

ECONOMICS
STUDENT-TEACHER'S BOOK
FOR TTC

3

OPTION:
SSE

© 2020 Rwanda Education Board

All rights reserved

This book is property of the Government of Rwanda. Credit must be given to
REB when the content is quoted.

FOREWORD

The Rwanda Education Board is honored to avail the Economics student book for teacher training Colleges (TTCs) in SSE and it serves as official guide to teaching and learning of Economics.

The Rwandan education philosophy is to ensure that young people at every level of education achieve their full potential in terms of relevant knowledge, skills and appropriate attitudes that prepare them to be well integrated in society and exploit employment opportunities.

The ambition to develop a knowledge-based society and the growth of regional and global competition in the job market has necessitated the shift to a competence-based curriculum. After a successful shift from knowledge to a competence-based curriculum in general education, TTC curriculum also was revised to align it to the CBC in general education to prepare teachers who are competent and confident to implement CBC in pre-primary and primary education. The rationale of the changes is to ensure that TTC leavers are qualified for job opportunities and further studies in higher education in different programs under education career advancement.

I wish to sincerely express my appreciation to the people who contributed towards the development of this document, particularly, REB staff, UR-CE lecturers, Teachers from general education and experts from Local Institution for their technical support.

I take this opportunity to call upon all educational stakeholders to bring in their contribution for successful implementation of this syllabus.

Dr. NDAYAMBAJE Irenée

Director General REB.

ACKNOWLEDGEMENT

I wish to sincerely express my special appreciation to the people who played a major role in development of Economics Teaching Methods and Practice. It would not have been successful without the support from different education stakeholders. My thanks first go to the leadership of UR-CE who started the review of the TTC curriculum in 2015.

I wish also to thank Rwanda Education Board (REB) leadership who took over and supervised the curriculum review process. I wish to extend my appreciation to Consultants, REB staff, Lecturers from UR-CE, TTC Principals, TTC Directors of Studies, Deputy Principals, Tutors and Teachers from General Education whose efforts during the revision process

MURUNGI Joan,

**Head of Curriculum Teaching and Learning Resources Department/
REB**

TABLE OF CONTENTS

FOREWORD	iii
ACKNOWLEDGEMENT	iv
INTRODUCTION.....	1
UNIT 1: INTERNATIONAL TRADE THEORIES.	4
1.1. International trade	5
1.2. Advantages, disadvantages and limitations of international trade.....	9
1.3: Theories of international trade.	14
UNIT 2: TERMS OF TRADE.....	30
2.1: Meaning and Forms of Terms of Trade:.....	31
2.2: Nature and how to improve the terms of terms of trade for developing countries.	34
UNIT 3: FREE TRADE AND TRADE PROTECTIONISM	40
3.1. Free Trade.....	41
3.2. Trade protectionism.....	45
3.3. Commercial policy	52
UNIT 4: BALANCE OF PAYMENT (BOP).	56
4.1. Meaning and terminologies used in Balance of Payment (BOP).....	57
4.2: Structure of BOP Accounts.....	58
UNIT 5: EXCHANGE RATES.....	72
5.1. Exchange rates.....	73
5.2. Devaluation.....	85
UNIT 6: ECONOMIC INTEGRATION.....	93
6.1: Meaning and objectives of economic integration.....	94
6.2: Conditions necessary for successful economic integration.....	96
6.3: Process/ stages/ levels of economic integration.	97
6.4: Advantages and disadvantages of economic integration.....	98
6.5: Obstacles/ impediments to successful economic integration in LDCs...	101
6.6: Case study of economic integration.	103

UNIT 7: GLOBALISATION	109
7.1: Meaning and forms of Globalization:	110
7.2: Multinational corporations (MNCs)	122
7.3: Foreign direct investments (FDIs).....	125
7.4: Global financial systems (GFS) and international financial institutions (IFI)	131
8.1. Economic growth	142
UNIT 8: ECONOMIC GROWTH AND ECONOMIC DEVELOPMENT..	142
8.2. Economic development.....	165
8.3.: Under development:.....	169
UNIT 9: AGRICULTURAL DEVELOPMENT.....	176
9.1. Meaning	177
9.2. Approaches to agriculture development	179
9.3 Measures to improve agricultural productivity.....	185
UNIT 10: INDUSTRIAL DEVELOPMENT.....	188
10.1: Meaning, advantages and limitations of industrial development.....	189
UNIT 11: DEVELOPMENT STRATEGIES:.....	206
11.2. Foreign aid and economic development.....	215
11.3: Infrastructure and economic development.	220
UNIT 12: ECONOMIC PLANNING.....	224
12.1. Economic planning.....	225
12.2: Principles of planning and qualities of a good economic plan	226
12.3: Classification of plans	228
12.4 Obstacles faced in formulation and implementation of development plans	234
UNIT 13: SECTORS OF THE RWANDAN ECONOMY:	236
13.1. Structure of Rwanda's economy	237
13.2. Privatization	252
REFERENCES.....	257

INTRODUCTION

This text book is part of the reform of the school curriculum in Rwanda: that is changes in what is taught in schools and how it is taught. It is hoped this will make what you learn in school useful to you when you leave school, whatever you do then.

In the past, the main thing in schooling has been to learn knowledge – that is facts and ideas about each subject. Now the main idea is that you should be able to use the knowledge you learn by developing competencies. These competencies include the ability to think for yourself, to be able to communicate with others and explain what you have learnt, and to be creative that is developing your own ideas, not just following those of the tutor and the text book. You should also be able to find out information and ideas for yourself, rather than just relying on what the tutor or text book tells you.

Activity-based learning

This means that this book has a variety of activities for you to do, as well as information for you to read. These activities present you with material or things to do which will help you to learn things and find out things for yourself. You already have a lot of knowledge and ideas based on the experiences you have had and your life within your own community. Some of the activities, therefore, ask you to think about the knowledge and ideas you already have.

In using this book, therefore, it is essential that you do all the activities. You will not learn properly unless you do these activities. They are the most important part of the book.

In some ways this makes learning more of a challenge. It is more difficult to think for yourself than to copy what the tutor tells you. But if you take up this challenge you will become a better person and become more successful in your life.

Group work

You can also learn a lot from other people in your class. If you have a problem, it can often be solved by discussing it with others. Many of the activities in this book, therefore, involve discussion. Your tutor will help to organize these groups and may arrange the classroom so you are always sitting in groups facing each other.

Research

One of the objectives of the new curriculum is to help you find things out for yourself. Some activities, therefore, ask you to do research using books in the library, the internet if your school has it. This, or other sources such as newspapers and magazines. This means you will develop the skills of learning for yourself when you leave school.

Skills lab

Economics subject is practical than being theoretical only that is why it requires time of skills lab which is a regular time on normal time table when student-teacher are required to complete learning activities working in manageable groups.

During skills lab activity student-teachers are given an opportunity to talk more and get more involved in the lesson than tutors. Student-teachers receive constructive feedback on work done (Tutor gives quality feedback on student presentations).

The Skills Lab prepares student-teacher to complete portfolio assignments on their own after classes. So the classroom activity should connect directly to the portfolio assignment and the tutor during the skills lab makes sure that he/she links the unit with the students.

Icons

To guide you, each activity in the book is marked by a symbol or icon to show you what kind of activity it is. The icons are as follows:



Thinking icon/Introductory activity

This indicates thinking for yourself or groups discussion. You are expected to use your own knowledge or experience, or think about what you read in the book, and answer questions individually or as group activity.



Thinking icon/Learning activity

This icon reminds you link your previous knowledge with the topic you are going to learn.

As a student feel free to express what you already know about the topic. What is most important is not giving the right answer but the contribution you are making towards what you are going to learn.



Application activity

Some activities require you to complete them in your exercise books or any other book. It is time for you show if you have understood the lesson by answering the questions provided.



Skills lab

This icon indicates a practical activity, such as a role play to resolve a conflict, participating in a debate and following instructions provided by the teacher. These activities will help you to obtain practical skills which you can use even after school.



End unit Assessment icon

This icon invites you to write down the results from activities including experiments, case studies and other activities which assess the attainment of the competences. Tutors are expected to observe the changes in you as student teacher.

UNIT 1

INTERNATIONAL TRADE THEORIES.

Key unit competence:

Analyze the importance of international trade to the development of the economy.



Introductory Activity

International trade is in principle, not different from domestic trade as the motivation and the behaviour of parties involved in a trade do not change fundamentally regardless of whether trade is across a border or not. However, in practical terms, carrying out trade at an international level is typically a more complex process than domestic trade. The main difference is that international trade is typically more costly than domestic trade. This is due to the fact that a border typically imposes additional costs such as tariffs, time costs due to border delays, and costs associated with country differences such as language, the legal system, or culture (non-tariff barriers). (Source: <https://en.wikipedia.org> 10/12/2019)

Required:

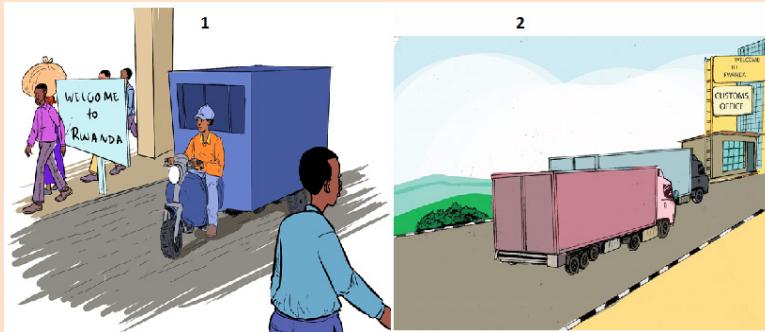
- i) What do you understand by the terms international trade and domestic trade?
- ii) What makes the two types of trade different?
- iii) How do countries get involved in international trade?
- iv) From the above extract, what makes international trade costlier than domestic trade?
- v) According to the extract above, if in practical terms, carrying out trade at an international level is typically a more complex process than domestic trade, why then, do countries go ahead to take part in it?

1.1. International trade

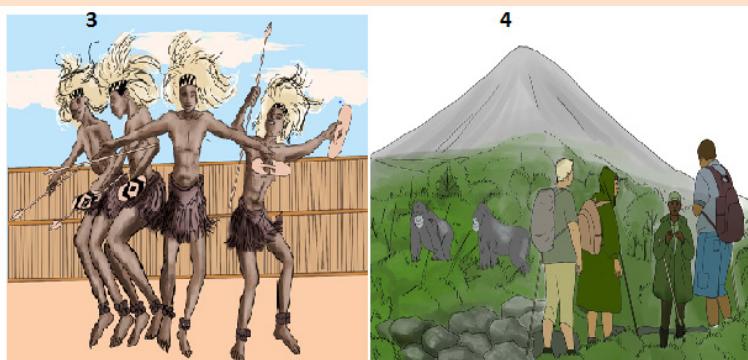
Activity 1.1



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?

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. In most countries, such trade represents a significant share of gross domestic product (GDP). Almost every kind of product can be found on the international market: food, clothes, spare parts, oil, jewelry, wine, stocks, currencies and water. Services are also traded: tourism, banking, consultancy and transportation. Therefore, trading globally gives consumers and countries the opportunity to be exposed to new markets and products.

A product that is sold to the global market is an export, and a product that is bought from the global market is an import. Without international trade, nations would be limited to the goods and services produced within their own borders. Whereas International trade constitutes those activities involving the exchange of goods and services across national boundaries, domestic trade involves exchange of commodities within the boundaries of a country. Therefore, international trade differs from domestic trade in the following aspects:

- 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.
- 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.
- Goods exchanged in domestic trade tend to be more standardized than goods in international trade. For instance, they are legally all measured either in metric or imperial standard measurement. If they are vehicles, they may have to conform to either being left-hand or right-hand drive vehicles. Hence, local production is for a standardized market. But in international trade, producers are confronted with different markets and may have a variety of different standards for different markets to fulfill.
- 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.
- 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.

- 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:

Activity 1.2



Visit the library or any other economics resource Centre, make research on international trade and thereafter, answer the following questions herein.



Basing on the photos above:

- i) Describe the trade relations involved in the images A, B, C and D.
- ii) Identify the countries involved in the trade relations according to images A, B C and D.
- iii) Identify and explain different terms used in international trade.

There are majorly two forms of international trade, namely;

a) Bilateral trade;

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 the exchange agreement of goods and services between two nations promoting trade and investment. The two countries will reduce or eliminate tariffs, import quotas, export restraints, and other trade barriers to encourage trade and investment. It varies depending on the type of agreement, scope, and the countries that are involved in the agreement.

Examples of bilateral trade agreements in Rwanda include,

The United States and Rwanda signed a Trade and Investment Framework Agreement (TIFA) in 2006, and a Bilateral Investment Treaty (BIT) in 2008. Rwanda has active bilateral investment treaties with Germany (1969), Belgium-Luxemburg Economic Union (1985), and the Republic of Korea (2013). Rwanda signed bilateral investment treaties with Mauritius (2001), South Africa (2000), Turkey (2016), Morocco (2016), the United Arab Emirates (2016), and Qatar (2018). The goals of bilateral trade agreements are to expand access between two countries' markets and increase their economic growth.

b) Multilateral trade;

Multilateral trade refers to the exchange of commodities among more than 2 countries or multilateral agreements are commerce treaties among three or more nations. The agreements reduce tariffs and make it easier for businesses to import and export. Since they are among many countries, they are difficult to negotiate. That same broad scope makes them stronger than other types of trade agreements once all parties sign. Some regional trade agreements are multilateral, for example, The African Continental Free Trade Area (AfCFTA), The East African Community (EAC), The Common Market for Eastern and Southern Africa (COMESA) and all global trade agreements are multilateral. The most successful one is the General Agreement on Trade and Tariffs [GATT].

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.



Application activity 1.1

1. Why do you think Rwanda participates in international trade?
2. Examine the arguments for and against each trade relations named above.

1.2. Advantages, disadvantages and limitations of international trade.

Activity 1.3



International trade allows countries, states, brands, and businesses to buy and sell in foreign markets; this diversifies the products and services that domestic customers can receive. However, international trade is not without its problems. One country can profit greatly from it by exporting, but not importing goods and services. It can also be used to undercut domestic markets by offering cheaper, but equally valuable goods. (<https://vittana.org>)

Required:

- c) Identify some of the benefits and costs of international trade cited above.
- d) What other benefits and costs are likely to come out of international trade.
- e) Explain what you think might be the hindrances to smooth international trade.

1.2.1: Advantages or arguments for International Trade.

International trade is a basic feature of economic activities in every country. At the same time, nearly every country in the world seeks to participate in international trade. Ideally, participation in international exchange confers several benefits or advantages to the participants and these may include among others the following;

- 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.
- It overcomes shortages i.e. if a country engages in international trade it overcomes such shortages brought by for example natural disasters.
- Market expansion; i.e. international trade widens markets for the participating countries e.g. LDCs raw materials thus assured markets for their raw materials. This has encouraged LDCs to move from subsistence production to a monetary one.
- Vent for surplus; International trade enables a country to utilize her resources thus full utilization of resources due to assured markets.
- International trade offers an opportunity to a country to sell a surplus of products and to make use of available land and labour. Many countries have products, which are surplus to their own requirements. It is only by exporting these products that they have any value at all. Without trade, the land and the labour used in their production would be idle. International trade therefore gives the country the opportunity to sell these products and to make use of the available land and labour.
- International trade stimulates competition and forces home producers to become more efficient which leads to better quality, lower prices and more output.
- 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.
- 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.
- 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.

- Promotes cultural and political ties between or among countries since there is understanding among trading partners which creates global peace and harmony among countries.
- International trade avails wide variety of commodities which increase the choice of consumers and their standard of living.
- 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.
- 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.
- 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

Despite the above-mentioned advantages of international trade, it comes with several demerits which include among others the following;

- It encourages dumping which causes price instabilities in the domestic country/ market.
- 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.
- If a country trades with another that is affected by inflation, this may result into imported inflation by the importing country.
- Loss of social economic and political sovereignty or independence especially by LDCs because MDCs always dictate unfair trading terms to LDCs.
- Loss of culture through demonstration effect as consumers of imported goods adapt to foreign consumption habits and cultures.
- International trade may result into over exploitation of domestic resources due to wider markets.
- Dangerous commodities may find their way into the country e.g. guns, drugs etc. which may worsen health and standard of living of people.
- Balance of Payment position may worsen where import expenditure may exceed export revenue.

- It may limit employment opportunities in the country by the domestic people who are outcompeted by foreigners who might have superior skills over locals.

1.2.3: Limitations of International Trade

A number of both social economic and political factors can hinder a country to participate fully in international trade. These factors are either internal or external influences and can be avoidable and or inevitable. These include among others the following;

- **Rapid depletion of exhaustible natural resources:** It could lead to a more rapid depletion or exhaustible of 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.
- **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.
- **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.
- **Over specialization:** Over specialization may be disastrous for a country. A substitute may appear and ruin the economic lives of millions.
- **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.
- **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.
- **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.
- **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.

- **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.
- **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.
- **Cost incurred for exporting:** a lot of money on transportation facilities has to be incurred when goods are exported to other countries.
- **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.
- **Differences in standards of measurement.** Different countries use different weights and measures.
- **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
- **Inadequate information** about goods available, their prices, quality etc. which hinders smooth international trade.
- **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: Theories of international trade.



Application activity.1.2

Study the images below and answer the questions that follow;



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

- Name what each photo portrays.
- Identify the exports and imports of Rwanda shown in the above photos.
- Analyze the impact of international trade to her development process.

There are different theories of international trade as put forward by different economists trying to explain the gains from international trade between or among countries involved. There are two basic principles or theories of international trade, and these include the following;

- Theory of absolute advantage
- Theory of comparative advantage

1.3.1: Theory of absolute advantage:

Activity 1.4



Analyse the case study below, use it to undertake research on international trade theories and answer the questions that follow:

Rwanda and Kenya can both produce washing soap, but Kenya can produce it with a higher quality and at a faster rate with greater profit than Rwanda. In the same context, both countries can both produce juice, but Rwanda can produce it with a higher quality and at a faster rate with greater profit than Kenya.

- a) What theory of international trade is portrayed in the case study above? Justify your answer.
- b) How will international trade between the two countries be made possible?
- c) Describe how the two countries will benefit from trade?

1.3.1.1: Meaning of absolute advantage:

The theory of absolute advantage, was put forward by Adam Smith to explain the gains from international trade as a result of specialization between countries. 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". According to Adam Smith, the law of absolute cost advantage for international trade, operates in such a way that countries will benefit if one of them has an absolute (cost) advantage in producing one commodity while the other has an absolute (cost) advantage in producing the other commodity.

A country that can produce a good at a lower cost than another country is said to have an absolute advantage in the production of that good. 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.

When two countries have absolute advantages in different goods, there are gains from trade to be reaped. According to the absolute cost advantage doctrine of Adam Smith, each country produces those goods for whose production is especially suited on account of its climate, fertility of its land and its natural

resources, and acquired capacity of its people, such as plants, buildings, means of transport, education and health. It will concentrate on the production of such commodities, producing more than its requirement, getting the surplus exchanged with goods and commodities from other countries.

The principle of absolute advantage involves comparing the quantities of a specific product that can be produced using the same quantity of resources in two different countries. For example, Rwanda is said to have an absolute advantage over Uganda in the production of Tea when an equal quantity of resources can produce more of Tea in Rwanda than in Uganda. Suppose that Rwanda has an absolute advantage over Uganda in one product, while Uganda has an absolute advantage over Rwanda in another, this is a case of reciprocal absolute advantage. This implies that each country has an absolute advantage in one product. In such a situation, the total production of both countries can be increased (relative to a situation of self-sufficiency) if each specialises in the product in which it has an absolute advantage.

1.3.1.2: Assumptions of absolute advantage.

The assumptions underlying the principle of absolute advantage include the following:

- **Lack of Mobility for Factors of Production:** Adam Smith assumes that factors of production cannot move between countries implying that the Production Possibility Frontier of each country will not change after the trade.
- **Trade Barriers:** There are no barriers to trade for the exchange of goods. Governments do not implement trade barriers to restrict or discourage the importation or exportation of a particular good.
- **Trade Balance:** Smith assumes that exports must be equal to imports. This assumption means that we cannot have trade imbalances, trade deficits, or surpluses.
- **Constant Returns to Scale:** Adam Smith assumes that we will get constant returns as production scales, meaning there are no economies of scale. However, if there were economies of scale, then it would become cheaper for countries to keep producing the same good as it produced more of the same good.

Given the above assumptions, an exchange of goods will occur (assuming a two-country two-commodity case), if each of the two countries can produce one commodity at an absolutely lower labour cost of production than the other.

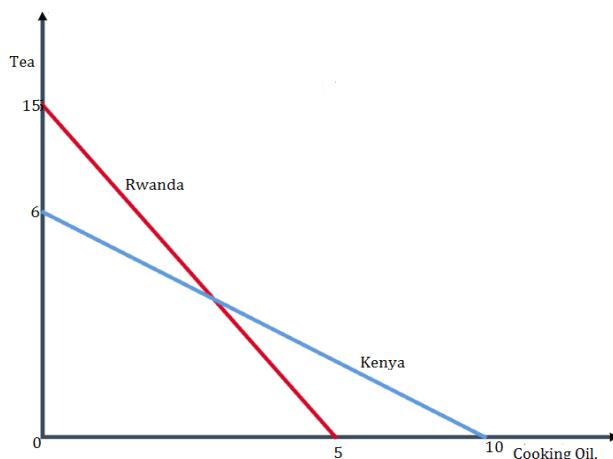
Let us take a two-country two-commodity case. E.g. Rwanda and Kenya producing Tea and Cooking oil respectively.

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 for businesses and countries to trade with one another. All countries engaged in open trade benefit from lower costs of production.

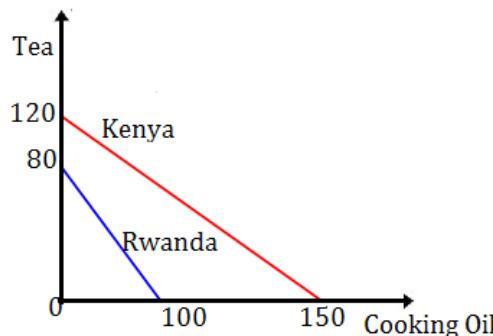
On the other side, given equal quantity of resources one country can produce both commodities better than another. Thus one country can have absolute advantage in production of both commodities than the other. This indicates a case of non-reciprocal absolute advantage.

Table 2: 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:

Activity .1.5



Analyse the case study below and answer the questions that follow.

Consider a college principal and his secretary. The College Principal is better at administering and managing college affairs than the secretary and is also a faster typist and organizer. In this case, the College Principal has an absolute advantage in both the administration and management services and secretarial work. Suppose the College Principal produces Rwf100, 000 per day in administration and management services and Rwf40,000 per day in secretarial duties. The secretary can produce Rwf0 in administration and management services and Rwf30,000 in secretarial duties in a day.

- a) Which theory of international trade is manifested in the case study above? Justify your answer.
- b) How will service delivery be possible?
- c) Between the College principal and his secretary, who should specialize in which service and why?
- d) What is the basis of specialisation by the two parties named above?
- e) To what extent is the theory applicable in real life experience?

1.3.2.1: Meaning of comparative advantage.

Theory of comparative advantage was advanced by David Ricardo in 1817. It followed Adam Smith's theory of absolute advantage and said that even in the absence of absolute cost advantage, international trade was possible. He postulated that even where one country had an absolute advantage in the production of both commodities, both countries would benefit, if the first country concentrated only on the production of the most advantageous commodity, leaving the second country to produce the other commodity. 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”. The specialising country would benefit from trade if it exchanges the surplus of its products for other products in which it has a higher opportunity cost.

1.3.2.2: Assumptions underlying comparative cost advantage

The theory of comparative cost advantage is based on the following assumptions:

- There is no intervention by the government in economic system, meaning there is free trade between two countries.
- Perfect competition exists both in the commodity and factor markets.
- 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.
- 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.
- Labour is the only factor of production and the cost of producing a commodity is expressed in labour units.
- Labour is perfectly mobile within the country but perfectly immobile among different countries.
- Transport costs are absent so that production cost, measured in terms of labour input alone, determines the cost of producing a given commodity.
- There are only two commodities to be exchanged between the two countries.
- Money is non-existent and prices of different goods are measured by their real cost of production.
- There is full employment of resources in both the countries.
- 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=

From the above example it can be calculated as;

- i. In Rwanda to produce Tea they forego cooking oil

$$\text{Thus} = \text{quantity of cooking oil/ quantity of tea} = 80/10 = 8$$

- ii. In Rwanda to produce cooking oil, they forego Tea,

$$\text{Thus} = \text{quantity of Tea/ quantity of cooking oil} = 10/80 = 0.125$$

- iii. In Kenya to produce Tea, they forego cooking oil,

$$\text{Thus} = \text{quantity of cooking oil/ quantity of tea} = 100/40 = 2.5$$

- iv. In Kenya to produce cooking oil they forego Tea,

$$\text{Thus} = \text{quantity of tea/ quantity of cooking oil} = 40/100 = 0.4$$

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.

- Developing countries have tended to specialize in producing primary products where they have a least opportunity cost e.g. Rwanda exports raw materials.
- Developing countries still have barter trade among arrangements themselves.
- Developing countries use labour intensive technology while developed countries use capital intensive technology so the assumption of no change in technology is realistic.
- There is some degree of mobility of factors of production among developing countries especially labour.

- Developing countries import manufactured commodities where they have a high opportunity cost.
- 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.

Though the theory of comparative advantage appears to explain the basis of choice for a country in terms of what to produce, what to export and import from others, it has been criticized by a number of writers on a number of the following accounts;

- 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. The world of only two countries producing only two commodities is a very unrealistic assumption. The real world is made up of a large number of countries engaged in production of a wide range of commodities.
- 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.
- The theory does not recognise the role of technological innovations in international trade. Which help in decreasing the cost of goods and increasing their supply not only in inter-regional trade but also in international trade.
- 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. Let us take an example of two countries; one small and the other large in terms of total output. The small country can specialise in the production of one good, but the large country will have to produce both goods, because the small country can neither supply the full requirements of the larger country nor can it absorb the surplus output of the larger country.
- 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. This has certainly affected the volume and direction of imports and exports and thus limiting the scope for specialisation between or among countries.

- 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. However big the difference between the cost ratios of the two commodities entering into trade may be, if it is narrowed down by the high cost of transporting the commodities, trade may not occur. The existence of transport costs gives rise to another class of goods besides those entering into trade, known as 'domestic goods.' Some writers have, therefore, suggested that the cost of production should include the transportation cost.
- 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.
- 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.
- 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.
- 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. When the production takes place under the operation of this law, the cost ratios in both countries will not remain constant.
- 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.
- 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.
- 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: Factors and benefits of comparative cost advantage:

Activity 1.6



Carry out research from any economic source about theories of international trade, examine and discuss together in class the;

- i) Factors for comparative advantage.
- ii) Benefits of comparative advantages.

Factors that determine comparative advantage.

Comparative Advantage is when a country may produce goods at a lower opportunity cost, but not necessarily have an absolute advantage in producing that good. This simply means that a country can produce a good at a lower cost than another country. Having a comparative advantage is not the same as being the best at something. In fact, someone can be completely unskilled at doing something, yet still have a comparative advantage at doing it! Comparative advantage is a dynamic concept meaning that it changes over time. Comparative advantage is what actually determines whether it pays to produce a good or import it. For a country, some of the factors below are important in determining the relative unit costs of production:

- **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.
- **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.

- **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.
- **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.
- **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.
- **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.
- **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.
- **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.
- **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.

- **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.
- **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.
- **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.
- **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.
- **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.
- **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. So, it is quite obvious that countries would have an advantage in producing those goods that use relatively large amounts of their most abundant factor of production. Certainly, countries with a relatively large amount of farmland e.g. developing countries, would have a comparative advantage in agriculture, and countries with a relatively large amount of capital i.e. developed countries, would tend to specialise in the production of manufactured goods. Or Countries with a huge supply of relatively cheap labour would specialise in labour-intensive products and countries with abundant capital would specialise in the production of capital-intensive products.
- **Human Skills:** Countries 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.

- **Product Life Cycles:** The product-life-cycle theory is related to international comparative advantage in that a new product will be the first produced and exported by the nation in which it was invented. As the product is exported elsewhere and foreign firms become familiar with it, the technology is copied in other countries by foreign firms seeking to produce a competing version. As the product matures, comparative advantage shifts away from the country of origin, if other countries have lower manufacturing costs for using the now-standardised technology. For example, the history of colour-television production shows how comparative advantage can shift over the product life cycle. It was invented in the US, and US firms initially produced and exported them. Over time, as the technology manufacturing them became well-known, countries like Japan and Taiwan came to dominate the business and had a comparative advantage over US firms in the manufacture of colour TVs. Once the technology is widely available, countries with cheaper assembly lines, due to lower wages, can compete effectively against the higher-wage nation that developed the technology.

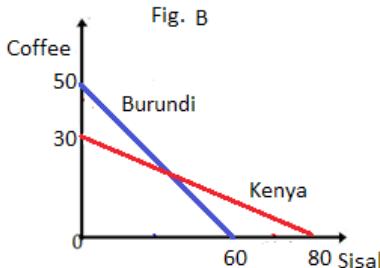
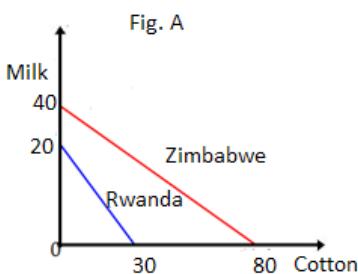
Benefits of comparative advantage.

- It encourages competition and improvement in efficiency so as to reduce costs of production.
- It encourages specialisation and exchange.
- It increases global output of commodities due to specialisation.
- It encourages economic cooperation and free trade among countries.
- It encourages mass production and reaping of economies of scale.
- It discourages duplication of industries i.e. setting up of industries which already exist in other countries.
- It widens market for exports between o among countries.
- It enables countries to get commodities which they cannot produce, thus increasing consumers choice.
- It enables countries to get foreign exchange through increased exports and other form of capital inflow.
- Specialisation results into effective utilisation of resources some of which would be idle.



Application activity 1.3

Analyse the figures below and answer the questions that follow.



- In each figure, identify the theory of international trade portrayed with supporting reason.
- What makes a difference between the two figures above?
- In which commodity should each country specialise and why?
- Why do you think, based on the comparative cost advantage developing countries are not able to benefit from international trade as much as developed countries?



End unit assessment

- Why would you advise your country to engage in international trade?
- Why do we buy goods from abroad if we can make them locally?
- Discuss the view that where there is no comparative advantage there is nothing to gain from international trade.
- Consider the view that gains from international trade are biased in favour of advanced industrial countries.

UNIT 2

TERMS OF TRADE.

Unit Competency:

Learners will be able to describe the terms of trade in LDCs.



Introductory activity

Using the case study below, visit the library or the internet or any economics source and research about international trade, using the gained knowledge and understanding, share and discuss the questions that follow.

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?

2.1: Meaning and Forms of Terms of Trade:

Activity 2.1



Analyse the case study below, undertake research from any relevant economic source within your reach and discuss the questions that follow;

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.

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? Since economies typically export and import many goods, measuring the terms of trade requires defining price indices for exported and imported goods and comparing the two.

A rise in the prices of exported goods in international markets would increase the terms of trade, while a rise in the prices of imported goods would decrease it. For example, countries that export oil products will see an increase in their terms of trade when oil products' prices go up, while the terms of trade of countries that import oil products would decrease. An improvement of a nation's terms of trade benefits that country in the sense that it can buy more imports for any given level of exports. The terms of trade may be influenced by the exchange rate because a rise in the value of a country's currency lowers the domestic prices of its imports but may not directly affect the prices of the commodities it exports. Terms of trade is the ratio of a country's export price index to its import price index, multiplied by 100.

Terms of trade can be expressed as;

$$TOT = \times 100 \text{ or } TOT = 100$$

Where; **P_x** = average price index for exports, **P_m** = 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

Terms of trade are categorized into two, namely;

- a) Barter / commodity terms of trade
- b) Income/ monetary terms of trade
- c) Barter/ commodity terms of trade.

Barter / commodity terms of trade 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:

$$\text{Barter terms of trade} = 100$$

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:

$$\text{Barter TOT} = 100 = 100 = 44.4$$

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

$$\text{Barter TOT} = 100 = 100 = 102.7.$$

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

a) 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= or

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;

$$= 124.4.$$

It implies that there is improvement in the income terms of trade by 24.4 percent 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

$$\text{Income TOT} = 53.3$$

It implies that the income terms of trade have deteriorated by 46.7% percent in 2019 as compared with 2018.

A rise in the index of income terms of trade implies that a country can import more goods in exchange for its exports. A country's income terms of trade may improve but its commodity terms of trade may deteriorate. Taking the import prices to be constant, if export prices fall, there will be an increase in the sales and value of exports. Thus, while the income terms of trade might have improved, the commodity terms of trade might have deteriorated.

The income terms of trade, is called the **capacity to import**. In the long-run, the total value of exports of a country must equal to its total value of imports, i.e., **or**. Thus determine which the total volume that a country can import is.



Application activity 2.1

- a) 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.

2.2: Nature and how to improve the terms of terms of trade for developing countries.

Activity 2.2



Developing countries are always interested in the trend in export and import prices and also more concerned about the trends in their export earnings and import payments. This is because these trends in turn determine the long-term trend in the balance of payments on current account and indicate whether future balance-of-payments difficulties are likely to arise. (<https://link.springer.com>)

- a) From the extract above, why do developing countries mind about keeping track of the trend of export and import prices?
- b) Basing on the extract above, carry out research to identify and describe the trend of export and import prices for developing countries.
- c) What causes the trend mentioned above for developing countries?
- d) Suggest possible measures that developing countries should undertake to streamline its export import price relationship.

2.2.1: Nature of terms of trade for developing countries:

Most LDCs have **unfavourable and deteriorating terms of trade**. The following are the main reasons for unfavorable and declining terms of trade of less developed countries:

Causes of deteriorating Terms of Trade in LDCs

- The less developed countries are mainly primary producing countries. Their exports mostly include primary products 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.
- Adoption of raw-material saving techniques by developed countries which reduces the demand for LDC's export.
- 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.
- 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.
- 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.
- 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.
- 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. This leads to the adverse terms of trade for the poor country, placing it at a disadvantageous bargaining position.
- 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.

- 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.
- 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.
- 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.
- 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.
- 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.
- 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

Most LDCs face unfavourable terms of trade, an indication that LDCs do not favourably enjoy the benefits from international trade. This implies they always export much and get little imports. LDCs should adopt any of the following policies in order to improve their terms of trade so as to enjoy more benefits from international trade.

- 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.

- Human resource development through education and training so as to reduce expenditure on imported labourforce which is always expensive.
- 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.
- 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.
- Promote regional integration and economic cooperation 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.
- 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.
- 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.
- 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 base.
- 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.
- Enhance the establishment of permanent national and international trade fair grounds which creates an opportunity for trade development as it gives business men a chance of regular expositions which helps them in sell and advertisements of their products.
- Enhance the establishment of business development centers (BDS) which facilitate easy coordination of business activities in rural areas to promote continuous and coordinated production.

- 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.
- 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.
- 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 exports as well.
- Diversify domestic production so as to reduce dependency on few traditional exports where terms of trade are unfavourable and keep on fluctuating.
- Adopt Import substitution strategy so as to minimize import expenditure
- Research innovations and inventions so as to promote technological development and use of intermediate technology to reduce expenditure on expensive capital.



Application activity 2.2.

- a) 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.



End 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	

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

Key unit competence:

Analyze the impact of free trade and trade protectionism in an economy.



Introductory activity

Following the opening of the African continental Free Trade Agreement in Kigali, Rwanda in March 2018, Africa is about to become the world largest free trade area; 54 countries merging into a single market of around 1.3 billion people with a combined GDP of 2.5 trillion Us Dollars. The major goal of this agreement was to establish a single market for goods and services across the continent, allow the free movement of business travelers and investments and also create a continental customs to streamline trade- and attract long term investments. The agreement between countries required members to remove tariffs from 90% of goods allowing free access to commodities, goods and services across the continent.

Basing on the above agreement

- a) What do you think is free trade?
- b) What are benefits and costs of such trade?
- c) Explain the measures that can be used to protect a country from the costs of such trade.

3.1. Free Trade

Activity 3.1



- (a). What is meant by the term free trade
- (b) Briefly explain the term free trade according to Adam Smith.

3.1.1. Meaning of free trade

Free trade refers to the unrestricted purchase and sale of goods and services between two or more countries. Under a free trade policy countries agree to buy or sell goods and services across international boundaries with little or no government tariffs, quotas, subsidies and other forms of restriction.

According to Adam Smith, the term “free trade” is used to mean “the system of commercial policy which draws no distinction between domestic and foreign commodities and, therefore, neither imposes additional burdens to the latter, nor grants any special favour to the former”

In other words, free trade implies complete freedom of international trade exchange. In this situation, there are no barriers to movement of commodities among countries and exchange can take its perfectly natural course.

3.1.2: Advantages of free trade

Activity 3.2.



Make research and discuss the view that free trade does more good than harm on the economy.

Free trade is the term given to trade between nations that takes place without the imposition of barriers in the form of tariffs, quotas or other measures by governments or international organizations. Free trade is generally considered by economists to be beneficial to international trade by encouraging competition, innovation, efficient production and consumer choice etc. Its advantages include among others the following

- **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. Thus Free trade permits large varieties of consumption goods which later improve consumer's welfare.

- **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.
- **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. In other words, countries are also be export those goods or services that they are most efficient in producing and import the items which other countries may produce more efficiently.
- **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. This compels domestic industries to look for ways to keep costs down by operating more efficiently and gives them an incentive to Innovate and look for improved products, processes and marketing methods. Thus, this constant search for new ideas and technology induces domestic producers to improve their efficiency which enables them to compete on the international market.
- **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. In other words; free trade creates many job opportunities in the country especially for the importers and exporters which in turn increases wages, interest, profits and rent
- **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.
- **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. This also favours specialization because a wide market will encourage the country to concentrate in the production of commodities where they incur lower costs and the surplus will be sold to other countries.

