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The Choice Of Optimal Monetary Policy Instrument For Kenya

James Gichuki*1 , Jacob Oduor2 , and George Kosimbei3

*1 Corresponding author: Kenyatta University 2 Kenya Institute for Public Policy research and Analysis (KIPPRA) and Kenyatta University 3 Kenya Institute for Public Policy research and Analysis (KIPPRA) and Kenyatta University

Abstarc :

The Central Bank of Kenya (CBK) has over the years used monetary policy to stabilize both inflation and output using two instruments; interest rates and reserve money simultaneously. However, literature suggests that the two instruments used simultaneously will not be effective in hitting the monetary policy targets. In fact, the CBK has over the years missed its inflation target, a fact that could in part be explained by the use of the two instruments simultaneously. The CBK therefore must make a choice between the two instruments. Literature suggests that the choice depends on the economic environment of the country in question. Furthermore, some literature argues that a combination policy which is a mix of these two instruments may work better than either of the two used independently. Using data for the period 1994 to 2010 and an error correction model (ECM), this study establishes that the interest rates result in minimum losses in output compared to the reserve money instrument. Furthermore, a combination instrument minimizes losses from equilibrium output better than the other two instruments taken independently. There is therefore need for the CBK to adopt a pure interest rate instrument policy strategy if it desires to use one isolated instrument. Better still; there is need for the CBK to construct a monetary policy conditions index which would help in the implementation of a combination instrument policy.

Key Word :
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