

**FACTORS INFLUENCING BILATERAL TRADE BETWEEN KENYA AND
HER TRADING PARTNERS**

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DECLARATION

This research project report is my original work and has not been submitted for any degree in any other University.

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This research project report has been submitted for examination with my approval as a university supervisor.

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DEDICATION

This work is dedicated to my endearing mama, Yes!

*It is here with us
To embrace*

*When we hold on long
To see with the soul
To hear with the spirit
To feel with the heart*

*It comes to fruition
For us
To make our mark
To set the precedence
In His gracious light...*

ABSTRACT

African countries continue to be the major destination of Kenya's exports followed by the European Union. It has however, been observed that some of the traditional trade partners of Kenya seem to be taken over by newcomers. This study sought to determine the factors that influence bilateral trade flows between Kenya and her trading partners.

The study was designed as a descriptive survey. The population was Kenya's trading partners and the subsequent sample was therefore nine countries. Primary and secondary data was collected. Secondary was collected on trade and economy from the Kenya National Bureau of Statistics and the World Bank Database while colony, culture and distance were searched from the internet. The model employed was the standard gravity model. Primary data was collected using questionnaires and interviews from key informants. Data was analysed using descriptive, correlation, and regression analyses.

The study found that consistent with literature, distance was negatively related with trade while colony, culture, and economy were positively related with trade. The model explained 41% of the variance in trade. However, the model was not significant in explaining the relationships and none of the determinants tested was significant at 5% level. The study concluded that standard gravity equation variables (colony, distance, border, culture, and economy) were not significant determinants of bilateral trade between Kenya and her trading partners. The study recommended that the Ministry of Trade should focus on institutional factors rather than those studied here in order to improve the bilateral trade as the factors studied here were not major determinants of trade.

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ACRONYMS

APEC	Asia-Pacific Economic Cooperation
AU	African Union
COMESA	Common Market for Eastern and Southern Africa
EAC	East African Co-operation
EU	European Union
GDP	Gross Domestic Product
ICT	Information and Communication Technology
IGAD	Inter Governmental Authority on Development
KNBS	Kenya National Bureau of Statistics
OECD	Organisation for Economic Co-operation and Development
SME	Small and Medium Enterprises
UK	United Kingdom
USA	United States of America

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

The global economy can be defined as one with the capacity to work as a unit in real time on a world scale. This globality concerns the core process and elements of the economic system, that is, design, production, distribution, consumption, services, and financial activities. Behind all this logic, there are some elements that make this new economic system possible: the transport and information technology revolutions, the liberalization process in many economies around the world during the 1980s and 1990s, the formation of a single international financial market, and the active role of the transnational corporations.

The creation of the single global market is changing the direction of trade in the world and countries are becoming more closely integrated than before. During the 1980s the phenomenon of economic integration accelerated at a great pace. Commodities, money, and information moved across national borders faster and more efficiently than ever before. The average annual growth rate of world exports from 1980 to 1990 was 5.3 percent, significantly higher than the average annual growth rate of world GDP of 3.1 percent (World Bank, 1996).

During the last few decades the most important transformation underlying the emergence of a global economy concerned the management of production and distribution, and the production process itself. In this sense, cities all around the world are becoming new

“regional centre’s” connecting the network of interactions on which the global economy is based. Moreover, as soon as a region in the world becomes integrated into the global economy, thereby injecting dynamism into its local economy and society, the setting up of the urban hub for advance services becomes a pre-requisite (Carrere, 2006).

1.1.1 Factors Influencing Trade Flows

There are a number of factors that could affect trade flows. The gravity model provides such factors. The gravity variables are distance, common border, cultural distance, colonial ties, and economic scale (Baxter and Kouparitsas, 2006). The greater is the distance between two countries, the higher are the costs associated with transporting goods, thereby reducing the gains from trade and reducing trade itself. Many researchers have shown that the influence of distance on trade is non-linear, with trade between bordering countries being significantly greater than countries that are positioned at similar distances, but do not share a border. Measures of ‘cultural distance’ have also been considered as determinants of international trade (Glick and Rose, 2002). In recent work, Glick and Rose (2002) investigate the importance of colonial ties for international trade. Empirical gravity models have shown that measures of economic scale are important determinants of bilateral trade.

A country’s factor endowments are thought to be important determinants of the country’s pattern of trade. The longstanding belief in the importance of factor endowments is a consequence of the widespread acceptance of the Heckscher-Ohlin model of international trade. Specifically, the Heckscher-Ohlin theory predicts that country pairs should trade more; the more different are their factor endowments. Early empirical investigations

based on the Heckscher-Ohlin theory were quite negative; the classic paper is by Bowen, Leamer, Sveikauskas (1987). Frankel, Stein and Wei (1995), in their study of regional trading blocs, find weak to no support for the Heckscher-Ohlin hypothesis. Frankel, Stein and Wei include, along with other variables differences in capital-labour ratios, educational attainment and land-labour ratios in a standard gravity equation. They find that the coefficients on these variables are positive as predicted by the theory but are not statistically significant. In contrast, a study by Ghosh and Yamarik (2005) finds that differences in per capita land are positively related to bilateral trade flows and are robust to the inclusion of other variables in their dataset, while differences in educational attainment and capital-labour ratios are significant in their base regressions, but fragile to the inclusion of indicators of stage of development. Recent papers by Debaere (2003) and Romalis (2004) also find strong empirical support for Rybczynski and Heckscher-Ohlin predictions on factor abundance and factor content.

The levels of development within the two countries that comprise a country pair may affect trade within the country pair. Theory alone is not definite on the sign of the relationship between this variable and the extent of bilateral trade. On the one hand, the “New View” of international trade developed by Helpman and Krugman (1985) stressed the large and growing trade between developed countries, with the bulk of this trade occurring in goods produced under monopolistic competition. On the other hand, Ricardian and Heckscher-Ohlin-Samuelson models would predict more trade between countries that are different from one another.

