
International and Public Affairs

2019; 3(2): 43-51

<http://www.sciencepublishinggroup.com/j/ipa>

doi: 10.11648/j.ipa.20190302.12

ISSN: 2640-4184 (Print); ISSN: 2640-4192 (Online)



Common External Tariffs and Trade Efficiency: Lessons for Cross-listed Firms in the East African Community

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To cite this article:Abwao Geoffrey Magani. Common External Tariffs and Trade Efficiency: Lessons for Cross-listed Firms in the East African Community. *International and Public Affairs*. Vol. 3, No. 2, 2019, pp. 43-51. doi: 10.11648/j.ipa.20190302.12**Received:** July 1, 2019; **Accepted:** August 7, 2019; **Published:** September 4, 2019

Abstract: The East African Community's trading bloc has attracted a lot of investment from the member countries yet it has not lived to its expectations. Some of the region's members have fallen out in the past and even re-considered their membership in EAC. Among other areas of focus on the region's integration is the implementation of common external tariffs and protection of the region's members in regional and global market spheres. However, trade efficiency still lags behind in the region compared to global benchmarks. There exists flimsy evidence in literature on whether the implementation of common external tariffs revitalizes trade efficiency in the region. This paper, therefore, propounds the relationship between the implementation of common external tariffs and cross-border trade efficiency within the EAC considering experiences from other regional blocs and the implications for cross-listed Kenyan firms. The paper analyzes secondary data for Kenyan imports and exports from World Integrated Trade Solution (WITS) and the Observatory of Economic Complexity (OEC) as well as Economic review reports from the World Bank, the African Development Bank (AfDB) and EAC. The analysis covering the financial years: 1995 to 2017 shows a number of factors, other than tariffs, that drive trade and trade efficiency. The study also reveals non-tariff barriers, inward-looking trade policies, protectionist policies, redundant trading rules across border, increasing cost of trading among other shortcomings to regional trade that arise from implementation of common external tariffs. Statistical evidence also indicate that trade efficiency is independent of the implementation of common external tariffs. In addition, empirical evidence shows prolonged trade deficit not only in the developed countries, but in the developing world as well. The study concludes that tariffs are good for trade regulation to the detriment cross-border trading even beyond the regional bloc. However, besides macroeconomic correlates, factors other than common external tariffs influence regional and cross-border trade efficiency. This calls for comprehensive in-region trade policy review, revitalization and commitment by the member states even as individual trading entities pursue advanced competitiveness in the regional and global markets.

Keywords: Common External Tariffs, Cross-Listing, Cross-Border Trading Efficiency

1. Introduction

1.1. Background to the Study

Economies of the world have varying reasons for implementing regional integration agenda. Various continents and regions come together in pursuit of common economic, social and political development. Like in other continents, African countries have been keen on driving their development agenda through regional collaborations. There is adequate evidence in support of Africa's concerted efforts towards regional integration [25, 32]. To implement its regional development agenda, the East African Community

(EAC) member states have made efforts to deepen regional integration and in-region trade by establishing closer economic links through a Free Trade Area (FTA), a Customs Union (CU), a Common Market (CM), a Monetary Union (MU) and development of a Political Federation (PF).

The EAC was established in July, 2010 by partner states including Kenya, Tanzania, South Sudan, Uganda, Rwanda and Burundi in pursuit of intra-regional trade liberalization. The purpose of the said liberalization was to ease free movement of factors of production majorly to widen and deepen the levels of economic and social cooperation among the member states. The socio-political and economic integration initiatives are aimed at creating an enabling

trading environment for enterprises in the wider regional market. However, regional integration faces a number of economic, political and social dynamics which present opportunities and threats to enterprises from the member states of the trading block.

The EAC member states and other developing economies have registered poor performance over time due to inward-looking trade policies, protectionist policies, over-valuation of exchange rates, inflation and low growth of exports. Such constraints have inhibited the traders' abilities to meet the requirements of current and emerging foreign markets [25]. It is upon this realization that nations pursue market integration, trade liberalization and development of export oriented trade policies for mutual benefits to the member states. According to the study [32] the formation of East African Community's Common Market presents myriad opportunities for enhancing the competitiveness of enterprises from member states as well as their comparative advantage against the global competition. The degree of market integration is critical for diversification, financing decisions, risk management and peace-building among the member states. It also enhances interdependence, cooperation and regional bargaining power in the course of market expansion.

