THE EFFECT OF FINANCIAL SECTOR DEVELOPMENT ON THE ECONOMIC GROWTH IN KENYA

By

PATRICIA WANZA MULI

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DECLARATION

This research project is my original work and has not been presented for a degree in any other university.

Signature..... Date.....

Muli W. Patricia

This research project has been submitted for examinations with my approval as the university supervisor.

Signed ..... Date.....

Dr. Cyrus Iraya
Department of Finance and Accounting
University of Nairobi

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DEDICATION

This project is dedicated to my parents Mr. & Mrs. Muli for having encouraged me to study and for constantly encouraging me to strive for excellence.

Special dedication to my husband, Denis for his encouragement, thoughts and prayers throughout the course of this project.

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ABBREVIATIONS

ANOVA: Analysis of Variance

CBK: Central Bank of Kenya

CMA: Capital Market Authority

FMLS: Fully Modified Ordinary Squares

FSD: Financial Sector Development

GDP: Gross Domestic Product

GNP: Gross National Product

KNBS: Kenya National Bureau of statistics

ABSTRACT

The study sought to determine the effect of financial sector development on the economic growth of Kenya. Economic growth was measured using real GDP growth rate. The determinants of financial sector development were stock, exports development,banking industry development and improved risk management. The study used secondary data covering the period from 1990 and 2016. The relationship between financial sector development and economic growth of Kenya was tested using regression analysis and analysis of variance. The study revealed that economic growth and financial sector development had been fluctuating during the study period (1990 - 2016). The study concluded that there is a strong relationship between financial sector development (exports development, stockmarket development, banking industry development and improved risk management) and economic growth of Kenya. The study also concluded that exports development, stock market development, banking industry development and improved risk management individually affects economic growth positively. However, only stock market development affects economic growth in a positive and statistically significant manner. The study recommended that the government should put in place mechanisms and policies that enhance improved exports development, stock market development, banking industry development and increased uptake of insurance services which in turns promotes growth.

CHAPTER ONE: INTRODUCTION

1.1 Background to the Study

Economic growth is every country's dream. This is because economic growth means reduced poverty level, reduced unemployment, increased productivity, improved government budget deficits and improved living standards as shown by good education, better healthcare services and an increase in social spending without an increase in tax rates (Straubhaar, 2003). Different countries have focused on different ways of enhancing their economic growth for instance through innovations, strategic immigration reforms, war on drugs, scrapping laws that are unclear and unnecessary, cutting health care costs, requiring unemployed workers to volunteer (Shapiro, 2013), while others are focusing on financial sector development (Petkovski&Kjovski, 2012). Some literature such as KIPPRA (2009) suggested that focusing on financial sectors development mostly by developing countries such as in African enables achievement of economic growth. However, this is not true in some circumstance due to varying reasons such as controls by the government (Onuonga, 2014).

The correlation between financial sector development (FSD) and economic growth has had contributions from different scholars who theoretically look at the relationship in different perspectives. These scholars include; Mises (1912) who through his theory of financial intermediary suggests that financial sectors play a crucial role of financial intermediation that involves resource allocations which enhance economic growth. John Maynand Keynes' (1936) Classical theory which suggests that the financial sector performs financial mediation which enhances new investments by encouraging savings which in turn enhances the country's economic growth. There is also Robert Solow and T.W Swan's (1956)Neo-classical Theory which proposes

that capital and labor which are mostly determine by the country's financial system in addition to technological progress are the main determinants of a country's economic growth. The three theories inform the study's findings.

The Kenya's financial sector is described as young and growing and dominated by the banking industry which has the responsibility of mobilizing savings, allocation of capital, providing risk management vehicles and oversight of investment decisions all of which improve the growth of the economy. According to Nyasha and Odhiambo (2015), this is the main reason as to why the Kenyan financial sector is usually referred as bank-based. The sector is also a crucial participant in the country's Vision 2030 which is a determinant of the country's economic development levels by 2030. According to the Republic of Kenya (2007), the financial sector in Kenya is tasked with the role of providing improved financial intermediation services between the different sectors and industries of the country's economy. Although the financial sector in Kenya is said to be performing well, it has however not reached its full potential in improving resource allocation in the country's economy.

1.1.1 Financial Sector Development

Financial sectors refer to policies, factors, and institutions which ensure that financial markets and institutions are effective and that participants are able to easily access funds/capital and other financial services (WEF, 2012). Financial sectors in developed countries are said to be developed thus are efficient in facilitating resource mobilization which enhance economic growth while most of the third world and developing countries, have less efficient and under developed financial sectors that have lower levels of banking intermediation (Kar, 2011). While most of the countries

that are developing have recently enhanced the efficiency of their financial markets, its relationship to the country's growth is still inconclusive.

The financial sector is suggested by some scholars to contribute to economic growth through different ways such as helping in running other sectors through provision of funds and financial risk management. Financial sectors also act as intermediaries between those with surplus and want to save and those with deficits thus want to borrow which improve the economic growth of a country. Scholars such as Schumpeter (1911) and Shaw (1973) as cited by Onuonga (2014) suggest that controls used by the government on financial sector for instance directing credit programs, poor or inadequate interest rates policies and also setting high reserve requirements discourages both the advancement of the country's financial sector and also its growth in economy and that this is most common in developing countries. A study by Mwakalobo (2013) established that for the country to achieve economic growth, it must ensure that their financial sector are efficient and are supported by effective and sound fiscal and monetary policies.

In Kenya, the financial sector has grown significantly in terms of its input to overall GDP. By end December 2015, financial sector's assets as a share of nominal GDP was 83.27 per cent in comparison to 88.41 per cent in 2014. The decline attributed to exclusion of assets belonging to3 banks placed under receivership. Market Capitalization for all listed and actively trading equities at the Nairobi Securities Exchange (NSE) accounted for 32.27% as at the end of Dec, 2015 with comparison to 42.61% at the year end, December 2014, reflecting a decline in shareholder's wealth due fall in share prices. In terms of the proportions by each sub-sector, the total banking sub-sector including Microfinance bank's assets accounted for 56.11 per cent; the Pension subsector accounted for 13.08 per cent; Insurance industry accounted for 7.90 per cent; and Saccos subsector

accounted for 5.59 per cent, respectively of nominal GDP by end December 2015. This research study determines the major role of financial sector development on the Kenya's economic growth.

1.1.2 Economic Growth

Economic growth can be defined as the increase/rise in the economy's ability and capacity to produce goods and services over a period of time (Bakang, 2015). It can also be defined as the increase/rise in the market value of products and services produced by a country's economy over a given period of time. Economic growth is also referred to as an increase in country's productive capacity. To measure the country's economic growth, the market value of all goods and services is considered. This includes: "personal consumption, private inventories, purchases by the government, the foreign trade balance and the paid-in construction costs. "The two main measures used to measure economic growth are Gross Domestic Product (GDP) and Gross National Product (GNP)." GDP refers to the maximum value of goods/services produced within the country's boundaries. On the other hand it measures the total worth of goods/services manufactured/produced within and outside the country by all its citizens over a given period (Surbhi, 2015). GDP can be short term or long-term. GDP can also be used to compare countries of different population and sizes. Here GDP per capita is used.

Since 1950, only 12 countries have achieved to grow at a rate of more than 7% for 25 years or more. These are; the United States, Japan, China, India, the UK, Brazil, Venezuela, Mexico, Poland, Thailand, Korea and Singapore. Many developing countries such as Africa, Latin America and the Middle East have achieved a high growth rate only for shorter periods (Eel-Erian & Spence, 2008). Like other developing countries, Kenya has a development plan that is long-term, Vision 2030. The plan is aimed at transforming the country into a middle-income economy by

2030. The plan consists of 3 key pillars that are: economic, social and political development. The economic development pillar is all about achieving an average economic growth rate of 10% per annum until 2030.

1.1.3 Financial sector and Economic Growth

The effect of FSD on economic growth has been reviewed by various scholars. Generally, scholars suggest a positive and significant relationship between the two factors (Wadud, 2005; Eita, 2007 & Ogola, 2016). However different scholars have been found to have different stands on this area of knowledge for instance; some scholars suggest a positive and significant relationship between financial sectors development and economic growth (Mwakalobo, 2013; Musamali, Nyamongo & Moyi, 2014; Muli, 2015; Urgaia, 2016). Ram (1999) and Favara (2003) suggest there is no link between the development of financial sector and the country's economic growth. There are also scalars who suggest a negative relationship which is found to be significant when the financial sector is liberated but insignificant when there is a lot of government control (Akinboade, 2000).

