"COPY THE NOTES, DIAGRAM AND CALCULATIONS WILL BE DRAWN WHEN SCHOOL RESUMES ".

FOREIGN TRADE/ INTERNATIONAL TRADE:

- Definition of international trade
- Basics or origin of international trade
- Principles of absolute and comparative advantage
- Factors that give rise to International trade
- Role of international trade
- Why LDC's have not benefited much from international trade
- Protectionism / trade restriction
- Limitations if international trade
- BOP
- TOT
- Foreign exchange system
- Economic integration

International trade refers to the exchange of goods and services across territorial or national boundaries.
It involves economic / commercial transactions that include transfer of goods and services as well as titles of ownership of financial instruments and properties.

International trade falls under two categories:

- Export trade.
- Import trade.

Export trade refers to the selling of goods and services of a given country abroad.
Import trade refers to the buying of goods and services of another country or other countries.

Foreign or International trade can take place between two or more countries which leads to bi-lateral or multilateral trade.
Bi-lateral trade refers to trade where business transactions take place between only two countries e.g. between Uganda and Tanzania, e.t.c
Multi-lateral trade refers to trade which takes place between / among more than two countries. In other words the exchange of goods and services is between one country and a number of other several countries.
International/foreign trade involves both visible and invisible items and therefore it can be divided into visible and invisible trade.
Visible Trade refers to trade that involves the exchange of only goods or tangible commodities between countries. E.g. Agricultural products like coffee, Cotton, machinery motor vehicle e.t.c.
Invisible trade refers to trade which involves the exchange of only services or intangible commodities between countries e.g. tourism, electricity, skilled man power etc.

Qn.
Distinguish between:
a. Visible exports and visible imports with examples
b. Invisible exports and invisible exports with examples

<u>Origin / basis of international trade:</u>
Trade among nations originated from where one country could not produce what others could. Nations produce different products due to majorly differences in resource endowment. It therefore becomes necessary for countries to satisfy the limited wants of their citizens through export and import trade.

<u>Causes of international trade:</u>
- Differences in natural resource endowment i.e. Lack of self sufficiency in the production of all required goods and services. Natural resources are unevenly distributed hence each country produces where nature best favors its resource endowment. Some resources are neither evenly distributed nor can they be transferred from one country to another e.g. climate.
- Differences in technological advancement among countries. Less developed countries have to acquire capital goods from developed countries as they are still backward in technological development. This therefore means that they can't produce certain products.
- Differences in tastes and preferences and their changes. A country may produce butter but ends up exporting much of it than her nationals can consume and also at times people's tastes and preferences change in favour of imported goods and services.
- Limited mobility of factors of production. There are barriers that restrict mobility of F.O.P e.g. labour and capital and this therefore means that it's the goods and services that must move thereby leading to foreign trade or international trade.
- Differences in production costs and therefore prices of different commodities among countries.
- Differences in the stock of capital accumulation. This means that countries carry out foreign trade to acquire capital so as to exploit their resources.

<u>Factors that give rise to/ Reasons why countries participate in international trade:</u>
- To get what such countries can not produce due to differences in natural resource endowment e.g. machinery ,petroleum products,e.t.c
- To get better technology from developed countries for the case of the low developing countries.
- To get skilled man power from other countries e.g. low developed countries use a number of expatriates due to lack of adequate skilled man power.
- To get foreign exchange as a result of exporting some commodities or products and such foreign exchange is used to import what is not produced locally.
- To create employment opportunities in export and import sectors e.g. customs tax officers, drivers who transit the goods.
- To get tax revenue from the duties charged like import and export duties which revenue is used to develop the economy.
- To enable the exchange of ideas and values at international level e.g. cultures, literature.

- To specialize in activities where each country is better off than the others so as to enable efficiency.

Qn:
Explain the factors that give rise to international trade.

The theory of international or foreign trade:
This is an extension of the theory of specialization but not individuals specializing but nations. According to the theory, total world output would expand if different countries specialize in the production of different commodities and engaged in exchange. For example Saudi Arabia produces more petroleum than for example Uganda and Uganda produces more beef than Saudi Arabia, then according to the theory, it would be of comparative advantage if Saudi Arabia specializes in production of petroleum and Uganda in the production of beef. Specialization here is based on the principal of opportunity cost that is to say countries specialize in the production of commodities where they incur the lowest opportunity cost and leave those commodities with high opportunity cost to other countries.

THE PRINCIPLE / LAW OF COMPARATIVE ADVANTAGE OR RICHARDIAN THEORY / THE LAW OF INTERNATIONAL TRADE:

It states that a country should specialize in the production of a commodity in which it has the least opportunity cost in comparison with another country.
It also states that comparative advantage exists when given two countries and two commodities within a given amount of resources one country can produce one of the commodities more cheaply and the second country can produce the other commodity more cheaply.
It can also be stated as that, comparative advantage exists when given two countries and two commodities with a given amount of resources one country can produce one of the commodities at the least opportunity cost and the other country can produce the other commodity at the least opportunity cost than in another.

It was put forward by David Ricardo in 1817 to improve on Adam Smith's principle of absolute advantage. It's this principle that serves as a basis for international trade since it advocates for specialization by countries.

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

Countries:	**Commodities:**	
	Generators:	**Coffee:**
A	400	600
B	100	300

a) Calculate the opportunity cost of producing each commodity in each country
b) In which commodity should each country specialize and why?

c) Given your answer in (b) above, what will be the total output offer specialization for each country?

2.

Country:	Commodities:	
	Cloth:	**Food:**
P	1000	4000
Q	30000	1500

a. Calculate the opportunity cost of producing each commodity in each country.
b. In which commodity should each country specialize and why?
c. Given your answer in (b) above, what will be the total output offer specialization for each country?

Note: From the table in question two above if country P concentrated on the production of cloth then for every unit of cloth produced 4 units of food are the opportunity cost.

By country Q concentrating on the production of cloth would have to forego 0.5 units of food for every unit of cloth produced.
Therefore the opportunity cost of concentrating on the production of cloth is higher in country P than in country Q.

Similarly concentration of country P on food production, she foregoes 0.25 units of cloth for every unit of food produced.
Therefore the opportunity cost of concentrating on the production of food is higher in country Q than in country P.

Therefore by the theory of comparative advantage, country P should specialize in food production since for each unit of food produced less cloth is foregone in country P than in country Q.

Likewise country Q should specialize on cloth production where it has a comparative advantage since for each unit of cloth produced less units of food are foregone in country Q than in country P.

Assumptions of the law of comparative advantage/ the Ricardian theory:

- Only two countries are involved
- Only two commodities are produced hence one country produces one
- A situation of full employment in both countries
- Free trade or no protectionism.
- Use of one currency or complete currency convertibility if not barter trade.
- Zero transport costs or same transport costs.
- Same and constant production techniques
- Homogenity of the factors of production or resources are equally efficient
- No government intervention e.g. through subsidization of producers and government control of price

- Elastic demand for goods and services (commodities)
- Constant opportunity cost ratios or constant returns to scale i.e. proportionate change in inputs causes the output to change by the same proportion.
- Perfect factor mobility within the country and perfectly immobile internationally.

Advantages of comparative advantage:

- It leads to increased world output due to specialization
- It leads to increased employment opportunities due to large scale production arising out of specialization
- It results into increased volume of trade and therefore more revenue to the country
- It promotes the exploitation of the idle resources due to the increased demand of a country's products.
- It reduces the production costs since each country concentrates on what it can do best hence higher profits are realized.
- Consumers are availed with low price products due to the low production cost incurred.

