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FINANCE

EFFECT OF EXTERNAL ECONOMIC FACTORS ON THE PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES IN NAIROBI COUNTY: A CASE OF SMALL AND MEDIUM ENTERPRISES IN KAMUKUNJI

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ABSTRACT

Purpose of Study: This study aimed to examine the impact of external economic factors—specifically interest rates, inflation rates, and exchange rates—on the growth and success of small and medium-sized enterprises (SMEs) in Nairobi County, Kenya.

Statement of Problem: SMEs in Nairobi County face significant challenges due to external economic fluctuations, with rising inflation, volatile exchange rates, and high interest rates increasing operational costs and limiting access to affordable financing. Understanding how these factors affect SME growth is critical to developing effective policy and financial support mechanisms.

Methodology: The study employed a purposive sampling technique to select SMEs from various industries in Nairobi County. Data collection involved structured questionnaires administered to SME owners and managers, interviews, and secondary data analysis from financial statements and economic reports. A mixed-method approach was used to analyze quantitative and qualitative data.

Results: The findings revealed that external economic factors significantly influence the growth and success of SMEs in Nairobi County, particularly in Kamukunji. High inflation rates increased operational costs, interest rate fluctuations limited access to affordable credit, and exchange rate volatility affected import costs and profit margins. These factors collectively constrained business expansion and financial stability.

Conclusion: The study concludes that SMEs in Nairobi County are highly vulnerable to economic fluctuations, which impact their financial viability and sustainability. Without proper mitigation strategies, these challenges could hinder long-term growth and success.

Recommendations: The study recommends that SMEs receive training on economic forecasting, financial management, and risk mitigation strategies. Additionally, government-backed credit programs, microfinance institutions, and subsidized loans should be promoted to enhance SMEs' access to affordable financing and improve their resilience to economic fluctuations

Keywords: *External Economic Factors, Performance*.

INTRODUCTION

A dramatic spike in inflation occurred as the world economy started to bounce back from the COVID-19 pandemic. After the outbreak upset supply networks, governments started to relax the restrictions. This caused aggregate demand to rise, leading to a small supply gap and price increases (Harding, Lindé, & Trabandt, 2023). In early 2022, Russia invaded Ukraine, significantly disrupting the supply of energy, while governments' expansionary fiscal measures to support companies and laborers increased inflationary pressures even more (Makin & Layton, 2021). Inflationary pressures will be temporary, foreign transfers will gradually restart, capacity utilization will rise, and central banks will be effective in keeping long-term inflation expectations low (Reifenschneider & Wilcox, 2022).

On the other hand, others argue that there is a real possibility that we're about to enter a period of continuously higher inflation than we've experienced in the past (Ghosh, 2022). Petrakis and Kostis (2014) analyze the significance of interpersonal trust and knowledge in the number of small and medium-sized enterprises. They arrive at the understanding that an increase in knowledge correlates positively with expansion of small and medium-sized businesses (SMEs), which, in turn, fosters greater interpersonal believe. It is crucial to remember, however, that the empirical findings suggest that interpersonal trust has minimal influence on the proliferation of SMEs.

SMEs play a crucial role in economic development by fostering trust, expanding knowledge, and supporting local entrepreneurship and technology. They significantly improve living conditions, generate employment, and reduce poverty (McKee, 2016). Additionally, SMEs contribute to productivity, domestic capital formation, and economic stability. Governments rely on them to drive job creation, economic growth, and GDP enhancement (Makin & Layton, 2021).

