

## Impact of Interest Rates on Housing Market in Kenya: A Supply Side

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### Abstract

The study investigated the influence of lending interest rates on housing construction and homeownership in Kenya. It utilised the unit root test, Granger causality test, and the generalized method of moments (GMM) model to analyze economic time series data from 1979 to 2025. The findings from the unit root tests indicated that the variables were I(1), confirming the absence of variables with I(2) properties. The regression coefficients demonstrate a significant negative effect of interest rates on housing supply, illustrating a one-way relationship between the two. Empirical results indicate that higher or rising lending interest rates contribute to a slowdown in the housing market. This phenomenon can be attributed to increased borrowing costs, which deter investment in housing construction both in the short and long term. These findings suggest that policymakers in Kenya should consider implementing measures to regulate bank lending rates and enhance oversight, thereby promoting affordable housing.

**Keywords:** Interest Rate, Housing Market, Construction Investment, Affordable Housing

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## 1. Introduction

Learning how interest rates change can help individuals understand their impact on their day-to-day lives. An increase in interest rate attracts capital inflows and thus strengthens the local currency (Mishkin, 2010). Conversely, an increase in interest rates slows economic growth since it reduces purchasing power; consumers do not have enough money to meet their financial needs adequately and have less desire to borrow. The interaction between these economic phenomena is often muddled by a series of other factors, such as levels of government debts, the sentiment of financial markets, trading terms, stability of the political arena, and the overall performance of the economy (Saunders, 2011). The impact of interest rate changes also depends on how developed the financial system is and how responsive banks are, as underdeveloped markets may delay these effects. Inflation expectations and consumer confidence further influence how interest rate shifts affect the economy (Thomi, 2022; Alazaki et al., 2024).

Interest rates in Kenya have undergone significant changes over the past few decades, reflecting both internal economic policies and external economic shocks. Interest rate changes are often influenced by both domestic fiscal and monetary policies as well as global economic conditions. In the post-independence era, Kenya's financial markets were largely regulated with fixed interest rates set by the government. However, from the 1990s onward, financial sector reforms led to the liberalization of interest rates, allowing market forces to largely determine lending and deposit rates (Ngugi & Kabubo, 1998). This liberalization was intended to promote efficient allocation of resources and improve access to credit. These reforms aligned with structural adjustments aimed at opening the economy, but challenges such as limited banking competition and global financial volatility kept interest rates high.

During the 1990s and early 2000s, Kenya experienced periods of high inflation, fiscal deficits, and currency depreciation, which contributed to elevated interest rates. Commercial bank lending rates often exceeded 20%, making borrowing expensive and limiting access to credit for many individuals and businesses (Kimura, 1997). High interest rates typically discourage borrowing and investment, slowing economic growth in affected sectors such as housing. The high lending rates reflected not only inflation expectations but also the perceived risks associated with lending in a relatively unstable economic environment. The high cost of borrowing had a dampening effect on investments, particularly in sectors like housing and manufacturing, which rely heavily on affordable credit. Additionally, a lack of long-term financing options hindered mortgage growth, forcing many to rely on informal credit and restricting private sector investment.

The mid-2000s brought some monetary policy stabilization, with the Central Bank of Kenya (CBK) implementing inflation targeting and tighter fiscal controls, resulting in a gradual decline in lending rates. However, interest rates remained volatile due to episodes of political instability, changes in government borrowing patterns, and global economic shocks. For instance, following the 2007-2008 post-election violence, economic uncertainty led to tightened credit and higher lending rates. In response, the government introduced interest rate caps in 2016 to curb excessively high lending rates and improve credit accessibility, especially for small and medium enterprises and households seeking mortgages (Kenya National Bureau of Statistics [KNBS], 2015). While intended to protect borrowers, these measures were complicated by political unrest and global crises that increased market volatility and risk.

Despite the interest rate cap's intent to make borrowing more affordable, it led to unintended consequences such as reduced credit supply by banks wary of lower returns and increased risk exposure (Ng'etich & Wangari, 2011). Overall, Kenya's interest rates have remained relatively high compared to global averages, reflecting structural challenges in the banking sector, inflation risks, and the overall macroeconomic environment. These trends have significant implications for credit accessibility, economic growth, and particularly for the housing market, where mortgage financing is sensitive to changes in interest rates. The credit tightening following the caps particularly affected sectors like housing and manufacturing that rely on affordable long-term finance, slowing economic diversification.

