Transmission Mechanisms of Monetary Policy in Ethiopia: Evidence from Structural VAR Approach

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ABSTRACT

Monetary policy is one of the most powerful and influential policy instruments available for an economy through which macro-economic and financial systems can be controlled. In order to run a healthy economy, it is crucial to understand how monetary policy works, through what mechanisms its policy actions are transmitted, what factors affect its transmission mechanisms, which channels are most effective and why they are effective. Thus, studying the transmission channels contributes to the understanding of the effectiveness of channels as well as the way monetary shocks affect the economy. This study, therefore, sought to examine the relative importance of the different monetary policy transmission channels and its effect on key macroeconomic variables (output and price) using quarterly time series data covering the period from 1994Q1 to 2016Q4 in Ethiopia. Structural Vector Autoregressive model was used to address the issues. The estimation result indicates that the monetary aggregate, exchange rate and credit channels are effective channels of monetary policy transmission in affecting output and inflation in Ethiopia, while the interest rate channel is weak. From a policy perspective, the results indicate that National Bank of Ethiopia is required to continuously monitor the developments of the monetary aggregate, the credit and foreign exchange markets in order to design effective monetary policies. In addition, it would help to the NBE to implement an effective monetary policy for achieving price and exchange rate stability and support sustainable economic growth through the appropriate monetary channels.

Keywords: Monetary policy Transmission Channel, National Bank, Ethiopia, SVAR