NATIONAL OPEN UNIVERSITY OF NIGERIA

SCHOOL OF BUSINESS AND HUMAN RESOURCE

COURSE CODE:BHM 754

COURSE TITLE:PRICE THEORY II (MACROECONOMICS)

COURSE GUIDE

BHM 754
PRICE THEORY II (MACROECONOMICS)

Course Developer Likita J. Ogba
Department of Economics
Faculty of Social Sciences
University of Jos
Plateau State Nigeria

Course Writer Likita J. Ogba
Department of Economics
Faculty of Social Sciences
University of Jos
Plateau State Nigeria

Course Editor
National Open University of Nigeria
Lagos.

NATIONAL OPEN UNIVERSITY OF NIGERIA

National Open University of Nigeria
Headquarters
14/16 Ahmadu Bello Way
Victoria Island
Lagos

Abuja Annex
245 Samuel Adesujo Ademulegun Street
Central Business District
Opposite Arewa Suites
Abuja

e-mail: centralinfo@nou.edu.ng
URL: www.nou.edu.ng

National Open University of Nigeria 2009

First Printed 2009

ISBN

All Rights Reserved

Printed by ……………..
For
National Open University of Nigeria

TABLE OF CONTENTS PAGE

Introduction... 1
What you will learn in this Course... 1
Course Contents……………………………………………….. 1
Course Aims.. 2
Course Objectives... 2
Course Materials.. 3
Study Units 3
Assignment.. 4
Tutor Marked Assignments (TMAs) 4
Final Written Examination…………………………………… 5
Conclusion.. 5

Introduction

Price Theory II (Macro economics) is a core course which carries two credit units. It is prepared and made available to all the students who are taking the postgraduate diploma in Financial Management. The course is a useful material to you in your academic pursuit as well as in your workplace as managers and administrators.

Course Contents

The course is made up of five modules: Module 1 has 3 Units, Module 2 has 3 Units, Module 3 has 4 Units, Module 4 has 3 Units and Module 5 has 2 Units, covering areas such as the background on the subject matter, appropriate mechanisms for handling economic issues instruments for handling international trade, trade restriction and free trade. Monetary and fiscal policies in Nigeria.

The course guide is meant to provide you with the necessary information about the course, the nature of the materials you will be using and how to make the best use of the materials towards ensuring adequate success in your programme. Also included in this course guide are information on how to make use of your time and information on how to tackle the tutor-marked assignment questions. There will be tutorial sessions during which your instructional facilitator will take you through your difficult areas and at the same time exchange ideas with your fellow learners.

Course Aims

The main aim of the course is to expose you to the elementary economics, the mechanisms necessary for managing the economy and the role of the various sectors and the linkages between them. The course also aims at making you have a greater appreciation of the role of government as the regulator of the economy and how this can affect your organization and you.

The aims of the course will be achieved by:

1.0 Explaining the nature of macro economics (price theory II)

2.0 Describing the necessary mechanism and structures for managing the economy through the use of money, inflation and unemployment;

3.0 Explaining the nature and process of international trade.

4.0 Describing the necessary structures for managing balance of payments

5.0 Explaining the nature of national income in the economy

6.0 Explaining the forms of national income equilibrium determination.

7.0 Discussing the peculiar role of monetary and fiscal policies in the economy.

Course Objectives

After completing this course, you should be able to:

8.0 Analyze the nature of the term price theory II, (macroeconomics)

9.0 Identify the necessary mechanisms for managing some economic issues.

10.0 Discuss the nature and method of international trade and balance of payment

11.0 Explain the mechanisms for managing money, inflation, unemployment

12.0 Explain the nature and practice of national income accounting

13.0 Analyze the various forms of strategies for managing the economy

14.0 Identify the functions of international organizations

15.0 Describe the strategic role of monetary and fiscal policy.

Course Materials

Major components of the course are:

1.0 Course Guide

2.0 study Units

3.0 Textbooks

4.0 Assignment Guide

Study Unit

There are fifteen units of 5 modules in this course, which should be studied carefully. These are as follows:

Module 1 The Basic principles of money and its effects in the Economy

Unit 1 Money

Unit 2 Inflation

Unit 3 Unemployment in Nigeria

Module 2 Principles and Practice of Trade

Unit 4 International Trade Theory

Unit 5 Principles of International Trade

Unit 6 Free trade and trade restriction

Module 3 International Trade and Organizations

Unit 7 International Tariff

Unit 8 Infant Industry argument

Unit 9 International Monetary Fund

Unit 10 The World Bank

Module 4 National Income and the Economy

Unit 11 National Income Accounting

Unit 12 National Income Measurement

Unit 13 Balance of Payment

Module 5 Economic Policies of Government

Unit 15 Monetary Policy

Unit 15 Fiscal Policy

Module 1 unit 1 simply presents the general background of money which form the core of the course. It is the basic means that an economy thrive upon. The second unit discusses the inflation as a problem that would have to be contended with as we use money. The next unit describes the main problem of most economies, unemployment. It can be minimized if appropriate measures are taken by managers of the economy. Module 2 units 1,2 and 3 explain the nature, process, principles of international trade. Module 3 units 1 and 2 discuss the necessary mechanisms for handling international trade issues, while unit 3 and 4 is used to explain the necessary role of international organizations such as IMF and World Bank and economic role of these organizations. Module 4 units 1,2, and 3 try to discuss national income and how the income can be used to improve the welfare of citizens. The remaining two units 1 and 2 under Module 5 describe the role of both monetary and fiscal policies and how these can be used in managing the economy, as that affects the stability of organizations within the economy.

Each study unit will take at least two hours, and it includes the introduction, objectives, main content, self-assessment exercises, conclusion, summary, tutor-marked assignment and references/further readings. Some of these exercises will necessitate interaction with your mates. You are advised to do so in order to share ideas in the course with your classmates. There are also textbooks under the references and other resources for further reading. They are meant to give you additional information if only you can lay your hands on any of them. You are advised to pratice the self-assessment exercises and tutor-marked assignment for greater understanding of the course. By so doing, the stated learning objectives of the course will be achieved.

Assignment

There are many assignments in this course and you are expected to do all of them by following the schedule prescribed for them in terms of when to attempt them and submit same for grading by your tutor.

Tutor-Marked Assignment

In doing the tutor-marked assignment, you are to apply what you have learnt in the contents of the study units. These assignments which are many in number are expected to be turned in to your Tutor for grading. They constitute 30% of the total score for the course.

Final Examination and Grading

At the end of the course, you will write the final examination. It will attract the remaining 70%. This brings the total score to 100%.

Summary

The course, price theory II (Macroeconomics) (BHM 754) exposes you to the issues involved in the economy and how to manage them. On the successful completion of the course, you would have been armed with the materials necessary for efficient and effective management of economic matters in any organization.

MAIN COURSE

BHM 754 PRICE THEORY II (MACROECONOMICS)

Course Writer/Developer Likita J. Ogba
Department of Economics
Faculty of Social Sciences
University of Jos
likitaogba@yahoo.com

Content Editor Dr. Audu Nanven Gambo
Department of Economics
Faculty of Social Sciences
University of Jos

Course Coordinator Caroline Aturu-Aghedo

National Open University of Nigeria
14 – 16 Ahmadu Bello Way, Victoria Island
Lagos.

Programme Leader Dr. O.J.Onwe

National Open University of Nigeria
14 – 16 Ahmadu Bello Way, Victoria Island
Lagos.

NATIONAL OPEN UNIVERSITY OF NIGERIA

National Open University of Nigeria
Headquarters
14/16 Ahmadu Bello Way
Victoria Island
Lagos

Abuja Annex
245 Samuel Adesujo Ademulegun Street
Central Business District
Opposite Arewa Suites
Abuja

e-mail: centralinfo@nou.edu.ng
URL: www.nou.edu.ng

National Open University of Nigeria 2009

First Printed 2009

ISBN

All Rights Reserved

Printed by ……………..
For
National Open University of Nigeria

TABLE OF CONTENTS PAGE

Module 1 The Basic principles of money and its effects in the Economy

Unit 1 Money

Unit 2 Inflation

Unit 3 Unemployment in Nigeria

Module 2 Principles and Practice of Trade

Unit 4 International Trade Theory

Unit 5 Principles of International Trade

Unit 6 Free trade and trade restriction

Module 3 International Trade Restrictions and Organizations

Unit 7 International Tariff

Unit 8 Infant Industry argument

Unit 9 International Monetary Fund

Unit 10 The World Bank

Module 4 National Income and the Economy

Unit 11 National Income Accounting

Unit 12 National Income Measurement

Unit 13 Balance of Payment

Module 5 Economic Policies of Government

Unit 15 Monetary Policy

Unit 15 Fiscal Policy

UNIT 1 MONEY

CONTENTS

1.0 Introduction
2.0 Objectives
3.0 Main content
    3.1 Historical Development of money
    3.2 Characteristics of money
    3.3 Functions of money
    3.4 Demand for money
    3.5 The Quantity Theory of money
4.0 Conclusion
5.0 Summary
6.0 Tutor-marked Assignment
7.0 References/ Further Reading

1.0 INTRODUCTION

Money is anything that is generally acceptable in payments for goods, services or settlement of debt. It is the means of valuation and payment for goods and services.

The existence of money facilitates exchange. Before the introduction of money in modern economic system, trade by barter was the means of exchange. Trade by barter refers to exchange of good for another good. The barter system was a difficult means of exchange because of the problems associated with it. It makes exchange to depend on double coincidence of wants. If a shoe maker wants beans, he must look for a person who needs his services of shoe sale or repair and has beans to exchange.

Trade by barter was also a difficult means of exchange because some of the goods are indivisible. If a shoemaker who wants some quality of cow meat, such trade could not take place because the cow cannot be divided since that time individuals exchange only in bulk.

There were different forms of money that were used. In Africa people used cowries, shells, salt, cigarettes as means of exchange. These commodities that were temporarily used as money were bulky and cannot be carried about for trade, there was no general acceptability and not durable hence there was a continuous evolving of money over time.

2.0 OBJECTIVES.

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

- Explain the term money
- Discuss the historical development of money
- Discuss the characteristic of money
- Explain the functions of money
- Explain the demand for money.

3.0 MAIN CONTENT.

3.1 Historical Development of Money.

In commodity money in the olden days when the use of money replaced trade by barter, the medium of exchange had to be something that is commonly used and considered valuable for its own sake, either for use or ornament.

Different time periods saw the use of things like cowries shells, fish, tobacco, tea, salt, and cattle, sheep Leather. This ware referred to as commodity money.

Metallic Money.

In another phase of the development of money came metallic money. It came into existence due to inconveniences and because commodity money was not divisible, durable, and homogenous. Therefore precious metals were devised, these include silver and gold which were cut into pieces and weighed. This served as a means of payment within that time-frame.

Token Coins.

Token coins were not worth their full face value. That means metals used If sold would not fetch the value they represented. In other words, the face value of token money was higher than the content or the intrinsic value of the coins.

Bank Notes.

Another phase in the development of money was banks notes. It began with London goldsmiths who received deposits of coins from merchants. These goldsmiths issued receipts for every deposit of coins from the merchants.

Gradually, the receipts were exchangeable for coins of the same value. The general acceptance of the receipts transformed into bank notes.

Token Money.

Represent bank notes that are generally acceptable without necessarily being convertible into metals whose values are equal to the face value represented by these notes. Modern bank notes are token money as their face value is higher than the value of the paper used in making them in any country.

SELF ASSESSMENT EXERCISE 1

Discuss the evolution of money in Nigeria

3.2 Characteristics Of Money.

Generally Acceptable.

Money should be generally acceptable by people. It can be used for payment of goods and services. The users should have confidence in it so that they can accept it readily anytime anywhere for purpose of transactions and general payments.

Divisible.

Money should be divisible into different units to make it possible for goods to be bought in small and large quantities based on individual choice. This means those who have large amount can buy large quantities while those who have little money will buy low quantities.

Homogeneous.

Money is homogeneous; a unit in each denomination must be the replica of any other unit in the same denomination. One hundred Naira note in Nasarawa state should be the same with that in Lagos state.

Portable.

Portability means money should be carried about at ease. Individuals can carry a reasonable quantity to engage in transactions in places of their choices.

Durability.

Money should be durable; it should not easily wear and tear. It should be something that can be kept for a long time and maintain its face value, in use.

Relatively Scarce.

It must not be too much. There should be some effort made before a person can get it. Money should be scarce to maintain its value among the users.

SELF ASSESSMENT EXERCISE 2

Carefully discuss the characteristics of money

3.2 The Functions of Money

Medium of Exchange.

Money is anything that is given in payment and accepted in exchange for goods and services. This makes it possible for money to be used in exchange for goods and goods exchange for money.

Measure of Value.

Money enables people to compare the quality of goods and services, value of different occupations at any time. If a commodity is sold for N100 and another sold at N120, one is able to compare the relative worth of the two commodities and decide on which one to choose and purchase.

Store of Value.

When there is stability in the price level. Money can be kept as wealth, in form of surplus holding over a long period without losing value. Money is often preferred as a form of reserve for future spending than any other asset. Some people derive satisfaction in keeping cash because it can serve as a store of value.

Standard of Deferred Payment.

Money enables payment for goods and services to be postponed till a later date. This is known as standard of deferred payment. Money allows for credit transactions. If a person buys some commodities today, payment can be postponed till another time or date.

Unit of Account.

Money as a unit of account had made it easier and convenient for making calculations, assigning prices to goods and services, costing, and record for the prices of goods and serves at any time can be done using money.

Liquidity.

Money confers liquidity on its owner because it allows the owner to buy any type of commodity when and where the person chooses. This gives liberty and freedom to the owner.

SELF ASSESSMENT EXERCISE 3

Explain the functions of money in Nigeria

3.4 The Demand for Money.

The demand for money is the desire to hold money in cash, liquid form instead of investing the money in some other assets. The demand for money emerged as a result of two important functions of money. The first is that money act as a medium of exchange and the second is that money functions as a store of value.

There are three main reasons why people demand for money. These are transaction, precautionary and speculative demand.

Transaction Demand for Money.

The transaction demand for money emerged because money functions as a medium of exchange. It is used in regular payment for goods and services. Transaction demand arises due to the need of cash for the current transactions of personal and business exchanges. Individuals want to keep cash to meet the immediate need for buying goods and services.

Precautionary Demand for Money.

This is the desire to provide for contingencies requiring sudden payments and for unforeseen events such as sickness, accidents. Precautionary demand for money depends on the level of income and business strength. The more the income of an individual, the more money is kept for precautionary purposes.

Speculative Demand for Money.

This is the money kept so that it can be exchanged for some other asset at any time the asset is considered profitable.

Individuals and entrepreneurs having funds after keeping sufficient amount for transaction and precautionary purposes, want to make speculative gain by investing in bonds and other income yielding assets.

SELF ASSESSMENT EXERCISE 4

Explain the reasons why people demand for money

3.5 The Quantity Theory of Money.

It is an attempt to explain the link between money and the general price level in an economy. This is due to the fact that money serves as a unit of account and a medium of exchange in modern economic system.

Quantity theory states that there is a direct relationship between the quantity of money and the level of prices in an economy. It therefore means that when the quantity of money increases by 20%, the prices of goods and services will increase by the same 20%. This according to fisher the relationship between money and prices can be quantified as follows.

MV = PT------------------ (1)

M refers to the stock of money, v refers to the velocity of transaction, P is the price level, T is the total number of transactions

The stock of money (m).

It is the country's bank notes and coins including all bank deposits in the country.

The total number of Transactions (T).

The number of transaction is determined by the resources available in that economy both in quality and quantity, the efficiency with which the resources are used and the extent of linkages in the economy. The more developed an economy the higher the number of transactions in that economy.

The price level.

This is the average price at which transactions are made within the economy. Sometimes wholesale or consumer price index is used as a means of determining the price level.

Velocity of circulation (v).

Velocity of circulation is generally the spending pattern of people. This spending pattern is institutionally determined. Government through legislation provides the framework for payment. In Nigeria the payment system is monthly. At the end of every month people are paid salaries through which they begin spending based on their needs.

The quantity theory emphasizes the need to hold money so as to finance transactions in the economy.
Given P, T and V, equation (1) can be re-arranged to yield the expression for the demand for money.

$$Md = M = \frac{PT}{V} \quad \ldots\ldots\ldots..(2)$$

When V and T are assumed constant then equation (2) would show that the demand for money is proportional to the price level. Similarly equation (2) can be re-arranged to show the price level.

$$P = \frac{MV}{T} \quad \ldots\ldots\ldots\ldots\ldots\ldots..(3)$$

Using equation (3) it can be seen that if V were constant and T independent of M then any increase in M would lead to a proportional increase in price. On the other hand a decrease in M will lead to a proportional decrease in price level (P).

SELF ASSESSMENT EXERCISE

Explain the quantity theory of money

4.0 CONCLUSION

The analysis of money in this unit shows that the emergence of token money (coins and notes) removed the problem associated with barter system of exchange. The use of money made it possible to value asset, set prices on goods and services given its general acceptance

5.0 SUMMARY.

The unit has thrown light on the meaning of money, the evolution, the demand for money, the characteristic of money. The functions of money were also highlighted. An elementary treatment of the quantity theory of money was also attempted to expose you to the relationship between money and prices in the economy.

6.0 TUTOR MARKED ASSIGNMENT

1. Mention and discuss the characteristics and functions of money
2. Discuss the demand for money in Nigeria

7.0 REFERENCES/FURTHER READING

Allen, H. and Qiu, J. (2007), Elastic Money, Inflation and Interest Rate Policy. Journal of Economic Literature, September.

He, P. and Randall, W. (2005),“Money and Banking in Search of Equilibrium”. International Economic Review. Vol. 46 No. 2

Kiyotoki, N. and Randall, W.(1993) “A search Theoretic Approach to Monetary Economics.” American Economic Review, 83.

Shi, S. (1997), “A Divisible Search Model of Fiat Money” Econometrica 65

Sun, H. (2007), “Banking Inside Money and Outside Money”

UNIT 2. INFLATION.

