ABSTRACT

Since 1950, trade openness and aid has led to the expansion of world output by fivefold. Trade accounted for 20% of Gross domestic Product (GDP) in 2002 and according to the Vision 2030 blue print, trade is a promising sector to raise GDP to 10% per annum in Kenya. The share of aid to developing countries declined from 1.49 percent in the 1980s to 1.22 percent in the 1990s. The same pattern is observed for Africa, with Kenya’s share declining from 4.16 percent to 3.24 percent. Kenya undertook several trade reforms under the Structural Adjustment Programs that resulted in trade openness and a dramatic build-up in aid flows. Studies conducted in various countries indicate divergent views on the relationship between trade openness, foreign aid, external debt and economic growth. It is therefore not clear whether trade openness, foreign aid and external debt does or does not promote growth in the case of Kenya. The purpose of this study was therefore to analyze relationship between trade openness, foreign aid, external debt and economic growth in Kenya with specific objectives of determining relationship between trade openness and economic growth, establishing relationship between foreign aid and economic growth and examining relationship between external debt and economic growth. This study was modeled on Adam Smith’s absolute advantage theory. The study used correlation research design based on annual time series data spanning 30 years from 1980 – 2009. Data was obtained from the World Development Indicators. The study used Vector Error Correction Mechanism to integrate long run and short run dynamics and Granger causality for directional causality. The results indicated significant positive relationship having t-statistics > 2.056 and unidirectional causality between trade openness, foreign aid, external debt and economic growth in Kenya, with coefficients of 0.98, 0.36 and 0.39 implying that 1 % increase in trade openness, foreign aid and external debt increases economic growth by 0.98%, 0.36% and 0.39% respectively. Economic growth is significantly error correcting at 34.7% annually. The study concluded that in the long run trade openness, foreign aid and external debt promote growth in Kenya. In view of this, the study adds to literature by proving Adam Smith’s theory and recommends that the government of Kenya to continue pursuing trade openness policies and do proper appraisals for government financed projects through borrowings and foreign aid to increase trade volumes and ensure that resources are used prudently to enhance economic growth.