Statement of the Problem

Because of the growing rural-urban migration and formal sector jobless chances, small and medium-sized enterprise (SME) growth in Kenyan urban areas has been sluggish. Nevertheless, the majority of SMEs fail in the first few months of operation, even with their increasing establishment. However, SMEs continue to be a vital component of Kenyan industry and poverty alleviation. The purpose of the study is to determine how the performance of SMEs in Kamukunji, Nairobi County, is impacted by external economic variables. Inflation sharply increased when the world economy started to recover from the

COVID-19 pandemic. Governments began to loosen the limitations after the epidemic disrupted supply chains, and as a result, aggregate demand rebounded, resulting in a brief supply gap and price hikes (Harding, Lindé, & Trabandt, 2023). Governments' expansionary fiscal policies to assist businesses and laborers raised inflationary pressures even more (Makin & Layton, 2021) and Russia's invasion of Ukraine in early 2022 further disrupted the supply of energy supplies. According to economists, capacity utilization will increase, international transfers will progressively resume, inflationary pressures will be transient, and central banks will be successful in maintaining low long-term inflation expectations (Reifenschneider & Wilcox, 2022).

The particular emphasis on SMEs in Nairobi City County, Kenya's Kamukunji Trading Center was especially pertinent in light of the particular difficulties that these companies encounter. SMEs in this area face several challenges, including difficult regulatory requirements, fierce rivalry from domestic and foreign companies, and restricted access to funding, as mentioned by Gure and Karugu (2018). The majority of Kenya's metropolitan districts have seen a steady increase in the number of SMEs. This is due to a rise in the number of young, educated people moving from rural to urban areas and an increase in formal sector jobless chances. However, as predicted by the Vision 2030 economic blueprint and the accomplishment of the Sustainable Development Goals (SDGs), small and medium-sized enterprises (SMEs) continue to be the primary pillar in Kenya's industrialization sector. SMEs in Kamukunji can keep experiencing performance issues and losing out on chances for expansion and improvement. Thus, the purpose of this study was to evaluate how external economic variables affected the organizational performance of small and medium-sized firms (SMEs) in Kamukunji Trading Center. The study also aimed to offer insights that may assist these businesses improve their competitiveness and long-term success.

General Objective

The general objective of the study was to establish the effect of external economic factors on the growth and success of small and medium enterprises in Nairobi County with a focus on SMEs in Kamukunji area.

LITERATURE REVIEW

The Resource-Based View (RBV) Theory anchors the study objectives by emphasizing that an organization's internal resources and capabilities form the foundation for strategy development. Initially proposed by Wernefelt in 1984 and later popularized by Barney in 1991, RBV focuses on optimizing internal resources to create value and achieve a competitive advantage. This approach highlights the coordination of operating systems, internal assets, and product delivery to enhance competitiveness. According to Barney, a firm can gain a sustained competitive edge when its resources meet the criteria of being valuable, rare, inimitable, and well-organized (Otola, Ostraszewska, & Tylec, 2013).

Empirical Literature Review

The empirical literature review explored various studies on change management across different sectors, offering insights that informed the study's research framework. In an environment of persistent inflation, businesses face challenges in forecasting, investment, and strategic planning. Managing fixed costs, pricing strategies, and borrowing becomes increasingly complex, particularly as rising prices diminish consumer purchasing power. This decline in demand leads to reduced sales, which, in turn, compresses profit margins and impacts financial stability. As a result, companies may struggle to meet their financial obligations, increasing the risk of non-performing loans and deteriorating the quality of financing (Mbambo, 2020).

Empirical studies highlight the significant impact of inflation on SMEs. Senturk, Keskin, Kiris, Turkoz, and Kiris (2013) found that in Turkey, rising inflation heightened operational costs while reducing profitability. Similarly, Parsan and Kim (2024) reported that inflationary pressures in Canada led to lower consumer spending and increased input costs, negatively affecting overall business performance. SMEs also struggle with demand forecasting due to price fluctuations driven by inflation, making production planning more challenging. This unpredictability extends to pricing, interest rates, and exchange rates, heightening risks for trading partners and potentially stifling commerce.

Exchange Rates and SMEs Performance.

Exchange rates significantly influence SMEs' cost structures, income, and overall competitiveness, particularly for those engaged in international trade. Altun (2017) found that exchange rate volatility negatively affected the export performance and profitability of Turkish manufacturing SMEs. Similarly, Bergman, Berthou, and Hericourt (2015) highlighted that financial constraints exacerbate the adverse effects of currency fluctuations on French SMEs' export behavior, emphasizing the need for financial tools to mitigate currency risks. According to Osoro and Ogeto (2014), businesses face three types of foreign exchange risk: economic, transactional, and translational. Research by Bahmani-Oskooee and Gelan (2018) indicates that increased foreign exchange transactions due to supply and demand fluctuations contribute to erratic exchange rates, creating financial opportunities and risks for commercial banks in African markets.

