

THE EFFECT OF TRADE FINANCE ON INTERNATIONAL TRADE IN KENYA

This research project is my original work and has not been submitted for a degree in any other university

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D61/60142/2010

This research project has been submitted for examination with my approval as University supervisor

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DECLARATION

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



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DEDICATION

This study is dedicated to my husband Isaac for his love and invaluable support during my study and to our daughter Samantha who kept on asking why I read so much A, B, C, Ds instead of staying at home with her.

To my supervisor, Dr.Sifunjo Kisaka, for his support and availability during this study.

To my loving parents Mr.Richard Nderitu and Mrs.Ann Nderitu for their love and encouragement during my pursuance for higher education and the value of education seed they planted in me in my formative years

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Most important is our Almighty God whose powerful hand led me throughout the study period and to all those in one way or another, contributed to the success of this study, I say, "God bless you all abundantly".

ABSTRACT

Trade is one of the most important economic sectors of a country's economy. The performance of the economy and trade sector has been very dismal and far below the target of Vision 2030. This is a clear manifestation of the impact of the numerous constraints being faced by the trade sector such as lack or inadequate provision of credit to enhance production or to import raw materials required for processing for export purposes. Modern trade depends on credit and other key financial services to finance trade-related expenditure and cover against trade-related risks.

Both international trade and the financial sector are important engines of growth in today's economies. The growing importance of these two sectors is highlighted by their expanding share in output over the last decades. The study adopted a descriptive survey design, which ensured understanding of the insight and ideas about the problem. This study utilized secondary data. The target population comprised of 43 banks in Kenya. The researcher utilized both published and unpublished sources but relied heavily on the published sources. The study employed both quantitative and qualitative research in its data analysis.

Data was presented using tables and graphs. Inferential statistics included correlation and regression analysis. Factor analysis of the independent variables was also determined. It was observed that the main exports commodities are tea products, coffee, petroleum products, fish and cement. The export partners are Uganda (15.9%), UK (10.3%), US (8.2%), Netherlands (7.9%), Tanzania (7.7%) and Pakistan (4.9%). The study revealed that trade credit had a mean score of .05341 with a standard deviation of 0.2219 and a minimum and maximum value of 0.0163 and 0.9784 respectively.

The study further indicated that letter of credit had a mean score of 0.42.94 and a standard deviation of 0.1908 with a minimum and maximum of 0.4812 and 0.67.50 respectively. Merchandise and Commodity traders are not represented by a sectoral association, but their importance is growing fast. In 2010 imports grew 30% in value, compared to 13% growth for exports. Traders could make greater use of trade finance operations and structured deals, since they generally have a small net worth compared to the operations they handle. The study recommended that there is need to develop the banks' awareness of the intrinsically secure and self-liquidating nature of trade finance. The Central Bank of Kenya should obtain the co-operation of the banks to segment Non-Performing Loan recordings. The study recommended that the bankers association and the bank should facilitate payment security

and the movement of goods, and promote official transactions. These will contribute to the development of formal sector. The study also recommended that the mechanism to sustain trade finance need to be well established.

TABLE OF CONTENTS

CHAPTER ONE	1
1.1 Introduction	1
1.2 Background	1
1.3 Objectives	1
1.4 Importance	1
CHAPTER TWO	2
2.1 Introduction	2
2.2 Theoretical Framework	2
2.2.1 Absolute Advantage	2
2.2.2 Comparative Advantage	2
2.2.3 Endogenous Growth	2
2.2.4 Increased Trade	2
2.2.5 Transition	2
2.3 Empirical Literature	2
2.4 Empirical Literature	2
2.4.1 Trade Policy	2
2.4.2 Trade Liberalization	2
2.4.3 Structure and	2
2.5 Summary	2
CHAPTER THREE	3
RESEARCH METHODOLOGY	3

TABLE OF CONTENTS

DECLARATION	i
DEDICATION	ii
CHAPTER ONE	1
INTRODUCTION	1
1.1 Background of the Study.....	1
1.1.1 Theoretical Background	1
1.1.2 Contextual Background.....	3
1.1.3 An Overview of the Kenyan Banking Sector	4
1.1.4 Trade Finance Services.....	4
1.2 Statement of the Problem	5
1.3 Objectives of the Study	6
1.4 Importance of the Study	6
CHAPTER TWO	6
2.1 Introduction.....	7
2.2 Theoretical Literature.....	7
2.2.1 Absolute Advantage Theory.....	10
2.2.2 Comparative Advantage Theory.....	12
2.2.3 Endogenous Advantage Theory.....	16
2.2.4 Increased Efficiency of Trading Global	17
2.2.5 Transactional Costs.....	19
2.3 Empirical Literature	20
2.4 Empirical Literature in Kenya.....	22
2.4.1 Trade Policies since Independence (Pre-Liberalization Era)	22
2.4.2 Trade Liberalization Period.....	25
2.4.3. Structure and Composition of Exports	26
2.5 Summary	27
CHAPTER THREE	29
RESEARCH METHODOLOGY	29

3.1	Introduction	29
3.2	Research Design	29
3.3	Population and Sampling	29
3.4	Data and Data Collection	30
3.5	Data Analysis	31
3.6	Data Validity and Reliability	33
CHAPTER FOUR.....		35
DATA ANALYSIS AND PRESENTATION OF FINDINGS.....		35
4.1	Introduction	35
4.2	Univariate Data Analysis	35
	Descriptive Statistics	35
4.2.1	Descriptive Statistics on Impact of Trade Finance on International Trade	35
4.2.2	Characteristics of Kenya's International Trade	36
4.2.3	Kenya's Imports and Exports	37
4.2.4	The Specific Trade Flows of the Various Sectors and the Provision of Trade Finance.....	38
4.3.1	Model of Fitness	40
4.3.2	Correlation Analysis	40
4.3.3	Analysis of Variance	42
4.3.4	Test of Multicollinearity	42
4.4	Discussion of Regression Analysis Results	43
4.5	Results of Factor Analysis on Impact of Trade Finance on International Trade	45
4.6	Summary of Findings	46
SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS		48
5.1	Introduction	48
5.2	Summary of the Study	48
5.3	Conclusions	51
5.4	Limitations of the Study	52
5.5	Recommendations for Further Research	52
APPENDICES		58

LIST OF FIGURES

Figure 4.1 Major Export Products	38
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LIST OF TABLES

Table 3.1 Target Population and Sampling Frame	30
Table 4.1 Descriptive Summary Statistics	36
Table 4.2: Main Characteristics of Kenya's International Trade.....	37
Table 4.3: Provision of Trade Finance in Horticulture, Manufacturing Sector and to Merchandise Traders (Million shillings)	39
Table 4.4: Regression Model Summary Results of the Effect of Trade Credit, Letter of Credit, Import Guarantee and Bill of Exchange on International Trade.....	40
Table 4.5: Correlation Matrix of the Impact of Trade Finance on International Trade.....	41
Table 4.6: Analysis of Variance (ANOVA) Results.....	42
Table 4.7 Test of Multicollinearity	42
Table: 4.8 Regression Results of the Relationship between Trade Credit, Letter of Credit, Import Guarantee and Bill of Exchange and International Trade.....	45
Table 4.9 Factor Analysis on Impact of Trade Finance on International Trade	46
Table 5.1 Summary of Empirical Findings.....	49

LIST OF ABBREVIATIONS AND ACRONYMS

BAFT	Bankers Association for Finance and Trade
COMESA	Common Market for Eastern & Southern Africa
EPC	Export Promotion Council
EU	European Union
EAC	East Africa Community
FAO	Food and Agriculture Organization
FPEAK	Fresh Produce Exporters Association of Kenya
GDP	Gross Domestic Product
HCDA	Horticultural Crops Development Authority
IMF	International Monetary Fund
KFC	Kenya Flower Council
KAM	Kenya Association of Manufacturers
PTA	Preferential Trade Area
WTO	World Trade Organization

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

1.1.1 Theoretical Background

Trade is one of the most important economic sectors of a country's economy. Adam Smith (1776) inquired into the origin of the wealth of nations and pointed to trade as an important source of a country's wealth. Michael Porter (1991) analysed how countries can increase their competitiveness by improving efficiency in the utilization of their resources especially their capacity in trade development. The performance of the economy and trade sector has been very dismal and far below the target of Vision 2030. This is a clear manifestation of the impact of the numerous constraints being faced by the trade sector such as lack or inadequate provision of credit to enhance production or to import raw materials required for processing for export purposes.

Despite the domination of Kenya exports by a handful of products, a review of the country's exports shows broad export base, which is indicative of under exploited export potential. From exports performance, the following broad sectors are singled out as key sectors warranting focus in export development endeavours. First Agriculture, mainly support for production of export oriented products and agro-processing of the same. Kenya's exports of 450,000 tons of vegetables, fruit and flowers to Britain and European markets have become the East African country's fastest growing economic sector. Kenya has seen phenomenal growth in its exports of cut flowers recently even taking into account mounting competition from Colombia, Ecuador, Israel, Zimbabwe, Zambia and Uganda. (FPEAK)

The Kenyan flower industry is expanding, with roses continuing to dominate the export market with sales up from 24.6 million kilograms in 1999 to 28.4 million kg in 2003, a 15% increase. The European Union (EU) is the principal importer of Kenya fresh produce. The Netherlands imports the bulk of flowers for sale through the auction system. Britain, Germany, The Netherlands and France are the major importers of fruits and vegetables. The Middle East market is an important outlet market for Kenyan fruits. Second manufacturing, whose share in total exports has been declining over the last five years due to increased costs

of production and insecurity fears by foreign investors especially since the Post Election Violence in 2007 (KAM, FPEAK).

The focus would be on product diversification, quality improvement and deepening of market penetration. Local resource based industries would indicate the highest potential. For these sectors to develop more there is need for available credit in the form of loans to enhance development. Market diversification poses a major challenge to Kenya in its quest for export development strategy. The above scenario prioritises export diversification in the search for an export development strategy for Kenya. Various studies have been conducted on the international trade and especially export trade in various countries. Newly developed nations of South East Asia together with Mexico, Brazil, India, Republic of South Africa and China have proved that export oriented economy can speed up economic development of a nation (WTO, IMF 2006-2009).

The current macroeconomic policy framework is generally considered conducive for export development. It encompasses foreign exchange policies, monetary policies, trade policies and the recent initiatives in formulating fiscal and infrastructural policies addressing the numerous problems cited by the business community as constraining production for export. The key challenge lies in implementation of these policies in order to allow the intended benefits to trickle down to the exporters. Propositions in literature on trade development state that there is a strong correlation between exports and the growth in Gross Domestic Product (GDP). Growth in exports can only be achieved if the exporters are given financial incentives in order to promote exports. (Trade Promotion Steering Committee study carried out by the World Bank in 1991).

Repeated transactions are an alternative way to reduce trade risk as the continuation value of a trading relationship gives firms an additional incentive to fulfil contracts. Therefore, they make exporter finance (Open Account) and importer finance (Cash in Advance) relatively more attractive compared to bank finance (Letter of Credit). Through the payment contract choice, financing costs and contracting environments in the source and the destination country interact to shape trade finance costs. These are variable trade costs proportional to the value of goods exported, isomorphic to the iceberg trade cost formulation as introduced by Samuelson (1954). Being an obstacle to trade, trade finance costs affect trade patterns. Exports increase in enforcement probabilities and decrease in financing costs. The latter effect is the larger the financing cost, the longer it takes from production to sale (IMF, 2009).

1.1.2 Contextual Background

Since its independence in 1963 there has been considerable progress in the trade reform in Kenya, advancing from import substitution from the colonial master to an export-oriented economy. Export led growth (ELG) policies of the successful East Asian economies is partly the motivation for Kenya to embark upon the policy. Kenya's export market is mainly concentrated on primary products. The agriculture sector contributes about 25 % of Kenya's GDP and accounts for 65% of total export earnings. Tea, horticulture, floriculture, coffee, pyrethrum, sisal, fishery, and leather products are the country's major agricultural exports. The focus of Kenya's exports on unprocessed primary products is mainly due to low levels of education among population and availability of abundant natural resources (Ministry of Trade and Industrialisation).

Kenya continues to improve her participation in the global trade and international business development. Kenya has become an import zone and the government needs to support its people to export more than import. Earnings from exports increase the supply of foreign exchange, which is needed to sustain the Import bill & to service the foreign debt (Kerre 1993). Asiko (1989:1) stated that negative exports earnings growth rates in developing countries have been associated with negative growth rates, declining investments and negative per capital growth rates.

