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Currency Fluctuations and Foreign Direct Investment in Kenya



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Abstract

Purpose: This study investigates the relationship between currency fluctuations and Foreign Direct Investment (FDI) in Kenya over the period from 2013 to 2022.

Methodology: Employing a causal explanatory research design and time-series secondary data, the study identifies the trends and determinants of currency fluctuation and its relationship with FDI. Secondary data is collected from the CEIC website while PICOT is utilized to select the relevant studies for analysis. The correlation analysis is conducted using SPSS to determine the relationship between currency fluctuation and FDI.

Findings: The analysis reveals mixed uptrend and downtrend in both variables, showcasing a substantial reduction in FDI in recent years. The correlation analysis establishes a statistically significant negative relationship between exchange rates and FDI, in alignment with the theory of hysteresis and option values. This underscores the impact of currency fluctuations on inducing uncertainty, resulting in reduced FDI due to high sunk costs and delayed investment decisions.

Unique Contribution to Theory, Practice and Policy: The study fills a crucial gap in the existing literature by offering insights on the relationship between currency fluctuation and FDI in the Kenyan context. Policy implications stress on the importance of stabilizing the Kenyan Shilling, mitigating real shocks, and fostering economic diversification to enhance the attractiveness of Kenya to foreign investments. This study provides valuable guidance for policymakers, the Kenyan government, and stakeholders seeking to formulate strategies that promote a conducive environment for sustained FDI and economic growth in Kenya.

Key words: *Currency Fluctuations, Foreign Direct Investment, Kenya*



1. Introduction

Foreign Direct Investment (FDI) has become a cornerstone of economic development, facilitating the flow of capital, technology, and expertise across borders. Countries worldwide are engaged in intense competition to attract FDI, recognizing its transformative impact on local economies (UNCTAD, 2023). Global economic interconnectedness, however, comes with its challenges, and one such critical factor is currency fluctuations. The volatility in exchange rates has the potential to influence the decisions of multinational corporations and investors as they navigate the complexities of diverse markets (Lal et al., 2023).

The United States has historically been a magnet for foreign investors, driven by its large consumer market, technological prowess, and stable legal and regulatory environment. FDI in the U.S. encompasses a wide range of industries, including manufacturing, services, and technology (Cutler et al., 2020). The inflow of foreign capital contributes significantly to job creation, innovation, and the overall competitiveness of the U.S. economy. Asia has emerged as a powerhouse in the global economy, with countries like China, India, Japan, and others driving economic growth and innovation. The region attracts substantial FDI, becoming a focal point for multinational corporations seeking new markets and opportunities (Seong et al., 2023).

According to Morgan et al., (2022) Sub-Saharan Africa has experienced a surge in FDI inflows, contributing significantly to economic growth and industrialization. The region's attractiveness to foreign investors is shaped not only by its abundant resources and emerging markets but also by the currency dynamics that characterize the African financial landscape.

South Africa has been a significant destination for Foreign Direct Investment (FDI) over the years. The country's economic growth and development are intricately tied to its ability to attract foreign capital, which plays a pivotal role in funding infrastructure projects, creating employment opportunities, and fostering technological advancements. South Africa has historically relied on FDI to supplement domestic investment, bridge funding gaps, and stimulate economic growth. FDI brings not only capital but also managerial expertise, technology transfer, and access to global markets (Ndikumana et al., 2020). The success of South Africa's economic development hinges on its ability to maintain a favorable environment for attracting and retaining foreign investors. Foreign Direct Investment plays a pivotal role in Nigeria's economic development strategy. It brings in capital, technology, managerial skills, and creates employment opportunities, contributing to industrialization and the diversification of the economy away from oil dependence (Yao & Liu, 2023).

Ethiopia has experienced robust economic growth in recent years, driven by investments in key sectors such as agriculture, manufacturing, and services. The government's commitment to infrastructure development, policy reforms, and strategic geographic location has attracted the attention of global investors. As a result, FDI has become a crucial component of Ethiopia's

economic transformation, contributing to job creation, technology transfer, and the diversification of the economy (Oqubay, 2018).

