

**THE RELATIONSHIP BETWEEN FINANCIAL DEVELOPMENT AND
ECONOMIC GROWTH IN KENYA**

BY

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DECLARATION

I hereby declare that this research project is my original work and has not been presented to any other institution of higher learning for academic purposes.

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This project has been submitted for examination with my approval as the University supervisor.

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DEDICATION

This project is dedicated to my wife Liberata, our daughter Tez, my parents and all my siblings for their support, sacrifices, patience and encouragements throughout my academic endeavours.

ABSTRACT

Economic growth of a country is determined by its prosperity and other sectors such as agriculture, education, financing, infrastructure and standards of living. In this regard, the researcher established need to educate and create awareness of existence of a relationship between the components of economic growth in a developing economy.

This project therefore, examines the causal relationship between financial development and economic growth in Kenya. The data of the project was collected from published secondary sources from KNBS, CMA, CBK and NSE. The data was analysed using SPSS version 17. The empirical results shown that the direction of causality between financial development and economic growth in Kenya is sensitive to the choice of proxy used for financial development. For example, when financial development is measured by the money to income ratio the direction of causality runs from financial development to economic growth, but when the bank deposits rates, lending rates are alternatively used to proxy financial development, growth is found to lead financial development. On balance, however, for Kenya, the economic growth seems to lead financial development.

In order to stimulate economic growth in Kenya, the Government could take several moves especially in bank supervision, monitor lending and borrowing rates and regularly review the inflation rate to promote development of financial institutions. The strengthening of above elements can boost financial development and accelerate economic growth. For instance, transparent rules and encouragement should be given.

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CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

Long-term sustainable economic growth depends on the ability to raise the rates of accumulation of physical and human capital, to use the resulting productive assets more efficiently, and to ensure the access of the whole population to these assets. Financial intermediation supports this investment process by mobilizing household and foreign savings for investment by firms; ensuring that these funds are allocated to the most productive use; and spreading risk and providing liquidity so that firms can operate the new capacity efficiently (Mishkin et al, 2000).

Financial development thus involves the establishment and expansion of institutions, instruments and markets that support this investment and growth process. Historically the role of banks and non-bank financial intermediaries ranging from pension funds to stock markets, has been to translate household savings into enterprise investment, monitor investments and allocate funds, and to price and spread risk. Yet financial intermediation has strong externalities in this context, which are generally positive (such as information and liquidity provision) but can also be negative in the systemic financial crises which are endemic to market systems (McKinnon, 1973).

Financial development and economic growth are thus clearly related, and this relationship has occupied the minds of economists from Smith to Schumpeter; although the channels and even the direction of causality have remained unresolved in both theory and empirics. Moreover, the wide range of organisational forms involved

precluded any clear conclusion as to what kind of financial institutions might maximize economic growth. None the less, strong causality from particular forms of organisation of financial institutions towards rapid economic growth has recently become a central axiom of economic theory, strengthened by apparent support from empirical cross-country studies of the relationship between indicators of financial development and observed rates of growth (Levy, 2005).

The relationship between financial development and economic growth has not been examined extensively in Kenya. In fact, the majority of the previous studies on this subject have concentrated mainly on Asia and Latin America, leaving the Eastern Africa countries either very little coverage or none at all (Odhiambo, 2009). Even where such studies have been undertaken, the empirical findings on the relationship between financial development and economic growth, and the mechanisms through which financial development impacts on the economic growth, have been largely inconclusive. Indeed, it is still unclear from the empirical front whether financial development, which results from financial sector reforms, really trickles down to the poor in terms of economic growth in developing countries (Odhiambo, 2009). While some previous studies argue in favour of a trickle-down effect between financial development and economic growth through a growth-enhancing effect, a number of recent studies maintain that financial sector development can only contribute to economic growth up to a certain threshold level of economic development (Jeannerney and Kpodar, 2005).

In fact some development economists believe that economic progress that results from increased economic growth does not improve the lives of the poor but typically trickles up to the middle-class and the very rich. Cross-country differences in growth have been the central issue of the development economists over the past few decades.

The large literature has come up with few explanations in characterizing the cross-country differences in growth, which can be categorized into two aspects, namely internal and external factors. Internal factors refer to the degree of macroeconomic stability, factor endowment of a country, educational attainment, institutional development, legal system effectiveness and factor accumulation while external factors relates to the international trade (exports and imports), exchange rate fluctuations and international capital mobility (Todaro, 1997).

The literature, nevertheless, has neglected the role of financial development in stimulating the growth rate of economic. In their essays collection, “the pioneers of development economics” who included three Nobel laureates have totally excluded the discussion of financial development in growth process (Meier and Seers, 1984). Moreover, Stern (1989) had not discussed the contribution of financial development on growth in his review. The significant role of financial development, however, has begun to receive considerable attention in the growth process. In his work, Schumpeter (1911) contends that the well-functioning financial system will spur technological innovations through the efficiency of resource allocation from unproductive sector to productive sector. This idea was viewed as the first framework in analyzing the finance-led growth hypothesis.

In contrast, Robison (1952) argues that the relationship should be started from growth to finance. According to this thought, a high rate of economic growth leads to a high demand for particular financial agreement or arrangement, and the well developed financial sector will automatically respond to these types of demand. This view was defined recently as growth led finance hypothesis. Goldsmith (1969), McKinnon (1973) and Shaw (1973) have significantly contributed to the literature of financial development and economic growth relationship in more formalized framework.

Although the original contribution to this literature have different channels of transmission in explaining the link between financial development and growth, the studies all coincide in suggesting that there is a significant and positive relationship between these two variables. Goldsmith (1969), for example, focuses on the relationship between financial development and the efficiency of investment. On the other hand, McKinnon (1973) and Shaw (1973) demonstrate the importance of financial liberalization in promoting domestic savings and hence investment.

According to the Goldsmith's (1969) framework, the evolution of domestic financial markets may enhance and lead to a high level of capital accumulation efficiency. In other words, he argues that the positive correlation between financial development and growth (the level of real per capital GDP) is mainly due to the efficient use of the capital stock. As an extension from earlier studies, McKinnon (1973) and Shaw (1973) admit the significance of financial development in promoting economic growth through high capital productivity. They, nonetheless, enrich the channel by incorporating the role of savings, which will further lead to a high level of investment. According to their model, the finance-growth link through saving and investment is significantly influenced by the public policy, which regarding to the evolution of the domestic financial systems. The public policies that lead to a financial depression (such as credit rationing, high reserve requirement and interest rate ceiling) will reduce the incentives to save Goldsmith's (1969).

The effect will result in the shortage of investment funds and thereby incur lower rate of economic growth. Therefore, they conclude that financial liberalization is crucial in fostering the growth process as the high rate of interest rate (especially saving or deposit rate) resulting from the liberalized policy encourages households to increase their incentives to save more. This view is different from Goldsmith (1969)'s model,

which assumes that both financial intermediation and growth are endogenous variables. Since the introduction of both finance-led growth and growth-led finance hypotheses, the relationship between financial development and economic growth has been subject to the considerable debate in the literature of development and growth Goldsmith's (1969).

