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SENIOR SIX TERM 3

TOPIC 1/2: International Trade

Competency: The learner demonstrates knowledge, understanding, and application of the concept of International Trade in the development of an economy.

International trade

International trade refers to the exchange of commodities across the national borders of the country.

OR

It refers to the exchange of commodities between residents of one country and those of other countries.

International trade can be visible or invisible trade.

Visible trade: This refers to the exchange of goods between countries.

Invisible trade: This refers to the exchange of services between countries for example tourism, electricity.

Foreign trade is divided into two forms

Bi-lateral trade. This is trade between two countries

Multi-lateral trade. This is trade among many countries,

Note.

If a country sells commodities to other countries, they are called exports. The activity is called **export trade**.

If a country buys commodities from another country, they are called imports and the activity is called **import trade**.

Why do countries carry out international trade?

- (i) **Resource limitations:** Not all countries have the same natural resources. For example, Uganda exports coffee but imports oil because it lacks petroleum reserves.
- (ii) **Comparative advantage:** Nations specialize in producing goods they can make more efficiently and trade for others. This boosts productivity and lowers costs.
- (iii) **Climate and geography:** Climate differences mean some crops or goods can only be produced in certain regions (e.g., bananas in tropical climates, wheat in temperate zones).
- (iv) **Access to larger markets:** Domestic markets are limited. International trade opens up global customers, increasing sales and profits.

- (v) **Technology differences:** Advanced economies may produce high-tech goods more cheaply, while developing nations supply raw materials.
- (vi) **Price and quality factors:** Countries import when foreign goods are cheaper or of better quality than domestic alternatives.
- (vii) **Economic growth and foreign exchange:** Exports earn foreign currency, which strengthens reserves and supports development.
- (viii) **Diversification and stability:** Relying on multiple trade partners reduces risks from local economic downturns.
- (ix) **Need for foreign exchange.** There is need for international trade for countries to acquire foreign exchange which can be used for import purposes.
- (x) **Need to dispose of the 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.
- (xi) **Need to promote international relations among countries through international trade.** In addition, some countries need international trade in order to further their political economic ideologies.

Example

- Japan imports oil and food but exports cars and electronics.
- Uganda exports coffee, tea, and fish but imports machinery, fuel, and medicine. This exchange balances needs and strengths across nations.

Principles (theories) of international trade

- (a) The Principle of absolute advantage.
- (b) The principle of comparative advantage

(a) The Principle (Theory) of Absolute advantage

This theory was advanced by Adam Smith. It states that given two countries producing two commodities using similar resources, a country should specialize in the production of the commodity where it can produce more units at less costs than the other country.

Example

Country	Tons of cotton	Tons of coffee
Kenya	10, 000	90,000
Uganda	50,000	100,000

From the table above, Uganda has absolute advantages in the production of both commodities. This is because given the same amount of resources, Uganda is able to produce more units of cotton and coffee than Kenya.

(b) The Principle (Theory) of Comparative advantage

- This principal states that given two countries producing two commodities using similar resources, a country should specialize in the production of a commodity where it incurs the least opportunity cost than the other.

- According to this theory, a country is said to have comparative advantage if it can produce commodity at a lower opportunity cost than the other country irrespective of the absolute advantage.

Example

Country	tons of Cotton	Tons of Coffee
Kenya	4000	16,000
Uganda	10,000	20,000

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

Opportunity cost of producing cotton

$$\text{For Uganda} = \frac{20,000}{10,000} = 2 \text{ tonnes of coffee.}$$

This means that to produce one unit of cotton, Uganda foregoes 2 units of coffee.

$$\text{For Kenya} = \frac{16,000}{4,000} = 4 \text{ tonnes of coffee.}$$

This means that to produce one unit of cotton, Kenya foregoes 4 units of coffee.

Therefore Uganda should specialize in the production of cotton since it has a lower opportunity cost (2 tons of coffee) than Kenya (4 tons of coffee). This means that Uganda has comparative advantages in the production of cotton.

Opportunity cost of producing coffee

$$\text{For Uganda} = \frac{10,000}{20,000} = \frac{1}{2} \text{ tons of cotton.}$$

This means that to produce one unit of coffee, Uganda foregoes $\frac{1}{2}$ units of cotton.

$$\text{For Kenya} = \frac{4,000}{16,000} = \frac{1}{4} \text{ tons of cotton.}$$

This means that to produce one unit of coffee, Kenya foregoes $\frac{1}{4}$ units of cotton.

Therefore Kenya should specialize in the production of coffee since it has a lower opportunity cost ($\frac{1}{4}$ tons) than Kenya (4 tons of coffee). This means that Uganda has comparative advantages in the production of cotton.

Assumptions of the theory of Comparative advantage

- (i) Two-country, two-commodity model: The theory assumes only two nations trading two goods, simplifying analysis.
- (ii) Constant opportunity costs: Production trade-offs remain fixed; resources are perfectly adaptable between goods.
- (iii) Perfect competition: Markets are assumed to be competitive, with no monopolies or distortions.

- (iv) Free trade without restrictions: No tariffs, quotas, or transport costs are considered.
- (v) Labor as the only factor of production: Ricardo assumed labor is the sole input, ignoring capital and technology.
- (vi) Full employment: All available labor is fully utilized in each country.
- (vii) Perfect mobility of labor within a country: Workers can move freely between industries domestically.
- (viii) Immobility of labor across countries: Workers cannot migrate internationally; trade substitutes for factor movement.
- (ix) No technological differences within a country: Each country has uniform production technology for its industries.
- (x) Trade is mutually beneficial: Both countries gain by specializing in goods where they have comparative advantage.

Weaknesses (Criticisms/Limitations) of the theory of comparative advantage

- (i) **Unrealistic assumptions:** Assumes only two countries and two goods, constant opportunity costs, and labor as the sole factor of production. Ignores capital, technology, and economies of scale.
- (ii) **Neglect of transport costs:** Ricardo's model assumes costless trade, but in reality, shipping, insurance, and logistics can outweigh comparative advantage.
- (iii) **Static framework:** Assumes comparative advantage is fixed, while in reality it changes with technology, education, and innovation.
- (iv) **Factor immobility:** Assumes labor is immobile internationally but perfectly mobile domestically. In practice, migration and capital flows affect trade patterns.
- (v) **No consideration of trade barriers:** Ignores tariffs, quotas, subsidies, and political restrictions that distort trade.
- (vi) **Income distribution effects:** Gains from trade may not be evenly distributed; some industries or workers lose out, causing unemployment or inequality.
- (vii) **Over-specialization risks:** Heavy reliance on one or two export commodities makes countries vulnerable to price fluctuations and external shocks.
- (viii) **Neglect of environmental and social costs:** Comparative advantage focuses on efficiency, ignoring sustainability, resource depletion, or exploitation of labor.

Example

- (i) A developing country may have comparative advantage in exporting raw materials, but this can trap it in low-value production and hinder industrialization.
- (ii) Over-specialization in oil or coffee exposes economies to global price volatility.

Relevance (Applications) of the theory of comparative advantage

- (i) **International trade policy:** Forms the foundation of free trade agreements (FTAs) and organizations like the WTO. Encourages countries to reduce tariffs and trade barriers, believing specialization benefits all.
- (ii) **Specialization of nations:** Countries focus on producing goods where they are relatively more efficient. Example: Uganda specializes in coffee exports, while Japan specializes in automobiles.

