NATIONAL OPEN UNIVERSITY OF NIGERIA

SCHOOL OF BUSINESS AND HUMAN RESOURCE MANAGEMENT

COURSE CODE: ENT 108

COURSE TITLE: MICRO ECONOMICS

COURSE GUIDE

ENT 108
MACRO-ECONOMICS

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Introduction

ENT 108: Macro-economics is a semester course work of two credit hours. It is available to all the students, taking the B.Sc. Programme in Entrepreneurial and Small Business Management in the School of Business and Human Resources Management.

This course consists of 15 units comprising the nature of national income, consumption, saving and investment, multiplier, accelerator and aggregate level of employment, inflation and deflation, international financial and economic institutions, monetary and fiscal policy, unemployment, demand and supply of money, financial institutions, and balance of trade and balance of payments.

The course is designed to give students an in-depth understanding of the nature of macroeconomics and the role macroeconomics variables play in the operations of the economy. The in-depth coverage of the course is to enable students appreciate the working mechanism of the economy, in terms of the effect of the interplay of macroeconomics variables on the economy. Furthermore, the course is also intended to enable students to understand the role such macroeconomics variables play in ameliorating the many economic problems in the society.

This Course Guide tells you what ENT 108: Macro-economics is all about in terms of the nature of the material. How to use the contents of the material is spelt out for adequate knowledge and eventual success in the course. Other information provided in the course includes: how to make use of your time in the course, self-assessment questions, tutor-marked assignments, etc. There will also be tutorial classes. Full details concerning the tutorial classes will be conveyed to you at the appropriate time.

Course Contents

The course contents consist of national income, consumption, saving and investment, multiplier, accelerator and aggregate level of employment, inflation and deflation, international financial institutions, international economic institutions, monetary policy, fiscal policy, unemployment, demand and supply of money, financial institutions, and balance of trade and balance of payments.

Course Aims

The aims of this course are to expose you to macro-economics, the importance of determination of national income, the interplay of consumption, saving and investment in the economy, and to understand the effect of interplay of multiplier and accelerator on the aggregate level of employment in the economy, the policy instruments normally employed to control money demand and supply in the economy, problem of inflation and ways to combat it, and to have a good grasp of the role of international economic and financial institutions in economic growth and development of economies. Also the role of GATT and UNCTAD in world trade, the role of the financial institutions in national economies, and the problems associated in balance of payments and appropriate ways to ameliorate them are discussed.

The aims will be achieved by:

1) explaining the meaning of national income;
2) explaining the importance of the determination of national income;
3) describing the various instruments of monetary and fiscal policy;
4) explaining the concepts of inflation, deflation and stagflation;
5) identifying and explaining the various ways to enhance the workings of multiplier and accelerator in the economy;
6) describing the role of international economic and financial institutions;
7) explaining the role of financial institutions;
8) highlighting the problems inherent in unemployment and how unemployment can be tackled; and
9) discussing the causes of balance of payments disequilibrium and how they can be ameliorated.

Course Objectives

At the end of the course, you should be able to:

i. explain the meaning of national income;
ii. discuss the importance of national income determination;
iii. explain the various instruments of monetary and fiscal policy;
iv. describe the concepts of inflation, deflation and stagflation;

v. explain the importance of financial institutions to any economy;
vi. describe the role of international economic and financial institutions;
vii. explain the concepts and principles of multiplier and accelerator;
viii. describe the interrelationship between consumption, saving and investment;
ix. describe the problem of unemployment and how it can be tackled;
x. explain demand for and supply of money;
xi. describe the causes of balance of payments disequilibrium and how they can be ameliorated.

Course Materials

(2) Course Guide
(3) Study Units
(4) Text books
(5) Assignment Guide

Study Units

There are 15 units in this course which should be studied carefully. The units are listed below:

Module 1

Unit 1 National Income
Unit 2 Determination of National Income
Unit 3 Circular Flow of Income
Unit 4 Significance and Limitations of National Income
Unit 5 Consumption, Saving and Investment

Module 2

Unit 1 Multiplier, Accelerator and Aggregate Level of Employment
Unit 2 Inflation and Deflation
Unit 3 International Financial Institutions
Unit 4 International Economic Institutions
Unit 5 Monetary Policy

Module 3

Unit 1 Fiscal Policy
Unit 2 Unemployment
Unit 3 Demand and Supply of Money
Unit 4 Financial Institutions
Unit 5 Balance of Trade and Balance of Payments

Each study unit includes an introduction, the objectives of the unit; the main contents, exercises, conclusions, summary, references and tutor-marked questions. It will take at least two hours to finish. You are expected to study the materials, reflect upon them and attempt the exercises. There are also reference materials, e.g. textbooks, for further reading. They are to give you additional information. Practice the self-assessment and tutor-marked questions for greater understanding of the course. By so doing the stated learning objectives will be achieved.

The Modules

The course is divided into 4 modules. The first three modules have 4 units each while the last have 3 units.

The first module treats national income, determination of national income, circular flow of income, and significance and limitations of national income

The second module discusses consumption, saving and investment, multiplier, accelerator and aggregate level of employment, inflation and deflation, and international financial institutions.

The third module treats international economic institutions, monetary policy, fiscal policy, and unemployment

The fourth and last module treats demand and supply of money, financial institutions, and balance of trade and balance of payments

Assignments

There will be tutor-marked assignments and you are expected to attempt all of them.

Tutor-Marked Assignment

In doing the tutor-marked assignments, you are expected to apply what you have learnt in the contents of the study units. After you attempt them, submit them to your tutor for grading. They constitute 40% of the total score.

Final Examination and Grading

At the end of the course, you will write the final examination. It makes up the remaining 60% for the total mark of 100%.

Summary

ENT 108 introduces you to national income, multiplier and accelerator principles, monetary and fiscal policy, demand and supply of money, unemployment, financial institutions, inflation, deflation and stagflation, international economic and financial institutions, as well as balance of trade and balance of payments, among other macroeconomics topics. On the successful completion of the course, you would have been armed with the principles and concepts of macroeconomics, which you need for a better awareness of the workings of the overall economy.

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MODULE 1

UNIT 1 NATIONAL INCOME

CONTENTS

1.0 INTRODUCTION

National income relates to the measure of the total value of goods and services produced in an economy over a period of one year. National income from all intents and purposes, serves to explain the performance of an economy. Therefore, it indicates whether the economy is growing or otherwise, it also reflects the performance of the business organizations in the economy, which serves as the agents for the production of goods and services.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- explain the meaning of national income
- identify and explain the concepts of national income
- mention the accounting relationships in national income.

3.0 MAIN CONTENT

3.1 Meaning of National Income

National income is regarded as the market value of all goods and services produced in an economy during a particular period of time, usually a year. According to Alfred Marshall, national income is the aggregate net products of and the sole source of payment for all the agents of production. Sir John Hicks explained that national income is made up of a collection of goods and services produced on a common basis which is measured in terms of money.

From the above definitions, it is appropriate to say that national income is the money value of the end result of all economic activities of a nation. Economic activities in any country result into a large number of goods and services, and make a net addition to the national stock of capital. Such goods and services constitute the national income of a closed economy. The closed economy is an economy which has no economic transaction with the rest of the world.

National income in open economy includes also the net results of a nation's transactions with the rest of the world (i.e., exports less imports). Alternatively, national income is called national product. Incomes are generated from the production of goods and services. This value of products represents incomes to households in form of wages, salaries, rent, interest, or profits. Thus, the total of all incomes must be exactly equal to the value of all goods and services produced in an economy within a particular year.

SELF ASSESSMENT EXERCISE 1

Explain the term national income.

3.2 Concepts of National Income

1. Gross National Product (GNP)

The gross national product (GNP) refers to the value of all goods and services produced during a specific period of time, usually one year, plus the difference between foreign receipts and payments. The GNP is, therefore, identical to the concept of gross national income (GNI); hence, GNP =GNI. Thus, while the GNP is estimated on the basis of product flows, the GNI is estimated on the basis of money income flows, i.e. wages, profits, rent, interest, etc.

2. Gross Domestic Product (GDP)

It refers to the value of total output of goods actually produced in the whole economy over a period of time, usually one year. It is the gross because allowance has not been made for the consumption of fixed capital used up in the production. When the value of the production is measured at the market price, we have what is commonly referred to as gross domestic product cost; it is regarded as gross domestic product at factor cost. The difference between the two lies in the fact that GDP as factor cost excludes the excess of indirect taxes over subsides that may have been levied on the goods and services, while the other does not.

3. Net National Product (NNP)

This is regarded as national income proper. It refers to the sum of all incomes accruing to all factors of production that are supplied by the residents of a given country over a period of time, usually a year, after deducting depreciation. Depreciation herein refers to the value of wear and tear of capital and machinery replacement after the year of use. Therefore,

GNP – Depreciation = NNP.
NNP = GNP – Depreciation.

Depreciation is, in essence, that part of total productive assets which are used to replace worn-out capital in the process of creating the GNP. Hence, in the process of producing goods and services (including capital goods), a part stock of capital is used up. Depreciation is therefore the term used to denote the worn-out or used up capital. An estimated value of depreciation is deducted from the GNP to arrive at the NNP.

The NNP is then the measure of net output available for consumption by the society. The NNP is usually the same as the national income at factor cost. The NNP is the usually measured at market prices, while direct taxes and indirect taxes are deducted. Hence, NNP – indirect taxes = national income.

4. Personal Income

Personal income is the total national income of a particular country or total GNP less payment of indirect taxes, less undistributed profits, less profits of public parastatals plus transfer payments (i.e. by government and business organizations), such as social security allowance, unemployment benefits, etc. Personal income refers to the income accruing to individuals, which can be used for paying taxes, consumption and savings. It constitutes the rewards earned by individuals due to their contribution to the productive sector of the economy.

5. Disposable Income

This refers to the income from all sources that accrue to households and private non-profit institutions after deducting direct taxes and other transfers. In essence, disposable income constitutes that amount which an individual can use for the purchase of goods and services and also for savings. In a frugal economy it is regarded as: Y=C+S.

SELF ASSESSMENT EXERCISE 2

Identify and explain the various concepts associated with national income

3.3 Accounting Relationships in National Income

1. Relations at Market Price

GNP = GNI (gross national income)
GDP = GNP less net income from abroad
NNP = GNP less depreciation
NDP (Net Domestic Product) =NNP less net income from abroad

2. Relations at Factor Cost

GNP at factor cost = GNP at market price less net indirect taxes
NNP at factor cost = NNP at market price less net indirect taxes
NDP at factor cost = NNP at market price less net indirect taxes
NDP at factor cost = GDP at market price less depreciation

3.4 The Significance of National Income Analysis

(1) It reflects the extent to which goods and services are valued in monetary term in any given economy.
(6) National income measures the entire value of goods and services produced in an economy over a particular period of time (usually a year). This can be appreciated from GDP, GNP or NNP analysis, as highlighted above.
(7) National income explains the performance of business organizations which constitute the unit that produces goods and services in any economy.
(8) It enables the business organization to appreciate their contribution to the different sectors of the economy.

(9) The GDP explains the overall contribution of the various businesses and individuals; either the citizens or foreigners.
(10) It also shows the extent to which foreigners' participation is relevant to the national economy.
(11) It enables businesses to adopt better resources allocation and adjustment procedures as it highlights the individual's contributions of different sectors of the national economy.

SELF ASSESSMENT EXERCISE 3

Mention the reasons for the determination of national income.

4.0 CONCLUSION

From the foregoing analysis, you can understand the meaning and essence of national income. You can also appreciate the reasons which inform the determination of national income, and the role it plays in the economy and business operations in any country.

5.0 SUMMARY

This study unit has discussed the meaning of national income. It also discussed the various concepts associated with national income and the accounting relationships among such concepts. Lastly, the unit also discussed the need for the determination of national income.

The next study unit discusses the three approaches used to measure the value of national income.

6.0 TUTOR-MARKED ASSIGNMENT

1. Identify and discuss the various concepts associated with national income.
2. Mention the merits of the determination of national income.

7.0 REFERENCES/FURTHER READINGS

Begg, D., S. Fischer and R. Dornbusch (2000). *Economics*, Sixth Edition. England: .Maindenhead Berkshire.

Lipsey, R.G. and K.A. Crystal (1997). *An Introduction to Positive Economics,* Oxford: Oxford Press.

Lipsey, R.G. et al (1987). *Economics*. New Delhi: Vikas Publishing House Pvt Limited.

UNIT 2 DETERMINATION OF NATIONAL INCOME

CONTENTS

1.0 INTRODUCTION

In the preceding unit, you have been introduced to the meaning, concepts and accounting relationships of national income. This unit exposes you to the different approaches to the measurement of the national income, and by extension the difficulties involved in such methods of determining the national income.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- mention and explain the three approaches for measuring national income
- identify and discuss limitations of the methods used for measuring national income.

3.0 MAIN CONTENT

3.1 Income Approach

National income is measured through the income approach by adding up all the incomes earned by the factors of production during the course of a year. In essence, it is the sum of all incomes received by households for their services to production. Such incomes include all wages, salaries, incomes earned by professionals, farmers, and armed forces and paramilitary personnel as well as all undistributed business profits and incomes earned by the country's citizens from abroad.

From the totality of the various incomes, deductions are made for payments to expatriates from the economy and all transfer payments on the national debts and to individuals. Therefore, national income can be regarded as the summation of the reward accrued to the factors of production (land, labour, capital, and entrepreneur) as a result of their contribution to the production of goods and services.

In summary, the income approach is the summation of the entire income accrued to the factors of production, due to their contribution to the economy, i.e. the summation of wages, interest, profit and rent.

The shortcomings involved in this method include the following:

1. Undistributed Incomes

More often, a substantial portion of income generated by business entities is retained in the business operations; the owners tend to reinvest what they have realized instead of sharing it as profits among the shareholders. Using this method to measure national income, therefore, may be misleading; major part of the profits cannot be calculated and this represents a shortfall in the level of net national income.

2. Absence of Rent Payment on Owner-occupier Houses

Houses occupied by their owners do not attract rent payments. This represents underestimation in national income.

3. Goods Produced and Consumed by Producers

An underestimation of national income involves some goods and services that are produced and consumed by the producers themselves under subsistence sector of the economy. Income from their payments which are foregone escapes estimation of the national income.

4. Unpaid Services

There are services which are rendered by some people that are not paid for. Examples are building of a house by the owner himself, laundry services rendered by the person himself, free services rendered to relations, and free services rendered to a person's relations, etc. Income from their payments which are foregone also escapes estimation of the national income.

5. Absence of Definite Remuneration for Self-Employed People

Some individuals who are self-employed do not claim definite wages or salaries. Self-employed people are those people who are not under the employment of any organizations or who are not employed by other individuals on wage or salary basis. These types of people do earn incomes which cannot be classified as a profit or reward to the entrepreneur or a wage, the reward to labour. Therefore, the procedure for measuring national income becomes faulty and hence leads to underestimation.

SELF ASSESSMENT EXERCISE 1

1. Explain the income method of national income estimation.
2. List and explain the problems involved in estimating national income using income approach.

3.2 Output Approach

This approach to measurement of national income, involves estimating the national income as the sum total of the market values of all goods and services produced in the economy, in a given period of time. It is only the value of the final goods and services that is considered in this approach to the measurement of national income. This is estimated by adding subsidies, and subtracting the value of indirect taxes.

In summary, the output approach is concerned with the measurement of the national income through the summing up of the market value of the final goods and services produced in an economy over a year.

The inherent shortcomings of the output method include the following:

- **Risk of Double Counting**

This arises due to the interrelationships between and among commodities whereby some firms' outputs constitute the inputs of other firms. In this situation, there is always a tendency for counting the value of some commodity more than one time. This is the problem of double counting.

- **Omission of Unpaid Services**

Some activities, especially services whose value is supposed to be incorporated, are often neglected in output estimation. For instance, the value of the services of a housewife which should be taken into consideration national income estimation is always neglected. Such form of service commands a value and deserves to be considered in national income.

- **Self-Service Activities**

The identification of some self-service activities is not easily realized. Therefore, to determine the extent and their level of their value in monetary terms will not be an easy task. Hence the income method always leads to underestimation of the actual amount of national income.

SELF ASSESSMENT EXERCISE 2

1. Explain the output method of national income estimation.
2. List and explain the problems involved in estimating national income using output approach.

3.3 Expenditure Approach

This method which is also known as the final method, measures national income at the final expenditure stages in the economy. In essence, the expenditure approach entails the measurement of the entire spending of households, firms and government on goods and service.

In estimating the national income using the total national expenditure, any of the following two methods are employed:

1. In this first method, all the money expenditure at market price are computed and added up together. The items of expenditure which are taken into consideration under this method are:

(a) private consumption expenditure;
(b) direct tax payments; and
(c) payment to non-profit making institutions and charitable organizations like schools, hospitals, orphanages, etc;

2. Under this second method, the value of all the products finally disposed of are computed and added up. The items of expenditure which are taken into consideration under this method are:

(a) consumer goods and services;
(b) private investment goods;
(c) public goods/services; and
(d) investment abroad.

The second method is more widely used because the requisite data required by this method can be collected with greater ease and accuracy. This approach, as portrayed above, involves estimating the sum of all consumption expenditure, investment expenditure, government expenditure and export expenditure.

Shortcomings inherent in the expenditure approach include the following:

1. It is technically difficult to isolate intermediate products from the final products.

2. It is practically an impossible task to obtain actual factor price of goods particularly in less developed countries.

In national income accounting, the basic overall aggregate being measured is the total value of output at factor cost either in constant or at current market prices. This can be considered in terms of the output (O) itself or the income (Y) it generates or the expenditure (E) required to purchase it. However, the details of each calculation give independent information but the totals do not since the three are defined so that they are identical. That is:

Total Income = Total Output = Total Expenditure

$$Y = O = E$$

SELF ASSESSMENT EXERCISE 3

1. Explain the expenditure method of national income estimation.
2. List and explain the problems involved in estimating national income using expenditure approach.

4.0 CONCLUSION

You can understand from the foregoing discussion that there are three approaches that could be used in measuring national income. All of these approaches have their peculiar shortcomings. The choice of any of the approaches depends upon the available data for measuring national income.

5.0 SUMMARY

The unit has discussed national income in terms of the three approaches (income, output and expenditure methods) that can be used to estimate it. The inherent limitations of each approach have been identified and discussed. The next unit discusses the circular flow of income.

6.0 TUTOR-MARKED ASSIGNMENT

Mention and discuss the three approaches used in measuring national income.

7.0 REFERENCES/FURTHER READINGS

Lipsey, R.G. and K.A. Crystal (1997). *An Introduction to Positive Economics*. Oxford: Oxford Press.

Lipsey, R.G. et al (1987). *Economics*. London: Harper and Row Publishers.

Dwivedi, D.N. (1987). *Managerial Economics*. New Delhi: Vikas Publishing House Pvt Limited.

UNIT 3 CIRCULAR FLOW OF INCOME

CONTENTS

1.0 INTRODUCTION

The Keynes's analytical framework holds that the entire economy can be divided into four sectors such as household sector, firms or the business sector, government sector, and foreign sector. However, there is a simple model which involves a circular flow of income to the two-sector model, involving only the household and firms or the business sectors. In this unit, we shall discuss the circular flow of income involving some sectors in the economy.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- identify various sectors of a national economy
- list and explain the flow of inputs and outputs and income among the sectors
- draw simple diagrams illustrating the circular flow of income.

3.0 MAIN CONTENT

3.1 Circular Flow of Income

The circular flow of income is a simple model of the economy showing flows of goods and services and factors of production between firms and households. In the absence of government and international trade this simple model shows that households provide the factors of production for firms who produce goods and services. In return the factors of production receive factor payments, such as wages, which in turn are spent on the output of firms.

In reality, households do not spend all their current income. Some of the income earned by the providers of factors of production is saved. This represents a leakage from the circular flow. In addition to the consumer spending, firms also carry out investment spending. This is an injection to the circular flow of income, as it does not originate from consumers' current income.

In actual fact, it can be considered two flows, one of goods and services and a flow of money. The size of these flows is an indicator of the amount of economic activity. The circular nature of the flows means that there will be a number of different ways of measuring the size of the flow. Economists maintain that there are three possible ways of measuring this flow with each way looking at a different part of the circular flow of income. All the three methods should give the same magnitude of the national income.

These methods are as discussed in the preceding unit such as the output method which shows the total amount of goods and service produced in one year, the expenditure method shows the total amount of domestic spending by consumers, firms, government and foreigners, and the income method shows the total incomes earned by the factors of production involved in the production of goods and services in one year.

In this unit we shall deal with the various aspects, of the theory of income determination, including the circular flow income, and the theory of the multiplier.

SELF ASSESSMENT EXERCISE 1

Explain the term circular flow of income.

3.2 Two-Sector Model

In this two-sector model, the economy is closed with no government and foreign sectors. The model assumes:

- There are only two-sectors-households and firms.
- Households are the owners, and firms are the users of those factors of production.
- Household incomes comprise factors' payments-wages, interest, rent and profits. Households spend their total income on consumer and capital goods.
- The economy is spendthrift, with no element of savings
- There is no foreign trade and no government expenditure.

The circular flow of income shows how income flows from firms to households and how expenditure flows households to firms. It portrays in very simple terms how the economy works. The circular flow of income is very useful in the theory of income determination, for it shows that, if withdrawals from the flow are equal to 'injections' into the flow, then national income will remain at the same level. Withdrawals are as result of savings, taxation and expenditure and imported goods. Injections are due to investment and government expenditures and income form exports.

Figure 3.1 below shows the two-sector model of a circular flow of national income. It involves a simple model showing only households and firms sectors.

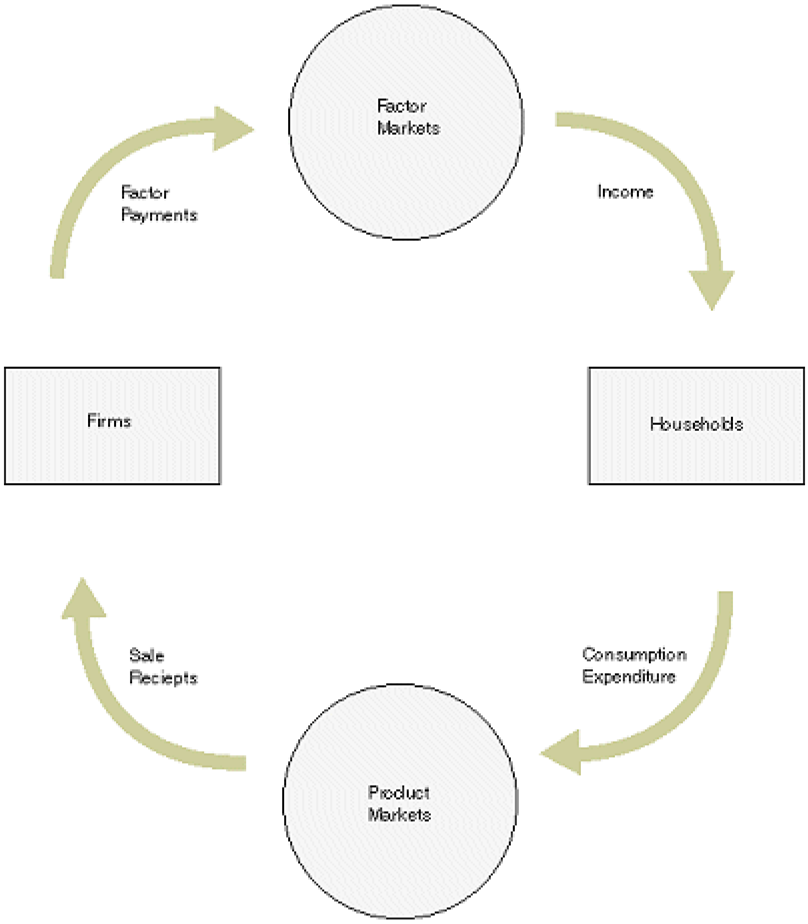

Fig 3.1: Two-Sector Model of Circular Flow of National Income.

In the real world, the government and international trade sectors must also be included. Economic systems are in reality three sector open economies. Consequently, there will be additional leakages and injections. Government spending will be injected into the circular flow and taxation will leak from it. Export flows will be injected and imports flows leaked. A full circular flow with leakages and injections is shown below.

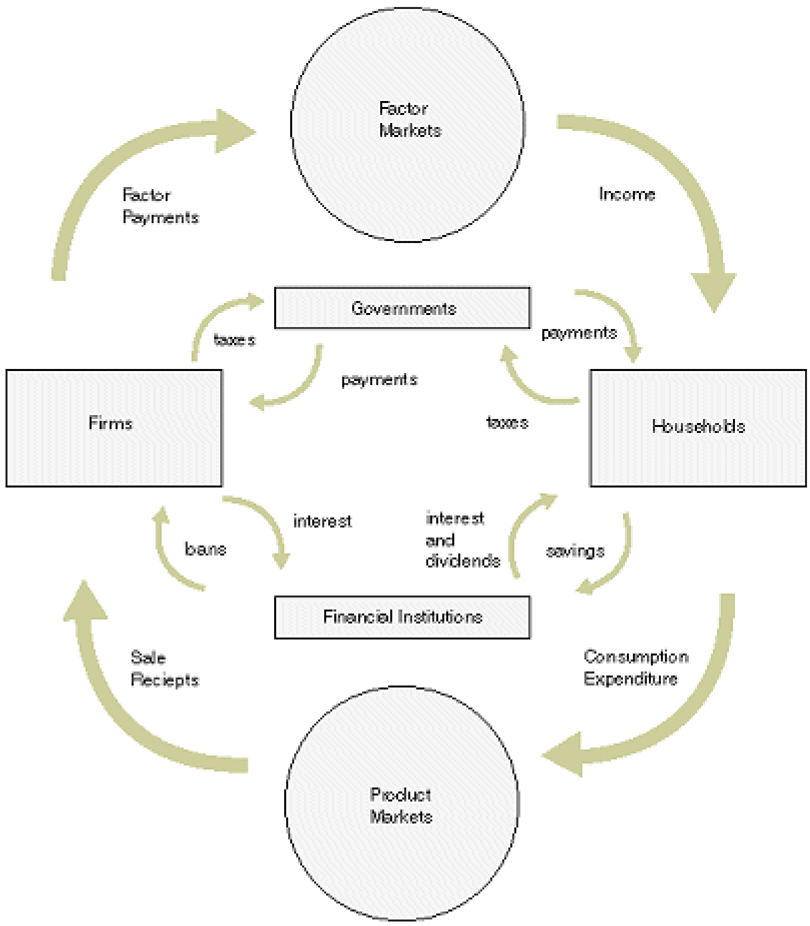

Fig 3.2: A Circle Flow of National Income

The Figure (3.2) above shows a circular flow of national income in an open economy, which shows a flow of income in an open economy. The above model of the economy demonstrates that economic activity is a flow involving many sectors.