Interest Rate and SME Performance.

Interest rates directly affect the cost of borrowing for SMEs influencing their investment capabilities and growth potential. The link between interest rates and SME financing in Vietnam is examined by (Nguyen, 2019), who finds that high interest rates severely restrict loan availability, which in turn restricts the growth and efficiency of businesses. Coeurdacier, De Santis, and Aviat (2015), who studied SMEs in Europe, concluded that lower interest rates encourage more investments and better financial health among SMEs, which supports this finding. The percentage of the loan principle that the lender receives from the borrower annually is known as the interest rate (Conard, 2021). The opportunity cost of lending money to the lender is represented by the interest rate (Del Negro et al., 2019).

Ndungu (2016) examined factors affecting SMEs' access to loans in Kenya, focusing on 1,020 SMEs in Nairobi, with a sample of 102 selected through stratified random sampling. The study found that the number of lending institutions, loan interest rates, collateral availability, and literacy rate were key determinants of credit accessibility. Similarly, Magembe (2017) investigated SME financing in Dar es Salaam, Tanzania, revealing that high interest rates and collateral requirements were major obstacles for financial institutions, with SMEs being primary contributors to non-performing loans.

Conceptual Framework

The conceptual framework shows the relationship between the change management practice determinants, which are the study independent variable organizational leadership and its effect on the dependent variable that is organizational resistance to change.

Figure 1: Conceptual Framework

METHODOLOGY

The study adopted a descriptive cross-sectional research design to analyze external economic factors affecting SMEs at a specific point in time rather than over an extended period (Saunders et al., 2016). The target population comprised clothing retailers, toy and toddler item sellers, electronics retailers, and general household item retailers in Kamukunji Market, totaling 125 SMEs, with the largest segment being toy and toddler item retailers (32%). Data was collected using a structured questionnaire designed to extract specific information from respondents, consisting of both structured and unstructured questions. Section 1 focused on retailers' background information, while Section 2 examined the impact of external economic factors on SME performance in Nairobi County. A 5-point Likert scale was employed for closed-ended questions, ranging from strong agreement to strong disagreement (Williams, 2024).

FINDINGS AND DISCUSSIONS

This section presents a detailed examination of the findings based on the variables under study. Notably, the section is structured in accordance to the objectives. The findings are thus, detailed as below:

Inflation Rate and SMEs Performance.

The study sought to understand the interrelationship between inflation rates and SMEs performance. The findings are as detailed below:

Table 2: Inflation Rate and SMEs Performance.

Statements	1	2	3	4	5
Inflation means that prices for things we buy go up. When this happens, people might not be able to buy as much with the money they have because it doesn't stretch as far. This can make more difficult for some people to pay for the necessities. Also, when prices go up, it can change how much money people who lend or borrow money can actually spend.	55%	35%	10%	0%	0%
During times of rising inflation, companies may experience a contraction in their profit and growth margins, which can in turn erode investor confidence. This diminished faith in the market may lead to a hesitance among investors to embrace the risks associated with equity ownership.	62%	32%	6%	0%	0%
Price increases brought on by inflation may result in decreasing consumer demand for non-essential goods, supply chain disruptions, and increased operating costs for small businesses. Comprehending these possible obstacles is essential for effectively managing inflationary times.	70%	23%	7%	0%	0%
Price increases reverberate beyond the immediate effects on customers. As we have noted, rising costs lead to demands for higher wages, as employees seek compensation that reflects the escalating inflation or consider alternative employment opportunities. Furthermore, businesses face significant challenges due to intensified supply pressures, as they grapple with the necessity of paying more for materials and products.	80%	20%	0%	0%	0%
The detrimental impact that inflation has on banks will eventually lower their success and profitability if proper actions are not taken. Because there is a significant demand for bank services and programs during periods of low inflation and high consumer purchasing power, banks must also make investments during these periods.	31%	21%	3%	0%	45%