- (iii) **Global supply chains:** Modern production is fragmented across countries, each contributing where they have comparative advantage. Example: Smartphones designed in the US, assembled in China, with components from Korea and Taiwan.
- (iv) **Economic growth and development:** Export-led growth strategies rely on comparative advantage to earn foreign exchange and boost GDP. Many Asian economies (e.g., South Korea, Singapore) leveraged this to industrialize rapidly.
- (v) **Business and investment decisions:** Firms outsource or offshore production to countries with comparative advantage in labor or resources. Example: Call centers in India due to lower costs and skilled English-speaking workforce.
- (vi) **Trade negotiations:** Comparative advantage is used as a guiding principle in bilateral and multilateral trade talks. Helps countries argue for market access in sectors where they are competitive.
- (vii) **Resource allocation efficiency:** Promotes optimal use of scarce resources by focusing on industries where productivity is highest.
- (viii) The theory is relevant under barter trade between two countries where they exchange commodities for commodities basing on the law of comparative advantage. For example Uganda used to exchange beans for oil in the late 1870's with Libya
- (ix) According to this theory countries have been able to acquire more goods and services from other countries which have ability to produce them more cheaply.

Illustrative Example

- (i) **Uganda** exports coffee, tea, and fish because of favorable climate and natural resources.
- (ii) It imports machinery, fuel, and medicine from countries with comparative advantage in industrial production.
- (iii) This exchange allows Uganda to grow its economy while meeting domestic needs.

Advantages/Positive role/Arguments for international trade

- (i) **Efficient resource allocation:** Countries specialize in producing goods where they have comparative advantage, ensuring optimal use of resources.
- (ii) **Access to a wider variety of goods:** Consumers enjoy products not available locally, such as tropical fruits in Europe or advanced technology in Africa.
- (iii) **Lower costs and competitive prices:** Imports often reduce production costs and increase competition, leading to affordable prices for consumers.
- (iv) **Economic growth and development:** Export-led growth strategies boost GDP, create jobs, and generate foreign exchange reserves.
- (v) **Technology transfer and innovation:** Trade exposes countries to new technologies, skills, and innovations that improve productivity.
- (vi) **Improved international relations:** Trade fosters cooperation, interdependence, and peaceful relations between nations.
- (vii) **Employment opportunities:** Expanding industries for exports creates jobs, while imports can stimulate new service sectors like logistics.
- (viii) **Stability through diversification:** Trading with multiple partners reduces reliance on domestic markets and cushions against local shocks.
- (ix) **Market expansion.** International trade widens the market for the countries product which leads to increased production hence economies of scale.

- (x) It encourages capital inflow from rich developed countries to poor countries in form of loans, grants, foreign capital investment. This leads to transformation of economies of developing countries.
- (xi) It promotes mutual understandings and diplomatic relations among countries. This enhances peace and economic stability among trading partners.

Example

- (i) **Uganda** exports coffee, tea, and fish, earning foreign exchange to fund development projects.
- (ii) It imports machinery, medicine, and fuel, which support industrialization and improve living standards.

Demerits (Disadvantages/Arguments against/Negative role) of international trade

- (i) **Economic dependence:** Countries may become overly reliant on foreign goods or markets, making them vulnerable to external shocks.
- (ii) **Unequal gains:** Benefits of trade are not evenly distributed; developed nations often gain more than developing ones.
- (iii) **Risk of over-specialization:** Heavy reliance on a few export commodities exposes economies to price fluctuations and global demand changes.
- (iv) **Unemployment in certain sectors:** Domestic industries that cannot compete with cheaper imports may collapse, leading to job losses.
- (v) **Exploitation of developing countries:** Rich nations may exploit poorer ones by buying raw materials cheaply and selling finished goods at higher prices.
- (vi) **Cultural erosion:** Global trade can lead to loss of local traditions, crafts, and cultural identity as foreign goods dominate.
- (vii) **Environmental damage:** Increased production for exports may cause resource depletion, pollution, and unsustainable practices.
- (viii) **Political and economic vulnerability:** Dependence on foreign trade can weaken sovereignty, as sanctions or trade restrictions can destabilize economies.
- (ix) **Imported inflation.** It leads to imported inflation especially when imports are bought at higher prices from countries experiencing inflation.
- (x) It **may encourage the importation of dangerous and harmful products** to the country in form of drugs, pornographic materials etc. Such products may adversely affect the country economically, culturally and socially
- (xi) **It encourages brain drain.** Brain drain refers to the massive movement of skilled labour from one country to another especially from developing, to developed countries. This leads to lack of skilled manpower in the developing countries

Example

Many African countries rely heavily on exporting raw materials (like oil, coffee, or minerals). When global prices fall, their economies suffer, showing the danger of over-specialization and dependence.

Commercial policy

This refers to the set of rules and measures adopted by the country for the conduct and

regulation of its foreign and domestic trade in order to achieve the desired economic objectives.

Objectives of the commercial policy

- (i) **Protect domestic industries:** Safeguard local businesses from foreign competition through tariffs, quotas, and subsidies.
- (ii) **Promote exports:** Encourage the sale of goods abroad to earn foreign exchange and strengthen the economy.
- (iii) **Correct balance of payments:** Reduce trade deficits by controlling imports and boosting exports.
- (iv) **Encourage industrialization:** Support the growth of manufacturing and modern industries, especially in developing countries.
- (v) **Maintain national security:** Restrict trade in strategic goods (like weapons or sensitive technology) to protect sovereignty.
- (vi) **Stabilize domestic economy:** Use trade policy to manage inflation, unemployment, and supply of essential goods.
- (vii) **Strengthen international relations:** Build diplomatic ties and cooperation through trade agreements and partnerships.
- (viii) **Promote consumer welfare:** Ensure availability of diverse goods at competitive prices, improving living standards.
- (ix) To increase employment opportunities.

Example

- (x) Uganda's commercial policy promotes **coffee exports** to earn foreign exchange, while imposing tariffs on certain imports to protect local industries.
- (xi) The European Union applies a **common commercial policy**, negotiating trade agreements collectively to secure better terms for member states.

Tools (Instruments) of the Commercial policy

1. Tariffs
2. Quotas
3. Exchange rate policy
4. Trade agreements
5. Economic integration
6. Dumping
7. State trading
8. Export credit

Note. **Beggar -my-neighbor** policy refers to the measure adopted by the country to improve on its economic conditions but with adverse effects on economies of its trading partners, for example dumping.

Protectionism (trade barriers/restrictions)

- **Protectionism** refers to the measures employed by the government (country) to regulate international trade.
- **Free trade** occurs when there are no trade barriers in international trade.

Tools (Instruments) of Protectionism (Trade barriers)

- (i) **Tariffs:** Taxes imposed on imported goods to make them more expensive and protect domestic industries.

Tariffs can either be *Advalorem* or specific.

Advalorem tax. This refers to the tax imposed on commodities basing on their monetary value. For example 30% of the value of the imported commodity as a tax

Specific tax. This is the tax imposed on commodities basing on their quantities or units imported for example a tax of 500/= imposed on each unit of the commodity imported.