Kenya's strategic location, diversified economy, and ongoing infrastructure development projects have attracted a considerable influx of FDI in sectors such as finance, manufacturing, energy, and telecommunications (International Trade Administration, 2022). FDI has become a catalyst for job creation, technology transfer, and the enhancement of local industries.

Currency fluctuations, characterized by changes in exchange rates, can significantly influence the attractiveness of a country for foreign investors. Kenya, like many other emerging economies, experiences fluctuations in its currency (European Investment Bank, 2022), the Kenyan Shilling (KES). These fluctuations can impact the profitability and risk perception of foreign investors operating in Kenya. Several factors contribute to currency fluctuations in Kenya, including global economic conditions, commodity prices, trade balances, and monetary policies. Additionally, domestic factors such as political stability, inflation rates, and fiscal policies can exert considerable influence on the value of the Kenyan Shilling.

According to Alhammouri & Alkhaldi (2017) comparative opportunity and risk are used as the determinant for investment decisions. Studies in the past have investigated the determinants of FDI in Kenya including the real interest rates, economic performance, urbanization, and external debts (Ndolo, 2015). However, there is no literature investigating the effect of currency changes on FDI. According to Oryema et al. (2022) currency is a major consideration by foreign investor based on whether it is overvalued or undervalued and extent of its variability. Despite the effect of currency fluctuations being studied in global literature, the results of such studies are usually inconclusive (Oryema et al., 2022).

Despite these efforts by the government to increase FDI, a report by CEIC data has revealed that the percentage of FDI to GDP has been decreasing gradually from 2017 (1.641%) to 2022 (0.347%) (CEIC Data, 2023). Studies have been conducted in the past evaluating the determinants of FDI with economists dedicated in investigating the reasons why multinational firms decide to invest in specific countries and why these determinants vary from time to time. Although the Central Bank of Kenya (2019) acknowledges that inflation and high level of currency fluctuation discourages investors from making long-term investments in the country since they are unsure of about the value of their investment, Kenya has experienced a significant depreciation of its currency in the recent years. Over the years the Kenya shilling has recorded significant volatility against the major currencies especially the US Dollar. According to Cyntonn, the Kenya shilling was weakened for the sixth year in 2022, recording a depreciation of 9%, 3.6% and 7.7% in 2022, 2021, and 2020 respectively (Cyntonn, 2023). Hanusch et al., (2018) highlights that volatility in currency is a potential deterrent to foreign investors since it increases the variance of the returns of overseas investments.

The decrease in Foreign Direct Investment (FDI) as a percentage of GDP in Kenya from 2017 to 2022, as reported by CEIC data, raises concerns about the potential impact of currency fluctuations on the country's attractiveness as an investment destination. The Kenyan Shilling's significant depreciation, particularly against the US Dollar, with a reported 9% decline in 2022, introduces uncertainty about the value of investments and poses challenges for foreign investors. While existing studies have explored various determinants of FDI in Kenya, there is a notable gap regarding the explicit examination of the influence of currency changes on FDI. Comparative opportunity and risk, identified as crucial determinants by Alhammouri & Alkhaldi (2017), highlight the need for a focused investigation into the relationship between currency fluctuations and FDI, addressing the concerns raised by the Central Bank of Kenya (2019) and aligning with findings by Hanusch et al. (2018). This study aims to fill this gap, providing insights essential for policymakers, investors, and stakeholders to enhance Kenya's appeal to foreign capital.

Therefore, the main aim of the study is to investigate the correlation between foreign direct investment (FDI) and currency fluctuations in Kenya. The specific objectives are: first, to analyze the trend of currency fluctuations in Kenya from 2013 to 2022 and identify its determinants; second, to examine the trend of FDI in Kenya during the same period; and third, and to determine the relationship between currency fluctuations and FDI in Kenya. These objectives guide the research in exploring the dynamics and interconnections between FDI and currency fluctuations within the Kenyan economic context.