Housing growth in Kenya has been shaped by a complex interplay of demographic shifts, urbanization, economic conditions, and policy initiatives. Over the past three decades, Kenya has experienced rapid urban population growth, with cities like Nairobi, Mombasa, and Kisumu witnessing an influx of residents seeking employment and better living standards. This population growth has increased the demand for housing, especially affordable housing for the burgeoning middle class and low-income earners (Mureithi, 2015). Changing household needs and lifestyles have increased demand for varied housing types, but investment in urban infrastructure has not kept pace, adding strain to cities.

Despite this rising demand, the supply of formal housing has lagged due to several constraints. High construction costs driven by expensive building materials, limited access to affordable financing, and bureaucratic regulatory processes have impeded developers from meeting demand. High construction costs and regulatory hurdles are common barriers to affordable housing in many developing countries. Additionally, a large proportion of the population relies on informal housing settlements, reflecting the inability of formal markets to provide affordable and adequate housing options (World Bank, 2018). This has resulted in a persistent housing deficit estimated to be in the millions of units, contributing to overcrowding and poor living conditions in urban slums. Land tenure challenges and rising material costs add to affordability problems, pushing many into informal settlements despite poor living conditions.

Government efforts to stimulate housing growth have evolved. Initiatives such as the creation of the National Housing Corporation (NHC) in the 1960s sought to increase public sector involvement in housing development. More recently, the Big Four Agenda launched in 2017 placed affordable housing as a key pillar, promoting partnerships between the government and private sector, improving mortgage financing mechanisms, and streamlining land acquisition processes (Ministry of Housing, 2018). The establishment of mortgage refinancing companies and the introduction of housing funds have aimed to reduce financing costs for developers and homebuyers.

However, the growth of the housing sector has remained uneven. While upscale and luxury housing developments have flourished in affluent neighbourhoods, affordable housing for the majority remains insufficient. The sector also faces challenges from inadequate infrastructure, fluctuating interest rates, and occasional political and economic instability. Furthermore, the high cost of credit, partly influenced by persistent high lending rates, has limited the ability of many Kenyans to access mortgages, thereby restricting homeownership growth and slowing overall housing development (Struzenegger & Levy, 2011). This disparity reflects deep socio-economic divides, with informal settlements expanding as formal affordable housing remains scarce. Infrastructure gaps in water, sanitation, and electricity further worsen the situation (Anierobi, 2023).

Despite these challenges, the housing sector remains a vital contributor to Kenya's economic development. It provides employment opportunities, stimulates allied industries such as construction and manufacturing, and contributes to urban development. With ongoing reforms and investments, there is potential for accelerated housing growth that meets the country's demographic needs and supports inclusive economic growth. The sector's multiplier effects are significant, and innovations in affordable finance and green construction present opportunities for more sustainable growth.

The interaction between interest rates and housing growth in Kenya reflects a complex and interdependent relationship. Interest rates, particularly lending rates, directly affect the cost of mortgage financing, which in turn influences the demand for housing. When interest rates are high, borrowing becomes expensive, reducing individuals' ability to afford home loans and dampening investment in housing development. Conversely, lower interest rates can stimulate demand for mortgages, increase construction activity, and boost overall housing supply.

Historically, the high interest rates prevalent during the 1990s and early 2000s contributed to slow growth in the formal housing sector, as many potential homeowners and developers were priced out of the market. This resulted in the proliferation of informal settlements as a more affordable alternative. Although monetary reforms and interest rate reductions in the mid-2000s provided some relief, the housing sector still struggled with affordability issues. The introduction of the interest rate cap in 2016 was aimed at improving access to credit for homebuyers by capping lending rates. However, this policy led to a tightening of credit supply, as banks became reluctant to lend at capped rates due to concerns over profitability and increased credit risk. This paradoxically limited the availability of mortgage financing and slowed housing growth in the short term.

The cyclical nature of interest rate movements continues to shape Kenya's housing market. External factors such as global interest rate trends and domestic monetary policy decisions influence the real cost of borrowing. Meanwhile, government initiatives like the Big Four Agenda seek to bridge the gap by enhancing access to affordable housing finance through innovative schemes and incentives.

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## 2. Literature Review

The Austrian School explains interest rates primarily through the concept of time preference, which posits that individuals inherently prefer present consumption over future consumption. This preference reflects the subjective valuation of time and uncertainty in consumption choices. Friedrich (1851) emphasized that interest rates emerge as a natural outcome of individuals' marginal utility for present goods being higher than for future goods (Hülsmann, 2007). This differential creates an incentive for lenders to defer consumption, as they require compensation (interest) for postponing gratification. In this framework, interest rates are not merely prices set in financial markets but expressions of deep-rooted psychological and behavioural factors influencing saving and investment. This theory underscores the importance of individual choice and temporal valuation, which has significant implications for housing markets where long-term financing decisions are critical.

