

THE IMPACT OF FINANCIAL INNOVATION ON FINANCIAL SECTOR DEVELOPMENT IN KENYA

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Abstract

This study examines the relationship between financial innovation and financial sector development by exploiting Generalized Method of Moments (GMM) framework and time series annual data over the period between 2000 and 2015. Financial innovation was measured by three indexes: currency-money ratio (CMR), e-money (EM) and e-payment (EP), whilst financial sector development was measured by four indicators: financial deepening (FDP) stock market development (SMD), domestic credit (DCR), and foreign direct investment (FDI). Based on the empirical results, evidence shows significant impact of financial innovation (except for CMR) on financial deepening, stock market development and domestic credit. However, there is insignificant effect of financial innovation on foreign direct investment (FDI). The reason of significant effect of these innovations is the case of high adoption rates and high market efficiency in the financial sector. On average, financial innovations have significant influence on financial sector development, hence boosting market efficiency. Financial innovation indicators can work for or against developmental effect via the transmission mechanism, hence impacting financial development. Rapid innovations as a phenomenon in the past decades have changed the array of financial services available to customers and increased the efficiency of the financial system and are becoming an important factor in the development of the banking sector. Financial institutions (i.e. banking sector) are faced with a number of important questions, for example, how to take full advantage of new innovations and technologies, and how e-developments can change the ways in provision of better financial services and remain competitive in the long-run. Therefore, the concerned authorities should be able to implement essential reforms (financial-economic), critical measures and forward-looking policies in order to combat implications associated with the changing financial environment for a viable and sustainable financial development.

Key words: Financial innovation, financial system, development indicators, GMM approach, Kenya