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Profiling Kenya's Exchange-Rate Misalignment and Its Co-movement with EU Export and Import Flow

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Abstract

Despite Kenya's export-oriented strategies, its trade balance remains import-driven, resulting in a persistent deficit that mirrors the depreciation of the Kenyan shilling. This study examined Kenya's exchange-rate misalignment and its relationship with trade flows with the European Union (EU) from 2015 to 2024. Using secondary data and a descriptive–correlational design, analysis was based on Purchasing Power Parity (PPP) and misalignment theory. Results show that the Real Exchange Rate (RER) remained consistently undervalued relative to the euro, while Kenya's trade deficit with the EU persisted, reflecting structural import dependence despite export growth. Correlation analysis revealed a significant negative association between exchange-rate misalignment and exports ($r = –0.692$, $p < 0.05$), but no significant link with imports or the trade balance. These findings indicate that shilling undervaluation supports export growth but has limited effect on imports and the deficit. The study concludes that exchange-rate policy should be complemented by industrial and trade diversification to address structural drivers of import dependence and strengthen Kenya's external balance.

Keywords: Bilateral Trade; Competitiveness; Purchasing Power Parity; Real Exchange Rate

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1. Introduction

Exchange rate misalignment referring to the gap between the real exchange rate (RER) and its equilibrium level carries important consequences for trade competitiveness and overall macroeconomic stability. In developing economies, including those in Africa, persistent misalignment has been associated with slower economic growth, structural trade imbalances, and reduced export performance, whereas economies with prudent exchange rate management have achieved more sustainable trade growth (Yotopoulos & Sawada, 2005).

Under floating exchange rate regimes, misalignment is often driven by speculative pressures that cause excessive

deviations from economic fundamentals. In fixed or managed regimes, misalignment typically reflects weak policy fundamentals that hinder appropriate adjustment to external and domestic shocks. Regardless of the exchange rate regime, sustained misalignment can undermine investment incentives, particularly in tradable goods sectors, and distort the structure of exports and imports (Ayele, 2022).

Within international trade, shifts in exchange rates change the relative prices of domestic versus foreign goods, thereby shaping trade flows. For developing countries, appreciation of the nominal exchange rate tends to reduce export competitiveness while stimulating imports, thereby widening trade deficits. Empirical evidence indicates that African economies, on average, experience higher exchange rate volatility than developed countries, largely due to weaker institutional capacity for exchange rate management (Gachoki, Okeri & Korir, 2021). This volatility increases transaction risk for exporters and importers, making the predictability of the exchange rate a critical factor in trade decision-making.

Ayele (2021) noted that, historically, the overvaluation of African currencies has eroded exporters' price competitiveness, discouraged production in the tradable sector, and, in some cases, fostered the emergence of parallel foreign exchange markets. According to Gachoki, Okeri, and Korir (2021), policy responses have included currency depreciation, the adoption of more flexible exchange rate regimes, and targeted trade measures such as import tariffs and export subsidies. These adjustments have had measurable effects on both the volume and the direction of trade flows.

In the case of Kenya, the degree of exchange rate misalignment and its interaction with bilateral trade flows particularly with key trading partners such as the European Union remains a critical area for empirical examination. Understanding this relationship is essential for informing policies aimed at enhancing Kenya's external competitiveness and ensuring sustainable trade growth.

2. Statement of the Problem

Despite successive policy reforms such as exchange rate liberalization and preferential EU market access under the African, Caribbean, and Pacific (ACP) countries and Economic Partnership Agreement (EPA) frameworks; Kenya's trade deficit with the EU has continued to widen over the years. The Kenya shilling has experienced episodes of significant fluctuation and misalignment, posing risks to trade competitiveness and stability. Although existing studies confirm that exchange rate volatility influences trade, few have examined how misalignment specifically co-moves with Kenya's export and import flows to the EU within the context of non-reciprocal trade agreements. This gap limits the evidence base needed to guide policies that align exchange rate management with Kenya's trade objectives. This study aims to describe the extent of Kenya's exchange rate misalignment and its relationship with bilateral trade flows between Kenya and EU.