The financial assets refer to the claims on real assets (Bondie et al, 2009). Financial assets therefore promote the development of the economy directly and indirectly by facilitating access to the pool of funds for financing company investments. The finance and the investment manager of companies therefore use the financial assets by evaluating the usefulness of each investment option available.

Investors are willing and able to invest in financial assets as a result of their personal judgment, risks evaluation and the efficiency of the market. In finance, efficient market refers to security prices reflecting all available information, in the strong hypothesis. According to Reilly (2007) an efficient capital market is one in which security prices adjust rapidly to the arrival of new information and, therefore the current prices of securities reflect all information about the security. He termed this as an informationally efficient market.

Reilly (2007) argues that for a capital market to be termed as efficient several assumptions are made. An initial and important promise of an efficient market requires that a large number of profit maximization participants analyze and value securities, each independently of the other. A second assumption is that new information regarding securities comes to the market in a random fashion, and the timing of one announcement is generally independent of others. The third assumption is profit maximizing investors adjust security prices rapidly to reflect the effect of new information. Although the price adjustments may be imperfect, it is unbiased.

Meaning that sometimes the market will over-adjust and other times it will under-adjust, but it cannot be predicted which one will occur at any given time. The combined effect of: Information coming in a random, independent, unpredictable fashion, numerous competing investors adjusting stock prices rapidly to reflect this new information means that one would expect price changes to be independent and random.

Most of the early work related to efficient capital markets was based on the random walk hypothesis, which contended that changes in stock prices occurred randomly (Levy, 2005). Fama (1970) presented the efficient market theory in terms of a fair game model, contending that investors can be confident that a current market price fully reflects all available information about a security and the reflected return based upon this price is consistent with risk. The primary hypothesis for EMH is that stock prices accurately and quickly reflect all available information in such a way that no one can earn abnormal return. The time for the adjustment for any new information is considered a critical factor; if the market adjusts more rapidly and accurately, it is considered more efficient (Olsen 1998).

While empirical studies often provide a direct relationship between financial development proxies and growth, much controversy remains about how these results should be interpreted. There are, at least, four main sources of controversy. First, the selection and measurement of financial development indicators remains as controversial issues among researchers. In general, the indicator has been measured largely by different type of monetary aggregates, which all of these measures have serious problem in interpretation (Gregorio and Guidotti, 1995). Second aspect of

controversy involves the causality direction of the financial development and economic growth. While some empirical works find supporting results for finance-led growth and/or growth-led finance, some provide additional evidence for the feedback causality relationship and even others conclude that there is no obvious relationship between financial development indicator and growth. Third controversy is resulting from the use of empirical approaches to the finance-growth hypothesis. The approaches used can be categorized into two groups. The first group focuses on the cross-country studies to test the relationship, while the second group emphasizes the use of regression application that was usually time series predicated. The second group of studies applies various time series techniques such as unit root tests, co-integration procedure, Granger causality test as well as pooled regression and panel data analysis. Finally, the debate concerning the channels by which financial development promotes economic growth is far to be settled (Gregorio and Guidotti, 1995).

1.2 Statement of the problem

The Long-term sustainability of economic growth of a country depends on the ability to raise the rates of accumulation of physical and human capital, to use the resulting productive assets more efficiently, and to ensure the access of the whole population to financial assets. Accordingly, Halkos et al. (2010) found that financial intermediation supports the investment process by mobilising domestic and foreign savings for investment by banks and other firms in ensuring that funds are allocated to the most productive use. Bose (2005) found out that financial development involves the establishment and expansion of institutions, instruments and markets that supports investment and growth process. This was echoed by Odhiambo (2009) who in his research for the relationship between finance and economic growth in South Africa

found out that financial intermediation has strong externalities which are generally positive but can also be negative to market systems. These views were different from Goldsmith (1969)'s model, which assumes that both financial intermediation and growth are endogenous variables. Financial development and economic growth are thus clearly related, and this relationship has occupied the minds of economists (Reilly et al, 2007).

In Kenya, several studies have been done in regard to financial development and economic growth. According to Omoke (2010), there is positive correlation between the capital market development and economic growth however his research was only for a period of five years between 2004 and 2009. Ndegwa (2008) in his research of the integration of Capital market in East Africa found out that the financial development in the region contributed positively to the economic growth of the eastern communities. The essence of financial development was further echoed in Kenya by Dinga (2009) in his research about the impact foreign investment on economic growth and found out that there existed a positive correlation.

According to the above international and local studies, a high rate of economic growth leads to a high demand for particular financial agreement or arrangement, and the well-developed financial sector will automatically respond to these types of demand. Since the introduction of both finance-led growth and growth-led finance hypothesis, the relationship between financial development and economic growth has been subject to the considerable debate in the literature of development and growth. Therefore, there exists a gap which this research study will address especially on how financial development impacts/relates on economic growth in Kenya.

1.3 Objective of the study

The objective of the study is to establish the impact of financial development to economic growth in Kenya.

1.4 Importance of the study

The study is important to the following stakeholders

To the Financial Analyst, the research will help enrich their collection of knowledge and hence they can be able to positively give advice to their clients with more confidence.

To the Academician the study helps to continue the study in relation to new and challenging environment. For example developing countries like Kenya. This will increase the body of knowledge in Finance and create an opportunity for further research on the interrelationship between the financial development and economic growth of a country.

To the Investor, the study will help an investor understanding the role they play in the improvement of economic growth in Kenya. And the chances of the investors being misinformed will be reduced by critically analyzing the research. The research will increase the current and potential investors' confidence in companies under the umbrella of CMA by highlighting their contribution to economic growth Kenya.

To financial institutions, the research will sensitive other financial managers and strategist on the modalities of handling the relationships in financial development, financial management and economic growth.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter examines empirical studies that have been done in the area of financial development especially Capital Markets players.

2.2 Financial development and economic growth

According to Mishkin et al (2000) financial development is usually defined as a process that marks improvement in quantity, quality, and efficiency of financial intermediary services. This process involves the interaction of many activities and institutions and possibly is associated with economic growth. The economic growth as defined Mishkin et al (2000) refers to the process by which a nation's wealth increases over time. The most widely used measure of economic growth is the real rate of growth in a country's total output of goods and services (gauged by the gross domestic product adjusted for inflation, or "real GDP").

2.2.1 The impact of financial development on economic growth

According to McKinnon (1973) liberalisation of financial markets allows financial deepening which reflects an increasing use of financial intermediation by savers and investors and the monetisation of the economy, and allows efficient flow of resources among people and institutions over time. This encourages savings and reduces constraint on capital accumulation and improves allocative efficiency of investment by transferring capital from less productive to more productive sectors.

