



ECONOMICS

STUDENT TEXTBOOK

GRADE 9

Writers:

Hussien Mohammed (M.Sc.)

Tadesse Ababu (M.Sc.)

Editors:

Mesfin Ketema (M.Sc.) (Content Editor)

Enguday Ademe (Ph.D) (Curriculum Editor)

Birhanu Engidaw (Ph.D) (Language Editor)

Illustrator:

Endalkachew Mengesha (M.Sc.)

Designer:

Derejaw Lake (M.Sc.)

Evaluators:



FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA
MINISTRY OF EDUCATION



HAWASSA UNIVERSITY

First Published **xxxxx** 2022 by the Federal Democratic Republic of Ethiopia, Ministry of Education, under the General Education Quality Improvement Program for Equity (GEQIP-E) supported by the World Bank, UK's Department for International Development/DFID-now merged with the Foreign, Common wealth and Development Office/FCDO, Finland Ministry for Foreign Affairs, the Royal Norwegian Embassy, United Nations Children's Fund/UNICEF), the Global Partnership for Education (GPE), and Danish Ministry of Foreign Affairs, through a Multi Donor Trust Fund.

© 2022 by the Federal Democratic Republic of Ethiopia, Ministry of Education. All rights reserved. The moral rights of the author have been asserted. No part of this textbook reproduced, copied in a retrieval system or transmitted in any form or by any means including electronic, mechanical, magnetic, photocopying, recording or otherwise, without the prior written permission of the Ministry of Education or licensing in accordance with the Federal Democratic Republic of Ethiopia as expressed in the Federal Negarit Gazeta, Proclamation No. 410/2004 - Copyright and Neighboring Rights Protection.

The Ministry of Education wishes to thank the many individuals, groups and other bodies involved – directly or indirectly – in publishing this Textbook. Special thanks are due to Hawassa University for their huge contribution in the development of this textbook in collaboration with Addis Ababa University, Bahir Dar University and Jimma University.

Copyrighted materials used by permission of their owners. If you are the owner of copyrighted material not cited or improperly cited, please contact the Ministry of Education, Head Office, Arat Kilo, (P.O.Box 1367), Addis Ababa Ethiopia.

Printed by:

xxxxxxx PRINTING

P.O.Box xxxxxx

xxxxxxx, ETHIOPIA

Under Ministry of Education Contract no. xxxxxxxxxxxx

ISBN: _____

Table of Contents

Contents	Page
Unit 1: Introducing Economics	1
1.1 Meaning of Economics	2
1.2 Branches of Economics	4
1.3 Methods and Approaches of Studying Economics	6
1.4 Decision Making Units	8
Unit Summary	10
Review Questions	11
Unit 2: The Basic Economic Problems and Economic Systems	13
2.1 The Basic Economic Problems: Scarcity, Choice, and Opportunity Cost .	14
2.2 Central Problems of Economies	19
2.3 Economic Systems	21
Unit Summary	25
Review Questions	26
Unit 3: Economic Resources and Markerts	29
3.1 Types of Resources and Factor Payments	30
3.2 Renewable and Non-renewable Resources	32
3.3 Types of Markets	34
3.4 Circular Flow of Economic Activities	36
3.5 Land as an Economic Resource in Ethiopia	40
Unit Summary	42
Review Questions	43
Unit 4: Introduction to Demand and Supply	45
4.1 Concept of Demand	46
4.2 Concept of Supply	50
4.3 Market Equilibrium	54
Unit Summary	58
Review Questions	59
Unit 5: Introduction to Production and Cost	62
5.1 Definition of Production, Inputs and Outputs	63
5.2 Periods of Production	65
5.3 Cost of Production.	69
Unit Summary	74
Review Questions	75

Unit 6: Introduction to Money	77
6.1 Definition of Money	78
6.2 Evolution of Money	80
6.3 Functions of Money	84
6.4 Demand and Supply of Money	86
6.5 Money and Electronic Banking.	87
Unit Summary	90
Review Questions	91
Unit 7: Introduction to Macroeconomics	93
7.1 Definition of Macroeconomic Variables	94
7.2 Macroeconomic Goals.	97
7.3 Macroeconomic Problems.	98
Unit Summary	102
Review Questions	103
Unit 8: Basic Entrepreneurship	105
8.1 Definition of Enterprise, Entrepreneur and Entrepreneurship	106
8.2 Creativity and Innovation in Solving Local Problems.	109
8.3 Entrepreneurial Attitudes, Behaviour and Mind-set	111
8.4 Windows of Entrepreneurial Opportunities.	115
8.5 Entrepreneurial Success, Teamwork and Diversity	117
8.6 Finance and Promotion of Entrepreneurship.	119
Unit Summary	121
Review Questions	122

Introduction to the Book

Any economy is composed of households, firms, and the government. In order to understand the complex nature of an economy, one needs to have a deeper understanding of each component in different market settings and how the whole economy works. To this end, economists conventionally classify economics into microeconomics and macroeconomics.

This student text book covers basic topics in both microeconomics and macroeconomics. The microeconomics part of the course is designed to introduce fundamental economic concepts such as scarcity, opportunity cost, and the laws of supply and demand. In addition, the essence of production theory and cost structures is covered in this part of the course.

The macroeconomics part of the course treats topics related to the concept, measurement, and problems of economy-wide performance. The objective of the course is to help students grasp the principles of Economics. This course introduces students to macroeconomic theories, which provide students with the necessary theoretical and analytical knowledge of basic economic concepts, thereby, increasing the students' engagement in various practical and theoretical issues of money and entrepreneurship.

Specifically, the course will:

- Introduce the students with the fundamental concepts of economics in general and fundamentals of microeconomics and macroeconomics in particular.
- Acquaint the students with the concepts of demand and supply, as well as market equilibrium.
- Introduce the students with the theories of production and cost, and how firms organize their production process and decide to minimize their costs.
- Introduce the students with the concept of money and entrepreneurship.

The book is organized into 8 units. Unit 1 focuses on introducing economics. Unit 2 deals with the basic economic problems and economic systems. Unit 3 deals with economic resources and markets. Unit 4 presents an introduction to demand and supply. Unit 5 is concerned with an introduction to production and cost. Unit 6 introduces the concept of money. Unit 7 deals with an introduction to macroeconomics. Finally, Unit 8 presents basic entrepreneurship.

Unit I

Introducing Economics

Introduction

Economics is an extremely useful subject, and its study and knowledge have acquired greater importance in recent times. As you know, an increasing number of countries all over the world are facing economic problems today, and this is one reason behind the growing importance of economics. Moreover, the study of economics advances logical thinking and analytical skills, and enhances our abilities for observation and judgment. So, we conclude that the study and knowledge of economics is useful to each of us and to the society as a whole. This unit deals with the definition and nature of economics, branches of economics, methods and approaches of studying economics, and decision-making units in an economy.

Unit Objectives

At the end of this unit, students will be able to:

- ◆ Define economics.
- ◆ Explain the difference between microeconomics and macroeconomics.
- ◆ Describe the methods used to study economics.
- ◆ Explain the characteristics of the three decision-making units.

Start-up Activities

1. What comes to your mind when you hear the term economics?
2. The foundation of modern economics rests on its two major branches. In pairs, discuss what the two branches are.
3. Is economics a positive science or a normative science, or both? Give your justification.
4. What are the basic decision-making units of an economy?

Key Concepts

Economics, economic theory, efficient allocation, nature of economics, scarcity, microeconomics, macroeconomics, deductive method, inductive method, normative economics, positive economics, households, business firms, and government

1.1 Meaning of Economics

At the end of this section, students will be able to:

- ◆ Define the term economics and
- ◆ Explain the nature of economics.

Start-up Activity

What comes to your mind when you hear the term economics?

Definition of Economics

The term economics is originally derived from the ancient Greek word *oikonomia*, meaning the management of a family or a household. This reveals that the subject of economics was first studied in ancient Greece. Economics is a branch of the social sciences.

Economics is an important discipline, and its prominence has increased in recent years in response to worldwide economic problems. At present, poverty, unemployment, inflation, recession, population explosion, etc., are worldwide problems. In order to understand and find solutions to such problems, an in-depth knowledge of economics is essential.

The definition of economics has developed over time. Economic theory has advanced over time, and different themes have gradually been included in the field. There is no complete definition of economics at the moment, and it is being revised in areas such as the definition of wealth, the definition of welfare, and the definition of scarcity.

Based on the above considerations, economics can be defined as follows.

Economics is a branch of social science that studies the efficient allocation of scarce resources so as to attain the maximum fulfillment of human needs. As a science of choice, economics studies how people choose to use scarce or limited productive resources (land, labour, equipment, technical knowledge, etc.) to produce various commodities.

The following statements are derived from the above definition of economics:

- Studies about scarce resources;
- It studies about allocation of resources;
- Allocation of resources should be efficient;
- Human needs are unlimited.

The objective of economics is to study how to efficiently allocate scarce resources to satisfy unlimited human needs to the maximum possible degree.

The Nature of Economics

The lack of uniformity in defining economics emanates from the shifting views about the subject matter over time. Some economists consider economics a ‘science’ while others consider it an “art.”

Economics as a Science

Science produces a systematic and organised body of knowledge that links causes and effects. This knowledge can be regarded as the knowledge of “what is”. In economics, several facts are systematically collected, classified, analysed, and interpreted to make predictions about the future. In this sense, economics could be considered a science.

Economics as an Art

One of the important definitions of art is a technique or a way of doing or achieving something. When dealing with problems such as unemployment, poverty, and inflation, economics provides principles and methods through which these problems can be solved. Hence, economics extensively examines the nature and causes of economic problems and sets the procedures for finding their solutions. From this perspective, we can consider economics as an art.

Activity 1.1

1. What is meant by the term economics?
2. Describe the nature of economics. Is economics a science or an art or both? Why?

1.2 Branches of Economics

At the end of this section, students will be able to:

- ◆ Distinguish between microeconomics and macroeconomics.
- ◆ Describe the fundamental problem of microeconomics and macroeconomics.

Start-up Activity

The foundation of modern economics rests on its two major branches. In pairs, discuss what the two branches are.

The field and scope of economics is growing rapidly and has come to encompass a wide range of themes. Accordingly, different new branches of the subject have emerged over time. Some of these branches are: development economics, environmental economics, industrial economics, international economics, labor economics, mathematical economics, monetary economics, welfare economics, resource economics, behavioural economics, experimental economics, health economics, etc. Modern economics, on the other hand, is built on two major branches: microeconomics and macroeconomics. However, the foundation of modern economics rests on two of its major branches, namely, microeconomics and macroeconomics.

Microeconomics

Microeconomics is concerned with the economic behavior of individual decision making units such as households, firms, and governments and their interactions and organizations through markets and industries. In other words, it deals with how households and firms make decisions and how they interact in specific markets. For example, the economic activities of a consumer, a producer, a firm or an industry, the income of individuals, the determination of prices of various products and factors of production, etc. fall under the scope of microeconomics. The fundamental problem of microeconomics is associated with resource allocation or the problem of price-determination.

Macroeconomics

Macroeconomics is a branch of economics that deals with the effects and consequences of the aggregate behaviour of all decision-making units in an economy. In other words, it examines the interrelations among various aggregate economic variables. For example, total employment, total output, national income, total investment, total consumption, etc. in an economy. In general, macroeconomics investigates the interrelationships of numerous aggregate economic variables, as well as their determination and the

causes of their fluctuations over time. The fundamental problem of macroeconomics is associated with full employment of economic resources.

Difference Between Microeconomics and Macroeconomics

Microeconomics is the study of individual decision-making units of an economy, like individual households and business firms. In contrast, macroeconomics is the study of an economy as a whole, and its focus is the study of broad, economy-wide aggregates. For example, when we study the price determination of a commodity in a market, our study is micro-analysis and is treated by microeconomics, but if we study the trend of the general price level of commodities over time in a country, our study is macro-analysis and is treated by macroeconomics. Note that both microeconomics and macroeconomics are complementary to each other. In other words, macroeconomics cannot be studied independently of microeconomics. Table 1.1 summarises the main differences between microeconomics and macroeconomics.

Table 1.1 Main differences between microeconomics and macroeconomics

Microeconomics	Macroeconomics
1. Studies individual economic units in an economy. 2. Deals with income, prices, outputs, etc. 3. Its central problem is price determination and allocation of resources. 4. Its main tools are the demand and supply of particular commodities and factors. 5. It helps to solve the central problems of what, how and for whom to produce. 6. Discusses how equilibrium of a consumer, a producer or an industry is attained. Examples: Price of teff, price of orange, income of Aberash, saving of Chala, etc.	1. Studies an economy as a whole and its aggregates. 2. Deals with national income and output and general price level. 3. Its central problem is determination of level of income and employment. 4. Its main tools are aggregate demand and aggregate supply of an economy as a whole. 5. Helps to solve the central problem of full employment of resources in the economy. 6. Deals with the determination of equilibrium income and employment at aggregate level. Examples: GDP of Ethiopia, General price level in Ethiopia, etc.

 Activity 1.2

1. Make a distinction between microeconomics and macroeconomics.
2. Explain the fundamental problems of microeconomics and macroeconomics.

1.3 Methods and Approaches of Studying Economics

At the end of this section, students will be able to:

- 💧 Explain the methods of studying economics; and
- 💧 Make a distinction between positive and normative economics.

Start-up Activity

Is economics a positive science or a normative science, or both? Give your justification.

1.3.1 Methods of Studying Economics

The fundamental objective of economics, like any science, is the establishment of valid generalisations about certain aspects of human behaviour. Those generalisations are known as theories. A theory is a simplified picture of reality. Economic theory provides the basis for economic analysis, which uses logical reasoning. There are two methods of logical reasoning, namely, deductive and inductive methods.

Deductive Method

The deductive method proceeds from general to particular. It involves reasoning from certain principles to the analysis of specific facts. In effect, it enables one to arrive at a particular conclusion starting from a general statement. The conclusions are then verified against observed facts. Example: A man is mortal. Abebe is a man. Therefore, Abebe is mortal.

Inductive Method

The inductive method is a process of reasoning from a part to the whole. This means it involves reasoning from the particular to the general or from the individual to the general. In this method, economists approach problems of science from a practical angle, reducing the gulf between theory and practice.

The inductive method develops economic theories on the basis of observations and experiments. In this method, comprehensive data about the prevailing economic conditions is collected. Then, an attempt is made to arrive at a hypothesis based on the observations and the collected data.

Example: During the harvest period, one may observe that the prices of grains decrease. This may be associated with an increase in the supply of grain at that time of the year. From this observation, a generalisation can be made: “keeping other factors constant, an increase in supply leads to a fall in prices.”

Note that deductive and inductive methods are complementary, i.e. one supports the other. They are not competing methods. Induction and deduction always complement each other in reasoning, but proper induction is not necessary for the truth of deduction. Induction generates general conclusions from specific instances, whereas deduction generates knowledge of specific instances from general knowledge.

1.3.2 Approaches of Studying Economics

Economics can be analysed from the point of view of two perspectives, namely, positive economics and normative economics. Positive economics is like a science that deals with knowledge and facts, while normative economics entails value judgment in applying the knowledge to solve problems.

Positive economics is concerned with the analysis of facts and attempts to describe the world as it is. It tries to answer the questions: what is; what was; or what will be? It does not judge a system as good or bad, better or worse.

Examples:

1. The number of secondary schools in Ethiopia is increasing.
2. The current inflation rate in Ethiopia is 12 percent.

Both of the above statements are known as “positive statements.” These statements are concerned with real facts and information. Any disagreement on positive statements can be cleared up with reference to the facts.

Normative economics is concerned with questions such as, “what the economy ought to be?” Or what the economy should be? It evaluates the desirability of alternative outcomes based on one’s value judgments about what is good and what is bad. In this case, since normative economics is loaded with value judgments, what is good for an individual may not be good for another. Normative analysis is a matter of opinion that cannot be proved or disproved with reference to facts. As a result, any disagreement on a normative statement can be resolved through voting.

Examples:

1. The government should introduce school feeding programmes in all schools.
2. There should be government intervention in the economy, whenever necessary.

Activity 1.3

1. Describe the methods used to study economics.
2. Explain the difference between positive and normative economics.

1.4 Decision Making Units

At the end of this section, students will be able to:

- ◆ Identify the decision-making units of an economy, and
- ◆ Explain the objectives of each decision-making unit.

Start-up Activity

What are the basic decision-making units of an economy?

An economy is divided into different sections. These sections are sometimes known as decision-making units of the economy. Customarily, they are described as economic agents. The basic decision making units of an economy are households, business firms, and the government. We discuss each of these decision making units of an economy as follows.

1. Households

Households are the chief owners of the factors of production, which encompass land, labour, capital, and entrepreneurship. They sell the services of these factors (termed “factor service”) to producers and, in return, receive their income in the form of rent, wages, interest, and profit. They spend an enormous portion of their income on purchasing goods and services from the producers. Nonetheless, they save part of their income, and also pay taxes to the government on their income.

2. Business Firms

In economics, we use the terms “business firms” and “producers” alternately. Firms hire the services of factors of production from households to produce commodities that they sell to households, to other firms, to the government or to other countries. Firms are the principal buyers of factors of production, and they are the leading producers of commodities. Business firms consist of both private and government enterprises.

3. Government

In economics, government is taken in the sense of ‘general government’ in order to disregard government enterprises. The government purchases goods and services from producers and factors services from households. It uses these commodities and factor services to provide free services, such as police, education, medical facilities, sanitation facilities, judicial services, etc., to the people in order to satisfy their combined needs for those services. The general government gets its income mainly from taxes levied on households and on business firms in the form of direct and indirect taxes.

The government imposes compulsory tax levies on individuals or firms. Taxes are levied in almost every country of the world, primarily to raise revenue for government expenditures, although they serve other purposes as well. The primary goal of a national tax system is to generate revenues to pay for government expenditures. Because public expenditures tend to grow with the national product, taxes are the main vehicles of government to finance to public expenditure. Consequently, every citizen is responsible to pay tax for the government to sustain the activities of public investments to ensure sustainable development of a country.

Activity 1.4

1. What are the decision-making units of an economy?
2. Discuss the objectives of decision-making units in an economy.

Unit Summary

Economics is a social science that studies the efficient allocation of scarce resources in order to attain the maximum fulfillment of unlimited human needs. Economics has two main branches: microeconomics (deals with the economic behaviour of individual economic units and individual economic variables) and macroeconomics (deals with the functions of the economy as a whole).

The central objective of economics is the efficient utilisation of scarce resources to satisfy unlimited human needs. Economics uses two methods of logical reasoning: deductive (involves reasoning from certain principles to the analysis of specific facts) and inductive (involves reasoning from the particular to the general) methods. Further, economics uses two approaches: positive economics (which deals with knowledge and facts) and normative economics (which entails value judgment in applying the knowledge to solve problems).

An economy is divided into different parts, which are sometimes called decision-making units. The basic decision making units of an economy are households (which are the chief owners of factors of production: land, labour, capital, and entrepreneurship), business firms (which hire the services of factors of production from households to produce commodities), and the government (which gets its income mainly from taxes levied on households and business firms in the form of direct and indirect taxes).

Review Questions

Part I: Write ‘True’ if the statement is correct or ‘False’ if it is not correct for each of the following statements.

1. Microeconomics deals with the determination of prices in individual markets.
2. Macroeconomics deals with the behaviour and decisions of individual economic units.
3. Microeconomics is also known as the theory of income and employment.
4. Microeconomics studies the decisions of individual people and firms, while macroeconomics studies the entire national economy.
5. The deductive method entails reasoning from certain principles to the analysis of facts.
6. Normative economics offers recommendations based on value judgments.
7. A household can be one person or more people who live under one roof but make separate financial decisions.
8. Businesses take the initiative to combine resources in order to produce goods and services.

Part II: Choose the correct answer among the alternatives for the following questions.

1. Microeconomics concerns itself with all of the following topics **except**:
 - A . Economic activities of individual firms, households, and other organizations.
 - B . Forces of supply and demand in a particular market.
 - C . Consumer behaviour and firms’ output decisions.
 - D . The behaviour and operation of the economy as a whole.
2. Which of the following is a normative statement?
 - A . Falling prices are good for consumers.
 - B . Falling prices encourage consumer spending.
 - C . The falling price of housing affects real income.
 - D . Rising prices encourage production.
3. Which of the following would best be described as a positive statement about economics?
 - A . Free markets are inherently unfair institutions.
 - B . Countries normally experience higher unemployment during recessions.
 - C . Business profit should be redistributed through taxes to benefit more of society.
 - D . Increasing taxes is positively wrong.

4. Which of the following is a normative statement?
 - A . Not all resources experience price rises.
 - B . Poverty is something society should reduce.
 - C . An increase in house prices is likely to cause a reduction in demand
 - D . Some of the earth's scarce resources are non-renewable.
5. Which of the following is the basic decision making unit of an economy?
 - A . Households
 - C . Business firms
 - B . Government
 - D . All of the above
6. Households spend an enormous portion of their income in purchasing goods and services from the
 - A . producers
 - C . other consumers
 - B . government
 - D . none of the above
7. Which of the following statements would best describe firms?
 - A . They are the principal buyers of factors of production
 - B . They are the leading producers of commodities.
 - C . They consist of both private and government enterprises.
 - D . All of the above
8. General government gets its income mainly from taxes levied on
 - A . households and business firms in the form of direct and indirect taxes
 - B . goods and services it provides to the producers
 - C . factor in the services it provides to households.
 - D . none of the above

Part III: Answer the following questions briefly and to the point.

