INTERNATIONAL TRADE & FINANCE

- This is trade btwn many countries of the world.
- Bilateral trade is a situation where only two countries are involved in trade.
- International trade involves exchange of goods & services or the flow of goods & services or even capital from one country to another.

Benefits/ Advantages of International Trade.

1. Facilitates improvement of infrastructure
2. Enables countries to acquire goods that they can't produce cheaply at home.
3. Promotes exchange of technology among diff. countries
4. Encourages mobility of factors of production from one country to another.
5. Improves the standards of living of citizens as they can import goods which are not produced at home.
6. Prevents emergence of monopoly.
7. Market prices of goods fall due to stiff competition.
8. A variety of goods & services are made available.
9. Encourages efficiency due to stiff competition among diff. countries.

Limitations/ Disadvantages of International Trade.

1. Brings erosion of culture.
2. Causes unfavourable balance of payments. $X < M$
3. Leads to depreciation of domestic currency.
4. Can cause unemployment due to importation of cheap labor & goods.
5. Can result to negative externalities such as pollution.
6. Exhaustion of natural resources which in the long run will cause borrowed inflation.

Theories of International Trade.

7/10/2016.

1. Theory of Absolute Advantage - Adams Smith.

- This was proposed by Adam Smith.
- A country is said to have an absolute advantage in the production of a commodity if it can produce a commodity more efficiently (with lower costs) than another country.
- The theory says a country should produce & export goods & services in which has a cost (absolute) advantages vis a vis with trading partners & should import those commodities it has negative (absolute) advantage.
- Smith developed his theory of absolute advantage by applying labour theory of value.
- This argues that the value of a good is proportional to the amount of labour employed in production.

Country.	Cost of producing one unit (in man hours).	
	Tea	Cloth
Kenya	5	10
UK	10	5

- In Kenya to produce one unit of tea it costs 5 man hours but to produce one unit of cloth it costs 10 man hours.
- In the UK, to produce one unit of tea, it costs 10 man hours but to produce one unit of cloth, it costs 5 man hours.
- So it is more costly to produce cloth in Kenya & equally to produce tea in the UK ∴ Kenya has absolute advantage in production of tea vis a vis the UK & the U.K has absolute advantage in production of cloth vis a vis Kenya.

NB/ A country can also be said to have absolute advantage if it can produce more of a commodity than another country, given its resources.

2. Comparative Advantage Theory. - David Riccardo.

- The theory was put forward by David Riccardo.
- He believed that 2 countries can still gain even if one country is more productive than the other in all the lines of production.
- A country has a comparative advantage if it can produce sth at a lower cost than another country.

Assumptions.

1. Only two countries are involved in international trade.
2. Only two commodities are traded in the international trade
3. No transport cost of goods traded btwn the two countries.
4. No barriers of trade. Existence of free trade.
5. Free factor mobility. ie free mobility of resources from one type of activity to another - occupational mobility.

	Cost of producing unit (in man hours)	
I	A	B
II	8	9
II.	12	10

- Country I has an absolute advantage in production of both commodities.
- It still pays both countries to trade. What is important is the comparative advantage.
- A country is said to have a comparative advantage in production of a commodity if it produces it at a relatively lower cost than another country.
- It should import those goods in which it has a relatively high cost of producing.
- Riccardo demonstrated this by introducing the concept of opportunity cost.

$\frac{\Delta Good1}{\Delta Good2}$ $\frac{8}{9} = 0.88$ $\frac{\Delta Good2}{\Delta Good1}$ $\frac{9}{8} = 1.125$

$\frac{12}{10} = 1.2$ $\frac{10}{12} = 0.83$

- The O.C of good A is the amount of the other good which has to be given up in order to produce one unit of the good.
- To produce a unit of Good A in Kenya, you need 8 man hours & 9 man hours to produce Good B in the same country.
- It is thus more expensive to produce Good B than Good A in Kenya.
- The O.C of producing a unit is equivalent to $8/9 = 0.88$ units of Good B.
- One unit of B $9/8 = 1.125$
- In the U.K 1 a unit of A = $12/10 = 1.2$ & one unit of B = $10/12 = 0.83$ units of A.
- B is cheaper to produce in the U.K in terms of resources as opposed to producing it in Kenya.
- The OC are thus lower in the U.K in Kenya.
- We consider the commodity A valued in terms of B. A is cheaper in Kenya than in the U.K.
- A country has comparative advantage in producing a commodity if the O.C of producing it is lower than in other countries.
- Kenya has a lower OC in producing A than B & the U.K has a lower opportunity cost in the production of B than A.
- In Kenya, they should specialize in production of A & import B.