On the other hand, some scholars like Christopoulos and Tsionas (2004) suggest that the relationship is the other way round where growth determines the FSD. Ang (2007) determined the extent to which FSD contributed to economic growth in Malaysia over the period 1960-2003 and established that in the longer-term, FD as measured by private capital stocks and the labor force has a significantly positive impact on the economic growth in Malaysia. Guryay, et al (2007), determined the between Northern Cyprus economic growth and FD over the period 1986-2004 and found that FSD has a postive relationship to the economic growth of Northern Cyprus.

Onuonga (2014) suggest that country's financial industry is crucial for the expansion of its economy in ways such as helping in the financial and risk management facilitation of other sectors

which spur economic growth. This realization has made players in the financial sector put more effort in the management and control of the sector to ensure stability and development.

Muli (2015) in his of the effect of FSD on Kenya's economic growth established a strong positive correlation between the two variables which suggests that financial sectors development enhances the growth of the Kenyan economy. These conflicting findings warrants further research to establish whether financial sector development affect economy.

1.1.4 Financial Sector Development and Economic Growth in Kenya

Kenya is generally described as Eastern and central Africa's hub for Financial, Transportation services and Communication. The Kenyan economy is described as being market-based. The economy is made up of industries such as; financial services, forestry and fishing, agriculture, mining and minerals, tourism, industrial manufacturing and energy. The Kenyan economy has experienced a good performance especially for the period 2004 and 2007 where the real GDP growth reached an average of almost 6 percent a year. Since then, the economy has however encountered a series of disruptions from shocks such as the global financial crises in 2008, post-election crisis of 2008, severe droughts and the rising prices of fuel and world food which slowed down to 1.6 percent in 2008. Then in 2009 the economy began to rebound as a result of strengthened banking supervision. This rebound continued in 2010 which saw the GDB reach 5.8. Kenya just like other developing countries, has adopted FSD as a vehicle for its growth in economy. This is through focusing on reforms on enhanced governance, transparency and re-engineering the business models in the sector to enhance its performance for economic growth (Kenya Financial Sector Stability Report, 2015).

The Kenyan economy has witnessed a continuous growth trajectory since 2013. In 2015 the country achieved a GDP of $69.977 billion which made it position 72 in the economies in the world. The economy then expanded by 5.7% in 2016 compared to 5.8% in 2015 although majority of the sectors of the economy had recorded a lower growth (KNBS, 2016). During this period, the country's inflation rate was maintained within the CBK'S 6.3% compared to 6.14% in 2015. This slight increment inflation was primarily caused by hiking of the prices of beverages and food and other commodities in the duration under review.

According to the World Bank (2017), the growth of the Kenyan economy is projected to increase to 6%in current year, from 5.9% in the previous year. The drivers for this include: an construction, inflation, fuel prices, financial sector, currency stability, an increased investment into energy and transportation sectors, a surge in remittances and a growing middle-class economy and increasing incomes. In 2017, out of 190 countries, Kenya was position 92 in the World Bank ease of doing business rating. This is an improvement from position 113 in 2016 (World Bank Group, 2017). This study determines the role that that financial sector development played in this continuous growth in the economy.

1.2 Research Problem

The concept of economic growth and the factors that affect it has recently received considerable attention from governments, non-governmental institutions and researchers due to the recent focus on economic growth for sustainability (Harrington, 2013). Despite most economies are focusing on financial sectors development for economic growth (Wadud, 2005 and Ogola, 2016), this area of knowledge is suggested to have inconclusive and conflicting results for instance; some scholars suggest a positive and significance relationship (Kagochi, 2013; Musamali et al. 2014; Muli, 2015;

Urgaia, 2016). Other scholars such as Ram (1999) and Favara (2003) suggest no link between the two variables. On the other hand, other scholars such as Akinboade (2000) suggest a negative relationship which is concluded to be significant when the financial sector is liberated but insignificant when there is a lot of government control. The literature is however not clear on the role that FSD plays on the country's economy. This is from the fact that no study has conclusively and exhaustively brought out the relationship between the two variables. This thus makes the review of the role of FSD on Kenya's economic growth of a unique component of review in this study.

Several studies have been reviewed on this area of knowledge for instance; Mwakalobo (2013) examined the effect of financial sector in the economic growth of Tanzania. Musamali et al. (2014) evaluated the relationship between financial sectors development and economic growth in Africa. Urgaia (2016) examined the input/contribution of the FSD on economic growth in East Africa's economic growth. Locally, Kagochi (2013) examined/evaluated the relationship between financial development and economic growth in Kenya using an expanded neoclassical growth approach. Onuonga (2014) empirically analyzed the relationship between financial development and economic growth in Kenya for the period 1980–2011. Muli (2015) examined the relationship between financial sector development and Kenya's economic growth.

Some studies on other countries were done for instance, Mwakalobo (2013) is based on Tanzania. Musamali (2014) is based on Africa without specific focus. Urgaia (2016) on the other hand is based on East Africa. These could not be used to represent the same in Kenya due to difference in factors such as market factors and economic performance. Some studies came close to tackling this topic, for instance Onuonga (2014) and Muli (2015). However, these studies were carried out few years back which calls for a study that would account for the time and changes in the market

factors and economic conditions. None of the studies reviewed focused on the exports, stock market development, risk management and banking sector development which are the focus of this study. This brings a gap in knowledge that this study seeks to address by answering the question what is the role of financial sector development on the economic growth of Kenya?

1.3 Objective of the Study

To determine the effect of FSD on the economic growth of Kenya

1.4 Value of the Study

A study on the effect of finance sector development and economic growth poses a unique opportunity not only to the government and other regulatory authorities responsible for policy formulation and implementation in Kenya but also to academicians and researchers.

To the government, policy makers and regulators of the Kenyan financial sector, e.g. CBK and CMA, the findings of this study enlighten them on the role that the country's financial sector plays.

To the management of financial institutions and other participants in the financial sector, this study enlightens them on the role that their institutions play in the growth of the economy thus encourage them to make wise decisions that act in the best interest of the sector.

To the researchers, academicians, the study contributes to literature on the effect of FSD on the economic growth. This study also acts as a basis for future studies on the effect of FSD on Kenya growth in economy.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter presents the that forms the basis of this study. Literature that relates to the study is viewed to identify the gaps in the knowledge. Theoretical empirical literature is reviewed through assessment of the various theories, the elements of financial sector and then the empirical studies on the effect of FSD on the economic growth. This is followed by the literature summary and then the research gaps.

2.2 Theoretical Review

Theories on FSD and economic growth by different scholars to try to explain what entails financial sector development and the role that it plays on the country's economic growth. This study's theoretical review is based on three theories which include; the Theory of Financial Intermediation, the Classical Growth Model and the Neo-Classical Theory.

2.2.1Theory of Financial Intermediation

Theory of Financial Intermediation was developed by Mises (1912). This theory views the banking sector as the financial intermediaries whose role is to gather deposits from those with surplus and lend it out to those with deficits to get interest. This activity creates liquidity (Dewatripont, Rochet, &Tirole, 2010). According to Mises (1912), the banks could either act as financial intermediaries or as creators of credit and money. According to the theory, financial intermediation involves transferring resources from those with surplus to those with deficits thus influencing investment which is significant to economic growth. Effective financial intermediation is able to overcome

market failures through resolving information asymmetry issues by transforming risk characteristics of various assets (Mises, 1912).

Schumpeter (1911) also supports the Theory of Financial Intermediation by suggesting that efficient and well-functioning intermediaries enhance the overall economic growth through enabling the pooling and allocating funds. It is also suggested that financial intermediation also promote innovation and entrepreneurship and which are essential components for economic development. Greenwood and Jovanovic (1990) also supports the view by suggesting that financial intermediation enhances economic growth through allowing investors to earn a higher rate of return on their capital. This theory is criticized by scholars such as Allen and Santomero (2001) on the grounds that it views concern to the financial sector. This theory is however relevant to this study for its suggestion that the financial sector acts as an intermediary to enhance funds flow which increases liquidity that improves economic growth.

2.2.2 Classical Growth Model

Classical theory also known as the Demand and Supply theory was developed by John Maynand Keynes (1936). Other scholars however argue that the Classical theory cannot be credited to one single scholar that belongs to the classical school (Vaish, 2000). The theory holds that finance is determined by the demand and supply of credit thus volatility in the finances in the country is of variability in the suppl demand of credit (Caplan, 2000). Harrod-Domar (1946) came up with the classical growth model for a closed economy which suggests that supply and demand of credit determines the ratios of savings and capital-output in an economy which in turn enhances the growth rate of gross national product (GNP). The theory assumes that the demand for credit comes

from businesses or people who borrow for consumption or litigation while supply of credit emanates from those who save from their current income.

