

Abstract

The paper investigates how income diversification and capital adequacy affect the liquidity creation of banks in Kenya. We employed unbalanced panel data from 36 commercial banks from 2001 to 2020. We extracted data from published banks' financial reports and statements. The study used the broad and narrow measures to measure liquidity creation. Owing to the persistent nature of liquidity creation, we used a dynamic panel model and a two-step system Generalized Method of Moments (SYS GMM) in the analysis. The findings suggest a positive linkage exists between income diversification and the liquidity creation of commercial banks, implying that well-diversified banks have a high level of liquidity creation and vice versa. However, the study discovered a negative relationship between capital adequacy and liquidity creation, supporting the financial fragility-crowding out hypothesis. Consequently, the study suggests that the diversification drive in banks must be reinforced to enhance their liquidity creation. Additionally, due to the tradeoff between capital adequacy and liquidity creation, an optimal level of capital is required to provide a buffer against shocks without negatively impacting liquidity creation, a crucial channel through which banks contribute to the economy.