

THE MODERATING ROLE OF FINANCIAL INCLUSION ON THE RELATIONSHIP BETWEEN FOREIGN PORTFOLIO INVESTMENT AND FINANCIAL GROWTH OF FIRMS LISTED AT THE NAIROBI SECURITIES EXCHANGE

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International Academic Journal of Economics and Finance (IAJEF) | ISSN 2518-2366

Received: 7th September 2026

Published: 10th October 2026

Full Length Research

Available Online at: https://iajournals.org/articles/iajef_v6_i1_140_152.pdf

Citation: Serem, J. K., Nyarombe, F. N. (2026). The moderating role of financial inclusion on the relationship between foreign portfolio investment and financial growth of firms listed at the Nairobi securities exchange. *International Academic Journal of Economics and Finance*, 6(1), 140-152.

ABSTRACT

Foreign portfolio investment (FPI) is widely presumed to strengthen the financial growth of listed firms by expanding capital access, improving liquidity and lowering the cost of capital, yet firms listed at the Nairobi Securities Exchange (NSE) continue to record uneven growth outcomes despite rising foreign participation and Kenya's advances in financial inclusion. This paper isolates and tests the moderating role of financial inclusion in this relationship, drawing on panel data from a balanced sample of 40 NSE-listed firms observed over the 2019-2024 period (240 firm-year observations). Guided by the Efficient Market Hypothesis, Capital Flow Theory and Financial Intermediation Theory, moderated panel regressions were estimated separately for foreign equity investment, foreign debt security investment, foreign derivative investment and a composite FPI index, using Driscoll-Kraay standard errors where cross-sectional dependence was detected. Financial inclusion did not significantly moderate the foreign equity-growth relationship ($\beta =$

0.002, $p = 0.449$) or the foreign derivatives-growth relationship ($\beta = -0.002$, $p = 0.548$), but it significantly and negatively moderated the relationship between foreign debt security investment and financial growth ($\beta = -0.026$, $p = 0.025$) and between composite foreign portfolio investment and financial growth ($\beta = -0.015$, $p = 0.029$). These results indicate that financial inclusion functions less as a growth amplifier and more as a structural substitute for foreign capital: as domestic financial access deepens, NSE-listed firms appear to rely less on foreign debt and foreign portfolio capital to sustain growth. The paper contributes fresh frontier-market evidence to the capital-flows and financial-inclusion literature and offers policy and managerial implications for balancing foreign capital with domestic financial-inclusion strategies.

Key words: Financial Inclusion; Foreign Portfolio Investment; Moderation; Financial Growth; Nairobi Securities Exchange; Panel Data.

INTRODUCTION

Foreign portfolio investment is usually believed to boost the financial development of the publicly listed companies and provide better liquidity, access to capital and governance discipline and cost of capital. Notwithstanding the upsurge in foreign investor interest and Kenya's substantial strides in financial inclusion (IMF, 2025; World Bank, 2025), it is noted that financial performance of firms quoted at the Nairobi Securities Exchange remains uneven. The empirical puzzle this paper explores is the lack of correlation between the growth of foreign participation, growing infrastructure for inclusive finance, and continued firm-level growth inequalities.

The International Monetary Fund (2025) defines portfolio investment as "cross-border holdings and transactions in equity and debt securities, but not those with the control threshold that is equal to or greater than direct investment. Foreign portfolio investment (FPI) comes into the country primarily through three channels in NSE-listed firms, namely, foreign equity investment (FEI), foreign debt security investment (FDSI), and foreign derivative investment (FDerI). The impact on financial growth cannot be the same across all channels, the conditioning effect of domestic financial inclusion on each channel is, a priori, not known.

The key to sustainable financial development is defined as financial inclusion, which is the accessibility, use, and benefit of affordable and appropriate formal financial services through digitized means, by firms (IMF, 2025; World Bank, 2025; Basnayake et al., 2024). According to Financial Intermediation Theory, inclusive financial systems can enhance the efficiency with which financial flows, such as FPI, are directed towards high-return opportunities (Mia et al., 2021). But it is equally possible that the development of a domestic financial-inclusion infrastructure does not augment, but rather replaces the growth contribution of foreign capital, providing viable local alternatives to foreign capital in the form of equity, debt and derivatives. The moderation question is whether financial inclusion enhances or replaces the growth impact of foreign portfolio investment, which is exactly the question that the present paper examines.

