THE CAUSAL RELATIONSHIP BETWEEN INFLATION, INTEREST RATE AND STOCK MARKET VOLATILITY IN KENYA

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ABSTRACT

This study examined the relationship between interest rate, inflation and stock market volatility in Kenya using both primary and secondary data. A monthly time series data for a period of 14 years from January 2001 to December 2014 was used to study the relationship. Additionally, 385 Questionnaires were distributed to individual investors to understand investor's perceptions on the relationship. The vector error correction model was used to analyse time series data for the long run causal relationship between inflation, interest rate and stock market volatility, while the granger causality test was used to analyse the short run relationship. Findings revealed that there was a positive and significant long run relationship between inflation rate and stock market volatility (t-statistic= 5.96). Findings also show a positive and significant short run relationship between inflation and stock market volatility (chi-square value of 13.39 and a p-value of 0.0039). The relationship between interest rate and stock market volatility was found to be negative and weakly significant both in the short run (p-value of 0.0683) and long run (t-statistic of -1.90). Results from investor's perception revealed that 69% of the respondents agreed that a change in inflation rate causes fluctuation in share prices. Additionally, primary data results show that 75% of the respondents agreed that sudden changes in the interest rate have always caused variations in the stock market returns.

Keywords: Volatility, Inflation, Interest rate, stock market volatility.