- **Restricts consumers' exploitation by domestic monopolists:** Free trade prevents growth of domestic monopolies who always exploit the consumers through charging high prices. This trade makes it hard for the domestic producers to increase prices in the market due to high levels of external competition where goods can easily be imported into the country at cheapest prices possible.
- **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 to improve in the same direction. This helps to increase the atmosphere of peace and good will among such countries hence increasing the volume of international trade.
- **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's tax revenue used for further development.
- **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. Therefore, free trade makes it easy because it takes place between countries with either little or no such costs.
- **Eliminates possibilities of trade malpractices** like smuggling with its negative effects. Free trade gives all people an opportunity to trade 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

- **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 outcompeted and pushed out of business by such cheap foreign products hence causing unemployment.
- **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 others.
- **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.

- **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.
- **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.
- **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.
- **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.
- **Worsens a country balance of payment problem.** Free trade becomes unfavorable for a country which exports primary products and imports full manufactured goods. This implies that a country's expenditures will continuously increase when the earnings from abroad are continuously declining thus worse the problem which in turn reduces a country's development.
- **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.
- **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.
- **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.
- **Discourages self-reliance.** It makes a country to over depend on imported goods since importation of goods becomes easy and cheap.



Application activity. 3.1.

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

3.2. Trade protectionism

3.2.1: Meaning of trade protectionism

Activity 3.3



Developing countries are beginning to overcome some major hurdles in their quest to expand trade with industrialized countries. Different trade agreements negotiated between countries to carry out free trade. This means that traditional trade protectionism measures of tariffs is falling away. But to some extent it is being replaced by domestic technical regulations that permit countries to restrict products that don't meet certain standards from entering their markets.

Basing on the above statement.

- (a). What is meant by trade protectionism and why do countries practice it?
- (b) Explain some of the domestic technical regulation that countries use to restrict products that don't meet their standards from entering their markets.

Trade protectionism refers to the different forms of barriers imposed on international trade to influence the flow or volume of commodities exchanged. It is a commercial policy of safe guarding the national interests through restrictions on international trade. It is used to regulate the inflow and outflow of commodities between or among countries involved in international trade so as to allow fair competition between imports and goods and services produced domestically. The doctrine of protectionism contrasts with the doctrine of free trade, where governments reduce as much as possible the barriers to trade.

3.2.2: Reasons for trade protectionism

- 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.
- To discourage dumping through imposing high tariffs on cheap and expired commodities from other countries into the country.
- 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.
- 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.
- To increase government revenue through import and export duties, of which revenue can be used to finance government development programs.
- To prevent importation of undesirable commodities and thus protect health of citizens e.g. ban (total refusal) of certain drugs, food stuffs and even other commodities basing on health grounds.
- To check imported inflation by increasing tariffs or prohibit importation of commodities from countries experiencing hyperinflation.
- To encourage full utilization of domestic resources especially for import substitution industrial strategy.
- 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.
- 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.
- 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)

Tools of protection are normally grouped into 2, namely;

- (a) Tariff barriers
- (b) Non-tariff barriers

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. In the same way the government may intervene in the foreign exchange market to lower the value of its currency by selling its currency in the foreign exchange market at higher price. Doing so will raise the cost of imports which discourage importation of goods.

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. When the total amount of goods to be imported is determined, this will help to reduce the physical amount of a commodity that is imported in a given period of 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.

Activity 3.4



Make research and discuss the view that protectionism should be adopted if developing countries are to achieve high growth rates.

The main arguments which are advanced to support the policy of protectionism are as follows:

- (i) **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.
- (ii) **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. For instance, the agrarian population is generally more submissive and loyal to the government than the industrial population. The government may want to preserve this class of people, by charging heavy import duties on foreign agricultural raw material and thus encourage them to take interest in their farming industry.
- (iii) **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. Thus protectionism protects infant industries against unfair competition from low cost imported products.
- (iv) **Protectionism guards against dumping:** Protectionism discourages dumping of cheap and at times substandard or expired goods in the country. If foreign industries resorts to dumping with a view to capturing foreign markets, then the other countries must protect their industries by levying high protective duties on such foreign goods in order to be restricted.
- (v) **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.
- (vi) **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 be 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.

- (vii) **Protectionism helps in checking imported inflation** by putting sanctions or even total ban on commodities from countries affected by inflation.
- (viii) **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.
- (ix) **National security purposes:** It also helps to safe guard a country's national security especially when importation of military armories are restricted into the country by unauthorized people.
- (x) **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.
- (xi) **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.
- (xii) **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

- (I) **Market distortion and loss of allocative efficiency:** Protectionism can be an ineffective and costly means of sustaining jobs.
- (II) **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.
- (III) **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.

- (IV) 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.
- (V) It encourages smuggling which reduces government revenue because smuggled goods are always not taxed.
- (VI) 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.
- (VII) Over protectionism leads to inefficiency whereby local producers will produce local quality goods because of limited competition caused by restriction of imports.
- (VIII) **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.
- (IX) **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
- (X) **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.
- (XI) **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.
- (XII) **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



Application activity 3.2

"Protectionism is the only best strategy that can be used in promoting the growth of domestic firms" Discuss

3.3. Commercial policy

3.3.1: Meaning of commercial policy

Activity 3. 5



"Due to the increased need for countries to gain more from international trade, the government of Rwanda developed a policy which involves influencing, directing and controlling trade in the country. In this case, more import substitution industries and export promotion industries have been established in the country".

Make research on international trade in Rwanda and thereafter discuss and present the following in class;

- (a)What economic term is given to such a policy?
- (b)What are the objectives of such a policy in Rwanda?
- (c)What policy tools have been adopted in Rwanda to improve her domestic industrial or commercial welfare?

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. It is a set of measures adopted by the government of a country towards international trade aimed at improving domestic industrial and commercial welfare. It can also be defined as 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

The main **objectives of commercial policy** are:

- To increase the quantity of trade with foreign nations.
- To preserve, the essential raw material for encouraging the development of domestic industries.
- To stimulate the export of particular products with a view to increasing their scale of production at home.
- To prevent the imports of particular goods for giving protection to infant industries or developing key industry.
- To restrict imports for securing diversification of industries.

- To encourage the imports of capital goods for speeding up the economic development of the country.
- To restrict the imports of goods with a view to correct the unfavorable balance of payments
- To assist or prevent the export or import of goods and services for achieving the desired rate of exchange.
- To enter into trade agreements with foreign nations for stabilizing the foreign trade.

3.3.3 Instruments/Tools of Commercial Policy:

The main **instruments or tools** mainly used for achieving the **objectives of commercial policy** are as follows:

1. Tariffs or Custom Duties: Tariff's or custom duties refers to the taxes imposed on 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 merchandise 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 subsidizes her domestic firms, they grow and expand and then sell their products at a cheaper price than foreign goods which reduces imports. 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. The government may regulate the imports by means of quotas. Under quota system, the maximum amount of a commodity which can be imported during a particular period is fixed by the government.

- 4. Trade Agreements:** The government of a country may enter into trade agreements with other countries for the exchange of goods. The **trade agreements may be bilateral or multilateral.** When two countries make a trade agreement for the exchange of goods, the agreement is said to be bilateral. When more than two countries enter into, trade agreement for ensuring fair and equal treatment to the imports and exports of the member countries, the agreement is called multilateral.
- 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.



Application activity 3.3

Explain the reasons behind the commercial policies adopted by the government of Rwanda in order to influence international trade.

Skills Lab



As we have seen, for countries to grow and develop, they need each other especially through international trade. Basing on the reasons and tools of protectionism applied in Rwanda, come up with the proposal for the products that you think should be restricted by the government from other countries, and provide reason as to why such products should be restricted and then submit your proposal to the responsible people in higher authorities for further consideration.



End unit assessment

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?

UNIT 4

BALANCE OF PAYMENT (BOP).

Unit Competency:

Learners will be able to analyse the balance of payment position of LDCs.



Introductory activity

Country 'Z' revealed its capacity to save to pay for its imports in 2018. It also showed how much economic output it produced to pay for her growth for that particular year. In 2017, it had shown that it had experienced her imports of goods, services and capital being greater than its exports while in 2018, it showed that her exports of goods, services and capital were more than its imports. For all the positions of country 'Z' in the years mentioned, however, she would endeavor to bring back her economy to equilibrium.

Required: Analyse the case study above and use it to carry out research from any economics related resource to;

- i) Explain the economic term that is given to the document that Country 'Z' used to present her capacity to save for the payment of its imports and her output produced to pay for her growth.
- ii) Describe economic situation in 2017 and 2018 respectively as stated in the case study.
- iii) Explain the resultant outcome for each position mentioned in ii) above.
- iv) Explain what, according to the case study, is described as '**equilibrium**'.
- iv) Identify the likely measures country 'Z' would put to bring her economy back to equilibrium.

4.1. Meaning and terminologies used in Balance of Payment (BOP).

Activity 4.1



Use the knowledge and understanding gained from the research carried out in the introductory activity above, to;

- a) 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.
 - vi) Relationship between trade in goods only and services only respectively.
 - vii) Statistical record of the character and dimensions of the country's economic relationships with the rest of the world.

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. It shows the relationships between a country's total expenditure abroad with its total income from abroad. It encompasses all transactions between a country's residents (individuals, firms and government bodies) and its nonresidents (individuals, firms and government bodies) involving goods, services and income; financial claims on and liabilities to the rest of the world; and transfers such as gifts. Thus, the balance of payments includes all external visible and non-visible transactions, together with their respective receipts and expenditures, of a country.

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 only.

4.2: Structure of BOP Accounts.

Activity 4.2



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.

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.



Application activity 4.1

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.

4.2.2: How to offset a BOP deficit and surplus.

Activity 4.3



Fill in the following gaps

1. a) If excess demand for foreign currency in some periods is balanced with excess supply in other periods, then falling reserves in some periods will be offset with rising reserves in other periods leading to

.....

.....

- b) When the central bank buys domestic currency and sells the foreign reserve currency in the private Forex, the transaction indicates a

.....

c) When the central bank sells domestic currency and buys foreign currency in the Forex, the transaction indicates a
.....
....

2. What should be done to rectify the two situations mentioned in b and c above?

4.2.2.1 Financing deficits/ How to correct a BOP deficit.

A BOP deficit is a situation where aggregate demand for foreign exchange exceeds aggregate supply for foreign exchange. Or a situation where a country's expenditure abroad is greater than her receipts from there. Methods to offset a BOP deficit should aim at reducing foreign exchange expenditure, increasing foreign exchange earnings and simultaneous reducing foreign exchange expenditure and increasing foreign exchange earnings. The financing of a deficit is achieved by:

- Selling gold or holdings of foreign exchange, such as US dollars, yen or euros,
- Borrowing from other Central Banks or the International Monetary Fund (IMF)
- Using of foreign exchange reserves available
- sale of public assets abroad
- Seeking aid and grants from other countries
- Attracting foreign investments into the country
- Import substitution strategy
- Restrictive monetary policy i.e. reduces the amount of money in circulation
- Improving the service industry e.g. tourism
- Devaluation.
- Export promotion strategy — increase the volume of exports and improve the quality of exports.
- Increase taxes and reduce government expenditure i.e. fiscal policy.
- Direct control — tariffs; quotas; exchange controls; complete ban, i.e. import restrictions.

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.

A BOP surplus is a situation where aggregate supply of foreign exchange exceeds aggregate demand for it. Or a situation where a country's receipts from abroad are greater than her expenditure there. A surplus will be disposed of by:

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

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.**



Application activity 4.2

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 (S_d) must equal domestic investment (I_d).
- c) An export surplus on current account ($X > M$) must be offset by an excess of domestic saving over investment ($S > I_d$).
- 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.....

4.2.3: Causes and Solutions to BOP deficits/problems in developing countries.

Activity 4.4



With reference to activity 4.3, we saw that at a certain point of time, a country can experience either of the two situations; i.e. where aggregate demand for foreign exchange exceeds aggregate supply for foreign exchange or, where aggregate supply of foreign exchange exceeds aggregate demand for it.

- i) Describe what is commonly experienced in your country with a clear justification.
- ii) Analyse the causes of such a situation in your country.
- iii) What practical measures does your country normally take to rectify such a position in international market?

4.2.3.1: Causes of BOP deficits in developing countries.

During transactions a country may register a deficit or surplus. If a country runs a deficit for a long time and for successive years, such a country is said to face BOP problems. Developing countries commonly register BOP deficit for a long time and for successive years, therefore, have always faced BOP problems due to the following socio-economic and political reasons.

- **Narrow Export Base:** Most developing countries have a narrow export base, basically agricultural commodities. They concentrate in relatively low value-added products which fetch low prices hence less earnings in return.
- **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. The exportable surplus reduces; therefore, government has to import more in order to support the alarming population thus causing much expenditure abroad leading to BOP deficits.
- **Poor technology in less developed countries:** There is less modernisation, balancing and replacement of machinery in the industrial sector in most developing economies. This has led to fall in production and decline in the quality of products thus has adversely affected exports.
- **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. The share of value-added goods must increase to earn foreign exchange and turn the trend of adverse balance of payment. The production of value-added goods is at basic stage in developing countries that leads to adverse BOP.
- **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. As such, due to devaluation, as tool for boosting exports is not effective.
Tough Competition: Stiff competition from the foreign value-added goods which has reduced the volume of foreign trade in developing countries. There is availability of higher standard goods at lower prices in international market. It causes reduction in developing countries' exports, which result in deficit in BOP. **Increase in Prices of Inputs:** The increase in the prices of fuel, electricity, high capital costs of imported machinery, exchange rates etc. have inflated developing countries' product prices. The high costs of both imported capital goods and industrial raw materials, on which domestic industries are heavily dependent, and the inflationary impact of the rise in the prices of inputs are not helping in achieving the export targets set in each financial year which results into deficit in BOP.

- **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. The advanced countries of the world have imposed technical barriers such as patents, copyrights, trade-marks and designs etc. on their imports. Developing countries have to upgrade the standard of purity and quality to compete for their products in the international market thereby leading to less foreign exchange earnings by Developing countries and consequently BOP deficits.
- **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.
- **Foreign Debts Servicing:** High expenditure on debt servicing since most Developing countries are poor and mostly rely on foreign resources especially through borrowing.
- **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.
- **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.
- **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.
- **Political instabilities and insecurity:** Experience shows that political instability and disturbances in Developing countries cause large capital outflows and hinder Inflows of foreign capital. For example, the wide spread political instabilities and insecurity in most Developing countries discourages production which reduces on the volume of exports. On the other hand, Developing Countries have to purchase modern weapons for their defense at a very high cost from different countries, which increases burden on their BOP and it becomes adverse.
- **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.

- **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.
- **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.
- **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.
- **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.
- **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.
- **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.
- **Insufficient export promotion institutions** to promote export sector through encouraging vent for surplus in most Developing Countries.
- **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.
- **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:

Sustained or prolonged deficit has to be settled by short term loans or depletion of capital reserve of foreign exchange and gold. The following remedial measures are recommended:

- **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.

- **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. If home production is increased e.g. chalk, fertilizer, paper, steel, edible oil and electrical goods, there will be less need for such imports.
- **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.
- 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.
- **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.
- **Encouraging investors** through establishing institutions that help and advise investors on investment prospects in the country.
- **Opening new markets** and making regional groupings to widen markets for their exports.
- **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.
- **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.
- **Seeking and being granted a debt relief** so as to reduce expenditure on debt servicing.
- **Population Control** so as to reduce on foreign exchange expenditure on imported commodities to cater for the alarming population.
- **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.
- **Strengthening the tourism industry** as an export diversifier.
- **Strengthening the ICA** so as to increase the export volume and bargaining power as well.

- **Economic legalization** so as to increase domestic productivity and export volume.
- Developing countries should process their primary products which adds value to them thus more foreign exchange earnings.
- 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.
- **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.
- **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.
- **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.
- **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.
- **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.



Application activity 4.3

Analyse the impact of BOP problem in developing nations' economies.

Skills Lab



Based on the knowledge, understanding and skills gained from this unit, as a business club in your school, make a financial statement at the end of the term showing your business transactions, based on the double entry basis. From the accountability, identify whether there is a surplus or shortage; in case of any position, describe how you will be able to dispose it off so as to attain equilibrium.



End unit assessment

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.

UNIT 5

EXCHANGE RATES.

Key unit Competency:

Analyse the various forms of exchange rate determination and their impact on economic development.



Introductory activity.

The table below shows different countries, their currencies and symbols and exchange rate.

Country	Currency name	Currency symbol	Current value in Rwf
Kenya	Kenyan Shilling	Ksh	8.964534 (as on 27 th Nov 2019)
Tanzania	Tanzanian shilling		
South Sudan	-	£	-
Japan	-	¥	-
-	Euro	-	-
USA	-	-	-
-	British Pound	-	-
-	Yuan	¥ or 元	-

Study the data in the table above. Make research and fill the table.

- i) In your own view, who determines the exchange rate between the Rwandan franc and other currencies?
- ii) Considering the exchange rate between Rwf and Kenyan Shilling given in the table above, how much Kenyan Shillings can one get from 100,000Rwf?
- iii) Supposing the Rwf gained more value against a Ksh, shall the above value in the exchange rate (8.964534) go above or below?
- iv) What do you think shall happen to the price in Rwf of goods Rwanda imports from Kenya if the Ksh gains more value against the Rwf?
- v) Supposing Rwanda imports goods with inelastic demand from Kenya. What do you think shall happen to their quantity demanded in Rwanda if the Ksh gains more value against the Rwf?

5.1. Exchange rates

5.1.1: Meaning of Foreign Exchange

Activity 5.1.



Agasaro is a Rwandan Import and export trader. She buys handcraft products from Rwandan Women Cooperative Society and exports them to Chinese consumers in China. On her way back from China, she buys Kitchen Ware from Dubai which she sells to Super market in Kigali, Rwanda.

- vi) Which currency do you think Agasaro uses to buy the handcraft products from Rwanda Women Cooperative society?
- vii) In which currency do you think she is paid when she sells her products in China?
- viii) Which currency do you think Agasaro uses to pay for the Kitchenware in Dubai markets and how does she get it?

Countries in international trade use currencies other than their own. This is because not every currency is acceptable in the world market. Payment of transactions among countries is carried out in hard or convertible currencies like US dollars, Japanese Yen, pound starlings etc.

Foreign exchange is the conversion of one currency into another currency. Foreign exchange market refers to the global market where currencies are traded virtually around the clock. The term foreign exchange is usually abbreviated as “**forex**” and occasionally as “**FX**.”

Foreign exchange transactions encompass everything from the conversion of currencies by a traveler at an airport kiosk to billion-dollar payments made by corporations, financial institutions and governments. Increasing globalisation has led to a massive increase in the number of foreign exchange transactions in recent decades.

The global foreign exchange market is the largest financial market in the world, with average daily volumes in the trillions of dollars. Foreign exchange transactions can be done for spot or forward delivery. There is no centralized market for foreign exchange transactions, which are executed over the counter and around the clock.

5.1.2: Terms used in foreign exchange.

Activity 5.2.



Make research and find the meaning of the following terms used in foreign exchange markets.

Foreign exchange rate; Exchange rate regime; Floating exchange rate; Fixed exchange rate; Pegged float exchange rate; Spot Market; Floating currency; Forward Market; International Currency Exchange; Currency Pairs; Foreign Exchange Market; Foreign Exchange Reserves; Foreign Exchange Risk.

The foreign exchange market has a number of basic terms used some of which include the following:

- **Foreign exchange rate.** The rate/price at which given currencies are exchanged for each other in the foreign exchange market
- **Exchange rate regime:** This is way in which an authority manages its currency in relation to other currencies in the foreign exchange market.
- **Floating exchange rate:** This is a system where the value of currency in relation to others is freely determined by the market forces of demand and supply for the currency.

- **Fixed exchange rate:** This is a system where a currency's value is tied to the value of another single currency, to a basket of other currencies, or to another measure of value, such as gold.
- **Pegged float exchange rate:** A currency system that fixes an exchange rate around a certain value, but still allows fluctuations, usually within certain values, to occur.
- **Spot Market.** This is where the price of a currency is established on the trade date but money is exchanged on the value date.
- **Floating currency.** This is a currency that uses a floating exchange rate
- **Forward Market.** A forward market/ trade is any trade that settles further in the future than spot.
- **International Currency Exchange.** This is a rate at which two currencies in the market can be exchanged.
- **Currency Pairs.** These are two currencies with exchange rates that are traded in the retail market.
- **Foreign Exchange Market.** This is a market where participants buy, sell, and exchange currencies daily.
- **Foreign Exchange Reserves:** These are reserves assets in foreign exchange that are held by a central bank.
- **Foreign Exchange Risk:** Foreign exchange risk is the chance that an investment's value will decrease due to changes in currency exchange rates.

Sources of Foreign Exchange

- Export of goods and services
- Transfer payments e.g. grants and aid
- Remittances and transfers of nationals working abroad
- Selling of public assets abroad
- Capital inflow through direct and foreign investments
- Profits, dividends and interests repatriated from investments abroad
- Funds from charitable organizations e.g. UNICEF
- Private foreign bank deposits in the local banks

- Borrowing from international countries, companies and individuals.

5.1.3: Forms/ types of exchange rates/ exchange rate systems/ regimes

Activity 5.3.



In line with a liberalized current and capital account of the balance of payments, NBR pursues a flexible exchange rate policy regime. In this regime, the price of Rwandan francs vis-a-vis the US dollar and other foreign currencies is determined by the market forces of demand and supply. NBR's involvement in the foreign exchange market is limited to occasional interventions (purchase or sale of US dollars) only to dampen excessive volatility in the exchange rate. Stable exchange rate movements in either direction (appreciation or depreciation), enable proper planning by all market players. NBR does not sell and/or purchase foreign exchange in the retail market. Intervention involves the process of purchasing and/or selling foreign exchange to the Foreign Exchange Interbank Market to stem the volatility of the currency when the Rwandan francs is appreciating and/or depreciating, respectively. It is done through the foreign exchange interbank market that comprises mainly commercial banks.

From the above case study,

- (i) What do you think is meant by
 - (a) Flexible exchange rate policy?
 - (b) Foreign exchange interbank market?
- (ii) What do you think will happen to the price/value of a Rwandan franc when NBR sells more of it on the foreign exchange interbank market?
- (iii) Apart from flexible exchange rate system, what do you think are the other types of foreign exchange rate systems?

Some of the major types of foreign exchange rates are as follows:

1. The gold standard exchange rate system
2. Fixed Exchange Rate System (Pegged Exchange Rate System).

3. Flexible Exchange Rate System (Floating Exchange Rate System).
4. Managed Floating Rate System.

5.1.3.1. The gold standard

Under the gold standard, a country's government declares that it will exchange its currency for a certain weight in gold. In a pure gold standard, a country's government declares that it will freely exchange currency for actual gold at the designated exchange rate. This "rule of exchange" allows anyone to go to the central bank and exchange coins or currency for pure gold or vice versa. The gold standard works on the assumption that there are no restrictions on capital movements or export of gold by private citizens across countries.

Because the central bank must always be prepared to give out gold in exchange for coin and currency upon demand, it must maintain gold reserves. Thus, this system ensures that the exchange rate between currencies remains fixed. The main argument in favor of the gold standard is that it ties the world price level to the world supply of gold, thus preventing inflation unless there is a gold discovery.

a) Advantages of the gold standard

- It solves the BOP problems automatically because of the automatic adjustment mechanism.
- There is neither currency appreciation nor currency depreciation since every unit of currency is tied to gold.
- There is economic stability because of a stable exchange rate system.
- Liquidity problem is easily solved because of free flow of gold.
- There is smooth international trade because gold is used as a medium of exchange.

b) Disadvantages of the gold standard exchange rate system

- It is difficult for the central bank to control money supply.
- When gold is in excess supply, it loses exchange value.
- It does not favour economic growth in countries with small quantities of gold.

5.1.3.2. Fixed Exchange Rate System:

Activity 5.4.



Make research and discuss the view that the foreign exchange rate should be fixed by the forces of demand and supply of the currency and not the central bank.

Fixed exchange rate system refers to a system in which exchange rate for a currency is fixed by the government at a specific rate in relation to a specific foreign currency for a period of time. Once this rate is fixed, it becomes illegal to exchange a currency at a parallel rate.

The basic purpose of adopting this system is to ensure stability in foreign trade and capital movements. To achieve stability, government undertakes to buy foreign currency when the exchange rate becomes weaker and sell foreign currency when the rate of exchange gets stronger. For this, government has to maintain large reserves of foreign currencies to maintain the exchange rate at the level fixed by it.

Under this system, each country keeps value of its currency fixed in terms of some 'External Standard'. This external standard can be gold, silver, other precious metal, another country's currency or even some internationally agreed unit of account. When value of domestic currency is tied to the value of another currency, it is known as '**Pegging**'.

The fixed exchange rate may be **undervalued or overvalued** i.e. **undervalued exchange rate** is where the exchange rate is fixed below the market or equilibrium value of the currency. For example, if the equilibrium rate is 600frw for a dollar and the rate is fixed at 300frw for a dollar, this leads to cheap imports and expensive exports hence BOP deficits.

Overvalued exchange rate is where the exchange rate is fixed above the market or equilibrium value of the currency. This leads to undervalued local currency which makes exports cheap and imports expensive hence improved BOP position.

In a fixed exchange rate system when the external value of the currency is increased, we refer to this as **revaluation** (increase in the value of domestic currency by the government) and when the external value of the currency is reduced, we refer to this as **devaluation** (reduction in the value of domestic currency by the government)

Countries can either choose a single currency to peg to, or a “basket” consisting of the currencies of the country’s major trading partners.

The pegged float exchange rate can be;

- **Crawling bands.** The market value of a national currency is permitted to fluctuate within a range specified by a band of fluctuation. This band is determined by international agreements or by unilateral decision by the central bank. Generally, the bands are adjusted in response to economic circumstances and indicators.
- **Crawling pegs.** This is an exchange rate regime, usually seen as part of a fixed exchange rate regime that allows gradual depreciation or appreciation in an exchange rate. The system is a method to fully utilize the peg under the fixed exchange regimes as well as the flexibility under the floating exchange rate regime.
- It is designed to peg at a certain value but, at the same time, to “glide” in response to external market uncertainties.
- **Pegged with horizontal bands:** This system is similar to crawling bands, but the currency is allowed to fluctuate within a larger band of greater than one percent of the currency’s value.

a) Advantages of fixed exchange rate system

- It encourages international trade by ensuring certainty and predictability of prices with goods involved in international trade
- It ensures stability in foreign exchange markets by avoiding constant appreciation and depreciation with in the currency which ensures confidence in the domestic market
- It minimizes speculation in the economy by both goods and foreign exchange markets and it is negative effects
- It reduces exploitation and cheating of foreign exchange buyers and holders by money markets and foreign exchange markets.
- It facilitates planning since income in form of foreign exchange assessed and predicted according to the rate of exchange.
- The government can easily use foreign exchange rate to minimize BOP deficits i.e. by rising the exchange rate and devaluing the domestic currency which makes exports cheap and imports expensive hence improvement in the BOP position
- Encourages long term capital inflows in an orderly manner thus encouraging investment

- Fixed exchange rates impose a price discipline on nations with higher inflation rates than the rest of the world, as such a nation is likely to face persistent deficits in its balance of payments and loss of reserves.

b) Disadvantages of fixed exchange rate system

- It is expensive to maintain because it requires a lot of foreign exchange reserves.
- It requires strict monitoring of the economy which is affected by insufficient personnel.
- It may lead to inflation if it is fixed above the market price or deflation if it is fixed below the market price.
- It reduces speculation which reduces business profitability.
- It discourages competition in foreign exchange markets which leads to inefficiency.
- The announced exchange rate may not coincide with the market equilibrium exchange rate, thus leading to excess demand or excess supply.
- The central bank needs to hold stocks of both foreign and domestic currencies at all times in order to adjust and maintain exchange rates and absorb the excess demand or supply.
- The cost of government intervention is imposed upon the foreign exchange market.
- It fails to identify the degree of comparative advantage or disadvantage of the nation and may lead to inefficient allocation of resources throughout the world.
- Fixed exchange rate does not allow for automatic correction of imbalances in the nation's balance of payments since the currency cannot appreciate/ depreciate as dictated by the market. It is too rigid so that the exchange rate system cannot respond to the changes in the economy. For example, when there is BOP surplus or deficit
- There exists the possibility of policy delays and mistakes in achieving external balance

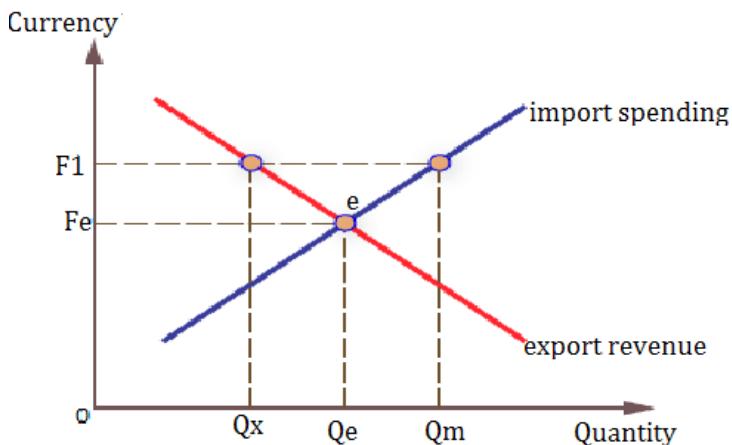
5.1.3.3. Flexible /floating/free/market/ fluctuating Exchange Rate System:

Flexible exchange rate system refers to a system in which exchange rate is determined by forces of demand and supply of different currencies in the foreign exchange market. The value of currency is allowed to fluctuate freely according to changes in demand and supply of foreign exchange. There is no official (Government) intervention in the foreign exchange market.

The exchange rate is determined by the market, i.e. through interactions of thousands of banks, firms and other institutions seeking to buy and sell currency for purposes of making transactions in foreign exchange.

When the supply of foreign exchange is equal to the demand for it, then equilibrium exchange rate is determined.

Figure 2: Exchange rate Equilibrium



From the figure above, forex equilibrium is obtained when import spending is equal to export revenue. i.e. at point 'e' in the above diagram. This means that the demand for forex is equal to its supply. F_e is equilibrium currency rate while Q_e is equilibrium quantity demanded and supplied of currencies. Below or above F_e , the demand for and supply of currencies isn't equal thus causing disequilibrium in the forex market (forex shortages or excess).

In a floating exchange rate system, when the external value of the currency increases, then this is called **currency appreciation** (low exchange rate) and when the external value declines, this is called **currency depreciation** (high exchange rate)

Table 1: Fixed Exchange Rate System Vs. Flexible Exchange Rate System:

Basis	Fixed Exchange Rate	Flexible Exchange Rate
Determination of Exchange Rate:	It is officially fixed in terms of gold or any other currency by government.	It is determined by forces of demand and supply of foreign exchange.
Government control	There is complete government control as only government has the power to change it.	There is no government intervention and it fluctuates freely according to market conditions.
Stability in Exchange Rate:	The exchange rate generally remains stable and only a small variation is possible.	The exchange rate keeps on changing.

a) Advantages of flexible exchange rate

- The system is automatic and therefore does not need a lot of government involvement and expenditure on foreign exchange rate monitoring
- Trade imbalances i.e. surpluses and deficits are corrected automatically by the forces of demand supply
- It responds to the rapid economic changes quickly since it is automatic
- It encourages proper resource utilization into their optimal use
- It increases the volume of international trade because of the freedom in the foreign exchange markets
- It encourages efficiency and competition in the money market

b) Disadvantages of the flexible exchange rate

- It creates uncertainty as it fluctuates and discourages international trade and capital movements
- It creates instabilities in the foreign exchange rate thus affecting planning and hence discouraging economic growth and development
- It encourages speculation in the foreign exchange where foreign exchange buyers may be cheated
- It is inefficient in correcting BOP deficits as the domestic demand for exports and imports remain inelastic
- It leads to fluctuations in export earnings which affects budgeting of the government

- It discourages long term contracts between borrowers and lenders which may discourage investments and economic growth and development
- In case there is no understanding between governments about manipulation of exchange rates, it may result into war of exchange rates with each country trying to establish favourable rates with other countries

c) Causes of Currency depreciation in LDCs

- Decline in the volume and value of exports (primary products)
- Decline in foreign exchange inflow due to political instabilities
- Decline in international payments in the domestic banks
- Reduction in the volume of grants, aid and loans
- Increase in demand for imports especially capital inputs and essential consumer goods
- Increase in foreign exchange expenditure e.g. on embassies, official trips abroad etc.
- Government policy of devaluation
- High rates of inflation which reduces domestic production

d) Effects of currency depreciation

Positive effects

- It increases the volume of exports hence foreign exchange earnings
- It encourages export promotion and import substitution industrialization which reduces foreign exchange expenditure
- It encourages domestic investments because the cost of production is low at home if inputs are not imported.
- It reduces the BOP problems because the expenditure on imports reduces
- It increases capital inflow and foreign investments
- It encourages exploitation of domestic resources because it is cheap to produce at home

Negative effects

- It reduces the volume of imports which might lead to scarcity of goods and services in the economy
- It makes projected planning difficult and distorted

- It increases the cost of production at home because of expensive imported inputs
- It increases the country's indebtedness abroad
- It worsens BOP problems since imports become expensive than exports
- It leads to loss of confidence in the local currency
- It may lead to over exploitation of resources since it is cheaper to produce at home.

5.1.3.4. Mixed/multiple/Managed/ Dirty Floating Rate System:

This refers to a system in which foreign exchange rate is determined by market forces and central bank influences the exchange rate through intervention in the foreign exchange market. It is a hybrid of a fixed exchange rate and a flexible exchange rate system.

In this system, central bank intervenes in the foreign exchange market to restrict the fluctuations in the exchange rate within certain limits. The aim is to keep exchange rate close to desired target values. For this, central bank maintains reserves of foreign exchange to ensure that the exchange rate stays within the targeted value.

When the exchange rate rises above the upper limit, the central bank intervenes and buys off the surplus or excess foreign exchange. When the exchange rate falls below the lower limit, the central bank supplies the needed foreign exchange. However, this depends on the purpose on which the foreign exchange is needed

a) Advantages of the managed floating exchange rate system

- It helps a country to export and import commodities of national priority
- Government can reduce unfair competition of foreign currencies over domestic currencies
- It reduces excessive foreign exchange fluctuations in the foreign exchange market
- It reduces speculation hence reducing hoarding and scarcity of foreign exchange

b) Disadvantages of the managed floating exchange rate system

- It is expensive for the government to supervise and maintain maximum and minimum margins
- It limits free convertibility of currencies hence limiting the flow of exports and imports

- It doesn't allow free exchange of currencies to determine the real value
- It might lead to malpractices such as over invoicing imports and under invoicing exports.



Application activity 5.1.

From your knowledge of exchange rates, carry out research on the factors that determine the exchange rate in a foreign exchange market and make class presentations.

5.2. Devaluation.

5.2.1. Meaning and reasons for devaluation.

Activity 5.5.



Make research and find the meaning of the following terms.

Currency devaluation. Currency depreciation. Currency appreciation.

Given the following as the exchange rate between a Rwf and US \$ is such that **US \$ 1 is equal to 900 Rwf**, the price of a car from an Auto market in Japan is 1000 US \$ while the price of Made in Rwanda Cotton fabric is 27000Rwf per metre.

Determine

- The price of the same car from the Auto market in Japan in Rwf?
- The price of Made in Rwanda cotton fabric in US\$?

Because of changes in demand and supply of a dollar and Rwf, the dollar gains more value against the Rwf such that the exchange rate changes and **US\$ 1 is equal to 1200Rwf**.

Basing on the new exchange rate, determine

- The price of the above car in Rwf.
- The price of the Made in Rwanda cotton fabric in US\$.

Compare the prices above before and after the changes. Derive a suitable conclusion.

Devaluation refers to deliberate government policy of reducing the value of domestic currency in the terms of other currencies i.e. the domestic currency becomes cheaper in relation to other countries' currencies.

Devaluation is only possible under the fixed exchange rate system. It takes place when there is fundamental disequilibrium in the balance of payment. The devaluating country has no supply rigidities but it is facing marketing difficulties.

LDCs devalue their currencies due to the following reasons;

- To make exports cheap and hence lead to more export, thereby leading to increase in foreign exchange earnings.
- To collect balance payment problems by reducing imports by making them expensive. This is because importers need more of the local currency in order to obtain foreign exchange they thus either have to import less or charge high prices hence low quantity demanded for them.
- To attract foreign and domestic investors as it becomes cheaper to invest in the economy as little foreign exchange can be exchanged for a lot of the local currency. Again due to devaluation there is export promotion leading to increased market for output produced by investors.
- To protect domestic infant industries from competition by cheap imports by making similar imports expensive.
- To promote self-sufficiency by encouraging import substitution industries and reduce dependency on imports from other countries.
- To conserve foreign exchange as it discourages imports and minimizes foreign exchange outflow and therefore can reduce on the problem of trade shortage.
- To increase on the level of productivity and thus domestic resource utilization this calls for employment of idle resource.
- To increase on employment opportunities at home through increased domestic production.
- Some LDCs undertake devaluation in order to fulfill IMF conditionalities in order to receive loans.
- To check on imported inflation because after devaluation, the inflation hit imports are too expensive and this discourages importers.
- To increase the nominal income of the producers of primary products that are exported

5.2.2 Conditions necessary for devaluation to be successful

Activity 5.6

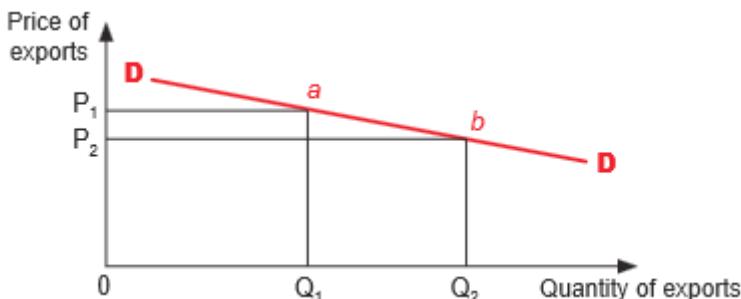


Make research and find the factors that can make devaluation succeed or fail.

A number of conditions have to be made for devaluation to be successful

- The demand for exports must be price elastic. That is, a small price reduction resulting from devaluation will lead to a proportionately large increase in their purchase and more foreign exchange will be earned.

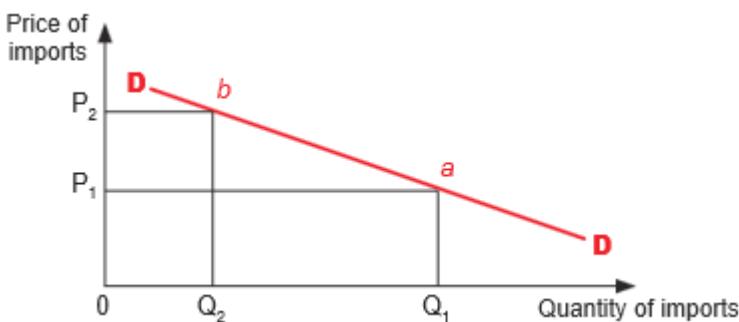
Devaluation and foreign exchange earnings.