- (ii) **Import quotas:** Limits on the quantity of a particular good that can be imported during a specific period.
- (iii) **Subsidies:** Financial support to domestic producers, making their goods cheaper and more competitive against imports.
- (iv) **Import licensing:** Requirement for businesses to obtain government permission before importing certain goods.
- (v) **Voluntary export restraints (VERs):** Agreements where exporting countries voluntarily limit the quantity of goods sent to another country.
- (vi) **Exchange controls:** Restrictions on foreign currency transactions, limiting the ability to pay for imports.
- (vii) **Embargoes:** Complete bans on trade with specific countries or products, often for political reasons.
- (viii) **Technical barriers:** Standards, regulations, and certifications (e.g., health, safety, environmental) that make it harder for foreign goods to enter the market.
- (ix) **Anti-dumping duties:** Extra tariffs imposed on imports sold below their fair market value to prevent unfair competition.
- (x) **Deflationary policy.** This is where the government through the central bank: uses the restrictive fiscal and monetary policies in order to reduce on the amount, of money circulating in the economy so as to check on the aggregate demand for imports. This can help to reduce on the quantity of imports to the country.
- (xi) **Devaluation.** This refers to the deliberate government policy of reducing the value of domestic currency in terms of other currencies. Devaluation discourages imports and encourages exports. This is because it makes exports cheap to the foreigners and imports expensive to the locals. However, this policy can be effective if imports and exports have elastic demand.
- (xii) **Transport discrimination.** This is where the government discriminates against imports in form of high transport charges while the locally produced goods are transported at low changes. This discourages the imports into the country.

Example

- (i) The **European Union** imposes tariffs on agricultural imports to protect its farmers.
- (ii) The **United States** has used anti-dumping duties against steel imports from China.
- (iii) Uganda may use import licensing to regulate sensitive goods like pharmaceuticals.

Merits (Advantages /Arguments) for Protectionism

- (i) **Safeguards infant industries:** Protectionism shields new or emerging industries from foreign competition until they become strong enough to compete globally.
- (ii) **Preserves domestic employment:** By limiting imports, local industries are protected, preventing job losses and ensuring stable employment.
- (iii) **Reduces dependence on foreign countries:** Encourages self-sufficiency in essential goods, reducing vulnerability to external shocks or political pressure.
- (iv) **Corrects balance of payments:** Restricting imports helps reduce trade deficits and stabilize the economy.
- (v) **Promotes national security:** Strategic industries (like defense, food, or energy) are protected to ensure independence in critical areas.
- (vi) **Encourages industrialization:** Developing countries use protectionist policies to nurture manufacturing sectors and diversify their economies.
- (vii) **Prevents dumping:** Protectionism guards against foreign firms selling goods below cost to destroy local industries.
- (viii) **Supports government revenue:** Tariffs on imports generate income for governments, which can be used for development projects.
- (ix) **Preserves cultural identity:** Limiting foreign goods can protect local traditions, crafts, and cultural industries from being overshadowed.
- (x) **For Health reasons.** Protectionism discourages the importation and consumption of harmful and dangerous imports by the local population. Such commodities are in form of expired drugs, food stuffs and other substandard commodities.
- (xi) **It helps to control imported inflation.** Trade restrictions are used to reduce on the importation of commodities from countries affected by inflation hence controlling imported inflation.
- (xii) **It saves the scarce foreign exchange earnings of the country.** Protectionism encourages the production of formerly imported commodities locally. This reduces foreign exchange outflow hence accumulating foreign exchange reserves
- (xiii) **It facilitates the development of skills for local entrepreneurs.** This promotes managerial capacity building through on job training and helps to reduce government expenditure on training costs.
- (xiv) **For retaliation purposes.** Some countries impose restrictions to retaliate against restrictions made by other countries on their exports.
- (xv) **For political purposes.** Trade restrictions can be used to promote and achieve political objectives. For example African countries managed to reduce apartheid rule in South Africa by imposing trade embargoes on the South African government of that time.

Example

- (i) The **United States** has imposed tariffs on steel and aluminum to protect domestic producers.
- (ii) Many **developing countries** use import restrictions to support infant industries like textiles or agriculture.

Demerits (Disadvantages/ Arguments against) Protectionism

- (i) **Higher prices for consumers:** Tariffs and quotas raise the cost of imported goods, reducing affordability and choice.
- (ii) **Inefficiency in domestic industries:** Shielded from competition, local firms may become complacent, producing lower-quality goods at higher costs.
- (iii) **Retaliation and trade wars:** Other countries may impose counter-tariffs, escalating into trade disputes that harm global commerce.
- (iv) **Limited variety of goods:** Restricting imports reduces consumer access to diverse products and innovations.
- (v) **Slower economic growth:** Protectionism can reduce exports, foreign investment, and overall economic dynamism.
- (vi) **Encourages smuggling and corruption:** Strict trade barriers may lead to illegal imports and rent-seeking behavior.
- (vii) **Misallocation of resources:** Resources may be diverted to inefficient industries instead of sectors with real comparative advantage.
- (viii) **Weakens international relations:** Restrictive policies can strain diplomatic ties and reduce cooperation between nations.
- (ix) **Hurts developing countries:** Protectionism in rich nations blocks market access for poorer countries, limiting their export opportunities.
- (x) **It promotes profit repatriation.** This is true if the protected industries are owned by foreign investors and this promotes capital flight hence limited capital accumulation in the economy.
- (xi) **It may lead to the emergency of local monopolies.** The protected domestic industries end up becoming monopolies. They restrict output and charge high prices hence exploiting the consumers.

Example

- The **Smoot-Hawley Tariff Act (1930)** in the United States raised tariffs on thousands of imports.
- It triggered retaliation from trading partners, worsening the Great Depression by reducing global trade.

Revision exercise 1

Section A questions

- 1 (a) Define the term "Dumping" as used in economics
(b) Give three demerits of dumping policy in the importing countries.
- 2 (a) State the vent for surplus theory of international trade
(b) Give three circumstances under which protectionism may fail to achieve economic development in an economy.
- 3 (a) State the "vent-for surplus" theory of international trade.
(b) State three assumptions underlying the principle of comparative advantage
- 4 (a) Define the term commercial policy.
(b) Outline three instruments (tools) of commercial policy used in your country.
- 5 (a) What are non-tariff barriers?
(b) Mention any three non-tariff barriers to trade.
- 6 (a) What is meant by the term beggar-my-neighbor policy?
(b) State three objectives of commercial policy in your country.
7. (a) Differentiate between tariffs and quotas

(b) Mention two objectives of imposing import duties in your country

Section B questions

- 1 (a) Differentiate between multilateral trade and bilateral trade
(b) "Developing countries should pull out from participating in International trade. Discuss.
- 2 (a) Explain why your country has gained less from foreign trade
(b) What policy measures are being adopted to improve on your country's low position in foreign trade?
- 3 Study the table below showing output levels of two countries in two commodities given the same units of labour, answer the questions which follow

Country	Commodities	
	Generators	Coffee
X	400	600
Y	100	300

- (a) State the country with absolute advantage in the production of both commodities.
(b) Calculate the opportunity cost of producing each commodity in each country
(c) In which commodity should each country specialize?
(d) What are the limitations of the comparative cost advantage theory in international trade?
- 4 (a) Explain the law of comparative cost advantage?
(b) Why may the use of the law of comparative cost advantage fail to bring about closer regional cooperation in East Africa?
- 5 (a) Distinguish between the principles of absolute advantage and comparative advantage
(b) To what extent is the theory of comparative advantage applicable in international trade in developing countries?
- 6 (a) Explain the various forms of protectionism employed in international trade
(b) What are the positive implications of protectionism in an economy?
- 7 (a) Why may government adopt protectionism policies in an economy?
(b) What problems are associated with adopting protectionism policies in an economy?