Regional integration efforts do not merely enhance competition, but competitiveness of the trading block as well as the member states' individual competitiveness in the global markets. Market integration efforts lead to the convergence towards a monopolistic competitive market structure [35]. The advances made towards the integration of EAC member states into a formidable trading block sought to address the social, political and economic deficiencies of the individual member countries. A number of legislations, treaties and binding cooperation agreements have been established to strengthen the region's trading block [10] However, extant literature point to various dynamics which include: significant tax pressures, administrative barriers, technical regulation, unstable political situations, heterogeneous monetary policy environments, fiscal variations as well as fiscal shocks – all which derail the entrepreneurial efforts and initiatives of the member countries [6, 14, 35, 17].

1.2. Statement of the Problem

The EAC was formed to improve the social, political and economic development of the member states and to protect the interests of the region. The purpose of the regional trading block is to establish a common market, a monetary union and customs union and a free trade area. The EAC economies thus came together to pursue East African market integration, trade liberalization and development of export oriented trade policies for mutual benefits to the member states. The member states have established common external tariffs to protect and enhance the region's competitiveness and performance in the market. However, despite the advancements made towards achieving the objectives of the EAC market integration, some of the member states have fallen out and others even pulled out of the trading bloc in the

past. Some of the reasons advanced for the scenario are: inward-looking trade policies, protectionist policies, over-valuation of exchange rates, inflation and low growth of exports [32, 6]. Such constraints have inhibited the traders' abilities to meet the requirements of current and emerging foreign markets [25]. Besides, there is flimsy evidence in literature on whether the implementation of common external tariffs revitalizes trade efficiency in the region. This paper, therefore, propounds the relationship between the implementation of common external tariffs and cross-border trade efficiency within the EAC considering experiences from other regional blocs.

1.3. Objective of the Study

1. To propound the relationship between East African Community's common external tariffs and cross-border trade efficiency for cross-listed Kenyan investment companies

1.4. Scope of the Study

The study of the relationship between external common tariffs and cross-border trade efficiency in the EAC was conducted in Kenya. This involved an analysis of secondary data for Kenyan imports and exports from World Integrated Trade Solution (WITS) and the Observatory of Economic Complexity (OEC). Other sources of information to supplement the secondary data included Economic review reports from the World Bank, the African Development Bank (AfDB) and EAC. The study lasted over a six month period beginning from February to July, 2019 and covered the financial years: 1995 to 2017.

1.5. Justification of the Study

This study provided important information for investment and trading decisions to companies listed on NSE and other EAC bourses. Market participants in the EAC bourses also gain current insights from the study findings upon which informed decisions and market activities can be undertaken. The EAC integration organs can also gain an understanding of the current scenarios in the region's capital markets to guide forward planning and action as the drive to establishing a formidable EAC trading block advances. Among other beneficiaries are commodity traders involved in importation and exportation of merchandise. The study findings also inform policy development and implementation at company, government and regional levels. Importantly, the study contributes to a body of literature in finance, regional markets and regional development.

2. Literature Review

2.1. Theoretical Review

Efficient Market Hypothesis

This study is anchored in the Efficient Market Hypothesis (EMH) theory which was initially developed by Fama

(1969). According to the proponent of the EMH theory, a market is efficient if the prices always fully reflect available information and all the available information is used in pricing securities. This implies informational efficiency since the available historical, public and privately held information is used by traders, investors and other market participants in evaluating security prices in the market. Accordingly, Fama (1969) argues that it is impossible to make economic profits through trading using the current accumulated information up to the moment of trading. Market efficiency takes different forms namely: the weak form of EMH, semi-strong form of EMH and strong form of EMH. The weak-form of EMH assumes that historical price information is instantaneously incorporated into prices while the semi-strong form of EMH assumes that prices reflect all the publicly available information and the strong-form of EMH assumes that besides the historical and publicly available information, private information is also reflected in the prices. Unlike in the semi-strong form and strong form of market efficiency, market participants who opt to use historical price information may not benefit much since such information is widely available and may not warrant competitive advantage