This paper narrows its focus down to the fourth objective of the broad paper that is the subject of the paper: to examine the moderating role of financial inclusion on the relationship between foreign portfolio investment - in its form of equity, debt-security and foreign derivative investment and the financial growth of firms listed at the NSE. Focusing the moderation in this way enables the strongest, most policy relevant findings in the broader study to be presented and explored in full analytical depth.

Objective And Hypotheses

This specific objective was set as the focus of this paper: To analyse the moderating effects of financial inclusion on the relationship between foreign portfolio investment (FPI) and the financial growth of firms listed at the NSE in relation to foreign equity investment, foreign debt security

investment, foreign derivative investment and its composite. Four corresponding null hypotheses were tested:

H04a: Financial inclusion does not moderate the relationship between foreign equity investment and financial growth of firms listed at the NSE.

H04b: Financial inclusion does not moderate the relationship between foreign debt security investment and financial growth of firms listed at the NSE.

H04c: Financial inclusion does not moderate the relationship between foreign derivative investment and financial growth of firms listed at the NSE.

H04d: Financial inclusion does not moderate the relationship between composite foreign portfolio investment and financial growth of firms listed at the NSE.

LITERATURE REVIEW

Theoretical Framework

This paper is based on three theories which are complementary. The Efficient Market Hypothesis (EMH), as well as the Capital Flow Theory, suggests that foreign capital should be goaded into the most efficient use, which should include an improvement in liquidity, financial price discovery and, in turn, the financial development of the recipient firm. Capital Flow Theory also predicts that capital should move towards economies or firms that have a relatively high expected return, which implies that investment and growth should be increased (Alfaro et al., 2008; Prasad et al., 2003). The theory, however, assumes that the recipient economy has an unlimited absorptive capacity, which fails to hold true if financial-inclusion gaps, weak financial systems or underdeveloped financial institutions limit firms' capacity to be productive with foreign capital (Prasad et al., 2003). This is an absorptive capacity critique, a theoretical link that can be used to explain the moderating effect of financial inclusion in the process of firms using foreign capital to grow: firms' absorptive capacity for foreign capital is lower when financial inclusion is lower, and higher when financial inclusion is higher; when there is poor financial inclusion, firms' absorptive capacity for foreign capital is lower, and when there is good financial inclusion, the need for foreign capital to grow may be lower.

The second theoretical underpinning is Financial Intermediation Theory (FIT) proposed by Gurley and Shaw, 1960 and Diamond and Dybvig, 1983 which outlines the importance of providing access to affordable and appropriate financial services for reducing the transaction costs, improving capital allocation and enhancing participation in financial markets, (Munyanyi & Mhlanga, 2021). The theory is that inclusive financial systems can improve the quality of the capital flow (in this case, FPI) by channelling it toward more productive investments (Mia et al., 2021). Financial inclusion may reinforce (complement) the link between financial performance and growth, because a better capacity to raise foreign funds through financial inclusion would allow firms to use foreign finance more efficiently, or it could dilute (substitute for) the link between financial performance and growth because foreign financing becomes redundant if

financial inclusion provides an efficient domestic source of finance. The empirical results presented in Section 4 are used to test these two predictions. The following section presents the empirical literature that discusses the moderating effect of financial inclusion.