Short – comings of the theory of comparative advantage and its limited applicability:

- The simplicity of considering only two countries is unrealistic. In the world today there are very many countries.
- Assumption of only two commodities is also unrealistic. Today a number of commodities are produced even in one country.
- Assumes free trade and yet in reality there are barriers to trade due to political, social and economic reasons.
- It wrongly assumes the possibility of full employment. Not all countries can achieve this for example LDCs and therefore excess capacity exists.
- It ignores transport costs or changes in transport costs which may wipe out comparative advantage and therefore the benefits of international trade.
- It ignores the need for self reliance by countries where each country would wish to produce all that it wishes to consume and therefore the need for diversification of production
- It assumes homogenity of the factors of production and therefore their being perfectly mobile yet they are not. For example labour differs in skills, talent, physique etc.
- It ignores the law of diminishing returns and its existence which can lead to the disappearance of comparative advantage. It assumes constant costs which is not the case in the real world as they change.
- It is static. It assumes no possibility of change in comparative advantage over time yet comparative advantage may be held by a country for a short period of time.
- Assumes barter trade yet in the real economies today there is more of monetary exchange.
- Assumes that demand is elastic yet the demand for agricultural products is inelastic.
- There can be international mobility of the factors of production like labour which enables importation of resources from other countries and other factors of production like land do not move at all within the same country.
- It ignores the existence of different currencies in use from one country to another and the difficulty in converting some. Different currencies have different values.
- With this principle in operation, then poor nations (LDCs) become poorer because they have to specialize in primary products and developed countries in industrial products

(manufactured products) hence the continuous price fluctuations and poor / deteriorating terms of trade (TOT) for LDCs.

- It does not take into account the changes and differences in technology between countries. A change in technology brings about a change in comparative advantage.
- It ignores the possibility of absolute advantage where a country can have the ability to produce both commodities more cheaply than the other hence it's difficult for it to specialize.

Applicability of the principle of comparative advantage to LDCs:

- LDCs have tended to specialize in Agriculture where they have comparative advantage.
- They tend to use labour intensive technology since labour is abundant.
- They import manufactured goods in which they have comparative disadvantage.
- There is some degree of factor mobility internally.
- There are some cases of free international trade for example AGOA arrangements.
- At times LDCs tend to use barter trade in exchange.

The principle of absolute advantage:

It states that given two countries, two commodities and a given amount of resources, a country can produce both commodities more cheaply than the other.

Illustration of the principle of absolute advantage / the theory of absolute cost advantage

Country	Maize (tons)	Sugar (tons)	Price of maize	Price of sugar
P	200	150	1.33	0.75
Q	150	50	3	0.3

From the table above, country P has absolute advantage in production of both maize and sugar i.e. it is cheaper to produce both maize and sugar in country P than in country Q. According to the law of absolute advantage, country Q world produce none of the two commodities however, in the real economic world, there is either specialization by each country or both countries will produce the two commodities. Specialization will take place on the basis of relative cost advantage.

According to the principle of relative cost advantage, a country produces a commodity she requires more of the abundant factors i.e. the factors she has better endowment in. This principle is also referred to as relative factor endowment theory which states that a country should specialize in a commodity that utilizes intensively its most abundant resource or factor.

On this basis, country Q is relatively better in maize production as it only foregoes 0.3 tons of sugar for each ton of maize produced compared to country A which foregoes 0.75 tons of sugar for every ton of maize produced.

Country P will specialize in sugar production as it's relatively better off in it as it only foregoes 1.3 tons of maize for every ton of sugar produced compared to country B which would forego 3 tons of maize for every ton of sugar produced.

Importance of international trade in development / advantages of international trade:

- It facilitates mobilization of foreign resources. Exports earn foreign exchange which is used to acquire capital so as to exploit a country's comparative advantage for development.
- It widens the market base which encourages countries to exploit their resources. They don't just rely on the domestic markets.
- It facilitates transfer of information and research at lower costs. This is mainly by LDCs from MDCs.
- It encourages specialization. It provides a vent for surplus output to be disposed of. This leads to utilization of the idol resources and thus improved social welfare.
- It expands consumers'choice.it creates a variety of goods and services for consumers in an economy and instead of relying on only a few goods and services produced locally, others are also imported.
- It enables countries to over come shortages and home supplies during times of hard ships like draught or famine.
- It promotes international co-operation due to the linkages with other countries hence peace and mutual understanding between them.
- It enables countries to take advantage of the economies of scale hence expansion of the infant firm. This is through the widened market that encourages large scale production.
- It is a source of more government tax revenue as a tax base is widened, for example in form of import duties, export duties.
- International trade facilitates better allocation of the F.O.P. through specialization and the element of competition which improves on quality and efficiency.
- It enables consumers to be exposed to better and cheaper goods and services and discourages monopoly tendencies in the economy and their associated dangers.
- It leads to creation of a number of employment opportunities both directly and indirectly in the import and export sector.
- It leads to infrastructural development hence facilitating trade. For example transport and communication, the financial sector is all improved.
- It reduces government expenditure where it is free and there is no production of high comparative advantage/opportunity cost products.
- Discourages monopoly tendencies and the associated dangers dues to competition from imported manufactured products.
- It discourages trade malpractices where it is free for example smuggling.

Disadvantages/ costs of international trade:

- It can lead to or cause imported inflation.
- It may cause Unemployment due to out competing of the local firms.
- It affects the development of the local infant industries negatively as they often produce at high costs and their products are of poor quality yet international trade subjects them to high competition which they can not with stand. There fore, they are eventually driven out of production.
- Harmful products to people's health may be imported which affects their standards of living for example cocaine, heroin etc
- It will worsen the balance of payments problems of a given country where there is excessive expenditure on imports.

- It may make a country over dependent on imports which exposes it to risks increase of war or any other crisis. This result into increased external economic dependence.
- It encourages dumping which under sells the local produces.

NB-dumping is the selling of goods of one country in another country at a very low price quite often lower than those changed in the home market.

- It leads to over exploitation of LDCs through foreign capital land aid and therefore it is looked at as a zero sum game because as one country gains, the other must lose and this is always on LDCs this results into political dominance.
- It encourages brain drain of the professionals which is a loss to that country.
- It's associated with limited exploitation of the available resources in that country due to imports.
- LDCs compared to MDCs start from unequal access to technology and resource endowment and therefore international trade benefits mainly those countries which have been fairly progressive and their industries have had a lead over those in LDCs.
- The theory of comparative advantage fails and trade on its basis has made the poor countries to grow poorer because of poor terms of trade i.e. unequal exchange.
- It worsens the terms of trade for the LDCs which specialize in cheaper primary products where they face stiff competition which may force a country to lower her export prices.

<u>Reasons why LDCs have not benefited much from international trade:</u>

- They export products of less value added.
- Trade barriers of MDCs limit their exports hence export low volumes.
- Limited variety of exports by LDCs which limits their revenue from exports
- Limited geographical concentration of trade i.e. there are few markets where they export their products.
- Flooding of the international market with products from the LDCs results into of all in their prices.
- They generally import manufactured products from MDCs which are very expensive.
- They export poor quality products that are less competitive on the international market. This is mainly due to poor technology.
- Unfavorable exchange rates that lead to too much expenditure a broad.
- Weak bargaining power of LDCs on the international market leading to low prices offered for their exports.
- Too much dependence on exportation of agricultural products whose prices are ever fluctuating.

<u>How the position of LDCs can be improved in international trade:</u>

- Encourage more value addition of exports.
- Negotiate for the removal of trade barriers by MDCs.
- Carrying out market research.
- Encourage economic integration among LDCs e.g. ECOWAS, COMESA, SADC.
- Institute a quota system to reduce (minimize) access supply.
- Encourage technological development and research to improve on the quality of exports from LDCs.
- Encourage an import substitution strategy.
- Diversity exports i.e. having as many exports as possible.

- Joint / form strong commodity agreements.
- Encourage barter trade to minimize foreign exchange out flow.

Factors that limit the success of international trade:

- Trade restrictions by different MDCs.
- High levels of documentation involved for example the imports and export licenses.
- Political instability in different countries which limits investment and free participation in international trade.
- Production of homogenous products especially among LDCs.
- Poor infrastructures which limits trade between countries.
- Poor relations with other countries.
- Socio – cultural differences and changes in tastes that limits the exchange of products.
- Long distances involved in the transportation of products e.g. Uganda being a land locked country means high transport costs via Kenya and Tanzania.
- Differences in currencies which necessitates exchanging them before taking part in international trade.

PROTECTIONISM / TRADE RESTRICTIONS:

These are measures taken by the government of a given country to control / restrict free movement of commodities especially imports between or among countries.
It can also refer to the restriction of free international trade between countries.