The efficiency as well as the level of investment is thus expected to rise with the financial development that liberalisation promotes. These benefits include a decrease in firms' in self-investment at low and even negative rates of return, allocation of credit by capital markets rather than by public authorities and commercial banks, a shift away from capital-intensive investments due to the higher cost of capital reflecting its scarcity, the lengthening of financial maturities, and the elimination of fragmented and inefficient curb markets (Balassa, 1993). Development of the financial system facilitates portfolio diversification for savers reducing risk, and offers more choices to investors increasing returns. Another important function of financial system is to collect and process information on (productivity-enhancing) investment projects in a cost effective manner, which reduces cost of investment for individual investors (King & Levine, 1993). The productive capacity of the economy is determined by the quality as well as by the quantity of investment and capacity utilisation is as important as the installed capacity. Easing credit constraint, particularly working capital, is expected to improve the efficiency of resource allocation and thereby reduce the gap between actual and potential output.

This new model is not clear about what institutional forms should in fact replace the previous system, which was clearly inefficient but did directly support strategic investment and growth objectives. In fact, financial systems serve five broad functions. First, they produce information ex ante about possible investments. Second, they mobilize and pool savings and allocate capital. Third, they monitor investments and exert corporate governance after providing finance. Fourth, they facilitate the trading, diversification and management of risk. Fifth, they ease the exchange of goods and services. While all financial systems provide these financial functions, and each of these functions can be expected to have an impact on economic growth, there

are large differences in how well they are provided. There are three basic characteristics of financial systems that are now regarded as capturing the impact of these five functions on economic growth: (i) the level of financial intermediation; (ii) the efficiency of financial intermediation; and (iii) the composition of financial intermediation.

First, the level of financial intermediation: the size of financial systems relative to an economy is important for each of the functions listed above. A larger financial system allows the exploitation of economies of scale, as there are significant fixed costs in the operation of financial intermediaries. As more individuals join financial intermediaries, the latter can produce better information with positive implications (an externalities) for growth, a channel emphasized in some of the earlier theoretical models of the finance growth literature (e.g. Greenwood & Jovanovic, 1990; Bencivenga & Smith (1991). A larger financial system can also ease credit constraints: the greater the ability of firms to borrow, the more likely that profitable investment opportunities will not be by-passed because of credit rationing. A large financial system should also be more effective at allocating capital and monitoring the use of funds as there are significant economies of scale in this function. Greater availability of financing can also increase the resilience of the economy to external shocks, helping to smooth consumption and investment patterns. More generally, a financial system plays an important function in transforming and reallocating risk in an economy. Besides cross-sectional risk diversification, a larger financial system may improve intertemporal risk sharing (Allen & Gale, 1997). By expanding a financial system to more individuals there will be a better allocation of risks, which can in turn boost investment activity in both physical and human capital, leading to higher growth rates.

Second, the efficiency of financial intermediation: the channels linking the size of the financial system and growth effectively assume a high quality of financial intermediation. The efficiency of financial systems, however, cannot be taken for granted, especially as information gathering is one of their key functions. Asymmetric information, externalities in financial markets (Stiglitz & Weiss, 1992) and imperfect competition (for example, as a result of fixed costs) can lead to sub-optimal levels of financing and investment, an inefficient allocation of capital, or have other undesirable consequences such as bank runs, fraud or illiquidity which are detrimental for economic growth. Some of these market imperfections may be best addressed through appropriate oversight by a public body but the legal and institutional background (including competition policy) may also foster the efficiency of financial markets and hence contribute to economic growth.

Third, the composition of financial intermediation: two important shifts in the composition of financial intermediation relate to the maturity of financing available and the growth of capital markets and institutional investors such as pension funds and insurance companies. The maturity of loans and bonds may affect the extent to which certain investments may be profitably exploited. On the other hand, the replacement of banks by markets appears to be a result of changes in the cost of intermediation. As noted by Jacklin (1987), there is no specific advantage to banks. If liquid equity markets exist, all agents will save through equities as they offer higher long-term returns. Indeed, the earliest corporate finance models even suggested the irrelevance of the choice of financing for company's investment decisions (Modigliani and Miller, 1958).

One potential channel for the composition of financial intermediation to affect the efficiency with which firms allocate resources is through its impact on corporate

governance. There is however no theoretical models that assess the role of markets as opposed to banks in boosting steady-state growth through their impact on corporate governance. Indeed, starting with Berle & Means in 1932 many researchers have observed the limited corporate governance capability afforded by markets, either because of diffused shareholdings - which leads to managerial discretion - or because of the excessive power often exerted by controlling owners - which can distort corporate decisions (Shleifer & Vishny, 1997).

2.2.2 Theory of capital and investment

Irving Fisher's theory of capital and investment was introduced in his *Nature of Capital and income* (1906) and *rate of investment* (1907), although it has its clearest and the most famous exposition in his *theory of interest* (1930). Of concern is what is called his "second approximation to the theory of interest" (Fisher, 1930: Chs. 6-8), which sets investment decision of the firm as an inter-temporal problem.

In his theory, Fisher assumed (note carefully) that all capital was circulating capital. In other words, all capital is used up in the production process, thus a "stock" of capital did not take him to task on this assumption in particular, questioning how Fisher could reconcile his theory of investment with Clarkian theory of production which underlies the factor market equilibrium. The second part of the separation theorem effectively claims that the firm's financing needs are independent of the production decision. To see why more clearly, we can restate this in terms of the Neoclassical theory of "real" loanable funds set out by Fisher (1930). The demand for "loanable funds" equals desired savings minus desired investment of savers.

Note the condition that total investment to be equal to total savings, then the demand for loanable funds must equal the supply for loanable funds and this is only possible if the rate of interest is appropriately defined. Is the interest rate was such that the

demand for loanable funds was not equal to the supply of it, then we would also not have investment equals savings. Thus, Fisher's "real" theory of loanable funds, the rate of interest that equilibrates supply and demand for loanable funds will also equilibrate investment and savings.

2.2.3 Market Microstructure and economic growth

Market microstructure is a branch of finance concerned with details of how exchange occurs in market. While the theory of market microstructure applies to the exchange of real or financial assets, more evidence is available on the microstructure of financial market due to the availability of transactions data from them. The major thrust of market microstructure research examines the ways in which the working processes of a market affects determinants of transaction cost, prices, quotes, volume, and trading behavior. O'Hara (1995) defines market microstructure as a study of the process and outcome of exchanging assets under a specific set of rules. While much of economics abstracts from the mechanisms affect the price formation process. Microstructure deals with issues of market structure and design, price formation process and price discovery, transaction and timing cost, information and disclosure, and market and investor behavior.

Market structure and design focuses on the relationship between price determination and trading rules. In some markets, for instance, assets are traded through dealers who keep an inventory (e.g. new cars), while other markets are dominated by brokers who act as intermediaries (e.g. housing). One of the important questions in microstructure research is how market structure affects trading cost and whether one structure is more efficient than another. Price formation and discovery focuses on the process by which the price for an asset is determined. For example, in some market prices are

formed through an auction process, in other market prices are negotiated (e.g. new cars) or simply posted (e.g. local supermarket) and buyers can choose to buy or not.

