ECONOMICS

STUDENT TEXTBOOK

GRADE 9

FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA
MINISTRY OF EDUCATION

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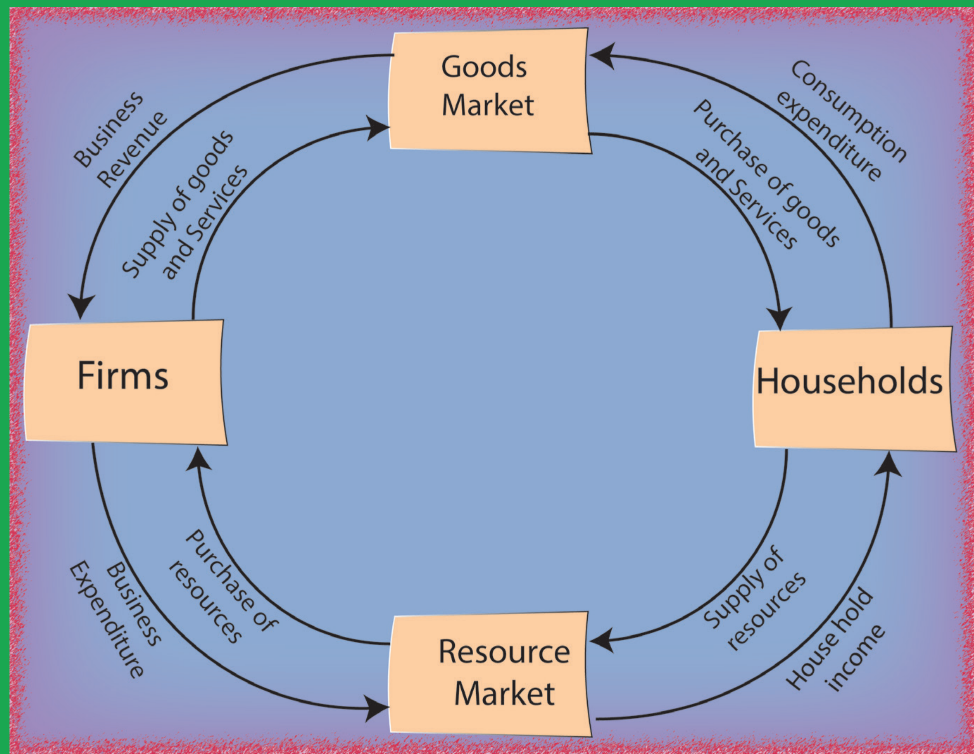

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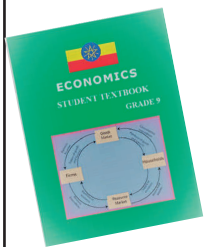

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Writers:

Hussien Mohammed Oumer (M.Sc.)

Tadesse Ababu Abebe (M.Sc.)

Editors:

Mesfin Ketema (M.Sc.)

Enguday Ademe Mekonnen (Ph.D.)

Birhanu Engidaw Getahun (Ph.D.)

Illustrator:

Endalkachew Mengesha Yasab (M.Sc.)

Designer:

Derejaw Lake Melie (M.Sc.)

Evaluators:

Mekonnen Bersisa Gadisa (Ph.D.)

Tariku Mulushewa Dessea (M.Sc.)

Ararssa Hora Dabi (M.Sc.)

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Introduction to the Book

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

This student textbook covers basic topics in both microeconomics and macroeconomics. The microeconomics part of the textbook introduces the fundamental economic concepts such as scarcity, opportunity cost, and the laws of demand and supply. In addition, this part of the textbook covers the concepts of production and costs of production. The macroeconomics part of the textbook covers topics related to the concepts of measurement and problems of economy-wide performance.

The objective of the textbook is to help students grasp the basic principles of Economics. It also introduces students to macroeconomic tools, 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. Furthermore, it introduces students to the basic concepts of money, macroeconomics and entrepreneurship. Specifically, the textbook will:

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

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

Unit 1 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 through time. Economic theory has advanced over time, and different themes have gradually been included into the field. There is no completed definition of economics yet, and the definition is essentially under improvement in areas such as the wealth definition, the welfare definition and the scarcity definition.

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:

- 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 satisfy the unlimited human needs up to the maximum possible degree through allocating the scarce resources efficiently.

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. 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 economyic 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
- Distinguish 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: 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 out of 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 the 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 main 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 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 a 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.

1. 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.

2. 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

3. 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.

4. 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.

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).

Definition of terms:

- Production efficiency is an economic concept that indicates the maximum level of output a manufacturer can produce without lowering the output of another product.
- Resource allocation is the distribution of finite resources to specified purposes selected from among several feasible possibilities.

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.

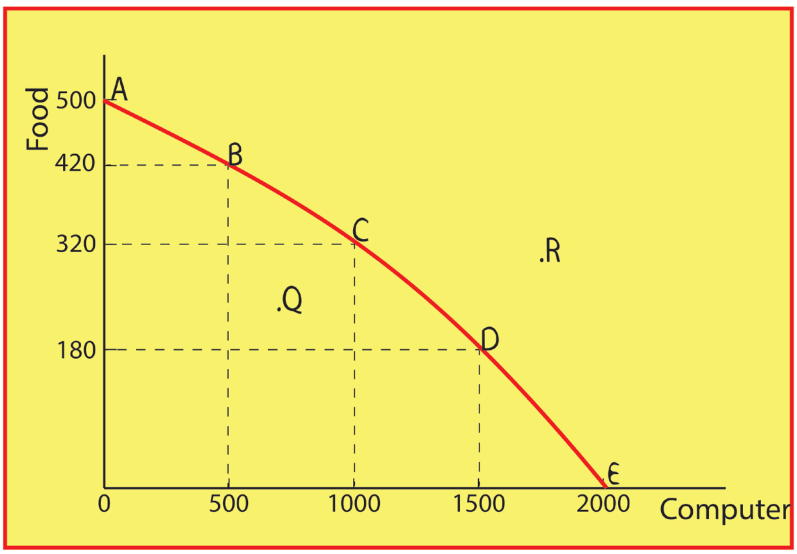

Figure 2.1 Production possibilities frontier/curve for Food and Computer

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).