FORMS / METHODS OF PROTECTIONISM/ TRADE RESTRICTION

These refer to the tools/ instruments used to restrict international trade which are either tariff or non – tariff barriers

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Tariff barriers are the restrictions to international trade which take the form of taxes.
They can also be defined as the tools that are used by a given country to restrict trade with other countries by use of taxation.

Non – tariff barriers on the other hand are those restrictions to free international trade which take other forms rather than taxation.

The various forms / methods of protection include the following;

Tariffs.

A tariff is a tax / duty levied on a product whenever it crosses an international boundary. It can be on exports or imports although today the export duty is no more in a number of countries due to liberalization of the economies.
Such a tax may be specific or ad valorem

Total ban / embargo

Here the government completely bans or prevents some goods from entry into the country or exit out of the country.

Imposition of Quotas

This is where the government allows only a specified or limited volume of goods to be imported or exported regardless of demand or supply conditions.

Quality control requirements

The respective government[s] through its/their standards bureau set[s] rules on the quality standards that imports should meet before they are allowed into that country.

Foreign exchange control : This is done by rationing the available foreign exchange. It is availed for importation mainly of essential commodities.E.g. in the early 1980s there was window 1 for primary sector and window 2 for the other sectors.

Subsidization of local producers:

This involves the government giving financial support to local producers to lower their production costs and enable them to compete favorable with the imported products.

Licensing policy:

This may involve issuing import licenses to a few business people importing desired products hence discriminating them or approving and issuing import licenses at a very high cost.

Direct administrative controls

This involves the government issuing some bureaucratic techniques or adopting certain policies so as to discourage imports for example anti – smuggling bodies.

Import deposits schemes or advanced deposits / payments on imports.

This is where the importers are required to deposit some money with the central bank for a given period and it has to be related with the value of the goods imported. This increases the cost of importing and tightens up credit conditions.

Campaigns.

Here the government persuades the nationals to buy the locally produced products instead of the imported ones.

Voluntary agreements.

This is where one government persuades another to limit or to pressurize its exporters to cut supplies to its market.

Devaluation.

This is the legal reduction in the value of a country's currency in terms of other currencies. It makes imports more expensive relative to the exports thus discourages imports.

State trading.

The government takes over exportation or importation of a given product / products and private individuals are not allowed to do so. This is more so for strategic or sensitive products like fire arms.

Case for protectionism / advantages of protectionism / positive implications of protectionism or trade restrictions:

The positive implications / advantages of protectionism or trade restrictions:

- It protects infant local industries from foreign competition. This allows them to reach a stage where they are large enough to enjoy the economies of scale.
- It increases on employment opportunities at home by promoting local firms
- It discourages dumping.
- It leads to self sufficiency / self – reliance there by reducing foreign dependence.
- It promotes) industries of strategic importance i.e. encourages production of products that are very important such that supply is not cut off during crises or armed conflicts.
- It encourages use of local resources.
- It protects the country against imported inflation.
- It reduces the B.O.P deficit or improves / corrects it as it reduces on foreign exchange expenditure.
- It prevents importation of undesirable or harmful products so as to protect the standard of living of the citizens.

- It is a source of government tax revenue for example on imports.
- It improves on a country's terms of trade.
- It strengthens political and economic cooperation among countries as a tariff may be imposed to give preferential rates to some countries where economic blocs are involved e.g. COMESA, SADC, EAC, ECOWAS etc.
- It reduces/controls political dominance more so where goods of strategic importance are involved.
- It stabilizes the exchange rates as imports are restricted and the exports are encouraged in order to get more foreign exchange.

N.B: For a question with why restrict trade? / Reasons for protectionism / trade restriction, the above points are changed to begin with ''To'. E.g. To protect infant local industries from foreign competition.

Case against protectionism / Negative implications of protectionism / Disadvantages of trade restriction /protectionism:

- It subjects nationals to highly priced products in the domestic market and this is due to lack of external (foreign) competition.
- It encourages consumption of poor quality products due to inefficient infant firms (industries) and lack of foreign competition.
- It encourages emergence of a monopoly situation and its related dangers.
- It encourages inefficient high cost firms as they are protected and due to limited competition.
- It reduces foreign exchange earnings due to restriction on exports.
- It encourages trade malpractices like smuggling and black market.
- It limits consumers' choice due to the limited variety of products in the domestic market and this undermines the nationals' standards of living.
- It discourages specialization and its associated advantages e.g. higher output, low production cost per unit of output e.t.c.
- It reduces government tax revenue for example import duties
- It leads to retaliation or beggar my neighbour policy from trading partners hence reduced gains from trade.
- It frustrates the inflow of foreign resources and also discourages private investment due to bureaucratic delays like in the acquisition of foreign exchange.
- Infant and protected firms may fail to grow where they are over protected.
- It reduces the market size or base.
- It increases government expenditure for example in the subdization of producers.
- The protected firms hold the government at ransom to continue reaping high profits.
- It encourages the tendencies of protected firms to remain infant which is not good for development.

FREE TRADE:

This refers to trade where the exchange is not restricted between countries.
Under free trade there is non – intervention of the government in international trade.

Arguments for / advantages / positive effects/ merits of free trade:

- It improves on the quality of products. This is due the high competition on the world market and also due to research and development. This optimizes material welfare.
- Low priced products are enjoyed due to high supply and competition.
- It enables mobilization or inflow or foreign resources like technology and skilled man power. This is because of the free movement without restrictions.
- It widens the market base as the entire world becomes a market for all the products.
- It avails a variety of products to the citizens. This is because of the importation of what is not produced thus widened consumers' choice and better standards of living.
- It creates more employment opportunities. People are employed both directly and indirectly under free trade.
- It leads to increased foreign exchange earnings as more products are exported.
- It discourages trade malpractices since importation and exportation are free.
- It widens the tax base hence more tax revenue due to import and export duties.
- It discourages monopoly tendencies and associated evils due to competition from other firms that are set up even on an international level.
- It encourages specialization and its advantages. This is based on the theory of comparative advantage. Countries become particularly better off hence increased real national income.
- It increases the efficiency of the local firms due to external competition. such firms impose their production methods and reduce their production costs.
- It promotes international cooperation and mutual understanding between countries. It creates an atmosphere of peace and good will between countries.
- It encourages faster expansion of the infant firms. This is because of the widened market.
- It helps avoid expenditure on implementing the protectionist policy.
- Free trade leads to economic development as it stimulates specialization and division of labour, widens the market, promotes healthy competition, improves on skills and facilitates raw materials, machinery and foreign capital availability.

Disadvantages / Negative implications of free trade:

- Local firms are out competed due to competition from the more efficient firms of other countries. This causes a number of problems like unemployment.
- It encourages dumping where a country may sell goods to another and have them sold at very low prices even below the costs of production in the foreign country. This out competes the local firms.
- It results into increased external economic dependence. This is because countries concentrate only in the production of goods where they have comparative advantages.
- Imported inflation may result.
- Leads to low tax revenue from imports as they are not taxed highly to restrict them.
- It worsens the balance of payments problem. Expenditure on imports increases compared to export earnings hence the B.O.P deficit for the case of LDCs.
- It results into low levels of exploitation of the local resources. Countries produce only products they have comparative advantage in and the rest are imported.
- It leads to importation of undesirable products with adverse effects on the nationals. free trade has no checks on production and trade in harmful products which undermine the health conditions of the local people where they are imported.

- It may result into unemployment due to out competing of the local firms.
- It may worsen a country's terms of trade where highly expensive products are imported and low priced privacy products are exported for the case of LDCs.
- It may result into political dominance where a country relies on imported products.
- It leads to imbalanced development as only sectors that a country has competitive advantaged in are emphasized and other sectors are neglected and remain undeveloped.

BALANCE OF PAYMENTS [B.O.P]:

This refers to the difference between a country's total expenditure abroad and its total revenue from a broad on both invisible and invisible items plans capital transfers in a given period of time usually 1 year.
It can also be defined as a summary record of all economic transactions between one country and the rest of the world during a given period of time usually one year.
It also refers to the difference between a country's total expenditure and payments and her total income or receipts from abroad plus capital transfer in a given period of time usually one year.

The B.O.P provides information on a nation's exports, imports, earnings of domestic residents on assets located abroad, earnings and domestic assets owned by foreigners, international capital movement and official transactions by the central bank and government.

