INTERNATIONAL TRADE

This refers to the buying and selling of goods and services among nations. It is a trade that goes beyond the boundaries of a country. It involves exports and imports.

IMPORTS

These are goods and services that legally cross the borders from one country into another. There are both visible and invisible imports.

Visible imports

These are tangible goods that are brought into a country from another country.

Invisible imports

These are services that are brought into a country from another country e.g. insurance, banking, etc.

EXPORTS

These are goods and services that are locally produced and sold to other countries. They can also be visible and invisible. Visible exports are tangible goods while invisible exports are services that are produced locally and sold to other countries.

VISIBLE TRADE

Refers to the buying and selling of tangible goods among different countries

INVISIBLE TRADE

Refers to the exchange of services between countries

OR

Is the exchange of invisible exports and invisible imports of a country e.g. tourism, electricity.

International trade can also be bi-lateral or multi-lateral.

BI-LATERAL TRADE

This involves exchanging of goods and services between two countries.

MULTI-LATERAL TRADE

This involves exchanging of goods and services among more than two countries.

THE ROLE OF INTERNATIONAL TRADE IN THE DEVELOPMENT OF A COUNTRY

POSITIVE ROLES

1. Enables the country to get what it does not produce.
2. Provides a variety of goods hence widening the consumers' choice.
3. Increases the efficiency of domestic firms due to competition from imported goods hence lowering average production costs.
4. Enables the country to dispose of the surplus output that would otherwise be wasted due to widened markets beyond the country's boundaries.
5. Promotes specialization and its benefits since there is existence of comparative advantage among countries as each country specializes in the production of a commodity where it incurs the least opportunity cost.
6. Enables a country to acquire new ideas and values especially on better production techniques hence helping to transform the economies from subsistence to commercialized production.
7. Promotes international friendship and cooperation among countries participating in trade hence promoting peace and stability among countries.
8. Leads to utilization of resources hence avoiding wastage. This is due to widened markets beyond the country's boundaries.
9. Promotes technology transfer i.e. shifting of new and efficient production methods from one country to another especially from developed countries to underdeveloped countries. This leads to effective exploitation of resources and production of better quality products.

10. Enables countries to acquire skilled labour from other countries as they trade together hence leading to increased productive capacity among nations hence leading to higher economic growth rates.

11. Promotes capital inflow/ foreign exchange from foreign investors and from goods being exchanged hence helping to close the foreign exchange gap.

12. Provides revenue to the government. This is obtained mainly from taxes imposed on exports and imports hence enabling the government to meet its expenditure needs.

13. Increased output hence economic growth. International trade leads to production of more goods due to existence of a big market among different countries participating in trade hence economic growth.

14. Provision of employment opportunities. This is arises due to enlarged investments as markets expand calling for more workers. Also jobs are provided to those participating in importation and exportation of goods and services hence enabling people get incomes thereby improving their standards of living.

15. Increased quality of output due to competition. International trade leads to increased quality of output being produced due to competition for market among different countries.

16. Promotes infrastructural development especially railway networks, bridges and roads so as to allow easier and cheaper movement of goods and services being traded between countries thereby promoting increased economic/ productive activities between countries.

17. Promotes entrepreneurship as investors engage in various investment activities to earn more profits due to widened markets.

18. Enables countries to get supplies in times of emergencies e.g. natural calamities like droughts, earthquakes, landslides, etc which would not be possible in absence of international trade hence helping to save life.

19. Supplements domestic production (output) hence overcoming a problem of scarcity of goods.

NEGATIVE ROLES

1. Leads to exhaustion of non-renewable resources due to over exploitation as the market keeps on growing.

2. Leads to cultural and moral erosion especially among low developing countries as people tend to copy foreign cultures and lifestyles.
3. Leads to collapse of domestic firms as they find it difficult to compete with high quality goods being imported into the country and sometimes at lower prices than the domestically produced goods.
4. Leads to imported inflation which is as a result of importing goods from inflation prone countries. This increases the cost of living in the country hence lowering peoples' standards of living.
5. Leads to poor terms of trade. This is as a result of exporting low quality and semi-processed goods from low developing countries that command low prices in international markets while importing expensive manufactured goods from developed countries.
6. Leads to balance of payments problems. This is arises due to high capital outflow in form of profit and income repatriation by foreign investors working in the country and also due to expenditure abroad on expensive manufactured goods being imported into the country.
7. Promotes dependence/ reduces self-sufficiency. This arises as countries expect to rely on goods produced from other countries instead of surviving on their own. This erodes the political and economic dependence.
8. Leads to importation of undesirable products such as pornographic material, indecent attires, destructive drugs and other intoxicants. Such products negatively affect the health and morals of people.
9. Leads to unemployment. This is arises due to technology transfer that tends to be more capital intensive than labour intensive and due to collapse of domestic firms due to their out competition.
10. Retards development of local skills. This arises because instead of the country struggling to come up with its own technology, own products and training its own manpower; it hopes to rely on technology and goods produced by other countries.
11. Leads to dumping with its negative effects such as closure of local firms due to their out competition, underutilization of local resources among others.

BASIS OF INTERNATIONAL TRADE

1. Difference in resource endowment. Different countries have different natural resource endowments in form of minerals, forests, etc. therefore there is need for countries to specialize and exchange in order to get what they do not have through international trade.
2. Need to dispose of surplus output. Some countries produce more than what they can consume. Therefore, there is need to sell off the excess output to other countries in order to avoid resource wastage.
3. Difference in comparative advantage between countries. There is need for specialization among countries in the production and exportation of commodities that they can produce at lower costs than other countries and import commodities that they can produce at high cost hence international trade.
4. Lack of self-sufficiency in terms of goods and services. No country can produce all what it needs therefore countries trade together in order to get what they cannot produce locally.
5. The need to earn foreign exchange. There is need for international trade for countries to acquire foreign exchange which can be used for import purposes.
6. Need to promote international relations among countries through international trade. In addition, some countries need international trade in order to further their political and economic ideologies.
7. Etc.

LIMITATIONS OF INTERNATIONAL TRADE

1. Poor infrastructures.
2. Low quality of goods produced for international markets.
3. Protectionism policies of importing countries.
4. Tendency for most LDCs to have similar comparative advantage/ production of similar commodities.
5. Political instabilities in various countries e.g. Democratic Republic of Congo, Central African Republic, Southern Sudan.
6. Absence of uniform/ same currency to be used among different trading partners.

7. Differences in languages hence limiting effective communication.
8. Differences in political ideologies between countries/ conflicts among leaders of different countries.
9. High tariffs and non-tariff barriers on trading partners. This restricts the volume and direction of trade.

LIBERALISATION OF INTERNATIONAL TRADE (TRADE LIBERALISATION)

Trade liberalization refers to the removal of unnecessary restrictions on trade, hence giving people liberty to trade without undue government interference so as to increase the volume and benefits of trade.

OR

Trade liberalization refers to the removal of unnecessary restrictions on trade (so that trade can be carried out with more freedom).

WAYS OF LIBERALISING TRADE

- Reduction of tariffs
- Removal of unnecessary subsidies to domestic firms.
- Abolition of quotas
- Privatization of state owned trading enterprises.
- Reduced bureaucratic/ administrative controls e.g. easing the process of acquisition of import licenses.
- Liberalizing the foreign exchange markets i.e. using floating exchange rate.

IMPLICATIONS OF TRADE LIBERALISATION IN AN ECONOMY

POSITIVE IMPLICATIONS

1. Increases employment opportunities.
2. Increases the level of output hence economic growth.
3. Controls structural inflation since participation in international trade controls scarcity of goods and services hence controlling structural inflation which arises as a result of supply rigidities.
4. Encourages resource utilization.
5. It encourages inventions and innovations/ leads to technological development.
6. Leads to efficiency of firms due to competition.
7. Leads to improved quality of goods being traded due to competition between local and foreign firms.
8. Increases tax revenue.
9. Upholds consumer sovereignty. Widens consumers' choices through increased variety of goods being traded.
10. Fights corruption in government departments due to abolition of unnecessary controls on trade.
11. Encourages foreign investment/ promotes resource inflows.
12. Stimulates development of infrastructures.
13. Improves balance of payment position through increased foreign exchange mainly from exports.
14. Reduces bureaucracy involved in trade due to reduced restrictions involved in international trade.
15. Improves relations between countries as countries continue to trade together hence improving peace and stability.
16. Promotes growth of entrepreneurship abilities due to widened markets hence leading to increased production capacity of nations leading to faster economic growth rates.