Limitations.

1. Transport cost.
Although a country may have comparative advantage this may have little value 4 it is off set by high transport costs.
2. Factors mobility.
They are assumed to be mobile ~~howev~~ however in reality this is not the case.

3. The theory assumes that there are only two countries in the world & only two commodities produced. In reality there are many countries engaged in trade & many countries participate & join international trade each year.

4. Obstacles to trade eg currencies, tariffs, taxes

5. Increasing cost.
There is a possibility that specialization could lead to increase in cost.

6. Specialization itself can create problems if there is a change in demand & also the theory does not explain how comparative advantage arises in the first place

Protection in Finance (Protectionism)

- This is a form of obstacle to international trade.
- Protective restrictions are normally imposed with an objective of protecting the infant industries.
- The restrictions may be imposed in the following forms;

1. Custom duty (Tariffs).
- These are imposed on goods entering into a country to reduce imports & ∴ protect domestic industries.
- The aim of import duties also include;
a) Correcting balance of payments (imbalance). Exports - Imports. E < I
b) Raising revenues for the govt.
- They are levied to enable domestic producers to compete on a more favourable term by making imported goods more expensive.

2. Quotas.
- Whereby a physical restriction is imposed on volume of goods which may be imported.
- To effect this, an import license is introduced.
- Each govt sets limits on the volume of goods of a particular type which may be imported each year.

3. Control of foreign currency.
- The govt. makes it hard for people to access foreign exchange making import difficult.

4. Subsidies.
Sometimes a govt can give subsidies to producers or manufacturers of locally made goods i.e so that the M.P of such commodities are cheaper than corresponding imported products. thus discouraging imports.

5. Administrative controls.
There are many administrative methods making it difficult to sell specific goods in certain countries eg a govt. may insist on technical specifications that would make it hard for certain goods to enter the country.

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6. Total ban or Trade embargo
In order to protect the domestic industry, the govt. can impose total ban on imported goods.

7. Hidden import substitution.
It is used to correct a balance of payment whereby the country concerned can decide to produce local domestic goods which will prevent the citizenship from importing goods.

Reasons/Advantages for Protectionism. May 2016 7b.

1. Protection of infant industries.
Protective policies are often used in developing nations to give new industries the opportunities to establish themselves.

2. To correct B.O.P deficits.
B.O.P is the diff btwn X & M. If an economy faces unfavourable B.O.P where M > X, the govt may introduce protective measures to discourage imports.

3. To raise govt revenue through customs.

4. To discourage dumping of goods.
Dumping occurs in a situation whereby the price of a good in a domestic market is higher but lower in a foreign country.

5. To protect strategic industries such as agriculture, manufacturing etc.

6. Economic recovery argument.
When an economy is facing depression or recession, the govt may develop protective methods to stimulate investments.

B.O.P
T.O.T

BALANCE OF PAYMENTS. May 2016 6a. 10/10/16.

- This is the difference btwn receipts from other countries & payments to other countries in a yr.
- It is the difference btwn inflows & outflows ~~of cu~~ for foreign currencies of a given economy for a given year.
- B.O.P is the economic transaction of one country with the rest of the world.
- It is the diff btwn visible & invisible exports vs visible & invisible imports.
- B.O.P will be surplus if total receipts > total payments.
- In this case, the B.O.P is favourable.
- On the other hand, B.O.P is said to be deficit if total payments are greater than receipts. In such a case, B.O.P is said to be unfavourable.
- It can be at equilibrium position if total payments are equals to ~~tot~~ total receipts.

