S6 ECONOMICS

INTERNATIONAL TRADE/EXTERNAL TRADE/ FOREIGN TRADE:

This is the exchange of goods between two or more countries.

OR: It is the trade between countries which involves a physical transfer of goods from one country to another.

TERMS USED IN INTERNATIONAL TRADE:

- **Export trade.** This is the selling of the country's goods to other countries e.g. Uganda mostly exports agricultural products such as cotton, coffee etc.
- **Import trade:** This is buying of goods and services from other countries.
- **Bilateral trade:** This is the exchange of goods and services between two countries.
- **Multilateral trade:** This is the exchange of goods and services among different countries/ among more than two countries.
- **Visible Trade:** This is the exchange of goods between or among different countries. i.e. physical goods that can be seen and felt.
- **Invisible trade:** This is the exchange of services between or among different countries e.g. insurance, banking etc
- **Entreport trade:** This is the type of trade where goods are imported by a country for the purpose of re-exporting them to another country. i.e. where a country exports commodity it had previously imported.
- **Visible imports**. This is buying of tangible goods from other countries.
- **Invisible Imports.** This is buying of services/ intangible goods from other countries. examples of invisible imports include tourism, education, banking etc.
- **Visible exports.** This is selling of tangible goods to other countries. Examples of visible exports include coffee, cotton, fish etc
- **Invisible exports**. This is selling of services/ intangible goods to other countries.

FACTORS THAT GIVE RISE TO INTERNATIONAL TRADE /ORIGIN/BASIS/CAUSES OF INTERNATIONAL TRADE:

International trade arises because there is no country that is capable of providing all the resources it requires to develop its full economic potential and satisfy the demands of its economy.

The factors that give rise to international trade include:

- **Differences in natural resource endowments/ Differences in climatic conditions.** Countries are endowed with different natural resources like minerals, oil, etc, thus countries produce different types of goods and in different quantities which necessitate exchange leading to international trade.
- **Differences in skills (natural and acquired). People** have different skills that lead to production of different goods and services and therefore the need for exchange leading to international trade.
- **Differences in level of technology.** There are wide gaps in technology between the developed and the less developed countries and thus production of different goods and services to be exchanged, this necessitates countries to participate in international trade.

- **Differences in tastes or demand.** Development in the country increases people's standards of living and hence may demand high quality products and a wider variety of them that are not produced at home but produced abroad, hence the need to participate in international trade.

THE BASIS OF INTERNATIONAL TRADE:

The basis for international trade is explained by the two theories/principles.

- The principle of absolute advantage.
- The law of comparative advantage.

1. The Absolute advantage principle:

This principle was developed by **Adam Smith** to show the advantage of international trade.

This principle states that *"given two countries and two commodities with a given amount of resources one country can produce both commodities more cheaply than the other."*

Assumptions of the principle of Absolute Advantage:

- There are only two countries in the world (Bilateral trade).
- There are only two commodities produced in the two countries.
- There are same amount of resources in the two countries.
- Labour is the only factor of production.
- Labour is mobile within the country but immobile between countries.

An illustration of the absolute cost advantage:

COUNTRY	RESOURCES	CLOTH ('000 METERS)	BEANS ('000 TONS)
A	1,000	10	40
B	1,000	08	20

The table shows that using the same amount of resources with one unit of labour, country A can produce either 10,000 meters of cloth or 40,000 tons of beans. Country B produces either 8,000 meters of cloth or 20,000 tons of beans using the same unit of labour.

Therefore, **country A** has absolute advantage in the production of both commodities (cloth and beans) over **country B** when same amount of resources are employed i.e. absolute advantage in cloth production of (10:8) absolute advantage in beans production (40:20). Therefore, country A is better endowed.

However, if a country has absolute cost advantage in production of different commodities than the other, total output can be increased and each country benefits if they would trade (exchange) and each country specializes in the production of that commodity in which it has comparative advantage i.e. if each of the two countries can produce one commodity at an absolutely lower labour cost of production than the other.

2. The principle of comparative cost advantage:

This principle states that *"a country should specialise in the production of a commodity in which it has least/lowest opportunity cost in comparison with another country"*

OR: *"Comparative advantage exists when given two commodities and two countries with a given amount of resources one country can produce one commodity more cheaply than the other"*

Assumptions of the principle of comparative advantage:

- There are only two countries e.g. **country A** and **country B.**
- Only two commodities are produced e.g. **commodity X** and **Y.**
- No transport costs are incurred in transferring the goods between the two countries.
- There is free trade between the two countries i.e. there are no trade barriers between the two countries.
- There is full employment of resources/ factors of production in both countries.
- Technology is constant.
- Factors of production are perfectly mobile within each country.
- Trade between the two countries is on the basis of barter trade system.
- Demand is elastic in both countries.
- There is constant comparative advantage in both countries.
- There are constant returns to scale or law of diminishing returns doesn't operate.
- Homogeneity of factors of production is assumed for example all units of labour are homogeneous or equally skilled.
- Tastes and preferences are similar in both countries.

This theory was developed by **David Ricardo** in the 19^{th} century (1817) to improve on Adam's principle of absolute advantage.

Adam Smith's principle does not show how much and where each country should specialise but just shows that one country produces more of both commodities than the other. However, each country should specialise in the production of that commodity in which it has a comparative advantage and buys from other country the commodity in which it has a comparative disadvantage. Ricardo claims this should be the basis on which countries should trade.

Therefore, there is a need to consider the opportunity cost of production in each country. i.e. how much of a commodity a country gives up in order to produce another commodity.

Example of comparative advantage:

COUNTRY	RESOURCES	CLOTH ('000 METERS)	RICE ('000 TONS)
A	1000	10	40
B	1000	8	20

Opportunity cost= $\frac{Alternative foregone}{Alternative undertaken}$

❖ **Opportunity Cost of producing Cloth**

$=\frac{\boldsymbol{Alternative\ foregone\ of\ rice}}{\boldsymbol{Alternative\ undertaken\ of\ cloth}}$

Country A 10 cloth = 40 Rice

1 cloth = $\frac{40}{10}$ Rice

1 cloth = 4 Rice

Therefore 1 meter of cloth = 4 tons of Rice

Country B 8 cloth = 20 Rice

1 cloth = $\frac{20}{8}$ Rice

1 cloth = 2.5 Rice

Therefore 1 meter of cloth = 2.5 tons of Rice

❖ **Opportunity cost of producing Rice**

$=\frac{\boldsymbol{Alternative\ foregone\ of\ cloth}}{\boldsymbol{Alternative\ undertaken\ of\ rice}}$

Country A 40 Rice = 10 cloth

1 Rice = $\frac{10}{40}$ cloth

1 Rice = 0.25 cloth

Therefore 1 ton of Rice = 0.25 meters of cloth

Country B 20 Rice = 8 cloth

1 Rice = $\frac{8}{20}$ cloth

1 Rice = 0.4 cloth

Therefore 1 ton of Rice = 0.4 cloth

COUNTRY	**CLOTH**	**RICE**
A	4	0.25
B	2.5	0.4

By producing 1 meter of cloth, country A foregoes 4 tons of rice and country B foregoes 2.5 tons of rice.
By producing 1 ton of rice, country A foregoes 0.25 meters of cloth and country B foregoes 0.4 meters of cloth.

Therefore, country A has a comparative advantage over country B in the production of rice. It incurs less opportunity cost (real cost) in producing rice than country B. Country B has a comparative advantage over country A in the production of cloth. Therefore, country **A** should specialise in production of **rice** and country **B** specialise in production of cloth.

RELEVANCE/APPLICABILITY OF THE PRINCIPLE OF COMPARATIVE ADVANTAGE

Note: To a lesser extent, the principle is applicable in developing countries and the following reasons are given to support that.

- Developing countries have tended to specialise in agricultural production where they have least/lowest comparative cost.
- There are some barter trade arrangements in developing countries as assumed by the theory because of lack of adequate foreign exchange.
- There is some degree of mobility of factors of production within individual countries as assumed by the theory.
- Developing countries mostly import manufactured goods where they have less comparative advantage.
- There are some cases of free trade as assumed by the theory as a result of economic integration e.g. preferential trade area etc.

- There is use of labour intensive techniques of production which is abundant and cheap for developing countries. This is because there is surplus labour.

.

Irrelevance/inapplicability/limitations/criticism of the principle of comparative advantage

NOTE: The weakness of comparative advantage theory is that it is based on a number of assumptions that are not realistic.

The principle of comparative advantage is **inapplicable/irrelevant** to a greater extent because of the following reasons:

- **It wrongly assumes only two countries involved in international trade**. The reality is that world trade is multi-lateral involving many countries.
- **The assumption of only two commodities is unrealistic**. There are more than two commodities produced in the two countries depending on demand for goods and service hence there is production of a wide variety of commodities.
- **It assumes barter trade as the only means of exchange which is wrong**. But in reality, in modern economies there is monetary exchange and barter trade is continuously dying out.
- **It assumes free trade yet in reality there are trade barriers**. This is because trade is often subjected to barriers to discourage imports and exports which limit the volume of trade operations.
- **It does not consider possibility of changes in technology yet there is technological progress**. Technological changes bring about changes in productive efficiency which helps to reduce costs of production of goods and increase their supply.
- **It ignores transport costs which cause differences in costs of production and this is not true**. This is because transport costs determine the pattern and profitability in international trade in developing countries.

- **It wrongly assumes the possibility of full employment**. In developing countries, there is underutilisation of resources which is reflected in excess capacity in production units due to low levels of technology, limited market, etc.
- **It ignores the possibility of international mobility of factors of production**. There can be international mobility of factors of production but also factors of production **are not** perfectly mobile within a country as the theory assumes.
- **It assumes homogeneity of factors of production yet they are not equally efficient.** This **is** because different units of factors of production possess different level of productivity and therefore they are different therefore not homogeneous. e.g. skilled, semi-skilled, and unskilled labour.
- **It assumes that demand is elastic yet the demand for agricultural products is inelastic**. Hence LDCs don't benefit in international trade due to low prices offered.
- **It ignores the possibility of absolute cost advantage**. It is possible for a country to produce both commodities more cheaply than the other which makes it difficult to determine the commodity in which either country should specialise.
- **It ignores possibility of change in comparative advantage over time yet it can change**. It may change in favour or dis-favour of one commodity over the other overtime. e.g. a country may be good in production of a commodity but because of improvement in technology, it shifts to production of another instead overtime.
- **It ignores the need for self reliance by countries**. Countries try to avoid over specialisation and try to produce a wide variety of goods as much as possible to reduce reliance on other countries.
- **It ignores the existence of diminishing returns yet diminishing returns occur**. Most developing countries are agro based economies and diminishing returns occur which reduces productivity or the level of output of the commodity where the country has a comparative advantage may reduce.
- **It makes poor countries poorer/poor terms of trade.** Developing countries specialise in the production of primary products whose prices are always lower and ever falling compared to manufactured goods from MDCs, hence the theory perpetually commits developing countries to being poorer as producers of primary products leading to unfavourable terms of trade.
- **It ignores the existence of different currencies used**. Yet currency differences between and among countries exist which affects costs of production.
- **There are no constant costs as assumed by the theory**. There are economies and diseconomies of scale due to specialisation in one commodity and this leads to varying average costs of production yet it's ignored by the theory.
- **It assumes similar needs (tastes and preference) in the two countries which is not true**. This is because different countries have different needs depending on age, religion, sex/gender, etc hence production of different goods and services.
- **It ignores equal costs of production/identical opportunity costs**. Countries may have the same costs in the production of a certain commodity and it becomes hard to find which country should specialise in a particular commodity.

