**ECONOMICS**

**FOR**

**BEGINNERS (EFB)**

**By**

**MOHAMED IBRAHIM JUSTICE GANAWAH**

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He is presently working on the following texts: **Commerce Theory and Practice, Corporate Business Finance, Corporate Business Strategy, Agricultural Marketing, Agricultural Financing and Development and Financial Economics** that would be published during the course of this year and next year.

DEDICATION

This book is dedicated to my Lord Jesus Christ for the wisdom, knowledge and understanding and my lovely and impeccable mother Madam Mamie Mariama Ganawah.

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**PREFACE**

This book “Economics for Beginners” is a fundamental economics text for pupils in high schools, students in institutes and colleges. This book helps in exposing students to the basic concepts in Economics and hence serves as a strong foundation to this all-important discipline called Economics. This book presented all the fundamentals of microeconomics and macroeconomics and helps to demystify the subject matter for anyone to understand the basic concepts.

This book is quite unique in nature as it is written in simple and clear English language with the objective of facilitating comprehension thereby increasing students’ interest in economics.

By and large, this book is written as a result of my professional experiences and inspirations in teaching over the years.

This book is a must-read for anyone desirous of knowing the basics of economics or those candidates preparing for West Africa Senior Secondary Certificate Examinations (WASSCE), students in certificates and diploma courses in colleges and polytechnics offering economics as a subjects or modules and even for year one undergraduate students. Welcome on board.

***Economist Mohamed Ibrahim Justice Ganawah***

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FOReWoRD

We hereby certify that this book titled: Elements of Economics, has been thoroughly reviewed. It contains key contemporary issues on both Microeconomics and Macroeconomics. It is particularly suitable for all students of the senior secondary schools, polytechnics, colleges, institutes and universities.

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**Chapter 1**

**NATURE AND SCOPE OF ECONOMICS**

**1.1 Definitions of Economics**

Economics as a subject has numerous definitions given by so many experts in the field.

Adam Smith in 1776 **(who is regarded as the father of Economics)**, says “Economics is about the making of wealth.”

According to Alfred Marshal in 1890 “Economics is the study of mankind in the ordinary business of life.”

John Stuart Mill in 1843 defined Economics as the “practical science of production and distribution of wealth.”

A.C. Pigou defined Economics as science of material welfare; he sees economics as a way of acquiring wealth to improve the welfare of human being.

The most generally acceptable definition of Economics is the one given by Lord Lionel Robbins. Lord Lionel C. Robbins defined Economics as the “science which studies human behaviour as a relationship between ends and scarce means which have alternative uses.

**According to Herbert Joseph Davenport** in 1913 defined Economics as “the science that treats phenomena from the stand point of price”.

Lord Lionel C. Robbins's in 1932 definition of Economics is generally accepted because his definition comprises all the major aspects of Economics. He defined Economics as that branch of social science which is concerned with the study of how individuals, households, firms, industries and government take decision relating to the allocation of limited resources to productive uses, so as to derive maximum gain or satisfaction.

Simply put, it is all about the choices we make concerning the use of scarce resources that have alternative uses, with the aim of satisfying our most pressing infinite wants and distribute it among ourselves.

**1.2 Nature of Economics**

Economics as a science and also an art.

**Economics is a science**: Science is an organised branch of knowledge, which analyses cause and effect relationship between economic agents.

Economics is also regarded as a science subject although it does not assume the same level of precision and accuracy like other science subjects. Economic deals with human behavior and human behavior changes. Economics adopts scientific method which involves:

* Observation
* Formulating hypothesis
* Collection of data
* Organizing or analyzing the data
* Formulating laws
* Testing the laws
* Prediction on the basis of the laws

Further, economics helps in integrating various sciences such as mathematics, statistics, etc. to identify the relationship between price, demand, supply and other economic factors.

* + **Positive Economics**: A positive science is one that studies the relationship between two variables but does not give any value judgment, i.e. it states ‘what is’. It deals with **facts about the entire economy**.
  + **Normative Economics**: As a normative science, economics **passes value judgement**, i.e. ‘what ought to be’. It is concerned with economic goals and policies to attain these goals.

**Economics is an art**: Art is a discipline that expresses the way things are to be done, so as to achieve the desired end. Economics has various branches like production, distribution, consumption and economics, which provide general rules and laws that are capable of solving different problems of society.

Therefore, economics is considered as science as well as art, i.e. **science in terms of its methodology and arts as in application**. Hence, economics is concerned with both theoretical and practical aspects of the economic problems which we encounter in our day to day life.

## 1.3 Scope of Economics

Economics is divided into two main types. These are: Microeconomics and **Macroeconomics.**

* Microeconomics: The part of economics whose subject matter of study is **individual units**, i.e. a consumer, a household, a firm, an industry, etc. It analyses the way in which the decisions are taken by the economic agents, concerning the allocation of the resources that are limited in nature.

It studies consumer behaviour, product pricing, and firm’s behaviour. Factor pricing, etc.

* **Macroeconomics**: It is that branch of economics which studies the entire economy, instead of individual units, i.e. level of output, total investment, total savings, total consumption, etc. Basically, it is the study of **aggregates and averages**. It analyses the economic environment as a whole, wherein the firms, consumers, households, and governments make decisions.

It covers areas like national income, general price level, the balance of trade and balance of payment, level of employment, level of savings and investment.

The **fundamental difference between micro and macroeconomics lies in the scale of study**. Further, in microeconomics, more importance is given to the determination of price, whereas macroeconomics is concerned with the determination of income of the economy as a whole.

Nevertheless, microeconomics and macroeconomics are **complementary** to one another, as they both aimed at **maximizing the welfare of the economy as a whole**.

From the standpoint of microeconomics, the objective can be achieved through the **best possible allocation of scarce resources**. Conversely, if we talk about macroeconomics, this goal can be attained through the**effective use of the resources of the economy.**

**1.4 Basic Concepts of Economics**

These are also referred to as the basic elements of economics. There are several basic concepts of economics in the literature, these are wants, scarcity, choice, scale of preference and opportunity cost.

1. **WANTS**

Want is simply that unquenchable desire or necessity by human beings to own goods or services that give satisfaction. Human wants and needs are many and are usually described as insatiable because the means of satisfying them are limited or scarce.

There is a clear distinction between a **need** and a **want** in economics. A need in economics is defined as something one needs to survive. The idea of survival is real, meaning someone would die without his/her needs being met. Examples of needs are food, water, and shelter. Whiles a **want** is simply something that people desire to have, that they may, or may not, be able to obtain. Again, with those two simple definitions, it doesn't seem like there should be much to talk about, but there is. Economics deals with how we allocate scarce resources, and those scarce resources may be needed to meet someone people's needs and other people's wants. So, we do need to talk about wants and needs.

1. **SCARCITY**

Scarcity as an important concept in economics means the resources which are available for the satisfaction of wants are limited (scarce). In other words, scarcity is the inability of human beings to provide themselves with all the things they desire or want. Human wants are unlimited. For instance, as a student you will need Le450,000.00 to buy school materials but you have only Le250,000.00. It can be seen that the money you have, which is your resources, will not be sufficient to buy all you need. You may satisfy some of your wants due to the unavailability of all the resources needed. It is important to note that, the available resources within the environment can never at any time be in abundance to satisfy all human wants. Since wants are **numerous** and **insatiable** relative to the available resources, human beings have to choose the most important ones and leave the less important ones. There would be no economic problem if resources were not scarce. So, it is very essential to think about how limited resources can be used alternatively to satisfy some wants of people to get maximum satisfaction as possible.

1. **CHOICE**

Choice is simply the process of selecting one or few goods or wants from the bundles of goods or wants. Human wants are unlimited and we cannot satisfy all of them because of our limited resources. We therefore decide which of the wants we can satisfy first. Choice arises as a result of the resources used in satisfying these wants. For example, Augustine Sarrah Conteh is desiring to buy ***Elements of Economics*** textbook and does not buy the ***Timberland boot***. Note that if human wants were limited or resources were unlimited, then, there would be no scarcity and there would be no problem of choice. Because of scarcity, we are forced to choose.

1. **SCALE OF PREFERENCE**

Scale of Preference is one of the most common economic concepts which means a list of wants or needs that a person, institution or government writes or comes up with in order of importance. In other words, it is the list of uit is a list showing the order in which we want to satisfy our wants in order of priority.

Here, the person puts his or her most pressing needs or wants at the top of the list and then the less important needs go to the bottom of the list.

Sometimes, the easiest way to explain economic concepts is to provide concrete examples. Let's say **Lunet** has a specific amount of money, such as $5,000. **Lunet** has certain wants that she needs to pay for. **Lunet** would put the things she needs or wants most at the top of the list, followed by other wants in descending order by importance. For example, **Lunet** may place rent and utility bills above all else. She may also have other bills to pay. Once the needs are taken care of, **Lunet** can add more to the list, such as a new computer or car. Next to each line item will be a numerical amount. For instance, if **Lunet**'s rent is $1,000, this will appear next to "rent" on her list. **Lunet** will add up the numbers as she goes along to see if she has enough money left over for wants.

Another example of a scale of preference is presented in table 1.1

|  |  |
| --- | --- |
| **ITEM** | **VALUE ($)** |
| Plasma Tv | 500.00 |
| Computer | 100.00 |
| Pair of Shoes | 50.00 |
| Mobile Phone | 50.00 |
| Bag | 85.00 |

From this table, MAM G’s most important wants have been placed at the top of the table with the less important ones at the bottom. According to MAM G, her most important need is a Plasma Tv and then a computer and then a pair of shoes. The mobile phone and the bag are her least pressing wants so she put it at the bottom of the table.

Let us assume that the MAM G had only $600.00 to spend, she would be able to purchase the plasma tv and computer only. Upon receiving another $85, she will now buy the pair of shoes and so forth. There is absolutely no way MAM G would purchase anything in the list before purchasing the pair of shoes.

**Benefits of Scale of Preference**

The following are direct benefits of using scale of preference concept directly:

* If you have little resources, using the concept correctly can help you best utilize what's available.
* You can produce the correct amount of goods for the consumer, meaning not too much or too little.
* Even if you have little resources, when the concept is used correctly, you can satisfy the needs of the consumer.
* You have a better chance of making correct decisions after you acquire resources.
* The priorities of people, such as the business owner and consumer, are more in line with the amount of available resources.

1. **OPPORTUNITY COST**

It is also known as real cost or true cost. It is simply as an expression of cost in terms of forgone alternatives. In other words, it refers to the wants that are left unsatisfied in order to satisfy another more pressing need. Human wants are many, while the means of satisfying them are scarce or limited. We are therefore faced with the problem where we have to choose one from a whole set of human wants, to choose one means to forgo the other.

For instance, let assume **Catherine Smith has two items to buy say a pair of Black shoes and a textbook. If she choose to buy the textbook instead of the pair of black shoes, it means she has forgone the pair of black shoes** in favour of the textbook. The pair of black shoes is thus what she has sacrificed in order to own the textbook. The pair of black shoes she has sacrificed is the forgone alternative and this is what is referred to as opportunity cost.

***Importance of Opportunity Cost***

* *Determination of Relative Prices of goods* - The concept is useful in the determination of the relative prices of different goods. For example, if a given number of factors can produce one table or three chairs, then the price of one table will tend to be three times equal to that one chair.
* *Fixation of Remuneration to a Factor* - The concept is also useful in fixing the price of a factor. For example, let us assume that the alternative employment of a college professor is work as an officer in an insurance company at a salary of Le40,000 per month. In such a case, he has to be paid at least Le40,000 to continue to retain him in the college.
* *Efficient Allocation of Resources* -The concept is also useful in allocating the resources efficiently. Suppose, opportunity cost of 1 table is 3 chairs and the price of a chair is Le100, while the price of a table is Le400. Under such circumstances, it is beneficial to produce one table rather than 3 chairs. Because, if he produces 3 chairs, he will get only Le300, whereas a table fetches him Le400, that is, Le100 more.

***Limitations***

The concept has the following drawbacks:

* *Specific*

If a factor’s service is specific, it cannot be put to alternative uses. The transfer cost or alternative cost in such a case is zero. This is pure rent, according to Mrs. Joan Robinson.

* *Inertia*

Sometimes, factors may be reluctant to move to alternative occupations. In such a case, a payment exceeding the pure transfer cost will have to be made to induce it to take to an alternative occupation.

* *Perfect Competition*

The concept rests on the assumption of perfect competition. However, perfect competition is a myth, which seldom prevails.

* *Private and Social Costs*

A discrepancy is likely to arise between private and social costs. For example, let us assume that a chemical factory discharges industrial refuse into a river. This causes serious health hazards, which cannot be measured in money terms.

* *Alternatives are not clearly known*

The foregone opportunities are often not ascertainable. This also poses a serious limitation of the concept.

**1.5 Importance of Studying Economics**

We study Economics because of the following reasons

* **Rational decision**

The study of economics enables individual, group or government to make a rational or wise choice among their numerous needs with their scarce resources.

* **Production**

The study of economics helps the producer to determine what to produce, where to produce, for whom to produce and to know the factor f production.

* **Provision of basic tools**

Economics helps to provide basic tools that will help to solve and analyze economic problems in any firm or organization.

* **Allocation of resources**

The knowledge of economics helps the government to allocate her scarce resources to different sector of the economy.

* **Preparation of budget**

Economics helps the government to determine her expected income and expenditure of the country.

* **Participation in government**

The knowledge of economics helps individual to participate in government affairs.

* **Satisfaction of wants**

It helps us to utilize the principle of choice and other concept of economics in satisfying our wants.

* **Consumption of commodities**

It assists us to determine the pattern of consumption in our environment.

* It helps government to develop programmes that are beneficial to the people.
* It helps business men and women to maximize their profits.
* The study of economics generally allows us make better financial decisions.

# **1.6 Basic Economic Problems** Allocation of resource means scientific management of resources in the production, distribution, and exchange. It deals with how much resource is necessary for what sector. It is the basic problem of every economy. We can satisfy only limited wants because we have limited resources. So, these limited resources are used in such a manner that the satisfaction derived from it is maximum. As the resources are limited in comparison to wants, the proper allocation of resources is necessary. The proper allocation of resources deals with the following fundamental problems of an economy.

**1. What to produce:** This means what amount of goods to be produced. Every demand of every individual can’t be satisfied. So, before producing anything, a decision should be made what goods are to be produced and to what extent.

**2. How to produce:** This means which techniques of production (labour intensive or capital intensive technique to be selected). After the decision of what to produce, we must next determine what techniques should be adopted to produce goods.

**3. For whom to produce:** This means how the produced goods and services are to be distributed among different income groups of people that is who should get how much. This is the problem of sharing of the national product.

**4. The problem of full employment:** This means the efficient use of scarce resources that is no waste or misuse of resources. Since resources are scarce in relation to human wants. It is necessary to utilize the available resources to achieve full employment for maximum possible satisfaction.

**5. The problem of growth:** This means how to achieve the growth of resources. The growth of resources is related to an increase in the level of production. Each economy faced the problem of how to increase its production capacity. For this, the economy has to decide about the rate of capital formation, investment, and savings.

**Chapter 2**

**THEORY OF DEMAND**

***2.1 Definitions***

It is crystal clear that, the use of the word ‘demand’ in Economics, is made to exhibit the relationship between the prices of a commodity and the amounts of the commodity which consumers want to purchase at those prices**.**

*Bober also defines* as, “By demand we mean the various quantities of given commodity or service which consumers would buy in one market in a given period of time at various prices, or at various incomes, or at various prices of related goods.”

According to Mohamed Ibrahim Justice Ganawah, “Demand is the want that is backed by the ability and willingness to pay.”

Generally, “Demand for a commodity is the quantity which a consumer is willing to buy at a particular price at a particular time.”

Characteristics of Demand

The definition of demand highlights four essential elements of demand: -

(i) Desire or want of the commodity (ii) Willingness and ability to pay

(iii) Possible Price of the commodity (iv) Period of time for which such demand is measured

**2.2 Demand Function**

Demand function shows the relationship between quantity demanded for a particular commodity and the factors influencing it.

**Types of Demand Function**

There are two types of demand functions. These are:

1. Individual demand function
2. Market demand function.

1. **Individual Demand function:-**

Individual demand function refers to the functional relationship between individual demand and the factor affecting individual demand.

It is expressed as:

Dx = f (Px, Pr, Y, T, F)

***Where:***

Dx = Demand for commodity x Px = Price of the given commodity x,

Pr = Prices of related Goods Y = Income of the consumer

T = Tastes and Preferences F = Expectation of change in price in future.

1. **Market demand function**:-

Market demand function refers to the functional relationship between market demand and the factors affecting market demand. Market demand function can be expressed as

Dx = f (Px, Pr, Y, T, F, Po, S, D)

Dx = Market demand of commodity x, Px = Price of given commodity x,

Pr = Prices of related goods; y = Income of the consumers;

T = Tastes and Preferences, F = Expectation of change in price in future;

Po = Size and composition of population; S = Season and weather; D = Distribution of Income.

**2.3 Factors that Influence Demand**

For facilitation of comprehension, let separate the determinants of demand into individual demand and market demand determinants.

* ***Determinants of Individual Demand***

Individual demand for a commodity means the total demand of an individual. Demand for a commodity increases or decreases due to a number of factors. The various factors affecting individual demand are:-

**1. Price of the given commodity/ Product**

Demand for a commodity depends on its price.

It is the most important factor affecting demand for the given commodity. Generally, there exists an inverse relationship between price and quantity demanded. It means as price increases, for a normal good, demand falls and vice-versa. However, there are exceptions, i.e., for Giffen goods, as price rises demand also rises. For example :- If the price of the given commodity (say gari) increases its quantity falls as satisfaction derived from tea will fall due to rise in its price.

The following determinants are termed as ‘other factors’ or factors ‘other than price’

2. **Price of related goods**

Consumption choices are also influenced by the alternative options available to users in the relevant market place. Market information regarding alternative products, quality, convenience and dependability all influence choices. Relationship can be in two forms: -

1. **Substitute goods**

 Substitute goods are those goods which can be used in place of one another for satisfaction of a particular want, like tea and coffee. An increase in the price of substitute leads to an increase in the demand for given commodity and vice – versa. For example: – If price of a substitute good (say, coffee) increases then demand for given commodity (say, tea) will rise as tea will become relatively cheaper in comparison to coffee. So, demand for a given commodity is directly affected by change in price of substitute goods.

1. **Complementary goods**

Complementary goods are those goods which are used together to satisfy a particular want, like tea and sugar, An increase in the price of complementary good leads to a decrease in the demand for given commodity and vice – versa. For example : – if the price of a complementary good (say, sugar) increases, then demand for given commodity (say, tea) will fall as it will be relatively costlier to use both the goods together. So, demand for a given commodity is inversely affected by change in price of complementary goods.

Example of substitute goods:- Tea and coffee, Coke and Pepsi, Pen and Pencil, CD and DVD, Ink pen and ball pen, Rice and wheat etc.

Example of complementary goods:-Tea and Sugar, Pen and ink, Car and Petrol, Bread and Butter, Pen and Refill, Brick and cement etc.

**3.  Income of the consumer**

A key determinant of demand is the level of income i.e., the higher the level of income the higher the demand for a given commodity. However, the effect of change in income on demand depends on the nature of commodity under consideration.

* If the given commodity is a normal good, then an increase in income lads to rise in its demand, while a decrease in income reduces the demand.
* If the given commodity is an inferior good, then an increase in income reduces the demand while a decrease in income leads to rise in demand.

For example, suppose income of a consumer increases. As a result, the consumer reduces consumption of toned milk and increases consumption of full cream milk. In this case ‘Toned milk’ is an inferior good for the consumer and ‘Full cream milk’ is a normal good.

**4. Tastes and Preferences**

Tastes and preferences of the consumer directly influence the demand for a commodity. They include changes in fashion, customs, habits etc. If a commodity is in fashion or is preferred by the consumers, then demand for such a commodity rises. On the other hand, demand for a commodity falls, if the consumers have no taste for that commodity.

**5. Expectation of future change in the price**

The current demand of a product also depends on its expected price in future. If the price of a certain commodity is respected to increase in near future, then consumers will buy more of that commodity now than what they normally buy. If, however, the price of a product is expected to fall then consumers has a tendency to postpone its consumption and as a result the present demand would also fall.

There exists a direct relationship between expectation of change in the prices in future and change in demand in the current period

For example: – If the price of petrol is expected to rise in future, its present demand will increase. Change in quantity demanded us change in demand: -

1. Change in quantity demanded: – Whenever demand for the given commodity changes due to change in its own price, then such change in demand is known as “Change in Quantity Demand”. For example, if demand for Pepsi changes due to Change in its own price, then such change in demand is known as “Change in Quantity Demanded”.
2. Change in Demand: – Whenever demand for the given commodity changes due to factors other than price, then such change in demand is known as “Change in demand”. For example: – If demand for Pepsi changes due to change in price of Coke or due to change in income or due to a change in taste, then such change in demand for Pepsi is known as change in demand.

**6. Economic Conditions**

The demand for commodities also depends upon prevailing business conditions in the country. For, example- during the inflationary period, more money is in circulation and people have more purchasing power. This causes an increase in demand of various goods even at higher prices. Similarly, during deflation (depression), the demand for various goods reduces in spite of lower prices because people do not have enough money to buy.

* ***Determinants of Market Demand***

Market demand for a commodity means the sum total of the demand of all individuals. Market demand depends, not only on the prices of the commodity and prices of related commodities but also on the number of factors.

**These are:**

**1. Pattern of Income Distribution**

If National income is equitably distributed, there will be more demand and vice-versa. If income distribution moves in favour of down­trodden people, then demand for such commodities, which are used by common people would increase. On the other hand, if the major part of National income is concentrated in the hands of only some rich people, the demand for luxury goods will increase.

**2. Demographic Structure**

Market demand is influenced by change in size and composition of population. Increase in population leads to more demand for all types of goods and decrease in population means less demand for them. Composition of population also affects its demand. Composition refers to the number of children, adults, males, females etc., in the population.

When the composition changes, for example, when the number of females exceeds to that of the males, then there will be more demand for goods required by women folk.

**3. Government Policy**

Government policy of a country can also affect the demand for a particular commodity or commodities through taxation. Reduction in the taxes and duties will allow more persons to enter a particular market and thus raising the demand for a particular product.

**4. Season and Weather**

Demands for commodities also depend upon the climate of an area and weather. In cold hilly areas woolens are demanded. During summer and rainy season demand for umbrellas may rise. In winter ice is not so much demanded.

**5. State of Business**

The levels of demand in a market for different goods depend upon the business condition of the country. If the country is passing through boom, the trade is active and brisk. The demand for all commodities tends to rise. But in the days of depression, when trade is dull and slow, demand tends to fall.

**2.4 Demand Schedule**

The demand schedule in economics is a table of quantity demanded of a good at different price levels. Given the price level, it is easy to determine the expected quantity demanded. This demand schedule can be graphed as a continuous demand curve on a chart where the Y-axis represents price and the X-axis represents the quantity.

According to PROF. ALFRED MARSHALL, “Demand schedule is a list of prices and quantities”. In other words, a tabular statement of price-quantity relationship between two variables is known as the demand schedule.

**Types of Demand Schedule**

**The demand schedule can be divided into two types. These are:**

1. Individual demand schedule;

2. Market demand schedule.

**1. Individual Demand Schedule:**

It represents the demand of an individual’ for a commodity at different prices at a particular time period. Table 2.1 shows a demand schedule for Jusgan Laptop on 27th May, 2019.

Table 2.1: Individual Demand Schedule

|  |  |
| --- | --- |
| Price of Jusgan laptop (Le) | Quantity Demanded |
| 5 | 5 |
| 4 | 7 |
| 3 | 9 |
| 2 | 20 |
| 1 | 25 |

**2. Market Demand Schedule:**

Market Demand Schedule is defined as the quantities of a given commodity which all consumers will buy at all possible prices at given moment of time. In a market, there are several consumers, and each has a different liking, taste, preference and income. Every consumer has a different demand.

The market demand actually represents the demand of all the consumers combined together. When a particular commodity has several brands or types of commodities, the market demand schedule becomes very complicated because of various factors. However, for a single item, the market demand schedule is rather simple. Study the market demand schedule for milk in table 2.2.

Table 2.2 Market Demand Schedule

|  |  |  |  |
| --- | --- | --- | --- |
| Price of Petrol Per Litre (Le) | Demand of Miss Bailor (in litres) | Demand of Miss Charm (in litres) | Market Demand (in litres) |
| 10 | 2 | 3 | 2+3=5 |
| 8 | 4 | 5 | 4+5=9 |
| 6 | 6 | 7 | 6+7=13 |
| 4 | 8 | 10 | 8+10=18 |
| 2 | 10 | 12 | 10+12=22 |

**2.5 Demand Curves**

The demand curve is a graphic statement or presentation of the relationship between product price and the quantity of the product demanded. It is drawn with price on the vertical axis of the graph and quantity demanded on the horizontal axis.

Demand curve does not tell us the price. It only tells us how much quantity of goods would be purchased by the consumer at various possible prices.

**Depending upon the demand schedule, the demand curve can be as follows:**

1. Individual Demand Curve

2. Market Demand Curve

**1. Individual Demand Curve**

An Individual Demand Curve is a graphical representation of the quantities of a commodity that an individual (a particular consumer) stands ready to take off the market at a given instant of time against different prices. In Fig. 2.1, an Individual Demand Curve is drawn on the basis of Individual Demand Schedule given above in table 2.1.

8

6

0

220

2

55

7

004

25

20

9956

D

Q

P

4

**2. Market Demand Curve:**

A Market Demand Curve is a graphical representation of the quantities of a commodity which all the buyers in the market stand ready to take off at all possible prices at a given moment of time. In Figure 2.2 a Market Demand Curve is drawn on the basis of Market Demand Schedule given in Table 2.2.

100

8

6

0

2

2

5

9

22

18

13

D

Q

P

4

Both, the individual consumer’s demand curve is a straight line. A demand curve will slope downward to the right.

It is not necessary, that the demand curve is a straight line. A demand curve may be a convex curve or a concave curve. It may take any shape provided it is negatively sloped.

**2.6 Law of Demand**

The law of demand expresses functional relationship between price and the quantity. It has been universally observed that people buy more quantity of goods when, they are available at a lower price and the quantity purchased declines with an increase in its price.

“A rise in the price of a commodity or service is followed by a fall in quantity demanded, and a fall in price is followed by an increase in quantity demanded”. Thus, lower the price, the larger is the quantity demanded of a commodity and vice-versa.

The law thus, states that other things being equal the quantity demanded varies inversely with price. Lower the price, greater is the effective demand; higher the price; lesser is the effective demand. His represented below in figure 2.3.

Price (P)100

Q1

Q2

Q3

P2

P1

P3

Normal dd

0

Quantity (Q)

**Characteristics of Law of Demand**

**The law of demand has three specific characteristics:**

1. General Tendency,

2. Relation to Time, and

3. Price and Demand Relationship.

**1. General Tendency**

The law simply indicates a general tendency of changes in quantity demanded with the changes in prices. However, it does not mention any specific propositions of changes in quantity demanded with changes in prices.

**2. Relation to Time**

The law of demand is always related to time, because the price changes from time to time and these are never fixed. Thus, the co-relation between the prices and the quantities demanded should be considered for a specific time or at particular instant.