2.2. Empirical Review

2.2.1. Cross-Border Market Efficiency

The EAC regional integration agenda provides for facilitation of cross-border trade and investment amongst the member states by enabling the exchange and mutual recognition of trade-related data and documents for efficient international trade transactions. Cross-border markets become efficient when the capital market prices correctly utilize all the available information instantaneously. Such information determines the form of market efficiency as defined by Fama’s (1969) Efficient Market Hypothesis (EMH) which are: weak form efficiency, semi-strong form efficiency and strong form efficiency. Empirical evidences show that cross-listed firms benefit from informational efficient pricing, reduced opacity arising from minimized informational asymmetry challenges, enhanced liquidity and visibility, signalling for and low cost of capitalization as well as investment efficiency after cross-listing [1, 28, 19]. Cross-listing an entity helps improve the firm’s visibility and enlarges its investor base. However, the advantages of cross-listing may be hard to come by considering exchange rate risks, incompatibility of trading and settlement systems, diverse trading regulations and failure by the issuing companies to increase free float shares in the new markets [3, 28, 23].

2.2.2. Common External Tariffs

Evidences from the implementation of common external tariffs in various trading blocs support the restriction of imports, protection of in-region industries, enhancing the attractiveness of local production and relaxed government interference with the private sector. Conversely, research findings show that tariff-based trade restrictions discourage competition which eventually leads to inefficiency of domestic firms and retaliation by other countries from hence

impeding imports and exports in the global markets [5]. Evidence from the tariff-based trade wars between the United States of America (USA) and China both targeting industrial parts, furniture, appliances, steel, food textiles, chemical products among others which influence trade and investing decisions. The trade tariffs raise commodity prices, reduce the supply of imports for households and businesses which thereby lowering economic output, the country’s GDP and worsens unemployment in the long run [34]. The trade wars do not spare stock markets and securities markets, which have also exhibited varied responses depending on their direct and indirect exposures to the US-China trade strains. The US-China trade tensions occasioned by tariff increments have also lowered the US stock market performance [29]. Figure 1 shows the USX drop against the benchmark index as at 21st June 2019 following the presidential pronouncement of 25% duty on imports up from 10%.

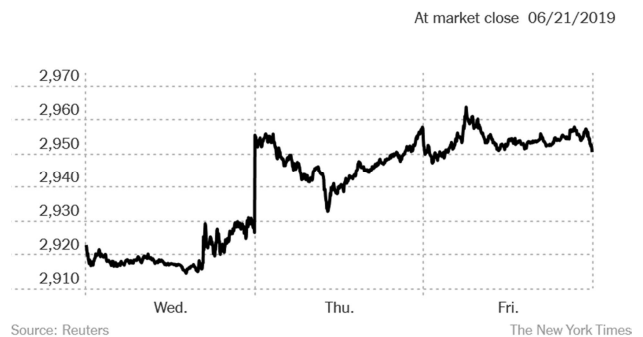


Figure 1. US-China Stock Market Performance.



Figure 2. US-China Stock Market Performance.

