

The Effect of Trade Liberalization on Economic Growth in Kenya



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ABSTRACT: Trade liberalization and its impact on economic growth has been a subject of debate for many years both at international and local level. The debate has been lengthened by the fact that there are no theoretical underpinnings that directly link trade liberalization to economic growth or are there any absolute terms and conditions by which trade liberalization leads to economic growth. Trade liberalization is the removal or reduction of barriers to trade that ensures free movement of goods and services from one nation to another. Kenya liberalized their trade with the hope of having dynamic gains from trade, and that the liberalization will lead to economic growth and, consequently, improve welfare. However, its key development challenges still include poverty, inequality, youth unemployment, continued weak private sector investment, and the vulnerability of the economy to internal and external shocks. This study aimed to examine the effect of trade liberalization on economic growth in Kenya and finding empirical answers to this phenomenon is what motivated this study. The objective of the study was to examine the effect of manufacturing output and foreign direct investment on Kenya's GDP. Foreign direct investment and manufacturing output were tested to determine their effect on the Kenyan economic growth. This study adopted descriptive research design. Time series data spanning 1990 to 2022 was used for the study. The data was meticulously sourced from the World Bank. A time series diagnostic test was carried out on the data. This study adopted descriptive designs. Vector Autoregressive (VAR) model was applied. Results showed that foreign direct investment inflows and manufacturing output had a significant effect on economic growth in Kenya. In conclusion, these findings imply that although foreign direct investment (FDI) may have negative effect on Kenya's economic growth while manufacturing output support economic growth. In order to sustain long-term economic growth, Kenyan policymakers may want to consider ways to draw in beneficial FDI while simultaneously emphasizing the manufacturing sector which will be beneficial for the economy.

OPERATIONAL DEFINITION OF KEY TERMS

Gross Domestic Product: The entire value of all products and services produced over a specific time period, often a year.

Trade liberalization: The lowering of trade restrictions is referred to as trade liberalization. Therefore, ensuring the free flow of products and services from one country to another depends on the elimination or decrease of trade obstacles.

FDI: This is investments made by foreigners in a firm that is resident in a country that the investor is not based.

Economic growth: This is gross domestic product rising over a one-year period as the primary quantitative measure of production.

Manufacturing output: The total amount of products and services produced by a whole nation during a given point in time period.

INTRODUCTION

Since the early 1970s, trade liberalization has dominated policy discussions in studies on development. The foundation of economic growth for developing nations is trade liberalization, a pathway via which products and services, foreign direct investments, and capital investments move across borders or to specific countries and areas (Zcan et al., 2018). The purpose of liberalizing trade is to improve production of goods and promote exports through the exploitation of fundamental theories of trade that are outcome of enhanced technical development and exposure to foreign competition. Removal or reduction of barriers to trade between countries have been emphasized in a bid to diversify their economies, countries embark on trade liberalization with the aim of boosting their overall economy.

The primary justification for this level of dedication in reforming trade program is the evident conviction that liberalization is a requirement for a change from relatively closed to relatively open economies. Most economists argued that liberalized economies

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expand more quickly than closed ones. Liberalization is necessary for growth if openness and growth are, in fact, positively correlated. Although they showed promise at first, current evidence indicates that not all trade changes have been as effective as hoped (Singh, 2012).

Trade liberalization has drawn a lot of attention from both established and developing nations since the world is quickly becoming a global village. Trade liberalization has led to a marked increase in the growth of global trade relative to world production. Global trade volume has grown sixteen times while global production (or GDP) has multiplied by five at an average compound annual growth rate of just over seven percent. In numerous countries, especially in South-East Asia, export growth has exceeded 10% yearly. In countries whose exports have a propensity to increase quickly, more open trade policies have resulted in quicker GDP growth. (Thirlwall, 2014).

Under the leadership of the World Trade Organization (WTO), International Monetary Fund (IMF), and World Bank, developing economies are confronted with new fiscal revenue issues and are compelled to modify their conventional revenue collecting strategies (WTO 2017). On the advice of the WTO, IMF, and World Bank, developing nations are likewise lowering their tariff rates from the previous three decades, following the lead of industrialized nations (Ali 2017).

Kenya's trade emancipation process developed in stages as a result of numerous trade facilitation techniques. The Kenyan government took action to implement trade policies that would support and safeguard the indigenous economy as soon as the country gained independence in 1963. Since policies promoting economic liberalization were put in place, the economy has undergone significant changes during the past 20 years. Among many other reforms, they include the elimination of import, pricing, and foreign exchange controls. In order to stay competitive, businesses have been forced to adapt their organizational structures, product designs, production methods, corporate cultures, and overall stance.