NEGATIVE IMPLICATIONS

1. Leads to imported inflation.
2. Competition pushes out inefficient firms leading to unemployment

3. Increases inflow of demerit goods due to absence of trade restrictions hence endangering peoples' health.
4. Technological development and technology transfer worsen the unemployment problem due to use of machines.
5. Promotes capital outflows in form of profit and income repatriation by foreign investors hence limiting capital accumulation.
6. Leads to environmental degradation due to desire for more output and profits both for domestic and foreign markets.
7. Leads to exhaustion of non-renewable resources due to their over exploitation.
8. Leads to dumping leading to suffocation of domestic industries.
9. Leads to economic dependence i.e. dependence on imported goods.
10. Leads to cultural and moral erosion.

GUIDING QUESTIONS

a) What is meant by **"trade liberalization"?** (1 mark)
b) State any **three** measures that have been taken to liberate trade in your country. (3 marks)
c) Examine the implications of trade liberalization on the economies of developing countries. (16 marks)

THEORIES OF INTERNATIONAL TRADE

1. THE PRINCIPLE OF ABSOLUTE ADVANTAGE

The principle of absolute advantage states that **"given two countries and two commodities with the same amount of resources, one country can produce both commodities more cheaply than the other."**

Study the table below showing output levels of two countries producing two countries with the same amount of resources and state the country with absolute advantage in the production of both commodities.

	Commodities

Country	Generators	Coffee
X	400	600
Y	100	300

Country X has absolute advantage in the production of both commodities.

2. <u>THE PRINCIPLE OF COMPARATIVE/ COMPETITIVE COST ADVANTAGE</u>

The principle of comparative cost advantage states that **“given two countries and two commodities with a given amount of resources, a country should specialize in producing a commodity where it has the least opportunity cost than the other.”**

Using the above table, calculate the opportunity cost of producing each commodity in each country. In which commodity should each country specialize?

<u>Solution</u>

$$Opportunity\ cost\ =\ \frac{Alternative\ forgone}{Actual\ production}$$

<u>Country X</u>

$$Opportunity\ \ cost\ (Generators) =\ \frac{600}{400}\ =\ 1.5$$

$$Opportunity\ cost\ (Coffee) =\ \frac{400}{600}\ =\ 0.67$$

<u>Country Y</u>

$$Oppotunity\ cost\ (Generators) =\ \frac{300}{100}\ =\ 300$$

$$Opportunity\ cost\ (Coffee) =\ \frac{100}{300}\ =\ 0.33$$

Country	Commodities	
	Generators	Coffee
X	1.5	0.67
Y	3	0.33

Country X should specialize in the production of generators while country Y should specialize in the production of coffee.

ASSUMPTIONS UNDERLYING THE PRINCIPLE OF COMPARATIVE ADVANTAGE

- Assumes two countries
- Assumes two commodities
- Assumes existence of free trade
- Assumes no transport costs
- It assumes full employment of resources in both countries
- Assumes demand is elastic.
- Assumes homogeneity of factors of production.
- Assumes constant returns to scale/ no diminishing returns
- Assumes existence of barter trade as a medium of exchange
- Assumes constant comparative advantage in both countries.
- Assumes constant technology
- Assumes perfect mobility of factors of production internally and immobility of factors externally

APPLICABILITY OF THE THEORY IN LDCS

1. Developing countries have tended to specialize in agriculture where they have the lowest comparative cost.
2. There are barter trade arrangements in low developing countries making the theory applicable.
3. There is use of labour intensive technology which is abundant in LDCs, which is more static.
4. There is some degree of mobility of factors of production within the region as assumed by the theory.
5. There are some cases of free trade in LDCs especially under common market arrangement.

INAPPLICABILITY/ LIMITATIONS OF THE COMPARATIVE COST THEORY

1. The simplicity of considering only two countries is unrealistic since trade is carried out by more than two countries.
2. The simplicity of considering only two commodities is unrealistic since trade between countries involves more than two commodities.
3. It assumes free trade yet in most countries there are trade barriers such as quotas, total ban, quality controls among others.
4. It ignores transport costs which cause differences in costs between countries.
5. It wrongly assumes the possibility of full employment of resources yet LDCs experience high levels of unemployment and underemployment.
6. It assumes that demand is elastic yet demand for agricultural products is inelastic.
7. It assumes homogeneity of factors of production yet these factors are heterogeneous.
8. It ignores the existence of diminishing returns as the principle assumes constant returns to scale.
9. It assumes barter trade only yet there is also monetary exchange.
10. It ignores the existence of different currencies used by different countries.
11. It assumes static comparative advantage among countries yet sometimes this advantage changes.
12. It ignores technological changes yet technology changes for example from labour intensive to capital intensive.
13. There can be international mobility of factors of production but the theory assumes perfect mobility of factors internally and immobility of factors externally.
14. It ignores the possibility of absolute advantage whereby a country can produce both commodities more cheaply than the other.
15. It ignores the need for self-reliance among countries as it puts emphasis on specialization between countries hence countries surviving on each other.

3. VENT FOR SURPLUS THEORY

The theory states that **"international trade provides opportunity for countries to utilize formerly idle resources to produce output for the export markets."**

GUIDING QUESTIONS

1. a) State the principle of comparative cost advantage. (1 mark)

   b) Give any three limitations of the above theory. (3 marks)

2. a) What is meant by "vent for surplus theory" used in international trade? (4 marks)

   b) Assess the role of international trade in the development of your country. (16 marks)

3. a) Distinguish between comparative advantage and the law of absolute advantage. (4 marks)

   b) To what extent is the comparative cost theory applicable to developing countries? (16 marks)

4. a) Study the table below.

Country	Commodity	
	Coffee (Kg)	Milk (Lr)
Kenya	4,000	7,000
Uganda	3,000	5,000

   i) Calculate the comparative cost advantage of producing each commodity in the two countries. (4 marks)

   ii) State a commodity in which each of the two countries should specialize. (2 marks)

   b) Explain the limitations of the theory of comparative cost advantage in developing countries. (14 marks)

TERMS OF TRADE

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

OR

Terms of trade is the rate at which a country's exports are exchanged for imports.

OR

Terms of trade is the purchasing power of a country's exports in terms of imports.

Terms of trade can be expressed in two ways;

1. **Barter terms of trade/ commodity terms of trade.**

   Is the ratio of the price index of exports to the price index of imports. It shows how much exports are required to purchase a unit imports.

$$Barter\ T.O.T = \frac{Price\ index\ of\ exports}{Price\ index\ of\ imports} = \frac{Px}{Pm}$$

   If $\frac{Px}{Pm} > 1,$ the country is said to be experiencing favourable terms of trade

   If $\frac{Px}{Pm} < 1,$ the country is said to be experiencing unfavourable terms of trade

   Barter terms of trade can also be expressed as a percentage using the formula;

$$Barter\ T.O.T = \left(\frac{Px}{Pm}\right)\times 100$$

   Barter terms of trade are favourable if $\left(\frac{Px}{Pm}\right)\times 100$ is greater than 100% and unfavourable if $\left(\frac{Px}{Pm}\right)\times 100$ is less than 100%.

2. **Income (monetary) terms of trade.**

   Is the ratio of the value of exports to the price index of imports. It shows how much a country can import using the revenue from exports.

$$Income\ terms\ of\ trade = \left(\frac{Px}{Pm}\right)\times Qx$$

$$= Barter\ T.O.T \times Qx$$

   Where;

   Qx = Quantity of exports

   Px = Price index of exports

Pm = Price index of imports

If Px $>$ Pm, → favourable terms of trade.

If Px $<$ Pm, → unfavourable terms of trade.