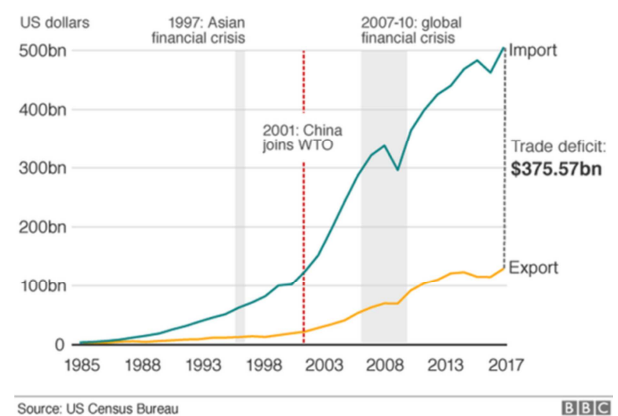
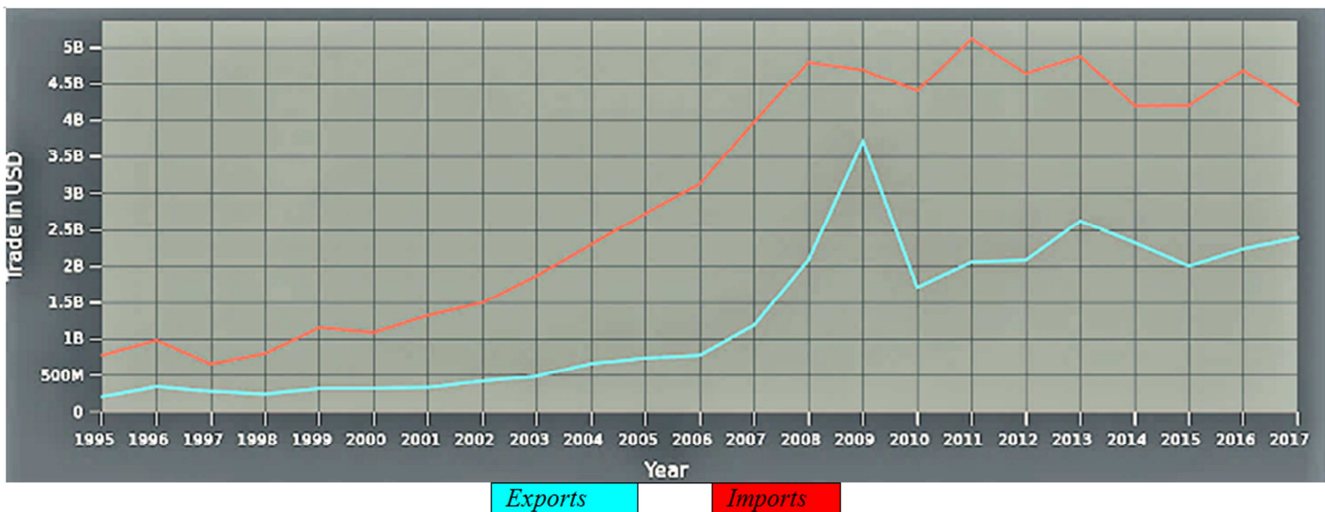


Figure 3. US trade in goods with China.

Empirical evidence [15] from analysis of the trade linkages and firm value based on the indications from the 2018 US-China “Trade War” market responses were evaluated. The evaluation of firms in both countries was hinged on their direct and indirect US-China trade experiences. The study revealed that US firms that rely on China for both importation and exportation had higher default risks coupled with diminished stock and bond returns. [25] The study presents a complex view of global trade from the US-China trade tensions whose impact affect many economies directly and indirectly. Various studies have also analysed the cross-border trading in developed and emerging markets following the imposition of common external barriers considering the exports and imports, the exports and trends, and major products traded in the regional blocs [5, 7-9, 11-13, 31, 22, 27, 32]. The analyses indicate a discourse in research findings concerning the imposition of tariffs on imports to various regions and countries.

In Central Europe, seven (7) European countries that are non-European Union members established the Central European Free Trade Agreement (CEFTA) in the year

2006 with the aim of creating a more enabling trading environment for the member states. The CEFTA members who include Serbia, Macedonia, Albania, Moldova, Montenegro, Bosnia and Herzegovina entered into a trade deal with the intention of reduce trade tariffs amongst the members of the trading block. Despite the successful implementation of zero tariff for trade amongst the member states, trading activities within the CEFTA region still suffer a number of non-tariff barriers including: numerous and redundant trade-related procedures, overlapping data and documentation requirements for firms, excessive inspections across the borders among others. Accordingly, the study [20] analysed the trade effects of Albania’s trade agreements with CEFTA members with a focus on the country’s exports. The study which used a trade growth decomposition methodology reveals that the agreement opened up the export market for the Albanian entities that did not export to CEFTA members prior to the trade deal. The findings of the study indicate that CEFTA increased the Albanian exports in the range 34% - 144%. Figure 4 shows the trends in trade balance between Albania and the world.