There are a wide range of explicit trade barriers used by the countries in our dataset. They can be roughly broken down into two groups. The first group measures barriers to flows of goods. Most of these barriers are non-tariff barriers, such as quotas, which explicitly limit the flows of goods. Tariff barriers are typically levied as an ad valorem tax (i.e., proportional to the value of an imported good). Due to data limitations, most prior studies of the determinants of bilateral trade have not used explicit measures of ad valorem tariffs or tariff-equivalent estimates of non-tariff barriers. In some cases, researchers have used country-specific or country-pair fixed effects to capture these trade barriers. In general, summary measures of trade liberalization are used, such as indicator variables that are one if country pairs are members of a free trade area and zero otherwise.

The Klein and Shambaugh (2004) study estimates the relationship between membership of a regional free trade area and bilateral trade flows. They find that, on average, members of free trade areas have trade flows that are 50 percent higher than trading partners that are not part of a free trade area. Ghosh and Yamarik (2004) use a large set of indicator variables that are specific to membership in a particular free trade area in their Bayesian extreme bounds analysis of free trade areas. They find that the relationship between this large set of regional free trade agreements and bilateral trade is fragile.

According to theoretical analyses, the relationship between exchange rate volatility and bilateral trade is ambiguous and typically depends on the source of exchange rate fluctuations (Bacchetta and van Wincoop, 2000 and Sercu and Uppal, 2003). The empirical literature is less ambiguous. There is a large body of empirical research which

finds that higher exchange rate volatility is associated with lower trade volumes. Klein and Shambaugh (2004), in their comprehensive analysis of the effect of fixed versus floating exchange rates on trade flows, find that direct exchange rate pegs have a statistically significant positive relationship with the volume of bilateral trade flows. In contrast, they find that indirect pegs do not have a statistically significant relationship with trade flows.

1.1.2 Kenya and Her Trading Partners

Kenya has bilateral trade agreements with many world countries and under these agreements, Kenya and its contracting partners accord each other mutual trade relations. These agreements have been used as instruments for promoting trade and improving economic relations between Kenya and these countries. However, it has been observed that the nature and type of bilateral trade between Kenya and other world countries seem to be changing in terms of the content and actors. This study therefore, seeks to understand factors that influence bilateral trade between Kenya and its trade partners in the process of her integration into the global market. Exports from Kenya enjoy preferential access to world markets under a number of special access and duty reduction programmes. Kenya is signatory to various agreements aimed at enhancing trade amongst member states (Ministry of Trade, 2010).

Kenya is one of the African countries that was quick to embrace the global market and business ideology. In the early 1990s Kenya embarked on structural and macroeconomic reforms, including trade in order to establish a more growth-conducive economic environment. The transition from import-substitution to outward-oriented policies has

made some progress, but has lagged in some areas, such as privatization. Macroeconomic stabilization appears to be taking hold: the rate of inflation was at 6% in 1998, down from nearly 46% at the time of Kenya's first trade Policy Review in 1993; and the fiscal deficit had turned from a deficit equivalent to over 5% of GDP in 1993 to a projected surplus in 1998 (Matthes, et. al., 2002). Besides, the structure of Kenya's economy has remained fairly stable. Agriculture remains the largest sector of the Kenyan economy, after services. The agricultural sector accounts for some 27% of real GDP and around 60% of earnings from total merchandise exports; and some 80% of the population depend on agriculture for their livelihood.

An upward trend in the ratio of trade to GDP has meant that the importance of foreign trade has increased for the Kenyan economy. Nevertheless, Kenya's main imports include machinery and transport equipment from Europe and Asia, and crude oil and petroleum products from the Middle East. To this end, Imports of agri-foodstuffs fluctuate with domestic harvests. The European Union (EU) remains Kenya's largest trading partner (both as a source of imports and a destination for exports). However, the Asian Tigers: Japan, China and Taiwan, and South Africa have increased their share in Kenyan imports, following its reintegration into the global economy. The share of Kenya's exports to the other East African Co-operation countries such as Uganda and Tanzania nearly doubled between 1993 and 1998, making this trading block the largest destination for Kenyan products after the EU. Kenya's trade policy objectives include moving towards a more open trade regime, strengthening and increasing overseas market access for Kenyan products, especially processed goods, and further integration into the world economy.

These policy objectives have been pursued through unilateral liberalization, and regional and bilateral trade negotiations, in particular within the African region, as well as through its participation in the multilateral trading system. In addition, Kenya is a member of the Common Market for Eastern and Southern Africa (COMESA), the East African Cooperation (EAC), the African Union (AU), and the Inter Governmental Authority on Development (IGAD).

Despite several countries benefiting from bilateral trade, there are various factors which tend to hamper smooth trade especially between Kenya and her trading partners. These factors may be economic, socio-cultural or political. Every type of economic union shares the development and enlargement of market opportunities as a basic orientation; usually markets are enlarged through preferential tariff treatment for participating members, common tariff barriers against outsiders or both. Enlarged, protected markets stimulate internal economic development by providing assured outlets and preferential treatment for goods produced within the customs union, and consumers benefit from lower internal tariff barriers among the participating countries. In many cases, external as well as internal barriers are reduced because of the greater economic security afforded domestic producers by the enlarged market (Anderson, et al., 2004).

Political amenability among countries is another basic requisite for development of a supranational market arrangement. Participating countries must have comparable aspirations and general compatibility before surrendering any part of their national sovereignty. State sovereignty is one of the most cherished possessions of any nation and

is relinquished only for a promise of significant improvement of the national position through cooperation. Economic considerations are the basic catalysts for the formation of a customs union group, but political elements are equally important. Generally cultural similarity eases the shock of economic cooperation with other countries. The more similar the culture the more likely an agreement is to succeed because members understand the outlook and viewpoint of their colleagues (Ravenhill, 2006).

1.2 Research problem

Recent research in international economics points at the likely relevance of barriers to trade other than tariffs and quotas. Rauch (2001) focuses on the importance of information costs that are related to physical (and cultural) distances. Deardorff (2001) argues that international trade patterns to a large extent depend on largely unobservable trading cost, instead of factor endowments and technology. On the same note, Anderson (2001) states that informal trade barriers appear to be very large even between similar countries, such as the US and Canada. Thus, informal trade barriers may help explain the home bias or border effect in trade (McCallum, 1995). Also Obstfeld and Rogoff (2000) highlight the possible role of unobserved trade costs in sorting out some of the apparent puzzles in international economics.

