in Kenya. The results indicated that sovereign credit ratings and rating outlooks do not have a statistically significant direct effect on FDI into Kenya. While the inclusion of macroeconomic control variables improved the models' explanatory power, their individual effects were not statistically significant. However, when institutional quality was introduced as a moderating variable, a significant interaction effect was observed between sovereign credit ratings and institutional quality. This suggests that the influence of sovereign credit ratings on FDI depends on the quality of a country's institutions, highlighting the importance of governance, regulatory effectiveness, and institutional credibility in attracting foreign investment.

The study contributes to the existing literature by integrating sovereign credit ratings, rating outlooks, and institutional quality to explain FDI in the Kenyan context. The findings underscore the importance of strengthening institutional quality while maintaining a stable macroeconomic environment to support sustainable FDI into Kenya.

Keywords: Foreign Direct Investment, Sovereign Credit ratings, Rating Outlooks, Institutional Quality, Signaling theory, Institutional theory, Kenya

TABLE OF CONTENTS

DECLARATION i

DEDICATION ii

ACKNOWLEDGEMENT iii

ABSTRACT iv

ABBREVIATIONS AND ACRONYMS xi

DEFINITION OF TERMS xii

CHAPTER ONE 1

1 INTRODUCTION 1

1.1 Background of the Study 1

1.1.1 Foreign Direct Investment 1

1.1.2 Sovereign Credit Ratings 3

1.1.3 Rating Outlooks 5

1.1.4 Institutional Quality 6

1.2 Statement of the Problem 8

1.3 Research Objectives 9

1.3.1 General Objective 9

1.3.2 Specific Objectives 9

1.4 Research Questions 9

1.5 Research Hypotheses 10

1.6 Scope of the Study 10

1.7 Significance of the Study 11

1.8 Chapter Summary 12

CHAPTER TWO 13

UT OMNES VNVM SINT

2 LITERATURE REVIEW 13
2.1 Introduction 13
2.2 Theoretical Review 13
2.2.1 Eclectic theory of International Production: "The OLI Framework." 13
2.2.2 Information Asymmetry Theory 15
2.2.3 Institutional Theory 16
2.2.4 Signaling Theory 17
2.3 Empirical Review 19
2.3.1 Sovereign Credit Ratings and FDI 19
2.3.2 Rating outlooks and FDI 21
2.3.3 Institutional Quality and FDI 23
2.4 Summary of the Literature and Research Gap(s) 25
2.5 Conceptual Framework 26
2.5.1 Operationalization of the Variables 28
2.6 Chapter Summary 30
CHAPTER THREE 31
3 RESEARCH METHODOLOGY 31
3.1 Introduction 31
3.2 Research Philosophy 31
3.3 Research Design 32
3.4 Population and Sampling 32
3.5 Data Collection Methods 33
3.6 Data Analysis 33
3.6.1 Descriptive statistics 34
3.6.2 Stationarity Test: Dickey-Fuller Generalized Least Squares (DF-GLS) test 34

3.6.3 Multicollinearity Test: Variance Inflation Factor (VIF) 35
3.6.4 Heteroskedasticity Test: Breusch-Pagan test 35
3.6.5 Autocorrelation Test: Breusch-Godfrey Test 35
3.6.6 Normality Test 36
3.7 Research Quality 37
3.8 Ethical Issues in Research 37
3.9 Chapter Summary 38
CHAPTER FOUR 39
4 PRESENTATION OF RESULTS/FINDINGS 39
4.1 Introduction 39
4.2 Descriptive Statistics 39
4.3 Distribution statistics 40
4.4 Correlation analysis 44
4.5 Diagnostic Tests 45
4.5.1 Test for Normality 45
4.5.2 Test for Multicollinearity 46
4.5.3 Test for Stationarity 46
4.5.4 Test for Autocorrelation 47
4.5.5 Test for Heteroskedasticity 48
4.6 Inferential statistics 48
4.6.1 Determine the effect of sovereign credit ratings on foreign direct investment in Kenya 48
4.6.2 Evaluate the effect of rating outlooks/watch status (positive/negative/stable) on foreign direct investment in Kenya 50
4.6.3 Examine the moderating effect of institutional quality on the relationship between sovereign credit ratings, rating outlooks, and foreign direct investment in Kenya 53

4.7 Chapter summary 55

CHAPTER FIVE 56

5 DISCUSSIONS, CONCLUSIONS, AND RECOMMENDATIONS 56

5.1 Introduction 56

5.2 Summary of findings 56

5.2.1 To determine the effect of sovereign credit ratings on foreign direct investment in Kenya 56

5.2.2 Evaluate the effect of rating outlooks/watch status (positive/negative/stable) on foreign direct investment in Kenya. 58

5.2.3 Examine the moderating effect of institutional quality on the relationship between sovereign credit ratings, rating outlooks, and foreign direct investment in Kenya 59

5.3 Conclusions 60

5.4 Policy recommendations 61

5.5 Limitations of the Study 62

5.6 Suggestions for Further Research 63

5.7 Chapter summary 64

REFERENCES 65

APPENDICES 76

APPENDIX I: ETHICAL REVIEW APPROVAL 76

LIST OF TABLES

Table 2.1 OPERATIONALIZATION OF VARIABLES 28
Table 4.1 DESCRIPTIVE STATISTICS 39
Table 4.2 PAIRWISE CORRELATIONS 44
Table 4.3 SHAPIRO-WILK W TEST FOR NORMAL DATA 46
Table 4.4 VARIANCE INFLATION FACTOR 46
Table 4.5 DICKEY-FULLER Generalized Least Squares TEST FOR UNIT ROOT 47
Table 4.6 Breusch–Godfrey LM test for autocorrelation 47
Table 4.7 BREUSCH-PAGAN/COOK-WEISBERG TEST FOR HETEROSKEDASTICITY .. 48
Table 4.8 OLS REGRESSION RESULTS FOR THE EFFECT OF SOVEREIGN CREDIT RATINGS ON FOREIGN DIRECT INVESTMENT IN KENYA 49
Table 4.9 OLS REGRESSION RESULTS FOR THE EFFECT OF RATING OUTLOOKS/WATCH STATUS ON FOREIGN DIRECT INVESTMENT IN KENYA 51
Table 4.10: Lagged rating Outlooks 52
Table 4.11 OLS RESULTS FOR THE MODERATING EFFECT OF INSTITUTIONAL QUALITY ON THE RELATIONSHIP BETWEEN SCRs, RATING OUTLOOKS, AND FDI IN KENYA 54
Table 4.12 Institutional quality robustness check 55

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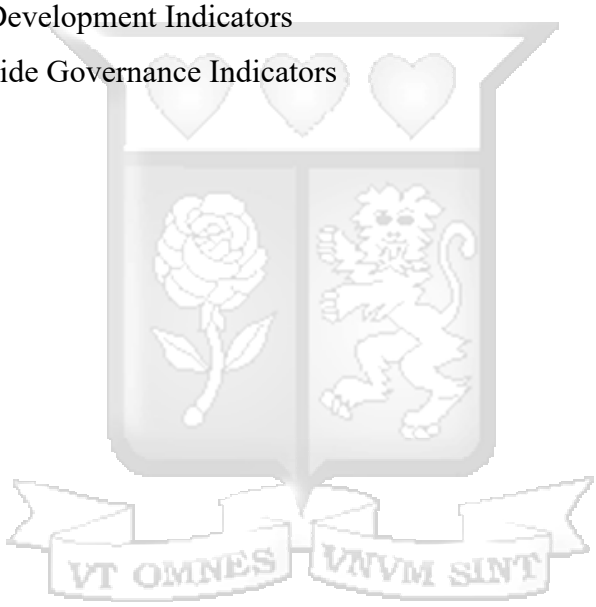
LIST OF FIGURES

Figure 1.1 FDI NET INFLOWS BOP, CURRENT US$ (World Bank Group, 2026b) 3
Figure 1.2 CREDIT RATING SCALES (UNDP, 2026) 5
Figure 2.1 CONCEPTUAL FRAMEWORK 27
Figure 4.1 FOREIGN DIRECT INVESTMENT 41
Figure 4.2 SOVEREIGN CREDIT RATINGS 41
Figure 4.3 RATING OUTLOOKS 42
Figure 4.4 INSTITUTIONAL QUALITY 42
Figure 4.5 GDP GROWTH 43
Figure 4.6 INFLATION 43
Figure 4.7 TRADE OPENNESS 44

VT OMNES VNVM SINT

ABBREVIATIONS AND ACRONYMS

Abbreviation	Meaning
CRA	Credit Rating Agency
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
MNC	Multinational Corporation
OLS	Ordinary Least Squares Regression
SCR	Sovereign Credit Rating
S&P	Standards & Poor
WDI	World Development Indicators
WGI	Worldwide Governance Indicators



DEFINITION OF TERMS

Foreign Direct Investment (FDI) – "cross-border investment made by a resident in one economy, to establish a lasting strategic relationship with another economy and to exert a significant degree of influence, evidenced by at least 10% voting power" (OECD, 2025).

Sovereign Credit Rating (SCR) – "A sovereign credit rating is an opinion issued by a rating agency that reflects its perception of the probability that the rated country will be able to fully and timeously service its debts" (UN Trade and Development" [UNCTAD], 2025a).

Rating Outlook- "An opinion regarding the direction of a credit rating over the immediate term, assessed as up to two years for investment grade ratings, and up to one year for speculative grade ratings" (S&P Global, 2024).

Institutional Quality- "traditions and institutions by which authority is exercised in a country. This includes the selection and monitoring of governments, their effectiveness in implementing sound policies, and their maintenance of respect for their citizens and the institutions that govern the social and economic interactions among them". According to the Worldwide Governance Indicators (WGI) framework, institutional quality is typically assessed through key governance indicators of voice and accountability, political stability and absence of violence/terrorism, government effectiveness, regulatory quality, rule of law, and control of corruption (World Bank Group, 2025b).

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CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

1.1.1 Foreign Direct Investment

Foreign Direct Investment (FDI) is widely recognized as an important driver of economic growth and development, particularly in developing economies. The World Bank Group (2025a) defines FDI as "net inflows of investment made to acquire a lasting management interest of at least 10 percent voting power in an enterprise operating in an economy other than that of the investor". Through capital inflows, technology transfer, employment creation, foreign exchange generation, and integration into global value chains, FDI contributes significantly to productivity enhancement, industrial development, and economic transformation. FDI also facilitates the transfer of expertise, innovation, and technology, thereby improving the competitiveness of host economies (OECD, 2025). Consequently, governments worldwide actively pursue policies to attract foreign investment to accelerate economic growth and improve their citizens' living standards.

Globally, FDI remains a major source of external financing, particularly for developing economies that face domestic resource constraints. However, investment flows remain unevenly distributed across countries and regions, with larger and more advanced economies attracting a substantial share of up to 90% of global investment (World Bank Group, 2025a). According to UNCTAD (2025b), global FDI declined by approximately 11 percent in 2024 due to heightened geopolitical tensions, tighter financial conditions, and continued economic uncertainty. Despite this decline, multinational enterprises continued to expand investments in strategic sectors such as semiconductors, the digital economy, and electric vehicles. As competition for global capital intensifies, countries increasingly seek to improve the factors that influence investment attractiveness, including macroeconomic stability, institutional quality, and investor confidence (OECD, 2025).

Within Africa, FDI continues to play a critical role in supporting economic development, infrastructure expansion, employment creation, and industrial transformation. Many African countries rely on foreign investment to supplement domestic savings, finance large-scale

development projects, and facilitate technology transfer (UNDP, 2025b). Although Africa recorded growth in FDI in 2024, largely driven by investments in energy, construction, mining, and infrastructure, the continent continues to attract a relatively small share of global investment flows (UNCTAD, 2025b). Further, concerns regarding governance quality, debt sustainability, political risk, institutional weaknesses, and macroeconomic instability continue to shape investor perceptions of African economies (APRM, 2025).

In Kenya, FDI has historically supported growth in the agricultural, manufacturing, financial services, information and communication, and infrastructure sectors. However, despite policy reforms aimed at improving the investment climate, FDI performance has remained relatively low and volatile. Between 2011 and 2022, FDI's contribution to GDP declined from 4.77 percent to 0.65 percent, while net FDI decreased from KSh 93.2 billion in 2022 to KSh 84.6 billion in 2023 (KNBS, 2024). As illustrated in Figure 1, FDI into Kenya has fluctuated considerably in the recent past. Although FDI has contributed significantly to employment creation and industrial development, particularly within Export Processing Zones (EPZs) and Special Economic Zones (SEZs), the declining contribution of FDI to GDP and the volatility in FDI have raised concerns regarding Kenya's ability to sustain the benefits associated with foreign investment (KIPPRA, 2024). These trends underscore the need to better understand the factors influencing foreign investors' decisions in the Kenyan context.

Literature identifies several determinants of FDI, including economic growth, inflation, exchange rate stability, trade openness, interest rates, infrastructure quality, market size, human capital, and access to finance, as well as institutional and political factors such as governance quality, regulatory effectiveness, political stability, and the rule of law (Busse & Hefeker, 2007; Sattar et al., 2025; Walsh & Yu, 2010). In Kenya, investors have cited taxation, electricity costs, constraints on access to finance, and institutional inefficiencies as significant hindrances to investment (KNBS, 2024). However, given the broad range of factors that influence investment decisions, international investors often face information asymmetry when evaluating potential host countries, particularly in emerging and developing economies (Muzaffarli & Mahmudlu, 2024).

Therefore, investors rely heavily on readily available information, including external assessments and indicators, to evaluate a country's risk and future economic outlook (Kim & Wu, 2008). While numerous factors influence FDI decisions, many of these factors are incorporated into sovereign

credit rating assessments (Cantor & Packer, 1996). Sovereign credit ratings and outlooks may therefore play a critical role in conveying information about a country's sovereign risk, thereby influencing foreign investment decisions.

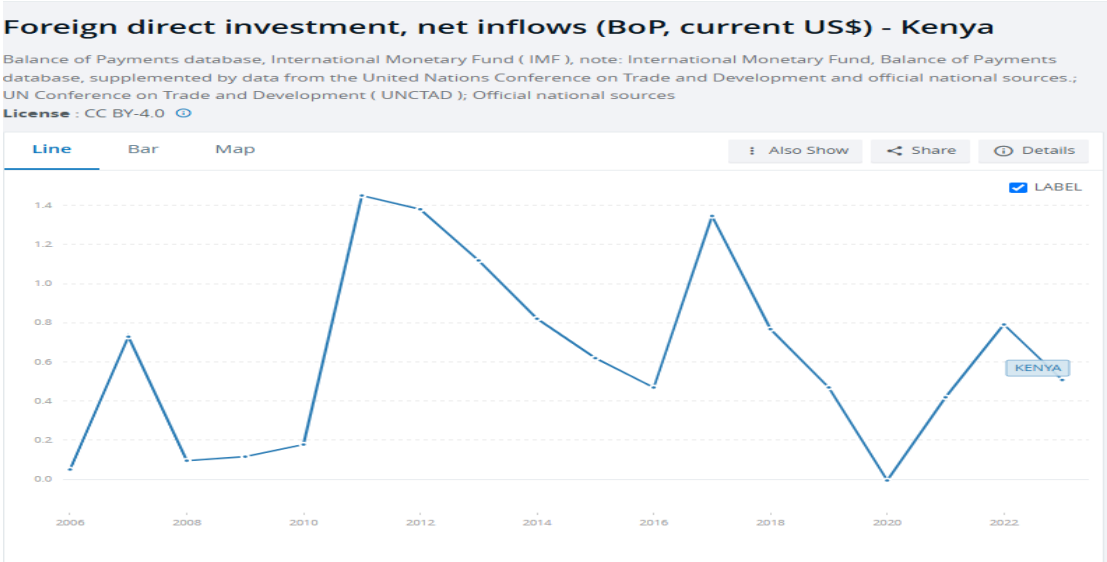


FIGURE 1.1 FDI NET INFLOWS BOP, CURRENT US$ (WORLD BANK GROUP, 2026B)

1.1.2 Sovereign Credit Ratings

Sovereign credit ratings (SCRs) are forward-looking assessments of a country's ability and willingness to meet its financial obligations as they fall due. They are issued by credit rating agencies such as Moody's, Standard & Poor's (S&P), and Fitch Ratings, and provide investors with an independent assessment of sovereign creditworthiness (Moody's, 2025a; S&P Global, 2026; Fitch Ratings, 2026). Ratings are typically assigned on a hierarchical scale, ranging from investment-grade ratings, which indicate relatively low credit risk, to speculative-grade ratings, which signal higher default risk. Figure 1.2 compares the sovereign credit rating scales used by the major rating agencies.

