

Foreign Exchange Risk Management and Financial Performance of Manufacturing Firms in Kenya

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Abstract

Foreign exchange risk management is an important consideration for manufacturing firms operating in an increasingly globalised business environment. Exchange rate fluctuations can affect the cost of imported raw materials, machinery, fuel, and other production inputs, thereby influencing profitability, liquidity, cash-flow stability, and overall financial performance. This study examines the effect of foreign exchange risk management on the financial performance of manufacturing firms in Kenya through a review of theoretical and empirical literature. The theoretical review is anchored on the International Fisher Effect theory, the Theory of Rational Expectations, and the Purchasing Power Parity theory, which explain the factors influencing exchange rate movements and firms' responses to currency-related uncertainties. The literature review methodology involved examining relevant scholarly publications, including empirical studies conducted in Kenya and other international contexts. The reviewed literature focuses on financial hedging practices, including forward contracts and currency swaps, as well as operational strategies, such as exposure netting and natural hedging, and non-financial approaches, including pricing adjustments and supplier negotiations. The reviewed studies generally indicate that foreign exchange risk management practices are associated with improved financial outcomes through reduced currency exposure, enhanced cash-flow stability, and improved profitability. However, the effectiveness of these practices may vary depending on firms' foreign currency exposure, financial resources, managerial capabilities, and prevailing macroeconomic conditions. The study recommends that manufacturing firms adopt integrated foreign exchange risk management strategies, strengthen exchange rate monitoring and forecasting, develop formal risk management policies, and invest in managerial capacity. Further empirical research is necessary to establish the relationship between specific foreign exchange risk management practices and financial performance across different manufacturing subsectors in Kenya.

1. INTRODUCTION

Foreign exchange risk management has become an important consideration for manufacturing firms operating in an increasingly interconnected global economy. Exchange rate fluctuations affect the domestic currency value of foreign currency-denominated transactions, thereby influencing production costs, revenues, cash flows, profitability, and overall financial performance. Manufacturing firms engaged in international trade are particularly exposed to foreign exchange risk because of their dependence on imported raw materials, machinery, equipment, technology, and other production inputs, as well as their involvement in export markets and foreign currency financing. Gupta and Aggarwal (2021) observe that multinational corporations experience foreign exchange exposure arising from cross-border trade, foreign investments, and foreign currency borrowing. Furthermore, global economic disruptions, geopolitical conflicts, pandemics, and commodity price fluctuations can intensify currency volatility, creating uncertainty in firms' financial planning and operational decisions. Consequently, the adoption of foreign exchange risk management practices, including forward contracts, currency options, swaps, and other hedging mechanisms, is important for managing exposure and stabilising corporate cash flows (IMF, 2022).

The significance of foreign exchange risk management is particularly evident in manufacturing, where exchange rate movements can influence both the cost structure and competitiveness of firms. Currency depreciation increases the domestic currency cost of imported inputs and foreign currency-denominated obligations, potentially reducing profit margins where firms are unable to transfer the additional costs to customers. Conversely, currency appreciation may reduce import costs while affecting the price competitiveness of exporters. Baur and Lucey (2020) emphasise the importance of hedging strategies in managing exchange rate volatility and mitigating its implications for firms operating in international markets. Effective foreign exchange risk management therefore extends beyond the reduction of financial exposure to encompass strategic financial planning, cost control, pricing decisions, and the maintenance of competitive advantage.

In Africa, manufacturing firms face considerable foreign exchange exposure because many production processes depend on imported raw materials, specialised machinery, and advanced technologies. Within East Africa, exchange rate fluctuations are associated with macroeconomic conditions, including inflation, trade imbalances, political uncertainty, and dependence on external financing. Kariuki and Wanjiru (2020) highlight the implications of currency volatility for manufacturing costs in the East African region. Such fluctuations may increase procurement expenditure, disrupt production budgets, constrain working capital, and complicate long-term investment decisions. These challenges are particularly significant for firms that generate most of their revenue in domestic currencies while meeting substantial obligations in foreign currencies. Accordingly, foreign exchange risk management is an important component of financial risk management and operational sustainability in the regional manufacturing sector.