2. Literature Review

The production flexibility argument and the theory of hysteresis and option values are two most dominant theories underpinning the relationship between currency fluctuation and FDI. The argument of production flexibility indicates that the major goal of foreign investors investing in a foreign country is to take advantage of the production flexibility and the macroeconomic uncertainty but not to export or re-export. According to Abel (1983) currency fluctuations increases the investment of the risk-neutral competitive organizations due to convex costs of adjustment. The production flexibility is based on the assumption that producers have the power to adjust the production costs such as capital costs and labor costs emanating due to price variability emanating from currency fluctuations. This results to firms experiencing production flexibility advantage more than the risk uncertainty. Cushman (1985) further reveals that multinational companies that invest in foreign countries in response to appreciation risk reduce exports to the foreign country but offset the decrease through exports by increasing capital increase and production. Therefore, there is a positive correlation between the currency fluctuations or price volatility with firms investing on a foreign market since it helps in production diversification, used as a shock absorber, or to compete with rivals within the same industry.

On the contrary, the theory of hysteresis and option value indicates that currency fluctuations leads to uncertainty thereby leading to reduced FDI emanating from high sunk cost which leads to delays

in investment. Dixit & Pindyck (1994) indicates that due to the intrinsic irreversibility of FDI, fluctuations tends to increase the “Marshallian zone of Inaction” and to avoid large sunken costs. The real-option theory that assumes the uncertainty and irreversible investment stresses that a firm gains value in flexibility by delaying an investment decision due to the fact that the investments are either completely or partially irreversible until the uncertainty is eliminated. Based on the belief that investors are risk averse rather than risk neutral, then the overall impact of uncertainty on investment is negative (Zeira, 1990). Since the waiting value increases with uncertainty even when considering risk-neutral firms, then currency fluctuation that increases uncertainty deters FDI decisions by foreign firms (Dixit & Pindyck, 1994).

For completeness, there is a section of literature that indicates that currency fluctuation may not be a major concern for foreign investors where other factors in the developing country or the host country determine the level of investment flow (Dehn, 2000). Examples of such factors include the geographical location, the abundance of natural resources and infrastructural development. As a result, currency fluctuation is likely to have an insignificant effect on the expected FDI flows.

3. Methodology

This study adopts a causal explanatory research design to investigate the correlation between currency fluctuations and Foreign Direct Investment (FDI) in Kenya. The research utilizes time-series secondary data covering the period from 2013 to 2022. The selection of this ten-year period is based on the consideration that it is sufficient to capture relevant trends, patterns, and fluctuations in both FDI and currency values. This study uses case study approach of Kenya and therefore no need of a sampling frame. Additionally, the data was collected from the CEIC website which has been in operation for over 30 years and has been the go-to source for providing reliable data to economists, investment professionals, business planners, government officials and academics. Secondary data on exchange rates and Foreign Direct Investment (FDI) as a percentage of Nominal Gross Domestic Product (GDP) in Kenya were collected. The use of reputable and regularly updated data source enhances the reliability and accuracy of the information used in the study. To identify and analyse the underlying causes of currency fluctuation, the Population, Intervention, Comparison or Control, Outcome, and Time (PICOT) framework was employed as a guide for the selection of studies to explain the trends in currency fluctuation, specifically focusing on Kenyan studies. Descriptive and inferential analyses were employed to investigate the impact and relationship between exchange rate fluctuations and Foreign Direct Investment (FDI) in Kenya. Descriptive statistics included line graphs to determine the trend for the two variables over the specified period, and scatter plots were used to visualize the relationship between exchange rate fluctuations and FDI. The Statistical Package for the Social Sciences (SPSS) was utilized for estimating the results of correlation, kurtosis, and skewness of the variables. Bivariate correlation, specifically using Pearson Correlation (r), was employed to evaluate the relationship between exchange rates and FDI.