CONTENTS

1.0 Introduction
2.0 Objectives
3.0 Main Content
3.1 Theories of inflation
3.2 Causes of inflation in Nigeria
3.3 Effects of inflation in Nigeria
3.4 Measures to control inflation
4.0 Conclusion
5.0 Summary
6.0 Tutor-marked Assignment
7.0 References/further reading

1.0 INTRODUCTION

Inflation is the persistent and appreciable rise in the general level of prices. It leads to a continuous and persistent decrease in the value of money in the country. Inflation is a condition in which supply of goods and services persistently fails to keep pace with the expansion in demand for goods and services.

This arises either from difficulties in keeping up the supply of consumer goods or the excessive availability of money at a given period. This creates disequilibrium between demand and supply which makes prices to rise persistently.

2.0 OBJECTIVES

At the end of this unit, you should be able to
- Explain the theories of inflation
- Assess the causes of inflation in Nigeria
- Discuss the consequences and remedies to inflation.

3.0 MAIN CONTENT

3.1 Theories of Inflation

3.1.1 Demand pull inflation.

This is a situation where an excess of aggregate demand over aggregate supply will generate inflationary rise in prices of goods and services. The demand-pull theory posits that prices of goods and services rise in proportion to the increase in the supply of money in the economy due to excess demand. When money supply increases it leads to increase in demand for goods and services, since the supply of goods and services cannot increase correspondingly with production of goods and services, this leads to rise in prices of the few commodities in the market.

3.1.2. Cost- Push Inflation.

Cost-push inflation arises due to wage increase that is enforced by trade unions and increase in profit by entrepreneurs. It is therefore an inflation that emerges due to wage push and profit- push lending to increase in the cost of production.

Usually cost-push cost inflation is caused by rise in money wages that exceed the productivity of labour. Trade unions press employers to give a wage increase that is in excess of the productivity of labour. This gradually generates increase in the cost of production that translates into inflation.

The higher wages granted to the workers increases their purchasing power, so they buy more goods and services, since production cannot increase in the short run, this worsens the problem of inflation in the country.

Profit-push by oligopolist and monopolistic firms can raise the price of their products as means of paying for the increase in labour cost and the cost of production. Due to market imperfection such firms are able to directly increase the price of their commodities leading to inflation.

3.2 Causes of inflation in Nigeria

3.2.1 Currency Depreciation.

Since the time that Nigeria adopted the flexible exchange rate system couple with persistent balance of payment deficit problem, the value of the

Naira has depreciated considerably. This depreciation raises domestic prices of goods and services.

3.2.2 Increase in Government Expenditure.

Inflation in Nigeria is also caused by rise in government spending. Government spending increases due to the creation of more states and local governments, provision of more social amenities like roads, electricity, etc. This has led to excess supply of money in the economy thereby creating inflation.

3.2.3 Removal of Petroleum Subsidy.

The federal government had at several times removed oil subsidy leading to increase in the prices of petroleum products and subsequently this led to increase in the cost of transportation. This increase in the cost of transportation affects all other commodities leading to inflation in Nigeria.

3.2.4 Low Capacity Utilization.

The underdeveloped nature of the country's technology leads to poor capacity utilization couple with poor infrastructural development has created a gap where the manufacturing sector does not respond quickly to changes in demand.

Therefore increase in demand cannot be met with increase in production. This has led to demand pull inflation.

Low Production of Domestic Foodstuff.

The increase in migration from rural to urban centres. Few people are left to farm in the rural areas. The result is a decrease in food production. This lead to increase in price of agricultural products. Other reasons for the low productivity is the poor climatic conditions, inadequate supply of farm inputs such as fertilizers, pesticides, harvesters. Therefore, the demand for food items is in excess of supply leading to rise in prices.

Poor Storage and Distributive System.

Poor and inadequate transport facilities leads to shortages of goods at places where they are most needed. Therefore demand exceeds supply leading to increase in prices.

Poor storage facilities results to agricultural products either being destroyed or sold at low price during harvest. During off-season therefore these commodities become scarce. The shortage leads to rise in prices of goods.

SELF ASSESSMENT EXERCISE

Explain the factors that lead to inflation in Nigeria.

3.3 Effects of Inflation

1. Decline in Standard of Living.

There is a decrease in the standard of living during period of inflation. The fixed income earners become worse-off due to non-flexibility in the wage rate during periods of inflation.

2. Increase in Profit.

The profit of firms is likely to rise during periods of inflation. This happens because prices of goods rise higher with the increase in the cost of production. Therefore profit of firms increases during the period of inflation.

3. Distortion in Capital Formation.

Inflation discourages saving because money loses its value rapidly. This creates distortion because savings lead to investment but when saving is discouraged investment declines in the economy. Inflation discourages entrepreneurs from investing due to scarcity of funds.

4. Deterioration in Balance of Payment.

Inflation leads to increase in domestic prices. This process makes export expensive and encourages import rather than export and this leads to deterioration in balance of payment.

5. Creditors Lose and Borrowers Gain.

Since money loses its values continuously during inflation, lending is discouraged because creditors become losers. Borrowers gain as they repay money whose value is far less than what it was when they received it.

6. Increase in Consumption.

Inflation encourages current consumption People spend their income on goods and services as they earn income rather then future consumption because of the continuous recline in the value of money.

SELF ASSESSMENT EXERCISE

Examine the effects of inflation in Nigeria.

3.4 Measures to control inflation.

1. Monetary Policy.

This is the use of central bank's instrument of monetary control to reduce money supply in the economy. These instruments of control are open market operation, discount rate, special deposit and moral suasion. The monetary policy instruments work on the ability of commercial banks to create bank credit. Inflation is controlled through the use of contractionary monetary policy. The policy reduces the ability of commercial banks to lend money to their customers and increase money supply. This process leads to a decrease in the demand for goods and services hence inflation is reduced.

2. Fiscal Policy.

Government uses taxation and expenditure to regulate the economy. When government want to control inflation it increases taxes and reduces government expenditure. This policy of government decreases individual disposable income. The reduction in the disposable income reduces aggregate demand and inflation is controlled.

3. Price Control.

Government can reduce inflation by fixing prices for both raw materials and finished goods. If there is adequate monitoring and enforcement of the price control, it will help reduce the rate of inflation in the country.

4. Wage Control.

Government can reduce cost-push inflation by wage control. This is a process where the government freezes wages to ensure that workers do not demand for increase in wages for a given period.

5. Rapid Industrialization.

Government can promote rapid industrialization as a way of checking demand-pull inflation. Rapid industrialization ensures that excess demand is eliminated by increase in the production of goods and services. Industrialization should be provided so that there will be no waste of perishable and seasonal commodities. These commodities will be available during off-season to the consumers. This can help reduce inflation in Nigeria.

SELF ASSESSMENT EXERCISE

Discuss the strategies for controlling inflation in Nigeria.

3.5 Measurement of Inflation

1.Wholesale Price Index.

The wholesale price index measures the prices of goods and services.

2. Consumer Price Index.

It measures changes in the prices of goods and services consumed by individuals. The consumer price index is often used because changes in it determine changes in the standard of living of people within a country.

3. The gross Domestic Product (GDP) Deflator.

It measures the price behaviour of the gross domestic products. It is calculated as the ratio of GDP in current prices to GDP in constant prices of a given time period.

4.0 CONCLUSION.

The analysis of inflation shows that it is a common macroeconomic problem in most countries of the world. Government has the responsibility of reducing inflation to the lowest level through a combination of fiscal, monetary and other measures. The main reason is that government has the responsibility of protecting its citizens from the fluctuation in the prices of goods and services.

5.0 SUMMARY.

The unit examined inflation, the scope and the causes of inflation. The theories of inflation were also examined and lessons for practical consideration as it relates to Nigeria were also discussed. The reasons for government intervention in monetary and fiscal policy options were also highlighted.

6.0 TUTOR-MARKED ASSIGNMENT

1. Discuss the causes of inflation in Nigeria
2. Explain the strategies for controlling inflation in Nigeria.

7.0 REFERENCE/ FURTHER READING.

Allen, H. and Qiu, J. (2007), "Elastic Money, Inflation and Interest Rate Policy." Journal of Economic Literature, September.

Cecchetti, S. Chu, R. and Steindel, N. (2000), "The Unreliability of Inflation Indicators". Federal Reserve Bank of New York. 6(4).

He, P. and Randall, W. (2005),"Money and Banking in Search of Equilibrium", International Economic Review. Vol. 46 No. 2

Kiyotoki, N.and Randall, W.(1993), "A search Theoretic Approach to Monetary Economics", American Economic Review, 83.

UNIT 3 UNEMPLOYMENT IN NIGERIA

CONTENTS

1.0 Introduction
2.0 Objectives
3.0 Main Content
3.1 Types of unemployment in Nigeria
3.2 Causes of unemployment in Nigeria
3.3 Effects of Unemployment
3.4 Remedies to Unemployment
4.0 Conclusion
5.0 Summary
6.0 Tutor- Marked Assignment
7.0 References/ further Readings.

1.0 INTRODUCTION

Unemployment is the number of people without any productive employment. Every government puts a number of policies in place to contain the problems of unemployment in the economy.

Technically unemployment is the number of people within a country or locality who are willing and able to work at the prevailing wage rate but are unable to find jobs for themselves in the locality or country.

In every economy, there exists a stock of people who are prepared and offer themselves for work but cannot find any, they therefore do any available work that is not commensurate with their professional training this is commonly known as underemployment.

2.0 OBJECTIVES

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

Explain the term unemployment
Discuss the causes of unemployment
Discuss the effects of unemployment
Explain the remedies to unemployment

3.0 MAIN CONTENT

3.1 The Types of Unemployment.

There are several types of unemployment in the country, some of these unemployment's are as follows:

1. Frictional Unemployment.

This is an unemployment that occurs when citizen are searching for jobs that suit them and can do it with their best ability given their professional qualification. This ranges from fresh graduates that had just finished their National Youth Services Corps (NYSC) and those retrenched and are searching for new jobs.

2. Residuals Unemployment.

When people are unemployed because of physical or mental disabilities. These individuals have the capacity and ability to work but were not offered employment due to their disabilities. The disabilities constitute a hindrance toward any gainful employment.

3. Cyclical Unemployment.

This is an unemployment caused by cyclical fluctuation in the economy. During depression when income and output falls, this lead to unemployment. Since income has fallen the demand for goods and services will also fall. This leads to a fall in output of goods. This decline in output results in losses to firms and the firms reduce cost by retrenching workers creating cyclical unemployment.

4. Seasonal Unemployment.

This occurs when workers are temporarily laid off due to seasonal fall in demand for their services. Employment in the ice cream factories for instance is only for the summer when the weather is hot. Ice cream sellers will be unemployed during winter when the weather is cold. This unemployment is attributed to seasonal changes.

5. Structural Unemployment.

This unemployment occurs when there are changes in a country's industrial structure leading to firms switching from one kind of production to another. A structural unemployment may result due to immobility of labour. The workers that do not have the skills to meet the change in technology and production technique will be retrenched.

6. Voluntary Unemployment.

This is an unemployment that people face because they choose to be unemployed. This occurs when individuals are bent on getting particular types of jobs they consider more rewarding than the existing ones. They remain unemployed until they find what they consider lucrative jobs.

SELF ASSESSMENT EXERCISE

Examine the various types of unemployment in Nigeria

3.2 CAUSES OF UNEMPLOYMENT

1. High Population Growth.

When population growth rate is far greater than the available job opportunities in a country, this will leave many people unemployed in that country.

2. Low Investment.

When there exists investment in form of establishment of industries, the industries will employ people thereby reducing unemployment. However, in Nigeria there is a low level of investment in the industrial and manufacturing sector hence the number of available vacancies is low compared to the number of qualified individuals. This has led to the high rate of unemployment in the country.

3. Rural, Urban Wage Difference.

There exists a wide gap between the wage rates of urban dwellers compared with the rural counterpart. This has led to migration of rural dwellers to the urban areas in search of high pay employment. This has led to unemployment, because the rural migrants do not have the technical knowledge to compete with urban dwellers.

4. Labour Immobility.

In Nigeria many people are in search of employment. They prefer to remain unemployed in a particular place because they cannot move from one geographical location to another, either due to social, political, marital or religious reason.

5. Capital Intensive Technology.

Nigeria is a country with high population. The most appropriate way of reducing unemployment is to adopt a labour intensive method of production. The labour intensive technology can employ a large labour force. Today, most industries adopt capital intensive technology and this has led to increase in unemployment.

SELF ASSEMENT EXERCISE.

Outline the causes of unemployment in Nigeria

3.3 EFFECTS OF UNEMPLOYMENT

1. Effect on Government.

As more people in a given country are unemployed, the revenue government generates from taxation is reduced. Equally government will have increased social security payment e.g pension, gratuity.

2. Effects on National Income.

Increased dependency of citizens due to unemployment reduces the income and the capacity of the working class. The income of the working class citizen would be shared with those that are unemployed. This sharing of the salary of the working class citizens reduces the aggregate income in the economy.

3 Social Effects.

Unemployment creates social vices among the citizens of a country. These includes robbery, smuggling, and social unrest.

Reduction in Standard of Living.

Unemployment generally reduces the standard of living of the unemployed. It also reduces the standard of living of the working brothers, sisters, or parents because the unemployed will depend on them for sustenance from the small salary that they earn.

SELF ASSESSMENT EXERCISE

Explain the consequences of unemployment in Nigeria

3.4 Remedies to Unemployment.

1. Population Control.

One of the most appropriate remedies to unemployment is for government to intensify effort toward educating people on the need and the importance of population planning and control through limiting the number of children per parent and other family planning controls. This will help reduce the growth rate of population thereby reducing unemployment in the country,

2. Labour Intensive Technology.

Government should put policy measures in place to ensure that the technology it is adopting is a labour intensive type which will help in reducing the rate of unemployment.

This can be effective when the government adopts local technology that suits the needs of the people rather than depending on those used by other countries.

Even Development.

Government can reduce unemployment by embarking on even development of all the country (infrastructural development) rather than focusing only on the urban centers.

When the rural areas are well developed, this will reduce rural- urban migration in search of jobs in the cities.

4. Encourage Investment.

The Nigerian entrepreneur needs to be encouraged toward investing in the manufacturing sector. Similarly government should encourage foreign investment so that foreigners can also establish industries and be able to increase the local capacity and reduce unemployment.

5. Effective Government Policy.

Government should implement some tax holiday measures and other tax incentives so that the existing industries can expand and produce at full capacity. The increase in capacity requires more labour. This process can reduce unemployment in the country.

6. Vocational and Technical Education.

Government can encourage the existence of vocational and technical education which will ensure that citizens need not depend on government all time as the only employer of labour. People can be self- employed in cottage industries that require little capital to establish. When a large population has technical and vocational education, it reduces the problem of unemployment. This is because many people will not depend on government as the only employer of labour.

SELF ASSESSMENT EXERCISE.

Carefully describe the remedies of unemployment.

4.0 CONCLUSION.

Unemployment is a problem that every government attempts to minimize to the lowest level. This is because it creates a lot of social pressures on the economy.

Usually government uses a combination of strategies to minimize the problem some of which include population control, even development of the economy, encourage investment, etc.

5.0 SUMMARY

The unit has thrown light on the meaning and the various dimensions of unemployment in Nigeria. The causes and effects of unemployment were also examined. Remedies for minimizing unemployment were also highlighted and discussed.

6.0 TUTOR-MARKED ASSIGNMENT

1. Explain the causes and solutions to unemployment
2. Mention and discuss the effects of unemployment

7.0 REFERENCE/ FURTHER READINGS.

Falokun, G.O.(1999), "Inter sectoral Indicators of Employment Potential in Nigeria ", NISER Monograph Series No. 2

Gordon, D. F.(1976), "A Neoclassical Theory of Keynesian Unemployment". The Philips Curve and Labour Market. Journal of Monetary Economics. Vol. 1

Olaloye, A.O. (1986), "Labour Market Adjustment and Unemployment Problems in Nigeria" in Unemployment and Underemployment in Nigeria. Nigerian Economic Society Proceedings, Kaduna, may 13-17.

Rama, M. (1998), How Bad is Unemploment in Tunisia? Assessing Labour Market Inefficiency in a Developing Country", Research Observer. Vol. 13 No. 1

UNIT 4 INTERNATIONAL TRADE THEORY

CONTENTS

1 . 0 Introduction

2. 0 Objectives

3.0 Main Content

3.1 Reasons for International Trade

3.2 Features of international trade

3.3 Problems of International Trade

3.4 Merits of International Trade

3.5 Benefits of International Trade.

4.0 Conclusion

5.0 Summary

6.0 Tutor-Marked Assignment

7.0 Reference/ further reading.

1.0 INTRODUCTION

In the modern world, there is no country that is self-sufficient or able to produce all the goods and services that are required to satisfy all the wants of the people in that country. Human needs usually vary from one location to another. Moreover, natural and human resources are not equally and evenly distributed across the globe. Some countries are endowed with mineral resources and land, while others have abundant capital, a skilled manpower or technical know-how. Nigeria for example has mineral resources like petroleum, coal, columbite, tin, while zambia is endowed with copper, the United States has highly developed technical knowledge and capital. International trade assists countries to obtain those commodities that they cannot produce. Since there is international division of labour or specialization, it means that every country tends to specialize in the production of a commodity for which it has the greatest cost advantage. It will benefit if it engages in trade with other nations.

2.0 OBJECTIVES

Explain the term international trade

Discuss the reasons for international trade

Examine the features of international trade

Discuss the problems of international trade

Explain the merits/ benefits of international trade.

3.0 MAIN CONTENT

3.1 Reasons for International Trade.

International trade is the movement of goods and services between countries. It involves the use of internationally accepted currency as a means of settlement of claims among the trading partners.

International trade is essential among countries of the world. Most countries are dependent on each other for the supply of the commodities they cannot produce within their geographical location. There are several reasons why nations engage in international trade. Some of the reasons are.

1. Differences in Climate.

All over the world, nations are located in different climatic zone. Therefore commodities that can grow in one climatic zone may not grow in another. Hence countries trade for commodities that cannot grow in their geographic locations.