African countries continue to be the major destination of Kenya's exports followed by the European Union (EU). It has however, been observed that some of the traditional trade partners of Kenya seem to be taken over by newcomers. For instance, between 2001 and 2007, imports from the United Kingdom (UK) grew at a much slower rate than imports from China and India. Currently, most of Kenya's roads are either being refurbished or

built anew by Chinese firms. And all the international airports are also being upgraded by Chinese owned firms. There are several trading partners with Kenya as shown in box 1 of appendix 4 where several commodities are traded as shown in box 2 of appendix 4.

Hernandez and Taningco (2010) did a study in East Asia where port infrastructure was found to be a major determinant of trade. De Groot et al (2003) in US noted that having similar institutional framework was a major determinant of trade flows. Further, Baxter and Kouparitsas (2006) revealed that exchange rates, similar sectors and currency union were major determinants of trade. There are very few studies in the area of international trade flows in Kenya. Kinuthia (2002) investigated the factors that influence export trade by focusing on local manufacturing firms in the pharmaceutical industry. Gichuru (2006) studied trade related barriers to Kenya's export of fruits and vegetables to the European Union. Apparently, there is no study that has been done on the factors that influence bilateral trade relations between Kenya and her partners. There is no study on bilateral trade done locally. This presents the gap which the present study sought to address by answering the following research question: what are the factors that influence bilateral trade relations between Kenya and her neighbours?

1.3 Research Objective

The objective of this study was to determine the factors that influence bilateral trade flows between Kenya and her trading partners.

1.4 Value of the Study

This study will have both theoretical and practical significance as little seems to have been done on international trade in Kenya, from the academic perspective. The study will therefore, be important in filling this information gap, as well as contributing more towards scientific knowledge in regards to Kenya's position in international trade. The world economy is getting highly integrated to the extent that a country cannot do without trade partnerships. Understanding the factors that influence international trade and its implication on young or growing economies like Kenya is of significance to the government, the non-governmental organizations and general public.

International trade affords the exchange of services, goods, and capital among various countries and regions without much hindrance. It accounts for a good part of a country's gross domestic product and is one of the important sources of revenue for a developing country like Kenya. With modern production techniques, highly advanced transportation systems, transnational corporations, outsourcing of manufacturing and services, and rapid industrialization, the international trade system is growing fast. Global trade can become one of the major contributors to the reduction of poverty.

Kenya has benefited from International Trade through enhanced domestic competitiveness, international trade technology, increase in sales and profits, extended sales potential of existing products, maintaining cost competitiveness in the domestic market, enhanced potential for business expansion, gain in global market share, reduced dependence on existing markets and stabilized seasonal market fluctuations. Further benefits can be reaped if there is a considerable decrease in barriers to trade in agriculture and manufactured goods.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

The chapter presents a review of theoretical literature on the determinants of bilateral trade. This is followed by an empirical review of literature on the determinants of bilateral trade. Then a summary of literature is provided.

2.2 The Theoretical Foundations of Bilateral Trade

A number of theories have been put forward by scholars to explain why bilateral trade relations occur between countries. Such theories seek to explain why trade takes place between two countries. Two notable theories that have been discussed and researched by scholars are the gravity theory and the monopolistic competition model. The gravity theory is presented in section 2.2.1 while monopolistic competition theory is presented in section 2.2.2.

2.2.1 Gravity Theory

The gravity model was first introduced in the 1960s by Tinbergen (1962), Pöyhönen (1963) and Linnemann (1966) to simply explain bilateral trade flows between home and host countries. This model is a reduced form of a general equilibrium model and variation of bilateral trade between two countries is only explained by countries' national income and distance between them. The gravity model was later augmented with many other explanatory variables such as population, trade bloc, common language etc. Subsequently, the gravity equation has been derived from different models including Ricardian, Heckscher-Ohlin and monopolistic competition models (Anderson, 1979,

Bergstan, 1985 and Deardorff, 1998). In these frameworks, the simple gravity equation is based on the absence of all barriers to trade with homogeneous products and then enhanced with assumption of differentiated production. These papers conclude that different theories might provide theoretical grounds for the gravity model.

There are a huge number of applications in the literature of international trade, which have improved the performance of the gravity model by considering the impacts of technology and substitution on trade. Bikker (1987) presents an extension of the gravity model by considering substitution between export and import flows. He also tests his extended model for 181 countries in 2005 and finds that the standard gravity model could be rejected in favour of his approach. Eaton and Kortum (2002) study the effects of innovation and geographical barriers on bilateral trade in the context of a Ricardian model. They assume that the gains from trade are larger when technology expands individual productivities. On the other side, decrease in geographical barriers permits the country to realize greater gain from bilateral trade. Empirical findings indicate that spreading of innovation, lowering of tariffs and geographical barriers raises bilateral trade for 19 OECD countries in 1990.

2.2.2 Monopolistic Competition Theory

New trade theory, as represented by the monopolistic competition model, has been developed to explain intra-industry trade among OECD countries (Lai and Zhu, 2004). A large portion of trade among these countries involves differentiated products (Evenett and Keller 2002). Monopolistic competition provides a coherent theory for product differentiation.

Since it is straightforward to incorporate trade costs into the standard monopolistic competition model, the theory has also motivated empirical investigations of the relationship between trade costs and bilateral trade. Some empirical studies have found that large variations in trade are explained by tariffs and transport costs (Hummel's 1999), while others have modelled trade costs indirectly as unexplained econometric fixed effects (Harrigan 1996). Besides the monopolistic competition model, a variety of empirical studies estimating the gravity equation have found that trade barriers explain a large portion of trade (e.g., Bergstrand 1985; Anderson and van Wincoop 2003).