The figure is divided into two parts. The upper half represents the factor market in which households sell and firms buy the services or factors of production. In the process, income factors, i.e. wages, interest, rent and profit move from the firm and flow to the household.

The lower part of the figure represents the product or commodity market where firms sell and households buy the commodities. In this process, household incomes flow to the firms and commodities flow to the household. From the diagram, therefore, payments flow firms to household in the form of payments for the factors of production; and from households back again to forms in the form of expenditure on goods and services within the economy.

SELF ASSESSMENT EXERCISE 2

Explain the circular flow of income in an open economy.

3.3 Concepts in National Income Determination

The various concepts involved in the theory of income determination are as discussed below.

1. Withdrawals

Withdrawals are incomes received in the course of the circular flow but which are not passed on in the flow. It is called withdrawals because it is the payment received from the flow but kept out of it. Examples are savings and undistributed profits of firms. Withdrawals have a contractionary effect on the national income.

2. Injections

An injection is income passed into the circular flow of income from outside the system. A good example is investments by firms. Injections have an expansionary effect on the national income.

3. Consumption

Consumption is that part of income which is spent on goods and services that are used up with a specified time, usually a short period.

4. Saving

Saving is that part of income which is neither spent on goods and services for current consumption, nor invested.

5. Investment

An investment is that part of income which is spent on real capital goods. That is, it is payment on physical productive assets, i.e. goods which are not meant for immediate consumption, e.g. factory buildings and road construction machinery.

SELF ASSESSMENT EXERCISE 3

List and explain the concepts of national income determination.

4.0 CONCLUSION

From the discussion above, you can appreciate the nature of circular flow of income. There two-sector model of circular flow of income clearly informs us as to how a simple economy works. The implication of the model for the open economy is that there are many variables at play in such an economy.

5.0 SUMMARY

This unit has been used to discuss the circular flow of national income. It has also discussed the two-sector model, which obtains in a simple economy. Furthermore, the type of circular flow of income that obtains in an open economy has been discussed in the unit. Lastly, various concepts related to it such as consumption, saving, investment, are also discussed. The next study discusses the significance and limitations of national income estimates.

6.0 TUTOR-MARKED ASSIGNMENT

Mention and explain the concepts associated with national income determination.

7.0 REFERENCES/FURTHER READINGS

Lipsey, R.G. and K.A. Crystal (1997). *An Introduction to Positive Economics.* Oxford: Oxford Press.

Lipsey, R.G. et al (1987). *Economics*. London: Harper and Row Publishers.

Dwivedi, D.N. (1987). *Managerial Economics*. New Delhi: Vikas Publishing House Pvt. Limited.

UNIT 4 SIGNIFICANCE AND LIMITATIONS OF NATIONAL INCOME

CONTENTS

1.0 INTRODUCTION

In the previous units, we have discussed extensively the nature of national income. The areas considered include the meaning of national income, the accounting relationships in national income, the methods involved in the measurement of national income and the circular flow of national income.

In this study unit, the importance and limitations of national income statistics will be discussed. In essence, you will be exposed to the understanding of the significance of the measurement of national income as well as the inherent limitations in the estimation of national income.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- discuss the significance of national income statistics
- identify and explain the inherent problems in national income estimation.

3.0 MAIN CONTENT

3.1 Significance of National Income Estimates

The estimate of the national income is useful in the following ways

1. The gross national product indicates the overall economic performance of a country. It tells whether the national out put is growing or declining. This is because an increase in the national

income represents increased national output. Since the national income is a measure of the value of total national output, an increase represents growth in the national product.

2. National income estimates help us to know the contribution made by each sector of the economy to national output. Since the national income is a representation of sectoral contributions, an analysis of the various contributions of different sectors of the economy is presented. This provides a basis for understanding the different sectoral contributions, and helps determine the rate at which each sector is growing or declining.

3. National income figures indicate the standard of living through showing the per capita income (PC) where PCI = GNP ÷ population. This measure, i.e., the per capita income explains the income per person, and the income per person indicates the standard of living of the people in a country. The higher the per capita income, the higher the standard of living and vice versa. If the national income of a country seen through the GNP increases, then with a constant population size, the standard of living of the country is expected to rise and vice versa.

4. It is used to compare the standard of living in different countries through the use of per capita income. The standard of living of different will enable a country to assess its performance in relation to other countries of the world, a particular country could determine the steps it could take to raise the standard living of citizens to match that of other nation's citizens.

5. National income statistics are used in determining how much a country should contribute to international organizations, e.g., the United Nations, I.M.F, World Bank, African Union (AU), etc. These agencies are specialized international bodies that perform different tasks and activities which are of global benefit and, naturally, being organizations charged with particular responsibilities, they need to be sponsored through different ways. The extent to which a particular country can contribute often depends on the level of her resources.

SELF ASSESSMENT EXERCISE 1

What are the uses of national income determination?

3.2 Problems Inherent in National Income Estimates

The general problems of measuring the national income irrespective of the approach used can be explained under the following points:

1. The Danger of Double Counting

This is in the areas of transfer payments, prices of intermediate goods, etc. you may want to ask what constitutes transfer payments and prices of intermediate goods. Transfer payments refer to the payments on income received by an individual which is not a reward for his own labour, e.g. bonuses, and charity. All these should be excluded from the overall national income estimate.

In the same consideration, the prices of intermediate goods, which are semi-finished goods, should be excluded. They are regarded as intermediate or semi-finished because they may likely be used to produce other products (final goods), which when considered will represent double counting of the same commodity (as input and as output).

2. Treatment of Depreciation

Depreciation, as seen in the previous unit, refers to wear and tear valuation. It remains a problem especially with respect to the expenditure approach, as its inclusion may amount to over/undervaluation of the real national income figure itself.

3. Treatment of Illegal Activities

Illegal activities such as prostitution and gambling are not included in the national income, whereas they are services and generate income. Since they generate income, such activities ideally are supposed to form part of national income as they represent earnings. Since they are considered in society as a taboo, they are not included. This negligence of these activities may tremendously render national income estimation insufficient.

4. Decision on Items to Include

There is the problem of what to include and what to exclude from the national estimation, for instance, the services of the housewife, which are economically valuable. Since all economic activities are supposed to assume value, the negligence of services such as those of the housewife represents a serious underestimation of the real value of the national income.

SELF ASSESSMENT EXERCISE 2

Identify and explain problems inherent in national income estimates.

3.3 Limitations of National Income Estimates

The estimate of the national income has some limitations. These problems make its usefulness questionable and even, sometimes, inadequate particularly when it is used as a measure of the standard of living for an economy.

1. The per capita income, which is calculated from the national income estimate, is only an average. Although it gives the flow of goods and services per person, it does not tell us how the goods and services are distributed among the various components of the economy.

2. National income estimates fail to tell us the kinds of goods and services produced. They only tell us the sectoral contribution in monetary terms.

3. The national income neglects some important factors which influence the standard of living. For instance, it does not consider life expectancy and working conditions. It only measures the volume of income irrespective of how it is generated.

4. Many people tend to give false information, thereby making the data available for national income computation misleading. For instance, businessmen often refuse to give the real picture of their business for fear of taxation.

5. The exchange of service for service is a practical problem facing national income data collection. For instance, in the rural areas of Africa communal activities are very common. This is a situation in which people organize themselves to work as a team for one another in turns.

6. The necessary tools to use, e.g. computers, telephones plus other administrative facilities are often unavailable or grossly inadequate, thereby impeding the efficiency of the people that gather information about the goods and services produced in the economy.

7. Some exchanges of goods, particularly in less developed economies, take place on barter basis. So computation on such goods in monetary terms is not possible. This has to do with those modes of exchange through trade by barter, whereby people exchange goods for goods.

8. Technical expertise for collecting national income data is sometimes lacking, especially in the less developed economies. This problem makes such countries rely on insufficient manpower to obtain the data.

9. Some illiterate businessmen and women do not keep accounts of their business, and that makes it difficult for accurate national income computation. This is a serious problem since it is through the summing up of the entire value of the national output that the national income is arrived at.

SELF ASSESSMENT EXERCISE 3

What are the limitations inherent in national income estimates?

4.0 CONCLUSION

National income accounting is of strategic importance to a country since it shows the output generated and the standard of living of the citizens of the country concerned. In this unit, therefore, you have been exposed to the significance of national income estimates. You also been exposed to the fact that the estimates of national income have some inherent problems and limitations.

5.0 SUMMARY

National income is the income received by the residents of a country in a given period as payment for services offered to production.

GDP at factor cost is total money value of all goods and services produced in a country over a period, minus indirect taxes, plus subsidies. GDP at constant prices is the GDP at market prices, collected for a series of years, and statistically adjusted to eliminate the influence of inflation.

GDP at market prices = GDP at market prices – depreciation. The national income can be measured by using the output, income or expenditure approach, each of which has peculiar problems, although all the three yield the same result.

The next study unit is used to discuss consumption, savings and investment.

6.0 TUTOR-MARKED ASSIGNMENT

Discuss the uses and limitations of national income estimates.

7.0 REFERENCES/FURTHER READINGS

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UNIT 5 CONSUMPTION, SAVING AND INVESTMENT

CONTENTS

1.0 INTRODUCTION

In unit three, you observed that consumption is one of the components of the national income. It constitutes the largest component of aggregate expenditure of most countries. Therefore, in order to predict the effects of shifts in autonomous expenditure on equilibrium national income, we need to know the relationship between consumption and national income. And also, in the simple tow-sector model, consumption is the only expenditure flow that is induced.

Saving arises from the fact that it is not all income generated that is consumed. The portion of income not consumed is saved, and this gives rise to the concept of investment. Hence, the three related concepts of consumption, saving and investment are discussed in this unit.

2.0 OBJECTIVES

At the end of this unit, it is expected that you should be able to:

- explain consumption and consumption function
- define both saving and investment
- explain the determinants of savings and investment

- discuss the propensities to save with the help of diagrams
- explain the theories of investment
- explain the importance of savings and investment to business firms.

3.0 MAIN CONTENT

3.1 Consumption

3.1.1 Meaning of Consumption

Consumption refers to the act of using goods and services to satisfy wants. By extension, consumption expenditure is that part of national income that is spent on purchasing goods and services for consumption in the economy.

The central proposition of this simple version of national income analysis is that aggregate real consumption expenditure in the economy is determined by the level of disposable (after tax) income. Disposable income, as propounded by John Maynard Keynes, is the 'propensity to consume', although nowadays it goes by the less elegant term 'consumption function'.

SELF ASSESSMENT EXERCISE 1

Explain the term consumption.

3.1.2 Consumption Function

The consumption function shows the level of aggregate consumption in the economy given some magnitude of the total income available to the economic variables such as the households. The diagram below shows an economy in terms of consumption as against some level of income.

Real disposable income is measured on the horizontal axis. The forty-five degree line denotes that any point on the line is equidistant from the two axes. The level of disposable income can, therefore, be measured vertically as a straight line with a slope of less than one. The slope of the consumption function, or the 'marginal propensity to consume', measures that fraction of each additional disposable income that will be consumed.

In theoretical terms, and as indeed empirical evidence, the marginal propensity to consume (MPC) is less than one. Consequently, at each additional disposable income, the households will increase its consumption by a fraction and will save the remainder Consumption

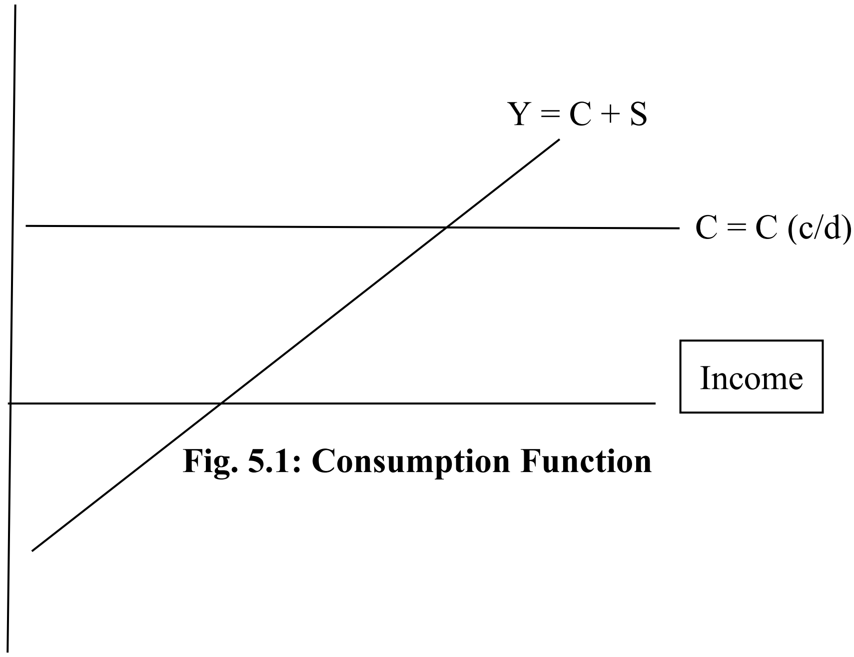

Fig. 5.1: Consumption Function

Using this simple case in which a constant proportion of income is spent on consumption, expenditure will be a certain per cent of the total income. Assuming it is 50 per cent, it means that 50 Naira of the total income will be spent on consumption. Both the APC and MPC are equal if the consumption function is a straight line emanating through the origin.

SELF ASSESSMENT EXERCISE 2

With appropriate diagram, discuss consumption function.

3.1.3 Consumption Function with Constant

Consumption functions are measured on the basis of annual data. Aggregate consumption and aggregate household income tend to fit the data appropriately if they contain a constant. The constant introduced changes the equation of the consumption function to become thus:

$$C = a+cy$$

From above: C = consumption; a = autonomous consumption; cy = consumption arising from income.

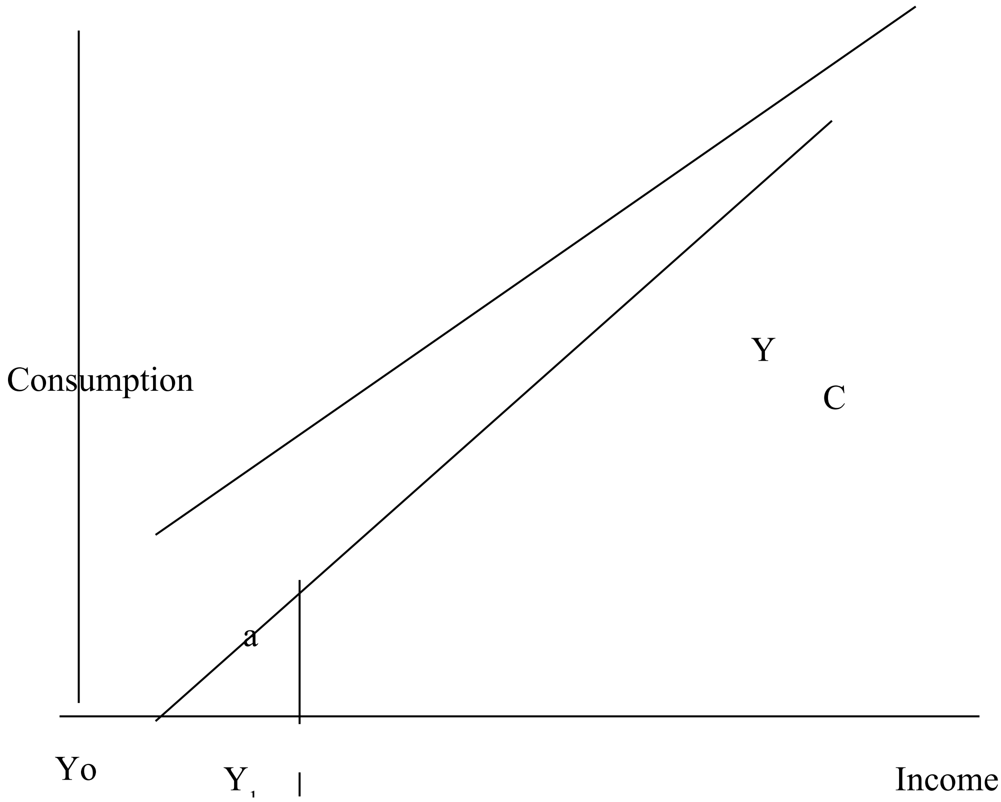

Fig. 5.2: Consumption Function with a Constant

Figure 5.2 shows a consumption function with an intercept of a and slope of C. when income goes from Yo to Y_1, MPC is $\frac{\Delta c}{\Delta Y}$

It means, mathematically, that C is the slope of the line, and economically, it refers to extent of the change in consumption with respect to a change in income. According to Keynes, it is called marginal propensity to consume (MPC). It shows what proportion of a change in income will be consumed. Thus: $\frac{\Delta \mathbf{c}\ \{dc\}}{\Delta \mathbf{Y}\ \{dy)} = MPC$

Keynes posited that the MPC should be positive, but less than 1, which means that some portion of additional income will be spent, not all of it, and it follows that consumption cannot be unaffected by a change in income.

Since we have assumed a linear relationship, it means that MPC is constant (the slope of the straight line is always a constant), and thus assumed that whatever the level of income of the households, any change from the level will be divided up into consumption and saving in the same fixed proportions.

Furthermore, the marginal propensity to consume (MPC) relates to changes in consumption induced by changes in income. In order to discover what proportion of a given of income is devoted to consumption, another concept called the average propensity to consume (APC) is needed. The average propensity to consume can be written as C/Y.

SELF ASSESSMENT EXERCISE 3

With appropriate diagram, discuss consumption function with autonomous constant.

3.1.4 Determinants of Consumption

There are many variables or factors that exert strong influence on consumption. These factors include:

1. Change in Income Distribution

If the income is skewed towards the rich, there will be more consumption of luxury goods, such as cars, jets, etc. while if the distribution of income is skewed towards the poor, then there will be more consumption of necessity goods such as food and clothes.

2. Changes in Terms of Credit

Anything that changes the cost and availability of credit temporarily, shift the consumption function and thus affect aggregate demand.

3. Changes in Existing Stock of Durable Goods

These changes are more volatile and can cause a sharp shift in the consumption function.

4. Changes in Wealth

If wealth comes unexpectedly, households will increase their savings and vice versa.

5. Changes in Price Level

As prices of commodities increase (as commodities are more expensive), consumption reduces and vice versa.

SELF ASSESSMENT EXERCISE 4

Identify and explain the various factors that influence consumption.

3.2 Savings

3.2.1 Meaning of Savings

Savings is defined as that part of all disposable income that is not consumed. Saving arises from the fact that it is not all incomes generated that is consumed. The portion of the total income in the economy that is not consumed normally goes into savings.

Basically, households in the economy decide how much to consume and how much to save. The households take the decision on how to divide their disposable income between consumption and saving. It follows that, once we can determine the dependence of consumption on disposable income, we can also know the dependence of saving on disposable income.

Two saving concepts are exactly parallel to the consumption concepts of APC and MPC. The average propensity to save, APS is the proportion of disposable income that households want to save. It is derived from diving total desired saving by total disposable income:

$$APC = DS/DYd.$$

The marginal propensity to save is the change in saving as a result of change in disposable income of the households.
Since income is either spent or saved, it follows that the fractions of income consumed and saved must account for all income; that is,

$$APC + APS = 1.$$

It also follows that the fraction of any increment to income consumed and saved must account for the increment. That is,

$$(MPC + MPS) = 1$$

Assuming MPC is 4/5 the MPS must be 1/5; the two together making 1.

SELF ASSESSMENT EXERCISE 5

Discuss saving in relation to APC, APS, MPS, and MPC.

3.2.2 Determinant of Savings

There are many variables or factors that exert strong influence on savings. These factors include:

1. Size of Income

Income is the major determinant of savings. The higher the income, the more one saves and vice versa. This is the more reason why high income earners save more than low income earners.

2. Rate of Interest

Classical economists consider that in order to induce people to forgo the present for future enjoyment, compensation in the form of interest has to be paid. The higher the rate of interest, the more people would save.

3. Psychological Attitudes

Some societies are by nature more thrifty than others, providing against sickness, unemployment, old age, and for education of dependants. Certain people save beyond these needs; either it gives them a feeling of power, independence or security or because they want to leave something to an heir.

4. Social Environment

Besides influencing the general attitude to saving, the environment can be a major factor in other ways. In an urban area example, there are a lot of banks, saving institutions, etc. such institutions usually campaign and advertise their products extensively. In rural areas, saving is very low because banks and saving institutions are not very much available.

5. Government Policy

The government can influence people's saving in a variety of ways. Some countries have compulsory saving schemes where people, especially workers, are forced to keep some portion of their income for the rainy day. In some other countries, the government tries to stimulate personal savings through the rate of interest, propaganda, income tax concessions as well as other special devices like savings certificates and premium bonds.

SELF ASSESSMENT EXERCISE 6

Identify and explain the various factors that influence savings.

3.3 Investment

3.3.1 Meaning of Investment

Investment is regarded as the expenses made on the production of goods for future consumption. It simply involves the act of producing goods that are not for immediate consumption; such as capital goods, inventory and residential housing. Investment expenditure, therefore, means expenditure on capital goods.

Investment expenditure is also a component of the national income, which has to be considered when determining the equilibrium national income. It has a short run and long run effect on the national income. In the short run, the important effect of investment is on aggregate expenditure, and by implication, on the degree to which existing recourses are employed.

By extension, it has an influence on the national income in the economy. In the long run, the decisive effect of investment on national income is through its effects on the capital stock, and hence, on the size of potential growth of the national income.

SELF ASSESSMENT EXERCISE 7

Explain the term investment.

3.3.2 Determinants of Investment

There are a number of factors that determine the level of investment in any economy. The most important ones among them are:

1. The Price and Productivity of Capital Goods

Cheap capital goods with high productivity will result in a high rate of investment and vice versa.

2. Business Expectations

These are the attitudes, beliefs or states of mind of people about the nature of economic events. Expectations are often crucial in determining economic behaviour. A firm or an investor may select a price level of output or investment alternative based on what the future of economic events is anticipated to be.

3. Development of New Techniques and New Products

The higher and the more sophisticated the techniques of production are the more the level of investment and vice versa.

4. Availability of Profits for Re-Investment

When the net profit is high, there is the possibility or re-investment by investors; but when the net profit is low, the level of re-investment by investors may be low.

5. Government Policy

Fiscal policies such as taxation, ranging from personal income tax and profit tax, to tariffs, shape the direction of investment. So also does the monetary policy such as preferential credit scheme, liquidity ratio, etc.

6. Level of National Income

It is expected that the higher the level of national income, the higher will be the level of investment in the economy.

7. Rate of Interest

The lower the rate of interest, the greater the number of investment opportunities that would be profitable and, therefore, the greater the investment expenditure firms wish to make, and vice versa. Let us dwell for a moment on investment by firms, which constitutes the largest single source of investment expenditure.

8. Level of Profits

Profits constitute the basic motive to the investment decisions of private sector firms. Firms spend money on new investment where they expect the investment to yield reasonable of profits over the cost of investment. The forces that affect these expectations determine the amount of desired investment expenditure in the economy as a whole. Such factors include the following:

a) The price and productivity of capital goods.
b) Expectations about the future demand for the output of capital goods and about the cost of producing those goods.
c) The development of new techniques of production and of new products.
d) Profits earned by firms and which are available for re-investment.

e) The rate of interest, the lower the rate of interest, the greater the number of investment opportunities that would be profitable and, therefore, the greater the investment expenditure firms would wish to make.

SELF ASSESSMENT EXERCISE 8

Identify and explain the determinants of investment.

4.0 CONCLUSION

From the foregoing discussion, you have observed that aggregate level of consumption has the potential effect of causing shifts in autonomous expenditure on equilibrium national income in the economy. You also understand that in a simple two-sector model, consumption is the only expenditure flow that is induced. The discussion also points out that saving arises from the fact that it is not all income generated that is consumed. The portion of income not consumed is saved, and this gives rise to the concept of investment.

5.0 SUMMARY

In this unit, three related macroeconomic variables of consumption, saving and investment have been discussed. Also, the meaning of consumption, consumption function and determinants of consumption have been discussed. In addition, the meaning and determinants of saving are also discussed. Lastly, the meaning and determinants of investment are explained.

The next study unit discusses multiplier, accelerator and aggregate level of employment

6.0 TUTOR-MARKED ASSIGNMENT

1. Differentiate between consumption, saving and investment.
2. Identify and explain the determinants of consumption and investment.

7.0 REFERENCES/FURTHER READINGS

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MODULE 2

UNIT 1 MULTIPLIER, ACCELERATOR AND AGGREGATE LEVEL OF EMPLOYMENT

CONTENTS

1.0 INTRODUCTION

In the preceding unit, you have been exposed to the discussion on consumption, saving and investment as they affect the economy in a given country. Multiplier and accelerator are also macroeconomic variables that also affect the operations of the economy in any country.