**3. Price and Demand Relationship**

The increase or decrease in the prices does affect the quantity demanded at a particular time. Thus, the change in the quantity demanded cannot be considered without change in prices. It must, therefore, be noted that the relationship between price and quantity demanded is relative.

**A****ssumptions of Law of Demand**

i. The income of the consumer remains same during the period under consideration.

ii. The prices of related goods remain unchanged during the period.

iii. The preferences and tastes of consumers must remain the same during the period of consumption.

iv. The quality of similar goods available in the market is almost unchanged.

v. During the period under study, it is presumed that prices are not likely to change in near future.

vi. No substitutes for the commodity in question are available.

**2.7 Exceptions to the Law of Demand**

There are certain exceptions to the law of demand. It means that under certain circumstances, consumers buy more when the price of a commodity rises and less when the price falls. In such case the demand curve slopes upward from left to right i.e. demand curve has a positive slope as is shown in Fig. 2.4. Many causes can be attributed to an upward sloping demand curve.

Q

D

P

**1. Ignorance**

Sometimes consumers are fascinated with the high-priced goods from the idea of getting a superior quality. However, this may not be always true. Superior/deceptive packing and high price deceive the people. This can be called as ‘Ignorance effect’.

**2. Speculative Effect**

When the price of a commodity goes up, people may buy larger quantity than before, if they anticipate or speculate a further rise in its price. On the other hand, when the price falls, people may not react immediately and may still purchase the same quantity as before, waiting for another fall in the price. In both the cases, the law of demand fails to operate. This is known as speculative effect.

**3. The Giffen Effect**

A fall in the price of inferior goods (Giffen Goods) tends to reduce its demand and a rise in its price tends to extend its demand. This phenomenon was first observed by SIR ROBERT GIFFEN, popularly known as Giffen effect.

He observed that the working-class families of U.K. were compelled to curtail their consumption of meat in order to be able to spend more on bread Mr. Giffen, British economist, observed that rise in the price of bread caused the low paid British workers to buy more bread.

These workers lived mainly on the diet of bread, when price rose, as they had to spend more for a given quantity of bread, they could not buy as much meat as before. Bread still being comparatively cheaper was substituted for meat even at its high price.

**4. Fear of Shortage**

People may buy more of a commodity even at higher prices when they fear of a shortage of that commodity in near future. This is contrary to the law of demand. It may happen during times of war and inflation and mostly in the case of goods which fall in the category of necessities of life like sugar, kerosene oil, etc.

**5. Prestigious Goods**

This is explained by Prof. ThorsfeinVebler Veblen. If consumers measure the desirability of a good entirely by its price and not by its use, then they buy more of a good at high price and less of a good at low price, Diamond, Jewellery and big cars etc., are such prestigious goods. In their case demand relates to consumers who use them as status symbol.

As their prices go up and become costlier, rich people think it is more prestigious to have them. So, they purchase more. On the other hand, when their prices fall sharply, they buy less, as they are no more prestigious goods. This is known as (Veblen effect) or (Demonstration effect).

**6. Conspicuous Necessities**

Another exception occurs in use of such commodities as due to their constant use, have become necessities of life. For example, in spite of the fact that the prices of television sets, refrigerators, washing machines, cooking gas, scooters, etc., have been continuously rising, their demand does not show any tendency to fall. More or less same tendency can be observed in case of most of other commodities that can be termed as ‘Upper-Sector Goods’.

**7. Bandwagon Effect**

The consumer’s demand for a good may be affected by the tastes & preferences of the social class to which he belongs. If purchasing diamond becomes fashionable, then, as the price of diamond rises, rich people may increase their demand for diamonds in order to show that they are rich.

**8. Snob Effect**

People sometimes buy certain commodities like diamonds at high prices not due to their intrinsic worth but for a different reason. The basic object is to display their riches to the other members of the community to which they themselves belong. This is known as Snob appeal.

**2.8** **Movement along a Demand Curve and Shifts in the Demand Curve**

**1. Change in Quantity Demanded (Movement along a Demand Curve)**

Extension and Contraction of Demand- The quantity demanded of a product does not remain constant, but keeps on changing due to various factors. If the quantity demanded changes due to change in price only, it is called expansion and contraction of demand. If price decreases, it results in expansion of demand and if price increases it results in contraction of demand. This situation is shown by movement along the same demand curve.

P

P2

P0

P1

D

0

Q

Q2

Q0

Q1

Figure 2.5 change in quantity demanded

In figure 2.5, we have shown expansion and contraction of demand. At price OP, quantity demanded is OQ. If price reduces to OP1, the quantity demanded increase to OQ1. This increase of quantity demanded would be called expansion of demand. If, however, price increases from OP to OP2, then quantity demanded decrease in equality would be called contraction of demand.

**2. Change in Demand— Shifts in the Demand Curve**

**Increase and Decrease of Demand:**

If the change in quantity demanded of a product takes place due to any factor, other than price of the product, then it is called increase or decrease of demand. This phenomenon is shown by a shift in the entire demand curve. For example- if the income of the consumer rises then his entire demand curve shifts to right which shows that consumer’s demand for the product has increased for every given price.

P ⃰

0

Q1

Q0

Q2

Q

D2

D0

D1

In the figure 2.6 we can say if demand increases due to increase in income then demand curve shifts to right from D to D1. If, however, the demand decreases due to fall in income then the demand curve shifts to left from D to D2.

**2.9 Kinds of Demand**

**The demands can be classified as:**

1. Price Demand

2. Income Demand

**1. Price Demand**

The price demand refers to various quantities of a commodity or services that are purchased at a given time and at given prices from the market. However, in such studies, the consumer’s taste, his income, habit and prices of related goods are assumed to be unchanged. Price demand has inverse relation with the price i.e., if the price of a commodity increases, its demand decreases and as the price decreases, its demand increases.

**2. Income Demand**

The income demand refers to the various quantities of a commodity or service purchased by the consumers at different income levels. It is assumed that the price of commodity, price of related goods and consu­mers’ tastes do not change. Under such conditions, with the increase in income, a consumer may purchase increased quantity of the commodity even though there may not be any fall in price.

**3. Cross Demand**

Cross demand refers to the quantity of a commodity which would be demanded as a consequence of changes in price of related complementary or substitute goods.

**(i) In the Case of Substitutes**

A rise in the price of good y (say Coffee) raises the demand for good x (Say Tea), similarly, a fall in the price of y, (Coffee) the demand for x (Tea) falls.

**(ii) In the Case of Complementary**

In case of comple­mentary goods such as pant and shirt, pen and ink, car and petrol, etc., a fall in the price of one good y (Say car) will raise the demand for good x (Say petrol). Conversely a rise in the price of y (Car) will bring a fall in the demand for x (Petrol).

**2.10 Types of Demand**

**From a practical point of view, t**here are 4 (four) basic types of demand, namely; **joint or complementary, competitive, derived, and composite demand.**

1. Joint Demand

2. Direct Demand and Derived Demand

3. Composite Demand

**1. Joint Demand**

When several items are demanded for one particular purpose such demand is known as Joint Demand. Demand for complementary goods is also known as Joint Demand. For example, for fabrication of furniture, the items required are wood, nails, varnish, etc.

Thus, whenever the demand of furniture increases, the demand of wood, nails, etc., also increases. This is called a Joint Demand. Similarly, for the construction of the houses, the demand for bricks, cement, masons, labourers, etc., will constitute a Joint Demand.

**2. Direct Demand and Derived Demand**

Whenever several items are required to make a particular commodity, the demand for various commodities is termed as the Derived Demand and demand of ultimate commodity is called as Direct Demand. For example, the demand for building is a direct demand and demands for cement, bricks, sand, timber, etc., are called as derived demands.

**3. Composite Demand**

A commodity can be used for several purposes and its demand is directly linked to its sweets various uses such a demand is known as Composite Demand. For example, milk is used for making tea, coffee, butter, cheese, curd, sweets and for direct consumption. The total demand of milk in the market is for all such purposes and it is called composite demand.

**4.Competitive Demand**

Demand is said to be competitive when two goods serve as close substitutes. That is, one good can be used in the absence of the other. Examples of such goods are butter and margarine, butter and mayonnaise. If the price of one of these goods increases, the demand for it decreases, resulting in an increase in the demand for the other. The reverse holds.

***Chapter 3***

***THEORY OF SUPPLY***

***3.1 Meaning of Supply***

Similar to demand, the concept of supply also is expressed as a relationship between price and quantity. Supply is a basic economic phenomenon that describes the total amount of a specific good or service that is available to consumers.

Supply refers to the quantity of a commodity that a firm is willing to offer for sale at a given price during a given period of time. The definition of supply highlights its four essential elements – quantity of a commodity, willingness to sell, price of the commodity and the period of time. Supply can be either for a single seller or for all the seller i.e., Individual Supply or Market supply.

Individual Supply refers to the quantity of a commodity that an individual firm is willing to offer for sale at a given price during a given period of time. Whereas, market supply refers to a quantity of a commodity that all the firms are willing to offer for sale at the given price during a given period of time.

***3.2 Features of Supply***

1. The concept of supply is a desired quantity. It indicates only the willingness i.e., how much the firm is willing to sell and not how it actually sells.
2. Supply of a commodity does not comprise the entire stock of the commodity. It indicates the quantity that the firm is willing to bring into the market at a particular price.
3. Supply is always expressed with reference to price**.** The supply of a commodity is always at a price because with a change in price the quantity supplied may also change.
4. Supply is always with respect to a period of time. The quantity of the commodity which the firm is willing to supply during a specific period of time.

***3.3 Supply Schedule***

Supply is the quantity of a commodity that a producer is willing and able to offer for sale at a given price during a given period of time. The quantity of a commodity being supplied by a firm can be represented in many ways, one of these is a supply schedule.

Supply schedule is a tabular statement showing number of units of a commodity being supplied at various levels of price, during a given period of time. There are two types of supply schedules –

1. Individual
2. Market

**Individual Supply Schedule**

Individual supply schedules refer to a tabular statement showing various quantities of a commodity that a producer is willing to sell at various levels of price, during a given period of time.

|  |  |
| --- | --- |
| Price (in Le) | Quantity supplied of Apples |
| 2 | 10 |
| 4 | 15 |
| 6 | 20 |
| 8 | 25 |
| 10 | 30 |

As seen in the schedule given above, quantity supplied of Apples increases with increase in price. The firm is willing to offer for sale 10 units of Apples at a price of Le2. When the price rises to Le10, supply also rises to 30 units.

**Market Supply Schedule**

Market supply schedule refers to a tabular statement showing various amounts of a commodity that all the producers are willing to offer for sale at various levels of price, during a given period of time. It is obtained by adding all the individual supplies at each and every level of price.

Market supply can be expressed as –

Sm=S1+S2…

Where Sm is the market supply and S1+S2… are the individual supply of supplier 1, supplier 2 and so on.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Price (in Le) | Individual Supply (units) | | Market Supply (units) |  |
|  | S1 | S2 | (S1+S2) | |
| 2 | 10 | 15 | 10+15=25 | |
| 4 | 15 | 20 | 15+20=35 | |
| 6 | 20 | 25 | 20+25=45 | |
| 8 | 25 | 30 | 25+30=55 | |
| 10 | 30 | 35 | 30+35=65 | |

As we can see in the table given above, market supply is obtained by adding the supplies of suppliers 1 and 2 at different prices. At price of Le2, market supply is 25 units. When price rises to Le4, market supply rises to 35 units, So, it also shows a direct relationship between price and quantity supplied.

The supply schedule shows the combinations of different quantities of a commodity that a producer is willing to sell at different levels of price. The graphical representation of a supply schedule is known as a Supply Curve.

***3.4 Supply Curve***

A Supply Curve is the locus of all the points showing various quantities of a commodity that a producer is willing to offer for sale at various levels of prices, during a given period of time, assuming no change in other factors.

This shows that there is direct relationship between price and the amount of a commodity that will be supplied by a producer or a firm, keeping other factors constant. It can be drawn for any commodity by plotting each combination of a supply schedule on a graph.  It can be drawn for both the types of supply schedules – individual and market supply schedule. Therefore, it is of two types – Individual and Market.

**Individual**

An individual supply curve is a graphical representation of an individual supply schedule.

|  |  |
| --- | --- |
| Price (in Le) | Quantity supplied of Apples |
| 2 | 10 |
| 4 | 15 |
| 6 | 20 |
| 8 | 25 |
| 10 | 30 |

0

5

10

15

20

25

5

10

15

20

25

Quantity supplied

S

P

Figure 3.1

SS is obtained by plotting points shown in the schedule given above. At every possible price, the firm is willing to sell a specific amount of its commodity. By joining all these points, we obtain a curve that slopes upwards. This is due to the positive relationship between the price of a commodity and the quantity supplied.

**Market**

Market supply curve is a graphical representation of a market supply schedule. We obtain it through horizontal summation of individual supply curves.

|  |  |  |  |
| --- | --- | --- | --- |
| Price (in Le) | Individual Supply (units) | | Market Supply (units) |
|  | S1 | S2 | (S1+S2) |
| 2 | 10 | 15 | 10+15=25 |
| 4 | 15 | 20 | 15+20=35 |
| 6 | 20 | 25 | 20+25=45 |
| 8 | 25 | 30 | 25+30=55 |
| 10 | 30 | 35 | 30+35=65 |

0

5

10

15

20

25

15

30

45

60

75

Quantity supplied

S

P

Figure 3.2

The points in market supply schedule given in the above table are graphically represented in the given graph. Sm has been obtained by horizontal summation of SA and SB.

A market supply curve is flatter than all the individual supply curves, because with change in price, the proportionate change in market supply is more than the proportionate change in individual supply.

***3.5 Law of Supply***

Various economists have extensively studied the behavior of sellers and producers and firms. As a result they arrived at a generalization of their behavior called the Law of Supply.

Law of supply states that there is a direct relationship between price and quantity supplied of the commodity, keeping other factors constant i.e. ceterus paribus.

We know that price is a dominant factor in determining the supply of a commodity. As price of the commodity increases, there is more supply of that commodity in the market and vice versa. This behavior is studied under the law of supply.

price

P1

P0

P2

Q2

Q0

Q1

Quantity supplied

S

O

Figure 3.3

The above given graph and table clearly show that more and more units of a commodity are being offered for sale as the price of the commodity is increased. The supply curve SS slopes upwards from left to right, indicating a direct relationship between price and quantity supplied.

**Assumptions**

While stating the law of supply, the phrase ‘keeping other factors constant’ or ‘ceteris paribus’ are used. This phrase is used to cover the following assumptions on which the law is based.

1. Price of other goods is constant.
2. There is no change in the state of technology.
3. Prices of factors of production remain the same.
4. There is no change in taxation policy.
5. Goals of the producer remain the same.

**Features of Law of Supply**

1. It states the positive relationship between the price of a commodity and its supply assuming that there are no changes in other factors.
2. The law of supply is a qualitative statement. It does not say anything about the quantity of increase in the supply of the commodity with a certain increase in price. It does not indicate the magnitude of change.
3. It also does establish any proportional relationship between the price of the commodity and its supply.
4. The law states a single sided approach where it talks about the change in supply due to the change in price but does not say anything about the change in price due to the change in supply.

**3.6 Exceptions to the Law of Supply**

As a general rule, the supply curve slopes upwards showing that the quantity supplied rises with a rise in price. However, in certain cases, positive relationships between supply and price may not hold true. The various exceptions to the law of supply are –

1. **Future Expectation –** If sellers expect a fall in price in the future, then the law of supply may not hold true. In this situation the sellers will be willing to sell even more aa lower price since they expect the price to fall even further therefore increasing their losses.
2. **Agricultural Goods –** The sale of agricultural goods are not subject to the law of supply since their production depends on climatic condition. Also, these are perishable goods and need to be sold in a certain time period after which they will have no value. Therefore, their supply might increase even at a lower price.
3. **Rare articles –** Rare, artistic and precious articles are also outside the scope of the law of supply. For example, supply of rare articles like painting of Mona Lisa cannot be increases even if the prices are increased.
4. **Backward Countries –** In economically backward countries, production and supply cannot be increased with increase in prices due to shortage of resources.

***3.7 Determinants of Supply***

There are several important factors that are the determinants of the supply of a commodity. A change in any of these factors will largely result in a change in the supply of the commodity.

* **Price of the given commodity**

The most important factor in determining the supply of a commodity is its price. As a general rule, the price of a commodity and the supply of the commodity are directly related. This means that as the price of the commodity increases, its supply will also increase and vice versa. This occurs as higher profits can be made at higher prices; therefore, it compels the firm to offer a higher quantity of goods.

* **Prices of Other goods**

We know that resources have alternate uses. Therefore, the quantity of a commodity that is supplied depends not only on its price but also on the prices of other commodities. If the price of another commodity increases, it becomes more profitable than the given commodity. As a result, the firm shifts its limited resources to the production of other goods rather than the given commodity.

* **Prices of factors of production**

When or the amount to be paid to the factors of production increases, the cost of production of the commodity also increases. As a result, the profitability of the commodity decreases, and thus the seller reduces the supply of the commodity. Similarly, if the prices of factors of decrease, the profitability of the commodity increases and the seller increases the supply of the commodity.

* **State of Technology**

The state or level of technology also influences the supply of the commodity in the market. Advanced technology allows the producer to produce the commodity at a lower cost of production thus increasing its profitability. As a result, the supply of the commodity is increased. However, technological degradation or complex and outdated technology will increase the cost of production and will lead to decrease in supply.

* **Government Policy**

The government’s taxation policy has effect on the quantity of commodity supplied. Increased taxes raise the cost of production thus reducing the supply of the commodity due to lower profit margin. Whereas, tax concessions and subsidies cause an increase in the supply of the commodity as they make it more profitable for the firms to supply goods.

* **Goals of the firm**

Usually, the goal or objective of a firm is profit maximization and because of that the supply of a commodity increases only at higher prices. But, with change in trend, some firms are willing to supply more at the same prices which do not maximize profits. The objective of such firms is to capture extensive markets and to enhance their status and brand name.

**Determinants of Market Supply**

The determinants of supply given above apply to both individual and market supply. Apart from the determinants of supply given above, market supply has some other factors determining the quantity of commodity supplied.

* **Number of firms in the market**

When the number of firms in the industry increases, market supply also increases due to large number of producers producing that commodity. However, market supply will decrease if some of the producers start leaving due to losses.

* **Future expectations regarding price**

If sellers expect a rise in price in the near future, the current market supply will decrease so that the supply can be increased when the prices are high. On the other hand, if the sellers fear that the price will fall in the near future, they will increase the supply of the commodity to avoid losses in the future.

* **Means of transportation and communication**

Proper infrastructural development like improvement in the means of transportation and communication help in maintaining adequate supply of the commodity.

**3.8 Movement along the Supply Curve or Change in Quantity Supplied vs Change in Supply**

Whenever supply for the given commodity changes due to change in its own price, then such change in supply is known as ‘Change in Quantity Supplied’. In this situation we have two occurrences’. These are: Expansion in supply and contraction in supply.

**Expansion in Supply**

Expansion in supply refers to a rise in the quantity supplied due to increase in the price of the commodity, other factors remaining constant. It leads to an upward movement along the same supply curve. Extension in supply is also known as ‘Increase in Quantity Supplied’.

**Contraction in Supply**

Contraction in supply refers to a fall in the quantity supplied due to decrease in price of the commodity, other factors remaining constant. It leads to a downward movement along the same supply curve. It is also known as ‘Decrease in Quantity Supplied’.

This contraction and expansion is shown below in figure 3.4

price

P1

P0

P2

Q2

Q0

Q1

Quantity supplied

S

O

**Shift in Supply Curve**

The changes in a supply curve can occur due to various factors. One of these changes is known as the shift in supply curve. Let us see what is meant by shift in supply curve.

**Shift in Supply Curve**

A supply curve is drawn to show the relationship between price and quantity supplied of a commodity assuming all other factors being constant. Although in reality, these factors do not always remain constant and are bound to change at some point. This change in other factors, i.e., factors other the price of the commodity, cause a shift in the supply curve.

For example, an increase in excise duty on a commodity will raise its cost of production which will lead to a fall in profit thus causing a decrease in the supply of the commodity even though its market price has not undergone any change. Such a decrease in supply cannot be represented by the original supply curve. It will lead to a shift in supply curve.

When supply of a commodity changes due to change in any factor other than the own price of the commodity, it is known as ‘change in supply’. It is graphically represented by a shift in the supply curve.

P

S2

S0

S1

P ⃰

0

Q

In the diagram given above, supply is OQ at the price OP\*. Change in other factors leads to a rightward or leftward shift in the supply curve.

**So** = original supply curve

**S1** = supply curve after a shift to the right

**S2** = supply curve after an inward shift

**Chapter 4**

**ELASTICITY OF DEMAND AND SUPPLY**

## *4.1 Elasticity*

## It is an important concept in neoclassical economic theory. Elasticity is a tool for measuring the responsiveness of one variable to changes in another, causative variable.

## In a simple term, elasticity is the measurement of the percentage change in one economic variable in response to a change in another.

***4.2 Elasticity of Demand***

Elasticity of demand is basically referring to the degree of responsiveness of quantity demanded to changes in the own price good or the consumer’s income or the price of an associated (related) good.

According to Marshall – “The elasticity or responsiveness of demand in a market is great or small according as the amount demanded increases much or little for a given fall in price and diminishes much or little for a given rise in price.”

***4.3 Determinants of Elasticity of Demand***

The following are the various factors on which elasticity of demand depends:

* Nature of the Commodity

In the first place, it depends on the nature of the commodity. Commodities which are supposed to be essential or critical to our daily lives must have an inelastic demand, since price change of these items does not bring about a greater change in quantity demanded.

But luxury goods have an elastic demand. Demand for these good can be quickly reduced when their prices rise. When their prices fall, consumers demand these goods in larger quantities. However, whether a particular commodity is a necessary or a luxury depends on income, tastes and preferences of the consumer.

* Availability of Substitutes

It is important to note that commodities having large number of substitutes must have an elastic demand. A change in the price of a good with plenty substitutes while the prices of the substitutes remain constant, will lead a consumer to substitute one for another.

If the price of a good goes down, buyers will demand more of it and less of its substitutes. Conversely, demand is fairly inelastic in the case of those commodities which do not have a large number of substitutes.

* Extent of Uses

There are some commodities which can be used for a variety of purposes. For example, electricity. If price per unit of electricity consumed falls, people will reduce their consumption of its substitutes (e.g., coal, gas, etc.) and increase the consumption of electricity.

Coefficient of price elasticity of demand in this case must be greater than one. On the other hand, when a commodity is used only for one or two purposes, a price change will have less effect on its quantity demanded and, therefore, demand will be inelastic.

* Habit Good

There are some commodities consumed out of habits and conventions— they have an elastic demand. Even in the face of rising prices of those commodities or falling income, people will consume those (such as, cigarette).

For this reason, price elasticity as well as income elasticity of demand for this type of commodity is inelastic. Further, gold orna­ments are used in the marriage ceremony rather out of convention, though gold prices are rising. When gold is used in this way, its demand becomes inelastic.

* Time Dimension

The shorter the time, lower will be the elasticity of demand. This is because in the short run satisfactory substitutes of a product may not be available. Thus, demand for a product in the short run usually becomes inelastic. Such a commodity will be elastic in the long run when close substitutes may be produced.

Thus, the response of quantity demanded to a change in price will tend to be greater (smaller), the longer (shorter) the time-span considered. In the long run, there is enough time for adjustments to be made following a change in price.

* Durability

Durable commo­dities have an elastic demand. If the price of these goods rises, people will spend less on these goods. On the other hand, following a fall in the price of durable commodities (e.g., refrigerator), people demand more of them. In the case of non-durable commodities, demand is elastic.

***4.4 Importance of Elasticity of Demand***

The concept of elasticity of demand is of great significance in economic analysis. It serves as a tool in framing certain economic policies.

* Poverty Amidst Plenty

The concept of elasticity of demand explains the paradox of poverty amidst plenty. A bumper crop of food-grains, the demand for which is inelastic, might spell economic disaster instead of bringing prosperity among the producers because a rich harvest will bring less and not more money to the farmers.

According to Prof. M. M. Bober ”If the demand for corn is inelastic a large crop will dictate a precipitously reduced price to the consumer, so that total revenue to the farmer may be less than from a smaller crop.”

* Theory of Distribution

It is useful in the determination of relative shares of the various factors of production. If the demand for a factor of production is less elastic, its share in the national dividend is higher and vice-versa. If elasticity of substitution is high, the share will be low.

* Incidence of Taxes

It is used in explaining the incidence of indirect taxes like sales tax and excise duty. Less is the elasticity of demand higher the incidence and vice-versa. In case of inelastic or less elastic demand, the consumers have to buy the commodity and must bear the tax.

* Business Decisions

The concept of price elasticity of demand has important practical applications in managerial decision-making. Often a business executive has to consider whether a lowering of price will lead to an increase in the demand for his product and if so to what extent and whether his profits would increase as a result there of? Here, the concept of elasticity of demand becomes vital in answering such questions.

* In Framing the Economic Policies

A knowledge of the consumer’s demand and also of the elasticity of demand is required by the government in formulating its economic policies. In controlling business cycles, removing inflationary and deflationary gaps in the economy and in directing the economy from one line of production to another, the government must have information as regards to the trends in demand, elasticity of demand etc.

* In deciding Price Policy

The study of elasticity of demand is not only important for the price policies of the producers, it is equally important in determining the factor rewards in a free enterprise economy.

For example, if the demand for labour is elastic the efforts of the trade unions to raise wages of the workers will meet with failures. On the contrary, if the demand for labour is relatively inelastic, it will be easy to raise worker’s wages.

* In the Determination of Public Utilities

This concept is also of paramount importance in enabling the government to decide as to which particular industry should be declared as Public Utilities and consequently owned and operated by the state. Public Utilities are vested with a public interest and hence it is desirable that those industries for whose products the demand is inelastic and which are controlled by private monopoly interests should be declared Public Utilities and taken over by the Government.

* Importance to Producer

From the point of view of an individual producer, the total demand for the commodity which he is producing has a major influence and controls the volume of production which he can sell at the different possible prices. But he will have to consider the elasticity of the total demand curve when he is contemplating a change in price because the elasticity of demand will show the responsiveness of his sales to the change in his price.

* Importance in Free Enterprise Economy

The entire output in a free enterprise economy is directed and controlled by the nature of consumer’s demand. If production is to be profitable, then the total output of goods and services produced must be adjusted determining influence upon the producers total demand for the different factors of production.

* In Determination of Taxation Policies

Elasticity of Demand is also of great help to the government in enabling it to formulate appropriation taxation policy. Taxes impose burden upon the tax payers and this burden should be equitably distributed between the different groups of tax payers.

* In Determination of International Trade Policies

This concept is also of great significance in international trade policies, i.e., in the calculation of the terms of trade. By terms of trade, we mean the rate at which a unit of domestic commodity will be exchanged for unit of another commodity of another country. The terms of trade are determined by reference to the mutual elasticities of demand of the two countries for each other goods. It is also helpful in solving the problem of devaluation of the currency of a country.