The study examined the impact of inflation on the performance of SMEs in Nairobi County, highlighting the far-reaching effects of rising prices on businesses and consumers. A key finding was that inflation leads to the depreciation of real income, reducing consumers' purchasing power and affecting both borrowers and lenders. The results indicated that 55% of respondents strongly agreed, 35% agreed, and 10% remained neutral, demonstrating that inflation significantly influences SME performance. As inflationary pressures mount, businesses face higher operational costs, particularly in raw materials, wages, and utilities, making it difficult to maintain stable profit margins.

Additionally, 62% of respondents strongly agreed and 32% agreed that rising inflation contributes to shrinking corporate profit and growth margins, which, in turn, weakens investor confidence and reduces their willingness to take risks in equity markets. SMEs particularly struggle to absorb these costs, as they often lack the financial resilience of larger enterprises. Furthermore, 70% of respondents strongly agreed that inflation-driven price increases reduce consumer demand for non-essential goods, disrupt supply chains, and elevate operational costs. This presents a significant challenge for SMEs, as they must navigate price volatility while ensuring business continuity.

Moreover, 80% of respondents strongly agreed that inflation pressures businesses to raise wages to match escalating living costs, leading to increased financial strain. Simultaneously, supply chain disruptions force firms to pay higher prices for essential materials and products, further tightening profit margins. However, inflation does not solely have negative consequences; it can reduce the real value of debt, which may benefit businesses with outstanding loans. Moderate inflation, when driven by strong economic growth, can also stimulate demand and allow businesses to increase prices, thereby enhancing profitability (Pettinger, 2016). Nevertheless, sustained high inflation remains detrimental, as it raises financial instability, intensifies competition for resources, and ultimately hampers SME growth and sustainability.

Exchange Rates and SMEs Performance.

The study also examined exchange rate interrelationship with performance, as detailed below;

Table 3: Exchange Rates and SMEs Growth and success.

Statements	1	2	3	4	5
The financial growth and success of the company will be impacted, and its market value may even be impacted, when domestic exchange rates are unstable.	70%	20%	10%	0%	0%
The market value of a company's equity may be immediately impacted if a shift in the foreign exchange rate influences the company's projections for present and future cash flows.	56%	43%	1%	0%	0%
When people buy and sell things from different countries, it affects how much money is worth. This can change how much stuff costs, how fast money moves around, and even how much money people earn in interest.	67%	30	3%	0%	0%
When the value of money goes up, it means you can buy more with it. Even though things might cost a little more in the store, people who make things are excited because they think it will be cheaper for them to get the parts they need from other places. So, they'll make more stuff to sell!	62%	30%	8%	0%	0%
When people talk about money from different countries, like the pound and the dollar, they sometimes guess how much one money will be worth compared to the other. If they thought the pound was going to get stronger (worth more) than before, now they think it will get even stronger. In addition, if they thought, the dollar was going to get weaker (worth less); now they think it will get even weaker.	76%	20%	4%		

The study found that exchange rate uncertainty significantly affects SME growth and market value in Nairobi County, with 70% of respondents strongly agreeing and 20% agreeing. Research in African finance indicates that higher foreign exchange demand and supply increase transactions, leading to fluctuating exchange rates (Bahmani-Oskooee & Gelan, 2018). These fluctuations create financial opportunities and risks for commercial banks, affecting both profitability and potential losses.

4.1.3 Interest Rate and SME Growth and success.

Table 4: Interest Rate and SME Growth and success.