3. Specific Objectives

a) To measure the degree of Kenya's exchange rate misalignment over the study period.

b) To describe the patterns and trends of bilateral trade flows between Kenya and the EU.

c) To examine the association between Kenya's exchange rate misalignment and its trade flows with EU.

4. Theoretical Framework

The Purchasing Power Parity (PPP) theory is one of the foundational models for explaining exchange rate determination and assessing currency misalignment. PPP asserts that, when prices are expressed in a common currency, identical goods and services should cost the same across countries (Krugman & Obstfeld, 2018). In its absolute version, Purchasing Power Parity (PPP) is satisfied when the nominal exchange rate matches the ratio of domestic to foreign price levels. In its relative version, PPP emphasizes dynamics over time, asserting that the rate of change in the exchange rate corresponds to the inflation differential between two countries.

In practice, PPP often fails to hold in the short run due to market frictions, trade barriers, differences in consumption baskets, transportation costs, and divergent economic structures (Murray & Papell, 2005). For developing economies such as Kenya, additional challenges such as concentrated export baskets, vulnerability to commodity price swings, and reliance on imports for capital goods can cause persistent deviations from PPP (Kiptui & Kipyegon, 2008).

When exchange rates deviate systematically from their PPP-implied levels, exchange rate misalignment occurs. Persistent overvaluation can erode export competitiveness, while undervaluation may temporarily boost exports but risk inflationary pressures and trade retaliation. In the Kenya–EU trade context, misalignment can erode the price advantage provided by preferential agreements like the Cotonou Partnership and Economic Partnership Agreement (EPA), reducing the effectiveness of duty-free and quota-free access to EU markets.

Empirical studies indicate that Kenya's shilling has undergone recurrent episodes of misalignment and volatility, influenced by inflation differentials, terms of trade shocks, capital flows, and policy shifts (Oiro, 2015). These deviations have coincided with widening trade deficits with the EU, despite preferential market access, suggesting that misalignment can distort the co-movement of export and import flows. By applying the PPP framework to measure and profile Kenya's exchange rate misalignment, this study provides an analytical foundation for assessing its interaction with bilateral trade performance.

5. Literature Review

5.1 Exchange Rate Regimes and Misalignment in Kenya

Kenya's exchange rate policy has undergone significant transformations since independence, shifting from a fixed regime to a market-determined system. Between 1963 and 1982, the East African shilling and later the Kenya shilling were pegged to the US dollar. This fixed regime coincided with persistent overvaluation, which reduced export competitiveness and prompted the government to employ tariffs, import controls, and export subsidies to manage trade imbalances (Kiptui & Kipyegon, 2008). From 1983 to 1993, the country adopted a crawling peg, characterized by substantial devaluations including three in 1993 aimed at correcting overvaluation and securing structural adjustment financing from the IMF and World Bank.

The shift to a fully floating regime in 1993 was designed to allow market forces to determine the exchange rate and improve export incentives. However, volatility persisted, driven by inflation, trade deficits, and external shocks such as oil price fluctuations and the global financial crisis (Oiro, 2015). According to Gachoki, Okeri, and Korir (2021), Kenya also experimented with a dual exchange rate system in the early 1990s before fully liberalizing by the mid-1990s. Despite these reforms, the Kenyan shilling has experienced recurrent misalignment and volatility, with episodes of sharp depreciation and appreciation stemming from external shocks, speculative pressures, and policy inconsistencies. Such deviations from equilibrium have distorted price competitiveness, undermined investment incentives, and eroded the predictability required for stable trade relations.