It is in this connection that in recognizing the importance of exports, the Kenya government has taken various steps aimed at "Export Promotion Programs" to stimulate trade development the problem notwithstanding have been developed as stated by Kerre (1993) include; Export Processing Zones (EPZ). Bodies charged with the responsibility of promoting trade have been established which include; Kenya Investment Authority (Ken Invest), Export Processing Zones Authority (EPZA), Export Promotion Council, Kenya association of Manufacturers (KAM), Kenya National Chamber of Commerce and Industry (KNCCI), Fresh Produce Exporters Association of Kenya (FPEAK)

There are also export credit scheme guarantees established to offer Kenyan exporters financial and consultancy assistance which include; The Kenya Export Assistance Scheme (KEAS), and Industrial Commercial and Development Corporation (ICDC). To promote trade, Kenya is subscribed to regional and world co-operations that include the East African Co-operation (EAC), Common Markets of East and Southern Africa (COMESA), Economic Partnership Agreements (EPAs), Africa Growth and Opportunity act (AGOA) and the World

Trade Organisation (WTO). Despite steps taken by the government to improve trade, Kenyan exporters still face various problems. Musoke (1980) found out that lack of pertinent information contributed to the poor performance of many exporting firms.

Export expansion has not been a success story due to various reasons. First, there is little financial support to export from both the government and banks. Banks offer more support to import, for example most of the bonds processed by banks are imports for production of exports like sugar and tobacco. Trade account deficit is growing every day- too much imports and very little exports leading to economic decline. There is information asymmetry i.e. Lack of available information on trade leading to most Kenyan exporters being less ardent in the business. There is lack of harmonization in the information available on trade. (Kenya; Unleashing the Potential for Trade and Growth. (World Bank Issue, February 2007)). There is also lack of up to date information on the Ministry of trade and industrialization websites.

1.1.3 An Overview of the Kenyan Banking Sector

For any trade to develop well, the availability of trade credit is very crucial. Despite the lack of programs to enhance the provision of trade credit, Kenya can boast of having a fairly well developed banking sector with well developed banking policies. It consists of 43 licensed commercial banks, six deposit taking microfinance institutions and one mortgage finance company.

The banking sector in Kenya is regulated by Central Bank of Kenya (CBK) Act of 1968 and the Banking Act. These Acts were introduced to facilitate the development and maintenance of a sound monetary policy in the economy and also to safeguard customers' deposits (CBK).

1.1.4 Trade Finance Services

The services rendered by banks in the provision of trade credit include; export/import loans, invoice discounting, financial guarantees, letters of credit, documentary collections, drafts and short-term advances. Trade finance services should be popularized by all commercial banks to all Kenyan exporters; big or small, so that they can improve their export business to enable the country achieve its objectives as per Kenya Vision 2030.

Export documents are Bill of lading, Cargo delivery order, Certificate of origin, Commercial Invoice; Customs export declaration, Inspection report, Packing List and Terminal Handling receipts. Import documents are Bill of lading, Certificate of origin, Commercial invoice; Customs import declaration, Inspection report, packing list and Terminal handling receipts

(The Guide to Documentary Credits, 3rd Edition by Gary Collyer). Banks refusal to accept back to back L/Cs and the lack of export financing have hindered growth in export trade.

1.2 Statement of the Problem

Modern trade depends on credit and other key financial services to finance trade-related expenditure and cover against trade-related risks. Both international trade and the financial sector are important engines of growth in today's economies. The growing importance of these two sectors is highlighted by their expanding share in output over the last decades. The ratio of international trade of goods and services to global GDP has risen from about 8 per cent at the founding of the GATT in 1947 to about one quarter of global GDP at present. Finance is the oil that keeps the wheels of trade rolling without which they would come to a halt. Trade is one of the key strategies that are critical to the resuscitation of the economy. Shipping goods internationally is risky and takes time. To allocate risk and to finance the time gap between production and sale, a range of payment contracts is utilized. In this study the optimal choice between these payment contracts considering one shot transactions, repeated transactions and implications for trade. Trade deficit can be used to measure the performance of the trade sector (IMF, 2009).

Banks are specialized in providing credits and also in checking credit worthiness of borrowers before and monitoring performance after the credit is accorded. As specialists they can do this at lower costs than individual lenders/savers. The bank is also able to spread the risk of default over a larger number of transactions, and can require various forms of collateral and restrictive covenants. Limited ability to borrow and lend internationally hampers the transfer of resources across countries and can increase GDP correlations. If investors have imperfect information or face liquidity constraints, limiting capital flows can actually decrease GDP correlations, as investors herd, or withdraw capital from many destinations simultaneously (Imbs 2004). Traders need credits to run their business. At present, there are many financial products to facilitate international trade such as remittance process which are transfer payments between countries, Bill of Exchange (B/E) and Letter of Credit (LC) which are used as guarantor of payments. Despite the presence of financial products as outlined above, growth of international trade has been sluggish and it is therefore against this background that this study was undertaken to find out the impact of trade finance on international trade.

This is one field that has not been studied in the recent past except in the Asian 'Tiger Nations'. The current study is designed to address the research gap on the impact of trade finance on international trade by quantitatively examining the basic links between trade and the financial sector, interrelationship between financial crises and trade and also how weak financial systems and financial instability hurt the flow of goods and services and why protectionism undermines financial stability.

1.3 Objectives of the Study

This study was carried out to achieve several objectives. First, the study was used to identify and prioritise the trade finance services offered by banks that are crucial to exporters and importers in Kenya. Second was to establish the role of trade credit and its impact on international trade. This determines the relationship between financial market conditions and international trade. This also shows the role of payment contract on international trade. These objectives brought about the following research questions. What is the role of trade credit on international trade? What is the relationship between financial market conditions and international trade? What is the role of payment contracts on international trade?

1.4 Importance of the Study

The findings of this study will be important to the following First, to all exporters and importers in order to determine what factors influence trade initiatives. Second, to Banks and financial institutions and their role in International trade financing. Third, to students who will be provided with relevant information on the contribution of credit facilities in enhancing international trade. Fourth, to Researchers/Academicians who will use the findings as a basis for further research. Fifth, to the government and other institutions that focuses on poverty alleviation. They will be informed on how trade issues can enhance economic growth and the subsequent wealth creation.

LITERATURE REVIEW

2.1 Introduction

A well-developed and stable financial sector and an open international trading system are two key components of prosperous economies. Section 2.2 starts out by briefly reviewing why trade openness and financial sector development are good for growth. The main purpose of this section is to explain the ways in which trade depends on a well functioning financial sector.

Section 2.3 examines the empirical literature. Particular emphasis is placed on understanding the role of banks—the key players in countries' financial systems. It is argued that trade is part of the solution to crisis rather than one of its causes. Trade is typically a very important element in maintaining and regaining financial stability, and open trade policies in the countries affected by crisis as well as in their export markets are key elements in the recovery from crisis.

2.2 Theoretical Literature

Much has been written on the subject of export trade and on the role of banks in international business especially in the South East Asia nations. Although trade credits are self-liquidating, typically backed by receivables, with low transfer and convertibility risks, they often collapse during banking crises. One reason may be that trade credits often involve only a limited relationship between the company and the bank. In the height of a crisis, banks typically reduce overall country exposure following a decision to cap an institution's country limit. Since trade credit lines are usually short-term, can be redeemed at par, and involve limited reputational risks, they are an easy asset class to cut in times of crisis. Indeed, trade credits declined by as much as 50 percent during the peak of the recent crises in Argentina and Brazil, and fell by a comparable magnitude during the Korean crisis of 1997–98. (Developing Countries and World Trade: Performance and Prospects by UNCTAD, Third World Network and Zed Books edited by Yilmaz Akyuz, 2003).

Surprisingly, given these magnitudes, the economic literature on the linkages between trade volumes and financing is very thin. One of the few papers written on the issue is by Ronci (2004), who considers the effects of constrained trade finance on trade flows for 10 emerging market countries experiencing financial crises. He considers three years before and after the crisis year and finds that the change in financing (defined as outstanding short-term trade credit for each country) has a significant positive effect on domestic export volumes even

after controlling for changes in world export volumes and relative prices. Similarly, the change in financing has a significant positive effect on domestic import volumes even after controlling for domestic growth and relative import prices.

Two of the major difficulties regarding policy making in the area of trade finance are the lack of reliable quantitative information and the limited evidence on the relationship between international trade and trade finance. The use and knowledge of these services by exporters is not well explored and little has been written about them. Much has been written on the subject of export trade and on the trade finance services offered by financial institutions in the South East Asian Nations but nothing on credit services in Kenya. Growing evidence suggests that international trade finance experienced severe adverse effects in terms of price as well as availability during the same period (Kenya; Unleashing the Potential for Trade and Growth. (World Bank Issue, February 2007).

The IMF-BAFT survey reports that approximately 90% of the banks raised the price of international trade finance facilities at the onset of the great trade collapse (Dorsey, 2009; Asmundson et al., 2011), and in some cases the price of letters of credit jumped from 15 basis points to 250 basis points (Auboin, 2009). Banks in emerging markets also reported that international trade finance transactions declined by 6% on average during the period. Behind the evidence lies the hypothesis that international trade finance is more sensitive to economic fluctuation or financial crisis than domestic trade finance (for example., Chauffour and Farole, 2009). Price data corroborates this hypothesis. Haddad, Harrison, and Hausman (2010) find that U.S. import prices actually rose in manufactured goods, especially in those sectors highly dependent on external finance. Ahn, Amiti, and Weinstein (2011) report that export price increased by 2.5% relative to domestic price in European Union countries, Japan and the U.S. These facts are strong evidence that supply side shocks played an important role in the great trade collapse.

It is argued that the absence of major protectionist backlashes in post-World War II crises is one of the main reasons why these crises did not become global. Evidence for a number of countries also suggest that trade and open trade policies have played a major role in economic recovery following financial crises. Analyzing the role of the multilateral trading system with regard to the trade and finance nexus the study finds that WTO rules constrain adverse public interventions in trade financing in important ways, including with regard to provisions on

restrictions on payments and transfers and on financial services trade, multiple exchange rate practices and exchange rationing, and export subsidies (WTO).

The multilateral trading system contributes to financial stability by promoting non-discriminatory trade liberalization, rule-based and predictable trade policies, and orderly trade conflict resolution. Furthermore, well-conceived liberalization of financial services trade can contribute to financial stability, and thereby indirectly benefit international trade. This study demonstrates that the WTO framework and the international financial system are interdependent elements of one global economic order, where trade cannot flourish without financial development and stability, and financial stability is unlikely to prevail without trade (WTO).

To understand how finance affects the number of exporters and the size of their sales, economist Kalina Manova (2010) exploits the fact that different industries tend to rely with different intensity on external finance, and the cost and availability of credit vary across countries. The research shows that countries in which credit is either more difficult or more expensive to obtain tend to export less, especially in industries that rely more heavily on external finance. Economists Nicolas Berman (2010) and Jerome Héricourt (2010) studied the relationship between trade and finance using firm-level survey data from nine emerging and developing countries from the World Bank. They showed that firms' financial health raises neither the probability of remaining an exporter once the firm has entered international markets nor the size of exports. However, access to finance affects the probability of becoming an exporter. They also showed that the level of financial development of a country—not just an individual firm's access to credit—can affect the probability of starting to export.

First, credits help to bridge the time between an order and payment for the order so that trade can take place even if none of the parties is liquid enough to finance the transaction. Second, the financial sector helps cover a number of risks for traders, such as commercial risk, transportation risk, exchange risk, and political risk. Numerous trade-specific financial instruments have been developed and governments sometimes help to cover particularly large or unpredictable risks in trade through export credit agencies. Financial crises are among the most causes for disruptions in international trade. In such crises, trade-related financing may become very expensive or even unavailable, and economic disruptions depress demand for traded goods and services (Kalina 2006).

Asiko (1989) recommended further study on the impact of the tertiary and services industries on export of commodities from the Preferential Trade Area (PTA). Otieno (1988) recommended a study of the Jua kali sector that would seek the bankers' view of the sector and measures which can be instituted to support the sector. He stated that ideally bankers are the providers of capital funds and their view could help in formulating policies to govern and develop the informal sector. It is on the basis of these recommendations that the study is being undertaken. The main objective of Trade Finance is to facilitate exporters' access to finance by bridging the knowledge gap between Banks and exporters by focusing on the needs of the traders. The aim of this paper is to fill this knowledge gap. There are many secondary sources of information, including research papers as well as government policy papers. Several theories of international trade are examined in this section.

2.2.1 Absolute Advantage Theory

The Scottish economist Adam Smith developed the trade theory of absolute advantage in 1776. A country that has an absolute advantage produces greater output of a good or service than other countries using the same amount of resources. Smith (1776) stated that tariffs and quotas should not restrict international trade; it should be allowed to flow according to market forces. Contrary to mercantilism Smith (1776) argued that a country should concentrate on production of goods in which it holds an absolute advantage. No country would then need to produce all the goods it consumed.