The modern sovereign rating industry has evolved significantly since the early 1900s, with sovereign ratings increasingly becoming an important component of international financial markets. Ratings of African sovereigns followed initiatives by development partners such as UNDP and rating agencies to improve African countries' access to international capital markets, with Kenya receiving its first sovereign credit rating in 2006 (Gaillard, 2012).

Cantor and Packer (1996) identified income per capita, GDP growth, inflation, fiscal balances, and external debt levels as key determinants of sovereign credit ratings. More recently, UNCTAD (2025a) and UNDP (2025a) highlighted the growing importance of governance quality, policy credibility, and institutional strength in sovereign rating assessments, particularly within developing economies.

UNCTAD (2025a) reported that, globally in 2025, only 24 countries held investment-grade ratings, most of which were advanced economies. Countries such as Australia, Sweden, Germany, and the Netherlands have maintained the highest S&P rating, AAA, reflecting strong institutional frameworks, stable macroeconomic environments, and robust fiscal positions. Further, UNCTAD (2025a) reported that improvements in regulatory quality alone are likely to increase the likelihood of higher sovereign ratings among developing countries by up to 25 percent, underscoring the importance of institutional quality in sovereign credit assessments.

In Africa, sovereign credit ratings have generally remained below investment grade, reflecting fiscal pressures, rising debt burdens, external vulnerabilities, and institutional challenges. Botswana remains one of the continent's highest-rated sovereigns, with ratings of BBB+ from S&P and A3 from Moody's, supported by prudent fiscal management, strong domestic savings, and relatively stable political and economic institutions (Moody's, 2025c; S&P Global, 2025c). Nevertheless, most African countries continue to hold non-investment-grade ratings, with rating outlooks remaining largely stable or negative due to persistent credit pressures (APRM, 2025). The African Peer Review Mechanism (APRM, 2025) further noted that improvements in governance quality, institutional effectiveness, and policy credibility are critical for strengthening sovereign creditworthiness and investor confidence across the continent.

Kenya has historically maintained non-investment-grade ratings, reflecting fiscal pressures, rising debt levels, and external financing constraints. Eickhoff (2025) reported that Kenya's public debt had reached approximately 68.3 percent of GDP by April 2025, while fiscal deficits continued to place pressure on the country's sovereign credit profile. Nevertheless, he reports that sovereign ratings remain important because they influence investor perceptions regarding country risk, borrowing costs, and access to international capital markets. Consequently, changes in Kenya's sovereign credit ratings may affect foreign investors' willingness to commit long-term capital to the country.

Despite their widespread use, sovereign credit ratings have attracted criticism regarding potential biases, pro-cyclicality, and their role during major financial crises. Nevertheless, they remain among the most influential indicators used by investors, lenders, and policymakers to assess country risk and investment attractiveness (UNDP, 2025a).

The figure shows the rating scales:

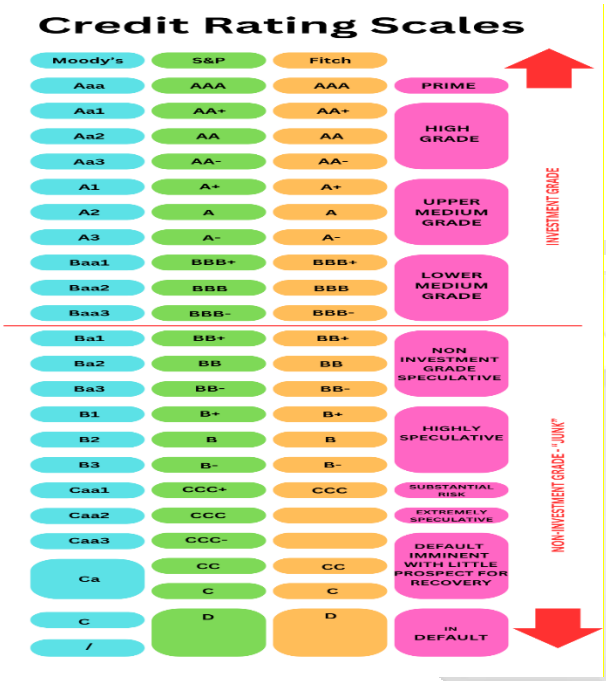


FIGURE 1.2 CREDIT RATING SCALES (UNDP, 2026)

1.1.3 Rating Outlooks

According to S&P Global (2024), outlooks assess whether a rating is likely to be upgraded, downgraded, or maintained based on prevailing economic, fiscal, political, and financial developments. Rating agencies typically assign positive, stable, negative, or developing outlooks depending on their expectations regarding future credit conditions.

Unlike sovereign credit ratings, which reflect current assessments of creditworthiness, outlooks signal the likelihood of future changes in ratings, based on prevailing economic and financial trends, before an actual rating adjustment occurs. These provide forecasts and early signals regarding potential changes in a country's credit profile, influencing its investment attractiveness (Trading View, 2025). Kaminsky and Schmukler (2002) found that rating outlook changes may

influence investor behaviour as strongly as actual rating changes, underscoring their importance in financial markets.

In Africa, sovereign outlooks have remained largely influenced by fiscal performance, debt sustainability, governance quality, and institutional effectiveness (APRM, 2025). Pangea Risk (2025) reported that the continent's credit prospects in 2025 were largely influenced by political transitions, rising debt burdens, and limited fiscal space, factors that continued to affect investor confidence and access to external finance. UNDP (2025b) further highlighted that despite the challenges facing African countries, those that implemented fiscal reforms and strengthened governance frameworks have generally experienced more favourable outlooks.

Kenya's sovereign outlook has been closely linked to developments in public debt management, fiscal consolidation efforts, foreign exchange reserves, and institutional reforms, with the recent rise in public debt levels heightening investor caution in the country (Eickhoff, 2025). Reuters (2025) reported that Moody's maintained Kenya's B3 rating with a stable outlook, citing reduced near-term default risk, improving foreign exchange reserves, and a narrowing of the current account deficit. Similarly, S&P maintained Kenya's sovereign rating at B with a stable outlook, reflecting expectations of gradual fiscal adjustment and macroeconomic stability (CNBC Africa, 2026). These developments suggest that rating outlooks provide investors with important forward-looking signals on Kenya's prospects as a viable foreign investment destination.

1.1.4 Institutional Quality

The Worldwide Governance Indicators define governance as the "traditions and institutions by which a country exercises authority, including the selection, monitoring, and formulation of sound policies, and the respect for citizens' rights through the state's operations". The Worldwide Governance Indicators (WGI) framework measures institutional quality using dimensions such as government effectiveness, regulatory quality, rule of law, control of corruption, voice and accountability, and political stability (World Bank Group, 2025b)

Institutional quality was measured using the rule of law, control of corruption, regulatory quality, and government effectiveness, as these governance indicators have been identified in previous empirical literature as influencing investment decisions. Empirical studies by Busse and Hefeker (2007) found that governance quality and institutional effectiveness play a significant role in

attracting FDI, while Rioba (2023) established that institutional quality significantly influences FDI in Kenya. Moreover, Osuma et al. (2024) found that improvements in governance quality, regulatory effectiveness, and corruption control enhanced investor confidence and investment inflows in Nigeria. These indicators were therefore considered the most relevant institutional quality indicators for examining the strength of the relationship between sovereign credit ratings, rating outlooks, and FDI in this study.

OECD (2021) emphasized that strong and accountable institutional frameworks enhanced investor confidence by lowering perceived risks and transaction costs. Such institutional qualities improved market efficiency and policy credibility and encouraged stable, sustained FDI.

Institutional quality has consistently been identified as an important determinant of FDI (OECD, 2019). Countries characterized by transparent institutions, effective regulation, and credible governance frameworks are generally perceived as more attractive investment destinations due to the reduced risks associated with doing business (Gelos & Wei, 2002).

In the Kenyan context, institutional quality remains particularly important, reducing bureaucratic burden in conducting business and thereby attracting more FDI into the country (Rioba, 2023). Emphasis has been placed on the role of governance reforms, policy credibility, and public financial management in strengthening investor confidence and supporting favourable sovereign credit assessments (UNDP, 2025b; UNCTAD, 2025a). Consequently, institutional quality may not only influence FDI directly but may also affect how investors interpret sovereign credit ratings and outlooks. This makes institutional quality an appropriate moderating variable in the relationship between sovereign credit ratings, rating outlooks, and FDI to Kenya.

Although Kenya was the sole unit of analysis, institutional quality remained relevant because it is a country-level characteristic that changes over time. The study employed a time series design covering the period from 2006 to 2023, during which Kenya experienced changes in government effectiveness, regulatory quality, rule of law, and control of corruption as measured by the Worldwide Governance Indicators (World Bank Group, 2025b). Therefore, institutional quality was treated as a time-varying country characteristic. Examining annual variations in institutional quality allowed the study to assess whether changes in Kenya's institutional environment influenced investor perceptions and moderated the relationship between sovereign credit ratings, rating outlooks, and FDI over time.

Although Kenya was the only country under study, institutional quality remained relevant because governance and institutional effectiveness are dynamic and change over time. The study therefore examined annual variations in Kenya's institutional quality between 2006 and 2023, capturing changes in government effectiveness, regulatory quality, rule of law, and control of corruption that may influence both investor perceptions and the relationship between sovereign credit ratings, rating outlooks, and FDI.

1.2 Statement of the Problem

Foreign Direct Investment (FDI) remains an important source of capital, employment, technology transfer, and economic growth in developing economies. In Kenya, however, FDI performance has remained low and volatile despite government efforts to improve the investment climate through policy reforms, Export Processing Zones (EPZs), and Special Economic Zones (SEZs) (KIPPRA, 2024). Between 2011 and 2022, FDI's contribution to GDP declined from 4.77 percent to 0.65 percent, while net FDI decreased from KSh 93.2 billion in 2022 to KSh 84.6 billion in 2023 (KNBS, 2024). Although FDI has contributed significantly to employment creation and industrial development, particularly within EPZs and SEZs where a substantial proportion of jobs are occupied by local workers, the declining contribution of FDI to GDP and the volatility in inflows have raised concerns regarding Kenya's ability to sustain the benefits associated with foreign investment, including capital formation, technology transfer, employment creation, and support for productive sectors of the economy (KIPPRA, 2024).

Sovereign credit ratings and rating outlooks are widely used by international investors as indicators of country risk and investment attractiveness. In theory, these credit signals should influence investment decisions by reducing information asymmetry and shaping investor perceptions of a country's macroeconomic and institutional stability (Muzaffarli & Mahmudlu, 2024). Empirical evidence generally supports the importance of sovereign credit signals, with Arogundade et al. (2022) finding a positive relationship between sovereign credit ratings and FDI across most Sub-Saharan African countries. The study further highlighted the possibility of reverse causality, with countries such as Kenya and Zambia showing unidirectional causality from FDI to SCR.

Findings from previous studies remain mixed, with some suggesting that investment decisions are influenced by broader macroeconomic and institutional factors beyond sovereign ratings alone (Walsh & Yu, 2010; Sanad et al., 2025). Moreover, existing studies have largely focused on sovereign credit ratings while giving limited attention to rating outlooks despite their forward-looking nature, with institutional quality being examined as an independent determinant of FDI without considering its potential moderating role in the relationship between sovereign credit ratings, rating outlooks, and FDI (Rioba, 2023; Chen & Jiang, 2023). Moreover, previous studies have also been conducted in regional or multi-country contexts, potentially masking the specific characteristics of Kenya (Arogundade et al., 2022).

Therefore, it remains unclear whether sovereign credit ratings and rating outlooks influence foreign direct investment in Kenya and whether this relationship is moderated by institutional quality. This study, therefore, sought to examine the effect of sovereign credit ratings and rating outlooks on foreign direct investment in Kenya, moderated for the role of institutional quality.

1.3 Research Objectives

1.3.1 General Objective

To evaluate the effect of sovereign credit ratings on foreign direct investment (FDI) to Kenya, while moderating for the role of institutional quality.

1.3.2 Specific Objectives

i. To determine the effect of sovereign credit ratings on foreign direct investment in Kenya.
ii. To evaluate the effect of rating outlooks/watch status (positive/negative/stable) on foreign direct investment in Kenya.
iii. To examine the moderating effect of institutional quality on the relationship between sovereign credit ratings, rating outlooks, and foreign direct investment in Kenya.

1.4 Research Questions

i. To what extent do sovereign credit ratings affect foreign direct investment in Kenya?

ii. What effect do sovereign rating outlooks have on foreign direct investment in Kenya?
iii. Does institutional quality moderate the relationship between sovereign credit ratings, rating outlooks, and foreign direct investment in Kenya?

1.5 Research Hypotheses

The following null hypotheses were therefore tested:

H_1: Sovereign credit ratings have no statistically significant effect on foreign direct investment in Kenya.

H_2: Rating outlooks have no statistically significant effect on foreign direct investment in Kenya.

H_3: Institutional quality has no statistically significant moderating effect on the relationship between sovereign credit ratings, rating outlooks, and foreign direct investment in Kenya.

1.6 Scope of the Study

This study examined the effect of sovereign credit ratings and rating outlooks on foreign direct investment (FDI) to Kenya. Further, the study incorporated institutional quality as a moderating variable to assess how governance structures and institutional strength shaped the effect of sovereign credit ratings and outlooks on FDI. Key macroeconomic factors of GDP growth, inflation, and trade openness were included as control variables to provide a comprehensive understanding of the determinants of FDI within the Kenyan context.

The study's contextual scope was limited to Kenya, a suitable case study given its reliance on FDI to support critical industries such as manufacturing and agriculture, and to drive GDP growth. The study covered the period 2006 to 2023, during which Kenya experienced fluctuations in FDI attributable to public debt levels, the Global Financial Crisis of 2007/08, the enactment of the Kenyan Constitution of 2010, the COVID-19 pandemic, alongside other global and local economic and policy reforms. Additionally, the start year was selected because it marked Kenya's first sovereign credit rating by the major international credit rating agencies, enabling a comprehensive assessment of the study variables over the entire period. The end year was restricted to 2023 to ensure the use of complete, fully reported annual data for all study variables. Additionally, major

data sources, including the World Bank and IMF databases, are subject to reporting and revision lags, making 2023 the most recent year for which consistent and comparable data were available across the variables included in the study.