4. Results and Discussion

The trend of currency fluctuations in Kenya from 2013 to 2022 and its Determinants

The figure below provides a visual representation of the trend of currency fluctuation between 2013 and 2022.

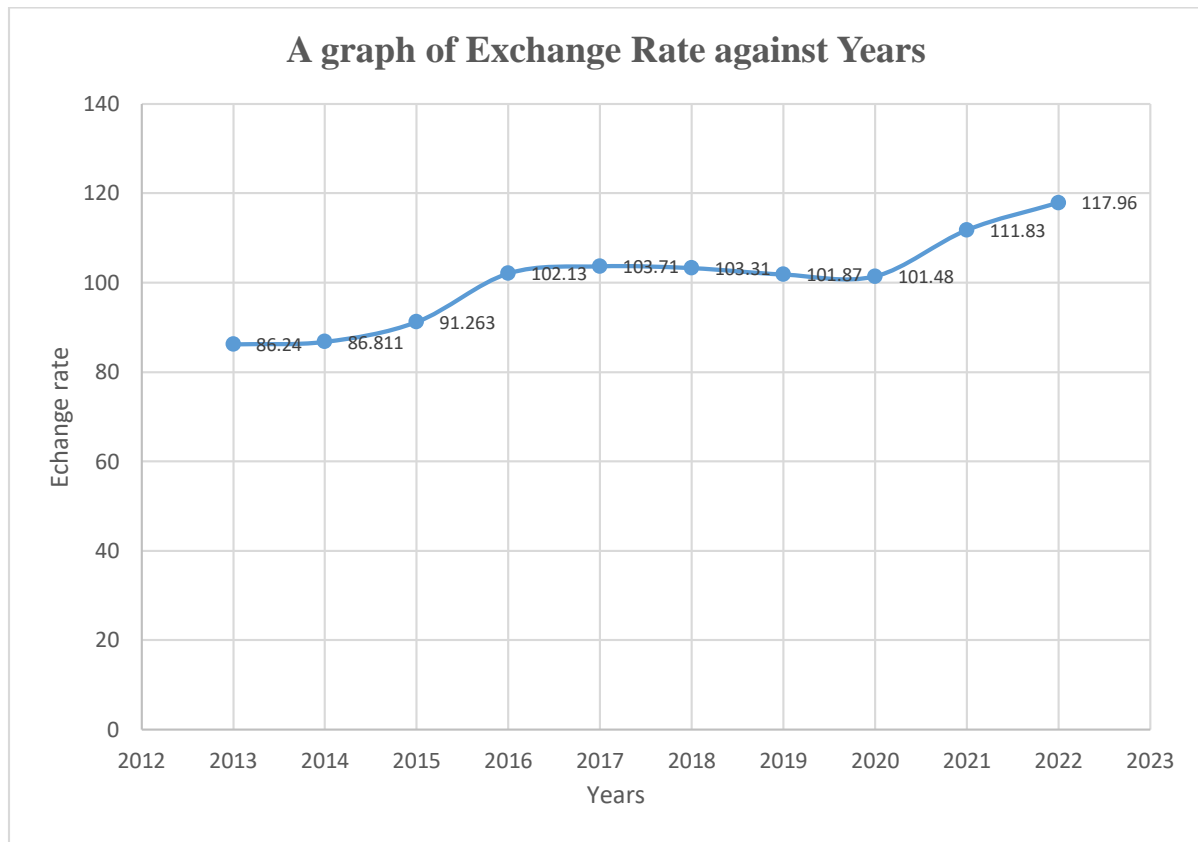


Fig 4.1: A graph of exchange rate against years

The exchange rate trend in Kenya between years 2013 and 2022 is visualized by Fig. 4.1 reveals distinctive patterns over the specified period. In the initial years from 2013 to 2015, the exchange rate remained relatively stable, fluctuating within the range of 86.24 to 91.263. This suggests a period characterized by minimal currency fluctuation. Moving into the subsequent years, from 2016 to 2018, the exchange rate experienced a slight increase, peaking at around 103.71 in 2017 and slightly decreasing to 103.31 in 2018. This indicates a period of currency appreciation, reflecting a rise in the value of the Kenyan Shilling against the reference currency, presumably the US Dollar. However, from 2019 to 2022, the trend shifts, and the exchange rate continues to rise, reaching 117.96 in 2022. This signifies a period of currency depreciation, indicating a decline in the value of the Kenyan Shilling against the reference currency.

Several determinants may be affecting the fluctuation of the Kenyan currency between the year 2013 and 2022 as demonstrated by the four studies that meets the PICOT criteria. Ogutu (2014) concluded that a positive and significant effect of trade balance on the depreciation of the Kenyan currency. The study also highlighted the importance of maintaining a flexible exchange rate while implementing necessary interventions through the Central Bank to stabilize the currency. Additionally, it revealed that shocks had adverse the real exchange rate, indicating a need for measures to mitigate these shocks. Next, Wasike (2013) revealed that economic strength, expectations, inflation rates, and political influences are identified as key determinants of currency fluctuation. Notably, the study highlighted