

INTERNATIONAL TRADE/FOREIGN TRADE

Refers to the exchange (buying and selling) of goods and services between and among countries.

Or Refers to the exchange of goods and services between one country and the rest of the world.

NOTE: Foreign trade involves both imports and exports, and involves the use of foreign currency. It occurs because not all countries can satisfy their requirements and they are endowed differently with resources.

Basic concepts

- **Import trade and export trade**

Import trade refers to the buying/purchase of goods and services from other countries

While

Export trade refers to the selling of (locally produced) goods and services to other countries.

- **Visible trade and invisible trade**

Visible trade refers to the trade (buying and selling) of tangible items/goods such as sugar, cement, fuel, machinery

While

Invisible trade refers to the trade in services such as insurance, banking services, tourism, education, entertainment.

- **Bilateral trade and multi-lateral trade**

Bilateral trade refers to the trade between two countries

While

Multi-lateral trade refers to the trade among more than two countries. Each country trades with a number of countries buying from some and selling to some.

THE BASIS/ NEED FOR INTERNATIONAL TRADE

The need for international trade is due to the following reasons:

1. ***Differences in natural resource endowment.*** Different countries have different types of natural resources such as minerals, climate and in different quantities. There is therefore for foreign trade for the less endowed countries to enjoy the benefits from such resources.
2. ***Difference in skills and technology.*** Some countries (LDCs) have poorly developed industrial technology and technical knowhow and therefore concentrate on producing raw materials and exchange for finished products from other countries (DCs)—hence the need for international trade.
3. ***Difference in tastes and preferences/demand.*** As development proceeds people's standards of living increase and demand for better /high quality goods and services, and even a wider variety of products.
4. ***Difference in level of production/comparative advantage.*** Many countries find it cheaper to consume imported goods than producing them locally. This is due to relative cost disadvantage i.e. the cost of producing them domestically greater than the cost of importation. Still some

countries produce in excess of what they require. As such they send the surplus to other countries and import certain items from there.

5. ***Need for political ties and cooperation between countries.*** A country trades with other countries to promote political ties or to extend its political ideology to other countries such as capitalism or socialism.
6. Vent –for-surplus argument.
7. Need to acquire goods and services that are not locally produced.
8. The need to increase competition in production/efficiency in production.
9. Need to generate foreign exchange , which is used to pay foreign debts, contribute to international organizations etc
10. The need to variety of products –hence increased consumer choice and standard of living.

Benefits / advantages / arguments for international trade

1. **Foreign trade enables countries to get goods which they cannot produce.** It increases the variety of goods and services available for consumer's choice, hence improving the standards of living.
2. **Promotes efficiency in production.** Foreign trade avails better quality and well priced products due to competition. It breaks monopoly of local producers leading to efficiency (better quality and more output).
3. **Promotes understanding and cooperation between and among countries.** It strengthens social, economic and political ties between countries, which are a basis for diplomatic missions, cultural exchange, foreign aid and economic integration.
4. **Widens the extent of market for a country's products.** This promotes investment and increases productivity. Market expansion also promotes specialization leading to more efficient use of resources.
5. **Vent-for-surplus argument.** Foreign trade enables a country to fully utilize the idle resources (underutilized) in order to satisfy foreign demand to increase national income. Countries have the capacity to produce more than what they consume locally.
6. **Enables the country to dispose-off surplus output,** which would otherwise be wasted. Exportation of these products makes them have value and enables the country to earn foreign exchange.
7. **Generates foreign exchange for the country.** This is through the export of commodities and the foreign currency is used to pay the foreign debts, import foreign goods and make contributions to international organizations.
8. **Creates more employment opportunities.** Many people are employed in the production of goods for export; while others are employed in handling of imports and exports. This in turn increases incomes and improves the standards of living.
9. **Leads to the introduction of new ideas (the education effect of international trade).** Foreign trade introduces new technologies, technical know-how (skill) and entrepreneurship. This is because foreign trade involves the movement of people from one country to another. In this case, foreign aid acts as an engine of growth.

10. **Generates more government revenue**, through import and export duties. This revenue is used in the development of various sectors in the country. Taxes are major source of government revenue in many developing countries.
11. **Permits and promotes international specialization**. It enables a country to concentrate in producing those commodities in which it best suited and for which it has more resources. This leads to maximization of output and minimizing of costs of production. Specialization increases the benefits from trade increase, national income and economic growth.
12. **Improves the social and economic infrastructure** of a country. in order to support international trade various forms of infrastructure such as transport routes, airports, banking facilities, power supply are set up and also expanded.

Disadvantages/arguments against international trade

1. **Undermines the development of local industries** especially in developing countries. The locally produced goods are out competed due to excessive importation goods, which at times are cheaper which limits their market.
2. **Foreign trade promotes international inequality**. The poor countries in most cases become poorer because of unfavourable terms of trade or unequal exchange rate system (since developing countries specialize in primary products).
3. **Encourages dumping of commodities**. Dumping refers to the selling goods by a country in a foreign market at lower prices than the prices charged in the home market. This also retards the development of local industries.
4. **Worsens balance of payment problems of a country**, most especially for developing countries. This is because they continue earning less from exports which are lowly priced and yet they spend more on imports which are expensive.
5. **It subjects the economy to imported inflation**. This occurs as a result of importing goods from a country already facing inflation. This leads to economic stagnation (due to high prices, high transport costs etc).
6. **Some imported goods have adverse/ negative effects on the citizens of a country**. some goods are harmful to the population such as expired drugs, cigarettes, pornographics and this negatively affects the health conditions of the population /negatively affects the standards of living.
7. **Undermines a country's political and economic independence**. Some of the participating countries dominate other countries by dictating terms of trade, which increases economic dependence.
8. **Leads to over exploitation of natural resources**. This is due to the desire to produce more output to satisfy the large foreign market. This leads to quick resource exhaustion, which is a great disadvantage to future generations.
9. **Encourages brain drain** and its negative effects. This is the movement of skilled personnel from one country to another looking for better job opportunities. Brain drain for example reduces the quality and quantity of domestic output.
10. **Limits employment opportunities in the home industries**. **This is** due to increased inflow of capital intensive technology; which uses more machines than manual labour. *(Still the importation of some commodities limits the growth of domestic firms, hence unemployment).*

11. **Erosion/ loss of cultural values** due to the demonstration effect. Many consumers of imported goods adopt foreign cultures and values/norms /habits.
12. **Encourages demonstration effects.** Many people develop strong attachment to imported goods which reduce domestic savings and investment.

***Note:** Dumping refers to the selling of commodities abroad / in the foreign market at lower prices than those charged in the home/local market.*

Effects of dumping in the recipient country

- *Local producers are outcompeted/ closure of local industries.*
- *Increases unemployment in the economy.*
- *Under utilization of local resources.*
- *Discourages local initiative / investment.*
- *Increases the import expenditure / distorts the BOP position.*
- *Cheap goods are availed to consumers*
- *Avails a variety of goods to consumers/increased volume of goods/ improves the consumer's welfare.*
- *Inferior goods at times sold to consumers*

THE PRINCIPLES/THEORIES OF ABSOLUTE ADVANTAGE AND COMPARATIVE ADVANTAGE

Theory of absolute advantage

This was developed by Adam Smith for international trade.

The theory of absolute advantage states that,

"A country has absolute advantage over another country in the production of a particular commodity if it produces more units of that commodity than another when both countries employ the same resources".

According to the principle of absolute advantage each country produces goods whose production suits it (based on resource endowment and capacity to produce). When two countries have absolute advantage in different goods, it enhances gains from trade. [The country produces more than its requirement and the surplus is exchanged with products from other countries]. i.e *when two countries have absolute advantage over each other in the production of different commodities , total production of both countries can be increased if each country produces the product in which it has absolute advantage.*

Note: Absolute advantage refers to the ability of a country (individual or firm) to produce more units of a commodity than another using the same amount of resources.

Example:

1. Study the table below and answer the questions that follow:

Country	Units produced	
	Maize	Wine
A	200	100
B	80	220

Determine the absolute advantage of country A and B.

Solution: country A has absolute advantage in producing maize (*since it produces more units of maize than B using the same quantity of resources*) while country B has absolute advantage in producing wine.

2. Study the table below showing country X and Y.

country	Units produced	
	Wheat	Rice
X	100	60
Y	50	120

Determine the absolute advantage

Solution: country X has absolute advantage (over Y) in producing wheat while country Y has absolute advantage in producing rice.

Note: A country can also have absolute advantage in the production of two commodities in terms of less input costs (more units) than another country. This is shown below:

1. Study the table below and determine the absolute advantage:

Country	Commodities	
	Generators	Tea
A	500	700
B	120	240

Solution: country A has absolute advantage in producing both commodities (generators and tea). On the other hand country Y has absolute disadvantage in producing both commodities.

2. Study the table below showing the production of commodity P and Q between two countries; and determine the absolute advantage and absolute disadvantage

Country	Units produced	
	Commodity P	Commodity Q
X	40	30
Y	80	100

Theory of comparative advantage

This was developed by Ricardo who followed Adam Smith.

Comparative advantage occurs when a country incurs less opportunity cost than another in the production of a given commodity.

According to the theory, **'a country should specialize in the production of a commodity in which it incurs the least real cost/ opportunity cost than another even if it has absolute advantage in the production of both commodities.'**

The comparative cost theory asserts that even when one country has absolute advantage in producing both commodities, both countries can benefit if one country concentrates on the production of the most advantageous commodity.

Assumptions of the theory of comparative advantage

- a) It assumes that trade takes place between two countries.
- b) Only two commodities are produced in each of the two countries.
- c) Both countries have similar needs and therefore attach the same importance on the goods produced.
- d) Assumes constant technology.
- e) *Labour is the only factor of production.
- f) All factors of production (labor) are homogeneous i.e. all labour is equally efficient.
- g) The comparative advantage does not change i.e. the cost ratios between the two countries remain constant/ factor endowments do not change.
- h) There are no transport costs (in moving goods from one country to another).
- i) Assumes free trade among countries i.e. there are no restrictions on trade/ goods and services have access to markets in other countries.
- j) There is perfect mobility of factors of production within the country (such that in absence of trade each country will divide up its resources for the two commodities), but the factors of production are perfectly immobile between countries.
- k) Assumes production at constant returns to scale (doubling the inputs in each country or firm leads to doubling of total output).
- l) There is full employment of resources.