Misalignment has important trade implications in that overvaluation erodes export competitiveness, while undervaluation raises the cost of imports. Empirical evidence from East Africa confirms that both misalignment and volatility impose tangible macroeconomic costs, including reduced economic growth and distorted trade flows (Oiro, 2015). Theoretical and empirical studies further highlight the negative effects of exchange rate instability on trade performance. Volatility increases transaction risks and hedging costs for exporters and importers, while sustained misalignment exerts longer-lasting impacts on trade flows. In the Kenyan context, research by Oiro (2015) and Musyoki, Pokhariyal, and Pundo (2012) finds that exchange rate fluctuations affect both export revenues and import demand. However, much of the literature focuses on short-term volatility, with limited attention to the distinct and persistent effects of prolonged misalignment a gap that is critical to understanding Kenya's trade dynamics with major partners such as the EU.

5.2 Trade Performance Between Kenya and EU

The European Union (EU) is one of Kenya's largest trading partners, importing mainly horticultural products, tea, and coffee, while exporting industrial machinery, chemicals, and manufactured goods to Kenya. Despite preferential market access under the Cotonou Partnership Agreement and later the Economic Partnership Agreement (EPA), Kenya's trade balance with the EU has remained in a persistent and widening deficit (Raga, Mendez-Parra, & te Velde, 2021). Between 2001 and 2003, Kenya's imports and exports to the EU moved closely together, but by 2011 the trade deficit had expanded significantly, reaching approximately 10% of GDP. Although exports to markets such as Spain, Italy, and Belgium grew during this period, they were consistently outpaced by imports of high-value industrial goods, particularly aircraft, electrical machinery, and power generation equipment (Republic of Kenya, 2013).

Multiple factors have contributed to the underperformance of Kenya's exports relative to imports. Exchange rate instability especially when coupled with overvaluation has eroded price competitiveness, while structural supply constraints and external shocks, including the global financial crisis, have further hindered export growth (International Monetary Fund [IMF], 2021). Empirical evidence from 2000 to 2016 indicates an average exchange rate misalignment of roughly ±6%, with misalignment tending to reduce imports and exerting an ambiguous effect on exports. Policy recommendations from these findings emphasize maintaining the Kenyan shilling within a narrow stability band while monitoring economic fundamentals (Gachoki, Okeri, & Korir, 2021).

At the regional level, studies in East Africa and Sub-Saharan Africa (SSA) reveal that real effective exchange rate (REER) misalignment and volatility impose tangible macroeconomic costs. For East African least-developed countries, deviations from equilibrium REER are linked to weaker growth (Ayele, 2021), while updated SSA

evidence shows significant exchange-rate pass-through to inflation, meaning that currency fluctuations can rapidly alter the relative prices faced by exporters and importers (IMF, 2021). Furthermore, recent African panel studies covering 2005–2019 and 1970–2019 report asymmetric and nonlinear impacts of exchange rate movements on trade balances and output, indicating that depreciations and appreciations have unequal effects (Raga et al., 2021). These insights underscore the importance of profiling the co-movement between Kenya's exchange rate misalignment and EU export and import flows rather than relying solely on simple correlation measures.

5.3 Research Gaps in Kenya–EU Trade Linkages

While prior studies confirm that exchange rate volatility impacts Kenya's trade flows, few have examined the specific role of exchange rate misalignment in shaping bilateral trade with the EU, particularly under non-reciprocal trade arrangements. This gap provides the basis for the current study.

6. Methodology

This study employed a descriptive–correlational research design using secondary data to profile Kenya's exchange-rate misalignment and its co-movement with EU export and import flows. The design was appropriate because the objective was to establish the nature and extent of the relationship between real exchange rate misalignment and bilateral trade flows without manipulating any variables (Mugenda & Mugenda, 2019). It enabled a factual and systematic description of trends in Kenya–EU trade performance, while also examining how misalignment corresponded with import and export patterns over time.

The study relied on secondary time-series data spanning the period 2015–2024. Data for all variables were obtained from reputable sources, including the World Bank (2025), Eurostat (2025), the Central Bank of Kenya (2025), the European Commission (2025), and historical records from global exchange rate and currency market databases (2025).

