ECONOMICS FOR SENIOR SIX

UNIT 1: INTERNATIONAL TRADE THEORIES.

1.1.1: Meaning of International trade.

International trade is the exchange of capital, goods, and services across international borders or territories, which could involve the activities of the government, companies and individuals.

Or **International trade:** refers to the exchange of commodities across national borders of country. Or it refers to the selling and buying of commodities and services between or among nations.

Difference between domestic trade and international trade

1. Transactions in domestic trade involve the use of **one currency,** normally the national currency or legal tender. while for international trade though, **various currencies** may be involved.
2. Trade within a country is **not subjected to barriers** restricting the movement of goods internally. On the contrary, movements of goods across national boundaries are **subjected to varying degrees of restrictions, i.e. tariffs, quotas.**
3. Goods exchanged in domestic trade tend to be **more standardized than goods in international trade**.
4. The paper work involved in domestic trade is normally **less voluminous compared to that involved in international trade.** There is hardly any paper work involved in the domestic trade.
5. International trade is typically **costlier than domestic trade**. The reason is that a boarder typically imposes additional costs such as tariffs, time costs due to boarder delays and costs associated with country differences such as language, the legal system or culture which isn't the case with domestic trade.
6. Factors of production such as **capital and labour are typically more mobile within a country than across countries.**

1.1.2: Forms of international trade:

1. **Bilateral trade or clearing trade or side deal** is the exchange agreement between two nations or trading groups that gives each party favored trade status pertaining to certain goods obtained from the signatories.

Or **Bilateral trade** the exchange agreement of goods and services between two nations promoting trade and investment

2. Multilateral trade refers to the exchange of commodities among more than 2 countries. or multilateral agreements are commerce treaties among three or more nations.

1.1.3: Terminologies used in international trade.

- **i)** **Exports**; these are commodities sold from one country to other countries.
- **ii)** **Imports;** these are commodities that are bought from one country to another country.
- **iii)** **Export trade**; this is the selling of commodities from one country to another.
- **iv)** **Import trade**; this is the buying of commodities from one country to another.
- **v)** **Visible trade**; this is the exchange of commodities that involve only goods. i.e. exchange of tangible or physical commodities between or among countries.
- **vi)** **Invisible trade**; this is the exchange that involves only services. i.e. exchange of intangible commodities like education, insurance, health, tourism etc.
- **vii)** **Entrepot trade**; this is the type of trade where goods are imported by a country for purposes of re-exporting them to another country.
- **viii)** **Balance of trade**; this is the relationship between visible exports and visible imports. The relationship can be positive, thus favourable balance of trade or negative, thus unfavourable balance of trade.
- **ix)** **Vent for surplus**; this refers to the theory which emphasizes increased exploitation of domestic idle resources so as to increase exports or foreign exchange hence increasing country's GDP.
- **x)** **Open economy**; this is an economy which is involved in international trade.
- **xi)** **Closed economy**; this is an economy which is not engaged in international trade at all.
- **xii)** **Gains from trade**; these are advantages which accrue from international trade.

1.2.1: Advantages or arguments for International Trade.

1. **It permits and fosters international specialization** in order to maximize output and minimize costs of production. This therefore leads to increased national income, savings, investment and employment opportunities for the participating countries.
2. **It overcomes shortages** i.e. if a country engages in international trade it overcomes such shortages brought by for example natural disasters.
3. **Market expansion;** i.e. international trade widens markets for the participating countries e.g. LDCs raw materials thus assured markets for their raw materials.
4. **Vent for surplus**; International trade enables a country to utilize her resources thus full utilization of resources due to assured markets.
5. International trade offers an opportunity to a country to sell **a surplus of products and to make use of available land and labour**
6. International trade stimulates **competition and forces home producers to become more efficient** which leads to better quality, lower prices and more output.
7. It leads to **introduction of new ideas**, **technologies, knowledge and skills, entrepreneurship and social change**. Thus, the dynamic effects of trade which stimulate economic development in the long run.

8. International trade provides **revenue to the government** from import and export duties. This revenue can be used to finance different development activities in the economy.
9. **Creation and maintenance of employment** i.e. once countries specialize for international trade in production of certain goods for export, it follows that there will be employment in those sectors.
10. **Promotes cultural and political ties** between or among countries since there is understanding among trading partners which creates global peace and harmony among countries.
11. International trade **avails wide variety of commodities** which increase the choice of consumers and their standard of living.
12. **It increases capital inflow** i.e. foreign exchange which it can use to pay off its foreign debts, pay contributions to international organizations and carry out development programs.
13. It enables a country **to get relief supplies by importing from other countries** e.g. in case it is hit emergencies like drought, floods and earthquakes.
14. It enables factor **mobility which promotes exchange of ideas and information** thus increase labour efficiency, solves unemployment problems and brings about development in the long run.

1.2.2: Disadvantages/ Arguments against International Trade

1. **It encourages dumping** which causes price instabilities in the domestic country/ market.
2. **Development of local industries is retarded** i.e. local industries may be outcompeted by more efficient foreign firms and this leads to increased unemployment in the domestic economy.
3. If a country trades with another that is affected by inflation, this may result **into imported inflation by the importing country.**
4. **Loss of social economic and political sovereignty or independence** especially by LDCs because MDCs always dictate unfair trading terms to LDCs.
5. **Loss of culture through demonstration effect** as consumers of imported goods adapt to foreign consumption habits and cultures.
6. **International trade may result into over exploitation of domestic resources** due to wider markets.
7. **Dangerous commodities may find their way into the country** e.g. guns, drugs etc. which may worsen health and standard of living of people.
8. **Balance of Payment position may worsen** where import expenditure may exceed export revenue.
9. **It may limit employment opportunities** in the country by the domestic people who are out competed by foreigners who might have superior skills over locals.

1.2.3: Limitations of International Trade

1. Rapid depletion of exhaustible natural resources: As countries begin to rise up their production levels, natural resources tend to get depleted with the time and it could pose a dangerous threat to the future generation.

2. **Import of harmful goods**: Foreign trade may lead to import of harmful goods like cigarettes, drugs, etc., which may harm the health of the residents of the country.

3. **It may exhaust resources**: International trade leads to intensive cultivation of land. Thus, it has the operations of law of diminishing returns in agricultural countries. It also makes a nation poor by giving too much burden over the resources.

4. Over specialization: Over specialization may be disastrous for a country. A substitute may appear and ruin the economic lives of millions.

5. Danger of starvation: A country might depend for its food mainly on foreign countries. In times of war, there is a serious danger of starvation for such countries.

6. **One country, gains at the expense of others:** One of the serious drawbacks of foreign trade is that one country may gain at the expense of other due to certain accidental advantages.

7. May lead to war: Foreign trade may lead to war; different countries compete with each other in finding out new markets and sources of raw material for their industries and frequently come into clash. This was one of the causes of first and Second World War.

8. Language diversity: Each country has its own language. As foreign trade involves trade between two or more countries, there is diversity of languages. This difference in language creates problem in foreign trade.

9. Differences in laws and regulations i.e. different countries have different laws and regulations that govern trade that do not coincide with laws of other countries which make it hard for traders from different countries to cope with those laws from other countries thus hindering international trade.

10. Competition to domestic producers: since goods are not only exported but also imported people are usually attracted to foreign goods and prefer to buy them instead of goods that have been produced within the nation. Domestic producers face a loss due to this.

11. Cost incurred for exporting: a lot of money on transportation facilities has to be incurred when goods are exported to other countries.

12. Too much dependence: when countries develop a habit of importing certain kinds of goods from another country, they usually reduce the amount of production of the same good within the country. So if the country that exports has a problem and is unable to export goods then the country that imports goods will suddenly face a shortage of goods.

13. Differences in standards of measurement. Different countries use different weights and measures.

14. Lack of standard currency to exchange commodities for i.e. there is no convenient means for buyers and sellers to exchange commodities since they both have different currencies. Exchanging to convertible currencies may distort the relative prices

15. Inadequate information about goods available, their prices, quality etc. which hinders smooth international trade.
16. Trade barriers which governments normally impose on flow of international commodities like tariffs, quotas, foreign currency, self-sufficiency etc. all limit international trade.

1.3.0: Theories of international trade.
1.3.1: Theory of absolute advantage:

The theory of absolute advantage was put forward by **Adam Smith**.
The law of absolute advantage states that "**Given two countries and same amount of resources, a country is said to have an absolute advantage over another in production of a given commodity if it can produce that commodity more efficiently at a lower input cost".**

Absolute advantage is therefore, the ability of an individual, a household or a firm or a country to produce some particular good or service with a smaller total input of labor, capital, land, etc. per unit of output than other economic actors.

1.3.1.2: Assumptions of absolute advantage.

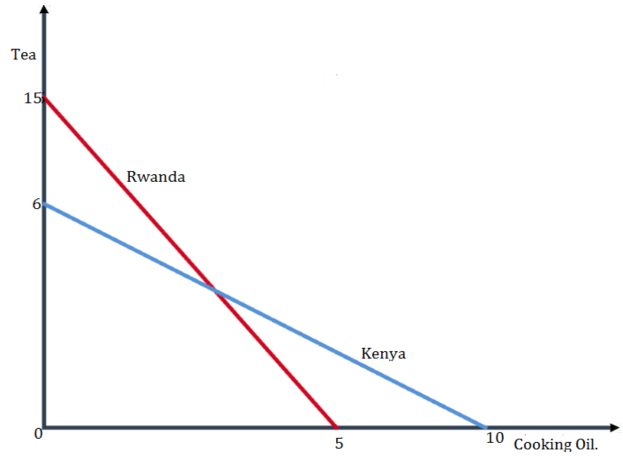
- **Lack of Mobility for Factors of Production**
- There **are no barriers to trade for the exchange of goods**.
- **Trade Balance:** Smith assumes that exports must be equal to imports
- **Constant Returns to Scale:** Adam Smith assumes that we will get constant returns as production scales, meaning there are no economies of scale.
- **Assumes that there are two commodities**
- **Assumes there are two countries in the world**

Let us take a two-country two-commodity case. E.g. Rwanda and Kenya producing Tea and Cooking oil respectively.

Table 1: Reciprocal absolute advantage production schedule.

Country	**Tea (tons)**	**Cooking oil (tons)**
Rwanda	15	5
Kenya	6	10
Total before specialisation	**21**	**15**
Total after specialisation	**42**	**30**

This information can be represented using production possibilities curve as below;
Figure 1: Absolute advantage between Rwanda and Kenya using a production possibilities curve.