The use of export promotion programs and structural adjustment policies (SAPs) which was implemented by the Kenyan government to stimulate economic growth. This era, which lasted from the end of the 1980s to the beginning of the 1990s, was established to address the structural rigidities, price volatility, and macroeconomic imbalances that had crept into the economy and caused poor service delivery by the public sector (Nyaga, 2015).

In Kenya, the agricultural sector still generates 67% of overall national exports, 70% of informal job created in rural Kenya, and source of income for about 80% of the population, despite relatively well-developed manufacturing and service sectors (Government of Kenya, 2010). Kenya is a much diversified nation in terms of its agro-ecological systems (World Bank, 2008). The performance of Kenya's agriculture was usually rated as good. Although there were taxes on the agriculture sector, they were not as high as in some other African nations (World Bank, 2014).

Kenya is an international major producer of dairy products, tea, meat, horticultural products, and coffee, and a major supplier of the main staple food crop maize and sugar for the local market, reflecting the high level of agricultural performance diversity within the nation. Strong agricultural activities in specific crops and various locations, however, has not always been enough to considerably alleviate rural poverty.

Export-Processing Zones (EPZs) make it easier to produce, assemble, and process products that are primarily aimed at export markets. Transactions in EPZs are exempt from import duties and limitations, which spares them from the administrative burdens and delays sometimes associated with other "partial-export" regimes (WTO 2014).

The EPZ plan, which was established in 1991, offers export-oriented businesses in specified zones a bundle of incentives. Kenya has more than 12 EPZs in various levels of development by 2013. They had made a total of Ksh. 10 million in investments. The EPZ companies are eligible for a number of privileges, including a ten-year exemption from corporation tax, duty and VAT on all of their inputs, stamp tax, rent and tenancy regulations, industrial and statistics registration requirements, and the Factories Act.

These incentives aim to reduce manufacturing costs in comparison to businesses operating outside of the EPZs. (Mwega 2017). Despite all these reforms more effort are been put in place for sustainability and revamping the economy. Moreover, the reforms are aimed at stimulating rapid economic growth

Adoption of trade liberalization by Kenya aims at allowing Kenya as a hub for economic activity to attain efficiency and specialization and also allowing them to obtain a competitive edge in the present world market which has experienced evolution such as globalization and openness in trade, which in turn increases productivity, reduce the price of imported commodities and cost of production in the country (Nyerre 2016). Therefore the aim of this study was to examine some trade variable, which will bring light to understand the effect of trade liberalization on economic growth in Kenya.

EMPIRICAL LITERATURE

Foreign Direct Investment and Economic Growth.

Zhang, (2016) used data from 11 economies in East Asia and Latin America to present an empirical analysis of the problem. Although it was predicted that FDI would accelerate host nation economic growth, it was discovered that how much FDI

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accelerated growth appeared to rely on country-specific factors. Particularly, host nations that implemented a liberalized trade policy, improved education and, therefore, human capital conditions, encouraged export-oriented FDI, while sustaining macroeconomic stability appeared to be more likely to use FDI to stimulate economic growth.

Khine (2018) used descriptive statistics to depict the Foreign Direct Investment Relations between Myanmar and ASEAN. The author makes an effort to illustrate why FDI is crucial for Myanmar in order to close the growth gap with other top ASEAN nations. After implementing a market-oriented economic strategy, Myanmar has implemented an FDI policy to increase FDI inflows.

Qamruzzaman (2022) used four skilled country groups, middle-low-income countries, low-income countries, middle-high-income nations, and a worldwide model—to explore the connection between renewable energy, FDI, and agricultural production. The empirical findings indicate that they have a typical inverted U-shaped connection. To put it another way, FDI considerably reduces energy use.

Zhang (2011) asserts that FDI promotes economic growth in nations with an open trade administration, a skilled worker force, and a high literacy rate. He continued by reiterating that FDI grants full access to global markets and serves as a conduit for the host nation to participate in the process of globalization.

Jacobs and Coolidge (2019) found a gradual association between foreign direct investment (FDI) and economic development in their research of 81 nations, with the relationship starting to decline in the mid-1980s. They argued that trade liberalization and foreign direct investment (FDI) have favorable effects on economic growth.