The theory of absolute advantage destroys the mercantilistic idea that international trade is a zero-sum game. According to the absolute advantage theory, international trade is a positive-sum game, because there are gains for both countries to an exchange. Unlike mercantilism this theory measures the nation's wealth by the living standards of its people and not by gold and silver. (The Wealth of Nations, Adam Smith 1776)

Businessmen naturally compare the money cost of the same good in different locations to draw inferences about the direction of trade. Absolute cost advantage appears to imply that a nation imports goods that are cheaper abroad and exports goods that are more expensive abroad. Absolute advantage appropriately addresses the householder's question of which good should be purchased, the businessman's question of how tough are my competitors?

The individual businessman can appropriately take all other prices as given when contemplating his own actions, such as entering a new export market. There is a difference between

currency) were equal in the two countries prior to the opening of trade, the home country would have a 'competitive' or absolute advantage in both goods: it could undersell the foreign country in both wheat and cheese (Smith 1776).

The absolute advantage is weak in the mathematical sense in the case where both countries continue to produce the good. Another illustration of the absolute advantage theory arises in popular concerns about the rapid productivity growth of China compared to the US. A 10% improvement in productivity will indeed secure a 10% cost advantage. Imports need not equal exports bilaterally in a many country world; overall balance only is required. Imports also need not equal exports in any single time period, with the aggregate trade imbalance offset by international borrowing or lending. Balanced trade in the aggregate at a point in time is a simplifying assumption appropriate to analyzing the causes of trade and the gains from trade. When allowing for intertemporal trade, the expected present value of trade balances must be equal to zero (Smith 1776).

With full-blown inter-temporal trade, essentially the same forces determine the pattern of trade and the gains from trade. Naturally, however, the time path of prices, especially the factor prices in the two countries, has important implications for trade volume and the gains from trade. With many goods, comparative advantage applies to ranges of goods rather than to a single good, and the dividing line between comparative advantage and disadvantage is endogenous. A 10% improvement in all Chinese productivity relative to the US is unlikely to change comparative advantage because Chinese wages will rise relative to US wages. Similarly a 10% drop in all US productivity due to tighter environmental regulations will be unlikely to change comparative advantage because US factor returns will fall. The widespread practice of making international comparisons of 'competitive advantage' is essentially misguided because it suggests the metaphor of a race.

The race metaphor is extended in concerns about 'a race to the bottom', which supposedly expresses the dilemma of countries seeking to implement pollution or labor standards but being pressured to lower standards by their competition with foreign countries that have low standards. But nations do not 'compete' as firms do. A firm may well be unable to survive after implementing pollution reduction when its competitors abroad do not follow suit and no other prices change in the new equilibrium. Nations cannot similarly put themselves out of business because factor prices will change in the new equilibrium. Polluting industries may or

may not survive at the new factor prices under the new regulations, but the nation's factors will be productively employed somewhere in the economy. Pollution reduction is costly with or without trade; nothing about the nature of a trading economy makes any essential difference to the nation's ability to implement desired standards.

2.2.2 Comparative Advantage Theory

"Buy low, sell high" logic leads economists to comparative advantage theory. Comparative advantage means the comparison of relative price differences between nations to explain the pattern of trade. For example, compare the relative price of wheat in terms of cheese at home to the same relative price in the foreign economy in a hypothetical equilibrium with no trade (autarky) or with restricted trade. The country with the lower relative price of wheat is said to have a comparative advantage in wheat while the other country has, symmetrically, a comparative advantage in cheese.

Buy low, sell high logic predicts that a country will export the good in which it has a comparative advantage. Focus on relative prices tends to cancel out forces (exchange rate manipulations, environmental or labor standards) which cause national differences in levels of non-traded factor (or goods) prices. Prices of non-traded factors of production adjust in general equilibrium so that each country ends up in the trade equilibrium with a competitive or absolute cost advantage in the good in which it has a comparative advantage. Partial equilibrium thinking takes factor prices as given and does not impose the external budget constraint that requires exports to pay for imports.

In the case of many goods, the prediction is that a country will on average export goods which are relatively cheap in the absence of trade and import goods which are relatively expensive in the absence of trade. The prediction is about correlation. Propositions in literature on trade development state that there is a strong correlation between exports and the growth in Gross Domestic Product (GDP). Growth in exports can only be achieved if the exporters are given financial incentives in order to promote exports. (Trade Promotion Steering Committee study carried out in 1991). Liberalization of international trade will cause the expansion of goods and service markets and this will also lead to the productivity level of countries and so the economic growth will accelerate.

The studies of Grossman and Helpman (1989, 1990) relating to the growth and foreign trade are very important. They stated that Research & Development Sector will bring the comparative advantage in the economy of country and will be a driving power of growth.

Especially less developed countries, liberalizing their foreign trades, with access to information stock of the world via technology transfer and in time, also in the influence of development of world trade, will provide important contributions in the name of growth from liberalizing (Ercan, 2002:133). Grossman and Helpman (1990), in the other studies, stated that differently in the countries having a comparative advantage, since the protective policies on the consumption of goods will cause the resources to go towards the sector producing information, they will be able to release a negative effect on the growth in long term (Grossman and Helpman 1990:814). Foreign trade will be able to release its negative effects on the growing of economies.

Prebisch, one of the economists arguing this view, understood that recommending "the free play of market forces" between unequal trading partners would only punish poorer commodity exporters at the same time as it brought advantages to the rich industrial core. Prebisch's agenda to attack the persistent trade imbalance and create the essential external conditions for accelerating the rate of growth included new modalities of participation for developing countries in the trading system which would guarantee price stabilization and improved market access for primary exports, allow greater policy for space to develop local industries and reduce barriers to their exports, establish more appropriate terms of accession to the multilateral system and reduce the burden of debt servicing. (Developing Countries and World Trade: Performance and Prospects by UNCTAD, Third World Network and Zed books edited by Yilmaz Akyuz, 2003).

Prebisch states that the oligopolistic market structure in the developed countries and the rigid prices will cause the gains resulted from technological improvements to go to factor owners with the higher product prices. This also leads to the earning transfer from less developed countries to the developed countries via international terms of trade (Han and Kaya, 2006:137).

In introducing the relationship between foreign trade and national income, five different views are presented (Örnek and Kaplan, 2004:113). Foreign trade has principally two major roles in the growing and development process. First of these is particularly short termed and this is to meet the import i.e. to provide foreign paying power that economic development efforts involve without leading to delays. The second is a more important problem and this, in accordance with radical change in economic structure, is to reshape the foreign trade or in

other words, to influence the distribution of resources, stimulating the international cooperation (Serin, 1998:321).

Foreign trade provides the effectiveness gains, reorganizing the distribution of foreign trade production factors between sectors (the effect "resource distribution"). Foreign trade leads to the increase in productivity, increasing domestic effectiveness and competition thanks to foreign trade (disciplining import hypothesis). Foreign trade enables the local producers to benefit from scale of economies, causing the expansion of foreign trade market volume (Effects of Scale of Economies).

Foreign trade will lead to increase of the rate of capacity use and thus increase in productivity, enabling supplied investment and intermediate goods, which have no substitution at home (the effect of providing input). And the last one is that foreign trade makes a contribution to technology, providing the informational flow between the countries and sectors (The effect of technology dissemination). These five different views are important, especially in providing the necessary growth rate of countries, in terms of introducing the importance of foreign trade.

Ricardo (1816) explained comparative advantage as due to differences in labor productivity. Suppose that it takes two hours of labor to produce a bushel of wheat in the home country, while it takes four hours of labor to produce a bushel of wheat in the foreign country. Also, it takes three hours of labor to produce a pound of cheese in the home country while it takes eight hours of labor to produce a pound of cheese in the foreign country. Ricardo saw that the world trade equilibrium would result in the home country exporting cheese and the foreign country exporting wheat. This is because in the absence of trade, a pound of cheese is worth 1.5 bushels of wheat (3 hours per pound of cheese divided by 2 hours per bushel of wheat) in the home country while a pound of cheese is worth 2 bushels of wheat in the foreign country. The labor market equilibrium which accompanies such a trade equilibrium must have a foreign wage of at most one-half of the home wage (since with a foreign wage equal to one-half the home wage, a bushel of wheat costs the same amount in each country, allowing production in both).

Considering a low wage foreign economy, the labor market equilibrium accompanying the trade equilibrium could have a foreign wage no lower than three-eighths of the home wage (since in this case a pound of cheese costs the same amount in each country).

Notice that countries export the good in which they have the comparative labor productivity advantage, cheese for the home country and wheat for the foreign country. The numbers chosen make no difference to the logic, what is essential is that comparative labor productivities differ. One special aspect of the numbers deserves emphasis however: the home country has an absolute labor productivity advantage in both goods yet trade occurs regardless.

Subsequent developments of trade theory generalized the production model. The essence of comparative advantage theory remains: trade is due to differences in relative prices that would obtain in the absence of trade, and an average of each country's citizens gain from such trade. The Heckscher-Ohlin analysis of the factor proportions model predicted that a country would have a comparative advantage in the good which made relatively intensive use of its relatively abundant factor. Thus if the home country were relatively abundant in capital (explaining why its labor was so much more productive in the preceding example), it would have a comparative advantage in the good which used capital relatively intensively. Conversely the foreign country is relatively abundant in labor and has a comparative advantage in the good which uses labor relatively intensively. Trade in goods compensates for the international immobility of factors.

The factor content extension of Heckscher-Ohlin trade theory predicts that trade patterns permit each country to consume factor services as if it were in a completely integrated world, smoothing out differences in national factor endowments. Recent empirical work has met with striking success in combining factor endowment differences with technology differences as an explanation of observed trade patterns (Davis and Weinstein, 2002). On average a country will import goods that would be relatively expensive in the absence of trade. The assumptions of the general model are that price taking consumers minimize the expenditure needed to realize any level of utility (real income), and producers behave so as to maximize the national product given the resource endowments. The first assumption implies downward sloping demand curves in the generalized form. The second assumption leads to upward sloping supply curves in the generalized form.

Trade theory also encompasses endogenous differences between countries. One focus is on economies of scale. The wider market due to trade induces a cost advantage in an industry in

one of the countries. Another theory is based on monopolistic competition, whereby the wider markets due to trade increase product variety as buyers seek the special characteristics of foreign brands. Differentiated products trade flows both ways within product categories.

Trade costs also shape the pattern of trade. The economic theory of gravity explains the complex bilateral trade patterns among countries. Actual trade is much lower than gravity predicts in a frictionless world, providing evidence of trade costs much larger than those due to policy or transportation. The costs are well explained by geography and a set of national differences.

The stability of the relationships over time suggests that these costs change slowly. There are gains from trade in all these models. But the division of the gains will be uneven and there will be losers. Distribution matters in two ways, between and within nations. Internationally, with only mild qualifications, gains are shared between nations: some trade is better than none. Each nation can act through trade policy to take more of the gain, however, leading to destructive trade wars with mutual losses. Within national economies, there are gains on average but there are ordinarily losers. National institutions act to redistribute some of the gains (U.S. Trade Adjustment Assistance) or provide temporary relief from losses due to trade (escape clause protection), at the cost of lowering the overall gain from trade.

2.2.3 Endogenous Advantage Theory

Many goods are traded because they are simply unavailable from local production. Some kinds of availability are exogenous to the interaction of nations - diamonds and oil are found only in a few locations. Endogenous availability is in contrast driven by advantage arising from the economic interaction of nations. Endogenous advantage normally coexists with comparative advantage but it is simpler to consider special cases independent of comparative advantage. Theory focuses on endogenous advantage resulting from economies of scale. In a formal but trivial sense, oil or diamond trade can be seen as comparative advantage trade - big oil deposits lead to a low relative price of oil where they are found.

2.2.4 Increased

Moreover, comparative advantage trade is often associated with the disappearance of some Trade based on scale economies features the possibility of multiple equilibria - one country will produce a good with scale economies but which nation ends up producing can be a matter of chance. Since advantage is endogenous, it appears attractive in developing countries to attempt to reverse the historical head start of rich countries by starting up production

will generally allow economies of scale to be more thoroughly exploited, so this is a source of gains from trade. Moreover, wider markets may support a wider range of products, which is still another source of gains from trade.

Each country shares in the gains from trade with scale economies under conditions that appear to be met in practice. The theoretical possibility that a country can lose from trade based on scale economies has drawn a lot of attention from development economists in particular (Ethier, 1982b). Gains can be guaranteed if a country expands production in a good with scale economies, so it looks more attractive to use policy to promote production of such goods. Scale economies come in two forms: external to the firm and internal to the firm. External scale economies are typified by specialized labor markets such as Silicon Valley, where the concentration of the market reduces search costs for computer engineers.

External scale economies need not be location specific, however. Increases in the scale of downstream final production can permit carrying on upstream input production as a more specialized process that is cheaper at large enough scale. Such scale economies can operate at the level of the world economy and appear to be bound up with the recent phenomenon of outsourcing (Ethier, 1982a). Global scale economies tend to guarantee mutual gains from trade among countries.