In our Absolute Advantage example, we assume that there are two countries e.g. Rwanda and Kenya, which are represented by a red and blue line respectively. We also assume that only two goods are produced e.g. Tea and cooking Oil. From the table 1 above; we can determine how many units of each commodity each country produces using the same resources.

Rwanda has an Absolute Advantage in the production of Tea (15 tons) because it incurs less input costs to produce a unit of Tea than Kenya, which produces 6 tons of the same commodity, using the same input costs.

Kenya has an Absolute Advantage in the production cooking oil (10 tons) than Rwanda which produces 5 tons, using the same input costs.

As a result, Rwanda will be better off if it specializes in the production of Tea and Kenya will be better off if it specializes in production of cooking oil. This is the case of **reciprocal absolute advantage.**

As you can see from our example, it makes sense from businesses and countries to trade with one another. All countries engaged in open trade benefit from lower costs of production.

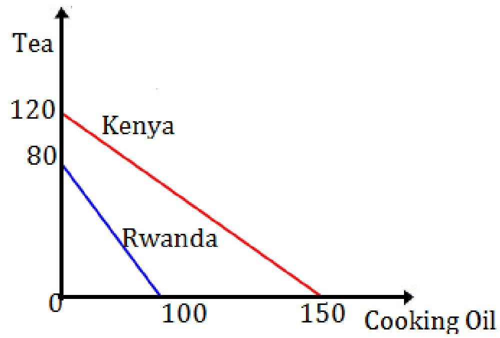
On the other side, given equal quantity of resources one country can produce both commodities better than another. Thus one country can have absolute advantage in production of both commodities than the other.This indicates a case of **non-reciprocal absolute advantage.**

Table2: non-reciprocal absolute advantage between Kenya and Rwanda production schedule.

Country	**Tea (tons)**	**Cooking oil (tons)**
Rwanda	80	100
Kenya	120	150
World total	**200**	**250**

The above information can be illustrated on the graph as below;

Figure 2: Absolute advantage between Kenya and Rwanda using a production possibilities curve.



From the above information in the table and graph, it can be seen that if Kenya decided to produce only Tea, it would produce 120 tons and if it decided to produce only Cooking oil, it would produce only 150 tons. Similarly, if Rwanda decided to produce only tea, it would produce only 80 tons, and if it decided to produce only cooking oil, it would produce 100 tons. Each country has several possible combinations of tea and cooking oil it can produce as shown along the production possibilities curve.

Because the Production possibilities frontier for Kenya is above that of Rwanda, it means that Kenya has absolute advantage over Rwanda in production of both tea and cooking oil. In this case of non-reciprocal absolute advantage, gains from trade can be realized when countries specialize basing on the opportunity cost of producing each commodity. This is explained by the theory/ principle of comparative advantage.

1.3.2: The theory of comparative advantage:

Theory of comparative advantage was advanced by **David Ricardo in 1817**.

Comparative advantage is the ability of a country to produce a commodity at less opportunity or real cost than another**.** Thus, a country has comparative advantage over another when it incurs less opportunity cost than another in the production of a given commodity.

The theory thus states that **"Given 2 countries and 2 commodities, with a given amount of resources, a country should specialise in producing a commodity where it has a least opportunity cost compared to another country**

1.3.2.2: Assumptions underlying comparative cost advantage

1. There is **no intervention by the government in economic system**, meaning there is free trade between two countries.
2. **Perfect competition exists both in the commodity and factor markets**.
3. There are **static conditions in the economy**. It implies that factor supplies, techniques of production, exchange rates and tastes and preferences are given and constant.
4. Production is **governed by constant returns to scale**; i.e. Production function is homogeneous which implies that output changes exactly in the same ratio in which the factor inputs are varied.

5. **Labour is the only factor of production** and the cost of producing a commodity is expressed in labour units.
6. **Labour is perfectly mobile** within the country but perfectly immobile among different countries.
7. **Transport costs are absent** so that production cost, measured in terms of labour input alone, determines the cost of producing a given commodity.
8. There are **only two commodities** to be exchanged between the two countries.
9. **Money is non-existent** and prices of different goods are measured by their real cost of production.
10. There is **full employment of resources** in both the countries.
11. **Trade between two countries takes place on the basis of barter**. Thus, the two countries have a double coincidence of wants with barter system of trade.

Table 3: Example; production possibilities between Rwanda and Kenya.

Country	Tea (tons)	Cooking oil (tons)
Rwanda	10	80
Kenya	40	100
Total	**30**	**120**

Kenya has absolute advantage in the production of both commodities, Tea and cooking oil over Rwanda. Kenya has the absolute advantage in Tea than Rwanda (4:1) and it has an absolute advantage in cooking oil than Rwanda (5:4). However, if we examine the domestic opportunity cost ratios, it is clear that each country has a relative or comparative advantage in the production of one commodity.

To get to know of who should specialise in what, we must calculate the opportunity cost of one commodity for the other. This is done by the formula;

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

From the above example it can be calculated as;

i. In Rwanda to produce Tea they forego cooking oil
   Thus = quantity of cooking oil/ quantity of tea = 80/10= 8
ii. In Rwanda to produce cooking oil, they forego Tea,
   Thus = quantity of Tea/ quantity of cooking oil = 10/80= 0.125
iii. In Kenya to produce Tea, they forego cooking oil,
   Thus = quantity of cooking oil/ quantity of tea = 100/40= 2.5
iv. In Kenya to produce cooking oil they forego Tea,
   Thus = quantity of tea/ quantity of cooking oil = 40/100= 0.4

This can be tabulated as;

Table 4: production schedule showing opportunity cost between Rwanda and Kenya

Country	Tea (tons)	Cooking oil (tons)
Rwanda	8	0.125
Kenya	2.5	0.4

In Rwanda, the domestic opportunity cost ratio is such that only 8 tons of cooking oil must be given up for each ton of Tea produced. The opportunity cost of producing one unit of cooking oil is 0.125 tons of Tea that must be foregone. However, in Kenya, the domestic opportunity cost ratio is such that 2.5 tons of cooking oil must be given up for each ton of Tea produced. The opportunity cost of producing one ton of cooking oil is 0.4 tons of Tea.
Rwanda therefore has a comparative advantage in the production of cooking oil since for each ton of cooking oil that is produced fewer units of tea are sacrificed than in Kenya. Similarly, Kenya, has a comparative advantage in the production of Tea since, for each ton of Tea that is produced; less cooking oil is sacrificed than in Rwanda.
If now Kenya concentrates on Tea and Rwanda on Cooking oil, then the two countries are bound to benefit assuming that the value of one ton of Tea is the same as that of one ton of cooking oil.
After specialization, the situation looks as indicated in the table below. The assumption is that resources have doubled in each country.

Table 5: Production after specialisation.

Country	Tea (tons)	Rice (tons)
Rwanda	0	160
Kenya	80	0
World Total	**80**	**160**

The production of Tea has increased by 50 and the production of cooking oil has increased by 40 tons.

1.3.2.3: Relevance/applicability of the comparative cost advantage.

1. Developing countries have tended to **specialize in producing primary products where they have a least opportunity cost** e.g. Rwanda exports raw materials.
2. **Developing countries still have barter trade** among arrangements themselves.
3. **Developing countries use labour intensive technology while developed countries use capital intensive technology** so the assumption of no change in technology is realistic.
4. There is some degree of **mobility of factors of production** among developing countries especially labour.
5. Developing countries **import manufactured commodities** where they have a high opportunity cost.
6. There are some cases of **free trade among developing countries** especially in economic integrations.

1.3.2.4: Criticisms/ limitations of the comparative cost advantage.

1. The model deals only with the situation in which trade **takes place between two countries and in two commodities**. However, this is a hypothetical situation which does not exist in real life since international trade takes place among more than two countries and in more than two commodities
2. The theory assumes that people all **over the world have similar tastes**. But this is untrue. People belonging to different levels of income have different tastes. In addition, the tastes also change according to the growth of an economy and with the opening of world markets and development of trade relations.
3. The theory **does not recognise the role of technological innovations in international trade**.
4. The theory rests upon the assumption that there is **complete specialisation or division of labour**. However, in the real world, complete specialisation is not possible.
5. It is wrong to assume **the existence of free world trade**. Countries do not always trade freely with each other. Different countries have always imposed different restrictions on the free movement of goods to other countries from time to time.
6. In his theory, Ricardo has shown no **consideration for transport costs, which play an important role in determining the profitability** and pattern of international trade.
7. The prevalence of **perfect competition in international trade is also an unrealistic assumption.** The conditions of perfect competition cannot be achieved in the real world.
8. The assumption that **all units of factors of production are equally efficient is too simplistic**. It is very difficult to find factors of production, which are equally efficient.
9. The theory assumes that countries **can shift resources from the production of one good to the production of another good.** In practice, there is likely to be a certain amount of factor immobility, which prevents this, especially in the short run.
10. The theory assumes the operation of the **law of constant costs or returns which is entirely unrealistic.** In practice, the usual rule in the production of goods is the operation of the law of increasing costs or diminishing returns, that is, beyond a certain point additional output can be obtained only at an increasing per unit cost.
11. **The theory assumes similar needs.** E.g. Uganda must want Rwanda’s Tea, and Rwanda must want Uganda’s Rice. This, however, may not be true in reality. For one reason or another, the cheapest source may not appeal to the customer country such that the customer prefers to buy from an expensive source. It should also be noted that two different currencies are used. However, the theory mentions nothing about them.
12. It is possible that the two **countries may incur the same cost in the production of certain commodity**. In such a case, it is hard to find which country should specialise in a particular commodity.
13. The principle of comparative advantage has been **criticized by developing countries on the grounds that if adhered to, it would perpetually commit them to being producers of raw materials.** Hence, condoning them to eternal poverty.

1.3.2.5.1 Factors that determine comparative advantage.

1. The quantity and quality of natural resources available for example some countries have an abundant supply of good quality soils, waterbodies, minerals farmland, oil and gas, or easily accessible fossil fuels which makes them able to have a comparative advantage than other countries which don't have or have little quantities or poor quality of such resources. The more available quantity and quality natural resources a country has, the more the comparative cost advantages and vice versa.