The study used annualized secondary data from reliable international and national databases, including the World Bank's World Development Indicators (WDIs), UNCTAD, the Central Bank of Kenya, other central bank databases, sovereign rating agency databases, and the Worldwide Governance Indicators (WGIs). The study relied exclusively on secondary data and adopted a quantitative explanatory design, using econometric techniques to analyse the study variables.

1.7 Significance of the Study

The main aim of this study was to examine the effect of sovereign credit ratings and rating outlooks on foreign direct investment (FDI) into Kenya, with institutional quality as a moderator. This study sought to contribute to existing academic literature by providing practical insights to support policy formulation and strategies around FDI management in Kenya. The choice of sovereign ratings, rating outlooks, institutional quality, and macroeconomic variables to control for the study introduced a comprehensive framework that captured both credit-related signals and underlying macroeconomic fundamentals influencing FDI into Kenya. Given the limited academic research on these variables to date, the study provides a basis for comparative research, particularly within the African context.

Moreover, investment institutions such as InvestKenya, Kenya National Chamber of Commerce and Industry, and other investment promotion agencies may benefit from this study. These institutions can rely on the findings in policy formulation around investment promotion strategies, aligning investment conditions, and working towards strengthening Kenya's positioning as an attractive investment destination. With the introduction of institutional quality as a moderating variable and the macroeconomic variables to control for the model, the study further incorporates the role of various policy stakeholders in influencing FDI into Kenya, thereby encouraging collaborative efforts towards policy formulation to that effect.

In addition, foreign investors and multinational corporations (MNCs) seeking information on Kenya as an investment destination will gain a better understanding of how credit ratings and outlooks, as well as institutional quality, shape investment decisions. Such information would be

critical in enhancing the risk assessment, informing portfolio allocation, and supporting more effective investments in the country.

1.8 Chapter Summary

This chapter provided a general overview of the background of the study variables, their relevance within Kenya, and briefly highlighted gaps that necessitate further research. The section also explored the research problem and the expected contribution to academia and policy.

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CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter presents a review of the literature on the study variables, i.e., FDI, SCRs, rating outlooks, and institutional quality. It begins with a theoretical literature review that explores the theories underpinning each variable, their proponents and critics, and their relevance to the study. It also includes an empirical literature review that explores and appraises prior studies on the variables and identifies potential research gaps that our study aims to address. The conceptual framework further diagrammatizes the interaction of the variables and their components within the study model, and finally, the operationalization of variables analyses the data characteristics and their sources, which later inform their application in the study methodology.

2.2 Theoretical Review

The theories explored in this section included the eclectic paradigm (OLI framework), which provides insights into why multinational corporations choose to invest in particular countries and how sovereign ratings may influence location-specific advantages, the information asymmetry theory, which aims to explain how sovereign credit ratings and outlooks act as signals to investors, by reducing uncertainty and bridging information gaps between host countries and potential investors, the institutional theory, which underscores how institutional quality shapes both sovereign ratings and the attractiveness of a country to foreign direct investment and the signaling theory, which explains how sovereign credit ratings and outlooks provide informational signals on country's investment landscape thereby influencing FDI attractiveness.

2.2.1 Eclectic theory of International Production: "The OLI Framework."

The Eclectic Theory of International Production, commonly referred to as the OLI Framework, was developed by Dunning (1973) and later refined in Dunning (1988). The theory explains why multinational corporations (MNCs) undertake foreign direct investment (FDI) by arguing that firms invest abroad when they possess Ownership (O), Location (L), and Internalization (I) advantages. Ownership advantages refer to firm-specific assets such as technology, expertise, and economies of scale. Location advantages arise from characteristics of the host country, including market size, macroeconomic stability, institutional quality, political environment, and government

policies. Internalization advantages explain why firms prefer direct ownership and control of foreign operations rather than licensing or contracting.

The theory is relevant to this study because sovereign credit ratings, rating outlooks, and institutional quality can be viewed as indicators of a country's location advantages. Sovereign credit ratings reflect a country's macroeconomic stability, fiscal sustainability, governance quality, and overall risk profile, while rating outlooks provide forward-looking information regarding future changes in these conditions. Consequently, favourable ratings and outlooks may enhance a country's attractiveness as an investment destination and influence foreign investment decisions.

Empirical evidence generally supports the position that favourable sovereign credit ratings encourage foreign direct investment. Arogundade et al. (2022) found that sovereign credit ratings had a positive and significant effect on FDI in Sub-Saharan Africa. Similarly, Bayar and Kılıç (2014) established positive causal relationships between sovereign credit ratings and FDI in Turkey. These findings suggest that sovereign ratings may be among the location-specific advantages that multinational enterprises consider when selecting host countries in which to invest.

However, empirical findings remain inconclusive across different contexts. Arogundade et al. (2022) also found evidence of unidirectional causality from FDI to SCRs in Kenya and Zambia, suggesting that stronger investment performance may itself contribute to improved ratings. Such findings indicate that the relationship between SCRs and FDI may vary depending on country-specific characteristics and institutional environments. Furthermore, limited empirical evidence exists on the combined effect of sovereign credit ratings, rating outlooks, and institutional quality on FDI in Kenya.

A key strength of the OLI Framework is that it provides a comprehensive explanation of the factors influencing multinational investment decisions and highlights the importance of country-specific characteristics in attracting FDI (Dunning, 1988). However, the empirical literature limits the exploration of the role of sovereign credit ratings in explicitly shaping investment decisions. Additionally, it assumes that investors have sufficient information to assess location advantages, an assumption that may not always hold in developing economies characterized by information asymmetries (Dunning, 1988).

Based on the OLI Framework, favorable sovereign credit ratings, positive rating outlooks, and stronger institutional quality may enhance investment attractiveness, thereby attracting FDI to Kenya.

2.2.2 Information Asymmetry Theory

Akerlof compared the business environment to a used-car market, where sellers with superior information about car quality have an advantage over buyers who lack the same information. Good cars are likened to “peaches” and not-so-good cars to “lemons”. Because of the skewed information, buyers are likely to buy the not-so-good cars, driving out sales for the good cars (Akerlof, 1970).

The theory is relevant to this study because foreign investors often have less information about a host country's investment conditions, including economic conditions, institutional frameworks, and sovereign risks, than the host country does. Sovereign credit ratings and rating outlooks, therefore, serve as mechanisms that reduce information asymmetry by providing critical information on a country's creditworthiness, macroeconomic stability, and governance environment. Reducing information gaps may influence foreign investors' willingness to invest in a country.

Empirical literature supports the role of sovereign credit ratings in bridging information gaps. UNDP (2025b) reported that sovereign ratings provided investors with valuable information regarding a country's economic and political environment, thereby influencing capital allocation decisions. Kim and Wu (2008) also found that sovereign credit ratings facilitate international capital flows by reducing barriers to information about governance and prevailing macroeconomic conditions for foreign investors. Cai et al. (2018) observed that sovereign credit ratings significantly influenced FDI to both OECD and non-OECD countries, with greater flows to lower-rated non-OECD countries.

However, empirical findings have remained mixed. Arogundade et al. (2022) found exceptions that for Kenya and Zambia, evidence suggested that FDI may influence ratings rather than ratings influencing FDI. Such findings imply that sovereign credit ratings may not always provide sufficient information to influence investment decisions and may need to be backed by other investment fundamentals.

A major strength of this theory is that it provides a strong explanation for the existence and relevance of sovereign credit ratings and outlooks in international investment markets. It explains why independent assessments can influence investor behaviour and capital allocation decisions. However, the theory assumes that the information provided is accurate, timely, and credible (Spence, 1973). Critics argue that credit rating agencies may exhibit biases, respond slowly, or have methodological weaknesses, thereby failing to fully eliminate information asymmetry (UNDP, 2025a).

Based on information asymmetry theory, higher sovereign credit ratings and favourable rating outlooks are expected to reduce uncertainty among foreign investors and, in turn, positively influence foreign direct investment in Kenya.

2.2.3 Institutional Theory

Proponents of the institutional theory were Meyer and Rowan (1977), who argued that organisations and economic actors operate within broader institutional environments comprising formal rules, regulations, norms, and governance structures. The theory generally suggests that stronger institutional frameworks tend to correspond to better investment climates and are therefore deemed more attractive for FDI into a country.

The theory is relevant to this study because institutional quality may influence both a country's attractiveness to foreign investors and the credibility of sovereign credit ratings and outlooks. In this study, institutional quality is conceptualized as a moderating variable that explains the strength of the effect of sovereign credit ratings and outlooks on foreign direct investment. Strong institutions may enhance the credibility of favourable sovereign ratings, whereas weak institutions may reduce investors' confidence even where ratings are relatively stable.

Empirical evidence generally supports the importance of institutional quality in attracting foreign investment. OECD (2021) emphasized that strong and accountable institutions improve investor confidence by reducing transaction costs, enhancing policy credibility, and lowering investment risk. Jung (2020) found that improvements in institutional quality reduced the costs of foreign direct investment and encouraged MNCs to expand into emerging economies. In a subsequent study, Jung (2022) established that institutional quality significantly influenced multinational firms' location decisions by affecting market entry costs and set-up costs.

Similarly, Chen and Jiang (2023) found that institutional quality significantly enhanced FDI through improved governance, transparency, and regulatory stability. Their study further demonstrated that institutional quality could play both mediating and moderating roles in influencing the effect of broader economic factors on FDI. In Kenya, Rioba (2023) found that institutional quality significantly influenced FDI, with positive effects from voice and accountability, political stability, and the rule of law, and negative effects from regulatory quality, government effectiveness, and control of corruption.

However, empirical findings remain inconsistent. While most studies report positive effects of institutional quality on FDI, Rioba (2023) found that certain governance dimensions, including regulatory quality, government effectiveness, and control of corruption, negatively influenced FDI in Kenya due to increased bureaucratic procedures associated with compliance requirements. These findings suggest that institutional quality may influence investment decisions differently in various countries and institutional indicators.

A major strength of the theory is that it provides a comprehensive and widely recognized basis for explaining how governance structures, regulations, and institutional arrangements influence investor behaviour (Meyer & Rowan, 1977). However, the theory does not fully explain why investors may continue investing in countries with relatively weak institutions where other factors, such as natural resources, market size, or strategic location advantages, remain attractive (Walsh & Yu, 2010). Furthermore, institutional quality may be difficult to measure comprehensively due to its qualitative and multidimensional nature (Kaufmann et al., 2010).

This theory posits that stronger institutional quality is expected to enhance investor confidence and strengthen the positive influence of sovereign credit ratings and rating outlooks on foreign direct investment. Therefore, institutional quality plays an important role in moderating the relationship between SCRs, rating outlooks, and FDI in Kenya.

2.2.4 Signaling Theory

Signaling theory was introduced by Spence (1973) to explain how parties with superior information communicate credible signals to less-informed parties in situations of information asymmetry. In his original labour market model, Spence argued that job applicants used educational qualifications as signals of productivity to potential employers. The effectiveness of a

signal depended on its credibility, observability, and cost, such that only individuals possessing the desired qualities could credibly send the signal. Consequently, signaling reduces uncertainty and facilitates more informed decision-making in imperfect markets.

The theory is particularly relevant to this study because sovereign credit ratings and outlooks serve as signals conveying information about a country's creditworthiness, macroeconomic stability, institutional environment, and future economic prospects to foreign investors. Since investors often have limited information about host countries, sovereign credit ratings and outlooks provide assessments of sovereign risk that may influence investment decisions. While ratings assess current creditworthiness, rating outlooks provide forward-looking information on the likely direction of future rating changes, thereby shaping investor expectations.

Empirical evidence supports the signaling role of sovereign credit ratings and outlooks. Cantor and Packer (1996) found that sovereign credit ratings significantly influenced sovereign bond yields and investor perceptions of country risk, even after controlling for macroeconomic fundamentals. Alsakka and Gwilym (2012) established that rating outlooks and watches contained significant information regarding future rating changes and influenced investor behaviour in sovereign debt markets. Similarly, Kaminsky and Schmukler (2002) found that changes in ratings and outlooks significantly affected financial markets, with outlook revisions often having effects deemed just as significant as the actual rating changes.

Despite this evidence, findings regarding the influence of sovereign credit signals remain mixed. While many studies conclude that ratings and outlooks influence investor behaviour, others suggest that investors may rely more heavily on underlying macroeconomic and institutional fundamentals than on rating announcements themselves (Matima, 2021; Rioba, 2023; Walsh & Yu, 2010). Furthermore, the significance of sovereign credit signals may vary across developed and developing economies, depending on institutional frameworks, markets, and access to information sources (Kaminsky & Schmukler, 2002; Kim & Wu, 2008).

A key strength of signaling theory is that it directly explains how sovereign credit ratings and rating outlooks influence investor perceptions and investment decisions. The theory provides a foundation for understanding why foreign investors may respond to rating upgrades, downgrades, and outlook revisions (Spence, 1973). Credit rating agencies have frequently been criticized for

biased ratings, particularly on the African continent, and for their role in major financial crises, raising concerns about the reliability of their signals (UNDP, 2025b).

Based on signaling theory, higher sovereign credit ratings and favourable rating outlooks are expected to signal greater economic prospects, thereby positively influencing FDI into Kenya. Given that rating outlooks provide forward-looking information, they may influence investment decisions even before actual rating changes occur.

2.3 Empirical Review

This section reviews existing literature on the effect of sovereign credit ratings (SCRs) and rating outlooks on foreign direct investment (FDI). It further examines how credit ratings and outlooks, controlled for macroeconomic factors in the model, influence investment decisions and FDI to Kenya, while moderating for the role of institutional quality. The section also highlights gaps in existing research, outlines the conceptual framework, and details the operationalization of the study variables.

In this study, foreign direct investment (FDI) was modelled as the dependent variable, while sovereign credit ratings (SCR) and rating outlooks were examined as the independent variables. Institutional quality as a moderating variable assessed how specific governance indicators influenced the relationship between SCRs, outlooks, and FDI. The model further controlled for macroeconomic factors, including GDP growth, inflation and trade openness.

Although extensive prior research had examined variables and their determinants separately, limited empirical research had examined the effects of both sovereign credit ratings and rating outlooks on FDI, while moderating the role of institutional quality, particularly in Kenya.

2.3.1 Sovereign Credit Ratings and FDI

Sovereign credit ratings (SCRs) are widely used by international investors as indicators of sovereign risk, fiscal sustainability, macroeconomic stability, and the overall investment climate. Governments, particularly in developing and emerging economies, often seek sovereign ratings to improve access to international capital markets and attract foreign investment (UNDP, 2025b). According to Cantor and Packer (1996), sovereign ratings influence not only borrowing costs but also investor perceptions of country risk, thereby affecting international capital allocation decisions.

Empirical evidence generally suggests that sovereign credit ratings influence foreign direct investment by reducing uncertainty and signaling a country's investment attractiveness. Cai et al. (2018), in a study involving OECD and non-OECD countries between 1985 and 2012, found that sovereign credit ratings significantly influenced FDI for both investing and recipient countries. The study found that highly rated OECD countries attracted more FDI, reflecting investors' preference for lower-risk environments. However, lower-rated non-OECD countries also attracted significant FDI, suggesting that some investors are willing to assume higher risk in pursuit of potentially higher returns. These findings imply that the influence of sovereign ratings on FDI may vary with country characteristics and investors' risk preferences.