Trade costs operate primarily via prices. In the context of the monopolistic competition model, the difficulty is created by the complexity of the constant elasticity of substitution (CES) price index in the presence of asymmetric trade costs. To resolve this difficulty, three approaches have been taken: (i) GDP price indexes are used to capture the price effects in the gravity equation, as in Bergstrand (1989) and Baier and Bergstrand (2001); (ii) estimated border effects are used to measure the price effects, as in Anderson and van Wincoop (2003); and (iii) fixed effects are used to account for the price effects, as in Harrigan (1996), Hummel's (1999), Redding and Venables (2002), and others. Lai and Zhu (2004) included asymmetric trade barriers and international differences in production costs in their study.

2.3 Determinants of Bilateral Trade Flows

Several studies that used gravity models have focused on the potential impacts of trade facilitation measures, including behind-the-border factors on international trade flows. In

particular, these studies have shown that trade costs, trading time, customs procedures, and trade related documentary requirements, among others, are major factors of trade flows. For instance, Djankov, Freund, and Pham (2010) study to what extent the time of delivering products from the factory to the ship affects trade in a sample of 126 countries, and they find that in general, a delay of one day lowers trade by 1%, with a larger impact on time-sensitive products such as agricultural and manufactured goods. Duval and Utoktham (2009) find in a sample of Asia-Pacific countries that a 5% reduction in the delivery cost for a good from the factory to the nearest port can lead to at least a 4% increase in exports.

Helble, Shepherd, and Wilson (2009) find that improving transparency in trade policy via simplification and greater predictability can reduce trade costs, boosting bilateral trade amongst 21 member countries of the Asia-Pacific Economic Cooperation (APEC). Sadikov (2007) uses a gravity model for a sample of 126 countries and shows that burdensome business registration procedures and export signature requirements can have a detrimental effect on exports, more so with differentiated products than homogeneous goods.

Other studies that have made use of gravity modeling have highlighted the important role of infrastructure on international trade. For example, Shepherd and Wilson (2009) find that bilateral trade flows in the Southeast Asia region are sensitive to information and communications technology (ICT) as well as to transport infrastructure, particularly port infrastructure. Using firm-level data with emphasis on small and medium enterprises (SMEs), Li and Wilson (2009) find that SMEs would more likely be an exporter and

would have higher export propensity if certain trade facilitation measures are improved, such as ICT and policy predictability. Indeed, certain case studies have pointed towards the strong potential of ICT in lowering the transaction costs of SMEs, and thereby facilitate their entry into international trade, like that of the Philippines (de Dios 2009) and Republic of Korea (Yang 2009). Wilson, Mann, and Otsuki (2005) show that port efficiency and the quality of service sector infrastructure, among others, are significant factors of trade flows in a sample of 75 countries. Nordås and Piermartini (2004) prove that infrastructure quality is a significant factor of trade performance, with port efficiency having the largest impact on trade amongst all infrastructure quality indicators.

Certain studies have argued that the level of financial development or access to finance, which is a major part of the overall domestic business or investment environment, can potentially affect international trade. Duval and Utktham (2009) find that improving credit information can raise exports of merchandise goods by up to 16%. Hur, Raj, and Riyanto (2006) find in a sample of 27 sectors in 42 countries that the level of financial development is positively associated with export shares and trade balances for those countries with more intangible assets. Beck (2002) provides evidence for a sample of 65 countries indicating that financial development has a large causal effect on exports and trade balances of manufactured products.

Other studies have pointed towards the potential impact of certain governance indicators—contract enforcement, corruption, institutional quality, investor protection, and the rule of law, among others, on international trade. Duval and Utktham (2009) show that in developing Asia, simplifying domestic contract enforcement procedures to

that of the average of member countries of the Organisation for Economic Co-operation and Development (OECD) can boost merchandise exports by up to 27%. Hur, Raj, and Riyanto (2006) find that improving investor protection can raise export shares and trade balances of countries with relatively more intangible assets. Méon and Sekkat (2006) use a gravity model composed of 38 to 60 countries and find that poor institutional quality is related to low manufactured exports; that control of corruption is the most significantly related to manufactured exports, compared to the rule of law or government effectiveness.

Hernandez and Taningco (2010) investigated the potential trade facilitation or "behind-the-border" determinants on bilateral trade flows in the East Asian region. Utilizing a gravity model approach, the study found that, overall, bilateral trade flows in East Asia are influenced by time delays in trade, the quality of port infrastructure, telecommunications services, and depth of credit information. The study further noted, however, that the potential impact of these "behind-the-border" measures varied across product groups or sectors. Specifically, the results revealed that bilateral trade in food and beverages as well as in transport equipment are sensitive to time delays, as food and beverages reflect issues on perishability and maintaining quality, while transport equipment makes use of just-in-time production practices and are involved in production sharing. Also, the quality of port infrastructure is found to be a major determinant of trade in industrial supplies, fuels and lubricants, capital goods (including parts and accessories), and consumption goods, suggesting that these products are relatively dependent on maritime transport. Access to finance by exporters and importers (as represented by the depth of credit information) is found to be significant and positively

related to bilateral trade in industrial supplies, fuels and lubricants, capital goods (including parts and accessories), and consumption goods; this implies that exporters and importers in these sectors are more dependent on financial capital as compared to the other sectors. Moreover, telecommunication services appeared to be an important "behind-the-border" factor for both trade in consumption goods and other goods, whereas contract enforcement is insignificant to trade in all product categories, except for other goods.

De Groot et al. (2003) studied the effect of institutions on trade flows, using a gravity model approach. Standard gravity equations incorporate factors such as geographical proximity, language, trade policy and common history as explanatory factors for variation in bilateral trade that reflect the costs of trade across geographical and cultural distance. The study extended this type of analysis by focusing on the relevance of the quality of governance and the extent of familiarity with the resulting framework of rules and norms in explaining variation in bilateral trade patterns. More specifically, the study tested whether institutional homogeneity and institutional quality have an independent impact on the trade volume between pairs of countries. The study found that having a similar institutional framework promotes bilateral trade by 13%, on average. Furthermore, a better quality of formal institutions tends to coincide with more trade. Depending on being either importer or exporter, an increase in overall institutional quality of one standard deviation from the mean leads to an estimated increase of 30-44% in bilateral trade.