From the figure above before devaluation foreign exchange earning from exports are OQ_1aP_1 and after devaluation foreign exchange earnings increase to OQ_2bP_2 . Rectangle OQ_2bP_2 is bigger than rectangle OQ_1aP_1 , meaning that more foreign exchange earnings are as a result of a fall in the price from OP_1 to OP_2 which increased quantity exported from OQ_1 to OQ_2 .

- The demand for imports should be price elastic so that imports appear to be expensive after devaluation and less of them are demanded hence less foreign exchange expenditure.

Devaluation and foreign exchange expenditure.



From the figure above, before devaluation, the price for imports was OP_1 and the quantity imported was OQ_1 . After devaluation, the price for imports increased from OP_1 to OP_2 and the quantity demanded of imports fell from OQ_1 to OQ_2 , thereby reducing the foreign exchange expenditure from OP_1aQ_1 to OP_2bQ_2 . Rectangle OQ_2bP_2 is smaller than rectangle OQ_1aP_1 .

- The supply of export in the devaluating country should be elastic such that as demand for export increases then more quantity of exports should be supplied
- The supply of imports should be price elastic in that when there is devaluation and there is a decrease in demand for imports, the quantity supplied for them should be able to reduce greatly.
- There should be no inflation in devaluating country so that after devaluation exports will be cheap and attractive to foreign importers hence more will be imported.
- There should be no restrictions on exports from the devaluating countries otherwise this would limit exports and hence earnings from exports.
- There should be no counter devaluation or other countries should not retaliate by devaluing their currency because this will neutralize the intention of devaluating countries.
- There should not be trade union to put pressure on wages and increase the cost of production.
- There should be excess capacity in devaluating country such that as exports are produced, imports are discouraged and more output is produced to substitute import.

- The marginal propensity to import in devaluing country should be low.
- The devaluing country should be able to compete favorably in the world market
- The devaluing country should be politically stable so as to ensure stable production
- There should be stability in the exchange rate system i.e. fixed exchange rate regime.

5.2.3: Effects of devaluation.

Activity 5.7



Make research and discuss the view that developing economies should use devaluation as a tool to bring out economic growth and development.

Positive effects

- It increases the volume of exports by making them cheap.
- It increases the volume of foreign exchange earnings by increasing on the volume of exports.
- It increases the capital inflow e.g. through foreign investment because it becomes cheaper to produce in the devaluing country.
- It improves balance of payment position due to increased foreign exchange earnings and reduced foreign exchange expenditure on import.
- Increase in domestic investments which increase exploitation of idle resources.
- It increases employment opportunities at home, e.g. through export promotion and import substitution industries.
- It leads to development of domestic infant industries by making similar imports expensive.
- It promotes self-sufficiency by encouraging exports and reducing the volume of imports.

Negative effects

- It worsens the balance of payment position because external market for products from developing economies is poor.
- It leads to imported inflation since devaluation increases prices of imports yet imports in developing economies have inelastic demand.
- It leads to capital flight by nationals because they will tend to invest outside to earn high value foreign currency.
- Due to inflation that may result from devaluation imported inputs become expensive which discourages production yet developing economies heavily depend on imported capital.
- It increases borrowing rate and debt servicing burdens by developing economies since they need a lot of income in terms of domestic currencies in form the foreign resources.
- It leads to persistent government budgetary deficit as a result of increased expenditure on imports which increases expenditure due to devaluation that makes import expensive.
- Saving levels can decline in economy because of liquidity preference to meet high price of imported commodities thus causing inflation.
- It affects fixed income earners because where as prices are increasing due to devaluation their income remains constant hence low real incomes.
- If it is common, it may discourage investors who lose confidence in the local currency.
- It may reduce the standards of living of people due to shortage of commodities in the economy as a result of restricting imports yet developing economies heavily depend on imports.
- 11. It also discourages competition by protecting infant industries which may provide low quality commodities yet charging high prices.12. It may hinder technological transfer because of the increase in the cost of imported commodities and inputs.

5.2.4: Success of devaluation policy in LDCs.

Activity 5.8.



Analyse the statements below and answer the questions that follow;

1. Under AGOA arrangement, African products have an opportunity to access American markets without strict tariff restrictions. And this implies that African producers would reap highly from this arrangement since their currencies have lower value in comparison to the US dollar. However, most African countries have not enjoyed maximum benefit from this?
2. Most developing countries import commodities that are price and income inelastic, for instance medicine. Even the supply of their products is also inelastic because of supply rigidities.

In reference to the above statements, discuss why devaluing currencies in developing countries may not easily benefit them.

Most developing economies which have tried devaluation as a measure to solve their BOP problems have not succeeded due to the following reasons

- Domestic elasticity of demand of their imports is low because of high population growth rate
- Developing economies import commodities that are price and income inelastic because they are mainly essential commodities
- There is protectionism by developed economies on products from developing economies so as to increase employment in MDCs.
- The elasticity of supply of products from developing economies is low because of domestic supply rigidities.
- Developing economies have competitive supply i.e. supply of similar commodities; they therefore tend to carry out competitive devaluation.
- Developing economies have inadequate co-operant factors especially capital and entrepreneur hence low production for exports.
- Most developing economies experience high rates of inflation which discourage export due to high costs of production
- Developing economies pursue unfavorable economic policies like trade legalization which increase the inflow of imports.

- There is high degree of malpractice for example smuggling because of inefficient administrative machinery hence increasing the volume of imports.
- Political instability and insecurity in developing economies discourage domestic production and foreign investment.
- There is counter devaluation among developing economies i.e. other countries retaliate by devaluing their currency.
- There is high marginal propensity to import due to the desire for essential capital input and imported raw materials.
- Developing economies exports are limited by low export quotas in the International Commodity Agreement (ICA)
- There are weak export promotion institutions in developing economies which reduce the benefits of devaluation.
- Developing economies face foreign exchange instabilities because of adapting liberal exchange rate systems.



Application activity 5.2.

The Kenyan shilling has a relatively higher value than the Rwandan franc. Assess the impact of this on the trade between Rwanda and Kenya.



End unit assessment

1. a) When and why is devaluation carried out?
b) How is devaluation of a currency supposed to address an economy's balance of payments current account deficit?
2. Under what circumstances may devaluation fail to achieve its intended objectives in an economy?
3. Explain the merits and demerits of floating exchange rate system.

UNIT 6

ECONOMIC INTEGRATION

Unit Competency:

Explain the importance of economic integration to the development of their economy.



Introductory activity

Many countries consider regional economic integration as one of the crucial elements of achieving their developmental goals. Rwanda as a nation, has joined a number of economic groupings.

According to you:

1. What do you understand by economic integration?
2. Which economic groupings do Rwanda belong to?
3. What do you think is the aim of Rwanda joining different economic groupings?

6.1: Meaning and objectives of economic integration

Activity 6.1.



(a) Write the following in full

- (i) EAC
- (ii) COMESA
- (iii) SADC
- (iv) ECOWAS
- (v) OPEC

(b. Explain the major objectives behind economic integrations in developing countries.

6.1.1. Meaning of economic integration.

Economic integration is a commercial policy where countries come together for the sake of economic benefits by eliminating trade barriers among themselves.

It can also be defined as the coming together of countries in a given region so as to promote trade and enjoy economic benefits by working collectively. It is aimed at increasing the share of member countries in international trade as a means of achieving political harmony amongst themselves and also to consolidate their influence in international or global politics.

Examples of economic integration include

1. East African Community-EAC,
2. Common Market of East and Southern Africa-COMESA,
3. Oil and Petroleum Exporting Countries- OPEC,
4. Southern Africa Development Community (SADC),
5. Economic Community for West African States-ECOWAS,
6. European Union-EU,
7. African Union- AU,
8. African Caribbean Pacific Countries (ACP)
9. Economic Community of the Great Lakes Countries (CPGL) and many others.

6.1.2: Objectives of economic integration

Coming together of countries in a given region so as to promote trade and enjoy economic benefits involves number of objectives;

1. To enlarge and diversify market for locally produced commodities in the region.
2. To reduce or eliminate trade barriers among themselves e.g. use of one currency or allowing local currencies among member states or encouraging barter trade.
3. To avoid duplication of commodities by encouraging specialization in each country.
4. To increase the utilization of domestic resources which cannot be exploited by a single country.
5. To enhance free flow of ideas, skills and technology in the region.
6. To reduce the cost of production by adopting large scale enterprises which makes them enjoy economies of scale.
7. To increase the bargaining power of member states in the international market.
8. To improve the terms of trade of member states.
9. To boost industrialization and production of commodities to out compete manufactured imports and reduce dependence among member states.
10. To promote political harmony and security in the region.
11. To expand employment opportunities for member states.
12. To decrease the exploitative powers of developed countries by reducing or stopping imports from developed countries that are always expensive.

6.2: Conditions necessary for successful economic integration.

Activity 6.2.



Explain the necessary conditions for successful economic integration in developing countries.

1. Geographical proximity i.e. countries coming together into an integration should be geographically close to one another or should share common borders in order to effect preferential treatment to each other.
2. Common and same ideology i.e. they should have common historical background and ideology so as to harmonize their social economic policies e.g. socialism capitalism and mixed economies.
3. They should be at the same level of development so as to ensure fair flow of resources otherwise resources would flow from less developed countries to developed countries.
4. There should be strong political will or similar political organization among cooperative countries i.e. commitment by leaders and their population.
5. Countries should be preferably of equal size because there is a likelihood of them having unequal quantities of resources.
6. The economies of countries should be in position of producing different products so that exchange is promoted.
7. There should be production of diversity of commodities thus specialization and exchange to be encouraged.
8. Citizens in the cooperative countries should have enough income so as to promote adequate market for commodities.
9. There should be political stability among cooperative countries so as to ensure smooth operation of the regional activities.
10. There should be a well-developed infrastructure like roads in all cooperative countries so as to make transportation of goods and services within the region simple and cheaper.
11. Countries should be complementary to one another so as to exchange their commodities.
12. There should be a common language in the region so as to make communication easy to all people within the region.

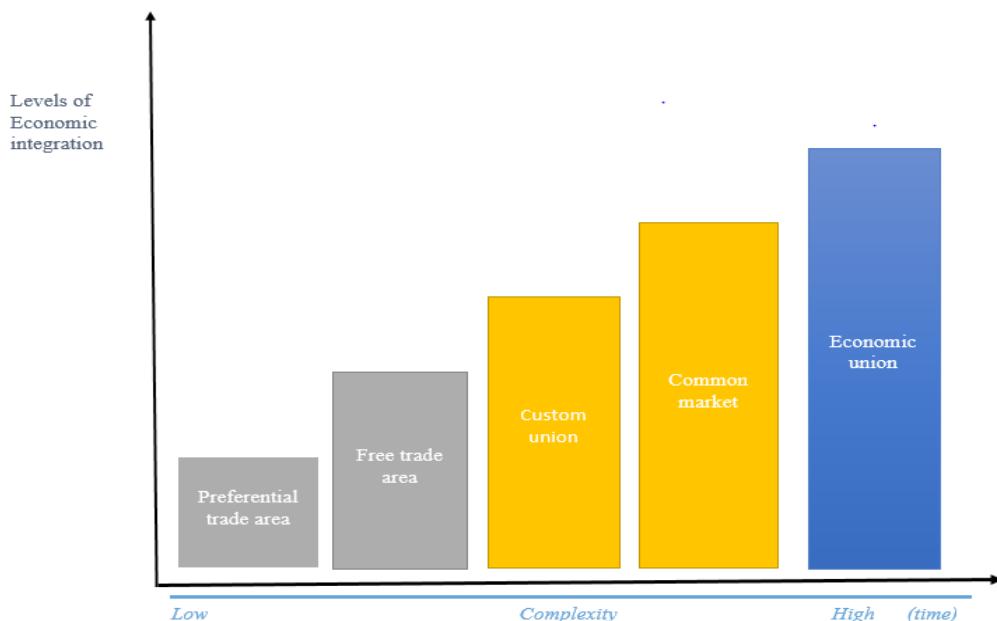
6.3: Process/ stages/ levels of economic integration.

Activity 6.3



For countries to fully integrate; they must pass through different levels of economic integration. Most economists regard an economic integration as “not a single day process” it requires a lot of effects, and a number of stages are involved.

Why do you think economic integration is regarded as “not a single day process” by most economists?



Economic integration is not a single day process, it's a long time journey from the day it was started (at low level) going through a lot of complexity up to the point it takes the highest level. Therefore, it's a gradual process that takes different stages which don't have a clear demarcation, but depends on how committed and willing the integrated economies are to reach up their expected goals. These include among others the following;

1. **Preferential Trade Area (PTA):** This is the initial level in the development of economic integration where countries start their cooperation. In here member countries give preferential treatment to each other. There are low tariffs charged on selected commodities from member states while high tariffs are charged on commodities from non-member states. This is often the first

small step towards the creation of a trading bloc. Agreements may be made between two countries (bi-lateral), or several countries (multi-lateral).

2. **Free Trade Area (FTA):** Here member countries agree to abolish or eliminate tariffs or trade barriers among themselves but each country retains separate tariff structure on commodities from non-member states.
3. **Custom union (CU):** This is where member countries eliminate all tariffs or trade barriers amongst themselves and in addition countries adopt a common tariff structure on commodities that are from non-member countries but there is no free flow of factors of production among member countries.
4. **Common market (CM):** In here, member countries eliminate trade barriers amongst themselves; charge a common tariff on commodities from non-member countries and allow free mobility of factors of production within the region e.g. capital and labor. This is done to boost production, increase employment and increase reward for factors of production and improve economic welfare in the region.**Economic community/ union (EC/ EU);** This is where there is eliminating of all tariffs among member states, adoption of a uniform tariff structure on commodities from non-member countries; free mobility of factors of production within the region; adoption of harmonious economic policy where countries in the same region have the same economic strategy, use the same policies and policy tools, joint ownership of enterprises and use of the same currency is adapted thus have the monetary unions, harmonization of the social services like education, health etc. increase the level of political identity and formation of political federation.

6.4: Advantages and disadvantages of economic integration

Activity 6.4



Make research and discuss the view that Rwanda's joining of the EAC has brought more benefits than costs.

6.4.1. Advantages of economic integration.

As a country joins different economic groupings, it is very much expectant to achieve its goals as had been the reason for its joining. These benefits include among others the following:

1. Trade creation effect. This is where the creation/formation of the economic cooperation results into a shift from consumption of expensive products from non-member countries to consumption of cheap products in member countries.
2. Expansion and extension of large markets; most economic integration provides sufficient wide export markets since member countries have to import within the region which therefore boosts production and promote rapid economic growth.
3. Skill development and technological transfer i.e. due to free mobility of factors of production, it facilitates skill development and technological transfer within cooperative countries.
4. It increases the bargaining power of member countries in the international market, therefore this increases their benefits from the international trade.
5. It increases the competition which leads to high productivity in terms of quantity and quality.
6. It facilitates specialization based on comparative cost advantage i.e. countries avoid competition in the production but instead specialize on the basis of comparative advantage which boosts production hence more volume of exports.
7. Sharing of common services like research, education health transport and communication becomes very easy which in turn increases efficiency since they are jointly operated thus reduction of duplication of services
8. It promotes industrialization among member states by establishing manufacturing industries.
9. Common currency is used and state adopts a common currency and it is strong and always stable which stabilizes prices in the region.
10. There is creation and expansion of employment opportunities and reduction of unemployment among member states due to the flow of factors of production freely amongst themselves.
11. It enhances political harmony and stability in the region i.e. common political problems can be solved through consultation and sharing of ideas
12. It helps in redistribution of income in the region i.e. economic integration fosters a more equitable distribution of resources when factors of production are allowed to flow freely between or among countries thus equalizing returns to each factor.
13. It reduces balance of payment deficit because economic integration leads to reduction of foreign exchange expenditure and increased export earnings.

14. It increases consumers' choice i.e. since a variety of goods are produced with in the region, countries get commodities at low prices and low costs thus maximizing profits.
15. It reduces administrative costs involved in import-export restrictions.
16. It promotes self-reliance among the cooperative countries i.e. it reduces economic dependence of LDCs on MDCs
17. It is a vent for surplus; the resources formerly unutilized can be exploited because of a wider market created by the integration.

6.4.2: Disadvantages of economic integration

Much as a country expects benefits from joining different economic groupings, it should as well expect the adverse effects out of it which may include the following;

1. Trade diversion i.e. this is where trade is diverted from low cost producers outside the integrated region to high cost producers with in the region. In addition, countries might continue using low quality products from within the region when they could have secured high quality goods from outside region.
2. Loss of revenue which could have been got from tariffs due to free flow of goods and services and factors of production within the region and common tariff structure on non-member states.
3. It may lead to loss and movement of resources and goods from less developed countries to more developed countries.
4. Most LDCs produce similar products and find it hard to trade among themselves leading to surplus.
5. When many industries are constituted in one country due to pull factors, it causes uneven distribution of industrial benefits.
6. Cooperative countries are forced to forego some of their national interests which reduce self-reliance and sovereignty.
7. It may lead to production of low quality products because of restriction of similar commodities from non-member countries.
8. It may lead to over exploitation and quick exhaustion of resources in order to supply a large market created in the region.
9. Large scale ventures may experience diseconomies of scale. It leads to loss of political sovereignty in case of a political integrated federation.
10. When there is political instability in one country, it may affect the whole integrated region because all countries depend on each other.

11. Other countries may retaliate and also impose restrictions on imports and thus may lead to formation of rival trade blocks.
12. It may lead to unemployment i.e. firms will be relocated to more cost effective location within the block thus it may lead to unemployment to other countries from where the firms move.



Application activity 6.1

One of the advantages of economic integration is trade creation and one of its disadvantages is trade diversion.

- (a). Basing on the above statement distinguish between trade creation and trade diversion.
- (b). Discuss the effects of trade creation and trade diversion on the economy.

6.5: Obstacles/ impediments to successful economic integration in LDCs.

Activity 6.5



Explain the factors that hinder successful operations of economic integrations.

- (i) **Political instabilities in some developing countries.** This hinders economic integration because most countries fear absorb the problems of other countries after integrating. Even after
- (ii) **Integration,** some countries may fail to work with others effectively in the region because of political problems in their countries hence hindering effectiveness of the regional integration.
- (iii) **Inadequate political commitments among member countries.** Where some member states are not committed to the activities of the integration. Sometimes do not send to meetings those officials who have the appropriate expertise on the issues to be discussed, and other times regional meetings are not attended to regularly.
- (iv) **Differences in political ideologies,** it is very hard for the integration to

be successful if member states have different ideologies. Most integrations in developing countries have failed simply because of differences in political ideologies.

(v) **Differences in levels of development.** It is very hard for countries to integrate successfully when some countries are more developed than others. Many economic integrations in Africa have failed after realizing that some countries within the region benefit much more from the grouping than others because of not being at the same developmental levels.

(vi) **External obstacles by developed countries.** These developed countries always fight against the economic integration of developing countries. Many economic integration in developing countries have been sabotaged by developed countries who always look at integration in such countries as a big obstacles towards their political and economic benefits.

(vii) **Unfavorable exchange rate system.** Some countries have currencies which have more value than other countries. When the value of currencies in the integration have different values this means that the exchange rate may be in favour of some countries and disfavour of others hence hindering integration.

(viii) **Differences in cultures.** It is always very hard for countries to integrate successfully when people totally have different cultures. Sometimes differences in cultures has been given as an excuse for the failure of some economic integration in developing countries. Culture means a lot towards people's cooperation, so when it is totally different it means there are some stages of cooperation which countries may not be able to reach at hence being an obstacle.

(ix) **Production of similar products.** It is totally hard for the integrated countries to reach higher stages of the economic integration simply because of producing similar products which makes it hard for countries to benefit from each other as it is always intended for thus being a big obstacle.

(x) **Need for self-reliance.** Some countries may refuse to integrate with others because of their need for self-reliance. Regional integration requires a country to sacrifice some of her national interest for the sake of the region like self-reliance in order to effectively cooperate with other countries which some countries fail to meet hence being an obstacle.

(xi) **Difference in fiscal and monetary policies.** It is very hard for countries to integrate if their monetary and fiscal policies are totally different. Many countries within the integration have failed effectively to cooperate with others simply because of differences in their tax structures and of which sometimes not favouring some member countries.

(xii) **Differences in geographical boundaries**, it is also very hard for countries to integrate successfully if they are not near each other because this makes transportation of goods so costly and very hard.



Application activity 6.2

"Many economic integrations in developing countries have been successful and others have failed to achieve their objectives". Discuss your views about the above statement.

6.6: Case study of economic integration.

Activity 6.6



Make research on East African Community (EAC) case study provided below and share with the whole class the following.

1. The countries that make up EAC
2. What are the objectives behind EAC formation?
3. Explain the achievements and challenges of EAC
4. Why did Rwanda join the EAC?
5. What has Rwanda benefited from EAC?

6.6.1. East African Community (EAC)

"EAC motto: one people, one destiny"



EAC flag



EAC Emblem



EAC map

The East African Community (EAC) is an intergovernmental organization composed of six countries in the African Great Lakes region in eastern

Africa: Burundi, Kenya, Rwanda, South Sudan, Tanzania, and Uganda, with its Headquarters in Arusha. The organization was founded originally in 1967, collapsed in 1977, and revived on 7 July 2000 following its ratification by the Original 3 Partner States – Kenya, Uganda and Tanzania. And later in July 2009 Rwanda and Burundi Joined East African community and in April 2016 South Sudan has also joined east African countries.

6.6.2. Aims and Objectives

The EAC aims at widening and deepening co-operation among the Partner States in, among others, political, economic and social fields for their mutual benefit and the following are some of the specific objectives of East African community;

The specific objectives of the EAC Integration are:

1. The attainment of sustainable growth and development of the Partner States by the promotion of a more balanced and harmonious development of the Partner States
2. The strengthening and consolidation of co-operation in agreed fields that would lead to equitable economic development within the Partner States and which would in turn, raise the standard of living and improve the quality of life of their populations.
3. The promotion of sustainable utilization of the natural resources of the Partner States and the taking of measures that would effectively protect the natural environment of the Partner States
4. The strengthening and consolidation of the long standing political, economic, social, cultural and traditional ties and associations between the peoples of the Partner States so as to promote a people-centered mutual development of these ties and associations;
5. The mainstreaming of gender in all its endeavors and the enhancement of the role of women in cultural, social, political, economic and technological development;
6. The promotion of peace, security, stability within, and good neighborliness among the Partner States.
7. The enhancement and strengthening of partnerships with the private sector and civil society in order to achieve sustainable socioeconomic and political development.

6.6.2. Achievements of the East African Community.

1. The most important achievement was the establishment of the EAC Custom Union. The Custom Union Protocol was signed in March 2004 and came into effect on January 1, 2005. Under Customs Union arrangements, goods produced within the EAC move across the border of partner states without taxation provided they qualify under rules of origin.
2. It has increased both inter and intra-regional trade, increased competition that has increased consumer's choice, reduction of costs, and attraction of foreign direct investments.
3. It has witnessed an increase in intra-EAC Foreign Direct Investments as well as Foreign Direct Investments from outside.
4. There is mutual recognition of standards marks across the region where the bureaus of standards have developed an EAC catalogue of standards.
5. It has led to establishment of One Stop Boarder Posts that have already been articulated within the auspices of the community law. This has facilitated trade within the community.
6. Has implemented Internal Tariff Elimination; this has facilitated smooth trade among the states.
7. As part of the joint effort to promote East Africa as a single tourist destination, partner states have participated in major international travel markets forums including the World Travel Market in London November 2005 and the International Tourism Bourse in Berlin in March 2006 which has helped in promoting East Africa as a single tourist destination and has resulted in attracting more tourists and increasing the contribution of the tourism industry to the East African economy.
8. Promotion of foreign policy co-ordination through collaboration in diplomatic and consular activities; collaboration in economic and social activities; liaison and exchange of information; and collaboration in administration and capacity building
9. The partner states have adopted an action program that has focused on increased employment and poverty reduction in the EAC. In this regard, the EAC projects and programs are assessed as to how they contribute towards poverty eradication in the region. Furthermore, the East African Community established an annual Ministerial Forum to focus on employment creation and poverty reduction.
10. Launched Lake Victoria Commission i.e. East African partner states have taken a number of steps to preserve the lake through the implementation of the Lake Victoria Environmental Management Program. This has

ensured sustainable use of Lake Victoria as vital for the sustainability of Lake Victoria.

11. Improvement of East African Infrastructure through the East African Road Network Project where a Tripartite Agreement on Road Transport has been ratified by partner states. The main objectives of the agreement are to facilitate interstate road transport through reduced documentation for crews and vehicles at border crossing, harmonized requirements for operation licensing and customs and immigration regulations, among others. In order to fast-track decisions on transport and communications, the EAC established the Sectoral Council on Transport, Communications and Meteorology.
12. Harmonization of Monetary and Fiscal Policies i.e. Steps toward the harmonization of monetary and fiscal policies have included convertibility of the partner states' currencies, harmonization of banking rules and regulations, harmonization of Finance Ministries' pre- and post-budget consultations, regular sharing of information on budgets, and reading of budget statements on the same day. In capital markets, there have been changes in the policies and trading practices and regulations in the three stock exchanges. The committee for The Establishment of Capital Markets Development that oversees development of the capital markets in the East African Community aims to develop East African Community Capital Markets including managing cross-listing of stocks.
13. Strengthened an East African Identity i.e. there have been developments designed to foster the feeling of integration among the people of the EAC and to facilitate an East African identity. These have included the introduction of the East African Community flag, the launching of an East African anthem and the East African passport.

6.6.3. Challenges of the East African Community

Despite the progress made throughout the years, some challenges remain noteworthy when it comes to establishment of some policies in the community and this has hampered the progress of the community;

1. Some citizens of some member states lack awareness of the regional integration process and cannot articulate the benefits that can be drawn from the EAC integration process. e.g. in Tanzania
2. Differences in social political ideologies amongst member states e.g. in Tanzania the social political system that was in place for over 3 decades after independence, makes people both in public and private sectors not very entrepreneurial as they tend to rely on the government

3. One of the reasons for the collapse of the previous East African Community in 1977 was the perception of disproportionate sharing of economic benefits accruing from regional markets and lack of a formula for dealing with the problem. It is still a challenge to the community to address problems arising from the implementation of the treaty.
4. Improving the performance of major ports such as Mombasa and Dar-es Salaam, and the East Africa Road Network and East Africa Railway Network are key challenges facing the East African Community. Improving supply conditions will enhance EAC capacity to withstand the forces of globalization
5. The EAC report on Fast Tracking (2004:81) reports that the fear of loss of sovereignty is an issue in the minds of some members of the political elite of East Africa. The fear is that as a Federation, the nation states would cease to have any meaningful powers; that they would be relegated to mere provinces within the Federation. This fear cannot be ignored and a mechanism is needed to eliminate such fears. This is a political challenge for East Africans.
6. Participation by citizens is at the core of the new East African Community. The treaty advocates the need for people-driven and people-centered development. East African people should play an active role in determining the progress of the new community. The Community will therefore have to live up to the expectations of the peoples of East Africa through implementing the treaty's provisions for the creation of an enabling environment for the private sector and civil society participation, the strengthening of the private sector; and enhancement of co-operation among business organizations and professional bodies.



Application activity 6.3

Examine the benefits of East African community towards the growth and development of your economy.



End unit assessment

1. a) What are the features of economic union
b) Analyze the objectives behind economic integration by nations
c) Examine the factors that may encourage formation of economic union in eastern Africa.
2. a) Why did the former East African Community fail in 1977?
b) What good things can the current EAC learn from the former EAC?
In what ways may economic integration solve problems of underdevelopment?

UNIT 7

GLOBALISATION

Unit Competency:

Analyse the impact of globalisation on Rwandan economy.



Introductory activity

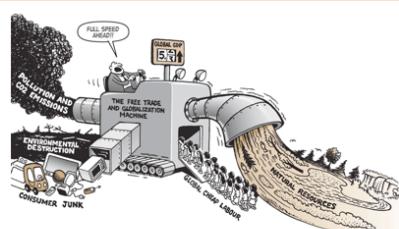
Since ancient times, humans have sought distant places to settle, produce and exchange goods enabled by improvements in technology and transportation. But not until the 19th century did global integration take off. Following centuries of European colonization and trade activity, that first “wave” of globalization was propelled by steamships, railroads, the telegraph, and other breakthroughs, and also by increasing economic cooperation among countries. The globalization trend eventually waned and crashed in the catastrophe of World War I, followed by postwar protectionism, the Great Depression, and World War II. After World War II in the mid-1940s, the United States led efforts to revive international trade and investment under negotiated ground rules, starting a second wave of globalization, which remains ongoing, though buffeted by periodic downturns and mounting political scrutiny. Source: <https://www.piie.com>

Analyse the above extract, base on it to carry out research and;

- a) Explain what you understand by the term globalisation.
- b) Describe what has sparked off globalisation in the modern world?

7.1: Meaning and forms of Globalization:

Activity 7.1



Base on the figures above to;

- Explain what you understand by the term globalisation
- Identify and explain the forms of globalisation portrayed.
- Describe other different forms which globalisation can take, apart from those forms identified above,

7.1.1: Meaning of Globalisation:

Globalisation is the growing interdependence of the world's economies, cultures, and populations, brought about by cross-border trade in goods and services, technology, and flows of investment, people, and information. Economically, globalization involves goods, services, the economic resources of capital, technology, and data. With the increased global interactions comes the growth of international trade, ideas, and culture. Globalization is primarily an economic process of interaction and integration that's associated with social and cultural aspects. Current globalization trends can be largely accounted for by developed economies integrating with less developed economies by means of foreign direct investment, the reduction of trade barriers as well as other economic reforms and, in many cases, immigration.

7.1.2: Forms of Globalisation:

Globalisation may take the following forms:

1. Economic Globalisation

Economic globalization is the increasing economic interdependence of national economies across the world through a rapid increase in cross-border movement of goods, services, technology, and capital. Economic globalization involves the process of increasing economic integration between countries, leading

to the emergence of a global marketplace or a single world market. It also involves worldwide economic system that permits easy movement of goods, production, capital, and resources. No national economy is an island now. To varying degrees, national economies influence one another. One country which is capital-rich invests in another country which is poor. One who has better technologies sells these to others who lack such technologies. Example: Multinational corporations.

2. Technological Globalisation.

This is the connection between nations through technology such as television, radio, telephones, internet, etc. This was traditionally available only to the rich but is now far more available to the poor. Much less infrastructure is needed now. Technological globalization makes it possible for countries to connect in other ways, such as financially through sending loved ones money across the globe or culturally by watching movies from other nations.

3. Political Globalisation.

Political globalization refers to the growth of the worldwide political system, both in size and complexity. It includes national governments, their governmental and intergovernmental organizations as well as government-independent elements of global civil society such as international non-governmental organizations and social movement organizations. It is the expansion of a global political system, and its institutions, in which inter-regional transactions e.g. trade are managed. Political cooperation between different countries is a form of globalization that is used to prevent and manage conflict. For example, global organizations such as the United Nations and the World Trade Organization were created to diffuse political issues and maintain order on an international scale.

4. Cultural Globalisation.

Cultural globalization refers to the transmission of ideas, meanings, and values around the world in such a way as to extend and intensify social relations. It involves the merging or “watering down” of the world’s cultures e.g. food, entertainment, language, etc. This process is marked by the common consumption of cultures that have been diffused by the Internet, popular culture media, and international travel. Cultural globalisation has been facilitated by the information revolution, the spread of satellite communication, telecommunication networks, information technology and the Internet etc. This global flow of ideas, knowledge and values is likely to flatten out cultural differences between nations, regions and individuals.

5. Financial globalisation

This is the interconnection of the world's financial systems e.g. stock markets, more of a connection between large cities than of nations.

6. Ecological Globalisation

This refers to seeing the Earth as a single ecosystem rather than a collection of separate ecological systems because so many problems are global in nature e.g. International treaties to deal with environmental issues like biodiversity, climate change or the ozone layer, wildlife reserves that span several countries.

7. Sociological Globalisation

This is a growing belief that we are all global citizens and should all be held to the same standards and have the same rights e.g. the growing international ideas that capital punishment is immoral and that women should have all the same rights as men.

8. Environmental globalisation:

This refers to the internationally coordinated practices and regulations (often in the form of international treaties) regarding environmental protection. An example of environmental globalization would be the series of International Tropical Timber Agreement treaties (1983, 1994, 2006), establishing International Tropical Timber Organization and promoting sustainable management of tropical forests. Environmental globalization is usually supported by non-governmental organizations and governments of developed countries, but opposed by governments of developing countries which see pro-environmental initiatives as hindering their economic development. Environmental globalization is related to economic globalization, as economic development on a global scale has environmental impacts on such scale, which is of concern to numerous organizations and individuals.

9. Military globalisation:

Military globalization is defined by David Held as "the process which embodies the growing extensity and intensity of military relations among the political units of the world system. It reflects both the expanding network of worldwide military ties and relations, as well as the impact of key military technological innovations (from steamships to satellites), which over time, have reconstituted the world into a single geostrategic space. Military globalization implies firmer integration of armed forces around the world into the global military system.

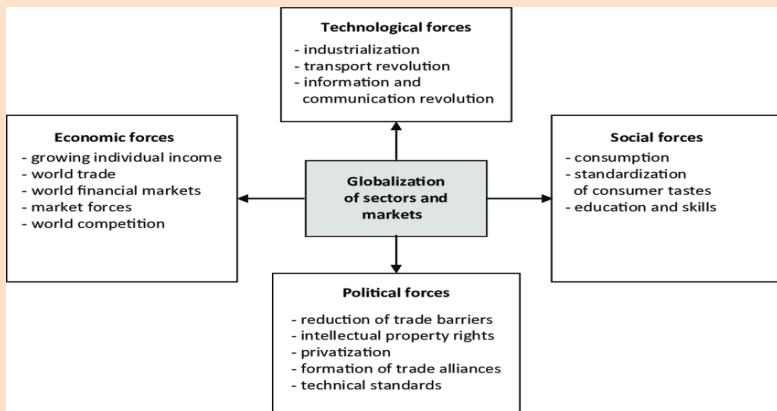


Application Activity 7.1.

What indicates that the world is globalized?

7.1.3: Causes and effects of Globalisation:

Activity 7.2



- From the image above, categorize the different factors that have given rise to globalisation.
- Other than the above mentioned factors, carry out research about globalisation, and cite what factors have given rise to globalisation in the recent past.

7.1.3.1: Causes of Globalisation:

Globalization is driven by various new development and gradual changes in the world economy. Generally, organizations go global for expanding their markets and increasing their sales and profits. The process of globalization has accelerated in the recent past due to a variety of factors, among which include the following;

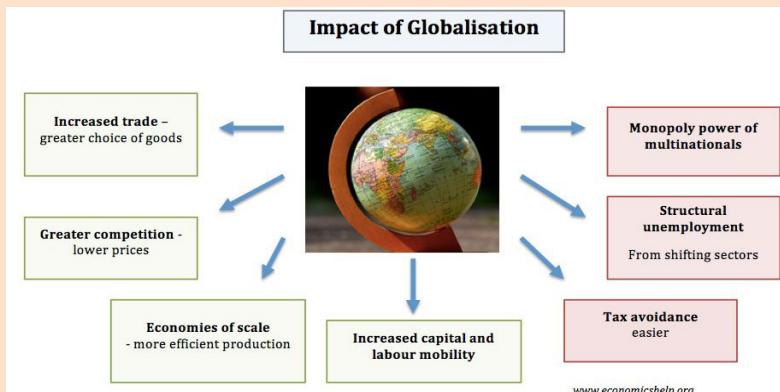
- **Improved transport, making global travel easier.** As transportation technology improved, travel time and costs decreased dramatically between the 18th and early 20th century. Today, modern aviation has made long-distance transportation and movement of people and goods across the globe, quick and affordable.

- **Increased rise in International education:** More and more students are seeking higher education in foreign countries and many international students now consider overseas study a stepping-stone to permanent residency within a country. The contributions that foreign students make to host nation economies, both culturally and financially has encouraged major players to implement further initiatives to facilitate the arrival and integration of overseas students, including substantial amendments to immigration and visa policies and procedures, hence promoting globalisation.
- **Transnational marriages:** There has been a growing rise in marriages between people from different countries thus spearheading globalization. A growing number of people have ties to networks of people and places across the globe, rather than to a current geographic location, thus, people are increasingly marrying across national boundaries making it easier to travel to different parts of the world since it's become "a single village", hence globalisation.
- **Improved technology:** Technological advances allows states to learn of others' existence and this makes it easier to communicate and share information around the world. E.g. through internet. Also, the advancement in technology and improved communication network has facilitated the exchange of goods and services, resources, and ideas, irrespective of geographical location. In this way, advanced technologies have led to economic globalization.
- Globalization has been spread by **Global journalism** which provides massive information and relies on the internet to interact, "makes it into an everyday routine to investigate how people and their actions, practices, problems, life conditions etc. in different parts of the world are interrelated.
- **Increased inter-dependency, stability, and regularity among world economies.** If states were dependent on their own production and resources to work then there is no way for any state to be mutually affected by the other. Therefore, interdependence is one of the driving forces behind global connections and trade.
- The rate of globalization has also increased under **the framework of the General Agreement on Tariffs and Trade and the World Trade Organization**, in which countries gradually cut down trade barriers and opened up their current accounts and capital accounts. This recent boom has been largely supported by developed economies integrating with developing countries through foreign direct investment, lowering costs of doing business, the reduction of trade barriers, and in many cases cross-border migration.

- **Growth of multinational companies** with a global presence in many different economies.
- **Growth of global trading blocs** which have reduced national barriers. (e.g. European Union, NAFTA, ASEAN)
- **Improved mobility of capital.** In past few decades there has been a general reduction in capital barriers, making it easier for capital to flow between different economies. This has increased the ability for firms to receive finance. It has also increased the global interconnectedness of global financial markets.
- **Increased mobility of labour.** People are more willing to move between different countries in search for work. Global trade remittances now play a large role in transfers from developed countries to developing countries.
- **Increase in Consumer Demand** acts as a main driver to facilitate globalization. Over the years, with increase in the level of income and standard of living, the demand of consumers for various products has also increased. Apart from this, nowadays, consumers are well aware about products and services available in other countries, which impel many organizations to work in association with foreign players for catering to the needs of the domestic market.
- **High Competition:** Organizations generally strive hard to gain competitive edge in the market. The frequent increase in competition in the domestic market compels organizations to go global. Thus, various organizations enter other countries (for selling goods and services) to expand their market share.
- **Reduction in Cross-trade Barriers:** Gradual relief in the cross-border trade restrictions by most governments has induced free trade, which, in turn, has increased the growth rate globalisation.