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

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:

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

$\Rightarrow$ 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 interprete its magnitiude.

5. 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.

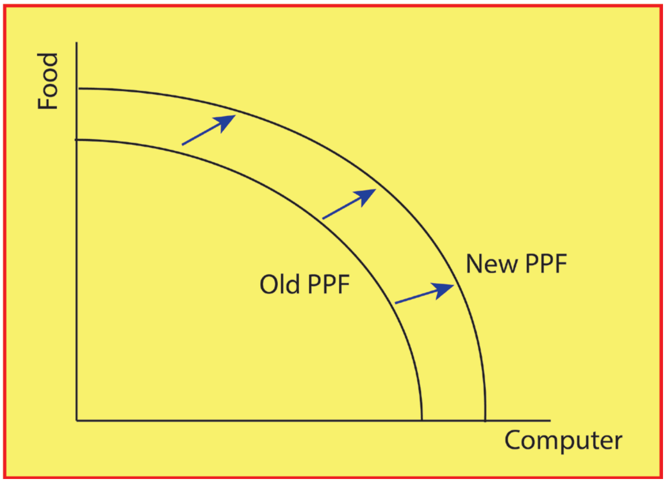

Figure 2.2 Economic growth with a new PPF

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.

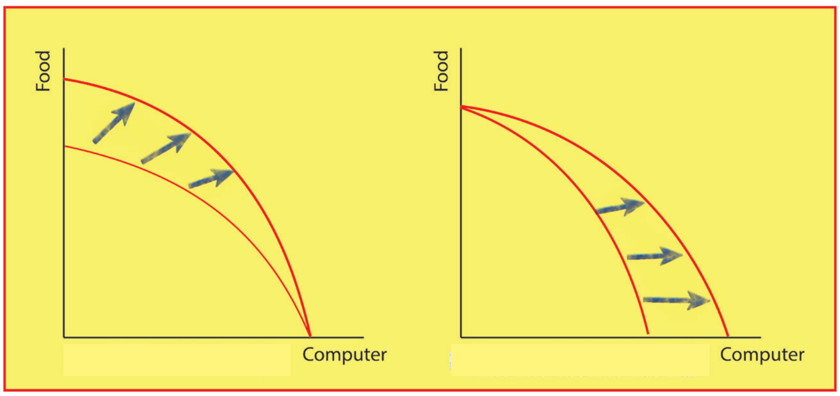

Figure 2.3 Effects of technological advancements in:
a) food production and b) computer production

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 Questions

Economic problems, which an economic system faces owing to scarcity of resources are known as basic economic problems. These problems are common to all economic systems. They are also referred to as central problems of an economy.

Consequently, every modern society should answer the following three basic questions:

1. What goods and services are to be produced?
2. How to produce goods and services?
3. For whom goods and services are to be produced?

Each of these basic questions is briefly discussed as follows.

1. 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.

2. 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.

3. 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 19^{th} 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.

- **Economic Planning:** The government uses instruments of economic planning to achieve coordinated rapid economic development, making use of both the private and the 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 around 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.

1. The concept of opportunity cost is based upon the principle of

   A . peoples need C. scarcity

   B . consumption D. profit

2. 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

3. 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.

4. 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 are 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 the 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, circular flow of economic activities and land as 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, real flows, good soil, and suitable climates.

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 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.

Labour market

The labour market is a market in which employees provide the labour services and employers provide the employment opportunities for labour. The labour market should be viewed at both the macroeconomic and microeconomic levels. For example, daily labourers, domestic workers, skilled workers, professionals, etc. provide labour services to the labour 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 among different sectors of the economy occur. Because of these transactions, income and expenditure move in a circular way in an economy. This is called 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 among 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. Real flow and money flow are the two main aspects of the circular flow of income 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 from the producers to the buyers.

Money (financial) flows

Money flows consist of the flows of:

- Money incomes from factor services such as rent, wages, interest, etc., and
- Money expenditures incurred for the purchase of goods and services.

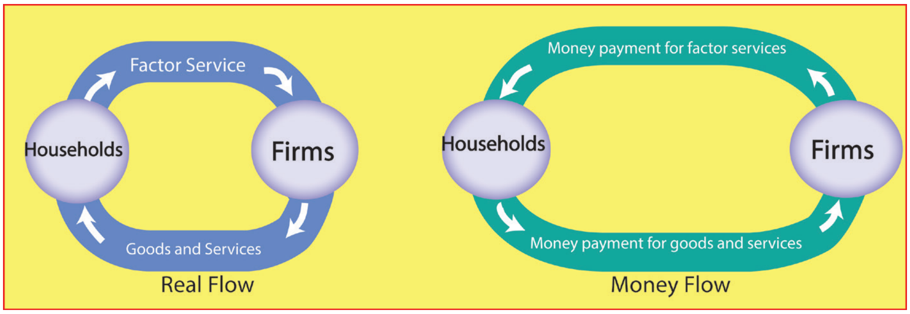

Figure 3.1 Circular flow of income: Real flow and money flow

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.