Kennedy (1966) then developed the open economies approach through expanding the Harrod-Domar growth model. The classical theory is also supported by the work of Schumpeter (1911) who suggests that financial intermediaries, through performing their financial activities/services such as risk management, savings mobilization, monitoring managers, facilitating transactions and also projects evaluation which enhances economic growth. This theory is however criticized by Ho and Saunders (1981) on the grounds that it does not consider the changes in the income levels of individuals (Mungai, 2013). The Classical theory is also criticized on the basis of failing to account for factors other than supply and demand for credit income, wealth, changes in the primary borrowers and the creation of funds (Ho and Saunders, 1981). Finance mediation enhances new investments through encouraging savings which in turn enhances economic growth.

2.2.3 Neo-Classical Theory

It was developed by Robert Solow and T.W Swan (1956). It is also referred to as the Solow Swan Growth Model was developed from the work of Robert Solow and T.W Swan (1956). This theory focuses on tree factors that affect economic growth. These include; labor, capital and technology advances. When it gets to a point where labor and capital reaches an equilibrium state, then it was the technological advances that impact the economic growth. According to this theory, accumulation of capital, productivity, population growth and technological progress influence the long-run growth of the economy (Solow, 1956). This emphasizes the crucial role that savings and capital investment enhance the county's economic growth. When the public saves their resources, and use it to build into the future, it expands the capacity of the economy.

This work is also supported by Goldsmith (1969) who focused on transforming the financial instruments that are short-term into long-term instruments and how this affects the economic growth. This theory is criticized on the grounds that it suggests that economic growth can only occur when there are technological advances. The theory is also criticized on the basis that it relies on diminishing marginal returns of capital and labor. The neo-classical economics are relevant to this study for their suggestion that capital and labor which are determine by the country's financial system in addition to technological progress are the main determinants of a country's economic growth.

2.3 Empirical Review

The empirical review of this study is based on international and local studes on the role of FSD on the growth.

2.3.1 International Studies

Mwakalobo (2013) determined the effect of FS on the growth in Tanzania. Using data for the banking industryof Tanzania, the study established that the performance of SEM and the banking sector as measured by market capitalization and domestic credit to private sector respectively has a positive on the rates of economic growth in Tanzania. The researcher also found out that the banking sector in Tanzania has a higher contribtion to economic growth than the stock exchange market. The researcher then concluded that banking industry/sector and stock exchange market enhance the allocation and distribution of resource in the economy which promotes the country's future economic growth.

Ray (2013) assessed the relationship between FD and India's economic growth between 1990-91 and 2010-11. The researcher carried out this study for the reason that the relationship between FSD and economic growth has been reviewed by many researchers who established that there is a significant positive relationship between the two variables. However, the researchers do not establish the direction of causality between the two. The study sought to find out whether financial development causes economic growth or vice versa. Granger causality test was used. It was established that financial development as by ratio of savings and gross domestic capital to the country's GDP causes economic growth in India. The study thus concluded that financial development has a stronger effect in the economy in India.

Musamali, Nyamongo and Moyi (2014) examined the relationship between financial development and economic growth in Africa. Data from a cross section of fifty countries in Africa was used for the period 1980-2008. The study used broad money supply to GDP ratio also called monetization variable and the ratio of credit to the private sector to the country's GDP to measure financial development. The study also included standard growth determinants such as; primary school enrolment, real per capita income, trade of goods of GDP, government consumption, inflation and gross domestic investment as a GDP in the model. The study established that both money supply and private sector credit had a positive relationship to economic growth however private sector loan/credit is strongly related to economic growth than money supply. The researchers also found that the Financial Sector Development relationship to economic growth is bi-directional. The study then concluded that Financial Sector Development is positively related to the economic growth among African.

Urgaia (2016) used the empirical studies to analyze the role FSD on Ecoomic Growth in East Africa over 1975 – 2014. Using Fully Modified Ordinary Least Squares (FMOLS) which is a

five-variable dynamic panel to estmat the short and long-run parameters, the researcher established that the fluctuations in the country's economic growth are caused by the long run shocks experiences in the financial Sector. The researcher also found that the financial sector accelerates and enhances the country's economic growth which in turn enhances the development of the financial sector. The researcher then recommended that reforms such as; adopting expansionary monetary policy and all-inclusive financial systems in the financial sector was beneficiary economic growth of the country.

2.3.2 Local Studies

Uddin, Sjö and Shahbaz (2013) reviewed the relationship between Kenya's economic growth and Financial Development between 1971 and 2011. The researchers employed the Cobb-Douglas production which was improved/augmented incorporation of financial development. The researchers determined that FSD as measured by (M2) , (M1) had a postive impact on economic growth in the long haul.

Waiyaki (2013) assessed the relationship between Financial Sector Development and economic growth and povety in Kenya for the period 1997-2012. The researcher employed OLS method under the PARCH model. The researcher mostly focused on the direction of causality between Financial Sector Development and economic growth. The study used Kenya's market stock and banking sector as a of FD. The study used variables such as; the advances to private sector, broad money supply M3, bank deposits, stock market turnover, stock market capitalization and volume of stocks traded. It was established that bank deposits lead to economic growth while other factors such as M3 and credt to the privte setor had no effect on economic growth.

Bakang (2015) empirically determined the effects of financial deepening/development on economic growth in the Kenyan banking sector for the period 2000 to 2013. The researcher used quarterly time series data from 2000 to 2013. The Johansen Jeluisus cointegration test was used. The study found that the factors under consideration; credit to the private sector, liquid liabilities, central and commercial bank's assets and commercial bank deposits have positive and statistically significant effects on GDP. The researcher then concluded that the banking industry in Kenya has an imprtnt role in the proces of economic expansion. The researcher thus recommended existing policies should be reinforced to encourage the public to save more money with commercial banks. The study also recommended that the policies on financial inclusion should be reinforced through increasing access and usage of formal banking services which then reduces banks transaction costs.

Onuonga (2014) empirically assessed the relationship between financial development and economic growth in Kenya for the period 1980–2011. Using the Granger causality analysis to determine the direction of causality the researcher established that there is a stable and long-term relationship between FD and economic growth in Kenya. The study also found that financial development has positive and significant relationship on the Kenya's economic growth. The researcher also found that there was a bi-directional relationship between Financial Development and the Kenya's economic growth within 1980–2011 which implies that financial development accelerates and enhances the country's economic growth and that economic growth in turn improves the development of the financial sector in Kenya. It was then recommended that the government needs to improve its fiscal policies and macroeconomic policies to attract foreign direct investment and also strengthen the reforms in the financial sector to improve the country's economic growth.

2.4 Determinants of Economic Growth

This secton summarizes the literatre examning the drivers of economy in Kenya. Economic growth is conventionally determined by exports development, stock market development, banking industry development and improved risk management. A comon fiding is that the mentioned variables plays an imporant role in contributing to economy in Kenya.

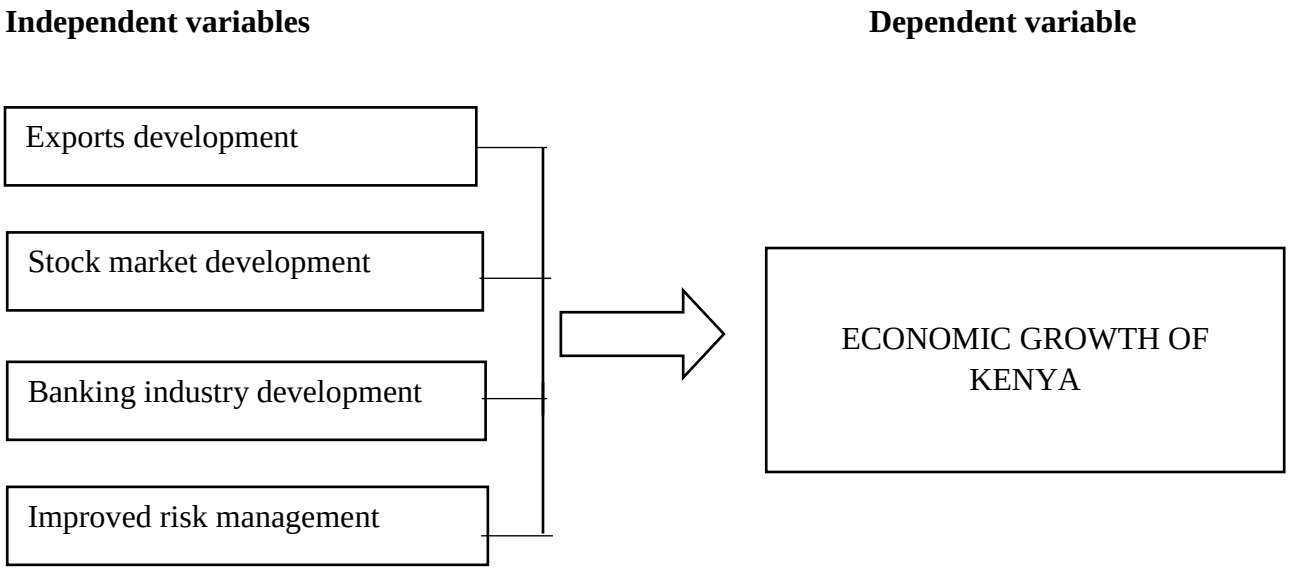
Economic growth is further characterized by increases real GDP per capita that ocur over the long-term, interest rates, savings and inflation rates. Stern (1991) describes economic 38 growth as evolvig from the suply side, such as the acumulation of phsical capital, the prgress of skills, ideas and inovation, the growth of population and how factors are used, combined, and managed..