The concept of the multiplier assumed a front burner in the 1930s when John Maynard Keynes, the eminent economist, posited that it should be employed as a tool to help governments to achieve full employment. The multiplier per se arises as a result of change in the aggregate income, consumption and investment in the economy. A related macroeconomic variable is the accelerator theory which relates investment to change in aggregate income and by extension, a change in aggregate demand in the economy. Hence, the multiplier process and the accelerator theory are the subjects of discussion in this unit.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- explain the multiplier effect
- identify and discuss factors affecting size of multiplier
- discuss the accelerator principle
- identify and explain limitations to accelerator principle.

3.1 Multiplier Principle

3.1.1 Multiplier Effect

The multiplier as an economic tool is regarded as macroeconomic "demand-management approach"which measures the amount of government spending needed to reach a level of national income that would prevent unemployment in the economy.

The higher is the propensity to consume domestically produced goods and services, the higher is the multiplier effect. An initial change in aggregate demand can have a much greater final impact on the level of equilibrium national income. This is commonly known as the multiplier effect. It comes about because injections of demand into the circular flow of income stimulate further rounds of spending. In other words, one consumer's spending becomes another's income. This leads to a much bigger effect on equilibrium output and the aggregate level of employment in the economy.

For instance, an investment of N300 million in business capital is capable of creating a new production plant in the country. This will set off a chain reaction of increases in expenditures. Firms that produce the capital goods that are purchased will experience an increase I their incomes and profits. Assuming they in turn, collectively spend about three fifth of that income, then N180 million will be added to the incomes of others.

Hence at this stage, total income has grown by N300 million + (0.6 x N300 million), thus giving the total of N480 million. The sum will continue as the producers of additional goods and services realize an increase in their incomes, of which they in turn spend 60% on even more goods and services.

The increase in total income will be N300 million + (0.6 x N300 million) + (0.6 x N180 million), which amounts to N588 million. The increase in the total income will continue indefinitely. Nevertheless, the additional rise in spending and income is a fraction of the previous addition to the circular flow.

Fundamentally, therefore, multiplier effects can be seen when new investment and jobs attracted into a particular town, city or region of a country. The increase in output and employment can be far greater than the initial injection of demand because of the interrelationships within the circular flow of income.

The overall effect is that the aggregate level of employment in the economy will be affected positively since more jobs are bound to be created as a result of the increase in the level of investment in the economy. In essence, more jobs will be created from the new investment occasioned by the increase in the aggregate demand for goods and services, which arises from the increase in aggregate income in the economy.

SELF ASSESSMENT EXERCISE 1

Explain the multiplier effect in the economy.

3.1.2 Factors Affecting Size of Multiplier

The government can influence the size of the multiplier through changes in direct taxes. For instance, a cut in the basic rate of income tax will increase the amount of extra income that can be spent on further goods and services.

Another factor affecting the size of the multiplier affect is the prosperity to purchase imported goods. For instance, if out of extra income people spend money on imported goods; this demand is not passed on in the form of extra spending on domestically output. It leaks away from the circular of income and spending.

The multiplier process also requires that there is sufficient spare productive capacity in the economy for extra output to be produced. If short-run aggregate supply is inelastic, the full multiplier effect is unlikely to occur, because increases in aggregate demand will lead to higher prices rather than a full increase in real national output. In contrast, when short-run aggregate supply is perfectly elastic a rise in aggregate demand causes a large increase in national output.

Empirical evidence has shown that the construction sector of the economy as a result of its multiplier effect is capable of dividing a tremendous magnitude of economic growth and job creation. In essence, there is compelling evidence on the multiplier effects of major capital investment projects in various economies around the world.

A major characteristic of the construction activity is the fact that it feeds through to many other related businesses. Fundamentally, construction operation has an "awkward linkages" into the likes of building materials such as steel, architectural services, legal services and insurance.

Most of the construction linkages tend to result in jobs. This makes a boom in construction peculiarly powerful in fuelling expansion in the economy. For example, for a given rise in building orders, the multiplier effect may be well over two. The implication is that every building job created will generate at least two others in related areas and in downstream activities such as retailing, which benefits when building workers spend their wages. Other industries particularly those where much of the output value comes in the form of imported components, might have a less multiplier effects arising from the new projects.

SELF ASSESSMENT EXERCISE 2

Identify and discuss factors affecting the size of multiplier.

3.2 Accelerator Principle

3.2.1 Accelerator Effect

The accelerator principle holds that a planned capital investment by private sector businesses is usually linked to the growth demand for goods and services in the economy. For instance, when consumer demand is rising strongly, businesses may increase investment to expand their production capacity and meet extra demand. This is the accelerator effect.

The accelerator effect in the form of increase in capital investment and expansion in production capacity has overall effect of creating more jobs in the economy. In essence, more jobs will be created from the new investment in production operations of the private sector companies.

Fundamentally, therefore, the accelerator principle is also a "demand-management" macroeconomic variable which is used to explain the relationship between investment and change in demand arising from a change in income of the consumers. The increase in aggregate demand for goods and services occasioned by an increase in the aggregate income of the consumers usually triggers off change in investment towards coping with the resultant increase in demand for goods and services.

According to the theory, therefore, investment is related to change in national income which results in change for more goods and services. Hence when national income is increasing it is necessary for businesses to invest more in production facilities in order to increase their capacity to produce consumer goods to meet increased consumer demand. This is aptly illustrated in Fig 6.1.

Fig 6.1. The Accelerator Principle (Consumer Demand and Capital Stock)

Year	**Annual sale**	**Change in sale**	**Required stock of capital K/Q is 5:1**	**Net investment, increase in the required capital stock**
1	10	0	50	0
2	10	0	50	0
3	11	1	55	5
4	13	2	65	10
5	16	3	80	15
6	19	3	95	15
7	22	3	110	15
8	24	2	120	10
9	25	1	125	5
10	25	0	125	0

As we can see in table 6.1 when change in sales is constant, change in investment is also constant with fixed K/Q. net investment occurs only when it is necessary to increase the stock of capital in order to change output.

It is expected that when national income in the economy is failing, there will be no incentive for the businesses to invest in order to replace old capital productive facilities as they wear out. There will also be no incentive for any investment in new (capital) productive facilities by prospective investors.

Basically, the accelerator effect ca work in the reverse direction, which can also affect the aggregate level of employment negatively. For instance, a slow down in consumer demand can create excess production capacity and may lead to a fall in planned investment.

Capital investment in a certain sector of the economy can slow down as a result of economic downturn, which spells a vast amount of spare production capacity. This is an under-utilisation of productive resources resulting from economic downturn. The downturn (economic) situation will lead to a sharp fall in capital investment spending.

The implication for the economy is that there will be loss of jobs; as a result of retrenchment of workers across the firms operating in the industry. Hence, as the accelerator mechanism working in reverse direction, there will be reduction in the aggregate level of employment; an unemployment situation in the economy.

The above economic scenario requires the intervention of the government in terms of taking ameliorative measures which can ensure positive accelerator effect; thus reversing the unemployment situation and enhancing the aggregate level of employment in the economy.

SELF ASSESSMENT EXERCISE 3

1. Explain the accelerator principle.
2. Explain how the accelerator effect can work in reverse direction.

3.2.2 Limitations of the Accelerator Principle

There are some limitations inherent in the accelerator mechanism. These are as follows:

(i) An increase in sales may be expected to be temporary. To this effect, new investment may not take place since overtime work or extra shifts would lead to expansion in the level of output. And this may not be desirable for the firms.

(ii) The accelerator principle does not provide for the fact that investment at any point in time can be restricted by a change in the capital invested. This negates the principle.

(iii) The definition of investment by the accelerator principle emphasizes capital widening, but is silent on capital deepening as it assumes capital-output ratio to be fixed.

(iv) The accelerator principle can work in the reverse direction, which negates its desirability in the economy since such situation leads to loss of jobs and thus increase in the unemployment level.

(v) There can be increase I the demand for certain goods and services of which the industry may not be willing to increase their investment in order to exploit the consumers. This negates the principle of accelerator effect.

SELF ASSESSMENT EXERCISE 4

Identify and discuss the limitations of accelerator principle.

4.0 CONCLUSION

Multiplier and accelerator are macroeconomic variables that affect the operations of the industries in the economy given an increase in the demand for goods and services as a resulting of increase in aggregate level of income.

Essentially, therefore, both multiplier and accelerator are macroeconomic demand-management variables which are amenable for use in propping up investment capacity of the industries in the face of an increase in the aggregate level of income in the economy. The purpose is to enhance consumer spending and subsequently the level of productive capacity of industries and the overall aggregate level of employment in the economy.

5.0 SUMMARY

This unit has been used to discuss important macroeconomic demand-management variables. Therefore, the multiplier mechanism in terms of its process and effect on the economy has been discussed in this unit. In addition, accelerator principle as the twin macroeconomic demand-management variable has also been discussed in this unit. The discussion examined the process of the accelerator mechanism and its inherent limitations. The next study unit is used to discuss inflation and deflation as well as a related term of stagflation.

6.0 TUTOR-MARKED ASSIGNMENT

1. Differentiate between multiplier and accelerator.
2. Mention and explain the limitations of the accelerator mechanism.

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UNIT 2 INFLATION AND DEFLATION

CONTENTS

1.0 INTRODUCTION

Inflation which today continues to confront policy-makers throughout the world in the form of dominant economic problem is as a result of rising prices. Throughout the ancient period, the civilized world frequently experienced higher prices in terms of metallic currency due to the discoveries of new mines and the improved methods of mining gold. The metallic inflation which followed the discovery of America constituted one of the most important instances of inflation in history. Hyperinflation in Germany in 1923 with its devastating effects is also an important instance of inflation in economic history.

This study unit discusses the nature, types and effects of inflation. This unit also discusses deflation as opposite scenario to inflation as well as stagflation.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- explain the meaning and nature of inflation
- identify and explain various types of inflation
- mention and discuss the effects of inflation

- identify and explain appropriate measures for controlling inflation
- explain the meaning of stagflation and deflation.

3.1 Inflation

3.1.1 Meaning of Inflation

A simple understanding of inflation is that it is a condition which produces a rising trend in the general price level in the economy. Nevertheless, inflation may be present in the economy if the sustained price rise, which would have otherwise occurred, is prevented from occurring by imposing various price and physical controls in the economy. Such a situation is called 'suppressed inflation.

According to the Chamber's Twentieth Century Dictionary, inflation is an undue increase in the quantity of money in proportion to buying power, it is an excessive issue of fiduciary money. Gardner Ackley has defined inflation "as a persistent and appreciable rise in the general level or average of prices." According to this definition, a sporadic price spurt or an imperceptible rise in prices will not be inflation. Elaborating further, Ackley has stated, "We define inflation as rising prices, not as 'high' prices. In some sense, then inflation is a disequilibrium state; it must be analyzed dynamically rather than with the tools of statistics." According to Crowther, inflation is a state in which the value of money is falling, i.e., prices are rising.

According to Pigou, inflation exists "when money income is expanding relatively to the output of work done by the productive agents for whom it is the payment." In general, inflation may, therefore, be defined as a sustained rise in the general level of prices brought about by high rates of expansions in aggregate money supply. Nevertheless, in contemporary discussions of inflation it is defined as a sustained rise in the general level of prices, however generated. All these definitions have a common feature stressing the point that inflation is a process of rising prices, and not a state of high prices, showing a state of disequilibrium between the aggregate supply and the aggregate demand at the existing or current prices, necessitating a rise in the general price level.

According to the market laws of supply and demand, an increase in prices per se should not be inflationary. Indeed, if anything, it should be anti-inflationary because consequent upon a given price rise, the total amount of goods and services demanded should decrease while the amount supplied should increase. This must be so unless the aggregate demand and aggregate supply functions are perfectly inelastic.

Inflation can arise in the economy on account of the increase in the money incomes of certain sections of the community without any corresponding increase in their productivity giving rise to an increase in the aggregate demand for goods and services which cannot be met at current prices by the total available supply of goods and services in the economy.

SELF ASSESSMENT EXERCISE 1

Explain the term inflation.

3.1.2 Nature of Inflation

A sustained rise in prices of about 2 per cent per year may be called "creeping" inflation, to distinguish it from "galloping" (or "hyper") inflation, which occurs when monthly price rise is of the order of 50 or 60 per cent or more, and from "trotting" inflation in which the price rise occurs at intermediate rates. The basic characteristic of creeping inflation is that the annual price rise is almost imperceptible so as to be lost sight of by casual observers. Any complacency in controlling the creeping inflation is likely to prove disastrous for the economic and political stability of the economy because creeping inflation must eventually accelerate through the trotting stage until it is galloping at ever faster rate, culminating in the complete collapse of the currency and the consequent disruption of the political and economic life of the country.

Such a hyperinflation in which, due to the astronomical rise in the prices of goods and services, money becomes almost worthless causing unbelievable hardships to people, had been witnessed in Germany in 1923, in Hungary in 1947, and in China in 1949. In hyperinflation it becomes undesirable to hold money for even the precautionary or speculative purposes as real capital losses as cash holdings become prohibitive.

For a milder sustained price rise, economists have used the terms walking inflation and running inflation. In the case of walking inflation, a sustained price rise may be around 8-10 per tent per year. For higher two-digit sustained annual price rise, the term 'running inflation' may be used. Thus, it is the rate of price rise that justifies our calling a particular situation as one of creeping, walking, running or of hyperinflation and sometimes there may be a good deal of overlapping between these terms depending upon the rate of price rise adopted for purposes of classification.

In hyperinflation the price increase is so rapid which shows that the annual rate of price rise is almost infinite, showing that there is almost no limit to price rise. In hyperinflation when, due to almost astronomical price increases, money becomes worthless, people revert back to barter or adopt some other country's money unit whose value is relatively stable to express deferred payment contracts. This happened in Germany when deferred payment contracts were expressed in American dollar instead of the German Mark which had become worthless.

The climax of hyperinflation is reached when the flight from currency becomes so fantastically high that the velocity of money in circulation approaches infinity. In the case of running inflation, the increase in prices is relatively mild although it is quite high compared to that under walking and creeping inflations. The price rise is least in creeping inflation as the slope of the curve is gentle.

We have associated inflation with a situation of sustained rising prices. It is not, however, the only meaning which has been given to inflation in the past. For the quantity theorist, for instance, inflation was synonymous with an increase in the quantity of money which, on the assumption of given velocity and transactions, caused a rise in the general level of prices. This means that a rise in prices is the effect of inflation and not inflation itself.

In a closed economy with low inventories and absence of institutional barriers to price rise, the excess of aggregate demand over aggregate supply would certainly cause rise in prices. It is, however, the excess demand which would be inflation and the rise in prices would merely be the symptom indicating its existence. However, excess demand need not necessarily lead to a rise in prices.

In an open economy it can be satisfied by increasing the imports with the result that so long as it is possible to finance a balance-of-trade deficit the price level will not rise even in the face of an excess demand phenomenon in the economy. Furthermore, a sustained price rise can be occasioned by factors other than excess demand at full employment and it would be wrong to refuse to call such price rise inflation on the ground that this has not been caused by excess demand.

SELF ASSESSMENT EXERCISE 2

Explain the following terms:

1. Creeping Inflation
2. Running Inflation
3. Hyper Inflation

3.1.3 Types of Inflation

1. Open and Suppressed Inflation

Inflation in an economy can be regarded as open or suppressed. Inflation is open when there is no barrier to price rise and it exists in the economy in the absence of government control on price rise. According to Milton Friedman, open inflation is an "inflationary process in which prices are permitted to rise without being suppressed by government price control or similar techniques." The post-war hyperinflations during the 'twenties' of the present century in Germany, Austria and Russia or in China in the 'forties' are cases in point.

On the other hand, suppressed inflation exists in the economy in those conditions in which consequent upon adopting policies of effective price control and rationing of essential goods by the state, price increases are suppressed. However, the prices so controlled rise with vengeance on the removal of these controls. In suppressed inflation the symptoms of open inflation—rising prices—are replaced by long queues of buyers waiting for their turn at government-run fair price and rationing shops and by other forms of non-price rationing while the economy continues to be afflicted with an inflationary problem.

Indeed, the economy is likely to suffer with greater affliction under suppressed inflation than under open inflation since: (i) the equilibrating effects of rising prices are eliminated in suppressed inflation, and (ii) expectations of future commodity shortages are more likely than are expectations of rising prices to increase the excess demand.

War-time government controls on commodity prices are examples of suppressed inflation while post-war inflations which emerge on the removal of price controls are examples of suppressed inflation, which develops into an open inflation with vengeance.

The word 'suppressed' connotes postponement of present demand to future and diversion of the demand from one good to another—from those goods whose prices are controlled and whose demand is rationed to those whose prices are not controlled and whose demand is not restricted through rationing.

Suppressed inflation suffers from many evils. Firstly, it creates many difficult administrative problems. A hierarchy of price controllers, supply and rationing officers with their many assistants, whose job it is to administer controlled prices and supervise the distribution of rationed goods, comes into existence. This raises the difficult problem of having an efficient, alert and free-from-corruption price control and rationing administrative set-up.

Experience of actual working of the price control and rationing schemes in the advanced countries like England, particularly during the period of war, and some of the underdeveloped countries like Nigeria shows that the rationing and price control administration is inefficient and easily corruptible. Nearer home is the unhappy experience of our own country in the 1980s where consumers were subjected to innumerable hardships due to the conspiracy between the price control administration and the hoarders selling controlled-price scarce consumer goods at black-market high prices, both becoming rich at the expense of the poor consumers.

Most times, black market develops through which controlled price goods are sold and the authorities become parties to the lucrative illegal activities of the black-marketeers. The authority being a party to the profitable activities of the black-marketeers, there soon develops a hidden price inflation, which is more dangerous than the open inflation, underneath the suppressed inflation.

It is, therefore, obvious that in the hands of corrupt and inefficient price control and rationing administration, manned by bureaucrats having little or no business acumen, suppressed inflation erupts after some time into severe open inflation. The appearance of black market in the economy is a cumulative process; once it appears it feeds upon itself. The existence of such a market gives rise to two parallel modes of transacting business— one in the legal manner in the open market and the other in an illegal manner in the black-market, the latter becoming more important than the former.

Empirical evidence indicates that excess purchasing power then causes a violent price inflation in the black markets, while the legal markets are drained of merchandise. Once the population finds that it cannot even buy its modest rations, black market operations become the preoccupation of everybody. Where one such black market transaction earns more money than a week's or a month's hard work, productivity will decline."^ Black markets and low public morale are the by-products of suppressed inflation.

Suppressed inflation also diverts economy's scarce productive resources away from the essential goods producing industries whose prices are statutorily fixed towards those industries which produce relatively non-essential goods whose production becomes more profitable since the prices of such goods are free to rise. The diversion of community's scarce resources away from the production of essential goods towards the production of relatively non-essential goods runs counter to the optimum-use theory of community's scarce resources causing diminution in community's total welfare. In short, scarce resources are not optimally allocated leaving much to be desired from optimum community welfare point of view.

According to Milton Friedman, suppressed inflation is worse than open inflation. Taking the post-war Germany for his illustration, Friedman has pointed out that in Germany after World War II prices were not allowed to rise although by usual standards there existed a substantial inflationary potential. If prices had been allowed to rise freely immediately after the war, the price level would have probably quadrupled which by any standard would be a large price rise. The price rise was, however, suppressed.

Ordinarily, it is extremely difficult to suppress a price-rise of this magnitude and to enforce price control when the free market price would be four times the controlled price. But there were certain especially favourable circumstances in Germany in the post-war period from the point of view of enforcing price control. Germany was at this time occupied by the armed forces of France, Britain, and USA. The occupation forces effectively enforced price control. As a consequence of the strict enforcement of price control, output in Germany was halved. The price system was prevented from functioning and people reverted to barter.

During such period people worked for two or three days in a week producing aluminum pots and saucepans in factories and spent the rest of the weekdays selling these saucepans, which they had been given as their pay by the factory owners, to the country-side farmers in exchange for potatoes or some other farm produce. Being a very inefficient mode of organizing resources people tried to change it by developing their own forms of money. Cigarettes began to be used as money for small transactions while cognac was used as money to conduct large transactions. Not withstanding this expedient, the output was halved compared to the output immediately at the end of the war due to suppressed inflation.

The reason for the so much disastrous nature of suppressed inflation is explained by the fact that price system is the only technique which has so far been discovered or invented for efficiently allocating the .resources between different competing uses and unfortunately the price system is prevented from operating. The clumsy physical controls which are substituted to replace the price system fail miserably to serve the function of an efficient allocator of scarce resources in the economic system.

SELF ASSESSMENT EXERCISE 3

Differentiate between open inflation and suppressed inflation.

2. Demand-Pull Inflation

This type of inflation, which is also known as excess demand inflation, occurs when aggregate demand exceeds aggregate output in the economy. Since quantity of goods produced cannot cope with aggregate demand in the economy, there will be general rise in the price level.

According to classical economic analysis, the price level depended directly and proportionately on the supply of money. Inflation, according to the classicists, occurs when the quantity of money increases and comes to a halt when the quantity of money becomes stable. The rate of inflation will depend upon the rate at which new money is created. This is the quantity theorist's explanation of the inflationary process.

Keynes's analysis of the excess-demand inflation assumes aggregate demand to exceed the aggregate supply at full employment level. Starting with the situation of full employment equilibrium, if investment demand increases then the aggregate demand for goods and services will exceed their aggregate supply at full employment level assuming a given level of prices at constant prices. This is the situation of disequilibrium which can be corrected only either through increase in the prices or through increase in the aggregate real output or through increase in both the prices and output. But since under our assumption the economy is already operating at full-employment no increase in aggregate output is possible.

Consequently, prices will rise sufficiently so as to bring about equilibrium between aggregate demand and aggregate supply. Since consumer demand is a function of real income, the excess demand will persist because the rise in prices raises people's money incomes as result of which the real income remains unchanged. Keynes severed the close relationship between the quantity of money and the level of aggregate demand by showing that even with constant money supply some inflation may be experienced. With the total quantity of money held constant, an increase in prices occasioned by increased aggregate demand would raise the transaction demand for cash balances.

3. Cost-Push Inflation

The cost-push inflation occurs due to the increase in the cost of supply price of goods, caused by increases in the input costs. According to this explanation, rapidly rising wage levels, unaccompanied by corresponding increase in labour productivity in certain key sectors of the economy become reflected in higher prices in these same sectors, particularly as demand recovers.

Consequent upon the above situation, the purchasing power of wages becomes eroded causing organized labour, including trade unions not involved in the initial round of wage increases, to seek redress in the form of further wage increases through their collective bargaining strength. The most common political expression of this view is based on the plea that monopolistic trade unions cause inflation by bidding up wages through exercising their superior collective bargaining power.

Stated in terms of the aggregate demand and aggregate supply functions, the cost-push inflation emerges in the economy, in the absence of excess demand, due to the pressure of various factors which shift the aggregate supply function upwards.

The two main factors responsible for the upward shift in the production costs are: (i) the higher money wages secured for their members by the labour unions without any corresponding increase in their productivity, and (ii) the higher prices charged from consumers by the monopolistic and oligopolistic producers. The upward shift in the aggregate supply function and the resulting rise in the general price level due to the first factor is designated as the 'wage-push' inflation to distinguish it from the 'profit push' inflation resulting from the operation of the second factor in the economy.

Generally speaking, the cost-push inflation in the economy occurs as a result of the combination of both the wage-push and the profit-push factors. According to those who hold that prices are pushed up by rising costs rather than by the demand-pull forces, some control in the form of prices and incomes policy is necessary to bring the spiral of rising prices to halt.

Both the demand-pull and the cost-push explanations of inflation are closely linked with the now widely held view that the problem of inflation is more sociological than economic in nature. In recent years, workers' and consumers' expectations have risen considerably far beyond the scope of existing productive capacity to meet their demands. A mounting stream of government transfer payments and increased government involvement have largely contributed to increased consumption directed to sap both individual initiative and the ability and incentive of the private enterprise sector to undertake the needed commitments to modernize and expand the economy's productive capacities.

SELF ASSESSMENT EXERCISE 4

Differentiate between cost-push inflation and demand-pull inflation.

4. Internationally Generated Inflation

It has been frequently argued by governments that inflation is not generated domestically but is rather an international phenomenon beyond their control. This view of inflation seeks to ascribe the price rise to international forces. Some economists believe that this type of inflation creeps into other countries as a result of global trade.

For instance, as a result sudden and perceptible rise in petroleum and petroleum-based products' prices in recent times, many countries have experienced inflation that can be ascribed to international price pressures. While it is true that international forces may contribute to inflationary pressures in any economy, particularly in an economy which is highly dependent on the outside world, at the same time it cannot be denied that inflationary pressures in the economy are chiefly fed by domestic factors.

5. Ratchet Inflation

Ratchet inflation emerges in the economy when although the aggregate demand is not excessive, it is so distributed in the economy that it is excessive in certain sectors of the economy and inadequate in others. In an economy with perfectly flexible wages and prices, prices would rise in those sectors where the demand was excessive and fall in those others where the demand was inadequate, keeping the general level of prices unchanged. However, due to price "administration" by strong trade unions and oligopoly industries prices tend to be rigid in downward direction. Thus while prices in the excess demand sectors rise, these do not fall in the deficient demand sectors. The net effect is a rise in the overall price level. Excess demand bids up prices while the administered wages and prices provide the ratchet preventing compensating fall in the prices elsewhere in the economy.

The ratchet process can be understood by assuming that an economy is composed of the 'light' industry and 'heavy' industry sectors. Let us assume that initially the demand in each industry is equal to the full potential output of each industry. Now suppose that a shift in the demand away from light industry to heavy industry takes place. Consequent upon this shift in the intersectional demand, prices in the heavy industry, where the demand is excessive, will rise while prices in the light industry where the demand has fallen will not register any fall due to downward price-rigidity. Consequently, the aggregate price level in the economy will be bidden up.

6. Mark-up Inflation

Holzman, Duesenberry, Ackley and some other economists have ascribed inflation to the practice of business corporations to compute costs and then add to these costs a certain mark-up to yield a given "target return" on the invested capital or sales. Mark-up pricing is a type of administered price-fixing, which as explained by some economists, leads to inflation.

