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The impact of trade openness on growth: The case of Kenya

Jacob W. Musila [a,*], Zelealem Yiheyis [b]

[a] *Faculty of Business, Athabasca University, Canada*
[b] *Department of Economics, Clark Atlanta University, USA*

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Abstract

This paper investigates the effects of trade openness on the level of investment and the rate of economic growth in Kenya using annual time series data. The aggregate trade openness and trade-policy induced openness are evaluated. Controlling for a number of factors, aggregate trade openness is found to have positively affected the level of investment and the rate of economic growth, although the effect on the latter is statistically insignificant. On the other hand, we find trade-policy induced openness to have negatively and significantly affected investment and the rate of economic growth. Granger Causality tests suggest that a change in trade openness influences the long-term rate of economic growth through the interaction with physical capital growth in the case of Kenya.
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1. Introduction

The nature of the relationship between trade openness and growth has long been a subject of controversy among economists. The controversy plays out at both the theoretical and empirical levels. In the standard neoclassical model of exogenous growth, changes in trade openness (or trade

* Corresponding author at: 1 University Drive, Athabasca, AB T9S 3A3, Canada. Tel.: +1 780 458 5600; fax: +1 780 675 6338.
E-mail address: jacobm@athabascau.ca (J.W. Musila).

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policy) can only affect the pattern of product specialization but not the long-term rate of economic growth. On the other hand, in the new growth theory, changes in trade policy can influence long-term rates of economic growth. But the nature of the impact of trade openness on long-term rate of growth when trading partners are structurally different in terms of innovation capabilities is ambiguous. Grossman and Helpman (1991) present a model where trade between a developed and less developed country (LDC) can, under certain conditions, improve long-term rate of growth in the LDC. Young (1991) and Stokey (1991) present models where trade between a developed country and LDC can reduce long-term growth rates in LDC. On the other hand, Spilimbergo (2000) presents a model where trade between advanced country and LDC can reduce long-term growth rate in the developed country.

Similarly, empirical evidence on the relationship between trade openness and long-term rate of growth is mixed. Some cross-country regression analyses find a positive relationship between trade openness and growth (Barro, 1991; Dollar, 1992; Dollar & Kraay, 2001, 2003; Edwards, 1998; Frankel & Romer, 1999; Sachs & Warner, 1995). Others find a negative relationship between trade openness and long-term rate of growth – i.e., a positive relationship between tariffs and long-term rate of growth (Clemens & Williamson, 2001; Irwin, 2002; O'Rourke, 2000). However, most of these early cross-country empirical studies suffer from a number of problems including weak theoretical foundations, poor quality data, inappropriate econometric techniques, and failure to adequately address the possibility of mutual causation (Baldwin, 2003; Rodriquez & Rodrik, 2001; Samman, 2005; Srinivasan & Bhagwati, 2001). According to Srinivasan and Bhagwati, in-depth studies of individual countries are the best approaches for understanding the relationship between trade openness and long-term rate of growth.

This paper estimates the effects trade openness, defined as the ratio of the sum of exports and imports to gross domestic product [$(X+M)$/GDP], and the rate of economic growth in Kenya using annual time series data. Unlike the early empirical studies that attempt to estimate the impact through a direct link between trade openness and the rate of economic growth, the present study investigates the influence of trade openness on economic growth via both the aggregate production function and the investment mechanism. Baldwin and Seghezza (1996a,b) present a theoretical model and cross-country evidence to support the view that investment is the main link between trade openness and economic growth. The present study, therefore, uses time-series data to investigate these links in the case of Kenya. To our knowledge, only Onjala (2002) attempted to investigate the relationship between trade openness and economic growth for Kenya using trade policy measures. However, the empirical evidence of Onjala's study is inconclusive in the sense that the estimates obtained are mixed in sign and statistically insignificant at the conventional levels. The results of the study have important policy implications, namely, whether the trade policy reforms pursued since the late 1980s have had the intended effects on trade openness and, in turn, on the level and rate of growth of economic activity.

The rest of the paper is organized as follows. The next section provides an overview of economic growth performance and major episodes in trade policy in Kenya. Section 3 outlines the theoretical framework on which the study is based. Section 4 presents the empirical models and discusses data issues. Section 5 presents the estimated results. The summary and conclusions of the study are presented in Section 6.

2. Economic growth, trade policy and trade openness in Kenya

The late 1960s and early 1970s were periods of remarkable economic growth and structural transformation in Kenya. The impressive growth performance was attributed mainly to

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