Abstract

This objective of research study was to establish the relationship between economic growth and yield spread (the difference between the three month Treasury bill and the ten year Treasury bond). There exists enormous literature not just on the potency of the yield spread to predict economic activity but its leading indicator property too. However, this paper is motivated by the lack of comparative evidence from emerging markets and developing countries. Numerous studies have established the findings that an upward sloping yield curve is indicative of increased levels of economic activity in the future whereas flat or inverted yield curve means that there will be slowdown in the level of economic activity. This study used a VAR model which satisfied stability test as well as absence of autocorrelation of the residuals. The study established that the yield spread is statistically significant in explaining economic growth. Growth too was found to statistically significant to explain the yield spread. After the study forecasted economic growth in Kenya and found out the economy is projected to grow at 5.8 and 5.9 for the third and fourth quarters of 2015 respectively and 6.0 and 6.1 for the first and second quarters of 2016 respectively. In addition, the study found out the identified structural break in the central bank rates (Monetary policy) had significant effect on the economic growth in Kenya. The findings of the study are consistent with those of the literature review and to that extent corroborates the findings the yield spread is capable of offering foresight in to the direction the economy is expected to take.