Transaction cost and timing cost is a factor that focuses on transaction cost and timing cost and the impact of transaction cost on investment returns and execution methods.

Transaction cost include order processing costs, adverse selection costs, inventory holding costs, and monopoly power. Information and disclosure focuses on the market information and transparency and the impact of the information on the behavior of the market participants (O'Hara, 1995)

2.2.4 Perspective Capital Markets and Growth of an economy

Capital markets can be seen from several perspectives; vast amount of capital available for investment, the instruments used to raise capital, the issuers of these securities, the financial intermediaries that facilitate the trading and transfer of securities from buyers to the sellers, and the stock exchange 'the market where these securities are traded'. To complete the equation, capital markets generally need regulators, whose principal role is to protect investors, ensure fair, efficient and transparent market operations. Regulators also protect the market from systematic risks or failure that may have serious consequences on the economy (Osei, 1998).

Countries in the early stages of economic development tend to have less organized and structured capital market activity. The economies of these countries are mostly dominated by subsistence agriculture or primary production. Industrial and service sectors are fairly rudimentary, with low levels of technology. These countries are also characterized by low levels of savings and investments, and underdeveloped financial systems (Enberg, 1975).

Capital market is therefore a market for long-term loans and equity capital. Companies and the government can raise funds for long-term investments via the

capital market. The capital market includes the stock market, the bond market, and the primary market (En berg, 1975). A well organized capital market is crucial for mobilizing both domestic and international capital. In most developing countries, however, capital has been a major constraint in economic development (Osei, 1998) Dailami and Atkin (1990) describe the provision of funds to finance domestic capital formation as a key factor in the prospects for long term economic growth in developing nations. The authors observe that the reality of a much reduced supply of foreign funds from previous sources, such as commercial banks, compels the government in many developing countries to pay increased attention on the importance of equity rather than debt, particularly in the financing of risky projects with long-term gestation periods.

Pardy (1992) observes, securities market have an important role to play in financial sector development and liberalization. The author argues that apart from providing a means of diversifying risk for both capital raisers and investors, securities markets could play other roles. For example, they are a mechanism for capital allocation and corporate monitoring, and a means for government to exercise market-based rather than direct fiscal and monetary policies for control.

Demirguc-Kunt (1992) observes that in the poorest developing countries, firms rely mostly on internal resources and informal credit markets for financing. Commercial bank is the main financial institutions. The author argues that the loan contracts of these commercial banks are generally short term, and formal direct credit market for long-term debt or equity do not exist, thereby constraining both corporate and economic growth.

Enberg (1975) recognizes the need for capital markets even for less developed economies. He argues that capital markets can significantly raise the level of domestic

savings and contribute to a more efficient allocation of such savings among competing uses. The author emphasizes that through the capital market, a variety of financial assets carry different risks, yield and liquidity, is added to the traditional type of financial assets such as demand and savings deposits. He further observes that the availability of this wider range of assets will induce people to increase the rate of current savings. The reason is that the capital markets enables savers to achieve a better wealth composition and also permits adjustments to be made in the wealth composition with speed and at a low cost whenever the circumstances change. Moreover, competition among users of capital market funds, including, government and individuals, will tend to increase the efficiency with which capital is used, with direct effect on growth rate of the economy.

2.2.5 Finance led growth, growth led finance or feedback causality

Ever since Schumpeter (1911), Robison (1952), McKinnon (1973) and Shaw (1973), the relationship between financial development and growth has been extensively investigated. A fundamental question asked in the earlier empirical studies, nonetheless, is whether there appears crucial causality running from financial development to economic growth? It is now generally admitted that the evolution of domestic financial sector is significant in affecting the pattern of economic growth (Levine, 1997). According to Wachtel (2001), moreover, there are at least four channels in which financial intermediaries promote economic growth through efficient allocation of resources. First, the financial intermediaries act as fund-transferring mechanisms to channel the excess fund from surplus units to deficit units (productive sectors). Second, financial intermediaries will offer more attractive and innovative instruments and incentives to encourage the mobilization of savings, which

in turn may promote higher saving rates. Third, financial institutions lower their costs of project evaluation and origination through economies of scale, and facilitate the monitoring of projects via corporate governance. Finally, as institutions which operating at economies of scale and obtain symmetry information, financial intermediaries provide opportunities to reduce risk management and promote liquidity level by promoting the development of markets and instruments with attractive characteristics that enable risk-sharing.

2.2.6 Determinants of development of capital markets of developing countries

Many factors affect the developments of the capital markets of developing countries. Demirgüç-Kunt and Levine (1995) points out the characteristics of stock market development as; traditional characteristics, which include market capitalization, the amount of new capital raised through stock offerings, the number of listed companies and turnover; institutional characteristics, which include regulations of the capital markets, information disclosure requirement, transparency rules and trading costs; and asset pricing characteristics, which is the efficiency with which the market prices risk and the degree of integration into world stock markets.

Pardy (1992) argues that there are two basic building blocks necessary for thriving securities market; first, a macroeconomic and fiscal environment conducive to the supply of good quality securities and sufficient demand for them; and secondly, a market infrastructure capable of supporting efficient operation of securities market. Under the first building block, the author indicates that the demand for and supply of securities is crucially linked to the state of the macro-economy. If macro-economy is conducive to profitable business operation, a sufficient number of sound businesses can develop to a stage where access to securities market is useful for their continued

growth. This means that if there is no sufficient profitable business with good prospects for the future, there is little reason to have securities market.

The market infrastructure that will make the securities market operate in an efficient, fair and stable manner is broken into three; first the institutional infrastructure, which provides the operational basis for the market, relates to intermediaries that provide trading, investment management and financial advisory services; market, market information services, transaction clearance and settlement systems, and securities transfer, registration and custody; and providers of ancillary services such as accounting and auditing; legal advice, and financial valuation and debt rating services; secondly, the regulatory infrastructure relates to not only to the government body that has power and the responsibility to supervise the market, but also includes their rules or accounting and auditing standards, plus the monitoring and enforcement of these rules; thirdly, the legal infrastructure provides the basic for the operational and regulatory framework. It provides for property rights, contractual relationships, form of incorporation, and rights and responsibilities of the participants in the market. It also specifies the powers and the responsibilities of the government supervisory authority and self-regulatory organizations (Pardy, 1992).

The first building block for sound securities market development put forward by Pardy (1992) recognizes the importance of fiscal policy (taxation). The author finds that differential effective tax rates on either income or capital gains from different financial instruments will distort capital raising and investment decisions. Pardy supports this conclusion by observing that quite a number of developing countries with state ownership of commercial banks have tax rates that discriminates in favor of savings and demand deposits as opposed to securities investment, and in favor of

borrowing from banks as opposed to raising capital from the public. For capital market development, these taxation differentials must be removed.

