Abstract

Since 2003, the monetary policy in Kenya has pursued inflation targeting policy that pegs the desired inflation rate at 5 per cent. However, Inflation targets in Kenya have been missed frequently and the CBK has been unsuccessful at keeping and maintaining the inflation at the target rate. The average level of inflation has also been higher (10.17%) compared with the level of inflation in developed (3%) and emerging economies (8%). Missed inflation targets present a dynamic inconsistency challenge to policy makers. Previous studies on inflation yield conflicting results as far as determinants of inflation in Kenya are concerned. The lack of consensus implies that the determinants of inflation in Kenya may not yet be known. Similarly previous studies on inflation in Kenya have a linear relationship between the variables in the models. There is no a priori reason to assume that the inflation model has to be linear without test for non-linear effects. The specific Objectives of the study were to establish the monetary and non-monetary determinants of inflation in Kenya and test for possible non-linearity in the inflation model in Kenya. The conceptual framework for the study was anchored on the aggregate demand and cost-push theories while an explanatory research design was adopted. Secondary quarterly data of all the variables during period of 2001 to 2013 were obtained from the databases of the Central Bank of Kenya and Kenya National Bureau of Statistics. Data was analyzed using OLS method. The study found out that real GDP growth negatively (β = -0.5150369) and significantly (P=0.0020) affect the inflation rate while changes in oil prices) positively (β=0.03753) and significantly (P=0.019) affect the inflation rates. It also found that the previous period’s inflation rate (lag inflation rate) positively (β=0.78760) and significantly (P=0.0000) affected inflation rates of the current period. The results mean that a unit increase in Real GDP results into a reduction of inflation by 0.515 units and that a unit increase in the price of oil would result into a 0.03753 increase in the levels of inflation. The results also mean that a unit increase in lagged inflation rate leads to a 0.787 increase in the current inflation rates. In addition the findings revealed that the inflation model exhibits a linear structure as the coefficients of squared terms of the predictor variables were found to be statistically insignificant. It concluded that real GDP growth, changes in oil prices and the previous period’s inflation rate to be the key determinants of inflation in Kenya. The study recommends that focus for policy makers should be growing the Real GDP as way of controlling the inflation rate. An increase in real GDP leads to a decrease in inflation rate and therefore policies geared towards increasing capital formation such as instituting investment tax credit can be used to spur real GDP growth. The second focus area for policy makers should be containing price fluctuation (changes in oil prices). According to the results an increase in Oil prices leads to an increase in inflation rate and therefore policy makers should adopt stabilization policies to deal with economic shocks that may put short-run pressure on factors that drive inflation.