REASONS FOR PARTICIPATING IN INTERNATIONAL TRADE

- To enable a country get what it does not produce. The country through participating in international trade will be able to acquire what it does not produce.
- To acquire variety of goods and services. By participating in international trade, the country will be able to import different commodities from different countries thus widening consumer's choice.
- To promote efficiency of the domestic firms. This is so because by participating in international trade the domestic firms will compete with foreign firms; this will compel local producers to improve the quality of their products in order to survive in business.

- To enable a country dispose off surplus output. This is because international trade will open up new markets hence the country will be able to dispose off her surplus output which cannot be consumed domestically.
- To promote specialisation and its benefits. The country participating in international trade will be able to specialise in production of goods in which it has greatest comparative advantage and this will lead to increase in the volume of goods produced.
- To enable a country acquire new ideas and values. By participating in international trade a country acquires new ideas and values which enables her to increase the rate of economic growth.
- To promote international friendship and cooperation. Participating countries in trading inevitably become friends and thus promote world peace.
- To promote utilisation of resources thus avoid wastage. International trade widens market which enables the country to utilise the would be idle resources such as land and labour and thus avoid wastage.
- To promote technological transfer. Participating in international trade enable a country to acquire modern technology which helps to accelerate rapid industrialisation in the country.
- To promote capital inflow. International trade attracts foreign investors who bring foreign capital into the country which is very essential in accelerating investment in the country.
- To provide revenue to the government. By participating in international trade nations generate more revenue through increasing tax base in form of import and export duties especially on luxurious goods.
- To create employment opportunities. By participating in international trade it enables a country to create and maintain employment opportunities, this is through the export and import multipliers.
- To promote entrepreneurship. Through participating in international trade people will acquire entrepreneurial abilities which will lead to increased investment in the country.
- To promote infrastructure development in form of roads, railways and air services. Infrastructure in form of roads, railways and air transport will be developed in order to ease the movement of goods and services between nations.
- To enable countries supplement/get supplies in times of emergencies. Through participating in international trade, countries will be able to acquire commodities in times of shortages brought about by unfavourable natural factors such as prolonged drought.
- It supplements domestic output. The country may be producing certain goods that are not in enough quantities therefore by participating in international trade the country is able to satisfy the domestic demand for certain goods by acquiring such goods from other countries.
- To supplement domestic output. Some countries may be producing certain goods that are not in sufficient quantities; therefore by participating in international trade the countries will be able to satisfy the domestic demand for certain goods by acquiring such goods from other countries.

ROLE OF INTERNATIONAL TRADE:

Positive role of international trade:

- It enables a country to get what it doesn’t produce by importing goods from other countries.
- It provides a variety of goods and services to the recipients because different commodities are imported from different countries hence widening consumer’s choice.

- It promotes efficiency of the domestic firms due to competition with the foreign firms.
- It promotes competition between domestic firms and foreign producers and this compels local producers to improve the quality of their products in order to compete with foreign producers.
- It enables the country to dispose off the surplus output because international trade opens up new markets hence the vent for surplus.

  Note: vent for surplus theory as used in international trade states that *"International trade provides an opportunity for countries to utilise the formally idle resources to produce output for the export market"*.

- It promotes specialisation and its benefits. It enables a country to specialise in the production of goods in which it has the greatest comparative advantage and this increase the volume of goods.
- It enables a country to acquire new ideas and values from other nations which helps such a country to increase on the rate of economic growth.
- It promotes international friendship and cooperation. International trade leads to friendship and peace because the trading partners inevitably become friends.
- It promotes utilisation of resources hence avoiding wastage. The widened market enables the country to utilise the would be idle resources such as land and labour.
- It promotes technological transfer which helps to accelerate rapid industrialization in the country.
- It promotes capital inflow. International trade attracts foreign investors who bring foreign capital into the country which is very essential in accelerating investment in the country.
- It provides revenue to the government through increased tax base inform of import and export duties especially on luxurious goods.
- It promotes employment creation. International trade promotes creation and maintenance of employment opportunities through export and import multipliers. As the level of international trade expands more jobs are created.
- It promotes entrepreneurship. Through participating in international trade people acquire entrepreneurial abilities which leads to increased investment in the country as now more people are able to undertake risks through initiating business and maintaining them.
- It promotes infrastructure development inform of roads, railways and air services. This is done in order to ease the movement of goods and services between nations.
- It enables the country to overcome shortages in times of natural calamities like floods, earthquakes etc. supplies are obtained from other countries inform of relief aid.
- It supplements domestic output. The country may be producing certain goods that are not in enough quantities therefore by participating in international trade the country is able to satisfy the domestic demand for certain goods by acquiring such goods from other countries.

Negative role of international trade:

- It leads to exhaustion of non-renewable resources due to over exploitation. It leads to quick depletion of non-renewable resources in an attempt to meet the increased foreign market.
- It leads to cultural erosion. Other cultures from other countries are adopted and therefore people abandon their own traditions.

- It leads to poor terms of trade. This is so because the country exports a lot of her products in order to import one unit of a good/ a service.
- It leads to balance of payment problems due to increased capital outflow because the country spends more on imports than it gains from exports.
- It leads to dumping and its associated evils.
- It promotes dependency/reduces self-sufficiency. It leads to economic dependence in that the poorer countries rely on richer countries for most of what they need especially the industrial products.
- It leads to importation of undesirable products i.e it encourages importation of demerit goods/expired goods which are dangerous to people's lives.
- It leads to imported inflation. This arises when a country imports commodities from another country suffering from inflation.
- It leads to unemployment. This is so when the domestic industries collapse because people prefer to buy goods from abroad which are of better quality.
- It retards the development of local skills i.e. in terms of management since the managers are mostly got from foreign countries.
- It leads to brain drain which is the movement of skilled labour from one country to another in search of better opportunities. It is disadvantageous in that the country loses skilled labour force which is very essential for her development.

LIMITATIONS /DIFFICULTIES ENCOUNTERED IN INTERNATIONAL TRADE:

- Transport difficulties and high transport costs. Trade between countries involves high transport costs because of the long distance between countries.
- Differences in currencies which necessitates currency conversion if trade is to take place and this exercise is time consuming.
- Differences in weights and measures. These differ from country to country and therefore cause difficulty of converting the weights and measures from one unit to another.
- Differences in languages, because of different languages spoken all over the world. Language barrier may interfere with communication, complicates advertising and therefore it becomes difficult to market the goods in other countries.
- Differences in political ideologies because countries always prefer to trade with other countries of the same political ideology.
- Imposition of tariff and non-tariff barriers to trade. This hinders the smooth flow of goods from one country to another.
- Long procedures involved in trade. There are many procedures in making an inquiry, orders, getting national approval etc. this is time consuming and it hinders the smooth flow of goods from one country to another.
- Political instabilities in some parts of the world. This makes the acquisition of goods from other countries difficult because of the fear to lose lives and property.
- There is great immobility of factors of production especially labour. Although mobile within a certain country. Labour mobility between countries is not easy. This may be due to land problems, customs, languages, government restrictions etc. capital is also immobile with regards to certain parts of the world for fear of risks associated with investment in these countries.

PROTECTIONISM:

This is the economic policy of restricting trade between nations through methods such as tariffs on imported goods, use of quotas, and a variety of other restrictive administrative government regulations.

Reasons for protectionism

- To protect local industries/producers/ infant industries from foreign competition i.e. because they are shielded from foreign competition. It gives them time to organise and establish themselves to become more efficient.
- To discourage the consumption of harmful products for example banning such products prevents their inflow in the country and hence the nationals are safe guarded against consumption of such undesirable goods.
- To prevent dumping/anti-dumping policy due to insufficient foreign exchange countries with un competitive products may use unfair means of selling their products at prices below the domestic price/give away price in the foreign market. Such a practice is referred to as **dumping.**

N.B:- *Dumping refers to the selling of commodities at lower prices than those charged at home.*

Dumping is normally resorted to so as to dispose off low quality but highly priced products. It can also be used to gain monopoly power in the supply of a given product in a number of countries.

Dumping can also be used to break into a new market. However the possible major reason behind dumping is to maintain price stability in the domestic market.

Effects of dumping in a recipient country

- ❖ Local producers are outcompeted/leads to closure of industries hence resulting into unemployment.
- ❖ Cheap goods are availed to consumers.
- ❖ Variety of goods are availed to consumers.
- ❖ Poor quality goods may be sold to the consumers.
- ❖ It leads to increased revenue to the government through taxation.
- ❖ It leads to underutilization of local resources.
- ❖ Discourages local initiate/discourages investment.
- ❖ Distorts the balance of payment position.
- ❖ Leads to increased foreign exchange expenditure.

- To correct the balance of payment problem, because the restrictions on imports reduce the quantities of goods imported in the country and this reduces the expenditure abroad and thus improve the balance of payment position.
- To increase employment opportunities/ to promote employment at home because protectionism enables the setting up or expansion of industries, this creates more employment opportunities to the nationals.
- To improve the terms of trade because the imposition of tariffs on imports improve the rate at which the country's imports exchange for the exports.
- To safe guard against imported inflation, imposing tariffs and non-tariff barriers on imports restricts the importation of goods from inflation countries.

- To reduce economic dependence because protectionism enhances local production this enables the country to move towards self-reliance.
- To raise revenue for the government. The government collects revenue from duties imposed on imports.
- To increase resource utilisation at home since protectionism enables the setting up of domestic industries that utilise the locally available resources such as land and labour.
- To retaliate/Revenge the tariffs imposed on goods by another country i.e. to block goods from those countries that are also protecting their economies.
- To strengthen political ties. A country may impose taxes on other countries in order to strengthen the political ties with which it is trading.
- To promote innovations at home, protectionism is undertaken so as to promote innovations at home as a way of attaining rapid economic growth, through coming up with appropriate domestic production methods in the economy.

MERITS/POSITIVE IMPLICATIONS OF PROTECTIONISM

- Leads to protection of domestic firms.
- Leads to improvement in balance of payment position.
- Discourages consumption and production of demerit goods.
- It helps in raising revenue for the government through taxation.
- It leads to creation of more employment opportunities/ increases employment opportunities because the industrial sector expands.
- Reduces economic dependence.
- Encourages the utilization of local resources i.e land and labour (makes market use of resources).
- Reduces on the political dominance.
- Helps to control imported inflation.
- Encourages innovations
- Improves on the terms of trade.
- Helps in retaliating against tariffs imposed by another country.

DEMERITS/NEGATIVE IMPLICATIONS OF PROTECTIONISM:

- It makes nationals to consume low quality goods i.e. the nationals are subjected to poor quality goods since the foreign goods are stopped from coming into the country and yet the infant industries are still inefficient thus making it difficult for them to produce high quality goods.
- The nationals are subjected to highly priced goods in the domestic market because the infant firms/industries operate at high cost and therefore sell their goods expensively.
- It leads to emergency of monopoly power and its associated evils i.e. the local firms become sheltered monopolies since they are protected against competition by the efficient firms abroad.
- It limits a variety of goods in the domestic market because most of the goods are stopped from coming into the country and the nationals depend on mostly domestically produced goods, this limits their choice.
- It encourages retaliation from the trading partners. This is because the countries on which the trade barriers have been imposed lose revenue; they also respond by putting trade barriers on goods entering on their own economies.
- It leads to loss of revenue from the import duties because of the reduced volume of imports.