Terms of trade (T.O.T)

Terms of trade refer to the rate at which the goods of one country are exchanged for the goods of another country. OR. Terms of trade refer to the purchasing power of the country's exports in terms of its imports.

Types of Terms of trade

- (a) **Barter (Commodity) T.O.T.** This refers to the ratio of export prices to the import prices. OR. It refers to the ratio of price index of exports to the price index of imports.

$$\text{Barter T.O.T} = \frac{\text{Price index of exports}}{\text{Price index of import}} = \frac{P_X}{P_M}$$

- If $\frac{P_X}{P_M} > 1$, the country is said to experience favorable terms of trade
- If $\frac{P_X}{P_M} < 1$, the country is said to experience unfavorable terms of trade

Barter T.O.T can also be expressed as percentage using the following formula

$$\text{Barter T.O.T} = \frac{P_X}{P_M} \times 100\%$$

Barter T.O.T are favorable if $\frac{P_X}{P_M} \times 100$ is greater than 100% and unfavorable if $\frac{P_X}{P_M} \times 100$ is less than 100%

- (b) **Income (Monetary) T.O.T.** This refers to the ratio of value of exports to the price index of imports. It shows how much a country can import using the revenue from exports

$$\text{Income T.O.T} = \frac{P_X \times Q_x}{P_M}$$

where Q_x = quantity of export, P_x = price of export and P_m = price index of imports

$$\text{Income T.O.T} = \frac{P_X \times Q_x}{P_M} = \text{Barter T.O.T} \times Q_x$$

- (c) **Gross barter T.O.T.** this refers to the ratio of the quantity of export to quantity of imports

$$\text{Gross barter} = \frac{Q_x}{Q_m}$$

where Q_x = quantity of export, Q_m = quantity of imports

Example

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

- (i) The barter T.O.T

$$\text{Barter T.O.T} = \frac{P_X}{P_M} \times 100 = \frac{120}{130} \times 100 = 92.3\%$$

- (ii) The income T.O.T

$$\begin{aligned} \text{Income T.O.T} &= \frac{P_X \times Q_x}{P_M} \\ &= \text{Barter T.O.T} \times Q_x \\ &= 92.3 \times 200 \\ &= 184.6 \end{aligned}$$

- (iii) State whether the country is facing or experiencing favorable and unfavorable T.O.T

The country is experiencing unfavorable terms of trade because the barter terms of trade is less than 100%

Causes of unfavorable terms of trade in developing countries

- (i) **Dependence on primary products:** Developing countries mainly export raw materials (coffee, tea, minerals, oil) whose prices fluctuate and often decline compared to manufactured goods.
- (ii) **Low demand elasticity for exports:** Demand for primary goods is relatively inelastic, meaning global buyers don't increase purchases much even when prices fall.
- (iii) **High demand elasticity for imports:** Developing countries import manufactured goods and technology, which are essential and often price-inelastic, forcing them to pay higher prices.
- (iv) **Technological backwardness:** Limited industrialization means they rely heavily on importing machinery, medicine, and advanced products at high costs.
- (v) **Global price fluctuations:** Commodity prices are unstable, while manufactured goods have more stable and rising prices, worsening trade terms.
- (vi) **Unfavorable trade policies:** Developed countries impose tariffs, quotas, and subsidies on imports from developing nations, reducing export earnings.
- (vii) **Over-specialization:** Heavy reliance on a few export commodities makes economies vulnerable to global shocks and declining prices.
- (viii) **Weak bargaining power:** Developing countries often lack strong trade negotiation capacity, leading to unfavorable agreements.
- (ix) **Population pressure:** Rapid population growth increases demand for imports (food, medicine, technology), worsening the import bill.
- (x) **Exchange rate instability:** Currency depreciation raises the cost of imports, further deteriorating terms of trade.
- (xi) **Production and exportation of similar products by developed countries.** This leads to excess supply on the world market hence low export prices as compared to import prices.
- (xii) **Discovery of synthetic substitutes by developed countries for exports from developing countries.** This has greatly reduced the demand for exports from developing countries hence low export prices.
- (xiii) **Some developing countries (like Uganda) are land locked.** This leads to high costs of transport for their exports and imports. The high transport costs reduce the prices for their exports and increase the prices for their imports hence unfavorable terms of trade.

Example

- (i) Uganda exports coffee and tea, but global prices are volatile.
- (ii) At the same time, it imports machinery, fuel, and medicine whose prices are stable or rising.
- (iii) This imbalance leads to **unfavorable terms of trade.**

Measures (solutions) to improve the Terms of trade in developing countries

- (i) **Diversification of exports:** Developing countries should avoid over-reliance on a few primary commodities by expanding into manufactured goods, services, and technology.
- (ii) **Value addition to exports:** Instead of exporting raw materials, countries can process them into finished or semi-finished goods (e.g., exporting roasted coffee instead of raw beans).
- (iii) **Industrialization:** Investing in manufacturing and modern industries reduces dependence on imports of industrial goods and strengthens export competitiveness.
- (iv) **Improving agricultural productivity:** Modern farming techniques, irrigation, and mechanization can increase yields and quality, boosting export earnings.
- (v) **Regional trade integration:** Forming trade blocs (like the East African Community) helps developing countries access larger markets and negotiate better trade terms.
- (vi) **Negotiating fair trade agreements:** Stronger bargaining in international trade deals can reduce tariffs and improve market access for exports.
- (vii) **Promoting non-traditional exports:** Expanding into tourism, ICT services, and creative industries diversifies foreign exchange sources.
- (viii) **Exchange rate management:** Stabilizing currency values helps reduce import costs and maintain favorable trade balances.
- (ix) **Investing in infrastructure:** Better transport, energy, and communication systems lower production costs and make exports more competitive.
- (x) **Encouraging domestic substitution:** Producing goods locally that are usually imported reduces the import bill and improves T.O.T.
- (xi) Carry out market research and advertisement as a way of improving on the marketability and prices of their exports.

Example

Uganda can improve its terms of trade by:

- (i) Exporting processed coffee instead of raw beans.
- (ii) Expanding into ICT services and tourism.
- (iii) Strengthening regional trade under the East African Community (EAC).

Balance of payments (B.O.P)

This refers to the difference between the country's total receipts from exports and total expenditure on imports in a given time.

If the country's receipts (revenue) from exports exceed her expenditure on imports, the country is said to have a balance of payment surplus and therefore it experiences favorable balance of payment.

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If the country's expenditure on imports exceeds her receipts from exports, the country is said to have balance of payment deficit and therefore it experiences unfavorable balance of payment.

Balance of Payment Account

The **Balance of Payments** is a **systematic record of all economic transactions** between residents of a country and the rest of the world during a given period (usually one year).