7. Statistical Analysis

In this study, the Purchasing Power Parity (PPP) approach was used to measure exchange rate misalignment. The procedure involved two steps:

RER was obtained by adjusting the nominal exchange rate (NER) for relative price levels between Kenya and the EU.

$$RER = NER \times (\frac{CPI - KES}{CPI - EUR})$$

The degree of Misalignment was established based on PPP Benchmark.

$$\%\, misalignment = (\frac{RER - \frac{1}{PPP}}{\frac{1}{PPP}}) \times 100$$

Bilateral trade flow data between Kenya and the EU were collected and used to compute trade growth rates and trade balances. Tables and graphs were then employed to illustrate and describe the patterns and trends over the study period. Lastly, Pearson correlations were used to examine the association between Kenya's exchange rate misalignment and its trade flows with the EU.

8. Results

8.1 To measure the degree of Kenya's exchange rate misalignment.

Table 1 shows that all values are negative, indicating that the RER is below the PPP benchmark. This means the Kenyan shilling was undervalued relative to the Euro throughout 2015–2024.

Table 1. Exchange Rate Misalignment between KES-EUR based on PPP (with base year 2015)

YEAR	EUR/KES	CPI-EU	CPI-KE	RER	PPP (EUR)	1/PPP	% ER
2015	0.0092	100.00	100.00	0.00920	35.83	0.0279	-67.0
2016	0.0089	100.18	106.30	0.00839	36.41	0.0275	-69.5
2017	0.0086	101.74	114.90	0.00762	36.60	0.0273	-72.1
2018	0.0084	103.57	120.20	0.00724	35.79	0.0279	-74.1
2019	0.0088	105.04	126.40	0.00731	38.09	0.0263	-72.2
2020	0.0082	105.76	133.30	0.00651	37.67	0.0265	-75.4
2021	0.0077	108.82	141.50	0.00592	35.81	0.0279	-78.8
2022	0.0081	118.82	152.30	0.00632	40.21	0.0249	-74.6
2023	0.0066	126.38	164.00	0.00509	40.01	0.0250	-79.6
2024	0.0069	129.67	171.40	0.00522	41.53	0.0241	-78.3

The RER remains consistently below the PPP-implied rate, reflecting a persistent undervaluation. The degree of undervaluation increases over time, peaking around 2023. This trend corresponds to the depreciation of the nominal exchange rate combined with faster inflation in Kenya relative to the EU, which makes Kenyan goods cheaper in real terms for EU buyers. The declining RER and rising undervaluation suggest that Kenyan exports to the EU likely became more competitive, while imports from the EU became more expensive in Kenya due to the weaker shilling. Faster inflation in Kenya relative to the EU (CPI-KE > CPI-EU) further reinforced the real undervaluation and Kenya's export competitiveness. The Kenya Shilling (KES) remained consistently undervalued against the Euro (EUR) between 2015 and 2024, based on PPP deviations. While slight year-to-year fluctuations were observed, the undervaluation trend persisted at relatively high levels throughout the period.

8.2 To describe the patterns and trends of bilateral trade flows between Kenya and the EU.

Table 2 shows that imports from the EU rose from €1.72 billion in 2015 to €1.96 billion in 2024, representing a net growth of 14%. Over the same period, exports to the EU increased from €964 million to €1.40 billion, a net growth of 45%. Despite this faster export growth, Kenya's trade balance with the EU remained consistently negative, with the deficit ranging from –€459 million in 2023 (smallest) to –€882 million in 2020 (largest). This indicates that while Kenya remains heavily dependent on EU imports, its growing exports have helped to slightly narrow the trade deficit.

Imports fluctuate with economic conditions (global crises, shocks, demand cycles) especially in 2016, 2019 and 2023 while exports were volatile but on a rising trend, closing some gap with imports. The KE-EU trade deficit is consistently negative meaning that Kenya remains structurally dependent on EU imports, though its export growth is helping moderate the deficit.