Internal scale economies are associated with imperfect competition when the size of the firm looms large relative to the market size. Trade tends to intensify competition and to reduce the inefficiency of monopoly, industries in some countries. Losses result when, in a trading equilibrium, a country imports the good with scale economies which it is producing. Since domestic scale is smaller, unit costs are higher, meaning that market forces perversely 'choose' to import a good with higher price than in self-reliance. Similar models have not found such equilibria but they are possible.

2.2.4 Increased Efficiency of Trading Global

The world has become one big global village. Global trade allows wealthy countries to use their resources - whether labour, technology or capital - more efficiently. Because countries are endowed with different assets and natural resources (land, labor, capital and technology), some countries may produce the same good more efficiently and therefore sell it more cheaply than other countries. If a country cannot efficiently produce an item, it can obtain

n by trading with another country that can. This is known as specialization in international le.

International trade not only results in increased efficiency but also allows countries to participate in a global economy, encouraging the opportunity of foreign direct investment (FDI), which is the amount of money that individuals invest into foreign companies and other assets. In theory, economies can therefore grow more efficiently and can more easily become competitive economic participants. For the receiving government, FDI is a means by which foreign currency and expertise can enter the country. These raise employment levels, and, theoretically, lead to a growth in the gross domestic product. For the investor, FDI offers company expansion and growth, which means higher revenues.

Export Trade Financing can be broken down into three major functions or concerns. The first is the method of payment, which includes such options as cash in advance, documentary letters of credit, documentary collections, and open account and may involve foreign currency. International divisions of banks are involved in assisting exporters with these components and can also provide technical advice to help a firm get paid by overseas buyers. The second is financing the export transaction cycle, or securing the working capital necessary to perform the export transaction. This may include pre-shipment working capital to finance the production cycle (for materials, inventory, and labor) and/or post-shipment working capital (to support open account terms). Several banks that provide such financing are listed in this study.

The third element may involve extending open account credit terms to overseas buyers. A bank will usually advance funds against overseas accounts receivable if (and frequently, only if) they are insured against commercial and political risks. An analysis of a typical credit portfolio at any bank will reveal that in general over 50% of all companies are involved in cross-border trade to one degree or another. Buying and selling goods and services outside of the domestic market place presents corporate entities, and the banks and financial institutions that provide support to these businesses, with a unique set of risk considerations and challenges in addition to the buyer defaulting.

The ultimate objective of any trading company is to get paid. It is the very reason that buyers and sellers conduct business together. Equally the prime objective of a bank and financial institution is to ensure that any finance that they provide to their clients in support of international trade is repaid in full and on time and that the transaction is profitable.

perspective of the potentially opposing needs and risk profiles of a bank and its client in a cross-border transaction, international trade finance mechanisms and procedures can provide risk mitigation techniques and additional comfort and security to all parties.

The IMF-BAFT survey reports that approximately 90% of the banks raised the price of international trade finance facilities at the onset of the great trade collapse (Dorsey, 2009; Edmundson et al., 2011), and in some cases the price of letters of credit jumped from 15 basis points to 250 basis points (Auboin, 2009). Banks in emerging markets also reported that international trade finance transactions declined by 6% on average during the period. Behind the evidence lies the hypothesis that international trade finance is more sensitive to economic fluctuation or financial crisis than domestic trade finance (e.g., Chauffour and Farole, 2009). Price data corroborates this hypothesis. Haddad, Harrison, and Hausman (2010) find that U.S. export prices actually rose in manufactured goods, especially in those sectors highly dependent on external finance. Ahn, Amity, and Weinstein (2011) report that export price increased by 2.5% relative to domestic price in European Union countries, Japan and the U.S. These facts are strong evidence that supply side shocks played an important role in the great trade collapse.

2.5 Transactional Costs

There are several barriers to International Trade.

Models of imperfect competition and increasing returns reveal an important role of transaction costs, i.e. those costs involved in transferring goods (or services) from producers to consumers, in determining the pattern of trade. Krugman (1980) shows that in case of two identical countries, except for market size, the country with the larger home market for (manufacturing) goods subject to scale economies will be the net exporter of these goods, but only if transaction costs are neither too low nor too high (prohibitive). (Zero transaction costs implying that the composition of trade is indeterminate, since scale of economies are not location-specific. Whereas very high transaction costs eliminate trade and bring about a self-reliant situation). This is called the "home market effect".

Increasing returns to scale induce firms to establish production in a single place and in order to minimize transaction costs; they prefer to locate near the larger market. The home market effect forms also a building block in the "new economic geography" launched by Krugman (1991a), and the same holds for some new trade models of linear demand.4 Recently, Head, Mayer and Ries (2002) have shown that the home market effect is quite robust to alternative

model specifications. However, virtually all these models do not care much about the specific characteristics of the transaction sector with respect to production technology or regulatory policy. Within the new economic geography transaction services are produced via a so-called "iceberg technology". That is, only part of the freight arrives at the customer, while some goods melt on the way to their destination. Consequently, there does not exist a separate transaction sector. Historically, Trade has been restricted in two major ways. One is through tariffs- taxes imposed on imports to increase their price in the domestic market. The other is through quotas- limits placed on the quantities of a product that can be imported. If the government is slow to grant licence, the licence fees are exorbitant, International trade is restricted.

2.3 Empirical Literature

The role of exports in economic development has been widely acknowledged. Ideally, export activities stimulate growth in a number of ways including production and demand linkages, economies of scale due to larger international markets, increased efficiency, adoption of superior technologies embodied in foreign-produced capital goods, learning effects and improvement of human resources, increased productivity through specialisation (Basu et al., 2000; Fosu, 1990; Santos- Paulino, 2000; and Giles and Williams, 2000) and creation of employment.

While practical evidence in support of export-led growth (ELG) may not be universal, rapid export growth has been an important feature of East Asia's remarkable record of high and sustained growth. In particular, the wave of growth in the four tigers (Hong Kong, South Korea, Singapore and Taiwan) and the Newly Industrialised Countries (such as Malaysia, Indonesia and Thailand) has been used to support the argument that carefully managed openness to trade through an ELG is a mechanism for achieving rapid growth (Giles and Williams, 2000).

The experiences of these countries have provided impetus to the neoclassical economists' view that ELG strategy can lead to growth. The subject of ELG can also be approached from the wider debate on openness (or trade) and growth. What appears to be gaining currency in recent years from cross-country growth differences is that most of the countries pursuing growth successfully are also the ones that have taken most advantage of international trade (Martin, 2001; Masson, 2001). These countries have experienced high rates of economic

favour of ELG and global trend towards trade liberalization appears to have influenced Kenya to adopt an export-led growth strategy. ELG is envisaged in Kenya's Poverty Reduction Strategy Paper (PRSP) as the strategy towards being industrialized (GOK, 2001). In this era of trade liberalization and globalisation, the importance of exports cannot be over-emphasised.

However, as a developing country, Kenya will undoubtedly need to become competitive to be able to carve a niche in the world market and realise its long-term goal of becoming an industrialised nation. This requires a combined effort to develop its production potential and move away from mere processing towards product brand in coffee and tea exports while at the same time encouraging the non-traditional exports. In this paper, exports are considered based on ELG in Kenya, which is likely to be more efficient beyond the openness arguments. This is because export-led growth will bring in technology transfer, efficient allocation of resources imposed by international competition and cost efficient allocation of resources. These effects provide a further impetus to growth beyond what openness can provide through dynamic interactions in the economy (Ndulu and Ndung'u, 1998).

This study attempts to examine factors that are likely to have influenced trends in Kenya's exports from a macroeconomic perspective. However, in consideration of the diversity of Kenya's export sector, an attempt is made to disaggregate the export sector for precise and comprehensive analysis. Different sub-sectors are likely to respond differently to macroeconomic policies and price incentives—this is unlikely to be captured using the highly aggregated export data. Kenya's leading exports are mainly primary agricultural products whose price movements and production factors differ in contrast to manufactured exports. Consequently, as a starting point, this study decomposes exports into three major categories: traditional agricultural exports of coffee and tea, and 'other exports of goods and services'. This also makes it possible to gauge the commodities export supply response. The next section of this paper provides background information on the evolution of the export sector in Kenya, including policies adopted since independence. A brief description of the structure and composition of exports is given in section three while section four provides a general review of theoretical and empirical work. This is followed by an overview of methodological issues in section five.

2.4 Empirical Literature in Kenya

2.4.1 Trade Policies since Independence (Pre-Liberalization Era)

It is important to parade the evolution of trade policies pursued since independence in order to understand Kenya's export structure and performance. This would then allow an assessment of the effects of these policies on export performance. The evolution of Kenya's trade policy can be traced to the later years of the colonial era during which the country was used and protected as a producer of agricultural and other raw materials for Britain's manufacturing sector and a ready market for manufactured goods from Europe. With increased competition for the Kenyan market (mainly from cheaper goods from India and Japan), the British government initiated a protected manufacturing sector in Kenya—the beginning of the import-substitution industrialization (ISI) strategy—to cater for the local market (SIMASG, 1989).

At independence therefore, Kenya adopted an industrialization policy based on import-substitution strategy which was highly characterised by protective trade barriers. At that time, the preoccupation of the government was on the use of the import substitution strategy to achieve economic independence and faster 'Kenyanisation' in ownership, management, production and distribution (SIMASG, 1989). Since the incentive structure was biased towards import substitution, a large proportion of the industrial output was geared towards the domestic captive market, which was more profitable than the export market.

This discouraged a strong drive towards export promotion and partly accounted for the poor export performance of Kenya's manufacturing sector and orientation towards consumer goods. The failure in export promotion or in industrialization may not be wholly blamed on the ISI strategy but rather on the failure of ISI to move beyond the first stage and therefore the fact that most first generation firms of ISI strategy remained at the infant stage. The first decade of independence recorded faster and higher economic growth in Kenya's economic history. There was expansion of output and employment propelled by expansionary fiscal policy (Wagacha, 2000). By the 1980s, Kenya had achieved a reasonable level of industrialization by regional standards (Lall and Pietrobelli, 2002). That notwithstanding, ISI like in most African countries failed to achieve the intended objectives despite the considerable protection and government patronage the industries enjoyed.

eral, the policy structure was heavily biased against exports—characterised by high
re rates of protection, price controls, foreign exchange controls and import licensing—
to difficulties in accessing imported inputs, bureaucratic and cumbersome
strative procedures, and over-valued currency. Several public enterprises enjoyed
oly status. The relatively rapid real growth in the 1970s, particularly in the last half,
ainly due to sharp increases in international prices of tea and coffee (for example the
export boom of 1977). The performance of manufactured exports remained weak;
cturing exports declined significantly as a share of total exports. Besides other effects,
ontrol regime also contributed to the negative effects on exports and the macro-
ic distortions in the economy. The break up of the East African Community (EAC)
ely affected the share of manufactured exports to the region and intensified the inward
tion.

series of external shocks in the 1970s, the inefficiency and inadequacy of the import-
ution policy became evident. The first oil crisis of 1973 that led to severe problems in
e of payments (BOP), and the collapse of the EAC in 1977, adversely affected the
nance of import-substitution enterprises. The latter removed the disguised
tiveness of Kenya's manufactured exports (Wagacha, 2000). The resultant high
costs and limited market led to excess capacity and inefficiencies (SIMASG, 1989).
ndiscriminate and open-ended protection distorted resource allocation, constricted
a competition and restricted technology inflows from abroad (Lall and Pietrobelli,
nancial system was characterized by repression factors including negative real interest
inefficiency in financial intermediation and underdeveloped financial markets. It was
ded that the prerequisites for financial liberalisation in Kenya and decontrol of interest
were not in place before the financial sector was liberalized. Efficiency had not been
ed in intermediation of financial assets and this was reinforced by the oligopolistic
re of the market where the financial sector is dominated by a few commercial banks.
conclusions included the fact that the financial markets were still in their infant stage,
ntral Bank had not yet gained independence in its operations politics made it difficult
uccessfully implement the prudent regulations. Therefore there are several loose ends that
o be tightened for the Kenyan economy to experience positive effects if financial
ization.

Mwenga et al (1994) used a simple analytical framework to study whether it was savings, fiscal or foreign exchange gap which was the binding constraint on capacity growth in Kenya and how these gaps evolved since the early 1970's. The three-gap framework applied in the study extended the traditional two-gap model by distinguishing the fiscal constraint as another major impediment to economic growth. These findings conclude that for intermediate import ratios, foreign exchange was the binding resource constraint to potential economic growth in Kenya and increase in foreign exchange through exports promotion and concessionary capital inflows and the associated reduction of import compression, would alleviate the saving, fiscal and external gaps that undermine good macroeconomic performance.

Mwenga et al (1990) in a study similar to the one done by Ngugi and Kabubo on the effect of real interest rates and the mobilization of private savings in Africa, the objective was to test the McKinnon Shaw Hypothesis. This states that an upward adjustment in real interest rates significantly increases the private sector's financial and non-financial savings which are then utilized to support a high level of credit supply and investment in the economy. The study suggested that the major impact of the high interest rate policy is in reducing the private sector's demand for credit and hence its aggregate spending.