Similarly, Arogundade et al. (2022), using data from 20 Sub-Saharan African countries between 2007 and 2019, found that sovereign credit ratings had a positive and significant effect on FDI, particularly during the period following the Global Financial Crisis. The scholars argued that sovereign ratings reduced information asymmetry and enhanced investor confidence by providing signals regarding macroeconomic stability and sovereign risk. While the study observed causality from SCRs to FDI in most countries, Kenya and Zambia exhibited unidirectional causality from FDI to SCRs. This finding raises the possibility of reverse causality, whereby higher FDI improves economic performance and fiscal sustainability, which in turn contributes to improved sovereign credit ratings. This suggests that the relationship between SCRs and FDI may be dynamic and context-specific rather than strictly unidirectional.

Bayar and Kılıç (2014) similarly found that the causal relationships between SCRs and FDI in Turkey from 1995 to 2013 differed across rating agencies. The study reported bidirectional causality between FDI and ratings assigned by S&P and Fitch, while Moody's ratings exhibited a one-way causal relationship. These findings suggest that the interaction between sovereign ratings and FDI may differ across rating agencies and institutional contexts, attributable to variations in rating methodologies and investor perceptions.

Further evidence is provided by Meyer and Mothibi (2021), who examined South Africa between 1994 and 2020 and found bidirectional relationships among sovereign ratings, FDI, and economic growth. The study suggested that sovereign ratings not only influenced investment decisions but were themselves influenced by broader economic performance indicators. Similarly, Emara and El Said (2021), studying 24 emerging economies between 1990 and 2018, found that the influence

of sovereign ratings on FDI became stronger during periods of domestic and global crises. This suggests that investors rely more heavily on rating signals during periods of higher uncertainty to inform potential investment decisions.

Although the literature generally supports a positive relationship between sovereign credit ratings and FDI, the findings remain inconsistent, varying across country contexts, macroeconomic conditions, and institutional settings. Most previous studies employ multi-country panel data techniques, which may mask country-specific dynamics in Kenya. Furthermore, the reverse causality identified by Arogundade et al. (2022) for Kenya suggests that the direction of influence between SCRs and FDI remains inconclusive and warrants further investigation using a country-specific framework.

Overall, the literature demonstrates that sovereign credit ratings are important signals that foreign investors consider when making investment decisions in host countries. However, the mixed findings, evidence of possible reverse causality, limited consideration of institutional quality, and multi-country analyses indicate the need for a Kenya-specific investigation.

2.3.2 Rating outlooks and FDI

While sovereign credit ratings assess a country's current creditworthiness, rating outlooks provide forward-looking information on the likely direction of future rating actions. According to S&P Global (2024), outlooks indicate the potential direction of long-term ratings over a specified period and reflect the probability of future upgrades or downgrades. Consequently, rating outlooks may influence investor expectations before actual rating changes occur, making them important signals in investment decision-making.

Despite their forward-looking nature, rating outlooks have received considerably less attention in the FDI literature compared to sovereign credit ratings. Most studies have focused on the effect of outlooks on financial markets, sovereign bond yields, and default risk rather than on foreign direct investment decisions. This has resulted in a limited understanding of whether outlooks independently influence long-term investment decisions and how their effects compare to those of sovereign credit ratings.

Kaminsky and Schmukler (2002), in a study of emerging markets between 1990 and 2000, found that changes in both sovereign credit ratings and outlooks significantly affected stock and bond

markets. Importantly, the study established that outlook revisions were often as influential as actual rating changes and generated substantial spillover effects across financial markets, particularly during periods of financial distress. These findings support the argument that investors respond not only to current assessments of creditworthiness but also to signals regarding future economic and financial conditions. However, the study focused on financial market reactions rather than FDI and excluded most Sub-Saharan African countries, limiting the applicability of its findings to the Kenyan context.

Alsakka and Gwilym (2012), using sovereign rating observations from Fitch, Moody's, and S&P between 1994 and 2009, found that both rating outlooks and watches conveyed significant information regarding future rating actions. The study further concluded that watches provided stronger short-term signals than outlooks because they reflected a higher likelihood of rating changes. While these findings highlight the signaling role of outlooks, the study primarily focused on sovereign debt markets and did not assess any effects on FDI.

Hamilton and Cantor (2004) similarly observed that rating outlooks provided important information beyond sovereign credit ratings by indicating the likely timing and direction of future rating actions. Their study found that negative outlooks and watchlist placements increased the probability of future downgrades, while positive outlooks often preceded upgrades. These findings suggest that outlooks may serve as critical signals to investors about the likelihood of future rating changes. However, the study focused on default risk and default probability rather than establishing their effect on FDI.

Generally, the reviewed studies suggest that rating outlooks provide valuable forward-looking information and may influence investor expectations even before actual rating actions occur. Nevertheless, the empirical evidence remains concentrated in developed financial markets and different markets. Therefore, the role that rating outlooks play in influencing FDI remains unclear, particularly in the Kenyan context.

Recent literature focused on Africa further highlights the relevance of outlooks within developing economies. APRM (2024) reported that many African sovereigns continue to maintain negative or unstable outlooks due to fiscal pressures, debt vulnerabilities, and governance concerns. UNDP (2025b) observed that outlook revisions often reflect anticipated changes in fiscal sustainability, economic reforms, and institutional performance before such developments are incorporated into

sovereign ratings. These observations suggest that rating outlooks may provide particularly important information in African economies where investors face greater uncertainty regarding future economic and institutional conditions.

Overall, the literature demonstrates that rating outlooks are important forward-looking signals that influence investor expectations and perceptions of country risk. However, existing studies largely focus on different markets and provide limited evidence on their effects on FDI, particularly when examined alongside SCRs and moderated by institutional quality. This, therefore, justifies the inclusion of rating outlooks to examine their effect on FDI in the Kenyan context.

2.3.3 Institutional Quality and FDI

Institutional quality has increasingly been recognized as a critical determinant of FDI, providing important information about a country's investment environment, with strong institutions enhancing a country's investment attractiveness by reducing perceived risk.

Empirical evidence generally supports a positive relationship between institutional quality and FDI. Hefeker and Busse (2007), while examining developing countries between 1984 and 2003, found that government stability, bureaucratic quality, democratic accountability, corruption control, and conflict management were significant determinants of FDI. They argued that foreign investors consider both political and institutional risks when allocating international capital. Their findings suggest that institutional quality plays an important role in reducing uncertainty and improving the attractiveness of host countries.

Similarly, Chen and Jiang (2023) found that institutional quality significantly enhanced FDI by improving governance effectiveness, regulatory stability, and transparency. The study demonstrated that institutional quality performed both mediating and moderating roles in influencing FDI. Specifically, institutional quality was found to mediate the effects of trade openness, technological innovation, and industrial upgrading on FDI while simultaneously moderating the effects of broader macroeconomic conditions. These findings provide important support for treating institutional quality as a moderating variable in the present study.

Evidence from developing economies further reinforces the importance of institutional quality. NASSOUR et al. (2020), studying Algeria, Turkey, and Saudi Arabia between 1984 and 2017, found that corruption and military involvement in political processes significantly reduced FDI.

Osuma et al. (2024) established that corruption and political instability negatively affected FDI in Nigeria, while improvements in institutional quality, regulatory effectiveness, and governance strengthened investor confidence and increased investment inflows. These findings suggest that institutional quality influences investor behaviour by shaping perceptions of risk and the ease of conducting business.

Within the Sub-Saharan African context, Matima (2021) found that institutional quality exerted a stronger influence on FDI than political risk as institutional indicators provided investors with a longer-term assessment of governance quality and regulatory certainty. The study argued that investors generally place greater emphasis on institutional frameworks than on short-term political developments when making long-term investment decisions. However, the study focused on institutional quality as a direct determinant of FDI and did not examine whether institutional quality influenced how investors interpreted sovereign credit ratings.

In Kenya, Rioba (2023) found that institutional quality significantly influenced FDI, although the effects varied across governance dimensions. While voice and accountability, political stability, and rule of law positively affected FDI, regulatory quality, government effectiveness, and control of corruption exhibited negative effects. These findings were attributed to increased bureaucratic procedures and compliance requirements associated with stronger regulatory frameworks. These results highlight that different governance dimensions may have different effects on investment decisions.

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The inconsistencies observed across studies suggest that institutional quality does not influence FDI uniformly across countries and regions. Furthermore, most previous studies examine institutional quality as an independent determinant of FDI, without considering its potential role in attracting foreign investment.

APRM (2024) corroborated this by highlighting that governance quality, policy credibility, fiscal discipline, and institutional effectiveness remain central considerations in sovereign risk assessments across Africa, while UNDP (2025b) emphasised that improvements in governance and institutional effectiveness were likely to strengthen investor confidence and improve sovereign credit assessments. These observations suggest that institutional quality may influence sovereign credit ratings and investment decisions.

Overall, the reviewed literature consistently demonstrates that institutional quality remains an important factor influencing FDI. However, limited empirical evidence exists on its moderating effect on the relationships among SCRs, rating outlooks, and FDI, particularly in the Kenyan context. This study, therefore, seeks to address this gap by examining whether institutional quality strengthens or weakens the effect of sovereign credit ratings and rating outlooks on FDI in Kenya.

2.4 Summary of the Literature and Research Gap(s)

The reviewed literature demonstrates that sovereign credit ratings, rating outlooks, institutional quality, and macroeconomic conditions are important factors influencing FDI. However, the findings remain mixed on the effect of sovereign credit ratings and rating outlooks on FDI.

Most empirical studies report a positive causal relationship between sovereign credit ratings and FDI. Studies by Cai et al. (2018), Bayar and Kılıç (2014), Emara and El Said (2021), and Arogundade et al. (2022) generally found that higher sovereign ratings improve investor confidence and attract greater FDI by signaling lower sovereign risk, stronger macroeconomic fundamentals, and improved investment conditions. These findings are consistent with the signaling and information asymmetry theories, which suggest that sovereign ratings reduce information gaps in investment decision-making.

Despite numerous studies providing this conclusion, important inconsistencies remain within the literature. Arogundade et al. (2022) found that while sovereign credit ratings positively influenced FDI across most Sub-Saharan African countries. However, in Kenya and Zambia, the findings showed that FDI influenced sovereign credit ratings rather than the reverse. Similarly, Bayar and Kılıç (2014) reported different causal relationships depending on the rating agency considered, while Emara and El Said (2021) observed that the influence of ratings became stronger during periods of economic and financial crises. These findings suggest that the relationship between sovereign credit ratings and FDI may vary according to country characteristics, institutional conditions, and prevailing economic circumstances.

The review further reveals that rating outlooks remain relatively underexplored despite their recognised signaling role. Although studies by Kaminsky and Schmukler (2002), Hamilton and Cantor (2004), and Alsakka and Gwilym (2012) demonstrate that rating outlooks contain important forward-looking information and often influence investor expectations before actual rating

changes occur, most existing studies focus on sovereign debt markets and other financial assets, rather than FDI. Consequently, limited empirical evidence exists regarding the extent to which rating outlooks independently influence FDI.

The literature also consistently highlights the importance of institutional quality in attracting FDI. Studies by Hefeker and Busse (2007), Matima (2021), Chen and Jiang (2023), Osuma et al. (2024), and Rioba (2023) demonstrate that governance quality, regulatory effectiveness, political stability, and corruption control significantly influence FDI. However, institutional quality has predominantly been examined as a direct determinant of FDI rather than as a factor influencing how investors interpret sovereign credit ratings and outlooks. Therefore, limited evidence exists regarding its moderating role in the relationship between sovereign credit ratings, outlooks, and foreign direct investment.

Methodologically, most existing studies adopt panel-data approaches involving multiple countries with differing institutional structures, economic characteristics, and investment environments. While such approaches enhance generalisability, they may mask country-specific dynamics. Furthermore, the possible reverse causality identified by Arogundade et al. (2022) suggests that the relationship between sovereign credit ratings and FDI may be in reverse, thereby requiring careful interpretation of empirical findings. Therefore, this study focuses solely on Kenya to isolate its context-specific characteristics.

Based on the reviewed literature, four key research gaps emerge. First, a conceptual gap exists as most studies focus exclusively on sovereign credit ratings, excluding rating outlooks. Second, a methodological gap exists because few studies examine the moderating effect of institutional quality on the relationship between sovereign credit signals and FDI. Third, a contextual gap exists because most available evidence comes from regional or multi-country studies, which may limit the applicability of the findings to Kenya.

2.5 Conceptual Framework

In this study, the dependent variable was FDI to Kenya (annual net US$ millions), expressed as ln(FDI) to stabilize variances within the model. The main explanatory variables were sovereign credit ratings and rating outlooks/watch actions. Institutional quality, measured as the average of selected WGIs, i.e., control of corruption, rule of law, regulatory quality, and government

effectiveness, was included as a moderator to capture how governance indicators alter the effect of ratings and outlooks on FDI. The model controlled for macroeconomic variables, including GDP growth, inflation, and trade openness, as these macroeconomic factors are widely recognised determinants of FDI and may influence foreign investors' decisions independently of sovereign credit ratings and rating outlooks (Walsh & Yu, 2010; Arogundade et al., 2022).

The conceptual framework below depicts the hypothesized relationships among these variables.