Rand and Thanoon (2020) employed dynamic panel models to validate the increasing influence of foreign direct investment on the economic expansion of East Asia. They held the view that, based on data from 28 developing countries, there is no correlation between the long-term and short-term effects of foreign direct investment (FDI) on economic growth; in fact, no single country was found to have a positive unidirectional long-term effect of FDI to GDP.

MANUFACTURING OUTPUT AND ECONOMIC GROWTH

In a research published in 2019, Araba examined the performance of the Nigerian manufacturing sector in terms of the correlation between energy consumption, performance, and productivity for manufacturing firms. The study's aggregate model led to the conclusion that the efficiency and productivity of Nigerian manufacturing companies are certainly influenced by the availability and cost of energy.

Abdul-Khaliq (2019) examined the causal relationship between Jordan's production growth and the country's economic growth using time series data from 2000 to 2016 and the Granger approach. Using the Granger causality test, this investigation determined which variables were causally related. They employed the co-integration test to determine whether or not there was a long-term relationship. This study revealed evidence of a unidirectional association between output and economic growth.

Herman (2016) said, using statistical analysis of economic data from Romania, that the reduction in manufacturing sector to GDP and employment creation is evidence of deindustrialization. Since 2000, the deindustrialization process has weakened, allowing industry to remain the engine of the Romanian economy.

Manufacturing boosts growth through structural change involving an increase in productivity, according to Cantore et al. (2017), who break down the impact of the manufacturing sector on economic development into structural transformation and employment impacts in 80 nations. Keho (2018) believes that in the majority of ECOWAS nations, industrial production boosts economic development. Moreover, the impact is especially noticeable in Senegal and Nigeria, where increased industrial production stimulates growth in the services and agricultural sectors.

Another result by Timmer and de Vries (2012) in a sample of Asian and Latin American countries is the rising importance of the service industry. Using growth accounting techniques, they examine the effects of different sectors during periods of growth accelerations, periods of regular growth, and periods of slowdown. They find that when there is usual expansion, manufacturing has the most influence. While manufacturing still makes a significant positive contribution, the service sector increasingly assumes this dominant position during periods of economic growth.

Su and Yao's (2017) research of long-run Granger causality tests, panel regression, and cross-sectional regression demonstrated that the expansion of the manufacturing sector propels the growth of the services sector. Based on their findings, the authors have concluded that manufacturing plays a crucial role in driving economic growth and that premature deindustrialization can have adverse impacts on economic growth.

According to research by Can and Okdi (2019), manufacturing production boosts economic development in newly industrialized nations. Arthur and Cook (2016) arrive to the conclusion that increasing manufacturing strengthens the incentives for saving and acquiring new technologies, both of which are essential for middle-income nations to see economic development. The findings of Arthur and Cook (2016) are supported by Marconi, and Araùjo (2016), who concluded that growth in manufacturing production is crucial for economic development and productivity, especially in middle-income nations.

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RESEARCH METHODOLOGY

Research design

The study employed descriptive research design which identified the causal relationship between the independent and dependent variables. This involved collection and analyzing of secondary data to ascertain the relationship between the independent variable and the dependent

Data Collection Instrument and Procedure.

The study used annual secondary data for each of the variable. A data capture sheet was used to obtain the information. The sheet contained an annual observation of each of the variables of this study relating to the effect of trade liberalization on economic growth in Kenya. The independent variables consisted of manufacturing output and foreign direct investment while gross domestic product is the dependent variable. The data was collected from database held by central bank of Kenya for the period of 32 years from 1990 and 2022.

Data analysis and presentation techniques

This study made use of statistical package for social service (SPSS) to assess the effect of trade liberalization on the economic growth of Kenya and was based on the vector autoregressive (VAR) approach,

RESULTS AND DISCUSSION

Descriptive Statistics for Each Variable

According to the information presented Table 1, Kenya's GDP, FDI and manufacturing output numbers vary considerably across observations, with a mean value of about 41.30 billion, 0.357 billion and 4.12 billion USD respectively.