Example:

Country	Production	
	Wine	Cloth
Uganda	90	60
Congo	30	40

Alternative foregone

Comparative cost= $\frac{\text{Alternative foregone}}{\text{Actual output}}$

- *Uganda has absolute advantage in the production of both wine and cloth since with the same amount of resources it can produce more of both commodities than Congo.*
- *For Uganda to produce 1 unit of wine, it foregoes $60/90=0.66$ of cloth.*
- *For Congo to produce 1 unit of wine, it foregoes $40/30=1.33$ of cloth.*

Uganda therefore has a comparative advantage in the production of wine, because for each unit of wine it produces it foregoes only 0.66 of cloth compared to Congo which foregoes 1.33 of cloth.

- *For Uganda to produce 1 unit of cloth, it foregoes $90/60=1.5$ of wine.*
- *For Congo to produce 1 unit of cloth, it foregoes $30/40=0.75$ of wine.*

Therefore Congo has comparative advantage in the production of cloth because for each unit of cloth it produces, it foregoes only 0.75 of wine compared to Uganda which foregoes 1.5 of wine.

Following the principle of comparative advantage, Uganda should specialize in the production of wine while Congo should specialize in the production of cloth.

Note: when countries specialize, the gains from trade are high since each country will produce more units of the commodity specialized in and hence exchange.

After specialization

Country	Wine	Cloth
Uganda	180	0
Congo	0	80

Exercises:

1. Study the table below output levels of two countries in two commodities given the same units of labour and answer the questions that follow:

Country	Commodities	
	Maize	Transformers
Uganda	50	20
Tanzania	20	10

- (a) Determine the absolute advantage
- (b) Determine the comparative cost advantage and the items of specialization

2. Study the table below showing the output levels of two countries given the same factor units and answer the questions that follow:

Country	Commodities	
	Wheat	Rice
X	100	60
Y	50	120

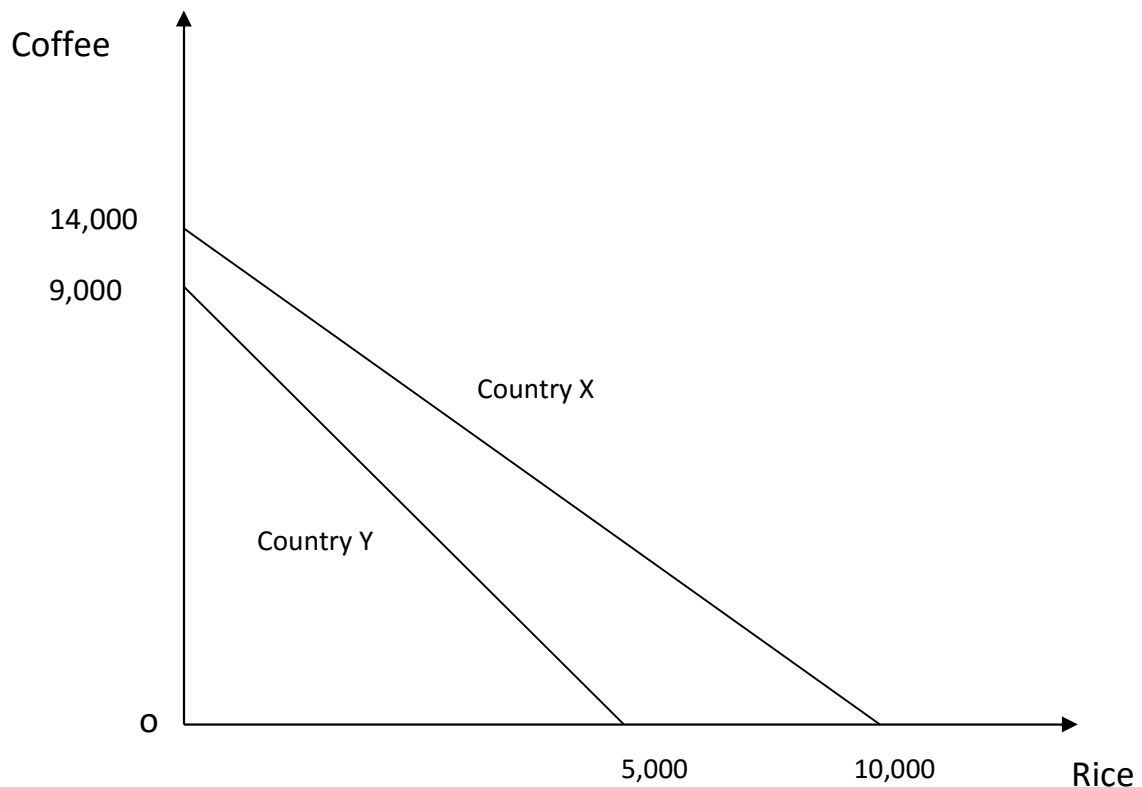
- (a) Show the absolute advantage
- (b) Calculate the opportunity cost of producing each commodity in each country
- (c) In which commodity should each country specialize?

3. Study the table below and answer the questions that follow:

Country	Units produced	
	Commodity P	Commodity Q
A	40	30
B	80	100

Determine the comparative advantage and the items of specialization

4. Study the figure below showing two production possibility frontiers for countries X and Y and answer the questions that follow:



- (a) State the principle of cost I international trade illustrated by the frontiers (1mk)
- (b) Which commodity should country X specialize in? illustrate your answer (3mks)

Solution

- *If country X decides to produce only coffee, it would produce 14,000 units and if it decides to produce only rice, it would produce only 10,000 units.*
- *If country X decides to produce only coffee, it would produce 9,000 units and if it decides to produce only rice, it would produce 5,000 units.*
- *Each of the two countries has many possible combinations of coffee and rice it can produce shown along the curve/PPF.*
- ***Country X has absolute advantage over country Y in the production of both commodities (coffee and rice) because the PPF for country X is above that of country Y.***
- *If the PPF curves cross each other, it implies that each country has absolute advantage in a particular commodity.*
- *Complete part (b) of the question.*

Criticisms / limitations of the theory of the theory of comparative advantage

The theory of comparative cost advantage has been criticized based on the following:

1. The theory assumes a world of two countries which is unrealistic because world trade involves many countries (multilateral).
2. The theory assumes production of two commodities (a two-commodity model) is unrealistic. This is because modern international trade involves several commodities.
3. The theory assumes a situation of free trade which is unrealistic. In reality many countries impose restrictions to trade/ trade barriers such as quotas, exchange rate control, tariffs among others. These affect the value, volume and direction of trade.
4. The theory did not consider transport costs, yet these greatly determine profitability and pattern of international trade (transport costs increase total costs and reduce benefits depending on the distance of operation). *It is impossible to have international trade without transport costs as the theory assumes.*
5. The assumption of constant cost is also unrealistic. In practice production operates under increasing costs or diminishing returns, which changes the comparative advantage. Therefore the cost ratios in both countries cannot remain constant. *(The costs of production are not always constant as the theory assumes implying that the comparative advantage changes with time yet the theory did not provide for adjustment when the costs change).*
6. The theory ignores the fact that many countries try to be self reliant and therefore want to produce as much as possible to reduce dependence on other countries. *(It does not consider each country to be self-reliant and emphasizes interdependence. It does not consider diversification and self-reliance which tend to disagree with specialization).*
7. The assumption of constant technology is unrealistic. The theory does not recognize that a country changes production costs in the long run with technological innovations (which can reduce comparative disadvantage).
8. The theory assumes that factors of production are perfectly mobile within a country which is not true. There is a certain amount of factor immobility, hence making it difficult to shift

resources from production of one good to another good (such as some labour is specific and specialized). *[still assumes that factors of production are perfectly immobile internationally which is also unrealistic because a number of factors favour mobility of labour/factor internationally]*

9. The theory assumes labour to be homogeneous (equally efficient) which is too simplistic. Labour varies/differs in skills, attitudes towards work, productivity experience among others.
 10. The theory concentrates on labour costs and ignores other non-labour costs of production, yet these are equally important such as capital and land costs.
 11. The theory does not consider differences in tastes, since it assumes that people all over the world have similar tastes. In reality tastes vary according to income group and change according to growth of an economy.
 12. The theory considers complete specialization which is not possible. The commodities may not be of comparable values (one high value and one low value). What a country may have as a comparative disadvantage may be a necessity commodity which it may not desire to give up.
 13. According to the theory, developing countries should specialize in primary products where they have comparative advantage, but this leads to unfavourable terms of trade when the developed countries specialize in manufactured goods which command higher prices.
 14. The theory does not provide for choice where countries incur same opportunity costs in the production of certain commodities and it is difficult to determine which country should specialize in what.
- The theory assumes that a country cannot exploit more resources and improve efficiency in production where it incurs more real costs.
 - The theory considers full employment which is unrealistic. There is always underemployment and in developing countries disguised unemployment is common (*due to absence of co-operant factors*).

Relevance of the comparative cost theory to developing countries

To a lesser extent the comparative cost theory is relevant to developing countries as seen below:

1. Developing countries have tended to specialize in the production of primary products in which they have the least opportunity cost as compared to the developed countries.
2. There are some cases of free trade which have made it possible for the developing countries to export some of their primary products to the developed countries.
3. Developing countries import manufactured goods in which they have a less comparative advantage.
4. In the production process developing countries use labour intensive production techniques since labour is relatively cheap as compared to capital.
5. The comparative cost theory guides in decision-making for certain regional groupings/integrations which emphasize specialization based on resource advantage such as EAC (East African Community).

FREE TRADE VERSUS PROTECTIONISM

FREE TRADE

Refers to a trade policy in which all restrictions/barriers to movement of goods and services between countries are removed.

Or Refers to the buying and selling of goods and services between and among countries without any restrictions/ barriers.