2. Demographics: A country that has a bigger and highly educated and skilled working-class group with a higher participation of women in productive activities, has a more comparative advantage than another which has an ageing or young population, high net outward and less educated and skilled labourforce and few women's participation in the labour force. This has an effect on the quantity and quality of the labour force available for industries engaged in international trade hence affecting a country's comparative advantage.

3. Rates of capital investment including infrastructure: Greater public infrastructure investment can reduce trade costs and hence increasing supply capacity of a country hence its comparative advantage over another country which does not have such infrastructures. Investment in roads, ports and other transport and ICT infrastructure strengthens productive and competitive capacity of a country for internal and international exchange.

4. Market levels: Rising demand/market helps countries to encourage specialisation, higher productivity and internal and external economies of scale. These long-run scale economies give regions and countries a significant unit cost advantage than those countries with less demand or market for their commodities.

5. Investment in research & development which can drive innovation and invention. A country that invests much in research and development, promotes mushrooming production techniques hence giving a greater comparative advantage than another which doesn't.

6. Foreign exchange rate stability: Fluctuations in the exchange rate affect the relative prices of exports and imports and cause changes in demand from domestic and overseas customers hence putting such affected countries at a less comparative advantage than another whose exchange rate is stable for long period of time.

7. Import controls such as tariffs, export subsidies and quotas – these can be used to create an artificial comparative advantage for a country's domestic producers.

8. Non-price competitiveness of producers - covering factors such as the standard of product design and innovation, product reliability, quality of after-sales support. These help a country to win market for their commodities hence giving such countries products a comparative advantage than others. Many countries are now building comparative advantage in high-knowledge industries and specializing in specific knowledge.

9. Institutions: Availability of institutions that facilitate production are important for comparative advantage and for growth of a given country. E.g. banking systems needed to provide capital for investment and export credits, legal systems that help to enforce contracts, political institutions and the stability of democracy is a key factor behind decisions about where international capital flows. These institutions provide a strong milestone to a country's production capacity hence its comparative advantage than another which has weak or non-existent institutions.

10. Size of entrepreneurial class: A bigger size of entrepreneurs in a country develops a new comparative advantage in a product either because they find ways of producing it more efficiently or they create a genuinely new product that finds a growing demand in home and international markets than a small size entrepreneurial class.

11. Trade Barriers: Subsidies and taxes implemented by the government create an artificial comparative advantage in a sense that a subsidy makes exports more competitive and a tax would discourage imports thus giving countries comparative advantage.

12. Inflation: An increase in the rate of inflation would make exported goods more expensive and imported goods cheaper thus putting the affected country at a lesser comparative advantage than the other.

13. Tradition: Sometimes comparative advantage maybe largely the result of acquired skills and tradition. People get used to doing a thing and keep on doing it, generation after generation. For example, the Swiss have a tradition of making watches, the Norwegians of operating a far-flung merchant fleet, and the French, of producing cheeses. Each of these traditions is certainly consistent with the resource endowment of the country in question, but it is not an inevitable outcome of it.

14. Technology: Technological differences between countries account for differences in labour productivity. The countries with the most advanced technology will have a comparative advantage with regard to those goods that can be produced most efficiently with modern technology.

15. Factor Abundance: Goods differ in terms of the resources, or factors inputs, required for their production. Countries differ in terms of the abundance of different factors of production: land, labour, capital and entrepreneurial ability.

16.**Human Skills: C**ountries with a relatively abundant stock of highly-skilled labour will have a comparative advantage in producing goods that require relatively large amount of skilled labour. Likewise, developing countries would be expected to have a comparative advantage in industries requiring a relatively large amount of unskilled labour.

Benefits of comparative advantage.

1. It encourages **competition and improvement in efficiency** so as to reduce costs of production.
2. It encourages **specialisation and exchange.**
3 .It increases **global output of commodities** due to specialisation.
4. It encourages **economic cooperation and free trade** among countries.
5. It encourages mass production and **reaping of economies of scale**.

6. It **discourages duplication of industries i**.e. setting up of industries which already exist in other countries.
7. It **widens market for exports** between or among countries.
8. It **enables countries to get commodities which they cannot produce**, thus increasing consumers choice.
9. It enables countries to **get foreign exchange** through increased exports and other form of capital inflow.
10. Specialisation results into **effective utilisation of resources** some of which would be idle.

UNIT 2: TERMS OF TRADE.

2.1.1: Meaning of terms of trade:

Terms of trade (TOT) *refers to the relative price of exports in terms of imports*. It is the ratio of export prices to import prices. It can be interpreted as the amount of import goods an economy can purchase per unit of export goods. *I.e. import purchasing power of exports*. For example, if an economy is only exporting Flowers and only importing telephones, then the terms of trade are simply the price of flowers over the price of telephones. In other words, how many telephones can you get for a unit of flowers sold?

Terms of trade is also the ratio of a country's export price index to its import price index, multiplied by 100.

Terms of trade can be expressed as;

TOT= $\frac{\text{Average price index of exports}}{\text{Average price index of imports}}\times\mathbf{100}$ or **TOT=** $\frac{\text{Px}}{\text{Pm}}\times\mathbf{100}$

Where; **Px** = average price index for exports, **Pm** = average price index for imports

Basically, TOT is Export Price over Import price times 100. If the percentage is over 100% then an economy is doing well (Capital Accumulation) thus ***favourable terms of trade*.** When this persists year after year, a country is said to have '***improving terms of trade'*.**

If the percentage is under 100% then an economy is not going well (More money going out than coming in) thus ***unfavourable terms of trade***. When this persists year after year, a country is said to have ***deteriorating terms of trade.***

2.1.2: Forms of Terms of Trade

a) **Barter/ commodity terms of trade.**

This is the relationship between export prices and import prices. I.e. the ratio of average price index of exports to the average price index of imports. Symbolically, it can be expressed as:

Barter terms of trade= $\frac{\text{Px}}{\text{Pm}}\times\mathbf{100}$

Where P = price, the subscript x =exports and m =imports.

Taking 2018 as the base year and expressing Rwanda's both export prices and import prices as 100, if we find that by the end of 2019 its index of export prices had fallen to 80 and the index of import prices had risen to 180. The terms of trade had changed as follows:

Barter TOT = $\frac{Px}{Pm}$ **×100=** $\frac{80}{180}$ **×100 = 44.4**

It implies that Rwanda's terms of trade declined by about 55.5 per cent in 2019 as compared with the 2018, thereby showing worsening of its terms of trade.

If the index of export prices had risen to 190 and that of import prices to 185, then the terms of trade would be

Barter TOT = $\frac{Px}{Pm}$ **×100=** $\frac{190}{185}$ **×100 =102.7.**

This implies an improvement in the terms of trade by 2.7 per cent in 2019 over 2018.

b) Income/ monetary terms of trade

This refers to the ratio of the value of exports (revenue from exports) to the price index of imports. This index is calculated by dividing the index of the value of exports by an index of the price of imports. This is called the "***Export Gain from Trade Index**.*"

It can be expressed as;

Income TOT= $\frac{Px.Qx}{Pm}$ **or** $\frac{\text{index of export price X export quantity}}{\text{index of import prices}}$

Example 1:

Taking 2017 as a base year and expressing Rwanda's both export prices and import prices as 100, if in 2019, the price of exports (PX) is 140, price of imports (Pm) is 90 and quantity of exports is 80 then income terms of trade is;

$$\frac{\mathbf{Px.Qx}}{\mathbf{Pm}} = \frac{\mathbf{140 \times 80}}{\mathbf{90}} \mathbf{= 124.4.}$$

It implies that there is improvement in the income terms of trade by 24.4percent in 2019 as compared with 2018.

***Example 2*:**

Taking 2018 as a base year again, and expressing Rwanda's both export prices and import prices as 100. If in 2019 Price of exports = 80, Price of imports =180 and Quantity of exports =120, then

Income TOT = $\frac{\mathbf{Px\ X\ Qx}}{\mathbf{Pm}} = \frac{\mathbf{80\ X\ 120}}{\mathbf{180}}$ **= 53.3**

It implies that the income terms of trade have deteriorated by 46.7% percent in2019 as compared with 2018.

Causes of unfavourable TOT and deteriorating Terms of Trade in LDCs

1. The less developed countries are mainly **primary producing countries** which are price and income inelastic, but their imports include capital goods which are expensive. Thus, the terms of trade for LDC's are always unfavourable and deteriorating year after year.

2. Adoption of **raw-material saving techniques by developed countries** which reduces the demand for LDC's export.
3. Most of the international **trading policies are influenced by MDCs** which favour them however disfavor LDCs. For example, LDCs are price takers in the world market hence their export prices are usually low, making them to have unfavourable terms of trade year after year.
4. Discovery of substitutes such as synthetic fibers e.g. plastics, nylon, which replace natural fibers in LDCs. This reduces on the volume of exports for LDCs.
5. Price movements through **business cycles**: The prices of primary products rise sharply in the prosperous periods and fall in the downswing of the business cycle. Thus, over successive cycles, the prices of the primary products have always fluctuated, and the primary producing countries have suffered an unfavourable movement in their terms of trade.
6. Long-term disparity in demand for manufactured and primary products. In the industrial countries, the income elasticity of demand for primary products is inelastic (i.e., less than one), while in the poor countries, the income elasticity of demand for manufactured goods is more elastic (exceeds one). This brings about unfavorable terms of trade year after year.
7. The less developed countries **use backward technology** as compared to the developed countries. As a result, their relative productivity is low, cost ratios are high, and price structure is also relatively high.
8. Most of the less developed countries experience **overpopulation and high population growth**. As a result, there is high internal demand for the goods and low exportable surplus. Moreover, the import demand of these countries is highly inelastic. This causes their terms of trade to fall.
9. Lack of Import Substitutes: Poor countries are greatly dependent on the advanced countries for their imports and have not developed import substitutes. On the other hand, the advanced countries are not so much dependent on the poor countries because they are capable of producing import substitutes. Thus, the poor countries have weak bargaining position in the international trade.
10. High transport costs: Most LDCs are land locked countries, this makes it difficult to link to regional or international markets make it difficult for trade development in the country. Therefore, making it costly to transport commodities to and from international markets, adversely affecting their terms of trade.
11. Unlike, the advanced countries, the less developed countries **cannot quickly adapt their supply of goods which are high in demand and whose prices are rising.** The reasons for this are: backward technology, market imperfections, immobility of factors of production, etc. Thus, the terms of trade of less developed countries tend to deteriorate and these countries fail to reap gains by increasing their supplies of exports during inflation due to Lack of adaptability.
12. Most LDCs produce more less **the same products which leads to limited market** among themselves. They therefore tend to increase their export shares to MDCs by reducing prices, yet they have to continue importing manufactured goods from MDCs which are highly priced.