The neoclassical theory builds upon the Austrian insights but grounds interest rate determination in equilibrium conditions arising from the marginal utility of consumption and intertemporal allocation of resources. Herman (1810) formulated the idea that the marginal utility of consumption diminishes as individuals consume more. Consequently, the interest rate is the equilibrium price balancing savings and investment; it reflects the rate at which consumers are willing to postpone consumption in exchange for future benefits (Gossen, 1854). In this model, the supply of savings, which comes from individuals' willingness to delay consumption, and the investment demand, consisting of projects that promise future returns, determine the interest rate. The neoclassical approach treats interest rates as an outcome of optimising behaviour under scarcity, where capital is allocated efficiently to its most productive uses. This theory is especially relevant to housing, where interest rates influence both the cost of financing and the return on investment for developers.

John Maynard Keynes revolutionized interest rate theory by focusing on money's role in economic activity. In his *General Theory* (1936), Keynes introduced the liquidity preference theory, which argues that interest rates are the "price" for parting with liquidity—the ease of holding cash or near-cash assets. Individuals demand liquidity for transactions, precautionary, and speculative motives. The supply of money, controlled by monetary authorities, interacts with this demand to determine the equilibrium interest rate. When liquidity preference is high, individuals prefer holding cash over bonds or loans, pushing interest rates up. Conversely, an increase in money supply can lower interest rates (Keynes, 1936). This theory highlights the role of financial markets and monetary policy in influencing interest rates and, by extension, borrowing costs. In housing finance, liquidity preference affects mortgage rates and the availability of credit, which are critical for stimulating housing supply.

Knut Wicksell's loanable funds theory presents interest rates as the outcome of the equilibrium between the supply of savings and the demand for investment funds in capital markets. Wicksell (1898) introduced the notion of the "natural" or "neutral" rate of interest—the rate consistent with stable prices and full employment. The market interest rate fluctuates around this natural rate depending on monetary policy and market conditions. If the market rate rises above the natural rate, borrowing becomes expensive, discouraging investment and slowing economic growth, including in capital-intensive sectors like housing. Conversely, when the market rate is below the natural rate, investment tends to increase, potentially leading to inflationary pressures. This theory highlights the role of capital market frictions and monetary interventions in shaping interest rate dynamics (Wicksell, 1898; Mankiw, 2016). The loanable funds approach underscores how distortions or mismatches between savings and investment can have ripple effects on housing supply.

The Neoclassical Growth Model, developed by Robert Solow (1956), explains long-run economic growth through capital accumulation, labour growth, and technological progress. In this model, interest rates indirectly affect economic growth by influencing the cost of capital and investment incentives. Higher interest rates increase the cost of borrowing, discouraging investment in physical capital, including housing development. Conversely, lower interest rates reduce financing costs, encouraging firms and individuals to invest more in capital goods. The Solow model assumes diminishing returns to capital, meaning that over time, continuous investment leads to slower growth unless there is technological advancement. Thus, the model highlights how stable and favourable interest rates can encourage capital investment, which is critical for expanding housing supply and improving infrastructure (Solow, 1956; Mankiw, 2016).

While the Neoclassical model emphasizes exogenous technological progress, the Endogenous Growth Model, pioneered

by Romer (1990) and others, endogenizes technological change and innovation as drivers of sustained economic growth. In this framework, interest rates influence growth not only by affecting physical capital investment but also by shaping incentives for human capital development, research and development (R&D), and knowledge spillovers. Lower interest rates reduce the cost of financing innovative projects and infrastructure investments, which are crucial for modern housing development and urbanization. By fostering a conducive financial environment, lower lending rates stimulate productivity growth and structural transformation, enabling the housing sector to expand sustainably. This model underscores the importance of financial markets and interest rates in driving the long-term dynamism of the housing market and broader economy (Romer, 1990; Barro, 1990).

### 3. Data and Methodology

The study estimation was based on time series data for Kenya, Tanzania, and Uganda, spanning the period 1979 to 2025. The study period was informed by the availability of data. The secondary data was collected from different institutions as follows. Housing supply represented by new units built was extracted from the Kenya National Bureau of Statistics (KNBS), while house price was collected from the World Bank (World Development Indicators) database.