* Monopoly Price Determination

A monopolist has to consider the elasticity of demand for his product when he determines its price or changes the existing price. If the elasticity of demand for his product is highly elastic, he will maximise his profits by fixing a lower price; because of a lower price he is able to increase his sales. If the elasticity of demand for his product is less elastic or highly inelastic, he is in a position to fix a high price for the commodity.

* In the Determination of Exchange Rate

It is of great help in enabling the government to fix a proper rate of foreign exchange for its currency that will keep her balance of payments in equilibrium. At the time of taking decision to devalue or revalue the currency, the government should carefully study the nature of the elasticity of demand and supply of its exports as well as for its imports.

**4.5 Types of Elasticity of Demand**

According to economics literature there are top three types of elasticity of demand. These are as follows:

* **Price Elasticity of Demand**
* **Income Elasticity of Demand**
* **Cross Elasticity of Demand**

## Price Elasticity of Demand

The price elasticity of demand is the response of the quantity demanded to change in the price of a commodity. It is assumed that the consumer’s income, tastes, and prices of all other goods are stables (steady). It is normally measured as a percentage change in the quantity demanded divided by the percentage change in price. It is represented as Ep. It is calculated as,

Ep =

Where:

Percentage Change in Quantity =

Percentage Change in Price =

Example one (1)

Calculate the price elasticity of demand for ***ECONOMICS FOR BEGINNERS*** textbook whose quantity demanded decreased from 350 units to 300 units when its price rose from Le150,000 to Le200,000.

***ANSWER***

Ep =

Where:

Percentage Change in Quantity =

Percentage Change in Price =

Original Quantity = 350 units

New Quantity = 300 units

Percentage Change in Quantity =

=

=

= 14.29%

Original Price = le150,000

New Price = le200,000

Percentage Change in Price =

=

=

= 33.3%

Ep =

= 0.43

Therefore, the price elasticity of demand for the ECONOMICS FOR BEGINNERS is 0.43.

***NOTE***: we can also calculate ***Price Elasticity of Demand*** using the equation system. Here we utilize the following formula:

Ep =

Ep =

**Example Two (2)**

Given the demand function of JUSGAN INVESTMENTS, Q = 100 - 0.5P. Calculate the price elasticity of demand when p = 15.

***ANSWER***

Given,

Since p=15, we substitute p into the demand function

Ep =

=

= (-0.5) x 0.162

= -0.026

= 0.026

* **Types of price elasticity of demand**

The price and quantity demanded relationship compel us to deduce the various types of price elasticity of demand. According to this relationship there are five types of price elasticity. The following are the basic five fundamental types of price elasticity of demand:

(i) Perfectly elastic demand,

(ii) Perfectly inelastic demand,

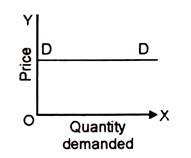
(iii) Unit elastic demand,

(iv) Less elastic or less than unit elastic demand,

(v) More elastic or more than unit elastic demand.

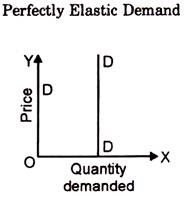
***(i) Perfectly Elastic Demand***

This is a situation where there is only un-perceptible change in price but demand changes unexpectedly. Its demand curve is parallel to axis of X. The numerical co-efficient of such elasticity of demand is infinity. In perfect competition model the demand curve is perfectly elastic. However, such situation is very rare in whole-sale market and stock and share market where a small change brings unprecedented demand.



**(ii) Perfectly Inelastic Demand**

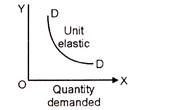
When there is considerable change in price, but the quantity demanded does not show any change, we call it perfectly inelastic demand. Such a situation rarely occurs in practice. At the most salt may be regarded as the only commodity with almost perfectly inelastic demand for most of the consumers. Its demand curve will be parallel to the Y-axis.



Here, Demand Curve DD is vertical. It suggests that demand remains unchanged at any price.

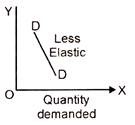
(iii) Unit Elastic Demand:

If change in the quantity demanded changes proportionately to change in price it is called unit elastic demand. Its curve is called Rectangular Hyperbola. The numerical value of the co-efficient of Elasticity of Demand in unity.



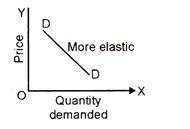
(iv) Less Elastic or Less than Unit Elastic Demand:

When the quantity demanded changes proportionately less than the change in price, it is less than unit elastic demand. The numerical value of the co-efficient of elasticity is less than unity.



**(v) More Elastic or More than Unit Elastic Demand**

When the quantity demanded changes more than the proportionate change in price, it is called more elastic demand. The numerical value of the co-efficient of elasticity is more than unity.

****

It should be remembered that the same elasticity is not available throughout the length of a particular demand curve. The above classification of the price Elasticity of Demand applies to the different segments of a demand curve.

## Income elasticity of demand

Income Elasticity of Demand for a commodity shows the extent to which a consumer’s demand for that commodity changes as a result of a change in his income. It shows the responsiveness of a consumer’s purchases of that commodity to a change in his income.

In a simple term it is defined as the ratio of proportionate change in the quantity demanded of the commodity to a given proportionate change in the income of the consumer.

It can be measured by the application of the following formula. Ey represents the income elasticity of demand. Here we have two kinds of goods in our analysis. These are normal goods and inferior goods. If Ey is positive i.e. greater than zero (Ey>0) then the good is a normal good and if Ey is negative i.e. lesser than zero (Ey<0) then the good is an inferior good.

Note: Normal good is further divided into ***luxury and necessity goods.***

A good is considered to be a ***luxury*** when Ey is greater than or equal to one (Ey≥ 1).

A good is considered to be a ***necessity*** when Ey is less than one but greater than zero (0< Ey< 1).

Ey =

**Example Three (3).**

Given that a consumer’s income is $150 and was able to buy 80 units of a good. The consumer’s demand rose to 120 units as a result of an increase in income to $220. Calculate the income elasticity of demand and interpret the result.

***ANSWER***

Ey =

Where:

Percentage Change in Quantity =

Percentage Change in Income =

Original Quantity = 80 units

New Quantity = 120 units

Percentage Change in Quantity =

=

=

= 50%

Original Income = $150

New Income = $220

Percentage Change in Income =

=

=

= 46.67%

Ey =

= 1.07

Therefore, the income elasticity of demand of the consumer is 1.07. Since Ey is greater than zero, the good is question is a normal good

***NOTE***: we can also calculate ***Income Elasticity of Demand*** using the equation system. Here we utilize the following formula:

Ey =

Ey =

Let now use this formula to solve example three. c

Ey =

= Qn – Qo = 120 - 80 = 40

= Yn – Yo = 220 -150 = 70

Y= Y0 = 150

Q = Q0 = 80

e1 =

Ey = 1.07

**Types of Income Elasticity**

There are basically five types of income elasticity. These are:

(i) Zero Income Elasticity of Demand

This refers to the situation where a given increase in consumer’s money income does not result in any increase or decrease in the quantity demanded of the commodity. The quantity bought of the commodity remains constant, despite the increase in the consumer’s income and in that case Total Expenditure remains constant. Symbolically, zero income elasticity of demand is expressed as Ey = 0.

(ii) Negative Income Elasticity of Demand

This refers to that situation where a given increase in the consumer’s money-income is followed by an actual fall in the quantity demanded of the commodity. This happens in the case of economically inferior goods. Here the total expenditure declines with the increase in income. Symbolically negative income elasticity of demand is expressed as Ey< 0.

(iii) Unitary Income Elasticity of Demand

This refers to the situation where the proportion of the consumer’s income spent on the commodity in question is exactly the same both before and after the increase in income. The income elasticity of demand here is equal to unity. Total expenditure increases in a constant ratio, proportionate to increase in income. Symbolically, unitary income elasticity of demand is expressed as Ey = 1.

(iv) Income Elasticity of Demand Greater than Unity

This refers to the situation where the consumer spends a greater proportion of his money-income on the commodity in question when he becomes richer and more prosperous. The income-elasticity of demand is greater than unity in the case of luxuries. In this total expenditure increases more proportionate than the increase in income. Symbolically, it is expressed as Ey> 1. If the value of Ey is greater than one, income Elasticity of Demand is said to be highly elastic.

(v) Income Elasticity of Demand Less than Unity

This refers to the situation where the consumer spends a smaller proportion of his money-income on the commodity in question when he becomes richer and more prosperous. The income elasticity of demand is less than unity in the case of necessaries, the expenditure on which increases in a smaller proportion when the consumer’s money income goes up. Symbolically, it is expressed as Ey< 1. If the value of Ey is less than one, income elasticity of demand is said to be low.

## *Cross elasticity of demand*

This demand is the ratio of the proportionate change in the quantity demanded of a commodity X in response to a given proportionate change in the price of some related commodity Y. It is denoted as Ec.

It may be calculated from the following formula:

Cross elasticity of demand of X and Y =

OR

Ec =

Cross-price elasticity of demand is a very useful concept as its value determines whether goods are substitutes or complements.

* When Ec is positive (greater than zero), the goods are substitutes.
* When Ec is negative (less than zero), the goods are complements.
* When Ec is 0, the goods are said to be unrelated or independent or neutral.

**EXAMPLE FOUR (4)**

Calculate the cross-price elasticity of demand if the quantity demanded of BAMA mayonnaise increases from 20 to 35 bottles, given an increase in the price of PADI mayonnaise from $5 to $8 per bottle and interpret your result.

***ANSWER***

Ec=

Where:

Percentage Change in Quantity Demanded for BAMA =

Percentage Change in Price of PADI =

Original Quantity = 20 units

New Quantity = 35 units

Percentage Change in Quantity Demanded for BAMA =

=

=

= 75%

Original Price = $5

New Price = $8

Percentage Change in Price of PADI =

=

=

= 60%

Ec =

= 1.25

Therefore, the cross elasticity of demand is 1.25, which means the goods (BAMA and PADI) are substitutes.

**Types of Cross Elasticity of Demand**

(i) Positive Cross Elasticity of Demand

(ii) Negative Cross Elasticity of Demand.

(i) Positive Cross Elasticity of Demand

The cross elasticity of demand depends on the nature of cross demand between the two commodities under consideration X and Y. They may be either substitutes or complementary goods. In case the commodities X and Y are substitutes, cross Elasticity of Demand will always be positive; because a rise in the price of X will lead to a rise in the demand for Y ; price of Y and demand for X change in the same direction. The numerical value of the elasticity here will depend upon the substitutability of the two commodities.

(ii) Negative Cross Elasticity of Demand.

On the other-hand in case the commodities X and Y are complementary to each other, cross elasticity of demand will be negative; because a rise in the price of Y will lead to a fall in the demand for X. Here the price of Y and demand for X change in opposite direction. Since cross elasticity of demand refers to the degree of substitutability of one commodity for another, as the price of one of them changes, it may also be called substitution Elasticity of Demand.

***4.6 Elasticity of Supply***

The elasticity of supply establishes a quantitative relationship between the supply of a commodity and it’s price. Hence, we can express the numeral change in supply with the change in the price of a commodity using the concept of elasticity. Note that elasticity can also be calculated with respect to the other determinants of supply.

However, the major factor controlling the supply of a commodity is its price. Therefore, we generally talk about the price elasticity of supply. The price elasticity of supply is the ratio of the percentage change in the price to the percentage change in quantity supplied of a commodity.

**4.7 *Price elasticity of supply***

Price elasticity of supply, denoted by Es, measures the degree of responsiveness of quantity supplied of a good or service to changes in the price of that good or service. It shows how quantity supplied changes as price of the good changes. The Es can be calculated using the formula below:

Es =

OR

es =

es =

**QUESTION FIVE (5)**

The supply function MAM G INVESTMENTS is Qs = 10 + 4P at P = 7, calculate the price elasticity of supply.

**ANSWER**

Es =

= 4

Qs = 10 + 4(7) = 10 + 28

Qs = 38

Es = 4

Es = 4

Es = 1

**EXCERCISE**

Calculate the price elasticity of supply of a commodity if there is a rise in quantity supplied from 40 to 60 units as a result of a rise in price from 12 to Le 15.

**Types of price elasticity of supply**

There are five types of price elasticity of supply. These are:

1. Relatively Greater-Elastic Supply

When the change in supply is relatively more when compared to the change in price, we say that the commodity has a relatively greater-elastic supply. In such a case, the price elasticity of supply assumes a value greater than 1. This is represented below.

Pa

Po

0

Q0

Qa

Q

S

∆Qs

P

A slight change in price brings about a large change in quantity supplied. Clearly, the percentage change in quantity supplied far outweighs the percentage change in price.

Goods that are elastic in nature are those with close substitutes.

1. Relatively Less-Elastic Supply

When the change in supply is relatively less when compared to the change in price, we say that the commodity has a relatively-less elastic supply. In such a case, the price elasticity of supply assumes a value less than 1. This is illustrated below.

Pa

P0

Q0

Qa

0

Q

S

P

It can be seen that a large increase in price will increase the quantity supplied only by a small proportion.

1. Unitary Elastic

For a commodity with a unit elasticity of supply, the change in quantity supplied of a commodity is exactly equal to the change in its price. In other words, the change in both price and supply of the commodity are proportionately equal to each other. To point out, the elasticity of supply in such a case is equal to one. Further, a unitary elastic supply curve passes through the origin. This is illustrated below.

Pa

P0

Q0

Qa

P

S

Q

0

1. Perfectly Elastic supply

A commodity with a perfectly elastic supply has an infinite elasticity. In such a case the supply becomes zero with even a slight fall in the price and becomes infinite with a slight rise in price. This is indicative of the fact that the suppliers of such a commodity are willing to supply any quantity of the commodity at a higher price. A perfectly elastic supply curve is a straight line parallel to the X-axis. This is illustrated below.

Q

P ⃰

Q0

Q1

Q2

Q3

0

S

P

1. Perfectly Inelastic Supply

A service or commodity has a perfectly inelastic supply if a given quantity of it can be supplied whatever might be the price. The elasticity of supply for such a service or commodity is zero. A perfectly inelastic supply curve is a straight line parallel to the Y-axis. This is representative of the fact that the supply remains the same irrespective of the price. This is illustrated below.

P

P3

P2

P1

P0

0

Q⃰

Q

S

The supply of exclusive items, like the painting of Mona Lisa, falls into this category. Whatever might be the price on offer, there is no way we can increase its supply.

***How to Find Equilibrium Price and Quantity?***

Equilibrium is the situation where we can see the equality of market demand quantity and supply quantity. In other words, it is a situation where an economy shows the equality of two opposite market forces. Economic equilibrium is a situation of the balance of economic forces and in this article, we’ll talk about the equilibrium Price and Quantity. It further illustrates the circumstance where the point supply equals to demand of a product with the behavior of equilibrium price and quantity determined at the point in which supply and demand curves intersect.

Market equilibrium can be calculated in various ways. In this book, we’ll look at the following methods.

1. Demand and Supply schedule
2. Demand and Supply curves
3. Demand and supply formulas

### **Demand and Supply Schedule**

Demand and Supply schedule shows the sample of market demand and supply as well as the price level relevant to different stages.

|  |  |  |
| --- | --- | --- |
| **Price Level** | **Quantity of Demand (QD)** | **Quantity of Supply (QS)** |
| 0 | 300 | 0 |
| 5 | 250 | 50 |
| 10 | 200 | 100 |
| 15 | 150 | 150 |
| 20 | 100 | 200 |
| 25 | 50 | 250 |
| 30 | 0 | 30 |

From the above schedule determine the equilibrium price and quantity.

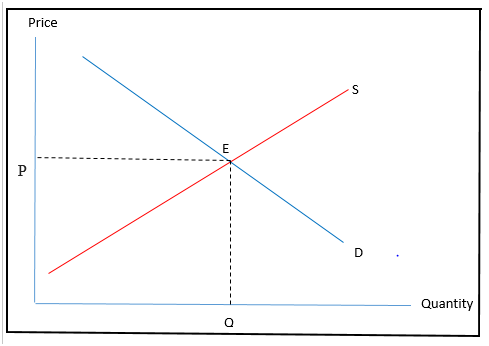
***Answer***

According to the figures in the above table, Market Equilibrium quantity is 150 and the Market equilibrium price is 15. It is the point where QD = QS, of the given figures.

### **Demand and Supply Curves**

This is the way how economist use demand and supply curves to prove the market equilibrium. This is a graphical representation of the market behavior and clearly shows the intersection point in the graph itself.

Using the previous demand and supply schedule we can create market equilibrium as below.



You can see the competitive equilibrium in above curve as 150 quantities and the price of $15.00 in this curve blue color line shows market demand and the orange color line shows market supply.

Where:

P = price

Q = quantity demanded and supplied

S = supply curve

D = demand curve

QE = equilibrium price

### **Demand and Supply Formulas**

With the same example let’s see how to calculate market equilibrium as below.

QD = Quantity demanded

QS = Quantity supplied

 P = Price

Condition: At the equilibrium point quantity demanded equals to the quantity supplied.

QD = QS

By substituting demand and supply formula to the given example equilibrium quantity and price can be calculated.

**Demand formula QD = a- bp**

**Supply formula QS = a + bp**

**a** is the intercept of the demand and supply curves. In other words, it is the demand and supply quantities at price zero.

**b** is the slope of two curves. This can be calculated by ΔQ / ΔP.

**EXAMPLE SIX**

**Given the demand and supply equations** as:.

QD = 300 – 10P,

QS = 0 + 10P

### You are required to find Equilibrium Price and Quantity.

**ANSWER**

**QD**                  =       **QS**

300-10p         =   0 +10P

300 / 20         =   20P / 20

 P                    =  15

By substituting P and Q values to both demand and supply equations, equilibrium price and quantity can be found as follows.

QD = 300-10P                                          QS =0+10P

QD = 300-10x 15                                     QS = 0+10×15

QD = 150                                                QS = 150

**EXAMPLE SEVEN (7)**

The market demand and supply functions for a laptop are as follows:

Qd = 35 – 2P (market demand function)

Qs = 20 + 3P (market supply function)

where Qd is quantity demanded, Qs is quantity supplied and P is market selling price.

Determine the equilibrium price and quantity of the laptop.

**ANSWER**

Qd = 35 -2P

Qs = 20 + 3P

At equilibrium, Qd = Qs

35 – 2P = 20 + 3P

35 – 20 = 3P + 2P

15 = 5P

P\* = 15/5 = 3

P\* = 3 (equilibrium price)

To get the equilibrium quantity (Q\*), we substitute P\* = P = 3 into either the demand or the supply function as follows:

Qd = 35 – 2P (demand function) Qs = 20 + 3P (supply function)

At P=3, At P=3,

Qd = 35 -2(3) Qs = 20 + 3(3)

= 35 – 6 = 20 + 9

Q\* = Qd = 29 (equilibrium quantity) Q\* = Qs = 29 (equilibrium quantity)

We can see that at equilibrium, quantity demanded equals quantity supplied. So at equilibrium price (p\*) = 3, Qd and Qs are equal.

Qd = Qs = 29

## What are the Special Features of Equilibrium in a Competitive Market?

The equilibrium shows following special features in a competitive market. These features can be used to identify and measure the market equilibrium.

1. Demand quantity is always equal to Supply quantity.
2. Demand price of the competitive economy is always equal to the price of supply.
3. There’s no high demand or high supply.
4. All the external forces which can influence the price and quantity is always absence in this kind of condition.
5. The consumer planned quantity is equal to the planned prices of supply.

### Conclusion

Equilibrium is always related to demand quantity and supply quantity. Market equilibrium can be found using supply and demand schedule, demand and supply curves and formula of demand and supply. The condition of market equilibrium shows the absence of external forces which can influence the price as well as quantity.

**Chapter 5**

**INTRODUCTION TO CONSUMER BEHAVIOUR**

***5.1 General Introduction***

The consumption pattern in the economy decision making is spearheaded by consumer. The consumer is referred to as the one who buys goods and services for satisfaction of wants. The main objective of the consumer is to get maximum satisfaction from spending his/her income on various goods and services. This satisfaction is also considered utility.

The theory of consumer behaviour looks at those factors that would explain the behaviour of consumers with respect to changes in the prices of commodities. This explains the main reason why more or less of a commodity is bought at a particular price.

There is always a need for the consumers to have comprehensive knowledge of all the essential information required for their decision making. These bits of information consist of the consumer’s income, the available commodities and their market prices. The consumer must always be in a position to compare and contrast the satisfaction (utility) he derives from different basket of commodities.

As producers it is also important to understand the utility of a good or service because it will directly influence the demand, and therefore price, of that good or service.

***5.2 Definitions of Utility***

The following are definitions given by prominent economics scholars:

The term **utility** is an economic term that was introduced by **Daniel Bernoulli** a Swiss mathematician in the mid-18th century. He referred to utility as the total satisfaction derived from consuming a good or service.

According to **Fraser** in his work on consumer behaviour “On the whole in recent years the wider definition is preferred and utility is identified, with desireness rather than with satisfyingness.”

According to **Prof. Waugh** “Utility is the power of commodity to satisfy human wants.”

According to **Prof. Hobson** “Utility is the ability of a good to satisfy a want.”

According to **Mohamed Ibrahim** **Justice Ganawah** “It is the satisfying power of a commodity”.

***5.3 Measurement of Utility***

There are two approaches to utility. These are:

* **Cardinal Utility Approach**
* **Ordinal Utility Approach**

The Measurement of utility in economics is essential as it will determine the value of the goods and services.Utility is measured differently in both these approaches.

* **Cardinal Measure of Utility**

The cardinal measurement of utility was put forward by the classical economists. They maintain that utility can be measured in the same way as weight or height. It is assumed that the cardinal measurement of utility can be in numerical terms and the imaginary measure is called utils. For instance, you have just consumed a pint of coke and a fried chicken. If you get more satisfaction form the coke than the fried chicken you can assign higher utils to the coke than the fried chicken. Let say you have 15 utils as the utility derived from the coke and 10 utils from the fried chicken.

But, utils cannot be taken as a standard unit for measurement of utility in economics as it can vary from individual to individual. Hence, several economists suggested the measurement of utility in monetary terms. This means that utility can be measured in terms of money or price which the consumer is willing to pay for the goods or services. In the above example, suppose 1 util is assumed to be equal to Le10. A pint of coke ice will yield utility worth Le150, while the fried chicken may yield utility worth Le100. This is termed as value of utility in terms of money.

* **Ordinal Measure of Utility**

Contemporary economists ignored the concept of cardinal measurement of utility in economics. They thought that utility is an abstract and theoretical concept and thus cannot be measured in numbers and absolute terms. Therefore, they recommended that a consumer can rank various combinations of goods and services in order of his preferences. For example, if a consumer consumes two goods, shawarma and pizza, then he can indicate whether he prefers shawarma over a pizza or the other way around, or whether he is indifferent between shawarma and pizza i.e., both are equally satisfying.

***5.4 Major Utility Concepts***

It is crystal clear that the cardinal utility approach measured utility in absolute numerical values in terms of utils or they can also be measured in monetary terms. Let us now turn to the key concepts i.e., Total Utility and Marginal Utility.

***5.4.1 Total Utility (TU)***

Total utility (TU) refers to the overall satisfaction got from the consumption of all possible units or quantity of a commodity by a consumer. It measures the total satisfaction obtained from the consumption of all the units of that good.

For example, you go to drink a star beer. The first (1st) beer gives you a satisfaction of 30 utils, and the second (2nd) one gives you a satisfaction of 25 utils, then the total utility from two beers is 30+25=55 utils. If the third (3rd) beer generates a satisfaction of 15 utils, the total utility from three beers will be 30+25+15=70 utils.

The total utility derived from the first unit of a commodity is known as initial utility. Total utility is zero at zero level of consumption. TU can be calculated as,

TUn = U1+ U2+U3+…………..+Un

Where,  
TUn = Total Utility from n units of a given commodity  
U1, U2, U3…………..,Un = Utility from the 1st, 2nd, 3rd…………nth unit  
n = number of units consumed

***5.4.2 Marginal Utility (MU)***

Marginal utility is the extra satisfaction derived from the consumption of one additional unit of the given commodity by a consumer. It is the utility derived from the last unit of a commodity purchased. Let consider the start beer example given above, when the 3rd beer is consumed, total utility increases from 55 utils to 70 utils. The additional 15 utils from the 3rd beer is the marginal utility MU. Therefore, marginal utility is the addition made to total utility by consuming one more unit of a commodity. MU can be calculated as,

MUn = TUn – TUn-1

Where,  
MUn = Marginal utility from nth unit  
TUn = Total utility from n units  
TUn-1 = Total utility from n-1 units  
n = Number of units of consumption

When the change in units of commodity consumed is more than one, MU can also be calculated as,

MU=

MU = OR MU=

***5.4.3 Graphical relationship between total utility and marginal utility***

The total utility (TU) increases with an increase in the consumption of a commodity as long as marginal utility (MU) is positive. In phase (d), total utility (TU) increases but at a diminishing rate because marginal utility (MU) in phase (e) from each successive unit tends to diminish. When total utility reaches its maximum at point m, marginal utility becomes zero at point m. This is known as point of satiation. The total utility (TU) curve stops rising at this stage. When the consumption is increased beyond this point, the point of satiation, total utility (TU) start falling and marginal utility (MU) becomes negative. This relationship between total utility (TU) and marginal (MU) is depicted by the Figure 5.1

Mu

0

(e)

(d)

Q

Q

n

m

Tu

Tu

Mu

0

**5.4.4 Average Utility**

Average utility (AU) refers to the total utility divided by the quantity consumed. It is the satisfaction obtained per unit of a good consumed.

AU =

**5.5 Law of Diminishing Marginal Utility**

The law of diminishing marginal utility was given by H.H. Gossen, which is why it is also known as ‘Gossen’s first law of consumption’. It is also known as the ‘Fundamental Law of Satisfaction’ or ‘Fundamental Psychological Law.

The law of diminishing marginal utility expresses an important relationship between utility and the quantity of a commodity consumed. **Law of Diminishing Marginal Utility states that as we consume more and more units of a commodity, the utility derived from each successive unit goes on decreasing.**

Table 5.1

|  |  |  |
| --- | --- | --- |
| **Unit (Q)** | **Total utility (TU)** | **Marginal utility (MU) =** |
| 1 | 9 | - |
| 2 | 15 | 6 |
| 3 | 20 | 5 |
| 4 | 23 | 3 |
| 5 | 25 | 2 |

The first unit is 1. The consumer continues to consume additional units up to the 5th unit. TU rises up to 20 (maximum point) after consuming 3 units. Beyond this point, TU begins to fall. MU falls continuously as more units of the commodity are consumed.

It must also be noted that although the Law of diminishing marginal utility says that MU decreases, it does not say anything about the rate at which the MU decreases or whether it is uniform or variable. It is also important that each unit of the commodity consumed is of the same quantity and the amount does not vary with repeated consumption.

**Assumptions of the Law of Diminishing Marginal Utility**

1. Cardinal measurement of utility is used.
2. It is assumed that utility is measured in monetary terms.
3. It is assumed that a reasonable quantity is consumed.
4. The consumption is assumed to be continuous.
5. The quality of the commodity consumed does not change.
6. The consumer is assumed to be rational.
7. The MU of one commodity has no relation to the MU of another commodity.
8. MU of money remains constant. As the consumer spends more on commodities, money becomes dearer to him and he tries to spend less which increases the MU of money. In this case, MU of money has to be constant to measure the MU of the commodity.
9. The prices of the commodities and the income of the consumer are assumed to be fixed.
10. It is assumed that the consumer has perfect knowledge of the various choices available to him.