Table 1: Descriptive Statistics

Variable	Obs	Mean (Billion USD)	Std. Dev. (Billion USD)	Min (Billion USD)	Max (Billion USD)
GDP of Kenya	33	41.30	36.10	5.75	130.00
FDI Inflows	33	0.357	0.44	0.05	1.45
Manufacturing output	33	4.12	2.97	0.49	9.08

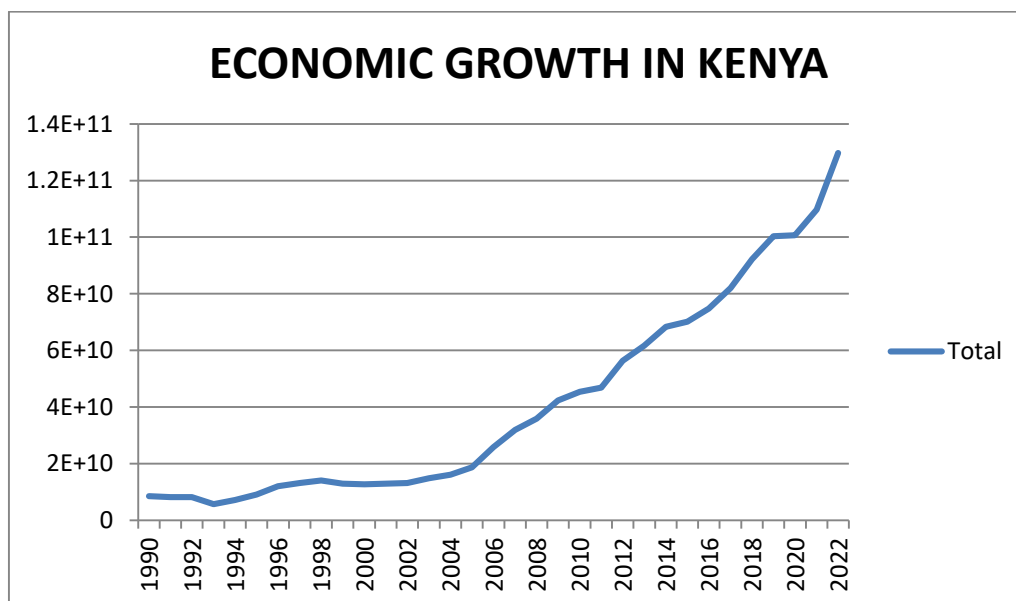


Figure 1: Economic growth of Kenya

Source: Research, 2024

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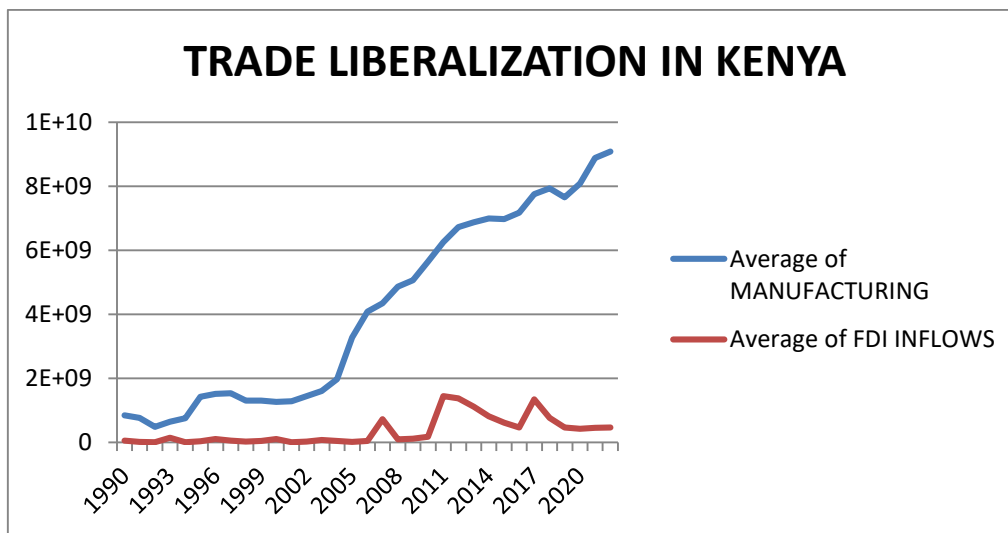


Figure 2: Trade liberalization in Kenya

Source: Research, 2024

Correlation Analysis

Table 1 Pairwise correlation

Variables	GDP	FDI Inflows	Imports	Manufacturing output
GDP of Kenya	1.0000			
FDI Inflows	0.5824*	1.0000		
Manufacturing output	0.9535*	0.7024*	0.9695*	1.000

Source: Research, 2024

The lower the p-value, the more significant the correlation is, indicating that the observed relationship is unlikely to have occurred by chance. There was a moderate positive correlation (0.5824) between GDP and FDI inflows in Kenya.. Further, there was an extremely strong positive correlation (0.9535) between GDP and manufacturing output in Kenya. Kenyan GDP was almost perfectly correlated with manufacturing output. This indicates that the growth in GDP is closely related to the performance of the manufacturing sector

Normality Assumption Using Jarque-Bera Test

The Jarque-Bera test statistic in Figure 4.3 was 0.0779, and its p-value was 0.962, which is larger than 0.05 and shows that the null hypothesis cannot be ruled out. Thus, there has been no alteration to the data supporting normal distribution.