2.3 Empirical reviews

In the financial literature on endogenous growth, the relationship between capital markets development and economic growth has received much attention (King and Levine, 1993; Levine, 1997; Rajan and Zingales, 1998; Filer, Hanousek, and Campos, 2007; Calderon and Liu, 2002, Carlin and Mayer, 2003), in this context, King and Levine (1993) state that the level of financial intermediation is a good predictor for economic growth rate, capital accumulation and productivity. In the same context, Carlin and Mayer (2003) concluded that is a strong relationship between the structure of countries' financial system and economic growth.

Garretsen, Lensink and Sterken (2004) found out a causal relationship between economic growth and financial market development; a 1% improvement of economic growth determines a 0.4% rise of market capitalization/GDP ratio. Yet, according to their results, market capitalization/GDP ratio does not represent a significant determinant of economic growth. Beck, Lundberg and Majnoni (2006), also found a positive correlation between capital market development (Measured by a dummy variable computed to reflect if the market capitalization exceed 13.5% of GDP) and economic growth. Bose (2005) offers a theoretical financial model that explains the positive correlation between stock market development and economic growth; the model is based on the hypothesis that for levels of GDP per capita higher than a certain threshold the information costs become lower than bankruptcy costs, determining the development of capital markets. Hence, it is explained why stock markets appeared late after banks.

Beckaert Harvey Lundblad (2005) analyzed financial liberalization as a special; case of capital market development and determined that equity markets liberalizations on average led to a 1% increase in annual real economic growth. Studying the link between domestic stock market development and internalization, Claessens, Klingebiel and Schuler (2006) using a panel data technique concluded that domestic stock market development as well as stock market internalization are positively influenced by the log of GDP per capital, the stock market liberalization, the capital account liberalization and the country growth opportunities and negatively influenced by the government deficit /GDP ratio.

Minier (2003) analyzed the influence of the stock market dimension on economic development by regression tree techniques: he found that the positive influence of stock market development on economic growth held only for developed stock markets in terms of turnover, in the case of the underdeveloped stock markets the influence is in terms of turnover, in the case of underdeveloped stock markets the influence is negative. Ergungor (2006) analyzed the impact of financial structure on the economic growth on the period 1980- 1995; he concluded that in countries with inflexible judicial systems the impact on economic growth is generated by the development of the bank system, whereas in countries with flexibility of judicial systems the development of the capital market had a stronger influence.

Studies on the relationship between capital market development and economic growth in different countries were performed. Nieuwerburgh, Buelens and Cuyvers (2006) analysed the long run relationship between stock market developments (measured as a logarithmic difference of GDP capital) in Belgium. They performed Granger causality tests and emphasized the stock market Development determined economic growth in Belgium especially in the period 1873- 1935 ,but also on the entire analyzed period

(1800-2000) with variation in times due to institutional changes affecting the stock market.

Hondroyannis, Lolos and Papapetrou (2005) studied the case of Greece (1986 -1999) they found out that the relationship between economic growth and capital market development is bi- directional. Studying the effect of different components of financial systems on economic growth in Taiwan, Korea and Japan, Liu and Hsu (2006) emphasized the positive effects of stock market development (measured by market capitalization as percentage of GDP, turnover as percentage in GDP and stock return) on economic growth. Bolbol, Fatheldin and Omran (2005) analyzed the effect of financial markets (measures by the ratio of market capitalization on GDP and turnover ratio) on total factor productivity and growth (the per capital GDP growth rate) in Egypt (1974-2002): they demonstrated that financial development had apposite influence on factor productivity and growth.

Levine et al (2005) studying the influence of stock markets and bank system development on economic growth on a sample of 11 Arab countries ,concluded that financial development could negatively influence the economic growth in countries with undeveloped financial systems ;they stressed the role of building a sound financial system. In the context of European Union enlargement ,an analysis of the relationship between capital markets development and economic growth rates and could explain why different countries reach different economic growth rates and could find solutions in order to stimulate the process of economic growth through capital market using public policy instruments . Related to this issue, even there are many studies regarding developed countries, approaches on East –European ex-communist countries economies are very few relatively to developed countries cases.

Romanian capital market had developed slowly starting from 1995. However, several years after 1989 Romania had negative economic growth rates (the real rate of GDP growth). Only since 2000 Romania had positive economic growth rates accompanied by the development of the financial system: these particular aspects could alter the relationship between economic growth and capital market development and more specifically the conclusion on whether capital market development is a good predictor for economic growth rate.

Kogi (2003) did a study on the future of collective investment schemes in the Kenyan capital market. He found that the Kenyan capital markets will continue to offer an array of investment products in the form of shares, bonds and unit trusts. The type of products chosen by the collective investment schemes to commit their capital will largely depend on their financial goals time frame and amount of capital available.

Otieno (2003) did a study on the contribution of the capital market development: The case of companies privatized at the NSE. Otieno found out that privatization broadens and deepens the capital market resulting from increased listings and market size, improved liquidity and regulatory infrastructure, improved awareness and enlarged investor base. Privatization has also provided opportunity for risk diversification, enhanced professionalism and increased Government attention.

Ndegwa (2008) studied the factors limiting the integration of the capital markets in East African Countries. He found that high interest rates on bank deposits associated with weaknesses in banking systems have contributed to unsustainable capital inflows. A key challenge for policy makers in the regional market countries was found to be reducing their vulnerability to volatile capital flows and to ensure that weaknesses in the financial sector do not limit the ability of authorities to pursue macroeconomic policies needed to safeguard monetary stability.

In his work, Schumpeter (1911) contends that the well-functioning financial system will spur technological innovations through the efficiency of resource allocation from unproductive sector to productive sector. In contrast, Robison (1952) argues that the relationship should be started from growth to finance. According to this thought, a high rate of economic growth leads to a high demand for particular financial agreement or arrangement, and the well-developed financial sector will automatically respond to these types of demand. This view was defined recently as growth-led finance hypothesis. Goldsmith (1969), McKinnon (1973) and Shaw (1973) have significantly contributed to the literature of financial development and economic growth relationship in more formalized framework. Although the original contribution to this literature have different channels of transmission in explaining the link between financial development and growth, the studies all coincide in suggesting that there is a significant and positive relationship between these two variables. Goldsmith (1969), for example, focuses on the relationship between financial development and the efficiency of investment. On the other hand, McKinnon (1973) and Shaw (1973) demonstrate the importance of financial liberalization in promoting domestic savings and hence investment. According to the Goldsmith's (1969) framework, the evolution of domestic financial markets may enhance and lead to a high level of capital accumulation efficiency. In other words, he argues that the positive correlation between financial development and growth is mainly due to the efficient use of the capital stock.

2.4 Conclusion

Study of finance-growth relationship is important to all countries because the development of domestic financial sector is significant in affecting the pattern of

economic growth by promoting economic growth through efficient allocation of resources. Further, financial intermediaries offer more attractive and innovative instruments and incentives to encourage the mobilization of savings, lower the costs of project evaluation and origination through economies of scale obtain symmetry information, as well as provide opportunities to reduce risk management and promote liquidity level. Therefore, it is of interest to all countries to gain insight into the finance-growth relationship. This review of the literature on the finance-growth relationship addressed the controversial issues of the theoretical and empirical literature over the past few decades and leads to the following conclusions.

