

**Financial innovations, interest rate elasticity of money demand and monetary policy transmission in Kenya**

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This study examines the impact of the major financial innovations that occurred in Kenya between 1996Q1 and 2013Q4 on the interest rate elasticity of money demand and the channels of monetary policy transmission. The study focuses on the institutional (creation of Monetary Policy Advisory Committee-MPAC), policy rate (launch of Central Bank Rate-CBR) and product (launch of mobile money) innovations. Based on an Autoregressive Distributed Lag model bounds testing approach to cointegration, narrow money (M1) is found to have a long run stable relationship with its determinants. The results show that in the short-run, the emergence of the innovations reduced the interest rate elasticity of money demand, thus indicating an improvement in effectiveness of monetary policy. However, except for the interest rate elasticity after the launch of MPAC that declined, the long-run interest rate elasticity increased after CBR and mobile money were introduced. Based on a two-stage structural vector autoregressive model, findings show that while both innovations did not significantly alter the interest rate channel the introduction of the CBR enhanced the effectiveness of the credit and exchange rate channels but dampened the stock prices channels. Mobile money innovation reduced the effectiveness of the stock prices and the exchange rate channels but enhanced the effectiveness of the credit channel. In both cases however, no channel guaranteed a complete pass through to prices and output. In this regard, the Central Bank of Kenya could consider: adopting M1 as the target monetary aggregate; improving the approach to changing the role of new policy instruments as well as developing frameworks for commercial banks' reserves management that account for growing usage of mobile money. Additionally, there is need to critically address the structural issues that impede transmission of monetary policy impulses to output and prices.