The balance of payment account takes the form of double entry accounting system like balance sheets of business enterprises. Exports and other transactions that lead to inflow of foreign exchange are recorded on the credit side while imports and other transactions that lead to outflow of foreign exchange are recorded on the debit side of the balance of payment account. Like all balance sheets, the balance of payment account must balance.

Components of the B.O.P Account

The B.O.P account has four major components;

- (a) The current account
- (b) The capital account.
- (c) The monetary (cash) account.
- (d) Errors and the omission's account.

(a) The current account

This is summary record of international transactions in goods, services and transfers. The current account is divided into;

- **Visible trade account.** This records receipts from exports and expenditure on imports resulting from the exchange of goods only (Visible trade). The difference between receipts from visible exports and expenditure on visible imports is called Balance of trade (visible balance of trade)
- **Invisible trade account.** This records receipts from exports and expenditures on imports resulting from exchange of services only (invisible trade). For example tourism, transport, medical, education etc.
- The difference between the receipts from services exported and expenditure on services imported is called invisible balance of trade.
- **Transfer payments (Unilateral transfer) account.** This records donations by the country and donations to the country. For example gifts and grants
- Current account balance = visible balance (trade balance) + invisible balance + net transfer payments.

(b) The capital account

This is a record of capital movements which are either be capital inflows or capital outflows of the country. Capital movements (flows) are in form of private or public foreign investments, loans, debt payments and repayments etc.

Balance of payments = Balance on Capital account + Balance on current account

(c) Monetary (cash) account

- This is also called the official settlement or financing account. It is a record of how foreign exchange reserves change in response to current and capital transactions. This account indicates a surplus or deficit on the B.O.P account and it shows how the dis equilibrium can be corrected
- When there is a surplus on the combined current and capital account, it implies an increase in the foreign exchange, reserves (Net inflow in the foreign exchange reserves). A deficit implies a net out flow (a decrease in foreign exchange reserves).

A balance of payment deficit can be offset (financed) by using accommodating items on monetary account. **Accommodating items methods** used by the central bank to establish a balance by offsetting a deficit in the balance of payment account. The process of financing a deficit using accommodating items is called accommodating the balance.

Examples of accommodating items include;

- (i) Selling the country's investments abroad.
- (ii) Using foreign exchange reserves available in the central bank.
- (iii) Selling gold stock held in the central bank.
- (iv) Borrowing from international lending institutions like IMF and World Bank.
- (v) Borrowing from friendly countries.
- (vi) Selling government securities abroad i.e. Treasury bills and bonds.

A balance of payment surplus can be offset (financed) by using autonomous items on the monetary account. Autonomous items are methods used by the central bank to bring about a balance by disposing off the surplus in the balance of payment account. The expenditure incurred in disposing off the surplus is called autonomous expenditure.

Examples of autonomous items include;

- (i) Making investments abroad
- (ii) Buying gold so as to increase on its stock in the central bank.
- (iii) Offering loans to other countries.
- (iv) Giving donations to other countries.
- (v) Offering loans to international institutions like I.M.F.
- (vi) Increasing on the stock of foreign exchange reserves in the central bank.

(d) Errors and Omissions account

This is also called a balancing item account. This part of the balance of payment account records errors and omission which may have been made in the process of making the balance of payment account. In this case the figure representing the errors and omissions made (Balancing item) is added or subtracted on any side of the balance of payment account for purposes of balancing.

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Format of the balance of payment account

Debt side	Credit side
Imports	Exports
Current account	
Goods importedXX	Goods importedXX
Services importedXX	Services importedXX
Transfer paymentXX	Transfer paymentXX
Capital account	
Loans to foreignersXX	Loans from foreignersXX
Investment in other countriesXX	Investment by foreigners..... XX
Cash account	
Accommodating itemsXX	Autonomous itemsXX
Errors and omissions account	
Balancing itemsXX	Balancing itemsXX

Causes of persistent balance of payment problems (Deficits) in Developing countries

Persistent balance of payment deficits are experienced by the country when its foreign exchange expenditure exceeds its foreign exchange earnings year after year. Balance of payment deficits are caused by

- (i) **Dependence on primary exports:** Developing countries rely heavily on raw materials (coffee, tea, minerals, oil) whose prices are volatile and often decline compared to manufactured imports.
- (ii) **High import bills:** Heavy dependence on importing machinery, fuel, medicine, and technology leads to large outflows of foreign exchange.
- (iii) **Low value addition:** Exporting raw commodities instead of processed goods reduces earnings, while imports are high-value finished products.
- (iv) **Unfavorable terms of trade:** Prices of exports fall relative to imports, forcing countries to export more to afford fewer imports.
- (v) **Rapid population growth:** Rising populations increase demand for food, medicine, and manufactured goods, worsening the import bill.
- (vi) **Weak industrial base:** Limited industrialization means countries cannot produce enough goods domestically, increasing reliance on imports.
- (vii) **Capital flight and debt servicing:** Outflows of capital and large external debt repayments drain foreign reserves.
- (viii) **Global price fluctuations:** Commodity prices are unstable, while manufactured goods have more stable and rising prices, worsening trade balances.

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- (ix) **Trade barriers in developed countries:** Tariffs, quotas, and subsidies imposed by rich nations reduce market access for developing countries' exports.
- (x) **Exchange rate instability:** Currency depreciation raises the cost of imports and worsens deficits.
- (xi) **Political instability and poor governance:** Corruption, mismanagement, and weak institutions discourage investment and reduce export competitiveness.
- (xii) **Low productive capacities in developing countries.** This is due to limited co-operant factors used in the production process like limited capital, use of poor technology, unskilled man power etc. This leads to low output for export purposes hence balance of payment deficits.
- (xiii) **Use of poor technology.** This results into inefficiency in resource use and the production of low quantity and poor quality exports which fetch low prices on the world market.
- (xiv) **Existence of natural disasters.** These include floods., drought, pests and diseases which adversely affect the agricultural sector hence a decline in agriculture export and export earnings.

Example

- (i) Uganda exports coffee and tea, but global prices are volatile.
- (ii) At the same time, it imports machinery, fuel, and medicine whose prices are stable or rising.
- (iii) This imbalance leads to **persistent balance of payment deficits.**

Measures (Policies) of solving balance of payment problems in developing countries

- (i) **Export promotion:** Encourage production and sale of goods abroad to earn more foreign exchange. Policies include tax incentives, subsidies, and marketing support for exporters.
- (ii) **Import substitution:** Develop domestic industries to produce goods that are usually imported (e.g., textiles, food processing, pharmaceuticals). Reduces dependence on foreign products and saves foreign exchange.
- (iii) **Diversification of exports:** Move away from reliance on a few primary commodities by expanding into manufactured goods, services, and non-traditional exports like tourism and ICT.
- (iv) **Value addition to exports:** Process raw materials into finished or semi-finished goods (e.g., exporting roasted coffee instead of raw beans). Increases export earnings and improves terms of trade.
- (v) **Exchange rate management:** Devalue or adjust currency to make exports cheaper and imports more expensive, encouraging export growth and reducing imports.
- (vi) **Foreign direct investment (FDI) promotion:** Attract foreign investors to bring in capital, technology, and foreign exchange.
- (vii) **Regional trade integration:** Strengthen trade blocs (e.g., East African Community) to access larger markets and reduce reliance on developed countries.