1. Define economics from the perspective of wealth, welfare, and scarcity. Which definition better suits economics? Why?
2. "Study and knowledge of economics are extremely useful and important." Explain.
3. Why do we study economics? Have you gained anything from this unit? Discuss them.
4. Explain the distinction between microeconomics and macroeconomics.
5. What do you understand by "positive economics" and "normative economics"?
6. Explain why economics deals with the allocation and efficient utilisation of scarce resources only.
7. In recent years, especially around big cities, there is the problem of air pollution and the likelihood of poisoning is high. Given this scenario, do you think that air is free resource? Justify your answer
8. Explain the main features of the various decision-making units of an economy.

Unit 2

The Basic Economic Problems and Economic Systems

Introduction

Obviously, you have heard about economics, and perhaps you have talked a lot about it in your day-to-day activities. You may have questions like: “What is an economic problem?” What does “efficient allocation” mean? What are human needs? This unit will answer these questions and introduce you to the fundamental concepts of economics at large. This unit focuses on the basic economic problems, the central problems of economies, and economic systems.

Unit Objectives

At the end of this unit, students will be able to:

- ◆ Describe the basic economic problem.
- ◆ Recognize how the basic economic problems affect individuals, firms, and society.
- ◆ Compare and contrast the main economic systems.

Start-up Activities

1. What basic concepts in economics can you mention? What do you mean by these concepts?
2. Discuss in pairs the basic economic problems and report the results of your discussion to the whole class.
3. What are the main types of economic systems? How do you classify them?

Key Concepts

Choice, economic problem, opportunity cost, scarcity, shortage, allocation of resources, choice of technique, problem of distribution, capitalism, command economy, freedom of choice, mixed economy, private property, profit motive, and traditional economy.

2.1 The Basic Economic Problems: Scarcity, Choice, and Opportunity Cost

At the end of this section, students will be able to:

- ◆ Define concepts like scarcity, choice, opportunity cost, and production possibility frontier
- ◆ Explain the difference between scarcity and shortage of resources
- ◆ Calculate the opportunity cost of a good.

Start-up Activity

What basic concepts in economics can you mention? What do you mean by these concepts?

Clearly, the scarcity of resources relative to unlimited human wants is a plain fact of life. Households, producers, and the whole economy are faced with the problem of scarcity of natural and human-made resources. Consequently, it is necessary to use resources as efficiently as possible. In effect, resources should be allocated efficiently among the prevailing choices. Some basic economic concepts are described as follows.

Scarcity

The fundamental economic problem that any human society faces is the problem of scarcity.

Scarcity refers to the fact that all economic resources that a society wants to use to produce goods and services are finite or limited in supply. However, their being limited should be expressed in relation to human wants. Thus, the term “scarcity” reflects the imbalance between our wants and the means to satisfy those wants. Scarcity of resources generates economic problems. If resources were fully abundant, there would be no economic problems at all.

Note: *Scarcity* does not mean *shortage*. A good is said to be scarce if the amount available is less than the amount people wish to have at zero price. On the other hand, we say that there is a shortage of goods and services when people are unable to get the amount they want at the prevailing price. A shortage is a specific and short term problem, while scarcity is a universal and endless problem.

Choice

If resources are scarce, output will be limited. If output is limited, we cannot satisfy all of our wants. So, a choice must be made. Due to the problem of scarcity, individuals,

firms, and governments are forced to choose as to what output to produce, in what quantity, and what output not to produce. In short, scarcity implies choice, which, in turn, implies an opportunity cost.

Scarcity → limited resource → limited output → unlimited human want
→ Choice involves costs → opportunity cost

Opportunity Cost

In a world of scarcity, a decision to have more of one thing, at the same time, means a decision to have less of another thing. Thus, the value of the next best alternative that must be sacrificed is the opportunity cost of the decision.

Definition: Opportunity cost is the amount or value of the next best alternative that must be sacrificed (forgone) in order to obtain one more unit of a product.

For example, suppose the country spends all of its limited resources on the production of cloth or computer. If a given amount of resources can produce either one meter of cloth or 20 computers, then the opportunity cost of one meter of cloth is the value of 20 computers.

Note the following points about opportunity cost:

- It is measured in terms of goods and services but not in terms of money.
- It should be in line with the principle of substitution of one activity for another.

To sum up, when the opportunity cost of any activity increases people substitute other activities in its place. In effect, the cost of producing a quantity of a commodity is measured in terms of the quantity of some other commodity that could have been produced in its place. In short, opportunity cost comes into being due to the problem of scarcity of resources and the fact that resources have alternative uses.

The Production Possibilities Frontier

The production possibilities frontier or curve (PPF/PPC) is a curve, which shows the various possible combinations of goods and services that the society can produce given its resources and technology. To draw the PPF/PPC we need the following assumptions.

1. The quantity and quality of economic resource available for use during the year is fixed.
2. There are two broad classes of output to be produced over the year.
3. The economy is operating at full employment and is achieving full production

(efficiency).

4. Technology does not change during the year.
5. Some inputs are better adapted to the production of one good than to the production of the other (specialization).

Suppose a hypothetical economy produces food and computer given its limited resources and available technology (see Table 2.1).

Table 2.1: Alternative production possibilities of a certain nation

Types of products	Unit	Production alternatives				
		A	B	C	D	E
Food	Metric tones	500	420	320	180	0
Computer	Number	0	500	1000	1500	2000

We can also display the above information with a graph as follows.

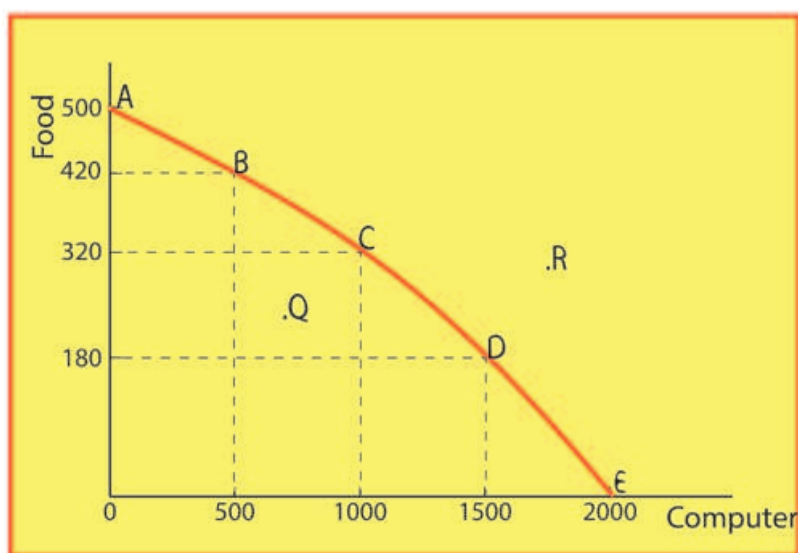


Figure 2.1 Production possibilities frontier/curve for Food and Computer

Note the following points:

- All points on the curve are both attainable and efficient.
- Any point inside the curve (for example, point Q) is attainable but inefficient.
- Any point outside the curve (for example, point R) is unattainable.

The PPF describes three important concepts:

- i) The concept of scarcity: even if a society employs all of its resources and uses them optimally, it cannot produce an infinite amount of output.
- ii) The concept of choice: any movement along the curve denotes a shift in preference.

iii) The concept of opportunity cost: when the economy produces on the PPF, producing more of one good necessitates sacrificing some of another, as reflected by the PPF's downward slope. Related to the opportunity cost, we have a law known as the law of increasing opportunity cost. This law states that as we produce more and more of a product, the opportunity cost per unit of the additional output increases. This makes the shape of the PPF concave to the origin.

Opportunity costs increase when we produce more of one good because economic resources are not completely adaptable to alternative uses (specialization effect).

$$\text{Opportunity cost of a good} = \frac{\text{the amount of the next best alternative sacrificed}}{\text{the amount of the good gained}}$$

Referring to Table 2.1 above, if the economy is initially operating at point B, what is the opportunity cost of producing one more unit of computer?

Moving from production alternative B to C, we have:

$$\text{Opportunity Cost} = \frac{320 - 420}{1000 - 500} = \left| \frac{-100}{500} \right| = \frac{1}{5} = 0.2$$

⇒ The economy gives up 0.2 metric tons of food per computer.

Note: we take absolute value of opportunity cost as we are interested to interpret its magnitude.

Economic Growth and the PPF

Economic growth, which is an increase in the total output level, occurs when one or both of the following conditions occur.

1. Increase in the quantity and quality of economic resources.
2. Advances in technology

Economic growth is represented by the outward shift of the PPF as depicted in Figure 2.2 below.

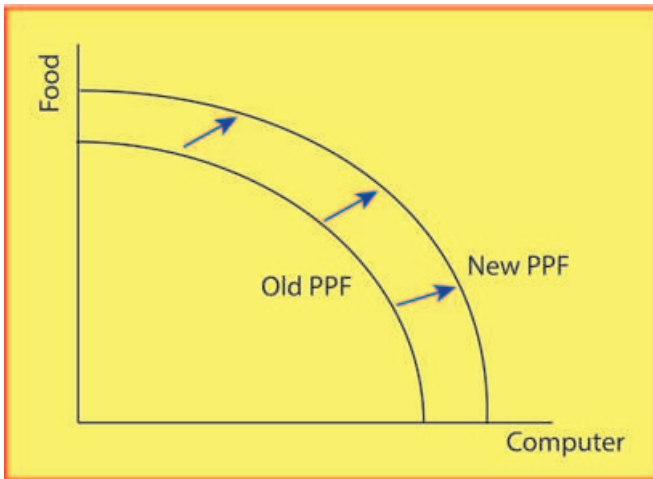


Figure 2.2 Economic growth with a new PPF

An economy can grow because of an increase in productivity in one sector of the economy. For example, improved technology applied to either food or computers would be illustrated by a shift of the PPF along the Y- axis or X-axis. This is called asymmetric growth.

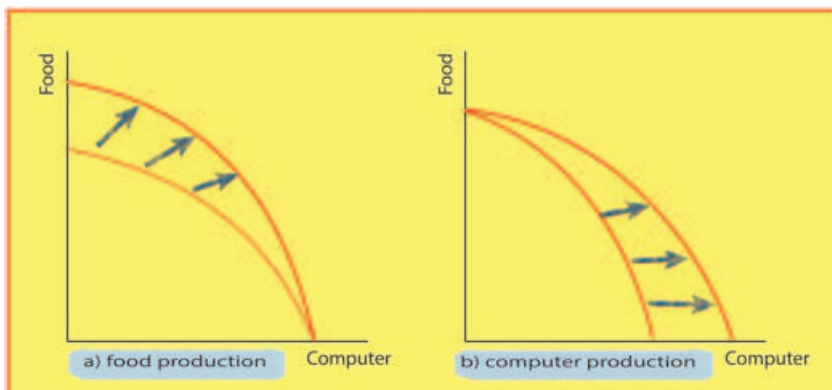


Figure 2.3 Effects of technological advancements in: a) food production and
b) computer production

Activity 2.1

1. Explain the following concepts briefly.
 - a. Choice
 - b. Opportunity Cost
 - c. Scarcity
2. What is the main difference between scarcity and shortage of resources?

2.2 Central Problems of Economies

At the end of this section, students will be able to:

- ◆ Describe the basic economic problems.
- ◆ Explain how the basic economic problems affect individuals, firms, and society.



Start-up Activity

Discuss in pairs the basic problems of economics and report the results of your discussion to the whole class.

Basic Economic Problems

Basic economic problems are those problems that an economic system faces due to the scarcity of resources. These problems are common to all economic systems. They are also referred to as the central problems of the economy.

Every modern society faces certain basic economic problems, namely,

- What goods and services are to be produced?
- How to produce goods and services?
- For whom are goods and services to be produced?

Each of these basic problems is briefly discussed as follows.

What goods and services are to be produced?

This question is also called the problem of the allocation of resources. It implies that every economy must decide on the type and quantity of goods to be produced. The economy must make choices between the productions of: consumption and capital goods, civil and military goods, and necessity and luxury goods.

How to produce goods and services?

This question is also referred to as the problem of choice of technique. Once an economy has reached a decision regarding the types of goods and services to be produced, and has determined their respective quantities, it must decide how to produce them, which entails choosing between alternative methods or techniques of production. For example, wheat can be produced using primitive tools and manual labour, or using modern machinery and some labour.

The various techniques of production can be classified into two groups: labour-intensive techniques and capital-intensive techniques. A labour-intensive technique involves the use of more labour, relative to capital, per unit of output. In contrast, a capital-intensive technique involves the use of more capital, relative to labour, per unit of output. The choice between these techniques depends on the available supplies of diverse production factors and their relative prices. Making a good choice is important for making the best possible use of limited resources to produce the maximum number of goods and services.

For whom are goods and services to be produced?

This problem is also called the problem of the distribution of the national product of a country. It relates to how a material product is to be distributed among the different members of a society.

The economy should decide, for instance, whether to produce for the benefit of a few rich people or for the majority of poor people. An economy that wants to produce for the benefit of the maximum number of people would first try to focus on the production of necessary goods for the whole population, and then on the production of luxury goods.

All these, and other fundamental economic problems, focus on human needs and wants. Many human efforts in modern society are directed towards the production of goods and services in order to satisfy human needs and wants. These human efforts result in economic activities that occur within the framework of an economic system.

Activity 2.2

1. What is the basic economic problem of all societies?
2. How does the fundamental economic problem affect individuals, firms, and society?

2.3 Economic Systems

At the end of this section, students will be able to:

- ◆ Define an economic system.
- ◆ Compare and contrast the main types of economic systems.



Start-up Activity

What are the main types of economic systems? How do you classify them?

The way a society tries to answer the basic economic questions mentioned above can be summarized by a concept known as the “economic system.” An economic system is a set of organizational and institutional arrangements established to answer the basic economic questions. The different types of economic systems are classified on the basis of ownership of economic resources. The main types of economic systems are: traditional economy or subsistence, capitalist economy, command economy, and mixed economy. These economic systems are discussed as follows.

1. Traditional economy

A traditional economy is a system that relies on customs, history, and time-honored beliefs. Tradition guides economic decisions such as production and distribution. Societies with traditional economies depend on agriculture, fishing, hunting, gathering, or some combination of them. They use barter instead of money.

Most traditional economies operate in emerging markets and developing countries. They are often in Africa, Asia, Latin America, and the Middle East. Traditional economies can also be found in pockets throughout the world, even in developing countries.

Main features of Traditional Economy

- Traditional economies centre on a family or tribe, and they use traditions gained from the elders’ experiences to guide day-to-day life and economic decisions.
- A traditional economy exists in a hunter-gatherer and nomadic society: These societies cover vast areas to find enough food to support them. They follow the herds of animals that sustain them, migrating with the seasons. These nomadic hunter-gatherers compete with other groups for scarce natural resources. There is little need for trade since they all consume and produce the same things.
- Most traditional economies produce only what they need. There is rarely a surplus or leftovers. That makes it unnecessary to trade or create money.

- When traditional economies do trade, they rely on barter. It can only occur between groups that do not compete. For example, a tribe that relies on hunting exchanges food with a group that relies on fishing. Because they just trade meat for fish, there is no need for cumbersome currency.
- They start to evolve once they start farming and settling down. They are more likely to have a surplus, such as a bumper crop, that they use for trade. When that happens, the groups create some form of money. That facilitates trading over long distances.

2. Capitalist Economy (Capitalism)

Capitalism is the oldest formal economic system in the world. It became widespread in the middle of the 19th century. In this economic system, all means of production are privately owned, and production takes place at the initiative of individual private entrepreneurs who work mainly for their own profit. Government intervention in the economy is negligible. This system is also referred to as a free market economy, simply a market economy, or laissez faire.

Main features of Capitalist Economy

- **The Right to Private Property:** This is the central feature of a capitalist economy. According to the principle of capitalism, all economic or productive factors, including land, factories, machinery, mines, etc. are under private ownership.
- **Freedom of Choice by Consumers:** Consumers can buy the goods and services that suit their tastes and preferences. Producers produce goods in accordance with the demands of consumers. This is called the principle of consumer sovereignty.
- **Competition:** In a capitalist economy, competition exists among sellers or producers of similar goods to attract customers. Among buyers, there is competition to obtain goods. Among workers, the competition is to get jobs. Among employers, it is to get workers and investment funds.
- **Limited government involvement :** The government does not interfere in day-to-day economic activities but confines itself to defence and the maintenance of law and order.
- **Self-Interest:** Self-interest guides and motivates individuals in the economy to strive for economic gain.
- **Inequalities in income:** In the capitalist economy, there is a large income inequality between the rich and the poor.

3. Command Economy (Socialism)

A command economy is also referred to as a socialist economy. In a command economy, the economic institutions that are engaged in the production and distribution of goods are owned and controlled by the state and are put to use under a centralised plan. Socialism started in Russia with the outbreak of the Great October Revolution in 1917. Since then, many countries in the world, including China, Vietnam, former East Germany, Poland, Hungary, Cuba, and Ethiopia, have adopted it. Several countries adopted this system after the Second World War. Nevertheless, socialism lost its acceptance and most of the former socialist countries adopted free market economies.

Main features of Command Economy

- **Collective Ownership:** All means of production are owned by society as a whole, and there is no right to private property.
- **Central Economic Planning :** Resource allocation is done by the controlling authority based on socio-economic goals.
- **Strong Role of Government:** Government has complete control over all economic activities.
- **Relative Equality of Incomes:** Private property does not exist in a command economy, the profit motive is absent, and there are no opportunities for the accumulation of wealth. In comparison to capitalism, all these factors lead to greater equality in income distribution in income terms.

4. Mixed Economy

A mixed economy is one of the economic systems having the combination of both the characteristics of capitalism and socialism: a combination of private and public ownership of the means of production, with some measures of control by the government. It incorporates some of the features of both capitalist and command economies and allows private and public sectors to co-exist.

Main Features of Mixed Economy

- **Co-existence of Public and Private Sectors:** Public and private sectors co-exist in this system. Their respective roles and aims are well-defined. Industries of national and strategic importance, such as heavy and basic industry, defence services, power generation, etc. are set up in the public sector, whereas the consumer-goods industry and small-scale industry are developed in the private sector.

- The government uses instruments of economic planning to achieve coordinated rapid economic development, making use of both the private and public sectors.
- Economic Equality: Private property is allowed, but rules exist to prevent the concentration of wealth. It is the belief that people should receive the same rate of pay for a job, regardless of race, gender, or other characteristics that are not related to their ability to perform the task.

Activity 2.3

1. What is meant by an economic system?
2. Explain the differences and similarities between capitalism and socialism.
3. Choose the economic system that is more relevant to the Ethiopian economy today and explain why it is so.

Unit Summary

Basic economic problems are the problems facing an economy today due to the scarcity of resources. These problems are common to all economies in the world. They are also known as central problems of economies. These problems originate from the scarcity of resources. Scarcity is the imbalance between unlimited human wants and limited available resources. In effect, it is the tension between the unlimited human wants and the means of satisfying them. The fundamental economic problem focuses on the unlimited human wants and limited means of satisfying those wants. Many human efforts in any society are directed towards the production of goods and services in order to satisfy the demand of the society for those goods and services.

Production Possibility Curve (PPC) is a curve that depicts all possible combinations of the maximum output that can be produced in an economy with given resources and technology. The PPC describes the concepts of scarcity, choice and opportunity cost. Linked to the opportunity cost, there is a law known as the law of increasing opportunity cost, which states that as we produce more and more of a product, the opportunity cost per unit of the additional output increases. This makes the shape of the PPC concave to the origin.

The way a society tries to answer the basic economic questions is summarised by a concept known as an economic system. An economic system is a set of organisational and institutional arrangements established to answer basic economic questions. In economics, there are four basic economic systems. These are traditional, capitalist, command, and mixed economies.

Review Questions

Part I: Write ‘True’ if the statement is correct or ‘False’ if it is not correct for each of the following statements.

1. Economics is best described as the study of how people, businesses, governments, and societies make choices to cope with scarcity.
2. Although a resource exists in unlimited supply, it can be considered as scarce.
3. Opportunity cost is the cost of a decision expressed in terms of the next best alternative.
4. Points lying outside the production possibility frontier represent combinations of two goods that correspond to the maximum possible output.
5. Economic growth can be achieved only through technological advancement.
6. Asymmetric growth occurs when an economy can grow due to an increase in productivity in one sector of the economy
7. A command economy allows economic freedom for consumers and producers
8. A capitalist economy is one in which resources are jointly allocated through the price mechanism and the government.
9. Societies with traditional economies depend on agriculture, fishing, hunting, gathering, or some combination of them.
10. Most traditional economies produce surplus product which necessitates trade.

Part II: Choose the correct answer among the alternatives for the following questions.