**Chapter 6**

**PRODUCTION PROCESS**

***6.1 Meaning of Production***

Since the primary purpose of economic activity is to produce utility for individuals, we count as production during a time period all activity which either creates utility during the period or which increases ability of the society to create utility in the future.

**According to Bates and Parkinson** “Production is the organised activity of transforming resources into finished products in the form of goods and services; the objective of production is to satisfy the demand for such transformed resources”.

**According to J. R. Hicks** “Production is any activity directed to the satisfaction of other peoples’ wants through exchange”. This definition makes it clear that, in economics, we do not treat the mere making of things as production. What is made must be designed to satisfy wants.

***6.2 Types of Production***

The following are the general types production:

**1. Primary Production**

Primary production is carried out by ‘extractive’ industries like agriculture, forestry, fishing, mining and oil extraction. These industries are engaged in such activities as extracting the gifts of Nature from the earth’s surface, from beneath the earth’s surface and from the oceans.

**2. Secondary Production**

This includes production in manufacturing industry, viz., turning out semi-finished and finished goods from raw materials and intermediate goods— conversion of flour into bread or iron ore into finished steel. They are generally described as manufacturing and construction industries, such as the manufacture of cars, furnishing, clothing and chemicals, as also engineering and building.

**3. Tertiary Production**

Industries in the tertiary sector produce all those services which enable the finished goods to be put in the hands of consumers. In fact, these services are supplied to the firms in all types of industry and directly to consumers. Examples cover distributive traders, banking, insurance, transport and communications. Government services, such as law, administration, education, health and defense, are also included.

***6.3 Factors of Production***

Production of a commodity or service requires the use of certain resources or factors of production. Since most of the resources necessary to carry on production are scarce relative to demand for them, they are called economic resources.

Resources, which we shall call factors of production, are combined in various ways, by firms or enterprises, to produce an annual flow of goods and services.

**(1) Land and Natural Resources**

In economics the term land is used in a broad sense to refer to all-natural resources or gifts of nature.

As the Penguin Dictionary of Economics has put it:**“Land in economics is taken to mean not simply that part of the earth’s surface not covered by water, but also all the free gifts of nature’s such as minerals, soil fertility, as also the resources of sea. Land provides both space and specific resources”.**

From the above definition, it is quite clear that land includes farming and building land, forests, and mineral deposits. Fisheries, rivers, lakes, etc. all those natural resources (or gifts of nature) which help us (the mem­bers of the society) to produce useful goods and services.

**Features of Land**

* **Fixed supply**

The total land area of earth (in the sense of the surface area available to men) is fixed. Therefore, the supply of lands is strictly limited.

* **Alternative uses**

Although the total supply of land is fixed, land has alternative uses. The same plot of land can be used to set up factories or to grow wheat or sugarcane or even to build a stadium. This means that the supply of land to a particular use is fairly (if not completely) elastic.

* **No cost of production**

Since land is a gift of nature, it has no cost of production. Since land is already in existence, no costs are to be incurred in creating it. In this sense, land differs from both labour (which has to be reared, educated and trained) and capital (which has to be created by using labour and other scarce resources or by spending money).

* **Differences in fertility**

Another important feature of land is that it is not homogeneous. All grades (plots) of land are not equally productive or fertile. Some grades of land are more productive than others. And Ricardo argued that rent arises not only due to scarcity of land as a factor but also due to differences in the fertility of the soil.

* **Operation of the law of diminishing return**

Production on land is subject to the operation of the law of diminishing return. As Alfred Marshall has put it “while the part which nature plays in production shows a tendency to diminishing return, the part which man plays shows a tendency to increasing return”.

This simply means that as more and more workers are employed on the same plot of land, output per worker will gradually fall (because each additional worker will make less and less contribution to total product). The law of diminishing return refers to diminishing marginal product of the variable factor.

* **Mobility**

Land is not geographically mobile. But, it is occupationally mobile. In most parts of Sierra Leone, for example, land has many alternative uses. It might be used for farmland, roads, rail­ways, airlines, public parks, playgrounds, resi­dential housing, office buildings, shopping complex, and so on.

* **Return**

The income received by the owner of land is known as rent. It may be noted that rent is usually paid for something more than the use of land or another natural resource, but includes also an element of payment for another factor which is involved in making the resource available in a usable form.

***(2) Labour***

Labour is also a primary factor of production. Labour is that it provides a human service. It refers to human effort of any kind—physical and mental— which is directed to the production of goods and services. ‘Labour’ is the collective name given to the productive services embodied in human physical effort, skill, intellectual powers, etc.

**Features of Labour**

In examining labour markets, it is important to recognise that labour has a number of special characteristics which distinguish it from ordinary commodities.

* **Dual Role**

Another important point to note is that labour is not only a factor of production. The supplier of labour-the worker-is also a consumer. Thus, labour plays a dual role in a modern economy. Labour is both the subject and the object of production.

* **Labour is an end and means in itself**

A commodity is only a means of production and the object of production is its consumption by labour. Labour, therefore, becomes a means to its own end.

* **The individual sells his services but not himself**

The employer, however, must be able to exert some control or authority over the actions of employees. This is not a very simple matter, which can be covered unambiguously by a contract of employment. A great deal of energy has been devoted to planning systems for the direction of employees, and even a brief examination of the state of industrial relations in most countries shows that still much remains to be done.

* **Labour is inseparable from the labourer**

In other words, labour and the labourer go together. When the seller sells a commodity, he does not necessarily go with the commo­dity. But the labour can supply his labour only when he goes with it. Moreover, when a seller sells a commodity, he parts with it. But when a labourer sells his labour, he retains the quality with him. He may gain the satisfaction of his services, but he cannot be separated from the labour.

* **The individual must be present when the labour services are used and thus a fifth feature is that labour services are not transferable**

For example, a person who has agreed to carry out certain tasks cannot transfer his services to someone else to do the work, while he does something else. This contrasts with commodities which can be transferred among individuals.

One conse­quence of having to ‘deliver’ the services personally is that employees have strong views on how their services should be used. Working conditions are of central importance to workers. It also means that workers must live near their place of work. The location may significantly affect labour market decisions.

* **Labour services cannot be stored**

Labour cannot be ‘saved’ or stored for future use (although rest may enhance performance to some extent).

* **Labour is perishable**

A commodity, if it is not disposed off today, can be disposed off the next day and it may not lose its value. Labour, however, is perishable in this that if the labourer is not able to sell his services for a day he cannot get the value for that day. It is lost forever; it is because of this that labour has a weak bargaining power.

* **Labour is affected by surroundings**

A commodity is usually very much affected by its surrounding; a labourer is very much affected by the surroundings because he is a living being. Therefore, any change in atmos­phere has an effect on his health feelings etc.

* **The supply of labour is independent of its demand**

In case of most commodities, we see that supply usually varies with demand but in case of labour its supply is in no way related to demand. Both are determined by different factors.

* **Labour services are enhanced by training**

Skill acquisition is often a lengthy and costly process. However, adjust­ments in the labour market, such as increasing the supply of a particular skill, often requires a long time. This also means that individuals do not usually train for more than one occupation as they only have a limited working life over which to justify the investment.

* **The mobility of labour has two aspects**

(a) The spatial or geographical mobility of labour, which relates to the rate at which workers move between geographical areas and regions in response to differences in wages and job availability (e.g., a worker from West Bengal moving to Mumbai) and

(b) The occupational mobility of labour which relates to the extent to which workers change occupations or skills in response to differences in wages or job availability (e.g., a jute mill worker joining a tea garden).

It may apparently seem that labour is the most mobile of all factors—both occupationally and geographically. Workers can move both freely from one industry to another and from one region to another.

* **Reward**

The reward or price that is paid to labour in return for the services it performs is known as a wage or salary. A man’s wages are asso­ciated with his productivity or efficiency and this, in its turn, depends on a variety of factors including the education and job training he has received, his innate skill and the extent to which he is motivated to put his best effort in the work he is doing.

***(3) Capital***

Capital, the third agent or factor is the result of past labour and it is used to produce more goods. Capital has, therefore, been defined as ‘produced means of production.’ It is a man-made resource. In a board sense, any product of labour-and-land which is reserved for use in future production is capital.

To put it more clearly, capital is that part of wealth which is not used for the purpose of consumption but is utilised in the process of production. Tools and machinery, bullocks and ploughs, seeds and fertilizers, etc. are examples of capital. We have already identi­fied certain things described as capital in our discussion on producers’ goods.

Even in ancient times, capital was created for producing food, hunting animals and for the transportation of goods. At that stage capital goods consisted of simple tools and implements. Even in the least developed countries some capital is used. In such countries people make use of simple ploughs, axes, bows and arrows, and leather bags to carry water.

* **Classification of Capital**

Capital can be classified in two broad categories that which is used up in the course of production and that which is not.

* Fixed capital means durable capital like tools, machinery and factory buildings, which can be used for a long time. Things like raw materials, seeds and fuel, which can be used only once in production are called circulating capital.
* Circulating capital refers to funds embodied in stocks and work-in- progress or other current assets as opposed to fixed assets. It is also called working capital.

**Two Features of Capital**

* Firstly, it entails a sacrifice, since resources are devoted to making non-consumable capital goods instead of goods for immediate con­sumption.
* Secondly, it enhances the producti­vity of the other factors, viz., land and labour.
* **Capital Formation**

People use capital goods like machines, equipment, etc. because capital goods are the creators of other goods. But this is not the whole truth. People use capital for another important reason to produce goods with less effort and lower costs than would be the case if labour were not assisted by capital. But in order to use capital goods people must first produce them. This calls for a sacrifice of current consumption.

When people use their labour to produce capital goods like textile producing machines, they can use the same labour for producing consumer goods like textiles. As Stan Lake has put it “The opportunity cost of the capital goods is the potential output of consumer goods which has to be foregone in order to produce that capital, the production of capital demands abstinence from current consumption.”

**Factors Affecting Capital Formation**

**The creation of capital depends on two things:**

(a) Savings and

(b) a diversion of resources (from the production of consumption goods to meet current needs to the production of capital goods to meet future needs).

Saving is the difference between current income and current consumption. In other words, it is the act of foregoing current consumption.

It means that resources otherwise used to produce consumer goods are set aside for producing capital goods. If people choose not to buy some consumer goods, with some part of their current income, they refrain from buying (utilising) the services of the factors required to make those goods.

These factors might, therefore, remain idle. But these savings may be borrowed and utilised by business firms (entrepreneurs) to finance the construction of capital goods. This is the second step—the diversion of resources for the production of consumer goods to the production of capital (producers) goods. It may be noted that savings make possible capital accumulation. It does not cause it.

**In short, capital formation depends on savings, which, in its turn, depends on two things:**

(1) The capacity to save and

(2) The desire to save.

The capacity to save depends on income and the existence of savings institutions like banks, insurance companies, post offices, stock exchanges, etc. If income is low, savings will also be low. Even if income is high savings will be low in the absence of the above-mentioned savings institutions.

**The desire to save depends on**

(1) the rate of interest and (2) stability in the value of money (i.e., the rate of inflation).

If the rate of interest is high people will be eager to save more by curtailing their current consumption. People will also be eager to save more if they expect that there will exist reasonable price stability in the economy in future.

* **Mobility of Capital**

Capital is both geographically and occupationally mobile. However, a certain portion of a nation’s capital stock which consists of such things as railway networks, blast furnaces and shipyards are highly specialised equip­ment and are virtually immobile in the geo­graphical sense. It is physically possible to dismantle them and move them to different sites or locations, but the cost of doing so will be so great that it will not be economically feasible to do so.

Some capital equip­ment is mobile in both the geographical and occupational sense. Examples of such capital equipment are electric motors, machine tools, hand tools, typewriters, and lorries. Such equipment can be used effectively in a wide variety of industries and are capable of moving from one location to another at very little cost.

* **Return**

The earning of capital, i.e., the price that has to be paid for it, is known as interest. If it stated as percentage of the principal, represen­ting the sum paid by a borrower who needs finance to purchase a piece of capital equip­ment.

***(4) Enterprise (Organisation)***

Organisation, as a factor of production, refers to the task of bringing land, labour and capital together. It involves the establishment of co-ordination and co-operation among these factors. The person in charge of organisation is known as an organiser or an entrepreneur. So, the entrepreneur is the person who takes the charge of supervising the organisation of production and of framing the necessary policy regarding business.

**Functions or Role of the Entrepreneur**

The entrepreneur in modern business performs the following useful functions:

* **Decision-making**

The primary task of an entrepreneur is to decide the policy of production. An entrepreneur is to determine what to produce, how to produce, where to produce, how much to produce, how to sell and so forth. Moreover, he is to decide the scale of production and the proportion in which he combines the different factors he employs. In brief, he is to make vital business decisions relating to the purchase of productive factors and to the sales of the finished goods or services.

* **Management Control**

Earlier writers used to consider management control one of the chief functions of the entrepreneur. Management and control of the business are conducted by the entrepreneur himself. So the latter must possess a high degree of management ability to select the right type of persons to work with him. But the importance of this function has declined, as the business nowadays is managed more and more by paid managers.

* **Division of income**

The next major function of the entrepreneur is to make necessary arrangement for the division of total income among the different factors of production employed by him. Even if there is a loss in the business, he is to pay rent, interest; wages and other contractual income out of the realised sale proceed.

* **Risk-taking and uncertainty-bearing**

Risk-taking is perhaps the most important function of an entrepreneur. Modern production is very risky as an entrepreneur is required to produce goods or services in anticipation of their future demand. Broadly, there are two kinds of risk which he has to face.

Firstly, there are some risks, such as risks of fire, loss of goods in transit, theft, etc., which can be insured against. These are known as measurable and insurable risks.

Secondly, some risks, however, cannot be insured against because their probability cannot be calculated accurately. These constitute what is called uncertainty (e.g., competitive risk, technical risk, etc.). The entrepreneur under­takes both these risks in production.

* **Innovation**

Another distinguishing function of the entrepreneur as emphasised by Schumpeter, is to make frequent inventions- invention of new products, of new techniques and discovering new markets—to improve his competitive position, and to increase earnings.

* **Importance of Enterprise**

The above description indicates the supreme position of the entrepreneur in production. This is particularly true in the capitalistic or even mixed economy which is based on the price-profit system. In the socialistic eco­nomy, the state becomes the entrepreneur; the scope of private entrepreneur is extremely limited in such an economy.

It is to be noted that the importance of the entrepreneur has been declining with the growth of joint-stock business and state-undertakings. This is due to the fact that risk is borne by the share­holders and the day-by-day control of the business is generally in the hands of salaried managers or managing directors.

* **A Separate Factor**

Some economists feel that the above entrepreneurial functions are no different from those of a particular and specialised form of labour. They point out that risk- bearing is not something peculiar to the entrepreneur.

Many types of labour have to take risk. For example, the miner or the air- hostess runs the risk of personal injury and life and most forms of labour run the risk of unemployment. But enterprise is a separate factor because the first three factors are substitutable to some extent, but the fourth factor is a specific factor and cannot be substituted by any other factor.

* **Mobility**

Enterprise seems to be the most mobile of all the four factors. There is need to train labour for some specific tasks to be performed in a particular industry (say, road transport service, hotel business or computer operation). Once labour is trained for some specific tasks appropriate to some particular industry, it cannot be easily and quickly transferred to some other industry to do a completely different job. But the basic functions of the entrepreneur-organisation, management and risk-taking are the same in all industries.

Whatever the nature, duration and extent of economic activity and entrepreneur has to raise capital to organise the factors of production, and take certain fundamental decisions on what, how and where to produce. The efficient operation of an enterprise, irrespective of its nature and form, depends on certain human relations and human qualities such as initiative, leadership orga­nisational ability and controlling capacity.

Very few people have these rare qualities. But those who have such qualities are able to operate effectively and efficiently in almost any industry.

* **Return**

The return to the entrepreneur is profit. Profit is the reward for successful conduct of business.

***6.4 Production Possibility Curve (PPC)***

Production possibility curve analysis graphically the problem of scarcity and choice present in an economy. It shows the maximum possible production of different combinations of two goods that can be produced with the given technology and resources. It also analyzes how much the production of one commodity has to be decreased when producing some other commodity.

The curve is also known as product transformation curve because when moving from one point to another, the uses of resources from one commodity transfer to the production of another commodity. The concept of the production possibility curve is based on the following assumptions:

1. The factors of production are limited.  
2. The factors are used only for the production of two goods x and y.  
3. The production technique is given.  
4. The factors are fully utilized.  
5. It is based on a short run.

Based on the above assumptions, the PPC can be explained with the help of table and diagram as follows: -

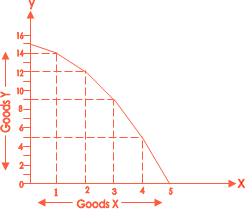
**Production Possibility Curve (PPC)**

|  |  |  |
| --- | --- | --- |
| Production possibilities | Goods x (In thousands) | Goods y (In thousands) |
| A | 0 | 15 |
| B | 1 | 14 |
| C | 2 | 12 |
| D | 3 | 9 |
| E | 4 | 5 |
| F | 5 | 0 |

Above table shows the various production possibility of goods x and y. If all the resources are used for the production of goods x, 5000 of goods x are produced. Similarly, if all the resources are employed for the production of goods y, 15000 of goods y are produced. These are the two extremes of production possibilities. In between these two extremes, there are many other production possibilities, like at combination B, thousand of goods x and 14000 of goods y can be produced. Similarly, at combination ‘C’, ‘D’ and ‘E’, the production possibilities of goods x are 2, 3, & 4 thousand and goods y are 12, 9 and 5 thousand are produced.

Therefore, it is clear that more of one goods can be obtained by cutting down the production of other goods. For example, if the producer produces within the combination ‘C’, the producer is ready to sacrifice two units of goods y for the production of one more unit of goods x.

A possibility schedule has been shown by the following figure: -



In the above figure, goods x and y are measured along x-axis and y-axis respectively. AF is the production possibility curve which is derived by joining the production possibility points A, B, C, D, E and F. Each point on PPC shows the efficient for the production.

***6.4.1 The shift in Production Possibility Curve (PPC)***Production Possibility Curve shift either downward or upward. PPC shift downward or upward due to the following reasons: –

**1. Change in the capital.**  
Increase in capital increases the quantity of production due to which PPC shift upward. And if capital investment decreases, then the production will also decrease which causes a downward shift in PPC.

**2. Change in labour force.**  
If the efficiency of labour force increases, then the production of goods also increases, as a result, the burden of labour force production will decrease. As a result, PPC shifts downward.

**3. Change in technology.**  
If the production technique is improved, then the production will increase which brings upward shift in PPC. If old technology is used in the production process, production will decrease which brings downward shift in PPC.

**4. Change in Time period.**  
PPC can shift due to the change in the time period. In the long run, the economy can gain efficiency which results in an increase in productivity. As a result, PPC shifts upward, but the economy can’t get efficiency in production, the production decreases and PPC shift downward.

Similarly, proper management of available resources, increase in economic growth, new raw materials, education, training to labour etc. increase the production which will shift the PPC upward. But mismanagement of available resources, decrease in economic growth, adequate raw materials, etc. decrease the production which will shift the PPC downward.

**6.4.2 Why PPC expands outwards?**  
Ans: PPC expands outwards due to different factors. Investment in new plants and machinery will increase the stock of capital. New raw materials may be discovered. Technological advances take place through new inventions; education and training make labour more productive. All these factors lead to increase in the production possibility of the country and while illustrating this growth of potential output in PPC, there will be an outward expansion of PPC.

**Chapter 7**

**MARKET STRUCTURE**

***7.1 Meaning of Market Structure***

Market structure refers to the nature and degree of competition in the market for goods and services. The structures of market both for goods market and service (factor) market are determined by the nature of competition prevailing in a particular market.

**7.2 Elements of Market Structure**

There are a number of determinants of market structure for a particular good. These are as follows:

* **Number and Nature of Sellers**

The market structures are influenced by the number and nature of sellers in the market. They range from large number of sellers in perfect competition to a single seller in pure monopoly, to two sellers in duopoly, to a few sellers in oligopoly, and to many sellers of differentiated products.

* **Number and Nature of Buyers**

The market structures are also influenced by the number and nature of buyers in the market. If there is a single buyer in the market, this is buyer’s monopoly and is called monopsony market. Such markets exist for local labour employed by one large employer. There may be two buyers who act jointly in the market. This is called duopsony market. They may also be a few organised buyers of a product.

* **Nature of Product**

It is the nature of product that determines the market structure. If there is product differentiation, products are close substitutes and the market is characterised by monopolistic competition. On the other hand, in case of no product differentiation, the market is characterised by perfect competition. And if a product is completely different from other products, it has no close substitutes and there is pure monopoly in the market.

* **Entry and Exit Conditions**

The conditions for entry and exit of firms in a market depend upon profitability or loss in a particular market. Profits in a market will attract the entry of new firms and losses lead to the exit of weak firms from the market. In a perfect competition market, there is freedom of entry or exit of firms.

But in monopoly and oligopoly markets, there are barriers to entry of new firms. Usually, governments have a monopoly in public utility services like postal, air and road transport, water and power supply services, etc. By granting exclusive franchises, entries of new supplies are barred. In oligopoly markets, there are barriers to entry of firms because of collusion, tacit agreements, cartels, etc. On the other hand, there are no restrictions in entry and exit of firms in monopolistic competition due to product differentiation.

* **Economies of Scale**

Firms that achieve large economies of scale in production grow large in comparison to others in an industry. They tend to weed out the other firms with the result that a few firms are left to compete with each other. This leads to the emergency of oligopoly. If only one firm attains economies of scale to such a large extent that it is able to meet the entire market demand, there is monopoly.

**7.3 Meaning of Market**

In everyday language, market refers to a particular place where goods are purchased and sold.

In economics, market does not mean a particular place but the whole area where the buyers and sellers of a product are spread. This is because in the present age the sale and purchase of goods are with the help of agents and samples. Hence, the sellers and buyers of a particular commodity are spread over a large area. The transactions for com­modities may be also through letters, telegrams, telephones, internet, etc. Thus, market in economics does not refer to a particular market place but the entire region in which goods are bought and sold. In these transactions, the price of a commodity is the same in the whole market.

According to Prof. R. Chapman, “The term market refers not necessarily to a place but always to a commodity and the buyers and sellers who are in direct competition with one another.”

In the words of A.A. Cournot, “Economists understand by the term ‘market’, not any particular place in which things are bought and sold but the whole of any region in which buyers and sellers are in such free intercourse with one another that the price of the same goods tends to equality, easily and quickly.” Prof. Cournot’s definition is wider and appropriate in which all the features of a market are found.

**7.4 Characteristics of Market**

* **An Area**

In economics, a market does not mean a particular place but the whole region where sellers and buyers of a product ate spread. Modem modes of communication and transport have made the market area for a product very wide.

* **One Commodity**

In economics, a market is not related to a place but to a particular product.

Hence, there are separate markets for various commodities. For example, there are separate markets for clothes, grains, jewellery, etc.

* **Buyers and Sellers**

The presence of buyers and sellers is necessary for the sale and purchase of a product in the market. In the modem age, the presence of buyers and sellers is not necessary in the market because they can do transactions of goods through letters, telephones, business representatives, internet, etc.

* **Free Competition**

There should be free competition among buyers and sellers in the market. This competition is in relation to the price determination of a product among buyers and sellers.

* **One Price**

The price of a product is the same in the market because of free competition among buyers and sellers.

**7.5 Forms of Market Structure**

On the basis of competition, a market can be classified in the following ways:

* Perfect Competition
* Monopoly
* Duopoly
* Oligopoly
* Monopolistic Competition
* **Perfect Competition Market**

This is a market in which the number of buyers and sellers is very large, all engaged in buying and selling a homogeneous product without any artificial restrictions and possessing perfect knowledge of market at a time. In the words of A. Koutsoyiannis, “Perfect competition is a market structure characterised by a complete absence of rivalry among the individual firms.” According to R.G. Lipsey, “Perfect competition is a market structure in which all firms in an industry are price- takers and in which there is freedom of entry into, and exit from, industry.”

**Characteristics of Perfect Competition**

The following are the conditions for the existence of perfect competition:

* **Large Number of Buyers and Sellers**

The first condition is that the number of buyers and sellers must be so large that none of them individually is in a position to influence the price and output of the industry as a whole. The demand of individual buyer relative to the total demand is so small that he cannot influence the price of the product by his individual action.

Similarly, the supply of an individual seller is so small a fraction of the total output that he cannot influence the price of the product by his action alone. In other words, the individual seller is unable to influence the price of the product by increasing or decreasing its supply.

Rather, he adjusts his supply to the price of the product. He is “output adjuster”. Thus, no buyer or seller can alter the price by his individual action. He has to accept the price for the product as fixed for the whole industry. He is a “price taker”.

* **Freedom of Entry or Exit of Firms**

The next condition is that the firms should be free to enter or leave the industry. It implies that whenever the industry is earning excess profits, attracted by these profits some new firms enter the industry. In case of loss being sustained by the industry, some firms leave it.

* **Homogeneous Product**

Each firm produces and sells a homogeneous product so that no buyer has any preference for the product of any individual seller over others. This is only possible if units of the same product produced by different sellers are perfect substitutes. In other words, the cross elasticity of the products of sellers is infinite.

No seller has an independent price policy. Commodi­ties like salt, wheat, cotton and coal are homogeneous in nature. He cannot raise the price of his product. If he does so, his customers would leave him and buy the product from other sellers at the ruling lower price.

The above two conditions between themselves make the average revenue curve of the individual seller or firm perfectly elastic, horizontal to the X-axis. It means that a firm can sell more or less at the ruling market price but cannot influence the price as the product is homogeneous and the number of sellers very large.

* **Absence of Artificial Restrictions**

The next condition is that there is complete openness in buying and selling of goods. Sellers are free to sell their goods to any buyers and the buyers are free to buy from any sellers. In other words, there is no discrimination on the part of buyers or sellers.

Moreo­ver, prices are liable to change freely in response to demand-supply conditions. There are no efforts on the part of the producers, the government and other agencies to control the supply, demand or price of the products. The movement of prices is unfettered.

* **Profit Maximisation Goal**

Every firm has only one goal of maximising its profits.

* **Perfect Mobility of Goods and Factors:**

Another requirement of perfect competition is the perfect mobility of goods and factors between industries. Goods are free to move to those places where they can fetch the highest price. Factors can also move from a low-paid to a high-paid industry.

* **Perfect Knowledge of Market Conditions**

This condition implies a close contact between buyers and sellers. Buyers and sellers possess complete knowledge about the prices at which goods are being bought and sold, and of the prices at which others are prepared to buy and sell. They have also perfect knowledge of the place where the transactions are being carried on. Such perfect knowledge of market conditions forces the sellers to sell their product at the prevailing market price and the buyers to buy at that price.

* **Absence of Transport Costs**

Another condition is that there are no transport costs in carry­ing of product from one place to another. This condition is essential for the existence of perfect compe­tition which requires that a commodity must have the same price everywhere at any time. If transport costs are added to the price of the product, even a homogeneous commodity will have different prices depending upon transport costs from the place of supply.