Example

Given that the price index of exports is 120 and the price index of imports is 130 and the quantity of exports is 200kgs. Calculate;

a) (i) The barter T.O.T

(ii) The income T.O.T

b) Comment on the country's terms of trade.

Solution

a) (i) $$Barter\ T.O.T = \frac{Price\ index\ of\ exports}{Price\ index\ of\ imports} \times 100$$

$$= \frac{120}{130} \times 100$$

$$= 92.3\%$$

(ii) $$Income\ T.O.T = Barter\ T.O.T \times Quantity\ of\ exports$$

$$= \frac{92.3}{100} \times 200$$

$$= 184.6$$

b) The country is experiencing unfavourable terms of trade because the barter terms of trade is less than 100%.

CAUSES OF UNFAVOURABLE TERMS OF TRADE IN LDCs (UGANDA)

1. **Falling prices of exports.**
2. **Importation of expensive manufactured capital and consumer goods.**
3. **Increasing substitution of exports with synthetics produced by developed countries.**
4. **Exportation of semi-processed agricultural and mineral products.** These have low value added on them therefore command low prices on the world market yet imported goods are highly manufactured and hence carry high prices.
5. **Market flooding of raw agricultural products leading to fall in export prices.** This is as a result of production and exportation of similar products by developing countries.

6. **Protectionist policies of developed countries in form of tariffs and non tariff barriers.** This is aimed at protecting their economies as a way of achieving self-sufficiency and self-reliance. This greatly reduces the demand for exports from developing countries leading to a fall in export prices.
7. **Weak bargaining power of LDCs.** In most cases, LDCs are price takers i.e. the prices of their exports in foreign markets are dictated by MDCs. MDCs dictate low prices for LDCs' products yet set high prices for their commodities causing unfavourable terms of trade.
8. **Invention of raw-material saving techniques of production by MDCs.** Developed countries have invented technology which uses less raw-materials from LDCs thereby leading to a reduction in demand for products from LDCs leading to low prices of LDCs' exports yet imported commodities are expensive causing unfavourable terms of trade.
9. **Low income elasticity of demand for LDCs' exports.** This implies that even when incomes increase worldwide, the demand for LDCs' exports remains low because they are mainly agricultural products thereby commanding low export prices yet import prices are high.
10. **Low quality of exports from LDCs.** This is partly due to limited skills and use of poor techniques of production therefore commanding low prices on the world market yet import prices are high.
11. **Rising prices of imports.** Generally, the rich in LDCs have a high marginal propensity to import especially due to the snob effect and the goods demanded include expensive wines, cars, mobile phones, jewelleries, etc. This enables developed countries to fix high prices on their products yet LDCs export semi-processed products whose prices are low causing unfavourable terms of trade.
12. **Unfavourable exchange rates.** This has resulted into undervaluation of LDCs' exports yet prices of imports remain higher causing unfavourable terms of trade.

NOTE

Emphasis should be on prices of exports being low or prices of imports being high, avoid "B.O.P".

EFFECTS OF DETERIORATING TERMS OF TRADE

1. **Leads to foreign exchange shortages** due to low prices of export commodities.

2. **Leads to imported inflation** due to rising prices of imported commodities.
3. **Worsens the country's B.O.P position and balance of trade position** since low prices of exports result into low earnings from abroad while rising prices of imports increase the country's expenditure abroad.
4. **Leads to low production** due to low prices of exported commodities limiting the rates of economic growth.
5. **Causes unemployment.** This is because low prices of export commodities discourage production and investments.
6. **Leads to reduction in level of investment** since low prices of export commodities are unattractive to investors.
7. **Causes currency depreciation** due to unfavorable exchange rates between the local currency and foreign currencies.

MEASURES THAT SHOULD BE TAKEN TO IMPROVE TERMS OF TRADE

1. **Process primary products** to add value on them thereby commanding high prices on the world market.
2. **Adopt import substitution industrial strategy.** This helps to produce formerly imported goods thereby reducing importation of expensive manufactured goods.
3. **Diversify export markets.** LDCs should look for different markets in various parts of the world for example through joining or strengthening regional cooperation. This increases the demand for exports hence raising the export prices.
4. **Strengthen commodity agreements.** LDCs should enter commodity agreements with other countries so that they can be offered fair and stable prices for the commodities they mainly import.
5. **Improve quality of exports** for example through research, adoption of better production techniques, training of labour to improve on its skills hence producing high quality exports that command high prices on the world market.
6. **Encourage importation from cheaper sources.** This helps to overcome importation of expensive manufactured goods thereby improving the country's terms of trade.

7. **Diversify products for export.** This helps to increase on the variety of goods for exportation so that when there is a fall in the price of some exports, other commodity prices remain high.
8. **Stabilize foreign exchange rates** for example through setting managed exchange rate to ensure fair competition between exports and imports.
9. **Negotiate for removal of trade barriers in export markets** such as tariffs, total ban, quality controls etc so as to raise demand for exports in the foreign markets which helps to raise prices for exported commodities.

GUIDING QUESTIONS

1. a) Distinguish between barter terms of trade and income terms of trade. (02 marks)
   b) State any two effects of unfavourable terms of trade in your country. (02 marks)
2. a) Account for unfavourable terms of trade in your country. (10 marks)
   b. Discuss the measures that have been taken to improve terms of trade in your country. (10 marks)

BALANCE OF TRADE

This is the difference between the value of a country's visible exports and visible imports.

BALANCE OF PAYMENTS

Refers to the difference between a country's receipts/ income from abroad and expenditure/ payments abroad during a given time

OR

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

OR

Refers to the difference between earnings/ incomes/ receipts from abroad and payments abroad (visible and invisible trade and not capital transfers) of a country during a given time.

If the country's receipts/ income from abroad exceed her expenditure/ payments abroad, the country is said to have a balance of payment surplus and therefore it experiences favourable balance of payments.

If the country's expenditure/ payments abroad exceeds her receipts/ income from abroad, the country is said to have a balance of payments deficit and therefore it experiences unfavourable balance of payments.

COMPONENTS OF THE BALANCE OF PAYMENTS ACCOUNT

1. **Current account.** This is a summary of all transactions which involves movement of goods and services between countries. The current account is divided into two i.e. the visible trade account and the invisible trade account.
2. **Capital account.** This records all transactions which involve movement of capital in and out of the country e.g. donations, grants, foreign investments, investments of nationals abroad, etc.
3. **Monetary (cash) account.** This is a record of a country's foreign exchange reserves/ resources from balance of payments current and capital accounts.
4. **Errors and omissions account.** This is also called a balancing item account. This part of the B.O.P account records errors and omissions which may have been made in the process of making the B.O.P account. The balancing item is added or subtracted on any side of the B.O.P account for purposes of balancing.

CAUSES OF BALANCE OF PAYMENTS DEFICITS IN LDCs/ UGANDA

1. **Low volume of exports.** The volume of exports in LDCs is generally low hence low foreign exchange earnings.
2. **Exportation of low quality products.** These are less competitive in the export markets resulting into low earnings from them.
3. **Exportation of mainly primary products such as agricultural raw materials.** These command low prices on the world market resulting into low foreign exchange earnings yet expenditure abroad is high.

4. **High propensity to import/ high preference for goods from other countries.** Most people in LDCs prefer buying goods from other countries as opposed to locally produced items. This increases the country's expenditure abroad yet earnings from abroad are low hence balance of payments deficit.
5. **Heavy expenditure on importation of military hardware.** This is due to political instability and destructive demonstrations existing in the country forcing government to spend heavily on importing fire arms yet earnings from abroad are low causing B.O.P deficit.
6. **Importation of highly priced (manufactured consumer and capital) good.** LDCs are highly dependent on imports hence high expenditure abroad leading to shortage of foreign exchange hence B.O.P deficit.
7. **High expenditure on payments/ servicing external debts.** Government is highly indebted and therefore has to service and repay external debts. This leads to high capital outflow yet earnings from abroad are relatively low hence causing shortage of foreign exchange hence B.O.P deficit.
8. **Trade restrictions in export markets.** MDCs are the major buyers of exports from LDCs but put restrictions on them e.g. total ban, quotas making it difficult to export more commodities to MDCs resulting into low foreign exchange earnings hence causing B.O.P deficit.
9. **Heavy government expenditure abroad e.g. on diplomatic missions, contributions to international organizations, etc.** a lot of government foreign exchange reserves are in such cases leading to shortage of foreign exchange hence B.O.P deficit.
10. **High level of profits and wages repatriation by foreigners working within the country.**
11. **Market flooding/ limited markets abroad.** This is due to exportation of similar products by developing economies.
12. **Prices of exports are externally determined.** Prices of exports of LDCs are dictated by MDCs and they fix low prices for those exports yet charge high prices for their commodities leading to low foreign exchange earnings causing B.O.P deficits.