7.1.3.2: Effects of Globalisation:

Activity 7.3



From the image above,

- Identify the positive and negative impact of globalisation.
- Discuss other effects of globalisation on world economies not mentioned in the image above.

The aim of globalization is to benefit individual economies around the world by making markets more efficient, increasing competition, limiting military conflicts, and spreading wealth more equally. The wide-ranging effects of globalization are complex and politically charged. As with major technological advances, globalization benefits society as a whole, while harming certain groups. Understanding the relative costs and benefits can pave the way for alleviating problems while sustaining the wider payoffs. Therefore, the effects of globalisation to global countries may include among others the following.

Positive effects of globalisation.

Globalisation can create new opportunities, new ideas, and open new markets that an entrepreneur may have not had in their home country. As a result, there are a number of positives associated with globalisation:

- Inward investment by Trans-National corporations (TNCs) has helped countries by providing new **jobs** and skills for local people.
- Foreign direct investment (FDI) have increased at a much greater rate than the growth in world trade, helping boost technology transfer, industrial restructuring, and the growth of global companies. They, therefore, have brought **wealth** and **foreign currency** to local economies as they buy

local resources, products and services. The extra money created by this investment has been spent on education, health and infrastructure for development purposes.

- It has enabled the sharing of ideas, experiences and lifestyles of people and cultures. People have experienced foods and other products not previously available in their countries.
- Increased competition from globalization has helped stimulate new technology development, particularly with the growth in FDI, which has helped improve economic output by making processes more efficient.
- Globalisation has increased awareness of events in far-away parts of the world. This has helped to make people more aware of global issues such as deforestation and global warming and alerted them to the need for sustainable development
- Globalization has tended to bring people into contact with foreign people and cultures. This has reduced the issue of xenophobia and its negative effects.
- Open world trade has increased economic growth and raised living standards of people in different countries across the world.
- Globalization enables large companies to realize economies of scale that reduce costs and prices, which in turn supports further economic growth, although this can hurt many small businesses attempting to compete domestically.
- Economic globalization has given governments of developing nation's access to foreign lending. When these funds are used on infrastructure including roads, health care, education, and social services, the standard of living in the country increases. If the money is used only selectively, however, not all citizens will participate in the benefits.
- Globalization has led to free trade between countries. This is one of its largest benefits to developing nations. Homegrown industries see trade barriers fall and have access to a much wider international market. The growth this generates, allows companies to develop new technologies and produce new products and services.
- It has allowed businesses in less industrialized countries to become part of international production networks and supply chains that are the main conduits of trade.
- Globalisation has led to more access to capital flows, technology, human capital, cheaper imports and larger export markets.

- Access to new markets; It creates greater opportunities for firms in less industrialized countries to tap into more and larger markets around the world
- Reduced tariff barriers encouraging global trade. Often this has occurred through the support of the WTO.
- Globalisation has helped build a global economic order governed by mutually accepted rules and overseen by multilateral institutions. This has created a better world with countries seeking to cooperate with one another to promote prosperity and peace. Free trade and the rule of law being the mainstays of the system, have helped to prevent most economic disputes from escalating into larger conflicts. E.g. International Monetary Fund (IMF), World Bank (WB), United Nations (UN), North Atlantic Treaty Organisation (NATO), World Trade Organisation (WTO) etc.
- Globalization encourages each country to specialize in what it produces best using the least amount of resources, known as comparative advantage. This concept makes production more efficient, promotes economic growth, and lowers prices of goods and services, making them more affordable especially for lower-income households.
- Larger markets enable companies to reach more customers and get a higher return on the fixed costs of doing business, like building factories or conducting research. Technology firms have taken special advantage of their innovations this way.
- Competition from abroad drives different firms in different countries to improve their products. Consumers have better products and more choices as a result.
- Expanded trade spurs the spread of technology, innovation, and the communication of ideas. The best ideas from market leaders spread more easily globally.
- Better-paying positions have opened up in manufactured exports, especially in high-tech areas, such as computers, chemicals, and transportation equipment and other high-skill work, notably in business services, such as finance and real estate.
- Globalization has helped narrow inequality between the poorest and richest people in the world. By outsourcing their services to developing countries, Transnational companies have saved money and changed people's lives. Because of this, poverty rates have declined worldwide over the past decades.

- One of the primary advantages of globalization is the free trade of goods and resources. For instance, a country that specializes in motor vehicles will produce cars and accessories in a location that achieves the lowest costs possible, and sell them on both local and foreign markets. This means that people living in other countries will be able to purchase these vehicles for less. At the same time, they will have access to a wider range of brands and models.
- Globalization has allowed people to relocate to wealthier countries and start their own business or find work. This has led to higher incomes and more opportunities in life. Additionally, migrants have always sent money home without paying exorbitant fees.
- The free movement of information and technology has enabled trade unions to fight for workers' rights worldwide. As new policies and regulations were enforced, labor rights increased. Additionally, sensitive issues, such as equal pay and gender equity, are becoming less and less prevalent.
- Multinational corporations are constantly expanding and hiring people in the countries where they operate. Others implement exchange programs to offer their employees the chance to work abroad. This further accelerates globalization and promotes economic growth.

Negative effects of globalisation

No matter how much economists are quick to commend the universal benefits of globalization, some politicians and other economist demonize globalization as a force that takes away domestic sovereignty of all sorts. These conflicting viewpoints have created a turbulence of opinions and policies across developed countries that range from extreme protectionism through trade barriers, like President Trump's example, to complete openness. Therefore, like everything else, globalization has its drawbacks and the following are some of them.

- The free trade of goods, services and information set the world economy into a cycle of income and employment growth. However, This, has led to declining money flows and tight credit across local and national economies.
- Furthermore, employees in developed countries are losing their jobs due to pay cuts. More and more companies are choosing to outsource work and export jobs as a means to keep the costs low, and this has led to unemployment in most countries.
- Large enterprises are now able to exploit tax havens worldwide, which has affected the local economy.

- The growth of international trade is worsening income inequalities, both between and within industrialized and less industrialized nations.
- The practice of outsourcing for cheaper labor is exploitative and widens the gap between the world's rich and the world's poor.
- Globalization has led to the interdependence between nations, which has caused regional or global instabilities where local economic fluctuations have ended up impacting a large number of countries relying on them.
- Political globalization has led to declining importance of the nation-state and the rise of other actors on the political scene.
- Globalization has often been criticized for taking away jobs from domestic companies and workers. Domestic industries go out of business because imports from other countries drive down prices, even if consumption increases. Small companies have found it difficult to compete and thus shut down, leaving workers unemployed, while the larger industries have experienced a significant protracted decline.
- In addition, it has contributed to job displacement especially low-wage workers in certain regions. Many of them other than facing lower earnings have been dropped out of the workforce. This is due to use of labor-saving technologies, like automated machines and artificial intelligence.
- Globalization has led to the increase in wages for workers, which has hurt corporate profitability. For example, rich countries which have a high comparative advantage in developing software, have driven up the price of software engineers around the world, thus making it difficult for foreign companies to compete in the market.
- The benefits of globalization have been unfairly sloped towards rich nations or individuals, creating greater inequalities and leading to potential conflicts both nationally and internationally as a result.
- Globalisation has increased Capital flight especially in developing where assets or money rapidly flow out because of there is increase in unfavorable financial conditions such as taxes, tariffs, labor costs, government debt and capital controls as a result of sharp drop in the exchange rate.
- Globalisation has moved taxation away from corporations, and onto individual citizens. Corporations have the ability to move to locations where the tax rate is lowest. Individual citizens have much less ability to make such a change. Also, with today's lack of jobs, each community competes with other communities with respect to how many tax breaks it can give to prospective employers.
- Globalisation has set up a currency "race to the bottom," with each country trying to get an export advantage by dropping the value of its currency. Because

of the competitive nature of the world economy, each country needs to sell its goods and services at as low a price as possible. This has been done in various ways like paying its workers lower wages; allowing more pollution; using cheaper more polluting fuels; or debase the currency by Quantitative Easing (also known as “printing money,”) in the hope that this will produce inflation and lower the value of the currency relative to other currencies.

- Globalisation has encouraged dependence on other countries for essential goods and services. With globalization, goods can often be obtained cheaply from elsewhere. Countries have come to believe that there is no point in producing their own food and clothes which they can obtain cheaply from other countries. It has become easy to depend on imports and specialize in something else and become dependent on other countries for essential commodities.
- Globalisation ties countries together, so that if one country collapses, the collapse is likely to ripple through the system, pulling many other countries with it. This is because countries are increasingly interdependent.
- Cultural uniqueness has been lost in favor of homogenization and a “universal culture” that draws heavily from the western culture. As a result of globalisation, the values and norms of developed countries are gradually rooted in developing countries. This has led to the growth of a monoculture - the culture of the north (developed countries) being imposed on the South (developing countries). This has led to erosion of the cultures and loss of identity of developing countries.
- Global commerce is increasingly dominated by transnational corporations which seek to maximize profits without regard for the development needs of individual countries or the local populations
- Competition among developing countries to attract foreign investment leads to a “race to the bottom” in which countries dangerously lower environmental standards.



Application activity 7.2

Analyse the impact of globalisation on Rwanda’s economy.

7.2: Multinational corporations (MNCs)

Activity 7.4



Africa's cloud
is Liquid®.

LIQUID
TELECOM

A



B



Guaranty Trust Bank

C

VIVO
ENERGY

ENGEN

D

Analyse the images above and answer the questions that follow.

- i) What activities does each photo portray?
- ii) Where do they originate from?
- iii) Identify different other companies that operate in Rwanda that don't belong to such activities named above and which are not of Rwandan origin.
- iv) How have they impacted Rwanda's development trend?

7.2.1: Meaning and examples of MNCs.

A **multinational corporation** or **worldwide enterprise** is an enterprise operating in several countries but managed from one (home) country. OR it is an organization that owns or controls production of goods or services in one or more countries other than their home country. It can also be referred to as an **international corporation**, a "**transnational corporation**", or a **stateless corporation**. Generally, any company or group that derives a quarter of its revenue from operations outside of its home country is considered a multinational corporation.

A multinational corporation is usually a large corporation which produces or sells goods or services in various countries. MNCs can get involved in;

- Importing and exporting goods and services
- Making significant investments in a foreign country
- Buying and selling licenses in foreign markets
- Engaging in contract manufacturing i.e. permitting a local manufacturer in a foreign country to produce their products
- Opening manufacturing facilities or assembly operations in foreign countries

Foreign Multinational Corporations in Rwanda

- Korea Telecom Rwanda Networks (KTRN)- the wholesaler of fourth-generation long-term evolution (4G LTE)
- Liquid Telecom- independent data, voice and IP provider and supplier of fibre optic, satellite and international carrier services to Africa's largest mobile network operators, ISPs and businesses of all sizes.
- Petroleum companies like Kobil Petroleum Rwanda, Engen etc.
- Mobile network providers like MTN and Airtel-Rwanda
- Financial institutions like Eco Bank, GT Bank, Bank of Africa, I &M bank etc.
- Construction companies like SMEC Rwanda, NITSAL INTERNATIONAL, Roko Construction Limited, STRABAG / ZÜBLIN INTERNATIONAL.

7.2.2: Effects of Multinational Corporations

Positive effects

- MNCs bridge the forex gap in developing countries by increasing forex inflow.
- They increase employment opportunities for citizens of the host countries since they operate on large scales.
- They close the investment gap through forex investment abroad.
- They lead to improvement in domestic technology through transfer of superior technology to developing countries based on research and development.
- MNCs produce more output especially processed or manufactured which increase exportation of manufactured goods hence more forex to developing.
- MNCs promote capital accumulation in developing countries through transfer of capital and building infrastructure.
- MNCs produce better quality products which help to improve standards of living of people in the society.
- They bring new marketing techniques developing countries markets research and promotional methods which encourage competition and efficiency.
- They provide revenue to the government through taxes imposed on activities of the MNCs.
- They help to train labor in the management basic skills and entrepreneur ability in developing countries.
- MNCs make a lot of profits which are ploughed back leading to the expansion of the economy there by promoting economic growth.

- They undertake high risks and can invest in long term projects like mining plantation and agricultural industries that bring about rapid economic growth and development.
- They are financially strong and hence provide large and cheap capital to developing countries by way of direct investment.
- They increase infrastructural development through construction of telecommunication etc.
- MNCs increase the exploitation of domestic resources which increase volume of productivity hence increasing export exchange.
- They promote international cooperation through consortiums hence increasing the volume of trade.
- They encourage competition which leads to efficiency and better-quality products.
- They help in filling the skilled manpower gap through exportation of expatriates or trained personnel to the recipient countries.

Negative effects of MNCs

- MNCs repatriate their profits to their mother countries which lead to resources outflow from developing countries thus disabling their development potentials.
- They are given tax exemption and holidays which reduce net government revenue from them.
- MNCs usually use capital intensive technology and therefore may not help to reduce their problems of unemployment in developing countries since are labor surplus economies.
- They create social costs like quick exhaustion of natural resources, environmental degradation etc. since they operate on large scale.
- MNCs influence internal policies of developing countries by bribing the legislature for example offering employment to the relatives of politicians in their companies and at times they subvert domestic fiscal policies which result into low standards of living.
- MNCs accelerate regional or sector imbalances e.g. urban and rural areas since they mostly set up their production activities in urban areas where infrastructure is already developed.
- MNCs cause income inequalities because they reserve top jobs for their nationals who are highly paid and low paying jobs to the nationals of investment countries.

- They promote external dependency of host countries on the countries where they originate.
- They reduce domestic initiative in technological and manpower development.
- MNCs can bring about discontent and unrest among workers employed by the government and indigenous firms due to the wage differentials between the workers in MNCs and other workers.



Application activity 7.3

With specific examples of multinational financial institutions that operate in Rwanda, assess their contribution towards the development process of your country.

7.3: Foreign direct investments (FDIs)

Activity 7.5



Analyse the photos above and answer the questions that follow;

- Identify the type of activities they deal in.
- State their countries of origin.
- What economic term is given to such companies?
- Cite different other examples of companies that are not of Rwandan origin that extend their services to Rwanda.
- Analyse the contribution of such companies to the development process of Rwanda.
- How do you think Rwanda has been able to attract these investments in her economy?

7.3.1: Meaning and examples of Foreign Direct Investments in Rwanda.

Foreign direct investments are the net inflows of investment to acquire a lasting management interest in an enterprise operating in an economy other than that of the investor. It refers to direct investment equity flows in the reporting economy. It is the sum of equity capital, reinvestment of earnings, and other capital. Direct investment is a category of cross-border investment associated with a resident in one economy having control or a significant degree of influence on the management of an enterprise that is resident in another economy. Direct foreign investment involves the transfer of productive resources or capital by foreign individuals, companies and MNCs to operate in an economy other than that of the investor.

Examples of FDIs in Rwanda

Some of the registered foreign direct investments in Rwanda include; Movit Uganda Ltd, JKK International from Dubai, which started a construction company; Mukwano Industries, Roofing Uganda, China Electronics, Lifa moto taxi-Chinese, ALINK Technologies, and Yvonne Exclusive Design, an upmarket fashion store, Egyptian House of Kitchenware, which opened a shop in Kimironko – Gasabo district for general trading, and Tanzania's Dodoma that makes mattresses.

7.3.2: Advantages of Foreign Direct Investments

- They increase the stock of capital in LDCs thus help break the cycle of poverty which enables LDCs to achieve rapid economic growth.
- Provide managerial, administrative and technical personnel, new technology, research and innovation in LDCs. this help to improve LDCs technics of production hence more employment opportunities.
- Increase government revenue from taxes imposed on production activities under taken by foreign investments.
- Increase productivity and efficiency due to high levels of technology used which leads to more export earnings and improvement in the Balance of payment position.
- Encourages entrepreneurial development in the country due to competition thus would lead to the citizens of that country to invest in their country hence more foreign exchange earnings.
- Create employment opportunities in the recipient countries.
- Increase savings thus closing the savings investment gap in LDCs.

- Due to the inflow capital assets, foreign investment promotes capital accumulation in LDCs.
- Help in the exploitation of idle resources in LDCs thus promoting economic growth and development.
- Increase consumer choice due to production of wide variety of quality products due massive productions.
- Increase the exploitation of domestic infrastructure e.g. transport facilities, communication facilities etc.
- It accelerates industrial growth through manufacturing and provision of services.
- Promotes international cooperation hence increase the volume of imports and exports.
- Local firms become efficient through competition.
- It fills the manpower gap through importation of expatriates' manpower.

7.3.3: Disadvantages Foreign Direct Investments

- It leads to profit repatriation and capital outflow thus worsening the balance of payment deficits in LDCs.
- Increased government expenditure in form of provision of basic facilities like land, power and other basic facilities as well as tax concessions, tax holidays, subsidized inputs etc.
- Cause income inequality in the recipient countries because top posts are reserved for their national and pay them very highly while citizens of the recipients' country occupy low status and low paying posts.
- Foreign investors at times exert pressure on the government and may influence the decision made by the government of the recipient country which brings about dependency and of autonomy in the recipient country.
- They bring about instabilities in the recipient country due to re-allocation of their investments into other countries.
- Foreign countries use capital intensive technology which creates technological unemployment thus may not help in solving the problem of unemployment.
- Increase demonstration effect in the recipient country due to increased number of foreigners who impose life style of developed countries in LDCs thus starting copying the consumption habits and lifestyle of the foreigners.
- Most of the private foreign investments are urban based and this creates the problems of rural urban migration and its negative effects.

- It leads to loss of government revenue through tax holidays, concessions etc.
- Causes dumping through importation of outside products or low-quality equipment.
- May lead to loss of markets of products from indigenous enterprises.
- May lead to irrational and exhaustion of domestic resources.

7.3.4: Ways of attracting foreign investors in Rwanda.

The Government of Rwanda (GoR) understands that private sector development is critical if Rwanda is to achieve its aim to reach middle-income status by 2020, and reduce the country's reliance on foreign aid. Over the past decade, the Government of Rwanda has undertaken a series of pro-investment policy reforms intended to improve the investment climate, expand trade in products and services, and increase levels of foreign direct investment. These include;

- In 2006, the Government of Rwanda consolidated multiple investment-related government agencies, including the Office of Tourism and National Parks, and the Rwanda Investment and Export Promotion Agency, to establish the Rwanda Development Board (RDB), which serves today as the country's chief investment promotion agency.
- There is no difficulty obtaining foreign exchange in Rwanda or transferring funds associated with an investment into a usable currency and at a legal market-clearing rate. In 1995, the government abandoned the dollar peg and established a floating exchange rate regime, under which all lending and deposit interest rates were liberalized. The central bank holds daily foreign exchange sales freely accessed by commercial banks.
- The government has maintained a high-profile anti-corruption effort and senior leaders articulate a consistent message emphasizing that fighting corruption is a key national goal. The government investigates corruption allegations and generally prosecutes and punishes those found guilty.
- Rwandan law provides permanent residence and access to land to investors who deposit USD 500,000 in a commercial bank in the country for a minimum of six months. There are neither statutory limits on foreign ownership or control, nor any official economic or industrial strategy that discriminates against foreign investors.
- Rwanda is a stable country with low violent crime rates. A strong police and military provide a security umbrella that minimizes potential criminal activity and political disturbances.
- Rwanda is a member of the East African Community (EAC), and participates in a customs union that helps facilitate the movement of goods produced in

the region and allows EAC citizens with certain skills to work in any member state.

- Rwanda has also established a free trade zone outside the capital, Kigali, which includes current and planned future communications infrastructure. Bonded warehouse facilities are now available both in and outside of Kigali for use by businesses importing duty free materials.
- RDB offers one of the fastest business registration processes in Africa: new investors can register online at RDB's website and receive approval to operate in less than 24 hours, and the agency's "one-stop shop" helps foreign investors secure required approvals, certificates, and work permits.
- The Government of Rwanda established the Privatization Secretariat and the Rwanda Public Procurement Agency to ensure transparency in government tenders and divestment of state-owned enterprises. Rwanda's ranking in Transparency International's "Corruption Perception Index" has improved significantly, falling from 102 in 2008, to 49 in 2013, the top ranked country in eastern Africa.
- The government reserves the right to expropriate property "in the public interest" and "for qualified private investment" under the expropriation law of 2007. The government and landowner negotiate compensation directly depending on the importance of the investment and the size of the expropriated property. RDB may facilitate expropriation in cases where the expropriation is potentially controversial.
- Rwanda is a signatory to the Convention on the Settlement of Investment Disputes (ICSID) and African Trade Insurance Agency (ATI). ICSID seeks to remove impediments to private investment posed by non-commercial risks, while ATI covers risk against restrictions on import and export activities, inconvertibility, expropriation, war, and civil disturbances. Rwanda is a member of the East African Court of Justice for the settlement of disputes arising from or pertaining to the East African Community (EAC). Rwanda has also acceded to the 1958 New York Arbitration Convention.
- Investors who demonstrate capacity to add value and invest in priority sectors have generally enjoyed more tax and investment incentives, including Value Added Tax (VAT) exemptions on all imported raw materials, 100 percent write-off on research and development costs, five-to-seven percent reduction in corporate income tax for firms whose exports are worth at least USD 3 million, duty exemption on equipment, and a favorable accelerated rate of depreciation of 50 percent in the first year. The government also offers grants and special access to credit to investors who develop in rural areas

- RDB has been successful in developing investment incentives and publicizing investment opportunities abroad. Registered foreign investors have obtained benefits in the past, including exemption from value-added tax and duties when importing machinery, equipment, and raw materials
- Protection of Property Rights; the law protects and facilitates acquisition and disposition of all property rights. Investors involved in commercial agriculture have leasehold titles and are able to secure property titles, if necessary. A property registration and land titling effort, the result of a 2005 land law, was completed in 2013.
- The Government of Rwanda has implemented transparency of the regulatory system; the government generally employs transparent policies and effective laws to foster clear rules consistent with international norms. Institutions such as the Rwanda Revenue Authority, the Ombudsman's office, Rwanda Bureau of Standards (RBS), the National Public Prosecutions Authority (NPPA), the Rwanda Utilities Regulatory Agency, the Public Procurement Agency, and the Privatization Secretariat all have clear rules and procedures.
- Rwandan law allows private enterprises to compete with public enterprises under the same terms and conditions with respect to access to markets, credit, and other business operations. Since 2006, the government has made an effort to privatize **State-Owned Enterprises** (SOEs), to reduce the government's non-controlling shares in private enterprises, and attract FDI, especially in the information and communications, tourism, banking, and agriculture sectors.
- There is a growing awareness of corporate social responsibility (CSR), but only a few companies – chiefly foreign-owned – have implemented sustainable programs. In recognition of the firm's strong commitment to CSR, the U.S. Department of State awarded Sorwathe, a U.S.-owned tea producer in Kinihira, Rwanda, the Secretary of State's 2012 Award for Corporate Excellence for Small and Medium Enterprises.
- Rwanda is eligible for trade preferences under the African Growth and Opportunity Act (AGOA), which the United States enacted to extend duty-free and quota-free access to the U.S. market for nearly all textile and handicraft goods produced in eligible beneficiary countries. The U.S. and Rwanda signed a Trade and Investment Framework Agreement (TIFA) in 2006, and a Bilateral Investment Treaty (BIT) in 2008. Rwanda has also signed bilateral investment treaties with Germany (1967) and Belgium (1985).
- The Export-Import Bank (EXIM) continues its program to ensure short-term export credit transactions involving various payment terms, including open accounts that cover the exports of consumer goods, services, commodities,

and certain capital goods. Rwanda is a member of the Multilateral Investment Guarantee Agency (MIGA) which issues guarantees against non-commercial risks to enterprises that invest in member countries and the African Trade Insurance Agency (ATI).

-Rwanda attempts to adhere to International Labor Organization (ILO) conventions protecting worker rights. Policies to protect workers in special labor conditions exist, but enforcement remains inconsistent. The government encourages, but does not require, on-the-job training and technology transfer to local employees



Application activity 7.4

1. Examine the hindrances to Foreign Direct Investments in Rwanda?

7.4: Global financial systems (GFS) and international financial institutions (IFI)

Activity 7.6



Undertake a documentary research about Global financial systems and institutions and share your views in class about.

- i) What global financial system and international financial institutions mean..
- ii) What is the role of Global financial system?
- iii) What are the components of Global financial system?

7.4.1: Global Financial Systems and international financial institution (IFI)

The **global financial system** is the worldwide framework of legal agreements, institutions, and both formal and informal economic actors that together facilitate international flows of financial capital for purposes of investment and trade financing. Since emerging in the late 19th century during the first modern wave of economic globalization, its evolution is marked by the establishment of central banks, multilateral treaties, and intergovernmental organizations aimed at improving the transparency, regulation, and effectiveness of international markets.

While the global financial system is edging toward greater stability, governments must deal with differing regional or national needs. Some nations are trying to systematically discontinue unconventional monetary policies installed to cultivate recovery, while others are expanding their scope and scale. Emerging market policymakers face a challenge of precision as they must carefully institute sustainable macroeconomic policies during extraordinary market sensitivity without provoking investors to retreat their capital to stronger markets. Nations' inability to align interests and achieve international consensus on matters such as banking regulation has perpetuated the risk of future global financial catastrophes.

The Global financial system has;

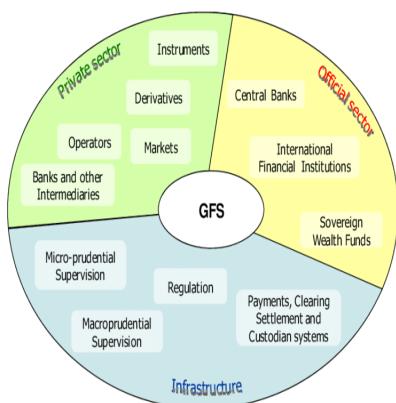
2 main functional components:

- The global capital market.
- The foreign exchange market.

There are two global institutions (Bretton woods institutions).

- The world Bank.
- The international monetary fund. (IMF)

The global financial system main components



An international financial institution (IFI) is a financial institution that has been established (or chartered) by more than one country, and hence are subjects of international law. Its owners or shareholders are generally national governments, although other international institutions and other organizations occasionally figure as shareholders. The best-known IFIs were established after World War II to assist in the reconstruction of Europe and provide mechanisms for international cooperation in managing the global financial system. They include the World Bank, the IMF, and the International Finance Corporation.

7.4.2: International Monetary Fund (IMF) and World Bank (WB)

Activity 7.7



Undertake a documentary research on IMF and discuss amongst yourselves in class about

- a) What led to the establishment of IMF?
- b) The objectives of IMF
- c) The functions of IMF
- d) IMF conditionalities.

7.4.2.1: International monetary fund (IMF):

The International Monetary Fund (IMF) is an organization of 189 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth and reduce poverty around the world.

Created in 1945, the IMF is governed by and accountable to the 189 countries that make up its near-global membership. The IMF's primary purpose is to ensure the stability of the international monetary system; the system of exchange rates and international payments that enables countries (and their citizens) to transact with each other. The Fund's mandate was updated in 2012 to include all macroeconomic and financial sector issues that bear on global stability.

The IMF's fundamental mission is to ensure the stability of the international monetary system. It does so in three ways: keeping track of the global economy and the economies of member countries; lending to countries with balance of payments difficulties; and giving practical help to members. IMF is headquartered in Washington, D.C.

A) Objectives of IMF.

- Establish International Monetary Cooperation amongst the various member countries through a permanent institution that provides the machinery for consultation and collaborations in various international monetary problems and issues.
- Ensure stability in the foreign exchange rates by maintaining orderly exchange arrangement among members and also to rule out unnecessary competitive exchange depreciations/ devaluation.

- Promote international trade so as to achieve its required expansion and balanced growth. This would ensure development of production resources and thereby promote and maintain high levels of income and employment among all its member countries.
- Eliminate or relax exchange controls imposed by almost each and every country before Second World War as a device to deliberately fix the exchange rate at a particular level. Such elimination of exchange controls was made so as to give encouragement to the flow of international trade.
- To establish a multilateral trade and payment system in respect to current transactions between members in place of the old system of bilateral trade agreements was another important objective of IMF.
- Help the member countries, especially the backward countries, to attain balanced economic growth by exchange the level of employment.
- Help the member countries in eliminating or reducing the disequilibrium or maladjustments in balance of payments. Accordingly, it gives confidence to members by selling or lending Fund's foreign currency resources to the member nations.
- Promote Investment and flow of Capital from richer to poorer or backward countries so as to help the backward countries to develop their own economic resources for attaining higher standard of living for its people, in general.
- To ensure there is sufficient international liquidity and total means of payment acceptable for international payment.
- To stabilize prices so as to increase the rates of economic growth and development among poor countries.
- To harmonize policies pursued by different countries so as to create peace among member nations.

B) Functions of the International Monetary Fund

- Maintains Exchange Stability thereby discouraging any fluctuations in the rate of exchange. It does so by making necessary arrangements like enforcing declaration of par value of currency of all members in terms of gold or US dollar, enforcing devaluation criteria, up to 10 per cent or more by more information or by taking permission from IMF respectively, forbidding members to go in for multiple exchange rates and also to buy or sell gold at prices other than declared par value.
- The Fund is helping the member countries in eliminating or minimizing the short-period equilibrium of balance of payments either by selling or

lending foreign currencies to the members. It also helps its members towards removing the long period disequilibrium in their balance of payments. In case of fundamental changes in the economies of its members, the Fund can advise its members to change the par values of its currencies.

- IMF enforces the system of **determination of par values** of the currencies of the members countries. As per the Original Articles of Agreement of the IMF every member country must declare the par value of its currency in terms of gold or US dollars. The members are given autonomy to float or change exchange rates as per demand supply conditions in the exchange market and also at par with internal price levels.
- IMF is exercising surveillance to ensure proper working and balance in the international monetary system, i.e., by avoiding manipulation in the exchange rates and by adopting intervention policy to counter short-term movements in the exchange value of the currency.
- The IMF has an important function to advise the member countries on various economic and monetary matters and thereby to help stabilize their economies.
- IMF is maintaining various borrowing and credit facilities so as to help the member countries in correcting disequilibrium in their balance of payments. These credit facilities include-basic credit facility, extended fund facility for a period of 3 years, compensatory financing facility, stock facility for helping the primary producing countries, supplementary financing facility, special oil facility, trust fund, structural adjustment facility etc. The Fund also charges interest from the borrowing countries on their credit.
- IMF is also entrusted with important function to maintain balance between demand and supply of various currencies. Accordingly, the fund can declare a currency as scarce currency which is in great demand and can increase its supply by borrowing it from the country concerned or by purchasing the same currency in exchange of gold.
- Maintenance of Liquidity of its resources by providing for the member countries to borrow from IMF by surrendering their own currencies in exchange. Again, for according accumulation of less demand currencies with the Fund, the borrowing countries are directed to repurchase their own currencies by repaying its loans in convertible currencies.
- Providing Technical Assistance to the member countries; by granting the member countries the services of its specialists and experts and also

by sending the outside experts. Moreover, the Fund has also set up two specialized new departments: Central Banking Services Department and Fiscal Affairs Department for sending specialists to member countries so as to manage its central banks and also on fiscal management.

- Reducing tariffs and other restrictions imposed on international trade by the member countries so as to cease restrictions of remittance of funds or to avoid discriminating practices.
- The IMF is also keeping a general watch on the monetary and fiscal policies followed by the member countries to ensure no flouting of the provisions of the charter.
- Buying and selling currency of the member countries and this assists debtor countries to purchase forex or to use SDRs in order to pay its debts. (SDRs are international reserve assets created by the IMF to supplement its member countries official reserves.) Its value is based on the basket of the currencies and it can be exchanged and freely usable by all countries. It is rather a potential claim on the freely usable currencies of the IMF members.
- It is a reservoir of the currencies of all the member countries from which a borrower nation can borrow the currency of other nations.
- It is a sort of lending institution in foreign exchange. However, it grants loans for financing current transactions only and not capital transactions.
- The Fund contributes to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all member nations.
- Assist countries to restructure their economies through SAPs facility.
- The IMF works with governments around the world to modernize their economic policies and institutions, and train their people. This helps countries strengthen their economy, improve growth and create jobs.
- The IMF provides loans to member countries experiencing actual or potential balance of payments problems to help them rebuild their international reserves, stabilize their currencies, continue paying for imports, and restore conditions for strong economic growth, while correcting underlying problems.
- The IMF oversees the international monetary system and monitors the economic and financial policies of its 189 member countries. As part of this process, which takes place both at the global level and in individual countries, the IMF highlights possible risks to stability and advises on needed policy adjustments.

7.4.2.2.: The World Bank (WB):

Activity 7.8



Undertake a documentary research on World bank, and discuss amongst yourselves in class about

- a) Why was the World Bank established?
- b) The objectives of World Bank
- c) The functions of WB
- d) What is the major difference between IMF and World Bank?

The World Bank is an international organization dedicated to providing financing, advice, and research to developing nations to aid their economic advancement. The bank predominantly acts as an organization that attempts to fight poverty by offering developmental assistance to middle- and low-income countries. Currently, the World Bank has two stated goals that it aims to achieve by 2030. The first is to end extreme poverty by decreasing the number of people living on less than \$1.90 a day to below 3% of the world population. The second is to increase overall prosperity by increasing income growth in the bottom 40% of every country in the world.

The World Bank was created in 1944 out of the Bretton Woods Agreement, which was secured under the auspices of the United Nations in the latter days of World War II. Since their founding both the World Bank and the International Monetary Fund have worked together toward many of the same goals.

Though titled as a bank, the World Bank, is not necessarily a bank in the traditional, chartered meanings of the word. The World Bank and its subsidiary groups operate within their own provisions and develop their own proprietary financial assistance products, all with the same goal of serving countries' capital needs internationally. The World Bank is headquartered in Washington, D.C. Currently it has more than 10,000 employees in more than 120 offices worldwide.

a) Objectives of World Bank:

- To help in the reconstruction and development of member countries by facilitating the investment of capital for the productive purposes, including the restoration and reconstruction of economies devastated by war.
- To encourage the development of productive resources in developing countries by supplying them investment capital.

- To promote private foreign investment through guarantees and participation in loans and other investment made by private investors.
- To supplement private foreign investments by direct loans out of its own capital for productive purposes.
- To promote long term balances growth of international trade and the maintenance of equilibrium in the balance payments of member countries by encouraging long term international investments.
- To bring about an easy transition from a war economy to a peace time economy.
- To help in raising productivity, the standard of living and the conditions of labour in member countries.

b) Functions of World Bank (IBRD)

The principal functions of the IBRD following.

- To assist in the reconstruction and development of the territories of its members by facilitating the investment of capital for productive purposes.
- To promote private foreign investment by means of guarantee of participation in loans and other investments made by private investors and when private capital is not available on reasonable terms to make loans for productive purposes out of its own resources from funds borrowed by it.
- To promote the long-term balance growth of international trade and the maintenance of equilibrium in balances of payments by encouraging international investments for development of productive resources of members.
- To arrange loans made guaranteed by it in relation to international loans through other channels so that more useful projects, large and small alike, will be dealt with first.

7.4.2.3: Structural Adjustment Programs (SAPs) / IMF Conditionalities.

Structural Adjustment Programs (SAPs) sometimes labeled as **the Washington Consensus** refers to a set of economic policies often introduced as a condition for gaining a loan from the IMF. SAPs are created with the goal of reducing the borrowing country's fiscal imbalances in the short and medium term or in order to adjust the economy to long-term growth. The bank from which a borrowing country receives its loan depends upon the type of necessity. The IMF usually implements stabilization policies and the WB is in charge of adjustment measures. Structural adjustment policies usually involve a combination of free-

market policies such as privatisation, fiscal austerity, free trade and deregulation. Structural adjustment policies have been controversial with detractors arguing the free market policies are often unsuitable for developing economies and lead to lower economic growth and greater inequality. Supporters of structural adjustment (IMF and World Bank) argue that these free-market reforms are essential for promoting a more open and efficient economy, which ultimately help to improve living standards and reduce relative poverty. SAPs therefore, are supposed to allow the economies of the developing countries to become more market oriented. This, then forces them to concentrate more on trade and production so it can boost their economy. They include among others the following;

Structural Adjustment Policies

To be eligible for a loan from IMF, developing countries often have to implement some or all of the following policies.

- Cutting Government Spending to reduce the budget deficit. Also known as 'fiscal austerity' e.g. reducing on government expenditure on education and health in order to reduce the size of the work force to reduce on government expenditure hence a balanced budget.
- Raising tax revenues and trying to improve tax collection by clamping down on tax avoidance.
- Control of Inflation. Usually through Monetary policy (higher interest rates) and fiscal austerity which have the effect of depressing aggregate demand.
- Privatisation of state-owned industries. This raises money for the government, but also, in theory, can help improve efficiency and productivity because private firms have a profit incentive to be more efficient.
- De-regulation of markets to encourage competition and more firms to enter the industry. Opening the economy to free trade by removing tariff barriers which protect domestic industries. i.e. avoid government control of prices which lead to inefficiency and to allow private producers to compete.
- Ending food subsidies. i.e. Raising food and petroleum prices to cut the burden of subsidies. This, can distort the market and lead to over-supply and hold back diversification of the economy to a more industrial based economy.
- Devaluation of currencies to restore competitiveness, increase forex and reduce current account deficit. This usually leads to higher import prices.

- Retrenchment of the civil servants and demobilization of the army in order to reduce on the size of the work force and government expenditure as well as ensure efficiency.
- Introduction of policies that attract both foreign and domestic investors. For example, reduction in borrowing rates and having an open economy.
- Infrastructural development in order to improve productivity thus promoting economic growth and development.
- Emphasizes on the improvement of productivity through research and adoption of modern technology.
- Market expansion through economic integration in order to increase export earnings.
- Ensure political stability and security in the economy.
- Forex liberalization and granting autonomy to the central bank to pursue on appropriate monetary policy.
- Focusing economic output on direct export and resource extraction.
- Improving governance and fighting corruption
- Enhancing the rights of foreign investors vis-à-vis national laws
- Increasing the stability of investment (by supplementing foreign direct investment with the opening of domestic stock markets)
- Creating new financial institutions



Application activity 7.5.