According to Ackley, the mark-up approach "places the emphasis where unions and businessmen place it, not on the level of prices per se, nor on supply and demand, but on the preservation of 'fair' relationship between buying prices (including the cost of living), and selling prices including, wage rates." In Ackley's view, when demand is higher the mark-up tends to be higher, about equal to cost increases, and less (but not too much) when demand is low and costs are high. An important point made by mark-up inflation theorists is that what is important is the process by which increases in prices and wages occur and not where the increases in prices initially occurred.

SELF ASSESSMENT EXERCISE 5

Differentiate between Ratchet inflation and Mark-up inflation.

3.1.4 Effects of Inflation

Many aspects of our everyday activities are in many ways influenced by the level of and changes in the rate of inflation. Consumers' real disposable personal incomes and consequently their spending capacity are significantly affected by changes in wages and prices. During periods of mild inflation consumers sometimes react by cutting their spending on luxury and other non-essential goods while in times of severe inflation substantial anticipatory buying or hoarding becomes a common feature as people shift from financial to real assets.

The business sector is also affected by inflation. During inflation, corporate and non- corporate profits rise sharply and businessmen react to rising prices by building up inventories. Inflation also affects the government sector in a number of ways. As prices rise, revenues yielded by indirect taxes also increase. Moreover, under a progressive direct tax system revenues from income taxes will rise at a faster rate than the growth rate of nominal incomes. Consequently, large transfer of resources from households to the government takes place.

Inflation not only affects the income and expenditure pattern of the major sectors of the economy but it also alters the existing pattern of distribution of wealth, making some groups better off relative to others. For example, debtors gain while creditors suffer. People dependent upon fixed incomes, such as pensioners, suffer most from inflation and their share of the national income inevitably declines unless they receive special assistance.

Inflation initially activates the economy. A business boom in its early stages causes only a modest rise in the cost of living of the people while it raises the level of employment in the economy. However, continuous inflation shakes the foundations of the political and economic stability of the system. It causes inequitable and arbitrary redistribution of income and wealth in society. The worst sufferers are the recipients of fixed incomes by way of salaries, pensions, and annuities. With respect to wealth, inflation inflicts losses on holders of government bonds, on holders of fixed deposits in banks, and on holders of life insurance policies and money.

To the holders of money, inflation adds to the cost of holding money as general price level in the economy rises. A continuous inflation can reduce the value of money to almost nothing, ruining the holders of money. Inflation wipes out savings completely. The social consequences of hyperinflation are no less terrifying than are its economic effects. Debtors liquidate their past debt obligations by offering worthless currency to their creditors. The value of accumulated cash savings evaporates. Hyperinflation replaces industry and thrift with hoarding and speculation.

Hyperinflation reaches its climax when the flight from money is such that the velocity of money approaches infinity. In Germany during the hyperinflation in 1920s life's entire savings could not buy even a cup of coffee. Consequently, periods of substantial inflation are characterized by low public morale.

SELF ASSESSMENT EXERCISE 6

Identify and explain the effects of inflation.

3.1.5 Control of Inflation

The phenomenon of inflation is frequently controlled by resorting to the instruments of monetary and fiscal policies. According to the classical quantity theory approach, demand inflation can be controlled by resorting to an appropriate monetary policy so as to halt expansion of the money supply.

According to the Keynesians, however, the monetary policy alone will not be able to check inflation. Consequently, it is suggested to apply the restrictive fiscal policy instruments of curtailing unproductive expenditure and widening and deepening the tax structure in the economy.

Since the cost-push inflation is largely caused by rising cost, supply inflation can be controlled by maintaining wage-rate stability by preventing those wage increases which are not related to the increase in labour's productivity.

A restrictive policy may check a wage-push inflation provided it reduces the aggregate demand and output sufficiently to create enough unemployment to prevent wage increases in excess of the increases in labour's productivity.

There is the 'deferred pay scheme' which was first suggested by Keynes. The amount credited to workers' saving accounts would remain blocked so long as inflation lasted and would be released when recession started. This scheme is a price stabilizing scheme as it aims to arrest both inflation and deflation.

The excess aggregate demand may also be controlled by introducing price control and compulsory rationing of essential goods in short supply. In a free society, these schemes are vehemently opposed by the people.

Used as anti-inflationary measures, the monetary and fiscal policies act as complimentary parts of anti-inflationary economic policy. Monetary policy which consists in controlling the supply and cost of money by the central bank is enforced by using different monetary instruments.

An important monetary policy instrument available to the central bank to curtail the supply of credit is the bulk sale of securities as part of its open market operations policy. The bulk sale of securities to the public and banking community by the central bank directly reduces the total amount of cash balances in public's asset portfolio and cash reserves with the commercial banks. The fall in the cash reserves of the banks forces them to reduce their total advances.

The indirect effect of open market sales of securities is seen in the rise of the interest rates. To the extent that investment is interest-elastic this will check excess investment activity and help in containing the inflationary pressures in the economy.

Raising the bank rate is another monetary policy instrument, which is used by the central bank to control inflation. Bank rate is central bank's lending rate which member banks must pay on their borrowings from the central bank against approved securities. A rise in the bank rate shows that central bank's monetary and credit policy is being directed toward credit squeeze to control inflationary forces in the economy.

The central bank can also restrain excessive credit expansion by the commercial banks as part of its anti-inflationary monetary policy by raising the minimum legal cash reserves required to be kept by the commercial banks with it. A rise in the minimum legal cash reserves ratio raises the total amount of cash balances which the bank must keep against their deposits with the central bank. This action will force the banks to curtail their total advances. The use of this power by the central bank forces the commercial banks to exercise greater caution in their lending activities and thus reinforces restrictive credit policy.

The central bank may resort to enforcing a policy of selective credit control. Selective credit control policy which takes the form of issuing directives to the commercial banks prohibiting them from lending against certain commodities or reducing the total credit limits sanctioned by the banks against certain commodities or in certain regions seeks to curb inflationary pressure in selected economic activities.

Devising a suitable tax policy directed toward restricting demand without discouraging production is a form of fiscal measure which can control inflation. Heavy excise duties on items of mass consumption which withdraw excess purchasing power from consumers without discouraging expansion of productive capacity provide a convenient method of restricting aggregate demand to aggregate available supply.

Postponing or curtailing government expenditure on unproductive public works will have a stabilizing effect in an inflationary period because such expenditure competes for resources with expenditure undertaken to expand productive capacity elsewhere in the economy. Unless the public works schemes add substantially to economy's productive capacity these should be deferred to be resumed in a period of slack activity and falling prices.

A judicious blending of monetary and fiscal policies requiring close cooperation between the central bank and the treasury can prove effective in controlling inflation in the economy if applied at proper time.

Wage-price freeze, temporarily during inflation, has also been suggested by some as a measure against inflation. To eliminate the distributional injustice inflicted by inflation it has been suggested to introduce cost of living escalation clause into all contracts. If wages, salaries, pensions, contracts, were subject to the price escalation clause, the distributional effect of inflation would be largely eliminated.

On a final note, it is sometimes argued that since the ultimate causes of inflation are political and sociological rather than economic in nature, it is in the political and social adjustments that answer to the inflation problem must be found. It must also be recognized that while many international and special influences may provide spur to inflationary pressures, in the final analysis inflation is a domestic problem in each country and it can be checked by means of responsible government economic policy, monetary and fiscal, as well as through special efforts aimed at expanding the productive capacity of the economy.

SELF ASSESSMENT EXERCISE 7

Identify and explain the various measures which can be used to control inflation.

3.2 Stagflation

The term 'stagflation' is a recent arrival in economic literature derived from joining together the 'stag' of stagnation and 'nation' of inflation. The term has been coined by economists to explain the recent paradoxical inflationary phenomenon in which sustained and substantial price increases have been accompanied by declining output and rising unemployment.

During the early 1970s most countries' governments were under strong political pressure to adopt expansionary programmes in order to reduce unemployment, and it seems likely that the eventual effect of the 1971 exchange rate realignment was to encourage a higher rate of output expansion associated with a higher rate of price increase than before 1971. The large and erratic changes that followed the abandonment of fixed exchange rates in 1973 acted as a check on the increase in real output by increasing uncertainty, and thus contributed to the unexpected severe downturn in 1975.

Restrictive financial policies adopted in order to curb the very rapid rates of inflation experienced in 1973 and early 1974 were associated with unusually severe declines in output and employment and with little or no fall in prices and wages. In short, substantial declines in output and employment coexisted with price and wage inflation in most world economies, particularly in the industrially advanced countries of the world. This situation was different from that of chronic inflation which was ubiquitous in developing countries during the 1950s and early 1960s.

SELF ASSESSMENT EXERCISE 8

Differentiate between inflation and stagflation.

3.3 Deflation

3.3.1 Meaning of Deflation

Deflation is regarded as a persistent downward movement of prices in general over a period of years. In other words, deflation may be defined as a state in which prices are falling, that is, the value of money is rising in the economy. Since deflation refers to the movement of prices, it is a monetary term.

Furthermore, since the downward movement in prices must be persistent, any sporadic decline in prices cannot be termed deflationary. Moreover, deflation is usually associated with falling economic activity and employment, nevertheless, the association is not rigid because it is possible to have depression without deflation.

3.3.2 Effects of Deflation

The presence of deflation in the economy is indicative of disequilibrium which has serious disturbing effects in the system. Apart from causing comprehensive changes in the total productive activity and consequently in the total output and employment in the economy, deflation causes an arbitrary redistribution of real income and wealth among various classes of people causing disharmony in society.

Falling prices force businessmen to reduce their inventories in the face of persistently sagging demand. Speculators rush to unload their holdings in order to "cash in" their paper profits. Wage earners cut-back their spending in order to save enough to fall back upon in period of unemployment which they foresee will soon engulf the economy. In course of time, a general "flight" from goods and other real property to money takes place, productive equipment grinds to a halt, factories are closed and workers are thrown out of employment.

Furthermore, businesses are liquidated and economy's entire productive structure is paralyzed. Not only does total output contract in period of deflation. Moreso, the fact that the shares in the gross national product going to different functional groups change haphazardly, it rewards some groups and punishing the others, regardless of the merits or demerits of the recipients.

The share of the GNP claimed by the workers—the active factor of production—declines both in relative and absolute terms on account of drastic fall in wages and employment. The rentier class claims a higher share in the total product since rent and interest remain relatively fixed.

Entrepreneurs suffer losses. The real burden of debt—public and private —increases. Like income, wealth is also arbitrarily redistributed in favour of the rich rentier class which receives more in real terms by way of repayment of principal sum and payment of interest, on old loans.

3.3.3 Deflationary Gap and its Control

Deflationary gap appears in the economy when total spending at the full employment level is insufficient to maintain that level of income. It can be defined as the amount by which total spending in the economy falls short of the full employment level of income at existing prices.

The existence of deflationary gap in the economy is of great significance since it can and does cause employment and income to fall in the economy. Deflationary gap implies that the leakages from the national income flow in the form of taxes (government's disposable income) and savings exceed the injections of investment and government spending.

A given amount of deflationary gap forces the national income to fall by more than the amount of the gap. This is, somehow, related to the fact that as income falls consumption also does as stated by the consumption function.

You have appreciated that basically the problem of deflation arises from the deficiency of the total spending which at full employment level of income is less than the level of that income. Consequently, to remove deflation economic policy measures should aim at raising the level of aggregate effective demand sufficiently so as to make it equal to the full employment level of national income.

Both the fiscal policy and monetary policy should be deployed for the purpose. Government spending should be raised while taxes should be reduced so as to raise peoples' total disposable income as a consequence of which aggregate consumption will increase.

Corporate and non-corporate business investment may be raised by providing various tax incentives while lowering the interest rates to be charged by banks on business loans. A massive public works programme aiming at increasing government spending without causing any adverse effects on private spending should be executed.

For instance, the 'New Deal' programme executed by the Roosevelt administration in the US to rid the American economy of the intractable depression of the 1930s shows that public works policy carefully planned and boldly executed can serve as an effective cure for deflation in the economy.

SELF ASSESSMENT EXERCISE 9

Mention the effects of and measures for controlling deflation.

4.0 CONCLUSION

From the foregoing analysis, you can understand the nature of inflation and its effects on the economy. You can also understand the various types of inflation and the appropriate measures which can be used to control inflation in any economy. Lastly you can also understand the meaning of deflation as well as stagflation and its variance with inflation.

5.0 SUMMARY

This study unit has been used to discuss the meaning and nature of inflation. In this unit, discussion is given to the various types of inflation and relevant measures which are necessary for controlling inflationary trend in any economy. The unit is also used to discuss the various effects of inflation in the economy. Lastly, the unit also explains the meaning of stagflation as well as deflation and its effects in the economy.

6.0 TUTOR-MARKED ASSIGNMENT

Identify and discuss various types of inflation.

7.0 REFERENCES/FURTHER READINGS

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UNIT 3 INTERNATIONAL FINANCIAL INSTITUTIONS

CONTENTS

1.0 INTRODUCTION

The aftermath of the World War II saw the setting up of a number of international institutions in the economic field such as the Food and Agriculture Organization, the International Bank for Reconstruction and Development, International Finance Corporation, International Development Association, etc. In the field of international trade, the effort was made for the adoption of the Charter for International Trade Organization at the Havana Conference on Trade and Employment.

In this unit, our discussion is centered on the analysis of the most prominent financial institutions established after the World War II to deal with economic and financial development of the world economy.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- explain the rational for the establishment of IBRD
- identify and explain the functions of IBRD
- discuss nature of membership, organization and lending operations of IBRD
- discuss the reasons for the establishment of IMF
- identify and explain ways through which IMF helps member countries.

3.1 The International Bank for Reconstruction and Development (IBRD)

3.1.1 Establishment of International Bank for Reconstruction and Development (IBRD)

The International Bank for Reconstruction and Development, popularly known as the World Bank, owes its birth to the deliberations of the United Nations Monetary and Financial Conference which met at Bretton Woods, New Hampshire, to prepare the final text of the Articles of Agreement of the International Monetary Fund and the International Bank for Reconstruction and Development from 1 .July to 22 July 1944. The World Bank was established on 25 December 1944 when the Articles of Agreement were ratified by the requisite number of member governments.

The global war had completely dislocated the multilateral trade and had caused massive destruction of life and property. The economies of England and other European countries had been completely shattered. While the need for promptly reconstructing the war-damaged economies of European countries was recognized, it was also recognized that a lasting world peace was threatened from the great disparities in incomes and wealth manifested in the wide differences in the standards of living between the developed and the underdeveloped countries. Consequently, the problem of raising the standard of living of the vast masses of people of underdeveloped countries brought to fore the need to develop rapidly the economies of these countries. Thus the Bretton Woods Conference was also responsible for establishing the International Bank for Reconstruction and Development.

SELF ASSESSMENT EXERCISE 1

Trace the origin of the World Bank.

3.1.2 Functions of International Bank for Reconstruction and Development (IBRD)

The World Bank is an international corporate institution whose capital stock is owned by its member nations. The principal functions of the Bank are:

1) To assist in reconstruction and development of the territories of its member governments by facilitating investment of capital for productive purposes;

2) To promote foreign private investment by guarantees of or through participation in loans and other investments made by private investors;

3) Where private capital is not available on reasonable terms, to make loans for productive purposes out of its own resources or out of the funds borrowed by it; and

4) To promote the long- range growth of international trade and the maintenance of equilibrium in members' international balance of payments by encouraging international investment for the development of the productive resources of members.

The World Bank's loans are given to help the members to build foundation of sound economic growth. Loans made or guaranteed by the Bank are, except in special circumstances, for the purpose of specific projects of economic development of members' economies. The Bank ensures that the proceeds of any loan are used only for the purpose for which the loan was granted.

The World Bank's total loans have been given for development of electric power, development of transportation, agriculture and rura1 development, providing educational facilities, urban development, development of industry, development finance of companies and development of technical assistance, population planning, telecommunications, tourism, water supply and sewerage.

SELF ASSESSMENT EXERCISE 2

Identify and explain the functions of the World Bank.

3.1.3 Membership and Organization of IBRD

Any country is eligible for World Bank's membership if it subscribes to the Charter of the Bank. A member can withdraw at any time its membership. Its withdrawal is, however, effective upon receipt by the

Bank of a written notice from the member to that effect. Failure to fulfill its obligations toward the Bank may lead to suspension of a member. Even when a government ceases to be a member, it is obliged to repay on demand its portion of the losses, if any, sustained by the Bank on its operations on the date when that government ceases to be a member.

The Bank has a Board of Governors, Executive Directors, a President and other staff. All powers of the Bank are vested in the Board of Governors consisting of one governor and one alternate appointed for five years by each member. No alternate can vote except in the absence of his principal. Each governor has the voting power which is related to the financial contribution of the government which it represents. Although even the smallest member gets a minimum number of votes, however, the voting power of the smaller share holders in the Bank is far outweighed by the voting power which the big share holders enjoy.

The United States of America with her substantial subscription has 21.48 per cent of the total voting power while the United Kingdom has 8.12- per cent of the total voting power. The Board of Governors meets once every year. Although mainly dealing with matters requiring only formal action, the annual meeting of the Board of Governors of the Bank is an important occasion for informal exchange of views at high level on major international, financial and monetary problems.

Among the total of 20 Executive Directors who direct the Bank's general operations, 5 are appointed by the 5 biggest share holders such as the United States, United Kingdom, the Federal Republic of Germany, Japan and France—and the remaining fifteen are elected by the other members. Each director holds voting power in proportion to the shares held by his government. With certain exceptions the Board of Governors has delegated all its powers to the Executive Directors who are responsible for the conduct of the general operations of the Bank.

The Executive Directors function in continuous session and meet regularly. A majority of the Directors exercising 50 per cent or more of the total voting power constitutes a quorum. The President of the Bank acts as Chairman of the Board of Directors. He has no vote except a deciding vote in case of an equal division. He is the chief of the operating staff of the Bank and is responsible to the Board of Governors of the Bank for the conduct of the ordinary business of the Bank and its organization. He is assisted by a number of heads of some departments.

SELF ASSESSMENT EXERCISE 3

Discuss nature of membership and organization of the World Bank.

3.1.4 Lending Operations of IBRD

The Bank makes loans to members in one or more of the following way:

1. By granting or participating in direct loans out of its own funds;
2. By granting loans out of funds raised in the market of a member or otherwise borrowed by the Bank;
3. By guaranteeing in whole or part loans made by private investors through the investment channels.

The total outstanding amount of the loans made or guaranteed by the Bank is not supposed to exceed 100 per cent of its total unimpaired subscribed capital, resources and surplus.

Before a loan is made or guaranteed the Bank ensures that:

xii. The project for which the loan is asked has been carefully examined by a competent committee as regards the merits of the proposal;
xiii. Borrower has reasonable prospects for repayment of loan;
xiv. Loan is meant for productive purposes; and
xv. Except in special circumstances, the loan is meant to finance the foreign exchange requirements of specific projects of reconstruction and development.

The Bank normally makes medium and long term loans, the term being related to the estimated useful life of the equipment or plant being financed. The Bank keeps itself informed on the projects which it finances by means of periodic reports received from the borrower and through on – the –spot inspections by its representatives. The interest rate charged by the Bank on its loans is the estimated cost to the Bank of borrowing money for a comparable term in the money market and is uniform without distinction among borrowers.

In addition to the rate of interest, the Bank charges on all loans a commission of one per cent for the purpose of creating a special reserve against loses and half per cent charges for meeting administrative expenses. The bank has made loans for specific development projects in the fields of agriculture, electric power, transport, telecommunications, industry, population planning, water supply, project preparation, tourism, urban development and education.

In view of the fact that the underdeveloped countries need basic transportation and communication facilities to develop their domestic economies and to provide new incentives for production, the Bank has also made loans for the development of transportation. Such lending includes the financing of high ways construction, development of airports and airlines, rehabilitation and development of railways, construction of pipelines development of ports and shipping and other modes of transportation.

SELF ASSESSMENT EXERCISE 4

Discuss the lending operations of the World Bank.

3.2 The International Monetary Fund (IMF)

3.2.1 Establishment of International Monetary Fund (IMF)

The International Monetary Fund was established with the objective of promoting international economic stability by promoting the balanced growth of world trade and by encouraging the multiconvertibility of national currencies. The Fund is a pool of central bank reserves and national currencies which are made available to Fund members under certain conditions. In a way, the pool may be regarded as an extension of member countries' central bank reserves.

The 1914 gold coin standard was abandoned by all the gold standard countries during World War I. After the cessation of hostilities, the desire was manifest among the leading world nations to return to the gold standard which had for a long period fostered the growth of stable international trade and economic relations. After the war, the United States of America was the first among the gold standard countries to return to the gold standard in 1919. The fear was, however, prevalent that other countries might resort to competitive currency depreciation in order to attract gold inflows.

Deflation decreases the total money supply, increasing money's scarcity and thereby raising the purchasing power of country's money unit. Dear money policy pursued consequent upon deflation causes an upward adjustment in the structure of interest rates in the country. The rise in the rates of interest accompanied by the fall in prices as result of deflation attracts foreign capital and reduces deficit of a country's external balance of payments. But deflation as a method of correcting adverseness of the external balance of payments is not adopted by a country so long as easier methods are available because deflation causes unemployment, fall in production and income in the country.

The Economic Conference convened in Geneva in 1922 had recommended that the member countries should adopt gold standard suggesting that world's total gold reserves should be held at two or three leading financial centres like London, New York and Paris, the other countries meeting their foreign exchange requirements by holding bank deposits and other liquid assets at these leading centres. The Conference had also recommended the regulation of credit in the interest of international peace and economic prosperity.

At the time of the post-war restoration of the gold standard, the franc was undervalued in relation to the pound sterling. Consequently France experienced surplus balance of payments situation and accumulated massive gold and foreign exchange reserves. This huge surplus in her external balance of payments should have been invested abroad if equilibrium was to be maintained. However, due to the reluctance of French investors to make long-term investments of their foreign balances abroad only a part of these foreign balances was invested abroad in the form of short-term and call deposits creating the problem of 'hot money' in the debtor countries. A substantial part of foreign balances held by the foreign creditors in the debtor countries was converted into gold.

The basic fact that international trade is a barter trade whereby ultimately the payment for a country's imports is made by her exports and vice versa was ignored by these creditor countries, particularly by France and America. Even the richest country has only limited reserves of gold to use in emergency to tide over deficit in her external balance of payments position. However, the deficit in the balance of payments experienced by the debtor countries was serious arising from fundamental disequilibrium in their balance of payments. To correct this deficit, massive gold outflows exhausting the entire gold holdings of the debtor countries took place without reaching any equilibrium in the balance of payments of these countries.

France and USA did not honour their obligations as world's leading creditor countries. These obligations were fulfilled with sincerity by England before World War I as the world's leading creditor nation. Gold was imported by France and USA to be locked in the central bank cellars and money supply did not expand as a consequence of massive gold inflows. This in effect meant thwarting the working of the price-specie-flow adjustment mechanism of the gold standard. Gold imports did not exert any pressure on domestic price level in USA and France. In the post-war world America had emerged as world's leading creditor nation.

A creditor country must be ready to receive payments of her loans by creating the necessary import surplus in her balance of trade, requiring her to follow an open door policy allowing free imports into the country. But unfortunately, United States of America became highly protectionist shutting her seashores for imports by erecting high import tariff walls.

An international monetary standard cannot function in a mad nationalist world. Consequently, the international gold standard broke down causing panic and confusion in the world.

After the breakdown of the post-war international gold standard during the thirties, a make- shift arrangement was evolved between England, the USA and France to achieve exchange stability by establishing exchange stabilisation funds by the three countries. The arrangement visualised by the Tripartite Agreement of 1936 worked until 1939. During the war no international monetary arrangement existed. After the breakdown of the gold standard, the world lost the most efficient automatic monetary standard on which nations had for long relied for restoring equilibrium in their external balance of payments. No alternative arrangement comparable to the gold standard, however, emerged to replace it. Instead each country dealt with its external balance of payments deficit in her own way in a manner that resulted in shrinkage of world trade in a world characterized by trade and payments restrictions.

Countries increasingly resorted to exchange clearing agreements, blocked accounts, multiple exchange rates and many other restrictions on international trade and payments. These restrictions on multilateral trade and payments increased in severity during the war. The enlightened public opinion and world statesmen feared that these restrictive trade and payments practices would continue after the war unless concerted international efforts were made to create some effective international machinery whereby-exchange stability could be guaranteed. It was the outcome of such convictions shared by the experts during the war that they prepared comprehensive plans of international monetary cooperation for implementation after the war.

The British Plan authored by the eminent British economist John Maynard Keynes took the shape of Keynes Plan while the plan prepared by the American expert Henry D. White was known as the White Plan. The basic features of the two plans were fused into a common plan evolved at a United Nations Monetary and Financial Conference of 44 nations held at Bretton Woods, New Hampshire in July 1944. The Conference gave birth to both the International Monetary Fund and the International Bank for Reconstruction and Development.

According to the Conference, three main economic problems dominated the post-war period. Firstly, in order to ensure world order and peace, it was essential to restore stability in the monetary systems of those countries which had been forced by the exigencies to abandon all conventional rules of monetary discipline observed under the gold standard. Secondly, it was necessary to find effective means to reconstruct the war-ravaged economies of the European countries.

Thirdly, it was realized that stable peace could never prevail in a world in which the developed nations were unconcerned of the untold miseries of vast sea of humanity living in the undeveloped and underdeveloped countries of Asia, Africa and Latin America. The world was to be made a better place to live for the masses of the poor Afro-Asian nations. This could be achieved only by diverting a part of world resources to the development of the economies of Afro-Asian countries.

The effective solution to the problems of reconstruction and development was necessary for ensuring an expanding world economy and for dismantling the complex trade and exchange restrictions that had grown during the previous decade. The IMF was established in order to abolish effectively all exchange and trade restrictions and to promote multilateral trading system while the World Bank was established to find an effective solution of the knotty problem of economic reconstruction and development.