A study by Baxter and Kouparitsas (2006) on what determines bilateral trade flows undertook an exhaustive search for robust determinants of international trade, where robustness was tested using three empirical methods. This was a theoretical paper with the goal of solely establishing statistically robust relationships. The study found that robust variables included a measure of the scale of factor endowments; fixed exchange rates; the level of development; and current account restrictions. Variables that were robust under certain methods and sample periods included exchange rate volatility, an index of sectoral similarity, and currency union. However, the estimated coefficient in currency union was much smaller than estimates obtained by prior researchers.

Grofman and Gray (2000) studied the extent to which trade among these nations can be characterized in terms of trade blocs. The study began with a simple regression of overall trade patterns on the trade patterns with a handful of key trading partners. This analysis supported a two-dimensional or three-dimensional structure to trade. The study then adapted ideas (“k-covers” and “minimal k-covers”) drawn from graph-theory to evaluate the extent to which the world consisted in 1995 of multiple trading blocs centred around leading trading nations or sets of geographically proximate nations. The graph-theoretic analysis was supplemented by a multidimensional scaling of the same data. Based on these analyses, the study argued that a tripolar structure (based on trade links to the U.S., Europe, and Japan) accounted for most of the variance from a common pattern of trade, with each of these factors having a clear geographic component. In addition, there was a fourth largely non-geographic (and non-orthogonal) factor linked to trade between members of the British Commonwealth. Above and beyond these patterns, the study also found further national differences in trading patterns linked to geographic distance (e.g., a

Nordic trade bloc). However, in line with the gravity model, the study also found that distance was mediated by GDP in that, *ceteris paribus*, a country which borders on (or is geographically proximate to) nations that have large GDPs is more likely to have a high proportion of its trade with those countries than will countries with neighbours who are poor.

Lai and Zhu (2004) studied the determinants of bilateral trade. The study presented a monopolistic competition model that incorporated asymmetric trade barriers and international differences in production costs. The model implied a highly non-linear bilateral trade equation. Estimation of this equation yielded parameters for the elasticity of substitution and trade costs that are more reasonable than those found in previous studies. A simulation indicated that trade liberalization would shift trade from rich countries to poor countries and from within continental trading partners with preferential trade agreements to intercontinental trading partners.

Habedard (2011) studied the impacts of the international political environment and institutions on trade flows by identifying eight hypotheses for the Ottoman Empire. A panel data set of 18 trade partners over 1879 to 1913 was used. The study estimated an augmented gravity model for Ottoman exports and imports with political and institutional variables added. The results showed that conflicts and alliances had significant effects on trade flows, but autocracy and regime durability did not. The findings also showed that free trade agreements played a significant role in the determination of Ottoman imports.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This section documents the procedures that were followed in arriving at the stated objectives. It highlights the study design, data collection methods and data analysis techniques.

3.2 Research Design

This study employed a descriptive survey research design. A survey is an attempt to collect data from members of a population in order to determine the status of that population with respect to one or more variables (Mugenda and Mugenda, 1999). The design involved a description of factors that influence bilateral trade between Kenya and her trade partners.

3.3 Population of the Study

The population of the study comprised a total of 38 people who were all covered in the study. Specifically the study targeted officials from the Ministry of Foreign Affairs and Ministry of Trade and Industry and the Kenya National Bureau of Statistics. Trade officials from the Export Promotion Council, Kenya National Chamber of Commerce, East African Co-operation Mission, African Union, IGAD and COMESA. Commercial Attachés from the Uganda, Tanzania, Egypt, China, Japan, UK, USA, UAE and South Africa Consulates were also interviewed.

3.3 Data Collection

Consistent with most of the studies in this area, secondary data was used. Secondary data was sought on exports and imports. This data was sought from the Kenya National Bureau of Statistics, the Central Bank of Kenya, and the World Bank Database. Data was collected for a period of 10 years. The following model was employed:

$$\text{TRADE} = \alpha + \beta_1\text{DISTANCE} + \beta_2\text{BORDER} + \beta_3\text{CULTURE} + \beta_4\text{COLONY} + \beta_5\text{ECONOMY} + \epsilon$$

These variables are defined in table 1.

Table 1: Operational Definition of Variables

Variable	Measure
Trade	Measured by the natural logarithm of total exports from country i to country j in period t.
Distance	The log of the distance between two countries
Border	Indicator variable of common borders which takes the value 1 if a country pair shares a border and zero otherwise.
Culture	An indicator of common language, which takes the value 1 if the country pair shares the same language and zero otherwise
Colony	Equal to 1 for country pairs that had the same colonizer.
Economy	Measured as the log of the product of the two countries' levels of GDP.

Primary data was also used in this study. This was collected through questionnaires and interviews. This method was preferred given the descriptive nature of this study. The Key Informant Interviews method was applied whereby, the researcher, having the objectives of the study in mind and the interview guide selected the most relevant members of the

target population to form the key informants for the study. The key informants for this study were the two (2) Permanent Secretaries or their representatives and two (2) other trade officials from each of the selected ministries, two (2) consulate officials from each of the concerned countries, and two (2) representatives from each of the said trade organizations.

3.4 Data Analysis Techniques

Data was entered into the SPSS software and analysed using descriptive analysis and regression analysis. A multiple regression analysis of the model was performed and the results interpreted based on the r^2 , adjusted r^2 , significance of F statistic, and the significance of the coefficient of the independent variables.

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter presents the results of data analysis. Data on all the variables in the study were available from the various economic surveys on Kenya from the Kenya National Bureau of Statistics and were therefore collected and used in the analysis. Specifically, data on exports and GDP were sought from the KNBS. Distance between countries was available from the internet especially from Google maps and hence was used to arrive at the distances.

Data on the rest of the variables (border, culture and colony) were categorical variables and since the information on whether the bilateral partners shared the border, had same language or had been colonised by the same country was readily available from the internet, these were collected and used in the analysis.