- It increases government expenditure since the government has to offer subsidies to the infant industries to enable them operate at a low cost.
- It encourages trade malpractices such as smuggling as the traders try to avoid the protectionist policies.
- The infant industries sometimes fail to grow i.e. they remain infant and beg the government for continued protection from foreign producers.
- It discourages specialisation and its associated advantages.
- It frustrates resource inflow.

INSTRUMENTS/ TOOLS OF PROTECTIONISM:

These are measures or policies that are employed by the government to regulate the movement of goods and services across national borders. These can take the form of tariff barriers or non-tariff barriers.

A: Tariff barriers (customs duties). These are restrictions that involve use of taxes to regulate international trade.

Tariffs are taxes imposed /levied on either imports or exports to regulate their flow. A tariff raises the price of the commodity on which it is imposed hence reducing its demand.

Therefore, import duty increases prices of imports which reduce their demand in the country thus making locally produced goods more competitive.

NB: An **import duty** is a tax imposed on goods entering the country.

Tariffs are most successful in reducing demand for imported goods when their demand is price **elastic.** Tariffs may be **specific/lump sum (**i.e. at affixed rate per physical unit of output**) or Advalorem** (i.e. in Proportion to the value of the commodity or transaction concerned).

Objectives of imposing import duties

- To raise revenue for the government.
- To protect domestic and infant industries producing a similar commodity.
- To improve the country's Balance of payment position.
- To discourage importation of undesirable goods.
- To minimise imported inflation.
- To discourage dumping.
- For strategic reasons.
- To increase the level of employment at home.

Effects of tariffs on the economy

- Domestic consumers buy fewer units of imports.
- Domestic producers supply more to the market.
- The government earns some tax revenue.
- Foreign suppliers provide less to the market.

B: Non-tariff barriers.

These are other methods or policies used to restrict trade other than tariffs/taxes.

Non-tariff barriers take the following forms.

.

- **The use of quota system.** The government fixes the maximum quantity of a particular commodity to be imported or exported during a certain period and nobody should import/ export more than that set quantity.

  NB: Trade quota. This is the predetermined amount of commodities to be imported or exported by a country in a given period of time.

- **Subsidisation of domestic industries.** This is done in order to lower the operational costs and enable such firms to compete favourably with the foreign firms.
  This eliminates foreign firms from accessing local markets because their products become more expensive on the local market compared to locally produced goods.
- **Total ban/trade embargo.** This is a complete refusal or prohibition on the importation or exportation of certain commodities e.g. narcotics (heroine) fire arms etc. A ban itself means that it is totally illegal to import or export a given commodity.

Reasons for imposing a total ban

i. To discourage entry of harmful goods e.g. opium, pornography etc.
ii. To protect young domestic industries against foreign competition.
iii. To retaliate against another country i.e. used as retaliatory measure in times of trade conflict between countries.
iv. To save foreign exchange. This is especially when there is a severe shortage of foreign exchange and what is available is reserved for necessities.
v. To promote a faster rate of industrialization.
vi. To reduce imported inflation.
vii. To encourage self–sufficiency / reduce dependence.
viii. To create more employment opportunities

- **Administrative controls/direct administrative controls.** This is when the government specifies complicated and lengthy bureaucratic procedures which importers have to go through before they are cleared to import goods into the country i.e. it involves restrictions/tight bureaucratic procedures/process. This discourages some people from importing and thereby helping to reduce the inflow of imports in the country.
- **Special import deposits.** This is when importers are required to make special deposits with the central bank a certain percentage of the value of imports in money before they are allowed to import i.e. some deposits are related to the value of goods to be imported. This reduces the capital available for imports hence reducing the volume of imports since the capital is tied up with the central bank.
- **State trading.** This is the means of importing of some commodities by only the government. This means some commodities may be imported, while others not imported hence limiting the amount of imports in the country.
- **Licensing.** This is when the government issues limited number of licenses to limit the number and nature of importers and exporters. In case of imports, import licenses can be given to the few importers or can be issued at a higher price for importation of certain commodities or issued to only imports of basic/priority goods while denying them to importers of non-essential goods.
- **Quality control requirements.** This is where the importing country sets high quality standards which imported goods must meet/ conform to before they are allowed into the country thus reducing the inflow of imports. e.g. Uganda National Bureau of Standards.
- **Use of currency devaluation.** Through devaluation, the government legally/officially reduces the value of a country's currency in terms of other currencies which encourages exports as they become cheaper in foreign markets while reducing the demand for imports by making foreign exchange expensive hence a reduction in the volume of imports.

FREE TRADE:

This refers to one in which goods and services can be imported/exported without any trade barriers such as tariffs, quotas etc.

Free trade has always been described as an engine of economic growth because it encourages countries to specialize in the activities in which they have a comparative advantage thereby increasing their production efficiency as well as their production of goods and services.

MERITS OF FREE TRADE:

- **Leads to mobilisation/inflows of foreign resources.** For instance, it facilitates technological development because technology is transferred from developed countries to developing countries.
- **It widens the market for goods and services** since the producers are able to sell in both domestic and foreign markets.
- **It enables the firms to enjoy benefits of economies of scale.** This is because there is. increase in market size which enables firms to increase their scale of production leading to a fall in the average cost of production.
- **It encourages specialisation and its advantages**. It encourages specialisation and its associated advantages because firms are able to produce according to comparative advantage.
- **Wide varieties of goods are availed**. Consumers get a variety of goods and services since it enables goods of different types to be brought into the country from all the different countries of the world. This widens the consumers' choice.
- **Promotes international co-operation**. It improves international cooperation because trading partners become friends in order to sustain the benefits of international trade.
- **It increases resource utilisation.** This is because more resources are used to increase output as a result of a widened market due to free movement of goods across countries.
- **Discourages monopoly tendencies in the economy**. It prevents the emergency of monopoly power and its associated dangers because the local firms are allowed to compete with foreign firms.
- **Leads to improvement in the quality of goods**. This is as a result of competition between local and foreign firms.
- **Leads to creation of more employment opportunities**. It increases the level of employment as a result of increased investment to produce goods for the export market.
- **It accelerates the rate of economic growth**. This is because it enables the country to utilise the formerly untapped resources to increase output of goods and services demanded in the foreign market.
- **It encourages the development of labour skills.** This is because it enables the transfer of knowledge and skills from one country to another
- **It leads to increased efficiency of local firms**. This is due to competition between the local and foreign firms where the local firms are compelled to reduce the production costs in order to remain in business.

- **Helps to avoid expenditure on implementation of protectionist policy**. This is because there is free movement of goods across countries and therefore there is no need for governments to spend on things like subsidisation of local firms to enable them compete with foreign firms.
- **Discourages trade malpractices**. This is because people are free to import or export without any form of restriction and therefore there is no need to resort to malpractices like smuggling.
- **Encourages faster expansion of infant firms**. This is because of the widened market due to the removal of barriers to international trade, which enables the countries to sell to various countries and thus enabling such firms to grow and expand.

DEMERITS OF FREE TRADE:

- **Local industries are outcompeted**. Infant industries are outcompeted because of stiff competition from the foreign firms due to removal of all restriction to international trade.
- **Leads to importation of undesirable/harmful products**. It encourages the consumption of demerit/harmful goods because they freely enter the country and these can cause health hazards to the nationals.
- **It leads to imported inflation**. This is a case when goods are imported from countries suffering from inflation.
- It leads to quick depletion of resources due to the large market that has to be catered for.
- **It worsens the balance of payment problem/deficit.** This is especially so in developing countries which import excessively from the developed countries due to low levels of industrialisation in such countries.
- **It encourages dumping.** This is because some countries export commodities to other nations at prices much lower than the prices charged in their own countries, this leads to the collapse of the firms in the recipient countries.
- **Leads to low tax revenue from imports.** This is because of the removal of the tariff barriers to international trade.
- **Leads to unemployment.** This is due to the outcompeting of local firms by the foreign firms which produce better products and sell them at relatively low prices compared to the local firms.
- **Leads to low level exploitation of local resources.** This is because goods from other countries tend to outcompete the locally produced goods especially in developing countries, thus limiting resources exploitation due to limited market for the locally produced goods.
- **Results into increased external economic dependence**. This is because of the increased reliance on imported manufactured capital and consumer goods in the developing countries.
- **Worsens the country's terms of trade**. This is because of the increased importation of highly priced commodities especially in the developing countries, yet such countries continue exporting commodities cheaply due to the value added of such products.
- **Results into political dominance**. This is due to over importation from certain countries which makes such donor countries to dominate the political affairs of the importing countries.

TERMS OF TRADE:

This refers to the ratio of the price index of exports to the price index of imports.

OR: The rate at which the country's exports are exchanged for imports.

OR: The relationship between the price index of exports and the price index of imports.

Therefore, it shows the opportunity cost made in obtaining goods from outside by giving out home produced goods.

Terms of trade is the opportunity cost of obtaining goods through international trade rather than producing them at home.

$$\text{Mathematically T.O.T} = \left(\frac{\text{Price index of exports}}{\text{Price index of imports}}\right) \times 100$$

100 is the standard deviation in the measure of terms of trade.

The value of the T.O.T index is taken as 100 in the base year. Therefore changes in the T.O.T are measured by the changes in the value of this index. Thus T.O.T is said to be favourable whenever T.O.T index is greater than 100 or when it rises i.e. whenever export price rises relative to the price of imports. It can also be regarded as favourable when T.O.T is greater than one which means that a one unit of exports buys more than one unit of imports.

T.O.T is favourable to a country when:-

- the demand for its exports is price inelastic such that higher export prices result into higher export revenue e.g. oil producing countries enjoy a stronger T.O.T than those countries that produce primary products.
- the supply of the exports is price elastic so as to easily satisfy the increase in demand for exports.
- there is a fall in price of imports.
- there is a rise in the value of the country's currency against foreign currencies.

T.O.T is unfavourable when the T.O.T index is less than 100 or when it falls. i.e. Whenever export prices fall relative to import prices. It can also be taken as unfavourable whenever it is less than one meaning that a one unit of exports cannot buy a one unit of import; thus more exports are needed to purchase a unit of imports.

Study the table below showing the T.O.T for country X (2005-2013) and answer questions that follow.

Question

Year	Export price index	Import price index	Terms of trade
2005	100	100	100
2007	142	108	(131.5)
2009	120	114	(105.3)
2011	128	132	(96.9)
2013	154	173	(89)

(i) Calculate T.O.T for the years 2005-2013

(ii) Did country X experience favourable or unfavourable terms of trade in 2009? Give reasons.

NB : It is favourable T.O.T. This is because export prices (Shs 120) were greater than import prices (Shs 114) and the value of index is greater than100 (105.3).

TYPES OF TERMS OF TRADE

1. Barter /commodity TOT

This is the rate of price index of exports to the price index of imports. It shows how much exports are required to purchase a unit of imports.

OR: - It is the relationship between price index of exports and the price index of imports mathematically B.O.T = $\left(\frac{price\ index\ of\ exports}{price\ index\ of\ imports}\right)$

If the ratio is greater than one or greater than 100 such that one unit of export buys less units of imports, we have unfavourable barter/commodity terms of trade.

If the ratio is less than one or hundred such that one unit of export buys less units of imports, we have unfavourable barter/commodity terms of trade.

2. Income terms of trade

This is the ratio of the value of the total exports to the price index of imports of a country.
i.e. the import purchasing power of exports.

The ratio shows how much a country can import using income from exports. i.e. ability of the country to buy imports using the total income received from selling exports i.e. the capacity to import out of export earnings.

Mathematically income T.O.T = $\left(\frac{price\ index\ of\ exports}{price\ index\ of\ imports}\right) X\ Quantity\ of\ output\ exported$

Causes of unfavourable terms of trade in developing countries

Terms of trade in developing countries are unfavourable and such as deteriorating. This is because of the following.