1. 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.

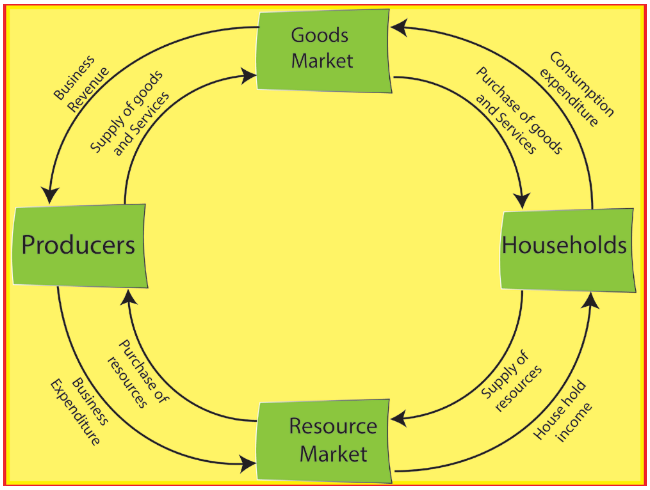

Figure 3.2: Circular flow of income in a two-sector economy

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.

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.

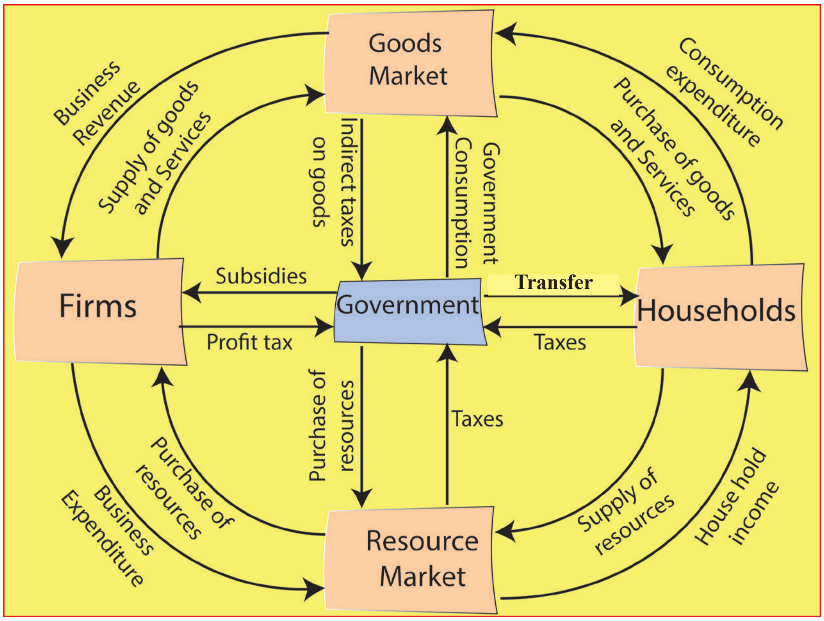

Figure 3.3: Circular flow of income in a three-sector economy

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 1,106,000 square kilometers of which 35 per cent is considered to be suitable for agriculture(CSA, 2007). 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 free gifts of nature and unlimited in supply) and economic resources (which are scarce in supply 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. While 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. While 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 a place 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. There 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 labour 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
   C. minerals, clean water and forests
   B . a mountain stream
   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 of 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 . Firms
   C. Households
   D. Government
10. In three sector circular flow model, the 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.
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 mark 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 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. How do you describe the term demand?
2. How do you define the term 'supply' in economics?
3. Can you define the concept of 'equilibrium'?

Key Concepts

Ceteris paribus, demand, demand schedule, demand curve, demand function, law of demand, supply, supply schedule, supply curve, law of supply, equilibrium, 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

How do you describe the term demand?

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 numerous. 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 thing 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 becomes 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.

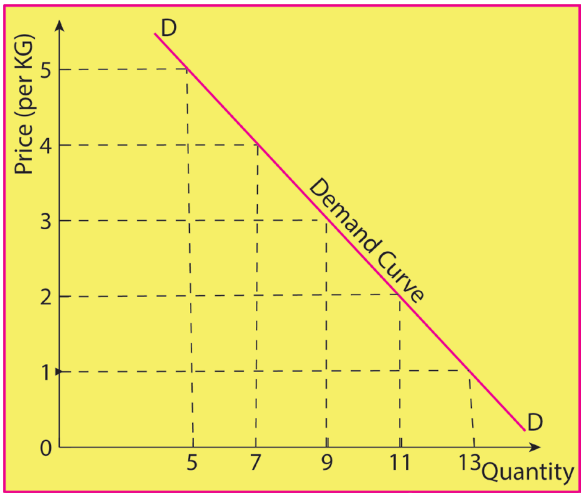

Figure 4.1: Individual household demand curve

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 the willingness of consumers to spend a certain price on a particular good or service. As market demand increases, price also increases. When it decreases, price will decrease as well. Market demand is derived by a simple horizontal summation of the quantity demanded for a commodity by all buyers at each price.

The market demand curve describes the relationship between various quantities of a commodity that consumers are willing to buy at different prices. Market demand curve is the horizontal summation of individual demand curves at the market price.

