PORTFOLIO FLOWS, MACROECONOMIC PRICES AND MONETARY POLICY IN KENYA.

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ABSTRACT

This study focuses on short term capital flows in Kenya. It investigates the effect of short term capital flows on macroeconomic prices and monetary policy management in Kenya. Empirical analysis is carried out to determine: the impact of short term capital flows on stock market performance using a multifactor pricing model, interest rate and exchange rate using a structural vector autoregressive model, and the effect of short term capital flows on monetary policy using a monetary policy rule.

The main findings are that stock market returns are affected by the expected and lagged unexpected portfolio flows. The price pressure and base-broadening hypotheses are supported. Participation of local investors improves returns. Macroeconomic factors, especially change in exchange rate and Treasury bill rate, improve returns. Short term flows affect monetary stability by reducing the interest rates over time and leads to currency appreciation. The exchange market pressure is mainly affected by changes in exchange rate and not by short term flows.

The bank rate is adjusted to accommodate changes in the economy to restore inflation to the targeted rate, but prominence is given to ensuring growth targets are met. Monetary authorities always ensure that changes in interest rates do not affect the macroeconomic activity, given the level of the smoothing parameter. The bank rate is adjusted with a higher magnitude when exchange rate is considered in the monetary policy rule.

The results suggest that short term capital flows have a disruptive effect on macroeconomic prices. Hence, to maintain stability in the economy and effectively manage monetary policy, short term capital flows should be considered in monetary policy management.