The main determinants of economic growth discussed in this study include; exports development (control variable), stock market development, banking industry development and improved risk management.

2.5 Conceptual framework

The focus of the study is to define the relationshp between the dependent and indepndent variables. In this study the dependent variable was Economic Growth of Kenya while the independent variable was financial sector development as proxied by exports development (control variable), stock market development, banking industry development and improved risk management.

Figure 1: Conceptual Framework



2.5.1 Banking Industry

Banking industry is responsible for pooling and trading risk in the market. This is through facilitating the lenders to have liquidity that is enough to finance investment projects that are long-term in nature. Banks may improve the economy through intermediation which enables savers save and access their funds immediately while at the assuring borrowers of long term access to finances. Bank industry diversifies the liquidity risk that individual lenders face at macro level (Greenwood and Smith, 1997) thus enabling them to avoid loses as a result of risk. This enhances economic growth.

2.5.2 Risk and Insurance development

Risk is the uncertainties that face an individual, the business or even the country. These uncertainties are is more so in businesses unlike in individuals because every decision that is business or entrepreneurial oriented is associated with risk (Demers, 2016). Comon risks include;

credit , market , foreign exchange and liquidity risks. Liquidity risk is the risk that arises from the inability of an individual, institution, or country to pay short term debts (Berk, 2009). Managing the risks entails resource planning, organizing, directing and controlling to achieve the set objectives in light of good or bad events (Head, 2009). Managing the risks in the businesses focses on identifyng what cold go wrong, evaluating which riss the firm should deal with and implement the strategies that help curb the effects of the risk (Business link UK, 2009).

2.5.3 Exports Industry Development

The relationship between exports and economic growth has raised a long-standing debate in both advanced and less advanced economies. Studies such as Shirazi and Manap (2005) and Kang (2015) confirm that there is a connection between export and country's economic growth. They suggest that exporting goods and services generate foreign exchange which is required to import foreign goods. The increase in the imports in turn stimulate a nation's capacity to produce in the long run. This is mostly common among less developed economies which are to a great extent disadvantaged when it comes to production of capital goods (Verter and Becvarova, 2016).

Determinants of the level of exports include; quality and value of exports, competitiveness, exchange rates and long run productivity.

2.5.4 Stock Market industry

Stock market is defined as an economic entity that enhances efficiency in capital formation and allocation/distribution (Osinubi, 2004). Many countries, especially developing countries have realized a rapid growth in their trading activities and financial markets in general. This is suggested by some scholars to be triggered by country's economic growth (Vacu, 2013). This leaves some questions; does stock market development affect economic growth? Is the relationship

significant? and the direction of the causality." The subject of SMD and economy growth is of great concern and interest to many economists. According to Mishkin (2004), effective and well-functioning financial markets encourages a high economic growth while poor performing financial markets are a reason for some countries remaining underdeveloped.

Obadan (1995) suggests that a well-functioning stock exchange market can, through stock market index be used to determine/calculate significant variations in general economy.

2.6 Summary of Literature Review

The study reviewed three theories that try to explain the role that developent of the country's finacial sector plays on economic growth of country. These include; the Theory of Financial Intermediation by Mises, the Classical theory by John Maynand Keynes and the Neo-classical Theory by Solow Swan. Empirical literature was also reviewed the relationship between Financial Sector Development and economic growth although the studies suggest conflicting findings. Some of the scholars suggest a positive and significance relationship, others have suggested a weak and insignificant relationship. Other scholars suggest a bi-diretional relationship which implies that FSD enhances the country's economic growth and that economic growth in turn improves the development of the financial sector in the country. From the literature, it can also be summarized that the components of the financial sector include; banking industry, risk and insurance industry, exports industry and the stock market industry. From litrature, it can also be concluded that effect of the financial sector on the economic growth varies across countries depending on their size.

2.7 Knowledge Gap

The theories reviewed focused on different aspects of economic growth for instance; the Theory of Financial Intermediation focused on the level of deposits gathered, the Classical theory focuses on the supply and demand for credit while the Neo-classical Theory focus on labor, capital and technology advances. The three theories thus lack a common understanding. Most of the empirical literature is from countries other than Kenya thus cannot be used to represent the same in Kenya due to difference in factors such as the factors of production and the country's economic condition. The empirical studies reviewed also use different measures to measure/calculate Financial Sector Development. The literature reviewed in this chapter suggests conflicting findings and conclusions on the relationship between FSD and economic grwth. It brings in a gap in knowledge that this study sought to bridge by determining the role of FSD on ecnomic growth.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

Identifies the researh methodologies to be followed during the collection, processing and analysis of data. The chapter discusses the research design, targeted population, collection of data and analysis of data.

3.2 Research Design

Refers to the procedures collectio of data and analyss so as to meet the study objectives (Dul and Hak, 2008). Descriptive time series correlation design was employed. Descriptive time series correlation research design considers a continuous record of data of the study variables over the study period. The descriptive aspect enabled the researcher to describe the characteristics of the variables (Orodho and Kombo, 2002). It helped in describing the main role/function of Financial Sector Development Kenya's economic growth. The correlation aspect was used to establish how financial sector development influences Kenya's economic growth. Therefore, it is justifiable to use time series correlation research design to find out the effect of FSD on Kenya's economy growth over time.

3.3 Data Collection

The importance of data collection is that it allows analysis and dissemination of accurate information and implementation of meaningful policy (Kombo & Tromp, 2006). Secondary data was used to establish the relationship between FSD and economic growth of Kenya. The secondary data for this study was sourced from the Kenya National Bureau of Statistics (KNBS), Cental bank of Kenya database, Insurance Regulatory Agency, Export Processing Zones Authority

and the Nairobi Securities Exchange. The data was also sourced from publications such as academics journals and other scholarly articles. The study was carried out in consideration of twenty-seven-year period (1982-2016z).

3.4 Data Analysis

The secondary data gathered was tested for normality and consistency before being analyzed using Statistical Package for Social Sciences (SPSS version 23) and Microsoft's' Excel 2016. Since the data collected was descriptive in nature, descriptive statistcs such as means and stadard deviations was used during analysis. The findings were tabulated and the trend of the variables over time presented using graphs.

3.4.1 Analytical Model

Multi-variate regression analysis used to deduce the effect FSD on Kenya's economic growth. The following regression model was used for this purpose:

$$\mathbf{Y} = \boldsymbol{\beta_o} + \boldsymbol{\beta_1}\mathbf{X_1} + \boldsymbol{\beta_2}\boldsymbol{X_2} + \boldsymbol{\beta_3}\mathbf{X_3} + \boldsymbol{\beta_4}\mathbf{X_4} + \boldsymbol{\varepsilon}$$

Y = Economic Growth of Kenya

$\mathbf{X_1}$ = Exports Development

$\mathbf{X_2}$=Stock Market Development

$\mathbf{X_3}$ = Banking Industry Development

$\mathbf{X_4}$ =Improved Risk Management

$\boldsymbol{\beta_o}$= constant term of the model

$\boldsymbol{\beta_1 - \beta_4}$ = co-efficients of the model

$\boldsymbol{\varepsilon}$ = the stochastic error term estimate

3.4.2 Measurement of the Variables

The dependdent variable was Economic Growth of Kenya while the inndependent variable was financial sector development as proxied by exports development, stock market development, banking industry development and improved risk management.