Foreign exchange risk management may involve financial hedging, operational adjustments, and natural hedging, depending on the nature and extent of a firm's exposure. Financial hedging involves the use of instruments such as forward contracts and currency swaps to manage the uncertainty associated with future foreign currency payments and receipts. Operational and natural hedging, in contrast, may involve aligning foreign currency revenues with expenditures, diversifying sourcing arrangements, and adjusting procurement or pricing decisions to reduce exposure. Mutua and Ouma (2021) suggest that firms adopting formal foreign exchange risk management practices tend to perform better than those relying on informal or ad hoc approaches. Although regional monetary cooperation initiatives seek to promote greater monetary stability, manufacturing firms continue to require internal mechanisms for identifying, assessing, and managing currency exposure. The effectiveness of these mechanisms is therefore an important consideration in explaining differences in firms' financial performance.

In Kenya, manufacturing firms operate within an economic environment characterised by dependence on imported industrial inputs, exposure to international commodity markets, changing exchange rates, high energy costs, and competition from imported products. These conditions create multiple channels through which foreign exchange movements may affect financial performance. Firms that import raw materials, machinery, fuel, and production technology may experience increased operating expenditure when the Kenyan shilling depreciates against major international currencies, particularly the United States dollar and the euro. Where firms lack effective hedging arrangements or have limited capacity to adjust selling prices, such increases may reduce gross profit margins, weaken liquidity, and constrain investment. Njuguna (2022) examines the relationship between exchange rate volatility and operational costs in Kenyan manufacturing, highlighting the relevance of currency movements to firms' cost structures. Consequently, the management of foreign exchange exposure is a significant financial and operational concern for manufacturing enterprises in Kenya.

The relationship between foreign exchange risk management and financial performance is also important because manufacturing firms differ in their exposure levels, financial resources, access to hedging instruments, and capacity to respond to exchange rate movements. Some firms may use derivative instruments, including forward contracts and currency swaps, while others may rely on operational measures such as price negotiation, supplier diversification, and the matching of foreign currency receipts with payments. The suitability and effectiveness of these strategies may vary according to firms' transaction volumes, foreign currency obligations, market conditions, and managerial capabilities. Gupta and Aggarwal (2021) provide a basis for understanding the relationship between foreign exchange exposure and corporate financial outcomes, while Baur and Lucey (2020) underscore the relevance of hedging in managing currency-

related uncertainty. These perspectives suggest that the financial benefits of foreign exchange risk management should be examined in relation to the specific circumstances of manufacturing firms.

Despite the importance of foreign exchange risk management, the extent to which its various strategies contribute to improved financial performance among manufacturing firms in Kenya requires further empirical investigation. Although appropriate risk management practices may help reduce exchange rate exposure and stabilise cash flows, their effectiveness cannot be assumed to be uniform across firms. Differences in the use of financial hedging instruments, operational risk mitigation practices, and pricing adjustments may produce different financial outcomes. Moreover, evidence concerning firms operating in other countries or sectors may not fully explain the circumstances of Kenyan manufacturing firms, given the distinctive characteristics of the local economic and business environment.

Against this background, the present study examines the effect of foreign exchange risk management on the financial performance of manufacturing firms in Kenya. The study focuses on understanding how foreign exchange risk management practices influence financial outcomes in a sector that is highly relevant to industrial development, employment creation, and economic growth. By examining the relationship between foreign exchange risk management and financial performance, the study seeks to generate evidence that can inform managerial decision-making, strengthen corporate financial risk management, and contribute to the broader understanding of currency risk management in emerging economies.

2. LITERATURE REVIEW

This chapter reviews the theoretical and empirical literature on the effect of foreign exchange risk management on the financial performance of manufacturing firms in Kenya. The review provides a theoretical foundation for understanding exchange rate movements, firms' exposure to foreign exchange risk, and the mechanisms through which risk management practices may influence financial outcomes. The theoretical review examines the International Fisher Effect (IFE) theory, the Theory of Rational Expectations, and the Purchasing Power Parity (PPP) theory. These theories explain the macroeconomic factors underlying exchange rate movements and provide insights into how firms anticipate, respond to, and manage currency-related uncertainties.

The empirical review examines previous studies on foreign exchange risk management practices, including forward contracts, currency swaps, internal hedging, operational hedging, and pricing strategies, and their relationship with financial performance. Particular attention is given to evidence from Kenya and other international contexts to establish the relevance of existing findings to manufacturing firms operating in the Kenyan economic environment. The chapter also considers the strengths and limitations of the reviewed theories and empirical studies to identify knowledge gaps that justify the present study.