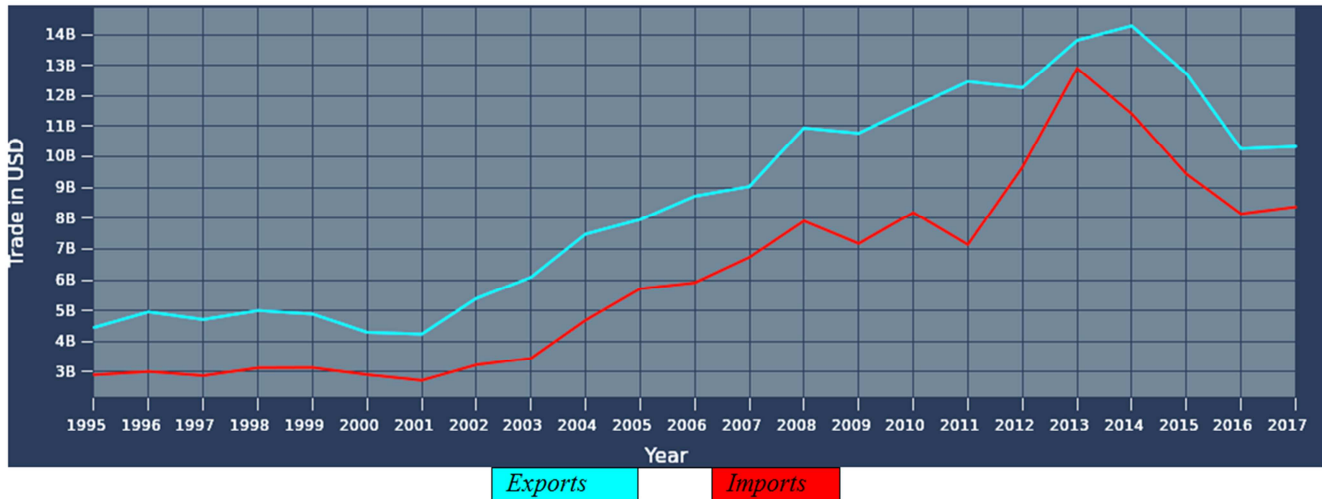
Source: The Observatory of Economic Complexity, 2019

Figure 4. Albanian Trade Balance.

Whereas the African Development Bank’s (2018) perspectives on the African Economic Outlook indicate resilience of the African economies with increased real output generally signalling good macroeconomic policy space, regional integration efforts and progress in structural reforms, earnings from exports still remain a concern for the African countries. For instance, [2] economic outlook shows that the tax revenue collection in Africa increased by 2.3% in absolute terms in 10 year-period from 2006 to 2016 compared to other continents. The tax revenue increment is attributed to among other categories, higher tax charges on domestic production, incomes and tariffs, some of which can be counterproductive and distortionary.

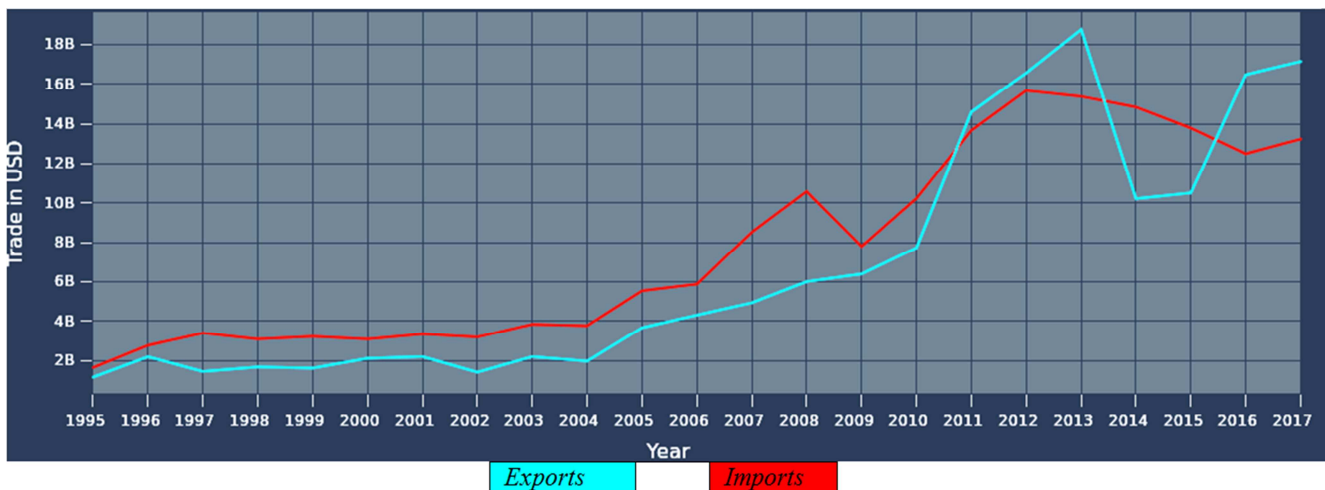
Despite the need to strengthen the economic resilience of African countries to lift the economies to new growth equilibrium, the economies still need to rethink their bilateral