Describe how the SAPs policies have impacted Rwanda.



End unit assessment

1. a) What role has the IMF played in economic development of your country
b) What structural adjustment programs have been implemented in your country?
2. a) Giving examples in Rwanda, analyse the role played by FDI's in Rwanda's development struggle.
b) Although Rwanda has tried her level best to attract Foreign Direct Investments, their inflow is still low. Why?
3. a) Explain the roles of World Bank.
b) Identify different sectors supported by World bank in Rwanda.

UNIT 8

ECONOMIC GROWTH AND ECONOMIC DEVELOPMENT

Key unit Competency:

Analyse the determinants and indicators of economic growth and development for an economy.

8.1. Economic growth



Introductory activity

Overarching goal of EDPRS 2

"Accelerating progress to middle income status and better quality of life for all Rwandans through sustained average GDP growth of 11.5% and accelerated reduction of poverty to less than 30% of the population"

Rapid Economic Growth (Avg. GDP growth of 11.5%)



Reduce Poverty to under 30%



Better quality of life for all Rwandans

(Source:http://www.minecofin.gov.rw/fileadmin/templates/documents/NDPR/EDPRS_2_Abridged_Version.pdf)

In your own view, what strategies has the government used to:

- i) Achieve sustained average GDP growth of 11.5%.
- ii) Accelerated reduction of poverty to less than 30% of the population.

8.1.1: Meaning and determinants of economic growth

Activity 8.1.



USA is said to be having a higher GDP growth than Rwanda. In your own view,

- a) What do you understand by the term GDP growth and how is it related to economic growth?
- b) What do you think are the reasons behind this phenomenon?

8.1.1.1: Meaning of economic growth:

Rwanda is one of the fastest growing economies in Africa. Although still developing, the nation has made a significant progress in recent years. This has been attributed to stable macroeconomic setting, good policy framework and quality of leadership in the country. The service and industrial sector is growing at a very high rate. All these have significantly impacted on the national income of the country as shown by the persistent increase in the gross domestic product.

Economic growth can be defined as the persistent quantitative increase in the volume of goods and services produced in a country. Or the persistent increase in the volume of goods and services over a period of time.

Economic growth is a material concept. It concerns itself with the growth of physical output, and does not take into account non-material factors like stress, happiness, etc. It is generally considered that economic growth does cause an increase in the standard of living provided that the increase in production exceeds any increase in population.

This concept of economic growth is usually illustrated by an outward shift of the production possibility curve or production possibility frontier.

The outward shift of the curve illustrates an increasing capacity to produce goods and services

Economic growth trends

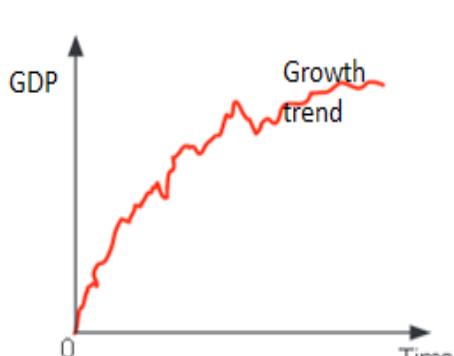


Fig. A

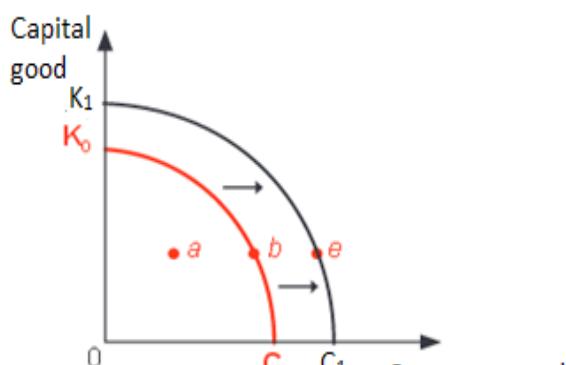


Fig. B.

The curve **K0C0** shows all possible combinations of capital and consumer goods available to a nation when all resources are fully employed.

Point **a** represents unemployment of some resources, under-utilization or excess capacity. Point **b** indicates full employment of all resources, while **e** represents economic growth. A movement from **a** to **b** or any other point on the curve represents an increase in real income. An outward shift of the Production Possibility Frontier (PPF) from **K0C0** to **K1C1** illustrates economic growth. While a backward shift of the production possibility frontier from **K1K2** to **K0C0** illustrates economic decline.

8.1.1.2: Factors that determine economic growth

Economic growth is an increase in real GDP; it means an increase in the value of goods and services produced in an economy. The rate of economic growth is the annual percentage increase in real GDP. There are several factors affecting economic growth, of a country which can be grouped into Demand-side factors (e.g. consumer spending) and Supply-side factors (e.g. productive capacity), but generally, these factors are as explained below;

- **Political situation.** When there is good political climate that builds investor confidence, there will be increase in the volume of goods and services while political instability will lead to low production of goods and services.
- **Technological development:** Technological development helps in increasing productivity with the limited amount of resources. Countries that have worked in the field of technological development grow rapidly as compared to countries that have less focus on technological development. The selection of right technology also plays an important

role for the growth of an economy. On the contrary, an inappropriate technology- results in high cost of production.

- **Level of capital.** When capital is available and in plenty, there will be increased production of goods and services while absence of capital leads to low production low economic growth.
- **Level of Market.** Presence of a large market will encourage producers to produce more goods and services while absence of market will lead to low production
- **Size of population.** A large population will make a big labour force that will produce more goods and services while a smaller population will imply low output.
- **Level of investment.** The rate at which an economy comes up with new investment determines economic growth.
- **Level of entrepreneur development.** Presence of large number of entrepreneurs will lead to invention of new methods of production which will increase output but when the level of entrepreneur development is low, production and economic growth will be low
- **Levels of infrastructure.** Investment in roads, transport and communication can help firms reduce costs and expand production. Without the necessary infrastructure, it can be difficult for firms to be competitive in the international markets. This lack of infrastructure is often a factor holding back some developing economies.
- **Human resource:** The quality of human resource is dependent on its skills, creative abilities, training, and education. If the human resource of a country is well skilled and trained then the output would also be of high quality. On the other hand, a shortage of skilled labor hampers the growth of an economy, whereas surplus of labor is of lesser significance to economic growth. Therefore, the human resources of a country should be adequate in number with required skills and abilities, so that economic growth can be achieved.
- **Natural Resources:** The natural resources of a country depend on the climatic and environmental conditions. Countries having plenty of natural resources enjoy good growth than countries with small amount of natural resources. The efficient utilization or exploitation of natural resources depends on the skills and abilities of human resource, technology used and availability of funds. A country having skilled and educated workforce with rich natural resources takes the economy on the growth path.

- **Government policy of subsidization and taxation.** When the government gives producers subsidies like loans, seeds etc, there will be increase in the volume of goods while if the government over taxes the people, production will be low.
- **Capital formation:** Capital formation increases the availability of capital per worker, which further increases capital/labor ratio. Consequently, the productivity of labor increases, which ultimately results in the increase in output and growth of the economy.
- **Social and Political Factors:** Social factors involve customs, traditions, values and beliefs, which contribute to the growth of an economy to a considerable extent. For example, a society with conventional beliefs and superstitions resists the adoption of modern ways of living. In such a case, achieving becomes difficult. Apart from this, political factors, such as participation of government in formulating and implementing various policies, have a major part in economic growth.
- **Consumer confidence.** Consumer and business confidence are very important for determining economic growth. If consumers are confident about the future they will be encouraged to borrow and spend thus encouraging production which spearheads economic growth. If they are pessimistic, they will save and reduce spending hence discouraging production and economic growth.
- **Interest rates.** Lower interest rates would make borrowing cheaper and should encourage firms to invest and consumers to spend. People with mortgages will have lower monthly mortgage payments so more disposable income to spend thus encouraging economic growth and the reverse is true when interest rates are high.
- **Value of exchange rate.** If a country's currency devalued, exports would become more competitive and imports more expensive. This would help to increase demand for domestic goods and services hence economic growth. A depreciation could cause inflation, but in the short term at least it can provide a boost to growth and vice versa. However, if depreciation happens for a long period of time, it discourages production and economic growth since businesses will no longer be profitable.
- Banking sector. The banking sector is very influential in determining investment and growth. If the banks lose money and no longer want to lend, it can make it very difficult for firms and consumers leading to a decline in investment and thus economic growth and vice versa.

- **The strength of labour markets.** If labour markets are flexible, then firms will find it easier to hire the workers they need. This will make expansion easier. Highly regulated markets could discourage firms from hiring in the first place, hence slowing down production and economic growth.

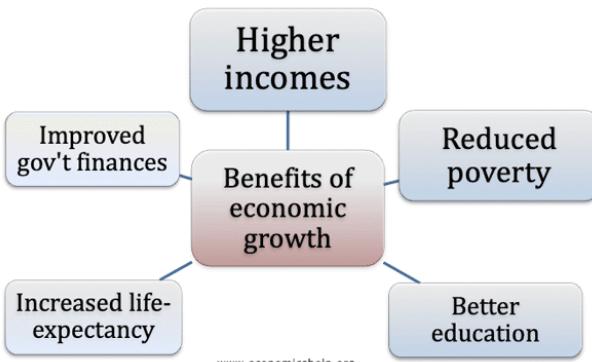
8.1.2: Benefits and costs of economic growth.

Activity 8.2.



Discuss the view that economic growth is a necessary evil.

8.1.2.1 Benefits of economic growth.



Economic growth means an increase in real GDP i.e. an increase in the value of national output, income and expenditure. Essentially the benefit of economic growth is higher living standards – higher real incomes and the ability to devote more resources to areas like health care and education. There are other various benefits to individuals and the entire economy as below.

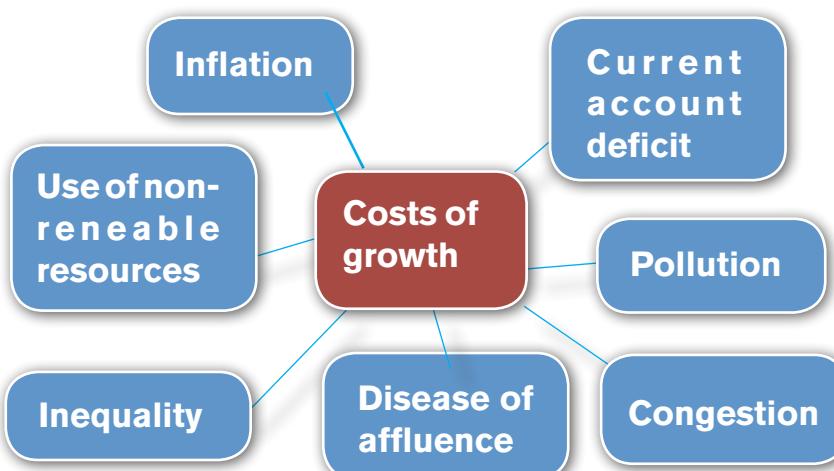
- There is **increased production of goods and services** which are vital to society and help to reduce malnutrition and other related diseases.
- **Widens the tax base of the country** through taxing the different economic activities hence increasing revenue to the government that can be used for development.
- **Economic independence** is attained since the country produces a lot of goods and services and this reduces relying on other countries for assistance.
- **Leads to increase in infrastructure development** such as roads, hospitals and schools among others which lead to the development of the country.

- **Urbanization and industrialization** are achieved because of construction of many industries to produce goods
- **General price level of goods and services will reduce** because of the increase in output
- **Reduction in balance of payment problems** in the country because the exports increase due to increased production and this improves the balance of payment position
- **Political stability** because people are well off and have a variety therefore there are no food conflicts which is a major cause of Insecurities.
- **Higher average incomes.** Economic growth enables consumers to consume more goods and services and enjoy better standards of living. This will reduce absolute levels of poverty and thus enabling a rise in life expectancy.
- **Lower unemployment.** With higher output and positive economic growth, firms tend to employ more workers creating more employment. Employment opportunities come up because of the increase in economic activities and this reduces the rates of poverty and its related problems.
- **Lower government borrowing.** Economic growth creates higher tax revenues, and there is less need to spend money on benefits such as unemployment benefit. Therefore, economic growth helps to reduce government borrowing. Economic growth also plays a role in reducing debt to GDP ratios.
- **Improved public services.** With increased tax revenues the government can spend more on public services, such as health and education etc. This can enable higher living standards, such as increased life expectancy, higher rates of literacy and a greater understanding of civic and political issues.
- **Money can be spent on protecting the environment.** With higher economic growth a society can devote more resources to promoting recycling and the use of renewable resources.
- **Investment.** Economic growth encourages firms to invest, in order to meet future demand. Higher investment increases the scope for future economic growth – creating a virtuous cycle of economic growth/investment.
- **Increased research and development.** High economic growth leads to increased profitability for firms, enabling more spending on research and development. Also, sustained economic growth increases confidence and encourages firms to take risks and innovate.
- **Economic development.** The biggest factor for promoting economic development is sustained economic growth. Economic growth plays a major

role in reducing absolute levels of poverty, increasing life expectancy thus promoting development.

- **More choice.** In less developed economies, a large proportion of the population work in agriculture/subsistence farming, economic growth enables a more diverse economy with people able to work in service sector, manufacturing and having a greater choice of lifestyles.
- **Enhanced business confidence:** Economic growth creates positive effect as encourage people running their businesses. As profits of small firms and business increase with economic growth, their business confidence and will to grow up to meet more challenges.

8.1.2.2: Costs of economic growth.

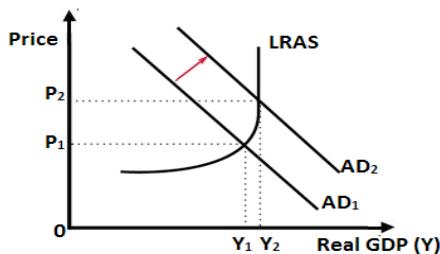


Economic growth means an increase in real GDP i.e. an increase in real income. This is usually considered beneficial, but also it brings about potential and undesirable economic and social costs as seen below;

- **Pollution of air, sound and water.** The industries set up to produce and persistently increase output level may produce fumes that pollute the environment and pour waste in air and water bodies. Noise from industrial machines may also make the environment unsuitable for human living.
- **Environmental degradation.** The ecosystem is normally tempered with in order to increase the volume of goods and services produced. Swamps are reclaimed, deforestation occur so as to give room to industries that produce and persistently increase output level to attain economic growth.

Erosion of cultural values. In order to attain faster rates of economic growth, nationals tend to adopt foreign ways of consumption, behavior and general ways of living. This costs the nation of the discipline and order that had been maintained for long.

- **Current consumption is normally foregone** so as to save enough, create capital assets that produce output to attain economic growth.
- **People forego leisure** which is an important aspect of improved standard of living. They work so hard to increase output and attain economic growth.
- **Increased indebtedness of developing countries.** In order to attain economic growth, most developing countries borrow to set up production ventures that produce and persistently increase the level of economic growth.
- **Industrial/occupational hazards.** Several upcoming industries set up to attain economic growth do not provide protective gadgets to the workers, consequently, workers inhale poisonous fumes causing them chronic diseases and death, and they sometimes lose body parts to the machines they are not oriented to.
- **The dangers of rural urban migration** like slum development, unemployment and overcrowdings arise. This is mainly because people leave villages for urban settings where they expect to find jobs and better social living standards.
- **Inflation.** If Aggregate Demand (AD) increases faster than Aggregate Supply (AS), then economic growth will lead to higher inflation as firms put up prices. Economic growth tends to cause inflation when the growth rate is above the long run trend rate of growth. It may be destabilizing for an economy as interest rate may increase and can cause a loss of competitiveness in international markets. It is when demand increases too quickly that we get a positive output gap and firms push up prices.



The figure above, shows that as aggregate demand increases from AD_1 to AD_2 , real GDP increases from Y_1 to Y_2 . However, aggregate supply in the long run does not correspond to aggregate demand leading to inflation as shown by an increase in price from also increases from P_1 to P_2 .

- **Boom and bust economic cycles.** If economic growth is unsustainable then high inflationary growth may be followed by a recession.

- Increased economic growth tends to cause an **increase in spending on imports**, therefore, causing a deterioration on the current account.
- **Environmental costs:** Increased economic growth will lead to increased output and consumption. This causes an increase in **pollution**. Increased pollution from economic growth will cause health problems such as asthma and therefore will reduce the quality of life.
- Connected to the above, economic growth also leads to **over exploitation of the natural resources** that leads to their quick depletion. This means greater use of raw materials and can speed up **depletion of non-renewable resources**.
- It also can also lead to problems of **congestion of traffic and houses** as more people can afford to buy a car, but it is hard to increase the supply of roads to meet demand. This leads to delays and easy disease spread; traffic congestion occurs as vehicles are ever flowing in and out of the industrial place causing unnecessary delays, workers in the industrial place tend to be accommodated near industries causing slum areas around and poor sanitation.
- **Inequality:** Higher rates of economic growth have often resulted in increased inequality because growth can benefit a small section of society more than others. For example, those with assets and wealth will see a proportionally bigger rise in the market value of rents and their wealth. Those unskilled without wealth may benefit much less from growth.
- **Regional disparities:** In connection to the above, although average living standards may be rising, there is a gap between rich and poor. It can widen the issues of poverty and make a wide gap between different regions, and this hinders economic development.
- **Diseases/problems of affluence:** With rising living standards it can cause unintended consequences. For example, with rising incomes, there are more goods to steal. Also, high growth can make people more materialistic which encourages crime. Also, higher incomes enable people to afford more food; this is a factor behind rise in obesity and health related problems.

8.1.3: Theories of growth.

Activity 8.3.



In the second quarter of 2019, GDP at current market prices was estimated to be Frw 2,255 billion, up to Frw 2,001 billion in Q2 2018. In this quarter, services sector contributed 47 percent of GDP, agriculture sector contributed 28 percent of the GDP, Industry sector contributed 17 percent of the GDP and 8 percent was attributed to adjustment for taxes and subsidies on products.

(Source: NISR: GDP National Accounts (Second Quarter 2019)

It can be observed that the service sector contributed much more than the other sectors.

In reference to the above scenario and in your own view, what do you think is the best approach towards growth of the economy and why?

- (i)** A balanced approach where all sectors contribute equally towards GDP?
- (ii)** An unbalanced approach where different sectors contribute differently towards GDP?

The theories of growth attempt to show the causes, sources and stages of economic growth and they have been developed from the developed nations to show the stages they passed through and how far they have gone. These theories include,

- (a) Balanced growth theory
- (b) Un balanced growth theory
- (c) Big push theory
- (d) Rostow's stages of growth

8.1.3.1: BALANCED GROWTH THEORY.

Activity 8.4.



Make research to find out the meaning, merits and demerits of the balanced growth theory of economic growth, and make presentation in class.

a) Meaning of Balanced growth theory:

Balanced growth theory of economic growth advocates for a simultaneous upbringing of all sectors in an economy so that sectors grow together in harmony and complement each other. The theory advocates for a **critical minimum effort** which is the minimum level of investment in all the sectors of the economy to ensure interdependence and self-sustaining growth.

b) Arguments in favour of balanced growth strategy

- Encourages **resource exploitation and utilization** because it creates high demand for these resources by the many sectors in operation
- **Widens the tax base** of the country because all the developed sectors are taxed by the government
- Encourages **forward and backward linkages** in the economy since some sectors provide raw materials while others provide market for those raw materials
- **Employment is created** because of the increased demand for labour to work in the different developed sectors.
- **Balanced of payment position may be improved** especially when production is for export.
- **Development in technology** is undertaken because of the need to produce good quality goods and services.
- **Self-reliance is created** since all sectors are developed at the same time and there are a variety of goods and services needed in the society.
- **Reduced income inequality** because most of the people are engaged in the production of goods and services.
- **Brain drain is reduced** because the people are able to find employment in the country.
- **Foreign exchange is saved** because there is little to import since the economy is self-sustaining.

c) Disadvantages of the theory

- May lead to **sectors being developed without quality** since it calls for a critical minimum effort.
- **Requires a lot of capital** which may be lacking in developing countries. This is because developing all sectors requires a lot on capital.
- It may lead to **over exploitation of resources**. This is because all sectors have to be developed.
- May lead to **uncoordinated plans and sectors** which may not lead to the development of the economy. The sectors may turn out to be without linkages
- **Over ambitiousness** may at times lead to inferior work since the expected results cannot be achieved.

d) Limitations of balanced growth

- A balanced growth strategy requires a lot of capital funds which are not yet available in developing economies.
- Developing countries do not have adequate skilled manpower to scatter in all sectors being developed at the same time.
- A balanced growth strategy requires proper planning and implementation of plans so as to coordinate the different projects running at the same time, developing countries are not blessed with such planning skills.
- A balanced growth strategy requires developed infrastructure in terms of transport and telecommunication network, hydroelectric power, among others, such developed infrastructure is still inadequate in developing economies, and so they cannot sustain a balanced growth strategy.
- Developing countries have under developed technology; it is still traditional and sometimes just intermediate that cannot support the growth of a balanced growth strategy.
- Developing economies have inadequate local and foreign market, such a market cannot support the much output from all sectors of the economy, thus it goes to wastage hence losses.

8.1.3.2: UNBALANCED GROWTH STRATEGY.

Activity 8.5.



Make research and discuss the view that unbalanced growth strategy is more suitable than balanced growth strategy in achieving high levels of economic growth in developing economies.

a) Meaning of unbalanced growth

Unbalanced growth strategy emphasizes the growth of a few vital leading sectors in an economy such that they expand and others are developed at a later stage. Here countries tend to concentrate so much on sectors like agriculture and industry since they employ a large number of people. Others like fishing, mining to mention but a few come at a later stage. The developed sectors will in turn pull others that were left behind

b) Advantages of the theory

- Needs little capital and resources which makes it possible in developing economies which have always dealt with deficit budgets
- Requires less expenditure. This is because a few sectors are looked at first then others come in later
- Easy to control and manage because a few leading sectors can easily be coordinated compared to the balanced growth theory
- Production can be controlled basing on demand forces because the country will be producing according to available markets
- The theory reserves some resources for the future use since some sectors are developed at a later stage
- Specialization is possible since the country concentrates on some sectors fast and others are developed later. This creates efficiency in production
- Requires micro-planning since it involves a small number of sectors which makes planning and implementation easy
- There will be less reliance on foreign loans and donations leading to limited balance of payment problems

c) Demerits of the theory

- Slows the rate of economic growth since the output from the few sectors is low and may not serve the whole nation at large. This may lead to constant importation

- Regional inequalities come up because some areas will develop at the expenses of others hence creating dualism with its associated problems
- Unemployment since there are a few sectors developed and worse still the sectors may resort to capital intensive technology to produce good quality
- Encourages dependence because the country cannot satisfy the needs of its people thus it keeps on importing what it cannot produce hence worsening the balance of payment position
- Leading sectors may not be able to pull others hence they will develop at the expense of others sine they may not be compatible
- Less tax revenue will be collected from the few sectors leading to constant borrowing with its associated problems
- Some resources will remain idle since the developed sectors cannot use them as resources hence under utilization
- A decline in one or two sectors will affect the economy drastically since it has no alternative sectors to run to
- There will be brain drain since few people will employed creating a vacuum in the country since the would be skilled people have fled in search for greener pastures

d) Limitations of the theory

- The strategy emphasizes specialization which has several weaknesses like limited varieties which limits choice and development, total loss in case of failure among others.
- The strategy limits employment opportunities, one or a few sectors promoted can employ only a few people and with special skills so limiting employment opportunities.
- The strategy denies the economy a chance to diversify which is a great input to development.
- Developing countries have a limited size of the market which cannot consume all the output from the sector being emphasized all over the country, so it leads to wastage of resources.
- The strategy encourages dependency on other nations, the output missed from the neglected sectors is to be imported which worsens the dependency problem and worsen the balance of payment problems of the country.
- The leading sector may fail to have a serious impact on the country worse still it may just make it under develop more.

- The strategy may lead to lagging behind sectors, the neglected sectors lag so behind that uplifting them later may be so expensive or even hard, and this further widens the gap between the sectors of the country.

8.1.3.3: Big push theory

Activity 8.6



Identify any one huge investment especially in the infrastructures that the government has initiated in the recent years or is planning to initiate in the near future.

In your own view, how have this and other massive investments in infrastructure and industry promote the growth of the economy?

a) Meaning of Big Push Theory:

Big push theory was advanced by an economist called Paul Rosenstein Rodan and it is the reason why some economists prefer calling it the **Rodanian theory**.

The theory states that developing countries must massively invest in a variety of industries and economic infrastructure so as to transform a backward agricultural economy into a self-sustained dynamic economy."

The theory advocates for a massive investment program to promote rapid industrialization and huge economic infrastructure.

b) Arguments in favor of big push strategy

- The theory advocates for setting up complementary industries. This rises the volume and variety of goods and services provided to the nationals giving them several to choose from so economic growth and development.
- The massive investment program emphasized by the theory accelerates a stagnant economy into high rates of economic growth.
- The theory advocates for industrial growth that provides several employment opportunities to nationals, this develops the nation further.
- The industrial progress that Walt Rodan advocated for provides forward and backward linkages to the agricultural sector all of which are necessary for the rapid development of developing countries.

- The theory calls for maximum exploitation of resources of developing countries and this reduces underutilization of resources
- There is a high likelihood of having a balanced development of the economy if the different varieties of industries are scattered in different parts of the developing countries.
- The theory encourages self-sufficiency that is the major symptom of development. The different varieties of industries produce different varieties of output, so reducing the need to import from other countries.

c) Disadvantages of the theory

- The theory calls for massive expenditure, such funds are not readily available in developing economies. It calls for borrowing from other nations that increase the indebtedness of developing economies.
- The big push theory ignores the role of agriculture in development. Agriculture is the major supplier of foodstuffs and raw materials to agro-based industries that developing countries can sustain.
- The massive industrialization that Rodan advocates for increases pollution that reduces the quality of life of the people.
- The theory calls for over exploitation of the natural resources due to the massive industrialization, this leads to their quick depletion.
- The heavy industrialization and economic infrastructural growth brings about the use of machines in production, these replace laborers so causing technological unemployment.
- The massive industrialization required by the theory calls for the rich foreign investors to developing countries. However these investors repatriate all profits to their home countries leaving developing economies in a worse state than they found them.

d) Limitations of the theory

- Inadequate funds and man power in developing economies to invest in the economy as the theory suggests.
- Inadequate resources to act as raw materials may be a hindrance to the development of industries
- Developing countries do not have adequate skilled manpower to scatter in all sectors being developed at the same time.

- Strategy requires proper planning and implementation of plans so as to coordinate the different projects running at the same time, developing countries are not blessed with such planning skills.
- Strategy requires developed infrastructure in terms of transport and telecommunication network, hydroelectric power, among others, such developed infrastructure is still inadequate in developing economies, and so they cannot sustain a balanced growth strategy.
- Developing countries have under developed technology; it is still traditional and sometimes just intermediate that cannot support the growth strategy.
- Developing economies have inadequate local and foreign market that cannot support the much output from all the industries of the economy.

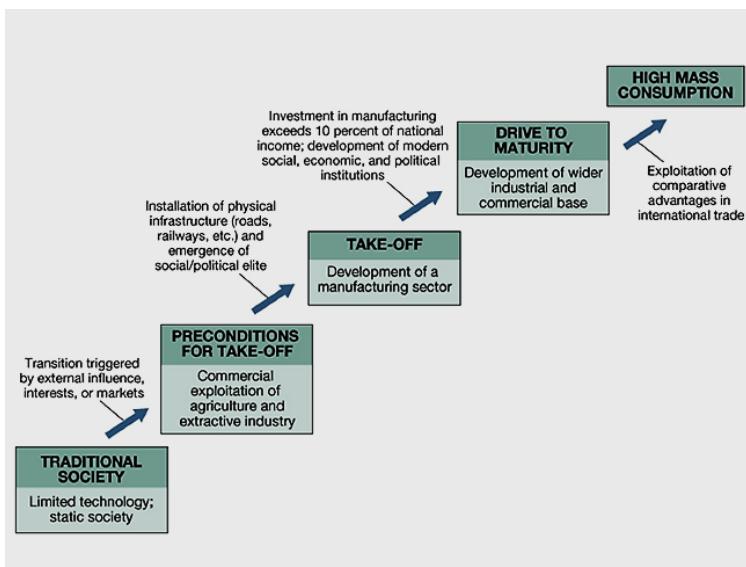
8.1.3.4: ROSTOW'S STAGES OF GROWTH

Activity 8.7



It has sometimes been argued that for developing countries to grow and develop, they have to follow the footsteps taken by the developed countries. Do you agree?

a) Rostow's stages of growth.



Professor Walt Whitman Rostow described the following stages through which societies pass to attain higher rates of economic growth and development. He described the stages together with the features at those stages of the way of life, way of doing work, level of capital accumulation, method of production, level of saving and investment among others as below;

3. Traditional stage
4. Transitional stage
5. Take off stage
6. Drive to maturity stage
7. Stage of high mass consumption

1. Traditional stage

This is the first stage in the development process where the economy is still in infancy and there is little progress taking place. It has the following features

- Subsistence production where output is for home consumption
- No use of money as a medium of exchange
- There is a high degree of communal organization where people work together as a community
- Traditional beliefs in culture lead to a lot of conservatism
- There are cases of disease and the nearest hospital is the bush
- Production is highly labour intensive
- There is almost no formal employment and organized income
- There is nothing like investment and savings in the economy and the economy is closed from external world
- High levels of resource wastage through unproductive activities like funeral rites, birth cerebrations, marriage etc

2. Transitional stage/ pre-condition to take off

In this stage there are signs that the economy is preparing to take off. It has the following features

- Dualism arises at this stage. Dualism is the co-existence of two contradicting sectors in an economy one developed and the other under developed. e.g. commercial agriculture versus subsistence agriculture, agriculture versus industry.
- The society starts moving away from dominant subsistence sector and traditional methods of production are reduced.

- A market economy starts emerging where people exchange their output for money.
- Industrialization starts more so the processing industry, these are normally agro-based industries processing agricultural output.
- Entrepreneurs start to emerge.
- Saving and investment start and rise up to 5% of the gross domestic product.
- Development of a national identity and shared economic interests.
- Mobility of labour begins.

3. Take off stage

This is the stage that involves rapid transformation in the country's social, cultural, political and economic spheres. It has the following characteristics

- Barriers to development are eliminated. Strong economic infrastructure like banks, hospitals, schools are set up.
- Savings and investment grow to between 5% and over 10% of the Gross Domestic Product, new industries are introduced and industrial growth takes faster rates.
- More employment opportunities are created; peoples' incomes rise because wages are higher.
- Idle resources are put to more efficient use through exploitation by the industries
- Modern and advanced technology is introduced in all sectors of the economy.
- Skilled and qualified labour and entrepreneurs start coming up.
- Education and literacy rates increase at faster rates.
- Rate of urbanization increases faster.

4. Prematurity stage/ Drive to maturity stage (self-sustained growth)

This is the stage which follows the take off stage and it has the following features

- The rate of saving and investment is between 10% and 20% of GDP.
- The economy undergoes fundamental political, social and economic advancements, technology progresses rapidly.
- Production for export grows further and there is limited importation of manufactured goods.

- The industrial sector is transformed from small scale to heavy industrialization.
- Agricultural mechanization emerges and such heavy agricultural machines like tractors, combine harvesters, multi crop thresher are used to increase agricultural productivity.
- There is maximum utilization of the country's resources.
- Modernization of the economy is very high and traditional norms, beliefs and customs are kicked away.
- There are high levels of employment opportunities and white collar jobs increase in availability.

5. Stage of high mass consumption

This is the last stage in growth where the economy has reached its climax. It has the following characteristics

- All resources in the country are fully exploited and utilized.
- Consumer durables like washing machines, cookers etc become necessities in every house hold.
- Incomes of the people are extremely high due to full employment conditions.
- Industrial growth is at its peak and they start producing luxuries like cosmetics, necklaces among others.
- The rates of saving and investments are over 20% of gross domestic product.
- There are high rates of exportation and the country's balance of payment position improves.
- Urbanization increases and there is an increase in the urban population.
- Country starts lending and donating to other nations.
- People reduce working hours and start enjoying leisure, they even start going abroad to tour and rest.

It is important to note that some stages overlap into others, so it may be difficult to identify the exact stage at which a society lies according to the features stated by Professor Walt Whitman Rostow.

b) Applicability of the theory in developing countries.

As talked about by Rostow, developing countries have tended to go through the same path though still a long way to go. The following features can be seen in the developing countries

- **Subsistence production** where output is for home consumption is very common in developing countries as a means for survival.
- **No use of money as a medium of exchange.** In some areas, exchange is through barter system while generally money is used as a medium of exchange in all societies.
- There is a high degree of **communal organization** where people work together as a community through cooperatives.
- Traditional beliefs in culture lead to **a lot of conservatism**. This is very common in developing countries and it has led to low quality output
- **Production is highly labour intensive** and this is because of the inadequacy in capital in developing countries
- High levels of **resource wastage** through unproductive activities like funeral rites, birth cerebrations, marriage etc. are common practices in developing countries
- **Dualism is common.** Dualism is the co-existence of two contradicting sectors in an economy one developed and the other under developed. E.g. commercial agriculture versus subsistence agriculture, agriculture versus industry.
- **Industrialization is common more so the processing industry,** these are normally agro-based industries processing agricultural output. As talked about in the pre-conditions to take off stage
- Entrepreneurs are emerging and this has **increased saving and investment** leading to increase of the gross domestic product.
- There are high cases of **labour mobility** in the developing countries both internal and external

c) Criticisms of Rostow's theory

- Rostow talks about progressing from stage to stage but does not show the mechanism of how it is done.
- Rostow bases his theory on American and European history and defines the American norm of high mass consumption as an integral to the economic development process to all industrial societies, so his model has no impact on other nations especially the developing agricultural nations.
- Rostow fails to demarcate one stage from the other as the features of take off and transitional stage tend to overlap into each other.
- Rostow bases his theory on savings, showing that growth occurs as the rate of savings increase with advancing stages but savings do not show a picture of economic growth because they may be autonomous.
- Whitman Rostow gives rates of savings and investment at different stages but does not show how the rates are determined, so they become unrealistic.



Application activity 8.1.

3.1. Sector Achievements and Challenges.

In the final year of the EDPRS II, the Rwandan economy has achieved tremendous results. Between 2013 and 2016, the economy expanded by more than 20%, over 600,000 jobs were added to the economy, and exports increased by almost 25%. Temporary international commodity price volatility was weathered and several key flagship initiatives have commenced, which, together with continued strong institutional performance, has firmly put Rwanda on the regional and global map, including the Kigali Convention Centre and the Kigali Logistics Platform. Rwanda is again the 2nd best performer in Africa in the World Bank's 2017 Doing Business Indicators and also 2nd in Africa in the World Economic Forum's 2017-18 Global Competitiveness Report.

(Source. Private Sector Development and Youth Employment Strategy (PSDYES) 2018-2024 Page 3)

In view of the above, examine the policy strategies that Rwanda has employed to reach the above levels of growth.

8.2. Economic development

Activity 8.8



Study and compare the set of pictures A&B, C&D, and E&F above and answer the questions that follow:

- i) What do you learn from the comparison?
- ii) What do you find desirable and undesirable about them?
- iii) What can be done to change the undesirable to the desirable?

8.2.1: Meaning of economic development

Economic development refers to the sustained quantitative and qualitative increase in the volume of goods and services produced over a period of time resulting into positive social, economic, and political institutional changes that may improve the quality of life of the population. It can also be defined as the process by which real GNP per-capita increases quantitatively and qualitatively over a very long period of time in the country.

Economic development can be measured by;

1. Increase in real per-capita income
2. Increase in things that improve the quality of life of man like food, housing, health care, security, leisure, freedom and others.

Economic development has got the following objectives.

- To reduce upon illiteracy rates and improve upon literacy among the citizens in the country.
- To attain higher rates of economic growth as shown by the increase in the gross domestic product
- To attain price stability/fight against inflationary tendencies in an economy so as to create certainty in the markets
- To reduce economic dependency or to attain self-reliance so as to reduce excess capital outflow and at the same time develop local production ventures
- To fight against unemployment so as to reduce poverty and improve the standards of living.
- To attain even resource distribution so as to reduce income inequalities among the people and regions.
- To improve upon skills of the people through education to reduce dependence on foreign experts who seem expensive.
- To improve upon security to life and property to ensure a good political atmosphere that will attract investors.
- To control population growth rates to desirable levels so as to reduce its associated problems.
- To attain equilibrium of the balance of payment position through increasing and improving upon the volume and value of exports and reducing spending on imports.

8.2.2: Comparison between economic growth and development.

Activity 8.9.



Having acquired knowledge and understanding about economic growth in sub section 8.1 and the meaning of economic development in subsection 8.2.1 of this unit, describe what you think are the distinguishing features of economic growth and economic development.

- Economic growth may involve the increase in the volume GDP only while economic development involves both increase in the quality and quantity/volume of GDP.
- Economic growth may take place even with uneven income distribution while development involves fair income distribution
- Growth can take place even with poor quality of output produced while economic development involves improvement in quality of output
- Economic growth may take a short period of time to achieve while development may take a long time to achieve.
- Economic growth may take place even with low quality of life of the people while development involves change in the quality of life
- Economic growth is a rapid process while economic development is a slow process
- Economic growth can be achieved without integration of economic sectors with economic dependence while development takes place when there is integration of economic sectors and self-sustenance.
- Economic growth may take place without change in economic institutions like banks while development takes place change with structural changes.

8.2.3: Indicators of economic development.

Activity 8.10.



Make research on the economies of the Netherlands and that of Rwanda, compare the two situations and explain what makes Netherlands economic condition better than that of Rwanda?

- Increase in per capita income since there is a high national income in the country.
- Better education and health services as shown by the increase in the educational institutions as well as the health facilities.
- Increased life expectancy i.e. number of years a person is expected to live increases because of the improved wellbeing.
- Improved technology which produces good quality goods and services that the people consume excessively.

- High levels of employment as showed by a fall in the unemployment rates.
- Goods and services suit the tastes of the people where by production is based on consumer sovereignty.
- Improvement in human and labour rights because of high rates of democracy practiced in the countries.
- Improved welfare of the people because of the good quality of the goods that are produced in the country.



Application activity 8.2.

Make research on the following countries and compare their economies and categorize them into high income, middle income and low-income status countries.