Recent studies paid increasing attention to most of methodological difficulties, and the result is more thorough specification and other tests, more attention to similar and heterogeneity issues, and more guarded and less cavalier policy conclusions. Admittedly, the finance-growth models are highly stylized, but this frontier research area may well yield stronger conclusions in the future. Fourth, channels such as efficiency of investment, financial liberalization, capital accumulation, productivity growth and technical change have been widely studied in determining the finance-growth relationship.

In other word, the lively statistical results of the past few decades have provided much support for the positive relationship between financial development and economic growth. A predominant body of research leans towards answering few key issues of the finance growth in the coming years: the choice of financial development measures, causality direction of finance and growth, econometric problems arise and the channels in linking both financial development and economic growth. There are challenging tasks for researchers with wide ranges of interest in the theory, measurement and techniques used.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter sets out the methodology that was used in this study. The section sets out appropriate research design for the study, the target population, the sample methods of data collections and data analysis

3.2 Research design

This was a descriptive research study highlighting the relationship between financial development and economic growth in Kenya. Therefore, the research design established whether there was a relationship that exists between financial development and economic growth. The design borrows relationships from the causal design to specify the extent of functional relationship between two or more variables. It analyzes the cause – effect relationship between the variables. Causal research is often used to infer causation or causality, that is, which variables are the causes (independent variables) and which variables are the consequences or effect (dependent variables)

3.3 Population

The Population of the study focused on listed banking institutions in Kenya's as per appendix 1.

3.4 Sampling

The Sample included all the banks listed in the NSE, the CBK, the CMA and the sample frame for this study focused on the variables of financial development and

economic growth for financial sector in Kenya from 2005 to 2010. The sample also included all financial institutions listed in NSE.

3.5 Data Collection

Secondary data was used for the study. The researcher visited the CMA, CBK and request for the CMA data for the years between 2005 and 2010 on financial sector development. GDP growth rate will be obtained from the Kenya National bureau of Statistics (KNBS).

3.6 Data Analysis

The data collected for the study was analyzed using a multivariate regression model. Statistical package for Social sciences (SPSS) Version 17 was used to aid in analysis of the data. The study used the secondary data collected from KNBS and capital markets. The following model will be used:

$$Y = \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \alpha$$

Where,

Y is the economic growth per capita real GDP in percentage

X_1 is the average lending rate

X_2 is the Average Deposit Rate.

X_3 is the Average nominal rate

X_4 is the Total Bank Assets which is the sum of all quoted bank total Assets

α represents other variables

CHAPTER FOUR

DATA ANALYSIS AND INTERPRETATION OF FINDINGS

4.1 Introduction

This chapter covers data analysis, interpretation and discussion of the research findings. The data is analyzed and presented in the form of tables, proportions and tables. The chapter establishes whether there exists a relationship between financial development and economic growth through the analysis of Kenya economic growth indicators. The research was based on the six years data from 2005 to 2010 and the data was analyzed using the statistical package for social sciences version 17.

The study used secondary data published by the Central Bank, Capital Market Authority, Kenya National Bureau of Statistics and the Nairobi Stock Exchange. The information helped to obtain the economic growth figures as well as the contributors to the economic growth in listed Banks.

The chapter first presents analysis of secondary data. It then presents analysis results for the data collected using the data collection checklist which culminates in a discussion of issues arising putting in the evidences obtained from published data.

4.2 Economic Growth in Kenya

Generally, a nation economic growth can be defined as the changes in production of goods and services produced by all sectors in the economy. If the production level at time t is greater than the production level at time $t-1$, then we can conclude that the nation undergo a positive growth. The Kenya's Economic growth was measured by the Gross Domestic Product (GDP). As shown in table 1.

Table 1 - Gross Domestic Product (GDP)

Year	Real GDP (%)
2005	5.7
2006	6.1
2007	7.1
2008	1.7
2009	2.6
2010	5.6

Source: Kenya National Bureau of Statistics

The GDP in 2005 was 5.7 which was the base rate for the research, the GDP increased by 7% to 6.1% in the year 2006. Due to the commitment of the Government to promote peace and stability, infrastructure and financial intermediation which even lead to the listing of Equity Bank of Kenya in the NSE. This attracted a positive economic growth by a change of 16.4% compared to year 2006 GDP amounting to 7.1% in year 2007.

Following the December, 2007 elections, the economy fell into challenges that are reflected by a drop by 76% from the GPD for 2007 amounting to 1.7%. The data published by the Kenya National Bureau of Statistics. Nevertheless, the economy started showing signs of recovery, following the signing of the National Peace and Reconciliation Accord, and aggressive marketing efforts by the Coalition Government. This lead to increase in economic growth by a margin of 53% which is reflected by 2.6% GDP. Increased investors confidence and commitment by the government to promote economic growth lead to economic growth of 5.6% reflecting a 115% compared to the GDP for 2009

4.3 Financial development

Financial development is defined as a process that marks improvement in quantity, quality, and efficiency of financial intermediary services. This process involves the interaction of many activities and institutions and is associated with economic growth. The four components of financial development used in the research study are as follows.

Table 2 - Measures of financial development

Year	Average lending rate (%)	Average deposit rate (%)	Average nominal interest rate (%)	Total asset (ksh BN)
2005	13.09	4.21	4.59	606.9
2006	13.79	4.35	8.74	695.1
2007	13.32	4.32	5.77	833.4
2008	14.06	4.48	6.33	1,099.1
2009	15.09	5.28	7.76	1,263.5
2010	14.30	4.45	11.24	1,548.4

Source: Central Bank of Kenya

4.3.1 Average lending interest rates

This represents the rate at which the financial institutions especially commercial banks lend loans and other credits to their customers. It is the rate embedded into the products and fee tables of commercial. These rates must be approved by CBK to ensure product and customers fairness in the banking industry. In Kenya the average lending rate for Kenya was steadily increasing.