Data was collected and organised into an MS Excel Spreadsheet before variables such as trade (proxied by exports), distance between countries (in kilometres) and economy (proxied by the product of GDPs) were standardised by getting their natural logarithms. The results are presented here as follows: first, the descriptive results are shown. These are followed by the correlation results and the regression results. A discussion of findings is then presented followed by summary of findings.

4.2 Descriptive Results

Table 4.1 shows the results of the descriptive analysis. The descriptive results are shown for trade, distance, border, culture, colony, and economy. Bilateral trade between Kenya and nine countries was studied. These countries are China, Japan, South Africa, Egypt, Tanzania, Uganda, United Kingdom (UK), United Arab Emirates (UAE) and United States of America (USA).

Table 4.1: Bilateral trade partner's data

Country	Trade (In MN \$)	Distance (In KMs)	Border	Culture	Colony	Economy (In BN \$)
China	33.48	7,893.90	0	0	0	7,298
Japan	34.10	10,935.16	0	0	0	5,867
South Africa	36.45	3,745.52	0	1	0	408
Egypt	18.12	3,080.03	0	0	0	229
Tanzania	33.31	780.96	1	1	1	23
Uganda	52.11	643.40	1	1	1	16
UK	40.21	7,201.96	0	1	0	2,431
UAE	18.86	3,124.31	0	0	0	360
USA	22.52	13,721.25	0	1	0	15,094

Source: Field Data (2012)

As shown in the table, data for nine trading partners was collected. In terms of exports from Kenya to her trading partners, the results show that more exports were made to Uganda (\$ 52.11 million) followed by United Kingdom (\$ 40.21 million) while the least exports were made to Egypt (\$ 18.12).

As regards the distances, Kenya is nearer to Uganda and Tanzania and they also share a border with Kenya. The cultures are also similar as Kiswahili is a national language in all the three countries and English as the official languages. The farthest trading partners were USA and Japan. Kenya also shares a language with South Africa, UK, and USA.

In terms of economy, the country with the highest GDP was USA followed by China and Japan. The smallest economies were Uganda and Tanzania. At the time, Kenya's GDP was USD 32 billion. Thus, Kenya's GDP was only higher than that of two of its trading partners (Uganda and Tanzania) but lower than the rest of the other trading partners.

4.3 Correlation Results

Table 4.2 shows the results of correlation analysis. The Pearson correlation was done for all the variables in the model.

Table 4.2: Correlation between trade and bilateral trade factors

		Trade	Distance	Border	Culture	Colony	Economy
Trade	Pearson Correlation	1	-.296	.499	.523	.499	-.232
	Sig. (2-tailed)		.440	.171	.148	.171	.548
	N		9	9	9	9	9
Distance	Pearson Correlation		1	-.872**	-.308	-.872**	.985**
	Sig. (2-tailed)			.002	.420	.002	.000
	N			9	9	9	9
Border	Pearson Correlation			1	.478	1.000**	-.804**
	Sig. (2-tailed)				.193	.000	.009
	N				9	9	9
Culture	Pearson Correlation				1	.478	-.288
	Sig. (2-tailed)					.193	.453
	N					9	9
Colony	Pearson Correlation					1	-.804**
	Sig. (2-tailed)						.009
	N						9
Economy	Pearson Correlation						1
	Sig. (2-tailed)						
	N						

** . Correlation is significant at the 0.01 level (2-tailed).

Source: Field Data (2012)

The results show that trade was negatively correlated with distance and economy. On the other hand, trade was positively correlated with border, culture and colony. There was also a very high correlation between distance and border, distance and colony, and

distance and economy. The results also show a high correlation between border and colony and between border and economy. Colony was also highly correlated with economy. This means that there was serial correlation between some of the independent variables.

4.4 Regression Results

Table 4.3 shows the results for the effect of bilateral trade factors on trade. The results are presented in terms of Pearson correlation (r), coefficient of determination (r^2) and the adjusted r^2 .

Table 2.3: Relationship between trade and bilateral factors

R	R Square	Adjusted R Square	Std. Error of the Estimate
.641 ^a	.411	-.178	.38711
a. Predictors: (Constant), Economy, Culture, Colony, Distance			
b. Dependent Variable: Trade			

Source: Field Data (2012)

The results show that there was a moderate correlation between the factors and trade ($r = 0.641$). The r^2 was 0.411 indicating that 41.1% of the variance in trade between Kenya and its partners was as a result of the four factors (economy, culture, colony, and distance). Border was not a predictor variable in the final analysis as it had a perfect correlation with colony. The SPSS therefore rejected this variable in the final analysis as it would double the relationship in the model.

Table 4.4 shows the analysis of variance (ANOVA) results. The results are interpreted using the F statistic and the significance of the F statistic.

Table 4.4: Analysis of variance

Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	.419	4	.105	.698	.632 ^b
Residual	.599	4	.150		
Total	1.018	8			
a. Dependent Variable: Trade					
b. Predictors: (Constant), Economy, Culture, Colony, Distance					

Source: Field Data (2012)

As the results show, the F statistic was 0.698 and the significance was 0.632. This means that the F statistic was not significant at 5% confidence level. Therefore, the bilateral model used in this study was not significant in estimating the determinants of bilateral trade in Kenya.

Table 4.5 shows the results for the relationship between various independent variables studied and trade.

Table 4.5: Determinants of bilateral trade in Kenya

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
Constant	-1.797	13.173		-.136	.898
Distance	-.210	1.259	-.640	-.167	.875
Culture	.234	.319	.346	.732	.504
Colony	.405	.979	.500	.413	.700
Economy	.131	.451	.901	.290	.786
a. Dependent Variable: Trade					

Source: Field Data (2012)

The results show that there was a negative relationship between distance and trade ($b = -0.210$) but this was not significant ($\text{Sig} = 0.875$) at 5% confidence level. This therefore means that in the case of Kenya, distance between it and its trading partners is not a major determinant of trade. Thus, it does not matter how far or near the trading partner is from Kenya. Kenya trades with its partners regardless of the distance between them.