A case for free trade

1. ***Free trade widens the markets.*** This is because the entire world becomes a market for all products and this promotes large scale production throughout the world.
2. ***Enables a variety of goods and services to be produced and availed*** for customers' benefit. This is because the consumption possibilities of a country expand beyond its production possibilities. This in turn widens consumers' choice and improves the standard of living.
3. ***Encourages optimum utilization of resources.*** It reduces wasteful use of resources in producing goods for which a country has a comparative disadvantage and can import cheaply from other countries. The benefits of specialization are enjoyed such as increase in output.
4. ***Free trade controls monopolies by creating healthy competition*** between producers in different countries. This leads to improvements in productive efficiency/increases the quality of output and reduces prices of output.
5. ***Promotes international cooperation among the trading partners.*** This is important for strategic reasons such promoting international peace.
6. Free trade ***increases employment opportunities.*** This is especially in the export promotion industries and thus increased incomes/ improved standards of living.
7. ***Facilitates development of skills, technical know-how and managerial efficiency.*** This is because of free movement personnel from one country to another and also the exchange of ideas between the people involved in the free trade.
8. ***Minimizes unnecessary shortages in the economy/country.*** This is due to increased volume of commodities coming from other countries and this regulates the prices/ ensures lower prices of commodities domestically.
9. ***Increases foreign exchange earnings. This is*** due to increased market for commodities in various countries without restrictions.
10. ***Reduces government expenditure;*** that would be used in protecting/ subsidizing infant industries. This in turn avails resources to fund other development projects.

A case against free trade

1. The free trade policy assumes conditions of perfect competition with no government intervention which is unrealistic.
2. ***Increases economic dependence of countries on each other.*** This is because countries specialize in production. This is dangerous during times of emergency such as war with a country having difficulties in importation of commodities.

3. ***Free trade does not provide a check on production and trade in harmful goods.*** This in turn affects the economic welfare or health conditions of people.
4. ***Results into dumping of commodities.*** A country sells goods at very low prices even below the cost of production in other countries and this causes a decline in infant industries.
5. ***Discourages the growth of infant industries.*** This is due to being subjected to competition from imported commodities that easily come into the country. This in turn limits employment opportunities.
6. ***Increases the importation of harmful goods such as narcotics, pornography, cigarettes.*** This is because commodities are easily brought into a country due to free trade. This negatively affects the economic welfare of the citizens.
7. ***Worsens balance of payment problems.*** This occurs developing countries depend more on developed countries for imported expensive manufactured goods.
8. ***Leads to underutilization of the local resources.*** This is because the nationals are assured of getting supplies from other countries.
9. ***Subjects the economy to imported inflation.*** This is due to importation of commodities from countries experiencing inflation.
10. ***Free trade limits tax revenue,*** which would be got from import and export duties.
11. ***Free trade is undesirable for strategic reasons.*** For example due to free trade unwanted military supplies /arms may be brought into the country and this threatens the security of the country.

Commercial policy

Refers to measures taken by government to influence and direct the value, volume and direction of trade (*so as to achieve the desired macro-economic objectives*).

Or these are measures and actions taken by government to influence and direct international trade and international payments.

Commercial policy aims at increasing a country's gains / shares in trade, maintain B.O.P equilibrium, a high rate of capital formation among others –all to accelerate the rate of economic development. The tools of commercial policy include the tariff and non-tariff barriers as well as policies regarding exports.

PROTECTIONISM /FOREIGN TRADE CONTROL

Refers to the putting up of artificial barriers to restrict the international flow of goods and services.

OR this is where the government imposes restrictions on goods and services entering (and leaving) a country. *It is usually adopted to reduce the volume of imports into a country.*

Protectionism is carried out as an attempt to minimize the dangers of free trade and mainly to protect home industries from foreign competition.

Methods /tools/forms of protectionism

These are the measures which are used by a country to restrict /regulate international trade.

1. Tariffs

A tariff is a tax imposed on imports and exports of a country.

Import tariffs are taxes imposed on imported goods with the aim of discouraging their consumption. Import duties increase the domestic price of imports making them expensive.

2. Non-tariff barriers

These are the other methods or policies that interfere with the free movement of imports (or exports) apart from using tariffs. Non-tariff barriers include: quotas, total ban, foreign exchange control, subsidies, and devaluation among others.

a) Quotas

These are quantitative restrictions on the amount of goods imported or exported in a given period of time. *(These are fixed physical quantities of commodities to be imported into a country in a given period of time)*. Where import quotas are imposed, intending importers will not go beyond fixed quantities even though demand is high. (An import quota is a quantity limit on the imports that are allowed to enter a country with in a given time period).

b) Total ban/trade embargo

This is where the government completely stops the importation of a given commodity into the country. It is a trade restriction especially on commodities considered harmful to society such as beef, drugs, pornographics, etc and those competing with local firms/ industries.

[Trade embargo]—involves prohibiting trade with a country whose policies are not acceptable such as putting international sanctions on countries with poor leadership activities, poor human rights records, poor economic policies].

c) Foreign exchange control

This is where the government through the central bank regulates the demand and supply of foreign exchange. The government controls the issuing of foreign currency to reduce the volume of imports e.g. foreign exchange is allocated to firms importing particular priority items/commodities.

d) Devaluation

This is a deliberate reduction in the value of a country's currency in terms of foreign currencies by the government under a fixed exchange rate system. This makes foreign exchange expensive, increasing import prices i.e. it encourages exports and discourages imports.

e) Import (and export) licenses

The government restricts the issuing of import licenses or export licenses/ permits. It may require exporters or importers to be cleared by the relevant departments, after satisfying certain laid down

conditions. For example licenses may be issued to just a few importers dealing in essential goods or to all interested importers but at very high charges.

f) Administrative control

The government institutes certain specifications and minimum international or national standards which importers and exporters have to respect. It may involve complicated and bureaucratic procedures in clearing and forwarding imports, documentation, complicated licensing, transport discrimination etc. this tiresome process discourages some of the importers.

g) Quality control requirements.

It also involves regulating the quality of commodities to be imported and discouraging some commodities (e.g. sub-standards). The government comes up with restrictions on the quality of the commodities to be imported and the goods that do not satisfy the standards are not allowed into the country.

h) Using Subsidies/ subsidization of local producers

This is the financial support given to home industries by government to lower their production costs and make their products competitive. (Or it is the payment by government to private sector to keep prices of goods and services below what they would be in the open market or to enlarge activities that otherwise would not take place). This enables the firms to sell goods cheaply to outcompete importers.

i) Preferential treatment.

This is where commodities from a particular trading partner/country are given first consideration or lower tax regime than commodities from other countries. For example after forming economic integration preferential treatment is given to member countries.

Reasons for protectionism

1. ***To protect infant industries.*** A country with industries that are just taking off / infant industries protects them from foreign competition by restricting imports until they reach a stage where they compete favourably.
2. ***To control/discourage dumping.*** Dumping refers to the selling of a commodity in foreign markets at prices lower than the domestic prices. Dumping discourages local production by channeling demand to lowly priced dumped goods.
3. ***To generate and maintain employment opportunities.*** Protectionism allows the local industries (or import-substitution industries) to expand due to a big market and in turn create more jobs. Also the linkages created with other sectors / industries widen the scope of employment, hence better standards of living.
4. ***To generate more government revenue.*** Protectionism especially the use of tariffs is a source of revenue to the government which in turn aids development projects/finances the government budget. The increase in people's incomes also increases the taxable capacity.

5. ***To improve the balance of payment position.*** Protectionism is an instrument of correcting the balance of payment deficit by reducing the volume of imports and hence reducing the foreign exchange expenditure.
6. ***To restrict/ discourage importation of some commodities which are harmful*** to citizens. For example certain drugs, tinned meat, cigarettes, films, magazines. This is for health reasons or protecting the country's standard of living.
7. ***To strengthen political relations with other countries.*** A country restricts importation of goods from a certain country so as to improve its political relations with another country.
8. ***To reduce foreign dependence and hence ensuring self-sufficiency.*** This is achieved by establishing import substitution industries to produce imported goods locally. Encourages self reliance since local producers fill the import gap.
9. ***To check on imported inflation.*** This is achieved by restricting imports from countries experiencing inflation or expensive sources.
10. ***To prevent slump in the economy.*** Importation of commodities from low-wage countries and from areas where are produced at low cost leads to a fall in aggregate demand, incomes and level of employment, generally leading to slump in the domestic economy. Where industries are protected, production increases and more output produced.
11. Protectionism is ***a necessary tool to retaliate*** against tariffs imposed by other countries on a country's exports.

Demerits of protectionism

1. ***Protectionism reduces competition.*** Local producers become monopolists due to lack of competition and this results into production of poor quality and highly priced goods/makes the local industries inefficient.
2. ***Provokes retaliation by other countries.*** Other countries retaliate by restricting importation of goods coming from a country which put up restriction on imports from other countries. This limits the size of the market/volume of exports and foreign exchange earnings.
3. ***Leads to smuggling of commodities into the country.*** Businessmen bring in goods illegally trying to avoid custom officials/ high taxes imposed on imported commodities. This leads to loss of government revenue.
4. ***Protectionism is costly to the government to implement.*** It increases supervisory costs such as anti-smuggling units, enforcing agencies, subsidizing of local industries. This strains the government budget and reduces funds available for other development projects.
5. ***Tariffs imposed on factor inputs increase the costs of production and increases the prices of commodities.*** Therefore the domestic producers end up not being protected (can cause cost-push inflation).
6. ***Devaluation is likely to increase the price of imported goods.*** For goods whose demand is inelastic (such as fuel), even with increase in their prices, their inflow into the country remain high, and therefore more foreign exchange is spent on such goods. *(Some commodities which are price inelastic continue to be imported at high prices. The consumers therefore end up paying higher prices hence reduced consumer surplus and standard of living)*
7. ***Protectionism reduces the volume of world trade, output and specialization.*** This exposes the world economy to the defects of economic depression.