In the year 2005 the rate which is the base rate for this study was 13.09 %, which increased by 5.35% to 13.79% in 2006 as a result of pressure from rising inflation. The average lending rate declined by a margin of 3.41% in the year 2007 compared to 2006 due to the government effort in controlling the rising inflations within the

Kenyan economy. This was however not achieved for long due to the Post Election violence which contributed to an increase in average deposit rate of 14.06% representing a 5.56% change. The average deposit rate further increased to 15.09% in the year 2009 representing a 7.33% change. This was however controlled by the government as a result of implementation on the signed Memorandum of understanding and the coalition government representing a decline in average lending rate of 5.24% to 14.30% in 2010

4.3.2 Average deposit interest rates

This represents the rate at which commercial banks discount all the deposits held by their customers. In the year 2005 the deposit rate was 4.21%, this further increased by 3.33% to 4.35% in the year 2006. A lower average deposit rate was recorded in 2007 of 4.32% representing a 0.69% decrease. This was not achieved for long, in the year 2008 the deposit rate increased by 17.86% amounting to 4.48%. This was the period when the economy of Kenya was recovering from the effects of disputed presidential elections. In 2009 the average deposit rate increased to 5.28% representing a 17.86%, this was however contained and reduced to 4.45% which was 15.72%

4.3.3 Average nominal interest rates

This represents the interest rate on an investment or loan without adjusting for inflation. In 2005 the average rate was 4.59% forming the base of the study. This latter increased to 8.74% representing a 90.41%. In 2007 the interest rate declined to 5.77% representing a drop of 34%. The year 2008 represented a nominal interest rate of 6.33% and 7.76% was the interest rate for the year 2009 representing a 22.59% increase as compared to 2008. The average change almost doubled in the year 2010 to 11.24%.

4.3.4 Total Financial Assets

The total financial assets of all the banks in Kenya as at 2005 was Ksh 606.9 Billions, this increased by 14.53% to Ksh 695.1 Billions in the year 2006. In the year 2007 the country recorded an increase of 19.90% which was Ksh. 833.4 Billions; this further increased by 31.88% to Ksh 1,099.10 Billions in the year 2008. A decrease in the rate of change to 14.96% of Ksh 1,263.50 was recorded in year 2009. in the year 2010 the total assets increased to Ksh 1,548.40 Billions representing a 22.55% increase as compared to the year 2009

4.4 Economic Growth and Financial development

Investigation as to whether there is a relationship between economic growth and financial development was carried through multiple linear regression using statistical package for social science version 17. Statistical significance at 95% confidence level was tested for the various correlation coefficients.

ANOVA (analysis of variance) is used to report quantities related to the overall explanatory power and significance of the regression model .Since p-value is less than 0.05 (critical level of significance) it is concluded that there is a relationship between economic growth and financial development

4.4.1 Correlation analysis

Table 2 shows correlation coefficients between the various variables of the study.

The coefficients give estimates of the intercepts and the slope coefficients. The standard error column gives the standard error (the standard deviation) of the estimated regression coefficients.

Table 3 - Coefficients

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>
Intercept	89.12315	12.72610	7.00318	0.04029
Average lending rate (%)	-10.98931	1.84374	-5.96033	0.10582
Average deposit rate (%)	12.83107	2.67888	4.78971	0.13103
Average nominal interest rate (%)	1.39772	0.21498	6.50167	0.04715
Total asset (ksh BN)	0.00060	0.00130	0.45984	0.04561

Research Findings

Table 3 shows the coefficients of the independent variables. The regression model can be written mathematically as:

$$\text{GDP} = -89.12315 - 10.98931X_1 + 12.83071X_2 + 1.39772X_3 + 0.00060X_4$$

Where

X₁ is Average Lending Rate (%)

X₂ is Average Deposit Rate (%)

X₃ is Average Nominal Interest Rate (%)

X₄ is Total Asset (Ksh BN)

We can therefore argue that economic growth is related to financial development and the major financial development measures that are associated with economic growth at 0.05 significance level are average nominal interest rate and Total Asset value given their small p values of 0.047 and 0.045 respectively as shown on Table 3 above

4.4.2 Significance of the model

Table 4 shows Adjusted $R^2 = 0.935$. This means that the model using financial development could be used to explain 93% of the variability of economic growth. We can therefore say that financial development has a large bearing on economic growth.

Table 4 R-Squared

Multiple R	R Square	Adjusted R Square	Standard Error
0.993	0.987	0.935	0.035

Source: Research Findings

Table 5 shows F- value of 19.03233, and f -significance of 0.01006 which means that there is high significance of the model at alpha= 0.05. This means that the model using financial development in banking institutions to measure economic growth can be relied on to explain the variability in economic growth

Table 5 Anova Table

	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>Significance F</i>
Regression	4	22.58336	5.64584	19.03233	0.01006
Residual	1	0.29664	0.29664		
Total	5	22.88			

Source: Research Findings

4.5 Summary and interpretations of findings

Financial development stimulates economic growth in Kenya by a less but positive margin. The economic growth requires investment from the banks and mobilizations of financial assets. When the financial institutions excel in their investments and growth of asset base, the economy responds positively but by a less margin.

The positive economic growth and its related demand for credit are necessary for investment. The investments are the key catalyst for the demand of financial services and therefore increase the development of financial institutions. A shift in investment pattern leads to a similar shift in the financial development of Kenya.

An increase in the deposit interest rates and total assets of financial institutions increased the mobilization of investments which improve the economic growth of Kenya. The mobilization and standardization by commercial banks in the

improvements and increase in financial assets improve the related economic growth of Kenya

The financial development is responsive to the changes in the lending interest rate. Any increase in the lending interest rate negatively affects the economic growth of the country by discouraging the borrowings by the investors. The Kenya's average lending interest rate is not constant and keeps varying in terms of the rate of change which can affect the predictions of the investors.

In summary the economic growth contributes more to financial development than the financial led economy. This was depicted by the relationship that existed between the financial development and the economic growth of the economy of Kenya for six years categorized by changes in political environments.

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary

The economic growth of Kenya is highly dependent on other factors other than the financial development. However, the contribution of the financial institutions to the economic growth cannot be ignored. The performance of financial institutions has a positive contribution to the economic growth of a country but it is not significant to reflect the exact change of economic growth rate as measured in GDP.

The economic growth rate increases, the demand for financial institutions also increases and therefore there exists a positive relationship between the financial development and economic growth in Kenya. As the demand for finances increases and other factors remain constant, the lending interest rate can be reduced thereby increasing the positive change in the economic growth.

The research was carried out in the listed financial banks which had all their financials regulated by the CBK and the data was tabulated from the reports of published CMA, KNBS and CBK. There has been a low listing of financial institutions in the stock market. As at the base year of the study (2005) there were only eight banks listed in the NSE and by year 2010 only two more banks were added to the market. This increased the reliance of the results of the study findings.

The NSE and CMA must embrace campaigns to encourage micro-financial institutions to be listed in the stock market. This will increase financial availability to potential investors and increase the performance of financial institutions.

5.2 Conclusions

The lack of high number of listed financial institutions in NSE is simply a manifestation of the lack of demand for their services. Furthermore, the measurement of financial development is essential because it has significantly different implications for the development policy (bank-based vs market-based). However, this measurement remains unclear. This research employs several financial measures and new data to gain insight into this issue. Therefore, the aim of this paper is to determine the long run and short run relationship between financial development and economic growth in Kenya.

In order to identify different financial measures of financial development, this research project utilized four indicators which include the lending interest rate, the deposit interest rate, the nominal interest rate and the total assets held by commercial banks. The financial development that covers the development of financial sector/intermediary, development of financial services, the development of deposit banks relative to the central bank in allocating domestic credit.