* **Absence of Selling Costs**

Under perfect competition, the costs of advertising, sales-promotion, etc. do not arise because all firms produce a homogeneous product.

**Perfect Competition vs Pure Competition**

Perfect competition is often distinguished from pure competition, but they differ only in degree. The first five conditions relate to pure competition while the remaining four conditions are also required for the existence of perfect competition. According to Chamberlin, pure competition means, competi­tion unalloyed with monopoly elements,” whereas perfect competition involves perfection in many other respects than in the absence of monopoly.” The practical importance of perfect competition is not much in the present times for few markets are perfectly competitive except those for staple food products and raw materials. That is why, Chamberlin says that perfect competition is a rare phenomenon.”

Though the real world does not fulfil the conditions of perfect competition, yet perfect competi­tion is studied for the simple reason that it helps us in understanding the working of an economy, where competitive behaviour leads to the best allocation of resources and the most efficient organisation of production. A hypothetical model of a perfectly competitive industry provides the basis for appraising the actual working of economic institutions and organisations in any economy.

* **Monopoly Market:**

Monopoly is a market situation in which there is only one seller of a product with barriers to entry of others. The product has no close substitutes. The cross elasticity of demand with every other product is very low. This means that no other firms produce a similar product. According to D. Salvatore, “Monopoly is the form of market organisation in which there is a single firm selling a commodity for which there are no close substitutes.” Thus, the monopoly firm is itself an industry and the monopolist faces the industry demand curve.

The demand curve for his product is, therefore, relatively stable and slopes downward to the right, given the tastes, and incomes of his customers. It means that more of the product can be sold at a lower price than at a higher price. He is a price-maker who can set the price to his maximum advantage.

However, it does not mean that he can set both price and output. He can do either of the two things. His price is determined by his demand curve, once he selects his output level. Or, once he sets the price for his product, his output is determined by what consumers will take at that price. In any situation, the ultimate aim of the monopolist is to have maximum profits.

**Characteristics of Monopoly**

The main features of monopoly are as follows:

* Under monopoly, there is one producer or seller of a particular product and there is no differ­ence between a firm and an industry. Under monopoly a firm itself is an industry.
* A monopoly may be individual proprietorship or partnership or joint stock company or a co­operative society or a government company.
* A monopolist has full control on the supply of a product. Hence, the elasticity of demand for a monopolist’s product is zero.
* There is no close substitute of a monopolist’s product in the market. Hence, under monopoly, the cross elasticity of demand for a monopoly product with some other good is very low.\
* There are restrictions on the entry of other firms in the area of monopoly product.
* A monopolist can influence the price of a product. He is a price-maker, not a price-taker.
* Pure monopoly is not found in the real world.
* Monopolist cannot determine both the price and quantity of a product simultaneously.
* Monopolist’s demand curve slopes downwards to the right. That is why, a monopolist can increase his sales only by decreasing the price of his product and thereby maximise his profit. The marginal revenue curve of a monopolist is below the average revenue curve and it falls faster than the average revenue curve. This is because a monopolist has to cut down the price of his product to sell an additional unit.
* **Oligopoly**

Oligopoly is a market situation in which there are a few firms selling homogeneous or differenti­ated products. It is difficult to pinpoint the number of firms in ‘competition among the few.’ With only a few firms in the market, the action of one firm is likely to affect the others. An oligopoly industry produces either a homogeneous product or heterogeneous products.

The former is called pure or per­fect oligopoly and the latter is called imperfect or differentiated oligopoly. Pure oligopoly is found primarily among producers of such industrial products as aluminium, cement, copper, steel, zinc, etc. Imperfect oligopoly is found among producers of such consumer goods as automobiles, cigarettes, soaps and detergents, TVs, rubber tyres, refrigerators, typewriters, etc.

**Characteristics of Oligopoly**

In addition to fewness of sellers, most oligopolistic industries have several common characteris­tics which are explained below:

* **Interdependence**

There is recognised interdependence among the sellers in the oligopolistic market. Each oligopolist firm knows that changes in its price, advertising, product characteristics, etc. may lead to counter-moves by rivals. When the sellers are a few, each produces a considerable fraction of the total output of the industry and can have a noticeable effect on market conditions.

He can reduce or increase the price for the whole oligopolist market by selling more quantity or less and affect the profits of the other sellers. It implies that each seller is aware of the price-moves of the other sellers and their impact on his profit and of the influence of his price-move on the actions of rivals.

Thus, there is complete interdependence among the sellers with regard to their price-output policies. Each seller has direct and ascertainable influences upon every other seller in the industry. Thus, every move by one seller leads to counter-moves by the others.

* **Advertisement**

The main reason for this mutual interdependence in decision making is that one producer’s fortunes are dependent on the policies and fortunes of the other producers in the indus­try. It is for this reason that oligopolist firms spend much on advertisement and customer services.

As pointed out by Prof. Baumol, “Under oligopoly advertising can become a life-and-death matter.” For example, if all oligopolists continue to spend a lot on advertising their products and one seller does not match up with them he will find his customers gradually going in for his rival’s product. If, on the other hand, one oligopolist advertises his product, others have to follow him to keep up their sales.

* **Competition**

This leads to another feature of the oligopolistic market, the presence of com­petition. Since under oligopoly, there are a few sellers, a move by one seller immediately affects the rivals. So each seller is always on the alert and keeps a close watch over the moves of its rivals in order to have a counter-move. This is true competition.

* **Barriers to Entry of Firms**

As there is keen competition in an oligopolistic industry, there are no barriers to entry into or exit from it. However, in the long run, there are some types of barriers to entry which tend to restraint new firms from entering the industry.

**They may be:**

(a) Economies of scale enjoyed by a few large firms;

(b) control over essential and specialised inputs;

(c) high capital requirements due to plant costs, advertising costs, etc.

(d) exclusive patents and licenses; and

(e) the existence of unused capacity which makes the industry unattractive.

When entry is restricted or blocked by such natural and artificial barriers, the oligopolistic industry can earn long-run super normal profits.

* **Lack of Uniformity**

Another feature of oligopoly market is the lack of uniformity in the size of firms. Finns differ considerably in size. Some may be small, others very large. Such a situation is asymmetrical. This is very common in the American economy. A symmetrical situation with firms of a uniform size is rare.

* **Demand Curve**

It is not easy to trace the demand curve for the product of an oligopolist. Since under oligopoly the exact behaviour pattern of a producer cannot be ascertained with certainty, his demand curve cannot be drawn accurately, and with definiteness. How does an individual seller s de­mand curve look like in oligopoly is most uncertain because a seller’s price or output moves lead to unpredictable reactions on price-output policies of his rivals, which may have further repercussions on his price and output.

The chain of action reaction as a result of an initial change in price or output, is all a guess-work. Thus a complex system of crossed conjectures emerges as a result of the interdependence­ among the rival oligopolists which is the main cause of the indeterminateness of the demand curve.

If the oligopolist seller does not have a definite demand curve for his product, then how does he affect his sales. Presumably, his sales depend upon his current price and those of his rivals. However, a number of conjectural demand curves can be imagined.

For example, in differentiated oligopoly where each seller fixes a separate price for his product, a reduction in price by one seller may lead to an equivalent, more, less or no price reduction by rival sellers. In each case, a demand curve can be drawn by the seller within the range of competitive and monopoly demand curves.

Leaving aside retaliatory price movements, the individual seller’s demand curve under oligopoly for both price cuts and increases is neither more elastic than under perfect or monopolistic competition nor less elastic than under mo­nopoly. It may still be indefinite and indeterminate.

* **No Unique Pattern of Pricing Behaviour**

The rivalry arising from interdependence among the oligopolists leads to two conflicting motives. Each wants to remain independent and to get the maximum possible profit. Towards this end, they act and react on the price-output movements of one another in a continuous element of uncertainty.

On the other hand, again motivated by profit maximisation each seller wishes to cooperate with his rivals to reduce or eliminate the element of uncertainty. All rivals enter into a tacit or formal agreement with regard to price-output changes. It leads to a sort of monopoly within oligopoly.

They may even recognise one seller as a leader at whose initiative all the other sellers raise or lower the price. In this case, the individual seller’s demand curve is a part of the industry demand curve, having the elasticity of the latter. Given these conflicting attitudes, it is not possible to predict any unique pattern of pricing behaviour in oligopoly markets.

**Duopoly**

Duopoly is a special case of the theory of oligopoly in which there are only two sellers. Both the sellers are completely independent and no agreement exists between them. Even though they are inde­pendent, a change in the price and output of one will affect the other, and may set a chain of reactions. A seller may, however, assume that his rival is unaffected by what he does, in that case he takes only his own direct influence on the price.

If, on the other hand, each seller takes into account the effect of his policy on that of his rival and the reaction of the rival on himself again, then he considers both the direct and the indirect influences upon the price. Moreover, a rival seller’s policy may remain unaltered either to the amount offered for sale or to the price at which he offers his product. Thus, the duopoly problem can be considered as either ignoring mutual dependence or recognising it.

* **Monopolistic Competition**

Monopolistic competition refers to a market situation where there are many firms selling a differ­entiated product. “There is competition which is keen, though not perfect, among many firms making very similar products.” No firm can have any perceptible influence on the price-output policies of the other sellers nor can it be influenced much by their actions. Thus, monopolistic competition refers to competition among a large number of sellers producing close but not perfect substitutes for each other.

**Characteristics of Monopolistic Competition**

The following are the main features of monopolistic competition:

* **Large Number of Sellers**

In monopolistic competition the number of sellers is large. They are “many and small enough” but none controls a major portion of the total output. No seller by chang­ing its price-output policy can have any perceptible effect on the sales of others and in turn be influenced by them. Thus, there is no recognised interdependence of the price-output policies of the sellers and each seller pursues an independent course of action.

* **Product Differentiation**

One of the most important features of the monopolistic competi­tion is differentiation. Product differentiation implies that products are different in some ways from each other. They are heterogeneous rather than homogeneous so that each firm has an absolute monopoly in the production and sale of a differentiated product. There is, however, slight difference between one product and other in the same category.

Products are close substitutes with a high cross-elasticity and not perfect substitutes. Product “differentiation may be based upon certain characteristics of the prod­ucts itself, such as exclusive patented features; trade-marks; trade names; peculiarities of package or container, if any; or singularity in quality, design, colour, or style. It may also exist with respect to the conditions surrounding its sales.”

* **Freedom of Entry and Exit of Firms**

Another feature of monopolistic competition is the freedom of entry and exit of firms. As firms are of small size and are capable of producing close substitutes, they can leave or enter the industry or group in the long run.

* **Nature of Demand Curve**

Under monopolistic competition no single firm controls more than a small portion of the total output of a product. No doubt there is an element of differentiation neverthe­less the products are close substitutes. As a result, a reduction in its price will increase the sales of the firm but it will have little effect on the price-output conditions of other firms, each will lose only a few of its customers.

Likewise, an increase in its price will reduce its demand substantially but each of its rivals will attract only a few of its customers. Therefore, the demand curve (average revenue curve) of a firm under monopolistic competition slopes downward to the right. It is elastic but not perfectly elastic within a relevant range of prices of which he can sell any amount.

* **Independent Behaviour**

In monopolistic competition, every firm has independent policy. Since the number of sellers is large, none controls a major portion of the total output. No seller by changing its price-output policy can have any perceptible effect on the sales of others and in turn be influenced by them.

* **Product Groups**

There is no any ‘industry’ under monopolistic competition but a ‘group’ of firms producing similar products. Each firm produces a distinct product and is itself an industry. Chamberlin lumps together firms producing very closely related products and calls them product groups, such as cars, cigarettes, etc.

* **Selling Costs**

Under monopolistic competition where the product is differentiated, selling costs are essential to push up the sales. Besides, advertisement, it includes expenses on salesman, allowances to sellers for window displays, free service, free sampling, premium coupons and gifts, etc.

* **Non-price Competition**

Under monopolistic competition, a firm increases sales and profits of his product without a cut in the price. The monopolistic competitor can change his product either by varying its quality, packing, etc. or by changing promotional programmes.

**Chapter 8**

**ECONOMIC SYSTEM**

***8.1 Introduction***

An **economic system** is basically a system of production, resource allocation and distribution of goods and services within a society or a given geographic area.

It includes the combination of the various institutions, agencies, entities, decision-making processes and patterns of consumption that comprise the economic structure of a given community. As such, an economic system is a type of social system. The mode of production is a related concept. All economic systems have three basic questions to ask: what to produce, how to produce and in what quantities, and who receives the output of production.

The way scarce resources get distributed within an economy determines the type of economic system. There are four different types of Economic Systems; a traditional economy, a market economy, a command economy, and a mixed economy. Each type of economy has its own strengths and weaknesses.

***8.2 Types of Economic System***

### **1. Traditional Economic System**

A traditional economic system is the oldest and most traditional type of economic system in the world. A huge part of the world follows this economic system. There are many elements of this economic system which the modern economic system, such as a mixed economic system, lacks. This economy still yields goods and amenities, which are a direct result of their customs, beliefs, tradition, and culture. The parts of the world which follow traditional economy are mostly rural, second or third world and are very close to the land because of farming, fishing, and cattle herding etc. This economy relies on a barter system and does not have any concept of money or currency.

A traditional economy is defined as an economic system where customs, traditions, and believes that helped to shape the culture also help to shape the products and services that are offered. These traditions and beliefs also become the foundation of rules that are used for the distribution of goods and services and the manner of their distribution.

A traditional economic system focuses exclusively on goods and services that are directly related to its beliefs, customs, and traditions. It relies heavily on individuals and doesn’t usually show a significant degree of specialization and division of labor. In other words, traditional economic systems are the most basic and ancient type of economies.

Large parts of the world still qualify as traditional economies, primarily rural areas of second- or third-world countries, where most economic activity revolves around farming and other traditional activities. These economies often suffer from a lack of resources. Either because those resources don’t naturally occur in the region or because other, more powerful economies restrict access to them.

Hence, traditional economies are usually not capable of generating the same amount of output or surplus that other types of economies can produce. However, the relatively primitive processes are often much more sustainable, and the low output results in much less waste than we see in any command, market, or mixed economy.

### **Advantages of a Traditional Economy**

#### **The traditional economy centers on the family.**

Because traditional economies tend to be rurally-based, the needed skills to produce goods or services are handed down to each new generation. That means the skills and traditions gained by the elders within each family group become the expressions of how the economy operates in the future. That process helps to keep family units together, keeping the economy centered on meeting the needs of one another.

#### **It is an economy which allows for movement and freedom.**

The traditional economy is based on the concept that you go where you must to obtain the resources you require to survive. Traditional economies are often nomadic by design as that allows each family group to follow migration or seasonal patterns of food growth. Groups that are following the concepts of a traditional economy rarely need to trade with the outside world because they are able to produce everything they need on their own.

#### **Traditional economies only produce what they require.**

Within the traditional economy, there is rarely any waste created when developing goods or services. Surplus is a rarity within this economy type as well. Most traditional economies will produce what they need and nothing more. That is because there is no value to this type of economy in the action of trading with someone else. Once needs are met, there is no need to continue producing.

#### **It heavily relies on the bartering system.**

Traditional economies rarely have a need for currency. That means when they do trade with other groups, the goal of the bartering is to obtain items that are required for survival. One group might be excellent farmers. Another group might be excellent hunters. By trading corn for venison, both groups can serve their individual needs better without the requirement of money changing hands to complete the transaction.

#### **Traditional economies usually evolve into a different type over time.**

Once a traditional economy can settle into a routine which involves farming, a surplus will eventually develop through improve growing methods. Instead of wasting that surplus, the economy will look to barter it with neighboring groups. If enough surplus becomes available, the traditional economy will develop some type of currency. With currency, long-distance trades become possible to relieve the pressures of surplus products.

#### **Friction is a rarity within a traditional economy.**

Because the groups in a traditional economy are family-based, the amount of friction that is present within the economy is minimal. That is because everyone is following the traditions and customs that are set forth by the elder. Each person knows their role within the economy and what is expected of them. That allows production levels to remain stable, no matter what the role of the individual may be. Members also know what they will receive for their work, which makes it possible for all basic needs to be met.

#### **Traditional economies can be very friendly to the environment.**

A traditional economy does not operate on a mass scale. These economies are small. Some may involve just one tribe or household. That means they are less destructive to the environment without sacrificing the needs of members. Although they may have limited production capabilities, the outcomes of these economies are predictable, which makes planning for future needs easier compared to other economy types.

### **Disadvantages of Traditional Economic system**

#### **There are high levels of competition in traditional economies.**

Because traditional economies focus on meeting internal needs above any other need, there can be high competition levels for available resources. Groups that are closely positioned to one another may find themselves fighting often to command limited natural resources in their region. That competition can take on many forms, including war, which may further limit the availability of resources to all affected groups.

#### **Traditional economies can be devastated by natural events.**

Weather plays a big role in determining the size and scope of success that a traditional economy receives. One bad growing season can be enough to stop farming altogether. If the migratory herds avoid an area because of bad weather, it may be difficult for those in the traditional economy to find their new location. To limit the negative impacts that unexpected changes in weather may cause, families within this economy type tend to limit their overall population growth.

#### **People starve if a harvest or hunting is poor.**

The traditional economy relies upon the efforts of farmers, hunters, and gatherers to provide food supports for the entire population. If there isn’t enough food that can be located, then there is a good chance that the people living within that economy will starve. Unlike other economy types, there is a very limited amount of food storage available. What is needed is what is grown or gathered, then used, right away. And, because bartering is a common practice, there is no way to obtain needed goods because there is nothing available for trade.

#### **Traditional economies are vulnerable to other economy types.**

Other economy types, such as command economies or market economies, often consume the natural resources that the traditional economy uses to support themselves. Because the other economy types are usually more advanced technologically, they can decide to come in and take what they need or want to meet their own needs.

#### **There are few options to expand personal horizons.**

Within the traditional economy, each person tends to know what their role will be in the production cycle. That becomes their responsibility. The only way they can move into a new responsibility is if someone dies or becomes disabled and are unable to continue working. For someone who wants to explore new options or try something different, the options available are few and far between. Many people within a traditional economy work the same job or fill the same role for most of their lives.

#### **It can devastate the environment.**

There have been numerous incidents where traditional economies harmed the environment instead of helping it. For example, in Haiti, forests are in decline because wood is being used as a fuel source. When the production of a traditional economy is not reflective of the needs of the environment, then it will eventually fail.

### **Command Economic System**

In centrally planned economy, is a type of economic of system where investment, production and allocation of capital goods is controlled by a centralized power. A planned economy may use centralized, decentralized, participatory or Soviet-type forms of economic planning.

Since the government is such a central feature of the economy, it is often involved in everything from planning to redistributing resources. A command economy is capable of creating a healthy supply of its resources, and it rewards its people with affordable prices. This capability also means that the government usually owns all the critical industries like utilities, aviation, and railroad.

In a command economy, it is theoretically possible for the government to create enough jobs and provide goods and services at an affordable rate. However, in reality, most command economies tend to focus on the most valuable resources like oil. Examples of this form of government include the Soviet Union before is dissolution in 1991, North Korea, Cuba, and China before it began to allow economic reforms in 1978.

**Characteristics of a centrally planned economy**

* The government creates a central economic plan. The five-year plan sets economic and societal goals for every sector and region of the country. Shorter-term plans convert the goals into actionable objectives.
* The government allocates all resources according to the central plan. It tries to use the nation's [capital](https://www.thebalance.com/what-is-financial-capital-3305825), labor, and [natural resources](https://www.thebalance.com/how-natural-resources-boost-the-u-s-economy-3306228) in the most efficient way possible. It promises to use each person's skills and abilities to their highest capacity. It seeks to eliminate unemployment.
* The central plan sets the priorities for the production of all goods and services. That includes quotas and price controls. Its goal is to supply enough food, housing, and other basics to meet the needs of everyone in the country. It also sets national priorities. These include mobilizing for war or generating robust [economic growth](https://www.thebalance.com/what-is-economic-growth-3306014).
* The government owns [monopoly](https://www.thebalance.com/monopoly-4-reasons-it-s-bad-and-its-history-3305945) businesses. These are in industries deemed essential to the goals of the economy. That includes finance, utilities, and automotive. There is no domestic competition in these sectors.
* The government creates laws, [regulations](https://www.thebalance.com/financial-regulations-3306234), and directives to enforce the central plan. Businesses follow the plan's production and hiring targets. They can't respond on their own to [free-market forces](https://www.thebalance.com/america-is-not-really-a-free-market-economy-3980689).

### **Advantages of a Command Economy**

* **Operations are consistent within a command economy**  
  Within the structure of a command economy, the businesses which do function are operating at the behest of the government. Their structures are dictated by the government, so there is consistency within the operational structures of each business. Instead of attempting a market takeover or trying to dominate a market share, the businesses work to produce the goods the society needs to function.
* **It creates a flexible industrial sector.**  
  Industries are directly operated or controlled by the government in a command economy, so their resources can be applied to whatever project needs to be completed. This creates a flexibility within the industrial sector that other economy formats cannot match. If there is a massive project that needs to be completed, the government can quickly transfer the resources that are necessary to get the job finished.
* **The exact demands of a society can be met.**  
  Within the structure of a command economy, the government seeks to maximize its efficiency. To do this, it will attempt to meet the exact demands that people have. By limiting over-production of items, there is less waste that occurs within the society. This creates more resources for the government to use in other areas. This may limit personal choice, but it also reduces the chances of a shortage occurring when production rates are based on accurate resources.
* **Any resource can work with any other resource.**  
  Can you imagine Apple and Samsung working together to produce technologies? Or Ford and General Motors working together to create automobiles? In a free market economy, businesses compete with one other to produce better products. In a command economy, any resource can be dictated to work with any other resource. This makes it easier to produce products on a larger scale because all resources, not just individualized business resources, are actively working to benefit society.
* **Acute demands can be quickly met.**  
  Within a command economy, the full resources of the government can become active at any given time. If an emergency occurs, such as a natural disaster, then it becomes possible to meet the general needs of the population with a greater speed than in other economy structures. This makes it possible for households to recover from an emergency quicker.

### **Disadvantages of a Command Economy**

### **It is a governmental structure which reduces personal freedoms** Because all economic structures are at the beck and call of the government, personal freedoms are limited within a command economy. In many instances, people can work one type of job and must do so because the government demands it. Refusal could mean jail time… or worse. Their income is dictated by the government as well. People are forced to pursue the greater good of the government instead of their own greater good.

* **It limits innovation**  
  There is no need for production to seek out research and development within a command economy because the government dictates everything. People must accept what the government gives them. This means there is no need to make products better tomorrow than they are today. Businesses are in the same position because the government often dictates who gets to work for them. The result is lower motivation to create a high-quality product or offer a helpful service.
* **It encourages illegal activities**  
  Within a command economy, people cannot always get what they need to meet the basic needs of living. To get these items, an underground market flourishes so that goods or services that are needed can be received outside of government control. This is the only way that outside goods, which may be better than domestic goods, can be received by a population in this type of economy.
* **It eliminates the competition**  
  Within a command economy, the government owns and controls everything. Competition is discouraged, if it is even allowed. Any private business would constantly be under the threat of a government takeover of their operations and have no options to recover their assets should that occur. Venezuela seized an auto plant from General Motors in 2017 and it cost the company $100 million.
* **It reduces communication**  
  Rationing occurs within a command economy on a frequent basis because the structures of this type of economy limit communication. The government doesn’t know what the population needs, so they mass-produce products based on what they believe is necessary for survival. The goal is to support the government first, so the products produced are based on what benefits the government the most. This results in an unbalanced set of goods that is virtually worthless.
* **It reduces exports**  
  The lack of communication doesn’t stop at the local population level. Governments operating a command economy struggle to speak with neighboring nations as well. This limits the export opportunities because there is no knowledge about what those other nations need.
* **It creates incentives that people don’t see as an incentive**  
  The incentive in a command economy is that a household gets to survive. Put in a hard day of work for the government in some way and you’ll get enough to help you make it to another day. There is no incentive for people to better themselves because any improvements or recognition go directly to the government.

The advantages and disadvantages of a command economy show that a lack of competition can be problematic. It may be a society that equalizes income and production to create more socioeconomic equality, but it also means that equality is defined by the centralized government.

### **3. Market Economic System**

A market economy is an economic system which controls the prices of goods and services. Pricing is based on the interactions of businesses and individuals within the society, providing a guide to how much or how little goods or services should be priced. Within a market economy, government intervention or interference is minimal and potentially non-existent. There is no central planning movement.

In a free-market economy, firms and households act in self-interest to determine how resources get allocated, what goods get produced and who buys the goods. This is opposite to how a command economy works, where the central government gets to keep the profits.

The market economic system is a theoretical concept. That means, there is no real example of a pure market economy in the real world. The reason for this is that all economies we know of show characteristics of at least some kind of government intervention. For example, many governments pass laws to regulate monopolies or to ensure fair trade, and so on.

In this type of economy, there is a separation between the government and the market. This separation prevents the government from becoming too powerful and keeps their interests aligned with that of the markets.

Historically, Hong Kong is considered an example of a free market society.

**Characteristics define a market economy**﻿

### **Private Property**

Most goods and services are privately-owned. The owners can make legally binding contracts to buy, sell, or lease their property. Their assets give them the right to profit from ownership. There are some assets U.S. law excludes. Since 1865, for example, you cannot legally buy and sell human beings.

* **Freedom of Choice**

Owners are free to produce, sell, and purchase goods and services in a competitive market. They only have two constraints. First is the price at which they are willing to buy or sell. Second is the amount of capital they have.

### **Motive of Self-Interest**

Everyone sells their wares to the highest bidder while negotiating the lowest price for their purchases. Although the reason is selfish, it benefits the economy over the long run. This auction system sets prices for goods and services that reflect their market value. It gives an accurate picture of supply and demand at any given moment.

### **Competition**

The force of competitive pressure keeps prices low. It also ensures that society provides goods and services most efficiently. As soon as demand increases for a particular item, prices rise thanks to the law of demand. Competitors see they can enhance their profit by producing it, adding to supply. That lowers prices to a level where only the best competitors remain. This competitive pressure also applies to workers and consumers. Employees vie with each other for the highest-paying jobs. Buyers compete for the best product at the lowest price.

### **System of Markets and Prices**

A market economy relies on an efficient market in which to sell goods and services. That's where all buyers and sellers have equal access to the same information. Price changes are pure reflections of the laws of supply and demand. There are five determinants of demand: product price, buyer's income, prices of related goods, consumer taste, buyer's expectations.﻿

### **Limited Government**

The role of government is to ensure that the markets are open and working. For example, it is in charge of national defense to protect the markets. It also makes sure that everyone has equal access to the markets. The government penalizes monopolies that restrict competition. It makes sure no one is manipulating the markets and that everyone has equal access to information.5﻿

## Advantages of a Market Economy

* **It provides a society with the right goods or services at the right time**  
  Because competition works with supply and demand in a market economy, businesses and individuals receive access to the exact goods or services that they need. Although the quality of these goods may vary based on who manufacturers them, different socioeconomic classes can access specific goods within their price range that they wish to own. This eliminates the ability to have a central authority dictate who should receive access to specific goods and at what price.
* **A market economy promotes entrepreneurship**  
  Because the emphasis within a market economy is on innovation, it creates an environment where entrepreneurship can thrive. It supports the process of discovering new products or services that will be wanted, while allowing individuals and businesses to decide which products or services will best meet their needs. It is a structure that provides profits for businesses of any size while creating satisfied customers at the same time.
* **It creates competition**  
  A market economy thrives because businesses are forced to continually innovate to survive. Businesses that refuse to innovate will be left behind because there will always be someone willing to look at things in a different way. This motivation is the foundation of a market economy because it must be there to encourage better products and services to be offered over time.
* **It reduces the need to store products**  
  Because the laws of supply and demand are enforced in a market economy, manufacturers produce goods based on the demands that the society requires. This reduces the need to store surplus products because anything that is extra will be sold at a deeply discounted price or simply destroyed. The goal is to find a balance between society’s demands and the number of goods that are produced.
* **Prices are usually kept down in a market economy**  
  Because competition is present within an industry, prices tend to stay lower because businesses are attempting to obtain as many customers as possible.