Statements	1	2	3	4
The cost of borrowing is one of the largest drawbacks that high interest rates have for small businesses. Since lenders charge a premium for borrowed funds, company owners' interest costs on loans and credit lines rise in tandem with the Fed rate.	40%	40%	20%	0%
Higher interest rates cause businesses to borrow less money for investments, funding little to nothing for projects that boost growth instead.	44%	40%	16%	0%
In addition to reducing consumer spending and slowing company expansion, higher cost of financing may influence the worth of a nation's currency and the health of its financial markets.	38%	40%	20%	2%
Businesses and consumers will reduce their expenditure when interest rates are rising. Stock prices and earnings will decline as a result.	62%	30%	7%	1%
A rise in interest rates can result in increased overhead, lower discretionary income, and higher interest payments for companies using company credit cards and current loans.	50%	40%	10%	0%

The study's third objective was to evaluate the impact of currency rates on the expansion and prosperity of SMEs in Nairobi County. Using a Likert scale, participants responded to five key questions assessing the effects of interest rate fluctuations. When asked about rising interest rates leading to reduced spending and lower earnings, 62% strongly agreed, 30% agreed, 7% were neutral, and only 1% disagreed. Additionally, 44% strongly agreed and 40% agreed that higher interest rates discourage borrowing for investment, limiting business growth initiatives. Regarding the financial burden of corporate credit cards and loans, 50% strongly sympathized, 40% agreed, and 10% remained neutral, highlighting the direct impact of interest rates on business operations.

Further analysis examined the broader economic implications of rising interest rates, such as reduced consumer spending, slowed business growth, currency valuation shifts, and financial market effects. The results showed that 38% of respondents strongly agreed, 40% agreed, 20% remained neutral, and 2% disagreed. Descriptive statistics revealed that elevated interest rates pose significant challenges for SMEs, particularly in borrowing costs. As central banks increase rates, lenders impose higher premiums on loans, making it more expensive for business owners to finance their operations. Survey results indicated that 40% of participants strongly agreed with this assertion, another 40% agreed, and 20% remained neutral, emphasizing the financial strain on SMEs.

SMEs in economies with less developed financial systems often face higher interest rates due to limited access to competitive loan options. Government policies also play a crucial role in shaping the financial landscape. According to Beltrame et al. (2023), access to financing remains a significant challenge for SMEs, as capital is essential for starting, expanding, and sustaining businesses. Factors such as an SME's risk profile, including its size, capital base, and credit history, influence borrowing ease (Cheong et al., 2020). Consequently, SMEs often face stricter lending requirements and higher interest rates. Additionally, global economic conditions impact available financial options, further complicating access to affordable credit for SMEs (Moulick et al., 2021).

SUMMARY OF FINDINGS

The study examined the impact of external economic factors on the growth and success of SMEs in Nairobi County, focusing on Kamukunji. Findings indicated that rising inflation significantly increases operational costs, including raw materials, rent, and utilities, making it difficult for SMEs to maintain profit margins. High and fluctuating interest rates further limit SMEs' access to affordable credit, restricting their ability to sustain or expand operations. Additionally, currency depreciation raises import costs, squeezing profit margins, although exporters may benefit slightly. SMEs play a crucial role in entrepreneurship, innovation, and employment, with formal SMEs contributing 45% of the workforce and 33% of GDP in developing nations (Kinyua, 2014; World Bank Group, 2015). Globally, there are approximately 365-445 million MSMEs, with 285-345 million operating informally (World Bank Group, 2015).

CONCLUSION

The study has found that external economic factors, including inflation, interest rates and exchange rate fluctuations, significantly affect the growth and success of SMEs in Kamukunji. These factors create challenges in maintaining profitability, accessing capital, and sustaining operations, particularly during periods of economic turbulence

RECOMMENDATIONS

The study recommends that SMEs in Kamukunji receive training and education on understanding and responding to external economic factors such as global markets, interest rates, inflation, and currency trends. Workshops on economic forecasting, financial management, and risk mitigation strategies can equip business owners with the necessary skills to navigate economic fluctuations effectively. Given that inflation and high interest rates raise operational costs, improving access to affordable financing is essential. This can be facilitated through government-backed credit programs, microfinance institutions, and subsidized loans, enabling SMEs to maintain liquidity and sustain operations during economic challenges.

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