Country	Land area.	GDP (ppp)	GDP growth rate.	GDP per capita	Unemployment rate.	Current account bal.
Japan						
Brazil						
South Africa						
South Sudan						

8.3.: Under development:

8.3.1: Meaning and characteristics of economic under development:

Activity 8.11.



Study the pictures above and.

- State what economic attachment is put onto the above pictures.
- What are the distinguishing features of countries that live in such conditions.

8.3.1.1: Meaning of economic underdevelopment:

Economic underdevelopment is an economic situation where a society has resources but has failed to put them to maximum use or maximum exploitation so as to improve the welfare of individuals.

Alternatively, economic underdevelopment is an economic situation where there is persistently limited resource exploitation so as to satisfy nationals' welfare to desirable levels.

8.3.1.2: Indicators/ characteristics or indicators of underdevelopment.

- **Dualism.** There is existence of two contrasting sectors one being developed while the other poor eg rich and poor, commercial agriculture and subsistence, educated and uneducated etc.
- **High population growth rate.** People tend to produce more children due to cultural factors.
- **High levels of dependence** since the country hasn't enough resources to cater for its citizens.
- **Predominance of agriculture** and most of output is for home consumption. This is because the economies have little capital to invest in other sectors like industry.
- **Weak and underdeveloped infrastructure** especially the roads are of poor quality and mainly are small feeder roads.
- **Predominance of a large subsistence sector.** This is brought by the small market in the country and worse still the quality is low.
- **Low level of productivity.** This is brought by poor technology that is rampant.
- **High levels of illiteracy and low-quality education.** There are few schools and worse still the available ones are of poor quality.
- **High levels of poverty among the people.** This is brought about by the high unemployment rates and still lack of capital to start up business.
- **Production is at excess capacity** i.e. produce less than what is needed by the people because of the poor techniques.
- **Political immaturity leading to instabilities** are a common characteristic because pf the constant struggle for power.

8.3.2: Causes and policy measures to solve the problem of underdevelopment in developing countries:

Activity 8.12.



Country	Total area	GDP (\$ 2017 est)	Income per capita(\$2017 est)
Rwanda	2 6 . 3 3 8 Sq/km	24.68	2,100
Singapore	719.2 Sq/km	528.1	94,100

Source: World fact book.

According to the information in the above table, Singapore is smaller than Rwanda by area. However, it has bigger GDP and Income per capita figures than Rwanda. In your own view,

- What factors explain this?
- Discuss the policy measures that Rwanda can put in place to overcome underdevelopment.

8.3.2.1: Causes of underdevelopment.

Economic underdevelopment in developing countries arises due to both internal and external factors as seen below;

Internal causes

- **Inadequate strategic raw materials** and industrial inputs like coal, gold which stimulate production, industrial growth and then production, this hinders industrialization causing under development.
- **Political unrests.** Peace and security are vital elements in the running and functioning of any country. Most developing countries have failed to provide security to their citizens. Civil strife, social unrest and political violence are common phenomena in Africa. This hinders production, scares away investors and destroy the already set capital assets for capital accumulation, causing under development.
- **Capital Deficiency:** Capital is of crucial importance for economic growth and development. However, this is what the developing countries lack. With the low level of national output much saving is not possible but whatever

there is, it is wasted away in conspicuous consumption and extravagance in social ceremonies or is invested in real estate or jewelry. This handicaps all productive enterprise and hinders economic growth and development in developing countries. Such countries are caught up in a vicious circle of poverty hence hampering development in their economies.

- **Limited Entrepreneurial and Managerial Talent.** This is responsible for missing available opportunities of profitable investment in most developing countries. Hence such countries remain economically backward.
- **Limited Skilled Personnel and Technical Know-how:** Another very important bottleneck in the way of economic development is the scarcity of technical know-how and skilled personnel in developing countries. These elements of productive power take long in building up and foreign technicians are very costly. Hence, the underdeveloped countries remain under-developed since they lack them.
- **Limited Size of the Market:** The purchasing power of the people of most people in developing countries is very low on account of their rampant poverty. Hence the productive enterprises are handicapped in the sale of goods. Only an expanding market can provide a fruitful field for profitable investment hence economic development in the developing countries.
- **Weak Infrastructure:** The developing countries lack an adequate and efficient means of transport and communications, a well-organized and developed banking system and adequate facilities for technical education. Without these no country can develop economically. Lack of adequate infrastructure is a big abstraction to economic growth.
- **Social and Institutional Set-up:** Social customs and attitudes of the people of developing countries are a great bar to economic progress. Conservatism, superstition, lack of ambition, undue regard for custom and status are a strain on economic progress. Economic backwardness in most developing countries is in no small measure due to joint family system, caste system, peculiar laws of inheritance and the other-worldly attitude of the people.
- **Growing Population:** The explosive rate of population growth in the developing countries undoubtedly retards their economic development. Whatever development takes place is swallowed up by the rising wave of population. The fruits of development are hardly sufficient to feed the tide of babies.
- **Dependence on Agriculture:** The majority of the population is engaged in agriculture which is carried on in a primitive manner. Naturally the national income remains at a low level. Economic development cannot be brought about in the absence of rapid industrialization

External causes include

- **Profit repatriation.** Several of the investments in developing countries are owned by foreigners, these take back the benefits ploughed out of these investments back to their home countries leaving developing countries in a worse state than they were found.
- **The debt servicing burden.** Developing countries contract loans to set up investments for development, all benefits obtained flow back to the lenders in servicing these debts and paying them back rather than re-investing them. These cause further under development of the developing countries.
- **High levels of Brain drain.** Several of the educated and high skilled personnel in developing countries go abroad for greener pastures. This leaves LDCs with the weak, dull, lazy and the unskilled labour force that cannot aid further development.
- **The unfavorable trade position.** Several LDCs produce and export primary products which are semi processed or not processed at all, consequently they fetch less revenue because of their low value causing under development.
- Alien Rule / Neocolonialism: Most of these countries have been under foreign rule which has kept them down. The foreign rulers could not be expected to take any genuine interest in the economic regeneration of the people. Economic backwardness of most developing countries may be largely attributed to the policies followed by colonial masters. Several developing countries, though claim to be independent still follow the principles, practices and policies of their former colonial masters which can no longer develop them, they continue to get loans from former colonialists, increasing their indebtedness causing further under development.

8.3.2.2: Policy measures to solve the problem of underdevelopment

- **Education reforms** have been undertaken. This has helped many people to access education so that they can be prepared to get jobs and remove the people from poverty
- **Land tenure reforms.** This is through land redistribution policies and making it accessible to all people in society so that they can be able to carry out agriculture.
- Kick start funds like the **one cow per family** has helped people to access cows that can be used as source of income through selling the milk

- **Progressive taxation.** This has reduced the gap between the rich and the poor people since the revenues collected are used to subsidize the poor and further infrastructure development
- **Improving infrastructure** like roads which helps in the movement of people and goods from areas of production to markets helps people to increase their earnings
- **Liberalization of the economy.** This has helped people to participate in economic activities and trade hence increasing their incomes and standards of living
- **Controlling population growth.** This has helped to reduce the ratio of resources to the population and also dependence burden among the families.
- **Modernizing agriculture.** This has helped reduce the level of poverty in rural areas where the activity is fully based. The people are able to increase the quality and quantity of their products hence receiving more incomes.
- **Improvement of the investment climate.** This has been through giving tax holidays and free land like the free investment zone in Masoro. This has attracted more investors and hence creating employment opportunities
- **Improvement of the political climate.** This has created good environment for production where by the people are not scared of carrying out any activity
- **Encouraging development of small scale enterprises.** These have also created more employment for the people in Rwanda and hence improving their standard of living
- **Formation of co-operatives.** This has been the basis for reducing income inequalities among the people. These such as Saccos like umurenge sacco, umwalimu sacco, producer co-operatives among others have encouraged micro savings and given small loans to the local people.



Application activity 8.3.

The Government of Rwanda Vision 2020 seeks to transform Rwanda into a middle-income country by 2020 and recently adopted vision 2050 that will turn Rwanda into upper middle income by 2035 and high-income country by 2050. In order to pave the way towards our long-term vision, the National Strategy for Transformation (NST) for the next 7 years from 2018-2024 has an ambitious objective to increase the quality of life of all Rwanda through rapid sustainable economic growth and accelerated Moving towards a Poverty Free Rwanda.

(Source: DRAFT REPORT. RWANDA FINANCIAL SECTOR STRATEGY 2018/2024. Page 10)

In your own view, what policy issues should the government put in place to drive the economy to reach a high-income status by 2050.



End unit assessment

1. Examine the factors that influence Rwanda's level of GDP growth rates.
2. What conditions are there to show that Rwanda's economy is an underdeveloped economy?
3. Suggest measures that can be used to reduce the level of underdevelopment in developing economies.

UNIT 9

AGRICULTURAL DEVELOPMENT

Unit competency:

Analyze the contribution of development strategies on the economy.



Introductory activity

Figure 1: Agriculture development



Using photos, A, B, C and D in figure1 above, discuss the following questions.

1. What activities are taking place in the photos above?
2. What is the difference between the activities carried out in the last two photos C and D?
3. What is agricultural development?
4. Give the advantages and disadvantages of agricultural development

9.1. Meaning

Activity 9.1



- (a). What is meant by the term agriculture.
- (b). Explain the advantages and disadvantages of agricultural practices in your district.

Agriculture is the growing of crops and rearing of animals. There are both food crops and cash crops involved together with a variety of animals. Agriculture is basically the backbone of developing countries contributing wholesomely to their economies and thus its development is paramount.

Agriculture development therefore is the process of promoting proper conditions for farming so that the quantity and quality improve drastically. It can also be looked at in the perspective of providing assistance to crop producers with various agricultural resources for better output attainment.

9.1.1. Arguments in favor of agriculture.

1. Provides enough food necessary to feed the population in both rural and urban areas.
2. Provides raw materials for agro based industries e.g sugar factories textile factories etc. which increases the rate of industrialization.
3. Provides employment to the people which enables earn income and improve their standard of living.
4. Increased output for export and reduced expenditures on imported agricultural goods which in turn increases the country foreign exchange.
5. Source of medicine to the people of the country especially through the herbs.
6. Provides backward linkages to the industrial sector where it acts as market for the industrial output such as the hoes, pangas etc.
7. Reduces rural urban migration because people are employed in the agriculture sector which is normally carried out in rural areas.
8. Facilitates development of infrastructure like roads because of the need to transport commodities from rural areas to the market.
9. Leads to fair distribution of income because of the employment provided to the people through agricultural activities.

10. It is source of government revenue through taxing commercial agricultural products which leads to the development.

11. It acts as training ground to many people, many people get skills from managing agricultural activities and apply them in other sectors which also lead to the development.

9.1.2 Disadvantages of agriculture.

- 1.** Agriculture prices keep on fluctuating consistently due to the differences between planned output and actual output together with poor climate conditions all which affect the supply and affect the producers
- 2.** Agriculture development may involve expansion of the firms among others and this may affect the growing population in terms of settlements leading to fragmentations
- 3.** Products are perishable and difficult to store. This is a big problem that affects developing countries and worse still they are bulk and may not be transported easily to other parts of the country
- 4.** Some crops have a long gestation period and thus the farmer may take long to gain from them even if the prices increase at present, the farmer may not increase supply thus losing out.
- 5.** Agriculture mostly depends on nature. If the rains fail to come, the farmers may fail to increase supply than what they may have anticipated and prices may go up. The inconsistencies in climate worsen the problem of price fluctuation of agricultural products.
- 6.** Most of the developing countries produce the same types of agricultural goods and thus products flood at the world market causing prices to fall down.
- 7.** Development of synthetic fibres which also have the same purpose with agricultural raw materials these reduces the demand for agricultural products.
- 8.** High rates of conservatism among the many farmers who prefer quantity to quality leading to poor quality and low revenue to them as earnings and to the government as through taxation.



Application activity. 9.1

Examine the role of agricultural development towards a country's development.

9.2. Approaches to agriculture development

9.2.1 Agriculture Mechanization

Activity 9.2

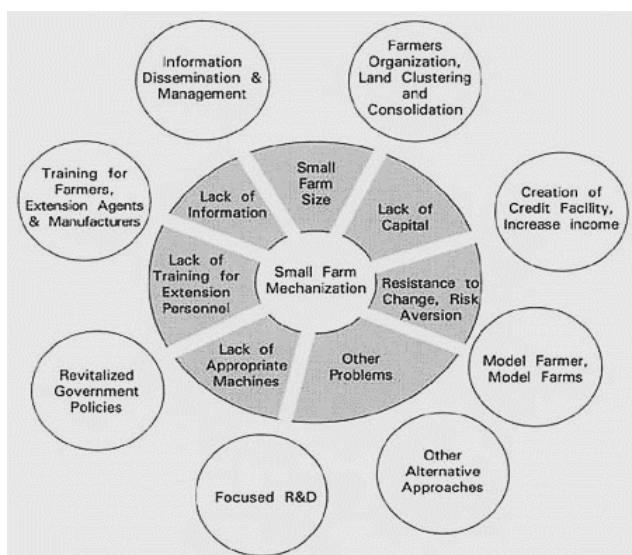


Basing on the photos A and B.

Figure 2: Mechanizing agriculture



1. What type of activities are taking place photos A and B above?
2. Describe the method of production used in the two picture?
3. What are the advantages and disadvantages of using the above mentioned machines?
4. Give reasons why using such machines is not common in your home areas.



C (problems and solutions to agriculture mechanization)

9.2.1.1 Meaning of agriculture mechanization

Agriculture Mechanization is part of agriculture modernization that involves the use of capital intensive techniques such as tractors, harvesters, irrigation pumps, ploughs and milking machines among others in production process. It is normally done to increase quality and quantity and also for time saving.

9.2.1.2. Arguments in favor of agriculture mechanization

1. **Time saving** especially during times of planting, ploughing among others. The machines do the work very quickly and save time that would have been used by the people
2. Encourages **large scale production** because machines use large pieces of land and this increases output that would be exported to earn the country foreign exchange.
3. **Good quality output** is produced because of constant use of machines which can be tuned and adjusted to produce good quality.
4. Reduces **the cost of production** because the expenditure to buy machines is not recurring but happens once compared to labour that has recurring expenditures i.e wages.
5. **Encourages specialization** depending on the machines which the farmers have and this increases the quality and quantity and time saving.
6. **Easy management** because the use of machines doesn't need close supervision than labour
7. Machines can act as **collateral security** when acquiring loans from financial institutions
8. Irrigation is possible which **reduces dependence** on nature and it may help increase output even when during dry periods

9.2.1.3 Disadvantages of mechanization

1. Capital intensive techniques cause **technological unemployment** where machines replace humans.
2. **Rural urban migration** may occur because mechanization requires large pieces of land and therefore the local people may lack for settlement
3. **Requires large sums of capital** to use because the machines such as tractors, sprinklers, harvesters, all have to be imported.
4. **Machines destroy the ecology** of the soil since they may not be appropriate to the soil.

5. Requires gently or flat large pieces of land yet most parts of the country are **hilly with steep slopes** thus being disadvantage.
6. Specialization as a result of mechanization may affect the country **export earning incase world market prices fall.**
7. **Over production.** This is because of the work easily done by machines during the process and this leads to surplus and resource wastage. This happens where the market is small.
8. **Over exploitation of resources** due to the desire for the high profits and excess production by the machines.

9.2.1.4 Limitations of mechanization

1. **Requires high skills** to operate the machines which are inadequate in the developing countries due to limited trainings.
2. **Existence of inadequate capital**, most people in agricultural sector cannot afford buying agricultural machines like tractors hence limiting the strategy.
3. **Requires large pieces of land** which is scarce in LDCs where the land is divided into small pieces called fragments due to high population growth rates.
4. **Existence of poor topography in some parts of country** where the land is surrounded by many hills. This limits the use of modern machines like tractors in the agricultural sector.
5. **High degree of conservatism** in the agricultural sector especially in rural areas. Here most farmers still have poor attitudes towards mechanization where by most of them prefer traditional methods to modern ones hence being a big limitation.
6. **Requires a good and efficient agricultural planning** which is not possible in terms of costs and management in developing countries.
7. Underdeveloped **infrastructure and technology** limits the use of machines since they require a well-developed road network.
8. **Existence of small market** for the agricultural output discourages most farmers from using machines so as to increase output since it may lead to surplus and a fall in prices.
9. Price fluctuation in agricultural sector also discourage many people from investing a lot of their money in buying machines because they may fear to make losses when prices reduce hence being a limitation.

10. Land fragmentation in the country where land is divided into small pieces yet this strategy requires large pieces of land hence being a limitation.

11. Machines sometimes destroy the ecology of the soil since they may not be appropriate to the structure



Application 9:2

Discuss the factors that hinder agriculture mechanization in most parts of the country

9. 2.2 Commercialization of agriculture in Rwanda

Activity 9.3



Basing on the photos A, B and C and D the figure given below, discuss the following questions.



1. What activities are being carried out in the figures A, B, C and D in the figure show above?
2. What are the benefits and demerits of carrying out the activities below?
3. Give reasons why using such activities are not common in your home area

9.2.2.1. Meaning of commercialization of agriculture

Commercialization of agriculture is the type of production that is intended for sell with an aim of getting profits. It normally involves large scale production with high technology most of the times. The quality tends to be better than that of subsistence production. In Rwanda the major food crops grown for sell include Irish potatoes, banana, and rice among others while the cash crops include tea and coffee among others. Among the animals are cows for beef and milk, goats and sheep among others. Commercial production involves the following **characteristics**:

1. Production is for the market either domestic or international
2. Use of improved seeds and breeds of cattle for better quality
3. Use of modern tools like tractors, harvesters, and sprinklers among others.
4. Skilled workers are employed compared to family labour used in subsistence production
5. High levels of productivity due to the need to serve a wide market and accumulate high profits
6. Land improvements through the use of fertilizers all in the need for high productivity. High quality is produced since the major aim is profit maximization.

9.2.2.2. Benefits of commercial agriculture

1. Develops skills of workers because of specialization and constant doing of the same work.
2. Increases the gross domestic product of the country because of the need for high profits and revenues.
3. Increases the incomes of the workers and the farmers at large. This is because production is for sale. This increases the standard of living of the workers.
4. Good quality products are produced since farmers produce purposely for sale which improves on standards of living of the people and their way of life.
5. Increases the exports of the country hence the increase in the foreign exchange earnings.
6. Increases the supply of food because in most cases it is carried out on large scales and this in turn reduces the price of food stuffs which increases people's standards of living.

7. Promotes industrialization because it involves production of raw materials on large scales in the country.
8. Capital accumulation may increase because of increased output for sell that will bring in revenues.
9. Sometimes it is done on a large scale so it utilizes the idle land that may be unproductive
10. Employment creation. The desire for too much profits make the owners of the farms to increase the number of workers hence creating employment.

9.2.2.3 Disadvantages of commercial agriculture.

1. Reduction in the food needed by the local people since production is mainly for sell and not home consumption.
2. Capital intensive techniques cause unemployment in the villages since mainly machines are used on the extensive land.
3. Requires large sums of capital to use because the machines such as tractors, sprinklers, harvesters, all have to be imported.
4. Requires large pieces of land and this is a problem in countries where land has rugged terrain with steep slopes in many parts of the country.
5. Specialization as a result of mechanization may affect the country incase world market prices fall.
6. Over production. This is because of the work easily done by machines during the process and this leads to surplus that may not be absorbed by the available market.
7. Over exploitation of resources due to the desire for the high profits and excess production by the machines

9.2.2.5 Limitations of commercial agriculture

- (i) Poor land tenure systems. Some of the land is owned by absentee land lords and hence it is inactive.
- (ii) Narrow markets. The market is low due to poverty among the people and the low quality that cannot yield much revenues.
- (iii) Poor infrastructure. This limits the movement of goods from gardens to market and also from areas of low prices to areas of high prices
- (iv) Lack of skilled man power. Most people have low skills and worse still they take long to adjust to the new techniques

- (v) Conservatism of farmers. Some farmers are very conservative and are not able to change to good quality output hence end up getting low revenue
- (vi) Inadequate capital. This is still very low and many producers cannot access the improved equipment necessary to improve the quality and quantity.
- (vii) Competition from other countries that produce the same at the world market. This leads to surplus and constant price fluctuation which affects the foreign exchange and incomes of the commercial farmers.



Application activity 9.3

Discuss the reasons as why commercial agriculture is encouraged in Rwanda.

9.3 Measures to improve agricultural productivity.

Activity 9.4



Basing on the photos given above; identify some of the measures taken by the government of Rwanda to improve agricultural productivity in the country.

1. Encouraging security in the country. This encourages many people both local and foreigners to invest in commercial agriculture which improves on agricultural productivity in the country.
2. Establishment of credit schemes in the country which support farmers with loans this can help to increase on farmers' capital which encourages them to produce on large scales.
3. Encouraging agricultural diversification where farmers are encouraged to carry out different activities in agricultural sector this increases their levels of income and output hence improving on agricultural productivity.
4. Establishing and developing agro based industries in the country. This increases the market for agricultural products and encourages many investors to invest in agricultural sector which in turn leads to increased agricultural productivity.
5. Educating farmers about different modern methods of farming this can help them on ways of improving their levels of output.
6. Developing infrastructures like roads which can easily help farmers to transport their products from rural areas to urban areas where the market is so big and this encourages many people to invest in the sector.
7. Establishing many agricultural research centers in which farmers can research and discover modern methods which can be used in the sector and also to provide improved seeds to them which in turn leads to increased outputs.
8. Promoting agricultural cooperatives in the country which extend agricultural services to farmers like storage services, improved seeds, transport services which all lead to the development of agricultural sector.
9. Improving on land tenure system where people are not allowed to divide their land into small plots this can help to encourage commercial agriculture which in turn leads to increased production.
10. Encouraging farmers to use pesticides which can help in fighting against pests and diseases, this in return can also help to increase on agricultural outputs.
11. Encouraging agricultural commodity agreements where the farmers of certain commodity come together and agree the price and the quality of their commodity this helps to reduce on price fluctuations hence leading to increased outputs.



Application activity 9.4

- (a). Examine the major challenges faced by the agricultural sector in developing economies.
- (b). Discuss measures being taken by most developing economies to solve such challenges.

Skills Lab



After having learnt about role of agriculture and commercial agriculture. Identify the most demanded agricultural goods at your school and come up with the proposal of agricultural project around the school that can provide such goods to school so as to reduce expenses, and then share your proposal with the school administration for further consideration.



End unit assessment

- (viii) Explain the reasons why agriculture is referred to as the “back bone” of many developing countries.
- (ix) In Rwanda using machines in agriculture sector has not been very common. Explain the reasons behind this scenario.
- (x) Mutoni is among the few farmers in Byumba district who has been producing beans, peas and ground nuts on large scale for commercial purposes.
 - (a). Which special name is given to the nature of agriculture Mutoni practices?
 - (b). Explain the advantages and disadvantages of Mutoni's agricultural practice.
 - (c). Explain the factors that hinders other people from joining the same agricultural practice like that of Mutoni.
4. Explain the measures taken by the government of Rwanda to improve agricultural productivity..

UNIT 10

INDUSTRIAL DEVELOPMENT

Unit competency:

Analyze the contribution of development strategies on the economy.



Introductory activity

Using the photos, A,B,C and D below, discuss the following questions.



- Identify the products that are produced by the industries identified in the above photos.
- Categorize the different activities named above in their respective industries.
- What general name would you give to the development of the above activities all together?
- Cite different other firms that do different activities in Rwanda that do not fall under any category named in b above.

10.1: Meaning, advantages and limitations of industrial development.

Activity 10.1



Basing on the photos and the cited examples of different firms in Rwanda that perform different activities in the introductory activity above,

- i) Distinguish between industry and industrial development.
- ii) Assess the impact of industrial development in Rwanda.
- iii) Describe the limitations of industrial development in Rwanda

10.1.1: Meaning of industrial development

With the Sustainable Development Goals (SDGs), Rwandans have the opportunity to act upon their vision for the future. The Goals address targets for development that are relevant within Rwanda just like in every country in the world that implements them. The Government of Rwanda, in line with global ambitions, has set national targets to successfully achieve the SDGs by 2030. One of the 17 SDGs implemented in Rwanda is number 9. Industry, Innovation and Infrastructure aimed at Building resilient infrastructure, promoting inclusive and sustainable industrialization and fostering innovation within the country. Therefore, industrial development is an engine to Rwanda's development goals and should be given emphasis and effort. **Industrial development** is the building and growing of industries within an economy. An **industry** is a group of companies that are related based on their primary business activities (product produced or sold). These industries include mass production, technological advances and other services. It may involve putting in place and developing the infant industries (industries which have just started operating and therefore have a small market, low output and high average costs).

Industrial development generally begins in response to domestic demand generated in the primary sector, which also provides investible funds for manufacturing industries. Demand for industrial products and investible saving represent possible uses of the surplus generated in agriculture (crops, livestock), fisheries, forestry, mining etc. as primary output comes to exceed subsistence needs. More often than not, the surplus generated in the primary sector is associated with export expansion.

10.1.2: Advantages of industrial development:

- Industrial development provides **well-sustained economic growth that can transform an economy**. Industrial growth and economic growth go hand in hand. For example, economies thrive due to more jobs, more money, and more opportunity. It is often linked with higher wages, high production, more money and more services for the economy leading to higher income per capita and more labor productivity thus increasing the standard of living. These opportunities can transform the economy inspiring endless amounts of growth.
- Industrial development leads to an **increased demand for goods and services**, therefore promoting more innovation and more financial opportunity which profits the entire community.
- **Prices of industrial products tend to be stable for a long period.** This price stability is a sign of development.
- Industrial development **provides forward and backward linkages to agriculture**, **forward linkages** are provided by providing market to its produce by processing it, and backward linkages by providing it with tools to use. These linkages bring about development.
- Industrial development **requires relatively less land**, so, it is the most appropriate development strategy for developing countries whose land is reducing due to persistent increases in the population size.
- Prices of industrial products are high, so the **industrial sector fetches more money** for the economy both locally and internationally.
- Industrial development is necessary for **modernisation of agriculture**. To increase agriculture productivity, there is need of chemical fertilizers, pesticides and weedicides, tractors, threshers, pump sets harvesters etc. to modernize agriculture, of which are all industrial products. Without industrial development, these goods cannot be produced. Agricultural products like cotton, sugarcane etc. are raw materials to industrial production in preparation of finished products like textiles and sugar etc. So industrial development is necessary for modernisation of agriculture.
- Industry **raises government tax revenue**. The industrial firms, labour, and output are all taxed to increase tax revenue.
- Industrial development **encourages the development of science and technology**. The industrial enterprises conduct research and develop new products. Industry conducts research on its wastes and develops byproducts; this makes an economy to thrive in technology in all corners of the economy.

- Industrial development facilitates **infrastructural growth**; industry requires hydroelectric power to run its machines and roads to transport its output and input to and from the industry. Consequently, intending industrialists induce government to set such infrastructure up or they set them up themselves. This develops the economy.
- Industrial development provides **more employment opportunities to all nationals**; the different linkages created by the industrial sector employ the almost all nationals i.e. educated, semi-skilled, and the unskilled.
- Industrial development **increases the availability of foreign exchange and improves upon the balance of payment position of the country**. Foreign industrialists come with foreign currency; in addition, the excess of the industrial sector is exported to fetch more foreign exchange. This increases the foreign exchange reserves of the nation so development.
- Industrial development helps in **capital formation** because in large scale industries, the surplus is very high. By using external and internal economies, industry can get higher profit which can be reinvested for expansion and development.
- Industrial development **promotes Urbanization**. This is because industrialisation in a particular region brings growth of transport and communication, schools, colleges, technical institutions, banking and health facilities are established near industrial base. Many ancillary units can be established after setting up of big industry. This promotes urbanization as one of the indicators of economic development.
- Industrial development **promotes self-reliance in different ways**. For example, during war and emergency or any other form of catastrophe and in case of any economic hardships, dependence on foreign countries for war weapons, food and medical relief may prove fatal. Self-reliance in capital and consumer goods and industrial infrastructure is also necessary thus the need for industrial development.
- Industrial development plays an important role in the **promotion of international trade**. Industrial products command higher values & their demand is inelastic, thus making a country to gain from trade. To meet the deficit in balance of payments, a country needs to produce import substitute products or go for export promotion through industrial development.
- Industrial development plays important role in **proper utilisation of resources by a country**. It makes a country to properly utilize her

resources to transform them into finished industrial products.

- Rapid industrial development helps a country in **quick alleviation of Poverty and Unemployment**. Since the slow growth of industrial sector is responsible for widespread poverty and mass unemployment in most developing countries, fast growth of industrial sector, may be helpful in eradicating poverty and unemployment more especially in rural areas.
- Industrial development helps in the **rapid growth of national and per capita income**. The history of economic development of advanced countries shows that there is a close relation between the level of industrial development and the level of national and per capita income.
- Industrial development is a sign of **higher standard of living and social change**: This is because it helps a country to produce goods and services of high quality in order to attain decent living standard.

10.1.3: Disadvantages of industrial development

Despite the numerous advantages brought by industrial development, the industries also have problems that they bring not only to the environment but also to the economy at large.

- Industrial development **pollutes the environment**. The fumes from machines spoil the atmosphere, industrial waste is poured in the waters, and there is noise. All these endanger the lives of the people so worsening their welfare and delaying development.
- **It worsens rural-urban migration** and its side effects like slum development in urban centers, congestion of traffic and under development of rural areas. This is mainly because industries are set up in urban centers.
- **It increases capital flight**; the foreign industrialists who are the majority in the sector take back all the benefits from the sector rather than re investing it in developing countries. This further under develops the country.
- **It increases technological unemployment in LDCs**. This is mainly because of the high use of capital-intensive techniques of production in the industrial sector. Therefore, there is co-existence of high levels of industrialization and high rates of unemployment.
- **It strains the government budget**. Expensive infrastructure must be set up for industry to develop, this sometimes necessitates borrowing which increases the indebtedness of the country.

- **It leads to environmental degradation;** sometimes swamps are reclaimed, forests cut down to give room to industrial growth, extinction of species etc. This under develops the economy since they tend to impose a major negative externality on human society.
- Financially, industrial development results in a **wide gap between the rich and poor** due to a division of labor and capital. Those who own capital tend to accumulate excessive profits derived from their economic activities, resulting in a high disparity of income and wealth.
- **Rapid urbanization** brought on by industrial development typically leads to the general deterioration of workers' quality of life and many other problems for society, such as crime, stress, and psychological disorders. Long working hours usually lead to poor nutrition and consumption of quick and low-quality foods, resulting in increased incidences of diseases, such as diabetes, heart attack, and strokes.

10.1.4: Problems faced by the industrial sector in developing nations

- Difficulty in **disposing off industrial waste**; the environment laws normally prohibit industrialists from polluting the environment; they find a challenge in finding where to divert the fumes or pour solid waste.
- **A narrow supply of quality raw materials**; most industries in developing countries are agro-based, the base on agriculture which is under developed and produces poor quality output. This on several occasions gives rise to poor quality industrial output whose marketability is hard. It sometimes necessitates importing raw materials that makes output too expensive and fails to compete on the world market.
- **A limited supply of skilled personnel**. Developing countries have a limited supply of qualified, skilled, and experienced personnel with industrial skills. This necessitates importing expatriates that increase the price of final goods and services since such people are expensive.
- **Under developed infrastructure**, industry requires well-developed road and telecommunication network to develop and a persistent supply of hydroelectric power. Their inadequacy is a great challenge to industrialist as they are forced to produce in excess capacity.
- **Limited capital funds**; since most people in developing countries are poor, they do not have adequate funds to expand their industries or even purchase more efficient and advanced machines.

- **Heavy taxes levied by government.** Governments of developing countries tend to tax industries heavily; this increases their costs of production and sometimes totally fail and close up the industrial plant.
- **Competition from abroad;** industrial products from LDCs are normally out competed by those from developed nations which are of good quality and low priced because such firms are already enjoying the economies of large scale.
- **Political instabilities and unrests from developing countries.** Industrialists in developing countries live in fear of having their entire plant destroyed by an insurgency that can erupt anytime in LDCS. Developing countries are politically insecure.
- **A small size of the market;** people in developing countries are poor, they cannot afford the prices of quality industrial output. This forces industrialists to produce in excess capacity.
- **Conservatism of the people in developing countries.** People in developing countries are rigid; they are not yet free with manufactured industrial goods. Consequently, several of industrial output is wasted if not exported.



Application activity 10.1.

Identify any practical solutions your government can put in place to foster industrial development.

10.2. Industrial development approaches.

Activity 10.2



Carry out a documentary research on industrial development, from any economics source within your reach, and identify different approaches that an economy of a country can undertake to develop her industrial sector in order to spearhead development in general. Discuss and share your views amongst yourselves in class.

Industrial development is one of the development goals in Rwanda. However, it is a complex and dynamic process. In Rwanda and developing countries in general, industrial development is even more complicated because it involves

the interactions of domestic firms and multinational corporations (MNCs), the role of the government, and the development of technology. Therefore, let us tackle production techniques as one of the approaches any economy can undertake for their industrial development process so as to achieve her goals of economic development. Such approaches may include among others the following; export promotion industrial strategy, import substitution industrial strategy, technology, small scale and largescale industrial strategy. However, in regard to this unit, we are going to dwell much on technology because it drives all other approaches in the long run. For example, if technology is well developed, it promotes large scale production, promotes production and export level and encourages a country to set up industries that produce commodities domestically thus reducing on their importation.

10.2.1. Technology

Activity 10.3



Use the photos below to answer the questions that follow:



- iv) Identify the activities taking place in photos 1,2, 3 and 4 above.
- v) Describe the technique of production used by each activity in the portrayed in the photos above.
- vi) What do you understand by the terms; technology and technique of production?
- vii) Which technique is most appropriate for Rwanda's development strategy?
- viii) Justify your answer.

10.2.1.1: Meaning of Technology.

Technology is a body of knowledge devoted to creating tools, processing actions and the extracting of materials. We apply technology in almost everything we do in our daily lives; e.g. at work, for communication, transportation, learning, manufacturing, securing data, scaling businesses and so much more. Technology is human knowledge which involves tools, materials, and systems. We can therefore, describe technology as products and processes used to simplify our daily lives. We use technology to extend our abilities, making people the most crucial part of any technological system. The application of technology typically results in products. If technology is well applied, it benefits humans; but the opposite is true, if used for malicious reasons. Therefore, for industrial development to mushroom, a proper technique must be chosen to foster rapid industrial growth and its comprehensive benefits to the entire economy.

A technique is any alternative method of production available to produce goods and services.

There is a great controversy on the question of choosing the technique of production i.e. between labour intensive and capital-intensive technique in less developed countries. All concerns differ to each other. Some are in favour of labor-intensive technique, others advocate for the capital-intensive technique. However, the choice of the technique may depend on the following:

- Benefit of the technique to the user.
- Efficiency of the technique.
- Prevailing economic conditions in the area or country.
- The cost of the technique.
- The advantages and disadvantages of the technique compared to others.

Thus, before formulating any decisive opinion on the question of which technique to choose for industrial development, let us study the arguments for and against each of these techniques

10.2.1.2: Capital intensive technology:

Activity 10.4



Analyse the photos below and answer the questions that follow.



A (cloth making)



B (beer processing)

- Which technique of production is being applied in the industries mentioned in the photos above? Support your answer.
- Identify different other activities that use such a technique in Rwanda.
- How does the above mentioned technique of production contribute to the development process of Rwanda's economy?
- Examine the hindrances to the use of the technique cited above in Rwanda.

a) Meaning of capital-intensive technology:

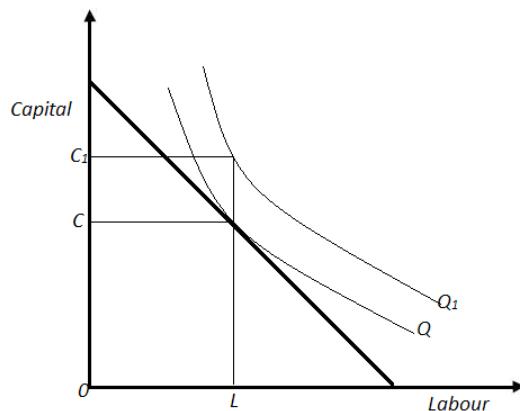
Capital intensive technique is technique that uses more proportion of machines than other factors of production like labour. It can also be called **labour saving technique**. Capital-intensive production represents the proportion of capital (machinery, equipment, inventories) relative to labour, measured by the capital-labour ratio. Normally under this technique of production, there are many machines compared to the number of people meaning that the capital-labour ratio is very high. It is sometimes called Labour saving technique.

Examples of capital-intensive industries include automobile manufacturing, oil production and refining, steel production, telecommunications, and transportation sectors (e.g., railways and airlines). All these industries require massive amounts of capital expenditures.

Although there is no mathematical threshold that definitively determines whether an industry is capital intensive, most analysts look to a company's capital expenses in relation to its labor expense. The higher the ratio between capital and labor

expenses, the more capital intensive a business is. For example, if Company A spent Frw10,000,000 on equipment in one year but only Frw3,000,000 on labor, Company A is probably in a capital-intensive industry.

Figure: Capital intensive technique



In the diagram above, isoquant Q represents the initial level of output, using OL amount of labour and OC amount of capital. With the introduction of new technique, a higher level of output is shown by labour (OL) but with greater dose of capital (OC_1). Therefore, capital intensive technique is using more capital with the same amount of labour.

b) Advantages of capital-intensive technique

- Production of **better-quality commodities**. This is because there are more machines used that can produce better goods.
- **Reduces the cost of supervision**. This is because machines are more than the people thus no need for a lot of supervision.
- **Encourages and promotes better and efficient methods and inputs** that can lead to high output
- **Promotes proper utilization of resources**. The machines tend to produce more hence reduce tendencies of excess capacity
- **Encourages technology transfer** from developed nations to developing nations and this leads to technology development in the recipient countries
- **Relatively cheap** since it does not associate with capital outlay like housing, medical care etc
- **Reduces industrial strike cases** because it uses more machines than labour
- **Increase labour mobility** from one place to another to acquire job opportunities

c) Disadvantages of capital-intensive technique

- **Leads to technological unemployment.** This is because more proportions of machines are used in relation to the labour
- **Expensive to install and maintain.** The machines that are employed are expensive to install and still maintenance is recurring in terms of costs
- **Requires skilled man power** which is scarce in low developing countries. This calls for acquisition of imported labour which may lead to profit repatriation.
- **Promotes capital outflow** when buying the machines and repairs. The machines have their repairs bought from outside countries and thus continuous outflow
- **Worsens the balance of payment position** when acquiring the machines since they are expensive
- **Promotes income inequality** because it creates technological unemployment when people are replaced with machines
- **High social costs** like pollution from the machines and this leads to environmental degradation that may be harmful to the people
- **High rates of resource exhaustion.** This is because the machines tend to produce a lot since there is no human judgment.
- **Promotes dependence on other countries** for machines and expatriates and this may limit the country to be self-reliant.