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'. Stock is the total volume of a commodity produced during a period less the quantity already sold out. Conversely, supply means the quantity which is actually brought to the market. Most of the time, producers do not offer all of their stock for sale in the market. For example, at the time of harvest, a large part of agricultural product is kept back in cold storage and is taken out during the off-season for sale at better prices. Likewise, a part of industrial product is usually kept back in stock and is offered for sale in the market at the 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 and it is described as:

> 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 price of a commodity, while quantity supplied refers to a specific amount of the commodity, which a producer is willing to sell at a specific price.

Law of Supply

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. The law of supply states that, ceteris paribus, there is a direct or positive relationship between price and the quantity supplied of a commodity.

Supply Schedule

A supply schedule is a tabular presentation of different quantities of a commodity offered for sale at different prices per time period. 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 4.2: 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 demand schedule shows the different quantities of Oranges demanded by an individual household at different prices. At Birr 5per kg consumer demands 5kg of Oranges. However, an individual household's demand becomes 13 kg of Oranges at Birr 1 per kg.

Supply curve

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

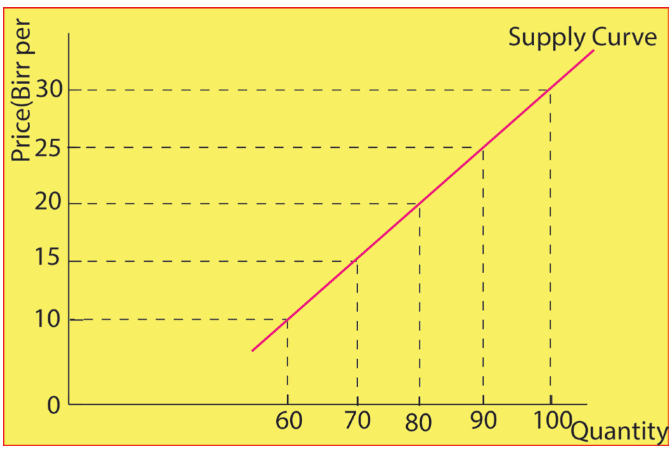

Figure 4.2 Individual seller's supply curve for oranges

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 derived by horizontally adding the quantity supplied of the commodity by all sellers at each price.

The market supply curve indicates the relationship between various quantities of a commodity that sellers are willing to offer for sale at different prices. Market supply curve is the horizontal summation of individual supply curves 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

Start-up Activity

Can you define the concept of 'equilibrium'?

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. However, they do not tell us the actual price of a good in general. We now come to the important question: How do the forces of demand and supply work together in order 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 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

Equilibrium quantity refers to the quantity of a good supplied in the marketplace when the quantity supplied by sellers exactly matches the quantity demanded by buyers. In other words, the equilibrium quantity is the amount of a commodity that is bought and sold at an equilibrium price.

Graphically, we depict market equilibrium as shown in the Figure below.

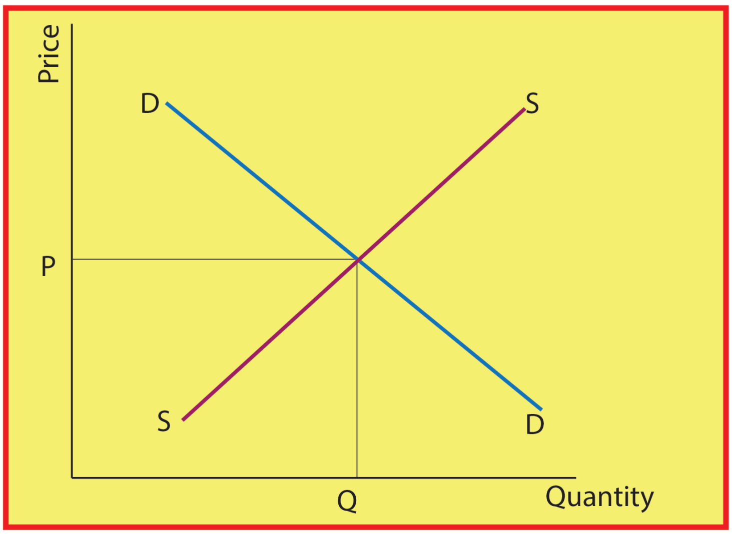

Figure 4.3 Market equilibrium

When the demand curve and the supply curve intersect, we have a point where the quantity that consumers are willing to purchase matches the quantity that suppliers are willing to supply at a given price. This point is known as the market equilibrium. From the market equilibrium we can derive market price and market quantity.

Note: This market equilibrium is not fixed; it is likely to change over time due to changes in the patterns of demand and supply.

Activity 4.3

1. What is the meaning of market equilibrium?
2. Explain the difference between equilibrium price and equilibrium quantity.