### **Disadvantages of a Market Economy**

* **Market economies tend to produce inferior goods and services.**  
  The goal of a market economy is to find balance between cost and profit. Businesses will minimize costs and maximize profits. That usually means skilled workers who demand high wages will be replaced by low or average-skill workers who can still produce a reasonably good product, but at a cheaper price. That means a market economy rarely provides the best possible goods and services that could be produced.
* **It harms the environment**  
  A market economy places an emphasis on the cost of good produced over any other factor. That means there are fewer environmental concerns that are addressed during the production of goods. When it costs less to dump waste in nature than it does to properly dispose of it, the lack of governmental interference or a central authority would allow such an action to occur.
* **Outsourcing is frequent in a market economy**  
  Because the goal is to produce the highest quality goods at the lowest possible prices, many companies outsource jobs and manufacturing to foreign providers. Outside of the developed world, wages are much lower.
* **Commodity prices typically rise in a market economy.**  
  Commodities are primary agricultural products or raw materials that are bought or sold. Coffee is a commodity, as is copper. In a market economy, these are the items that are essential to the manufacturing process. Without them, a business cannot create goods or services for sale. Because supply and demand apply, and most businesses need commodities to function, the pricing of these goods is higher and that increase gets put into the final consume price tag.
* **Economy imbalances occur frequently within a market economy**  
  It is crystal clear that the Great Recession in 2007-2009 occurred because of a lack of regulation in several sectors, including housing, around the world. Similar recessions have occurred throughout history because a market economy eventually creates an imbalance. When more businesses attempt to maximize profits without regard to risk, eventually a negative event occurs and the consumers tend to be the hardest hit by the fallout.

### **4. Mixed Economic System**

A mixed economy is a combination of different types of economic systems. This economic system is a cross between a market economy and command economy. In the most common types of mixed economies, the market is more or less free of government ownership except for a few key areas like transportation or sensitive industries like defense and railroad.

To a certain extent, most countries have a mixed economic system. For example, Sierra Leone, Liberia, Sudan etc..

A mixed economy can fall anywhere on the spectrum between pure capitalism and pure socialism. Most governments decide to socialize specific industries in this structure because of how important they are for the public good.

Economists believe that a mixed approach is less efficient than a pure free market, but this approach creates more equality for the consumer. It provides for equal information and rational participation in ways that an extreme approach on either side cannot offer.

**Characteristics of mixed economy**

### **Co-existence of public and private sectors:**

Both public and private enterprises exist in this economic system. The role and areas of both the sectors arc well defined.

The relative roles assigned to the public and private sector differ from economy to economy. But generally, the public sector is expected to perform certain basic functions such as:

(i) Development of economic infrastructures.

(ii) To promote basic industries that require huge investment and are of long gestation periods;

(iii) To promote industries in backward regions where inducement to invest is low.

(iv) To develop defence production industries in public sector.

Similarly, the private sector is expected to supplement the efforts of public sector and to take advantages of investment opportunities enhanced by public enterprises.

In the mixed economy the two sectors are not rivals. The two sectors are partners in the process of development, because for the efficient working of this system the co-operation between the two sectors is necessary.

The private sector in mixed economy operates under certain controls and regulations of the government.

### **Economic planning**

Generally, a mixed economy is a planned economy. Public sector enterprises have to work according to a definite plan to achieve certain predetermined aims and objectives. Similarly, the private sector is not left to develop in its own way.

The growth of private sector is also regulated through various controls and incentives to achieve the objects of plans.

Thus, the nature of economic planning in mixed economies is ‘planning by direction’ for the public sector and for private sector ‘planning by inducement’ is adopted’.

To ensures faster economic growth, the developmental programmes of both the sectors are coordinated in such a way that growth in one sector complements the growth in the other sector.

### **Division of industrial undertakings**

There is division of industrial enterprises in a mixed economy. The division of industrial sector may differ from economy to economy. Generally, the industrial economy is divided into following:

**(i)** Exclusively State Monopoly. In it same strategic and basic industries are included.

**(ii)** Private Sector Industries. In it industries of lesser importance are included such as consumer goods industries, small scale industries, etc.

**(iii)** Joint Sector Industries. The industries included in this sector are developed jointly by public and private sector.

**(iv)** Common Industrial Sector. Both public and private sector can establish industrial units in this sector.

### **Existence of social welfare and private profit motive**

In mixed economy public sector works as the principle of social welfare motive. Public sector tries to reduce regional economic inequalities and to increase employment opportunities.

The basis of price policy of public sector is social welfare instead of private profit. Whereas the operations and price policy of private sector is guided by private profit motive.

But the private profit motive is controlled by government through fiscal and monetary policies, direct controls, etc.

### **Individual freedom**

The people have freedom of consumption and to choose their occupations in this economic system. Private entrepreneurs are to choose technique of production.

From the above discussion, it is clear that mixed economy is a marriage between capitalism and socialism.

It is an attempt to have the merits of both capitalism and socialism Therefore, it is said and rightly too that mixed economic system a golden path between capitalism and socialism.

### **Advantages of the Mixed Economy**

* **A mixed economy distributes goods and services to where they need to be.**  
  Most mixed economies retain the characteristics of the traditional economic approach. Those traditions don’t guide functionality because most people aren’t even aware of their actions. You go hunting, purchase a fishing license, and go to the grocery store each week. Those activities are possible because the structure of this approach ensures that goods and services are where they’re needed for each community.
* **Supply and demand get measured through pricing instead of regulation.**  
  Instead of creating one price for each item someone requires, the structure of the mixed economy allows for competition. The state might regulate an industry, but it is up to the individual players to be innovative. This competitive drive encourages a system of supply and demand that impacts pricing. When there are low levels of products or services in high demand, then the price to acquire them goes up. If the opposite occurs, then the price goes down.
* **A mixed economy automatically allocates capital to the most efficient producers.**  
  Competition in the mixed economy encourages producers to seek out innovative processes. Consumers have the option to choose whatever goods or services they prefer, but the average person will select the item that provides them with the highest value proposition. That means the structure of this approach automatically allocates the highest levels of resources to the organizations that create the best outcomes.
* **The mixed economy minimizes the disadvantages of a market approach.**  
  When a purist capitalistic approach is the preference of an economy, then vital areas can experience neglect if they aren’t profitable – or don’t make enough profit to satisfy producers in that industry. The three primary areas that typically benefit from this approach are aerospace, defense, and technology. When there is a larger governmental role in the development of these vital resources, then faster mobilization can occur to protect these areas. This advantage also creates more opportunities for employment, higher wages, and vocational specialization that aren’t always possible in other approaches.
* **It equalizes the levels of control found in the economy**  
  In pure capitalism, the producers are in full control of goods and service acquisition. The pure socialistic approach places the government in this position. It is only in the structures of a mixed economy where both of these elements come together with cohesiveness. This fusion generates a need to coordinate responsibilities within the marketplace to help it continue growing. That means there is an equal level of distribution.
* **People become the driver of economic success**  
  When a purist socialist approach is the economy’s preference, then a group of people or organizations work together to meet the needs of everyone. Instead of private ownership, everything is mutually owned in some way. Communism takes this idea to an extreme by putting everything into the hands of the state. The purist capitalist will have everyone pursue the highest levels of competition and innovation possible.
* **The mixed economy rewards the hardest workers.**  
  If you are highly productive in a mixed economy, then you have an opportunity to create your own definition of success. Even if an employer doesn’t recognize these efforts, you can become an entrepreneur to create a self-employment resource that generates the income you want. The power to work or not is in your hands, and you have the option to chase after whatever goals you prefer. That means you can work a job that gives you more family time, focus on a high-income situation, or find part-time employment so that you can pursue a hobby.

### **Disadvantages of the Mixed Economy**

* **It can leave the less competitive members of society without support.**  
  The mixed economy can take on all of the disadvantages that other approaches generate since it is a mix of capitalism and socialism. That means its primary problem involves the members of society who cannot reach the same levels of innovation or competition. When the marketplace has too much freedom, then these at-risk individuals and companies might find themselves without any support from the government.
* **The mixed economy doesn’t eliminate the possibility of monopolies.**  
  When the government can still centrally plan in specific industries while operating in a mixed economy, then there can be problems with oligarchies or monopolies forming. This issue often happens in the defense industries that support the armed services. When subsidies become necessary to help people afford goods or services, then it creates more debt for the state to manage. This process slows economic growth in the long-term perspective that short-term gains cannot manage.
* **A mixed economy often produces high taxation responsibilities.**  
  The state is responsible for public-sector services that make the marketplace accessible to consumers and producers. That means it needs financial support that comes from thee two entities. The most common method of achieving this result is through taxation. The mixed economy will tax companies and individuals at different levels, with more government involvement often dictating a higher level of responsibility in this area.
* **The state has the power to change its mind in a mixed economy.**  
  The mixed economy serves at the luxury of the government. Officials have the opportunity to change their minds with this approach, sliding it toward a purist state if that is their preference.
* **The mixed economy encourages people and agencies to go into debt.**  
  One of the most prominent dangers of the mixed economy is overdevelopment. This disadvantage occurs in the centralized planning of the public sector most often, but individuals and companies can also fall into this debt trap. Government-run industries can hastily turn into subsidized mergers that require massive spending. The state then shifts budget resources from other segments to settle those charges, creating new obligations in a never-ending cycle.
* **The mixed economy encourages special interest activities.**  
  The synergy between the government and operating producers creates a market where each lobbies the other. Successful organizations can lobby the state to receive more tax breaks, subsidies, and other financial considerations. This process can lead to a company taking on more risks than the free market would allow, creating problems that eventually need a fix.

**Chapter 9**

**NATIONAL INCOME**

***9.1 Introduction***

There is a great desire to measure the success, or performance of our economy.

Are we getting ‘bigger’ (and better) or ‘smaller’ (and worse) over time? The need to evaluate the magnitude of our economic performance is important to planners and policy-makers, who want to know how well the economy is performing so that they can set goals and make policy recommen­dations.

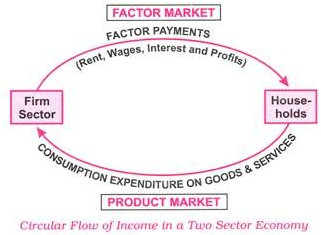
An accurate measurement of the economy’s performance is also important to private businesses because failure to do that can lead to wrong decision making.

According to Simon Kuznets national income is defined as “the net output of commodities and services flowing during the year from the country’s productive system in the hands of the ultimate consumers.”

In other words, National Income is the total amount of income accruing to a country from economic activities in a year’s time. It includes payments made to all resources in the form of wages, interest, rent and profits.

***9.2 The Circular Flow Model of the Economy***

There is a continuous flow of goods and payments between the producers of goods and services, which we call businesses, and individuals, who typically live-in family units called households. The nature and direction of these exchanges are presented in the circular flow model of Income and output. This model is presented in Fig. 9.1.



Income and output are flow concepts; that is, they are measured over a span of time. The flow of incomes from businesses to households and vice-versa will continue unabated at a stable, or equilibrium, magnitude if income received is utilised or spent at the same rate, and if there is no siphoning of funds (resources) out of the flow.

For example, a teacher’s supply of services brings in income that can be used to buy automobiles, vacations, food and other goods. In sum, the total spending is the total amount that households spend and that equals the total amount that buyers of factors had to pay. In other words, total spending equals total income.

### ***9.3 Importance of National Income Analysis***

The following are the significance of national income analysis:

* **For the Economy**

National income data are of great importance for the economy of a country. These days the national income data are regarded as accounts of the economy, which are known as social accounts. These refer to net national income and net national expenditure, which ultimately equal each other.

Social accounts tell us how the aggregates of a nation’s income, output and product result from the income of different individuals, products of industries and transactions of international trade. Their main constituents are inter-related and each particular account can be used to verify the correctness of any other account.

* **National Policies**

National income data form the basis of national policies such as employment policy, because these figures enable us to know the direction in which the industrial output, investment and savings, etc. change, and proper measures can be adopted to bring the economy to the right path.

* **Economic Planning**

In the present age of planning, the national data are of great importance. For economic planning, it is essential that the data pertaining to a country’s gross income, output, saving and consumption from different sources should be available. Without these, planning is not possible.

* Economic Models

The economists propound short-run as well as long-run economic models or long-run investment models in which the national income data are very widely used.

* Research

The national income data are also made use of by the research scholars of economics. They make use of the various data of the country’s input, output, income, saving, consumption, investment, employment, etc., which are obtained from social accounts.

* Per Capita Income

National income data are significant for a country’s per capita income which reflects the economic welfare of the country. The higher the per capita income, the higher the economic welfare of the country.

* Distribution of Income

National income statistics enable us to know about the distribution of income in the country. From the data pertaining to wages, rent, interest and profits, we learn of the disparities in the incomes of different sections of the society. Similarly, the regional distribution of income is revealed.

### ***9.4 Methods of Measuring National Income***

There are four methods of measuring national income. Which method is to be used depends on the availability of data in a country and the purpose in hand?

#### **(1) Product Method**

According to this method, the total value of final goods and services produced in a country during a year is calculated at market prices. To find out the GNP, the data of all productive activities, such as agricultural products, wood received from forests, minerals received from mines, commodities produced by industries, the contributions to production made by transport, communications, insurance companies, lawyers, doctors, teachers, etc. are collected and assessed at market prices. Only the final goods and services are included and the intermediary goods and services are left out.

#### **(2) Income Method**

According to this method, the net income payments received by all citizens of a country in a particular year are added up, i.e., net incomes that accrue to all factors of production by way of net rents, net wages, net interest and net profits are all added together but incomes received in the form of transfer payments are not included in it. The data pertaining to income are obtained from different sources, for instance, from income tax department in respect of high income groups and in case of workers from their wage bills.

#### **(3) Expenditure Method**

According to this method, the total expenditure incurred by the society in a particular year is added together and includes personal consumption expenditure, net domestic investment, government expenditure on goods and services, and net foreign investment. This concept is based on the assumption that national income equals national expenditure.

#### **(4) Value Added Method**

Another method of measuring national income is the value added by industries. The difference between the value of material outputs and inputs at each stage of production is the value added. If all such differences are added up for all industries in the economy, we arrive at the gross domestic product.

### ***9.5 Difficulties or Limitations in Measuring National Income***

# The following are some of the bottlenecks in the computation of national income:

* **Exclusion of Real Transactions**

In measuring national income from the output side only those items which are purchased and sold through the market are included.

However, all direct sales of various goods and services are excluded.

In other words, GDP includes the money value of those items which are sold through the market at current prices.

In developing countries like Sierra Leone, a major portion of output is not sold through the market. Yet these are produced by using economic resources and satisfaction is derived from consuming various non-marketed goods and services. Examples are barter transactions and various free services rendered at personal levels.

Many useful services are produced by members of households for the benefit of themselves or their families. Husbands and wives perform useful services for themselves and their families when they prepare meals, make household repairs, and handle their own financial affairs.

#### **The Value of Leisure**

All of us place some value on our time. We sell some of our time to employers for labour income; however, we retain much of it for our own use of leisure. Some of this leisure is used to render household services that escape inclusion in GDP. The satisfaction we get from recreational activities and other uses of our leisure time are also not included in GDP.

#### **Cost of Environmental Damage**

The people of a country may be able to enjoy more and better goods and services each year, but they must also put up with more congestion, dirty air, polluted water and other environmental costs that decrease the quality of their lives. Costs are associated with pollution and other aspects of industrial activity that damage the environ­ment.

The costs of environmental damage are not subtracted from the market value of final products when GDP is calculated. Some economists, therefore, believe that GDP overestimates the value of output by failing to take into account environmental costs of production.

#### **The Underground Economy**

Sierra Leone has a vast underground economy. This economy consists of transactions that are never reported to tax and other government authorities. It includes transactions involving illegal goods and services, such as trading in harmful drugs, gambling, smuggling and prostitution. These illegal goods and services are final products that are not included in GDP.

The transactions of the underground economy also include activities by people who do not comply with tax laws, immigration laws, or government regulations and who do not report their income to tax authorities. The underground (unofficial) economy is also called parallel economy.

#### **Transfer Payments and Capital Gains**

All domestic transfer payments (personal, private and government) are excluded from national income of a country. For example, if an individual receives a cash gift from his father who is also a resident of Sierra Leone, it will not be a part of Sierra Leone’s national income. The same argument is valid if a student receives Tata Foundation Scholarship for higher studies. This is an example of business transfer payments.

Another example of transfer is the subsidy received by producers of milk from the government. Still another is retirement pension. A surprise omission from national income accounts is interest on government bonds. It is an example of government transfer. It is excluded from national income because the government pays interest on bonds not from profits of public sector enterprises but by imposing tax on people.

So, there is transfer of income from taxpayers to bondholders. But there is no net increase in society’s output of goods and services in the process. And it may be a happy coincidence if the same individual is both a taxpayer and a bondholder at the same time. So net interest paid by government (interest paid to individuals less interest received from state governments from loans and advances) is not a par: of national income.

However, any transfer payment from abroad will be a part of a country’s national income. Thus, if an individual receives $20,000 from his father who is a non-resident Sierra Leonean, it will be part of Sierra Leone’s national income.

#### **Valuation of Inventories**

We have already noted how inventories are to be treated in national income accounts. However, while estimating national income of a country, one problem has to be faced. This problem arises due to price level changes, i.e., inflation and deflation which lead to stock appreciation or depreciation. And the national income accountants have to face certain problems associated with the valuation of inventories.

Two methods are normally used for inventory valuation, viz., (i) the market price method and (ii) the factor cost method. According to the market price method, stock appreciation (increase in inventory) is valued at current market prices of goods held in inventories. It may be noted that market price of every item stocked includes imputed (notional) profit which may or may not be realised in the same year.

On the other hand, if the factor cost method of valuing inventories is used, imputed profit is excluded from cost calculation. This is the usual practice.

In fact, during inflation, the market value of inventories and reported profits will be higher than they actually are. So, they have to be deflated by the price index (or the GDP deflator) to neutralise the effects of inflation. Otherwise, a company will be required to pay extra tax on inflated profits.

And it will not be able to retain a substantial amount of earnings, e.g., it will find it difficult to replace an old machine when it wears out completely. It may be noted that during inflation such reported profits are partly illusory (because they are the result of favourable market conditions and not increased volume of sales).

So, if such profits are not deflated appropriately, nominal profits will be higher than-real profits. And, as a result, a company will have to pay more taxes than it is supposed to pay.

Therefore, its undistributed profit will also be less than what it should be. Therefore, it will not be possible to set aside adequate funds for depreciation. Old machines cannot be replaced when they wear out completely.

#### **Self-Consumption**

A special problem arises in agriculture which is the most dominant sector in less developed countries (LDCs) like Sierra Leone. Subsistence farmers who produce food for themselves and their family members consume a major portion of their own output every year. Since this portion is not sold through the market, it is excluded from GDP.

The reason is that it is difficult to measure the market value of this output. A lot of arbitrariness is involved in the process of measuring it.

#### **Lack of Official Records**

Another problem arises due to lack of reliable data. The reason is that many people in LDCs like Sierra Leone sell their output through the market no doubt but they do not maintain any official accounts of their transactions.

For example, most road­side small traders, (retailers) as also many business enterprises in the unorganised sectors (mainly sole proprietorship organisations or single-owner firms) and self-employed persons do not keep proper records of their incomes and expenses.

This is why it is difficult to include proprietor’s income (which is essentially a mixed income) in the national income accounts of a country. However, in theory, such income is a part of national income. The reason is that it is earned through market transactions.

#### **Imputed Income**

Imputed income such as income from owner-occupied houses and flats is a part of a person’s taxable income. Therefore, it is a part of national income. Such income is fixed on the basis on notional rent. Even if an individual keeps his house vacant, he has to pay tax on notional rent.

In this case, the value of the service rendered by the house has to be imputed. The same thing is true of unintended inventories. For example, if a firm is not able to sell its entire output during the current year, the unsold stock will have to be valued at the current market price and included in national income.

#### **Valuation of Government Service**

Finally, government services provided to people free of cost are also to be included. However, it is very difficult to find the true values of such services, since these are not sold through the market. As Prof. Amit Bhaduri comments, the valuation of services of many public goods like a museum or a park becomes highly problematic.

This, in turn, raises the question of how to evaluate the economic contribution, i.e., value added of the government which is the provider of public goods like national defence, law and order, etc. for which no market prices exist. In the absence of market prices for many types of public services, the problem of their valuation must be somewhat arbitrarily settled by accounting conventions.

# ***9.6 Factors Determining the Size of National Income***

**The following points will highlight the five factors that determine the size of national income.**

#### **1. Natural and Human Resources**

The quantity and quality of a country’s resources exert perhaps the most important influence on its national income. For example, fertile soil, ready sources of power, easily worked mineral deposits; a favourable climate, navigable rivers, etc. will have a beneficial effect on a country’s productive capacity.

Capital equipment may range from simple hand tools to the most up-to-date forms of industrial machinery. Generally, the achievement of an increasing output of goods is associated with increased investment in capital equipment. For example, a miner can extract a greater quantity of mineral resources from the earth with the aid of machinery than with only a pick and shovel. Thus, the effectiveness with which natural and human resources are used depends to a large extent on the capital equipment available.

The size of the working population is deter­mined by factors such as the age structure of the population and social attitudes. For example, the social attitude towards women is important in this respect. If the community judges that ‘a woman’s place is in the home’, then the talents of many women may be wasted.

#### **Technical Knowledge**

New methods of production and new ways of utilising resources may increase the output of goods and services. A community which is keen to try out new ideas or inventions in industry and commerce is likely to enjoy a higher standard of living than a country which is slow to adopt new ideas.

#### **Political Stability**

Political stability is essential for the expansion of business activities. War and internal revolution interfere with production because they add to normal commercial risks. Thus, peace and a stable government promote confidence and encourage production.

#### **Terms of Trade**

Trade benefits all countries which engage in it, but the degree of benefit enjoyed by a particular country will vary according to changes in the price levels at which it sells its exports and imports. Favourable terms of trade occur if the prices of imports fall relatively to the prices of exported goods. This means that a larger quantity of imports can be obtained for a given quantity of exports. Hence, more goods are available and national income is increased.

#### **Foreign Investment**

A net income from foreign investment means that the creditor country can obtain goods and services from debtor countries without having to give goods and services in return. Thus, if two countries have the same Gross Domestic Products then the country with the more favourable net return from foreign invest­ment will have the higher national income.

**Chapter 10**

**MONEY**

***10.1 Definitions***

Money is defined as an economic unit that functions as a generally recognized medium of exchange for transactional purposes in an economy.

Money provides the service of reducing transaction cost, namely the double coincidence of wants. Money originates in the form of a commodity, having a physical property to be adopted by market participants as a medium of exchange.

Another definition which helps to understand money is, “the means of valuation and of payment as both the unit of account and the generally acceptable medium of exchange.”

***10.2 Attributes of Money***

For one to say a particular object is money, it must have the following unique attributes. The following are the unique attributes of money.

* **Legal Tender**

Legal tender is money that is designated as the official form of payment recognized by a government and legal system. Legal tender may be used to settle all financial obligations. In many cases, this is a requirement of the law. For example, a banana farmer may not be able to pay workers with bananas according to labor laws but must offer a minimum wage in legal tender.

* **Liquidity**

It is a measure of how easily an asset can be bought and sold. A currency that is a widely accepted medium of exchange and legal tender is considered perfectly liquid. This means that it can be used easily and instantly. Value stored in other forms may be much more difficult to use. For example, if you have a Le25, 000,000 worth house it may take you months or even a year to sell it to buy something else. If you have Le25, 000,000 in cash it can be used instantly.

* **Stability**

Money is utmost valuable once it has a stable value. If the value of money speedily appreciates, a process known as deflation, people will hoard money and normal economic processes will break down. If the value of money falls quickly, a process known as inflation, people will spend it as soon as they get it and it will no longer represent a store of value. If money rapidly goes up and down in price it will represent a risk and may fall out of use as a medium of exchange.

* **Homogeneity**

Money should be homogenous in the entire system. This simply means there should be uniformity in all the coins and paper notes in circulation. For example, a ten thousand Leone note (Le10,000.00) in Bo city must be the same in Freetown, Makeni, Kenema, Kabala etc.

* Portability

Money must be portable i.e. it must be easy to carry around and exchanged with other currencies.

* **Confidence**

In order for money to function as a store of value and medium of exchange, people need to have confidence in the value of the money. For example, a currency that is backed by a stable and reputable government with massive resources and the ability to collect future tax revenues has higher confidence level.

* **Divisibility**

Money should be divisible into smaller units to be able to facilitate all sort of transactions. For example in Sierra Leone we have different denominations such as Le10,000, Le5,000.00, Le2,000.00, and Le1,000.00 notes as well as Le500.00, Le100.00 and Le50.00 coins to be able to effect smaller transactions.

* **Scarcity**

Money should be relative scarce but not too scarce. The more of the money we have in circulation the lesser the value of the money becomes. It is prudent to always maintain some level of scarcity of the money in circulation.

* **Acceptability**

Money must be generally acceptable by its users due to the fact that it is backed by law.

* **Durability**

The object or item that is used as money must be able to stand the test of time without getting damaged.

# ***10.3 Functions of Money***

**The following points highlight the top six functions of money.**

#### **A Medium of Exchange**

First and prime, money acts as a medium of exchange that expedites marketable transactions. Money enables one to buy variety of goods and services. Money as a medium of exchange eliminates the difficulties associated with the barter system where goods are directly exchanged for goods. For example, if you want to buy a **Timberland Boot** you need to have something that producer of the **Timberland Boot** happens to want at that moment. Money solves this problem by providing a universal system for commercial exchange.

* **A Measure of Value**

It is crystal clear that under barter system, it is very difficult to measure the value of goods. For instance, a **Cow** may be valued as worth ten bags of **Rice** or four **Goats. This makes it difficult for trade to take place.**

Money is the measuring bar of everything. By acting as a common denominator, it permits everything to be priced, that is, valued in terms of money. Thus, people are enabled to com­pare different prices and thus see the relative values of different goods and services.

#### **Money as a Store of Value (Purchasing Power)**

Money serves as a store of value for the purpose of future transactions. The main challenges of using commodities such as salt or animals like horses or cows as money is that after some period they deteriorate and lose economic value.