SELF ASSESSMENT EXERCISE 5

Discuss the formation of the International Monetary Fund.

3.2.2 Purpose of International Monetary Fund

The functions of the Fund as mentioned in the Second Amendment to the Articles of Agreement of the International Monetary Fund, which became effective from 1 April 1978, are as presented below:

1. To promote international monetary cooperation through a permanent institution; which provides the machinery for consultation and collaboration on international monetary problems;

2. To facilitate the expansion and balanced growth of international trade and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.

3. To promote exchange stability, to maintain orderly exchange arrangements among members and to avoid competitive exchange depreciation.

4. To assist in the establishment of a multilateral system of payments in respect of currency transactions between members

and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

5. To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.

6. In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

SELF ASSESSMENT EXERCISE 6

Identify and discuss the functions of the International Monetary Fund.

3.2.3 Structure of International Monetary Fund

The Fund's structure is mentioned in the Articles of Agreement. Article XII states that "the Fund shall have a Board of Governors, an Executive Board, a Managing Director, and a staff." The highest authority of the Fund is the Board of Governors, in which each of the member countries is represented by a Governor and an Alternate Governor. In most cases the Fund's Governors are either ministers of finance or central bank governors in their countries. The Board of Governors normally meets once a year, but it may vote by mail between meetings.

According to the Second Amendment of the Articles of Agreement which became effective from 1 April 1978, the Board of Governors may decide to establish a new Council at the ministerial level to "supervise the management and adaptation of the international monetary system, including the continuing operation of the adjustment process and developments in global liquidity, and in this connection to review developments in the transfer of real resources to developing countries."

The Council, which is intended to be a decision-making body, would also consider proposals to amend the Articles of Agreement of the Fund. Pending establishment of the Council, the Board of Governors is advised in the areas outlined above, by a 21-meniber Interim Committee on the International Monetary System, established by a resolution adopted at the 1974 Annual Meetings. In addition, the Interim Committee advises the Board of Governors "in dealing with sudden disturbances that might threaten the International Monetary

System." At the end of 1979, the Fund had 140 members with total quotas amounting to SDR 39,016.5 million.

The Board of Governors has delegated many of its powers to the Board of Executive Directors which is "responsible for conducting the business of the Fund" and is, therefore, in permanent session at the Fund headquarters in Washington. The Executive Board deals regularly with a wide variety of administrative and policy matters, issues Annual Reports to the Board of Governors, conducts discussions to complete the process of consultations with members, and from time to time produces comprehensive studies on crucial issues of particular relevance to the international financial aspects of the economies of Fund members.

There are some Executive Directors. Out of the Executive Directors, six are appointed (five by the members with the largest quotas—the United States, the United Kingdom, the Federal Republic of Germany, France, and Japan—and one appointed by Saudi Arabia by virtue of its being one of the two largest creditor members) and 15 are elected by as many constituencies, representing the remaining 134 members of the Fund. The Executive Board selects the Managing Director, who is the chairman of the Executive Board. In addition, he is chief of the operating staff of the Fund and conducts, under the direction of the Executive Board, the ordinary business of the Fund.

SELF ASSESSMENT EXERCISE 7

Discuss the structure of the IMF operations.

3.2.4 Mode of Operation of IMF

With its capital and reserves held in gold, SDRs and members' currencies and borrowings raised in the international exchange markets, the Fund endeavors to eliminate foreign exchange fluctuations and encourage multilateral trading through its operations. The Fund Agreement requires that "the par value of the currency of member shall be expressed in terms of gold as a common denominator or in terms of the US dollar of the weight and fineness in effect on 1 July 1944." The par values of members' currencies are expressed in terms of the gold, SDR and US dollars in a uniform manner with six significant figures, other than initial zeros.

A member declares the par value of her currency which it cannot alter beyond 10 per cent without obtaining the Fund's permission. Change in the initial par value up to 10 per cent can be effected by the member herself after making her intention known to the Fund and the Fund will not object to a member changing the initial par value of her currency up to 10 per cent. However, changes in the par value of member's currency beyond 10 per cent cannot be made without prior approval of the Fund. A member can change the initial par value of her currency only to correct the fundamental disequilibrium in her balance of payments.

Although fundamental disequilibrium has not been formally defined, a serious disequilibrium to justify a country's request for devaluation of her currency in excess of 10 per cent should be evident from a persistent deficit in her balance of payments. If the Fund has reason to believe that a member's balance of international payments is caught in the whirlpool of fundamental disequilibrium, "it shall not object to a proposed change because of the domestic, social or political policies of the member proposing the change."

According to the Fund, a stable exchange rate system is essential for balanced growth of multilateral trade. Consequently, the Fund eliminates fluctuations in the par values of currencies of the members by helping them in correcting their balance of payments disequilibrium. When a member country is faced with serious deficit in her external balance of payments, the Fund sells to it the scarce foreign currency needed by her to pay her foreign exchange obligations. Thus, the Fund provides a breathing time to its members during which they should be able to correct their balance of payments deficit.

However, if the deficit in the balance of payments of a member is due to some fundamental cause such as overvaluation of her currency or high cost of domestic production impairing member's capacity to increase her exports needing structural changes in her economy, the Fund asks the member to effect the necessary changes. For example, it will ask the member to take necessary fiscal, monetary and other measures to control inflation in the economy and raise the labour productivity in order to effect the required fall in cost-price structure to enable the country to increase her exports in order to correct her balance of payments deficit.

Where there is conflict between a member's domestic financial policy over which the Fund has no control and the maintenance of exchange stability which is one of its major objectives, the Fund mainly relies on the use of persuasion. In the event of the member persistently indulging in policies contradictory to Fund's objectives, the Fund can refuse access to its funds to the member concerned.

A significant change was made in the permissible margin within which the day-to-day fluctuations in the exchange rate around the par value can take place. Effective from 18 December 1971 the exchange rates of members' currencies against their intervention currencies could fluctuate within wider margins of 22.5 per cent on either side of the parity relationship in place of the old narrow margins of 1 per cent on either side of the par values of the currencies. It means that a member who maintained the exchange rate for its currency within these margins in terms of its intervention currency could permit resulting exchange rates for its currency in relation to currencies other than its intervention currency to fluctuate within margins of 4.5 per cent from parity, with further margin of 1 per cent in certain circumstances. This change replaced the old adjustable by the new crawling peg.

The new provisions in the second amendment Articles of Agreement of the Fund, provide for flexibility in foreign exchange rates in as much as money are not bound to establish par values for their currencies; the margins for exchange transactions based on parity relationships between currencies for which par values have been established will be wider than those under the present Articles; and the Fund will have the authority to change the margins. In addition, a member will be able to abandon a par value without establishing a new one, unless the Fund decides otherwise by a high majority of the total voting power.

Upon entry into effect of the Second Amendment from 1 April 1978, all par values established under the present Articles have ceased to exist for the purposes of the amended Articles.

While the Fund sells foreign currencies to its members, it purchases these from those members whose currencies are involved or from those members who have acquired these currencies through export earnings. The Fund does not encourage its members to buy foreign currency in large amount. A member can buy foreign currency from the Fund to tide over her temporary balance of payments deficit. This amount cannot exceed the maximum prescribed limit. When a member buys foreign currency from the Fund, it pays for it in her own currency. Consequently, the amount of member's currency with the Fund increases.

The Fund imposes penalty on the member if her currency holdings with the Fund exceed 25 per cent of her quota. For each subsequent increase of 25 per cent slab the penalty increases progressively. The Fund sells currencies to members against their subscriptions for short period which should not exceed five years' duration to enable the members to tide over their temporary balance of payments difficulties. A member can purchase the currency she needs from the Fund not exceeding 25 per cent of its quota in any one year. The purchases may be increased each year in the same percentage slab until all amounts to 125 per cent of its quota.

Consequently, at the end of five years of continuous purchases the Fund would hold the maximum amount of currency of the member equaling 200 per cent of its quota; 125 per cent on account of the purchases made by the member of foreign currency or currencies and 75 per cent being the share of the original subscription held in member's currency.

Scarcity of currency of a country in foreign exchange market shows a surplus in the balance of payments of the member country. It implies an export surplus in the balance of payments of a country. A member with chronic surplus in her balance of payments is as guiltier of disturbing the exchange stability as is that member which has chronic deficit in her balance of payments since both do irreparable damage to the cause of balanced growth of international trade. The Fund, therefore, asks the member to remove the surplus in her balance of payments by revaluing her currency. As soon as the Fund declares a particular currency 'scarce' the concerned country should revalue her currency so that costs and prices in the country may increase und her imports may increase and exports may fall thereby increasing the supply of currency of the country for the other members.

SELF ASSESSMENT EXERCISE 8

Discuss the mode of operation of IMF.

3.2.5 Determination of Par Values of Member Countries' Currencies

Under the provisions of Fund, the par values of currencies of members are expressed in terms of gold, SDR, and the US dollar. Consequently, in Fund's scheme gold had been retained as a basis of determination of the par values of members' currencies. Judged from the manner in which the members transact with the Fund, there appears an analogy between the gold standard and the Fund plan. Under the Fund scheme, a member with a deficit in her balance of payments is in a position similar to the one that was faced by a gold-losing country under the gold standard while a member with surplus in her balance of payments enjoys a position analogous to that of a gold-receiving country under the gold standard. Note that SDR means special drawing rights.

Under the Fund scheme, a member can deal with the Fund "only through its treasury, central bank, stabilization fund or other similar agency." The Fund is not a clearing house for all international payments. In fact, a large chunk of international payments is cleared through the foreign exchange market without Fund's interference. Transactions made by a member with the Fund are of an exceptional nature comparable to gold or short-term capital movements under the gold standard.

To understand this analogy, let us suppose that faced with a temporary shortage of the US dollars, Nigeria wants to buy the dollars from the Fund. As an act of sale of dollars to the Central Bank of Nigeria (CBN) by the Fund, the CBN will draw against the Fund's dollar account maintained with the Federal Reserve Bank of New York. Consequently, the Fund's dollar account with the Federal Reserve Bank of New York will decrease while the purchase price will be credited to Fund account maintained with the Central Bank of Nigeria. The Central Bank of Nigeria will sell acquired dollars to the commercial banks who in turn will sell them to their customers. This will reduce the deposits of the commercial banks and consequently their reserves with the CBN too will be reduced. Thus, the transaction will have a deflationary effect on the Nigerian economy unless the Central Bank of Nigeria makes additional cash reserves available or the commercial banks possess additional cash reserves.

The opposite trend will operate in the US economy. Since the dollars purchased by Nigeria would be spent to pay for the imports made by Nigeria from the United States, it would increase the deposits and reserves of the American commercial banks enabling them to follow an expansionary policy by expanding credit. Thus transactions with the Fund influence "bank reserves in precisely the same way as the movements of gold under the gold standard." It is argued that the provisions of the Fund with regard to gold are not merely a window dressing and gold plays an important role "as the Fund's most liquid asset and as a common anchorage for the members' currency system."

At the instance of the Second Amendment to the Fund's Articles of Agreement, the role of the gold in the international monetary system has been substantially reduced and in its place SDR has been assigned a principal place in the new international monetary system. Consequently, the old controversy about the role of gold in the Fund scheme has now ceased.

Under the new arrangement, the function of gold as the unit of value of SDR has been eliminated and its role as common denominator of the par values of currencies has ended. The official price of gold has been abolished and members are free to deal in gold in the market and among themselves. Members are no longer under obligation to make payments to Fund in gold, nor is Fund any longer required to make payments to members in gold and the authority of Fund has been eliminated except under decisions taken by a high majority of 85 per cent of the total voting power.

The Fund is also required to complete the disposition of 50 million fine ounces of gold, and will decide on the disposal of the remainder of its gold holdings (100 million ounces) in various ways by sale on the basis of market prices or at the official price in effect before the second amendment.

Under the new arrangement, SDR is the principal reserve asset in the international monetary system and it has replaced gold as a means of payment by members to the Fund and by the Fund to members and the value of currencies held in the General Resources Account of the General Department is to be maintained in terms of SDRs in accordance with exchange rates determined for the purpose of transactions in SDRs. In short, gold has been completely delinked from the Fund.

The value of the SDR is no longer expressed in gold, and the method of valuation of the SDR is determined by the Fund by a high majority of the voting power. According to the decision which became effective on 1 July 1978 the SDR is valued in terms of the basket of 16 members' currencies with weights given to each currency reflecting both its financial and commercial importance.

SELF ASSESSMENT EXERCISE 9

Discuss the determination of par values of member countries’ currencies by IMF.

3.2.6 Use of International Monetary Fund's Resources

Under the gold standard, whenever a country was faced with deficit in her external balance of payments, the normal course open to her was to finance the deficit by using her own official gold reserves before any corrective measure could operate. If the gold reserves of the country were inadequate for the purpose, she had to supplement her gold reserves by short-term external borrowing.

Foreign banks including central banks constituted the principal source of such short-term credit facilities before the establishment of the Fund. These foreign banks assisted the countries in financial difficulties by providing short-term loans with or without the pledge of gold, mostly in the form of revolving credits. Under gold standard, a country faced with the balance of payments deficit could acquire foreign exchange by paying her own currency in exchange. The central banks of the two countries entered into swap arrangements under which each of the two central banks made available to its counterpart at the other end its own currency and that other (purchaser) bank paid for it by crediting the account of the creditor (seller) bank in its own currency.

The country involved could also raise funds to finance the temporary deficit in her balance of payments through the sale of bills of exchange in local currency with the condition that the country's government would repurchase such bills at the unchanged foreign rate after a short period, usually 91 days. The central bank of the country concerned usually serves as the channel through which such transactions takes place. Irrespective of the form of the arrangement, the credit-worthiness of the debtor was the most important consideration in determining the rate of interest, the duration and the amount of the loan which could be made available to the country.

The establishment of the Fund has made an important addition to the existing institutional arrangements for the borrowing of short-term funds. The Fund is an important source of supply of international liquidity, both conditional and unconditional. The terms and conditions on which credit can be made available to a member from the Fund and the total loan that can be given to a member are laid down in the Fund's Articles of Agreement.

For instance, the borrowing member must have paid her subscription, must have declared the par value of her currency and cannot borrow more than 25 per cent of her quota during a 12-month period and her total borrowing should not exceed 125 per cent of its quota. The Fund grants loans of foreign currencies to members to correct the temporary deficit in their balance of payments which is likely to be removed at the earliest possible period. For example, a country's external balance of payments position may become adverse due to heavy imports of food-grains due to severe famine. This deficit is of a temporary nature as it would disappear after one or two years when the new harvest in the coming years puts the country's balance of payments in order. The Fund helps the member in such a case.

Nevertheless, if the deficit in the balance of payments of a member country is due to certain permanent and persistent cause, such as overvaluation of the currency of the member, the Fund does not help the member in correcting the deficit in her balance of payments. Instead it advices her to bring the external value of her currency into conformity with the par values of currencies of other members by affecting necessary devaluation of her currency.

SELF ASSESSMENT EXERCISE 10

Discuss the modality for the use of International Monetary Fund's resources in helping member countries.

4.0 CONCLUSION

From the foregoing analysis, you can understand the modality and reasons for the establishment of both the World Bank and the International Monetary Fund. You can also understand the lending operations of both financial institutions towards helping the economic development of member countries as well as bailing them out of balance of payment problems. Lastly you can also understand the means through which the par values of the member countries' currencies are determined by the IMF.

5.0 SUMMARY

This study unit has been used to discuss the origin and nature of operations of both the World Bank and the International Monetary Fund. In this unit, discussion is also devoted to the reasons for the existence of the two international financial institutions. The unit is also used to discuss the functions of World Bank and IMF to the member countries in the areas of economic development and ameliorating their balance of payment problems.

The next study unit is used to discuss international economic institutions.

6.0 TUTOR-MARKED ASSIGNMENT

What are the functions of the World Bank to the member countries?
Identify and explain the reasons for the establishment of IMF.

7.0 REFERENCES/FURTHER READINGS

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UNIT 4 INTERNATIONAL ECONOMIC INSTITUTIONS

CONTENTS

1.0 INTRODUCTION

In the previous study unit, you have been exposed to the international financial institutions established after the World War II. In this study unit, some international economic institutions which were established at the same time with those financial institutions are discussed. Such international economic institutions include the General Agreement on Tariffs and Trade (GATT) and the United Nations Conference on Trade and Development (UNCTAD).

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- mention the reasons for the establishment of GATT
- identify the reasons for the establishment of UNCTAD
- mention and explain the defects inherent in operations of GATT
- discuss the functions of UNCTAD.

3.1 General Agreement on Tariffs and Trade (GATT)

3.1.1 Origin of General Agreement on Tariffs and Trade

The General Agreement on Tariffs and Trade (GATT) was negotiated in 1947. The 23 countries which originally signed it were at the time engaged in drawing up the charter for a proposed International Trade Organization (ITO) which would have been a United Nations specialized agency. The GATT was based largely on selected parts of the draft ITO charter with the purpose of liberalizing trade.

GATT was provided with the minimum institutional arrangements because it was expected that the responsibility would soon be taken over by the proposed ITO. However, plans for the ITO had to be abandoned when it became clear that its charter would not be ratified. Consequently, the GATT was left as the only international instrument for laying down the trade rules accepted by nations responsible for bulk of the world trade.

The highest body of GATT is the Session of Contracting Parties which is usually held annually. GATT decisions are generally arrived at by consensus and not by vote and when on rare occasions voting takes place each contracting party (member country) has only one vote. Most decisions by vote are taken by simple majority, but a two-thirds majority of votes cast, with the majority comprising of more than half the member countries, is needed for "waivers" authorizations in particular cases, and to depart from specific obligations under the Agreement.

SELF ASSESSMENT EXERCISE 1

Trace the origin of GATT.

3.1.2 Membership of General Agreement on Tariffs and Trade

The membership of GATT has increased from 23 contracting parties at the time it was negotiated in 1947 to 84 contracting parties on 24 November 1979 drawn from different parts of the world. In addition to 84 member countries, 3 countries had acceded provisionally while the number of countries to whose territories the GATT has been applied and which now, as independent states, maintain a de facto application of the GATT pending final decisions as to their future commercial policy stand at 30. Thus, about 117 countries are currently applying the rules of GATT in their international trade.

GATT, which entered into force in January 1948, is a multilateral treaty subscribed to by 84 countries which together account for about 90 per cent of world trade. It is the only multilateral instrument that lays down agreed rules for international trade. Since its inception, GATT has also functioned as the principal international body concerned with negotiating the reduction of trade barriers and with international trade relations.

GATT is thus both a code of rules and a forum in which countries can discuss and solve their trade problems and negotiate to enlarge world trading opportunities. The uninterrupted flow and tremendous growth in the volume of international trade over the years has provided continuing evidence of GATT's success in its double role. GATT rules govern the trade of its member countries and the conduct of their trade relations with one another.

3.1.3 Purpose of General Agreement on Tariffs and Trade

Over the years, GATT in the international economic scene has evolved considerably, and its activities have been greatly influenced by the major developments that have taken place. These developments include changes in the relative strengths of important countries or groupings of countries, the emergence of the developing countries as a major factor in international affairs, the trend toward economic groupings, and the growing interest of Eastern European countries in the GATT.

The trade problems of the developing countries and their solution have become a progressively increasing pre-occupation of GATT. The growing international awareness in the early nineteen-sixties of the relevance of trade to the problems of the developing countries and the increasing attention and resources devoted to this aspect of the development problem stemmed in no small part from the work done by GATT. The developing member countries of GATT have been able to apply some of GATT's provisions.

Recently, GATT has increasingly focused its attention on the trade interests of developing countries and the promotion of these interests has been an important element in the multilateral trade negotiations which have been the principal focus of GATT's work ever since the "Tokyo Round" of multilateral trade negotiations was held in September 1973. The Tokyo Declaration that was passed at a Ministerial meeting held in Tokyo in September 1973 is a document embodying the agreement to open the new round of trade negotiations, more ambitious in scope than any ever previously attempted.

The Declaration also provides for the possibility of improvements in the framework and procedures of GATT itself. While developed countries are expected to negotiate on a basis of reciprocity, that is, to make trade concessions balancing those that they receive, they do not expect from the developing countries contributions that are inconsistent with their individual financial, trade and development needs. Under the provisions of the Tokyo Declaration, a Trade Negotiations Committee guides the negotiations. It consists of the representatives of all the countries engaged in the negotiations. These countries, numbering 99, account together for more than nine-tenth of world exports.

SELF ASSESSMENT EXERCISE 2

Discuss the purpose for the establishment of GATT.

3.1.4 GATT and Tariff Redactions

As you have already observed, GATT is an international forum for discus-and negotiations on trade. Its principal purpose is to effect substantial reduction in tariffs and other barriers to trade. The GATT has been able to achieve this objective through long series of negotiations.

The most ambitious of these negotiations opened in September 1973 by a Ministerial meeting in Tokyo which was attended by 102 countries. There are other seven major trade negotiations which took place under its auspices in 1947 (in 'Geneva), in 1949 (in Annecy, France), in 1951 (in Torquay, England), in 1956 (in Geneva), in 1960-61 (in Geneva, the "Dillon Round"), in 1964-67 in (Geneva, the "Kennedy Round") and the "Tokyo Round" held in Tokyo in 1973, among others.

In addition to these major trade negotiations, smaller-scale negotiations have preceded the accession to GATT of individual countries such as Japan, Switzerland and Hungary. As a result, the tariff rates for thousands of items entering into world trade have been either reduced or bound against increase. The Kennedy Round of trade negotiations alone reduced the average level of world industrial tariffs by about one-third. The concessions agreed upon in these trade negotiations have affected a high proportion of the total world trade of GATT countries, and indirectly, the trade of many non-members as well. GATT has thus contributed greatly to the spectacular growth of world trade since 1948.

SELF ASSESSMENT EXERCISE 3

Discuss the role played by GATT in tariff reduction since its inception.

3.1.5 Defects and Future of GATT

While GATT undoubtedly provides a useful forum for holding multilateral negotiations on reciprocity basis and also provides machinery for discussing and settling disputes, it is nothing more than a code of behavior. Although the Kennedy Round marks the most spectacular achievement of GATT, yet it is merely an improvement. The GATT has no super national authority and protection has been justified by taking recourse to various escape clauses. Due to the diverse nature of GATT membership, uniform general rules are difficult to frame and political and economic motives are frequently entangled.

The combination of the principle of non-discrimination with the principle of reciprocity causes pertinent biases and formidable problems. Furthermore, since the negotiations take place on commodity to commodity basis, there is a bias in favour of trade with each other as against trade with third parties

Although in principle GATT recognizes that multilateral trading is better than bilateralism yet in practice the principle of reciprocity places a premium on bilateralism. Thus there is need to reconcile the non-discriminatory multilateral trading with the principle of reciprocity. Moreover, it is necessary to provide new opportunities for all countries to expand their trade by reducing tariff and non-tariff restrictions that now hamper exchanges of industrial and agricultural products.

And in doing so, not only GATT declaration but economic necessity and social justice require that additional trade benefits be made available to the developing countries. The GATT is not a representative world body as it excludes important countries of the communist block and also excludes some newly independent developing nations. It has been called the "rich countries' club" by the developing countries. According to these countries, GATT has mostly served the interests of the United States and other developed countries of Europe.

In those products which are of special interest for developing countries, GATT rules do not apply. For example, trade in cotton textiles is regulated under a special arrangement which came into force in 1962. Under this arrangement, the developing countries are requested to impose voluntary quotas on their exports when some importing country feels that it is threatened by imports from cheaper world sources.

Judging from the totality of its working, it can be said that GATT has proved its case by playing an important role in reducing the tariffs and other barriers to trade. "It has succeeded in surviving the post-war period of general balance of payments difficulties without surrendering the principle that such restrictions were to be allowed only as exceptions to general rule which itself should be applied as soon as circumstances permitted.

If present is any guide for the future, the GATT has a bright future assured for it. As long as the money and trade policies of world countries fall short of the idea of free trade, there will remain the necessity for the sincere and successful efforts of GATT.

SELF ASSESSMENT EXERCISE 4

Identify the defects inherent in the operations of GATT.

3.2 United Nations Conference on Trade and Development (UNCTAD)

3.2.1 Origin of UNCTAD

Among numerous institutions which have been created under the banner of the United Nations Organization is the United Nations Conference on Trade and Development, popularly known as UNCTAD. The international economic institution came into being as a result of the UN resolution on 'Development Decade' of 1961. This organization is a forum of nations for finding and resolving the various international knotty problems of trade and development.

The Cairo Conference of the developing countries held in July 1962 on the problem of economic development passed the 'Cairo Declaration of Developing Countries' calling for the convening of the United Nations Conference on Trade and Development and constituting an "International Trade Organization" (ITO) which would consider vital questions relating to the international trade of the poorer nations.

The United Nations Economic and Social Council agreed to convene such a conference—the first UNCTAD—and passed Resolution on 3 August 1962 which was endorsed by the United Nations General Assembly in its Resolution of 8 December 1962. The historic decision of the United Nations General Assembly to name 1960-69 as a 'Development Decade' was a further recognition of the deep world-wide concern with the urgent necessity raising the living standards of the peoples of the developing countries. All these developments led to the convening of the United Nations Conference on Trade and Development in Geneva from March to June 1964.

In July 1963, the United Nations Economic and Social Council passed a resolution for UNCTAD to be convened at an interval of not more than three years. The United Nations General Assembly accepted the recommendation and UNCTAD was established as a permanent organ of the UN General Assembly. The UN General Assembly also defined the functions, activities and membership of UNCTAD.

UNCTAD has set up a Trade and Development Board as a policy making body to take policy making decisions when the Conference is not in session. The Board is composed of 55 members elected on the basis of equitable geographical distribution. The Board is also helped by subsidiary committees which deal with the problems of primary products, manufactured and semi-manufactured goods, development finance and questions relating to invisible services, including shipping and insurance, etc.

SELF ASSESSMENT EXERCISE 5

Discuss the origin of UNCTAD.