and multilateral regulations for trade facilitation at national, sub-regional and regional levels. The study [22] reviewed the changing landscape of trade facilitation and regional development issues in West Africa in the wake of technological advancements, digital commerce and increased trade integration. The study underscores trade integration and intergovernmental collaboration efforts towards strengthening South-South regional trade partnerships which account for the trade expansion being experienced in Africa. Despite the ongoing African Continental Free Trade Area (AfCFTA) negotiations, the study findings reveal increasing trade costs to sub-regional trading blocs mainly arising from increasing non-tariff measures including: lengthy customs processes, inadequacies of transport, logistics and infrastructure and well as incoherent cross-border trade documentation.



Source: The Observatory of Economic Complexity, 2019

Figure 5. Cote De'Ivoire's Trade Balance.



Source: The Observatory of Economic Complexity, 2019

Figure 6. Ghanaian Trade Balance.

Empirical studies and analyses from developed economies also associate deficiencies in both bilateral and multilateral trade to factors including unfavourable customs entry procedures, stringent administrative entry procedures, technical barriers to trade, costs involved in accessing trade-related services among others. Besides the common external tariffs imposed by regional trading blocs, various shortcomings of existing and emerging regional and sub-regional free trade agreements have causal relationships with some new economic structure changes in the contemporary globalization and regionalization discourse. These shortcomings concur with the paper [9] analysis of the perspective of the future of free trade agreements and their potential shortcomings from Singapore's experiences. The study recommends more comprehensive free trade agreements that can: eliminate non-tariff barriers and eliminate potential barriers; enhance intellectual property protection; manage trade and FDI policies and enhance regional and global trade integration in future.

In Africa, regional trading blocs have made concerted efforts towards realization of the continent's trade integration besides strengthening the sub-regional free trade agreements. The study [26] analysed the impact of regional integration among countries from the Common Market of Eastern and Southern Africa (COMESA) -EAC-Southern African Development Community (SADC) tripartite free trade agreement which was established in 2011. The analysis used an extended gravity model on a panel of 51 African countries using data for 15 years from 1995 to 2010. The study particularly analysed average tariff data on global imports and the findings revealed negative correlation between tariffs and imports as individual countries within the African region seek to protect their respective national interests more than they do with regional trade interests. As the research [18] observe, this scenario is partly because not all African countries within each of the tripartite trading blocs are integrated to their specific regional blocs.

The paper [11] analysed the relationship between trade

openness and domestic market share with a focus on the manufacturing firms in Egypt. The study which analysed how manufacturing plants in Egypt respond to changes in trade tariffs used firm-level data and relied on Levinsohn and Petrin (2003) methodology to determine the level of total factor productivity for the sampled Egyptian manufacturing entities. The methodology used allows for the use of a commonly observable variable to control for unobserved productivity based on the assumption of inherent perfect competition. According to the findings of the said study, which is in agreement with heterogeneous business models of international trade, a decline in market concentration and the market share of the firms studied after the trade policy reforms pursued in 2004.