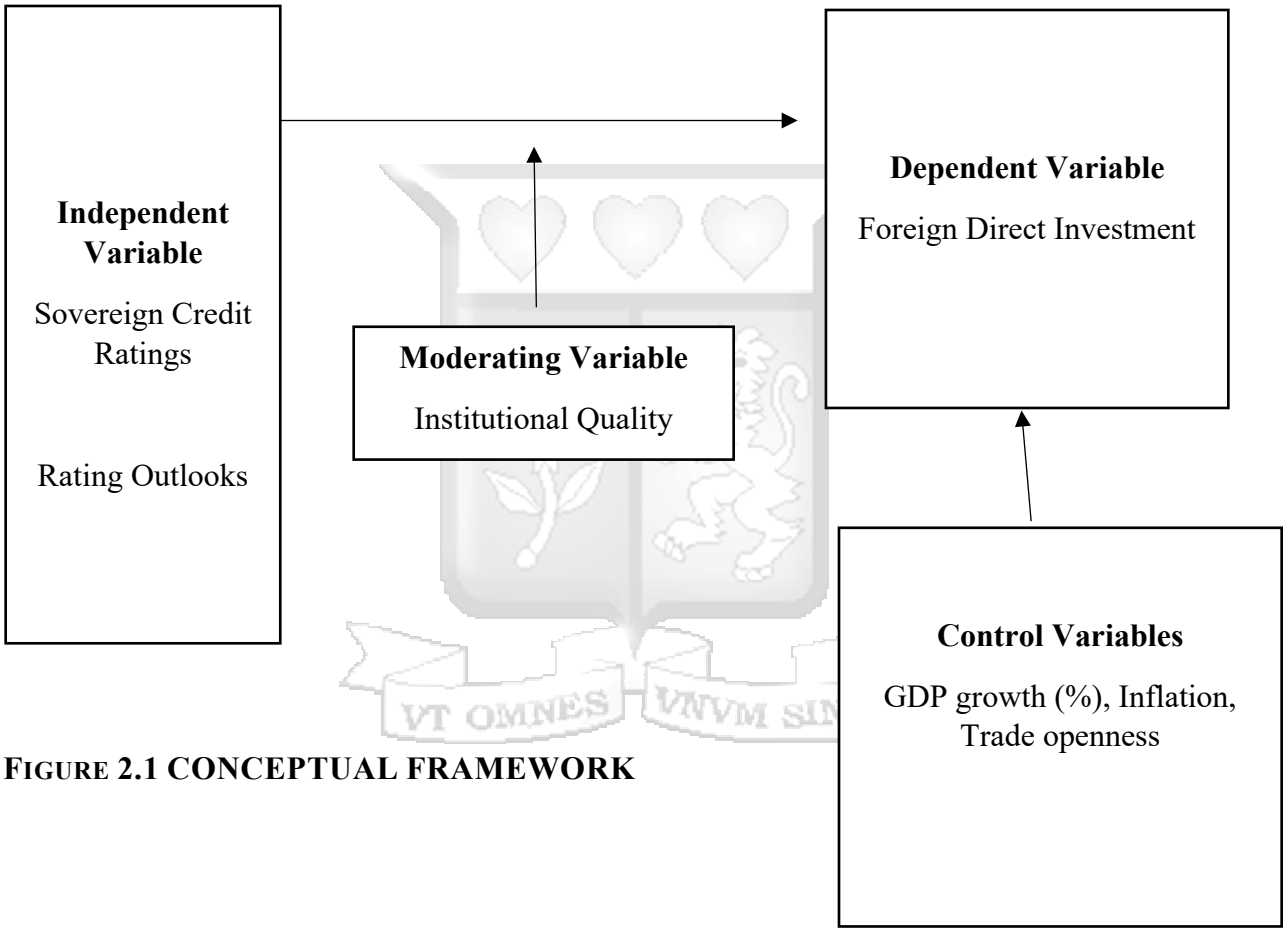


FIGURE 2.1 CONCEPTUAL FRAMEWORK

2.5.1 Operationalization of the Variables

TABLE 2.1 OPERATIONALIZATION OF VARIABLES

Variable name	Abbreviation	Description	Measurement	Data type	Theory	Source
Foreign Direct Investment	FDI	Capital flows from foreign entities into Kenya's economy	Annual net FDI (US$ millions); natural log-transformed to stabilize variance	Continuous (ratio)	Eclectic Paradigm (OLI Framework)	World Bank World Development Indicators (WDI) (World Bank Group, 2026b)
Sovereign Credit Ratings	SCR	Assessment of Kenya's creditworthiness by S&P, Moody's, and Fitch	Converted letter grades into a standardized numerical scale (e.g., AAA=1… D=21)	Ordinal (coded to numerical)	Information Asymmetry Theory	S&P, Moody's, Fitch ratings reports (2006 to 2023) via Trading Economics (Trading Economics, 2026a)
Rating Outlooks	OUT	Rating agencies' forward-looking assessment of potential rating change	Dummy variable: Positive = 1, Stable/None = 0,	Categorical	Signalling Theory	S&P, Moody's, Fitch outlook/watch reports via

			Negative = –1			Trading Economics (Trading Economics, 2026a)
Institutional Quality	IQ	Average governance quality captures the rule of law, control of corruption, government effectiveness, and regulatory quality	Mean of WGI scores (standardized index, –2.5 to +2.5)	Continuous (index)	Institutional Theory	Worldwide Governance Indicators (WGIs) (World Bank Group, 2026g), (World Bank Group, 2026a), (World Bank Group, 2026d), (World Bank Group, 2026f)
GDP Growth Rate (%)	GDPG	Annual percentage growth rate of GDP at market prices	Annual % change	Continuous (ratio)		World Bank WDIs (World Bank Group, 2026c)

Inflation	INF	Measure of macroeconomic stability	Annual % change in Consumer Price Index (CPI)	Continuous (ratio)		World Bank WDIs (World Bank Group, 2026e)
Trade Openness	TO	Extent of integration into global trade	(Exports + Imports) as a % of GDP	Continuous (ratio)		World Bank WDI (World Bank Group, 2026h)

2.6 Chapter Summary

This chapter reviewed the theoretical and empirical literature, exploring how sovereign credit ratings and outlooks influence investors' FDI decisions in host countries. The review highlighted conceptual, contextual, and methodological gaps, establishing the areas of contribution that this study aims to address, particularly in the Kenyan context.

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CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter discusses the research methodology employed to examine the effect of sovereign credit ratings (SCRs) and outlooks on foreign direct investment (FDI) in Kenya. It begins by outlining the research philosophy, which provides the study's underlying assumptions. The second section discusses research design, describing the overall approach and framework adopted to achieve the study objectives. The third section presents the population and sampling techniques used to identify and select the study's data sources. The fourth section details the data collection methods and tools, highlighting the data sources and procedures used. The fifth section focuses on data analysis and presentation, explaining the techniques and models used to analyse the data. The sixth section addresses research quality, including the reliability, validity, and robustness of the study's findings. Finally, the chapter concludes with ethical considerations, outlining the principles and measures observed to ensure integrity and compliance in the research process.

3.2 Research Philosophy

Saunders et al. (2009) describe research philosophy as a set of beliefs and assumptions that underpin how knowledge is developed through research. The assumptions include epistemological assumptions, which concern the nature of knowledge, ontological assumptions, which concern the nature of reality, and axiological assumptions, which concern the influence of the researcher's values on their research. Positivist philosophy refers to working with observable social realities to produce generalizations, i.e., a focus on data and facts that are completely uninfluenced by human bias and interpretation (Saunders et al., 2009). The philosophy leans towards quantitative research through surveys, experiments with statistical analyses to approve or disapprove hypotheses (Zyphur & Pierides , 2020).

Interpretivism emphasizes the subjectivity of reality, which is dependent on different human experiences and values. It is mainly used in qualitative research, allowing flexibility in interpreting the collected data (Mwita, 2025). Pragmatist philosophy asserts that the research methodology is driven by the underlying research problem. Pragmatists may use multiple methods depending on which one allows for the collection of credible, reliable, and relevant data (Saunders et al., 2009).

This study, therefore, adopted a positivist research philosophy, which was most appropriate because it relied on secondary quantitative data from reputable international databases and rating agencies to draw conclusions about the variables. The philosophy allowed for hypothesis testing to examine the effect of sovereign credit ratings and rating outlooks on FDI into Kenya.

3.3 Research Design

This study adopted a quantitative explanatory (causal) research approach to examine the effect of sovereign credit ratings (SCRs) and outlooks on foreign direct investment (FDI) in Kenya between 2006 and 2023. An explanatory design was particularly appropriate because the study sought to establish the effect of sovereign credit ratings and outlooks on FDI to Kenya during the period under study, while accounting for the moderating effect of institutional quality.

The entire population of available annual observations on Kenya's sovereign credit ratings and outlooks from Standard & Poor's, Moody's, and Fitch, together with FDI and institutional quality indicators, derived from the World Development Indicators (WDIs) and the average of governance measures in the Worldwide Governance Indicators (WGIs), was used. Consistency and reliability were ensured through standardized, internationally recognized datasets, while reviews of empirical literature and theoretical frameworks supported their validity. Data analysis combined descriptive statistics with econometric techniques, including regression analysis, to examine relationships among the study variables and assess their statistical significance.

3.4 Population and Sampling

This study was a single-country case study of Kenya, using all available annual country-level data from 2006 to 2023. The dataset included sovereign credit ratings and outlooks from S&P, Moody's, and Fitch, annual FDI in US$ millions, and World Bank indicators of institutional quality. By including all observations, the study effectively ensured a complete and unbiased dataset for robust econometric analysis. The study covered the period 2006 to 2023, during which Kenya experienced fluctuations in FDI alongside major domestic and global developments, including changes in public debt dynamics, the Global Financial Crisis, the COVID-19 pandemic, and various economic and policy reforms. Additionally, 2006 was selected as the start year because it marked Kenya's first sovereign credit rating by the major international credit rating agencies, enabling a comprehensive assessment of the study variables over the entire period. The end year was restricted to 2023 to ensure the use of complete and fully reported annual data for all study

variables. Furthermore, major data sources, including the World Bank and IMF databases, are subject to reporting and revision lags, making 2023 the most recent year for which consistent and comparable data were available across the variables included in the study.

3.5 Data Collection Methods

The study relied on secondary annual data obtained from reputable international databases. FDI, GDP growth, inflation, and trade openness data were obtained from the World Bank's World Development Indicators (WDIs). Institutional quality indicators were obtained from the Worldwide Governance Indicators (WGIs) database. Sovereign credit ratings and rating outlook data were obtained from Moody's, S&P Global, Fitch Ratings, and supporting databases via Trading Economics. The specific measurement and operationalization of each variable are presented in Table 2.1.

3.6 Data Analysis

The analysis utilized annual time-series data for Kenya from 2006 to 2023. Data was organized into annual series, cross-checked for completeness, and consistency across viable data sources. Sovereign credit ratings were then converted into standardized annual numeric values for analysis (e.g., AAA=1, AA+), consistent with prior studies. This enabled quantitative analysis of categorical rating data (Cantor & Packer, 1996). Where a rating agency issued more than one rating within the year, the last rating issued was used, and the ratings from the three agencies were subsequently averaged to arrive at an annual sovereign credit rating (SCR) for Kenya (Afonso et al., 2011). The averaging approach was adopted to capture the overall sovereign credit signal available to investors rather than agency-specific assessments. While studies such as Mugobo and Mutize (2016) suggest that rating agencies may have differential effects, the present study focused on the aggregate influence of sovereign credit on FDI. Furthermore, the limited variation in Kenya's ratings and the relatively small sample size made separate agency-level analysis less feasible. Dummy variables, positive = 1, stable/none = 0, and negative = –1 were assigned to the rating outlooks. FDI, expressed as annual net inflows in US$ millions from the WDIs, was subjected to a natural logarithm (ln(FDI) to stabilize variances within the model.

Institutional quality measured using WGI indicators of control of corruption, rule of law, government effectiveness, and regulatory quality, was averaged to derive a standardized index. The model also controlled for GDP growth, inflation and trade openness.

Ordinary Least Squares (OLS) regression was used to examine the effect of sovereign credit ratings and rating outlooks on FDI in Kenya, with the effect moderated by institutional quality. OLS was considered appropriate because the study sought to estimate the direction and significance of the relationships among the variables using annual time-series data. The technique is widely used in research and provides estimates that are clear to interpret.

Furthermore, given the study used annual data from 2006 to 2023, resulting in 18 observations. Given the relatively small sample size and the study's objective of examining relationships among a limited number of variables, OLS was considered a suitable estimation technique. However, because time-series data may be affected by issues such as non-stationarity, multicollinearity, serial correlation, and heteroskedasticity, diagnostic tests were conducted before estimation to address the limitations presented using OLS in this study.

The stationarity of the variables was examined using the Dickey-Fuller Generalized Least Squares (DF-GLS) unit root test, considered more reliable for small samples (Elliott et al., 1996). Multicollinearity was assessed using the Variance Inflation Factor (VIF), serial correlation using the Breusch-Godfrey LM test, heteroskedasticity using the Breusch-Pagan test, and normality using the Shapiro-Wilk test. These tests were conducted to assess whether the data satisfied the assumptions underlying OLS regression and to ensure the validity and reliability of the estimated results.

3.6.1 Descriptive statistics

These are tests carried out to summarize data to draw useful conclusions about the relationship between variables in a sample or population (Yellapu, 2018). The mean, standard deviation, minimum, and maximum values were first computed to summarize the data and provide insights into the variables' central tendencies and variability.

3.6.2 Stationarity Test: Dickey-Fuller Generalized Least Squares (DF-GLS) test

Testing for stationarity in time-series data is important because non-stationary variables may produce spurious regression results, leading to misleading statistical inferences. The study therefore examined the stationarity properties of the variables using the Dickey-Fuller Generalized Least Squares (DF-GLS) unit root test. The DF-GLS test was preferred because it has greater

power than the conventional Augmented Dickey-Fuller (ADF) test, particularly in small samples (Elliott et al., 1996).

Where a variable was found to be non-stationary, appropriate transformations, including differencing where necessary, were considered to achieve stationarity prior to estimation. Sovereign credit ratings, originally expressed in alphanumeric form, were converted into a numerical scale to facilitate quantitative analysis. Similarly, rating outlooks were coded as Positive = 1, Stable = 0, and Negative = –1 to enable their inclusion in the regression models and stationarity testing.

3.6.3 Multicollinearity Test: Variance Inflation Factor (VIF)

To test for multicollinearity among the independent variables before model estimation, the VIF test was applied. Multicollinearity tests were conducted to assess whether strong or perfect relationships (collinearity) existed among the independent variables in the model, i.e., sovereign credit ratings and rating outlooks. VIF provides an easy way to compute and interpret collinearity, whilst highlighting the affected variables (Belsley et al.,1980). Given that outlooks signal future changes in ratings, the test examined how each explanatory variable separately explained the effect on FDI to Kenya in the model.

3.6.4 Heteroskedasticity Test: Breusch-Pagan test

Heteroskedasticity arises in regression analysis where outliers interfere with model interpretation. The test confirmed the homoskedasticity of error variances, an underlying assumption of the OLS regression used in the study, thereby ensuring that the least squares estimators remained unbiased. Where heteroskedasticity would have been detected, robust standard errors would be employed to correct (Abdul-Hameed & Matanmi, 2021). The Breusch-Pagan test checked for heteroskedasticity, where the null hypothesis stated that the variance of the error term was constant (homoskedasticity), and where the error variances changed, then robust errors were applied (Mart´ın, 2023).

3.6.5 Autocorrelation Test: Breusch-Godfrey Test

The Breusch-Godfrey (BG) test is commonly used to detect autocorrelation in dynamic models. It is conducted under the null hypothesis that the residuals are not serially correlated. Under the null

hypothesis, the test statistic is compared against a chi-square distribution with one degree of freedom to determine whether autocorrelation is present (Rois et al., 2012). The test was conducted to assess the presence of autocorrelation in the model residuals, with the null hypothesis stating that no serial correlation existed. Where autocorrelation had been identified, corrective measures would be considered to improve the reliability and validity of the regression results. The test concluded that no serial correlation was present.

3.6.6 Normality Test

The error component in a conventional linear regression model must be normally distributed with zero mean (Haschka, 2024). This is a significant assumption because these error components rely linearly on the computed coefficients. Consequently, the resulting coefficients follow a normal distribution with population parameter and population variance when the error terms have a normal distribution with zero mean and variance. The normality test was conducted to assess whether the model residuals were normally distributed, with the null hypothesis that they were normally distributed. The test established that the residuals of the variables under study were normally distributed.

Model

Given the annual frequency of the data and the single-country time-series nature of the study, Ordinary Least Squares (OLS) regression analysis was employed to examine the effect of sovereign credit ratings and rating outlooks on foreign direct investment (FDI) in Kenya. The analysis further assessed the moderating effect of institutional quality on the effect of sovereign credit ratings and rating outlooks on FDI, while controlling for selected macroeconomic variables. This study considered two regression models: one without a moderating variable and the other incorporating one.