- **Increasing substitution of exports with synthetic/artificial products by the developed countries.** This has resulted into declining demand and hence declining prices of imports leading to unfavourable terms of trade**.**
- **Protectionist policies of the developed countries**. This limits the accessibility to the market thus leading to the sale of export products at prices less than those of imports thus leading to deteriorating terms of trade.
- **Importation of expensive manufactured capital and consumer goods** yet developing countries export cheap products thus leading to unfavourable terms of trade.
- **Weak bargaining power of the developing countries on the world market.** since the prices of exports are determined by the buyers and in most cases, the developed countries determine low prices for our exports and yet we continue importing expensively leading to unfavourable terms of trade.
- **Invention of raw material saving techniques of production by the developed countries**. This leads to fewer units of raw materials being used in the production of final products thus leading to falling prices of our exports compared to the rising prices of imports and hence deteriorating terms of trade.

- **Low quality for exports of developing countries**. Exports from developing countries are generally of low quality compared to the products of the developed countries and as a result, the low-quality products are exchanges at unfavourable ratios with high quality products of the developed countries thus leading to unfavourable terms of trade.
- **Market flooding i.e. over supply of raw materials**. This leads to a fall in the prices of exports amidst rising prices of imports hence declining terms of trade.
- **Rising prices of imports amidst falling of exports**. Prices of imports on the world market are ever rising due to increasing transport costs, taxes etc yet export prices are kept low hence leading to unfavorable Terms of trade.

Effects of deteriorating terms of trade

- It leads to a decline in economic growth rate.
- It leads to a decline in employment levels.
- It leads to a decline in government revenue from taxation of exports.
- It leads to decline in incomes of export producers.
- Planning based on export earning becomes difficult.
- It leads to unfavorable balance of payment position.

Measures to improve the terms of trade:

Primary exports should be processed to add value. This will enable developing countries to sell their export products at higher prices

Adopt import substitution strategy. This will lead to increased local production of industrial products that were formerly imported; this will reduce the importation of expensive goods.

Diversify export market. This will widen the market for exports which increases the demand for the products and this will lead to an increase in prices of the export products.

Improve the quality of exports. This will attract more buyers which will increase the prices of such exports as a result of increased demand thus improvements in the terms of trade.
Encourage importation from cheaper sources. This will help such countries to avoid importing expensive goods to improve the terms of trade.

Diversify products for exports. This help to reduce the effects of price fluctuation and at the same time increase the demand for export products and thus increase prices of exports.
Foreign exchange rates should be stabilised. This will keep the demand for exports stable in order to sell at a high price.
Negotiate for the removal of trade barriers in the export market. This will increase the demand for the products due to the widened market which will lead to an increase in prices of exports thus improve the terms of trade.

Strengthen commodity agreements. These will help to negotiate for fair prices of products; this will improve the terms of trade.

BALANCE OF TRADE:

This refers to the difference between the **value of visible imports** and **value of visible exports**.

The balance of trade of developing countries has continued to worsen and this is because of the following reasons:-

- Exportation of mainly primary products which are of low value added.
- Excessive importation of expensive manufactured products which increase import expenditure.
- Low quality products are exported and these fetch low prices which reduce the earning of the developing countries.
- Determination of prices of exports by the developed countries and they usually set low prices of the exports from developing countries.
- Low income elasticity of demand for exports which leads to low demand for exports and eventually leading to low earnings.
- Low volume of exports which reduces the export earnings.

BALANCE OF PAYMENT:

This refers to the difference between a country’s receipts/ incomes from abroad and expenditure/payments abroad during a given time.

OR: It is a systematic record of a country’s receipts and payments in international transactions in a given year.

OR: The difference between earnings/incomes/receipts from abroad and payments abroad (visible and invisible trade and net capital transfers) of a country during a given time.

Receipts/earnings from abroad come from the following

- Capital inflows
- Grants/donations from abroad.

When the receipts/earnings are less than the expenditure abroad, the balance of payment is said to be unfavourable. However, when the earnings from abroad are more than the expenditure abroad, then the balance of payment is said to be favourable.

STRUCTURE/COMPONENTS OF THE BALANCE OF PAYMENT SHEET:

The B.O.P accounts consists of four components / accounts.

- Current account,
- Capital account,
- Monetary account and
- Errors and omissions.

1. **Current accounts (income Account)**

This is a summary /record of all transactions which involve the physical movement of goods and provision of services in a given period. Therefore, it records total incomes from the country's visible and invisible exports and the country's total expenditure on visible and invisible imports. It is divided into sub accounts.

(a) Visible trade account (trade in goods/ balance of trade account)

This is an account that records all receipts/ revenue from visible exports (export of goods) and all expenditure /payments on the visible imports (imports of goods). The difference between revenue (foreign exchange) from exports and expenditure on imports is called **Balance of Visible Trade or Visible balance/trade balance.**

When the value of visible exports exceeds the value of visible imports on this account, the country is said to have a **favourable trade balance (balance of trade surplus)**. When the value of visible imports exceeds the value of visible exports, it is **unfavourable balance of trade (balance of trade deficit/adverse Trade Balances).**

(b) Invisible Trade (Trade in services).

This is an account that records the revenue from services rendered abroad (invisible exports) and expenditure on foreign services (invisible imports. **i.e.** shows the transactions made with the rest of the world in terms of services e.g. Banking, Tourism, Insurance, Air and sea freight for exports and imports etc.

The difference between all the credit (receipt from abroad) and all the debts (expenditure abroad) rising from visible and invisible transactions is called. **"Balance of payment on current account**. This is the best indicator of a country's trading position.

NB: When the value of visible and invisible exports exceeds the value of visible and invisible imports it is called "**favourable current account (current account surplus**).

When the value of visible and invisible imports exceeds the value of visible and invisible exports it is called "**unfavourable current account (current account deficit)**

2. **Capital Account:**

This is an account that records all transactions arising from capital movements into (capital inflow) and out of the country (capital outflow). The movement may be of private capital or public capital. Capital flows may be in form of buying securities. (outflows) which involves purchase of foreign exchange by citizens and selling securities(inflow) which involves purchase of a country's currency by the foreigners. E.g. with outflows, assume Ugandans want to invest in Rwanda government treasury bills and bonds. Ugandans have to get foreign exchange from the bank of Uganda.

This becomes the debt item in the Uganda balance of payments. With inflows, if Rwanda residents want to invest in a new industry in Uganda, they have to purchase Uganda shillings from the bank of Uganda and surrender foreign currency. This becomes a credit item in the Uganda balance of payments.

3. **Official settlements/cash or monetary account/official financing account.**

This is an account that records the foreign exchange reserves as they are indicated in the current and capital accounts. It shows the surplus or deficit in B.O.P accounts and shows how the imbalance can be overcame or rundown i.e. shows how the deficit is financed or the surplus is spent.

(a) If there is a deficit on the combined current and capital accounts/monetary account, it means a shortage or decrease in foreign exchange reserves of a country. In this case, the government uses what is called accommodating items to offset a deficit. This may be through:-

- Using previous foreign exchange reserves.
- Borrowing from friendly countries.
- Borrowing from IMF and World Bank/ getting IMF facilities e.g. oil facility, special drawing rights etc.
- Selling securities e.g. bonds etc.
- Sell of gold reserves.
- Sell of investments of a country abroad (disinvestment).

This increases supply of foreign exchange to offset a deficit and create a balance on a debt and credit sides of B.O.P account.

NB: **Accommodating items** are items required/used to offset a deficit to attain a B.O.P stability/equilibrium.

(b) If there is a surplus, it is desirable as it indicates an increase in the foreign reserves on monetary account. However a surplus has to be disposed off to attain B.O.P equilibrium. In this case the government can use what is **called autonomous items.** This may be through:-

- Buying/purchase of IMF gold.
- Lending to other countries.
- Investing in assets abroad/in foreign countries.
- Giving out gifts and grants/ Aid.
- Purchase of domestic enterprises.

This item helps to decrease/reduce the foreign reserves hence getting rid of the surplus and creating balance.

NB: **Autonomous items** are items required/used to offset a surplus in order to attain B.O.P equilibrium.

4. Errors and Omissions. This is a balancing part of a B.O.P account that takes into account or considers errors and mistakes during calculation of figures or omissions made during collection of the data. It is provided to balance the B.O.P and since a B.O.P is a balance sheet, it must balance. i.e. the credit and debt sides of the B.O.P accounts statement must be equal or balance. Thus, it is used to make statistical adjustments to ensure that B.O.P balances. For this reason, a balancing item is inserted which is the difference between the known total of official financing and the recorded currency flows to correct disequilibrium.

NB: The balance of payment must always balance:

A mismatch between earnings and expenditure is called balance of payment equilibrium.

There are two types of balance of payment disequilibrium

Balance of payment surplus: This is a situation where earnings/receipts from exports are greater than the expenditure on imports in a given period of time

Causes of balance of payment surplus

- Appreciation in the terms of trade.
- Increased foreign exchange/capital inflow.
- High quality of products for exports.
- Reduction in the export expenditure.
- Political stability and hence less expenditure on the military hardware.
- A large export base/increased volume of exports.

Disposing off balance of payment:

- Offering grants/donations to developing countries.
- Lending to other countries.
- Construction of infrastructure.
- Accumulating reserves.

Balance of payment deficit: This is a situation where the country's expenditure abroad is greater than the country's receipts from abroad during a given period of time.

Causes of balance of payment deficit in developing countries:

- **Low volume of exports thus low export earnings**. The volume of developing countries exports is lower than the volume of imports due to reliance on natural factors in production and limited industrialisation leading to low quantity/volume of exports hence limited foreign exchange earnings yet there is high expenditure of foreign exchange on imports leading to balance of payment deficit.
- **Exportation of mainly primary products such as agricultural raw materials.** Developing countries mainly export primary products such as agricultural raw materials with low value added due to limited industrialisation and such products are less competitive hence fetch low foreign exchange earnings yet there is high foreign exchange expenditure on imports leading to balance of payment deficit.

- **Exportation of low quality exports.** Exports are mainly of poor quality due to poor methods of production and thus they are less competitive on the world market hence fetch less foreign exchange earnings compared to high foreign exchange expenditure on imports leading to balance of payment deficit.
- **High marginal propensity to import/ High preference for goods from other countries.** Most rich people in developing countries have high preference for goods from developed countries and this drains scarce foreign exchange on imports in the country yet there is little foreign exchange earnings from exports thereby leading to balance of payments deficit.
- **Political instability leading to heavy expenditure on the importation of military hard ware.** There is high expenditure on imports of military hardware and defense related equipment yet there are low foreign exchange earnings from exports and political instabilities also reduce productive capacity of developing countries leading to low volume of exports hence low foreign exchange earnings thus balance of payment deficit.

