

**ANALYSIS OF THE FINANCIAL DEEPENING DETERMINANTS  
INFLUENCING SECURITIES MARKET DEVELOPMENT IN KENYA**

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**Thesis Submitted to the Board of Postgraduate Studies in Partial Fulfillment of the  
Requirements for the Conferment of the Degree of Doctor of Philosophy in Business  
Administration of Laikipia University**

**DECEMBER 2017**

## ABSTRACT

Despite reforms undertaken to improve the macroeconomic and legal environment believed to foster capital markets development, the securities market in Kenya remains underdeveloped. The market has not fully contributed to economic growth as was expected at the onset of the reform period in early 2000s. Previous studies on securities market development have concentrated only on macroeconomic stability and institutional quality and arrived at conflicting conclusions. These studies have ignored other factors like market microstructure, intermediary development, foreign capital flows, and changes in governance systems and regimes. Their assessment of securities market development (SMD) has been limited to the use of market capitalization which is a measure of size, thereby ignoring other measures like depth and breadth of market activity and liquidity. This has left policymakers with no clear knowledge on how to stimulate securities market development. Guided by Calderon-Rossell Partial Equilibrium Theory of financial market development, the objective of this study was to analyse the influence of financial deepening determinants on SMD in Kenya between 1997 and 2016. Using an *ex post facto* research design of a predictive nature, monthly secondary data on value of shares listed and traded, macroeconomic variables, bank savings and credit, foreign capital flows, microstructure were collected from NSE, CMA, CBK and KNBS. Market capitalization, value traded and market turnover ratios were computed and nuanced into a SMD index. Test of dependence and normality were done to check for multicollinearity and distribution. Data for predictor financial deepening determinants were regressed against SMD index. ARDL Bounds estimation was used to assess the long-run and short-run cointegration between the predictor variables and SMD. Results showed that all indicators of macroeconomic environment had a significant relationship with SMD. Particularly, there was cointegration relationship between inflation rate (positive short-run), interest rate (negative short-run), foreign exchange rate (negative short-run and long-run) and securities market development. Secondly, results indicate that institutional quality via regulatory reforms to protect investors had a positive short- and long-run cointegration relationship, while attraction of foreign investors was not statistically significant. Thirdly, financial intermediary development only positively influenced SMD through private domestic savings in the short-run, while bank credit to private sector was not statistically significant. While foreign capital flows through Diaspora remittances negatively influenced SMD both in the short- and long-run, influence of cross-border listing was not statistically significant. Also, market microstructure changes through automation positively influenced SMD both in the short- and long-run, while transaction frequency positively influenced SMD, with a cointegration short-run relationship. Lastly, governance systems and regimes through demutualization and political regime change both positively and significantly influenced SMD in the long-run. Overall, ARDL bounds test confirmed a stable long-run relationship between SMD and its determinants. Every month, 27.4 percent of the divergence from long-run equilibrium SMD was corrected by short-run adjustment, though the speed of adjustment was slow. To promote SMD in Kenyan, the study recommends that policy makers should focus on the following: design sound policies that stabilize macroeconomic environment; encourage savings using policies that further develop financial intermediaries to mobilize more savings; improve the institutional framework to further tightening investor protection regulations; re-modulate trading ecosystem to foster safe and robust trading infrastructure; create laws which facilitate less costly foreign capital flows; give incentives to firms to issue different types of securities so as to improve transaction frequency and liquidity; lobby brokers to further reduce their stockholding in NSE Ltd and create a conducive stable political environment; and design policies aimed at promoting Kenya's economic growth.