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. Demand schedule refers to a tabular representation of the relationship between price and quantity demanded.
3. A change in price of coffee will not affect the quantity demanded of coffee.
4. A change in price of wheat will affect the quantity stored of wheat.
5. Equilibrium price is the price at which quantity demanded equals quantity supplied.
6. An increase in quantity supplied of a commodity leads to a decrease in its price.
7. At equilibrium price, the quantity demanded and quantity supplied are not equal.
8. Market equilibrium is a situation in which quantity demanded of a commodity equals the quantity supplied of 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
   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 in price of a commodity affects
   A . the quantity demanded of a commodity.
   B . consumers' willingness to buy the good.
   C . consumers' ability to buy the good.
   D . all of the above.
5. Which one of the following is not held constant in defining the demand schedule?
   A . Number of consumers
   B . Price of the good in question
   C. Prices of other goods
   D. Number of sellers in a market
6. Which of the following statements is not correct?
   A . Demand curves tell us how much consumers demand at different prices.
   B . Supply curves tell us how much producers supply at different prices.
   C . Demand and supply curves can tell us the actual price of a good in general.
   D . All of the above.
7. An economic system is said to be in equilibrium when.
   A . its important variables show no change
   B . no forces are acting on them to produce a change in their values
   C . A and B
   D . all of the above
8. The intersection of a market demand curve and a market supply curve for a commodity determines the
   A . equilibrium price for the commodity.
   B . equilibrium quantity for the commodity.
   C . point of neither increase nor decrease in price of the commodity.
   D . all 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
2. What is the difference between demand and the quantity demanded for a commodity?
3. To get the market demand curve for a product, why do we add individual demand curves horizontally rather than vertically?
4. To get the market demand curve for a product, why do we add individual demand curves horizontally rather than vertically?
5. When is the market said to be in a state of equilibrium?

Unit 5
Introduction to Production and Cost

Introduction

This chapter has two major sections. The first part will introduce you to the basic concepts of production and production function, essential features of short run production functions and the stages of short run production. The second part mainly deals with the difference between economic cost and accounting cost, the characteristics of short run cost functions, and the relationship between short run production functions and short run cost functions.

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 combining various inputs to produce an output for consumption. It is the act of creating output in the form of a commodity or a service which contributes to the utility of individuals. In other words, it is a process in which the inputs are converted into outputs. For example, when we produce wheat on a plot of land with the help of inputs like labour, capital and seeds, it is termed as production of wheat.

Inputs are economic resources that can be used in the production of goods and services. In economics, there four basic inputs commonly used in the production of goods and services. These are labour, capital, land and entrepreneurial ability.

Outputs are inputs transformed into final usable form since inputs give less satisfaction to the consumer by themselves. In other words, outputs are consequences of the production process.

We can classify outputs into tangible and intangible ones. Tangible outputs are physical products that can be touched. Intangible outputs are products, which may have value but are not physical objects. The main difference between tangible and intangible outputs is that tangible output is something that a person can see or touch, and thus it has a physical existence while intangible output is something, which a person cannot see or touch and thus it does not have any physical existence.

Examples of tangible outputs include: building, machinery, equipment, car, etc. that have long term physical existence. Examples of intangible outputs include: insurance coverage, consultancy service, computer software, educational training, health care service, etc. that cannot often be tried out, inspected, or tested in advance.

Type of Inputs

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. Raw materials and labour inputs are examples of variable inputs.

Activity 5.1

1. Make a classroom observation and explain the inputs used in the teaching-learning process.
2. Define production and explain the difference between inputs and outputs
3. Distinguish between fixed and variable inputs.

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 short run and long run?

This classification of periods of production is mainly based on the degree of flexibility of economic resources to changes in business environment of products consuming those resources. The two periods of production are commonly known as short run and long run.

Short run 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 materials.

Long run refers a period of production in which all inputs are variable or there is no fixed input. A firm can install a new plant or construct a new factory building. Long-run is the period during which the size of the plant can be changed. Thus, all the factors of production 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 in the Short Run

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): - 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 one variable input

Variable input (labour)	Fixed input (capital)	Total Product (TP) (In quintals)	Average product (AP)	Marginal Product (MP)	Stages of Production
0	10	0	-	-	**Stage I**
1	10	10	10	10	
2	10	28	14	18	
3	10	51	17	23	
4	10	76	19	25	
5	10	95	19	19	**Stage II**
6	10	108	18	13	
7	10	108	15.4	0	
8	10	96	12	-12	**Stage III**
9	10	80	8.89	-16	

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

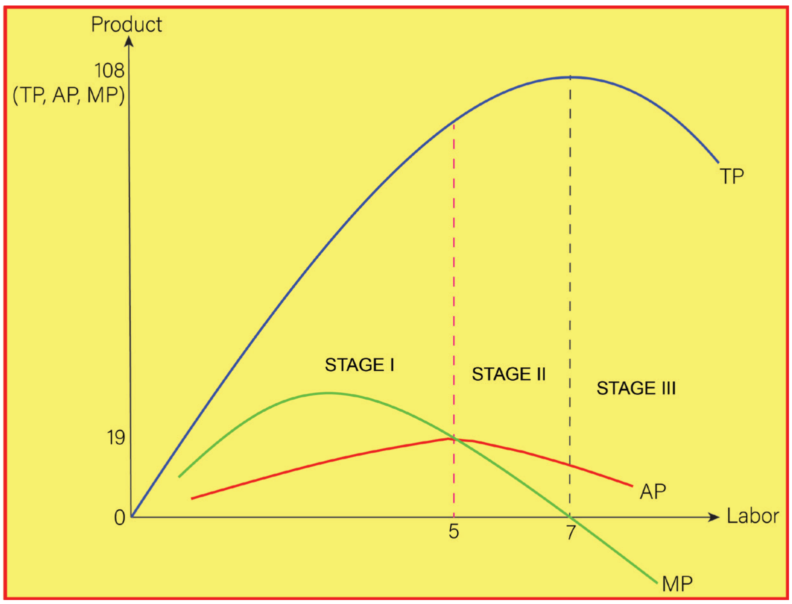

Figure 5.1 Stages of production

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

1. 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: are costs standing for the values of non-purchased resources owned and used by firms in their own production activities. These are costs of firms' own and self-employed resources in carrying out activities such as 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 uses.