13. **Limited variety of exports.** Exports of LDCs are mainly agricultural with few manufactured goods hence resulting into low earnings from abroad yet they heavily import which raises the country's expenditure abroad causing B.O.P deficit.

EFFECTS OF BALANCE OF PAYMENTS DEFICIT IN DEVELOPING COUNTRIES

NEGATIVE

1. Reduces the volume of imports.
2. Limited employment opportunities due to reduced investments.
3. Discourages investments
4. May lead to inflation due to shortage of essential goods
5. Encourages currency depreciation.
6. Retards economic growth.
7. Leads to low savings and investments.
8. Leads to depletion of foreign reserves.
9. Leads to high taxation levels in order to raise revenue for government expenditure.
10. Promotes trade protectionism which results in retaliation.

POSITIVE EFFECTS

1. Promotes regional economic cooperation.
2. Promotes import substitution industrialization strategy hence growth of the industrial sector.
3. Encourages diversification of exports.
4. Encourages improvement in quality of exports.
5. Stimulates effort to increase volume of exports
6. Promotes development of local skills to reduce dependence on imported labour expatriates.

MEASURES THAT SHOULD BE TAKEN TO IMPROVE B.O.P POSITION IN DEVELOPING COUNTRIES

1. **Use of trade restrictions** to discourage imports e.g. import quotas, import duties, total ban on some imports thereby reducing the volume of imports thus cutting down the country's expenditure abroad.

2. **Adopt import substitution industrialization strategy.** This helps to produce goods that were formerly imported so as to reduce the volume of imports hence cutting down the country's foreign exchange.
3. **Creation of peaceful, stable and conducive political climate.** This helps to reduce huge foreign exchange expenditure on military hardware thereby saving foreign exchange.
4. **Diversification of exports.** This is involves production of a variety of exports which raises the country's earnings from abroad hence improved B.O.P position.
5. **Negotiate for debt conversion and debt cancellation.** This is reduces capital outflow on debt servicing hence leading to growth in output for exports hence increasing foreign exchange earnings and it also reduces expenditure on imports.
6. **Undertake export promotion industrialization strategy.** This increases the volume of exports hence increased export earnings.
7. **Devaluation of the domestic currency.** This makes exports cheaper becoming more competitive in foreign markets thus increasing foreign exchange earnings while making imports more expensive which reduces their demand hence reduced expenditure abroad.
8. **Strengthen commodity agreements.** This helps to raise bargaining power of LDCs which increases the prices of LDCs' exports hence increased export earnings hence improving B.O.P position.
9. **Training of local manpower to reduce dependence on imported skilled labour.** This increases on output and reduces profit and wages repatriation.
10. **Restructuring foreign missions and diplomatic travels e.g. having one ambassador to serve in a number of countries thus reducing on unnecessary foreign travels.** This helps to save on foreign exchange of a country hence improving the country's B.O.P position.
11. **Improve quality of exports for example through research, adoption of better production techniques, training of labour to improve on its skills** hence producing high quality exports that command high prices on the world market hence fetching high revenues from abroad thus improving the balance of payments position.
12. **Diversify export markets mainly through regional cooperation.** This helps to widen market for the country's exports hence raising the country's foreign exchange earnings.

13. **Encourage barter trade.** This helps to minimize the use of foreign exchange and cut down foreign exchange expenditure hence improving the country's B.O.P position.

GUIDING QUESTIONS

1. a) Distinguish between **"Balance of trade"** and **"Balance of payments".** (02 marks)

   b. State any **two** effects of balance of payments deficits in your country. (02 marks)

2. a) Account for the balance of payments problem in developing countries. (10 marks)

   b. Suggest measures that should be taken to improve balance of payments position in developing countries. (10 marks)

3. What are the components of the balance of payments account?

COMMERCIAL POLICY

Is the deliberate government policy meant to influence and direct the value, volume and direction of trade in an economy.

INSTRUMENTS OF COMMERCIAL POLICY

- ₤ Taxation/ tariffs on imports/ import duty.
- ₤ Subsidization of local firms.
- ₤ Total ban/ trade embargo/ trade sanctions.
- ₤ Foreign exchange control.
- ₤ Quality control e.g. thorough U.N.B.S
- ₤ Administrative controls e.g. licensing, physical checks, etc.
- ₤ Import quotas.
- ₤ Liberalization of the economy.
- ₤ Devaluation of local currency.
- ₤ Allowing the local currency to depreciate in value.

PROTECTIONISM

Is the economic policy of restricting trade between nations, through methods such as tariff on imported goods, import quotas and a variety of other restrictive government regulations.

DIFFERENT FORMS OF PROTECTIONISM USED IN INTERNATIONAL TRADE

1. **Tariff barriers/ import duty.** This is the use of taxes on imports to limit their volume of flow into the country.
2. **Total ban/ trade embargo/ trade sanctions.** This refers to complete prohibition of importation of certain goods.
3. **Import quotas.** These are quantitative restrictions on goods being imported into the country.
4. **Quality controls.** These help to restrict low quality cheap goods capable of competing with domestically produced goods. This is achieved by setting high quality requirements imports must meet before being imported into the country. In Uganda, quality control measures are set by Uganda National Bureau of Standards (U.N.B.S).
5. **Use of tight administrative controls like licensing, tight bureaucratic processes** hence discouraging some importers/ participants in international trade.
6. **Foreign exchange control.** Trade is limited by allocating only a small amount of foreign exchange to importers so that they do not buy imports which are not essential.
7. **Subsidization of domestic firms.** Government may support local producers by giving them money to help them lower the production costs hence making their goods more competitive than the imported ones.
8. **Encouraging regional integration/ state trading.** International trade can be restricted by forming regional cooperation in which trade to non-member states is restricted and not restricted between member states.
9. **Provision of tax incentives such as tax holidays tax exemptions to local firms** to help them lower the production costs.

NOTE

1. A tariff is a tax/ duty imposed/ levied on either exports or imports.
2. Tariff barriers are restrictions put to control international trade (free trade) by the use of taxes e.g. import and export duties.

3. Non-tariff barriers are restrictions put to control international trade (free trade) by using other means other than taxation e.g. total ban/ trade embargo/ trade sanctions, administrative controls such as licensing, quality control measures, manipulation of exchange rates, provision of subsidies to local firms, etc.

BENEFITS/ MERITS/ POSITIVE IMPACT OF PROTECTIONISM

1. Protects infant/ domestic industries from foreign competition thus enabling them to grow.
2. Discourages dumping of foreign goods by imposing heavy duties on dumped goods hence making them expensive.
3. Improves the country's balance of payments position by reducing the country's foreign exchange expenditure on imports.
4. Reduces external resource dependence/ promotes self-sufficiency. This is achieved through protecting domestic industries.
5. Raises revenue for the government through taxation by imposing tariffs on substitute imports.
6. Protects domestic employment through protecting home industries.
7. Discourages importation of demerit goods especially drugs, spirits, pornographic materials by either use of heavy tariffs on such products or even imposing a total ban on them.
8. Controls imported inflation through discouraging imports. This encourages investment in the country.
9. Encourages utilization of local resources by encouraging domestic production instead of relying on imported goods.
10. Improves the country's terms of trade through restriction of highly priced imports.
11. Encourages investment in the economy leading to increased output hence economic growth.
12. Minimizes political control by foreigners which enables the country to achieve its political objectives.

NOTE

For reasons, apply "To" e.g.