The results also show a positive relationship between culture and trade ($b = 0.234$) but this was also not significant ($\text{Sig} = 0.504$) at 5% level. Thus in the case of Kenya, the fact that the trading partner shares the same culture (in terms of the language) or not does not determine whether Kenya trades with it or not. Bilateral trade between Kenya and its partners is therefore unaffected by the culture differences or similarities.

The study found that colony had a positive relationship with trade ($b = 0.405$). This relationship was not significant ($\text{Sig} = 0.700$). This means that sharing of the same colonial master between Kenya and its trading partners was not a major determinant of bilateral trade. It therefore does not matter whether Kenya shares a colonial master with a trading partner or not in order to trade with it.

Lastly, the results showed that economy had a positive relationship with trade ($b = 0.131$) but the relationship was also insignificant ($\text{Sig} = 0.786$). Therefore, in the case of Kenya, the size of the economy of the trading partner does not influence trade with Kenya. Thus, economy was not a major determinant of bilateral trade between Kenya and her trading partners.

4.5 Discussion of Findings

The study has found that distance had a negative effect on trade but was not a major determinant of bilateral trade in Kenya. Distance serves as a proxy for the size of transportation costs and also reflects other distance related trade costs. The results of this study are therefore consistent with those of De Groot et al (2003) who found that distance negatively affected the intensity of trade.

The study found that culture had a positive effect on bilateral trade in Kenya but it was not a major determinant of bilateral trade. These results are consistent with literature where culture has been found to have a positive sign on trade (De Groot et al., 2003). However, the results for Kenya as far as effect of culture is concerned were not significant at 5%.

The study found that colony had a positive effect on bilateral trade in Kenya. Studies such as De Groot et al (2003) have found a positive effect of colony on trade hence the results of the study are consistent with literature. However, the effect was not significant at 5% level.

Consistent with literature, the study found a positive effect of economy on bilateral trade. De Groot et al (2003) in their study had also found that economy had a positive effect on trade. The relationship in this study was however insignificant at 10%.

4.6 Summary of Findings

The analysis was done bilateral trade between Kenya and nine other countries. These countries are China, Japan, South Africa, Egypt, Tanzania, Uganda, United Kingdom (UK), United Arab Emirates (UAE) and United States of America (USA).

The study found that Kenya had more exports to Uganda (USD 52.11 M) than to any of its other trading partners while the least exports were to Egypt (USD 18.12 M). Of the nine countries, Uganda was the closest in terms of distance while USA was the furthest. In terms of their economies, the smallest was Uganda while the largest was USA.

Standard gravity equation was tested in this study. The results of the correlation showed that there was some serial correlation among the independent variables. Further, border had a perfect correlation with colony and was therefore dropped in the final regression. The study found that the factors contributed to 41.1% of the variance in trade. However, from the ANOVA, the F statics showed that the model was not significant in explaining the relationship. The results showed that distance had a negative effect on trade while culture, colony, and economy had positive effects on trade. However, none of these determinants were significant at 5% level.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Summary of the study

This study sought to investigate the determinants of bilateral trade in Kenya. The study adopted a descriptive survey design. Nine trading partners of Kenya were selected. Secondary data was collected from the KNBS, the CBK, and the World Bank Database on six variables namely trade (dependent variable), distance, border, culture, colony, and economy. Primary data with key informants was also collected. Data analysis on the model was performed using descriptive and regression analysis.

The study revealed that Kenya had more exports to Uganda (USD 52.11 M) while the least exports were to Egypt (USD 18.12 M). Uganda was the closest trading partner in terms of distance while USA and Japan was the furthest trading partner. In terms of their economies, the smallest was Uganda while the largest was USA.

The study found that the factors contributed to 41.1% of the variance in trade. Consistent with literature, the study found that distance had a negative effect on trade while culture, colony, and economy had positive effects on trade. However, none of these determinants were significant at 5% level.

5.2 Conclusion of the study

From the findings of this study, the study concludes that bilateral trade in Kenya is not determined by geographical distance, cultural distance, colonial ties, or economic

performance of the trading partners. This means that the standard gravity model of determinants of bilateral trade does not explain the bilateral trade in Kenya.

In as much as the results are consistent with the literature as far as the effect of each of the variables on trade is concerned, the study failed to find any significant effects and therefore rejected these factors as determinants of bilateral trade in Kenya. Further, the model was not significant in explaining the relationship and therefore the study concludes that the standard gravity model was a poor estimator of the determinants of bilateral trade.

5.3 Recommendations of the study

The study makes a number of recommendations. First, it is recommended that Government officials responsible for trade relations especially the Ministry of Trade should take cognizance of the fact that bilateral trade relations in Kenya are not significantly influenced by culture, colony, economy, or geographical distance. All these factors relate to the trading partners and therefore the Ministry should focus on other factors other than the characteristics of trading partners for trade.

The study further recommends that there is need for Kenya to expand trade activities with the neighbouring countries as there is some evidence to suggest that distance has a negative effect of trade. As was the case for Uganda where the most exports were made to Uganda, it is important that these avenues be addressed more by focusing on the countries closer to Kenya for exports. This recommendation is also based on the fact that Kenya is more industrially superior to its neighbours and therefore it can export more to them than it can import.

5.4 Limitations of the Study

Getting primary data through interviews with the officials who were targeted by the study was a major problem. Most of them were unavailable as they were attending to other official duties and therefore made it difficult to collect primary data. Secondary data was therefore relied upon. But this secondary data is more reliable and therefore the results are also reliable.

Secondly, bilateral trade data was very hard to come by as the data available from the sources that had been listed in chapter 3 were for total exports and not for specific countries. The research had therefore to rely on country specific data available from various internet sources.

5.5 Suggestions for Further Research

The study suggests that more studies need to be carried out by expanding the sample size of the study from the nine that were studied in this study. This way, a conclusive dataset can be found that will enable better estimations to be carried out.

The study also suggests that the gravity model used in this study should be expanded in future studies to include institutional factors as these are also deemed to determine bilateral trade in literature.

