- production or output method sums the value added (value of production less input costs) by all businesses (agriculture, mining, manufacturing, services);

- Expenditure method adds all spending:
  - ✓ private consumption e.g., food and clothing;
  - ✓ government consumption e.g., remuneration of public sector employees;
  - ✓ investment e.g., factories, manufacturing plants; and
  - ✓ exports (foreigners' spending) less imports (spending abroad)
- income method aggregates the total incomes from production and includes employees' wages and salaries, income from self-employment, businesses' trading profits, rental income, trading surpluses of government enterprises and corporations.

* Theoretically the output, expenditure and income measures of GDP should be identical. In practice discrepancies exist due to shortcomings in data collection, timing differences and the lack of informal sector data.

* **Interpretation:** Interpretation of GDP numbers depends on business cycle timing. For example, strong economic growth after an economic recession usually indicates the utilization of idle capacity; during the expansion phase it may suggest the installation of new and additional capacity to add to future production while at the peak it may imply inflationary pressures.

* Likely impact on:

(i) Interest rates: High GDP growth could be inflationary if the economy is close to full capacity. This will lead to rising interest rates as market participants expect the central bank to raise interest rates to avoid higher inflation.

(ii) Bond prices: Higher interest rates mean falling bond prices.

(iii) Share prices: High growth leads to higher corporate profits – this supports share prices. However inflationary fears and higher interest rates usually impact share prices negatively.

(iv) Exchange rate: Strong economic growth will tend to appreciate the exchange rate as higher interest rates are expected.

Private consumption spending

* **Definition:** Consumption spending by households represents the largest proportion of GDP. It is divided into a number of categories including durable goods (goods expected to last more than 3 years), non-durable goods (food and clothing) and services. It is presented as quarterly and annual totals.

(USD) - the foreign currency - is equal to seventy Kenya Shillings (KSHS) - the local currency - the exchange rate in direct terms is Kshs 70.

- In indirect terms it is the price of the domestic currency in terms of the foreign currency e.g., if one Kenya Shilling is equal to $0.014 the indirect exchange rate is USD0.014.
- The foreign exchange market plays a crucial role in facilitating cross-border trade, investment, and financial transactions.

Characteristics

- Most currency exchanges are made via bank deposits. Banks dealing in the foreign exchange market tend to be concentrated in certain key financial cities.
- The foreign exchange market is highly integrated globally and operates 24 hours a day – when one major market is closed another is open so trading can take place 24 hours a day moving from one centre to another.

- Currencies are traded over-the-counter (OTC) with trading taking place telephonically or electronically.
- Most foreign exchange transactions take place in US dollars – the primary vehicle currency. Currencies are traded over-the-counter (OTC) with trading taking place telephonically or electronically.
- Most foreign exchange transactions take place in US dollars – the primary vehicle currency.

Instruments

- **Exchange rates**
  A range of rates exist based on when delivery of the currency is required.
  (i) ***The spot rate***
- The spot rate is quoted for 'immediate' (in practice, two working days) delivery. There are two spot rates for a currency. The bid rate is the rate at which one currency can be purchased in exchange for another while the offer rate is the rate at which one currency can be sold in exchange for another.
- The terms bid and offer originate from inter-bank transactions, which are mainly quoted against the US dollar. The bid rate is the rate the bank is willing to pay to buy dollars (and sell the non-dollar currency) and the offer rate is the rate at which the bank will offer to sell dollars (and buy the non-dollar currency). The difference, or spread, between the two rates provides the bank's profit margin on transactions.

(ii) ***The forward rate***

- Foreign exchange can be bought and sold not only on a spot basis, but also on a forward basis for delivery on a specified future date. With a forward transaction, the sale or purchase is agreed to now but will take place on some future date, thereby fixing the exchange rate now for a future exchange of currencies. Forward transactions are known as forward exchange contracts or forward contracts.

- **Continuous Vs. Call Markets:** most markets operate on a continuous basis during opening hours, implying that trading can take place at any time that the markets are open. However, some markets are trade at specific times during opening hours. Such markets are known as call markets because the securities are called for trading. There has to be sufficient time between calls to allow offers to buy and sell securities to accumulate and so make trading worthwhile.
- **Stock Vs. Flow Markets:** Once a security has been issued, it exists in the market place until it matures and is redeemed. Though a security can be sold, it can be sold only to someone who is willing to buy it. Clearly, it is impossible for everyone to sell their holdings of a particular security. Therefore, there is a market for the entire stock of a particular security, and there is also a market for the flow purchases and sales of that security over time.
- **Primary Vs. Secondary Markets:** The primary market is the new issues market for shares and bonds (initial public offer). The secondary market is the market in which existing securities (second hand bonds and shares) are subsequently traded.
- Seasoned Public Offers (SPOs): Additional new shares or bonds issued by an entity that already has such securities trading in the secondary market i.e. there has already been an IPO in the past.

The bond and long-term debt market

The market defined

* Capital markets are markets in which institutions, corporations, companies and governments raise long-term funds to finance capital investments and expansion projects.

* The bond and long-term debt market as well as the equity market fall under the capital market definition.

Characteristics

* Bonds and long-term debt instruments are traded on organized exchanges or over-the-counter.

* A distinction should be drawn between primary and secondary bond markets. The primary market is where new bond and long-term debt instruments issues are sold.

* The secondary market is the market in which previously issued bond and long-term debt instruments are traded.

Debentures

- **Definition:** A fixed-interest-bearing security issued by an industrial or commercial concern for a stated period. The debenture contract consists of the debenture itself and the indenture or trust deed. The debenture is the primary contract between the issuer and investor and represents a promise by the issuer to pay interest as specified and repay the nominal value at maturity. The trust deed is a supplementary contract between the issuer and the trustees (representatives of the debenture-holders) setting out the rights of individual debenture holders. Debentures can also be secured, redeemable, convertible, callable, variable-rate and profit-sharing.

- **Maturity:** May range from in excess of 5 years up to 30 years.

- **Marketability:** Certain issues have an active secondary market

- **Quality:** Obligation of the issuer

- **Market participants:**

- **Issuers:** Corporations

- **Investors:** Mainly insurance companies and hedge, mutual and pension funds

- **Advantages- Issuers:**
  - Fixed-rate interest cost over the life of the debenture is certain. This assists in planning and budgeting for capital projects.

- **Advantages- Issuers:**
  - Depends on the terms and conditions of the debentures. For example a redeemable feature is advantageous to the issuer as when interest rates fall, the issuer can redeem the outstanding debenture and re-issue a new debenture at the lower interest rate.

- **Disadvantages – Issuers:**
  - Depends on the terms and conditions of the debentures. For example, restrictive covenants may restrain the freedom of the management of the company in their operatio

- **Advantages – investors**
  - Depends on the terms and conditions of the debentures. For example, restrictive covenants may protect investors by limiting the risk to which the management of the company may expose the company.

- **Disadvantages- investors**
  - Depends on the terms and conditions of the debentures. For example, unsecured debentures have no preferential claim over any of the assets of the company