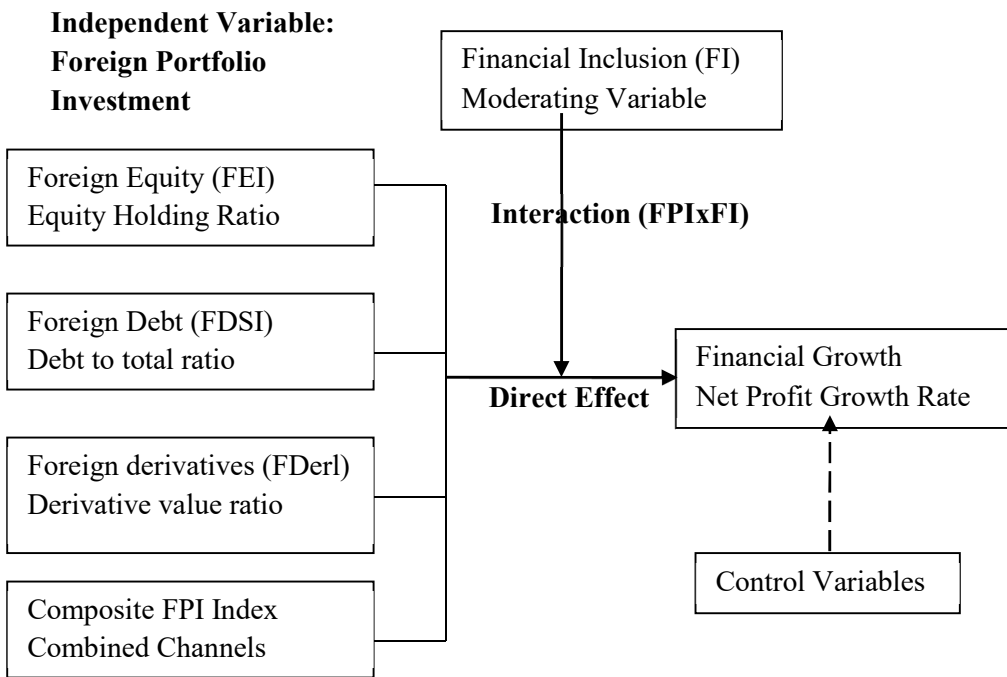
Empirical Review on the Moderating Role of Financial Inclusion

In the Indian context, Raghutla and Chittedi (2021) found that financial inclusion had both a demand-side effect (mobilisation of saving from households) and a supply-side effect (increasing retail-investor participation in the equity market) and that these effects were complementary rather than substitutable in the Indian equity market. Foreign portfolio investment, however, has not, in an African context, had enough capacity to spur firm and economy internal growth, as reported by Hampande (2017) and Makoni (2016), which is more in line with a limited or substitutive role of accompanying financial-development channels rather than a strongly complementary role.

The substitution logic tested in this paper can be related to foreign debt financing studies. Capital-structure inefficiencies among Nigerian Exchange-listed companies (Ndallah 2020) suggest that domestic financial-inclusion channels can serve as buffers, mitigating the negative consequences of over-leveraging, and thereby reducing firms' reliance on external financing, including foreign financing. Likewise, López and Méndez (2021) have identified that firms with more access to digital-banking and credit-network services were able to more effectively transform foreign-currency debt into productive investments, suggesting that inclusion is a facilitative, not necessarily a replacement, mechanism at the debt-management level. The mixed results from the complementary-type of results in some equity-market contexts, to substitutive and buffering results in others, highlight the lack of settled theoretical or empirical understanding of the direction of the moderating effect, one of which this paper's frontier-market panel evidence comes to speak.

Conceptual Framework

The conceptual framework proposes that financial inclusion is a moderating variable, between three independent variables, namely foreign equity investment, foreign debt security investment and foreign derivative investment, along with their composite index and the dependent variable, financial growth. Based on Financial Intermediation Theory, financial inclusion is considered to have the potential to affect the magnitude or the direction of each FPI-growth path, and if the interaction term for a particular channel is statistically significant, it suggests the path was moderated, whereas, if interaction term is not significant, it suggests that financial inclusion left the path of a particular channel unchanged.



RESEARCH METHODOLOGY

Research Design, Population and Sample

The research philosophy used in this study was positivist, while the research design that was used was explanatory longitudinal panel design. The population of this study was all the 64 firms listed at NSE at the time of the study in twelve sectors. Using inclusion and exclusion criteria (uninterrupted listing status, full annual reporting requirements and evidence of FPI participation) the purposive sampling process resulted in a balanced sample of 40 firms and 240 firm-year observations. A structured data extraction checklist was used to retrieve the secondary data from published annual reports, NSE records and CMA related sources.

Measurement of Variables

Foreign equity investment was calculated as the percentage of foreign equity to total equity, foreign debt security investment as the percentage of foreign total debt to total debt, and foreign derivative investment as the percentage of foreign market value of the firm's derivatives to its total market value of derivatives. The frequency of use of foreign financial services (equity, debt, derivative and capital) as a share of the overall frequency of portfolio-investment activity was used to measure financial inclusion. Net profit growth rate was used as a measure of financial growth. All variables were winsorized at the first and the 99th percentile to reduce the effect of extreme observations, and mean-centred before defining the interaction terms to reduce non-essential multicollinearity and simplify the interpretation of the coefficients of the moderation.