The B.O.P is expressed as an account with the debit and credit side.
On the credit side of the B.O.P account, the following are the principal items shown,

- Income / receipts from exports.
- Grants or donations
- Loans
- Capital inflows
- Proceeds or profits from foreign investment

On the debit side of the B.O.P account, the following items are shown;

- Expenditure on imports
- Transfer payments abroad
- Loans given to foreigners
- Capital outflows
- Interest payments abroad.

B.O.P ACCOUNT / STATEMENT:

This refers to a systematic record of all the financial or economic transactions between one country and the rest of the world in a given trading period or year. It comprises the following accounts;

- Current account
- Capital account
- Monetary / cash / official settlements balance / official financing account/ accommodative finance account.
- Errors and omissions account.

Current account:

This is an account where all the transactions in visible and invisible commodities i.e goods and services are recorded.

The current account is divided into;

- visible / merchandise account
- invisible trade / service account
- Unilateral transfer / transfer payments account.

a. The visible trade / merchandise account is one where all transactions in visible / physical goods are recorded.

The difference between a country's income or earnings from visible exports and her expenditure on visible imports is referred to as **balance of trade or balance of visible trade.**

The B.O.T can also be a deficit or negative or passive and this is when the expenditure on visible imports exceeds earnings from visible exports for given country.

N.B – Negative balance of visible trade or balance of trade is referred to as a trade gap.

b. Invisible trade / service Account

This is an account on which all the transactions in services or intangible items are recorded. For example insurance, banking, tourism, air and sea freight e.t.c.

The difference between the earnings from the invisible exports and expenditure on invisible imports is called **the invisible trade balance.**

NB – Balance of payments on a current account is the comparison of all the receipts from abroad (credits) and all the expenditure abroad (debts) arising form visible and invisible trade. It is the best indicator of a country's trading position.

Equilibrium balance of trade is a situation where the expenditure on visible imports is equal to the earnings form visible exports.

Capital account:

This is an account on which capital movements i.e. capital outflows and capital inflows are recorded. Capital movement may take the form of:

- Direct foreign investment where residents of one county transfer capital to another country to create new productive capital.
- Portfolio investment capital where residents transfer funds for the purpose of investing in bonds or shares of firms in another country.
- Purchase of long term government securities or shares in public companies.
- Purchase and sale of short term instruments by foreign nationals e.g. treasury bills.

N.B. The difference between capital inflows and outflows is called **balance of payments on capital account.**

Where capital inflows exceed capital outflows, this is referred to as **a capital account surplus** and **a capital account deficit** occurs when the capital inflows are less than capital outflows.

A Capital account equilibrium occurs when capital inflows are equal to capital outflows.

Monetary / cash / official settlements balance / official financing account / accommodative finance account:

On this account, the deficits or surpluses in the B.O.P on both the current and capital accounts are settled or recorded. It is the balancing item or account.
It shows how the B.O.P deficit can be financed or how a B.O.P surplus can be run down.

N.B: Items in the form of reserves to offset a deficit or a surplus in the B.O.P are called **accommodating items.**

Errors and omissions account:

This is the account intended to correct any mistakes or statistical errors made in the other accounts to ensure that the B.O.P balances.

In other words, it shows all the errors and omissions which cause a discrepancy between the debit and credit totals.

N.B: A B.O.P surplus can be run – down or offset by:

- Accumulation of foreign reserves.
- Special drawing rights-SDRs.
- Payment of loans.
- Investment abroad.
- Lending.

A B.O.P deficit can be closed by:

- Selling the gold reserves
- Drawing from the foreign reserves.
- Disinvestment i.e. selling off assets abroad
- Borrowing.

FOREIGN RESERVES / FOREIGN EXCHANGE RESERVES:

This refers to the total value of all the gold, hard currencies like the US Dollar and special drawing rights (SDR's) held by a country both a reserve and a fund from which international payments are done.

Importance of foreign reserves / foreign exchange reserves:

- Used for covering B.O.P deficits or debts
- They are an indicator of the performance of an economy in international trade
- They are payments for the required imports
- They are used as reserves for future payments
- They determine the value for the domestic currency or exchange rate.
- They can be used to indicate the level of self reliance / self sufficiency.
- They determine the international liquidity of a country.

IMPORTANCE OF THE B.O.P ACCOUNT:

- It reveals a country's indebtedness
- It shows a country's performance in international trade.
- It shows the rate of capital inflow and outflow.
- It shows the proportion of a country's national income contributed by the outside sources i.e. the contribution of foreign trade to GNP.
- It shows the structure of a country's imports and exports
- It is on its basis that the country makes decisions on import restriction, foreign exchange control, devaluation and drawing plans.
- It guides in the formulating of the commercial policy.
- The monetary and fiscal policies are formulated on the basis of the balance of payments account.

COMMERCIAL POLICY:

This refers to the government policy meant to influence and direct the value, volume and direction or level of trade in an economy.
It can also be defined as a set of deliberate government measures to influence the valued, volume and direction or level of trade in an economy.
In other words, it refers to a set of measures by the government aimed at regulating commercial activities in an economy.

Objectives of commercial policy

- To increase the volume of export
- To increase the amount of foreign exchange earnings
- Diversifying the exports.
- To increase the competitiveness of the exports.
- To attain stability in the B.O.P position
- To minimize importation of non – essential products
- To encourage the growth of the infant – domestic industries.

Instruments / tools of commercial policy:

These are the methods / measures which are adopted to achieve the objectives of commercial policy.
They include the following:

- Taxation / taxes
- Subsidies / subsidization of producers
- Trade ban / trade embargo
- Manipulation of exchange rates.
- Quality control by licensing physical cheques, bureaucracy e.t.c.
- Devaluation
- Trade agreements
- Quota system
- Dumping.

BALANCE OF PAYMENTS DISEQUILIBRIUM:

It refers to a situation where a country's payments or expenditure abroad is either greater or less than her total incomes or receipts from abroad.

In simple terms, it's a situation where there is either a B.O.P surplus or B.O.P deficit.

B.O.P surplus / surplus B.O.P

It's a situation where a country's earnings / receipts from abroad plus capital inflow are greater than its expenditure abroad.

N.B A B.O.P problem refers to the persistent B.O.P deficit year after year.

Causes of B.O.P deficit in LDCs like Uganda:

A B.O.P deficit is caused by factors that lead to too much expenditure abroad combined with those factors that limit earnings from abroad. such factors include the following;

- Exportation of alternate products with low value added or low quality. This leads to less export earnings compared to import expenditure.
- Importation of high volumes of expensive manufactured consumer products or high MPM.This leads to high expenditure approach e.g. on electronics. There is also importation of expensive capital goods.
- Low output in the domestic economies or limited industrialization which may lead to low volume of products. This means less exports and export earnings compared to import expenditure.
- Limited market as all the LDCs sell in the same external markets which results into flooding the market and hence lowering of the prices.
- The prices of exports are dictated by the major powers because of the weak bargaining power of the LDCs. such prices are low hence less export earnings.
- Debt servicing which leads to high capital outflows. This means high expenditure abroad which worsens the B.O.P position of LDCs as they constantly.
- High inflation in LDCs' economies which limits the demand for their exports and also reduces their foreign exchange earnings.
- Profit and income repatriation by foreigners i.e. investors and expatriates. These increase capital outflow and reduce capital accumulation hence the deficit in the B.O.P.
- Protectionism and discriminatory policies in MDCs. These limit the LDCs' exports hence less foreign exchange earnings.
- High military expenditure on weapons / arms due to political unrest. This leads to high expenditure abroad.
- Price fluctuation of exports or unfavourable natural factors which determine the agricultural output which is exported as LDCs are mainly agro-based. This brings inless export earnings more so when the prices reduce.
- Excessive expenditure by the government bureaucrats on foreign mission and foreign travels.
- Limited variety of exports which means less export earnings yet import expenditure is high.
- High population growth rate which means increased expenditure on imports to cater for the big population and reduced exports of goods and services.
- Poor and ever fluctuating exchange rates. This leads to high expenditure of the local currency to import a given unit of a product.
- Unfavorable terms of trade for the products from LDCs hence less export earnings and high import expenditure.