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APPENDICES

Appendix 1: Letter to Respondents

Dear Sir/Madam,

RE: RESEARCH QUESTIONNAIRE

I am pursuing a Masters in Business Administration degree course at the University of Nairobi. As partial fulfilment of the course, I am required to submit a research project. The topic of my research is an assessment of “*Factors Influencing Bilateral Trade between Kenya and her Trading Partners*”.

Your Ministry/organization has been identified for participation in this study/survey as a source of pertinent information to enable for data collation for the report.

The information provided is strictly for academic purpose and will be handled in strict confidence. A copy of the research report would be availed to you upon request.

Your assistance and co-operation to this end will be highly appreciated.

Yours sincerely,

Joselyne Mbula

Appendix 2: Questionnaire on Determinants of Bilateral Trade

Introduction

Dear Respondent,

The study is aimed at assessing factors influencing trade between Kenya and her trading partners. The information you provide will be treated with utmost confidentiality and is purely for academic purposes.

SECTION A: ECONOMIC FACTORS

1. On a scale of 1-5 please rank the economic factors influencing bilateral trade between Kenya and her trading partners. Where 1=Strongly Disagree, 2= Disagree, 3=Not Sure 4=Agree and 5=Strongly Agree.

ECONOMIC FACTORS	1	2	3	4	5
Unfavourable balance of payment (trade deficits) have affected bilateral trade between Kenya and her trading partners					
Unfavourable exchange rate movements has affected bilateral trade between Kenya and her trading partners					
Currency crisis has limited the purchasing power between Kenya and her trading partners					
Trade agreements (taxes and tariffs) have affected bilateral trade between Kenya and her trading partners					
Others (Specify).....					

SECTION B: SOCIO-CULTURAL FACTORS

2. On a scale of 1-5 please rank the socio-cultural factors influencing bilateral trade between Kenya and her trading partners. Where 1=Strongly Disagree, 2= Disagree, 3=Not Sure 4=Agree and 5=Strongly Agree.

SOCIO-CULTURAL FACTORS INFLUENCING BILATERAL TRADE	1	2	3	4	5
Unpredictable behaviours of consumer s have affected bilateral trade between Kenya and her trading partners					
Customers’ preferences					
Customers’ perception					
Geographical distances					
Buyers’ insolvency					
Others (Specify).....					

SECTION C: POLITICAL FACTORS

3. On a scale of 1-5 please rank the political factors influencing bilateral trade between Kenya and her trading partners. Where 1=Strongly Disagree, 2= Disagree, 3=Not Sure 4=Agree and 5=Strongly Agree.

POLITICAL FACTORS INFLUENCING BILATERAL TRADE	1	2	3	4	5
Change of leadership					
Political unrest (war and violence)					
Governmental action to prevent transaction being completed (interventions)					
Unfavourable legal factors					
Others (Specify).....					

SECTION D: GENERAL CHALLENGES TO BILATERAL TRADE

4. On a scale of 1-5 please rank the general challenges influencing bilateral trade between Kenya and her trading partners. Where 1=Strongly Disagree, 2= Disagree, 3=Not Sure 4=Agree and 5=Strongly Agree.

GENERAL CHALLENGES TO BILATERAL TRADE	1	2	3	4	5
Lack of export diversification					
Poor infrastructure and inefficient trade facilitation					
Weakening currency which affects international trade					
High inflation rates					
Others (Specify).....					

5. In your opinion, what do you think should be done in order to achieve a balanced bilateral trade between Kenya and her trading partners?

Appendix 3: Interview Guide on Determinants of Bilateral Trade

1. How have the following economic factors influenced bilateral trade in Kenya?
 - a) Balance of payment
 - b) Exchange rate movements
 - c) Currency crisis
 - d) Trade agreements
 - e) Inflation

2. How have the following socio-cultural factors influenced bilateral trade in Kenya?
 - a) Consumer behaviour
 - b) Customer preferences
 - c) Customer perception
 - d) Geographical distances
 - e) Buyers insolvency

3. How have the following political factors influenced bilateral trade in Kenya?
 - a) Change of leadership
 - b) Political unrest
 - c) Government action
 - d) Legal factors

4. How have the following factors influenced bilateral trade in Kenya?
 - a) Export diversification
 - b) Infrastructure

The end

Appendix 4: Kenya's Trading Partners and Exports

Box 1: Kenya's Trading Partners

Kenya has bilateral trade agreements with the following countries: Argentine, Bangladesh, Bulgaria, China, the former Czech and Slovak Republic, Djibouti, Egypt, Ethiopia, India, Iran, Lesotho, Nigeria, Pakistan, Poland, Romania, Rwanda, Republic of Korea, Sudan, Tanzania, Thailand, the former USSR, the former Yugoslavia, Zambia and Zimbabwe. Under these agreements, Kenya and its contracting partners accord each other the MFN treatment in all matters with respect to their mutual trade relations. These agreements have been used as instruments for promoting trade and improving economic relations between Kenya and these countries (Ministry of Trade, 2010). Kenya's export partners are mainly Uganda, Tanzania, United Kingdom, Netherlands, Pakistan, Egypt, Germany, Rwanda, Democratic Republic of Congo and Sudan. The import partners are United Arab Emirates, Saudi Arabia, South Africa, United Kingdom, Japan, United States of America, India, Germany, China, France, and Israel

Box 2: Kenya's Exports

International trade plays a vital role in Kenya's economic development. Kenya's principal exports include tea, coffee, horticultural products, sisal, pyrethrum, wattle extract, hides and skins, fish, fish preparations and petroleum products (Anderson, et al., 2004). Kenya's major imports include machinery and transportation equipment (capital goods), petroleum products, and iron and steel (intermediate goods), edible oils and fats, resins and plastics, fertilizers, raw materials.

Appendix 5: Quantitative Data Instrument

Country	Trade	Distance	Border	Culture	Colony	Economy
China						
Japan						
South Africa						
Egypt						
Tanzania						
Uganda						
UK						
UAE						
USA						