13. Most LDCs lack a considerable manufacturing **sector as a result of political instability and insecurities**, thus reduce the volume of manufactured commodities that would be exported.
14. Lack of diversification in production in LDCs; Most LDCs depend on a few traditional cash crops like tea, coffee, cotton tobacco, sisal, cocoa etc. which limits the amount of income they get from exports compared to developed countries that export to LDCs a wide variety of manufactured goods.

2.2.2: How to improve Terms of Trade for LDCs

1. Carry out **adequate market research** so as get enough information to widen markets for their commodities. This enables them to access new clients and overcome supply constraints domestically, regionally and internationally.
2. Human resource development through education and training so as to reduce expenditure on imported labourforce which is always expensive.
3. Promote peace and security in all parts of their countries so as to instill confidence, for their security and property as well, among both local and foreign investors.
4. Ensure good governance for example, by fighting against all forms of financial indiscipline like corruption and embezzlement of government funds in all sectors which promotes transparency and efficiency thus increased gains from trade.
5. Promote **regional integration and economic co**operation among developing countries. by trading among themselves in order to avoid exploitation by developed countries. For example, Rwanda is already a member to regional and international bodies like East African Community (EAC), Common Market for Eastern and Southern Africa (COMESA) and its free trade area and is able to access the whole market without any barriers to trade.
6. Promote the development of private sector so as to promote efficiency in production and increase the exploitation of idle resources which increases export volume thus increasing gains from international trade.
7. Make all possible efforts to establish business legal reform task force mandated to reform all business laws which will create conducive legal environment for trade by both local and foreign investors and increase the gains from international trade among themselves.
8. Establish financial sector task force with the mandate of solving all problems in the financial sector. This will help avail easy and cheap credit facilities to potential investors and business class which boosts their productive levels thus increasing the export ba**se.**
9. Establish the trade points which will provide all trade related information; this becomes an opportunity as trade information will be easily obtained in one place. This attracts different investors from within and outside the country’s economy thus promoting production directed towards export and or reducing import expenditure.
10. Enhance the establishment of **permanent national and international trade fair grounds** which creates an opportunity for trade development as itgives business men a chance of regular expositions which helps them in sell and advertisements of their products.

11. Enhance the establishment of **business development centers (BDS) which facilitate easy coordination of business activities in rural areas** to promote continuous and coordinated production.

12. Establish **Export processing zone which facilitate trade development in particular** and development in general. This helps transform their commodities into finished products so as to increase the export value and gains from trade as well.

13.Form producer cooperatives and associations to bargain for higher prices for their exports. Governments should take initiative in cooperatives development so as to create an opportunity for trade development, as from a strong cooperative movement trade is improved.

14. Take up strong measures to control population growth e.g. through family planning campaigns so as to increase on the level of exports and reduce the volume of imports as well.

15. Diversify domestic production so as to reduce dependency on few traditional exports where terms of trade are unfavourable and keep on fluctuating.

16. Adopt Import substitution strategy so as to minimize import expenditure

17. Research innovations and inventions so as to promote technological development and use of intermediate technology to reduce expenditure on expensive capital.

UNIT ASSESSMENT.

1 a. What distinguish barter terms of trade from income terms of trade?

b. Study the table below showing terms of trade for a country (2012-2016) and answer the questions that follow;

Year	**Export price index**	**Import price index**	**Terms of Trade**
2015	100	100	
2016	130	110	
2017	110	124	
2018	120	140	
2019	165	190	

i) Calculate the terms of trade for the years 2015 to 2019

ii) Explain the nature of terms of trade between 2016 and 2019 and support your answer.

2. a) Why have terms of trade tended to move against developing countries' economies?

b) Does favourable terms of trade mean favourable balance of trade

UNIT 3: FREE TRADE AND TRADE PROTECTIONISM

3.1 FREE TRADE

Free trade refers to the unrestricted purchase and sale of goods and services between two or more countries.

3.1.2: Advantages of free trade

1. **Improves consumers' welfare.** Free International trade avails consumers in a particular country with a wider choice of goods and services because it makes easy for them to find both imported and locally produced goods and services cheaply
2. **Reduced costs of production by domestic businesses**. With free trade, domestic businesses may also have **a** chance to reduce their costs of production by buying imported raw materials or new technology without restrictions and this in turn leads to reduction in general price levels in the country.
3. **Encourages specialization among countries.** With free trade, a country is able to specialize in the production of a commodity where they incur lower costs than other countries and cheaply get buy commodities where they incur higher costs from other countries
4. **Encourages competition between domestic and foreign industries:** Free International trade increases competition as domestic industries must compete with foreign firms in the same industry in their own country.
5. **Increased earnings for the factors of production.** Under free trade, factors of production will also be able to earn more, as they will be employed for better use i.e. optimally utilized.
6. **Imports become Cheaper.** Free trade enables the country to get imports at cheap rates since it is becomes easy for the country to get goods and services from other countries with little or no restriction and this reduces prices in the domestic market which later favours customers.
7. **Enlarges a country's market in other countries**: Free trade widens the size of the country's market in the way that a country is able to sell their products in other countries without any restriction.
8. **Restricts consumers' exploitation by domestic monopolists**: Free trade prevents grow of domestic monopolies who always exploit the consumers through charging high prices.
9. **Promotes international cooperation among countries and mutual understanding as well**. It is also known that the more countries work together in terms of buying and selling goods and services even their relationships tend improve in the same direction.
10. **Widens tax base in the economy** as a result of variety of goods and services produced and exchanged. This increases a country's tax base which in turn increases a country tax revenue used for further development.

11. **Reduces administrative costs of protectionism** such as enforcing quotas, foreign exchange control, subsidies etc. The government to enforce such policies incurs a lot of administrative costs such as supervision costs etc
12. **Eliminates possibilities of trade malpractices** like smuggling with its negative effects. Free trade gives all people an opportunity to with little or no government restrictions and this helps people to trade freely without getting involved in such malpractices.

3.1.3: Disadvantages of free trade

1. **Unemployment increases**. Free trade makes it becomes easy to import some products at a cheaper price than the domestic ones and this causes some industries to be out competed and pushed out of business by such cheap foreign products hence causing unemployment.
2. **Increases uneven distribution of income among countries.** As a result of free international trade, some countries will be able to take advantage of their natural resources, skilled workforce or economies of scale to sell their goods and services internationally on more favorable terms than other countries without such advantages and then get more revenue compared to other.
3. **Prices fluctuation on the global market.** Most developing countries always export semi or unprocessed products whose prices are always fluctuating on the global market hence making such countries to gain less from free trade.
4. **Increases dumping of goods.** Free trade enables other countries to sell their surplus products in our countries at lower prices compared to their home prices. This has a number of negative effects on the economy like reducing market for domestically produced goods, causes unemployment and narrowing a country's tax base and many others.
5. **Degradation of natural resources**. Since free trade expands a country's market in other countries this leads to over exploitation of natural resources like timber, minerals and other natural resources as the way of increasing more products on the market which later leads to environmental degradation.
6. **Destruction of native culture**. Since free trade also allows free movement of people between countries. This makes it easy for people with bad cultural practices to spread it in other countries which leads to destruction of a country's good culture and sometimes accompanied with other negative effects like diseases and death.
7. **Reduced tax revenue for government.** Since free trade allows countries to trade with other with little or no restrictions, this means that a country's import and export duties are reduced which also slows down a country development.
8. **Worsens a country balance of payment problem**. Free trade becomes unfavorable for a country which exports primary products and imports full manufactured goods.

9. **Worsens the importation of undesirable commodities in the country.** Free trade has adverse effects on consumers since there is no check on production and trade of various harmful goods. This undermines the health conditions of local people.

10. **Unfair competition between developed and developing countries**. Competition induced under free trade is unfair and unhealthy. Backward countries cannot compete with advanced countries.ie Local infant industries are outcompeted by cheap imported products from abroad since they cannot compete favourably with MDCs.

11. **Encourage brain drain.** Since it allows people to move freely between countries with little or no restrictions this makes it easy for many people to move to developed countries looking for greener pastures which in turn reduces skilled labour force in developing countries.

12. **Discourages self-reliance**. It makes a country to over depend on imported goods since importation of goods becomes easy and cheap.

Activity

1. **Why do we buy goods from abroad if we can make them locally.**
2. **Consider the view that gains from free trade are biased in favour of advanced industrial countries.**

Expected answers to home activity

1. We buy goods from abroad when we can actually make them locally due to the following reasons:
   - Domestic production might be **expensive than importing** thus basing on comparative advantage we have to import such commodities where we face a high opportunity cost.
   - Imported goods might be of **good quality** than domestic ones because the imported ones might be from technologically developed nation. Thus, on health grounds and living standards of citizens we need to import however much we can produce that commodity.
   - A country would be limited to the goods and services within its borders thus need to **increase consumer's choice** through increased variety.
   - **To increase efficiency in domestic producers** by exposing them to competition with foreign commodities.
   - Our home-made commodities might be of **higher value/ grade** thus need to export them and import the same but less value commodities, the difference in price is a lot to the country in form of exchange.
   - Sometimes a country would import raw materials even if they have them in their country so that **they don't use up their supply**. This helps in periods when other sources around the world dry up or become inaccessible.
2. **Gains from free trade are biased in favour of advanced industrial countries due to the following reasons:**
   - Declining price/ value of exports of developing countries due to **low quality products which cannot compete favourably in the world market**

- Increasing prices of imports due to **increased demand for capital goods and tariffs on imports** which increases prices further.
- Declining volume of exports which reduce income terms of trade due to **protection by developed countries** and low production as a result of lack of capital and skills
- **High rates of inflation in developing countries** which reduce demand for their exports
- **Poor investment climate in developing countries** that encourage people to invest in developed countries thus continuous capital outflow.
- **Natural calamities in most developing countries** which has caused agricultural failure and led to low agricultural export earnings.
- **Most developing countries are landlocked** thus the high transport costs reduce the gains from trade by developing countries.
- **Poor infrastructure** like storage facilities and air transport in most developing countries which makes export of delicate products like fruits and flowers difficult.
- **Weak economic integration** among developing countries.
- **Monopoly power of developed countries** which pay less for raw materials and charge high prices for final commodities. Etc.