2. Differences in The Level of Industrial Development.

Some countries are more developed than others and therefore can produce goods which cannot be produced in those that are not industrially advanced. International trade facilitates exchange of goods between countries that are developed and those that are developing.

3. Differences in the Level of Technology.

Some countries are more technologically developed than others. The countries with better technology produce the commodity at a cheaper rate and more efficient. This brings about trading between countries so that those with better technology produce goods needed by other without the technology.

4. Differences in Factor Endowments.

International trade is necessary because mineral resources such as oil, gold, iron ore, coal, manganese, copper are not evenly distributed around the world. Some countries have these mineral resources in abundance while others do not have the mineral resources. Those that do not have trade with those that are endowed with the mineral resources for mutual benefits.

SELF-ASSESSMENT EXERCISE 1.

Identify the reasons for international trade among countries.

3.2 Features of International Trade

1. Currency.

In international trade, countries have different monetary systems, and used different currencies compared with internal trade that uses the same currency.

2. Trade Imbalance Problem.

When there is trade imbalance among countries, movement of resources do not occur due to restrictions, people do not move freely and easily from one country to another for the purpose of skill and work even though with globalization, capital and entrepreneurs can move more easily than labour. Therefore if one country is buying more from another than it is selling, it will find it difficult to pay for the import. The reserves of the foreign currency will decline as a result of more payments than receipts.

3. Languages.

International trade is often complicated by having different languages spoken and used in the trading countries. It requires the study of an internationally acceptable language as a medium of communication.

4. Artificial Barriers.

Goods that are used for trade among countries face government restrictions and control. Countries face government restrictions and controls such as tariffs, quotas and exchange controls.

5. Distance.

International trade involves long distances in the movement of goods and services. This involves a lot of shipment, money and time.

6. Immobility of Factors of Production.

Governments across the world have put in place some restrictions that limit free movement of goods and services among trading nations. Compared with internal trade where movement is free for factors of production.

SELF ASSESSMENT EXERCISE 2.

Examine the features of International trade.

3.3. The problems of international trade.

1. Physical Problems.

International trade has the physical problem of lack of good transport system. Even those that are available have high risk rate associated with their use.

2. Communication Problem.

In international trade, the system of communication is not adequate. The telephone, telex, fax systems are not well developed in some countries. This makes communication difficult in international trade.

3. Differences in Currency.

International trade compels trading partners to convert currencies to that which is acceptable to them, because a legal tender in one country may not be a legal tender in other countries. This difficulty necessitates conversion of currencies for settlements to take place.

4. Weights and Measures.

Countries do no use the same system of weights and measures. Some countries use pounds while others use kilograms, some measure in yards, feet and inches. While others use metres and centimeters. All these technical differences create problem in international trade among countries.

5. Differences in Political Ideology.

Different countries pursue different ideology, social and economic policies that sometimes constitute a hindrance to international trade. Some countries practice capitalism, others socialism, some a mixture of the two systems. Therefore differences in political ideologies become a hindrance to international trade among countries.

6. Protectionist Policy.

In international trade, countries commonly practice protectionist policy by protecting their economy from the dumping of goods from abroad. Most developed countries protect their agriculture from agricultural export produced cheaply from other nations. This measure is aimed at protecting the income of the indigenous farmers and the local industries. These protectionist policies of governments all over the world inhibit trade among nations.

7. Lack of Foreign Exchange.

In the process of international trade a country may be constrained by lack of sufficient foreign exchange and inadequate international liquidity. This reduces the ability of the country to engage in international trade with other countries. This is because settlement of claims involves the use of foreign exchange. Lack of adequate foreign exchange reserve may hinder a country's ability to engage in trade with other counties.

8. Problem of Tradition/Religion.

Tradition and religions can be a problem in international trade. In some countries, e.g. India beef is not eaten while it is a good meal in other countries. This can reduce the potentials of trade among nations.

9. Language or Linguistic Problem.

10. The differences in languages spoken over the world can reduce the potentials of international trade. A Nigerian businessman who wants to trade with a counterpart in china or France has to learn the basic French or Chinese before trade can effectively take place.

SELF-ASSESSMENT EXERCISE

Discuss the problems associated with international trade.

3.4 Merits of International Trade.

1. International trade brings about efficient allocation of resources among countries. This is because every country specializes in producing the commodities that it has a comparative advantage. This enables countries to channel their resources and factors of production to the areas that they can produce the optimal quantity of output.

2. International trade leads to increase in the total world output of goods. Production of goods and services rises to the highest level because of specialization in the production of goods leads to increase in the quantity of goods produced for trade.

3. International trade creates variety of goods to be made available to consumers in any country. Commodities that are not produced in a given geographical location can be brought to the region through trade. New markets are also opened as new products come into existence.

4. International trade increases the standard of living all over the world. This is because individuals have a choice on the goods available and the value and condition of living becomes better due to the large variety of goods.

5. International trade builds friendship among countries. As countries trade with each other, they become familiar with each other, understand each other better and protect the interest of trade partners leading to peace among countries.

6. International trade brings about exchange of ideas, improvement in production technique and improvement in the quality of goods and services.

7. International trade increases specialization. Each country tries to specialize in the production of goods that it has comparative advantage. This reduces aggregate price because specialization leads to decrease in price per unit and the total cost of production declines.

SELF-ASSESSMENT EXERCISE

Outline the merits of international trade.

4.0 CONCLUSION

The analysis of the unit shows that international trade is vital among nations. It help to provide an avenue for specialization, increase world output, brings more variety of the goods and services around the trading partners.

Despite the numerous benefits, it has some challenges some of which include foreign exchange, differences in transport, language, etc. these problems not withstanding, international trade is beneficial among countries of the world.

5.0 SUMMARY

The unit examined the meaning of international trade and the reasons why trade takes place among nations. The problems and the merits of international trade were highlighted and discussed.

6.0 TUTOR MARKED ASSIGNMENT.

1. Explain the reasons why trade takes place among countries.

2. Mention and discuss the merits of international trade.

7.0 REFERENCE/FURTHER READINGS.

Dornbush, R. (1980), Macroeconomics. New York : Basic Books

Lawal, O. A. (1982), Essential of A' level Economics of West Africa Heinemann Educational Books Nig Ltd.

Nearl, P. (1980), "Non- Trade goods and the Balance of trade in a Neo – keynesian Temporary Equilibrium", Quarterly Journal of Economics, 3

Swan T. (1968), Readings in international Economics. Homewood, New York

UNIT 5, PRINCIPLES OF INTERNATIONAL TRADE

CONTENTS

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 Absolute Advantage Principle

3.2 Comparative Advantage Principle

3.3 Heckscher –ohlin factor Endowments.

4.0 Conclusion

5.0 Summary

6.0 Tutor Marked Assignment

7.0 References/ further readings.

1.0 INTRODUCTION

The principles of international trade serve as the basis which trade takes place among nations of the world. This ranges from the Adam Smith's principle of Absolute Advantage, David Recardo's Comparative cost advantage theory, the Heckscher-ohlin factor endowment principle. There is no country that can claim it has all the advantages in trade, but to identify the resources within its boundary and harness them for the benefit of trade.

2.0 OBJECTIVES.

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

Explain the absolute advantage principle of international trade

Discuss the comparative advantage principle of international trade

Discuss the factor price principle

Discuss the factor prices

3.1 The Principle of Absolute Advantage.

International trade theory explains why trade takes place between countries. Adam Smith was one of the first economists to show international trade as a means of increasing the welfare and output of nations. He argues that "The tailor does not make his own shoe, he exchanges a suit for shoes thereby both the shoe –maker and the tailor gain. In the same manner a whole country can gain, by trading with other countries". The gain Adam Smith explains is possible if one country has absolute advantage over the other in the production of the commodities of trade.

Let us assume two countries Nigeria (N) and Ghana (G) with the same total resources available devote half of their resources to cotton production and half to the production of oil. The following annual units of output are recorded.

	Cotton	**Oil**
Country N	400	1000
Country G	1200	600
World output	1600	1600

From the table, country N is more efficient in the production of oil than cotton, while country G is more efficient in the production of cotton than oil. Country N has absolute advantage in oil production while country G has absolute advantage in cotton production (Ogba, 1998)

If each of the countries now specializes in that commodity in which it has absolute advantage than given constant return to scale, the following unit of output will be produced.

	Cotton	**Oil**
Country N	-	2000
Country G	2400	-
World output	2400	2000

From the table, N is more efficient in the production of oil than cotton while country G is more efficient in the production of cotton than oil. Country N has absolute advantage in oil production while country G has absolute advantage in cotton production, (Ogba, 1998).

If each of the countries now specializes in that commodity in which it has absolute advantage than given constant return to scale, the following unit of output will be produced.

	Cotton	Oil
Country N -		2000
Country G.	2400 -	____
World output	____ 2400	2000 ____

Since during specialization the resources are moved from one commodity production to the other, country N will shift resources from the production of cotton to the production of oil. The oil output will double for the country. Similarly country G will move resources from the production of oil to cotton where it has absolute advantage, hence output will double for the country. Before specialization, the world output for the two commodities was 3200 units for the two countries, but after specialization country G produce 2400 of cotton and country N produce 2000 units of oil.

The world output now becomes 4400 units. This shows that countries benefit in international trade due to specialization through the increase in world output.

SELF-ASSESSMENTEXERCISE.
Using appropriate examples discuss the Absolute Advantage Principle of trade.

3.2 The Principle of Comparative Cost Advantage.

This principle was propounded by David Ricardo. The fact that countries gain from international trade is summed up in the principle of comparative costs, which states that "countries will benefit from international trade by specializing in those commodities in the production of which they have the greatest comparative cost advantage over other countries or the least comparative disadvantage".

Basically this means that countries should concentrate on producing those commodities which they produce more cheaply than other countries. This could be because of the availability of cheap labour, adequate sunshine or rainfall, skilled labour, capital, natural resources compared to other countries.

The last phase of the least comparative cost disadvantage shows that even if a country cannot produce anything more cheaply than others, it should concentrate on goods where its disadvantage is least. This principle of comparative cost is not confined to international trade; division of labour is also based on the same principle. We would quite truthfully state that people will gain from specializing in those activities in which they have the greatest comparative advantage over other people, or the least comparative disadvantage.

David Ricardo develops the comparative cost advantage principle of trade as an alternative to Adam Smith's explanation of trade by Absolute advantage. Ricardo stated that absolute advantage is not the only principle behind international trade because countries still trade with each other even if one country has absolute advantage in the production of both commodities. Such trade is based on the theory of comparative cost. A country enjoys the comparative cost advantage where its cost of production is low and that product greater output compared to the cost of its partner in trade. But the second country will specialize in the production of the commodity that it has less disadvantage.

	Petroleum	**Electricity**
Country N	1100	1200
Country G	500	300
World output	1600	1500

Country N is more efficient in the production of both petroleum and electricity. However its comparative advantage is greater in the production of electricity, while the comparative disadvantage of country G is less in the production of petroleum than electricity as shown by the output for the two commodities.

We can determine the opportunity cost (oc) of production of unit of petroleum with respect to electricity. OCPE = output of petroleum with respect to electricity. In the determination of the opportunity of production for a unit of electricity in terms of petroleum in each country can be determined. OCEP = output of electricity /output of petroleum.

Hence we can determine the productivity of each country with respect to each commodity.

Country	Opportunity cost of petroleum With respect to electricity	Opportunity cost of electricity wilt respect to petroleum.
Country N	0.9	1.09
Country G	1.66	0.6

When country N now specialises in the production of electricity and G specialise in petroleum. The output of the countries can be shown as follows.

	Petroleum	**Electricity**
Country N	-	2400
Country G.	1000	-
World output	1000	2400

At the point of specialization the resources used in the production of the two commodities by each country are now channeled to the production of the specialized commodity. After specialisation world output increased from 3000 units to 3400 units of output.

The factors that determine comparative cost theory are

a. Differences in opportunity cost is the basic justification of the theory of trade.

b. Resources need be sufficiently mobile for the principle to operate effectively; labour employed in a declining industry may not easily be able to find employment elsewhere.

c. Constant returns to scale have been assumed. It may be that decreasing returns are experienced at some stage, so that theoretically stronger country does not take as much of the market as the theory would suggest.

d. Transport cost, which in the theory is ignored might lessen the potential benefit of trade.

SELF-ASSESSMENT EXERCISE

Using any appropriate example, discuss the comparative cost advantage principle of trade.

3.3 Heckscher-ohlin Factor Endowments Principles.

The Heckscher-ohlin principle explains the patterns of trade in terms of factor endowments. The principle states that a country has a comparative advantage in the good that is relatively intensive in the country's relatively abundant factor.

The explanation of this principle is that different factor endowment seems to be one of the most important factors used in international trade. Secondly, international trade is linked to the domestic allocation of resources and distribution of income. Also a country's factor endowment is itself determined in part by economic phenomena; the present capital stock determines what the future capital stock will be in the system. Thus it becomes possible to examine the relationship between international trade and economic development and growth and between international trade and international capital movement. Thirdly, the factor endowments approach can be made conceptually general enough to include many other possible explanations. That is, we can regard climate, technical knowledge, patents, location as themselves factors used in the process of production.

There are four basic assumptions in this principle, they include,

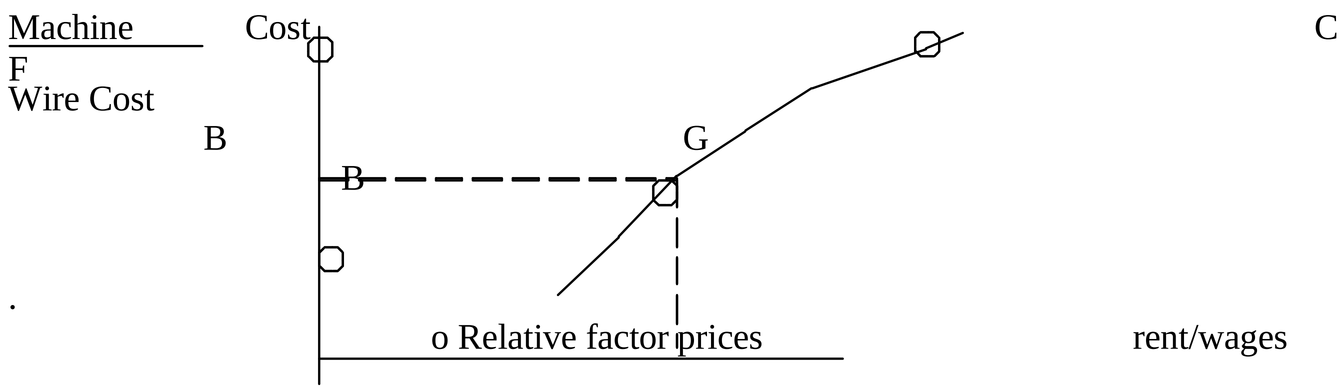
1. There are two countries, two goods and two factors of production (capital and labour). The two factors are needed in order to study the role of relative factor endowments, limiting the number to two makes the model simple.

2. The two factors are available in fixed amounts in each of the two countries, these factors are fully mobile between industries within each country, but are immobile between countries; all market have free and perfect competition.

3. The two countries are alike in every respect except for their endowments of the two factors. In particular, the technologies for production are available to both countries and they have identical tastes in the sense that if they face identical prices for wine and machines they will consume them in identical proportions.

4. For each of the two goods there is a given technology (available to both countries) indicating how capital and labour can be combined to produce output. This technology possesses constant returns to scale (varying both capital and labour in the same proportion will vary output in that proportion) The assumptions ensures that the principle in reality is connected to the basic idea that trade is due to different factor endowments.

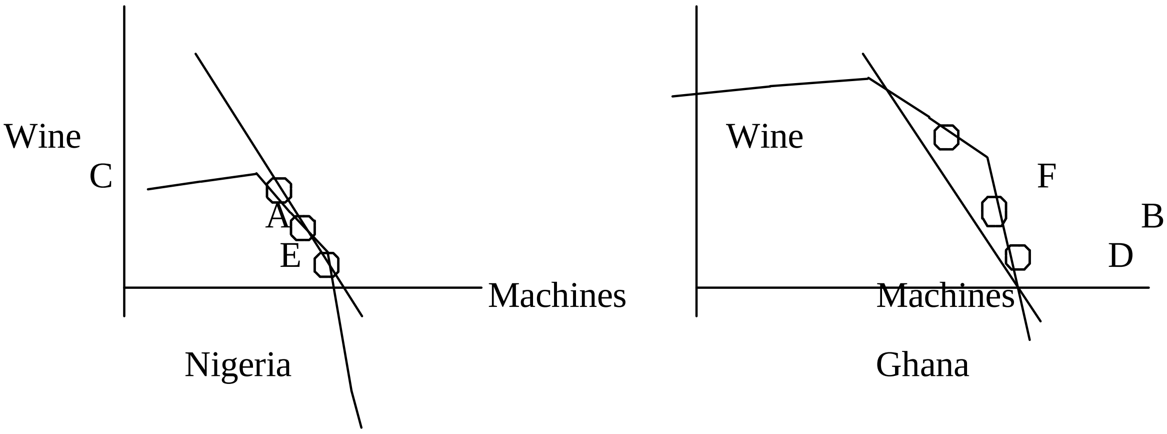
In each country, capital and labour are hired to produce outputs and firms use no other inputs. Firms pay wage in order to hire labour and rent in order to hire capital. This the wage and the rent in a country fully determine the cost of producing wine and machines in that country. Consider a change in relative factor prices. Say an increase in the wage with the rent remaining constant. This increases cost in both industries. But the two industries will not be affected the same way. Since the machine industry is labour intensive, its costs will be increased proportionally more than cost in the wine industry, labour is not as important. A rise in the wage relative to the rent increases the cost of the labour – intensive good (machines) relative to that of the capital intensive good (wine). This relationship can be shown graphically.



Three features are important in the diagram, first it is a technological relationship, its slope depends on relative factor intensive. Second, because the curve is a technology, the curve applies to both countries.