Table 2. Total Good: KE-EU trade flows and balance, annual data 2015-2024

Year	Imports (M EUR)	% growth	Exports (M EUR)	% growth	Balance (M EUR)
2015	1721		964		-757
2016	1515	-11.90	894	-7.30	-622
2017	1528	0.80	930	4.10	-598
2018	1659	8.60	925	-0.50	-734
2019	1621	-2.30	988	6.70	-633
2020	1874	15.60	992	0.40	-882
2021	1896	1.20	1078	8.70	-818
2022	2009	6.00	1256	16.50	-754
2023	1721	-14.30	1263	0.50	-459
2024	1960	13.90	1403	11.10	-557

Kenya consistently ran a trade deficit with the EU between 2015 and 2024, as imports remained higher than exports

throughout the period. Imports generally trended upward with fluctuations, while exports, though smaller, grew more rapidly and slightly narrowed the gap. The deficit peaked around 2020 when imports surged and exports stagnated, but improved in 2023 as imports declined and exports stabilized. Overall, the trend reflects Kenya's structural reliance on EU imports alongside a gradual strengthening of exports.

8.3 To examine the link between Kenya's exchange rate misalignment and its trade flows with the EU

As undervaluation deepens (with more negative misalignment), Kenya's exports generally increase, suggesting a positive co-movement between exchange rate undervaluation and export growth. Imports, by contrast, rise modestly and display a weaker, less consistent relationship with misalignment. The trade balance fluctuates over the period but shows signs of narrowing in recent years, indicating that undervaluation likely supports exports and contributes to reducing the trade deficit.

Table 3. Correlations

Variables		Misalignment	Exports	Imports	Balance
Misalignment	Pearson Correlation	1	-.692*	-.566	-.170
	Sig. (2-tailed)		.027	.088	.638
	N	10	10	10	10
Exports	Pearson Correlation	-.692*	1	.729*	.366
	Sig. (2-tailed)	.027		.017	.298
	N	10	10	10	10
Imports	Pearson Correlation	-.566	.729*	1	-.369
	Sig. (2-tailed)	.088	.017		.293
	N	10	10	10	10
Balance	Pearson Correlation	-.170	.366	-.369	1
	Sig. (2-tailed)	.638	.298	.293	
	N	10	10	10	10
*. Correlation is significant at the 0.05 level (2-tailed).					

The correlation analysis in Table 3 reveals a statistically significant negative association between exchange rate misalignment and Kenya's exports to the EU ($r = –0.692$, $p < 0.05$). In contrast, there is a statistically significant positive association between exports and imports ($r = 0.729$, $p < 0.05$). This implies that overvaluation of the Kenyan shilling reduces exports, while undervaluation supports them, consistent with economic theory.

By contrast, the association between misalignment and imports ($r = –0.566$) and trade balance ($r = –0.170$) is weaker and statistically insignificant, suggesting that Kenya's import demand from the EU and its persistent trade deficit are less sensitive to exchange rate misalignment and more influenced by structural trade patterns. Overall, the findings confirm that undervaluation of the shilling tends to improve Kenya's export performance to the EU, but its effect on imports and the overall trade balance is limited.

9. Discussion

9.1 Kenya's Exchange Rate Misalignment Dynamics

The results show that Kenya's real exchange rate (RER) between 2015 and 2024 remained generally misaligned, alternating between undervaluation and overvaluation. Evidence from the Central Bank of Kenya (2018) indicates that the shilling was largely undervalued between 2015 and 2017, with small but persistent gaps from equilibrium. More recently, the International Monetary Fund (2023) reported a shift in misalignment signs, estimating an overvaluation of 4–15 percent in 2022, followed by an undervaluation of –1 to –7.6 percent in 2023 after significant currency adjustment. These findings confirm that the shilling exhibited both over- and undervaluation within the period, consistent with the empirical estimates presented in this study.

The estimates further point to persistent undervaluation during much of the sample period, as shown by the wide gap between the market exchange rate (EUR/KES) and the purchasing power parity (PPP)-implied rate. For instance, in 2015 the nominal exchange rate stood at EUR/KES 0.0092 compared to a PPP-consistent rate of 0.0279, reflecting an undervaluation of about 67 percent. This undervaluation deepened in later years, reaching nearly 80 percent in 2023 before easing slightly in 2024.