8. ***Protectionism reduces/limits on the variety of goods and services in the domestic market.*** This undermines consumer choice and standard of living. (Consumers are forced to consume commodities which do not suit their tastes).
9. ***Reduces the political cooperation and friendship between and among countries.*** This limits diplomatic relations, cultural exchange/exchange of ideas, foreign aid, and economic integration among others.
10. ***Leads to unnecessary shortages of commodities.*** This is in situations where the local producers have low capacity to produce and supply the local market. This in turn leads to higher domestic prices for the consumers.
11. ***Likely to increase unemployment.*** The people involved in import and export trade since imports are restricted and yet even firms producing for export may close down.
12. ***Encourages resource misallocation*** because it allows high cost inefficient firms to remain in production
13. ***Leads to loss of government revenue in form of import duties.*** This is due to complete ban on the importation of commodities or due to reduction in the volume of commodities imported.

THE POSITION OF DEVELOPING COUNTRIES IN FOREIGN/INTERNATIONAL TRADE

Today world trade is dominated by developed/industrialized countries and therefore developing countries do not benefit much from international trade.

Features of foreign trade of developing countries

- Dependence on a few exports. Most LDCs depend on one or two goods for most of their exports.
- High degree of dependence on foreign trade. The export and import ratio to national income is high.
- Excessive reliance on imports of intermediate inputs and a wide range of essential manufactured consumer goods.
- Dependence on former colonial masters as the major sources of imports.
- Limited exportation of manufactured goods (although some are expanding steadily).
- Limited trade between and among LDCs themselves. Most of their trade is with developed countries but this is tending to change with regional groupings.
- Excessive reliance on imports which exceed exports. This makes BOP deficit a permanent feature of LDCs' foreign trade.
- Many developing countries do not have a direct access to the sea, making their exports less competitive.

***Reasons why developing countries earn less from international trade**

A number of reasons explain why developing countries perform poorly in foreign trade:

1. Falling prices of exports.
2. Production of almost similar products by most developing countries.

3. Increasing competition/ substitution of LDCs exports with synthetic products in developed countries.
4. Protectionist policies from developed countries against LDC' exports.
5. Over importation of expensive manufactured capital and consumer goods.
6. Exportation of semi-processed agricultural and mineral products/ primary products.
7. Weak bargaining power / position of developing countries in the world market.
8. Low quality produce for export from developing countries.
9. Low income elasticity of demand of exports from LDCs
10. Fluctuating and unfavourable exchange rates for LDCs
11. Invention of raw material saving techniques by MDCs
12. Prices of LDC's exports are determined by the major buyers (MDCs)
13. Unfavourable terms of trade.
14. ***Surplus/ over production hence flooding the markets.*** Most LDCs do not regulate the supply of their primary products and this often leads to over production and the resulting excess supply leads to very low prices on the world market.
15. ***Rampant political instability in many parts of developing countries.*** Many developing countries do not have a substantial manufacturing sector due to diverting more resources to buying military hardware and thus reducing the volume of manufactured goods—hence earning less from international trade.
16. ***Rapid population growth rates***

BALANCE OF PAYMENT

Balance of payment is the difference between receipts from visible and invisible exports and the payments for both visible and invisible imports of a country during a given period of time.

[OR it is the financial record of a country's transactions with the rest of the world during a given period of time usually a year OR ***refers to the difference between the foreign exchange expenditure and the foreign exchange earnings of a country from all sources in a given period of time***]

It shows the relationship between a country's total expenditure abroad with total income from abroad in a given period of time. It also includes capital movements i.e. capital inflow and capital outflow.

Factors that influence a country's balance of payments

Importance of balance of payment figures

- Necessary for international comparison of performance between different countries.
- B.O.P statistics reveal the country's performance in international trade.
- Show the degree of dependence on other countries or on a particular commodity for export.
- Necessary for external assistance such as from IMF to solve the BOP deficit.
- Important tool in the country's development planning needs.

BALANCE OF PAYMENT ACCOUNT

The credit items reflect the transactions that give rise to in-payments to the home country (inflow of foreign exchange) such as export earnings, foreign investments in the home country etc

The debit items reflect transactions that give rise to payments outwards from the home country (out flow of foreign exchange) such expenditure on imports, foreign investment by domestic nationals, lending to foreign countries etc

The balance of payment account comprises of the following:

1. Current account

This is the summary of all transactions which involve the movement of goods and services between a country and the rest of the world.

It is divided into two:

- a) **Visible account/trade.** This shows a record of all earnings from visible exports and expenditure on visible imports. The difference between the value of a country's visible exports and visible imports in a given period, usually a year is referred to as **balance of trade (B.O.T)**.
- b) **Invisible account/trade.** This shows the record of earnings from all services rendered abroad and expenditures on foreign services. The services include: insurance, banking, tourism, transport services among others. The difference between the value of foreign exchange received on invisible exports and foreign exchange spent on invisible imports is referred to as **invisible balance**.

2. Capital account

This is a record of all transactions which involve the movement of capital in and out of the country (capital inflow and capital outflow). Capital inflow includes: foreign investments in the home country, donations and grants from abroad, long term and short term borrowing from abroad etc

Capital outflow includes: investment in other countries, donations and grants to other countries, short term and long term lending etc

3. Cash or monetary account

This shows a record of a country's foreign exchange reserves held by the monetary authority. A balance on each account i.e. the capital and current account will show changes in the country's foreign reserves.

The monetary/cash/official settlement account shows the surplus or deficit (and how the balance can be run down to balance the B.O.P account).

{In case of a surplus, the monetary account states means of disposing it off/ reducing foreign reserves to maintain equilibrium such as investing abroad, stocking foreign exchange reserves with the central bank, lending other countries, giving foreign aid, paying debts acquired from other countries, increasing reserves in IMF etc. In case of a deficit, the monetary account states so as to overcome it/ increasing foreign reserve holdings such as through selling investments abroad, borrowing from abroad, use of foreign reserves from previous B.O.P, asking for grants, foreign aid, with drawing reserves from IMF etc}.

4. Errors and omissions

This is the balancing item and it includes all the likely errors and omissions in the data collected.

Note: other concepts

Balance of trade

Refers to the difference between the value of a country's visible exports and visible imports in a given period, usually a year.

- Favourable/positive balance of trade refers to a situation where the value of a country's visible exports exceeds the value of its visible imports.
- Unfavourable/negative balance of trade—refers to a situation where the value of a country's visible exports is less than the value of its visible imports.
- *Autonomous transactions/items---are entries on the balance of payment account which are voluntary foreign earnings either between governments or private individuals. These take place in the current and capital accounts regardless of other items in the B.O.P account.
- *Accommodating (compensatory) transactions/items—are entries of sale of foreign assets or short term financial assets to cover a B.O.P deficit.

Balance of payment positions

- **Balance of payment equilibrium**

Refers to a situation where a country's foreign exchange expenditure equals to foreign exchange earnings from all sources in a given period of time, usually a year.

- **Balance of payment disequilibrium**

Refers to a situation where a country's foreign exchange expenditure is not equal to the foreign exchange earnings from all sources in a given period of time, usually a year.

- **Balance of payment surplus (favourable balance of payment)**

Refers to a situation where a country's total receipts from all sources abroad are greater than its total expenditures abroad in a given period of time.

- **Balance of payment deficit (unfavourable balance of payment)**

Refers to a situation where a country's total receipts from all transactions abroad are less than its total expenditures abroad in a given period of time.

- **Balance of payment problems**

Refers to a situation where a country's total receipts from all foreign transactions are persistently less than its total expenditures abroad year after year.

Causes of balance of payment problems in developing countries

1. ***Exportation of primary products with low value added / low quality exports.*** Developing countries export primary products which are of low quality and no value-added and hence

leading to low foreign exchange earnings yet their expenditure continues to be high on the manufactured goods.

2. ***Unfavourable terms of trade for developing countries.*** Exportation of mainly cheap goods by developing countries leads less export earnings year after year while the importation of highly priced manufactured goods leads to increasing import expenditure.
3. ***Low volume of exports, hence low foreign exchange earnings.*** There is low volume of exports due to a large subsistence sector and supply rigidities such as drought, floods, pests and diseases [*dependence on natural factors in production*] which limit agricultural output and this leads to less inflow of export earnings.
4. ***Protectionism and discriminatory policies of developed countries.*** Use of quotas, tariffs and other trade restricting policies limits the quantity/ volume of exports from developing countries—hence reduced export earnings, yet they continue importing heavily—hence increased import expenditure.
5. ***Prices of exports being dictated by major buyers (due to weak bargaining power of developing countries).*** The major buyers/developed countries usually set low prices in their favour and therefore developing countries continuously earn less from their exports.
6. ***Excessive expenditure on imports of military hard ware/ political instability in many parts of developing countries.*** Many developing countries are experiencing political instability which makes them to spend more on military hardware. The instability also reduces the productive capacity and hence reduced volume of exports since investors are discouraged—hence reduced foreign exchange earnings and yet import expenditure increases.
7. ***Excessive capital flight/ outflow due to debt servicing.*** Developing countries pay for the huge loans incurred and high interest rates on the loans which leads to heavy expenditure on debt servicing and debt payment—increasing foreign exchange expenditure and yet there are low foreign exchange earnings year after year.
8. ***Excessive government expenditure on foreign travels and diplomats/foreign missions*** (e.g. embassies). This increases the foreign exchange expenditure hence exhausting the foreign exchange reserves causing balance of payment problems.
9. ****High and fluctuating exchange rates.*** High exchange rates make foreign currency very expensive and hence increasing expenditure on imported goods, yet the export earnings are low.
10. ***High rates of inflation.*** Developing countries experience high rates of inflation which makes their exports expensive and this makes them less competitive on the world market(less foreign exchange earnings) since foreigners buy less from a country experiencing inflation; yet the import expenditure continues to be high.
11. ***Limited variety of exports/Limited diversification in production among developing countries.*** Most developing countries depend on the production of a few traditional cash crops, and this limits the amount of income they get from exports and yet the import expenditure is high.
12. ***High population growth rates in developing countries.*** This results into increased volume of imports and less exports due to increased consumption—hence increased foreign expenditure and yet the export earnings are low.