To investigate the effect of interest rates on the growth of housing, the following empirical models were adopted. Based on the works of Sodji (2024), a growth regression model was formulated as shown.

$$HS_t = \alpha + \beta LIR_t + \gamma X_t + \varepsilon_t \quad (3)$$

Where  $\varepsilon$  is the error in the model, subscript  $t$  is the time (period) dimension. The independent variable  $HS$  represents housing supply, which is measured by the volume of new housing structures as presented in the empirical works of Mutai (2025). The explanatory variables included interest rate (ILR), denoted by the change in lending interest rates.  $X$  denotes the study control variable during regression. The study control variable is house price (HP), represented by the average house value.

Thus, the econometric model used during analysis has the following equation.

$$HS_t = \alpha + \delta_1 LIR_t + \gamma X_t + \varepsilon_t \quad (5)$$

Economic literature proposes many estimation methods for dynamic panel data models with expected endogeneity problems. The most popular econometric method for estimating a dynamic model is the Generalised Method of Moments (GMM) proposed by Arellano and Bond (1991), which relies on lagged independent variables as internal instruments. The study adopted the Generalised Method of Moments (GMM) as the estimation model. The main strengths of the GMM technique include controlling endogeneity problems, correcting for heteroscedasticity and serial correlation, controlling simultaneity, eliminating country-fixed effects, and unobserved heterogeneity (Arellano & Bond, 1991; Mose, 2024; Sodji, 2024). For robust results, several residual diagnostic tests were applied, such as Hansen's test and the normality test. J-tests or Hansen tests are conducted to check for the validity of the exclusion restrictions. The null hypothesis states that instruments are correctly excluded from the GMM regression (Hansen & West, 2002).

This study adopted the Phillips-Perron (PP) test technique to check for stationarity, the alternative to the Fisher-Augmented Dickey-Fuller (ADF) test. The main strength of PP over other tests is its robustness to heteroskedasticity and autocorrelation without the need to explicitly specify the number of lags for the test regression. PP achieves this by applying a non-parametric correction to the test statistic using a Newey-West covariance estimator, making it more suitable when the time series exhibits complex error structures. The PP unit root test is specified as shown in Equation 6:

$$\Delta X_t = \alpha_i + \beta_i X_{t-1} + \sum_{j=1}^k \gamma_{i,j} \Delta X_{t-j} + \varepsilon_t \quad (6)$$

Where  $\Delta$  is the first difference operator,

$X_t$  is the dependent variable,

and  $\varepsilon_t$  is the stochastic term.

In the case of data, if values are found to be non-stationary, it is necessary to use a unit root test for the expectation of good results. Finally, one limitation of Mutai's (2025) empirical work was the failure to check the direction of causality between tax revenue and capital flight; the current study will fill that gap by conducting a Granger causality test (Granger, 1988).

## 4 Empirical Results

### 4.1 Unit Root test for Stationary

The study employed the Phillips-Perron (PP) unit root test to rigorously examine the stationarity properties of the key variables involved in the analysis. Stationarity testing is a critical preliminary step in time series analysis as it ensures that

the variables' statistical properties, such as mean and variance, remain constant over time, which is essential for valid inference. Table 1 presents the detailed PP unit root test results for all variables under study, namely housing supply (HS), lending interest rate (LIR), and house prices (HP).

Table 1: Results of Unit Root Test for Stationarity using PP Test

Variables	Level		First difference		Remark
	Statistics	Prob.	Statistics	Prob.	
<i>HS</i>	-1.4251	0.5617	-11.9230	0.0000	I(1)
<i>LIR</i>	-2.5675	0.1077	-5.5942	0.0000	I(1)
<i>HP</i>	-0.8574	0.7910	3.2107	0.0263	I(1)

The null hypothesis for the PP test assumes the presence of a unit root, implying non-stationarity in the variable's time series. As evident from Table 1, none of the variables are stationary at their levels, as indicated by the relatively high p-values exceeding the conventional 5% significance threshold. However, upon first differencing, all variables show significant test statistics with p-values below 0.05, rejecting the null hypothesis of a unit root. This confirms that housing supply, interest rate, and house prices are integrated of order one, denoted as I(1). Some GMM estimators, especially those based on Arellano-Bover type moment conditions (which use lagged differences as instruments for level equations), can consistently estimate the autoregressive (AR) parameter, even when the true parameter is one (a unit root). This consistency allows for unit root inference.

#### 4.2 Results of GMM

The Generalized Method of Moments (GMM) estimator was employed to assess the impact of interest rates on the supply of houses in Kenya. GMM is particularly useful in addressing potential endogeneity issues and providing consistent parameter estimates in dynamic panel data settings. Table 2 summarises the GMM regression output.