- (viii) **Debt management:** Restructure or negotiate external debt to reduce repayment burdens and free up foreign exchange.
- (ix) **Import controls:** Use tariffs, quotas, and licensing to limit non-essential imports.
- (x) **Boosting remittances and foreign aid:** Encourage diaspora remittances and negotiate for development aid to supplement foreign reserves.
- (xi) **Improving productivity and competitiveness:** Invest in infrastructure, technology, and skills to make exports more competitive globally.

Example

Uganda can reduce B.O.P deficits by:

- a. Promoting processed coffee exports.
- b. Expanding into ICT services and tourism.
- c. Encouraging import substitution in pharmaceuticals and textiles.
- d. Strengthening regional trade under the East African Community (EAC).

Exchange rates

- Exchange rate refers to the value of the country's currency in terms of other currencies. For example \$1 = UG shs. 3670.
- **Hard currency.** This refers to the currency which can easily be converted into other currencies and it is internationally recognized and accepted. For example pound, dollar, euro etc.

Types of exchange rates

(a) Fixed (Pegged) exchange rate.

This is where the value of the country's currency in terms of other currencies is fixed by the monetary authority (government)

Merits of (Arguments for) a fixed exchange rate

- (i) **Stability in international trade:** Fixed rates reduce uncertainty in foreign transactions, encouraging exports, imports, and long-term contracts.
- (ii) **Promotes investment:** Predictable exchange rates attract foreign direct investment (FDI) since investors face less currency risk.
- (iii) **Controls inflation:** By tying the domestic currency to a stable foreign currency (like the US dollar), countries can limit excessive inflation.
- (iv) **Encourages economic discipline:** Governments must maintain sound fiscal and monetary policies to sustain the fixed rate, reducing reckless spending.

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- (v) **Boosts confidence in the currency:** Stability reassures businesses, investors, and citizens, strengthening trust in the national currency.
- (vi) **Prevents speculation:** Fixed rates reduce opportunities for speculative attacks on the currency, unlike floating systems where traders exploit fluctuations.
- (vii) **Facilitates planning:** Businesses and governments can plan budgets, investments, and trade strategies more effectively with predictable exchange rates.
- (viii) **Supports balance of payments stability:** By maintaining a fixed rate, countries avoid sharp swings in import/export costs, helping stabilize external accounts.

Example

- (i) Many developing countries peg their currency to the **US dollar** to stabilize trade and attract investment.
- (ii) For instance, some African nations with fixed or managed exchange rates benefit from reduced volatility in import costs for fuel and machinery.

Demerits of a fixed exchange rate

- (i) **Loss of monetary policy flexibility:** Governments cannot freely adjust interest rates or money supply to respond to domestic economic conditions because they must maintain the fixed rate.
- (ii) **Risk of currency crises:** If the fixed rate is unrealistic, speculative attacks may occur, forcing devaluation and destabilizing the economy.
- (iii) **Costly to maintain:** Central banks must hold large foreign exchange reserves to defend the fixed rate, which is expensive and unsustainable.
- (iv) **May encourage black markets:** When official rates differ from market realities, parallel (illegal) currency markets often emerge.
- (v) **Difficulty in adjusting to shocks:** Fixed rates prevent automatic adjustment to external shocks (like commodity price changes or global recessions), worsening balance of payments problems.
- (vi) **Potential trade imbalances:** If the currency is overvalued, exports become expensive and imports cheap, leading to persistent trade deficits.
- (vii) **Risk of imported inflation or deflation:** Pegging to a foreign currency means domestic prices may be influenced by inflation or deflation in the anchor country.
- (viii) **Political vulnerability:** Countries may be forced to adjust policies to suit the anchor currency nation, reducing sovereignty.

Example

In the 1990s, **Argentina's fixed exchange rate (peso pegged to the US dollar)** collapsed because the country could not sustain the peg amid economic shocks, leading to a severe financial crisis.

(b) **Flexible (Free/Floating) Exchange rate.**

This is where the value of the country's currency in terms of other currencies is determined by forces of demand and supply of the foreign currency.

Merits of a free exchange rate (Exchange rate liberalization)

- (i) **Automatic adjustment of balance of payments:** Exchange rates adjust naturally to correct deficits or surpluses, reducing the need for government intervention.
- (ii) **Flexibility:** Currencies can respond quickly to global shocks, inflation, or changes in demand and supply.
- (iii) **Preserves monetary policy independence:** Governments can use interest rates and money supply to manage domestic economic conditions without worrying about maintaining a fixed rate.
- (iv) **Encourages efficiency:** Exchange rates reflect true market conditions, discouraging inefficiency and misallocation of resources.
- (v) **Reduces need for foreign reserves:** Unlike fixed systems, countries don't need to hold large reserves to defend the currency, saving resources.
- (vi) **Discourages speculation:** Since rates fluctuate freely, speculators cannot easily predict or exploit government interventions.
- (vii) **Promotes competitiveness:** Depreciation of currency makes exports cheaper and imports more expensive, encouraging domestic industries and improving trade balances.
- (viii) **Reflects economic fundamentals:** Exchange rates mirror inflation, productivity, and growth levels, giving a realistic picture of the economy.

Example

- (i) If Uganda's imports rise sharply, the Ugandan shilling may depreciate under a free exchange rate system.
- (ii) This makes imports more expensive and exports (like coffee and tea) cheaper, helping restore balance of payments automatically.

Demerits of a Flexible exchange rate (Exchange rate liberalization)

- (i) **Exchange rate instability:** Frequent fluctuations create uncertainty in international trade and discourage long-term contracts and investments.
- (ii) **Speculation risks:** Currency markets may be influenced by speculators, leading to sharp and unpredictable swings in exchange rates.
- (iii) **Imported inflation:** Depreciation of the local currency makes imports more expensive, fueling inflation in developing countries.
- (iv) **Discourages trade and investment:** Uncertainty in exchange rates can reduce foreign direct investment (FDI) and hinder international trade.
- (v) **Balance of payments vulnerability:** Persistent deficits may cause continuous depreciation, worsening economic instability.

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- (vi) **Volatility in small economies:** Developing countries with weak currencies face excessive volatility, making planning and budgeting difficult.
- (vii) **Risk of currency depreciation spiral:** If confidence in the currency falls, depreciation may become self-reinforcing, leading to economic crises.
- (viii) **Higher transaction costs:** Businesses must spend more on hedging and managing currency risks, raising costs of trade.
- (ix) **Weakens government control:** Authorities have less ability to stabilize the economy through direct intervention compared to fixed systems.

Example

- (i) In many African countries, liberalized exchange rates have led to **sharp depreciations** of local currencies against the US dollar.
- (ii) This raised the cost of imports like fuel and medicine, contributing to inflation and worsening living standards.
- (c) **Mixed (Managed float /Dirty float/Adjustable peg) Exchange rate.** This is where the exchange rate is controlled by the government but it is allowed to fluctuate between certain limits. There exists the upper and lower exchange rate limits within which buying and selling of foreign exchange takes place.
- (d) **Dual exchange rate system.** This is where there is co-existence two parallel exchange rates within the country.
- (e) **Multiple exchange rates.** This is where there is existence of more than two exchange rates within the country. It is common where there is liberalization in selling and buying of foreign currency.

