CHAPTER TWO

NATIONAL INCOME

1.2 National Income.

National Income is a measure of the money value of goods and services becoming available to a nation from economic activities. It can also be defined as the total money value of all final goods and services produced by the nationals of a country during some specific period of time – usually a year

1.3 Concepts of National Income

1. **Gross Domestic Product-** The money value of all goods and services produced within the country but excluding net income from abroad.
2. **Gross National Product-** The sum of the values of all final goods and services produced by the nationals or citizens of a country during the year, both within and outside the country.
3. **Net National Product-** The money value of the total volume of production (that is, the gross national product) after allowance has been made for depreciation (capital consumption allowance).
4. **Nominal Gross National Product-** The value, at current market prices, of all final goods and services produced within some period by a nation without any deduction for depreciation of capital goods.
5. **Real Gross National Product-** This is the national output valued at the prices during some base year or nominal GNP corrected for inflation.
6. **National Income Accounting-** This refers to the measuring of the total flow of output (goods and services) and of the total flow of inputs (factors of production) that pass through all of the markets in the economy during the same period. To see exactly what national income includes, how it is measured, and what it can tell us, we start with economic models. Economic Models are a simplification of a real world or a practical situation aimed at explaining that situation within a set of assumptions

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resorted to because it permitted the extension of the supply of money beyond the availability of gold and silver.

Functions of Money

1. **A medium of exchange**. This is its most important role. Without money we would live in a barter economy where we would have to trade goods and services for other goods and services. If I had fish but wanted bread, I would need to find someone who was in the precise opposite situation. In a monetary economy I can trade fish for money with one individual and money for bread with another. Money solves what is called the double coincidence of wants.
2. **A unit of Account.** In a monetary economy, all prices may be expressed in monetary units which everyone may relate to. Without money, prices must be expressed in units of other goods and comparing prices are more difficult. You may find that a Chicken costs 2 kilos of beans in one place and 4 kilos of strawberries in another. Finding the cheapest grilled chicken is not easy.
3. **Store of Value.** If you are a fisherman and have a temporary surplus of fish that you want to store for the future, storing the fish might not be a great idea. Money, on the other hand, stores well. Other commodities, such as gold, have this feature as well.

Characteristics of Money

1. **Portability.** It is necessary for money to be easily transported so that people can carry it around with them on a daily basis. This also allows for the ease of transaction so that money can be transferred from one place to another.
2. **Uniformity.** Depending on the different types of currency that are available, money within that specific currency must look the same. This also allows for money to be counted and measured accurately.

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a loss of the interest it might otherwise have earned. There are two schools of thought to explain the demand for money, namely the Keynesian Theory and the Monetarist Theory. These will be discussed later.

The demand for money and saving

The demand for money and saving are quite different things. Saving is simply that part of income which is not spent. It adds to a person's wealth. Liquidity preference is concerned with the form in which that wealth is held. The motives for liquidity preference explain why there is desire to hold some wealth in the form of cash rather than in goods affording utility or in securities.

2. The supply of money

Refers to the total amount of money in the economy

Most countries of the world have two measures of the money stock – **broad money supply** and **narrow money supply**. Narrow money supply consists of all the purchasing power that is immediately available for spending. Two narrow measures are recognized by many countries.

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a. **M0 (or monetary base)** consists of notes and coins in circulation and the commercial banks' deposits of cash with the central banks.

b. **M2** which consists of notes and coins in circulation and the NIB (noninterest- bearing) bank deposits – particularly current accounts. Also in the M2 definition are the other interest-bearing retail deposits of building societies. Retail deposits are the deposits of the private sector which can be withdrawn easily. Since all this money is readily available for spending it is sometimes referred to as the "transaction balance". Any bank deposit which can be withdrawn without incurring (a loss of) interest penalty is referred to as a "sight deposit". The broad measure of the money supply includes most of bank deposits (both sight and time), most building society deposits and some money-market deposits such as CDs (certificates of deposit).

and expenditure do not perfectly synchronize in time. People receive income either on monthly, weekly, or yearly basis but spend daily, therefore money is needed to bridge the time interval between **receipt of income** and its **disbursement over time**. The amount of money that consumers need for transactions will depend on their **spending habits, time interval after which income is received** and **Income.** Therefore holding habit and Interval Constant, the higher the income level the more the money you hold for transactions. Keynes thus concluded that transactions demand for money is Interest Inelastic.

ii. **Precautionary Demand for Money-** Individuals and businessmen require money for unseen contingencies, Keynes hypothesized that individuals' demand and institutional factors in society to be considered in the short run. Money demanded for these two motives is called active balances, because it is demanded to be put to specific purposes. The demand for active balances is independent of the rate of interest. Hence the demand curve for active balances is perfectly inelastic.

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iii. **Speculative Demand for Money-** Finally, money is demanded for speculative motives. This looks at money as a store of value i.e. money is held as an asset in preference to an income yielding asset such s government bond. Keynes thus explained the Speculative motive in terms of the buying and selling of Government Securities or Treasury Bills on which the government pays a fixed rate of interest. According to Keynes, securities can be bought and sold on the free market before the government redeems them, and the price at which they are sold does not have to be equal to their face value. It can be higher or lower than the face value depending on the level of demand for securities.

THE BANKING SYSTEM

DEFINITION OF COMMERCIAL BANKS

A Commercial Bank is a financial institution which undertakes all kinds of ordinary banking business like accepting deposits, advancing loans and is a member of the clearing house i.e.

specialized institutions often called Financial Intermediaries. **It's the** government's bank that controls the monetary and fiscal policies in an economy.