2.1. Theoretical Review

The theoretical foundation of this study comprises the International Fisher Effect (IFE) theory, the Theory of Rational Expectations, and the Purchasing Power Parity (PPP) theory. These theories provide complementary explanations of the economic factors that influence exchange rate movements and the decisions firms make when managing foreign exchange exposure. The IFE theory explains the relationship between interest rate differentials and anticipated currency movements, the Theory of Rational Expectations explains how firms use available information to anticipate exchange rate changes, while PPP theory links exchange rate movements to differences in national price levels and inflation.

These theoretical perspectives are relevant to manufacturing firms in Kenya because such firms may depend on imported raw materials, machinery, fuel, and other production inputs priced in foreign currencies. Exchange rate fluctuations can consequently influence procurement costs, operating expenditure, pricing decisions, cash flows, and profitability. Understanding these relationships is essential for explaining why firms adopt foreign exchange risk management practices and how such practices may affect financial performance. Al Mansoori et al. (2024) emphasise the significance

of exchange rate volatility for firm profitability, valuation, and financial stability, particularly in emerging economies. The three theories therefore provide a basis for examining the relationship between foreign exchange risk management and financial performance among manufacturing firms in Kenya.

International Fisher Effect (IFE) Theory

The International Fisher Effect (IFE) originates from the Fisher Effect developed by Irving Fisher in 1930. The theory proposes that differences in nominal interest rates between countries reflect differences in expected inflation and that these differentials are associated with expected exchange rate movements. Under the IFE, a currency associated with a relatively higher nominal interest rate is expected to depreciate against a currency with a lower nominal interest rate, assuming the relevant theoretical conditions hold (Madura, 2020; Eun & Resnick, 2022).

For instance, differences between Kenyan and United States interest rates may influence capital flows and expectations concerning the future value of the Kenyan shilling against the US dollar. Where exchange rate depreciation occurs, Kenyan manufacturing firms that depend on imported raw materials, machinery, fuel, and other foreign currency-denominated inputs may experience increased procurement and production costs. Such increases can place pressure on profit margins, particularly when firms are unable to adjust selling prices or implement appropriate risk management measures.

The IFE is based on assumptions concerning efficient capital markets, capital mobility, rational investor behaviour, and the relationship between nominal interest rates, expected inflation, and exchange rates. Its principal constructs include nominal interest rates, inflation expectations, and exchange rate movements. The theory predicts that differences in nominal interest rates are associated with corresponding expected changes in exchange rates, although the relationship may not hold consistently under actual market conditions (Shapiro, 2020; Hill, 2020).

The International Fisher Effect (IFE) theory is relevant to this study because it provides a macroeconomic explanation of exchange rate movements that expose manufacturing firms in Kenya to foreign exchange risk. Interest rate differentials and associated inflation expectations may contribute to changes in the value of the Kenyan shilling, thereby affecting the domestic currency cost of imported inputs and foreign currency-denominated obligations. In response, manufacturing firms may adopt foreign exchange risk management strategies, particularly forward contracts and currency swaps, to reduce uncertainty surrounding future foreign currency transactions. Bartram et al. (2020) examine the effects of derivatives on firm risk and value, while Nguyen et al. (2021) highlight the role of hedging instruments in mitigating foreign exchange exposure. Similarly, Al Mansoori et al. (2024) and Raza et al. (2022) provide a basis for examining the relationship between hedging practices and firm performance. The theory therefore supports the study by explaining the potential relationship between macroeconomic conditions, exchange rate movements, foreign exchange risk management practices, and financial performance, particularly how manufacturing firms exposed to foreign currency transactions may adopt hedging mechanisms to manage cost uncertainty and protect profitability. However, the theory has limitations because its assumptions concerning efficient markets, capital mobility, and rational investor behaviour may not fully reflect actual market conditions (Kamau et al., 2025). Exchange rate movements are also influenced by geopolitical risks, economic uncertainty, market expectations, and structural factors, which may limit the theory's predictive accuracy (Al Mansoori et al., 2024). Consequently, although the IFE provides a useful explanation of the macroeconomic conditions associated with foreign exchange exposure, it does not independently establish whether particular risk management practices improve the financial performance of manufacturing firms in Kenya.