Effects of the B.O.P Deficit or problem in an economy:

- It leads to the reduction in the volume of imports due to forex shortages.
- It may result into disinvestment abroad in order to earn foreign currencies.
- It encourages currency depreciation due to the limited forex vis-à-vis the local currency.
- It encourages external borrowing hence increased indebtedness.
- It results into high taxes on nationals so as to raise more funds for import expenditure.
- Inflationary conditions may occur due to limited ability to import and supplement local production.
- It results into limited employment opportunities due to limited investments.
- It retards the rate of economic growth due to limited foreign exchange to expand production.
- It leads to how standards of living due to limited availability of imported quality products.
- Depletion of the foreign exchange reserves may occur or it can lead to shortage of forex.

Measures to solve the B.O.P problem / deficit in an economy:

- Trade restrictions like tariffs, quotas, complete loan, e.t.c. to limit imports more so on products produced locally hence reduced expenditure.
- Diversify the exports so as to earn more foreign exchange.
- Diversify the export markets through formation of regional co-operations so as to increase export earnings due to widened market.
- Devaluation of the domestic currency. This increases the volume of exports hence more foreign exchange and it reduces the demand for imports.
- Man power training to reduce expenditure on expatriates. This is through education and training of the local manpower.
- Strengthening commodity agreements of which it is a signatory. This increases the bargaining power for better terms of trade and thus more export earnings.
- Limit expenditure on foreign missions and diplomatic travels. This is through restructuring and limiting trips by ministers or government officials hence reduced government expenditure.
- Create a conducive political atmosphere to limit military expenditure and also attract investors.
- Create a conducive investment climate e.g. by having good fiscal and monetary policies, liberalization, e.t.c.
- Encourage barter trade to minimize use of foreign exchange.
- Use of the accumulated foreign reserves.
- Adopt restrictions on profit repatriation.
- Improve on infrastructure to encourage production and hence exports.
- Population control so as to reduce demand and hence imports.
- Selling foreign investments.

TERMS OF TRADE:

It refers to the relation between the price index of exports to the price index of imports of a country.
It can also be defined as the rate at which a country's exports can be exchanged for her imports in a given period of time.
The T.O.T represent the units of the domestically produced products foregone to secure one unit of imported products.
Hence terms of trade are the opportunity cost of obtaining products through international trade rather than producing them at home.
Terms of trade are calculated from the formula:

Terms of trade can therefore be expressed as a ratio or as a percentage.

TYPES OF TERMS OF TRADE:

T.O.T are either net barter / commodity terms of trade or income terms of trade.

Net Barter / commodity terms of trade:
This refers to the ratio of export prices to the import prices in a given period of time in a given country.
It can also be defined as the ratio of the price index of exports to the price index of imports.
Barter terms of trade are calculated from the formula:

Barter Terms of Trade show how much exports are required to purchase a unit of imports i.e. the number of import items that can be exchanged for a given unit of exports.
In other wards, B.T.O.T is the import purchasing power of exports.

Also the B.T.O.T can be calculated from the formula:

X

INCOME TERMS OF TRADE (Y.T.O.T):

These refer to the ratio of the value of exports to the price index of imports of a given country in a given period of time.
It can also be defined as the value of exports relative to the value of imports.
Y.T.O.T are calculated from the formula:

Y.T.O.T measure a country's capacity to import out of its export earnings i.e. they show how much the country can import using total income from her exports. **N.B:** Income T.O.T = B.T.O.T X Quantity of exports

Examples:

1) Given that a country's price index for exports is 167 and her price index for imports 113, calculate the terms of trade.

2) Calculate the income T.O.T given that a country's price per unit exports was shs.1000, its price per unit imports was shs. 2100 and volume of exports was 2200units.

The above answer means that a country can buy a greater volume of imports with a given volume of exports.

Unfavourable T.O.T:

This refers to a situation when export prices are relatively lower than import prices.
It can also be referred to as a situation where export price index is lower than import price index there by making the T.O.T co-efficient to be less than 100% or 1.

N.B.

Improving terms of trade: This is when the terms of trade are persistently rising every year or the export prices persistently rise relatively to the import prices.

Deteriorating terms of trade: This is when the terms of trade are persistently falling year after year or the exports tend to earn fewer imports than before i.e. the exports become cheaper in terms of imports.

Effects of deteriorating / Unfavourable terms of trade:

- It leads to foreign exchange shortages due to more import expenditure than export earnings.
- It worsens the country's balance of payments position as it leads to low export earnings compared to prices of imports.
- It may discourage production due to low / falling export prices which in turn leads to low economic growth.
- It causes or increases unemployment due to how production levels.
- It reduces the levels of investment due to limited investment capital as exports earn less hence low incomes that would have been invested.
- It makes the government in power unpopular which may lead to political unrest by nationals.
- It leads to inflation due to importation of highly priced products both capital and consumer ones.
- It causes currency depreciation due to the shortage of foreign exchange.
- It may increase a country's external debt burden due to borrowing from other countries.

Causes of Unfavorable T.O.T in LDCs:

- Low prices of exports from LDCs compared to the high import prices.
- Increasing substitution / competition of exports with synthetics produced by MDCs.This makes their exports to be at low prices due to reduced demand.
- Protectionism by MDCs against exports from LDCs.This means low prices for the exports and also limited market.
- Importation of expensive manufactured capital and consumer goods. such imports are more expensive compared to the exports of LDCs.
- Exportation of semi-processed primary products like the agricultural and mineral products. Such products command low prices on the world market compared to the imports of LDCs.
- Weak bargaining power of LDCs on the world market. This is due to their lack of cooperation and competition from MDCs hence LDCs are unable to advocate or bargain for higher prices of their exports which are even of poor quality.
- Low/poor quality of LDCs' products. This makes them command low prices on the world market and they are always out competed.

- Low income elasticity of demand for their products. Demand for primary products does not increase with incomes hence decreases in their prices.
- Unfavorable exchange rates for their currencies. This makes their currencies to have less value hence imports become expensive compared to their exports.
- Market flooding of primary products by L.D.Cs on the world market leading to a fall in export prices.This is because L.D.Cs produce similar products and have weak quota systems.
- Invention of raw material saving technologies by MDCs.This reduces the demand for the primary products of LDCs hence reduced prices for such exports yet import prices are high.
- Dictation of prices of LDCs exports by MDCs which always set prices in their favour hence unfavourable terms of trade.

Measures to improve T.O.T of LDCs:
- Processing their export primary products to add value
- Adopt an import substitution strategy.
- Diversifying their export markets / joining or strengthening regional cooperation.
- Strengthening commodity agreements so as to bargain for higher prices for their exports.
- Improving the quality of their exports through industrialization– manufacturing sector.
- Encouraging importation from cheaper sources.
- Diversify the export products to reduce dependency on a few with many producers and hence low prices.
- Stabilization of the foreign exchange rates.
- Negotiating for the removal of trade barriers in the export market.

FOREIGN EXCHANGE:

This refers to the currencies of other countries that are found in a given country.

The total amount of foreign currencies held by the central bank of a given country is what is referred to as **foreign reserves.**

Ways of earning foreign exchange:
- Through exportation of products.
- Through borrowing / seeking loans from external sources.
- Soliciting for donations / grants
- Through remittances by nationals living abroad.
- Attraction of foreign investors leading to capital inflow.
- Investments abroad on which returns are made.
- Selling off investments abroad i.e. disinvestment.

Causes of foreign exchange shortages:
- Unfavorable T.O.T
- Debt servicing as the interest paid on loans reduces the foreign exchange.
- Political instability which leads to high expenditure on imported military hardware.
- Excessive dependency on imported products due to the high demonstration effect.

- Protectionism by MDCs which limits their exports.
- Price fluctuations
- Limited export base hence limited foreign exchange earnings
- Reliance on expatriate manpower
- Mismanagement of foreign exchange by government officials who use it for personal benefits.
- Inflation which reduces demand for LDCs' exports.
- High expenditure on the ever increasing population.
- High level of profit/income repatriation.

