

Examining the Influence of Exchange Rate on Bilateral Trade Balance between Kenya and the European Union

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Abstract

The research investigated how exchange rate fluctuations influence the bilateral trade balance between Kenya and the European Union (EU). It relied on secondary data sourced from institutions such as the World Bank, the Central Bank of Kenya, and surveys conducted by the Kenya National Bureau of Statistics. Descriptive analysis was applied to reliable import and export data from selected EU countries, and the findings were presented narratively. The study focused on the period between 2001 and 2016. The results revealed that several key factors, including trade openness, inflation, and foreign aid shape Kenya's economic growth. Specifically, trade openness, net foreign assets, and oil prices emerged as significant determinants of growth. While greater trade openness was found to promote economic expansion, rising oil prices had the opposite effect, constraining Kenya's economic performance.

Keywords

National Economic growth, Global Financial Institutions, Currency Fluctuations, and Bilateral Trade Balance

1. Introduction

Exchange rate refers to the value of one country's currency relative to that of another. The stability of a nation's exchange rate directly affects its economic performance. A stable exchange rate often translates into steady growth in trade volumes (Wesseh & Niu, 2012). However, volatility in trade is much more pronounced in developing countries, reported to be up to four times higher than in developed nations (Calderon, Chong, & Loayza, 2002). Countries with unstable

exchange rates, therefore experience significantly higher levels of volatility.

In Africa, exchange rate overvaluation, where a currency is valued above its actual worth, has been more widespread in recent decades compared to the 1980s. Over time, many African nations have shifted from fixed exchange rate regimes to flexible ones, based on the belief that devaluation can improve economic performance. Advocates of flexible exchange rates argue that although devaluation may be costly, alternative adjustment mechanisms would be even less favorable. Bird (1998) notes that international financial institutions have actively promoted devaluation as a corrective measure against currency overvaluation, further encouraging developing countries to abandon pegged exchange rate systems.

Overvaluation in developing countries often fosters the growth of parallel, illegal foreign exchange markets that siphon scarce foreign currency from official channels. This phenomenon has been observed in countries such as Tanzania and Burma, where rationing of foreign exchange has created opportunities for a few individuals to reap significant profits (Csermely, 1994).

Kenya's exchange rate between 2001 and 2016 experienced both appreciation and depreciation, marked by episodes of sharp volatility (Oiro, 2015). Studies suggest that Kenya's exchange rate has often been misaligned, working to its disadvantage while favoring developed nations. For example, Kiptui and Kipyegon (2008) observed that exchange rate depreciation tends to generate trade dynamics that generally disadvantage developing economies, such as Kenya.

Kenya's main imports from the European Union (EU) include motor vehicles and spare parts, medicines, agrochemicals, and petroleum products. In contrast, its exports to the EU primarily consist of agricultural and horticultural products such as tea, coffee, tobacco, fish, sugar, textiles, fruits, and vegetables. Misalignments in the exchange rate have complicated this trade relationship, often undermining Kenya's position in the trade balance (Kiptui & Kipyegon, 2008). Against this backdrop, this study examines the effect of exchange rate movements on the bilateral trade balance between Kenya and the European Union.

2. Statement of the Problem

Kenya, as a developing economy, relies heavily on agriculture and tourism to drive growth. Trade relations with the European Union, however, have been persistently unbalanced. Imports from the EU consistently surpass Kenya's exports, and this disparity has worsened over the years. While imports continue to rise, Kenya's exports have not grown at the same pace, creating a trade imbalance that favors the EU.

Exchange rates play a critical role in shaping trade flows and determining volatility (Oiro, 2015; Ogutu, 2014). Yet, limited research has explored how trade partners like Kenya and the EU might achieve a more balanced trade relationship, thereby improving the balance of payments. This gap motivates the present study, which seeks to answer the following research question: What is the impact of exchange rate fluctuations on the bilateral trade balance between Kenya and the Eu-

European Union?

3. Purpose of the Study

The purpose of this research is to examine the effect of exchange rate fluctuations on the bilateral trade balance between Kenya and the European Union.

4. Objectives of the Study

The following objective guided the study:

- a) To determine the influence of the exchange rate on the bilateral trade balance between Kenya and the European Union.

5. Research Questions

The study was guided by the following research question:

- a) What was the influence of the exchange rate on the bilateral trade balance between Kenya and the European Union?

6. Significance of the Study

The findings of this research are likely to benefit several key stakeholders, including the Central Bank of Kenya, the Ministry of Trade, and the Ministry of Foreign Affairs, which are instrumental in creating a favorable environment for Kenya's bilateral trade relations with the European Union. These institutions also bear the responsibility of formulating policies that guide Kenya's participation in both bilateral and multilateral trade agreements. By providing evidence on the relationship between exchange rate fluctuations and trade balance, the study may assist policymakers in designing effective exchange rate policies that enhance Kenya's exports to the European Union in line with Vision 2030. Such policies would serve as guidelines for regulating imports and exports, ensuring that trade outcomes are more advantageous to Kenya.