- The concept of opportunity cost is based upon the principle of
A . peoples need C. scarcity
B . consumption D. profit
- The concept of choice would become irrelevant if
A . a very simple economy is considered C. capital was eliminated
B . poverty were eliminated D. scarcity was eliminated
- Which of the following statements best describes the economic problem?
A . The fact that economies often go into decline.
B . The presence of high level of unemployment.
C . Matching endless wants with limited resources.
D . The problem that high exchange rates discourage exports.
- The production possibility frontier can be considered as a measure of
A . potential output C. nominal output
B . Real output D. total output

5. Any point lying on a production possibility curve indicates:
 - A . inefficient utilisation of resources
 - B . unattainable goods to be produced
 - C . full utilisation of resources
 - D . none of the above
6. A production possibility curve is:
 - A . a horizontal straight line
 - B . a vertical straight line
 - C . an upward sloping curve
 - D . a downward sloping curve
7. Which of the following is not a feature of a capitalist economy?
 - A . right to private property
 - B . inequality of income
 - C collective ownership
 - D . None of the above
8. Which of the following is a feature of a command economy?
 - A . maximum social welfare
 - B . collective ownership
 - C . central economic planning
 - D . All of the above
9. Which of the following features persist in a mixed economy?
 - A . All resources are allocated through the price mechanism.
 - B . Resources are allocated through the price mechanism and the government.
 - C . There is a big income inequality between the rich and the poor.
 - D . The government commands how all resources used.
10. Which of the following best captures the three basic economic questions of every society?
 - A . What, when, and why?
 - B . What, how, and for whom?
 - C . How much, how often, and for whom?
 - D . When, where, and why?

Part III: Work out the following problems based on the given information.

1. Assume that a certain simplified economy produces only two goods, X and Y, with given resources and technology. The following table gives the various possible combinations of the production of the two goods (all units are measured in millions of tons).

Table 2.2: The production possibilities schedule of the two goods, X and Y.

Production Possibility	Good X	Good Y	Opportunity Cost of Good X
A	0	100	
B	2	90	
C	4	60	
D	6	20	

- a) Calculate the opportunity cost of the production of good X at each point and fill the answers in the table above. What law does the trend in those values exhibit?
- b) What changes are required for this economy to shift the PPF outward?

2. Calculate the opportunity cost, per unit of sugar in terms of cloth, at the different production possibilities for the hypothetical data on a country shown in the table below.

Table 2.3 Hypothetical production possibility schedule for cloth and sugar

Production possibilities	Cloth (million metres)	Sugar (million kg)
A	0	50
B	1	45
C	2	38
D	3	30
E	4	20
F	5	6

Part IV: Answer the following questions briefly and to the point.

1. What are the central problems of an economy? Discuss them in detail.
2. Define scarcity, choice and opportunity cost. Can you link them to your day to day lives?
3. What do you understand by the term economic system? How can economic systems be classified on the basis of ownership of resources?
4. Discuss the economic systems in Ethiopia during the FDRE, Military and Imperial regimes.
5. What is capitalism? Describe its main features.
6. Discuss the basic characteristics of a command economy.
7. Explain the concept of mixed economy, giving its main features.
8. Which economic system provides the right to private property?
9. Distinguish between labour intensive and capital intensive production techniques.

Unit 3

Economic Resources and Markets

Introduction

The vital economic problem that any human society faces is the scarcity of resources. Scarcity refers to the fact that all economic resources that a society needs to produce goods and services are limited in supply. The term “scarcity” reflects the imbalance between unlimited human wants and the means to satisfy those wants. This unit deals with types of resources and factor payments, renewable and non-renewable resources, types of markets, the circular flow of economic activities, and land as an economic resource in Ethiopia.

Unit Objectives

At the end of this unit, students will be able to:

- ◆ Describe resources.
- ◆ Describe the types of resources and factors of payment.
- ◆ Make a distinction between renewable and non-renewable resources.
- ◆ Recognize the important role of land in Ethiopia as a resource.

Start-up Activities

1. Can you explain the meaning of resources?
2. How do you define renewable and non-renewable resources?
3. How do you describe the term “market”?
4. What is the circular flow of economic activities?
5. How do you define land in the context of agriculture in Ethiopia?

Key Concepts

Economic resources, free resources, factor payments, fossil fuels, natural gas, non-renewable resources, recycling, renewable resources, renewal process, replenished, solar energy, wind energy, labour market, financial market, households, business firms, government, money flows and real flows.

3.1 Types of Resources and Factor Payments

At the end of this section, students will be able to:

- ◆ Define resources.
- ◆ Explain the types of resources and factor payments of each category of resources.

Start-up Activity

Can you explain the meaning of resources?

Resources are inputs used in the process of production in order to make goods and services available to the society. There are two types of resources; namely, free resources and economic resources.

Free resources: A resource is said to be free if the amount available to a society is greater than the amount people desire to have at zero price. In other words, free resources are the free gifts of nature, which are unlimited in supply and have no prices. For example, air, sunshine, solar energy, and a mountain stream.

Economic (Scarce) Resources: A resource is said to be economic or scarce when the amount available to a society is less than what people want to have at zero price. Since economic resources are scarce or not available in plenty, they have non-zero prices. Price is the test of whether a resource is an economic or a free good.

Examples of scarce resources are:

- All types of human resources: manual, intellectual, skilled and specialized labor;
- Most natural resources, like land (especially fertile land), minerals, clean water, forests, and wild animals,
- All types of capital resources (like machines, intermediate goods, and infrastructure) and
- All types of entrepreneurial resources.

Generally, we can divide economic resources into four broad categories. These are land, labour, capital, and entrepreneurship. Each of these categories is briefly described below.

- **Labour:** refers to the physical as well as mental efforts of human beings in the production and distribution of goods and services. The reward for labour is wage.
- **Land:** refers to the natural resources, or all the free gifts of nature, used in the production of goods and services. The reward for the services of the land is rent.

- **Capital:** refers to all the manufactured inputs that can be used to produce other goods and services. Example: equipment, machinery, transport and communication facilities, etc. The reward for the services of capital is interest
- **Entrepreneurship:** refers to a special type of human talent that helps to organize and manage other factors of production to produce goods and services and takes the risk of making losses. The reward for entrepreneurship is profit.

Activity 3.1

1. Define resources and point out the two types of resources.
2. Describe the four categories of economic resources and cite their factor payments.

3.2 Renewable and Non-renewable Resources

At the end of this section, students will be able to:

- ◆ Define renewable and non-renewable resources.
- ◆ Explain the difference between renewable and non-renewable resources.
- ◆ Describe the concept of conservation of natural resources

Start-up Activity

How do you define renewable and non-renewable resources?

There are many types of resources that go into producing goods and services. These resources have been broadly classified into two categories: renewable resources and non-renewable resources.

Renewable resources are resources that have the potential to be replaced over time through natural processes. The renewal process may be relatively quick, as with sunshine, which comes on a daily basis. Or else, the renewal process may be very slow, as in the formation of soil, which may take hundreds of years. Examples of renewable resources are solar energy, wind energy, soil, trees, grass, geothermal pressure, and ground water.

Non-renewable resources are resources whose stock or reserve is limited or fixed, and which are found in the ground. The available supply of non-renewable resources may be replenished through recycling, but the overall supply remains relatively constant. Examples of non-renewable resources are natural gas, coal, steel, aluminum, and oil.

All natural resources should be used wisely. We must conserve natural resources. “Conserve means not misusing, spoiling, or wasting things. This is especially true for nonrenewable resources. However, even some renewable natural resources can be depleted (run out) if they are all killed or overused. We must also protect our natural resources from pollution. Pollution occurs when people put harmful chemicals and other things into nature. Oil spilled into water, toxic chemicals in the air, or garbage dumped on the side of the road are examples of this problem.

Conservation of natural resources

To conserve natural resources, you can reduce, reuse, and recycle them. For example, turn off the lights when you are not in a room. This will reduce the use of fossil fuels used to generate electricity. Ride your bicycle and walk more, to reduce the amount of gasoline used to transport you. You can reuse things. Things like plastic jugs, jars, paper, and bags can be reused. Each time you reuse something, you conserve the

natural resources that would have been used to make the new one.

Finally, you can recycle. Recycling means reusing a natural resource or product to make something new. It also means collecting and sending these things for reuse. Items that can be easily recycled include: glass, some plastics, paper, cardboard, aluminum, and steel. Some plastics and metals are hard to recycle. They are often made from mixtures of materials. Mixtures can be hard to separate. Try to buy and use things that you can recycle.

In general, natural resources, both renewable and nonrenewable, are important to all of us. We must conserve and carefully use natural resources. Our future depends on them.

Activity 3.2

1. What do you mean by renewable and non-renewable resources?
2. What is the difference between renewable and nonrenewable resources?
3. What can you do to take care of natural resources?

3.3 Types of Markets

At the end of this section, students will be able to:

- ◆ Define a market.
- ◆ Distinguish among the financial market, goods and services market, and labour market.

Start-up Activity

How do you describe the term “market”?

A financial market is an institution where two parties can meet to facilitate the exchange of goods and services. The parties involved are usually buyers and sellers. The market may be physical, like a retail outlet, where people meet face-to-face, or digital, like an online market, where there is no direct physical contact between buyers and sellers. Although there are many types of markets, in this section we focus on three types of markets. These are the goods and services market, the labor market, and the financial market. We can briefly discuss each of these markets as follows.

Goods and services market

The goods and services market is where households purchase consumable goods and services and businesses sell their goods and services. This market includes stores, the Internet, and any other place where consumer goods and services are exchanged.

When you go to the store, shop on the internet, or even just trade with your friend, you are dealing in the goods and services market. It is in this market that end products are traded. Consumers pay money to businesses to acquire something. Money flows from the consumer to the business firms continuously.

Labor market

The labor market is a market in which employees provide labor services and employers provide employment opportunities for labor. The labor market should be viewed at both the macroeconomic and microeconomic levels. For example, daily laborers, domestic workers, skilled workers, professionals, etc. provide labor services to the labor market.

Financial market

A financial market is any place where securities, currencies, bonds, and other financial assets are traded between two parties. This market is the basis of capitalist societies, and it provides capital formation and liquidity for businesses. It can be physical or digital. Examples of financial markets include bond, stock, share, etc.

Activity 3.3

1. List down the different kinds of markets found in your surroundings and classify them into goods and services markets, labour markets, and financial markets, if any.
2. Explain the difference between the goods and services market and the labor market.

3.4 Circular Flow of Economic Activities

At the end of this section, students will be able to:

- ◆ Define circular flow of income.
- ◆ Explain the models of circular flow.
- ◆ Construct a circular flow of economic activities and interpret them.



Start-up Activity

What is the circular flow of economic activities?

The circular flow of economic activities is a simplified macroeconomic model of the basic economic relationships in a market economy. This model gives an overview of how households, businesses, and the government interact in different markets by exchanging goods and services, productive resources (inputs or the factors of production), and money.

Production, exchange, and consumption are three important activities of an economy. As people carry out these economic activities, transactions between different sectors of the economy occur. Because of these transactions, income and expenditure move in a circular way in an economy. This is called the “circular flow of income” or “circular flow diagram.” Before we illustrate and explain the circular flow of income in an economy, let’s consider the different sectors into which an economy is divided for this purpose. These sectors are also sometimes known as decision-making units of the economy. Generally, they are called “economic agents.”

Definition: A circular flow of income is a visual model of an economy that shows how a currency, such as the Birr, flows through markets among decision-making units.

Circular flows of income and expenditure

A circular flow is a pictorial representation of the continuous flow of payments and receipts for goods and services and factor services between different sectors of the economy. It also refers to the process whereby the income and expenditure of an economy flow in a circular manner continuously through time.

Types of flows

Economic transactions, like the sale and purchase of goods and factor services, generate two types of flows, namely, real flows and money flows. Money flow and real flow are the two main aspects of the circular flow of the income economic model. Both refer to exchanges of goods and services for money, but the two concepts differ in how they refer to the opposite sides of these exchanges as they relate to individuals

and companies.

Note that real flows and money flows are two sides of the same coin. A real flow of goods and services is matched by an equal but opposite money flow.

Real flows

real flows consist of the flows of

- factor services from the owners of factor services to the producers, and
- goods and services are passed from the producers to the buyers.

Money (financial) flows

money flows consist of the flows of

- money earned from factor services such as rent, wages, interest, and so on; and
- the money expenditures incurred for the purchase of goods and services.

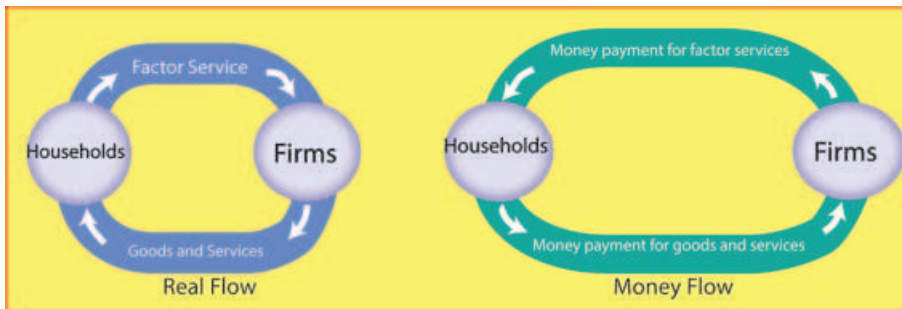


Figure 3.1 Circular flow of income: Real flow and money flow

- **Models of circular flow**

For closed economies, we have two types of circular flow models:

1. a two-sector model, consisting of the flows between households and business firms,
2. three-sector model, consisting of the flows among households, business firms, and the government sector.

- **Two-sector circular flow model**

The two-sector model represents a private, closed economy with only two sectors, namely, the household sector and the business sector (firms).

In this model, the underlying assumptions are:

- i . There are only two sectors in the economy: the household sector and business firms.
- ii . Household sectors are owners of factors of production, and they supply factor services to firms.

- iii . Firms produce goods and services and sell their entire output to households.
- iv . Households receive income for their factor services and spend the entire amount on consumption.
- v . There is no saving in the economy.
- vi . There is no government sector.
- vii . It is a closed economy, and therefore, there are no exports or imports.

The circular flow in a two-sector economy is illustrated in the figure below.

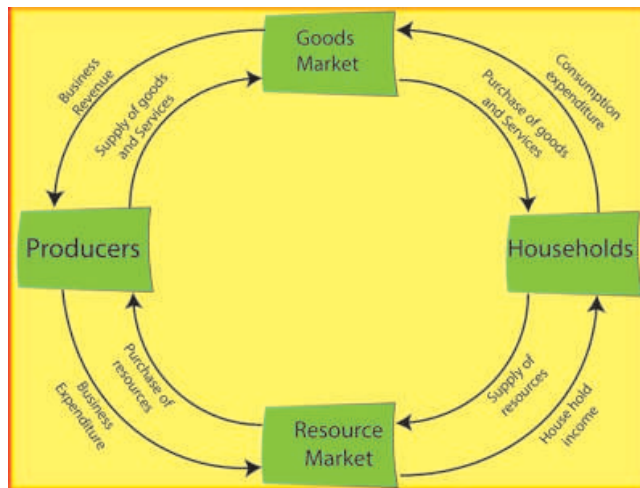


Figure 3.2: Circular flow of income in a two-sector economy

Note that the above figure shows the two types of flows—real flow (of factor services and of goods and services) and money flow.

There is a continuous flow of factor services (in the form of land, labour, capital, and entrepreneurship) from households to firms in the economy. Firms produce goods and services with the help of these factors and supply them to households for consumption. This is called the “real flow of goods and services.” The inner circle of the diagram shows that real flow.

Since, in a monetary economy, all payments are made in money, the real flow is also the money flow of income, which is shown as the outer circle of Figure 3.2. When firms get factor services from households, they make monetary payments against them. Households spend this income on the purchase of goods and services from firms for their own consumption. Because, in this model, households spend all their income on consumption of goods and services, the total money receipts of the firms are the same as the total income of the households. Thus, money flows from firms to households (as payments for factor services) and back from households to firms (as payments for goods and services). This is the money flow of income shown by the outer circle of the diagram in Figure 3.2.

- **Three-sector circular flow model**

In the three-sector circular flow model, the economy has three sectors: households; firms; and government. In this model, the activities of the government (and those of the other two sectors) influence the flow of income. Government economic activities are divided into two categories: government revenue and government expenditure. The circular flow of income in a three-sector economy is shown in the figure below.

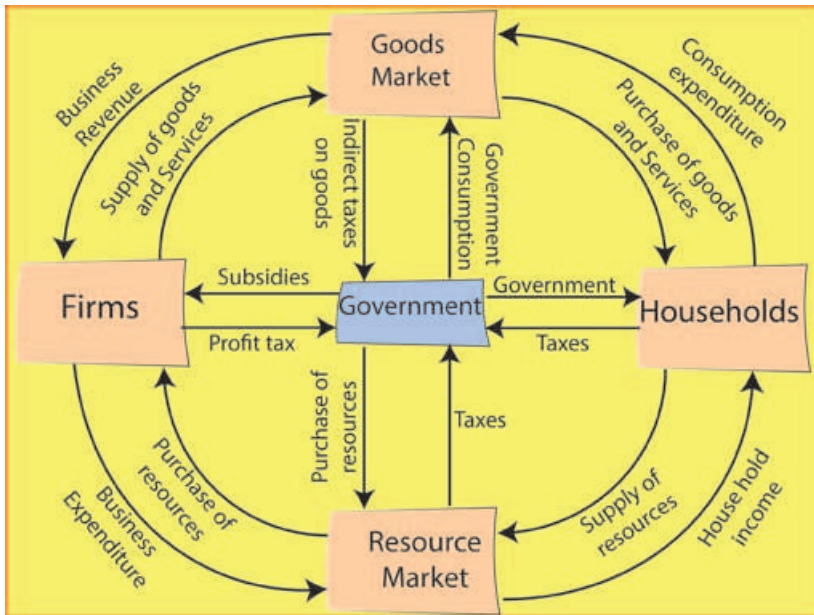


Figure 3.3: Circular flow of income in a three-sector economy

The above figure shows that firms make payments to households in return to factor services received from them. Households make payments to firms for goods and services purchased from them. Households' savings are deposited in the capital market, which in turn, they give their savings to the firms for investment.

Government gets its revenue by imposing taxes on households and on firms. Government pays back this revenue to the firms and households by purchasing goods and services from them. Also, government gives subsidies to the firms and transfer payments to the households. In this way, national income flows in a circular form among the three sectors of the economy.

Activity 3.4

1. What are the main models of circular flow?
2. Draw a two-sector economy circular flow diagram and discuss the role of each economic agent – the households and business firms.
3. Define circular flow diagram.

3.5 Land as an Economic Resource in Ethiopia

At the end of this section, students will be able to:

- Explain the important role of land as an economic resource in Ethiopia.
- Identify the two main soil types found in most of the Ethiopian highlands.

Start-up Activity

How do you define land in the context of agriculture in Ethiopia?

For a country like Ethiopia, where agriculture is the backbone of the economy, land is a very important economic resource. In the context of agriculture, land refers to areal extent as well as its productivity of food crops and other crops. It is well-known that Ethiopia has a total area of 1,104,300 square kilometers of which 35 per cent is considered to be suitable for agriculture. The availability of this amount of land for agricultural purposes is directly or indirectly the result of good soil and suitable climate for the performance of agriculture.

As far as the types of soil are concerned, most of the highlands have two main soil types that are generally believed to be suitable for agriculture. These soil types are:

- Red-to-reddish brown soils: These soil types are well endowed with the required minerals for crops and they are found in areas of relatively good drainage. Further, these soil types are friable – easy to plough.
- Brownish-to-grey and black soils with high clay content: With proper drainage and conditioning, these soils have excellent agricultural potentials.

Regarding the climatic aspect, the formation of different agro-ecological zones due to altitude has multiplied the resource potential of the land of Ethiopia. The presence of different agro-climate zones results in the growth of different types of crops that increases Ethiopia's potential for the production of exportable items in order to earn foreign currency.

The Ethiopian people had been struggling for centuries with the inequitable land holdings of the country and effectively removed the feudal system in 1975. The socialist system that came into being in 1975 under the slogan “Land to The Tiller” paradoxically overturned the slogan and ended up in state ownership rather than giving it to the people. The existing government, which controlled power in 1991, was expected to remove land rights problems, among others by giving land to the people in tenure. But it maintained state ownership of land and controls all urban and rural land together with natural resources. Although state controls land ownership, rural peasants and pastoralists are guaranteed lifetime “holding” right that gives all

rights except sale and mortgage. Even if it is not mentioned in the constitution, urban residents are also provided with the right to get land for residence on a 99 years lease based agreement. The state ownership of land in the present-day Ethiopia is far from ideal since it restricts the different land rights of use, rent, lease, endowment, and inheritance for different reasons. Since redistribution of land is highly restricted, access to rural land is also almost non-existent. The constitution is commended for its protection of land holdings against arbitrary state eviction by inserting a provision that gives “commensurate” amount of compensation during expropriation. However, successive implementation of proclamations has violated this protection by denying market value (fair compensation) for loss of property.

In short, the amount of compensation in the event of expropriation is insufficient. By creating more access to rural land, liberating the land holding rights, and by compensating fairly the loss of properties during expropriation, the current government could give more secure land rights compared to its predecessors.

Activity 3.5

1. Describe the important role of land as an economic resource in Ethiopia.
2. What are the two main soil types found in most Ethiopian highlands?

Unit Summary

Resources can be categorized as free resources (which are the free gifts of nature and unlimited in supply) and economic resources (which are scarce like land, labour, capital and entrepreneurship). A resource is said to be free if the amount available to a society is greater than the amount people desire to have at zero price. A resource is said to be economic when the amount available to a society is less than what people want to have at zero price.

Renewable resources are resources that have the potential to be replaced over time through the natural processes. Non-renewable resources are resources whose stock or reserve is limited or fixed, which are found in the ground. The available supply of non-renewable resources may be replenished by recycling but the overall supply remains relatively constant.

A market is an institution where two parties can meet to facilitate the exchange of goods and services. The parties involved are usually buyers and sellers. The market may be physical like a retail outlet, where people meet face-to-face, or digital like an online market, where there is no direct physical contact between buyers and sellers. These are three markets discussed in this section, namely, goods and services market, labour market, and financial market.