Theory of Rational Expectations

The Theory of Rational Expectations was developed by John F. Muth (1961) and subsequently advanced through the work of Robert Lucas (1972). The theory proposes that economic agents form expectations about future economic variables using the information available to them and their understanding of how the economy operates. Applied to foreign exchange markets, the theory suggests that firms and other economic agents use available information to anticipate exchange rate movements and make financial decisions accordingly (Muth, 1961; Lucas, 1972).

The theory emphasises information availability, expectation formation, rational decision-making, and market responses. It assumes that economic agents make systematic use of available information when forming expectations, although this does not imply that their forecasts are always accurate. Exchange rate expectations may influence decisions concerning the timing of foreign currency transactions, procurement commitments, pricing arrangements, and the adoption of financial hedging instruments. Mankiw (2021) and Eun and Resnick (2022) provide relevant theoretical foundations for understanding economic expectations and international financial decision-making.

For manufacturing firms in Kenya, expectations regarding the future movement of the Kenyan shilling against major trading currencies may influence the management of imported inputs and foreign currency obligations. For example, a firm anticipating depreciation of the shilling may consider entering into a forward contract to establish an exchange rate for a future payment. Alternatively, it may revise procurement schedules, negotiate prices with suppliers, or align foreign currency receipts with payments to reduce exposure. Li et al. (2024) highlight the importance of expectations in understanding currency risk management and firm performance.

The Theory of Rational Expectations is relevant to this study because foreign exchange risk management requires manufacturing firms to assess available information and make informed decisions under uncertainty. Firms often make procurement, production, pricing, and financing commitments before the exchange rates applicable to future transactions are known, making their decisions dependent on how effectively they interpret economic information and anticipate currency movements. The theory provides a basis for explaining the adoption of foreign exchange risk management practices, including forward contracts, currency swaps, and price negotiation, as firms anticipating unfavourable currency movements may employ these strategies to minimise uncertainty in future cash flows and mitigate potential adverse effects on profitability. Consequently, the theory helps explain how managerial expectations influence the selection and implementation of foreign exchange risk management strategies and their potential effects on the financial performance of manufacturing firms in Kenya. However, the theory has limitations in environments characterised by incomplete information, market inefficiencies, and economic uncertainty, where firms may have unequal access to financial information, forecasting expertise, and hedging instruments. Furthermore, expectations may not accurately predict unexpected economic shocks or abrupt exchange rate movements. Ranaldo and Somogyi (2021) and Al Mansoori et al. (2024) provide a basis for understanding the limitations of rational expectations and the complexity of currency markets. Therefore, although the theory is useful for explaining the role of information and managerial expectations in foreign exchange risk management, its application must recognise that firms make decisions under imperfect information and that accurate forecasting does not necessarily eliminate foreign exchange losses.

Purchasing Power Parity (PPP) Theory

The Purchasing Power Parity (PPP) theory is associated with Gustav Cassel (1918) and is founded on the law of one price. The law of one price proposes that identical goods should have the same price across different countries when expressed in a common currency, assuming that relevant market conditions permit price equalisation. PPP extends this principle by proposing that exchange rates adjust over time in response to differences in national price levels (Cassel, 1918; Krugman et al., 2020).

The theory distinguishes between absolute and relative purchasing power parity. Absolute PPP relates exchange rates to the ratio of national price levels, while relative PPP proposes that exchange rate changes over time reflect differences in inflation rates between countries. Under relative PPP, a country experiencing higher inflation than its trading partners would generally be expected to experience currency depreciation over time. The theory is based on assumptions that include relatively frictionless trade, limited market distortions, and the comparability of goods and price levels. Inflation rates, national price levels, and exchange rates are therefore central constructs of PPP theory (Obstfeld & Rogoff, 2021; Madura, 2020).

Differences in inflation rates and production costs are particularly relevant to manufacturing firms in Kenya because many firms obtain raw materials, machinery, fuel, and intermediate goods from international markets. Changes in exchange rates may increase the domestic currency cost of imported inputs, while differences in domestic and foreign

price levels may influence the competitiveness of locally manufactured products. Firms may respond through supplier negotiations, pricing adjustments, sourcing diversification, and financial hedging. Hill (2020) and Mwangi (2024) are cited in the study in relation to the implications of price differences and exchange rate movements for firms' financial and operational decisions. Mwangi (2024) further provides the cited basis for the relationship between exchange rate movements, relative price changes, and inflation dynamics.