The empirical results obtained fulfilled the objective of this research. The SPSS version 17 regressions with the diagnostic test were utilized to investigate the relationship between financial development indicators to economic growth. The empirical results from this study are mixed. For Gross Domestic Product in percentage and Credit provided by the banking system long run positive relationship were reported while for Domestic banks relative to the central bank in allocating domestic credit negative significant relationship is reported that shows in long run, the importance of central bank is greater rather than the deposit bank in allocating domestic credit.

5.4 Policy recommendations

Financial development is still a key contributor to the economic growth of Kenya. There is a need to stimulate more financial institutions and monitor their performance to improve the reporting and operations in Kenya. This can be achieved by regularly reviewing the interest rates to foster investor's confidence and to balance the cost of operating financial institutions. There should be reforms in financial industries and sensitization of the financial sector to modernize operations and increase information to the customers and investors (Shareholders) in order to improve efficiency in the market.

The financial regulator must develop measures to ensure there are increased, stable and reliable financial institutions in Kenya. The regulator must allow the banks to develop products that are modern and allow for the creativity in the industry. The regulator needs to encourage mergers and acquisitions of small banks to increase to threshold required to be listed in the NSE. This will encourage the mobilization of savings and increase the total financial assets available to Kenya.

There is need to develop modern means and mechanisms of encouraging savings within the financial institutions such as sharing information on the current prevailing interest rates on the customers deposits. Use of mobile and internet to track the growth of individual investor's deposits and the development of micro-financial institution to fully pledged banks.

The full financial driven economic growth can be achieved by the liberalization of the financial sector and review of the current laws governing the operations of commercial banks. The regulator should keenly monitor the performance of the banks and ensure adequate controls are in place.

5.4 Recommendations for further study

In order to achieve a detailed knowledge on the relationship that exist between the financial development and economic growth of a developing economy, the following researches ought to be done. There is a need to study the relationship between the financial sector developments with regard to the economic growth. This will clearly highlight the overall contributions to the economic growth by financial sector to give a more a specific results.

In addition the research should be done to cover the current time such as 2011 so as to highlight relationships in a more turbulent environment. A research covering a wider range is likely to give more accurate and specific results of the extent of the relationship.

5.5 Limitations of the study

A limitation for the purpose of this research was regarded as a factor that was present and contributed to the researcher getting inadequate information for the complete analysis of financial economic indicators in a developing country. The project sample frame of six years study could have limited the results and this might generalise to other situations. This led to unstable results for the regression analysis. Utilizing data for long periods has the effect of smoothing out random fluctuations hence achieving a good fit.

All the data was collected from secondary sources and any error in original data could not be avoided however all data is from reliable sources only.

Most data was an approximation to the actual figures as highlighted by the sources due to huge figures involved in all financial institutions of Kenya. This could have affected the results of financial development indicators and the entire conclusion.

The cost of obtaining information and the turnaround time by the NSE posed a great challenge and reduced the time available for the verification and quality assurance of the project.

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APPENDICES

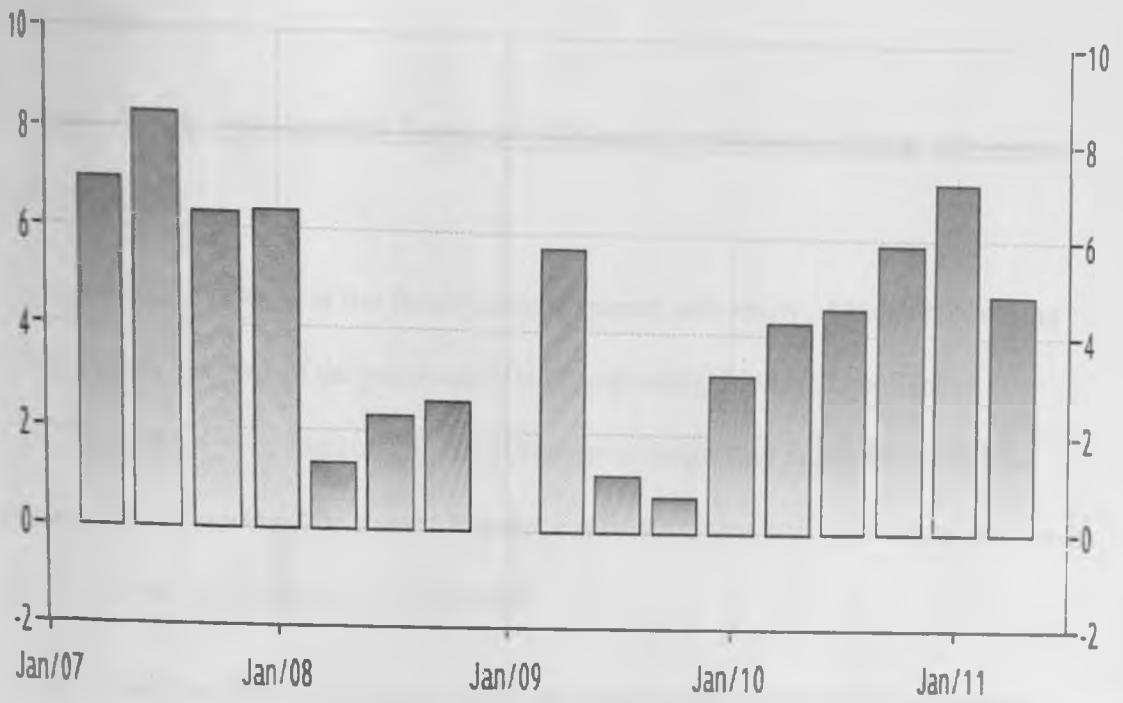
Appendix 1: Listed Banking institutions

NO	Name of the company
1	Barclays Bank Ltd
2	CFC Stanbic Holdings Ltd
3	Diamond Trust Bank Kenya Ltd
4	Housing Finance Co Ltd
5	Kenya Commercial Bank Ltd
6	National Bank of Kenya Ltd
7	NIC Bank Ltd
8	Standard Chartered Bank Ltd
9	Equity Bank Ltd
10	The Co-operative Bank of Kenya Ltd

Source: Nairobi Stock Exchange

Appendix 2: Kenya Annual GDP growth Rate

KENYA ANNUAL GDP GROWTH RATE



source: TradingEconomics.com, Kenya National Bureau of Statistics

Appendix 3: Letter of introduction

Dear sir/madam,

RE: Research on relationship between financial development and economic growth in Kenya

I am a postgraduate student at the faculty of commerce, university of Nairobi pursuing my MBA course. As part of the requirements for my study, I intend to collect secondary data from your institution. The information requested is purely needed for academic purposes and will be treated in strict confidence, and will not be used for any other purpose other than for my research.

I would be most grateful if you would allow me access to all information relevant to my research. Any additional information you might consider necessary for this study is most welcome. Thanks in advance for your assistance in accessing the much needed information.

Yours sincerely

Peter Ndwiga

MBA candidate

Supervisor

Dr. Aduda

Lecturer

Department of Finance
and Accounting

University of Nairobi