Since factors are not internationally mobile and labour in one country does not compete with labour in another country, wages and rents in one country need not equal those in another. Thus the two countries may be at different points on the curve; for example Nigeria could be on F and Ghana at G. But both countries should be somewhere on the same curve as long as they have the same technology.

There is a relationship between the costs of machines and wine and the prices of these goods. If a good is produced in a country, its price must equal its cost in long run equilibrium. If cost exceeds price, no one will wish to produce it and the industry will close down, if price exceeds cost the profit will induce competition forcing the two into equality. Thus if the wage- rent ratio in Ghana equals OA and if wine and machine are both produced in Ghana, then if a good is not produced, cost could exceed prince. Thus if Ghana is specialized in wine, the relative price of machine in terms of wine could equal OD. If Ghana is specialized in machine, the relative price could equal OC.



Nigeria is the relatively capital- abundant country and therefore is better equipped to produce the capital intensive good wine. This is reflected in the generally steeper slope of the Nigeria's possibility curve equilibrium is at A compared to that of what at B. Thus without trade, wine is relatively cheaper in terms of machine in Nigeria than in Ghana. It should be noted that the greater the dissimilarity in relative factor endowments, the greater the dissimilarity in their production possibility frontiers. If the two countries had identical endowments of capital per worker, their production possibility frontiers would have identical shapes.

4.0 CONCLUSION

International trade is necessary among nations as no country is sufficient in itself. Geographical and climatic differences have made it mandatory for countries to seek for trade with other countries as a means of increasing the variety of goods available within its geographical location.

5.0 SUMMARY.

The unit examined the basic principles of international trade as a means of increasing world output as countries specialize in the production of commodity that they have comparative advantage. This allows nations to specialize in the production that it has the advantage in production.

6.0 TUTOR-MARKED ASSIGNMENT

1. Explain and illustrate absolute advantage principle of trade

2. Explain and illustrate the comparative advantage principle of trade.

7.0 REFERENCE/FURTHER READING.

Anderson, D. (1985), Economics of West Africa. Macmillan Publisher, Nigeria.

Balassa. B. (1979), "The changing pattern of comparative Advantage in manufactured Goods", Review of Economics and statistics, No. 2

Dixit, A .K. and Norma, V. (1980), Theory of international Trade, London Cambridge University Press.

Ogba, L. (1998), Principles of Economics 2. Abayomi Publishers Lagos, Nigeria.

Postner, H.H. (1975), "factor content of Canadian International Trade, Ottawa Economic council of Canada.

Williams, J.R.(1970), "The resources content in International Trade Canadian journal of Economic Vol. 2.

UNIT 6 FREE TRADE AND TRADE RESTRICTION

CONTENTS.

1.0 Introduction
2.0 Objectives
3.0Main Content
3.1Free trade, Arguments for free trade
3.2Trade restriction
3.3Arguments for trade restriction
4.0 Conclusion
5.0 Summary
6.0 Tutor marked Assignment
7.0 Reference/ further readings.

1.0 INTRODUCTION

Free trade is a situation where a country abolishes all forms of restrictions on trade and services flow freely. All the restrictions that countries place to check the trans-border is an attempt by nations to limit the movement of goods and services across boarders. Although many countries know that they can benefit more in international trade, there is nevertheless some form of barriers or protection in external trade relations.

2.0 OBJECTIVE

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

* Explain free trade concept.

Discuss reasons in favour of free trade

Explain trade restriction strategies.

3.0 MAIN CONTENT.

3.1 Reasons Supporting Free Trade.

1. Free trade leads to increase in real world output, income of all participating countries due to specialization. Assuming that the factors of production are mobile, that is, they can shift from one occupation to another, assume that shifting of factors from one occupation to another does not lead to diminishing returns in the growing industry used in trade, the cost of transportation and other transport facilities is ignored, we can take

and compare equal combinations of factors of production in the two countries.

2. Free trade leads to lower prices for imported goods and also factor movement to where they can earn more returns in the global economy. This is possible because of specialization in production and factors of production are used efficiently leading to decrease in the overall cost of production as counties that produce the commodity inefficiently stop producing the commodity. At the end of the transaction, the commodity would be sold at a lower price.

3. Free trade leads to a greater variety of goods in the domestic economy which increases the consumer welfare and choice. Free trade allows for free flow of goods and services. Therefore every country have enough variety of every commodity for its citizens within the economy this reduces the effort and time wastages searching for any commodity needed for consumption leading to improvement in the welfare of the people.

When varieties are available, it reduces the potentials of competition in the purchase of the commodity.

4. There is increase in employment opportunities throughout the world when countries specialize in production. They now produce, enmass, hence increase in demand for labour.

5. Free trade also leads to diffusion or spread of technology. This is because when countries are trading and if there is an innovation that increase the production of a given country others will emulate the technique. Free trade assists in the movement of technology and technical ability through the mobility of labour to where it earns the highest returns.

6. Free trade also makes the establishment of monopoly to remain very difficult in the economy due to competition and availability of substitutes.

SELF ASSESSMENT EXERCISE

Explain the reasons that support free trade.

3.2 Trade Restriction.

This is a process or a combination of measures that inhibit the free flow of goods between countries and thereby prevents resources being used in accordance with comparative cost advantage and factor endowment principle. Some of those measures that restrict trade include.

1. Prohibition.

The simplest and most effective form of restriction is outright ban. This could be applied to exports as well as imports. It would certainly be contrary to the principle of comparative cost advantage and factor endowment principle of trade. The reasons for prohibition on trade among countries is not usually economic but social and political reasons. They are usually advanced to justify prohibitions by different countries.

2. Quota.

Instead of prohibition on the movement of goods and services into or out of a country, the government may impose a limit to the volume of goods imported or exported at any given period. Quota is setting a maximum volume of import or export for a given economy. Once the level has been reached in the specified period, no more quantity would be allowed into the country. This would be the quota for that period. This could be done by a number of countries, together deciding upon the volume of total exports that would be in their interest and then giving each member of the agreement a quota. When a group acts jointly in this manner to reduce competition by a common selling policy it is known as a cartel. On the other hand countries can limit the volume of import as a means of regulating the economy and preventing dumping.

3. Exchange Control.

An indirect, but very effective way of restricting trade is to impose regulations on the use of foreign currency, or on what has to be done with foreign currency with which to buy imported goods. Countries can allocate foreign exchange as a means of regulating the use of foreign exchange for the purpose of limiting imports into the country. The restriction is usually imposed by the central bank and implemented by the commercial banks.

4. Subsidies.

They are payment made to producers or sellers of a commodity for various reasons. They will interfere with the flow of goods between countries. If goods produced for local consumption are subsidised their prices will fall and import of similar goods will be made less competitive as the import will now attract higher prices due to the fact that the locally produced commodities are subsidised. Subsidies on exports will have a more direct effect on comparative costs by making the subsidised export cheaper and giving them an advantage over non-subsidies goods produced locally.

5. Import licensing.

The government can limit import by imposing a complex import licensing procedures. This can assist in reducing the volume of import into the economy.

SELF ASSESSMENT EXERCISE

Discuss the strategies for trade restriction

4.0 CONCLUSION

All over the world, it is accepted that international trade is necessary, free trade ought to be encouraged among countries. This free trade is to facilitate movement of goods and services. However countries restrict trade among themselves. The reason for restricting trade ranges from political, social to religious basis. Countries allow a guide flow of goods and services so as to protect its economy from external commodity domination.

5.0 SUMMARY.

The unit examined the concept of free trade and advanced reasons why free trade is beneficial. The unit also gave highlight on trade restriction and the strategies that are often adopted for trade restriction, some of which are Quota, embargo, exchange control,etc.

6.0 TUTOR-MARKED ASSIGNMENT

1. Explain the reason for free trade
2. Explain the various strategies for trade restriction.

7.0 REFERENCES/FURTHER READINGS

Baldwin, R. E. and Multi J.H. (1980), "Welfare Effects of the United states of a significant multilateral Tariff Reduction", Journal of international Economics, August.

Caves, R.E. and Jones R.W. (1981), World Trade and Payment. 3rd ed Boston: little brown.

Corden. W. M (1971), The theory of protection. Oxford University Press.

Either. W.J. (1971), "Dumping" Journal of political Economy, June Either ,
E.J. (1977) "The theory of Effective Protection in General.Equilibrium: Effective- Rate Analogues of Nominal Rates", Canadian Journal of Economics. May

Yeats, A. J. (1979), Trade Barriers facing Developing Countries, New York: St Martins.

UNIT 7. INTERNATIONAL TARIFF

CONTENT

1.0 Introduction
2.0 Objectives
3.0 Main Content
3.1 Tariff and export duties
3.2 Tariff and Economic effects
3.3 Tariff and factor endowment
3.4 Tariff and national income
4.0 Conclusion
5.0 Summary
6.0 Tutor –Marked Assignment
7.0 References/Further Reading

1.0 INTRODUCTION

The theory of international trade makes a strong case for free trade among nations. Yet governments have always attempted to control trade to at least some extent, and deliberate free –trade policies have been very rare historically even in the developed countries. Many instruments can be used to exercise commercial policy. Perhaps the most familiar is a tax on imports, commonly called tariff. Of course exports might also be taxed, and both import and exports are sometimes subsidised (a negative tax). In addition, many non-tariff barriers do not involve taxes or subsidies at all. Quantitative restrictions, for example, limit the quantities of specific goods that can be imported (or sometimes, exported). In principle there might be other maximum or minimum quotas on either exports or imports, but a quota on the maximum quantity of a good that can be imported in a specific time intervals is perhaps the most familiar form. Sometimes tariffs and quotas are combined. A tariff – quota (or custom quota) does not prohibit imports above the quota amount but instead subjects them to a higher tariff than that imposed on imports within the quota at a given period.

3.1 Tariff and Export Duties

Tariff or taxes on trade are a very common way of cutting down imports. All goods which are subject to a tariff will be charged the relevant amount of duty by the customs.

Tariff could be a specific tax or duty. In this case so much is paid on each unit imported, measured by weight or simply counted. Or it could be an advalorem tax, which is assessed according to the value of the goods imported. This would be a certain percentage of the value of the commodity.

Duties are often placed on exported goods, especially by developing countries. The purpose of these is usually to raise revenue for the government, rather than to restrict the volume of trade from the economy. Many developing countries use export duties as a means of getting revenue for other economic activities. They are not designed to limit the level of exports and seldom have this effect. They are usually a means of taxing the income of farmers in a very convenient and cheap way. This is because the farmers usually produce only one or two cash crops for export purposes. Export duties / tax does not make them to produce less, since they have no other sources of income outside of the farm cash crops. They cannot alter the composition of their output except over a long period, since many crops take a long time to grow.

Sometimes export taxes are only imposed when the world price reaches a certain high level. This often applies to the export of minerals. The government is then only taking away some of the windfall profits that would accrue to the produces and total output would not be reduced by the tax (Anderson, 1995),

SELF ASSESSMENT EXERCISE

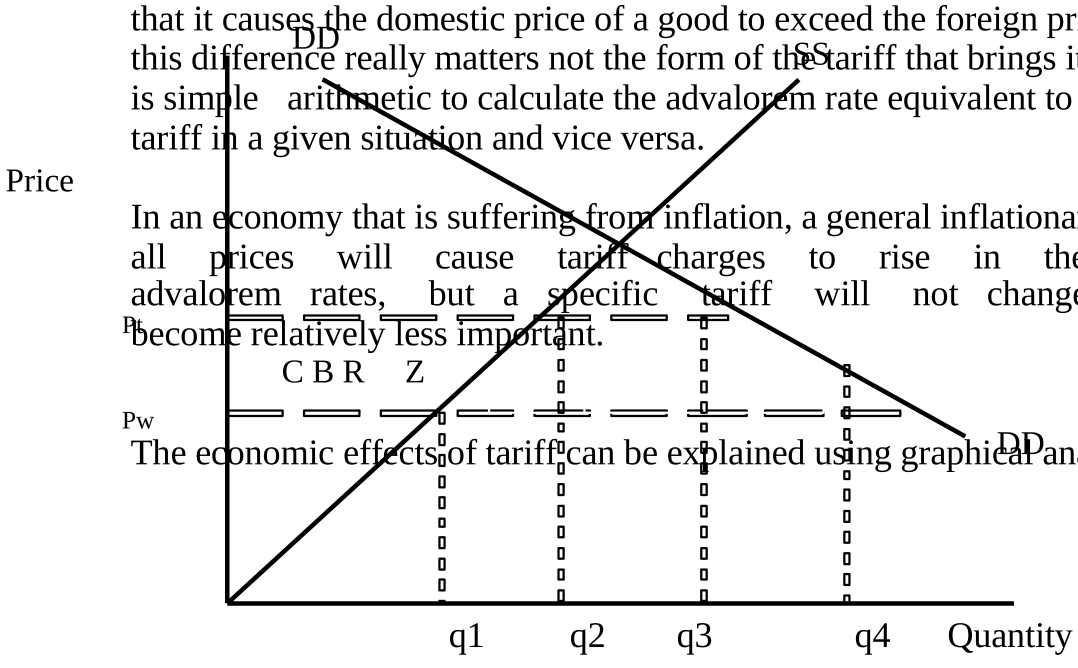
Explain tariff and export duties in an economy.

3.2 Tariff and its Economic Effects

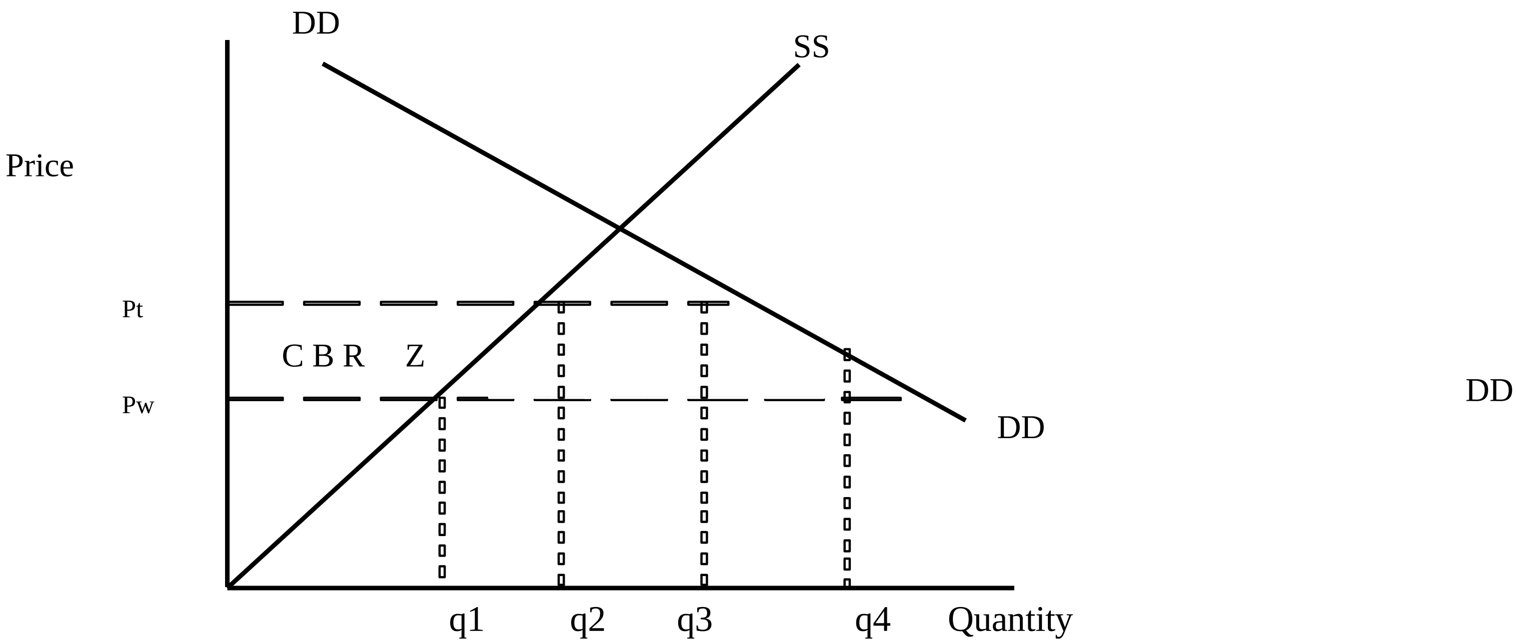
A tariff is a tax on imports: the price a domestic purchaser pays for an imported goods exceeds the amount the foreign exporter charges on the commodity. All the economic effects of a tariff follow from this simple fact that it causes the domestic price of a good to exceed the foreign price. Only this difference really matters not the form of the tariff that brings it about. It is simple arithmetic to calculate the advalorem rate equivalent to a specific tariff in a given situation and vice versa.

In an economy that is suffering from inflation, a general inflationary rise in all prices will cause tariff charges to rise in the same proportion with advalorem rates, but a specific tariff will not change at all and so will become relatively less important.

The economic effects of tariff can be explained using graphical analysis.



The economic effects of tariff can be explained using graphical analysis.



When tariff is imposed, price increases from Pw to Pt and reduce the quantity of imports from q4 - q1 to q3 – q2. The revenue derived from tariff is equal to the shaded area R. The area C is redistributed to domestic producers who increase their output from q1 to q2. The area represented by B is the cost of putting additional resources into domestic production for the commodity that is to be produced locally as a substitute for the import.

DD

Area Z is a loss to consumers as a result of decrease in the quantity demanded.

a) Price effect, due to the imposition of tariff price of goods increases from Pw to Pt.

b) Protection effect. Domestic producers and the industries within the economy will enjoy increase in output from q1 to q2 due to the protection in form of tariff.

c) Consumption effect. The tariff had resulted in increase in prices from pw to pt therefore consumer demand decrease from q4 to q3.

d) Welfare effect. Price of goods increases, quantity demanded falls. This reduces the welfare of the consumers. Therefore tariff can lead to misallocation of resources associated with the area B, Z. therefore the consumer welfare decreases due to tariff. However producers benefit due to increase in production capacity, if the production is large enough it can outweigh the negative welfare effects of tariff.