By the end of the 1970s, the government started recognising the need for an export-oriented industrial strategy as indicated in National Development Plans of 1974-1978 and 1979-83. Nonetheless, adherence to import-substitution still lingered. In the early 1980s, partly due to the increasing pressure for structural adjustment reforms, the government began to demonstrate commitment to a liberalization policy, a major component of which was a shift from import-substitution to export-promotion strategy.

The major turning point in policy was in the form of *Sessional Paper No.1 of 1986 on Economic Management for Renewed Growth* in which the government committed itself to liberalize the economy and adopt an outward-looking development strategy. By this time, Kenyan exports had deteriorated tremendously. Merchandise export earnings as a percentage of GDP had for example declined from 19.6% in the 1970s to 16.97% over 1980- 84 and to 13.6% over 1985-89 (Glenday and Ndi, 2000).

Ten years ago, manufacturing accounted for 11 percent of Kenya's economy—and it is the same today despite a decline in the share of agriculture from 30 percent to 25 percent.

growth has been in services, particularly transport and telecommunications, the resurgence of Kenya Airways and Kenya's telecom revolution. If one imports a need enough dollars to pay for these imports. Ideally, exports will give everything. When exports aren't enough—which is the situation in Kenya today, the gap is filled through other financial inflows, including remittances, private investment, and aid from development partners (WorldBank: Kenya Economic Update, Dec.2010, p. 3).

Since the export compensation scheme established in 1976, a number of export promotion schemes were initiated. These include Manufacturing under Bond (MUB) and Export Processing Zones (EPZs) established in 1988 and 1990, respectively. Other export incentive schemes were Green Channel, Export Guarantee and Credit Scheme, the revival of the Kenya Trade Authority (KETA), Export Promotion Council and the Export Promotion Incentives Office (EPPO) for tax rebates on imported inputs for exporters. The export promotion programmes were mainly geared towards promoting manufactured exports—labour-intensive manufactures. MUB and EPZs targeted new investments while duty and VAT exemption schemes targeted existing manufacturers (Glenday and Ndiir, 2000).

EPZs were aimed at using the abundant semi-skilled labour to produce labour-intensive manufactures, notably garments and foot wear for overseas market—perhaps similar to 'sweat shops' in Asia (Glenday and Ndiir, 2000). That notwithstanding, export promotion in the 1980s remained weak largely due to very high effective rates of protection accorded to domestic industries, exchange rate bias against exports, high cost of inputs, foreign exchange controls and administrative delays, high transaction costs levied against the profitability of exports, among others. In addition, the export incentive schemes remained unattractive and less successful due to weaknesses in implementation and poor coordination.

The Liberalization Period

Liberalization started with a conversion of quantitative restrictions to tariffs equivalent. The government embarked on phased tariff reductions and rationalisation of the tariff bands. By 1991, quantitative restrictions affected only 5% of imports compared with 12% (Swamy, 1994). Over the 1987-92 period, the number of tariff categories and tariff rates were reduced from 25 to 11 and 170% to 70% respectively (Mwega,

weighted tariff rate to 12.8%, down from 25.6% (Glenday and Ndi, 2000). The number of tariff bands (including duty free) was reduced from 15 in 1990/91 to four (4) in 1997/98 and the top regular tariff rate from 100% to 25% over the same period. That notwithstanding, the most significant shift in trade policy regime came in May 1993 with the abolition of trade licensing requirements and more importantly, foreign exchange controls (Ndung'u, 2000 and Vere et al., 2001). Foreign exchange retention schemes for exporters were introduced at a rate of 50% and later increased to 100% in February 1994 (Mwega, 2002).

Regional trade integration measures under the East African Cooperation and the wider Common Market for Eastern and Southern Africa (COMESA) also accounted for the dominant share of the increase in Kenya's exports, particularly in manufactured exports. The economic recovery and trade liberalization initiatives in the region, particularly in Uganda, have provided an impetus for overall increase in import demand. Recorded exports to COMESA increased from an average of 15% for the period 1990-1992 to 34% in 1996-98 (Glenday and Ndi, 2000). On the other hand, Kenyan exports to European Union (EU) showed a downward trend in the late 1990s, and especially from 1997. Exports to the EU have mainly been agricultural products—tea, coffee and horticultural products.

The impact of export incentive schemes especially MUB and EPZs designed to target dedicated export processing for overseas' markets has not been significant (Glenday and Ndi, 2000). Unlike in the fast growing Asian countries, Kenya has not been successful in gaining competitiveness in labour-intensive export processing. Some of the incentives such as exemption from foreign exchange controls were overtaken by the liberalization of the foreign exchange market in 1993. Other incentives have also been eroded over time. As tariff rates have declined over time, the net subsidy provided by the export promotion schemes have also declined. Other subsidies like the import duty and VAT rebates by EPPO have been marred by delays and therefore eroded their incentive value. Other indirect additional costs associated with restriction of choice of location, bureaucracy and risk of excess capacity have tended to discourage entry into the EPZs. Most of the parks have remained undeveloped and under-utilised.

4.3. Structure and Composition of Exports

Like most sub-Saharan African countries, Kenya's export structure is predominantly composed of primary commodities—mainly tea, coffee and horticulture—besides tourism.

ain non-traditional exports such as horticultural products have experienced rapid growth
he last few decades, manufactured goods make only a small proportion of total exports.
ides horticultural products, coffee and tea still remain key export commodities. The share
manufactured exports has not only remained small but has also been declining.

Consequently, export growth has been highly erratic, based on fluctuations in earnings from a
traditional primary exports and the tourism sector. The decline in Kenya's export
performance is mainly attributed to muddled government policies that produced an anti-
export bias (Wagacha, 2000). In developed economies where both money markets and overall
financial markets are well developed, exporters have few problems obtaining bank loans at
uniform market interest rates. Pre-shipment export financing is handled through normal
commercial loans, like any other production financing. In these economies, all exporters
enjoy neutral status without a special export financing system. In most developing
economies, on the other hand, money and financial markets are not well developed and are
highly segmented. Thus exporters cannot be assured neutral status in competitive money and
financial markets. Large firms are favoured over small ones and demand for physical
collateral is paramount closing off many small and medium traders.

Consequently, a developing economy's export capability can hardly be exploited.
Guaranteeing automatic access to financing at uniform interest rates for all activities
generating export value added is therefore important. Since automatic availability of capital
at uniform interest rates and equal treatment of all activities generating export value added
is of primary importance as long as the rate is neutral vis-à-vis beneficiaries of domestic
credit rationing and foreign competitors.

Summary

International trade is very important to all importers and exporters. Almost all labels on our
clothes, shoes, food products we buy or even the cars we drive are imported. The key to trade
is specialization. Some people specialize in cutting hair while others in fixing TV sets. These
people exchange their services for money which they use to buy the specialized talents &
services of others.

Aggarwal (1982) summarized problems facing Kenya exporters to the U.S. and European
markets as follows. First, lack of complementary production and product diversification
among African countries and low levels of investment. These structural constraints are

ns systems, as well as by supply-side constraints that are experienced by
rs that can erode export competitiveness. Second, half-hearted attempts at
egration, illustrated by continuing high tariffs on products of export interest to
partners and the persistence of non-tariff barriers (NTBs), sustain unfulfilled
ational trade barriers can be summarised as follows. There isn't available
n about shipping lines in the markets. High freight rates charged on the routes. It's
to export or import products. Delays in securing export compensation in case of a
mentation for both imports and exports are complicated. Procedures for export of
that are highly perishable especially in horticulture are too long. (Kenya;
g the Potential for Trade and Growth. (World Bank Issue, February 2007)).

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter describes the research methodology that was used in the study. To examine the relationships between trade integration and financial integration bilateral data was used and the gravity model was the selected approach. Many studies support this model for its ability in explaining bilateral trade and financial flows such as Portes and Rey (2005), and Shin and Yang (2006). Section 3.2 explained the research design, section 3.3 discusses the study population, sampling method and procedures, section 3.4 describes data collection procedures and instruments, and section 3.5 presents the data analysis, reporting and ethical issues.

3.2 Research Design

The study adopted a descriptive survey design, which ensured ease in understanding the insight and ideas about the problem. According to Creswell (2003), descriptive survey designs are used in preliminary and exploratory studies, to allow researchers to gather information, summarize, present data, and interpret it for the purpose of clarification.

Also according to Kothari (2004), descriptive survey design involves large numbers of persons, and describes population characteristics by the selection of unbiased sample. It involves using secondary data, and generalizing the results of the sample to the population from which it is drawn. Descriptive survey design is flexible enough to provide opportunity for considering different aspects of a problem under study (Kothari, 2004).

This design was further appropriate for this study since Neumann (2000) note that descriptive survey research is intended to produce statistical information about the aspects of the research issue (in this case international trade in Kenya) that may interest relevant stake holders. Exploration serves other purposes as well.

The purpose of the study was to address two objectives. First, identify and prioritize the trade finance services offered by banks that are crucial or preferred by exporters and importers in Kenya and secondly to examine whether trade finance vary with types of export business or sector.

3.3 Population and Sampling

According to Mugenda and Mugenda (2003) a population is defined as a complete set of individuals, cases or objects with common observable characteristics. The study population

comprised of 234 respondents from Export Processing Zone and all the banks registered as per the banking act. The list of banks was obtained from the CBK website. (Appendix I).

In the study respondents were selected being 45% of the population. According to Kothari (2000) one requires a minimum of 30 % for a small population. According to Mugenda and Mugenda (2003) target population is the population to which a researcher wants to generalize results of a study.

Sampling was done in the banks. The sample was obtained from the CBK list as at December 2011 of 43 commercial banks. This directory was used as the sampling frame because it gave a comprehensive list after the banking crisis of 1997. Ten commercial banks that offered more than 50% of trade finance were identified. This convenience sample was considered by the banking sector as appropriate since it constitutes the major providers of trade credit finance towards promoting Kenya's international trade. Banks that offer less than 50% of trade finance services were sampled from the remaining thirty-three at every fourth interval.

Table 3.1 Target Population and Sampling Frame

Category	Target population	Sample size
Commercial Banks	43	13

The study adopted stratified and simple random sampling. The study sampled 30% of the target population as Neuman (2000) recognizes this as an adequate sample in a descriptive survey study.

3.4. Data and Data Collection

Data collection is a term used to describe a process of preparing and collecting data, for example, as part of a process improvement or similar project. The purpose of data collection is to obtain information to keep on record, to make decisions about important issues, or to pass information on to others.

Secondary data was collected to provide information regarding trade finance and international trade. This data was obtained from selected commercial banks.

Data Collection Instruments

This study utilized secondary data. The researcher utilized both published and unpublished sources but relied heavily on the published sources.

Desk Review

Document reviews (official reports, scientific publications, and 'grey literature'). It is useful to start the assessment or monitoring process with an initial document review, relying on published or non-published documents. Documents that may be particularly helpful, if available, include: analytical reports based on relevant national surveys, censuses or data inventories, reports generated through research studies, programme evaluation and policy analysis reports, legal and regulatory documentation, documents that provide information as relevant to international trade. The desk review was suitable for this study as the researcher reviewed the export reports to compile data on impact of trade finance on international trade.

3.5 Data Analysis

Data was analyzed to test the relationship between trade finance and Import/Export (I/E). Descriptive statistics was used to summarize the data. This was based on the data collected and comparisons of percentages, simple tabulation, frequencies, mean, standard deviations and graphs. Descriptive statistics was done through the computer using the Statistical Package for Social sciences (SPSS). Apart from descriptive statistics the variables were regressed using multiple regression models and inferential statistics will involve use of correlation.

Spearman Rank Correlation Coefficient method of analysis was used to prioritise and test whether trade finance by ranks vary with exporters in Kenya. The scales were then refined for the various constructs using factor analysis in order to obtain a detailed perceptual, attitudinal and behavioural. Qualitative data was analysed through thematic analysis. The quantitative data obtained was analyzed by use of descriptive statistics (frequencies and statistics) and inferential statistics. Descriptive statistics in form of frequencies, means and standard deviations were utilized to analyze data from observation schedules. Data was presented in form of tables and figures.

3.5.1 Conceptual Model

$$\text{Intr} = F(\text{TC}, \text{LC}, \text{IG}, \text{B/E}) \dots \dots \dots (i)$$

The dependent variable is International trade; independent variable is trade finance. The study sought to find out to what extent trade finance (its parameters singly and jointly) affects international trade in Kenya. In this case, trade finance is represented by 2 parameters: trade credit, types of payment contract.