Effects of balance of payment problems in developing countries

- 1) Accelerates perpetual poverty and under development. The retrenchment of workers consequently escalates absolute poverty.
- 2) Reduces a country's benefit from international trade. This is due to shortage of foreign exchange and reduced volume of imports. (depletion of foreign exchange reserves)
- 3) Increases the external debt/ increases economic dependence on other countries. This is due to the increasing need for foreign aid including high interest loans which increase debt servicing and the debt burden.
- 4) Accelerates the rate of inflation due to the highly priced imports.
- 5) Leads to deterioration/ decline in the standards of living /economic welfare in LDCs. For example this is due to high taxation levels that result.
- 6) Results into currency depreciation
- 7) Causes unemployment of resources and poor remuneration of labour due to lowly priced exports.
- 8) Over reliance on foreign aid which encourages dependence and foreign domination by donors (economic imperialism).
- 9) Limits the level of savings and investment, and hence retarding economic growth and development.
- 10) Results into disinvestment/ reduces the rate of investment.
- 11) Developing countries become vulnerable to international policies geared against them such as by IMF, WTO, IBRD etc
- 12) Makes government unpopular due to continued economic slump—hence a source of demonstrations and uprisings/revolts.

Solutions to the balance of payment problems/ deficit

The measures should generally aim at increasing a country's foreign exchange earnings and reducing the foreign exchange expenditure.

1. **Establishing import substitution industries.** This involves producing goods that were formerly imported locally and this reduces the volume of imports, hence reduced foreign exchange expenditure.
2. **Establishing export promotion industries.** Producing more goods and services for export and therefore earning more foreign exchange. Manufactured industrial goods command high prices on the world market.
3. **Borrowing from international financial institutions.** In the short run the country borrows and the borrowed funds are invested in productive projects that produce more exports (to earn more forex) or for domestic consumption (to reduce forex expenditure).
4. **Investment promotion policies.** Government encourages both local and foreign investors thereby increasing capital inflow and reducing capital outflow. Policies like tax holidays and subsidies attract more investors who add value to the export commodities—hence increasing foreign exchange.

5. **Improving infrastructure** for example transport net work, water supply, banking facilities etc. this reduces the cost of production and increases domestic output ;hence reducing foreign exchange expenditure on imports/ increasing foreign exchange earnings from exports.
6. **Diversifying of the exports from developing countries.** This involves including non-traditional exports like fruits, flowers, fish, tourism services among others and hence increasing foreign exchange earnings.
7. **Putting up import restrictions in a country.** For example tariffs, quotas, total ban on the importation of certain goods (such as luxurious and the harmful goods) thereby reducing foreign exchange expenditure. (This is more effective if jointly taken by all LDCs).
8. **Controlling inflation.** This involves the fiscal policies of increasing taxes to reduce disposable income and reducing government expenditure to reduce inflationary tendencies and make a country's exports attractive.
9. **Foreign exchange control.** Government through the central bank restricts the amount of foreign exchange released to importers. This reduces the volume of imports and hence cutting down the foreign exchange expenditure on imports.
10. **Using barter trade.** Encourage exchange of goods for goods in international market and this reduces the use of foreign currency and hence reduced foreign exchange expenditure.
11. **Advocate for debt cancellation or debt rescheduling.** A country negotiates with some creditors for the cancellation of some of the debts or the rescheduling of the repayment period.
12. **Devaluation policy.** Devaluation makes a country's currency cheaper in terms of other currencies. This makes the exports cheaper to the foreign buyers and imports more expensive. Therefore more foreign exchange is earned and less is spent.
13. **Ensuring/encouraging peace and stability in all parts of the country** through peace talks and amnesty which also increases capital inflow and reduces government spending on the military.
14. **Formation/ strengthening of economic integration among developing countries.** This is intended to widen the market to increase exports since the countries trade among themselves, and also strengthens the bargaining power of developing countries in the international market through joint action.
15. **Diversifying the export markets through market research.** Government is expanding markets for their output in various countries so as to reduce over dependence on a few countries –hence increasing foreign exchange earnings.
16. **Formation of strong commodity agreements.** This helps to fix favourable prices for exports, hence increasing the gains from international trade. However this calls for joint action and commitment in observing the terms of the agreement for developing countries to increase their gains from foreign trade.
17. Encourage the use of population control measures (to reduce the population growth rate).

TERMS OF TRADE

Terms of trade refers to the ratio of the price index of exports to the price index of imports OR

Refers to the measure of purchasing power of a country's exports in terms of its imports.

[The rate at which a country's exports are exchanged for its imports]

Terms of trade represent the quantity/ amount of exports that must be sold so as to get a unit of imports].

Terms of trade can be expressed as:

- a) **Barter terms of trade (commodity terms of trade)** is the ratio of the price index of exports to the price index of imports (and it shows how much exports are required to purchase a unit of imports).

$$\text{Barter terms of trade} = \frac{\text{Price index of exports}}{\text{index of imports}}$$

- b) **Income terms of trade (monetary terms of trade)** is the ratio of the value of exports to the price index of imports [and it measures the local import purchasing power of exports –the capacity to import out of export earnings/export revenue].

$$\text{Income terms of trade} = \frac{\text{Value of exports}}{\text{index of imports}}$$

If the income terms of trade equals to 1, then it is balanced. If it is less than 1, the terms of trade are unfavourable but if it is greater than 1 the terms of trade are favourable or [if it is equal to 100, the terms of trade are balanced; less than 100, they are unfavourable ; greater than 100, the terms of trade are favourable.

Note: if the T.O.T are favourable, it implies that one unit of exports will purchase more than one unit of imports. On the other hand, if the terms of trade are unfavourable, it implies that one unit of exports will purchase less than one unit of imports.

Example:

Study the table below and answer the questions that follow:

Year	Export price	Import price
1990	284	216
1991	240	228
1992	256	264
1993	308	346

Calculate the terms of trade from 1990 to 1993 and explain whether it is favorable or unfavourable.

Factors determining terms of trade

- Changes in commodity prices
- the exchange rates
- Elasticity of demand for imports and exports
- Level of technological development.
- Changes in tastes and preferences
- Tariffs and other commercial instruments
- Devaluation.
- Trade agreements

The terms of trade can be favourable, improving, unfavourable and deteriorating.

- **Favourable terms of trade**

Refers to a situation where the prices of exports of a country rise relative to the prices of imports.

- **Improving terms of trade**

Refers to a situation where the prices of exports persistently rise relative to the prices of imports year after year.

- **Unfavourable terms of trade**

Refers to a situation where the prices of imports of a country rise relative to the prices of exports

- **Deteriorating terms of trade**

Refers to a situation where there is persistent rise in the prices of a country's imports relative to prices of exports year after year.

Causes of unfavourable terms of trade in developing countries

1. ***Substitution of LDCs exports with synthetic products by developed countries.*** The LDC's products face competition from synthetic products made by the developed countries for example cotton from polyester and nylon which leads to drastic fall in the prices of primary raw materials.
2. ***Production of similar products by the developing countries.*** This has limited the trade among them and this makes them struggle to export to the developed countries leading to reduced prices of the exports yet they continue importing expensive goods from the developed countries.
3. ***Protectionism policies/ import restriction of developed countries.*** Many developed countries are pursuing self-sustaining economic policies whereby they utilize their own resources and hence put restrictions on imports from developing countries (such as using quotas) and this reduces the demand of products from the less developed countries—hence low prices and yet imports are expensive.
4. ***Exportation of primary products with low value added.*** Developing countries produce primary products particularly minerals and agricultural products in the unprocessed form, and

this makes such exports cheap in the export market yet the developing countries continue importing expensive goods.

5. **Weak bargaining power of developing countries on the world market.** The developing countries are unable to organize themselves into a strong force for bargaining purpose due to limited cooperation among them; and thus they continue exporting their products at low prices.
6. **Low quality of the exports.** The quality of the products from developing countries is low due to poor methods of production and this reduces their prices on the world market.
7. **Low income elasticity of demand for the exports of developing countries.** This means that as incomes of the consumers in developed countries increase, the quantity demanded almost the same and hence exports fetching low prices, while the imported goods are highly priced.
8. **Unfavorable exchange rates.** High exchange rates make foreign currency very expensive and hence high prices of imported goods, yet the export prices are low.
9. **Invention of raw material saving techniques by developed countries.** Technological advancement in developed countries leads to reduced quantities of raw materials demanded from developing countries, hence reduced prices of such products, yet the imports are expensive.
10. **Surplus/ over production hence flooding the markets [failure to regulate output].** Most LDCs do not regulate the supply of their primary products and this often leads to over production and the resulting excess supply leads to very low prices on the world market.

Guiding questions

SECTION A

1. Distinguish between the following:
 - (a) Barter terms of trade and income terms of trade
 - (b) Invisible balance and balance of trade
 - ©favourable balance of trade and unfavourable balance of trade
 - (d) Domestic trade and foreign trade
 - (e) Visible trade and invisible trade
 - (f) Improving terms of trade and deteriorating terms of trade
2. (a) Distinguish between balance of payment deficit and balance of payment surplus (2mks)
(b) State two ways of solving balance of payment deficit in your country (3mks)
3. (a) Differentiate between balance of trade and terms of trade (2 mks)
(b) Mention two ways of improving terms of trade in your country (2mks)
4. (a) What is meant by balance of payment disequilibrium? (1mk)
(b) State any three causes of balance of balance of payment disequilibrium in developing countries (3mks)
5. (a) Distinguish between balance of payment deficit and balance of payment problems (2mks)
(b) State any two effects of balance of payment problems in your country (2mks)
6. (a) What is meant by dumping? (1mk)
(b) State any three effects of dumping in the recipient country (3mks)
7. (a) distinguish between tariff and non-tariff barriers as used in economics (2mks)

- (b) Explain any two on-tariff barriers used by your country (2mks)
- 8. (a) What is meant by commercial policy? (1mks)
- (b) Mention any three instruments of commercial policy (3mks)