Devaluation

Devaluation refers to the deliberate government policy of reducing the value of its currency in terms of other currencies. OR. It refers to the reduction in the value the country's currency in terms of other currencies under the fixed exchange rate system.

Example

Before devaluation \$1 = UgX 3600

After devaluation \$1 = UgX 4000

Currency depreciation. This refers to the reduction in the value of the country's currency in terms of other currencies due to the forces of demand and supply of the foreign currency. OR. It is the reduction in the value the country's currency in terms of other currencies under the floating exchange rate system.

Currency revaluation. This refers to the legal increase in the value of country's currency in terms of other currencies.

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Currency appreciation. This refers to increase in the value of the country's currency in terms of other currencies due to the forces of demand supply of the foreign currency.

Reasons for devaluation

- (i) **Correcting balance of payments deficits:** Devaluation makes exports cheaper and imports more expensive, helping reduce persistent trade deficits.
- (ii) **Boosting export competitiveness:** Lower currency value encourages foreign buyers to purchase more exports, increasing foreign exchange earnings.
- (iii) **Discouraging imports:** By making imported goods more expensive, devaluation reduces reliance on foreign products and saves reserves.
- (iv) **Encouraging domestic production:** Higher import costs push consumers and industries to rely more on locally produced goods, stimulating local industries.
- (v) **Reducing external debt burden:** If debt is denominated in local currency, devaluation can reduce the real value of repayment compared to foreign currency obligations.
- (vi) **Attracting foreign investment:** A weaker currency lowers production costs for foreign investors, making the country more attractive for investment.
- (vii) **Correcting overvaluation of currency:** Sometimes a currency is artificially strong, hurting exports. Devaluation restores realistic value aligned with market conditions.
- (viii) **Responding to economic shocks:** Global recessions, commodity price drops, or capital flight may force governments to devalue to stabilize the economy.
- (ix) **Improving foreign reserves:** By reducing imports and boosting exports, devaluation helps conserve scarce foreign exchange reserves.

Example

If Uganda faces a **balance of payments deficit** due to high import bills for fuel and medicine, devaluation of the Ugandan shilling can make coffee and tea exports cheaper abroad, while discouraging excessive imports.

Conditions necessary for devaluation to be successful

- (i) **Elastic demand for exports:** Foreign demand for the country's exports must be sufficiently elastic, so that lower prices lead to a significant increase in export volumes.
- (ii) **Elastic demand for imports:** Domestic demand for imports should be elastic, meaning higher prices discourage consumption and reduce import volumes.
- (iii) **Absence of inflationary pressures:** Devaluation should not trigger excessive inflation; otherwise, rising domestic prices will cancel out the benefits of cheaper exports.
- (iv) **Strong productive capacity:** The country must have the ability to expand production of export goods to meet increased foreign demand.
- (v) **Diversified export base:** Success requires a variety of export products, not just dependence on a few primary commodities whose demand may be inelastic.

- (vi) **Stable political and economic environment:** Investors and traders must have confidence in the economy; instability undermines the benefits of devaluation.
- (vii) **Supportive trade policies:** Complementary measures such as export promotion, import substitution, and reduction of trade barriers are needed.
- (viii) **Adequate foreign exchange reserves:** Reserves help stabilize the currency and manage short-term shocks after devaluation.
- (ix) **Marshall–Lerner condition satisfied:** The sum of the price elasticities of demand for exports and imports must be greater than one for devaluation to improve the balance of payments.

Example

If Uganda devalues the shilling, success depends on whether global buyers increase purchases of coffee and tea (elastic demand) and whether Ugandans reduce imports of fuel and luxury goods (elastic demand).

Factors as to why devaluation has not been successful in developing countries

- (i) **Inelastic demand for exports:** Many developing countries export primary commodities (coffee, tea, minerals) whose global demand is relatively inelastic. Lower prices do not significantly increase export volumes.
- (ii) **Inelastic demand for imports:** Imports such as fuel, medicine, and machinery are essential and cannot easily be reduced even when prices rise after devaluation.
- (iii) **Weak productive capacity:** Limited industrialization and poor infrastructure prevent countries from expanding production to take advantage of increased export demand.
- (iv) **Over-reliance on primary products:** Heavy dependence on a few raw materials makes economies vulnerable to global price fluctuations, limiting the benefits of devaluation.
- (v) **Inflationary pressures:** Devaluation raises the cost of imports, fueling inflation. Rising domestic prices cancel out the competitive advantage of cheaper exports.
- (vi) **Debt burden:** External debts denominated in foreign currencies become more expensive to service after devaluation, worsening balance of payments problems.
- (vii) **Capital flight:** Devaluation often reduces investor confidence, leading to outflows of capital and further weakening of the currency.
- (viii) **Structural rigidities:** Poor governance, corruption, and weak institutions hinder effective implementation of supportive policies needed to make devaluation work.
- (ix) **Lack of diversification:** Without a broad export base, countries cannot exploit new markets or products after devaluation.
- (x) **Political and social instability:** Instability discourages foreign investment and undermines the potential benefits of devaluation.

Example

- (i) If Uganda devalues the shilling, the cost of importing fuel and medicine rises sharply.

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- (ii) Since these imports are essential and cannot be reduced, the expected improvement in the balance of payments is offset by inflation and higher debt servicing costs.

Economic integration (regional integration/co-operation)

Economic integration refers to the coming together of different countries in carrying out economic activities so as to benefit from the economies of scale. OR. This is where a group of countries join together in carrying out economic activities with a view of increasing social and economic benefits from trade.

Examples of Economic integration

1. East African community (EAC)
2. Economic community of West African states (ECOWAS)
3. European Economic Union (EEU)

Conditions necessary for successful economic integration

- (i) **Political stability and commitment:** Member states must have stable governments and demonstrate strong political will to cooperate and honor integration agreements.
- (ii) **Economic compatibility:** Countries should have relatively similar levels of economic development to avoid imbalances where stronger economies dominate weaker ones.
- (iii) **Complementary production structures:** Economies should produce goods and services that complement each other, encouraging trade rather than competition.
- (iv) **Adequate infrastructure:** Efficient transport, communication, and energy networks are essential to facilitate movement of goods, services, and people across borders.
- (v) **Strong institutional framework:** Effective regional institutions are needed to enforce rules, resolve disputes, and coordinate policies among member states.
- (vi) **Harmonization of policies:** Countries must align trade, monetary, fiscal, and industrial policies to avoid conflicts and ensure smooth integration.
- (vii) **Mutual trust and cooperation:** Integration requires transparency, trust, and willingness to compromise among member states.
- (viii) **Removal of trade barriers:** Tariffs, quotas, and restrictions must be reduced or eliminated to allow free flow of goods and services.
- (ix) **Stable macroeconomic environment:** Low inflation, stable exchange rates, and sound fiscal policies create confidence and reduce risks in integration.
- (x) **Equitable distribution of benefits:** Mechanisms should be in place to ensure that all member states benefit fairly, preventing resentment and withdrawal.
- (xi) **Public support and awareness:** Citizens must understand and support integration efforts, as political resistance can undermine progress.

Example

- (i) The **East African Community (EAC)** has made progress in integration by harmonizing customs policies, improving infrastructure, and promoting free movement of people.

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- (ii) However, challenges like political instability and economic disparities among member states sometimes slow down success.

Forms (Stages) of economic integration

The stages of economic integration are classified according to the level of development as follows.