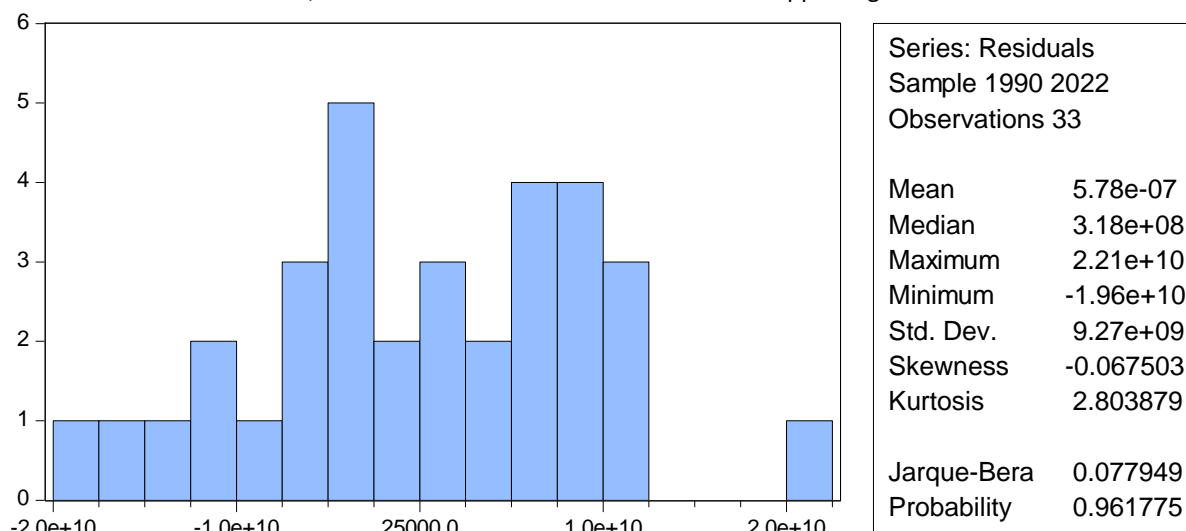


Figure 3: Jarque-Bera test for Normal Distribution of Residual.

Source: Research, 2024

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Serial Correlation

The findings showed that the chi-square p-value was 0.0741. The study came to its conclusion by accepting the null hypothesis that there was no serial correlation. Additionally, Durbin Watson (1951), who proposed that the d-statistic lay between 1.5 and 2.0, provides support for the findings. The table show Durbin Watson statistic was 1.77 confirming no serial correlation.

Table 2: Breusch-Godfrey Serial Correlation LM Test

F-statistic	20.29601	Prob. F(2,27)	0.0000	
Obs*R-squared	1.81797	Prob. Chi-Square(2)	0.0741	
Sample: 1990 2022				
Included observations: 33				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
FDIINFLOWS	10.53493	4.151425	2.537665	0.0172
MANUFACTURING	1.387699	1.566163	0.886050	0.3834
C	9.03E+08	2.44E+09	0.370414	0.7140
RESID(-1)	0.563273	0.183666	3.066839	0.0049
RESID(-2)	0.490784	0.197952	2.479311	0.0197
R-squared	0.600545	Mean dependent variable	5.78E-07	
Adjusted R-squared	0.526571	S.D. dependent variable	9.27E+09	
S.E. of regression	6.38E+09	Akaike info criterion	48.15231	
Sum squared residuals	1.10E+21	Schwarz criterion	48.42440	
Log likelihood	-788.5131	Hannan-Quinn criterion.	48.24386	
F-statistic	8.118402	Durbin-Watson stat	1.77173	
Prob(F-statistic)	0.000088			

Source: Research, 2024

Homoscedasticity Using Breusch-Pagan / Cook-Weisberg

The test's findings, presented in Table 4, reveal that the residuals of the model exhibit a homoscedastic distribution. The null hypothesis is supported by the p-values for the chi-square test statistics of 0.0598, which are greater than the significance cutoff of 5% (0.05).

