The finance-growth nexus: New evidence from Kenya

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Kenya, though plagued with persistent corruption and poverty, has attracted many Chinese investments lately. In this setup, financial institutions become enablers of potential investors, to channel funds to productive projects; good governance then permits efficient management of such projects, encouraging growth. From another point of view, growth also expedites the formation and development of financial institutions. The existing literature on Kenya has primarily focused on banking, the backbone of the financial system, and its securities market, the fourth in Africa in market capitalization (Barve, 1984). Better financial inclusion to create financial stability was analyzed by Aduda and Kalunda 2012. Ahmed et al., 2011, studied the causal effect of interest liberalization on growth. Wolde-Rufael (2009) found that financial development significantly impacts economic growth in the long-run. Aduda et al. (2014) found that capital deepening positively affects GDP growth.

The primary objective of this paper is to shed some further light on the connection between financial development and economic growth in Kenya over the period 1960-2012. A Cobb-Douglas production function augmented by incorporating financial deepening is used. This paper contributes to the existing literature by including new financial variables and presents a more extensive empirical analysis of the finance-growth nexus between financial deepening using a battery of diagnostic checks. The latter is measured by percentage of domestic credit to private sector to GDP and percentage of foreign direct investment to GDP. It uses a vector error-correction model (VECM) to determine the causal relationship between finance and economic development, in both static and dynamic models. Three alternative representations are proposed: the plain Cobb-Douglas function using four macroeconomic factors, the extended one using four factors and one including three factors and an interaction term of two financial factors.

Multi-variate granger tests, in the short and the long-run, and the variance decomposition show uni-directional causality running from the capital and labor to income growth, and a bi-directional causality between domestic credit to private sector and income growth. All coefficients in the VECM model are stable (using CUSUM and CUSUMSQ stability tests, Brown et. al. 1975) over the sample period. Our findings emphasize the importance of financial development in improving capital allocation and growth in Kenya. FDI is found to be causing growth in the short-run. Policies should encourage the foreign investment, especially, one targeting labor-intensive sectors.