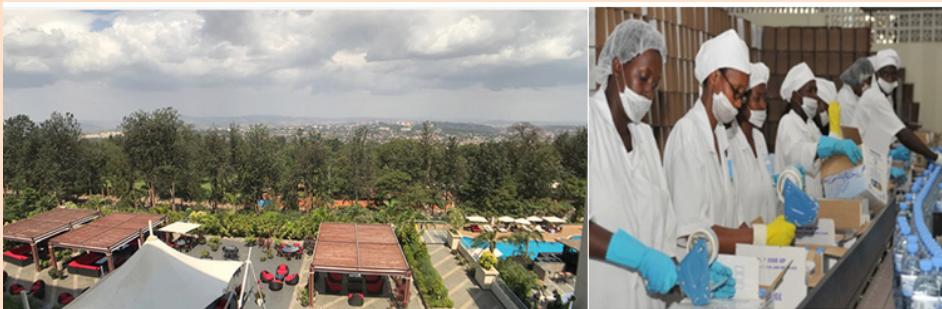
d) Limitations of capital-intensive technique

- **Inadequate capital** by the people limits them to acquire the machines hence they resort to labour intensive technique.
- **High tax charged on the importation of the machines** makes people to shun away from them and they retain the labour
- **Inadequate market** both internal and external discourages people to use the capital-intensive technique since the excess supply will not have the market to use it.
- **Inadequate raw materials** leading to constant importation creating constant balance of payment problems
- **High operation costs** due to large scale production. This affects the operations of the business and it may result into increase in prices

- **Under developed infrastructure like roads limit the movement of the machines** and it may affect the development of the technique of production
- **Requires developed technology which still lacks.** In developing countries, technology is still intermediate which is still low and cannot produce the large quantities

10.2.2. Labour intensive technology.

Activity 10.5



Using the photos above, discuss the following questions.

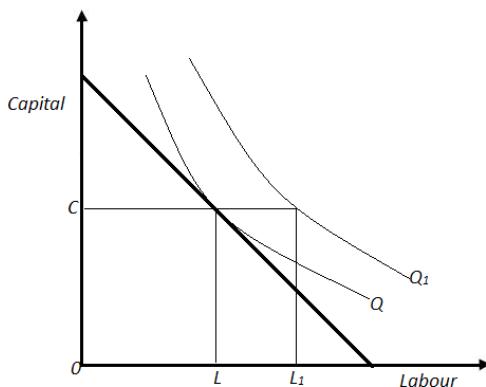
- a) Identify the form of activities in the photos above and the technique used in their production processes. Justify your answer.
- b) Identify different other activities that use such a technique in Rwanda.
- c) Examine the contribution of such a technique to the development process of Rwanda.
- d) What hinders its effective use in Rwanda?

10.2.2.1: Meaning of labour intensive technique

Labour intensive technique is that technique which uses comparatively larger amount of labour and small doses of capital. It is that technique by which more of labour and less of capital is required for the process of production. With this method of production, it is possible to raise output by using the same amount of capital but greater amount of labour. It is sometimes called **capital saving or one-pound technique**. The degree of labor intensity is typically measured in proportion to the amount of labour required to produce the goods/services; the higher the proportion of labor costs required, the more labor intensive the business.

Labour-intensive industries include restaurants, hotels, agriculture, and mining. Even with the use of certain tools under this technique, a person must be involved with the vast majority of the work. Many positions that are part of the service industry are also labor-intensive those within the hospitality industry and the personal care industry.

Figure: Labour intensive technique illustration.



- In the diagram above, isoquant Q shows the initial level of output which is being produced by using OL labour and OC amount of capital. With the adoption of new technology, a higher level of output is represented by the isoquant Q_1 ; can be produced by the same amount of capital i.e. **OC**. In this case, greater amount of labour is OL_1 . This shows that the technique is labour intensive.

10.2.2.2 Advantages of labour intensive technique.

- **Cheap and easily afforded** since it uses mostly labour as compared to the machines and labour is cheap.
- **Source of employment** to the people and hence reduces the unemployment problem in the country.
- **Helps in income distribution** since the number of the unemployed is low since the technique employs more labour.
- **Requires little/ limited skills.** The techniques may not need complicated skills compared to the capital-intensive technique
- **Reduces social costs such as pollution.** The technique does not involve extrusion of fumes on land, water and atmosphere hence it does not degrade the atmosphere.
- Increased employment **increases aggregate demand and investment**

- **Needed in agriculture where human judgment is paramount.** Some decisions in agriculture cannot be done by machines hence labour is the best option.
- Helps control **over exploitation of resources.** Production can be controlled when using labour through reducing on the areas that are being used. This helps to reduce exploitation.
- No need to **import expatriates** since the technique can be operated by the labour which is available

10.2.2.3. Disadvantages of labour intensive technique

- **Low productivity** compared to capital intensive technique. This is because the labour cannot do the work as quick as the machines
- **Costly in the long run** in terms of feeding, med-care among others and this increases the cost of production compared to when machines are used.
- **Produces low quality output** because of the low skills possessed by the workers
- **Underutilization of resources** is common since the labour cannot cover wide areas during the production process
- **It does not encourage technology development** because it uses more labour compared to machines. This further leads to under development.
- **Labour unrests and strikes** are common when using this method and this leads to production stopping for some time hence no output and earnings.
- **It is hard to standardize output using the technique.** Labour may not be able to produce good standard output because it may not have a standard measure.

10.2.2.4. Limitations of labour intensive technique

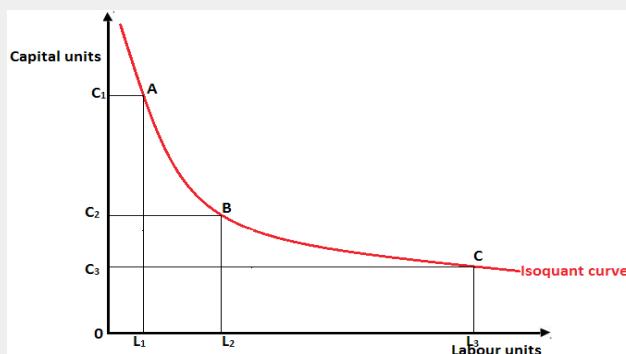
- **Inadequate labour due to rural urban migration** and younger and elder leaving industries with no option but capital-intensive techniques
- **Need to produce good quality output calls for capital intensive technique** so as to get output that can compete at the bigger stage in the market.
- Increase in demand calls for **increased supply which can only be done by capital intensive techniques**

- **Specialization requires more use of machines** since it requires use of expansive land or covers wide industrial areas.
- **Production where human judgment is not needed** can be easily done by machines compared to labour when the major aim is to maximize output
- **In the long run it may be costly** when the expenditures on medication, housing allowance among others set in.
- **Government policy of standardization** may not be put into consideration by labour intensive techniques but rather capital-intensive techniques.



Application activity 10.2

Study the graph below and answer the question that follow.



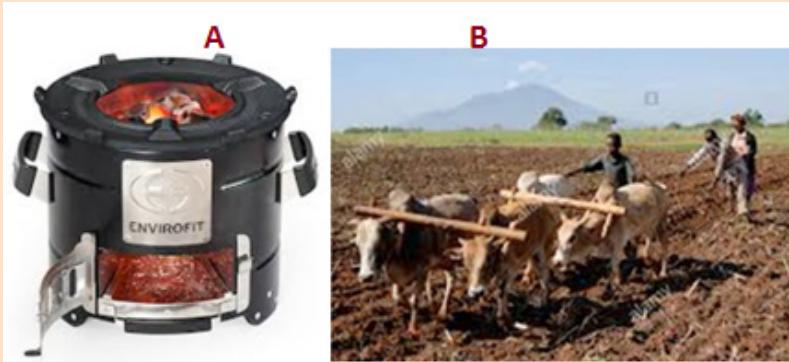
- a) What is an isoquant curve?
- b) What technique of production is portrayed at points A, B & C respectively?
Give supporting reasons for your answers.
- c) Which production technique would you recommend for your economy to apply and why?

10.2.3: Intermediate technology

Activity 10.6



Analyse the Photos below and answer the questions that follow.



- Which technique of production is cited in photos A and B above? Give a clear justification.
- Comparing the images in activity 10.4, 10.5 and these in 10.6, what marks the difference among the techniques used in production?
- What are the major distinguishing features of the technique mentioned in a) above?

a) Meaning of intermediate technology

Intermediate technology is the type of technology which is midway between the modern technology and the traditional-primitive technology. Intermediate technology involves, simple and practical tools, basic machines and engineering systems that economically disadvantaged farmers and other rural people can purchase or construct from resources that are available locally to improve their well-being. Designed to focus on people rather than machines, intermediate technology is considered to be more harmonious with the environment and with traditional ways of life. Intermediate technology requires a regional approach to development and requires four conditions for its success.

- Workplaces should be created in areas where the majority of the people live.
- Workplaces should be cheap so that they can be created in large numbers with little capital.
- Methods of production should be fairly simple, requiring low skills and suitable for maintenance and repair at the workplace.

iv. Production should depend basically on local materials for local use.

b) Features of intermediate technology

- The technology is fairly simple to use.
- The technology uses the local materials.
- It is cheap and affordable.
- It should be manageable by the majority of the people.
- It is user friendly meaning it may not affect the environment.
- It contains elements of both the traditional and modern technology.



Application activity 10.3

- a) Analyse the arguments for and against the use of intermediate technology in Rwanda.
- b) What do you think hinders its applicability in Rwanda?
- c) Describe how a country can attain intermediate technology.



End unit assessment

1. The development of Masoro area in Gasabo district has got many benefits to the people and economy at large. Examine the benefits talked about above.
2. Using more machines is more advantageous than using more workers. Discuss.
3. a) What is meant by appropriate technique of production?
b) Identify the features of appropriate technology.
c) Describe the advantages and limitations of the use of appropriate technology.
4. Rwanda, just like any other country, has always transferred technology from other countries to improve her productive capacity in the country. Analyse the impact of technological transfer in Rwanda.

UNIT 11

DEVELOPMENT STRATEGIES:

Key unit Competency:

Analyse the contribution of development strategies on the economy.



Introductory activity

Funding Public Investments

In general, there are three sources for funding and financing public investments:

i) Internal funding sources, ii) external funding support and iii) borrowing as financing source with the requirement to be paid back at least partly.

Internal funding sources entail domestic tax and non-tax revenues, which are used to fund the recurrent as well as the development budget.

External funding support refers to Budget and Project Support from Development Partners. According to the Rwanda Aid Policy from 2006, Budget Support is the transfer of resources from a Development Partner to the Rwandan budget. The same lines of authority and procedures that govern the normal Rwandan budget are applicable...

(Source: National Investment Policy. MINECOFIN April, 2017)

From the above extract,

- (i) Identify the three sources of funding public investments highlighted in the case study above.
- (ii) With relevant examples give the sectors you know where the government has invested extensively.
- (iii) Why do you think the government at times uses external support and borrowing to fund public investment?
- (iv) Between infrastructure and education, which sector in your own view should receive the biggest share of public investment? Justify your answer.

11.1: Education.

11.1.1. Meaning of education.

Activity 11.1



- Analyse the activity taking place in each of the two pictures above.
And identify the difference if any.
- Which one are you familiar with?

Education refers to the process of acquiring worthwhile knowledge, skills and values that aid an individual to engage in development activities of his/her country. The knowledge may be technical know-how of something, facts of an event, among others while the skills may be reading, drawing, speaking among others and finally the values may be love for the environment, socialization among others

Education is both formal and informal;

Formal education; This is a set of worthwhile knowledge, skills and values obtained from organized institutions, monitored by qualified personnel and following a well-made curriculum. These institutions from which it is acquired may be schools, universities and other training institutions.

Informal education is a set of worthwhile knowledge, skills and values obtained from outside the formal set up i.e it can be got from anywhere or anyone and any time. There is no organized curriculum to be followed.

11.1.2: Role of education to development.

Activity 11.2.



In order to realize the aim articulated in 1.6 (Rwanda Education policy 2003, General objective), the following general objectives shall be defined in education:

- To educate a free citizen who is liberated from all kinds of discrimination, including gender-based discrimination, exclusion and favouritism;
- To contribute to the promotion of a culture of peace and to emphasize Rwandese and universal values of justice, peace, tolerance, respect for human rights, gender equality, solidarity and democracy;
- To dispense a holistic moral, intellectual, social, physical and professional education through the promotion of individual competencies and aptitudes in the service of national reconstruction and the sustainable development of the country;
- To promote science and technology with special attention to ICT;
- To develop in the Rwandese citizen an autonomy of thought, patriotic spirit, a sense of civic pride, a love of work well done and global awareness;
- To transform the Rwandese population into human capital for development through acquisition of development skills.
- To eliminate all the causes and obstacles which can lead to disparity in education be it by gender, disability, geographical or social group.
- (Source: Education policy. 2003)
- Basing on the above objectives of the education policy in Rwanda (2003), discuss the role of education in facilitating economic growth in the country.

Education, in every sense, is one of the fundamental factors of economic development. No country can achieve sustainable economic development without substantial investment in human capital. Education enriches people's understanding of themselves and world. It improves the quality of their lives and leads to broad social benefits to individuals and society. Education raises people's productivity and creativity and promotes entrepreneurship and technological advances. In addition, it plays a very crucial role in securing

economic and social progress and improving income distribution. Economists therefore, accept that investment in education, or human capital, is an important element in the economic development process as below.

- Increases technological knowledge of labour and this can help in skill development necessary for development
- Encourages innovation and invention which may lead to development of technology in the country
- Encourages people to acquire good standard of living. This is because the people get exposed to different ways of life
- Breaks cultural rigidities since people have knowledge about the outside world hence they can implement what they study about the outside world.
- Saves foreign exchange spent on expatriates since the country is able to produce its own citizens that can do the work of the expatriates.
- It helps to reduce the rate of population growth. The educated tend to like smaller families because they understand the dangers related to bigger families.. They also understand well the use of population control methods.
- Reduces the subsistence sector since the educated will be in search for money therefore they will engage in commercialized agriculture.
- Widens the tax base since it provides employment to the people after studying and still in the education sector employment opportunities are created.
- May lead to reduction in the population growth rate since the educated knowledge about the control measures and the dangers of population explosion

However, on the other side, if no well-set education policies are put in place, education may hamper development in the following ways.

- May cause balance of payment problem because the educated tend to copy and buy expensive things from abroad (high rates of demonstration)
- Causes unemployment especially when theoretical and creates job seekers than creators.
- Causes rural urban migration as the educated seek better opportunities in the urban centers leading to open urban unemployment
- Social discrimination among the educated and the uneducated as the educated see themselves as superior
- Accelerates income inequality since the educated will acquire better paying jobs than the uneducated

- May lead to brain drain in search for employment opportunities abroad after failing to get employment home.

11.1.3: Problems faced by education sector in developing countries

Activity 11.3



Key challenges in the sector

Despite considerable progress made in the education sector over the last five years, some key challenges remain. These are priorities that need to be addressed in this ESSP. The 2017 Education Sector Analysis (MINEDUC, forthcoming) outlines five key challenges, including the following:

Challenge 1: Insufficient teacher competencies in subject content, pedagogy and languages of instruction (English and Kinyarwanda) threaten to jeopardise curriculum delivery and inclusion, and ultimately negatively impact on student learning outcomes.

(Source: EDUCATION SECTOR STRATEGIC PLAN 2018/19 TO 2023/24 Page 24)

Analyse the case study in the extract above and

- a) Identify the challenges in the education sector mentioned therein.
- b) In reference to the above what do you think are the other challenges facing the education sector in Rwanda?

Education at a global level is one of the challenges that countries have prioritized for this century. It is a complex and laborious task that involves sustainable policies and to some extent agreements with various nations aimed tackling the difficulties and inefficiencies in developing countries' education sector. In many developing countries, there are several challenges to this sector. Some of which include the following.

-Lack of expertise: An increasingly technological world requires an effort in terms of specialisation and professional training. However, there are limited skilled and specialized personnel at all levels in the education sector in most developing countries. Most qualified instructors move to other sectors and even abroad where they can have better remuneration.

-**Limited motivation** to teachers has led to limited teaching staff: A lack of economic resources goes hand in hand with a lack of a greater number of teachers in most developing countries. Currently, there is a wave of teacher migration, ending up emigrating and together with the lack of educational resources for the training of new professionals, most developing countries have been deprived of the would-be potential teachers. Those who try to persevere, end up bringing up half-baked products since they are under paid thus their morale down.

-**Non-compulsory education:** Many countries do not value the obligation of school attendances within their laws. Parents are not obliged to educate their children and therefore the children may not be registered at school or only attend classes on the days they wish. This leads to absenteeism and poor quality education output.

-There are **limited teaching/learning materials**, most of the subjects are theoretically taught, and this keeps the education sector backward.

-The education curriculum in developing countries is **still colonial based**. Most of the subjects taught and their content is no longer relevant, they train learners for white collar jobs, they make more job seekers than job makers so accounting for the rampant unemployment in the country.

-**Inequality:** The world's illiterate population consists of 780 million people. Two thirds of these are women. The need for the inclusion of girls, right from primary school to university education, is essential to achieve the goal of universal education, but unfortunately, male prejudice is still something that is present which makes education difficult to attain for many women. Some parents prefer to educate boys compared to girls and this has accelerated gender inequality and income inequality among the males and females.

-**Inefficient and ineffective school networks like use of digital education** and better schools to take on more students hampers education in developing countries. Digital education as a technological aid, helps teachers and students by making an infinite stream of knowledge available, which can be renewed and updated without increased costs in school materials. However, this is lacking in most developing countries, making children who attend school, to leave the education system without gaining basic reading and mathematics skills.

-**High school dropout rate:** Many children leave school before completing their education due to family pressures like to look after the home while parents are working, taking care of younger siblings or being sent directly to work or marry before they are legally of age in order to contribute financially to the family, hence leading to many drop outs. This deprives the economy of a big number of future skilled labour force and entrepreneurs.

-The economic crisis that has been felt in most developing countries has resulted into reduced **education budgets**, leading to inadequate funds for the education sector. This leaves some areas and schools in the rural areas with lack of equipment to use hence hindering the development.

-Rampant poverty in developing countries: Education in most developing countries is expensive, thus making it costly. Due to poverty, many parents in developing countries are unable to send their children to school or even buy for them scholastic materials. Many countries in developing economies uphold mandatory payment rates for all students, regardless of family income. This means that many children stop attending school because their parents cannot afford these payments.

11.1.4: Measures of promoting education.

Activity 11.4.



The ESSP identifies a total of 17 sector outcomes under nine strategic priorities, with targets that are both ambitious but feasible. Actions to achieve these outcomes are further elaborated in this chapter. New areas under this ESSP include STEM, ICT, innovation, research and development, all of which are key national priorities. In addition, the competency-based curriculum includes entrepreneurship and business development, citizenship and national identity, with an emphasis on critical thinking, creativity and innovation, research, problem-solving and lifelong learning. There is also a strong focus on improving quality through both, regular assessment of learners and teacher continuous professional development (CPD).

(Source: EDUCATION SECTOR STRATEGIC PLAN 2018/19 TO 2023/24 Page 24)

Basing on the above case study, discuss and identify the policy measures that can be adopted to solve the challenges faced in the education sector in Rwanda.

Education is a fundamental human right and an essential tool to ensure that all Rwandese citizens; women and men, girls and boys realize their full potential. The development of human resources is one of the principal factors in achieving sustainable economic and social development. Education and training have been considered as a critical fulcrum to achieve development and poverty reduction in Rwanda. Even if Rwanda has made significant progresses in terms

of access to education, there is a need to improve the quality of education. Here are some of the ways Rwanda has put in place to improve her education sector:

- **A New Educational Model:** Investing in test scores and achievement is no longer a useful way to focus on education, therefore, a new educational model combining traditional content with important financial, health and administrative skills has been put in place through curriculum revision from knowledge based to competence-based curriculum (from KBC to CBC). Students are now made to practice teamwork, leadership and critical thinking. They also gain exposure to entrepreneurship projects such as identifying and exploiting market opportunities through business ideas such as community recycling. This shift away from standardized learning is preparing Rwandan students to make a positive impact on the social and economic wellbeing of their communities.
- **Improved Resources for Teachers:** Computer-assisted learning is inevitably improving education in Rwanda and has enhanced the educational experience of both teachers and students. The computers that have age-appropriate learning software and a technically educated staff that knows how to maintain them has been implemented in most schools in Rwanda. These methods to improve education in Rwanda, will continue to encourage student enrollment, and most importantly, will ensure that children stay in school and learn more while they are there.
- The Ministry of Education (MINEDUC) has been active in promoting the **use of ICT in schools** and coordinating the One Laptop per Child project in the country. ICT education is extending from tertiary institutions to all primary and secondary schools.
- **Promoted vocational education** so as to produce students that have practical skills and can start their own businesses instead of waiting for employment.
- **There are regular inspections of all learning institutions** to assess the quality of education, infrastructures, human resources, student recruitment and curriculum. Education being a shared responsibility between parents, teachers and policymakers, Rwanda saw it necessary to keep evaluating the progress in education by taking stock of what has worked, what has not worked and the gaps so as to improve the quality of education.
- **Increased teacher remuneration and motivation** so as to increase their performance and achievement. For example, the recently announced 10 percent salary increment for teachers in state schools and government subsidized schools is expected to create a solid foundation for retaining and attracting the former and new teachers respectively. This will Increase

the motivation of the teachers so that they can carry out their activities genuinely and professionally.

- **Provided parents with information on the value of education:** This is aimed at increasing and maintaining school enrollment. Most adults in Rwanda are illiterate and do not have the awareness necessary to improve both their living conditions and those of their children. Responsible leaders at local levels in all parts of the country have been tasked to educate parents about the value of educating their children and to make them aware that a parent's investment in education is crucial for the success of their children.
- **Reduced the cost of Education through cost sharing:** Rwanda has abolished school fees in primary schools, while in secondary schools through the 9- and 12-years basic education the government has undertaken paying part of the students' tuition and the students pay a smaller part and applied cost sharing especially in high institutions of learning. The move has triggered a large increase enrollment especially in primary level and thus has reduced the rate of school dropouts.
- **Policies for girl child** have been embarked on through reducing their entry points at the higher institutions of learning and also when recruiting for secondary schools. Organizations such as Imbuto Foundation in Rwanda has had a major role in girl child education.
- **Encouraged active participation of the private sector in the education system** through taking up government educational programs as well as setting up new schools at affordable fees structures.
- **Educational loans to help the students at higher levels.** This is common in Rwanda under the government fees/ tuition structure where the students in the higher institutions are given educational loans and they pay back in installments on completion of the studies when they get jobs.
- **Expanded access to pre-school**, including better nutrition to reduce malnutrition among young children through tightening school and district-level management of the early grade.
- **Capped class size** at no more than 50 students per class by hiring new staff, and expanding affordable, proven models of early grade instruction.
- **Location of the schools close to rural habitations**, pro-poor conditional cash transfers and related publicity campaigns on the benefits of schooling.
- **Strengthened professionalism of teachers to improve outcomes.** Recently, it has been proposed that low-performing teachers should have options for improvement and exit for those falling short of minimum

professional standards. There is recent move by the government to only recruit education professionals because, with teachers being a major factor in quality of education and progression of students, the task of educating Rwandan children should be entrusted to highly trained, well skilled and passionate people right from nursery to higher institutions of learning. Therefore, serving educators need to be subjected to structured guides and competency-based training options, along with career progression pathways through CPD courses like the recently graduated primary and secondary headteachers, deputy head teachers, teachers and TTC tutors.

- **Government implemented a school feeding programme** that is partially subsidized but involves a compulsory cost-share with parents.



Application activity 11.1

From your knowledge of the education sector in your district and the problems facing it, write a proposal to the District Director of Education (DDE) suggesting practical ways of improving education in your district.

11.2. Foreign aid and economic development

Activity 11.5.



- (i) Identify the organisations highlighted in the pictures above.
- (ii) What do you know about them?
- (iii) Apart from the above organisations, what other organisations and countries have come in to help Rwanda's development drive?
- (iv) In which ways have these and other organisations helped developing economies to grow.

11.2.1: Meaning and forms of foreign development.

11.2.1.1: Meaning of foreign aid.

Foreign Aid is the international transfer of resources either on loan or grant from one country to another. Or it can be defined as any form of assistance given by one country to another so as to achieve its intended objective. It can either be economic, technical, and military among others.

11.2.1.2: Forms of foreign aid.

- **Capital** which may include money and machines.
- **Consumer goods** like clothes, food among others that are needed in times of disaster.
- **Military aid** i.e. military hardware.
- **Education facilities** like text books and scholarships.
- **Grants**, these are resource transfers that do not require any repayment.
- **Loans.** These are resource transfers that must be paid back with or without interest. There are two types of loans.
 - a. **Soft loans.** These are given with a long grace period, long repayment period and a very low or no interest at all.
 - b. **Hard loan.** This type of a loan attracts a high interest rate, a very short or no grace period and a very short repayment period.
- **Direct foreign investment.** These are resource transfers by foreign business people in form of business companies or investments.
- **Man power aid.** These are resource transfers to developing countries in form of high-level qualified personnel like teachers, economists, technicians, doctors, researchers etc.
- **Medical aid.** This is extended to developing countries in form of drugs, medical research, and construction of health centers to improve upon the health of people.
- **Tied aid.** This is extended to the recipient country with strings attached. It is sent to serve a specified purpose and sometimes in a specified place.
- **Multilateral aid.** This is aid from multilateral companies and international agencies. Major multilateral donors are; USAID, UN, I.M.F, world bank among others
- **Bilateral aid.** This is a government to government aid. One country giving aid to the other, major bilateral donors are; Great Britain, U.S.A, China.

11.2.2: Need for foreign aid.

Activity 11.6.



The Fifth
Integrated Household Living Conditions Survey
EICV5
2016/17

Rwanda Poverty Profile Report

November 2018

NISR
NATIONAL INSTITUTE OF
STATISTICS OF RWANDA

UNDP
RWANDA
United Nations Development Programme

EU

UKAid
from the British people

WORLD BANK

The picture above shows the 2nd page of the Rwanda poverty profile report 2016/17.

- (i) Identify the organisations that were involved in making the survey.
- (ii) Which of the organisations identified in (i) above do not belong to the Government of Rwanda?
- (iii) Why do you think Rwanda seeks assistance from such organisations/ countries?

Countries, especially with developing economies, need foreign aid due to the following reasons.

- **To close the domestic savings-investment gap** due to lower savings relative to desired investment.
- **To reduce the tax burden on their citizens**, this keeps them with enough disposable income, increase their purchasing power hence improved living standards in the economy generally.
- **To increase domestic productivity** through growth of skills and provision of high wages.
- **To accelerate industrial growth** by providing both initial and running capital
- **To close the forex gap** due to low export base.

- **To facilitate development and expansion of domestic infrastructure**
e.g. transport and communication facilities, power projects etc.
- **To fund the budget deficits** e.g. seeking for soft loans and grants to supplement domestic revenue. This increases a country's resources and helps in meeting its deficits especially in the national budget.
- **To relieve the country of effects of disasters** by seeking for relief materials for the people displaced or affected by such disasters / calamities like famine, landslides earth quakes and floods which normally leave nations in a helpless state. Thus, countries seek foreign aid to help regain their stand.
- **To close the skilled manpower gap** because of the low education and training through aid in form of technical assistance. The skilled manpower that is inadequate in developing countries alongside its need is covered by the manpower aid from developed nations.
- **To close the technology gap** in developing countries through technological transfer; aid in form of machines and other equipment to developing countries improves upon quality of output and production methods so developing countries.
- **To provide employment opportunities to people in developing countries.** If aid is directly invested, it employs people of developing countries and indirectly to people who supply to the investments put up.
- **To close the foreign exchange gap in developing countries.** Financial aid extended to developing countries in form of foreign currencies increases foreign exchange reserves in developing countries hence developing their economies.
- **To increase availability of commodities to the citizens of their country.** E.g. aid in form of consumer and capital goods.
- **To strengthen international relations** since foreign aid may help keep good political ties with others.

11.2.3: Problems of relying on foreign aid.

Activity 11.7.



From your own thinking, what are the dangers resulting from depending on foreign resources by any given country for its development progress?

- **It worsens the debt servicing problem;** loans contracted must be paid back and on several occasions with interest, this drains the national resources and denies nationals essentials.
- **There is high balance of payment deficit.** The high out flow of resources to pay back loans and service them worsens the balance of payment position of the country.
- **Sometimes the technological aid given is inappropriate,** it may be too under developed or beyond the standards of developing countries, so it may just be wasted.
- **Sometimes the pre-conditions set for foreign aid are disastrous for the country.** Countries may be forced to devalue their currency, retrench workers or even accept anti-social inhuman acts like homosexuality in order to receive their aid.
- **Tied foreign aid is sometimes tied to unproductive projects** like digging boreholes in rural areas, financing wars. This brings difficulty in paying back since such projects do not bring monetary returns.
- **The political strings tied to the aid sent ruins the country its independence.** Sometimes nations are forced to vote democratically which they are not ready for or even change leaders.
- **Foreign aid slows down initiative and hard work.** Citizens of developing countries become lazy expecting to live on aid.
- **Foreign aid erodes the social and cultural values of nationals.** They tend to adopt the cultures of the donor whom they normally take as their role model.
- **Foreign aid distorts planning of developing countries.** This is because it normally comes in bits and normally it's not completed or even sent as promised.
- **Foreign aid reduces local production** as people expect to live on foreign sent goods. This retard economic growth of nations.



Application activity 11.2

From your knowledge on foreign aid,

- c) Why do you think countries give out aid to others?
- d) What do you think developing countries can do to reduce the level of dependence on foreign aid?

11.3: Infrastructure and economic development.

Activity 11.8.



Study the pictures A - J above and;

- Identify what each of them shows.
- What general economic term is given to the above pictures collectively?
- Discuss how they facilitate the growth of Rwanda's economy.

11.3.1: Meaning of Infrastructure.

Infrastructure can broadly be defined as long-term physical and structural elements/assets of the economy that facilitate the provision of goods and services that are geared towards development of the country.

Social Infrastructure is a subset of the infrastructure sector that includes assets that accommodate social services and improve the welfare of the population. It can also be defined as a combination of basic facilities which are necessary for human development. Examples of social infrastructure assets include schools, universities, hospitals, prisons and community housing.

Economic infrastructure on the other hand refer to internal facilities of a country that make business activity possible, such as communication, transportation, and distribution networks, financial institutions and markets, and

energy supply. It can also be defined as a combination of basic facilities which is helpful in economic development of an economy and businesses.

It can be seen that social infrastructure is very important because it lays ground for the economic infrastructure. Both of these infrastructures are complementary to each other and are necessary for the overall development of an economy.

The examples of infrastructure in different sectors can be seen in the table below.

Sector	Examples
Health	- Medical facilities - Ancillary infrastructure eg offices, car parks, training facilities
Education	- Schools ie primary and secondary - Tertiary facilities - Residential student accommodation
Housing	- State or council housing - Defense force housing
Civil and utilities	- Community and sport facilities - Local government facilities - Water and waste water treatment plants
Transport	- Bus stations - Parks and rides. - Roads , airports etc
Corrections and justice	- Prisons

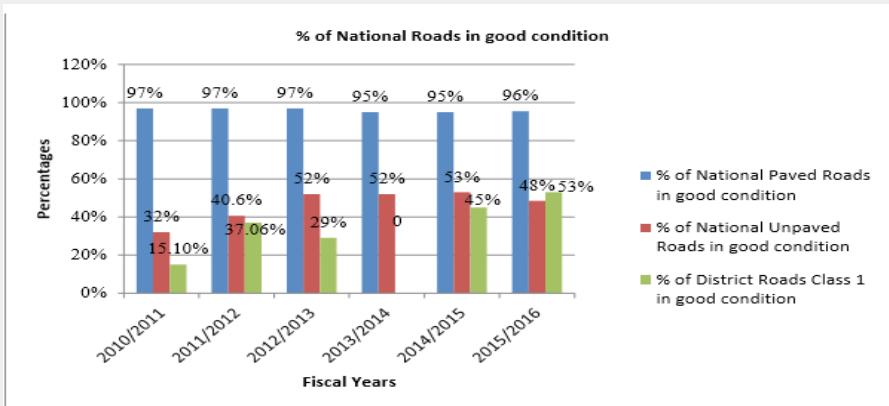
11.3.2: Role of infrastructure in economic development

Infrastructure development has played a very significantly positive role in the growth performance of countries in recent times. Where development of economic infrastructures has followed a rational, well - coordinated and harmonized path, infrastructure has received the following big boost:

- It provides services that are part of the **consumption bundle** of residents.
- Roads and other transport infrastructures **facilitate production** by easing the movement of inputs from their sources to the firms and output from the firms to the market.
- Large - scale expenditures for public works **increase aggregate demand** and provide short- run stimulus to the economy
- **It serves as an input into private sector production**, thus augmenting output and productivity
- Education is a very important **source of economic growth** as the Denison study shows. Even though education may be a social investment, it is also an economic investment since it enhances the stock of human capital.
- Health, like education, is a very important argument in the socio- economic production function. A popular saying is that 'a sound mind usually resides in a healthy body'. Health is one of the major determinants of **labour productivity and efficiency**.
- Investment in infrastructure is often considered as one of the **most effective tools for fighting poverty**.
- Access to infrastructure is essential for **improving economic opportunities and decreasing inequality**. For example, adequate transportation networks in developing countries could give the poor better access to schools, hospitals, and centers of commerce, which in turn would improve the education, health, and entrepreneurial opportunities that strengthen a country's economic potential.
- Housing enables people to have **a peace mind and thus also improves their standards of living and livelihoods**.
- **Sport facilities are used for co-curricular activities** that enable to have a disease free body. A healthy body is a health mind as the saying goes, these facilities improve on the life expectancy of the people
- **Prisons as part of correction centers and the justice** help to educate and bring right the people who may have created offences. They also educate the prisoners and they come out changed
- Bus stations, car parks, rides and communication centers help to **connect people through transit**. They aid in communication and linking of the people to other areas



Application activity 11.3



Chronological Evolution of the Roads in Good Condition (Source: RTDA, 2017)

In your own view, why do you think the government has put a lot of effort in maintaining a high standard of road infrastructure in the country?



End unit assessment

- 1.a) Describe why education is regarded as:
 - v) An investment
 - vi) A consumer good.
- b) How has education solved the problem of underdevelopment in Rwanda?
2. Explain why countries find it beneficial to give assistance to other?
3. "Without infrastructure in a country like Rwanda, there is no development" support the above statement.

UNIT 12

ECONOMIC PLANNING

Unit competency:

Analyze the need for economic planning in an economy.



Introductory activity

Introductory activity.

Case study

Two provinces Kigali and Eastern, carried out their planning following the national plan by the central government. The source of the funds would be from the central government and foreign aid. Kigali planned to develop all sectors i.e. education, agriculture, industry and infrastructure but this was to be achieved in the long run. Eastern province planned to develop agriculture and infrastructure first then others would come later and this was to be achieved in the short run. There were various reasons why these plans were carried out. During the process, there were many problems faced when implementing the plans. Kigali city failed to accomplish some projects within the stated time while eastern province left some sectors completely under developed. This led to the need to revise the plans prepared by the two provinces

Basing on the case study above, discuss the following questions:

- a) Explain the meaning of the term planning
- b) What are the characteristics of a good plan?
- c) What conditions should be present for the above provinces' plans to be successful
- d) Discuss the factors that hinder the success of economic plan.

12.1. Economic planning

Activity 12.1



1. Identify different objectives of economic planning and development planning
2. In your own view, why do countries plan?

12.1.1. Meaning of economic planning

Economic planning refers to government attempt to direct, influence and control economic activities and resource allocation to achieve economic objectives such as:

- Increasing the level of employment opportunities
- Increasing production
- Increasing investments

Development planning refers to government attempt to influence and direct activities and choices to achieve economic, social and political objectives such as

- Reducing poverty levels
- Reducing income inequalities
- Maintaining sustainable growth
- Ensuring good and stable governance

There is a simple distinction between development planning and economic development planning. The former aims at attainment of desired political, social, and economic targets while the latter aims at attainment of only economic objectives.

12.1.2. Rationale for planning.

1. **For optimum allocation of resources in the economy** so as to eliminate imbalances in resource allocation.
2. Helps the economy in **mobilizing funds from international organizations** like IMF, World bank etc since they give funds according to the plans made.
3. Helps to **remove price instabilities** and attain a favorable balance of payment equilibrium

- 4. To eradicate the defects of price mechanism;** the automatic forces of demand and supply sometimes show weaknesses in efficiently allocating resources in an economy; these weaknesses are ironed out by development planning.
- 5. Plans are needed to bring up a balance between the private and the public sector,** plans show the relative importance of each sector and so appropriate measures are taken to support the more desired sector.
- 6. To attain a higher level of economic growth and development,** plans are made to set up the required infrastructure to attain and increase the rate of economic growth and development.
- 7. Plans are a pre-requisite for getting foreign assistance.** Developing countries persistently draw deficit budgets, the deficit is to be obtained from donors, and these require well-made plans to release resources.
- 8. To reduce dependence on other nations,** plans are drawn to for developing countries to move away from dependence to self-sustenance.
- 9. To fight hyper rated of inflation;** developing nations draw plans to devise means to moderate the rate inflation and attain economic stability.
- 10. To eradicate the unemployment problem** this is so rampant in developing countries.



Application activity 12.1.

Explain the importance of economic planning towards a country's development.

12.2: Principles of planning and qualities of a good economic plan

12.2.1. Principles of planning.

Activity 12.2



Explain the principles behind any successful economic development plan.

The planning mechanism must adhere to certain principles in order to be successful among these include the following:

1. **Consistence.** A good plan must be consistent and avoid any contradictions in the economy. The techniques and the objectives to be achieved must be followed.
2. **Proportionality.** A good plan must be proportional whereby it must be on regional level than concentrating on a small area.
3. **Compatibility.** A good plan should be able to use the available raw materials. Planners should base on the available resources.
4. **Sequencing.** This principle involves putting in place minor projects to facilitate the major ones.
5. **Relevance.** A good plan should be in line to achieve the intended goals and objectives because this makes it socially important.
6. **Feasibility.** A good plan should be politically and administratively achievable so as to make its implementation easy.
7. **Optimality.** Planners should take into account the resources available and plan to exploit them in the most efficient way.
8. **Comprehensiveness.** A good plan should cover the whole economy because of the linkages among the sectors. This is because a partial plan may bring about imbalances in economy that may retard development.