Measures to conserve foreign exchange:
- Setting up import substitution industries.
- Adopting an export promotion strategy.
- Diversification of the export base
- Devalue the local currency.
- Train local manpower / entrepreneurs
- Undertake foreign exchange control.
- Ensure political stability.
- Undertake import restriction measures.
- Put in place a favourable investment climate to attract foreign investors.
- Acquire soft loans.

Financial / foreign exchange control:
This refers to the government control over factors that determine the rate of exchange in a free and independent atmosphere.
In other words, it refers to government regulations that are in line with the buying and selling of foreign exchange.

Measures of financial control:
- Establishment of official rates of exchange for sale and purchase of foreign exchange.
- Enforcement of regulations relating to surrender to government whatever foreign exchange people of that country possess.
- Allocation of foreign exchange between people requiring it.
- Restricting use of domestic currency by foreigners and entering into agreement with other governments to make payments according to specified procedures e.g. exchange clearing agreements.

Reasons for financial control:
- To stabilize the rate of exchange.
- To check capital flight from a country.
- To ensure availability of foreign exchange to enable importation of essential products.
- To protect home industries against foreign competition as imports are restricted.

Merits / advantages of foreign exchange control:

- It maintains exchange rate stability.
- Conserves foreign exchange that can be used to meet strategic defence and planning needs of a country.
- It aids in control of multiplication of foreign industries and in regulating their operations in national interest.
- It improves a government's capacity to repay its external loans.
- It makes importation of essential capital / consumer goods possible by availing the needed foreign exchange.
- It helps in correcting B.O.P disequilibrium by import restriction.
- It protects domestic industries from foreign competition
- It acts as an instrument of anti-deflation policy.
- It acts as a source of government revenue.
- It controls speculative activities in foreign exchange.

Disadvantages:

- It leads to inequalities between countries as in some cases restrictions are very low from which some countries gain more and vice versa.
- It encourages smuggling and black markets in foreign exchange.
- It reduces volume and value of international trade by restricting exports and imports due to retaliation from other countries.
- It creates inefficiency, red tape and corruption among people. connected to its administration.
- It entails large expenses as many people have to be employed in its smooth functioning.

Determinants of demand for foreign currency:

- Volume of imports
- Debt servicing requirements of a given country.
- Government's external obligation
- Central bank's intervention

Determinants of supply of foreign currency:

- Volume of exports
- Level of capital inflow by foreign investors.
- Level of inflow of grants and donations.

FOREIGN EXCHANGE RATE:

This is a rate at which a country's currency can be exchanged or exchanges for other currencies within the foreign exchange market.

It can also be defined as a price of a country's currency in terms of other currencies in foreign exchange markets.

In other words it refers to number of units of a foreign currency that one unit of a domestic currency can/will buy or buys.

1TZ.shs =UGX 1.05

1$ =UGX 2200

Real exchange rate refers to the number of domestic products used to buy one unit of foreign products.
The real exchange rate shows the competitiveness of a country's exports.

Types / systems of exchange rates:

Different countries operate different exchange rate systems and thus they include:

- Free / flexible / floating exchange rate system.
- Fixed / pegged exchange rate system.
- Managed / controlled / dirty float exchange rate system.
- Dual exchange rate system.

Free exchange rate system:

This is one where the exchange rate is determined purely by forces of demand and supply in the foreign exchange market.
It's one purely determined by the market forces of demand and supply in the market without intervention of the central authorities.

The demand for foreign currency comes as a result of the following:

- The need to import products
- The tourists who need to go out of the country
- Residents who wish to invest abroad.
- Diplomats representing a country abroad.
- Government officials on official trips abroad.
- Students who need to study abroad.

The supply of foreign currency arises from:

- exports
- foreign investors in the country
- foreign diplomats in the country
- Tourists into the country.
- Foreign students in a country.

Advantages:

- It provides automatic mechanism for collecting trade imbalances i.e. B.O.P disequilibrium.
- It preserves the autonomy of domestic monetary policy. It enables a country to pursue an independent internal monetary policy without the regard to other countries' policies.
- It saves the country a burden of holding large official reserves by its central bank.
- It's easy to administer i.e. no need to work out a new exchange rate which may require experts.
- It gives the most realistic value of the local currency vis-à-vis other currencies.
- It discourages cooperation of parallel foreign markets.
- It encourages investment due to easy access to foreign exchange.
- It clears the money market. Increase in the supply of the currency without corresponding increase in its demand leading to the exchange rate to fall and vice versa.

Disadvantages of adopting a free exchange rate system:

- It discourages long term contracts in international trade due to uncertainty in the value of currencies. This makes it difficult to plan for international trade.
- It encourages speculation in the foreign exchange international market. This may lead to its hoarding and instability in that currency.
- It encourages capital outflow due to uncertainty hence reduced investing.
- It hinders production due to speculation.
- It promotes price speculation due to instabilities in the exchange rates.
- It may encourage inflation more so during currency depreciation.
- It worsens a country's B.O.P problem due to excessive importation or causes instabilities in the B.O.P positions.

N.B:- The free exchange rate system solves the B.OP problem through:

- Restriction of imports
- Import substitution
- Export promotion
- Encouraging barter trade.

FIXED EXCHANGE RATE SYSTEM:

It's where the exchange rate is fixed by currencies of the monitory authorities or control of the central bank and it doesn't vary for a given period of time.
The rate is fixed in relation to a particular currency or vehicle currency [basket of currencies]

Advantages

- It encourages long-term contract trade or planning. This is because of certainty regarding future exchange rates.
- It stabilizes the value of the domestic and foreign currency.
- It reduces or discourages speculation of the foreign exchange markets. This
- is due to restricted or limited depreciation or appreciation of currency.
- It encourages investment due to the stability of exchange rates.
- It reduces production and hence promotes economic growth due to investments increasing.
- It stabilizes the prices in the economy i.e. checks on the inflationary tendencies.
- Encourages long term capital inflow.
- It eliminates B.O.P problem where surplus increases money supply and a deficit reduces money supply.

- Requires large official reserves to be kept by the central bank.
- Encourages economic dependence so as to get enough currencies.
- It's administratively expensive to maintain for example needs people to monitor / determine it.
- It's not realistic as it does not reflect the time purchasing power of currency.
- Encourages the emergence of illegal foreign exchange markets and it creates foreign currency shortages where it's too low.
- Discourages investment.It's appropriate during a time of high inflation and unemployment.

A fixed / pegged corrects a B.O.P deficit through;

- Devaluation
- Exchange control or restriction
- Borrowing
- Disinvestments

Managed / controlled / influenced / dirty float exchange rate system:

This is one where the forces of demand and supply determine the rate at which the local currency exchanges for the other currencies but within the limits set by the monetary authorities like the central bank.

N.B: The exchange rate can change but only within the fixed margin.

Advantages

- It controls fluctuations of exchange rates hence avoids over valuation or under valuation of local currency.
- It safe guards importers and exporters from rapid and constant fluctuations in earnings which may cause losses.
- It ensures that there is a favourable exchange rate on the market.
- It controls or minimizes the action of speculators in the foreign exchange market.
- It allows monetary authorities to still maintain control over the exchange rates.
- It encourages investment and planning as the foreign exchange rate does not go below or above the determined levels.

Disadvantages:

- Less profits are earned by importers when the foreign currency appreciates or gains value due to excessive demand.
- It requires the government to keep large official reserves.
- It becomes quite difficult to attain complete stability in the exchange rates.
- It limits the free operation of price mechanism and therefore the rates are not a true reflection of the purchasing power of the currency.
- It does not eliminate uncertainties in the foreign exchange market.

Dual exchange rate system:

This is where the monetary authority of a given country operates/adopts two exchange rate systems at the same time one meant for priority sectors and the other one for the non priority sectors.

Advantages:

- Encourages importation of essential / priority products.
- Discourages importation of luxurious products.
- Makes foreign exchange readily available to all the categories of importers.
- It encourages investment in the priority sectors.
- Reduces speculation in the foreign exchange market.
- Reduces profits of importers under the non priority sectors.

Reasons for government control of exchange rates:

- To minimize / control inflation by controlling currency depreciation
- To limit importation of unnecessary products by having a fixed exchange rate system.
- To ensure exchange rates stability.
- To encourage investment and production in an economy/
- To protect domestic producers from external competition.
- To control capital outflow / profit repatriation.
- To reduce on its B.O.P problem
- To reduce or minimize specialization in the foreign exchange markets.