Analytical Model

Multiple regression model was used to assess the collective effect of the independent variables. According to Lavrakas, (2008) advantages associated with multiple regression analysis are that this process offers a more accurate explanation of the dependent variable in more variables are included in the analysis, and that the effect of a particular independent variable is made more certain, since the possibility of distorting influences from other independent variables is removed.

$$Y_1 = \beta_0 + \beta_1 TC + \beta_2 LC + \beta_3 IG + \beta_4 B/E + e \dots\dots\dots ii)$$

Where

Y_1 = Exports

Y_2 = Imports

TC = Trade Credit

LCC = Letter of Credit

IG = Import Guarantee

B/E = Bill of Exchange

Above variables are all measured in Kenya shillings (KES).

The study appreciates that there are other factors that may be influencing international trade in Kenya apart from the variables being investigated. The error term (e) represents "noise" or interference.

The importance of trade credit is particularly marked among small and medium firms, which are normally thought of as the breeding ground for entrepreneurs and constitute an essential component of a healthy economic structure (Staley and Morse (1965). There are many financial products to facilitate international trade such as remittance process which will facilitate payment between countries. Bill of Exchange (B/E) and Letter of Credit (LC) are used as guarantees of payments.

The study adopted Pearson correlation to find out the strength of relationship between the independent variables as well as international trade in Kenya. The coefficient of correlation determine the degree (strength) of relationship and its value is between -1 and 1.

value 0 implies no relationship, 1 implies a perfect positive relationship, -1 means a negative relationship. An absolute value of r between 0.5 and less than 1 implies a strong relationship between the variables. If the value r is greater than 0.3 and less than 0.5 then the relationship is moderate. The relationship is weak if the value of r is less than 0.3.

The Student's t-Distribution was used to estimate parameters such as mean value and the population variance since the data observed had additive errors (e). The t-Distribution accounts for the extra uncertainty that results from this estimation. Further, multiple regression analysis was used to determine whether the group of factors proposed together predicted international trade in Kenya. The analysis was carried out using Statistical Package for Social Sciences (SPSS) computer software version 19.

Data Validity and Reliability

Validity establishes the relationship between the data and the variable or construct of interest. It estimates how accurately the data obtained in a study represents a given variable or construct in the study (Mugenda, 2008). The researcher used secondary data from Kenya Association of Manufacturers annual economic reviews.

According to Devellis (1991), as cited by Mugenda, (2008) reliability is the proportion of variance attributable to the time measurement of a variable and estimates the consistency of each measurement over time from a research instrument. It is a measure of the degree to which a research instrument would yield the same results or data after repeated trials

CHAPTER FOUR

DATA ANALYSIS AND PRESENTATION OF FINDINGS

Introduction

This chapter describes how data collected for this study was analysed. Section 4.2 presents univariate data analysis which describes the variables in the data set. Section 4.3 describes the coefficient of determination or model of fitness i.e. the r-square which shows residual variability of the values around the regression line relative to the overall variability.

Section 4.4 discusses the Regression analysis results to test the relationship between the variables. Section 4.5 enumerates the results of factor analysis on the impact of trade finance on international trade. Section 4.6 summarises the findings. As noted earlier, the study uses basically secondary data.

Univariate Data Analysis

Descriptive Statistics

Descriptive statistics of the dependent and independent variables was determined in order to describe the variables in the data set. It showed the range of values as well as central tendency of the values. It enhanced the understanding of the basic features or characteristics of the data collected and enable the researcher to identify any outlier in the data set that may pose challenges in data analysis. Various descriptive statistics were worked out which included arithmetic means, standard deviation and minimum and maximum values for each of the variables using SPSS version 19. The major exports and imports and the main characteristics of Kenya's international trade is also presented in this section.

Descriptive Statistics on Impact of Trade Finance on International Trade

From table 4.1 it can be observed that the study sampled 13 commercial banks in Kenya for the 13 observations. The study revealed that trade credit had a mean score of 0.05341 with a standard deviation of 0.2219 and a minimum and maximum value of 0.0163 and 0.0844 respectively. The study further indicated that letter of credit had a mean score of 0.4812 and a standard deviation of 0.1908 with a minimum and maximum of 0.4812 and 0.6720 respectively. Import guarantees had a mean score of 1.3885 and a standard deviation of 0.0708 with minimum and maximum value of 0.0708 and 1.8551 while bill of exchange had a mean score of 0.4779 and a standard deviation of 0.1965 with minimum and maximum

Descriptive Summary Statistics

	Observations	Mean	Standard Deviation	Min	Max
credit	13	0.5341	0.2219	0.0163	0.9784
credit	13	0.4294	0.1908	0.4812	0.6750
guarantees	13	1.3885	0.6672	0.0708	1.8551
change	13	0.4779	0.1965	0.0974	0.3947

Characteristics of Kenya's International Trade

As shown in Table 4.2, it can be observed that the main exports commodities are tea products, coffee, horticultural products, fish and cement. The export partners are Uganda (15.9%), UK (10.3%), Netherlands (7.9%), Tanzania (7.7%) and Pakistan (4.9%). It can further be observed that the main import commodities are Machinery and transportation equipment, motor vehicles, iron and steel, resins and plastics while the import partners include UAE (11.8%), China (8.3%), India (8.8%), US (7%), South Africa (6.4%), Japan (4.7%) and Kenya (4.7%).

COMESA is the leading market destination for Kenyan exports, accounting for 36.6% of the total value of exports in 2011. The EAC is the destination of more than half of the total exports to the African region. Kenya's exports to the COMESA and EAC region mainly consist of manufactured goods, which include consumables, steel products and pharmaceuticals. Kenyan trade with the European Union (EU) on the other hand gives a contrasting picture. The value of exports to the European Union, expanded by 9.3% in 2011 from 8.8% in 2010. However, the share of exports destined for the EU market declined from 26.4% in 2010 to 25.4% in 2011. Trade activities with neighboring African countries involve substantial cross-border operations which are still settled in cash. This is very true of smaller businesses. This can be compared to the more traditional trade which is effected via the financial sector for deals with European buyers/suppliers and the rest of the world. This contrasting scenario has a definite impact on the trade finance patterns.

Main Characteristics of Kenya's International Trade

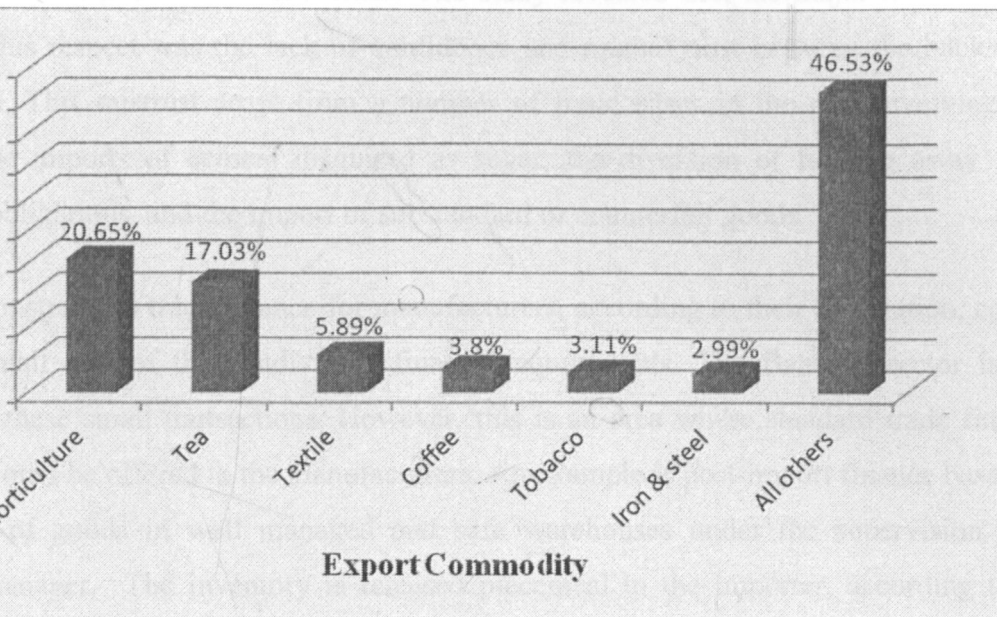
Commodities	Exports - partners	Imports - commodities	Imports - partners
Products,	Uganda (15.9%)	Machinery and	UAE (11.8%)
	UK (10.3%)	transportation	India (8.8%)
in products,	US (8.2%)	equipment,	China (8.3%)
	Netherlands	petroleum	Saudi Arabia
	(7.9%)	products,	(8.3%)
	Tanzania (7.7%)	motor vehicles,	US (7%)
	Pakistan (4.9%)	iron and steel,	South Africa
		resins and	(6.4%)
		plastics	UK (5.3%)
			Japan (4.7%)

IA, The World Fact book

Kenya's Imports and Exports

The agricultural sector, notably horticulture, tea and coffee, are Kenya's largest exports. The country has long and very specific trade patterns, with their respective trade flows and financing is of paramount importance. From the findings, the major export was horticulture followed by tea products (17.03%) and textile (5.89%). To a lesser extent, textile and clothing exports were also significant export items; however, their share has decreased since the lapse of the Multi Fibre Agreement in 2005. The proportions of the different export items for the year 2011 are shown in figure 4.1. Kenya is a large exporter/re-exporter to the region, mainly to EAC and COMESA. It is estimated that about half of these regional exports are manufactured locally, with the other half consisting of re-exports. Main import commodities are Machinery and transportation equipment, petroleum products, motor vehicles, iron and steel, resins and plastics.

Major Export Products



Export Promotion Council 2012

Specific Trade Flows of the Various Sectors and the Provision of Trade

the horticulture sector is the largest sector in terms of export value. Exports are mostly to Europe; more specifically, 65% go to Holland, 23% to the UK, 7% to Germany and France. It was evident that it does not appear that banks are actively trying to assist growers or the consolidators based on structured finance. This could include the use of the Euro (the main currency of exports) against a pledge of the export contracts, which is then notified to the buyers and assigns all insurance. (This is another case where the provision of an export commercial insurance would be a significant improvement. While the exporters are exporting directly, the consolidators or traders collect the production from the growers for export). Should there be no contract, as is the case with the auction system, the bank factors should provide necessary comfort to the bank. These include reliance on the bank to assume the volumes of trade, the exporter's commitment to channel all its trade through the same auction house, and the irrevocable assignment of all payments.

Exporters and Commodity traders are not represented by a sectoral association, but their numbers are growing fast. In 2010 imports grew 30% in value, compared to 13% growth for exports. Traders could make greater use of trade finance operations and structured deals, but they generally have a small net worth compared to the operations they handle. They do not have access to the most sophisticated products such as transferable LCs, back to back

s or possibly red clause LCs, and pre- and post-shipment funding based on security underlying goods or commodities. The study revealed that the major drawback for in this respect was the lack of confidence and mutual trust between the banks and nts. This mistrust arose from a number of fraud cases in the past involving, for the imports of cement disguised as sugar, the diversion of funding away from d obligations, and the import of substandard or counterfeit goods.

constraint to trade finance for manufacturers, according to their association, comes small size of their individual finance requirements. The Banking sector is not to these small transactions. However, this is an area where standard trade finance s could be offered to the manufacturers. An example is post-import finance based on ol of goods in well managed and safe warehouses under the supervision of a manager. The inventory is released piecemeal to the importer, according to its ter payment. The warrants are in the name of the bank (impact on their balance of the importer, and are pledged to the bank. In the context of fast growing regional the banks face certain challenges in providing competitive export finance to the urers. These challenges include: the small amount of individual trade; the ce of the cash cross-border trade in such goods; the development of mobile phone sfers, which will probably become international soon; and the absence of readily commercial export insurance. Table 4.3 shows trade finance in horticulture, uring sector and merchandise traders by selected banks in 2011.

Table 4.3: Provision of Trade Finance in Horticulture, Manufacturing Sector and to Merchandise Traders (Million shillings)

	Horticulture	Manufacturing sector	Merchandise traders
Central Bank of	4,554	2,865	902
Baroda	1,745	604	409
Commercial	2,869	107	675
Bank	4,449	2106	976
State bank of	809	1032	308

3.1 Model of Fitness

R-square, also known as the Coefficient of determination is a commonly used statistic to evaluate model fit. R-square is 1 minus the ratio of residual variability. When the variability of the residual values around the regression line relative to the overall variability is small, the predictions from the regression equation are good. R square as measure of association varies from 0 to 1 with zero indicating no relationship, 1 indicating a perfect relationship and also gives an estimate of how much change in the dependent variable are explained by the independent variables.

Table 4.4: Regression Model Summary Results of the Effect of Trade Credit, Letter of Credit, Import Guarantee and Bill of Exchange on International Trade

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
	0.887401	0.787481	0.754786	0.8143

Predictors: (constant), Trade credit, letter of credit, import guarantee and bill of exchange

From the results shown in table 4.4, the model shows a goodness of fit as indicated by the coefficient of determination (R^2) with a value of 0.7875. This implies that the independent variables trade credit, letter of credit, import guarantee and bill of exchange explain 78 percent of the variations of international trade.