3.2.2 Functions of UNCTAD

The main purpose of creating UNCTAD was to gear up speedy development of the underdeveloped countries by solving the problems of the sluggish expansion of their export trade, deficits in their external balance of payments and excessive burden of foreign debt, etc.

The specific functions of UNCTAD including the following:

1. to promote international trade, especially with a view to accelerating the economic development of the underdeveloped countries, particularly trade between countries with different systems of economic and social organization taking into account the functions performed by the existing international organizations.

2. to formulate the principles and policies of international trade and related problems of economic development.

3. to make proposals for putting the said principles and policies into effect and to take such other steps within its competence as may be relevant to this end.

4. generally, to review and facilitate the coordination of activities of other institutions within the United Nations system in the field of international trade and related problems of economic development and in this regard to cooperate with the General Assembly and the Economic and Social Council in respect of the performance of their chartered responsibilities.

5. to be available as a centre for harmonizing the trade, related development policies of governments and regional economic

groupings in pursuance of Article 7 of the United Nations Charter.

SELF ASSESSMENT EXERCISE 6

Mention the functions of UNCTAD.

3.2.3 Directive Principles of UNCTAD

The first UNCTAD was held in Geneva from 23 March to 16 June 1964. The conference was attended by delegates from 120 countries, 13 specialized agencies, and 32 non-government bodies. The aim of the conference was to provide means of international cooperation and to find appropriate solution to the problems of world trade in the interest of the whole world and particularly recognizing the urgent needs of the developing countries.

For the above purpose the conference laid down a number of principles, policies and recommendations to bring about basic changes in the working and set-up of trade relations between the advanced and poor nations.

The following were the important directive principles laid down and accepted by the Conference:

1. Economic development and social progress should be the common concern of the whole international community for which peaceful relations and cooperation should be sought.

2. National and international economic policies should be directed towards the attainment of the division of labour consistent with the needs and interests of the developing countries in particular, and the world as a whole in general.

3. Developing countries should reduce restrictions on trade that hinder the trade of the underdeveloped countries and should increase the markets for the products of developing nations.

4. Developed countries should extend new preferential concessions, both tariff and non-tariff to developing countries also. These should not be limited to developed countries only.
5. Assistance and aid from the developed countries should not be principles of equality and non-interference in their internal affairs. No distinction should be made on the basis of economic systems. It was decided to hold a periodic meeting of UNCTAD after every three years. The Trade and Development Board was authorized to

take policy making decisions when the conference was not in session.

There were other conferences held after the above. The above conference has been discussed herein in order to throw some light into the operations of the institution.

SELF ASSESSMENT EXERCISE 7

Mention the directive principles as enunciated by the UNCTAD I Conference.

4.0 CONCLUSION

From the foregoing analysis, you can understand the origin and purpose of both the GATT and UNCTAD in the world trade and economic development. You can also understand the nature of the membership of GATT. In addition, you are now in a position to discuss the role played by GATT in the reduction of tariff and the defects inherent in the operation of the institution. Lastly, from the analysis, you can also understand the nature, functions and the directive principles of UNCTAD.

5.0 SUMMARY

This unit has been used to discuss the origin of both GATT and UNCTAD. Furthermore, the unit has also been used to discuss the purpose, functions and defects inherent in the operations of GATT. The functions and directive principles involved in the operational activities of NCTAD have also been discussed in this unit. The next unit discusses monetary policy.

6.0 TUTOR-MARKED ASSIGNMENT

10) Mention and explain the functions of GATT.
11) Identify and discuss the functions of UNCTAD.

7.0 REFERENCES/FURTHER READINGS

Begg, D., S. Fischer and R. Dornbusch (2000). *Economics*, Sixth Edition. Berkshire, England: Maindenhead.

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UNIT 5 MONETARY POLICY

CONTENTS

1.0 INTRODUCTION

The monetary policy is one of the stabilisation policies normally employed by the government to manage the economy. In essence, monetary policy is one of the stabilisation measures which the government employs to check economic fluctuations in any economy. The monetary policy is used in conjunction with the fiscal policy, by the government, to check macroeconomic problems such as inflation, unemployment, low level of aggregate consumption and production by suing taxes and expenditure.

Monetary policy is the subject of discussion in this unit. The policy is discussed in relation to its meaning, objectives of the policy and the major instruments employed by the government in implementing its objectives.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- explain the meaning of monetary policy
- identify and discuss the objectives of monetary policy
- mention and explain the instruments of monetary policy.

3.0 MAIN CONTENT

3.1 Meaning of Monetary Policy

Monetary policy involves the manipulation of some monetary variables by the central bank to regulate the supply and demand for money in the economy.

In essence, monetary policy refers to the use of monetary variables such as the interest rate regime, credit rationing, directives on credits, and total money supply or quantity of money in circulation to regulate the economy.

In the modern time, monetary policy is not only being used to regulate money supply in the economy. The scope of its use has been extended to cover issues such as external monetary relations in the area of imports restriction regarding demand and consumption of foreign goods.

For instance, when the imported goods are becoming very expensive, the monetary authorities may deem it fit to control their demands and consumption through the contraction of credits in order to reduce access to cheap money for affording them.

Also since inflationary and deflationary trends can result in arbitrary redistribution of income, monetary policy can be employed to control such macroeconomic problems in order to maintain stable level of prices.

SELF ASSESSMENT EXERCISE 1

Explain the term monetary policy.

3.2 Objectives of Monetary Policy

The major objectives for the use of monetary policy, just like the fiscal policy, include the following:

1. Maintaining Price Stability

This is achieved by keeping inflationary trend in check in the economy. Inflation can arise as a result of excess supply of money in the economy, which can be checked by contracting money supply or reducing money in circulation.

The reduction in the quantity of money in circulation has the effect of depleting the income available to the consumers, thus reducing their disposable income and the quantity of goods that they can afford to purchase. This has the overall effect of checking inflation in the economy and thus the general price level is curtailed from rising.

Since monetary policy can be employed to control inflationary and deflationary trends, as you have observed in the foregoing discussion, by implication it can be employed to maintain stable level of prices in the economy.

2. Maintaining Full Employment

This implies the reduction of the level of unemployment in the economy. This can be achieved through credit expansion during a depressed state in the economy. The availability of cheap money to the investors affords them to expand their business operations and also establish new ones through diversification of operations.

The expansion in business operations and increased investment make possible the employment of idle resources including labour which are unemployed as a result of the depressed state of the economy.

3. Stimulate Economic Growth and Development

The reduction in the level of unemployment in the economy implies the engagement of the idle labour which can be used to stimulate economic growth and development.

The credit expansion instituted to stem the tide to the depressed state of the economy through availability of cheap money to the investors affords them the opportunity to expand their business operations and also establish new ones as a result of diversification of operations.

The expansion in business operations and increased investment make possible the employment of all categories of idle resources which are unemployed as a result of the depressed state of the economy, serves as potential catalyst for economic growth and development.

4. Maintaining Favourable Balance of Payments Position

You have observed from the explanation of the nature of monetary policy that the scope of its use has been extended to cover issues such as external monetary relations in the area of imports restriction regarding demand and consumption of foreign goods.

Since it can be used to curtail the importation and consumption of expensive and luxury goods through the contraction of credits in order to reduce access to cheap money for affording them, monetary policy can be employed to maintain a favourable balance of payments position for the economy.

5. Maintaining Stability in External Value of Country's Currency

You have observed from preceding discussion that contraction of credits can lead to the curtailment of the access to cheap money for purchasing imported goods, which can be expensive and luxury in nature. Monetary policy, therefore, can be employed to maintain a favourable balance of payments position for the economy.

Furthermore, contraction of credits available for consumer goods, particularly the imported goods, can lead to the enhancement of the survival of the infant industries. It can also encourage the establishment of import substitution industries in the economy. This will conserve the country's foreign exchange earnings, and hence spells a favourable balance payments position for the economy.

SELF ASSESSMENT EXERCISE 2

List and discuss the various objectives which the monetary policy can be used to achieve in the economy.

3.3 Instruments of Monetary Policy

There are some instruments which are normally employed by the monetary authorities such as the Central Bank of Nigeria and Federal Ministry of Finance for implementing monetary policy. Such instruments include the following:

3.3.1 Open Market Operation

The open market operation thrives on the sale and purchase of government securities such as treasury bills, treasury certificates, and government bonds, among others.

The transactions are carried out by the central bank on periodic basis. This depends on the state of the economy. For instance, the Central Bank of Nigeria can sell government securities such as bonds to mop up excess liquidity occasioned by the period of economic expansion. The sale of government securities by the apex bank results in monetary contraction.

The sale of the government securities results in depressing their price and thereby occasion withdrawal of money from the public. It is mandatory for the commercial banks to purchase government securities. Hence, as these securities are purchased by the commercial banks through the transfer of bank deposits to the central bank, it reduces the capacity of the banks to create credits.

In corollary, during the period of depression (economic contraction) the central bank buys back government securities to release more money into the economy through the commercial banks. Hence, as government securities are sold by the central bank through the transfer of bank deposits back to them from the central bank; it reduces the capacity of the commercial banks to create credits.

You will understand from this analysis that the buying and selling of treasury bills, treasury certificates and other government securities regulates the cash liquidity of the commercial banks with which to create credits in the economy.

3.3.2 Bank Rediscount Rate

The bank rediscount rate is the rate of interest at which the central bank lends money to the commercial banks. This bank rate is normally varied from time to time in order to use it to regulate the supply of money in the economy.

The Central Bank of Nigeria introduced the monetary policy rate in December 2006 to replace the minimum rediscount rate in Nigeria. The implication is that the MPR as the level at which banks obtain credit from the apex bank. The rate is usually adjusted periodically to maintain overall macroeconomic stability in terms of regulating money supply in the economy.

In order to reduce money in circulation, the apex bank will raise the rate, which will result in raising the cost of borrowing from the bank. It has concomitant effect of raising the rate of interest for private sector borrowing. This discourages corporate bodies and prospective investors from borrowing from the commercial banks. Hence, the flow of funds to the private sector in the economy is curtailed.

In the period of depressed economy, the rediscount rate is lowered to encourage the commercial banks to borrow from the apex bank which enhances their credit creation capacity. The implication is that corporate bodies and prospective investors are encouraged to borrow from the commercial banks. Hence, the flow of funds to the private sector in the economy is expanded.

3.3.3 Liquidity Reserve Ratio

This is applicable to regulation of the liquid cash with the commercial banks with a view to vary their credit creation capacity. During the period of inflation or excess liquidity in the economy, the apex bank will increase the ratio of the commercial banks demand and time deposits held with it to reduce the quantity of money in circulation.

In corollary, during the period of deflation or illiquidity in the economy, the apex bank will decrease the ratio of the commercial banks demand and time deposits held with it to increase the quantity of money in circulation.

3.3.4 Selective Credit Control

This measure is used by the central bank to direct the credit flows of commercial banks to particular sectors of the economy with a cautionary note that such directive does not affect the total credit in the economy. It is also used with the intention to change the composition of credit from undesirable trend to a desirable pattern that ensures meaningful economic growth and development.

The examples of such favoured sectors of the economy in Nigeria are agriculture, solid minerals, transport, power and infrastructure, generally, which have occupied a front burner in the country's economic policies in the quest to use them to diverse the economy and enhance the country's economic growth and development.

3.3.5 Special Directives

The apex bank also has the statutory authority to instruct commercial banks to increase their loan portfolio beyond what they consider adequate, to certain areas of economic activities in the economy.

For instance, the central bank can instruct commercial banks to increase their loan portfolio to the sectors which the government considers to be strategic to the economic growth and development of the country. Examples of such sectors in the country are agriculture, solid minerals, transport, and power.

3.3.6 Minimum Cash Ratio

The cash ratio is the minimum proportion of cash deposits that the commercial banks must maintain with apex bank for daily commitment in terms of meeting customers demand.

The central bank alters the ratio on periodic basis in order to regulate the supply of money in the economy. The ratio is raised when the apex bank desires to curtail credit expansion by the commercial banks. On the other hand, the ratio is reduced when the apex bank desires to encourage credit expansion by the commercial banks.

3.3.7 Moral Suasion

This is a subtle means of controlling the commercial banks in terms of encouraging them to favour some selected sectors of the economy in the process of extending credit facilities to the private sector.

As you have observed from the preceding discussion, the favoured sectors of the economy in Nigeria are agriculture, solid minerals, transport, power and infrastructure generally. The Governor of the Central Bank of Nigeria, during the Annual Bankers Committee Meeting, is expected to persuade the chief executives of commercial banks to give preferential consideration to such sectors of the economy.

3.3.8 Exchange Control

It has been argued that exchange control by various countries in the West Africa sub-region is necessitated by persistent deficits in their foreign accounts. Hence they are compelled to introduce tight exchange controls over the limited foreign exchange earnings, which is the responsibility of their respective apex banks.

For example, the Central Bank of Nigeria supervises foreign exchange transactions in the country, and it has introduced some measures to curtail its use over the years. The pre-1986 period witnessed tight control on the usage of foreign exchange by individuals and private sector organisations. The introduction of SAP in the late 1986 brought about transactions on foreign exchange with strict supervision by the apex bank.

The apex bank also intervenes occasionally to guide against abuse in the foreign exchange market so as to maintain stability in the external value of the country's currency.

SELF ASSESSMENT EXERCISE 3

List and explain the various instruments with which monetary policy can be implemented in the economy.

4.0 CONCLUSION

From above analysis, you can understand the meaning of monetary policy and the significance of its use in any economy. You can also understand the fundamental objectives for which the monetary policy is instituted to achieve in using it. Furthermore, you are exposed to the instruments which are amenable for use in pursuing and achieving the objectives of monetary policy.

5.0 SUMMARY

This unit has been used to discuss the nature of monetary policy, its fundamental objectives and the instruments which are normally employed by the appropriate authorities to implement the monetary policy objectives towards tackling macroeconomic problems in any country. The next study unit is used to discuss fiscal policy; the Siamese twin of the monetary policy.

6.0 TUTOR-MARKED ASSIGNMENT

Mention and discuss the fundamental instruments which can be used to pursue and achieve the objectives of monetary policy.

7.0 REFERENCES/FURTHER READINGS

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MODULE 3

UNIT 1 FISCAL POLICY

CONTENTS

1.0 INTRODUCTION

In the last unit, monetary policy as one of the stabilisation measures which the government employs to check economic fluctuations in the economy is discussed. Another form of such stabilisation measures is the fiscal policy, which is the subject of our discussion in this unit.

Fiscal policy is used by the government to check macroeconomic problems such as inflation, unemployment, low level of aggregate consumption and production by suing taxes and expenditure.

In this unit, therefore, fiscal policy as a macroeconomic measure is discussed so that you will become conversant with such stabilisation policy in terms of the use of taxes and government expenditure to tackle above macroeconomic problems.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- explain the meaning of fiscal policy
- identify and discuss the objectives of fiscal policy
- explain the tools of fiscal policy.

3.1 Meaning of Fiscal Policy

Fiscal policy refers to the use of taxation and government expenditure to check some economic adversities such as inflation, unemployment, low level of aggregate consumption and production by the government with the help of government agencies such as the Finance Ministry, the Budget Office, Federal Inland Revenue Service, etc.

In other words, fiscal policy is normally employed by the government to pursue and achieve some macroeconomic objectives in terms of checking economic problems such inflation, unemployment, low level of aggregate consumption and production.

Basically, therefore, fiscal policy is employed by the government to prop up aggregate production and consumption in the economy in order to tackle major macroeconomic problems which border on inflation and unemployment.

Hence, fiscal policy is used in complementary stance with the monetary policy towards pursuing and achieving fundamental economic objectives such as attainment of full employment, maintaining stability in price level, and desirable balance of payment position, among others. The overall purpose for the use of fiscal policy is the attainment of desirable level of economic growth and development.

SELF ASSESSMENT EXERCISE 1

Discuss the term fiscal policy.

3.2 Objectives of Fiscal Policy

The fundamental objectives for the use of fiscal policy include the following:

1. Control of Inflation

A major macroeconomic problem of inflation is normally tackled with the use of fiscal policy, in addition to the use of the monetary policy as you have observed in the preceding unit. Inflation can arise as a result of excess supply of money in the economy, which can be tackled with the use of increased taxation on the income of the consumers, thus reducing their disposable income.

The returns on investment (or operational incomes) of the corporate organisations can also attract lower level of taxation with the intent of encouraging them to expand their productive capacity. The effect translates in increased level of production and more employment of labour, which tends to reduce the level of unemployment.

2. Increase in Employment Opportunities

The fiscal policy is also aimed at creating more employment opportunities in the economy. This can be achieved with the use of government expenditure, which can be directed at propping up the level of production in terms of production expansion to accommodate idle labour resources.

3. Promotion of Economic Stability

Fiscal policy can be used to ensure economic stability by employing import and export duties, which are forms of taxation on imported and exported goods.

The use of fiscal policy is very crucial in the face of economic fluctuations as a result of the cyclical nature of economic cycle. Moreso, most economies of the world are exposed to external economic fluctuations given the fact that they operate within a global economy. Hence, to counter the undesirable effects of globalisation, the less developed countries are compelled to use fiscal policy in checking external economic fluctuations.

For instance, higher import duties can be used to check the importation and consumption of luxury goods. Therefore, the use of higher import duties can result in curbing reckless spending by the consumers, and thus checking imported inflation.

4. Increase in Rate of Investment

Fiscal policy can also be used to enhance the rate of investment in a given economy. This can be achieved by granting tax waivers by the government or the granting of tax holiday for pioneer status for emerging and infant industries.

The use of lower tax rate on consumer incomes can serve as a potent means of encouraging increase in aggregate consumption in the economy and thus enhancing investment expansion by the existing industries, and attracting foreign direct investment into the economy.

5. Redistribution of National Income

The fiscal policy can be used to redistribute the national income among the citizens in an economy. This is aimed at ensuring that extreme income and wealth inequalities are reduced or totally obliterated in the economy.

The use of progressive taxation structure can ensure redistribution of national income among the citizens by increasing the real income of the middle and lower incomer earners while reducing the incomes of the upper class in the economy.

The tax regime can also be extended to cover personal wealth of individuals, expenditure, real estate, and consumption of luxury goods and services, among others. The effect is reducing incomes of the wealthy individuals while increasing incomes of the lower and middle class in the economy.

SELF ASSESSMENT EXERCISE 2

Mention and discuss the various objectives of fiscal policy.

3.3 Instruments of Fiscal Policy

The tools normally employed by the government in the use of fiscal policy include the following:

3.3.1 Taxation

Taxation refers to the compulsory levy imposed on the people and corporate bodies and other businesses operating in an economy. The compulsory levy is imposed on the incomes, real estate, goods, services, and business transactions.

Taxes can be direct or indirect. Taxation is regarded as direct when imposed on the incomes of individuals, corporate bodies and other businesses. It is regarded as indirect tax when it is imposed on goods and services consumed by the people in the economy.

Taxation is regarded as the most effective tool of fiscal policy because it can be used to achieve the following objectives.

i) To check conspicuous consumption.
ii) Redirect investment from consumer goods to capital goods.
iii) To encourage saving and investment.
iv) To redistribute incomes and thus reduce economic inequalities.
v) Increase government revenue earnings in the economy.
vi) To enable the government develop infrastructure.
vii) Make possible the mobilisation of economic surpluses.
viii) To help curb unemployment through lower company taxation and tax relief.
ix) To develop infant industries through higher import duties.
x) To redirect investment into neglected areas of the economy.

Hence, the government manipulates taxation to pursue and achieve fiscal policy objectives; either raising or reducing tax incidence on individuals and corporate organisations in the economy.

3.3.2 Public Expenditure

This refers to the government expenditure which is expended on the development of both economic and social infrastructure. In practice, government spending is either increased or decreased to tackle macroeconomic problems such as unemployment, inflation, low level of aggregate consumption and production in the economy, among others.

The government expenditure, therefore, is strategic towards ensuring enhanced growth rate in the economy, creating more employment opportunities, raising aggregate income, and reducing income inequalities, among others.

3.3.3 Public Budget

This refers to the financial plan of the government which is based on estimated (or projected) revenue and expected expenditure in a fiscal year. The government budget can be surplus or deficit.

The government budget is regarded surplus when the projected income for the fiscal year exceeds the estimate expenditure for the same period. The public budget is said to be deficit when the projected income for the fiscal year is less than the estimate expenditure for the same period.

The surplus budget is used when there is too much money in circulation in the economy, which is an invitation to inflation. The deficit budget is used when the economy is in a depressed state. A balanced budget is achieved when the economy is in equilibrium, which is a state of neither inflationary nor deflationary.

4.0 CONCLUSION

From the foregoing analysis, you can understand the meaning of fiscal policy and the essence for its use in any economy. You can also understand the fundamental objectives for which the fiscal policy is instituted to achieve in the economy. Furthermore, you are exposed to the tools which are amenable for use in pursuing and achieving the objectives of the fiscal policy.

5.0 SUMMARY

This study unit has been used to discuss the nature of fiscal policy, its fundamental objectives and the tools which are normally employed by the government to implement the fiscal policy objectives towards tackling macroeconomic problems in the economy.

6.0 TUTOR-MARKED ASSIGNMENT

Mention and discuss the fundamental tools which can be used to pursue and achieve the objectives of fiscal policy.

7.0 REFERENCES/FURTHER READINGS

Lipsey, R. G. and K. A. Crystal (1997). *An Introduction to Positive Economics.* Oxford: Oxford Press.

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UNIT 2 UNEMPLOYMENT

CONTENTS

1.0 INTRODUCTION

Basically, the labour force comprises all those people holding a job or registered as being willing and available for work. The unemployment rate refers to the percentage of the labour force without a job but registered as willing and available for work.

Nonetheless, some people without a job are really looking for work but have not bothered to register as unemployed. These people are not normally included in the official statistics for the registered labour force, and therefore will not appear as registered unemployed. Yet from an economic viewpoint, such people are in the labour force and are unemployed.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- explain the meaning of unemployment
- discuss the nature of unemployment
- identify and explain the various types of unemployment
- differentiate between private and social cost of unemployment.

3.0 MAIN CONTENT

3.1 Nature of Unemployment

Unemployment is a stock concept measured at a point in time. Its level rises when the newly unemployed exceed people getting new jobs or quitting the labour force altogether.

You have to appreciate the fact that people working can be unemployed. There are three ways through which people working can become unemployed. Firstly, some people are sacked or made redundant (job-losers). Secondly, some are temporarily laid off but expect eventually to be re-employed by the same company at a later date. Thirdly, some people voluntarily quit their existing jobs. Nevertheless, the inflow to the level of unemployment can also come from people not previously in the labour force. For instance, unemployment level can rise from the school leavers which constitute the new entrants. Furthermore, it can also arise from people who once had a job, then ceased even to register as unemployed, and now coming back into the labour force in search of a job. These are the re-entrants.

Some people are bound to leave the unemployment pool in the opposite directions. For instance, some get jobs while others give up looking for jobs and leave the labour force completely. However, some of this latter group may simply have reached the retirement age at which they can draw a pension; many of them are discouraged workers. And discourage workers are pessimistic about finding a job and therefore, leave the labour force.

SELF ASSESSMENT EXERCISE 1

Explain the nature of unemployment.

3.2 Meaning of Unemployment

Unemployment is regarded as a situation whereby labour as a factor of production is not utilized in productive activities. Hence, unemployment of labour occurs when a person is willing and able to work and cannot get a suitable job.

Unemployment can be classified into voluntary and involuntary. The voluntary unemployment involves a situation when there is a job opportunity but the unemployed person is not willing to accept the job for reasons such as unacceptable wage rate, lack of interest on the nature of the job, lack of mobility to where it is available, unfavourable condition of service, etc.

The involuntary unemployment occurs when a person is willing to accept a job at the prevailing wage rate but cannot get a job.

SELF ASSESSMENT EXERCISE 2

Differentiate between voluntary and involuntary unemployment.

3.3 Types of Unemployment

There are various types of unemployment which are classified in the areas of frictional, structural, demand-deficient, or classical. Such types of unemployment are discussed below.

(1) Frictional Unemployment

This type of unemployment is the irreducible minimum level of unemployment in a dynamic society.

It includes people whose physical or mental handicaps make them almost unemployable, but it also includes the people spending short spells in unemployment as they hop between jobs in an economy where both the labour force and the jobs on offer are continually changing.

(2) Structural Unemployment

It refers to unemployment arising because there is a mismatch of skill and job opportunities when the pattern of demand and production changes.

For example, a skilled welder may have worked for 25 years in shipbuilding but is made redundant at 50 when the industry contracts in the face of foreign competition. That worker may have to retrain which is more in demand in today's economy. But firms may be reluctant to take on and train older workers. Such workers become the victims of structural unemployment.

(3) Demand-Deficient Unemployment

This occurs when output exceeds aggregate demand for products. Hence, a decline in demand for the products of the firms will bring about a reduction in the usage of factors of production, which include labour.

It is instructive to note that until wages and prices have adjusted to their new long-run equilibrium level, a fall in aggregate demand will lead to lower output and employment. Some workers will go to work at the going real wage rate but will be unable to find jobs. Only in the longer run will wages and prices fall enough to boost the real money supply and lower interest rates to the extent required to restore aggregate demand-deficient, and unemployment be eliminated.

Since the classical model assumes that flexible wages and prices maintain the economy at full employment, classical economists had some difficulty explaining the high unemployment levels of the 1930s. Their diagnosis of the problem was partly that union power was maintaining the wage rate above its equilibrium level and preventing the required adjustment from occurring.

(4) Classical Unemployment

This describes the unemployment created when the wage is deliberately maintained above the level at which the labour supply and demand schedules intersect.

It can be caused either by the exercise of trade union power or by minimum wage legislation which enforces a wage in excess of the equilibrium wage rate.

The modern analysis of unemployment takes the same types of unemployment but classifies them rather differently in order to highlight their behavioural implications and consequences for government policy. Modern analysis stresses the difference between voluntary and involuntary unemployment under this consideration.