Diagnostic Testing and Estimation Strategy

The panel data were first passed through the diagnostic tests such as multi-collinearity, heteroskedasticity, serial correlation, cross sectional dependence and stationarity before estimating. The modified Wald test showed that the data were groupwise heteroskedastic ($\chi^2(40) = 1680.84$, $p < 0.001$); the Wooldridge test revealed that the data exhibited serial correlation ($F(1,39) = 4.183$, $p = 0.048$); and Persian's CD test confirmed that the data had high cross sectional dependence ($CD = 36.2$, $p < 0.001$, magnitude = 0.560). For all fixed-effects specifications, the Driscoll-Kraay standard errors (Hoechle, 2007) were generally preferred to conventional robust standard errors due to the cross sectional dependence that was confirmed. A Hausman specification test was conducted for each of the four FPI constructs to determine the specification to be estimated (fe vs. re), and foreign equity investment was estimated using RE, with Huber-White robust standard errors. Foreign debt security investment, foreign derivative investment, and composite FPI were estimated using FE, with Driscoll-Kraay standard errors. Throughout, year dummies (with 2019 as the base year) were added to account for common shocks over time, such as the Covid-19 pandemic.

Moderation Model Specification

The general moderated panel regression form was tested separately for each FPI construct, and jointly for the composite index, with the exception of the numbers 0 and 1 that represent the absence and presence of financial inclusion, respectively.

$$FG_{it} = \beta_0 + b_1 FE_{lit} + b_2 FDSI_{lit} + b_3 FDer_{lit} + b_4 (FE_{lit} \times FI_{lit}) + b_5 (FDSI_{lit} \times FI_{lit}) + b_6 (FDer_{lit} \times FI_{lit}) + \varepsilon_{it}.$$

where FG_{it} is the financial growth of firm i in year t , FE_{lit} , $FDSI_{lit}$ and $FDer_{lit}$ are foreign equity, foreign debt security and foreign derivative investment respectively, FI_{lit} is financial inclusion, b_4 , b_5 and b_6 are the moderation coefficients of interest for each FPI channel, and ε_{it} is the error term. The fourth hypothesis, a composite hypothesis, in which the 3 disaggregated FPI terms were replaced by the composite FPI_{lit} term and its interaction with FI_{lit} , was tested with an equivalent specification. A statistically significant interaction coefficient ($p < 0.05$) was interpreted as a sign of moderation of the relationship between the FPI-financial growth relationship, while a non-significant interaction coefficient was seen as the absence of moderation.

RESEACH RESULTS

Moderation of the Foreign Equity Investment-Financial Growth Relationship

After the interaction term was added to the model, the direct effect of foreign equity investment on financial growth had a statistically significant negative effect ($\beta = -0.010$, $p = 0.007$). In fact, financial inclusion did not significantly affect financial growth ($\beta = -0.003$, $p = 0.455$), and importantly the interaction between foreign equity investment and financial inclusion was not significant ($\beta = 0.002$, $p = 0.449$). The model accounts for about 54.6% of the within firm variation (within $R^2 = 0.5459$) and has a low rho value of 0.078, meaning that only about 7.8% of the total

variation in financial growth was due to between firm differences. The null hypothesis H04a was thus retained: financial inclusion has no significant impact on the relationship between foreign equity investment and financial growth. The positive, though non-significant, sign of the interaction effect indicates that there is only a weak evidence of a negative effect of financial inclusion on inequality over the six-year period which is not strong enough to reach significance level.

Moderation of the Foreign Debt Security Investment-Financial Growth Relationship

From the moderation model for foreign debt security investment (Table 1), it was found that the interaction between foreign debt security investment and financial inclusion turned out to be negative and significant ($\beta = -0.026$, $p = 0.025$), while the foreign debt security investment itself was found to be non-significant ($\beta = 0.004$, $p = 0.498$) when the interaction term was added. The direct effect of financial inclusion was also not significant ($\beta = 0.003$, $p = 0.880$). The null hypothesis H04b was thus rejected: financial inclusion has a significant and negative moderating effect on the relation between foreign debt security investment and financial growth, and this is in line with a substitution effect that suggests that the higher the level of financial inclusion, the lower the need for foreign debt to support financial growth.