SECTION B

1. (a) Why do countries participate in international trade? (10mks)
- (b) Explain the instruments used to restrict international trade (10mks)
2. (a) Distinguish between comparative advantage and absolute advantage (4 mks)
- (b) To what extent is the comparative advantage theory applicable in your country? (16 mks)
3. (a) What is trade liberalization? (4mks)
- (b) Explain the benefits of trade liberalization (16 mks)
4. (a) Account for the balance of payment in your country (10mks)
- (b) Examine the measures being used to control the balance of payment problem in your country (10mks)
5. (a) Why do countries restrict international trade? (10mks)
- (b) Explain the dangers of restricting international trade on the economy in developing countries (10mks)
6. (a) Explain the tools of protectionism in your country (10mks)
- (b) Examine the consequences of protectionism in your country (10mks)
7. (a) distinguish between tariff and non-tariff barriers to trade (4mks)
- (b) In what ways has the government of your country restricted international trade? (16 mks)
8. (a) Explain the law of comparative advantage (6mks)
- (b) What is the contribution of international trade to the development of your country? (16 mks)
9. (a) Explain why developing countries benefit less from international trade (10mks)
- (b) Explain the measures that may enable the developing countries to benefit more from international trade (10mks)
10. (a) Distinguish between barter terms of trade and income terms of trade (4 mks)
- (b) Account for the terms of trade experienced by developing countries. (16mks)
11. (a) What are the causes of deteriorating terms of trade in your country? (10mks)
- (b) Examine the measures being taken to improve the terms of trade in your country (10mks)
12. (a) Account for unfavourable terms of trade in your country (10mks)
- (b) What are the measures has your government undertaken to improve on the terms of trade? (10mks)
13. (a) Explain then problems that have tended to limit high level of international trade in your country (10mks)
- (b) What are the steps your country is taking to strengthen its trading position? (10mks)
14. (a) Why have less developed countries continued to benefit less than more developed countries in international trade? (10mks)
- (b) What should be done so as to improve on this poor position of less developed countries in international trade? (10mks)
15. (a) Differentiate between balance of trade and balance of payment (4mks)
- (b) Explain the causes of balance of payment deficits in an economy (16 mks)

FOREIGN EXCHANGE

Foreign exchange refers to the currency or interest bearing bond of other countries. Or it is a system whereby one currency is exchanged for another currency.

It is often synonymous with foreign currency.

Foreign currency reserves refer to the amount of foreign currency held by a country in the central bank such as pound sterling, Japanese yen, us dollar, gold reserves, SDRs etc

***Importance of foreign reserves/ the need for foreign exchange**

- Payment for imports of consumer, capital and intermediate goods.
- Servicing and repaying foreign debts
- Financing diplomatic missions abroad—to enable them to carry out various activities on behalf of government.
- For international traveling of individuals and government delegations
- Financing a B.O.P deficit.
- Foreign reserves back up the local currency of a country, determining money supply and value.
- The amount of foreign reserves indicates the performance of a country in foreign trade.
- Used for foreign investments such as buying of shares, securities etc in foreign companies.
- Payment for membership and increasing reserves with international organizations such as IMF.
- Payment of expatriates employed in the production process.

Supply of foreign exchange

Refers to the amount of foreign exchange available at a given rate in a given period of time.

Determinants of supply of foreign exchange/sources of forex

1. The amount of earning from a country's exports(goods and services)
2. The inflow of foreign capital such as by investors
3. The amount of foreign aid in form of grants, loans etc from other countries.
4. The amount of expenditure by foreign diplomats and NGOs in the country
5. The remittances and transfers from nationals working abroad.

Demand for foreign exchange

Refers to the amount of foreign exchange desired by the people at a given rate in a given period of time.

Determinants of demand for foreign exchange/ why is forex demanded?

1. The quantity of a country's imports/ the country's expenditure on imports
2. The rate of capital outflow i.e. the need by locals to invest or save abroad
3. The level of expenditure on a country's diplomats abroad
4. For membership subscription in international or regional organizations such as EAC, UNO, AU etc

Reasons for foreign exchange shortages in developing countries

1. ***A narrow export base.*** This is limited to the export of primary exports which have low prices in foreign markets leading to low foreign exchange earnings.
2. ***Declining terms of trade;*** caused by falling commodity prices , discovery of synthetic substitutes etc
3. ***Debt servicing problems.*** These debts have to be serviced with the sacrifice of foreign exchange by developing countries. This is even compounded by the high interest rates on loans leading to foreign exchange expenditure.
4. ***Poor quality or sub-standard industrial output.*** This is outcompeted by the goods from developed countries and this reduces foreign exchange earnings further.
5. ***The breakdown of some export-oriented industries*** such as tourism and mining; leading to foreign exchange shortages.
6. ***Repatriation of foreign exchange by foreign owned companies and MNCs,*** in form of profits and dividends.
7. ***Excessive government expenditure.*** Such as military hardware, wars, travelling of government delegations abroad etc. This is also attributed to the rampant political instabilities in some areas.
8. Mismanagement of foreign exchange through private consumption and improper allocation.
9. High capital outflow such as by citizens who keep money in foreign banks or invest in other countries.
10. High marginal propensity to import (MPM). This increases the foreign exchange expenditure.
11. The currency of LDCs cannot be used in international trade and therefore have no opportunity to create hard currency.

Steps that can be taken to conserve foreign exchange in developing countries

1. Developing countries should ensure proper foreign exchange allocation.
2. Reduction in government expenditure through retrenchment and cost-sharing.
3. Diversify export base so as to ensure high export earnings.
4. Use of some import restrictions to minimize the forex expenditure.
5. Seek for debt rescheduling or cancellation from the donor countries or organizations.
6. Devaluation policy to limit the misuse of hard currency.
7. Engage in regional organizations where other means of exchange can be used such as barter system.
8. Encourage export promotion industries to add value to exports and import substitution industries to avoid wastage of foreign exchange.
9. Encourage foreign investors to increase capital inflow and undertake investments.
10. Promote reliance or use of local resources to save on hard currency.

FOREIGN EXCHANGE SYSTEMS

Refers to the system of converting money into other currencies acceptable internationally. Money is exchanged for other currencies in forex markets, which can be within the country or outside.

A foreign exchange market refers to a market mechanism which brings together buyers and sellers of foreign exchange.

Functions of foreign exchange markets

1. Enables people to transfer foreign exchange from one country to another.
2. Transfer credit to creditworthy customers who may need foreign exchange for investment.
3. Link commercial banks in the world. A forex market acts as a meeting place for all commercial banks and other financial institutions dealing in forex.
4. Enables users to acquire forex and exchange it for other currencies with ease through forces of demand and supply.
5. May be used as a tool by the central bank in regulation of foreign exchange rates.
6. Provides facilities for speculation which includes bonds and treasury bills—which can also aid in monetary policy.
7. Provide technical advice to traders, government and others about international financial systems.

Note: Forex markets in Uganda are in form of forex bureaus (bureau de change) established in 1990. There are over 80 forex bureaus in Uganda. Still many banks carry out forex activities such as Dfcu, crane bank, standard chartered bank, Cairo international bank etc.

Foreign exchange rates

Foreign exchange rate refers to the rate at which a country's currency is exchanged for another currency.

Or Refers to the price of a country's currency in terms of another currency in the foreign exchange market.

[Note: some currencies are easily converted into other currencies i.e. they are acceptable internationally in carrying out transactions and they are called hard currency. While other currencies are not acceptable in international transactions and are called soft currencies]

Determinants of the exchange rate

1. Volume of domestic output.
2. Volume of a country's exports.
3. Volume of imports.
4. Level of foreign exchange revenue.
5. Government policy on foreign exchange determination.
6. Level of capital inflow.
7. Political climate.
8. Rate of inflation in other countries.

Types of exchange rate/Methods of determining the foreign exchange rates

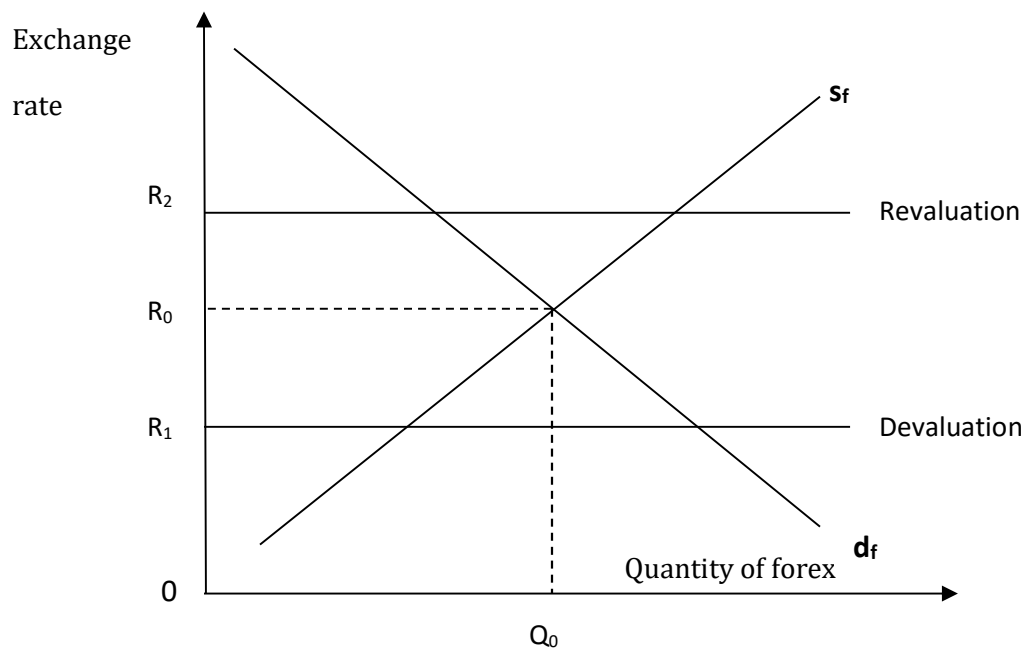
Fixed exchange rate/ pegged exchange rate

Refers to the exchange rate fixed/determined by the central monetary authority /by the government through the central bank.

The value or the exchange rate is pegged to the major currencies like Japanese yen, pound sterling, us dollar etc. The exchange rate remains constant in the foreign exchange market for a certain period of time due to government intervention.

Note: *Fixed/pegged exchange rate system* refers to where the exchange rate is determined by the central monetary authority.