The circular flow of economic activities is a simplified macroeconomic model of the basic economic relationships in a market economy. This model gives an overview of how households, businesses and government interact in different markets by exchanging goods and services, productive resources and money.

For a country like Ethiopia, where agriculture is the backbone of the economy, land is a very important economic resource. In the context of agriculture, land refers to areal extent as well as its productivity of food crops and other crops.

Review Questions

Part I: Write ‘True’ if the statement is correct or ‘False’ if it is not correct for each of the following statements.

1. By labour, we mean only the physical labour involved in the production of goods and services.
2. Recycle means to reuse a natural resource or product to make something new.
3. The goods market is the basis of capitalist societies, and it provides capital formation and liquidity for businesses.
4. The labor market is a market in which employees provide the labour services and employers provide the employment opportunities for labour.
5. Financial market is any place where securities, currencies, bonds, and other financial assets are traded between two parties.
6. Production, saving and making transfers are three important activities of an economy.
7. The two-sector model represents a private closed economy with only two sectors, namely, household sector and the business sector (firms).
8. Government gets its revenue through selling goods to households and firms in the three sector circular flow model.
9. Land is an example of a free resource at present in Ethiopia.
10. For a country like Ethiopia, where agriculture is the backbone of the economy, land is a very important economic resource.

Part II: Choose the correct answer among the alternatives for the following questions.

1. A resource is said to be free if the amount available is
 - A . less than the amount people desire to have at a non-zero price.
 - B . greater than the amount people desire to have at a non-zero price.
 - C . greater than the amount people desire to have at a zero price.
 - D . less than the amount people desire to have at a zero price.
2. Which of the following statements is correct?
 - A . Air, sunshine, and solar energy are examples of economic resources.
 - B . A resource is said to be economic when the amount available is plenty.
 - C . Price is the test of whether a resource is economic or free.
 - D . Since economic resources are plenty, they have a very low price.

3. All of the following are examples of scarce resources except
 - A . a skilled and specialized labour
 - B . a mountain stream
 - C. minerals, clean water and forests
 - D. all types of capital resources
4. Which one of the following indicates all the manufactured inputs that can be used to produce other goods and services?
 - A . Labour
 - B . B. Entrepreneurship
 - C. Land
 - D. Capital
5. Which of the following is an example of a renewable resource?
 - A . Solar energy
 - B . Wind energy
 - C. Soil and forests
 - D. all of the above
6. _____ occurs when people put harmful chemicals and other things into nature.
 - A . Pollution
 - B . B. Conservation
 - C. Depletion
 - D. Preservation
7. Which one of the following measures is necessary to take care on natural resources?
 - A . Reducing their use
 - B . Reusing them
 - C. Recycling them
 - D. All of the above
8. A closed economy does not allow:
 - A . Sale of goods to households
 - B . Sale of goods to government
 - C. Sale of goods to other countries
 - D. Sale of goods to business firms
9. Which of the following does not go with the three-sector circular flow model?
 - A . Investment
 - B . C. Firms
 - B. Households
 - D. Government
10. In three sector circular flow model, the two main government economic activities are:
 - A . Government revenue and expenditure.
 - B . Government saving and payments.
 - C . Government purchases and sales.
 - D . Government transfers and expenditure.

Part III: Answer the following questions briefly and to the point.

1. What is the basic difference between free and economic (scarce) resources?
2. Describe the four categories of economic resources. Which of them you and your family owned?
3. How do you catgorise the types of resources go into producing goods and services? Explain each of the categories briefly and give examples.
4. Explain how pollution occurs and give examples of this problem.

5. What is the difference between financial market and labour market?
6. Explain circular flows of income. Distinguish between real flows and money flows.
7. Describe circular flows of income in a three-sector economy.
8. Discuss the nature of land ownership rights in the context of Ethiopia during the pre-1974 period, from 1975 to 1991 and from 1991 to the present.

Unit 4

Introduction to Demand and Supply

Introduction

You may have questions such as next: What does demand mean? What does the law of demand say? What does supply mean? What does the law of supply say? What does market equilibrium mean? The purpose of this unit is to explain what demand and supply are and show how they determine equilibrium price and quantity. We will also show how the concepts of demand and supply reveal consumers and producers sensitivity to price change. This unit deals with the concept of demand, the concept of supply and market equilibrium.

Unit objectives

At the end of this unit, students will be able to:

- ◆ Define the concepts of demand and supply.
- ◆ Explain the laws governing demand and supply.
- ◆ Describe the equilibrium price and quantity



Start-up Activities

1. Why do individuals respond differently to an increase in price? Do you think that there are commodities, which we continue consuming with the same amount, even if their price is increasing?
2. How do you define the term ‘supply’ in economics?
3. Think of the situation in your local market, list down expensive and cheap goods in the market, and explain the reasons for price differences.



Key Concepts

Ceteris paribus, demand, demand schedule, demand curve, demand function, law of demand, supply, supply schedule, supply curve, law of supply, market demand, market supply, market equilibrium, equilibrium price, and equilibrium quantity.

4.1 Concept of Demand

At the end of this section, students will be able to:

- Define the concept of demand
- Analyse the law of demand

Start-up Activity

Why individuals respond differently to an increase in price? Do you think that there are commodities, which we continue consuming the same amount even if their price is increasing?

Demand

The terms demand, desire and want are frequently used synonymously to express what an individual needs and would like to acquire. Demand states that the consumer must be willing and able to buy a commodity which he or she desires at a given price during a given period of time.

Accordingly, demand is distinct from a mere desire to acquire something. Human wants are unlimited and desires are several. However, only a desire backed up by the ability to pay the price for the commodity and the willingness to purchase it, is called a demand. We can say demand refers to an effective desire. A desire becomes an effective demand only when it is backed by the following three features:

- ability to pay for the good desired,
- willingness to pay the price of the good desired, and
- availability of the good itself

Furthermore, demand for a good is constantly stated relative to a specific price and certain time. For instance, an individual may be interested to buy a certain jeans at a price of Birr 500, but he or she could not absolutely demand it if its price is Birr 900. Likewise, an individual may be willing to buy a room heater at a price of Birr 1000 during a cold season, but he or she may not be interested in buying it at this price during a hot season.

Based on the aforementioned considerations, we can define demand as follows:

Demand for a commodity is the amount of it that a consumer is willing to buy at various given prices and a given moment of time.

Quantity Demanded

Quantity demanded is the amount of commodity a consumer must be willing and able to buy which he/she desires at a given price during a given period of time.

Law of Demand

Law of demand states that, *ceteris paribus*, price of a commodity and its quantity demanded are inversely related. *Ceteris paribus* means other things remain the same. In other words, the higher the price, the lower the quantity demanded. The law of demand is a fundamental principle of economics that states that at a higher price consumers will demand a lower quantity of a good.

Demand Schedule

A demand schedule is a tabular description, which presents various quantities of a commodity that would be demanded at different prices. Demand schedule refers to a tabular representation of the relationship between price and quantity demanded. It demonstrates the quantity of a product demanded by an individual or a group of individuals at specified price and time.

Table 4.1: Individual household demand schedule for Oranges per week

Price (Birr Per kg)	Quantity Demanded/week
5	5
4	7
3	9
2	11
1	13

The above demand schedule shows the different quantities of oranges demanded by an individual household at different prices. At Birr 5 per kg, the consumer demands 5kg of oranges. However, an individual household's demand for 13 kg of oranges at Birr 1 per kg.

Demand Curve

A demand curve is a graphical representation of the relationship between different quantities of a commodity demanded by an individual at different prices per time period.

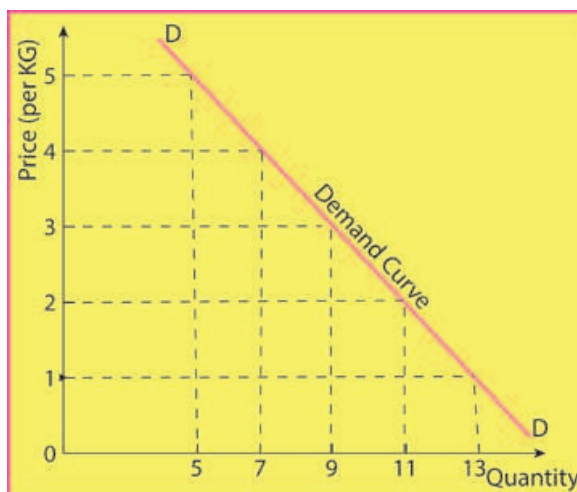


Figure 4.1: Individual household demand curve

Demand Function

It is a mathematical representation of the relationship between price and quantity demanded, *ceteris paribus*. A typical demand function is given by:

$$Q_d = f(P)$$

where, Q_d is the quantity demanded and P is the commodity's price,

Market demand

Market demand describes the demand for a given product and who wants to purchase it. This is determined by how willing consumers are to spend a certain price on a particular good or service. As market demand increases, so does the price. When demand decreases, prices will go down as well. A simple horizontal summation of the quantity sought for a commodity by all buyers at each price yields market demand.

Table 4.2: Individual and market demand schedule for a commodity

Price (Birr/kg)	Individual Demand (kg/week)			Market Demand (kg/week)
	Consumer-1	Consumer-2	Consumer-3	
8	0	0	0	0
5	3	5	1	9
3	5	7	2	14
0	7	9	4	20

The preceding demand schedule shows the different quantities of oranges demanded by different consumers at different price levels in the market. At Birr 5 per kg, consumer-1 demands 3 kg, consumer-2 demands 5 kg, and consumer-3 demands

only 1 kg. Thus, market demand at Birr 5 per kg is 9 kg. However, at Birr 3 per kg, consumer-1 demands 5 kg, consumer-2 demands 7 kg, and consumer-3 demands 2 kg. So, market demand at Birr 3 per kg is 14 kg. The individual and market demand curves for the data given in the above table are depicted in the figure below.

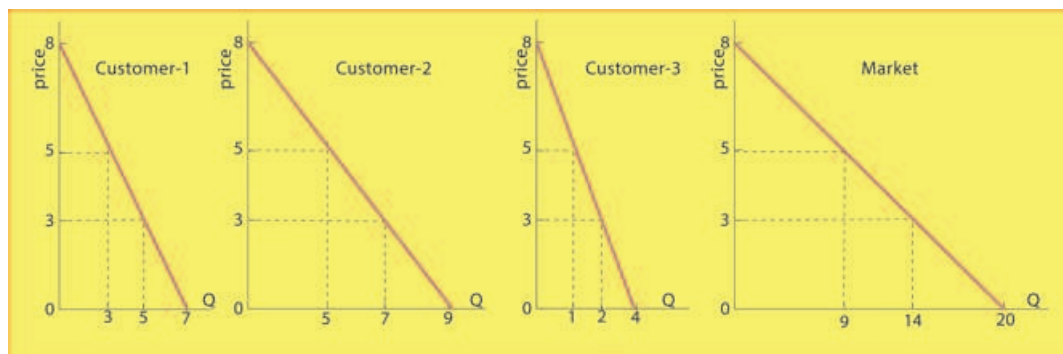


Figure 4.2 Individual and market demand curve for a commodity

✎ Activity 4.1

1. Define demand and state the law of demand.
2. Explain why the demand curve always slopes downwards from left to right.

4.2 Concept of Supply

At the end of this section, students will be able to:

- ◆ Define the concept of supply.
- ◆ Analyse the law of supply



Start-up Activity

How do you define the term ‘supply’ in economics?

Supply

In ordinary language, the term “supply” is often misused and confused with the term “stock”. A commodity “stock” is the total volume of a commodity produced during a period less the quantity already sold out. Conversely, supply means the quantity that is actually brought to the market. Most of the time, producers do not offer all of their stock for sale on the market. For example, after harvest, a large portion of agricultural products are kept in cold storage and sold at a higher price during the off-season. Likewise, a part of an industrial product is usually kept back in stock and offered for sale in the market at a time when it can bring higher prices. Thus, we can say that stock is potential supply, and supply may be less than or equal to the stock of a commodity. However, in economics, the term supply has a specific meaning, which is defined as follows:

Supply of a commodity refers to the various quantities of it which producers are willing and able to offer for sale at a particular time at various corresponding prices.

Quantity Supplied

Quantity Supplied indicates various quantities of a commodity that sellers (producers) are willing and able to provide at different prices in a given period of time. In economics, “quantity supplied” describes the number of goods or services that suppliers will produce and sell at a given market price. The quantity supplied differs from the actual amount of supply as price changes influence how much supply producers actually put on the market.

Note that supply shows the relationship between the quantity supplied and the price of a commodity, while quantity supplied refers to a specific amount of the commodity that a producer is willing to sell at a specific price.

Like the law of demand, the law of supply demonstrates the quantities sold at a specific price. But unlike the law of demand, the supply relationship shows an upward slope.

This means that the higher the price, the higher the quantity supplied. According to the law of supply, there is a direct or positive link between a commodity’s price and the quantity delivered.

Supply Schedule

A supply schedule is a tabular presentation of different quantities of a commodity offered for sale at different prices per time period. A supply schedule is a chart that shows how much product a supplier will have to produce to meet consumer demand at a specified price based on the supply curve.

Table 4.3: Individual seller’s supply schedule for oranges

Price (Birr Per kg)	Quantity Supplied (kg/week)
10	60
15	70
20	80
25	90
30	100

The above supply schedule shows the different quantities of a commodity that an individual seller is willing to provide at different prices. At Birr 15 per kg, the seller provides 70 kg per week, while at Birr 30 per kg; the seller provides 100 kg of the commodity per week.

Supply curve

A supply curve shows the information of a seller’s supply schedule graphically rather than in a tabular form.

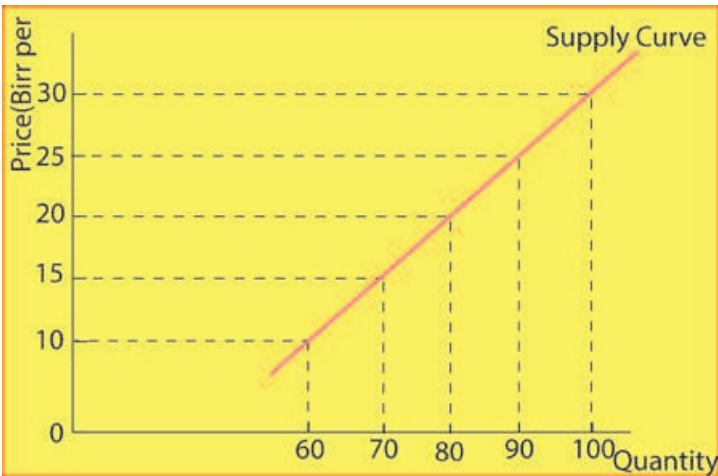


Figure 4.3 Individual seller’s supply curve for oranges

Supply Function

A supply function is a mathematical representation of the relationship between price and quantity supplied of a commodity, all other things remaining the same. A typical supply function is given by:

$$Q_s = f(P)$$

where, Q_s is quantity supplied and P is the price of the commodity.

Market supply

Market supply is the total amount of an item producers are willing and able to sell at different prices, over a given period of time. Market supply is calculated by summing the quantity supplied of the commodity by all sellers at each price horizontally.

Table 4.4: Derivation of the market supply of a commodity

Price per unit	Quantity supplied by seller-1	Quantity supplied by seller-2	Quantity supplied by seller-3	Market supply/ week
5	11	15	8	34
4	10.5	13	7	30.5
3	8	11.5	5.5	25
2	6	8.5	4	18.5
1	4	6	2	12

The preceding supply schedule shows the various quantities of a commodity that different sellers supply to the market at different prices over the given time period. At Birr 5 per kg, seller-1 delivers 11 kg, seller-2 delivers 15 kg, and seller-3 delivers 8 kg. Accordingly, the market supply at Birr 5 per kg is 34 kg. However, at birr 2 per kg, seller-1 delivers 6 kg, seller-2 delivers 8.5 kg, and seller-3 delivers only 4 kg. Thus, the total market supply at Birr 2 per kg is only 18.5 kg.

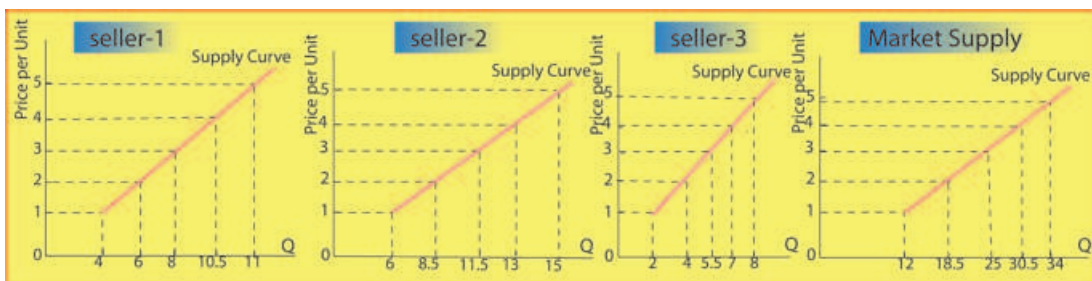


Figure 4.4: Individual and market supply curves

The preceding market supply curve depicts the horizontal summation of individual supply curves. It indicates the relationship between various quantities of a commodity that sellers are willing to offer for sale at different prices. Market supply is found by horizontally summing individual supplies at the market price.

Activity 4.2

1. Define supply and state the law of supply.
2. Why does the supply curve slope upward to the right?

4.3 Market Equilibrium

At the end of this section, students will be able to:

- ◆ Define market equilibrium
- ◆ Show the equilibrium price and the equilibrium quantity from the graph.
- ◆ Outline the graph of market equilibrium.
- ◆ Explain the concept of excess demand and excess supply in the market.

Start-up Activity

Think of the situation in your local market and enumerate the goods that are expensive and cheap in the market; and explain the reasons for price differences.

In the preceding sections, we have discussed both the consumers' demand for goods in a market and the firms' supply of goods in a market independently. Demand and supply curves tell us how much consumers demand and how much producers supply at different prices, respectively. They do not, however, tell us the actual price of a product in general. We now come to the important question: how do the forces of demand and supply work together so as to determine market prices? We explain how forces of demand and supply help in attaining “equilibrium” and how the “equilibrium price” is determined.

The concept of equilibrium

The term “equilibrium” refers to a state of balance. In the physical world, when two opposing forces acting on an object are balanced so that the object is held stationary, the object is said to be in equilibrium. In simple terms, when the object under the action of forces working in opposite directions has no tendency to move in any direction, the object is in equilibrium. Similarly, an economic system is said to be in equilibrium when its important variables show no change, and when no forces are acting on them to produce a change in their values. For instance, after attaining equilibrium, a consumer has no intention of re-allocating his or her money or income. Likewise, a firm is said to be in equilibrium when it has no tendency to change its level of output by either increasing or decreasing it. Thus, there is a tendency to move towards the equilibrium price. This tendency is known as the “market mechanism,” and the resulting balance between supply and demand is called “market equilibrium.”

In real world economic activities, equilibrium may never be actually realised. The central feature of equilibrium analysis in economics is the concept that economies tend towards equilibrium when no external forces are acting on them.

Market equilibrium

In the context of price determination, equilibrium refers to a situation in which the quantity demanded of a commodity equals the quantity supplied of the commodity. In brief, it refers to the balance between the opposite forces of demand and supply, known as market equilibrium.

Equilibrium price

The price at which the quantity demanded of a commodity equals the quantity supplied is called ‘equilibrium price’. The forces of demand and supply determine the price of a commodity in a given market. At an equilibrium price, the quantity demanded and the quantity supplied are equal.

Equilibrium quantity

The equilibrium price is the price at which consumers are willing to buy the same quantity of a commodity that producers are willing to sell. The amount that is bought and sold at an equilibrium price is called the ‘equilibrium quantity’.

An illustration of market equilibrium

With a view to understanding how the forces of demand and supply operate in a market to determine the equilibrium price and quantity, let’s consider an imaginary market with a large number of buyers and sellers of a commodity, say, oranges. Table 4.5 shows the imaginary market’s demand and supply schedule for oranges at different prices.

Table 4.5: Market demand and supply schedule of oranges

Price (Birr per kg)	Demand (kg)	Supply (kg)	Trend
5	1000	200	Excess demand
10	800	400	Excess demand
15	600	600	Equilibrium
20	800	800	Excess supply
25	200	1000	Excess supply

In the above market demand schedule, there is one price at which market demand is equal to market supply. This price is birr 15 per kg because, at this price, quantity demanded is equal to quantity supplied, that is, 600 kg of oranges. Accordingly, the equilibrium price is found to be Birr 15 per kg. It is the only price at which the maximum number of buyers and sellers are satisfied. Thus, as long as market demand

and supply remain unchanged, the price will neither tend to rise nor fall below this equilibrium price. If there is any change in the equilibrium quantity, there will be either excess demand or excess supply in the market.

Case of Excess Demand

Excess demand for a commodity means that consumers want to buy more than what the producers are willing to supply. If at a given price, demand for a commodity is in excess of supply, competition among buyers will push the price up to the point at which demand becomes equal to supply. Suppose the actual price of oranges prevailing at a particular time period in the market is Birr 10 per kg. At this price, demand for oranges is 800 kg while supply is 400 kg, i.e., there is an excess demand of 400 ($= 800 - 400$) kg. This will create competition among buyers to buy oranges, which are in short supply, and push the price up until it reaches the equilibrium price of Birr 15 per kg, where demand becomes equal to supply ($= 600$ kg of oranges).