BALANCE OF TRADE

- It is the difference btwn visible exports & visible imports. On the other hand, the B.O.P includes both visible & invisible items.
- The B.O.T is ∴ part of the B.O.P.
- Visible exports & imports refers to tangible (physical) goods. eg clothes, electronics etc.
- Invisible exports & imports refers to services eg banking, tourism, insurance, education etc.

Components of Balance of Payments.

a) Current Account:
It shows the balance btwn the exports & imports of visible & invisible items during a particular year.

b) Capital Account:
This involves long term payments either inwards or outwards. This includes foreign loans & grants.

Causes of Disequilibrium in B.O.P.

1. Unfavourable Terms of Trade of Primary Products.
T.O.T are unfavourable since we get very low prices for exports but pay exorbitant prices for the imports of manufactured goods.

2. Shortage of capital.
Most of the less developed countries are producers of primary products & cannot process some of the minerals & agricultural resources due to lack of capital.

3. Increase in Imports.
Imports of poor countries are too high.

$$T.O.T = \frac{\text{Export Price Index}}{\text{Import Price Index}} \times 100\%$$

4. Natural calamities.
such as droughts, floods, famine etc.

5. Devaluation policy.
Devaluation adopted by other countries may result in B.O.P deficit in other countries eg If Uganda devalues her ~~ex~~ currency then her coffee will become cheaper in international markets than Kenya's coffee lowering demand for Kenyan coffee.

6. Capital flight:
When large volumes of capital are withdrawn or moved from a country, it can result to B.O.P deficit.

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Methods of Curing Unfavourable B.O.P.

1. **Export promotion.**
This can be achieved by encouraging production of goods for export to help increase exports. eg; a) giving export compensation to exporters
b) Using commercial attachees in embassies abroad to promote exports & trade fairs
c) doing international exhibitions in other countries to promote exports
d) Customs drawbacks - we return customs paid to import inputs to be used to make goods 4 export
e) Giving subsidies to local producers
f) Devaluation of currency to make exports cheaper

2. **Import restrictions**
Imports of consumer goods are discouraged while imports of producer goods is encouraged.

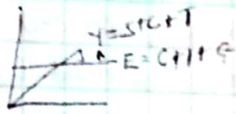
3. **Devaluation.**
Exports become cheaper to foreigners & imports to the residents become expensive. This helps to correct unfavourable B.O.T.

4. **Diversification of exports.**
One way of reducing deficits in B.O.P is for developing countries which depend on one or two export commodities to diversify their exports ie increase the range of commodities they export.

5. **Increased production.**
Expanding production of goods & services will lead to increase in volume of exports

6. **External ~~soft~~ sought loans.**
Loans can be sought from the IMF & World Bank

7. **Deflation.**
This is a policy of reducing expenditure with intention of curing a deficit by reducing demand for imports.



Currency Devaluation & Currency Depreciation.

- Devaluation is the deliberate lowering of the value of a domestic currency against any acceptable foreign currency.
- The reasons for devaluing a domestic currency against hard currencies is to improve terms of trade & correct unfavourable B.O.P.
- When a currency is devalued, against foreign currencies, the exports of a country becomes cheaper & imports become expensive to citizens decreasing the volume of imports.

Conditions Necessary for Currency Devaluation to Work.

- Devaluation policy is not adopted by the other countries.
- Demand for exports in the international markets must possess a higher elasticity of demand.

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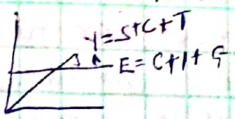

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3 Inflationary pressure does not increase because costly imports increase prices in the country.

4 Extra exports must be available.

- Currency depreciation occurs if demand for goods produced by a particular country goes down in the international markets.
- Its currency will lose its value.

Effects of Currency Depreciation.

1. It can lead to capital flight where international investors may take their money out of the country.
2. High prices of import items.
3. It makes the exports of the country cheaper.
4. Increased exports.
5. Reduction in imports since they are too expensive.
6. T.O.T will be unfavourable.