Illustration of fixed exchange rate system



[When a country decides to make its currency cheaper in terms of other currencies we say there has been devaluation. If the exchange rate is fixed below the equilibrium rate, the exchange rate is undervalued and the local currency is overvalued i.e. less local currency is needed for one unit of foreign currency. However when a country decides to make its currency more expensive in terms of other currencies, we say there has been revaluation. If the exchange rate is fixed above the equilibrium rate, the exchange rate is overvalued but the local currency is undervalued i.e. more local currency is needed for one unit of foreign currency].

Note:

- **Over valuation of currency** –is the fixing of the value of the country's currency by the monetary authority above the equilibrium exchange rate. [Giving the local currency more value than its real value]. **Overvalued exchange rate** refers to the exchange rate which is officially fixed by the government at a level higher than its real value / shadow value.
- **Under valuation of currency** –is the fixing of the value of the country's currency by the government (monetary authority) below the equilibrium exchange rate. [Giving of the local currency less value than the real value]. **Under valued exchange rate** refers to the exchange rate which is officially fixed /set by government at a level lower than its real value/ shadow value.

Effects of currency under valuation

- *Increases exportation of goods*
- *Reduces imports*
- *Increases capital inflows*
- *Encourages domestic production*
- *Reduces imported inflation*

Advantages of fixed exchange rates

1. Encourages stability in the exchange rate, hence minimizing uncertainties in the foreign exchange market. This promotes international trade (import and export) since there is less speculation.
2. A fixed exchange rate exerts a strong discipline on domestic firms and employees to keep their costs under control in order to remain competitive in international markets. This helps to maintain low inflation.
3. The system handles the country's balance of payments needs directly without having to rely on demand and supply which are unpredictable.
4. The prices of home products and prices of imported commodities tend to be stable in the domestic market.
5. Makes planning easy and negotiation for long term projects possible since the exchange rate is relatively stable.
6. Guarantees the government or the central bank an opportunity to control forex market hence protecting the interests of sellers and buyers of forex.
7. Reduces exploitation of buyers of forex by the money market.

Disadvantages of fixed exchange rates

1. The system requires huge official reserves to be successfully operated, which are inadequate in developing countries given a persistent BOP deficit.
2. The system may lead to over valuation or under valuation of a country's currency, hence not a true reflection of the economic situation at that point in time.
3. The system imposes a burden on the monetary authority in the management of foreign exchange reserves and exchange control, and this leads to misallocation of the scarce resources.

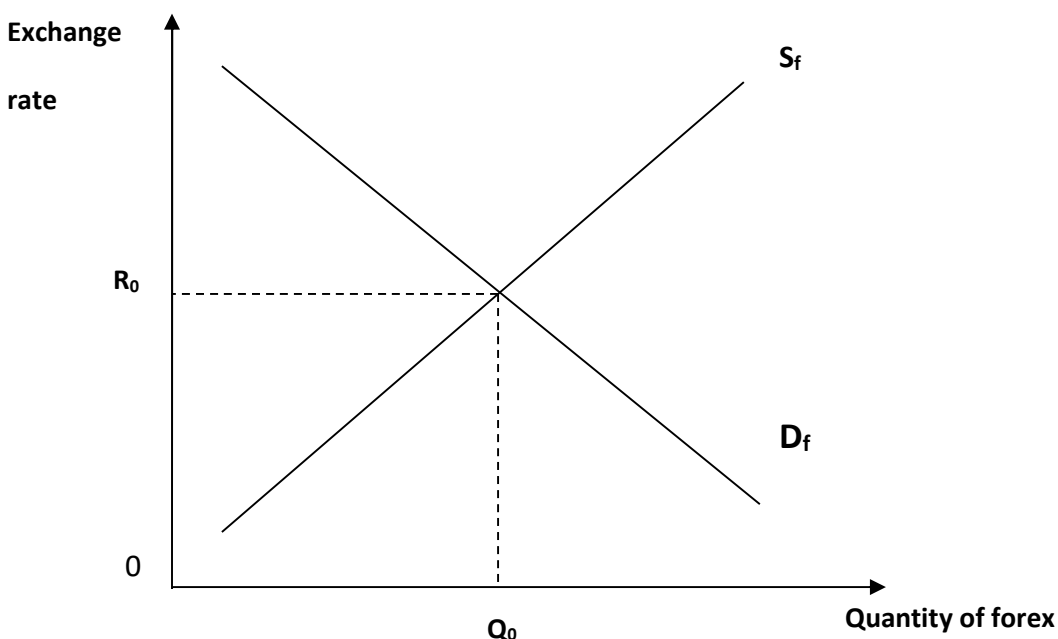
4. Denies consumers of foreign exchange free convertibility of their currency. This is because it gives government an opportunity to intervene. (it discourages competition in the foreign exchange market).
5. When it is fixed above the equilibrium, imports become expensive and this may result into inflation or high cost of living.
6. It is difficult to maintain in the long run since it is subject to change due to BOP problems, changes in commodity prices etc facing the country.

Free/ fluctuating exchange rate

Refers to the exchange rate/one which is determined by the interaction of market forces of demand and supply of a particular currency/ in foreign exchange market. It is also called **floating/ flexible /market/ equilibrium exchange rate**

Note: *Free/floating/flexible/ fluctuating exchange rate system* refers to where the exchange rate is determined by the free interaction of the market forces of demand and supply.

Illustration of free exchange rate system



Note:

When the supply of a particular currency increases other factors being constant, exchange rate will be low.

When the value of a currency rises as a result of changes in demand and supply, then that currency has appreciated. However when the value of a currency falls due to changes in demand and supply, then that currency has depreciated.

Currency appreciation—refers to the increase/rise in the value of a country's currency in terms of other currencies under a fluctuating exchange rate system (or due to forces of demand and supply).

Currency depreciation—refers to the loss of value/fall in the value of a country's currency in terms of other currencies under a fluctuating exchange rate system.

Types of floating exchange rates:

- a) **Clean float (free-floating exchange rate.** This is the exchange rate that is determined by forces of demand and supply without any government intervention. The exchange rate is independent of any influence of the monetary authority.
- b) ***Dirty float/ managed float/ mixed float.** This is the exchange rate where the central bank intervenes in the free exchange market by fixing variable margins between which the exchange rate should float/fluctuate. It is managed because the central bank controls the flexibility by setting upper and lower limits in advance.

Advantages of free exchange rate

- 1. Gives the true value /price of a country's currency in terms of other currencies, hence avoiding over and under valuation. It gives a true reflection of the economic condition of the economy.
- 2. It is cheap because it does not require large official foreign exchange reserves to be supported.
- 3. Earns the government some revenue especially when the domestic currency appreciates.
- 4. Encourage competition in the forex market which improves the services.
- 5. Allows free convertibility of currency, hence benefiting buyers when it reduces and sellers when it increases.
- 6. Allows private individuals to deal in forex market because it minimizes government control.

Disadvantages of free exchange rate

- 1. Makes planning difficult because the exchange rate is unstable and unpredictable. This encourages speculation and hoarding (*in the selling of foreign currency or other liquid assets like bonds, treasury bills*).
- 2. Creates a lot of uncertainty in the foreign exchange market hence discouraging investors, importers and exporters. (When the exchange rate increases, importers suffer while when it falls the exporters suffer).
- 3. A flexible exchange rate is inflationary. A depreciating currency increases the price of imports leading to cost-push inflation.
- 4. It subjects the economy to external forces and disturbances. For example the earnings from exports fluctuate since the exchange rates are not stable.
- 5. It may have adverse effects on the country's balance of payments position if not regulated.
- 6. Long-term contracts are affected since the price of goods depends on the exchange rate that is not predictable.
- 7. It leads to exploitation of buyers of foreign exchange. This is because the exchange rate may not be uniform in all markets which creates disorder in the market.

Dual /multiple exchange rate system

This is where two or more exchange rates are set by government to operate side by side (in a given period of time). Priority imports (e.g. necessities) are given a favourable exchange rate while non-priority imports (e.g. luxurious goods) are given a less favourable rate.

Note:

Revaluation of currency —refers to the deliberate government policy to increase/raise the value of the country's currency in terms of other currencies under a fixed exchange rate system.

[Refers to the legal raising of the value of the country's currency by the government in terms of foreign currency under a fixed exchange rate system]. Revaluation is the opposite of devaluation.

DEVALUATION

Devaluation refers to the deliberate/legal reduction in the value of the country's currency by the government in terms other currencies under a fixed exchange rate system.

[Or refers to the deliberate government policy to reduce the value of a country's currency in terms of other currencies under a fixed exchange rate system]

It is usually aimed at improving on the B.O.P i.e. by increasing the amount of foreign exchange earnings from exports and decreasing the amount of foreign exchange expenditure.

[The immediate effects of devaluation are: makes a country's currency cheaper and foreign currencies expensive, makes a country's exports cheaper and thus more forex earnings, makes imports expensive and forces the country to reduce the imports]

Conditions necessary for the success of devaluation

1. ***Demand for imports must be price elastic.*** A small increase in price resulting from devaluation leads to a very big decrease in the quantity demanded of imports. This reduces the foreign exchange expenditure.
2. ***The foreign demand for exports must be price elastic.*** A small reduction in price resulting from devaluation leads to a very big increase in quantity demanded of exports and hence more foreign exchange is obtained.
3. ***The supply of exports must be price elastic*** such that as demand increases, supply also increases i.e. there should be no supply rigidities in an economy. In such a situation more is available for export and hence more foreign exchange generated.
4. ***Other countries producing similar goods should not devalue at the same time i.e. there should be no retaliation.*** This is necessary so as to make the exports of the country which has devalued to appear cheaper compared to other country's exports.
5. ***The country devaluing should be free from inflation.*** This is because inflation erodes all the benefits of devaluation for example it makes the prices of exports expensive.

6. ***The exchange rates of devaluating countries must be fixed*** i.e. set by the government (central monetary authority).
7. ***The home country must be having import substitution industries*** to produce the goods that were previously imported locally.
8. ***There should be political stability in the home country*** to ensure capital inflow and high export production.
9. ***There should be strong administrative machinery*** to coordinate and implement the devaluation policy.