- **Importation of high volume of (manufactured consumer and capital) goods.** There is inelastic demand for highly priced imported goods like machinery, spare parts and this leads to high foreign exchange expenditure leading to depletion of foreign exchange reserves yet there are low foreign exchange earnings leading to balance of payment deficit.
- **High expenditure on payments/servicing debts.** There is accumulation of heavy external debt as a result of borrowing from external source and the payment of external debt obligation drains the scarce foreign exchange reserves yet there are low foreign exchange earnings from exports thus leading to balance of payment deficit.
- **Trade restrictions in export markets.** More developed countries protect their markets against imports from developing countries through tariffs and other non tariff barriers limiting the market for developing countries' exports and this limits foreign exchange earnings yet there is growing demand for imports that increases foreign exchange expenditure on imports thereby leading to balance of payment deficit.
- **Heavy government expenditure abroad** e.g. on diplomatic missions, contributions to international organisations. Most governments in developing countries have excessive expenditure on diplomatic missions, foreign travels, contributions to international organisations, etc which exhaust foreign exchange reserves yet there are low foreign exchange earnings from exports thus leading to balance of payment deficit.
- **High levels of profits and wage repatriation.** There is high rate of capital outflow in form of profits and income/wage repatriation by multinational corporations, foreign investors and expatriates and this reduces foreign exchange in the country yet there is low capital inflow thereby leading to balance of payment deficit.
- **Market flooding/ limited markets abroad due to exportation of similar products by developing countries.** Developing countries tend to export similar products to the same external markets and this result into excess supply or flooding of the markets leading to fall in prices of exports thus low foreign exchange earnings yet there is high foreign exchange expenditure on expensive imports leading to balance of payment deficit.
- **Prices of exports are externally determined by the major buyers/ MDCs.** There is weak bargaining power among developing countries for their exports which the major buyers the developed countries dictate/fix low prices for the developing countries' exports hence low foreign exchange earnings yet there is high foreign exchange expenditure on imports of manufactured goods leading to balance of payment deficit.

Limited variety of exports. Developing countries rely on a narrow range of mainly agricultural products, few industrial goods and limited services leading to low foreign exchange earnings yet there is high foreign exchange expenditure on imports thus leading to balance of payment deficit.

EFFECTS OF BALANCE OF PAYMENT DEFICIT IN AN ECONOMY

- Depletion of foreign exchange reserves/shortage of foreign exchange.
- High taxation levels result in a bid to finance the deficit.
- Limited levels of savings and investments due to high capital outflow.
- Inflationary conditions occur due to reduction in imports.
- Reduction in import capacity/volume of imports.
- Limited employment opportunities due to limited investments.

- Retards the rate of economic growth and development.
- Encourages currency depreciation.
- May lead to disinvestment abroad.
- Indebtedness due to external borrowing to cover the deficit. i.e. Increase the external borrowing to overcome the deficit.

MEASURES THAT CAN BE TAKEN TO REDUCE BALANCE OF PAYMENT DEFICIT IN DEVELOPING COUNTRIES:

- **Impose trade restrictions to discourage imports.** This can be through use of tariffs and non tariff barriers which reduce the volume of imports, thereby limiting foreign exchange expenditure on imports and thus improve the balance of payment position.
- **Promote import substitution industrialiation.** This will encourage production locally the industrial goods that were formerly imported which will reduce the volume of imports thereby cutting total spending abroad hence saving the scarce foreign exchange thereby improving balance of payment position.
- **Diversify export markets.** This can be done through formation of regional co-operation and consolidating existing ones. e.g. COMESA, EAC etc. which will help to widen or diversify the export markets through increased demand for exports thereby increasing export earnings hence improve balance of payment position.
- **Increase the volume of exports.** This will lead to an increase in the foreign exchange earnings which will lead to improvement on the balance of payment position.
- **Diversify exports/ widen exports.** This will call for production of a range/wide variety of export crops and industrial manufactured products so as to reduce dependency on few exports hence increase foreign exchange earnings and thus improve the balance of payment position.
- **Stabilise political atmosphere**. This will help to reduce huge expenditure on importation of military hardware hence reduce foreign exchange expenditure abroad and save the scarce foreign exchange which will lead to an improvement in the balance of payment position.
- **Undertake manpower development/training to reduce expenditure on expatriates**. This will increase the supply of local skilled manpower so as to reduce foreign exchange expenditure on expatriates hence save scarce foreign exchange which will improve the balance of payment position
- **Restructure foreign missions and reduce foreign travels by government officials.** This will reduce excessive government expenditure thus save the scarce foreign exchange originally spent on foreign missions and diplomatic travels which will improve on the balance of payment position.
- **Strength/ join commodity agreements to increase bargaining power in export markets.** This will increase bargaining power for higher/better prices for exports from developing countries hence increase foreign exchange earnings and thus improve the balance of payment position.
- **Appeal for debt relief/ debt conversion.** This will help to extend loan payment to a future date, so as to settle the accumulated debts and some debts voluntarily cancelled through negotiations thus reduce the high rate of capital outflow on debt servicing thus improve the balance of payment position.
- **Process exports to increase value and prices.** The increased value of exports will lead to increased prices of such exports which will enable developing countries to increase foreign exchange earnings and thus improve the balance of payment position.

- **Improve the quality of exports.** This will lead to increased demand for exports and thus these products will command high prices on the world market which enable developing countries to increase foreign exchange earnings and thus improve the balance of payment position.
- **Encourage depreciation of the currency/ devalue the domestic currency.** This will make local currency relatively cheaper which will make exports more attractive which will increase their demand hence increase earnings from exports and less expenditure on imports since they are expensive thus improve the balance of payment.
- **Negotiate for the removal of trade restriction on exports**. This will increase the market for products from developing countries which will lead to increase in foreign exchange earnings and thus improve the balance of payment position.

FOREIGN EXCHANGE RATE AND DEVALUATION:

FOREIGN EXCHANGE RATE:

This is the price of the domestic currency stated in terms of another currency.

In other words, a foreign exchange rate compares one currency with another to show their relative values.

TYPES OF EXCHANGE RATE:

FLEXIBLE/FLOATING EXCHANGE RATE SYSTEM:

This is where the rate of exchange of one country's currency into another country's currency is determined by the market forces of demand and supply.

NB: Flexible/Floating exchange rate: This is one at which the rate of the local currency exchanges for other currencies is determined by the market forces of demand and supply.

There are two types of floating exchange rate:

(a) Clean float exchange rate: This is one in which the rate at which the local currency exchanges for other currencies is purely determined by the market forces of demand and supply and there is no government interference at all.

(b) Managed exchange rate: This is one in which forces of demand and supply determines the rate at which the local currency exchanges for other currencies but with limits set by the monetary authority.

Merits of managed exchange rate:

- Safe guards importers and exporters from rapid and constant fluctuations in earnings which may cause losses.
- Control fluctuations of the currency rates.
- It ensures that there is stability in the exchange rate because it cannot go beyond the upper/lower set limit because it controls the actions of speculators.

General advantages of flexible exchange rate

- It provides an automatic mechanism for correcting the balance of payment disequilibrium.
- Preserves the independence/autonomy of the domestic monetary policy.
- It saves the country from the burden of holding large official reserves.
- It gives the most realistic value of the local currency against other currencies.
- It discourages the operation of the parallel exchange rate system.
- It encourages investment in the country because foreign investors can easily repatriate their profits.

Disadvantages of a floating exchange rate system

- It leads to uncertainty in the in the foreign exchange market.
- Projected planning is made difficult.
- It leads to inflation i.e. due to currency depreciation and hence increases in prices of imported goods.
- It leads to fluctuations in the foreign exchange earnings.
- It discourages long term contracts between borrowers and lenders and thus may discourage investment.

Currency depreciation: This is the **fall/decrease** in the **value** of the local currency in relation to foreign currencies under the **flexible exchange rate system.**

OR: It refers to the **fall** in **the value** of the local currency in relation to foreign currencies due to the interplay of the **forces of demand and supply** in the foreign exchange market.

Effects of currency depreciation

- It leads to inflation/rise in prices domestically.
- Projected planning is made difficult.
- Speculation is encouraged.
- It worsens the external debt burden.
- It encourages investment.
- It makes exporters receive higher local currency values.
- It supports higher prices paid to producers of exports.

Currency appreciation: This is the gain in the value of the local currency against other foreign currencies as a result of the interplay of the market forces of demand and supply.

Effects of currency appreciation:

- It reduces the volume of exports because exports become more expensive.
- It makes imports cheaper.
- It leads to increase in the volume of imports.
- It discourages domestic production because very few people are willing to buy exports.
- It reduces foreign exchange earnings and this is because it reduces the volume of exports.
- It discourages capital inflow.

FIXED EXCHANGE RATE SYSTEM: This is where the rate of exchange of one country’s currency into another currency is determined by the monetary authority/government.

OR: - This is where the rate of a given currency in relation to a convertible/ hard currency is determined by the government/monetary authority.

Note: - A fixed exchange rate. This is the one in which the rate of exchange of one country's currency into another country's currency is determined by the monetary authority.

Merits of a fixed exchange rate system

- It encourages long term contracts between borrowers and lenders.
- It helps to stabilize the value of the currency. This also stabilises domestic prices for goods and services in a given period of time.
- It encourages investment especially long term investments in a country.
- It discourages speculation in the foreign exchange markets.
- The public gains confidence in the strength of their local currency due to minimum depreciation of the currency.
- It encourages international trade i.e. it safe guards importers and exporters since it Minimises the possibilities of uncertainties.

Demerits of a fixed exchange rate system:

- It reduces the volume and value of international trade.
- It breeds black market in the foreign exchange market.
- It is expensive to administer since it is fixed by the government i.e government has to hire scouts to ensure that the policy is being abided by.
- It discourages foreign investments. This is because of the difficulty in remitting the profits/acquiring hard currency for purchase of intermediate goods.
- It promotes retaliation in foreign trade this is due to currency devaluation.
- It requires the maintenance of large foreign exchange reserves.
- It promotes corruption i.e. bribing officials in order to get the hard currency.
- It causes delay in trade because it is bureaucratic.

Foreign exchange control. This refers to **where** the state/monetary authority regulates the **rate** at which the local currency exchanges for foreign currencies.

FEATURES OF EXCHANGE CONTROL:

- Complete government control over the foreign exchange market.
- All foreign currencies are required to be surrendered to the central bank.
- The Central bank sanctions and allocates all foreign payments in respect of the different currencies.
- The central bank fixes the official exchange rate.
- There is regulation of the currency to be supplied to the importers.
- The exporters are required to surrender foreign currencies to the central bank.
- Only specified banks are licensed dealers that can deal in foreign exchange.
- The central bank acts as a discriminating monopolist by charging lower rates of exchange for the purchase of essential goods and higher rates for the purchase of luxury goods.

OBJECTIVES OF FOREIGN EXCHANGE RATE CONTROL:

- **To correct the unfavourable position**. Imports are limited by limiting the allocation of foreign currencies for importation thus with limited imports and limited outflow of foreign exchange, balance of payment position improves.
- **To stabilise the exchange rate**. This is because the exchange rate will be determined by the monetary authority and it will not keep changing.
- **To achieve price stability/ control inflation**. This is because currency regulation will be used to allocate foreign exchange for the importation of essential goods to supplement the domestic supply.
- **To encourage investment.** This is because foreign exchange control will prevent capital flight /capital outflow. Flight /foreign capital will be averted and this will instead be used for investment at home.
- **To protect domestic industries.** Exchange control will protect domestic industries against competition by foreign producers; this will be done by allocating the foreign exchange for only importation of goods not locally produced.
- **To control the importation of undesirable goods.** Imports of harmful products will be reduced by the allocation of less foreign exchange for their importation. This will reduce their inflow in the country.
- **To raise revenue for government.** Exchange control is used as a means of raising revenue for the government by the exchange authority selling to traders foreign currencies at rates higher than the rate it buys from them.
- **To check capital flight/ control capital outflow.** This because foreign exchange control will limit capital outflow, since the monetary authority will remit the amount of foreign exchange that moves out of the country.
- **To ensure availability of foreign exchange.** This is because the monetary authority will allocate more foreign exchange to those who intend to import essential goods such as consumer goods and intermediate goods to facilitate industrial development.
- **To acquire foreign exchange for servicing the country's external debts.** This will be done by fixing the value at which the local currency exchanges for foreign currencies at a higher value than that allowed by the market forces of demand and supply. The currency will be undervalued in order to import more goods at lower prices, import capital equipments and raw materials so as accumulate reserves to pay a large foreign debt.
- **To discourage speculation in the foreign exchange market.** Control of foreign exchange rate maintains the rate at which the local currency exchanges for other currencies over a long period of time. This discourages speculation because the exchange rate doesn't change.
- **To encourage long term planning.** This is because foreign exchange control will ensure a stable exchange rate which will promote long term planning.