Table 3: Heterskedasticity Test: Breusch-Pagan-Godfrey

F-statistic	4.987885	Prob. F(3,29)	0.0065	
Obs*R-squared	11.23202	Prob. Chi-Square(3)	0.0105	
Scaled explained SS	7.823540	Prob. Chi-Square(3)	0.0598	
Test Equation:				
Method: Least Squares				
Date: 10/06/23 Time: 14:47				
Sample: 1990 2022				
Included observations: 33				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	2.75E+19	3.70E+19	0.743511	0.4632
FDI INFLOWS	-1.59E+11	5.67E+10	-2.800888	0.0090
MANUFACTURING	4.21E+10	2.36E+10	1.784895	0.0847
R-squared	0.340364	Mean dependent variable	8.33E+19	
Adjusted R-squared	0.272126	S.D. dependent variable	1.14E+20	
S.E. of regression	9.69E+19	Akaike info criterion	94.99107	
Sum squared residual	2.72E+41	Schwarz criterion	95.17247	
Log likelihood	-1563.353	Hannan-Quinn criterion	95.05211	
F-statistic	4.987885	Durbin-Watson stat	1.892540	

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Prob(F-statistic) 0.006532

Source: Research, 2024

Multicollinearity Using Variance Inflation Factors (VIF)

The VIF test produced values ranging from 1.13 to 1.65. Variables with a high VIF of 10 indicate substantial multicollinearity (Newbert, 2008). There can be no problems with this study from the VIF's point of view. As a result, based on the results of the diagnostic tests, multicollinearity does not appear to be a problem.

Table 4: VIF Measure for Multicollinearity

Variables	Variance inflation Factors (VIF)	Tolerance (1/VIF)
Manufacturing output	1.65	0.6061
FDI inflows	1.13	0.8850
Mean VIF	1.39	

Source: Research, 2024

Table 5: Model Estimation

Source	SS	df	MS	
Residual	3.8926e+22	3	1.2975e+22	Number of obs = 33
	2.7474e+21	29	9.4739e+19	F(3, 29) = 136.96 Model
Total	4.1674e+22	32	1.3023e+21	Prob > F = 0.0000
				R-squared = 0.9341
				Adj R-squared = 0.9273
				Root MSE = 9.7e+09

gdp	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]
Fdi(inflows)	-17.34457	5.697323	-3.04	0.005	-28.9969 -5.692233
manufacturing	8.421382	2.367712	3.56	0.001	3.578868 13.2639
_cons	-1.22e+10	3.72e+09	-3.29	0.003	-1.98e+10 -4.63e+09

Source: Research, 2024

DISCUSSIONS OF THE FINDINGS

The table presents regression coefficients of the trade liberalization variables on economic growth in Kenya. FDI inflows have a negative and significant contribution on economic growth ($\beta=-17.345$, $p=0.005<0.05$). The manufacturing output have a positive and significant effects on economic growth with respective coefficients $\beta=8.421$ ($p=0.001<0.05$). From the findings, the coefficient (β) for FDI inflows is -17.345. Since this coefficient is negative, it suggests that there is a negative relationship between FDI inflows and economic growth. In other words, an increase in foreign direct investment (FDI) is associated with a decrease in economic growth. The negative sign indicates an inverse correlation. This negative relationship is statistically significant because the p-value (0.005) is less than the commonly used significance level of 0.05. Therefore, the negative impact of FDI inflows on economic growth is considered statistically significant in this analysis.

The coefficient for manufacturing output is 8.421. This positive coefficient suggests a positive relationship between manufacturing output and economic growth. When manufacturing output increases, it is associated with a rise in economic growth. This effect is statistically significant because the p-value (0.001) is less than 0.05, indicating a significant impact of manufacturing output on economic growth.

The study found that FDI negatively influence economic growth. According to the study, the short-term negative effects on GDP caused by FDI may be the result of sectorial imbalance, as FDI may weaken local industries. For instance, if a sizable part of FDI is focused on industries that directly compete with already-existing local enterprises, it could result in a brief decline in GDP as domestic industries adapt to the new competition. If FDI entails extensive resource extraction without significant value addition,

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it can result in a situation where raw materials are exported, which would have a limited positive impact on domestic economic growth. If the profits from resource extraction are not being invested back into the local economy, this could result in a decline in GDP.