(5) Search Unemployment

This occurs when a person refuses to accept an available job and therefore remain unemployed in order to search for a better job. It is voluntary because the person can find job which he is not ready to accept. It is also involuntary because the person has not yet avail himself or herself of the type of job he/she is interested in accepting.

(6) Seasonal Unemployment

This is the type of unemployment that occurs on seasonal basis. For instance, labour employed in farming activities during the rainy season will become jobless during the dry season. Another good example is the labour engaged in fishing activities, which is laid off during the period of bad weather condition.

SELF ASSESSMENT EXERCISE 3

Identify and explain the various types of unemployment.

3.4 The Private and Social Cost of Unemployment

In this section we discuss the private and social cost of unemployment. We begin with the private cost.

3.4.1 The Private Cost of Unemployment

It is important to recall voluntary and involuntary unemployment for the analysis. When individuals are voluntarily unemployed, they reveal that they do better by being unemployed than by accepting the job offers that they face at the going wage rate. Under these circumstances the private cost of unemployment (the wage forgone by not working) is less than the private benefits for being unemployed. What are these benefits? First, the individual is entitled to transfer payments from the government in form of social security allowance. These are of two kinds. Workers who have previously contributed to the national insurance scheme are entitled to unemployment benefit for first 12 months after they become unemployed. Thereafter they become entitled to supplementary benefit, the ultimate backstop in a welfare state such as Great Britain.

There are other benefits to be derived from being unemployed. First, there is the value of leisure. By refusing a job, some people are revealing that the extra leisure is worth more to them than the extra disposable income derivable from a job. Second, some people expect to get a better job after a temporary spell of unemployment. These future benefits must be set against the current cost of lower disposable income.

When people are involuntarily unemployed, the picture changes. Involuntary unemployment means that people would like to work at the going wage but cannot find a job because there is excess labour supply at the existing level of employment.

The distinction between voluntary and involuntary unemployment is important because it may affect our value judgment about how much attention should be paid to the unemployment problem. When unemployment is involuntary, people are suffering more and the case for helping them is stronger.

3.4.2 The Social Cost of Unemployment

For the analysis, it is necessary to distinguish between voluntary and involuntary unemployment. When unemployment is voluntary, individuals prefer to be good for the society as a whole.

There is one obvious discrepancy between individual benefits. For an individual, unemployment and supplementary benefit are part of the benefits of being unemployed. But these transfer payments give no corresponding benefit to society as a whole. They may ease the collective conscience about poverty and income inequality, but they are not payments for the supply of any goods or services that other members of society may consume. To this extent, the value judgment that we ought to support the unemployed becomes contentious.

However, this does not mean that society should go to the opposite extreme and try to eliminate voluntary unemployment completely. First, society is perfectly entitled to adopt the value judgment that it will maintain a reasonable living standard for the unemployed, whatever the cost in resource misallocation. Second, even in terms of allocative efficiency, the efficient level of voluntary unemployment is certainly above zero.

In a changing economy, it is important to match up the right people to right jobs. Getting this match right allows society as a whole to produce more output. Freezing the existing pattern of employment in changing economy will eventually lead to a mismatch of people and jobs. The flow through the pool of unemployment is one of the mechanism through which society reallocates people to more suitable jobs and increases total output in the long run. If unemployment benefits make this transition smoother, society may gain.

Two points emanating from earlier analysis are also relevant here. First, even when unemployment is high, flows both in and out of the pool are large relative to the pool itself. Second, people who do not get out of the pool quickly are in danger of stagnating when unemployment is high.

Involuntary unemployment has an even higher social cost. Since the economy is producing below capacity, it is literally throwing away output that could have been made by putting these people to work. Moreover, involuntary unemployment may entail more human and psychological suffering than voluntary unemployment. Although this is hard to quantify, it is also part of the social cost of unemployment.

SELF ASSESSMENT EXERCISE 4

Differentiate between social and private cost of unemployment.

4.0 CONCLUSION

From the foregoing analysis, you can understand the meaning and types of unemployment. You can also appreciate the nature of unemployment as well as the social and private cost of unemployment, which do influence the nature of policies that may be initiated by the government to cushion the effects of unemployment, and by extension the measures adopted to stem the economic problem.

5.0 SUMMARY

This study unit has been used to discuss the meaning and nature of unemployment. It also discusses the various types of unemployment. Lastly, the unit also discusses the social and private cost of unemployment.

6.0 TUTOR-MARKED ASSIGNMENT

Mention and explain the various types of unemployment.

7.0 REFERENCES/FURTHER READINGS

Begg, D., S. Fischer and R. Dornbusch (2000). *Economics,* Sixth Edition. Berkshire, England: Maindenhead.

Lipsey, R.G.and K.A. Crystal (1997). *An Introduction to Positive Economics*. Oxford: Oxford Press.

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UNIT 3 DEMAND AND SUPPLY OF MONEY

CONTENTS

1.0 INTRODUCTION

Money as a legal tender in any economy has been introduced to ease the process of economic transactions. In advanced economies, money as a means of payment (such as coins and bank notes) has assumed diverse forms and nature that it now includes representative money such as cheques, stamps, electronic cards, bank drafts, banker's cheques, among others. In the less developed countries, the most popular forms of money are the coins and bank notes. These are known as legal tender because they must be accepted by everybody in economic transactions in such countries.

This study unit is used to discuss the motives which make people to hold some quantity of money (demand for money) beyond its subsistence use and the factors that influence the demand for money. In addition, the unit is also used to discuss the quantity of money in circulation (supply of money) at any point in time and the factors, besides government influence, that affect its supply in any given economy.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- explain the meaning and functions of money
- discuss demand for money
- discuss the three motives for holding money
- explain factors affecting demand for money

- discuss supply of money
- explain factors affecting supply of money.

3.1 Meaning and Functions of Money

Money can be defined as any asset that is generally accepted as the means of payment for goods and services and in settlement of debts within any economy. According to Begg, Fischer and Dornbusch (2000), money is any generally accepted means of payment for delivery of goods or settlement of debt. Hence money is a medium of exchange for goods and services, and by extension, it is acceptable for the settlement of debts and any other financial obligations.

The above views on the essence of money portray that "money is usually not wanted for its own sake, but for what it garner for the person who possesses it. Forms of money include mainly coins and paper notes. However, there are other forms of money which are distinct and different the form group. These are regarded as near-money or representative money since they have to be converted into physical cash before they can easily be used in exchange of goods and services as well as in settlement of debts.

The functions of money include the following:

1. Medium of Exchange

This is the foremost function of money since without being generally accepted for exchange it seizes to be money and a legal tender. It means that money performs the important function of ensuring that the process of exchange in the economy is facilitated. Hence, the legal tender as the official currency in any economy replaces the cumbersome process of barter.

2. Store of Value

The wealth possessed by an individual can be saved in form of money for the future use. This implies that money serves as a means by which we can create a stock of wealth which can be converted into use in the future.

3. Standard of Deferred Payment

Money enables people to engage in credit transactions, which can be assessed in monetary terms for the future settlement. Hence, the presence of money makes possible the practice of borrowing and lending as well as credit purchases. It also facilitates the postponement to future date spending on some commitments in business, households and government circle.

4. Unit of Account

Money makes it possible to denominate the goods and services that are transacted on in the economy. In other words, money as a unit of account, serves as a common denominator used for measurement of goods and services. Therefore, money as a unit of measurement enables the prices of goods and services to be determined.

5. Measure of Value

Money serves as a common standard by which the value of commodities can be determined. In other words, money as a unit of account different values of goods and services to determined. Hence, money facilitates the measurement of differences in the values of goods and services.

SELF ASSESSMENT EXERCISE 1

1. Explain the term money.
2. Identify and explain the functions of money.

3.2 The Demand for Money

3.2.1 Concept of Demand for Money

The demand for money refers to the amount of money which people are willing to hold in a given period of time. In discussing the demand for money, our main focus will be to look at the variables that actually motivate people to hold part of their wealth in money assets as opposed to other assets. It is important to note that because holding money has a cost, there is a limit to which people can hold money.

Various theories on the demand for money explain why people are willing to hold cash balances as opposed to other assets which can be easily converted into cash. There appears to be a consensus of opinion among all monetary theorists that among other factors, income and rate of interest are important parameters that will affect the demand for money in any given economy.

SELF ASSESSMENT EXERCISE 2

Explain the term demand for money.

3.2.2 Motives for Holding Money

The three motives for holding money, as propounded by Lord Maynard Keynes in his liquidity preference theory, are as highlighted and discussed below.

1. Transactions Motive

The need for people to hold some money for daily transactions is referred to as the transactions motive. In other words, transactions motive of holding money refers to the need to hold money to meet up various transactions that are carried out on a daily basis. Keynes argued that there is hardly any economic agent whose cash receipt perfectly matches its cash payment at all times.

For instances, most workers receive their income on a monthly basis, some weekly, etc. However, not all necessities could be bought and stored up till the next salary period. Even if this is feasible, other expenses on items such as transport to work, newspaper, feeding at work, etc, are met on daily basis or at shorter interval than receipt of income. Most businesses find their operational demands in this similar situation. For instance, goods may have to be sold on credit or on monthly basis but daily operational expenses have to be met.

The difficulty in synchronizing the inflow and outflow of funds creates the need to hold some cash to meet daily expenses till the next cash inflow period. Money held for the purpose of ameliorating this situation is known as transactions motive. The amount of money that an individual will hold for the transactions purpose is a function of the level of income. The higher the level of income earned by an individual the higher the amount of money that will be held for transactions.

Transactions motive is also influenced by such other factors like intervals of time between workers earnings, family size, life style, consumption habit, etc.

2. Precautionary Motive

Precautionary motive refers to holding money for unforeseen circumstances and eventualities that may arise without notice. According to this postulate, emergency situations such as sudden illness, damages to household facilities, arrival of unexpected visitors necessitate the need for holding money for precautionary motive.

Money people hold with which to meet such unexpected commitments in life is said to be held for precautionary purpose. For instance, for a businessman, there may be the need to set some money aside for the mere fact that cash requirements for operations may exceed what has been budgeted for in the cash flow forecast or some debtors from whom payments are due may fail to pay.

In the government circle, for instance, the tax revenue generated may fall short of expected amount and this calls for precautionary measure in the budget. Furthermore, national exigencies such as earthquake, drought, flood, outbreak of communicable diseases, or fire outbreak may necessitate unexpected public spending. These emergencies do give rise to the need for holding money for the purpose of precautionary expenditure.

3. Speculative Motive

Under this consideration, Lord Keynes posited that people hold money above their active balance requirements so that they may make profits by "speculating" on the prices of bonds. According to Keynes, when prices falls suddenly, people will want to use the opportunity to purchase bonds, assets, goods, etc; and resell later when prices appreciate. He linked the speculative demand with interest rate which reflects movement of the prices of bond.

Keynesians believe that there are circumstances when an economic unit will prefer to hold money in excess of their transactionary and precautionary requirements. People do hold money in expectation of fall in prices of goods, so that they can buy and later sell them when prices rise. Money that people hold to take advantage of price changes is known as speculative motive.

SELF ASSESSMENT EXERCISE 3

Identify and explain the three motives for holding money.

3.2.3 Factors Affecting Demand for Money

The demand for money is a function of factors which are listed and explained below.

1. Level of Income

A person whose earning is of relatively large sum would be expected, all things being equal, to have more cash balances for transactions, precautionary and speculative motives than an individual whose income is barely enough to take care of daily survival or for subsistence purpose. Hence, the latter is only preoccupied with the transactions motive for holding part of income compared to the former who can provide for all the three demand motives.

2. The Size of Individual Wealth

An individual who has a large wealth would be expected, all things being equal, to have more of each of the various investment assets that are accommodated in his wealth portfolio. These assets would include money. A person who has a total wealth of say N15million, for example, would have more money in his wealth portfolio than a person whose total wealth holding is just N750,000. When the wealth holding increases, demand for money will be expected to increase just as demand for other assets will be expected also to increase within the portfolio framework.

3. Interest rate

Interest refers to the cost of money, the alternative forgone or the opportunity cost of holding perfectly liquid balances as opposed to interest bearing securities. When interest rate rises, the opportunity cost of holding money will rise. It implies that it will become more expensive to hold money. Hence, the demand for money will consequently fall. On the other hand, low rate of interest will increase the incentive to hold cash as opposed to interest bearing securities because what is lost is insignificant particularly when one considers the transaction costs involved in the acquisition and realization of interest bearing securities.

4. Individual Preferences

According to the monetarists, people prefer to hold money because of the confidence it brings to the holder. The importance that people attach to money as a form of wealth, given the same level of opportunity cost sill vary and this will affect individuals demand for money. Some people attach enormous value to the convenience of liquidity and confidence which money possesses, as opposed to other assets like bond, physical goods and other financial assets.

Such individuals believe that the liquidity and confidence that money generates constitutes some form of implicit yield and it is the comparison of this implicit yield with the explicit yield which is the interest forgone, that actually influences a person's propensity to hold cash. The greater the value that an individual attaches to these implicit yields, the higher will be his demand for money and vice-versa.

SELF ASSESSMENT EXERCISE 4

Identify and explain the factors that influence demand for money.

3.3 Supply of Money

3.3.1 Concept of Supply of Money

The supply of money refers to the amount of money which is available in an economy at any given time; which is in sufficiently liquid and available for immediate spending. Hence, it implies that supply of money at any moment is the total sum of all the money holdings of all the members of the society. Money supply in any economy is expressed as M1, M2 or M3.

M1 refers to the total amount of currency held by the public or currency in circulation, plus demand deposits.

M2 refers to the total amount of currency held by the public or currency in circulation plus demand deposits plus time deposits.

M3 refers to the total amount of currency held by the public or currency in circulation, plus demand deposits plus time deposits plus banks' loans.

The loans granted by the banks are considered herein in M3 since such loans increase the stock of money in circulation in the economy. When the banks lend out money, the borrowers receive extra money as injected into the money in circulation. Needless to say that nobody else has any less money as a result of the loans.

The existing depositors could still write cheques against their deposits. The banks take the amount of loans out of the vaults and put it back into circulation, and therefore, they succeed in increasing the money supply in the economy.

SELF ASSESSMENT EXERCISE 5

Identify and discuss the various components of money supply.

3.3.2 Factors Affecting Money Supply

The fact remains that the monetary authorities such as the central bank is the major determinant of the money stock or supply of money. This is in consideration of the fact that regulation of the monetary base and control over most of the other variables that affect money supply are vested in them.

There are other variables or factors that affect money supply in any economy as highlighted and discussed below.

1. Monetary Base

The money supply has the potential to increase if the central bank expands the monetary base. The monetary base or high powered money is the total of bank reserves plus currency in the hands of public. These two important components (bank reserves and currency in circulation) constitute the uses of the monetary base and are naturally influenced by the central bank's policies as well as the behaviour of both the public and the banks.

For instance, if the central bank increases the monetary base by allowing commercial banks more liquidity in excess of reserve requirements, all things being equal, there will be more money available for supply in the economy.

2. Credit Creation

The extent to which commercial banks are allowed to create credits in the process of financial intermediation by giving out loans will affect the extent of money supply. This is hinge don the fact that the demand deposits they create through lending facilities are part of the money supply. When banks create credit, the lending facility or loans and overdrafts will in turn lead to demand deposit.

The money multiplier is the magnitude by which the money supply will increase if there is any increase in deposit. The higher the level of deposits in banks, the higher their ability to create credit, and the more credit they lend out to the investing public, the more the level of money supply in the economy.

3. Portfolio Behaviour of the Public

This is related to the banking habits of the public. For instance, if most people keep their money in bank, the banking system will have liquid reserves to lend out and create derivative deposit which is the deposit created through lending. Deposit created through customers deposit is the primary deposit.

The currency outside the banking system constitutes leakages in the money creation process and the less these leakages are the more the ability of banks to create derivative deposit and by extension, increase money stock in circulation. In developed financial system where banking habit is well adopted and imbibed, the marginal propensity to hold currency will be very low. The smaller this marginal propensity to hold currency the higher will be the bank deposit and therefore, the higher the money supply. If the marginal propensity to hold currency increases, the liquidity of commercial bank will nose dive and by implication, money supply will similarly fall.

4. Policies of Monetary Authorities

The policies of the monetary authorities such as the central bank employed in reaction to the mood of the economy will have effects on money supply. The sale of marketable securities such as treasury bills, and treasury certificates, for example, will facilitate a reduction in money supply causing a reduction in overall liquidity of the economy.

Monetary policies such as the use of special deposit and the issuance of stabilization security also affect money supply in the economy. Monetary policies such as legal reserve ratio and rediscount rate adjustment will also have the same effect on money supply. Central bank being a supervisory authority on supply of fund to the banking system, its manipulation of the re-discount rate will affect commercial banks lending rate. Demand for loan is determined principally by the rate of interest, and by implication, bank lending will fall when interest rate rises. The fall in demand for bank credit as a result of a rise in interest rate will cause a contraction in money supply.

5. Foreign Exchange Transactions

The availability of foreign exchange will have the tendency to increase domestic money supply. The supply of foreign exchange in the economy comes in form of personal incomes or transfers of foreign currency and foreign exchange generate through by business entities which can be sold to an authorized dealer or deposited it in foreign exchange domiciliary account. This does not affect domestic money supply because only deposits in local currency will be part of the officially designated money supply.

On the other hand, if such magnitude of foreign currency is converted into local currency, the equivalent amount in local currency will increase the currency in circulation; therefore causing an increase in money supply in the economy. On the other hand, when an individual wants to import, he will need to buy foreign exchange, transferring local currency to the central bank and that will reduce money supply.

In essence, therefore, dealings in foreign exchange will have the effect of locking up part of money supply through demand for foreign exchange for import or expanding money supply through sale of foreign exchange generated from exports of goods and services.

SELF ASSESSMENT EXERCISE 6

Identify and discuss factors that influence money supply.

4.0 CONCLUSION

From the foregoing analysis, you can understand the meaning, forms and function of money. You can also appreciate the motives which inform the tendency for people to hold money as well as the factors which influence the demand for money. You have learnt the nature of the supply of money and the factors that influence the quantity of money in the economy at a given point in time.

5.0 SUMMARY

This study unit has been used to discuss the meaning, forms and functions of money. It is also used to discuss the demand for money, determinants for the demand for money. Lastly, the unit is also used to discuss supply of money and the factors that influence the quantity of money in circulation within the economy at a given point in time. The next study unit is used to discuss financial institutions.

6.0 TUTOR-MARKED ASSIGNMENT

1. Differentiate between demand for money and supply of money.
2. Mention and discuss factors that influence the supply of money.

7.0 REFERENCES/FURTHER READINGS

Begg, D., S. Fischer and R. Dornbusch (2000). *Economics,* Sixth Edition. Berkshire, England: Maindenhead.

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UNIT 4 FINANCIAL INSTITUTIONS

CONTENTS

1.0 INTRODUCTION

Financial institutions are the financial intermediaries between the savers of surplus funds and the investors who are in need of extra funds to fund business undertakings. The main financial institutions in Nigeria are the commercial banks that bestride the country's economic landscape like colossus. The other financial institutions have become captives to the commercial banks because they are mostly such institutions parent companies.

The central bank is at the apex position in the financial system of any economy. The bank controls the other banks in the country. The other financial institutions include development banks, insurance companies, the stock exchange, mortgage banks, and foreign exchange market. In this unit, you are exposed to the discussion on financial institutions in the economy.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- explain the meaning of central bank
- identify and discuss the functions of the central bank
- discuss nature and functions of commercial banking

- mention and discuss the functions of commercial banks
- discuss the importance of mortgage banks
- identify and explain functions of insurance companies
- discuss the significance of the stock exchange in the economy
- explain the importance of mortgage banks.

3.0 MAIN CONTENT

3.1 The Central Bank

3.1.1 Central Banking in the Economy

The central bank of any economy constitutes the apex of the financial system. In other words, the central bank occupies the apex position to other financial institutions in the economy. Hence, it regulates controls and supervises the operations of all other financial institutions in that economy. Its operations are very strategic in national economic management and planning of the economy.

3.1.2 Functions of Central Bank

The central bank as the most strategic financial institution in the economy performs the following functions.

1. Banking functions

These functions include the following:

i) Keeps the government bank accounts
ii) Lends money to the government;
iii) Acts as a banker's bank, i.e. banker to other financial institutions;
iv) Serves as clearing house for commercial banks.

2. Agency Functions

These functions include the following:

i) Provides exchange medium i.e. notes and coins on behalf of the government;
ii) Acts as registrar of government companies and corporations;
iii) Manage the underwriting, issue, sale and liquidation of government debt instruments like treasury bills, loan stocks, etc.;
iv) Administers the country's foreign exchange regulations and maintains the international value of the currency;
v) Keeps the government's gold reserve and maintains the Exchange Equalization Account;

vi) Represents the country on international financial institutions like the World Bank, African development Bank, International Monetary fund, etc. and maintains link with and account of, these bodies; and
vii) Manages the national debt.

3. Advisory functions

These functions include the following:

i) is the chief monetary adviser to the federal government;
ii) Undertakes research on the various facets of the economy and provides report to the government for necessary policy actions; and
iii) co-ordinates returns from financial institutions.

4. Regulatory Functions

These functions include the following:

i) acts as the watchdog of the economy,' regulates money supply, interest rate and formulates necessary monetary policies in line with the dictate of the economy as may be from time to time;
ii) maintains the integrity of the of banking system through supervision of banks, banking examination and invoking necessary sanctions to ensure conformity and high ethical standard;
iii) supervises the creditability of institutions entering the banking system;
iv) initiates and advises the government on regulations or amendment to regulations as may be necessary to further strengthen the financial system.

SELF ASSESSMENT EXERCISE 1

Identify and discuss functions that central bank performs in the economy.

3.2 Commercial Banks

3.2.1 Meaning of a Commercial Bank

A commercial bank engages in the business of receiving from the public the money which is payable on demand and making advances to customers. In other words, a commercial bank is an institution that engages in financial intermediation. A commercial bank, therefore, has the business operations of receiving money from outside sources as deposits and creating credits through loan facility. Hence, banking business can be described as that of trading in money and other financial assets with a view of making profits.

A commercial bank can also be defined as a financial institution which accepts money and other valuable for safe custody. In other words, a commercial bank can be referred to as an institution dealing in money, an intermediate party between the borrower and the lender and therefore, a company that specializes in financial intermediation. This is because the bank mobilizes funds from those who have surplus to part with temporarily and channels such funds to the prospective borrowers in the economy.

Commercial banks in Nigeria operate branch banking. Branch banking is characterized by a single banking company conducting operations on the basis of branch network, maintaining many branches in many major towns and cities within the country.

SELF ASSESSMENT EXERCISE 2

Differentiate between a central bank and a commercial bank.

3.2.2 Functions of Commercial Banks

The commercial banks provide numerous services to the banking public in the country. Such functions of commercial banks are as follows.

1. Mobilization of Savings

A major function of commercial banks is the mobilization of savings through the provision of facilities as saving institutions. As funds are mobilized through the various types of accounts operated by the customers, the commercial bank in turn makes the funds available to investors for investment purposes by the process of granting credit facilities to them. Hence, these funds are made available to business entities to enable them expand their productive capacity and to individuals and households to facilitate consumption.

2. Granting Credit Facilities

The hallmark of commercial bank operations is the extension of credit to worthy borrowers. In making credit to the banking public, commercial banks render great economic services. Their actions impact positively on the economy because production is increased, capital investments are expanded and a higher standard of living for the citizens is realized. The credits of the commercial banks are given out in the forms of loans and overdrafts which are repayable by the beneficiaries. The commercial bank is required by the shareholders to earn reasonable returns on loan facilities through interests charges associated with lending.

3. Agents of Funds Transfer

Another major function of a commercial bank is by acting as agent of payment and facilitating the transfer of funds for their customers. This is usually carried out through operations such as the use of cheques as a means of payment, carrying out of standing orders, mail or telegraphic money transfer, open credit or cashing credit, cards and direct debiting, among others. By using these facilities, the bank assists her numerous customers to make funds available from one point to another, and also honour payment obligations on behalf of their customers.

4. Loan Syndication Services

Commercial banks do also, on behalf their customers, arrange loan syndication services whenever approached to do so. Loan syndication arises whenever a customer requires a huge loan facility which a single bank may consider as being too risky for one bank to carry in its loan portfolio. Hence, loan syndication involves a bank sourcing for other willing banks who will be ready to bear the burden, by sharing to provide a part of the required loan facility, thereby spreading the risk. This service enables very huge financial resources to be mobilized for customers when such funds are needed.

5. Keeping of Valuables

Commercial banks also have one of their functions as assisting their various customers to keep their valuables in safe custody. Such valuables like wills, certificates, jewelleries, deeds of title to land, etc, are usually accepted by the banks for safe custody, thus avoiding losses through theft, misplacement or destruction through fire outbreak.

6. Investment Advisory Services

Commercial banks can also offer investment and business advisory services to their customers by advising them on areas of profitable investment opportunities. These investment advices are necessary because the success of a customer's business will mean that the bank too will benefit. In this regards, banks have trained personnel capable of providing superlative advice on investments opportunities.

7. Brokerage Services

Commercial banks also engage in brokerage services for their customers. They participate in floating new securities for their customers and also assisting their customers to buy into new securities. Therefore, bonds, stocks and shares are bought and sold besides collection of dividends on behalf of their customers.

8. International Trade Services

Commercial banks also assist their customers to facilitate international business transaction through the provision of needed foreign exchange and international payments through the issuance of letters of credit and other relevant documents. They also issue travelers cheques to people traveling abroad as well as the conversion of local currency into foreign currencies. They also give vital information concerning their customers as may be required by foreign business partners.

9. Status Enquiry Services

Commercial banks in their daily operations also provide reference reports on behalf of their various customers regarding status profile about the standing of their customers when other business partners seek to know the credit worthiness or position of their business associates. These references when given by a commercial bank on behalf of its customer, goes a long way to boost the image and business of such a customer.