The Purchasing Power Parity (PPP) theory is relevant to the present study because it explains how differences in inflation and price levels may contribute to exchange rate movements and, consequently, influence the financial performance of manufacturing firms in Kenya. When the Kenyan shilling depreciates in response to macroeconomic conditions, firms that depend on imported inputs may experience increased production costs, which can reduce profit margins and overall financial performance if the additional costs cannot be fully transferred to customers. The theory also provides a basis for understanding how manufacturing firms respond to changing economic conditions through pricing adjustments, supplier negotiations, and alternative sourcing arrangements, which, alongside financial hedging instruments, may help manage foreign exchange exposure and maintain competitiveness. Within the conceptual framework of this study, PPP explains the potential relationship between inflation differentials, exchange rate movements, foreign exchange risk management practices, and financial performance by highlighting how firms respond to currency-related cost pressures. However, the theory has limitations because it does not fully account for transaction costs, trade barriers, product differentiation, and differences in market structures. Furthermore, exchange rates may deviate from PPP predictions in the short run due to market rigidities, capital flows, speculative activity, and external shocks. Al Mansoori et al. (2024) and Delis et al. (2022) provide a basis for recognising that exchange rate behaviour and corporate performance are influenced by multiple economic and structural factors beyond relative price levels. Therefore, although PPP offers a useful explanation of the relationship between inflation and exchange rate movements, it should be considered alongside other economic and firm-specific factors when examining the effect of foreign exchange risk management on the financial performance of manufacturing firms in Kenya.

2.2. Empirical Review of Literature

Empirical research has examined the relationship between foreign exchange risk management and financial performance across different economic settings and industry sectors. The literature focuses on strategies such as internal hedging, forward exchange contracts, currency swaps, operational adjustments, and strategic pricing. These practices are intended to reduce exposure to exchange rate fluctuations, improve cash flow predictability, and protect profitability. However, their effectiveness may depend on firms' exposure profiles, access to financial instruments, operational characteristics, and the economic environment in which they operate.

In Kenya, Muiro et al. (2019) investigated internal hedging strategies among firms and found that exposure netting and operational hedging improved cash flow stability. Their findings suggest that firms that actively manage foreign exchange exposure may experience lower earnings volatility and better financial outcomes. Internal hedging is particularly relevant to manufacturing firms because the alignment of foreign currency receipts and payments, together with adjustments to procurement and operational arrangements, may reduce the net exposure arising from international transactions. Nevertheless, the extent to which such strategies translate into improved overall financial performance requires consideration of the costs and limitations associated with their implementation.

Similarly, Nzioka and Maseki (2017) examined currency risk management practices among Kenyan firms and established that forward contracts and strategic pricing contributed to improved financial performance by minimising exchange rate losses. Their findings highlight the potential contribution of both financial and operational measures to foreign exchange risk management. For manufacturing firms, forward contracts may provide greater certainty regarding future import payments, while pricing strategies may help manage changes in input costs. However, the ability to transfer additional costs to customers may depend on competitive pressures, market demand, and the availability of substitute products.

Focusing specifically on manufacturing firms in Kenya, Maitha (2020) examined the effect of forward exchange contracts on financial performance and reported a strong positive relationship between the use of such contracts and return on

assets (ROA). The study suggests that firms using forward contracts to manage currency exposure may be better positioned to protect profitability, particularly where their operations depend on imported raw materials and participation in export markets. The findings provide a relevant empirical basis for examining financial hedging as a component of foreign exchange risk management. However, the relationship between forward contract use and financial performance should also be considered in light of the costs of hedging, the extent of firms' foreign exchange exposure, and the possibility that firms with stronger financial resources may be more capable of adopting formal risk management practices.