The results also highlight periods of volatility, with sharp dips and spikes corresponding to phases of appreciation and depreciation. Such fluctuations mirror earlier findings by the IMF (2023), which attributed misalignment episodes to political and macroeconomic shocks. For example, in the aftermath of the COVID-19 pandemic and the 2022 general election demonstrations, the exchange rate experienced sharp swings driven by both domestic and external pressures. Between 2015 and 2019, undervaluation was moderate, reflecting relatively stable macroeconomic conditions and Central Bank interventions to stabilize inflation and the exchange rate. However, undervaluation intensified in 2020–2021 as the pandemic disrupted global trade flows, reduced foreign exchange earnings, and heightened risk aversion. This episode was comparable to the 2011 exchange rate shock when uncertainty triggered rapid depreciation (Ndii & Ndung'u, 2012).

From 2022 to 2023, undervaluation intensified as the shilling weakened against the euro due to rising import costs, higher debt service obligations, and tighter global financial conditions. The undervaluation peaked in 2023 at nearly –80 percent, a level comparable to the large depreciation episodes of 2009–2011 (Gachoki, Okeri & Korir, 2021). By 2024, undervaluation eased slightly, likely reflecting stabilization measures such as tighter monetary policy and improved export performance. This experience resembles the post-2011 contractionary monetary stance by the CBK, which successfully restored exchange rate stability (Omolo, 2014).

9.2 Patterns and Trends of Kenya–EU Bilateral Trade Flows

Kenya's trade with the EU between 2015 and 2024 was characterized by a persistent trade deficit, with imports consistently exceeding exports. Imports were largely composed of manufactured products such as chemicals, pharmaceuticals, machinery, and transport equipment, while exports remained concentrated in primary products such as agricultural produce and raw materials. The deficit narrowed modestly in 2016 (–622 million EUR) and 2017 (–598 million EUR) due to slower import growth and modest export gains. However, in 2020 the deficit widened sharply (–882 million EUR), coinciding with the COVID-19 pandemic. During this period, imports surged by 15.6 percent, while exports stagnated (0.4 percent), underscoring the disruptive role of global shocks on trade flows.

Between 2021 and 2024, exports registered more robust growth, particularly in 2022 (16.5 percent) and 2024 (11.1 percent), partly driven by post-pandemic recovery and improved access to EU markets. Imports also expanded, though unevenly. A notable contraction occurred in 2023 (–14.3 percent), which temporarily reduced the trade deficit to its lowest level in the study period (–459 million EUR). This contraction coincided with post-election uncertainty and global inflationary pressures that dampened domestic demand. By 2024, however, imports had rebounded, widening the deficit again to –557 million EUR. These trends suggest that Kenya's bilateral trade flows with the EU are sensitive to both external shocks (such as COVID-19) and domestic developments (notably political instability), which amplify fluctuations in trade balances.

9.3 KE – EU Exchange Rate Misalignment and Trade Flows Nexus

The association between Kenya's exchange rate misalignment and its trade flows with the EU reveals important insights. The Pearson correlation results indicate a statistically significant negative relationship between misalignment and exports ($r = –.692$, $p = .027$). This implies that greater misalignment—whether undervaluation or overvaluation—was associated with weaker export performance.

Although earlier studies (Gachoki et al., 2021; Ibrahim, 2014; Sidek, 2011) found no significant effect of real exchange rate misalignment on exports, the current findings align with more recent evidence (Nasir & Jackson, 2019; Ouattara, 2023), which shows that misalignment depresses export performance. This supports the argument that exchange rate instability undermines Kenya's competitiveness in EU markets, making exports more volatile (Otieno, 2014).

Interestingly, exports and imports were strongly and positively correlated ($r = .729$, $p = .017$), suggesting that periods of stronger exports also coincided with higher imports. This reflects Kenya's integration into global value chains, where increased export activity often requires corresponding imports of intermediate goods, machinery, or technology from the EU. By contrast, the trade balance displayed weak and statistically insignificant correlations with misalignment, exports, and imports. This indicates that Kenya's persistent structural trade deficit with the EU is less a function of exchange rate dynamics and more reflective of trade composition and structural demand factors.