Despite the efforts to enhance trade liberalization, little progress in the fight against corruption as well as a less enabling business environment affect business activities in the country [4, 13]. Though the the research [30] posits that the Egyptian economy has stabilised most recently as the macro-economic and policy reforms have consistently improved the country’s external position, parity in trade balance still manifests. There is weak market competition despite remarkable developments in the private sector. The reforms have seen the reduction of tariffs and tariff bands narrowed down only applied to a few commodities and therefore, the tariff reductions have insignificantly translated into increased integration of the Egyptian economy. Figure 7 illustrates the trade patterns after the reforms.



Source: The Observatory of Economic Complexity, 2019

Figure 7. Egyptian Trade Balance.

Figure 7 shows a deficit in balance of trade alongside the high debt ration standing at 98.7% of the GDP in financial year 2018 as the current account deficit narrowed.

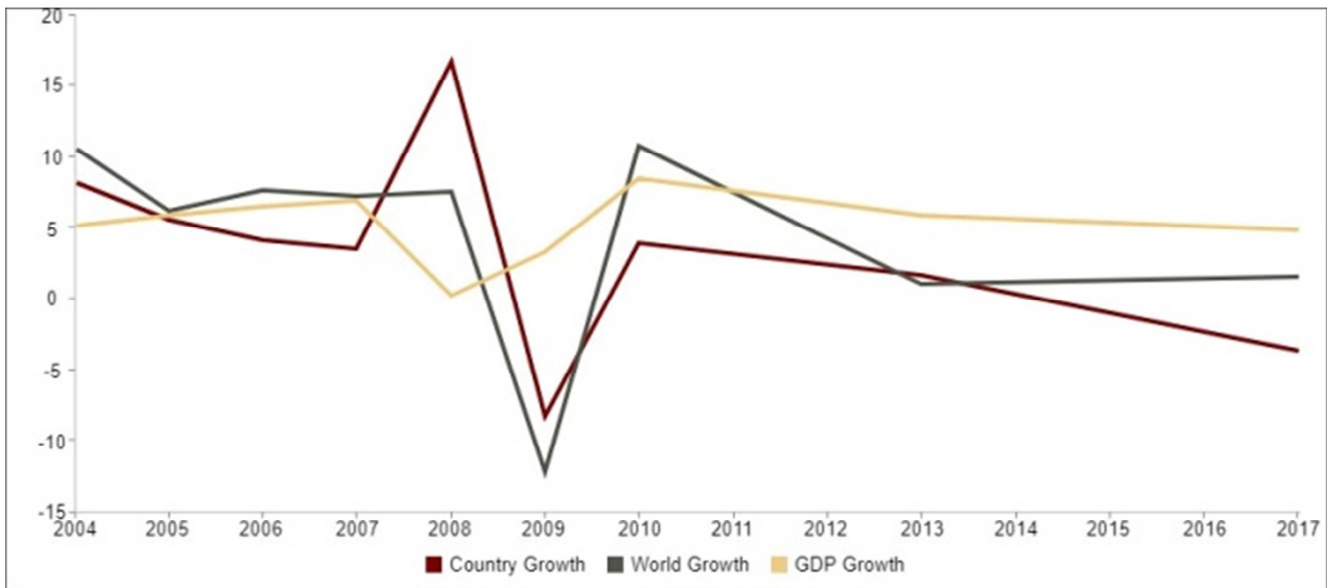
From the time of inception of the EAC, the in-region trade agreements have not been immune to negative effects of free trade and developments in regional integration. This is evidenced by the low percentage of intra-African trade as a percentage of the total trade relative to other developing regions. Unlike other African regional trading blocs, the EAC partners have made more concerted efforts to harness their economic potential and ease the regional trade burden associated with tariffs, other taxes restrictions and nonconforming measures. However, the East African Common Market Scorecard of 2016 shows that the free movement of capital, services and goods amongst the partners within the EAC region is fraught with challenges. The EAC exports only 20 per cent of its commodities to the EAC market, a phenomenon that brings out acute imbalances in trade in the region resulting from non-tariff barriers to the free flow of capital, goods and services. The EAC member states continue to make progress on eliminating tariffs by partners and non-tariff barriers inhibiting intra-regional trade. This is evident from the information gathered from commercial and investment banks, brokerage houses, central banks, stock exchanges and World Bank Group reports on compliance to the region’s Free Trade Agreements [31].