At the international level, Parlak and İlhan (2016) investigated exchange rate exposure among Turkish manufacturing firms and reported that firms with unhedged foreign currency positions experienced significant financial losses during periods of currency depreciation. In contrast, firms employing hedging instruments, including forward contracts and currency swaps, were better able to stabilise their financial performance. These findings underscore the importance of managing foreign exchange exposure in manufacturing environments characterised by international sourcing and foreign currency transactions. Although the study provides useful comparative evidence, differences in market conditions, financial infrastructure, and firm characteristics may limit the direct generalisation of its findings to manufacturing firms in Kenya.

Jeevanandam (2020) also emphasised the importance of transaction risk management strategies, particularly forward contracts and currency swaps, in reducing uncertainty in international business transactions. The study indicates that firms adopting proactive approaches to foreign exchange risk management tend to achieve more stable earnings and improved financial performance over time. This perspective is relevant to manufacturing firms because uncertainty surrounding future exchange rates may affect procurement budgets, cash flow forecasts, supplier payments, and the cost of production. Appropriate hedging arrangements may reduce this uncertainty and support more predictable financial planning.

Taken together, the reviewed studies suggest that foreign exchange risk management practices can contribute to improved financial outcomes by reducing exposure to currency volatility and stabilising cash flows (Ombui et al., 2026). Evidence from Kenya highlights the relevance of internal hedging, forward contracts, and strategic pricing, while international evidence underscores the potential contribution of forward contracts and currency swaps. However, the findings do not establish that every foreign exchange risk management strategy produces the same financial benefits across all firms. Differences in the nature of foreign currency exposure, implementation costs, managerial capabilities, and market conditions may influence the effectiveness of individual strategies.

The literature therefore provides a foundation for investigating the effect of foreign exchange risk management on the financial performance of manufacturing firms in Kenya. It also points to the need for context-specific empirical evidence that examines how the practices adopted by manufacturing firms relate to financial outcomes. By focusing on the Kenyan manufacturing sector, the present study seeks to contribute to understanding the relationship between foreign exchange risk management and financial performance within the country's economic and industrial environment.

3. METHODOLOGY

This study adopted a literature review methodology to examine existing theoretical and empirical evidence on the effect of foreign exchange risk management on the financial performance of manufacturing firms in Kenya. Relevant literature was identified from academic journals, scholarly books, institutional publications, and electronic databases, including Google Scholar, Scopus, and Web of Science. The review focused on studies addressing foreign exchange risk management practices, including forward contracts, currency swaps, internal hedging, operational hedging, and pricing strategies, as well as their relationship with financial performance. Both Kenyan and international studies were considered to provide a broader understanding of the subject and identify findings relevant to the Kenyan manufacturing sector. The selected literature was analysed thematically to compare research findings, assess the theoretical perspectives underpinning previous studies, identify methodological limitations, and establish gaps in existing knowledge. The findings informed

the study's theoretical foundation and provided a basis for justifying further investigation into the relationship between foreign exchange risk management and the financial performance of manufacturing firms in Kenya.

4. DISCUSSION

The reviewed theoretical and empirical literature demonstrates that foreign exchange risk management is an important consideration in explaining the financial performance of manufacturing firms operating in international markets. The International Fisher Effect (IFE), the Theory of Rational Expectations, and the Purchasing Power Parity (PPP) theory provide complementary explanations of the macroeconomic conditions that influence exchange rate movements and firms' responses to currency-related uncertainty. Collectively, these theories suggest that interest rate differentials, inflation expectations, price-level differences, and the availability of economic information can influence exchange rate movements and the financial decisions of manufacturing firms (Madura, 2020; Eun & Resnick, 2022; Mankiw, 2021; Obstfeld & Rogoff, 2021). For manufacturing firms in Kenya, which may depend on imported raw materials, machinery, fuel, and other production inputs, exchange rate depreciation can increase operating costs and reduce profitability. These theoretical perspectives therefore provide a foundation for examining how foreign exchange risk management practices may influence financial performance.

The empirical literature generally indicates a positive relationship between foreign exchange risk management and financial performance. Muiru et al. (2019) found that currency hedging positively influenced the financial performance of listed firms in Kenya, highlighting the importance of managing foreign exchange exposure. Similarly, Nzioka and Maseki (2017) reported that internal and external hedging techniques were significantly associated with the financial performance of non-banking firms listed on the Nairobi Securities Exchange. Their findings suggest that foreign exchange risk management can influence profitability, sales revenue, cash flows, and liquidity, with internal hedging demonstrating a stronger effect than external hedging in their study. These findings indicate that manufacturing firms may benefit from combining financial hedging instruments with operational measures to manage currency exposure.