3.2.1: Meaning of trade protectionism

Trade protectionism refers to the different forms of barriers imposed on international trade to influence the flow or volume of commodities exchanged.

3.2.2: Reasons for trade protectionism

1. To **protect infant industries** against unfair competition from low cost products from abroad. Infant industries normally produce at high costs and their products are of poor quality and thus need to be protected from cheap and high quality import goods.

2. **To discourage dumping** through imposing high tariffs on cheap and expired commodities from other countries into the country.

3. **To increase employment opportunities** at home by reducing imported goods. When a country limits imported goods, this stimulates domestic demand for local products which contains local industries in operation so that they can keep providing employment.

4. **To reduce external economic dependence and promote self-sufficiency** eg through establishment of import substitution industries to produce formerly imported commodities to ensure self-reliance in the economy.

5. **To increase government revenue through import and export duties**, of which revenue can be used to finance government development programs.

6. **To prevent importation of undesirable commodities and thus protect health of citizens** e.g. ban (total refusal) of certain drugs, food staffs and even other commodities basing on health grounds.
7. **To check imported inflation by increasing tariffs or prohibit importation of commodities** from countries experiencing hyperinflation.
8. **To encourage full utilization of domestic resources** especially for import substitution industrial strategy.
9. **To improve on the BOP position of a country**. Restrictions may be imposed on imports in order to reduce the amount of goods imported and this helps to reduce foreign exchange expenditure abroad thus improving BOP position of a country.
10. **For security purposes** e.g. a country may impose restrictions like embargo or total ban on importation of strategic commodities like firearms, military hardware etc. to maintain security in the country.
11. **For retaliation purposes** i.e. countries impose restrictions to retaliate against other countries restrictions on her exports.

3.2.3: Tools of protectionism (Barriers to Foreign/International Trade)

Tariff barriers to trade

These are restrictions in form of **taxes on imports and or exports**. They are at times called ***customs duties***. They are divided into;

(i) Import duties: These are taxes imposed on goods and services imported into the country.

(ii) Export duties: These are taxes imposed on goods and services exported to other countries.

Non-tariff barriers to trade

These are **non-tax restrictions or regulations** in international trade. It can also be taken as other forms the government use to restrict imports and exports rather than imposing taxes.

Forms of Non-tariff barriers to trade

1. Total ban. The government of a country by law may totally ban the import or export of certain commodities for reasons of health or for promoting the growth of certain industries in the country. For instance, when foot and mouth disease attacks cattle in a certain country, the government may totally prohibit the import of beef from the country experiencing that problem.

2. Foreign exchange control. Exchange control implies the government regulations relating to buying and selling of foreign exchange. The government then may allocate the foreign exchange among only the licensed importers so as to reduce the amount of foreign exchange given to importers in order to reduce on imports.

3. Quotas. These are physical quantities of commodities that are supposed to be imported or exported in a given period of time set by the government. In order to reduce imports, the government may specify the maximum amount of a commodity which can be imported from each producing country in a given time.

4. Preferential treatment. The government of a country may give preferential treatment in the rate of taxes to some of the countries. The granting of preferential treatment results in the formation of trade blocks because imports from countries which are not giving preferential treatment will be highly taxed thus limiting amount of goods imported.

5. Import monopolies. When the government of a country takes responsibility of importing all the necessary commodities herself, this also reduces on the amount of imported goods in the country because all other importers are restricted.

6. Import licenses. Another barrier which restricts the import of goods from abroad is the import license. If the government of a country allows the import of foreign commodities to the licensed importers, the trade is very much brought under control because all unlicensed importers will be restricted from importing goods into the country which reduces on the physical amount of goods imported.

7. Embargo/ sanctions:

This is an extreme form of trade barrier. Embargoes prohibit import from a particular country as a part of the foreign policy. In the modern world, embargoes are imposed in times of war or due to severe failure of diplomatic relations

8. **Anti-dumping legislation:** Supporters of anti-dumping laws argue that they prevent "dumping" of cheaper foreign goods that would cause local firms to close down. However, in practice, anti-dumping laws are usually used to impose trade tariffs on foreign exporters.

9. Political campaigns advocating domestic consumption . This involves encouraging citizens to consume their home made commodities e.g. the "Buy made in Rwanda" campaign in Rwanda. This promotes the market for local products which has a number of benefits to citizens and in turn leads to reduction in the amount of goods imported.

10. Employment-based immigration restrictions. This may involve labour certification requirements or numerical caps on work visas. If such requirements are at higher levels, it will restrict many unnecessary workers to enter in the country.

11. Direct subsidies: Government subsidies (in the form of lump-sum payments or cheap loans) are sometimes given to local firms that cannot compete well against imports. These subsidies are supposed to "protect" local jobs, and to help local firms adjust and meet their standards to those of the world markets

3.2.4: Advantages / arguments for trade protectionism.

1. **Protectionism reduces unemployment reduces:** The use of tariffs discourages imports and raises their prices to the domestic consumers. This increases the production of locally produced goods due to the increased local market and this in turn more employment is provided for the home population.
2. **Preserves certain class of population or certain occupation:** The government of a country on political or social grounds may favor protectionism for preserving certain classes of people or certain occupations
3. **Protects the domestic infant industries**. A newly established industry is just like a newly born baby. As the baby cannot grow up unless it is nursed and well protected, similarly, an infant industry cannot face the blast of foreign competition unless it is given full protection till it grows to its full structure
4. **Protectionism guards against dumping:** Protectionism discourages dumping of cheap and at times substandard or expired goods in the country
5. **Keeps money at home.** Protectionism is also advocated on the grossly fallacious argument of "Keeping money at home". When we buy manufactured goods abroad, we get the goods and the foreigners get the money. When we buy the manufactured goods at home, we get both the goods and the money which has a great advantage towards the development of the country.
6. **Protectionism increases government revenue:** Protectionism is also advocated on the ground that it raises revenue for the state through import and export duties. To this it is pointed out that if prohibitive high tariffs are imposed on the import of foreign goods, then they may not be imported at all and the government would not able to collect the revenue at all. On the other hand, if a moderate protectionism duty is levied, then it may serve both the purposes of collecting revenue and protecting industries.
7. Protectionism helps in **checking imported inflation** by putting sanctions or even total ban on commodities from countries affected by inflation.
8. **Protectionism conserves national resources:** Protectionism is essential for preserving the natural resources of a country which can be used to meet the needs of the future generation. The unrestrained trade often leads to quick exhaustion of mineral resources which would be very vital for the development of the country.
9. **National security purposes:** It also helps to safe guard a country’s national security especially when importation of military armies are restricted into the country by unauthorized people.
10. **Reduces shortages in the home country.** The government can use protectionism to reduce shortage in the country through restricting exports and favouring imports so as to increase the amount of goods available on the domestic market.
11. **It encourages full utilization of domestic resources.** If imports are discouraged and demand for domestic goods is encouraged, it encourages domestic producers to use the available idle resources in order to increase production to meet the domestic demand.

12. **It checks on the production and consumption of harmful products in the economy.** High import duties on certain imported commodities or their total ban discourages inflow of such commodities on health and moral grounds which improve the standards of living of the citizens of the protecting countries.

3.2.5: Dangers of protectionism

1. **Market distortion and loss of allocative efficiency**: Protectionism can be an ineffective and costly means of sustaining jobs.
2. **It may lead to trade diversion in case trade protectionism** is in form of regional integration. It makes the country shift her trade from low cost nonmember state to high cost member states.
3. **It may lead to inflation** due to high import tariff especially if imports have inelastic demand because such goods will still be imported even if high taxes are imposed which in turn affect the price of other goods leading to inflation.
4. **Trade barriers spoil the relationship between countries**. Protectionism acts as retaliation against the trading partners (beggar-my neighbor policy) i.e. when a certain country restricts goods from another country even that country restricts goods from that country which in turn ends up spoiling their trade relationships.
5. **It encourages smuggling which reduces government revenue** because smuggled goods are always not taxed.
6. **It promotes monopoly** i.e. protected domestic industries will become monopolies when imports are restricted and as a result such industries begin exploiting consumers by charging high prices.
7. **Over protectionism leads to inefficiency** whereby local producers will produce local quality goods because of limited competition caused by restriction of imports.
8. **Loss of economic welfare**: Welfare is reduced through higher prices and restricted consumer choice since imports are restricted and consumers may end up consuming low quality and expensive commodities.
9. **Extra costs for exporters:** For goods that are produced globally, high tariffs and other barriers on imports act as a tax on exports, damaging economies, and jobs, rather than protecting them It leads to high production costs thus high prices for domestic final goods due to the fact that LDCs normally import raw materials and spare parts
10. **It may lead to scarcity inflation** especially if there are high taxes on imports which limits supply of goods and services thus scarcity in the country that results into high prices for the few commodities available.
11. **Limited inflow of skilled labour into the country**. If foreign workers are restricted into the country this may create inefficiency in some sectors of the country

due to limited skilled workers and this may result into poor performance of such sectors which also affects a country's development.

12. **Production of poor quality products**. When home producers are protected from external competition this makes it easy for them produce poor and expensive products which in turn affects people's standards of living

3.3. Commercial policy

A Commercial policy or **trade policy** or **international trade policy or economic policy** refers to the set of rules and regulations that are intended to change international trade flows and particularly to restrict imports.

Or

Commercial policy is the government policy meant to influence, control and direct the volume of trade, value and the direction of trade in the country.

3.3.2 Objectives of commercial policy

1. To increase the **quantity of trade** with foreign nations.
2. **To preserve, the essential raw material** for encouraging the development of domestic industries.
3. **To stimulate the export of particular products** with a view to increasing their scale of production at home.
4. **To prevent the imports of particular goods** for giving protection to infant industries or developing key industry.
5. **To restrict import**s for securing diversification of industries.
6. **To encourage the imports of capital goods** for speeding up the economic development of the country.
7. **To restrict the imports of goods** with a view to correct the unfavorable balance of payments
8. **To assist or prevent the export or import** of goods and services for achieving the desired rate of exchange.
9. **To enter into trade agreements** with foreign nations for stabilizing the foreign trade.

3.3.3 Instruments/Tools of Commercial Policy:

1. **Tariffs or Custom Duties:** Tariff's or custom duties refers to the taxes imposed goods exported, imported or passing through the territories of another country.