2. Economic Cost and Accounting Costs

It is obvious that costs and profits are inseparable concepts of business. Here, the main idea is to understand the cost treatment differences and their consequence in cost analysis of business activities.

Economists and Accountants define and treat costs differently. Economists define costs in terms of opportunity costs and they include these implicit costs in profit calculations. Thus,

Economic cost = Implicit costs + Explicit costs

Accounting cost is the monetary value of all purchased inputs used in production; it ignores the cost of non-purchased (self-owned) inputs. It considers only direct expenses such as wages/salaries, cost of raw materials, depreciation allowances, interest on borrowed funds and utility expenses (electricity, water, telephone, etc.). These costs are said to be explicit costs. Explicit costs are out of pocket expenses for the purchased inputs.

3. Fixed and Variable 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 costs of fixed inputs. For example. rents on leased properties, interest on borrowed funds, the wear and tear of machineries, 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, variable costs of a firm are dependent on the level of output. Examples of variable costs are wage of workers excluding the administrative staff, cost of raw materials, etc.

Total cost is the sum of total fixed cost and total variable cost. Or

$$TC = TFC + TVC$$

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:

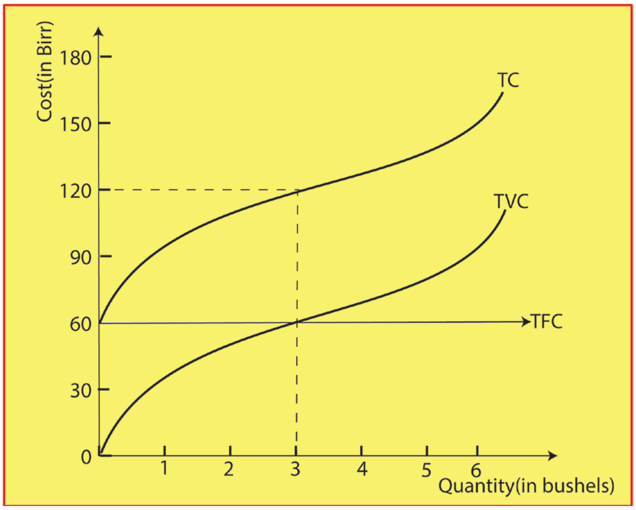

Figure 5.2 Cost curves

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 (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.

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

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

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 values of the production process.

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. Long run period of production is a period of production in which all inputs are variable or there is no fixed input. A fixed input is one whose quantity cannot be changed during the period under consideration. In contrast, 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 produced by all workers and expressed in terms of quantity (Q). Average product (AP) is total product per unit of labour input. Marginal product (MP) is the change in total output resulting from a unit change in the variable input.

Cost of production is the monetary outlays associated with production activity. 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 of non-purchased inputs owned and used by firms in their own production activities.

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 cost and total variable cost. Average total cost is the total cost per unit of output and is calculated by dividing the total cost by quantity produced. Marginal cost is the change in total cost resulting from a unit change in output produced.

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 concepts of production and costs are independent facts.
2. Production function is the technical relationship between inputs and outputs.
3. An input whose quantity can be changed during the short period under consideration is known as a fixed input.
4. Economic cost is the sum total of explicit cost and implicit cost.
5. Accounting cost refers to the cost of purchased inputs only.
6. When total product increases at an increasing rate, marginal product increases.
7. When marginal product is greater than average product, this means that average product is falling.
8. When marginal product equals average product, this means that average product is minimum.
9. Fixed costs are those costs that vary as the firm changes the level of output.
10. MC is the additional cost that a firm incurs to produce all units of output.

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
   C . Consumption
   B . Production
   D . Resource

2. Any good or service that comes out of a production process, is known as:

   A . Output
   C . Labour
   B . Input
   D . Economic resource

3. When the short-run marginal product of labour 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
   C . 290
   B . 270
   D . 220

5. The supply of economic resources in the short run production that cannot change is

   A . Fixed inputs
   B . Variable inputs
   C . Labor and raw materials
   D . Average variable costs

6. Which of the following is/are not a good indicator or measure of output per unit input?

   A . Total product
   B . Average product
   C . Marginal Product
   D . Both A and C

7. A specific type of costs that are always incurred even if the firm does not produce anything.

   A . Accounting costs
   B . Variable costs
   C . Total cost
   D . Fixed costs

8. In the short-run,

   A . All costs are fixed
   B . All costs are marginal
   C . Some costs are fixed
   D . All costs are variable

9. Suppose output increases from 50 to 51 units and total cost increases from birr 260 to birr 293. The MC of the extra output is birr,

   A . 553
   B . 226.5
   C . 33
   D . 29

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.

Unit 6
Introduction to Money

Introduction

This unit introduces the nature of money-what it is, what it works-and its critical role in the functioning of the economic system. In this unit, we discuss the efficient-resources-allocating role which 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 money 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 an economy?
4. Discuss why people hold money.
5. Discuss the possible advantages of electronic money.

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. What are 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 differed 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 Emperer 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. What is meant by 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 an 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. What constitutes the supply of money?

6.5 Money and Electronic Money (e-money)

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

- Explain the meaning of electronic money.

Start-up Activity

Discuss the possible advantages of electronic money.

Electronic money is an electronic store of monetary value on a technical device that may be used widely for making payments. For example, payments can be performed in a number of ways such as debit card, prepaid cards, and credit make paying at point of sale terminals quick and simple.