SELF ASSESSMENT EXERCISE 2

Discuss the economic effects of tariff on an economy.

3.3 Tariffs and Factor – Endowments Theory

Tariffs raises the domestic price of importables relative to exportables. Based on the Heacscher – ohlin principle of trade, a country has a comparative advantage in the commodity whose production is relatively intensive in the country's relatively abundant factor.

It follows, then that a tariff raises the domestic price of the goods that uses intensively the country's relatively scarce factor. If Nigeria is capital abundant and exports capital intensive wine, then a Nigerian tariff raises the Nigerian price of labour intensive machines relative to wine. The tariff tends to displace resources from wine production to machine production.

A tariff protects that industry which makes intensive use of the country's relatively scarce factor. The factor endowment theory also sheds light on how protection influences the domestic distribution of income. Usually a rise in the price of any commodity causes the price of the factor used intensively in the production of that commodity to rise in even greater proportion and the reward of the other factor falls. Since a tariff can be expected to raise the domestic relative price of the good in the country's scarce factor, it follows that the reward of the scarce factor rises relative to both commodities, and the reward of the abundant factor falls relative to both commodities.

A tariff increases the real income of the country's relatively scarce factor and reduces the real income of the relatively abundant factor. Thus the tariff redistributes income within the tariff levying country, so that some class will favour protection and some class will oppose it. However, the country as a whole will lose, as long as the terms – of -trade effects of the tariff does not outweigh the consumption and production costs. This means that the abundant factor loses more from a tariff than the scarce factor gains; the former could in principle compensate the latter to forgo protection and still be better off than with a tariff. But in the absence of any sort of compensation or redistribution, those people whose, income comes from the earnings of the scarce factor have a definite interest in protection even if it is harmful to their country overall (Ethier, 1983).

One the other hand, it is argued that tariff improves the terms of trade of the levying country, if that country is large enough in world markets. It also reduces the volume of trade generating production and consumption cost. But a moderate tariff could benefit a large country, that is the favourable terms of trade effect could outweigh the unfavorable consumption and protection costs.

This then is one possible motive for tariff protection to increase national welfare by improving the terms of trade.

Equally, the essence of tariff is the exploitation of monopoly power. If a country can influence world prices, the citizens of that country collectively posses monopoly power by withholding part of their export supply they can force the price up. Equivalently, they have monopolistic power in the market for their imports, and by restricting demand they can hold price down. The tariff is the instrument by which the country's citizens collectively regulate the market behaviour to their advantage.

SELF ASSESSMENT EXERCISES

Discuss the effect of tariff using factor endowment.

3.4 Tariff and National Income

A tariff is an instrument of trade policy and it makes imports more expensive relative to domestic goods and so induces the population of the country to shift its demand from import to goods produced in the domestic economy. This means less of a given income will now be spent on imports and more on domestic goods. This in turn stimulates the demand for domestic demand for goods and increase the domestic national income. A tariff stimulates domestic income by switching demand from foreign goods to domestic goods.

Thus in the Keynesian economy, a tariff becomes an instrument for the control of aggregate demand, increases in a tariff stimulate the economy and tariff reduction dampen it. By switching demand from foreign goods toward domestic goods a tariff affects the rest of the world in the opposite direction to its effects on the domestic economy. A tariff increase tends to lower foreign income as it increases domestic income. This is fine if the rest of the world wishes to reduce aggregate demand, but a source of conflict if it does not. That is, the tariff as an instrument of control over aggregate demand, generates international conflict when the domestic economy is in the same stage of the business cycle as the rest of the world.

SELF ASSESSMENT EXERCISE 4

Explain the effect of tariff on domestic income and the effect on the world economy.

4.0 CONCLUSION

Countries in the world know that there are economic benefits of free international flow of goods and services, yet every country imposes tariff as a means of limiting imports into the country. This is to boost the domestic production, prevent the economy from serving as a dumping ground as well as increase the domestic national income. Ultimately every country tries to strike a balance between free trade and trade restriction.

5.0 SUMMARY

The unit examined international tariff, tariff and export duties, the economic impact of tariff was also carefully explained, showing price effects, welfare effects and affects on consumption. Highlight of tariff and factor endowment, national income were also given in the unit.

6.0 TUTOR MARKED ASSIGNMENT

1. Explain the effects of tariff in an economy.
2. Mention and discuss the effects of tariff on income

7.0 REFERENCES/ FURTHER READING

Baldwin R..E. (1980), "Welfare Effects on the United State of a significant multilateral Tariff Reduction" Journal of international economics, August.

Caves, R.E. and Jones R..W. (1981), World Trade and Payments 3rd Edition Boston; Little Brown.

Carden, W.M. (1974), Trade Policy and Economic Welfare. Oxford: Oxford University Press.

Ogba, L. (1998), Principles of Economics II, Abayomi Pacicaging Lagos, Nigeria.

Pinchin. H.A. (1979), The Regional Impact of the Canadian Tariff Oltawa, Canada.

Yeats, A.J. (1979), Trade Barrier Facing Developing Countries New York St. Martins.

UNIT 8. INFANT INDUSTRY ARGUMENT

CONTENTS

1.0 Introduction
2.0 Objectives
3.0 Main Content
3.1 Infant industry argument; Production Perspective
3.2 Economic argument for infant industries protection
3.3 Socio-political argument for infant industries protection
4.0 Conclusion
5.0 Summary
6.0 Tutor Marked Assignment
7.0 References/Further Reading

1.0 INTRODUCTION

One of the main reason for trade protection is that protection assist infant industries. Protection of infant industries may sometimes result in economic gains in the long run, though for the time being it involves the acceptance of loss. A country in the agricultural stage of development, about to advance into the manufacturing stage, will meet difficulties during the transition period in competing with industrialized nations already established in agricultural production. The argument is that feeble and newly started industries cannot survive without protection. The cost that is involved in protecting the industries will be repaid as soon as the industries have acquired sufficient strength and capacity to stand on their own in the production process.

This protection is necessary because at the initial phase of production their products are costly and inferior compared with imported products. As the production process advance the production improve and the quality of their commodities improved and as capacity of production increases the cost per unit of the commodity decreases.

2.0 OBJECTIVES

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

- explain the argument supporting protecting infant industries
- explain economic argument for infant industries
- explain socio-political argument for infant industries.

3.0 MAIN CONTENT

3.1 The Infant Industry argument (Production Perspective)

In developing countries industries are still at the infant stage of production and cannot compete with the industries of advance countries hence the need for the protection. The industries should be shielded from competition from other countries. This will allow them improve on their production efficiency. The reasons for infant industries are as follows;

1)Low capital infant industries in developing countries have low capital compared with their foreign counterpart that have huge capital used in production.

2)Low investment infant industries have low investment in equipments, and there is no enough capital to have large assembly plants so protection will allow the infant industries to grow and expand.

3)Low capacity of production, most infant industries are operating at low capacity in their production process. This means cost of production will be high compared with the advanced countries industries that operate at full capacity and have low cost of production. Therefore protection is necessary for the infant industries so that they can expand their production capacity.

4)Structural problems. Industries in developing countries face challenges of structural problems such as power, water, road, communication and security. The poor state of these infrastructures in developing countries cumulatively acts as a means of increasing the cost of production and limiting their production. Protection of the infant industries is necessary, as industries in developed countries do not face these infrastructural problems so they produce at lower cost compared with infant industries.

5)Economies of scale. Industries in the advance countries enjoy economies of large scale production. Because they produce large quantity the unit cost of production is low compared with infant industries that produce low quantity and high cost of production per unit. The infant industries need protection so that they can expand to the point of maturity and also enjoy large scale production.

SELF ASSESSMENT EXERCISE
Explain the basic argument for infant industry protection.

3.2 Economic Argument for Infant Industries Protection.

The economic argument for the protection of infant industries are numerous, some of which include the following.

Revenue. When infant industries are encouraged to operate effectively they become a source of revenue to the government in form of excise duties. Excise duties are taxes imposed on local industries in the economy. The more of these infant industries the more revenue would be generated through the industries.

Employment. When infant industries grow they employ more citizens in the country. The simplest means of combating unemployment is to encourage the establishment of the small scale industries. As the infant industries are protected from competition they expand their production capacity. As expansion in production take place more individuals will be employed.

Increase in income. The protection of the infant industries will lead to increase income in the economy. All the money that would be used to purchase the commodity through international trade will now circulate within the country. Instead of allowing the money to flow out of the economy through payments for the imported commodity, it will be used in the domestic economy.

Improve balance of trade. If imports persistently exceed export, a country is going to find difficulty in paying for the imports. It will not be earning enough foreign currency from its exports. In this case if there is protection of infant industries, as they become matured in the process of production, they will produce enough for domestic consumption as well as export. If there are many of such industries in an economy, the country will export more than it import thereby improve the balance of trade. This is because more foreign exchange would be earned that will exceed payments for imports.

Anti-dumping. Government can protect infant industries so that the quality of their products improves gradually up to international standard. As more industries in the local market produce standard goods the country will no longer serve as a dumping ground for substandard imports.

SELF ASSESSMENT EXERCISE 2

Explain the economic reasons for infant industries protection.

3.3 Socio-Political Reasons for Infant Industries Protection

Self-sufficiency.

One of the main reasons for the protection of infant industries from foreign competition is for the purpose of self-sufficiency. A nation that is too highly dependant on import is likely to be vulnerable to the business cycle internationally. When there is instability in the country of import then consumption as well as production becomes distorted. A country that is self –sufficient will be cable to provide all it needs to the citizen during periods of war. Therefore countries protect their infant industries as a means of economic independence as these industries grow and become competitive enough over time.

Economic Diversification.

Diversity of industry helps a country and gives it greater stability. Diversification help insulate a country from the impact of foreign depression. A diversified economy is safeguarded from foreign trade disturbances. It is in a better position to maintain prosperity and defend itself from external trade cycles.
Reduce Excessive rural – urban migration. Infant industries usually have a wide geographical spread. Some are rural base while others are urban. When a large proportion of the infant industries are rural in nature, they will employ the rural labour, this serve as a check to rural urban migration in the country.

SELF ASSESSMENT EXERCISE
Explain the socio – economic reasons for infant industries.

4.0 CONCLUSION

Infant industries argument is pursued by most countries at the early phase of development. It has its own merit as it helps the domestic industries to grow, provide revenue and employment for the citizens of the country. Every country globally practices one form of protection or the other for different reasons. Infant industries protection serves as a means of promoting local self –sufficiency in some basic areas of industrial production and other economic life.

5.0 SUMMARY

The unit examined the argument for infant industries protection from three broad areas beginning from the production perspective to economic and socio-political perspective. It is true that most countries of the world had practice protection. This is to protect the infant industries as well as the economy.

6.0 TUTOR MARKED ASSIGNMENT

1)Discuss the production perspective argument for infant industries protection.

2)Discuss the economic and socio-political view of infant industries protection.

7.0 REFERENCES/FURTHER READING.

Balassa, R. (1971). The Structure of Protection in Developing Countries:

Baltimoro John Hopkins University Press.

Baldwn, R.E. (1979). The Multilateral Trade Negotiations, Washington American Enterprise Institute

Caves, R.E and Jones R.W (1981), World Trade and Payments 3rd Edition Boston; Little Brown.

Dixit, A.K. ad Norman, V. (1980). Theory of International Trade. Cambridge; Cambridge University Press.

Dornbusch, R. (1980). Open Economy Macroeconomics. New York Basic Books.

Princus, J. (1975) “Pressure Groups and the Pattern of Tariffs” Journal of Political Economy, July.

Yeats, A.J. (1979) Trade Barrier Facing Developing Countries New York St. Martins.

Unit 9. THE INTERNATIONAL MONETARY FUND (IMF)

CONTENTS

1.0 Introduction
2.0 Objectives
3.0 Main content
3.1The objective of Establishing International Monetary fund
3.2The functions of international monetary fund
3.3The loan structure of international monetary fund.
3.4The conditionalities of international monetary fund loan.
3.5Appraisal of IMF performance.
4.0 Conclusion
5.0 Summary
6.0 Tutor-marked Assignment
7.0 Reference/ further Readings.

1.0 INTRODUCTION.

The international monetary fund (IMF) was established by 44 countries under the Bretton woods Agreement of July, 1944. The reason for its establishment was for nations to have a common platform that can reduce global depression that ravaged the word economy in 1920s and 1930s which led to the adoption independent policies of trade restrictions, exchange rate control, exchange rate depreciation as a means of improving export base. The action of nations led to word trade decline and increased world depression. International monetary fund was principally established to promote economic and financial cooperation among member states as well as facilitate the expansion and balanced growth of world trade. The operation of international monetary fund commenced in march 1947. By 1991 the membership of the fund had increase to 151 countries.

3.0 MAIN CONTENT

3.1 The Objectives of International Monetary Fund.

The Articles of Agreement and the charter of the fund specify the following as the objective of its creation.

1. Monetary Cooperation.

The fund was established to promote international monetary cooperation through a permanent Institution which provides the machinery for consultation in common international monetary issues and problems.

2 Balanced International Trade Growth.

The fund 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 Exchange Rate Stability.

Another objective of the fund is to promote exchange rate stability by ensuring orderly exchange arrangements among member countries and avoid competitive exchange rate depreciation.

4 Multilateral Payment System.

The fund assists in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth in world trade.

5 Making Fund's Resources available to Members.

The fund is to lend confidence to members by making the funds resources available to them under adequate safeguard, thus providing them with opportunity to correct maladjustment in their balance of payment without resorting to measures destructive of national or international prosperity among the member countries.

6 Reduced International Balance of Payment Disequilibrium.

The fund is to assist member countries shorten the duration and lessen the degree of disequilibrium in the international balance of payment that member countries may likely face from time to time.

SELF-ASSESSMENT EXERCISE 1
Discuss the objectives of International monetary fund.

3.2. Functions of International Monetary Fund.

1. Fulfill Member Objectives.

The fund is to ensure that all members observe and implement the objectives set out for all member nations.

2. Regulate Balance of Payment Policies.

The fund serve as the guardian of good conduct in balance of payment policies and practices of member nations. It helps reduce tariffs and other trade restrictions by member countries. This ensures that members do not impose restriction on trade.

3. Technical Support.

The fund renders technical advice to member countries on monetary and fiscal policies. It also provides technical support to member countries with balance of payment problems. The fund provides personnel that have technical knowledge of monetary in fiscal and balance of payment policies.

4. Exchange Rate Stability.

The fund in assist in exchange rate stability of member nations, that the par value of each countries exchange is expressed in terms of gold or U.S. dollar.

5. Grant Loan to Member.

The fund grant loan to members to case financial problems. Though there are procedures and guidelines for the granting of loans to member countries.

SELF ASSESSMENT EXERCISE
Explain the functions of international monetary fund.

3.3 Loan Structure of International Monetary Fund

1 Reserve Facility.

The reserve facility represents the use of member own liquid reserve within the fund, and it does not constitute the use of the funds own credit. It is available to member countries without any charge attached to it. Up to 25% of the country's quota can be borrowed without any condition.

2 First Credit Facility.

This facility is used after the deduction of the reserve facility. The next 25% have varying and ascending degree of conditions. Such conditions focus on reducing budget deficit, price adjustment, and devaluation. For a member country to qualify and have access to this facility it should demonstrate that it has balance of payment problem and reasonable efforts are being made to solve them.

3 Compensatory Financing.

This facility is granted when a member is faced with balance of payment problems resulting from a sudden loss in export earnings. The amount of credit to be given to a member nation cannot exceed 100% of its quota contributed to the fund.

4 Buffer Stock Facility.

This credit facility is aimed at providing financial support for loss of stockpile of commodities. Credit up to 50% of a country's quota can be provided to the country in need. This facility is important especially in developing economies where cash crops are seasonal and constitute the only export earning.

5 Extended Financing Facility.

The facility is granted to member counties to meet their balance of payment deficits for a given period. The credit provided under this facility is larger than the quota contribution of members.

6 Stand-by Facility.

It is a supplementary financing facility to assist members that have serious balance of payment deficit. The facility is extended to low-income member countries. It also reduces the cost of borrowing.

SELF ASSESSMENT EXERCISE.

List and discuss the loan facilities of International monetary fund.

3.4 The Conditionalities of IMF Loan.

1 Devaluation.

This is a process of reducing the external value of the country's currency. The purpose of devaluation is to bring down the value of the nation's currency in relation to other international currencies. It is meant to help that country export more of its goods by making the value of her export cheaper. This condition assumes that other relevant countries do not devalue their currency. It is also assumed that through devaluation, the country may achieve balance of payment stability as it discourages importation as import become expensive.

2 Removal of subsidy.

Another condition is the removal of subsidy. This entails removal of government monetary contribution in the production of any commodity. In Nigeria government was compelled to remove subsidy on petroleum. The removal of subsidy usually has negative effects on the economy, in the form of higher prices.

3 Reduced Public Expenditure.

Government must make effort to reduce extra-budgetary spending. The reduction in government expenditure is aimed at reducing inflation in the affected country through reduced money supply.

4Trade Liberalization.

This involves the removal of all forms of trade restriction. This allows free flow of goods in and out of the economy. The strategy is assumed to take advantage of specialisation in international trade practice.

5 Reduction of Domestic Price Level.

Government must take measures that will reduce inflation to the barest minimum. This is designed to make the prices of consumer goods cheaper, which in turn will create demand, thereby creating more employment because increase in demand necessarily leads to increase in production.

6 Wage Freeze.

Government should freeze all wages. There should be no increase in wage of workers. This is aimed at reducing government expenditure on wages, salaries and allowances. It is also to reduce the emergence of cost push inflation that result from increase in wages.

7 Flexible Interest Rate.

Interest rate should be flexible. Interest rate is to be determined by the forces of demand and supply. Government should not fix any minimum or maximum interest rate. This is to determine the real cost of borrowing in the economy

Self assessment exercise
Assess the conditionalities of international monetary fund.

3.5 Appraisal of IMF Performance.

1 Conservative Approach.

The IMF has been using conservative approach by laying down stringent conditions for lending to member nation that are in critical need of assistance. It charges high interest rates and required nations to payback the loan within 3 to 5years. Extend loan facility has 4 to 10 years and borrowed money from the fund's own resources ought to be paid in 3 to 7 years.