<u>Determinants of exchange rates in an economy:</u>

- The demand for and supply of foreign currencies or speculation in the money market or exchange market thus has direct on the movement of the exchange rate.
- Government policy on the exchange rate e.g. in case of fixed or pegged exchange rate.
- Inflation rates in other countries.
- Level of capital inflow. capital inflow leads to appreciation of domestic currency and vice versa.
- Level of foreign exchange reserves. The higher the level of the foreign exchange reserves, the stronger the domestic currency and vice versa.
- Rate of domestic money supply: the higher it is, the weaker the domestic currency and vice versa.
- Volume of exchange. The higher it is, the stronger the domestic currency and vice versa.
- Volume of domestic output. The higher it is, the stronger the domestic currency.
- Volume of imports. The higher it is, the weaker the domestic currency and vice versa.
- Political climate.

<u>Currency appreciation:</u>

This refers to the rise in the value of the local currency in relation to other currencies as a result of the free inter play of the forces of demand and supply in the foreign exchange market. This usually occurs under a floating exchange rate system.

In other words, it is when the currency of a given country gains its exchange value in relation to other currencies in the country's money market due to the market forces of demand and supply.

<u>Currency depreciation:</u>

This refers to the fall in the value of the local currency against the foreign currencies as a result of the free interplay of the forces of demand and supply in the foreign exchange market. It can also be defined as a situation when the currency of a given country automatically loses its exchange value relative to other currencies due to the market forces of demand and supply in the exchange market.

<u>Causes of currency depreciation:</u>

- Reduction in the volume of exports
- Increase in the volume of imports
- Increased government expenditure abroad
- Increased capital outflow

- Reduction in capital inflow

Effects of currency depreciation:

- Rise in domestic prices or results into inflation
- Projected planning is made difficult.
- Encourages speculation in the foreign exchange market
- Encourages foreign investment
- It makes exporters receive higher local currency value i.e. increases their incomes.
- It supports higher prices to export products.
- It worsens the external debt burden.

DEVALUATION:

This is legal / official / deliberate lowering or reduction in the value or exchange rate of a country's currency in terms of foreign currencies.
It can also be defined as the lowering of the value of the local currency against foreign currencies by the central bank / monetary authority of a given country.

The purpose of devaluation is to encourage exports while discouraging imports by making the exports cheaper and imports more expensive in terms of the domestic currency. It increases the exchange rate.
This policy is carried out as a last resort by a country with a serious B.O.P deficit. It is applicable where there is a fixed exchange rate system.

For example:

Given that the exchange rate is 1US dollar = UGX 1500, calculate the new exchange rate after devaluation by 20%.

Reasons for Devaluation:

- To increase the volume of exports
- To reduce the volume of imports
- To reduce the B.O.P problems.
- To reduce the importation and consumption of undesirable products.
- To protect the local firms from external competition.
- To reduce the evils of imported inflation.

- To attain self reliance or dependence on imports is reduced and import substitution industries are established.
- To attract investment by both local and foreign investors.
- To increase the foreign exchange earnings.
- To encourage and increase the rate of exploitation of the local resources.

EFFECTS OF DEVALUATION:

POSITIVE:

- It increases the volume of exports as they are made cheaper.
- It leads to increase in foreign exchange earnings due to the increased volume of exports.
- It improves a country's B.O.P position hence saves the scarce foreign exchange. This is because imports are made expensive therefore their consumption reduces.
- Encourages domestic production due to wider market and limited external competition.
- Encourages the exploitation of the idle resources due to the widened market outside and limited external competition.
- Results into increase in foreign capital inflows due to reduced production costs.
- Reduces the volume of imports as they are made expensive.

NEGATIVE:

- It results into retaliation by the trading partners because it interferes with international trade.
- It leads to inflation. This is because exports become cheaper and little is left in the country hence increasing prices.

CONDITIONS NECESSARY FOR DEVALUTION TO SUCCEED:

The major objective of devaluation is to increase exports since they are made cheaper and to reduce imports since they are made more expensive. However, to achieve this objective the following conditions are necessary:

- The demand for exports should be price elastic. This means that a small reduction in export prices leads to a bigger increase in the demand for exports hence more foreign exchange earned.
- The demand for imports musts be price elastic. This mean that as small increase in the import prices leads to a large reduction in the demand for them hence less expenditure on them.
- The supply of imports must be price elastic. This means that the volume of imports must decrease as their prices reduce.
- Inflation should not exist in the devaluing country so as not to reduce the demand for exports.
- Competing countries should not devalue their currencies at the same time. In other wards, there shouldn't be competitive devaluation or beggar my neighbour policy. If it's otherwise, there will be no competitive advantage gained.
- Absence of protectionism/export restriction from the devaluing country should be non existent.
- Absence of political unrest or instability so as to encourage large scale interment for the export sector.
- The devaluing country should be operating a fixed exchange rate system.

- A high state of technology should exist to produce high quality products.
- There should be export promotion by the government or else production may be for the local market.
- There should be no smuggling of imports.
- When a deficit is realized in a country/s B.O.P it should be as small as possible to be covered by exports.

WHY DEVALUATION MAY FAIL TO SOLVE THE B.O.P PROBLEM:

- When the demand for export is price inelastic.
- The demand for imports may be price inelastic.
- The supply of exports may be price inelastic
- The supply of imports may be price inelastic.
- Existence of competitive devaluation i.e. trading partners devaluing at the same time.
- People in the devaluing country may have a high marginal propensity to import.
- The devaluing country may be facing inflation
- The exports may be of poor quality.
- Weak administrative machinery to co-ordinate and implement the devaluation policy.
- Production may be at full capacity or there is full employment.
- Government not controlling the exchange rates through the central bank hence no fixed exchange rate system.
- Political unrest that scares away investors.
- Smuggling of imports.
- Deficit in the B.O.P may be too large to be overcome by devaluation policy.
- Limited investment in the export sector.

NB.

Revaluation refers to official/legal increase in the value of the local currency against other countries' currencies .

This is possible under a fixed exchange rate system .

Over valuation refers to where there exchange rate is fixed above the market competitive price i.e. one determined by market forces of demand and supply

BEGGAR -MY -NEIGHBOUR POLICY:

This is a deliberate trade policy under taken be one country in the hope of gaining more at the expense of her trading partners.

It can also be defined as an economic measure under take by one country to improve her domestic conditions at the expense of her trading partners. For example: Devaluation, dumping, use of tariffs, e.t.c.

REASONS FOR ADOPTING A BEGGAR -MY –NEIGHBOUR POLICY

- To promote the growth of domestic infant industries.
- To discourage the importation and consumption of harmful products.
- To improve on the B.O.P position.
- To raise more government tax revenue.
- To create more employment opportunities domestically.
- To fight or control imported inflation.
- For Retaliatory purposes.

- The need to save the scare foreign exchange through reduced imports.

NB: Vent for surplus theory of trade is theory that international trade provides an opening up of markets in order to exploit their idle resources to provide supply output for export.

ECONOMINIC INTERGRATION / CO-OPERATION / PREFERENTIAL TRADING ARRANGMENTS:

It refers to the coming together of several countries for the sake of mutual economic benefit to all.

This aims of increasing the benefits of international trade and can result into political co-operation. For example PTA, FTA, CU [customs Union].

Objectives of economic integration /co-operation / preferential trading arrangement:

- To eliminate trade restrictions between member states.
- To diversify and widen export markets of member countries.
- To promote peace and stability among member states so as to enhance economic development. In other words to strengthen relations btn countries.
- To promote more fair and harmonious development for production and marketing structures
- To create an enabling environment for foreign cross-border and domestic investment and joint promotion of research and adoption of science for development.
- To encourage specialization and avoid duplication of products.
- To protect infant industries within the integration.
- To encourage free factor mobility within the integration.
- To jointly develop infrastructure within the integration [to promote joint development of all fields of economic activity and the joint adoption of macro-economic policies and programmes].
- To reduce expenditure in form of paying import and export duties.
- To increase employment opportunities in the member countries.

FORMS /STAGES/ ELEMENTS /TYPES OF ECONOMIC INTEGRATION.