Evidence specific to Kenyan manufacturing firms further reinforces the importance of foreign exchange risk management. Maitha (2020) established a significant relationship between foreign exchange risk management strategies and return on assets (ROA), identifying forward contracts, currency options, swaps, and leads and lags among the strategies associated with financial performance. The study also highlighted the relevance of currency invoicing and netting in managing foreign exchange exposure. These findings suggest that the choice of risk management strategy matters because different instruments address foreign exchange exposure through different mechanisms. Forward contracts, for example, can provide greater certainty over future exchange rates, while operational strategies can help align foreign currency receipts and payments. However, the effectiveness of these practices may depend on their suitability to a firm's exposure profile, the cost of implementation, and the availability of financial instruments.

International evidence provides further support for the importance of managing foreign exchange exposure. Parlak and İlhan (2016) reported that Turkish manufacturing firms with unhedged foreign currency positions experienced significant financial losses during periods of currency depreciation, whereas firms using forward contracts and currency swaps were better able to stabilise their financial performance. Jeevanandam (2020) similarly emphasised the role of transaction risk management strategies in reducing uncertainty in international business transactions. These findings are consistent with the argument that effective foreign exchange risk management can reduce the adverse financial consequences of currency volatility. Nevertheless, differences in economic conditions, financial market development, and access to hedging instruments mean that findings from international settings should be interpreted cautiously when applied to manufacturing firms in Kenya.

The theoretical and empirical literature also indicates that the relationship between foreign exchange risk management and financial performance is not automatic. Although the IFE explains how interest rate differentials may be associated with exchange rate movements, and PPP links currency movements to differences in price levels, neither theory independently establishes the financial benefits of particular hedging strategies. The Theory of Rational Expectations

adds a managerial decision-making perspective by explaining how firms use available information to anticipate currency movements and select appropriate risk management responses. However, the assumptions underlying these theories may be constrained by imperfect information, market inefficiencies, unexpected economic shocks, and differences in firms' financial capabilities (Ranaldo & Somogyi, 2021; Al Mansoori et al., 2024; Delis et al., 2022). Consequently, the financial outcomes of foreign exchange risk management may depend not only on the strategies adopted but also on the quality of implementation and the prevailing economic environment.

A further consideration emerging from the reviewed literature is the importance of distinguishing between the adoption of foreign exchange risk management practices and their actual effectiveness. A firm may employ forward contracts, currency swaps, or pricing adjustments without necessarily achieving improved financial performance if the strategies are poorly aligned with its exposure or involve substantial costs. Conversely, firms that combine appropriate financial hedging with operational measures may be better positioned to manage foreign exchange uncertainty. Bartram et al. (2020) and Raza et al. (2022) provide a basis for examining the relationship between derivative use, hedging practices, and firm performance. This suggests that the assessment of foreign exchange risk management among manufacturing firms in Kenya should consider both the practices employed and their relationship with measurable financial performance indicators.

Despite the evidence provided by previous studies, further investigation is warranted to establish how foreign exchange risk management relates to financial performance within the Kenyan manufacturing sector. Existing Kenyan studies have examined listed firms, non-banking companies, and manufacturing firms, but their findings may differ because of variations in research designs, study periods, performance measures, and the strategies examined. Moreover, evidence from other countries may not fully reflect the financial market conditions and operational challenges facing manufacturing firms in Kenya. The present study therefore seeks to contribute to this body of knowledge by examining the effect of foreign exchange risk management on the financial performance of manufacturing firms in Kenya. The discussion provides a basis for investigating whether the adoption of appropriate foreign exchange risk management practices is associated with improved profitability and financial stability in the Kenyan manufacturing context.