Equation 1 (With no moderating variable):

$$\ln (FDI_t) = \beta 0 + \beta 1\ SCR_t + \beta 2\ OUT_t + \varepsilon_t$$

Equation 2 (With moderating variable):

$$\ln(FDI_t) = \beta 0 + \beta 1\ SCR_t + \beta 2\ OUT_t + \beta 3\ IQ_t + \beta 4(SCR_t \times IQ_t) + \beta 5(OUT_t \times IQ_t) + \sum_{i=1}^{k} \gamma'\ Controls_t + \varepsilon_t$$

Where:

- $\ln(FDI_t)$ denotes the natural logarithm of annual FDI (US$ millions).
- SCR_t represents Kenya's sovereign credit rating, converted into a standardized numeric scale.
- OUT_t captures sovereign rating outlooks or watchlist classifications (positive = 1, negative = –1, stable = 0).
- IQ_t is institutional quality, measured as the average of four World Governance Indicators of control of corruption, rule of law, government effectiveness, and regulatory quality.
- $Controls_t$ a vector of macroeconomic variables, including GDP growth, inflation and trade openness.
- ε_t the stochastic error term.

3.7 Research Quality

The quality of this study was ensured by using reliable secondary data from globally recognized sources, such as the World Bank and central bank databases. Sovereign credit ratings, outlooks, FDI, and institutional quality are widely recognized in the literature as indicators of investment performance in countries and are critical contributors to Kenya's institutional frameworks and GDP growth.

3.8 Ethical Issues in Research

The study relied solely on publicly available secondary data, eliminating risks associated with confidentiality or participant consent. All data sources were acknowledged and cited appropriately. Ethical rigor was maintained through transparent reporting of methods, avoidance of data manipulation, and objective presentation of results. Finally, in line with the Strathmore University research policies, ethical approval for data collection and subsequent analysis was sought from the Strathmore University Institutional Scientific and Ethics Review Committee (SU-ISERC).

3.9 Chapter Summary

This chapter outlined the research methodology, broken into the research philosophy and design, population and sampling, data collection methods, data analysis using OLS regression, and the initial diagnostic tests to enhance the validity of the regression results, research quality, and ethical considerations. In general, the chapter detailed the methodological framework, which guided the findings presented subsequently in Chapter Four.

CHAPTER FOUR

PRESENTATION OF RESULTS/FINDINGS

4.1 Introduction

This chapter presents the study findings in three sections. The first section presents the preliminary data analysis, including descriptive statistics, distribution analysis, and pairwise correlation analysis of the study variables. The second section presents the diagnostic test results, while the third section presents the inferential analysis and hypothesis testing for the study objectives.

4.2 Descriptive Statistics

Table 4.1 presents the descriptive statistics of the study variables over the period 2006 to 2023. The results indicate notable variation across variables, reflecting changes in Kenya's macroeconomic and institutional conditions over time.

TABLE 4.1 DESCRIPTIVE STATISTICS

Variable	Obs.	Mean	Std. Dev.	Min	Max
Foreign Direct Investment	18	18.91	4.812	0	21.099
Sovereign Credit Ratings	18	13.056	0.236	13	14
Rating Outlooks	18	-0.333	0.485	-1	0
Institutional Quality	18	42.979	2.310	38.368	45.674
GDP growth	18	4.719	2.142	-.273	8.058
Inflation	18	8.739	5.225	3.961	26.24
Trade Openness	18	42.66	10.31	27.24	58.4

Source: Author Computation (2026)

Foreign direct investment (FDI) had a mean of 18.91 and a standard deviation of 4.812, indicating moderate variability in inflows over the study period. The minimum value of 0 and the maximum of 21.099 suggest periods of negligible inflows alongside relatively high investment episodes, indicating fluctuations in Kenya’s investment attractiveness.

Sovereign credit ratings had a mean of 13.056 and very low variability (standard deviation = 0.236), indicating relative stability in Kenya's credit rating over time, with only slight changes between rating categories. Similarly, rating outlooks show limited variation, with a mean of -0.333 and a standard deviation of 0.485, suggesting that negative or stable outlooks were more prevalent during the period under study.

Institutional quality had a mean of 42.979 and a standard deviation of 2.310, indicating moderate variation in governance and institutional performance. This suggests that while institutional quality fluctuated over time, the changes were relatively gradual.

Among the macroeconomic variables, inflation exhibited substantial variability with a mean of 8.739, a standard deviation of 5.225, and a maximum of 26.24, indicating periods of macroeconomic instability. GDP growth averaged 4.719 with moderate variation, while trade openness recorded a relatively high mean of 42.66 with notable variability, suggesting fluctuations in Kenya's integration into global trade.

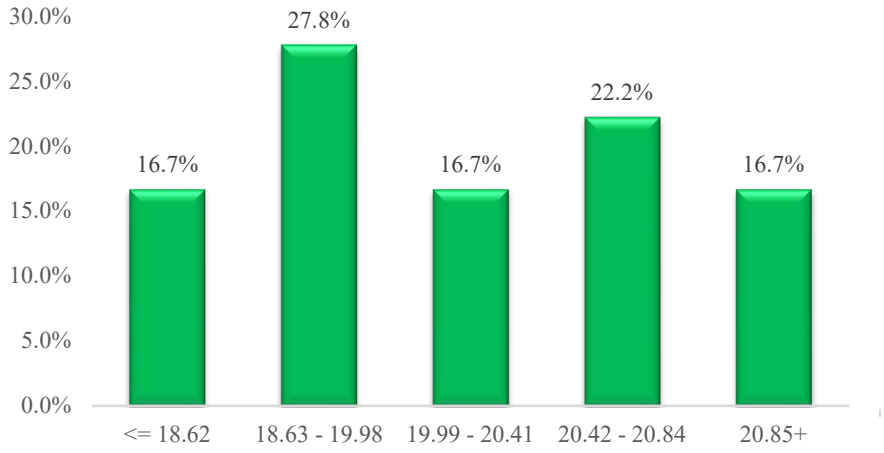
Overall, the descriptive statistics indicated that while some variables, such as sovereign credit ratings, remained relatively stable, key variables in the study, including FDI, inflation, and GDP growth, exhibited variability. This variation provided a basis for examining the effects of sovereign credit ratings and rating outlooks on FDI in Kenya.

4.3 Distribution statistics

The study variables were grouped into five quantile-based categories to assess their distribution across the study period.

Foreign direct investment values were transformed into natural logarithms and grouped into five categories. The lowest categories, one (<= 18.62), three (19.99 – 20.41), and five (20.85+), each accounted for 16.7% of the distribution. Category four (20.42 – 20.84) had 22.2%, whereas category two (18.63 – 19.98) had 27.8% of the distributions, as indicated in Figure 4.1 below:

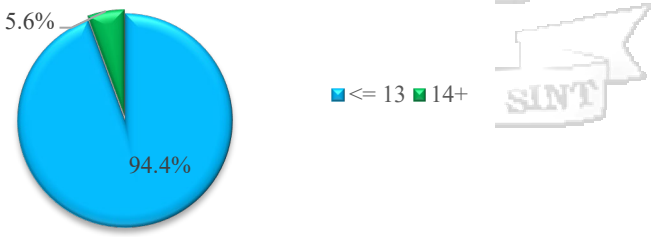
FIGURE 4.1 FOREIGN DIRECT INVESTMENT



Source: Author Computation (2026)

Sovereign credit ratings were assigned to two categories. Category one (<= 13), accounting for 94.4% of the distributions, and category two (14+), accounting for 5.6%, as indicated in Figure 4.2 below:

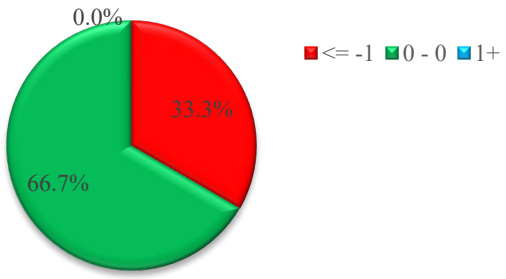
FIGURE 4.2 SOVEREIGN CREDIT RATINGS



Source: Author Computation (2026)

Rating outlooks were assigned to three categories. Category one (<= -1) 33.3%, category two (0 – 0) 66.7%, and category three (+1) 0% of the distributions, as depicted in Figure 4.3 below:

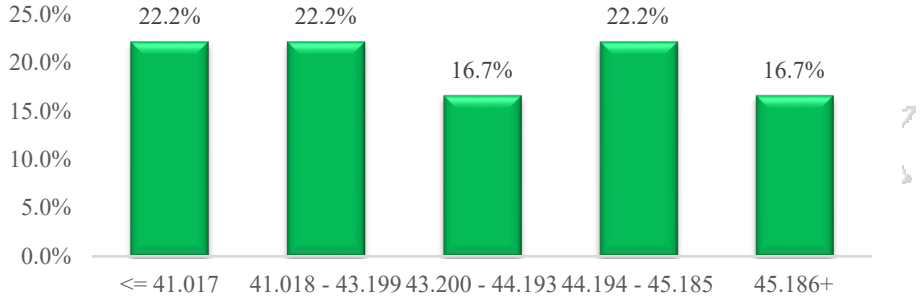
FIGURE 4.3 RATING OUTLOOKS



Source: Author Computation (2026)

Institutional Quality was grouped into five categories. Category one (<= 41.017), category two (41.018 - 43.199), and category four (44.194 - 45.185) each had 22.2% of the distributions, whereas category three (43.200 - 44.193) and five (45.186+) each had 16.7% of the distributions, as in Figure 4.4 below:

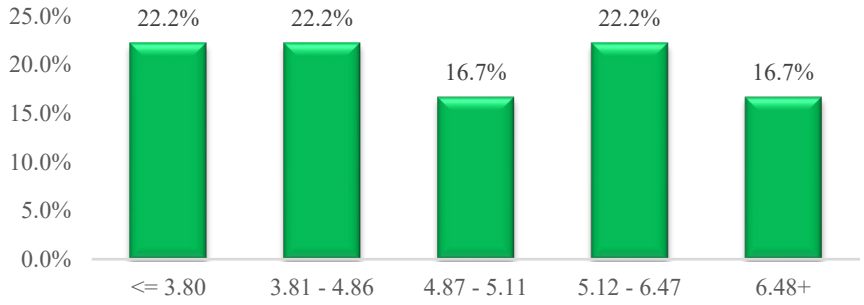
FIGURE 4.4 INSTITUTIONAL QUALITY



Source: Author Computation (2026)

GDP growth was grouped into five categories. Category one (<= 3.80), category two (3.81 - 4.86), and category four (5.12 - 6.47) each had 22.2% of the distributions, whereas category three (4.87 - 5.11) and category five (6.48+) each had 16.7% of the distributions, as in Figure 4.5 below:

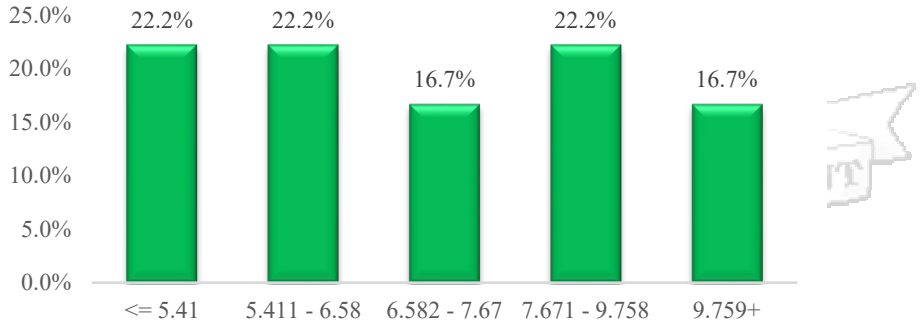
FIGURE 4.5 GDP GROWTH



Source: Author Computation (2026)

Inflation was grouped into five categories, with category three (6.582- 7.67) and category five (9.759+) each having 16.7% of the distributions, whereas category one (<= 5.41), category two (5.411 – 6.58), and category four (7.671 – 9.758) had 22.2% of the distributions each, as in Figure 4.6 below:

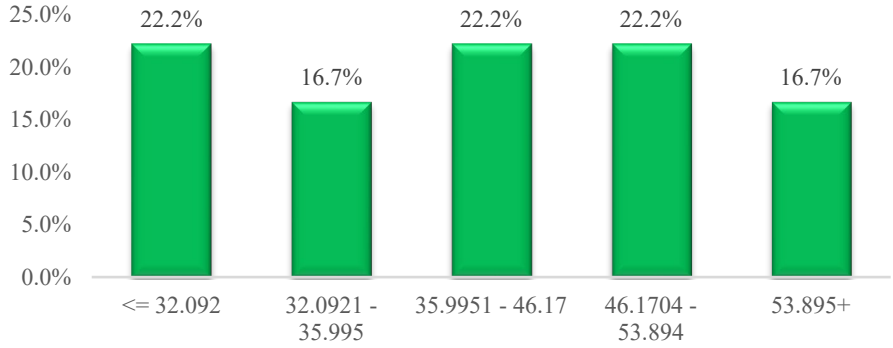
FIGURE 4.6 INFLATION



Source: Author Computation (2026)

Trade openness was grouped into five categories. Category one (<= 32.092), category three (35.9951 - 46.17), and category four (46.1704 - 53.894) each had 22.2% of the distributions, whereas category two (32.0921 - 35.995) and category five (53.895+) each had 16.7% of the distributions, as in Figure 4.7 below:

FIGURE 4.7 TRADE OPENNESS



Source: Author Computation (2026)

4.4 Correlation analysis

The pairwise correlation results presented in Table 4.2 indicate that all variables, except GDP growth, were significantly correlated with the dependent variable, FDI, supporting their suitability for inclusion in the regression model.

TABLE 4.2 PAIRWISE CORRELATIONS

Variables	-1	-2	-3	-4	-5	-6	-7
(1) Foreign Direct Investment	1						
(2) Sovereign Credit ratings	0.078	1					
	-0.758						
(3) Rating Outlooks	0.294	-0.343	1				
	-0.237	-0.163					
(4) Inflation	0.071	-0.051	0.262	1			
	-0.778	-0.841	-0.294				
(5) GDP growth	0.582*	0.097	0.143	-0.391	1		
	-0.011	-0.7	-0.571	-0.108			
(6) Trade Openness	0.314	-0.256	0.720*	0.634*	0.085	1	
	-0.204	-0.306	-0.001	-0.005	-0.737		

(7)							
Institutional Quality	0.013	0.246	-0.604*	-0.671*	0.059	-0.855*	1
	-0.958	-0.326	-0.008	-0.002	-0.815	0	

*** $p<0.01$, ** $p<0.05$, * $p<0.1$

Source: Author Computation (2026)

4.5 Diagnostic Tests

To ensure the data's suitability for regression analysis and to validate the assumptions underlying Ordinary Least Squares (OLS), diagnostic tests were conducted prior to inferential analysis. The tests conducted included checks for normality, multicollinearity, stationarity, autocorrelation, and heteroscedasticity.

4.5.1 Test for Normality

The error component in a conventional linear regression model must be normally distributed with zero mean (Haschka, 2024). This is a significant assumption because these error components rely linearly on the computed coefficients. Consequently, the resulting coefficients follow a normal distribution with population parameter and population variance when the error terms have a normal distribution with zero mean and variance.

We employed the Shapiro-Wilk test using the following hypothesis to test the normalcy test in this investigation: The alternative hypothesis proposed non-normally distributed residuals, whereas the null hypothesis assumed normally distributed disturbance terms (Haschka, 2024).