However, for many people, electronic money means a 24-hour access to cash through an automated teller machine (ATM) or Direct Deposit of pay-checks into checking or savings accounts. Broadly speaking, electronic money involves different types of transactions, rights, responsibilities and sometimes fees.

Electronic money is also known as electronic fund transfer (EFT), which uses computers and electronic technology in place of checks and other paper transactions. EFT is 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 people use other types of debit cards that require your signature or a scan. In the context Ethiopia, ATMs are electronic terminals that let you bank almost virtually any time.

Advantages of e-money:

- ✓ the ability to move money quickly
- ✓ better recordkeeping
- ✓ global money transfers
- ✓ the ability to move large sums of money without any physical burden

Disadvantages of e-money

- ✓ cybercrime and new digital forms of money laundering (crime)
- ✓ users must have a minimum level of training and knowledge, especially with more complicated forms of electronic transfers
- ✓ some types of e-money, most notably crypto currencies, are closely linked to criminal activity
- ✓ both hardware and software are required to perform transfers of electronic cash

✎ Activity 6.5

1. Explain the meaning of electronic money.
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 money involves many different types of transactions, rights, responsibilities and sometimes, 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 that allows transaction 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. Transaction motive for holding money refers to the desire of the 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.
5. It was exchange of goods for goods, known as barter.
6. One of the limitations of the barter system entails the nature of divisibility of commodities on the basis of the exchange ratio.
7. Money as legal tender meaning that legally it must be accepted as payment for debts.
8. Money enables rational economic calculation and choice
9. Money held under the speculative motive serves as a store of value as money held under the transaction motive does.
10. One of the advantages of e-money is the ability to move money quickly.

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 C . Portability
   B . Divisibility D . All
2. Which of the following refers to anything that is generally accepted as payment for goods and services?
   A . Checks C . Checking account deposits
   B . Money D . All
3. 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 C . mobile banking
   B . credit card 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
6. Payments through electronic money can be performed in a number of ways such as
   A . debit card
   B . prepaid cards
   C . credit cards
   D . all
7. The bulk of the currency with the public is in the form of currency notes issued by,
   A . National Bank of Ethiopia
   B . Commercial Bank of Ethiopia
   C . Private Commercial Banks
   D . all
8. The money supply consists of,
   A . metallic money
   B . coins
   C . currency notes
   D . all
9. It relates to the desire to hold one's resources in liquid form in order to take advantage of market movements in the future,
   A . the speculative motive
   B . the precautionary motive
   C . the transaction motive
   D . both A & C
10. When the barter system was replaced by monetary system, the primitive money was first used,
   A . paper currency
   B . checks
   C . commodity money
   D . e-money

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.

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.
- Identify the basic macroeconomics variables.
- Describe the relationship among 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 Pi 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.

GDP + NFI = GNP

Where NFI denotes Net Factor Income from Foreign Sources

On the other hand, NFI = (factor income received from abroad by a country's citizens) – (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 NFI > 0, then GNP > GDP

NFI < 0, then GNP < GDP

NFI = 0, then GNP = GDP

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

Per Capita Income: - the ratio of the GDP of a country to its total population. It determines the average income of individual citizens of the country under consideration, which enables to evaluate the living standard of the population.

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.
- Fair 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 rise cannot be called inflation. It is a persistent and appreciable rise in prices which is called inflation.
- during inflation, all costs and prices do not rise together and in the same proportion. It is an increase in the general level of prices 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.

3. Trade Balance Deficit

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.

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

When the trade balance is in surplus this means that a country has earned more from its exports of goods than while disequilibrium means that the condition is either deficit or surplus.

A deficit in balance of trade occurs when the total receipts are exceeded by total payments; it has paid for its imports of goods. For example, the Ethiopian economy has been experienced a deficit balance of trade as the national's export receipt is shortfalls of import expenditure.

4. Balance of Payments Deficit

The 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.

Though the credit and debit are written balanced in the balance of payment account, it may not remain balanced always. Very often, debit exceeds credit or the credit exceeds debit causing an imbalance in the balance of payment account. Such an imbalance is called the disequilibrium. Disequilibrium may take place either in the form of deficit or in the form of surplus. For example, the same reflection from a deficit balance of trade goes to the balance of payment of the country.

✎ **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 what fraction of those who would like to work do not have a job. The trade balance deficit occurs when there is difference between receipts from exports of goods and expenditure on imports of goods. The balance of payments deficit occurs when there a difference 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 a temporary unemployment.
2. Unemployment leads to exploitation of labour.
3. During inflation the prices of all goods and services rise together.
4. The economy does always work smoothly without fluctuations.
5. During inflation, all costs and prices do not rise together and in the same proportion.
6. Unemployment is referring to individuals who are employable and actively not seeking a job.
7. Disguised unemployment is very common in third world countries.
8. Labour force includes group of people within a specified age bracket (15 -64), who are without a job but are actively searching for a job.

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? C . Who are available for work

   B . Who are willing to work D . All of the above

2. The general goals of macroeconomic policy are;

   A . High rate of economic growth C . Price instability

   B . The rule of the law D . All

3. If the national economy is closed, i.e. a country has no interaction with the rest of the world then

   A . GNP > GDP C . GNP = GDP

   B . GNP < GDP D . All

4. Which is/&are the following example/s of structural unemployment?

   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. Which one of the following is wrong about Gross Domestic Product (GDP)?