Table 3.4.2: Measurement of the Variables

	Variable	**Measurement**
Y	Economic Growth of Kenya	Mesured as the annual growth rate of the real GDP of Kenya
X_1	Exports Development	Mesured as the annual growth rate of exports of both goods and services
X_2	Stock Market Development	Mesured as the annual market capitalization of Kenya
X_3	Banking Industry Development	Mesured as the annual growth rate of customer deposits and transactions within commercial banks in Kenya
X_4	Improved Risk Management	Measured as the annual growth rate in the uptake of insurance services in Kenya

Source: Researcher (2017)

3.4.3 Test of Significance

To determine the significance of the correlation between FSD and Kenya's Economic Growth, the researcher do all the calculations at 95% degrees of confidence interval with a p-value of 0.05 or less being considered as indicator of adequacy for a statistically significant relationship.

The goodness of fit of the regression model to the data collected was tested by use of the ANOVA (Analysis of Variance) with an F statistic at 5% level of significance and a p-value of 0.05 or less**.**

To ensure that the data collected is suitable for parametric tests such as Pearson's correlation, regression analysis and Analysis of Variance, the data was subjected to tests of normality such as Shapiro-Wilk Test and the Kolmogorov-Smirnov test of normality. A p-value equal to or lesss than 0.05 was considered as an adequate indicator of a normally distributed data.

CHAPTER FOUR: DATA ANALYSIS, FINDINGS AND INTERPRETATION

4.1 Introduction

This chappter presents the analyssis and interpetations of the studdy fidings in regard to the effect of FSD on the growth of Kenya. Ssecondary data was from various sources such as the World Bank and the Knbs. Exports development, stock market development, banking industry development and improved risk management were selected as indicators of financial sector development while economic growth was measured using real GDP growth rate of Kenya. The researcher used regression analysis to test the effect of financial sector development on the economic growth of Kenya. Goodness of fit and reliability of the regression model derived was tested using analysis of variance.

4.2 Diagnostic Tests

The researcher carried out tests of normality on the collected data. The hypothesis was stated as follows:

H_o: “The sample data are not significantly different than a normal population”.

H_a: “The sample data are significantly different than a normal population”.

p-value recorded was greatter than 0.05 indicates that the data was extracted from a normally distributed population and implies that the null hypothesis should reject it. The of the test are as shown in Table 4.2.

Table 4.2: Tests of Normality

	Kolmogorov-Smirnova[a]			Shapiro-Wilk		
	Statistic	df	Sig.	Statistic	df	Sig.
Economic Growth	.120	35	.200*	.926	35	.201
Exports Development	.193	35	.102	.938	35	. 408
Stock Market Development	.152	35	.140	.902	35	.050
Banking Industry Development	.115	35	.200*	.962	35	.269
Improved Risk Management	.144	35	.164	.964	35	.304
*. This is a lower bounnd f the true significance.						
a. Lilliefors Sigificance Correction						

Source: Research Findings (2017)

Both Shapiro-Wilk and Kolmogorov-Smirnova tests had p-values greater than 0.05. This indicates that the data was extracted from a normally distributed population and was therefore fit for use in parametric tests such as Pearson's correlation, regression analysis and analysis of variance. Therefore, the researcher accepted the null hypothesis and consequently rejected the alternate hypothesis.

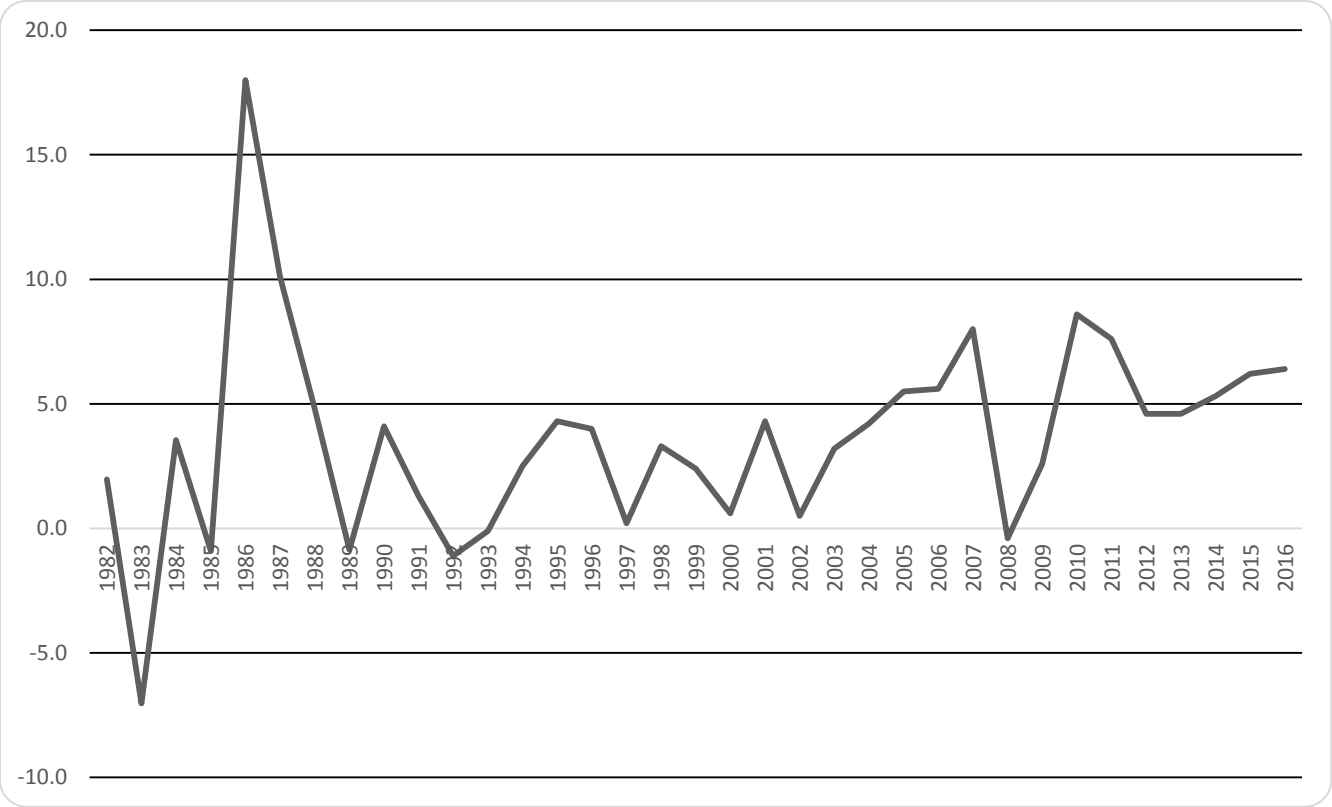
4.3 Descriptive Analysis

This chapter discusses the trend of the Kenya's economic growth and financial sector development as proxied by Exports Development, Stock Market Development, Banking Industry, development and Improved Risk Management during the period 1982-2016.

4.3.1 Economic Growth of Kenya

The economic growth of Kenya as measured using real GDP growth rate. The trend is as shown in Figure 4.3.1.

Figure 4.3.1: Economic Growth of Kenya



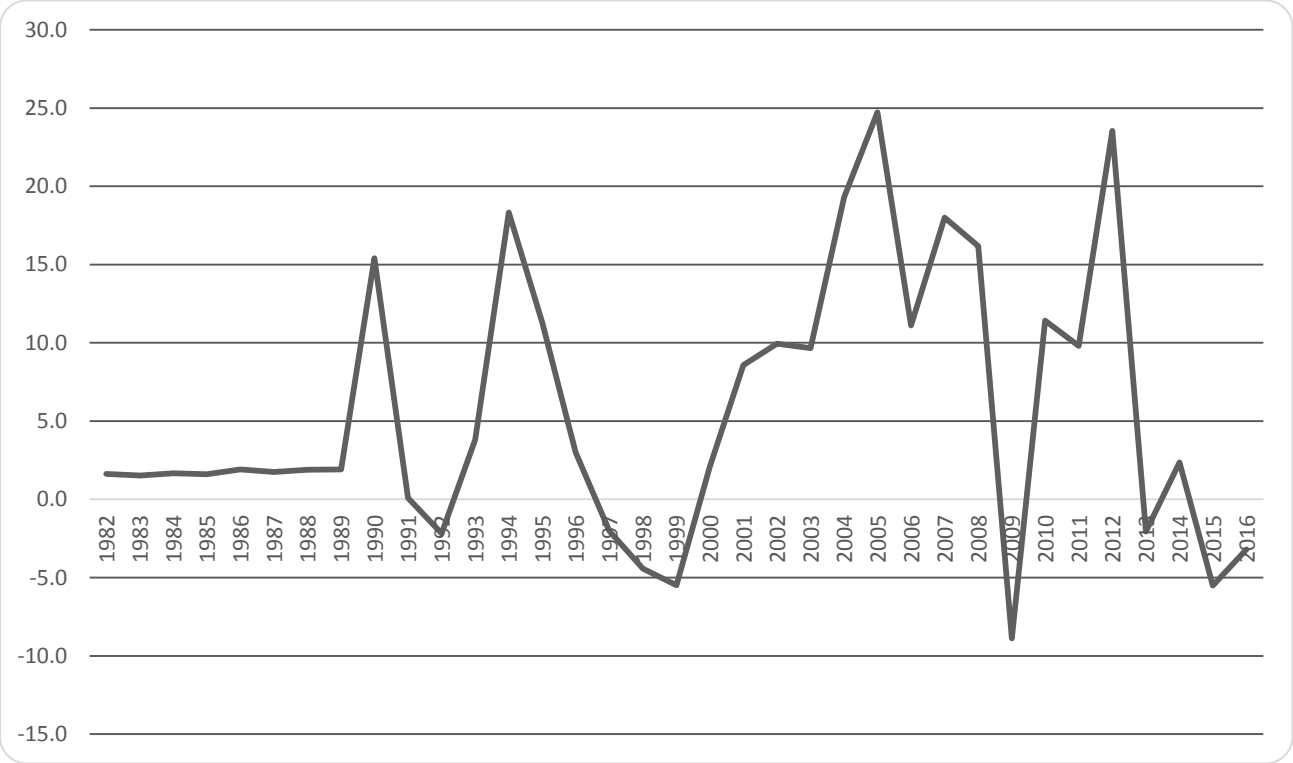
Source: Research Findings (2017)