Case of Excess Supply

An excess supply of a commodity means that consumers want to buy less than what the producers are willing to supply. If, at a given price, the quantity supplied of a commodity exceeds the quantity demanded, competition among sellers will push the price down to the point at which demand becomes equal to supply. Suppose at a particular time period, the price of oranges is set at Birr 20 per kg, at which the demand is 400 kg while the supply is 800 kg, i.e., there is an excess supply of 400 kg. In this case, competition among sellers to sell their oranges will push down the price until it reaches Birr 15 per kg. Eventually, the price will settle at Birr 15 per kg, at which point demand is 600 kg of oranges and supply is also 600 kg. This shows that demand and supply are holding each other in balance and that the equilibrium price has been reached.

A graphical presentation of market equilibrium

The determination of equilibrium price and equilibrium quantity can be illustrated graphically with the help of a market demand curve and a market supply curve.

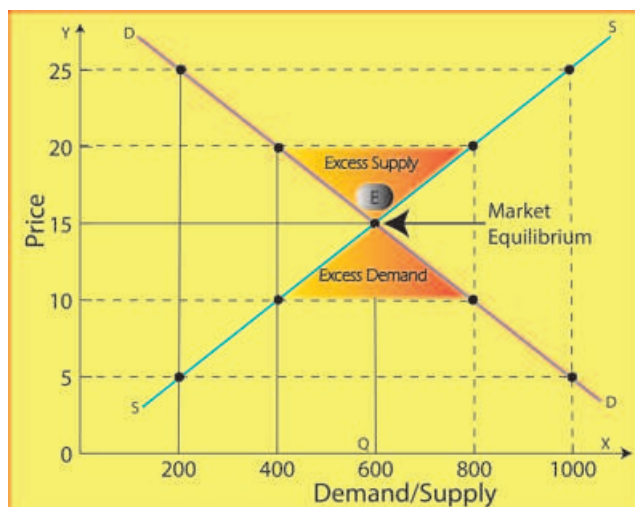


Figure 4.5 depicts the market's equilibrium.

The above graph displays the market demand and supply schedule of the previous illustration, in which DD is the demand curve and SS is the supply curve.

The demand and supply curves intersect at point E, where the equilibrium price is Birr 15, and the quantities demanded and supplied are equal to 600 kg. Consequently, Birr 15 will be the equilibrium price and 600 kg will be the equilibrium quantity. In brief, the graphically equilibrium price of a commodity is the intersection point of the demand and supply curves. Furthermore, the graph depicts circumstances of excess demand and surplus supply.

✎ Activity 4.3

1. Define the market equilibrium?
2. Sketch the graph of market equilibrium from the following data and label it with the letter 'E'.

Price (Birr per kg)	Demand (kg)	Supply (kg)
1	500	100
2	400	200
3	300	300
4	200	400
5	100	500

3. Find the equilibrium price and equilibrium quantity from the graph, and identify the market trends.
4. Explain the concept of excess demand and excess supply in the market.

Unit Summary

Demand for a commodity is the amount that will be purchased at a particular price during a particular period of time. The law of demand states that, other things remaining constant, the quantity demanded of a commodity increases when its price falls and decreases when it rises. The law can be described using a demand schedule, a demand curve, and a demand function. A demand schedule is a table that describes the different quantities of a commodity demanded at different prices. A demand curve is the graphical representation of a demand schedule. Individual demand for a commodity is the amount a single consumer buys at a given price during a particular period of time. Market demand is the total quantity of a commodity that all households are willing to buy at a given price during a given period of time.

Supply is the quantity of a commodity that producers are willing to produce and offer for sale at a particular price during a given period of time. The law of supply states that, other things remaining the same, the quantity of a commodity that firms will produce and offer for sale rises with a rise in price and falls with a fall in price. A supply schedule is a tabular description that shows various quantities that producers are willing to produce and sell at various prices during a given period. Individual supply is the quantity of a commodity that one firm is willing to produce and offer for sale at a particular price during a given period of time. Market supply is the quantity of a commodity that all the producers are willing to produce and offer for sale at a particular price during a given period of time.

Market equilibrium is a situation in which the quantity demanded of a commodity equals the quantity supplied of the commodity. An equilibrium price is the price at which quantity demanded equals quantity supplied. An equilibrium quantity is the amount of a commodity bought and sold at an equilibrium price. Graphically, the equilibrium price is determined at the point of intersection of the demand curve and the supply curve.

Review Questions

Part I: Write 'True' if the statement is correct or 'False' if it is not correct for each of the following statements.

1. The only factor that can cause a change in the quantity demanded of a commodity is a change in the price of the commodity.
2. A surplus exists when the market price is above the equilibrium price.
3. A change in the price of coffee may affect the quantity of petroleum demanded.
4. A change in the price of wheat may affect the quantity of wheat supplied.
5. A change in the income of a consumer causes a change in the quantity demanded of a commodity.
6. An increase in the quantity demanded of a commodity leads to a decrease in the equilibrium price.
7. Excess supply of a commodity means that consumers want to buy less than what the producers are willing to supply.
8. Graphically, the equilibrium price of a commodity is the intersection point of the demand and supply curves for the commodity.
9. The amount of a commodity that is bought and sold at a lower price is called the equilibrium quantity.
10. Provided that market demand and supply remain unchanged, the price will neither tend to rise nor fall below this equilibrium price.

Part II: Choose the correct answer among the alternatives for the following questions.

1. Demand reflects the quantity of a commodity that consumers want.
A . want to buy it at a different price,
B . need to buy at alternative prices.
C . are willing and able to buy at alternative prices.
D . can be bought at alternative prices.
2. A demand schedule shows the relationship between the quantity demanded of a commodity over a given period of time and the _____
A . price of the commodity. C. income of the consumers.
B . taste of the consumers. D. price of related commodities.

3. More of a commodity will be purchased at lower prices because
 - A . consumers substitute this commodity for others whose price has not changed.
 - B . at lower prices, consumers can buy more of this commodity with a given money income.
 - C . more consumers will buy the commodity at lower prices than at higher prices.
 - D . all of the above
4. A change price of a commodity
 - A . affects the consumer's ability to buy the good.
 - B . affects the consumer's willingness to buy the good.
 - C . changes the tastes of consumers.
 - D . all of the above.
5. Which one of the following is not held constant in defining the demand schedule?
 - A . income of a consumer
 - B . prices of the good in question
 - C . prices of other goods
 - D . number of consumers
6. A movement along a demand curve can be caused by a change in
 - A . income of a consumer
 - B . the price of other goods
 - C . expectation about future prices
 - D . the price of the good in question
7. A movement along a supply curve can be caused by a change in
 - A . the price of the good in question
 - B . the price of related goods
 - C . expectation about future income
 - D . taste of a consumer
8. The intersection of a market demand curve and a market supply curve for a commodity determines
 - A . the equilibrium price for the commodity.
 - B . the equilibrium quantity for the commodity.
 - C . the point of neither surplus nor shortage for the commodity.
 - D . all of the above
9. Which of the following statements is not true when price is above the equilibrium price?
 - A . The quantity supplied exceeds the quantity demanded of the commodity.
 - B . There is a shortage of the commodity.
 - C . The pressure on the commodity price is down ward.
 - D . There is a surplus of the commodity.
10. Excess demand for a commodity means that the consumers want to buy
 - A . more than its supply
 - B . less than its supply
 - C . equal to its supply
 - D . none of the above

Part III: Answer the following questions briefly and to the point.

1. Distinguish between the following pair of concepts:
 - a. Individual demand and market demand
 - b. Individual supply and market supply
 - c. Excess demand and excess supply
2. What is the difference between demand and the quantity demanded for a commodity?
3. Why does the quantity of salt demanded tend to be unresponsive to changes in its price?
4. Why do we add individual demand curve for a product, why do we add individual demand curve for a product?
5. When is the market said to be in a state of equilibrium?

Unit 5

Introduction to Production and Cost

Introduction

Based on our discussion in the previous unit, we know that the supply price of a given level of output depends upon the cost of production of the corresponding level of output. Cost of production, in turn, depends upon the physical relation between inputs and output and the prices of inputs. Assuming that the prices of inputs are given, cost of production will depend upon the physical relationship between inputs and output. A study of the relationship between inputs and output is known as the ‘theory of production’. A study of the relationship between output and cost of production is what we call ‘theory of costs’. In the present unit we discuss various aspects and elements of these two theories in order to understand better the behaviour of firms (producer) in the production of goods and services.

Unit Objectives

At the end of this unit, students will be able to:

- ◆ Describe productivity
- ◆ Explain the types of inputs and outputs.
- ◆ Analyze types of cost of production



Start-up Activities

1. Have you ever been engaged yourself in any production activity?
2. What makes a period of production short run and long run?
3. Assume a wheat flour factory using different types of factors of production. Discuss what variable and fixed costs are incurred.



Key Concepts

Input, Outputs, Production, Short-run, Long-run, Production function, Cost, Fixed cost, Variable cost, Total cost, and Marginal cost

5.1 Definition of Production, Inputs and Outputs

At the end of this section, students will be able to:

- Describe production
- Explain inputs and outputs

Start-up Activity

Have you ever been engaged yourself in any production activity?

Production is a process of transforming inputs into outputs. For example, when we get wheat on a plot of land with the help of inputs like labor, capital and seeds, it is termed as production of wheat. Similarly, when, in a cloth mill, inputs like labor, capital and threads are transformed into cloth, it is called production of cloth. Similarly, services are also produced in an economy. For instance, in economics, services of a teacher, a doctor, a singer and servants are also called production.

Production Function

The production function indicates the maximum amount of output that can be produced with the help of each possible combination of inputs. Production function is the maximum set of output(s) that can be produced with a given set of inputs.

More importantly, it shows the relationship between various combinations of inputs and the maximum outputs obtainable from those combinations. It defines the boundaries of maximum output that can be produced from the combination of inputs. In other words, it also describes technological relationships between inputs and outputs.

Mathematically, it can be represented as $Q = f(X_1, X_2, X_3, \dots, X_n)$

Where, Q = the maximum output produced

and $X_1, X_2, X_3, \dots, X_n$ are n-different types of inputs

Type of Inputs

Inputs are economic resources that can be used in the production of goods and services.

Inputs can be divided into two main groups – fixed and variable inputs. A fixed input is one whose quantity cannot be varied during the period under consideration. Building and machinery are examples of fixed inputs. An input whose quantity can be changed during the period under consideration is known as a variable input.

Definition:

Outputs are consequences of the production process. Outputs can be classified as tangible and intangible products: Tangible goods are physical products defined by the ability to be touched. They are distinct from intangible goods, which may have value but are not physical entities. Goods that are tangible play a large part in retail, though the purchasing of intangible goods is now widely available through the Internet (online shopping).

The primary difference between tangible and intangible is that tangible is something which a person can see, feel or touch and thus they have the physical existence, whereas, the intangible is something which a person cannot see, feel or touch and thus do not have any of the physical existence.

Examples of tangible assets include Land, Building, Machinery, Equipment, Cash, Plant, any property that has long term physical existence or purchased for the use of business operations and not for sale, Vehicles, etc. An Intangible Asset is assets that do not have a physical existence.

Intangible products—travel, insurance, repair, consulting, computer software, education, health care—can seldom be tried out, inspected, or tested in advance.

** Activity 5.1**

1. Make a class room observation what inputs are utilizing in teaching learning process
2. Describe production.
3. Explain inputs and outputs.

5.2 Periods of Production

At the end of this section, students will be able to:

- 💧 Describe the short run and long run production
- 💧 Differentiate among Total Product, Average Product and Marginal Product

Start-up Activity

What makes a period of production is short run and long run?

This classification of period of production is mainly based on the degree of flexibility of economic resources to changes in business environment of products consuming those resources.

Short run period of production refers to a period of production in which at least one of the inputs is fixed while the remaining is variable. This implies that an increase in output in the short-run can be brought about by increasing those inputs that can be varied, which are known as ‘variable inputs’. For example, if a producer wishes to increase output in the short-run, she/he can do so by using more of variable factors like labour and raw material.

Long run period of production is a period of production in which all inputs are variable or there is no fixed resource in general. A firm can install a new plant or raise a new factory building. Long-run is the period during which the size of the plant can be changed. Thus, all the factors are variable in the long-run.

It must be understood that when we say short run and long run it does not necessarily mean a relatively short or long period of time like one year or less than one year or like two or five years. It rather refers to the nature of economic arrangement of the inputs in response to the changing economic environment.

Total Product, Average Product and Marginal Product

The productivity of variable inputs can be measured in different forms:

Total product (TP): -it is the overall amount of output produced by the factors of production employed over a given period. It is the gross or entire output by workers and expressed in terms of Quantity (Q). In the short run production function, a firm obtains its total product by using a combination of variable inputs with specific amount of fixed inputs.

Average product (AP): - a firm's average product is obtained by dividing the total output by the number of workers employed. This can be put in the form of $AP = TP/L$; Where AP=Average Product, TP= Total Product and L=Labor.

Similarly, average product of labor may be defined as

$$AP_L = \frac{TP}{L}$$

Where, TP stands for total production.

AP_L stands for average product for labor.

The average product is a good indicator of the productivity of labor. Productivity is a measure of output per unit input (i.e. output ratio for each level of input and the corresponding level of output).

Marginal Product (MP): - it is holding the quantities of other factors constant, the increase in output which results from using one additional or extra unit of a single factor input, is called the marginal physical product or simply marginal product. In other words, all other things being equal the MP is the percentage change in total output resulting from a percentage change in variable input.

$$MPL = \Delta TP / \Delta L$$

Where, ΔTP stands for change in total production

ΔL stands for change in labor input

Mathematically, $MP = \Delta TP / \Delta L$. Both the MP and AP of the variable factor (labor) are derived from the TP of labor. Thus, the three returns, viz. total product (TP), marginal product (MP) and average product (AP) are interrelated.

Table 5.1 Production function with variable input

Variable input (labor)	Total Product (TP) (In quintals)	Average product (AP)	Marginal Product (MP)	Stages of Production
0	0	-	-	Stage I
1	10	10	10	
2	28	14	18	
3	51	17	23	
4	76	19	25	
5	95	19	19	Stage II
6	108	18	13	
7	108	15.4	0	
8	96	12	-12	Stage III
9	80	8.88	-16	

The above schedule can also be expressed graphically by drawing TP, MP and AP curves.

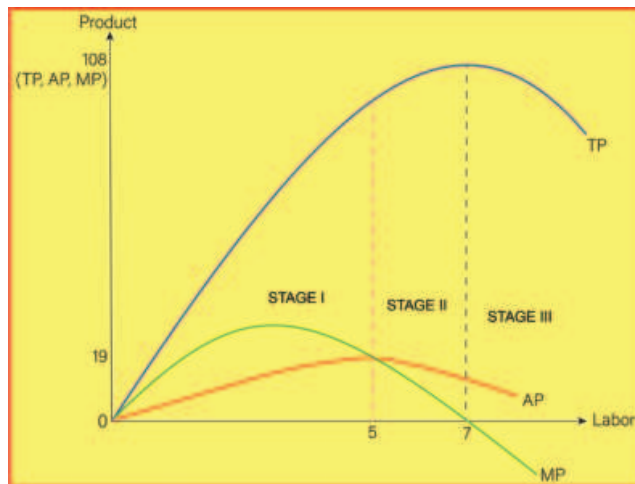


Figure 5.1 Stages of production

There is a relationship between total product, marginal product, and average product.

The relationship between MP and AP:

When $MP > AP$, this means that AP is rising,

When $MP = AP$, this means that AP is the maximum,

When $MP < AP$, this means that AP is falling.

Graphically, the relationships between the MP curve and the AP curve are as follows:

So long as the MP curve lies above the AP curve, and the AP curve is a positively sloping curve, the AP rises

When the MP curve intersects the AP curve, AP is at its maximum,

When the MP curve lies below the AP curve, the AP curve slopes downward

The relationship between TP and MP:

When TP increases at an increasing rate, marginal product increases,

While TP increases at a diminishing rate, MP declines,

When the total product reaches its maximum, the marginal product becomes zero,

When TP begins to decline, MP becomes negative.

 Activity 5.2

1. Differentiate among Total Product, Average Product and Marginal Product
2. Elaborate the concepts of fixed and variable inputs in relation to short-run and long-run production functions by giving a practical example in your locality.

5.3 Cost of Production

At the end of this section, students will be able to:

- ◆ Define the cost of production.
- ◆ Differentiate among the different types of costs.



Start-up Activity

Assume a wheat flour factory using different types of factors of production. Discuss what variable and fixed input costs are incurred.

The concepts of production and cost are inseparable. The cost of production generally refers to the monetary outlays associated with production activity, or it is the total expenditures and sacrifices made in the entire process of production and distribution of goods and services.

Types of Cost of Production

Cost: To produce goods and services, we need production factors. These factors of production (resources) are bought through monetary outlays from factor markets. Thus, costs are defined as the monetary values of inputs used in the production of items.

Explicit and implicit costs

Explicit costs: These are the actual monetary payments or cash outlays that business firms make to outsiders who are suppliers of inputs or resources to them. For example, the rewards of labour, land, capital, and entrepreneurs are all costs for a business firm that employs them in certain production processes. In addition, there are other payments made for other raw materials, fuel, transport, sieve, power, and the like are all costs to a firm. Such costs are usually termed “accounting costs” because they are out-of-pocket costs. Thus, accounting cost refers to the cost of purchased inputs only, and this only refers to the explicit cost.

Implicit costs: These are costs that stand for the values of non-purchased resources owned and used by firms in their own production activities. They are said to be implicit costs. There are costs of firms’ own and self-employed resources in carrying out activities like the salary of an owner-manager or the estimated rent of a building that belongs to the owner of a firm, etc. The values of these self-owned resources should be estimated from what they could earn in their best alternative use.

Explicit costs plus implicit costs equal economic costs.

Opportunity costs: The opportunity cost of a good or service is the value of the best alternative that is forgone in order to produce a good or undertake the service. These costs are also called *economic costs* because they include both explicit (costs involving actual payments) and implicit (benefits that would have resulted from choosing the sacrificed alternative direct payments).

Economic Cost

It is obvious that costs and profits are inseparable concepts in business. Here, the main point is to understand the cost treatment differences and their consequences in cost analysis of business activities. Economists define costs in terms of opportunity costs, and they include implicit costs in profit calculations.

Thus, economic cost = implicit cost + explicit cost

Total Cost, Average Cost and Marginal Cost

In a production process, firms make a monetary payment to outsiders who are suppliers of inputs or resources to them. These cost outlays can be defined as total cost, average cost, and marginal costs.

Fixed costs are those costs that do not vary as the firm changes the level of output. These are costs that are always incurred even if the firm does not produce anything. These are also fixed-input costs. e.g. rents on leased properties, interest on borrowed funds, the wear and tear of machinery, the cost of administrative staff, etc.

Variable costs are those costs of production that directly vary with the level of output of the firm. When output is zero, variable costs are also zero. But as the firm expands its output, these costs tend to rise. In short, the variable costs of a firm are dependent on the level of output. Examples of variable costs are the wages of workers excluding the administrative staff, the cost of raw materials, etc.

Total cost: - is the sum of total fixed cost and total variable cost.

$$TC = TFC + TVC$$

Where, TC = Total Cost; TFC = Total Fixed Cost; TVC = Total Variable Cost.

Table 5.2 Short run costs of a firm

Q (output)	TFC (birr)	TVC (birr))	TC (birr))
0	60	0	60
1	60	20	80
2	60	40	100
3	60	60	120
4	60	65	125
5	60	75	135
6	60	120	180

We can also show the above data graphically, as follows:

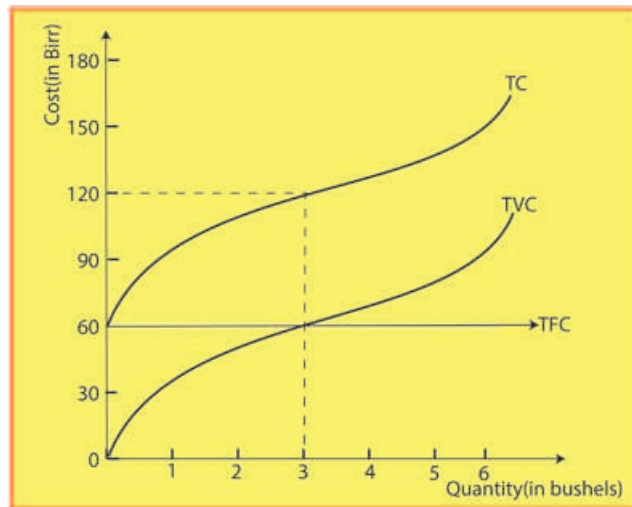


Figure 5.2 Cost curves

From table 5.2, we observe that TFC is birr 60 even if the output is zero. Moreover, the TFC curve is parallel to the quantity axis and has 60 birr above it. However, TVC is zero when output is zero and rises as output rises. The TVC initially rises at a decreasing rate, but later on it increases at an increasing rate. This is true because the firm initially uses few variable inputs with fixed inputs and at this point the TVC increases at a decreasing rate. Later on, as the firm employs more and more variable inputs with fixed inputs, the cost of the firm tends to rise at an increasing rate.

The TC is the sum of the TVC and TFC at every output level. For this reason, the TC curve has the same shape as TVC.

Average Total Cost (ATC): This is the total cost per unit output and is calculated by dividing the total cost by the quantity produced. This means that $ATC = TC/Q$. It can also be divided into two parts, like the average variable cost (AVC) and the average

fixed cost (AFC).