2 Exchange Rates Stability Failure.

The fund has not been able to maintain stable exchange rate arrangements among member nations

3 Discriminatory policies.

The fund implements policies that are favourable to developed countries even though majority of the members are developing nations.

4 Exchange Rate Restriction.

The fund has not been able to eliminate exchange rate restriction as member countries restrict world trade through various exchange rate control measures.

5 Inappropriate Conditionalities.

The fund has adopted the same conditionalities for different countries seeking its loan facilities without taking into consideration the peculiarities of different nations. The uniqueness of economic situation not withstanding, it therefore adopt a "one cap fit all" strategy.

6 Poor Monetary Relations.

The bank has been playing a secondary role in international monetary relations rather than the initial objective of playing a primary role in international monetary relations among countries.

SELF ASSESSMENT EXERCISE

Attempt an appraisal of International monetary fund performance

4.0 CONCLUSION

The analysis show that the International monetary fund has a place in the management and reduction in world economic crisis. It has drawn membership from developed and developing countries. This provided a platform that nations could share ideas in common problems. But the fund has not been able to meet the needs of the member nations because of the conditionalities associated with borrowing from the fund.

The conditionalities has reduce the role the fund would have played in international monetary relations.

5.0 SUMMARY.

The unit examines the reasons for the establishment of international monetary fund, the scope of its operation in effort to minimize world economic crisis. It has assisted in the management of international liquidity even though it has conditionalities that nation fulfill before securing loan from it.

6.0 TUTOR-MARKED ASSIGMENT.

1. Explain the conditionalities for borrowing from IMF
2. Attempt an assessment of the performance of IMF.

7.0 REFERENCE/ FURTHER READINGS.

IMF. Annual Reports

IMF Finance and Development

Solomon, R. (1977), The international monetary fund.

www.worldbank.org/finance/asset/imag

www.worldbank.org/finance/html/amicl.

http://www.amlcl.org

www.cato.org/pubs/journals/cj25n1-2

www.uiowa.edu/ifdebook2/pdf

Unit 10 THE WORLD BANK

CONTENT

1.0 Introduction
2.0 Objectives
3.0 Main content
3.1 The Objective of the World bank
3.2 The functions of the world bank
3.3 Lending activities of the bank
3.4 Conditions for world bank loans
3.5 Appraisal of the world bank.
4.0 Conclusion
5.0 Summary
6.0 Tutor-marked Assignment
7.0 References/Further Reading.

16.0 INTRODUCTION

The world Banks also known as international Bank for reconstruction and Development (IBRD) was established in a 1945 based on the Bretton woods agreement of 1944. It was to help bring about a smooth transition from a wartime to a peacetime economy. It was established for the reconstruction of the war torn economies where member nations can draw resources to rebuild their respective nations.

17.0 OBJECTIVES

Identify the objective of world Bank.
Explain the functions of the world Bank
Examine the borrowing and lending activities of the Bank
Assess the performance of world Bank

3.0 MAIN CONTENT.

3.1. Objective of World Bank

1 Availability of Funds.

The World Bank has funds of its own that it can lend needy nations for development purposes. The bank therefore seek to maintain ununtilised access to funds in the markets in which it borrows for the use of member countries.

2 Minimize the Effective Cost of Funds.

The bank is to minimize the effective cost of funds to the needy nations. This is done through the currency mix of its borrowings and the time of borrowings. In the former case, it tends to maximize borrowings in currencies with low nominal interest rates. The time of borrowings in manipulated in two ways: (i) When interest rates are expected to rise, the bank seek to increase its borrowing. (ii) when interest rates expected to fall, it seek to defer borrowings.

3 Maturity Transformation between Borrowing and Lending.

The bank has to itself a funding strategy which is to provide an appropriate degree of maturity transformation between its borrowing and lending. Maturity transformation is the banks capacity to lend at longer maturities than it borrows. It also provides nations with modest degree of maturity transformation.

4 Guarantee Loans.

The world bank can underwrite or guarantee loans made by other nations to developing nations because the bank has considerable expertise and inside-knowledge about nations. The World Bank guarantees that a borrower is reasonably sound and thereby makes it possible for a developing country to receive loans.

SELF ASSESSMENT EXECISE
Examine the objectives of World Bank

3.2. Functions of the World Bank.

1 Assist in the Reconstruction. The world bank is to assist in the reconstruction and development of member nations that where affected by the world war. Through facilitation of investment capital for productive purposes. The bank is to encourage the development of productive facilities and resources in developing countries of the world.

2 Promote Private Investment. The world bank function in promoting private investment through guarantees or participations in loans and other investment made by private investors, and when capital is not available on reasonable terms, to supplement private investment by providing finance for productive purposes out of its own resources or from borrowed funds.

3 Growth in International Trade. World bank was established to promote long term balanced growth of international trade and the maintenance of equilibrium in the balance of payments of member nations. This is by encouraging international investments for the development of productive resources, thereby assisting in raising productivity, the standard of living and conditions of workers in member nations.

4 Assist Arrange Loans. The bank arrange loans made and guarantee nations that are members who borrow. It also assist nation set priority targets so that small and large projects that are most beneficial to members are dealt with as a priority.

5 Raise Productivity. The bank helps in raising productivity and therefore raises the living condition of citizen of member nations.

SELF ASSESSMENT EXERCISE
Outline the functions of the world bank.

3.3 Lending and Borrowing activities of the Bank.

Lending operations. The world bank finances its lending in the international capital markets and currency swap agreements. In the currency swap proceeds of a borrowing country are courted into a different currency, and simultaneously a forward exchange agreement is executed providing for a schedule f future exchanges of the two currencies in order to recover the currency converted. The effect of currency swaps is to transform the cost of original borrowing to a cost which reflects the market yield of the currency obtained in the conversion.

1. Central bank facility. It is a one year facility for borrowing from official sources, particularly central banks.

2. Floating rate facility. It is a means that the world bank can help meet some of the objective of its funding strategy. The floating rate market enables the bank to gain access to a set of investors like commercial banks and other financial institutions which have not bought debt instrument.

3.4. Conditions for World Bank loans.

1 Market Condition. Before the bank would grant a loan to any member nation it assess the prevailing market condition and be convinced that the member nation cannot get the loan facility at the prevailing market condition in alternative sources before it grant the loan..

2 Project-tier loans. One of the conditions for sourcing for loans from the World Bank is that the project to be funded should a development or reconstruction project.

3 Central Bank Guarantee. The central bank of the borrowing country would guarantee the repayment of the principal, the interest and other charges associated with the loan.

4 Committee Recommendation. The bank requires that the project for which the loan is sourced for has been recommended by a competent committee in the form of written report after a careful study of the merits of the project proposal for the period.

5 National Capacity. The borrower nation or the guarantor is in a position to meet its financial obligations for the loan.

6 Structural Adjustment. One of the conditions given by the world bank is structural adjustment. The structural adjustment condition target the reduction in balance of payment deficit reduction in extra-budgetary expenditure and the member nation look inward in its development agenda. Encourage production for export, maintenance of critical infrastructure.

SELF ASSESSMENT EXERCISE

Explain the conditions for sourcing world bank loan.

3.5. Appraisal of World Bank

1 Granting of Loans. The world bank has been able to grant loans to developing countries to establish infrastructure like hospital, schools. This has help raise productivity and the standard of living of member countries.

2 Reconstruction Effort. The bank has been successful in the reconstruction and development. It financed reconstruction of Europe after the Second World War.

3 Bank Charge. The banks charges of interest on loans are too high for most member nations.

4 Lending Procedure. The lending procedure is faulty because it lay emphasis on the repaying capacity of the borrowing nation before granting a loan facility. These conditions do not favour developing countries due to poverty prevalence. The repaying capacity of these countries is low and that place them on a disadvantage.

5 Discriminatory Policies. The bank is dominated by western countries. This makes the bank to focus on capital project at the expanse of infrastructural projects.

6 Structural Adjustment Programme. The condition that every borrowing nation follows an action plan of structural adjustment has made access to world bank loan tight for most developing countries. This is because the structural adjustment action plan does not take into consideration the rigidities in the member nations.

4.0 CONCLUSION.

The analysis of World Bank shows that the bank plays a useful role in reconstruction of many countries after the Second World War. It has also assisted developing countries in the development of some infrastructure. It is therefore important for developing countries to channel their resources appropriately, promote the development of their countries and improve the welfare of its citizens.

5.0 SUMMARY.

The unit has thrown light on the objective of world bank. The function and the conditions for granting loans to member countries were examined. An appraisal of the bank shows that there are some achievements as well as areas of improvement to ensure that member nations take advantage of its existence to develop their economies.

6.0 TUTOR- MARKED ASSIGNMENT

1. Mention and discuss the objective of world Bank
2. Attempt and assessment of the performance of the world bank

7.0 REFERENCES/ FURTHER READING

www.worldbank.org/finance/html/amicl.

http://www.amlcl.org

www.cato.org/pubs/journals/cj25n1-2

www.uiowa.edu/ifdebook2/pdf

Unit 11 NATIONAL INCOME ACCOUNTING.

CONTENTS

1.0 Introduction
2.0 Objectives
3.0 Main Content
3.1 Meaning and concepts of National income
3.2 The determinants of National income
3.3 The uses of National income
3.4 The problems of National income
3.5 The Limitations of National income comparison.
4.0 Conclusion
5.0 Summary
6.0 Tutor- marked Assignment
7.0 References/ further readings.

5.0 INTRODUCTION

National income accounting is a term that is used interchangeably with national output or national expenditure within a given geographical boundary of a country. Equally, national income has been defined in different ways. National income means the total value of goods and services produced in a country within a year. In other words, the total income that accrues to a country from economic activities in a given period usually one year.

2.O OBJECTIVES

At the end of this unit you should be able to

- Explain the term national income and its concepts.
- Discuss the determinants of national income.
- Discuss the uses of national income and measurement.
- Explain the problems of national income measurement.
- Assess the limitations of national income comparison.

3.0 MAIN CONTENT.

3.1 National income is the summary of a country's economic performance by measuring the aggregate income and output of goods and services within a specified period of time, usually one year. In other words it is the net output of commodities and services flowing during the year from the country's productive system in the hands of the ultimate consumers.

3.1.1. Concepts of National Income.

1. Gross Domestic Product (GDP). It is the sum of the monetary value of goods and services produced by the residents or people living in a given geographical location or country for a given time irrespective of their nationalities. This ensures that all goods that are imported into the country are excluded, it helps in determining the domestic production capacity and the level of employment of a country.

2. Gross National Product (GNP). It is the summation of all the monetary value of goods and services produced by the nationals or indigenes of a country irrespective of where they are resident. This measures the contribution of only the national to the economy in terms of production of goods and services. It measures the total flow of good and services at market value resulting from current production during a given period in a country including all income from abroad.

3. Net National Product (NNP). The net national product is the total flow of goods and services at current market prices resulting from current production during a given period in a country including all income from abroad less depreciation. Therefore, net national product is gross national product minus depreciation.

4. Per Capital Income (PCI). It is the ratio of gross national product to the population. It measures the purchasing power of individuals resident in a country. It is used to measure whether the standard of living of the citizens of a country is improving or deteriorating.

SELF-ASSEMENT EXERCISE 1

List and explain the concepts of National income

3.2. Determinants of National Income.

1. Natural Resources. When a country has abundant natural resources like minerals, good fishing water, large water body for hydro-electricity, fertile land good climate and these resources are properly utilized, it will lead to increase in the national income of a country. Countries that do not have natural resources have low national income, all things being equal.

2. Efficient Technology. The use of modern technique of production will save time and reduce cost. The increase in efficiency in the economy will lead to increase in the national income of the country.

3. Age Stratification. When a country has a good working population that have the necessary education and other technical skills, the working age group will contribute highly to the increase in the size of the national income. This can be contrasted with a population that is composed of old age group or little children age group that cannot contribute in the process of production such a country will have low national income.

4. Political Stability. When there is stability in government, this will promote domestic activities economically and may also attract foreign investment. This will result in a rise in the national income, but where there is political instability or violence, this will discourage economic activities in the country and it will reduce the size of the national income since bulk of the money will be used in purchasing arms and productivity will be very low.

5. Receipts from International Trade. When a country engages in international trade and the demand for the export goods increases, this will lead to increase in foreign earnings. If the earnings from abroad are used effectively, it results in increase in national income.

6. Nature of Investment. A country can increase the size of its investment by attracting foreigners in the productive sectors of the economy. Similarly it can seek for grants, aids and improve its local investment potentials in the productive sector. This may lead to increase in the national income.

7. Production Capacity. In a country where most companies and industries operate at full capacity, it means there is production efficiency with low unit cost and this can lead to increase in the national income. But in countries that firms do not operate at full capacity, there will be less efficiency with high unit cost and it results in low national income.

SELF-ASSEMENT EXERCISE 2.

Explain the factors that determine national income in a country.

3.3 Uses of National Income.

1. Measures the Standard of Living. National income estimate is used in measuring the standard of living of the people in a country. The income that each individual earns is measured in relation to others or the ratio of the gross national product to the population of the country and it often determines the standard of living of the people in the country.

2. Measures Sectoral Contribution. It measures the contribution of each sector of the economy so that any sector that is lacking will be given priority attention by planner or the government of the country.

3. Measures Growth Rate. National income can be used to show the growth rate of the economy, the technical advancement and the value of national resources can be used to improve the welfare of the citizens.

4. International Contribution. Quota contribution in some international organisations like the International Monetary Fund and the World Bank depends on the national income values or figures of a given country. A high income shows economic prosperity and therefore contributes more to the international organisations.

5. Planning. An increase in national income indicates that there are favaourable economic activities showing that there is efficient planning process in the economy.

Similarly, national income is used to measure the contribution by each sector of the economy. The sector that is performing poorly can be given attention by planners in the country.

SELF-ASSESMENT EXERCISE 3.
Outline the uses of national income.

3.4 Problems of National Income Measurement.

1. Double Counting. When national income is to be computed only income received or payments made for current legitimate supply of goods and services are considered. Transferred payments, gift and grants are excluded this is to avoid double counting. Double counting arises also due to the inability to distinguish between finished and intermediate products.

2. Price Changes. Price changes within an economy fail to keep stable the measurement of national income. An increase in price level in a country, will reflect in an increase in national income even when the production of goods and services had fallen within the period. On the other hand, a decrease in price level, the national income decreases even though production of goods and services might have increased.

3. Capital Gain and Losses. The capital gain and losses that accrue to property owners through increase or decrease in the market value of their assets or due to changes in demand are excluded in the measurement of national income.

4. Economic Activity. There is no clear definition of economic activity what some countries classify as economic activity is not the same with some other countries. An example is the duty of a full-time housewife. While in some countries she earns an income because raising children is considered an activity, some other countries do not consider it as an activity that is worth earning income. These differences create problems in national income measurement.

5. Non-market Activities. There are some activities that individuals do without monetary payment even through they are economic activities. Example a student who polishes his shoes himself has engaged in do –it-yourself service. This would have been an income to a cobbler. Another example is the rent that would have been paid by a person who occupies his own house. These non - market activities affect the national income.

6. Depreciation. This is the wear and tear of machines. It is difficult to determine the value of depreciation of fixed assets when the prices of these assets keep changing over time. This problem makes it difficult for the computation and measurement of national income.

7. Unreliable Statistics. Most developing countries do not have adequate record keeping mechanism; those that are available are unreliable, inadequate or outdated. Example the data you may obtain from the bureau of statistics may be different from the one from central bank over a given field of research.

8. Illegal Activities. There are some activities that bring income to the participants but are not legal such as smuggling, stealing. When a country has a large population engaged in illegal activities then there will be problem in the measurement of national income.

SELF-ASSESSMENT EXERCISE 4.
Carefully examine the problems of national income measurement.

3.5 Limitations of National Income comparison.

1. Differences in Trading Structures/process. In developed countries, there is a high rate of trading activities that pass through the formal market compared to developing countries where a lot of trading activities do not go

through the formal market. This leads to differences in the value of national income among countries.

2. Data Collection. Data source, collection and reliability differences couple with large-scale black –market activities in developing countries makes it difficult to value all the activities in the economy. This makes it difficult to compare national income of countries.

3. Government Services. The relative importance of government in providing basic services such as health, education varies considerably between countries. In an economy where such services are provided by the private sector, there will be differences in the value of national income when compared with countries where government provides them.

4. Capital Goods. Income spent on the provision of ornaments in a country, though the output may increase, may not improve the welfare of people compared to an economy where income is spent on basic social amenities which will improve the welfare of the people.

5. Demographic Differences. The differences in countrie's commitment and peculiarity can lead to variation in national income values. For example, countries that spend large income in taking care of dependants, this will reduce the current living standard of the non-dependant because the non-dependant subsidies the living of the dependants.

6. Inflation. The differences in the inflationary problems among countries make national income comparison difficult. Even when the adjustment for inflation is made using the GDP deflator. The basis of the adjustments for inflation differs making income comparison rather difficult.

SELF-ASSESSMENT EXERCISE 5.

Carefully explain the limitations of national income comparison

4.0 CONCLUSION.

The analysis of national income shows that it is very vital for every government to determine its income. When the national income is known it helps to determine whether the citizens are living in a good condition or otherwise. National income allows governments to take necessary steps to adjust their economy in line with international standards.

5.0 SUMMARY

The unit examined the concepts of national income in an economy. It also explained the various determinants of national income. The uses and the problems of national income were also highlighted and discussed.

60. TUTOR MARKED ASSIGMNEMT.

1. Explain the main determinants of national income
2. Discuss the problems of national income measurement.

7.0 REFERENCES/ FURTHER READING.

Blinder, A. S. (1975), "Distribution Effects and Aggregate Consumption Function" Journal of Political Economy.June

Campbell, R. M. (1981), Economics Principles, Problems, and Policies. McGraw – Hill Book company, New York.

Dernburg, T. F. and McDougal, D. M. (1980), Macroeconomics, 6th ed. McGraw – Hill Book Company. New York.