ROLE OF CENTRAL BANK

1. **Government's banker**: Government's need to hold their funds in an account into which they can make deposits and against which they can draw cheques. Such accounts are usually held by the Central Bank
2. **Banker's Bank:** Commercial banks need a place to deposit their funds; they need to be able to transfer their funds among themselves; and they need to be able to borrow money when they are short of cash. The Central Bank accepts deposits from the commercial banks and will on order transfer these deposits among the commercial banks. Consider any two banks A and B. On any given day, there will be cheques drawn on A for B and on B for A. If the person paying and the person being paid bank with the same bank, there will be a transfer of money from the account or deposit of the payee. If the two people do not bank with the same bank, such cheques end up in the central bank. In such cases, they cancel each other out. But if there is an outstanding balance, say in favour of A, then A's deposit with the central bank will go up, and B's deposit will go down. Thus the central bank acts as the Clearing House of commercial banks.
3. **Issue of notes and coins:** In most countries the central bank has the sole power to issue and control notes and coins. This is a function it took over from the commercial banks for effective control and to ensure maintenance of confidence in the banking system.
4. **Lender of last resort:** Commercial banks often have sudden needs for cash and one way of getting it is to borrow from the central bank. If all other sources failed, the central bank would lend money to commercial banks with good investments but in temporary need of cash. To discourage banks from over-lending, the central bank will normally lend to the commercial banks at a high rate of interest which the commercial bank passes on to the

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CHAPTER FIVE

INFLATION AND UNEMPLOYMENT

Definition and Types of Inflation

The word inflation has at least four meanings.

1. A persistent rise in the general level of prices, or alternatively a persistent falls in the value of money.
2. Any increase in the quantity of money, however small can be regarded as inflationary.
3. Inflation can also be regarded to refer to a situation where the volume of purchasing power is persistently running ahead of the output of goods and services, so that there is a continuous tendency of prices – both of commodities and factors of production – to rise because the supply of goods and services and factors of production fails to keep pace with demand for them. This type of inflation can therefore, be described as persistent/creeping inflation.
4. Finally inflation can also mean runaway inflation or hyper-inflation or galloping inflation where a persistent inflation gets out of control and the value of money declines rapidly to a tiny fraction of its former value and eventually to almost nothing, so that a new currency has to be adopted.

Demand-pull inflation is when aggregate demand exceeds the value of output (measured in constant prices) at full employment. The excess demand of goods and services cannot be met in real terms and therefore is met by rises in the prices of goods. Demand-pull inflation could be caused by:

Causes of Inflation

At present three main explanations are put forward: cost-push, demand-pull, and monetary.

Cost-push inflation occurs when the increasing costs of production push up the general level of prices. It is therefore inflation from the supply side of the economy. It occurs as a result of increase in:

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scale and full utilization of resources). Suppose that each country has equal resources and devotes half its limited resources to citrus fruit and half to beef and the production totals are:

	Units of Citrus fruits	**Units of Beef**
Country X	10	5
Country Y	**5**	**10**
World total	**15**	**15**

The relative or comparative costs of citrus production are lower in country X than in country Y, but the situation is reserved in the case of beef production. Country X has an absolute advantage in citrus fruit production and Y has an absolute advantage in beef production. If each country specializes in the production of the commodity in which it is most efficient and possesses absolute advantage, we get:

	Units of Citrus fruits	**Units of Beef**
Country X	20	0
Country Y	0	20
World total	**20**	**20**

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The gains from trade are obvious with five units more of fruit and five more of beef – provided we assume that transport costs are not so enormous as to rule out gains made.

THEORY OF COMPARATIVE ADVANTAGE

In his theory put forward in a book published in 1817, David Ricardo argued that what was needed for two countries to engage in international trade was comparative advantage. He believed that 2 countries can still gain, even if one country is more productive then the other in all lines of production. Using the Labour Theory Value, Ricardo's contribution was to show that a sufficient basis for trade was a difference, not in absolute costs. He illustrated his theory with 2 countries and two commodities, I and II and A and B respectively.

COUNTRY COST OF PRODUCING ONE UNIT (In Man-hours)

	A	B
I	8	9
II	12	10

Reasons for Protection

- **Cheap Labour-** It is often argued that the economy must be protected from imports which are produced with cheap, or 'sweated", labour. Some people argue that buying foreign imports from low wage countries amounts not only to unfair competition, but continues to encourage the exploitation of cheap labour in those countries as well as undermining the standard of living of those in high wage economies.
- **Infant Industry Argument-** Advocates of this maintain that if an industry is just developing, with a good chance of success once it is established and reaping economies of scale, then is it necessary to protect it from competition temporarily until it reaches levels of production and cost which allow it to compete with established industries elsewhere, until it can "stand on its own feet". The argument is most commonly used to justify the high level of protection that surrounds the manufacturing industry in developing countries, as they attempt to replace foreign goods with those made in their own country ("import substitution").

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- **Structural Unemployment-** The decline of the highly localized industry due to international trade causes great problems of regional (structural) unemployment. If it would take a long time to re-locate the labour to other jobs, then this can put the government, under considerable political and humanitarian pressure, to restrict the imports that are causing the industry to decline.
- **Dumping-** If goods are sold on a foreign market below their cost of production this is referred to as dumping. This may be undertaken either by a foreign monopolist, using high profits at home to subsidize exports for political or strategic reasons. Countries in which such products are "dumped" feel justified in protecting themselves. This is because dumping could result in the elimination of the home industry, and the country then becomes dependent on foreign goods which are not as cheap as they had appeared.