Thus, money is used as a store of purchasing power. It can be held over a period of time and used to finance future payments. More­over, when people save money, they get the assurance that the money saved will have value when they wish to spend it in the future. However, this statement holds only if there is no severe inflation (or deflation) in the country.

#### **Money as a Basis of Credit**

Money facilitates loans. Borrowers can use money to obtain goods and services when they are needed most. A newly married couple, for example, would need a lot of money to completely furnish a house at once. They are not required to wait for, say ten years, so as to be able to save enough money to buy costly items like cars, refrigerators, television, microwave, home theater, etc.

#### **Money as a Unit of Account**

Money is used to measure value in a monetary economy. It is used to measure and record financial transactions as also the value of goods or services produced in a country over time. The Leone (Le), dollar ($), pound sterling, cedi, naira, franc etc., are all examples of unit of account. Also, as a unit of account, money allows us to keep records of payments debts.

#### **Money Serves as a Standard of Postponed Payment**

Money allows credit transactions. Here again money is used as a medium of exchange, but this time the payment is spread over a period of time. Thus, when goods are bought on hire-purchase, they are given to the buyer upon payment of a deposit, and he then pays the remaining amount in a number of installments.

***8.4 Types of Money***

There are different kinds of money in circulation in an economy. But for the purpose of this text I would only look at the most important types. There following are the major types of money discussed below:

* **Commodity Money**

It is a money that has a commodity value or intrinsic value used as a medium of exchange. It was the simplest kind of money used in during the barter system of trade.

In a very simple term, a commodity money is when a commodity is used for exchange purpose. Examples of commodity money includes, gold, silver, copper, cowries, ginger, tobacco, umbrella, beads etc.

* **Fiat Money**

This is the money that is backed by the government and that makes it to be generally acceptable as a medium of exchange. Fiat money does not have any intrinsic value like the commodity money. The value of fiat money is determined by government order which makes it a legal instrument for all transaction purposes. Today Fiat money is the basis of all the modern money system. The real value of fiat money is determined by the market forces of demand and supply. For instance, Leone in Sierra Leone, Ringgit in Malaysia, Rand in South Africa, Won in South Korea, Dollar in the United States of America, the Pound sterling in United Kingdom, Naira and Kobo in Nigeria, Cedi in Ghana etc.

* **Fiduciary Money**

It is crystal clear that in recent times the financial system is extremely fiduciary. Fiduciary money is money that is generally accepted by the public as a medium of exchange based on the simple fact that people have faith in the financial system and government.

Simply put, fiduciary money is when any bank assures its customers to pay in different types of money and the customer can sell the promise or transfer it to somebody else. There are examples of fiduciary money are cheques, banknotes etc.

* **Commercial Bank Money**

This is also known as demand deposits money. It is simply the claims made against financial institutions by its customers that can be used for the purchase of goods and services. A demand deposit account is an account in which customers can withdraw funds at any point in time via cheques without any prior notice. Customers withdraw cash using cheques, bank draft, online banking etc.

* **Fractional Money**

It is a amalgam type of money which is partially supported by a commodity and has a fiat money transaction purpose. If the commodity loses its value then Fractional money converts into Fiat money.

* **Currency**

This is the money we usually see in circulation in the economy on a daily basis in the form of coins and notes. It is also referred to as pure money. Coins and notes plus bank deposits forms the very basics of money supply in the economy.

***10.5 Money Demand***

**The demand for money simply means the desire/craving to hold money as oppose to investing it.** Keynes propounded a theory of demand for money which occupies an important place in his monetary theory. Keynes uses the term liquidity preference to refer to the desire to hold money. How much of his income or resources will a person hold in the form of ready money (cash or non-interest-paying bank deposits) and how much will he part with or lend depends upon what Keynes calls his “liquidity preference.” Liquidity preference means the demand for money to hold or the desire of the public to hold cash.

**Reasons for Money Demand**

(i) The transactions motive,

(ii) The precautionary motive, and

(iii) The speculative motive.

**1. The Transactions Demand for Money:**

The transactions motive relates to the demand for money or the need for money balances for the current transactions of individuals and business firms. Individuals hold cash in order “to bridge the interval between the receipt of income and its expenditure”. In other words, people hold money or cash balances for transaction purposes, because receipt of money and payments do not coincide.

Most of the people receive their incomes weekly or monthly while the expenditure goes on day by day. A certain amount of ready money, therefore, is kept in hand to make current payments. This amount will depend upon the size of the individual’s income, the interval at which the income is received and the methods of payments prevailing in the society.

The businessmen and the entrepreneurs also have to keep a proportion of their resources in money form in order to meet daily needs of various kinds. They need money all the time in order to pay for raw materials and transport, to pay wages and salaries and to meet all other current expenses incurred by any business firm.

**2. Precautionary Demand for Money:**

Precautionary motive for holding money refers to the desire of the people to hold cash balances for unforeseen contingencies. People hold a certain amount of money to provide for the danger of unemployment, sickness, accidents, and the other uncertain perils. The amount of money demanded for this motive will depend on the psychology of the individual and the conditions in which he lives.

**3. Speculative Demand for Money:**

The speculative motive of the people relates to the desire to hold one’s resources in liquid form in order to take advantage of market movements regarding the future changes in the rate of interest (or bond prices). The notion of holding money for speculative motive was a new and revolutionary Keynesian idea. Money held under the speculative motive serves as a store of value as money held under the precautionary motive does. But it is a store of money meant for a different purpose.

Nothing is certain in the dynamic world, where guesses about the future course of events are made on precarious basis, businessmen keep cash to speculate on the probable future changes in bond prices (or the rate of interest) with a view to making profits.

**Chapter 11**

**FINANCIAL INSTITUTIONS**

***11.1 Meaning of Financial Institutions***

Bottom of Form

Financial institutions are companies in the financial sector that provide a broad range of business and services, including banking, insurance, and investment management. Governments of the country consider it essential to oversee and to regulate these institutions as they play an integral part in the economy of the country.

There are many different types of financial institutions that exist in the financial market for fund flows. These are divided primarily based on the type of transactions performed by them, i.e., some of them are involved in the depositary type of the transaction. In contrast, others are involved in the non-depositary type of transactions.

***11.2 Meaning of Banking***

The entire concept of bank is deeply rooted in Italy when merchants were engaging in the act of exchanging money.

A bank is defined as a financial establishment that accepts deposits from the public and give out advances and pays out when the customers make demands.

Banking is defined as an industry that handles cash, loans and other financial assets.

**11.3 Central Bank**

A central bank is generally recognized as a bank which constitutes the apex of the monetary and banking structure of its country and which performs as best as it can, in the national economic interest. It is the pinnacle of all financial institutions in the nation.

The importance of a central bank lies in its function of managing the financial system of the country, internally as well as externally. By the nature of its business, the central bank is closely connected with the banking system and money market of the country and can definitely regulate the monetary system of country in the general interest of the nation.

**11.3.1 The Features of Central Bank**

The following are the essential features of a central bank:

* **Single Organization**

In a country there has only one central bank exist. In the world, there has been no existence of two or more central bank in any country. So central bank can be called as single organization. For this reason, it does not require to compete with other banks.

* **Legal entity**

Central bank is established by the special act of parliaments. As a result, legal entity of central bank is much stronger than other banks. This strong legal entity gives special privilege to other banks.

* **Nature ownership**

The ownership of central bank can be fully government or joint venture of government and private ownership. But the reality said that government owned central bank is maximum in the world.

* **Difference in objective**

Because the operations of the central bank are such as profoundly to affect the monetary and credit situation, they cannot be undertaken solely for the purpose of making profit. The profit motive should only be a secondary consideration, and not the primary motive for central banking operations.

* **Note issue**

The issue of note is the most important function of a central bank. In fact, the practical experience shown that the central bank is the most suitable and appropriate medium for the issue of note.

* **Control**

In the present century, central bank has become as part of the economic set up in a country. All over the world, Central bank is under the control of government particularly it has been work under the direction of department of finance or treasury.

* **Relation with Government**

The central bank is closely related to the government as its banker and the financial adviser. It is generally an organ of the government and performing the banking operations of government. Central bank represents the government not only in country but also the outside of the country as well.

* **Guardian of the money market**

An effective monetary management requires a centralized country over both currency and credit. Being in close and intimate contact with the money market a central bank is in a position to know best when and to what extent to expand or to contract currency and credit to meet the changing requirements of the money market.

* **Banker and controller of other banks**

The central bank functions as a banker’s bank. It also controls and regulates the cameral bank and other financial institutions. For effective control central bank prescribes different rules and regulations and it is mandatory to maintain these rules by other banks.

* **Lender of the last Resort**

As a lender or the resort central bank provides rediscounts and advances to the commercial banks in times of credit stringency. It also gives loan to the govt. when requires.

* **Controller of Foreign Exchange**

The central bank maintains the foreign exchange reserves of the country and attempts to stability in the exchange rates.

**11.3.2 Functions of Central Bank**

One can find some differences in the style of functioning of a central bank. Its functions in an under­developed country differ from those in a developed country. But the central bank performs the following common but vital functions in every country.

* **Monopoly Power of Note Issue**

In the 19th century, commercial banks in many countries enjoyed the right to issue notes.

As the notes issued by them lacked uniformity, governments could not be prevented from over-issuing (or under-issuing) of notes. In view of these problems, the central bank has been given the monopoly power of note issue. It has been empowered to do so in the interest of uniformity and to bring a balance between demand for money and supply of money (i.e., prevention of over-issue or under-issue of notes).

The notes issued by the central bank are considered as legal tender money of the country and form the cash basis of the credit of commercial banks. Being the sole supplier of money in the economy, the central bank regulates the volume of currency of the country. It has also the power to withdraw worn and torn notes from circulation in exchange for new ones, so that good quality notes and coins circulate in the economy.

* **Bankers’ Bank**

Commercial banks are required, by law or convention, to keep a certain percentage of their deposits are serves with the central bank. In this way, it acts as a custodian of cash reserves. Banks draw cash balances from the central bank as and when the situation demands.

As a bankers’ bank, it acts as a lender of the last resort. If commercial banks face serious liquidity crisis they approach the central bank and it stretches its lending hand to them—either by discounting bills or buying securities from them. This sort of accommodation makes the central bank a lender of the last resort. This is essential to prevent bank failure.

It gives advice to banks on good/sound banking practice. A central bank usually discusses government policy with them and reports back to the government. Thus, a central bank closely monitors the activity of commercial banks.

* **Banker, Agent and Adviser to the Government**

The central bank acts as a banker, agent and adviser to any government. As a banker of the government, it has to maintain banking accounts of both central and state governments. It makes and receives payments on behalf of the government as it acts as the agent of the government.

Truly speaking, government (central, state, and union territories) expenditure (say, on road building, hospital construction, etc.,) and revenue (say from income tax, excise duty, etc.,) pass through the central bank. In brief, it performs merchant banking functions for the government.

It also provides short-term loans and advances (known as ways and means advances) to the government to enable the latter to tide over its financial difficulties. It also advises the government on necessary monetary and financial matters such as market borrowing, loan repayment, deficit financing, and control of inflation.

* **Controller of Credit**

The central bank of a country prescribes broad parameters of banking operations within which the country’s banking and finance system operates. In a modern credit-oriented economy, credit is an important component of money supply. Being profit-making institutions, commercial banks may adopt the policy of undue expansion or contraction of credit to suit their needs.

This may lead to inflation or deflation. Neither of the two is desirable. To ensure price stability, credit supply is to be regulated. And, this task has been entrusted with the central bank. The central bank, through its credit control policy, intends to curb the lending potential of commercial banks.

Actually, it keeps the creation of credit within limits. It is accepted that this is its most important function. However, for controlling credit, it uses several official instruments like the bank rate, open market operations, and so on.

* **Custodian of Foreign Exchange Reserves**

With the aim of facilitating foreign trade and payment and promoting orderly development and maintenance of foreign exchange market, a central bank acts as the manager of foreign exchange. The central bank acts as the sole custodian of gold and foreign currencies for the purpose of issuing notes and for correcting an adverse balance of payments situation.

In this connection, one may note that, by holding gold and foreign currencies, the central bank intends to stabilize foreign exchange rate. Like internal price stability, stability in foreign exchange rate is equally vital. A central bank aims at affecting the foreign exchange rate (i.e., the rate at which one currency is converted into another currency) by buying and selling foreign currencies in the foreign exchange market.

* Acts as a clearing house for the settlement of accounts of commercial banks.
* Studies different aspects of economic problems, compiles data and informa­tion and publishes reports and periodi­cals, etc.
* To develop the money and capital markets.
* To strengthen the banking structure.
* To meet the genuine financial needs of agriculture and industry, and so on.

***11.4 Commercial Banks***

A commercial bank is a retail financial institution which performs the functions of accepting deposits from the general public and giving loans for investment with the aim of earning profit. Examples of commercial banks in Sierra Leone includes: Sierra Leone Commercial Bank (SLCB), Rokel Commercial Bank, Zenith Bank, Access Bank, Eco bank, UBA etc.

There are two major features of a commercial bank. These are borrowing and lending. They accept deposits and lend money to projects to earn Interest (profit). In short, banks are financial intermediaries. They are the midfielders between the surplus unit and the deficit unit in the financial system. The rate of interest offered by the banks to depositors is called the borrowing rate while the rate at which banks lend out is called lending rate.

***11.4.1 Functions of Commercial Banks***

The following are the major functions of a commercial bank:

* **Commercial banks accept deposits from customers**

A commercial bank accepts deposits in the form of current, savings and fixed deposits. It collects the surplus balances of the Individuals, firms and finances the temporary needs of commercial transactions. The first task is, therefore, the collection of the savings of the public. The bank does this by accepting deposits from its customers. Deposits are the lifeline of banks.

* **It gives loans and advances**

The second major function of a commercial bank is to give loans and advances particularly to businessmen and entrepreneurs and thereby earn interest. This is, in fact, the main source of income of the bank. A bank keeps a certain portion of the deposits with itself as reserve and gives (lends) the balance to the borrowers as loans and advances in the form of cash credit, demand loans, short-run loans, overdraft etc.

* **Discounting bills of exchange**

A bill of exchange represents a promise to pay a fixed amount of money at a specific time in the future. Alternatively, a bill of exchange is a document acknowledging an amount of money owed in consideration of goods received. It is a paper asset signed by the debtor and the creditor for a fixed amount payable on a fixed date. It works like this.

Suppose, A buys goods from B, he may not pay B immediately but instead give B a bill of exchange stating the amount of money owed and the time when A will settle the debt. Suppose, B wants the money immediately, he will present the bill of exchange to the bank for discounting. The bank will deduct the commission and pay to B the present value of the bill. When the bill matures after specified period, the bank will get payment from A.

* **Overdraft facility**

An overdraft is an advance given by allowing a customer keeping current account to overdraw his current account up to an agreed limit. It is a facility to a depositor for overdrawing the amount than the balance amount in his account.

In other words, depositors of current account make arrangement with the banks that in case a check has been drawn by them which are not covered by the deposit, then the bank should grant overdraft and honour the check. The security for overdraft is generally financial assets like shares, debentures, life insurance policies of the account holder, etc.

* **Agency functions of the bank**

The bank acts as an agent of its customers and gets commission for performing agency functions as under:

**(i) Transfer of funds**

It provides facility for cheap and easy remittance of funds from place-to-place through demand drafts, mail transfers, telegraphic transfers, etc.

**(ii) Collection of funds**

It collects funds through cheques, bills, bundles and demand drafts on behalf of its customers.

**(iii) Payments of various items**

It makes payment of taxes. Insurance premium, bills, etc. as per the directions of its customers.

**(iv) Purchase and sale of shares and securities**

It buys sells and keeps in safe custody securities and shares on behalf of its customers.

(v) Collection of dividends, interest on shares and debentures is made on behalf of its customers.

(iv) Acts as Trustee and Executor of property of its customers on advice of its customers.

**(vii) Letters of References**

It gives information about economic position of its customers to traders and provides similar information about other traders to its customers.

* **Performing general utility services**

**The banks provide many general utility services, some of which are as under:**

(i) Traveller’s cheques. The banks issue traveler’s cheques and gift cheques.

(ii) Locker facility. The customers can keep their ornaments and important documents in lockers for safe custody.

(iii) Underwriting securities issued by government, public or private bodies.

(iv) Purchase and sale of foreign exchange (currency).

***11.5 Key Concepts***

**11.5.1 Types of Deposits**

* **Current account deposits**

This is also known as demand deposits. Such deposits are payable on demand. Here, depositors can withdraw cash at any given and number of times depending upon the balance in their account. The bank does not pay any Interest on these deposits but provides cheques facilities. These accounts are generally maintained by businessmen and Industrialists who receive and make business payments of large amounts through cheques.

* **Fixed deposits**

This is also known as time deposits. Fixed deposits have a fixed period of maturity and are referred to as time deposits. These are deposits for a fixed term, i.e., period of time ranging from a few days to a few years. These are neither payable on demand nor they enjoy cheques facilities.

They can be withdrawn only after the maturity of the specified fixed period. They carry higher rate of interest. They are not treated as a part of money supply Recurring deposit in which a regular deposit of an agreed sum is made is also a variant of fixed deposits.

* **Savings account deposits**

These are depositors whose main objective is to save. Savings account is most suitable for individual households. They combine the features of both current account and fixed deposits. They are payable on demand and also withdraw able by cheques. But bank gives this facility with some restrictions, e.g., a bank may allow four or five cheques in a month. Interest paid on savings account deposits in lesser than that of fixed deposit.

***11.5.2 Forms of Loans***

**(i) Cash Credit**

An eligible borrower is first sanctioned a credit limit and within that limit he is allowed to withdraw a certain amount on a given security. The withdrawing power depends upon the borrower’s current assets, the stock statement of which is submitted by him to the bank as the basis of security. Interest is charged by the bank on the drawn or utilised portion of credit (loan).

**(ii) Demand Loans**

A loan which can be recalled on demand is called demand loan. There is no stated maturity. The entire loan amount is paid in lump sum by crediting it to the loan account of the borrower. Those like security brokers whose credit needs fluctuate generally, take such loans on personal security and financial assets.

**(iii) Short-term Loans**

Short-term loans are given against some security as personal loans to finance working capital or as priority sector advances. The entire amount is repaid either in one installment or in a number of installments over the period of loan.

***11.5.3 Investment***

**Commercial banks invest their surplus fund in 3 types of securities:**

(i) Government securities, (ii) Other approved securities and (iii) Other securities. Banks earn interest on these securities.

***11.5.4 Difference between Demand Deposits and Time (Term) Deposits***

(i) Deposits which can be withdrawn on demand by depositors are called demand deposits, e.g., current account deposits are called demand deposits because they are payable on demand but saving account deposits do not qualify because of certain conditions on withdrawal. No interest is paid on them. Term deposits, also called time deposits, are deposits which are payable only after the expiry of the specified period.

(ii) Demand deposits do not carry interest whereas time deposits carry a fixed rate of interest.

(iii) Demand deposits are highly liquid whereas time deposits are less liquid,

(iv) Demand deposits are checkable deposits whereas time deposits are not.

***11.5.5 Difference between Overdraft facility and Loan***

(i) Overdraft is made without security in current account but loans are given against security.

(ii) In the case of loan, the borrower has to pay interest on full amount sanctioned but in the case of overdraft, the borrower is given the facility of borrowing only as much as he requires.

(iii) Whereas the borrower of loan pays Interest on amount outstanding against him but customer of overdraft pays interest on the daily balance.

**Chapter 12**

**INFLATION**

## *12.1 Introduction*

Inflation is often defined in terms of its supposed causes. Inflation exists when money supply exceeds available goods and services. Or inflation is attributed to budget deficit financing. A deficit budget may be financed by the additional money creation. But the situation of monetary expansion or budget deficit may not cause price level to rise. Hence the difficulty of defining ‘inflation’.

Inflation may be defined as ‘a sustained upward trend in the general level of prices’ and not the price of only one or two goods. G. Ackley defined inflation as ‘a persistent and appreciable rise in the general level or aver­age of prices’. In other words, inflation is a state of rising prices, but not high prices.

It is not high prices but rising price level that con­stitute inflation. It constitutes, thus, an over­all increase in price level. It can, thus, be viewed as the devaluing of the worth of money. In other words, inflation reduces the purchasing power of money. A unit of money now buys less. Inflation can also be seen as a recurring phenomenon.

As inflation is a state of rising prices, de­flation may be defined as a state of falling prices but not fall in prices. Deflation is, thus, the opposite of inflation, i.e., a rise in the value of money or purchasing power of money. Disinflation is a slowing down of the rate of inflation.

### ***12.2 Types of Inflation***

As the nature of inflation is not uniform in an economy for all the time, it is wise to distin­guish between different types of inflation. Such analysis is useful to study the distribu­tional and other effects of inflation as well as to recommend anti-inflationary policies.

**(i) Creeping or Mild Inflation:**

If the speed of upward thrust in prices is slow but small then we have creeping inflation. What speed of annual price rise is a creeping one has not been stated by the economists. To some, a creeping or mild inflation is one when annual price rise varies between 2 p.c. and 3 p.c. If a rate of price rise is kept at this level, it is con­sidered to be helpful for economic development. Others argue that if annual price rise goes slightly beyond 3 p.c. mark, still then it is considered to be of no danger.

**(ii) Walking Inflation:**

If the rate of annual price increase lies between 3 percent and 4 percent, then we have a situation of walking inflation. When mild inflation is allowed to fan out, walking inflation appears. These two types of inflation may be described as ‘moderate inflation’.

Often, one-digit inflation rate is called ‘moder­ate inflation’ which is not only predict­able, but also keep people’s faith on the monetary system of the country. Peoples’ confidence gets lost once moderately maintained rate of inflation goes out of control and the economy is then caught with the galloping inflation.

**(iii) Galloping and Hyperinflation:**

Walking inflation may be converted into running inflation. Running inflation is danger­ous. If it is not controlled, it may ulti­mately be converted to galloping or hyperinflation. It is an extreme form of inflation when an economy gets shattered. “Inflation in the double- or triple-digit range of 20, 100 or 200 percent a year is labelled “galloping inflation”.

### **(iv) Currency inflation**

This type of infla­tion is caused by the printing of cur­rency notes.

**(v) Credit inflation**

Being profit-making institutions, commercial banks sanction more loans and advances to the public than what the economy needs. Such credit expansion leads to a rise in price level.

**(vi) Deficit-induced inflation**

The budget of the government reflects a deficit when expenditure exceeds revenue. To meet this gap, the government may ask the central bank to print additional money. Since pumping of additional money is required to meet the budget deficit, any price rise may then be called the deficit-induced inflation.

**(vii) Demand-pull inflation**

An increase in aggregate demand over the available output leads to a rise in the price level. Such inflation is called demand-pull in­flation. But why does aggregate demand rise? Classical economists attribute this rise in aggre­gate demand to money supply. If the supply of money in an economy ex­ceeds the available goods and services, demand-pull in­flation. appears. It has been described by Coulborn as a situation of “too much money chasing too few goods.”

**(viii) Cost-push inflation**

Inflation in an economy may arise from the overall increase in the cost of production. This type of inflation is known as cost-push inflation. Cost of pro­duction may rise due to an increase in the prices of raw materials, wages, etc. Often trade unions are blamed for wage rise since wage rate is not completely market-determined. Higher wage means high cost of production. Prices of commodities are thereby increased.

A wage-price spiral comes into opera­tion. But, at the same time, firms are to be blamed also for the price rise since they simply raise prices to expand their profit margins. Thus, we have two im­portant variants of CPI wage-push in­flation and profit-push inflation.

**12.3 Causes of Inflation**

* **A depreciation of the exchange** rate increases the price of imports and reduces the foreign price of a country`s exports. If consumers buy fewer imports, while exports grow, aggregate demand will rise – and there may be a multiplier effect on the level of demand and output.
* **Higher demand from a fiscal stimulus** e.g. lower direct or indirect taxes or higher government spending. If direct taxes are reduced, consumers have more disposable income causing demand to rise. Higher government spending and increased borrowing creates extra demand in the circular flow.
* **Monetary stimulus to the economy-**A fall in interest rates may stimulate too much demand – for example in raising demand for loans or in leading to house price inflation. Monetarist economists believe that inflation is caused by “too much money chasing too few goods" and that governments can lose control of inflation if they allow the financial system to expand the money supply too quickly.
* **Higher Indirect Taxes**-for example a rise in the duty on alcohol, fuels and cigarettes, or a rise in Value Added Tax. Depending on the price elasticity of demand and supply for their products, suppliers may choose to pass on the burden of the tax onto consumers.
* **Rising Labour Costs-** caused by wage increases, which are greater than improvements in productivity. Wage costs often rise when unemployment is low because skilled workers become scarce and this can drive pay levels higher. Wages might increase when people **expect higher inflation** so they ask for more pay in order to protect their real incomes. Trade unions may use their bargaining power to bid for and achieve increasing wages, this could be a cause of cost-push
* **A fall in the exchange rate-**this can cause cost push inflation because it leads to an increase in the prices of imported products such as essential raw materials, components and finished goods.
* **Monopoly employers/profit-push inflation**- where dominants firms in a market use their market power (at whatever level of demand) to increase prices well above costs.

### ***12.4 Effects of Inflation***

* **Effects on Production**

It hinders capital formation as inflation increases the price of capital goods. It is disincentives to the producer to invest more capital. It stimulates the speculative activities like hoarding and misallocation of productive resources.

* **Effect on Debtors**

Due to inflation the debtors pay back less in real terms, thus they are gainers during the inflation.

* **Effect on Creditors**

The creditors tend to lose as they get less as compared to what they have lent.

* **Effect on Entrepreneurs**

The entrepreneur gain on the account of windfall profit arises because price rises at faster rate as compared to cost of production.

* **Effect on Investors**

When the price rises, the return on equities goes up on account of rise in profits while bonds and debenture holder gains nothing as their income remains fixed.

* **Effect on Farmers**

Farmers generally gain during the period of inflation on the account of following reasons:

* + The price of farm products goes up faster than cost
  + Farmers are generally debtors in India. They have to pay less in real terms.
* **Effect on Wage earners/ Labourers**

The unorganized workers suffer during inflation because wages do not rise as much as the rise in price of commodities which they consume.

* **Effect on Middle class/Salaried**

The middle class which receives fixed income in the form of past savings, fixed interest or rent, pensions etc. suffers during the period of rising prices as their incomes remains fixed.

* **Effect on Government**

The government has to spend more on goods and services for carrying out their project and schemes. This may lead to increase in deficit or taxes are raised.

## *12.5 Measures* *for Controlling Inflation*

Inflation is considered to be a complex situation for an economy. Inflation has to be controlled. Otherwise, the extent of damage done to the economy will be substantial and the economy would take a long time to recover from the effects of inflation. Measures to check inflation would include steps to control the growth of demand and increase in agricultural and industrial supply so that balance between demand and supply is maintained. Government has made efforts to overcome inflationary situation and bring about price stability.

The different measures used for controlling inflation are explained below.

#### **1. Monetary Measures**

The government of a country takes several measures and formulates policies to control economic activities. Monetary policy is one of the most commonly used measures taken by the government to control inflation.

In monetary policy, the central bank increases rate of interest on borrowings for commercial banks. As a result, commercial banks increase their rate of interests on credit for the public. In such a situation, individuals prefer to save money instead of investing in new ventures.