To protect infant/ domestic industries…

DEMERITS/ DANGERS/ ARGUMENTS AGAINST PROTECTIONISM

1. It subjects nationals to consumption of highly domestic priced goods.
2. It subjects the nationals to consumption of poor quality domestic goods due to absence of competition.
3. Limits the variety of goods in the domestic market hence limited consumer choices.
4. Protectionism is an expensive exercise since it calls for subsidization of local firms by the government.
5. It encourages monopoly tendency with it associated negative consequences because local producers are protected from competition from imported goods.
6. Encourages trade malpractices such as smuggling which leads to loss of government revenue.
7. Results into loss of government revenue from import duties especially where the country uses quotas and total ban which restrict importation of goods that would have been taxed.
8. Encourages retaliation from other trading partners which limits the benefits of international trade.
9. Protected industries have a tendency of remaining infant because they are always subsidized and protected by the government.
10. It encourages inefficiency in the protected firms due to absence of competition from imported goods.

FREE TRADE

Free trade is the economic policy of carrying out trade between countries without any trade barriers such as tariffs, quotas, total ban or any other variety of other restrictive government regulations.

MERITS OF FREE TRADE

1. Leads to improvement in quality of goods produced since it forces countries to carry out research and compete favourably.
2. Enables a country to enjoy low priced goods since tariffs like import duties are eliminated.
3. Helps to mobilize and raise inflow of foreign resources e.g. technological capital, foreign skills etc due to a widened market and improved investments.
4. Avails a wide variety of goods thereby widening the consumers' choices.

5. Leads to creation of more employment opportunities since more resources are exploited and the market base expands.
6. Increases foreign exchange earnings as countries freely export without restrictions hence helping to close the foreign exchange gap.
7. It encourages specialization between countries as trading partners are able to specialize in commodities where they incur the least opportunity cost.
8. Discourages trade malpractices such as smuggling.
9. Raises the level of economic growth since more resources are exploited due to a widened market.
10. Prevents rise of monopoly since goods can be imported ort exported without any restrictions.
11. Promotes international cooperation as goods and other resources can freely move to different countries without restrictions.
12. Encourages faster expansion of infant firms due to competition from foreign substitute commodities.

DEMERITS OF FREE TRADE

1. Local industries are outcompeted. This arises due to importation of low priced goods that have no restrictions exposing a lot competition to locally produced goods.
2. Results into unemployment due to domestic industries being out competed by foreign goods and technology transfers and development.
3. It encourages dumping leading to suffocation of domestic industries.
4. It results into increased external economic dependence since the economy cannot be self-sustaining hence being forced to adopt foreign decisions from other countries and having to rely on foreign resources for survival.
5. May result into imported inflation especially when the country is over relying on imports leading to low standards of living.
6. Results into low tax revenue from imports since tariffs on imported goods are eliminated.
7. Worsens the country’s balance of payments position due to excessive expenditure on imported goods.

8. Results into low levels of exploitation of local resources. This is due to over importation thereby resulting into low levels of economic growth.
9. Leads to importation of undesirable goods with their negative effects on nationals since restrictions such as quality control no longer exist.
10. May worsen the country's terms of trade since imported goods in most cases are highly priced yet export commodities have low prices due to their low quality.

ASSIGNMENT

1. Why may protectionism by avoided in an economy?

Solution

A student needs to be well versed with costs of protectionism or benefits of free trade.

- ₤ To save nationals from highly priced domestic goods.
- ₤ To save nationals from consuming poor quality domestic goods due to absence of competition.
- ₤ To provide a variety of goods from both foreign and domestic markets.
- ₤ To reduce costs of administration incurred by the government in supporting local firms and enforcing protectionist policies.
- ₤ To control domestic monopoly arising due to protectionism.
- ₤ Fear of trade malpractices such as smuggling which leads to loss of government revenue.
- ₤ Fear of losing revenue from taxes obtained from international trade.
- ₤ To promote competition between domestic firms and foreign producers hence promoting growth, innovations and inventions.
- ₤ Fear of retaliation effects/ beggar my neighbour policies which limit the benefits from international trade.
- ₤ To increase efficiency in domestic firms due to competition from imported goods.

2. **"Protectionism rather than free trade should be adopted if countries are to benefit from international trade."** Discuss.

GUIDING QUESTIONS

1. a) What is meant by the term **"protectionism"?** **(**01 mark)

   b) Give any **three** reasons why there is need for protectionism in your country. (03 marks)

2. a) Distinguish between trade liberalization and free trade/
   Distinguish between protectionism and commercial policy (02 marks)

   b) Mention any **two** forms of protectionism used in international trade. (02 marks)

3. a) Explain the methods used for restricting imports in your country. (06 marks)

   b) Examine the effects of imports restrictions in your country. (14 marks)

DUMPING

This refers to the selling of commodities I external/ foreign markets at lower prices than those charged at home (local market).

REASONS FOR DUMPING

- To expand market for the producers.
- To earn foreign exchange.
- To dispose of surplus output at home
- To outcompete domestic producers thereby enjoying monopoly power.

EFFECTS OF DUMPING IN THE RECIPIENT COUNTRY

- Local producers are outcompeted/ closure of industries.
- Cheap goods are availed to consumers.
- There is provision of a variety of goods to consumers hence increased consumer choices.
- Inferior goods may be sold to consumers.
- Increased revenue to the government through taxation.
- It perpetuates the problem of external economic dependence.
- It leads to unemployment.
- Leads to underutilization of local resources.
- Discourages local initiatives/ investment.
- Distorts the balance of payments position of the country/ increased import expenditure.

DEVALUATION

This refers to the legal/ official reduction in the value of a country's currency in relation to other currencies.

OBJECTIVES OF DEVALUATION

- ₤ To improve B.O.P position of the country.
- ₤ To increase the volume of exports.
- ₤ To discourage dumping
- ₤ To encourage local production/ to protect domestic industries.
- ₤ To meet/ fulfill IMF conditionality.
- ₤ To retaliate to other countries those have devalued.
- ₤ To reduce importation by making imports expensive.

QUESTION

Given that the exchange rate is 1 £ = 1000 Ug.shs. Calculate the new exchange rate after devaluation of the shilling by 20%

Solution

Given that;

Old exchange rate; 1 £ = 1000 Ug.shs

Devaluation = 20%

$$New\ exchange\ rate;\ 1\,£ = \left(\frac{120}{100} \times 1000\right) Ug.shs$$

$$1\,£ = 1200\ Ug.shs$$

HOW DEVALUATION HELPS TO IMPROVE B.O.P POSITION

After devaluation, exports become cheaper. The country exports more and therefore earns more foreign exchange.

After devaluation, the country's currency becomes of less value compared to other countries' currencies.

After devaluation, imports become more expensive. The country imports less and therefore reduces foreign exchange expenditure.

CONDITIONS NECESSARY FOR DEVALUATION TO BE SUCCESSFUL

1. **The price elasticity of demand for exports must be elastic.** In such a case, a small decrease in price resulting from devaluation leads to a very big rise in quantity demanded of exports therefore more foreign exchange being earned.
2. **The price elasticity of demand for imports must be elastic.** In such a case, a small increment in the price of imports due to devaluation leads to a very big decrease in the volume of goods imported.
3. **The supply of exports must be price elastic i.e.** there should not be supply rigidities in the production of exports.
4. **The supply of imports must be price elastic** so that an increase in the price imports leads to a drastic reduction in the supply of imports.
5. **Other competing countries producing similar goods must not devalue their currencies at the same time.** If they do, no benefits are enjoyed i.e. there should not be retaliation by other countries.
6. **There should be no inflationary tendencies in the country carrying out devaluation.** This is because even after devaluation, exports will remain expensive therefore being unattractive in the foreign markets.
7. **A country devaluating its currency should not be at full employment** so that when the demand for exports increases, the country can increase production to meet the market requirements.
8. **The country intending to devalue her currency must be the major producer or exporter of commodity/ commodities within the region.**
9. **There should be no trade restrictions in the importing countries (**countries buying exports from the devaluing country) otherwise when there are restrictions such as tariffs, total ban, quotas, etc the intended objectives of devaluation cannot be achieved.