the impact of budget reading expectations, current account deficits, and political interference on the foreign market of Kenyan products. The findings underscored the complexity of factors influencing currency fluctuations, ranging from economic indicators to political events. Kiptui's study (2015) indicated that demand shocks significantly influenced the real exchange rate, highlighting the role of real shocks in driving currency movements. The study also suggested that Kenya's exchange rate could play a stabilizing role, particularly if it absorbs real shocks and is less affected by controllable nominal shocks. This underscores the interconnectedness of real economic factors and exchange rate dynamics. Lastly, Abid et al. (2020) interest rates, inflation, and remittances as significant predictors of exchange rate volatility. The findings aligned with economic theories such as Interest Rate Parity (IRP) and Purchasing Power Parity (PPP), emphasizing the impact of interest rates in attracting foreign investors and the role of inflation in influencing exchange rate volatility.

The period of stability period of the currency from 2013 to 2015 may be attributed to the influence of economic strength, expectations, and political stability, as noted by Wasike (2013), acting as stabilizing factors. The subsequent uptrend from 2018 to 2019, indicating currency appreciation, aligns with factors such as increased economic growth and optimism. However, the shift in the trend towards depreciation from 2019 to 2022. This depreciation may be linked to a myriad of factors, including high inflation rates, as highlighted by Wasike (2013), and adverse shocks impacting the real exchange rate, as indicated by Ogutu (2014). The complex interplay of these determinants underscores the need for a comprehensive understanding of economic indicators, political events, and global dynamics to accurately grasp the intricacies of exchange rate dynamics in Kenya.

The trend of FDI in Kenya

Fig. 4.1 visualizes the trend of FDI in Kenya between 2013 and 2022.