Currency Appreciation.

- It occurs if there is a high demand for goods produced & exported by a country
- This occurs because there will be high demand for domestic currency by foreigners to enable them to purchase goods produced by that country whose demand for its products is high.

REGIONAL ECONOMIC INTEGRATION

Economic integration is a process or state of affairs designed to abolish discrimination btwn economic units belonging to diff. national states.

Types of Economic Integrations.

1. Free trade Area.
It exists when a no. of countries agree to abolish tariffs, quotas $ any other physical barriers to trade btwn them while retaining the right to impose as they ~~wh~~ wish their own level of customs duty on trade with the rest of the world.

2. Customs Unions
Exists when a no. of countries decide to permit free trade among themselves without trade barriers while imposing a common external tarrif against imports from the rest of the world.

3. Common Markets.
The countries in addition to forming a custom's union decide to allow mobility of citizens to take up employment in the other country $ factors of production are mobile.

4. Economic Union
- Countries set up joint economic institutions involving a degree of international economic decision making.

14/10/16.

Arguments for Economic Groupings in Africa.

1. Increase in competition
The enlarged market will increase competition btwn firms leading to efficiency in production.

2. Improvement of infrastructure in the region.

3. Facilitates mobility of expertise & technology btwn countries.

4. Allows citizens to access a variety of goods.

5. Extension of industry.
The large market created by economic groupings will lead to establishment of large industries which produce for high demand.

6. Extension of market.
Permitting economies of scale to be enjoyed.

7. Trade creation.
It allows a country to shift or change its source of import or supply from a more expensive source to a cheaper source.

Arguments Against Economic Groupings in Africa.

1. Most countries produce similar goods hence they are not of much assistance to each other.

2. Unequal benefits - Some countries benefit more than others from the union.

3. Diff levels of development.
Some countries are more developed than others

4. Loss of revenue through abolishment of customs duty.

5. Poor infrastructure inhibits trade btwn countries.

6. Political instability.

7. Diff. in ideology.

8. Trade diversion. - This is where a country's source of import is shifted from a cheaper source to a more expensive source.

INTERNATIONAL INSTITUTIONS (BRETTON INSTITUTIONS.

- These are also referred to as the Bretton woods Institutions.
- They were formed in Bretton woods after the World War to finance the reconstruction of the economies of the affected countries.

INTERNATIONAL MONETARY FUND.

Objectives:

1. Facilitate & promote international trade among member countries.
2. To encourage economic co-operation among member countries.
3. To ensure stability in foreign exchange rates.
4. To eliminate exchange rate control among member countries.
5. To reduce disequilibrium in international B.O.P of members.
6. To promote investment & capital formation.

EXTERNAL DEBT PROBLEM.

- The causes of persistent & rising external debts are;

1. Misappropriation of funds.
   The misuse of this funds increases the burden of external debts.

2. Natural calamities & adverse conditions.
   eg poor weather conditions & other natural disasters.

3. Budgetary deficits.
   Most developing countries are not able to raise enough revenue internally to finance their budgets

4. Low domestic savings.
   The NI of most developing countries is too low & as a result, savings are low

5. Population pressure.
   Increased population increases govt expenditure drastically.

6. Unfavourable terms of trade.
   As a result of this, countries receive low prices for their exports but pay high prices for imports.

7. Corruption.
   This is theft of public funds by state officials

8. Deficit B.O.P
   Receipts from foreign countries are less than payments to foreign countries.

9. Over-reliance on foreign aid.

Solutions to External Debt Problems.

1. Increase domestic savings & internal borrowing.
2. Proper & effective use of funds.
3. Improving terms of trade
4. Improving collection of taxes
5. Reducing population growth rate.
6. Eradicating corruption so as to utilise resources or funds appropriately.
7. Take appropriate measures to increase exports & decrease imports
8. Professional feasibility study should be carried out to determine the economic viability of projects.

Floating / Fluctuating

Exchange Rates.