3.2 Correlation Analysis

Correlation is a technique for investigating the relationship between two quantitative, continuous variables. Pearson's correlation coefficient (r) is a measure of the strength of the association between the two variables. The value of r can range from -1 to +1 and is independent of the units of measurement. A value of r near 0 indicates little correlation between attributes; a value near +1 or -1 indicates a high level of correlation. When two attributes have a positive correlation coefficient, an increase in the value of one attribute indicates a likely increase in the value of the second attribute. A correlation coefficient of less than 0 indicates a negative correlation. That is, when one attribute shows an increase in value, the other attribute tends to show a decrease. In order to examine the possible degree of multicollinearity among the repressors, correlation matrixes of the variables are presented in table

5: Correlation Matrix of the Impact of Trade Finance on International Trade

	Trade credit	Letter of Credit	Import Guarantee	Bill of Exchange	International trade
Credit	1				
Letter of Credit	.753	1			
Import Guarantee	.654	.453	1		
Bill of Exchange	.546	.642	.750	1	
International trade	.953	.752	.618	.865	1

Correlation matrix indicates that letter of credit was highly correlated with trade credit. Import guarantee was also highly correlated to trade credit (.654) but moderately correlated to letter of credit (.453). The bill of exchange was moderately correlated with the trade credit (.546) and highly correlated with letter of credit and import guarantee with a correlation coefficient of .642 and .750 respectively. International trade was highly correlated with trade credit (.953), letter of credit (.752) and bill of exchange (.865) but moderately correlated to import guarantee (.618). The correlation matrix reaffirms the findings in the regression analysis that trade credit, bill of exchange and letter of credit are critical in international trade.

Findings of the study concur with Martin (2001) who argued that internationally active firms rely intensively on trade credits even though they are considered particularly expensive. Martin further argued that trade credits can alleviate financial constraints arising from asymmetric information because they serve as a quality signal and reduce the uncertainty associated with international transactions. A study by Giles and Williams (2000) indicated that contract enforcement introduces a limited-enforcement problem, as the importer can delay payment after receipt of the shipment, which repeated interaction alleviates. For firms too infrequently engaged in international trade to establish a credible reputation, a firm can increase credibility by guaranteeing multiple importers, but only if exporters can credibly punish the bank should it renege on one of them. Mutually confirmed bank guarantees overcome the need for collective punishment and further increase credibility as repeated claims between banks reduce the net amount to be renegeed on.

Analysis of Variance

Analysis of variance is a procedure that tests to determine whether differences exist between two or more population means specifically ANOVA compares two or more populations of interval data. In order to find out whether the mean differences are statistically significant Analysis of Variance (ANOVA) was done. The findings are shown in Table 4.6. The F value of 26.323 indicates that the overall regression model is significant and it has some explanatory value. This indicates that there is a significant relationship between the independent variables and the dependent variables.

Table 4.6: Analysis of Variance (ANOVA) Results

	Sum of Squares	Df	Mean Square	F	Significance
Regression	78.75987	4	19.95657	26.323	0.000
Residual	4.364139	26	6.321698		
Total	83.124009	30			

4 Test of Multicollinearity

Multicollinearity test among the exploratory variables was undertaken in order to eliminate any collinearity between two or more variables which may cause error in the result of the regression model.

Table 4.7 Test of Multicollinearity

Variable	Tolerance	VIF
Trade credit	0.950	1.052
Letter of credit	0.737	1.357
Import guarantee	0.802	1.247
Bill of exchange	0.632	1.582

Multicollinearity occurs when two or more independent variables strongly influence each other, as a rule of thumb correlation coefficient of 0.8 is an evidence of severe multicollinearity problem. The presence of multicollinearity, makes the estimation and hypothesis testing about an individual coefficients regression not possible because it makes the regression coefficients undefined or unstable and the standard

ors for the coefficients wildly inflated, making these coefficients significantly not different
n zero.

e Variance Inflation Factor (VIF) and Tolerance level are commonly used for assessing
lticollinearity problems. The VIF shows the degree to which each independent variable is
ained by other independent variables. As a rule of thumb, a VIF greater than 10 and
erance level greater than 1 indicates presence of harmful collinearity (Gujarati, 2003).
erall, it can be concluded that looking at the magnitude of the correlation coefficients and
nsidering the VIF and Tolerance results on table 4.7, multicollinearity is not a potential
blem in the regression models for this study and the dataset together with the variables are
ropriate for this type of study.

Discussion of Regression Analysis Results

ltivariate data analysis was carried out using a panel multiple linear regression model to
the effects of the relationship between the dependent variable (International trade) and
four explanatory variables (trade credit, letter of credit, import guarantee and bill of
hange). The analysis was done using SPSS computer software version 19.

gression analysis was utilized to investigate the relationship between the variables. These
luded an error term, whereby a dependent variable was expressed as a combination of
ependent variables. The unknown parameters in the model were estimated, using observed
ues of the dependent and independent variables (Stoodley, Lewis and Stainton, 1980).

e following model represents the regression equation representing the relationship between
ernational trade and as a linear function of the independent variables (trade credit, letter of
dit, import guarantee and bill of exchange), with ϵ representing the error term.

$$= \beta_0 + \beta_1 TC + \beta_2 LC + \beta_3 IG + \beta_4 B/E + e \dots\dots\dots i)$$

(Regression equation)

) Where

Y_1 = Exports

Y_2 = Imports

TC= Trade Credit

LCC= Letter of Credit

B/E= Bill of Exchange

The above variables are all measured in Kenya shillings (KES).

Incorporating the Beta values into equation 1 we have:

$$Y_0 + 0.972 TC + 0.643LC + 0.862IG + 0.719B/E + e \dots \dots \dots (ii)$$

(Regression equation with beta values)

The beta values in the above equation represent the estimated parameters as indicated above. Advantages associated with multiple regression analysis are that this process offers a more complete explanation of the dependent variable in that more variables are included in the analysis, and that the "effect of a particular independent variable is made more certain, for the possibility of distorting influences from other independent variables is removed". From Table 1, the variable 'trade credit' has the most statistically significant coefficient as indicated by a t-ratio of 2.436. This implies that a one unit change in trade credit will change the international trade by 2.436 units. There is also a positive relationship between international trade and import guarantee with a statistically significant coefficient as indicated by a t-ratio of 2.322. A one unit change in import guarantee will change international trade by 2.322 units. Letter of credit is also statistically significant as indicated by a t ratio of 2.089. Bill of exchange is also statistically significant as indicated by a t ratio of 2.275. This implies that all our factors, trade credit, letter of credit, import guarantee and bill of exchange have great effect on international trade.

Regression Results of the Relationship between Trade Credit, Letter of Port Guarantee and Bill of Exchange and International Trade

	Unstandardized Coefficients		Standardized Coefficients	T- values	T- critical	P Values	Signifi- cance
	Beta	Std. Error	Beta				
	5.492	6.20		0.912	2.681	0.05	0.37
t	1.32	1.233	0.365	2.436	2.681	0.055	0.286
edit	1.86	1.435	0.96	2.089	2.681	0.106	0.03
rantee	1.82	1.336	0.97	2.322	2.681	0.134	0.024
ange	1.5	1.27	0.787	2.275	2.681	0.325	0.031

cal Value 2.681 (statistically significant if the t-value is less than 2.681: from table

).

of Factor Analysis on Impact of Trade Finance on International Trade

ly factor analysis is used to confirm the validity and reliability of the study
 rammer (2003:13) describe factor analysis as a set of techniques for determining
 o which variables that are related can be grouped together so that they can be
 combined variable (factor) rather than a series of separate variables. Foster
 explains that the relationship between the original variable and the factors is
 n terms of a correlation (or loading) with large sizes of such correlations
 a strong association between the variable and that factor. He further indicates that
 ling of 0.03 or more is frequently taken as meaningful when interpreting a factor.
 herefore adopts this as a yardstick of what to include as factor variables. Bryman
 (2004:29) considers that the square for each entry is a measure of variance
 s the Eigen value for the factor and any factor should be considered if the value
). Bryman and Cramer (2004) suggestion that factor rotation is done to improve
 of the variables to fit the model into a data set such that the standard deviations
 reduced to as minimal as possible is considered and adopted in this study. This
 nces and depicts the common process shared by like items in the study. Table
 e results of factor analysis.

Table 4.9 Factor Analysis on Impact of Trade Finance on International Trade

Factors	Factor Loading	Eigen value	% of Variance	Cumulative %
Trade credit	0.80	3.04	32.77	32.77
Financial market conditions	0.73	2.94	27.54	60.31
Payment contract	0.84	1.93	16.72	77.03

Kaiser-Meyer-Olkin (KMO), Measure of Sampling Adequacy = 0.77, Bartlett's Test of Sphericity: Approx. Chi-Square = 2649.12; df = 2.10; Sig. = 0.05.

Factor analysis on impact of trade Finance on international trade presented in table 1, KMO measures of sampling adequacy = 0.87 explained by 77.03% of the variance loaded with 3 factors labelled as trade credit, financial market conditions and payment contract. Eigen value is included as a factor when loading is done on variables and the resulting is greater or equal to one. The Eigen values which represents the amount of variance explained by each factor and determines the factor loading as noted for Factor 1 to be 3.04, Factor 2 to be 2.94 and Factor 3 to be 1.93. With respect to the three factors, only factors with Eigen value loading greater than 1.0 were extracted.

Summary of Findings

From the findings, the main exports commodities are tea products, coffee, petroleum products, fish and cement. The export partners are Uganda (15.9%), UK (10.3%), US (8.2%), Netherlands (7.9%), Tanzania (7.7%) and Pakistan (4.9%). It can further be observed that the main import commodities are Machinery and transportation equipment, petroleum products, motor vehicles, iron and steel, resins and plastics while the import partners includes UAE (8.8%), China (8.3%), India (8.8%), US (7%), South Africa (6.4%), UK (5.3%) and Japan (7%). The horticulture sector is the largest sector in terms of export value. Exports are mostly directed to Europe; more specifically, 65% go to Holland, 23% to the UK, 7% to Germany and 5% to France.

The correlation matrix indicates that letter of credit was highly correlated with trade credit (0.53). Import guarantee was also highly correlated to trade credit (.654) but moderately correlated to letter of credit (.453). The bill of exchange was moderately correlated with the trade credit (.546) and highly correlated with letter of credit and import guarantee with a

correlation coefficient of .642 and .750 respectively. International trade was highly correlated with trade credit (.953), letter of credit (.752) and bill of exchange (.865) but moderately correlated to import guarantee (.618). The correlation matrix reaffirms the findings in the descriptive analysis that trade credit, bill of exchange and letter of credit are critical in international trade.

The regression model of fitness shows a goodness of fit as indicated by the coefficient of determination with a value of 0.7875. This implies that the independent variables trade credit, letter of credit, import guarantee and bill of exchange explain 78 percent of the variations of international trade. From regression analysis, the four factors, trade credit, letter of credit, import guarantee and bill of exchange have great impact on international trade.

Summary of the Study

The study sought to investigate the impact of trade finance on international trade. It was carried out to investigate the impacts of trade credit, letter of credit, import guarantee and bill of exchange on international trade. Specifically, the study sought to achieve the following objectives: First, the study sought to identify and provide the trade finance services offered by banks that are critical in international trade. Second was to identify the role of trade credit, letter of credit, import guarantee and bill of exchange in international trade. The study also sought to identify the factors that influence international trade.

The study employed a descriptive survey design. The study was carried out in Kenya. To examine the relationship between trade credit, letter of credit, import guarantee and bill of exchange and international trade, the study used secondary data which were gathered from published and unpublished sources. The study heavily relied on the primary data collected from the study. The study used the following statistical methods: univariate, bivariate and multivariate analysis. The study was carried out using SPSS version 19. The study was carried out in Kenya. The study was carried out in Kenya. The study was carried out in Kenya.

CHAPTER FIVE

SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

Introduction

There is a positive correlation between the dependent and independent variables. Section 5.2 summarises the study. Section 5.3 makes conclusions based on the findings. Section 5.4 gives recommendations for further research. The recommendations of the study and areas for further research are also presented. This section presents the findings from the study in comparison to what other scholars have said as noted under literature review.

Summary of the Study

Generally, the study sought to investigate the impact of trade finance on international trade. The study was carried out to investigate the impacts of trade of trade finance on international trade. Specifically the study sought to achieve the following objectives. First, the study sought to identify and prioritise the trade finance services offered by banks that are crucial to exporters and importers in Kenya. Second was to establish the role of trade credit and its impact on international trade which determines the relationship between financial market conditions and international trade and also shows the role of payment contract on international trade.