Table 1. Moderation of Foreign Debt Security Investment to Financial Growth (Driscoll-Kraay FE; $n = 240$)

Predictor	Coefficient (β)	Std. Error	t	p-value
FDSI_w (main effect)	0.004	0.006	0.72	0.498
FI_w (main effect)	0.003	0.017	0.16	0.880
FDSI_w $\times$ FI_w (interaction)	-0.026	0.008	-3.18	0.025*
Constant	0.065	0.003	23.90	0.000*

Note: * significant at $p < 0.05$.

Year dummies included but omitted for brevity; within R-squared = 0.5475.

Moderation of the Foreign Derivative Investment-Financial Growth Relationship

Foreign derivative investment and financial inclusion were not statistically significant ($\beta = -0.002$, $p = 0.548$) and the main effect of foreign derivative investment was not statistically significant before and after adding the interaction term ($\beta = -0.004$, $p = 0.671$). H04c was consequently not rejected. Again, this is in line with the general observation that foreign derivatives are extensively traded by NSE listed companies, but they are most commonly used as a risk management tool rather than a growth tool, meaning the direct and financial inclusion/conditioned effect of foreign derivatives on financial growth are not significant.

Moderation of the Composite Foreign Portfolio Investment-Financial Growth Relationship

In the baseline model, the foreign equity index and the index of debt security and derivative investment had a negative but non-significant direct effect on financial growth, respectively ($\beta = -0.007$, $p = 0.618$ and $\beta = -0.102$, $p = 0.070$). In the baseline model, the foreign equity index and the index of debt security and derivative investment had negative but non-significant direct effects on financial growth, respectively ($\beta = -0.007$, $p = 0.618$ and $\beta = -0.102$, $p = 0.070$). With the addition of financial inclusion and interaction, the direct effect of composite FPI became negative and statistically significant ($\beta = -0.021$, $p = 0.048$), financial inclusion alone was not statistically significant ($\beta = -0.0004$, $p = 0.982$), and the interaction term between composite FPI and financial inclusion was negative and statistically significant ($\beta = -0.015$, $p = 0.029$). H04d was thus rejected. This is the major finding of this study where foreign portfolio investment is shown to have a significant negative moderating effect on the overall relationship between foreign portfolio investment and financial growth for NSE listed companies and its inclusion in this model uncovers the otherwise masked negative direct effect of a composite FPI.

Table 2. Moderation of Composite Foreign Portfolio Investment to Financial Growth (Driscoll-Kraay FE; $n = 240$)

Predictor	Coefficient (β)	Std. Error	t	p-value
Composite_FPI_w (main effect)	-0.021	0.009	-2.45	0.048*
FI_w (main effect)	-0.0004	0.016	-0.02	0.982
Composite_FPI_w × FI_w (interaction)	-0.015	0.005	-3.04	0.029*
Constant	0.067	0.004	19.20	0.000*

Note: * significant at $p < 0.05$. Year dummies included but omitted for brevity.

Summary of Moderation Hypotheses

Table 3. Summary of Moderation Hypotheses Testing Results

Hypothesis	FPI Construct			Interaction β	p-value	Decision	
H04a	Foreign Equity Investment			0.002	0.449	Not rejected - no moderation	
H04b	Foreign Investment	Debt	Security	-0.026	0.025*	Rejected	-
H04c	Foreign Investment	Derivative		-0.002	0.548	Not rejected - no moderation	
H04d	Composite FPI			-0.015	0.029*	Rejected	-

Note: * significant at $p < 0.05$.

RESEARCH DISCUSSION

The four moderation tests, taken together, create a consistent and theoretically coherent pattern: the financial inclusion moderates the relationship between FPI and financial growth only in the case of finance based on debt capital (foreign debt security investment and, consequently, the composite index that represents the combined effect of both debt and equity capital), but not in the case of finance based on equity capital and on derivatives. The financial inclusion interaction coefficient is negative in both cases of significant moderation, suggesting that financial inclusion has a negative impact on the contribution of foreign capital to financial growth. This pattern is read as a substitution effect: as NSE-listed firms increasingly access domestic capital, digital payments and other forms of financial inclusion, they do not seem to become more dependent on foreign borrowings and foreign portfolio investments to support their growth, in line with the notion that financial inclusion offers a viable, and presumably preferred, domestic source of finance for the firms.