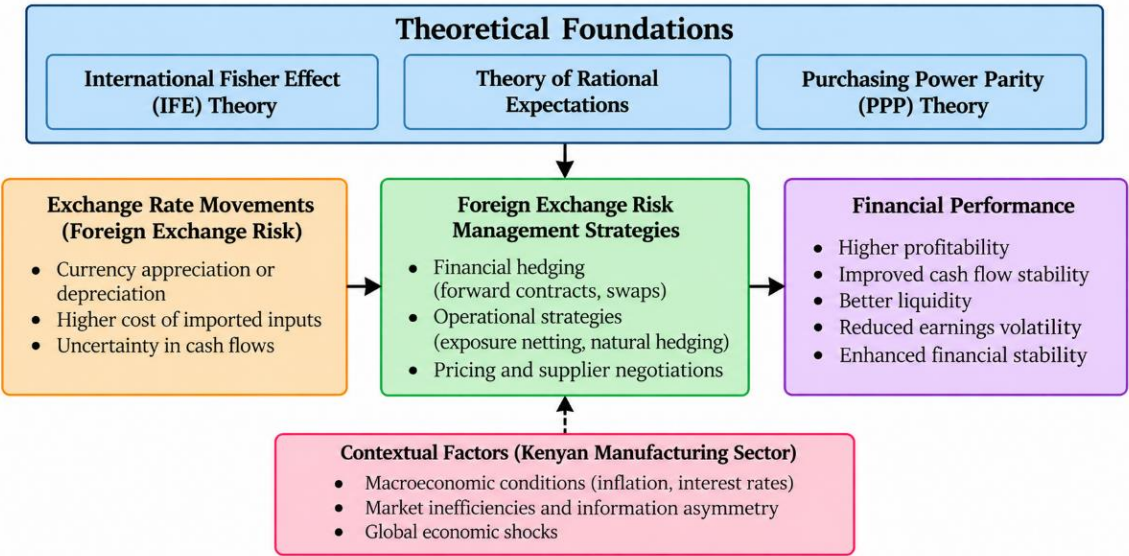


Figure 1: Synthesis of Foreign Exchange Risk Management and Financial Performance

Figure 1 illustrates the relationship between foreign exchange risk management and the financial performance of manufacturing firms in Kenya. The International Fisher Effect, Rational Expectations, and Purchasing Power Parity theories explain the factors influencing exchange rate movements, which create risks such as increased import costs and cash-flow uncertainty. Manufacturing firms can manage these risks through financial hedging, operational strategies, and pricing and supplier negotiations to improve profitability, cash-flow stability, liquidity, and overall financial performance.

The effectiveness of these strategies may be influenced by macroeconomic conditions, market inefficiencies, information asymmetry, and global economic shocks.

5. CONCLUSION AND RECOMMENDATIONS

5.1. Conclusion

The reviewed theoretical and empirical literature demonstrates that foreign exchange risk management is an important consideration in the financial performance of manufacturing firms in Kenya. Exchange rate fluctuations can influence the cost of imported raw materials, machinery, fuel, and other production inputs, thereby affecting profitability, liquidity, cash-flow stability, and overall financial performance. The International Fisher Effect, Theory of Rational Expectations, and Purchasing Power Parity theory provide complementary explanations of exchange rate movements and the decisions firms make to manage currency-related uncertainties. Empirical studies by Muiru et al. (2019), Nzioka and Maseki (2017), and Maitha (2020) indicate that foreign exchange risk management practices, including forward contracts, internal hedging, and pricing strategies, are associated with improved financial outcomes. However, the effectiveness of these strategies may vary depending on firms' foreign currency exposure, financial resources, managerial expertise, and prevailing economic conditions. The review further indicates the need for context-specific evidence on the relationship between foreign exchange risk management and financial performance within Kenya's manufacturing sector. Consequently, examining the effectiveness of financial hedging, operational strategies, and pricing and supplier negotiations is important for understanding how manufacturing firms can mitigate exchange rate exposure and strengthen their financial performance.

5.2. Recommendations

Manufacturing firms in Kenya should strengthen foreign exchange risk management by adopting appropriate financial hedging instruments, such as forward contracts and currency swaps, alongside operational strategies, including exposure netting, natural hedging, and currency invoicing. Firms should regularly monitor exchange rate movements and macroeconomic indicators to support informed financial planning, strengthen supplier negotiations, review pricing policies, and explore alternative sourcing arrangements. Additionally, they should invest in staff training, establish formal foreign exchange risk management policies, and periodically evaluate the effectiveness of their strategies against financial performance indicators. Further empirical research is recommended to establish how different foreign exchange risk management practices influence profitability, liquidity, return on assets, and cash-flow stability across manufacturing firms of different sizes and subsectors in Kenya.

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