PTA [Preferential Trade Area]:

This is the first stage of economic integration where members reduce tariffs among themselves for selected products i.e. Imports from member states. However, each country retains its tariff structure on non–member states.

FREE TRADE AREA [FTA]:

This is a form of integration where member states eliminate all tariffs among themselves to allow free movement of products and also abolish any other trade barriers but continue to charge different tariffs on products from non-member states.

CUSTROMS UNION [CU]:

It is where the integrating countries eliminate all individual tariff structures or trade restrictions among themselves and adopt a common external tariff on products from non-member states e.g. East African customs union.

COMMON MARKET [CM]:

This is a form of integration where member states eliminate all individual tariff structures, adopt a common external tariff and there is free movement of factors of production among the member states e.g. COMESA.

ECONOMIC COMMUNITY [EC]:

This is a form of Integration where member states eliminate all individual tariffs,adopt a common external tariff,allow free movement of F.O.P among member state and there exists supra-national corporations and institutions.

ECONOMIC UNION:

It is where integration countries eliminate all individual tariffs, adopt a common external tariff, allow free movement of F.O.P among member states, adopt common economic policies ,plan jointly and use the same currency hence have a monetary union

CONDITIONS NESSARRY FOR THE SUCCESS OF ECONOMIC INTEGRATION.

- Countries should be in the same region or share common borders.
- Countries or intending members must be of a relatively same level of development .This is to avoid over exploitation of some member countries.
- Intending countries should be of approximately the same population or market size.
- Countries should be ready to promote good relations among themselves.
- Intending member countries should have similar political and economic ideology.
- Comparative advantage must differ among the countries i.e. there should be specialization on different products.
- Willingness to sacrifice national interests by the intending member countries in favour of the integration. In other words, there should be political will and willingness to give up personal sovereignty of individual countries.
- Similarity in historical background by intending member countries.
- There should be a well developed infrastructure among the countries e.g. the road network.
- They should have common social factors or background like language, culture and religion.

LIMITATIONS OF ECONOMIC INTERGRATION AMONG LDCs:

- Tend to produce similar products hence limited market. This is due to duplication
- Failure to share resources equally. This results into some countries developing faster at the expense of others.
- Differences in the level of development. some states are economically more advance than the other hence benefits are not equitably distributed.
- Desire for self reliance by member states.
- Fear of loss of customs revenue.
- Political instability or immaturity.
- Lack of political support. This is due to ideological pluralism hence different conceptions as to how goal of integration are to be achieved.
- Conflicts among leaders.
- Differences in economic policies free market economy versus gov’t intervention.

- Poor infrastructure among countries which makes transport and communication difficult.
- Limited proximity which maker co-ordination difficult.
- External influence more so from MDCs.

MERITS OF ECONOMIC INTEGRATION/ CO-OPERATION:

- It leads to trade creation and this encourages specialization along comparative cost lines and utilization of resources.
- Stimulates establishment and expansion of manufacturing industries thus leading to accelerated industrial growth and economies of scale.
- Provides a vent for surplus output and therefore resources available are utilized due to widened market. It also encourages further utilization of capacity where excess capacity exists.
- It increases gains from international trade and reduces costs of duplication e.g. one industry in one country to serve the whole group i.e. it encourages specialization hence efficiency.
- It increases accessibility foreign resources because of increased credit worthiness hence financing bodies can easily lend such an integration rather than individual countries.
- It encourages competition of industries to external ones which increases production efficiency and improvement in quality.
- Promotes economies of scale as countries conduct research and collect information jointly at lower costs. This facilitates spread of knowledge and skills.
- It increases employment opportunities due to increased factor mobility. It therefore fosters fair income distribution.
- Member countries tend to share common services / infrastructure hence it lowers each country's expenses on such services / infrastructure e.g. railways, air transport services e.t.c.
- It reduces scarcity inflation in member states due to increased supply of products.
- It increases the bargaining power of member states in the international arena which improves their T.O.T.
- It leads to / promotes political cooperation and mutual understanding among member states.
- Where one currency is used, trade between member states is eased this increases volume of trade.

<u>Demerits of economic integration:</u>

- It leads to loss of revenue (customs duties) that would be realized if there was no integration.
- Movement of products may be in one direction leaving other countries impoverished hence imbalanced development.
- May lead to trade diversion as trade may shift from low cost member states to high cost non-member states.
- Consumers may be compelled to buy poor quality products within the region instead of importing better quality ones outside integration.
- Distribution of industries may be done at the expense of the economies of scale due to purposes of distributing of projects and benefits on political grounds.

- There can be uneven distribution of industries which may result into unequal development of come countries in the integration and may cause misunderstandings.
- Countries may produce the same type of products hence surpluses may result and lack adequate market thereby leading to wastage.
- Member states may be their political sovereignty. This is because sometimes they have to act in the interest of all hence national interest may be sacrificed especially where some states are at low levels of development.
- Costs of staffing may become higher as labor force of the integration can be transferred to far places. This increases the expenditure of member states.
- It leads to quick depletion of resources so as to produce more for export hence environmental degradation.

TRADE CREATION:

It refers where after economic integration there is a shift from consuming products of high cost non member states to those of the low cost member states.
It can also be defined as a state where formation of an economic integration results into a country buying cheaply from a member country what formerly bought more expensively from non-member countries.
It can also be looked at as a situation where economic integration results into a shift in production from high cost producers to low producers within the member countries.

TRADE DIVERSION:

This a situation where formation of an economic cooperation results into countries buying expensively from a member country what they formerly bought more cheaply from non – member countries.
It can also be defined as a situation where there is a shift in the focus of trade or production from a low cost non-member country to high cost member countries in the integration.
In other words, it’s when trade shifts from cheap non-member countries to expensive products from member countries.

Advantages of trade diversion:

- Leads to regional self–reliance.
- It enables infant industries in the member states to grow due to protection from imported similar products.
- Encourages specialization and exportation by the member states.
- It increases cooperation between member states.
- It reduces importation of undesirable products from non-member states.

Disadvantages of trade diversion:

- Results into highly priced products in the integration hence low consumption levels.
- Loss of export and import tax revenue.
- It results into a limited variety of products due to limited importation.
- Low quality products are produced due to limited competition from non member states.
- It leads to increased smuggling of products from non-member states.

TRADE LIBERALIZATION:

This is the removal unnecessary controls in trade hence giving people the freedom to trade without undue government controls or restrictions.

Positive implication / advantages:

- Leads to increased employment opportunities due to the increased economic activities.
- It results into increased level of output hence increased economic growth rate.
- It tends to control structural inflation.
- Increases resources utilization and this is because of many participants in the economic activities.
- It encourages inventions and innovations and this is due to the desire to produce better quality products due to the increased competition.
- Competition forces the firms to be more efficient and produce better quality products so as to remain in business.
- Leads to increased tax revenue because of the many economic activities and the participants involved.
- Fights corruption due to reduced bureaucracy.
- It leads to improved B.O.P position when exports are encouraged and imports are reduced.
- It reduces wealth and income inequalities amongst people and regions. This is because individuals and regions are allowed to participate in the economic activities.
- Upholds consumer sovereignty.
- It enables production of a variety of products hence widened consumer choice.
- It encourages foreign investment or resource inflow.

- It makes an economy easily exposed to economic instabilities more so price fluctuations. This is due to excessive or limited supply of / demand for products.
- Competition pushes out inefficient firms thereby leading to unemployment.
- Income and wealth inequalities may result where the government does not control them.
- Results into a danger of resources misallocation as undue government controls are removed.
- Leads to duplication of products which results into resources wastage.
- There is a danger of quick depletion of resources due to over exploitation given a large number of people engaged in the exploitation.
- Flooding of markets is sometimes bound to force prices to go very low to uneconomic levels hence low or no profits which negatively affects the rate of economic growth.
- Consumer choices are distorted as persuasive adverting is used.
- Leads to consumer exploitation due to consumer ignorance and limited or no government intervention.
- It encourages capital outflow or profit repatriation mainly by foreigners.
- It may expose the population to harmful products due to government removal of controls.
- It may give rise to monopoly and its associated evils where the inefficient firms are out competed.