The mean value of Kenya's GDP across observations is approximately 41.30 billion USD. Kenya's GDP has ranged between a minimum of 5.75 billion USD and a maximum of 130.0 billion USD, according to the data. The economy of Kenya has undergone severe changes, and the economy's very high standard deviation suggests that GDP estimates might range widely. The minimum and highest values draw attention to the variation and economic variety of the nation during the observed time. The records show that FDI has varied in Kenya, with a mean value of roughly 0.357 billion USD. From 0.05 at the lowest end to 1.45 billion at the highest, FDI quantities are available. Foreign direct investment into Kenya has fluctuated somewhat. The average manufacturing production is roughly 4.12 billion USD. Minimum and maximum manufacturing output values are 0.49 and 9.03 billion dollars, respectively. Kenya's manufacturing sector shows moderate variability. The standard deviation suggests some fluctuations around the mean value. The range between the minimum and maximum values indicates the diversity in manufacturing activities within the country.

Kenyan goods and services become more competitive in the global market. This can boost economic growth by increasing revenue for domestic industries and creating jobs. While liberalization promotes exports, it also exposes domestic industries to greater competition from foreign goods and services. This can lead to increased efficiency as domestic industries strive to improve their products and processes to remain competitive. However, it can also lead to job losses in sectors unable to compete.

Manufacturing output had a considerable and significant positive impact on GDP. From an economic perspective, manufacturing has the potential to generate a significant multiplier effect on the economy. When manufacturing output increases, it creates demand for various inputs such as raw materials, labor, machinery, and services. This increased demand for inputs stimulates economic activity in multiple sectors, leading to further production, job creation, and income generation. The additional income earned by individuals and businesses is then spent on consumption, creating a cascading effect that magnifies the initial increase in manufacturing.

Access to international markets can encourage diversification of the Kenyan economy. Instead of relying heavily on a few sectors, a diversified economy is often more resilient and can sustain economic growth in the long term. Trade liberalization can lead to a greater variety of goods and services available to consumers, often at lower prices due to increased competition. This can improve the overall standard of living for the population. Increased trade, especially exports, can lead to higher government revenue through taxes and tariffs. This revenue can be reinvested in public infrastructure, education, and healthcare, fostering economic development. However, it's important to note that the benefits of trade liberalization are not automatic and can be influenced by various factors, such as the quality of institutions, infrastructure, the skill level of the workforce, and global economic conditions. Additionally, there are potential challenges, such as trade imbalances, that need to be managed to ensure sustainable economic growth.

Manufacturing requires a lot of labor and can produce positions for people with a range of skills, from assembly line workers to engineers and designers. Higher economic growth is facilitated by more work possibilities, which also lower unemployment and increase consumer spending. The extraction of raw materials, transportation, logistics, and services are all strongly related to manufacturing. A rise in manufacturing develops favorable supply chain connections that help a variety of businesses. .

However, it's crucial to remember that depending on the unique economic backdrop, policy, and other factors, the exact degree of this link might change. This study is supported by Chakravarty and Mitra (2009) who came at the conclusion that India's manufacturing sector drives economic growth. The manufacturing industry, according to the authors, also fosters growth in other industries over the long run. Singariya and Sinha (2015) discovered using the Johansen test that there is a long-term association between the variables in India and the causal direction from manufacturing to GDP.

CONCLUSION

The study can infer a number of economic implications about the connections between these trade liberalization factors and Kenya's economic development based on its findings.

Here are some policy recommendations for Kenya to boost its economic growth based on the trade liberalization factors. These policy suggestions ought to be put into practice with an emphasis on long-term economic sustainability and inclusive growth, taking into account the particular difficulties and chances present in Kenya's economic environment. Trade liberalization, when implemented effectively, can have positive effects on economic growth by promoting efficiency, fostering innovation, and enhancing overall competitiveness. The following are policy suggestions. Implement institutional reforms to improve the ease of doing business, enhance contract enforcement, and reduce corruption. Transparent and efficient institutions create a favorable environment for trade and investment. Support export-oriented industries and help diversify export markets. Diversification

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reduces dependency on a specific market and enhances resilience against economic fluctuations. Improve infrastructure, including transportation, energy, and communication networks. Efficient infrastructure reduces trade costs and makes it easier for businesses to engage in international trade.

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