Reasons for devaluation (positive effects of devaluation)

1. ***To discourage excessive importation*** especially of luxurious commodities. It is a policy of protectionism since imports become expensive and demand may fall, which may solve the B.O.P problems.
2. ***To encourage exports*** so as to earn much more. After devaluation exports become cheaper in foreign markets; which increases the volume of exports and as a result more foreign exchange is earned.
3. ***To increase domestic production/industrial development.*** This is because it encourages production for export and the domestic market since imports are discouraged.
4. ***To control the use of the scarce foreign exchange.*** This is because the central bank through devaluation gets full control of foreign exchange.
5. ***The beggar my neighbour policy*** i.e. adopting retaliation policy against other countries which have adopted protectionism at the expense of other countries.
6. ***To attain a more realistic value of the domestic currency.*** The use of forex in non-productive activities is reduced.
7. ***To check on imported inflation.*** Devaluation discourages importation hence reducing on the possibility of importing from countries that are experiencing inflation.
8. ***To promote self-reliance.*** After devaluation producers are discouraged to use imported inputs and foreign expatriate labour since they become expensive.
9. ***To protect infant industries*** and encourage utilization of local resources, and the employment multiplier expands.

Disadvantages of devaluation (negative effects of devaluation)

1. ***Devaluation tends to be inflationary.*** Leads to high prices of imported essential products due to the fact that it makes imports expensive yet LDCs have inelastic demand for imports.
2. ***It revokes retaliation by trading partners,*** hence worsening the B.O.P problems. The trading partners may also devalue their own currencies to offset the effects of devaluation by the country; which creates economic difficulties in the broader financial markets.
3. ***Devaluation increases the cost of imported raw materials*** and this results into increased cost of production.
4. ***Leads to industrial unrest*** due to adverse effects on low income earners and fixed salary earners. These in turn demand for high wages.

5. **Devaluation reduces the standard of living of the people.** This is because the locally produced goods may be of poor quality and yet imports are discouraged. More so it reduces the supply of goods and reduces consumers' choice.
6. **Loss of revenue from exports.** As countries devalue in order to attract demand, less is sold due to inelastic demand in foreign markets. A reduction in price does not lead to a large increase in demand.
7. **The heavily indebted LDCs lose much** because they have to use large amounts of resources to pay the debts since foreign currency is expensive.
8. **Devaluation reduces the confidence of investors in the country's economy**, since devaluation is viewed as a sign of economic weakness.

Why may devaluation fail to solve B.O.P problems? (Why may devaluation fail to realize its aims?)

1. When the foreign demand for exports of a country are mainly price inelastic.
2. When the domestic demand for imports is price inelastic.
3. When the elasticity of supply for exports by LDCs is low/inelastic.
4. When there is a low level of industrialization in the home country.
5. When there is inflation in the devaluing country, making exports expensive.
6. When there is political instability in the home country.
7. In case of competitive devaluation by competing suppliers/ retaliation.
8. In case of weak administrative organs of LDCs to implement devaluation.
9. In case of trade restrictions on exports (protectionism)
10. When the supply of exports is inelastic due to supply rigidities/bottlenecks.

Reasons why devaluation fails to achieve its objectives

1. **The foreign demand for exports of developing countries is mainly inelastic.** Some importers maintain almost the same quantity of imports (for example by using raw material saving technology) despite the reduced prices rendering devaluation useless.
2. **The domestic demand for imports by developing countries is inelastic.** Despite the rise in prices of imports due to devaluation the quantity demanded is almost the same since they are dependent on imports especially of manufactured goods (high marginal propensity to import).
3. **The elasticity of supply for exports by LDCs is low/ inelastic.** This is especially in the short run due to the long gestation period of most agricultural products and supply rigidities since they are mostly dependent on natural factors. This makes it difficult to increase the supply of exports to increase the foreign demand.
4. **Developing countries export the same commodities**, so they compete for international markets. They are therefore bound to have competitive devaluation or the beggar my neighbour policy is likely to be adopted.
5. **The political instabilities and uncertainties in LDCs** have made it difficult for devaluation to achieve its objectives. These reduce the confidence of investors and hence less supply available to export at cheaper prices (or to produce the formerly imported goods).

6. **Low level of industrialization in most LDCs.** The amount of exports is low and thus the country cannot benefit from export market after devaluation.
7. **High rates of inflation in the devaluing country,** making exports expensive and thus losing market, yet devaluation is intended to make the exports cheaper.
8. **Absence of strong administrative machinery** to coordinate and implement the devaluation policy.

Questions

SECTION A

- 1) (a) Distinguish between overvalued exchange rate and undervalued exchange rate (2 mks)
(b) Outline any two effects of overvalued exchange rate (2 mks)
- 2) (a) Distinguish between currency revaluation and currency under valuation (2 mks)
(b) Mention any two effects of currency under-valuation (2 mks)
- 3) (a) Differentiate between currency appreciation and currency depreciation (2 mks)
(b) Give any two effects of appreciation of currency (2 mks)

SECTION B

- 4) (a) How can devaluation be used to solve the balance of payment problems of a country?
(b) Why may devaluation fail to be successful in developing countries?
- 5) (a) Distinguish between currency devaluation and currency depreciation
(b) Why has devaluation failed to assist developing countries to attain macro-economic stability?
- 6) (a) Explain devaluation as a means of achieving balance of payment equilibrium.
(b) Why may devaluation fail to achieve an improvement in the B.OP?
- 7) (a) Distinguish between Devaluation and Revaluation
(b) Why may a country devalue its currency?
- 8) (a) Explain how the exchange rate is determined by demand and supply
(b) What are the advantages and disadvantages of floating the exchange rate?
- 9) (a) Distinguish between nominal and real exchange rate
(b) Explain the merits and demerits of a pegged exchange rate system.
- 10) (a) Distinguish between a floating exchange rate and a fixed exchange rate (4 mks)
(b) What are the merits and demerits of foreign exchange control in an economy? (16 mks)
- 11) (a) Explain the reasons why a country devalues its currency (10 mks)
(b) What are the reasons for the failure of the devaluation process? (10 mks)
- 12) What are the effects of devaluation in an economy?

Trade liberalization

Refers to the removal of unnecessary control on trade by the government so as to give people a chance/ liberty to participate in trade.

It is the removal of unnecessary restrictions to trade (by relaxing instruments like quotas, total ban, tariffs, administrative control etc) in order to give people the opportunity for increased participation in trade (to increase the value, volume and benefits of trade).

Advantages of trade liberalization

1. Increases employment opportunities.
2. Leads to increased volume of output produced, hence increases economic growth rates.
3. Controls structural inflation.
4. Increases the level of resource exploitation.
5. Encourages innovations and inventions in the economy./ technological transfer and development.
6. Promotes efficiency in production due to competition. Improves the quality of goods.
7. Increases/generates government revenue.
8. Reduces income and wealth inequalities in the economy.
9. Provision of a variety of commodities to consumers, which widens consumers' choice.
10. Encourages consumer sovereignty.
11. Encourages capital inflow
12. Improves the balance of payment position as exports are encouraged
13. Promotes infrastructural development
14. Improves international relations with other countries/ trading partners
15. Promotes economic diversification
16. Promotes entrepreneurial and labour skills

Disadvantages of trade liberalization

1. Opens the economy to economic instabilities in the world such as price fluctuations.
2. Increases unemployment because Stiff competition kicks out the inefficient firms/ collapse of some firms due to stiff competition
3. Encourages misallocation of resources.
4. Duplication in production, hence wastage of resources
5. Over exploitation of resources leading to quick depletion
6. Flooding of the market with commodities due to over production, and this some times forces prices to go very low.
7. Excessive advertisement misguides the consumers/ distortion of consumer choices due to intensive sales promotion.
8. Encourages capital outflow.
9. Increased exposure of the public to harmful products/ consumer exploitation due to ignorance
10. Emergence of monopoly and its negative effects, as the inefficient firms are kicked out of production.
11. Increases income and wealth inequalities
12. Accelerates environmental degradation such as pollution.
13. Increases foreign economic dominance

International monetary fund (IMF)

It is an international financial organization that over sees the global financial system by observing exchange rates and balance of payments, and provides both financial and technical assistance to member countries. It has head quarters in Washington D.C and has offices in many parts of the world.

Objectives of IMF

- To stabilize exchange rates
- To stabilize prices in order to promote economic growth and development especially among poor countries
- To establish market oriented systems among developing countries
- To promote trade and remove all trade restrictions
- To provide financial assistance in form of loans and grants to member countries which are greatly affected by B.O.P problems
- To provide technical assistance to under developed economies through economic policies and reforms
- To promote cooperation among countries by involvement in international trade
- To establish a better mechanism of paying international debts
- To harmonize policies in different countries as a way of creating international peace.

Structural adjustment programs (SAPs)/ conditionalities of IMF

Structural adjustment programs refers to the policy measures set by undertaken by the government to change/ restructure structural features of the economy, with the purpose of accelerating economic growth rates or achieve certain economic objectives.

These are economic policies set by IMF (International Monetary Fund) which countries must follow as a precondition to obtain loans and make debt repayments among other benefits.

As a country borrows it agrees to make adjustments in its economic policies to control the problems that led to seek aid in the first place.

The structural adjustments programs are designed by IMF and they include:

1. Privatization policy
2. Devaluation policy
3. Export-led growth such as export diversification
4. Investment policy such as tax holidays, fair laws
5. Liberalization of the economy
6. Liberalization of the foreign exchange market
7. Fiscal policy /Balance budgets such as by cutting government expenditure
8. Removal of price controls

Structural adjustment programs (SAPs) of IMF in Uganda

1. Privatization policy
2. Liberalization of the economy
3. Investment policy such as tax holidays, fair laws etc
4. Fiscal policy implementation, involving reduction in government expenditure, to fight corruption in the civil service, strengthening tax collections, Retrenchment/ Demobilization/ cost sharing.
5. Foreign exchange policy such liberalization of the foreign exchange market
6. Monetary policy such as regulating money supply and security markets.
7. Infrastructural development policy
8. Agricultural modernization
9. Export diversification