Custom duties are generally classified into three classes;

(a) Transit duties are those taxes which are levied upon merchandize passing through the territories of another country.

(b) Import duties are those taxes which are levied on the goods brought into the country. Import duties are chiefly levied for revenue or for protection purpose or for both.

(c) Export duties are those taxes which are imposed on goods exported from the country. Export duties, like import duties, are also imposed for raising revenue and to restrict the export of certain raw material with the view to encourage the development of domestic industries.

2. Subsidizing domestic industries. When the government subsidies her domestic firms, they grow and expand and then sell their products at a cheaper price than foreign goods which reduces on importations. The subsidies may be direct or indirect. **Direct subsidies** are paid in cash from the public treasury but the **indirect subsidies** involve reducing taxes imposed on locally produced goods.

3. **Direct Restrictions on Imports:** The government may totally prohibit the import of certain commodities into the country with the intent of increasing foreign exchange or for protection of domestic industries or for discouraging the use of particular commodities because they are injurious to health.
4. **Trade Agreements:** The government of a country may enter into trade agreements with other countries for the exchange of goods.
5. **Economic integration.** This is the economic cooperation of countries in the same region so as to improve gains from trade among themselves.
6. **Devaluation.** This is the legal reduction in the value of a county's currency in terms of other countries' currencies. This is done to increase the demand for exports as they become cheap and reduce that of imports since they become expensive.
7. **Import substitution strategy.** This is where a country establishes domestic enterprises at home to produce goods at home which were previously imported in to the country. This is done with the intent of reducing import expenditure.
8. **Foreign exchange control.** This is the regulation of inflow and outflow of foreign exchange e.g. by fixing the foreign exchange rate.
9. **Basic infrastructure policy.** This involves expansion and improvement of domestic infrastructure like roads, railway, dams and many others in order to promote domestic production so as to reduce the amount of goods imported in the long run.

UNIT4: BALANCE OF PAYMENT (BOP).

4.1.1: Meaning of Balance of Payment (BOP)

Balance of payment (BOP) also known as balance of international payments, is a statement that summarizes an economy's transactions with the rest of the world for a specified time period. It is a summary statement of a nation's financial transactions with the outside world.

4.1.2: Terminologies used in BOP:

a) **Balance of trade;** this refers to the difference between visible exports and imports.
b) **Balance of invisible trade;** this refers to the difference between invisible exports and imports.

c) **BOP deficit or unfavourable BOP**; this is where total expenditure abroad is greater than total receipts from abroad.
d) **BOP surplus or favourable BOP;** this is where total receipts from abroad are greater than total expenditure abroad.
e) **BOP disequilibrium**; this is where receipts from abroad are not equal to expenditures abroad i.e. either there is a BOP deficit or a BOP surplus.
f) **BOP equilibrium;** this is a situation where revenues from abroad are equal to expenditures abroad.
g) **BOP accounts;** this refers to the statistical record of the character and dimensions of the country's economic relationships with the rest of the world.
h) **Visible trade;** this involves the exchange of goods only
i) **Invisible trade;** this involves the exchange of services

4.2.1: The BOP accounts.

The balance of payments account of a country is constructed on the principle of ***double-entry book-keeping*.** Each transaction is entered on ***the credit and debit side of the balance sheet***. In balance of payments accounting, the practice is to show credits on the left side and debits on the right side of the balance sheet. The balance of payment represents a summation of country's current demand and supply of the claims on foreign currencies and of foreign claims on its currency. It is prepared in a single currency, typically the domestic currency for the country concerned.

When a payment is received from a foreign country, it is ***a credit transaction*** while payment to a foreign country is ***a debit transaction***. The principal items shown on the credit side (+) are exports of goods and services, unrequited (or transfer) receipts in the form of gifts, grants etc. from foreigners, borrowings from abroad, investments by foreigners in the country and official sale of reserve assets including gold to foreign countries and international agencies. Therefore, sources of funds for a nation, such as exports or the receipts of loans and investments, are recorded as positive or surplus items.

The principal items on the debit side (-) include imports of goods and services, transfer (or unrequited) payments to foreigners as gifts, grants, etc., lending to foreign countries, investments by residents to foreign countries and official purchase of reserve assets or gold from foreign countries and international agencies. Therefore, uses of funds, such as for imports or to invest in foreign countries, are recorded as negative or deficit items.

These credit and debit items are shown vertically in the balance of payments account of a country according to the principle of double-entry book-keeping. Horizontally, they are divided into the following categories: the current account, the capital account, the official settlements account or the official reserve assets account and the errors and omission account as explained below.

1. Current Account:

The current account of a country consists of all transactions relating to trade in goods and services and unilateral (or unrequited) transfers. **Service transactions** include costs of travel and transportation, insurance, income and payments of foreign investments, etc. **Transfers** relate to gifts, foreign aid, pensions, private remittances, charitable donations, etc. received from foreign individuals and governments to foreigners.

In the current account, merchandise, exports and imports are the most important items. Exports are shown as a positive item and are calculated f.o.b. (free on board) which means that costs of transportation, insurance, etc. are excluded. On the other side, imports are shown as a negative item and are calculated c.i.f. (costs, insurance and freight) and included.

The difference between exports and imports of a country is its balance of visible trade or merchandise trade or simply balance of trade. *If visible exports exceed visible imports, the balance of trade is favourable. In the opposite case when imports exceed exports, it is unfavourable.*

It is, however, services and transfers or invisible items of the current account that reflect the true picture of the balance of payments account. The balance of exports and imports of services and transfer payments is called *the balance of invisible trade.*

The invisible items along with the visible items determine the actual current account position. *If exports of goods and services exceed imports of goods and services, the balance of payments is said to be* ***favourable.*** *In the opposite case, it is* ***unfavourable.*** The net value of these visible and invisible trade balances is the ***balance on current account.***

2. Capital Account:

The capital account of a country consists of its transactions in financial assets in the form of short-term (between three months and less than one year) and long-term (one year or more) lending and borrowings and private and official investments. In other words, the capital account shows international flows of loans and investments, and represents a change in the country's foreign assets and liabilities.

There are two types of transactions in the capital account—private and government. Private transactions include all types of investment: direct, portfolio and short-term. Government transactions consist of loans to and from foreign official agencies.

In the capital account, borrowings from foreign countries and direct investment by foreign countries represent ***capital inflows***. They are positive items or credits because these are receipts from foreigners. On the other hand, lending to foreign countries and direct investments in foreign countries represent ***capital outflows***. They are negative items or debits because they are payments to foreigners. The net value of the balances of short-term and long-term direct and portfolio investments is ***the balance on capital account***. *The sum of current account and capital account is known as the* **basic balance.**

3. The Official Settlements Account or official financing account (cash or monetary account).

The official settlements account or official reserve assets account is, in fact, a part of the capital account. It measures the change in nations' liquidity and non-liquid liabilities to foreign official holders and the change in a nation's official reserve assets during the year. It includes a country's gold stock, holdings of its convertible foreign currencies and SDRs, and its net position in the IMF". It shows transactions in a country's net official reserve assets.
This account records all the transactions related to the change in the country's foreign exchange reserves and also shows the official foreign reserves in response to current and capital accounts. If there is a surplus on the combined current and capital accounts, this means that the foreign exchange reserves of a country have increased. If there is a deficit on the combined current and capital accounts, this means that the foreign exchange reserves of a country have decreased.

4. Errors and Omissions:
This is a balancing item so that total credits and debits of the three accounts must equal in accordance with the principles of double entry book-keeping so that the balance of payments of a country always balances in the accounting sense. In theory, the Capital and Financial Account balance should be equal and 'opposite' to the Current Account balance so that the overall Account balances, but in practice this is only achieved by the use of a balancing item called ***net errors and omissions***. This device compensates for various errors and omissions in the balance of payments data, and which brings the final balance of payments account to zero.
The errors may be due to statistical discrepancies & **omission may be due to certain transactions may not be recorded**. For e.g.: A remittance by a Rwandan working abroad to Rwanda may not get recorded, or a payment of dividend abroad by an MNC operating in Rwanda may not get recorded or so on. The errors and omissions amount, equals to the amount necessary to balance both the sides.

Financing deficits/ How to correct a BOP deficit.

1. Selling gold or holdings of foreign exchange, such as US dollars, yen or euros,
2. Borrowing from other Central Banks or the International Monetary Fund (IMF)
3. Using of foreign exchange reserves available
4. sale of public assets abroad
5. Seeking aid and grants from other countries
6. Attracting foreign investments into the country
7. Import substitution strategy
8. Restrictive monetary policy i.e. reduces the amount of money in circulation
9. Improving the service industry e.g. tourism
10. Devaluation.
11. Export promotion strategy — increase the volume of exports and improve the quality of exports.
12. Increase taxes and reduce government expenditure i.e. fiscal policy.

13. Direct control — tariffs; quotas; exchange controls; complete ban, i.e. import restrictions.

N.B

Establishing BOP balance by using the above measures is called ***accommodating BOP*** and the items used to get rid of a BOP deficit are known as ***settlement or accommodating or compensatory or induced items.***

4.2.2.2: Financing surplus/ How to offset a BOP surplus.

1. Buying gold or currencies.
2. Paying off debts.
3. Building a stock of foreign exchange reserves
4. Lending to foreign countries
5. Providing aid and grants to other countries
6. Purchase and storage of durable goods
7. Opening current account deposits in foreign banks
8. Purchase of short- and long-term securities from abroad
9. Direct investments abroad.

N.B

The expenditure aiming at getting rid of the BOP surplus through the above means is known as ***autonomous expenditure*** and the items used are known as ***autonomous items.***

4.2.3.1: Causes of BOP deficits in developing countries.