In addition, the study contributes to the improvement of export policies and supports the adoption of flexible and independent monetary policies by the Central Bank of Kenya. When implemented effectively, such measures would stabilize exchange rate management, minimize fluctuations, and strengthen Kenya's balance of payments. The findings are also important for the agricultural and tourism sectors, which remain central to Kenya's economy and are highly sensitive to exchange rate volatility. Strengthening these sectors through better policy interventions would help Kenya gradually transition from its current developing status toward middle-income or even developed economy status.

7. Methodology

The study adopted a descriptive research design and relied on secondary data covering the period between 2001 and 2016. Data was obtained from credible institutions such as the World Bank, the Kenya National Bureau of Statistics, and the Central Bank of Kenya. Descriptive analysis, mostly by narration, was used to ex-

plain the characteristics of the data. Sometimes percentages were also used to illustrate the findings of the research. Descriptive research was used because it provides a comprehensive overview and a detailed understanding of the subject under investigation while at the same time providing room for comparison (Orodho, 2005). Variables relevant to the study's objectives were identified and analyzed to facilitate meaningful comparisons, which ultimately informed the conclusions regarding the nature of bilateral trade relations between Kenya and the European Union.

8. Data Analysis and Discussion

According to the study, the main traded goods between Kenya and the European Union were agricultural products, which were Kenya's exports to the European Union. Meanwhile, machinery, mineral products, as well as pharmaceutical and chemical products, were imported from the European Union. This has been shown in **Table 1** as illustrated below.

Table 1. Tabulation of Kenya's main exports and imports with the European Union.

Item	Type	% proportion
Agricultural goods like tea, coffee and flowers	Exports	25%
Machinery like automobiles & military aircrafts	Imports	25%
Mineral products like lubricants, oils, and iron	Imports	25%
Pharmaceutical and Chemical products	Imports	25%
TOTAL		100%

Table 1 above illustrates the trade imbalance between Kenya and the European Union. Kenya imports by far more goods from the European Union than it exports there. This is a misalignment in trade relations of Kenya with the European Union that favors the European Union more than Kenya. Thus, it creates an imbalance in trade where the European Union benefits more than Kenya does. The above **Table 1** illustrates that Kenya's main exports are agricultural goods, while its main imports are machineries, mineral products, as well as pharmaceutical and chemical products. Kenyan exports to the European Union were primarily agricultural, including tea, coffee, flowers, fruits, peas, and beans. Compared to the exports, the imports were significantly higher. The imports were mainly machinery, mineral products, as well as pharmaceutical and chemical products. The machineries were mainly passenger vehicles, personal cars, trucks, agricultural machinery, and military aircraft. The mineral products were mineral fuels, iron, steel, and oils. The pharmaceutical and chemical products were antibiotics, spirits, tinctures, pills, tablets, lozenges, and creams (Central Bank of Kenya, 2017).

There is a need for Kenya to increase its exports to the European Union to bring about balance in trade. Kenya could increase its exports in several ways. One such is by advocating for value addition (Swibe, 2023). According to Swibe (2023), agricultural goods could be further processed to increase quality as well as to be preserved for longer periods in order to reach the European markets without spoiling.

Swibe (2023) further advocates for benchmarking visitations to other areas, regions, and countries in order to come up with the best methods of carrying out value addition in Kenya. In this way, the quality of the Kenyan products would compete favorably on the world market. Another way of increasing the exports is by diversifying the goods for export. The overreliance on just a few agricultural goods would lead to Kenya exporting very few goods to the European Union compared to imports from such European countries. The regulations and policies regarding exports should be simplified. Thus, too many bureaucratic procedures could be done away with. This would reduce unnecessary queues during the export process to the European Union (Adewa, 2016).

The Kenyan government should come up with policies to reduce taxation on exported goods. This would encourage Kenyans to venture into exporting their goods to the international market, such as the European Union. Thus, taxation does not motivate investment in business but, on the contrary, discourages. Although taxation is very important in raising revenue for the government, it also significantly reduces citizens' ability to save their finances. Another way of increasing exports to the European Union is by improving access to finance. This could be done by making loans easily available to Kenyan exporters. Such loans should have low interest rates (Adewa, 2016). Adewa (2016) further avers that Kenya should negotiate trade agreements with other countries, such as the European Union, to remove barriers and facilitate the free flow of goods for export to foreign countries, including the European Union. Such barriers include unjustified packaging, labelling, and product standards, as well as other barriers like restrictive licenses as well as corrupt and lengthy customs procedures.

