

Financial sector innovations and interconnectedness: impact on productivity, value addition and economic growth in Kenya

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ABSTRACT

This paper visualizes that the advances in technology vis-à-vis the globalization process have had externalities on the financial sector. The financial sector is leveraging on these developments to enhance service delivery to its clients, as well as secure returns arising from these advances. The growth in technology and the globalization process have contributed to innovations in the financial sector. These innovations have in turn enhanced at least the interconnectedness within the sector, and to the real economy. It then anticipates that this connection may be critical for policy purposes, that is, the sensitivity of the real economy to monetary policy, and also for macro prudential surveillance. Within this framework, it therefore proposes to establish a measure of Kenya's financial innovations, the extent of connectedness within the financial sector and to the real economy, and whether the interconnectedness can be attributed to the innovations.

An assessment of financial innovations and financial interconnectedness is therefore necessary to appreciate the linkages between them. Greater interconnectedness has however also been associated with possible risks of financial risks. Critical policy questions that need attention are: the financing and incidence of financial innovations, the productivity effects of the innovations, and a measure of likelihood of innovations in this sector. Policy questions relating to interconnectedness include: the multiplier effect, the sufficiency of the interconnectedness, and stability of a highly interconnected system.

The objectives of this paper are to develop measures of the inter-connectedness of the financial sector and connectedness of the financial sector with the real sector. An assessment of the link between the two measures will also be done, and the contribution to productivity and growth. the share of finance in Kenya's GDP. Kenya is a hub of financial services within the East African region and is well recognized globally for setting the pace in mobile money transfer services. Financial innovations have expanded at an unprecedented rate, much ahead of financial regulations. Whether the growing innovations can explain financial connectedness therefore needs to be explored. How do financial sector innovations impact on the connectedness of the financial sector? This paper brings these issues to the fore.

SIGNIFICANCE OF THE STUDY

Kenya's financial system has evolved rapidly over the years. In the last two or three decades, we have witnessed the development of mobile money transfers (including M-PESA and AIRTEL

Money services), the growth of branch banking or agent banking, investment in long term government bonds for development finance, and more so, were moving closer and closer to a cashless economy, as seen in preference for visa cards for payment of bills, and so on. It is therefore undisputed that with these rapid developments, and the progress still being made in the financial sector in terms of financial intermediation, a growing interconnection between the financial sector and that between the financial sector and real economy is being forged, either knowingly or unknowingly.

The vision 2030 (Republic of Kenya, 2007), which lays out the development agenda for the country is the evidence that much more rapid growth in the financial sector needs to be fostered to attain the goals of the plan, key among them being the attainment of a ten percent economic growth status by the year 2030.

The growing linkages between the financial sector and the real economy has been, and will still be an issue of interest for policy makers who seek to understand the nature of this interaction, and indeed, the level of connectedness that exists, if any. It is therefore an understatement to mention that such a measure will be highly sought for especially in the policy environment.

The importance of connectedness in understanding fundamental macroeconomic and the likelihood of increasing systemic risk in the finance and insurance industry through a complex and time-varying network of relationships, have been emphasized by Diebold and Yilmaz (2011, p1), Billio et al (2012) and Summer (2013). Nevertheless, the need to quantify and measure this interconnection is useful for financial stability analysis.