1. **Narrow Export Base**: Most developing countries have a narrow export base, basically agricultural commodities
2. **Consumption oriented society:** Due to rapid rise in population and increased consumption habits in most developing countries, the domestic manufactured goods are mostly consumed in the country
3. **Poor technology in less developed countries:** There is less modernisation, balancing and replacement of machinery in the industrial sector in most developing economies.
4. **Production of primary products:** Most developing countries produce and export primary products which are both price and income inelastic thus earning less from international trade
5. **Devaluation**: The repeated devaluation of developing countries' currencies has not helped in the increase of exports. It has made the imported inputs costlier. The demand for their goods in the international market is inelastic

6. **Heavy protectionist policies by Developed countries**: Protectionist policies by developed countries on developing countries like imposition of tariff and non-tariff barriers have adversely affected developing countries' exports..
7. **Fall in Terms of Trade**: The import unit values are higher than the export unit values for most Developing countries. A decline in terms of trade causes imbalance in the balance of payment.
8. **Foreign Debts Servicing**: High expenditure on debt servicing since most Developing countries are poor and mostly rely on foreign resources especially through borrowing.
9. **Import of Capital Goods**: Most Developing Countries import expensive capital goods for rapid industrialization of their countries in order to build up the economy. The heavy import of machinery has considerably increased the import bill and has adversely affected balance of payment.
10. **High demonstration effect**: Most developing countries have Import oriented economies through demonstration effect leading to high demand for capital and luxurious goods thus leading to high foreign exchange expenditure which adversely affect BOP position.
11. **Rise in Oil Prices**: The sharp rise in the prices of oil in the recent past is taking a big amount of the foreign exchange earnings. Developing countries import bill of petroleum group increases year after year leading to BOP problems in Developing Countries.
12. **Political instabilities and insecurity**:Experience shows that political instability and disturbances in Developing countries cause large capital outflows and hinder Inflows of foreign capital.
13. **Fluctuations in the prices of exports of Developing Countries:** Since Developing Countries normally export primary products, their prices keep on fluctuating in the international market therefore BOP deficit when export prices fall.
14. **Imported inflation.:** Since most Developing Countries import expensive capital goods, it makes them to produce expensively thus leading to expensive exports which reduces their demand in the external markets thus less foreign exchange earnings from them.
15. **High population growth in Developing Countries:** High population growth in poor countries adversely affects their BOP because it increases the needs of the countries for imports and decreases their capacity to export.
16. **Natural calamities in Developing Countries:** Natural calamities like bad weather reduce the yields from the agricultural sector as their dominant export sector thus leading to adverse BOP.
17. **Poor infrastructure in most Developing Countries:** Most Developing countries have poorly developed and insufficient socio-economic infrastructure which has led to supply rigidities thus less export volume and therefore less earnings from them.
18. **Changes in fashions, tastes and preferences in the world market:** This has reduced on the demand for Developing countries' exports thus adversely affecting their BOP position.

19. **Unfair International Commodity Agreement (ICA):** Weak ICA leading to less bargaining powers in the international markets leading to low export prices and low earnings from exports hence BOP deficits.
20. **Insufficient export promotion institutions** to promote export sector through encouraging vent for surplus in most Developing Countries.
21. **Inflation in most Developing Countries' economies:** Most Developing countries' economies are hit by inflation which makes their exports expensive leading to low demand for them in the international markets thus earning less from them.
22. **Depreciation of Developing countries' currencies:** Persistent depreciation of Developing countries' currencies has made their products (exports) cheap while imports expensive thus high foreign exchange expenditure.

4.2.3.2: Solutions to BOP deficits in developing countries:

1. Export promotion: Export promotion agencies, Export Development Fund and Export Processing Zones etc. should be made more active to increase export and to correct the BOP.

2. Import restrictions and Import Substitution. Governments should increase import duties on commodities similar to those produced at home, encouraging domestic industries to use local raw materials so as to manufacture Import substitutes in the country

3. **Use restrictive monetary policy to control inflation** which discourages exports and encourages imports. This lowers the prices in the country for domestic commodities thus raising their demand in and out of the country.

4. **Government should control foreign exchange** by ordering all exporters to surrender their foreign exchange to the central bank and then ration out foreign exchange among licensed importers.

5. **Devaluation of domestic currency** which makes domestic goods cheaper for the foreigners. However, care should be taken that devaluation should not cause rise in internal price level.

6. **Encouraging investors** through establishing institutions that help and advise investors on investment prospects in the country.

7. **Opening new markets** and making regional groupings to widen markets for their exports.

8. **Ensuring political stability and security** in all parts of the country so as to attract investors, easy exploitation of resources which increases production activities thus increase the volume of exports and as well reduce on the expenditure on importation of military hard ware.

9. **Training local manpower** e.g. through universal primary and secondary education and setting up different training institutions so as to increase skills of indigenous manpower and reduce foreign expatriates.

10. **Seeking and being granted a debt relief** so as to reduce expenditure on debt servicing.
11. **Population Control** so as to reduce on foreign exchange expenditure on imported commodities to cater for the alarming population.
12. **Innovations and inventions** to improve on technology so as to improve on productivity, increase the volume of exports and foreign exchange earnings as well. This also improves the quality of products according to international standard.

13. **Strengthening the tourism industry** as an export diversifier.
14. **Strengthening the ICA** so as to increase the export volume and bargaining power as well.
15. **Economic legalization** so as to increase domestic productivity and export volume.
16. Developing countries should process their primary products which adds value to them thus more foreign exchange earnings.
17. Labour intensive industries should be established, because labour is cheaper in Rwanda, these industries can be set up at lower cost. The products of these industries can be exported.
18. **Reduction in export duties which** makes developing countries' export competitive in the international market. Foreigners will prefer to import from developing countries because of low prices.
19. **Joint Venture:** Establishing industries with joint venture of foreign investors can also push up the export sector. The products of these industries can be sold in the foreign market.
20. **Import of Only Essential Items:** Only essential items should be imported which are needed for our industrial production. Import of luxuries should be banned. People should be educated to come out from the complex of foreign goods.
21. **Infrastructural development:** Rehabilitate and develop socio-economic infrastructure to increase production and exchange of goods and services across national borders to increase foreign exchange earnings.
22. **Exchange Control** so to minimize the imports. Exchange control should be followed, so that there is no wastage of foreign exchange to import of un-necessary commodities and luxuries.

EXERCISE 1

1. Distinguish between tariff barriers and non-tariff barriers to trade
2. Explain the various non-tariff barriers used to restrict international trade in your country
3. Explain argument for and against protectionism policy.
4. (a) What is trade liberalization?

   (b). Would you advocate for trade liberalization, why?

EXERCISE 2

Balance of Payment Account	
Credits (+) - Receipts	**Debits (-) - Payments**
1. Current Account	
Exports	**Imports**
a) Goods b) Services c) Transfers	a) Goods b) Services c) Transfers
2. Capital Account	
a) Borrowing from foreign countries b) Direct investments by foreign countries	a) Lending to foreign countries b) Direct investment in foreign countries
3. Official settlement account	
a) increase in foreign official holdings	a) increase in official reserve of gold and foreign currencies.
4. Errors and Omissions	

Analyse the information in the table above and answer the questions that follow.

a) What does the table portray?
b) Why are some items recorded on the credit items while others on the debit side?
c) What examples can you give on transfers on either side?
d) What does direct investment by foreign countries and direct investment in foreign countries mean?
e) Describe how each account works.

EXERCISE 3

1. With examples, distinguish between credit and debit items on the BOP account.
2. What do the following mean on the BOP accounts?
   i) A "+" placed on the credit entry.
   ii) A "-" placed on the debit entry.
3. Fill in the gaps below.
   i) Any time an item (good, service or asset) is exported from a country, the value of that item is recorded as a ………………… (…) entry on the balance of payments, while
   ii) Any time an item (good, service or asset) is imported into a country, the value of that item is recorded as a ……………… (…) entry on the balance of payments.
4. a) If credits are Rwf5, 000,000 and debits are Rwf4, 000,000, what is the net balance on the BOP account? Interpret your answer.
   b) If exports are Rwf80bn and imports are Rwf100bn then how much are net exports? Interpret your answer.

EXERCISE 4

1. A balance of payments surplus means;

a) A country's export earnings are less than her expenditures on imports.
b) A country's export earnings are more than her expenditures on imports.
c) A country's earnings from exports are equal to what it spends on imports.
d) Only exports but does not import at all.
2. The balance of payments always balances in the accounting sense because of the following except;
a) Total domestic expenditures (C + I + G) must equal current income (C + S + T)
b) Domestic saving (Sd) must equal domestic investment (Id).
c) An export surplus on current account (X > M) must be offset by an excess of domestic saving over investment (S > Id).
d) Inflows must always be greater than outflows.
3. Explain how a deficit or surplus is measured in the balance of payments.
4. Fill in the gaps below;
a) If the total debits are more than total credits in the current and capital accounts, including errors and omissions, the net debit balance measures…………………………………………………………………………….
b) If total credits are more than total debits in the current and capital accounts, including errors and omissions, the net debit balance measures………………………………………………………………………………

EXERCISE 5

1. a) To what extent is inflation a cause of BOP in LDCs.
b) What policy measure would you suggest to reduce BOP problems in Rwanda?
2. (a) What fiscal and monetary measures may be employed to reduce inflationary pressures on the external balance of payments?
(b) What is the relationship between the domestic economy and the balance of payments?
3. Balance of payments must always "balance". With reference to your country, explain the Existence of either "favourable or unfavourable" balance of payments position.

ASSIGNMENT

UNIT 1: INTERNATIONAL TRADE

1a) Why Rwanda participates in international trade

b) Describe the forms of international trade with relevant example.