The study findings revealed significant fluctuations in the economic growth rate of Kenya over the study period (1982-2016). The lowest growthh rate of -7.0 was in 1983 while the highest growth rate of 18.0% was recorded in 1986. Further, low growth rates were recorded in 1992 (-1.1%), 1997(0.2%), 2002 (0.5%) and 2008 (-0.4%). These periods of low economic growth rate coincide with the periods Kenya held general elections.

4.3.2 Exports Development

The study sought to know the level of exports development in Kenya by looking at the annual growth rate of exportss of both goods n services. The results of the study are as shown in Figure 4.3.2.

Figure 4.3.2: Exports Development



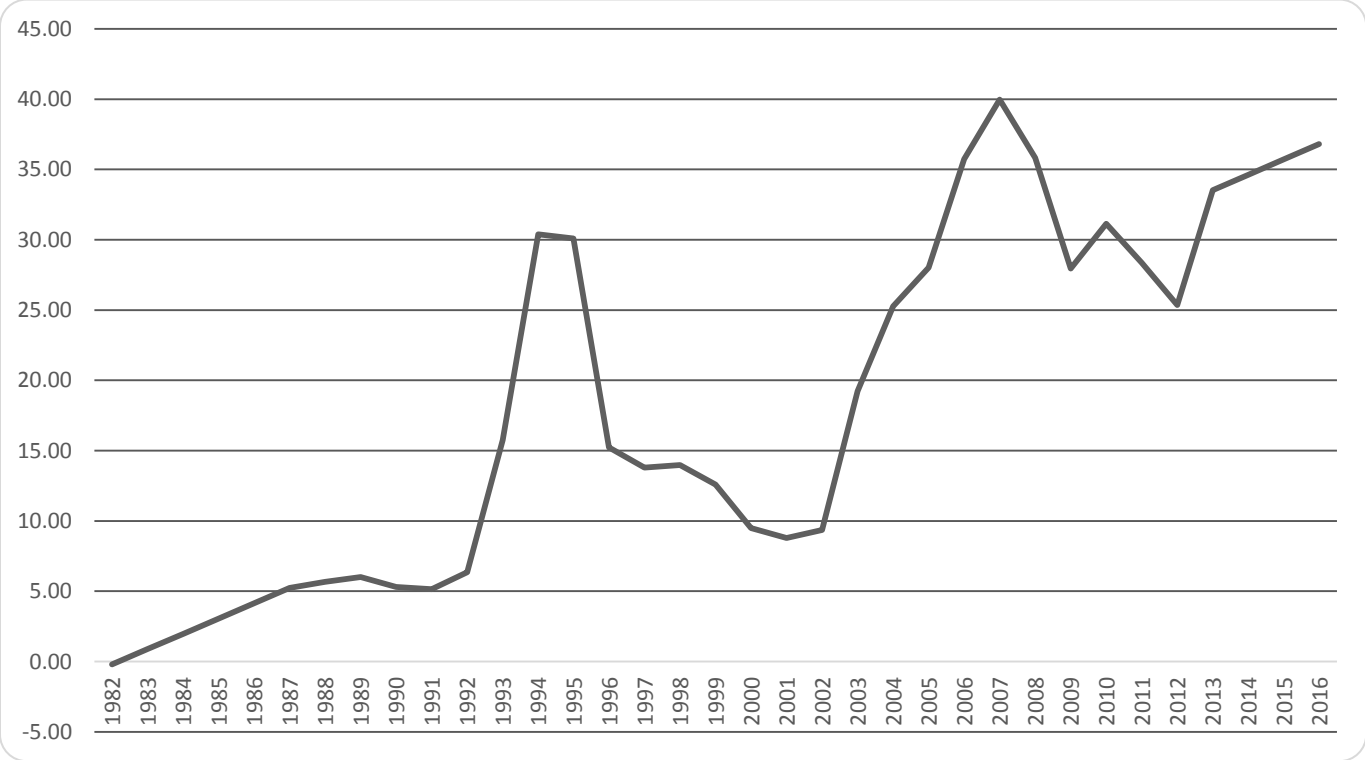
Source: Research Findings (2017)

The study found out that the annuall growth of exports (both goods and services) in Kenya was highly fluctuating during the study period (1982-2016). The lowest growth rates recorded were -4.4% and -8.9% in 1998 and 2009 respectively while the highest growth rates of 24.7% and 23.6% recorded in 2005 and 2012 respectively.

4.3.3 Stock Market Development

The study further sought to establish the level of stock market development in Kenya. This was measured using annual market capitallzation to GDPs ratio for the period 1982-2016. The trend of stock market development during the study period is as shown in Figure 4.3.3.

Figure 4.3.3: Stock Market Development



Source: Research Findings (2017)

The data collected indicated that Kenya's stock market development was at its lowest in 1982 when a value of -0.21 was recorded. The second lowest stock market capitalization to GDP ratio of 0.88 was recorded in 1983. Stock market development was at its highest in 2007 with a value of 39.96 while the second lowest value of 36.8 was recorded in 2016.

4.3.4 Banking Industry Development

The study also soght to establish the level of banking industry development in Kenya. This was measured using annual growth rate of customer deposits and transactions within commercial banks in Kenya for the period 1982-2016. The trend of banking industry development during the study period is as shown in Figure 4.3.4.

Figure 4.3.4: Banking Industry Development

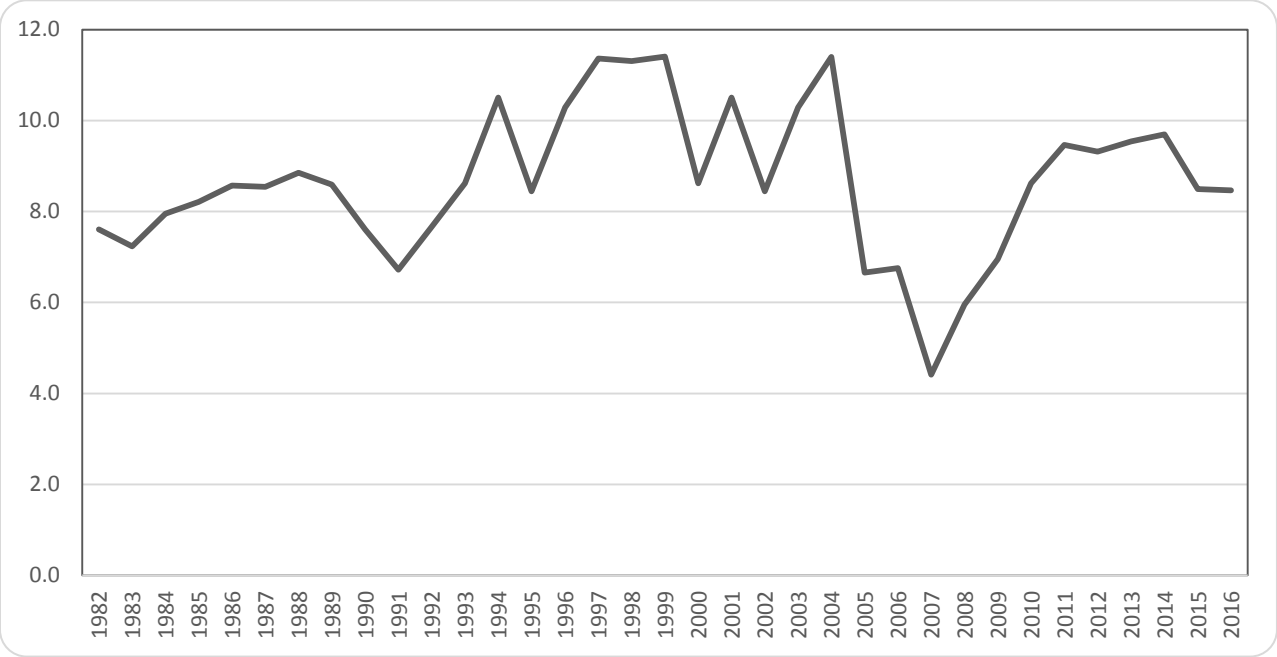
Source: Research Findings (2017)