This would reduce money supply in the market, which, in turn, controls inflation. Apart from this, the central bank reduces the credit creation capacity of commercial banks to control inflation.

**The monetary policy of a country involves the following:**

**(a) Rise in Bank Rate:**

This refers to one of the most widely used measure taken by the central bank to control inflation.

The bank rate is the rate at which the commercial bank gets a rediscount on loans and advances by the central bank. The increase in the bank rate results in the rise of rate of interest on loans for the public. This leads to the reduction in total spending of individuals.

**The main reasons for reduction in total expenditure of individuals are as follows;**

**(i) Making the borrowing of money costlier:**

This refers to the fact that with the rise in the bank rate by the central bank increases the interest rate on loans and advances by commercial banks. This makes the borrowing of money expensive for general public.

Consequently, individuals postpone their investment plans and wait for fall in interest rates in future. The reduction in investments results in the decreases in the total spending and helps in controlling inflation.

**(ii) Creating adverse situations for businesses:**

This implies that increase in bank rate has a psychological impact on some of the businesspersons. They consider this situation adverse for carrying out their business activities. Therefore, they reduce their spending and investment.

**(iii) Increasing the propensity to save:**

This refers to one of the most important reason for reduction in total expenditure of individuals. It is a well-known fact that individuals generally prefer to save money in inflationary conditions. As a result, the total expenditure of individuals on consumption and investment decreases.

**(b) Direct Control on Credit Creation:**

This constitutes the major part of monetary policy.

**The central bank directly reduces the credit control capacity of commercial banks by using the following methods:**

**(i) Performing Open Market Operations (OMO):**

This refers to one of the important method used by the central bank to reduce the credit creation capacity of commercial banks. The central bank issues government securities to commercial banks and certain private businesses.

In this way, the cash with commercial banks would be spent on purchasing government securities. As a result, commercial bank would reduce credit supply for the general public.

**(ii) Changing Reserve Ratios:**

This Involves increase or decrease in reserve ratios by the central bank to reduce the credit creation capacity of commercial banks. For example, when the central bank needs to reduce the credit creation capacity of commercial banks, it increases Cash Reserve Ratio (CRR). As a result, commercial banks need to keep a large amount of cash as reserve from their total deposits with the central bank. This would further reduce the lending capacity of commercial banks. Consequently, the investment by individuals in an economy would also reduce.

#### **2. Fiscal Measures**

Apart from monetary policy, the government also uses fiscal measures to control inflation. By adopting suitable measures in taxation, public expenditure and borrowing, the government can effectively curb inflation.

In order to reduce the disposable income with the people, the tax rates could be enhanced on a selective basis or new taxes could be introduced by which a sizeable portion of the purchasing power of the community could be reduced.

Government expenditures cannot be reduced for all sectors especially for essential for areas, such as defense, health, education, and law and order. In such a case, reducing private spending is more preferable rather than decreasing government expenditure. When the government reduces private spending by increasing taxes, individuals decrease their total expenditure.

For example, if direct taxes on profits increase, the total disposable income would reduce. As a result, the total spending of individuals decreases, which, in turn, reduces money supply in the market. Therefore, at the time of inflation, the government reduces its expenditure and increases taxes for dropping private spending.

#### **3. Price Control**

Another method for ceasing inflation is preventing any further rise in the prices of goods and services. In this method, inflation is suppressed by price control, but cannot be controlled for the long term. In such a case, the basic inflationary pressure in the economy is not exhibited in the form of rise in prices for a short time. Such inflation is termed as suppressed inflation.

The historical evidences have shown that price control alone cannot control inflation, but only reduces the extent of inflation. For example, at the time of wars, the government of different countries-imposed price controls to prevent any further rise in the prices. However, prices remain at peak in different economies. This was because of the reason that inflation was persistent in different economies, which caused sharp rise in prices. Therefore, it can be said inflation cannot be ceased unless its cause is determined.

**Chapter 13**

**UNEMPLOYMENT**

## 13.1 Meaning of Unemployment

**Unemployment** represents the number of people in the work force who want to work but do not have a job. It is generally stated as a percentage and calculated by dividing the number of people who are unemployed by the total work force.

Furthermore, it is those people in the workforce or pool of people who are available for work that does not have an appropriate job. Usually measured by the unemployment rate, which is dividing the number of unemployed people by the total number of people in the workforce, unemployment serves as one of the indicators of an economy’s status.

The **work force** is made up of those people who want to work; it excludes people who are retired, disabled, and able to work but not currently looking for a position; for instance, they may be taking care of children or going to college.

**13.2 Types of Unemployment**

Before explaining the various types of unemployment, it is necessary to define the term unemployment. Everyman’s Dictionary of Economics defines unemployment as “involuntary idleness of a person willing to work at the prevailing rate of pay but unable to find it.”

It implies that only those persons are to be regarded as unemployed who are prepared to work at the prevailing rate of pay but they do not find work. Voluntarily unemployed persons who do not want to work like the idle rich, are not considered unemployed.

* **Frictional Unemployment**

Frictional unemployment exists when there is lack of adjustment between demand for and supply of labour. This may be due to lack of knowledge on the part of employers about the availability of workers or on the part of workers that employment is available at a particular place.

It is also caused by lack of necessary skills for a particular job, labour immobility, breakdowns of machinery, shortages of raw materials, etc. The period of unemployment between losing one job and finding another is also included under frictional unemployment.

* **Seasonal Unemployment**

Seasonal unemployment results from seasonal fluctuations in demand. Employment in ice factories is only for the summer. Similarly, ice-cream sellers remain unemployed during winter and chestnut-sellers during summer. The same is the case with agricultural workers who remain employed during harvesting and sowing seasons and remain idle for the rest of the year.

* **Cyclical Unemployment**

Cyclical unemployment arises due to cyclical fluctuations in the economy. They may also be generated by international forces. A business cycle consists of alternating periods of booms and depressions. It is during the downswing of the business cycle that income and output fall leading to widespread unemployment.

* **Structural Unemployment**

Structural unemployment results from a variety of causes. It may be due to lack of the co-operant factors of production, or changes in the economic structure of the society. The word structural implies that “the economic changes are massive, extensive, deep-seated, amounting to transformation of an economic structure, i.e., the production functions or labour supply distribution.

More specifically, it refers to changes which are large in the particular area, industry or occupation.” Shifting patterns in the demand for the products of various industries have also been responsible for this type of unemployment.

There are, however, economists who argue that the higher unemployment in America since 1957 has been due to causes other than inadequate demand: (1) A faster rate of technological change; (2) a displaced worker remains unemployed for a number of days in finding a new job; and (3) most of the unemployed workers belong to blue-collar groups.

The supporters of the structural transformation thesis hold that the number of vacancies is greater than or equal to the number of displaced workers due to structural changes in a particular area, industry or occupation, and that unemployment is not due to inadequacy of demand.

* **Technological Unemployment**

Modern production process is essentially dynamic where innovations lead to the adoption of new machineries and inventions thereby displacing existing workers leaving behind a trail of unemployment. When there is automation or displacement of old technology by a new one requiring less workers than before, there is technological unemployment.

A special case of technological unemployment is that “which is not due to improvements in the technique of production but in the technique of organisation.” It pertains to making management more efficient which may decide upon modernising existing facilities or closing down obsolete plants. In all such cases unemployment is bound to decrease.

In fact, there is little to distinguish between structural and technology unemployment. One of the causes of structural unemployment is technological change. Technological change itself causes obsolescence of skills thereby leading to structural unemployment.

* **Disguised Unemployment**

Disguised or concealed unemployment or underemployment is a notable feature of underdeveloped countries. Such unemployment is not voluntary but involuntary. People are prepared to work but they are unable to find work throughout the year due to the lack of complementary factors.

Such unemployment is found among rural landless and small farmers due to the seasonal nature of farm operations and inefficient land and equipment to keep them fully employed. A person is said to be disguised unemployed if his contribution to output is less than what he can produce by working for normal hours per day. His marginal productivity is nil or negligible, and by withdrawing such labourers, farm output can be increased.

* **Voluntary unemployment**

Voluntary unemployment happens when a worker decides to leave a job because it is no longer financially fulfilling. An example is a worker whose take-home pay is less than his or her cost of living.

* **Demand deficient unemployment**

This is the biggest cause of unemployment that happens especially during a recession. When there is a reduction in the demand for the company’s products or services, they will most likely cut back on their production, making it unnecessary to retain a wide workforce within the organization. In effect, workers are laid off.

**13.3 General Causes of Unemployment**

The following are few major causes of unemployment.

* **A large number of technological advancements**

It is very needless to say that today we live in an age of technology. Previously companies required a lot of labour in order to perform tasks for them.

However, nowadays, **computers and various other machines** can perform even the most complex of tasks in just minutes. In addition to that, some years ago, even sending one message or reply took so much of time.

Nowadays with the **help of the internet**, things are done in a matter of minutes and it is for this reason that so many people are no longer required to do tasks which required manual labour and intellectual ability. This is one of the reasons for unemployment.

* **Jobs have become increasingly specialized**

Big companies provide their employees with a large number of benefits and facilities. It is for this reason that when looking for employees, they have a large number of specifications.

Unless a person fulfils all the requirements, he or she will not even be considered for the position at hand. Since job descriptions have become so very specific and particular, people are finding it very tough to even get an interview.

At such a point in time, there is little which can be done, because companies will not be willing to take on board those who are not exactly perfect for the job.

* **Companies prefer hiring a few people on board**

Previously top companies hired a large number of people so as to ensure that all the jobs get done in a proper manner, within the stipulated deadline.

However, nowadays, companies prefer to hire as few people as possible on board. This is so that they do not have to spend too much money on salaries and secondly so that their trade secrets do not go out. They are only willing to hire those people who they trust and are entirely sure of.

Many bosses believe that hiring five (5) competent people on board is better than having 20 average people. Offices only hire Rockstar employees who are all-rounders and are capable of excellent work at all times.

* **People voluntarily choose to remain unemployed**

There are many individuals out there who are very specific when it comes to choosing jobs, simply because they do not work in a company which they would not like to mention on their Curriculum Vitae or resume, in the future.

On the other end of the spectrum, there are those individuals who are willing to take up any job as long as they are getting a salary and job.

The first kind of people prefer to wait for the right job to come along and that is why they end up being unemployed. They too want to be employed but they are unwilling to take up simply any and every job which happens to come their way.

* **A higher literacy rate among men and women**

Till a few years ago, the literacy rate of the world over was not very high at all. However nowadays more and more people from even the rural regions are coming forward in order to receive an education.

In addition to these even women are being encouraged to come forward and study so that their future is bright and promising. It is very sad indeed that because so many people are educated, the **number of jobs is falling short** and that is why there is so much of unemployment, especially in big cities.

Once people are well educated, chances are that they will be unwilling to accept a job which is not worthy of their intellect.

* **The issue of the immobility of the workforce**

In certain places, job opportunities are more than others. Some places are just not developed enough to provide jobs to a large number of people.

The immobility of the work or labour force is one major reason for unemployment as well. For various reasons, certain able people are simply unwilling to migrate from one location to the next. Rather than taking the plunge, they prefer to remain close to home and families as well.

Doing this is something which is not very wise simply because if you realize that your current location does not hold much potential for you and your career, you must be willing to relocate.

* **Global economic crisis which exists**

Of all the many causes of unemployment which exist, the main causes of unemployment can be pointed to the global economic crisis which exists at the moment and has been existing for a while.

This economic crisis has affected in a very negative manner, the trade between countries. Countries which were previously rather rich have not been able to withstand the economic crisis.

In order to avoid any kinds of major losses, companies too have begun to decrease the production of their goods, since not many individuals are willing to invest a lot of money in purchasing things.

**13.4 Effects or Consequences of Unemployment**

* **Affects the economy of a region very negatively**

It is rather interesting to note that the global economic crisis is not merely a cause but also an effect of unemployment.

Once people are unemployed the government of a country becomes responsible for providing the people with amenities and facilities which they cannot afford. So, when so many people in a country are unemployed it automatically results in **recession**.

* **Reduces the spending power of both the employed as well as unemployed**

Once people are unemployed, they are naturally unwilling to have any purchasing power.

However, besides the unemployed, even those who are employed are unwilling to spend a lot of money, simply because they fear that if things get worse and the company closes down, they too might end up losing their jobs.

* **Makes the individual feel very depressed**

In addition to affecting the country and society it also negatively affects the individual who begins to second guess all his decisions as well as his personal worth at such a time.

* **It is a cause of distress to the entire family**

When someone in the family is unemployed, it is usually not just that one person but the entire family which is affected and has to suffer.

In addition to money being scarce in the family, the family also has to cater to the emotional needs of the person who is unemployed.

* **Increase in crime in the country**

Of all the negative effects of unemployment, one of the worst effects is that it **leads to an increase in crime in the country**.

When breadwinners in a family are unable to provide for their loved ones, they have no option but to resort to crime as well as foul means in order to feed their family members.

At such a time when people are unable to keep body and soul together, their conscience seizes to function and they do what seems correct to them at the moment as well as under the given circumstances. It is often said that **desperate times call for desperate measures** and that is the motto which such people choose to live by.

**Chapter 14**

**INTERNATIONAL TRADE**

***14.1 Introduction***

**International trade** is referred to as economic transactions that are made between countries. Among the items commonly traded are consumer goods, such as television sets and clothing; capital goods, such as machinery; and raw materials and food. Other transactions involve services, such as travel services and payments for foreign patents. International trade transactions are facilitated by international financial payments, in which the private banking system and the central banks of the trading nations play important roles.

International trade and the accompanying financial transactions are generally conducted for the purpose of providing a nation with commodities it lacks in exchange for those that it produces in abundance; such transactions, functioning with other economic policies, tend to improve a nation’s standard of living. Much of the modern history of international relations  concerns efforts to promote free trade between nations.

# ***14.2 Types of International Trade***

There are three main types on international trade. These are:

* Export Trade
* Import Trade
* Entrepot Trade
* Export Trade - this is the selling of goods and services out of the country. For example, if a resident of Sierra Leone sells goods to residents in the United States of America.
* Import Trade – this is the buying of goods and services from another country. For example, if a resident in Sierra Leone buys goods from residents in the United States of America.
* Entrepot Trade – it is also known as re-export and it is a combination of export and import trade. This is an international trade system that involves importing goods from one country and exporting it to another country after adding some value to it. For example, United States of America imports Iron ore from Sierra Leone and makes iron rods from it and then exports it to other countries.

***14.3 Reasons for International Trade***

**Reduced dependence on your local market**

Your home market may be struggling due to economic pressures, but if you go global, you will have immediate access to a practically unlimited range of customers in areas where there is more money available to spend, and because different cultures have different wants and needs, you can diversify your product range to take advantage of these differences.

* **Increased chances of success**

Unless you’ve got your pricing wrong, the higher the volume of products you sell, the more profit you make, and overseas trade is an obvious way to increase sales.  In support of this, UK Trade and Investment (UKTI) claim that companies who go global are 12% more likely to survive and excel than those who choose not to export.

* **Increased efficiency**

Benefit from the economies of scale that the export of your goods can bring – go global and profitably use up any excess capacity in your business, smoothing the load and avoiding the seasonal peaks and troughs that are the bane of the production manager’s life.

* **Economic advantage**

Take advantage of currency fluctuations – export when the value of the pound sterling is low against other currencies, and reap the very real benefits.  Words of warning though; watch out for import tariffs in the country you are exporting to, and keep an eye on the value of sterling.  You don’t want to be caught out by any sudden upsurge in the value of the pound, or you could lose all the profit you have worked so hard to gain.

* **Innovation**

Because you are exporting to a wider range of customers, you will also gain a wider range of feedback about your products, and this can lead to real benefits.  In fact, UKTI statistics show that businesses believe that exporting leads to innovation – increases in break-through product development to solve problems and meet the needs of the wider customer base.  53% of businesses they spoke to said that a new product or service has evolved because of their overseas trade.

**6- Growth**

The holy grail for any business, and something that has been lacking for a long time in our manufacturing industries – more overseas trade = increased growth opportunities, to benefit both your business and our economy as a whole.

## ****14.4 Some Fundamental International Trade Theories****

Theories serves as the basics in understanding important concepts. Here we are going to look at two important theories in the field of international trade.

The following are the two fundamental theories of international trade:

* **Absolute Advantage Theory**

This **theory was propounded 1776 by Adam Smith who is considered as the father of economics in his published work titled “The Wealth of Nations” which focused on the** on the concept of increasing the efficiencies in the production processes.Adam Smith argued that a country has an absolute advantage in the production of a product when it is more efficient than any other country producing it. Countries should specialize in the production of goods for which they have an absolute advantage and then trade these goods for the goods produced by other countries. In economics, principle of absolute advantage refers to the ability of a party (an individual, or firm, or country) to produce more of a good or service than competitors, using the same number of resources.

For instance, if two countries specialize in exactly the same kind of product. But the product of one country being better in quality or lower in price will bring tremendous absolute advantage to the country as compared to the other one. From another point of view, if two countries specialize in entirely different products, then they can quickly increase their influence in their localities by having trade with each other (by creating absolute advantages at both ends).

**Some Assumptions**

1. Trade is between two countries

2. Only two commodities are traded

3. Free Trade exists between the countries

4. The only element of cost of production is labour

**Significance**

1. More quantity of both products

2. Increased standard of living for both countries

3. Increased production efficiency

4. Increase in global efficiency and effectiveness

5. Maximization of global productivity and other resources productivity

**Criticisms against Absolute Advantage Theory**

1. No absolute advantages for many countries

2. Country size varies

3. Country by country differences in specializations

4. Deals with labour only and neglects other factors of production

5. Neglected Transport cost

6. Theory is based on an assumption that Exchange rates are stable and fixed.

7. It also assumes that labor can switch between products easily and they will work with same efficiency which in reality cannot happen.

* **Comparative Advantage**

Comparative advantage refers to the ability of a country to produce particular goods or services at lower opportunity cost as compared to the others in the field. Due to differences in geographical situations, efficiency of labour, climate and natural resources, a country may have the ability to produce a commodity at a lower cost as compared to the other.

As compared to absolute advantage, **Comparative Advantage** favors relative productivity. According to this concept, as put forward by David Ricardo in **1817**, a country with maximum absolute advantage in the creation of more than one product as compared to other, can still trade with another country with less efficient ways to create that product, that’s readily available in first, to boost its productivity.

To illustrate this idea with an example, let’s say that I have expertise in two fields like graphics designing and writing, where designing lets me earn a lot more than writing. Keeping in mind that I can work on only one side at a time, I will most likely hire a writer, and we both will work in a comparative atmosphere.Bottom of Form

In such cases, every country specializes in producing the commodity in which its comparative productions cost is the least. Therefore, all the entities can mutually benefit from voluntary trade and cooperation.

## *Assumptions of Comparative Advantage*

1. There are only two countries, assume A and B.
2. Both of them produce the same two commodities, X and Y.
3. Labour is the only factor of production.
4. The supply of labour is unchanged.
5. All labour units are homogeneous.
6. Tastes are similar in both countries.
7. The labour cost determines the price of the two commodities
8. The production of commodities is done under the law of constant costs or returns.
9. The two countries trade on the barter system.
10. Technological knowledge is unchanged.
11. Factors of production are perfectly mobile within each country. However, they are immobile between the two countries.
12. Free trade is undertaken between the two countries. Trade barriers and restrictions in the movement of commodities are absent.
13. Transport costs are not incurred in carrying trade between the two countries.
14. Factors of production are fully employed in both the countries.
15. The exchange ratio for the two commodities is the same.

## *Criticisms of Comparative Advantage*

1. The theory only considers labour costs and neglects all non-labour costs involved in the production of the commodities.
2. The theory considers all labour to be homogenous. However, in reality, labour is heterogeneous due to different grades and kinds.
3. The theory assumes similar tastes for all. However, the tastes differ with the growth of economies and income brackets.
4. The theory assumes that a fixed proportion of labour is used in the production of all commodities. However, in reality, utilization of the proportion of labour depends on the type of commodity being produced.
5. The theory has an unrealistic assumption of constant costs. However, large-scale productions lead to cost reduction and thereby increase the comparative advantage.
6. Transport costs play an essential role in determining the pattern of trade. But the Ricardo theory neglects this independent factor of production.
7. The assumption of the factors of production being mobile internally is unrealistic. The factors do not move freely from one region to another or one industry to another. The greater the degree of specializations in an industry, the more immobile the factor will be.
8. The assumption of the theory of having only two countries and two commodities is unrealistic as international trade takes place among countries trading numerous commodities.
9. Every country implements restrictions on the movement of goods to and from the countries. Thus, tariffs and trade restrictions play a role in world imports and exports. However, the theory assumes free and perfect world trade.
10. The theory assumes full employment. However, every economy has an existence of underemployment.
11. A country may or may not want to trade a commodity due to military, strategic or development considerations. Therefore, self-interest stands in the operation of the comparative advantage theory.
12. The Ricardian theory considers only the supply side of world trade and neglects the demand side.
13. The theory only explains how two countries gain from international trade. But the theory fails to explain how the gains from the trade are distributed between the two countries.

### **Merits of International Trade**

**1. It provides a foundation for international growth.**  
Companies that are involved in exporting can achieve levels of growth that may not be possible if they only focus on their domestic markets. This allows brands and businesses an opportunity to achieve sustained revenues from a diversified portfolio of customers in several markets instead of a limited customer base in a single home market.

**2. International trade improves financial performance.**  
Brands and businesses which assert themselves in foreign trade work can increase their financial performance. This allows them to augment the returns they achieve on their investments into research and development. By rotating the products or services through the global market, the commercial lifespan of each opportunity can be amplified, expanding what existing products and services can provide. This benefit can even be achieved if a domestic market is no longer interested.

**3. It spreads out the risk a brand and business must assume**  
Organizations can better protect themselves from risk thanks to international trade because of the amount of diversification that can be achieved. Whether it is a financial disaster, like the Great Recession of 2007-2009, or a natural disaster like Hurricane Katrina, a company with an international presence can survive and even maintain profitability without domestic customer support. A home market may be unstable, but international trade can still let the brand and business be stable.

**4. International trade encourages market competitiveness.**  
When a brand and business compete in several markets simultaneously, then it must focus on its competitiveness for it to be able to thrive. By observing a larger range of trends because of their greater level of global market access, brands and businesses can focus on quality, design, and product development improvements so that they can continuously improve and diversify.

**5. International exchange rates can be beneficial to a business.**  
Brands and businesses involved with international trade can further reduce their risk by taking advantage of monetary exchange rates. If a company does most of its trading in US dollars, then trading with Japan to spread the risk of the exchange rate between the yen and the dollar can potentially add to the profits of the company. The same could be said of the euro or the pound to the dollar.

**6. Revenue streams have some protection.**  
Although all risk cannot be eliminated from international trade, a series of contracts, insurance, and financial instrument trading can help to protect the revenue streams a brand and business is able to develop.

### **14.6 Disadvantages of International Trade**

**1. There is always a political risk involved with international trade.**  
Different countries provide their own political risks at varying levels, while domestic politics changes over time and presents an ongoing challenge. A government can change laws in a discriminatory fashion or create regulations that directly impact a specific organization.

**2. There can be severe exchange rate risks.**  
Many businesses focus on emerging markets for their products or services because it can greatly extend the lifespan of them. This also means the exchange rates in those emerging markets may fluctuate wildly, making it difficult to forecast finances for budgeting purposes. The value of assets and liabilities that are in foreign currencies creates the potential of a brand and business becoming immediately less competitive overnight, resulting in steep revenue losses.

**3. International trade also presents cultural complications.**  
Different cultures have different attitudes, standards, and expectations that can create problems for a brand and business. Failing to consider the expectation a different culture may have can lead to mistakes that damage the reputation of the brand and can be very costly to the bottom line. Any step of the sales process could create an offense. Something as simple as inappropriate packaging can be enough to permanently damage a brand’s reputation.

**4. It has a credit risk that must be specifically managed.**  
Many brands and businesses tend to overlook the risk of non-payment when they begin to operate in the world of international trade. Credit risks can be managed by obtaining insurance or a letter of credit, but customer finances and credit can still impact the number of potential sales that can be received within a market.

**5. International trade increases the risk of proprietary information theft.**  
Going into an international market with a product or service increases the risk of another brand or business stealing proprietary information, marketing concepts, or even a personal identity. China has a reputation of doing this, even if there isn’t a business presence in the local market.

***14.7 Balance of Payment***

Balance of Payment is simply defined as a statistical statement that shows the transaction in goods, services and income between an economy and the rest of the world.

A balance of payments **deficit** means the country **imports** more goods, services, and capital than they **export**. It must borrow from other countries to pay for its imports.

A balance of payments**surplus** means the country **exports** more than it **imports**. It provides enough capital to pay for all domestic production. The country might even lend outside its borders.

A country's balance of payments tells you whether it saves enough to pay for its **imports**. It also reveals whether the country produces enough economic output to pay for its growth. The BOP is reported for a quarter or a year.

***Components of BOP***  
  
 *a) Current account* showing export and import of visible (also called merchandise) and invisibles (also called non-merchandise). Invisibles take into account services, transfers and income.

1. **Visible trade** – This is the net of export and imports of goods (visible items). The balance of this visible trade is known as the trade balance. There is a trade deficit when imports are higher than exports and a trade surplus when exports are higher than imports.
2. **Invisible trade** – This is the net of exports and imports of services (invisible items). Transactions mainly consist of shipping, IT, banking and insurance services.
3. **Unilateral transfers to and from abroad** – These refer to payments that are not factor payments. For example, gifts or donations sent to the resident of a country by a non-resident relative.
4. **Income receipts and payments** – These include factor payments and receipts. These are generally rent on property, interest on capital, and profits on investments.

*b) Capital account*showing a capital expenditure and income for a country. It gives a summary of the net flow of both private and public investment into an economy. External commercial borrowing (ECB), foreign direct investment, foreign portfolio investment, etc form a part of capital account.

**The three major components of the Capital account:**

**1. Loans to and borrowings from abroad** – These consist of all loans and borrowings given to or received from abroad. It includes both private sector loans, as well as public sector loans.

**2. Investments to/from abroad** – These are investments made by nonresidents in shares in the home country or investment in real estate in any other country.

**3.Changes in foreign exchange reserves** – Foreign exchange reserves are maintained by the central bank to control the exchange rate and ultimately balance the BOP.

*c)* ***Errors and omissions****:*Sometimes the balance of payment does not balance. This imbalance is shown in the BOP as errors and omissions. BOP is compiled using the double entry book keeping system consisting assets and liabilities.

* **Terms of Trade**

This is the relationship between the prices at which a country sells its exports and the prices paid for its imports. If the prices of a country’s exports rise relative to the prices of its imports, one says that its terms of trade have moved in a favourable direction, because, in effect, it now receives more imports for each unit of goods exported. The terms of trade, which depend on the world supply of and demand for the goods involved, indicate how the gains from international trade will be distributed among trading countries. The concept is also applied to different sectors within an economy (e.g., agricultural and manufacturing sectors).

An abrupt change in a country’s terms of trade (e.g., a drastic fall in the price of a primary product that is a country’s main export) can cause serious balance-of-payments problems if the country depends on the foreign exchange earned by its exports to pay for the import of its manufactured goods and capital equipment.

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