EXTERNAL AID INFLOWS AND THE REAL EXCHANGE RATE IN KENYA.

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M.A RESEARCH PROJECT

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Abstract.

This paper estimates an empirical model for Kenya's real exchange rate with special focus on foreign aid. A model of the real exchange rate determination is adopted and foreign aid proxied by the amount of overseas development assistance as a percentage of GDP incorporated as one of the fundamentals of the real exchange rate. The main hypothesis of the study is that aid inflows cause real appreciation. The results show that foreign aid has resulted into the depreciation of the real exchange rate for the period under study. This finding runs counter to the Dutch disease and theoretical expectations which predicts that aid inflows will lead to real appreciation. The probable reason for this effect is that there could have been some offsetting capital flows (capital flight), or that the impact of aid was neutralised through increased imports and sterilization by the central bank. The results further suggest that openness of the economy and depreciation of the nominal real effective exchange rate also lead to depreciation of the real exchange rate. Government consumption, technological progress and terms of trade are found to lead to real appreciation.

Though the depreciation of the real exchange rate is good for a small open economy like Kenya due to improvement in the international competitiveness of her exports, real depreciation can also be injurious to local importers since imports become relatively more expensive.

The study therefore, recommends that for external aid to be effective, policy management needs to focus on ensuring the prevalence of appropriate monetary and exchange rate management.