The study adopted a descriptive survey design, which ensured ease in understanding the problem and ideas about the problem. To examine the relationships between trade integration and financial integration bilateral data was used and the gravity model was the selected method. This study utilized secondary data where the researcher utilized both published and unpublished sources but relied heavily on the published sources. Review of empirical studies revealed a mixed relationship between trade finance and international trade in both developed and developing markets. Univariate, bivariate and multivariate data analysis was performed using data analysis software (SPSS version 19). The result of the Generalised Least Square random effect estimation regression model revealed the following;

Table 5.1 Summary of Empirical Findings

	Coefficient (β)	Std. Error
Trade Credit	0.365	1.233
Factor of Credit	0.96	1.435
Export Guarantee	0.97	1.336
Rate of Exchange	0.787	1.27

The findings of the study revealed a number of short term financing instruments that can be employed by the importer. These include: Import finance loans which is a facility that allows importer to access finance to pay for imports and use the proceeds from the sale of the imported products to pay the loan. The cost of this facility is the market rate of interest plus the miscellaneous upfront charges. Another short term trade financing instrument that is utilized by banks in the case of importers included Bankers' acceptances which is a negotiable short-term money market instrument created by a bank to provide credit for financing a specific import transaction. The bank accepts a time draft drawn on itself, substituting its own credit for the credit of the buyer. The title to the draft is endorsed to the bank to finance its customers by sourcing funds through the money market.

The short term trade finance services available for exporters include, pre-shipment finance (pre-export finance) which is a facility extended to exporters for export-related production. The amount of credit obtained is usually limited to a percentage of the agreed sales price and payment is structured to ensure self-liquidation through export proceeds, i.e. the lender is repaid when the buyer pays. The cost of the facility is the market rate of interest plus miscellaneous processing charges. Another facility that is available to the exporters includes factoring which is a method that involves the sale of receivables e.g. billing of exchange or promissory note, by an exporter to his bank for discounting. The exporter receives the value of the receivables less the standing charges and interest charge for the period remaining to the maturity of the bill of exchange. The other post-shipment finance covers a wide range of financing methods that can be used once the goods have been shipped. If the reputation and creditworthiness of the buyer is good, the bank can discount the receivable. Other trade finance services offered by commercial banks in Kenya include buyer's credit which is a facility granted by a lender to a buyer at the request of the buyer or the seller. It is used in

structured project financing packages, normally for large export orders of machinery equipment. Other facilities include escrow and export credit.

Study findings indicated that trade credit had a positive influence on international trade as indicated by statistically significant correlation coefficients. Based on the findings of the study, trade finance conditions is one of the factors that affect international trade. Indeed, studies have shown that up to 90% of all trade transactions are supported by some form of trade finance (Ronci, 2004). From the study, it was revealed that the main part of trade finance takes the form of trade credits, which are considered a particularly expensive form of financing: implicit annual trade credit interest rates can amount to up to 40%. Based on the findings it was observed that trade credits are extended bilaterally between firms and exist in form of supplier credits and cash in advance. In contrast, a supplier credit (SC) is granted from the seller of a good to the buyer such that the payment of the purchasing price can be delayed for a certain period of time.

Payment contract was found to have a positive significant relationship with the international trade. The study revealed that international contract enforcement was weak and bank guarantees provided a way of ensuring trade, especially when local courts are unable or unwilling to enforce payment from importers. With imperfect contract enforcement, the importer can refuse payment, but the resulting loss of future cooperation serves as an incentive for honest behavior. Such importers credibility of payment can be established through the introduction of a bank that sequentially guarantees payment to exporters on behalf of multiple importers if exporters can collectively punish deviations against any one of them. Yilmaz Akyuz, (2003) observed that there is widespread evidence that firms rely on international contracts in order to ensure cooperation from their partners.

A positive and statistically significant relationship exists between financial market conditions and international trade. The study findings indicated that the financial market conditions may have far-reaching repercussions on cross-border economic activity. Two aspects of the financial market conditions may affect the international trade. On the producer side, the credit crunch at the height of the market imperfection may result in a severe reduction in the availability of external finance, thus curtailing firms' production and export capacities. On the consumer side, the gloomy economic outlook may lead to a slowdown in global demand in general, and for imports in particular. From the study it was revealed that in unstable

financial market, the banks will be hesitant to provide trade finance facilities. This is because financial outflows reduce liquidity in the domestic banking system, international banks operating in the domestic market reduce credit in order to cut the exposure of parent banks and shortages of foreign currency prevent banks lending the foreign exchange needed for import of inputs or export of goods. High transport charges.

Conclusions

From the findings, the study concluded that financial constraints matter in international trade. The analysis of findings has shown that firms are substantially influenced by financial constraints when deciding on exporting and importing activities. Thus, in theoretic or empiric work, it is advisable to take into account the effects of financial constraints on firms' behavior in international trade. It was also concluded that not all banks in Kenya have the capacity to offer trade finance facilities to exporters and importers. Their ability to offer 'real' trade finance credit, i.e. without extra collateral, depends on their credit with correspondent/confirming banks. The study further concludes that trade credits can help to alleviate financial constraints experienced by firms in international trade despite higher transaction costs. If external funds are not sufficiently available, firms can still overcome financial frictions if other firms redistribute their funds in form of trade credits. Moreover, trade credits can serve as credible signals of quality and reduce part of the high uncertainty in international trade.

Based on the findings of the study it was concluded that payment contract is an important aspect of international trade. Further guaranteeing banks and large intermediaries can be seen as mechanisms for establishing reputation for firms unable to do so themselves. The study also concluded that firms participating in international trade can overcome limited enforcement issues if they are a part of networks or interact sufficiently often. Empirical results suggest that a bank more frequently interacting can improve matters if it can extract sufficient profits and exporters can collectively punish it by withdrawing business if it reneges on one of them and that a conforming bank of the exporters is shown to overcome the assumption of collective punishment and further mutually confirmed guarantees further produces "netting" when banks have mutual outstanding. The analysis suggests a concentrated industry in which banks interact repeatedly with the same parties internationally in line with observed patterns.

Results from empirical review suggests that financial market conditions adversely affect international trade, and that the use of trade credit play an important role in the relative performance of importing and exporting firms. In particular, when financing conditions deteriorate, the more financially-vulnerable firms turned to trade credit from suppliers as a supplement to standard forms of financing. In addition, firms that are able to replace external finance with trade credit have better sales performance. In contrast to domestically-oriented firms, export-intensive firms with comparable financial vulnerability rely less on trade credit as an alternative source of finance, and experience sharper declines in sales. These results provide an explanation for the disproportionate decline in global trade during the recent crisis.

4 Limitations of the Study

Since the study was limited to commercial banks that offered more than 50% of trade finance, and covers only a sample of 13 commercial banks, the question would be whether the findings can be generalized. Such generalizations requires further in depth studies with larger samples.

Again empirical studies have shown that a number of factors related affect international trade. However this study sought to investigate the trade finance and international trade. Trade finance was represented by trade credit, letter of credit, imports guarantee and payment contracts while country specific factors, such as macroeconomic indicators, level of development of capital market, development of the banking sector, level of economic development and a host of other factors which may influence international trade were not considered.

Another area of limitation for this study is the source of data collection, both primary and secondary sources of data could have been useful for the study, but for the lack of resources and impossibility of reaching all the targeted respondents, the researcher relied on secondary sources of data for this study, because of convenience, accuracy and easy access of information.

5 Recommendations for Further Research

Based on the findings, the study recommended that there is need to develop the banks' awareness of the intrinsically secure and self-liquidating nature of trade finance. The Central Bank of Kenya should obtain the co-operation of the banks to segment Non-Performing Loan recordings. They would thus be able to offer a more precise analysis of the difficulties faced by the banks according to the type of borrowers, the sectors, or – as far as this study is

cerned – the type of financing. Trade finance operations should appear less risky than other financing instruments such as a secured overdraft. The findings of the study have implications for the design of policy to cushion the effect of future financial crises. Policymakers and firms would be well-advised to facilitate the development of trade credit as an additional source of financing when financial and credit markets become impaired.

While the African Trade Insurance Agency has been in existence for a number of years, its capacity to issue commercial risk insurance appears limited by its available manpower. It is recommended that this organisation actively research the possibility of forming some sort of association with private insurance companies or Credit rating companies involved in the region. Together they could explore possible co-operation/sub-contracting arrangements which would expand its capacity hence promoting international trade.

In regards to payment contract the study recommend that the bankers association and the trade associations should facilitate payment security and the movement of goods, and promote official transactions. These will contribute to the development of formal sector. This will involve a review and analysis of the reasons behind the large cross-border operations in order to identify actions to encourage traders to use safer channels. The bankers association and the trade associations should show appreciation of the trade finance requirements and trends in the market. They will focus attention on the trade finance needs of international traders.

In relation to the effects of financial market conditions on international trade, the study recommended that the mechanism to sustain trade finance need to be well established. In the wake of the financial crisis governments, international financial institutions, regional development banks and parts of national banking systems stepped in to increase the supply of trade finance. There is ample evidence that the same bodies are taking action to improve the supply of trade finance and the current instability of financial market announcements from IFC, various international financial institutions, regional governments and regional development banks about finance for trade.

The study also recommended that trade finance needs to be targeted to be effective. The study identified variations in availability of trade finance. There are also sectoral variations and differences between firms that have differing relationships to their customers. As the crisis unfolds it may begin to affect more businesses. Broadly-targeted support to increase lending capacity in the banking system – in both importing and exporting countries –

not necessarily reach the firms that are in most need. Firms with established exporting records that have repeat transactions with a range of established customers are more likely to obtain what bank finance is available and more likely to give and receive trade credit than other firms.

The study further recommended that the Ministry of Finance and the Government Procurement office should revive the discussion paper prepared by the Kenya Institute for Economic Policy Research and Analysis (KIPPRA) on supporting international trade to Access the Public Procurement Market in Kenya. This is particularly important because the Government is a significant buyer of imported equipment which could be sourced by importers. From the findings, the study recommended that the Kenya Bankers Association conduct a comprehensive review of the growth of the banks' trade finance operations by economic sector and by export market. The goal would be to identify the trends and characteristics of these operations, thus helping the banks to meet the evolving requirements. The study should be undertaken to review and analyse the significant cash-based cross-border transactions so as to identify actions to encourage traders to avail more secure channels for such transactions.

The study should be undertaken to further understand the factors that determine the use or non-use of trade credit between firms and, in particular, whether there are impediments to the cross-border flow of trade credit that prevent export-oriented firms from using this form of financing to the same extent as their domestic-oriented counterparts.

Further studies using micro data of the choice of contracts can be undertaken to shed further light on the impacts of weak contract enforcement and reputations for international trade.

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Bank of Baroda (BOB) Ltd

Bank of India

Barclays Bank of Kenya Ltd

CFC Standard Bank

Chase Bank (K) Ltd

CITIBANK N.A. Kenya

Commercial Bank of Africa Ltd

Commercial Bank of Kenya Ltd

Commercial Bank of Kenya Ltd

Co-operative Bank Ltd

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44 Co-operative Bank Ltd

45 Gulf African Bank Ltd

46 Habib Bank Ltd

47 Habib Bank AG Zurich

48 ICM Bank Ltd

49 Imperial Bank Kenya Ltd

50 Jamii Bora Bank Ltd

51 Kenya Commercial Bank Ltd

52 K-Rep Bank Ltd

53 Middle East Bank Kenya Ltd

54 National Bank of Kenya Ltd

55 NIB Bank Ltd

56 Old Bank of Kenya Ltd

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DICES

DIX I

OF COMMERCIAL BANKS IN KENYA (AS AT DECEMBER, 2011)

ABC Bank (Kenya)	23.	Giro Commercial Bank Ltd
Bank of Africa Kenya Ltd	24.	Guardian Bank Ltd
Bank of Baroda (K) Ltd	25.	Gulf African Bank Ltd
Bank of India	26.	Habib Bank Ltd
Barclays Bank of Kenya Ltd	27.	Habib Bank AG Zurich
CFC Stanbic Bank	28.	I&M Bank Ltd
Chase Bank (K) Ltd	29.	Imperial Bank Kenya Ltd
Citibank N.A.Kenya	30.	Jamii Bora Bank Ltd
Commercial Bank of Africa Ltd	31.	Kenya Commercial Bank Ltd
Consolidated Bank of Kenya Ltd	32.	K-Rep Bank Ltd
Cooperative Bank of Kenya Ltd	33.	Middle East Bank Kenya Ltd
Credit Bank Ltd	34.	National Bank of Kenya Ltd
Development Bank of Kenya Ltd	35.	NIC Bank Ltd
Diamond Trust Bank Ltd	36.	Oriental Commercial Bank Ltd
Dubai Bank Kenya Ltd	37.	Paramount Universal Bank Ltd
Ecobank Ltd	38.	Prime Bank (Kenya) Ltd
Equatorial Commercial Bank Ltd	39.	Standard Chartered Kenya
Equity Bank Ltd	40.	Trans National Bank Kenya
Family Bank Ltd	41.	United Bank for Africa Ltd
Fidelity Commercial Bank Limited	42.	Victoria Commercial Bank
Finna Bank Ltd	43.	Housing Finance Ltd
First Community Bank Ltd		
Central Bank of Kenya Directory		