Shapiro, E. (1982), Macroeconomic Analysis, 5th ed. Harcourt Bruce Jovanovich, Inc. New York.

Suits, D. B. (1963), The Determinants of Consumer Expenditure, A Review of Present Knowledge. Prentice – Hill

Unit 12. NATIONAL INCOME MEASUREMENT.

CONTENTS

1.0 Introduction
2.0 Objectives
3.0Main content
3.1 Measurement of national income using income approach.
3.2 Measurement of national income using product method
3.3 Measurement of national income using expenditure method
4.0 Conclusion
5.0 Summary
6.0 Tutor-marked Assignment
7.0 References/further readings

1.0 INTRODUCTION

The measurement of national income involves three approaches. The income, the product and the expenditure methods. The income method identifies the rewards of the factors of production, adding together their contribution to the flow of income in the economy. The product method considers the value addition to the process of production at different stages.
The expenditure method measures the expenditure of household, the government, investors and the external balance to arrive at the equilibrium income.

2.0 Objectives

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

- Calculate national income using income method
- Calculate the national income using production method
- Calculate the national income using the expenditure approach.

3.0 MAIN CONTENT.

3.1 Computation of National Income Using Income Approach.

The process entails identifying the rewards of all the factors of production and adding together the contributions of each factor to get the national income.

The factors of production are Land = rent (R) capital = interest (i) labour = wages and salaries (W) entrepreneur = profit ( ). In should be noted that all income that is received without a corresponding supply of goods and services should be excluded in the calculation, some of the income without corresponding supply of goods are transfer payments, gift, grants, pensions relief. The exclusion is necessary to avoid double counting.

NI=R +I + w +

Where NI = National income, R=rent, I = interest,

W= wages, = profit.

Example 1

Given the following income variables for a hypothetical economy. Wages and salaries = N23,000, interest N 1,500, rent = N 6000

Profit = N205,000. Compute the national income.

Solution:-

Given that national income (NI) =R+ I + w +

= 6000+15000+23000+205000

= 289500.00

SELF-ASSEMENT EXERCISE.

Given the hypothetical income variables as follows. Interest = N23800, rent = N120,000, profit = N 300000, wages and salaries = N 80, 000

Compute the national income.

3.2 The Product Method.

The product method involves taking the sum of the values of the contribution made by individual sector of the economy.

Example: Given the following items about an economy. (all values in millions).

Agriculture, foresting and fishing = 420, mining and Quarrying = 100, Manufacturing = 205, transport and communication = 75, building and construction = 85, Banking, finance and insurance = 105, wholesale and Retail trade = 65 Government services (health, Education, Defence) =52.5, Community, Social and personal services = 81.5, other services = N30, Net income from abroad =70, capital consumption allowance = 112, indirect business tax =108.

i) Compute the gross domestic product ii) Compute the gross national product iii) Compute the national income.

Solution.
Add the contributions from the various sources to get the gross domestic product.

Agriculture, foresting and fishing.	=	420
Mining and Quarrying	= +	100
Manufacturing	= +	205
Transport and Communication	= +	75
Building and construction	= +	85
Banking finance and insurance	= +	105
Wholesale and Retail Trade	= +	65
Government Services (health, Education, Defence)	= +	52.5
Community, Social and Personal Services	= +	81.5
Other Services	= +	30
Gross Domestic Product	= +	1219
Plus Net income from abroad	= +	70
Gross National Product	= +	1289
Less Capital Consumption allowance	-	112
Net National product		1177
Less Indirect business tax	-	108
National Income		1069

SELF ASSESSMENT EXERCISE

A hypothetical Nigerian economy has the following variables. Agriculture, forestry and fishing = 800, mining and Quarrying 180 Manufacturing 330, Transport and communication =160, Building and construction =150, Banking, Finance and Insurance =220, Wholesale and retail trade = 160, government services =303, community, social and personal services =263, other services =90. Net income from abroad = 309 Capital consumption allowance =119, indirect business tax = 216
a). Calculate the gross domestic product, b) calculate the gross national product, c). Calculate the net national product, d). Calculate the national income.

3.3. The Expenditure Method.
This approach measures the expenditure from the household, entrepreneurial investment government expenditure, import and export. This method involves the total volume of expenditure on goods and services in a particular year. Y = C + I + G + X - M. Where C =Consumption by household, I = Investment by entrepreneurs, G = government expenditure, X = export, M = Import.

3.3.1 Components of the Expenditure Method

1 Consumption (c) . This is the total household expenditure in the economy on goods and services made within a given period of time usually one year. When we want to know how much a household consume we should know the income of the household. C = a + by d a = autonomous consumption, yd = Disposable Income, b = marginal propensity to consume. Marginal propensity to consume is the change in consumption as a result of change in disposable income.

2. Investment (I). It is the expenditure for the production of capital goods like new plants, equipment and machines used in the production of goods and services which are not for current consumption. The ability of entrepreneurs to invest depends on the interest rate which is the price of capital as a factor of production and returns on such investment.

3. Government Expenditure (G). Government expenditure on goods and services shows how much the government expends within the domestic economy. This includes spending of all tiers of government: federal state and local government. This includes all expenditure in the provision and maintenance of public utilities.

4 Net Export (X –M). Net export is the difference between export and import in an economy. It is influenced by the exchange rate among countries. The difference in the elasticity of demand for the commodities, the absorption or competitiveness, the output generated the inflationary trend among the trading partners.

3.3.2 Quantitative Illustration

1.) (i)A three sector Economy. This is an economy that is composed of three agents, consumers, investor and government. Government usually impose tax on income of consumers.

Y = C + I + G and C = a + byd , Yd = Y – T

Substitute into the income variables

Y – T

Substitute into the income variables

Y = C + I + G

= a + byd + I + G

Open the bracket and expand.

= a + by – bt + I + G

Collect like terms

$Y - by = a - bt + I + G$

$Y(1-b) = a - bt + I + G.$

Make Y the subject to arrive at equilibrium income.

$$Y = \frac{a - bt + I + G}{1-b}$$

(b) Illustration of a three sector economy with values.

Given that C = 300 + 0. 6yd, T = 10, I = 400, G = 700

Calculate the equilibrium national income.

Solution: $Y = C + I + G$

$Y = 300 + 0.6yd + 400 + 700$

Substitute the tax function

$Y = 300 + 0.6(y - T) + 400 + 700$

$Y = 300 + 0.6y - 0.6T + 400 + 700$

Substitute the tax value

$Y = 300 + 0.6 - 6 + 400 + 700$

Collect like terms

$Y - 0.6y = 300 - 6 + 1100$

$Y(1-0.6) = 1400 - 6$

$Y(0.4) = 1394$

$$Y = \frac{1394}{0.4}$$

$$= 3485$$

2)(a) Illustration of an open economy. This is an economy that include the external sector in income determination.

$Y = C + I + G + X - M.$

$C = a + byd$, $yd = Y - T$

The equilibrium national income algebra can determined as follows.

$Y = C + I + G + X - M.$

Substitute for consumption

$Y = a + byd + I + G + X - M$

Substitute

$Y = a + b(y - t) + I + G + X - M$

Open the bracket.

$Y = a + by - bt + I + G + X - M$

Collect like terms

$Y - by = a - bt + I + G + X - M$

$Y(1-b) = a - bt + I + G + X - M$

Make y the subject of the equation to derive the equilibrium national income.

$$Y = \frac{a - bt + I + G + X - M}{1 - b}$$

(b) Illustration using values: Given the following information for an economy

C = 380 + 0.5yd, I = 602, G = 804, T=100, X =200, M= 150

Compute the equilibrium national income.

Y = C + I + G +X-M

Y = 380 + 0.5yd + 602 + 804 + 200 – 150

Substitute tax and subtract import.

Y= 380 + 0.5 (Y- T) + 602 + 804 + 50

Substitute the value of tax

Y= 380 + 0.5y-0.5t + 602 + 804 + 50

Y= 380 + 0.5y – 0.5(100) + 1456

Y= 380 + 0.5y – 50 + 1456

Collect like terms

y- 0.5y = 380 – 50 + 1456

y (1-0.5) = 1836 – 50

y(0.5) = 1786

$$y = \frac{1786}{0.5} = 3572.$$

SELF-ASSEMENT EXERCISE

Given the following figures for an economy, C= 400 + 0.8yd
I = 900, G = 5000, X = 320, M = 280, T = 80. Calculate the equilibrium national income.

4.0 CONCLUSION.

The unit analysis shows that national income can be computed quantitatively using algebra and values. It is very important for government to know the income of the country so as to take measures that will help improve the living condition of its citizens.

5.0 SUMMARY

This unit examined the calculation of national income using income, value added and expenditure approaches. The expenditure approach was subdivided into a three sector, closed economy and the open economy to expose you to the workings of national income in a country.

6.0 TUTOR-MARKED ASSIGNMENT

1. Given the following hypothetical values of an economy $C= 608 + 0.22yd$, $T= 80$, $I = 404$, $G = 606$, $X =204$, $M = 104$. Calculate the equilibrium national income

2. The following data represent the data for a closed economy. $C = 310 + 0.3yd$, $I = 402$, $G = 900$, $T= 10$.
Calculate the equilibrium national income

7.0 References/ Further Reading

Campbell, R. M. (1981), Economics Principles, Problems, and Policies. McGraw – Hill Book company, New York.

Dernburg, T. F. and McDougal, D. M. (1980), Macroeconomics, 6th ed. McGraw – Hill Book Company. New York.

Shapiro, E. (1982), Macroeconomic Analysis, 5th ed. Harcourt BruceJovanovich, Inc. New York.

Suits, D. B. (1963), The Determinants of Consumer Expenditure, A Review of Present Knowledge. Prentice – Hill

UNIT 13. BALANCE OF PAYMENT

CONTENTS

1.0 Introduction

2.0 Objectives

3.0 Main Content

3.1 Types of balance of payment accounts

3.2 Balance of payment disequilibrium

3.3. Solutions to balance of payment disequilibrium

3.4 Theories of balance of payment.

4.0 Conclusion

5.0 Summary

6.0 Tutor-marked Assignment

7.0 References/further readings

1.0 INTRODUCTION

Balance of payment is a systematic record of transactions between a country with other countries of the world within a given year. It is the listing of receipt and payment of all international transactions for a country, involving trade position, changes that takes place in net financial positions as a foreign lending that take place in net financial position as a foreign lender or borrower and other changes in the official reserve holding of a country. Balance of payment is an accounting double entry book-keeping procedure showing debit and credit in balance sheet analysis.

As a country receive payment from a foreign counterpart, it is a credit transaction and payments to a foreign partner is a debit transaction. The main items that are recorded on the credit side are export of goods and services, unrequited (or transfer) receipts in form of gifts from foreigners borrowing from abroad, investments from foreigners in the country, official sale of reserve assets including gold to foreign countries and international agencies of the world. The main items on the debit side of the account are imports of goods and services, transfer payments to foreigners, lending to foreign countries, investment by residents to foreign countries, official purchase of reserve assets or gold from foreign countries and international organisation.

3 Objectives

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

- Explain balance of payment concept.
- Discuss the types of balance of payment accounts
- Explain the causes of balance of payment disequilibrium
- Explain the solution to balance of payment account.
- Discuss the theories of balance of payment.

3.0 MAIN CONTENT

3.1 Types of Balance of Payment Account.

The balance of payment accounts are divided into three. The current account, the capital account, and the official settlements accounts or the official reserve assets account.

1. The Current Account. This account is made up of all transactions relating to trade in goods and services, unilateral (unrequited) transfer. Services transactions include travel and transportations, income and payment on foreign investments etc. Transfer payments relate to gifts, foreign aid, pension, private remittances, charitable donations that are received from foreign individuals and governments to foreigners. The current account is subdivided into three, first the visible account which is a record of receipts from export and payments for import of goods. These tangible goods can be seen and inspected at the point of entry by the law enforcement like custom. Secondly the invisible or account of services. It is the record for exports and payment for imports and services that cannot be seen physically. Some of the examples are insurance, banking and consultancy services. Thirdly, the unrequited account or transfer. It is a record of receipt or payment for which no present or future return payment is required. This payment can be materials or financial, it includes gifts, remittances, and grants.

2. The Capital Account. This account shows a country's transactions in financial assets that are both short and long-term. It includes borrowings, lending's, private and government investments. The capital account shows international flow of loans and investments, changes in the country's foreign asset and liabilities.

The long-term capital transaction shows the international capital movements that have a maturity period of one year or more including direct investments like building of a foreign plant, a portfolio investment, purchase of foreign bonds, stocks and international loans. The short-term international capital transactions range from three months to eleven months. The credit side of this account shows the loans and investments made by foreign countries in Nigeria while the debit side shows loans and investments made by Nigeria to other countries around the world.

3. Official Settlements Accounts. This account is also known as cash account. It shows how the balance on both the current and capital accounts are settled. This account is principally a balancing item account so as to keep the balance of payment at equilibrium or balance. It measures the change in a nation's liquid and non-liquid liabilities to foreign official holders and the change in a nation's official reserve assets within a year.

SELF ASSESSMENT EXERCISE

Explain the three main accounts used in balance of payment

3.2 Balance of Payment Disequilibrium.

Balance of payment disequilibria often emerge as a result of random variations in trade, seasonal fluctuations, the effects of weather and agricultural productivity in a developing country like Nigeria. Any temporary deficit or surplus in balance of payment caused by the temporary factors often correct themselves within a short period. There are long term fundamental disequilibria that are caused by fundamental changes in the economic conditions of a country. Some of the factors that had led to the balance of payment problems include.

1. Fluctuation in Export Demand. The demand for primary goods exported by developing countries is price elastic. A change in the price of these goods at the international market results to a decline in foreign exchange earnings. This has contributed to the balance of payment deficit problems in Nigeria. Equally bad harvest caused by drought can result in a fall in the production of export crops. The reduction in export crops yield will lead to a reduction in export earning creating a gap between export and import. This can lead to balance of payment deficit.

2. Discriminatory tariff. Developed countries usually prefer to trade among themselves to trading with developing countries. The goods that come from developing countries are taxed heavily compared to that which originate from a developed country. This high tax reduces the value of export thereby reducing export earnings leading to balance of payment disequilibrium.

3. Slow Pace of Non-oil Sector Contribution. The neglect of the manufacturing and the agricultural sectors has led to a fall in earnings from the export in these sectors. Over dependence on the oil for export and the collapse of oil price in the international market resulted in a decline in foreign exchange earnings leading to balance of payment disequilibrium.

4. Import Substitution Policy. The developing countries in an attempt to stimulate local production in the domestic economy made them to embark on import substitution policy. This policy involves buying machines that cannot be fabricated locally as well as some raw materials used in production from abroad using foreign exchange. This has led to depletion of foreign reserve leading to balance of payment disequilibrium.

5. Over Valued Currency. When a currency is overvalued, import will be cheaper and export expensive. This encourages importation and discourages export. When this variation continues for a long time, it depletes the foreign reserve leading to balance of payment disequilibrium.

6. Population. One nagging problem of all developing countries is high population growth. Less than half of the population is within the working age group, therefore demand for goods exceed supply. The gap is often bridged by importation of goods hence the depletion of foreign exchange reserve leading to balance of payment disequilibrium.

7. Technological Change. Change in technology has made developed countries to reduce the consumption and demand for primary products of developing countries. Advanced technology has made it possible to use substitutes such as synthetic petroleum products instead of buying cotton t from developing countries, this has reduced the foreign exchange earnings of the developing countries leading to balance of payment disequilibrium.

SELF ASSESSMENT EXERCISE

Discuss the causes of balance of payment disequilibrium in Nigeria.

3.3 Solutions to Balance of Payment Disequilibrium.

A country that has disequilibrium in its balance of payment can correct or minimise the disequilibrium through a combination of the following factors.

1. Export Promotion. A country that experiences balance of payment disequilibrium can diversify its export of goods and services so that it does not depend on only one source. It can encourage its citizens to export more of the locally produced goods. This will increase the foreign exchange earnings for the country. When the export increases over a long period it will reduce balance of payment equilibrium.

2. Quota. The government can fix a quota for import from the different trading partners so that excess can be minimized and it can save its foreign exchange on import this will correct balance of payment problems.

3. Tariff. Government can correct balance of payment problems by the increase in tariff on import as a means of discouraging import. This can lead to reduction in foreign exchange spent on import of goods and services.

4. Foreign Exchange Control. Strict controls of allocation of foreign exchange to priority areas of import can lead to a reduction of non-essential import into the country. If the practice is sustained for a long period, it will reduce the foreign exchange spent on imports.

5. Devaluation. Devaluation is the reduction in the value of a country's currency, depending on the elasticity of import and export. Devaluation can reduce import by making export cheaper and import expensive.

6. Reduced Government Expenditure. Government can reduce its expenditure on goods that require high import content. The expenditure reduction will reduce the foreign exchange allocation for import. This will reduce balance of payment disequilibrium.

7. Borrowing. Borrowing from international institutions is another measure that help nations resolve balance of payment disequilibrium. This measure is often not used all the time because of the interest rate charges associated with borrowing.

SELF ASSESSMENT EXERCISE

Explain the remedies to balance of payment problems in Nigeria

3.4 Theories of Balance of Payment.

1. The Monetary Approach. The monetary approach to balance of payment explains the changes that take place in the balance of payment as a result of the changes in demand and supply of money. This theory states that balance of payment disequilibrium is caused by the changes in the demand and supply of money in the economy. The monetary approach is based on the following assumptions

a. The demand for money in an economy is assumed to be a stable function of a small number of aggregate economic variables, they include income, wealth, and the interest rate The demand for money increases as income increases and decreases as the interest rate increases.

b. The law of one price holds for identical goods sold in different countries, after allowing for transport cost. It means that the price of trade and amount of output for a country are exogenously determined. When adjustment for the exchange parity, the price of a county's output of a commodity is lower than the world price, traders will buy the commodity and sell it in the world market. This process bids up domestic price until it equals the world price. The increase in world output will not change the world price.

c. Every economy and country is assumed to be fully employed, hence increased demand in any country cannot be met by an increase in domestic output .

d. Under fixed exchange rates, the sterilization of currency flow is not possible because of the law of one price holds in international money market under a system of fixed exchange rate. A balance of payment disequilibrium therefore, is defined as equals to the excess of money supply through domestic credit creation over extra demand for money as a result of increased demand for cash balances.