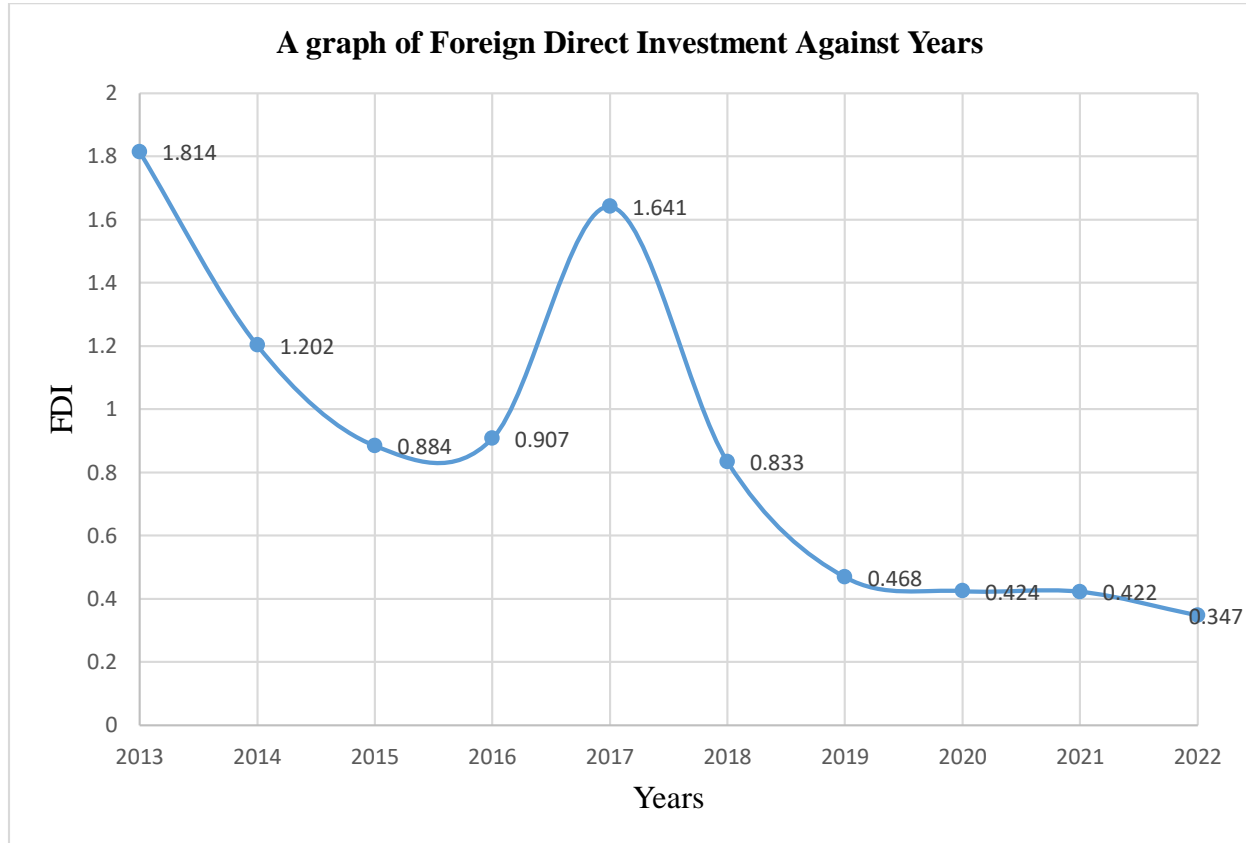


Fig 4.2: A graph of foreign direct investment against years

Fig. 4.2 visualizes the trend of Foreign Direct Investment (FDI) in Kenya over the years 2013 to 2022 which exhibits notable fluctuations. In 2013, FDI was at its peak at 1.814. However, this upward trajectory was followed by a substantial decline in 2014, with FDI dropping to 1.202, signifying a downtrend. The trend continued downward in 2015, where FDI reached 0.884. In 2016, there was a reversal of the downtrend, as FDI increased to 0.907. The year 2017 marked a significant uptrend, recording the highest value in the dataset at 1.641. However, this was followed by a sharp decline in 2018, with FDI dropping to 0.833. The downtrend continued in 2019, where FDI decreased to 0.468. In 2020, FDI remained relatively stable, indicating a period of consistency with a slight decrease to 0.424. The downtrend persisted in 2021, as FDI further declined to 0.422. The data for 2022 shows a notable decrease, reaching 0.347, signaling a continued downtrend in foreign investment. Overall, the FDI trend in Kenya has been characterized by periods of both uptrends and downtrends, reflecting the dynamic nature of economic conditions and external factors influencing foreign investment over the specified years.

The Relationship between Currency Fluctuations and FDI in Kenya

The table below presents the results for the correlation between the exchange rate and FDI.