The study found out that the banking industry development of Kenya was high in the early 1990s (1990-1998) while it slowed down from 1999 to 2016. However, during those periods, there were significant fluctuations. The highest growth rate (18.4%) in customer deposit was recorded in 1998 followed by a growth rate of 17.59% in 1996. The lowest growth rates of 2.43% and 4.13% in customer deposit were recorded in 2004 and 2003 respectively.

4.3.5 Improved Risk Management

Lastly, the study sought to establish the level of improved risk management in Kenya. Improved risk management in Kenya was measured using the annual growth rate in the uptake of insurance services in Kenya between 1982-2016. The trend of uptake of insurance services in Kenya during the study period is as shown in Figure 4.3.5.

Figure 4.3.5: Improved Risk Management



Source: Research Findings (2017)

Although there were significant variations in the uptake of insurance services in Kenya, the results above indicate increasing uptake between 1982and 2004 and then again between 2006 and 2014. The highest growth rate of 11.4% was recorded in the years 1997, 199 and 2004. The lowest (4.4%) uptake of insurance services in Kenya was recorded in 2007.

4.4 Correlation Analysis

Pearson correllation analysis was conduccted to test whether the study varriables correlated. A p-value of 0.05 or less was used as an indicator of significant correlations. The results re as shown in Table 4.4.

Table 4.4: Correlation Analysis

		Economic Growth	Exports Development	Stock Market Development	Banking Industry Development	Improved Risk Management
Economic Growth	Pearson Correlation	1				
	Sig. (2-tailed)					
Exports Development	Pearson Correlation	.139	1			
	Sig. (2-tailed)	.424				
Stock Market Development	Pearson Correlation	.681	.329	1		
	Sig. (2-tailed)	.002	.054			
Banking Industry Development	Pearson Correlation	.237	.378*	.471**	1	
	Sig. (2-tailed)	.171	.225	.104		
Improved Risk Management	Pearson Correlation	.028	.177	.104	.251	1
	Sig. (2-tailed)	.871	.309	.550	.147	
*. Correlation is significant at the 0.05 level (2-tailed).						
**. Correlation is significant at the 0.01 level (2-tailed).						

Source: Research Findings (2017).

The study out that there was a positve and statistically significant corelation (r = .681, p = .002) between economicc growth of Kenya and the stock marketdevelopment. The study also found out that all the other variables were positively but insignificantly correlated. The findings also indicate that the independent variables had no multi-collinearity and therefore they could be used independently.

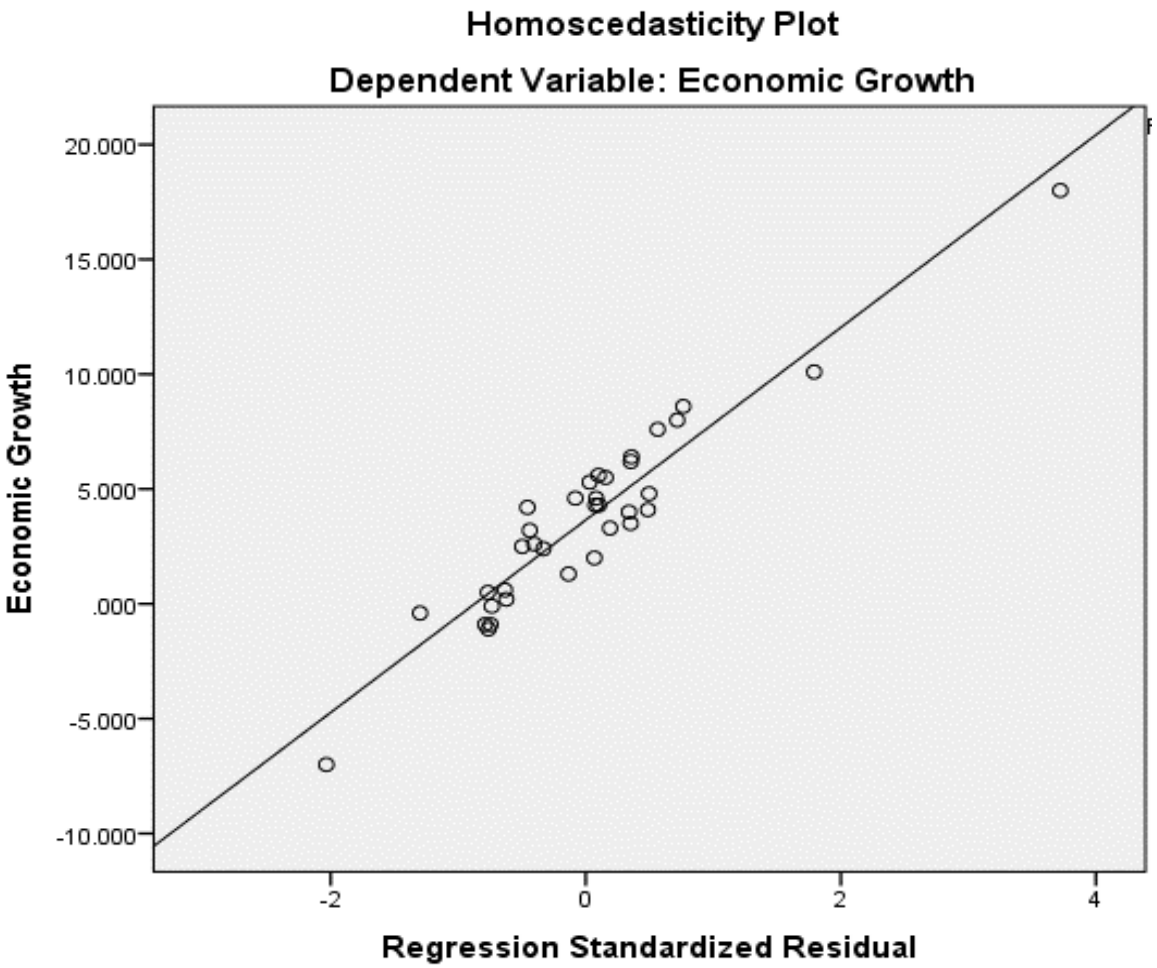
4.5 Regression Analysis

Was conducted to establish the of financial sector development on the economic growth of Kenya. Financial sector development was measured using improved risk management, exports development, stock market development and banking industry development while economic growth was measured using real GDP growth rate.

4.5.1 Homoscedasticity Test

As a requirement for regression, the investigator sort to find out whether there is a random disturbance in the relationship between the independent variables. The graph below shows exhibit of homoscedasticity.

Figure 4.5.1 Homoscedasticity plot



From the homoscedasticity plot graph above, it is evident that the error term is the same across all the independent variables (Improved Risk Management, Stock Market Development, Exports Development, and Banking Industry Development) which therefore means that our assumption is met.

4.5.2 Model Summary

Table 4.5.2: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.618[a]	.382	.299	4.192149	1.730

a.Predictors: (Constant), Improved Risk Management, Stock Market , Exports, Banking Industry Development

b.Dependent Variable: Economic Growth

Source: Research Findings (2017).

It found out that there was a strong and positive (R= 0.618) between FSD on the Growth i Kenya. The result further indicates that the value of the adjjusted R-squared was 0.299. It implies that the financial sector development (improved risk management, exports development, stock market development and banking industry development) accounts for 29.9% of the changes in the economic growth of Kenya.

This is further justified by the Durbin –Watson statistic of 1.730 which is less than 2 meaning there is positive seriall correlation between the variables.