Table 2: GMM Estimators

Variable	Coefficient	Standard error	t-Statistics	p-Value
<i>LIR</i>	-0.6673	0.2665	-2.5043	0.0160
<i>HP</i>	0.8576	0.1723	4.9766	0.0000
LIR does not Granger-cause HS			3.9521(0.0153)	
			0.2589(0.8545)	
Durbin Watson test = 1.99			Adjusted R <sup>2</sup> = 0.53	
J-Statistics test = 5.24			P-value 0.07	
Jarque Bera test = 2.36			P-value = 0.31	
*, **, *** show 10%, 5% and 1% levels of significance, respectively				

The estimates from GMM indicate interest rates have a significantly negative effect on the supply of houses in the housing economy. The coefficient of interest rate is -0.67, suggesting that for every 1% increase in lending interest rate, the housing supply will decrease by 0.67 % in Kenya. Higher interest rates reduce the supply of housing in both the short and long terms.

The consistent negative relationship implies that increased borrowing costs discourage investment in housing construction, either in the short run or ultimately. Interest rates charged by commercial banks and microfinance institutions may discourage the take-up of mortgages to purchase or supply these houses. When the interest rates rise, residential construction will fall in the short run; this affects the elasticity of housing supply and may also lead to a rise in rents even though residential prices fall (Just, 2023). The regression result agrees with the findings of Theuri (2013) in Kenya that the interest rate slows real estate development. Further, the causality result shows a unidirectional flow from interest rate to supply of houses, indicating that rising interest rates can lead to changes in housing supply, possibly due to the demand for houses that can push interest rates available to housing sector investors.

The GMM model result suggests that the price of houses has a positive and significant effect on housing supply in Kenya. The increase in housing prices is significantly positively related to the housing supply. The coefficient of the price of houses is 0.86, suggesting that for every 1% increase in the price of housing, the housing supply will increase by 0.86%. In the long run, increased house prices will lead to the supply of houses increasing. This means there will be increased development as house prices rise since it enhances profitability. The study findings agree with the findings of Theuri (2013) that the price of housing has a substantial positive effect on the number of houses delivered in Kenya. As housing prices become favourable for the producers, the number of houses increases.

From the regression equation, the R-squared was estimated to be 0.53, implying about 53 per cent of the change in the dependent variable is explained by the independent variables. The P-value of the J-statistic is greater than 0.05, indicating the presence of validity in instruments. Durbin-Watson has confirmed there is no correlation among the residuals. The Jarque-Bera test was not significant, which signals that the data have a normal distribution.

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## 5 Conclusion and Recommendation

The study aimed to investigate the impact of interest rates on the housing production and home ownership supply in the context of Kenya for the period 1979–2025. The study used time series data amounting to 47 observations for interest rates, housing prices, and housing supply as dependent variables. By relying on the GMM model to achieve accurate results that reflect the impact of interest rates on housing construction in Kenya, and to understand the balances between the time series of the variables. The study proved that in the short run and long run, only the interest rate had an impact on the supply of houses, which can be justified by increased borrowing costs that discourage investment in housing construction, either in the short run or ultimately. These findings suggest that, since interest rates negatively impact the supply of homes, the Central Bank of Kenya must ensure that interest rates remain low and stable to reduce borrowing costs for homebuyers and developers. Adjustments to policy interest rates can influence borrowing costs, subsequently impacting housing demand and construction expenses.

To effectively address the impact of interest rates on housing supply, central banks should adjust their interest rate policies with careful consideration of market dynamics. Lowering interest rates can stimulate borrowing and boost housing demand, but it's crucial to strike a balance to avoid overheating the market. Additionally, supporting affordable housing initiatives through programs that subsidise loans for developers or offer tax incentives can stabilize the market, ensuring that the benefits of lower interest rates extend to a broader population. Promoting long-term fixed interest rates is also essential, as it provides homeowners with payment stability and encourages investment in housing. Regularly monitoring economic indicators will enable policymakers to adapt their strategies proactively, understanding how interest rates influence inflation, employment, and consumer behaviour. Clear communication from central banks regarding future interest rate policies is critical to reducing uncertainty and enhancing market confidence. Lastly, promoting alternative financing models, such as co-housing and community land trusts, can help mitigate the adverse effects of rising interest rates and create additional pathways to affordable housing.

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The authors declare that they are not aware of any competing financial interests or personal relationships that may have influenced the work described in this document.

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## Ethical considerations

The article followed all ethical standards appropriate for this kind of research.

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