Thus, $ATC = TFC/Q + TVC/Q$, $AFC = TFC/Q$, and $AVC = TVC/Q$.

$$AFC + AVC = ATC$$

Marginal cost of production

Marginal Cost (MC):- it is the extra or additional total cost that results from producing one more unit of output; or it is the change in total cost resulting from a percentage change in output, i.e.

$$MC = \Delta TC / \Delta Q \text{ or } \Delta TFC / \Delta Q + \Delta TVC / \Delta Q$$

or $MC = \Delta TVC / \Delta Q$, when $\Delta TFC = 0$ (in the short run)

Average and Marginal Cost Curves

Cost curves show variations in average and marginal costs with the level of output. Since TFC is constant, it falls continuously as output increases, forming a rectangular hyperbola. As the AVC declines, it first reaches a minimum level and then starts rising. It shows a U-shaped structure. The MC also declines first, reaches its minimum, and then rises. The MC curve passes through the minimum point of both the AVC and ATC curves.

The figure below shows the relationship between the AC and MC curves.

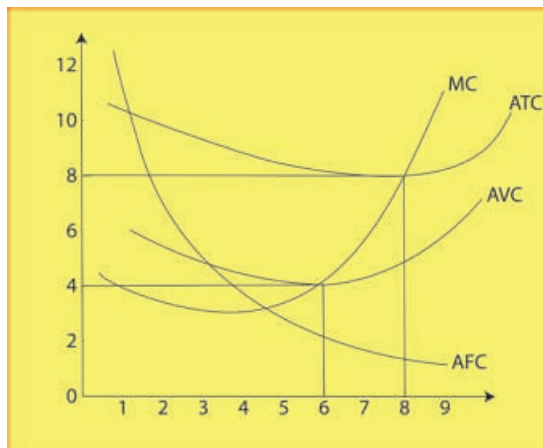


Figure 5.3 Relationship among cost curves

As we can see from the above figure, for each positive level of output, ATC is computed by dividing TC by the amount of output produced. Similarly, AVC and AFC are computed by dividing the variable and fixed costs by outputs, respectively. These average costs are represented by curves labeled ATC, AVC, and AFC.

Now, note the following points from the diagram:

- In the output range where the MC curve lies below the ATC curve, the ATC curve is falling and the MC curve is rising. The ATC curve is rising for the output range where the MC curve is above the ATC curve.
- In the output range where the MC curve lies below the AVC curve, the AVC curve is falling and the MC curve is rising. The AVC curve is rising for the output range where the MC curve is above the AVC curve.
- The MC curve cuts both the ATC and AVC at their minimum points while it is rising.
- The ATC is above the AVC for all output levels because the ATC is the sum of the AVC and the AFC.
- The gap between ATC and AVC is getting smaller and smaller for the reason that the AFC continuously decreases with increasing output.

Activity 5.3

1. Define the cost of production.
2. Outline and present in a class room different types of costs for a wheat flour factory.

Unit Summary

The production function indicates the maximum amount of output that can be produced with the help of each possible combination of inputs. Outputs are the values of the production process.

A short-run period of production refers to a period of production in which at least one of the inputs is fixed while the remaining inputs are variable. A long-run period of production is a period of production in which all inputs are variable or there are no fixed resources in general. A fixed input is one whose quantity cannot be changed during the period under consideration. A variable input is an input whose quantity can be changed during the period under consideration.

Total product (TP) is the gross or entire output by workers and is expressed in terms of quantity (Q). Average product (AP) can be expressed as $AP = TP/L$. A Marginal Product (MP) is the percentage change in total output resulting from a percentage change in variable input.

For the monetary outlays associated with production activity, costs of production stances are used. Explicit costs are the actual monetary payments or cash outlays that business firms make to outsiders who are suppliers of inputs or resources to them. Implicit costs are costs arising from the value of non-purchased resources owned and used by firms in their own production activities. The opportunity cost of a good or service is the value of the best alternative that is forgone in order to produce a good or undertake the service.

Fixed costs are costs that are always incurred even if the firm does not produce anything. Variable costs are those costs of production that directly vary with the level of output of the firm. Total cost is the sum of total fixed and total variable costs. Average total cost is the total cost per unit output and is calculated by dividing the total cost by the quantity produced. The change in total cost caused by a percentage change in output is referred to as the marginal cost.

Review Questions

Part I: Write “True” if the statement is correct or “False” if it is not correct for each of the following statements.

1. An economic cost is the sum total of explicit and implicit costs.
2. When total product increases at an increasing rate, marginal product increases.
3. When the marginal product exceeds the average product, it indicates that the average product is declining.
4. When marginal product equals average product, this means that the average product is the minimum.

Part II: Choose the correct answer among the alternatives for the following questions.

1. The process of using different factors of production in order to make goods and services available is known as:
A . Investment
B . Production
C . Consumption
D . Resource
2. Any good or service that comes out of a production process, is known as:
A . Output
B . Input
C . Labour
D . Economic resource
3. When the short-run marginal product of labor is negative:
A . total product is also negative.
B . Total products are rising, but at a diminishing rate.
C . Total products are rising at an increasing rate.
D . Total products are declining.
4. Suppose the average product of 6 workers is 150 units of a good and that of 7 workers is 170 units. The MP of the seventh worker equals:
A . 200
B . 270
C . 290
D . 220

Part III: Answer the following questions briefly and to the point.

1. Define production function.
2. Explain two types of production function based on time period of production.
3. Describe the relationship between the average product and the marginal product with the help of graph.
4. Describe the relationship between marginal product and total product with the help of graph

5. Explain the explicit and implicit cost.
6. Define the average total cost curve, average variable cost curve, and marginal cost curve.
7. Explain the relationship among average total cost curve, average variable cost curve, and marginal cost curve with the help of graph.

Unit 6

Introduction to Money

Introduction

This unit introduces the nature of money—what it is, how it works—and its critical role in the functioning of the economic system. In this unit, we discuss the efficient-resources-allocating role that money plays in the economy and its basic functions.

Unit Objectives

At the end of this unit, students will be able to:

- ◆ Describe the functions of money.
- ◆ Describe the evolution of money in Ethiopia and globally.
- ◆ Enumerate the factors affecting the demand and supply of money.
- ◆ Explain the role of money and electronic banking in an economy.



Start-up Activities

1. What is money made of? What does it look like?
2. What was the significance of inventing money?
3. What is the use of money in the economy?
4. Talk about why people keep money.
5. Discuss the potential benefits of electronic banking.



Key Concepts

Customarily, Debt, Money, Precious Metal, Medium of Exchange, Barter System, Medium of Exchange, Standardization, Portability, Durability, Transactions, Precautionary, speculative, stock, automatic teller machine (ATM), and electronic fund transfers

6.1 Definition of Money

At the end of this section, students will be able to:

- ◆ Explain the meaning of money.
- ◆ Identify the criteria for a commodity to be accepted as money.

Start-up Activity

What is money made of? What does it look like?

Economists define money as generally accepted in payment for goods or services or in the repayment of debts. When most people talk about money, they are talking about currency. If, for example, someone comes up to you and shouts loudly, “your money or your life,” you should quickly handover all your currency rather than risk your life. You would not ask, “What exactly do you mean by money?”

Money is any good that is widely used and accepted in transactions involving the transfer of goods and services from one person to another. Money is a commodity accepted by general consent as a medium of economic exchange. It serves as the medium for expressing prices and values; as currency, it circulates anonymously from person to person and country to country, facilitating trade and serving as the primary measure of wealth.

An essential characteristic that money has is that it is immediately exchangeable for all kinds of marketable assets, such as goods and services, real estate, or whatever. Each person accepts money as a means of payment because he/she is confident that others will accept it as payment for him/her. The social convention could either be established through legal or other means. For a commodity to be accepted as money, it must meet the following criteria.

- **Standardization:** it must be easily standardized, making it simple to ascertain its value.
- **Acceptability:** It must be widely accepted as a medium of exchange.
- **Divisibility:** It must be divisible so that it is easy to make a change.
- **Portability:** it must be easy to carry.
- **Durability** – it should not degrade quickly.

Money may be any commodity chosen by common consent as a medium or instrument of exchange. All other commodities are thus expressed and valued in terms of that commodity regarded as money. Such a commodity should be recognizable and acceptable to all who use it as a medium of exchange. It is a commodity that is accepted

customarily without any special test of quality or quantity.

Generally speaking, money is an economic unit that functions as a generally recognized medium of exchange for transactional purposes in an economy. Money originates in the form of a commodity, having a physical property that can be adopted by market participants as a medium of exchange.

Activity 6.1

1. Discuss in-group the general definition of money.
2. Identify the criteria for a commodity to be accepted as money.

6.2 Evolution of Money

At the end of this section, students will be able to:

- ◆ Describe how money has evolved overtime.
- ◆ Define the meaning of bartering.

Startup Activity

What was the significance of inventing money?

Life among ancient humans was not as complex as it is today. Human needs were simple, and almost everybody satisfied them by producing whatever the individual required. The individual provided the bare necessities of life. The individual was self-sufficient in the sense that everybody engaged in hunting and gathering for food, made their own clothing, and had their own dwelling. Economic activities were, thus, confined to production and consumption.

In the course of time, humans gained knowledge through learning by doing, formed families, and their individual needs increased. Human beings realize that now it is not possible for them to satisfy their rising needs by producing everything for themselves. As a result, self-sufficiency came to an end and the process of exchange started.

Bartering

Initially, the exchange was direct. That is, it was an exchange of goods for goods. Such an exchange is known as “barter.” Under the barter system, an individual produces goods in greater quantities than they could be consumed, so as to exchange the surplus with another person for something the producer needs in return. The economy based upon this system of exchange is called the barter economy.

Limitations of the barter system: A direct exchange of one good for another without the mediation of money has a number of difficulties associated with it. These are:

- **Lack of double coincidence of wants:** This is the most important problem of the barter system. The barter system requires that a person having a surplus of one commodity be able to find another person who not only wants that commodity but also has something acceptable to offer in exchange.
- **Lack of a common measure of value:** Different commodities have different values. There is no common value under the barter system. For example, if a sheep is to be exchanged for wheat, it is difficult to decide in what proportion the two goods are to be exchanged. Thus, it is difficult to settle the terms of exchange.
- **Indivisibility of commodities:** There are many goods which are indivisible. If

someone wants to exchange a horse for getting a pair of shoes, the person will have to part with a portion of the horse on the basis of the exchange ratio. In this process, the horse loses its identity and value as a horse. Hence, the exchange is unthinkable.

- **Difficulty in storing and transferring wealth:** Most goods, such as rice, wheat, cattle, skin, and so on, lose their value over time or involve high storage costs. Further, the transfer of these goods from one place to another involves a huge transportation cost.
- **Difficulty in deferred payments:** In the barter exchange system, payment is not always made right away, but rather after some time has passed. This is because there is an absence of stability in the prices of goods. Besides, there is an absence of quality and general acceptability in goods. In this way, it is very difficult to make different payments in the form of goods.

The history of money (in Ethiopia and the global context)

When the barter system was replaced by the monetary system, primitive money was first used in the form of commodity money. The choice of the particular commodity to be used as money was determined by factors such as the location of the community and the economic development of the community.

The problem with a payment system based exclusively on commodity money, is it a precious metal or any other valuable commodity, is that such a form of money is very heavy and is hard to transport from one place to another.

The next development in the payments system was paper currency (pieces of paper that function as a medium of exchange). Initially, paper currency embodied a promise that it was convertible into coins or into a quantity of precious metal.

In most countries, however, currency has evolved into fiat money, paper currency decreed by governments as legal tender (meaning that legally it must be accepted as payment for debts) but not convertible into coins or precious metal. Paper currency has the advantage of being much lighter than coins or precious metal, but it can be accepted as a medium of exchange only if there is some trust in the authorities who issue it and printing has reached a sufficiently advanced stage that counterfeiting is extremely difficult.

Paper currency and coins have the major drawbacks of being easily stolen and being expensive to transport because of their bulk if there are large amounts. To combat this problem, another step in the evolution of the payments system occurred with the development of modern banking: the invention of checks. In this case, someone will

have a checking account at a bank and can write checks whenever he wants to make some payment, and the holder of the check can cash it at the bank.

Checks are payable on demand, which allows transactions to take place without the need to carry around large amounts of currency. The introduction of checks was a major innovation that improved the efficiency of the payments system. The use of checks thus reduces the transportation costs associated with the payment system and improves economic efficiency. Another advantage of checks is that they can be written for any amount up to the balance in the account, making transactions for large amounts much easier. Checks are advantageous in that loss from theft is greatly reduced, and they provide convenient receipts for purchases.

With the development of the computer and advanced telecommunications technology, there would seem to be a better way to organize our payments system. All paperwork could be eliminated by converting completely to what is known as an electronic means of payment (EMOP), in which all payments are made using electronic telecommunications. Examples of e-money include visa cards, credit cards, and the like.

According to official records, it was since the third century A.D. (during the reign of King Endybis and Aphilas) that the Axumite kingdom began using its own coins for both internal and external trading, although coins might have existed many years before. With the fall of the kingdom, however, the coins disappeared from circulation and, since then, in Ethiopia, various commodities like a bar of salt (amole), cloth, beads, etc., have been used as money. The most important and widely spread one, however, was salt. Until, the emergence of Maria Theresa, salt was the most popular medium of exchange. Even after the introduction of Maria Theresa to Ethiopia, salt continued to exist as one of the popular mediums of exchange. In addition to commodity money, metallic money like Maria Theresa, the coins of Menelik II, Haileselassie I, the Lire, the East African shilling, and the present type of coins have been serving as a medium of exchange before modern money came into being.

The Maria Theresa Thaler has had a long history in Ethiopia and has had an important place in the monetary evolution of the country. The coin was first minted in Vienna in 1751 to commemorate the coronation of Maria Theresa as empress of Austria. Interestingly enough, this coin was not used as a legal currency in its country of origin. It is believed that Maria Theresa was introduced into Ethiopia by traders between the late 18th and early 19th century. Maria Theresa served as a medium of exchange until

1945. Although it was not as popular as Maria Theresa, the first national coin was minted by Emperor Menelik II, in 1893. Menelik's coins were replaced by the new metallic coins issued in July 1933 bearing the image of the Emperor Haileselassie.

Paper money was issued by the Bank of Abyssinia for the first time in 1914. However, it was unusual in society, and it failed to gain acceptance because most people were only familiar with metallic coins. Paper money was again issued by the Bank of Ethiopia (the successor of the Bank of Abyssinia) in 1932. These notes were 100 percent backed by gold deposits and thus served as a medium of exchange alongside the salt bar and the Maria Theresa until the Italian occupation in 1936. In 1941, when the country was liberated from the brief Italian occupation, it had no national currency and no financial institutions. Following the restoration of independence in 1941, many foreign currencies started to be used as mediums of exchange, including the Italian Lire, the Maria Theresa Dollar, the East African Shilling, the Indian Rupee, and the Egyptian Pound, circulating as a medium of exchange. While the lire was a holdover from the Italian occupation and the Maria Theresa Dollar was a carryover from earlier periods, the rest of the currencies were introduced by British military forces who helped liberate the country and took over administration. It was only in July 1945 that the Ethiopian government issued the new national currency, the Birr. With the development of the banking system, checks have also started to be used as money, though there have been some developments in that regard in recent years.

Activity 6.2

1. Discuss the various stages (development process) the world has been passing through to come up with the current use of money.
2. Define the meaning of bartering.

6.3 Functions of Money

At the end of this section, students will be able to:

- 💧 Explain the basic functions of money.

Start-up Activity

What is the use of money in the economy?

In every society, money performs four basic functions. All of these functions play significant roles in the operation of the economy.

1. The medium of exchange functions

The most basic function of money is to serve as a medium of exchange. In almost all market transactions in our economy, money in the form of currency or checks is a medium of exchange. It is used to pay for goods and services.

Although money has no power to satisfy human wants directly, it does have the power to purchase those things that have utility and satisfy human wants. Using money as a medium of exchange promotes economic efficiency by eliminating the time spent on exchanging goods and services.

The time spent trying to exchange goods or a service is called a “transaction cost.” In a barter economy, transaction costs are high because people have to satisfy a “double coincidence of wants”—they have to find someone who has a good or service they want and who also wants the goods or services they have to offer.

Money is therefore a lubricant that allows the economy to run more smoothly by lowering transaction costs and encouraging specialization and the division of labour.

2. Money as a unit of account

The second role of money is to provide a unit of account. It is used to measure value in the economy. We measure the value of goods and services in terms of money. Just as we measure weight in terms of pounds or distance in terms of miles.

Imagine how hard it would be to shop in a supermarket with a thousand different items on its shelves. To make sure that you can compare the prices of all items, the price tags of each item would have to list up to 999 different prices, and the time spent reading them would result in a very high transaction cost.

The solution to the problem is to introduce money into the economy. Money units serve as a unit of measurement in terms of which the values of goods and services exchanged in the economy are measured and expressed. Money enables an orderly

pricing system, which is essential for:

- Rational economic calculation and choice
- Transmitting economic information among individuals

3. Money as a store of value

Money also functions as a store of value; it is a repository of purchasing power over time. A store of value is used to save purchasing power from the time income is received until it is spent. This function of money is useful because most of us do not want to immediately spend our income on receiving it. We'd rather prefer to wait until we have the time or the desire to shop.

Money is not unique as a store of value; any asset, be it money, stocks, bonds, land, houses, art, or jewellery, can be used to store wealth. Many such assets have an advantage over money as a store of value: they often pay the owner a higher interest rate than money, maintain price value and provide service as a house. If these assets are more desirable stores of value than money, why do people hold money at all? The answer to this question relates to the important economic concept of liquidity, or the relative ease and speed with which an asset can be converted to a medium of exchange.

4. Money as a standard of deferred payments

Money lets you buy now and pay later. Or it lets you lend now and collect later. When people save money, that money can be borrowed and channeled into investments. It is the deferred payment function of money that permits this transfer of spending power from earners—savers to borrowers—spenders. It permits the easy transfer of resources out of their less desired (less productive, less profitable) uses and into their more desired (more productive, more profitable) uses.

Activity 6.3

1. Why is money a poor means of holding wealth?

6.4 Demand and Supply of Money

At the end of this section, students will be able to:

- ◆ Explain the motives for holding money.
- ◆ Describe what constitutes the supply of money.

Start-up Activity

Discuss why people hold money.

It will be useful to have an idea of the demand for and supply of money. The modern notion of money and its aspects is different from the traditional one. Let us analyse the demand for and supply of money separately.

Demand for Money

The old idea about the demand for money was that money was demanded to complete business transactions. In other words, the demand for money depends on the volume of trade or transactions. As a result, demand for money increased during a boom period or when trade was erratic, and decreased during a depression or a lull in trade.

The modern idea about the demand for money was put forward by John Maynard Keynes, the famous English economist, who gave birth to what has been called the Keynesian Economics. According to Keynes, the demand for money, or liquidity preference, as he called it, means the demand for money to hold.

People want money for three main reasons:

- (i) Transactional motivation
- (ii) Precautionary motive
- (iii) A speculative motivation

Each one of them could be explained as follows.

(i) Transaction purpose:

This motive can be looked at from the:

- (a) perspective of consumers seeking income to meet their household expenditures, also known as the income motive, and
- (b) point of view of businessmen, who require money and want to hold it in order to carry on their business, i.e., the business motive.

(a) Income motive:

The transaction motive relates to the demand for money or the need for cash for the

current transactions of individual and business exchanges. Individuals hold cash in order “to bridge the interval between the receipt of income and its expenditure.” This is called the “income motive.”

Most people receive their income by the week or the month, whereas the expenditure is on a day-to-day basis. A certain amount of money, therefore, is kept on 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 payment current in the locality.

(b) Business motive:

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

It is clear that the amount of money held, under this business motive, will depend to a very large extent on the turnover (i.e., the volume of trade of the firm in question). The larger the turnover, the greater, in general, the amount of money needed to cover current expenses.

(ii) Precautionary motive:

The precautionary motive for holding money refers to the desire of people to hold cash balances for unforeseen contingencies. People hold a certain amount of money to provide for the risk of unemployment, sickness, accidents, and other more uncertain losses. The amount of money held under this motive will depend on the nature of the individual and on the conditions in which he lives.

(iii) Speculative motive:

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

Thus, the amount of money required to be held under the various motives constitutes the demand for money.

Supply of money

Just as the demand for money is the demand for money to hold, similarly, the supply of money means the supply of money to hold. Money must always be held by someone, otherwise it cannot exist. Hence, the supply of money means the sum total of all the forms of money held by a community at any given moment.

The money supply consists of (a) metallic money or coins, (b) currency notes issued by the currency authority of the country, whether it be the central bank or the government, and chequable bank deposits. In old times, coins formed the bulk of the money supply of the country. Later, currency notes eclipsed metallic currency, and now the bank deposits in current accounts withdrawable by cheques have overwhelmed all other forms of money.

Thus, “money supply” means the total volume of monetary medium of exchange available to the community for use in connection with the economic activity of the country. Broadly speaking, the money supply in a country is composed of two main elements, viz., (a) currency with the public; and (b) deposit money with the public.

In order to arrive at the total amount of currency with the public, we add: (i) currency notes in circulation; (ii) circulation of birr notes and coins; and (iii) circulation of small coins; and from the total, deduct: “Cash in hand with banks”. The bulk of the currency in the hands of the public is in the form of currency notes issued by the National Bank of Ethiopia.