CURRENCY DEVALUATION: This refers to the legal or official reduction or lowering of the value of the country's currency in terms of other currencies.

OR:- The lowering of the value of the local currency against foreign currencies by the central bank/government/monetary policy.

Devaluation makes local currency relatively cheaper while external currency more expensive. Therefore exports become cheaper and their demand increases leading to increase in foreign exchange earnings while imports become relatively expensive which reduces the demand for imports leading to a reduction in foreign exchange expenditure hence improving the balance of payment position.

NB: Devaluation is only possible when there is a fixed exchange rate and the government can fix the rate of currency in relation to other currencies.

Given that the exchange rate is 1poud = Ug. Shs. 1000, Calculate the new exchange rate after devaluation of the Shilling by 20%.

Answer

New exchange rate = 1,000 + $\left(\frac{20}{100} \times 1{,}000\right)$ Ug Shs.

=1,000+200

1pound = Ug Shs. 1,200

OR:

$\frac{120}{100} \times$ 1,000

1pound = Ug. Shs. 1,200

RATIONALE/REASONS FOR CURRENCY DEVALUATION

- **To increase the volume of exports.** It makes exports relatively cheaper leading to increase in their demand on world market thereby leading to increase in foreign exchange earnings.
- **To reduce the volume of imports.** Foreign currency becomes relatively more expensive making imports expensive reducing the demand for them thereby reducing foreign exchange expenditure on imports.
- **To improve B.O.P position.** Devaluation reduces the volume of imports which reduces foreign exchange expenditure on imports and increases foreign exchange earnings from increased exports thus improving B.O.P position.
- **To increase foreign exchange earnings.** This results from increase in the volume of exports as they become relatively cheaper.
- **To increase foreign capital inflow.** This is by foreign investors who are attracted to invest in a country whose demand for its exports abroad is high which boosts their profit margin.
- **To encourage domestic production/protect domestic industries.** Devaluation increases nominal income of producers/farmers who produce for exports. This acts as an incentive to producers to increase production to meet external demand.
- **To promote self reliance/ to reduce foreign dependence.** Devaluation discourages demand for imports as they become expensive and encourages consumption of locally produced goods hence promoting self reliance.
- **To retaliate against trading partners that have devaluated their currencies.** Devaluation is used as a retaliatory measure against high tariffs imposed by other countries on a country's exports. i.e. beggar-my neighbor policy.
- **To check on imported inflation.** Devaluation makes imports relatively expensive which minimizes possibility of importing goods from inflation prone countries.
- **To fulfill the IMF and World Bank conditionality.** Devaluation is sometimes inevitable to fulfill the IMF World Bank conditions. This helps a country (especially LDCs) to get foreign aid.

- **To discourage dumping**. This is by reducing the volume of imports which become relatively expensive by devaluing a country's currency.

POSITIVE EFFECTS OF CURRENCY DEVALUATION:

- It leads to an increase in the volume of exports.
- It leads to reduction in the volume of imports because devaluation makes imports more expensive.
- Increases foreign exchange earnings because of increased volume of exports.
- Leads to improvement in the balance of payment position because of the reduction in import expenditure and an increase in export earnings.
- Leads to an increase in capital flow.
- It checks on imported inflation.
- It discourages dumping and its related evils.

NEGATIVE EFFECTS OF CURRENCY DEVALUATION:

- **Leads to retaliation by other trading partners (beggar-my neighbour policy).** This reduces export earnings and strains the relationship between or among trading partners.
- **Leads to inflation if the price elasticity of demand for imports is inelastic.**
- Devaluation reduces the level of imports leading to increase in their prices hence causing inflation in an economy.
- **Discourages domestic investment.** This is by increasing prices of raw materials and capital goods as imports become expensive leading to increase in costs of production.
- **May lead to deterioration of T.O.T.** This is a result of low prices of exports and an increase in prices of imports.
- **B.O.P may worsen in case demand for imports by the devaluating country is inelastic.** This implies increased expenditure on imports worsening B.O.P problem.
- **Leads to persistent government budgetary deficit.** This is due to increased government expenditure on imports.

CONDITIONS NECESSARY FOR DEVALUATION TO SUCCEED IN SOLVING A COUNTRY'S BALANCE OF PAYMENT PROBLEM:

Certain conditions must be met for devaluation to be successful. These include: -

- **Demand for a country's exports must be price elastic**. If the demand for exports is price elastic, a small reduction in price (resulting from devaluation) leads to proportionately larger increase in quantity demanded of exports hence more foreign exchange earnings.

- **The domestic demand for imports must be price elastic** (The demand for imports of the devaluing country must be price elastic). Devaluation makes imports more expensive, therefore a small rise in price of imports leads to a larger reduction in quantity demanded of imports hence less expenditure of foreign exchange.
- **The domestic supply of exports must be price elastic** (i.e. the supply of exports of the devaluing country must be price elastic). As the demand for exports in foreign markets increases, supply of exports in the devaluing country should also increase in order to meet the increase in demand so as to increase foreign exchange earnings.
- **The supply of imports to the devaluing country must be price elastic.** A slight increase in the price of imports should result into/ lead to a significant decrease in quantity demanded of imports in the devaluing country.

- **Competing countries/trading partners must not devalue at the same time.** There should be no retaliation/counter devaluation at the same time or at same rate by the trading partners. Counter devaluation re-establishes a situation similar before devaluation as exports of the devaluing country do not become cheaper in comparison to products of the competing countries e.g. not all coffee producing countries should devalue at the same time.
- **There should be no inflation in the exporting country.** Inflation erodes the competitive advantage secured by the devaluation. It makes the country's exports expensive which reduces foreign demand for exports.
- **There must be a fixed exchange rate regime in the devaluing country.** There should be only one official rate regime/ruling fixed by the government. Therefore there should be no parallel or multiple foreign exchange markets where importers can obtain foreign exchange currency at lower rates.
- **There must be no restrictions/trade barriers on the exports of the devaluing country.** Trade barriers reduce the smooth flow of exports hence less foreign exchange earnings.
- **There must be political stability in the devaluing country.** This ensures increased production for exports and a stable capital inflow.
- **There must be strong administrative machinery to co-ordinate and implement the devaluation policy timely and effectively.**
- **The exchange rate must be fixed by the government.** This enables the government to lower the value of its currency in relation to other currencies.

CIRCUMSTANCES UNDER WHICH DEVALUATION MAY FAIL TO ACHIEVE ITS OBJECTIVES/FAIL TO SOLVE BALANCE OF PAYMENT PROBLEM IN AN ECONOMY

Devaluation is intended to increase exports and reduce imports thereby improving balance of payment position. However this may not be possible or achieved under the following circumstances.

- **When domestic demand for imports is price inelastic.** In this case, a rise in import price does not reduce demand for imports. The quantity demanded of imports remains more or less the same hence foreign exchange expenditure remains high hence failing to solve the balance of payment problem.
- **When demand for exports is price inelastic.** In this case the quantity purchased/demanded of exports remains more or less the same as before even if the price of exports reduces hence still lower foreign exchange earnings from exports.
- **When the supply of exports is inelastic especially in the short run/when there is full employment of resources.** Supply may be inelastic due supply rigidities like long gestation period for agricultural products, exhaustion of a certain raw material, etc hence failing to satisfy the increase in the foreign demand thus less foreign exchange earnings.
- **When the supply of imports is price inelastic.** Even if prices of imports increase, the supply of imports may not reduce as more or less quantity of imports are demanded which leaves foreign exchange expenditure the same.
- **When the competing countries devalue at the same time or at the same rate.** Competitive devaluation/retaliation by the trading partners may make their exports appear more attractive taking a way the competitive advantage gained by the devaluing country, hence foreign exchange earnings remain low.
- **When the devaluing country is experiencing inflation.** High rate of inflation leads to high prices for exports and therefore low demand for them and less foreign exchange earnings. Therefore inflation erodes the competitive advantage secured by devaluation.
- **When the devaluing country has various/multiple exchange rates.** This enables importers to secure foreign exchange elsewhere at more favourable rates than the official exchange rate fixed by

the government. In other words it becomes hard for the government to legally lower the value of the currency in terms of foreign currencies.

- **When there are restrictions imposed on a country's exports.** Protectionist policies like tariffs, quotas etc imposed on a country's exports limit the quantity of exports hence limiting foreign exchange earnings.
- **When there is political instability in devaluing country.** Political instability makes investment and production to increase exports difficult leading to less export earnings. Also it increases expenditure on military hardware which increases foreign exchange out flow hence worsening balance of payment problem.
- **When a country's exports are of poor quality.** Poor quality products are less competitive on the world market and therefore even if the prices of exports reduce, quantity demanded may remain more or less the same hence less foreign exchange realized

REASONS WHY DEVALUATION FAILS TO SOLVE BALANCE OF PAYMENT PROBLEM IN DEVELOPING COUNTRIES:

- **The developing countries' demand for imports is price inelastic.** Many of the imports are essential goods which cannot be substituted by local products e.g. machinery, drugs etc hence there is continued expenditure of foreign exchange even with an increase in the cost of imports since demand remains high.
- **The demand for developing countries' exports is price inelastic.** Developing countries mainly export unprocessed or semi–processed primary products whose demand is inelastic hence less foreign exchange earnings.
- **The supply of developing countries' exports is price inelastic.** There are structural bottlenecks or rigidities like drought, long gestation for agricultural products, political instabilities etc which limit the supply of (primary) exports hence low foreign exchange earnings.
- **The supply of imports is price inelastic.** Even if prices of imports increase, the quantity of goods imported remains more or less the same hence the same expenditure of foreign exchange as before.
- **There is competitive devaluation/ counter devaluation from trading partners.** Developing countries almost produce and export similar goods and therefore tend to devalue their currencies at the same time. This erodes the advantages secured by devaluation hence earn less foreign exchange from their exports.
- **Discriminatory and trade restrictions of developed countries against exports from developing countries.** This limits market for developing countries exports in developing countries and hence reduces the rate at which foreign exchange earnings are accumulated making no improvement in balance of payment position.
- **Developing countries mainly produce and export low quality products.** These products are less competitive on the world market and therefore fetch low prices leading to less foreign exchange earnings, thus failure to improve the balance of payment position.
- **There are multiple foreign exchange rates.** Importers easily obtain foreign exchange at favourable rates than the official exchange rate hence the government failure to control foreign exchange outflow.
- **Expansionary monetary policies employed developing countries** This leads to increase in purchasing power for imports hence increased foreign exchange expenditure.
- **There are high levels of inflation in many developing countries.** This makes exports expensive which reduces foreign demand for exports hence less foreign exchange earnings.
- **Most developing countries experience political instabilities**. Political instabilities discouraged investments and production hence reduced export capacity of developing countries thus less foreign exchange earnings.

- **Presence of parallel /multiple foreign exchange markets.** This makes the value of the local currency appreciate against foreign currencies hence making exports expensive.