This is in contrast to the complementary effect reported in the Indian equity market context by Raghutla and Chittedi (2021), whose results suggest that financial inclusion supported both demand- and supply-side growth of the capital market. It builds on, rather than replaces, evidence from other markets in Africa that foreign portfolio investment does not have a significant impact on the growth of firms' internal capital (Hampane, 2017; Makoni, 2016), and adds to that evidence

by uncovering where and why: not because FPI is unimportant, but because a robust domestic financial-inclusion infrastructure is increasingly replacing it, especially in the debt market. This outcome is also in line with the results obtained by Ndallah (2020) from their study of the effect of mobile money and microfinance access on the willingness of exchange-listed firms in Nigeria to pay the external over-leveraging costs, which shows that inclusive finance buffers the firms.

From an EMH/CFT perspective, the results are incongruent, since they suggest that foreign investment doesn't simply seek out and support firm growth, irrespective of the domestic financial-inclusion environment. The absorptive capacity critique of Capital Flow Theory, on the contrary, is reinforced by a significant negative interaction among debt-based FPI and the composite index: the ability of the firm to translate foreign investments into growth is not predetermined, but is influenced by the strength of the domestic financial inclusion channels, and when the latter are robust, the impact of foreign investment seems to diminish. This, at the same time, is consistent with the main premise of Financial Intermediation Theory, which is that inclusive financial systems efficiently reallocate capital - Here it is an effective redirection from foreign debt to domestic sources of funds, instead of an amplification of the growth effect of foreign capital.

It is also significant that there is little in the way of moderation of foreign equity and foreign derivative investment. The negative direct impact of foreign equity on financial growth did not significantly change because of the financial-inclusion status of a firm, indicating that the pressures of foreign equity (dividend repatriation, international reporting and governance conditions) have a largely independent impact. Financial inclusion, on the other hand, seems to be ill-equipped to condition foreign derivatives as a tool for risk management as opposed to growth.

CONCLUSION AND IMPLICATIONS

This paper aimed at finding out if financial inclusion has a moderation effect on the link between foreign portfolio investment and financial growth of NSE listed firms. The evidence indicates that it does this selectively: the relation between foreign debt security and growth as well as the composite FPI-growth relation are significantly and negatively moderated by financial inclusion, while the foreign equity- and foreign derivative-growth relation are not significantly moderated by financial inclusion. Its overall picture is one where financial inclusion is a structural filter or replacement for foreign capital, rather than an unmediated amplifier of the growth effects of foreign capital a scenario with direct implications for the treatment of the financial-inclusion strategy-foreign-capital-mobilisation nexus in the context of NSE-listed firms and Kenyan capital-market policy.

At the firm level, management and treasury teams at NSE-listed companies should think of financial inclusion as a business approach to managing the cost and composition of capital: integrating financial inclusion as a tool to lower the dependence on foreign debt rather than a CSR

initiative can help firms' growth, and can provide a natural hedge to cushion the impact of currency and repatriation risk from foreign funding. The findings also highlight the need for financial inclusion to be integrated into capital-markets resilience strategy, beyond social-welfare policy: a wide, engaged domestic investor and credit base will offer listed companies greater financial stability and help mitigate the negative impact of a rapid reversal in foreign investor sentiment. This introduction into the disclosure of the nature of foreign debt, its maturity structure, and hedging arrangements, in combination with the disclosure of the purpose of using derivatives, would go along with this approach.

There are some limitations in the study. Each financial inclusion and financial growth was assessed by a single composite indicator instead of multidimensional indicators, and the six-year period used was sufficient for the observed effects, but might underestimate longer-term moderation dynamics. Future studies should investigate whether the substitution pattern reported here persists when financial inclusion is split into access, use and digital-finance components of financial inclusion, and consider other potential moderators, such as exchange-rate volatility, inflation, corporate-governance quality and regulatory quality as the two cases examined in this study are the only two cases where there is evidence of a significant interaction between financial inclusion and the FPI-growth relationship.

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