INFLATION IN KENYA: AN EMPIRICAL ANALYSIS

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ABSTRACT

The paper analyses the dynamics of inflation in Kenya by assessing the relative importance of monetary and external factors. This was done through a multivariate Granger-non-causality tests and the decomposition of the forecast error variance into variable specific innovations.

Using Granger-noncausality tests the study found that monetary base growth, exchange rate movements, real income growth, exchange rate of inflation and interest rate movements have significant effects on inflation. The monetary base growth, interest rate and exchange rate movements have strong feedback effects on inflation. This implies that a shock on any of this variables, will have permanent effects. Broad money, M3, on the other hand, is driven by inflation without feedback effects. These results point to the differential impact of the two money supply aggregates on the rate of domestic inflation.

Using variance decomposition, the exchange rate was found to be the most important variable accounting for half of the

innovations in the price level. The paper thus concludes that exchange rate movements are more important than money supply growth in explaining Kenya's inflationary process.