CURRENCY REVALUATION: This refers to the official/ legal rising of the value of a country's currency in terms of the other currencies/foreign currencies.

Given that the exchange rate is 1poud = 1000 Ug Shs. Calculate the new exchange rate after revaluation of the Shilling by 20%.

Answer

New exchange rate = 1,000 - $\left(\frac{20}{100} \times 1{,}000\right)$ Ug Shs.

=1,000-200

1pound = Ug Shs. 800

OR:

$\frac{80}{100} \times$ 1,000

1pound = Ug. Shs. 800

OTHER TERMS ASSOCIATED WITH FOREIGN EXCHANGE RATE/SYSTEM:

Pegged exchange rate: This is the one set/determined by the country's monetary authority in relation to a particular currency

OR: This is the one set/determined by the country's monetary authority in relation to a particular currency.

Dual exchange rate. This is one in which there are two official exchange rates in the economy one for priority sector and another one for non priority sector fixed by the central bank.

The Central Bank can decide to operate two exchange rates like a fixed exchange rate and a free exchange rate. E.g. in Uganda between 1982 to1984, there was window 1 operated under a fixed exchange rate for importers of priority/essential goods and window 2 under flexible exchange rate for non-priority goods.

Reasons why a country may adopt a dual exchange rate system:

- To encourage importation of essential goods e.g. machinery
- To encourage the development of priority sectors.
- To promote investments in the country.
- To promote the growth the infant industries.
- To enable investors obtain foreign currencies

Advantages of Dual Exchange rate

- Reduces depreciation of the domestic currency.
- Reduces speculation activities in foreign exchange market.
- Minimises over valuation and under valuation of domestic currency.
- Reduces B.O.P problem by fixing different rates for imports and exports.
- Makes foreign exchange available to all categories of importers.
- Enables a country to encourage imports which are of national priority and discourages those which are not.

- Monetary authorities maintain control over the exchange rate.
- Gives confidence to foreign investors since the government can maintain control over exchange rate.

Disadvantages of Dual exchange rate

- Leads to malpractices such as over invoicing imports and under invoicing exports due to big exchange rate differentials.
- Distorts world trade and hinders/limits free flow of foreign exchange

Currency under valuation: It refers to the fixing of the value of the country's currency by the government below the equilibrium exchange rate (true/actual value)

E.g. If the equilibrium exchange rate is us $1 = Ug Shs 1000/= and the government fixes the exchange rate at us $1= Ug Shs 1500/=
This makes exports very cheap and the imports very expensive.

Effects of currency under valuation:

- It increases the exportation of goods
- It reduces imports
- It leads to increased capital inflow
- It encourages domestic production.
- It reduces imported inflation.
- It improves on the balance of payment position of a country due increased foreign exchange inflow.
- It worsens the external debt burden.

Currency over valuation:

This is fixing the value of the country's currency by a monetary authority above the equilibrium exchange rate or at a much higher value than its real price in the market.
e.g. If the equilibrium/real value of a shilling is US$1=Ug Shs 1000/= and the government fixes the exchange rate at US $1=Ug Shs 500/=

FOREIGN EXCHANGE RESERVES: These are foreign currencies held by the country's central bank, used to pay its liabilities.

OR: It refers to the total value of all foreign currencies and special drawing rights held by the country as both reserves and a fund from which international payments can be made.

FOREIGN EXCHANGE MARKET: This is a market where foreign exchange is traded at a price that is expressed by the exchange rate.

FOREIGN EXCHANGE EARNINGS. This refers to the country's income from other countries mainly through exportation.

NET FOREIGN EXCHANGE EARNINGS. This refers to the sum total of all currency receipts less expenditure abroad during a given fiscal year

SOURCE OF FOREIGN EXCHANGE:

- Exports of goods e.g. Coffee, cotton, tea etc.
- Exports of services e.g. banking, tourism, transport, etc.
- Capital inflow from foreigners wishing to invest in the country or wishing to buy shares in companies.
- Borrowing from abroad.
- Remittances and transfers from nationals working abroad.
- Unrequited transfers such as gifts and donations from abroad.
- Foreign travelers in the country e.g.by tourists.
- Divestiture/selling assets abroad and within the country.
- From foreign diplomatic mission and non government organisations within the country e.g. UNICEF, IMF etc.

Reasons why foreign exchange is demanded

- For payment of membership subscription fees in the international organisation such as UNICEF. World Health Organisation, African Union
- In order to pay expatriates.
- For local investors who may want to invest in foreign countries.
- To purchase imports

CAUSES OF FOREIGN EXCHANGE SHORTAGE IN DEVELOPING COUNTRIES:

- **Heavy debt burden.** This is caused by debt serving of the accumulated debts which leads to capital outflow that reduces foreign exchange reserves thereby causing a shortage of foreign exchange in the country.
- **Massive/excessive profit repatriation by foreign investors and multinational corporations.** Most of the investments are owned by foreigners who repatriate profits to their mother countries hence causing a shortage in foreign exchange.
- **Narrow export base/low export diversification.** Most LDCs export a limited variety/range of exports thereby earning less foreign exchange.
- **Limited markets for exports/poor quality exports.** LDCs export goods with no or low values added because of limited industrialization. These exports don’t compete favourably on the world market hence fetch less foreign exchange.
- **Existence of political instabilities.** Political instability lead to high expenditure of foreign exchange on military hard ware and other defense related equipment thereby reducing foreign exchange reserves.
- **Limited and absence of investment ventures abroad.** There are generally no or limited investments abroad that can generate foreign currency unlike MDCs that have many investments in different countries.
- **High marginal propensity to import.** LDCs tend to spend excessively on imports of manufactured and consumer goods which drain the scarce foreign exchange.

- **Excessive government expenditure on diplomatic missions, foreign travels, etc**. This exhausts foreign exchange reserves
- **Low levels of industrialization**. This results into unfavourable T.O.T and thus low levels of foreign exchange earnings.
- **Ever increasing prices of petrol products.** This leads to increased expenditure of the scarce foreign exchange on imports of petrol products hence leading to further shortage of foreign exchange.
- **High levels of corruption and mismanagement of foreign exchange by government officials.**
- **Breakdown of import substitution industries.**

POLICIES FOR CONSERVING FOREIGN EXCHANGE IN DEVELOPING COUNTRIES:

- **Diversify exports.** This involves exporting of a wide range/variety of exports so as to increase on foreign exchange earnings.
- **Encourage/promote import substitution industrial development strategy.** This encourages production locally industrial goods that were previously imported hence saving scare foreign exchange.
- **Adopt/promote export promotion industrial development strategy**. This aims at producing for external market and increase exports of manufactured goods that fetch more foreign exchange earnings.
- **Form / join regional co-operation/economic integration.** This increases market for exports hence more foreign exchange earnings.
- **Improve the quality of exports**. This aims at attracting foreign markets so as to earn more foreign exchange.
- **Restructure foreign missions and diplomatic travels**. This reduces government expenditure hence saving the scarce foreign exchange.
- **Ensure proper manpower planning.** Ensure training of local man power and emphasize the use of local labour force other than expatriates thereby reducing foreign exchange expenditure on expatriates.
- **Ensure political stability.** This reduces foreign exchange expenditure on military hardware hence saving the scarce foreign exchange.
- **Encourage Barter trade system of exchange.** This saves scarce foreign exchange that would be spent on imports.
- **Appeal for debt rescheduling and cancellation**. This reduces debt service hence reducing foreign exchange outflow.
- **Undertake trade restrictions**. This discourages imports thereby saving scarce foreign exchange.
- **Improve the tax system**. This improves the domestic earnings and hence reduces external borrowing.

- **Ensure proper foreign exchange allocation by government to reduce mismanagement** Through import restrictions in order to reduce foreign exchange expenditure on imports

FACTORS THAT DETERMINE THE DEMAND FOR FOREIGN CURRENCY:

- **Price of imports.** An increase in price of imports leads to an increase in demand for foreign currency to buy a unit of import as imports become expensive where as a decrease in price of imports reduces import expenditure hence demand for foreign currency.
- **The volume of imports.** An increase in the volume of imports leads to an increase in demand for foreign currency to meet an increase in expenditure on imports where as a decrease in the volume of imports leads to a decrease in demand for foreign currency since fewer imports of goods and services are required/imported.
- **Debt servicing requirements.** When the debt servicing requirements are high, the demand for foreign currency is also high to service the debt. When the debt servicing requirements are low the demand for foreign currency is also low.
- **Need to accumulate reserves.** When the need to accumulate reserves is high, it implies keeping more foreign currency to create more reserves hence an increase in demand for foreign currency. When the need to accumulate reserves is low, it implies keeping less foreign currency and hence less demand for foreign currency.
- **Government's external obligations.** When the government external obligations are many, the demand for foreign exchange is high to meet the external obligations but when the external obligations are few, the demand for foreign exchange is low.
- **Corporate repatriation needs.** When the need for corporate repatriation (by foreign investors or firms) is high, it implies having more foreign currency and hence high demand for foreign currency. Less corporate repatriation needs implies having less foreign exchange and hence less demand for foreign currency.

THE FACTORS THAT DETERMINE THE SUPPLY OF FOREIGN CURRENCY:

- **Price of exports.** An increase in price of exports makes exports expensive on the world market which reduces foreign demand for them hence less supply of foreign currency. A reduction in price of exports makes them more attractive on the world market leading to an increase in volume of exports hence more foreign currency is supplied.
- **Volume of exports.** An increase in the volume of exports results into an increase in export earnings hence an increase in supply of foreign currency. A reduction in the volume of exports reduces the inflow of export earnings hence less supply of foreign currency.
- **Levels of capital inflow.** An increase in the level of capital inflow inform of grants, donations etc leads to increase in supply of foreign currency. Whereas a reduction in the level of capital inflow either because of political instability etc reduces the level of supply of foreign currency.
- **Central Bank intervention in foreign exchange market.** When the central Bank pursues restrictive monetary policy measures, the supply of foreign exchange is low. On the other hand when the central Bank relaxes its policy, the supply of foreign exchange in the economy is high.
- **Government's external borrowing for consumption.** An increase in government external borrowing leads to an increase in supply of foreign currency to meet the increase in consumption expenditure. A reduction in government external borrowing implies less expenditure on consumption hence less supply of foreign exchange.

FACTORS THAT DETERMINE AN EXCHANGE RATE IN AN ECONOMY:

- **The rate of domestic money supply**. A high rate of domestic money supply brings about a weaker local currency. This is because there is too much money available to buy less of the foreign currency hence loss in value for the domestic currency. While a low rate of domestic money supply leads to a stronger local currency since less foreign currency is needed this makes the domestic currency stronger.