REASONS WHY DEVALUATION MAY FAIL TO ACHIEVE ITS OBJECTIVES

1. **The demand for exports in LDCs is price inelastic.** This is majorly due to the fact that LDCs produce majorly agricultural commodities whose demand is inelastic.
2. **Demand for imports in exchange is price inelastic** meaning that even when the price for imports increases, quantity demanded remains more or less the same therefore less foreign exchange is saved.
3. **The supply of exports in exchange is also price inelastic i.e.** even when the demand for exports in foreign markets increases, LDCs cannot easily increase supply because they have a lot of supply rigidities/ difficulties.
4. **Other countries are also devaluing their currencies i.e. retaliation effect.** Therefore the exports from the devaluing country appear more expensive therefore having less demand in the foreign markets.
5. **The supply of imports in LDCs is price inelastic.** This means that supply is not highly affected even when prices increase after devaluation.
6. **There are a lot of trade restrictions in MDCs where LDCs export their commodities.** Such restrictions include quality controls, quotas and tariffs among others. This limits the demand for LDCs’ exports thereby having less foreign exchange earned.
7. **LDCs are experiencing high rates of inflation** and therefore prices of exports continue to rise before and after devaluation therefore not being attractive in the foreign markets leading to low foreign exchange earned.
8. **The devaluing countries in LDCs are not the major producers or exporters in the region** therefore cannot maximize the benefits of devaluation.
9. **There is a high marginal propensity to import in LDCs** due to existence of limited economic activities and high demonstration effects therefore the demand for imports still remains high which increases the country’s expenditure on imports and therefore devaluation fails to improve the country’s B.O.P position.
10. **There are a lot of trade malpractices in LDCs especially smuggling** therefore commodities continue to be imported in the country using illegal means which increases foreign exchange expenditure on imports.

11. **Exportation of mainly low quality products by LDCs.** This implies that those products cannot compete favourably on the world market and have low price therefore foreign exchange earning obtained from them even when devaluation takes place is low.

ECONOMIC INTEGRATION

Refers to the coming together of two or more countries in a given region for the sake of mutual (economic) benefit of all member states

OR

Refers to the merging to various degrees the economies and economic policies of two or more countries in a given region for the mutual benefit of member states

OBJECTIVES OF ECONOMIC INTEGRATION

1. To expands markets for products of member states.
2. To increase the volume and benefits of trade by removing trade restrictions.
3. To control unnecessary competition and duplication of services in the region.
4. To increase specialization among member countries hence increased benefits of trade.
5. To increase job opportunities in the region.
6. To enable member states undertake joint development projects which may require huge capital e.g. railway networks.
7. To strengthen political and economic relationships between member states.
8. To increase the level of resource utilization/ exploitation i.e. vent for surplus theory of international trade.
9. To increase the bargaining power of member states producing similar goods on the world market.
10. To foster balanced development of the region among member states.
11. To strengthen and regulate industrial and commercial relationships.
12. To fight neo-colonialism of MDCs by reducing dependence of LDCs on developed countries.
13. To improve T.O.T of member states through trade creation.
14. To encourage industrial development in the region through widened markets and exports.
15. To increase access to foreign resources especially through the World Bank and IMF that can easily be given to integrating countries than individual countries.

STAGES OF INTEGRATION

Economic integration has different stages and they include;

1. Preference trade area (PTA)
2. Free trade area (FTA)
3. Customs union
4. Common market
5. Economic union

1. PREFERENTIAL TRADE AREA (PTA)

This is where countries reduce tariffs between or among themselves on selected commodities.

2. FREE TRADE AREA (FTA)

This is where countries eliminate all tariffs between or among themselves but continue to charge different tariffs on goods that are imported from non-member countries.

3. CUSTOMS UNION

This is where countries eliminate all tariffs between or among themselves and in addition, they adopt a common tariff structure on commodities from non-member countries.

Features of a customs union

- Free movement of goods and services among member states/ absence of internal tariffs.
- Common external tariff structure.

4. COMMON MARKET

This is where countries eliminate tariffs between or among themselves, adopt common external tariff structure and in addition, there is free movement of factors of production amongst themselves/ within the region.

Features of a common market

- Free movement of goods and services among member states/ absence of internal tariffs.
- Common external tariff structure.
- Free mobility of factors of production among member states.

- ₤ Free movement of goods and services among member states/ absence of internal tariffs.
- ₤ Common external tariff structure.

5. **ECONOMIC UNION/ COMMUNITY/ FEDERATION**

This is where countries eliminate tariffs between or among themselves, adopt common external tariff structure, allow free mobility of factors of production amongst themselves and in addition , countries institute joint ownership of certain enterprises like railways, banks, roads, dams, etc, all economic policies of countries are harmonized and there is establishment of a common currency.

Features of an economic union

- ₤ Free movement of goods and services among member states/ absence of internal tariffs/ free trade within the union
- ₤ Common external tariff structure.
- ₤ Free mobility of factors of production among member states.
- ₤ Joint ownership of certain enterprises like railway, roads, banks, dams, etc.
- ₤ Harmonious economic, fiscal and political policies.
- ₤ Use of a common currency.
- ₤ Strong regional institutions.

CONDITIONS NECESSARY FOR THE SUCCESS OF ECONOMIC INTEGRATION

1. **Close proximity/ geographical proximity/ nearness to each other.** The countries should be in the same region or share common borders.
2. **Political stability among the member states.** The member states should be politically stable so as to implement what they have discussed and agreed upon.
3. **Similar political and ideological policies.** Intending member countries should have same political and economic ideologies.
4. **Uniform of common currency to facilitate trade.** Intending countries should be ready to use the same currency e.g. Euro under European Union.
5. **Relatively common language/ traditions and cultures.** Intending countries should establish a common language to ease communication and facilitate trade.

6. **Relatively at the same level of development.** The countries intending to integrate must be at relatively the same level of development to ensure equal distribution of economic benefits.
7. **Ability to specialize in different commodities or services/ differences in comparative cost advantage.**
8. **All the countries intending to integrate must be free from external intervention or policies.**
9. **The countries should preferably be of equal size (market size)** so as to contribute equally to the economic development of each member country.
10. **There should be well developed infrastructure in all countries intending to integrate.**
11. **Political will or massive support.** There should be political support and commitment among people in the countries intending to integrate.

MERITS/ BENEFITS OF ECONOMIC INTEGRATION

1. **Leads to production of high quality products** due to increased competition among producers of different countries.
2. **Reduces costs of production.** Economic integration allows member countries to conduct research and collect information jointly at lower costs.
3. **It increases gains from international trade and reduces costs of duplication e.g.** one industry in one country to serve the whole group
4. **Controls imported inflation (trade creation effect).** Trade shifts from high cost non-member states to low cost member states.
5. **Creates political cooperation and understanding among member states.**
6. **Leads to increased employment opportunities** due to free mobility of factors of production and a bigger market that leads to expansion of production and investment in general.
7. **Widens consumers' choice** due to production of a variety of goods.
8. **It leads to transfer of knowledge and skills among member states.**
9. **It improves bargaining power of member states for their exports on the world market.**
10. **Promotes vent for surplus theory.** The resources formerly idle are utilized because of the widened market.
11. **Increases specialization and its advantages.**

12. **Stimulates establishment and expansion of manufacturing industries.**
13. **Provides easy access to foreign resources e.g.** financial bodies such as World Bank and IMF can easily lend to integrated countries other than individual countries.
14. **Leads to increased economic growth** due to increased production of goods as the market size expands.
15. **May lead to use of one currency** hence facilitation of trade.
16. **Enables firms among member countries to enjoy economies of scale** due to a wider market and production on a large scale.
17. **Promotes use of same services.** Economic integration leads to joint provision of infrastructure such as railway networks, roads hence reducing costs of operation.
18. **Etc.**

<u>DISADVANTAGES OF ECONOMIC INTEGRATION</u>

1. **Leads to trade diversion i.e.** countries under economic integration shift trade from low cost non-member countries to high cost member countries forcing citizens to buy expensive goods from within the region yet they would be in position to buy similar goods cheaply from non-member countries.
2. **It leads to sacrifice of national interests/ independence** especially under economic union where countries have to use the same currency and are under one leader.
3. **Leads to loss of government revenue** especially from imports from member countries since tariffs are abolished on certain commodities traded within the region.
4. **Leads to uneven distribution of industries** because free movement of goods and services may be in one direction especially from the poor to relatively richer countries but within the same union hence poor countries do not maximize the benefits of integration.
5. **It compels member countries to consume poor quality goods produced by member states** as cooperation restricts them from trading with non-member countries.
6. **It promotes misunderstandings among countries** especially when industries are not fairly distributed.
7. **All countries in the region may be producing similar goods** leading to surplus production in the region hence resource wastage.