4.5.3 Coefficients of Determination

Table 4.5.3: Coefficients of Determination

Coefficients[a]								
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Collinearity Statistics	
		B	Std. Error	Beta			Tolerance	VIF
1	(Constant)	1.795	4.628		-.388	.701		
	Exports Development	.014	.092	.030	.158	.876	.820	1.219
	Stock Market Development	.167	.064	.210	2.61	.014	.751	1.332
	Banking Industry Development	.156	.216	.150	.721	.476	.694	1.442
	Improved Risk Management	.238	.459	.093	.520	.607	.928	1.077

Source: Research Findings (2017).

At 95% confidence level, the regression coefficients indicated that FSD (exports development, stock development, banking industry development and improved risk management) has a combined effect on economic growth of Kenya as shown in table 4.5.3.

It is evident that only stock market development produced positive and statistically significant values for this study (high t-values (2.61), $p < 0.05$). Exports development, banking industry development and improved risk management produced positive but statistically insignificant values for this study as evidenced by (t= 0.014, p= 0.876) , (t= 0.156, p= 0.476) and (t= 0.238, p= 0.607) respectively.

The following regression equation was estimated:

$Y = 1.795 + 0.167X_1$

Where,

Y = Economic growth

X_1 = Stock Market Development

On the estimated regression model above, the constant = 1.795 shows that if financial sector development (exports development, stock market development, banking industry development and improved risk management) were rated zero, the economic growth of Kenya would be 1.795. A unit increase in stock market development would lead to increase in economic growth by 0.167 respectively.

4.5.4 Analysis of Variance

To verify goodness of fit of the regression model, Analysis of Variance (ANOVA) statistics was used. Results are as shown in Table 4.5.3.

Table 4.5.4 Analysis of Variance (ANOVA)

ANOVA[a]						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	86.503	4	21.626	2.855	.0407 [b]
	Residual	227.223	30	7.574		
	Total	286.727	34			
a. Dependent Variable: Economic Growth						
b. Predictors: (Constant), Improved Risk Management, Stock Market Development , Exports Development, Banking Industry Development						

Source: Research Findings (2017)

As above, the study established that the regression moddel had a significance level of 4.07% which is an indication that the model was ideal for predicting the effect of FSD on the growth of Kenya

since the value of significance (p-value) was less than 5%. This implies that the model is fit for the data.

4.6 Interpretation of the Findings

The study determine the effect of financial sector development on the economy of Kenya. The study used secondary data covering the period from 1982 and 2016 for analysis. The relationship between FSD and EG of Kenya was tested using regression analysis and analysis of variance.

The study established that there is a strong relationship between FSD and EG in Kenya. Stock market development produced positive and statistically significant values. Financial sector development (exports development, stock market development, banking industry development and improved risk management) have a positive effect on the economic growth.

CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

Chapter provides summary, discussions and conclusions to the research. The researcher further presents the limitations of the study and the recomendations for both the research and for the policy and practice.

5.2 Summary of Findings

It soght to determine the effect of financial sector development on the economic growth of Kenya. The study revealed that growth and fsd had been fluctuating during the study period (1982 - 2016). The study established that there is a strong correlation between FSD and economic growth of Kenya. This implies that financial sector development (exports development, stockmarket development, banking industry development and improved risk management) have a postive effect on the country's economic growth.

The study used Pearson product-moment correlation analysis to test whether the study variables were correlated. The study found out that all the other variables were positively but insignificantly correlated. The findings also indicate that the independent variables had no multi-collinearity and therefore they could be used independently as determinants of economic growth in Kenya.

The regression coefficients indicated that financial sector development (exports development, smd, banking industry development and improved risk management) has a combined postive effect on economic growth of Kenya. This was done at 95% degrees of confidence. It was found out that only stock market development produced positive and statistically significant values for this study. Exports development, banking industry development and improved risk management produced positive but statistically insignificant values for this study.

The findings of this study are similar to those of Bakang (2015) and Onuonga (2014). Bakang (2015) sought to determined "the effects of financial deepening/development on economic growth in the Kenyan banking sector for the period 2000 to 2013" and concluded that the banking industry in Kenya has an important role in the process of economic expansion. Onuonga (2014) sought to

assess to "the relationship between financial development and economic growth in Kenya for the period 1980–2011 and found out that financial development has positive and significant relationship on the Kenya's economic growth."

Through regression analysis, the researchers established that there was a strong relattionship (R= 0.618) between FSD and economic growth of Kenya. The result of the study also found out that financial sector development (exports development, stockmarket development, banking industry development and improved risk management) accounts for 29.9% of the total variance in economic growth. This implies that there are other key determinants of a country's economic growth other than financial sector development as proxied by exports development, stock market development, banking industry development and improved risk management.

5.3 Conclusion

The research sought to determine the effect of FSD (exports development, stockmarket development, banking industry development and improved risk management) on the economic growth of Kenya.

The study concludes that there is a strong relationship between financial sector development (exports development, stockmarket development, bank industry development and improved risk management) and economic growth of Kenya.

The study also concluded that exports development, stockmarket development, banking industry development and improved risk management individually affects economic growth positively. However, only stock market development affects economic growth in a positive and statistically significant manner. This means that an increase in either will lead to economic growth while a decrease in either will have a negtive impact on the economic growth.

It can be concluded that financial sector development has a significant postive effect on economc growth in Kenya. The results are consistent with previous research conducted by Onuonga (2014) and Bakang (2015). Onuonga (2014) sought to assess to "the relationship between financial development and economic growth in Kenya for the period 1980–2011 and he found out that financial development has positive and significant relationship on the Kenya's economic growth." Bakang (2015) concluded that the banking industry Kenya in the process of economic expansion.

This paper concludes that it is evident that FSD is important in determining the economic growth in Kenya. In conclusion it can be said that further developments in the exports, banking and stock market industry will all act as a spuur to economic growth in Kenya.

Kenya's economy will grow positively independent of the financial sector development and this therefore concludes that there are components that can drive the economy that are not captured in the model of this study and hence there would still be a positive growth in Kenya's Economic Growth even with no any development in the industries mentioned.

5.4 Policy Recommendations

The study finding unveiled a nomber of recommendations concerning the findings of the study. The following are therefore recommendations on the findings;

The study recommends that the government should put in place mechanisms and policies that enhance improvement of exports industry, stock market industry, banking industry and increased uptake of insurance services which in turns promotes economic growth.

Kenya's economic growth will grow positively independent of the financial sector development and this therefore means that there are other factors that drive the economic growth which are not captured in this model. These components need to be identified, their relationship with the economic growth established and their management plans put into place for the enhancement of the Economic growth.

Exports have a positivve impact on the Economic rate hence trade relationships and international relations should be; established, enhanced, strengthened and protected as this will grow and open up Kenya's export market and its trading partners.

To improve on the insurance services uptakes, all insurance stakeholders should conduct an intensive awareness campaign by use of media, testimonials, flyers, magazines, newsletters among others. Also, affordable products can be introduced to reach out to the low-income earners hence increase the number of Kenyans taking up insurance services. The Government can also come up with more tax incentives to motivate more citizens to embrace insurance. The insurance industry should employ more intermediaries to increase accessibility of the insurance services.

5.5 Limitations of the Study

It mainly depended on the data extracted from the database of KNBS and World Bank. Therefore, the researcher had no direct control of the data accuracy. The data was however counterchecked against the two sources to ensure reliability.

Market capitalization varies on daily, if not hourly basis. The data used to capture capitalization is the historical data as it was on the day when the listed firms were presenting their financial reports to the Nairobi Securities Exchange as required by law. The study does not answer the question of what would be the findings if a more frequent data capture was used to capture the market capitalization.

The paper failed to put into considerations other components that may have and may have influenced the real economic rate growth such as inflation and interest rates and terms of trade (proxy for external shocks to the economy).

Time was a limiting factor considering that the researcher was in a full-time employment.

5.6 Suggestions for Future Studies

In future, other determinants of economic growth should be investigated as financial sector development (exports development, stock market development, banking industry development and improved risk management) could only account for 29.9% of the economic growth as the other 71.1% are possibly explained by other factors not considered in this study.

The study suggests that further research be conducted on the relationship between economic growthh and financial deepening of other financial service sectors for examples cooperative societies to assess the relationship and compare it with the findings in the insurance industry. This is because the Savings and Credit Cooperative Societies (SACCOs) have experienced enormous growth and they are accessed by a big segment of the population.

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APPENDIX I: DATA COLLECTION FORM

	Real GDP	Annual Growth Rate of Exports	Annual Market Capitalization	Annual Growth Rate of Customer Deposits	Annual Growth Rate in the Uptake of Insurance Services
1982					
1983					
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