   A . It measures the current production of goods and services only

   B . It is less than GNP if the net factor income received from abroad is negative

   C . It measures the values of final goods and services produced within the territory of a country irrespective of who owns that output.

   D . When the net factor income received from abroad is zero, GDP is equal to GNP

6. The general objectives of a macroeconomic policy are to achieve:
   A . Economic growth
   B . Full employment
   C . Stable balance of payment
   D . all
7. A situation where “too much money” chases “too few goods.”
   A . Cost push inflation
   B . Demand pull inflation
   C . Supply side inflation
   D . both A & C
8. A situation of voluntary switching of jobs in search of better jobs.
   A . Frictional unemployment
   B . Structural Unemployment
   C . Cyclical Unemployment
   D . all
9. It represents the difference between receipts for exports of goods and expenditure on imports of goods.
   A . Balance of Payments
   B . Visible balance
   C . Trade Balance
   D . both B & C

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.

Unit 8 Basic Entrepreneurship

Introduction

Many industry observers have debated on the origin of entrepreneurship. The fact to note here is that most scholars who debate the origin of entrepreneurship are either Economists or Historians. The common forum accepts that the concept of "Entrepreneur" is derived from the French concept 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. Entrepreneurships foundations are based on economics and other such 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 among 'entrepreneurship', 'enterprise' and' entrepreneur'?
2. What is the importance of creativity and innovation to entrepreneurship?
3. How do you relate entrepreneurship with entrepreneurial attitudes, behaviour and mind-set?
4. What are the windows of entrepreneurial opportunities?
5. What is the importance of teamwork for Entrepreneurial Successes?
6. What are the sources of finance for entrepreneurial development?

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 among "entrepreneurship," "enterprise," and "entrepreneur."

An enterprise is defined as a legal entity possessing the right to conduct business on its own, for example, to enter into contracts, own property, incur liabilities and establish bank accounts.

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 which satisfies customer needs.

Entrepreneurship is the process of identifying opportunities in the market place, arranging the resources required to pursue these opportunities and invest resources in order to exploit the opportunities for long term gains. It involves creating incremental wealth by bringing together resources in new ways to start and operate an enterprise. Entrepreneurship is a practice and a process that results in creativity, innovation and enterprise development and growth. Engaging in entrepreneurship shifts people from being "job seekers" to "job creators" which is critical in countries that have high rate of unemployment like Ethiopia. However, it requires a lot of creativity as driving force behind innovation.

Bethlehem Tilahun Alemu is an Ethiopian entrepreneur. When she was 25, she started a business immediately after graduating from college. She founded SoleRebels, a shoe company that uses recycled tires. In 2014, she was named the fastest growing brand in Africa by Forbes.

Another well-known entrepreneur is Haile Gebrselassie. He is a retired long-distance runner, marathoner and national hero from Ethiopia. Aside from his running career, Haile is a successful businessman. He is even considered one of the richest people in Ethiopia. Haile owns Marathon Motors. The company also assembles Hyundai vehicles and recently rolled its first electric car out of the assembly plant. Haile is involved in investments in hospitality, entertainment, real estate, agriculture and technology and employs over 3000 of his people across a variety of businesses.

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.

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 18^{th} 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 18^{th} century was the differentiation of the entrepreneurial role from the capital providing role.

But in the late 19^{th} and early 20^{th} 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 among creativity, innovation, and entrepreneurship.

Start-up Activity

What is the importance of creativity and innovation to 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. Indicate the possibility of creativity and innovation towards entrepreneurship.
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, company 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 find 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 the job not a job-seeker.
2. All business persons 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.
5. Cooperation among teammates is one of the key elements of success.
6. Finding the sources of finance may be important for the development of new products.
7. The process of setting up a business is known as entrepreneurship.
8. Social entrepreneurship is the process by which individuals explore business for personal interest.
9. Innovation is a means to the exploitation of opportunity.
10. Extension is described as the creation of a new product, service or process.

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

1. The type of innovation which is described as the creation of a new product, service or process.

   A . Invention C . Duplication

   B . Extension D . Synthesis

2. Which is one of the key elements of business success?

   A . Cooperation C . Team working

   B . Work independently D . Both A and C.

3. The first place entrepreneurs should take for start-up money is

   A . Friends and relatives C . Partners

   B . Personal saving D . Angels

4. An ability to use spoken and written language to express ideas and inform others.

   A . Motivation Skills C . Communication Skills

   B . Delegation Skills D . Delegation Skills

5. It indicates the commanding role to drive social change to and a potential payoff with its benefit to society.

   A . Social entrepreneurship C . Trader

   B . Entrepreneur D . All

6. __________ has been recognized as important contributors to a nation's economic growth.

A . Creativity | C . Entrepreneurship

B . Innovation | D . All

7. Entrepreneurs should be passionate about their: ideas, goals and companies.

A . Bravery | C . Passion

B . Flexibility | D . Integrity

8. Some of the most important general management skills are:

A . planning Skills | C . strategy Skills

B . financial Skills | D . all

9. It is the ability to allocate tasks to different people.

A . Delegation Skills | C . Negotiation Skills

B . Motivation Skills | D . Communication Skills

10. Entrepreneurs must demonstrate to others that they are trustworthy and honest.

A . Integrity | C . Strong Work Ethics

B . Flexibility | D . Passion

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. Identify any five qualities of a successful entrepreneur
4. What are the basic steps in the creativity process?
5. Describe the four distinct types of innovation.

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