Besides currency, the money supply of the public includes deposit money, i.e., the bank balances held in current accounts of the banks. Currency, rather than bank deposits, has a dominant position in developing countries because the majority of commercial transactions are conducted in cash as a medium of exchange, rather than through cheques as in advanced countries.

Thus, the supply of money in a country, by and large, depends on the credit control policies pursued by the banking system of the country.

Activity 6.4

1. Explain the motives for holding money.
2. Describe what constitutes the supply of money.

6.5 Money and Electronic Banking

At the end of this section, students will be able to:

- ◆ Explain the meaning of electronic banking.
- ◆ Understand the use of electronic banking.

Start-up Activity

Discuss the possible advantages of electronic banking.

For many people, electronic banking means 24-hour access to cash through an automated teller machine (ATM) or direct deposit of pay checks into checking or savings accounts. But electronic banking involves many different types of transactions, rights, responsibilities, and sometimes fees.

Electronic Fund Transfer

Electronic banking, also known as electronic fund transfer (EFT), uses computer and electronic technology in place of checks and other paper transactions. EFTs are initiated through devices like cards or codes that let you, or those you authorize, access your account. Many financial institutions use ATM or debit cards and Personal Identification Numbers (PINs) for this purpose. Some use other types of debit cards that require your signature or a scan. For example, some use radio frequency identification (RFID) or other forms of “contactless” technology that scans your information without direct contact with you.

Here are some common EFT services in Ethiopia:

ATM is electronic terminal that lets you bank at almost virtually any time. To withdraw cash, or transfer funds between accounts, you generally insert an ATM card and enter your PIN.

Activity 6.5

1. Explain the meaning of electronic banking.
2. Visit banks in your area and ask people why they prefer to use ATMs.

Unit Summary

Money is defined as anything that is generally accepted in payment for goods or services or in the repayment of debts. Barter means the exchange of goods for goods before the invention of money. Money serves as a medium of exchange. Money serves as: a measure of value, a standard of deferred payment, a store of value, and helps transfer value.

In Ethiopia, various commodities like a bar of salt (amole), cloth, beads, etc., have been used as money. The most important and widely spread one, however, was salt. Until, the emergence of Maria Theresa, salt was the most popular medium of exchange. Even after the introduction of Maria Theresa to Ethiopia, salt continued to exist as one of the popular mediums of exchange.

Money is often defined in terms of the basic functions that it provides. Money serves as a medium of exchange, as a store of value, as a unit of account and a standard of different payment. Money's most important function is as a medium of exchange to facilitate transactions. Without money, all transactions would have to be conducted by barter, which involves the direct exchange of one good or service for another.

The demand for money was simply that money was demanded for completing business transactions, which, in turn, depended on the volume of trade or transactions. There are three main motives on account of which money is wanted by the people, namely, (i) the transaction motive, (ii) the precautionary motive, and (iii) the speculative motive.

The money supply is the total amount of money in cash, coins, and balances in bank accounts in circulation. The money supply is commonly defined to be a group of safe assets that households and businesses can use to make payments or hold as short-term investments.

Electronic banking involves many different types of transactions, rights, responsibilities, and fees.

Review Questions

Part I: Write 'True' if the statement is correct or 'False' if it is not correct for each of the following statements.

1. Checks are payable on demand, which allows transactions to take place without the need to carry a large amount of currency.
2. The acceptance of money as a medium of exchange is a matter of social convention.
3. The transaction motive for holding money refers to the desire of people to hold cash balances for unforeseen contingencies.
4. The supply of money in a country, by and large, depends not on the credit control policies pursued by the banking system of the country.

Part II: Choose the correct answer among the alternatives for the following questions.

1. For a commodity to be accepted as money, it must meet certain criteria.
A . Standardization
B . Divisibility
C . Portability
D . All
2. Which of the following refers to anything that is generally accepted as payment for goods and services?
A . Checks
B . Money
C . Checking account deposits
D . All
3. The major drawbacks of paper currency and coins are
A . They are easily stolen.
B . They can be expensive to transport.
C . They have a problem with a common measure of value.
D . Both A and B
4. Examples of e-money include,
A . Visa card
B . Credit card
C . Mobile banking
D . All

5. For a commodity to be accepted as money, it must meet the following criteria.
- A . Unit of account
 - B . Standardization
 - C . Measure of value
 - D . Differed payment

Part III. Answer the following questions briefly and to the point.

1. How was the barter system used before the advent of money?
2. Define what money is.
3. What are the major drawbacks to paper currency and coins?
4. What criteria must be met for a commodity to be accepted as money?
5. Explain the three main motives for holding money.
6. What constitutes the supply of money?

Unit 7

Introduction to Macroeconomics

Introduction

Macroeconomics deals with the economy as a whole. Macroeconomics (from the Greek prefix makro-meaning “large”) is a branch of economics dealing with the performance, structure, behavior, and decision-making of an economy as a whole. For example, using interest rates, taxes, and government spending to regulate an economy’s growth and stability are the mandates of macroeconomics. This includes regional, national, and global economies.

Macroeconomists study topics such as GDP, unemployment rates, national income, price indices, output, consumption, unemployment, inflation, saving, investment, energy, international trade, and international finance. In the present unit, we discuss the concept of macroeconomics.

Unit Objectives:

At the end of this unit, students will be able to:

- ◆ Explain the meaning of macroeconomics and indicate its problems.
- ◆ Determine the fundamental macroeconomic variables.
- ◆ Describe the relationship between unemployment, inflation, and growth.

Start-up Activities

1. Does everything that is produced in Ethiopia belong to the country? How do you think national income would be measured?
2. What are the major macroeconomic goals of a country?
3. Describe a country’s macroeconomic problems.

Key Concepts

National Income, GDP, GNP, Per Capita Income (PCI), Employment, Inflation, Deflation, and Unemployment

7.1 Definition of Macroeconomic Variables

At the end of this section, students will be able to:

- ◆ Define the concept of macroeconomics.
- ◆ Explain the basic macroeconomic variables.

Start-up Activity

Does everything that is produced in Ethiopia belong to the country? How do you think national income would be measured?

Macroeconomics is the study of economic behavior and policies that influence consumption and investment, trade balance, and other determinants of various macroeconomic variables. Examples of macroeconomic factors include economic output, unemployment rates, and inflation. These indicators of economic performance are closely monitored by governments, businesses, and consumers alike. In this section, we will examine macroeconomic problems such as inflation and unemployment and their effects on output and redistribution.

Gross Domestic Product (GDP): It is the total value of currently produced final goods and services that are produced within a country's boundary during a given period of time, usually one year.

In order to understand the meaning of GDP, note the following points:

- It measures the current production only.
- It takes into account final goods and services only (only the end products of various production processes) or we do not include the intermediate products in our GDP calculations. I.e., intermediate goods are goods that are completely used up in the production of other products in the same period that they themselves are produced.
- It measures the value of final goods and services produced within the boundaries/territory of a country, irrespective of who produces them.

In measuring it, we take the market values of goods and services ($GDP = \sum P_i \times Q_i$)

Where P_i denotes the prices of outputs produced in various sectors of an economy over a given time period.

Q_i = the quantity of various final goods and services produced in an economy.

Gross National Product (GNP): the total value of goods and services produced by

domestically owned factors of production in a given time period (usually one year), regardless of their geographical location.

$$\text{GDP} + \text{NFI} = \text{GNP}$$

Where NFI denotes Net Factor Income from Foreign Sources

On the other hand, $\text{NFI} = (\text{factor income received from abroad by a country's citizens}) - (\text{factor income paid for foreigners abroad})$.

The net financial impact (NFI could be negative, positive, or zero depending on the amount of factor income received by the two parties.

When $\text{NFI} > 0$, then $\text{GNP} > \text{GDP}$

$\text{NFI} < 0$, then $\text{GNP} < \text{GDP}$

$\text{NFI} = 0$, then $\text{GNP} = \text{GDP}$

If the economy is closed or a country has no interaction with the rest of the world

Nominal and real GDP

GDP and GNP are measured in money terms, and this measurement may take the form of nominal or real GDP or GNP.

Nominal GDP is the monetary value of currently produced goods and services measured at current prices. This is not important when comparing a country's economic performance over time.

Real GDP is a measure of real output that excludes the effect of price changes from the GDP calculation. It is the value of currently produced goods and services measured at a constant price.

$$\text{Real GDP} = \frac{\text{Nominal GDP}}{\text{Price index}} \times 100$$

Example: Using the following data about a hypothetical nation, calculate Real GDP for the nation in the years

Year	Nominal GDP	Consumer price index	Real GDP
2017	26	849.9	$26/849.9 \times 100 = 3.06$
2018	28	858.4	$28/858.4 \times 100 = 3.26$
2019	36	704.2	$36/704.2 \times 100 = 3.26$

Economic growth during 2017-2019 can be measured: -

$$\text{Nominal GDP} = \frac{(36-28)}{28} \times 100$$

$$\begin{aligned}\text{Real GDP} &= \frac{\text{Nominal GDP}}{\text{Price index}} \times 100 \\ &= 28.6 - 28 = 0.6\%\end{aligned}$$

Activity 7.1

1. Discuss in, a group of three, the essential issues in macroeconomics.
2. Compare Ethiopia's GDP with the GDP of other developing countries.

7.2 Macroeconomic Goals

At the end of this section, students will be able to:

- ◆ Identify the macroeconomic goals of a country.

Start-up Activity

What are the major macroeconomic goals of a country?

We know that macroeconomic analysis deals with the behavior of the economy as a whole with respect to output, income, employment, general price level, and other aggregate economic variables. With a view to bringing about desirable changes in such variables, nations (developed as well as developing) need to adopt various macroeconomic policies. These policies vary from one economy to another and according to the prevailing economic conditions within a specific economy.

The general objectives of a macroeconomic policy are to achieve:

- Economic growth is defined as a consistent increase in national income.
- Full employment means the maximum possible utilization of factors of production in the production process.
- Stable balance of payment: It is the statistical record of all economic transactions between domestic residents and the rest of the world that attains equilibrium.
- Price stability: it is the stable level of prices in the economy that avoids long periods of inflation or deflation and sustains the value of money over time. Price level stability is important for savers.
- Equality in the distribution of income and wealth

Activity 7.2

1. Discuss the major macroeconomic goals of a country.

7.3 Macroeconomic problems

At the end of this section, students will be able to:

- Identify problems with macroeconomics.
- Explain the meanings of inflation and unemployment.
- Mention the types of unemployment.



Start-up Activity

Describe a country's macroeconomic problems.

The economy does not always run smoothly. There are often fluctuations in the level of economic activity. At times, the economy finds itself in the grip of a recession when levels of national income, output, and employment are far below their full potential levels. During a recession, there is a lot of idle or unutilized productive capacity, that is, available factors of production are not working to their full capacity. Some of the key questions addressed by macroeconomics include: What causes inflation? What causes unemployment?

1. Inflation

Inflation, in general terms, is described as a situation characterized by a sustained increase in the general price level. It may be noted thus:

- a small rise in prices or an irregular price. A rise cannot be called inflation. It is a persistent and appreciable rise in prices that is called inflation.
- During inflation, all costs and prices do not rise together and in the same proportion. An increase in the general level of prices is measured by a price index, which is an average of consumer or producer prices.

Inflation occurs when the prices of goods and services rise, while deflation occurs when those prices decrease. The balance between these two economic conditions, opposite sides of the same coin, is delicate, and an economy can quickly fluctuate from one condition to the other.

Causes of inflation

- Increase the money supply.
- An increase in the input costs
- Imported inflation
- Weaker exchange rate
- Decline in productivity

Types of inflation

Let us understand how inflation originates or what causes it. Depending upon the specific causes, two types of inflation have been distinguished: (1) Demand –pull inflation (2) Cost-push inflation

- Demand-pull inflation results from an increase in aggregate demand when the economy is producing at or near full capacity. This demand is growing faster than the economy's productive capacity at full employment. This is a situation where “too much money” chases “too few goods.” This is an example of a situation in which the primary factor at work is an increase in aggregate demand for output, whether from the government, entrepreneurs, or households. The result is that the pressure of demand is such that it cannot be met by the currently available supply of output.
- Cost push, also known as supply-side inflation, occurs as a result of a continuous decline in aggregate supply. This may be due to bad weather, an increase in wages, or the prices of other inputs. Setbacks in agricultural and industrial production due to various reasons—shortages of raw materials, power breakdowns, strikes and lockouts, bad weather conditions, increases in input prices, etc.—lead to a decreased supply of goods in comparison to their demand, which further leads to price rises.

2. Unemployment

Unemployment is a term referring to individuals who are employable and actively seeking a job but are unable to find a job. Included in this group are those people in the workforce who are working but do not have an appropriate job.

Interestingly, people who have not looked for a job in the past four weeks but have been actively seeking one in the last 12 months are put into a category called the “marginally attached to the labor force.” Within this category is another category called “discouraged workers,” which refers to people who have given up looking for a job.

The labor force consists of all those who are fit for work and are willing and available to work. In other words, if we exclude children, old people, individuals who are unable to work, etc., from the population of a country, we get the number of those who are able to work. We further deduct from this those who are not willing or are not available to work. This gives us the labor force.

The labor force includes groups of people within a specified age bracket (15–64) who are actually employed and those who are without a job but are actively searching for a job.

The labor force is made up of both employed and unemployed people.

Unemployment, therefore, refers to that portion of the labor force that is without a job but is actively searching for one. Thus, for a person to be categorized as unemployed, two conditions must be fulfilled:

- that the person is without a job and able to work
- the person wants to have a job and is willing to work at the current market wage,

The unemployment rate is usually measured by dividing the number of unemployed people by the total number of people in the workforce. Unemployment serves as one of the indicators of a country's economic status.

Types of unemployment

- a. Frictional unemployment refers to a brief period of unemployment experienced by people due to
 - Seasonality of work, e.g., construction workers
 - Voluntary switching of jobs in search of better jobs
 - Entrance to the labor force, e.g., a student immediately after graduation
 - Re-entering the labor force
- b. Structural unemployment results from a mismatch between the skills or locations of job seekers and the requirements or locations of the vacancies. It refers to a situation in which workers become jobless due to a loss of demand in particular regions or industries. For example, if an agricultural graduate is looking for a job at a construction site. Thus, unemployment that arises due to a change in the pattern of demand, leading to changes in the structure of production in the economy, is called “structural unemployment.” Structural unemployment signifies a mismatch between the supply and demand for labor.
- c. Cyclical unemployment is generated due to the absence of vacancies. This usually happens due to a deficiency in demand for commodities. Thus, unemployment that arises due to inadequate overall demand associated with the downswing, recession, or depression period of a trade cycle is called “cyclical unemployment.”

Disguised unemployment in the Ethiopian economy

Disguised unemployment is unemployment that does not affect aggregate economic output. It occurs when productivity is low and too many workers are filling too few jobs. It can refer to any part of the population that is not employed at full capacity.

Disguised unemployment, or hidden unemployment, is an economic term used to refer to the portion of the labor force that is involved in redundant work, which creates minimal to no productivity. Disguised unemployment is very common in third world countries, which are still developing and have large populations. This is known as a labor surplus.

Trade Balance

The trade balance is sometimes referred to as the “visible balance” because it represents the difference between receipts for exports of goods and expenditure on imports of goods, which can be visibly seen crossing frontiers. The receipts for exports are recorded as a credit in the balance of payments, while the payment for imports is recorded as a debit. When the trade balance is in surplus, this means that a country has earned more from its exports of goods than it has paid for its imports of goods.

Trade Balance = Receipts for exported goods – Payments on imported goods

Balance of Payments

A balance of payments is a statistical record of all the economic transactions between residents of the reporting country and residents of the rest of the world during a given time period. The usual reporting period for all the statistics included in the accounts is a year. However, some of the statistics that make up the balance of payments are published on a more regular monthly and quarterly basis. Without question, the balance of payments is one of the most important statistical statements for any country.

It reveals how many goods and services the country has been exporting and importing, and whether the country has been borrowing from or lending money to the rest of the world. In addition, whether or not the central monetary authority (usually the central bank) has added to or reduced its reserves of foreign currency is reported in the statistics.

Activity 7.3

1. Define inflation and explain its causes and types.
2. Explain the meaning of unemployment and disguised unemployment.

Unit Summary

National income is broadly defined as the aggregate monetary value of all the final goods and services produced in a country during a year. GDP is one of the national income accounting measures; it is the sum of four categories of expenditure in consumption, investment, government purchases, and net exports.

The economy does not always run smoothly. At times, the economy finds itself in the grip of a recession when levels of national income, output, and employment are far below their full potential levels. During a recession, there is a lot of idle or unutilized productive capacity, that is, available factors of production are not working to their full capacity.

Inflation is the persistent rise in the general price level of all goods. Inflation occurs when the prices of goods and services rise, while deflation occurs when those prices decrease. The balance between these two economic conditions, opposite sides of the same coin, is delicate, and an economy can quickly fluctuate from one condition to the other.

The unemployment rate shows that a fraction of those who would like to work do not have a job. The trade balance is sometimes referred to as the “visible balance” because it represents the difference between receipts for exports of goods and expenditure on imports of goods, which can be visibly seen crossing frontiers. The balance of payments is a statistical record of all economic transactions between residents of the reporting country and residents of the rest of the world during a given time period.

Review Questions

Part I: Write 'True' if the statement is correct or 'False' if it is not correct for each of the following statements.

1. Frictional unemployment is temporary unemployment.
2. Unemployment leads to the exploitation of labour.
3. During inflation, the prices of all goods and services rise together.

Part II: Choose the correct answer among the alternatives for the following questions.

1. The labour force consists of all those:
A . Who is fit for work?
B . Who are willing to work
C . Who are available for work
D . All of the above
2. The general goals of macroeconomic policy are;
A . High rate of economic growth
B . The rule of the law
C . Price instability
A . All
3. If the national economy is closed, autarky, i.e., a country has no interaction with the rest of the world, then
A . $GNP > GDP$
B . $GNP < GDP$
C . $GNP = GDP$
D . All
4. Which of the following examples of structural unemployment is/are correct?
A . A civil engineering graduate is looking for a job at a clinic.
B . A student immediately after graduation
C . An agricultural graduate looking for a job at "Piassa"
D . A and C.
5. This is a situation where «too much money» chases «too few goods.»
A . Supply side inflation
B . Cost-push inflation
C . Demand-pull inflation,
D . All

Part III. Answer the following questions briefly and to the point.

1. Define macroeconomics
2. Explain the general goals of a macroeconomic policy.
3. Discuss the difference between GDP and GNP.
4. Do you think, in a closed economy, GDP and GNP are equal? Justify.
5. Discuss the concepts of frictional, structural, and cyclical unemployment with the help of examples.
6. Explain the concept of inflation. In particular, differentiate between demand-pull inflation and cost-push inflation.

Unit 8

Basic Entrepreneurship

Introduction

Many industry observers have debated the origins of entrepreneurship. The fact to note here is that most scholars who debate the origins of entrepreneurship are either economists or historians. The common forum accepts that the concept of “entrepreneur” is derived from the French concept of “entrepreneur,” which matches closely with the English concept of business conduct. The entrepreneurship theory has been changing throughout several decades of business growth and has received numerous definitions and characteristics from different scholars, who believe that some qualities are common among most entrepreneurs. Entrepreneurship is founded on economics as well as other disciplines such as history, politics, education, culture, experience, and networking.

Unit Objectives

At the end of this unit, students will be able to:

- ◆ Elaborate the concepts of “enterprise,” “entrepreneur,” and “entrepreneurship.”
- ◆ Discuss the role of entrepreneurs in economic development.
- ◆ Analyze entrepreneurial attitudes and behaviour.
- ◆ Explain the relationship between entrepreneurial success and alertness to opportunities, teamwork, and diversity.



Start-up Activities

1. Distinguish between “entrepreneurship,” “enterprise” and “entrepreneur”?
2. What is the importance of creativity and innovation in entrepreneurship?
3. How do you relate entrepreneurship with entrepreneurial attitudes, behaviours, and mindsets?
4. What are the windows of entrepreneurial opportunity?
5. What are the sources of finance for entrepreneurial development?
6. What is the importance of teamwork in entrepreneurial success?



Key Concepts

Entrepreneurship, enterprise, entrepreneurs, teamwork, diversity, attitudes, behavior, and mindset

8.1 Definition of Enterprise, Entrepreneur, and Entrepreneurship

At the end of this section, students will be able to:

- ◆ Define the concepts of “entrepreneurship,” “enterprise,” and “entrepreneur.”
- ◆ Explain Social Entrepreneurship.

Start-up Activity

Distinguish between “entrepreneurship,” “enterprise,” and “entrepreneur.”

Entrepreneurship is intuitively understood to be a process, and an entrepreneur is a person who engages in entrepreneurial activity, such as running their own business.

1. Entrepreneurship is the process of identifying opportunities in the marketplace, arranging the resources required to pursue these opportunities, and investing the resources to exploit them for long term gains. It involves creating incremental wealth by bringing together resources in new ways to start and operate an enterprise.
2. Entrepreneurship is the process through which individuals become aware of business ownership and then develop ideas to initiate a business.
3. Entrepreneurship can also be defined as the process of creating something different and better with value. This entails devoting the necessary resources and assuming the accompanying financial, psychological, and social risks to receive the resulting monetary rewards.
4. Entrepreneurship is a practise and a process that results in creativity, innovation, and enterprise development and growth. Engaging in entrepreneurship shifts people from being “job seekers” to being “job creators,” which is critical in countries that have a high rate of unemployment. However, it requires a lot of creativity as the driving force behind innovation.