That is;

H_0: normality of residuals
H_1: non-normality of residuals

Results in Table 4.3 below, with a p-value greater than 0.05 (0.51539), indicate that the residuals of the variables under study were normally distributed.

TABLE 4.3 SHAPIRO-WILK W TEST FOR NORMAL DATA

Variable	Obs.	W	V	z	Prob>z
Residuals	17	0.95357	0.981	-0.039	0.51539

Source: Author Computation (2026)

4.5.2 Test for Multicollinearity

According to Midi et al. (2013), a high degree of association between independent variables suggests the possibility of multicollinearity. They also claim that when VIF is more than 10 or less than 1, multicollinearity is present. This was used in the current study to assess collinearity among the independent variables. Table 4.4 below shows that multicollinearity was not detected amongst the variables.

TABLE 4.4 VARIANCE INFLATION FACTOR

	VIF	1/VIF
Trade openness	4.82	0.208
Rating Outlooks	4.22	0.238
Inflation	2.35	0.429
Economic growth	1.43	0.700
Sovereign credit ratings	1.36	0.734
Mean VIF	2.84	

Source: Author Computation (2026)

4.5.3 Test for Stationarity

Unit root properties were examined using the DF-GLS test of Elliott et al. (1996), which has higher power than the standard ADF test in small samples.

Stationarity in statistics refers to the property of data that shows variance, autocorrelation, and a mean that does not substantially fluctuate over time. It is argued that stationary data lacks unit roots (Chopra, 2025). The study examined the stationarity of the variables using the Dickey-Fuller

Generalized Least Squares (DF-GLS) unit root test, where a variable was considered stationary if the DF-GLS tau statistic was more negative than the corresponding 5% critical value.

Results presented in Table 4.5 indicate that the DF-GLS test statistics were more negative than the corresponding 5% critical values at the first difference. Accordingly, the null hypothesis of a unit root was rejected, implying that the variables were stationary after first differencing and therefore integrated of order 1, I(1).

TABLE 4.5 DICKEY-FULLER GENERALIZED LEAST SQUARES TEST FOR UNIT ROOT

Variable	DF-GLS tau	5% Critical Value	Decision
Foreign Direct Investment	-3.770	-3.421	Stationary
Sovereign Credit ratings	-3.421	-1.732	Stationary
Institutional Quality	-4.406	0.306	Stationary
GDP growth	-3.465	-3.421	Stationary
Inflation	-3.421	-1.069	Stationary
Trade Openness	-3.421	-1.796	Stationary

Source: Author Computation (2026)

4.5.4 Test for Autocorrelation

The research applied autocorrelation tests to ensure there is no serial correlation in the adopted regression model. The study applied the Breusch-Godfrey LM test to detect autocorrelation in time-series data. From the results in Table 4.6 below, the chi-square statistic of 1.204 and the p-value of 0.2725 > 0.05 indicate that there is no serial correlation.

TABLE 4.6 BREUSCH–GODFREY LM TEST FOR AUTOCORRELATION

lags(p)	chi2	df	Prob > chi2
1	1.204	1	0.2725

H_0: no serial correlation

Source: Author Computation (2026)

4.5.5 Test for Heteroskedasticity

The study employed the Breusch-Pagan approach to assess whether the regression model exhibited heteroscedasticity. Table 4.7 indicates no evidence of heteroscedasticity, as the p-value is greater than 0.05.

TABLE 4.7 BREUSCH-PAGAN/COOK-WEISBERG TEST FOR HETEROSKEDASTICITY

Chi-Square	df	Sig.
0.870	1	0.350

Source: Author Computation (2026)

4.6 Inferential statistics

The strength of the relationship between the dependent and independent variables was assessed using inferential statistics. The model used in this study was Ordinary Least Squares (OLS) regression.

4.6.1 Determine the effect of sovereign credit ratings on foreign direct investment in Kenya

Results presented in Table 4.8 indicate that sovereign credit ratings have a positive but statistically insignificant relationship on FDI to Kenya when estimated without control variables ($\beta = 0.047$, $p = 0.250$). This suggests that improvements in sovereign credit ratings are associated with higher FDI. However, the relationship is not strong enough to yield a statistically significant effect. When GDP growth, inflation, and trade openness are included as control variables, the coefficient on sovereign credit ratings increases from 0.047 to 0.139 but remains statistically insignificant ($p = 0.284$). This finding suggests that sovereign credit ratings do not independently explain fluctuations in FDI to Kenya.

The control variables exhibit mixed effects on FDI. GDP growth and inflation display negative coefficients, while trade openness exhibits a positive coefficient. However, none of the variables convey a statistically significant effect on FDI.

The explanatory power of the model improves following the inclusion of the control variables, with the R-squared increasing from 0.002 to 0.106. This suggests that macroeconomic conditions help explain variations in FDI beyond sovereign credit ratings alone, although a substantial proportion of the variation remains unexplained by the variables included in the model. The overall model remains statistically insignificant, as reflected by the low F-statistic.

Overall, the findings suggest that sovereign credit ratings provide positive signals about a country's investment environment, but these signals do not, on their own, translate into higher FDI. The findings are broadly consistent with the Eclectic (OLI) Paradigm, which posits that foreign investors consider a range of location-specific advantages when making investment decisions. Consequently, favourable sovereign credit ratings alone may be insufficient to attract FDI in the absence of broader economic and institutional conditions. The null hypothesis that sovereign credit ratings have no statistically significant effect on FDI to Kenya is therefore not rejected.

TABLE 4.8 OLS REGRESSION RESULTS FOR THE EFFECT OF SOVEREIGN CREDIT RATINGS ON FOREIGN DIRECT INVESTMENT IN KENYA

Attributes	Without control	With controls
Constant	0.000	0.000
	(0.243)	(0.255)
Sovereign Credit Rating	0.047	0.139
	(0.250)	(0.284)
GDP growth		-0.044
		(0.334)
Inflation		-0.410
		(0.432)
Trade openness		0.425
		(0.414)

F statistic	0.035	0.386
R squared	0.002	0.106
No. Observations	18	18

Note: Standard errors are reported in parentheses. **, *** indicates significance at the 95% and 99% level respectively.

Source: Author Computation (2026)

4.6.1.1 Effect of Lagged Sovereign Credit Ratings on FDI

The sovereign credit rating exhibits virtually no time variation in the sample: 17 years at B+/B and one year at B. With only a single non-B+/B observation, the rating variable is collinear with the constant after controlling for GDP growth, and no meaningful coefficient can be estimated. We therefore do not report regression results for rating levels. This limited variation makes it difficult to determine whether changes in sovereign credit ratings influence FDI in Kenya.

4.6.2 Evaluate the effect of rating outlooks/watch status (positive/negative/stable) on foreign direct investment in Kenya

Results presented in Table 4.9 indicate that rating outlooks have a positive but statistically insignificant relationship on FDI to Kenya when estimated without control variables ($\beta = 0.026$, $p = 0.250$). This suggests that favourable rating outlooks are associated with marginally higher FDI. However, the relationship is not sufficiently strong to establish a statistically significant effect. In line with Signaling Theory, rating outlooks provide forward-looking information regarding a country's future creditworthiness and economic prospects, thereby serving as signals that may influence investor perceptions. Upon including GDP growth, inflation, and trade openness as control variables, the coefficient on rating outlooks becomes negative but remains statistically insignificant ($\beta = -0.324$, $p = 0.403$), suggesting that rating outlooks do not independently explain variation in FDI to Kenya.

The inclusion of GDP growth, inflation, and trade openness improved the model's explanatory power, with the R-squared increasing from 0.001 to 0.133. This suggests that macroeconomic conditions help explain variations in FDI beyond rating outlooks alone, although a greater

proportion of the variation remains unexplained in the model. Similarly, the F-statistic increased from 0.011 to 0.497 following the introduction of the control variables. However, the low F-value indicates that the explanatory variables do not jointly provide a statistically significant explanation of FDI to Kenya during the study period.

Overall, the findings suggest that while rating outlooks provide useful forward-looking signals to investors, they do not independently influence FDI to Kenya. Consequently, rating outlooks may be interpreted alongside broader macroeconomic and institutional conditions rather than as standalone determinants of FDI. The null hypothesis that rating outlooks have no statistically significant effect on FDI to Kenya is therefore not rejected.

TABLE 4.9 OLS REGRESSION RESULTS FOR THE EFFECT OF RATING OUTLOOKS/WATCH STATUS ON FOREIGN DIRECT INVESTMENT IN KENYA

Attributes	Without control	With controls
Constant	0.000	0.000
	(0.243)	(0.251)
Rating outlooks	0.026	-0.324
	(0.250)	(0.403)
GDP growth		-0.032
		(0.320)
Inflation Rate		-0.481
		(0.440)
Trade openness		0.666
		(0.547)
F statistic	0.011	0.497
R squared	0.001	0. 133
No. Observations	18	18

Note: Standard errors are reported in parentheses. **, *** indicates significance at the 95% and 99% level, respectively.

Source: Author Computation (2026)

4.6.2.1 Effect of Lagged Rating Outlooks on FDI

To capture the timing between sovereign risk signals and realized investment, we specify the rating outlook in the year t-1 as a predictor of FDI in year t. This lag structure reflects the institutional reality that multinational firms require time to process new information, adjust risk assessments, and execute cross-border capital expenditures.

The results indicate a statistically significant relationship between lagged rating outlooks and FDI, as evidenced by the joint significance test (F = 4.06, p = 0.045), as presented in Table 4.10. This finding suggests that rating outlooks issued in the preceding year contain information relevant to explaining subsequent FDI. The results support the proposition that investors respond not only to current sovereign credit assessments but also to forward-looking signals regarding a country's future creditworthiness and economic prospects.

TABLE 4.10: LAGGED RATING OUTLOOKS

Variable	**(1) lnFDI**
Lagged outlook =Negative	0.405
	(0.413)
Lagged outlook = Stable	
ln (GDP)	0.378
	(0.154)
Constant	20.023
	(0.404)
F- test Outlook	4.06
Prob > F	0.045

Notes: Newey-West standard errors with 2 lags in parentheses. Base: Stable outlook. One observation lost due to lag,

_*p<0.05, ** pp<0.01_

Source: Author Computation (2026)

4.6.3 Examine the moderating effect of institutional quality on the relationship between sovereign credit ratings, rating outlooks, and foreign direct investment in Kenya

Results presented in Table 4.11 indicate that, in the absence of interaction terms, sovereign credit ratings and rating outlooks exhibit a positive but statistically insignificant effect on FDI to Kenya. However, when institutional quality is introduced as a moderating variable, the interaction between sovereign credit ratings and institutional quality becomes negative and statistically significant ($\beta = -6.750$, $p < 0.05$), whereas the interaction between rating outlooks and institutional quality remains statistically insignificant.

The significant interaction effect suggests that institutional quality plays an important role in shaping investors' interpretation of sovereign credit ratings. Specifically, the negative interaction coefficient indicates that the positive effect of sovereign credit ratings on FDI diminishes as institutional quality improves. This implies that in environments characterized by stronger governance, regulatory quality, government effectiveness, and the rule of law, investors may rely less on sovereign credit ratings as standalone indicators of investment attractiveness, as institutional frameworks themselves provide credible information about the investment environment.

The interaction effect between rating outlooks and institutional quality was negative but not statistically significant ($\beta = -1.670$, $p > 0.05$). This suggests that although improvements in institutional quality may reduce investors' reliance on rating outlooks as a source of information, there is insufficient evidence to conclude that institutional quality significantly moderates the relationship between rating outlooks and FDI in Kenya. The negative coefficient nevertheless indicates that in stronger institutional environments, investors may place less emphasis on rating outlooks and may rely more on governance structures, regulatory quality, and other sources of information when making investment decisions.

Furthermore, the explanatory power of the model improves substantially following the inclusion of the interaction terms, with the R-squared increasing from 0.004 to 0.319. Similarly, the F-statistic increases from 0.030 to 1.52, indicating an improvement in overall model fit, although the

model remains statistically insignificant at conventional significance levels. These findings suggest that incorporating institutional quality enhances the model's ability to explain variations in FDI beyond sovereign credit ratings and rating outlooks alone.

The findings are consistent with both signaling theory and institutional theory. While sovereign credit ratings and rating outlooks serve as signals that help reduce information asymmetry for investors, their effectiveness depends on the broader institutional environment in which investment decisions are made.

TABLE 4.11 OLS RESULTS FOR THE MODERATING EFFECT OF INSTITUTIONAL QUALITY ON THE RELATIONSHIP BETWEEN SCRS, RATING OUTLOOKS, AND FDI IN KENYA

Attributes	**Without interaction terms**	**With interaction terms**
Constant	9.78e-17	0.597
	(0.250)	(0.365)
Sovereign Credit Rating	0.063	6.533**
	(0.274)	(2.814)
Rating outlooks	0.047	1.655
	(0.274)	(0.812)
Moderating effect of sovereign credit ratings and FDI in Kenya		-6.750**
		(2.934)
Moderating effect of rating outlooks and FDI in Kenya		-1.670
		(0.976)
F statistic	0.030	1.52
R squared	0.004	0. 319
No. Observations	18	18

Note: Standard errors are reported in parentheses. **, *** indicates significance at the 95% and 99% level, respectively.

Source: Author Computation (2026)

4.6.3.1 Robustness Check on Institutional Quality

Table 4.12 below presents findings of tests for robustness to alternative institutional measures. The composite WGI index is significant at the 10% critical value (lag 1), indicating that broad institutional quality matters. Disaggregating by dimension revealed that this effect is driven entirely by regulatory quality at 5% critical value lag (1), which captures the government's ability to formulate sound policies and regulations.

Real GDP remains highly significant across all models at 5% critical values lag (1), confirming market size as the primary determinant. The results indicate that while Kenya's market attracts FDI, improvements in regulatory quality provide additional leverage to increase inflows.

TABLE 4.12 INSTITUTIONAL QUALITY ROBUSTNESS CHECK

	1 (AVG)	2 (RQ)	3(RL)	4 (CC)	5(GE)
Institutional	2.585	24.467**	-0.030	-7.003	-3.030
measure	(4.904)	(21.229)	(2.038)	(6.604)	(7.7310)
lngdp	0.507**	0.826**	0.638**	1.074**	0.769**
	(0.524)	(0.779)	(0.601)	(0.858)	(0.774)
N	18	18	18	18	18

Source: Author Computation (2026)

4.7 Chapter summary

This chapter presented the study's empirical findings using descriptive analysis, distribution statistics, diagnostic tests, and regression analysis. The results indicate that sovereign credit ratings and rating outlooks did not have a statistically significant direct effect on FDI to Kenya. However, institutional quality was found to play an important moderating role in the relationship between sovereign credit ratings and FDI, while no significant moderating effect was observed for rating outlooks. The findings further suggest that, consistent with signaling theory, sovereign credit ratings and outlooks are interpreted alongside broader economic and institutional conditions rather than in isolation. The implications of these findings are discussed in the subsequent chapter.

CHAPTER FIVE

DISCUSSIONS, CONCLUSIONS, AND RECOMMENDATIONS

5.1 Introduction

This chapter presents a summary of the study findings, conclusions, and limitations. It discusses the findings in relation to the study objectives, existing literature, and the underlying theoretical frameworks. The chapter also provides policy recommendations and suggests areas for future research.