10. Trusteeship and Executorships Services

Commercial banks also provide sundry services such as trusteeship and executorships of wills, estates, investments and businesses on behalf of their customers where such customers requests the bank to become their surrogate managers over such property or investments.

11. Execution of Monetary Policies

A major function of the commercial banks is in the execution of monetary policies of government through compliance with the directives and regulation of the central bank in its operations. The central bank on behalf of the government in the quest to stabilize the economy, do initiate policies from time to time which are aimed at regulating the entire economy. The commercial banks constitute the implementing agents by carrying out these directives as stipulated by the central bank in their operations.

SELF ASSESSMENT EXERCISE 3

Identify and discuss the functions of commercial banks.

3.3 Development Banks

The development banks are the banks established by the government to encourage the economic growth and development of the country. Presently, examples of such banks in Nigeria are the Bank for Industry (BOI) and the Nigerian Agricultural, Cooperative, and Rural Development Bank (NACRDB). The development banks by virtue of their mandate are banks that specialize in providing long-term and medium-term loans for the development of industries and participate in development projects in any sector of the national economy.

These banks are sometimes involved in direct investments (equity holdings) to accelerate development projects. They do also periodically conduct detailed feasibility studies in some areas of the economy in order to identify development projects that could be financed from internal funds available or that could be financed through internal and external participation.

The functions of development banks include the following:

i. To stimulate economic development of the country.
ii. Harnessing funds for industrial and agricultural development
iii. Encourage savings form small income earners.
iv. Introduce appropriate strategies for channeling micro credits to small investors.
v) Delivery of micro credits to businessmen and women.
vi) Make funds available to industrialists for the purpose of industrial expansion.
vii) Liaise with development partners for encouragement of industrial development in the country.
viii) Formulate appropriate policies that can encourage industrialists to invest in strategic areas of the economy.
ix) Develop extension services to help industrialists for efficient operations.
x) To engage in other operations necessary to boost industrial productions.

SELF ASSESSMENT EXERCISE 4

What are the functions of the development banks?

3.4 Insurance Companies

Insurance companies are financial institutions established for the purpose of accepting risks and losses as they occur in business enterprises in any economy. In the course of operations they collect premiums which form a pool out of which the insured parties are compensated in the event of loss.

Insurance companies insure their clients against risks and uncertainties of two kinds. The first group refers to risks and uncertainties which can be calculated and forecast with some measure of accuracy. Examples of such risks are those associated with burglary, fire outbreak, accidents, etc.

The second group refers to those risks and uncertainties which cannot be calculated or forecast. Examples of these risk and uncertainties are flood, thunder, volcano, earthquake, typhoon, and business inefficiency, among others.

Insurance business thrives on pooling of risks, which involves accepting risks from a large number of people and collecting contributions through premiums to generate a fund, out of which compensations are paid to those who suffer one kind of loss or the order.

An insurance company can sometimes spread the clients' risks by re-insuring part of the risks with other insurance companies. The issue of re-insurance arises because the risk involved is greater than what a particular insurance company can cope with considering its capital and expertise.

The functions of insurance companies include the following:

i) They assume responsibility for business risks of their clients by accepting to compensate them in the event of incurring losses insured against.
ii) They help to mobilize funds which can be accessed by investors for industrial development.
iii) They pool financial resources of individuals and corporate entities through premiums with which to participate in financial intermediation.
iv) They help the industries to manage their risks and therefore, help their clients to transfer their business risks to another party.
v) Insurance companies facilitate business operations by helping corporate entities to shed their operational risks.
vi) They facilitate educational development through education endowment policy in their operational portfolio.
vii) They facilitate economic growth and development in the economy.

SELF ASSESSMENT EXERCISE 5

What are the functions of insurance companies?

3.5 The Stock Exchange

The stock exchange is the nerve centre of the capital market. The capital market itself is a network of facilities for mobilizing and dealing on medium and long term funds. The monetary instruments traded in the sock exchange are those whose maturity period is from 5 years and above; e.g., bonds, shares, loan stock, etc.

In the case of Nigeria, the capital market has two segments-the primary segment and the secondary segment. The primary segment is the situation where firms issue new securities, debt or equity to investors and are sold through investment bankers who act as agents for the companies selling the securities or instruments. It is a major source of capital for companies.

The secondary segment of the capital market on the other hand is the market where the old securities are bought and sold. Since the stock exchange is the melting pot of the capital market, existing securities purchased initially at the primary market are then traded in the stock exchange.

The members of stock exchange are stockbrokers and jobbers. Stockbrokers buy and sell securities on behalf of the investing members of the public for a commission called brokerage. The stock jobbers buy and sell securities on their own account to earn profits called jobber's turn. They do specialize in particular types of securities. The Nigerian Stock Exchange has only stockbrokers as it dealing members due to its level of development.

The functions of the stock exchange include the following;

1. It mobilizes financial resources for industrial investment.
2. To fill the resources gap for long term and medium term borrowing and lending by Nigerians.
3. To provide avenues for the Nigerian government and its agencies to mobilize long and medium term capital for the economic development of the country.
4. To allow for free interaction of foreign businessmen and their Nigerian counterparts to trade in foreign business shares.
5. To provide the framework for a code of conduct to regulate the activities of transactions in securities.
6. To oversee the operations of the market to ensure fair trading in dealings by the Exchange members.

7. To ensure fair pricing of new issues of investment securities.
8. To develop the capital market in the country by ensuring adequate branch network in the economy.
9. Ensure the listing of public limited companies on the Exchange.
10. To foster public confidence in the operations of the Exchange by guiding against abuses by dealers.
11. It provides a ready market for buying and selling of long-term securities such as bonds, shares, stocks, etc.
12. It provides new enterprises with a guide to terms on issuance of new issues.
13. It serves the capital market by giving liquidity to long-term capital or securities which can be used permanently by corporate bodies.
14. It encourages the investing public to invest in long-term securities since the Exchange serves as an avenue to dispose off such securities whenever the need arises.
15. It guides and protects the investing public by influencing the members of Exchange to keep to the market's regulations and requirements.

SELF ASSESSMENT EXERCISE 6

What are the functions of the stock exchange?

3.6 Mortgage Banks

These are financial institutions established to engage in the business of facilitating housing development. Their operational activities, therefore, are geared towards financing personal buildings of their customers or houses built for outright sale to the public.

The customers of mortgage banks save with the intention of accumulating enough amount of money to meet the required portion of the estimated cost of buildings. This enables the customers to secure the remaining portion of the total cost the building as loan from the bank with to finance the property for eventual ownership. The property financed by the bank serves as the collateral security.

In advanced countries, theses banks are financed by the private investors. This is not the case in developing countries where mortgage bans are financed by both the government and private investors. For instance, in Nigeria, some mortgages institutions are financed by the government while others are financed and established by private investors.
The main function of mortgage institutions is that they mobilize savings of their customers and invariably grant them loan facilities with which

to finance housing estate either by outright purchase or by building their own houses, which meet their tastes and preferences.

In order to encourage private housing ownership, as a matter of policy by the government, the interest rate for mortgage loans is generally low and the repayment periods are usually relatively over a long period of time.

SELF ASSESSMENT EXERCISE 7

Discuss the importance of mortgage banks in an economy.

3.7 Foreign Exchange Market

This is the market which provides the forum for the sale purchase of foreign exchange or foreign currency. In this market, the country's currency like the naira is exchanged for other currencies from other countries. Examples are US dollars, British pound sterling, Japanese Yen, and Italian lira, among others.

In Nigeria, the nerve centre of foreign exchange market business is Lagos which is the commercial melting pot of the country. Therefore, Lagos acts as the clearing house, balancing the demand for, and supply of foreign currencies required by individuals and corporate bodies within the country.

The participants of the Lagos foreign exchange market are Central Bank of Nigeria and commercial banks. The apex bank being the regulatory authority in the financial system of the country, exercises strict control over the transactions in the foreign exchange market. The central bank has the responsibility of ensuring that no foreign currencies are taken out of the country outside its control so as to conserve the nation's foreign exchange earnings.

Price determination in the foreign exchange market is effected through the interaction between the forces of demand and supply. The structure of foreign exchange market is highly competitive because there is no single buyer or seller is large enough to influence the market price. However, the central bank in Nigeria does intervene in the foreign exchange market to ensure sanity so as to maintain price stability in the economy generally.

SELF ASSESSMENT EXERCISE 8

Discussion the importance of foreign exchange market in the economy.

4.0 CONCLUSION

From the foregoing analysis, you can understand the nature and types of financial institutions. You can also understand the fact that the central bank occupies the regulatory position over the operations of the financial system in any economy. The commercial banks occupy a strategic position in the scheme of operational activities of the financial institutions in the economy since all others depend on the vital services being performed by them. You can also understand from above analysis that all other financial institutions aside central bank and commercial banks still carry out important functions in the economy.

5.0 SUMMARY

This study unit has been used to discuss the nature and types of financial institutions which operate in the economy. It is also used to discuss the nature and functions of the central bank as well as the commercial banks. In addition, the unit is also used to discuss mortgage banks, stock exchange, and insurance companies. Lastly, the unit also considers the role of foreign exchange market in the finiancial system of the economy. The next study unit is used to discuss financial institutions.

6.0 TUTOR-MARKED ASSIGNMENT

1. Differentiate between commercial bank and development bank.
2. Mention and discuss the functions of the central bank.

7.0 REFERENCES/FURTHER READINGS

Begg, D., S. Fischer and R. Dornbusch (2000). *Economics,* Sixth Edition. Berkshire, England: Maindenhead.

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UNIT 5 BALANCE OF TRADE AND BALANCE OF PAYMENTS

CONTENTS

1.0 INTRODUCTION

Originally, balance of payments was used to denote an excess of payments over receipts in international trade between two countries. Under gold standard this excess meant an outflow of gold from the country. The term, however, soon began to be used in the natural sense of the state of balance of international accounts, whether negative or positive. Consequently, we speak of the term balance of payments whether there is an outflow or inflow of gold.

Basically, the term balance of payments as used in international trade covers the entire relationship between imports and exports of goods and services. Therefore, the subject is no more restricted to the situation of excess of payments over receipts. The mercantilists of those days prefixed the adjectives ‘favourable’ and ‘unfavorable’ to denote respectively gold inflows and outflows. Both adjectives were, however, rejected during the process of classical reaction to mercantilism on the plea that it were the commodities and not gold that constituted real national wealth and that there was nothing favourable about a surplus export of commodities in exchange for gold.

This consideration led to the use of such prefixes as ‘active’ and ‘passive’ and ‘positive’ and negative’. These terms were also found equally unsatisfactory. For example, there is nothing ‘passive’ about a gold outflow or ‘active’ about a gold inflow. The terms in current use are surplus and deficit as these do not suffer from any important ambiguity and are also in harmony with the current accounting practice in trade.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- explain the meaning of balance of trade
- discuss the nature of balance of payments
- identify components of balance of payments
- differentiate between balance of trade and balance of payments
- discus the importance of balance of payments
- identify the causes of disequilibrium and ways of ameliorating it.

3.0 MAIN CONTENT

3.1 Balance of Trade

A country exports and imports many visible goods and invisible services in international trade. Invisible services include tourism, shipping and other transport services, banking and insurance services for whose exports and imports payments are made and received by the country in international trade.

A country's balance of trade refers to the difference between the value of imports and exports of commodities or visible items of trade. The balance of payments is also more comprehensive in the sense that it includes the total debts and credits relating to all the items on account of which a country makes payments to and receives payments from rest of the world. In short, the balance of trade is only a part of the balance of payments. The balance of trade is simply the difference between the value of commodity in terms of exports and imports.

The balance of trade is usually the largest component of international balance of payments of a country. The other major components of a country's balance of payments are the payments made to and received from rest of the world on account of interest, dividends, investments and loans, government expenditure, gold and capital movements, gifts, and reparations payments, among others.

A favorable balance of trade may co-exist with an adverse balance of payments and vice versa. For example, a country’s balance of trade may be unfavourable but her balance of payments can be favourable. This may arise from the fact that in exports of invisible items of trade (such as services) and interest earnings on her foreign investments she received more in payments from rest of the world than she paid to rest of the world on account of imports of goods in international trade transactions.

SELF ASSESSMENT EXERCISE 1

Explain the term balance of trade.

3.2 Meaning and Components of Balance of Payments

The balance of payments of any country refers to the difference between the total value of exports and the total value of imports of goods and services. The exports or imports comprise both the visible and invisible items of trade in terms of goods and services.

The international balance of payments of a country is a statistical record kept in the form of a balance sheet comprising all her foreign economic transactions during any given period of time. In other words, it presents a summary account of all international transactions of a country during a certain given period of time.

According to the International Monetary Fund, "the balance of payments for a given period is defined ... as a systematic record of all economic transactions during the period between residents of the reporting countries…" According to the US Department of Commerce, "the balance of payments of a country consists of the payments made within a stated period of time between the residents of that country and the residents of foreign countries.

The balance of payments may be defined in a statistical sense as an itemized account of all transactions involving receipts from foreigners on the one hand, and payments made to foreigners on the other. Since the former relates to the international income of a country, they are called 'credits,' and since the later relates to international outflows, they are called 'debits'.

According to Kindleberger, "the balance of payments of a country is a systematic record of all economic transactions between the residents of the reporting country and residents of foreign countries during a given period of time." It comprehends all payments made by a country to other countries and all receipts which accrue to a country from abroad.

Since balance of payments is a systematic record of a country's total money receipts from and payments to abroad, the difference between receipts and payments is either surplus or deficit. A country's total money receipts refer to the total revenue that accrues to its residents while the total payments refer to the payments made by the residents of that country.

Expressing a country's residents' total receipts, R, and their total payments, P, into their domestic and foreign components and if the domestic receipts and domestic payments are identical, then international balance of payments, B, of a country can be expressed as follows.

$$B = R - P = (R_d + R_f) - (P_d + P_f)$$
$$B = R_f - P_f \qquad (\text{since } R_d = P_d)$$

For an open economy, the total receipts may differ from the total payments and their difference represents the difference between foreign receipts (R_f) and foreign payments (P_f). The positive difference is termed as a surplus while the negative difference is termed as a deficit in the international balance of payments of a country.

The balance of payments of a country is not a balance-sheet showing a country's foreign assets and liabilities at any given point of time. It shows, for any given period of time, the flow of a nation's total receipts from abroad and its total payments made to abroad. Following the conventional rules of double entry accounting, a nation's total payments and total receipts for any given period of time must be in balance. Furthermore, one nation's receipts are payments for others while the receipts of other nations are payments for the nation.

Usually, a country's external balance of payments distinguishes between items on current and capital accounts. In the current account are included all kinds of exports and imports of goods and services, interest and dividend payments, private gifts, and so on. The capital account, sub-divided into short-term and long-term capital transfers, lists the imports and exports of all kinds of debt instruments and corporate stocks as well as imports and exports of monetary gold. Reparations and other unilateral transfers are generally listed separately.

Like the domestic transactions, international transactions recorded in the balance of payments of a nation comprise the total purchases (imports) and total sales (exports) of goods and services, purchases and sales of claims and unilateral transfers. The following example explains the different items included under various subheads in the international balance of payments of a country.

For the components of the balance of payments position of a country, see Fig. 15.1 below.

Fig. 5.1: Components of Balance of Payments

Receipts (Credits)	Payments (Debits)

1. Exports of goods and services: (a) Merchandise (b) Services (c) Income from foreign investments	1. Imports of goods and services: (a) Merchandise (b) Services (c) Foreign income from investments made at home
2. Sales of long-term claims: (a) Equity claims (b) Debt claims	2. Purchases of long-term claims: (a) Equity claims (b) Debt claims
3. Sales of short-term claims: (a) Against deposits (b) Others	3. Purchases of short-term claims: (a) Against deposits (b) Others
4. Sales of gold	4. Purchases of gold
5. Unilateral receipts	5. Unilateral payments
6. Errors and omissions	6. Errors and omissions

SELF ASSESSMENT EXERCISE 2

1. Explain the term balance of payments.
2. Mention the components of balance of payment.

3.3 Importance of Balance of Payments

The international balance of payments, which is a quantitative summary of a country's international financial transactions over a given period of time, reveals various aspects of a country's international economic position.

The international balance of payments of a country furnishes information about the international economic position of the country. Such information helps the government in taking decisions regarding monetary and fiscal policies on the one hand and on trade and payments issues on the other.

The balance of payments is also used to determine the influence of foreign transactions on the level of national income. In the case of an underdeveloped country, the balance of payments shows the extent of dependence of the country's economic development on the financial assistance given by the developed capital-lending countries and international financial institutions such as IMF, World Bank and IDA.
In the case of an advanced country, financially well off, having far-flung foreign investments and receiving a large income flow in form of dividend and interest income, the balance of payments can show the extent to which its citizens are living on their past exports.

Basically, the most important significance of the study of a country's international balance of payments lies in its being an indicator of the changing international economic position of a country.

The balance of payments is an economic barometer which if properly handled by an economic analyst, can be used to appraise a nation's short-term international economic prospects, to evaluate the degree of its international solvency, and to determine the appropriate foreign exchange rate of the money unit of a nation.

SELF ASSESSMENT EXERCISE 3

Discuss the importance of balance of payments.

3.4 Shortcomings Inherent in Balance of Payments

Notwithstanding that a country's international balance of payments serves as its economic barometer, there are many things which cannot be known by a mere study of the balance of payments.

1. A favorable balance of payments position is not always a sign of the economic prosperity of a country nor is adverseness of a country's international balance of payments always an indicator of a country's economic bankruptcy.

2. A balance of payments deficit per se is not the proof of the competitive weakness of a nation in foreign markets. One would need to know a good deal more about the causes and prospects of the deficit. The longer a country's balance of payments "deficit continues, however, the more it would seem to point to some fundamental difficulty.

3. Similarly, a favourable balance of payments position should not always make the government of a country complacent because a poor country may have an unfavourable balance of payments due to massive inflows of foreign loans and equity capital or a country may have favourable balance of payments resulting from speculative foreign capital inflows in anticipation of appreciation of her money unit.

4. Similarly, an economically strong nation like the United States of America may have an adverse international balance of payments resulting from the massive assistance she may have given to poor debtor nations. A debtor and economically backward nation at the time of receiving foreign loans will normally enjoy a favourable

balance of payments position while a creditor country may have an unfavourable balance of payments position at the time of giving foreign loans or making investments abroad.

5. A deficit or surplus balance of payments of a country *per se* is not an infallible index of the economic bankruptcy or prosperity of the country because a deficit balance of payments (in the case of a creditor nation) is compatible with economic prosperity and provides no cause for national alarm while a surplus balance of payments (as in the case of a debtor nation receiving loans) does not always indicate sound economic condition of the country.

6. Furthermore, the balance of payments does not give information in sufficient detail to be useful. It is only insufficient material that is made available about the short-term capital movements of the period, and in some cases it may be very important to distinguish one kind from the other. Apart from this, the balance of payments, as it is generally prepared by some countries, does not give the breakdown of transactions by reference to the countries with which they have taken place.

7. The main difficulty is that a country's balance of payments deals only with the transactions of the period under review. It does not provide data about the assets and liabilities that relate one country to others. It is not possible to determine from the balance of payments the debtor-creditor status of one country in relation to another or others, although it is possible to know the changes in that status during the period in question.

8. The balance of payments of a country does not tell the whole story; at best it tells only a part of it. Therefore, it is essential to have an analytical mind in order to get facts out of the bald statistics contained in the balance of payments. To get a correct idea of the true picture of a country's economic situation it is not enough to know whether her international balance of payments is deficit or surplus; one must go deeper and find out the causes which have occasioned the deficit or surplus in the international balance of payments of the country.

All the foregoing criticisms notwithstanding, a country's international balance of payments can, however, provide us with some information vital to our understanding of that country's economic dealings with other countries. It shows us, for instance, the composition of these dealings, the flows of goods and services and changes, if any, in the country's status as a debtor or creditor in relation to other countries.

SELF ASSESSMENT EXERCISE 4

Identify and explain the shortcomings inherent in balance of payments.

3.5 Causes of Disequilibrium in Balance of Payments

Disequilibrium in the balance of payments position of a country may arise due to various reasons.

1. It may be due to those factors which may simultaneously worsen a country's balance of payments position and reduce income in the country and *vice versa.*

2. It may also be due to such factors which while raise the level of national income in the country, deteriorate the balance of payments position of the country and *vice versa.*

3. There may be some other factors which while cause disequilibrium in the balance of payments position of a country, leave the level of income unaffected.

4. The balance of payments disturbance arising from a shift in the foreign demand away from one country's products to another's because such a shift causes similar changes in a country's balance of payments position and the level of income.

5. Similar disequilibrium in the balance of payments of a country will also be caused by international capital movements, e.g., balance of payments disequilibrium caused by differences between different countries' costs or rates of price rise.

6. Another consideration refers to those disturbances in the balance of payments which while leaving a country's current account unaffected, affect only its liquidity position. These disturbances arise from the domestic or foreign wealth holders' desire to change the composition of their assets portfolio in such a manner so as to increase their holdings of foreign securities.

7. The desire on wealth holders' part to increase their total holdings of foreign government securities and corporate shares will increase the pressure on country's external balance of payments; increasing its deficit in the process.

SELF ASSESSMENT EXERCISE 5

Mention and explain the causes of balance of payments disequilibrium.

3.6 Removal of Disequilibrium in Balance of Payments

Disequilibrium in the international balance of payments of a country indicates a state of imbalance between autonomous international payments (demand for foreign exchange or currencies) and receipts (supply of foreign exchange or currencies).

Removal of this disequilibrium means a change in the relationship between the payments and receipts sides of the ledger so that the two sides become equal. To remove a deficit in the balance of payments of a country, autonomous receipts must expand relatively to payments while to eliminate a surplus position, payments must expand relatively to receipts.

In short, the adjustment between receipts and payments in a country's balance of the payments requires necessary changes in those variables to which the payments and receipts are functionally related. A complete list of all these variables embraces the economic universe since all the parts of an economic system are interrelated.

Attention may, however, be confined to only the key variables. These key variables in the case of the balance of payments of a country are the foreign exchange rates, prices of internationally-traded goods and services, levels of income and government control over international transactions. Any change in any one or more of these variables will materially affect the position of the balance of payments of a country on account of their strong functional relationship with autonomous international payments and receipts. Assuming that the disequilibrium in the external balance of payments position of a country is of the deficit variety we can discuss the adjustment of the balance of payments disequilibrium through different methods.

1. Change in Foreign Exchange Rate

Disequilibrium in the balance of payments is a state of imbalance between the total demand for and the total supply of foreign exchange revealed by the existence of either excess supply of or excess demand for foreign exchange at any given rate of foreign exchange.

Ceteris paribus, if at any given rate of foreign exchange the balance of payments of a country is in disequilibrium, equilibrium can be restored by making appropriate changes in the foreign exchange rate such that while the demand for foreign exchange (imports) decreases the supply of foreign exchange (exports) increases thereby eliminating the deficit gap in country's external balance of payments.

Ceteris paribus, if the foreign exchange rate is higher in a country, the prices of her exports will be lower in the foreign markets while the prices of her imports will be higher. This will strengthen the competitive position of the country as a seller of her goods in international markets.

The degree to which the balance of payments deficit will be reduced as a consequence of a given change—devaluation—in the foreign exchange rate will depend upon the price elasticity of domestic demand for imports and on the price elasticity of foreign demand for a country's exports.

2. Change in Prices

Change in the prices of the country's commodities can be used in correcting the balance of payments deficit. Changes in the relative national prices could be achieved through the differential rates of absolute price changes at home and abroad, keeping the foreign exchange rate stable.

The extent to which price changes can remove balance of payments disequilibrium depends upon the price elasticities of demand for imports at home and abroad. The balance of payments deficit of a country will be eliminated or improved as a consequence of price fall if the price elasticities of demand for the currency-country's imports and exports are high.

3. Change in Income

Autonomous balance of payments transactions are also functionally related to income. Ceteris paribus, higher income at home leads to higher imports while higher income abroad will cause an increase in the exports of the country. Consequently, a deficit in the balance of payments of a country may be corrected through either a decrease in national and personal incomes at home or through an increase in national and personal incomes abroad.

The degree of responsiveness of imports and exports to changes in income at home and abroad, is measured by the marginal propensity to import or by the income elasticity of demand for imports. The marginal propensity to import is the ratio of change in imports in response to an infinitesimal change in income.
In measuring the ratio of relative changes in imports to changes in national, the income elasticity of demand for imports is the most appropriate concept. It may be defined as the percentage in total imports divided by the percentage change in national income. It is given as:

$$R_I = \frac{\text{Marginal Propensity to Import}}{\text{Average Propensity to Import}}$$

National income and balance of payments of a nation are intimately related with one another such that changes in one cause changes in the other.

There are other measures which can be employed by a country to correct balance of payments disequilibrium. These include ban on importation, imposition of quota, imposition of import duties, reduction in export duties, etc.

SELF ASSESSMENT EXERCISE 6

Mention and explain means of correcting balance of payments disequilibrium.

4.0 CONCLUSION

From the foregoing analysis, you can understand the meaning of both balance of trade and balance of payments, and their differences. You can also appreciate the importance of balance of payments and its inherent shortcomings. Furthermore, you can also understand the causes of disequilibrium in balance of payments and some of the ways through which such disequilibrium can be ameliorated.

5.0 SUMMARY

This study unit has been used to discuss the meaning of the balance of trade. Also in this unit, the meaning and components of balance of payments discussed. Furthermore, the inherent shortcomings in the balance of payments are discussed. Lastly, the unit also discusses the causes of disequilibrium in balance of payments and the means of obliterating the balance of payments disequilibrium.

This study unit happens to be the last unit for the course. The expectation is that you might have read and digested the preceding study units before coming to this unit, which is used to conclude the analysis of the course.

6.0 TUTOR-MARKED ASSIGNMENT

1. Explain the term balance of payments.
2. Mention and explain the causes of balance of payments disequilibrium and how it can be ameliorated.

7.0 REFERENCES/FURTHER READINGS

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