- **The volume of exports**. A high volume of exports brings about a stronger local currency because more foreign currency is brought into the country to buy more exports which increase the value of the local currency. However a lower volume of exports leads to a weaker local currency since less foreign currency is brought into the country thus leading to a decrease in the value of the local currency.
- **The volume of imports**. A high volume of imports leads to a weak local currency because a lot of foreign currency is needed to import more goods thus loss of value of the domestic currency. On the other hand, a low volume of imports brings about a strong local currency since less foreign exchange is required for the importation of goods leading to high value of the local currency.
- **The level of foreign exchange reserves/Ratio of the foreign reserves to the domestic money supply.** The high ratio of foreign exchange reserves to the domestic money supply leads to a stronger local currency exchange since less of the foreign exchange is demanded hence increasing the value of the local currency a low ratio of foreign reserves to the domestic money supply leads to a weaker local currency because more foreign exchange is needed to supplement the low reserves leading to a weaker local currency.
- **The demand and supply of foreign exchange:-** the demand and supply of foreign exchange has a direct effect on the movement of the exchange rate. A high demand for foreign exchange leads to a weaker currency since too much of the foreign currency is needed leading to low value of the local currency while a low demand for foreign exchange leads to a stronger currency. This is because loss of foreign exchange is needed resulting into an increase in the value of the local currency.
- **Government policy on exchange rates**. In case of a fixed exchange rate system where the government deliberately devalues the country's currency, it increases the exchange rate and hence lowers the value of the local currency in terms of foreign currencies. On the other hand, the government revalues her currency; it lowers the exchange rate which leads to an increase in value of the country's local currency in relation to other foreign currencies.
- **The level of capital inflow**. Increased capital inflow leads to increased supply of foreign exchange which lowers the exchange rate and hence leading to appreciation of the local currency in comparison to foreign currencies yet increased capital outflow leads to reduced supply of foreign exchange in the economy in the economy which raises/increases the exchange rate and hence leading to depreciation of the local currency.
- **The rate of inflation in other countries**. A higher rate of inflation in other countries leads to an increase in demand for foreign exchange due to high costs of importation. This leads to an increase in exchange rate and hence leas to depreciation of the local currency. Which a low rate of inflation in thither countries leads to a decrease in demand for foreign exchange due to low costs of importation. This lowers the exchange rate thus appreciation of the local currency.
- **Political climate/atmosphere of the country**. Instability leads to increased demand for foreign exchange by a country in order to buy arms and ammunitions and at the same time political instability destroys production unite which leads to increased importation of goods. This leads to an increase in the exchange rate and therefore deprecation of the local currency. While political stability leads to less demand for foreign exchange due to reduced desires of importation of fire arms and also other consumer goods because they can now be produced domestically due to political stability. This lowers the exchange rate and hence appreciation of local currency

- **The volume of domestic output.** A high volume of output produces leads to a stronger local currency since less foreign exchange is needed for importing goods hence high value of domestic currency. However a low volume of domestic output leads to a weaker local currency because of high need for more foreign exchange.

ECONOMIC CO-OPERATION/INTEGRATION:

This is the coming together of **two or more** countries in **a given region** for the sake of **mutual economic benefits** of all member states.

OR:-The merging to various degrees the economies and economic policies of two or more countries in a given region for the mutual benefits of member countries.

Examples of economic integration include:

i) The European Union (EU)

ii) The Economic Community of West African States. (ECWAS)

iii) The East African Community (EAC)

iv) South African Development Community (SADC)

v) Kagera Bain Organisation (KBO)

This cooperation aims at increasing the benefits of international trade to member countries and can still result into political co-operation which may reduce costs of national conflicts and possibility of wars and also free movement of people may facilitate peace within the region

STAGES/FORMS OF ECONOMIC INTEGRATION:

1. Preferential Trade Area (PTA): This is the first stage of economic integration where countries give preferential treatment to one another in the religion by reducing tariffs on selected goods from the member states while maintaining tariff on non-selected goods in the member states.

2. Free Trade Area (FTA). This is a form of economic integration where countries eliminate trade barriers amongst themselves but they charge different external tariffs while trading with non-member countries.

3. Customs Union. This is a form of regional cooperation in which member states in addition to eliminating trade barriers amongst themselves agree to impose a common external tariff on non-member states.

4. Common Market. This is the form of regional Corporation where member states eliminate trade barriers, have a common external tariff on non-member states, have free mobility of factors of production as well as sharing common external services.

5. Economic Union. This is the form of region corporation where a member state eliminate trade barriers among themselves have a common external tariff for non-member states, have free mobility for factors of production, have common social services and in addition have a common fiscal policy.

6. Political Union/Complete integration. This is the highest level of integration and at this level, the member states surrender all national sovereignty to the regional supreme body and in some cases the regional supreme body and in some cases the region has one president

Conditions necessary for the success of economic integration

- The countries joining should be relatively at the same level of development
- There should be political stability in the region so as to create a conducive climate for investment in all the countries.
- The countries joining should not be producing so as enable exchange among themselves.
- There should be good infrastructural development i.e. good roads, communication facilities e.t.c so as to enable easy movement of goods from one country to another.
- The countries joining should be in the same geographical area so as to minimize the cost of transporting goods.
- The countries joining should have the same political ideology. This ensures that they should have similar political systems.
- There should be no social difference in terms of religion, culture, languages etc all these should be the same.
- Countries should have the same economic policies. This becomes easy to integrate the policies.
- There should be a bigger population size in the religion so as to provide a bigger market for the products.
- The countries joining should have common currency in order to remove the burden of currency conversation.

REASONS FOR ECONOMIC INTEGRATION:

- To promote international trade among the member states because of the removal of trade barriers such that goods move from one country to another freely.
- To stimulate the expansion and establishment of manufacturing industries as a result of expanding the market, more industries are established to produce goods and services.
- To promote resources utilisation (vent for surplus). This is due to widened market which puts more resources to use in order to increase output and serve a bigger market.
- To have easy access to foreign resources because donors find it easier to lend money to an integration rather than individual countries.
- To reduce the average cost of carrying out research because the cost of research is carried out among the member countries and then the information is shared.
- To improve the quality of products arising from competition between the different industries within the region.
- To increase the bargaining power of the country in the region because now they bargain for fair prices of their products as a group but not as individual countries.
- To share common services/ to improve infrastructure i.e. modern infrastructure is put in place and such modern infrastructure like good roads eases the movement of goods from one country to another.
- To promote international relations/understanding. This because co-operation among member states is enhanced as a result of trading with another countries..
- To create employment opportunities as a result of free mobility of factors of production as well as employment opportunities created by the big industries established.

- To promote economic growth. This arises from increased production of goods and services in order to serve a bigger market.
- To promote investment within the region. This is due to a large market that compels producers to produce more output.
- To promote a variety of goods and services among the member states. This is because different types of goods come from different countries within the region which widens the consumer's choice.

Merits of regional economic integration:

- It leads to trade creation effect. This encourages specialisation and utilization of resources:

Note: **Trade creation** refers to the situation where trade shifts from a **high cost** non member country to a **low cost** member country (ies) as a result of economic integration.

OR:- This is a state where formation of an economic cooperation results into a country buying **cheaply** from a country what it formerly bought more **expensively** from non member countries.

Effects of trade creation

i) Leads to low prices for goods and services.

ii) Increases resource utilisation

iii) Promotes trade among member countries.

- It leads to creation of a wide market /It results into a vent for surplus i.e. resources formerly unutilised are utilised because of the widened market resulting from economic integration.
- It increases resource utilisation hence avoiding wastage.
- It leads low average cost of joint research/ Encourages joint research/ leads to sharing of cost of research.
- It encourages countries to compete and this improves the quality of the products they produce.
- It improves the bargaining position/power of the region internationally; this is because the member states negotiate as a block.
- It leads to joint provision of infrastructure e.g. railway services, this eases movement of goods among the member countries.
- It creates political co-operation and understanding among the member countries, this is because members in the integration become friendly so as to achieve the objectives of the integration.
- It leads to increased employment of factors of production such as labour due to easy factor mobility within the member states.
- It leads to production of a wide variety of goods and services thus widening the consumer choice.
- It attracts foreign investors/ foreign resources due to the widened market within the region.
- It leads to specialisation and its associated advantages such increased output, production of better quality products etc.
- It leads to increased economic growth rate/ Increases output. This is because producers increase output in order to serve a wider market.

- Economies of scale are enjoyed by the firms/Efficiency of the firms is promoted among the member states. This is because these firms produce on large which enables them to enjoy economies of large scale production.
- Avoids duplication of resources/goods. This is because one industry is established in one country to the serve the entire region.
- Stimulates industrial development. This is because the widened market attracts people to invest in the industrial sector in order to earn more profits.
- Promotes use of one currency hence facilitating trade.

Disadvantages of economic integration

- It results into **trade diversion effect**. This is where trade shifts from a low cost member country to a high cost member country as a result of economic integration.

Effects of trade diversion

1) It leads to growth of infant industries in the member states.
2) It leads to low quality goods due limited competition.
3) It leads to loss government revenue due to removal of tariffs.
4) It leads to limited variety of goods thus limiting consumer's choice.
5) It leads to high prices of goods and services.
6) It leads to regional self-reliance
7) It leads to low consumption levels
8) It discourages unity of the member states
9) Leads to smuggling of cheaper commodities from non- member states

- National interests are compromised. This is because member states are supposed to promote the interest of the integration and not their own as member states.
- It leads to loss of government revenue. This is because goods move freely among member states since there are no customs duties charged for goods from such countries.
- There is a possibility of benefits moving in one direction especially if the member states are not at the same level of development i.e. the benefits moves to more developed countries within the region.
- It subjects people to products of poor quality. This is because most of what is available from member states are not goods of good quality due to poor technology and limited skilled labour this is the case with integration within the developing world.
- It leads to high costs of staffing as labour force is transferred to far places leading to high expenditure on accommodation.
- It leads to uneven distribution of industries. This is because more industries are established in the member countries where the market is bigger and where there is more development infrastructure.
- It creates interdependence among the countries with the region as a result of specialisation and this suffocates self-sufficiency.

Factors that have hindered/undermined the success of economic integration in developing countries:

- They tend to produce similar goods which tend to limit market for their goods/output within the region.
- Failure to share the benefits equitability, such that benefits go to more developed countries within the region leaving others poor and frustrated.
- Differences in political ideologies. There is no common political ideology pursed; different countries have different political ideologies which tend to conflict e.g. single party system against multiparty in some states.
- Fears of loss of customs revenue as a result of member states do not commit themselves to the removal of trade barriers.
- Political instability. This makes some countries insecure for the investors and as a result countries become reluctant to join the integration with politically unstable countries which may not be part of the integration.
- Differences in economic policies. This makes it hard to harmonize such policies hence failure to implement the objectives of economic integration.
- Conflicts among the leaders as a result, they fail to agree on anything which makes it hard to implement the objective of the integration.
- External interference especially from donors. Sometimes external forces try to influence policies of the member states thereby leading to collapse of regional economic cooperation.
- Poor infrastructure e.g. poor road network which makes the transportation of goods within the region difficult.
- Lack of political will/support by the nationals within the integration because some are ignorant about the benefits of economic integration and sometimes they are not interested in joining the economic integration.
- Limited geographical proximity. Some member states have a wider geographical separation which increases costs of integration in form of administration and movement of goods and factor flow.
- Differences in currencies. There is lack of common currency to ease trade. This results into a problem of exchange rate hence limiting smooth running of trade among member states

COMMERCIAL POLICY: This is the deliberate government policy meant to influence and direct the value, volume and direction of trade in an economy.

OBJECTIVES OF COMMERCIAL POLICY:

- To increase foreign exchange earnings in the country.
- To increase government revenue.
- To increase gross domestic product of the country.
- To encourage foreign investment.
- To protect domestic industries.
- To create employment opportunities.
- To improve foreign /international relations
- To stabilise the B.O.P position of the country

TOOLS/INSTRUMENTS OF COMMERCIAL POLICY

1. Taxation/tariffs on imports/import duty
2. Subsidisation of local firms
3. Total ban/trade embargo/trade sanction
4. Foreign exchange control
5. Quality control e.g. through U.N.B.S
6. Administrative/Physical checks
7. Liberalisation of the economy

BEGGAR MY NEIGHBOUR POLICY

This is a policy adopted by a country to benefit its economy but harmful to other economies. Examples such of such policies include import restriction, devaluation of a currency etc.