Various empirical analyses have as well been done on the impact of tariffs in Kenya which have elicited critical views on trade, investment, integrated market discourse. According to the paper [16] in their evaluation of the impacts of tariff reduction and mixed fiscal policy on Kenyan agricultural and food industry, economic welfare is enhanced by elimination of trade tariffs. The study used the Macro Computable General Equilibrium Model and assumed close interrelation between thecountry’s fiscal policy and economic welfare. However, the study findings indicate that the elimination of tariffs enhances economic welfare subject to some optimal government expenditure. The findings further link the improved economic welfare to, among other factors, high consumption in the economy, improved levels of consumer incomes, GDP, increased demand for factor endowments and limited public service expenditure. This implies that a country’s economic welfare is dependent on a myriad factors besides elimination of tariffs as a way of trade liberalization.

This argument is asserted by the study [24] review paper which examined the welfare effects of the reciprocal free trade pacts between Sub-Saharan Africa and the industrialized world. Using the General Equilibrium Model framework, the study underscored the inaccurate estimation of trade impacts explained by variances in labour productivity growth rates. The findings concur with the conclusion by the research [16] noting that the elimination of

reciprocal tariff with the industrialized world slightly improves trading implying that trade liberalization is not a panacea for economic welfare improvement. Developing countries need to improve their capital productivity, competitiveness and address other non-tariff barriers in order

to realize greater benefits of bilateral and multilateral trade. Figure 8 Shows a trend analysis of Kenya's economic welfare over a 14 year period from 2004 – 2017 in support of the foregoing discussion.



Source: World Integrated Trade Solution (2019)

Figure 8. Kenya Country Growth V/S World Growth V/S GDP Growth.

The results shown in Figure 8 indicate that Kenya had a total export of US\$5,747,414,820 and total imports of US\$ 16,690,197,050 in leading to a negative trade balance of US\$ -10,942,782,230. The trade growth is -3.67% compared to a world growth of 1.50%. GDP of Kenya is 79,263,075,749.27 in current US\$. Kenya services export is 4,647,692,401.86 in BoP, current US \$ and services import is 3,091,958,193.70 in BoP, current US \$. Kenya exports of goods and services as percentage of GDP is 13.17% and imports of goods and services as percentage of GDP is 24.08% (World Bank Group, 2018).

3. Conclusion

Statistical findings from World Integrated Trade Solution (WITS) and the Observatory of Economic Complexity (OEC) as well as Economic review reports from the World Bank, the African Development Bank (AfDB) and EAC are consistent on the trade deficits comparing imports and exports statistics. The in-country and in-region statistical analysis following the implementation of common external tariffs show low welfare gains from regional integration for countries that do not eliminate non-tariff barriers while countries that reduce non-tariff barriers experience comparatively high welfare gains. Besides, statistical analysis shows prolonged deficits in balance of trade and balance of payments in both developed and developing economies and the EAC is no exception. Trade inefficiencies and market imperfections persist despite numerous market integration and innovation efforts. Non-tariff barriers, inward-looking trade policies, protectionist policies,

redundant trading rules across borders, increasing cost of trading among other shortcomings to regional trade still constrain bilateral and multilateral trade in spite of the implementation of common external tariffs in the region. For cross-listed entities, empirical results show inefficiencies in regional trading activities evidenced by prolonged trade deficit in the developed and developing world countries. The study concludes that tariffs are good for trade regulation to the detriment cross-border trading both within and beyond the regional bloc. However, besides macroeconomic correlates, factors other than common external tariffs influence regional and cross-border trade efficiency. From a policy perspective, the imperatives for enhanced trade efficiency in the emerging EAC markets include a comprehensive intra-region trade policy review, revitalization and refocused commitment by the member states towards regional market efficiency through liberalization even as individual trading entities pursue advanced competitiveness in the regional and global markets.

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