5.2 Summary of findings

The research study's overall objective was to evaluate the effect of sovereign credit ratings on foreign direct investment (FDI) to Kenya, while moderating for the role of institutional quality. The researcher utilized secondary data from World Bank reports, S&P, Moody's, Fitch ratings reports, and supporting databases like Trading Economics. The study analysis utilized annual time-series data for Kenya from 2006 to 2023. Data were organized into annual series, cross-checked for completeness, and subjected to descriptive, distributional, and correlational analyses. This study then employed diagnostic tests to assess the model's validity and accuracy, including tests for normality, multicollinearity, stationarity, autocorrelation, and heteroskedasticity.

Ordinary Least Squares (OLS) regression was used to estimate the effect of sovereign credit ratings and rating outlooks on FDI, with institutional quality as a moderator. The results indicate that sovereign credit ratings and rating outlooks do not have a statistically significant direct effect on FDI to Kenya. However, institutional quality significantly moderates the relationship between sovereign credit ratings and FDI, highlighting the importance of the broader institutional environment in shaping foreign investment decisions.

5.2.1 To determine the effect of sovereign credit ratings on foreign direct investment in Kenya

The first objective of the study was to determine the effect of sovereign credit ratings on FDI in Kenya. The findings indicate that sovereign credit ratings do not have a statistically significant effect on FDI. Although the coefficient on sovereign credit ratings remained positive with and without the control variables, the relationship was not statistically significant. This suggests that

changes in sovereign credit ratings were not associated with meaningful changes in FDI during the study period. The insignificant relationship may partly be explained by the limited variation in Kenya's sovereign credit ratings over the study period, which made it difficult to identify the effect of rating changes on FDI.

The findings are consistent with those of Cai et al. (2018), who argue that the influence of sovereign credit ratings on investment decisions is conditional on broader macroeconomic and institutional factors rather than ratings alone. Similarly, Bayar and Kılıç (2014) observed that sovereign credit ratings should be considered alongside other economic factors when assessing their impact on investment flows. The findings also align with Arogundade et al. (2022), who found evidence of a unidirectional relationship from FDI to sovereign credit ratings in Kenya, suggesting that FDI may influence sovereign ratings, rather than the reverse.

However, the findings differ from those of Kim and Wu (2008) and Emara and El Said (2021), who found that sovereign credit ratings positively influence international capital flows and foreign investment decisions. These differences may be attributed to variations in country context, sample periods, methodological approaches, and the limited variation in Kenya's sovereign credit ratings during the study period. The findings of Arogundade et al. (2022) further point to the possibility of reverse causality, whereby increased FDI strengthens a country's economic and fiscal position, leading to improvements in sovereign creditworthiness rather than sovereign credit ratings directly attracting FDI.

Overall, the findings suggest that sovereign credit ratings alone are insufficient to explain FDI in Kenya, with investors likely considering a broader set of economic, institutional, and country-specific factors when making investment decisions.

The findings can be interpreted through the lens of both signaling theory and institutional theory. Signaling theory suggests that sovereign credit ratings provide information that reduces information asymmetry and helps investors assess country risk. However, the insignificant relationship between sovereign credit ratings and FDI suggests that investors do not rely solely on these ratings when making investment decisions. Institutional theory further emphasizes the importance of governance structures, regulatory effectiveness, and institutional credibility in

shaping investment decisions. The findings therefore suggest that sovereign credit ratings alone may be insufficient to explain FDI in Kenya without considering the wider institutional and economic environment.

5.2.2 Evaluate the effect of rating outlooks/watch status (positive/negative/stable) on foreign direct investment in Kenya.

The second objective of the study was to evaluate the effect of rating outlooks/watch status (positive, negative, or stable) on FDI to Kenya. The results indicate that rating outlooks have a positive but statistically insignificant relationship with FDI when estimated without control variables. Upon the inclusion of macroeconomic control variables, the coefficient on rating outlooks becomes negative but remains statistically insignificant. These findings suggest that rating outlooks do not independently influence FDI to Kenya and that investors may interpret such signals alongside broader economic conditions rather than as standalone determinants of investment decisions.

These findings are broadly aligned with existing empirical evidence. For instance, Harilal (2020) found that rating outlooks do not independently trigger significant market responses, particularly in emerging markets where investors rely on a wider set of economic and institutional indicators. Similarly, Ghachem et al. (2023) reported limited direct effects of outlooks in financial markets, noting the influence of the broader macroeconomic conditions.

Further, Alsakka and Gwilym (2012) also found that rating outlooks provide forward-looking information to investors and can influence market perceptions, although their effects may be context-dependent and vary across markets. This suggests that rating outlooks remain useful informational signals even where their direct effect on investment decisions is not statistically significant.

Overall, the results indicate that rating outlooks do not independently drive FDI to Kenya. Rather, they form part of a broader information set that investors consider when evaluating investment opportunities. This interpretation is consistent with signaling theory, which posits that rating outlooks help reduce information asymmetry by providing forward-looking information about sovereign risk and future economic prospects. However, the findings suggest that such signals

alone are insufficient to influence FDI and are likely assessed alongside broader economic and institutional conditions.

5.2.3 Examine the moderating effect of institutional quality on the relationship between sovereign credit ratings, rating outlooks, and foreign direct investment in Kenya

The final objective of the study was to examine the moderating effect of institutional quality on the relationship between sovereign credit ratings, rating outlooks, and FDI to Kenya. The results indicate that, in the absence of interaction terms, sovereign credit ratings and rating outlooks do not exert a statistically significant influence on FDI. However, when institutional quality is introduced as a moderating variable, the interaction between sovereign credit ratings and institutional quality becomes statistically significant, whereas the interaction between rating outlooks and institutional quality remains statistically insignificant. This suggests that institutional quality plays an important role in shaping the relationship between sovereign credit ratings and FDI.

The significant negative interaction effect between sovereign credit ratings and institutional quality implies that the positive influence of sovereign credit ratings on FDI diminishes as institutional quality improves. This suggests that in environments characterized by stronger governance, regulatory quality, government effectiveness, and the rule of law, investors may rely less on sovereign credit ratings as standalone indicators of investment attractiveness, as institutional frameworks themselves provide credible information about the investment environment.

These findings are supported by existing empirical literature. Chen and Jiang (2023) demonstrated that strong institutional frameworks attract FDI by improving the overall investment environment, while Rioba (2023) found that governance indicators such as political stability, rule of law, and accountability positively influenced FDI. Similarly, Islam et al.(2020) and Ideba et al. (2025) found that institutional quality strengthens the influence of economic and financial factors on investment outcomes.

The findings can be interpreted through both signaling theory and institutional theory. Signaling theory suggests that sovereign credit ratings and outlooks provide information that helps investors

assess country risk and reduce information asymmetry. Institutional theory further emphasizes the importance of governance quality and institutional credibility in shaping investment decisions. The significant moderating effect observed in this study indicates that the influence of sovereign credit signals on FDI depends on the broader institutional environment within which foreign investors operate.

5.3 Conclusions

Foreign direct investment (FDI) is a critical driver of economic growth in developing countries, contributing to capital formation, technology transfer, employment creation, and foreign exchange earnings. Despite its importance, empirical evidence on the determinants of FDI remains mixed, particularly within African economies where efforts to attract foreign investment have intensified.

This study examined the effect of sovereign credit ratings and rating outlooks on FDI to Kenya, while incorporating institutional quality as a moderating variable. The analysis included GDP growth, inflation, and trade openness as macroeconomic control variables. Using annual time-series data from 2006 to 2023 and applying Ordinary Least Squares (OLS) estimation, the study evaluated the effect of sovereign credit signals on FDI to Kenya.

The findings indicate that sovereign credit ratings and rating outlooks do not have a statistically significant direct effect on FDI to Kenya. The inclusion of macroeconomic control variables improved the models' explanatory power, although their individual effects were not statistically significant. Further, the results reveal that institutional quality significantly moderates the relationship between sovereign credit ratings and FDI. Specifically, the negative and significant interaction effect suggests that the influence of sovereign credit ratings on FDI diminishes as institutional quality improves.

Based on the empirical findings, the study therefore failed to reject the first null hypothesis that sovereign credit ratings have no significant effect on FDI to Kenya. Similarly, the study failed to reject the second null hypothesis that rating outlooks/watch status have no significant effect on FDI to Kenya. However, the study rejected the third null hypothesis that institutional quality does not significantly moderate the relationship between sovereign credit ratings, rating outlooks, and

FDI. The findings indicate that institutional quality plays a significant moderating role in the relationship between sovereign credit ratings and FDI in Kenya.

Overall, the study demonstrates that sovereign credit ratings and rating outlooks are not independent determinants of FDI but rather form part of a broader set of economic and institutional factors considered by investors. The findings underscore the importance of strengthening governance frameworks, regulatory quality, and institutional effectiveness in enhancing investment attractiveness. The moderating role of institutional quality is explained by signaling and institutional theories, which suggest that the influence of sovereign credit ratings on FDI depends on the broader institutional environment.

5.4 Policy recommendations

This section presents the practical and theoretical implications of the study, based on the effect of sovereign credit ratings and rating outlooks on FDI into Kenya, moderated by the role of institutional quality. The findings indicate that sovereign credit ratings and rating outlooks do not independently exert a significant influence on FDI. However, institutional quality significantly moderates the relationship between sovereign credit ratings and FDI, highlighting the importance of the broader institutional environment in shaping foreign investment decisions.

From a policy perspective, the findings suggest that efforts to attract FDI should focus not only on improving sovereign creditworthiness but also on strengthening institutional quality. In the short term, government agencies and investment promotion agencies, e.g., the National Treasury, the Central Bank of Kenya, and InvestKenya, should prioritize fiscal transparency, public debt reporting, policy communication, and the dissemination of information on economic reforms and investment opportunities. Such measures can help reduce information asymmetry and strengthen investor confidence.

Over the medium to long-term, public governance institutions such as the Judiciary, the Ethics and Anti-Corruption Commission (EACC), and the Public Service Commission should focus on strengthening the rule of law, contract enforcement, regulatory quality, public sector accountability, and the control of corruption. Sustained progress in these areas is likely to enhance

institutional credibility and create a more predictable and attractive environment for foreign investors.

Although sovereign credit ratings and rating outlooks were not found to directly influence FDI, they remain important informational signals to investors. Government agencies responsible for economic management and investment promotion should therefore continue communicating progress on economic and institutional reforms, thereby reinforcing investor confidence and supporting Kenya's investment attractiveness.

From a theoretical perspective, the study highlights the complementary roles of signaling and institutional theories. While sovereign credit ratings and rating outlooks provide signals regarding country risk and economic prospects, the findings suggest that the effectiveness of these signals depends on the quality of underlying institutions. Strong institutional frameworks reduce information asymmetry and provide investors with alternative sources of credibility beyond sovereign credit assessments.

In conclusion, enhancing FDI into Kenya requires a coordinated approach involving economic management, investment promotion, and governance institutions to effectively communicate economic reforms, thereby enhancing investor confidence in Kenya's investment climate and supporting sustainable foreign direct investment.

5.5 Limitations of the Study

The study covered the period 2006 to 2023, yielding 18 annual observations. This relatively small sample size may limit statistical power and constrain the complexity of econometric models that can be reliably estimated. In addition, the study focused exclusively on Kenya, which may limit the generalizability of the findings to other countries with different economic, political, and institutional environments. The single-country focus also makes it difficult to fully isolate the effects of sovereign credit ratings and rating outlooks from broader country-specific events and external shocks that may have influenced FDI during the study period.

Further, the study relied exclusively on quantitative secondary data, which limited its ability to capture qualitative factors influencing foreign investment decisions, such as investor perceptions,

political considerations, and institutional dynamics. Future studies could adopt a mixed-methods approach incorporating stakeholder interviews and qualitative analysis to provide deeper insights into the determinants of FDI.

Finally, although institutional quality was included as a moderating variable, measuring institutional quality remains challenging due to its multidimensional and largely intangible nature. The use of composite governance indicators may not fully capture all aspects of institutional performance and may be subject to measurement error. In addition, the relationship between institutional quality, sovereign credit ratings, and FDI may be affected by endogeneity and possible reverse causality, whereby improvements in investment inflows may themselves contribute to stronger institutions and sovereign creditworthiness.

5.6 Suggestions for Further Research

This study examined the effects of sovereign credit ratings and rating outlooks on foreign direct investment (FDI) in Kenya and assessed the moderating effect of institutional quality on this relationship. While the findings provide useful insights, areas remain open for further research.

Future studies could extend the analysis to a broader panel of African or emerging economies. This would allow for cross-country comparisons and improve the generalisability of findings on how sovereign credit signals influence FDI under different institutional and macroeconomic environments. Further research could also explore alternative econometric techniques, such as Autoregressive Distributed Lag (ARDL) models or Vector Error Correction Models (VECM), to capture dynamic long-run and short-run relationships among sovereign credit ratings, outlooks, institutional quality, and FDI.

Future scholars could consider disaggregation of foreign direct investment into sector-specific inflows, greenfield vs brownfield investments, to determine whether sovereign credit signals have differential effects across sectors or FDI types, as well as introduce qualitative aspects of FDI beyond simply aggregate inflows, which could provide a more comprehensive understanding of the effects on FDI in the study.

Finally, future studies could further investigate the role of institutional quality at a more granular level by examining the individual components of governance, including rule of law, corruption

control, regulatory quality, and government effectiveness, to better understand their distinct moderating effects on the relationship between sovereign credit signals and FDI.

5.7 Chapter summary

This chapter presented a summary of the study findings, the conclusions drawn from the empirical results, and the limitations encountered during the study. The chapter also outlined the policy implications of the findings and provided recommendations for future research on the effects of sovereign credit ratings and rating outlooks on FDI into Kenya, as well as the moderating role of institutional quality.

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APPENDICES

APPENDIX I: ETHICAL REVIEW APPROVAL

Strathmore UNIVERSITY

4th May 2026

Ms Njeru Rita,
rita.njeru@strathmore.edu

Dear Ms Njeru,

RE: Effect of Sovereign Credit Ratings on Foreign Direct Investment Inflows to Kenya: The Moderating Role of Institutional Quality

This is to inform you that SU-ISERC has reviewed and **approved** your above **SU-masters** research proposal. Your application reference number is **SU-ISERC3518/26.** The approval period is from **4th May 2026 to 3rd May 2027.**

This approval is subject to compliance with the following requirements:

i. Only approved documents including (informed consents, study instruments, and MTA) will be used
ii. All changes including (amendments, deviations, and violations) are submitted for review and approval by SU-ISERC.
iii. Death and life-threatening problems and serious adverse events or unexpected adverse events whether related or unrelated to the study must be reported to SU-ISERC within 72 hours of notification
iv. Any changes, anticipated or otherwise, that may increase the risks or affect the safety or welfare of study participants and others or affect the integrity of the research must be reported to SU-ISERC within 72 hours
v. Clearance for the export of biological specimens must be obtained from relevant institutions.
vi. Submission of a request for renewal of approval at least 60 days prior to the expiry of the approval period. Attach a comprehensive progress report to support the renewal.
vii. Submission of an executive summary report within 90 days of completion of the study to SU-ISERC.

Before commencing your study, you will be expected to obtain a research license from National Commission for Science, Technology, and Innovation (NACOSTI) https://research-portal.nacosti.go.ke/ and obtain other clearances needed.

Yours sincerely,

Mr Ambrose Rachier,
Chairperson; SU-ISERC