1. **Preferential Trade Area (PTA).** This is the stage where countries reveal the need for integration. They reduce tariffs among themselves on selected commodities.
2. **Free Trade Area (FTA).** This is the stage where member countries eliminate all tariffs and other non-tariff barriers among themselves but each member country maintains its own tariff structure on commodities from nonmember countries.
3. **Customs Union.** This is the stage where member countries eliminate all trade and non-trade barriers amongst themselves. In addition, they adopt a common tariff structure on commodities from nonmember countries.
4. **Common Market.** This is the stage where member countries eliminate all trade barriers amongst themselves and charge a common tariff structure on commodities from non-member countries. In addition, they allow free mobility of factors of production within the integrated region such as capital and labor.
5. **Economic union (Economic community/federation).** This is the stage where member countries eliminate all trade barriers among themselves, charge a common tariff structure on commodities from non-member countries and they allow free mobility of factors of production within the region. In addition, member countries jointly own certain enterprises like Banks, Railways, roads, Dams etc. They also adopt common economic policies and strategies and they use a common currency for example the European economic community.

Merits (Benefits) of economic integration

- (i) **Expansion of markets:** Member states gain access to larger regional markets, encouraging mass production and economies of scale.
- (ii) **Increased trade:** Removal of tariffs and quotas boosts intra-regional trade, improving efficiency and resource allocation.
- (iii) **Improved resource utilization:** Integration allows countries to specialize in goods where they have comparative advantage, reducing duplication and waste.
- (iv) **Enhanced bargaining power:** A united bloc can negotiate better trade deals with external partners compared to individual countries.
- (v) **Attraction of foreign investment:** Larger, stable markets attract foreign direct investment (FDI), bringing in capital, technology, and jobs.
- (vi) **Lower production costs:** Free movement of goods, services, and factors of production reduces costs and increases competitiveness.
- (vii) **Economic stability:** Integration cushions member states against external shocks by pooling resources and coordinating policies.

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- (viii) **Infrastructure development:** Regional projects (roads, railways, energy grids) are easier to finance and implement collectively.
- (ix) **Employment creation:** Expanded industries and services generate more jobs across member states.
- (x) **Political and social cooperation:** Integration fosters peace, unity, and stronger diplomatic ties among member countries.

Example

- (i) The **East African Community (EAC)** has promoted free movement of people and goods, boosting trade among Uganda, Kenya, Tanzania, Rwanda, Burundi, South Sudan, and the DRC.
- (ii) This has attracted investment in regional infrastructure like roads and energy projects.

Dements of economic integration

- (i) **Unequal distribution of benefits:** Stronger economies often dominate weaker ones, creating imbalances and resentment among member states.
- (ii) **Loss of sovereignty:** Countries must surrender some control over trade, monetary, and fiscal policies to regional institutions.
- (iii) **Risk of trade diversion:** Integration may shift trade from more efficient global producers to less efficient regional ones, reducing overall welfare.
- (iv) **Economic disparities:** Differences in levels of development can lead to unequal gains, with poorer countries struggling to compete.
- (v) **Political conflicts:** Rivalries, mistrust, or lack of political will can undermine cooperation and slow down integration efforts.
- (vi) **Adjustment costs:** Domestic industries may collapse when exposed to stronger regional competition, leading to unemployment.
- (vii) **Dependence on regional partners:** Over-reliance on neighboring countries makes economies vulnerable to regional shocks or instability.
- (viii) **Slow decision-making:** Consensus-based institutions may delay policy implementation, reducing efficiency.
- (ix) **Cultural and social tensions:** Free movement of people can sometimes cause friction, xenophobia, or disputes over labor markets.
- (x) **Risk of external vulnerability:** A bloc may face collective challenges (like sanctions or global recessions) that affect all members simultaneously.

Example

- (i) In the **East African Community (EAC)**, Kenya's stronger industrial base often overshadows smaller economies like Burundi, leading to concerns about unequal benefits.
- (ii) Political instability in some member states has also slowed down deeper integration.

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Revision Exercise 2

Section A questions

- 1 (a) Distinguish between Barter terms of trade and income terms of trade.
(b) Calculate the barter T.O.T for the country if her import index is 125 and her export index is 85. Comment on your results.
- 2 (a) Distinguish between a trade balance and accommodating item.
(b) Mention two ways of accommodating the balance under balance of payment.
- 3 (a) Define the term foreign exchange reserves?
(b) Give any three uses of foreign exchange reserves in your country.
(c) Mention three ways of increasing the foreign exchange reserves of the country.
- 4 (a) What is meant by currency devaluation?
(b) Give three circumstances under which devaluation may fail to succeed.
- 5 (a) Distinguish between currency appreciation and currency depreciation.
(b) Given that the exchange rate of Ugandan shillings for Us dollar is shs 1800/ = 1 Us dollar. Calculate the new, exchange rate when Ugandan shilling depreciated by 10%.
- 6 (a) what is the difference between a floating exchange rate and a fixed exchange rate? (b) Give any two merits of a floating exchange rate system
- 7 (a) Distinguish between a Managed float exchange rate and dual exchange rate.
(b) Mention any two objectives of devaluation.
- 8 (a) Distinguish between currency over valuation and currency undervaluation.
(b) State any two effects of currency depreciation in your country
- 9 (a) Distinguish between a Customs Union and a common market
(b) Give two factors limiting the establishment of a customs Union among the East African countries
- 10 (a) Differentiate between trade creation and Trade diversion
(b) Mention two demerits of trade diversion in an economy
- 11 (a) Differentiate between preferential trade area union and Free Trade Area
(b) Mention two conditions necessary for the success of economic integration
- 12 (a) Distinguish between transfer payments and transfer earnings
(b) Mention any three sources of transfer payments to your country.
- 13 Mention four factors that determine the exchange rate in an economy
14. Distinguish between the following terms.
 - (a) Dumping and state trading
 - (b) Advolorem tax and specific tax.
 - (c) Import duty and export duty.
 - (d) Balance of trade and invisible balance of trade
 - (e) Visible trade and invisible trade.
 - (f) Accommodating items and autonomous items.

Section B questions

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- 1 (a) Distinguish between Barter terms of trade and income terms of trade
(b) Account for the unfavorable terms of trade in your country
- 2 (a) Account for the persistent balance of payment deficits in your country
(b) What policy measures are being taken to improve on your country's balance of payment position?
- 3 (a) Explain the components of the balance of payment account.
(b) Explain the methods of offsetting a deficit and a surplus in the balance of payment account.
- 4 (a) Explain the conditions necessary for devaluation to succeed
(b) Explain why devaluation may fail to achieve an improvement in balance of payments in an economy
- 5 (a) Define the term exchange rate liberalization.
(b) Explain the merits and demerits for liberalizing exchange rate.
- 6 (a) Explain the stages of economic integration.
(b) Examine the factors limiting of economic integration in developing countries.
- 7 (a) Distinguish between customs union and common market.
(b) What are the implications of creating the East African Community to your country?
- 8 "Protectionism rather than free trade should be adopted if the country is to benefit from international trade". Discuss.
- 9 (a) To what extent is inflation the cause of balance of payment problems in your country.
(b) Explain why your country has failed to reduce balance of payment problems.

Thank you
Dr. Bbosa Science