2a) Explain the different terminologies used in international trade

b) Explain the arguments for and against bilateral and multilateral trade relations

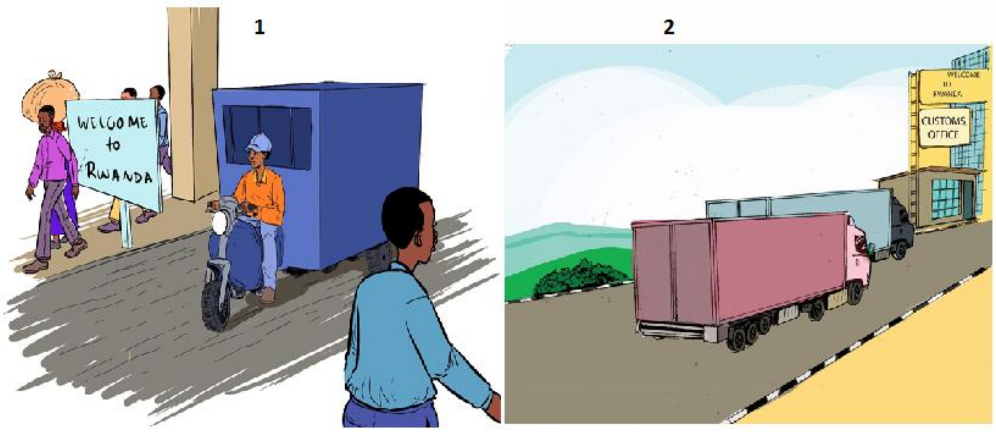
3a) Explain the valuable impacts international trade has brought to Rwanda's economy

b) Why developing countries are not able to benefit from international trade as much as developed countries, based on the comparative cost advantage

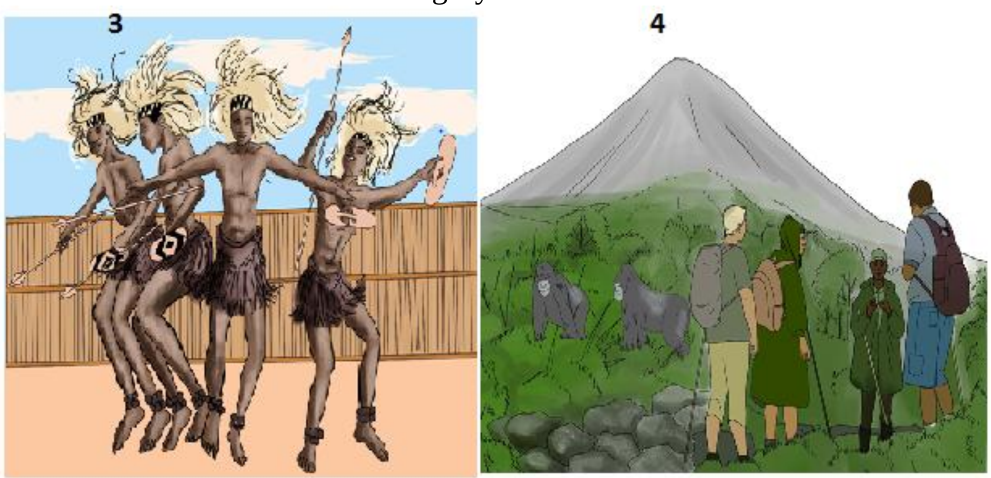
4a) Why do we buy goods from abroad if we can make them locally

b) Discuss the view that where there is no comparative advantage there is nothing to gain from international trade

5a) Consider the view that gains from international trade are biased in favour of advanced industrial countries
b) Analyse the case studies below and answer the questions that follow:
1. *Muramuzi and Munana are both traders in Rwanda they produce and sell their goods in any district of their choice in Rwanda.*
2. Nkurunziza and Vuguziga produce flowers and craftwork respectively, they sell in Rwanda and other countries outside Rwanda.
Required:
(i) Basing on types of trade you know, what do we call trade in scenario 1 and 2 respectively?
(ii) What are the likely effects from each scenario above?
6a) **Analyse the case studies below and answer the questions that follow.**
1. Suppose Ishimwe, a Rwandan trader, signs a trade agreement with Musheija, a Tanzanian trader, to always exchange commodities together, how would you call that in relation to the notion of forms of international trade?
2. Ishimwe and Musheija have now diversified their trade agreements, after their countries joining different economic groups like African Union COMESA etc., they exchange their commodities with other countries' traders; how would you call that in relation to forms of international trade?
3. Muhirwa and Masenge are two farmers who produce same commodities i.e. Passion fruits and oranges respectively. It is assumed that they all have equal resources but Muhirwa produces 60 tons of passion fruits and 90 tons of Oranges per season while Masenge produces 40 tons of passion fruits and 80 tons of oranges per season. Given this situation and using the knowledge gained from the theories of international trade in this unit;
i) Which theory of international trade is explained in the above case study, and why?
ii) If they are to specialise, who should specialise in which commodity and why?
b) **How would you call the form of trade where:**
i) Rwanda receives tourists from Ethiopia or hires doctors from India?
ii) Rwanda sells her Tea to Zimbabwe or buys cars from China?
iii) How would you distinguish the two forms of trade in (i) and (ii) above?
(iv) Which of the two forms of exchange mentioned in (iii) above do you think benefits Rwanda
7. Analyse the images below and answer the questions that follow.



Category A



Category B

Required:

a) In terms of trade, how are the two categories above different?

b) Supposing those commodities shown in the categories above are either entering or leaving out of the country, what specific name is given to each case?

c) How do we call that trade in such commodities, in case they are exchanged;

i) Within the boundaries of a country where they are produced?

ii) Across the borders of the country of production?

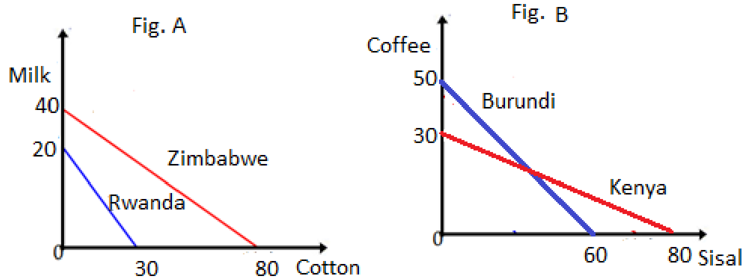
d) What makes it different to trade within the country's boundaries and across her territories?

8. **Study the images below and answer the questions that follow**:

With reference to Rwanda's economy based on the photos above;

a) Name what each photo portrays.
b) Identify the exports and imports of Rwanda shown in the above photos.
c) Analyze the impact of international trade to her development process.
d) Explain what you think might be the hindrances to smooth international trade.

9. Analyse the figures below and answer the questions that follow.



a) In each figure, identify the theory of international trade portrayed with supporting reason.
b) What makes a difference between the two figures above?
c) In which commodity should each country specialise and why?
d) Examine the factors and benefits of comparative advantage.

UNIT 2: TERMS OF TRADE

10. **Analyse the case study below and answer the questions below it.**
In 2017, Rwanda exported her tea to Brazil and in turn imported guns from there. The price of tea per ton was 800 dollars while that of a gun was 1,700 dollars. The next year i.e. 2019, tea prices in the world market fell by 20% while that of guns remained constant.

a) What economic term do we call the relationship between Rwanda's export prices and import prices?
b) Calculate the terms of trade for Rwanda in 2017 and 2019 respectively.
c) Describe the nature of terms of trade of Rwanda in 2017 and 2019 respectively. Support your answer.
d) How can terms of trade be expressed?

11a) What distinguish barter terms of trade from income terms of trade?
b. Study the table 1 below showing terms of trade for a country (2012-2016) and answer the questions that follow;
Table 1

Year	**Export price index**	**Import price index**	**Terms of Trade**
2015	100	100	
2016	130	110	
2017	110	124	

2018	120	140	
2019	165	190	

iii) Calculate the terms of trade for the years 2015 to 2019

iv) Explain the nature of terms of trade between 2016 and 2019 and support your answer.

c. Why have terms of trade tended to move against developing countries'economies?

d. Does favourable terms of trade mean favourable balance of trade?

12 **Analyse the case study below and answer the questions below it.**

In 2018, to purchase laptops from China, it required Rwanda to export 200 tons of coffee there. Suppose each ton of coffee cost $20 and that of laptop is $60;

i) How many laptops did Rwanda purchase from China using her tons of coffee?

ii) What economic term is given to relationship between the value of Rwanda's coffee and China's laptops?

iii) Describe what the term named above means to an economy.

iv)Describe how the different forms of terms of trade can be expressed.

13a)**Under what circumstances may the capacity of a country to import**

i) Increase.

ii) Decline.

b) Describe the different directions the terms of trade position of a country can take.

c) If in 2019 Rwanda exports 1000 tons of hides and skin to Brazil each at US$ 500 in exchange for cars each at US$2000

i) What are we aiming at in looking at prices of imports and exports plus their quantities?

ii) Describe the relationship between Rwanda's export and import values.

iii) Calculate the income terms of trade and barter terms of trade in 2019 and interpret your findings.

14a) Examine the possible causes of changes in the terms of trade for developing countries.

b) Explain the effects of deteriorating terms trade in your country.

15a) Calculate the terms of trade index given the index of export prices as 80 and the index of import prices as 120. Interpret your answer.

b) Given that in 2018 the price of exports was 160, price of imports was 280 and quantity of exports was 80, calculate;

(i) Barter terms of trade.

(ii) Income terms of trade.

(iii) If in the following year price of exports increased to 200 holding prices of imports constant, calculate the barter terms of trade and interpret the terms of trade.

16) Distinguish between favourable terms of trade and unfavourable terms of trade.

b) How would you advise your country to have her terms of trade favourable year after year?

c) What conditions do you think are in place for?

(i) Favourable terms of trade.

(ii) unfavourable terms of trade.

17. Study the table below showing the terms of trade for country G (2011-2015) and answer the questions that follow;

Table 2

Year	**Export price index**	**Import price index**	**Terms of trade**

2014	100	100	
2015	420	370	
2016	250	210	
2017	180	230	
2018	160	190	

Required:

(i) Calculate the terms of trade for the years 2014-2018 and interpret for each year.

(ii) Describe the terms of trade for country G in 2017.

(iii) Advise country Z on her terms of trade position for the next year.

UNIT 3: FREE TRADE AND TRADE PROTECTIONISM

18a)What is meant by the term free trade

b) Briefly explain the term free trade according to Adam smith.

c) To what extent has free trade contributed towards the growth and development of a country's international trade?

19a) Discuss the view that protectionism should be adopted if developing countries are to achieve high growth rates.

b)What is meant by commercial a policy?

c) What are the objectives of such a policy in Rwanda?

d) What policy tools have been adopted in Rwanda to improve her domestic industrial or Commercial welfare.

20a) Distinguish between tariff barriers and non-tariff barriers to trade

b) Explain the various non-tariff barriers used to restrict international trade in your country

21. Explain argument for and against protectionism policy.

22a)What is trade liberalization?

b) Would you advocate for trade liberalization, why?

23a) What are infant industries?

b) Suggest any three ways of protecting infant industries in your country

24a) Explain reasons as why the government may take an increase in the use of quotas compared to other methods.

b) Explain the following theories of commercial policy

i) The national defense theory

ii) The infant industry theory

iii) The antidumping theory

UNIT 4: BALANCE OF PAYMENT

25a**)** Describe what you understand by the term Balance of payment

b) **State the economic terms given to the situations where there is;**

i) Import expenditure being greater than export earnings

ii) Import expenditure being less than export earnings

iii) Import expenditure and export earnings are equal.

iv)Trade in only goods
v)Trade in only services.
iv) Relationship between trade in goods only and services only respectively.
v) Statistical record of the character and dimensions of the country's economic relationships with the rest of the world.