8. **It involves high costs of staffing e.g.** employing regional coordinators, ministers from regional cooperation making it expensive to manage.
9. **Worsens international inequalities** especially for strong regional groupings which have a strong bargaining power compared to the weaker government.
10. **It leads to loss of political and economic independence** especially in the last two stages of economic integration where member states harmonious economic, fiscal and political policies.
11. **It leads to sacrifice of economies of scale in distributing of industries.** This is because countries have to specialize in certain products while giving up other products to other countries.
12. **It leads to sabotage and foreign interference** especially from developed countries which want to exercise their supremacy on LDCs by dictating prices for their exports hence struggle to weaken regional cooperation among LDCs.

FACTORS LIMITING ECONOMIC INTEGRATION IN DEVELOPING COUNTRIES

1. **They tend to produce similar goods.** This limits the market and lowers the volume of trade making the comparative advantage benefit limited.
2. **Fear of not gaining from integration.** This is due to absence of a mechanism to facilitate equitable sharing of gains of cooperation.
3. **Fear of loss of customs revenue.** This limits member states to reach certain stages of economic integration because they still want to obtain revenue through taxing imported goods.
4. **Existence of political instabilities in some countries.** Wars in some countries discourage economic activities and trade in general and sometimes those instabilities are sponsored by member states of economic integration hence hindering the success of cooperation.
5. **Difference in the level of development.** This leads to unequal distribution of benefits hence limiting economic integration.
6. **Differences in the social factors e.g. culture, religion, language, etc.** This makes it difficult to harmonize policies in their region.

7. **Conflicts among leaders.** Some heads of states are unable to sit on the same negotiating table with others mainly due to political conflicts and greed for resources of the country.
8. **Differences in currencies.** This discourages smooth running of trade among member states hence discouraging economic integration.
9. **Differences in political ideologies.** This makes it difficult to harmonize policies in their region.
10. **External interference/ sabotage.** MDCs tend to influence certain members to withdraw from economic integration hence weakening regional economic integration.
11. **Poor infrastructure among countries.** E.g. poor roads and railway networks. This limits movement of goods and factors of production among member states.
12. **Differences in economic policies.** Some countries believe in capitalism while others believe in socialism and others are mixed hence failure to adopt similar economic policies.
13. **Lack of political support/ will.** This is mainly due to ignorance of the people about the benefits of economic integration.
14. **Limited geographical proximity between countries i.e. some intending countries do not share the same borders.** This limits effective preferential treatment and construction of the necessary joint infrastructure to link all member states.
15. **Differences in the size of the market / population.** This limits equal contribution to the economic development of each member country.
16. **Difference in infrastructural development.**

NOTE

Trade creation

Is where economic integration results into a shift of trade from high cost non-member countries to low cost member countries.

Trade diversion

Is where economic integration results into a shift of trade from low cost non-member countries to high cost member countries.

Disadvantages of trade diversion

♫ Consumption of poor quality goods

- ♫ People are forced to buy high priced goods
- ♫ Reduced government revenue.
- ♫ Limited variety of products.

GUIDING QUESTIONS

1. a) Define the term economic integration (01 mark)

   b. Give any three merits of economic integration. (03 marks)

2. a) Distinguish between a customs union and a common market. (02 marks)

   b. State any two advantages of common market. (02 marks)

3. a) What are the features of an economic union? (06 marks)

   b. Explain the factors that limit economic integration among developing countries. (14marks)

4. a) Explain the various forms of economic integration. (10 marks)

   b. Explain the conditions necessary for the success of economic integration. (10 marks)

OTHER CONCEPTS USED IN INTERNATIONAL TRADE

FOREIGN EXCHANGE

Foreign exchange refers to currencies of other countries that a given country keeps.

FACTORS WHICH DETERMINE THE DEMAND AND SUPPLY OF FOREIGN CURRENCY

1. **Price of imports.** The higher the prices of imports, the higher the demand for foreign currency and the lower the price of imports, the lower the demand for foreign currency.
2. **Volume of imports.** High volumes of imports lead to high demand for foreign exchange to purchase to those imports and low volumes of imports lead to less demand for foreign currency.
3. **Debt servicing requirements.** When there is high demand for debt servicing requirements, the demand for foreign currency is high and when there is less debt servicing requirements, the demand for foreign currency is low.

4. **Government's external obligation.** When government has many external obligations, the demand for foreign currency is high to accomplish these external obligations and the demand is low with less external government obligations.
5. **Central bank intervention in foreign currency markets.** When the central bank intervenes through use of restrictive measures, the supply of foreign currency is low and when the central bank relaxes the policies, the supply of foreign currency is high.
6. **Price of exports.** The higher the price of exports, the higher the supply of foreign currency since the producers are going to supply more and the lower the prices of exports, the lower supply of foreign currency because lower prices of exports discourage supplies since they get less foreign exchange.
7. **Volume of exports.** The higher the volume, the higher the supply of foreign currency and the lower the volume of exports, the lower the supply of foreign currency.
8. **Need to accumulate reserves.** The higher the need to accumulate foreign reserves, the lower the supply of foreign currency and the lower the need to accumulate foreign reserves, the higher the supply of foreign currency.
9. **Level of capital inflow.** The higher the capital inflow, the higher the supply of foreign currency and the lower the capital inflow, the lower the supply of foreign currency.
10. **Level of inflow of grants/ donations.** The higher the inflow of grants/ donations, the higher the supply of foreign currency and the lower the inflow of grants, the lower the supply of foreign currency.

FOREIGN RESERVES

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

Importance/ uses of foreign reserves

- used for covering trade deficits
- used for covering balance of payments deficit
- An indicator of performance of an economy in international trade.

Provides reserves for future payments for example meeting debt obligations.\determine the value of domestic currency.

How foreign reserves are acquired

___From a balance of payments surplus

___Capital inflow especially from foreign investors.

___Borrowing externally from the World Bank and IMF.

___Remittances of nationals living and working abroad.

___Disinvestment that is the sale of government assets abroad.

FOREIGN EXCHANGE EARNINGS

Foreign exchange earnings refer to a country's income from other countries (mainly through exportation).

Net foreign exchange earnings refer to the total sum of all foreign currency receipts less expenditure in a given fiscal year

FOREIGN EXCHANGE MARKET

Foreign exchange market is a market where foreign exchange/ foreign currencies are traded at a price that is expressed by the exchange rate.

EXCHANGE RATE

Exchange rate refers to the rate at which a country's currency is exchanged with other currencies in the foreign exchange market.

OR

This is the price of the domestic currency in terms of the foreign currency

Factors that determine the exchange rate in money market

(Factors that influence the strength of a country's currency relative to other currencies

1. **Volume of domestic output.** The higher the volume of domestic output, the stronger the currency and the lower the volume of domestic output, the weaker the currency.

2. **Volume of exports.** The higher the volume of exports, the stronger the currency and the lower the volume of exports, the weaker the currency.
3. **Rate of domestic money supply.** The higher the rate, the weaker the currency and the lower the rate, the stronger the currency.
4. **The level of foreign exchange reserves.** The higher the volume of foreign exchange reserves, the stronger the currency and the lower the volume, the, weaker the currency.
5. **The level of capital inflow and outflow.** High capital outflow leads to appreciation of domestic currency while high capital outflows lead to depreciation of the domestic currency.
6. **The rate of inflation in a country.** High inflation rates discourage investments and exports weakening the local currency while low inflation rates encourage investments and exportation making the currency strong.
7. **Political climate.** A favourable political climate encourages investments, stimulates production and inflow of foreign exchange making the currency stronger while unfavourable political climate discourages investors and production in general hence weakening the currency.
8. **Volume of imports.** The higher the volume of imports, the weaker the currency and the lower the volume of imports, the stronger the currency.