- This is the rate at which one currency can be exchanged for another or the price of one currency in terms of another.
- There are diff. sys. under which exchange rates are determined;

1. Floating / Fluctuating Exchange Rate Sys.

- It is determined by the demand & supply of the country's currency. If the exchange rate is left free to find its own level according to supply & demand, this is termed as free float.
- If the govt behind the scenes is taking action to influence it (by buying or selling its currency) this is termed as controlled float.

Advantages of a Floating Sys.

1. It permits a gradual, smooth & automatic adjustment to a country's exchange rate. There is no sudden overnight change that warrants mass speculation.
2. There is no need to have to work out what the new exchange rate should be. It will be found by demand & supply which will ensure appropriate rates.
3. There is no over or under valuation of currency.
4. It prevents rapid inflation from having a damaging effect on the countries' export.
5. Capital inflows do not create more money in the economy as the CBK does not have to create more money with which to buy foreign currency.

Disadvantages of a Floating Sys.

1. Speculation in the currency would cause the exchange rate to become unstable & to fluctuate excessively.
2. If the exchange rate fluctuates too much, they will adversely affect trade & capital inflows.
3. There will be general uncertainty & forward planning becomes more difficult.
4. Capital movements can change the exchange rate with damaging effects on the economy. eg If the exchange rate appreciates, the exports of the country shall be less competitive.

2. Fixed Exchange Rate Sys.

- This is a rate of exchange btwn 2 or more currencies which do not vary or at least only within narrow limits.
- It can take any of the following forms;

a) Gold standard - This occurs when a unit of a country's currency is valued in terms of a specific amount of gold.
b) Pegged - The govt pegs the exchange rate ie a rate is fixed & then guaranteed by the govt. The pegging can also be done in relation to another currency.

Advantages of a Fixed Exchange Rate Sys.

1. It makes International Trade more stable.
2. Less uncertainty about what the exchange rate is going to be.
3. Plans can be made for trade & investment since one is sure about the future.
4. The country is more likely to fight inflation firmly.
5. Countries cannot manipulate the exchange rate to take advantage.

Disadvantages

1. Foreign exchange reserves have to be maintained to help stabilize the exchange rates.
2. No smooth & automatic adjustment in the exchange rate.
3. The govt has to work out what the exchange rate should be.
4. A currency may be over/under valued.
5. Fixed exchange rates become inappropriate at times of high rates of inflation btwn countries.

3. Managed Flexibility Exchange Rate Sys. Dirty
- The exchange rate is allowed to fluctuate but not as freely as under the floating sys.
- If the govt feels that the exchange rate is too low it will step in & raise it eg by reducing the supply of the currency.

Foreign Exchange Reserves.

It constitutes a country's holding in foreign hard currencies by its local Central Ba

Generation of Foreign Exchange Reserves.

1. Increased exports.
2. Foreign investments.
3. Foreign aid.

Role of Foreign Exchange Reserves.

1. Facilitate international transactions.
2. Facilitate govt intervention. eg in fixed exchange regime.
3. To finance B.O.P deficit.
4.

Structural Adjustment Programs.

- These are proposals made by donors such as IMF to less developed countries to help tackle ~~their~~ macro-economic problems.
- Macro-economic problems include;
- Inflation.

10-11
11-12
8-9
9-10

2. Unemployment.
3. Uneven distribution of income & resources.
4. Unfavourable B.O.P & T.O.T
5. Low GDP growth rate.
6. Burden of external debt.
7. Huge budgetary deficits.
8. Low per capita income.
9. Poverty.

- SAPs reforms include;
1. Economic reforms such as;
a) Price decontrol for almost all goods & services.
b) Exchange rates decontrol
c) ~~Privat~~ Privatization
d) Interest rates to be determined by the forces of demand & supply.
e) Allow competition in production & distribution of goods & services.
f) Less govt. spending to avoid budgetary deficit.

2. Political reforms by;
a) Introducing multi-party democracy.
3 b) Economic governance & transparency in economic management by setting up mechanism to minimize corruption.
4 c) Reduce budgetary deficits by introducing cost-sharing in social services such as education & health.