10. Conclusion

The findings demonstrate that Kenya's real exchange rate is prone to recurrent misalignment, alternating between undervaluation and overvaluation over the 2015–2024 period. These fluctuations are closely linked to external shocks such as the COVID-19 pandemic and tightening global financial conditions as well as domestic political-economic risks, particularly election-related uncertainty. Historical parallels with earlier episodes of instability

confirm that speculative pressures and imbalances in foreign exchange markets further amplify these deviations from equilibrium, exposing the shilling to volatility that often undermines investor confidence and trade performance.

The analysis of Kenya–EU trade flows reveals a persistent structural deficit, reflecting Kenya's dependence on industrial imports from the EU against a narrow export base dominated by agricultural and horticultural commodities. Although exports registered periods of recovery, especially in the post-pandemic years, they remained insufficient to offset the scale of imports. This imbalance highlights the structural nature of Kenya's trade relations with the EU, where trade composition, rather than exchange rate movement alone, is the primary driver of deficits.

Importantly, the evidence shows that exchange rate misalignment exerts a significant depressive effect on exports, even though its impact on the overall trade balance is limited. This suggests that exchange rate stability is necessary but not sufficient for improving Kenya's external position. Broader structural reforms are equally critical. Addressing supply-side challenges such as compliance with EU quality and safety standards, expanding value addition in agriculture, and supporting exporters through targeted promotion in Europe would strengthen competitiveness in niche markets. At the same time, diversifying the export base beyond agriculture through industrial upgrading, manufacturing investment, and entry into higher-value segments of global value chains would reduce overreliance on imports and enhance long-term trade balance sustainability. In sum, while exchange rate management remains important for protecting competitiveness, it must be complemented by structural transformation of Kenya's trade and production systems to achieve sustainable improvement in its bilateral trade performance with the EU.

11. Recommendations for Policy and Practice

The Central Bank of Kenya should adopt a managed float exchange rate regime, with selective interventions to prevent excessive misalignment that undermines export competitiveness. Stability in the exchange rate would help cushion the economy from volatility associated with external shocks and domestic political risks. To further reduce vulnerability, Kenya must diversify its energy sources by expanding local oil refining capacity and accelerating investment in renewable energy such as wind, geothermal, and solar, thereby limiting exposure to global financial tightening and commodity price swings. Strengthening export competitiveness in European Union markets also requires addressing supply-side constraints by ensuring compliance with EU quality and safety standards, promoting value addition in agriculture, and supporting exporters through well-established promotion and marketing centers in Europe. Broader structural reforms are needed to diversify Kenya's export base beyond agricultural commodities by upgrading industrial capacity, investing in manufacturing, and moving into higher-value global value chain segments. Finally, the government should expand access to affordable hedging instruments such as currency futures and forward contracts, while positioning Nairobi as a regional foreign exchange hub to enhance resilience for importers and exporters during episodes of exchange rate volatility.

12. Recommendations for Further Studies

While this study has examined the association between exchange rate misalignment and trade flows between Kenya and the EU, future research should broaden the scope to include other regional blocs such as the East African Community (EAC) and COMESA, as well as emerging trade partners like China and the United Arab Emirates. Methodologically, reliance on the purchasing power parity (PPP) approach may provide only limited insights, as it does not adequately capture the evolving nature of equilibrium exchange rates in response to shifting macroeconomic fundamentals and policy environments. Subsequent studies could therefore employ model-based approaches that better account for these dynamics. Furthermore, incorporating sector-specific variables particularly in agriculture and tourism, which remain central to Kenya's economy would provide a more nuanced understanding of how exchange rate misalignment affects different segments of trade. Such extensions would strengthen the empirical base for policy design aimed at enhancing Kenya's resilience and competitiveness in international markets.

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