Several economic variables had a significant effect on Kenya's exchange rate and balance of payments in its trade with the European Union. These variables included productivity, oil prices, net foreign assets, and the openness of trade.

Productivity emerged as an important driver of economic growth, as higher productivity is generally associated with stronger exchange rates. Although Kenya has recorded improvements in areas such as agriculture and tourism, the growth has been relatively modest (Central Bank of Kenya, 2017). While exports from these sectors have increased, they have not kept pace with imports from the European Union, resulting in a balance of payments that is tilted in favor of the European Union. Balassa (1964) observed that technological progress typically increases productivity in developed countries, yet Edwards (1997) argued that the same pattern is not always evident in developing economies, where reliance on agriculture and slower technological progress limit gains.

Oil prices were another critical factor, with rising global oil costs shown to negatively affect Kenya's exchange rate (Central Bank of Kenya, 2017). As a net importer of oil, Kenya faces rising domestic production costs when oil prices increase, leading to currency depreciation and worsening trade imbalances with the European Union. This aligns with the findings of Kiptui and Kipyegon (2008), who noted that higher oil prices in global markets weaken developing economies

dependent on imports.

The level of net foreign assets also influenced trade outcomes. The European Union, as a developed region, holds far greater foreign assets compared to Kenya. This disparity enables the European Union to maintain stronger trade positions, while Kenya continues to face deficits as imports rise more sharply than exports.

The openness of trade was found to benefit the EU more than Kenya. Trade liberalization in Kenya has stimulated higher demand for imports, thereby depreciating the local currency and worsening the balance of payments (Central Bank of Kenya, 2017). Zakaria and Ghauri (2011) similarly observed that liberalization in developing countries tends to disproportionately increase imports, resulting in unfavorable trade balances.

The study was restricted to the period from 2001 to 2016 because it provided the real picture of Kenya's limited overreliance of exporting mainly agricultural products, while Kenya imported from the European Union a variety of diversified goods consisting of majorly machinery, mineral products as well as pharmaceutical and chemical products. This created a situation of misalignment where Kenya's imports were more than its exports to the European Union. This was thus a period of which Kenya experienced significant exchange volatility and a trade deficit favoring the European Union, which led to so much weakening of the Kenya shilling (Central Bank of Kenya, 2017).

9. Conclusion

The study set out to examine the impact of exchange rate fluctuations on the trade balance between Kenya and the European Union. The findings indicate a persistent misalignment in trade relations, consistently favoring the European Union. Several economic factors, including productivity, oil prices, net foreign assets, and trade openness, were shown to contribute significantly to this bilateral trade imbalance. While Kenya's exports, primarily agricultural products, have registered modest growth, they remain far lower than the rapidly increasing imports from the European Union.

In conclusion, Kenya's dependence on agriculture and tourism, combined with exchange rate misalignments and external economic pressures, has entrenched an unfavorable balance of payments with the European Union. Addressing these challenges requires deliberate policy interventions, improvements in productivity, and diversification of the economy to ensure more balanced and sustainable bilateral trade relations between Kenya and the European Union.

10. Recommendation of the Study

Based on the findings of this research, several recommendations can be proposed to improve Kenya's bilateral trade balance with the European Union. First, Kenya should consider establishing a strong regional exchange market comparable to the Johannesburg Stock Exchange in South Africa. Nairobi or Mombasa could serve as potential hubs for such a market, which would enhance the diversity of both

imports and exports and strengthen Kenya's role in regional and international trade.

Second, the government should develop and implement policies aimed at monitoring market fluctuations to minimize deviations in the exchange rate. These policies could include reducing dependence on imported oil and encouraging more efficient use of petroleum products. In addition, reviving the Changamwe Oil Refinery should be prioritized, as it would help the country reduce its vulnerability to global oil price shocks and stabilize its bilateral trade balance.

Globalization has created a growing demand for healthy and high-quality food products in international markets. To take advantage of these opportunities, Kenyan exporters should be trained on the requirements and standards of foreign markets. Equipping exporters with this knowledge would enable them to better access and compete in the European Union market, thereby improving Kenya's export performance and reducing the persistent bilateral trade imbalance.

Kenya as a government should explore a variety of ways to increase its exports to the European Union. One way of doing this is by simplifying the export regulations of the Kenyan exports. For instance, the bureaucratic procedures regarding the exportation of goods should be done away with. Hence, the long queues when it comes to the exportation of goods would also be avoided. Furthermore, the Kenyan government should provide relevant information regarding the export markets in the European Union so that Kenyan exporters can take advantage and increase the variety of goods to be exported to the European Union.

Conflicts of Interest

The authors declare no conflicts of interest regarding the publication of this paper.

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