In general, the process of entrepreneurship includes five critical elements. These are:

- 1) the ability to spot a potentially profitable opportunity.
- 2) the ability to commercialise the perceived opportunity, also referred to as innovation
- 3) the ability to pursue it in the long term.
- 4) the ability to pursue it methodically.
- 5) acceptance of failure as a possibility.

Based on the above concepts of entrepreneurship, an entrepreneur can be defined as follows:

An entrepreneur is any person who creates and develops a business idea and takes the risk of setting up an enterprise to produce a product or service that satisfies customer needs.

The history of entrepreneurship

During the ancient period, the word “entrepreneur” was used to refer to a person managing large commercial projects through the resources provided to him. In the 17th century, a person who had signed a contractual agreement with the government to provide stipulated products or services was considered an entrepreneur. In this case, the contract price is fixed so that any profit or loss reflects the entrepreneur’s effort.

In the 18th century, the first theory of an entrepreneur was developed by Richard Cantillon, who said that an entrepreneur is a risk-taker. If we consider the merchants, farmers, and professionals, they all operate at risk. For example, if the merchants buy products at a known price and sell them at an unknown price, this shows that they are operating at risk. The other development during the 18th century was the differentiation of the entrepreneurial role from the capital providing role.

But in the late 19th and early 20th centuries, an entrepreneur was viewed from an economic perspective. An entrepreneur organises and operates an enterprise for personal gain. The concept of an entrepreneur as an inventor was established in the mid-twentieth century.

From the historical development of entrepreneurship, it is possible to see that the perception of the word “entrepreneur” was developed from managing commercial projects to the application of innovation in business ideas.

What is social entrepreneurship?

Social entrepreneurship is attracting growing amounts of talent, money, and attention, but along with its increasing popularity has come less certainty about what exactly a social entrepreneur is and does.

The emerging field of social entrepreneurship is growing rapidly and attracting increased attention from many sectors. There are several reasons behind the popularity of social entrepreneurship. Basically, there is something interesting and appealing about entrepreneurs and the stories of why and how they do their job. People, like Muhammad Yunus and Steve Jobs, were attracted to social entrepreneurship for many

reasons. These extraordinary people come up with brilliant ideas for creating new products and services that dramatically improve people's lives.

But interest in social entrepreneurship exceeds the phenomenon of popularity and attraction among people. Social entrepreneurship indicates a commanding role in driving social change and has a potential payoff with its benefit to society. The potential benefits of social entrepreneurship are clear to many of those promoting and funding these activities. However, the actual definition of social entrepreneurship is less clear. In fact, we would argue that the definition of social entrepreneurship today is anything but clear. As a result, social entrepreneurship has become so broad that it now has a home for all manner of socially beneficial activities.

Activity 8.1

1. Give the definitions of “entrepreneurship” and “entrepreneur.”
2. What is social entrepreneurship?

8.2 Creativity and Innovation in Solving Local Problems

At the end of this section, students will be able to:

- ◆ Indicate the possibility of creativity and innovation leading to entrepreneurship.
- ◆ Describe the relationship between creativity, innovation, and entrepreneurship.



Start-up Activity

What is the importance of creativity and innovation in entrepreneurship?

Creativity, innovation, and entrepreneurship have been recognised as important contributors to a nation's economic growth. These three terminologies are chronologically interrelated, and it is very important to look into them to get their full picture.

A. Creativity

Creativity is defined as the tendency to generate ideas, alternatives, or possibilities that may be useful in solving problems, communicating with others, and entertaining ourselves and others. Creativity is the ability to come up with new ideas and to identify new and different ways of looking at problems and opportunities. It is a process of assembling ideas by recombining elements already known but wrongly assumed to be unrelated to each other. This definition has three key elements that are worth considering:

- Creativity is an ongoing process.
- Ideas: creativity results in ideas that have potential value.
- Recombining: the creative process is one of putting things together in unexpected ways.

In order to be creative, you need to be able to view things in new ways from different perspectives. Thus, creativity is the development of original and potentially useful ideas about products, practises, services, or procedures for an organisation.

B. Innovation

Innovation lies at the heart of the entrepreneurial process and is a means to the exploitation of opportunities. It is the implementation of a new idea at an individual, group, or organisational level.

There are four distinct types of innovation, namely,

- An invention is defined as the creation of a new product, service, or process.
- Expansion is the growth of a product, service, or process.
- Duplication is the replication of an already existing product, service, or process.
- Synthesis: the combination of existing concepts and factors into a new formulation.

C. From Creativity to Entrepreneurship

Creativity is the ability to develop new ideas and to discover new ways of looking at problems and opportunities. Innovation is the ability to apply creative solutions to those problems and opportunities in order to improve people's lives or enrich society.

Creativity leads to the generation of novel and innovative ways of doing business. Exploring new niches and coming up with new ideas leads to efficiency, which eventually gives an entrepreneur a competitive advantage.

Activity 8.2

1. Recognize the potential for entrepreneurship through creativity and innovation.
2. What is the relationship among creativity, innovation, and entrepreneurship?

8.3 Entrepreneurial Attitudes, Behaviour and Mind-set

At the end of this section, students will be able to:

- ◆ Describe the key attitudes every entrepreneur must have.
- ◆ Identify your skills and attributes to be more innovative.



Start-up Activity

How do you relate entrepreneurship with entrepreneurial attitudes, behaviour, and mindset?

An entrepreneurial mind-set is a state of mind that an individual possesses. The way people think and their attitude towards the pursuit of their goals is an important tool that enables them to undertake entrepreneurial activities.

Entrepreneurs are innovators and creators who, due to their way of thinking and mind-set, give their business the best chance of surviving. Effectively, it means that they are brave in the decisions they make. They will actively seek clients and take risks. Further, they possess a range of other characteristics that help to make an entrepreneurial mindset so important. Not all entrepreneurs succeed in every business activity. A successful entrepreneur fails at least once. What matters is how entrepreneurs learn from their failures and exploit them.

Key attitudes every entrepreneur must have for a business project:

1. Passion

Entrepreneurs should be passionate about their: ideas, goals, and companies. This passion is what drives them to do their business. Whatever drives an individual to try to succeed is where his or her passion lies, and that passion is essential to entrepreneurial life.

2. Bravery

Entrepreneurs are fearful that they will not succeed in the sense that a well-conceived idea cannot be executed. However, they do not let these fears of failure inhibit them. Since they are brave, they learn from their failures. They utilise their fear of failing to push them to work hard and strive to correct the mistakes that have caused them to fail. Thus, it is bravery that drives them to pursue successful businesses.

3. Flexibility

Entrepreneurs usually experience obstacles. There are some difficulties to overcome in any business. However, entrepreneurs must possess flexible mindsets so they can

change in a way that seems to lead towards failure. Flexible entrepreneurs should modify the route towards their established goal in order to achieve it successfully.

4. Strong Work Ethics

It is not easy to start from the ground up and become a successful business owner. Many hours of hard work, frustration, creativity, and supervision are devoted to a new business. Entrepreneurs are always working—establishing new ideas, creating new products, designing new processes, hiring clever and brilliant people.

5. Integrity

Entrepreneurs must demonstrate to others that they are trustworthy and honest. Regardless of the type of business they plan to establish, colleagues, sellers, customers, and investors must trust them. Suppliers need to know that payments for goods they have shipped will arrive on time. Customers need to know that whatever product or service they have ordered will be delivered as promised. Colleagues need to know that they are a valued part of the company's success. Investors need to know that a company has a potential to grow.

Skills and attributes to be more innovative

A skill is simply knowledge that is demonstrated through action. It is the ability to perform in a certain way. An entrepreneur is someone who has a good business idea and can turn that idea into reality.

Turning an idea into reality is based upon two kinds of skills. These are general management skills and people management skills.

i) General Management Skills: These are the abilities required to organise a company's physical and financial resources. Some of the most important general management skills are:

- a) **Strategy Skills:** refer to the ability to think about the business as a whole, to understand how it fits into its market, how it can organise itself to deliver value to its customers, and how it does so better than its competitors.
- b) **Planning Skills:** The ability to consider what the future may hold, how it will impact the business, and what needs to be done now to prepare for it.
- c) **Marketing Skills:** refers to the ability to see beyond the firm's contributions and their features, to be able to see how they satisfy the customer's needs

and why the customer finds them attractive.

- d) **Financial Skills:** This refers to the ability to manage money, keep track of expenses, and monitor cash flow, as well as evaluate investments in terms of their potential risks.
- e) **Project Management Skills:** The ability to organise projects in order to establish specific objectives and timelines to ensure that the necessary resources are in the right place at the right time.
- f) **Time Management Skills:** the ability to use time productively in order to prioritise important tasks and complete them on time.

ii) People Management Skills: A business can only be successful if the people who run it are properly guided and committed to putting in the necessary effort on its behalf. An entrepreneurial undertaking also needs the support of people from outside the organization, such as customers, suppliers, and investors. To be effective, an entrepreneur should demonstrate a variety of skills while dealing with other people. Some of the most important people management skills are:

- a) **Communication Skills:** the ability to express ideas and inform others orally and in writing.
- b) **Leadership Skills:** the ability to inspire people to work in a certain way and to complete the tasks required for the business's success.
- c) **Motivational Skills:** the ability to entice and compel people to complete tasks. Motivation requires an understanding of what drives people and what they expect from their jobs.
- d) **Delegation Skills:** the ability to delegate tasks to different people. Effective delegation involves more than instructing. It requires an understanding of the skills that people possess and how they use them to achieve future business needs.
- e) **Negotiation Skills:** the ability to understand what is required in a situation, what motivates others in that situation, and identify opportunities to maximise outcomes for all parties.

All of these different people skills are intertwined. Here, entrepreneurial performance

results from a combination of business knowledge, general management skills; people skills, and personal motivation. A successful entrepreneur must use these skills and learn to use them. Entrepreneurs should constantly work to improve their skills in these areas, identify their strengths and weaknesses, and plan how to develop these abilities in the future.

Activity 8.3

1. Describe the key attitudes every entrepreneur must have.
2. Explain the skills and attributes of an entrepreneur to be more innovative.

8.4 Windows of Entrepreneurial Opportunities

At the end of this section, students will be able to:

- 💧 Identifying methods for finding new business opportunities.

Start-up Activity

What are the windows of entrepreneurial opportunity?

Aspiring entrepreneurs can come up with ideas all day long, but not every idea is necessarily a good one. For an idea to be worth pursuing, we must first determine whether it can be converted into an entrepreneurial opportunity. An entrepreneurial opportunity is the point at which identifiable consumer demand meets the possibility of satisfying the requested product or service. In the field of entrepreneurship, specific criteria need to be met to move from an idea into an opportunity. It begins with developing the right mindset—a mindset where the aspiring entrepreneur sharpens his or her senses on consumer needs, and conducts research to determine whether the idea can become a successful new project.

In some cases, opportunities are found through a deliberate search, especially when developing new technologies. In other instances, opportunities emerge unintentionally by chance. In most cases, however, an entrepreneurial opportunity arises from recognising a problem and making a concerted effort to solve it.

In the 20th century, economist Joseph Schumpeter stated that entrepreneurial innovation is the disruptive force that creates and sustains economic growth. But in the process, it can also destroy established companies, reshape businesses, and interrupt employment. He termed this force “creative destruction.” Schumpeter described business processes, including the concept of reduction, as designed to increase company efficiency. The change in business development in the economy improves our lifestyle, but it can make other activities or products out-dated.

Schumpeter identified the following methods for finding new business opportunities:

- Develop a new market for an existing product.
- At least one new source of resources that would allow the entrepreneur to manufacture the product at a low cost.
- Use existing technology to produce an old product in a new way.
- Use an existing technology to produce a new product.
- Finally, use new technology to produce a new product.

We can understand theories of opportunity as related to supply or demand, or as approaches to innovations in the use of technology. The first situation is a demand opportunity, whereas the second one is a supply situation. The last three are technological innovations.

Activity 8.4

1. What are the entrepreneurial opportunities in your surroundings?

8.5 Entrepreneurial Success, Teamwork and Diversity

At the end of this section, students will be able to:

- 💧 Explain the importance of teamwork to the success of a business.

Start-up Activity

What is the importance of teamwork for entrepreneurial success?

Many companies nowadays emphasise the importance of ability. They are encouraging the idea that a few top employees are responsible for most of the overall success. However, most recent productivity studies have shown that even successful leaders need the help of a strong team in order to succeed. As a result, the value of teamwork is increasingly being emphasised, with companies spending millions on team-building strategies.

Why Does Teamwork Matter to Business Success?

Teamwork brings numerous benefits to companies:

1. Teamwork fosters cooperation

Cooperation among teammates is one of the key elements of success. Football teams in which players choose to pass the ball to teammates with better chances of scoring win championships more often than teams with successful leaders trying to keep their hero status and take the shot on their own, even when others might have had better chances.

The same is true for every team that is supposed to achieve a common goal. Working together by sharing experience and ideas, instead of keeping them to themselves can bring better results for all parties involved, and for the whole company.

2. Collaboration broadens perspectives

When working alone on your own, you only have a single perspective on things. While that is not essentially wrong, it can be very restricting. On the other hand, working with a team offers different perspectives and ideas, which might end up bringing much better results.

Studies have shown that teams with members coming from diverse backgrounds (gender, age, ethnicity, etc.) are more creative and perform better by up to 35 percent, compared to non-diverse teams. That shows the importance of having different perspectives to work with: instead of viewing a single side of things, teamwork offers a 3 dimensional picture.

3. Teamwork increases productivity

In a team, the workload is shared among team members with different knowledge and skills. Members coordinate efforts to do a better job, in a shorter time than a single person does.

Different people have different problem-solving methods. They generate new ideas and solutions that would be difficult for an individual to handle. Effective brainstorming sessions help teams in their search for innovative ideas. They also enable them to find solutions by building on each other's ideas.

4. Teamwork provides opportunities for learning

Having people with different skills, levels of experience, and abilities working together does not only mean that they will work better and faster. They are exchanging knowledge with one another while chatting about work issues. They are growing together and improving their abilities.

5. The company's culture is shaped by teamwork

A team that works well together will raise a spirit of friendship, loyalty, and cooperation that will shape the company's culture. Working in a positive environment increases morale and overall happiness and satisfaction, creating a feeling of belonging to something bigger. Eventually, the team becomes a community, in which everyone understands their role and plays their part in achieving the common goal.

By supporting each other, team members build relationships based on trust and mutual respect. Positive team relationships make employees more reliable, effective, and productive. All these qualities ultimately contribute to the success of the company.

Activity 8.5

1. Describe how teamwork makes your assignments in class easier.

8.6 Finance and Promotion of Entrepreneurship

At the end of this section, students will be able to:

- ◆ Identify the financial requirements for entrepreneurial ventures.
- ◆ Explain the various sources of finance.



Start-up Activity

What are the sources of finance for entrepreneurial development?

Finding the sources of finance may be important for a variety of reasons. The development of new products can be costly, and capital may be required. Such developments are financed internally, whereas the capital to purchase machinery may come from external sources. In this case, many organisations have to look for short term capital in the form of loans, working capital, etc., in order to provide finance.

A. Budgetary Requirements

All businesses need money to finance different activities. Considering the types and adequacy of funds available, it is important to use funds with appropriate funding methods.

- 1. Permanent Capital:** The permanent capital base of a small firm usually comes from an investment in a share company or personal loans to form partners or invest in sole proprietorship. It is used to finance the start-up costs of an enterprise or major developments and expansions in its life cycle. It may be required for a significant innovation, such as a new product development. Ideally, permanent capital is only repaired when the firm can afford it; investment in equity is rewarded by dividends from profits, or a capital gain when shares are sold.
- 2. Working capital is a type of short-term financing.** Most small firms need working capital to pay for raw materials and cover other costs. Requirements for this kind of short-term financing will vary considerably by business type. In some cases, this will be sufficient to finance the start-up of a small business, so that suppliers are effectively financing the business. Although short-term finance is normally used to fund the trading of a business, it is also sometimes needed to purchase assets that are short-lived, such as company vehicles, which may be changed every 4 or 5 years.
- 3. Asset Finance: A medium- to long-term loan.** The purchase of physical assets is typically financed over a longer period of time, ranging from 3 to 10 years or more, depending on the asset's useful life. Plants, machinery, equipment, compa-

ny vehicles, and buildings can all be financed with short-term or long-term loans from a variety of sources.

B. Financing Options

Financial resources are essential for business, but particular requirements change as an enterprise grows. Obtaining those resources in the amount needed and at the right time can be difficult for entrepreneurial projects because they are generally considered more risky than established enterprises. Financing is more than just getting money; it is a process of managing assets wisely in order to use capital efficiently.

The critical issue in financing is to guarantee sufficient cash flow for operations, as well as to plan financing that matches with changes in the enterprise. Businesses obtain cash from different sources.

- 1. Personal saving:** In the first place, entrepreneurs should pay for start-up money from their own pockets. As a general rule, entrepreneurs should provide at least half of the start-up funds in the form of personal savings.
- 2.** After finishing their own saving, entrepreneurs should turn to friends and relatives who might be willing to invest in their business. The entrepreneur is expected to describe the opportunities and risks of the business.
- 3. Partners:** An entrepreneur can choose to take on partners to expand the capital formation of the proposed business.
- 4. Angels:** These are private investors who are wealthy individuals, often entrepreneurs, who invest in start-up businesses in exchange for taking risks in these businesses.
- 5. Venture capital firms:** These are private organisations that invest in new businesses with the expectation of a high return and a high growth potential. They provide start-up capital, development funds, or expansion funds.

Activity 8.6

1. What are the financial requirements for entrepreneurial development?
2. Explain the various sources of finance.

Unit Summary

An entrepreneur is an individual who creates a new business, bearing most of the risks and enjoying most of the rewards. The process of setting up a business is known as “entrepreneurship.” The entrepreneur is commonly seen as an innovator, a source of new ideas, goods, services, and business or procedures. Entrepreneurship is a process, and the entrepreneur is the person undertaking entrepreneurial activity, such as starting their own business.

Social entrepreneurship hints at the imperative to drive social change, and it is that potential payoff that has its lasting and transformational benefit to society. Social entrepreneurship is the process by which individuals, start-ups, and entrepreneurs develop and fund solutions that directly address social issues. A social entrepreneur, therefore, is a person who explores business opportunities that have a positive impact on their community, society, or the world.

Entrepreneurs are business people who can detect and sense the availability of business opportunities in any given scenario. They will then take advantage of these opportunities to develop new products by utilising new manufacturing methods in various markets.

Creativity is the ability to come up with new ideas and to identify new and different ways of looking at problems and opportunities. Essentially, creative entrepreneurs are investors in talent—their own or other people’s. The most renowned creative entrepreneurs have combined creative flair with entrepreneurial ability to build multimillion-dollar business empires. Examples include Haile Gebrselassie (an Ethiopian retired long-distance track and road running athlete).

Innovation lies at the heart of the entrepreneurial process and is a means to the exploitation of opportunity. An innovation is a process by which a domain, a product, or a service is renewed and brought up to date by applying new processes, introducing new techniques, or establishing successful ideas to create new value.

Review Questions

Part I: Write 'True' if the statement is correct or 'False' if it is not correct for each of the following statements.

1. An entrepreneur is a person who creates a job, not a job-seeker.
2. All business people are entrepreneurs.
3. Interest in social entrepreneurship transcends the phenomenon of popularity and fascination with people.
4. Tests of creativity measure only the number of alternatives that people can generate.

Part II: Choose the correct answer among the alternatives for the following questions.

1. This type of innovation is described as the creation of a new product, service, or process.
A . Invention
B . Extension
C . Duplication
D . Synthesis
2. Which of the following is a critical component of business success?
A . Cooperation
B . Work independently
C . Team working
D . Both A and C.
3. The first place entrepreneurs should look for start-up capital is on the internet.
A . Friends and relatives
B . Personal saving
C . Partners
D . Angels
4. An ability to use spoken and written language to express ideas and inform others.
A . Motivation Skills
B . Delegation Skills
C . Communication Skills
D . Delegation Skills

III. Answer the following questions briefly and to the point.

1. Give at least two definitions for entrepreneurship and two for "entrepreneur."
2. Who are the potential candidates for entrepreneurship?
3. Choose any five characteristics of a successful entrepreneur.

4. What are the basic steps in the creativity process?
5. Describe the four distinct types of innovation.
6. What are the basic methods for finding new business opportunities?

References and Further Readings

1. Ayele Kuris (2003), Ethiopian Economy, A.A., Ethiopia
2. Ayele Kuris (2006), The Ethiopian Economy: Principles of Practices, A.A. Ethiopia.
3. Boumol, W. J., and Blinder, A. S. (2011). Economics Principles and Policy, 11th Edition, South-Western, Cengage Learning
4. Campbell, R., et al. (2005). Economics, McGraw-Hill Higher Education
5. Curtis, D. and Irvine, I. (2020). Principles of Macroeconomics, 2nd ed., Publisher: Lyryx
6. Gould, P. and Fergusson, C.E. (1998). Microeconomics Theory, 6th ed., Irwin-Dorsey Ltd.
7. Hyman, David N. (1997). Economics, McGraw-Hill
8. Hirsh, Robert D., and Peters, Michael P. (2002). Entrepreneurship, 5th ed., McGraw-Hill
9. Mankiw, N. Gregory (2009). Principles of Economics, 5th ed., South-Western
10. Paul A. Samuelson and William D. Nordhaus. (2010). Economics, 19th ed., McGraw-Hill
11. Salvatore D. (1997). Microeconomics theory and applications, 3rd ed., Pearson