Table 4.1 Correlation between exchange rate and FDI

Correlations		EXR	Fdi
EXR	Pearson Correlation	1	-.650*
	Sig. (2-tailed)		0.042
	N	10	10
Fdi	Pearson Correlation	-.650*	1
	Sig. (2-tailed)	0.042	
	N	10	10

* Correlation is significant at the 0.05 level (2-tailed).

Source: Statistical Package for the Social Sciences

Table 4.1 presents the results of the correlation analysis between the exchange rate (EXR) and Foreign Direct Investment (FDI) in Kenya. The Pearson Correlation coefficient between EXR and FDI is -0.650, and this correlation is found to be statistically significant at the 0.05 level (2-tailed). The negative sign of the correlation coefficient indicates an inverse relationship between exchange rates and FDI. Therefore, as the exchange rates fluctuate, there is a tendency for FDI to move in the opposite direction. The significance level of 0.042 suggests that the observed correlation is unlikely to be due to random chance, providing confidence in the reliability of the relationship. The correlation coefficient of -0.650 suggests a moderate to strong negative correlation, implying that as exchange rates increase or decrease, FDI is likely to respond with a corresponding decrease or increase.

These results align with the literature emphasizing the theory of hysteresis and option values (Dixit & Pindyck, 1994). This negative correlation supports the argument that currency fluctuations lead to uncertainty, resulting in reduced FDI due to high sunk costs and investment delays, as proposed by Dixit & Pindyck. The inverse relationship between exchange rates and FDI, supports the notion that as the currency fluctuates, FDI tends to move in the opposite direction. This result contradicts the production flexibility argument, which posits a positive correlation between currency fluctuations and FDI, suggesting that firms invest in foreign markets to take advantage of production flexibility and macroeconomic uncertainty, not necessarily for exporting or re-exporting (Abel, 1983; Cushman, 1985). The statistically significant correlation coefficient and its direction imply that currency fluctuation-induced uncertainty deters FDI decisions by foreign firms, reinforcing the theory of hysteresis and option values in the context of the Kenyan economy (Dixit & Pindyck, 1994; Zeira, 1990).

5. Conclusion

In conclusion, this study aimed to investigate the relationship between currency fluctuations and Foreign Direct Investment (FDI) in Kenya. Through a comprehensive analysis of currency

fluctuation and FDI data spanning between 2013 and 2022, the study identified distinct trends in both currency values and FDI. Specifically, there was no clear trend in both FDI and currency fluctuation. However, the trend reveals that the FDI has reduced significantly in the recent years while the inward. The results, particularly the significant negative correlation between exchange rates and FDI, align with the theory of hysteresis and option values. The findings emphasize the role of currency fluctuations in inducing uncertainty, leading to reduced FDI due to high sunk costs and delayed investment decisions. These insights contribute to the existing literature by addressing the specific gap in understanding the impact of currency changes on FDI in the Kenyan context. Policymakers, including the Kenyan government and the Central Bank, along with investors and stakeholders, can leverage these findings to formulate strategies that mitigate the adverse effects of currency fluctuations, fostering a more conducive environment for foreign investments in Kenya.

6. Recommendations

The policy implications of this study underscore the importance of implementing measures by the Kenyan government and the Central Bank to stabilize the Kenyan Shilling and minimize the impact of currency fluctuations to promote Foreign Direct Investment (FDI) in the country. Policymakers should focus on maintaining economic stability, addressing inflation rates, and implementing flexible exchange rate mechanisms. Additionally, efforts to absorb and mitigate real shocks, as highlighted in the literature, can contribute to creating a more predictable investment climate. Policymakers, including the Kenyan government, may consider implementing targeted interventions during periods of heightened uncertainty to reassure foreign investors. Furthermore, fostering economic diversification, infrastructure development, and enhancing political stability can act as catalysts for attracting FDI, mitigating the negative effects of currency fluctuations. Overall, a holistic approach to economic management and policy formulation is essential to enhance Kenya's attractiveness as an investment destination.

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