12.2.2: Qualities of a good development plan

A good plan is characterized by the following:

1. It should be as **comprehensive** as possible. It should cover practically all the sectors of the economy. It should cover both the rural and urban areas.
2. It should combine **top-down and bottom-up planning approaches** through an intensive dialogue between the national, regional and local development agencies between the various levels of planning — national, regional, district and lower local governments.
3. A development plan should be **socially relevant**, and it must involve the people in a development effort.
4. A development plan must be **economically feasible**. The resources to implement the plan must be available.
5. A development plan must be **politically and administratively possible**. It must be accepted by political leaders otherwise it might never be implemented.



Application activity 12.2.

Discuss the qualities of a good economic development plan in your country.

12.3: Classification of plans

Activity: 12.3.



Make research and answer the following

1. Explain briefly the following categories of plans.
 - (a) Medium term plan
 - (b) Decentralised plan
 - (c) Comprehensive plan
 - (d) Indicative planning.
2. Match the following with their correspondences
 - (a). Capitalist plan for individual sectors like agriculture, industry
 - (b). Medium term plan integrates all activities within the region.
 - (c). Sectoral plan are made in favour of private investors
 - (d) Regional plan cover between 3-10 years
- 3.....is the type of plan prepared and implemented by the central government after consulting various organs
- 4..... is a plan prepared by the government and it provides information to the private sector without influencing their decisions directly.

12.3.1 Classification of plans according to time element:

(a) Short term planning

This is when plans are made to cover a short period of time between 1-3 years.

(b) Medium term planning

This is when plans are made to cover a period of about 5-7years.

(b) Long term planning (perspective planning).

This is when plans are made to cover a long period of time beyond 10 years and can even be over tens of years

12.3.2 Classification of according to coverage.

(a) Comprehensive planning (macroeconomic planning)

This is when plans are made to cover **all sectors** of the economy like Agricultural sector, Industrial sector, Service sector, Public sector, Private sector etc

Merits of comprehensive planning

1. Allows economic growth to move hand in hand with economic development since plans are for the development of the economy as a whole.
2. Caters for the problems that may be going on in the economy at a particular period of time such as unemployment, poverty, and inflation among others.
3. Leads to full utilization of resources because the government plans for all sectors.
4. Increases government revenue because when all sectors are planned for the government revenue increase through taxes.
5. Reduces balance of payment problems because when all sectors are planned for, exports may increase and imports will reduce.
6. Reduces regional inequality when all sectors are planned for; they all develop at the same level.
7. Encourages economic growth to move hand in hand with economic development when all sectors are developed. i.e. there is improvement in people's standards of living.
8. Encourages inter dependence between different sectors when they are all planned for and developed which later increases the rate of economic growth.

Demerits of comprehensive planning

1. They are expensive to administer and monitor; it requires adequate amount of funds to scatter in all sectors being developed at the same time which funds are not readily available in developing countries.
2. Developing countries have a limited supply of the skilled personnel that can be everywhere at the same time to monitor the different sectors growing at the same time.
3. Comprehensive plans give rise to inflation in short run. This is because much money is set into circulation at the same time to see a comprehensive plan succeed.
4. Comprehensive planning may bring distortions in the major national objectives since a single plan covering the whole country may be hard to implement.
5. It is hard to give rise to a single plan that answers the needs of different groups and regions of people at different development levels. This makes comprehensive planning hard.

(b) Partial planning/fragmentary plan/micro plan:

These are plans drawn to cover only part of the economy. It may be only a region or may be drawn just for a sector.

Advantages of partial planning

1. Cheap and easy to administer because it economizes the use of skilled man power which is a problem in LDCs.
2. Allows planners to concentrate on a few vital sectors which they can develop successfully and achieve economic growth.
3. Develops skills of planners which they can use to take more comprehensive plans.
4. Cheap to manage, it doesn't require a lot of capital. Therefore, it is easy to manage and implement because it is in the financial reach of the country.
5. Requires less data which can be got easily since it covers a small sector.
6. Suitable because of wide difference in the level of development between regions.**7.** Helps in development of the leading sectors first and then other sectors follow because it covers only few or one sector and in case of Political instabilities in some countries make it a good idea to develop some areas first and others follow later.

Disadvantages of partial planning

1. Leads to wastage of resources because of many un coordinated plan
2. Leads to unbalanced development in the economy when the government plans only one or few sectors.
3. Leads to underutilization of resources when the government plans to develop few or one sector since some area are not planned and catered for.
4. Leads to unemployment when only one or few sectors are developed which inturn reduces people's standards of living.
5. Leads to balance of payment problems because if only one or few sectors are developed export will be less and more will be imported.
6. Causes inflation because when the government plans to develop one or few sectors this leads to low production output.
7. Leads to wastage of resources because the government may use a lot of resources to plan for only few sectors yet the same resources can be used for many other sectors.

12.3.3 Classification according to hierarchy of planning

1. **Project plan.** This is a plan designed to guide the control and execution of a given project in a particular sector.
2. **Sectoral plan.** This is when plans are made to cover **one sector** of the economy e.g if plans are made to cover the agricultural sector alone. An example can be **Plan for Modernization of Agriculture - PMA**
3. **National economic plan.** This is a plan for the whole nation which has to be consistent with the national resources.
4. **Regional plan.** This is a plan which integrates all activities, programs and projects within the region aimed at attaining national objectives.

12.3.4. Classification according to system of implementation..

(a) Indicative planning

This is where the government indirectly influences economic activities and choices through a set of fiscal and monetary policies. Its used in market economies.

It can also be defined as a situation where the government prepares a plan and provides information to the private sector (communities) to implement it without influencing their decisions directly.

(b) Imperative plan.

This is a plan prepared and implemented by the central authority in consultation with various organs, offices and agencies.

12.3.5. Classification according to economic systems.

(a) Decentralised planning (Bottom-to-Top)

This is when plans are made from the lower level administrative units ie from grassroots following national objectives e.g each district makes its own development plan depending on its resources and requirements.

Merits of Decentralized planning

- **It favours local priorities and interests.** Each regional has its own resources, requirements and priorities. Thus plans will be made according to each region's individual requirements.
- **It takes care of and utilizes local resources.** This make it consistent with each region's resources.
- **It encourages people participation.** The lower level administrative units are involved in plan formulation. This creates a sense of ownership and makes implementation easier.
- **It gives the local people a chance to manage their destiny** using local resources.
- **It is suitable where the country is geographically so large.**
- **It is cheap, quick and direct to addressing people's needs.** This is because people are involved in addressing their problems using their resources.
- **It reduces the responsibility of the central government.** This gives it ample time and resources to attend to other crucial services.

Demerits of Decentralized planning

- **Lack of planning skills at local levels.** Most regions may not have the necessary skills required to design good economic plans.
- It may lead to **duplication of services** and activities in different areas
- Local objectives may **diverge from national objectives**
- **Uneven distribution of resources** in different areas may lead to imbalances

- The **central government may relax** knowing local areas cater for themselves
- It puts **more pressure** on local governments

(b) **Centralized planning (Top-to-Bottom).**

This is when plans are made at the national level and the lower level administrative units implement.

Advantages of centralized planning

1. **Leads to balanced regional development** because when the government plans all regions are considered.
2. **Helps to solve the problems of inflation** because when the government plans for all sectors; the levels of production increase which reduces inflation levels.
3. **The plans drawn are for high-level development of the nation.**
So it collects all the skilled labour in the nation for its formulation and implementation.
4. **They are always consistent with national development objectives.**
They are consciously drawn and cannot divert from national set targets.
5. They are flexible; they can be changes according to variations in national goals.

Disadvantages of centralized planning

1. The interests of some areas **may not be considered when the government plans** for the economy at once.
2. **Leads urbanization plus its negative effects** because in most government plans more emphasis is put on urban areas and then neglect rural areas.
3. **Expensive in terms of data collection and also implementation** because for the government to plan for all sectors require a lot of capital which is always lacking in most LDCs
4. **Discourages self-initiatives** i.e. people may ignore the plan since they know that all responsibilities are in hands of the government.
5. A wide distance between the planning body and the source of finances makes centralized planning hard.
6. Developing countries have **a limited supply of skilled personnel** needed to implement such plans.



Application 12.3

Explain the reasons as why the government may prefer partial planning to compressive planning in an economy.

12.4 Obstacles faced in formulation and implementation of development plans

Activity 12.4



Explain the reasons as why many economic development plans in developing countries have not achieved their major objectives.

1. **Over ambitious plans.** Most of the plans try to achieve many objectives at once and in the end they fail to accomplish them.
2. **Insufficient and unreliable data.** Data in some countries is difficult to get and sometimes unreliable and this makes planning difficult.
3. **Unexpected social and economic disturbances.** These may be internal such as agricultural hazards like pests or external instabilities all making the planning and implementation difficult.
4. **Institutional weaknesses.** The planning machinery may be separated from day to day decision making, inadequate communication about the goals and objectives may hinder implementation.
5. **Lack of political will.** Most people lack commitment and a sense of nationalism which hinders the national planning system of the country.
6. **Inadequate resources.** Plans always remain on paper because of failure to mobilize resources both from within and outside.
7. **Inadequate qualified man power.** Most developing countries lack qualified man power and most of their plans are made by outsiders who know little about the economic situations in these countries.
8. **Political instabilities and constant change of governments.** These affect the already made plans because each new government has got its own plan for development. Still the funds which would be for plan implementation are directed towards buying military hard ware.

9. Poor sequencing. In LDCs there is lack of funds to put up micro/ small projects which can lead to bigger plans. This leads to failure of the bigger plans.

10. Corruption and embezzlement. Most plans have failed because of high levels of corruption in which most of the funds are directed to peoples' selfish interest.



Application activity 12. 4

Discuss the importance of economic development planning in an economy.

Skills Lab



Come up with individual development plan for the next three coming years as you are finalizing with this level of education. Come up with principles that are supposed to guide your plan, suggest the possible challenges that you are likely to encounter during the implementation of your plan, and then also suggest the possible measures of how such challenges can be addressed in order to achieve your personal development plan objectives. Then keep it safely for implementations and future reference.



End unit assessment

5. Distinguish between economic planning and economic development planning.
6. Planning can be done on a small scale and large scale. Examine the advantages and disadvantages of planning for the economy comprehensively.
7. Explain the reasons as why the government may prefer decentralized planning to centralized planning in the economy.
8. Discuss the principles of effective economic development planning.

UNIT 13

SECTORS OF THE RWANDAN ECONOMY:

Key unit Competency:

Describe the role of informal and privatization to Rwandan economy



Introductory activity

An enhanced way of collaborating with the private sector will be Joint Ventures. They will be aiming at a more private sector driven approach to commercial investments limiting the temporal participation of the government by agreeing upon clear exit and risk mitigation options. The possibility to strategically withdraw from Joint Ventures forms part of the concept of privatisation, which generally covers the divestiture of shares in existing (partly) state owned enterprises.

1. Involving the private sector through PPP arrangements

PPPs are relatively new in Rwanda. It is the objective of Rwanda to expand the application of PPPs across sectors where they demonstrate potential for sustainable development gains. In this regard, PPPs are seen as a suitable step to attract further domestic and foreign investors by efficiently sharing inherent project risks and thereby making investment in the provision of public goods and services more attractive for private partners.

2. Founding State Owned Enterprises

Founding new state-owned entities shall be an option to drive economic development in cases, where public investment is needed due to market failure causing the absence of private sector interest or where promising business cases in strategic sectors, like transport, agriculture, manufacturing, etc., are too risky to be developed by the private sector.

Another rationale applies, when there is a need to enhance public services to improve the population's well-being (e.g. public utilities for water, electricity, sanitation...).

The aim founding new SOEs should be to create an environment that attracts and gives confidence to the private sector to invest (catalytic investments). Upon the market's readiness to invest, the State shall consider privatizing the entity by selling off its shares.

3. Catalysing the development of private businesses through Joint Ventures,

Joint Ventures are meant to be used as an instrument to incentivize and drive private investments in strategic commercial markets with foreign and domestic partners, which are seen as key to develop the Rwandan economy. The rationale to promote Joint Ventures is to tap into strategic opportunities and to encourage knowledge and technology transfer into strategic sectors.

(Extract from National Investment Policy. MINECOFIN, April, 2017)

Read the above extract from the National Investment Policy and use it to answer the questions that follow.

- (i) What do you think is the meaning of PPPs?
- (ii) For what reason is the government interested in applying PPPs?
- (iii) For what reasons may the government opt to start state owned entities?
- (iv) What do you think are joint ventures and for what reason may the state decide to enter into joint venture with the private sector?
- (v) From the extract above, identify the ways that the state can use to carry out privatisation.

13.1. Structure of Rwanda's economy

Structure of an economy is a range of characteristics or features that describe the economy of a country. These features range all the way from agriculture, industry, service that may be private or public. These sectors have each contributed the gross domestic product and greatly contributed towards the development of the country. This unit looks at the following sectors of the Rwandan economy,

- iv) The informal sector.

- v) The public sector.
- vi) The private sector.

13.1.1. Informal sector

Activity 13.1



A

B

C

Study the pictures above and

- vii) Describe the activities taking place in each of the above pictures.
- viii) Describe what you think are the common features of the activities in the pictures.
- ix) Identify other activities in Rwanda that have similar features.
- x) In your own view how important are these activities to the economy.

13.1.1.1. Meaning of informal sector.

Inclusive growth is one of the strategies of government of Rwanda to reduce poverty and inequality. Vision 2020 Umurenge is a pro-poor social protection programme under the country's growth blueprint, Economic Development and Poverty Reduction Strategy. The strategy that is currently in the second phase aims at poverty reduction through inclusive growth in Rwanda. One of the factors contributing to high poverty levels in the country is lack of formal employment that has resulted into growth of a big informal sector.

Informal sector is an intermediate sector existing between the traditional and the modern sector comprised of the self-employed. Informal sector is part of the economy which is not accounted for through payment of taxes and also is not monitored through any form of government and authority. Activities of informal economy are not included in GDP. The concept of the informal sector was

introduced in 1972 by the International Labour Organisation (ILO) in its Kenya Mission Report. ILO defines informality as “a way of doing things characterized by ease of entry, reliance on indigenous resources, family ownership, small scale operations, labour intensive / adaptive technology, skills acquired outside of the formal sector, unregulated and competitive markets”.

The informal sector workforce can be categorized into three broad groups: owner-employers of micro enterprises; own-account workers, dependent workers, paid or unpaid, including wage workers in micro-enterprises, unpaid family workers, apprentices, contract labour, home workers and paid domestic workers, as proposed by the ILO/International Confederation of Free Trade Unions (ICFTU) international symposium of 1999.

In Rwanda, people employed in the local informal sector include street vendors, hawkers, street vendors, hawkers, taxi operators, tax washers, bicycle riders and motorcyclists, charcoal sellers, domestic workers, carpenters, ironsmiths, hairdressers and barbers, brick layers, and restaurants, and workers in tea plantations and mines, unregistered service providers, among others. The sector remains a significant contributor to the country GDP. Generally, **they are mainly characterized by the following;**

- Mainly produce on **small scale** because of the low capital employed.
- Mainly **use poor or simple technology** since they cannot acquire modern developed machines
- Produce mainly **low-quality goods** since the machines they possess cannot produce good quality output
- **Keep poor or no records** mainly because they are done on small scale
- Basically, **sole proprietorship** meaning they are owned by single individuals and most owned by families
- Dominated by **semi-skilled or unskilled personnel**
- Use basically **local resources** that are provided naturally
- Basically, produce for the **local market** since they cannot produce to feed the entire external market.
- Business operated in **open and semi-permanent structures** that can easily be demolished and the business transferred to another location.

13.1.1.2. Advantages of informal sector

In recent years, there has been increase in growth of young labour force and informal sector has become fundamental source of income and means of livelihood. Informal sector is one of the biggest employer's in developing

countries, providing employment to vulnerable sections of the population, including women, and youth. Almost nine in 10 rural and urban workers on the continent have informal jobs, and most of these are women and youth. Informal sector is thus source of generating reasonable income and livelihood for people employed in informal sector in developing countries. Developing countries have experienced a very rapid growth in informal sector employment in recent years due to lack of formal jobs in labour market. Therefore, it **has played a great role in development of their economies as follows:**

- **Creates employment opportunities** since it is labour intensive and this promotes income distribution. In Rwanda, according to a report by United Nations Economic Commission for Africa, informal sector employment accounts for 73.4 per cent of total employment outside agriculture sector. The report indicates that three out of four people in Rwanda are employed in the informal sector, and percentage reaches to over 80 per cent in case of women.
- **Produce essential goods** that are beneficial to low income earners.
- **Provide training grounds** for growth of entrepreneurs.
- **Provide revenue to the government** through taxation of the business activities.
- **Their growth paves way for transformation** into a modern dynamic sector.
- **Promotes development of appropriate technology** which suits the resources of the country.
- **Promotes linkages in production** i.e. forward and backward and this leads to achievement of an integrated economy.
- **Promotes the spirit of self-sustenance** thereby reducing the prevailing dependence on simple consumer products.
- **Paves way for the development of small-scale industries** through innovation and invention carried out.
- **Widens consumer choice** since it produces a variety. This is because there are many producers working under the informal sector.
- **Promotes both local and international trade** since they too, participate in productive activities alongside formal sector. For example, A survey commissioned by Trade Mark East Africa, Pro-femmes Twese Hamwe and International Alert on cross-border trade, shows that 82 per cent of the cross-border traders come from informal sector.

13.1.1.3. Disadvantages of informal sector.

- Unexpected growth of the informal sector **would risk the stability of fiscal policy that depends on government revenue**. i.e. it Leads to public revenue instabilities since production cannot be relied upon and also high rate of tax avoidance and evasion.
- Continuing growth of the informal sector **threatens the private sector that operates formally**. When the informal sector grows, it is a burden for firms in the formal private sector and they are the ones paying taxes providing government revenue.
- Informal sector **distorts the natural competitive process** as firms operating in that sector enjoy an unfair cost advantage through tax avoidance.
- Some informal firms **reduce their scale of operation** in order to remain undetected by the government which makes them less efficient.
- Informal sector **drags the development process of a country** because it subsidizes employment in less productive activities.
- Wasteful competition leading to **duplication of goods and services and wastage of resources**.
- **Pollution and its effects to the environment** leading to degradation and hindering development.
- Causes **congestion in the semi-urban areas** with its associated problems like prostitution, slums, theft etc
- Leads to **underemployment and unemployment** hence labour capacity to produce goods is not fully put to use.
- Produces at **excess capacity and end up exploiting consumers** through high prices.
- Informal sector **limits informal employment, productivity**, and as consequence, economic growth is retarded.
- **Produce low quality goods** and this leads to low standard of living of the people and low-income earnings
- **High administrative costs on the side of the government** and this leads to increased government expenditure.



Application activity 13.1.

A



B



C



Analyse the pictures above.

- (i) What activity is taking place in the pictures above?
- (ii) What do you think can be done to improve the economic activities of the people involved in such businesses?

13.1.2. Public sector:

13.1.2.1. Meaning and characteristics of public sector.

Activity 13.2.



- a) Write the following in full.
 - i) **RURA.**
 - ii) **RSB.**
- b) Based on their operation, under what sector would you categorize them?
- c) Identify other organisations or enterprises in Rwanda that fall under such a category as the above mentioned.
- d) What are the distinguishing features of the sector given in (b) above?
- e) What hinders their effective effort towards spearheading Rwanda's development process?

13.1.2.2. Meaning of Public sector

Public sector is part of the economy that is owned and operated by the government. The government owns and carries out the major economic decisions. Government enterprises include public corporations/enterprises which provide specific services for free or reduced prices, government parastatals which are nonprofit making and local authorities which provide essential services. Rwanda's Public Sector appears to be the main focus of much of the capacity building support in the country. In Rwanda's Public Sector significant resources are being devoted to human resources development in form of short-term training, seminars and workshops. In Rwanda, it's the role of Ministry of Public Service and Labor to supply the Rwandan Administration with efficient organization and Human Resource structures to fit the objectives of finest public services deliveries at the best possible costs.

Rwanda, through Rwanda Public Sector Law 19th October 2000, enacted a new law on public sector creating an independent body to regulate competition in the sector particularly telecommunications, water and electricity.

13.1.2.3. Characteristics of the public sector

- **Development oriented** i.e. aims at developing the nation
- **Characterized by bureaucracy and red tape.** This involves arrangement of procedures so as to achieve what someone wants
- **Normally takes on projects which require large capital** that cannot be taken up by the private sector
- Medium and large-scale industries **dominate.**
- **Employs a large size of the population** however with the present trend, its contribution is reducing
- **Normally organized on monopoly basis** as it provides services which are vital to the people
 - **High levels of external influence** in decision making and implementation of the plans since foreigners fund the projects
 - **Limited flexibility** as it is for private sector in the production of goods and services

13.1.2.4. Advantages and disadvantages of the public sector.

Activity 13.3.



Make research and discuss the view that it's the public sector that can drive the economy towards economic growth.

a) Advantages of public sector.

- The public sector **controls major and essential sectors of the economy** which are risky to put into private hands e.g power production, water and sanitation.
- The public sector **mobilise finance to start large enterprises** that the private sector firms may not easily manage e.g construction of dams.
- The public sector is essential in **establishing natural and state monopolies** that provide essential services that cannot be left under the private sector.
- The public sector **controls strategic industries that are risky to be handled by the public sector.** For instance the security related industries.

- Public sector firms **create employment opportunities in all regions and sectors.** This helps to reduce the level of inequalities in incomes, sectors and regions. Thus the public sector brings about a balance in regional and sectorial development.
- Public sector **firms earn revenue for the government.** Some of them are profit making and so bring in income for the government.
- The public sector **caters for long term need of the country.** It aims at national interest and development but not private interest.
- The public sector **starts enterprises and sells them to the private sector.** This usually happens in areas where the private sector is slow to invest either because of the risks involved or less profitable.
- The public sector **provides public goods/services like roads and street lighting** most which are non-profitable but essential to the population.
- The public sector **caters for the future generations** by ensuring sustainable use of the available resources. It minimizes over exploitation of the country's resources. For instance REMA ensures the protection of the environment during the production process.
- The public sector **regulates the production of commodities** that are taken to be vital to the society for instance medicine.

b) Disadvantages of the public sector.

- Under the public sector there is **no consumer sovereignty.** Consumers do not have the power to determine what to producer i.e they can only purchase what is brought on the market.
- There is **no variety of commodities** on the market. This is because resource allocation is in the hands of government organs only implying one or few producers.
- There is an **element of monopoly.** This creates scarcity of commodities in the markets, leads to increase in prices, reduces competition and efficiency in production..
- There is **production of low quality** output because of lack of competition due to monopoly tendencies in the public sector.
- The public sector increases the **government responsibilities and expenditures.** This may become a burden to the government.
- **It is usually inefficient.** This is because of lack of the profit motive in production to drive stimulate efficiency.

- The public sector is usually dominated by **corrupt and embezzlement practices**. This is because of lack of close supervision.
- Because of high government interference through selecting top management and constant change of officials among others management **may be inactive**.
- The public sector is always **influenced by bureaucratic red tape** which slows down decision making and implementation.

13.1.2.5. Problems faced by the public sector.

- **Limited finance** due to narrow tax base and this limits expansion
- **Corruption and embezzlement** which has depleted funds which would be invested
- **Persistent inflation** in the country increases the cost of production and amount of risks
- **Inadequate skilled man power** due to poor man power training policy and this has led to dependence on foreign labour which is expensive
- **Foreign influence by external organizations** like IMF and World Bank into the activities and dictating policies to be followed by the country
- **Poor management** because of heavy government intervention through selecting top management and constant change of officials among others
- **Inadequate infrastructural facilities** needed for development like road facilities, telecommunication among others limits coordination of different sectors
- **Bureaucratic red tape** which slows down decision making and implementation
- **Sector runs a lot of objectives** which conflict and in the end there is poor performance due to involvement in un productive enterprises
- **Limited market** both domestic and foreign explains the poor performance of the manufacturing establishment.



Application activity 13.2.

Chapter i: General provisions

Article 1: Purpose of these Regulations

The purpose of these regulations is to establish a regulatory framework for the construction, installation, operating and upgrading petrol service stations in Rwanda.

Article 2: Scope of these Regulations

These regulations shall apply to any person carrying out or intending to carry out the activities related to the construction, installation, operation and upgrading petrol and bio-fuel service stations.

(REGULATIONS N°003/ENERGY/PSS/RURA/2014 GOVERNING THE CONSTRUCTION, INSTALLATION AND OPERATION OF PETROL SERVICE STATIONS)

- a) In your own view, why is the government interested in regulating the construction, installation and operating petrol stations in the country?
- b) Generally, what do you think are the objectives of the public sector towards the development.

13.1.3. Private sector

13.1.3.1. Meaning of the private sector and its characteristics:

Activity 13.4



Undertake research on Private sector in Rwanda, and answer the questions that follow;

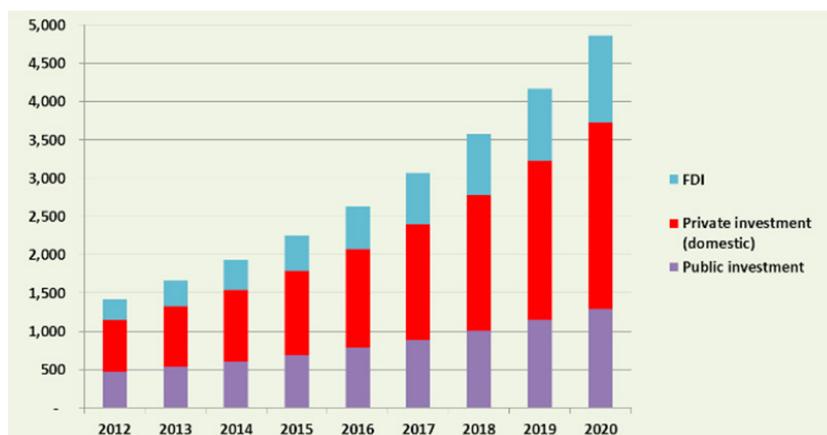


- (i) Which organization uses the above logo?
- (ii) Cite some of the enterprises in your locality that work under such an organisation.
- (iii) Describe features of a sector under which the enterprises given in (ii) work.

Private sector is an area of production activities that are not mainly owned by the government. It may include the informal sector, farmers, self-employed among others. The private is very active in a free market economy and mixed economic system as compared to the command economic system. This is because most of the resources are owned by the companies and individuals which and who are free to take all the economic decisions like how to produce, when to produce, for whom to produce, etc with no government intervention. The government simply comes in to carry out regulations during the production process.

The private sector plays a big role in the growth of the economy. The chart below shows the performance of private investment in Rwanda with domestic private investments performing much better between the five years.

Achieving Vision 2020 with investment (USD millions)



Source: RWANDA PRIVATE SECTOR DEVELOPMENT STRATEGY 2013-18.
Ministry of Trade and Industry (MINICOM)

13.1.3.2. Characteristics of private sector.

- It is mainly operated on a **small scale with some few large** scale but expanding enterprises.
- The private sector is largely **dominated by individual producers** (sole traders) with some limited number of joint stock enterprises.
- It is characterized by **high levels of competition** because of the large number of practitioners.
- It is largely driven by the **profit motive**.
- It mainly produces **consumer goods and a few producer goods**.
- It largely uses **labour intensive techniques of production** in the small scale enterprises which dominates the sector.
- It is mainly **active in urban centers than rural areas** because of the ready market.
- The sector is still **small but expanding**.

13.1.3.3. Advantages and disadvantages of the private sector.

Activity 13. 5



Undertake research about privatisation, and thereafter;

- a) Make an analysis on the view that Rwanda needs to strengthen more the private sector than the public sector in order to achieve high levels of growth in the economy.
- b) Identify the challenges faced by the private sector in Rwanda.

Advantages of the private sector.

- **Employ majority of the people** hence reduce unemployment and this increases incomes and standard of living
- **Produces goods and services** hence contributing greatly to national income after the sale of the goods
- **Promotes gradual growth of the economy** since it stimulates entrepreneurship which leads to discovery of new techniques of production
- **Contributes to growth and modernization of industry in the**

country through mobilizing of private savings, stimulating consumption and investment

- **Helps exploiting the local resources** hence reducing excess capacity that exploits consumers through high prices
- **Uses local resources** hence reducing foreign expenditure or resources and raw materials
- **Contributes to government revenue** through taxation of the people, structures and also then profits of the business.
- **Sector re-invests (ploughs back) profits** hence expanding the existing productive capacity which increases economic growth and the size of the national income.
- **Technological development** is enhanced as the sector is innovative and adopts new techniques to suit the changing consumer tastes.
- **Helps to reduce the subsistence sector** by monetarizing of majority of the economy.
- **Infrastructure development** because of its tremendous expansion and this further leads to the development of the country.

Disadvantages of private sector.

- **Mostly located in urban centers** hence cause rural urban migration with its associated problems like theft, prostitution and slum development among others which retards development
- **Tendency of using capital intensive techniques** to increase production leads to unemployment with its associated problems like poor standards of living to mention but a few
- **Tends to specialize in few activities** leading to consumer exploitation in form of high prices since sometimes they become monopolies with no competition
- **Concentrates on small scale production activities** and this may not enable it to generate adequate economies of scale
- **The use of rudimentary/ outdated technology** limits production hence little output for the growth of the country
- **The sector is profit motivated** hence it may not provide services that are good for the society but nonprofit making
- **Capital outflow** may occur if the productive ventures are owned by

foreigners and thus the country may lose foreign exchange.

- **Limited levels of diversification** due to production of similar commodities hence the consumers do not get a variety
- **Production of low quality goods** which may fetch little when exported hence low foreign exchange
- **Income inequalities** may arise where a few people get engaged in such activities and this may create tension in society and underdevelopment of some regions

13.1.3.4. Challenges of the private sector.

- **Under developed infrastructure** like roads limits their movement of inputs and output from their production sites to the markets. This sometimes cause losses to them
- **Inadequate market** both within and outside. This is because of the low quality of the goods that are produced and worse still they produce similar goods that create surplus at the markets
- **Poor technology.** The technology is still low and this has continuously led to low output and low revenues.
- **Competition.** Most of them produce similar products hence calling for high advertisement costs which lead to increased cost of production. The inefficient firms are sometimes driven out of the business leading to unemployment
- **Low prices paid by the consumers.** This is sometimes due to price legislation by the government. The firms earn low profits that don't enable them to develop.
- **Under developed structure for production.** Some of the firms under the private sector don't have permanent markets so they don't have a developed structure of production. This has sometimes led to over production and wastage of resources
- **Inadequate capital for production.** This is the major problem that the private sector faces. Some have few equipment that cannot enable them to get loans from the banks hence their businesses have constantly not changed from small scale to large scale.
- **Low levels of skills of the entrepreneurs** which has led to low innovations and invention leading to low quality outputs and low profit.
- **Undeveloped capital and money markets.** This limits the rate of

mobilization of capital.



Application activity 13.3

From your understanding of the problems facing the private sector, what do you think should be done to promote the private sector in developing economies?

13.2. Privatization

13.2.1. Meaning of privatization

Activity 13.6



Make research on privatisation, find out and explain;

- i) What it means
- ii) The different forms in which a company can be privatized.
- iii) Examples of firms in Rwanda that have been privatized and the form of privatisation that were employed.

Privatisation of public enterprises refers to transfer of ownership and control of government or state assets, firms and operations to private investors. Or **Privatization** is the reduction of the role of the state in the national economy while at the same time increasing private ownership and private sector both local and foreign. Or it refers to the transfer of production assets from state ownership to private ownership.

13.2.2. Forms of privatization

Privatization takes various forms

- **De-nationalization (divestiture):** This involves the sale of all or part of the enterprise owned by the government to private people or the public. It may also take the form of,
 - i. **Total sale**
 - ii. **Joint venture** where the government enters into agreement with private firms and individuals

iii. Abandonment, winding up or **liquidation**.

- **Liberalization (De-regulation)**: This involves opening up entry into activities which were previously restricted to the public sector enterprises only by allowing private sector participation. This is meant to increase competition and good quality output.

- **Contracting out**: This is where the provision of the good or service is transferred from the public to the private sector while the government retains the responsibility to supply the good or service. It takes the following forms.

- a. **Franchising**. This is the right to market on behalf of the government
- b. **Contract management**. Here the government owns the property but gives out management like maintenance, providing goods and services among others
- c. **Leasing or renting**. Here the government contracts the private sector to provide part of the service or to use/ rent its assets.
- d. **Cost sharing: This is where the government retains ownership of the enterprises but the beneficiaries contribute to the running costs e.g in schools and universities where the government pays part of the fees and the students pay the rest.**

13.2.3. Advantages and disadvantages of privatization

Activity 13.7.



From the research carried out in activity 13.5 above,

- i) Discuss the view that the transfer of state enterprises from public ownership to private ownership is the best strategy to stimulate growth of the economy.
- ii) What do you think hinders effective privatisation drive in Rwanda?

Advantages of privatization.

- **Increased efficiency** in the privatized firms leading to good quality goods and services.
- **Increased output** from the privatized firms because of improved efficiency.
- **Reduced corruption and financial mismanagement of the enterprises.** This is because of close supervision by the owners of the enterprises.
- **Reduced burden from the state** to concentrate on the production of essential services. It reduces the responsibility of the government to only strategic functions.
- **Increased revenue to the government** realized from the sold enterprises.
- **Increased competition** resulting into emergence of several firms providing services which had been monopolized by the state enterprises
- **Increased private sector confidence in the country.** This encourages private investments and so encourages further growth of the economy.
- **Reduced government budgetary deficits** by reducing government expenditures.

Disadvantages of privatization.

- **Increased resource outflow** by the new owners of the enterprises through profit repatriation. This occurs when the privatized enterprises are taken over by foreign firms.
- The government loses property through transactions with **dubious businessmen who don't pay but spoil the property.**
- **Increased debts to the government** because a lot of money is borrowed to fund the process yet little may be realized after selling.
- **Domination of foreign businesses in the economy as the domestic ones are reduced** because of lack of enough funds to purchase the privatized firms.
- **Poor working conditions to the workers in form of low wages, longer hours of work,** etc.
- **Environmental degradation** through over exploitation of natural resources.
- **Associated with low levels of labour** absorption in some sectors, underemployment and even reduction of local employment because they bring in foreign labour.

- **Over competition** leads to use of non-price competition measures which include reduction in weight of goods like bread etc.

13.2.4. Limitations of privatization.

- **Corruption in the privatization unit** i.e. some officials are not transparent and connive with prospective buyers
- **Opposition from the general public** often delays the process of privatization.
- **Poor valuation of the enterprises** leads to assets being sold at giveaway prices
- **Poor states of the enterprises** due to poor maintenance making it hard to sell them
- **Political sabotage.** Opposition leaders sometimes block the sale of enterprises just to frustrate the government and advance their causes
- **Poverty among the nationals makes the enterprises** to be sold to foreigners leading to foreign domination in the country.
- **Small market discourages potential buyers** due to limited potential for expansion
- **Political instability in some parts of the economy** discourages potential investors from buying the enterprises.
- **Unscrupulous buyers.** Some buyers who win the bids to buy the enterprises are not genuine and end up not paying after taking over the property.
- **Under developed capital markets.** Government enterprises are sold under a capital market so its underdevelopment limits the potential buyers to access the enterprises.
- Fear of nationalization



Application activity 13.4.

- i) How would you differentiate privatization from nationalization?
- ii) What do you think are the reasons behind government transferring some of her enterprises to private hands?
- iii) Why may the government decide to nationalize private firms?



End unit assessment

1. Explain the role of the private sector in the growth of economies in developing countries.
2. (i) Distinguish between divestiture and cost sharing as forms of privatization.
(ii) Describe the major problems faced by the government when transferring her enterprises to the private sector?
3. i) Under what sector of the economy do you classify charcoal sellers and salons?
ii) Describe the contribution of the above sector to the development of the economy.
4. Explain the problems faced by the public sector in developing countries.

REFERENCES

1. Mirembe E. N. (2017); Economics for Rwanda Secondary Schools Learner's Book Senior Five. Kigali: Fountain Publishers Rwanda Ltd
2. BWEBARE N. E (2017); Economics for Rwanda Secondary Schools Learner's Book Senior Six. Kigali: Fountain Publishers Rwanda Ltd
3. Jim, B, Safari J.B., Patrick W., Tony G. (2016) ; Economics For Rwandan Schools student book Senior four . Kigali: Longhorn Publishers (Rwanda) Ltd.
4. Alain, A. (2008). Economics, fifth edition. Pearson Education.
5. Asiimwe, H.M. (2009). Fundamental Economics. East Africa Edition.
6. Asiimwe. H.M (2013), Senior Secondary Economics student books 4,5 and 6 MK Publishers Ltd
7. Chrisdom M.A. (2006). Economics for advanced level, Paper one and Professional Studies. Published by The General Publishing House LTD.
8. Chrisdom M. A. (2006). Economics for advanced level, Paper one and Professional Studies. Published by The General Publishing House LTD.
9. Eleazar, C.I., Turner, P.H., and Turner, D. (1993). Economics for Senior Secondary School in East Africa. Published by The Macmillan Press LTD.
10. Grant, S.G., and Stanlake. (2000). Introductory Economics. 7th Edition. Pearson Education Limited.
11. Harvey.J., and Jowsey, E. (2007) Modern Economics. 8th edition 2007. Published by Palgrave Macmillan.
12. Lipsey and Chrystal. (2007). Economics. Eleventh Edition. Oxford University Press.
13. Lipsey, R.G., and Harbour, C. (1992). First Principles of Economics. Second Edition. Oxford University Press.
14. Maunder, P., Myers, D., Wall, N., and Miller, R.L. (2000). Economics Explained. HarperCollins Publishers Limited.
15. Tayebwa, B. M.B. (2007). Basic Economics. Published by Genuine Researcher and Publishers (GRP).

Electronic Reference

1. <https://www.researchgate.net/publication/5028931> An_introduction_to_the_search_theory_of_unemployment. 20-10-2019
2. <https://www.investopedia.com/terms/f/financialinstitution.asp> on 21-10-2019
3. <https://en.wikipedia.org> 10/12/2019)