Balance of payment disequilibrium shows excessive money supply in the economy at a given time. This makes people to exchange their excess money for foreign securities and goods. An equilibrium can be restored when the central bank sells foreign exchange and buys the excess domestic currency in a fixed exchange rate system as a means of eliminating the excess supply of domestic currency.

3 The Absorption Approach.

The theory states that if a country has balance of payment disequilibrium, it indicates that people are absorbed more than they produce within the time. It means domestic expenditure on consumption and investment is greater than national income. Using this theory, balance of payment is the difference between the national income and total absorption (consumption and investment expenditure).

Balance of payment disequilibrium can be corrected by either increasing domestic income or reduction in consumption and investment (absorption). The second option is for the country to adopt devaluation as a means of increasing export and reducing imports into the economy all things being equal.

4.0 CONCLUSION

The unit analysis shows that balance of payment is vital to every economy, because there is no country that operates in isolation. Every country would engage in one form of trade or the other. It is important that disequilibrium in the balance of payment be minimised through a careful analysis of import and export of goods and services. This ensures close monitoring of the external sector performance and stable balance of payment.

5.0 SUMMARY

This unit examined the meaning and scope of balance of payment. The various types of balance of payment accounts. The causes and solution to balance of payment disequilibrium were also considered.

5.0 TUTOR MARKED ASSIGNMENT

1 Outline the cause of balance of payment disequilibrium in Nigeria.

2. Examine the possible solution to balance of payment problems.

7.0 REFERENCES / FURTHER READING

Dixit, A. K. and Norman, V. (1980), Theory of international Trade, Cambridge. Cambridge University Press.

Thingan M . L. (1988), Macroeconomic Theory, Konark Publishes PVT Ltd New Debhi India.

Kindeberger C. P. (1973), International Economics, Knoneric Publishers Ltd.

Willfred, E. (1983), Modern International Economics, W. w. Norton and company New York.

Unit 14 MONETARY POLICY.

CONTENT

1.0 Introduction
2.0 Objectives
3.0 Main content
3.1 The role of monetary policy in an economy
3.2 The instruments of monetary policy implementation
3.3 Problems of monetary policy
3.4 Solutions to monetary policy implementation
4.0 Conclusion
5.0 Summary
6.0 Tutor-marked Assignment
7.0 References/further reading

1.0 INTRODUCTION

Monetary policy is a combination of strategies by the central bank of Nigeria to control credit in the economy. It is also the measures by the central bank of Nigeria to control the supply of money as a means of reducing inflation and promote economic development. Usually an excess supply of money in the economy will result in high prices and a decline in the balance of payment.

The central bank of Nigeria can adopt an expansionary monetary policy. This involves an increase in money supply and credit in the economy. This will help promote economic activities. This strategy is used when there is a slow pace of economic activities. Another perspective that the central bank result to is the use of contractionary monetary policy. The central bank uses this policy when there is inflation and wants to reduce it. The contractionary monetary policy reduces credit and money supply in the economy.

2.0 OBJECTIVES

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

Explain the term monetary policy
Discuss the objectives of monetary policy
Explain the instruments of monetary policy
Asses the problems and solutions of monetary policy.

3.0 MAIN CONTENT

3.1 The objectives of monetary policy.

The objectives of monetary policy can be divided into four: price stability, full employment, economic growth, balance of payment stability.

1. Price Stability. One of the main reasons for monetary policy is to stabilise the prices of goods and services. The fluctuation in prices of goods and services bring uncertainty and instability in the economy.

Rising and falling prices of goods and services in the economy are harmful because it brings about losses in the value of money. Monetary policy therefore, helps stabilise prices, keeps the value of money stable and promote economic welfare of the citizens.

2. Economic Growth. Monetary policy helps in promoting rapid economic growth. When the prices of goods and services are stable, and when the economy's production capacity increases more people are employed in industries. This ensures that more goods and services are produced, it helps improve the welfare of the people living in the country. Economic growth here is the process whereby the income of people increases over a long time.

3.Full Employment. This is a situation where everybody who wishes to be employed, has a job at the prevailing wage rate without considerable delay. As government increases the pace of economic activities through monetary policy, more industries will be established. These established industries absorb an increasing number of people that will be employed in the economy.

4.Balance of Payment Stability. This occurs when imports equal exports within a given time. This shows that the country is not spending too much on imports of goods and services at any given time.
The country would have enough foreign exchange reserve to meet the needs of the economy.

SELF ASSESSMENT EXERCISE 1

Identify the objectives of monetary policy in Nigeria.

3.2 The Instruments of Monetary Policy.

1.Bank Rate. This is the minimum-lending rate of the central bank at which it rediscounts government securities held by the commercial banks.

When there is inflation, the central bank increases the bank rate. Borrowing by commercial banks from the central bank becomes costly and this discourages borrowing from the central bank. The commercial banks in turn increase their lending rate to customers. This reduces credit and money available in the economy. This then reduces the rate of inflation in the country.

On the other hand, when prices are depressed, the central bank reduces the bank rate. This makes it cheap for commercial banks to borrow from the central bank while the commercial banks reduce their lending rate to customers and this makes credit available and increases money supply.

2.Open Market Operation. This is the sale and purchase of government securities in the money market by the central bank of Nigeria. When there is inflation and government wants to reduce it, the Central Bank sell securities to the commercial banks. This reduces the reserves of the commercial banks by the proportion of what they paid the central bank. This leads to reduction in cash available for commercial banks to grant credit to the customers.

When the economy is experiencing recession, the central bank buys the securities from the commercial bank. The process increases the reserve of the commercial banks. Consequently the commercial banks can grant more credit lending to increase in output, employment, income and demand.

3.Reserve Ratio. This is the amount of cash that commercial banks are required legally to keep as a percentage of its total deposit. When there is inflation, the central bank raises the reserve ratio and this reduces the ability of the commercial banks to grant credit. The process reduces investment output and employment leading to a reduction in money supply. On the other hand, the central bank may lower the reserve ratio leading to increase in the cash available for the banks and this enables the banks to grant more credit to its customers.

4. Selective Credit. The central bank uses selective credit to influence specific types of credit for particular reasons. If the government wants to promote the development of the agricultural sector, the central bank through its policy directs that the commercial banks give a certain percentage of their loans to the agricultural sector.

5. Special Deposit. The central bank can call for special deposits, that is every commercial bank would be mandated to keep a certain percentage of their deposits with the central bank. This will reduce the total cash available to the bank leading to a decrease in the ability of the commercial banks to grant credit to its customers and subsequently reduce money supply in the economy.

SELF ASSESSMENT EXERCISE
Explain the instruments of monetary policy

3.3 Problems of Monetary Policy.

1. Poor Banking Habit. In Nigeria most people prefer to keep money at home rather than in the bank. This reduced the ability of the central and commercial banks to control money supply in the country. This attitude weakens the monetary policy effectiveness in Nigeria.

2. Underdeveloped Money Market. The money market in Nigeria is still growing. There are not enough securities to be used as instruments of monetary control in the money market and the economy.

3. Lagged Responses. There exists time lag between the time a problem is detected and the period that the central bank takes action. This time difference reduces the effectiveness of monetary policy in Nigeria.

3.4 Solution to monetary policy Problems.

1. Educate the Citizens on Banking. The citizens should be educated and sensitised to the need for them to always keep their money in the bank. The more cash that is kept in the bank, the better the ability of the banks to implement monetary policy.

2. Development of the Money Market. When the money market is developed, more securities will be made available for daily transaction and trading. The process will increase the velocity of money in circulation when the central bank needs to change its policy it will be effective. The bank can as well reduce the velocity of money in circulation through its control of the money market.

3. Minimize Lagged Responses. The central bank can reduce the existence of policy lags in policy implementation by regularly taking an assessment of the market, secondly it can cooperate with the ministry of finance so that there will be a blend between the monetary policy authorities and fiscal policy authorities.

SELF ASSESSMENT EXERCISE

Identify the problems of monetary policy and the possible solutions to the problems.

4.0 CONCLUSION

The analysis shows that the central bank plays a key role in the regulation of the economy through monetary policy. It is important for the government to empower the central bank to carry out its functions effectively. This will allow the central bank intervene in the activities of the economy through open market operation and other policy

5.0 SUMMARY

The unit has thrown light on the operation of monetary policy. Effective control of the monetary policy variables is necessary to shield the citizens from the harmful effect of inflation and unemployment. The instruments of monetary policy were highlighted and the problems and possible solutions of monetary policy were also discussed.

6.0 TUTOR- MARKED ASSIGNMENT

1. Examine the role of central bank in monetary policy implementation in Nigeria
2. Discuss the instruments of monetary policy in Nigeria and highlight the problems and the solutions of the policy.

7.0 REFERENCES/ FURTHER READING

Berensten, A. and Waller, C.(2005), Optimal Stabilization Policy with Flexible Prices. Working paper. CBN (1979), Twenty Years of Central Banking in Nigeria. Research Department Central Bank of Nigeria Lagos.

King, M. (1990), "Challenges for Monetary Policy: New and old" In New Challenges for Monetary Policy, Federal Reserve Bank of Kansas City, 11

Ogbe, N. E. (1978), "The Problems of Monetary Management in Nigeria" A paper presented the seminar Department of Economics university of Lagos

Woodford, M.(2000), "Financial Market Efficiency and the Effectiveness of Monetary Policy" Federal Reserve Bank of New York, 13

UNIT 15 FISCAL POLICY

CONTENTS

1.0 Introduction
2.0 Objective
3.0 Main content
3.1 The role of fiscal policy in the economy
3.2 The instruments of fiscal policy
3.3 Problems of fiscal policy
3.4 Solutions to fiscal policy
4.0 Conclusion
5.0 Summary
6.0 Tutor-marked Assignment
7.0 References/ Further Reading.

1.0 INTRODUCTION

Fiscal policy in any country constitutes an important instrument for economic stabilization. Fiscal policy refers to a combination of measures that affect government receipts and expenditure over a period of time. It can be defined as a policy under which the government uses its expenditure and revenue programmes to produce desirable effects and avoid undesirable effects on the income, production and employment in the economy.

Fiscal policy is used to moderate economic fluctuation through government tax measures and expenditure programmes for a period usually one year. In Nigeria, fiscal policy is implemented by the Federal Ministry of Finance and other agencies under the ministry.

Fiscal policy can either be expansionary or contractionary. An expansionary fiscal policy involves a decrease in the tax rate and an increase in government expenditure for a given time. A decrease in tax rate increases the aggregate income and the purchasing power of the people This enable, people to buy more goods and services consequently increasing the pace of economic activities.
A contractionary fiscal policy involves an increase in taxation and a decrease in government expenditure. The contractionary fiscal policy reduces the income of individuals and the aggregate demand leading to a decline in economic activities. The contractionary policy is used to reduce inflation. Fiscal policy involves the use of two main instruments: taxation and government expenditure.

2.0 Objective

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

- Explain the term fiscal policy
- Discuss the various instruments of fiscal policy
- Explain the objectives of fiscal policy
- Assess the problems of fiscal policy and the solutions.

3.0 MAIN CONTENT

3.1 The role of Fiscal Policy in an Economy.

1. Price Stability. Fiscal policy can be used as a means of attaining price stability. When the economy is experiencing inflation, government can use contractionary fiscal policy where government increases tax rate and reduce expenditure. These measures reduce income and ability of individuals to purchase goods and services because it reduces the money in circulation, leading to reduction in inflation.

When there is economic slump, government uses expansionary fiscal policy. It involves a decrease in taxation and an increase in government expenditure. The process will lead to increase in income, purchasing power and an outflow of income. Consequently, there will be an increase in economic activities.

2. Full Employment. When government wants to promote full employment in the economy it reduces tax rate and increase budgetary expenditure. This will increase the flow of cash in the economy. The availability of cash encourages entrepreneurs to establish more industries that will employ more people. This will reduce the degree of unemployment in the economy.

3.Equitable Income Distribution and Wealth. Government uses fiscal policy as a means of equitable income distribution through pay as you earn (P.A.Y.E) tax and increased expenditure in providing basic amenities like education, security, road, water supply and electricity.

These amenities will benefit both the rich and the poor, but the poor receive subsidy in form of reduced cost for these amenities. This uplifts the poor as they benefit in form of increase income, welfare and it helps break the vicious cycle of poverty. This is a form of assistance to the poor because if these amenities were to be privately provided, the poor cannot afford them. The tax income government used to provide the amenities to all its citizens is a means of income redistribution.

4. Equitable Balance of Payment. Government can use fiscal policy to improve its balance of payment. This is done through the imposition of tariffs on imported goods. Government can raise import tax (duties) to discourage the import of some items into the economy. This reduces the foreign exchange that would be paid on imports. The continuous adjustment of these measures ensures that the external balance is equitable.

3.2 INTRSUMENTS OF FISCAL POLICY

1. Taxation. One of the tools for fiscal policy implementation is taxation. Fiscal policy through the variation in taxation affects national income, employment, output and prices of goods and services in the country. A reduction in taxation during depression increases the aggregate demand for goods and services and leads to an increase in income through the multiplier effect. While an increase in tax has the effect of reducing disposable income thereby reducing expenditure on goods and services during inflation, reduces national income, output and prices. This serves as a means of reducing inflation in the country.

2. Government Expenditure. A variation in government expenditure also affects national income, employment, output and prices. At period of economic depression, government increases its expenditure. The increase in government expenditure adds to the aggregate demand for goods and services because of the increase in income. This process leads to increase in investment and consumption in the economy. On the other hand a decrease in government expenditure during inflation reduces aggregate demand, national income employment, output and prices of goods and services. Government uses these strategies to control inflationary and deflationary problems in the economy.

SELF ASSESSMENT EXERCISE

Explain the instruments of fiscal policy in Nigeria.

3.3 Problems of Fiscal Policy

1.Tax Evasion. Tax evasion is a process whereby individuals and corporate bodies dodge payment of tax. When a large population do not want to pay tax, fiscal policy becomes ineffective as an instrument of economic stabilisation. This process of tax evasion also reduces the aggregate revenue that government would generate within a period of time.

2.Tax Avoidance. This is a deliberate attempt by individuals and corporate bodies to reduce the total amount that should be paid to the government. This is done by under-reporting of total income or taking advantage of certain loopholes in the tax law to reduce the amount payable as tax. If this is done in a large scale then fiscal policy becomes ineffective.

3.Political Instability. When a country experiences political instability, then individuals and corporate bodies may not be in a position to pay tax. This makes fiscal policy ineffective.

4.Structural Lags. There are periods in which lags reduces the effectiveness of fiscal policy. Two types of lag are common, the inside lag and the outside lag. The inside lag is a time period between the occurrence of a problem in an economy and the time to take appropriate measures to minimise the problems. Outside lag is the time taken for a policy to reduce economic problems is taken and the actual time of implementation of the policy.

5.Corruption. When the tax officers are corrupt, they collude with taxpayers to reduce the amount that is payable to government. This reduces the effectiveness of fiscal policy in the country.

3.4. SOLUTIONS TO FISCAL POLICY PROBLEMS

1. Educate the Citizens. People evade tax due to ignorance, especially when they do not know what the government does with tax income. Therefore, they can be educated through the media and other public forums.

2.Revise Tax Laws. Tax avoidance usually takes place when people discover certain loopholes in the tax laws. Therefore tax laws should be revised from time to time. Secondly there should be adequate warnings against such acts. Penalties and sanctions should be imposed on those engaged in tax avoidance.

3.Good Government: There should be good governance so as to minimise political instability in the country. When the citizens see and feel the impact of government, then they may be more willing to pay tax.

4.Good Remuneration of Tax Inspectors. Those who implement tax or tax inspectors should be adequately remunerated so that they would not take bribe. Adequate remuneration with appropriate education of tax officers will ensure that they carry out their duty appropriately.

SELF ASSESSMENT EXERCISE
Explain the problems and solutions to fiscal policy.

4.0 CONCLUSION.

The analysis of fiscal policy shows that, it is critical for the workings of a state economy. Individuals and corporate bodies should get involved to ensure that fiscal policy is successful. The major reason for fiscal policy implementation in the economy is to ensure price stability, balance of payment, income distribution. There are several weakness of fiscal policy. Some of the weakness includes tax evasion, avoidance and policy lags. However, appropriate education, discipline from the tax payers and tax collectors would make fiscal policy a success.

5.0 SUMMARY.
The unit highlighted the meaning of fiscal policy. The objective of fiscal policy. The various instruments of fiscal policy in Nigeria. The limitation of fiscal policy and the strategies to check these limiting factors were also discussed.

6.0 TUTOR- MARKED ASSIGNMENT.
1. Explain the problems and solutions of fiscal policy
2. Discuss the instruments of fiscal policy in Nigeria

7.0 REFERENCES/ FURTHER READING

Blanchard, O.C. (2002) An Empirical Characterisation of the Dynamic Effects of changes in Government Spending and Taxes on Output. Quarterly Journal of Economics, vol. 117, 4.

Berensten, A. and Waller, C.(2005), Optimal Stabilization Policy with Flexible Prices. Working paper.

Botman, D. Laxton, D. and Romanov, A. (2004), A New Open Economy Macro Model for Fiscal Policy Evaluation, IMF

CBN (1979), Twenty Years of Central Banking in Nigeria. Research Department Central Bank of Nigeria Lagos.

King, M. (1990), “Challenges for Monetary Policy: New and old” In New Challenges for Monetary Policy”, Federal Reserve Bank of Kansas City, 11

Ogbe, N. E. (1978), “The Problems of Monetary Management in Nigeria”, A paper presented the seminar, Department of Economics university of Lagos

Woodford, M.(2000), “Financial Market Efficiency and the Effectiveness of Monetary Policy”, Federal Reserve Bank of New York, 13