FOREIGN EXCHANGE RATE CONTROL

This is the state regulation of the rate at which the local currency can be exchanged for foreign currencies.

OBJECTIVES OF FOREIGN EXCHANGE CONTROL

1. **To raise revenue for the government.**
2. **To retaliate against another country**
3. **To protect domestic industries.**
4. **To ensure price stability/ control inflation.**
5. **To improve terms of trade.**
6. **To improve B.O.P position.**
7. **To control capital flight.**

8. **To create employment.**
9. **To discourage importation and consumption of harmful products.**
10. **To ensure stability of exchange rate.**
11. **To encourage investment.**
12. **To encourage long-term planning.**
13. **To ensure availability of foreign exchange to facilitate trade.**
14. **To acquire foreign exchange for servicing the country's external debt.**

TYPES OF FOREIGN EXCHANGE RATE SYSTEMS

There are different types of foreign exchange rate systems i.e.

1. Flexible/ floating/ free exchange rate system.
2. Fixed exchange rate system
3. Dual exchange rate system
4. Managed exchange rate system
5. Pegged exchange rate system

FLOATING EXCHANGE RATE SYSTEM

This is an exchange rate system where the rate at which the local currency is exchanged with other currencies is determined by inter-play of market forces of demand and supply of foreign currency.

Advantages

- It preserves the autonomy/ independence of the domestic monetary authority.
- It saves the country the burden of holding large official foreign exchange reserves.
- It is cheap to administer.
- It gives the most realist value of the local currency in terms of other currencies.
- Provides automatic mechanism for correcting B.O.P disequilibrium.
- It encourages investment.
- It leads to generation of adequate foreign exchange through exports, loans and grants.
- Discourages emergence of illegal or parallel foreign exchange market.

Disadvantages

- It encourages speculation in the foreign exchange market.
- It makes planning very difficult especially for export and import sectors
- May lead to imported inflation.
- It subjects a lot of uncertainties to the investors since it keeps on fluctuating hence discouraging capital inflow.
- It encourages the operation of parallel foreign exchange markets e.g. smuggling.

FIXED EXCHANGE RATE SYSTEM

This is an exchange rate system where the rate at which the local currency is exchanged with other currencies is fixed/ determined by the monetary authority.

Advantages

- It induces production and promotes economic growth.
- It encourages long term capital inflows
- It stabilizes prices in the economy i.e. it checks on inflationary tendencies.
- It encourages long term planning or contract trade.
- It helps to stabilize the value of the domestic and foreign currencies.
- It reduces speculation in the foreign exchange market due to limited depreciation and appreciation of currencies.
- It encourages exporters and importers to engage in international trade without concern about exchange rate movements of the currency to which their local currency is linked.
- It minimizes capital outflows.

Disadvantages

- It does not provide an automatic mechanism for correcting imbalances in trade and B.O.P position.
- It discourages foreign investors.
- It makes the country unable to pursue an independent monetary policy free from external influence.
- It requires the country to hold large official reserves of foreign exchange for the policy to succeed.

- ₤ It limits the amount of foreign exchange generated by the government through transactions.
- ₤ Requires exchange control administration which is costly (it is expensive to enforce)

PEGGED EXCHANGE RATE

Is one which is fixed/ determined by the monetary authority in relation to a particular foreign currency e.g. Ugandan shilling being pegged or fixed to US dollar like 1$ = 1000 Ug. Shs. Such that the values of other currencies are determined according to the shilling dollar relationship

NOTE

For merits and demerits of pegged exchange rate, refer to those for fixed exchange rate.

MANAGED EXCHANGE RATE SYSTEM

(Mixed/managed float/ dirty float/ adjustable peg)

This is an exchange rate system where the inter-play of market forces of demand and supply of foreign currency determine the rate at which the local currency is exchanged with other currencies but within certain limits set by the monetary authority.

Advantages

- ₤ It controls fluctuations of exchange rates and avoids undervaluation or overvaluation of the local currency.
- ₤ It safeguards imports and exports from rapid and constant fluctuations which cause losses.
- ₤ It ensures that there is a favourable exchange rate in the foreign exchange market.
- ₤ It controls the actions of speculators.
- ₤ The monetary authority maintains some control over the exchange rate.
- ₤ It regulates the flow of funds in and out of a country.
- ₤ It promotes international trade due to easy access to foreign exchange.
- ₤ It provides an automatic mechanism of correcting trade imbalance.

Disadvantages

- It reduces the volume and value of international trade.
- It is expensive for the government to administer.
- It worsens the debt burden of a country.
- It requires maintenance of large foreign reserves.
- It makes long term planning difficult due to uncertainty and instability in foreign exchange earnings.
- It encourages speculation in the foreign exchange market.
- It leads to depreciation of the local currency.
- It causes imported inflation.
- It leads to Balance of Payments problems.

DUAL EXCHANGE RATE SYSTEM

This is a situation where there are two official exchange rates in the country one being favourable to cater for essential or priority sectors and the other for non essential areas and each of the exchange rates is determined by the monetary authority.

OR

This is where there is co-existence of two parallel exchange rates within the country.

NOTE

1. In absence of "system" under exchange rate, avoid using "where, is a process, is a situation when" because all those define a system and not a rate.

CURRENCY UNDERVALUATION

This is the fixing of the value of the country's exchange rate by the monetary authority below the equilibrium exchange rate above which it is illegal to trade/ exchange foreign currency.

An undervalued exchange rate is one fixed by the monetary authority below the equilibrium exchange rate above which it is illegal to trade foreign currency.

Effects of currency undervaluation

- Increases exportation
- Reduces imports
- Encourages domestic production.
- Reduces imported inflation.
- Improves B.O.P position.
- Worsens external debt burden

CURRENCY OVERVALUATION

This is the fixing of the value of the country's exchange rate by the monetary authority above the equilibrium exchange rate below which it is illegal to trade foreign currency.

An overvalued exchange rate is one fixed by the monetary authority above the equilibrium exchange rate below which it is illegal to trade foreign currency.

Effects of currency overvaluation

- Reduces exportation
- Increases importation
- Discourages domestic production due to reduced demand.
- Worsens Balance of Payment position.
- Reduces the external debt burden
- Leads to imported inflation.
- Promotes trade malpractices for example black market.

CURRENCY REVALUATION

This is the legal/ official increase in the value of the country's currency in relation to other currencies.

CURRENCY APPRECIATION

This is the increase in the value of a country's currency in terms of other currencies due to inter-play of market forces of demand and supply of foreign currency.

Effects of currency appreciation

- Encourages investment

Reduces revenue from import duties

Leads to low pay for export producers

Exports become less competitive

Worsens competition against local producers.

Worsens balance of payments position

Disorganises exporters because they are paid less in local currency.

CURRENCY DEPRECIATION

This is the fall in the value of the country's currency in terms of other currencies due to the inter-play of market forces of demand and supply of foreign currency.

OR

It is the reduction/ loss in value of domestic currency against foreign currencies under free exchange rate system.

Causes of currency depreciation

- Low earnings from exports on the world market.
- Increased importation of goods and services.
- Rising inflation in the domestic market.
- Heavy debt servicing
- Increase in fuel prices on the world market
- Decline in the service sector
- Increase in demand for foreign currencies.
- Deteriorating terms of trade.

Effects of currency depreciation

Positive

- It encourages foreign investment/ increases foreign capital inflow
- Imports become very expensive
- Makes exporters receive higher local currency value

- Increases the volume of exports

Negative

- Leads to rise in the price of domestic products/ leads to inflation
- Discourages investment
- Projected planning is made difficult.
- It encourages speculation.
- Worsens the external debt burden
- Leads to loss of confidence in the country’s currency